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**IRS ENROLLED AGENT - 1995 EXAMINATION
OFFICIAL ANSWERS & EXPLANATIONS**

1995. PART 1

1. **True.** For 1994, a return must be filed by any dependent who is single, under age 65, and has received unearned income in the amount of \$600 or more.
2. **True.** Where a substantial understatement of tax in a joint return is attributable to the grossly erroneous items of one spouse, the other spouse may be an “innocent spouse” and relieved of liability, including interest and penalties, if the innocent spouse had no knowledge of (or reason to know of) the substantial understatement, and, based on all the facts and circumstances, it is inequitable to hold the innocent spouse liable for the deficiency.
3. **True.** The fair market values of capital items, such as furniture, appliances, and cars, that are bought for a person during the tax year may be included in the dependency support computation.
4. **False.** Although interest from tax-exempt municipal bonds is generally not taxable, the amount of interest received must be reported on the taxpayer’s return.
5. **True.** Capital gain distributions received from a mutual fund should be reported as long-term capital gains, regardless of how long the shareholder may have owned the stock in the mutual fund.
6. **True.** If a home is rented out for fewer than 15 days during the tax year, no rental income is includible in gross income, and no business expenses attributable to rental are deductible.
7. **True.** The buyer’s basis in the property does not include the portion of the payments that is considered to be “interest expense.”
8. **False.** Property transferred in a deferred exchange will qualify for nonrecognition even if the replacement property is not in existence or is being produced at the time that it is identified as the replacement property.

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9. **False.** Under a special rule for disabled taxpayers, during the five-year period preceding the sale of a residence, a taxpayer who (1) becomes physically or mentally incapable of self-care, and (2) owns a residence and uses it as his or her principal residence, for at least one year during the five-year period is treated as having used the property as a principal residence during any part of the five-year period in which he or she owns the property but resides in a licensed care facility.
10. **True.** If loss deductions exceed gross income for the tax year, the excess is taken into account as negative taxable income up to \$3,000 (\$1,500 if married filing a separate return).
11. **True.** Because Mr. Cramer spends most of his working time and earns most of his salary in Baltimore, it is his tax home. However, when he returns to Pittsburgh to work, he is away from his tax home and can deduct his portion of living expenses even though he is staying in the family home.
12. **True.** Alimony payments that decrease or terminate during the first three years may be subject to the recapture rule.
13. **True.** For purposes of the medical expense deduction, the term “dependent” has the same meaning as it does for determining the dependency exemptions except that the gross income test does not apply.
14. **False.** No deduction is allowed for interest on indebtedness incurred to purchase tax-exempt securities.
15. **True.** Because the taxpayers are wage earners, and not sole proprietors, they may report and pay employment taxes for household employees on their annual Form 1040, Schedule H.
16. **False.** Generally, individuals who are married at the close of the tax year must file a joint return in order to claim the elderly and disabled credit.
17. **True.** Generally, a portion of the AMT paid in a tax year may be carried forward as a credit that can be used to reduce the taxpayer’s regular tax liability less certain adjustments.
18. **False.** The amount of the earned income credit that may be received as an advance payment is limited to 60% of the maximum credit available to an individual with one qualifying child. The advance payment is not available to an individual who does not have a qualifying child.
19. **False.** In order for a debt to be deductible, it must, among other things, be a valid and enforceable obligation to pay a fixed or determinable sum of money. Mr.

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- Baldwin loaned money to a related party, without benefit of a written note or established payment plan in a jurisdiction that requires a writing for an agreement to be binding. No payments have actually been made and no effort has been made to collect the amount due. Based on these facts, this debt is not a valid or enforceable obligation, and is, therefore, nondeductible.*
20. **False.** *The deduction for personal exemptions is not allowed in computing AMT.*
21. **C.** *April 17, 1995. The last date for filing an income tax return for a calendar-year decedent who died in 1994 (absent extensions) is April 17, 1995.*
22. **D.** *Head of household. A divorced or single parent who otherwise qualifies is entitled to head-of-household filing status even if she is not entitled to the exemption because of a waiver.*
23. **A. 7.** *While Mrs. Randall's cousin fails to satisfy the relative requirement because she is only a cousin, she qualifies as a dependent because she was a member of the taxpayer's household for the entire year. Although the son's earned income (\$3,500) was in excess of the 1994 exemption (\$2,450), he qualifies because he had not yet attained the age of 19 before December 31, 1994. While Mrs. Randall's mother's income (\$2,800) exceeded the 1994 deduction amount, her full income from Social Security, which is ordinarily excluded from gross income, is disregarded.*
24. **C.** *Ms. Givonni, who had a \$4,000 tax liability for 1994, expects a tax liability of \$4,400 for 1995 with \$3,900 withholding. Ms. Salinas is not required to make estimated tax payments because she had no tax liability in 1994; Mr. Lane is not required to make estimated tax payments because the difference between his withholding and his tax liability for 1995 is less than \$500; Mr. Charles is not required to make an estimated tax payments because the amount withheld for 1995 was at least as great as his tax liability for 1994.*
25. **D.** *Series E Bonds traded for Series HH Bonds and no cash was received. Owners of Series E bonds who exchange such bonds for Series H bonds and elect to defer Series E bond interest for tax purposes are not required to report such interest until the Series H bonds are redeemed, disposed of, or mature, whichever comes first.*
26. **C.** *MR. and Mrs. Thomas rented a mountain cabin from Lucia for four days in October. Lucia rented their lake house for four days also. They each paid a fair rental price. Lucia's use of the Thomas house under a reciprocal arrangement is a personal purpose.*
27. **D.** *A payment on the sale of real property was made to an escrow account on December 28, 1994, but the payment was not received by the taxpayer until January 15, 1995, when the transaction was closed and the buyer authorized release of the money held in escrow. Where a contract of sale is executed*



subject to conditions as to title, and the purchase money is placed in escrow, income on the sale is not taxable until the purchasers have found the title satisfactory and authorized release of monies held in escrow.

28. **D.** *The fair market value of the property. The basis of property received for services performed is equal to the fair market value of the property, less the amount paid, if any, for the property.*
29. **B.** *\$65,000. When an alternate valuation date is not elected, the income tax basis of property acquired from a decedent is the fair market value of the property on the date of the decedent's death.*
30. **C.** *If a stock dividend is taxable, the basis of the old stock does NOT change. The basis of the old stock would be adjusted only if the distribution were nontaxable; no allocation of the adjusted basis of the old stock, between the old and new stock, occurs when the distribution is taxable.*
31. **B.** *Rental house. Like-kind property includes property held for productive use in a trade or business or for investment purposes.*
32. **A.** *In the case of stocks and bonds, the holding period begins on the day after the trading day. With respect to a security that is purchased and sold on a registered security exchange, the holding period begins on the day after the taxpayer purchases the security.*
33. **A.** *\$0. Pamela may not claim any deductible loss because she sold the stock to her sister, a related party.*
34. **D.** *Manny has to amend his 1993 tax return and recognize the entire amount of the gain from the sale of his former residence. Deferral of gain is permitted only if the taxpayer purchases and uses the a new residence within two years after the sale of the old residence. Failure to purchase and use a new residence during the replacement period will result in a loss of rollover treatment, even if such failure is due to circumstances beyond the taxpayer's control.*
35. **C.** *\$245,000. Eddie can exclude \$125,000, which is the maximum excludable amount, and Myrtle can exclude her full gain of \$120,000. Each can claim an exclusion because the respective sales took place before they were married.*
36. **D.** *Sydney does NOT have a tax home. Sydney is a itinerant, since he has no established residence.*
37. **D.** *Any reimbursement paid must be based on a fixed daily amount not to exceed the Government's per diem rate. If a reimbursement arrangement between an employee and employer meets the requirements of a business connection,*

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- substantiation, and return of excess payments, then all amounts paid under the arrangement are treated as paid under an accountable plan.*
38. **C.** *Premium paid under a divorce or separation agreement for life insurance to the extent that the other spouse owns the policy. Alimony consists of any payment is cash received by, or on behalf of, a spouse under a divorce or separation instrument. It does not include child support payments or a payment made because of a liability to make such payment after the payee spouse's death.*
39. **C.** *One-half of the self-employment tax. A taxpayer may deduct one-half of his self-employment tax liability for the year as a business expense in arriving at adjusted gross income; it cannot be taken as an itemized deduction.*
40. **B.** *Whether the organization is a 50% or 30% organization. A written acknowledgment of a charitable contribution of at least \$250 must include the amount of the cash contribution, whether the donee provided any goods or services in consideration of the donation, and a description and good-faith estimate of the value of any goods or services provided to the donor, but not whether the organization is a 50% or 30% organization.*
41. **B.** *Long-term capital loss. Individuals may treat a loss on a deposit in an insolvent financial institution as an ordinary loss, a personal casualty loss in the year in which the loss can be reasonably estimated, or a short-term capital loss in the year in which there is no prospect of recovery.*
42. **D.** *Traveling to her new home. "Moving expenses" include the reasonable expenses of traveling from the former residence to the new place of residence.*
43. **D.** *Education expenses are deductible as long as the minimum educational requirements have been met, the education is not qualifying for a new trade or business, and the education is necessary to maintain or improve skills in the established trade or business. Education expenses are not deductible if they are required the to meet the minimum educational requirements to qualify for the taxpayer's present employment or if the education qualifies the taxpayer for a new trade or business. In addition, the education must maintain or improve a skill required of the taxpayer in his or her employment.*
44. **A.** *\$1,000 or more in a year. Individuals who employ domestic workers are required to withhold and pay Social Security and Medicare taxes for any employee for whom they pay \$1,000 or more in a calendar year.*
45. **B.** *Earnings from self-employment. The post-1993 earned income credit is based on "earned income," which includes earnings from self-employment.*
46. **B.** *\$49,500. Because Mr. Bagley's adjusted gross income (\$180,00) for the preceding taxable year exceeds \$150,000, he must pay 110 percent of the*



preceding year's tax (\$45,000), since this amount is less than 90 percent of the current year's tax (\$70,000).

47. **B.** \$10,500. A member of the clergy must include in income any compensation received in exchange for services rendered. Rental value of a dwelling house furnished to an ordained minister as part of compensation is excludable from gross income.
48. **A.** \$2,500. Shareholders who elect to receive shares of greater value than their dividends under a dividend reinvestment plan receive taxable distributions to the extent of the fair market value of their shares.
49. **B.** \$8,500. Capital gains dividends are reportable as long-term capital gains, regardless of how long the shareholder may have owned the stock in the mutual fund.
50. **C.** \$10 capital gain, zero stock basis. A return of capital on a shareholder's stock reduces the basis of the stock. The excess of the return of capital over the shareholder's basis is gain from the sale or exchange of property.
51. **C.** \$4,500. A cash basis taxpayer must include in gross income for the year all items of taxable income actually or constructively received during the year, whether in cash, property or services, However, a lessor does not realize income upon termination of a lease merely because he thereby acquires improvements made by the lessee. Advance rent received upon execution of a lease is includible in gross income in the year received, whether the taxpayer is on the cash or the accrual basis.
52. **D.** \$13,000. Accrual basis taxpayers report income when it is earned. Taxpayers who barter property or services are taxed on their fair market value. Security deposits are income if and when the lessor becomes entitled to the funds by reason of the lessee's violation of the terms of the lease. Advance rent received upon execution of a lease is includible in gross income in the year received, whether the taxpayer is on the cash or accrual basis. Andre must include \$10,000 for the ten months of 1994 that the house was rented to the first tenant. The \$600 security deposit is includible because Andre became entitled to the funds, due to the damages sustained by the premises. Although Andre and Jerry have agreed that Jerry's work is in exchange for December 1994 and January 1995 rent, the entire fair market value of Jerry's work (\$2,400) is includible in Andre's gross rent for 1994 because it constitutes advance rent.
53. **C.** \$15,000. A taxpayer who actively participates in rental real estate activities may use up to \$25,000 of passive activity losses from such activities as deductions against nonpassive income. The \$25,000 is reduced, but not below zero, by 50 percent of the amount by which the taxpayer's adjusted gross income

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for the year exceeds \$100,000. For this purpose, adjusted gross income is calculated without regard to taxable social security benefits or any passive activity loss.

54. **A.** \$20,000. A degree candidate at a qualified educational organization may exclude from gross income amounts of a fellowship grant used for tuition and course-related fees, books, supplies, and equipment. Amounts received for room and board are includible in gross income.
55. **C.** \$2,250. The amount of social security benefits that an individual must include in gross income is the lesser of (1) one-half of the annual benefits received or (2) one-half of the amount that remains after subtracting the appropriate base amount from the taxpayer's provisional income. Provisional income is the sum of the taxpayer's modified adjusted gross income and one-half of his social security benefits. Modified adjusted gross income is the individual's adjusted gross income (excluding any social security or tier 1 railroad benefits) increased by the amount of tax-exempt interest received during the tax year. The base amount is \$32,000 for married individuals filing a joint return.
56. **B.** \$35,500. Salary is included in gross income. Interest credited on a savings account is taxable to an accrual basis and a cash basis taxpayer when credited.
57. **A.** \$348,000. Basis of property acquired by purchase consists of its cost (both cash and debt obligations) plus certain fees and expenditures. These expenditures include survey costs, transfer taxes, charges for installing utility services, and amounts that the seller owes that the purchaser agrees to pay.
58. **B.** \$25,000. If an exchange is only partially tax-free because it involves an exchange of both like-kind property and "other" property or money so that gain must be recognized, the basis for the like-kind property received is the adjusted basis of the property transferred, minus the sum of the money and the fair market value of any other property received, plus the amount of the gain that was recognized.
59. **B.** \$15,000. For purposes of determining gain on the sale of property acquired by gift, the basis is that of the last preceding owner who did not acquire the property by gift.
60. **C.** \$800. Dividends on preferred stock are taxable under the dividend distribution rules. Under these rules, the basis of stock received is the fair market value of the stock on the date received.
61. **A.** \$60,000. The gain from a sale or exchange of property is the excess of the amount realized from the sale or exchange over the property's adjusted basis. The adjusted basis of an asset is generally its original cost plus the cost of any capital improvements to the property and less any depreciation or depletion. In computing the amount realized, the seller does not include any reimbursement for



real property taxes treated under Code Sec. 154(d) as imposed on the purchaser.

62. **C.** \$45,000. *The taxation of some or all of the gain from the sale of a principal residence can be postponed if a new principal residence is bought or built within the period beginning the two years before and two years after the sale of the old residence. In such cases, the gain on the sale is recognized only to the extent that the adjusted sale price of the old residence exceeds the price of the new residence. The cost of obtaining a new residence includes only the costs attributable to the purchase, construction, reconstruction or improvement of a new residence that are capital expenditures and incurred during the two years before the sale of the old residence or two years after the sale of the old residence. The construction of a deck constitutes a capital expenditure.*
63. **C.** \$40,000. *If, in an exchange of property for property of like kind, other (unlike) property or money is received in addition to the like-kind property, gain is recognized, but only up to the sum of the money and the fair market value of the other property received. The amount of any liabilities of the taxpayer assumed by the other party to an exchange is treated as money received by the taxpayer.*
64. **A.** \$19,500 ordinary income; \$1,500 capital gain. *The Section 1231 gain (\$21,000) is recharacterized as ordinary income to the extent of depreciation recaptured (\$15,500). The remaining \$5,500 portion is also recharacterized as ordinary income to the extent of unaccounted for Section 1231 loss over the preceding five years (\$4,000).*
65. **A.** \$242,000. *Because the adjusted sales price of Lynn's prior residence was \$121,000 and she will own a 50% interest in the replacement residence, the value of the replacement residence must be at least \$242,000 for both Lynn and Jeff to postpone recognition of gain.*
66. **C.** \$24,000. *Individual taxpayers who sell their personal residence may exclude up to \$125,000 of the gain realized on the sale if they have attained age 55 prior to the date of the sale. If a taxpayer elects the exclusion and purchases and occupies another principal residence within two years before or after the sale of the old residence and the adjusted sales price (after deduction by the exclusion) is less than the cost of the new residence, then the taxpayer must defer the gain and reduce the basis of the new residence by such nonrecognized gain.*
67. **C.** \$10,500; \$9,500. *Gain on sale is determined by subtracting the selling price of the old home and the adjusted basis of the old home from its selling price. The deferred or postponed gain is determined by subtracting the taxable gain from the amount of gain realized on the sale.*
68. **B.** \$17,000; (\$5,000). *Gains and losses resulting from the sale or exchange of capital assets held for not more than one year are characterized as short-term.*



Gains and losses resulting from the sale or exchange of capital assets help for more than one year are characterized as long-term (Code Sec. 1222). Capital gain dividends are taxed as long-term capital gains regardless of how long the shareholder has owned stock in the fund (Code Sec. 852(b)(3)(B)). The ABC stock (\$15,000) and the automobile (\$2,000) were the only items generating short-term gain, resulting in a net of \$17,000. The XYZ stock (\$14,000), the land (\$8,000) and the mutual fund distribution (\$1,000) were all long-term assets, resulting in a net loss of \$5,000.

69. **C.** \$0. There is no gain or loss. The basis for gain is the adjusted basis in the hands of the donor (\$11,000). The result of subtracting the basis from the sale price (\$9,000 - \$11,000) is a negative number. A gain cannot be less than 0. The basis for loss is the fair market value at the time of the gift, when the adjusted basis is greater than the fair market value. The result of subtracting the basis from the sale price (\$9,000 - \$7,200) is a positive number. A loss cannot be larger than 0.
70. **A.** \$7,160. \$7,160 is the maximum amount deductible by Dan in 1994. That is, the standard mileage allowance multiplied by Dan's total business miles, 24,000x.29 (\$6,960) plus Dan's business parking and tolls (\$200) equals \$7,160.
71. **B.** \$9,562. The basis for figuring depreciation for the new van is (1) the adjusted basis of the old van (\$5,412), determined by subtracting the depreciation taken (\$7,388) from the cost of the old van (\$12,800), plus (2) any additional amount paid for the new van, (\$9,800) totaling \$15,212, minus (3) the excess, if any, of the total amount of depreciation that would have been allowable before the trade if the old van had been used 100% or business (\$9,850), over the total amounts actually allowable as depreciation during those years (\$7,388), totaling \$2,462. The total depreciation basis for the new van (\$12,750) must be reduced by the amount of personal use (25%) to determine the depreciation basis for the new van (\$9,562).
72. **C.** \$1,750. The amount Banks can deduct before the percentage of adjusted gross income limitation is \$1,750. The deduction for business meals and entertainment is limited to 50% of the actual expense. Business gifts are limited to \$25 per donee.
73. **A.** \$3,000. the amount of capital expenditure deductible as medical expenses is \$3,000. Although capital expenditures are generally not deductible, there can be a medical expense deduction in connection with a capital expenditure to the extent that the amount of such expenditure exceeds the amount of the increase in the value of the property affected.
74. **D.** \$500. The amount deductible for 1994 is \$500. Doctor's fees, costs of prescription medicine and the costs of medical insurance premiums are all deductible. Medical insurance reimbursements must be offset against the medical expense amounts. Expenses for health club dues, even though

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suggested by a physician, are not deductible since only those expenses incurred primarily for the prevention or alleviation of a physical or mental defect or illness are deductible. The amount deductible is the amount of allowable expenses which exceeds 7.5% of the taxpayer's AGI.

75. **C.** \$4,100. \$4,100 is the amount allowable as an itemized deduction for taxes for 1994. All the taxes listed may be deducted with the exception of the sales tax paid to purchase a new car. Individuals may not deduct sales tax.
76. **D.** \$0; \$1,880. The official answer is D. However, it is CCH's contention that this answer is incorrect and that the correct answer is C. \$0; \$1,930. Humberto cannot deduct any amount of real estate taxes attributable to 1992 because he did not own the property in 1992. Real estate taxes are apportioned between the buyer and seller based on the number of days each held the property in the tax year. Even though the actual tax bill was \$200 in excess of the credit Humberto received at closing, he cannot deduct that amount because a cash basis buyer or seller is treated as though he has paid his share of the real estate tax on the date of the sale, if the other party to the transaction was personally liable for the taxes on that date. Although Humberto paid the entire amount of the 1993 bill in 1994, he must deduct the amount of the credit he received at closing from the seller from the total amount paid (\$2350 less \$420) to determine the amount deductible (\$1930).
77. **C.** \$1,005. Any distribution out of earnings and profits by a corporation to its shareholders is considered a dividend unless it is a return of capital. The holding period of an asset for purposes of long-term gain treatment is one year from the date of acquisition, not including the day of acquisition and including the day of disposition. In this case, the only dividend reinvestment received one year away from the date of sale was the one received December 1, 1993. All others were received less than one year from the date of sale.
78. **C.** \$7,500. The official answer is C. However, it is CCH's contention that this answer is incorrect and that the correct answer is \$5,500, which is not given. The amount of AMT credit earned by a taxpayer in a given year is the portion of the AMT paid that is attributable to deferral preferences. Once the credit "earned" in a given tax year is determined, it is aggregated with all other credits earned in prior tax years and reduced by all other credits used in prior tax years. The "net credits" are then carried over to succeeding tax years and used to reduce the regular tax liability of the later tax years. The AMT credit cannot be used to reduce the regular tax liability below the tentative minimum tax. The first year Ted and Alice had an AMT credit was 1993 in the amount of \$8,500. The problem gives no indication that this credit was used since no regular tax amount is given. Since the AMT credit cannot exceed the amount of the regular tax, the amount of the credit for 1994 is limited to \$3,000. By subtracting the AMT credit amount

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taken in 1994 (\$3,000) from that earned in 1993 (\$8,500), the carryover amount to 1995 is \$5,500.

79. **C. 50%.** Bradshaw's gross profit percentage is 50%. It is calculated by dividing the gross profit (\$5,000) by the total contract price (\$10,000). The gross profit is determined by subtracting the adjusted basis (\$19,000) and the sale expense (\$1,000) from the total amount received (\$25,000). The total contract price is determined by subtracting the mortgage assumed by the buyer (\$15,000) from the total amount received (\$25,000).
80. **C. \$7,000.** The amount Juan will show on his 1994 income tax return is a gain of \$7,000. If an installment obligation is sold, the gain or loss is the difference between the "basis" of the obligation and the "amount realized" by the holder of the obligation. "Basis" is defined as the excess of the face amount of the obligation over the income that would be returnable if it were paid in full. "Amount realized" includes the cash paid or credit to the account of the seller. The selling price (\$20,000) less the down payment received (\$4,000) and less the installments received prior to sale (\$0) results in the balance unpaid (\$16,000). The balance unpaid (\$16,000) less the remaining income returnable (50% gross profit ratio x balance unpaid (\$16,000)) results in the basis of the obligation (\$8,000). The amount realized on the sale of the note (\$15,000) less the basis of the obligation (\$8,000) results in the gain to the taxpayer of \$7,000.



PART 2

1. **True.** In general, a change in accounting period will be approved when it is established that there is a substantial business purpose for making the change.
2. **True.** A workforce in place, including its composition, terms and conditions (contractual or otherwise) of employment, is a section 197 intangible asset.
3. **False.** Basis of property is adjusted downward for depreciation allowable rather than allowed.
4. **True.** An accrual method taxpayer who, pursuant to an agreement, receives payment in one tax year for services required to be performed by him before the end of the next succeeding tax year may include such payments in gross income as earned through the performance of the services.
5. **True.** cash discounts representing a fair interest rate may or may not be subtracted in computing the cost of goods purchased, at the taxpayer's election. A trade discount must be treated as a reduction in the cost of new items in inventory in the year of purchase.
6. **False.** A vacation pay deduction is generally limited to the amount of pay earned during the year to the extent (1) the amount is paid to employees during the year or (2) the amount is vested as of the last day of the tax year and is paid to employees within 2.5 months after the end of the year. If such vacation pay is not paid until after the expiration of the 2.5-month period, the employer may deduct vacation pay when paid in its tax year that includes the last day of the employee's tax year for which the payment is reported as income by the employee.
7. **False.** When a cash-basis taxpayer-lessee makes advance rental payments (i.e., payments that are consideration for the use of the rented premises in future years), such payments are generally not deductible in the tax year in which they are made but must be allocated over the period of time for which the premises will be used. Although the official answer is False, CCH believes that the question is misleading because it does not specify that the rental payments are for periods beyond the present tax year.
8. **True.** Taxpayers may deduct the ratably amortized capital costs of specified intangible assets referred to as "section 197 intangibles" over a 15-year period beginning in the month of acquisition.

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9. **False.** Since Beth's guarantee of Turbo Corporation was made to protect her investment in the business as an officer and principal shareholder, she may not deduct the amount guaranteed at the time of default as a business bad debt. To qualify as a business bad debt, Beth's dominant motive for making the guarantee must be proximately related to the guarantor's trade or business.
10. **True.** Taxpayers who use an accrual method of accounting, derive all their income from services and do not charge interest or penalties for late payments may use the nonaccrual-experience method to report bad debts.
11. **True.** All property placed in service after 1986 is depreciated under the straight-line basis, so there is no excess depreciation to recover.
12. **True.** The depreciation on Section 1250 property acquired by gift is the same as it would be in the hands of the donor. When claiming such depreciation, a taxpayer must be able to substantiate the basis of assets being depreciated and the amount of the deduction.
13. **False.** An entity may use a tax year for which it establishes a business purpose without making a section 444 election first; however, the taxpayer may make such an election without first requesting permission to use the tax year and being denied permission.
14. **False.** In a family partnership where the material income-producing factor is not a capital asset, the family member must provide substantial or vital services to the partnership to be considered a partner for federal tax purposes.
15. **False.** Relief of partnership liabilities is treated as a distribution of money to the partner. Consequently, any amount of the relief that exceeds the partner's basis in her partnership interest must be recognized as a capital gain.
16. **True.** Payments to a retiring partner are treated as made in exchange for the partner's interest in partnership property, not as a distributive share or guaranteed payment.
17. **False.** Chad's basis in the car would be \$6,000. When property is distributed in liquidation of a partner's interest, the basis of the property must equal the basis of the partner's interest. When several properties are distributed, the partner's basis is first allocated to the amount of money received, then to inventory items received and finally to the remaining property.
18. **False.** Costs incurred for alterations to existing products do not qualify for the credit.
19. **False.** For the purposes of computing self-employment tax, net earnings from self-employment includes the total amounts of income derived from the operation

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- of any trade or business. The tax is computed on an aggregate basis from total earnings from self-employment.*
20. **True.** *Every person in whose name a highway motor vehicle is registered at the time of its first taxable use in any tax period must file Form 2290, Heavy Vehicle Use Tax Return.*
21. **D.** *If you operate several businesses, you must use the same accounting method for each of the businesses. When a taxpayer has two or more separate businesses and keeps a complete and separate set of books and records for each, he may use a different method of accounting for each business so long as such method clearly reflects income of that particular enterprise.*
22. **D.** *An adjustment in the useful life of depreciable asset NOT subject to ACRS or MACRS property. An adjustment in the useful life of a depreciable asset is not considered a change in the method of accounting requiring consent of the IRS because it is an item that is traditionally corrected by adjustments in the current and future years.*
23. **B.** *They can wait until January 17, 1995, to make their first and only estimated tax payment. They special rules that apply to farmers regarding estimated tax liability allow farmers to ignore the first three installment dates and pay all estimated tax by January 15 (or the first business day after that date) of the following year and file their tax return by the regular due date.*
24. **D. Research.** *Research costs are considered currently deductible expenses and do not need to be capitalized under the uniform capitalization rules.*
25. **B.** *Wages paid to employees for constructing a new building to be used in the business. Salaries incurred in connection with the construction of capital assets are not currently deductible; they must be recovered through depreciation under the uniform capitalization rules.*
26. **C.** *Depreciate the improvements using the modified cost recovery system (MACRS). The cost of improvements made to lease property by the lessee is recovered under the MACRS rules without regard to the lease terms.*
27. **B.** *27.5 years, mid-month convention. MACRS depreciation rules require that non-residential real property placed in service after 1986 be depreciated over 27.5 years using the mid-month convention.*
28. **D.** *She can deduct ONLY her payment of Bridget's share of debt as a bad debt. A partner that pays more than her proportionate share of a partnership debt that becomes uncollectible is permitted to take a bad debt deduction equal to the amount in excess of that partner's share of the debt.*



29. **B.** She must include \$5,500 in “other income” on her Schedule C for 1994. Recovery of previously deducted bad debt amounts is reported as “other income” on Schedule C.
30. **C.** The interest should be deducted as a current expense and the sales tax should be included in the basis of the machine. Generally, interest expense is currently deductible when paid, but sales tax incurred in connection with an acquisition of property is added to the basis of the property.
31. **B.** The property must be used in a trade or business. The taxpayer is not required to use the clean-fuel vehicle property in a trade or business in order to claim the deduction.
32. **C.** A taxpayer may amend a prior year’s return to include the election as long as the election is made before the expiration of the statute of limitations. An NOL election may be made on an amended return if the return is filed on or before the due date for filing returns for the year the election is sought. An election, once made for any tax year, is irrevocable.
33. **B.** Do nothing to inventory for 1994, report the \$4,000 as additional gross receipts in 1994. If property is involuntarily converted into money or other property not similar to the converted property, such as insurance proceeds, the taxpayer must report the realized amount as gain in the year the money or other property is received.
34. **D.** Because the brother’s co-ownership of the property is NOT a trade or business, they do NOT have a partnership. Each brother must report his respective share of income and expenses on Schedule E, Form 1040. Selection of the proper schedule for reporting rental income depends upon whether services are provided to tenants. In this fact situation, since no services are provided, Schedule E is the appropriate reporting vehicle.
35. **C.** July 31. The correct year is determined using the least aggregate deferral rule.
36. **B.** Guaranteed payments to partners for services or for the use of capital. The payment is a deductible business expense to the partnership and must be included in the gross income of the partner receiving the payment as the partner’s distributive share of ordinary income.
37. **D.** Income from discharge of indebtedness. Most elections affecting the computation of taxable income derived from a partnership must be made by the partnership. However, the election to reduce the basis of depreciable property for amounts excluded from gross income because of discharge of indebtedness must be made by each partner separately.



38. **C.** Gives rise to a current deduction to the partnership. See IRS Pub. 54, page 13. Under the cash receipts and disbursements method of accounting, an amount is includible in gross income when actually or constructively received. (Reg. § 1.451-1). Under Code Sec. 752, a partner's basis in the partnership interest is increased by the partner's assumption of the partnership liabilities.
39. **B.** Audra must include a gain on her individual return, and her basis in her partnership interest is zero. When encumbered property is contributed to a partnership, a partner recognizes gain to the extent the partner is deemed to be relieved of a portion of the debt. Audra has a \$42,000 basis upon contribution (\$20,000 property basis plus \$22,000, which is half the \$44,000 debt). She is also deemed to receive a cash distribution of \$44,000 (the amount of the debt), creating a gain of \$2,000. This gain does not affect Audra's basis in her partnership interest.
40. **A.** For property that was an unrealized receivable in the hands of the contributing partner, any gain or loss on a disposition by the partnership is ordinary income or loss. In the case of inventory items, this rule applies only if the sale takes place within five years from the date of distribution.
41. **B.** Brothers and sisters. The "family" of any individual includes only a spouse, ancestors, lineal descendants and any trusts for the primarily benefit of such persons.
42. **A.** Norita. . 40 percent; Corporation owned entirely by Norita's husband. . . 60 percent. Norita is treated as owning the stock owned by her spouse, children, grandchildren and parents. Here, Norita is treated as owning her husband's 60 percent interest, attributing to her a more than 50 percent ownership in the partnership's capital and profits.
43. **A.** Gain or loss is the difference between the amount realized and the adjusted basis of the partner's interest in the partnership. Generally, a partnership interest is a capital asset, so gain or loss on the exchange or sale of the interest is capital gain or loss.
44. **B.** Your tentative minimum tax. The amount that may be claimed as the general business credit is limited based on tax liability. The general business credit may not exceed net income tax minus the greater of the tentative alternative minimum tax or 25% of net regular tax liability above \$25,000.
45. **A.** Troy, a 60% owner in a S corporation, received \$40,000 as his distributive share of the corporation's taxable income. Although S corporation shareholders are treated similarly to partners for many tax purposes, they are not subject to the self-employment tax on their shares of the S corporation's ordinary income.

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46. **B.** \$35,500. Using the residual method, the purchase price is allocated first to the assets to the extent of their fair market value (FMV) and any excess is allocated to goodwill and going concern value. Here, the FMV of the assets (\$942,500) is subtracted from the purchase price (\$960,000) for goodwill and going concern value of \$35,500.
47. **A.** Wage expense \$8,000; gain on sale \$2,000. An employee who receives property as compensation for services for an amount less than the property's fair market value (FMV) must include in gross income the difference between the amount paid for the property and the amount of its FMV at the time of the transfer. A gain results because the FMV is more than the adjusted basis.
48. **B.** \$4,000; \$2,750. Lou and Casey's adjusted bases in their cabs before the exchange are \$2,000 and \$2,750, respectively. After the exchange, Casey does not recognize any gain even though he received cash in the exchange. However, Lou's basis of his new cab is the adjusted basis of his old cab increased by the amount of additional cash paid for the new cab. (\$2,000 adjusted basis plus \$2,000 cash).
49. **D.** \$5,400. Assuming that Bob is a cash-basis taxpayer, generally, rental expenses are deductible by a cash-basis taxpayer-lessee in the tax year in which they are paid. However, the general rule does not apply to advance rental payments. Advance rental payments made by a cash-basis taxpayer-lessee are generally not deductible in the tax year in which they are made but must be allocated over the period of time for which the premises may be used as a result of such payments.
50. **B.** \$11,750. The adjusted basis of the property exceeds the \$20,000 threshold by \$10,000, the maximum dollar amount is \$7,500 (\$17,500 minus \$10,000). Jerrard's share of the partnership deduction is \$3,750. Jerrard may deduct the full \$8,000 for the computer. Her maximum Section 79 deduction is \$11,750 (\$3,750 plus \$8,000).
51. **C.** \$470. Eligible business start-up expenses include the consultant fees, accountant fees, expenses for hiring and training employees and advertising expenses. Sally can deduct expenses over a period of time not less than 60 months and can claim 6 months of amortization in 1994.
52. **B.** \$2,275. Dr. Water's deduction is limited because, although he traveled outside the United States primarily for business purposes, more than 25% of his time was spent on nonbusiness activities. Therefore, he may deduct \$1,400 (70%) of the air travel costs, \$700 (70%) of his lodging costs and \$175 of his meal expenses. The meal deduction is subject to the 50% limitation, which must be applied before the deductible amount can be figured. Thus, \$500 meal expenses subject to the 50% limit equals \$250. 70% of the \$250 is deductible \$175.

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53. **D.** \$1,500. The expenses of a meal include amounts spent on food and tips relating to the meal. The amount allowable as a deduction for meal expenses is limited to 50 percent of the expenses. Transportation expenses to and from a business meal are 100 percent deductible. No deduction is permitted for club dues.
54. **D.** \$325. \$200 (50 percent) of the meal expense is deductible and the deduction for gifts to clients is limited to \$25 per person. Here, the Crowells gave each of 5 clients a \$40 gift. The Crowells may deduct \$125 of this \$200 gift expense.
55. **D.** \$45,000. Land is a business asset that must be capitalized (Pub. 334, page 17). Environmental clean-up costs are deductible as a business expense. See Pub. 334, page 94. The costs of moving machinery from one location to a new location is also deductible as a business expense.
56. **D.** \$2,000; \$500; \$0. The hobby loss rules apply to an activity not engaged in for profit, since the law does not use the word "hobby." Deductions are allowed, to a certain extent, to individuals and S corporations according to a 3-tiered ordering rule.
57. **C.** \$2,775. Sherri's deductions exceeded her income by \$9,600. The required adjustment reduce Sherri's net operating loss for 1994 to \$2,775. \$9,600 minus \$2,450 (personal exemption) minus \$3,375 (standard deduction minus interest income) minus \$1,000 (capital loss on sale of stock).
58. **C.** \$11,000. If in addition to receiving like-kind property, a taxpayer also receives money, the amount of recognized gain is the lesser of the amount of money received or the amount of gain on the exchange. The amount of money received here is \$3,000 (i.e., \$1,000 cash plus the \$2,000 of assumed liabilities) and the amount of gain on the exchange is \$2,000 (\$11,000 in property received plus \$1,000 cash plus \$2,000 of assumed liabilities minus \$12,000 in property transferred). The lesser of these two amounts is \$2,000. The aggregate basis of the like-kind property received is the adjusted basis of property transferred (\$12,000), minus the sum of the money received (\$3,000 - \$1,000 cash plus the \$2,000 assumed liability), plus the amount of any gain recognized as a result of the exchange (the aforementioned \$2,000). As indicated, the amount of any liabilities of the taxpayer assumed by the other party to an exchange is treated as money received by the taxpayer in the exchange. Thus, \$12,000 - \$3,000 + \$2,000 = \$11,000 (Code Sec. 1031 and Reg. Sec. 1.1031 (d)-2).
59. **C.** (\$2,500); (\$500). If an owner of Section 1244 stock invests additional capital but is not issued additional shares of stock, the amount of the additional investment is added to the basis of the originally issued stock, but this subsequent increase to the basis of the originally issued stock does not qualify for ordinary loss treatment. Any resulting loss must then be apportioned between



- the qualifying Section 1244 stock and the non-qualifying additional capital interest (Code Sec. 1244). Since the additional capital interest of \$2,000 is one-sixth of the total basis of \$12,000, the \$3,000 loss is apportioned as follows: \$500 of capital loss (one-sixth of \$3,000) and \$2,500 of capital loss (one-sixth of \$3,000) and \$2,500 of qualifying ordinary loss.*
60. **C.** \$12,000. Section 1245 property and Section 1245 recovery property are both subject to the Code Sec. 1245 recapture rules. Section 1245 property is generally depreciable personal property used in a trade or business. Accordingly, Betty Lou must recapture the \$12,000 gain on the personal property. The residential rental property and the intangible land rights are specifically excluded from the definition of Section 1245 recovery property.
61. **D.** \$90,000. Since any depreciation recapture under Code Secs. 1245 and 1250 is includible in income in the year that the property is disposed of in an installment sale, Miranda must report \$90,000 (\$65,000 plus \$25,000) of depreciation recapture on her return (Code Sec. 453(l)).
62. **C.** \$2,667. In general, the amount deductible as a business casualty loss is the difference between the fair market value of the business property immediately before the casualty reduced by the fair market value of that property immediately after the casualty, reduced by any insurance received (Code Sec. 165). Accordingly, (\$133,000 minus \$120,000) minus \$9,000 equals \$4,000. Since only two-thirds of Baron's loss was attributable to business property, Baron's deductible business casualty loss is \$2,667 ($\frac{2}{3} \times \$4,000$).
63. **A.** \$12,025. Max should include \$12,025 (\$9,200 + (\$5,700 - \$2,875)) in gross income on his Schedule F. Cash basis farmers must report any gain from the sale of breeder cows on Form 4797 (Code Sec. 1231 (b)(3)).
64. **B.** \$300. A solvent individual taxpayer generally realizes income to the extent that his debts are forgiven (Code Sec. 108(a)). On his individual tax return, Ted need only include the forgiveness of his personal debt of \$300. The remaining \$800 of debt constitutes income to Ted's business.
65. **B.** \$14,400. A partner must separately account for charitable contributions, taxes paid to foreign countries and losses from the sale of property used in a trade or business (Code Sec. 702). Accordingly, the JLC Partnership must increase its ordinary income by \$14,400 (\$3,000 plus \$2,500 plus \$8,900) and separately state that amount on its Schedule K.
66. **B.** \$10,000; \$8,000; \$9,000. An active partner's deductible loss cannot exceed the amount of the adjusted basis of his or her interest in the partnership at the end of the partnership tax year in which the loss occurred (Code Sec. 704(d)). Since the \$30,000 loss is to be shared 4:3:3 (\$12,000: \$9,000: \$9,000), Ray's and Fay's losses are limited to their adjusted bases of \$10,000 and \$8,000.



However, since Kay's adjusted basis is \$12,000, she can take her full \$9,000 share of the loss.

67. **A.** \$4,500. *Losses arising from a passive activity generally are deductible only against income from that or another passive activity (Code Secs. 469(a) and (d)). Since Mr. C is a passive investor in JLC, his deductible loss is limited to his \$4,500 passive income from other sources.*
68. **B.** \$168,000. *A general partner's basis in his partnership interest is increased by his share of the partnership's recourse liabilities (Code Sec. 752 (a)). Todd's share of the additional partnership liability (45 percent of \$240,000=\$108,000) plus his original basis of \$60,000 gives him an adjusted basis of \$168,000. Although Todd's share of the partnership loss is 45 percent of \$600,000, or \$270,000, his deductible loss is limited to his adjusted basis of \$168,000 (Code Sec. 704(d)).*
69. **C.** \$32,000. *A general partner's basis in his partnership interest is increased by his share of the partnership's recourse liabilities for which he is ultimately liable (Code Sec. 752 (a)). Partner B's ultimate share of the bank debt (\$12,000 per the separate agreement) plus his original basis of \$20,000 gives him an adjusted basis of \$32,000. Although Partner B's share of the partnership loss is 55 percent of \$60,000, or \$33,000, his deductible loss is limited to his adjusted basis of \$32,000 (Code Sec. 704(d)).*
70. **A.** \$0; \$16,000. *A taxpayer who realizes a capital gain on the disposition of certain depreciable property must recapture all or part of that gain as ordinary income. The amount that must be recaptured is the lesser of the total of depreciation deductions allowed or allowable with respect to the property, or the total gain realized (Code Sec. 1245). Furthermore, capital gain does not result from the sale or exchange of depreciable property between "related persons," defined as a person and any entities controlled (more than a 50-percent interest) by him. Thus, in the case of a sale or exchange between related persons, any gain remaining after recapture of depreciation is also treated as ordinary income (Code Sec. 1239 and Reg. § 1.1245-6(f)). In this example, the \$16,000 difference between the sale price and the computer system's adjusted basis is all characterized as ordinary income: \$12,000 pursuant to Code Sec. 1245 and the remainder because Mr. Thomas and his 70-percent owned partnership are related persons.*
71. **A.** \$0. *If a taxpayer purchases property from a related party who sustained a loss on the transaction but was not allowed a deduction for the loss due to the related party rules, any gain realized by the taxpayer on a subsequent sale of the property is recognized only to the extent that the gain exceeds the amount of the previously disallowed loss (Code Sec. 267(d)). In this question, the \$30,000 loss in the sale of the property is disallowed since the two partnerships involved are*



- related parties. The Black Partnership recognizes no loss when it sells the property for \$12,000 more than it paid for the property, but it also does not recognize any gain since that \$12,000 is less than the \$30,000 previously disallowed loss.*
72. **D.** \$60,000 guaranteed payment, \$2,500 loss. Even though a partnership incurs a loss for a tax year, an active partner who receives a guaranteed payment must nevertheless take into account the full amount of such payment (Code Sec. 707(c)). This inclusion is required even when the partnership loss is caused by that guaranteed payment to the partner. Furthermore, the partner must also take into account his distributive share of the partnership loss. Accordingly, Jay must include his \$60,000 guaranteed payment and 25 percent of the \$10,000 loss (\$50,000-\$60,000) on his individual return.
73. **A.** \$0. Generally, no gain or loss is recognized to either the partnership or its partners (including the contributing partner) on a contribution of property to the partnership in exchange for a partnership interest (Code Sec. 721(a)). Accordingly, Scott's property contribution to the partnership in exchange for a 45-percent interest in the partnership is a nonrecognition transaction.
74. **B.** \$4,500. Any fixed or guaranteed amount paid by a partnership to a partner without regard to the income of the partnership is a guaranteed payment taxable to the recipient-partner and deductible by the partnership (Code Sec. 707(c)). Since Gary's distributive share of the partnership's income would only be \$7,500 (25 percent of \$30,000), the amount necessary to bring that amount up to the promised \$12,000 (\$4,500) constitutes a guaranteed payment that is deductible by his partnership.
75. **C.** \$10,000 capital gain. A partner's basis in her partnership interest, which is a capital asset, is decreased to the extent that her share of the partnership's liabilities is assumed by another (Code Sec. 752(b)). Once relieved of her \$30,000 share of partnership liabilities, Tina's adjusted basis in her partnership interest is \$10,000. Having sold her partnership interest for \$20,000 cash, she has \$10,000 of capital gain.
76. **B.** \$80,000; \$20,000. When the basis of property in the hands of a partner is determined from the basis of his partnership interest, as is the case with distributions in liquidation of a partner's entire interest, the amount of a partner's basis in his partnership interest is allocated among the properties received after subtracting the amount of any cash and inventory items received. The allocation of the remaining basis to these properties must then be made in proportion to the partnership's adjusted bases in such property (Code Sec. 732). In this case, Asya's \$300,000 partnership interest, minus \$140,000 for the cash and minus the \$60,000 in inventory leaves a remaining basis of \$100,000. This \$100,000 is then allocated to the building and computer according to the 4:1 basis proportion (\$160,000: \$40,000) of the ATP Partnership in the building and computer, resulting in a \$80,000:\$20,000 basis ratio for Asya.



77. **B.** \$12,000. The basis of property received in a nonliquidating distribution from a partnership, while generally the same as the basis of the property in the hands of the partnership, cannot exceed the basis of the recipient-partner's partnership interest, reduced by the amount of money received by the partner in the same transaction (Code Sec. 732(a)(2)). Accordingly, Eliot's partnership interest is reduced to \$12,000 on the receipt of the \$48,000 nonliquidating distribution, and although the equipment has a fair market value and an adjusted basis of \$18,000, its basis is limited to Eliot's \$12,000 basis in his partnership interest.
78. **D.** \$0; \$12,500. A retiring partner who receives partnership payment for the partner's entire interest in the partnership is taxable on any gain only to the extent that the amount of money received exceeds his adjusted basis in his partnership interest (Code Sec. 736). The general rule for reporting such payments is that gain is taken into account only after the money received exceeds basis. Distributions need not be reported by the withdrawing partner until basis is recovered. Thereafter, all money distributions are reported as gain in the year received (Code Sec. 731). Accordingly, Robert's \$40,000 adjusted basis minus the forgiveness of his \$15,000 share of partnership liabilities (Code Sec. 752) leaves him with a basis of \$25,000. The receipt of \$2,500 for 15 months totals \$37,500, \$12,500 more than his remaining basis. Consequently, Robert has a \$12,500 capital gain, all reportable in 1994 when his basis is finally exceeded by the monthly distributions.
79. **B.** \$6,000 ordinary income; \$18,000 capital gain. To the extent that money received by a partner in exchange for her partnership interest is attributable to her share of the value of unrealized receivables, that money is treated as ordinary income (Code Sec. 751). The remainder is treated as income attributable to a capital asset (Code Sec. 741). Accordingly, after Cynthia is relieved of her share of partnership liabilities, her partnership basis is \$4,000 (\$19,000 - \$15,000) (Code Sec. 752). On the sale of her interest for \$28,000, she has \$24,000 above her basis to account for. Since her share of unrealized receivables is \$6,000, she has \$6,000 of ordinary income, and the remaining \$18,000 constitutes capital gain.
80. **B.** \$7,500. Wages received as a corporate employee are not self-employment income, even if the employee is the sole shareholder of the corporation. Net income and distributions from an S corporation also are not self-employment income. However, the fee for services rendered as a director of a corporation is self-employment income as are guaranteed payments to a limited partner for services actually rendered to or on behalf of the partnership (Code Sec. 1402). Consequently, Ruth's director fees and her guaranteed payments result in \$7,500 of self-employment income.



PART 3

1. **False.** A tax-free transfer to a controlled corporation only applies to a transfer of property. A transfer of services in exchange for stock is fully taxable.
2. **True.** Unless the indebtedness exceeds the basis of transferred property, the existence of debt does not affect the tax-free nature of the transfer.
3. **True.** Pre-opening advertising costs are deemed start-up expenses and generally must be amortized.
4. **False.** A transferee corporation's holding period generally includes the transferor's holding period if the transferor transferred the property in a nontaxable exchange for stock.
5. **False.** An accrual-basis method taxpayer only may deduct expenses and interest owed to a related cash-basis method taxpayer when the accrual-basis method taxpayer makes the payment and the amount paid is includible in the gross income of the cash-basis method payee.
6. **True.** If a corporation issues stock to a creditor in satisfaction of its indebtedness, the corporation is treated as having satisfied the indebtedness with an amount of money equal to the fair market value of the stock. Thus, the corporation realizes cancellation of indebtedness income to the extent that the amount of the indebtedness exceeds the value of the transferred stock.
7. **False.** The election to forgo the net operating loss carryback is made for a tax year at a time. An election in one tax year does not affect future tax years.
8. **False.** The official answer is False. However, it is CCH's contention that the official answer is incorrect. According to IRS Pub. 17, *Your Federal Income Tax*, a return of capital (which is a distribution that is not paid out of the earnings and profits of a corporation) should be reported on Form 1099-DIV or other statement from the corporation.
9. **True.** Accumulated earnings and profits, not just current earnings and profits, are taken into account in determining whether a distribution is a dividend.
10. **False.** Although exceptions apply, distributions of stock or stock rights with respect to preferred stock generally are taxable.
11. **True.** Property in these cases is generally treated as worth at least as much as the liability attached to it.

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12. **True.** When a tax is imposed at the corporate level on excess net passive income, the amount of passive income to be reported by each shareholder is reduced by the allocable portion of the tax.
13. **False.** The testing period for passive investment income and C corporation earnings and profits is three years, not two.
14. **True.** The personal representative of the domestic estate must file an income tax return for the estate regardless of income because Mr. Alisandros is a beneficiary who is a nonresident alien.
15. **False.** An estate tax return must be filed only if the gross estate's value exceeds \$600,000; not if it is exactly \$600,000.
16. **True.** No gain is reported on the transfer of property from a decedent to his or her estate or beneficiary because there is no sale or other taxable disposition of the property.
17. **False.** An estate's unused net operating loss carryover or capital loss carryover existing upon termination of the estate can be used by a beneficiary succeeding to property of the estate.
18. **True.** A calendar-year taxpayer receiving an extension of time for filing his or her income tax return automatically receives an extension to that same extended due date for filing his or her gift tax return for that same year.
19. **True.** One test for determining when fixed or determinable annual or periodical income, gains or losses are effectively connected with a U.S. trade or business is whether the activities are a material factor in the realization of the income generated.
20. **True.** If income of a complex trust is required to be distributed, it is currently taxable to the beneficiary whether or not it is actually distributed.
21. **D.** An automatic extension of time for filing a corporate income tax return also extends the time for paying the tax due on the return. In most cases, a corporation must pay the full amount of the tentative unpaid tax liability estimated on Form 7004 by the original due date.
22. **D.** Neither Ferdinand nor Isabella will recognize gains on the exchange. Because Ferdinand and Isabella hold a combined controlling amount in Columbus, each will defer the gain from the transfer.

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23. **B.** Any amount treated as a dividend. The transferor's basis in stock received is generally equal to his basis in the property transferred to the corporation, but is increased by any amount treated as a dividend.
24. **C.** Starting with the month the corporation actively engages in business. A corporation's organizational expenditures may be amortized over any period of at least 60 months that the taxpayer selects, but the period must begin with the month in which the corporation begins business .
25. **A.** A corporation cannot deduct contributions that exceed 10 percent of its taxable income. A corporation's allowable charitable contribution deduction for a given tax year cannot exceed 10 percent of the corporation's taxable income for the year. Any excess amount can be carried forward to the following tax year.
26. **D.** Capital losses can be deducted only up to the amount of the capital gains. Thus, because capital losses may be deducted only from capital gains, the deduction may not exceed those gains.
27. **C.** The controlled group is allowed a \$250,000 accumulated earnings credit for EACH member. A controlled corporate group is permitted only one \$250,000 accumulated earnings credit, shared among the members.
28. **A.** Payable in addition to the regular tax. Corporations are subject to an alternative minimum tax founded on taxable income, but broadened to include tax preferred income and deductions. This calculation produces a tentative minimum tax. If that amount exceeds the regular tax, the excess is added to the regular tax due.
29. **C.** When the liquidating distribution equals or exceeds \$600 in a calendar year. When a corporation makes distributions to a shareholder, in partial or complete liquidation, that exceed \$600 in any one calendar year, the corporation must furnish the shareholder with Form 1099-DIV.
30. **A.** The shareholders will be allowed to recover their respective basis in the stock before recognizing any gains. If a corporation makes a series of distributions in the course of a complete liquidation, each shareholder is entitled to recover his entire basis in his shares before recognizing gain.
31. **B.** October 15, 1996. The period within which the Service may assess a tax liability is shortened from three years to 18 months when it receives a request for prompt assessment. In this case, October 15, 1996, is 18 months after April 15, 1995, the date on which the prompt assessment request was made.
32. **D.** A partnership. Only individuals and specified trusts and estates may be S corporation shareholders. Other entities, including partnerships and corporations, are ineligible.

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33. **C.** *Net operating losses. Net passive income includes the gross receipts derived from royalties, rents, dividends, interest, annuities, and the sale or exchange of stock or securities. The term does not include “net operating losses.”*
34. **C.** *A capital gain. For S corporations having no accumulated earnings and profits, distributions are tax-free up to the shareholder’s basis in the corporation’s stock. Distributions in excess of stock basis are treated as a capital gain.*
35. **B.** *Apply at the shareholder level rather than at the corporate level. For S corporations, the at-risk rules applicable to losses apply at the shareholder level rather than at the corporate level.*
36. **D.** *A shareholder’s pro rata share of any nonseparately stated income of the S corporation. Allocations of income increase a shareholder’s basis. They do not decrease basis.*
37. **D.** *The S corporation issues its stock to another corporation. Only individuals and specified trusts and estates may be S corporation shareholders. Other entities, including corporations and partnerships, are ineligible. Thus, issuing stock to a corporation renders the corporation ineligible for subchapter S status.*
38. **C.** *On John’s final return, all income is reported on the accrual method regardless of the accounting method John had employed. In computing income for the decedent’s last tax year, only amounts properly includible under the taxpayer’s method of accounting are included.*
39. **C.** *Income tax on income received after decedent’s death. Unpaid income taxes are deductible if they are on income includible in a decedent’s income tax return for a period before, but not after, the decedent’s death.*
40. **A.** *Credit for marital deduction. The marital deduction is not a credit against the estate, but rather is a deduction from the gross estate in determining the taxable estate.*
41. **C.** *A transfer of a future interest that is not more than the annual exclusion (\$10,000). Since a gift of a future interest is not eligible for the \$10,000 annual exclusion, a gift tax return must be filed, irrespective of the gift’s value.*
42. **B.** *The value of a gift made to one’s spouse who is NOT a United States citizen. Although a marital deduction is available for a gift to a spouse who is a U.S. citizen, regardless of the spouse who is a U.S. citizen, regardless of the citizenship or residence of the donor, the marital deduction is not available for a gift made to a spouse who is not a U.S. citizen.*

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43. **D.** If the spouses are divorced during the year, they still may split a gift made before the divorce so long as neither marries anyone else during that year. Gift-splitting does not apply if a spouse remarries during the tax year in which the gift is made.
44. **B.** Generally, the trust is taxed on the income currently distributed and on the portion it has accumulated. A trust is allowed a distribution deduction for amounts required to be distributed currently and any other amounts properly paid, credit or required to be distributed.
45. **D.** ALL the income from Trust A and HALF from Trust B is taxed to Bill. Income from Trust A is fully includible by the grantor when it is held or accumulated for future distribution to the grantor or spouse. Income from Trust B is includible to the extent it is distributed to satisfy a legal obligation of the grantor to the recipient beneficiary, other than the grantor's spouse.
46. **B.** \$10,000. The official answer is B. \$10,000. However, it is CCH's contention that choice A may also be correct. Choice B is correct if it is assumed that either the limo transferred by Jeeves, or the limo received by him, was held for personal use and not for productive use in a trade or business or for investment (that is, the limos are not like-kind property). If it is assumed that either limo was personal-use property, the usual rules governing transfers to controlled corporations apply. Thus, while transferors generally recognize no gain or loss on transfers of property for stock, transferors recognize gain, but not loss, to the extent of any other property (money or property other than stock of the controlled corporation) received in the exchange. The amount of the gain recognized may not exceed the value of the property received in the exchange. Thus, the \$10,000 value of the limo (other property) is taxable to Jeeves. However, if it is assumed that both limos were property held for productive use in a trade or business or for investment, the like-kind exchange rules could apply. Those rules state that neither gain nor loss is recognized when property held for productive use in trade or business or for investment is exchanged for like-kind property. Application of those principles would create in essence a transfer to a controlled corporation coupled with a like-kind exchange of limos. In that case, Jeeves would recognize no gain on the combined transfer.
47. **B.** \$10,000. Without a bona fide purpose, the transfer cannot be made tax free. The \$5,000 worth of stock is a dividend. Because liabilities assumed by the transferee corporation on the condo (\$165,000) exceed its adjusted basis (\$160,000), Carroll recognizes gain to the extent of the excess (\$5,000). Thus, the combined taxable gain is \$10,000.
48. **C.** \$19,000. The basis of the property received by the controlled corporation in exchange for its stock is equal to the transferor's basis in the property (\$16,000), increased by the amount of any gain recognized by the transferor (\$3,000 as a result of the cash distribution). Thus, corporation K takes the property with a \$19,000 basis.



49. **D.** \$44,000. Because less than 80 percent of the stock was acquired for property (30 percent was acquired for services), the control requirement fails and the transfer by Anthony does not qualify for tax-free treatment. Therefore, Paradise takes the property from Anthony with a basis equal to \$44,000, the value of the property as well as the stock exchanged for it.
50. **D.** \$65,000. Because Ms. R receives only 60 percent of the Rain stock, she is not in control, and the transfer is not tax free. Accordingly, the basis of the property received by Rain in exchange for its stock is equal to the Ms. R's basis in the property (\$60,000), increased by the amount of any gain recognized by Ms. R \$5,000 (\$65,000 fair market value of the stock less \$60,000 basis).
51. **C.** \$10,000. If a corporation issues stock to a creditor in satisfaction of its indebtedness, the corporation is treated as having satisfied the indebtedness with an amount of money equal to the fair market value of the stock. The excess of the debt (\$30,000) over the fair market value of the stock (\$20,000) is income to the corporation.
52. **C.** \$40,000. A corporation that distributes property in redemption of its stock generally recognizes gain, but not loss, if it pays all or part of the redemption price by transferring property whose fair market value exceeds its basis to the corporation. Thus, Belle Corporation must recognize the \$40,000 gain inherent in the difference between the value of the Gaston stock (\$44,000) and its basis (\$4,000).
53. **B.** \$136,000. The dividends received deduction cannot exceed 80 percent of taxable income for the year. However, the taxable income limitation applies if the aggregate of the corporation's net income or loss from operations, dividend income, and otherwise fully available dividends received deduction does not yield a net operating loss. Applying this test, taxable income would be \$10,000 (negative \$30,000 (operating loss) plus \$200,000 (dividend) less \$160,000 (the otherwise available dividends received deduction based on \$200,000 multiplied by 80 percent)). Accordingly, the taxable income limitation applies and since Jeffer's taxable income for the year (without regard to the dividends received deduction) is \$170,000, the dividends received deduction cannot exceed \$136,000 (\$170,000 multiplied by 80 percent).
54. **B.** \$43,000. The charitable contribution deduction cannot exceed 10 percent of taxable income for the year. For this purpose, taxable income includes dividend income, but is not affected by charitable deduction or the dividends received deduction. Thus XYZ has taxable income for the year of \$320,000 ([\$1,000,000 gross receipts plus \$65,000 dividend income], minus [\$350,000 salaries plus \$395,000 operating expenses]). The charitable contribution deduction for the

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- year is \$32,000 (\$320,000 multiplied by 10 percent). This leaves \$43,000 (\$75,000 minus \$32,000) available as a carryover.
55. **C.** \$30,000. Capital losses of a corporation may be deducted only to the extent of its capital gains.
56. **B.** \$30,000. The dividends received deduction is not affected by any NOL carryovers. Further, based on the taxable income limitation discussed in answer #53, above the limitation does not apply here since there would be a net operating loss of \$30,000 (negative \$50,000 (operating loss) plus \$100,000 (dividend) less \$80,000 (the otherwise available dividends received deduction based on \$100,000 multiplied by 80 percent)). Since the limitation is not applicable, Pack Corporation may deduct the full \$80,000, resulting in a current year net operating loss of \$30,000, as computed above. Again, the 1993 NOL carryover is irrelevant.
57. **A.** \$147,500. The year's net operating loss is the excess of applicable operating expenses, \$447,500 (\$450,000 minus \$2,500 of contributions) over gross income (\$300,000).
58. **C.** \$10,000. The excess of the call price over face value (\$10,000) is deductible interest to Stone.
59. **C.** \$450. Alternative minimum tax is the excess of tentative alternative minimum tax over the regular tax liability. In this case, tentative alternative minimum tax is \$17,600, determined by adding taxable income (\$85,000) to preference items (\$45,000), subtracting total adjustments to taxable income (\$2,000), subtracting the exemption amount (\$40,000), and multiplying by the alternative minimum tax rate of 20 percent. (That is: \$85,000 plus \$45,000 equals \$130,000 less \$2,000 equals 128,000 less \$40,000 equals \$88,000 multiplied by 20% equals \$17,600.) Because regular tax liability (\$17,150) is less than the tentative alternative minimum tax (\$17,600), the excess (\$450) is the alternative minimum tax.
60. **C.** \$27,500. The \$40,000 exemption amount for alternative minimum taxable income purposes is reduced by 25 cents for each dollar by which AMTI exceeds \$150,000. Thus, Barrett's exemption is reduced by \$12,500 (\$200,000 income less \$150,000 equals \$50,000 multiplied by 25% equals \$12,500). This leaves a remainder of \$27,500 (\$40,000 less \$12,500).
61. **C.** \$179,500. Unappropriated retained earnings equal the 1994 opening (1993 closing) balance (\$50,000), plus net income for 1994 (\$125,000), plus the tax refund (\$17,000), minus the cash distributions (\$12,500).
62. **B.** \$100,000. Schedule M-1 reconciles income or loss per books with income or loss per return. The \$76,000 income per books is adjusted by adding federal income taxes (\$18,000), excess contributions (\$2,000), and meals in excess of the 50 percent limitation (\$8,000), and subtracting tax-exempt interest (\$4,000).



63. **C.** \$2,000 dividend income; \$11,000 capital gain. Because the distribution date is October 1 (three-fourths into the calendar year), \$30,000 of the current year's earnings and profits deficit (\$40,000 multiplied by 3/4) reduces the accumulated earnings and profits as of that date to \$2,000 (\$32,000 minus \$30,000). A dividend cannot exceed earnings and profits. Thus, only \$2,000 of the distribution is a dividend. The next \$2,000 eliminates Murphy's basis in his stock, and the remaining \$11,000 is treated as a capital gain.
64. **D.** \$60,000. In the case of distributed property that is not appreciated property, earnings and profits are reduced by the property's basis. However, the distribution cannot create negative earnings and profits. In determining whether negative earnings and profits are created, first look to current year's earnings and profits. Since the distributed property's basis (\$6,000) is less than current year's earnings and profits (\$8,000) no deficit in earnings and profits is created. Thus, earnings and profits are reduced by full \$6,000.
65. **C.** Negative \$70,000. On the distribution date, July 1 (the half-way point in the calendar year), Vernon had earnings and profits of \$30,000 (\$100,000 accumulated minus \$70,000 first half-year deficit in current earnings and profits). Of the \$35,000 distributed, only \$30,000 is a dividend (the amount of earnings and profits). Therefore, only \$30,000 is subtracted from remaining earnings and profits, leaving a balance of \$0 on that date. The corporation's accumulated earnings and profits as of December 31, 1994, is a \$70,000 deficit (the \$70,000 second half-year deficit in current earnings and profits plus the \$0 accumulated balance resulting from the July 1 distribution).
66. **C.** \$7,000. A corporation that distributes property is subject to the recapture of depreciation it has taken on the property distributed. Thus, \$7,000 is recaptured as ordinary income. (The remaining \$500 of gain would likely be capital gain.)
67. **D.** \$40,000. A corporation that makes an in-kind shareholder distribution of property subject to a liability recognizes gain as if it had sold the property to the shareholder at an amount not less than the liability.
68. **B.** \$50,000 ordinary dividend; \$50,000 capital loss. Because Daniel received the stock through inheritance, he takes a stepped-up basis of \$250,000 (fair market value at the date of the transferor's death). The \$50,000 dividend is ordinary dividend income and does not affect Daniel's basis. Thus, when he liquidated the corporation and receives the remaining \$200,000, he has a capital loss of \$50,000 (\$200,000 distribution minus \$250,000 basis).
69. **C.** \$45,000 capital gain for Turbo; \$65,000 capital gain for Lea. A redemption distribution is substantially disproportionate with respect to a shareholder (and qualifies for capital gains treatment) if after the redemption, she owns less than

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- 50 percent of the total combined voting power of all classes of voting stock and her percentage of voting stock and ownership percentage of common stock after the redemption is less than 80 percent of that immediately before the redemption. Lea meets these criteria and has \$65,000 of capital gain (\$125,000 land value minus \$60,000 stock basis). Turbo has capital gain of \$45,000 because a corporation that makes an in-kind distribution of property whose fair market value (\$125,000) exceeds its basis (\$80,000) recognizes gain as if it had sold property to the shareholder at its fair market value.
70. **D.** \$200,000 capital gain. A distribution in redemption of a shareholder's entire interest generally results in capital gain or loss, irrespective of earnings and profits. Ward receives \$450,000 reduced by his basis of \$250,000.
71. **C.** \$4,500,000 dividend. Because Diana owns 100 percent of the stock before and after the redemption, the transaction is a dividend to the extent that Charles Corporation has earnings and profits. Because the distribution (\$4,500,000) is less than earnings and profits (\$5,000,000), the entire amount is taxable as a dividend.
72. **A.** 65 percent. An individual is treated as constructively owning stock owned directly or indirectly by his spouse, children, grandchildren and parents. Thus, Matthew is treated as owning his shares (40 percent) and his father's (25 percent).
73. **B.** \$36,000. For an S corporation, distributions are generally treated as made first from the accumulated adjustments account, and second as dividends from accumulated earnings and profits. For 1994, the accumulated adjustments account is \$264,000 (\$204,000 current-year ordinary income plus beginning account balance of \$60,000). Thus \$264,000 of the \$300,000 is treated as a distribution from the accumulated adjustments account. Since accumulated earnings and profits (\$150,000) exceed the remaining unaccounted for distribution (\$36,000) the full \$36,000 is a dividend from earnings and profits.
74. **C.** \$75,000. The amount of losses and deductions an S corporation shareholder can claim is limited to the adjusted basis of the shareholder's stock. Thus, for 1994, Karl can deduct only \$75,000 of the loss.
75. **B.** \$32,500. Lisa's basis in Computers without taking the dividend into account was \$35,000 (\$25,000 purchase price plus \$10,000 income for 1994). The \$2,500 dividend reduces that basis to \$32,500. The \$7,800 loss from 1993 (a C corporation year) is a built-in loss and does not affect the basis computation.
76. **B.** \$8,650. Only the items of income actually or constructive received by a cash-basis method taxpayer before death are accounted for on the final return. Mr. Cross must include the interest (\$8,000) actually received and dividends (\$650) constructively received, but not the rental income (\$2,000) due in August 1994



since that amount was not actually or constructive received by Mr. Cross as of his date of death.

77. **C.** \$6,000. Unless the terms of the will provide otherwise, the widow includes \$6,000, representing her pro rate share (60 percent of \$10,000) in gross income.
78. **D.** \$798,000. All of Ed's listed items including accrued interest and dividends declared but unpaid as of his date of death are includible in his gross estate. A dividend is includible in decedent's gross estate only if the decedent dies after the record date of the dividend; the record date is the date when the shareholder of record becomes entitled to receive the dividend. This question assumes that the record date was the date the dividend was declared.
79. **B.** \$3,320,000. When alternative valuation is elected, the value of the decedent's gross estate is determined six months after the decedent's death or on earlier disposition. Since the house was sold prior to end of the six-month period, its value for the estate tax purposes was \$900,000, not \$800,000.
80. **C.** \$63,000. Taxable income (\$68,000) is modified by adding tax-exempt interest (\$10,000) and subtracting capital gains allocable to corpus (\$15,000).

PART 4

1. **False.** Only communication with the IRS concerning a taxpayer's rights, privileges or liabilities are included. "Practice Before the Internal Revenue Service" does not include representation before the United States Tax Court.
2. **True.** As a general rule, an individual must be an attorney, certified public accountant, or enrolled agent to represent a taxpayer before the IRS. There are limited circumstances where others not within these categories may represent a taxpayer. However, the fact pattern in the question does not present such circumstances.
3. **True.** A practitioner may be suspended or disbarred from practicing before the IRS if he knowingly aids another person to practice before the IRS when that person is suspended, disbarred or otherwise ineligible to do so.
4. **False.** An attorney, certified public accountant, or enrolled agent as well as a notary public is not permitted to certify papers, administer oaths, or perform any official act with respect to any matter before the IRS in which he is employed as counsel, attorney or agent.

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5. **True.** Although an enrolled agent generally cannot make, either directly or indirectly, uninvited solicitations of employment in matters related to the IRS, according to IRS Circular 230, Practice Before the IRS, the restriction does not apply to making the availability of professional services known to others practitioners, as long as the person or firm contacted is not a potential client.
6. **True.** After the complaint is filed, the practitioner then has at least 15 days to file an answer. Failure to deny or answer an allegation contained in the complaint is deemed to be an admission.
7. **True.** If the enrolled agent fails to appear at a hearing after receiving notice, he shall be deemed to have waived his right to a hearing and the administrative law judge may make his decision against him by default.
8. **False.** An enrolled agent is prohibited from making an uninvited solicitation of employment to a potential new client in a matter related to the IRS. However, this restriction does not apply to seeking new business from an existing or former client in a related matter.
9. **False.** The IRS may not initiate an examination to harass a taxpayer. However, the IRS has wide latitude in determining what a legitimate purpose is for the initiation of an examination. The Taxpayer Compliance Measurement Program (TCMP) is a random selection system used to determine a taxpayer's correct tax liability.
10. **True.** If the taxpayer pays the total amount due within ten days of the billing date, he will not be billed for additional interest.
11. **True.** The Tax Court has deficiency jurisdiction (disputed tax does not have to be paid first) whereas the federal district courts and the Court of Federal Claims have refund jurisdiction (disputed tax must be paid before an action is brought for a refund).
12. **True.** The Tax Court's jurisdiction to redetermine deficiencies by the IRS depends on the issuance of a notice of deficiency by the IRS and the filing of a Tax Court petition by the taxpayer. The petition must be filed within 90 days of the issuance of the notice of deficiency (150 days if mailed when the taxpayer is outside the United States).
13. **True.** Although the penalty for willful or reckless conduct is \$1,000, that amount is reduced by any preparer penalty paid under the \$250 understatement penalty for unrealistic positions. As a result, the total of the two penalties cannot exceed \$1,000.
14. **False.** An income tax return preparer must furnish a completed copy of the original income tax return to the taxpayer no later than when the original return (the individual return) is presented for the taxpayer's signature. It cannot be



- furnished when the second return (the S corporation return) is presented for signature.
15. **False.** If more than one return preparer is involved in the preparation of an income tax return, the individual who has the primary responsibility for the overall substantive accuracy of the return is considered to be the return preparer who is required to sign the return.
 16. **True.** The IRS requires each person who employs a return preparer to retain for three years a record of the name, taxpayer identification number, and principal place of work of each employee employed during any return period.
 17. **True.** If the proposed adjustments in a field examination case, including penalties and interest, exceed \$2,500 but do not exceed \$10,000, the taxpayer must file a brief written statement of the issues to initiate an administrative appeal.
 18. **False.** Form 8821, Tax Information Authorization, only authorizes an appointee to receive certain confidential tax information.
 19. **False.** The taxpayer's representative becomes attorney of record by signing the petition as the counsel for the petitioner; a power of attorney is unnecessary. The representative must be admitted to practice before the Tax Court and he should provide his Tax Court and he should also provide his Tax Court Bar Number on the petition.
 20. **True.** A partnership, and not any one partner, is an employer for Keogh plan purposes.
 21. **False.** While a Keogh plan may include a qualified cash or deferred arrangement (CODA), annual contributions by an employee are limited to a set dollar figure, which is adjusted each year for inflation. In 1995, the monetary cap is \$9,240.
 22. **True.** For purposes of determining a taxpayer's allowable IRA contribution, compensation includes any alimony or separate maintenance payment includible in the taxpayer's gross income under a divorce or separate maintenance decree.
 23. **True.** To establish its exemption, an organization must file a written application with the key director for the district in which the principal place of business or principal office of the organization is located. There are specific forms depending on the type of organization applying for the exemption. If filed within the 15-month period, then retroactive treatment is available.
 24. **False.** Regulations represent the official Treasury interpretation of the Code. They generally are accorded the force and effect of law as long as they are reasonable and consistent with the statutory provisions they interpret. The Tax

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- Court is bound by the legislative regulations to the same extent that other courts are.*
25. **False.** *The usual purpose of temporary regulations is to provide immediate guidance for a temporary period when substantial legislation has been enacted. Temporary regulations are effective until superseded by final, not proposed, regulations.*
26. **False.** *Revenue rulings are the IRS's official published interpretations on the application of the Code, treaties or regulations to particular facts. They do not have the same status of laws and regulations, and courts are not bound by them.*
27. **False.** *The Tax Court lacks jurisdiction over employment taxes. However, it does have jurisdiction over the self-employment tax.*
28. **True.** *An acquiescence or nonacquiescence represents the Commissioner's official response to a Tax Court decision that is adverse to the IRS. A nonacquiescence means that the IRS does not accept the decision and will not follow it in cases involving similar facts.*
29. **True.** *Unless the IRS and taxpayer consents otherwise, for taxes assessed after November 5, 1990, the government has ten years from the time an assessment is made to collect the taxes, either through initiating a court proceeding or administratively by levy.*
30. **True.** *The purpose of filing a notice of federal tax lien is to give notice to the taxpayer's creditors that the government has a claim against all the taxpayer's property. The federal tax lien attaches to all property and rights to property, whether real or personal, belonging to the taxpayer at the time the lien arises, as well as to property subsequently acquired during the period of the lien.*
31. **True.** *Filing a petition in bankruptcy automatically stays the IRS from collecting tax from the debtor. The stay lasts until the bankruptcy case is closed or dismissed or the debtor is discharged or denied a discharge.*
32. **True.** *Although a bankruptcy stay does not prevent tax assessments, a tax lien generally does not take effect during the pendency of a bankruptcy.*
33. **True.** *The trust and fund recovery penalty may be imposed against any person required to collect, account for, and pay over trust fund taxes who willfully fails to do so. Trust fund taxes include withheld income taxes and employment taxes.*
34. **True.** *Enrollments must be renewed every three years. To qualify for renewal, enrolled agents must meet the continuing professional education requirements, which also must be satisfied in three-year cycles.*

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35. **True.** Generally, a renewal application for the next three-year enrollment cycle must be made during the three-month period ending on January 31 of the last year of the enrollment cycle.
36. **D.** Under the limited practice provisions in Circular 230, an individual who is under suspension or disbarment from practice before the IRS may NOT engage in limited practice before the IRS. If an individual is suspended or disbarred from practice before the IRS, he may not engage in practice before the IRS on behalf of a client under any circumstances. In addition, an individual may not knowingly aid another person to practice before the IRS when that person is suspended or disbarred from practice before the IRS.
37. **B.** Advise the client of the noncompliance. The enrolled agent, CPA or attorney has the duty to advise the client of the noncompliance. However, he is not required to notify the IRS.
38. **D.** Tom lives in New Jersey. His books and records are in Delaware where his business is located and where he works. Tom wishes a transfer of the examination of his return to Delaware. Generally, a taxpayer's return is examined in the IRS district in which the taxpayer lives. However, IRS Pub. 556 provides that the return can be transferred to another district where it can be examined more quickly and conveniently, such as the district where the taxpayer's books and records are located.
39. **D.** PAY the tax, file a claim for refund requesting that the claim be immediately rejected so he may file a refund suit in District Court. The official answer is D. However, it is CCH's contention that choice B is also correct. A taxpayer has three basic alternatives in contesting an adverse determination by the IRS or a preliminary or statutory notice of deficiency: requesting an administrative appeal; not pay the tax and petition Tax Court; or pay the tax, file a refund claim, and file a refund suit in a district court or Court of Federal Claims. Therefore, B and D are both correct.
40. **D.** A written protest MUST contain a declaration under penalties of perjury, signed by the taxpayer that the statement of facts is true and correct. Although a written protest generally must contain a sworn statement made by the taxpayer under penalty of perjury declaring that the statement of facts presented in the protest, and in any accompanying schedules, are true, correct and complete to the taxpayer's best knowledge and belief, a substitute declaration may be submitted by the taxpayer's representative stating that the taxpayer prepared the protest and accompanying documents, and whether the representative knows personally that the protest and accompanying documents are true and correct.
41. **A.** Ron dies after furnishing tax return information to his tax return preparer. Ron's tax return preparer discloses the information to Jerry, Ron's nephew, who



- is NOT the fiduciary of Ron's estate. A return preparer may not disclose tax return information of a decedent to an individual that is not a fiduciary of the decedent's estate.*
42. **B.** *The total disputed deficiency (tax and penalties) for ALL tax years at issue must be \$10,000 or less. The official answer is B. However, it is CCH's contention that choice D is ambiguous and arguably a correct choice, too. The question states that one of the four choices is an incorrect statement. Choice B is an incorrect statement because according to Tax Court Rule 171 the \$10,000 monetary cap is tested on a year-by-year basis and not by aggregating all the tax years before the court. Although choice B is an incorrect statement, choice D is a confusing and misleading statement and thus arguably an incorrect statement, too. Trials in a small tax court proceeding are more informal than regular Tax Court trials, and, unlike regular Tax Court trials, small tax court proceedings are not bound by the Federal Rules of Evidence.*
43. **D.** *Someone who prepares, as a fiduciary, a return or claim for refund for any person. Someone that prepares a return solely in a fiduciary capacity is not deemed to be an income tax return preparer.*
44. **A.** *\$1,000. A \$1,000 penalty may be imposed on an income tax return preparer if any part of an understatement of tax on an income tax return or refund claim is attributable to a willful attempt by the preparer in any manner to understate tax liability of another person.*
45. **C.** *If the IRS assesses either the section 6694(a) or section 6694(b) penalty, within 30 days the preparer can either pay the entire amount and then file for refund, or pay at least 15 percent of the entire amount and then file a claim for the amount paid. The claim, which is made on Form 6118, Claim of Income Tax Return Preparer, must be filed with the service center that issued the statement of notice and demand to the preparer. A minimum of 15 percent need only be paid.*
46. **D.** *P, prepared income tax returns for compensation, and signed the income tax returns with a facsimile signature stamp. One qualifying as an income tax return preparer must put his original signature on the tax return. The signature must be manually applied; a facsimile signature does not satisfy this requirement. A paid preparer subject to the signature requirement need not be an enrolled agent attorney or CPA.*
47. **A.** *An income tax return preparer who operates a check chasing agency that cashes, endorses, or negotiates income tax refund checks for returns he prepared. A return preparer operating a check chasing agency that cashes the refund check of a taxpayer whose return the preparer prepared is subject to the penalty for negotiating a taxpayer's refund check.*



48. **C.** A declaration that the representative is NOT currently under investigation by the IRS. The Declaration of Representative is a statement made by a representative under the penalty of perjury that he or she is: (1) one of the types of persons authorized to practice before the IRS; (2) not currently suspended or disbarred from practice before the IRS; (3) authorized to represent the taxpayer for the matter specified in the power of attorney; and (4) aware of the regulations governing practice before the IRS. It is filed with a power of attorney and its failure to indicate current investigation by the IRS will not invalidate the power of attorney.
49. **D.** To request the disclosure of confidential tax return information. To request the disclosure of confidential tax return information, an individual must make a request under the Freedom of Information Act (FOIA). The rules under FOIA determine an individual's entitlement to confidential return information. Although Form 2848 can be used, it need not be used for tax return information disclosures.
50. **D.** Nancy need ONLY file a signed statement (notice of substitution or delegation) with the appropriate IRS office. A substitution is made by filing the following items with the IRS: (1) a notice of substitution or delegation signed by the practitioner who was appointed under the power of attorney, (2) a declaration of representative made by the new representative, and (3) a power of attorney that authorizes the substitution or delegation.
51. **A.** The CAF number is entered into the IRS database which allows the IRS to automatically send copies of notices to the representative. The Centralized Authorization File (CAF) is an automated system designed to allow IRS personnel to identify representatives and the scope of their authority.
52. **A.** Records that support the basis of property should be kept until the statute of limitations expires for the year that the property was acquired. Records regarding the basis of property are relevant and should be kept for as long as the taxpayer owns the asset. If the taxpayer exchanges an asset for another asset, for which the basis in the new asset is determined by the basis in the exchanged asset, the records regarding the basis of the exchanged asset should also be maintained as long as the new asset is owned by the taxpayer.
53. **C.** At least 4 years after the due date of the return or after the date the tax is paid, whichever is later. Unemployment tax records must be retained for at least four years after the tax to which the records relate is due, or four years after the tax is paid, whichever is later.
54. **B.** An employer's Keogh plan must permit all employees to participate in the plan. A Keogh plan, not unlike most retirement plans, need only meet minimum coverage requirements to be a qualified plan.



55. **D. Defined benefit pension plan.** The maximum annual benefits permitted for defined benefit plan participants is the lesser of \$90,000, adjusted for inflation, or 100 percent of the participant's average compensation for his or her highest three consecutive calendar years.
56. **C. Accountants.** The Service has ruled that a U.S. citizen employed as a common-law employee cannot establish a Keogh plan. Thus, choices B and D are both wrong. Furthermore, a common-law employee cannot establish a Keogh plan, even though income earned from his or her employment constitutes net earnings from self-employment under the statutory definition of self-employment. Thus, choice A is also wrong.
57. **B. Made to an employee before reaching the age of 59 1/2.** Unless an exception exists to the contrary (for example, the other three choices), a distribution is exempt from the 10-percent additional tax only if it is made on or after the date on which the employee attains age 59 1/2.
58. **A. An owner employer borrowing money from her plan for business purposes would NOT constitute a prohibited transaction.** The lending of money or extension of credit between a plan and a disqualified person is a prohibited transaction and the term disqualified person includes an employer.
59. **C. The plan must make it impossible for its assets to be used for, or diverted to, purposes other than for the benefit of employees and their beneficiaries.** A qualified plan, including a Keogh plan, must provide that benefits may not be assigned, alienated or anticipated.
60. **C. If the employee takes out the excess deferral by April 17, 1995, the amount is NOT considered contributed for purposes of satisfying (or not satisfying) the nondiscrimination requirements.** For purposes of applying the nondiscrimination requirements with respect to highly compensated employees, excess deferrals are not to be disregarded merely because they are excess deferrals or because they are distributed in accordance with the corrective distribution requirements.
61. **C. \$3,500.** For a married couple filing a joint return, each spouse can generally contribute up to the lesser of \$2,000 or an amount equal to the compensation includible in gross income for the year to an IRA. Since Marianne earned \$38,000 in 1994, the maximum she can contribute is \$2,000, and since Vince earned \$1,500, the maximum he can contribute is \$1,500. Thus, the total contribution they can make as a couple is \$3,500.
62. **C. \$2,000.** Since Gary's earned income (\$3,500) exceeds \$2,000, the maximum allowable contribution to a spousal IRA is \$2,000. Gary cannot contribute any amount to an IRA for himself during 1994 because he turned 70 1/2 during that year.



63. **D.** An individual retirement account with a trustee who invests one's money in life insurance contracts. No part of the funds of an IRA may be invested in life insurance contracts. However, an individual retirement account's funds may be invested in an annuity contract providing, in the event of death before distributions begin, for a payment equal to the total premiums paid or, if more, the contract cash value.
64. **B.** \$2,250. The largest allowable IRA deduction available to Ruth and Lester for 1994 is \$2,250. Both Lester's net rental income (\$8,000) and the couple's joint taxable investment income (\$6,000) are disregarded as compensation for purposes of determining maximum available IRA contribution. However, these amounts are includible in determining modified AGI (AGI before adjustment for IRA deduction). The couple's modified AGI is \$39,058, consisting of Ruth's salary (\$25,000), the rental income (\$8,000), the joint taxable investment income (\$6,000), and Lester's jury duty pay (\$58). Since the couple are filing a joint return and their modified AGI is below \$40,000, there is no reduction in IRA deduction resulting from Ruth's active participation in a retirement plan. Accordingly, since Ruth's compensation was \$25,000, she can contribute and thus the couple can deduct \$2,000. In addition, while Lester earned just \$58, he can elect to be treated as having no compensation for the tax year. A spousal contribution of up to \$250 is available since the couple filed a joint tax return, Lester elected to be treated as having no compensation, Lester is under 70 1/2, and Ruth had compensation that was includible in gross income. As a result, the total available IRA deduction for 1994 is \$2,250 (\$2,000 plus \$250).
65. **A.** \$15,750. Gail's maximum deductible contribution to her SEP-IRA is the lesser of \$15,750 (\$150,000 multiplied by 10.5 percent) or \$18,699, calculated as follows: Reduce Gail's compensation (\$200,000) by one-half of her self-employment tax (one-half of \$6,435 is \$3,217.50) and multiply the difference by the self-employment person's rate using table contained in IRS Pub No. 560 (10.5 percent yields a rate of .095023). In no event can the deduction exceed \$30,000.
66. **D.** By the due date of the employer's tax return including extensions. A deduction for contributions to a qualified plan, including a SEP, is generally allowed for the tax year in which contributions are paid. Contributions paid on or before the due date of returns, including extensions, for a particular tax year are deemed paid on the last day of that tax year.
67. **D.** April 1, 1995. In the case of IRA distributions, the excess accumulation excise tax is avoided if required distributions begin to be made as of April 1 of the calendar year following the calendar year in which the individual attains age 70 and one-half. Since Ms. Rhoades attained age 70 and one-half on September 30, 1994, required distributions must begin to be made by April 1, 1995.

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68. **B.** Pay the penalty tax that is due with the return, attach a written statement to the return explaining the situation and wait for the IRS to approve by sending a refund of the penalty tax which was paid. The Service can waive the excise tax if it is satisfied that there was reasonable error and that reasonable remedial steps have been taken by the taxpayer. To make a waiver request, a taxpayer must file Form 5329, pay excise tax owed, and attach a written explanation showing when excess accumulation was removed or what the taxpayer has done to have it withdrawn. Any tax paid will be refunded if the waiver is granted.
69. **A.** A central or parent organization may file Form 990, Return of Organization Exempt From Income Tax, for two or more local organizations that are NOT private foundations. However, this return is in addition to the central or parent organization's separate annual return if it must file one. A parent or central exempt organization files a separate return for itself. If it chooses, the organization may also file a group information return for two or more local organizations, as long as none of the local organizations are private foundations.
70. **D.** ALL courts are bound by the Code section. The Internal Revenue Code is federal law and thus binding on all federal courts.
71. **D.** Public hearings are NOT held on proposed regulations. The purpose of proposed regulations is to give the public an opportunity to be heard before the regulations are promulgated in their final form.
72. **B.** Judicial. The three classes of Treasury Regulations are temporary, final and proposed regulations.
73. **D.** The government prints the regular and memorandum Tax Court decisions in bound volumes. Only Tax Court regular decisions are printed by the government in bound volumes.
74. **B.** Workmen's compensation. Workmen's compensation, including any amount payable for dependents, is property which is exempt from levy.
75. **B.** In most states that have state income taxes, the IRS can levy a state refund check and apply the state fund to a federal tax debt. Generally, a state refund check is property which is subject to levy. Levies attach to both property and property rights.
76. **B.** After the sale, the IRS uses the proceeds first to satisfy the tax debt. The sale proceeds are applied first against the expenses of the proceedings, next against any federal excise tax imposed directly on the property, and then against the tax liability for which the levy was made, including a separate supporting statement containing the basis for the taxpayer's explanation.
77. **B.** Doubt as to the liability for the amount owed must be supported by evidence and the amount acceptable under the offer in compromise will depend on the

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degree of doubt found in the particular case. If an offer in compromise is based on doubt as to liability, the grounds must be fully and completely explained and supported by evidence.

78. **D.** *While you are making installment payments, interest will continue to accrue only on the tax liability due. Interest accrues on the unpaid tax liability as well as on unpaid interest and penalties, too.*
79. **C.** *An enrolled agent who does not meet the renewal requirements for ONE enrollment cycle will be required to take and pass all four parts of the Special Enrollment Examination in order to regain enrolled agent status. Although a noncomplying enrolled agent will not be required to take an examination, he or she will be given an opportunity to state the basis for the noncompliance with the possible consequence of being placed on the roster of inactive enrolled agents for a three-year period.*
80. **C.** *April 1, 1999. Renewal dates are April 1, 1990, and every three years thereafter. Therefore, the enrollment card of an enrolled agent who was initially enrolled on May 10, 1996, would terminate on April 1, 1999.*