Student name ______________________________ UNID _________________

SAMPLE EXAMINATION I Answer Key

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

1) If a taxpayer's total tax liability is $4,000, taxable income is $20,000 and total economic income is $40,000, then the effective tax rate is 20 percent.
Answer: FALSE
Explanation: The effective rate would be $4,000/$40,000 = 10 percent.
Page Ref.: I:1-5

2) Limited liability company members (owners) are responsible for the liabilities of their limited liability company.
Answer: FALSE
Page Ref.: I:1-23

3) Denzel earns $120,000 this year through his job as a sales manager. What is his FICA tax?
A) $7,459.
B) $7,803.
C) $8,362.
D) $9,180.
Answer: C
Explanation: C) (106,800 × .062) + (120,000 × .0145) = $8,362.
Page Ref.: I:1-11

4) A married taxpayer filing a separate tax return may claim an exemption for the taxpayer's spouse when the spouse has no gross income and is not claimed as a dependent by another.
Answer: TRUE
Page Ref.: I:2-12 and I:2-25

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

6) Ben, age 67, and Karla, age 58, have two children who live with them and for whom they provide total support. Their daughter is 21 years old, blind, is not a full-time student and has no income. Her twin brother is 21 years old, has good sight, is a full-time student and has income of $3,600. Ben and Karla can claim how many personal and dependency exemptions on their tax return?
A) 2
B) 3
C) 4
D) 5
Answer: C
Explanation: C) Ben and Karla get two personal exemptions for themselves. Although their daughter is not their qualifying child, she still qualifies as a dependent since she meets all of the dependency tests for a qualifying relative. Their son qualifies as their dependent as he is their

qualifying child and need not meet the gross income test. Therefore, they are entitled to a total of four personal and dependency exemptions.
Page Ref.: I:2-13 and I:2-14

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) Tom and Alice were married on December 31 of last year. What is their filing status for last year?
A) They file as single.
B) They file as married joint or married separate.
C) They file as single for half the year and married for the other half.
D) They file as single for 364 days and married for one day.
Answer: B
Explanation: B) Marital status is determined as of the last day of the tax year. If the couple was married on December 31, they are considered married for the entire year and may file either married filing jointly or married filing separately (B).
Page Ref.: I:2-21

9) 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

10) The recipient of a taxable stock dividend includes the value of the stock received in gross income and that amount becomes the basis for the stock received.
Answer: TRUE
Page Ref.: I:3-17

11) Gregory receives 100 shares of stock from his employer as a year-end bonus. The fair market value of the stock is included in Gregory's income for the year.
Answer: TRUE
Page Ref.: I:3-5; Example I:3-3

12) One of the requirements that must be met in order to defer recognition of income for advance payments for goods is:
A) the taxpayer's method of accounting for the sale for tax purposes is the same as the method used for financial reporting purposes.
B) the goods are on the taxpayer's premises on the last day of the tax year.
C) the goods are produced in the United States.
D) the amount received is more than the taxpayer's cost of the goods.
Answer: A
Explanation: A) The tax reporting method must match the financial reporting method.
Page Ref.: I:3-11

13) Which of the following is least likely to result in a constructive dividend?
A) an unreasonable salary paid to a shareholder
B) a sale of a corporations' asset to a shareholder at fair market value
C) a payment by a corporation of a shareholder's debts
D) a payment by a corporation of a shareholder's personal expenses
Answer: B
Explanation: B) The sale of an asset at fair market value will not result in a constructive dividend.
Page Ref.: I:3-18

14) Dividends on life insurance policies are generally excludable income because they are considered a return of premium.
Answer: TRUE
Page Ref.: I:4-6

15) 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	$40,000

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

16) 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

17) Martha, who has been employed by the Smythe Corporation for ten years, receives a $400 watch as a length of service award in a meaningful presentation. The fair value of the watch is taxable.
Answer: FALSE
Page Ref.: I:4-14

18) Carter is the beneficiary of a $100,000 policy on the life of his mother. Carter sells the policy to his brother, Parker, for $30,000. Parker subsequently pays premiums of $15,000. Upon his

mother's death, how much of the insurance proceeds must Parker include in income?
A) $0
B) $45,000
C) $55,000
D) $100,000
Answer: C
Explanation: C) If there has been a transfer for valuable consideration as is the case here, the life insurance proceeds are taxable but may be reduced by the investment in the policy. Thus, $55,000 {$100,000 - ($30,000 + 15,000)} is taxable.
Page Ref.: I:4-5; Example I:4-8

19) Nelda suffered a serious stroke and was admitted to a nursing home for 140 days. Nursing home charges, including physician fees and other related expenses were $35,000. Under Nelda's long-term care insurance contract, she received reimbursements of $38,000. How much of the $38,000 reimbursement must be included in Nelda's gross income in 2009?
A) $0
B) $1,200
C) $2,000
D) $3,000
Answer: A
Explanation: A) $280/day × 140 days = $39,200 is the limit on the exclusion. Since her reimbursement was less than the maximum exclusion, the difference is not taxable.
Page Ref.: I:4-9; Example I:4-19

20) Tim earns a salary of $40,000. This year, Tim's employer establishes a cafeteria plan under which Tim signed a salary reduction of $2,500 for which $1,500 is to cover his health insurance premiums and $1,000 is available to reimburse medical expenses. During the year, he is reimbursed $900 for medical expenses. What is the total taxable to Tim this year?
A) $37,500
B) $37,600
C) $38,400
D) $40,000
Answer: A
Explanation: A) His taxable salary is $37,500 ($40,000 salary - $2,500 amount of salary reduction agreement). The payments for the health insurance premiums and the reimbursement of medical expenses are not taxable. Tim loses the $100 ($1,000 - $900) which was set aside for medical expenses and not claimed.
Page Ref.: I:4-17; Example I:4-28

21) An expense is considered necessary if it is "appropriate and helpful" in the taxpayer's business.
Answer: TRUE
Page Ref.: I:6-8

22) A wash sale occurs when a taxpayer realizes a loss on the sale of stock or securities and the taxpayer acquires substantially identical stock or securities within a 61 day period after the date of sale.
Answer: FALSE
Explanation: The 61-day period of time extends from 30 days before the date of the sale to 30 days after the date of the sale.
Page Ref.: I:6-24

23) 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

24) Liz, who is single, lives in a single family home and owns a second single family home that she rented for the entire year at a fair rental rate. Liz had the following items of income and expense during the current year.

Income:	
Gross salary and commissions from Ace Corporation	$50,000
Rent received from tenant in Liz's rental house	10,000
Dividends received on her portfolio of stocks	5,000
Expenses:	
Unreimbursed professional dues	200
Subscriptions to newsletters recommending stocks	900
Taxes, interest and repair expenses on rental house	3,500
Depreciation expense on rental house	2,300

What is her adjusted gross income for the year?
A) $50,750
B) $58,100
C) $59,200
D) $65,000
Answer: C
Explanation:

C) Gross salary and commissions from Ace Corporation	$50,000
Rent received from tenant in Liz's rental house	10,000
Dividends received on her portfolio of stocks	5,000
Gross income	$65,000
For AGI Deductions:	
Taxes, interest and repair expenses on rental house	(3,500)
Depreciation expense on rental house	(2,300)
Adjusted Gross Income	$59,200

Page Ref.: I:6-4

25) American Healthcare (AH), an insurance company, is trying to persuade Congress to enact nationwide anti-smoking legislation. As part of this effort, AH paid $500,000 to hire a lobbying firm to discuss its concerns with members of Congress. AH also contributed $100,000 to candidates for political office who support limiting public smoking. What amount of these expenditures can AH deduct?
A) $0
B) $100,000
C) $500,000
D) $600,000
Answer: A
Explanation: A) Lobbying expenses are only deductible if incurred for local issues; political contributions are not deductible.
Page Ref.: I:6-15; Example I:6-19

26) Sheila sells stock, which has a basis of $12,000, to her daughter for $7,000, the stock's fair market value. Subsequently, the daughter sells the stock to an unrelated party for $5,000. Which of the following is true for the Sheila and the Daughter?

Sheila	Daughter
A) recognizes no loss	recognizes loss of $2,000
B) recognizes no loss	recognizes loss of $5,000
C) recognizes loss of $3,000	recognizes loss of $5,000
D) recognizes loss of $3,000	recognizes loss of $2,000

Answer: A

Explanation: A) The $5,000 ($7,000 - $12,000) loss on Sheila's sale to Daughter is disallowed under the related party transaction rules. Her daughter's subsequent sale at a $2,000 loss, however, is recognized.

Page Ref.: I:6-28; Example I:6-35

27) Mackensie owns a condominium in the Great Smokey Mountains. During the year, Mackensie uses the condo a total of 27 days. The condo is also rented to tourists for a total of 73 days and generates rental income of $8,900. Mackensie incurs the following expenses in the condo:

Expense	**Amount**
Mortgage interest	$ 3,000
Property taxes	1,500
Utilities	2,500
Insurance	1,800
Depreciation	11,000

Using the Court method of allocating expenses, the amount of depreciation that Mackensie may take with respect to the rental property will be

A) $2,476.

B) $4,861.

C) $7,300.

D) $10,000

Answer: B

Explanation: B) Rental income	$8,900
Minus: Mortgage interest (73/365 × $3,000)	(600)
Property taxes (73/365 × $1,500)	(300)
Utilities (73/100 × $2,500)	(1,825)
Insurance (73/100 × $1,800)	(1,314)
Depreciation (Remaining income)	(4,861)
Taxable rental income	$ -0-

Page Ref.: I:6-33; Example I:6-42

28) Expenditures for long-term insurance premiums qualify as a medical expense deduction subject to an annual limit based upon the age of an individual.

Answer: TRUE

Page Ref.: I:7-5

29) Interest expense incurred in the taxpayer's trade or business is deductible as a *for* AGI deduction without limitation if the taxpayer materially participates in the business.

Answer: TRUE

Page Ref.: I:7-13

30) All of the following are deductible as medical expenses except

A) vitamins and health foods that improve a taxpayer's general health.

B) payments to Christian Science practitioners for treatment of a specific medical condition.
C) payments to a hospital for laboratory fees and X-rays for diagnosis of a medical problem.
D) cosmetic surgery necessary to correct a deformity arising from a congenital abnormality.
Answer: A
Explanation: A) Vitamins and health foods are not deductible as medical expenses.
Page Ref.: I:7-4

31) On September 1, of the current year, Samuel, a cash-basis taxpayer, sells his farm to Edward, also a cash-basis taxpayer for $100,000. Samuel's basis in the farm is $65,000. The real property tax year is the calendar year. Real estate taxes on the property for the year are $3,650 and are payable on April 1 of the following year. The sales agreement does not provide for apportionment of real estate taxes between the buyer and seller. Assume Samuel pays all of the real estate taxes prior to the sale. The effects of this sales structure will be:

	Taxes allocated to Samuel	**Taxes allocated to Edward**	**Effect on Samuel's Gain**
A)	$1,220	$2,430	increase gain by $1,220
B)	$2,430	$1,220	increase gain by $2,430
C)	$2,430	$1,220	decrease gain by $2,430
D)	$1,220	$2,430	decrease gain by $1,220

Answer: C
Explanation:
C) Taxes allocated to Edward:
(122/365 days) × $3,650 = $1,220 rounded.
Decrease Samuel's gain by $1,220.
Taxes allocated to Samuel = $3,650 - $1,220 = $2,430.
Page Ref.: I:7-11; Example I:7-10

32) Carlos purchased a machine for use in his trade or business several years ago for $25,000. During the current year, Carlos donates the machine to the local community college. At the time of the contribution, the machine's adjusted basis is $10,000 and its FMV is $15,000. Carlos's AGI for the year is $28,000. What is the amount of his charitable contribution deduction?
A) $10,000
B) $14,000
C) $15,000
D) $25,000
Answer: A
Explanation: A) Because the machine is ordinary income property (if sold the machine would have resulted in section 1245 ordinary income), the amount of the contribution is adjusted basis of $10,000.
Page Ref.: I:7-24; Example I:7-27

33) Alvin gave his daughter Martha section 1244 stock which he had purchased from the corporation. Martha's basis in the stock was $15,000. If she subsequently sells the stock for $10,000, the $5,000 loss is ordinary.
Answer: FALSE
Explanation: Since Martha is not an original owner, she does not get the benefit of 1244 ordinary loss treatment.
Page Ref.: I:8-5

34) Shirley, who is married and files a joint return, is sole shareholder of ABC Corporation. She sold all of her stock in the corporation for $100,000. Shirley had organized the corporation in 2002 by contributing $225,000 and receiving all of the capital stock of the corporation. ABC Corporation is a domestic corporation engaged in the manufacturing of ski parkas. The stock in ABC Corporation qualified as Sec. 1244 stock. The sale results in a (n)

A) ordinary loss of $125,000.
B) long-term capital loss of $125,000.
C) long-term capital loss of $100,000 and ordinary loss of $25,000.
D) ordinary loss of $100,000 and long-term capital loss of $25,000.
Answer: D
Explanation: D) The loss realized is $100,000 - $225,000 = ($125,000). Since the stock is Section 1244 stock and Shirley is an original owner, the first $100,000 (for married individuals) of the loss is treated as ordinary. The remainder of $25,000 ($125,000 - $100,000) is treated as long-term capital gain since Shirley held the stock longer than 12 months.
Page Ref.: I:8-5

35) Leonard owns a hotel which was damaged by a hurricane. The hotel had an adjusted basis of $1,000,000 before the hurricane. A recent appraisal determined that the hotel's FMV was $1,500,000 before the hurricane and $700,000 afterwards. Leonard received insurance proceeds of $500,000. His AGI is $60,000. What is the amount of his deductible casualty loss?
A) $293,900
B) $300,000
C) $793,900
D) $800,000
Answer: B
Explanation: B) For business property partially destroyed, the amount of the loss is the lower of the decline in FMV or adjusted basis. The decline in FMV is $800,000. Leonard received insurance proceeds of $500,000, resulting in a deductible casualty loss of $300,000.
Page Ref.: I:8-20

<u>II. Problem Solving Question (50 points):</u>

1) On April 1, 2009, Martha, age 67, begins receiving payments of $3,000 monthly from her employer's qualified retirement plan. She had contributed $90,000 to the plan. The anticipated number of payments is 210.
a. How much of the payments are taxable in 2009?
b. In 2029, Martha, age 87, continues to receive retirement payments. How much of the payments are taxable in 2029?
c. Assume that Martha dies on December 20, 2011. She had received all twelve of her 2011 payments. What are the tax consequences on her 2011 tax return?

Answer:
a. $90,000 / 210 = 429 monthly exclusion. The monthly taxable amount is $3,000 - 429 = $2,571. In 2009, $2571 × 9 = $23,139 is taxable to Martha.
b. In 2029, Martha will have recovered all of her contributions to the retirement plan. The entire amount of her payments will be taxable ($3,000 × 12 = $36,000).
c. Martha has received 33 payments prior to her death and will have recovered $429 × 33 = $14,157. She has not recovered $75,843 of her contributions ($90,000 - 14,157) and this amount is deductible on her final tax return.
Page Ref.: I:3-22, Example I:3-30