

Student name _____

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EXAMINATION I Answer Key**I. Multiple Choice Questions (Please choose the Best answer for each question. 10 points each, 350 points total):**

1) The federal income tax is the dominant form of taxation by the federal government.

- a. True
- b. False

Answer: TRUE

Page Ref.: I:1-2

2) While federal and state income taxes as well as the federal gift and estate taxes are generally progressive in nature, property taxes are proportional.

- a. True
- b. False

Answer: TRUE

Page Ref.: I:1-12

3) Charlotte pays \$16,000 in tax deductible property taxes. Charlotte's marginal tax rate is 25%, effective tax rate is 20% and average rate is 22%. Assuming that Charlotte uses itemized deduction for other reasons anyways, her tax savings from paying the property tax is

- A) \$3,200.
- B) \$3,520.
- C) \$4,000.
- D) \$8,000.

Answer: C

Explanation: C) $\$16,000 \times 0.25 = \$4,000$.

Page Ref.: I:1-5

4) All of the following statements are true except

- A) the net income earned by a sole proprietorship is reported on the owner's individual income tax return.
- B) the net income of an S corporation is subject to double taxation because it is taxed at the entity level and dividends paid from the S corporation to individual shareholders are also taxed.
- C) the net income of C corporation is subject to double taxation because it is taxed at the entity level and dividends paid from the C corporation to individual shareholders is also taxed.
- D) LLCs are generally taxed as partnerships.

Answer: B

Explanation: B) An S Corporation is a flow-through entity, not a taxable entity. The items of income/loss are allocated to each shareholder who pays tax on the items on their individual income tax returns.

Page Ref.: I:1-22 and I:1-23

5) Gross income is income from whatever source derived less exclusions.

- a. True
- b. False

Answer: TRUE

Page Ref.: I:2-3

- 6) A child credit is a fully refundable credit – no matter what your income level you can get it.
- a. True
 - b. False

Answer: FALSE

Page Ref.: I:2-20

7) In 2009 Brett and Lashana (both 50 years old) file a joint tax return claiming as a dependent their son who is blind. Their standard deduction is

- A) \$11,400.
- B) \$12,500.
- C) \$12,800.
- D) None of the above.

Answer: A

Explanation: A) Blindness of a dependent does not increase the standard deduction of the taxpayers

Page Ref.: I:2-11

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

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

Assuming a multiple support declaration exists, which of the brothers may claim his mother as a dependent?

- A) any of the sons
- B) James or Joseph
- C) Joseph only
- D) None of them

Answer: B

Explanation: B) Although no one provides more than 50 percent of Anna's support, a qualifying pool of individuals (John, James, and Joseph) provide over 50 percent of Anna's support. Any one of them who provides more than 10 percent (James or Joseph) may claim Anna assuming a multiple support agreement is filed.

Page Ref.: I:2-17

9) The filing status in which the rates increase most rapidly is:

- A) single.
- B) head of household.
- C) married filing separately.
- D) married filing jointly.

Answer: C

Explanation: C) The rates on the married filing a separate return schedule increases more rapidly than other individual rate schedules.

Page Ref.: I:2-23

10) The portion of a taxpayer's wages that are garnished by court order and forwarded to pay a delinquent bank loan are not taxable income to the taxpayer.

Answer: FALSE

Page Ref.: I:3-5; Example I:3-6

11) Interest credited to a bank savings account is taxed regardless of whether or not it is withdrawn.

- a. True
- b. False

Answer: TRUE

Page Ref.: I:3-10

12) Unemployment compensation is exempt from federal income tax.

- a. True
- b. False

Answer: FALSE

Page Ref.: I:3-24

13) In December 2009, Max, a cash basis taxpayer, rents an apartment to Charlie. Max receives both the first and last months' rent totaling \$1,000 plus a security deposit of \$400. The amount of income reported as taxable in 2009 is:

- A) \$500.
- B) \$900.
- C) \$1,000.
- D) \$1,400.

Answer: C

Explanation: C) A security deposit is not taxable until final disposition. That is, it is not taxable unless nonrefundable or until the tenant moves out and all or part of the deposit is not returned to the tenant. Rent is taxable when received.

Page Ref.: I:3-15; Example I:3-18

14) As a result of a divorce, Michael pays Judy \$75,000 in year one and \$25,000 per year in subsequent years. How much of the \$75,000 in year one is properly characterized as alimony, and will not be recaptured later?

- A) \$25,000
- B) \$35,000
- C) \$40,000
- D) \$75,000

Answer: C

Explanation:

C) First year alimony	\$75,000
Minus: \$15,000 change limit	(15,000)
Minus: Average 2nd and 3rd year alimony	(25,000)
Minus: Amount to be recaptured	(35,000)
Amount not subject to recapture	<u>\$40,000</u>

Page Ref.: I:3-20; Example I:3-27

15) During 2009, Marla's employer withheld \$2,000 from her wages for state income tax. Marla claimed the \$2,000 as an itemized deduction on her 2009 federal income tax return. Her total itemized deductions for 2009 were \$6,000. Marla's taxable income for 2009 was a negative \$20,000. Marla received the \$2,000 as a refund from the state during 2010. What amount must Marla include in income in 2010?

- A) \$0
- B) \$1,000
- C) \$2,000

D) \$6,000

Answer: A

Explanation: A) Since she would have owed no income tax even without the state tax deduction, the refund is not taxable. She received no tax benefit.

Page Ref.: I:3-27; Example I:3-36

16) The fair value of lodging cannot be excluded from gross income unless the employee is required to accept the lodging as a condition of employment and the lodging is for the convenience of the employer.

Answer: TRUE

Page Ref.: I:4-14

17) John, an employee of a manufacturing company, suffered a heart attack and was advised to not work for six months. He received \$1,500 per month of disability benefits as a result of firm-provided group insurance policy. The benefits are includible in John's gross income.

a. True

b. False

Answer: TRUE

Explanation: Employer-provided disability benefits are taxable.

Page Ref.: I:4-9; Example I:4-17 and I:4-18

18) In the case of foreign-earned income, U.S. citizens may avoid double taxation of income by both the U.S. and the host country by utilizing a foreign tax credit or by electing the foreign earned income exclusion.

a. True

b. False

Answer: TRUE

Page Ref.: I:4-18

19) Lily had the following income and losses:

Salary	\$75,000
Prize from quiz show	25,000
Unemployment compensation	8,000
Embezzled funds	30,000
Partnership Income	35,000

What is Lily's adjusted gross income (not taxable income)?

A) \$135,000

B) \$143,000

C) \$165,000

D) \$173,000

Answer: D

Explanation: D) $\$75,000 + \$25,000 + \$8,000 + \$30,000 + \$35,000 = \$173,000$.

Page Ref.: I:3-24

20) All of the following fringe benefits paid for by the employer may be excluded from an employee's gross income except

A) discounts on services of 25 percent.

B) membership fees in professional organizations.

C) recreational facilities on employer's premises.

D) unused airline seats for airline employees where the employee is required to fly "standby."

Answer: A

Explanation: A) The maximum discount for services is 20%.

Page Ref.: I:4-13

21) In September of 2009, Amanda sold shares of qualified small business stock for \$1,000,000 that had a basis of \$200,000. She had held the stock for 7 months. Forty-five days after the sale she purchased other qualified small business stock for \$1,100,000. How much of the gain will she recognize?

A) \$ -0-

B) \$100,000

C) \$800,000

D) \$900,000

Answer: A

Explanation: A) If the proceeds from the sale of small business stock held more than 6 months are reinvested in other small business stock within 60 days of the sale, no gain is recognized.

Page Ref.: I:4-21

22) Expenses are deductible only if connected to trade or business or property held for the production of income.

a. True

b. False

Answer: FALSE

Explanation: Other expenses are allowed by the Code such as interest expense, taxes, bad debts, medical expenses, alimony, and moving, etc.

Page Ref.: I:6-2

23) At the election of the taxpayer, a current deduction is allowed for the lesser of actual business start-up expenditures incurred or \$5,000 with the remainder capitalized and amortized over 180 months.

a. True

b. False

Answer: TRUE

Page Ref.: I:6-15

24) Taxpayers may deduct all of the expenses attributable to the rental of a vacation home, regardless of the gross income generated by the property.

a. True

b. False

Answer: FALSE

Page Ref.: I:6-37

25) Charlie owns 75% of Pet Foods, Inc. As CEO, Charlie must travel extensively and does so on the company jet. In addition, he also uses the jet to take several personal vacations. Charlie reports the value of the personal use of the jet, \$100,000 as additional compensation. Which of the following is true in terms of the corporation?

A) The corporation includes \$100,000 as miscellaneous income.

B) The \$100,000 has no impact on the corporation's income tax.

C) The corporation takes a deduction of \$100,000 for compensation expense.

D) The corporation takes a deduction of \$100,000 for dividend expense.

Answer: C

Explanation: C) Because the \$100,000 is considered taxable compensation to Charlie, the corporation gets a related compensation expense deduction.

Page Ref.: I:6-9; Example I:6-10

26) All of the following statements are true except

A) A tax deduction is allowed to a taxpayer for estimated warranty expense.

B) A tax deduction is allowed in association with a warranty only in the year in which warranty work is performed.

C) A tax deduction is allowed for a contested amount if the amount is paid prior to final settlement.

D) No tax deduction is allowed to an accrual basis taxpayer for the amount of a down payment for a non-recurring expense when the work is to be performed in a subsequent period.

Answer: A

Explanation: A) No tax deduction is allowed until warranty work is actually done.

Page Ref.: I:6-21; Example I:6-25, I:6-26, and I:6-27

27) For individuals, all deductible expenses must be classified as deductions for AGI or deductions from AGI.

a. True

b. False

Answer: TRUE

Page Ref.: I:7-2

28) Assessments or fees imposed for specific privileges or services are not deductible as taxes.

a. True

b. False

Answer: TRUE

Page Ref.: I:7-9

29) Interest paid on student loans up to \$2,500 is deductible from AGI, subject to income limitations.

a. True

b. False

Answer: FALSE

Page Ref.: I:7-19

30) Mr. and Mrs. Gere, who are filing a joint return, have adjusted gross income of \$50,000. During the tax year, they paid the following medical expenses for themselves and for Mrs. Gere's mother, Mrs. Watson. The Gere's could claim Mrs. Watson as their dependent but she has too much gross income.

Insulin for Mr. Gere	\$1,000
Health insurance premiums for Mrs. Gere	\$3,100
Long-term care insurance premiums for Mr. Gere, age 63	\$1,500
Hospital bill for Mrs. Watson	\$5,200
Doctor bill for Mrs. Gere	\$4,000

Mr. and Mrs. Gere received no reimbursement for the above expenditures. What is the amount of their deductible itemized medical expenses?

A) \$9,200

B) \$11,050

C) \$13,800

D) \$14,800

Answer: B

Explanation:

B) Insulin for Mr. Gere	\$1,000
Health insurance premiums for Mrs. Gere	\$3,100
Long-term care insurance premiums for Mr. Gere	\$1,500
Hospital bill for Mrs. Watson	\$5,200
Doctor bill for Mrs. Gere	<u>\$4,000</u>
Total expenses	14,800
Minus: 7.5% of AGI ($\$50,000 \times 0.075$)	(<u>3,750</u>)
Deduction	<u>\$11,050</u>

Page Ref.: I:7-7

31) On July 31 of the current year, Marjorie borrows \$120,000 to purchase a new fishing boat. The loan is secured by her personal residence. On the date of the loan, the outstanding balance on the original debt incurred to purchase the residence is \$300,000 and the FMV of the home is \$450,000. Interest on what total amount is deductible by Marjorie in the current year?

A) \$300,000

B) \$400,000

C) \$420,000

D) \$450,000

Answer: B

Explanation: B) Interest on \$300,000 of acquisition indebtedness and \$100,000 of home equity indebtedness. The home equity indebtedness is the lesser of home equity of \$150,000 or \$100,000.

Page Ref.: I:7-17; Example I:7-18

32) A loss must be both realized and recognized to be deductible.

a. True

b. False

Answer: TRUE

Page Ref.: I:8-2

33) Material participation by a taxpayer in a passive activity is satisfied if the individual participates in the activity for more than 500 hours during the year.

a. True

b. False

Answer: TRUE

Page Ref.: I:8-11

34) A business bad debt gives rise to an ordinary deduction while a nonbusiness bad debt is treated as a short-term capital loss.

a. True

b. False

Answer: TRUE

Page Ref.: I:8-26

35) Brandon, a single taxpayer, had a loss of \$45,000 from a rental real estate activity A in which he actively participated. He also had \$24,000 of income from rental real estate activity B in which he actively participated. He acquired both investments in 2005. If Brandon has no other

passive income or losses and has adjusted gross income of \$70,000 before considering passive activities, how much loss from rental activities can he use to offset his nonpassive income?

- A) \$21,000
- B) \$24,000
- C) \$25,000
- D) \$45,000

Answer: A

Explanation: A) \$24,000 of the loss offsets \$24,000 income from the other passive activity, leaving a \$21,000 loss. The \$21,000 may offset nonpassive income using the special allowance of up to \$25,000.

Page Ref.: I:8-15

II. Problem Solving Question (50 points):

1) Jamal, age 52, is a manager for Triple W Company. His annual salary is \$100,000 and he receives the following fringe benefits during the current year:

- Triple W pays for all employees' health and accident insurance. Triple W pays \$4,000 for Jamal's health insurance during the year.
- Triple W provides Jamal with group-term life insurance coverage of \$200,000 during the year. The monthly inclusion amount per \$1,000 of coverage is \$.23.
- Triple W has a flexible benefits plan in which employees may participate to pay any costs not reimbursed by their health insurance. Jamal has \$3,600 withheld from his salary under the plan. During the year he receives reimbursements of \$3,300.
- Triple W pays for mass transit passes for all employees of \$100 a month.
- Triple W pays Jamal's annual membership dues of \$450 to the Society of Human Resource Management Association. The company also subscribes to several management journals for Jamal costing \$650 a year.
- Jamal took a college class on employment law and Triple W reimbursed his tuition of \$6,000.
- Jamal's consumption of coffee provided by Triple W is valued at \$700 a year.

How much income must Jamal report from his job?

Answer: Salary	\$100,000	
Excess life insurance coverage	414	$[(200-50) \times .23 \times 12]$
Flexible benefits plan	(3,600)	
Tuition assistance	<u>750</u>	$(\$6,000 - \$5,250)$
Gross Income	\$97,564	

The health insurance premiums are excluded. Mass transit passes provided by an employer of up to \$130 a month are excludable. The membership dues and subscriptions are working condition fringe benefits and are not taxable. The maximum exclusion for tuition is \$5,250. Coffee is a de minimis fringe benefit and is not taxable.

Page Ref.: I:4-10 through I:4-13