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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. Business Entities

Employer Identification Number

1. An employer Identification Number (EIN) is required for the following entities EXCEPT:

- A. A sole proprietorship with no employees.
- B. A partnership.
- C. A trust or an estate.
- D. An employee plan.

ANSWER: A

An employer Identification Number (EIN) is required for the following:

- 1. Reporting employment taxes and excise taxes.
- 2. A partnership.
- 3. A corporation.
- 4. Limited Liability Company (LLC)
- 5. A trust or an estate.
- 6. An employee plan.
- 7. An exempt organization.

2. A sole proprietor will need a new employer identification number (EIN) for which of the following?

- A. Changing the name of the business
- B. Incorporating
- C. Operating multiple businesses
- D. Changing business locations

ANSWER: B

A sole proprietor will need a new EIN if any of the following are true:

- Filing for bankruptcy under Chapter 7 (liquidation) or Chapter 11 (reorganization).
- Incorporating.
- A sole proprietor that takes in partners and operate as a partnership.
- Establishing a pension, profit sharing, or retirement plan.

A sole proprietor will not need a new EIN if any of the following are true:

- Change the name of your business.
- Change location or add locations.
- Operating multiple businesses.

Chapter 1. Business Entities

3. Under which of the following situations would a business need a new employer identification number?

- A. A partnership that declares bankruptcy.
- B. A C corporation that elects S corporation status.
- C. A partnership is terminated and a new partnership begins.
- D. A corporation changes its name.

ANSWER: C

A partnership will need a new EIN if any of the following are true:

- Incorporating.
- One partner takes over and operates as a sole proprietorship.
- The partnership is terminated and a new partnership is begun.

A partnership will not need a new EIN if any of the following are true:

- The partnership declares bankruptcy. However, if a liquidating trust is established for a partnership that is in bankruptcy, an EIN for that trust is required.
- The partnership name changes.
- Change location or add locations.
- The partnership terminates under IRC Section 708 (b)(1)(B). A partnership shall be considered terminated if within a 12-month period there is a sale or exchange of at least 50% of the total interest in partnership capital and profits to another partner. If the purchaser and remaining partners immediately contribute the properties to a new partnership, they can retain the old partnership EIN.

A corporation will need a new EIN if any of the following are true:

- The corporation is a subsidiary of a corporation and currently uses the parent's corporate EIN.
- The corporation becomes a subsidiary of a corporation.
- The corporation becomes a partnership or a sole proprietorship.
- The corporation creates a new corporation after a statutory merger.
- The corporation receives a new corporate charter.

A corporation will not need a new EIN if any of the following are true:

- The corporation is a division of a corporation.
- After a corporate merger, the surviving corporation uses its existing EIN.
- A corporation declares bankruptcy. However, if a liquidating trust is established for a corporation that is in bankruptcy, an EIN for that trust is required.
- Corporate name change or change in location or add locations.
- The corporation elects to be taxed as an S Corporation by filing Form 2553.
- The corporation is sold and the assets, liabilities and charters are obtained by the buyer.
- After a corporate reorganization, the corporation only changes identity, form, or place of organization.

Accounting Periods

4. Which of the following must adopt the calendar year as their tax year?

- A. A taxpayer who keeps no books or records.
- B. An S corporation.
- C. A tax shelter.
- D. A partnership.

ANSWER: A

A taxpayer must adopt the calendar year if:

- The taxpayer keeps no books or records;
- The taxpayer has no annual accounting period;
- The taxpayer's present tax year does not qualify as a fiscal year; or
- The taxpayer is required to use a calendar year by a provision in the Internal Revenue Code or the Income Tax Regulations.

5. Which of the following would be considered a fiscal tax year?

- A. 02/15/2021 - 03/15/2022
- B. 08/01/2021 - 07/31/2022
- C. 04/01/2021 - 04/30/2022
- D. 01/01/2022 - 12/31/2022

ANSWER: B

A fiscal year is 12 consecutive months ending on the last day of any month except December.

6. Which of the following dates would NOT be considered the end of a tax year?

- A. The last Friday in June.
- B. September 30.
- C. April 15.
- D. December 31.

ANSWER: C

A tax year that ends on the same day of the week (e.g., the last Friday in June) is a 52-53-week tax year. A tax year ending on the last day of the month except December (e.g., September 30) is a fiscal year. A tax year ending on December 31 is a calendar year.

7. In order to adopt a fiscal tax year on its first federal income tax return, the taxpayer must

- A. Maintain books and records and report income and expenses using that tax year.
- B. Attach a completed Form 1128 to its fiscal year basis income tax return.
- C. File a short period return.
- D. Get IRS approval.

ANSWER: A

To adopt a fiscal year, a taxpayer must maintain books and records and report income and expenses using the same tax year.

Chapter 1. Business Entities

8. A partnership, S corporation or personal service corporation can elect to use a tax year other than its required tax year, if it

- A. Elects a year that meets the deferral period requirement.
- B. Is not a member of a tiered structure as defined by the regulations.
- C. Has not previously had an election in effect to use a tax year other than its required tax year.
- D. All of the above.

9. A taxpayer must file which form to request the IRS approval to change the taxpayer's tax year?

- A. Form 1128
- B. Form 2553
- C. Form 3115
- D. Form 8716

ANSWER: D

A partnership, S corporation, or personal service corporation (PSC) can elect under section 444 to use a tax year other than its required tax year. Certain restrictions apply to the election. A partnership or an S corporation that makes a section 444 election must make certain required payments and a PSC must make certain distributions. A partnership, S corporation, or PSC can make a section 444 election if it meets all the following requirements:

1. It is not a member of a tiered structure (defined in section 1.444-2T of the regulations).
2. It has not previously had a section 444 election in effect.
3. It elects a year that meets the deferral period requirement.

ANSWER: A

A taxpayer must file Form 1128, Application To Adopt, Change, or Retain a Tax Year, to request IRS approval to change his or her tax year.

Accounting Methods

Cash Basis

10. Which of the following entities can use the cash method of accounting?

- A. A qualified personal service corporation.
- B. A corporation (other than an S corporation or a qualified personal service corporation) with average annual gross receipts of \$29 million.
- C. A partnership with a corporation (other than an S corporation and a qualified personal service corporation) as a partner and with the partnership having average annual gross receipts of under \$30 million.
- D. A tax shelter.

ANSWER: A

The cash method of accounting is used by most individuals and many small businesses with no inventories. The following entities cannot use the cash method:

- A corporation (other than an S corporation or a qualified personal service corporation) with average annual gross receipts for the preceding 3 years exceeding \$27 Million.
- A partnership with a corporation (other than an S corporation and a qualified personal service corporation) as a partner and with the partnership having average annual gross receipts for the preceding 3 years exceeding \$27 Million.
- A tax shelter.

A personal service corporation that meets the following function and ownership tests can use the cash method.

1. **Function test.** A corporation meets the function test if at least 95% of its activities are in the performance of services in the fields of health, veterinary services, law, engineering (including surveying and mapping), architecture, accounting, actuarial science, performing arts, or consulting.
2. **Ownership test.** A corporation meets the ownership test if at least 95% of its stock is owned, directly or indirectly, at all times during the year by one or more of the following:
 - a. Employees performing services for the corporation in a field qualifying under the function test.
 - b. Retired employees who had performed services in those fields.
 - c. The estate of an employee described in (1) or (2).
 - d. Any other person who acquired the stock by reason of the death of an employee referred to in (1) or (2), but only for the 2-year period beginning on the date of death.

Chapter 1. Business Entities

11. A cash basis taxpayer works on commissions. In November, he received \$2,000 in commissions earned and an advance of \$7,000 in commissions for future sales in the following year. What amount must be included in income for this year?

- A. \$9,000
- B. \$2,000
- C. \$3,167
- D. \$0

ANSWER: A

A cash basis taxpayer reports income when it is actually or constructively received.

12. Generally, all of the following entities may use the cash method of accounting EXCEPT:

- A. A farming business with gross receipts of \$27 Million or less.
- B. A partnership with no inventories and average annual gross receipts of \$27 Million or less.
- C. A qualified personal service corporation.
- D. A corporation (other than an S corporation) with average annual gross receipts exceeding \$27 Million.

ANSWER: D

The following entities cannot use the cash method, including any combination of methods that includes the cash method:

- 1. A corporation (other than an S corporation or a qualified personal service corporation) with average annual gross receipts for the preceding 3 years exceeding \$27 Million.
- 2. A partnership with a corporation (other than an S corporation and a qualified personal service corporation) as a partner and with the partnership having average annual gross receipts for the preceding 3 years exceeding \$27 Million.
- 3. A tax shelter.

The following entities are not prohibited from using the cash method of accounting:

- 1. Any corporation or partnership, other than a tax shelter, with average gross receipts for the preceding 3 year of \$27 Million or less.
- 2. A qualified personal service corporation.
- 3. Farming businesses with average annual gross receipts for the preceding 3 years of \$27 Million or less.

13. Which of the following accounting methods is NOT an acceptable method of reporting income and expenses?

- A. If an inventory is necessary to account for your income, you must use an accrual method for purchases and sales. You can use the cash method for all other items of income and expenses.
- B. If you use the cash method for figuring your income, you can use the accrual method for figuring your expenses.
- C. Any combination that includes the cash method is treated as the cash method.
- D. You can use different accounting methods for reporting business and personal items.

ANSWER: B

The **combination (hybrid) method of accounting** uses any combination of cash, accrual, and special methods of accounting if the combination clearly shows income and it is used consistently. However, the following restrictions apply:

- 1. If an inventory is necessary to account for income, the accrual method must be used for purchases and sales. The cash method for all other items of income and expenses can be used.
- 2. **If the cash method is used for figuring income, the cash method must be used for reporting expenses.**
- 3. If the accrual method is used for reporting expenses, the accrual method must be used for figuring income.
- 4. Any combination that includes the cash method is treated as the cash method.

Accrual Basis

14. Which of the following statements is NOT correct?

- A. Under an accrual method of accounting, you generally report income in the year earned and deduct or capitalize expenses in the year incurred.
- B. Under an accrual method of accounting, you generally report receipt of an advance payment for services to be performed in a later tax year as income in the year you receive the payment.
- C. Under an accrual method of accounting, business expenses and interest owed to a related person who uses the cash method of accounting are deductible when the all-events test has been met.
- D. Under an accrual method of accounting, you can take a current deduction for taxes when economic performance occurs.

ANSWER: C

Under an accrual method of accounting, a taxpayer generally deducts or capitalizes a business expense when both the following apply:

- 1. The all-events test has been met. The test is met when:
 - a. All events have occurred that fix the fact of liability, and
 - b. The liability can be determined with reasonable accuracy
- 2. Economic performance has occurred. If the expense is for property or services provided to the taxpayer, or for the taxpayer's use of property, economic performance occurs as the property or services are provided or the property is used. If the expense is for property or services provided to others, economic performance occurs as the taxpayer provides the property or services.

Business expenses and interest owed to a related person who uses the cash method of accounting are not deductible until the payment is made and the corresponding amount is includible in the related person's gross income.

Chapter 1. Business Entities

15. The ABC Partnership sells computers and maintains its accounting system on the accrual basis. ABC sold and delivered a computer on December 29, 2021 and billed the customer \$3,250 on January 7, 2022. ABC received the \$3,250 payment on February 15, 2022. The check cleared on February 22, 2022. On which date will ABC recognize this income?

- A. January 7, 2022
- B. February 15, 2022
- C. December 29, 2021
- D. February 22, 2022

16. A calendar year accrual basis taxpayer sold merchandise on December 30. She billed the customer in the first week of January. The billing was returned for insufficient postage and she sent a second bill in February. When should she include the sale in income?

- A. January
- B. March
- C. December
- D. February

17. A taxpayer can compute his taxable income under which of the following accounting methods?

- A. Hybrid method
- B. Accrual method
- C. Special method for certain items
- D. All of the above

ANSWER: C

Under the accrual method of accounting, income is reported in the year earned and expenses are deducted or capitalized in the year incurred.

ANSWER: C

Under the accrual method of accounting, income is reported in the year earned and expenses are deducted or capitalized in the year incurred.

ANSWER: D

A taxpayer can compute his taxable income under any of the following methods:

1. Cash method.
2. Accrual method.
3. Special methods of accounting certain items of income and expenses.
4. Combination (hybrid) method using elements of two or more of the above.

18. Generally, a substantial business inventory requires use of which method of accounting?

- A. Cash
- B. Hybrid
- C. Accrual
- D. None of the above.

ANSWER: C

A small business taxpayer can choose not to keep an inventory but must still use a method of accounting for inventory that clearly reflects income. An inventory is necessary to clearly show income when the production, purchase, or sale of merchandise is an income-producing factor. If a taxpayer must account for an inventory in his business, he must use the accrual method for purchases and sales.

Exceptions for small business taxpayers. A taxpayer qualifies as a small taxpayer if he or she has average annual gross receipts of \$27 Million or less (indexed for inflation) for the 3 prior tax years and is not a tax shelter as defined in section 448(d)(3).

Related Parties

19. Which of the following is NOT considered a related person?

- A. Two S Corporations if the same person owns more than 50% of each.
- B. Members of a family.
- C. An Individual and a Corporation where the individual owns, directly or indirectly 25% of the stock of the Corporation.
- D. Grantor of any Trust.

ANSWER: C

All of the following are considered a related person.

1. Members of a family, including only brothers and sisters (either whole or half), husband and wife, ancestors, and lineal descendants.
2. Two corporations that are members of the same controlled group as defined in section 267(f).
3. The fiduciary of two different trusts, and the fiduciary and beneficiary of two different trusts, if the same person is the grantor of both trusts.
4. A tax-exempt educational or charitable organization and a person (if an individual, including family members of the individual's family) who directly or indirectly controls the organization.
5. **An individual and a corporation when the individual owns, directly or indirectly, more than 50% of the value of the outstanding stock of the corporation.**
6. The grantor and fiduciary, and the fiduciary and beneficiary, of any trust.
7. Any two entities, (corporation, S corporation, partnership, trust, etc.) if the same persons own more than 50% of each entity.
8. A personal service corporation and any employee-owner, regardless of the amount of stock owned by the employee-owner.

Chapter 1. Business Entities

20. Special rules apply to like kind exchanges between related persons. Under these rules, related persons are

- A. The taxpayer and a member of his or her family.
- B. The taxpayer and a corporation in which the taxpayer has a 25% ownership.
- C. The taxpayer and a partnership in which the taxpayer directly or indirectly owns a 25% interest in the capital or profits.
- D. All of the above.

21. Which of the following individuals is NOT considered a related party for deducting expenses on the accrual method?

- A. Half-sister
- B. Brother
- C. Mother
- D. Step-sister

22. Taxpayer Q, a cash basis taxpayer, owned 25% of W, Inc. stock. W, Inc. files a calendar year U.S. Corporate Income Tax Return Form 1120 employing the accrual method of accounting. Q loaned W, Inc. \$100,000 at the beginning of 2021. The accrued interest on this loan was \$5,000 as of December 31, 2021. W, Inc. paid Q the \$5,000 in January of 2022. How should Q report the interest income and W, Inc. report the interest expense from this transaction?

- A. W, Inc. reports the expense in 2021 and Q reports the income in 2021.
- B. W, Inc. reports the expense in 2021 and Q reports the income in 2022.
- C. W, Inc. reports the expense in 2022 and Q reports the income in 2022.
- D. None of the above.

ANSWER: A

Refer to the analysis on the previous question. A taxpayer must own **more than 50%** of a partnership or corporation for the taxpayer and either entity to be related persons.

ANSWER: D

For the purpose of the related party rule, the following individuals are related persons:

- 1. Brothers and sisters (either whole or half).
- 2. Husband and wife.
- 3. Ancestors and lineal descendants (e.g. Parents, grandparents, children, and grandchildren)

A step-sister is not considered a related party.

ANSWER: B

For the accrual basis taxpayer expenses are deductible when the liability is incurred. There are also special rules for the accrual basis taxpayer when dealing with related persons. Expenses owed to a related cash basis person cannot be deducted until the payment is actually made and the related cash basis taxpayer includes the amount in income.

In the question the taxpayer and the corporation are not related persons because the taxpayer does not own more than 50% of the corporation's stock.

Change in Accounting Method

23. Which of the following accounting changes do NOT require the consent of the IRS?

- A. Correction of a math error.
- B. Change from accrual method to cash method.
- C. Change in the method inventory is valued.
- D. Change from cash method to accrual method.

ANSWER: A

The following changes in accounting method require the consent of the IRS:

1. Change from cash to accrual or vice versa (unless required to change to an accrual method and the change is made automatically).
2. Change in the method or basis used to value inventory.
3. Change in the method of figuring depreciation or amortization method (except certain permitted changes to the straight line method).
4. Change involving the adoption, use, or discontinuance of any other specialized method of computing taxable income.
5. Change where the IRC and Treasury Regulations requires the IRS consent before adopting the change.

Consent is not required from the IRS for the following changes:

1. A correction of a mathematical or posting error.
2. Correction of an error in computing tax liability (such as an error in computing a credit).
3. An adjustment of any item of income or deduction that does not involve the proper time for including it in income or deducting it.
4. An adjustment in the useful life of a depreciable asset. A taxpayer cannot change the recovery period for ACRS or MACRS property.

24. Which form is used to request a change in accounting methods with the IRS?

- A. Form 1128.
- B. Form 2553
- C. Form 3115
- D. Form 8716

ANSWER: C

A taxpayer must file Form 3115, Application for Change in Accounting Method, to request a change in either an overall accounting method or the accounting treatment of any item.

Inventories

25. The following methods of accounting for inventory are considered acceptable EXCEPT:

- A. Cost.
- B. First In First Out.
- C. Last In First Out.
- D. Trade Discount Method.

ANSWER: D

There are three methods of identifying item in inventory:

- 1. Specific identification.
- 2. First-in first-out (FIFO).
- 3. Last-in first-out (LIFO).

The common methods to value inventory are:

- 1. Cost method.
- 2. Lower of cost or market method.
- 3. Retail.

26. Which of the following is NOT an acceptable inventory practice?

- A. You claim a casualty or theft loss of inventory through the increase in the cost of goods sold by properly reporting your opening and closing inventories.
- B. To properly value inventory at cost, reduce the invoice price of inventory by a trade discount.
- C. Under the lower of cost or market method, compare the market value of each item on hand on the inventory date with its cost and use the lower of the two as its inventory value.
- D. To properly value inventory at cost, include only the direct costs associated with each item.

ANSWER: D

To properly value inventory at cost, include both the direct and **indirect** costs associated with each item.

27. The taxpayer is a merchant who has purchased inventory items. He withdrew some of these items for personal use. He must

- A. Increase his sales by the cost of the items withdrawn.
- B. Reduce the cost of purchases by the cost of the personal use items.
- C. Reduce the cost of purchases by the fair market value of the personal use items.
- D. Reduce beginning inventory by the cost of the personal use items.

ANSWER: B

If a taxpayer purchases inventory items, the cost of inventory items used for personal use must be subtracted from total purchases.

28. Which of the following items is generally included in inventory?

- A. Goods for sale that someone else has consigned to you.
- B. Equipment used in your business to manufacture goods.
- C. Goods you have sent out on consignment for someone else to sell.
- D. Goods in transit to you for which title has not yet passed to you.

ANSWER: C

Include the following items when accounting for inventory:

- 1. Merchandise or stock in trade.
- 2. Raw materials.
- 3. Work in process.
- 4. Finished products.
- 5. Supplies that physically become a part of the item intended for sale.

Include the following merchandise in inventory:

- 1. Purchased merchandise if title has passed to the taxpayer, even if the merchandise is in transit or the taxpayer does not have physical possession for another reason.
- 2. Goods under contract for sale that have not yet segregated and applied to the contract.
- 3. Goods out on consignment.
- 4. Goods held for sale in display rooms, merchandise mart rooms, or booths located away from the taxpayer's place of business.

Do not include the following merchandise in inventory:

- 1. Goods that have sold, but only if title has passed to the buyer.
- 2. Goods consigned to you.
- 3. Goods ordered for future delivery if you do not yet have title.

If merchandise is sold by mail and payment is made upon delivery (C.O.D. orders), title of the merchandise passes when payment is made. Therefore, merchandise sent C.O.D. is included in inventory until the buyer pays for it.

Uniform Capitalization Rules

29. The uniform capitalization rules will apply in all of the following situations EXCEPT:

- A. Produce real or tangible personal property for sale to customers.
- B. Acquire property for resale.
- C. Produce real or tangible personal property for use in a business or activity carried on for profit.
- D. Produce property under a long-term contract other than a home construction.

ANSWER: D

A taxpayer is subject to uniform capitalization rule if he or she:

- 1. Produces real property or tangible personal property for use in a trade or business,
- 2. Produce real property or tangible property for sale to customers, or
- 3. Acquires property for resale.

Chapter 1. Business Entities

30. Which of the following activities would subject a taxpayer to the uniform capitalization rules?

- A. Taxpayer produces real or tangible property for non-business use.
- B. Taxpayer acquires property not for resale.
- C. Taxpayer produces real or tangible personal property for sale to customers.
- D. None of the above.

ANSWER: C

A taxpayer is subject to uniform capitalization rule if he or she produces real property or tangible personal property for use in a trade or business.

31. Which of the following classes of property are excepted from the uniform capitalization rules?

- A. Property produce under a long-term contract, except for certain home construction contracts.
- B. Property produce that is not use in a trade, business, or activity conducted for profit.
- C. Qualified creative expenses incurred as a self-employed writer, photographer, or artist that are otherwise deductible.
- D. All of the above.

ANSWER: D

For tax years beginning in 2022, a taxpayer is not subject to the uniform capitalization rules if your average annual gross receipts are \$27 Million or less for the 3 preceding tax years and you're not a tax shelter. In addition, the following are not subject to the uniform capitalization rules.

1. Property produce that is not use in a trade, business, or activity conducted for profit.
2. Qualified creative expenses paid or incurred as a freelance (self-employed) writer, photographer, or artist that are otherwise deductible on the taxpayer's tax return.
3. Property produce under a long-term contract, except for certain home construction contracts.
4. Research and experimental expenses deductible under section 174 of the IRC.
5. Before 2018, costs for personal property acquired for resale if the average annual gross receipts for the 3 previous tax years don't exceed \$10 million.

Chapter 2. Partnerships

Formation

1. Which of the following organizations formed after 1996 can be classified as a partnership?

- A. An insurance company.
- B. A tax-exempt organization.
- C. A real estate investment trust.
- D. A husband and wife carrying on a business together.

ANSWER: D

For federal tax purposes, the term "partnership" includes a syndicate, group, pool, joint venture, or similar organization that is carrying on a trade or business, and that is not classified as a trust, estate, or corporation. An unincorporated organization (including a limited liability company) formed after 1996 is classified as a partnership for federal tax purposes if it has two or more members and if it is none of the following:

- 1. An organization formed under a federal or state law that refers to it as a corporation, body corporate, or body politic.
- 2. An organization formed under a state law that refers to it as a joint-stock company or joint-stock association.
- 3. An insurance company.
- 4. Certain banks.
- 5. An organization wholly owned by a state or local government.
- 6. An organization specifically required to be taxed as a corporation by the Internal Revenue Code.
- 7. Certain foreign organizations.
- 8. A tax-exempt organization.
- 9. A real estate investment trust.
- 10. An organization classified as a trust under Regulations section 301.7701-4 or otherwise subject to special treatment under the Internal Revenue Code.
- 11. Any other organization that elects to be classified as a corporation by filing Form 8832.

2. A domestic limited liability company with at least two members that does not file Form 8832, Entity Classification Election, is classified as

- A. An entity disregarded as an entity separate from its owner by applying the rules in regulations section 301.7701-3.
- B. A partnership.
- C. A corporation.
- D. A non-entity which requires members to report the income and related expenses on Form 1040.

ANSWER: B

Refer to the analysis on the previous question. A domestic limited liability company with at least two members that does not file Form 8832, Entity Classification Election, is classified as a partnership.

Family Partnerships

3. Regarding family partnerships, if a husband and wife carry on a business together and share in the profits and losses:

- A. They must have a formal partnership agreement to be considered a partnership.
- B. They can report the income or loss on a combine Schedule C (Form 1040) if they are filing a joint return.
- C. They should each carry his or her share of the partnership income or loss from the Form 1065 Schedule K-1 to their joint or separate individual income tax returns.
- D. Combine the self-employment income on a single Schedule SE (Form 1040).

4. Members of a family can be partners. Family members generally will be recognized as partners if

- A. The partnership agreement states that they have a right to share in earnings and profits of the partnership.
- B. Capital is not a material income-producing factor, they joined together in good faith for the conduct of a business, and they agreed that contributions of each entitle them to a share in the profits, and some capital or service has been (or is) provided by each partner.
- C. Capital is a material income-producing factor, they acquired their capital interest in a bona fide transaction, actually own the partnership interest but allow the related partner to control the interest.
- D. The partnership agreement designates who the partners are, what degree of service they will perform for the partnership and the extent to which they share in the profits, losses, and other attributes of the partnership.

5. Members of a family who must meet special requirements to be recognized as partners for determining a partner's distributive share include all of the following EXCEPT:

- A. Spouses.
- B. Ancestors.
- C. Lineal descendants.
- D. Brothers and sisters.

ANSWER: C

Generally, if a husband and wife jointly own and operate an unincorporated business and share in the profits and losses, they are partners in a partnership and must file Form 1065.

Exception: If a husband and wife materially participate as the only members of a jointly owned business, and they file a joint return, they can make an election to be treated as a qualified joint venture instead of a partnership. By making the election, they will not be required to file Form 1065 for any year the election is in effect. Instead they will divide all items of income, gain, loss, deduction, and credit between themselves in accordance with their respective interest in the venture. Each spouse must file a separate Schedule C and Schedule SE.

ANSWER: B

Family members can form and operate a partnership. The partnership must meet one of the following two requirements in order to be recognized:

- 1. If capital is a material income-producing factor, the partnership interest must be acquired in a genuine transaction (including gift) and the owner must actually control the interest, or
- 2. If capital is not a material income producing factor, the partners must have joined together in good faith to conduct a business. In addition, they must have agreed that contributions of each entitle them to share in the profits. Some capital or service must be provided by each partner.

ANSWER: D

A family partnership includes only spouses, ancestors (parent), and lineal descendants (child), or any trust for the primary benefit of those persons. Brothers and sisters are not considered family members.

6. A father sold his daughter 50% of his business partnership. The partnership had an \$80,000 profit this year before deducting any compensation to the partner as a guaranteed payment. Capital is a material income-producing factor. He performed services worth \$55,000, which is reasonable compensation. The daughter performed no services. How much income will he claim on his individual tax return?

- A. \$40,000
- B. \$55,000
- C. \$67,500
- D. \$80,000

ANSWER: C

Of the \$80,000 of distributive share of the partnership's ordinary income allocated to the partners, \$55,000 is allocated to the father for services performed. Of the remaining \$25,000, 50% is allocated to the father. He must report \$67,500 ($\$55,000 + (\$25,000 \times 50\%)$) of partnership income.

Filing Requirements

7. A partnership was formed on September 15, 2022, and elected to use a fiscal year ending November 30th. The partnership was required to file its return by which of the following dates?

- A. December 31, 2022
- B. January 15, 2023
- C. February 15, 2023
- D. March 15, 2023

ANSWER: C

The partnership return is due on or before the 15th day of the 3rd month after the end of the partnership tax year. No return is required to be filed before the first tax year in which the partnership has income or deductions.

8. A partnership with a fiscal year ending March 31 terminated the partnership on January 31, 2022. If no extension is filed, by what date must they file their final Form 1065 U. S. Return of Partnership Income?

- A. March 15, 2022
- B. April 15, 2022
- C. May 15, 2022
- D. July 15, 2022

ANSWER: B

The partnership's tax year ends on the date of termination. The partnership return is due on or before the 15th day of the 3rd month after the end of the partnership tax year.

9. A timely filed Form 7004, Extension of Time to File, will provide a partnership with the following?

- A. An automatic extension of 2 months to file the tax return.
- B. An automatic extension of 4 months to file the tax return.
- C. An automatic extension of 5 months to file the tax return.
- D. An automatic extension of 6 months to file the tax return.

ANSWER: D

A partnership can request an automatic 6-month extension of time to file by filing Form 7004 by the regular due date of the partnership return.

Chapter 2. Partnerships

10. A calendar year partnership, with two partners, filed its 2021 Form 1065 tax return on December 31, 2022. An extension of time to file was filed. What is the amount of their Failure to File penalty?

- A. \$50
- B. \$450
- C. \$1,450
- D. \$1,760

ANSWER: D

A penalty is assessed against any partnership that must file a partnership return and fails to file on time, including extensions, or fails to file a return with all the information required. The penalty is \$220 times the total number of partners in the partnership during any part of the tax year for each month (or part of a month) the return is late or incomplete for a maximum of 12 months. The return with the 6 month extension was due September 15, 2022.

Failure to File penalty:

$\$220 \times 2 \text{ partners} \times 4 \text{ month (Sept - Dec)} = \$1,760$

11. A partnership can be subject to a penalty for failure to furnish a Schedule K-1 to each partner. What is the amount of the penalty for each failure to furnish a Schedule K-1?

- A. \$100
- B. \$200
- C. \$290
- D. \$295

ANSWER: C

A **\$290** penalty may be imposed with respect to each Schedule K-1 for which a failure occurs. The maximum penalty is \$3,532,500 for all such failures during a calendar year. If the requirement to report correct information is intentionally disregarded, each \$290 penalty is increased to \$580 or, if greater, 10% of the aggregate amount of items required to be reported. There is no limit to the amount of the penalty.

Organization Expenses

12. An election to amortize may be made for qualifying costs of organization for a partnership. Which of the following is NOT considered a qualifying cost?

- A. A cost incurred in the creation of the partnership and not for starting or operating the partnership trade or business.
- B. Accounting fees for services incident to the organization or the partnership.
- C. Legal fees for preparation of the partnership agreement.
- D. The costs of acquiring assets for the partnership.

ANSWER: D

Neither the partnership nor any partner can deduct, as a current expense, amounts paid or incurred to organize a partnership or to promote the sale of, or to sell, an interest in the partnership. A partnership can elect to deduct up to \$5,000 of organizational costs as a current business expense. The \$5,000 deduction is reduced by one dollar for each dollar the amount the total organizational costs exceed \$50,000. If the total costs are \$55,000 or more, the deduction is reduced to zero. Any remaining costs must be amortized. The costs that are not deducted currently can be amortized ratably over a 180-month period. The period must start with the month the partnership begins business. The election is automatic. Organization expenses that can be amortized include the following:

1. Legal fees for services incident to the organization of the partnership, such as negotiation and preparation of a partnership agreement.
2. Accounting fees for services incident to the organization of the partnership.
3. Filing fees.

Expenses that cannot be amortized (regardless of how the partnership characterizes them) include expenses connected with the following actions:

1. Acquiring assets for the partnership or transferring assets to the partnership.
2. Admitting or removing partners other than at the time the partnership is first organized.
3. Making a contract relating to the operation of the partnership trade or business (even if the contract is between the partnership and one of its members).
4. Syndicating the partnership. Syndication expenses, such as brokerage, registration, and legal fees and printing costs connected with the issuing and marketing of interests in the partnership, are capitalized and cannot be depreciated or amortized.

Chapter 2. Partnerships

13. A partnership formed during the year and incurred the following costs:

- \$2,500 to an attorney for negotiating and preparing the partnership agreement.
- \$250 for filing fees for the partnership agreement.
- \$1,000 to a CPA for services incident to the organization of the partnership.
- \$500 in costs associated with transferring assets to the partnership.

What is the maximum dollar amount that the partnership can elect to expense as organizational costs?

- A. \$3,750
- B. \$4,250
- C. \$4,000
- D. \$1,750

14. On November 15, Partnership Z paid \$10,000 in accounting and legal fees to prepare and file the partnership agreement. The partnership began business on December 1. Which of the following is a permissible election for treatment of the \$10,000 payment?

- A. Deduct \$10,000.
- B. Deduct \$5,000 and amortize the remaining \$5,000 over a 5-year period.
- C. Deduct \$5,000 and amortize the remaining \$5,000 over 180 months.
- D. Amortize \$10,000 over a 5-year period.

ANSWER: A

Refer to the analysis on the previous question. Costs associated with acquiring assets for the partnership or transferring assets to the partnership cannot be amortized.

ANSWER: C

A partnership can choose to deduct up to \$5,000 of organizational costs as a current business expense. Any remaining costs must be amortized over a 180-month period.

Tax Year

15. A partnership has a December 31 tax year which is the tax year of all its partners. It is not a member of a tiered structure nor has it previously made a section 444 election. If it makes a section 444 election, which of the following tax years can it elect?

- A. March 31.
- B. June 30.
- C. September 30.
- D. The partnership CANNOT elect any of the above.

ANSWER: D

A partnership can make a section 444 election if:

1. It is not a member of a tiered structure,
2. It has not previously had section 444 election in effect, and
3. It elects a year that meets the deferral period required.

Deferral period is the number of months between the end of the tax year the partnership wants to use and the close of the required year. An election to change a tax year from its required year will be allowed only if the deferral period of the tax year it wants to use is not longer than the shorter of:

1. Three months or less, or
2. The deferral period of the tax year being change.

If the current year is the required year, the deferral period is zero. Therefore, the partnership will not be allowed to make a section 444 election.

16. A partnership is organized in with three general partners. The partners include a corporation with a tax year ending on March 31 and a 60% interest in partnership capital and profits, and two individuals, each having a calendar tax year and a 20% interest in partnership capital and profits. The partnership's required tax year ends on

- A. March 31
- B. September 30
- C. October 31
- D. December 31

ANSWER: A

If one or more partners having the same tax year own an interest in partnership's profits and capital of more than 50%, the partnership must use the tax year of those partners (majority interest tax year).

Partners' Distributive Share of Income, Expenses, Gains and Losses

17. A partner is considered NOT at risk for which of the following amounts?

- A. The money and adjusted basis of any property the partner contributed to the activity.
- B. The partner's share of net income retained by the partnership.
- C. An allocation of a loss, deduction, or expense attributable to a partnership nonrecourse liability.
- D. Certain amounts borrowed by the partnership for use in the activity if the partner is personally liable for repayment.

ANSWER: C

The at-risk rules limit a partner's deductible loss to the amounts for which that partner is considered at risk in the activity. A partner is considered at risk for:

1. The money and adjusted basis of any property he or she contributed to the activity.
2. The partner's share of net income retained by the partnership.
3. Certain amounts borrowed by the partnership for use in the activity if the partner is personally liable for repayment or the amounts borrowed are secured by the partner's property (other than property used in the activity).

Chapter 2. Partnerships

18. If the partner's distributive share of a partnership item cannot be determined under the partnership agreement, it is determined by his or her interest in the partnership. The partnership interest is determined by taking into account all of the following items EXCEPT:

- A. The partner's relative contributions to the partnership.
- B. The interests of all partners in economic profits and losses (if different from interests in taxable income or loss) and in cash flow and other non-liquidating distributions.
- C. The amount of the partnership's nonrecourse liabilities.
- D. The right of the partners to distributions of capital upon liquidation.

19. 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

20. A partnership's tax year ends on December 31. Partner X dies on April 15. Partner X's and his estate's distributive share of partnership income, which is considered to be earnings from self-employment, for the year of death, is \$12,000. What amount of income must be used to figure Partner X's self-employment tax for his final Form 1040?

- A. \$0
- B. \$3,000
- C. \$4,000
- D. \$12,000

ANSWER: C

If a partner's distributive share of a partnership item cannot be determined under the partnership agreement, it is determined by his or her interest in the partnership. The partner's interest is determined by taking into account all the following items:

- 1. The partners' relative contributions to the partnership.
- 2. The interests of all partners in economic profits and losses (if different from interests in taxable income or loss) and in cash flow and other nonliquidating distributions.
- 3. The rights of the partners to distributions of capital upon liquidation.

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.

ANSWER: C

A different rule applies in computing a deceased partner's self-employment income for the year of death. The partner's self-employment income includes the partner's distributive share of income earned by the partnership through the end of the month in which the partner's death occurs. This is true even though the deceased partner's estate or heirs may succeed to the decedent's rights in the partnership. For this purpose, partnership income for the partnership's tax year in which a partner dies is considered to be earned equally in each month.

In this question, the partner's distributive share of income is \$1,000 for each month. The partner died on April 15, so **\$4,000** ($\$1,000 \times 4$; Jan - April) is considered to be earnings from self-employment for the deceased partner.

21. In computing the ordinary income of a partnership, a deduction is allowed for

- A. A net operating loss.
- B. Guaranteed payments to partners.
- C. Short term capital losses.
- D. Contributions to qualified charities.

ANSWER: B

Guaranteed payments are deducted by the partnership as a business expense. The following are separately stated items and included as separate items on the partners' returns. They are not deducted on the partnership's return.

- 1. Ordinary income or loss from trade or business activities.
- 2. Net income or loss from rental real estate activities.
- 3. Net income or loss from other real estate activities.
- 4. Gains and losses from sales or exchanges of capital assets.
- 5. Gains and losses from sales or exchanges of section 1231 property.
- 6. Charitable contributions.
- 7. Dividends (passed through to corporate partners) that qualify for the dividend-received deduction.
- 8. Taxes paid or accrued to foreign countries and U.S. possessions.
- 9. Other items of income, gain, loss, deduction, or credit, as provided by regulations.

22. Which of the following partnership items must be separately stated on the partner's K-1?

- A. Cost of goods sold.
- B. Employee benefit programs.
- C. Charitable contributions.
- D. Taxes and licenses.

ANSWER: C

Charitable contributions are separately stated on the partner's K-1. Costs of goods sold, employee benefit programs, and tax and license are deducted in figuring the partnership's net income.

23. During the tax year, a partnership generated the following income and expenses:

- Employee wages: \$15,000
- Income from rental real estate: 20,000
- Charitable contributions: 500
- Cost of goods sold: 10,000
- Income from sales: 75,000

What is the correct amount of ordinary income (loss) from trade or business activities that the partnership should report on Schedule K?

- A. \$65,000
- B. \$69,500
- C. \$50,000
- D. \$30,000

ANSWER: C

Charitable contribution and income from real estate are separately stated on the partner's K-1.

Income from sales.....	\$75,000
Less: Cost of goods sold.....	10,000
Employee wages.....	<u>15,000</u>
Ordinary Income.....	<u><u>\$50,000</u></u>

Chapter 2. Partnerships

24. A partnership had gross receipts of \$250,000 and had the following other items of income and expenses:

- Salaries: \$50,000
- Insurance: \$5,000
- Charitable Contributions: \$5,000
- Licenses: \$5,000
- Rental Income: \$25,000
- Guaranteed payments to Partners: \$75,000

What is the ordinary income or loss that should report on its Form 1065?

- A. \$85,000
- B. \$115,000
- C. \$100,000
- D. \$150,000

25. All of the following items must be separately stated on the partnership's Schedule K (Form 1065) and included as separate items on the partner's return EXCEPT:

- A. Ordinary gains and losses from Form 4797, Part II.
- B. Gains and losses from sales or exchanges of capital assets.
- C. Guaranteed payments to the partners.
- D. Interest income.

26. Mr. P and Mr. D are equal partners in the P&D Partnership. P&D has a fiscal year ending on January 31. Both partners file their individual tax returns on a calendar year basis. For the tax year ending January 31, 2022, P&D had taxable income from the active conduct of its business of \$100,000 of which \$60,000 was earned in 2021. How much of their partnership taxable income should the partners each include in computing their taxable income limit for the 2022 tax year?

- A. \$50,000
- B. \$20,000
- C. \$30,000
- D. \$0

ANSWER: B

Charitable contribution and income from real estate are separately stated on the partner's K-1.

Gross receipts.....	\$250,000
Less: Salaries.....	50,000
Insurance.....	5,000
Licenses.....	5,000
Guaranteed payments.....	75,000
Ordinary income.....	<u>\$115,000</u>

ANSWER: A

Ordinary gains and losses from Form 4797, Part II are not a separately stated item and are included in computing the partnerships income.

ANSWER: A

A partner's income or loss from a partnership is the partner's distributive share of partnership items for the partnership's tax year that ends with or within the partner's tax year. Since the partnership's tax year ends in 2022, the partners will report their \$50,000 (\$100,000 × 50%) share of the partnership's income of \$100,000 on their 2022 tax returns.

27. F & J Partnership had the following income for the current year:

- Income from operations: \$170,000
- Tax exempt interest: \$10,000
- Dividends from foreign corporations: \$5,000
- Net rental Income: \$20,000

Partner F and Partner J share the profits and losses equally. What is each partner's share of the partnership income (excluding all partnership items which must be accounted for separately)?

- A. \$85,000
- B. \$95,000
- C. \$97,500
- D. \$170,000

28. If any partner's interest in a partnership changes during the year, which of the following cash basis items of the partnership must be prorated on a daily basis to determine each partner's share of partnership income or loss?

- A. Interest.
- B. Taxes.
- C. Payments for services or for the use of property.
- D. All of the above.

29. A partnership has \$1,000 of nonrecourse liabilities and \$500 of recourse liabilities. The recourse liabilities are attributable to Partner K who is a 50% partner. K contributed property with a fair market value of \$400 and an adjusted basis of \$250 for her interest in the partnership. The first year of business the partnership incurred a \$4,000 loss. How much of this loss, if any, may Partner K deduct on her tax return?

- A. \$250
- B. \$1,250
- C. \$1,750
- D. \$2,000

ANSWER: A

Tax exempt interest, dividends, and net rental income are separately state items on the partnership's tax return and are not included in figuring the partnership's ordinary income. They are listed on Schedule K (Form 1065). The partner's share of partnership income is \$85,000 ($\$170,000 \times 50\%$).

ANSWER: D

If any partner's interest in a partnership changes during the tax year, each partner's share of certain cash basis items of the partnership must be determined by prorating the item on a daily basis. This rule applies to the following items for which the partnership uses the cash method of accounting:

1. Interest.
2. Taxes.
3. Payments for services or for the use of property.

ANSWER: B

A partner's basis in a partnership includes the partner's share of partnership liabilities. A partner's share of partnership liabilities depends on whether the partner has an economic risk of loss for that liability. A partner's share of a liability equals that partner's share of the economic risk of loss. Nonrecourse loans are liabilities of the partnership for which no partner bears the economic risk of loss. A partner's distributive share of partnership loss is allowed only to the extent of the adjusted basis of the partner's partnership interest. Start with the partner's adjusted basis:

Property contributed by partner(adj basis)	\$ 250
Partner's share of liability	
($\$500 + (\$1,000 \times 50\%)$)	1,000
Partner's adjusted basis (before loss)	1,250
Partner's share of loss	
($\$4,000 \times 50\%$) Allowable loss	
(to extent of adjusted basis)	1,250
Partner's adjusted basis after loss	<u><u>-0-</u></u>

Chapter 2. Partnerships

30. B invested \$20,000 cash for a 55% interest in ABC Partnership. B materially participates in the partnership's business and the partnership agreement states he is liable for all of the partnership's debts. The only partnership debt at the year-end was a \$17,000 loan from a bank. Partner B and the other general partner had a separate agreement that B's liability would not exceed \$12,000. The partnership reported a \$60,000 ordinary loss for the tax year. Assuming there were no other adjustments to B's basis, what is the amount of B's deductible loss?

- A. \$37,000
- B. \$33,000
- C. \$32,000
- D. \$20,000

31. Mr. M invested \$10,000 cash for a 25% interest in M&L partnership. He materially participates in the partnership business. The partnership had an \$80,000 loss. The partnership agreement states that Partner M is additionally liable for all of the partnership liabilities of \$5,000. What is the amount of M's deductible loss for the partnership?

- A. \$10,000
- B. \$11,250
- C. \$15,000
- D. \$20,000

ANSWER: C

The at-risk rule applies to business activities conducted through a partnership. The at-risk rules limit a partner's deductible loss to the amounts for which that partner is considered at risk in the partnership. A partner is considered at risk for all of the following amounts:

1. The money and adjusted basis of any property the partner contributes to the partnership.
2. The partner's share of net income retained by the partnership.
3. Certain amounts borrowed by the partnership for use in the business if the partner is personally liable for repayment or the amounts borrowed are secured by the partner's property (other than property used in the partnership).

In this question, the partner can only deduct losses equal to the amount he is at risk. The partner invested \$20,000 and is personally liable for \$12,000 of the partnership's liabilities; therefore, he can deduct \$32,000 of his \$33,000 ($\$60,000 \times 55\%$) share of the partnership's ordinary loss.

ANSWER: C

The partner's basis in the partnership is \$15,000 (\$10,000 cash contribution plus the \$5,000 in partnership liabilities he is personally liable. Therefore, he can deduct \$15,000 of his share of partnership losses of \$20,000 ($\$80,000 \times 25\%$).

32. With regard to a partnership computing its income, which of the following is determined by the individual partners and NOT the partnership?

- A. Accounting methods.
- B. Amortization of certain organization fees and start-up costs.
- C. Income from cancellation of debt.
- D. Depreciation methods.

ANSWER: C

The partnership, not the partners, makes most choices about how to compute income. These include choices for:

- 1. Accounting methods.
- 2. Depreciation methods.
- 3. Accounting for specific items, such as depletion or installment sales.
- 4. Nonrecognition of gain on involuntary conversions of property.
- 5. Amortization of certain organization fees and business startup costs of the partnership.

However, each partner, not the partnership, decides how to treat foreign and U.S. possessions taxes, certain mining exploration expenses, and income from discharge of indebtedness.

Partnership Distribution

Partner's Gain or Loss

33. The adjusted basis of a partner's partnership interest is \$17,500. The partner received a distribution of \$9,000 cash and a piece of land with an adjusted basis of \$2,500 and a fair market value of \$4,000. What is the gain to be recognized at the time of these distributions?

- A. \$1,500
- B. \$0
- C. \$4,500
- D. \$6,000

ANSWER: B

A partner recognizes gain on a partnership distribution only to the extent any money (and marketable securities treated as money) included in the distribution exceeds the adjusted basis of the partner's interest in the partnership. Any gain recognized is generally treated as capital gain from the sale of the partnership interest on the date of the distribution. If partnership property (other than marketable securities treated as money) is distributed to a partner, he or she generally does not recognize any gain until the sale or other disposition of the property.

In this question, the partner would not recognize a gain since the cash and adjusted basis of the land received was less than the partner's basis in the partnership. Any gain on the land will be recognized when she sells it. The distribution decreases the adjusted basis of her interest in the partnership to \$6,000 ($\$17,500 - (\$9,000 + \$2,500)$).

Chapter 2. Partnerships

34. A partner's adjusted basis in the partnership is \$15,000. The partner received a non-liquidating cash distribution of \$2,500 and a piece of land with an adjusted basis of \$7,500 and a fair market value of \$5,000. What is the gain or loss to be recognized at the time of the distribution?

- A. \$5,000 loss
- B. \$2,500 loss
- C. \$0
- D. \$5,000 gain

35. Generally, a partner does not recognize loss on a partnership distribution unless all of the following requirements are met EXCEPT:

- A. The adjusted basis of the partner's interest in the partnership exceeds the distribution.
- B. The adjusted basis of the partner's interest in the partnership exceeds the fair market value of the property distributed.
- C. The partner's entire interest in the partnership is liquidated.
- D. The entire distribution is in money, unrealized receivables, or inventory items.

Partner's Basis for Distributed Property

36. A partner who acquired a part of his partnership in a sale may be able to choose a special basis adjustment for the property. Which of the following is correct?

- A. The distribution must be made within 1 year after the partner acquired the partnership interest.
- B. The partner's basis for the property distributed is the same as it would have been if the partnership had chosen the optional adjustment to basis.
- C. The partnership may also choose the optional adjustment to basis when the partner acquired the partnership interest.
- D. All of the above.

ANSWER: C

Refer to the analysis on the previous question. The partner would not recognize a gain or loss on the land until he or she sells it. The distribution decreases the adjusted basis of the partner's interest in the partnership to \$5,000 ($\$15,000 - (\$2,500 + \$7,500)$).

ANSWER: B

A partner does not recognize loss on a partnership distribution unless all of the following requirements are met:

1. The adjusted basis of the partner's interest in the partnership exceeds the distribution.
2. The partner's entire interest in the partnership is liquidated.
3. The distribution is in money, unrealized receivables, or inventory items.

ANSWER: B

A partner who acquired any part of his or her partnership interest in a sale or exchange or upon the death of another partner may be able to choose a special basis adjustment for property distributed by the partnership. To choose the special adjustment, the partner must have received the distribution within **2 years** after acquiring the partnership interest. Also, the partnership must **not** have chosen the optional adjustment to basis when the partner acquired the partnership interest. If a partner chooses this special basis adjustment, the partner's basis for the property distributed is the same as it would have been if the partnership had chosen the optional adjustment to basis.

37. A partner in a partnership receives \$1,000 cash and property worth \$2,000 in which the partnership has a basis of \$1,500. The partner's basis in the partnership at the time of the distribution is \$20,000. The partnership has assets of \$40,000 and no outstanding liabilities. This distribution is at the end of the year after partnership income (loss) has been recorded. How much gain should the partner recognize on the distribution and what is his basis in the property received?

- A. Recognizes a gain of \$500 on the property received and partner's basis in the property is \$2,000.
- B. Recognizes gain of \$1,500 on the property and cash received. Partner's basis in the property received is \$3,500.
- C. Recognizes no gain on the property received. Partner's basis in the property received is \$1,500.
- D. Recognizes a gain of \$1,000. Partner's basis in the property received is \$1,500.

38. A partner's adjusted basis in a partnership is \$50,000. She receives a distribution of \$10,000 cash, land that has an adjusted basis of \$30,000 and a FMV of \$50,000. What is her adjusted basis in the land?

- A. \$20,000
- B. \$30,000
- C. \$40,000
- D. \$50,000

39. The adjusted basis of partner's partnership interest is \$10,000. He receives a distribution of \$4,000 cash and property that has an adjusted basis to the partnership of \$8,000. (This was NOT a distribution in liquidation.) What is the partner's basis of the distributed property?

- A. \$8,000
- B. \$6,000
- C. \$14,000
- D. \$2,000

ANSWER: C

Unless there is a complete liquidation of a partner's interest, the basis of property (other than money) distributed to the partner by a partnership is its adjusted basis to the partnership immediately before the distribution. However, the basis of the property to the partner cannot be more than the adjusted basis of his or her interest in the partnership reduced by any money received in the same transaction.

ANSWER: B

Unless there is a complete liquidation of a partner's interest, the basis of property (other than money) distributed to the partner by a partnership is its adjusted basis to the partnership immediately before the distribution. However, the basis of the property to the partner cannot be more than the adjusted basis of his or her interest in the partnership reduced by any money received in the same transaction.

ANSWER: B

Refer to the analysis on the previous question.

Partner's basis in the property distributed:
 Partner's basis
 in partnership interest.....\$10,000
 Less: Cash received..... 4,000
 Partner's basis
 in the property distributed.....\$ 6,000

Transactions Between Partnership and Partners

Guaranteed Payments

40. Payments made by a partnership to a partner that are determined without regard to the partnership income are called

- A. Guaranteed payments
- B. Minimum payments
- C. Ordinary income
- D. Capital gains

41. All of the following are true statements describing guaranteed payments EXCEPT:

- A. Guaranteed payments are payments made to a partner without regard to the partnership's income.
- B. Guaranteed payments are included in income in the partner's tax year in which the partnership's tax year ends.
- C. Premiums for health insurance paid by a partnership on behalf of a partner for services as a partner are treated as guaranteed payments.
- D. Guaranteed payments to a partner cannot create a loss on the partnership return (Form 1065).

42. Under the terms of ABC's partnership agreement, Partner E received, as a guaranteed payment, 12 monthly payments of \$1,000 from 2/11/2021 to 1/31/2022 from ABC partnership. His distributive share of the partnership income is 10%. The ABC partnership has \$60,000 of ordinary income after deducting the guaranteed payment. How much must E include on his individual tax return for 2022 if he is a calendar year taxpayer and the partnership year ends 1/31/2022?

- A. \$1,000 guaranteed payment and \$6,000 ordinary income
- B. \$1,000 guaranteed payment and \$500 ordinary income
- C. \$12,000 guaranteed payment and \$500 ordinary income
- D. \$12,000 guaranteed payment and \$6,000 ordinary income.

ANSWER: A

Guaranteed payments are payments made by a partnership to a partner that are determined without regard to the partnership income.

ANSWER: D

Guaranteed payments are payments made to a partner without regard to the partnership's income. A partnership treats guaranteed payments for services, or for the use of capital, as if they were made to a person who is not a partner.

Premiums for health insurance paid by a partnership on behalf of a partner are treated as guaranteed payments.

Guaranteed payments are included in income in the partner's tax year in which the partnership's tax year ends.

Guaranteed payments are a deductible business expense to the partnership and could create a loss on the partnership return.

ANSWER: D

A partner's income or loss from a partnership is the partner's distributive share of partnership items for the partnership's tax year that ends with or within the partner's tax year. Since the partnership's tax year ends on 1/31/2022, the partner reports his distributive share of the partnership income of \$6,000 ($\$60,000 \times 10\%$) and his guaranteed payments of \$12,000 ($\$1,000 \times 12$ months) in his calendar tax year of 2022.

43. A partner in a partnership is to receive 40% of the partnership's income, but not less than \$20,000. The partnership has a net income of \$10,000 after deducting the \$20,000. How much can the partnership deduct for the partner's guaranteed payment on Form 1065 Partnership Return.

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

44. A partner received a \$10,000 guaranteed payment as a partner in a partnership on June 30, 2022. The partnership is on a fiscal year ending March 31, 2023. How much of the payment, if any, should the partner include on his individual income tax return for tax year ended December 31, 2022?

- A. \$0
- B. \$5,000
- C. \$7,500
- D. \$10,000

45. Under a partnership agreement, partner is to receive 40% of the partnership's income, but not less than \$15,000. The partnership's net income was \$30,000 before considering the minimum guarantee amount. What amount can the partnership deduct as a guaranteed payment and what amount of income is the partner required to report?

	<u>Partnership</u>	<u>Partner</u>
A.	\$3,000	\$15,000
B.	\$15,000	\$15,000
C.	\$3,000	\$27,000
D.	\$15,000	\$27,000

ANSWER: B

If a partner is to receive a minimum payment from the partnership, the guaranteed payment is the amount by which the minimum payment is more than the partner's distributive share of the partnership income before taking into account the guaranteed payment.

The partner is guaranteed a payment of at least \$20,000 a year. The \$20,000 payment is treated as follows:

Amount received.....	\$20,000
Less: Partner's share of income (((\$20,000 + \$10,000) × 40%).....	<u>12,000</u>
Partner's guaranteed payment.....	<u>\$ 8,000</u>

ANSWER: A

Guaranteed payments are included in income in the partner's tax year in which the partnership's tax year ends. In the question, the partnership's tax year ends on March 31, 2023. Therefore, the guaranteed payment received on June 30, 2022 would be included in the partner's individual income tax return for tax year ending December 31, 2023.

ANSWER: A

The partner is guaranteed a payment of at least \$15,000 a year. The \$15,000 payment to the partner is treated as:

Amount received.....	\$15,000
Less: Partner's share of income (\$30,000 × 40%).....	<u>12,000</u>
Partner's guaranteed payment.....	<u>\$ 3,000</u>

Guaranteed payments are deductible by the partnership as business expenses. Guaranteed payments are reported by the partner as ordinary income, in addition to the appropriate distributive share of ordinary income from the partnership.

Sale or Exchange of Property to Related Parties

46. Mr. J owns a 55% capital interest in ABC Partnership. His brother owns 60% interest in XYZ Partnership. ABC sold a piece of property with an adjusted basis of \$50,000 and a fair market value of \$55,000 to XYZ for \$45,000. What is ABC's RECOGNIZED loss?

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

47. AB Partnership is a 70% owner of CD Partnership. On August 1, 2021, CD sold land to AB for \$40,000, which had an adjusted basis to CD of \$50,000. On September 1, 2022, AB sold the land to an unrelated party for \$70,000. What is the amount of AB's gain?

- A. \$0
- B. \$10,000
- C. \$20,000
- D. \$30,000

48. Taxpayer J and his brother each own a 40% interest in J & K Partnership. J also owns a 70% interest in MG Partnership. In 2021 J & K sold a building to MG Partnership for \$100,000. J & K's adjusted basis of the building at the time of the sale was \$110,000. In 2022, MG sold the building for \$115,000. How much gain or (loss) will MG RECOGNIZE?

- A. \$0
- B. \$5,000
- C. \$10,000
- D. \$15,000

ANSWER: A

Losses are not allowed from a sale or exchange of property (other than an interest in the partnership) between two partnerships in which the same person(s) directly or indirectly own more than 50% of the capital or profits in each partnership. An individual is considered to own the interest directly or indirectly owned by a family member. Family member includes only brothers, sisters, half-brothers, half-sisters, spouses, ancestors, and lineal descendants.

ANSWER: C

Losses are not allowed from the sale or exchange of property (other than an interest in the partnership) between two partnerships in which the same persons directly or indirectly own more than 50% of the capital or interest in each partnership. If the purchaser later sells the property, only the gain realized that is greater than the loss not allowed will be taxable.

Transaction between related partnerships:

Selling price.....	\$40,000
Less: Adjusted basis.....	<u>50,000</u>
Disallowed loss.....	<u>\$10,000</u>

Transaction between AB and unrelated party:

Selling price.....	\$70,000
Less: Adjusted basis.....	<u>40,000</u>
Disallowed loss.....	<u>10,000</u>
Gain on sell to unrelated party.....	<u>\$20,000</u>

ANSWER: B

Refer to the analysis on the previous question.

Transaction between related partnerships:

Selling price.....	\$100,000
Less: Adjusted basis.....	<u>110,000</u>
Disallowed loss.....	<u>\$ 10,000</u>

Transaction between MG and unrelated party:

Selling price.....	\$115,000
Less: Adjusted basis.....	<u>100,000</u>
Disallowed loss.....	<u>10,000</u>
Gain on sell to unrelated party.....	<u>\$ 5,000</u>

49. A taxpayer owns 50% of the capital interest in ABC Partnership and 50% of the profits interest in XYZ Partnership. In 2020 for \$100,000, ABC Partnership sells land to XYZ Partnership, which XYZ Partnership will use in its trade or business. The ABC Partnership's adjusted basis in the land at the time of the sale was \$120,000. In 2022, the XYZ Partnership sells the land to an unrelated third party for \$160,000. How much gain will the XYZ Partnership recognize?

- A. \$30,000
- B. \$40,000
- C. \$60,000
- D. \$20,000

ANSWER: C

Since the partner does not own more than 50% of either partnership the sale between the partnerships is not a related parties transaction.

Transaction between ABC and XYZ partnerships:
 Selling price.....\$100,000
 Less: Adjusted basis..... 120,000
 Allowed loss.....\$ 20,000

Transaction between XYZ and third party:
 Selling price.....\$160,000
 Less: Adjusted basis..... 100,000
 Gain on sale.....\$ 60,000

Contribution of Property

50. A taxpayer contributed property having an adjusted basis to him of \$10,000, to LMN Partnership for a 45% interest in the partnership. At the time of the contribution, the property had a fair market value of \$20,000. What is the amount and character of the taxpayer's gain on this transaction?

- A. \$0
- B. \$4,500 long-term capital gain
- C. \$10,000 ordinary income
- D. \$10,000 long-term capital gain

ANSWER: A

Neither the partners nor the partnership recognize a gain or loss when property is contributed to the partnership in exchange for a partnership interest.

51. Mr. J and Mr. T formed an equal partnership. J contributed \$10,000 cash and T contributed depreciable equipment that he has owned for 6 months with a fair market value of \$10,000 and an adjusted basis of \$2,000. J had taken \$3,000 in depreciation on the equipment before he transferred it to the partnership. What amount should T report as a gain as a result of this transaction?

- A. \$0
- B. \$3,000
- C. \$4,000
- D. \$8,000

ANSWER: A

Neither the partners nor the partnership recognize a gain or loss when property is contributed to the partnership in exchange for a partnership interest.

Chapter 2. Partnerships

52. Taxpayer P and Taxpayer K formed a partnership in which they share income and loss equally. K contributes land on which there is a recourse mortgage of \$18,000. The land has an adjusted basis to K of \$15,000 and a fair market value of \$20,000 at the time of the contribution. P contributes \$2,000 to the partnership in cash. What amount of gain should K recognize as a result of the contribution of property?

- A. \$0
- B. \$9,000
- C. \$5,000
- D. \$2,000

53. A taxpayer acquired a 30% interest in a partnership by contributing property that had an adjusted basis to her of \$25,000, fair market value of \$50,000 and a \$40,000 mortgage. The partnership assumed the liability. What is her gain or loss on the contribution of her property to the partnership?

- A. \$0
- B. \$3,000 gain
- C. \$12,000 gain
- D. \$10,000 loss

54. A taxpayer contributed stock with a FMV of \$10,000 and a basis of \$5,000 to a partnership (which would be treated as an investment company if it had been incorporated) for a 50% interest. What is the partnership's basis in the stock?

- A. \$0
- B. \$2,500
- C. \$5,000
- D. \$10,000

ANSWER: A

Neither the partners nor the partnership recognize a gain or loss when property is contributed to the partnership in exchange for a partnership interest. If contributed property is subject to a debt or if a partner's liabilities are assumed by the partnership, the basis of that partner's interest is reduced (but not below zero) by the liability assumed by the other partners. This partner must reduce his or her basis because the assumption of the liability is treated as a distribution of money to that partner.

ANSWER: B

Generally, no gain or loss is recognized by the partner or the partnership when a partner contributes property to a partnership. However, if the property contributed is subject to liabilities in excess of the partner's basis, the partner will recognize a capital gain. This gain is treated as a capital gain from the sale or exchange of a partnership interest and would not increase the partner's basis in the partnership.

In this question, the partner is responsible for 30% of the liability on the contributed property because it is now partnership property. The partner is relieved of \$28,000 ($\$40,000 \times 70\%$) of the liability on the contributed property and her adjusted basis was \$25,000. Therefore, she has a taxable gain of \$3,000 ($\$28,000 - \$25,000$).

ANSWER: D

If a partner contributes property to a partnership, the partnership's basis in the property is the same as the partner's adjusted basis for the property when it was contributed, increased by any gain recognized by the partner at the time of the contribution. Gain is recognized when property is contributed (in exchange for an interest in the partnership) to a partnership that would be treated as an investment company if it were incorporated. The gain is the difference between the partner's adjusted basis in the property contributed and its FMV.

Partnership's basis in property contributed by partner:

Partner's adjusted basis	
in the property.....	\$ 5,000
Partner's gain on transaction	
(\$10,000 - \$5,000).....	5,000
Partnership's basis in property.....	<u>\$10,000</u>

55. With regard to the character of the gain or loss to a partnership on a later disposition of contributed property, which of the following statements is correct?

- A. For property that was an unrealized receivable in the hands of the contributing partner, any gain or loss would be ordinary income or loss to the partnership ONLY for dispositions within 5 years after the contribution.
- B. For property that was an inventory item in the hands of the contributing partner, any gain or loss would be ordinary income or loss to the partnership ONLY for dispositions within 5 years after the contribution.
- C. For property that was a capital asset in the hands of the contributing partner, any gain or loss would be ordinary income or loss to the partnership ONLY for dispositions within 5 years after the contribution.
- D. All of the above are correct.

56. Taxpayer M and Taxpayer J formed a partnership. M contributed \$25,000 in cash and J contributed property with an adjusted basis of \$40,000, with a fair market value of \$25,000. The partnership sells the contributed property to an unrelated party 2 years after start up for \$27,000. How much gain (loss) should the partnership recognize on the sale of the contributed property?

- A. \$0
- B. \$2,000 gain
- C. \$15,000 loss
- D. \$13,000 loss

57. Generally, no gain or loss is recognized by the partnership or a partner when the partner contributes property to the partnership, unless:

- A. The partnership is being formed.
- B. A gain is realized on the transfer of property to a partnership that would be treated as an investment company if the partnership were incorporated.
- C. The partnership is already operating.
- D. Unencumbered depreciable property is contributed.

ANSWER: B

For unrealized receivables, inventory items, and certain capital asset property contributed by a partner to a partnership, the character of the partnership's gain or loss on a later disposition is determined by the following rules:

1. For property that was an **unrealized receivable** in the hands of the contributing partner, any gain or loss on a disposition by the partnership is ordinary income or loss.
2. For property that was an **inventory item** in the hands of the contributing partner, a gain or loss on a disposition by the partnership within 5 years after the contribution is ordinary income or loss.
3. For property that was a **capital asset** in the contributing partner's hands, any loss on a distribution within 5 years is a capital loss. The capital loss is limited to the amount the partner's adjusted basis of the property exceeds the property's FMV.

ANSWER: D

If the property was a capital asset in the contributing partner's hands, any loss on its disposition by the partnership within 5 years after the contribution is a capital loss. The capital loss is limited to the amount by which the partner's adjusted basis for the property exceeded the property's fair market value immediately before the contribution.

Sales price or property.....	\$27,000
Less: Adjusted basis.....	<u>40,000</u>
Capital loss.....	<u>\$13,000</u>

ANSWER: B

Gain is recognized when property is contributed (in exchange for an interest in the partnership) to a partnership that would be treated as an investment company if it were incorporated. A partnership is generally treated as an investment company if over 80% of the value of its assets is held for investment and consists of certain readily marketable items. These items include money, stocks and other equity interests in a corporation, and interests in regulated investment companies and real estate investment trusts.

Basis of Partner's Interest

58. A general partnership distributed \$8,000 cash to a partner during the year. The partner's adjusted basis (including his share of liabilities) in his partnership interest at the beginning of the year was \$9,500. His share of the partnership's taxable loss for the year was \$1,000. What was the partner's ending basis in partnership interest?

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

ANSWER: A

The partner's basis in a partnership is increased by the partner's:

1. Additional contributions to the partnership.
2. Distributive share of both taxable and nontaxable partnership income.
3. Distributive share of the excess of the deductions for depletion over the basis of the depletable property.
4. Distributive share of increase in liabilities.

The partner's basis is decreased (but not below zero) by:

1. The amount of money and the adjusted basis of property distributed to the partner by the partnership.
2. The partner's distributive share of the partnership losses (including capital losses).
3. The partner's distributive share of nondeductible partnership expenses that are not capital expenditures.
4. The amount of the partner's deduction for depletion for any partnership oil and gas wells, up to the proportionate share of the adjusted basis of the wells allocated to the partner.
5. The partner's share of any section 179 expenses, even if the partner cannot deduct the entire amount on his or her individual income tax return.
6. Partner's distributive share of decrease in liabilities.

Partner's adj. basis	
(beginning of year)	\$9,500
Less: Cash distributed to partner	8,000
Partner's share of partnership's loss ..	<u>1,000</u>
Partner's ending adjusted basis	<u><u>\$ 500</u></u>

59. Taxpayer B and Taxpayer J formed a new partnership. B contributes property that has an adjusted basis of \$1,400 and a fair market value of \$2,000 to the partnership. J contributes \$2,000 in cash to the partnership. Each partner's capital account as reflected on the partnership's books is \$2,000. What is the adjusted basis of each partner's interest?

- A. B's at \$1,400 and J's at \$1,400.
- B. B's at \$1,400 and J's at \$2,000.
- C. B's at \$1,700 and J's at \$1,700.
- D. B's at \$2,000 and J's at \$2,000.

ANSWER: B

The basis of a partner's interest in a partnership is the money plus the adjusted basis of any property the partner contributed to the partnership.

60. A taxpayer provides services to a partnership in exchange for a capital interest of 30% worth \$25,000. The taxpayer's basis in the partnership is

- A. Zero since she exchanged services for her interest.
- B. \$25,000, which must be reported by her as income in the year of receipt if the interest is vested.
- C. The present value of \$25,000, computed over the lesser of her remaining life or the average remaining life of the other partners.
- D. Considered a profits interest and has a zero basis.

61. Taxpayer E and Taxpayer B form a partnership with contributions of \$30,000 each. B is not a general partner. Under the partnership agreement, E and B share all partnership profits and losses equally. The partnership borrows \$70,000 to purchase depreciable equipment to be used in the partnership's business. E was required under the partnership agreement to pay the creditor if the partnership defaulted. Based upon these facts, what are E and B's basis in the partnership?

	<u>E</u>	<u>B</u>
A.	\$30,000	\$30,000
B.	\$65,000	\$65,000
C.	\$100,000	\$30,000
D.	\$100,000	\$100,000

62. A taxpayer contributes property with a fair market value of \$7,000, adjusted basis of \$4,000, and a mortgage of \$1,000, which the partnership assumes, to a partnership for a 40% interest in the partnership. What is his basis in the partnership?

- A. \$4,000
- B. \$3,000
- C. \$6,000
- D. \$3,400

ANSWER: B

A partner can acquire an interest in partnership capital or profits as compensation for services performed or to be performed. The fair market value of such an interest received by a partner is compensation for services and must be included in the partner's gross income in the first tax year in which the partner can transfer the interest or the interest is not subject to a substantial risk of forfeiture (vested).

ANSWER: C

A partner's basis in a partnership includes the partner's share of partnership liabilities. A partner's share of partnership liabilities depends on whether the partner has an economic risk of loss for that liability. A partner's share of a liability equals that partner's share of the economic risk of loss. A limited partner has no obligation to contribute additional capital to the partnership and, therefore, does not have an economic risk of loss in partnership liabilities. B, a limited partner, has no risk of loss in the \$70,000 liability. His basis in the partnership is the amount of money contributed, **\$30,000**. E does have a risk of loss on the liability and can include the entire amount of the liability in his basis. E's basis would then be **\$100,000** (\$30,000 + \$70,000).

ANSWER: D

A partner's adjusted basis in a partnership is the adjusted basis of property contributed, including money, to the partnership. If the property contributed is subject to indebtedness or if a partner's liabilities are assumed by the partnership, the basis of that partner's interest is reduced by the liability assumed by the other partners.

Adjusted basis of property contributed...	\$4,000
Less: Relief of liabilities (1,000 × 60%)	<u>600</u>
Basis in partnership.....	<u><u>\$3,400</u></u>

Chapter 2. Partnerships

63. A partner's basis in a partnership interest includes the partner's share of a partnership liability in all of the following EXCEPT:

- A. A liability that creates or increases the partnership's basis in any of its assets.
- B. A partner's share of accrued but unpaid expenses of a cash basis partnership.
- C. A liability that is a nondeductible, non-capital expense of the partnership.
- D. A liability that gives rise to a current deduction to the partnership.

ANSWER: B

A partner's basis in a cash basis partnership includes a partnership liability only if, and to the extent that, the liability:

- 1. Creates or increases the partnership's basis in any of its assets,
- 2. Gives rise to a current deduction to the partnership, or
- 3. Is a nondeductible, noncapital expense of the partnership.

Disposition of Partner's Interest

Sale, Exchange or Other Transfer

64. Which of the following statements about the effect of a sale or exchange of a partner's interest in a partnership is correct?

- A. The entire transaction is always treated as the sale of a capital asset.
- B. The partnership may make an election for an optional adjustment to the basis of partnership assets in the year the interest is transferred.
- C. The exchange of a partnership interest generally qualifies for like-kind exchange treatment.
- D. The gain on the sale of a partnership interest may not be reported on the installment basis.

ANSWER: B

If a partner receives money or property in exchange for any part of a partnership interest, the amount due to his or her share of the partnership's unrealized receivables or inventory items results in ordinary income or loss. This amount is treated as if it is not a capital asset. The exchange of a partnership interest does not qualify for like-kind exchange treatment. The part of the gain on the sale of a partnership interest that is capital gain may be reported on the installment basis.

65. A partner's adjusted basis of his partnership interest at the end of the year was \$30,000, which includes his \$12,000 share of partnership liabilities. He sold his interest in the partnership for \$20,000, and was relieved of his share of partnership liabilities. What is the gain or loss he must recognize?

- A. \$0
- B. \$32,000 gain
- C. \$10,000 loss
- D. \$2,000 gain

ANSWER: D

If the selling partner is relieved of any partnership liabilities, the selling partner must include the amount of the liability relief as part of the amount realized for his or her interest.

Selling partner's gain:

Cash received.....	\$20,000
Relief of liability.....	<u>12,000</u>
Amount realized.....	32,000
Less: Adjusted basis in partnership....	<u>30,000</u>
Capital gain.....	<u>\$ 2,000</u>

66. A partner's adjusted basis of his partnership interest at the end of the year was \$35,000, which included his \$16,000 share of partnership liabilities and the contributed cash. The partnership had no other liabilities and no unrealized receivables or substantially appreciated inventory items. On December 31, he sold his entire interest in the partnership for \$19,000 cash. He did not take any distributions in the year. What is the amount of the partner's capital gain or loss?

- A. \$0
- B. \$1,000 loss
- C. \$16,000 gain
- D. \$19,000 gain

67. A partner sold her partnership interest for \$25,000. Her adjusted basis at the time of the sale is \$22,500 which includes her \$12,500 share of partnership liabilities. When she initially invested in the partnership, she contributed \$10,000 worth of equipment. There was no profit or loss at the partnership level at the time she sold her interest. What is the amount and nature of her gain or loss from the sale of her partnership interest?

- A. \$7,500 ordinary loss
- B. \$10,000 capital gain
- C. \$12,500 ordinary gain
- D. \$15,000 capital gain

68. A partner's adjusted basis in a partnership is \$38,000, which includes his \$30,000 share of partnership liabilities. The partnership has no unrealized receivables or inventory items. He sells his interest in the partnership for \$15,000 in cash. He had been paid his share of the partnership income for the tax year. What is the gain or loss on the sale?

- A. \$7,000 gain
- B. \$15,000 gain
- C. \$15,000 loss
- D. \$23,000 loss

ANSWER: A

If the selling partner is relieved of any partnership liabilities, the selling partner must include the amount of the liability relief as part of the amount realized for his or her interest.

Selling partner's gain:	
Cash received.....	\$19,000
Relief of liability.....	<u>16,000</u>
Amount realized.....	35,000
Less: Adjusted basis in partnership....	<u>35,000</u>
Capital gain.....	<u>\$ - 0-</u>

ANSWER: D

If the selling partner is relieved of any partnership liabilities, the selling partner must include the amount of the liability relief as part of the amount realized for his or her interest.

Selling partner's gain:	
Cash received.....	\$25,000
Relief of liability.....	<u>12,500</u>
Amount realized.....	37,500
Less: Adjusted basis in partnership....	<u>22,500</u>
Capital gain.....	<u>\$15,000</u>

Since the partnership had no unrealized receivables or inventory items the \$15,000 recognize gain is a capital gain.

ANSWER: A

If the selling partner is relieved of any partnership liabilities, the selling partner must include the amount of the liability relief as part of the amount realized for his or her interest.

Selling partner's gain:	
Cash received.....	\$15,000
Relief of liability.....	<u>30,000</u>
Amount realized.....	45,000
Less: Adjusted basis in partnership....	<u>38,000</u>
Capital gain.....	<u>\$ 7,000</u>

Since the partnership had no unrealized receivables or inventory items the \$7,000 recognize gain is a capital gain.

Chapter 2. Partnerships

69. A loss incurred from the abandonment of a partnership interest is an ordinary loss when

- A. The partner receives a de minimis or deemed distribution.
- B. The partner's capital account reflects a positive balance.
- C. The partner transfers the entire interest to a non-related party.
- D. The transaction is not a sale or exchange and the partner has not received an actual or deemed distribution from the partnership.

ANSWER: D

A loss incurred from the abandonment or worthlessness of a partnership interest is an ordinary loss only if both of the following tests are met.

- 1. The transaction is not a sale or exchange.
- 2. The partner has not received an actual or deemed distribution from the partnership.

Payment for Unrealized Receivables and Inventory Items

70. A partner has a partnership interest with a zero basis. The partnership has inventory valued at \$250,000. His share of the ordinary income to be received from the sale of the inventory would be \$10,000. The partner sells his partnership interest for \$30,000. The partner will report the following gain:

- A. \$30,000 capital gain.
- B. \$20,000 ordinary gain and \$10,000 capital gain.
- C. \$10,000 ordinary gain and \$20,000 capital gain.
- D. No gain or loss.

ANSWER: C

If a partner receives money or property in exchange for any part of a partnership interest, the amount that is his or her share of unrealized receivables or inventory items is ordinary income. This amount is treated as if it were received for the sale of property that is not a capital asset. Therefore, the partner must treat the \$10,000 share of inventory items as ordinary income.

Amount realized:

Cash.....	\$30,000
Less: Adjusted basis.....	<u>0</u>
Amount recognized.....	30,000
Less: Ordinary income recognized.....	<u>10,000</u>
Capital gain.....	<u>\$20,000</u>

71. A partner's adjusted basis in a partnership is \$38,000, which includes his \$30,000 share of partnership liabilities. His share of unrealized receivables in the partnership is \$12,000. The partner sold his share of the partnership interest for \$45,000 cash. What is the amount and character of the partner's gain?

- A. \$12,000 ordinary gain; \$25,000 capital gain.
- B. \$25,000 ordinary gain; \$12,000 capital gain.
- C. \$7,000 capital gain.
- D. \$37,000 capital gain.

ANSWER: A

If a partner receives money or property in exchange for any part of a partnership interest, the amount that is his or her share of unrealized receivables or inventory items is ordinary income. This amount is treated as if it were received for the sale of property that is not a capital asset. Therefore, the partner must treat the \$12,000 share of unrealized receivables as ordinary income.

Amount realized:

Cash.....	\$45,000
Relief of liabilities.....	<u>30,000</u>
Total amount realized.....	75,000
Less: Adjusted basis.....	<u>38,000</u>
Amount recognized.....	37,000
Less: Ordinary income recognized.....	<u>12,000</u>
Capital gain.....	<u>\$25,000</u>

72. A limited partner's adjusted basis in the partnership is \$50,000, which includes his share of partnership liabilities of \$10,000. His share of unrealized receivables in the partnership is \$12,000. The partner sold his partnership interest for \$85,000 cash. What is the amount and character of the partner's gain?

	<u>Capital Gain</u>	<u>Ordinary Gain</u>
A. \$0		\$35,000
B. \$45,000		\$0
C. \$33,000		\$12,000
D. \$23,000		\$12,000

73. Partner A received inventory items with a basis of \$20,000 in complete dissolution of a partnership. Within five years, Partner A sells the entire inventory for \$30,000. What amount and type of gain should Partner A report?

- A. \$0
- B. \$10,000 short-term capital gain
- C. \$10,000 long-term capital gain
- D. \$10,000 ordinary gain

Liquidation at Partner's Retirement or Death

74. Which of the following statements about the liquidation of a partner's interest is NOT correct?

- A. A retiring partner is treated as a partner until his or her interest in the partnership has been completely liquidated.
- B. The retiring partner will recognize a gain on a liquidating distribution to the extent that any money distributed is more than the partner's adjusted basis in the partnership.
- C. Payments in liquidation of a partnership interest that are not made in exchange for the interest in partnership property are reported as capital gain by the recipient.
- D. Former partners who continue to make guaranteed periodic payments to satisfy the partnership's liability to a retired partner after the partnership is terminated can deduct the payments as business expense in the year paid.

ANSWER: C

The partner's share of unrealized receivables (\$12,000) will be ordinary income. If a partner is relieved of his or her share of partnership liabilities, it is treated as cash received.

Amount realized:	
Cash.....	\$85,000
Relief of liabilities.....	<u>10,000</u>
Total amount realized.....	95,000
Less: Adjusted basis.....	<u>50,000</u>
Amount recognized.....	45,000
Less: Ordinary income recognized.....	<u>12,000</u>
Capital gain.....	<u><u>\$33,000</u></u>

ANSWER: D

If a partner receives money or property in exchange for any part of a partnership interest, the amount that is his or her share of unrealized receivables or inventory items is ordinary income.

Selling price of inventory items.....	\$30,000
Less: Adjusted basis.....	<u>20,000</u>
Ordinary gain.....	<u><u>\$10,000</u></u>

ANSWER: C

Payments made by the partnership to a retiring partner or successor in interest of a deceased partner that are not made in exchange for an interest in partnership property are treated as distributive shares of partnership income or guaranteed payments.

Chapter 2. Partnerships

75. Which of the following statements about the liquidation of a partner's interest is NOT correct?

- A. A retiring partner is treated as a partner until his or her interest in the partnership has been completely liquidated.
- B. The remaining partners' distributive shares of partnership income are reduced by payments in exchange for a retired partner's interest in partnership property.
- C. The retiring partner will recognize a gain on a liquidating distribution to the extent that any money distributed is MORE than the partner's adjusted basis in the partnership.
- D. Payments in liquidation of an interest that are NOT made in exchange for the interest in partnership property are reported as ordinary income by the recipient.

76. Which of the following statements about payments made to a retiring partner, or successor in interest of a deceased partner, that are not made in exchange for an interest in the partnership property is correct?

- A. Payments made within five years of the partner's retirement or death are always treated as made in exchange for an interest in the partnership property.
- B. Payments made within five years of the partner's retirement or death are always treated as distributive shares of partnership income.
- C. If the amount of the payment is based on partnership income, the payment is taxable as a distributive share of partnership income.
- D. If the amount of the payment is based on partnership income, the payment is treated as a guaranteed payment.

ANSWER: B

Payments made in liquidation of the interest of a retiring or deceased partner in exchange for his or her interest in partnership property is considered a distribution, not a distributive share or guaranteed payment. The remaining partners' distributive shares are reduced only if the payments are treated as distributive shares of partnership income or guaranteed payments.

ANSWER: C

Payments made by the partnership to a retiring partner or successor in interest of a deceased partner that are not made in exchange for an interest in partnership property are treated as distributive shares of partnership income or guaranteed payments. This rule applies regardless of the time over which the payments are made. If the amount is not based on partnership income, it is treated as a guaranteed payment.

77. When payments are made to a retiring partner, or successor in interest of a deceased partner, for an interest in the partnership property, which of the following is correct?

- A. Payments that are based on partnership income are not taxable as a distributive share of partnership income but for the interest in the partnership.
- B. A retiring partner is treated as a partner until his or her interest in the partnership has been completely liquidated.
- C. Payments made for a retiring partner's share of the partnership's unrealized receivables are treated as made in exchange for partnership property if capital is not a material income producing factor and the retiring partner was a general partner.
- D. If the amount of the payment is based on partnership income, the payment is treated as a guaranteed payment.

ANSWER: B

Payments that are based on partnership income are taxable as a distributive share of partnership income. For income tax purposes, a retiring partner or successor in interest of a deceased partner is treated as a partner until his or her interest in the partnership has been completely liquidated. Payments made for a retiring partner's share of the partnership's unrealized receivables are treated as made in exchange for partnership property that is not a capital asset. If the amount of the payment is based on partnership income, the payment is treated as distributive shares of partnership income or guaranteed payments.

Chapter 3. C Corporations

Businesses Taxed as Corporations

1. Which of the following types of domestic business entities, formed after 1996, must be taxed as a corporation?

1. A business specially required to be taxed as a corporation by the Internal Revenue Code.
 2. An insurance company.
 3. Any business formed under state law that refers to itself as a corporation.
 4. A single member limited liability company.
- A. 2 and 3 only.
B. 1, 2 and 3 only.
C. 3 only.
D. All of the above.

ANSWER: B

To be treated as a corporation for tax purposes, an organization, formed before 1997, must have the majority of the following characteristics:

1. Continuity of life.
2. Centralization of management.
3. Limited liability.
4. Free transferability of interests.

The rules that must be used to determine whether a business is taxed as a corporation changed for businesses formed after 1996. However, a business formed before 1997 and taxed as a corporation under the old rules will generally continue to be taxed as a corporation. The following businesses formed after 1996 are taxed as corporations.

1. A business formed under a federal or state law that refers to the business as a corporation, body corporate, or body politic.
2. A business formed under a state law that refers to the business as a joint-stock company or joint-stock association.
3. An insurance company.
4. Certain banks.
5. A business wholly owned by a state or local government.
6. A business specially required to be taxed as a corporation by the Internal Revenue Code.
7. Certain foreign businesses.
8. Any other businesses formed after 1996, if an election to be taxed as a corporation is filed for the business on Form 8832 within 75 days of the date the election takes effect.

A single member limited liability company will automatically be treated as a sole proprietorship unless an election is made to be treated as a corporation using Form 8832, Entity Classification Election.

Chapter 3. C Corporations

2. What form must a limited liability company (LLC) file in order to elect to be taxed as a C corporation?

- A. Form 1065 (U. S. Partnership Tax Return).
- B. Form 8832 (Entity Classification Election).
- C. Form 1120 (U. S. Corporation Income Tax Return).
- D. Form 7004 (Application for Extension of time to file for corporations).

3. Which of the following types of domestic business entities, formed after 1996 cannot be taxed as a corporation?

- 1. An insurance Company.
 - 2. A business specially required to be taxed as a corporation by the Internal Revenue Code.
 - 3. A limited liability company with two or more active members.
 - 4. Entity that elects to be treated as a real estate mortgage investment conduit.
- A. 4 Only.
 - B. 1, 2, and 4 Only.
 - C. 3 Only.
 - D. 2 Only.

4. Most unincorporated businesses formed after 1996 can choose whether to be taxed as a partnership or a corporation. The regulations provide for a default rule if no election is made. If an election is not made and the default rules apply, which of the following is true?

- A. Any new domestic eligible entity having at least two or more members is classified as a partnership.
- B. Any new domestic eligible entity with a single member is disregarded as an entity separate from its owner.
- C. If all members of a new foreign entity have limited liability, it is classified as an association.
- D. All of the above are true.

ANSWER: B

An LLC or any other business can elect to be taxed as a C corporation by filing Form 8832, Entity Classification Election.

ANSWER: A

A real estate mortgage investment conduit (REMIC) is an entity that is formed for the purpose of holding a fixed pool of mortgages secured by interests in real property. A REMIC issues regular and residual interests to investors. For tax purposes, a REMIC is generally treated as a partnership with the residual interest holders treated as the partners.

ANSWER: D

The regulations provide for a default rule if no election is made. There are two default rules, the domestic default rule and the foreign default rule. The domestic default rule states that unless an election is made on Form 8832, Entity Classification Election, a domestic eligible entity is:

- 1. A partnership if it has two or more members.
- 2. Disregarded as an entity separate from its owner if it has a single owner.

The foreign default rule states that unless an election is made on Form 8832, a foreign eligible entity is:

- 1. A Partnership if it has two or more members and at least one member does not have limited liability.
- 2. An association if all members have limited liability.
- 3. Disregarded as an entity separate from its owner if it has a single owner that does not have limited liability.

5. ABC, an eligible entity, made an election by filing Form 8832, Entity Classification Election, on December 15, 2020, to be taxed as a partnership effective for January 1, 2021. Under the general rule, what is the earliest date ABC can elect to be taxed as a corporation by filing another Form 8832?

- A. January 1, 2022
- B. January 1, 2026
- C. December 15, 2024
- D. December 15, 2026

6. Which of the following statements regarding a closely held corporation is true?

- A. A personal service corporation can be a closely held corporation.
- B. A closely held corporation is a corporation which more than 80% of the value of its outstanding stock is, directly or indirectly, owned by or for five or fewer individuals.
- C. A closely held corporation is a corporation which more than 50% of the value of its outstanding stock is, directly or indirectly, owned by or for five or fewer individuals.
- D. A closely held corporation cannot include trusts or private foundations as its shareholders.

ANSWER: B

Once an eligible entity makes an election to change its classification, the entity generally cannot change its classification by election again during the **60 months** after the effective date of the election. However, the IRS may (by private letter ruling) permit the entity to change its classification by election within the 60-month period if more than 50% of the ownership interests in the entity as of the effective date of the election are owned by persons that did not own any interests in the entity on the effective date of the entity's prior election. The 60-month limitation does not apply if the previous election was made by a newly formed eligible entity and was effective on the date of formation.

ANSWER: C

A corporation is closely held if all of the following apply:

1. It is not a personal service corporation.
2. At any time during the last half of the tax year, more than 50% of the value of its outstanding stock is, directly or indirectly, owned by or for five or fewer individuals. "Individual" includes certain trusts and private foundations.

Chapter 3. C Corporations

7. A corporation is a personal service corporation if it meets all of the following requirements EXCEPT:

- A. Its principal activity is performing personal services.
- B. Its employee-owners substantially perform the services.
- C. Its employee-owners own more than 10% of the fair market value of its outstanding stock.
- D. It's accounting period cannot be the calendar year.

ANSWER: D

A corporation is a personal service corporation if it meets all of the following requirements:

1. Its principal activity during the "testing period" is performing personal services. Generally, the testing period for any tax year is the prior tax year. If the corporation has just been formed, the testing period begins on the first day of its tax year and ends on the earlier of:
 - The last day of its tax year, or
 - The last day of the calendar year in which its tax year begins.
2. Its employee-owners substantially perform the services in (1). This requirement is met if more than 20% of the corporation's compensation cost for its activities of performing personal services during the testing period is for personal services performed by employee-owners.
3. Its employee-owners own more than 10% of the fair market value of its outstanding stock on the last day of the testing period.

Personal services include any activity performed in the fields of accounting, actuarial science, architecture, consulting, engineering, health (including veterinary services), law, and the performing arts.

A personal service corporation must use a calendar tax year unless:

- It elects to use a 52-53-week tax year that ends with reference to the calendar year or tax year elected under section 444;
- It can establish a business purpose for a different tax year and obtains the approval of the IRS, or
- It elects under section 444 to have a tax year other than a calendar year.

Property Exchanged for Stock

8. A taxpayer formed a corporation with only one class of voting stock and all stock has voting rights. In order to apply Internal Revenue Code section 351 treatment of nonrecognition of any gain, the taxpayer has to have what percentage of control of ownership of the corporation immediately after transferring assets to the corporation for stock?

- A. At least 75% of the total voting stock.
- B. At least 50% of the total voting stock.
- C. At least 80% of the total voting stock
- D. At least 20% of the total voting stock

9. Mr. V and Mr. F formed a corporation. In exchange for 50% of the outstanding shares of the corporation's voting stock, which had a total par value of \$400,000, Mr. V contributed property with a fair market value of \$200,000 for which he had paid \$300,000 in a prior year. Mr. F contributed property with a fair market value of \$200,000 for which he had paid \$100,000 in a prior year and received the other 50% of the outstanding stock. How much gain or loss will V and F recognize on the transfer of property?

- A. V will recognize \$100,000 loss; F will recognize \$100,000 gain.
- B. No gain or loss to either V or F.
- C. V will recognize \$0 loss; F will recognize \$100,000 gain.
- D. None of the above.

10. Taxpayer J had previously incorporated his sole proprietorship by transferring property to his newly formed corporation in exchange for 100% of the stock. These assets, if sold, would produce a gain of \$100,000. A week after incorporation, J sells other assets for cash to the corporation that produce a loss of \$20,000. J is attempting to avoid Section 351 on the transfer of the loss assets in order to recognize the loss for tax purposes. Which statement best explains the tax consequences?

- A. J has a recognized loss of \$20,000 to report.
- B. J has a recognized gain of \$100,000 and a recognized loss of \$20,000 to report.
- C. J has neither a recognized gain nor recognized loss to report.
- D. J has only a recognized gain of \$100,000.

ANSWER: C

If an individual transfers property (or money and property) to a corporation in exchange for stock in that corporation (other than nonqualified preferred stock), and immediately afterward is in control of the corporation, the exchange is usually not taxable (IRC section 351). This rule applies both to individuals and to groups who transfer property to a corporation. It also applies whether the corporation is being formed or is already operating. To be in control of a corporation, the individual or group of transferors must own, immediately after the exchange, at least **80%** of the total combined voting power of all classes of stock entitled to vote and at least **80%** of the outstanding shares of each class of nonvoting stock.

ANSWER: B

If one or more persons transfer money or property to a corporation solely in exchange for stock of that corporation, and immediately after the exchange they (Mr. V and Mr. F) control the corporation (80% or more ownership of stock), neither the transferors nor the corporation recognizes a gain or loss.

ANSWER: C

If a person transfers money or property to a corporation solely in exchange for stock of that corporation, and immediately after the exchange they control the corporation (80% or more ownership of stock), neither the transferors nor the corporation recognizes a gain or loss (section 351 transfer). Since the taxpayer owns more than 50% of the corporation, no loss can be recognized between the taxpayer and the corporation.

Chapter 3. C Corporations

11. Which of the following is an example of nonqualified preferred stock in a Section 351 transaction?

- A. The holder of the stock has the right to require the issuer or a related person to redeem or buy the stock.
- B. The issuer of the stock is required to redeem or buy the stock.
- C. The dividend rate on the stock varies with reference to interest rates, commodity prices, or similar indices.
- D. All of the above.

12. The basis of property purchased is usually its cost. In determining the acquisition basis in C corporation stock, a shareholder must know

- A. The amount paid in cash or property.
- B. The amount paid in cash and debt obligations.
- C. The value of provided services and debt obligations assumed.
- D. All of the above.

13. The basis of stock received in exchange for property transferred to a corporation is the same as the basis of the property transferred with certain adjustments. Which one of the following would NOT decrease the basis of the stock received?

- A. The fair market value of other property received.
- B. Any amount treated as a dividend.
- C. Any money received.
- D. Any loss recognized on the exchange.

ANSWER: D

Nonqualified preferred stock is treated as property other than stock. Therefore, there could be gain. Generally, it is preferred stock with any of the following features.

1. The holder has the right to require the issuer or a related person to redeem or buy the stock.
2. The issuer or a related person is required to redeem or buy the stock.
3. The issuer or a related person has the right to redeem or buy the stock and, on the issue date, it is more likely than not that the right will be exercised.
4. The dividend rate on the stock varies with reference to interest rates, commodity prices, or similar indices.

ANSWER: D

The basis of the stock received by the shareholder is generally the adjusted basis of the property transferred and cash paid. Decrease this amount by any cash the shareholder received and the fair market value of any other property received. Also, decrease this amount by the amount of any liability the corporation or another party to the exchange assumed from the shareholder, unless payment of the liability gives rise to a deduction when paid.

ANSWER: B

The basis of stock received in exchange for the transfer of property to a corporation is the same as the basis of the property transferred

decreased by:

1. FMV of any other property received.
2. Amount of any money received.
3. Any loss recognized on the exchange by the shareholder.

increased by:

1. Any amount treated as a dividend.
2. Any gain recognized on the exchange.

14. A taxpayer contributes machinery and real property to a corporation that has been in existence for several years as follows:

<u>Asset</u>	<u>Adjusted Basis</u>	<u>Fair Market Value</u>
Machinery	\$100,000	\$150,000
Real Property	\$500,000	\$550,000

The corporation has two classes of stock. One with voting rights and one without voting rights. In exchange for the machinery and real property, the taxpayer receives stock with a fair market value of \$700,000. Immediately after the transfer, he owns 75% of the outstanding shares of corporate stock with voting power and 80% of the outstanding shares of each class of nonvoting stock of the corporation. Which of the following statements is true?

- A. \$100,000 gain is recognized by the taxpayer.
- B. No gain is recognized by the taxpayer.
- C. \$100,000 loss is recognized by the corporation.
- D. \$100,000 gain is recognized by the taxpayer and the corporation will recognize a loss in the amount of \$100,000.

15. Taxpayer A and Taxpayer B, as a group, transfer a building with a basis of \$100,000 to the ABC Corporation in exchange for 66.67% of each class of stock with a fair market value of \$300,000. The other 33.33% of the stock was already issued to an unrelated party. What is the gain, if any, that A, B, or the ABC Corporation must recognize?

- A. A and B: \$0; ABC Corporation: \$0.
- B. A and B: \$0; ABC Corporation: \$300,000.
- C. A and B: \$200,000; ABC Corporation: \$0.
- D. A and B: \$0; ABC Corporation: \$200,000.

16. A taxpayer transfers property worth \$50,000 to a corporation and provides personal services worth \$5,000 in exchange for stock valued at \$55,000. Immediately after the exchange the taxpayer owns 90% of the corporation's outstanding stock. What is the taxpayer's income recognition?

- A. \$55,000 Capital Gain, \$0 Ordinary Income.
- B. \$0 Capital Gain, \$5,000 Ordinary Income.
- C. \$0 Capital Gain, \$50,000 Ordinary Income.
- D. \$5,000 Capital Gain, \$0 Ordinary Income.

ANSWER: A

The shareholder exchanged property for 75% of the voting stock in the corporation. Since the exchange was not for control of the corporation (80% or more of the total combine voting and outstanding shares), the exchange is taxable to the shareholder. The corporation does not recognize a gain on the transfer.

Shareholder's recognized gain on the exchange:

FMV of stock.....	\$700,000
Less: Adj. basis in property transferred (\$100,000 + \$500,000)	600,000
Recognized gain on the exchange....	<u>\$100,000</u>

ANSWER: C

Since the exchange was not for control of the corporation (80% or more), the exchange is taxable to the shareholders. The corporation does not recognize a gain on the transfer.

Shareholders' recognized gain on the exchange:

FMV of stock.....	\$300,000
Less: Adj. basis in property transferred.....	100,000
Capital gain on the exchange.....	<u>\$200,000</u>

ANSWER: B

Since the exchange was for control of the corporation (80% or more) there is no recognized gain on the property transferred. However, the value of the stock received for services is ordinary income to the recipient.

Chapter 3. C Corporations

17. Mr. S and Mr. J each transfer property with a basis of \$10,000 to a corporation in exchange for stock with a fair market value of \$30,000. The total stock received by them represents 75% of each class of stock of the corporation. The other 25% of each class of stock was issued earlier to an unrelated person. The taxable consequences are

- A. None because it is transfer of property for stock.
- B. Mr. S and Mr. J each recognize a gain of \$20,000.
- C. Mr. S and Mr. J each recognize a gain of \$30,000.
- D. 80% of the transaction is recognized as a taxable gain.

18. Taxpayer Z transfers real estate with a basis of \$40,000 and a FMV of \$90,000 to a controlled corporation in return for stock in the corporation. Just before the transfer, Z obtains a loan secured by the real estate and uses the \$10,000 loan proceeds to buy a new motorcycle. Along with the real estate, the mortgage is transferred to the corporation. Which of the following are true with regard to the tax consequences to Z?

- A. The mortgage assumed by the corporation does not exceed his basis in this particular property transferred but because the liability is considered boot, Z has to report a gain.
- B. No bona fide business purpose exists for the corporation to assume Z's loan.
- C. Using the proceeds for personal purposes is like the corporation distributing cash, which would be taxed as boot under normal circumstances.
- D. All of the above.

19. Mr. S transfers assets with an adjusted tax basis to him of \$50,000 to Z Corp., a C-corporation, in exchange for special business equipment worth \$5,000 and 100% of all the stock in Z Corp. worth \$100,000. How much gain does Mr. S realize and how much gain must he recognize on the transfer?

- A. \$0 realized, \$0 recognized.
- B. \$55,000 realized, \$0 recognized.
- C. \$55,000 realized, \$55,000 recognized
- D. \$55,000 realized, \$5,000 recognized.

ANSWER: B

Since the exchange was not for control of the corporation (80% or more), the exchange is taxable to the shareholders.

Shareholder's recognized gain on each exchange:
FMV of stock.....\$30,000
Less: Adj. basis
 in property transferred..... 10,000
Capital gain on the exchange.....\$20,000

ANSWER: D

If the corporation assumes the shareholder's liabilities, the exchange is generally not treated as if the shareholder received money or other property. However, there are two exceptions to this treatment:

1. If the liabilities the corporation assumes are more than the shareholder's adjusted basis in the property he or she transferred, gain is recognized up to the difference. However, if the liabilities assumed give rise to a deduction when paid, such as a trade account payable or interest, no gain is recognized.
2. If there is no good business reason for the corporation to assume the shareholder's liabilities, or if the shareholder's main purpose in the exchange is to avoid federal income tax, the assumption is treated as if the shareholder received money in the amount of the liabilities.

ANSWER: D

If a taxpayer receives property or money in addition to stock in exchange for property transferred, in an 80% control transaction, any gain is recognized (taxable) to the extent of the money received or FMV of the property received.

FMV of stock.....\$100,000
FMV of equipment received..... 5,000
Amount realized..... 105,000
Less: Adj basis of property transferred 50,000
Realized gain.....\$ 55,000

Although the taxpayer had a realized gain of \$55,000, he will only have to recognize a gain to the extent of the FMV of property received (**\$5,000**).

20. Ms. J transferred a factory building with an adjusted basis of \$70,000 and a fair market value of \$110,000 to the CT Corporation in exchange for 100% of CT Corporation stock and \$20,000 cash. The building was subject to a mortgage of \$25,000, which CT Corporation assumed. The fair market value of the stock was \$75,000. Which is the amount of Ms. J's realized gain and recognized gain?

	<u>Realized</u>	<u>Recognized</u>
A.	\$25,000	\$25,000
B.	\$50,000	\$40,000
C.	\$50,000	\$20,000
D.	\$35,000	\$20,000

21. Mrs. O transferred property that had an adjusted basis to her of \$20,000 and a FMV of \$50,000, to X Corporation in exchange for 100% of X Corporation's only class of stock, \$5,000 cash and office furniture worth \$5,000. At the time of the transfer the stock had a FMV of \$40,000. What amount of gain must Mrs. O recognize?

- A. \$0
- B. \$10,000
- C. \$50,000
- D. \$30,000

ANSWER: C

If a taxpayer receives property or money in addition to stock in exchange for property transferred, in an 80% control transaction, any gain is recognized (taxable) to the extent of the money received or FMV of the property received. If the corporation assumes the shareholder's liabilities, the exchange is generally not treated as if the shareholder received money or other property unless the liabilities the corporation assumes are more than the shareholder's adjusted basis in the property. The liability assumed by the corporation is used to figure the amount of realized gain but not recognized gain.

FMV of stock.....	\$75,000
Mortgage assumed by corporation.....	25,000
Cash received.....	<u>20,000</u>
Amount realized.....	120,000
Less: Adj basis of property transferred	<u>70,000</u>
Realized gain.....	<u>\$50,000</u>

Although the taxpayer had a realized gain of \$50,000, she will only have to recognize a gain to the extent of the cash received (**\$20,000**).

ANSWER: B

If a taxpayer receives property or money in addition to stock in exchange for property transferred, in an 80% control transaction, any gain is recognized (taxable) to the extent of the money received or FMV of the property received.

FMV of stock.....	\$40,000
Cash.....	5,000
FMV of office furniture received.....	<u>5,000</u>
Amount realized.....	50,000
Less: Adj basis of property transferred	<u>20,000</u>
Realized gain.....	<u>\$30,000</u>

Although the taxpayer had a realized gain of \$30,000, she will only have to recognize a gain to the extent of the cash (**\$5,000**) and the FMV of property received (**\$5,000**).

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22. Ms. Y transferred land with an adjusted basis to her of \$40,000 and a fair market value of \$95,000 to N Corporation in exchange for 100% of N Corporation's only class of stock. The land was subject to a liability of \$45,000, which N Corporation assumed. The fair market value of N Corporation's stock at the time of the transfer was \$50,000. What amount of gain must Y recognize and what is her basis in the corporation stock?

- A. \$0 recognized gain, \$40,000 basis.
- B. \$55,000 recognized gain, \$95,000 basis.
- C. \$5,000 recognized gain, \$0 basis.
- D. \$5,000 recognized gain, \$45,000 basis.

23. Ms. B transferred a building with a FMV of \$200,000 to ABC, Inc. in exchange for 100% of the stock, which had a FMV of \$150,000. Her basis in the building was \$100,000. ABC, Inc. also assumed Ms. B's \$10,000 mortgage on the building. Which of the following choices correctly reflects Ms. B's taxable gain and her basis in the stock received?

- A. Recognized gain of \$60,000 and a basis in the stock of \$100,000.
- B. Recognized gain of \$0 and a basis in the stock of \$90,000.
- C. Recognized gain of \$50,000 and a basis in the stock of \$100,000.
- D. None of the above.

24. A taxpayer owns a farm with a FMV of \$500,000 and a mortgage of \$200,000. Her basis in the farm is \$400,000. She exchanged the farm for stock in a transfer under IRC section 351. What is her basis in the new stock?

- A. \$300,000
- B. \$200,000
- C. \$500,000
- D. \$700,000

ANSWER: C

In an 80% controlled transaction (IRC §351 transaction), the exchange is usually not taxable. However, if a shareholder exchanges property subject to a liability which is assumed by the corporation, the shareholder will recognize a gain in the amount that the liability exceeds the shareholder's adjusted basis in the property. Since the liability assumed by the corporation exceeds the shareholder's adjusted basis in the property there is no basis in the stock received.

Assumption of mortgage by corp.....	\$45,000
Less: Adj. basis of property transferred	<u>40,000</u>
Recognized gain.....	<u>\$ 5,000</u>

ANSWER: B

In an 80% controlled transaction (IRC §351 transaction), the exchange is usually not taxable. The basis of stock received by the shareholder is the adjusted basis of the property transferred by the shareholder. Also, decrease this amount by the amount of any liability the corporation assumed from the shareholder.

Shareholder's basis in the stock:

Adjusted basis of the property

transferred.....	\$100,000
Less: Liability assumed by corp.....	<u>10,000</u>
Shareholder's basis in the stock.....	<u>\$ 90,000</u>

ANSWER: B

Shareholder's basis in the stock:

Adjusted basis of the property

transferred.....	\$400,000
Less: Liability assumed by corp.....	<u>200,000</u>
Shareholder's basis in the stock.....	<u>\$200,000</u>

25. Mr. C transferred the title of a condo he owned in Mexico to his 100% owned accounting corporation in exchange for stock worth \$5,000. Mr. C used the condo for personal purposes and there was no bona fide business reason for the transfer. At the time of the transfer, the condo had a fair market value of \$170,000, an adjusted basis of \$160,000, and a mortgage of \$165,000 (which was assumed by the corporation). What is the amount of Mr. C's recognized gain?

- A. \$165,000
- B. \$10,000
- C. \$5,000
- D. \$0

ANSWER: B

The excess liability rule to figure any taxable gain, discussed in the analysis on the previous questions, does not apply if the transfer had no bona fide business purpose. Instead, the gain on the property transferred to the corporation is taxable to the extent of all the liabilities assumed by the corporation plus the FMV of any property (other than the corporation's stock) received.

FMV of property transferred.....	\$170,000
Less: Adjusted basis.....	<u>160,000</u>
Realized gain.....	<u>\$ 10,000</u>

Since the liabilities assumed by the corporation (\$165,000) is more than the gain realized on the transfer (**\$10,000**), the entire gain is recognized.

Services Exchanged for Stock

26. Mr. J was one of five shareholders of a corporation. Each received stock valued at \$100,000. The other four shareholders each contributed \$100,000 for their stock. Mr. J contributed \$50,000 and his services to build the corporate headquarters. He valued his services at \$50,000. How much income must Mr. J recognize on this transaction?

- A. \$100,000 of ordinary income.
- B. \$50,000 of ordinary income and \$50,000 of capital gain income.
- C. No income recognition.
- D. \$50,000 of ordinary income.

ANSWER: D

The value of the stock received for services is ordinary income to the recipient.

27. Mr. B transfers property worth \$50,000 to the ABC Corporation and provides personal services worth \$5,000 in exchange for stock valued at \$55,000. Immediately after the exchange Mr. B owns 90% of ABC's outstanding stock. What is B's gain if any?

- A. No capital gain, no ordinary income.
- B. No capital gain, \$5,000 ordinary income.
- C. No capital gain, \$50,000 ordinary income.
- D. \$5,000 capital gain, no ordinary income.

ANSWER: B

The transfer of an individual's services to a corporation in return for stock results in taxable compensation to the individual (bartering). This is ordinary income and not a capital gain. The \$5,000 should be reported as compensation subject to self-employment tax.

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28. Mr. C agreed to provide all the legal work of organization and incorporation of a corporation for \$5,000 cash and \$5,000 worth of stock in the corporation. Which of the following statements regarding the exchange is true?

- A. C will recognize \$5,000 in ordinary income.
- B. C will recognize \$10,000 in ordinary income.
- C. C will recognize \$5,000 ordinary income and \$5,000 capital gain.
- D. C will not have to recognize any income because the transfer is nontaxable.

ANSWER: B

The transfer of an individual's services to a corporation in return for stock results in taxable compensation to the individual (bartering). This is ordinary income in the amount of cash received (**\$5,000**) plus the fair market value of stock received (**\$5,000**).

Return Filing and Payment Requirements

29. ABC Corporation's tax year ends on October 31, 2022. When is ABC Corporation's income tax return required to be filed?

- A. January 31, 2023
- B. January 15, 2023
- C. February 15, 2023
- D. February 31, 2023

ANSWER: C

A corporation must file its income tax return by the 15th day of the 4th month after the end of its tax year.

30. ABC, Inc., a regular domestic corporation and calendar year taxpayer, had taxable income of \$10,000 for the year 2022. Because the company's accountant was on vacation during the month of April 2023, the corporate income tax return was not filed in a timely manner and no extension was filed. The new accountant mailed the return on September 15, 2023. Disregarding any possible late payment penalty, and assuming no estimated tax payments were made, calculate the maximum failure to file penalty that could be assessed against ABC, Inc.

- A. \$1,000
- B. \$450
- C. \$525
- D. \$270

ANSWER: C

A corporation's taxable income is taxed at a flat rate of 21%. The corporation's return was due on April 15, 2023. The failure to file penalty is computed at 5% of the tax not paid by the due date for each month, or part of a month, that the return is delinquent, up to a maximum 25% penalty. The failure to file penalty, however, is reduced by any failure to pay tax penalty. This penalty may be imposed on tax payments, other than estimated payments, made after the due date, at the rate of 0.5% for each month or part of a month which payment is delinquent, up to a maximum of 25%. In this instance, the corporation's return was filed 5 months after its due date. The maximum penalty would be 25% of \$2,100 tax due.

Corporation's income tax:

$$\$10,000 \times 21\% = \$2,100$$

Corporations failure to file penalty:

$$\mathbf{5\ months \times 5\% \times \$2,100 = \$525}$$

31. XYZ Corporation forgot to request an extension and filed its Form 1120 late for calendar year 2022. It paid the \$500 balance due when it filed the return on June 22, 2023. The minimum delinquency penalty will be

- A. \$125
- B. \$210
- C. \$450
- D. \$500

32. A corporation has a fiscal year end of June 30, 2022. What is the last date on which it can request an extension of time to file its tax return for the year ending June 30, 2022?

- A. September 15, 2022.
- B. October 15, 2022.
- C. March 15, 2023.
- D. April 15, 2023

33. AC Corporation's tax year ends on June 30, 2022. If AC Corporation timely files a Form 7004, Extension of Time to File, what is the extended due date of AC Corporation's income tax return for tax year ended June 30, 2022?

- A. March 15, 2023
- B. March 30, 2023
- C. April 15, 2023
- D. May 15, 2023

34. Generally, if a new corporation is filing a short-period return with a tax year ending on July 31, when must it file its income tax return?

- A. By October 15th.
- B. By November 15th.
- C. By December 15th.
- D. January 31st of the following year.

35. A calendar year homeowner association must file its 2022 Form 1120-H by which filing date?

- A. January 31, 2023
- B. March 15, 2023
- C. April 15, 2023
- D. October 15, 2023

ANSWER: C

A corporation must file its income tax return by the 15th day of the 3rd month after the end of its tax year. Therefore, a calendar year corporation must file its return by March 15. If the corporation does not file Form 7004 to request a 6-month extension and files the return after March 15, the return is filed late. The penalty for filing late is 5% of the unpaid tax for each month or part of a month the return is late, up to a maximum of 25% of the unpaid tax. The minimum penalty for a return that is over 60 days late is the smaller of the tax due (\$500) or **\$450**.

ANSWER: A

A corporation must file Form 7004 to request a 6-month extension of time to file a corporation tax return before the due date of the return. The due date of a corporation's return is usually the 15th day of the 4th month after the end of its tax year. However, a corporation with a fiscal tax year ending June 30 must file by the 15th day of the **3rd month** after the end of its tax year.

ANSWER: C

A corporation must file Form 7004 to request an automatic 6-month extension of time to file a corporation tax return before the due date of the return. The due date of a corporation's return is usually the 15th day of the 4th month after the end of its tax year. However, a corporation with a fiscal tax year ending June 30 must file by the 15th day of the **3rd month** after the end of its tax year. For a corporation with a fiscal tax year ending June 30, the automatic extension period is 7 months (not 6 months).

ANSWER: B

A new corporation filing a short-period return must generally file by the 15th day of the 4th month after the short period ends.

Note: A corporation with a short tax year ending anytime in June will be treated as if the short year ended on June 30, and must file by the 15th day of the 3rd month after the end of its tax year.

ANSWER: C

Generally, an association must file Form 1120-H by the 15th day of the 4th month after the end of its tax year. However, an association with a fiscal year ending June 30 must file by the 15th day of the 3rd month after the end of its tax year.

Estimated Tax Payments and Extensions

36. Corporations generally must make estimated tax payments if they expect their estimated tax (income tax less credits) to be equal to or more than

- A. \$1
- B. \$500
- C. \$600
- D. \$1,000

37. The amount required to be paid in estimated tax installments by a corporation is the lesser of 100% of the tax shown on the return for the preceding 12 month tax year (if some tax was reflected), or what percentage of the tax shown on its return for current year (determined on the basis of actual income or annualized income)?

- A. 100 percent
- B. 97 percent
- C. 95 percent
- D. 90 percent

38. If a corporation is required to make estimated tax payments because it expects its tax to be \$500 or more for the year, the first installment payment of estimate tax is due by

- A. The 15th day of the 3rd month of the corporation's tax year.
- B. The 15th day of the 4th month of the corporation's tax year.
- C. The 15th day of the 5th month of the corporation's tax year.
- D. The 15th day of the 6th month of the corporation's tax year.

ANSWER: B

A corporation must make estimated tax payments if it expects its estimated tax to be \$500 or more.

ANSWER: A

The payment required in installments is the lesser of:

1. 100% of the tax for that year, or
2. 100% of the tax shown on the tax return for the preceding 12 month tax year.

ANSWER: B

Installment payments of estimated tax are due by the 15th day of the 4th, 6th, 9th, and 12th month of the corporation's tax year.

39. A C corporation overestimated how successful it would be in the tax year. Final calculations show it will have an NOL and owe no taxes. It had overpaid its estimated taxes for the year by \$700. The corporation wants its tax refund as soon as possible. What should it do?

- A. File a Form 1120, U.S. Corporation Income Tax Return, as quickly as possible before the 15th day of the fourth month after its year ended and wait for the money.
- B. File Form 7004, Application for Automatic Extension of Time to File Corporation Income Tax Return, as quickly as possible and state on the form that it had overestimated its tax and wishes a quick refund as quickly as possible.
- C. File Form 4466, Corporation Application for a Quick Refund, after the close of the corporation's tax year and no later than the due date for filing the corporation's tax return (not including extensions), and use it as a worksheet to show that it had overpaid its estimates by \$700.
- D. Write a letter to the appropriate IRS Service Center and ask for a quick refund of overpaid corporate tax estimates.

Organizational and Start-Up Expenses

40. All of the following can be amortized as organizational expenditures for a newly formed corporation EXCEPT:

- A. Organizational meeting expenses of the corporate directors.
- B. Organizational meeting expenses of stockholders.
- C. Fees paid to attorney for legal expenses in conjunction with creation of corporation.
- D. Commissions to investment banker for initial public offering of stock.

ANSWER: C

A corporation that has overpaid its estimated tax for the tax year can apply for a quick refund if the overpayment is at least 10% of its expected tax liability **and** at least \$500. The corporation must file Form 4466, Corporation Application for a Quick Refund, after the close of the corporation's tax year and no later than the due date for filing the corporation's tax return (not including extensions).

ANSWER: D

Organizational expenses are those directly for the creation of a corporation that would normally be chargeable to a capital account. A newly formed corporation may choose to treat them as deferred expenses and amortize them over a period of at least 180 months, starting with the first month of active engagement in business. A corporation can elect to deduct up to \$5,000 of organizational costs as a current business expense. The \$5,000 deduction is reduced by one dollar for each dollar the amount the total organizational costs exceed \$50,000. If the total costs are \$55,000 or more, the deduction is reduced to zero. Any remaining costs must be amortized. The costs that are not deducted currently can be amortized ratably over a 180-month period. Organizational expenses include:

- Expenses of temporary directors.
- Organizational meetings of directors or shareholders.
- Fees paid to a state for incorporation.
- Accounting expenses and legal services incident to organization (e.g., Drafting the charter, bylaws, minutes of organizational meetings, and terms of the original stock certificates).

Expenses for issuing and selling stock or securities, such as commissions, professional fees, and printing costs, cannot be deducted or amortized.

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41. Which of the following are NOT organizational costs that can be amortized?

- A. Costs of temporary directors.
- B. Costs of issuing and selling stock.
- C. State incorporation fees.
- D. Legal fees to draft the bylaws of the corporation.

ANSWER: B

The following costs are not organization costs. They are capital expenses that cannot be amortized.

- 1. Costs for issuing and selling stock or securities, such as commissions, professional fees, and printing costs.
- 2. Costs associated with the transfer of assets to the corporation.

42. A corporation incurred \$15,000 in start-up costs when it opened for business. What is the minimum period over which these expenses can be recovered?

- A. 12 months
- B. 36 months
- C. 60 months
- D. 180 months

ANSWER: D

A corporation can elect to deduct up to \$5,000 of organizational costs and an additional \$5,000 of start-up costs as a current business expense. The \$5,000 deduction is reduced by one dollar for each dollar the amount the total organizational costs exceed \$50,000. If the total costs are \$55,000 or more, the deduction is reduced to zero. Any remaining costs must be amortized. The costs that are not deducted currently can be amortized ratably over a 180-month period.

43. Which of the following tests must a corporation meet before it can amortize the organizational costs?

- A. The costs are for the creation of the corporation.
- B. The costs are chargeable to a capital account.
- C. The costs could be amortized over the life of the corporation if the corporation had a fixed life.
- D. All of the above.

ANSWER: D

A corporation can amortize an organization cost only if it meets all of the following tests:

- 1. It is for the creation of the corporation.
- 2. It is chargeable to a capital account.
- 3. It could be amortized over the life of the fixed life.
- 4. It is incurred before the end of the first tax year in which the corporation begins business. A corporation using the cash method of accounting can amortize organizational costs incurred within the first tax year, even if it does not pay them in that year.

44. Which of the following costs qualify as business start-up costs?

- A. Deductible interest.
- B. State and local taxes.
- C. A survey of potential markets.
- D. Research and experimental costs.

ANSWER: C

A start-up expenses are expenses occurred for:

- 1. Creating an active trade or business, or
- 2. Investigating the possibility of creating or acquiring an active trade or business.

Start-up expenses include the cost for the following items:

- 1. A survey of potential markets.
- 2. An analysis of available facilities, labor, supplies, etc.
- 3. Advertising for the opening of the business.
- 4. Salaries and wages for employees who are being trained and for their instructors.
- 5. Travel and other necessary expenses for lining up distributors, suppliers or customers.
- 6. Salaries and fees for executive, consultants or for other professional services.

Business Income and Deductions

45. XYZ Corp. has passive losses of \$250,000 from a rental activity. Its active business income is \$150,000 and its portfolio income is \$50,000. What is XYZ Corp.'s taxable income if a) XYZ is a closely held corporation and b) XYZ is a personal service corporation?

- A. a) \$50,000; b) \$200,000
- B. a) \$50,000 loss; b) \$200,000
- C. a) \$50,000; b) \$50,000
- D. a) \$200,000; b) \$50,000

ANSWER: A

The passive activity rules apply to personal service corporations and closely held corporations. The passive activity rule limits losses from passive activities to the amount of passive activity income. Portfolio income (e.g., interest, dividends, annuities, and royalties) is not passive activity income. A closely held corporation can offset net active business income with its passive activity loss. However, it cannot offset its portfolio income with its passive activity loss. A personal service corporation cannot offset net active business income or portfolio income with its passive activity loss.

46. If a corporation transfers its stock to an employee as payment for services, the amount the corporation can deduct would be

- A. The corporation's basis in the stock transferred.
- B. The fair market value of the stock on the date of the transfer.
- C. The fair market value of the stock when the corporation issues the W-2.
- D. None of the above.

ANSWER: B

If a corporation transfers a capital asset, including stock, to an employee as payment for services, the corporation can deduct as wages the FMV of the asset on the date of the transfer.

Related Party Transactions

47. The following persons are related to a corporation EXCEPT:

- A. An individual who owns, directly or indirectly, more than 50% of the value of the outstanding stock of the corporation.
- B. A partnership if the same persons own more than 40% in value of the outstanding stock of the corporation and more than 50% of the capital or profits interest in the partnership.
- C. Any employee-owner if the corporation is a personal service corporation, regardless of the amount of stock owned by the employee-owner.
- D. Another corporation that is a member of the same controlled group as defined in section 267(f) of the Internal Revenue Code.

48. Taxpayer K transferred property with an adjusted basis of \$45,000 and fair market value of \$50,000 to H Corporation in exchange for 65% of H Corporation's only class of stock. At the time of the transfer, the stock K received has a fair market value of \$55,000. What is H Corporation's basis in the property after the exchange?

- A. \$0
- B. \$45,000
- C. \$55,000
- D. \$60,000

49. When Ms. J formed a corporation, she transferred property with a basis of \$100,000 to the corporation in exchange for 75% of the stock. The fair market value of the stock she received was \$50,000. How should she report this transaction on her tax return?

- A. No reporting required because the exchange is non-taxable.
- B. Report a \$50,000 capital loss.
- C. Ms. J has a non-deductible \$50,000 loss.
- D. Report a \$50,000 ordinary loss.

ANSWER: B

The following persons are related to a corporation:

- 1. Another corporation that is a member of the same controlled group as defined in section 267(f) of the Internal Revenue Code.
- 2. An individual who owns, directly or indirectly, more than 50% of the value of the outstanding corporation stock.
- 3. A trust fiduciary when the trust or the grantor of the trust owns, directly or indirectly, more than 50% in value of the outstanding corporation stock.
- 4. An S corporation if the same persons own more than 50% in value of the outstanding stock of each corporation.
- 5. 5. A partnership if the same persons own more than 50% in value of the outstanding stock of the corporation and more than 50% of the capital or profits interest in the partnership.
- 6. Any employee-owner if the corporation is a personal service corporation, regardless of the amount of stock owned by the employee-owner.

ANSWER: C

If a corporation receives property by issuing stock for it, other than in an 80% controlled transaction, the corporation's basis in the property is the FMV of the stock at the time of the exchange.

ANSWER: C

A loss from an exchange in which the shareholder owns more than 50% of the corporation's stock is not deductible.

50. A taxpayer transfers land with an adjusted basis of \$500,000 to corporation. In exchange, he receives shares of stock with a fair market value of \$300,000 and cash in the amount of \$175,000. He owns 51% of all the outstanding stock immediately after the transfer. What is the taxpayer's deductible loss on the transaction?

- A. \$0
- B. \$25,000 loss
- C. \$200,000 loss
- D. \$325,000 loss

51. Ms. B sold her LM Corporation stock to her mother for \$8,000. B's cost basis in the stock was 15,000. Her mother later sold this stock to an unrelated party, for \$20,000. What is Ms. B's RECOGNIZED gain or loss?

- A. \$2,000
- B. \$7,000
- C. \$7,500
- D. \$0

52. Mr. L owned 35 shares of BF Corporation stock for which he had paid \$3,500. He sold this stock to his sister for \$3,000. His sister later sold this stock to her cousin for \$10,000. What is Mr. L's and his sister's gain or loss?

- A. \$0 loss for Mr. L and \$6,500 gain for his sister.
- B. \$0 loss for Mr. L and \$7,000 gain for his sister.
- C. \$500 loss for Mr. L and \$7,000 gain for his sister.
- D. \$0 for Mr. L and \$0 for his sister.

ANSWER: A

A loss from an exchange in which the shareholder owns more than 50% of the corporation's stock is not deductible.

ANSWER: D

Losses are not allowed on sales or exchanges between related parties. Family members include brothers, sisters, spouse, ancestors and lineal descendants. Any loss which was not allowed by the related person can be used by the related purchaser upon sale of the asset.

Ms. B's transaction with mother:

Selling price.....	\$ 8,000
Less: Adjusted basis.....	<u>15,000</u>
Disallowed loss.....	<u>\$ 7,000</u>

ANSWER: A

Losses are not allowed on sales or exchanges between related parties. Family members include brothers, sisters, spouse, ancestors and lineal descendants. A cousin is not treated as a family member. Any loss which was not allowed by the related person can be used by the related purchaser upon sale of the asset.

L's transaction with sister:

Selling price.....	\$3,000
Less: Adjusted basis.....	<u>3,500</u>
Disallowed loss.....	<u>\$ 500</u>

Sister's transaction with unrelated party:

Selling price.....	\$10,000
Less: Adjusted basis.....	<u>3,000</u>
Realized gain.....	7,000
Less: Previously disallowed loss.....	<u>500</u>
Recognized gain.....	<u>\$ 6,500</u>

Chapter 3. C Corporations

53. Taxpayer R sold his LMB Corporation stock to his sister for \$8,000. R's cost basis in the stock was \$15,000. His sister later sold this stock to an unrelated party for \$15,500. What is his sister's REALIZED gain?

- A. \$500
- B. \$7,000
- C. \$7,500
- D. \$0

ANSWER: C

Losses are not allowed on sales or exchanges between related parties. Family members include brothers, sisters, spouse, ancestors and lineal descendants. Any loss which was not allowed by the related person can be used by the related purchaser upon sale of the asset. The question is asking for realized gain, not recognized gain.

R's transaction with sister:

Selling price.....	\$ 8,000
Less: Adjusted basis.....	<u>15,000</u>
Disallowed loss.....	<u>\$ 7,000</u>

Sister's transaction with unrelated party:

Selling price.....	\$15,500
Less: Adjusted basis.....	<u>8,000</u>
Realized gain.....	<u>\$ 7,500</u>

The sister's **recognized** gain would be \$500 (\$7,500 - \$7,000, Taxpayer R's disallowed loss).

Dividends-Received Deduction

54. Corporations cannot take a deduction for dividends received from the following entities EXCEPT:

- A. A regulated investment company.
- B. A real estate investment trust.
- C. A corporation whose stock has been held less than 46 days during the 90-day period beginning 45 days before the stock becomes exdividend with respect to the dividend.
- D. Any corporation under an obligation (pursuant to a short sale or otherwise) to make related payments for positions in substantially similar or related property.

ANSWER: A

Corporations cannot take a deduction for dividends received from the following:

1. A real estate investment trust.
2. A corporation exempt from tax either for the tax year of the distribution or the preceding tax year.
3. A corporation whose stock has been held less than 46 days during the 91-day period beginning 45 days before the stock becomes ex-dividend with respect to the dividend.
4. A corporation whose preferred stock has been held less than 91 days during the 181-day period beginning 90 days before the stock becomes ex-dividend with respect to the dividend if the dividends received on it are for a period or periods totaling more than 360 days.
5. Any corporation, if the corporation receiving the dividend is under an obligation (pursuant to a short sale or otherwise) to make related payments for position in substantially similar or related property.

55. Which of the following statements regarding the corporate dividends-received deduction is NOT true?

- A. Generally, a corporation can deduct 50% of the dividends received from a corporation of which it owns less than 20%.
- B. Generally, a corporation can deduct 65% of the dividends received from a corporation of which it owns 20% or more.
- C. The dividends-received deduction is unlimited.
- D. No deduction is allowed for dividends from tax exempt corporations.

56. The XYZ Corporation owns 25% of the stock of the ABC Corporation, a domestic corporation. In 2022, XYZ Corporation received \$10,000 dividends from the ABC Corporation stock. Assuming no other limitations apply, XYZ Corporation's dividends-received deduction is:

- A. \$0
- B. \$5,000
- C. \$6,500
- D. \$10,000

ANSWER: C

A corporation can take a deduction for 65% of the dividends received or accrued if it owns 20% or more of the paying domestic corporation. This deduction is only 50% if the receiving corporation owns less than 20% of the paying corporation. In either case, the deductions are limited to 65% (for 20% or more corporations) and 50% (for less than 20% corporations) of taxable income, computed without allowance for the net operating loss (NOL) deduction, the deduction for dividends received, or any capital loss carryback to current tax year. However, if a corporation has an NOL for the current tax year, then the 65% (or 50%) of taxable income limitation does not apply. In determining whether a corporation has an NOL, the dividends-received deduction is figured without the 65% (or 50%) taxable income limitation.

ANSWER: C

A corporation can deduct, within certain limits, 65% of the dividends received or accrued if the corporation receiving the dividends owns 20% or more of the distributing corporation.

Corporation's dividends-received deduction:

$$\text{\$10,000} \times 65\% = \text{\$6,500}$$

Chapter 3. C Corporations

57. A corporation loses \$75,000 from operations. It receives \$100,000 in dividends from a 20%-owned corporation. What is the Corporation's dividends-received deduction?

- A. \$0
- B. \$50,000
- C. \$65,000
- D. \$100,000

58. A corporation loses \$30,000 from operations. It receives \$100,000 in dividends from a 20%-owned corporation. What is the Corporation's dividends-received deduction? What is the corporation's dividends-received deduction?

- A. \$0
- B. \$45,500
- C. \$50,000
- D. \$65,000

59. Z Corporation and X Corporation are domestic corporations. The Z Corporation owns 25% of the X Corporation. Z Corporation's income from business for tax year is \$500,000 and business expenses are \$750,000. In addition to the income from business, Z Corporation also received dividends from X Corporation in the amount of \$100,000. Z Corporation's dividend received deduction is

- A. \$0
- B. \$50,000
- C. \$65,000
- D. \$100,000

ANSWER: C

A corporation can take a deduction for 65% of the dividends received or accrued if it owns 20% or more of the paying domestic corporation. This deduction is only 50% if the receiving corporation owns less than 20% of the paying corporation. In either case, the deductions are limited to 65% (for 20% or more corporations) and 50% (for less than 20% corporations) of taxable income, computed without allowance for the net operating loss (NOL) deduction, the deduction for dividends received, or any capital loss carryback to current tax year. However, if a corporation has an NOL for the current tax year, then the 65% (or 50%) of taxable income limitation does not apply. In determining whether a corporation has an NOL, the dividends-received deduction is figured without the 65% (or 50%) taxable income limitation.

The corporation's taxable income is \$25,000 (\$100,000 - \$75,000) before the deduction for dividends received. If it claims the full dividends-received deduction of \$65,000 (\$100,000 × 65%) and combines it with an operations loss of \$75,000, it will have an NOL of \$40,000 (\$25,000 - \$65,000). Therefore, the 65% of taxable income limit does not apply. The corporation can deduct the full \$65,000.

ANSWER: B

Refer to the analysis on the previous question. The corporation only loses \$30,000 from operations. Its taxable income is \$70,000 (\$100,000 - \$30,000) before the deduction for dividends received. After claiming the dividends-received deduction of \$65,000 (\$100,000 × 65%), its taxable income is \$5,000 (\$70,000 - \$65,000). Because the corporation will not have an NOL after applying a full dividends-received deduction, its allowable dividends-received deduction is limited to 65% of its taxable income, or **\$45,500** (\$70,000 × 65%).

ANSWER: C

The corporation's NOL is \$150,000 (\$250,000 - \$100,000) before the deduction for dividends received. If it claims the full dividends-received deduction of \$65,000 (\$100,000 × 65%) and combines it with an operations loss of \$150,000, it will have an NOL of \$215,000. Therefore, the 65% of taxable income limit does not apply. The corporation can deduct the full **\$65,000**.

60. ABC, Inc. is a foreign corporation. DF Corporation owns 10% of ABC, Inc.'s outstanding stock. DF Corporation received \$100,000 in dividends from ABC, Inc. DF Corporation may deduct, within certain limits, what percentage of the dividends received?

- A. 15%
- B. 50%
- C. 65%
- D. 100%

61. XYZ Inc., a small business investment company, had the following items of income and expense:

- Income from operations: \$55,000
- Dividend income from ABC, Inc., (a domestic corporation): \$15,000
- Expenses of operations: \$20,000

What is XYZ Inc.'s dividend received deduction?

- A. \$10,500
- B. \$12,000
- C. \$15,000
- D. \$3,000

Below-Market Loans

62. Sky Corporation is a C Corporation. Mr. J owns 80% of all the outstanding shares of Sky Corporation stock. In 2013, J advanced funds to Sky Corporation as a loan. The loan instrument executed between J and Sky Corporation is a demand note. The principal balance due on the loan from Sky Corporation is \$300,000. After J demanded repayment of the outstanding loan on March 20, 2022, Sky Corporation transferred to J preferred stock with a fair market value of \$325,000 in settlement of the debt. J has the right to require Sky Corporation to redeem the preferred stock. Which of the following is true?

- A. The transfer of stock to J qualifies as a §351 transfer.
- B. The transfer of stock is a nontaxable transaction because J is in control of the corporation.
- C. The transfer of stock to J is a §1244 Qualified Small Business Stock transaction.
- D. J must recognize income on the transaction.

ANSWER: D

Generally, 100% of the foreign-source portion of dividends (and items treated as dividends) from 10%-owned foreign corporations received after December 31, 2017, may be deducted.

ANSWER: C

Small business investment companies can deduct 100% of the dividends received from a taxable domestic corporation.

ANSWER: D

The shareholder's demand loan to the corporation is a below-market loan. A below-market loan is a loan on which no interest is charged or on which interest is charged at a rate below the applicable federal rate. In this question, the shareholder would treat the \$25,000 of the \$325,000 stock to settle the debt as interest received on the loan.

Charitable Contributions

63. R Corporation made a charitable contribution to a qualified organization of \$40,000 in cash plus a vehicle with a fair market value of \$15,000. For the tax year, R Corporation had \$400,000 in total income, \$100,000 in total expenses not including the above charitable contributions, and would have a reportable dividend received deduction of \$50,000. How much of the charitable contribution can R Corporation deduct for the tax year?

- A. \$15,000
- B. \$25,000
- C. \$30,000
- D. \$40,000

64. ABC Corporation, a calendar year accrual basis corporation, made cash charitable contributions totaling \$40,000 during the year. Prior to determining its charitable contribution deduction, ABC had taxable income of \$300,000 after a dividends-received deduction of \$42,000. What is the amount of ABC Corporation's current year charitable contribution deduction?

- A. \$40,000
- B. \$34,200
- C. \$30,000
- D. \$32,400

65. A corporation's charitable contributions are limited to 10% of its taxable income. Any contributions over the 10% limit can be carried over to each of the following

- A. 3 years
- B. 5 years
- C. 10 years
- D. The excess contributions cannot be carried over.

ANSWER: C

Contributions are limited to 10% of taxable income. Taxable income, for purposes of computing the 10% charitable contribution deduction limit, is figured without taking into account the following:

1. Deductions for charitable contributions.
2. The dividend-received deduction.
3. The deduction allowed under section 249 of the Internal Revenue Code.
4. The domestic production activities deduction.
5. Any net operating loss carryback to tax year.
6. Any capital loss carryback to the tax year.

Gross income.....	\$400,000
Less: Total expenses.....	<u>100,000</u>
Taxable income for 10% contribution...	300,000
Maximum contribution rate.....	<u>× 10%</u>
Contribution deduction.....	<u><u>\$ 30,000</u></u>

ANSWER: B

Taxable income, for purposes of computing the 10% charitable contribution deduction limit, is figured without taking into account the dividends-received deduction.

Charitable deduction:

$$\text{\$342,000} \times 10\% = \text{\$34,200}$$

ANSWER: B

Charitable contributions over the 10% limit can be carried over to each of the following 5 years. Any excess not used up within that period is lost.

Capital Gains

- 66.** A C corporation's capital gains are taxed at
- A. Long-term capital gains rate of 15%.
 - B. Long-term capital gains rate of 20%.
 - C. Taxed at the corporation's income tax rate.
 - D. Capital gains for a C corporation are taxed at the shareholder's capital gain rate.

ANSWER: C

The capital gains tax rate for corporations is the same as the income tax rate. All income for a corporation is taxed at the federal corporate tax rate.

Capital Losses

67. In tax year 2022, XYZ Corporation had a \$10,000 long-term capital loss and a \$5,000 short-term capital gain. In tax year 2018, XYZ Corporation reported \$1,000 in long-term capital gains and \$4,000 in short-term capital gains. XYZ Corporation reported no other capital gains or losses in any other tax year. How much net capital loss will be available for XYZ Corporation to carry into tax year 2023?

- A. \$0
- B. \$1,000
- C. \$4,000
- D. \$5,000

ANSWER: D

A corporation can deduct capital losses only up to the amount of its capital gains. In other words, if a corporation has an excess capital loss, it cannot deduct the loss in the current tax year. Instead, it carries the loss to other tax years and deducts it from any net capital gains that occur in those years.

A capital loss is carried to other years in the following order:

1. 3 years prior to the loss year.
2. 2 years prior to the loss year.
3. 1 year prior to the loss year.
4. Any loss remaining is carried forward for 5 years.

68. D Corp. incurred net short-term capital gains of \$40,000 and net long-term capital losses of \$90,000. Taxable income from other sources was \$500,000. How are the capital gains and losses treated on the tax return, Form 1120?

- A. \$3,000 of the excess net long-term capital losses are deducted currently and the \$47,000 remainder is carried forward indefinitely.
- B. None of the excess net long-term capital losses are currently deductible, but may be carried back to the three preceding years and then forward five years as short-term capital losses.
- C. Excess net long-term capital losses are fully deductible.
- D. Excess net long-term capital losses of \$50,000 are carried back two years and then carried forward 20 years as short-term capital losses.

ANSWER: B

A corporation, other than an S corporation, can deduct capital losses only to the extent of its capital gains. It carries the loss to other years and deducts it from capital gains that occur in those years. The corporation first carries a net capital loss back 3 years. Any excess capital loss is then carried forward 1 year (2 years back) and then 1 more year (1 year back). If any capital loss is remaining, it is carried forward 5 years.

Chapter 3. C Corporations

69. Which of the following statements is NOT true regarding corporate capital losses?

- A. Excess net capital losses may not be deducted in the current year.
- B. Capital losses may only offset capital gains.
- C. Net capital losses may be carried back to the three preceding tax years.
- D. Net capital loss carryovers may be carried forward to seven succeeding tax years from the year of the loss.

70. XYZ Corporation incurred net short-term capital gains of \$40,000 and net long-term capital losses of \$90,000. Taxable income from other sources was \$500,000. How are the capital gains and losses treated on the tax return, Form 1120?

- A. \$3,000 of the excess net long term capital losses are deducted currently and the \$47,000 remainder is carried forward indefinitely.
- B. None of the excess net long term capital losses are currently deductible, but may be carried back to the three preceding years and then forward five years as short term capital losses.
- C. Excess net long term capital losses are fully deductible.
- D. Excess net long term capital losses of \$50,000 are carried back two years and then carried forward 20 years as short term capital losses.

71. With regard to the treatment of capital losses by a corporation, other than an S corporation, which of the following statements is NOT true?

- A. If a corporation has a net capital loss it cannot deduct the loss in the current year.
- B. When a corporation carries a long-term net capital loss to another year, it is treated as a short-term loss.
- C. A Corporation may not carry a capital loss from, or to, a year for which it is an S corporation.
- D. When figuring a current year net capital loss, you must include any capital loss carried from another year.

ANSWER: D

A corporation, other than an S corporation, can deduct capital losses only to the extent of its capital gains. It carries the loss to other years and deducts it from capital gains that occur in those years. The corporation first carries a net capital loss back 3 years. Any excess capital loss is then carried forward 1 year (2 years back) and then 1 more year (1 year back). If any capital loss is remaining, it is carried forward **5 years**.

ANSWER: B

The \$50,000 (\$90,000 loss - \$40,000 gain) excess net long-term capital loss may be carried back to the three preceding years and then forward five years as short term capital losses.

ANSWER: D

When figuring current year's net capital loss, a corporation cannot use any capital loss carried from another year. A corporation cannot carry a capital loss from, or to, a year for which it is an S corporation.

Net Operating Losses

72. Regarding a C corporation's net operating loss (NOL) arising in a tax year ending after 2020, which of the following statements is NOT true?

- A. A corporation can carry the NOL forward indefinitely.
- B. A corporation generally figures and deducts a the same way as an individual.
- C. A corporation can carryback the NOL 3 years.
- D. A corporation is not subject to section 461, which limits the amount of losses from the trades or businesses of noncorporate taxpayers.

ANSWER: C

A corporation generally figures and deducts a net operating loss (NOL) the same way an individual, estate, or trust does. A corporation's NOL generally differs from individual, estate, and trust NOLs in the following ways.

1. A corporation can take different deductions when figuring an NOL.
2. A corporation must make different modifications to its taxable income in the carryback or carryforward year when figuring how much of the NOL is used and how much is carried over to the next year.
3. A corporation uses different forms when claiming an NOL deduction.
4. A corporation is not subject to section 461, which limits the amount of losses from the trades or businesses of noncorporate taxpayers.

For tax years after 2020, an NOL cannot be carried back. The loss can then be carried forward indefinitely.

Tax Calculations

73. A C corporation had reportable taxable income of \$10,000. How much federal income tax is required to be paid?

- A. \$1,500
- B. \$2,100
- C. \$2,500
- D. \$3,500

ANSWER: B

For tax years beginning after 2017, corporations, including qualified personal service corporations, figure their tax by multiplying taxable income by 21%.

Corporation's taxable income:

$$\text{\$10,000} \times 21\% = \text{\$2,100}$$

Controlled Group of Corporations

74. Y, Inc. directly owns stock of A Corporation. To determine if A Corporation is a member of a controlled group with Y, Inc. as the common parent, Y, Inc. must own at least what percentage of the voting and total value of the A Corporation stock?

- A. 51%
- B. 75%
- C. 80%
- D. 100%

ANSWER: C

A parent-subsidary controlled group is created if:

1. One or more chains of corporations are connected through stock ownership with a common parent corporation,
2. Eighty percent or more of the voting power or value of the stock of each corporation in the group other than the parent is owned by one or more corporations in the group, and
3. The common parent corporation owns at least 80 percent of the voting or value of the stock of one of the other corporations in the group.

Chapter 3. C Corporations

75. Which of the following statements about a controlled group of corporations is true?

- A. Members of a controlled group are treated as one group to figure the applicability of the additional 5% and the additional 3% tax.
- B. A parent corporation and its 80% owned subsidiary make up a controlled group.
- C. All members of a controlled group need not use the parent corporation's tax year.
- D. All of the above.

76. The D Corporation has two subsidiary corporations. In order to determine that the subsidiary corporations are in a controlled corporate group, which of the following must be true?

- A. Ten or fewer persons (individuals, estates, or trusts) own at least 80% of the voting stock or value of shares of each of two or more corporations.
- B. Ten or fewer persons own more than 50% of the voting power or value of shares of each corporation, considering a particular person's stock only to the extent that it is owned identically with regard to each corporation.
- C. A persons' stock ownership is not taken into account for purposes of the 80% requirement unless that shareholder owns stock in all of the corporations considered to be in the group.
- D. The subsidiaries must be located in the same state.

Earnings and Profits

77. H, Inc., a calendar year taxpayer, had an accumulated earnings and profits balance at the beginning of the year of \$20,000. During the year, H, Inc. distributed \$30,000 to its sole individual shareholder. On December 31, H, Inc. reported taxable income of \$50,000, federal income taxes of \$7,500, and had tax exempt interest on municipal bonds of \$2,500. What is H, Inc.'s accumulated earnings and profits balance at the end of the year?

- A. \$15,000
- B. \$25,000
- C. \$30,000
- D. \$35,000

ANSWER: D

Refer to the analysis on the previous question. A controlled group of corporations is subject to the same tax rates as though the group was one corporation.

ANSWER: C

A controlled group of corporations exist if **five or fewer persons** (individuals, estates, or trusts) own at least 80% of the voting stock or value of the shares of each of two or more corporations **and** these **five or fewer persons** own more than 50% of the voting power or value of the shares of each corporation, taking into account a person's stock only to the extent that it is owned identically with regard to each corporation. The subsidiaries do not need to be located in the same state.

ANSWER: D

Taxable income per return.....	\$50,000
Add: Tax exempt interest.....	2,500
Less: Federal income taxes paid.....	<u>(7,500)</u>
Current year's E&P.....	<u>\$45,000</u>

Accumulated E&P 1/1.....	\$20,000
Current year's E&P.....	45,000
Less: Distribution.....	<u>(30,000)</u>
Accumulated E&P 12/31.....	<u>\$35,000</u>

Reconciliation of Income (Schedule M-1)

78. Which schedule does a corporation use to reconcile its accounting income or loss with the taxable income or loss reported on its tax return?

- A. Schedule A
- B. Schedule L
- C. Schedule M-1
- D. Schedule M-2

79. A corporation is preparing Schedule M-1 of its Form 1120, U. S. Corporation Income Tax Return. Which of the following statements is incorrect with regard to the preparation of Schedule M-1?

- A. The starting point is net income per books and the ending point is taxable income before the NOL and dividends-received deductions.
- B. Life insurance proceeds paid on the death of a key employee is a negative adjustment to book income to arrive at taxable income.
- C. Federal income taxes on book income are added back to net book income to arrive at taxable income.
- D. The premiums paid on the key employee life insurance policy are a negative adjustment to book income to arrive at taxable income.

80. The following information is available from the books of ABC Corporation. Determine what taxable income should be reported on Form 1120.

Federal income tax accrued for the tax year	\$55,000
Net income per books, after tax	\$148,000
Life insurance premiums (not deductible on return)	\$17,000
Tax exempt interest income	\$15,000

- A. \$150,000
- B. \$201,000
- C. \$205,000
- D. \$220,000

ANSWER: C

Schedule M-1 reconciles a corporation’s financial accounting income or loss with the taxable income or loss reported on the Form 1120. Schedule M-2 reconciles a corporation’s retained earnings at beginning of year with retained earnings at end of year. Schedule A is used to calculate a corporation’s cost of goods sold. Schedule L provides the beginning and end of the year balance sheets based on the corporation's books. Corporations with total receipts and total assets at the end of the tax year of less than \$250,000 are not required to complete Schedules L, M-1, and M-2.

ANSWER: D

Schedule M-1, Reconciliation of Income (Loss) per Books With Income per Return, starts with the net income (loss) per books, after reduction for federal income tax accrued. It provides for the necessary adjustments to reconcile this amount with the corporation's taxable income before the NOL and dividend-received deductions.

Insurance proceeds on the death of a key employee are not taxable and have to be subtracted from book income to arrive at taxable income.

Since Schedule M-1 starts with book income after the reduction for federal income tax accrued, the federal income taxes on book income are added back to net book income to arrive at taxable income.

The premiums paid on the key employee life insurance policy that are not deductible must be added to book income to arrive at taxable income.

ANSWER: C

Federal income tax accrued is subtracted from book income and needs to be added to book income to arrive at taxable income. The premiums paid on the life insurance policy that are not deductible have to be added (positive adjustment) to book income to arrive at taxable income. Tax-exempt income is subtracted from book income to arrive at taxable income.

Net income per books.....	\$148,000
Federal income tax.....	55,000
Life insurance premiums.....	17,000
Less: Tax exempt interest.....	(15,000)
Taxable income.....	<u>\$205,000</u>

Chapter 3. C Corporations

81. A calendar year cash basis corporation had the following transactions during the year:

- Net income per books (after tax estimates): \$100,000
- Federal income tax paid: \$22,250
- Excess of capital losses over capital gains: \$5,000
- Interest from municipal bonds: \$11,000
- Expenses related to municipal bond interest: \$500

What is the corporation's taxable income?

- A. \$116,750
- B. \$139,000
- C. \$127,750
- D. \$ 77,750

ANSWER: A

Income per books includes income that is tax-exempt (not included in taxable income). It also includes deductions that are not deductible against taxable income, such as life insurance premiums on the life of key employees where the corporation is the beneficiary, capital losses in excess of capital gain, charitable deductions in excess of 10% of taxable income and expenses related to tax-exempt income. These items must be adjusted to book income to arrive at taxable income as shown on Form 1120. Federal income tax accrued is subtracted from book income and needs to be added to book income to arrive at taxable income. Life insurance premiums not deductible on the return must be added back to book income to arrive at taxable income. Tax-exempt income is subtracted from book income to arrive at taxable income.

Net income per books.....	\$100,000
Federal income tax.....	22,250
Excess of capital losses over capital gains.....	5,000
Expenses related to municipal bond interest.....	500
Less: Tax-exempt interest.....	<u>(11,000)</u>
Taxable income.....	<u>\$116,750</u>

82. A corporation realized net book income in the amount of \$300,000 for the tax year. Included in the net book income are the following:

- Federal Income Taxes: \$4,000
- Excess Capital Losses over Capital Gains: \$10,000
- Tax Exempt Interest Income: \$5,000

What is the corporation's taxable income?

- A. \$290,000
- B. \$304,000
- C. \$280,000
- D. \$309,000

ANSWER: D

Federal income tax is subtracted from book income and needs to be added to book income to arrive at taxable income. A corporation can deduct capital losses to the extent of capital gains. The difference between capital losses and capital gain is added to net income per books. Tax-exempt interest is subtracted from net income per books.

Net income per books.....	\$300,000
Federal income tax.....	4,000
Excess capital losses over capital gains	10,000
Less: Tax exempt interest.....	<u>(5,000)</u>
Taxable income.....	<u>\$309,000</u>

83. A corporation had a net loss per its books:

Gross sales		\$340,000
Cost of goods sold	\$150,000	
Depreciation	\$60,000	
Charitable contribution	\$10,000	
Salaries	\$130,000	
Meals and entertainment	\$20,000	
Net income (loss) per books	(\$30,000)	
Total per books	\$340,000	\$340,000

The corporation uses an accelerated method of depreciation for tax purposes, but not for book purposes. The corporation's tax depreciation will be \$75,000. What is the taxable income for federal income tax purposes?

- A. (\$5,000)
- B. (\$35,000)
- C. (\$25,000)
- D. (\$20,000)

ANSWER: C

Since the corporation has a net loss, the \$10,000 for the charitable contribution is added to the net income (loss) per books. Entertainment expense deduction is limited to 50%. Add 50% of entertainment expenses to net income (loss) per books. Tax-exempt interest is subtracted from net income (loss) per books. The difference between the accelerated method of depreciation used for tax purposes and the depreciation used to determine the income (loss) per books is subtracted from net income per books.

Net income per books.....	(\$30,000)
Charitable contribution.....	10,000
Entertainment expense	
(\$20,000 × 50%).....	10,000
Less: Depreciation	
(\$75,000 - \$60,000).....	(15,000)
Taxable income.....	<u><u>(\$25,000)</u></u>

84. The following information is available from the record of a corporation. Compute current year earnings and profits.

Taxable income, Form 1120	\$50,000
Federal income taxes paid	\$7,500
Nondeductible portion of travel and entertainment	\$500
Excess of capital losses over capital gains	\$1,000

- A. \$41,500
- B. \$48,500
- C. \$41,000
- D. \$42,000

ANSWER: C

Taxable income per return.....	\$50,000
Less: Federal income taxes paid.....	7,500
Nondeductible portion of T & E	500
Excess of capital losses over gains....	<u>1,000</u>
Current year's earning and profits.....	<u><u>\$41,000</u></u>

Accumulated Earnings Tax

85. A personal service corporation has two shareholders. It has made irregular and infrequent distributions to its shareholders. The balance sheet reflects unappropriated retained earnings in the amount of \$800,000 and no marketable securities. It has no specific, definite, and feasible plans for use of the earnings accumulation in its business. It has been determined that the amount needed to redeem a deceased shareholder's stock is \$500,000. What is the amount of Accumulated Earnings Tax that it could be subject to for tax year ended December 31?

- A. \$0
- B. \$19,300
- C. \$22,500
- D. \$30,000

ANSWER: D

A corporation can accumulate its earnings for a possible expansion or other bona fide business reasons. However, if a corporation allows earnings to accumulate beyond the reasonable needs of the business, it may be subject to an accumulated earnings tax of **20%**. To determine if the corporation is subject to this tax, first treat an accumulation of \$250,000 or less generally as within the reasonable needs of most businesses. Treat an accumulation of \$150,000 or less as within the reasonable needs of a business whose principal function is performing services in the fields of accounting, actuarial science, architecture, consulting, engineering, health (including veterinary services), law, and the performing arts.

Reasonable needs of the business include the following:

1. Specific, definite, and feasible plans for use of the earnings accumulation in the business.
2. The amount necessary to redeem the corporation's stock included in a deceased shareholder's gross estate, if the amount does not exceed the reasonably anticipated total estate and inheritance taxes and funeral and administration expenses incurred by the shareholder's estate.

In this question, the accumulated earnings to meet reasonable needs for the personal service corporation are \$650,000 (\$500,000 + 150,000). This amount is not subject to the accumulated earnings tax.

The tax on excess accumulated earnings:

Excess accumulated earnings	
(\$800,000 - \$650,000).....	\$150,000
Accumulated earnings tax rate.....	<u>× 20%</u>
Accumulated earnings tax.....	<u><u>\$30,000</u></u>

Distributions to Shareholders

86. Common kinds of distributions by a corporation to shareholders are

- A. Ordinary dividends
- B. Capital gain distribution
- C. Nontaxable distribution
- D. All of the above

ANSWER: D

A corporate distribution to a shareholder is generally treated as a distribution of earnings and profits. Any part of a distribution from either current or accumulated earnings and profits is reported to the shareholder as a dividend. Any part of a distribution that is not from earnings and profits is applied against and reduces the adjusted basis of the stock in the hands of the shareholder (nontaxable distribution). To the extent the balance is more than the adjusted basis of the stock, the shareholder has a gain (usually a capital gain) from the sale or exchange of property.

87. Which of the following statements regarding distributions of stock is NOT true?

- A. Distributions of stock and stock rights are never treated as property.
- B. Stock rights are distributions by a corporation of rights to acquire its stock.
- C. Distributions of stock dividends and stock rights are generally tax free to shareholders.
- D. Expenses of issuing a stock dividend are not deductible but must be capitalized.

88. A corporation authorized a year end distribution to its three shareholders. Each distribution would be equal in value but the shareholder could choose to receive the distribution in cash or corporate stock. If a shareholder chose to receive corporate stock, the distribution should be treated as

- A. A tax free distribution of stock.
- B. A distribution of property.
- C. A like-kind exchange.
- D. None of the above.

89. A corporation has \$100,000 current earnings and profits to cover any distributions. It distributes land with a fair market value of \$30,000 and adjusted basis of \$10,000 to its sole shareholder who has \$70,000 basis in her stock. This is not a liquidation or redemption. Which statement below best describes the tax consequences to the corporation and to the stockholder?

- A. The corporation will recognize gain of \$20,000 and the shareholder a taxable dividend of \$20,000.
- B. The corporation will recognize gain of \$20,000 and the shareholder a taxable dividend of \$30,000.
- C. The corporation will recognize gain of \$20,000 and the shareholder will have a non-taxable return of capital reducing her basis by \$30,000.
- D. None of the above.

ANSWER: A

Most distributions are in money, but they may also be in stock or other property. For this purpose, "property" generally does not include stock in the corporation or rights to acquire this stock. Stock and stock rights are treated as property if any of the following apply to their distribution:

1. A distribution instead of money or other property.
2. A distribution that gives cash or other property to some shareholders and an increase in the percentage interest in the corporation's assets or earnings and profits to other shareholders (**disproportionate distribution**).
3. The distribution is on convertible preferred stock and has the same result as in (2).
4. A distribution that gives preferred stock to some common shareholders and gives common stock to other common stock shareholders.
5. A distribution on preferred stock.

ANSWER: B

Refer to the analysis on the previous question.

ANSWER: B

A corporation will recognize a gain on the distribution of property to a shareholder if the FMV of the property is more than its adjusted basis. Any part of a distribution from either current or accumulated earnings and profits is reported to the shareholder as a dividend.

Chapter 3. C Corporations

90. A corporation distributes an office building to a shareholder of the corporation. The fair market value of the building exceeds its basis to the corporation. Which of the following statements is true with regard to this transaction?

- A. The corporation realizes but does not recognize gain on this distribution.
- B. The corporation elects not to report the gain on this distribution.
- C. The corporation must recognize gain on this distribution.
- D. The shareholder must recognize the losses on this distribution on his return.

91. A corporation distributed a property with a fair market value of \$250,000 to a shareholder. The corporation's basis in the painting was \$150,000. Current year earnings and profits were \$500,000. No other distributions were made during the year. What amount of dividend must the shareholder report?

- A. \$0
- B. \$150,000
- C. \$250,000
- D. \$100,000

92. A corporation distributed a property with a fair market value of \$250,000 to a shareholder. The corporation's basis in the painting was \$150,000. How should the distribution be reported on the return of the corporation?

- A. No reporting required.
- B. \$150,000 distribution reduces assets on the balance sheet but no effect on tax.
- C. \$100,000 taxable gain.
- D. \$250,000 taxable gain.

ANSWER: C

A corporation will recognize a gain on the distribution of property to a shareholder if the FMV of the property is more than its adjusted basis.

ANSWER: C

The amount of the distribution is the FMV of the property distributed. Since the corporation has earnings and profits of more than \$250,000 (FMV of property distributed) the entire \$250,000 distribution is treated as a dividend.

ANSWER: C

The corporation will recognize a gain on the distribution in the amount that the FMV of the property exceeds its adjusted basis.

Corporation's recognized gain:

FMV of property distributed.....	\$250,000
Less: Adjusted basis.....	<u>150,000</u>
Recognized gain.....	<u>\$100,000</u>

93. A corporation distributed an office building to its 60% shareholder. The fair market value of the building on the date of the distribution was \$300,000. The corporation's basis in the building was \$200,000. The shareholder assumed the mortgage on the building that had a principal balance of \$100,000 on the date of distribution. Current year earnings and profits of the corporation were \$400,000. No other distributions were made during the year. What should the shareholder report on his tax return for the year of the distribution?

- A. \$0; distributions to shareholders result in no gain or loss to the shareholder.
- B. \$300,000 dividend.
- C. \$200,000 dividend.
- D. \$100,000 dividend.

94. A shareholder owns 100% of the outstanding shares of a corporation. He acquired these shares for \$5,000. The corporation had total earnings and profits at the end of the year of \$10,000. On December 31, the corporation distributed \$8,000 in cash and property with a fair market value of \$7,000 to the shareholder. How much in capital gain must the shareholder report from this distribution?

- A. \$0
- B. \$5,000
- C. \$10,000
- D. \$15,000

95. A corporation distributed real estate with a FMV of \$500,000 to its sole shareholder. The corporation's basis in the real estate is \$400,000. What is the tax effect of the distribution to the corporation and what is the shareholder's basis in the real estate?

- A. \$0 gain/loss to the corporation; \$400,000 basis to the shareholder.
- B. \$100,000 gain to the corporation; \$400,000 basis to the shareholder.
- C. \$0 gain/loss to the corporation; \$500,000 basis to the shareholder.
- D. \$100,000 gain to the corporation; \$500,000 basis to the shareholder.

ANSWER: C

The amount of the distribution is the FMV of the property reduced by any liabilities assumed by the shareholder.

Amount received by shareholder on distribution:	
FMV of property received in distribution	\$300,000
Less: Mortgage assumed by shareholder...	<u>100,000</u>
Amount received by shareholder.....	<u>\$200,000</u>

Since the corporation has earnings and profits (\$400,000) in excess of the amount of the distribution, **the entire \$200,000 is a dividend.**

ANSWER: A

A corporate distribution to a shareholder is treated as a distribution of earnings and profits. Any part of a distribution from either current or accumulated earnings and profits is a dividend to the shareholder. The amount of distribution in excess of earnings and profits is a return of capital.

Distribution to shareholder (\$8,000 cash + \$7,000 FMV of property).....	\$15,000
Less: Dividend (E & P).....	<u>10,000</u>
Return of capital (adjusted basis).....	<u>5,000</u>
Capital gain.....	<u>\$ - 0-</u>

ANSWER: D

The corporation will recognize a gain on the distribution in the amount that the FMV of the property exceeds its adjusted basis. The FMV of the property becomes the shareholder's basis in that property.

Corporation's recognized gain:	
FMV of property distributed.....	\$500,000
Less: Adjusted basis.....	<u>400,000</u>
Recognized gain.....	<u>\$100,000</u>

Chapter 3. C Corporations

96. During the calendar year, a corporation made a \$40,000 cash distribution to its sole shareholder. The corporation's current year earnings and profits (as of the close of the year and without reduction for distributions during the year) is \$25,000. Accumulated earnings and profits is \$10,000. What amount of dividend should be reported on Form 1099-DIV issued to the shareholder for the year?

- A. \$40,000
- B. \$5,000
- C. \$0
- D. \$35,000

97. A corporation distributes \$75,000 in cash along with land having a \$50,000 adjusted basis and a \$60,000 FMV to its shareholder. What gain must the corporation recognize?

- A. \$10,000
- B. \$75,000
- C. \$25,000
- D. \$0

98. A corporation distributed a property to its only shareholder. The property had a FMV of \$75,000 and an adjusted basis to the corporation of \$50,000. The property was subject to a secured loan of \$90,000, which the shareholder assumed. What is the corporation's gain or loss on the distribution?

- A. \$0
- B. \$40,000 gain
- C. \$15,000 loss
- D. \$25,000 gain

99. A corporation distributes property with a basis of \$1,000 and a fair market value of \$4,000 subject to a liability of \$6,000 to a shareholder. What is the gain or loss the corporation must recognize as a result of the distribution?

- A. \$3,000 gain
- B. \$1,000 loss
- C. \$5,000 gain
- D. \$0

ANSWER: D

A corporate distribution to a shareholder is generally treated as a distribution of earnings and profits. Any part of a distribution from either current or accumulated earnings and profits is reported to the shareholder as a dividend.

ANSWER: A

If a corporation distributes property, other than its own stock, to a shareholder and the property's FMV exceeds the corporation's adjusted basis, treat the property as sold at the time of distribution. The corporation recognizes gain on the excess of the FMV over the adjusted basis of the property.

Corporation's recognized gain:

FMV of property distributed.....	\$60,000
Less: Adjusted basis.....	50,000
Recognized capital gain.....	<u>\$10,000</u>

ANSWER: B

If a corporation distributes property subject to a liability to a shareholder and the shareholder assumes the liability, the corporation will recognize a gain in the amount that the liability assumed by the shareholder exceeds the corporation's adjusted basis in the property.

Corporation's gain on property distributed:

Relief of liability.....	\$90,000
Less: Adjusted basis.....	50,000
Gain on property distributed.....	<u>\$40,000</u>

ANSWER: C

If a corporation distributes property subject to a liability to a shareholder and the shareholder assumes the liability, the corporation will recognize a gain in the amount that the liability assumed by the shareholder exceeds the corporation's adjusted basis in the property.

Corporation's gain on property distributed:

Relief of liability.....	\$6,000
Less: Adjusted basis.....	1,000
Gain on property distributed.....	<u>\$5,000</u>

100. A corporation distributes land to a shareholder. The fair market value of the land exceeds its basis to the corporation. Which of the following statements is true with regard to this transaction?

- A. The corporation must recognize gain on this distribution.
- B. The corporation realizes but does not recognize gain on this distribution.
- C. The corporation has neither a realized nor a recognized gain on this distribution.
- D. The shareholder has a recognized loss on this distribution.

101. Which of the following statements regarding corporate distributions is NOT true?

- A. Under no circumstances may a distribution, whether in cash or property, generate a deficit in Earnings and Profits.
- B. Under no circumstances may a distribution, whether in cash or property, add to a deficit in Earnings and Profits.
- C. In a corporate distribution, the Earnings and Profits account is reduced by the amount of money distributed.
- D. In a corporate distribution, the Earnings and Profits account is reduced by the lesser of the FMV or the adjusted basis of the property distributed.

102. A corporation distributed depreciable personal property having a fair market value of \$9,500 to its shareholders. The property had an adjusted basis of \$5,000 to the corporation. It had correctly deducted \$3,000 in depreciation on the property. What is the amount of the corporation's TOTAL recognized gain on the distribution and how much of this gain will be considered ordinary income?

	Total Recognized <u>Gain</u>	Ordinary <u>Income</u>
A.	\$4,500	\$0
B.	\$4,500	\$3,000
C.	\$4,500	\$4,500
D.	\$9,500	\$0

ANSWER: A

A corporation will recognize a gain on the distribution to a shareholder in the amount that the FMV of the property exceeds its adjusted basis.

ANSWER: D

In a corporate distribution, the corporation's earnings and profits account is reduced by the amount of the money distributed or the greater of the FMV or the adjusted basis of the property distributed. The distribution cannot reduce the corporation's earnings and profits below zero.

ANSWER: B

If the FMV of depreciated property distributed to shareholders is more than the adjusted basis of that property, the corporation must report as ordinary income any gain to the extent of depreciation taken. The remainder of the gain is a capital gain.

FMV of property distributed.....	\$9,500
Less: Adjusted basis.....	5,000
Recognized gain.....	4,500
Less: Ordinary income (depreciation)....	<u>3,000</u>
Capital gain.....	<u><u>\$1,500</u></u>

Chapter 3. C Corporations

103. A calendar-year corporation had accumulated earnings and profits at the beginning of the year of \$5,000. At the end of the year, the corporation had current-year earnings and profits of \$1,000. On December 31, the corporation distributed to its sole shareholder a property purchased for \$10,000 with a fair market value of \$8,000. The shareholder assumed a liability on the property of \$1,000. What amount of dividend paid to the shareholder must the corporation report as an ordinary dividend on Form 1099-DIV?

- A. \$6,000
- B. \$7,000
- C. \$8,000
- D. \$10,000

104. A corporation decided to distribute shares of its own stock to its employees at year-end as a reward for a profitable year. Each employee was to receive 10 shares with a fair market value of \$100 per share. Employees were offered a choice of cash or the stock dividend. What is the tax effect to the employees of this distribution?

- A. \$0; distributions of stock dividends and stock rights are tax-free to shareholders.
- B. \$1,000 taxable income to the employees who chose to receive cash and no effect on the employees who received stock.
- C. \$1,000 taxable income to each employee.
- D. None of the above.

105. The ABC Corporation, a calendar-year, accrual-basis taxpayer, distributed shares of the XYZ Corporation stock to ABC's employees in lieu of salaries. The salary expense would have been deductible as compensation if paid in cash. On the date of the payment, ABC's adjusted basis in XYZ Corporation's stock was \$20,000 and the stock's fair market value was \$100,000. What is the tax effect to ABC Corporation?

- A. \$100,000 deduction.
- B. \$20,000 deduction.
- C. \$20,000 deduction and \$80,000 recognized gain.
- D. \$100,000 deduction and \$80,000 recognized gain.

ANSWER: A

A corporate distribution to a shareholder is treated as a distribution of earnings and profits. Any part of a distribution from either current or accumulated earnings and profits is a dividend to the shareholder.

The amount of the distribution is the fair market value of any property transferred to the shareholder less the liability assumed by the shareholder.

Distribution (\$8,000 - \$1,000).....	\$7,000
Less: Dividend (E&P; \$5,000 + \$1,000)....	<u>6,000</u>
Return of capital.....	<u>\$1,000</u>

ANSWER: C

If a corporation distributes stock to an employee, the distribution is treated as taxable compensation in the amount of the FMV of the stock distributed.

ANSWER: D

If property is transferred to employees as payment for services rendered, the corporation can deduct as wages the FMV of the property transferred. The corporation would recognize a gain in the amount that FMV exceeds the corporation's adjusted basis in the property. Hence, the corporation would deduct \$100,000 as wages and recognize a capital gain of \$80,000 (\$100,000 - \$20,000).

106. A corporation partially compensates employee with 100 shares of stock. The stock is selling for \$200 per share at the time the employee receives his shares. On December 31, the employee sells his 100 shares of stock for \$300 each. How much of an employee compensation expense can the corporation deduct for the shares?

- A. \$0
- B. \$10,000
- C. \$20,000
- D. \$30,000

ANSWER: C

If property is transferred to an employee as payment for services rendered, the corporation can deduct as wages the FMV of the property transferred.

Reporting Dividends and Other Distributions

107. With regard to the filing of Form 1099-DIV all of the following are true EXCEPT:

- A. Corporate payers file this form to report dividends and other distributions of stock of \$10 or more.
- B. Corporate payers file this form for every person for whom any federal income tax was withheld under the backup withholding rules.
- C. Corporate payers file this form for each person to whom payments of \$600 or more were made as a part of a liquidation.
- D. This form is filed by payers for royalties paid to authors.

ANSWER: D

The payer files Form 1099-DIV with the IRS for each shareholder to whom the payer paid dividends and other distributions on stock of \$10 or more during the calendar year. Corporate payers must file this form for every person for whom any federal income taxes was withheld under the backup withholding rules even though the amount of the payment may be below the normal threshold for filing form 1099-DIV. The payer must file this form for each person to whom payments of \$600 or more were made as a part of a liquidation. Form 1099-MISC is filed by the payer for royalties.

108. The sole shareholder of a corporation received a \$100 dividend distribution from his corporation. Current earnings were \$1,000. What reporting requirements apply to this distribution?

- A. No reporting requirements apply because the distribution is less than \$600.
- B. No reporting requirements apply because the distribution is not taxable.
- C. Form 1099-DIV should be filed because the distribution is a dividend and is at least \$10.
- D. Form 1099-MISC should be filed to report miscellaneous income.

ANSWER: C

The payer files Form 1099-DIV with the IRS for each shareholder to whom the payer paid dividends and other distributions on stock of \$10 or more during the calendar year.

Chapter 3. C Corporations

109. A corporation made payments during the year that are required to be reported to the IRS and the recipients on Form 1099-DIV in paper format. What are the due dates to file Form 1099-DIV?

- A. Filing date to IRS: February 28; Filing date to recipients: January 31
- B. Filing date to IRS: January 31; Filing date to recipients: January 31
- C. Filing date to IRS: March 15; Filing date to recipients: March 15
- D. None of the above

110. Annual statement Form 1099-DIV must be furnished to recipients of which of the following:

- A. Liquidating distributions
- B. Patronage dividends
- C. Both answers A and B
- D. None of the above

Withholding Taxes

111. A corporate payer of an individual shareholder dividend does not have the taxpayer identification number for that shareholder. What backup withholding percentage rate must the corporate payer use for this shareholder's dividend payments?

- A. 15%
- B. 24%
- C. 28%
- D. 30%

ANSWER: A

The corporation must furnish Forms 1099-DIV to shareholders by January 31 of the year following the close of the calendar year during which the corporation made the distribution. The corporation must file Form 1096 to summarize and transmit its Forms 1099-DIV to the IRS by the last day of February of the year following the year of payment. If filing Form 1099-DIV electronically, the due date to the IRS is March 31 of the following year.

ANSWER: A

Liquidating distributions are reported on Form 1099-DIV. Patronage dividends are reported on Form 1099-PATR.

ANSWER: B

A payer must withhold **24%** (backup withholding rate) from a reportable payment made to a U.S. person that is subject to Form 1099 reporting for any of the following reasons:

1. The U.S. person has not provided its taxpayer identification number (TIN) in the manner required.
2. The IRS notifies the payer that the TIN furnished by the payee is incorrect.
3. There has been a notified payee underreporting.
4. There has been a payee certification failure.

Stock Redemptions

112. A corporation is owned by Mr. A, Mr. A's son and Mr. A's niece. Mr. A owns 50 shares in the corporation, his son owns 25 shares, and his niece owns 25 shares. How many shares does Mr. A constructively own?

- A. 25
- B. 50
- C. 75
- D. 100

113. Mr. R owns 100 shares of ABC, Inc. stock he purchased for \$10 per share. The 100 shares that R owns represent all of the outstanding stock. ABC, Inc. redeems 25 of Mr. R's shares for \$50 per share. ABC, Inc. had earnings and profits of \$100,000. Mr. R must report what amount of capital gain from this redemption of his stock?

- A. \$0
- B. \$1,000
- C. \$4,000
- D. \$5,000

114. A corporation has two equal shareholders, A and B. Each shareholder owns 10 shares of the corporation's stock. Each share has a \$100 basis and a \$150 FMV. The corporation, which has sufficient earnings and profits, redeems 5 shares from B at the \$150 FMV. What income does B recognize as a result of the redemption?

- A. \$750 dividend
- B. \$250 capital gain
- C. \$500 capital gain
- D. \$1,000 capital gain

ANSWER: C

Under the constructive ownership rules for stock redemptions, an individual is considered owning stock that is owned, directly or indirectly, by the following:

1. Spouse (if not legally separated),
2. Children,
3. Grandchildren,
4. Parents,
5. A trust (if individual is beneficiary),
6. A partnership (in proportion to individual's interest), and
7. A corporation (in proportion to interest) if individual owns 50% or more of value in stock of corporation.

ANSWER: A

Since the shareholder owns 100% of the corporation, the distribution will not lower the shareholder's basis. The shareholder still owns 100% of the stock of the corporation and his basis remains the same. The distribution \$1,250 (25 share at \$50) is considered a dividend to the extent of E & P (\$100,000).

ANSWER: B

If a corporation redeems its stock, the redemption is treated as a distribution, in part or full payment, in exchange for stock, if the distribution is a substantially disproportionate redemption of stock. Since only one shareholder's stock is redeemed it is a disproportionate redemption and the redemption is treated as a sale of stock.

Shareholder's recognized gain:
Sales price of stock ($\$150 \times 5$ shares).....\$750
Less: Adjusted basis ($\$100 \times 5$ shares)..... 500
Capital gain.....\$250

Chapter 3. C Corporations

115. A stock redemption is the acquisition by a corporation of its stock from a shareholder. A stockholder who owns all of the stock of a corporation sells back one half of his stock for cash. Which of the following statements is true with regard to this stock redemption? Assume current Earnings and Profits greater than redemption amount.

- A. This sale back to the corporation of one half will cause no percentage change in the shareholder's ownership.
- B. After the redemption, the shareholder will own all of the stock in the corporation.
- C. The stock redemption resembles a dividend distribution and will be taxed accordingly.
- D. All of the above.

116. Taxpayer A acquired 10 shares of XYZ, Inc. stock for \$50 per share. XYZ, Inc. decided to reacquire all of its outstanding stock, which it did for \$200 per share. What amount of capital gain must A report on the redemption of his stock?

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

117. Taxpayer E owns 5 of the 1,000 outstanding shares of ABC, Inc. stock. E purchased his 5 shares for \$500 per share. At the end of the year, ABC, Inc. has earnings and profits of \$1,000,000. ABC, Inc. redeems all of E's 5 shares at the end of the year for \$1,500 per share. What amount of capital gain must E report from the redemption of his stock?

- A. \$2,500
- B. \$0
- C. \$7,500
- D. \$5,000

ANSWER: D

Since the shareholder owns all the stock in the corporation, the partial redemption of stock still means the shareholder owns 100% of the stock outstanding. The partial redemption is treated as a dividend to the extent of earnings and profits.

ANSWER: C

A complete redemption of a shareholder's stock is treated as a sale and the shareholder recognizes a capital gain or loss on the transaction. Because the redemption terminates the shareholder's interest, none of the payment is considered a dividend. Therefore, earnings and profits are ignored.

Cash received (10 shs × \$200).....	\$2,000
Less: Adj. basis in stock (10 shs × \$50) ..	500
Capital gain.....	<u>\$1,500</u>

ANSWER: D

A complete redemption of a shareholder's stock is treated as a sale and the shareholder recognizes a capital gain or loss on the transaction. Because the redemption terminates the shareholder's interest, none of the payment is considered a dividend. Therefore, earnings and profits are ignored.

Cash received (5 shs × \$1,500).....	\$7,500
Less: Adjusted basis in stock	
(5 shs × \$500).....	<u>2,500</u>
Capital gain.....	<u>\$5,000</u>

Corporate Liquidations

118. With respect to a partial liquidation under IRC§302 (b)(4), which of the following statements is NOT true?

1. The redemption must be part of a plan.
 2. The shareholder may be a corporation.
 3. The redemption may be prorata.
 4. The distribution may not be made in the year after the plan was adopted.
- A. 1 & 2
B. 1 & 3
C. 2 & 4
D. 3 & 4

119. Mr. M purchased 100 shares of XYZ, Inc. for \$10 per share. XYZ, Inc. completely liquidated and distributed \$8,000 to M. Mr. M must report income from this distribution as

- A. Ordinary other income
B. Dividends
C. Capital gains
D. Return of capital

120. A fiduciary representing a dissolving corporation may file a request for prompt assessment of tax. Generally, this request reduces the time allowed for assessment to

- A. 12 months
B. 18 months
C. 24 months
D. 30 months

121. Which of the following will not shorten the period for assessing the tax when a fiduciary representing a dissolving corporation requests a prompt assessment of tax under Internal Revenue Code section 6501(d) by filing a Form 4810?

- A. Where the taxpayer did not report substantial amounts of gross income.
B. Where the taxpayer was filing a final return.
C. Where the taxpayer filed a false return.
D. Both answer A and answer C.

ANSWER: C

A distribution shall be treated as being in exchange for stock in a partial liquidation of a corporation if:

1. The distribution is not essentially equivalent to a dividend,
2. The distribution is pursuant to a plan and occurs within the taxable year in which the plan is adopted or within the succeeding year, and
3. The redemption of stock is held by a shareholder who is not a corporation.

ANSWER: C

In a complete liquidation, the distribution is considered a sale of property in exchange for stock. The difference between the shareholder's basis in stock and the FMV of property received in exchange for the stock is reported as a capital gain or loss.

ANSWER: B

If such a request is made, an assessment or a preceding in court without assessment for the collection of any tax must then be begun within **18 months** after the receipt of a written request for a prompt assessment.

ANSWER: D

The prompt assessment of tax will not shorten the period for assessing the tax, or for beginning court action to collect it if the taxpayer or fiduciary did not report substantial amounts of gross income, or the taxpayer or fiduciary filed false or fraudulent tax returns.

Chapter 3. C Corporations

122. Under a plan of complete liquidation, a corporation distributed land, having an adjusted basis of \$26,000, to its sole shareholder. The land was subject to a liability of \$38,000 which the shareholder assumed for legitimate business purposes. The fair market value of the land on the date of distribution was \$35,000. What is the amount of ABC's recognized gain or loss?

- A. \$9,000 gain
- B. \$12,000 gain
- C. \$3,000 loss
- D. \$29,000 loss

123. Pursuant to a complete liquidation, a corporation distributes the following to a shareholder: Inventory, basis \$10,000, FMV \$20,000; and land held as an investment, basis \$5,000, FMV \$40,000. The land is subject to a \$30,000 liability. What are the amounts and character of income to be recognized by the corporation?

- A. \$10,000 ordinary income; \$35,000 capital gain.
- B. \$10,000 ordinary income; \$65,000 capital gain.
- C. \$0 ordinary income; \$0 capital gain.
- D. \$10,000 ordinary income; \$5,000 capital gain.

124. Ms. R purchased 100 shares of XYZ Corporation stock for \$500. R received \$5,000 in a distribution from the partial liquidation of XYZ Corporation. On her personal income tax return, R must report income from this transaction as

- A. Dividends
- B. Capital gains
- C. Other
- D. None of the above

125. When is a corporation required to file a Form 1099-DIV for a liquidating distribution?

- A. Never. Liquidating distributions do NOT require a Form 1099-DIV.
- B. When the liquidating distribution equals or exceeds \$10 in a calendar year.
- C. When the liquidating distribution equals or exceeds \$600 in a calendar year.
- D. Always, liquidating distributions in any amount require the filing of a Form 1099-DIV.

ANSWER: B

A corporation will recognize a gain or loss upon distribution of property in complete liquidation to a non-corporation shareholder as if the corporation had sold property to a shareholder at FMV. If property distributed is subject to a liability that is assumed by the shareholder, the property distributed will be treated as having a FMV not less than the liability.

FMV of property distributed	
(not less than the liability).....	\$38,000
Less: Adjusted basis.....	26,000
Capital gain.....	<u>\$12,000</u>

ANSWER: A

The corporation will have an ordinary gain of \$10,000 (\$20,000 - \$10,000) on the distribution of the inventory items. A corporation will recognize a gain on the distribution of property to a shareholder if the FMV of the property is more than its adjusted basis. This is generally the same treatment the corporation would receive if the property were sold.

Capital gain on distribution of land:	
FMV of land.....	\$40,000
Less: Adjusted basis.....	5,000
Capital gain.....	<u>\$35,000</u>

ANSWER: B

In a partial liquidation of a corporation, the redemption of stock is treated as a sale and not a dividend.

ANSWER: C

A corporation making any distribution in liquidation must file Form 1099-DIV in each calendar year of the liquidation for each shareholder to whom it makes distributions of \$600 or more.

126. When a taxpayer formed his corporation five years ago, he invested \$5,000 in corporate stock. This year, when his basis in the stock was \$10,000, he liquidated his corporation receiving \$15,000 cash. How should he report this disposal on his tax return?

- A. No reporting required for liquidating distributions.
- B. Report \$10,000 long-term capital gain.
- C. Report \$5,000 long-term capital gain.
- D. Report \$5,000 ordinary income.

127. A corporation is dissolved on July 9, 2022. What is the due date, without extensions, for the filing of the final corporate income tax return?

- A. March 15, 2023
- B. December 31, 2022
- C. October 15, 2022
- D. November 15, 2022

ANSWER: C

In a complete liquidation, the distribution is considered a sale of property in exchange for stock. Earnings and profits are ignored because the distribution is not a dividend. The difference between the shareholder's basis in stock and the FMV of property received in exchange for the stock is reported as a capital gain or loss.

Cash received in liquidation.....	\$15,000
Less: Adjusted basis in stock.....	<u>10,000</u>
Long-term capital gain.....	<u>\$ 5,000</u>

ANSWER: D

A corporation that has dissolved must file by the 15th day of the 4th month after the date it dissolved. However, a corporation with a fiscal tax year ending June 30 must file by the 15th day of the 3rd month after the end of its tax year.

Chapter 4. S Corporations

The Election

1. A corporation may elect to be an S corporation if it meets the following tests EXCEPT:

- A. It is a domestic corporation.
- B. It has no more than 100 shareholders. A husband and wife (and their estates) are treated as one shareholder for this requirement. All other persons are treated as separate shareholders.
- C. It has only one class of stock.
- D. The majority of the shareholders must agree to the corporation's decision to be an S corporation.

ANSWER: D

To qualify for S corporation status, a corporation must meet all the following requirements:

- 1. It is a domestic corporation.
- 2. It must have only one class of stock.
- 3. It must have no more than 100 shareholders. A husband and wife (and their estates) are treated as one shareholder. All other persons are treated as separate shareholders.
- 4. It must have as shareholders only individuals, estates, exempt organizations described in section 401(a) or 501(c)(3), or certain trusts described in section 1361(c)(2)(A). Corporations and partnerships cannot be shareholders.
- 5. It must have shareholders who are citizens or residents of the U.S. Nonresident aliens cannot be shareholders.
- 6. It is not one of the following ineligible corporations:
 - a. A bank or thrift institution that uses the reserve method of accounting for bad debts under section 585.
 - b. An insurance company subject to tax under the rules of subchapter L of the Code.
 - c. A corporation that has elected to be treated as a possessions corporation under section 939.
 - d. A domestic international sale corporation (DISC) or former DISC.
- 7. It has or will adopt or change to one of the following tax years.
 - a. A tax Year ending December 31.
 - b. A natural business year.
 - c. An ownership tax year.
 - d. A tax year elected under section 444.
 - e. A 52-53-week tax year ending with reference to a year listed above.
 - f. Any other tax year for which the corporation establishes a business purpose.
- 8. All shareholders must agree to the corporation's decision to be an S corporation.

Chapter 4. S Corporations

2. Which of the following conditions will prevent a corporation from qualifying as an S corporation?

- A. The corporation has both common and preferred stock.
- B. The corporation has 70 shareholders.
- C. One shareholder is an estate.
- D. One shareholder is a resident alien.

3. A corporation may elect to be an S corporation if it meets all of the following conditions EXCEPT:

- A. Its only shareholders are individuals.
- B. It has no more than 100 shareholders.
- C. It has only one class of stock, 50% with voting rights and 50% with non-voting rights.
- D. It is a domestic international sales corporation.

4. Which of the following is NOT eligible to be a shareholder of an S corporation?

- A. A domestic partnership.
- B. Individuals who are not nonresident aliens.
- C. Estates.
- D. An exempt organization described in section 401 (a) or 501(c)(3).

5. Regarding a corporation's election for S status, which of the following statements is correct?

- A. Generally, a properly completed and timely filed election for S corporation status must be made by the 15th day of the 4th month of the start of business or beginning of the entity's tax year.
- B. A filed election for S status will be deemed made timely, if it is included with the corporation's initial filing of its annual report of income on Form 1120S.
- C. A corporation cannot file for S status unless it has a tax year ending on December 31.
- D. Certain corporations with reasonable cause for not timely filing Form 2553 can request to have the form treated as timely filed by filing 2553 as an attachment to Form 1120S, U.S. Income Tax Return for an S Corporation.

ANSWER: A

To qualify for S corporation status a corporation must have only one class of stock.

ANSWER: D

Refer to the analysis on question #1. A corporation can have one class of stock even if there is a difference in the voting rights of the stock. Generally, a corporation is treated as having one class of stock if all outstanding shares of the corporation's stock have the same rights to distributions and liquidation proceeds. A domestic international sales corporation (DISC) or former DISC does not qualify for S corporation status.

ANSWER: A

Eligible shareholders of an S corporation are individuals, estates, exempt organizations described in section 401 (a) or 501(c)(3), or certain trusts described in section 1361(c)(2)(A). Corporations and partnerships cannot be shareholders in an S corporation.

ANSWER: D

The election of S corporation status is effective for a tax year if Form 2553 is filed:

1. Any time during the previous tax year, or
2. By the 15th day of the 3rd month of the tax year to which the election is to apply.

Certain corporations with reasonable cause for not timely filing Form 2553 can request to have the form treated as timely filed by filing 2553 as an attachment to Form 1120S, U.S. Income Tax Return for an S Corporation. The reasonable cause must be stated on Form 2553.

A fiscal year corporation can make the election for S corporation status.

Termination of S Corporation Status

6. All of the following events would cause an S Corporation to cease qualifying as an S Corporation EXCEPT:

- A. Having more than 100 shareholders.
- B. The transfer of its stock to a corporation
- C. The transfer of its stock to a nonresident alien.
- D. Failure of the passive income test for two consecutive years.

7. All of the following events would cause an S Corporation to cease qualifying as an S corporation EXCEPT:

- A. Having more than 100 shareholders.
- B. The transfer of its stock to a corporation.
- C. The transfer of its stock to a nonresident alien.
- D. The election is revoked with the consent of shareholders that, at the time the revocation is made, had 40% of the stock.

8. Which shareholders must consent to have a corporation's S election revoked?

- A. Any shareholder regardless of percentage ownership.
- B. Any two shareholders holding at least 10% each.
- C. All shareholders regardless of percentage ownership.
- D. Any shareholder or group of shareholders owning more than 50%.

ANSWER: D

Some of the events that can cause the corporation to cease qualifying as an S corporation include the following:

1. Having more than 100 shareholders.
2. Transferring stock in the S corporation to
 - A corporation.
 - A partnership.
 - An ineligible trust.
 - A nonresident alien.
3. Creating a second class of stock.
4. Acquiring a subsidiary, other than certain non-operating subsidiaries

An S corporation would cease to qualify as an S corporation if it has accumulated earnings and profits and derives more than 25% of its gross receipts from passive investment income for three consecutive years.

ANSWER: D

The election to be an S corporation may be revoked with the consent of shareholder's who hold **more than 50%** of the number issued and outstanding shares of stock.

ANSWER: D

The election to be an S corporation may be revoked with the consent of shareholder's who hold **more than 50%** of the number of issued and outstanding shares of stock.

Chapter 4. S Corporations

9. Which of the following statements regarding the termination of an S corporation election is true?

- A. The election may be revoked with the consent of shareholders who, at the time the revocation is made, hold more than 50% of the number of issued and outstanding shares.
- B. The election may be revoked by the board of directors of the corporation only if they are not shareholders.
- C. The election terminates automatically if the corporation derives more than 25% of its gross receipts from passive investment income during the year.
- D. The election may be revoked by the IRS if there is a history of 10 years of operating losses.

10. On December 1, 2021, a 55% shareholder in an S corporation elected to terminate the corporation's status as an S corporation, effective on January 1, 2022. It continued to operate as a C corporation. What would be the earliest date that it could again elect S status without IRS consent?

- A. January 1, 2024
- B. December 1, 2026
- C. January 1, 2027
- D. Since election to terminate S status requires 100% of the outstanding shareholders' consent, the 55% shareholder cannot make the election by himself.

11. All of the following events would cause an S Corporation to cease qualifying as an S corporation EXCEPT:

- A. Having more than 100 shareholders.
- B. The transfer of its stock to a corporation.
- C. The transfer of its stock to a resident alien.
- D. The election is revoked with the consent of shareholders who, at the time the revocation is made, had 55% of the stock.

ANSWER: A

The election to be an S corporation may be revoked with the consent of shareholder's who hold more than 50% of the number issued and outstanding shares of stock. A corporation's status as an S corporation will be terminated if both of the following conditions occur for **three** consecutive tax years:

- 1. It has pre-S corporation earnings and profits at the end of each tax year, and
- 2. Its passive investment income for each tax year is more than 25% of gross receipts.

ANSWER: C

Once the election to terminate S status is made, it stays in effect until the election is terminated. If the election is terminated in a tax year beginning after 1996, the corporation (or a successor corporation) can make another election on Form 2553 only with IRS consent for any tax year before the 5th tax year after the first tax year in which the termination took effect. After the 5th year of termination, the shareholders can make the election for S status without the consent of the IRS.

ANSWER: C

A resident alien can be a shareholder of an S corporation. A nonresident alien cannot.

Filing Requirements and Extensions

12. A calendar S corporation that does not file an extension must file its 2022 tax return by:

- A. February 15, 2023
- B. March 15, 2023
- C. April 15, 2023
- D. June 15, 2023

13. An S corporation may receive an automatic extension of time for filing its federal income tax return by filing Form 7004 by the due date of the corporation's return. This will extend the time for filing by

- A. 3 months
- B. 5 months
- C. 6 months
- D. 7 months

ANSWER: B

An S corporation must file its income tax return by the 15th day of the 3rd month after the end of its tax year.

ANSWER: C

An S corporation can receive an automatic 6-month extension of time for filing its federal income tax return by filing a Form 7004 by the due date of the corporation's return.

Shareholder's Basis

14. On January 1, Mr. W had a \$2,000 basis in an S corporation in which he owns 50% of all outstanding stock. In January, Mr. W contributed a patent that he had acquired for \$1,000 to the corporation. During the year, the corporation received \$5,000 in royalty income from that patent. It also received \$2,500 in ordinary income and had \$500 in section 179 deductions. At the end of the year, the corporation returned ownership of the patent, which now had a fair market value of \$5,000, back to Mr. W. What is W's basis in the corporation on December 31?

- A. \$1,000
- B. \$1,500
- C. \$2,500
- D. \$5,000

ANSWER: B

In an S corporation, the shareholder's basis will increase or decrease from his or her pro-rata share of the following items:

Increase basis:

1. All income items of the S corporation, including tax-exempt income, that are separately stated and passed through to the shareholder.
2. Any nonseparately stated income of the S corporation.
3. The amount of the deduction for depletion that is more than the basis of the property being depleted.

Decreases basis:

1. Distributions by the S corporation that were not included in the shareholder's income.
2. All loss and deduction items of the S corporation that are separately stated and passed through to the shareholder.
3. Any nonseparately stated loss of the S corporation.
4. Any expense of the S corporation that is not deductible in figuring its income and not properly chargeable to capital accounts.
5. The shareholder's deduction for depletion of oil and gas property held by the S corporation to the extent it is not more than the shareholder's share of the adjusted basis of the property.

The FMV of the property (patent) distributed to the shareholder would decrease the shareholder's basis.

Adjusted basis January 1.....	\$2,000
Add: Property contributed (patent).....	1,000
Royalty income (\$5,000 × 50%).....	2,500
Ordinary income (\$2,500 × 50%).....	1,250
Less: Section 179 deduction (\$500 × 50%)..	(250)
Property distributed to S/H (patent)....	(5,000)
Adjusted basis December 31.....	<u>\$ 1,500</u>

15. Mr. J is the sole shareholder of an S corporation. On January 1, J has a basis in the corporation of \$2,000. The corporation's tax return shows the following:

Ordinary income	\$10,000
Interest income	\$1,000
Nondeductible expenses	\$2,000
Real estate rental loss	\$5,000
Section 179 expense	\$1,500
Distribution to Mr. J	\$3,000

What is J's basis in the corporation on December 31?

- A. \$0
- B. \$3,500
- C. \$4,500
- D. \$1,500

16. A shareholder's basis in an S corporation stock was \$100,000 before adjusting for current year activity. After consideration of each of the items below, what is the taxpayer's basis in his S Corporation stock?

- \$10,000 tax-exempt income
 - \$20,000 non-separately stated income
 - \$15,000 excess of depletion deduction over the basis of the property being depleted
- A. \$110,000
 - B. \$145,000
 - C. \$105,000
 - D. \$125,000

17. Which of the following will NOT affect a shareholder's basis in his or her S corporation stock?

- A. Any Section 179 depreciation deduction, which is separately stated to the shareholder.
- B. Any tax exempt income earned by the corporation which is separately stated to the shareholder.
- C. Any Code Section 1245 capital loss which is recognized by the corporation and separately stated to the shareholder.
- D. Salary and wages.

ANSWER: D

A shareholder's share of all income items would increase his basis in the S corporation. Deductible items of the S corporation that are separately stated and passed through to the shareholder would decrease the shareholder's basis. Distributions by the S corporation that were not included in the shareholder's income would decrease the shareholder's basis.

Adjusted basis January 1.....\$ 2,000
Add: Ordinary income..... 10,000
Interest income..... 1,000
Less: Nondeductible expenses.....(2,000)
Real estate rental loss.....(5,000)
Section 179 deduction.....(1,500)
Cash distribution.....(3,000)
Adjusted basis December 31.....\$ 1,500

ANSWER: B

In an S corporation, the shareholder's basis will increase from his or her pro-rata share of the following items:

1. All income items of the S corporation, including tax-exempt income, that are separately stated and passed through to the shareholder.
2. Any nonseparately stated income of the S corporation.
3. The amount of the deduction for depletion that is more than the basis of the property being depleted.

Shareholder's basis:

Adjusted basis beginning of year.....\$100,000
Tax-exempt income..... 10,000
Non-separately stated income..... 20,000
Excess depletion deduction..... 15,000
Shareholder's basis end of year.....\$145,000

ANSWER: D

A section 179 depreciation deduction, which is separately stated to the shareholder, would decrease the shareholder's basis. Tax exempt income earned by the corporation which is separately stated to the shareholder would increase the shareholder's basis. A Code Section 1245 capital loss which is recognized by the corporation and separately stated to the shareholder would decrease the shareholder's basis.

Chapter 4. S Corporations

18. If an S Corporation has no accumulated earnings and profits from prior operations as a C Corporation, any amount distributed to a shareholder

- A. Must be returned to the S Corporation.
- B. Increases the shareholder's basis in the stock.
- C. Decreases the shareholder's basis in the stock.
- D. Has no effect on the shareholder's basis in the stock.

19. Which of the following would NOT reduce a shareholder's basis in S Corporation stock?

- A. A shareholder's pro-rata share of an expense not deductible in computing the corporation's taxable income and not chargeable to the capital account.
- B. A shareholder's share of all loss and deduction items of the S Corporation that are separately stated and passed through to the shareholder.
- C. A shareholder's pro-rata share of any non-separately stated loss of the S Corporation.
- D. The excess of the corporation's deductions for depletion over the basis of the property subject to depletion.

ANSWER: C

Distributions by the S corporation that were not included in the shareholder's income decreases the shareholder's basis in the stock.

ANSWER: D

The excess of the corporation's deductions for depletion over the basis of the property subject to depletion increases the shareholder's basis.

Losses

20. An S corporation has a \$3,500 ordinary loss for the year. Its sole shareholder has a basis in the corporation of \$1,500. Which of following statements is correct?

- A. The shareholder may deduct a \$3,500 loss on his return.
- B. The shareholder may deduct a \$1,500 loss on his return and carry back a \$2,000 loss to the previous year.
- C. The shareholder may deduct a \$1,500 loss on his return and carry forward a \$2,000 loss indefinitely.
- D. The shareholder may deduct a \$1,500 loss on his return and loses the remaining \$2,000 loss.

ANSWER: C

The amount of losses a shareholder can take is limited to the adjusted basis of the shareholder's stock. Any losses in excess of the shareholder's basis is carry forward indefinitely for use when the shareholder's stock basis is restored.

21. Ms. W owns 100% of an S corporation. At the beginning of the year, she had a zero basis and an unused ordinary loss carryover from the corporation in the amount of \$5,000. During the year, W secured a bank loan of \$10,000 on her personal residence and made a shareholder loan of that amount to the corporation. At the end of the year, it reported on its schedule K a \$1,000 ordinary loss and a \$3,000 cash distribution made to W. W has \$10,000 in flow-through reportable income from other S corporations. How much of corporation's ordinary loss can W deduct on her personal return?

- A. \$6,000 in loss
- B. \$5,000 in loss
- C. \$3,000 in loss
- D. \$0 in loss

22. Ms. M is a 50% shareholder in an S corporation, which suffered a \$100,000 loss for the tax year ending December 31. M's basis in her stock as of December 31 was \$25,000. What can M do with the disallowed loss of \$25,000?

- A. Carry back the loss three years to offset any personal taxes paid.
- B. Carry forward the loss indefinitely for use if her basis in her stock is sufficiently restored.
- C. Nothing. There is no provision for using disallowed losses from an S corporation, in any other tax year but that in which the loss occurred.
- D. Ms. M does not have a disallowed loss and can use the full \$50,000 loss in the tax year.

23. Taxpayer B and Taxpayer S were equal sole shareholders of an S Corporation. The corporation realized a \$50,000 operating loss for the tax year ending December 31. As of January 1, B's basis in his stock was \$15,000 and S's was \$5,000. During the tax year, S mortgaged her home for \$25,000 and lent the money to the corporation. Although not personally liable, B told her not to worry and that if anything happened, he would help pay the mortgage debt. Calculate the amount of allowable loss deduction each shareholder would be able to recognize on their individual tax returns.

- A. B \$25,000 and S \$25,000.
- B. B \$15,000 and S \$5,000.
- C. B \$15,000 and S \$30,000.
- D. B \$15,000 and S \$25,000.

ANSWER: A

Any loans a shareholder makes to the corporation would increase his or her basis in the corporate stock.

Shareholder's basis for deducting loss:

Adjusted basis January 1	\$ 0
Add: Loan to corporation.....	10,000
Adjusted basis before loss deduction.....	10,000
Less: Allowable loss (\$1,000 + \$5,000)...	6,000
Adjusted basis December 31.....	<u>\$4,000</u>

ANSWER: B

A shareholder can carry forward the loss indefinitely for use when her stock basis is restored.

ANSWER: D

The amount of losses and deductions a shareholder can take is limited to the adjusted basis of:

1. The shareholder's stock, plus
2. Any loans the shareholder makes to the corporation.

Each shareholder realized a \$25,000 (\$50,000) loss.

B's deductible loss:

Adjusted basis on January 1	\$15,000
Less: Allowable losses.....	15,000
Adjusted basis on December 31	<u>\$ 0</u>

S's deductible loss:

Adjusted basis on January 1	\$ 5,000
Loan to S corporation.....	25,000
Less: Allowable loss.....	25,000
Adjusted basis on December 31	<u>\$ 5,000</u>

Capital Gains

24. Corporation X has always been an S corporation. Its capital gains are taxed at

- A. Long-term capital gains rate of 15%.
- B. Long-term capital gains rate of 20%.
- C. Taxed at the corporation's income tax rate.
- D. Capital gains for an S corporation are taxed at the shareholder's capital gain rate.

ANSWER: D

Capital gains of an S corporation are passed through to the shareholders and taxed at their capital gains rate on their individual income tax returns.

Pass Through Items

25. All of the following are considered separately stated items for Form 1120S shareholders EXCEPT:

- A. Net income or loss from rental real estate activities.
- B. Interest income.
- C. Royalty Income.
- D. Depreciation.

ANSWER: D

The following are separately stated items that pass through to the shareholders and are deducted on their individual tax return and expenses deducted by the S corporation to compute ordinary income and loss of the corporation.

<u>Separately Stated Items</u>	<u>Corporate Expenses</u>
1. Net income or loss from rental real estate activities.	1. Compensation to officers.
2. Net income or loss from other rental activities.	2. Salary and wages.
3. Portfolio income or loss, Interest income, Dividend income Royalty income Short-term capital gain or loss: and Long-term capital gain or loss	3. Repairs
4. Section 1231 net gain or loss.	4. Bad debts.
5. Charitable contributions.	5. Rents.
6. Health insurance premiums.	6. Taxes.
7. Section 179 expense deduction.	7. Interest.
8. Expenses related to portfolio income or loss.	8. Depreciation.
9. Credits, Low-income housing credit, Qualified rehabilitation expenses, and other credits.	9. Advertising.
10. Investment interest expense.	10. Employee benefit program.
11. Tax preference and adjustment items needed to figure shareholder's alternative minimum tax.	11. Pension and profit sharing.
12. Foreign taxes.	12. Organizational expenses

Net income or loss from rental real estate activities, interest income, and royalty income are all separately stated items.

26. All of the following are considered separately stated items for Form 1120S shareholders EXCEPT:

- A. Charitable contributions.
- B. Low-income housing credit.
- C. Section 179 expense deduction.
- D. Organizational expenses.

ANSWER: D

Charitable contributions, low-income housing credit, and section 179 expense deduction are all separately stated items.

27. Which of the following items is NOT a separately stated item of a qualifying S corporation?

- A. Interest income.
- B. Charitable contributions.
- C. Interest expense on business operating loans.
- D. Net long term capital gain.

ANSWER: C

Interest expense on business operating loans is deducted in figuring the S corporation's net income or loss and is not a passed through item.

28. An S corporation had the following activity during the year:

- \$500,000 gross sales of RV's and campers
- \$300,000 operating expenses
- \$1,000 interest income
- \$3,000 charitable contributions
- \$10,000 Section 179 expense

How much ordinary income from trade or business activities will be reported on Schedule K, Shareholders' Shares of Income, Credits, Deductions, etc.?

- A. \$188,000
- B. \$190,000
- C. \$198,000
- D. \$200,000

ANSWER: D

Interest income, charitable contributions, and section 179 expense deductions are separately stated items and are not included to determine the corporation's ordinary income from trade or business activities. These items are separately stated on the shareholder's Schedule K-1 and deducted in the shareholder's individual income tax return.

ordinary income from trade and business activities:

Gross sales.....	\$500,000
Less: operating expenses.....	<u>300,000</u>
ordinary income.....	<u>\$200,000</u>

Taxes

29. An S corporation can be subject to which of the following taxes:

- A. Built-in gains tax.
- B. Excess net passive income tax.
- C. Both A & B.
- D. None of the above.

ANSWER: C

An S corporation may be subject to the following taxes:

1. Tax on excess net passive investment income.
2. Tax on built-in gains.
3. Investment credit recapture tax.
4. LIFO recapture tax.

Chapter 4. S Corporations

30. An S corporation will be subject to Excess Net Passive Income Tax:

- A. Even if it has always been an S corporation.
- B. It has passive investment income for the year that is at least 20% of gross receipts.
- C. Both answer A and answer B.
- D. None of the above.

ANSWER: D

If an S corporation has pre-S corporation earnings and profits at the end of a tax year and its passive investment income (income from passive activities such as gross receipts from royalties, rents, dividends, interest, annuities, and sales or exchanges of stock or securities) is more than 25% of its gross receipts, the S corporation may be subject to a tax on excess net passive income. An S corporation will not be subject to the tax if it has been an S corporation for each of its tax years.

Distributions to Shareholders

31. Previous years cash distributions to a shareholder have reduced his or her stock basis to zero in an S Corporation. How will any further cash distributions be treated for tax purposes if the company continues to have losses?

- A. It will be treated as a deemed sale of the shareholder's stock.
- B. It will be treated as a capital contribution to the corporation.
- C. It will receive passive activity loss treatment, subject to any limitations.
- D. It will be carried over indefinitely to be offset with future earnings.

ANSWER: A

If an S corporation has no accumulated earnings and profits, any distributions to a shareholder that is more than the shareholder's basis is treated as a capital gain from the sale or exchange of stock.

32. If an S corporation, which has Accumulated Earnings and Profits (AE&P) is allowed to treat shareholder distributions as being made from the AE&P account, how will those distributions be taxed?

- A. They will be taxed as dividend income.
- B. They will be taxed as ordinary earned income.
- C. They will be taxed as capital gain income.
- D. They will not be taxed, as it would be deemed a return of shareholder capital.

ANSWER: A

If an S corporation has Accumulated Earnings and Profits (AE&P) from years before it became an S corporation, it can treat shareholder distributions as being made from (AE&P). The distributions will be treated as taxable dividends.

33. Which of the following statements regarding distributions from an S corporation is correct?

- A. Property distributions are applied in a different manner than cash distributions.
- B. Absent an election, distributions are considered to come first from accumulated earnings and profits, if the corporation has accumulated earnings and profits from when it was a C corporation.
- C. A shareholder's right to nontaxable distributions from previously taxed income may be transferred to another person.
- D. A distribution from the previously taxed income account is tax free to the extent of a shareholder's basis in his or her stock in the corporation.

ANSWER: D

Property distributions are applied in the same manner as cash distributions. If an S corporation has earnings and profits but has not elected to distribute them first, any distribution made will first come out of the accumulated adjustment account (AAA), to the extent of the AAA. A shareholder's right to nontaxable distributions from previously taxed income cannot be transferred to another person.

Chapter 5. Business Income and Expenses

Information Returns

1. Mr. A, a self-employed business man, has prepared payroll tax returns and income tax returns for XYZ, Inc. on a continuous basis. XYZ, Inc. paid Mr. A \$900 for his services. What is XYZ, Inc.'s reporting responsibility?

- A. File a W-2 for \$900.
- B. File a 1099 MISC for \$900.
- C. No documents need to be filed because the payee is a sole proprietor.
- D. No documents need to be filed because the payer, XYZ, Inc., is incorporated.

ANSWER: B

A taxpayer must file Form 1099-MISC, Miscellaneous Income, to report certain payments made in the taxpayer's business. These payments include:

- 1. Payments of \$600 or more for services performed for your business by people not treated as your employees, such as fees to subcontractors, attorneys, accountants, or directors.
- 2. Rent payments of \$600 or more, other than rents paid to real estate agents.
- 3. Prizes and awards of \$600 or more that are not for services, such as winnings on TV or radio shows.
- 4. Royalty payments of \$10 or more.
- 5. Payments to certain crew members by operators of fishing boats.

Self-Employment Income

2. Which of the following earnings is NOT subject to self-employment tax?

- A. Gains and losses, by a dealer in options or commodities, from dealing or trading in foreign currency contracts.
- B. Fees earned by a professional fiduciary who administers a deceased person's estate.
- C. Partnership income for a limited partner.
- D. All of the above.

ANSWER: C

The following are types of self-employed income.

- 1. Non-employee compensation.
- 2. Income from sole proprietorship.
- 3. Income as an independent contractor.
- 4. Corporate director fees.
- 5. Partnership income from partnership operating a business (unless limited partner).
- 6. Bartering income.
- 7. Real estate rent (if received as a real estate dealer).
- 8. Income paid to retired insurance agents based on commissions received prior to retirement.
- 9. Newspaper vendor's income if the vendor is 18 or older.
- 10. Net earnings of members of the clergy (unless given an exemption or taken a vow of poverty).
- 11. Gains and losses, by a dealer in options or commodities, from dealing or trading in section 1256 contracts (regulated futures contracts, foreign currency contracts, nonequity options, dealer equity options, and dealer securities futures contracts) or property related to those contracts.
- 12. A professional fiduciary who administers a deceased person's estate.

Chapter 5. Business Income and Expenses

3. 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 | |

4. A sole proprietor, had the following transactions:

Received rental income. \$7,500

Performed legal services for ATI Corpor-

ation 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

5. 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

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)..... 24,000

Gross income.....\$31,500

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.

6. 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.

Employees' Pay

7. An employer can deduct all of the following payments to an employee EXCEPT:

- A. \$500 for a length-of-service award to an employee after the employee's first 4 years of employment.
- B. A \$25 Christmas ham to each employee.
- C. \$400 for a safety achievement award to an employee.
- D. A bonus to an employee at the end of the year.

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.

ANSWER: A

An achievement award is an item of tangible personal property that meets all the following requirements:

- It is given to an employee for length of service or safety achievement.
- It is awarded as part of a meaningful presentation.
- It is awarded under conditions and circumstances that do not create a significant likelihood of disguised pay.

An award will qualify as a length-of-service award only if either of the following applies:

- The employee receives the award after his or her first 5 years of employment.
- The employee did not receive another length-of-service award (other than one of very small value) during the same year or in any of the prior 4 years.

The deduction for the cost of employee achievement awards given to any one employee during the tax year is limited to the following:

- \$400 for awards that are not qualified plan awards.
- \$1,600 for all awards, whether or not qualified plan awards.

Bonuses are deductible if the bonus is intended as additional pay for services that were actually performed and not as a gift. This applies whether the bonus was cash or property.

An employer can deduct as nonwage business expense, food or merchandise of nominal value distributed to employees at holidays.

Chapter 5. Business Income and Expenses

8. An employee incurred \$375 in travel expenses on a two-day business trip. When he returned to his tax home, he worked late and incurred \$90 for meals. The employee gave his employer an adequate accounting within a reasonable time and did not have any excess reimbursement. What amount, if any, must be included in the employee's W-2?

- A. \$375
- B. \$465
- C. \$0
- D. \$90

9. Generally, an employer can fully deduct the cost of which of the following fringe benefits provided to an employee:

- A. Cafeteria plans.
- B. Retirement planning services.
- C. Transportation (commuting) benefits.
- D. Meals not included in the employee's wages.

10. All of the following are excludable from wages EXCEPT:

- A. A non-cash achievement award valued at \$100.
- B. Meals furnished during work hours for the benefit of the employer.
- C. Employer provided vehicles when used by employee for personal purposes.
- D. De minimis fringe benefit.

ANSWER: C

If the employer has an accountable plan for reimbursements that requires employees to adequately account for their expenses and return the excess reimbursements, then no amount is reported as taxable income on Form W-2.

ANSWER: D

A fringe benefit is a form of pay provided to an employee. An employer can deduct the costs of fringe benefits as a business expense. The following are examples of fringe benefits:

1. Benefits under qualified employee benefit programs (e.g., cafeteria plans, dependent care and education assistance, and group-term life insurance).
2. Adoption assistance.
3. De minimis (minimal) benefits.
4. No-additional-cost services.
5. Retirement planning services.
6. Transportation (commuting) benefits.
7. Working condition benefits.

An employer can generally deduct only 50% of the cost of furnishing meals to his or her employees unless the value of the meals are included in the employee's wages.

ANSWER: C

If an employer-provided vehicle was available for personal use, the taxpayer receives a taxable fringe benefit. The value of the personal use must be included in the taxpayer's pay.

11. Which of the following fringe benefits cannot be excluded from the employee's income?

- A. Memberships in municipal athletic facilities for employees, their spouses and their dependent children.
- B. Holiday gifts other than cash with a low market value.
- C. Transportation (commuting) benefits up to \$280 per month.
- D. Qualified employee discounts given employees on certain property and services offered to customers in the ordinary course of the line of business in which the employee performs services.

12. Mr. Z, the sole proprietor of Z's Wholesale, transferred an automobile used in his business to Mr. Y, an employee of Z's Wholesale, for business related services rendered during the year. Z's adjusted basis in the automobile was \$6,000 and the fair market value was \$8,000 at the time of the transfer. Z had purchased the automobile two years ago for \$11,000. Mr. Z also paid \$80,000 in employee salaries, not including the automobile given to Mr. Y. Z is a cash basis taxpayer. What is his total salary and wage deduction?

- A. \$48,000
- B. \$80,000
- C. \$86,000
- D. \$88,000

13. An employer transferred office equipment used in his business to his employee, as payment for services. The value of the services provided was \$3,000. At the time of the transfer, the equipment had a fair market value of \$4,000 and an adjusted basis of \$4,750. How does the employer report this transfer on his income tax return?

- A. Wage expense \$0; loss on sale \$4,750
- B. Wage expense \$3,900; loss on sale \$850
- C. Wage expense \$4,000; loss on sale \$750
- D. Wage expense \$4,750; loss on sale \$0

ANSWER: A

An employer can exclude from his or her employee's gross income the value of an **on-premises** gym or other athletic facility the employer provides and operates if substantially all use during the calendar year is by employees, their spouses and their dependent children. The exclusion does not apply to any athletic facility if access to the facility is made available to the general public through sale of memberships.

ANSWER: D

An employer can deduct as wages the FMV of a capital asset transferred to an employee for services performed. The employee must include the FMV of the asset received in income.

ANSWER: C

An employer can deduct as wages the FMV of capital assets or an asset used in business he or she transfers to an employee as payment for services. The employer treats the deductible amount (FMV) as received in exchange for the asset and must recognize any gain or loss realized on the transfer. The gain or loss is the difference between the FMV and the adjusted basis on the date of the transfer.

Chapter 5. Business Income and Expenses

14. An employer transferred an automobile used in his business to an employee as payment for services. The value of the services provided was \$7,000. At the time of the transfer, the automobile had a fair market value of \$8,000, and an adjusted basis of \$6,000. How does the employer show this transfer on his income tax return?

- A. Wage expense \$8,000; gain on sale \$2,000
- B. Wage expense \$7,000; gain on sale \$1,000
- C. Wage expense \$7,000; gain on sale \$0
- D. Wage expense \$0; gain on sale \$2,000

15. Which of the following fringe benefits for meals is subject to the 50% deduction limit?

- A. Meals furnished to your employees at the work site when you operate a restaurant.
- B. Meals furnished to your employees as part of the expense of a company picnic.
- C. Meals furnished to your employees at your place of business when more than half of these employees are provided the meals for your convenience.
- D. Meals furnished to a customer during a business discussion.

ANSWER: A

An employer can deduct as wages the FMV of a capital asset transferred to an employee for services performed. The employer will recognize a gain or loss on the transfer. The gain or loss is the difference between the FMV of the asset and its basis to the employer.

Employer's capital gain:

FMV of automobile (deducted as wages)....	\$8,000
Less: Adjusted basis.....	<u>6,000</u>
Capital gain.....	<u>\$2,000</u>

ANSWER: D

The 50% limit on deductions for the cost of meals does not apply if the meals to employees qualify as a de minimis benefit. De minimis meals are any meal or meal money provided by an employer to employees that has little value that accounting for them would be unreasonable or administratively impractical. The following are examples of de minimis meals:

1. Coffee, doughnut, or soft drinks.
2. Occasional meals or meal money provided to enable an employee to work over time.
3. Meals furnished on the employer's premises that are provided for the employer's convenience.
4. Occasional parties or picnics for employees and their guests.
5. Meals provided at an employer-operated eating facility for employees if the annual revenue from the facility equals or exceeds the direct cost of the facility.

16. In order to qualify as an accountable plan for employee reimbursement, the employer plan must satisfy all of the following EXCEPT:

- A. The expenses have a business connection.
- B. The employee must make an adequate and timely accounting to the employer.
- C. The employer must pay a per diem for meals.
- D. The employee must timely return any excess reimbursements.

ANSWER: C

To be an accountable plan, the employer's reimbursement must include all three of the following rules:

1. The expenses must have a business connection (i.e., expenses must have been paid or incurred while performing services as an employee,
2. The employee must adequately account to employer for these expenses within a reasonable time (60 days), and
3. The employee must return any excess reimbursement within a reasonable period of time (120 days).

The reimbursement or allowance does not have to be based on the federal per diem rate. However, any reimbursement or allowance that exceeds the federal per diem rate, the excess must be included in box 1 as wages on the employee's W-2. If the reimbursement or allowance is less than or equal to the federal per diem rate, it is not included in wages on the employee's W-2. If the plan calls for actual expense reimbursement, adequate accounting is made and the excess returned, then no amount is reported as taxable income on Form W-2.

17. A cafeteria plan is a written plan that allows employees to choose between receiving cash or taxable benefits instead of certain qualified benefits for which the law provides an exclusion from wages (deferral). Which of the following can be included in a cafeteria plan?

- A. Life insurance premiums.
- B. Membership dues to athletic facilities.
- C. Scholarships or fellowships.
- D. Tuition reduction.

ANSWER: A

A cafeteria plan, including a flexible spending arrangement, is a written plan that allows employees to choose between receiving cash or taxable benefits instead of certain qualified benefits for which the law provides an exclusion from wages. If an employee chooses to receive a qualified benefit under the plan, the fact that the employee could have received cash or a taxable benefit instead will not make the qualified benefit taxable.

Generally, a cafeteria plan does not include any plan that offers a benefit that defers pay. However, a cafeteria plan can include a qualified 401(k) plan as a benefit. Also, certain life insurance plans maintained by educational institutions can be offered as a benefit even though they defer pay.

Qualified benefits include the following benefits:

1. Accident and health benefits (but not medical savings accounts or long-term care insurance).
2. Adoption assistance.
3. Dependent care assistance.
4. Group-term life insurance coverage (including costs that cannot be excluded from wages).
5. Health savings accounts (HSAs). Distributions from an HSA may be used to pay eligible long-term care insurance premiums or qualified long-term care services.

A cafeteria plan cannot include the following benefits:

1. Archer medical savings accounts.
2. Athletic facilities.
3. De minimis (minimal) benefits.
4. Educational assistance.
5. Employee discounts.
6. Employer-provided cell phones.
7. Lodging on your business premises.
8. Meals.
9. No-additional-cost services.
10. Retirement planning services.
11. Transportation (commuting) benefits.
12. Tuition reduction.
13. Working condition benefits.
14. Scholarships or fellowships.

18. Mr. R owns a delivery truck and delivers bread to retailers locally for the AB Bakery. He owns his delivery route. Mr. R received a W-2 with gross wages of \$30,000 in Box 1. His Federal income tax rate is 15%. Mr. R is considered what type of employee and had what amount withheld for Federal income tax (FIT)?

	<u>Employee Type</u>	<u>FIT</u>
A.	Statutory	\$4,500
B.	Common law	\$4,500
C.	Statutory	\$0
D.	Common law	\$0

ANSWER: C

Under common law rules, anyone who performs services for an employer is an employee if the employer can control what will be done and how it will be done. This is so even if the employer gives the employee freedom of action. The determining factor is the employer's right to control the details of how the services are performed by the employee.

If workers are independent contractors under the common law rules, such workers may be treated as employees by statute (statutory employees) for certain employment tax purposes if they fall within any one of the following four categories and meet the three conditions described under Social security and Medicare taxes, below:

1. **A driver who distributes beverages (other than milk) or meat, vegetable, fruit, or bakery products; or who picks up and delivers laundry or dry cleaning, if the driver is the employer's agent or is paid on commission.**
2. A full-time life insurance sales agent whose principal business activity is selling life insurance or annuity contracts, or both, primarily for one life insurance company.
3. An individual who works at home on materials or goods that the employer supplies and that must be returned to the employer, if the employer also furnishes specifications for the work to be done.
4. A full-time traveling or city salesperson who works on the employer's behalf and turns in orders to the employer from wholesalers, retailers, contractors, or operators of hotels, restaurants, or other similar establishments. The goods sold must be merchandise for resale or supplies for use in the buyer's business operation. The work performed for the employer must be the salesperson's principal business activity.

Social security and Medicare taxes. Social security and Medicare taxes must be withheld from the wages of statutory employees if all three of the following conditions apply:

1. The service contract states or implies that substantially all the services are to be performed personally by them.
2. They do not have a substantial investment in the equipment and property used to perform the services (other than an investment in transportation facilities).
3. The services are performed on a continuing basis for the same payer.

Federal unemployment (FUTA) tax. For FUTA tax, the term employee means the same as it does for social security and Medicare taxes, except that it does not include statutory employees in categories 2 and 3 above. Thus, any individual who is an employee under category 1 or 4 is also an employee for FUTA tax purposes and subject to FUTA tax.

Federal income tax (FIT) is not withheld from the wages of statutory employees.

Chapter 5. Business Income and Expenses

19. Supplemental wages are compensation paid in addition to an employee's regular wages. They do NOT include payments for

- A. Accumulated sick leave.
- B. Nondeductible moving expenses.
- C. Vacation pay.
- D. Travel reimbursements paid at the Federal Government per diem rate.

20. Mr. B works on the loading dock for the LD Partnership from 7:00 am to 3:00 pm, Monday-Friday. Ms. S, the full-time secretary, works a 4-day week. Mr. M is the sole proprietor and is a licensed accountant. Mr. X works a different schedule each week for an employer. How many of these individuals are considered employees?

- A. 3
- B. 2
- C. 1
- D. None.

21. How frequently must an employer make payroll tax deposits if the employer reported more than \$50,000 in taxes for the lookback period?

- A. Quarterly
- B. Monthly
- C. Weekly
- D. Semiweekly

ANSWER: D

Supplemental wages are compensation paid in addition to an employee's regular wages. They include, but are not limited to, bonuses, commissions, overtime pay, payments for accumulated sick leave, severance pay, awards, prizes, back pay and retroactive pay increases for current employees, and payments for nondeductible moving expenses. Other payments subject to the supplemental wage rules include taxable fringe benefits and expense allowances paid under a nonaccountable plan. Travel reimbursements paid at the Federal Government per diem rate fall under an accountable plan and are not included in income.

ANSWER: B

To determine whether an individual is an employee or an independent contractor under the common law, the relationship of the worker and the business must be examined. All evidence of control and independence must be considered. In any employee-independent contractor determination, all information that provides evidence of the degree of control and the degree of independence must be considered. The general rule is that an individual is an independent contractor if the payer has the right to control or direct only the result of the work and not what will be done and how it will be done. The earnings of a person who is working as an independent contractor are subject to SE tax.

ANSWER: D

There are two deposit schedules—monthly or semiweekly—for determining when an employer deposits social security, Medicare, and withheld income taxes. The deposit schedule that a calendar year employer must use is based on the total tax liability that the employer reported on Form 941 during the four-quarter lookback period that begins July 1 and ends June 30 of the previous year. If the employer reported payroll taxes of \$50,000 or less for the lookback period, the employer makes monthly deposits. If the employer reported payroll taxes of more than \$50,000 the lookback period, the employer make semiweekly deposits.

22. All of the following persons may be responsible for the trust fund trust fund recovery penalty EXCEPT:

- A. An officer of a corporation.
- B. An employee in the payroll department.
- C. A member of the board of trustees.
- D. A corporate director or shareholder.

ANSWER: B

If income, Social Security, and Medicare taxes are not withheld or are not paid to the IRS, a penalty may be assessed against any person responsible for collecting, accounting for, and paying of the taxes. A responsible person may be:

- An officer or an employee of a corporation.
- A member or employee of a partnership.
- A corporate director or shareholder.
- A member of a board of trustees of a nonprofit organization.
- Another person with sufficient authority and control over funds to direct their disbursement.

This penalty does not apply to the employer's portion of social security or FUTA. The penalty is computed based on two amounts which constitute trust fund tax:

- The unpaid income taxes that should have been withheld, or were withheld but not paid, plus
- The employee's portion of the Social Security/Medicare taxes that should have been withheld, or were withheld but not paid.

23. An employer should keep a copy of Form W-2 for how many years?

- A. Two years
- B. Three years
- C. Four years
- D. Five years

ANSWER: C

Keep all records of employment taxes for at least 4 years. These should be available for IRS review.

Interest Expenses

24. On June 30, Ms. C, who uses the cash method of accounting, borrowed \$30,000 from a bank to use in her business. She was to repay the loan in one payment with \$2,000 interest due on December 30. On December 30, she renewed that loan plus the interest due. The new loan was for \$32,000 (the original unpaid loan and unpaid interest). How much can she deduct as interest expense?

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

ANSWER: C

A cash method taxpayer can deduct only interest payments actually made during the tax year.

Chapter 5. Business Income and Expenses

25. A sole proprietor purchased and placed in service a machine used for production purposes. The machine cost \$10,000 plus \$500 sales tax. He financed the entire purchase price. He paid total interest of \$850 on the note. Concerning the income tax treatment of the above expenses, which of the following statements is correct?

- A. Under the uniform capitalization rules, the interest AND sales tax should be included in the basis of the machine.
- B. Under the uniform capitalization rules, the interest should be included in the basis of the machine and the sales tax should be deducted as a current expense.
- C. The interest should be deducted, as a current expense and the sales tax should be included in the basis of the machine.
- D. The interest AND sales tax should be deducted as a current expense.

ANSWER: C

Purchased property that is used for production purposes is not under the uniform capitalization rules. The interest paid on a loan for purchased property is deductible. The sales tax paid on the purchase of a business property must be added to the cost of the property.

Bad Debts

26. Which is NOT a true statement regarding business bad debts?

- A. The debt does not have to be due to be worthless.
- B. A bad debt can result from a loan to a supplier.
- C. Cash basis taxpayers can take a deduction for amounts never received or collected.
- D. A debt can arise from the guarantee of a debt that becomes worthless.

ANSWER: C

Cash basis taxpayers report income when they receive payment. They cannot take a bad debt deduction for amounts owed them that they have not received and cannot collect because they never included those amounts in income.

27. How does a sole proprietor report a business bad debt?

- A. As an itemize deduction on Schedule A (Form 1040 or 1040-SR).
- B. As a short-term capital loss on Form 8949.
- C. As a negative figure on other income on Schedule 1 (Form 1040 or 1040-SR).
- D. Under other expenses on Schedule C (Form 1040 or 1040-SR).

ANSWER: D

A sole proprietor reports a business bad debt on his or her Schedule C (Form 1040 or 1040-SR). Nonbusiness bad debts are reported as a short-term capital loss on Form 8949.

28. In 2021, a sole proprietor had a bad debt deduction of \$6,000. He reported the business on the accrual method of accounting and used the specific charge-off method for bad debts. In 2022, he recovered \$4,500 of the \$6,000 previously deducted in 2021. What is the correct way to report this recovery?

- A. Report \$4,500 as "Other Income" on Schedule C in 2022.
- B. Report \$4,500 as "Other Income" Schedule 1 (Form 1040 or 1040-SR) in 2022.
- C. Report \$4,500 as "Other Income" on an amended 2021 Form 1040X return.
- D. Report \$4,500 as a reduction of "Bad Debt" on Schedule C in 2022.

ANSWER: A

A recovery of a business bad debt would be included in business income as other income on Schedule C. A recovery of nonbusiness bad debt would be reported as other income on Schedule 1 (Form 1040 or 1040-SR).

Travel and Entertainment

29. A taxpayer usually lives and works in St. Louis, but is assigned to a job in Little Rock for an indefinite period of time. How much, if any, of the following monthly expenses can be deducted?

- Rent: \$1,000
 - Meals: \$230
 - Travel: \$35 to go home on weekends
- A. \$1,265
 - B. \$1,035
 - C. \$1,150
 - D. \$0

ANSWER: D

If a taxpayer's assignment or job away from his or her main place of work is temporary (one year or less), the taxpayer's tax home does not change and the travel and living expenses are deductible. However, if the assignment or job is indefinite, the location of the assignment or job becomes the taxpayer's new tax home and the expenses are not deductible.

30. A sole proprietor takes a business trip to Reno. On the way to Reno he stops in Las Vegas to visit a friend. He spends three days in Las Vegas and six days in Reno. His travel expenses for the nine days are \$630. If he had not stopped in Las Vegas, the cost of the six-day trip to Reno would have been \$420. How much may be deducted before considering any meals limitation?

- A. \$420
- B. \$630
- C. \$580
- D. None of the above

ANSWER: A

If the trip was primarily for business and the taxpayer makes a nonbusiness side trip, the taxpayer can deduct only the business related travel expenses. Since the taxpayer's business related expenses are \$420 that is the amount that can be deducted.

Chapter 5. Business Income and Expenses

31. With regard to deductible travel expenses when attending a convention, all of the following statements are correct EXCEPT:

- A. If you can show that your attendance benefits your trade or business you can deduct yours and your family travel expenses providing the expenses are reasonable.
- B. You cannot deduct expenses for attending a convention, seminar, or similar meeting held outside the U.S. area unless the meeting is directly related to your trade or business.
- C. You must reduce otherwise deductible travel expenses that you pay by the reimbursements not reported on your Form W-2 that you received from others for these expenses.
- D. If you establish that a meeting held on a cruise ship is directly related to your trade or business, you may be able to deduct up to \$2,000 per year of expenses.

32. The standard meal allowance can be used to figure a deduction for all of the following EXCEPT:

- A. Business travel, if you are self-employed.
- B. Travel in connection with investment property.
- C. Travel for qualifying educational purposes.
- D. Travel to obtain medical treatment.

33. A self-employed taxpayer took one of his clients to a Broadway show. The visit to the show occurred directly after a substantial business discussion with that client. He paid a ticket broker \$300 for two tickets to that show. The face value of each ticket was \$100 (\$200 total). What is the total deductible expense for both tickets?

- A. \$0
- B. \$100
- C. \$150
- D. \$200

ANSWER: A

A taxpayer can deduct travel expenses when attending a convention if he or she can show that attendance benefits his or her trade or business. Expenses for family members are not deductible.

ANSWER: D

A taxpayer can use the standard meal allowance to figure meal expenses when traveling in connection with investment and other income-producing property and when traveling for qualifying educational purposes. A taxpayer cannot use the standard meal allowance to figure the cost of meals when traveling for medical or charitable purposes.

ANSWER: A

For expenses paid or incurred after December 2017, the tax law has changed. Traditionally, meals and entertainment expenses have followed the same set of rules. For expenses after December 2017, meals are now treated differently from entertainment expenses. Generally, entertainment expenses are nondeductible for expenses paid after December 2017.

34. Which of the following is a deductible entertainment expense?

- A. Taking a client to the theater.
- B. Recreational expenses for employees at a holiday party.
- C. Expenses for conducting business at a country club.
- D. None of the above.

35. When an employer reimburses an employee for meals under an accountable plan while the employee is away from home, the employer must

- A. Include 50% of the cost of meals as income to the employee.
- B. Do nothing.
- C. Deduct only 50% of the reimbursement on his or her tax return.
- D. Add 100% of the meals as income to the employee.

ANSWER: B

In general, entertainment expenses are nondeductible. However, there are a few exceptions to the general rule including the following.

- Entertainment treated as compensation on the employer's originally filed tax returns (and treated as wages to employees).
- Recreational expenses for employees such as a holiday party or a summer picnic.
- Expenses related to attending business meetings or conventions of certain exempt organizations such as business leagues, chambers of commerce, professional associations, etc.
- Entertainment sold to customers. For example, if a taxpayer runs a nightclub, his or her expenses for the entertainment furnished to customers, such as a floor show, aren't subject to the nondeductible rules.

ANSWER: C

Under an accountable plan, employee reimbursements are not included in the employee's income. The employer can deduct 50% of meals expenses reimburse to the employee.

Insurance Expenses

36. All of the following insurance premiums are deductible as a business expense EXCEPT:

- A. Fire, theft and flood insurance.
- B. Employer's liability insurance.
- C. Life insurance as security for business loan.
- D. Overhead insurance which pays John's overhead expenses in the event of his long period of disability caused by his sickness or injury.

ANSWER: C

Deductible insurance premiums related to a business:

- 1. Fire, theft, flood, or other casualty insurance.
- 2. Credit insurance that covers losses from business bad debts.
- 3. Group hospitalization and medical insurance for employees, including long-term care insurance.
 - a. If a partnership pays accident and health insurance premiums for its partners, it generally can deduct them as guaranteed payments to partners.
 - b. If an S corporation pays accident and health insurance premiums for its more-than-2% shareholder-employees, it generally can deduct them, but must also include them in the shareholder's wages subject to federal income tax withholding.
- 4. Liability insurance.
- 5. Malpractice insurance that covers personal liability for professional negligence resulting in injury or damage to patients or clients.
- 6. Workers' compensation insurance set by state law that covers any claims for bodily injuries or job-related diseases suffered by employees in your business, regardless of fault.
 - a. If a partnership pays workers' compensation premiums for its partners, it generally can deduct them as guaranteed payments to partners.
 - b. If an S corporation pays workers' compensation premiums for its more-than-2% shareholder-employees, it generally can deduct them, but must also include them in the shareholder's wages.
- 7. Contributions to a state unemployment insurance fund are deductible as taxes if they are considered taxes under state law.
- 8. Overhead insurance that pays for business overhead expenses during long periods of disability caused by injury or sickness of the taxpayer.
- 9. Car and other vehicle insurance. Deduct only part of premiums that applies to business use.
- 10. Life insurance covering officers and employees if the employer is not directly or indirectly a beneficiary under the contract.
- 11. Business interruption insurance that pays for lost profits if the business is shut down due to a fire or other cause.

Nondeductible premiums.

1. Self-insurance reserve funds.
2. Loss of earnings due to sickness or disability.
3. Certain life insurance and annuities:
 - a. Life insurance policies that cover the taxpayer, his employees, or any person with a financial interest in the business if the taxpayer is a beneficiary of the policy.
 - b. Partners. If a partner in a partnership takes out an insurance policy on his or her own life and names his or her partners as beneficiaries to induce them to retain their investments in the partnership, the partner is considered a beneficiary and cannot deduct the insurance premiums.
4. Life Insurance to secure a loan.

37. All of the following insurance premiums are ordinarily deductible as a business expense EXCEPT:

- A. Workers compensation on behalf of partners in a business partnership.
- B. Life insurance on the life of an employee with the employee's wife as the beneficiary.
- C. Self-insurance reserve funds.
- D. Malpractice insurance covering a professional's personal liability for negligence resulting in injury to business clients.

38. The J&M partnership paid liability insurance on its building of \$2,200 for the year 2022. This represents a premium for one year. J&M also prepaid fire insurance premiums of \$2,400. The premium paid was for 2022 and 2023. What is the amount of insurance that J&M may deduct for 2022?

- A. \$2,200
- B. \$3,400
- C. \$4,600
- D. \$2,400

ANSWER: C

The taxpayer cannot deduct amounts credited to a reserve set up for self-insurance. This applies even if the taxpayer cannot get business insurance coverage for certain business risks.

ANSWER: B

If a taxpayer pays an insurance premium that covers more than one tax year, the taxpayer can deduct only the part of the premium that applies to the current tax year. Deduct only the amount of fire insurance that covers 2022 (\$1,200).

Deductible insurance expense:	
Liability insurance.....	\$2,200
Fire insurance (premiums that cover 2022).....	<u>1,200</u>
Deductible insurance expense.....	<u><u>\$3,400</u></u>

Chapter 5. Business Income and Expenses

39. A calendar-year basis taxpayer bought a fire insurance policy on a building he uses in his business. The insurance is effective November 1 and he paid a premium of \$1,200 for 2 years of coverage. How much can he deduct for the year?

- A. \$1,200
- B. \$600
- C. \$100
- D. \$50

ANSWER: C

If a taxpayer pays an insurance premium that covers more than one tax year, the taxpayer can deduct only the part of the premium that applies to the current tax year.

Deductible insurance premium:

$$\$1,200 \div 24 \text{ months} = \$50/\text{month}$$

$$\$50 \times 2 \text{ months (Nov - Dec)} = \$100$$

Business Gifts

40. Ms. L sells products to JM Company. She gave the firm five packages of cashews to thank five employees for the referrals. Ms. L paid \$75 for each package. How much can she deduct for the gifts?

- A. \$375
- B. \$125
- C. \$188
- D. None of the above

ANSWER: B

There is a \$25 per person per tax year limit for business gifts regardless of the value of gifts.

Deductible expense for business gifts:

$$\$25 \times 5 = \$125$$

Casualty and Theft Losses

41. A taxpayer suffered an \$11,000 loss of inventory when his cooler malfunctioned. He had no insurance for this type of loss. He shows this loss on his tax return by

- A. Taking a bad debt deduction of \$22,000, the amount he would have sold the inventory for.
- B. Taking an ordinary loss on Form 4797 of \$11,000.
- C. Taking a business loss on his Schedule C as reflected by an increase of \$11,000 in cost of goods sold.
- D. Taking a loss of \$11,000 as a bad debt on Schedule D.

ANSWER: C

A casualty or theft loss of inventory is automatically claimed through the increase in cost of goods sold by properly reporting opening and closing inventories. Do not claim this loss as a casualty or theft loss. Include any insurance reimbursements in income.

42. In October 2022, Mr. P, an accrual basis taxpayer, had \$30,000 in inventory items held for sale to customers completely destroyed by a fire that was started by an electrical malfunction. Mr. P fully expects to be reimbursed the entire \$30,000 by his insurance company in February 2023. Which of the following is a correct method of reporting the loss and expected reimbursement for federal income tax purposes?

- A. For 2022, decrease the cost of goods sold by \$30,000.
- B. For 2022, the loss is accounted for in the cost of goods sold; for 2023, include the \$30,000 reimbursement in ordinary income.
- C. For 2022, decrease the cost of goods sold by the \$100 casualty loss rule; for 2023, include the \$30,000 reimbursement in ordinary income.
- D. Mr. P is not required to make any adjustments for 2022 or 2023 since the reimbursement offsets the loss.

43. A hurricane destroyed Mr. F's tractor. He had purchased the tractor for \$8,000 and had correctly deducted \$6,000 of depreciation. His adjusted basis in the tractor was \$2,000. His insurance company reimbursed him \$9,000 and he spent \$7,500 for a new tractor later in the year. How much ordinary income should he report?

- A. \$0
- B. \$1,500
- C. \$6,000
- D. \$7,000

ANSWER: D

Even though the taxpayer will not be reimbursed until the next year, he must subtract the expected reimbursement from the loss. In this case, he expects to be fully reimbursed, so no loss adjustment is required.

ANSWER: B

If insurance payments or other reimbursements are more than the adjusted basis in the property destroyed, a gain will be realized from the casualty. To postpone all the gain, the cost of the replacement property must be at least as much as the insurance reimbursement received. If the cost of the replacement property is less than the reimbursement, include any gain realized from the reimbursement in income up to the amount of the unspent reimbursement.

Recognized gain on the reimbursement:

Insurance reimbursement.....	\$9,000
Less: Adjusted basis in tractor.....	<u>2,000</u>
Realized gain on reimbursement.....	<u>\$7,000</u>
Recognized gain (\$9,000 reimbursement - \$7,500 used for replacement tractor).....	<u><u>\$1,500</u></u>

Taxes

44. Which of the following statements regarding deductible taxes is correct?

1. Local benefit taxes for business assets are deductible only if they are for maintenance, repair, or interest charges related to those benefits.
 2. Real estate taxes on business property included in monthly mortgage payments placed in escrow cannot be deducted unless the lender actually paid the taxing authority.
 3. Taxes on gasoline, diesel fuel and other motor fuels that you use in your business should be deducted as part of the cost of the fuel.
 4. Any tax imposed by a state or local government on personal property used in your trade or business is deductible
- A. 1, 2 and 4
B. 2 and 4
C. 1 and 3
D. 1, 2, 3 and 4 (All of the above)

45. A taxpayer had the following expenditures relating to commercial real estate that he owns:

- County property tax: \$2,000
- State property tax: \$1,000
- Assessment for sewer construction: \$1,200
- Charges for sewer and water service: \$500

What is the amount he can deduct as real estate taxes on his commercial real estate?

- A. \$2,000
B. \$3,000
C. \$4,200
D. \$4,700

ANSWER: D

Local benefit taxes for business assets are deductible only if they are for maintenance, repair, or interest charges related to those benefits

Real estate taxes included in monthly mortgage payments placed in escrow cannot be deducted unless the lender actually paid the taxing authority. This is true whether the real property is used for business or not.

Taxes on gasoline, diesel fuel, and other motor fuels used in business should be deducted as part of the cost of the fuel. Do not deduct these taxes as a separate item.

Any tax imposed by a state or local government on personal property used in your trade or business is deductible.

ANSWER: B

Taxes charged for local benefits and improvements that tend to increase the value of the property are not deductible. These taxes must be added to the basis of the property. These include assessments for streets, sidewalks, water mains, sewer lines, and public parking facilities. Water bills, sewerage, and other service charges assessed against a business property are not real estate taxes, but are deducted as business expenses.

Deductible real estate taxes:

County property tax.....	\$2,000
State property tax.....	<u>1,000</u>
Deductible real estate taxes.....	<u><u>\$3,000</u></u>

46. Pleasant Beach City, to improve downtown commercial business, converted a downtown business area street into an enclosed pedestrian mall. The city assessed the full cost of construction, financed with 10-year bonds, against the affected business properties. The city is paying the principal and interest with the annual payments made by the property owners. The portion that the business owners were assessed to pay the construction costs is

- A. Deductible as taxes.
- B. Deductible as a business expense.
- C. A non-depreciable capital expenditure.
- D. A depreciable capital expenditure.

Rent Expense

47. On January 1, a taxpayer leased a property for her business for 5 years for \$6,200 per year. She paid the full \$31,000 during the first year of the lease. What is the rental deduction for the year?

- A. \$31,000
- B. \$6,200
- C. \$15,500
- D. \$24,800

48. A business owner leased an office for 4 years beginning in March for \$1,500 per month. On March 1, he paid \$33,000 in rent. How much can he deduct for the year?

- A. \$33,000
- B. \$18,000
- C. \$0
- D. \$15,000

ANSWER: D

Assessments for local benefits that tend to increase the value of the property (e.g., assessments for construction of streets, sidewalks, and water and sewer systems) are not deductible. These assessments must be capitalized (added to the basis of the property).

ANSWER: B

If a taxpayer pays rent in advance, she can deduct only the amount that applies to the use of the rented property during the year. The balance must be deducted only over the period to which it applies.

ANSWER: D

If a taxpayer pays rent in advance, he or she can deduct only the amount that applies to the use of the rented property during the year. The balance must be deducted only over the period to which it applies.

Deductible rent expense:

\$1,500 × 10 months (March - Dec) = \$15,000

Other Business Expenses

49. With regard to "other" business expenses, all of the following statements are correct EXCEPT:

- A. Reimbursements you make to job candidates for transportation or other expenses related to interviews for possible employment are deductible business expenses.
- B. Legal fees paid to acquire a new office building are ordinary and necessary expenses directly related to operating your business and are deductible as business expenses.
- C. You may deduct your own education expenses, including certain related travel that is related to your trade or business.
- D. None of the above.

ANSWER: B

Legal fees related to operating a business are deductible as business expenses. However, legal fees paid to acquire business assets are not deductible. These fees must be added to the basis of the property.

50. Amounts paid or incurred to demolish a structure are

- A. Deductible as a casualty loss.
- B. Capitalized and amortized over a 180 month period.
- C. Treated as a reduction of the basis of the structure.
- D. Capitalized and added to the basis of the land where the demolished structure was located.

ANSWER: D

Any amount paid or incurred to demolish a structure or any loss for the undepreciated basis of a demolished structure cannot be deducted. These amounts must be added to the basis of the land where the demolished structure was located.

51. Which of the following is deductible as a business expense?

- A. A penalty for late performance of a contract.
- B. A penalty for late filing of Form 1065 Partnership return.
- C. A penalty for violating the state maximum highway weight law.
- D. A penalty paid to the city for violating the city's housing codes.

ANSWER: A

Penalties paid for late performance or nonperformance of a contract are deductible. However, a taxpayer cannot deduct penalties or fines paid to any government agency or instrumentality because of a violation of any law. These fines or penalties include amounts...

- 1. Paid due to a conviction for a crime or after a plea of guilty or no contest.
- 2. Paid as a penalty imposed by federal, state, or local law in a civil action, including certain additions to tax and additional amounts and assessable penalties imposed by the Internal Revenue Code.
- 3. Paid in settlement of actual or possible liability for a fine or penalty, whether civil or criminal.
- 4. Forfeited as collateral posted for a proceeding that could result in a fine or penalty.

Examples of nondeductible penalties and fines include:

- 1. Fines for violating city housing codes.
- 2. Fines paid by truckers for violating state maximum highway weight laws.
- 3. Fines for violating air quality laws.
- 4. Civil penalties for violating federal laws regarding mining safety standards and discharges into navigable waters.

52. Under which situation below is a deduction allowable for an office in your home?

- A. Your home is the only fixed location of your business of selling mechanics' tools at retail. You regularly use your walk-in closet for storage of inventory and product samples. You also use this area occasionally for personal purposes.
- B. You are an attorney and use a den in your home to write legal briefs. Your family also uses the den for recreation.
- C. You use part of your home exclusively and regularly to read financial periodicals and reports, clip bond coupons, and carry out similar activities to monitor personal investments.
- D. You use your walk-in closet at home exclusively and regularly to bill customers, clients, or patients; to set up appointments; and to order supplies. You also rent office space downtown where you also conduct those same activities. You use the home office three days a week and the rented office space two days a week.

ANSWER: A

To qualify to claim expenses for the business use of the home, a taxpayer must meet both of the following tests:

1. The business part of the home must be used exclusively and regularly for the taxpayer's trade or business.
2. The business part of the home must be:
 - a. The principal place of business, or
 - b. A place where the taxpayer meets or deals with patients, clients, or customers in the normal course of the trade or business, or
 - c. A separate structure (not attached to the home) used in connection with the trade or business.

A taxpayer generally does not have to meet the exclusive use test for the part of the home that the taxpayer regularly uses either for the storage of inventory or product samples, or as a daycare facility.

The home office qualifies as principal place of business if it meets the following requirements:

1. Used exclusively and regularly for administrative or management activities of the trade or business.
2. The taxpayer has no other fixed location where to conduct substantial administrative or management activities of the trade or business.

If the taxpayer has more than one business location, determine the principal place of business based on the following factors:

1. The relative importance of the activities performed at each location.
2. If the relative importance factor does not determine the principal place of business, consider the time spent at each location.

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.

Depreciation, Section 179, Amortization, and Depletion Deduction

Depreciable Property

55. A taxpayer purchased a building lot in 2019 for \$25,000 and constructed his primary residence there for an additional \$175,000. In 2022, he converted it to a rental property. On the date he made this change the fair market value of the converted property was \$225,000. For depreciation purposes, what is his basis in this rental property?

- A. \$150,000
- B. \$175,000
- C. \$200,000
- D. \$225,000

ANSWER: B

If a taxpayer held property for personal use and later changes it to business use or use in the production of income, the basis of the property is the lesser of the following:

1. The fair market value of the property on the date of the change from personal use.
2. The original cost or other basis adjusted as follows:
 - a. Increased by the cost of any improvements.
 - b. Decreased by any tax deductions claimed for casualty and theft losses and other items that reduced the basis.

The taxpayer's adjusted basis in the house when he changed it to business use was \$175,000. On the same date his property had a FMV of \$225,000, of which \$28,125 ($\$225,000 \times (\$25,000 \div \$200,000)$) was for the land and \$196,875 ($\$225,000 \times (\$175,000 \div \$200,000)$) was for the house. The basis for depreciation on the house is the **adjusted basis (\$175,000)**, because it is less than the FMV of \$196,875.

Chapter 5. Business Income and Expenses

56. A taxpayer wants to convert his personal residence to a rental property. He paid \$300,000 for the property and the allocation of value for tax assessment has always been 2/3 building and 1/3 land. Over the years, he incurred \$50,000 in permanent improvements to the house. He claimed a casualty loss deduction of \$5,000 in one year. On the date of conversion, the fair market value of the property was \$600,000. What is the basis for depreciation of this rental?

- A. \$600,000
- B. \$345,000
- C. \$245,000
- D. \$400,000

57. Mr. B paid \$950,000 for an office building and furnishings on January 1. He plans to use the General Depreciation System (GDS) under MACRS for the depreciation of his property. What recovery period must he use for the following items?

- \$900,000 for the building
- \$50,000 for office desks and file cabinets
 - A. 27.5 years for the entire asset, building and furniture.
 - B. 39 years for the building and 5 years for the office furniture.
 - C. 27.5 years for the building and 7 years for the office furniture.
 - D. 39 years for the building and 7 years for the office furniture.

58. Which of the following is not a MACRS depreciation methods under GDS?

- A. The 200% declining balance method over a GDS recovery period.
- B. The 150% declining balance method over a GDS recovery period.
- C. The 100% declining balance method over a GDS recovery period.
- D. The straight line method over a GDS recovery period.

ANSWER: C

Refer to the analysis on the previous question. The depreciable basis in the house is the smaller of:

Adjusted basis of the house:

Cost of house ($\$300,000 \times 2/3$).....	\$200,000
Improvements to house.....	50,000
Less: Casualty loss.....	(5,000)
Adjusted basis of house.....	<u>\$245,000</u>
or	
FMV of house.....	<u>\$600,000</u>

ANSWER: D

The recovery period for nonresidential real property is 39 years and 7 years for office furniture.

ANSWER: C

MACRS provides three depreciation methods under GDS and one depreciation method under ADS.

- The 200% declining balance method over a GDS recovery period.
- The 150% declining balance method over a GDS recovery period.
- The straight line method over a GDS recovery period.
- The straight line method over an ADS recovery period.

Section 179 Deduction

59. The maximum section 179 expense that a taxpayer can elect to deduct for property placed in service in a year is:

- A. \$850,000
- B. \$950,000
- C. \$1,000,000
- D. \$1,080,000

60. A taxpayer purchased and placed in service a packaging machine at a cost of \$2,800,000. He had \$3,000 taxable income from his business before considering the deduction allowed under section 179. What is his allowable section 179 deduction?

- A. \$1,080,000
- B. \$980,000
- C. \$3,000
- D. \$0

61. A taxpayer bought and placed in service computer equipment during the year. He paid \$15,000 cash and received a \$3,000 trade-in allowance for his old computer equipment. He had an adjusted basis of \$4,000 in the old computer equipment. He used both the old and new computer equipment 90% for business and 10% for personal purposes. His allowable section 179 expense deduction is

- A. \$16,200
- B. \$13,500
- C. \$12,600
- D. \$15,000

ANSWER: D

The maximum section 179 expense a taxpayer can elect to deduct in is **\$1,080,000**.

ANSWER: C

The total cost that can be deducted each year under section 179 is limited to the taxable income from the active conduct of any trade or business during the tax year. In this question, the taxpayer is limited to his \$3,000 of taxable income.

ANSWER: B

If a taxpayer purchases a property with cash and a trade-in, part of the basis in the new property is the adjusted basis in the trade-in property. Therefore, only the portion of the new property's basis paid by cash qualifies for the section 179 deduction. When a property is used for both business and nonbusiness use figure the part of the cost of the property that is used for business use by multiplying the cost of the property by the percentage of business use.

New computer (cash paid).....	\$15,000
Multiply by business use.....	<u>× 90%</u>
Section 179 expense deduction.....	<u><u>\$13,500</u></u>

Chapter 5. Business Income and Expenses

62. A calendar year taxpayer bought and placed in service in 2020 an item of 3-year property at a cost of \$5,000. She elected the Section 179 deduction of \$5,000 for the property. She used the property 100% for business in 2020 and 2021. In 2022, she used it for personal purposes only. She must determine if she needs to recapture any of the Section 179 deduction, because of the change from business to personal. If allowable depreciation for 2020 and 2021 would have been \$3,500 (if Section 179 had not been elected) how much Section 179 recapture must she claim?

- A. \$0
- B. \$1,500
- C. \$3,500
- D. \$5,000

63. JM Company placed in service a machine that cost \$2,800,000. If JM placed no other Section 179 property in service during the year, how much is the Section 179 maximum dollar limit?

- A. \$0
- B. \$525,000
- C. \$980,000
- D. \$1,080,000

64. A taxpayer bought a new car for \$64,000 on March 2. He will use the automobile 100% of the time in his business. The recovery period for passenger autos is 5 years. What is the maximum amount of depreciation that can be taken for the year?

- A. \$64,000
- B. \$19,200
- C. \$11,200
- D. \$3,160

65. On January 1, a taxpayer purchased a car for \$30,000. Her business use was 60% during the year. What is her total deduction for calendar tax year?

- A. \$1,836
- B. \$11,200
- C. \$11,520
- D. \$19,200

ANSWER: B

A taxpayer may have to recapture the section 179 deduction if the percentage of business use drops to 50% or less in any year during the property's recovery period. To figure the amount to recapture, take the following steps:

1. Figure the depreciation that would have been allowable on the section 179 deduction claimed.
2. Subtract the depreciation that would have been allowable from the section 179 deduction claimed.
3. The result is the amount that must be recaptured.

Amount of section 179 recapture:

$$\text{\$5,000} - \text{\$3,500} = \text{\$1,500}$$

ANSWER: C

There is an investment limit and an income limit for section 179 property. For each dollar of cost of section 179 property placed in service exceeds \$2,700,000 in a tax year, the \$1,080,000 maximum is reduced dollar for dollar to zero. In this question the taxpayer placed a machine in service costing \$2,800,000. Because the machine cost is \$100,000 more than \$2,700,000, the taxpayer must reduce their \$1,080,000 limit by \$100,000. The section 179 maximum dollar limit is **\$980,000**.

ANSWER: B

The first-year limit on the total section 179 deduction, special depreciation allowance, and depreciation deduction for most cars including trucks and vans has increased to \$19,200 (\$11,200 if electing not to claim the special depreciation allowance).

ANSWER: C

The first-year limit on the total section 179 deduction, special depreciation allowance, and depreciation deduction for most cars has increased to \$19,200 (\$11,200 if you elect not to claim the special depreciation allowance). The \$19,200 limit must be multiplied by the business portion of the auto.

Total deduction:

$$\text{\$19,200} \times 60\% = \text{\$11,520}$$

Amortization

66. Section 197 intangibles acquired after August 10, 1993 must be amortized over

- A. 5 years
- B. 10 years
- C. 15 years
- D. 20 years

67. All of the following "Section 197 intangibles" acquired after August 10, 1993, must be amortized over 15 years EXCEPT:

- A. A covenant not to compete entered in connection with the acquisition of an interest in a trade or business.
- B. A patent that you created, but not in connection with the acquisition of assets constituting a trade or business or a substantial part of a trade or business.
- C. A fast food franchise.
- D. A governmental license including renewals.

ANSWER: C

Section 197 intangibles acquired after August 10, 1993 must be amortized over 15 years.

ANSWER: B

The following assets are section 197 intangibles.

- 1. Goodwill.
- 2. Going concern value.
- 3. Workforce in place.
- 4. Business books and records, operating systems, or any other information base, including lists or other information concerning current or prospective customers.
- 5. A patent, copyright, formula, process, design, pattern, know-how, format, or similar item.
- 6. A customer-based intangible.
- 7. A supplier-based intangible.
- 8. A license, permit, or other right granted by a government unit or agency (including issuances and renewals).
- 9. A covenant not to compete entered into in connection with an acquisition of an interest in a trade or business.
- 10. A franchise, trademark, or trade name.
- 11. A contract for the use of, or a term interest in, any item above.

Depletion

68. All of the following qualify for the depletion deduction EXCEPT:

- A. Oil and gas
- B. Timber
- C. Land
- D. Geothermal deposits

ANSWER: C

Depletion is the using up of natural resources by mining, quarrying, drilling, or felling. The depletion deduction allows an owner or operator to account for the reduction of a product's reserves. Depletion can be deducted for mineral property or standing timber. There are two ways of figuring depletion on mineral property:

1. Cost depletion.
2. Percentage depletion.

For mineral property, a taxpayer must use the method that gives him the larger deduction. For standing timber, the taxpayer must use cost depletion. Mineral property includes oil and gas wells, mines, and other natural deposits (including geothermal deposits). Land cannot be depreciated or depleted.

69. Which of the following would NOT qualify for a depletion deduction?

- A. Gas well
- B. Timber lot
- C. Oil refinery
- D. Stone quarry

ANSWER: C

Refer to the analysis on the previous question. An oil well would qualify as a depletion deduction, not an oil refinery.

General Business Credit

Work Opportunity Credit

70. An employee that qualifies for the work opportunity credit must be a member of a targeted group. All of the following are considered a targeted group EXCEPT:

- A. Qualified veteran.
- B. A qualified relative of the employer.
- C. Qualified summer youth employee.
- D. Long-term family assistance recipient.

ANSWER: B

The work opportunity credit provides businesses with an incentive to hire individuals from groups that have a particularly high unemployment rate or other special employment needs. The business does not have to be in an empowerment zone, enterprise community, or renewal community to qualify for this credit. An employer can claim this credit if he pays or incurs "qualifying first-year wages" to a "targeted group employee." A targeted group employee is any employee who has been certified by the employer's state employment security agency as a:

1. Long-term family assistance recipient.
2. Qualified recipient of Temporary Assistance for Needy Families (TANF).
3. Qualified veteran.
4. Qualified ex-felon.
5. Designated community resident.
6. A Vocational rehabilitation referral.
7. A qualified summer youth employee.
8. Supplemental Nutrition Assistance Program (SNAP) benefits (food stamps) recipient.
9. An SSI recipient.

Credit for Small Employer Pension Startup Costs

71. A taxpayer started a SIMPLE plan for all five of her employees and herself. It cost her \$400 in fees to administer the plan. She never had a pension plan prior to starting this plan. Her tax credit is

- A. \$200
- B. \$400
- C. \$0
- D. \$100

ANSWER: A

The credit for small employer pension startup costs (Form 8881) applies to pension plan startup costs. If an employer begins a new qualified defined benefit or defined contribution plan (including a 401(k) plan), SIMPLE plan, or simplified employee pension, she can receive a tax credit of 50% of qualified startup costs up to a maximum of \$500 each year for the first three years of the plan. The employer can choose to start claiming the credit in the tax year before the tax year in which the plan becomes effective. The employer must have had 100 or fewer employees who received at least \$5,000 in compensation for the preceding year. At least one participant must be a non-highly compensated employee. The employees generally cannot be substantially the same employees for whom contributions were made or benefits accrued under a plan of any of the following employers in the 3-tax-year period immediately before the first year to which the credit applies.

Credit for small employer pension startup costs:

\$400 administer fees × 50% = \$200

Disabled Access Credit

72. The F&E Partnership spent \$100,000 on eligible access expenditures that qualify for the disabled access credit. The partnership had gross receipts of \$1 million and 30 full-time employees during the preceding tax year. What is the amount of the disabled access credit for the year?

- A. \$5,000
- B. \$10,000
- C. \$250
- D. \$50,000

73. A taxpayer owns an office building. He opened a business in 2021 and made numerous renovations during 2022 to the building to bring it into compliance with the Americans with Disabilities Act of 1990. He had gross receipts of \$750,000 dollars and ten full-time employees during 2021. He spent \$15,000 in eligible access expenditures. What is the current year Disabled Access Credit?

- A. \$5,000
- B. \$1,500
- C. \$14,750
- D. \$7,500

ANSWER: A

An eligible small business is entitled to a nonrefundable disabled access credit for expenditures incurred to make a business accessible to disabled individuals. For purposes of the credit, an eligible small business is any business or person that:

1. Had gross receipts for the preceding tax year that did not exceed \$1 million or had no more than 30 full-time employees during the preceding tax year.
2. Elects (by filing Form 8826) to claim the disabled access credit for the tax year.

The amount of the credit is 50% of the amount the expenditures for a year that are more than \$250 but not more than \$10,250. The credit is figured as follows:

1. Total eligible access expenditures...\$100,000
2. Minimum amount..... \$250
3. Subtract line 2 from line 1..... \$99,750
4. Maximum amount..... \$10,000
5. Enter the smaller of line 3 or line 4 \$10,000
6. Multiply line 5 by 50%.....\$ 5,000

ANSWER: A

Refer to the analysis on the previous question. The amount of the credit is 50% of the amount the expenditures for a year that are more than \$250 but not more than \$10,250. The credit is figured as follows:

1. Total eligible access expenditures...\$15,000
2. Minimum amount..... 250
3. Subtract line 2 from line 1 14,750
4. Maximum amount..... 10,000
5. Enter the smaller of line 3 or line 4 10,000
6. Multiply line 5 by 50%.....\$ 5,000

Employer-Provided Childcare Facilities and Service Credit

74. XYZ, Inc. remodeled and converted a portion of their building into a licensed child care facility open for the care of any of their employees' children. The cost of this remodeling qualifies for which of the following:

- A. An asset to be depreciated over the remaining useful life of the building.
- B. An adjustment to income of 75% of the costs, with the balance depreciable.
- C. A tax credit of 25% of the qualified expenses, maximum credit of \$150,000, with the balance depreciable.
- D. Section 179 expensing election.

75. In regards to the credit for Employer-Provided Child-care facilities and services, which of the following is NOT true?

- A. The employer applies for the credit on Form 8882, Credit for Employer-Provided Child Care Facilities and Services.
- B. The credit allows for 25% of qualified expenses paid for employee childcare.
- C. The credit allows for 10% of qualified expenses paid for childcare resource and referral services.
- D. The dollar amount of the credit is not limited.

76. A taxpayer runs a manufacturing business employing several people with young children. He decided he would allocate some of the unused space in his manufacturing facility to a child care facility. He incurred \$20,000 in qualified childcare facility expenditures. He had no qualified childcare resource and referral expenditures and had no pass through credits. What is his employer-provided childcare facilities and service credit?

- A. \$20,000
- B. \$2,000
- C. \$10,000
- D. \$5,000

ANSWER: C

The employer-provided childcare facilities and services credit applies to the qualified expenses an employer pays for employee childcare and qualified expenses paid for childcare resource and referral services. The credit is 25% of qualified expenses an employer pays for employee childcare and 10% of qualified expenses paid for childcare resource and referral services. This credit is limited to \$150,000 each year.

ANSWER: D

Refer to the analysis on the previous question. This credit is limited to \$150,000 each year.

ANSWER: D

The credit is 25% of qualified expenses an employer pays for employee childcare.

Credit for employer-provided childcare facility:
 $\$20,000 \times 25\% = \$5,000$

Limitation on Losses

Net Operating Losses

77. A non farmer taxpayer sustained a net operating loss (NOL) for the tax year. The NOL can be

- A. Carried back 2 years, then carry forward 10 years.
- B. Carried forward up to 10 years.
- C. Carried forward indefinitely.
- D. An NOL cannot be carried forward.

ANSWER: C

The special rules permitting 5-year carrybacks for 2018, 2019, and 2020 net operating losses (NOLs) added by the Coronavirus Aid, Relief, and Economic Security Act (CARES Act) of 2020 have expired. Generally, taxpayer can only carry NOLs arising in tax years ending after 2020 forward indefinitely. An exception applies to certain farming losses, which may be carried back 2 years. The NOL can then be carried forward indefinitely.

78. Which of the following losses generally would NOT generate a net operating loss?

- A. Loss from trade or business.
- B. Casualty or theft loss resulting from a federally declared disaster.
- C. Loss from rental property.
- D. Loss created by sale of personal residence for less than its cost.

ANSWER: D

A net operating loss results when deductions are more than income in a particular tax year. An NOL must be caused by deductions from one of the following:

1. A trade or business.
2. Unreimbursed employee business expenses (only for employees still eligible to take employee business expenses).
3. Casualty or theft losses resulting from a federally declared disaster.
4. Moving expenses (only for member of the Armed Forces on active duty that qualify to deduct moving expenses).
5. Rental property.

79. A taxpayer owns a business that generated a \$7,000 loss. She sold some of the land she uses for the business at a \$3,000 gain, and some business equipment at a loss of \$1,000. She also earned \$1,750 from her part-time job. She earned \$450 in interest on her personal savings account. She files as single and claims the standard deduction. Her standard deduction is \$12,950. Her net operating loss (NOL) is

- A. \$2,250
- B. \$10,600
- C. \$2,800
- D. \$3,250

ANSWER: D

The first step in figuring an NOL is to separate the business income and deductions from nonbusiness income and deductions. Salary and wages earned are considered business income. The interest income is considered non-business income. Ignore the personal exemption and standard deduction in figuring an NOL.

Net operating loss:

Wage.....	\$1,750
Net gain on sale of business property	
(\$3,000 - \$1,000).....	2,000
Net loss from business.....	<u>(7,000)</u>
Net operating loss.....	<u><u>(\$3,250)</u></u>

Not-for-profit Activities

80. The portion of expenses which exceeds income from an activity is not deductible if that activity is classified as a hobby. A taxpayer may, however, establish the presumption that an activity (one not related to horses) is a bona fide business engaged in for profit if

- A. The activity shows a profit at least 50% of the time.
- B. The activity is profitable at least 2 out of 5 consecutive years.
- C. The activity shows a profit at least 2 out of 7 consecutive years.
- D. The activity is profitable at least 3 out of 5 consecutive years.

81. The disallowance of not-for-profit activity losses applies to all of the following EXCEPT:

- A. C Corporations
- B. S Corporations
- C. Partnerships
- D. Trusts

82. In determining whether an activity is engaged in for profit, the relevant facts and circumstances are taken into account. All of the following may indicate you are carrying on the activity for profit EXCEPT:

- A. You carry on the activity in a businesslike manner.
- B. You depend on income from the activity for your livelihood.
- C. You can expect to make a future profit from the appreciation of assets used in the activity.
- D. Despite your lack of profitability, you continue to use the same methods of operation to prove that you are serious and the activity is not just a hobby.

ANSWER: D

An activity is presumed carried on for profit if it produced a profit in at least 3 of the last 5 years including the current year. Activities that consist primarily of breeding, training, showing, or racing horses are presumed carried on for profit if they produced a profit in at least 2 of the last 7 tax years.

ANSWER: A

The limit on not-for-profit losses applies to individuals, partnerships, estates, trusts, and S corporations. It does not apply to corporations other than S corporations.

ANSWER: D

In determining whether a taxpayer is carrying on an activity for profit, all the facts are taken into account. No one factor alone is decisive. Among the factors to consider are whether:

- 1. The activity is carried on in a businesslike manner.
- 2. The time and effort put into the activity indicates intent to make it profitable.
- 3. Depending on income from the activity to make a living.
- 4. Losses are due to circumstances beyond the taxpayer's control (or are normal in the start-up phase of your type of business).
- 5. Changing methods of operation in an attempt to improve profitability.
- 6. The taxpayer, or his or her advisors, have the knowledge needed to carry on the activity as a successful business.
- 7. Taxpayer was successful in making a profit in similar activities in the past.
- 8. The activity makes a profit in some years, and how much profit it makes.
- 9. Expectation to make a future profit from the appreciation of the assets used in the activity.

Passive Activity Limits

83. A taxpayer materially participated in a business for a tax year if any of the following tests are met EXCEPT:

- A. The taxpayer participated in the activity for more than 500 hours.
- B. The taxpayer participated in the activity for more than 100 hours during the tax year, and participated at least as much as any other individual for the year.
- C. The taxpayer's participation was substantially all the participation in the activity of all individuals for the tax year, including the participation of individuals who did not own any interest in the activity.
- D. The taxpayer materially participated in the activity for any 3 (whether or not consecutive) of the 5 immediately preceding tax years.

ANSWER: D

A taxpayer has materially participated in a trade or business activity for a tax year if any of the following tests is met:

- 1. The taxpayer participated in the activity for more than 500 hours.
- 2. The taxpayer participation was substantially all the participation in the activity of all individuals for the tax year, including the participation of individuals who did not own any interest in the activity.
- 3. The taxpayer participated in the activity for more than 100 hours during the tax year, and participated at least as much as any other individual (including individuals who did not own any interest in the activity) for the year.
- 4. The activity is a significant participation activity, and the taxpayer participated in all significant participation activities for more than 500 hours. A significant participation activity is any trade or business activity in which the taxpayer participated for more than 100 hours during the year and in which the taxpayer did not materially participate under any of the material participation tests, other than this test.
- 5. The taxpayer materially participated in the activity for any 5 (whether or not consecutive) of the 10 immediately preceding tax years.
- 6. The activity is a personal service activity in which the taxpayer materially participated for any 3 (whether or not consecutive) preceding tax years. An activity is a personal service activity if it involves the performance of personal services in the fields of health (including veterinary services), law, engineering, architecture, accounting, actuarial science, performing arts, consulting, or any other trade or business in which capital is not a material income-producing factor.
- 7. Based on all the facts and circumstances, the taxpayer participated in the activity on a regular, continuous, and substantial basis during the year.

At-Risk Rules

84. A taxpayer started his own business. He paid \$8,000 for a truck, contributed \$15,000 cash and paid \$20,000 for tools for the business. His bank loaned \$50,000 to buy a building for the business. The building secures the loan. What is his at-risk amount for this activity?

- A. \$53,000
- B. \$43,000
- C. \$93,000
- D. \$103,000

ANSWER: B

Generally, a deductible loss from a trade or business or other income-producing activity is limited to the investment "at-risk" in the activity. A taxpayer is "at-risk" for the following items:

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

At-risk amount for activity:

Cash.....	\$15,000
Truck.....	8,000
Tools.....	<u>20,000</u>
At-risk amount for activity.....	<u>\$43,000</u>

Since the building is used to secure the loan and is also used in the activity, the \$50,000 loan is not at risk.

Chapter 6. Business Assets

Basis of Property

Purchase of Property

1. A taxpayer operated a small manufacturing plant and purchased a new plastic mold stamping machine. The cost included the following:

- Cost of machine: \$88,000
- Sales tax: 4,000
- Freight charges to deliver property to her: 1,500
- Excise taxes: 2,000

What is the basis in the machine?

- A. \$95,500
- B. \$93,500
- C. \$89,500
- D. \$88,000

ANSWER: A

The basis of property purchased, for use in a business, 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).

Cost of machine.....	\$88,000
Sales tax.....	4,000
Freight charges to deliver property....	1,500
Excise taxes.....	2,000
Basis in the machine.....	<u>\$95,500</u>

2. A taxpayer purchased a truck to be used in his business. The truck's cost was \$22,000. In addition, he paid sales tax of \$1,100 and \$900 freight to have the truck delivered immediately from another dealer. What is the depreciable basis of the truck?

- A. \$22,000
- B. \$23,100
- C. \$24,000
- D. \$22,900

ANSWER: C

Cost of the truck.....	\$22,000
Sales tax.....	1,100
Freight charges to deliver truck.....	900
Depreciable basis of the truck.....	<u>\$24,000</u>

Chapter 6. Business Assets

3. 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

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.....	<u>1,500</u>
Cost basis in house.....	<u><u>\$127,100</u></u>

4. A sole proprietor bought a building for \$350,000 cash. Settlement costs were \$12,500. The business placed \$15,000 in escrow for future payment on taxes and insurance and assumed an existing mortgage of \$20,000 on the property. Legal fees of \$7,500 were incurred for defending and perfecting title in a lawsuit that occurred during the year. What is the adjusted basis of the building?

- A. \$390,000
- B. \$405,000
- C. \$385,000
- D. \$377,500

ANSWER: A

Refer to the analysis on the previous question. Amounts placed in escrow for future payment of items such as taxes and insurance are not included in the basis of a property.

Adjusted basis of the building:

Cash paid.....	\$350,000
Settlement costs.....	12,500
Assumption of mortgage.....	20,000
Legal fees for defending & perfecting title.....	<u>7,500</u>
Adjusted basis of the building.....	<u><u>\$390,000</u></u>

5. 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

6. 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: 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>

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>

Chapter 6. Business Assets

7. 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

8. 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

9. P&L Partnership purchased a building for business purposes for \$200,000. Carpeting was installed at a cost of \$8,000 and furniture was purchased at a cost of \$10,000. Legal fees of \$700 and recording fees of \$100 were incurred at the time the building was purchased. What is the cost basis of the building?

- A. \$218,800
- B. \$200,000
- C. \$200,800
- D. \$218,000

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.....	250
Basis in the property.....	<u>\$200,650</u>

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>

ANSWER: C

The cost basis of the building includes the purchase price (\$200,000), legal fees (\$700), and recording fees (\$100). The furniture is not part of the cost basis of the building and is depreciated over its own recovery period. The carpeting is an improvement and is not added to the cost basis of the building.

10. 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.

11. 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.

12. 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

13. 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

14. 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

15. 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

16. 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

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.

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.

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.

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.....	<u>48,000</u>
Donee's basis in the property.....	<u>\$66,200</u>

Inherited Property

17. 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.

18. 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.

Chapter 6. Business Assets

19. 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

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.

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: 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.

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

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.

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: 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.

Property Received in Nontaxable Transactions

23. A taxpayer exchanged a building for another like-kind building. His had a basis of \$16,000, plus he had made \$10,000 in improvements prior to the exchange. He exchanged it for a building worth \$36,000. He did not recognize any gain from the exchange on his individual tax return. What is his basis in the new property?

- A. \$26,000
- B. \$36,000
- C. \$10,000
- D. \$16,000

ANSWER: A

The basis of the property received in a nontaxable exchange is the same as the basis of the property exchanged increased by the additional amount paid.

Basis of the new property:	
Basis of old property.....	\$16,000
Improvements.....	<u>10,000</u>
Basis of the new property.....	<u>\$26,000</u>

24. A taxpayer owned an office building for investment purposes. His adjusted basis in the building was \$75,000 and the fair market value (FMV) was \$90,000. He exchanged his investment for other real estate held for investment with a FMV of \$80,000. What is his basis in the new building?

- A. \$80,000
- B. \$90,000
- C. \$95,000
- D. \$75,000

ANSWER: D

Since no cash or unlike property was received in addition to like-kind property in a like-kind exchange, the basis of the property received is the same as the basis of the old property exchanged.

Chapter 6. Business Assets

25. The total basis for all properties qualifying for nontaxable exclusion that you receive in a partially nontaxable exchange is the total adjusted basis of the properties you give up with the following adjustments EXCEPT:

- A. Any additional cost you incur.
- B. Any money you receive.
- C. Unlike property you receive up to its cost on the date of the exchange.
- D. Any gain you recognize on the exchange.

ANSWER: C

A partially nontaxable exchange is an exchange in which unlike property or money is received in addition to like property. The basis of the property received is the same as the basis of the property given up, with the following adjustments:

- 1. Decrease the basis by the following amounts:
 - a. Any money received.
 - b. Any loss recognized on the exchange.
- 2. Increase the basis by the following amounts:
 - a. Any additional costs incurred.
 - b. Any gain recognized on the exchange.

Stock Dividends, Rights and Splits

26. 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

27. 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

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 shs × \$20 = \$6,000

Basis after 3 for 2 stock split:

\$6,000 ÷ 450 shares = \$13.33 a share

28. 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

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.

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.

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.

30. 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

31. 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.

Adjustments to Basis

32. All of the following items will increase the basis in an asset EXCEPT:

- A. Section 179 deduction.
- B. Capital improvements.
- C. Installation costs.
- D. Zoning cost.

ANSWER: A

A section 179 deduction will **decrease** the basis of an asset. The following items **increase** the basis of a property:

1. The cost of extending utility service lines to the property.
2. Impact fees.
3. Legal fees, such as the cost of defending and perfecting title.
4. Legal fees for obtaining a decrease in an assessment levied against property to pay for local improvements.
5. Zoning costs.
6. The capitalized value of a redeemable ground rent.

The cost of painting the interior of the building is a current expense that is deductible in the year paid. It does not have to be capitalized (added to basis).

33. Which of the following does NOT reduce the basis of property?

- A. Credit for qualified electric vehicles
- B. Depreciation
- C. Zoning Costs
- D. Section 179 deductions

ANSWER: C

The following items decrease the basis in a property:

1. The section 179 deduction.
2. Depreciation.
3. The deduction for clean-fuel vehicles and clean-fuel vehicle refueling property.
4. Nontaxable corporate distributions.
5. Deductions previously allowed (or allowable) for amortization, depreciation, and depletion.
6. Exclusion from income of subsidies for energy conservation measures.
7. Credit for qualified electric vehicles.
8. Gain from the sale of an old home on which tax was postpone.
9. Investment credit (part or all of credit) taken.
10. Casually and theft losses.
11. Certain canceled debt excluded from income.
12. Rebates received from the manufacturer or seller.
13. Easements.
14. Gas-guzzler tax.
15. Tax credit or refund for buying a diesel-powered highway vehicle.
16. Adoption tax benefits.
17. Credit for employer-provided child care.

Zoning costs increases the basis of property.

34. A taxpayer has both short-term capital loss and nontaxable distribution 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 invested.
- C. Short-term capital loss reduces the basis of the investment.
- D. Short-term capital losses have no effect on basis.

ANSWER: C

A nontaxable distribution is a return of capital and would reduce the basis of the investment. Short-term capital losses have no effect on basis of the investment.

Goodwill

35. When a group of assets that is a trade or business is purchased for a lump sum, the price assigned to each asset may be determined by using any of the following rules EXCEPT:

- A. Make the allocation among the assets in proportion to (but not in excess of) their fair market value on the purchase date.
- B. The seller and the buyer may make a written agreement to allocate the consideration or the fair market value of any asset. The agreement is binding on both parties unless the IRS determines that the amounts are not appropriate.
- C. The seller and the buyer may make a specific allocation to each asset if it is based on the value of each asset and the seller and the buyer have adverse interests.
- D. Make the allocation among the assets in the following order: 1) cash, demand deposits, etc. 2) certificates of deposit, U. S. Government securities, readily marketable stock or securities, and foreign currency; 3) Section 197 intangibles (other than goodwill and going concern value); and 4) any excess is allocated to tangible assets based on fair market value.

ANSWER: D

When acquiring a group of assets that is a trade or business to which goodwill (or going concern value) could attach, use the following method to allocate the purchase price to the various assets. Allocate the purchase price in the following order:

1. Cash, demand deposits and similar accounts.
2. Certificates of deposits, U.S. Government securities, readily marketable stock or securities, and foreign currency.
3. Accounts receivable, mortgage, and credit card receivables that arose in the ordinary course of business.
4. All other assets except section 197 intangibles, goodwill, and going concern value.
5. Section 197 intangibles except goodwill and going concern value.
6. Goodwill and going concern value (whether or not they qualify as section 197 intangibles).

Gains and Losses on Sales of Business Property

Section 1231 Property

36. Which of the following transactions is NOT a transaction that results in a gain or loss subject to section 1231 treatment?

- A. Sales or exchanges of leaseholds.
- B. Sales or exchanges of cattle and horses.
- C. The sale of a copyright, literary, musical, or artistic composition that you created.
- D. Sales or exchanges of unharvested crops sold together with land to the same buyer.

ANSWER: C

The following transactions result in gain or loss subject to section 1231 treatment:

1. **Sales or exchanges of real property or depreciable personal property.** This property must be used in a trade or business and held longer than 1 year. Generally, property held for the production of rents or royalties is considered to be used in a trade or business. Depreciable personal property includes amortizable section 197 intangibles.
2. **Sales or exchanges of leaseholds.** The leasehold must be used in a trade or business and held longer than 1 year.
3. **Sales or exchanges of cattle and horses.** The cattle and horses must be held for draft, breeding, dairy, or sporting purposes and held for 2 years or longer.
4. **Sales or exchanges of other livestock.** This livestock does not include poultry. It must be held for draft, breeding, dairy, or sporting purposes and held for 1 year or longer.
5. **Sales or exchanges of unharvested crops.** The crop and land must be sold, exchanged, or involuntarily converted at the same time and to the same person and the land must be held longer than 1 year. The taxpayer cannot keep any right or option to directly or indirectly reacquire the land (other than a right customarily incident to a mortgage or other security transaction). Growing crops sold with a lease on the land, though sold to the same person in the same transaction, are not included.
6. **Cutting of timber or disposal of timber, coal, or iron ore.** The cutting or disposal must be treated as a sale.
7. **Condemnations.** The condemned property must have been held longer than 1 year. It must be business property or a capital asset held in connection with a trade or business or a transaction entered into for profit, such as investment property. It cannot be property held for personal use.
8. **Casualties and thefts.** The casualty or theft must have affected business property, property held for the production of rents and royalties, or investment property (such as notes and bonds). The property must have been held longer than 1 year. However, if the casualty or theft losses are more than the casualty or theft gains, neither the gains nor the losses are taken into account in the section 1231 computation.

Section 1245 Property

37. In 2018, a taxpayer purchased a machine used in his business. The machine cost \$50,000 and he claimed a \$20,000 section 179 deduction for that machine. In 2022, he sold the machine for \$52,000. The accumulated depreciation from 2018 through 2022 was \$18,974 (not including the section 179 deduction). How much is the taxable gain and what portion of that gain must be reported as ordinary income under section 1245?

- A. Taxable gain of \$40,974 and ordinary income of \$38,974.
- B. Taxable gain of \$40,974 and ordinary income of \$40,974.
- C. Taxable gain of \$20,974 and ordinary income of \$18,974.
- D. Taxable gain of \$2,000 and ordinary income of \$2,000.

38. A taxpayer sold a business asset for \$65,000. He purchased the asset for \$90,000. He has taken \$60,000 of depreciation, which includes \$10,000 Section 179 expensing election. The taxpayer will report the following on the sale of the asset:

- A. Ordinary loss of \$25,000.
- B. Long-term capital gain of \$35,000.
- C. Ordinary income of \$35,000.
- D. Ordinary income of \$10,000 and long-term capital gain of \$25,000.

ANSWER: A

A gain on the disposition of section 1245 property is treated as ordinary income to the extent of depreciation allowed or allowable on the property. The amount of gain treated as ordinary income is limited to the lower of:

- 1. Depreciation and amortization taken (recomputed basis minus adjusted basis), or,
- 2. The gain on disposition.

A gain on the disposition of section 1245 property is treated as ordinary income to the extent of depreciation:

Cost of candy making machine.....	\$50,000
Less: Accumulated depreciation.....	38,974
Adjusted basis.....	<u>\$11,026</u>

Amount realized.....	\$52,000
Less: Adjusted basis.....	11,026
Gain from sale.....	<u>\$40,974</u>

Ordinary income is \$38,974, or the lesser of:

- 1. Recomputed basis, \$38,974 (depreciation taken), or
- 2. Gain from disposition \$40,974.

ANSWER: C

Refer to the analysis on the previous question.

Cost of backhoe.....	\$90,000
Less: Accumulated depreciation.....	60,000
Adjusted basis.....	<u>\$30,000</u>

Amount realized.....	\$65,000
Less: Adjusted basis.....	30,000
Gain from sale.....	<u>\$35,000</u>

Ordinary income is \$35,000, or the lesser of:

- 1. Recomputed basis, \$60,000 (depreciation taken), or
- 2. Gain from disposition \$35,000.

Chapter 6. Business Assets

39. Which of the following types of depreciable property is NOT Section 1245 property?

- A. Single purpose agricultural (livestock) structures.
- B. Tangible personal property.
- C. Intangible personal property.
- D. Office building.

ANSWER: D

Section 1245 property includes any property that is or has been subject to an allowance for depreciation and that is:

1. Personal property (both tangible and intangible),
2. Other tangible property (except most buildings and their structural components) used as:
 - a. An integral part of manufacturing, production, or extraction or of furnishing transportation, communications, electricity, gas, water, or sewage disposal services,
 - b. A research facility in any of the activities in (a) above, or
 - c. A facility in any of the activities in (a) for the bulk storage of fungible commodities.
3. Real property (not included in (2)), to the extent its adjusted basis was reduced by amortization deductions for certified pollution control facilities, reforestation expenditures, on-the-job training and child-care facilities, or for which a section 179 deduction was taken,
4. Single purpose agricultural (livestock) or horticultural structures, or
5. Storage facilities (except buildings and their structural components) used in distributing petroleum or any primary product of petroleum.

An office building is section 1250 property.

Section 1250 Property

40. A taxpayer sold his rental house for \$190,000. The depreciation taken under ACRS was \$67,500. If the taxpayer had used the straight-line method, the depreciation would have been \$64,500. How much Section 1250 gain did this taxpayer have when the house was sold?

- A. \$3,000
- B. \$64,500
- C. \$67,500
- D. \$122,500

ANSWER: A

The section 1250 gain (ordinary income) is the difference between the depreciation taken using the accelerated method and the depreciation using the straight line method.

Accelerated depreciation (given).....	\$67,500
Less: Straight-line depreciation.....	64,500
Section 1250 gain (ordinary income)....	<u>\$ 3,000</u>

Nontaxable Property Transactions

41. All of the following statements with respect to the identification requirement of like-kind property are correct EXCEPT:

- A. You can identify more than one replacement property.
- B. You cannot identify replacement property that is not yet in existence or is being produced.
- C. The property to be received must be identified on or before the day that is 45 days after the date you transfer the property given up in the exchange.
- D. You must clearly describe the replacement property in the signed written document that you deliver to the other person involved in the exchange.

42. Which of the following transactions qualifies as a like-kind exchange?

- A. The exchange of a copyright on a novel for a copyright on a song.
- B. An exchange of the "goodwill or going concern value" of a business for the "goodwill or going concern value" of another business.
- C. An exchange of land improved with an apartment house for land improved with a store building.
- D. An exchange of personal property used predominantly in the United States for personal property used predominantly outside the United States.

ANSWER: B

To be nontaxable, a like-kind exchange must meet all the following conditions:

- 1. Both the property transferred and the property received must be real property used in a trade or business or investment property.
- 2. The real property must not be held primarily for sale.
- 3. There must be an exchange of like-kind real property.
- 4. Real property to be received must be identified within 45 days after the date of transfer of the real property given up in the exchange.
- 5. The exchange must be completed the earlier of:
 - a. Within 180 days of the transfer of property given up in the exchange,
 - b. The due date, including extensions, of tax return.

If, in addition to like property, a taxpayer receives money or unlike property in a like-kind exchange, the taxpayer must recognize any gain realized to the extent of the money and the FMV of the unlike property received.

ANSWER: C

Refer to the analysis on the previous question.

Chapter 6. Business Assets

43. Assuming all items are held for use in a business or for investment, which of the following does NOT qualify as a nontaxable like-kind exchange?

- A. The exchange of stock of one corporation held for investment for stock of another corporation to be held for investment.
- B. The trade of an apartment house for a store building that is subsequently rented out.
- C. The exchange of a vacant city lot for unimproved farm land.
- D. An exchange of real estate you own for a real estate lease that runs 30 years.

44. Which of the following statements with respect to the exchange of like-kind property is correct?

- A. If there is an exchange of like-kind property in which you also received cash and the exchange results in a loss to you, you are allowed to deduct a loss to the extent of cash received.
- B. If there is an exchange of like-kind property in which you also give cash and the exchange results in a gain to you, you must report any gain to the extent of the cash given.
- C. If there is an exchange of like-kind property in which you also receive cash and the exchange results in a gain to you, you do NOT have to report the gain.
- D. If there is an exchange of like-kind property in which you also give cash and the exchange results in a loss to you, you CANNOT deduct a loss.

45. If there is a like-kind exchange of property between related parties, how long do they have to wait to dispose of the property received in order NOT to recognize any gain on the exchange?

- A. NO waiting period
- B. 6 months
- C. 1 year
- D. 2 years

ANSWER: A

The exchange of real estate you own for a real estate lease that runs 30 years or longer is a like-kind exchange. However, not all exchanges of interests in real property qualify. The exchange of a life estate expected to last less than 30 years for a remainder interest is not a like-kind exchange.

ANSWER: D

If, in addition to like property, a taxpayer receives money or unlike property in a like-kind exchange, the taxpayer must recognize any gain realized to the extent of the money and the FMV of the unlike property received. If the taxpayer, in addition to giving up like-kind property, pays money, the taxpayer recognizes no gain or loss on the exchange. The basis of the property received is the basis of the property given up, increased by the money paid.

ANSWER: D

No gain or loss is recognized on like-kind exchanges of business or investment properties. This applies even if the exchange of property is between related parties. However, if either related party disposes of the like-kind property within 2 years after the exchange, the gain or loss on the exchange must be recognized.

46. A taxpayer exchanges real estate held for investment with an adjusted basis of \$400,000 and a mortgage of \$100,000 for other real estate to be held for investment. The other party agrees to assume the mortgage. The fair market value of the real estate she receives is \$500,000. She pays exchange expenses of \$10,000. What amount of gain does she realize?

- A. \$100,000 gain
- B. \$190,000 gain
- C. \$90,000 gain
- D. \$200,000 gain

ANSWER: B

If a property, transferred in a nontaxable exchange, is subject to a liability or the other party assumes any liability, treat the relief of liability as if cash was received in the amount of the liability. The taxpayer must recognize any gain realized to the extent of the money and the FMV of the unlike property received. Figure the gain as follows:

FMV of like property received.....	\$500,000
Mortgage relieved.....	<u>100,000</u>
Amount realized.....	600,000
Less: Adj. basis property transferred..	400,000
Exchange expenses.....	<u>10,000</u>
Realized gain.....	<u><u>\$190,000</u></u>

Chapter 7. Estates and Trusts

Final Return for Decedent - Form 1040 or 1040-SR

1. Ms. J died on August 18. All of the following statements are correct EXCEPT:

- A. Ms. J's death does NOT close the tax year of the partnership in which she was a partner before it normally ends.
- B. Medical expenses paid by Ms. J before her death are deductible on her final income tax return if deductions are itemized.
- C. On Ms. J's final return, all income is reported on the accrual method of accounting regardless of the accounting method that she had used.
- D. Any tax credits that applied to Ms. J before her death may be claimed on her final income tax return.

ANSWER: C

The method of accounting regularly used by the decedent before death also determines the income included on the final return.

2. The decedent died on June 30. The decedent used the cash method of accounting, and a calendar year-end. What total amount of the following is includible in the decedent's final return (Form 1040)?

Taxable Interest	
(earned equally all year).....	\$2,000
Dividends (declared on June 15, and	
received on July 10).....	500
Final wages (received July 10).....	<u>2,500</u>
Total.....	\$5,000

- A. \$1,000
- B. \$2,500
- C. \$4,000
- D. \$3,500

ANSWER: A

If the decedent uses the cash method, only income actually or constructively received before death is included in the final return.

Income included in the decedent's final return (Form 1040):

Taxable interest (\$2,000 ÷ 2; Jan - Jun) = \$1,000

Chapter 7. Estates and Trusts

3. A taxpayer died on January 8. All of the following could be deducted on the decedent's final Form 1040 EXCEPT?

- A. Unused net operating loss carryover.
- B. The full amount of the standard deduction.
- C. Medical expenses paid by the estate within one year of death.
- D. Funeral expenses.

ANSWER: D

The rules for deductions allowed to an individual also apply to the decedent's final income tax return. If the decedent did not itemize deductions on the final return, the full amount of the appropriate standard deduction is allowed regardless of the date of death. Medical expenses that were not paid before death are liabilities of the estate and are shown on the federal estate tax return (Form 706). However, if medical expenses for the decedent are paid out of the estate during the 1-year period beginning with the day after death, all or part of the expenses can be treated as paid by the decedent at the time they were incurred. A decedent's net operating loss deduction from a prior year and any capital losses (including capital loss carryovers) can be deducted only on the decedent's final income tax return.

Income Tax Return of an Estate - Form 1041

Filing Requirements

4. Mr. J died on November 30, 2022. After his death, but prior to December 31, 2022, his estate received the following cash receipts:

- Life insurance proceeds: \$50,000
- Social Security death benefits: \$250
- Redeemed Certificate of Deposit of which \$100 was accrued interest: \$10,100
- Mutual fund dividend distribution: \$200

Assuming that none of the beneficiaries are nonresident alien individuals and the executor of the estate adopted a calendar year for the estate, Form 1041 will need to be filed on or before

- A. March 15, 2023
- B. April 15, 2023
- C. August 30, 2023
- D. Form 1041 does not need to be filed for the tax year.

ANSWER: D

Proceeds from a decedent's life insurance policy are excluded from income. The \$250 social security death benefits are also excluded from income. The \$100 accrued interest on the CD and the \$300 mutual fund dividend are under the \$600 threshold to file an estate tax return. Form 1041 is not required to be filed.

5. A taxpayer died on March 18. The estate tax year ends on December 31. The estate had the following items of income during the year:

- Interest: \$250
- Dividends: \$150
- Stock sale-stock proceeds net of broker's commission: \$10,000
- Basis of the stock: \$9,900

The estate made no distributions during the year. Which of the following statements regarding the requirement to file a Form 1041 tax return are true?

- A. The estate is not required to file a tax return.
- B. The estate is required to file a tax return.
- C. If the estate has expenses that reduce its income below \$600, no estate tax return is required.
- D. Both B and C.

6. Mr. A died on June 30. His personal representative enlisted the aid of Mr. A's nephew, an Enrolled Agent, to prepare a Fiduciary Income Tax Return (Form 1041) for the calendar year. Mr. A's nephew did not charge a fee for the preparation of the return. Who must sign the return prior to filing?

- A. Only Mr. A's personal representative.
- B. Only Mr. A's nephew.
- C. Both the personal representative and the preparer.
- D. None of the above.

ANSWER: A

The interest (\$250), dividends (\$150) and gain on the sale of \$100 (\$10,000 - \$9,900) are under the \$600 threshold to file an estate tax return. Form 1041 is not required to be filed.

ANSWER: A

The personal representative must sign the Fiduciary Income Tax Return (Form 1041). Only a paid preparer is required to sign the return.

Income, Exemptions and Deductions

7. Income in respect of a decedent must NOT be included in the income of which of the following:

- A. The decedent's final 1040 or 1040-SR filing.
- B. The decedent's estate (if received by the estate).
- C. The beneficiary's filing (if the right to income is passed directly to and received by the beneficiary).
- D. Any person to whom the estate properly distributes the right to receive it.

ANSWER: A

Income in respect of the decedent is income which the decedent had a right to and would have reported if death had not occurred. This income was not included on the final return (Form 1040 or 1040-SR) and must be included in the gross income of:

1. The decedent's estate, if the estate receives it,
2. The beneficiary, if the right to the income is passed directly to the beneficiary and the beneficiary receives it, or
3. Any person to whom the estate properly distributes the right to receive it.

Chapter 7. Estates and Trusts

8. A decedent used the cash method of accounting. At the time of his death, he was owed \$5,000 for work performed. This \$5,000 amount was paid prior to the decedent's estate being settled. The sole beneficiary of the estate is the decedent's son but the \$5,000 was not distributed before the settlement of the estate. The \$5,000 must be included in the income of

- A. Decedent's final income tax return.
- B. Decedent's estate's income tax return.
- C. The income tax return of the beneficiary.
- D. Does not need to be reported.

9. A cash method taxpayer died on September 30. After her death but prior to December 31, her beneficiary received the following:

- Rental income: \$1,500
- Proceeds from a life insurance policy: \$20,000
- Dividend declared on September 27: \$6,000

What amount is considered income in respect of a decedent?

- A. \$1,500
- B. \$7,500
- C. \$3,000
- D. \$27,500

10. A taxpayer died during the year. Using the information below, determine the amount of income in respect of a decedent that must be reported on the estate's Form 1041 income tax return.

	Received Before Death	Received After Death
Wages	\$10,000	\$3,000
Renewal commissions	\$20,000	\$7,000
Life insurance (on taxpayer's life)		\$100,000

- A. \$3,000
- B. \$10,000
- C. \$110,000
- D. \$170,000

ANSWER: B

For a cash method taxpayer, income actually or constructively received before death is included in the final return and not considered income in respect of a decedent. The \$5,000 received after death is reported on the decedent's estate return (Form 1041).

ANSWER: B

Proceeds from a decedent's life insurance policy are excluded from income.

Income in respect of a decedent:

Rental income.....	\$ 1,500
Dividend.....	<u>6,000</u>
Income in respect of a decedent.....	<u>\$ 7,500</u>

ANSWER: B

For a cash method taxpayer, income actually or constructively received before death is included in the final return and not considered income in respect of a decedent. Proceeds from a decedent's life insurance policy are excluded from income.

Income in respect of a decedent:

Wages.....	\$ 3,000
Renewal commissions.....	<u>7,000</u>
Income in respect of a decedent.....	<u>\$10,000</u>

11. An estate did not make any distributions to beneficiaries. From the information below, determine the estate's taxable income after allowing the estate exemption amount.

- Taxable interest: \$1,000
 - Gain on sale of stock: \$5,000
 - IRA distribution (\$0 basis): \$50,000
 - Executor's fees: \$5,000
- A. \$400
B. \$11,600
C. \$50,400
D. \$55,600

12. Ms. B died the previous year. During the current year, her estate received the following:

- Interest income: \$2,500
- Dividend income: \$5,000
- Long Term Capital Gain: \$2,500

Pursuant to her will, 50% of all income was to be distributed to a specific qualifying charitable organization. The executor complied with the provision in a timely manner. Assuming all income was accumulated, what is the estate's taxable income?

- A. \$10,000
B. \$2,500
C. \$5,000
D. \$4,400

13. A decedent had a \$2,000 net operating loss carry-forward to his final year. The maximum allowable amount of net operating loss carryforward deducted on his final income tax return was \$500. What amount of the unused operating loss is carried forward to the estate income tax return? (The decedent's final 1040 did not generate any additional net operating loss).

- A. \$0
B. \$1,500
C. \$2,000
D. None of the above.

ANSWER: C

Gross income of an estate consists of all items of income received or accrued during the tax year including interest, dividends and gain from the sale of property. An estate is allowed an exemption deduction of \$600 in computing its taxable income.

Estate's taxable income:	
Taxable interest.....	\$ 1,000
Gain on sale of stock.....	5,000
IRA distribution (\$0 basis).....	<u>50,000</u>
Estate's gross income.....	56,000
Less: Executor fees.....	5,000
Exemption deduction.....	<u>600</u>
Estate's taxable income.....	<u><u>\$50,400</u></u>

ANSWER: D

An estate qualifies for a deduction for amounts of gross income paid or permanently set aside for qualified charitable organizations. The adjusted gross income limits for individuals do not apply. However, to be deductible by an estate, the contribution must be specifically provided for in the decedent's will. An estate is allowed an exemption deduction of \$600 in figuring its taxable income.

Estate's taxable income:	
Interest income.....	\$ 2,500
Dividend income.....	5,000
Long term capital gain.....	<u>2,500</u>
Gross income.....	10,000
Less:	
Charitable deduction (50% of \$10,000)	5,000
Exemption deduction.....	<u>600</u>
Estate's taxable income.....	<u><u>\$ 4,400</u></u>

ANSWER: A

Carryover losses resulting from net operating losses or capital losses sustained by the decedent prior to death are deducted only on the decedent's final income tax return. These losses cannot be deducted on the estate's income tax return (Form 1041).

Chapter 7. Estates and Trusts

14. In general, which of the following statements is NOT true?

- A. An estate or trust may use the net operating loss not able to be used by the decedent in his final Form 1040 or 1040-SR filing.
- B. An estate or trust may carry its net operating loss back two years.
- C. If a farming loss, the estate or trust may carry the loss back 5 years.
- D. An estate or trust may elect to carry its net operating loss forward only.

ANSWER: A

Carryover losses resulting from net operating losses or capital losses sustained by the decedent prior to death are deducted only on the decedent's final income tax return. These losses cannot be deducted on the estate's income tax return (Form 1041).

Credits, Tax, and Payments

15. Which of the following statements is true regarding estate income tax returns filed on Form 1041?

- A. Form 1041 has its own tax rate schedule.
- B. Estates are never liable for the alternative minimum tax.
- C. All estates are subject to the same estimated tax rules that apply to Form 1040 or 1040-SR.
- D. None of the above.

ANSWER: A

Estates and trusts may be liable for the alternative minimum tax. Estates with tax years ending 2 or more years after the date of the decedent's death must pay estimated tax in the same manner as individuals.

16. A calendar year estate came into existence November 12, 2021. It had a tax balance due of \$15,000 on the 2021 return. The estate executor expects to have a \$10,000 balance due on the 2022 tax return. The estate will not be finalized until 2023. Income is received evenly throughout the year, and there is no withholding. The executor is required to make estimated payments on

- A. April 15, 2022; June 15, 2022; September 15, 2022; January 15, 2023.
- B. December 31, 2022 if the return is filed on or before February 28, 2023.
- C. Either A or B.
- D. No estimated payments are required.

ANSWER: D

Only estates with tax years ending 2 or more years after the date of the decedent's death are required to make estimated tax payments. Estates pay estimated taxes in the same manner as individuals.

Distribution to Beneficiaries from an Estate (Distributive Net Income)

17. Mrs. A died on June 30. According to the terms of her will, \$20,000 was paid to each of her three children prior to the end of the year. Additionally, the estate was to pay from earnings, \$20,000 to each child. The estate had net earnings of \$30,000. Assuming no charitable contributions were made, how much income will each child report?

- A. \$30,000 ordinary income.
- B. \$40,000 ordinary income.
- C. \$10,000 ordinary income.
- D. \$0

ANSWER: C

In giving or leaving property to another through the last will and testament (bequest) any distribution of the estate's income to a beneficiary is included in the beneficiary's gross income to the extent of the estate's distributable net income. A distribution will not be included in the beneficiary's gross income if his 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.

A bequest is the act of giving or leaving property to another through the last will and testament. In this question, the bequest of \$20,000 for each child is not taxable, and the beneficiaries must share the distributable net income of \$30,000 in relationship to their one-third share.

Beneficiaries tax income from estate:

$$\text{\$30,000} \div 3 = \text{\$10,000}$$

18. Which of the following statements is NOT true?

- A. The beneficiary of an estate or trust may be taxed on money required to be distributed whether actually distributed or not.
- B. Money distributed to a beneficiary from an estate is taxed twice - on the estate return and on the beneficiary's return.
- C. Tax-exempt interest distributed to a beneficiary is not taxable to the beneficiary.
- D. Losses of estates and trusts are generally not deductible by the beneficiaries.

ANSWER: B

If an estate or trust must distribute all its income currently to its beneficiaries, the beneficiaries must report their share of the distributable net income whether or not they actually received them. An amount distributed to a beneficiary for inclusion in income retains the same character for the beneficiary that it had for the estate. An estate is allowed a deduction for any income that must be distributed currently. Money distributed to a beneficiary is included in the beneficiary's income and deducted by the estate. It is not taxed on both the estate's and the beneficiary's tax returns. Losses of estates and trusts are generally not deductible by the beneficiaries. However, if the estate has unused loss carryovers for its last year, they are allowed to those beneficiaries who succeed the estate's property.

Chapter 7. Estates and Trusts

19. An estate fiscal tax year runs from April 1, 2021 to March 31, 2022. The estate made distributions to beneficiaries on December 12, 2021 and March 15, 2022. Assuming the estate has taxable income, in what year will its beneficiaries be required to report taxable distributions?

- A. 2021
- B. 2022
- C. Both 2021 and 2022
- D. Neither 2021 nor 2022

20. A taxpayer is the sole beneficiary of her father's estate. The estate was closed ten months after her father's death, and the executor is filing one (first and final) Form 1041. After all expenses of the estate were paid, the following amounts were paid out to the taxpayer.

- Cash: \$12,000
- IRA (decedent had no basis): \$300,000
- Wages paid after death: \$6,000
- Stocks (FMV): \$75,000
- Life insurance: \$150,000

How much of the payment will be reported on the taxpayer's Form 1040?

- A. \$0
- B. \$6,000
- C. \$306,000
- D. \$543,000

21. Which of the following statements concerning the deduction for estate taxes by individuals is true?

- A. The deduction for estate tax can be claimed only for the same tax year in which the income in respect of a decedent must be included in the recipient's income.
- B. Individuals may claim the deduction for estate tax whether or not they itemize deductions.
- C. The estate tax deduction was a miscellaneous itemized deduction that is no longer deductible.
- D. None of the above.

ANSWER: B

Each beneficiary who receives a distribution from the estate for the tax year or to whom any item is allocated must receive a Schedule K-1 or substitute. Beneficiary must treat estate items the same way on their individual return as they are treated on the estate's income tax return. A beneficiary must include his or her share of the estate income on his or her return for the tax year in which the last day of the estate's tax year falls.

ANSWER: C

Any distribution that would be income to the estate is reported as income to the beneficiaries. The IRA (with no basis to the decedent) and the wages paid after death is considered income to the beneficiary.

Estate income distributed to and reported by beneficiary:

IRA.....	\$300,000
Wages.....	6,000
Estate income.....	<u>\$306,000</u>

ANSWER: A

Income that a decedent had a right to receive is included in the decedent's gross estate and is subject to estate tax. This income in respect of a decedent is also taxed when received by the recipient (estate or beneficiary). However, an income tax deduction is allowed to the recipient for the estate tax paid on the income. The deduction for estate tax can be claimed only for the same tax year in which the income in respect of a decedent must be included in the recipient's income. Individuals can claim this deduction only as an itemized deduction on Schedule A (Form 1040 or 1040-SR).

Trusts

22. Which of the following types of trusts is NOT considered a separate legal entity for Federal tax purposes?

- A. Simple trusts
- B. Tax-exempt trusts
- C. Grantor trusts
- D. Complex trusts

ANSWER: C

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).

23. Which of the following statements regarding grantor trusts is true?

- A. A grantor of a grantor trust does not report income from the trust unless distributions are made from the trust.
- B. A grantor trust is a good way to shelter income.
- C. Income from a grantor trust is taxed to the grantor in the same manner as if no trust existed.
- D. All of the statements are true.

ANSWER: C

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).

24. The trustee of a grantor type trust must never

- A. Give all payers of income the name and TIN of the grantor and the address of the trust.
- B. File a trust return, completing only the entity information, and attach a statement identifying the grantor to whom the income is taxable.
- C. File Forms 1099 with the IRS showing the trust income as paid to the grantor.
- D. File a trust return, figuring the tax on all income and deductions of the trust.

ANSWER: D

A grantor trust is not a separate taxable entity. All income, deductions and credits are not reported on Form 1041, U.S. Income Tax Return for Estates and Trusts. Instead these items are reported on the individual tax return (Form 1040 or 1040-SR) of the grantor.

25. As a general rule, a trust may qualify as a simple trust if

- A. The trust instrument requires that all income must be distributed currently.
- B. The trust does not distribute amounts allocated to the corpus of the trust.
- C. The trust has no provisions for charitable contributions.
- D. All of the above.

ANSWER: D

As a general rule, a trust may qualify as a simple trust if:

1. The trust instrument requires that all income must be distributed currently.
2. The trust does not distribute amounts allocated to the corpus of the trust.
3. The trust has no provisions for charitable contributions.

Chapter 7. Estates and Trusts

26. A trust requires that all trust income be distributed at least annually. There are no provisions for charitable contributions. To be treated as a simple trust, what must also be true?

- A. Trust income can consist of interest and dividends only.
- B. There were no other distributions of corpus in the current year.
- C. All beneficiaries must be U.S citizens or resident aliens.
- D. All of the above.

ANSWER: B

A simple trust is required to distribute all of its income currently and is not allowed to distribute out of corpus. The trust will cease to be a simple trust for any year it distributes corpus. A simple trust also cannot make charitable contributions.

27. All of the following statements about trusts are true EXCEPT:

- A. The income distributed to the beneficiary retains the same character as that earned by the trust.
- B. The Net Distributable Income of a simple trust excludes capital gains distributions that are allocable to corpus under the terms of the governing instrument and applicable local law.
- C. The income distribution deduction is the greater of distributable net income or net accounting income.
- D. All of the taxable income that is not taxed to the beneficiaries is taxed to the trust.

ANSWER: C

The distribution deduction is limited to the distributive net income.

28. Which of the following is a characteristic of a simple trust?

- A. A trust in the final year of administration.
- B. A trust which is partially liquidated during the taxable year.
- C. A trust which is allowed a personal exemption deduction of \$300.
- D. A trust which distributes an amount out of corpus.

ANSWER: C

A simple trust is allowed a personal exemption deduction of \$300. All other trusts are allowed a deduction of \$100. A simple trust cannot make a distribution out of corpus.

29. A trust was required to distribute \$10,000 a year to its sole beneficiary out of the trust's income for the year. The distributable net income of the trust was \$8,000 and the actual amount distributed was \$7,000. How much income must the beneficiary report?

- A. \$10,000
- B. \$8,000
- C. \$0
- D. \$7,000

ANSWER: B

A beneficiary of a complex trust must include in income any amount that is paid, credited, or required to be distributed for the tax year whether or not the amount is distributed. Since the trust's distributable net income is \$8,000, that is the amount the beneficiary must report as income.

30. The B Trust is a Simple Trust. Per the information listed below, how much taxable income is passed through to the beneficiaries?

- Taxable interest: \$1,000
- Tax exempt interest: \$1,000
- Fiduciary fee: \$400
 - A. \$1,600
 - B. \$600
 - C. \$800
 - D. \$1,800

31. A complex trust has a controlling instrument that specifically allocates capital transactions to the corpus of the trust. The instrument goes on to state that \$2,000 will be set aside out of gross income for charitable purposes and that \$10,000 in income is required to be distributed each year. At the end of the year, the trust had \$20,000 in gross income, which included \$5,000 in capital gains. If there was no other information to consider, what is the trust's income distribution deduction?

- A. \$18,000
- B. \$13,000
- C. \$10,000
- D. \$5,000

32. If a trust has adjusted total income of \$10,000, distributable net income of \$11,000, and \$12,000 is required to be currently distributed, what is its income distribution deduction?

- A. \$11,000
- B. \$12,000
- C. \$2,000
- D. \$10,000

33. A trust has distributable net income of \$60,000, which includes \$5,000 of tax-exempt income. The trustee distributed \$75,000 to the trust's sole beneficiary. What amount will be shown as the distribution deduction on the trust's Form 1041?

- A. \$55,000
- B. \$60,000
- C. \$70,000
- D. \$75,000

ANSWER: C

Fiduciary fees must be allocated between taxable income and nontaxable income to determine the amount to deduct in arriving at taxable income of the trust.

Taxable trust income passed through:
Taxable interest.....\$1,000
Less: Fiduciary fee (50%)..... 200
Taxable trust income passed through..... \$ 800

ANSWER: C

The distribution deduction for a trust is limited to the distributed net income. The trust had \$20,000 in gross income but the trust instrument requires that \$10,000 be distributed each year. Therefore, the trust's income distribution deduction is **\$10,000**.

ANSWER: A

The distribution deduction for a trust is limited to the distributed net income.

ANSWER: A

The distribution deduction for a trust is limited to the distributed net income without including tax exempt income.

34. What is a complex trust's distribution deduction based on the following information (capital gains are allocated to income, there is no interest income, and there is no charitable contribution)?

- Adjusted Total Income: \$10,000
 - Capital Gain (included in Adjusted Total Income): \$2,000
 - Income required to be distributed currently: \$5,000
- A. \$10,000
 - B. \$5,000
 - C. \$0
 - D. \$8,000

35. The computation of distributable net income of a trust takes into account which of the following items?

- A. Income distribution deduction
- B. Exemption
- C. Tax-exempt interest
- D. All of the above

36. An irrevocable trust incurred a net operating loss (NOL) from normal business operations during its fourth, non-final year of existence. Which of the following statements is correct concerning the (NOL)?

- A. The NOL is passed through to the beneficiaries and claimed on their returns.
- B. The NOL is carried back, or if elected, carried forward, under the same rules for individuals.
- C. The NOL is lost because excess deductions can only be passed through in the final year of a trust.
- D. The NOL can, only be claimed in the final year of the trust.

37. The trustee of a simple trust has prepared Form 1041 for the tax year. After determining the proportionate share of distributable net income for each beneficiary, the trustee must provide the beneficiary a copy of which Federal form for inclusion on the beneficiary's Form 1040 or 1040-SR for the year?

- A. Form 1099-MISC.
- B. Schedule K-1 (Form 1041).
- C. Form 1099-T.
- D. No form, since a simple trust does not distribute income.

ANSWER: B

A complex trust may deduct only the amount of income required to be distributed currently including any amount required to be distributed which may be paid out of income or corpus to the extent the amount is paid out of income for the year.

ANSWER: C

A trust's distributable net income includes items of gross income and deductions used to calculate the taxable income of the trust. It also includes tax-exempt interest. The Income distribution deduction and the exemption are deducted after computing distributed net income.

ANSWER: B

Like an estate, a trust can claim a net operating loss deduction, figured in the same way as an individual's, except that it cannot deduct any distributions to beneficiaries or the deduction for charitable contributions in figuring the loss or the loss carryover. An unused net operating loss carryover or capital loss carryover existing upon termination of the trust is allowed to the beneficiaries succeeding to the property of the estate. That is, these deductions will be claimed on the beneficiary's tax return. This treatment occurs only if a carryover would have been allowed to the estate in a later tax year if the estate had not been terminated.

ANSWER: B

A simple trust is required to distribute all of its income currently. Schedule K-1 is used to report the beneficiary's share of income, deductions, and credits from a trust.

Chapter 8. Tax-Exempt Organizations

Application, Approval, and Appeal Procedures

1. Which of the following is NOT a section 501(c)(3) tax-exempt organization?

- A. American Society for Prevention of Cruelty to Animals.
- B. Red Cross.
- C. State chartered credit unions.
- D. Privately owned nursing home.

ANSWER: D

Generally, only the five following types of organizations can be qualified charitable organizations.

1. A community chest, corporation, trust fund, or foundation organized or created in or under the laws of the U.S., any state or possession of the U.S. It must be organized and operated only for:
 - a. Religious.
 - b. Charitable.
 - c. Educational.
 - d. Scientific.
 - e. Literary purposes.
 - f. For the prevention of cruelty to children or animals.
2. War veterans' organizations, including posts, auxiliaries, trusts, or foundations, organized in the U.S. or any of its possessions.
3. Domestic fraternal societies, orders, and associations operating under the lodge system. Note: The contribution is deductible only if it is used solely for charitable, religious, scientific, literary, or educational purposes, or for the prevention of cruelty to children and animals.
4. Certain nonprofit cemetery companies or corporations. Note: The contribution is not deductible if it can be used for the care of a specific persons, lot or mausoleum crypt.
5. The U.S. or any state, or U.S. possession, or an Indian tribal government or any of its subdivisions that perform substantial government functions.

2. Which of the following organizations could NOT receive approval for tax-exempt status under Internal Revenue Code section 501(c)(3)?

- A. A local chapter of the Salvation Army.
- B. A partnership for scientific research.
- C. A college alumni association.
- D. A local boys club.

ANSWER: B

To qualify for tax-exempt status an organization must be a corporation, community chest, fund, foundation, or a trust. It cannot be an individual or a partnership.

3. An organization seeking recognition of exemption from federal tax under section 501(c)(3) must file which form?

- A. Form 1023
- B. Form 1024
- C. Form 990
- D. Form 990-T

ANSWER: A

An organization seeking recognition of exemption from federal tax under section 501(c)(3) of the Internal Revenue Code must file Form 1023, Application for Recognition of Exemption Under Section 501(c)(3) of the Internal Revenue Code. Along with the application, the organization must attach the following information:

1. **Employer identification number (EIN).** Every exempt organization must have an EIN, whether or not it has any employees. An EIN is required before an exemption application is submitted.
2. **Organizing document.** Each application for exemption must be accompanied by a conformed copy of your organization's Articles of Incorporation (and the Certificate of Incorporation, if available), Articles of Association, Trust Indenture, Constitution, or other enabling document. If the organization does not have an organizing document, it will not qualify for exemption.
3. **Bylaws.** Bylaws alone are not organizing documents. However, if your organization has adopted bylaws, include a current copy. The bylaws need not be signed if submitted as an attachment. Bylaws may be considered an organizing document only if they are properly structured (includes name, purpose, signatures, and intent to form an organization).
4. **Conformed copy.** A conformed copy is a copy that agrees with the original and all amendments to it. If the original document required a signature, the copy should either be signed by a principal officer or, if not signed, be accompanied by a written declaration signed by an authorized officer of the organization. With either option, the officer must certify that the document is a complete and accurate copy of the original. A certificate of incorporation should be approved and dated by an appropriate state official.
5. **Description of activities.** The application must include a full description of the proposed activities of your organization, including each of the fundraising activities of a section 501(c)(3) organization and a narrative description of anticipated receipts and contemplated expenditures.
6. **Financial data.** The application must include financial statements showing receipts and expenditures and a balance sheet for the current year and the 3 preceding years (or for the number of years your organization was in existence, if less than 4 years). For each accounting period, describe the sources of receipts and the nature of expenditures.

4. To be tax-exempt an organization must be one of the following:

- A. A sole proprietorship
- B. A partnership
- C. A corporation
- D. An individual

ANSWER: C

To be tax-exempt an organization must be one of the following:

- A corporation.
- Unincorporated association.
- A trust.

Sole proprietorships, partnerships, individuals, or loosely associated groups of individuals do not qualify.

Filing Requirements

5. Which of the following organizations is NOT required to file an annual information return such as Form 990, Return of Organization Exempt From Income Tax?

- A. All are required to file - no exceptions.
- B. Any exempt organization with annual gross receipts exceeding \$50,000.
- C. A convention or association of churches with annual gross receipts exceeding \$50,000.
- D. Any chamber of commerce with annual gross receipts exceeding \$50,000.

ANSWER: C

Every organization exempt from federal income tax under section 501(a) must file an annual information return except the following organizations:

1. A church or association of churches.
2. A church-affiliated organization that is exclusively engaged in managing funds or maintaining retirement programs.
3. A school below college level affiliated with a church or operated by a religious order.
4. Church-affiliated mission societies if more than half of their activities are conducted in, or are directed at persons in, foreign countries.
5. An exclusive religious activity of any religious order.
6. A state institution, the income of which is excluded from gross income under section 115.
7. A corporation described in section 501(c)(1) that is organized under an Act of Congress, an instrumentality of the United States, and is exempt from Federal income taxes.
8. An integrated auxiliary of a church.
9. A stock bonus, pension, or profit-sharing trust that qualifies under section 401.
10. A religious or apostolic organization described in section 501(d).
11. A private foundation described in section 501(c)(3) and exempt under section 501(a) (required to file Form 990-PF, Return of Private Foundation).
12. A foreign organization, or an organization located in a U.S. possession, that normally has annual gross receipts from sources within the U.S. of \$50,000 or less.
13. A governmental unit or an affiliate of a governmental unit that meets the requirements of Revenue Procedure 95-48, 1995-2 C.B. 418.
14. An exempt organization (other than a private foundation) having gross receipts in each tax year that normally are \$50,000 or less.

6. A tax-exempt organization that is required to file Form 990 must file the form by which filing date?

- A. The 15th day of the third month after the end of the tax year.
- B. The 15th day of the fourth month after the end of the tax year.
- C. The 15th day of the fifth month after the end of the tax year.
- D. The 15th day of the sixth month after the end of the tax year.

7. Which one of the following tax-exempt organization can file Form 990-EZ, Short Form Return of Organization Exempt From Income Tax?

- A. A private foundation.
- B. An organization with gross receipts during the year less than \$100,000 and total assets at the end of the year of \$500,000.
- C. An organization with gross receipts during the year less than \$200,000 and total assets at the end of the year of \$500,000.
- D. An organization with gross receipts during the year less than \$500,000 and total assets at the end of the year of \$1,000,000.

8. Which return might a tax-exempt organization be required to file?

- A. Employment tax returns.
- B. Annual information return, Form 990.
- C. Report of cash received.
- D. All of the above.

ANSWER: C

Form 990, Return of Organization Exempt From Income Tax, must be filed by the **15th day of the 5th month** after the end of the tax year.

ANSWER: C

If an organization has gross receipts less than \$200,000 and total assets at the end of the year less than \$500,000, it can file Form 990-EZ, instead of Form 990.

A private foundation files Form 990-PF.

ANSWER: D

Every employer, including a tax-exempt organization, who pays wages to employees, is required to file employment tax returns. Even though an organization is tax-exempt, it still may be liable for tax on its unrelated business income. Every organization exempt from federal income tax, except those listed in the analysis on question 5, must file an annual information return Form 990 (Form 990-PF if the organization is a private foundation).

Chapter 8. Tax-Exempt Organizations

9. Which of the following tax-exempt organizations can submit Form 990-N, Electronic Notice (e-Postcard) instead of filing Form 990 or Form 990-EZ?

- A. A tax-exempt organization with annual gross receipts of \$50,000
- B. A tax-exempt organization with annual gross receipts of \$70,000
- C. A tax-exempt organization with annual gross receipts of \$100,000
- D. A tax-exempt organization with annual gross receipts of \$250,000

10. A tax-exempt organization is subject to tax on unrelated business income if that income is at least:

- A. \$500
- B. \$1,000
- C. \$2,500
- D. \$5,000

11. A tax-exempt organization subject to tax on unrelated business income must file Form 990-T by which date?

- A. The 15th day of the third month after the end of the tax year.
- B. The 15th day of the fourth month after the end of the tax year.
- C. The 15th day of the fifth month after the end of the tax year.
- D. The 15th day of the sixth month after the end of the tax year.

ANSWER: A

Small tax-exempt organizations with annual gross receipts normally \$50,000 or less must submit Form 990-N, Electronic Notice (e-Postcard) for Tax-Exempt Organizations Not Required to File Form 990 or 990-EZ, with the IRS each year, if they choose not to file a Form 990 or 990-EZ. Form 990-N must be completed and filed electronically. There is no paper form.

This filing requirement for Form 990-N does not apply to:

- Churches, their integrated auxiliaries, and conventions or associations of churches,
- Organizations that are included in a group return,
- Private foundations required to file Form 990-PF, and
- Section 509(a)(3) supporting organizations required to file Form 990 or Form 990-EZ.

ANSWER: B

Form 990-T is required if the organization's gross income from unrelated businesses is **\$1,000 or more**.

ANSWER: C

Form 990-T, Exempt Organization Business Income Tax Return, must be filed by the **15th day of the 5th month** after the end of the tax year.

12. Tax-exempt organizations must file Form 990-T, Exempt Organization Business Income Tax Return if the organization has over \$1,000 or more in

- A. Income from a unrelated trade or business
- B. Dividends
- C. Royalties
- D. All of the above.

ANSWER: A

Any domestic or foreign organization exempt under section 501(a) or section 529(a) that has gross income of \$1,000 or more from a regularly conducted unrelated trade or business must file Form 990-T. Unrelated trade or business income is the gross income derived from any trade or business regularly carried on and not substantially related the organization's exempt purpose or function.

The following types of income (and deductions directly connected with the income) are generally excluded when figuring unrelated business taxable income.

- Dividends, interest, annuities and other investment income.
- Royalties.
- Rents. Rents from real property, including elevators and escalators, are excluded in computing unrelated business taxable income. Rents from personal property aren't excluded. However, special rules apply to "mixed leases" of both real and personal property.
- Income from research. A tax-exempt organization may exclude income from research grants or contracts from unrelated business taxable income. However, the extent of the exclusion depends on the nature of the organization and the type of research.
- Gains and losses from disposition of property. Also excluded from unrelated business taxable income are gains or losses from the sale, exchange, or other disposition of property other than:
 - a. Stock in trade or other property of a kind that would properly be includable in inventory if on hand at the close of the tax year,
 - b. Property held primarily for sale to customers in the ordinary course of a trade or business, or
 - c. Cutting of timber that an organization has elected to consider as a sale or exchange of the timber.

Chapter 9. Retirement Plans for Businesses

Qualified Plans

1. What is the deadline for setting up a qualified plan for a calendar year employer for 2022?

- A. December 31, 2022
- B. January 31, 2023
- C. April 15, 2023
- D. October 15, 2023

ANSWER: A

To take a deduction for contributions for a tax year, the qualified plan must be set up by the last day of that year (December 31 for calendar year employers).

2. A sole proprietor contributes to his self-employed pension plan. Where will he take his deduction on his income tax return?

- A. Form 1040 or 1040-SR, Schedule C.
- B. Form 1040 or 1040-SR, Schedule 1, as an adjustment to gross income.
- C. Form 1040 or 1040-SR, Schedule A, as an itemized deduction.
- D. Form 1040 or 1040-SR, Form 8606.

ANSWER: B

Contributions to self-employed retirement plan are deducted as an adjustment to gross income on Schedule 1 (Form 1040 or 1040-SR).

3. Which of the following is more than the allowable contribution amount to a self-employed retirement plan?

- A. Contribution of \$12,000 to a self-employed individual's own defined contribution qualified plan. The individual's net earnings from self-employment (on Schedule C) are \$40,000.
- B. \$20,000 to the SEP-IRA of an employee who earned \$100,000.
- C. \$12,000 contribution into a SIMPLE IRA by an employee who earns \$30,000.
- D. A contribution of \$15,000 to an employee's account in a defined contribution plan. The employee earned \$40,000.

ANSWER: A

A self-employed taxpayer making a contribution for himself to a SEP or qualified plan must make special computations to figure his maximum deduction for these contributions. Earnings from self-employment are figured by taking net earnings from self-employment (on Schedule C) and subtracting the income tax deduction allowed for the deductible part of self-employment tax and the deduction for contribution made on behalf of the self-employed person. Therefore, the deduction for annual employer contributions to his own SEP plan, a profit-sharing plan, or a money purchase plan, cannot be more than 25% of his net earnings (figured without deducting contribution for himself).

For 2022, contributions made to an employee's SEP-IRA cannot exceed the lesser of 25% of the employee's compensation or \$61,000.

The amount an employee can have contributed into his or her SIMPLE IRA cannot be more than \$14,000 (\$17,000 for participants age 50 or older) for 2022.

For 2022, a defined contribution plan's annual contribution cannot exceed the lesser of 100% of the compensation paid to the employee or \$61,000.

4. Generally, if a distribution is made to an employee under the retirement plan before he or she reaches age 59, the employee may have to pay a 10% additional tax on the distribution. All of the following distributions are exceptions to this rule EXCEPT:

- A. Distributions made to a beneficiary (or to the estate of the employee) on or after the death of the employee.
- B. A series of substantially equal periodic payments beginning after separation from service and made at least annually for the life or life expectancy of the employee.
- C. Distributions made to an employee after separation from service if the separation occurred before the calendar year in which the employee reached age 55.
- D. Distributions made to an alternate payee under a Qualified Domestic Relations Order (QDRO).

ANSWER: C

The 10% tax will not apply if distributions before age 59½ are:

- 1. Made to a beneficiary (or to the estate of the employee) on or after the death of the employee.
- 2. Made due to the employee having a qualifying disability.
- 3. Made as part of a series of substantially equal periodic payments, beginning after separation from service, made at least annually for the life or life expectancy of the employee or the joint lives or joint life expectancies of the employee and his or her designated beneficiary. The payments under this exception must continue for at least 5 years or until the employee reaches age 59½, whichever is longer.
- 4. Made to an employee after separation from service, if the separation occurred during or after the calendar year in which the employee reaches age 55.
- 5. Made to an alternate payee under a qualified domestic relations order (QDRO).
- 6. Made to an employee for medical care to the extent that the distribution does not exceed the amount allowable as a medical expense deduction (determined without regard to whether the employee itemizes deductions).
- 7. Timely made to reduce excess contributions under a 401(k) plan.
- 8. Timely made to reduce excess employee or matching employer contributions (excess aggregate contributions).
- 9. Timely made to reduce excess elective deferrals.
- 10. Made because of an IRS levy on the plan.
- 11. Made as a qualified reservist distribution.
- 12. Made as a permissible withdrawal from an EACA.
- 13. Made as a qualified birth or adoption distribution.
- 14. Made as a qualified disaster distribution.

5. Which of the following retirement plans qualifies for the 10-year (averaging) tax option?

- A. IRA
- B. Section 401(k) plan.
- C. Section 403(b) plan
- D. Roth IRA

ANSWER: B

The 10-year (averaging) tax option is used to figure the tax on a qualified lump-sum distribution. The taxpayer pays the tax only once for the year the distribution is received, not over the next ten years. The lump-sum distribution is for the participant's entire balance of an employer's qualified plan. The participant must have been born before January 2, 1936. The following distributions do not qualify for the 10-year tax option:

1. Any distribution if an earlier election to use either the 5-year or 10-year tax option had been made after 1986 for the same plan participant.
2. U.S. Retirement Plan Bonds.
3. A distribution made during the first 5 tax years that the participant was in the plan, unless it was paid because the participant died.
4. A distribution from an IRA.
5. A distribution from a tax-sheltered annuity (section 403(b) plan).
6. A corrective distribution of excess deferrals, excess contributions, or excess annual additions.
7. A lump-sum credit or payment from the Federal Civil Service Retirement System (or the Federal Employees' Retirement System).

6. Regarding retirement plans, prohibited transactions are transactions between the plan and a disqualified person. Which of the following is exempt from the prohibited transaction rules?

- A. A fiduciary of the plan.
- B. A person providing services to the plan.
- C. An employer, any of whose employees are covered by the plan.
- D. A disqualified person receiving any benefit to which he or she is entitled as a plan participant or beneficiary.

ANSWER: D

The following are disqualified persons with regards to prohibited transactions:

1. The employer of participants in the plan.
2. A 10% or more (in capital or profits) partner in a partnership having the plan.
3. A fiduciary of the plan.
4. Highly compensated employees (earning 10% or more of the employer's yearly wages).
5. Employee organizations, any of whose members are covered by the plan.
6. Persons providing services to the plan.
7. Family members (spouse, ancestors, direct descendants, and any spouse of a direct descendant).
8. Corporations, partnerships, trusts, or estates in which a taxpayer owns, directly or indirectly, at least half the:
 - a. Total voting stock or the value of all stock of the corporation,
 - b. Capital interest or profit interest of the partnership, or
 - c. Beneficial interest of the trust or estate.

Chapter 9. Retirement Plans for Businesses

7. All of the following statements in respect to self-employed retirement plan prohibited transactions are correct EXCEPT:

- A. A 10% partner in a partnership having a retirement plan is a disqualified person.
- B. Disqualified persons include persons providing services to the plan.
- C. Dealing with plan income or assets by a fiduciary in his or her own interest is a prohibited transaction.
- D. If the prohibited transaction is NOT corrected within the taxable period, an additional tax of 80% of the amount involved is imposed.

ANSWER: D

If the prohibited transaction is NOT corrected within the taxable period, an additional tax of **100%** of the amount involved is imposed.

Simplified Employee Pension (SEP)

8. A self-employed individual is a calendar year taxpayer. If he wants to set up a SEP plan for his business for the year 2022, he must do so by

- A. December 31, 2022
- B. January 31, 2023
- C. April 15, 2023
- D. October 15, 2023

ANSWER: D

Contribution to a SEP Plan must be made by the due date (**including extensions**) of the employer's tax return for that year.

9. What is the maximum contribution that can be made to a SEP IRA for 2022?

- A. \$20,500
- B. \$52,000
- C. \$61,000
- D. \$64,000

ANSWER: C

For 2022, contributions to an employee's SEP-IRA cannot be more than the smaller of 25% of the employee's compensation or \$61,000. Do not consider the part of the employee's compensation over \$305,000.

10. When figuring the deduction for contributions made to your own SEP-IRA, compensation is your net earnings from self-employment, which takes into account

- A. A reduction for all of your self-employment tax.
- B. A reduction for the maximum allowable contribution to your own SEP-IRA.
- C. The deduction for the deductible part of your self-employment tax and the deduction for contributions to your own SEP-IRA.
- D. A & B above.

ANSWER: C

When figuring the deduction for employer contributions made to his or her own SEP-IRA, compensation is net earnings from self-employment less:

- 1. The deduction for the deductible part of his or her self-employment tax, and
- 2. The deduction for contributions to his or her own SEP-IRA.

11. Which of the following retirement plans does NOT have a salary reduction (elective deferral) component to it?

- A. Simplified Employee Pension Plan (SEP)
- B. SIMPLE IRA Plan
- C. SIMPLE 401(k) Plan
- D. Qualified 401(k) Plan

ANSWER: A

A simplified employee pension (SEP) is a written plan that allows a self-employed taxpayer to make contributions toward his or her own retirement and employees' retirement without getting involved in a more complex qualified plan. Under a SEP, the taxpayer/employer makes the contributions to a traditional individual retirement arrangement (called a SEP-IRA) set up by or for each eligible employee. A SEP-IRA is owned and controlled by the employee, and the taxpayer/employer makes contributions to the financial institution where the SEP-IRA is maintained.

Savings Incentive Match Plans for Employees (SIMPLE)

12. An employer who has been in business for several years wants to set up a SIMPLE IRA for his employees. The employer has NOT previously maintained a SIMPLE IRA. What is the deadline for the employer to set up a SIMPLE IRA for 2022?

- A. Anytime from January 1, through October 1, 2022
- B. December 31, 2022
- C. April 15, 2023
- D. October 15, 2023

ANSWER: A

An employer can set up a SIMPLE IRA plan effective on any date from January 1 thru October 1 of a year, provided the employer did not previously maintain a SIMPLE IRA plan. This requirement does not apply if the employer is a new employer that comes into existence after October 1 of the year the SIMPLE IRA plan is set up and the employer sets up a SIMPLE IRA plan as soon as administratively feasible after the employer's business comes into existence. If the employer previously maintained a SIMPLE IRA plan, the employer can set up a SIMPLE IRA plan effective only on January 1 of a year. A SIMPLE IRA plan cannot have an effective date that is before the date the plan is adopted.

Chapter 9. Retirement Plans for Businesses

13. The SIMPLE 401(K) plan is a qualified retirement plan. The SIMPLE is not subject to nondiscrimination and top-heavy rules if the plan meets all of the conditions EXCEPT:

- A. Under the plan, the employee may choose salary reduction contributions to a trust up to \$14,000.
- B. Participants age 50 and over can make a catch-up contribution up to \$3,000.
- C. Employers must make matching contributions of 3% of compensation for the year or nonelective contributions of 2% of compensation on behalf of each eligible employee who has at least \$5,000 of compensation from his employer for the year.
- D. The employee's rights to any contributions are forfeitable.

14. For 2022, what is the maximum amount that an employee can choose to have contributed on his or her behalf, assuming other requirements are met, to a SIMPLE plan, if the employee is over 50 years old?

- A. \$12,000
- B. \$14,000
- C. \$17,000
- D. \$20,500

15. Your employee, age 45, earned \$85,000. You make a 2% nonelective contribution. The total contribution that may be made under a SIMPLE IRA plan is

- A. \$12,500
- B. \$13,500
- C. \$14,000
- D. \$15,700

ANSWER: D

A SIMPLE 401(k) plan is not subject to the nondiscrimination and top-heavy rules if the plan meets the following conditions:

1. Under the plan, an employee can choose to have the employer make salary reduction contributions for the year to a trust in an amount expressed as a percentage of the employee's compensation, but not more than \$14,000 for 2022. If permitted under the plan, an employee who is age 50 or over can also make a catch-up contribution of up to \$3,000.
2. The employer must make either:
 - a. Matching contributions up to 3% of compensation for the year, or
 - b. Nonelective contributions of 2% of compensation on behalf of each eligible employee who has at least \$5,000 of compensation for the year.
3. No other contributions can be made to the trust.
4. No contributions are made, and no benefits accrue, for services during the year under any other qualified retirement plan of the employer on behalf of any employee eligible to participate in the SIMPLE 401(k) plan.
5. The employee's rights to any contributions are non-forfeitable.

ANSWER: C

An employee can choose to have the employer make salary reduction contributions for the year to a trust in an amount expressed as a percentage of the employee's compensation, but not more than \$14,000. If permitted under the plan, an employee who is age 50 or over can also make a catch-up contribution of up to \$3,000.

ANSWER: D

The salary reduction contributions that an employer can make on behalf of an employee under a SIMPLE plan are limited to \$14,000 (\$17,000 if age 50 or older). Therefore, the total contribution made to the employee's SIMPLE IRA is the \$14,000 salary reduction plus the \$1,700 ($\$85,000 \times 2\%$) nonelective employer contribution, or **\$15,700**.

16. A taxpayer, age 43, opened a SIMPLE IRA on January 19, 2021. On September 22, 2022, she withdrew the entire \$10,000 value of the account. The distribution does not meet any early withdrawal exceptions to the additional tax on early distributions. How much additional tax (penalty) is this distribution subject to?

- A. \$600
- B. \$1,000
- C. \$1,500
- D. \$2,500

17. A self-employed taxpayer, age 50, has net earnings of \$50,000. What is the most that can be contributed to her SIMPLE (employer and employee contributions)?

- A. \$7,000
- B. \$14,000
- C. \$17,000
- D. \$18,500

401(k) Plans

18. The basic limit on elective deferrals in 401(k) plans (excluding SIMPLE plans) for participants under age 50 is

- A. \$17,500
- B. \$18,500
- C. \$19,500
- D. \$20,500

19. A taxpayer, age 51, wants to defer the maximum amount possible to his 401(k) plan. What is the amount of basic and catch-up contributions he may make for tax year 2022?

- A. \$20,500
- B. \$22,500
- C. \$24,500
- D. \$27,000

ANSWER: D

Early distributions occurring within the first 2 years of participating in a SIMPLE IRA are subject to a 25% additional tax. The penalty is 10% for early distributions after the 2-year period.

Additional tax penalty:

$$\text{\$10,000} \times 25\% = \text{\$2,500}$$

ANSWER: D

The amount an employee can choose to have contributed to a SIMPLE IRA is \$14,000 for 2022 (\$17,000 if age 50 or older). An employer is generally required to match each employee's salary reduction contributions on a dollar-for-dollar basis up to 3% of the employee's compensation. A self-employed person is treated as both an employer and employee for computing the contribution limits to a SIMPLE IRA.

Maximum contributions limit:

Employee salary reduction contribution..\$17,000

Employer matching contribution

(\$50,000 × 3% maximum)..... 1,500

Maximum contributions limit.....\$18,500

ANSWER: D

For 2022, the basic limit on elective deferrals for taxpayers under age 50 is **\$20,500**.

ANSWER: D

For 2022, the basic limit on elective deferrals is \$20,500. A 401(k) plan can permit participants who are age 50 or over at the end of the calendar year to also make catch-up contributions. The catch-up contribution limit for 2022 is \$6,500.

Chapter 9. Retirement Plans for Businesses

20. A qualified 401(k) plan can include what type of contribution arrangement?

- A. Cash
- B. Elective deferral
- C. All the above
- D. None of the above

21. A taxpayer received a total distribution of \$40,000 from his employer's 401(K) plan consisting of \$25,000 in cash, and land with a fair market value of \$15,000. If the taxpayer decides to keep the land, what is the total amount that he can roll over to his IRA?

- A. He may substitute \$15,000 of his own funds for the property and consider his rollover to be \$40,000 in cash.
- B. He can roll over only \$15,000 the value of the land he received.
- C. He can roll over the \$25,000 cash received into his IRA.
- D. He is required to sell the land before any part of the distribution can be rolled over.

22. Which of the following correctly states the maximum allowable catch up contribution only for a participant age 50 or over for the year 2022?

- A. \$6,500 for a 401(k) plan.
- B. \$2,000 for a SIMPLE plan.
- C. \$500 for a traditional IRA.
- D. \$1,500 for a Roth IRA.

ANSWER: C

A 401(k) plan can include a cash or deferred arrangement under which participants can choose to have their employer contribute part of their before-tax compensation to the plan rather than receive the compensation in cash. In general, a qualified plan can include a cash or deferred arrangement only if the qualified plan is one of the following plans:

1. A profit-sharing plan.
2. A money purchase pension plan in existence on June 27, 1974, that included a salary reduction arrangement on that date.

ANSWER: C

If a taxpayer receives property in an eligible rollover distribution from a qualified retirement plan, the taxpayer cannot keep the property and contribute cash to a traditional IRA in place of the property. The taxpayer must either roll over the property or sell it and roll over the proceeds.

ANSWER: A

The following are the maximum catch up contribution for a participant age 50 for each retirement plan for tax year 2022.

Retirement Plan	Catch-up Amount
Traditional IRA	\$1,000
Roth IRA	\$1,000
401(k) plan	\$6,500
SIMPLE plan	\$3,000

Chapter 10. Farm Accounting

1. Qualified farmers have the following choices to file their tax return without incurring any penalties:

- A. File and pay 100% of the tax due by March 1 each year.
- B. File one estimated payment for two-thirds of the tax by January 15 and file and pay the balance by April 15.
- C. File and pay the tax due by April 15 each year.
- D. Both A and B.

ANSWER: D

If at least two-thirds of a taxpayer's gross income for 2021 or 2022 was from farming, the taxpayer is a qualified farmer and can choose either of the following options for his or her 2022 tax:

- 1. Make one required annual payment by January 15, and file the tax return by April 15.
- 2. File the return by March 1, and pay all the tax due. No annual payment is required.

The required annual payment is the smaller of the following amounts:

- 1. $66\frac{2}{3}\%$ (.6667) of total tax for 2022.
- 2. 100% of the total tax shown on 2021 return. (The return must cover all 12 months.)

2. A calendar year taxpayer, has the following amounts of gross income for 2022:

- Wages - \$10,000
- Interest - \$2,000
- Farm income - \$200,000

The taxpayer has tax, including self-employment tax, of \$20,000, and withholding of \$1,000. To avoid any filing or estimated tax penalties, he must

- A. File an estimated tax payment by January 15, 2023, and pay 60% of the tax due.
- B. File his tax return and pay all tax due by March 1, 2023.
- C. File an estimated tax payment by March 1, 2023, and pay $66\frac{2}{3}\%$ of the tax due.
- D. File his tax return and pay all tax due by April 15, 2023.

ANSWER: B

If at least two-thirds of a taxpayer's gross income for 2021 or 2022 was from farming, the taxpayer is a qualified farmer and can choose either of the following options for his or her 2022 tax:

- 1. Make one required annual payment by January 15, and file the tax return by April 15.
- 2. File the return by March 1, and pay all the tax due. No annual payment is required.

The required annual payment is the smaller of the following amounts:

- 1. $66\frac{2}{3}\%$ (.6667) of total tax for 2022.
- 2. 100% of the total tax shown on 2021 return. (The return must cover all 12 months.)

Chapter 10. Farm Accounting

3. For purposes of the estimated tax for qualified farmers, all of the following statements are true EXCEPT:

- A. A qualified farmer does not have to make any estimated payments if he files by the first day of the third month after the close of the tax year and pays 100% of the previous year's taxes with the return.
- B. You are a qualified farmer if at least two-thirds of your previous year's gross income is from farming.
- C. The required annual payment is due on the 15th day after the close of the tax year.
- D. The required annual payment is two-thirds of your current year's tax or 100% of the previous year's tax.

4. For purposes of estimated tax exceptions for farmers, all of the following are considered gross income from farming EXCEPT:

- A. Gains from the sale of investment stock (securities).
- B. Gross farm rental income.
- C. Gains from the sale of livestock used for breeding, draft, sport, or dairy purposes.
- D. Gross farm income from partnerships, S corporations, estates and trusts.

5. Who of the following may use farm income averaging, assuming farm income rules are met?

- A. A natural person filing a Form 1040, a partner in a partnership, and a shareholder in an S Corporation.
- B. A natural person filing a Form 1040, a partnership, an S Corporation and a C Corporation.
- C. A natural person filing a Form 1040, a partner in a partnership, and a shareholder in a C Corporation.
- D. A natural person filing a Form 1040, a partner in a partnership, an estate, and a trust.

ANSWER: A

A qualified farmer does not have to make any estimated payments if he or she files his or her tax return by the first day of the third month after the close of the tax year and pays all the tax due.

ANSWER: A

For purposes of estimated tax exceptions for farmers, gross income from farming includes the following:

- 1. Gross farm income from Schedule F, Profit or Loss From Farming.
- 2. Gross farm rental income.
- 3. Gross farm income from partnerships, S corporations, estates and trusts.
- 4. Gains from the sale of livestock used for draft, breeding, sport, or dairy purposes.

ANSWER: A

A taxpayer who is engaged in a farming business may elect to use farm income averaging if the taxpayer is an individual, a partner in a partnership, or a shareholder in an S corporation. By income averaging, the taxpayer can average all or some of his or her current year's farm income by shifting it to the 3 prior years (base years). The taxpayer can use the farm income averaging even if he or she were not engaged in a farming business in any of the base years.

6. Farm income averaging is computed on Schedule J, which may be filed

- A. For the current year when a taxpayer files Schedule F showing a farm loss.
- B. For the current year which includes Schedule F showing net income from farming.
- C. Only by IRS after the taxpayer's return is completed and reviewed.
- D. On a family farming corporation with less than \$27 Million in gross receipts

7. Which of the following statements is correct about crop insurance and disaster payments?

- A. The insurance proceeds can be deferred only if the farmer can show that the income from the crops would normally be reported in a tax year following the year of damage.
- B. An accrual basis taxpayer can elect to include crop insurance proceeds in income for the tax year following the tax year in which the crops were damaged.
- C. Insurance proceeds received in the tax year following the tax year in which the crops were destroyed can be deferred until the tax year following receipt of the proceeds.
- D. A separate election to defer the inclusion of crop disaster payments must be made for each damaged crop of the trade or business.

8. In November of 2021, a cash basis farmer sells 100 additional beef feeder cattle (raised for resale) due to severe lack of water in his area. Normally, these feeders sell in February 2022. The transaction is correctly reported

- A. In 2021 as a capital gain or loss.
- B. In 2022 as a capital gain or loss.
- C. Upon election, as ordinary farm income in either 2021 or 2022.
- D. Not taxable due to drought conditions.

ANSWER: B

Refer to the analysis on the previous question. The taxpayer must have net income from farming to elect to use farm income averaging.

ANSWER: A

A taxpayer can choose to postpone reporting crop insurance proceeds as income until the year following the year the damage occurred if the following three conditions are met:

- 1. The taxpayer uses the cash method of accounting.
- 2. The crop insurance proceeds are received in the same year the crops are damaged.
- 3. The taxpayer can show that he or she would have included income from damage crops in any tax year following the year the damage occurred.

One choice (to postpone reporting the proceeds) covers all crops representing a single business.

ANSWER: C

If a farmer sells more livestock, including poultry, than he normally would in a year because of a drought, flood, or other weather-related condition, he can choose to postpone reporting the gain from selling the additional livestock until the next year. To qualify the farmer must meet all the following conditions:

- 1. Principal trade or business is farming.
- 2. Use the cash method of accounting.
- 3. Show that, under usual business practices, the additional animals would not have been sold this year except for the weather-related condition.
- 4. The weather-related condition caused an area to be designated as eligible for assistance by the federal government.

Chapter 10. Farm Accounting

9. A calendar-year farmer uses the cash method of accounting. She normally sells 200 head of sheep a year. Because of a drought, she sold 250 head of sheep. The farmer realized \$50,000 from the sale. The affected area was declared a disaster area eligible for federal assistance on March 12. How much, if any, income can the farmer postpone to the next year?

- A. \$10,000
- B. \$50,000
- C. \$12,500
- D. \$0, since only sales because of flooding qualify for postponement.

10. Which of the following statements is correct in regard to postponing gains from sales caused by drought conditions?

- A. Livestock NOT raised or sold in a drought area, will qualify if the sale occurred solely because of drought conditions.
- B. Livestock sold before the area became eligible for Federal assistance qualify so long as the drought that caused the sale also caused the area to be designated as eligible for Federal assistance.
- C. Poultry qualifies if the sale was due to drought conditions.
- D. All of the above are correct.

ANSWER: A

If, because of drought, flood, or other weather-related conditions, a cash basis farmer sells more livestock than she normally would, she may choose to defer the gain from sale of the additional animals to the next year provided that she meets the following conditions:

1. Principal business is farming.
2. Cash method of accounting used.
3. Can show that, under usual business practices, she would not have sold the animals this year except for the weather-related condition.
4. The weather-related condition resulted in an area designated as eligible for federal assistance.

The deferred amount is computed by:

1. Dividing total income realized from all livestock sold in the class during year by total member sold.
2. Multiplying this result by excess number sold solely because of drought.

Deferment in this case is:

$$(\$50,000 \div 250) \times (250 - 200) = \$200 \times 50 = \$10,000$$

ANSWER: D

The livestock does not have to be raised or sold in an area affected by a weather-related condition for postponement to apply. However, the sale must occur solely because of a weather-related condition that affected the water, grazing, or other requirements of livestock.

Sales made before the area became eligible for Federal assistance qualify if the weather-related condition that caused the sale also caused the area to be designated as eligible for federal assistance.

Poultry is considered livestock in regards to postponing gains from sales caused by drought, flood, or other weather-related conditions.

11. If you sell more livestock than you normally would in a year because of a drought, flood, or other weather related condition, you may be able to postpone reporting the gain from selling the additional animals until the next year. You must meet all of the following conditions to make the election EXCEPT:

- A. You can show that, under your usual business practices, you would not have sold the animals this year except for the weather-related conditions.
- B. The weather-related conditions caused an area to be designated as eligible for assistance by the Federal government.
- C. You use the accrual method of accounting.
- D. Your principal trade or business is farming.

12. A farmer has the following sources of income:

- Milk sales: \$100,000
- Sales of old dairy cows: 12,000
- Agricultural Program Payments: 30,000
- Sales of calves raised for sale: 2,000
- Corn sales: 24,000
- Tractor sold: 7,000

The income to be reported on Schedule F, "Profit or Loss from Farming", is

- A. \$175,000
- B. \$156,000
- C. \$168,000
- D. \$163,000

ANSWER: C

If a taxpayer sells more livestock, including poultry, than he normally would in a year because of a drought, flood, or other weather-related condition, the taxpayer may be able to postpone reporting the gain from selling the additional animals until the next year. The taxpayer must meet all the following conditions to qualify:

- 1. Taxpayer's principal trade or business is farming.
- 2. The taxpayer uses the cash method of accounting.
- 3. The taxpayer can show that, under usual business practices, he would not have sold the additional animals this year except for the weather-related condition.
- 4. The weather-related condition caused an area to be designated as eligible for assistance by the federal government.

ANSWER: B

Income reported on Schedule F does not include gains or losses from sales of the following:

- 1. Land or depreciable farm equipment.
- 2. Buildings and structures.
- 3. Livestock held for draft, breeding, sport, or dairy purposes.

These gains are capital gains and are reported on Form 4797, Sales of Business Property.

Gross income reported on Schedule F:

Milk sales.....	\$100,000
Agricultural Program Payments.....	30,000
Sales of calves raised for sale.....	2,000
Corn sales.....	<u>24,000</u>
Farm income report of Schedule F.....	<u><u>\$156,000</u></u>

Chapter 10. Farm Accounting

13. A cash basis farmer, operates a cow-calf breeding operation. The breeder cows are NOT primarily held for sale. In addition to the calves raised on his farm, he also purchases calves for resale. The farmer had the following acquisitions and dispositions of cattle:

- Purchase of 30 calves for resale: \$3,420
- Sale of 30 calves purchased for resale: 6,100
- Sale of 45 calves raised by the farmer: 10,400
- Sale of 10 breeder cows: 6,750
- Original cost of breeder cows: 5,500
- Accumulated depreciation on breeder cows: 2,860

What amount should the farmer include in gross income on his Schedule F?

- A. \$13,080
- B. \$15,720
- C. \$16,500
- D. \$18,580

14. A taxpayer had the following total gross income:

- Taxable interest: \$45,000
- Dividends: \$1,000
- Rental income (Schedule. E): \$1,500
- Farm income (Schedule F): \$75,000
- Gain from sale of farm animals: \$5,000

How much of gross income qualifies as gross income from farming?

- A. \$75,000
- B. \$80,000
- C. \$81,500
- D. \$127,500

ANSWER: A

Refer to the analysis on the previous question.

Gross income reported on Schedule F:

Sale of 30 calves purchased for resale..	\$ 6,100
Sale of 45 calves raised by farmer.....	<u>10,400</u>
Gross receipts.....	16,500
Less expenses:	
Purchase of 30 calves for resale.....	<u>3,420</u>
Gross income.....	<u><u>\$13,080</u></u>

ANSWER: B

Gross in from farming:

Farm income (Schedule F).....	\$75,000
Gain from sale of farm animals.....	<u>5,000</u>
Gross income from farming.....	<u><u>\$80,000</u></u>

15. A farmer operated a cattle and grain farm. He sold \$42,000 of grain and \$23,000 of cattle held for breeding purposes. He also received patronage dividends from the local feed store of \$432, feed assistance payments of \$1,200, and \$1,500 for haying a neighbor's meadow. He should report the following on Schedule F of his federal income tax return:

- A. \$45,132
- B. \$67,700
- C. \$44,700
- D. \$66,932

ANSWER: A

Income reported on Schedule F does not include gains or losses from sales of the following:

- 1. Land or depreciable farm equipment.
- 2. Buildings and structures.
- 3. Livestock held for draft, breeding, sport, or dairy purposes.

Patronage dividends are reported as farm income on Schedule F.

Farm income reported on Schedule F:

Sale of grain.....	\$42,000
Patronage dividend.....	432
Feed assistance payments.....	1,200
Haying a neighbor's meadow.....	<u>1,500</u>
Farm income reported on Schedule F	<u><u>\$45,132</u></u>

16. A cash basis cattle rancher sold 12 head of cattle for \$9,600. The cattle were born on his ranch in 2019. During the 3 years that the rancher used these cattle in his breeding operation, he spent \$10,000 for feed and other expenses related to the cattle. How much is the gain or loss and where should he report the amount on his Federal income tax return?

- A. Report a net gain of \$9,600 on Part I, Form 4797.
- B. Report a net loss of \$400 on Part I, Form 4797.
- C. Report \$9,600 from the sale of the cattle on Part I, Schedule F.
- D. Report a net loss of \$400 on Part I, Schedule F.

ANSWER: A

The basis of an animal sold is zero if the costs of raising it were deducted during the years the animal was being raised. The gain is then the gross sales price. Sales of livestock held for draft, breeding, sport, or dairy purposes are reported on Form 4797 instead of Schedule F.

Chapter 10. Farm Accounting

17. A farmer sold a 3-year old raised dairy cow for \$600. It cost him \$75 for shipping and commissions to sell the cow. He reports this sale as follows on his tax return:

- A. A loss of \$700 on his Schedule F because he believed it cost him \$1,300 to raise the dairy cow.
- B. A Section 1245 gain of \$525 reported on Form 4797 Part III.
- C. A gain of \$525 reported on Schedule F as ordinary farm income.
- D. A Section 1231 gain of \$525 reported on Part I of Form 4797.

ANSWER: D

Section 1231 gains and losses are the taxable gains and losses from section 1231 transactions (dispositions of property used in business). Gain or loss on the following transactions is subject to section 1231 treatment:

1. **Sale or exchange of cattle and horses.** The cattle and horses must be held for draft, breeding, dairy, or sporting purposes and held for 2 years or longer.
2. **Sale or exchange of other livestock.** This livestock must be held for draft, breeding, dairy, or sporting purposes and held for 1 year or longer. Other livestock includes hogs, mules, sheep, and goats, but does not include poultry.
3. **Sale or exchange of depreciable personal property.** This property must be used in your business and held longer than 1 year. Generally, property held for the production of rents or royalties is considered to be used in a trade or business.
4. **Sale or exchange of real estate.** This property must be used in your business and held longer than 1 year. Examples are a farm or ranch (including barns and sheds).
5. **Sale or exchange of unharvested crops.** The crop and land must be sold, exchanged, or involuntarily converted at the same time and to the same person, and the land must have been held longer than 1 year.
6. **Distributive share of partnership gains and losses.** Taxpayer's distributive share must be from the sale or exchange of property listed earlier and held longer than 1 year (or for the required period for certain livestock).
7. **Cutting or disposal of timber.** Must treat the cutting or disposal of timber as a sale, as described in chapter 10 under Timber.
8. **Condemnation.** The condemned property must have been held longer than 1 year.
9. **Casualty or theft.** The casualty or theft must have affected business property, property held for the production of rents or royalties, or investment property (such as notes and bonds). Must have held the property longer than 1 year.

Gains and losses from property used in farming are reported on Form 4797.

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