Pearsons Federal Taxation 2024 Individuals 37th edition Franklin Test Bank

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***Pearson's Federal Taxation 2024: Individuals, 37e* (Franklin)**
Chapter I1: An Introduction to Taxation

LO1: History of Taxation in the United States

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

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

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

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

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

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

LO2: Types of Tax Rate Structures

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

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

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

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

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

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

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

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

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

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

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

12) Which of the following taxes is regressive?
A) Federal Insurance Contributions Act (FICA)
B) excise tax
C) property tax
D) gift tax
Answer: A
Explanation: For upper income wage earners, the Social Security tax ceases at a maximum wage base. For 2023, wages over $160,200 are not subject to the Social Security tax.
Page Ref.: I:1-5; Topic Review I:1-1
Objective: 2

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

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

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

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

17) Briana, who is single, has taxable income for 2023 of $90,000, resulting in a total tax of $15,108. Her total economic income is $100,000. Briana's average tax rate and effective tax rate are, respectively,
A) 16.79% and 15.11%.
B) 16.79% and 22%.
C) 15.11% and 22%.
D) 15.11% and 16.79%.
Answer: A
Explanation: Average tax rate: $15,108 ÷ $90,000 = 16.79%
Effective tax rate: $15,108 ÷ $100,000 = 15.11%
Page Ref.: I:1-5 and I:1-6; Example I:1-5
Objective: 2

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

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

LO3: Other Types of Taxes

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

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

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

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

5) For gift tax purposes, a $17,000 annual exclusion per donee is permitted in 2023.
Answer: TRUE
Explanation: Donors are allowed to exclude $17,000 per donee per year for gift tax purposes.
Page Ref.: I:1-8
Objective: 3

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6) In 2023, an individual will be subject to gift tax on gifts made to a charity greater than $17,000.
Answer: FALSE
Explanation: Contributions to charity are not limited by the gift tax exclusion.
Page Ref.: I:1-8
Objective: 3

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

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

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

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

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

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

13) Paul makes the following property transfers in 2023:

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

The total of Paul's taxable gifts, assuming he does not elect gift splitting with his spouse, subject to the unified transfer tax is
A) $203,000.
B) $223,000.
C) $245,000.
D) $279,000.
Answer: A
Explanation: $220,000 - $17,000 = $203,000. The gift to the unrelated friend is below the $17,000 annual gift tax exclusion. The gifts to his wife and to the charity are not subject to gift tax.
Page Ref.: I:1-8; Example I:1-6
Objective: 3

14) Charlie makes the following gifts in 2023: $40,000 to his spouse, $30,000 to his church, $18,000 to his nephew, and $25,000 to a friend. Assuming Charlie does not elect gift splitting with his wife, his taxable gifts in the current year will be
A) $27,000.
B) $9,000.
C) $26,000.
D) $43,000.
Answer: B
Explanation: ($18,000 - $17,000) + (25,000 - $17,000) = $9,000. The gift to his spouse and the charitable gift are not subject to gift taxes.
Page Ref.: I:1-8; Example I:1-6
Objective: 3

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15) Shaquille buys new cars for five of his friends. Each car cost $70,000. What is the amount of Shaquille's taxable gifts?
A) $0
B) $265,000
C) $333,000
D) $350,000
Answer: B
Explanation: 5 × ($70,000 - $17,000) = $265,000
Page Ref.: I:1-8; Example I:1-6
Objective: 3

16) In 2023, an estate is not taxable unless the sum of the taxable estate and taxable gifts made after 1976 exceeds
A) $4,769,800.
B) $10,000,000.
C) $5,113,800.
D) $12,920,000.
Answer: D
Explanation: The unified credit equivalent for estate and gift taxes is $12,920,000 for 2023. This exclusion amount equates to a unified credit of $5,113,800.
Page Ref.: I:1-9; Example I:1-7
Objective: 3

17) Eric dies in 2023 and has a gross estate valued at $16,500,000. The estate incurs funeral and administrative expenses of $100,000 and also pays off Eric's debts which amount to $250,000. Eric bequeaths $600,000 to his wife. Eric made no taxable transfers during his life. Eric's taxable estate will be
A) $2,630,000.
B) $15,550,000.
C) $2,880,000.
D) $16,500,000.
Answer: B
Explanation: ($16,500,000 - $100,000 - $250,000 - $600,000) = $15,550,000
Page Ref.: I:1-10; Example I:1-8
Objective: 3

18) Jose dies in 2023 and has a gross estate valued at $13,000,000. Over the past ten years, Jose had made taxable gifts of $400,000. The estate incurs funeral and administrative expenses of $100,000 and also pays off Jose's debts which amount to $300,000. Jose bequeaths $500,000 to his wife. What is the amount of Jose's tax base, the amount on which the estate tax is computed?
A) $12,100,000
B) $12,500,000
C) $0
D) $80,000
Answer: B
Explanation: $13,000,000 - $100,000 funeral/administrative expense - $300,000 liabilities - $500,000 marital transfers = $12,100,000 taxable estate + $400,000 gifts = $12,500,000 tax base
Page Ref.: I:1-10; Example I:1-8
Objective: 3

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

20) Kole earns $170,000 in 2023 in his job as a sales manager. What is his FICA tax?
A) $12,397
B) $10,063
C) $12,255
D) $13,005
Answer: A
Explanation: (160,200 × .062) + (170,000 × .0145) = $12,397
Page Ref.: I:1-11
Objective: 3

21) Jillian, a single individual, earns $230,000 in 2023 through her job as an accounting manager. What is her FICA tax?
A) $13,537
B) $13,267
C) $17,595
D) $17,865
Answer: A
Explanation: (160,200 × .062) + (230,000 × .0145) + ((230,000 - 200,000) × .009) = $13,537
Page Ref.: I:1-11
Objective: 3

22) Martha is self-employed in 2023. Her self employment income is $170,000. What is her self-employment tax?
A) $26,010
B) $24,795
C) $24,511
D) None of the above
Answer: B
Explanation: (160,200 × .124) + (170,000 × .029) = $24,795
Page Ref.: I:1-11
Objective: 3

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23) Vincent makes the following gifts during 2023:
Cash gift to wife of $15,000
Gift of automobile valued at $35,000 to his adult son
Gift of golf clubs valued at $5,000 to a friend
Cash donation to church of $10,000

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

	Gift Value	Adjustment	Taxable Gift
Cash to wife	$15,000	spousal gifts excluded	$ 0
Auto to son	35,000	less $17,000 exclusion	18,000
Clubs to friend	5,000	less $17,000 exclusion	0
Church donation	10,000	charity gifts excluded	0
Taxable gifts			$19,000

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

24) Jeffery died in 2023 leaving a $16,000,000 gross estate. Six months after his death, the gross assets are valued at $16,100,000. In years prior to 2023 (but after 1976), Jeffery had made taxable gifts of $300,000. Of the $16,000,000 gross estate, estate assets valued at $3 million were transferred to his wife and $100,000 was used to pay administrative and funeral expenses. Jeffery had debts of $200,000 which were paid by the estate, and the remainder of the estate was transferred to his children.
a. What is the amount of Jeffery's taxable estate?
b. What is the tax base for computing Jeffery's estate?
c. What is the amount of estate tax owed if the unified credit is $4,625,800?
d. Alternatively, if six months after his death, the gross assets in Jeffery's estate declined in value to $15,000,000, can the administrator of Jeffery's estate elect the alternate valuation date?
Answer:

Gross Estate	$16,000,000
Minus: Funeral and administrative expenses	(100,000)
Minus: Debts	(200,000)
Minus: Marital deduction	(3,000,000)
Taxable estate (a)	**$12,700,000**
Plus: Taxable gifts made after 1976	300,000
Tax base (b)	**$13,000,000**
Tentative tax on estate tax base $345,800 + [.4 × (13,000,000 - $1,000,000)]	$ 5,145,800
Minus: Tax credits (unified tax credit)	5,113,800
Unified transfer tax due (c)	**$ 32,000**

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d. The alternate valuation date (six months after the date of death) may be elected only if the aggregate value of the gross estate decreases during the six-month period following the date of death and the election results in a lower estate tax liability. In this case, the alternate valuation date can be elected.
Page Ref.: I:1-10; Example I:1-8
Objective: 3

25) Mia is self-employed as a consultant. During 2023, Mia earned $180,000 in self-employment income. What is Mia's self-employment tax?
Answer: .124 × $160,200 = $19,865
.029 × $180,000 = 5,220
Self-employment tax $25,085
Page Ref.: I:1-11
Objective: 4

LO4: Criteria for a Tax Structure

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

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

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

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

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

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

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

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

LO5: Entities in the Federal Income Tax System

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

21) Brad and Angie had the following income and deductions during 2023:

Salaries	$125,000
Interest income	10,000
Itemized deductions	31,000
Taxes withheld during year	13,000

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

Salaries	$125,000
Interest income	10,000
Gross income	135,000
Deduction for AGI	0
AGI	135,000
Itemized deductions	(31,000)
Taxable income	$104,000

Tax = $10,294 + .22(104,000 - 89,450) = $13,495
$13,495 - 13,000 taxes withheld = $495 taxes due
Page Ref.: I:1-17 and I:1-18; Example I:1-13
Objective: 5

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22) Chris, a single taxpayer, had the following income and deductions during 2023:

Salary	$65,000
Interest on bank account	300
Tax-exempt interest	200
Deduction for AGI	2,500
Itemized deductions	14,000
Taxes withheld	7,500

Calculate Chris's tax liability due or refund.

Answer: Salary	$65,000
Interest on bank account	300
Gross income	65,300
Deduction for AGI	(2,500)
Adjusted gross income	62,800
Itemized deductions	(14,000)
Taxable income	$48,800

Tax $5,147 + .22(48,800 - 44,725) = $6,044
$7,500 taxes withheld -6,044 tax = $1,456 tax refund
Page Ref.: I:1-17 and I:1-18; Example I:1-13
Objective: 5

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

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

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

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

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

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

LO6: Tax Law Sources

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

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

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

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

LO7: Enactment of a Tax Law

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

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

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

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

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

6) List the steps in the legislative process for major tax reform.
Answer:
1. Tax bill is introduced by member(s) of House of Representatives and referred to House Ways and Means Committee.
2. House Ways and Means Committee considers and studies House bill.
3. House Ways and Means Committee votes and approved bill is forwarded to full House.
4. Approval of House bill by the House of Representatives.
5. Senate Finance Committee modifies and amends House bill into separate Senate bill.
6. Approval of Senate bill by the Senate.
7. Both bills sent to Joint Conference Committee
8. Reconciled bill issued by a Joint Conference Committee and sent to House and Senate for approval.
9. Approval or veto of legislation by the President.
10. New tax law and amendments incorporated into the Code.
Page Ref.: I:1-24 and I:1-25; Table I:1-2
Objective: 7

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LO8: Administration of the Tax Law and Tax Practice Issues

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

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

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

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

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5) Alan filed his 2022 tax return on April 1, 2023, shortly before the April 15 due date. His return contains no misstatements or omissions of income. The statute of limitations for changes to the return expires
A) April 1, 2026.
B) April 15, 2026.
C) April 15, 2027.
D) The statute of limitations never expires.
Answer: B
Explanation: The three-year statute applies, beginning with the April 15 due date of the return.
Page Ref.: I:1-28
Objective: 8

6) Peyton has adjusted gross income of $2,000,000 on his 2022 tax return, filed April 15, 2023, the due date. He accidentally failed to include $200,000 that he received for a television advertisement. How long does the IRS have to audit Peyton's federal tax return?
A) until April 15, 2025
B) until April 15, 2026
C) until April 15, 2029
D) The IRS can audit Peyton's return at any future date.
Answer: B
Explanation: The omission does not exceed 25% of reported gross income, so the three-year statute still applies. Since the omission was accidental, the rules for fraud do not apply.
Page Ref.: I:1-28
Objective: 8

7) Latashia reports $100,000 of gross income on her 2022 tax return, filed on the April 15, 2023 due date. She omits $30,000 of income, but the error was not fraudulent. When does the statute of limitations for examining her tax return expire?
A) April 15, 2025
B) April 15, 2026
C) April 15, 2029
D) It never expires.
Answer: C
Explanation: The six-year statute applies since the omitted income exceeds 25% of the gross income reported.
Page Ref.: I:1-28
Objective: 8

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

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

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

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

B)

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

C)

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

D)

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

Answer: C
Explanation: The penalty for failure to file is 5% per month up to 25%. The failure to pay penalty is 0.5% per month up to 25%.
Page Ref.: I:1-28 and I:1-29
Objective: 8

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11) Frederick failed to file his 2022 tax return on a timely basis. In fact, he filed his 2022 income tax return on October 31, 2023 and paid the amount due at that time. He failed to make timely extensions. Below are amounts from his 2022 return:

Taxable income	$120,000
Total tax liability on taxable income	22,200
Total tax withheld from his salary	22,000

Frederick sent a check for $200 in payment of his liability. He thinks that he has met all of his financial obligations to the government for 2022. Given a due date of April 15, 2023, what additional amounts may Frederick be liable for assuming any applicable interest rate is 6%?
Answer: Since Frederick's return is filed late and the final balance due on the return is paid late, Frederick is subject to further interest and penalties on his 2022 income tax return. Both interest and penalties are computed on the net tax due.

There are two penalties to which Frederick would be subject, a failure to file (timely) penalty and a failure to pay the tax (timely) penalty. The late payment penalty is .5% per month to a maximum of 25%; the late filing penalty is 5% per month to a maximum of 25%. However, both penalties are not assessed together. The taxpayer will be assessed the maximum combined 25% penalty imposed on the $200 additional tax due, or $50. In addition, the IRS will assess interest.
Page Ref.: I:1-28 and I:1-29
Objective: 8

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

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

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

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

LO9: Components of a Tax Practice

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

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

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L10: Computer Applications in Tax Practice

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

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