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Introduction

The Phoenix Tax Group Guarantee

We have been successfully preparing tax practitioners to pass the Special Enrollment Exam for over 20 years. Practitioners who have used our study materials, study strategies and have put in the time and effort have had over a 90% passing rate.

30 Day Money-Back Guarantee

If you are not satisfied with any of our products, you can return them for a full refund, excluding shipping and handling charges. A refund must be requested within 30 days of purchase, and all hardcopy materials must be returned in the original box. No credit will be given for any materials marked on, missing or damaged in any way. To request a refund, fill out the Refund Request form below.

Pass Guarantee

1. The Pass Guarantee applies only to products designated as "Packages."
2. To receive a refund, you must have taken and failed a test/exam twice.
3. You must provide your failed scores for both failed exams by filling out the Refund Request form below. This must be done within 30 days of the second failed exam.
4. Hard copy materials must be returned within 30 days of the second failed exam.
5. If you purchased Enrolled Agent study materials together in a three part package, refunds will be pro-rated for the part being returned.
6. The refund will only apply to the person who purchased the study materials from The Phoenix Tax Group. The refund policy does not apply to companies purchasing study materials for employees.

Instructions

To ensure proper credit, please fill out our online refund request form.

<http://www.phoenixtax.com/about/refunds>

Course Objectives

These study materials are designed to prepare students to pass the IRS Special Enrollment Examination the first time they take the exam. After completing your study, you should have the tax knowledge needed to pass the exam.

The material is covered at an intermediate level. It is helpful if the student has had some beginning level courses relating to tax law and at least a year of income tax preparation experience.

You will be learning tax law from the study cards, and exercising your understanding with test questions from previous years' exams, in addition to our own questions that are similar to questions on the exam. The questions are all multiple choice (no true/false). All of the questions and study material have been updated to 2022 tax law. The 2023 exam (May 2, 2023 - February 28, 2024) will cover the federal tax law as of December 31, 2022.

Note: All references on the examination are to the Internal Revenue Code, forms and publications, as amended through December 31, 2022. Also, unless otherwise stated, all questions relate to the calendar year 2022. Questions that contain the term 'current tax year' refer to the calendar year 2022.

The material is broken down into three parts similar to the parts on the exam. Part 1 discusses individual income tax law, Part 2 discusses sole proprietorship and partnership, corporation (including S corporation), fiduciary, estate, and trust tax law and tax-exempt organizations, and Part 3 discusses practitioner ethics, recordkeeping, IRS tax examination, appeals, and collection procedures, practitioner rules and penalties, and research materials. Because we categorize the questions and study cards, all questions and content pertaining to a specific tax law are grouped together, even though they might be asked in more than one part of the exam.

We feel we have the best and most comprehensive enrolled agent exam preparatory materials available. However, we are always looking for ways to improve. We would appreciate it if you would take a moment to complete our online evaluation at [http:// www.phoenixtax.com/ea_survey](http://www.phoenixtax.com/ea_survey).

If you have any questions regarding any of the questions in this book, please email us at **support@phoenixtax.com**. Do not call our 800 number.

Good luck on the exam.

How to Prepare for the Exam

The following is a set of guidelines for preparing for the exam:

1. We recommend that you study a minimum of 100 to 120 hours total for all three parts of the exam. For Part 1, we recommend 35-45 hours of study. For Part 2, we recommend 45-60 hours of study. For Part 3, we recommend 20-25 hours of study. Break up your study time. Do not try to study 3 or 4 hours at a time. Most people's comprehension level starts to fade after an hour. Unlike other exam prep courses, we have designed our materials to take with you wherever you go. Use your spare time during the day to study the cards. You will be surprised how much you can absorb by studying in intervals of 15 to 30 minutes. Read the study cards before proceeding to the questions in the book.
2. DO NOT rely on your tax experience to pass this exam. It has been our experience that people with limited tax experience (one year or less) have a far better success rate on this exam than people with many years of tax experience. The reason is that preparers with years of experience tend to rely on their practical knowledge of taxes. This exam tests on theory, not practical experience. The IRS is primarily interested in your ability to understand the tax law and to properly and accurately determine taxable income (i.e., figuring basis in an asset to determine gain, what income is taxable, what deductions are allowed, etc.).
3. You can now use a calculator to do the computational questions. Prometric will provide you with a hand-held calculator. You cannot bring your own calculator.
4. Be familiar with the tax forms and the filing dates for those forms. There are quick reference cards for tax forms at the bottom of each card deck. Also, be familiar with the different penalties that can be assessed against a taxpayer and a tax preparer.
5. The exam will test on a specific tax law in more than one part. For example, questions pertaining to property basis or retirement plans will be tested in both Part 1 and Part 2; questions pertaining to recordkeeping in Part 1 and Part 2 could be tested in Part 3; taxpayer penalties could be tested in all three parts. Therefore, we strongly recommend you to take the exam in the following order. Take Part 1 first, Part 2 second and Part 3 last. You should also take all three parts of the exam as close together as possible.
6. You must have a positive attitude toward this exam. If you do not think you can pass this exam, you won't. Fifty percent of preparing for this exam is being mentally prepared.

About the Computer Based SEE Exam

The Internal Revenue Service has contracted with Prometric to conduct its examination program. Prometric provides computerized testing at test centers throughout the world. The IRS and Prometric are working together closely to ensure that examinations meet federal requirements as well as professional examination development standards.

Testing Dates

The 2023 SEE examination begins May 2, 2023 and examinations will be offered continuously through February 28, 2024. The exam is in three parts. The three parts **DO NOT** have to be taken at once. You can take one part at a time. Once you have taken and passed one part, you have two years from the date of passing that part to take and pass the other two parts.

Testing Fees

The exam costs \$206 per part.

Exam Questions

Each part of the exam has 100 questions. All questions are weighted equally.

Time Limited for the Exam

You are given 3.5 hours to complete each part of the exam. The actual seat time is 4 hours to allow for a tutorial at the beginning and a survey at the end.

Examination Results

The exam is graded on a scale of 40 - 130 with 40 being the lowest score and 130 being the highest score possible. You must have a score of 105 or better for each part of the exam to pass. You will receive your scores immediately after taking the exam.

Passing Score

If you pass, the score will only show a passing designation. It will not show a score.

Failing Score

If you fail, your score report will show a scaled score between 40 and 104. You will also receive diagnostic information to assist you with future examination preparation. Diagnostic information will show an indicator of 1, 2, or 3 meaning:

1. Considerably below the minimally acceptable score. It is important for you to approach how you study this topic as you prepare to take the test again. You may want to consider taking a course or participating actively in a study group on this topic.
2. Marginally below the minimally acceptable score. You should study this topic in detail as you prepare to take the test again.
3. At or above the minimally acceptable score. Be sure to review this topic as you prepare to take the test again.

Experimental Questions

The examination may include some experimental questions that will not be scored. If present, they are distributed throughout the exam and will not be identified as such. These are used to gather statistical information on the questions before they are added to the exam as scored items. These experimental questions will not be counted for or against your final score.

Obtain a PTIN

You must have a PTIN to sign up for the Enrolled Agent Exam. Chances are you already have your PTIN, but if you do not, you will have to get one. The IRS Tax Professional PTIN Sign-up System is available at www.irs.gov/ptin. Once online, you will need to:

Create Your Account. Provide your name, email address, and security question information. The system will then email your temporary password, which you will change when you go back to enter your information in the PTIN application.

Apply for Your PTIN. Complete the online application by providing personal information, information about your previous year's tax return, professional credentials, and more.

Get Your PTIN. Your PTIN will be provided online.

It takes about 15 minutes to sign up online and receive your PTIN. If you opt to use the paper application, Form W-12 IRS Paid Preparer Tax Identification Number (PTIN) Application, it will take 4-6 weeks to process.

PTIN renewal. PTINs must be renewed annually by December 31 for the following year. Renewal Open Season usually begins each year in mid-October.

Registering and Scheduling an Examination Appointment

Registration Process

You can register and schedule the exam using one of the three following options:

A. Online—www.prometric.com/see

B. By phone

1. Call Prometric at 800.306.3926

C. By mail

1. Mail your completed Form 2587 to:

Prometric

Attn: IRS Special Enrollment Examination

7941 Corporate Drive

Nottingham, MD 21236

2. Wait 6 to 10 calendar days for delivery and processing before scheduling an examination appointment.

Scheduling an Examination

Candidates can take each part of the examination at their convenience. Consequently, parts do not have to be taken on the same day, or on consecutive days. All parts do not have to be taken or scheduled during an examination window.

Candidates can take examination parts up to four times each during the testing period (May 2, 2023 to February 28, 2024). Once your registration has been processed, you can schedule an examination appointment at any time online at www.prometric.com/see or by calling 800-306-3926 between 8 a.m. and 9 p.m. (Eastern Time), Monday through Friday. You will be provided a number confirming your appointment. Record and keep this confirmation number for your records—you will need it to reschedule, cancel or change your appointment in any way.

Examination Locations

Examinations are administered by computer at a Prometric Testing Center. Currently, the Special Enrollment Examination is given at nearly 300 Prometric testing centers located across the United States and internationally. Test centers are located in most major metropolitan areas. A complete list of these testing centers, addresses and driving directions is located at www.prometric.com/irs. In the box titled Do More, click on "Continue" and select your preferred test location. Most locations are open on Saturdays and some locations are open on Sundays and evenings.

Testing Fees

The testing fee is \$206 for each part of the examination. This fee is paid at the time you schedule your examination. Accepted forms of payment include: MasterCard, Visa, American Express, Discover, Diner's Club cards bearing the MasterCard symbol and JCB. Electronic checks are also accepted when scheduling by phone. Money orders, paper checks and cash are not accepted. Examination testing fees are not refundable or transferable.

Rescheduling Your Appointment

If you need to reschedule an examination for another date, time or location, you must contact Prometric. Rescheduling fees will apply as follows:

- No fee if you reschedule at least 30 calendar days prior to your appointment.
- \$35 fee if you reschedule five to 29 calendar days before your appointment.
- Another \$206 full examination fee if you reschedule less than five calendar days before your appointment date.

Chapter 1. Income Tax Return

Filing Requirements

U.S Citizens and Residents Living Outside the U.S.

1. In which of the following situations is NO return required to be filed?

- A. Single, filing status single, under age 65, gross income \$13,100.
- B. Married, joint filing status, both spouses under age 65, gross income \$26,500.
- C. Single, filing status single, age 70, gross income \$13,500.
- D. Married filing separately, age 65, gross income \$5,000.

2. Under which circumstance would a self-employed taxpayer filing single and under age 65 have to file a tax return?

- A. The taxpayer had gross income from self-employment of \$400 and expenses of \$100.
- B. The taxpayer had gross income from self-employment of \$4,000 and expenses of \$3,000.
- C. The taxpayer had gross income from self-employment of \$14,000 and expenses of \$15,000.
- D. Both B & C.

ANSWER: C

Taxpayers, under age 65, filing as single must file a tax return if their gross income is at least \$12,950.

Married taxpayers, both under 65, filing jointly must file a tax return if their gross income is at least \$25,900.

Taxpayers, age 65 or older, filing single must file a return if their gross income is at least \$14,700.

Married taxpayers, any age, filing separately must file a return if their gross income is at least \$5.

ANSWER: D

A taxpayer must file Form 1040 and Schedule SE (Form 1040), Self-employment Tax, if net earnings from self-employment were \$400 or more.

For self-employed taxpayers, gross income includes the amount on line 7, gross income, of Schedule C (Form 1040). Gross income on line 7 of Schedule C is figured by taking gross receipts (net sales) and subtracting cost of goods sold. A single taxpayer under age 65 must file a tax return if his or her gross income is at least \$12,950.

Dependents

3. A taxpayer, under age 65, who can be claimed as a dependent on another person's tax return must file a tax return if the dependent taxpayer has unearned income of more than

- A. \$950
- B. \$1,150
- C. \$4,400
- D. \$12,950

ANSWER: B

A taxpayer, under age 65, who can be claimed as a dependent on another person's tax return must file a tax return if the dependent taxpayer has unearned income of more than **\$1,150**.

Chapter 1. Income Tax Return

4. Which of the following taxpayers, who could be claimed as a dependent, must file a tax return?

- A. Dependent taxpayer, blind and age 25, filing status single, unearned income of \$2,400
- B. Dependent taxpayer, age 66, filing status single, unearned income of \$1,800
- C. Dependent taxpayer, age 69 and blind, filing status married, earned income of \$13,000
- D. Dependent taxpayer, age 20, filing status single, earned income \$13,900

ANSWER: D

A dependent must file a tax return if any of the following apply:

Single Dependent

- Unearned income was more than \$1,150 (\$2,900 if age 65 or older OR blind; \$4,650 if age 65 or older AND blind).
- Earned income was more than \$12,950 (\$14,700 if age 65 or older OR blind; \$16,450 if age 65 or older AND blind).

Gross income was more than the larger of:

1. \$1,150 (\$2,900 if age 65 or older OR blind; \$4,650 if age 65 or older AND blind), or
2. Earned income (up to \$12,550) plus \$400 (\$2,150 if age 65 or older OR blind; \$3,900 if age 65 or older AND blind).

Married Dependent

- Gross income was at least \$5 and spouse files separate return and itemizes deductions.
- Unearned income was \$1,150 (\$2,550 if age 65 or older OR blind; \$3,950 if age 65 or older AND blind).
- Earned income was more than \$12,950 (\$14,350 if age 65 or older OR blind; \$15,750 if age 65 or older AND blind).
- Gross income was more than the larger of:
 - a. \$1,150 (\$2,550 if age 65 or older OR blind; \$3,950 if age 65 or older AND blind) or,
 - b. Earned income (up to \$12,550) plus \$400 (\$1,800 if age 65 or older OR blind; \$3,200 if age 65 or older AND blind).

Nonresident Aliens

5. A nonresident alien can claim the following itemized deductions EXCEPT:

- A. State and local income taxes
- B. Casualty and theft losses attributed to a federally declared disaster.
- C. Charitable contributions to foreign organizations
- D. Noncash contributions.

ANSWER: C

Resident and nonresident aliens can claim similar itemized deductions on their U.S. tax returns. However, nonresident aliens generally can claim only deductions related to income that is effectively connected with their U.S. trade or business. These deductions include state and local income taxes. A nonresident alien can deduct charitable contributions to U.S. organizations and casualty and theft losses even if they do not relate to his or her effectively connected income. Use Schedule A (Form 1040NR) to claim itemized deductions.

Extensions of Time to File

6. Which of the following statements regarding extensions of time to file is correct?

- A. An automatic 2-month extension can be obtained by filing Form 4868, Application for Automatic Extension of Time To File U.S. Individual Income Tax Return.
- B. An additional automatic 4-month extension can be obtained by filing Form 4868, Application for Additional Extension of Time To File U.S. Individual Income Tax Return.
- C. A penalty for late payment may still be charged even if an extension is granted.
- D. An extension request for a 2022 individual income tax return must be filed by August 15, 2023.

7. All of the following concerning extension of time to file are correct EXCEPT:

- A. An automatic 6-month extension can be requested by filing Form 4868.
- B. If the required payment is made by credit card by the regular due date for the return, the return can be filed any time before the 6-month extension period ends.
- C. Requesting an automatic 6-month extension before the regular due date for the return postpones the requirement to make payment of any tax due.
- D. An automatic 6-month extension can be requested by using IRS e-file (electronic filing).

ANSWER: C

An automatic 6-month extension of time to file an individual return can be obtained by filing Form 4868, Application for Automatic Extension of Time to File U.S. Individual Income Tax Return.

A penalty for late payment may still be charged even if an extension is granted.

An extension request for an individual income tax return must be filed by the original due date of the return (usually April 15 of the next year).

ANSWER: C

A taxpayer may obtain an automatic 6-month extension of time to file a U.S. individual income tax return in one of the following ways:

1. Electronically file Form 4868, Application For Automatic Extension of Time To File U.S. Individual Tax Return, using tax software with a personal computer,
2. Pay all or part of the estimated taxes due using a credit or debit or by using the Electronic Federal Tax Payment System (EFTPS), or
3. File a paper Form 4868 by mail.

An extension of time to file is not an extension of time to pay. Taxpayer must make an accurate estimate of tax liability for that year and pay any amount due with Form 4868. If the taxpayer cannot pay the full amount of tax due, he or she can still get the extension. The taxpayer will owe interest on the unpaid amount.

Chapter 1. Income Tax Return

8. Which of the following statements is true regarding the filing of a Form 4868, Application for an Automatic Extension of Time to File?

- A. Interest is not assessed on any income tax due if a Form 4868 is filed.
- B. Form 4868 provides the taxpayer with an automatic additional 4 month extension to file.
- C. Even though you file Form 4868, you will owe interest and may be charged a late payment penalty on the amount you owe if you do not pay the tax due by the regular due date.
- D. A U.S. citizen, who is out of the country on April 15, will be allowed an addition 12 months to file as long as "Out of the Country" is written across the top of Form 4868.

9. Which of the following is true regarding the filing of Form 4868, Application for Automatic Extension of Time to File a U.S. Individual Income Tax Return?

- A. Filing Form 4868 provides an automatic 2-month extension of time to file and pay income tax.
- B. Any U.S. citizen who is out of the country on April 15, is allowed an automatic 4-month extension of time to file his or her return and pay any federal income tax due.
- C. Interest is charged on tax not paid by the due date of the return even if an extension is obtained.
- D. Electronic filing cannot be used to get an extension of time to file.

10. A taxpayer can get an automatic 6-month extension by all of the following EXCEPT:

- A. Filing Form 4868.
- B. E-file Form 4868 using a tax software or a tax professional.
- C. Paying part or all of the estimate taxes due by using a credit card over the phone or internet.
- D. Calling the IRS and asking for an extension.

ANSWER: C

An extension of time to file is not an extension of time to pay. When filing an extension, a taxpayer must make an accurate estimate of his or her tax for the tax year. If the taxpayer cannot pay the full amount due, he or she can still get an extension but will owe interest and penalties on the unpaid amount. A taxpayer is allowed an automatic 2-month extension (until June 15 for calendar-year taxpayers) to file the return and pay any federal income tax that is due if the taxpayer is a U.S. citizen or resident and on the regular due date of the return:

- 1. Was living outside of the U.S. and Puerto Rico, and his or her main place of business or post of duty is outside the U.S. and Puerto Rico, or
- 2. Is in the military or naval service on duty outside the U.S. and Puerto Rico.

ANSWER: C

Refer to the analysis on the previous question. Any U.S. citizen who is out of the country on April 15, is allowed an automatic **2-month extension** of time to file his or her tax return and pay any federal income tax due. An extension of time to file can be electronically filed.

ANSWER: D

A taxpayer may obtain an automatic 6-month extension of time to file a U.S. individual income tax return in one of the following ways:

- 1. Electronically file Form 4868, Application For Automatic Extension of Time To File U.S. Individual Tax Return, using tax software with a personal computer.
- 2. Pay all or part of the estimated taxes due using a credit or debit card or by using the Electronic Federal Tax Payment System (EFTPS).
- 3. File a paper Form 4868 by mail.

Filing Status

11. A married couple with no children lived apart for all of the year. On December 31, they were legally separated under a decree of separate maintenance. Based on the facts, which of the following is the **ONLY** filing status choice available to them?

- A. Married filing joint return.
- B. Married filing separate return.
- C. Head of household.
- D. Single.

12. Which of the following is **NOT** a requirement a taxpayer must meet to claim head of household filing status?

- A. The taxpayer's spouse did **NOT** live in the same home with his or her spouse during the last 6 months of the tax year.
- B. The taxpayer paid more than half of the cost of keeping up the home for the entire year.
- C. The taxpayer's home was the main home of the taxpayer's dependent parent for more than half the year.
- D. The taxpayer is unmarried or considered unmarried on the last day of the year.

13. Which of the following is **NOT** a requirement that must be met in determining whether a taxpayer is considered unmarried for head of household filing status purposes?

- A. An individual must file a separate return.
- B. An individual must pay more than one-half the cost of keeping up a house for the tax year.
- C. An individual's home must be, for the entire year, the main home of his child, stepchild, or adopted child which he or the noncustodial parent can properly claim as a dependent.
- D. An individual spouse must not have lived in their home for the last six months of the tax year.

ANSWER: D

A taxpayer's filing status is single if he or she is unmarried or legally separated from spouse under a divorce or separate maintenance decree and does not qualify for another filing status. A taxpayer is considered unmarried for the whole year if, on the last day of the year, the taxpayer is unmarried or legally separated from spouse under a signed divorce or separate maintenance decree.

ANSWER: C

A taxpayer may file as head of household if he or she meets all of the following requirements.

- 1. Is unmarried or considered unmarried on the last day of the year.
- 2. Paid more than half the cost of keeping up a home for the year.
- 3. A qualifying person lived with the taxpayer in the home for more than half the year (except for temporary absences, such as school). The taxpayer must pay more than half the cost of keeping up a home that was the main home for the entire year for a parent or pay more than half the cost of keeping a parent in a rest home or home for the elderly.

ANSWER: C

Under certain circumstances a married person is considered unmarried for tax purposes. A taxpayer is considered unmarried if the taxpayer meets all of the following tests.

- 1. Files a separate return.
- 2. Paid more than half the cost of keeping up a home for the year.
- 3. Did not live with a spouse for the last six months of the year.
- 4. The taxpayer's home was the main home for the taxpayer's child, stepchild, or eligible foster child for more than half the year.
- 5. Must be able to claim the child as a dependent. The taxpayer can still meet this test if child was not claimed because noncustodial parent is allowed to claim the child as a dependent.

Chapter 1. Income Tax Return

14. A taxpayer is divorced from his wife since March 1st of the tax year. They have two minor children. One child lives with the taxpayer and the other child lives with the mother. The children have been with their respective parents from March through December of the tax year. The taxpayer provides all of the support for the minor child living with him. The filing status with the lowest rate that the taxpayer qualifies for is

- A. Married filing separately.
- B. Single.
- C. Head of household.
- D. Married filing jointly.

15. A taxpayer was married with two dependent children. Her husband died in April and she did not remarry before the end of the year. Which filing status should the taxpayer use for her tax return?

- A. Single
- B. Married Filing Jointly
- C. Head of Household
- D. Qualifying Surviving Spouse

16. Who would NOT be a qualifying person for purposes of filing as Head of Household?

- A. Your mother whom you can claim as a dependent.
- B. Your adopted child who lives with you, is married, and can be claimed as your dependent.
- C. Your foster child who lived with you all year and is your dependent.
- D. Your aunt, related to you by blood. She does not live with you but is your dependent.

ANSWER: C

A taxpayer may file as head of household if he or she meets all of the following requirements:

1. Is unmarried or considered unmarried on the last day of the year.
2. Paid more than half the cost of keeping up a home for the year.
3. A qualifying person lived with the taxpayer in the home for more than half the year (except for temporary absences, such as school). Exception for parent: A dependent parent does not have to live with the taxpayer. The taxpayer must pay more than half the cost of keeping up a home that was the main home for the entire year for a parent or pay more than half the cost of keeping a parent in a rest home or home for the elderly.

ANSWER: B

If a spouse dies during the year, the surviving spouse is considered married for the whole year and can choose to file married filing jointly.

ANSWER: D

To file as head of household, the qualifying person must live with the taxpayer for more than half of the year and be claimed as a dependent by the taxpayer. A foster child must live with the taxpayer for the entire year to qualify the taxpayer for head of household. A taxpayer is eligible to file as head of household even if the parent who can be claimed a dependent does not live with the taxpayer. The taxpayer must pay more than half the cost of keeping up a home that was the main home for the entire year for a parent or pay more than half the cost of keeping a parent in a rest home or home for the elderly.

17. In some cases, one spouse may be relieved of joint responsibility for tax, interest, and penalties on a joint return for items of the other spouse that were incorrectly reported on the joint return. If the spouse lives in a community property state, what type of relief is the spouse qualified to request?

- A. Innocent spouse relief
- B. Separation of liability
- C. Equitable relief
- D. Community property relief

ANSWER: C

In some cases, one spouse may be relieved of joint liability for tax, interest, and penalties on a joint return for items of the other spouse that were incorrectly reported on the joint return. A taxpayer can ask for relief no matter how small the liability. There are four types of relief available.

1. **Innocent spouse relief.** A taxpayer must meet all of the following conditions to qualify for innocent spouse relief:
 - a. Filed a joint return which has an understatement of tax due to erroneous items of taxpayer's spouse (or former spouse).
 - b. Establish that at the time the taxpayer signed the joint return the taxpayer did not know, and had no reason to know, that there was an understatement of tax.
 - c. Taking into account all the facts and circumstances, it would be unfair to hold the taxpayer liable for the understatement of tax.
2. **Separation of liability.** Applies to joint filers who are divorced, widowed, legally separated, or have not lived together for the 12 months ending on the date election of this relief is filed.
3. **Equitable relief.** Applies to all joint filers who do not qualify for innocent spouse relief or separation of liability and to married couples filing separate returns in community property states.

Community property laws. A taxpayer must follow community property laws when filing a tax return if married and live in a community property state. Generally, community property laws provide that the taxpayer and spouse are both entitled to one-half of the total community income and expenses. If the taxpayer and spouse filed a joint return in a community property state, both spouses are jointly and severally liable for the total liability on the return. However, community property laws are not taken into account in determining whether an item belongs to the taxpayer or spouse (or former spouse) if requesting relief from joint and several liability.

Relief From Liability for Tax Attributable to an Item of Community Income. A taxpayer is not responsible for the tax relating to an item of community income if all the following conditions exist.

1. Did not file a joint return.
2. Did not include the item of community income in gross income
3. The item of community income did not include (a) spouse's wages, salaries or other compensation; (b) spouse's business income; (c) spouse's share of partnership income; (d) spouse's income from separate property; and (e) any other income belonging to spouse under community property law.

18. A married couple lived apart beginning June 1. Their one minor child lived with her mother all year. The wife worked all year and provided more than half the cost of keeping up the home for herself and her minor child. The wife signed Form 8332, Release of Claim to Exemption for Child of Divorced or Separated Parents, allowing her husband to claim their child as a dependent on his separately filed return. The wife's proper filing status is

- A. Single
- B. Married filing jointly
- C. Married filing separately
- D. Head of household

- 4. The taxpayer established that he or she did not know of, and had no reason to know of, that community income.
- 5. Under all facts and circumstances, it would not be fair to include the items of community property in the taxpayer's gross income.

ANSWER: D

A custodial parent can file head of household even if he or she allows the noncustodial parent to claim the child as a dependent as long as the custodial parent meets the other requirements. Form 8332, Release/Revocation of Release of Claim to Exemption for Child by Custodial Parent, allows the noncustodial parent to claim the child as a dependent and claim the child tax credit, additional child tax credit, and credit for other dependents. It doesn't apply to other tax benefits, such as the earned income credit, dependent care credit, or head of household filing status.

Dependents

19. There are five tests which must be met for a child to be a qualifying child. Which of the following is NOT a requirement?

- A. Residency Test
- B. Relationship Test
- C. Gross Income Test
- D. Support Test

ANSWER: C

A person can be claimed as a dependent if he or she is a qualifying child or qualifying relative and meets the following three tests.

1. **Dependent taxpayer test.** The taxpayer cannot claim anyone else as a dependent if the taxpayer can be claimed as a dependent by another person.
2. **Joint Return Test.** A taxpayer is not allowed an exemption for a dependent if he or she files a joint return. **Exception:** The dependent filed a joint return merely as a claim for refund and no tax liability would exist for either spouse on separate returns.
3. **Citizen or Resident Test.** To meet this test, the person must be a U.S. citizen or resident, or a resident of Canada or Mexico, for some part of the calendar year.

Qualifying Child. The following are the five tests that must be met for a child to be a qualifying child.

1. **Relationship Test.** To meet this test, a child must be:
 - a. A son, daughter, stepchild, eligible foster child, or a descendant (e.g., grandchild) of any of them, or
 - b. A brother, sister, half brother, half sister, stepbrother, stepsister, or a descendant (e.g., niece or nephew) of any of them.
2. **Age Test.** To meet this test, a child must be:
 - a. Under age 19 at the end of the year,
 - b. A full-time student under age 24 at the end of the year, or
 - c. Permanently and totally disabled at any time during the year, regardless of age.
3. **Residency Test.** To meet this test, a child must have lived with the taxpayer for more than half of the year. There are exceptions for temporary absences, children who were born or died during the year, kidnapped children, and children of divorced or separated parents. A child is considered to have lived with the taxpayer during periods of time when either the taxpayer or child or both, are temporarily absent due to special circumstances such as illness, education, business, vacation, or military service.
4. **Support Test.** To meet this test, the child cannot have provided more than half of his or her own support for the year.
5. **Joint Return Test.** To meet this test, the child cannot file a joint return for the year. **Exception.** The joint return test does not apply if the child and his or her spouse file a joint return merely as a claim for refund.

Chapter 1. Income Tax Return

20. A taxpayer is the sole support of his mother. To claim her as a dependent, she must be a resident of which of the following countries for some part of the year?

- A. United States
- B. Mexico
- C. Canada
- D. Any of the above.

21. With regard to claiming a dependent, all of the following statements are correct EXCEPT:

- A. A person does NOT meet the member of the household test if at any time during the tax year the relationship between the taxpayer and that person violates local law.
- B. A person who died during the year, but was a member of your household until death, will meet the member of the household test.
- C. To meet the citizenship test, a person must be a U.S. citizen or resident, or a resident of Canada or Mexico.
- D. In calculating a person's total support, do NOT include tax-exempt income used to support that person.

22. All the following qualify as a dependent EXCEPT:

- A. A taxpayer's deceased wife's stepmother who lived with the taxpayer for 7 months during the tax year. She had no income and filed no tax return. The taxpayer provided more than half of her total support.
- B. A taxpayer's son who filed a joint return with his wife to receive a refund of all his withholding. No tax liability would have been due even if they had filed separate returns. All other exemption tests are met.
- C. A taxpayer's 23 year-old daughter who is not a student and earned \$4,400. She lived with the taxpayer all year and the taxpayer provided more than half of her total support.
- D. A taxpayer's 17 year-old niece who is a resident of Canada but lived with the taxpayer for 10 months. She earned \$500 during the summer and the taxpayer provided more than half of her total support.

ANSWER: D

To meet the citizen or resident test, a person must be a U.S. citizen, or resident, or a resident of Canada or Mexico, for some part of the calendar year in which the taxpayer's tax year begins.

ANSWER: D

In figuring a person's total support, include tax-exempt income, savings, and borrowed amounts used to support that person. Tax-exempt income includes certain social security benefits, welfare benefits, nontaxable life insurance proceeds, Armed Forces family allotments, nontaxable pensions, and tax-exempt interest.

ANSWER: C

Stepparents or in-laws do not have to live with the taxpayer the entire year to meet the member of household or relationship tests. The joint return test does not apply if a joint return is filed by the dependent and his or her spouse merely as a claim for refund and no liability would exist for either spouse on separate returns. To meet the resident test, a person must be a U.S. citizen or resident, or a resident of Canada or Mexico, for some part of the calendar year in which the tax year begins. A taxpayer cannot take an exemption for a dependent if that person had gross income of \$4,400 or more. This test does not apply if the person is the taxpayer's child and is either:

1. Under age 19 at the end of the year, or
2. A full-time student under age 24 at the end of the year.

23. Taxpayer A and Taxpayer B were divorced and the divorce decree was silent regarding the exemption for their 12-year-old daughter. B has legal custody of her daughter and did not sign a statement releasing the exemption. B earned \$8,000 and A earned \$80,000. The daughter had a paper route and earned \$4,500. The daughter lived with A for 4 months of the year and with B for 8 months. Who may claim the daughter as a dependent?

- A. B may, since she had gross income over \$4,400 and files her own return.
- B. Since the daughter lived with both A and B during the year, they both may claim her as an exemption.
- C. B may, since she has legal custody and physical custody for more than half the year.
- D. A may, since he earned more than B and, therefore, is presumed to have provided more than 50% of the daughter's support.

ANSWER: C

The parent who has custody of the child for the greater part of the year (the custodial parent) is generally treated as the parent who provides more than half of the child's support. It does not matter whether the custodial parent actually provided more than half of the support.

Chapter 2. Income

Wages, Salaries, Tips, and other Earnings

1. A single taxpayer received the following income from her employer:

Wages (Box 1 of W-2)	\$50,000
Christmas ham (fair market value)	\$22
Dependent care benefits (Box 10 of W-2)	
(Spent \$3,000 for childcare).	\$2,000
Group term life insurance	
(\$40,000 death benefit).	\$50

How much gross income must be reported?

- A. \$50,000
- B. \$50,022
- C. \$50,072
- D. \$52,072

2. A taxpayer is a waitress and earned \$15,000 in wages, not including any tips. She received tips of \$17 in March, which she did not report to her employer. Because she became ill in February and did not return to work until late March, she also forgot to report the \$58 for tips that she received in February. She did report the \$7,000 she received as tips for the rest of the year. How much income must she report as wages, tips and other compensation?

- A. \$22,185
- B. \$22,075
- C. \$15,260
- D. \$15,183

3. A taxpayer received the following from his employer during the year: \$25,000 regular wages, \$5,000 cash bonus, trip valued at \$1,000, and parking valued at \$100 per month at a lot adjacent to the office building. His employer contributed \$200 per month to a 401(k) plan for him. The taxpayer chose not to set aside any of his pay for the retirement plan. How much income should be report?

- A. \$34,600
- B. \$33,400
- C. \$31,000
- D. \$32,200

ANSWER: A

Holiday gifts received from an employer such as a turkey, ham, or other item of nominal value are not included in income. Dependent care benefits up to \$5,000 (\$2,500 if married filing separately) are nontaxable if the amount of benefits received is used for qualified childcare expenses. The cost of up to \$50,000 of group-term life insurance coverage provided by an employer is not included in gross income.

ANSWER: B

All tips received are income and are subject to federal income tax. Tips of less than \$20 a month do not have to be reported to the taxpayer’s employer and are not subject to social security and Medicare tax but are still subject to federal income tax.

ANSWER: C

Bonuses and prizes such as vacation trips are included in income. Qualified parking fringe benefit provided by an employer of up to \$280 a month can be excluded from a taxpayer’s income. Employer’s contribution to an employee’s retirement plan is not included in the employee’s income at the time of the contribution.

Taxpayer’s gross income:

Wages.....	\$25,000
Bonus.....	5,000
Trip.....	1,000
Gross income.....	<u>\$31,000</u>

Chapter 2. Income

4. During an all-employee awards ceremony a company gave an employee, a new bicycle for her outstanding safety record. This award was presented to the employee for her services to the company and in accordance with the company's qualified employee achievement awards program. The bicycle cost the company \$1,200 and has a fair market value of \$1,700. What amount must the employee include in income?

- A. \$1,200
- B. \$0
- C. \$1,700
- D. \$500

5. A taxpayer broke her leg this past year and was unable to work for three months. During this time, she received \$2,500 in sick pay from her employer. She also received \$1,000 from her personally purchased accident policy. How much of these benefits is taxable income?

- A. \$0
- B. \$2,500
- C. \$1,000
- D. \$3,500

6. The following fringe benefits are non-taxable EXCEPT:

- A. A nonstatutory option to buy or sell stock or other property as payment for services when the option is received or exercised.
- B. The value of accident or health plan coverage provided by an employer.
- C. Long-term care coverage contributions made by an employer to provide coverage for long-term care services.
- D. Contributions by an employer to an employee's medical savings account.

ANSWER: B

If an employee receives tangible personal property (other than cash, a gift certificate, or an equivalent item) as an award for length of service or safety achievement, the employee can exclude its value from income. However, the amount excluded is limited to the employer's cost and cannot be more than \$1,600 (\$400 for awards that are not qualified plan awards) for all such awards the employee receives during the year. The employer must make the award as part of a meaningful presentation, under conditions and circumstances that do not create a significant likelihood of it being disguised pay. However, the exclusion does not apply to the following awards.

1. A length-of-service award if you received it for less than 5 years of service or if you received another length-of-service award during the year or the previous 4 years.
2. A safety achievement award if you are a manager, administrator, clerical employee, or other professional employee or if more than 10% of eligible employees previously received safety achievement awards during the year.

In this question, the award meets the above requirements and is from a qualified plan. Therefore, the employer can deduct the \$1,200 for the award and exclude the award from the employee's income.

ANSWER: B

Sick pay received from an employer is part of the taxpayer's salary or wages. If the taxpayer paid the entire cost of a health or accident insurance plan, any amounts received from the plan for personal injury or sickness is not included in income.

ANSWER: A

If a taxpayer receives a nonstatutory option to buy or sell stock or other property as payment for services, the taxpayer will have income either when he or she receives the option or when he or she exercises the option.

7. The fringe benefit that must be included in wages and reported on Form W-2 is

- A. Health or accident insurance coverage provided by an employer.
- B. Contributions by an employer to provide long-term care services.
- C. Employer provided parking near the place of business valued at less than \$280 per month.
- D. Group-term life insurance coverage in excess of \$50,000.

ANSWER: D

The cost of up to \$50,000 of group-term life insurance coverage that is provided by an employer is not included in income. However, the cost of group-term life insurance in excess of \$50,000 must be included in wages and reported on Form W-2.

Interest Income

8. Generally, interest income from the following bonds is tax exempt EXCEPT:

- A. Local government bonds
- B. State government bonds
- C. Qualified private activity bonds
- D. U.S Savings bonds

ANSWER: D

The following interest income is exempt from federal taxes:

- 1. State and local government obligations. Tax-exempt interest is still required to be reported on an individual's tax return.
- 2. Interest received on the redemption of qualified U.S. saving bonds if used to pay for higher educational expenses during the same year.
- 3. Interest on a private activity bond that is a qualified bond.

Note: Interest received on tax-exempt private activity bonds, if issued after August 7, 1986, generally is a "tax preference item" and may be subject to the alternative minimum tax.

9. A taxpayer had municipal bond interest of \$6,000, certificate of deposit interest of \$4,000, reinvested corporate bond interest of \$2,000, mutual fund municipal bond interest of \$7,000 and savings account interest of \$1,000. How much is taxable interest?

- A. \$3,000
- B. \$7,000
- C. \$20,000
- D. \$16,000

ANSWER: B

Interest on municipal bonds is not taxable

Taxable interest:

CD interest.....	\$4,000
Corporate bond interest.....	2,000
Savings account interest.....	<u>1,000</u>
Taxable interest.....	<u><u>\$7,000</u></u>

Chapter 2. Income

10. A taxpayer received the following income:

- \$200 in interest credited to his bank account but not withdrawn or used during the year.
- \$2,000 in interest received as a beneficiary in a trust established by the taxpayer's father and included on Schedule K-1 from the trust.
- \$100 in interest on a bond issued by the state of Georgia.
- \$1,000 bond interest, City of Atlanta municipal bond

How much is the taxable interest income?

- A. \$3,300
- B. \$0
- C. \$2,200
- D. \$1,300

11. A single taxpayer received interest income of \$40,000 consisting of the following: certificate of deposit \$6,000 (which is reinvested), savings account \$4,000, City of Glendale Municipal Bond \$8,000, mortgage note \$12,000, Cobb County Municipal Bond \$7,000, and corporate bond \$3,000. What is the amount of taxable interest income?

- A. \$40,000
- B. \$25,000
- C. \$19,000
- D. \$33,000

12. If a taxpayer receives a Form 1099-INT that includes an amount as a nominee for the real owner, the taxpayer should do the following EXCEPT:

- A. Report the full amount shown as interest on Schedule B.
- B. Subtract the nominee distribution from the subtotal.
- C. File a Form 1099-INT for that interest belonging to someone else with the IRS.
- D. Forward the Form 1099-INT to the real owner of the interest and not report the interest.

ANSWER: C

Income is constructively received when it is credited to taxpayer's account or made available to the taxpayer. Distributive shares of interest from a trust, estate, partnership or S corporation reported on a Schedule K-1 are taxable interest. Interest on obligations issued by a state, a possession of the United States, or any of their subdivisions (e.g. local government) is not taxable income.

Taxable interest:

Interest credited to bank account.....	\$ 200
Interest received and reported on K-1...	<u>2,000</u>
Taxable interest.....	<u>\$2,200</u>

ANSWER: B

Interest on the municipal bonds are not taxable.

Interest Income:

Certificate of deposit.....	\$ 6,000
Interest on savings account.....	4,000
Mortgage note.....	12,000
Corporate bond.....	<u>3,000</u>
Interest income.....	<u>\$25,000</u>

ANSWER: D

If a taxpayer receives a Form 1099-INT that includes an amount as a nominee for the real owner, report the full amount shown as interest on Schedule B, then subtract the nominee distribution from the subtotal. If the taxpayer received interest as a nominee, the taxpayer must file a Form 1099-INT for that interest with the IRS.

Dividends and Other Distributions

13. Which of the following statements about dividends received from a dividend reinvestment plan is true?

- A. Reinvested dividends are not taxable if not removed from the account.
- B. Reinvested dividends are not taxable until the related stock is sold.
- C. Reinvested dividends automatically receive capital gains treatment when received.
- D. Reinvested dividends are treated as normal dividends on Schedule B.

14. A taxpayer received a dividend from XYZ Corporation. The taxpayer has elected, using XYZ's dividend reinvestment plan, to purchase additional stock at FMV with the dividend received. The dividend was \$1,500 and the FMV of the stock purchased was \$1,475. A \$25 service charge was applied to this transaction. What must be reported as dividend income?

- A. \$0
- B. \$1,500
- C. \$1,525
- D. \$1,475

15. An individual taxpayer has capital gain distributions only, and no other capital gains. Which of the following satisfies the reporting requirements?

- A. All capital gain distributions must be entered on Schedule B.
- B. No Schedule D is required and the amount is entered directly on Form 1040 or 1040-SR.
- C. Dividends and capital gains distributions are totaled on Schedule B and carried to the front page of Form 1040 or 1040-SR.
- D. If there are no other capital gains, capital gain distributions must be combined with interest on the Schedule B.

ANSWER: D

A corporation's dividend reinvestment plan lets the shareholder choose to use his or her dividend to buy more shares of stock in the corporation instead of receiving the dividends in cash. If the shareholder elects to use the dividend to buy additional stock, the shareholder must report as dividend income the FMV of the additional stock on the dividend payment date.

ANSWER: B

A corporation's dividend reinvestment plan lets the shareholder choose to use his or her dividend to buy more shares of stock in the corporation instead of receiving the dividends in cash. If the shareholder elects to use the dividend to buy additional stock, the shareholder must report as dividend income the FMV of the additional stock on the dividend payment date. A shareholder must report as dividend income any service charge subtracted from cash dividends before the dividends are used to buy the additional stock.

ANSWER: B

If a taxpayer receives capital gains distributions only and no other capital gain, the taxpayer reports the distribution on Form 1040 or 1040-SR. No Schedule D is required. Only interest and dividend income are reported on Schedule B.

Rental Income and Expenses

16. Which of the following is NOT rental income in the year received?

- A. Security deposit, equal to one month's rent, to be refunded at the end of the lease if the building passes inspection.
- B. Payment to cancel the remaining lease.
- C. Repairs paid by the tenant in lieu of rent.
- D. January rent received in December.

ANSWER: A

The following are considered rental income in the year received.

- 1. Advance rent (rent received before the period it covers).
- 2. Payment by the tenant for canceling a lease.
- 3. Landlord expenses paid by the tenant.
- 4. Fair market value of property or services received in exchange for rent.

Security deposits are not included in income if they are to be returned to the tenant at the end of the lease. If the tenant forfeits security deposit due to breach of lease, include the security deposit in rental income.

17. A taxpayer rented his cottage for 10 days to a stranger and used the cottage for 20 days for his own personal use. The cottage was not used the rest of the year. He had rental income of \$1,000 and he paid \$600 for repairs. How should he report these activities on his tax return?

- A. \$1,000 income, \$600 expense
- B. \$333 income, \$200 expense
- C. \$0 income, \$0 expense
- D. \$667 income, \$400 expense

ANSWER: C

If the property rented was used for personal purposes for more than the greater of 14 days or 10% of the total days rented at a fair rental price, do not report any rental income or deduct any rental expenses if rented for less than 15 days.

18. A taxpayer signed a 5-year lease to rent office space to a tenant. The tenant paid \$24,000 for the first year's rent and \$24,000 for the last year's rent. The taxpayer reports his income using the accrual method of accounting. How much of the \$48,000 is included in the taxpayer's tax income?

- A. \$24,000
- B. \$120,000
- C. \$48,000
- D. \$0

ANSWER: C

Advance rent is any amount received before the period that it covers. Advance rent is included in rental income in the year it is received regardless of the period covered or the method of accounting used by the taxpayer.

Rental income:	
First year rent.....	\$24,000
Advance rent.....	24,000
Rental income.....	<u>\$48,000</u>

19. Tenants moved into your rental property and paid a \$10,000 security deposit. You agreed to use this security deposit as their last month's rent. Additionally, they paid a painting contractor \$2,500 to paint the interior. How much of these payments should be reported as rental income for this year?

- A. \$0
- B. \$5,000
- C. \$10,000
- D. \$12,500

ANSWER: D

Security deposits received but that are to be returned at the end of the lease are not included in income. If an amount called a security deposit is used as a final payment of rent, it is advance rent and included in income. If a tenant pays any of the landlord's expenses, the payments are rental income. The landlord can deduct the \$2,500 as rental expenses.

Rental Income:
 Advance rent.....\$10,000
 Landlord expenses paid by tenant..... 2,500
 Rental income.....\$12,500

20. Tenants had a pipe burst in the basement of the taxpayer's rental home. They had the plumber come out and repair the pipe and damage. They paid the plumber \$575 and deducted \$575 from their rent of \$5,000. How much rent should be considered income that month?

- A. \$5,000
- B. \$4,425
- C. \$5,575
- D. \$5,745

ANSWER: A

If a tenant pays any of the landlord's expenses, the payments are rental income.

Rental Income:
 Rent (\$5,000 - \$575).....\$4,425
 Landlord expenses paid by tenant..... 575
 Rental income.....\$5,000

21. A taxpayer owns and operates an assisted-living facility. The taxpayer provides maid service and meals in a common dining room. Where should the taxpayer report the income and expenses from this activity?

- A. Other Income on Schedule 1 (Form 1040 or 1040-SR) and expenses as itemized deductions on Schedule A.
- B. Income and expenses on Schedule E, Supplemental Income and Loss.
- C. Income and expenses on Schedule C, Profit or Loss from Business.
- D. Short-term capital gain on Schedule D.

ANSWER: C

If a taxpayer rents a building, rooms, or apartments, and provides only heat and light, trash collection, etc., the taxpayer should be reported rental income and expenses on Part 1 of Schedule E (Form 1040 or 1040-SR). If the taxpayer provides significant services that are primarily for the tenant's convenience, such as regular cleaning, changing linen, or maid service, the taxpayer should report rental income and expenses on Schedule C (Form 1040 or 1040-SR).

Chapter 2. Income

22. Which of the following expenditures in connection with a rental property can be deducted as a repair?

- A. Putting on a new roof.
- B. Installing new cabinets.
- C. Paving a driveway.
- D. Replacing a broken window.

ANSWER: D

A repair keeps the property in good working condition and does not materially add to the value of the property. The costs of repairs are deductible. Repainting the property inside or out, fixing gutters or floors, fixing leaks, plastering, and replacing broken windows are examples of repairs. If repairs are made as part of an extensive remodeling or restoration of the property, the whole job is an improvement.

An improvement adds to the value of the property, prolongs its useful life, or adapts it to new uses. The costs of improvements increase the basis of the property and are not deductible. Improvements must be depreciated. Examples of improvements are remodeling a room, putting up a fence, paving a driveway, putting on a new roof, and putting in new plumbing, wiring, or cabinets.

23. A rental property owner had some major expenses during the year as follows:

- \$2,000 to replace the cabinets in the kitchen
- \$500 to replace the stove
- \$600 to replace the built-in dishwasher
- \$400 to resurface the tub in the master bathroom

What is the amount and character of these expenses?

- A. \$2,000 capital improvements and \$1,500 repairs expense.
- B. \$2,600 capital improvements and \$900 repairs expense.
- C. \$400 capital improvements and \$3,100 repairs expense.
- D. \$3,100 capital improvements and \$400 repairs expense.

ANSWER: D

Refer to the analysis on the previous question. The replaced kitchen cabinets, stove, and dishwasher are capital improvements that must be depreciated. The \$400 to resurface the tub is a repair.

24. A landlord made several repairs and improvements to his rental house. He spent \$1,500 to add carpeting in the hallway, \$550 for a stove, and \$750 for a refrigerator, \$170 to replace the broken faucet in the bathroom, and \$590 to replace damaged shingles on the roof. How much of these costs must he depreciate?

- A. \$3,560
- B. \$2,800
- C. \$1,300
- D. \$3,390

ANSWER: B

Adding carpeting, replacing a refrigerator and stove are improvements to the property and must be depreciated over their useful life. Replacing a broken faucet is a repair and the cost can be deducted as a rental expense. Repairing damaged shingles on the roof is also a repair. Replacing the entire roof would be an improvement.

Improvements to be depreciated:

Carpet.....	\$1,500
Stove.....	550
Refrigerator.....	750
Improvements to be depreciated.....	<u>\$2,800</u>

25. A landlord had these expenses for his rental house:

1. Replaced a screen in the storm door.
2. Replaced the heating system.
3. Sowed grass seed in some bare spots on the lawn.
4. Built a detached two-car garage.
5. Installed a new dishwasher.
6. Bought a welcome mat for the front stoop.

Which of these items must be depreciated rather than deducted as an expense on his Schedule E?

- A. 1, 3, 4, and 5.
- B. 2, 4, 5, and 6.
- C. 2, 4, and 5.
- D. 3, 4, and 6.

26. Which of the following costs incurred on rental property should be classified as a capital improvement?

- A. Replacing a 20-year-old roof.
- B. Repainting all of the interior walls.
- C. Refinishing the existing wood floors.
- D. Replacing a broken window pane.

27. A taxpayer owns a house that she rents to non-related parties. She incurred the following costs during the year:

- \$400 to resurface a tub in the master bathroom.
- \$500 to paint the kitchen after installing new cabinets.
- \$2,000 to replace cabinets in the kitchen.
- \$600 to replace the built-in dishwasher.

How should these costs be characterized and in what amounts?

- A. \$3,100 as improvements to be capitalized and \$400 as repairs.
- B. \$400 as improvements to be capitalized and \$3,100 as repairs.
- C. \$3,500 as improvements to be capitalized.
- D. \$2,000 as improvements to be capitalized and \$1,500 as repairs.

ANSWER: C

Replacing a screen door, repairing a bare spot in the lawn and purchasing a welcome mat would not materially add to the value of the rental property and are be considered deductible expenses. Replacing the heating system, building a detached two-car garage, and installing a new dishwasher are capital improvements and must be depreciated.

ANSWER: A

Replacing a roof is a capital improvement. Repainting all of the interior walls, refinishing the existing wood floors, and replacing a broken window pane are all repairs.

ANSWER: A

If a taxpayer makes a repair as part of an extensive remodeling, the whole job is an improvement. Therefore, the painting of the kitchen after installing new cabinets is an improvement. Replacing a built-in dishwasher is also an improvement.

Chapter 2. Income

28. A taxpayer owns a duplex. He lives in one half and rents out the other half at fair rental value. He wants to take depreciation on the building, the appliances, and major remodeling in the bathroom on the rental side. What depreciation may be taken?

- A. 27.5 year MACRS on both sides of the duplex, 7 year MACRS on the appliances and remodeling.
- B. 27.5 year MACRS on the rental side, 0 on the personal side, and 7 year MACRS on the appliances and remodeling.
- C. 27.5 year MACRS on both sides of the duplex, 5 year MACRS on the appliances and remodeling.
- D. 27.5 year MACRS on the rental and remodeling, 5 year MACRS on the appliances, and no depreciation on the personal side.

29. A taxpayer purchased an office building and used office furnishings. The used office furnishings consisted of chairs, desks, and file cabinets. \$900,000 of the purchase price was allocated to the office building and \$50,000 of the purchase price was allocated to the used office furnishings. According to the General Depreciation System (GDS) under MACRS for depreciation, what recovery period must she use for the purchased items?

- A. 27.5 years for the entire asset, building and furnishings.
- B. 39 years for the building and 5 years for the used office furnishings.
- C. 27.5 years for the building and 7 years for the used office furnishings.
- D. 39 years for the building and 7 years for the used office furnishings.

30. A taxpayer purchased a heating, ventilating and air conditioning (HVAC) unit for his rental property on December 15th. It was delivered on December 28th and was installed and ready for use on January 2nd. When should the HVAC unit be considered placed in service?

- A. December 15th.
- B. December 28th.
- C. December 31st.
- D. January 2nd.

ANSWER: D

Residential rental property and any additions and improvements to the property are depreciated over 27.5 years. Appliances are depreciated over 5 years. No depreciation is taken on the personal side.

ANSWER: D

Nonresidential real property is depreciated over 39 years. Office furniture is depreciated over 7 years.

ANSWER: D

Begin depreciating property when it is placed in service. Property is considered placed in service in a rental activity when it is ready and available for use.

31. A taxpayer owns a rental apartment building property. This is the only rental property that he owns. He actively participates in this rental activity as he collects the rents and performs ordinary and necessary repairs. He had a loss of \$30,000 on this rental activity and had no reportable passive income. His adjusted gross income, without regard to this rental loss, is \$60,000. How much of the rental loss may be deducted?

- A. \$30,000
- B. \$25,000
- C. \$0
- D. \$6,000

32. A married taxpayer owns ten apartment buildings that are managed by his brother's real estate business. At the end of the year, the apartment buildings resulted in a \$40,000 loss. He earned \$80,000 in wages as a lawyer. His wife earned \$20,000 from her part time job. Their other income included \$5,000 in dividends from their mutual funds. They had no other income. How much of the rental loss can be use?

- A. \$0
- B. \$20,000
- C. \$25,000
- D. \$40,000

33. A taxpayer owns a four-family apartment building and actively participates in the rental activity. He advertised, rented the apartments to the tenants, collected rents, and made repairs. His brother also owns an apartment building and spends more than half his time developing, constructing, renting, managing, and operating his apartment building as well as providing regular cleaning, linen service and maid service for the convenience of the tenants. Which one has self-employment income from his apartment building?

- A. Taxpayer
- B. Taxpayer's brother
- C. Both the taxpayer and his brother
- D. Neither

ANSWER: B

A taxpayer can deduct up to \$25,000 of loss from a passive rental real estate activity from nonpassive income only if he or she actively participated in the activity. A taxpayer actively participated in a rental real estate activity if he or she (and spouse) owned at least 10% of the rental property and made management decisions in a bona fide sense.

ANSWER: A

A taxpayer can deduct up to \$25,000 of loss from a passive rental real estate activity from nonpassive income only if he or she actively participated in the activity. A taxpayer actively participated in a rental real estate activity if he or she (and spouse) owned at least 10% of the rental property and made management decisions in a bona fide sense. In this question, the taxpayer did not actively participate in the rental real estate activity and cannot deduct any of the loss against nonpassive income. Dividends and interest are not considered passive income.

ANSWER: B

Rent from real estate is not self-employed income unless either of the following applies:

1. The taxpayer is a real estate dealer.
2. The taxpayer provides services for his or her tenants.

Passive Activities

34. A taxpayer took out a \$100,000 nonrecourse loan and bought an apartment building. The building is not security for the loan. He spent \$25,000 of his own money on repairs before he rented the apartment building to the public. He is single, works full-time and earns \$80,000 per year. His loss from the rental real estate activity, in which he actively participates, is \$30,000. He has no passive income. For what amount is the taxpayer at-risk and how much the passive loss from the rental activity is deductible?

	<u>At-Risk</u>	<u>Passive Loss</u>
A.	\$100,000	\$25,000
B.	\$25,000	\$25,000
C.	\$125,000	\$30,000
D.	\$125,000	\$25,000

35. Passive activity rules apply to

- A. Closely held corporations.
- B. Partnerships.
- C. S corporations.
- D. Grantor trusts.

ANSWER: B

The at-risk rules limit losses from most activities to the taxpayer's amount at risk in the activity. A taxpayer is at risk in any activity for:

1. The money and adjusted basis of property the taxpayer contributed to the activity, and
2. Amounts the taxpayer borrowed for use in the activity if:
 - The taxpayer is personally liable for repayment, or
 - The taxpayer pledged property (other than property used in the activity) as security for the loan.

A taxpayer is not considered at risk for his or her share of any nonrecourse loan used to finance an activity or to acquire property used in the activity unless the loan is secured by property not used in the activity or the loan is secured by real property used in the activity. Nonrecourse financing is financing for which the borrower is not personally liable. In this question, the \$100,000 loan is nonrecourse and the real property (apartment building) is not security for the loan. Therefore, the taxpayer's at risk amount is the \$25,000 he spent for repairs.

Rental real estate activities are generally considered passive activities. Generally, losses from passive activities can be deducted only against income from other passive activities. However, if the taxpayer actively participated in a passive rental real estate activity, the taxpayer can deduct up to \$25,000 of loss from the activities from nonpassive income.

ANSWER: A

The passive activity rules apply to the following:

1. Individuals.
2. Estates.
3. Trusts (other than grantor trusts).
4. Personal services corporations.
5. Closely held corporation.

Even though the rules do not apply to grantor trusts, partnerships, and S corporations directly, they do apply to the owners of these entities.

36. A real estate professional owns ten rental properties. The real estate activities are his sole occupation which he works at all year. He was involved in the operation of all the properties on a regular, continuous, and substantial basis. At the end of the year his real estate operations resulted in a \$75,000 net loss. His spouse had received \$90,000 in wages. Their only other income during the year was \$5,000 interest. Which of the following statements is true?

- A. They may fully offset their \$95,000 income with their \$75,000 real estate loss on their joint tax return.
- B. They may not offset their \$95,000 income with any real estate loss on their joint tax return.
- C. They may offset their \$95,000 income with \$25,000 of their real estate loss on their joint tax return if actively participated in the real estate activity.
- D. None of the above statements is true.

ANSWER: A

Real estate activities in which a taxpayer materially participated are not passive activities if the taxpayer is a real estate professional. Losses from these activities are not limited by the passive activity rule.

Retirement Plans, Pensions, and Annuities

Traditionals IRAs

37. A taxpayer made deductible contributions to traditional individual retirement accounts for several years. She decides to withdraw \$10,000 from one of her accounts. She is 61 years old. How does this transaction affect the taxpayer's tax return?

- A. Must report the entire amount of \$10,000.
- B. Does not have to report anything because the taxpayer is older than 59½ years.
- C. Does not have to report any amount because this was not withdrawn from a Roth IRA.
- D. Must report all of the distribution received but can elect to use the 10-year option.

ANSWER: A

If a taxpayer made only deductible contributions to a traditional IRA, the taxpayer has no basis in her IRA. Any distributions are fully taxable when received.

38. Owners of traditional individual retirement accounts (IRAs) are required to begin receiving distributions no later than the following:

- A. By April 1 of the year following the year in which the owner reaches age 72.
- B. By April 1 of the year in which the owner reaches age 72.
- C. By January 1 of the year in which the owner reaches age 72.
- D. By April 1 of the year following the year in which the owner reaches age 59½.

ANSWER: A

A taxpayer must start receiving distributions from his or her IRA account by April 1st of the year following the year the taxpayer reaches 72.

Chapter 2. Income

39. A taxpayer turned 72 on June 1, 2022. He must receive his minimum distribution from his IRA by

- A. April 15, 2023.
- B. December 31, 2022.
- C. June 30, 2022.
- D. April 1, 2023.

40. If a taxpayer fails to take a required minimum distribution from a traditional IRA, the excess accumulation is subject to a penalty of

- A. 6%
- B. 10%
- C. 15%
- D. 50%

41. A taxpayer over age 72 is required to make minimum distribution for the year of \$3,000. If the taxpayer only took a distribution of \$1,000, what is the amount of excise tax on the excess accumulation?

- A. \$120
- B. \$200
- C. \$1,000
- D. \$2,400

42. All of the following are examples of prohibited transactions with a traditional IRA EXCEPT:

- A. Selling property to it.
- B. Using it as security for a loan.
- C. Buying property for personal use with your IRA funds.
- D. Taking a distribution before age 59½.

ANSWER: D

A taxpayer must begin receiving distributions from his or her traditional IRA no later than **April 1st** of the year following the year in which he or she reaches age 72.

ANSWER: D

If distributions are less than the required minimum distribution for the year, the taxpayer may have to pay a **50% excise tax** for that year on the amount not distributed as required.

ANSWER: C

If distributions are less than the required minimum distribution for the year, the taxpayer may have to pay a 50% excise tax for the excess accumulations.

Tax on the excess accumulations:

\$2,000 (\$3,000 - \$1,000) × 50% = \$1,000

ANSWER: D

A prohibited transaction is any improper use of a traditional IRA account or annuity by the taxpayer, his or her beneficiary, or any disqualified person.

Disqualified persons include the taxpayer's fiduciary and members of his or her family (spouse, ancestor, lineal descendant, and any spouse of a lineal descendant).

The following are examples of prohibited transactions with a traditional IRA:

1. Borrowing money from it.
2. Selling property to it.
3. Receiving unreasonable compensation for managing it.
4. Using it as security for a loan.
5. Buying property for personal use (present or future) with IRA funds.

43. The use of IRA funds in prohibited transactions can result in additional taxes and penalties. Which of the following is NOT a prohibited transaction in a traditional IRA?

- A. Borrowing money from the IRA.
- B. Selling property to an IRA.
- C. Inheriting a spouse's IRA.
- D. Using an IRA as security for a loan.

44. A taxpayer, age 57, has a traditional IRA from which she has taken a taxable distribution of \$8,000. Under which of the following circumstances will the distribution be subject to the 10 percent penalty for premature distributions?

- A. Taxpayer's AGI is \$30,000 and she had \$13,000 in unreimbursed deductible medical expenses which exceed 7.5% of her adjusted gross income.
- B. Taxpayer's granddaughter is a sophomore in college and the taxpayer paid her tuition expenses of \$10,000.
- C. The taxpayer uses the \$8,000 to refinance his main home.
- D. The distribution was made pursuant to an IRS levy on the taxpayer's IRA.

ANSWER: C

Refer to the analysis on the previous question.

ANSWER: C

A taxpayer will not have to pay the 10% penalty for premature distribution for the following situations.

1. The distribution is used pay the taxpayer's unreimbursed medical expenses that are more than 7.5% of his or her adjusted gross income.
2. The distribution is used to pay for medical insurance for the taxpayer, spouse, and dependents and all the following conditions apply.
 - a. The taxpayer lost his or her job.
 - b. The taxpayer received unemployment compensation paid under any federal or state law for 12 consecutive weeks because of job loss.
 - c. The taxpayer received the distribution during either the year the taxpayer received the unemployment compensation or the following year.
 - d. The taxpayer received the distribution no later than 60 days after the taxpayer has been reemployed.
3. The taxpayer is disabled.
4. Distributions are to beneficiaries of a deceased IRA owner.
5. Receiving distributions in the form of an annuity.
6. The distribution is used for qualified education expenses for the taxpayer, his or her spouse, children, or grandchildren.
7. Distribution used to buy, build, or rebuild a first home (up to \$10,000).
8. The distribution is due to an IRS levy of the qualified plan.
9. The distribution is a qualified reservist distribution.
10. The distribution is a qualified birth or adoption distribution.
11. Made as a qualified disaster distribution.

Chapter 2. Income

45. Generally, which of the following is a prohibited transaction concerning a traditional IRA?

- A. Withdraw funds for qualified higher education expenses.
- B. Pledging an IRA account as security for a mortgage.
- C. Withdraw funds for qualified medical expenses.
- D. Withdraw funds to purchase a first home.

46. A taxpayer died and left his traditional IRA to his nephew. What is the nephew allowed to do with the inherited IRA?

- A. He could make additional direct contributions to the IRA, treating it as his own.
- B. He could roll over amounts out of the inherited IRA to another IRA tax-free.
- C. He could make additional contributions, which were rollovers from Roth IRAs.
- D. None of the above.

47. At age 50, a taxpayer began taking distributions from her IRA as part of a series of substantially equal periodic payments. This year, at age 62, the taxpayer took out a one-time additional distribution of \$20,000. What amount of recapture tax must be paid due to a change in distribution method?

- A. \$0
- B. \$2,000
- C. \$3,000
- D. \$20,000

Roth IRAs

48. Generally, which of the following rules apply to both traditional IRA's and Roth IRA's?

- A. Non-rollover contributions are generally limited to \$6,000 (\$7,000 if age 50 or older) or 100% of compensation, whichever is less.
- B. Contributions are always nondeductible.
- C. Contributions may not be made for the tax year in which you reach age 72, or for years thereafter.
- D. Contribution phase out limits are the same for both traditional IRA and ROTH IRA's.

ANSWER: B

Using an IRA as security for a loan is a prohibited transaction.

ANSWER: D

If a taxpayer inherits a traditional IRA from anyone other than a spouse, the taxpayer cannot treat the inherited IRA as his or her own. This means that contributions (including rollover contributions) cannot be made to the IRA and the IRA cannot be rolled over into another IRA.

ANSWER: A

A taxpayer, who is under the age of 59½, can receive distributions from a traditional IRA that are a part of a series of substantially equal payments over the taxpayer's life (or life expectancy) without having to pay the 10% tax on premature distributions. The payments under this exception must continue for at least 5 years, or until the taxpayer reaches age 59½, whichever is the longer period. A lump-sum distribution of the balance in the IRA before the required 5-year period would be subject to the 10% additional tax.

ANSWER: A

Contributions to a traditional IRA are deductible, but contributions to a Roth IRA are not. There is no age limit for contributions to a traditional or Roth IRA. The AGI phase-out limits for a traditional IRA and a Roth IRA are different.

49. Which of the following is correct regarding contributions to a Roth IRA?

- A. Contributions may be made regardless of age provided other requirements are met.
- B. Contributions may be deducted if you are within certain income limits.
- C. Contributions may be deducted if you are not covered under a retirement plan.
- D. Contributions may not be deducted, but earnings are taxable when distributed.

50. Which of the following amounts may be converted directly to a Roth IRA, provided all requirements are met?

- A. Amounts in a SIMPLE IRA, and the two-year participation period have been met.
- B. Amounts in a traditional IRA inherited from a person other than a spouse.
- C. Hardship Distribution from a 401 (k) plan.
- D. Required minimum distributions from a traditional IRA.

51. The maximum allowable deduction for contributions to a Roth IRA, if neither you nor your spouse was covered for any part of the year by an employer retirement plan, is

- A. \$0
- B. \$6,000
- C. \$7,000 if age 50 or older
- D. Both B & C.

ANSWER: A

Unlike a traditional IRA, a contribution to a Roth IRA is not deductible and qualified distributions are tax free. Contributions can be made regardless of the taxpayer's age and the taxpayer can leave amounts in his or her Roth IRA as long as they live.

ANSWER: A

A taxpayer can convert amounts from either a traditional, SEP or SIMPLE IRA to a Roth IRA. A taxpayer can also convert amounts from a qualified retirement plan into a Roth IRA. For a SIMPLE IRA, the conversion cannot take place during the 2-year period beginning on the date the taxpayer first participated in a SIMPLE IRA plan maintained by his or her employer. An inherited IRA from someone other than a spouse cannot be converted to a Roth IRA. A taxpayer cannot convert amounts that must be distributed from a traditional IRA or a hardship distribution from a 401 (k) plan into a Roth IRA.

ANSWER: A

Unlike a traditional IRA, a contribution to a Roth IRA is not deductible and qualified distributions are tax free.

Chapter 2. Income

52. A taxpayer made a rollover contribution from his traditional IRA to a newly created Roth IRA on December 1, 2021. Also, on February 1, 2023 he made another rollover contribution from an employer IRA to the same account. Which of the following is correct?

- A. He may not withdraw the funds tax free earlier than December 1, 2026.
- B. He may not withdraw funds tax free earlier than February 1, 2028.
- C. He must make the February 1, 2023 rollover contribution into a separate Roth IRA account to properly identify another five year holding period.
- D. He may not withdraw the funds tax free earlier than January 1, 2026.

53. A taxpayer has a traditional IRA with a basis of \$8,800. On December 31, he converted \$44,000 of the \$88,000 total value of the IRA to a Roth IRA. He files as head of household and his AGI, without the conversion, is \$62,000. What amount of income will be included income as the result of this conversion?

- A. \$8,800
- B. \$35,200
- C. \$39,600
- D. \$44,000

ANSWER: D

A taxpayer can convert amounts from either a traditional IRA, SEP, or SIMPLE IRA into a Roth IRA. A taxpayer can also convert amounts from a qualified retirement plan into a Roth IRA. To qualify as a tax free distribution from a Roth IRA, the distribution must be made after the 5-year period beginning with the first taxable year for which a contribution was made to a Roth IRA and the distribution is:

- 1. Made on or after the date the taxpayer reaches age 59½.
- 2. Made because the taxpayer is disabled,
- 3. Made to a beneficiary or to the taxpayer's estate after death, or
- 4. Used to buy a first home (\$10,000 lifetime limit).

A taxpayer does not have to set up separate Roth IRA accounts for each contribution to properly identify another 5-year period. However, the 5-year period must be separately determined for each conversion contribution. In this question, the taxpayer may not withdraw the funds rolled over from his traditional IRA to a Roth on December 1, 2021, until after the 5-year period beginning with the first day of the taxable year (2021) the contribution was made. Therefore, the earliest the funds can be withdrawn tax free is **January 1, 2026**.

ANSWER: C

The conversion from a traditional IRA to a Roth IRA is treated as a taxable distribution. The amount included in income is the amount of the conversion less the taxpayer's basis in the traditional IRA that was converted.

Taxable amount of conversion:
Amount converted (50% of \$88,000).....\$44,000
Less: Basis in traditional IRA converted
 (50% of \$8,800).....4,400
Taxable amount of conversion.....\$39,600

54. A single taxpayer's modified adjusted gross income was \$148,000, of which \$116,000 was earned income. He made a \$4,000 contribution to his previously established Roth IRA. What is the penalty for excess contributions if he doesn't withdraw the contribution (and all attributable earnings) by the due date of the return (including extensions), or recharacterize the contribution by the due date of the return (including extensions)?

- A. \$0
- B. \$240
- C. \$300
- D. \$400

55. Distributions from a Roth IRA must begin no later than April 1 of the year following the year the account owner reaches age

- A. 59½
- B. 70½
- C. 72
- D. No required minimum distribution date.

56. Generally, an eligible taxpayer, 50 years of age or older, may make which of the following in tax year?

- A. A \$7,000 contribution to a traditional IRA.
- B. A \$7,000 contribution to a Roth IRA.
- C. A \$7,000 contribution to a traditional IRA, and a \$7,000 contribution to a Roth IRA.
- D. Either A or B but not both.

ANSWER: B

A taxpayer cannot make a contribution to a Roth IRA if his modified AGI is over \$144,000 (\$214,000 if married filing jointly). A 6% excise tax applies to any excess contribution to a Roth IRA. An excess contribution to a Roth will not be subject to the penalty if it is withdrawn on or before the due date (including extensions) for that year's tax return.

Penalty for excess contributions:

$$\text{\$4,000} \times 6\% = \text{\$240}$$

ANSWER: D

Unlike a traditional IRA, a Roth IRA has no required minimum distribution date. The taxpayer is never required to take a Roth IRA distribution.

ANSWER: D

If contributions are made to both Roth IRAs and traditional IRAs, the contribution limit for Roth IRAs is the same as the limit would be if contributions were made only to Roth IRAs, but then reduced by all contributions (other than employer contributions under a SEP or SIMPLE IRA plan) for the year to all IRAs other than Roth IRAs. This means that the contribution limit is the lesser of:

1. \$6,000 (\$7,000 if age 50 or older) minus all contributions (other than employer contributions under a SEP or SIMPLE IRA plan) for the year to all IRAs other than Roth IRAs, or
2. Taxable compensation minus all contributions (other than employer contributions under a SEP or SIMPLE IRA plan) for the year to all IRAs other than Roth IRAs.

Social Security

57. A married couple filed a joint return. The husband received \$8,000 in Social Security benefits and his wife received \$4,000. Their income also included \$10,000 taxable pension income and interest income of \$2,000. What part of their Social Security benefits will be taxable?

- A. \$0
- B. \$6,000
- C. \$24,000
- D. \$12,000

ANSWER: A

If all income including tax-exempt income plus one-half Social Security benefits are more than the base amounts (\$25,000 for single; \$32,000 for married filing jointly) but less than (\$34,000 for single; \$44,000 for married filing jointly), taxable Social Security benefits is the smaller of the following:

1. One-half the net benefits received, or
2. One-half of the amount by which the sum of modified AGI and one-half the Social Security benefits exceed the base amount.

Taxable interest.....	\$ 2,000
Taxable pension.....	10,000
½ Social Security	
$((\$8,000 + \$4,000) \times \frac{1}{2})$	<u>6,000</u>
Modified AGI + ½ net benefits.....	18,000
Less: Base Amount (MFJ).....	<u>32,000</u>
Excess of modified AGI + ½ net	
benefits over base amount.....	<u>\$ 0</u>
or,	
50% of Social Security Benefits.....	<u>\$ 6,000</u>

58. A single taxpayer received Social Security benefits of \$8,000, which includes \$500 for Medicare premiums. Withdrawals from her IRA were \$16,000 and she received \$22,000 from a pension. She also had other income of \$14,000. How much is her adjusted gross income?

- A. \$59,225
- B. \$58,800
- C. \$60,000
- D. \$60,500

ANSWER: B

Distributions from the taxpayer's IRA and her pension income are taxable. Eighty-five percent of a taxpayer's social security benefits are taxed if one-half of the benefits and all other income, including tax-exempt income is more than \$34,000 (\$44,000 if married filing jointly).

Taxpayer's AGI:	
IRA withdrawals.....	\$16,000
Pension income.....	22,000
Other income.....	14,000
Social security benefits $(\$8,000 \times 85\%)$	<u>6,800</u>
Adjusted gross income.....	<u>\$58,800</u>

59. A single taxpayer received Social Security payments totaling \$14,000 (this includes Medicare premium of \$600), dividend and interest income of \$21,000, a pension of \$30,000 and a taxable IRA benefits of \$16,000. What is his adjusted gross income?

- A. \$80,400
- B. \$78,900
- C. \$78,390
- D. \$67,000

ANSWER: B

A taxpayer's social security benefits are taxed at 85% if the total of one-half his social security benefits and all other income including tax-exempt income is more than \$34,000 (\$44,000 if married filing jointly).

Total of one-half social security benefits and all other income:

One-half of social security benefits.....	\$ 7,000
Dividends & interest.....	21,000
Pension.....	30,000
Taxable IRA benefits.....	<u>16,000</u>
Total.....	<u>\$74,000</u>

Since the total of one-half social security benefits and all other income is more than \$34,000, 85% of the taxpayer's social security benefits are taxable.

Adjusted gross income:

Taxable social security benefits

(14,000 × 85%).....	\$11,900
Dividends & interest.....	21,000
Pension.....	30,000
Taxable IRA benefits.....	<u>16,000</u>
Adjusted gross income.....	<u>\$78,900</u>

60. A single taxpayer works part-time as a security guard earning \$8,000. He received \$5,000 interest from a saving account and \$2,500 interest from tax-exempt municipal bonds. His Social Security benefits were \$12,000 and his taxable pension was \$6,000. To determine if any of his Social Security is taxable, the taxpayer should compare how much of his income to the \$25,000 base amount?

- A. \$27,500
- B. \$21,500
- C. \$19,000
- D. \$25,000

ANSWER: A

When figuring the amount of a taxpayer's income to compare with his or her base amount include the following amounts:

1. One-half of the social security benefits,
2. Taxable income, and
3. Tax-exempt income.

Taxpayer's income to compare with his base amount:

One-half of social security

(\$12,000 × ½).....	\$6,000
Wages.....	8,000
Taxable interest.....	5,000
Tax-exempt interest.....	2,500
Taxable pension.....	<u>6,000</u>
Income to compare with base amount.....	<u>\$27,500</u>

Foreign Source Income & Foreign Earned Income Exclusion

61. A taxpayer worked for 3 months in Russia and earned \$25,000 while in Russia. She also had interest income on a bank account in Russia of \$100. She is a United States citizen and, except for the 3 months spent in Russia, resides in the United States. She did not receive either a Form W-2 or a Form 1099 for her earnings while in Russia. How much of the income earned in Russia does she have to report?

- A. \$0
- B. \$100
- C. \$25,000
- D. \$25,100

62. A taxpayer is a U.S. citizen living and working in France for all of the year. She received wages of \$150,000, dividends of \$10,000 and alimony of \$20,000. She decides to use the foreign earned income exclusion available to her and file Form 2555. What is the amount of foreign earned income before any limitations are applied?

- A. \$0
- B. \$80,000
- C. \$150,000
- D. \$180,000

ANSWER: D

A U.S. citizen with income from sources outside the United States (foreign income), must report all such income on her tax return unless it is exempt by U.S. law. This is true whether the taxpayer reside inside or outside the United States and whether or not the taxpayer received a Form W-2 or 1099 from the foreign payer. This applies to earned income (such as wages and tips) as well as unearned income (such as interest, dividends, capital gains, pensions, rents and royalties).

ANSWER: C

To claim the foreign earned income exclusion, the foreign housing exclusion, or the foreign housing deduction, a taxpayer must satisfy all three of the following requirements.

1. Tax home must be in a foreign country.
2. Must have foreign earned income.
3. Must be either:
 - a. A U.S. citizen who is a bona fide resident of a foreign country or countries for an uninterrupted period that includes an entire tax year,
 - b. A U.S. resident alien who is a citizen or national of a country with which the United States has an income tax treaty in effect and who is a bona fide resident of a foreign country or countries for an uninterrupted period that includes an entire tax year, or
 - c. A U.S. citizen or a U.S. resident alien who is physically present in a foreign country or countries for at least 330 full days during any period of 12 consecutive months.

Foreign earned income is pay for personal services performed, such as wages, salaries, or professional fees received for services perform during a period in which both of the following requirements are met.

1. Tax home is in a foreign country.
2. Either the bona fide residence test or the physical presence test is met.

Unearned income such as interest, dividends, alimony, etc., do not qualify for the exclusion.

63. To claim the foreign earned income exclusion a taxpayer must meet all of the following requirements EXCEPT:

- A. The taxpayer must have foreign earned income.
- B. The taxpayer's tax home must be in a foreign country.
- C. The taxpayer must be physically present in a foreign country for more than 6 months in the tax year.
- D. The taxpayer must be physically present in a foreign country for at least 330 full days during any period of 12 consecutive months.

ANSWER: C

Refer to the analysis on the previous question.

64. Which form is used to claim the foreign earned income exclusion?

- A. Form 673
- B. Form 2550
- C. Form 2555
- D. Form 1040NR

ANSWER: C

A taxpayer must file Form 2555 to claim the foreign earned income exclusion.

65. What is the maximum amount of the foreign earned income exclusion?

- A. \$95,000
- B. \$97,600
- C. \$105,100
- D. \$112,000

ANSWER: D

The maximum foreign earned income exclusion is now adjusted annually for inflation. For 2022, the maximum exclusion has increased to \$112,000.

66. Which of the following income qualifies for the foreign earned income exclusion?

- A. Salaries & wages
- B. Dividends & interest
- C. Pensions
- D. All of the above.

ANSWER: A

Foreign earned income is pay for personal services, such as wages, salaries, or professional fees performed while working in a foreign country.

67. U.S. payers of income other than wages, such as dividends and royalties, are required to withhold tax on nonwage income paid to nonresident aliens at a flat tax rate of

- A. 25%
- B. 28%
- C. 30%
- D. 31%

ANSWER: C

U.S. payers of income other than wages, such as dividends and royalties, are required to withhold tax on nonwage income paid to nonresident aliens at a flat tax rate of **30%**.

Other Income

Canceled Debts

68. A cash basis taxpayer had a \$5,000 loan from his local credit union. He lost his job and was unable to make the payments on this loan. The credit union canceled the \$3,000 remaining amount due on the loan. The taxpayer did not file bankruptcy nor was he insolvent. How much is included in his income as a result of this occurrence?

- A. \$5,000
- B. \$3,000
- C. \$0
- D. \$8,000

69. A taxpayer owns a business and reports her income and expenses as a sole proprietor on a Schedule C. One of the financial institutions that she borrowed money from in order to start her business cancels her debt. She had a balance due of \$5,000 when the debt was canceled. Which of the following statements is true?

- A. She does not have to report the forgiveness of the debt as income.
- B. She must report the \$5,000 debt cancellation as other income on Schedule 1 (Form 1040 or 1040-SR).
- C. She has to report the \$5,000 debt cancellation as income on her Schedule C.
- D. She has to report the relief of debt of \$5,000 as a long-term gain on Schedule D.

70. How is a discount received for the early payment of a mortgage loan treated?

- A. No actions or reporting required.
- B. Treat the discount amount as canceled debt and report as other income on Schedule 1 (Form 1040 or 1040-SR).
- C. Reduce a home mortgage interest deduction by the amount of the discount.
- D. Report the discount amount as interest income.

ANSWER: B

Do not include a canceled debt in gross income in the following situations:

- The debt is canceled in a bankruptcy case under title 11 of the U.S. Code.
- The debt is canceled when the taxpayer is insolvent. However, the taxpayer cannot exclude any amount of canceled debt that is more than the amount by which the taxpayer is insolvent.
- The debt is qualified farm debt and is canceled by a qualified person.
- The debt is qualified real property business debt.
- The cancellation is intended as a gift.
- The debt is qualified principal residence indebtedness.

ANSWER: C

If the debt is a nonbusiness debt, report the canceled amount as other income on Schedule 1 (Form 1040 or 1040-SR). If the debt is a business debt, report the canceled amount on Schedule C.

ANSWER: B

A discount received for the early payment of a mortgage loan is treated as canceled debt. Canceled debt is reported as other income on Schedule 1 (Form 1040 or 1040-SR).

71. H, a cash basis taxpayer, owned and operated a business. He began having difficulty paying his business debts. H owed Y, his computer consultant, \$2,200 for services rendered at his business and \$500 for non-business services rendered at his home. Y forgave the entire debt of \$2,700. H is neither bankrupt nor insolvent. What amount will H be required to include in income on his tax return?

- A. \$0
- B. \$2,200
- C. \$500
- D. \$2,700

72. All of the following canceled debt can be excluded from income EXCEPT:

- A. A student loan if the taxpayer works for a certain period of time in certain professions.
- B. A canceled debt if the payment of the debt would be deductible to a cash method taxpayer.
- C. A qualified principal residence indebtedness up to \$2,000,000.
- D. A canceled debt that is more than the amount by which the taxpayer is insolvent.

ANSWER: C

Canceled debt, other than as a gift or because of bankruptcy, must be included in income. However, do not include canceled debt in income if the payment of the debt would be deductible. In this question, the \$2,200 computer consultation for business would have been a business deduction if paid. Therefore, it is not included in income.

ANSWER: D

Do not include a canceled debt in gross income in the following situations:

- The debt is canceled in a bankruptcy case under title 11 of the U.S. Code.
- The debt is canceled when the taxpayer is insolvent. However, the taxpayer cannot exclude any amount of canceled debt that is more than the amount by which the taxpayer is insolvent.
- The debt is qualified farm debt and is canceled by a qualified person.
- The debt is qualified real property business debt.
- The cancellation is intended as a gift.
- The debt is qualified principal residence indebtedness (up to \$2 million).

Certain student loans contain a provision that all or part of the debt incurred to attend the qualified educational institution will be canceled if the taxpayer works for a certain period of time in certain professions for any of a broad class of employers.

A taxpayer does not have income from the cancellation of a debt if the payment of the debt would be deductible. This exception applies only if the taxpayer uses the cash method of accounting.

Bartering

73. In September 2022, a self-employed lawyer performed legal services for a client that has a men's clothing store. In payment for his services, the lawyer received store credit of \$3,500 in 2022. The lawyer uses \$1,500 of his store credit in 2022 and the balance in 2023. How should the lawyer report the income?

- | | <u>2022</u> | <u>2023</u> |
|----|-------------------|-------------|
| A. | \$3,500 | \$0 |
| B. | \$1,500 | \$2,000 |
| C. | \$0 | \$3,500 |
| D. | None of the above | |

74. A sole proprietor, had the following transactions:

Received rental income. \$7,500
 Performed legal services for ATI Corporation in return for 10 shares of stock . . . \$24,000
 Recovered accounts receivable that had been written off and deducted in 2020 (did not reduce tax). \$20,000

What amount must be included in gross income?

- A. \$44,000
 B. \$27,500
 C. \$31,500
 D. \$51,500

ANSWER: A

A taxpayer must include in income the fair market value of property or services received in bartering. The taxpayer must include in income the value of the store credit in the year received.

ANSWER: C

Rental income and barter income (shares of stock) are included in gross income. The taxpayer had written off the accounts receivable as a business bad debt in 2020. Recovery of a bad debt that was previously deducted is considered income in the year of recovery. However, the taxpayer can exclude from income the recovered amount deducted for bad debt if the deduction did not reduce the taxpayer's taxes in the year deducted.

Gross income:	
Rental income.....	\$ 7,500
Barter Income	
(legal services performed).....	<u>24,000</u>
Gross income.....	<u>\$31,500</u>

Partnership Income

75. Q and R are equal partners in the Q&R Partnership. Q receives a guaranteed payment of \$5,000. The partnership had distributive net income (after deducting the guaranteed payment of \$5,000) of \$80,000. What amounts are earned income subject to self-employment tax?

- A. Q: \$37,500; R: \$37,500
 B. Q: \$42,500; R: \$42,500
 C. Q: \$40,000; R: \$40,000
 D. Q: \$45,000; R: \$40,000

ANSWER: D

General partners of a partnership are subject to self-employment tax on partnership earning from the partnership. Limited partners are not subject to self-employment on partnership earning. Both general partners and limited partners are subject to self-employment on guaranteed payments.

Court Awards and Damages

76. A taxpayer received disability income of \$6,000. All premiums on the health and accident policy were paid by his employer and included in his income. In addition, he received compensatory damages of \$10,000 as a result of inadvertent poisoning at a local restaurant. He received no other income this year. How much income must be included on his tax return?

- A. \$16,000
- B. \$10,000
- C. \$6,000
- D. \$0

ANSWER: D

In determining if the amount received in a court settlement or judgment is included in income, consider the item that the settlement replaces. Include the following in income:

1. Interest on any award.
2. Compensation for lost wages or loss profits in most cases.
3. Punitive damages including amounts received as punitive damages for physical injury or physical sickness.
4. Amounts received in settlement of pension rights (if taxpayer did not contribute to the plan).
5. Damages for:
 - a. Patent or copyrights infringement,
 - b. Breach of contract, or
 - c. Interference with business operations
6. Back pay and damages for emotional distress received to satisfy a claim under Title VII of the Civil Rights Act of 1964.
7. Attorney fees and court costs (including contingent fees) where the underlying recovery is included in income.
8. Attorney fees and costs relating to whistleblower awards where the underlying recovery is included in gross income.

The following compensatory damages are not included in income:

1. Personal physical injury or physical sickness (whether received in a lump sum or installments).
2. Emotional distress due to physical injury or sickness.

If the taxpayer pays the entire cost of a health or accident insurance plan, any amounts received from the plan for personal injury or sickness is not included in income. In this case, the premiums were paid by the employer but were included in the taxpayer's income. Therefore, the taxpayer paid the premiums and the benefits are not taxable.

Scholarships and Fellowships

77. A college student working on a degree in accounting received the following:

- A \$4,000 scholarship used for tuition at State University
- A \$1,000 scholarship used for fees and books
- An \$8,000 fellowship used for room and board

Compute the amount that must be include in income.

- A. \$8,000
- B. \$5,000
- C. \$13,000
- D. \$9,000

78. A degree candidate had education- related expenses and received financial assistance as follows:

- Tuition: \$3,000
- School fees: \$300
- Books and supplies: \$900
- Room and board: \$3,500
- Academic scholarship: \$2,500
- VA subsistence payments: \$1,000
- Scholarship from a civic organization: \$2,500

How much income must be report as income?

- A. \$5,000
- B. \$0
- C. \$4,200
- D. \$800

79. A taxpayer received a scholarship consisting of \$6,000 for tuition, \$1,500 for fees, \$500 for books, \$800 for required equipment, and \$6,000 for room and board. The taxpayer is not a degree candidate. Which of the following amounts should be include in taxable income?

- A. \$6,000
- B. \$14,800
- C. \$0
- D. \$6,800

ANSWER: A

A candidate for a degree can exclude amounts received as a qualified scholarship or grant. A qualified scholarship or grant is any amount received for:

1. Tuition and fees to enroll at or attend an educational organization, or
2. Fees, books, supplies, and equipment required for courses at the educational institution.

The money received for tuition, books, supplies, and fees must be spent on those expenses to be excluded. Amounts used for room and board do not qualify for the exclusion.

ANSWER: D

The money received for tuition, books, supplies, and fees must be spent on those expenses to be excluded. Amounts used for room and board do not qualify for the exclusion. Allowances paid by the Department of Veterans Affairs (VA) are not considered scholarship or fellowship grants and are not included in gross income.

Scholarships amount (\$2,500 + \$2,500)....	\$5,000
Less: Tuition.....	3,000
School fees.....	300
Books and supplies.....	900
Scholarships amount included in income...	<u>\$ 800</u>

ANSWER: B

A scholarship or fellowship is tax free only if:

1. The taxpayer is a candidate for a degree at an eligible education institution, and
2. The taxpayer used the scholarship or fellowship to pay qualified education expenses.

Chapter 3. Gains and Losses

Basis of Property

Purchase of Property

1. A married couple purchased a house to use as rental property. They paid the following amounts: \$100,000 cash, assumption of an existing \$25,000 mortgage, title search \$500, recording fees of \$100, points for their new loan of \$1,000, and the seller's part of the property taxes of \$1,500. The seller did not reimburse them for the property taxes. What is their cost basis in the house?

- A. \$100,000
- B. \$125,000
- C. \$127,100
- D. \$128,100

2. A taxpayer purchases rental property for \$160,000. She uses \$25,000 cash and obtains a mortgage for \$135,000. She pays closing costs of \$10,000, which includes \$5,000 in points on the mortgage and \$5,000 for and title costs. Her initial basis in the property is

- A. \$35,000
- B. \$170,000
- C. \$165,000
- D. \$160,000

ANSWER: C

If the asset purchased is real estate the following settlement costs are included in the basis of the property:

- 1. Abstract fees.
- 2. Charges for installing utility services.
- 3. Legal fees (including title search and preparing the sales contract and deed).
- 4. Recording fees.
- 5. Survey costs.
- 6. Transfer taxes.
- 7. Title insurance.
- 8. Any amounts the seller owes but which the buyer agrees to pay, such as back taxes or interest, recording or mortgage fees, charges for improvements or repairs, and sales commissions.

Include the assumption of the existing mortgage in the basis of the property. Points paid on the new loan are an interest expense deduction and are not added to the basis.

Cost basis in the house:	
Cash paid.....	\$100,000
Assumption of mortgage.....	25,000
Title search.....	500
Recording fees.....	100
Seller's part of property tax.....	1,500
Cost basis in house.....	<u>\$127,100</u>

ANSWER: C

Points paid on the new loan are an interest expense deduction and are not added to the basis. Generally, deduct the points over the term of the loan.

Adjusted basis of the rental property:	
Cost of property.....	\$160,000
Bank fees.....	5,000
Adjusted basis of the building.....	<u>\$165,000</u>

Chapter 3. Gains and Losses

3. A taxpayer purchased a house on an acre of land and paid the following amounts:

- \$100,000 mortgage
- \$2,000 in points to the bank
- \$1,000 in real estate taxes owed by the seller
- \$1,000 in closing costs to the bank for legal, recording, title insurance and survey fees
- \$1,000 in escrowed Real Estate taxes to the bank

What is the basis in the house and land purchased?

- A. \$100,000
- B. \$102,000
- C. \$104,000
- D. \$106,000

ANSWER: B

The following are some settlement fees and closing costs that cannot be included in the basis of the property being purchased.

1. Fire insurance premiums.
2. Rent for occupancy of the property before closing.
3. Charges for utilities or other services relating to occupancy of the property before closing.
4. Charges connected with getting a loan, such as:
 - a. Points (discount points, loan origination fees).
 - b. Mortgage insurance premiums.
 - c. Loan assumption fees.
 - d. Cost of a credit report.
 - e. Fees for an appraisal required by a lender.
5. Fees for refinancing a mortgage.

If these costs relate to business property, items (1) through (3) are deductible as business expenses. Items (4) and (5) must be capitalized as costs of getting a loan and can be deducted over the period of the loan. Escrowed real estate taxes would be a deduction when they are paid to the governing tax authority by the bank.

Basis in the property:

Cost of home.....	\$100,000
Real estate taxes owed by the seller...	1,000
Closing costs.....	<u>1,000</u>
Basis in the property.....	<u>\$102,000</u>

4. A taxpayer purchased a home for \$200,000 and incurred the following additional expenses:

- \$200 fire insurance premiums
- \$500 mortgage insurance premiums
- \$400 recording fees
- \$250 owner's title insurance

Compute the basis in the property.

- A. \$201,350
- B. \$200,000
- C. \$200,650
- D. \$201,150

ANSWER: C

Refer to the analysis on the previous question.

Basis in the property:

Cost of home.....	\$200,000
Recording fees.....	400
Owner's title insurance.....	<u>250</u>
Basis in the property.....	<u>\$200,650</u>

5. A taxpayer purchased a rental property for \$100,000. The taxpayer gave \$25,000 as a cash down payment and financed \$75,000. Closing costs were \$4,000 and points were \$4,000. What is his basis in the property?

- A. \$33,000
- B. \$108,000
- C. \$104,000
- D. \$100,000

ANSWER: C

Points paid to obtain a loan are deductible as interest unless they must be amortized over the life of the loan. Do not add the points to the basis of the property.

Basis in the rental property:

Cash.....	\$ 25,000
Mortgage.....	75,000
Closing costs.....	4,000
Basis in the rental property.....	<u>\$104,000</u>

6. Cost basis of property includes all of the following EXCEPT:

- A. Certain settlement fees and other costs.
- B. Sales taxes charged on the purchase.
- C. Real estate taxes paid for seller without reimbursement.
- D. Loan assumption fees.

ANSWER: D

The basis of property purchased is its cost. The cost is the amount paid in cash or in other property or debt obligations. The cost also included amounts paid for:

1. Sales tax.
2. Freight.
3. Installation and test.
4. Excise taxes.
5. Legal fees (when required to be capitalized).
6. Revenue stamps.
7. Recording Fees.
8. Real estate taxes (if assumed for the seller).

Include settlement fees and closing costs that are for buying the property. Loan assumption fees must be capitalized as costs of getting a loan and can be deducted over the period of the loan.

7. The cost basis of rental property includes all of the following EXCEPT:

- A. Fees paid to the settlement attorney
- B. Recording fees and transfer taxes
- C. Real estate taxes owed by the seller paid by the buyer
- D. Mortgage insurance premiums

ANSWER: D

If the asset purchased is real estate the following settlement costs are included in the basis of the property:

1. Abstract fees.
2. Charges for installing utility services.
3. Legal fees (including title search and preparing the sales contract and deed).
4. Recording fees.
5. Survey costs.
6. Transfer taxes.
7. Title insurance.
8. Any amounts the seller owes but which the buyer agrees to pay, such as back taxes or interest, recording or mortgage fees, charges for improvements or repairs, and sales commissions.

Chapter 3. Gains and Losses

8. A sole proprietor owned a car which he used in his business for the past two years. Its adjusted basis was \$13,500. He sells his car to a dealer for \$14,500. He then buys a new car for \$20,500 from the same dealer. What is the basis in the new car?

- A. \$13,500
- B. \$14,500
- C. \$19,500
- D. \$20,500

ANSWER: C

When a taxpayer sells an old car used in business, and buys a new one at the same dealer, it is considered a like-kind exchange. No gain or loss is recognized. The basis in the new car is the basis in the old car increase by any money paid. In this question, the taxpayer paid an additional \$6,000 (\$20,500 - \$14,500 paid for old car). His basis in the new car will be the basis of the old car (\$13,500) plus the additional money paid (\$6,000).

Property Received by Gift

9. A taxpayer received two acres of land valued at \$10,000 as a gift. The donor's adjusted basis was \$12,000. The taxpayer subsequently sold the land for \$20,000. For purposes of computing his gain, what is the basis in the land?

- A. \$12,000
- B. \$10,000
- C. \$ 8,000
- D. \$ 2,000

ANSWER: A

If the FMV of the property received as a gift was less than the donor's adjusted basis, the donee's basis for figuring the **gain** on its sale or other disposition is the same as the **donor's adjusted basis**. The donee's basis for figuring the loss on the sale or other disposition is its FMV at the time the gift is received.

10. A father gave his son a rental house. The donor's adjusted basis was \$71,000. The fair market value of the rental house on the day of transfer was \$90,000. If the son sells the house at a gain, his basis in the property will be

- A. \$90,000
- B. \$80,000
- C. \$71,000
- D. \$81,000

ANSWER: C

If the FMV of the property is equal to or greater than the donor's adjusted basis, the basis is the donor's adjusted basis at the time the donee received the gift. Increase the basis by all or part of any gift tax paid, depending on the date of the gift.

11. A taxpayer received a gift of 200 shares of mutual funds stock. The stock was worth \$20,000 when the donee received it. The donor had originally paid \$10,000 for the stock. The taxpayer sold the stock for \$15,000. What is the basis in the stock, disregarding gift tax?

- A. \$0
- B. \$20,000
- C. \$10,000
- D. \$15,000

ANSWER: C

If the FMV of property received by gift is equal to or more than the donor's adjusted basis, then donee's basis is donor's adjusted basis plus part of the gift tax paid on it that is due to the net increase in value of the gift.

12. A taxpayer gave her sister a rental house. The taxpayer had purchased the property for \$60,000 and has taken \$17,000 in depreciation. Just before the transfer she also paid \$5,000 for a room addition. Gift tax of \$18,200, attributed to the increased value, was paid. The fair market value of the rental house on the day of transfer was \$90,000. The sister's basis in the property will be

- A. \$90,000
- B. \$60,000
- C. \$66,200
- D. \$42,000

13. A father deeded his son 400 acres of land. The fair market value (FMV) on the date of the transfer was \$350,000. The father had paid \$40,000 for the land. No gift tax was paid on the transfer. When the father died six months later, the fair market value of the land was \$400,000. What is the son's basis in the 400 acres?

- A. \$400,000
- B. \$350,000
- C. \$40,000
- D. \$260,000

14. A father gave his daughter a residential house. He had purchased the house for \$250,000. The fair market value on the date of the gift was \$300,000. The father had added a \$25,000 roof the year before he gave it to his daughter. The daughter converts the house to a residential rental property within one year of the gift. The daughter's basis in the property is

- A. \$300,000
- B. \$250,000
- C. \$225,000
- D. \$275,000

15. Which of the following is the depreciable basis in rental property that is placed in service after receiving it as a gift, if the donor's basis was more than the fair market value of the property?

- A. The fair market value on the date of the gift, plus or minus any required adjustments to basis.
- B. The fair market value of the property on the date it is converted to a rental property.
- C. The donor's basis of the property plus or minus any required adjustments to basis.
- D. All of the above.

ANSWER: C

If the FMV of the property was equal to or greater than the donor's adjusted basis, the donee's basis is the same as the donor's adjusted basis plus all or part of any gift tax paid.

Basis in property:

Gift tax attributed to increased value...	18,200
Adjusted basis of property to donor.....	48,000
Donee's basis in the property.....	<u>\$66,200</u>

ANSWER: C

The transfer of the property was by gift and not by inheritance. If the FMV of the property was equal to or greater than the donor's adjusted basis, the donee's basis is the same as the donor's adjusted basis plus all or part of any gift tax paid, depending on the date of the gift.

ANSWER: D

If the FMV of the property was equal to or greater than the donor's adjusted basis, the donee's basis is the same as the donor's adjusted basis plus all or part of any gift tax paid, depending on the date of the gift.

Donee's adjusted basis:

Donor's purchase price of house.....	\$250,000
Roof.....	<u>25,000</u>
Donee's adjusted basis.....	<u>\$275,000</u>

ANSWER: C

The depreciable basis in rental property that is placed in service after receiving it as a gift, if the donor's basis was more than the fair market value of the property is the donor's basis in the property plus or minus any required adjustments to basis

Inherited Property

16. The basis in property inherited from a decedent is generally one of the following EXCEPT:

- A. The FMV of the property at the date of the individual's death.
- B. The FMV on the alternate valuation date, if the personal representative for the estate chooses to use alternate valuation.
- C. The decedent's adjusted basis in land to the extent of the value that is excluded from the decedent's taxable estate as a qualified conservation easement.
- D. The decedent's adjusted basis.

17. A taxpayer died and left his daughter a commercial rental property. He purchased the property for \$150,000 and had taken \$45,000 in depreciation. The fair market value (FMV) on his death was \$200,000. Six months after his death, the property was re-titled into the daughter's name by the estate's representative. There was no alternative valuation done on the transfer. The FMV on that day was \$210,000. The daughter's basis in the property is

- A. \$210,000
- B. \$200,000
- C. \$150,000
- D. \$125,000

ANSWER: D

The basis in property inherited from a decedent is generally one of the following:

- 1. The FMV of the property at the date of the individual's death.
- 2. The FMV on the alternate valuation date if the personal representative for the estate chooses to use alternate valuation.
- 3. The value under the special-use valuation method for real property used in farming or a closely held business if chosen for estate tax purposes.
- 4. The decedent's adjusted basis in land to the extent of the value excluded from the decedent's taxable estate as a qualified conservation easement.

The estate qualified for, and the executor elected, the alternate valuation method. Under the alternate valuation method property in the estate is valued according to the following rules:

- 1. Any property sold or disposed of within 6 months after the decedent's death is valued as of the date on which it is first disposed of.
- 2. Any property not sold or disposed of within 6 months after decedent's death is valued as of 6 months after the date of the decedent's death.

ANSWER: B

Basis of inherited property is either:

- 1. FMV at the date of the decedent's death, or
- 2. FMV at the alternate valuation date, if the estate elects to use alternate valuation.

18. On June 1, 2021, a taxpayer gave his father a property which had an adjusted basis of \$150,000 and a fair market value of \$200,000. On January 20, 2022, the father died and left the property to the taxpayer. The property had a fair market value of \$225,000 on January 20, 2022. What is the taxpayer's basis in the property?

- A. \$0
- B. \$150,000
- C. \$200,000
- D. \$225,000

19. Taxpayer C and Taxpayer D owned, as joint tenants with right of survivorship, business property that they purchased for \$40,000. C furnished one fourth of the purchase price and D furnished three fourths of the purchase price. Depreciation deductions allowed before D's death were \$8,000. Under local law, each had a one-half interest in the income from the property. At the time of D's death, the fair market value of the property was \$80,000, three fourths of which is includable in D's estate. What is C's basis in the property at the date of D's death?

- A. \$80,000
- B. \$60,000
- C. \$66,000
- D. \$56,000

Property Received for Services

20. A taxpayer received a parcel of land from her employer as payment for her services. The employer's basis in the land was \$6,000 and the land had a FMV of \$10,000. The taxpayer's basis in the land is

- A. \$0
- B. \$6,000
- C. \$10,000
- D. \$4,000

ANSWER: B

If a taxpayer gave an appreciated property to the decedent within 1 year before the decedent's death, the taxpayer's basis in this property is the same as the decedent's adjusted basis in the property immediately before his or her death, rather than the FMV of the property. Appreciated property is any property whose FMV on the day it was given to the decedent is more than its adjusted basis.

ANSWER: C

When a property is held by two or more persons under a joint tenancy with the right of survivorship, the surviving tenant inherits the deceased tenant's interest in the property at death. The surviving tenant's basis in the property is increased by the fair market value of the deceased tenant's interest in the property at date of death. Since under local law, each owner owned one half interest in the income from the property, the depreciation expense is split evenly between the two owners.

C's basis in the property at the date of death:
Interest C bought

(¼ of \$40,000 cost).....\$10,000

Interest C received on D's death

(¾ of \$80,000 FMV)..... 60,000

Total interest before depreciation..... 70,000

Less: Depreciation before D's death

(½ of \$8,000)..... 4,000

C's basis at the date of death..... \$66,000

ANSWER: C

The FMV of property received by an individual for services must be included in income in the year received. The amount the individual includes in income is his or her basis in the property.

Chapter 3. Gains and Losses

21. Taxpayer R, an electrician, needed a new service van. He was a frequent customer of Al's Grill. Al wanted to remodel his kitchen. Al offered to sell his catering van with a fair market value of \$10,000, to R for \$8,000 and pay \$1,000 cash in return for R's rewiring his kitchen. If R agrees to do the work under these terms, what will be his basis in the van received?

- A. \$10,000
- B. \$11,000
- C. \$8,000
- D. \$9,000

22. Ms. M set up a computer system for Mr. T's business. In return, Mr. T gave Ms. M a storage facility. Ms. M plans to use this facility for business purposes and plans to depreciate it. The fair market value of Ms. M's services and the storage facility was \$50,000. Mr. T's basis in the storage facility was \$30,000. How should Ms. M treat the transaction and what is her depreciable basis for the property?

- A. Ms. M should include \$50,000 in income and use \$30,000 as the depreciable basis for the storage facility she received.
- B. Mr. T should include \$30,000 in his income and use \$50,000 as the depreciable basis for the storage facility.
- C. Ms. M should include \$30,000 in income and use \$50,000 as the depreciable basis for the storage facility.
- D. Ms. M should include \$50,000 in income and use \$50,000 as the basis for the storage facility.

ANSWER: A

If, as compensation for services, a taxpayer purchases goods or property for less than FMV, the difference between the purchase price and the property's FMV must be included in income. In this question, the taxpayer's basis in the van is the amount he paid for the van (\$8,000), plus cash paid (\$1,000), plus the difference between the purchase price and the van's FMV that must be included in income (\$1,000) for a total of \$10,000.

ANSWER: D

The FMV of property received by an individual for services must be included in income in the year received. The amount the individual includes in income is his or her basis in the property. If the service were performed for a price agreed on beforehand, that price will be accepted as the FMV of the property.

Stock Dividends, Rights and Splits

23. A taxpayer purchased two shares of common stocks in a company. He paid \$90 for one share and paid \$110 for the next share. Later in the year, the company declared a 2 for 1 common stock split. His new basis in the stock shares is

- A. Average of the 4 shares at \$50 a share.
- B. Two shares at \$90 a share and two shares at \$110 a share.
- C. Four shares at \$200 a share.
- D. Two shares at \$45 a share and two shares at \$55 a share.

ANSWER: D

Stock splits are not taxable; however, the basis in the stock is adjusted to reflect more stock.

Basis before 2 for 1 stock split:

1 sh = \$90

1 sh = \$110

Basis after 2 for 1 stock split:

\$90 ÷ 2 shares = \$45 a share

\$110 ÷ 2 shares = \$55 a share

24. Ms. J purchased 300 shares of stock five years ago, for \$20 a share. The directors voted a 3 for 2 stock split. After the split, Ms. J had 450 shares. What is Ms. J's basis per share after the split?

- A. \$60.00
- B. \$20.00
- C. \$13.33
- D. \$5.00

25. A taxpayer purchased 10 shares of ABC Corporation common stock for \$100 per share. She purchased an additional 10 shares of ABC Corporation common stock for \$200 per share. At the end of the year, ABC Corporation declared a 2 for 1 common stock split. What is her total basis in her ABC Corporation common stock?

- A. \$3,000
- B. \$4,000
- C. \$5,000
- D. \$6,000

26. A taxpayer bought 200 shares of stock at \$9 per share for a total cost of \$1,800. Later in the year, he bought an additional 300 shares at \$12 per share for a total of \$3,600. At the end of the year, the stock split 3 for 1. What is the basis per share in the stock after the split?

- A. 200 shares at \$9 and 300 shares at \$12.
- B. 600 shares at \$3 and 900 shares at \$4.
- C. 200 shares at \$3 and 300 shares at \$4.
- D. 600 shares at \$9 and 900 shares at \$12.

27. A taxpayer purchased one share of common stock in a computer company for \$90. Shortly after he purchased it, the corporation distributed two new shares of common stock for each share held. What is his basis for each of the three shares of common stock?

- A. \$90
- B. \$180
- C. \$30
- D. \$0

ANSWER: C

Stock splits are not taxable; however, the basis in the stock is adjusted to reflect more stock.

Basis before 3 for 2 stock split:

$$300 \text{ shs} \times \$20 = \$6,000$$

Basis after 3 for 2 stock split:

$$\$6,000 \div 450 \text{ shares} = \$13.33 \text{ a share}$$

ANSWER: A

A stock split is the distribution by a corporation of its own stock. In a nontaxable stock split, the total basis in stock after a stock split does not increase.

ANSWER: B

Stock splits are not taxable. However, the basis in the stock is adjusted to reflect more stock.

Basis before 3 for 1 stock split:

$$200 \text{ shs} \times \$9 = \$1,800$$

$$300 \text{ shs} \times \$12 = \$3,600$$

Basis after 3 for 1 stock split:

$$\$1,800 \div 600 \text{ shares} = \$3 \text{ a share}$$

$$\$3,600 \div 900 \text{ shares} = \$4 \text{ a share}$$

ANSWER: C

A stock dividend is the distribution by a corporation of its own stock. In a nontaxable stock dividend, the total basis in stock after a stock dividend or stock split does not increase. The basis must be divided by the old stock plus the new stock which results in a lower per share basis.

Basis before stock dividend:

$$\$90 \text{ per share}$$

Basis after stock dividend:

$$\$90 \div 3 \text{ shares} = \$30/\text{share}$$

Chapter 3. Gains and Losses

28. Ms. C purchased 100 shares of preferred stock of ABC Corporation for \$5,000. During the year, she received a stock dividend of 20 additional shares of preferred stock in ABC. On the date of the distribution, the preferred stock had a fair market value of \$40 per share. What is Ms. C's basis in the new stock she received as a result of the stock dividend?

- A. \$1,000
- B. \$833
- C. \$800
- D. \$0

29. Which of the following statements is TRUE?

- A. Stock dividends are distributions made by a corporation of another corporation's stock.
- B. In computing basis for new stock received as a result of a nontaxable dividend, it is immaterial whether the stock received is identical or not to the old stock.
- C. If a stock dividend is taxable, the basis of the old stock does NOT change.
- D. If you receive nontaxable stock rights and allow them to expire, you have a loss equal to the fair market value of the rights.

30. SSB Corporation declared and distributed a stock dividend of 1 share for each 4 shares held by each stockholder. Mr. D had 100 shares and received 25 additional shares. Which of the following is TRUE?

- A. The stock dividend is not taxable, since the stockholder did not receive cash.
- B. The stock dividend is taxable for the fair market value of the shares received on the date of issue.
- C. Mr. D purchased his 100 shares of stock for \$5.00 per share. He must adjust the basis of the 125 shares to \$4.00 a share.
- D. This is non-taxable because it is a return of capital.

ANSWER: C

Distribution of stock dividends and stock rights are taxable if the distribution is on preferred stock. If a taxpayer receives taxable stock dividends or stock rights, their FMV at the time of the distribution is included in income. This amount is the basis in the stock or stock rights received.

$$20 \text{ shares} \times \$40 \text{ per share} = \$800$$

ANSWER: C

A stock dividend is the distribution by a corporation of its own stock. In a nontaxable stock dividend, the total basis in stock after a stock dividend or stock split does not increase. The basis must be divided by the old stock plus the new stock which results in a lower per share basis. If a taxpayer receives nontaxable stock rights and allows them to expire, they have no basis and the taxpayer cannot take a loss for them.

ANSWER: C

If the new stock received as a nontaxable dividend is not identical to the old stock on which it is declared, the adjusted basis of the old stock must be divided between the old stock and the new stock in the ratio of the FMV of each lot of stock to the total FMV of both lots on the date of distribution of the new stock.

31. Ms. K bought stock in the BB Corporation for \$2,000 three years ago. Last year, Ms. K received a return of capital distribution of \$100 as a partial return on her investment. This year, she sold the stock for \$3,000. Her basis in the stock is

- A. \$3,000
- B. \$2,100
- C. \$1,900
- D. \$2,000

ANSWER: C

A return of capital distribution reduces the basis in the stock by the amount of the distribution.

Property Transfers Between Spouses

32. Under the terms of their divorce agreement executed in November, Mr. J transferred stock to his former wife as a property settlement. At the time of the transfer, the stock had a basis to Mr. J of \$50,000 and a fair market value of \$30,000. What is the tax consequence of this transaction to Mr. J and what is the wife's basis in the stock?

	<u>Mr. J's Income</u>	<u>Wife's Basis</u>
A.	\$20,000 loss	\$30,000
B.	\$20,000 gain	\$50,000
C.	\$0 gain or loss	\$30,000
D.	\$0 gain or loss	\$50,000

ANSWER: D

Property settlements in a divorce are not taxable. If the transfer of property is incident to divorce, the adjusted basis to the transferee is the same as the transferor's adjusted basis.

Capital Gains and Losses

Holding Period

33. A taxpayer bought investment property on March 9, 2021 and sold it on March 9, 2022. The property cost \$100,000 and it was sold for \$135,000. What is the character of the gain or loss?

- A. Long term gain of \$35,000
- B. Ordinary income \$135,000
- C. Short term gain of \$35,000
- D. Long term gain of \$135,000

ANSWER: C

If a capital asset is held for 1 year or less, the gain or loss from its disposition is short term. For investment property, the holding period starts the day after the title to the property is received.

Selling price.....	\$135,000
Less: Adjusted basis.....	<u>100,000</u>
Short-term capital gain.....	<u>\$ 35,000</u>

Chapter 3. Gains and Losses

34. Mr. X purchased XYZ Inc. stock in 2020 and sold it in 2022. In 2022, he also traded in a copy machine that he had been using in his business for three years for a new model. On December 15, 2022, he inherited 35 shares of ZZZ Inc. stock. What is the holding period for these properties at the end of the year?

- A. All short term.
- B. XYZ Inc. stock long term, copy machine and ZZZ Inc. stock short term.
- C. XYZ Inc. and ZZZ Inc. stock long term; copy machine short term.
- D. All long term.

35. A taxpayer purchased 100 shares of publicly traded stock January 2, 2022 for \$1,000. He sold all his shares December 31, 2022 for \$1,500. On January 4, 2023, the settlement date, the stocks were actually delivered and payment received in his account. How and when should he report this sale?

- A. \$500 long term capital gain on 2022 return.
- B. \$500 short term capital gain on 2022 return.
- C. \$500 long term capital gain on 2023 return.
- D. \$500 short term capital gain on 2023 return.

36. A taxpayer bought shares in a mutual fund for \$250. She received a capital gain distribution, also known as a capital gain dividend, of \$90 on Form 1099-DIV. How should she report the capital gain dividend on her tax return?

- A. Need not report it.
- B. Reduce the basis on the stock to \$160.
- C. Report \$90 as ordinary income.
- D. Report the \$90 as long-term capital gain.

ANSWER: D

If an investment property is held for **more than 1 year**, the capital gain or loss is long-term. For nontaxable exchanges, the holding period of the new property includes the holding period of the old property, which begins on the day after the old property was acquired. Inherited property is considered to have been held for more than one year even if the property is disposed of within one year after the decedent's death.

ANSWER: B

If an investment property is held for 1 year or less, the capital gain or loss is short-term. For the purchase of stocks and bonds, the holding period begins on the day after the trading date and ends on the trading date the security is sold, not the settlement date.

ANSWER: D

Report a capital gain distribution from a mutual fund as long-term gain regardless of how long the shares in the fund have been owned.

Net Capital Gain Computation

37. Mrs. M trades stock in ABC Company with an adjusted basis of \$7,000 for DEF Company stock with a fair market value of \$10,000. She had no other transactions during the year. What is the amount realized and what is her gain or loss on this transaction?

- A. The amount realized is \$10,000 and the amount of gain is \$3,000.
- B. The amount realized is \$10,000 and the amount of loss is \$3,000.
- C. The amount realized is \$7,000 and the amount of gain is \$4,000.
- D. The amount realized is \$17,000 and the amount of gain is \$3,000.

38. In computing the gain or loss from a sale or trade of property, which statement below best describes the amount realized?

- A. The money actually received.
- B. The fair market value of the property on the transaction date.
- C. Everything received for the property.
- D. The value of any services received.

39. Mr. F purchased 100 shares of K Company common stock for \$100 per share. In June, K Company declared a 2 for 1 common stock split. Mr. F sells 50% of his K Company common stock shares for \$200 per share immediately after he receives his stock split shares. He sells his remaining K Company shares at the end of the year for \$100 per share. What is Mr. F's total gain from the sale of his K Company shares?

- A. \$15,000
- B. \$20,000
- C. \$25,000
- D. \$30,000

ANSWER: A

The exchange of stock is not a qualified nontaxable exchange.

FMV of stock received (realized).....	\$10,000
Less: Adjusted basis of stock traded...	<u>7,000</u>
Taxable gain.....	<u>\$ 3,000</u>

ANSWER: C

The amount realized from a sale or exchange is the total of all money received plus the fair market value of all property or services received. The amount realized also includes any liabilities that were assumed by the buyer and any liabilities to which the property transferred is subject, such as real estate taxes or a mortgage.

The gain or loss realized from a sale or exchange of property is usually a recognized gain or loss for tax purposes. Recognized gains must be included in gross income. Recognized losses are deductible from gross income.

ANSWER: B

Stock splits are nontaxable distributions made by a corporation of its stock. Divide the basis for the old stock between the old and new stock.

Basis in stock before 2 to 1 stock split:

$(100 \text{ shs} \times \$100) = \$10,000$

Basis in stock before 2 to 1 stock split:

$(\$10,000 \div 200 \text{ shares}) = \50 per share

Gain on sale of stock:

Sale of 50% stock (100 shs \times \$200).....	\$20,000
Sale of 50% stock (100 shs \times \$100).....	<u>10,000</u>
Amount realized.....	30,000
Less: Adjusted basis.....	<u>10,000</u>
Capital gain.....	<u>\$20,000</u>

Chapter 3. Gains and Losses

40. Ms. K bought stock for \$475 on March 31. On November 15, she received a non-taxable distribution of \$155 on the 50 shares of stock she owned. She sold the stock for \$300 on December 22. What is her gain or loss on the sale?

- A. \$175 gain
- B. \$175 loss
- C. \$20 gain
- D. \$20 loss

41. On December 31, Mr. J received a capital gain distribution of \$750 from his mutual fund. He owned his mutual fund shares since June 30. How should Mr. J report the capital gain distribution on his tax return?

- A. \$750 short-term capital gain
- B. \$750 long-term capital gain
- C. \$0
- D. \$750 ordinary dividend

42. Mr. M sold a building for \$100,000 cash plus property with a fair market value (FMV) of \$10,000. He had purchased the building for \$85,000. He made \$30,000 worth of improvements and deducted \$25,000 for depreciation. The buyer assumed Mr. M's real estate taxes of \$12,000 and mortgage of \$20,000 on the building. What is the amount realized on the sale of the building?

- A. \$110,000
- B. \$142,000
- C. \$130,000
- D. \$145,500

ANSWER: D

A nontaxable distribution is a return of capital and reduces the basis in the stock.

Sale of stock:

Selling price of stock.....	\$300
Less: Adjusted basis of stock	
(\$475 - \$155 return of capital).....	<u>320</u>
Capital loss.....	<u>\$ 20</u>

ANSWER: B

Capital gain distributions paid on mutual funds are reported as long-term capital gains regardless of how long the shares in the mutual funds are owned.

ANSWER: B

The amount realized from a sale is the total all money received plus the fair market value of all property or services received. The amount received also includes any liabilities that were assumed by the buyer and any liabilities to which the property sold is subject, such as real estate taxes or a mortgage.

Amount realized:

Cash.....	\$100,000
FMV of property received.....	10,000
Real estate taxes assumed by buyer....	12,000
Mortgage assumed by buyer.....	<u>20,000</u>
Amount realized.....	<u>\$142,000</u>

43. A proprietor bought a commercial building several years ago. He made a down payment of \$20,000 in cash and assumed a mortgage for \$100,000. After he paid off the mortgage, he later sold the building for \$180,000. Straight line depreciation taken up to the date of sale was \$18,000. What is the total gain on the sale?

- A. \$78,000
- B. \$80,000
- C. \$60,000
- D. \$160,000

ANSWER: A

If a taxpayer buys a property and assumes (or buys subject to) an existing mortgage on the property, the taxpayer's basis includes the amount paid for the property plus the amount to be paid on the mortgage.

Amount realized:

Cash.....\$180,000

Adjusted basis:

Down payment..... \$20,000

Mortgage assumed..... 100,000

Total..... 120,000

Less: Depreciation..... 18,000

Adjusted basis..... 102,000

Realized gain on sale..... \$ 78,000

44. Mr. Y sold a building for \$100,000 cash plus property with a fair market value (FMV) of \$10,000. He had purchased the building in for \$85,000. He made \$30,000 worth of improvements and deducted \$25,000 for depreciation. The buyer assumed Mr. Y's real estate taxes of \$12,000 and mortgage of \$20,000 on the building. Mr. Y paid selling expenses of \$3,500. What amount of gain should be RECOGNIZED on the sale of the building?

- A. \$16,500
- B. \$36,500
- C. \$52,000
- D. \$48,500

ANSWER: D

The amount realized from the sale is the total of all money received plus the FMV of all property received, any liabilities that were assumed by the buyer such as a mortgage and real estate taxes. The adjusted basis is the original cost of the property plus improvements to the property.

Amount realized:

Cash.....\$100,000

Other property rec'd (FMV).. 10,000

Real estate taxes assumed

by buyer..... 12,000

Mortgage assumed by buyer... 20,000

Total amount realized.....\$142,000

Adjusted basis:

Cost of Building..... 85,000

Improvements..... 30,000

Total..... 115,000

Less: Depreciation..... 25,000

Adjusted basis..... 90,000

Plus: Broker's commissions.. 3,500 93,500

Recognize gain on sale..... \$ 48,500

45. To determine net capital gains/losses for the year:

- A. Net all capital gains, both long-term and short term, together.
- B. Net short-term gains/losses and long-term gains/losses separately, then combine.
- C. Net short-term gains/losses and long-term gains/losses and report only any net gains.
- D. Net all gain transactions together and all loss transactions together, then combine.

ANSWER: B

The totals for short-term capital gains and losses and the totals for long-term capital gains and losses must be figured separately. Do this by adding all short-term capital gains. Then add all short-term capital losses. Subtract one total from the other. The result is net short-term capital gain or loss. Follow the same steps to merge long-term capital gains and losses. Then combine short-term capital gains or losses with long-term capital gains or losses.

Chapter 3. Gains and Losses

46. Mr. L purchased 100 shares of ABC stock on May 31, 2021, for \$100 per share. On October 28, 2021, he sold the 100 shares for \$90 per share. On November 22, 2021, his wife, Mrs. L purchased 100 shares of ABC stock for \$80 per share. Mrs. L held the stock until September 30, 2022. On that date, she sold the stock for \$110 per share. They filed married filing separately on all returns. Which of the following is correct?

- A. Mr. L has a short-term loss of \$1,000 on his 2021 tax return.
- B. Mrs. L has short-term gain of \$3,000 on her 2022 tax return.
- C. Mrs. L will have a short-term gain of \$3,000 on her 2022 tax return and Mr. L takes the short-term loss \$1,000 on his 2021 tax return.
- D. Mrs. L will have a long-term gain of \$2,000 on her 2022 tax return and Mr. L will not have any capital loss on his 2021 tax return.

ANSWER: D

A taxpayer cannot deduct losses from sales or trades of stock or securities in a wash sale. A wash sale occurs when the taxpayer sells or trades stock or securities at a loss and within 30 days before or after the sale the taxpayer:

- 1. Buys substantially identical stock or securities.
- 2. Acquires substantially identical stock or securities in a fully taxable trade, or
- 3. Acquires a contract or option to buy substantially identical stock or securities.

If a taxpayer sells stock and his spouse or a corporation controlled by him buys substantially identical stock, the transaction is a wash sale. If the loss was disallowed because of the wash sales rules, add the disallowed loss to the cost of the new stock. The holding period for substantially identical stock or securities acquired in a wash sale includes the period the old stock was held.

Sale of ABC stock by taxpayer:

Selling price (100 shs × \$90).....	\$ 9,000
Less: Adjusted basis.....	<u>10,000</u>
Disallowed loss on wash sale.....	<u>\$1,000</u>

Sale of ABC stock by spouse:

Selling price (100 shs × \$110).....	\$11,000
Less: Adjusted basis:	
Purchase price (100 shs × \$80).....	8,000
Disallowed loss by husband.....	<u>1,000</u>
Long-term capital gain.....	<u>\$ 2,000</u>

47. A taxpayer files single and had the following capital gains and losses:

- \$500 loss on the sale of stock he purchased on January 14, 2022 and sold on August 10, 2022.
- \$5,000 loss on the sale of stock purchased October 1, 2021 and sold November 1, 2022.
- \$1,000 gain on the sale of a vacant lot held for 5 years.

How should the capital gains and losses be initially reported?

- A. \$4,500 long term loss.
- B. \$4,000 long term loss and \$500 short term loss.
- C. \$4,500 long term loss and \$1,000 short term loss.
- D. \$5,500 long term loss and \$1,000 short term gain.

ANSWER: B

Refer to the analysis on the previous question.

Short-term capital loss.....	(\$ 500)
Long-term capital gain.....	\$1,000
Long-term capital loss.....	<u>(5,000)</u>
Net long-term capital Loss.....	<u>\$ 4,000</u>

48. A taxpayer bought 50 shares of stock for \$500 two years ago. In January, she received a return of capital of \$100. She received an additional return of capital of \$50 in December. What must be report as long-term capital gain on her tax return?

- A. \$150
- B. \$50
- C. \$100
- D. \$0

49. A taxpayer determines that he has both a short-term capital loss of \$2,000 and a nontaxable distribution of \$1,000 from an investment. The following statements are correct EXCEPT:

- A. The basis of the investment is reduced by the non-taxable distribution.
- B. Non-taxable distribution is a return of capital.
- C. The short-term capital loss can be used to offset capital gains (if any) for the year.
- D. Any unused short term capital loss may be carried back three years.

50. A taxpayer bought a motorcycle. He and paid \$500 cash and took over payments when the principal balance was \$5,000. He added accessories that cost \$1,000. Ten years later, a collector paid \$8,000 for the motorcycle. The taxpayer applied the entire \$8,000 to the \$10,000 purchase price of a new cycle. What are the tax consequences of these transactions?

- A. \$0 taxable gains because the cycle was a personal asset
- B. \$2,500 taxable gain
- C. \$1,500 taxable gain
- D. \$1,500 gain is not taxable; basis in new cycle is reduced to \$8,500

ANSWER: D

A return in capital reduces the basis in the stock. It is not taxed until the basis in the stock is reduced to zero. When the basis in the stock has reduced to zero, any additional return of capital is reported as a capital gain.

ANSWER: D

Any unused short term capital loss may be carried forward until it is used up.

ANSWER: C

Property used for personal purposes such as a main home or a vehicle does not qualify for nontaxable exchanges. The sale of the old motorcycle and the purchase of the new one are two separate transactions.

Gain on the sale of the motorcycle:

Selling price.....	\$8,000
Less: Adjusted basis (\$500 + \$5,000 + \$1,000).....	6,500
Taxable gain.....	<u>\$1,500</u>

Chapter 3. Gains and Losses

51. A taxpayer sold two collections. Determine the amount and character of her gains/losses on these sales:

Coin collection she began as a child with a basis of \$1,000, sold for \$5,000.

Collection of original short stories she wrote in 2018, sold for \$20,000.

- A. \$20,000 long-term capital gain.
- B. \$24,000 long-term capital gain.
- C. \$4,000 long-term capital gain and \$20,000 ordinary income.
- D. \$24,000 ordinary income.

ANSWER: C

The sale or trade of a capital asset results in a capital gain or loss. The sale of a noncapital asset results in ordinary income. The sales would be treated as ordinary income. Everything owned is a capital asset except the following:

- 1. Property held for sale to customers or property that will physically become part of merchandise for sale to customers.
- 2. Depreciable property used in trade or business.
- 3. Real property used in trade or business.
- 4. A copyright; a literary, musical, or artistic composition; a letter or memorandum.
- 5. Accounts or notes receivable acquired in the course of a trade or business or for services rendered as an employee.
- 6. U.S. Government publications received free or at a discount.
- 7. Certain commodities derivative financial instruments held by commodities derivatives dealers.
- 8. Hedging transactions, but only if the transaction is clearly identified as a hedging transaction before the close of the day on which it was acquired, originated, or entered into.
- 9. Supplies of a type regularly used or consumed in the ordinary course of a trade or business.

52. Mr. K is a carpenter. He makes half of his income as an employee. He makes the other half of his income from a personal business where he purchases, renovates and then resells houses. In January, Mr. K purchases a house that is not his residence for \$50,000. He spends \$10,000 in materials renovating the house, which he sells in November for \$90,000. What is the amount and character of the gain from this transaction?

- A. \$20,000 ordinary gain
- B. \$30,000 short-term capital gain
- C. \$30,000 ordinary gain
- D. \$20,000 short-term capital gain

ANSWER: C

Refer to the analysis on the previous question. Property held for sale to customers or property that will physically become part of merchandise for sale to customers is not a capital asset. Since the taxpayer business is renovating and reselling house the house is not a capital asset and the gain is ordinary.

Gain on house sold:

Selling price.....	\$90,000
Less: Adjusted basis	
(\$50,000 + \$10,000).....	60,000
Ordinary gain.....	<u><u>\$30,000</u></u>

Sale of Gifted Property

53. A taxpayer received a boat as a gift from his father. At the time of the gift, the boat had a fair market value of \$60,000 and an adjusted basis of \$80,000 to the father. The taxpayer sold the boat for \$75,000. What is the amount and character of the gain?

- A. Ordinary income of \$15,000.
- B. Long-term capital gain of \$15,000.
- C. Long-term capital loss of \$5,000.
- D. Neither a gain nor a loss.

54. Ms. H acquired an acre of land as a gift. At the time of the gift, the acre had a fair market value (FMV) of \$20,000. The donor's adjusted basis in the land was \$15,000. No gift tax was paid on the gift. No events occurred to increase or decrease her basis in the property. Ms. H later sold the acre for \$10,000. What is the gain or loss on the sale?

- A. \$5,000 loss.
- B. \$10,000 loss.
- C. \$10,000 gain
- D. No gain or loss

55. Mrs. W purchased a manuscript in 2019 for \$10. In the year before her death, Mrs. W gave the manuscript to her granddaughter. At the time of the gift, the manuscript had an appraised value of \$510. At the time of Mrs. W death, the manuscript was valued at \$610. The granddaughter sells the manuscript for \$1,010. What is the amount and character of the gain from the sale of this manuscript?

- A. \$1,000 long-term capital gain.
- B. \$1,000 ordinary gain.
- C. \$500 long term-capital gain.
- D. \$400 long-term capital gain.

ANSWER: D

If the FMV of the property received as a gift was less than the donor's adjusted basis, the donee's basis for figuring the gain on its sale or other disposition is the same as the donor's adjusted basis. The donee's basis for figuring the loss on the sale or other disposition is its FMV at the time the gift is received.

Figuring the loss:

Selling price.....	\$75,000
Less: Adjusted basis (FMV).....	<u>60,000</u>
Loss on sale.....	<u>\$ 15,000</u>

Figuring the gain:

Selling price.....	\$75,000
Less: Adj. basis (donor's adj. basis) ..	<u>80,000</u>
Capital gain.....	<u>\$ 15,000</u>

ANSWER: A

If the fair market value of the property is equal to or greater than the donor's adjusted basis, the basis is the donor's adjusted basis at the time the gift was received increased by all or part of any gift tax paid.

Figuring the loss:

Selling price.....	\$10,000
Less: Adjusted basis	
(donor's adj. basis).....	<u>15,000</u>
Loss on sale.....	<u>\$ 5,000</u>

ANSWER: A

If the fair market value of the property is equal to or greater than the donors adjusted basis, the basis is the donor's adjusted basis at the time the gift was received increased by all or part of any gift tax paid.

Figuring the gain:

Selling price.....	\$1,010
Less: Adjusted basis	
(donor's adj. basis).....	<u>10</u>
Long-term capital gain.....	<u>\$ 1,000</u>

Sale of Inherited Property

56. Ms. Q's father purchased 1,000 shares of stock for \$10 per share on December 30, 2021. Ms. Q inherited the 1,000 shares of stock from her father on September 15, 2022. The FMV at the time of the inheritance was \$20 per share. On December 20, 2022, she sold the stock for \$25 per share. What is the amount and character of her gain?

- A. The gain of \$15,000 is short-term capital gain.
- B. The gain of \$15,000 is long-term capital gain.
- C. The gain of \$5,000 is long-term capital gain.
- D. The gain of \$5,000 is short-term capital gain.

57. Mrs. E's brother purchased 100 shares of stock for \$10 per share on December 30, 2021. Mrs. E inherited the stock from her brother on September 15, 2022 when it had a fair market value of \$15 per share. On December 20, 2022, she sold the stock for \$20 per share. What is the amount and character of her gain?

- A. The gain of \$1,000 is short-term capital gain.
- B. The gain of \$1,000 is long-term capital gain.
- C. The gain of \$500 is long-term capital gain.
- D. The gain of \$500 is short-term capital gain.

58. Mr. R collected baseball cards as a hobby. R had shared his interest in this hobby with his niece P, who was now also an avid card collector. At the time of his death, R's collection had a fair market value of \$10,000 and an adjusted basis of \$2,000, while P's collection had a fair market value of \$5,000 and an adjusted basis of \$1,000. Upon his death, R's entire card collection went to P. With the death of her uncle, P lost interest in the hobby and sold all of the cards for \$20,000. What is P's gain on the sale of these baseball cards?

- A. \$5,000
- B. \$9,000
- C. \$13,000
- D. \$17,000

ANSWER: C

The basis in the inherited stock is the FMV at the time of the individual's death. The sale of inherited property is treated as a long-term gain or loss.

Selling price (1,000 shs × \$25).....	\$25,000
Less: Adjusted basis (1,000 shs × \$20)..<	<u>20,000</u>
Long-term capital gain.....	<u>\$ 5,000</u>

ANSWER: C

The basis in the inherited stock is the FMV at the time of the individual's death. Inherited property is considered to have been held for more than one year even if the property is disposed of within one year after the decedent's death.

Selling price (100 shares × \$20).....	\$2,000
Less: Adjusted basis (100 shares × \$15)..<	<u>1,500</u>
Long-term capital gain.....	<u>\$ 500</u>

ANSWER: B

The basis in inherited property is the FMV of the property at the date of the decedent's death.

Figuring the gain:

Selling price.....	\$20,000
Less: Adj. basis (\$10,000 + \$1,000).....	<u>11,000</u>
Capital gain.....	<u>\$ 9,000</u>

Capital Loss Limitations and Carryovers

59. A taxpayer sold securities resulting in a capital loss of \$7,000. The taxable income on his return was \$26,000. What amount of the loss can he carry over to the next year?

- A. \$7,000
- B. \$3,000
- C. \$0
- D. \$4,000

60. A married couple sold stock resulting in a short-term capital loss of \$4,000. Their taxable income was \$10,000. How much of the capital loss is deductible on their joint return and how much must be carried over to the next year?

- A. \$4,000 loss; \$0 carryover.
- B. \$3,000 loss; \$0 carryover.
- C. \$3,000 loss; \$1,000 carryover.
- D. \$0 loss; \$4,000 carryover.

61. Mr. B sold securities for a capital loss of \$7,000. He and his wife decide to file separate returns for the year. His taxable income was \$26,000. What amount of capital loss can he deduct on his tax return and what amount can he carry over to the next year?

- A. \$7,000 this year and \$0 carry over to next year.
- B. \$3,000 this year and \$4,000 carry over to next year.
- C. \$4,000 this year and \$3,000 carry over to next year.
- D. \$1,500 this year and \$5,500 carry over to next year.

ANSWER: D

The yearly limit on the amount of the capital loss that can be deducted is \$3,000. Capital losses in excess to the yearly limit must be carried over to the next year.

Capital loss.....	\$7,000
Allowable capital loss.....	<u>3,000</u>
Capital loss carryover.....	<u>\$4,000</u>

ANSWER: C

Capital loss is limited to \$3,000 per year. Capital losses in excess to the yearly limit must be carried over to the next year.

Capital loss.....	\$4,000
Allowable capital loss.....	<u>3,000</u>
Capital loss carryover.....	<u>\$1,000</u>

ANSWER: D

The yearly limit on the amount of the capital loss that can be deducted is \$1,500 if married and filing a separate return. Any remaining loss must be carried over to the next year.

Nonbusiness Bad Debt

62. When Mr. F loaned \$2,000 to his brother, his brother signed a note and made monthly payments until he was injured in an accident. Mr. F is still owed \$500 and his brother, who is no longer able to work, has declared bankruptcy. Mr. F had also guaranteed his brother's bank loan as a favor to his brother and was required to pay off the \$800 loan balance. Mr. F, a cash method taxpayer, is also owed \$500 rent by a former tenant. How much bad debt deduction can Mr. F take on his tax return?

- A. \$1,800
- B. \$500
- C. \$1,000
- D. \$1,300

63. Nonbusiness bad debts must be deducted as

- A. Ordinary loss on Form 4797.
- B. Long-term capital loss on Schedule D.
- C. Short-term capital loss on Form 8949 and Schedule D.
- D. Investment expense as an itemized deduction.

64. A loss on deposits can occur when a bank, credit union, or other financial institution becomes insolvent or bankrupt. If you incur such a loss, you may be able to deduct it as any one of the following:

- A. Short-term capital loss.
- B. Long-term capital loss.
- C. Ordinary loss.
- D. No deduction.

ANSWER: B

A bad debt must be genuine for a taxpayer to deduct the loss. A debt is genuine if it arises from a debtor-creditor relationship based on a valid and enforceable obligation to repay a fixed and determined sum of money. To deduct a bad debt, the taxpayer must have a basis in it, that is, the taxpayer must have already included the amount in income or loaned out money. To be deductible, nonbusiness bad debts must be totally worthless. Partially worthless nonbusiness bad debts are not deductible. A taxpayer cannot take a bad debt deduction for a loan that he guaranteed that became worthless unless he can show that the reason for making the guarantee was to protect his investment or for some other profit motive.

ANSWER: C

Nonbusiness bad debts must be deducted as short-term capital losses on Form 8949 and Schedule D.

ANSWER: A

A loss on deposits can occur when a bank, credit union, or other financial institution becomes insolvent or bankrupt. If a taxpayer has this type of loss, he or she can choose one of the following ways to deduct the loss.

- As a casualty loss (but only to the extent the loss does not exceed personal casualty gains).
- As a nonbusiness bad debt deducted as a short-term capital loss on Form 8949 and Schedule D.

65. Ms. P loaned money to Ms. S in 2020. Ms. S signed a loan agreement and made the agreed upon monthly payments until May, 2022 when she stopped making payments. Ms. P called Ms. S and wrote her a letter requesting payment but received no response. Then Ms. P read in the newspaper that Ms. S had filed for bankruptcy with no assets. Ms. P can take a deduction for a bad debt

- A. Only on her timely filed 2022 return.
- B. By amending her 2022 return within three years.
- C. By amending her 2020 return.
- D. On her timely filed 2022 return or by amending her 2022 return within seven years.

Section 1244 (Small Business) Stock

66. A husband and wife purchased Section 1244 (Small Business) stock. Which of the following statements is correct?

- A. If they incurred a loss on Section 1244 stock, they can deduct the loss as a capital loss rather than as an ordinary loss.
- B. If the stock becomes worthless, they can claim an ordinary loss limited to \$50,000 individually or \$100,000 together on a joint return, per year.
- C. If the loss is \$60,000 and they do not have any other losses, they can only deduct \$50,000 as ordinary loss on their joint return.
- D. If they incurred a gain on Section 1244 stock, they should treat it as ordinary gain.

67. Mr. F files a joint return with his wife. Mr. F incurred a loss of \$125,000 on the sale of his qualifying small business stock (Sec. 1244). How much of this loss is deductible on their joint return as an ordinary loss?

- A. \$125,000
- B. \$ 3,000
- C. \$100,000
- D. \$ 50,000

ANSWER: D

To be deductible, a nonbusiness bad debt must become totally worthless. In this question, the debt did not become worthless until 2022. If a taxpayer did not deduct a bad debt on his or her original return for the year it becomes worthless, he or she can file an amended return within 7 years from the date the original return had to be filed or 2 years from the date the taxes were paid, whichever is later.

ANSWER: B

An ordinary loss rather than a capital loss can be taken on the sale, trade or worthlessness of small business stock (section 1244 stock). Small business stock is stock in a domestic small business corporation which was issued for money or property. In order to qualify as a small business corporation, the corporation must derive more than 50% of its gross receipts from the active conduct of a trade or business for the five most recent tax years before the loss. This does not include income from rents, royalties, dividends, interest, or annuities and gains from sales and trades of stocks or securities. A single taxpayer can deduct up to \$50,000, and a married taxpayer can deduct up to \$100,000 as ordinary losses. Any amount in excess of these limits is considered a capital loss.

ANSWER: C

Refer to the analysis on the previous question.

Chapter 3. Gains and Losses

68. Qualified small business stock, for purposes of applying rollover and exclusion rules, is stock that meets all the following tests EXCEPT:

- A. Stock in a C corporation.
- B. Originally issued after August 10, 1993.
- C. Acquired by original issue in exchange for money or other property or as pay for services.
- D. Total gross assets of \$100,000,000 or less at all times after August 10, 1993 and before it issued the stock.

69. Generally, if you own stock in a small corporation that meets the requirements of Section 1244 (small business) stock and you sell that stock at a loss, the loss is reported as

- A. Short term loss on Schedule D limited to \$3,000.
- B. Ordinary loss on Form 4797 limited to \$25,000 for a single individual and limited to \$50,000 for those filing a joint return.
- C. Long term loss on Schedule D limited to \$3,000.
- D. Ordinary loss on Form 4797 limited to \$50,000 for a single individual and limited to \$100,000 for those filing a joint return.

ANSWER: D

Qualified small business stock, for purposes of applying rollover and exclusion rules, is stock that meets all the following tests:

1. It must be stock in a C corporation.
2. If the stock was issued before July 19, 1984, the stock must be common stock. If issued after July 18, 1984, the stock may be either common or preferred.
3. As of the date the stock was issued, the corporation must have been a qualified small business (**total gross assets of \$50 million or less**).
4. Acquired by original issue in exchange for money or other property or as pay for services.
5. The corporation must have met the active business test and have been a C corporation during substantially all the time the stock was held.
6. Within the period beginning 2 years before and ending 2 years after the stock was issued, the corporation cannot have bought more than a de minimis amount of its stock from the taxpayer or a related party.
7. Within the period beginning 1 year before and ending 1 year after the stock was issued, the corporation cannot have bought more than a de minimis amount of its stock from anyone, unless the total value of the stock it bought is 5% or less of the total value of all its stock.

ANSWER: D

An ordinary loss rather than a capital loss can be taken on the sale, trade or worthlessness of small business stock (section 1244 stock). A single taxpayer can deduct up to \$50,000, and a married taxpayer can deduct up to \$100,000 as ordinary losses on a joint return. Any amount in excess of these limits is considered a capital loss.

Sale to Related Parties

70. A taxpayer sold a business lot to his son for \$120,000. He received this lot in a tax-deferred exchange in 2020 for a lot that cost him \$175,000 in 2017. The taxpayer will recognize the following:

- A. No gain or loss
- B. An ordinary loss of \$55,000
- C. A long-term gain of \$120,000
- D. A long-term loss of \$175,000

71. Mr. C owns all of the shares of ABC Corporation. He also owns a 60% partnership interest in XYZ, LLC. XYZ sold a building with an adjusted basis of \$100,000 to ABC Corporation for \$80,000. What is the amount of XYZ's deductible loss from this transaction?

- A. \$20,000
- B. \$12,000
- C. \$8,000
- D. \$0

72. Mr. N made the following dispositions of property:

Sold publicly traded stock, which cost \$2,000 and had been held for 2 years, for \$3,000.

Sold land, which cost \$20,000 and had been held for 9 months, to his brother for \$16,000.

How should Mr. N report these dispositions?

- A. \$1,000 long-term capital gain.
- B. \$3,000 long-term capital loss.
- C. \$3,000 short-term capital loss.
- D. \$3,000 ordinary loss.

ANSWER: A

A taxpayer cannot deduct a loss on the sale or trade of property, other than a distribution in complete liquidation of a corporation, if the transaction is directly or indirectly between the taxpayer and the following related parties:

1. Family members, including only brothers, sisters, half-brother, half-sisters, spouse, ancestors (parents, grandparents, etc.), and lineal descendants (children, grandchildren, etc.).
2. A corporation in which the taxpayer directly or indirectly owns more than 50% in value of the outstanding stock.
3. A grantor and fiduciary, and the fiduciary and beneficiary, of any trust.
4. A tax-exempt charitable or educational organization that is controlled directly or indirectly by the taxpayer.
5. A corporation and a partnership if the same person owns more than 50% in the value of the outstanding stock of the corporation and more than 50% of the capital interest or profits interest, in the partnership.

ANSWER: D

Refer to the analysis on the previous question. Losses are not allowed on sales or exchanges between related parties.

ANSWER: A

Losses are not allowed on sales or exchanges between related parties. Family members include brothers, sisters, spouse, ancestors and lineal descendants.

Publicly traded stock:

Selling price.....	\$3,000
Less: Purchase price.....	<u>2,000</u>
Long-term capital gain.....	<u>\$1,000</u>

Chapter 3. Gains and Losses

73. Ms. G paid \$10,000 for stock in a start-up company. A few months after she bought it, she sold the stock to her brother H, for \$8,000, its current value. Later, he sold the stock to an unrelated party for \$15,000. What gain or loss should Ms. G and H recognize on their tax returns in the year of sale?

- A. G recognizes \$2,000 loss; H recognizes \$7,000 gain.
- B. G recognizes \$2,000 loss; H recognizes \$5,000 gain.
- C. G recognizes \$0 loss; H recognizes \$7,000 gain.
- D. G recognizes \$0 loss; H recognizes \$5,000 gain.

74. Mr. M owned 100% of the stock in G Corporation. G Corporation sold a computer with an adjusted basis of \$5,000 and a fair market value of \$8,000 to Mr. M's uncle for \$4,000. What is the amount of G Corporation's deductible loss on the sale of this computer?

- A. \$4,000
- B. \$3,000
- C. \$1,000
- D. \$0

75. Ms. S sold land to her brother for \$6,000. Ms. S's basis in the land was \$7,000. She cannot deduct the \$1,000 loss. The brother sold the same land to an unrelated party for \$5,500, realizing a loss of \$500. What amount of loss can the brother deduct?

- A. \$0
- B. \$500
- C. \$1,500
- D. \$1,000

ANSWER: D

Losses are not allowed on sales or exchanges between related parties. Family members include brothers, sisters, spouse, ancestors and lineal descendants. If property received from a related party is sold or traded at a gain, recognize the gain only to the extent that it is more than the loss previously disallowed to the related party.

Ms. G's transaction with her brother:

Selling price.....	\$ 8,000
Less: Adjusted basis.....	<u>10,000</u>
Disallowed loss.....	<u>\$ 2,000</u>

Brother's transaction with unrelated party:

Selling price.....	\$15,000
Less: Adjusted basis.....	<u>8,000</u>
Realized gain.....	7,000
Less: Previously disallowed loss.....	<u>2,000</u>
Recognized gain.....	<u>\$ 5,000</u>

ANSWER: C

An uncle is **not** a related party so the loss is deductible.

G Corp's transaction with an unrelated party:

Selling price.....	\$4,000
Less: G Corp's adjusted basis.....	<u>5,000</u>
Deductible loss.....	<u>\$1,000</u>

ANSWER: B

If property received from a related party is sold or traded at a gain, recognize the gain only to the extent that it is more than the loss previously disallowed to the related party.

Brother's transaction with an unrelated party:

Selling price.....	\$5,500
Less: Adjusted basis.....	<u>6,000</u>
Deductible loss.....	<u>\$ 500</u>

76. A taxpayer sells stock that he purchased in 2019, to his brother for a \$500 loss. He also sells a truck, purchased in 2020, to ABC Corporation, his 100% owned C corporation, for a profit of \$800, including \$500 of depreciation recapture. What is the effect of these transactions on the taxpayer's tax return?

- A. A loss of \$500 on the stock and no gain on the truck.
- B. A disallowed loss on the stock, \$500 ordinary gain and \$300 long-term capital gain on the truck.
- C. A loss of \$500 on the stock and \$800 ordinary gain on the truck.
- D. A disallowed loss on the stock and \$800 ordinary gain on the truck.

77. Mr. C uses a property in his business. C's sister, Ms. L, has a property she uses in her business. On December 27, 2021, C and L exchanged properties. The fair market value of C's property was \$200,000 with an adjusted basis of \$65,000. The fair market value of L's property was \$215,000 and its adjusted basis was \$70,000. On December 28, 2022, C sold the exchanged property to a third party for \$220,000. What is the amount of gain, if any, that C has to report on his tax return?

- A. \$0
- B. \$130,000
- C. \$135,000
- D. \$150,000

Installment Sales

78. Mr. H sold 100 acres of land. His original cost was \$100,000. He sold the property for \$500,000 cash and the buyer assumed a mortgage of \$200,000. Mr. H had settlement costs of \$50,000. He received a \$150,000 down payment with the balance to be paid over 10 years. His gross profit is

- A. \$400,000
- B. \$550,000
- C. \$600,000
- D. \$700,000

ANSWER: D

Losses are not allowed on sales or exchanges between related parties. Any loss which was not allowed by the related person can be used by the related purchaser upon sale of the asset. If a gain is recognized on the sale or exchange of property to a related person, the gain may be ordinary income even if the property is a capital asset. It is ordinary income if the sale or exchange is a depreciable property transaction or a controlled partnership transaction.

ANSWER: D

Special rules apply to like-kind exchanges between related parties. Under these rules, if either person disposes of the property within 2 years after the exchange, then the exchange is disqualified from nonrecognition treatment. The gain or loss on the original exchange must be recognized as of the date of that later disposition.

Taxpayer's recognized gain:
 FMV of property received.....\$215,000
 Less: Adjusted basis of old property.. 65,000
 Recognized gain.....\$150,000

Also, the sister must report on her 2022 tax return a gain of \$130,000 (\$200,000 - \$70,000).

ANSWER: B

The gross profit is the selling price, less the adjusted basis, expenses of sale and depreciation recapture income. The selling price is the entire cost of the property to the buyer and includes any of the following:

- Any money received.
- The FMV of any property received.
- Any existing mortgage or other debt the buyer pays, assumes, or takes.
- Any selling expenses the buyer pays.

Selling price (\$500,000 + \$200,000)...\$700,000
 Less: Adjusted basis..... 100,000
 Expenses of sale..... 50,000
 Gross profit.....\$550,000

Chapter 3. Gains and Losses

79. A married couple purchased 40 acres of undeveloped land for \$120,000. They paid personal real estate taxes of \$50,000, which they elected to add to the property's basis. They sold the property for \$600,000, having total settlement costs of \$70,000. The settlement costs are allowable as an expense of sale. They received a down payment of \$100,000 with the balance to be paid over 15 years. What is their gross profit percentage?

- A. 60%
- B. 72%
- C. 68.33%
- D. 82%

80. Married taxpayers purchased a vacation home for \$100,000. They sold the property for \$500,000 and received a down payment of \$200,000. They took a mortgage from the purchaser for the remaining \$300,000. What is their gross profit percentage on this sale?

- A. 40%
- B. 60%
- C. 80%
- D. 90%

81. A widow, sold 100 acres of land she and her husband paid \$20,000 for in 2002. He died in 2016. As of the date of his death, the land was valued at \$100,000 for estate tax purposes. The widow sold the land for \$200,000 on an installment basis. What is her gross profit percentage?

- A. 90%
- B. 70%
- C. 50%
- D. 60%

ANSWER: A

The gross profit percentage determines how much of a payment on an installment sale represents nontaxable return on capital and how much represents taxable gain.

In order to calculate the gross profit percentage, start by calculating the gross profit. The gross profit is the selling price, less the adjusted basis, expenses of sale and depreciation recapture income. The selling price is the entire cost of the property to the buyer. After calculating the gross profit, divide that amount by the contract price. The contract price is the total of all principal payments received by the seller on the installment sale.

Selling price.....	\$600,000
Less: Adjusted basis	
(\$120,000 + \$50,000).....	170,000
Expenses of sale.....	70,000
Gross profit.....	<u>\$360,000</u>

Contract price.....	\$600,000
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$$\text{GP}\% = \text{GP} \div \text{CP}$$

$$\text{GP}\% = \$360,000 \div \$600,000 = 60\%$$

ANSWER: C

Selling price.....	\$500,000
Less: Adjusted basis.....	100,000
Gross profit.....	<u>\$400,000</u>

Contract price.....	<u>\$500,000</u>
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$$\text{GP}\% = \text{GP} \div \text{CP}$$

$$\text{GP}\% = \$400,000 \div \$500,000 = 80\%$$

ANSWER: B

The surviving spouse adjusted basis in the land would be her share of the original cost of the land of \$10,000 (\$20,000 × 50%) plus the FMV of her husband's interest in the land she inherited upon his death (\$50,000).

Selling price.....	\$200,000
Less: Adjusted basis.....	60,000
Gross profit.....	<u>\$140,000</u>

Contract price.....	<u>\$200,000</u>
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$$\text{GP}\% = \text{GP} \div \text{CP}$$

$$\text{GP}\% = \$140,000 \div \$200,000 = 70\%$$

82. A married couple sell their lake house for \$250,000. Their original cost was \$175,000 and they had improvements of \$25,000. They have never used the house as a business or rental property. They agreed to take \$50,000 down and finance the balance. Monthly payments are to begin next year. How much capital gain must they report in the year of sale?

- A. \$10,000
- B. \$50,000
- C. \$15,000
- D. \$0

ANSWER: A

Selling price.....	\$250,000
Less: Adjusted basis.....	<u>200,000</u>
Gross profit.....	<u><u>\$ 50,000</u></u>

Contract price.....	<u><u>\$250,000</u></u>
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GP% = GP ÷ CP

GP% = \$50,000 ÷ \$250,000 = 20%

Amount received (Down payment).....	\$ 50,000
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Gross profit percentage.....	× .20
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Capital gain.....	<u><u>\$10,000</u></u>
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Sale Of Principal Residence

83. Married taxpayers sold their principal residence for \$1,000,000. They purchased the home in 2015 for \$250,000. They incurred improvement costs of \$100,000, real estate commissions of \$60,000 and other settlement costs of \$10,000. They lived in this home until the date of sale. They file a joint return and have not previously excluded a gain on another home. What is their maximum taxable gain?

- A. \$750,000
- B. \$140,000
- C. \$80,000
- D. \$150,000

ANSWER: C

A taxpayer can exclude up to \$250,000 the gain on the sale of a main home if all of the following are true.

1. Taxpayer owned the home for at least 2 of the last 5 years (the ownership test).
2. Taxpayer lived in the home as his or her main home for at least 2 of the last 5 years (the use test).
3. The taxpayer did not exclude gain from the sale of another home during the 2-year period ending on the date of the sale.

Taxpayers filing jointly can exclude up to \$500,000 of the gain on a main home if all of the following are true.

1. Married and file a joint return for the year.
2. Either spouse meets the ownership test.
3. Both spouses meet the use test.
4. Both spouses did not exclude gain from the sale of another home during the 2-year period ending on the date of the sale.

Reduced exclusion: An exclusion can still be claimed, but the maximum amount of the gain that can be excluded will be reduced, if the taxpayer did not meet the ownership and use tests for a home sold due to:

1. A change in place of employment,
2. Health, or
3. Unforeseen circumstances.

The exclusion is prorated by the number of days the taxpayer meets the ownership and use test divided by 730 days (two years).

If the taxpayer does not meet the above requirements, none of the gain can be excluded. If the requirements are met, a taxpayer can take the exclusion every two years.

To figure the gain or loss on the sale of a main home, take the selling price subtract the selling expenses, then subtract the adjusted basis of the property. The adjusted basis of a home is the purchase price plus any additions or improvements.

Selling price.....	\$1,000,000
Less: Selling expenses:	
R/E commissions.....	60,000
Settlement costs.....	<u>10,000</u>
Amount realized.....	930,000
Less: Adjusted basis:	
Purchase price.....	250,000
Improvements.....	<u>100,000</u>
Gain.....	580,000
Less: Exclusion.....	<u>500,000</u>
Taxable gain.....	<u>\$80,000</u>

84. A married couple purchased their primary residence in 2015 for \$100,000. While they lived there, they made renovations at a cost of \$125,000. They lived there until July 1, 2019. On June 15, 2022, the residence was sold for \$800,000. From July 1, 2019, until June 15, 2022, the home was unoccupied. They file a joint return, and they have never excluded a gain from the sale of another home. What is their maximum taxable gain?

- A. \$575,000
- B. \$0
- C. \$75,000
- D. \$200,000

85. A single person sold his principal residence for \$700,000. He purchased his home in 2015 for \$150,000 and lived there until he sold it. He paid for capital improvements of \$75,000, paid real estate commissions of \$36,000 and other settlement costs of \$4,000. How much taxable gain must be report?

- A. None
- B. \$185,000
- C. \$435,000
- D. \$225,000

86. Taxpayer R and Taxpayer J were single and each owned a home. In August, they sold their respective homes. R had a gain of \$330,000 and J has a gain of \$220,000. Both R and J had met the age, ownership and use tests at the time of their sales for the exclusion of gain from the sale of a principal residence by an individual. R and J were married in October. They plan on filing a joint return. How much of the COMBINED gains from the sales of their homes can be EXCLUDED on their joint tax return?

- A. \$500,000
- B. \$470,000
- C. \$250,000
- D. \$125,000

ANSWER: C

Refer to the analysis on the previous question.

Taxable gain on sale of main home:

Selling price.....	\$800,000
Less: Adjusted basis:	
Purchase price.....	100,000
Improvements.....	<u>125,000</u>
Gain.....	575,000
Less: Exclusion.....	<u>500,000</u>
Taxable gain.....	<u>\$75,000</u>

ANSWER: B

Capital improvements are added to the basis of the residence. The \$36,000 commissions and \$4,000 settlement costs are deductible selling expense when figuring the amount realized.

Taxable gain on sell of principal residence:

Purchase price.....	\$150,000
Capital improvements.....	<u>75,000</u>
Adjusted basis.....	<u>\$225,000</u>
Selling price.....	\$700,000
Less: Selling expenses	
(\$36,000 + \$4,000).....	<u>40,000</u>
Amount realized.....	660,000
Less: Adjusted basis.....	<u>225,000</u>
Gain on sale.....	435,000
Less: Exclusion on sale.....	<u>250,000</u>
Taxable gain.....	<u>\$185,000</u>

ANSWER: B

If a taxpayer and his or her spouse each owned separate homes and sold them, they can each exclude gain up to \$250,000 provided they meet the requirements.

Gain excluded:

R	\$250,000
J (up to \$250,000).....	<u>220,000</u>
Total gain excluded.....	<u>\$470,000</u>

Chapter 3. Gains and Losses

87. A single taxpayer bought her first home three years ago, and paid \$100,000 plus \$1,000 closing costs. She added a deck that cost \$5,000. In July, a real estate dealer accepted her house as a trade-in and allowed her \$125,000 toward a new house priced at \$200,000. How should she report this transaction on her return?

- A. \$19,000 long-term capital gain.
- B. No reporting because the trade is not a sale.
- C. \$0 taxable gain and reduce her basis in her new house by \$19,000.
- D. No reporting required.

88. Which of the following does NOT qualify for exclusion from income of all or part of the gain from the sale of their main home?

- A. A taxpayer sold a personal residence on January 1, 2021 and excluded all the gain. He sold another personal residence on December 30, 2022. The sale was NOT due to health problems or a change in employment.
- B. A taxpayer owned and lived in her house from January 1, 2017 until February 15, 2018 when she moved out. She moved back into the house July 12, 2020 and then sold it October 20, 2022. The sale was NOT due to health problems or a change of employment.
- C. A taxpayer sells her house, that she had owned and lived in for ten years, in February and gets married one month later. Her husband had excluded the gain on the sale of his residence on his last year's return.
- D. A taxpayer is divorced from his spouse in 2018 and the spouse is allowed to live in the house until it is sold on July 15, 2022.

ANSWER: D

The trade of an old home for a new one is treated as a sale and a purchase. Since the taxpayer has a \$250,000 exclusion, there is no taxable gain on the sale of the old home. The taxpayer does not report the sale of her main home on her tax return unless she has a taxable gain.

ANSWER: A

A taxpayer can exclude the entire gain on the sale of a main home up to \$250,000 (\$500,000 if married). To claim the exclusion the taxpayer must meet the ownership and use tests. This means that during the 5-year period ending on the date of the sale, the taxpayer must have:

1. Owned the home for at least 2 of the last 5 years (the ownership test), and
2. Lived in the home as his or her main home for at least 2 of the last 5 years (the use test).
3. During the 2-year period ending on the date of the sale, the taxpayer did not exclude gain from the sale of another home.

The required 2 years of ownership and use (during the 5-year period ending on the date of the sale) do not have to be continuous.

An exclusion can still be claimed, but the maximum amount of the gain that can be excluded will be reduced, if the taxpayer did not meet the ownership and use tests for a home sold due to:

1. A change in place of employment,
2. Health, or
3. Unforeseen circumstances.

89. A single taxpayer paid \$150,000 for her residence in January 2017 and lived in it until January 2021. She then moved away and rented her home from February 2021 until she sold it August, 2022 for \$240,000. While it was rental property, she deducted \$20,000 of depreciation. What amount of gain on the sale of her residence is excludable from income?

- A. \$250,000
- B. \$90,000
- C. \$110,000
- D. \$240,000

ANSWER: B

The taxpayer meets the ownership and use tests to claim the exclusion. However, the taxpayer cannot exclude the part of the gain equal to any depreciation allowed after May 6, 1997.

Gain on the sale excludable from income:	
Sales price.....	\$240,000
Less: Adjusted basis	
(\$150,000 - \$20,000).....	<u>130,000</u>
Realized gain.....	110,000
Less: Depreciation.....	<u>20,000</u>
Gain on the sale excludable from income	<u><u>\$90,000</u></u>

90. A single taxpayer owned and used her house as her main home from January 2017 until January 2021. She then moved away and rented her home from February 2021 until she sold it in August 2022. Her home sold for \$240,000, which included \$20,000 of depreciation and \$12,000 of selling expenses. Using a zero basis, compute the amount that is excludable from income.

- A. \$208,000
- B. \$220,000
- C. \$228,000
- D. \$240,000

ANSWER: A

Gain on the sale excludable from income:	
Sales price.....	\$240,000
Less: Adjusted basis.....	-0-
Selling cost.....	<u>12,000</u>
Realized gain.....	228,000
Less: Depreciation.....	<u>20,000</u>
Gain on the sale excludable from income	<u><u>\$208,000</u></u>

91. A single taxpayer purchased his home for \$150,000 in 1995. He sold it for \$350,000 (including \$100,000 for the land). This was his primary residence until it was sold. However, he claimed one-fifth of his home as an office for his self-employed business. He claimed a total of \$10,000 depreciation over the years. The depreciation taken since May 6, 1997 was \$8,000. The \$150,000 purchase was assessed at \$90,000 building and \$60,000 land. Calculate the taxable income as a result of the sale of this primary residence.

- A. \$8,000
- B. \$10,000
- C. \$200,000
- D. None

ANSWER: A

If a taxpayer depreciated part of his primary residence because the home was used for business purposes or as rental property, he cannot exclude the part of the gain equal to any depreciation allowed as a deduction for periods after May 6, 1997.

Chapter 3. Gains and Losses

92. A taxpayer had a taxable gain on the sale of his main home, which could NOT be excluded on his tax return. He had no business use of the home. Which schedule does he need to submit to report the gain?

- A. Schedule C, for sole proprietors.
- B. Schedule A, for itemized deductions.
- C. Form 8949 and Schedule D, for capital gain.
- D. Schedule SE, for self-employment income.

ANSWER: C

Do not report the sale of a main home on the tax return unless:

- There is a gain on the sale and the gain does not qualify for full exclusion,
- There is a gain and the taxpayer chooses not to exclude it, or
- The taxpayer receives Form 1099-S.

Report the entire gain or loss on Form 8949, Sales and Other Dispositions of Capital Assets, and Schedule D (Form 1040), Capital Gains and Losses.

Chapter 4. Adjustments to Income

Individual Retirement Arrangements (IRAs)

1. All of the following types of accounts are permitted for Individual Retirement Arrangements EXCEPT:

- A. A trust or custodial account at an IRS approved entity.
- B. An individual retirement annuity.
- C. An employer and employee association trust account.
- D. Individual savings bonds clearly designated as an IRA.

2. Mrs. M, a nonworking spouse, files a joint return with her husband, Mr. M, who is not covered by a pension plan at work. Their AGI is \$50,000 and Mr. M plans to contribute \$6,000 to a traditional IRA. Mrs. M, who is 51, wishes to contribute to an IRA. What is the maximum amount she can contribute?

- A. \$6,000
- B. \$2,000
- C. \$7,000
- D. \$2,500

ANSWER: D

An Individual Retirement Arrangement can be one of the following.

- Traditional IRAs
 - 1. Individual retirement account.
 - 2. Individual retirement annuity.
 - 3. Simplified employee pension (SEP).
 - 4. Employer and employee association trust account.
- Savings Incentive Match Plans for Employees (SIMPLE plans).
- Roth IRA

The sale of individual retirement bonds issued by the Federal government was suspended after April 30, 1982.

ANSWER: C

If neither spouse is covered for any part of the year by an employer retirement plan, the maximum amount each can contribute to an IRA is \$6,000 (\$7,000 if age 50 or older. In the case of a married couple with unequal compensation who file a joint return, the deduction for contributions to the traditional IRA of the spouse with less compensation is limited to the lesser of:

- 1. \$6,000 (\$7,000 if the spouse with the lower compensation is 50 or older), or
- 2. The total compensation includible in the gross income of both spouses for the year reduced by the following three amounts:
 - a. The IRA deduction for the year of the spouse with the greater compensation.
 - b. Any designated nondeductible contribution for the year made on behalf of the spouse with the greater compensation.
 - c. Any contributions for the year to a Roth IRA on behalf of the spouse with the greater compensation.

Chapter 4. Adjustments to Income

3. A single taxpayer has income totaling \$2,000. She is 35 years of age and the income she received consists of \$1,500 earned from clerical work and \$500 from interest income. What is the maximum amount of money that she can contribute to a traditional IRA?

- A. \$0
- B. \$1,500
- C. \$2,000
- D. \$6,000

4. A single taxpayer, age 55, has earnings of \$75,000. She has no other retirement plan coverage. She contributes \$7,000 to a traditional IRA. How much of the \$7,000 contribution may she deduct?

- A. \$0
- B. \$2,000
- C. \$6,000
- D. \$7,000

5. Mr. P and Mrs. P, age 52 and 48, are married and file a joint return. Mrs. P earned \$98,000. Mr. P owns a business that showed a net profit of \$500. Mrs. P was covered by an employer's plan, Mr. P was not. Their modified adjusted gross income was \$209,000 before any IRA contribution. What is the maximum deductible amount that Mr. P can contribute to a traditional IRA?

- A. \$0
- B. \$3,500
- C. \$6,000
- D. \$7,000

6. Mr. R, age 35, and Mrs. R, age 51, are married and file a joint return. Mr. R is covered by an employer plan and he had compensation of \$50,000. Mrs. R had compensation of \$2,000. Their Modified AGI was \$220,000. What is the amount of the deductible contribution that can be made for Mrs. R to her traditional IRA?

- A. \$2,000
- B. \$6,000
- C. \$7,000
- D. \$0

ANSWER: B

The most that can be contributed for any year to a traditional IRA is the smaller of the following amounts.

1. \$6,000 (\$7,000 if age 50 or older), or
2. Taxable compensation for the year.

The taxpayer is limited to the amount of her compensation of **\$1,500**.

ANSWER: D

Since the taxpayer is not covered by a retirement plan at work and is age 50 or older, she can deduct the full \$7,000.

ANSWER: B

If a taxpayer is not covered by an employer retirement account and files a joint return, he or she may be able to deduct all of his or her contribution to an IRA even if the taxpayer's spouse is covered by a plan. In this case, the deduction limited of \$7,000 (age 50 or older) must be reduced if the taxpayer's modified adjusted gross income on the joint return is more than \$204,000. No deduction is allowed if modified AGI is more than \$214,000. The husband who is not covered by a plan will use the top phaseout range of \$214,000.

1. Enter top phaseout range.....\$214,000
2. Enter modified AGI combined,
if married filing jointly)..... 209,000
3. Subtract line 2 from 1..... 5,000
4. Multiply line 3 by 60% **(70% if
age 50 or older)**(Round to the next
highest multiple of \$10)..... 3,500
5. Enter compensation (both spouses).. 98,500
6. IRA deduction. The smaller of 4 & 5 \$3,500

ANSWER: D

Refer to the analysis on the previous question. No deduction is allowed if modified AGI is more than \$214,000.

7. Mr. B, age 50, and Mrs. B, age 63, filed a joint return with a modified adjusted gross income of \$155,000. Mrs. B's only income was \$10,800 of Social Security. Mr. B is covered by a retirement plan at work where he receives compensation of \$85,000. He wishes to contribute to an IRA for himself and for his wife. Which of the following will provide them the greatest allowable tax benefit?

- A. He may contribute \$7,000 to each IRA, but only take a deduction for the \$7,000 to his IRA.
- B. He may contribute \$7,000 to each IRA, but take no deduction for either IRA.
- C. He may contribute \$7,000 to each IRA, and take a deduction of \$7,000 for each IRA.
- D. He may contribute \$7,000 to each IRA, but only take a deduction for the \$7,000 to his wife's IRA.

8. A single taxpayer, age 35, has total wages of \$45,000 and is covered by a retirement plan at work. His adjusted gross income is \$71,000 before any IRA contribution. He contributes \$6,000 to his IRA account. What amount can he deduct on his tax return?

- A. \$3,000
- B. \$4,200
- C. \$6,000
- D. \$0

ANSWER: D

A taxpayer, who is married filing jointly and covered by a retirement plan, cannot deduct a contribution made to an IRA if his modified AGI on the joint return is \$129,000 or more. His spouse, if age 50 and older and not covered by a retirement plan, can take the full deduction of \$7,000 for her IRA if their AGI is not over \$204,000.

ANSWER: B

Use the following worksheet to figure IRA deductions for single taxpayers covered under an employer plan. The phaseout range of a single taxpayer is \$68,000 - \$78,000.

1. Enter top phaseout range.....	\$78,000
2. Enter modified AGI.....	<u>71,000</u>
3. Subtract line 2 from 1.....	<u>7,000</u>
4. Multiply line 3 by 60% (70% if age 50 or older) (Round to the next highest multiple of \$10).....	4,200
5. Enter compensation.....	45,000
6. Enter contributions.....	6,000
7. IRA deduction. The smaller of 4, 5, & 6.....	<u>\$4,200</u>

Chapter 4. Adjustments to Income

9. Mr. L and Mrs. L, both age 40, file a joint return. Mr. L is covered by a retirement plan but Mrs. L is not. Mrs. L wishes to make a contribution to a traditional IRA, and her earnings alone are \$1,500. The combined earnings on the joint return are \$150,000 (the same as the modified AGI). Which of the following is correct?

- A. Mrs. L may make a nondeductible contribution of \$1,500.
- B. Mrs. L may make a deductible contribution of \$6,000.
- C. Mrs. L may not make any contribution.
- D. Mrs. L may make a deductible contribution of \$1,500 and a nondeductible contribution of \$1,500.

10. Mr. and Mrs. W, both age 30, file a joint return for the tax year. Mrs. W is a full-time student with no taxable compensation and Mr. W had taxable compensation of \$35,000. He plans to contribute and deduct \$6,000 to his traditional IRA. How much may each deduct for contributions to their individual traditional IRA's and what is the compensation Mrs. W uses to figure her contribution limit?

	<u>IRA deduction</u>	<u>Compensation for Mrs. W to Figure IRA Contribution Limit</u>
A.	\$6,000	\$29,000
B.	\$6,000	\$35,000
C.	\$3,000	\$32,500
D.	\$3,000	\$30,000

ANSWER: B

In the case of a married couple with unequal compensation who file a joint return, the deduction for contributions to the traditional IRA of the spouse with less compensation is limited to the lesser of:

1. \$6,000 (\$7,000 if the spouse with the lower compensation is 50 or older), or
2. The total compensation includible in the gross income of both spouses for the year reduced by the following three amounts:
 - a. The IRA deduction for the year of the spouse with the greater compensation.
 - b. Any designated nondeductible contribution for the year made on behalf of the spouse with the greater compensation.
 - c. Any contributions for the year to a Roth IRA on behalf of the spouse with the greater compensation.

If a taxpayer is not covered by an employer's retirement account and files a joint return, she can deduct all of her contribution to an IRA even if the taxpayer's spouse is covered by a plan if their modified adjusted gross income on their joint return is not more than \$204,000.

ANSWER: A

Refer to the analysis on the previous question. The non-working spouse must reduce her total compensation of both spouses by the amount of the IRA contribution of the spouse with more compensation. In this question, Mrs. W's compensation for figuring her IRA contribution limit is **\$29,000** (\$35,000 - \$6,000). Her maximum IRA contribution is **\$6,000**.

11. A 72-year-old single taxpayer earned \$22,000. Her modified adjusted gross income is \$35,000. She participates in her employer's pension plan. For the year, she contributed \$7,000 to a traditional IRA. How much of her contribution can be deducted?

- A. \$0
- B. \$4,000
- C. \$6,000
- D. \$7,000

12. A contribution to an individual retirement plan (IRA) is deductible for tax year 2022 in which of the following situations:

- A. The individual's employer does not have a retirement plan at any time during 2022.
- B. The contribution is made on October 15, 2023 under a properly filed and accepted extension.
- C. The individual is covered by a retirement plan, but does not have any compensation in 2022.
- D. All of the above.

13. Which of the following is a true statement regarding a rollover distribution from a qualified plan to a traditional IRA?

- A. To be an eligible rollover, you must rollover the entire distribution from the qualified plan.
- B. You can deduct the distribution rolled over, up to the amount of the allowable deductible contribution limit for the year.
- C. If you chose the direct rollover option, the payer must generally withhold 20% of it for income tax.
- D. A hardship distribution from a qualified plan is not an eligible rollover distribution.

14. Which of the following is NOT a true statement regarding a direct rollover option distribution to another qualified retirement plan?

- A. To be a direct eligible rollover, you must pay withholding tax on the amount being rolled over.
- B. On a direct eligible rollover, no tax will be withheld from any part of the distribution.
- C. You may choose to have any part or all of an eligible rollover distribution paid directly to another retirement plan.
- D. If an eligible rollover distribution is paid to you generally there will be tax withheld.

ANSWER: D

For tax years beginning after 2019, the rule that a taxpayer is not able to make contributions to a traditional IRA for the year in which the taxpayer reaches age 70½ and all later years has been repealed.

ANSWER: A

The most that can be contributed to a traditional IRA is the smaller of the following amounts.

1. \$6,000 (\$7,000 if age 50 or older), or
2. Taxable compensation for the year.

A taxpayer can make contributions to his or her IRA for a year at any time during the year or by the due date for filing his or her tax return for that year, **not** including extensions.

ANSWER: D

A taxpayer can make a partial rollover from a qualified plan to a traditional IRA. The amount not rolled over is taxable and may be subject to the 10% additional tax. Rollovers are not deductible. There is no withholding on a direct rollover.

ANSWER: A

A taxpayer may choose to have any part or all of an eligible rollover distribution paid directly to another retirement plan. If the direct rollover option is chosen, no tax is withheld from any part of the distribution that is directly paid to the trustee of the other retirement plan.

Chapter 4. Adjustments to Income

15. A single taxpayer, age 40, is covered by a pension plan at work. For 2021, he could have contributed and deducted \$5,500 but could only afford to contribute \$1,000, which he did on April 14, 2022. After April 15, 2022, he contributed \$6,000 for tax year 2022. Since his Modified AGI for 2022 was over \$68,000, he computed that his reduced IRA deduction for 2022 was \$600. Which of the following is NOT an option available for the taxpayer?

- A. He can deduct \$5,100 in 2022 since he had a carryover from the immediately preceding tax year.
- B. He can withdraw the nondeductible \$5,400 contribution by April 15, 2023.
- C. He can leave the entire contribution in the IRA and elect to treat the entire \$6,000 as a non-deductible contribution.
- D. He can leave the entire contribution in the IRA as a \$600 deductible contribution and a \$5,400 non-deductible contribution.

16. A single taxpayer, age 35, made an excess contribution to his traditional IRA in 2022 of \$1,000, which he withdrew by April 15, 2023. At the same time, he withdrew the \$50 income that was earned on the \$1,000. Which of the following statements are true?

- A. He must include the \$50 in his gross income in 2022.
- B. He would have to pay the 6% excise tax on the \$1,050.
- C. He would have to pay the 10% additional tax on the \$50 as an early distribution.
- D. Both A & C.

17. Mr. E and Mrs. E were married. Mr. E had established a traditional IRA to which he made contributions and had taken no distributions. The total value of the IRA was \$50,000 of which \$20,000 was nondeductible contributions. Mr. E died. As the spousal beneficiary, which of the following applies to Mrs. E?

- A. Mr. E's \$20,000 basis in the IRA may be treated as basis to Mrs. E.
- B. When Mrs. E receives the distribution, she may not roll it over to her own traditional IRA.
- C. Mrs. E must begin receiving periodic distributions by December 31 of the fifth year following Mr. E's death.
- D. Mrs. E must pay a 10% penalty on the funds in the IRA if she receives an immediate distribution after Mr. E's death.

ANSWER: A

A taxpayer cannot apply an excess contribution to an earlier year even if he contributed less than the maximum amount allowable for the earlier year. However, the taxpayer may be able to apply it to a later year if the contributions for that later year are less than the maximum allowed for that year.

ANSWER: D

A taxpayer will not have to pay the 6% tax if he withdraws the excess contribution made during a tax year and also withdraws any interest or other income earned on the excess contribution. The withdrawal must be completed by the date of the tax return for that year, including extensions. The taxpayer must include any interest or other income earned on the excess contribution in gross income. The interest or other income withdrawn is subject to the 10% tax on early distribution.

ANSWER: A

If a taxpayer inherits a traditional IRA from a spouse, the taxpayer can roll it over into a new traditional IRA in his or her name or choose to make the inherited IRA his or her own. If a taxpayer inherits a traditional IRA from a person who had a basis in the IRA because of non-deductible contributions, that basis remains with the IRA.

The spouse who inherited the traditional IRA is not required to receive periodic distributions until the year the deceased spouse would have turned 72. If the deceased spouse is over 72, the surviving spouse must take the deceased spouse's required minimum distribution unless the surviving spouse treats the IRA as his or her own.

A beneficiary of a deceased IRA owner is excepted from the 10% for early withdrawal.

18. A single taxpayer, age 40, has W-2 income of \$31,000. He contributed \$7,000 to his traditional IRA. He has excess contributions of how much?

- A. \$2,500
- B. \$2,000
- C. \$1,000
- D. \$0

19. A single taxpayer, age 49, made a \$6,000 contribution to her traditional IRA in 2022. Her compensation for the year was \$5,000. She filed a Form 4868 for an extension until October 15, 2023 to file her return. In order to avoid the 6% additional tax on excess contributions, the taxpayer must do which of the following:

- A. Withdraw the \$1,000 excess contribution and all interest earned on the \$1,000 by December 31, 2022.
- B. Withdraw the \$1,000 excess contribution and all interest earned on the \$1,000 by April 15, 2023.
- C. Withdraw the \$1,000 excess contribution and all interest earned on the \$1,000 by October 15, 2023.
- D. File an election to deduct the \$1,000 on her 2023 return by attaching a statement to her 2022 return.

20. A single taxpayer, age 71, had compensation of \$2,500. He made a \$7,000 contribution to his traditional IRA during the year. The balance of the IRA account at the end of the year was \$10,000. He did not withdraw any amount of the contribution by the due date of the tax return. What would be the tax as a result of an excess contribution?

- A. \$0
- B. \$270
- C. \$350
- D. \$420

ANSWER: C

The most that can be contributed to a traditional IRA is the smaller of the following amounts.

1. \$6,000 (\$7,000 if age 50 or older), or
2. Taxable compensation for the year.

ANSWER: C

A taxpayer will not have to pay the 6% tax if she withdraws an excess contribution made during a tax year and also withdraws any interest or other income earned on the excess contribution. The withdrawal must be completed by the date of the tax return for that year, **including extensions**.

ANSWER: A

A taxpayer can now make a contribution if over age 70½. There is no excess contribution.

Chapter 4. Adjustments to Income

21. A taxpayer's tax return shows the following income:

- \$800 wages
- \$6,490 unemployment compensation
- \$1,000 taxable alimony (under a decree of divorce or separate maintenance executed before 2019).
- \$8,000 rental income

What is the earned income for the purpose of determining how much can be contribute to an IRA?

- A. \$800
- B. \$7,290
- C. \$1,800
- D. \$16,290

ANSWER: C

In determining whether an IRA can be set up or a contribution can be made, compensation includes:

1. Wages, salaries, tips, professional fees, bonuses, and other amounts received for providing personal services.
2. Commissions.
3. Self-employment income.
4. Taxable alimony and separated maintenance (under a decree of divorce or separate maintenance executed before 2019).
5. Nontaxable combat pay.

Compensation does not include the following.

1. Earnings and profits from property, such as rental income, interest income, and dividend income.
2. Pension or annuity income.
3. Any deferred compensation.
4. Income from a partnership for which the taxpayer does not provide services that are a material income-producing factor.
5. Any other amounts excluded from income, other than nontaxable combat pay, such as foreign earned income and housing costs.

Earned income for determining IRA contribution:

Wages.....	\$ 800
Taxable alimony.....	<u>1,000</u>
Earned income.....	<u>\$1,800</u>

22. Ms. D, who is single, worked recently for a telephone company in France, and earned \$1,500 for which she claimed the foreign earned income exclusion. In addition, she earned \$1,200 as an employee while she was in the U.S. She also received taxable alimony of \$400 for the year. What is her maximum amount of allowable contribution to a traditional IRA?

- A. \$1,600
- B. \$2,000
- C. \$1,200
- D. \$1,900

ANSWER: A

Foreign earned income amounts that are excluded from income are excluded from earned income for IRA purposes.

23. Generally, an IRA contribution is limited to the lesser of \$6,000 (\$7,000 if age 50 or older), or the taxpayer's compensation. Which of the following items is NOT treated as compensation for this limitation?

- A. Wages earned by an individual under the age of 18.
- B. Taxable alimony (under a decree of divorce or separate maintenance executed before 2019).
- C. Pension income.
- D. Commissions.

24. Which of the following is compensation for the purpose of contributions to individual retirement accounts?

- A. Deferred compensation received.
- B. Foreign earned income excluded from income.
- C. Pension or annuity income.
- D. Taxable alimony and separate maintenance (under a decree of divorce or separate maintenance executed before 2019).

25. Which of the following is NOT considered earned compensation for IRA contribution purposes?

- A. Deferred compensation.
- B. Wages and salaries.
- C. Self-employment income.
- D. Commissions.

26. When figuring compensation for a self-employed individual for purposes of determining the amount of an allowable contribution to a traditional IRA, which of the following statements is NOT true?

- A. Self-employment income must be reduced by the deduction allowed for the deductible part of your self-employment taxes.
- B. When you have both self-employment income, and salary and wages, your compensation includes both amounts.
- C. If you have a net loss from self-employment, you must subtract the loss from any salary or wages received when figuring total compensation.
- D. In order to include net earnings from a trade or business as compensation, your personal services must be a material income producing factor.

ANSWER: C

Pension income is not compensation.

ANSWER: D

For IRA purposes, compensation includes any taxable alimony and separate maintenance payments received under a decree of divorce or separate maintenance but only with respect to divorce or separation instruments executed before 2019, that have not been modified to exclude such amounts.

ANSWER: A

Deferred compensation is not considered earned compensation for IRA contribution purposes.

ANSWER: C

If a taxpayer is self-employed (a sole proprietor or a partner), compensation is the net earnings from a trade or business (provided personal services are a material income-producing factor) reduced by the total of:

- The deduction for contributions made to the retirement plans, and
- The deduction allowed for the deductible part of self-employment taxes.

Do not subtract self-employment loss from salaries and wages when figuring total compensation.

Chapter 4. Adjustments to Income

27. An IRA may be invested in all of the following accounts EXCEPT:

- A. Bank CD.
- B. Mutual Fund.
- C. Annuity.
- D. Artwork.

ANSWER: D

If a taxpayer's traditional IRA invests in collectibles, the amount invested is considered distributed to the taxpayer in the year invested. The taxpayer may have to pay the 10% additional tax on early distributions. Collectibles include the following:

1. Art works.
2. Rugs.
3. Antiques.
4. Metals.
5. Gems.
6. Stamps.
7. Coins.
8. Alcoholic beverages.
9. Certain other tangible personal property.

An IRA can invest in one, one-half, one-quarter, or one-tenth ounce U.S. gold coins, or one-ounce silver coins minted by the Treasury Department. It can also invest in certain platinum coins and certain gold, silver, palladium, and platinum bullion.

28. Which of the following would be an allowable investment for a traditional IRA?

- A. Stamps.
- B. An oil painting.
- C. One-ounce silver coins minted by the Treasury Department.
- D. All of the above.

ANSWER: C

Refer to the analysis on the previous question.

29. If a taxpayer did not live with his or her spouse at any time during the year and files a separate return, the taxpayer's filing status for determining the deduction phase out for a traditional IRA is

- A. Single
- B. Married filing jointly
- C. Married filing separately
- D. Any of the above.

ANSWER: A

If a taxpayer did not live with his spouse at any time during the year and files a separate return, the taxpayer's filing status is single for purpose of determining the amount that he can deduct as a contribution to an IRA.

30. A single taxpayer had made nondeductible contributions to a traditional IRA totaling \$2,000, giving him a basis in his IRA at the end of the year of \$2,000. By the end of the year, his IRA earns \$400 in interest income. During the year, he receives a distribution of \$600. What is the taxpayer's basis in his IRA after the distribution?

- A. \$1,400
- B. \$1,500
- C. \$1,600
- D. \$1,800

ANSWER: B

If a taxpayer makes nondeductible contributions or rolls over any after-tax amounts to any traditional IRAs, the taxpayer will have a cost basis equal to the amount of those contributions. These nondeductible contributions are not taxed when they are distributed. They are a return of investment in the IRA. Only the part of the distribution that represents earnings and gains is taxable. The taxpayer figures the taxable amount of the distribution on Form 8606. The taxpayer's basis in the IRA is reduced by the amount of the distribution that is tax free.

Basis in IRA after distribution	
Basis in IRA before distribution.....	\$2,000
Divide by value of IRA before	
distribution.....	$\div 2,400$
Percent of distribution not taxed.....	.833
Multiply distribution by the above percent \times	600
Nontaxable distribution.....	<u>\$500</u>

Basis before distribution.....	\$2,000
Less: nontaxable distribution.....	500
Basis after distribution.....	<u>\$1,500</u>

Qualified Plans

31. For 2022, a defined contribution plan's annual contributions to the account of a participant cannot exceed

- A. \$45,000
- B. \$55,000
- C. \$58,000
- D. \$61,000

ANSWER: D

For 2022, a defined contribution plan's annual contributions and other additions (excluding earnings) to the account of a participant cannot exceed the lesser of the following amounts.

1. 100% of the participant's compensation.
2. \$61,000.

Simplified Employee Pension

32. For 2022, what is the maximum contribution to a SEP IRA?

- A. \$20,500
- B. \$27,000
- C. \$55,000
- D. \$61,000

ANSWER: D

Contributions made for a year to a common-law employee's SEP-IRA cannot exceed the smaller of 25% of the employee's compensation or \$61,000.

When figuring the deduction for contributions made to your own SEP-IRA, compensation is your net earnings from self-employment, which takes into account both the following deductions.

1. The deduction for the deductible part of your self-employment tax.
2. The deduction for contributions to your own SEP-IRA.

401(k) Plans

33. For 2022, the limit on elective deferrals (401(k) plans) is which amount for taxpayers under age 50?

- A. \$17,500
- B. \$18,500
- C. \$20,500
- D. \$27,000

ANSWER: C

For 2022, the basic limit on elective deferrals is \$20,500 (\$27,000 for participants age 50 and older).

Health Savings Account

34. To qualify for a health savings account, a taxpayer must meet all the following requirements EXCEPT:

- A. Have a high deductible health plan.
- B. Not be enrolled in Medicare.
- C. Cannot be claimed as a dependent on someone else's tax return.
- D. Have other health coverage that is not a high deductible health plan.

ANSWER: D

To be an eligible individual and qualify for an HSA, a taxpayer must meet the following requirements:

1. Have a high deductible health plan (HDHP).
2. Have no other health coverage that is not an HDHP.
3. Not be enrolled in Medicare.
4. Cannot be claimed as a dependent on someone else's tax return.

A taxpayer can still be an eligible individual even if his or her spouse has non-HDHP coverage provided the taxpayer is not covered by that plan. However, the taxpayer can have additional insurance that provides benefits only for the following items:

1. Liabilities incurred under workers' compensation laws, tort liabilities, or liabilities related to ownership or use of property.
2. A specific disease or illness.
3. A fixed amount per day (or other period) of hospitalization.

A taxpayer can also have coverage (whether provided through insurance or otherwise) for the following items:

1. Accidents.
2. Disability.
3. Dental care.
4. Vision care.
5. Long-term care.

Student Loan Deduction

35. A single taxpayer had a student loan for qualified higher education expenses. The interest payments on the loan were \$3,200 for the year. His adjusted gross income for the year was \$90,000. How much may he deduct in arriving at adjusted gross income?

- A. \$0
- B. \$1,000
- C. \$2,500
- D. \$3,200

ANSWER: A

A taxpayer can deduct up to \$2,500 of interest paid in a tax year. The amount of student loan interest deduction for will be phased out (gradually reduced) if the taxpayer's AGI is between \$70,000 and \$85,000 (\$145,000 and \$175,000 if filing a joint return).

Penalty on Early Withdrawal

36. A taxpayer received \$1,000 as interest income and also paid an early withdrawal penalty of \$1,200 on a certificate of deposit she had at the local bank. Which of the following is the correct way for the taxpayer to report these items on her tax return?

- A. Include \$0 interest in gross income and deduct \$200 as an adjustment to income.
- B. Include \$0 interest in gross income.
- C. Include \$1,000 interest in gross income and deduct \$1,200 as an itemized deduction.
- D. Included \$1,000 interest in gross income and deduct \$1,200 as an adjustment to income.

ANSWER: D

A taxpayer must report the gross amount of interest paid or credited during the year on a time-saving account without subtracting the penalty for early withdrawal. Deduct the entire penalty as an adjustment to gross income even if it is more than the interest income.

Other Adjustments to Income

37. Which one of the following is NOT an adjustment to total income in arriving at adjusted gross income?

- A. Interest paid on student loans
- B. Health insurance of self-employed persons
- C. Certain contributions to a medical savings account
- D. Contributions to a Roth IRA

ANSWER: D

The following are adjustments to total income in arriving at adjusted gross income:

- 1. IRA deduction.
- 2. Student loan interest deduction.
- 3. Health savings account deduction.
- 4. Moving expenses (only for certain Armed Forces members).
- 5. Part of self-employment tax.
- 6. Self-employed health insurance deduction.
- 7. Self-employed SEP, SIMPLE, and qualified plans.
- 8. Penalty on early withdrawal of savings.
- 9. Alimony paid (under a decree of divorce or separate maintenance executed before 2019).
- 10. Jury duty pay given to the taxpayer's employer.
- 11. Expenses from the rental of personal property.
- 12. Certain required repayments of supplemental unemployment benefits.
- 13. Foreign housing deduction.
- 14. Expenses of fee-basis officials or certain performing artists.
- 15. Educator expenses (up to \$250).

A contribution to a Roth IRA is not deductible.

38. A taxpayer is self-employed and reports net income on his Schedule C. During the year, he paid the following: \$5,200 child support, \$5,000 alimony under a decree of divorce or separate maintenance executed in 2017, \$6,000 in medical insurance premiums, and contributed \$2,000 to his IRA plan. His deductible part of self-employment tax is \$3,500. What amounts are deductible in arriving at adjusted gross income?

- A. \$11,000
- B. \$13,000
- C. \$16,500
- D. \$21,700

ANSWER: C

Child support is not deductible. Alimony paid under a decree of divorce or separate maintenance executed before 2019 that has not been modified after 2018, medical insurance for a self-employed person, the deductible of self-employment tax and an IRA contribution are adjustments to gross income.

Deductions at arriving at AGI:

Taxable alimony.....	\$ 5,000
Medical insurance.....	6,000
Self-employment tax.....	3,500
IRA contribution.....	<u>2,000</u>
Deductions at arriving at AGI.....	<u>\$16,500</u>

Chapter 5. Standard Deductions and Itemized Deductions

Medical Expenses

1. Which of the following is a medical deduction?

- A. Legal abortion.
- B. Maternity clothing.
- C. Health club dues advised by your doctor.
- D. None of the above.

ANSWER: A

Legalized abortion is a deductible medical expense. Maternity clothing is not a deductible medical expense. Health club dues are also not a deductible medical expense, even if advised by a doctor.

2. Generally, the taxpayer may deduct the cost of medical expenses on Schedule A for which of the following?

- A. Doctor prescribed birth control pills.
- B. Controlled substances, like marijuana, that are in violation of federal law.
- C. Trips for general health improvement.
- D. Marriage counseling.

ANSWER: A

A taxpayer cannot include in medical expenses amounts paid for controlled substances (such as marijuana, laetrile, etc.), in violation of federal law. Travel that is merely for the general improvement of one's health is not deductible. Expenses for marriage counseling are also not deductible.

3. Which of the following expenses are NOT deductible as medical expenses?

- A. Insulin used for diabetes.
- B. Wig, purchased upon the advice of a physician for the mental health of a patient who has lost all of his or her hair from disease.
- C. Swimming lessons, recommended by a doctor for improvement of general health.
- D. Acupuncture used for migraines.

ANSWER: C

Expenses for general health are not deductible medical expenses even if recommended by a doctor. Those expenses include the following:

- Health clubs.
- Household help.
- Social activities such as dancing or swimming lessons.
- Trips for general health improvement.

A wig purchased upon the advice of a physician for the mental health of a patient who has lost all of his or her hair from disease is a deductible medical expense.

Chapter 5. Standard Deductions and Itemized Deductions

4. Of the following medical expenses paid by Mr. B during 2022. How much can he deduct before limitations?

- \$1,000 for his wife's hospitalization in 2021; they were married in 2022.
 - \$1,000 for his daughter's braces; she is his dependent in 2022.
 - \$2,000 for his son's 2021 medical treatment; he was Mr. B's dependent in 2021 but does not qualify as a dependent for 2022.
- A. \$4,000
B. \$2,000
C. \$1,000
D. \$0

5. A cash basis taxpayer incurred the following expenses for himself and his son whom he claims as a dependent on his return:

- \$800 for braces.
- \$100 for babysitting so he could visit the chiropractor.
- \$900 for emergency room services for his son \$875 was covered by insurance; the taxpayer paid the remaining \$25 in the next year.

The medical expense deduction before limitations is

- A. \$800
B. \$825
C. \$900
D. \$925

6. Which of the following may NOT be deducted as medical expenses?

- A. \$1,000 long-term care insurance.
B. \$600 for eyeglasses.
C. \$300 for maternity clothes.
D. \$3,000 to a family physician for medical care.

ANSWER: A

To claim medical expense for a spouse, a taxpayer must be married either at the time the spouse received the medical service or at the time the medical expenses were paid. Likewise, a taxpayer can deduct medical expenses paid for a person who was the taxpayer's dependent at the time the medical services were provided or at the time the medical expenses were paid.

ANSWER: A

Expenses for dental treatment, including braces, are a deductible medical expense. Expenses paid for babysitting and child care are not a deductible medical expense even if the expense allows the taxpayer to get medical or dental treatment.

Deductible medical expenses:

Dental (braces).....	\$ 800
Emergency room services (\$900 - \$25 paid the next year).....	875
Total medical expenses.....	1,675
Less: Amount covered by insurance.....	875
Deductible medical insurance.....	<u>\$ 800</u>

ANSWER: C

Maternity clothes are not a deductible medical expense.

7. To qualify for a medical expense deduction as your dependent, a person must be your dependent either at the time the medical services were provided or at the time you paid the expenses. A person generally qualifies as your dependent for purposes of the medical expense deduction if:

- A. The person would qualify as a qualified child or qualified relative.
- B. The person was a foreign student staying briefly at your home.
- C. The person is your sibling's unmarried adult child.
- D. The person is the unrelated caregiver for your elderly parents.

8. Which of the following will NOT usually be 100% deductible as a medical expense?

- A. Adding an elevator to your home to allow access to a second-floor bedroom.
- B. Modifying the hardware on doors.
- C. Lowering the kitchen cabinets.
- D. Building entrance and exit ramps.

ANSWER: A

A taxpayer can deduct medical expenses paid for a person who was the taxpayer's dependent at the time the medical services were provided or at the time the medical expenses were paid. A person generally qualifies as a dependent for purposes of the medical expense deduction if both of the following requirements are met:

- 1. The person was a qualifying child or a qualifying relative, and
- 2. The person was a U.S. citizen or national, or a resident of the United States, Canada, or Mexico

ANSWER: A

Certain improvements made to a home to accommodate a taxpayer, his or her spouse or dependent's disabled condition do not usually increase the value of the home and the cost can be included in full as medical expenses. These improvements include, but are not limited to the following items:

- 1. Constructing entrance or exit ramps for the home.
- 2. Widening doorways at entrances or exits to the home.
- 3. Widening or otherwise modifying hallways and interior doorways and stairways.
- 4. Installing railings, support bars, or other modifications to bathrooms.
- 5. Lowering or modifying kitchen cabinets and equipment.
- 6. Moving or modifying electrical outlets and fixtures.
- 7. Installing porch lifts and other forms of lifts but generally **not elevators**.
- 8. Modifying fire alarms, smoke detectors, and other warning systems.
- 9. Adding handrails or grab bars anywhere.
- 10. Modifying hardware on doors or areas in front of entrance and exit doorways.
- 11. Grading the ground to provide access to the residence.

Chapter 5. Standard Deductions and Itemized Deductions

9. All of the following capital improvements may be itemized and deducted as medical expenses EXCEPT:

- A. Cost of constructing wheelchair accessible ramps for your home.
- B. Cost of modifying a car with special hand controls.
- C. Lowering or modifying kitchen cabinets and equipment.
- D. An elevator costing \$8,000 that adds \$8,000 to the appraised value of your home.

10. A taxpayer broke his hip and must now use a wheelchair. He modified his home to accommodate the wheelchair. He had his home appraised for refinancing just before the improvements to his home. The value of his home was \$200,000. After he made the modifications and improvements listed below, the value was \$202,000. He incurred the following expenses during the year. Without consideration of adjusted gross income limitations, compute the amount that may claim on his tax return as a medical expense:

- \$3,000 to construct a ramp in the entrance of his home to accommodate his wheelchair.
 - \$4,000 for installation of a lift to transport the wheelchair from the first to the second floor of his house.
 - \$1,000 for adding handrails around his tub.
 - \$200 to repair his chimney.
- A. \$8,200
 - B. \$6,200
 - C. \$6,000
 - D. \$8,000

11. Mr. G must use a wheelchair. Upon advice from his doctor, he installed an elevator and widened the front entrance of his house, incurring \$10,000 and \$3,000 in respective costs. Mr. G had purchased his house for \$146,000. An appraisal showed the fair market value of Mr. G's house immediately after these modifications at \$154,000. Also Mr. G decided to join a health club primarily to improve business contacts and for recreational purposes. He paid a \$1,250 annual membership fee to make use of this facility. Compute Mr. G's currently deductible medical expense.

- A. \$14,250
- B. \$5,000
- C. \$13,000
- D. \$6,250

ANSWER: D

Refer to the analysis on the previous question. A taxpayer can include in medical expenses amounts paid for special equipment installed in the home, or for improvements, if their main purpose is medical care. The cost of the improvement is reduced by the increase in the value of the property.

ANSWER: C

A taxpayer can include in medical expenses amounts paid for special equipment installed in the home, or for improvements, if their main purpose is medical care. The cost of permanent improvements that increase the value of the property may be partly included as a medical expense. The cost of the improvement is reduced by the increase in the value of the property.

Cost of the ramp.....	\$3,000
Installation of a lift.....	4,000
Adding handrail around tub.....	<u>1,000</u>
Total qualified medical expenses.....	8,000
Less: Increase value of the property....	<u>2,000</u>
Deductible medical expense.....	<u>\$6,000</u>

ANSWER: B

Refer to the analysis on the previous question. Expenses for general health are not deductible even if following a doctor's advice. These expenses include the following.

- Health club dues
- Household help (even if recommended by a doctor)
- Social activities, such as dancing or swimming lessons
- Trip for general health improvement

Cost of the elevator.....	\$10,000
widening the front entrance.....	<u>3,000</u>
Total qualified medical expenses.....	13,000
Less: Increase value of the property....	<u>8,000</u>
Deductible medical expense.....	<u>\$5,000</u>

12. A taxpayer flew to Chicago for surgery. He incurred the following costs in connection with the trip:

Round-trip airfare	\$ 350
Lodging (\$100 night × 2 nights)	200
Restaurant Meals.	80
Hospital & Surgeon	5,000

What is the medical expense?

- A. \$5,550
- B. \$5,630
- C. \$5,000
- D. \$5,450

13. A taxpayer can deduct only the amount of medical expenses that is more than what percentage of the taxpayer's adjusted gross income?

- A. 5%
- B. 7.5%
- C. 10%
- D. 0%

ANSWER: D

Amounts paid for transportation primarily for, medical care qualify as medical expenses. A taxpayer can include in medical expenses the cost of lodging not provided in a hospital or similar institution while away from home if he or she meets all of the following requirements:

1. The lodging is primarily for and essential to medical care.
2. The medical care is provided by a doctor in a licensed hospital or in a medical facility related to, or the equivalent of, a licensed hospital.
3. The lodging is not lavish or extravagant under the circumstances.
4. There is no significant element of personal pleasure, recreation, or vacation in the travel away from home.

The amount that can be included in medical expenses for lodging cannot be more than \$50 for each night for each person. Meals are not deductible that are not part of inpatient care.

Deductible medical expenses:

Round-trip airfare.....	\$ 350
Lodging (\$50 night × 2 nights).....	100
Hospital & Surgeon.....	5,000
Deductible medical expenses.....	<u>\$5,450</u>

ANSWER: B

A taxpayer can deduct only the amount of medical expenses that is more than 7.5% of the taxpayer's adjusted gross income regardless of age.

Chapter 5. Standard Deductions and Itemized Deductions

14. Insurance premiums for which of the following policies qualify as a medical expense?

- A. Life insurance policies.
- B. Policies providing payment for loss of earnings.
- C. Replacement of lost or damaged contact lens.
- D. Policies for loss of life, limb, or sight.

ANSWER: C

The following insurance policies can be included in deductible medical expenses.

1. Hospital, surgical fees, and other medical and dental expenses.
2. Prescription drugs and insulin.
3. Replacement of lost or damaged contact lenses.
4. Long-term care (subject to additional limitations).
5. Medicare B - supplemental medical insurance.
6. Medicare D - voluntary prescription drug insurance.

Premiums paid for the following are not deductible:

1. Life insurance.
2. Policies providing payment for loss of earnings.
3. Policies for loss of life, limb, sight, etc.
4. Policies that pay a guaranteed amount each week for a stated number of weeks if the individual is hospitalized for sickness or injury.
5. The part of car insurance premiums that provides medical insurance coverage for all persons injured in or by the taxpayer's car because the part of the premium for the taxpayer, his or her spouse and dependents is not stated separately from the part of the premium for medical care for others.
6. Health or long-term care insurance if the taxpayer elects to pay these premiums with tax-free distributions from a retirement plan made directly to the insurance provider and these distributions would otherwise have been included in income.

15. Which of the following is deductible as medical insurance?

- A. Medical portion of auto insurance policy that provides coverage for all persons injured in or by your car.
- B. Insurance policy that pays you \$50 a day if you are unable to work due to illness or injury.
- C. Medicare Part B.
- D. Policies for loss of life, limb, sight, etc.

ANSWER: C

Refer to the analysis on the previous question. Medicare B is a supplemental medical insurance. Premiums paid for Medicare B are a medical expense.

Taxes

16. Compute the amount a taxpayer can deduct for taxes paid on Schedule A, Itemized Deductions.

- State income tax: \$8,000
- Federal income tax: \$12,000
- County real estate tax: \$5,000
- Fee for a car inspection that is used only personally: \$50
- Homeowners' association fees on a personal home: \$500
- Self-employment tax: \$1,000

- A. \$25,500
- B. \$21,000
- C. \$20,000
- D. \$10,000

ANSWER: D

The following are tax and fees that can be deducted:

1. State, local, foreign income tax.
2. General sales tax (if a taxpayer chooses to deduct sales tax instead of state and local income tax).
3. Foreign income taxes.
4. Employee contribution to state disability fund or state unemployment fund.
5. Real estate taxes (state, local and foreign).
6. State and local personal property taxes.
7. Taxes related to a business or producing income.
8. Taxes on property producing income.
9. Tenant's share of real estate taxes paid by co-ops.

The following are taxes and fees that are not deductible:

1. Federal income taxes.
2. Employee contributions to private or voluntary disability plans.
3. Taxes for local benefits.
4. Trash and garbage pickup fees.
5. Homeowners' association charges.
6. Federal excise taxes.
7. Foreign real estate taxes.
8. Estate, inheritance, legacy, or succession taxes.
9. Fines and penalties.
10. Gift taxes.
11. License fees for personal purposes (such as marriage, driver's, and dog license fees).

One-half of self-employment tax is an adjustment to gross income on Schedule 1 (Form 1040 or 1040-SR). The state income taxes and real estate taxes are limited to \$10,000.

Chapter 5. Standard Deductions and Itemized Deductions

17. Which of the following costs are deductible on Schedule A as taxes?

1. Personal property tax on an airplane.
 2. Garbage pickup itemized on the real estate bill.
 3. Real estate tax on property owned in Canada.
 4. Sales tax paid on the purchase of a personal car.
- A. None of the above.
B. 1, 3, and 4.
C. 2 and 4.
D. All of the above.

18. Mr. and Mrs. L bought a home July 1, 2022. Real estate taxes are assessed in their state on April 1, 2022 for property owned in 2021. The 2021 tax is due October 1, 2022. When they bought the house, they agreed to pay all taxes due after the date of purchase. Taxes of \$1,200 for 2021 were due October 1, 2022 and they paid this amount October 1, 2022. In 2023, they received a property tax bill for \$1,500 for 2022. Payment is due October 1, 2023. What amount can they deduct on their 2022 return as real property tax?

- A. \$1,200
B. \$600
C. \$750
D. \$0

19. Taxes deductible as an itemized deduction include all of the following EXCEPT:

- A. Real estate taxes based on the assessed value of the property and charged uniformly against all property.
B. State and local income taxes.
C. Taxes you paid on property owned by your parents or children.
D. Personal property taxes based on the value of the personal property.

ANSWER: B

Deductible real estate taxes are any state, local or foreign taxes on real property levied for the general public welfare. Deductible real estate taxes do not include taxes charged for local benefits and improvements that increase the value of the property. They also do not include itemized charges for services (such as trash collection) to specific property or people, even if the charge is paid to the taxing authority. General sales tax paid on the purchase of personal property is deductible. Personal property taxes are deductible if it is a state or local tax that is:

1. Charged on personal property,
2. Based only on the value of the personal property, and
3. Charged on a yearly basis, even if it is collected more or less than once a year.

ANSWER: D

Taxpayers can only deduct real estate taxes if they own the property during the period to which the tax imposed relates, not when the real estate taxes are due.

In this question, the taxpayers did not own the property in 2021, the period to which the taxes are imposed; therefore, the \$1,200 property taxes due October 1, 2022 are not deductible. The \$1,200 must be added to the basis of the property. For year 2023, the taxpayer's can deduct \$750 of the \$1,500 tax bill as real property tax since they owned the property for half the year in 2022 (July - Dec) and must add the remaining \$750 to the basis of the property.

ANSWER: C

In order for a tax to be deductible it must be imposed on the taxpayer (not a third party) and paid during the tax year. Taxes imposed on other individuals are not deductible even if the individual is related. If a spouse owns property and pays real estate tax on it, the taxes are deductible on the spouse's separate return or on the spouse's and taxpayer's joint return.

Interest Expenses

20. Ms. R owns a home but lives with her sister. She lets her son live in the house. The mortgage only has Ms. R's name on the property as she did not add her son's name to the property deed. Since her son lives in the house, he makes the monthly mortgage payment. Who can deduct the mortgage interest expense for the year?

- A. The son, since he makes the payments.
- B. Ms. R, since she owns the property and is liable for the payments.
- C. Both, since they are related.
- D. Neither, since Ms. R is not paying her liability and her son is paying for what he is not liable.

21. A taxpayer borrowed \$100,000 to buy land for investment. Her income sources for the year include: \$3,000 interest, \$1,000 dividends, and \$4,000 royalties. How much of the \$5,000 interest expense paid on the land loan can she deduct this year?

- A. \$8,000
- B. \$4,000
- C. \$3,000
- D. \$5,000

22. How much of the following interest expense is deductible on Schedule A, before limitations? The taxpayer is reporting \$1,500 in investment income.

- \$1,200 interest paid on a loan used to purchase a vacant lot held for investment.
 - \$750 interest paid on a qualifying student loan.
 - \$2,700 credit card interest on an advance used to make a down payment on a new home.
 - \$625 interest on a loan used to invest in tax-free bonds.
- A. \$1,200
 - B. \$1,950
 - C. \$4,650
 - D. \$3,900

ANSWER: B

A taxpayer can deduct home mortgage interest if all the following conditions are met.

1. The taxpayer files Form 1040 or 1040-SR and itemize deductions on Schedule A.
2. The mortgage is a secured debt on a main home or second home in which the taxpayer has an ownership interest.

ANSWER: D

If a taxpayer borrows money to buy property held for investment, the interest paid on the loan is investment interest. Generally, a taxpayer's investment interest expense is limited to the amount of his or her net investment income. Net investment income is gross income from property held for investment, such as interest, dividends, annuities, and royalties. In this question, the taxpayer's net investment income is \$8,000 (\$3,000 + \$1,000 + \$4,000); therefore, she can deduct the entire \$5,000 of investment interest.

ANSWER: A

If a taxpayer borrows money to buy property held for investment, the interest paid on the loan is investment interest. Generally, a taxpayer's investment interest expense is limited to the amount of his or her net investment income. In this question, the taxpayer has investment income of \$1,500, so he or she can deduct the entire \$1,200 as investment interest on Schedule A. The \$750 interest paid on a qualified student loan is deducted as an adjustment to gross income on Schedule 1 (Form 1040 or 1040-SR). Credit card interest is personal interest and is not deductible. Interest on a loan used to purchase tax-exempt securities is not deductible.

23. A married couple have interest and dividends (investment income) of \$14,000. They have margin interest of \$16,000, home mortgage interest of \$12,000, equity loan interest of \$3,000 on a \$50,000 loan used to buy a car, credit card interest of \$4,500 and automobile loan interest of \$2,000. They have no tax-exempt investments. What amount can they take as interest deductions after limitations?

- A. \$26,000
- B. \$52,500
- C. \$29,000
- D. \$37,500

ANSWER: A

Interest on credit cards and an auto loan is personal interest and not deductible. The deduction for investment interest is limited to the amount of a taxpayer's net investment income. Home equity loan interest is no longer deductible if the loan proceeds were not used to buy, build, or substantially improve the home.

Deductible interest:

Margin interest (up to investment income of \$14,000).....	\$14,000
Home mortgage interest.....	<u>12,000</u>
Deductible interest.....	<u>\$26,000</u>

24. A taxpayer paid interest as follows:

- \$100 on a personal credit card
- \$200 on funds borrowed in order to purchase \$6,000 in tax-exempt securities
- \$500 interest on a personal car loan. The car is not used for business
- \$10,000 on a home mortgage

What is the amount of deductible interest?

- A. \$17,400
- B. \$10,600
- C. \$10,000
- D. \$10,800

ANSWER: C

Credit card interest and interest on a personal car loan are personal interest and are not deductible. Interest on a loan used to purchase tax-exempt securities is not deductible.

25. Which of the following payments can be deducted, at least in part, as interest?

- A. Points that the seller paid to a lender to arrange financing for the purchase of a main home.
- B. Interest paid on a loan used to purchase tax-exempt bonds.
- C. Mortgage insurance premiums.
- D. Loan fees for a home mortgage.

ANSWER: A

The buyer treats points paid by the seller as if he or she had paid them and can deduct part (or all of them) in the year the points are paid. Interest to purchase tax-exempt securities premiums is not deductible. Mortgage insurance premiums are no longer deductible for 2022.

26. Which of the following would disqualify points from being fully deductible in the year paid?

- A. The points were computed as a percentage of the amount of the mortgage.
- B. The loan proceeds were used to purchase a second home.
- C. The payment of points is common in your area.
- D. The points are clearly stated on the settlement statement.

ANSWER: B

Points are fully deductible in the year paid if all of the following tests are met.

- 1. The loan is secured by the main home.
- 2. Paying points is an established business practice in the area where the loan was made.
- 3. The points paid were not more than the points generally charged in that area.
- 4. The taxpayer uses the cash method of accounting.
- 5. The points were not paid in place of amounts that originally are slated separately on the settlement statement, such as appraisal fees, inspection fees, title fees, attorney fees, and property taxes.
- 6. The loan is used to buy or build the main home.
- 7. The points were computed as a percentage of the principal amount of the mortgage. They cannot be a specifically stated flat fee.
- 8. The amount is clearly shown on the settlement statement.
- 9. The funds provided by the taxpayer at or before closing, plus any points the seller paid, were at least as much as the points charged.

Points paid on loan to purchase a second home must be amortized over the life of the loan.

27. A married couple had adjusted gross income of \$100,000. They had mortgage interest of \$12,000, home equity loan interest of \$6,000 on a loan to buy a boat, automobile loan interest of \$3,000, second home mortgage interest of \$4,000 and credit card interest of \$2,000. The total allowable interest deduction is

- A. \$31,000
- B. \$24,000
- C. \$22,000
- D. \$16,000

ANSWER: D

Interest on credit cards and a car loan are personal interest and not deductible. Home equity loan interest is no longer deductible if the loan proceeds were not used to buy, build, or substantially improve the home.

Deductible interest:

Mortgage interest.....	\$12,000
Mortgage interest on a second home.....	4,000
Deductible interest.....	<u>\$16,000</u>

28. A married couple have total wages of \$95,000 plus interest income of \$3,000 and dividends of \$2,000. They paid mortgage interest of \$7,000, car loan interest of \$2,000, mobile home interest of \$4,000, personal loan interest of \$1,000 and margin interest of \$6,000. How much interest can be deducted on Schedule A?

- A. \$16,000
- B. \$20,000
- C. \$12,000
- D. \$13,000

ANSWER: A

A mobile home is treated as a second home. The mobile home interest is deductible. Investment interest (margin interest) is limited to investment income.

Deductible interest:

Mortgage interest.....	\$ 7,000
Mobile home interest.....	4,000
Investment interest (limit to investment income; \$3,000 + \$2,000).....	5,000
Deductible interest.....	<u>\$16,000</u>

Charitable Contributions

29. Charitable contribution deductions may be limited to 60% of your adjusted gross income. Your deduction may be further limited to 20%, 30%, or 50% of your adjusted gross income depending on the type of organization. Organizations that qualify for the 50% limit include the following EXCEPT:

- A. Churches.
- B. Educational organizations with regular faculty and curriculum and regularly enrolled students.
- C. Hospitals and certain medical research organizations associated with these hospitals.
- D. Civic leagues, social and sports clubs, labor unions, and chambers of commerce.

30. All of the following organizations qualify for deductible contributions EXCEPT:

- A. A public library.
- B. Salvation Army.
- C. Churches.
- D. Most foreign organizations.

31. A taxpayer donated \$100 to the United Way, \$200 to Veterans of Foreign Wars, and \$300 to his neighbor whose home was destroyed by a tornado. How much is the deduction for charitable contributions?

- A. \$300
- B. \$400
- C. \$500
- D. \$600

ANSWER: D

The following is a partial list of the types of organizations that are 50% limit organizations.

1. Churches and religious organizations.
2. Educational organizations with a regular faculty and curriculum that normally have a regularly enrolled student body attending classes on site.
3. Hospitals and certain medical research organizations associated with these hospitals.
4. Publicly supported charities.
5. Private operating foundations.
6. Private nonoperating foundations that make qualifying distributions of 100% of contributions within 2½ months following the year they receive the contributions.
7. Certain private foundations whose contributions are pooled in a common fund, the income and principal of which are paid to public charities.

ANSWER: D

Foreign organizations (except certain Canadian, Israeli, and Mexican charities) are not qualified charitable organizations.

ANSWER: A

A taxpayer can deduct a contribution of money or property made to a qualified organization. A taxpayer cannot deduct a contribution made to an individual.

32. A husband and wife contribute money to various organizations each year. They file a joint return and their adjusted gross income is \$100,000. They contributed to the following organizations:

- \$5,000 to Alta Sierra country club.
- \$10,000 to prevention of cruelty to animals.
- \$2,000 to State Bar association (This state bar association is not a political subdivision of the state, serves both public and private purposes, and the funds uses are unrestricted and can be for private purpose.)
- \$12,000 to cancer research foundation.
- Donated clothing to Salvation Army. (They purchased the items for \$1,000, but the fair market value of the same items at a thrift store is equal to \$50.)

How much can they deduct as charitable contributions for the year?

- A. \$29,050
- B. \$25,000
- C. \$22,050
- D. \$24,000

33. Some contributions may be limited to 50% of the taxpayer's adjusted gross income. Deductions to which of the following organizations are subject to the 50% limitation on deductible contributions?

- A. Churches and conventions of organizations of churches and educational organizations with regular faculty and curriculum and regularly enrolled students.
- B. Groups whose purpose is to lobby for law changes.
- C. Homeowner's associations.
- D. Political groups or candidates for public office.

ANSWER: C

A taxpayer cannot deduct contributions to organizations that are not qualified to receive tax-deductible contributions, including the following:

1. Certain state bar associations if:
 - a. The state bar is not a political subdivision of a state,
 - b. The bar has private, as well as public, purposes, such as promoting the professional interests of members, and
 - c. The contribution is unrestricted and can be used for private purposes.
2. Chambers of commerce and other business leagues or organizations.
3. Civic leagues and associations.
4. Communist organizations.
5. Country clubs and other social clubs.
6. Foreign organizations other than:
 - a. A U.S. organization that transfers funds to a charitable foreign organization if the U.S. organization controls the use of the funds or if the foreign organization is only an administrative arm of the U.S. organization, or
 - b. Certain Canadian, Israeli, or Mexican charitable organizations. See Certain Foreign Charitable Organizations under Organizations That Qualify to Receive Deductible Contributions, earlier.
7. Homeowners' associations.
8. Labor unions.
9. Political organizations and candidates.

Deductible charitable contributions:

Prevent cruelty to animals.....	\$10,000
Cancer research foundation.....	12,000
Donated clothing to Salvation Army.....	50
Deductible charitable contributions....	<u>\$22,050</u>

ANSWER: A

Contributions made to the following are not charitable contributions.

1. Civic leagues, social and sports clubs, labor unions, and chambers of commerce.
2. Foreign organizations (except certain Canadian, Israeli, and Mexican charities).
3. Groups that are run for personal profit.
4. Groups whose purpose is to lobby for law changes.
5. Homeowner's associations.
6. Individuals.
7. Political groups or candidates for public office.

Chapter 5. Standard Deductions and Itemized Deductions

34. A taxpayer volunteered at her local art museum where she conducted art education seminars. She was required to wear a blazer that the museum provided, but she paid the dry cleaning costs of \$200 for the year. The blazer was not suitable for everyday use. Her travel to and from the museum was 1,000 miles for the year. She estimates the value of the time she contributed during the year at \$2,000 (\$20/hr x 100 hours). Her Schedule A deduction for charitable contributions is

- A. \$2,340
- B. \$2,140
- C. \$140
- D. \$340

35. A married couple contributed \$18,000 in cash to their church. They also donated \$3,000 to a private foundation which is a nonprofit cemetery organization. They knew a 30% limit applies to contributions to such foundations. Their adjusted gross income for the year was \$30,000. Their deductible contribution for the year and any carryover to next year is

- A. \$18,000 with \$0 carryover to next year.
- B. \$15,000 with \$6,000 carryover to next year.
- C. \$21,000 with \$0 carryover to next year.
- D. \$18,000 with \$3,000 carryover to next year.

ANSWER: D

A taxpayer cannot deduct the value of his or her time or services. A taxpayer can deduct the cost and upkeep of uniforms that are not suitable for everyday use and that must be worn while performing donated services for a charitable organization. A taxpayer can also deduct actual car expenses or a standard mileage rate of 14 cents a mile for use of his or her car in giving services.

Deductible charitable contributions:

Dry cleaning for uniform.....	\$200
Car expense (1000 mile x 14 cents/mile)...	<u>140</u>
Deductible charitable contributions.....	<u>\$340</u>

ANSWER: D

The amount of the taxpayers' deduction is limited to 60% of their adjusted gross income, and may be limited to 50%, 30% or 20% of their adjusted gross income, depending on the type of property donated and the type of charitable organization. If contributions are more than the limits, deduct them in the following order (up to 60% of AGI):

1. Contributions qualifying for the 60% limit,
2. Contributions qualifying for the 50% limit,
3. Contributions qualifying for the 30% limit, and
4. Contributions qualifying for the 20% limit.

Deductible charitable deduction:

Cash to church.....	\$18,000
Donation to private foundation.....	3,000
Less: 60% of AGI limitation.....	<u>18,000</u>
Carryover to next year.....	<u>\$ 3,000</u>

36. Which of the following is a deductible charitable contribution?

- A. Part of the cost of providing housing to a foreign exchange student.
- B. The value of blood donated.
- C. Buying raffle tickets where the proceeds benefit a church.
- D. Donating clothing that is in fair condition.

ANSWER: A

A taxpayer can deduct up to \$50 a month for qualifying expenses of having a foreign or American student who:

1. Lives in the taxpayer's home under a written agreement with a qualified organization as part of a program of the organization to provide educational opportunities for the student,
2. Is not the taxpayer's relative or dependent, and
3. Is a full-time student in the twelfth or any lower grade at a school in the United States.

A person cannot claim a deduction for the value of his or her time or services contributed to a qualified organization including blood donations and the value of lost income while working as an unpaid volunteer.

A person also cannot deduct as a charitable contribution amounts paid to buy raffle or lottery tickets or to play bingo or other games of chance.

A person cannot take a deduction for clothing or household items donated unless the clothing or household items are in good used condition or better.

37. A taxpayer's adjusted gross income is \$40,000. How much of the following contributions (after limitations, if any) can he deduct on Schedule A?

- \$1,000 paid at a charity auction for a week at a fishing resort. The trip is valued at \$1,000.
 - \$500 to the local Chamber of Commerce.
 - Land adjacent to his church for use as a parking lot. The fair market value of the land is \$35,000. The taxpayer paid \$20,000 for the land. He doesn't elect to reduce the fair market value to qualify for a different AGI limit.
- A. \$20,000
 - B. \$12,000
 - C. \$10,500
 - D. \$ 8,000

ANSWER: B

If a taxpayer receives a benefit as a result of making a contribution to a qualified organization, the taxpayer can deduct only the amount of the contribution that is more than the value of the benefit received. A taxpayer cannot deduct contributions to nonqualifying organizations such as chambers of commerce and other business organizations. Contributions of appreciated property are limited to 30% of the taxpayer's AGI, if the taxpayer does not elect to reduce the fair market value of the property by the amount of appreciation (increase in value) when figuring the deduction. In this question, the taxpayer received a benefit valued at \$1,000 which was the amount of the contribution so no deduction is allowed for the charity auction. The taxpayer's deduction for charitable contributions (appreciated land) is limited to 30% of the taxpayer's AGI of \$40,000 or **\$12,000**.

Deductible charitable deduction:

Land (FMV).....	\$35,000
Less: 30% of AGI limitation.....	<u>12,000</u>
Carryover to next year.....	<u><u>\$23,000</u></u>

Chapter 5. Standard Deductions and Itemized Deductions

38. A taxpayer has an adjusted gross income of \$50,000. He donated capital gain property valued at \$25,000 to his church and did not choose to reduce the fair market value of the property by the amount that would have been long-term capital gain if he had sold it. His basis in the property was \$20,000. In addition, he made the following contributions:

- \$500 to upgrade the city public park.
- \$1,000 to the Hill City Chamber of Congress.
- \$5,000 to a charitable organization in Germany.

Compute the deduction for charitable contributions in the current year (without regard to any carry over or carry back amounts).

- A. \$25,000
- B. \$31,500
- C. \$16,500
- D. \$15,500

39. Married taxpayers, both full time teachers, wanted to volunteer their services to work for the tsunami victims. Their services consisted of going to various neighborhoods in the community to raise funds for the tsunami cause. While volunteering, they kept records of the costs involved. These costs included time spent, out of pocket expenses for travel, and car expenses.

- The valued their volunteered time at \$500 total for the year.
- Out of pocket expenses that were directly related to their services performed (\$25 for parking fees and \$350 for gas and oil).
- Car expenses for new tires at \$200 and registration fees at \$90.

If the taxpayers elect to take the actual expenses, how much can they deduct?

- A. \$375
- B. \$665
- C. \$875
- D. \$1,165

ANSWER: D

Contributions of appreciated property are limited to 30% of the taxpayer's AGI, if the taxpayer does not elect to reduce the fair market value of the property by the amount of appreciation (increase in value) when figuring the deduction.

Deductible charitable deduction:

Capital gain property (FMV).....	\$25,000
Less: AGI limitation (30% × \$50,000)....	<u>15,000</u>
Carryover.....	<u>\$10,000</u>

Capital gain property (AGI limitation)..<	\$15,000
Upgrade the city park.....	<u>500</u>
Charitable deduction.....	<u>\$15,500</u>

ANSWER: A

A taxpayer cannot deduct the value of his or her time or services. However, the taxpayer can deduct out-of-pocket expenses in giving services. A taxpayer can also deduct actual unreimbursed out-of-pocket car expenses that are directly related to the use of the car in giving services to a charitable organization. The taxpayer cannot deduct general repair and maintenance expenses, depreciation, registration fees, or the cost of tires or insurance.

Deductible charitable contribution:

Parking fees.....	\$ 25
Gas and oil.....	<u>350</u>
Deductible charitable contribution.....	<u>\$375</u>

40. If the taxpayer makes a contribution by cash, check, credit card or payroll deduction to a qualified organization, what record of the contribution is the taxpayer required to obtain from the organization?

- A. If the amount is for some item or service, like a charity dinner, and over \$100, the taxpayer must have a separate acknowledgment for each contribution.
- B. For annual payroll deductions over \$250, the taxpayer must have a separate acknowledgment for each contribution.
- C. Weekly contributions of \$50 to the taxpayer's church must have a separate acknowledgment for each contribution.
- D. For contributions under \$250, the taxpayer must keep an account, statement, receipt or other reliable written record.

ANSWER: D

A taxpayer cannot deduct a cash contribution, regardless of the amount, unless he or she keeps one of the following:

- 1. A bank record that shows the name of the qualified organization, the date of the contribution, and the amount of the contribution. Bank records may include:
 - a. A canceled check.
 - b. A bank or credit union statement.
 - c. A credit card statement.
- 2. A receipt (or a letter or other written communication) from the qualified organization showing the name of the organization, the date of the contribution, and the amount of the contribution.
- 3. For a payroll deduction, the taxpayer must keep:
 - a. A pay stub, Form W-2, or other document furnished by the employer that shows the date and amount of the contribution, and
 - b. A pledge card or other document prepared by or for the qualified organization that shows the name of the organization.

To claim a deduction for a contribution of \$250 or more, the taxpayer must have an acknowledgment of his contribution from the qualified organization or certain payroll deduction records. The acknowledgment must meet these tests.

- 1. It must be written.
- 2. It must include:
 - a. The amount of the contributed,
 - b. Whether the qualified organization gave the taxpayer any goods or services as a result of his contribution (other than certain token items and membership benefits), and
 - c. A description and good faith estimate of the value of any goods or services described in (b).
- 3. The acknowledgment is received on or before the earlier of:
 - a. The date of filing the tax return for the year the contribution is made, or
 - b. The due date, including extensions, for filing the return.

In figuring whether a contribution is \$250 or more, do not combine separate contributions. For example, a contribution of \$50 each week to a church is considered a separate contribution. If contributions are made by payroll deduction, the deduction from each paycheck is treated as a separate contribution.

Chapter 5. Standard Deductions and Itemized Deductions

41. A taxpayer made cash contributions to her local chapter of the Society for Prevention of Cruelty to Animals (SPCA) to care for stray dogs and cats. She donated several times a year but she paid less than \$250 for the entire year. What documentation must the taxpayer keep and provide to the IRS upon request in order to substantiate her tax return charitable contribution deduction?

- A. No documentation is necessary since the contribution is less than \$250.
- B. A receipt for each donation that shows the amount, date, and to whom paid.
- C. An acknowledgment from the SPCA that she made contributions during the year.
- D. A self-prepared statement or letter would be sufficient for contributions less than \$250.

42. Contributions of \$250 or more can be claimed as a deduction only if you have written acknowledgment of your contribution from the qualified organization or certain payroll deduction records. The acknowledgment must contain all of the following EXCEPT:

- A. The amount of cash you contributed.
- B. Whether the organization gave the donor any goods or services as a result of the contribution.
- C. A description and good faith estimate of the value of any goods or services the donor received.
- D. A description and good faith estimate of the value of the time and services the donor provided.

43. A taxpayer has the following records of charitable contributions he made in 2022. How much can he deduct on Schedule A, Itemized Deductions?

- \$300 check to local church but no written acknowledgment.
 - \$600 by payroll deduction of \$50 per month to United Way.
 - \$400 fair market value of furniture to a qualifying shelter with receipt and acknowledgment from the shelter dated November 1, 2023.
- A. \$1,300
 - B. \$900
 - C. \$600
 - D. \$1,000

ANSWER: B

Refer to the analysis on the previous question.

ANSWER: D

The written acknowledgment must include:

1. The amount of cash contributed.
2. Whether the qualified organization gave the donor any goods or services (other than token items of little value).
3. A description and good faith estimate of the value of any goods or services provided to the donor.
4. A statement that the only benefit received by the taxpayer was an intangible religious benefit, if that was the case. The acknowledgment does not need to describe or estimate the value of an intangible religious benefit. An intangible religious benefit is a benefit that generally is not sold in commercial transactions outside a donative (gift) context. An example is admission to a religious ceremony.

ANSWER: C

A taxpayer can claim a deduction for a contribution of \$250 or more only if he or she has an acknowledgment of the contribution from the qualified organization. The taxpayer must receive the acknowledgment on or before the earlier of:

1. The date the taxpayer's files his or her return for the year the contribution is made, or
2. The due date, including extensions, for filing the return.

In figuring whether a contribution is \$250 or more, do not combine separate contributions. If contributions are made by payroll deduction, the deduction from each paycheck is treated as a separate contribution.

44. Which of the following statements regarding documentation requirements for charitable contributions is NOT true?

- A. If the total deduction for all noncash contributions for the year is more than \$500, Section A of Form 8283, Noncash Charitable Contributions, must be completed.
- B. A noncash contribution of less than \$250 must be supported by a receipt or other written acknowledgment from the charitable organization.
- C. A deduction of more than \$1,000 for one property item generally requires that a written appraisal be obtained and attached to the return.
- D. A contribution charged to a credit card is a cash contribution for purposes of documentation requirements.

ANSWER: C

A deduction of more than **\$5,000** for one property item generally requires that a written appraisal be obtained and attached to the return. Cash contributions include those paid by cash, check, credit card, or payroll deduction.

Nonbusiness Casualty and Theft Losses

45. A taxpayer's mountain cabin was destroyed by fire in a federally declared disaster area. The cost of the cabin was \$100,000 (including \$10,000 for the land). The fair market value (FMV) of the property before the fire was \$120,000 (\$105,000 for the building and \$15,000 for the land). After the fire, the FMV was \$15,000 (value of the land). The taxpayer collected \$85,000 from her insurance company. Her casualty loss (before applying the \$100 and 10% limits) is

- A. \$0
- B. \$20,000
- C. \$5,000
- D. \$15,000

ANSWER: D

In figuring a loss to real estate own for personal use, all improvements (such as buildings and the land containing the improvements) are considered together. The loss is the smaller of the decrease in the FMV of the property or its adjusted basis.

Adjusted basis of property.....	<u>\$100,000</u>
FMV of property before casualty.....	\$120,000
Less: FMV of property after casualty..	<u>15,000</u>
Decrease in FMV.....	<u>\$105,000</u>

Amount of loss:	
Lesser of A/B or decrease in FMV.....	\$100,000
Less: Insurance reimbursement.....	<u>85,000</u>
Casualty loss.....	<u>\$ 15,000</u>

46. A taxpayer's antique car caught fire and was totally destroyed. The car was appraised for \$22,500. He only had it insured for \$15,000 since this was more than enough to cover his adjusted basis of \$9,000. He decided not to replace the car. What should the taxpayer report on his tax return?

- A. Deduct a loss of \$7,500
- B. Deduct a loss of \$6,000
- C. Report income of \$6,000
- D. No reporting is required.

ANSWER: C

If the reimbursement is more than the adjusted basis in the property, a gain is recognized in the amount that the insurance reimbursement exceeds the adjusted basis in the property.

Recognized gain on the insurance reimbursement:	
Insurance reimbursement.....	\$15,000
Less: Adjusted basis.....	<u>9,000</u>
Recognized gain.....	<u>\$ 6,000</u>

Chapter 5. Standard Deductions and Itemized Deductions

47. A taxpayer's car was completely destroyed in a fire in a federally declared disaster area. He did not file a claim with his insurance company because he feared his premiums would be raised. His loss was \$4,500. His policy had a \$1,000 deductible. How much casualty loss can he claim on his return (before the deduction limits)?

- A. \$0
- B. \$4,500
- C. \$3,500
- D. \$1,000

ANSWER: D

If an insured non-business casualty is not reported to the insurer, the loss cannot be deducted. However, this rule does not apply to the portion of the loss not covered by insurance such as a deductible. In this question, the taxpayer had a \$1,000 deductible; therefore, he can take a \$1,000 casualty loss.

48. A taxpayer's home was completely destroyed by fire in a federally declared disaster area. She had no insurance. On which of the following forms would she report her loss?

- A. Form 4684, Casualties and Thefts and Form 1040 or 1040-SR as an adjustment to income.
- B. Schedule A, Itemized Deductions, only.
- C. Form 4684, Casualties and Thefts, and Schedule A, Itemized Deductions.
- D. Form 4684, Casualties and Thefts, only.

ANSWER: C

Use Form 4684, Casualties and Thefts, to report a gain or deductible loss from a casualty or theft. Report a gain on Schedule D (Form 1040 or 1040-SR). Report a loss on Schedule A.

Other Itemized Deductions

49. A taxpayer spent \$2,500 for lottery tickets during the year. She saved all her tickets. She won \$2,000 in November on a \$1 ticket. Her adjusted gross income is \$50,000. How much of her lottery ticket costs can she deduct as an itemized deduction?

- A. \$0
- B. \$1
- C. \$2,500
- D. \$2,000

ANSWER: D

Gambling losses up to the amount of gambling winnings are deducted as an itemized deduction. A taxpayer can deduct gambling losses only up to gambling winnings.

50. A taxpayer won \$5,000 in the lottery. She also won \$200 playing bingo at her lodge hall. She is not a professional gambler. She kept meticulous records of the \$6,550 she spent on gambling expenses. How much may she deduct on her Schedule A?

- A. \$0
- B. \$200
- C. \$5,200
- D. \$6,550

51. Which of the following is NOT an itemized deduction?

- A. Federal estate tax on income in respect of a decedent.
- B. Gambling losses up to the amount of gambling winnings.
- C. Casualty and theft losses from income-producing property.
- D. Union dues.

ANSWER: C

Refer to the analysis on the previous question. The taxpayer must keep an accurate diary or similar record of the losses and winnings. The diary should contain at least the following information:

1. The date and type of specific wager or wagering activity.
2. The name and address or location of the gambling establishment.
3. The names of other persons present with the taxpayer at the gambling establishment.
4. The amount(s) won or lost.

In addition to a diary, the taxpayer should also have other documentation. The taxpayer can generally prove his or her winnings and losses through Form W-2G, Certain Gambling Winnings, Form 5754, Statement by Person(s) Receiving Gambling Winnings, wagering tickets, canceled checks, substitute checks, credit records, bank withdrawals, and statements of actual winnings or payment slips provided to the taxpayer by the gambling establishment.

ANSWER: D

Miscellaneous itemized deductions subject to the 2% AGI limit are no longer deductible. The following are itemized deductions.

1. Amortizable premium on taxable bonds.
2. Casualty and theft losses from income-producing property.
3. Excess deductions of an estate or trust.
4. Federal estate tax on income in respect to a decedent.
5. Gambling losses to the extent of gambling winnings.
6. Impairment-related work expense of persons with disabilities.
7. Unlawful discrimination claims.
8. Losses from Ponzi-type investments.
9. Repayments of more than \$3,000 under a claim of right.
10. Unrecovered investment in an annuity

52. Which of the following is a itemized deductions on Schedule A?

- A. Home office expense.
- B. Federal estate taxes on income in respect of a decedent.
- C. Trade association dues.
- D. Job hunting expenses.

ANSWER: B

Refer to the analysis on the previous question. Federal estate tax on income in respect is an itemized deuction.

Qualified Business Income (QBI) Deduction

53. Which of the following taxpayers is eligible for the Qualified Business Income (QBI) Deduction?

- A. Sole proprietors
- B. Partnerships
- C. S corporations
- D. All of the above.

ANSWER: A

Owners of sole proprietorships, partnerships, S corporations and some trusts and estates may be eligible for a qualified business income (QBI) deduction (Section 199A). S corporations and partnerships are not eligible for the deduction. Instead, S corporations and partnerships must pass through the necessary information to their shareholders or partners (on Schedule K-1) so they may figure their deduction.

54. Which of the following income does NOT qualify for the Qualified Business Income (QBI) Deduction?

- A. All W-2 wages
- B. Net income from a sole proprietorship
- C. Section 199A Qualified REIT dividends
- D. Section 199A Qualified PTP income

ANSWER: A

The QBI deduction has two components:

1. **QBI Component.** This component of the deduction equals 20% of QBI from a domestic business operated as a sole proprietorship or through a partnership, S corporation, trust or estate. The QBI Component is subject to limitations, depending on the taxpayer's taxable income, that may include the type of trade or business, the amount of W-2 wages paid by the qualified trade or business and the unadjusted basis immediately after acquisition (UBIA) of qualified property held by the trade or business.
2. **REIT/PTP Component.** This component of the deduction equals 20% of qualified real estate investment trust (REIT) dividends and qualified publicly traded partnership (PTP) income. This component is not limited by W-2 wages or the UBIA of qualified property. Depending on the taxpayer's taxable income, the amount of PTP income that qualifies may be limited depending on the PTP's trade or business.

Chapter 6. Credits

Earned Income Credit (EIC)

1. Which of the following conditions would NOT prevent an individual from qualifying for earned income credit?

- A. Married filing separately filing status
- B. Being a qualifying child of another person
- C. Age 25
- D. Investment income of more than \$10,300

ANSWER: C

All taxpayers must meet the following six rules to qualify for the earned income credit.

- 1. Have a valid social security number.
- 2. Filing status cannot be married filing separately.
- 3. Must be a U.S. citizen or resident alien for the entire year.
- 4. Cannot claim the earned income credit if filing Form 2555, Foreign Earned Income.
- 5. Investment income must be \$10,300 or less.
- 6. Must have earned income.

Additional rules if the taxpayer has a qualifying child.

- 1. Child must meet the relationship, age, residency and joint return tests.
- 2. Qualifying child cannot be the qualifying child of another person with a higher AGI.
- 3. Taxpayer cannot be a qualifying child of another person.

Additional rules for taxpayers with no qualifying child.

- 1. Must meet the age requirements (generally age 19). If MFJ only one spouse must meet age rule.
- 2. Taxpayer cannot be the dependent of another person.
- 3. Taxpayer cannot be a qualifying child of another person.
- 4. Must have lived in the U.S. for more than half of the year.

Figuring and claiming the earned income credit.

Total earned income and modified AGI must be less than:

- \$16,480 (\$22,610 if married filing jointly) if taxpayer does not have a qualifying child.
- \$43,492 (\$49,622 if married filing jointly) if taxpayer has one qualifying child.
- \$49,399 (\$55,529 if married filing jointly) if taxpayer has two qualifying children.
- \$53,057 (\$59,187 if married filing jointly) if taxpayer has three or more qualifying children.

Chapter 6. Credits

2. The earned income credit is available to all of the following EXCEPT:

- A. Persons with a qualifying child.
- B. Persons without a qualifying child.
- C. Some nonresident aliens.
- D. Persons with investment income of \$10,800.

3. Which of the following is NOT a test to determine if a child is a qualifying child for the Earned Income Tax Credit (EITC)?

- A. Relationship
- B. Age
- C. Residency
- D. Support

ANSWER: D

A taxpayer without a qualifying child can claim the earned income credit as long as that person meets the age requirement (generally 19) at end of the year and his or her earned income is under \$16,480 (\$22,610 for married filing jointly). A nonresident alien can claim the credit only if he or she:

- 1. Is married to a U.S. citizen or a resident alien, and
- 2. Chooses to be treated as a resident for the whole year.

Taxpayers cannot claim the credit if their investment income is more than \$10,300.

ANSWER: D

A qualifying child must meet the following four tests:

- 1. **Relationship Test.** To be a qualifying child, a child must be the taxpayer's:
 - a. Son, daughter, stepchild, eligible foster child, or a descendant of any of them (e.g., grandchild), or
 - b. Brother, sister, half-brother, half-sister, stepbrother, stepsister, or a descendant of any of them (e.g., niece or nephew).
- 2. **Residency Test.** Child must have lived with taxpayer in the United States for more than half the year.
- 3. **Age Test.** To meet the age test, the qualifying child must be one of the following:
 - a. Under age 19 at the end of year and younger than the taxpayer (or spouse, if filing jointly).
 - b. Under age 24 at the end of year, a full-time student, and younger than the taxpayer (or spouse, if filing jointly).
 - c. Permanently or totally disabled at any time during the year, regardless of age.
- 4. **Joint Return Test.** To meet this test, the child cannot file a joint return for the year. **Exception:** The joint return test does not apply if the child and his or her spouse file a joint return only as a claim for refund.

4. You and your son lived with your mother all year. You are 23 years old. Your only income was \$9,300 from a part-time job. Your mother's adjusted gross income was \$15,000. All her income was from her job. Which of the following is NOT correct?

- A. Your son meets the conditions to be a qualifying child for purposes of the earned income credit for both you and your mother.
- B. You cannot claim the earned income credit.
- C. You are a qualifying child for your mother.
- D. The person with the higher AGI may be able to claim the credit.

5. Which of the following is NOT considered earned income for the purposes of earned income credit?

- A. Amounts deducted from wages for insurance under a cafeteria plan.
- B. Disability benefits received at age 35 under a former employer's insurance plan.
- C. Unemployment compensation.
- D. Gross income received as a statutory employee.

ANSWER: B

To meet the age test, the qualifying child must be one of the following:

- 1. Under age 19 at the end of year and younger than the taxpayer (or spouse, if filing jointly).
- 2. Under age 24 at the end of year, a full-time student, and younger than the taxpayer (or spouse, if filing jointly).
- 3. Permanently or totally disabled at any time during the year, regardless of age.

ANSWER: C

Earned income when figuring the earned income credit includes:

Taxable earned income

- 1. Wages, salaries, and tips.
- 2. Union strike benefits.
- 3. Long-term disability benefits received before minimum retirement age.
- 4. Net earnings from self-employment.
- 5. Gross income received as a statutory employee.
- 6. Nontaxable combat pay if taxpayer elects to include in earned income.

Note: Earned income no longer includes employee compensation that is nontaxable.

When figuring the earned income credit, the following are **not** included in earned income.

- 1. Interest and dividends.
- 2. Social security and railroad retirement benefits.
- 3. Welfare benefits.
- 4. Pensions or annuities.
- 5. Veteran's benefits.
- 6. Worker's compensation benefits.
- 7. Alimony.
- 8. Child support.
- 9. Unemployment compensation.
- 10. Taxable scholarship or fellowship grants that were not reported on W-2.
- 11. Variable housing allowance for the military.
- 12. Nontaxable military pay.
- 13. Earnings for work performed while an inmate at a penal institution.

Chapter 6. Credits

6. Which of the following taxpayers may claim earned income credit?

- A. Taxpayer, 50 years of age, who has a qualifying child for whom she provides sole support. She received \$15,000 in Social Security benefits and \$500 in interest income.
- B. Taxpayer, 42 years old, who was divorced the entire year. She had investment income of \$3,400 and had W-2 wages of \$9,000.
- C. Taxpayer, age 51, who is single received retirement benefits of \$5,000.
- D. Taxpayer, age 35, who is single and has one qualifying child. She had \$38,000 in wages and her adjusted gross income is \$45,000.

7. Which of the following is earned income for earned income tax credit purposes?

- A. Unemployment compensation.
- B. Alimony.
- C. The wages of a minister who has an exemption from self-employment tax.
- D. The wages of an inmate working in the prison laundry.

8. A taxpayer without a qualifying child can qualify for the earned income credit if the taxpayer meets the following rules EXCEPT:

- A. Cannot be claimed as a dependent on anyone else's return.
- B. Cannot file as single or married filing separately.
- C. Investment income must be \$10,300 or less.
- D. Cannot file Form 2555, Foreign Earned Income Exclusion.

ANSWER: B

A taxpayer claiming earned income credit cannot have investment income greater than \$10,300. To qualify for the earned income credit, a taxpayer's AGI must be less than:

- \$16,480 (\$22,610 if married filing jointly) if taxpayer does not have a qualifying child.
- \$43,492 (\$49,622 if married filing jointly) if taxpayer has one qualifying child.
- \$49,399 (\$55,529 if married filing jointly) if taxpayer has two qualifying children.
- \$53,057 (\$59,187 if married filing jointly) if taxpayer has three or more qualifying children.

ANSWER: C

Unemployment compensation, alimony, and earnings for work performed while an inmate at a penal institution are not considered earned income.

ANSWER: B

A taxpayer can qualify for the earned income credit without having a qualifying child if all of the following rules are met:

1. Must have earned income.
2. Earned income and modified adjusted gross income must each be less than \$16,480 (\$22,610 for married filing jointly).
3. Investment income must be \$10,300 or less.
4. Filing status cannot be married filing separate.
5. Cannot be a qualifying child of another person.
6. Must be at least age 25 but under age 65 (if MFJ only one spouse must meet age rule).
7. Cannot be claimed as a dependent on anyone else's return.
8. Main home must be in the U.S. for more than half the year.
9. Cannot file Form 2555, Foreign Earned Income Exclusion.

9. To qualify for the earned income credit, a taxpayer cannot be a qualifying child of another person. A taxpayer is the qualifying child of another person if

- A. The taxpayer is the other person's child, adopted child, stepchild, grandchild, or eligible foster child.
- B. The taxpayer is under age 19, under age 24 and a full-time student, or any age and permanently and totally disabled at any time during the year.
- C. The taxpayer lived with that person in the U.S. for more than half the year (all year if an eligible foster child).
- D. All of the above.

10. A taxpayer can claim the earned income credit if the taxpayer's filing status is all of the following EXCEPT:

- A. Single
- B. Head of household
- C. Married filing jointly
- D. Married filing separate

11. Which form or schedule must a taxpayer attach to his or her return if the taxpayer has a qualifying child and is claiming the earned income credit?

- A. Form 8801
- B. Form 8862
- C. Schedule EIC
- D. The EIC worksheet.

12. The IRS may ask a taxpayer to provide documents to prove the taxpayer is entitled to claim the earned income credit. These documents include the following EXCEPT:

- A. Birth certificate.
- B. School records.
- C. Medical records.
- D. Passport.

ANSWER: D

To qualify for the earned income credit, a taxpayer cannot be a qualifying child of another person. A taxpayer is the qualifying child of another person if all the following apply:

- 1. The taxpayer is the other person's child, adopted child, stepchild, grandchild, or eligible foster child.
- 2. The taxpayer is under age 19, under age 24 and a full-time student, or any age and permanently and totally disabled at any time during the year.
- 3. The taxpayer lived with that person in the U.S. for more than half the year (all year if an eligible foster child).

ANSWER: D

A married taxpayer must file a joint tax return to claim the EIC. The taxpayer's filing status cannot be married filing separately.

ANSWER: C

A taxpayer must complete Schedule EIC and attach it to his or her tax return if the taxpayer has a qualifying child and is claiming the EIC. Schedule EIC provides the IRS with information about the qualifying children, including their names, social security numbers, relationship to the taxpayer, and the amount of time they lived with the taxpayer during the year.

ANSWER: D

The IRS may ask a taxpayer to provide documents to prove the taxpayer is entitled to claim the earned income credit. The IRS will tell the taxpayer what documents to send them. These may include birth certificates, school records, medical records, etc. The IRS will also send the taxpayer a letter with the name, address, and telephone number of the IRS employee assigned to the case.

Child and Dependent Credit

13. Which one of the following could prevent an individual from qualifying for the child and dependent care credit?

- A. Investment income of more than \$10,300.
- B. Paying for care for more than one qualifying person.
- C. Not identifying the care provider on the tax return.
- D. Paying for child care while looking for work.

14. Which of the following is a disqualification for the Child and Dependent Care Credit?

- A. Head of household filing status.
- B. Making child care payments to relatives.
- C. Paying for care for your spouse who is not physically or mentally able to care for himself or herself while you work.
- D. Child care only while you perform unpaid volunteer work.

ANSWER: C

To claim the credit for child and dependent care expenses, a taxpayer must file Form 1040 or 1040-SR and meet all of the following tests.

1. **Qualifying person test.** The care must be for one or more qualifying persons.
2. **Earned income test.** Must have earned income during the year.
3. **Work-related expense test.** Must pay child and dependent care expenses in order to work or look for work.
4. Cannot make payments for child and dependent care to a spouse or someone who can be claimed as a dependent. If payment is to a child, the child cannot be a dependent and must be age 19 or older by the end of the year.
5. Can be any filing status except married filing separate. Must file a joint return if married.
6. **Provider identification test.** Must identify the care provider on the tax return.
7. If excluding dependent care assistance benefits provided by employer (up to \$5,000), the exclusion must be less than the dollar limit for qualifying expenses (\$3,000 if one qualifying person, \$6,000 if two or more qualifying persons).

Expenses are considered qualifying expenses if:

1. They allow the taxpayer to work or look for work, and
2. They are for a qualifying person's care.

ANSWER: D

Refer to the analysis on the previous question. A taxpayer can count work related expenses paid to a relative as long as the relative is not a dependent. Child and dependent care expenses must be work related to qualify for the credit. Expenses are considered work related only if both of the following are true:

1. They allow the taxpayer to work or look for work, and
2. They are for a qualifying person's care.

A taxpayer is not considered gainfully employed if he or she does unpaid volunteer work or volunteer work for a nominal salary.

15. A married couple both work full time. They have three children ages 18, 6, and 3. For purposes of claiming the Child Care Credit, which of the following expenses qualify?

- A. Payments to the taxpayers' 18-year-old daughter to care for her 3-year-old sister.
- B. Payments to the taxpayers' 20-year-old niece who lives with them and can be claimed as their dependent.
- C. Payments to the husband's mother who lives with them but does not qualify as their dependent.
- D. Payments to a private school for their 6-year-old to attend first grade.

16. Each of the following are qualifying persons for purposes of claiming the child and dependent care credit EXCEPT:

- A. A spouse who was physically or mentally unable to care for himself or herself.
- B. A dependent, age 14, for whom the dependency exemption is claimed.
- C. A dependent who was physically unable to care for himself or herself for whom the dependency exemption would have been claimed if the dependent had earned less than \$4,400 in gross income.
- D. A child who lives with the custodial parent who cannot claim the child as a dependent because the noncustodial parent provided \$600 for the child's support and can claim the child as a dependent under a pre-1985 divorce decree.

17. Which one of the following is NOT a qualifying person for purposes of the child and dependent care credit?

- A. Spouse who was physically not able to care for himself or herself.
- B. A qualifying child who was age 12 when the care was provided.
- C. Child who was under age 13 when the care was provided, but who lived with the taxpayer's former spouse all year.
- D. Dependent who was mentally not able to care for himself or herself and the taxpayer can claim an a dependen.

ANSWER: C

A taxpayer can count work-related payments made to relatives who are not dependents, even if they live in the taxpayer's home. However, do not count any amounts paid to:

- 1. A dependent who the taxpayer can claim as a dependent on his or her return,
- 2. A child who was under age 19 at the end of the year, even if he or she is not a dependent,
- 3. A spouse, or
- 4. The parent of the qualifying child who is the qualifying person and is under age 13.

Expenses to attend first grade or a higher grade are not qualified expenses in figuring the Child Care Credit.

ANSWER: B

The following are qualifying persons for purposes of claiming the child and dependent care credit:

- 1. A qualifying child under age 13 when the care was provided,
- 2. A spouse who was physically or mentally unable to care for himself or herself, or
- 3. A dependent who was physically or mentally unable to care for himself or herself and either:
 - a. Was the taxpayer's dependent, or
 - b. Would have been the taxpayer's dependent except that:
 - i. He or she received gross income of \$4,400 or more,
 - ii. He or she filed a joint return, or
 - iii. The taxpayer or the taxpayer's spouse if filing jointly could be claimed as a dependent on someone else's tax return.

ANSWER: C

Refer to the analysis on the previous question. A non-custodial parent cannot treat his or her child as a qualifying person even if he or she can claim the child as a dependent.

Chapter 6. Credits

18. Mr. and Mrs. M have three children all under the age of ten. The twins, who are three years old, attended preschool costing a total of \$12,000. The third child, who is nine, attended an after-school nursery at a cost of \$5,500. Mrs. M has earned income of \$34,000 and Mr. M earns \$45,000. What amount of childcare expenses is to be used to determine the credit?

- A. \$3,000
- B. \$5,000
- C. \$16,000
- D. \$6,000

19. Mr. and Mrs. Z have four children ranging in age from two to ten. Mr. Z has wages of \$90,000 and Mrs. Z \$75,000. Two of the children went to nursery school at a total cost of \$15,000. The two older children attended a qualified after school program that costs \$7,500. Mr. Z received dependent care benefits from his employer of \$5,000 that was not included in his income. What amount of childcare expenses can be used to determine the credit on their return?

- A. \$1,000
- B. \$3,000
- C. \$6,000
- D. \$22,500

20. Mr. and Mrs. K work and their daughter attends day care. The cost of day care is \$700 per month. Mr. K's earned income for the year was \$10,000 and Mrs. K's earned income was \$40,000. They had no other income or adjustments. What amount of child care credit can they claim?

- A. \$480
- B. \$600
- C. \$720
- D. \$900

ANSWER: D

There is a dollar limit on the amount of work-related expenses that can be used to figure the credit. This limit is \$3,000 for one qualifying child or **\$6,000 for two or more qualifying persons.**

ANSWER: A

If a taxpayer received dependent care benefits (\$5,000) that were excluded or deducted from income, the taxpayer must subtract that amount from the dollar limit that applies to the taxpayer (\$6,000).

ANSWER: B

For one child, the maximum allowable expenses on which the credit is based, is \$3,000. The maximum credit is 35% of work-related expenses if AGI is \$15,000 and under, and is reduced 1% for every \$2,000 increase up to \$43,001 AGI (minimum credit is 20%). This is the best way to remember the applicable percentage.

Maximum allowable expenses	
(One child).....	\$3,000
Applicable % (20% minimum credit).....	× 20%
Child care credit.....	<u>\$ 600</u>

21. Mr. and Mrs. M's dependent children, ages 3 and 4, attend day care where the total expense was \$7,200. Mr. M earned \$80,000 and Mrs. M earned \$5,000. How much child care credit can they claim?

- A. \$0
- B. \$600
- C. \$1,000
- D. \$1,200

ANSWER: C

The amount of work-related expenses used to figure the credit can't be more than:

1. The taxpayer's earned income for the year if single at the end of the year, or
2. The smaller of the taxpayer or his or her spouse's earned income for the year if married at the end of the year.

The amount of work-related expenses use to figure the credit cannot be more than \$5,000 (the smaller of the taxpayer's earned income or that of his or her spouse). The maximum credit is 35% of work-related expenses if AGI is \$15,000 or under and is reduced 1% for every \$2,000 increase up to \$43,001 AGI (minimum credit is 20%).

Child care credit:

work related expenses (dollar limit).....	\$5,000
Multiply: Percentage for AGI of \$85,000	$\times 20\%$
Child care credit.....	<u>\$1,000</u>

22. A spouse who is either a full-time student or not able to care for himself or herself is treated as having earned income of which amount?

- A. \$250 if there is one qualifying person.
- B. \$500 if there are two or more qualifying persons.
- C. \$0 regardless of how many qualifying persons.
- D. Both A & B.

ANSWER: D

A spouse who is either a full-time student or not able to care for himself or herself is treated as having earned income. His or her earned income for each month is considered to be at least \$250 if there is one qualifying person, or at least \$500 if there are two or more. If a spouse works during that month, use the higher of \$250 (or \$500) or his or her actual earned income for that month. If a spouse is a full-time student or not able to care for himself or herself for only part of a month, the full \$250 (or \$500) still applies for that month. If, in the same month, both the taxpayer and his or her spouse are either full-time students or not able to care for themselves, only one spouse can be considered to have this earned income of \$250 (or \$500) for that month.

23. A taxpayer with one child earns \$24,000 a year. He pays work-related expenses of \$2,900 for the care of his 4-year-old child and qualifies to claim the credit for child and dependent care expenses. His employer pays an additional \$1,000 under a qualified dependent care benefit plan. What amount of work-related expenses can the taxpayer use to figure the child and dependent care credit?

- A. \$1,900
- B. \$2,000
- C. \$2,900
- D. \$3,000

ANSWER: B

If the taxpayer received dependent care benefits that were exclude from income, the taxpayer must subtract that amount from the dollar limit. The dollar limit for the taxpayer's work-related expenses is \$3,000 (one qualifying person). Figure the credit on only **\$2,000** of the \$2,900 work-related expenses he paid because his dollar limit is reduced by \$1,000.

Child Tax Credit and Credit for Other Dependents

24. A single taxpayer has adjusted gross income of \$65,000, no foreign source income and a tax before credits of more than \$8,000. Her dependents include her son, who turned 17 in September, her daughter, who is 12 and her niece, who is 6. All of the children are U.S. citizens and lived with her all year. What is the amount of child tax credit and other dependent credit she may claim?

- A. \$2,000
- B. \$4,000
- C. \$4,500
- D. \$6,000

ANSWER: C

The maximum credit claimed is \$2,000 for each qualifying child. The tax credit will be refundable only up to \$1,500, depending on T/P's income, and the T/P must have earned income of at least \$2,500 to even be eligible for the refund. For the credit for other dependents, the maximum credit is \$500 for each person. The taxpayer must reduce his or her child tax credit if his or her modified AGI is above the amount shown for each filing status.

- Married filing jointly - \$400,000
- All other filing statuses - \$200,000

For the child tax credit, a qualifying child for purposes of the child tax credit must be all of the following.

1. Be the taxpayer's son, daughter, stepchild, foster child, brother, sister, stepbrother, stepsister, or a descendant of any of them (e.g., grandchild, niece or nephew).
2. Was under age 17 at the end of the year.
3. Did not provide over half of his or her own support.
4. Lived with the taxpayer for more than half the year.
Exception: The noncustodial parent can claim the child tax credit for a child if the custodial parent released a claim for the child as a dependent on Schedule 8332, and the noncustodial parent attached the release to his or her return.
5. Is claimed as a dependent on the taxpayer's return.
6. Does not file a joint return for the year (or files it only as a claim for refund).
7. Was a U.S. citizen, a U.S. national, or a resident of the U.S.

A person qualifies a taxpayer for the ODC if the person meets all of the following conditions.

1. The person is claimed as a dependent on the taxpayer's return.
2. The person cannot be used by the taxpayer to claim the child tax credit or the additional child tax credit.
3. The person is a U.S. citizen, U.S. national, or U.S. resident alien.

25. For purposes of claiming the child tax credit, which of the following is NOT a requirement for a qualifying child?

- A. Child must be under age 17 at the end of the year.
- B. Child must be a citizen or resident of the United States.
- C. Child must be claimed as a dependent.
- D. Child must live with the taxpayer for the entire year.

26. Which of the following is NOT a requirement for a qualifying child for purposes of the child tax credit?

- A. The child is claimed as your dependent.
- B. The child was under age 18 at the end of the year or under age 24 at the end of the year and was a student.
- C. The child is your son, daughter, adopted child, grandchild, stepchild, or foster child.
- D. The child is a citizen or resident of the United States.

27. A taxpayer filed as head of household and would like to take the child tax credit for her child. Which of the following statements is NOT correct regarding the child tax credit?

- A. Her child must be under 18 at the end of the tax year.
- B. The taxpayer must claim her child as a dependent.
- C. All or part of the child tax credit may be refundable.
- D. If the taxpayer's adjusted gross income is above \$200,000, her credit will be reduced or eliminated.

ANSWER: D

Refer to the analysis on the previous question.

ANSWER: B

To claim the child tax credit, a qualifying child must be under age 17 at the end of the tax year.

ANSWER: A

A qualifying child for purposes of the child tax credit must be under **age 17** at the end of the tax year. The credit amount of the credit may be reduced if modified adjusted gross income (AGI) is more the amounts shown below for each filing status.

- Married filing jointly - \$400,000
- All other filing statuses - \$200,000

All or part of the child tax credit may be refundable. Figure the refundable amount on Schedule 8812, Additional Child Tax Credit and enter the refundable amount on Form 1040 or 1040-SR.

Chapter 6. Credits

28. Which of the following statements is NOT true regarding the child tax credit?

- A. A qualifying child can be a nonresident alien.
- B. The credit is fully refundable for most taxpayers and some taxpayers can receive up to half of it, in advance.
- C. The child tax credit may be limited depending on modified adjusted gross income.
- D. The maximum child tax credit for each qualifying child is \$2,000

ANSWER: A

A qualifying child for purposes of the child tax credit must be all of the following.

1. Be the taxpayer's son, daughter, stepchild, foster child, brother, sister, stepbrother, stepsister, or a descendant of any of them (e.g., grandchild, niece or nephew).
2. Was under age 17 at the end of the year.
3. Did not provide over half of his or her own support.
4. Lived with the taxpayer for more than half the year.
Exception: The noncustodial parent can claim the child tax credit for a child if the custodial parent released a claim for the child as a dependent on Schedule 8332, and the noncustodial parent attached the release to his or her return.
5. Is claimed as a dependent on the taxpayer's return.
6. Does not file a joint return for the year (or files it only as a claim for refund).
7. Was a U.S. citizen, a U.S. national, or a resident of the U.S.

29. For purposes of claiming the credit for other dependents, which of the following is NOT a qualifying person?

- A. A dependent.
- B. A dependent that qualifies for the child tax credit.
- C. A U.S. resident alien.
- D. A U.S. national.

ANSWER: B

A person qualifies a taxpayer for the credit for other dependents if the person meets all of the following conditions.

- The person is claimed as a dependent on the taxpayer's return.
- The person cannot be used by the taxpayer to claim the child tax credit or the additional child tax credit.
- The person is a U.S. citizen, U.S. national, or U.S. resident alien.

Education Credits

30. A taxpayer has two dependent children who are attending an accredited college. His son is a senior who spent \$11,000 for tuition and fees. His daughter is a freshman and had tuition expenses of \$4,000. The taxpayer meets all the income and filing status requirements for the education credits. There is no tax-free assistance to pay these expenses. What is the maximum credit that he may claim on his tax return?

- A. \$2,500 American opportunity credit.
- B. \$2,200 American opportunity credit and \$2,000 Lifetime Learning Credit.
- C. \$5,000 American opportunity credit.
- D. \$2,500 American opportunity credit and \$2,500 Lifetime Learning Credit.

ANSWER: C

American opportunity credit. The maximum credit per student is \$2,500 (100% of the first \$2,000 and 25% of the next \$2,000 of qualified education expenses). The credit is available for the first 4 years of post-secondary education, and 40% of the credit is refundable for most taxpayers. The threshold at which this credit is reduced is higher than that for the lifetime learning credit. For 2022, the amount of your credit is gradually reduced (phased out) if your modified adjusted gross income (MAGI) is between \$80,000 and \$90,000 (\$160,000 and \$180,000 if you file a joint return).

Lifetime learning credit. A taxpayer may be able to claim a lifetime learning credit of up to \$2,000 for qualified education expenses paid for all students enrolled in eligible educational institutions. The amount of the lifetime learning credit is 20% of the first \$10,000 of qualified education expenses you paid for all eligible students. The maximum amount of lifetime learning credit you can claim is \$2,000 ($20\% \times \$10,000$). The credit is available for an unlimited number of years. For 2022, the amount of your credit is gradually reduced (phased out) if your modified adjusted gross income (MAGI) is between \$80,000 and \$90,000 (\$160,000 and \$180,000 if you file a joint return).

Qualified Education Expense. Only certain expenses for course-related books, supplies, and equipment qualify.

Qualified expenses for the American opportunity credit. Qualified education expenses include amounts spent on books, supplies, and equipment needed for a course of study, whether or not the materials are purchased from the educational institution as a condition of enrollment or attendance.

Qualified expenses for the lifetime learning credits. Qualified education expenses include only amounts for books, supplies, and equipment required to be paid to the institution as a condition of enrollment or attendance.

Chapter 6. Credits

31. Ms. K, her son, and daughter are all in graduate school. Her son and daughter are not her dependents although they live with her and she pays all of their education expenses. Ms. K paid \$6,000 in qualified tuition expenses for herself. She also paid \$2,500 in qualified tuition expenses for her son and another \$2,500 for her daughter. Her adjusted gross income is \$90,000 and she files as head of household. Which of the following is correct?

- A. Ms. K may claim no American opportunity credit and \$2,000 Lifetime Learning Credit.
- B. Ms. K may claim \$5,000 American opportunity credit and \$1,000 Lifetime Learning Credit.
- C. Ms. K may claim neither the American opportunity credit nor the Lifetime Learning Credit.
- D. Ms. K may claim no American opportunity credit and \$1,000 Lifetime Learning Credit.

32. A taxpayer paid his educational expenses at a community college where he completed his freshman year and began his sophomore year. His father provides more than half of the support for him and claims an exemption for him on his tax return. Which of the following is correct?

- A. The taxpayer is eligible to take the American opportunity credit on his tax return.
- B. The father is eligible to take the American opportunity credit on his tax return.
- C. The taxpayer and his father may split the American opportunity credit between their tax returns.
- D. Neither may take the American opportunity credit.

33. Which of the following statements is NOT true regarding tax benefits for education?

- A. The American opportunity credit may be claimed for tuition expenses incurred in the first 4 years of post-secondary education.
- B. The dollar limitations for the American opportunity credit are calculated on a per student basis.
- C. The Lifetime Learning Credit is allowed for tuition paid for graduate program studies.
- D. Room and board are qualifying expenses for any education credit.

ANSWER: C

A taxpayer cannot claim the American opportunity credit or lifetime learning credit if his or her modified AGI is \$90,000 or more (\$180,000 or more if married filing jointly). Taxpayers cannot take an education credit for someone who is not their spouse or dependent. Also, taxpayers cannot take the American opportunity credit for graduate studies.

ANSWER: B

If a taxpayer claims an eligible student as his or her dependent, any expenses paid by the student are treated as paid by the taxpayer. Only the taxpayer can claim the education credit.

ANSWER: D

For purposes of an education credit, qualified education expenses are tuition and certain related expenses required for enrollment or attendance at an eligible educational institution. Student-activity fees and expenses for course-related books, supplies, and equipment are included in qualified education expenses only if the fees and expenses must be paid to the institution as a condition of enrollment or attendance. Room and board are not qualified expenses for any education credit.

Credit for the Elderly or the Disabled

34. Mr. H is 55 years old. In order to qualify for the credit for the elderly or the disabled, he must have:

- A. Retired on permanent and total disability.
- B. Received nontaxable disability benefits.
- C. Reached mandatory retirement age.
- D. Worked at least part-time for the minimum wage in two of the preceding three years.

ANSWER: A

To qualify for the credit for the elderly or the disabled an individual must be a U.S. citizen and:

1. Be age 65 or older by the end of the tax year, or
2. If under age 65, the individual must meet the following:
 - a. Be retired on permanent and total disability,
 - b. Did not reach mandatory retirement age before the tax year, and
 - c. Received taxable disability benefits.

Foreign Tax Credit

35. A United States citizen paid the following foreign income taxes:

- \$10,000 tax paid to England on consulting fee income.
- \$5,000 tax paid to Spain on earned income for which she claimed the foreign earned income exclusion.
- \$1,000 tax paid to France which she deducted as an itemized deduction.

These were the citizen's only sources of income. Her U.S. tax liability was \$23,000. What amount of foreign tax credit can she claim?

- A. \$16,000
- B. \$0
- C. \$10,000
- D. \$7,000

ANSWER: C

A taxpayer can choose to deduct foreign taxes paid on her schedule A or take a foreign tax credit, but not both. A taxpayer cannot take a foreign tax credit on income excluded from U.S. tax under the foreign earned income exclusion. In this question, the taxpayer deducted the \$1,000 tax paid to France as an itemized deduction. She also claimed the foreign earned income exclusion on the earned income from Spain. She can only take a foreign tax credit for the \$10,000 she paid to England on the consulting fee income.

36. A single taxpayer received a Form 1099-DIV from her global mutual fund that showed dividend income of \$500 and foreign taxes withheld of \$67. This is the only foreign source income she received for the year. Her income tax before any credits is \$4,320. On which of the following forms may she elect to claim a credit for the foreign tax paid?

- A. On Schedule 3 (Form 1040 or 1040-SR) as a refundable credit.
- B. On Schedule 3 (Form 1040 or 1040-SR) as a non-refundable credit.
- C. Form 1040 or 1040-SR, Schedule A, Itemized Deductions, Line 6, "Other Taxes."
- D. Form 1040 or 1040-SR, Schedule B, by electing to reduce the dividend income by \$67.

ANSWER: B

A taxpayer can claim the foreign tax credit without using Form 1116 if all of the following requirements are met.

1. All gross foreign source income was from interest and dividends and all of that income and the foreign tax paid on it were reported on Form 1099-INT, Form 1099-DIV, or Schedule K-1 (or substitute statement).
2. If the taxpayer had dividend income from shares of stock, the taxpayer held those shares for at least 16 days.
3. The taxpayer is not filing Form 4563 or excluding income from sources within Puerto Rico.
4. The foreign taxes for the tax year are not more than \$300 (\$600 if filing a joint return).
5. All of the foreign taxes were legally owed and not eligible for a refund and paid to countries that are recognized by the U.S. and do not support terrorism.

Adoption Credit

37. Which of the following is NOT a qualified adoption expense?

- A. Attorney fees.
- B. Court costs.
- C. Travel expenses.
- D. Expenses for carrying out any surrogate parenting arrangement.

ANSWER: D

Qualified adoption expenses are reasonable and necessary expenses directly related to, and whose principal purpose is for, the legal adoption of an eligible child. These expenses include the following.

1. Adoption fees.
2. Court costs.
3. Attorney fees.
4. Travel expenses (including amounts spent for meals and lodging) while away from home.
5. Re-adoption expenses to adopt a foreign child.

Qualified adoption expenses do not include expenses:

1. That violate state or federal law.
2. For carrying out any surrogate parenting arrangement.
3. For the adoption of your spouse's child.
4. For which you received funds under any federal, state, or local program.
5. Allowed as a credit or deduction under any other federal income tax rule.
6. Paid or reimbursed by your employer or any other person or organization.

38. A taxpayer may be able to take a tax credit for qualified expenses paid to adopt an eligible child of up to which amount?

- A. \$11,150
- B. \$12,100
- C. \$12,650
- D. \$14,890

ANSWER: D

A taxpayer may be able to take a tax credit of up to **\$14,890** for qualified expenses paid to adopt an eligible child. The credit may be allowed for the adoption of a child with special needs even if the taxpayer does not have any qualified expenses.

Retirement Savings Contributions

39. A taxpayer can take the retirement savings contributions credit for the following contributions to a retirement plan EXCEPT:

- A. Traditional IRA.
- B. Roth IRA.
- C. 401(k) plan.
- D. Rollover contributions to a Roth IRA.

ANSWER: D

Eligible contributions include the following:

1. Contributions to a traditional or Roth IRA.
2. Salary reduction contributions (elective deferrals, including amounts designated as after-tax Roth contributions) to:
 - a. 401(k) plan (including a SIMPLE 401(k)).
 - b. A section 403(b) annuity.
 - c. An eligible deferred compensation plan of a state or local government (a governmental 457 plan).
 - d. A SIMPLE IRA plan.
 - e. A salary reduction SEP.
3. Contributions to a section 501(c)(18) plan.

40. Which of the following can take the retirement savings contributions credit?

- A. A taxpayer, age 20.
- B. A taxpayer, age 19, who is a dependent on someone else's return.
- C. A full-time student age 22.
- D. A taxpayer, age 16.

ANSWER: A

If a taxpayer makes eligible contributions to a qualified retirement plan, an eligible deferred compensation plan, or an IRA, the taxpayer can claim the credit if all of the following apply.

1. Taxpayer is age 18 or older.
2. Taxpayer was not a full-time student.
3. No one else can claim the taxpayer as a dependent.
4. Taxpayer's AGI is not more than:
 - a. \$68,000 if filing status is married filing jointly.
 - b. \$51,000 if filing status is head of household.
 - c. \$34,000 if filing status is single, married filing separately, or qualifying surviving spouse.

Credit for Prior Year Minimum Tax

41. Which of the following applies to the allowable credit for prior year minimum tax?

- A. Any unused portion may not be carried forward.
- B. It is allowed in full against the current year's tax.
- C. It may only be carried forward for five years.
- D. The allowable credit cannot reduce the current year's tax below the current year's tentative minimum tax.

ANSWER: D

A taxpayer may be able to claim a credit for prior year minimum tax against current year's tax. The amount of the credit for any taxable year cannot reduce the current year's regular tax below the current year's tentative alternative minimum tax. Any excess may be carried forward to subsequent tax years until it is used up.

Chapter 6. Credits

42. Individuals who pay AMT, Alternative Minimum Tax, may take a credit against regular income tax in future years for only the portion of the AMT that is attributable to

- A. Deferral items.
- B. Exclusion items.
- C. Both A & B.
- D. Itemized deductions.

43. A taxpayer had to pay \$4,000 alternative minimum tax last year. This year his regular income tax is \$60,000 and alternative minimum tax on his income is \$57,000 so he will pay only regular income tax. How much credit for prior year minimum tax can he take this year?

- A. \$0
- B. \$4,000
- C. \$2,000
- D. \$3,000

ANSWER: A

The AMT is attributed to two types of adjustments and preferences: deferral and exclusion items. Deferral items, such as depreciation, generally do not cause a permanent difference in taxable income over time. Exclusion items, such as standard deduction, do cause a permanent difference. The minimum tax credit is allowed only for the AMT attributed to deferral items.

ANSWER: D

A taxpayer may be able to claim a credit for prior year minimum tax against current year's tax. The amount of the credit for any taxable year cannot reduce the current year's regular tax below the current year's tentative alternative minimum tax. Any excess may be carried forward to subsequent tax years until it is used up. In this question, the taxpayer had a credit for prior year minimum tax of \$4,000. The credit for this year cannot reduce the current year's regular tax (\$60,000) below the current year's alternative minimum tax (\$57,000); therefore, the credit for this year would be \$3,000 (\$60,000 - \$57,000).

Chapter 7. Taxes

Alternative Minimum Tax

1. Which of the following would NOT be a part of the computation of alternative minimum tax?

- A. Depreciation.
- B. Refund of state and local taxes included in gross income.
- C. Self-employment tax.
- D. Certain itemized deductions.

ANSWER: C

The following are adjustments to taxable income in computing alternative minimum tax:

- 1. Add standard deduction (if claimed).
- 2. Add itemized deductions claimed for state and local taxes, certain interest, most miscellaneous deductions, and part of medical expenses.
- 3. Subtract refund of state and local taxes included in gross income.
- 4. Add accelerated depreciation that is more than straight line.
- 5. Difference between gain or loss on the sale of property reported for regular tax purposes and AMT purposes.
- 6. For stock acquired during the year through the exercise of an incentive stock option, add the amount of any fair market value of the stock that is more than the amount that was paid for it.
- 7. Change in the method of determining passive activity loss deduction.
- 8. Add certain depletion that is more than the adjusted basis of the property.
- 9. Add part of the deduction for certain intangible drilling costs.
- 10. Add tax-exempt interest on certain private activity bonds.
- 11. Add 7% of qualified small stock (section 1202) gain if purchase stock before 9/28/10.

Self-employment tax is not an adjustment or tax preference item when computing alternative minimum tax.

2. Which of the following is NOT a tax preference item or an adjustment to taxable income for alternative minimum tax purposes?

- A. Add accelerated depreciation that is more than straight line.
- B. Addition of the standard deduction (if claimed).
- C. Addition of all itemized deductions (if claimed).
- D. Subtraction of any refund of state and local taxes included in gross income.

ANSWER: C

Refer to the analysis on the previous question. Addition of itemized deductions claimed for state and local taxes, certain interest, most itemized deductions, and part of medical expenses are adjustments to taxable income for alternative minimum tax purposes. Not all itemized deductions are adjustments for AMT purposes.

Chapter 7. Taxes

3. Which of the following items are NOT adjustments or tax preference items for computing alternative minimum tax?

- A. Tax-exempt interest on certain private activity bonds.
- B. Standard deduction.
- C. Interest income.
- D. Itemized deduction for state and local taxes.

4. The alternative minimum tax is tentative minimum tax over

- A. Taxable income.
- B. Regular tax.
- C. Alternative minimum taxable income.
- D. Tax preference items.

ANSWER: C

Interest income is not an adjustment or tax preference item for computing alternative minimum tax

ANSWER: B

The alternative minimum tax is tentative minimum tax over regular tax.

Self-Employment Tax

5. A taxpayer has a small business that has a profit of \$15,000. The taxpayer's husband has a farm that has a loss of \$7,000. They are married. Which of the following is correct regarding their self-employment tax computation?

- A. If they file separately, the husband may not elect to use the optional method.
- B. The taxpayer must pay self-employment tax on \$15,000.
- C. On a joint return, the self-employment tax may be computed based on \$8,000 of income for the taxpayer only.
- D. If they file separately, they may elect to split the net profit for self-employment tax purposes, each paying based on \$4,000.

ANSWER: B

Married taxpayers filing a joint return cannot file a joint Schedule SE. This is true whether one spouse or both spouses have earnings subject to SE tax. If both spouses have earnings subject to SE tax, each spouse must complete a separate Schedule SE and attach both schedules to the joint return.

Household Employment Taxes

6. In which situation would a taxpayer NOT be required to file Schedule H, Household Employment Taxes, for the year?

- A. Paid \$2,400 wages for babysitting in the taxpayer's home.
- B. Withheld \$100 Federal income tax from payments to the taxpayer's yard worker.
- C. Paid \$2,400 to his or her mother for house-keeping.
- D. Paid household help, other than his or her mother, \$1,000 for the period July, August, and September.

7. Ms. P pays Ms. A, an unrelated person, \$100 per week to come to her home and care for her children while she works part-time. Ms. A requests that Ms. P withhold \$10 Federal income tax from each paycheck. Ms. P has other filing obligations such as Form W-2. Ms. P must do which of the following?

- A. File Form 941 quarterly, reporting social security, Medicare and federal withholding.
- B. File Schedule H (Form 1040) quarterly, reporting social security, Medicare, and federal withholding.
- C. File Schedule H as an attachment to her Form 1040, reporting social security and Medicare on the wages paid. File Form 940 reporting federal income tax withheld.
- D. File Schedule H as an attachment to her Form 1040 and report social security, Medicare, FUTA, and federal tax withholding.

ANSWER: C

A taxpayer must file Schedule H, Household Employment Taxes, to figure total household employment taxes (social security, Medicare, FUTA, and withheld federal income taxes). A taxpayer must withhold and pay social security and Medicare taxes if he or she pays cash wages of \$2,400 or more in 2022 to any one household employee. A taxpayer must pay federal unemployment tax (FUTA) if he or she pays cash wages to household employees totaling \$1,000 or more in any calendar quarter. Do not count wages paid to any of the following individuals:

- 1. Spouse
- 2. Taxpayer's child who is under the age of 21.
- 3. Taxpayer's parent. Exception: Count these wages if both of the following conditions apply.
 - a. Parent cares for taxpayer's child who is either of the following:
 - i. Under the age of 18, or
 - ii. Has a physical or mental condition that requires the personal care of an adult for at least 4 continuous weeks in a calendar quarter.
 - b. Taxpayer's marital status is one of the following:
 - i. Divorced and have not remarried,
 - ii. Widow(er), or
 - iii. Living with a spouse whose physical or mental condition prevents him or her from caring for the child for at least 4 continuous weeks in a calendar quarter.

ANSWER: D

A taxpayer uses Schedule H (Household Employment Taxes) to figure his or her total household employment taxes (social security, Medicare, FUTA, and withheld federal income taxes). These household employment taxes are added to the taxpayer's income taxes on Schedule 2 (Form 1040 or 1040-SR). Schedule H must be attached to the tax return.

Estimated Tax Payments

8. A taxpayer had adjusted gross income of \$98,000 and a total tax liability in 2021 of \$20,000. In 2022, the taxpayer has a tax liability of \$25,000. The taxpayer's withholding was increased to \$23,500. He will file his tax return 2022 on April 10, 2023. To avoid the underpayment of estimated tax penalty, the taxpayer must:

- A. Pay the additional \$1,500 due by April 15, 2023.
- B. Pay an additional \$1,500 by January 15, 2023.
- C. File an annualized estimated tax computation.
- D. Do nothing, as he has satisfied the minimum tax payment requirements.

9. Which statement pertaining to estimated tax payments is NOT true?

- A. An individual, whose only income is from self-employment, will have to pay estimated payments.
- B. If insufficient tax is paid through withholding, estimated payments may be necessary.
- C. Estimated tax payments are required when the withholding taxes are greater than the overall tax liability.
- D. Estimated tax is used to pay not only income tax, but self-employment tax and alternative minimum tax as well.

ANSWER: D

A taxpayer must make estimated tax payments for 2022 if he or she expects to owe at least \$1,000 in tax for 2022, after subtracting withholding and credits, and expects his or her withholding and credits to be less than the smaller of:

- 1. 90% of the tax to be shown on taxpayer's 2022 tax return, or
- 2. 100% of the tax shown on taxpayer's 2021 tax return. The return must cover all 12 months.

The taxpayer's 2022 withholding of \$23,500 was more than 100% of his 2021 tax liability of \$20,000. Therefore, the taxpayer is not subject to the underpayment of estimated tax penalty.

ANSWER: C

Estimated tax payments are only required when insufficient tax is paid through withholding. Self-employed taxpayers generally pay their taxes through estimated payments. Estimated tax is used to pay not only income tax, but self-employment tax and alternative minimum tax as well.

10. A taxpayer made no estimated tax payments for 2022 because she thought she had enough tax withheld from her wages. In January 2023, she realized that her withholding was \$2,000 less than the amount needed to avoid a penalty for the underpayment of estimated tax so she made an estimated tax payment of \$2,500 on January 10. She filed her 2022 return on March 1, 2023, showing a refund due her of \$100. Which of the following statements is NOT true regarding the estimated tax penalty?

- A. She will not owe a penalty for the quarter ending December 31, 2022, because she made sufficient payment before January 15, 2023.
- B. She will not owe a penalty for any quarter because her total payments exceed her tax liability.
- C. She could owe a penalty for one or all of the first 3 quarters even though she is due a refund for the year.
- D. If she owes a penalty for any quarter, the underpayment will be computed from the date the amount was due to the date the payment is made.

11. A taxpayer sold her investment property March 30, 2022 at a gain of \$50,000. She expects to owe \$10,000 in additional income taxes on this sale. She had a tax liability of \$900 for 2021 and will have no withholding for 2022. Her first estimated tax payment is due on what date

- A. April 30, 2022
- B. April 15, 2022
- C. January 31, 2023
- D. June 15, 2022

12. A single taxpayer started a home-based dress business on March 1, 2022. She was an employee and paid income taxes of \$6,000 for 2021. Her business had net income of \$0, \$9,000, \$11,000, and \$15,000 respectively for each of the calendar quarters in 2022. Her total tax liability for the year was \$5,500. Her first payment of estimated taxes is due

- A. April 15, 2022.
- B. No estimates due if she files by Jan. 31, 2023.
- C. June 15, 2022.
- D. Her tax liability for 2021 exceeds 90% of her 2022 tax liability so no estimates are required to be paid.

ANSWER: B

If a taxpayer did not pay enough estimated tax for each payment period, she could be charged a penalty for that period or periods even though she is due a refund for the year.

ANSWER: B

The payment due date for the first estimated tax period (January - March) is April 15th.

ANSWER: C

A taxpayer does not make estimated tax payments until he or she has income on which taxes will be owed. A taxpayer makes his or her first payment by the due date for the first period in which estimated taxes are due. In this question, the taxpayer was not required to make estimated tax payments until the second period for which the due date is June 15, 2022.

Chapter 7. Taxes

13. Taxpayers, whose AGI was more than \$150,000 the previous year, must make estimated tax payments if they expect withholding and refundable credits to be the lesser of 90% tax liability or what percent of last year's total tax?

- A. 80%
- B. 90%
- C. 100%
- D. 110%

14. Which of the following is NOT an estimated tax period?

- A. January 1 - March 31.
- B. April 1 - June 30.
- C. June 1 - August 31.
- D. September 1 - December 31.

15. A taxpayer expects to owe \$2,000 in tax. The taxpayer's tax liability for the previous year was \$0. The taxpayer must make the following estimated tax payments:

- A. Quarterly payments of \$500.
- B. Quarterly payments of \$450.
- C. Quarterly payments of \$400.
- D. The taxpayer is not required to make estimated tax payments.

16. A taxpayer does not have to make the fourth quarter tax payment for his tax return if the taxpayer does the following.

- A. Files the tax return by January 15, and pays the rest of the tax owed.
- B. Files the tax return by January 31, and pays the rest of the tax owed.
- C. Files the tax return by February 28, and pays the rest of the tax owed.
- D. Files the tax return by March 1, and pays the rest of the tax owed.

ANSWER: D

If the taxpayer's 2021 adjusted gross income was more than \$150,000 (\$75,000 if married filing separately for 2022), the taxpayer will have to make estimated tax payments if he or she expects to owe, after subtracting withholding and credits, at least \$1,000 in tax in 2022 and expects withholding and credits to be less than the smaller of:

- 1. 90% of the tax liability in 2022, or
- 2. 110% of the tax liability in 2021.

ANSWER: B

The following are the payment periods and due dates for each payment:

<u>For the period</u>	<u>Due date</u>
Jan. 1 - March 31	April 15
April 1 - May 31	June 15
June 1 - August 31	September 15
Sept. 1 - Dec. 31	January 15 next year

ANSWER: D

A taxpayer does not have to pay estimated tax for the tax year if all three of the following conditions are met.

- 1. The taxpayer had no tax liability for the previous year.
- 2. The taxpayer was a U.S. citizen or resident for the entire year.
- 3. The taxpayer's previous tax year covered a 12-month period.

ANSWER: B

If the taxpayer files his Form 1040 or 1040-SR by January 31, and pays the rest of the tax due, he does not need to make the estimated tax payment that would have been due on January 15.

17. Which of the following statements is NOT correct regarding estimated tax payments of married taxpayers filing separate returns?

- A. If both spouses make separate estimated tax payments either spouse can use all of the estimated tax payments on his or her separate tax return.
- B. If the married taxpayers make jointly estimated tax payments, either spouse can claim all of the estimated tax payments.
- C. In a noncommunity property state, if both spouses make separate estimated tax payments each spouse can only take credit for the estimated tax payment made by that spouse.
- D. If a married couple makes joint estimated tax payments for the year and divorce during the year, either spouse can claim all of the joint payments.

ANSWER: A

In a noncommunity property state, if a married couple makes separate estimated tax payments and files separate returns, each spouse can only take credit for his or her own payments.

If a married couple makes joint estimated tax payments, the taxpayers must decide how to divide the payments between each separate tax return. One of spouses can claim all of the estimated tax paid and the other none or the taxpayers can divide it in any other way agreed upon. If the taxpayers cannot agree, the taxpayers must divide the payments in proportion to each spouse's individual tax as shown on the separate returns.

If a married couple makes joint estimated tax payments and divorced during the year, either spouse can claim all or part of the joint payments. If the taxpayers cannot agree on how to divide the payments, the taxpayers must divide them in proportion to each spouse's individual tax as shown on the separate returns.

Chapter 8. Estate and Gift Tax

Estate Tax Return - Form 706

1. A single person died during the year. The executor does NOT elect the alternate valuation date. Given the following information, determine the value of gross estate.

	FMV at date of death
Certificate of deposit	\$1,100,000
Mortgage receivable on sale of property	\$2,000,000
Painting & collectibles	\$1,500,000
Income tax refund due from 2021 individual tax return	\$30,000
Household goods and personal effects	\$500,000

- A. \$4,600,000
- B. \$4,630,000
- C. \$5,100,000
- D. \$5,130,000

ANSWER: D

The gross estate includes all property in which the decedent had an interest (including real property outside the United States). It also includes:

1. Certain transfers made during the decedent's life without an adequate and full consideration in money or money's worth.
2. Annuities.
3. The includable portion of joint estates with right of survivorship.
4. The includable portion of tenancies by the entirety.
5. Certain life insurance proceeds (even though payable to beneficiaries other than the estate).
6. Property over which the decedent possessed a general power of appointment.
7. Dower or curtesy (or statutory estate) of the surviving spouse.
8. Community property to the extent of the decedent's interest as defined by applicable law.

Value of gross estate:

Mortgage receivable.....	\$2,000,000
Certificate of deposit.....	1,100,000
Painting & collectibles.....	1,500,000
Income tax refund.....	30,000
Household goods and personal effect	<u>500,000</u>
Value of gross estate.....	<u><u>\$5,130,000</u></u>

Chapter 8. Estate and Gift Tax

2. A single taxpayer died during the year. Based on the following information, determine the value of his gross estate.

Cash	\$15,000
Life Insurance on his life (payable to his estate)	\$1,200,000
Jointly owned property (Percentage includible- 100%)	\$4,100,000

- A. \$5,315,000
- B. \$5,115,000
- C. \$4,115,000
- D. \$4,100,000

ANSWER: A

The gross estate includes the value of property held jointly at the time of death by the decedent and anyone who has the right to survivorship. However, that part of the property acquired by a person other than the decedent for adequate and full consideration in money, or by bequest or gift from a third party is not included in the decedent's gross estate. The gross estate includes the proceeds of life insurance on the decedent's life if:

1. The proceeds are received by the estate,
2. The proceeds are received by another for the benefit of the estate, or
3. The proceeds are not received by or for the benefit of the estate and the decedent possessed incidents of ownership in the policy.

Value of gross estate:

Cash.....	\$ 15,000
Life insurance.....	1,200,000
Jointly owned property (100% includible).....	4,100,000
Value of gross estate.....	<u>\$5,315,000</u>

3. A taxpayer died on June 30. Her executor identified the following items belonging to her estate:

- Personal residence with a fair market value of \$400,000 and an existing mortgage of \$100,000.
- Certificate of deposit in the amount of \$150,000 of which \$10,000 was accrued interest payable at maturity on August 1.
- Stock portfolio with a value at date of death of \$2,000,000 and a basis of \$500,000.
- Life insurance policy, with her daughter named as an irrevocable beneficiary, in the amount of \$150,000.

Assuming that no alternate valuation date is elected, what is the gross value of her estate?

- A. \$2,700,000
- B. \$2,090,000
- C. \$2,550,000
- D. \$2,450,000

ANSWER: C

Refer to the analysis on the previous question. The life insurance policy, with the daughter named as an irrevocable beneficiary, is not included in the gross estate.

Value of gross estate:

Home.....	\$ 400,000
Certificate of deposit.....	150,000
Stock portfolio.....	2,000,000
Value of gross estate.....	<u>\$2,550,000</u>

4. A single taxpayer died in March. Based on the following information, determine the value of his gross estate.

	FMV on date of death
His revocable grantor trust	\$1,700,000
Life Insurance on his life (payable to his estate)	\$1,250,000
Stock given to his son 5 years ago (no gift tax was paid)	\$ 50,000

- A. \$2,250,000
- B. \$2,700,000
- C. \$2,950,000
- D. \$3,000,000

5. A taxpayer dies leaving a gross estate of \$16,500,000. Considering the following potential deductions and other information, what will be the taxable estate?

- Funeral expenses paid out of the estate: \$10,000
- Value of the residence owned jointly with decedent's spouse that will pass to the spouse (this property is included in the gross estate): \$240,000
- Mortgage on residence: \$20,000
- Value of property given to charitable organizations per the decedent's will: \$50,000

- A. \$16,500,000
- B. \$16,240,000
- C. \$16,220,000
- D. \$0

ANSWER: C

The value of property transferred before death is generally not included in the gross estate with the following exceptions:

1. Certain gift taxes (not gifts).
2. Transfers of life insurance.
3. Transfers with retained life estate.
4. Transfer taking effect at death.
5. Revocable transfers.

value of gross estate:

Life insurance.....	\$1,250,000
Revocable grantor trust.....	<u>1,700,000</u>
value of gross estate.....	<u><u>\$2,950,000</u></u>

ANSWER: C

The following are deductions allowed against the gross estate of the decedent:

1. Administration and funeral expenses.
2. Claims against the estate.
3. Mortgages and debt.
4. Casualty and theft losses.
5. Marital deduction (all property that is included in the gross estate and passes to the surviving spouse is eligible for the marital deduction).
6. Charitable contribution deduction (if the decedent leaves property to a qualifying charity, it is deductible from the gross estate).
7. Losses during the estate administration.

Taxable estate:

Gross estate.....	\$16,500,000
Less: Funeral expenses.....	10,000
Marital deduction (property passed to spouse less the unpaid mortgage).....	220,000
Charitable contribution.....	<u>50,000</u>
Taxable estate.....	<u><u>\$16,220,000</u></u>

Chapter 8. Estate and Gift Tax

6. Based on the following information, what is the total allowable deduction against the decedent's estate?

- Mortgages and notes (receivable): \$10,000
- Income in respect of a decedent: \$5,000
- Funeral expenses: \$12,000
- Attorney fees: \$20,000

- A. \$47,000
- B. \$32,000
- C. \$42,000
- D. \$10,000

7. In general, which of the following items are allowable deductions against a decedent's estate (Form 706)?

- A. Funeral Expenses
- B. Mortgages (decedent's liability)
- C. Charitable Bequests
- D. All of the above.

8. Which of the following statements is true regarding allowable deductions on Form 706, United States Estate Tax Return?

- A. Penalties incurred as the result of a federal estate tax deficiency are deductible administrative expenses.
- B. Attorney fees paid incidental to litigation incurred by the beneficiaries are a deductible administrative expense.
- C. Executor's commissions may be deducted if they have actually been paid or if it is expected that they will be paid.
- D. Funeral expenses are not an allowable expense.

ANSWER: B

Refer to the analysis on the previous question. Both attorney fees and funeral expenses are deductible against the decedent's estate.

ANSWER: D

The following are deductions allowed against the gross estate of the decedent:

1. Administration and funeral expenses.
2. Claims against the estate.
3. Mortgages and debt.
4. Casualty and theft losses.
5. Marital deduction (all property that is included in the gross estate and passes to the surviving spouse is eligible for the marital deduction).
6. Charitable contribution deduction (if the decedent leaves property to a qualifying charity, it is deductible from the gross estate).
7. Losses during the estate administration.

ANSWER: C

Administrative expenses include executor commissions, legal fees for the estate, and miscellaneous expenses. Expenditures not essential to the proper settlement of the estate, but incurred for the individual benefit of beneficiaries are not deductible. Penalties incurred as the result of a federal estate tax deficiency are not deductible. Funeral expenses are an allowable expense.

9. All of the following items can be claimed as deductions against a decedent's estate EXCEPT:

- A. Specific bequest to son.
- B. Executor's fees.
- C. Legal fees to settle estate.
- D. Charitable bequests.

10. In general, on Form 706, you can claim a marital deduction for gifts to your spouse. Generally, you cannot take the marital deduction if the gift to your spouse is a terminal interest. You may elect to deduct a gift of a qualified terminal interest property (QTIP) if it meets three requirements. Which of the following is NOT a necessary requirement?

- A. No part of the entire interest is subject to another person's power of appointment.
- B. Your spouse is entitled for life to all of the income from the entire interest.
- C. The income is paid yearly or more often.
- D. Your spouse has the unlimited power, while he or she is alive or by will, to appoint the entire interest in all circumstances.

11. When Mrs. L's husband died in 2019, he set up a qualified terminable interest property (QTIP) trust, naming her as the beneficiary for her life. Mrs. L died in 2022. Given the following information, determine the value of Mrs. L's gross estate.

	<u>FMV on date of death</u>
Mrs. L's revocable grantor trust	\$ 1,750,000
QTIP trust	\$3,000,000

- A. \$ - 0 -
- B. \$1,750,000
- C. \$3,000,000
- D. \$4,750,000

ANSWER: A

A bequest is the act of giving or leaving property to another through the last will and testament. Generally, any distribution of income (or property in kind) to a beneficiary is an allowable deduction to the estate and is includible in the beneficiary's gross income to the extent of the estate's distributable net income. However, a distribution will not be an allowable deduction to the estate and will not be includible in the beneficiary's gross income if the distribution meets the following requirements.

1. It is required by the terms of the will.
2. It is a gift or bequest of a specific sum of money or property.
3. It is paid out in three or fewer installments under the terms of the will.

ANSWER: D

A taxpayer may elect to deduct a gift of a qualified terminal interest property (QTIP) if it meets three requirements.

1. The spouse is entitled to all the income from the property for life.
2. The income is payable annually or at more frequent intervals.
3. No person has the power to appoint any part of the property to any person other than the spouse.

ANSWER: D

A marital deduction can be claimed for an individual for certain qualified terminable interest property (QTIP) that passes to the surviving spouse. To qualify as QTIP, the surviving spouse must have the right to all income from the property for life. When the surviving spouse dies, the value of the QTIP, for which a marital deduction was allowed, is included in the surviving spouse's gross estate. In this question, Mrs. L's husband claimed a marital deduction for the QTIP trust on his estate tax return. Upon her death, Mrs. L must include the QTIP trust along with her revocable trust in her gross estate.

Chapter 8. Estate and Gift Tax

12. Given the following information, determine the value of the decedent's gross estate:

	FMV at date of death
Beneficiary for life of a QTIP trust (Qualified terminal interest property)	\$3,000,000
Irrevocable trust (decedent was the grantor, but retained no interest in the trust)	\$1,000,000
Revocable grantor type trust (decedent was the grantor)	\$2,500,000

- A. \$5,500,000
- B. \$6,500,000
- C. \$3,500,000
- D. \$4,000,000

13. A cash basis taxpayer died on September 30 2022. Assume the following details regarding the assets of her estate:

Her home was appraised for \$1,800,000 at the date of her death and sold on April 15, 2023 for \$1,750,000.

She had a time certificate in the amount of \$100,000. The certificate was redeemed for funeral expenses on October 1, 2022. (Ignore interest for purposes of this question).

She had common stock valued at \$2,350,000 at the date of death. On the alternate valuation date, the stock was valued at \$2,250,000.

She had personal and household furnishings that were appraised at \$25,000 as of the date of death. The executor gave all of the items to a charity on November 1, 2022.

If the alternate valuation date is elected, what is the gross value of the estate?

- A. \$4,125,000
- B. \$4,225,000
- C. \$3,975,000
- D. \$3,875,000

ANSWER: A

Refer to the analysis on the previous question regarding a QTIP trust. An irrevocable trust where the decedent retains no interest in the trust is not included in the decedent's gross estate. With a revocable grantor trust the decedent has an interest in the trust and the trust is included in the decedent's gross estate.

Value of gross estate:

Beneficiary for life of a QTIP trust.....\$3,000,000
Revocable grantor type trust..... 2,500,000
Value of gross estate.....\$5,500,000

ANSWER: A

By electing the alternate valuation method, property in the estate is valued according to the following rules:

1. Any property distributed, sold, exchanged, or otherwise disposed of within 6 months after the decedent's death is valued as of the date on which it is first distributed, sold, exchanged, or otherwise disposed of.
2. Any property not disposed of within 6 months after the decedent's death is valued as of 6 months after the date of the decedent's death.
3. Any property, interest, or estate that is affected by mere lapse of time is valued as of the date of the decedent's death. However, this is adjusted for any difference in value not due to mere lapse of time as of 6 months after the decedent's death, or, if earlier, as of the date of its disposition.

Value of gross estate:

House (valued at date of sale).....\$1,750,000
Time certificate..... 100,000
Stock (valued 6 months after DOD)... 2,250,000
Household furnishings..... 25,000
Estate value.....\$4,125,000

14. A taxpayer died on March 15, 2022. The assets included in her estate were properly valued as follows:

	<u>3/15/2022</u>	<u>7/15/2022</u>	<u>9/15/2022</u>
Personal Residence	\$850,000	\$900,000	\$1,000,000
Stocks held	3,400,000	\$3,200,000	\$3,300,000

The executor sold the home on July 15, 2022 for \$900,000. The alternate valuation date was properly elected. What is the value of the estate reported for estate tax purposes?

- A. \$4,250,000
- B. \$4,400,000
- C. \$4,200,000
- D. \$4,100,000

15. Which of the following statements concerning the alternate valuation election is true?

- A. The alternate valuation election may be made even if no estate tax will be paid if the election is not made.
- B. If the alternate valuation election is made, it is possible for some but not all of the assets to be included in the decedent's estate at a higher FMV than on the date of death.
- C. If the alternate valuation election is made, assets that are disposed of within 6 months of the decedent's death are generally valued on the date of death.
- D. None of the statements are correct.

ANSWER: C

Since the alternate valuation date was elected, the value of the personal residence for estate tax reporting is valued at the date it was sold (\$900,000) and the stock is valued as of 6 months after the date of the decedent's death (\$3,300,000) for a total estate value of \$4,200,000.

ANSWER: B

The following provisions apply to the election of the alternate valuation method:

1. The election must be made on the first estate tax return filed for the estate and be made on a return filed within 1 year of the due date (including extensions) for filing the return. The election cannot be changed.
2. The election may be made only if it will decrease the value of the gross estate and the sum of the estate tax and the generation-skipping transfer tax.
3. The election applies to all of the property in the estate.

If the alternate valuation election is made, assets that are disposed of within 6 months of the decedent's death are generally valued as of the date on which they are first distributed, sold, exchanged, or otherwise disposed of.

Chapter 8. Estate and Gift Tax

16. Which of the following items are included in a decedent's gross estate?

The decedent's IRA, where the decedent's spouse is the named beneficiary.

A checking account with the decedent's daughter as joint tenants. The daughter's funds were used to set up the account.

Assets held in the decedent's revocable grantor trust.

- A. All of the assets are included in the decedent's estate.
- B. The IRA and checking account are included in the decedent's estate.
- C. The IRA and the assets in the revocable grantor trust are included in the decedent's estate.
- D. None of the assets are included in the decedent's estate.

17. Which of the following items is NOT an allowable deduction on a decedent's estate tax return?

- A. Bequest to a surviving ex-spouse.
- B. Property taxes accrued before death but not paid until after death.
- C. Executor's fees for administering the estate.
- D. None of the items is allowed as a deduction against the decedent's estate.

18. Which of the following tax credits is NOT allowed on an Estate Tax return (Form 706)?

- A. Credit for foreign death taxes
- B. Unified credit
- C. Credit for tax on prior transfers
- D. State inheritance tax credit

ANSWER: C

The gross estate includes the value of property held jointly at the time of death by the decedent and anyone who has the right of survivorship. However, that part of the property acquired by a person other than the decedent for adequate and full consideration for money is not included in the decedent's gross estate.

In this question, the checking account held jointly by the decedent and the decedent's daughter is not included in the gross estate because the account was set up with the daughter's funds.

A grantor trust is not a separate taxable entity. Income earned by a grantor trust is taxable to the grantor and reported on the grantor's individual income tax return (Form 1040 or 1040-SR). All assets held in the grantor trust are included in gross estates.

ANSWER: A

A bequest is the act of giving or leaving property to another through the last will and testament. Generally, any distribution of income (or property in kind) to a beneficiary is an allowable deduction to the estate and is includible in the beneficiary's gross income to the extent of the estate's distributable net income. However, a distribution will not be an allowable deduction to the estate and will not be includible in the beneficiary's gross income if the distribution meets the following requirements.

1. It is required by the terms of the will.
2. It is a gift or bequest of a specific sum of money or property.
3. It is paid out in three or fewer installments under the terms of the will.

ANSWER: D

The following credits are allowable against estate tax:

1. Unified credit.
2. Credit for tax on prior transfers.
3. Credit for foreign death taxes.

State inheritance taxes are a deduction, not a credit against estate tax.

19. Following the death of her husband, the executrix of his estate paid the following:

1. Medical expenses of the decedent, paid within six months of the date of death, and not claimed on the decedent's final income tax return.
2. Funeral expenses of her husband.
3. State inheritance taxes.
4. Qualified charitable contributions, as a bequest dictated by the Will of her husband.

Which of the preceding generally would be allowable deductions in determining the taxable estate on the Federal Estate Income Tax Return (Form 706)?

- A. 1 and 3 only
- B. 1, 2 and 4 only
- C. 2 and 3 only
- D. 1, 2, 3, and 4

20. Which of the following is NOT a credit against gross estate tax in determining net estate tax?

- A. Foreign death taxes
- B. Qualified charitable contributions
- C. Unified credit
- D. Credit for tax on prior transfers

21. A taxpayer died on June 1, 2022. After determining that an estate tax return will be required, his executor decided to use the alternate valuation date for valuing the gross estate. Which of the following dates will be the alternate valuation date?

- A. April 15, 2023
- B. December 31, 2022
- C. December 1, 2022
- D. On or before the due date of the Federal Estate Tax Return.

ANSWER: D

Medical expenses of the decedent paid after the death of the decedent and not claimed on the decedent's final income tax return are deductible. Funeral expenses, state inheritance taxes, and qualified charitable expenses are also deductions in determining the taxable estate on the Federal Estate Income Tax Return (Form 706).

ANSWER: B

Qualified charitable contributions are a deduction, not a credit against gross estate tax.

ANSWER: C

The election is applicable only if an estate tax return is required to be filed and applies to all the property in the estate. By electing the alternate valuation method, property in the estate is valued according to the following rules:

1. Any property distributed, sold, exchanged, or otherwise disposed of within 6 months after the decedent's death is valued as of the date on which it is first distributed, sold, exchanged, or otherwise disposed of.
2. Any property not disposed of within 6 months after the decedent's death is valued as of 6 months after the date of the decedent's death.
3. Any property, interest, or estate that is affected by mere lapse of time is valued as of the date of the decedent's death. However, this is adjusted for any difference in value not due to mere lapse of time as of 6 months after the decedent's death, or, if earlier, as of the date of its disposition.

22. An extension of time to pay estate tax may be granted if the executor can show reasonable cause as to why the estate is unable to pay the tax timely. All of the following are illustrations of reasonable cause EXCEPT:

- A. Since the estate includes a claim to substantial assets in a pending lawsuit, the gross estate cannot be determined when the tax is due.
- B. The liquid assets of the estate are located in several jurisdictions and are not within the immediate control of the executor.
- C. The estate would have to borrow funds at an interest rate higher than generally available to satisfy claims against the estate that are due and payable.
- D. Payment of the estate taxes would require the liquidation of more than 50% of the assets of the estate.

23. A taxpayer died April 30, 2022. His gross estate totaled \$15.6 million dollars. Assuming no extension is granted, the executor must file Form 706, United States Estate Tax Return, on or before

- A. April 15, 2023.
- B. August 15, 2022.
- C. January 30, 2023.
- D. October 31, 2022.

24. If an extension is NOT granted, when must Form 706 be filed to report estate and/or generation-skipping transfer tax?

- A. By the 15th day of the fourth month following the date of death.
- B. Within 6 months after the date of death.
- C. Within 9 months after the date of death.
- D. Within 1 year after the date of death.

ANSWER: D

The IRS will allow additional time to pay estate tax if reasonable cause can be shown. The additional time is usually up to twelve months, but could be extended up to ten years. Reasonable cause can be any of the following:

- 1. There are enough assets to pay the tax, however, the assets are not under the immediate control of the administrator.
- 2. Most of the estate's assets consist of rights to receive future payments and the current cash assets are not enough to pay the tax without borrowing against the estate assets and diminishing the estate.
- 3. The estate includes a substantial claim which cannot be collected without a lawsuit and the amount of the estate cannot be determined.
- 4. Reasonable efforts have been made to convert estate assets.

Additionally, if the gross estate includes an interest in a closely held business, the executor can arrange installment payments. The decedent, however, must have been a U.S. citizen or resident at the time of death.

ANSWER: C

For 2022, an estate tax return must be filed if the value of the gross estate at the date of death was **more than \$12,060,000**. The Form 706 is due nine months after the date of the decedent's death at the Service Center for the state in which the decedent was domiciled at the time of death. Form 706 must be filed by January 30, 2023.

ANSWER: C

The Form 706 is due **9 months** after the date of the decedent's death.

25. A taxpayer died on September 30, 2022. His gross estate was valued at \$11,400,000. Unless an extension is granted, a Federal Estate Tax Return (Form 706) must be filed on or before

- A. April 15, 2023
- B. January 15, 2023
- C. June 30, 2023
- D. A Federal Estate Tax Return does not have to be filed.

ANSWER: D

For 2022, an estate tax return must be filed if the value of the gross estate at the date of death was more than \$12,060,000.

Gift Tax Return - Form 709

26. Mr. J made several transfers during the calendar year. In January, he paid \$17,000 of tuition directly to State University for his friend, S. He gave his niece, P, \$6,000 for her school tuition. In addition, in May, he also gave the following graduation gifts:

- Cash to his friend, S: \$10,500
- Cash to his niece, P: \$10,000

He gave no other gifts during the year. From the information above, must Mr. J file a gift tax return, and why?

- A. No, total gifts to any one individual during the year do not exceed \$16,000.
- B. No, each transfer was under \$16,000.
- C. Yes, total gifts given during the year exceed \$16,000.
- D. Yes, total gifts to friend S exceed \$16,000.

ANSWER: A

The general rule is that any gift is taxable. However, there are exceptions to the rule. The following gifts are not taxable gifts.

1. The first \$16,000 given to someone during a calendar year (the annual exclusion).
2. Tuition or medical expenses paid directly to an educational or medical institution for someone else.
3. Gifts to a spouse (the marital deduction).
4. Gifts to a political organization for its use.
5. Gifts to charities.
6. Gifts to certain exempt organizations described in 501(c)(4), 501(c)(5), and 501(c)(6)

If after using the above exceptions, a taxpayer has taxable gifts, he or she can eliminate or reduce the gift tax using the unified credit. A U.S. citizen or resident must use the unified credit to reduce any gift tax for which he or she may be liable. A unified credit applies to both the gift tax and the estate tax. Any unified credit used against gift tax in one year reduces the amount of credit that can be used against gift tax in a later year. The amount of the credit depends on when the gift was made. When applying the credit first use the exception from gift tax mention above.

Gifts made in:	Unified credit	Applicable Exclusion Amount
2002 - 2010	\$345,800	\$1,000,000
2011	\$1,945,800	\$5,000,000
2012	\$1,993,800	\$5,120,000
2013	\$2,045,800	\$5,250,000
2014	\$2,081,800	\$5,340,000
2015	\$2,117,800	\$5,430,000
2016	\$2,125,800	\$5,450,000
2017	\$2,141,800	\$5,490,000
2018	\$4,417,800	\$11,180,000
2019	\$4,505,800	\$11,400,000
2020	\$4,577,800	\$11,580,000
2021	\$4,625,800	\$11,700,000
2022	\$4,769,800	\$12,060,000

27. A taxpayer has elected to treat transfers (on behalf of his son) made by him during tax year to a qualified state tuition program as made ratably over 5 years. His total contribution to this plan, which he made during calendar year, is \$80,000. What amount will be treated as a taxable gift?

- A. \$80,000
- B. \$64,000
- C. \$16,000
- D. \$0

28. A taxpayer made the following transfers during the year:

- To his neighbor in the amount of \$19,000
- To his nephew in the amount of \$18,000
- To his uncle in the amount of \$17,000

All of the transfers are gifts that qualify for the annual exclusion. What is the total annual exclusion amount for gifts listed on Form 709?

- A. \$48,000
- B. \$32,000
- C. \$16,000
- D. \$15,000

29. A single individual made the following gifts during the calendar year:

- Payment directly to sister's qualifying college for tuition: \$20,000
- Payment directly to sister's qualifying college for room and board: \$25,000
- Cash to nephew: \$16,000
- Cash to brother: \$30,000

What is the gross amount of gifts that must include on his Form 709, United States Gift Tax Return?

- A. \$91,000
- B. \$75,000
- C. \$56,000
- D. \$55,000

ANSWER: D

The gift tax does not apply to amounts paid on behalf of an individual to a qualifying domestic or foreign educational organization. The payment must be made directly to the educational organization and it must be for tuition only. No educational exclusion is allowed for amounts paid for books, supplies, or room and board. Contributions to a qualified tuition program (529 plan) on behalf of a designated beneficiary do not qualify for the educational exclusion. However, if a taxpayer contributed more than \$16,000 to a 529 plan on behalf of any one person, the taxpayer may elect to treat up to \$80,000 of the contribution for that person as if the taxpayer made it ratably over a 5-year period. The election allows the taxpayer to apply the annual exclusion to a portion of the contribution in each of the 5 years starting with the year of the contribution.

ANSWER: A

A separate \$16,000 annual exclusion applies to each person to whom the taxpayer makes a gift. The taxpayer made 3 gifts to 3 different people, therefore the total annual exclusion amount for gifts listed on his Form 709 would be **\$48,000** (\$16,000 × 3).

ANSWER: D

In figuring gross amount of gifts to report on Form 709, do not include the amount paid for an individual's education if the amount paid for that individual is made directly to an educational organization as tuition. Also, do not report any gift that is not over the \$16,000 annual exclusion.

Gross amount of gifts reported on Form 709:
 Payment directly to sister's qualifying college for room and board.....\$25,000
 Cash to brother..... 30,000
 Gross amount of gifts.....\$55,000

Chapter 8. Estate and Gift Tax

30. A taxpayer gave a vase worth \$40,000 to his sister. His basis in the vase is \$10,000. What amount will he report as the value of the gift on Form 709?

- A. \$10,000
- B. \$20,000
- C. \$30,000
- D. \$40,000

31. Which of the following situations would require the filing of Form 709?

- A. A married couple agree to split gifts which total \$20,000 to one individual.
- B. A single taxpayer gave more than \$16,000 during the year to any one donee.
- C. Any of the gifts made that were of a future interest.
- D. All of the above.

32. Which of the following statements regarding the annual exclusion for gift taxes is true?

- A. The gift of a present interest to more than 1 donee as joint tenants qualifies for only 1 annual exclusion.
- B. A gift of a future interest cannot be excluded under the annual exclusion.
- C. The annual exclusion amount is \$15,000.
- D. None of the above.

ANSWER: D

In determining the value of a gift, use the fair market value at the time the gift is made.

ANSWER: D

A taxpayer must file a gift tax return if any of the following apply.

1. Gave gifts that are more than the annual exclusion to someone (other than spouse).
2. The taxpayer and his or her spouse are splitting a gift.
3. The taxpayer gave a person (other than spouse) a gift that the person cannot actually possess, enjoy, or receive income from until sometime in the future.
4. The taxpayer gave his or her spouse an interest in property that will be ended by some future event.

ANSWER: B

A gift of a future interest cannot be excluded under the annual exclusion. A gift is considered a future interest if the donee's rights to use, possession, and enjoyment of the property or income from the property will not begin until some future date. The gift of a present interest to more than one donee as joint tenants qualifies for the annual exclusion for each donee. The annual exclusion amount is \$16,000.

33. During the calendar year, Ms. M gave several gifts to relatives. Which of the following gifts must be reported in an annual gift tax return?

1. \$25,000 to her mother to help pay for medical expenses.
 2. A \$20,000 Federal tax-exempt municipal bond to her sister.
 3. 100 shares of stock to her daughter (Ms. M's basis in the stock was \$12,000 and the fair market value at the date of gift was \$20,000).
 4. \$20,000 to a qualified university for her son's dormitory fees.
- A. 2 and 4 only
B. 2, 3, and 4 only
C. 3 only
D. 1, 2, 3, and 4

34. All of the following are deductions allowed in determining the gift tax EXCEPT:

- A. A gift to the state of Pennsylvania for exclusively public purposes.
- B. The value of a gift made to one's spouse who is not a United States citizen.
- C. A gift made to one's spouse, a United States citizen, in excess of \$100,000.
- D. A gift of a copyrightable work of art to a qualified organization if you do not transfer the copyright to the charity.

35. During the calendar year, a taxpayer made the following payments:

- \$19,000 to a qualified political party.
- \$20,000 to a local hospital for his mother's recent operation.
- \$25,000 to the state university for his nephew's tuition expense.
- \$18,000 to his favorite qualified charity.

What is the gross amount that must report on his gift tax return (Form 709)?

- A. The taxpayer does not have to file a gift tax return for the calendar year.
- B. \$82,000
- C. \$64,000
- D. \$16,000

ANSWER: D

For a gift to be excluded under the medical exclusion the payment must be made directly to the medical care provider. A gift over the annual exclusion (\$16,000) must be reported on a gift tax return. The value of a gift is its fair market. For a gift to be excluded under the educational exclusion, the payment must be made directly to the qualifying educational organization and it must be for tuition only. No educational exclusion is allowed for amounts paid for books, room and board, or other similar expenses that do not constitute direct tuition costs.

ANSWER: B

A taxpayer may deduct from the total amount of gifts made during the calendar year the value of gifts made to his or her spouse. The amount of the marital deduction is unlimited. To qualify for the marital deduction, the following conditions must be met at the time the gift is made.

1. The spouses must be married.
2. The spouse receiving the gift must be a U.S. citizen. However, the spouse making the gift does not have to be a U.S. citizen or resident.

ANSWER: A

Payments to a qualified political party or charity are excluded from gift tax. Payments made for medical expenses and tuition on behalf of someone are excluded from gift tax as long as the payments are made directly to the medical provider and educational organization.

Chapter 8. Estate and Gift Tax

36. During the year, a taxpayer made the following potentially taxable gifts:

- \$1,000 to the Democratic Party.
- \$5,000 to a local university for her nephew's tuition.
- \$9,000 to a local university for her nephew's room and board.
- \$20,000 to a local hospital for her sister's surgery.
- Sold land with a fair market value of \$17,000 to her brother for \$100.

What is the total taxable gifts for the year?

- A. \$33,000
- B. \$20,900
- C. \$1,900
- D. \$900

37. A single individual has not been required to file a gift tax return in any prior year. During the year, she paid \$18,000 tuition directly to State University for her sister. She gave her brother \$8,000 to pay medical bills for his daughter. She also donated \$20,000 to the United Way. Is she required to file a gift tax return?

- A. No.
- B. Yes, because the gift to her sister exceeded \$16,000.
- C. Yes, because the United Way donation exceeded \$16,000.
- D. Yes, because the total gifts she gave during the year exceeded \$16,000.

38. A single taxpayer made the following transfers during the year:

- \$17,000 to his daughter
- \$18,000 political contribution
- \$5,000 charitable contribution
- Car to his son (\$22,000 basis; \$18,000 FMV)

What is the gross amount of gifts that will be reported on his Form 709 (before deductions)?

- A. \$35,000
- B. \$49,000
- C. \$53,000
- D. \$57,000

ANSWER: D

The sale of the property valued at \$17,000 for \$100 is treated as a gift. The amount of the gift is \$16,900 (\$17,000 - \$100). The taxable amount of the gift is **\$900** (\$16,900 - \$16,000 annual exclusion). All of the other gifts are excluded from gift tax.

ANSWER: A

The following gifts are not taxable gifts.

1. The first \$16,000 given to someone (the annual exclusion).
2. Tuition or medical expenses paid directly to an educational or medical institution for someone else.
3. Gifts to a spouse (The marital deduction).
4. Gifts to a political organization for its use.
5. Gifts to charities.
6. Gifts to certain exempt organizations described in 501(c)(4), 501(c)(5), and 501(c)(6)

No gift tax return is required to be filed.

ANSWER: A

Only gifts that are subject to gift tax are included on Form 709. The value of a gift is the fair market value of the property.

Gross amount of gifts:

FMV of Car to son.....	\$18,000
Cash to daughter.....	<u>17,000</u>
Gross amount of gifts.....	<u><u>\$35,000</u></u>

39. For the calendar year 2022, if a gift tax return is required to be filed and the donor is not deceased, what is the due date of the return excluding extensions?

- A. Within 75 days of making the gift.
- B. On or before December 31, 2022.
- C. No earlier than January 1, 2023 and no later than April 15, 2023.
- D. Within 180 days of making the gift.

40. Which of the following statements regarding gift splitting is correct?

- A. The couple must have been married at the time the gift was given, but either or both spouses may be remarried during the year.
- B. The couple must have been married at the time the gift was given and the spouse who gave the gift may not be remarried during the year.
- C. The couple need not be married at the time of the gift, but must be married by the end of the year.
- D. The couple must be married at all times during the year.

41. Mr. G and Mrs. G are married. During the year, Mr. G gave \$34,000 to his brother and Mrs. G gave \$30,000 to her niece. They both agree to split the gifts they made during the year. What is the taxable amount of gifts, after the annual exclusion, each must report on Form 709?

- A. They each have taxable gifts of \$16,000.
- B. Mr. G has a taxable gift of \$18,000 and Mrs. G has a taxable gift of \$14,000.
- C. They each have taxable gifts of \$1,000.
- D. Mr. G has a taxable gift of \$2,000 and Mrs. G has a taxable gift of zero.

ANSWER: C

Form 709 must be filed on or after January 1, 2023 but not later than April 15, 2023.

ANSWER: B

A gift made by a married couple can be considered made one-half by each spouse. This effectively lowers the amount of the taxable gift and each spouse can also use the full annual exclusion and the unified credit.

Gift splitting increases the amount which can be transferred to a person to \$32,000 rather than the usual \$16,000. Both spouses are required to consent. If the spouses consent to gift splitting, all the gifts made during the year that qualify must be split. The consent to split gifts cannot be made after a gift tax return is filed and the due date for filing the return has passed.

A husband and wife are not required to file a joint income tax return and must be married only at the time the gift was made. They can even be divorced after the gift splitting but must not remarry within the year of the gift splitting.

ANSWER: C

To split gifts, the spouses must each file separate gift tax returns and sign the consent section of the other's gift tax return signifying that the spouse agrees to treat all gifts as made one-half by each spouse. Gift splitting increases the amount which can be transferred to a person to \$32,000 rather than the usual \$16,000. In this question, each spouse would report **\$1,000** $((\$34,000 - \$32,000) \div 2)$ of the gift to Mr. G's brother on their separate gift tax return.

Chapter 8. Estate and Gift Tax

42. Mr. D and Mrs. D, who were married, made a gift to their son of \$35,000 on January 2. In July, they were legally divorced. Mrs. D married Mr. H on December 20. Which answer below best describes this situation?

- A. The gift-splitting benefits are available to Mr. D and Mrs. D if Mrs. D consents.
- B. The gift-splitting benefits are NOT available to Mr. D and Mrs. D because they were divorced during the year.
- C. The gift-splitting benefits are NOT available to Mr. D and Mrs. D because Mrs. D remarried during the year.
- D. The gift-splitting benefits ARE available to Mr. D and Mrs. D because they were married at the time the gift was made.

43. During the year, a single taxpayer made the following transfers:

She deeded her personal residence to her daughter and herself to be held in joint tenancy, the fair market value of the residence at the time of transfer was \$150,000.

She placed a \$30,000 bank account in joint tenancy with her daughter. Neither she, nor her daughter, made any withdrawals during the year.

She placed a \$20,000 bank account in joint tenancy with her daughter. During the year, she withdrew \$2,000 and her daughter withdrew \$5,000 from the account.

She bought \$10,000 in U.S. savings bonds registered as payable to herself or her daughter. Neither she, nor her daughter, cashed any of the bonds during the year.

What is the gross amount of gifts given?

- A. \$105,000
- B. \$80,000
- C. \$30,000
- D. \$5,000

44. The annual gift tax exclusion amount is allowed on which of the following gifts:

- A. \$30,000 cash to Friend A.
- B. \$30,000 car to Friend B.
- C. \$30,000 remainder interest to Friend C.
- D. Both Friend A and Friend B.

ANSWER: C

To split the gift the spouses must be legally married to each other at the time of the gift. If they divorce during the year, they still may split the gift so long as neither marries anyone else during the year. **Both** spouses must consent to the use of gift splitting.

ANSWER: B

If a taxpayer buys property with his or her own funds and the title to the property is held by the taxpayer and the donee as joint tenants with right of survivorship and if either the taxpayer or the donee may give up those rights by severing their interest, the taxpayer has made a gift to the donee in the amount of half the fair market value of the property. If a taxpayer creates a joint bank account for himself or herself and the donee, the taxpayer has made a gift to the donee when the donee draws on the account for his or her own benefit. If a taxpayer buys a U.S. savings bond registered as payable to himself or herself or the donee, there is a gift to the donee when he or she cashes the bond for his or her benefit.

Gross amount of gifts:

Personal residence (50% of FMV).....	\$75,000
Daughter's withdrawal from bank account.....	<u>5,000</u>
Gross amount of gifts.....	<u>\$80,000</u>

ANSWER: D

A gift of a future interest cannot be excluded under the annual exclusion. A gift is considered a future interest if the donee's rights to the use, possession, and enjoyment of the property or income from the property will not begin until some future date. Future interests include reversions, remainders, and other similar interests or estates.

45. Which of the following entities is required to file Form 709, United States Gift Tax Return?

- A. An individual.
- B. An estate or trust.
- C. A corporation.
- D. All of the above.

ANSWER: A

Only individuals are required to file gift tax returns. If a trust, estate, partnership, or corporation makes a gift, the individual beneficiaries, partners, or stockholders are considered donors and may be liable for the gift and GST taxes.

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