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Question 1

Question Type: **MultipleChoice**

Don Wolf became a general partner in Gata Associates on January 1, 1989, with a 5% interest in Gata's profits, losses, and capital. Gata is a distributor of auto parts. Wolf does not materially participate in the partnership business. For the year ended December 31, 1989, Gata had an operating loss of $100,000.

In addition, Gata earned interest of $20,000 on a temporary investment. Gata has kept the principal temporarily invested while awaiting delivery of equipment that is presently on order. The principal will be used to pay for this equipment. Wolf's passive loss for 1989 is:

Options:

A- $0

B- $4,000

C- $5,000

D- $6,000

Answer:

C

Explanation:

Choice 'c' is correct. Wolf's passive loss for 1989 is $5,000 ($100,000 operating loss 5% interest in partnership).

Choice 'a' is incorrect. Wolf did not materially participate in the partnership, so the loss was passive.

Choice 'b' is incorrect. Wolf's passive loss of $5,000 could not be reduced by his distributive share of the partnership's 'interest income' totaling $1,000. Interest income is considered 'portfolio income,' and neither the partnership nor a partner can offset it against passive losses.

Choice 'd' is incorrect. No items of income or deduction from portfolio income or activities in which the taxpayer materially participates may be combined or offset with passive losses unless the activity generating the loss is completely disposed of in a taxable transaction.

Question 2

Question Type: MultipleChoice

Under a $150,000 insurance policy on her deceased father's life, May Green is to receive $12,000 per year for 15 years. Of the $12,000 received in 1987, the amount subject to income tax is:

Options:

A- $0

B- $1,000

C- $2,000

D- $12,000

Answer:

C

Explanation:

Choice 'c' is correct. $2,000.

Death benefit	$150,000
Amount received in 1987	$ 12,000
Less: Return of principal ($150,000 ÷ 15 years)	(10,000)
Taxable interest	$ 2,000

Question 3

Question Type: **MultipleChoice**

An individual had the following capital gains and losses for the year:

Short-term capital loss	$70,000
Long-term gain (unrecaptured Section 1250 at 25%)	56,000
Collectibles gain (28% rate)	10,000
Long-term gain (15% rate)	20,000

What will be the net gain (loss) reported by the individual and at what applicable tax rate(s)?

Options:

A- Long-term gain of $16,000 at the 15% rate.

B- Short-term loss of $3,000 at the ordinary rate and long-term capital gain of $86,000 at the 15% rate.

C- Long-term capital gain of $3,000 at the 15% rate, collectibles gain of $10,000 at the 28% rate, and Section 1250 gain of $56,000 at the 25% rate.

D- Short-term loss of $3,000 at the ordinary rate, long-term capital gain of $10,000 at the 15% rate, collectibles gain of $10,000 at the 28% rate, and Section 1250 gain of $56,000 at the 25% rate.

Answer:

A

Explanation:

Choice 'a' is correct. Specific netting procedures for capital gains and losses are outlined in the Internal Revenue Code for non-corporate taxpayers.

Gains and losses are netted within each tax rate group (e.g., the 15% rate group). The facts of this question have already performed this step for us.

Short-term Capital Gains and Losses

1. If there are any short-term capital losses (this includes any short-term capital loss carryovers), they are first offset against any short-term gains that would be taxable at the ordinary income rates.

2. Any remaining short-term capital loss is used to offset any long-term capital gains from the 28% grate group (e.g., collectibles).

3. Any remaining short-term capital loss is then used to offset any long-term gains from the 25% group (e.g., un-recaptured Section 1250 gains).

4. Any remaining short-term capital loss is used to offset any long-term capital gains applicable at the lower (e.g., 15%) tax rate.

Long-term Capital Gains and Losses

1. If there are any long-term capital losses (this includes any long-term capital loss carryovers) from the 28% rate group, they are first offset against any net gains from the 25% rate group and then against net gains from the 15% rate group.

2. If there are any long-term capital losses (this includes any long-term capital loss carryovers) from the 15% rate group, they are offset first against any net gains from the 28% rate group and then against net gains from the 25% rate group.

In this case, we are given net short-term capital losses of $70,000 to start with. Following the rules above, this first goes to offset any short-term gains at the ordinary income rates, but there are none in the facts. So, the next step is to offset the losses against any 28%

rate gain long-term capital gains. The facts provide that there is $10,000 in gains from collectibles (taxable at the 28% rate). The remaining short-term loss ($60,000) is next used to offset the long-term capital gains at the 25% rate. The facts give us un-recaptured Section 1250 gains of $56,000 (taxed at the 25% tax rate). The remaining short-term capital loss is $4,000 ($70,000 - $10,000 - $56,000 = $4,000). The balance of the short-term capital losses is finally used to offset any capital gains taxed at the 15% tax rate, which the facts give us as $20,000. Therefore, after the $4,000 remaining short-term capital loss is applied to offset the $20,000 long-term capital gain taxed at the 15% tax rate, there is an amount of $16,000 remaining of long-term capital losses to be taxed at the 15% tax rate.

Choices 'b', 'c', and 'd' are incorrect, per the ordering rules discussed above.

Supplemental Questions

Question 4

Question Type: **MultipleChoice**

Gibson purchased stock with a fair market value of $14,000 from Gibson's adult child for $12,000. The child's cost basis in the stock at the date of sale was $16,000. Gibson sold the same stock to an unrelated party for $18,000. What is Gibson's recognized gain from the sale?

Options:

A- $0

B- $2,000

C- $4,000

D- $6,000

Answer:

B

Explanation:

Choice 'b' is correct. Losses are disallowed on most related party sales transactions even if they were made at an arm's length (FMV) price. The basis (and related gain or loss) of the (second) buying relative depends on whether the second relative's resale price is higher, lower, or between the first relative's basis and the lower selling price to the second relative. In this case, the $4,000 capital loss on the sale by Gibson's adult child to Gibson [$12,000 SP - $16,000 Basis] is disallowed. Gibson's basis is determined by his selling price to a third party. In this case, the selling price is $18,000, which is HIGHER than the original basis of Gibson's adult child. Gibson's basis in the stock is, therefore, his adult child's basis of $16,000. Gibson's recognized basis is calculated as follows:

Selling price	$18,000
Basis	(16,000)
Gain	$ 2,000

Choice 'a' is incorrect. There would be a zero gain or loss if the selling price were between the adult child's basis and Gibson's purchase price, but this is not the case in the facts.

Choice 'c' is incorrect. This answer option uses the fair market value of the stock at the date of purchase as the basis. As is discussed above, the rules do not provide for this treatment. [$18,000 SP - $14,000 FMV = $4,000]

Choice 'd' is incorrect. This would be the answer if the basis were Gibson's purchase price of $12,000; however, because the stock sold for more than Gibson's child's basis and the child had a disallowed loss on the sale to Gibson, Gibson is allowed to use his child's original basis of $16,000 as his basis for the stock on the date of the second sale. [$18,000 SP - $12,000 PP = $6,000]

Question 5

Question Type: **MultipleChoice**

Which of the following statements is the best definition of real property?

Options:

A- Real property is only land.

B- Real property is all tangible property including land.

C- Real property is land and intangible property in realized form.

D- Real property is land and everything permanently attached to it.

Answer:

D

Explanation:

Choice 'd' is correct. Real property includes land and all items permanently affixed to the land (e.g., buildings, paving, etc.)

Choice 'a' is incorrect. Real property includes more than just the land (as per the Explanation: above); it includes all items permanently affixed to land.

Choice 'b' is incorrect. 'All' tangible property could include moveable personal property and is therefore, incorrect.

Choice 'c' is incorrect. 'Intangible property in realized form' is a distracter and a contradiction in terms.

Question 6

Question Type: MultipleChoice

Starr, a self-employed individual, purchased a piece of equipment for use in Starr's business. The costs associated with the acquisition of the equipment were:

Purchase price	$55,000
Delivery charges	725
Installation fees	300
Sales tax	3,400

What is the depreciable basis of the equipment?

Options:

A- $55,000

B- $58,400

C- $59,125

D- $59,425

Answer:

D

Explanation:

Choice 'd' is correct. The rules for depreciable basis in tax are generally the same as the GAAP rules for capitalizing an asset. The depreciable basis is the cost associated with the purchase of the asset and with getting the asset ready for its intended use. Further improvements are also capitalized, and the basis is reduced for any accumulated depreciation. In this case, the cost of obtaining the equipment and getting the equipment ready for its intended use includes all the items shown above, as follows:

Purchase price	$55,000
Delivery charges	725
Installation fees	300
Sales tax	3,400
Total depreciable basis	$59,425

Choice 'a' is incorrect. The costs of delivery charges, installation, and sales tax are all part of the cost of obtaining the asset and getting the asset ready for its intended use. All of these charges are included in the depreciable basis of the equipment.

Choice 'b' is incorrect. The costs of delivery charges and installation are both part of the cost of obtaining the asset and getting the asset ready for its intended use. These charges are included in the depreciable basis of the equipment.

Choice 'c' is incorrect. The cost of installation is part of the cost getting the asset ready for its intended use. This charge is included in the depreciable basis of the equipment.

Question 7

Question Type: MultipleChoice

Which of the following sales should be reported as a capital gain?

Options:

A- Sale of equipment.

B- Real property subdivided and sold by a dealer.

C- Sale of inventory.

D- Government bonds sold by an individual investor.

Answer:

D

Explanation:

Choice 'd' is correct. Government bonds held by an individual investor are considered capital assets in the hands of the investor. When these types of security investments are sold, the resulting gain or loss is reported as capital.

Choice 'a' is incorrect. In this case, we must assume that the BEST answer is option 'd' (as that option would ALWAYS result in capital gain or loss treatment) and that the examiners are assuming that the equipment is depreciable equipment that has been used in a business for over one year. [If the equipment had been considered a personal asset by the examiners and had sold for a gain, it would also be a capital asset that sold for a capital gain, and there would be two correct answers. Remember that the correct answer is the option that best answers the question.] Depreciable equipment used in a business and held for over one year falls under the category of Section 1245 property. When Section 1245 assets are sold at a gain, all the accumulated depreciation on the asset is recaptured as ordinary income (the same category as the depreciation expense was deducted against), and any remaining gain (typically, in practice, this is not the case, though, as the asset would have had to sell for an amount greater than its purchase price) is capital gain under Code

Section 1231. [Note that Section 1245 applies only to gains. If the asset had sold for a loss, the loss would have been ordinary under Section 1231.]

Choice 'b' is incorrect. Real property sold by a dealer is considered inventory and results in ordinary income or ordinary losses upon sale. Inventory is not a capital asset and is not afforded the capital gain benefits.

Choice 'c' is incorrect. Inventory is not a capital asset and is not afforded the capital gain benefits. The sale of inventory results in ordinary income or loss (e.g., gross profit on sales) being reported on the tax return, as inventory is an asset held for sale in the ordinary course of business.

Question 8

Question Type: MultipleChoice

Wallace purchased 500 shares of Kingpin, Inc. 15 years ago for $25,000. Wallace has worked as an owner/employee and owned 40% of the company throughout this time. This year, Kingpin, which is not an S corporation, redeemed 100% of Wallace's stock for $200,000. What is the treatment and amount of income or gain that Wallace should report?

Options:

A- $0

B- $175,000 long-term capital gain.

C- $175,000 ordinary income.

D- $200,000 long-term capital gain.

Answer:

B

Explanation:

Choice 'b' is correct. An investment in a capital asset (e.g., stock) results in the income being capital (either a capital loss or a capital gain). Ownership percentage is not a factor in the calculation, and, in this question, nor is the fact that the corporation is not an S corporation. The calculation is simple:

Wallace invested $25,000 in the stock and received $200,000 for 100% of his investment 15 years later.

The capital gain is $175,000 ($200,000 - $25,000), and it is considered long-term because the stock was held for greater than one year.

Choice 'a' is incorrect. There is $175,000 of gain on the transaction ($200,000 - $25,000). This type of transaction is not a transaction that is excluded from tax in the tax code.

Choice 'c' is incorrect. An investment in a capital asset (e.g., stock) results in the income being capital (either a capital loss or a capital gain). Although the calculation of the income is correct (i.e., $175,000), ordinary income is not the proper treatment for this transaction.

Choice 'd' is incorrect. Although this transaction does result in a long-term capital gain, Wallace has basis in the stock ($25,000), and the gain is calculated as the proceeds from the sale ($200,000) less the basis in the stock.