

## Chapter 1 Introduction to Taxation

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**Note to Instructor:** The reference tables in the appendix of the text may be required for a limited number of answers to the questions and problems in this chapter. This is indicated by “REFERENCE TABLES REQUIRED” after the learning objective.

**True-False:** Insert **T** for **True** and **F** for **False** before the questions.

\_\_\_\_\_ 1. A hidden tax is one that is included with a payment but not specifically identified.

ANSWER      True LO 1.1  
DIFFICULTY: Easy

\_\_\_\_\_ 2. Both sales and use taxes are collected in the state in which the sale takes place.

ANSWER      False LO 1.1  
DIFFICULTY: Easy

\_\_\_\_\_ 3. The person receiving the gift pays the gift tax.

ANSWER      False LO 1.1  
DIFFICULTY: Easy

\_\_\_\_\_ 4. The value added tax is a type of consumption tax.

ANSWER      True LO 1.1  
DIFFICULTY: Easy

\_\_\_\_\_ 5. The type and degree of connection between a business and a state necessary for a state to impose a tax is referred to as nexus.

ANSWER      True LO 1.1  
DIFFICULTY: Easy

\_\_\_\_\_ 6. The 16<sup>th</sup> Amendment to the US Constitution that provided for an income tax was ratified in 1939.

ANSWER      False LO 1.1  
DIFFICULTY: Easy

\_\_\_\_\_ 7. Any current changes to the tax laws are now amendments to the Internal Revenue Code of 2019.

ANSWER      False LO 1.1  
DIFFICULTY: Easy

\_\_\_\_\_ 8. A flat tax generally would be considered a regressive tax.

## 2 Taxation for Decision Makers Test Bank

ANSWER False LO 1.2  
DIFFICULTY: Easy

\_\_\_\_\_ 9. Adam Smith's four canons of taxation are Equity, Certainty, Economy and Convenience.

ANSWER True LO 1.3  
DIFFICULTY: Easy

\_\_\_\_\_ 10. Vertical equity asserts that persons in similar circumstances should face similar tax burdens.

ANSWER False LO 1.3  
DIFFICULTY: Easy

\_\_\_\_\_ 11. There are three basic taxable entities: the individual, the fiduciary, and the C corporation.

ANSWER True LO 1.4  
DIFFICULTY: Easy

\_\_\_\_\_ 12. All interest paid to a taxpayer must be included in gross income.

ANSWER False LO 1.4  
DIFFICULTY: Moderate

\_\_\_\_\_ 13. The lowest tax rate on the tax rate schedules for taxable incomes is the same for individuals and C corporations.

ANSWER False LO 1.4 REFERENCE TABLES REQUIRED  
DIFFICULTY: Easy

\_\_\_\_\_ 14. A \$100 tax deduction is more valuable to a taxpayer than a \$100 tax credit.

ANSWER False LO 1.4  
DIFFICULTY: Easy

\_\_\_\_\_ 15. A corporation incurring a net operating loss in 2019 can only carry that loss forward to offset profits in future years.

ANSWER True LO 1.5  
DIFFICULTY: Moderate

\_\_\_\_\_ 16. All limited liability companies (LLCs) can file their tax returns as partnerships.

ANSWER False LO 1.5  
DIFFICULTY: Moderate

\_\_\_\_\_ 17. Partnerships and S corporations are flow-through entities.

ANSWER True LO 1.5  
DIFFICULTY: Easy

**Short-Answer Questions:** Provide a brief written answer to each of the following questions.

1. Name and describe two types of taxes other than the income tax. Give an example of each.

**ANSWER** Wealth taxes are those taxes levied on the value of property owned by a taxpayer. Examples include real estate taxes, tangible taxes, intangible taxes, and inventory taxes. Wealth transfer taxes are those taxes levied on the value of property transferred to another. Examples are the gift, estate, and inheritance taxes. Consumption taxes are taxes levied on the value of goods or services that are purchased for consumption. Examples include sales, use, excise, and value added taxes.

LO 1.1

DIFFICULTY: Easy

2. Compare a sales tax to a use tax.

**ANSWER** A sales tax is levied on a purchase at the point of sale regardless of the state of residence of the purchaser. A use tax is levied on a purchased item brought into a different state for use when a sales tax is not paid by the purchaser in the state where the item was purchased. Normally the sales and use taxes in a specific state are levied at identical rates.

LO 1.1

DIFFICULTY: Moderate.

3. Differentiate a wealth tax from a wealth transfer tax and give an example of each.

**ANSWER:** A wealth tax is a tax levied on the value of a person's possessions at a specific point in time; common wealth taxes would be real estate taxes that are levied on the owner of real property or intangible taxes on stocks. The wealth transfer tax is levied on the value of a person's possessions that are transferred to another person; the gift and estate taxes are examples of wealth transfer taxes.

LO 1.1

DIFFICULTY: Moderate

4. Compare progressive, proportional, and regressive taxes.

**ANSWER** The tax rate in a progressive system of taxation increases at a greater rate than the rate of increase in income. The higher the income, the greater the percentage of taxes paid. The tax in a proportional system of taxation increases at the same rate as the rate of increase in income. The percentage of taxes paid would be the same over all income levels. The tax rate in a regressive system of taxation increases at a slower rate than the rate of increase in income. The higher the income, the smaller the percentage of taxes paid.

LO 1.2

DIFFICULTY: Moderate

5. What are Adam Smith's four canons of taxation? Briefly describe each.

**ANSWER** Certainty—a taxpayer knows what the tax consequences of a transaction will be when the transaction is undertaken. Equity—the tax is fair relative to the taxpayer's level of income and circumstances. Economy—the costs of administering and complying with the tax are small relative to the amount of taxes collected. Convenience—the payment of taxes is simple and easy.

LO 1.3

DIFFICULTY: Easy

#### 4 Taxation for Decision Makers Test Bank

6. Explain how horizontal equity differs from vertical equity.

ANSWER Horizontal equity would require taxpayers with similar incomes to pay a like amount of taxes. Vertical equity would require taxpayers with greater (lesser) incomes to pay a greater (lesser) amount of taxes.

LO 1.3

DIFFICULTY: Easy

7. What tax provision encourages the fiduciary of an estate or a trust to distribute the income annually to the beneficiaries?

ANSWER: The tax rates applicable to the income that a trust or an estate receives are far more progressive than any other entity; they have no 12 or 32 percent tax rates and the highest tax rate (37%) begins at \$12,750 of taxable income (\$12,500 in 2018).

LO 1.4 REFERENCE TABLES RECOMMENDED

DIFFICULTY: Easy

8. Briefly compare a sole proprietorship to a corporation as a business entity.

ANSWER A sole proprietorship has only one owner; a corporation can have one or an unlimited number of owners. The corporation has limited liability; the sole proprietor is responsible for the liabilities of the business. There generally are few if any legal requirements to establish a sole proprietorship; a corporation must be incorporated under the laws of one of the states and can issue different classes of stock and bonds. The sole proprietor cannot take advantage of employee status, must pay self-employment taxes, and reports all results of operations on his or her own tax return. A shareholder-employee of a corporation is eligible for most employee fringe benefits and the corporation files a completely separate tax return from that of any owner. The sole proprietor is fully liable for all debts of the business; shareholders are only at risk for their capital investment and are not liable for the debts of the corporation. There are other differences as well, too numerous to mention.

LO 1.5

DIFFICULTY: Moderate

9. Why are S corporations and partnerships called flow-through entities?

ANSWER S corporations and partnerships are called flow-through entities because they do not pay taxes on their incomes and gains. Instead the revenue and expense items flow through to the entity's owners and are included in and taxed along with the owners' other income.

LO 1.5

DIFFICULTY: Easy

10. What are the fiduciary entities and how are they created?

ANSWER The two fiduciary entities are the trust and the estate. A trust is created by a grantor who places assets in trust for the benefit of another person. A trustee manages the trust assets. An estate is created anytime a person who owns or has an interest in assets subject to estate taxes dies.

LO 1.5

DIFFICULTY: Easy

**Problems:** Provide numerical solutions for each of the following.

1. Cragen Corporation has gross income of \$625,000 and operating expenses of \$418,000. What is its taxable income? What is its income tax liability in 2019? How would your answer change if Cragen Corporation also had a \$20,000 capital loss due to a stock sale?

ANSWER \$207,000 taxable income; \$43,470 tax; no change

Taxable income = \$625,000 - \$418,000 = \$207,000.

Income tax = .21 x \$207,000 = \$43,470

No change because the deductibility of capital losses for a corporation in the current year is limited to offsetting capital gains.

LO 1.4

DIFFICULTY: Easy

2. The Shoe Market Inc. (a regular corporation) had \$1,875,000 of shoe sales and its cost for these shoes was \$688,000. In addition, Shoe Market received \$5,000 of corporate bond interest income and \$6,000 interest income on State of California bonds. It paid \$512,000 for salaries and had \$552,000 of other operating expenses. What is Shoe Market's taxable income? What is its income tax liability for 2019?

ANSWER \$128,000 taxable income; \$26,880 tax

Taxable income = \$1,875,000 - \$688,000 + \$5,000 corporate bond interest - \$512,000 salaries - \$552,000 expenses = \$128,000. [Interest on state bonds is tax exempt.]

Income tax = .21 x \$128,000 = \$26,880.

LO 1.4

DIFFICULTY: Moderate

3. Walter is married and files a joint return. If his adjusted gross income is \$64,000 and he has \$32,850 of deductions in 2019. What is his taxable income? What is his income tax liability?

ANSWER \$31,150 taxable income; \$3,350 tax

Taxable income = \$64,000 - \$32,850 in deductions = \$31,150.

Income tax = [(\$31,150 - \$19,400) x .12] + \$1,940 = \$1,410 + \$1,940 = \$3,350.

LO 1.4 REFERENCE TABLES REQUIRED

DIFFICULTY: Moderate

4. Susie is single, has salary income of \$26,200, and \$12,200 of deductions in 2019. What is her taxable income? What is her income tax liability?

ANSWER \$14,000 taxable income; \$1,486 tax

Taxable income = \$26,200 - \$12,200 deduction = \$14,000

Income tax = \$970 + [(\$14,000 - \$9,700) x .12] = \$970 + \$516 = \$1,486

LO 1.4 REFERENCE TABLES REQUIRED

DIFFICULTY: Moderate

5. Chloe and Bill, both single with no dependents, plan to marry either immediately before or immediately after year-end. Chloe's income for 2019 is \$89,200 and Bill's is \$86,200 before subtracting \$12,200 for the standard deduction for each. Would they have a marriage penalty or a marriage benefit if they married at the end of 2019?

ANSWER Neither, the tax liability remains the same as a married couple.

As single taxpayers:

## 6 Taxation for Decision Makers Test Bank

Chloe's taxable income:  $\$89,200 - \$12,200 \text{ standard deduction} = \$77,000$ .

Bill's taxable income:  $\$86,200 - \$12,200 \text{ standard deduction} = \$74,000$ .

Chloe's income tax:  $\$4,543 + [.22 \times (\$77,000 - \$39,475)] = \$4,543 + \$8,255.50 = \$12,798.50$ .

Bill's income tax:  $\$4,543 + [.22 \times (\$74,000 - \$39,475)] = \$4,543 + \$7,595.50 = \$12,138.50$ .

Total tax as single taxpayers:  $\$12,798.50 + \$12,138.50 = \$24,937$ .

As a married couple: Taxable income:  $\$89,200 + \$86,200 - \$24,400 \text{ standard deduction} = \$151,000$ .

Their income tax:  $\$9,086 + [(\$151,000 - \$78,950) \times .22] = \$9,086 + \$15,851 = \$24,937$

LO 1.4 REFERENCE TABLES REQUIRED

DIFFICULTY: Hard

6. Darden Corporation has taxable income of \$200,000. If it distributes 25 percent of its after-tax income to its sole shareholder who has other taxable income of \$103,000, what is the total tax burden on this \$200,000 of income?

ANSWER \$47,925 total tax is 23.96% of \$200,000

Tax on \$200,000 =  $\$200,000 \times .21 = \$42,000$  corporate tax.  $(\$200,000 - \$42,000) \times .25 = \$39,500$

distributed to the shareholder. Individual tax =  $\$39,500 \times .15 \text{ dividend rate} = \$5,925$ . Total tax =  $\$42,000 + \$5,925 = \$47,925$ . The \$47,925 total tax is 23.96% of \$200,000.

LO 1.4 & 1.5 REFERENCE TABLES REQUIRED

DIFFICULTY: Hard

7. Harold is a 40 percent partner in HDT Partnership. At the beginning of the year, his partnership interest basis was \$20,000. The partnership had net income of \$58,000 for the year and it made an \$8,000 distribution to Harold. What is Harold's basis at the end of the year? What is the amount included in Harold's gross income? What is the net amount taxable to Harold this year due to his interest in this partnership (assuming the QBI deduction is not limited)?

ANSWER \$35,200

Harold's share of the partnership's net income =  $\$58,000 \times 40\% = \$23,200$

Basis:  $\$20,000 + \$23,200 - \$8,000 = \$35,200$  basis

Gross Income: Harold's share of the partnership's net income, \$23,200. The distribution is not taxable.

Taxable Income: Harold's share of the partnership's net income,  $\$23,200 - (\$23,200 \times 20\% \text{ QBI deduction}) = \$18,560$

LO 1.5

DIFFICULTY: Moderate

8. Karen, single with the standard deduction being the only deduction for her individual tax return, wants to set up a business. She will use either a sole proprietorship or incorporate as a regular corporation. She expects the business to earn \$160,000 after all expenses and payments to Karen except for federal taxes. Karen will take \$40,000 from the business for living expenses (as a distribution from a sole proprietorship or a salary from a corporation). Considering only income taxes for 2019, should she establish the business as a C corporation or as a sole proprietorship? Assume the income will qualify for the QBI deduction.

ANSWER Karen should not incorporate because she will save \$14,047.50.

As a C corporation: Income tax on corporation =  $\$120,000 \times .21 = \$25,200$

Tax on \$40,000 salary: taxable income =  $\$40,000 - \$12,200 \text{ standard deduction} = \$27,800$ ; income tax =  $\$970 + [.12 \times (\$27,800 - \$9,700)] = \$970 + \$2,172 = \$3,142$ ; total tax =  $\$25,200 + \$3,142 = \$28,342$ .

As a sole proprietorship, Karen would be taxed on \$96,000 of income  $[(\$120,000 - \$120,000) \times .20 \text{ QBI deduction}]$ . Taxable income =  $\$96,000 - \$12,200 = \$83,800$ ; income tax =  $\$4,543 + [.22 \times (\$83,800 -$

$\$39,475] = \$4,543 + \$9,751.50 = \$14,294.50$ . Based on income taxes alone, Karen should not incorporate as she will pay  $\$14,047.50$  ( $\$28,342 - \$14,294.50$ ) less in taxes.

LO 1.4 & 1.5

REFERENCE TABLES REQUIRED

DIFFICULTY: Hard

9. Sylvester, single, takes the \$12,200 standard deduction when filing his income tax return. His sole proprietorship averages net income of \$125,000 annually. He needs \$50,000 per year to live on. If he incorporates his business, would he pay more or less in total income taxes if he takes a salary of \$50,000 for his living expenses? Assume the income will qualify for the QBI deduction. (Consider only income taxes.)

ANSWER: If he does not incorporate, Sylvester will save \$4,845.50 in taxes.

As a sole proprietorship: Taxable income:  $\$125,000 - (\$125,000 \times .20 \text{ QBI deduction}) - \$12,200 = \$87,800$ .

Income tax:  $\$14,382.50 + [.24 \times (\$87,800 - \$84,200)] = \$14,382.50 + \$864 = \$15,246.50$

As a corporation: Corporate taxable income:  $\$125,000 - \$50,000 \text{ salary} = \$75,000$ . Income tax:  $\$75,000 \times .21 = \$15,750$ . Sylvester's taxable income:  $\$50,000 - \$12,200 = \$37,800$ .

Income tax:  $\$970 + [.12 \times (\$37,800 - \$9,700)] = \$970 + \$3,372 = \$4,342$ . Total tax:  $\$4,342 + \$15,750 = \$20,092$ .

If he does not incorporate, Sylvester will save \$4,845.50 ( $\$20,092 - \$15,246.50$ ) in taxes.

LO 1.4 & 1.5

REFERENCE TABLES REQUIRED

DIFFICULTY: Hard

### Other Objective Questions

Identify the following with an **E** if all or part of the item could be an exclusion from gross income or **D** if all or part of the item could be a deduction.

- |                                  |                                        |
|----------------------------------|----------------------------------------|
| _____ a. Scholarship             | _____ f. State income taxes            |
| _____ b. Medical expense         | _____ g. Tax exempt interest income    |
| _____ c. Charitable contribution | _____ h. Student loan interest expense |
| _____ d. Life insurance proceeds | _____ i. Social Security benefits      |
| _____ e. Inheritances            | _____ j. The value of food stamps      |

ANSWER. a. E b. D c. D d. E e. E f. D g. E h. D i. E j. E

LO 1.4

DIFFICULTY: Moderate

**Multiple Choice:** Select the best answer for each of the following questions.

- What is a tax?
  - a voluntary payment to the government for services received
  - a penalty
  - a fine
  - a forced payment to the government

## 8 Taxation for Decision Makers Test Bank

ANSWER: d

LO 1.1

DIFFICULTY: Easy

2. Which of the following is a tax?

- a. Dog license
- b. Parking fine
- c. Water usage fee
- d. Import duty

ANSWER: d

LO 1.1

DIFFICULTY: Easy

3. Which of the following types of taxes is not levied by the U.S. government?

- a. Sales tax
- b. Income tax
- c. Gift tax
- d. Estate tax

ANSWER: a

LO 1.1

DIFFICULTY: Easy

4. Which of the following types of taxes is a consumption tax?

- a. Estate tax
- b. Income tax
- c. Gift tax
- d. Use tax

ANSWER: d

LO 1.1

DIFFICULTY: Easy

5. William lives in Delaware but works for a company that has offices in both Maryland and Pennsylvania. William spent four months working in Pennsylvania and 8 months working in Maryland.

- a. Only Delaware can impose a state income tax on his income.
- b. Only Maryland can impose a state income tax on his income as he worked there the longer time period.
- c. Only Pennsylvania and Maryland can impose state income taxes on his income.
- d. Delaware, Pennsylvania, and Maryland can impose state income taxes on his income.

ANSWER: d

LO: 1.1

DIFFICULTY: Moderate

6. Which of the following is a type of wealth tax?

- a. A tax on a person's salary
- b. A tax on stocks owned by the taxpayer

- c. A tax on purchases made at a department store
- d. A tax on property given to a grandchild

ANSWER: b

LO 1.1

DIFFICULTY: Moderate

7. Which type of tax is a real property tax?
- a. Income tax
  - b. Consumption tax
  - c. Wealth tax
  - d. Use tax

ANSWER: c

LO 1.1

DIFFICULTY: Easy

8. When appreciated property is transferred, the gift tax is based on
- a. replacement cost of the property
  - b. fair market value of the property on the date of the gift
  - c. the donor's original cost of the property
  - d. the donor's original cost increased by half of the appreciation

ANSWER: b

LO 1.1

DIFFICULTY: Moderate

9. Which of the following types of taxes is levied by almost all states on some or all goods purchased?
- a. Sales tax
  - b. Income tax
  - c. Property tax
  - d. Wealth transfer tax

ANSWER: a

LO 1.1

DIFFICULTY: Easy

10. Which of the following statements is false?
- a. Use taxes are assessed on out-of-state purchases used in the purchaser's state.
  - b. The estate tax is based on the fair market value of property transferred at the owner's death.
  - c. Tariffs are taxes levied on goods and materials brought into a country.
  - d. Gift taxes are imposed on the recipient of the gift.

ANSWER: d

LO 1.1

DIFFICULTY: Moderate

11. Which of the following types of taxes is not levied by the U.S. government?
- a. Excise tax
  - b. Income tax
  - c. Value added tax

## 10 Taxation for Decision Makers Test Bank

d. Gift tax

ANSWER: c

LO 1.1

DIFFICULTY: Easy

12. Kate received \$140,000 in salary in 2019. What is her FICA tax if the Medicare rate is 1.45% and the Social Security rate is 6.2% on a maximum of \$132,900 in 2019?

- a. \$10,270
- b. \$10,710
- c. \$10,167
- d. \$10,607

ANSWER: a

$(\$140,000 \times 1.45\%) + (\$132,900 \times 6.2\%) = \$2,030 + \$8,239.80 = \$10,269.80$

LO 1.1

DIFFICULTY: Moderate

13. Alexander received \$80,000 in salary in 2019. What is his FICA tax if the Medicare rate is 1.45% and the Social Security rate is 6.2% on the 2019 maximum of \$132,900?

- a. \$4,960
- b. \$6,120
- c. \$6,540
- d. \$10,920

ANSWER: b

$\$80,000 \times (1.45\% + 6.2\%) = \$6,120.$

LO 1.1

DIFFICULTY: Easy

14. Ethan received \$135,000 in salary in 2019. What is his FICA tax if the Medicare rate is 1.45% and the Social Security rate is 6.2% on the 2019 maximum of \$132,900?

- a. \$10,327.50
- b. \$10,197.30
- c. \$10,166.85
- d. \$9,918.30

ANSWER: b

$(\$135,000 \times 1.45\%) + (\$132,900 \times 6.2\%) = \$1,957.50 + \$8,239.80 = \$10,197.30.$

LO 1.1

DIFFICULTY: Moderate

15. By what right does the U.S. levy an income tax on individuals?

- a. A law proposed by the President and approved by the Senate
- b. Public Law 1913
- c. The 16<sup>th</sup> Amendment to the Constitution
- d. An Act of Congress ratified by the states

ANSWER: c

LO 1.1

DIFFICULTY: Easy

16. Current changes to the federal tax law are amendments to which of the following?
- a. The Internal Revenue Code of 1913
  - b. The Internal Revenue Code of 1954
  - c. The Internal Revenue Code of 1986
  - d. The Internal Revenue Code of 2018

ANSWER: c

LO 1.1

DIFFICULTY: Easy

17. Which of the following is an objective of taxation?
- a. Raise revenue
  - b. Foster social goals
  - c. Stimulate the economy
  - d. All of the above

ANSWER: d

LO 1.1

DIFFICULTY: Easy

18. William is single and had salary income from his position as Chief Financial Officer of Zippy Bank of \$450,000 putting him in the 37% marginal tax bracket. He also had \$35,000 in income from the dividends on the stock of his previous employer. What tax rate will apply to William's dividend income?
- a. 15%
  - b. 20%
  - c. 35%
  - d. 39.6%

ANSWER: b

LO: 1.2 REFERENCE TABLES RECOMMENDED

DIFFICULTY: Moderate

19. John earns \$25,000 and pays \$2,000 in taxes. Marcy earns \$60,000 and pays \$4,000 in taxes. How would you characterize this tax system?
- a. A flat tax system
  - b. A proportional system
  - c. A regressive system
  - d. A progressive system

ANSWER: c

$\$2,000/\$25,000 = .08$ ;  $\$4,000/\$60,000 = .0667$

LO 1.2

DIFFICULTY: Moderate

20. The Mercury Corporation must decide whether to invest in some new machinery for its business. Which tax rate is the most relevant for making this decision?
- a. The average tax rate
  - b. The marginal tax rate
  - c. The nominal tax rate

## 12 Taxation for Decision Makers Test Bank

- d. The effective tax rate

ANSWER: b

LO 1.2

DIFFICULTY: Moderate

21. Which of the following statements describes the correct relationship between marginal and average tax rates in a progressive tax system?
- a. The marginal tax rate is higher than the average tax rate.
  - b. The average tax rate is higher than the marginal tax rate.
  - c. The marginal and average tax rates are the same.
  - d. The average tax rate will always be half of the marginal tax rate.

ANSWER: a

LO 1.2

DIFFICULTY: Easy

22. Which of the following federal income tax rates applies to a C corporation in 2019?
- a. 15%
  - b. 21%
  - c. 25%
  - d. 35%

ANSWER: b

LO 1.2

DIFFICULTY: Easy

23. What is the marginal tax rate for a single individual with \$110,000 of taxable income in 2019?
- a. 10%
  - b. 12%
  - c. 22%
  - d. 24%

ANSWER: d

LO 1.2 REFERENCE TABLES REQUIRED

DIFFICULTY: Easy

24. Which of the following best describes horizontal equity?
- a. All taxpayers should pay some taxes on their incomes
  - b. As income increases, taxes should increase
  - c. Persons with equal incomes should pay the same amount of taxes
  - d. A person with capital gains should pay less tax than a person with the same amount of salary income

ANSWER: c

LO 1.3

DIFFICULTY: Moderate

25. Which of the following best describes vertical equity?
- a. All taxpayers should pay some taxes on their incomes
  - b. As income increases, taxes should increase

- c. Persons with equal incomes should pay the same amount of taxes
- d. A person with capital gains should pay less tax than a person with the same amount of salary income

ANSWER: b

LO 1.3

DIFFICULTY: Moderate

26. Which of the following are included in Adam Smith's characteristics of a good tax?
- a. Certainty
  - b. Economy
  - c. Convenience
  - d. All are included

ANSWER: d

LO 1.3

DIFFICULTY: Easy

27. Two married persons with moderately high incomes will pay more taxes than two single persons with the same income. This is commonly called:
- a. vertical equity.
  - b. horizontal equity.
  - c. a marriage bonus.
  - d. a marriage penalty.

ANSWER: d

LO 1.3

DIFFICULTY: Easy

28. Daniel is single with taxable income of \$40,000 in 2019. What is his marginal tax rate?
- a. 10%
  - b. 12%
  - c. 22%
  - d. 24%

ANSWER: c

LO 1.4 REFERENCE TABLES REQUIRED

DIFFICULTY: Easy

29. Charlotte is a head of household with taxable income of \$40,000 in 2019. What is her marginal tax rate?
- a. 10%
  - b. 12%
  - c. 22%
  - d. 24%

ANSWER: b

LO 1.4 REFERENCE TABLES REQUIRED

DIFFICULTY: Easy

## 14 Taxation for Decision Makers Test Bank

30. Ethan and Mia are married and file a joint tax return. Their taxable income is \$200,000 in 2019. What is their marginal tax rate?
- a. 10%
  - b. 12%
  - c. 22%
  - d. 24%

ANSWER: d

LO 1.4 REFERENCE TABLES REQUIRED

DIFFICULTY: Easy

31. What is an individual's maximum annual deduction for capital losses?
- a. \$3,000
  - b. An amount equal to capital gains only
  - c. An amount equal to capital gains plus \$3,000
  - d. Individuals cannot deduct capital losses

ANSWER: c

LO 1.4

DIFFICULTY: Easy

32. What is a corporation's annual deduction for capital losses?
- a. \$3,000
  - b. An amount equal to capital gains only
  - c. An amount equal to capital gains plus \$3,000
  - d. Corporations cannot deduct capital losses

ANSWER: b

LO 1.4

DIFFICULTY: Moderate

33. Which of the following is never included in computing gross income?
- a. Loss on stock sale
  - b. Social security benefits
  - c. Unemployment benefits
  - d. Gifts

ANSWER: d

LO 1.4

DIFFICULTY: Easy

34. Which of the following is normally not included in gross income?
- a. Cash dividend
  - b. Corporate bond interest income
  - c. Stock dividend
  - d. All are included in gross income

ANSWER: c

LO 1.4

DIFFICULTY: Moderate

35. What is George's gross income if he has the following: \$78,000 salary, \$4,000 dividend income, \$2,000 interest income on city of San Francisco bonds, a gain of \$14,000 on a stock sale, and a \$4,000 operating loss on a small sole proprietorship that he owns?
- \$78,000
  - \$84,000
  - \$92,000
  - \$96,000

ANSWER: c

[\$78,000 + \$4,000 + \$14,000 - \$4,000 = \$92,000] Interest on municipal bonds is tax exempt.

LO 1.4

DIFFICULTY: Moderate

36. What is Jorge's gross income if he has the following: \$78,000 salary, a \$2,000 capital loss from the sale of stock, and \$3,000 of municipal bond interest income.
- \$79,000
  - \$78,000
  - \$77,000
  - \$76,000

ANSWER: d

[\$78,000 salary - \$2,000 capital loss from the sale of stock = \$76,000] Interest on municipal bonds is tax exempt

LO 1.4

DIFFICULTY: Easy

37. Jason operates his business as a C Corporation. For the year, the business income is \$120,000, business expenses are \$20,000, and there is a \$2,000 capital loss as a result of a stock sale. What is the C Corporation's taxable income for the year?

- \$120,000
- \$118,000
- \$100,000
- \$98,000

Answer: c

[\$120,000 business income - \$20,000 business expenses = \$100,000] A C corporation may only offset capital losses against capital gains.

LO 1.4

DIFFICULTY: Moderate

38. Abigail is married filing separately with taxable income of \$175,000. What is her marginal tax rate?
- 37%
  - 35%
  - 32%
  - 24%

ANSWER: c

LO 1.4 REFERENCE TABLES REQUIRED

DIFFICULTY: Easy

## 16 Taxation for Decision Makers Test Bank

39. How much income tax must the Benton Trust pay in 2019 if its taxable income (after all deductions) is \$4,600?
- a. \$460
  - b. \$690
  - c. \$747
  - d. \$1,240

ANSWER: c

$((\$4,600 - \$2,600) \times .24) + \$260 = \$740$

LO 1.4 REFERENCE TABLES REQUIRED

DIFFICULTY: Easy

40. Which of these persons never pays taxes directly?
- a. Individual
  - b. Partnership
  - c. C corporation
  - d. Fiduciary

ANSWER: b

LO 1.5

DIFFICULTY: Easy

41. Which of these entities is taxed directly on its income?
- a. Limited Liability Company
  - b. C Corporation
  - c. Partnership
  - d. Sole Proprietorship

ANSWER: b

LO 1.5

DIFFICULTY: Easy

42. What is the earliest year to which a corporation can use a net operating loss from 2019?
- a. 2018
  - b. The first year after 2019 the corporation's gross income exceeds its tax deductions for the year.
  - c. The first year after 2021 that the corporation earns any revenues
  - d. 2017

ANSWER: b

LO 1.5

DIFFICULTY: Easy

43. Which of the following is not a tax credit allowed a corporation?
- a. Foreign tax credit
  - b. Education credit
  - c. Investment tax credit
  - d. Alternative minimum tax credit

ANSWER: b

LO 1.5

DIFFICULTY: Easy

44. Harold has a 50% interest in a general partnership that has a \$14,000 loss for the year. He materially participates in the partnership, his basis in the partnership is \$10,000 at the beginning of the year. He also has salary from other employment of \$46,200. If he is single and claims the standard deduction, what are his taxable income and tax liability, respectively, in 2019?
- \$27,000; \$3,046
  - \$39,000; \$4,510
  - \$46,000; \$5,963
  - None; \$0

ANSWER: a

Taxable income = \$27,000 and the tax liability is \$3,046.

Taxable income = \$46,200 - \$7,000 partnership loss (50% x \$14,000) - \$12,200 standard deduction = \$27,000. Tax Liability:  $[(\$27,000 - \$9,700) \times 12\%] + \$970 = \$3,046$ . Harold has sufficient basis to deduct the loss in the current year.

LO 1.5 REFERENCE TABLES REQUIRED

DIFFICULTY: Moderate

45. Harold has a 50% interest in a general partnership that has a \$14,000 loss for the year. He materially participates in the partnership, his basis in the partnership is \$10,000 at the beginning of the year. He also has salary from other employment of \$46,000. What is Harold's basis in the partnership at the end of the year?
- \$14,000
  - \$10,000
  - \$7,000
  - \$3,000

ANSWER: d

\$14,000 loss x Harold's 50% ownership interest = \$7,000 loss allocated to Harold [deductible to the extent of basis] Beginning basis \$10,000 - \$7,000 deductible loss = \$3,000 ending basis

LO 1.5

DIFFICULTY: Easy

46. Ted owns 20% of Genco (a C corporation) that had taxable income of \$100,000 and paid a total of \$50,000 in dividends to its shareholders. Ted also owns 10% of Subco (an S corporation) that had \$100,000 of taxable income and distributed a total of \$60,000 to its shareholders. How much must Ted include in his gross income as a result of being a shareholder in these two corporations?
- \$16,000
  - \$20,000
  - \$26,000
  - \$30,000

ANSWER: b;  $[(.20 \times \$50,000) + (.10 \times \$100,000)]$

LO 1.4 & 1.5

DIFFICULTY: Moderate

47. Which of the following business entities does not file a separate business tax return to report income from operations?
- Sole proprietorship
  - S corporation
  - C corporation

## 18 Taxation for Decision Makers Test Bank

### d. Partnership

ANSWER: a

LO 1.5

DIFFICULTY: Easy

48. Jason purchased a 20 percent interest in JKL Partnership for \$20,000 at the beginning of the year. At year-end, the partnership reported net income of \$15,000 and distributed \$2,000 cash to Jason. What is Jason's year-end basis?

- a. \$20,000
- b. \$21,000
- c. \$23,000
- d. \$33,000

ANSWER: b

$[\$20,000 + (.2 \times \$15,000) - \$2,000 = \$21,000]$

LO 1.5

DIFFICULTY: Moderate

49. Jason purchased a 20 percent interest in JKL Partnership for \$20,000 at the beginning of the year. At year-end, the partnership reported net income of \$15,000 and distributed \$2,000 cash to Jason. What is included in Jason's gross income as a result of his interest in JKL Partnership?

- a. \$15,000
- b. \$7,000
- c. \$5,000
- d. \$3,000

ANSWER: d

[Partnership income of \$15,000 x 20% ownership = \$3,000. The \$2,000 distribution is a tax free reduction to basis  $\$20,000 + (.2 \times \$15,000) - \$2,000 = \$21,000]$

LO 1.5

DIFFICULTY: Moderate

50. Jason purchased a 20 percent interest in JKL Partnership for \$20,000 at the beginning of the year. At year-end, the partnership reported net income of \$15,000 and distributed \$2,000 cash to Jason. Assuming Jason's QBI deduction is not limited, what is the net amount taxable to Jason's this year as a result of his interest in JKL Partnership?

- a. \$15,000
- b. \$12,000
- c. \$3,000
- d. \$2,400

ANSWER: d

[Partnership income of \$15,000 x 20% ownership = \$3,000. QBI deduction is  $\$3,000 \times .20 = \$600$ .  $\$3,000 - \$600 = \$2,400$ . The \$2,000 distribution is a tax free reduction to basis  $\$20,000 + (.2 \times \$15,000) - \$2,000 = \$21,000]$

LO 1.5

DIFFICULTY: Hard

51. Which of the following business entities has no provision that limits some or all of the liability of the owner?
- a. C corporation
  - b. Sole proprietorship
  - c. S corporation
  - d. Limited liability company

ANSWER: b

LO 1.5

DIFFICULTY: Easy

52. Terri owns a 50 percent interest in the TT Partnership. At the beginning of the year, her basis in her partnership interest was \$75,000. The partnership reports a \$40,000 loss for the year and distributes \$4,000 cash to Terri. What is her basis in her partnership interest at the end of the year?
- a. \$111,000
  - b. \$75,000
  - c. \$51,000
  - d. \$31,000

ANSWER: c

$[\$75,000 - (.5 \times \$40,000) - \$4,000 = \$51,000]$

LO 1.5

DIFFICULTY: Moderate

53. Terri owns a 50 percent interest in the TT Partnership. At the beginning of the year, her basis in her partnership interest was \$75,000. The partnership reports a \$40,000 loss for the year and distributes \$4,000 cash to Terri. What is Terri's deductible loss (included in her gross income) as a result of her 50 percent interest in TT?
- a. \$75,000
  - b. \$51,000
  - c. \$20,000
  - d. \$16,000

ANSWER: c

[Terri's basis is first reduced by the distribution and then by her 50% share of the TT Partnership loss, which is deductible to the extent of her basis after the distribution;  $75,000 - (.5 \times \$40,000) - \$4,000 = \$51,000$  ending basis]

LO 1.5

DIFFICULTY: Moderate

54. Which of the following is not a characteristic of an S corporation?
- a. Owners have limited liability
  - b. The corporation is taxed directly on operating income
  - c. The corporation can have no more than 100 shareholders
  - d. Shareholders must consent to the original S election by the corporation

ANSWER: b

LO 1.5

DIFFICULTY: Easy

## 20 Taxation for Decision Makers Test Bank

55. In which of the following entities may an owner-employee benefit from all employee tax-free fringe benefits?
- a. C corporation
  - b. S corporation
  - c. Partnership
  - d. Sole proprietorship

ANSWER: a

LO 1.5

DIFFICULTY: Easy

56. Which of the following is not a characteristic of both S corporations and partnerships?
- a. Both are flow through entities
  - b. Owners increase basis for debt undertaken by an S corporation or partnership
  - c. Both forms limit owner's participation in tax-free fringe benefits
  - d. Owners increase basis for gains and decrease basis for losses

ANSWER: b

LO 1.5

DIFFICULTY: Easy

57. Deazia is the sole proprietor of Baldwin Hair Salon that reported net income of \$44,000 for the year. During the year she withdrew \$20,000 from the business for personal use. How much income from the above must Deazia include in her gross income for the year?
- a. \$20,000
  - b. \$24,000
  - c. \$44,000
  - d. \$64,000

ANSWER: c

A sole proprietor is taxed on the entire net income for the year even though she did not withdraw all of it from the business.

LO 1.5

DIFFICULTY: Moderate

58. Jordan is the sole proprietor of Adams Company that reported \$70,000 of income and \$13,000 of expenses for the year. During the year he withdrew \$11,000 from the business for personal use. Jordan is in the 24% marginal tax bracket. How much income from the above must Jordan include in his gross income for the year?
- a. \$68,000
  - b. \$57,000
  - c. \$14,250
  - d. \$11,000

ANSWER: b

[\$70,000 - \$13,000 = \$57,000 net income.] A sole proprietor is taxed on the entire net income for the year even though he did not withdraw all of it from the business.

LO 1.5

DIFFICULTY: Moderate

59. Elena owns 25% of a partnership that reported net income of \$100,000 for the year. Elena's basis in her partnership interest is \$20,000 at the beginning of the year. During the year \$5,000 was distributed to Elena from the partnership. How much should Elena include in her gross income for the year?
- \$30,000
  - \$25,000
  - \$5,000
  - \$0

ANSWER: b

The partner is taxed on her entire share of income for the year even though she did not receive all of it as a distribution from the partnership ( $\$100,000 \times 25\% = \$25,000$ ).

LO 1.5

DIFFICULTY: Moderate

60. Elena owns 25% of a partnership that reported net income of \$100,000 for the year. Elena's basis in her partnership interest is \$20,000 at the beginning of the year. During the year \$5,000 was distributed to Elena from the partnership. Assuming Elena's QBI deduction is not limited, how much in the net amount Elena is taxed on this year as a result of her interest in this partnership?
- \$24,000
  - \$20,000
  - \$4,000
  - \$0

ANSWER: b

The partner is taxed on her entire share of income for the year even though she did not receive all of it as a distribution from the partnership ( $\$100,000 \times 25\% = \$25,000$ ). The QBI deduction is \$5,000 [20% of \$25,000 (assuming Elena's QBI deduction is not limited)].  $\$25,000 - \$5,000 = \$20,000$ .

LO 1.5

DIFFICULTY: Hard

61. Elena owns 25% of a partnership that reported net income of \$100,000 for the year. Elena's basis in her partnership interest is \$20,000 at the beginning of the year. During the year \$5,000 was distributed to Elena from the partnership. What is Elena's basis at the end of the year?
- \$40,000
  - \$30,000
  - \$25,000
  - \$20,000

ANSWER: a

$\$20,000$  beginning basis +  $\$25,000$  income allocated to Elena -  $\$5,000$  distribution to Elena =  $\$40,000$ .

The partner is taxed on her entire share of income for the year even though she did not receive all of it as a distribution from the partnership ( $\$100,000 \times 25\% = \$25,000$ ).

LO 1.5

DIFFICULTY: Moderate

62. Sophia owns 20% of a partnership that reported net income of \$130,000 for the year. During the year \$18,000 was distributed to Sophia from the partnership. How much should Sophia include in her gross income for the year?
- \$44,000
  - \$29,000

## 22 Taxation for Decision Makers Test Bank

- c. \$26,000
- d. \$44,000

ANSWER: c

The partner is taxed on her entire share of income for the year even though she did not receive all of it as a distribution from the partnership ( $\$130,000 \times 20\% = \$26,000$ ).

LO 1.5

DIFFICULTY: Moderate

63. Crystal invested \$8,000 cash in CRK Partnership for a 30% general partnership interest. In its first year of operations, CRK lost \$15,000. In its second year of operations, CRK lost an additional \$14,000. How much of the second year's losses can Crystal deduct in that year?
- a. \$700
  - b. \$2,400
  - c. \$3,500
  - d. \$4,200

ANSWER: c

$[\$8,000 - (\$15,000 \times .30) = \$3,500$  basis at beginning of second year] ( $\$14,000 \times .30 = \$4,200$  but limited to \$3,500 basis)

LO 1.5

DIFFICULTY: Hard

64. Elena owns 40% of Martinez, Inc., a regular C corporation, that reported net income of \$80,000 for the year. During the year \$8,000 was distributed to Elena from the corporation's earnings and profits. How much income from the corporation should Elena include in her gross income for the year?
- a. \$40,000
  - b. \$32,000
  - c. \$8,000
  - d. \$3,200

ANSWER: c

The shareholder is only taxed on the \$8,000 dividend income received.

LO 1.5

DIFFICULTY: Easy

65. Emma owns 40% of Johnson, Inc., a regular C corporation, that reported a net loss of \$50,000 for the year. Emma acquired her stock on January 1 of the current year by investing \$4,000 cash. In July, the corporation took out a bank loan for \$25,000. How much of the loss can Emma deduct on her tax return for the year?
- a. \$0
  - b. \$4,000
  - c. \$9,000
  - d. \$10,000

ANSWER: a

Losses from C corporations do not flow through to shareholders.

LO 1.5

DIFFICULTY: Moderate

66. Emma is a 40% General Partner of JohnsonPartners that reported a net loss of \$50,000 for the year. Emma joined the partnership on January 1 of the current year with a beginning basis of \$4,000. During the year, JohnsonPartners took out a bank loan for \$25,000. How much of the loss can Emma deduct on her tax return for the year?
- \$0
  - \$4,000
  - \$14,000
  - \$20,000

ANSWER: c;

Emma's share of the loss is \$20,000 [ $\$50,000 \times 20\%$ ] and is deductible to the extent of her basis in JohnsonPartners. Emma's basis in JohnsonPartners is \$14,000 [ $\$4,000$  beginning basis +  $\$10,000$  ( $\$25,000$  loan  $\times 40\%$ )].

LO 1.5

DIFFICULTY: Moderate

67. Emma owns 40% of Johnson, Inc., a corporation that elected to be treated as an S corporation that reported a net loss of \$50,000 for the year. Emma acquired her stock on January 1 of the current year by investing \$4,000 cash. In July, the corporation took out a bank loan for \$25,000. How much of the loss can Emma deduct on her tax return for the year?
- \$0
  - \$4,000
  - \$9,000
  - \$10,000

ANSWER: b

Emma's share of the loss is \$20,000 [ $\$50,000 \times 20\%$ ] and is deductible to the extent of her basis in Johnson, Inc. Emma's basis in Johnson, Inc. is the investment of \$4,000. The S Corporation's bank loan is not included in Emma's stock basis.

LO 1.5

DIFFICULTY: Moderate

68. Mason owns 45% of an S corporation that reported net income of \$105,000 for the year. During the year, \$20,000 was distributed to Mason from the corporation. How much should Mason include in his gross income for the year?
- \$20,000
  - \$47,250
  - \$56,250
  - \$67,250

ANSWER: b

$\$105,000 \times 45\% = \$47,250$ .

LO 1.5

DIFFICULTY: Easy

69. Mason owns 45% of an S corporation that reported net income of \$105,000 for the year. During the year, \$20,000 was distributed to Mason from the corporation. Assuming Mason's QBI deduction is not limited, how much is the net amount that Mason is taxed on this year as a result of his investment in the S corporation?
- \$16,000

## 24 Taxation for Decision Makers Test Bank

- b. \$37,800
- c. \$45,000
- d. \$53,800

ANSWER: b

$\$105,000 \times 45\% = \$47,250$  gross income inclusion –  $\$9,450$  ( $20\% \times \$47,250$  QBI deduction) =  $\$37,800$

LO 1.5

DIFFICULTY: Hard

70. Emily is a 20% shareholder in an S corporation. Emily acquired her interest on January 1 of the current year by investing \$10,000 for 20% of the corporation's stock. In March, the corporation took out a bank loan for \$100,000. The corporation reported a net loss for the current year of \$200,000. How much of this loss can Emily deduct on her current year's tax return?
- a. \$40,000
  - b. \$30,000
  - c. \$20,000
  - d. \$10,000

ANSWER: d

Emily's share of the loss would be \$40,000 ( $\$200,000 \times 20\%$ ) but the amount she can deduct in the current year is limited to her \$10,000 basis (\$10,000 invested).

LO 1.5

DIFFICULTY: Hard

71. Emily is a 20% shareholder in an S corporation. Emily acquired her interest on January 1 of the current year by investing \$10,000 for 20% of the corporation's stock. In March, the corporation took out a bank loan for \$100,000. The corporation reported a net loss for the current year of \$200,000. If Emily is in the 22% tax bracket, what is her tax savings by deducting this loss on her current year's tax return?
- a. \$8,800
  - b. \$6,600
  - c. \$4,400
  - d. \$2,200

ANSWER: d

Emily's share of the loss would be \$40,000 ( $\$200,000 \times 20\%$ ) but the amount she can deduct in the current year is limited to her \$10,000 basis (\$10,000 invested). The  $\$10,000$  deduction  $\times$  22% marginal tax rate = \$2,200 tax savings

LO 1.5

DIFFICULTY: Hard

72. Ian contributes \$9,000 in exchange for a 30 percent interest in a C corporation. For 2018, the corporation reported a total loss of \$35,000 and made no cash distributions. For 2019, the corporation reported net income of \$45,000 and made a cash distribution to the shareholders. Ian received \$5,000 of this cash distribution in 2019. Ian is in the 24% marginal tax bracket and 15% dividend rate in both 2018 and 2019. How much income tax did Ian save for 2018 as a result of his share of loss from this corporation and how much income tax does Ian pay as a result of his ownership in the corporation for 2019?
- a. zero tax savings in 2018 and \$750 tax in 2019
  - b. zero tax savings in 2018 and \$3,360 tax in 2019

- c. \$2,520 tax savings in 2018 and \$3,360 tax in 2019
- d. \$2,520 tax savings in 2018 and \$2,550 tax in 2019
- e. \$2,940 tax savings in 2018 and \$3,780 tax in 2019

ANSWER: a

\$750 in 2019 ( $\$5,000 \times 15\%$ ). A C corporation is not a flow-through entity. Ian is only taxed on the \$5,000 dividends he received in 2019 using the 15% dividend rate.

LO 1.5

DIFFICULTY: Hard

**Note to Instructor: The information provided for problems 73 – 95 is identical.**

Jerry and Matt decide to form a business. Jerry will contribute \$4,200 for a 35% interest and Matt will contribute \$7,800 for a 65% interest. The business will take out a \$25,000 loan to cover the balance of their working capital needs. They expect that the business will have a loss of \$38,000 for the first year. In the second year, the business will have a profit of \$52,000 and it will distribute \$5,200 to Matt and \$2,800 to Jerry. Jerry is in the 32% marginal tax bracket and Matt is in the 24% marginal tax bracket. Their marginal tax brackets will not change as a result of profit or loss from this business. Assume their QBI deduction is not limited.

73. What is included in Jerry's gross income as a deductible loss in the first year if they organize the business as a partnership?
- a. \$4,200
  - b. \$8,750
  - c. \$12,950
  - d. \$13,300
  - e. \$19,000

ANSWER: c

Jerry's share of the loss would be \$13,300 ( $\$38,000 \times 35\%$ ) but the amount he can deduct in the first year is limited to his \$12,950 basis [ $\$4,200$  invested +  $(\$25,000 \text{ loan} \times 35\%)$ ]. The excess \$350 loss is carried forward.

LO 1.5

DIFFICULTY: Easy

74. What is Jerry's income tax savings (rounded to the nearest dollar) for the first year if they organize the business as a partnership?
- a. \$0
  - b. \$1,344
  - c. \$4,144
  - d. \$4,389
  - e. \$4,655

ANSWER: c

Jerry's share of the loss would be \$13,300 ( $\$38,000 \times 35\%$ ) but the amount he can deduct in the first year is limited to his \$12,950 basis [ $\$4,200$  invested +  $(\$25,000 \text{ loan} \times 35\%)$ ]. The excess \$350 loss is carried forward. His tax savings is \$4,144 ( $\$12,950 \times 32\%$ ).

LO: 1.5

DIFFICULTY: Moderate

75. What is Jerry's basis at the end of the first year if they organize the business as a partnership?

## 26 Taxation for Decision Makers Test Bank

- a. \$0
- b. \$350
- c. \$4,200
- d. \$12,950
- e. (\$350)

ANSWER: a

Jerry's \$4,200 invested + (\$25,000 loan x 35%) = \$12,950 - \$12,950 loss deduction = 0. The excess \$350 loss is carried forward.

LO: 1.5

DIFFICULTY: Easy

76. What is included in Matt's gross income as a deductible loss in the first year if they organize the business as a partnership?
- a. \$7,800
  - b. \$16,250
  - c. \$19,000
  - d. \$24,050
  - e. \$24,700

ANSWER: d

Matt's share of the loss would be \$24,700 (\$38,000 x 65%) but the amount he can deduct in the first year is limited to his \$24,050 basis [\$7,800 invested + (\$25,000 loan x 65%)]. The excess \$650 loss is carried forward.

LO: 1.5

DIFFICULTY: Moderate

77. What is Matt's income tax savings (rounded to the nearest dollar) for the first year if they organize the business as a partnership?
- a. \$0
  - b. \$2,184
  - c. \$5,772
  - d. \$6,916
  - e. \$24,050

ANSWER: c

Matt's share of the loss would be \$24,700 (\$38,000 x 65%) but the amount he can deduct in the first year is limited to his \$24,050 basis [\$7,800 invested + (\$25,000 loan x 65%)]. The excess \$650 loss is carried forward. His tax savings is \$5,772 (\$24,050 x 24%).

LO: 1.5

DIFFICULTY: Moderate

78. What is Matt's basis at the end of the first year if they organize the business as a partnership?
- a. \$0
  - b. \$650
  - c. \$7,800
  - d. \$24,050
  - e. (\$650)

ANSWER: a

Matt's \$7,800 invested + (\$25,000 loan x 65%) = \$24,050 - \$24,050 loss deduction = 0. The excess \$650 loss is carried forward.

LO: 1.5

DIFFICULTY: Easy

79. What is included in Jerry's gross income as a deductible loss for the first year if they organize the business as an S Corporation?
- \$0
  - \$4,200
  - \$8,750
  - \$12,950
  - \$13,300

ANSWER: b

Jerry's share of the loss would be \$13,300 (\$38,000 x 35%) but the amount he can deduct in the first year is limited to his \$4,200 basis (\$4,200 invested). The excess \$9,100 loss is carried forward.

LO: 1.5

DIFFICULTY: Moderate

80. What is Jerry's income tax savings (rounded to the nearest dollar) for the first year if they organize the business as an S corporation?
- \$0
  - \$1,344
  - \$4,274
  - \$4,389
  - \$4,655

ANSWER: b

Jerry's share of the loss would be \$13,300 (\$38,000 x 35%) but the amount he can deduct in the first year is limited to his \$4,200 basis (\$4,200 invested). The excess \$9,100 loss is carried forward. His tax savings is \$1,344 (\$4,200 x 32%).

LO: 1.5

DIFFICULTY: Moderate

81. What is included in Matt's gross income as a deductible loss for the first year if they organize the business as an S Corporation?
- \$0
  - \$7,800
  - \$16,250
  - \$24,050
  - \$24,700

ANSWER: b

Matt's share of the loss would be \$24,700 (\$38,000 x 65%) but the amount he can deduct in the first year is limited to his \$7,800 basis (\$7,800 invested). The excess \$16,900 loss is carried forward.

LO: 1.5

DIFFICULTY: Moderate

82. What is Matt's income tax savings (rounded to the nearest dollar) for the first year if they organize the business as an S corporation?
- \$6,916

**28 Taxation for Decision Makers Test Bank**

- b. \$5,320
- c. \$4,634
- d. \$1,872
- e. \$0

ANSWER: d

Matt's share of the loss would be \$24,700 ( $\$38,000 \times 65\%$ ) but the amount he can deduct in the first year is limited to his \$7,800 basis ( $\$7,800$  invested). The excess \$16,900 loss is carried forward. His tax savings is \$1,872 ( $\$7,800 \times 24\%$ ).

LO: 1.5

DIFFICULTY: Moderate

83. What is Jerry's basis at the end of the second year if they organize the business as a partnership?
- a. \$0
  - b. \$6,300
  - c. \$27,950
  - d. \$15,050
  - e. \$15,400

ANSWER: d

Jerry's basis at the end of the first year was zero [ $\$4,200$  invested + ( $\$25,000$  loan  $\times 35\%$ ) -  $\$12,950$  deductible loss]. The excess \$350 loss is carried forward to the second year. His basis at the beginning of the second year is zero but is increased for his \$18,200 ( $\$52,000 \times 35\%$ ) share of profits. It is reduced for the \$2,800 distribution to him and his \$350 loss carried forward from the first year. His basis at the end of the second year is \$15,050 ( $0 + \$18,200 - \$2,800 - \$350$ ).

LO: 1.5

DIFFICULTY: Hard

84. What is Matt's basis at the end of the second year if they organize the business as a partnership?
- a. \$0
  - b. \$11,700
  - c. \$27,950
  - d. \$28,600
  - e. \$33,800

ANSWER: c

Matt's basis at the end of the first year was zero [ $\$7,800$  invested + ( $\$25,000$  loan  $\times 65\%$ ) -  $\$24,050$  deductible loss]. The excess \$650 loss is carried forward to the second year. His basis at the beginning of the second year is zero but is increased for his \$33,800 ( $\$52,000 \times 65\%$ ) share of profits. It is reduced for the \$5,200 distribution to him and his \$650 loss carried forward from the first year. His basis at the end of the second year is \$27,950 ( $0 + \$33,800 - \$5,200 - \$650$ ).

LO: 1.5

DIFFICULTY: Hard

85. What is Jerry's stock basis at the end of the second year if they organize the business as an S corporation?
- a. \$0
  - b. \$6,300
  - c. \$27,950
  - d. \$15,050
  - e. \$15,400

ANSWER: b

Jerry's basis at the end of the first year was zero [\$4,200 invested - \$4,200 deductible loss]. The excess \$9,100 loss is carried forward to the second year. His basis at the beginning of the second year is zero but is increased for his \$18,200 ( $\$52,000 \times 35\%$ ) share of profits. It is reduced for the \$2,800 distribution to him and his \$9,100 loss carried forward from the first year. His basis at the end of the second year is \$6,300 ( $0 + \$18,200 - \$2,800 - \$9,100$ ).

LO: 1.5

DIFFICULTY: Hard

86. What is Matt's stock basis at the end of the second year if they organize the business as an S corporation?
- \$0
  - \$11,700
  - \$28,600
  - \$33,800
  - \$44,850

ANSWER: b

Matt's basis at the end of the first year was zero [\$7,800 invested - \$7,800 deductible loss]. The excess \$16,900 loss is carried forward to the second year. His basis at the beginning of the second year is zero but is increased for his \$33,800 ( $\$52,000 \times 65\%$ ) share of profits. It is reduced for the \$5,200 distribution to him and his \$16,900 loss carried forward from the first year. His basis at the end of the second year is \$11,700 ( $0 + \$33,800 - \$5,200 - \$16,900$ ).

LO: 1.5

DIFFICULTY: Hard