Chapter 1

Introduction to Taxation

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

\_\_\_\_\_ 1. Both sales and use taxes are collected in the state in which the sale takes place.

ANSWER: False

LO: 1.1

DIFFICULTY: Easy

\_\_\_\_\_ 2. The person giving the gift pays the gift tax.

ANSWER: True

LO: 1.1

DIFFICULTY: Easy

\_\_\_\_\_ 3. The value added tax is a type of consumption tax.

ANSWER: True

LO: 1.1

DIFFICULTY: Easy

\_\_\_\_\_ 4. A flat tax generally would be considered a regressive tax.

ANSWER: False

LO: 1.2.

DIFFICULTY: Easy

\_\_\_\_\_ 5. Adam Smith’s four canons of taxation are Equity, Certainty, Economy and Convenience.

ANSWER: True

LO: 1.3

DIFFICULTY: Easy

\_\_\_\_\_ 6. The 16th Amendment to the US Constitution that provided for an income tax was ratified in 1913.

ANSWER: True

LO: 1.4

DIFFICULTY: Easy

\_\_\_\_\_ 7. The first codification of the Internal Revenue Code took place in 1954.

ANSWER: False

LO: 1.4

DIFFICULTY: Easy

\_\_\_\_\_ 8. There are three basic taxable entities: the individual, the fiduciary, and the C corporation.

ANSWER: True

LO: 1.5

DIFFICULTY: Easy

\_\_\_\_\_ 9. All interest paid to a taxpayer must be included in gross income.

ANSWER: False

LO: 1.5

DIFFICULTY: Moderate

\_\_\_\_\_ 10 A taxpayer’s filing status determines the basic standard deduction allowed.

ANSWER: True

LO: 1.5

DIFFICULTY: Easy

\_\_\_\_\_ 11. A married person filing a separate return has the lowest standard deduction amount.

ANSWER: False

LO: 1.5

DIFFICULTY: Easy

\_\_\_\_\_ 12. The lowest tax rate on the tax rate schedules for taxable incomes is the same for individuals and C corporations.

ANSWER: False

LO: 1.5

DIFFICULTY: Easy

\_\_\_\_\_ 13. Only corporations are allowed to carry their net operating losses both backwards and forwards.

ANSWER: False

LO: 1.5

DIFFICULTY: Easy

\_\_\_\_\_ 14. The alternative minimum tax is a tax determined on a broadened definition of income with no deductions permitted.

ANSWER: False

LO: 1.5

DIFFICULTY: Easy

\_\_\_\_\_ 15. All limited liability companies (LLCs) can file their tax returns as partnerships, or electively, as corporations.

ANSWER: False

LO: 1.6

DIFFICULTY: Easy

\_\_\_\_\_ 16. Partnerships and S corporations are flow-through entities.

ANSWER: True

LO: 1.6

DIFFICULTY: Easy

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

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

ANSWER Wealth taxes are those taxes levied on the value of property owned by a taxpayer. Examples include real estate taxes, tangible taxes, intangible taxes, and inventory taxes.

Wealth transfer taxes are those taxes levied on the value of property transferred to another. Examples are the gift, estate, and inheritance taxes. Consumption taxes are taxes levied on the value of goods or services that are purchased for consumption. Examples include sales, use, excise, and value added taxes.

LO: 1.1

DIFFICULTY: Easy

2. Compare a sales tax to a use tax.

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

LO: 1.1

DIFFICULTY: Moderate

3. Compare progressive, proportional, and regressive taxes.

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

LO: 1.2

DIFFICULTY: Moderate

4. What are Adam Smith’s four canons of taxation? Briefly describe each.

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

LO: 1.3

DIFFICULTY: Easy

5. Explain how horizontal equity differs from vertical equity.

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

LO: 1.4

DIFFICULTY: Easy

6. Explain the difference between a business’s gross revenue and its gross income.

ANSWER Gross revenue is the total of all revenue, normally from sales of goods or services. Gross income is gross revenue less cost of goods sold.

LO: 1.5

DIFFICULTY: Easy

7. When does a seller realize a loss of the sale of an asset?

ANSWER A seller realizes a loss on the sale of an asset if the amount received for the asset is less than the basis of the asset in the seller’s hands.

L0 1.5

DIFFICULTY: Easy

8. When would an individual use the standard deduction instead of itemizing deductions?

ANSWER An individual would normally use the standard deduction when the sum of his or her itemized deductions after all limitations are applied does not exceed the standard deduction.

LO: 1.5

DIFFICULTY: Easy

9. Which is more advantageous, a deduction *for* or a deduction *from* adjusted gross income? Why?

ANSWER A deduction *for* adjusted gross income is more valuable than an equal amount of deduction *from* adjusted gross income because many of the deductions *from* AGI have some limitation imposed on their deductibility based on AGI. The deductions *for* AGI generally are not subject to any reduction but they do reduce the amount of AGI before the limitations on deductions *from* AGI are imposed—meaning the limitations based on AGI are smaller. In addition, deductions *for* AGI are allowed to be deducted regardless of the taxpayer’s filing status; deductions *from* AGI are only valuable if they exceed the taxpayer’s standard deduction.

LO: 1.5

DIFFICULTY: Moderate

10. What uses are made of adjusted gross income (AGI) in the individual tax model?

ANSWER The intermediate income concept of adjusted gross income provides a number that can be used as a limit for some itemized deductions, as a threshold minimum for the deduction of other itemized deductions, and as a basis for determining the phase-out of other benefits.

LO: 1.5

DIFFICULTY: Moderate

11. Explain the difference in owner’s liability for the general business debts of a limited liability company (LLC) and a limited liability partnership (LLP).

ANSWER The owners of a limited liability company are not liable for the general debts of the company. The general partners in a limited liability partnership are personally liable for the general debts of the partnership.

LO: 1.5

DIFFICULTY: Easy

12. What is the purpose of the alternative minimum tax?

ANSWER The alternative minimum tax is designed to ensure that higher income taxpayers pay some amount of income tax. The tax base on which the tax is levied is broadened by including certain income items that are exempt from tax for regular tax purposes and disallowing certain regular tax deductions.

LO: 1.5

DIFFICULTY: Moderate

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

ANSWER A sole proprietorship has only one owner; a corporation can have one or an unlimited number of owners. The corporation has limited liability; the sole proprietor is responsible for the liabilities of the business. There generally few if any legal requirements to establish a sole proprietorship; a corporation must be incorporated under the laws of one of the states and have a corporate chapter. The sole proprietor cannot take advantage of employee status and reports all results of operations on this or her own tax return. A shareholder-employee of a corporation is eligible for fringe benefits and the corporation files a completely separate tax return from that of any owner. There are other differences as well, too numerous to mention.

LO: 1.5 & 6

DIFFICULTY: Moderate

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

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

LO: 1.6

DIFFICULTY: Easy

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

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

LO: 1.6

DIFFICULTY: Easy

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

**Note to Instructor:** Reference table for **c**orporate and/or individual tax rate schedules required for certain problem solutions as indicated after the problem’s learning objective.

1. Janis purchased an asset for $50,000. During the five years she owned the asset she deducted $30,000 of depreciation expense and spent $5,000 on a major improvement. Determine Janis’s gain or loss on the sale of the asset for: a. $29,000; b. $18,000

ANSWER a. $4,000 gain; b. $7,000 loss

Adjusted basis = $50,000 – $30,000 + $5,000 = $25,000. a. $29,000 - $25,000 = $4,000 gain. b. $18,000 – $25,000 = $7,000 loss.

LO: 1.5

DIFFICULTY: Easy

2. Conrad sold an asset for $27,000. The asset originally cost $98,000 and depreciation deductions on the asset were $59,000. What is Conrad’s gain or loss on the sale of the asset?

ANSWER $12,000 loss.

Adjusted basis = $98,000 – $59,000 = $39,000; $27,000 - $39,000 = $12,000 loss.

LO: 1.5

DIFFICULTY: Easy

3. The Walstore Shoe Market had $1,875,000 of shoe sales and its cost for these shoes was $688,000. In addition, Shoe Market received $5,000 of corporate bond interest and $6,000 interest on State of California bonds. It paid $512,000 in salaries and had $552,000 of other operating expenses. What is Shoe Market’s taxable income? What is its income tax liability?

ANSWER $128,000 taxable income; $33,170 tax

Taxable income = $1,875,000 - $688,000 + $5,000 interest - $512,000 salaries - $552,000 expenses = $128,000. [Interest on state bonds is tax exempt.] Income tax = ($50,000 x .15) + ($25,000 x .25) + ($25,000 x .34) + ($28,000 x .39) = $33,170.

Reference table(s) required for solution (Individual income tax tables).

LO: 1.5

DIFFICULTY: Moderate

4. Walter is married, files a joint return, and has three dependent children. If his adjusted gross income is $64,000 and he has $6,000 in itemized deductions in 2015, what is his taxable income? What is his income tax liability?

ANSWER $31,400 taxable income; $3,787.50 tax

Taxable income = $64,000 – (5 x $4,000) exemptions - $12,600 standard deduction (exceeds itemized deductions) = $31,400. Income tax = ($18,450 x .10) + [($31,400 - $18,450) x .15] = $1,845 + 1,942.50 = $3,787.50.

Reference table(s) required for solution (exemptions and standard deduction).

LO: 1.5

DIFFICULTY: Moderate

5. Susie is single, has salary income of $26,000, and $6,000 of itemized deductions in 2015. What is her taxable income? What is her income tax liability?

ANSWER $15,700 taxable income; $1,893.75 tax

Taxable income = $26,000 - $4,000 personal exemption - $6,300 standard deduction = $15,700 (The standard deduction exceeds the itemized deduction). Income tax = ($9,225 x .10) + [($15,700 - $9,225) x .15] = $922.50 + $971.25 = $1,893.75

Reference table(s) required for solution (exemptions and standard deduction).

LO: 1.5

DIFFICULTY: Moderate

6. Cragen Corporation has gross income of $625,000 and operating expenses of $418,000. What is its taxable income? What is its income tax liability?

ANSWER $207,000 taxable income; $63,980 tax

Taxable income = $625,000 - $418,000 = $207,000. Income tax = ($50,000 x .15) + ($25,000 x .25) + ($25,000 x .34) + ($107,000 x .39) = $63,980

Reference table(s) required for solution (corporate tax tables).

LO: 1.5

DIFFICULTY: Easy

7. Zenith Corporation has $900,000 of gross income and $720,000 of operating expenses. It has alternative minimum taxable income of $520,000. What is its alternative minimum tax?

ANSWER $50,550

Tentative alternative minimum tax = $520,000 x .20 = $104,000. Taxable income = $900,000 – $720,000 = $180,000. Income tax = ($50,000 x .15) + ($25,000 x .25) + ($25,000 x .34) + ($80,000 x .39) = $53,450. Alternative minimum tax: $104,000 - $53,450 = $50,550

(Reference table(s) required for solution.)

(Reference table(s) required for solution (Individual income tax tables).

LO: 1.5

DIFFICULTY: Easy

8. Allred Corporation has taxable income of $467,000 and a general business credit of $46,000. Determine the corporation’s refund or net tax due if it made estimated tax payments of $80,000.

ANSWER $32,780 tax due

Income tax = $467,000 x .34 = $158,780; $158,780 - $46,000 - $80,000 = $32,780 tax due.

(Reference table(s) required for solution (corporate tax tables).

LO: 1.5

DIFFICULTY: Easy

9. Chloe and Bill plan to marry either immediately before or immediately after year-end. Chloe’s taxable income for 2015 is $89,000 and Bill’s is $86,000 before their exemptions and deductions. Neither has any dependents nor itemized deductions. Would they have a marriage penalty or a marriage benefit if they married at the end of 2015?

ANSWER Marriage penalty

As single taxpayers: Chloe’s taxable income: $89,000 - $4,000 exemption - $6,300 standard deduction = $78,700. Bill’s taxable income: $86,000 - $4,000 exemption - $6.300 standard deduction = $75,700. Chloe’s income tax: ($9,225 x .10) + ($28,225 x .15) + ($41,250 x .25) = $15,468.75. Bill’s income tax: ($9,225 x .10) + ($28,225 x .15) + (38,250 x .25) = $14,718.75. Total tax as single taxpayers: $15,468.75 + $14,718.75 = $30,187.50

As a married couple: Taxable income: $89,000 + $86,000 – (2 x $4,000) - $12,600 standard deduction = $154,400. Their income tax: ($18,450 x .10) + ($56,450 x .15) + ($76,300 x .25) + ($3,200 x .28) = $30,283.50. If they married, they would have a marriage penalty of $96 ($30,187.50, - $30,283.50).

(Reference table(s) required for solution (Individual income tax tables).

LO: 1.5

DIFFICULTY: Hard

10. Joe is in the 28 percent marginal tax bracket. He has $50,000 to invest. He can invest in taxable bonds paying 5 percent interest or tax-exempt bonds paying 3.75 percent interest. Which bonds should he invest in?

ANSWER Joe should invest in the tax-exempt bonds.

[.05 x (1 - .28)] = .036 after-tax return for taxable bonds. Joe should invest in the tax-exempt bonds because the return is higher.

LO: 1.2 & 1.5

DIFFICULTY: Moderate

11. Carlyle needs to borrow some money for some unexpected bills. He can get a home equity loan at 8 percent interest for which the interest is deductible. Alternatively, he can borrow on his life insurance at 5 percent, but the interest is not deductible. Which is his best alternative if his marginal tax rate is 35 percent?

ANSWER Carlyle should borrow on his insurance.

[.08 x (1 - .35)] = .052; Carlyle should borrow on his insurance as the interest rate is lower.

LO: 1.2 & 1.5

DIFFICULTY: Moderate

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

ANSWER $66,453 total tax is 33.23% of $200,000

Tax on $200,000 = ($50,000 x .15) + $25,000 x .25) + $25,000 x .34) + ($100,000 x .39) = $61,250 corporate tax. ($200,000 - $61,250) x .25 = $34,687.50 distributed to the shareholder. Individual tax = $34,687.50 x .15 dividend rate = $5,203.13. Total tax = $61,250 + $5,203 = $66,453. The $66,453 total tax is 33.23% of $200,000.

Reference table(s) required for solution (Individual income tax tables).

LO: 1.6

DIFFICULTY: Hard

13 Harold is a 40 percent partner in HDT Partnership. At the beginning of the year, his partnership interest basis was $20,000. The partnership had net income of $58,000 for the year and it made an $8,000 distribution to Harold. What is Harold’s basis at the end of the year?

ANSWER $35,200

$20,000 + (.40 x $58,000) – $8,000 = $35,200 basis

LO: 1.6

DIFFICULTY: Easy

14. Karen, single with no dependents, wants to set up a business. She will use either a sole proprietorship or incorporate as a regular corporation. She expects the business to earn $45,000 after all expenses and payments to Karen except for federal taxes. Karen will take $25,000 from the business for living expenses (as a distribution from a sole proprietorship or a salary from a corporation). Considering only income taxes for 2015, should she establish the business as a C corporation or as a sole proprietorship?

ANSWER Karen should incorporate.

As a C corporation: Income tax on corporation = $45,000 x .15 = $6,750. Tax on $25,000 salary: taxable income = $25,000 - $6,300 standard deduction – $4,000 exemption = $14,700; income tax = ($9,225 x .10) + ($5,475 x .15) = $922.50 + $821.25; total tax = $6,750 + $1,743.75 = $8,493.75. As a sole proprietorship, Karen would be taxed on $70,000 of income ($45,000 + $25,000 salary). Taxable income = $70,000 – $4,000 - $6,300 = $59,700; income tax = ($9,225 x .10) + ($28,225 x .15) + ($22,250 x .25) = $10,718.75. Based on income taxes alone, Karen should incorporate as she will pay $2,225 ($10,718.75 - $8,493.75) less in taxes.

Reference table(s) required for solution (Individual income tax tables).

LO: 1.6

DIFFICULTY: Hard

15. Sylvester is single and has no dependents. His sole proprietorship averages net income of $125,000 annually. He needs $50,000 per year to live on. If he incorporates his business, would he pay more or less in total income taxes if he takes a salary of $50,000 for his living expenses? (Consider only income taxes.)

ANSWER

If he incorporates, Sylvester will save $5,718.50 in taxes.

As a sole proprietorship: Taxable income: $125,000 - $4,000 exemption - $6,300 standard deduction = $114,700.

Income tax: ($9,225 x .10) + ($28,225 x .15) + ($53,300 x .25) + ($23,950 x .28) = $25,187.25.

As a corporation: Corporate taxable income: $125,000 - $50,000 salary = $75,000. Income tax: ($50,000 x .15) + ($25,000 x .25) = $13,750. Sylvester’s taxable income: $50,000 - $4,000 - $6,300 = $39,700.

Income tax: ($9,225 x .10) + ($28,225 x .15) + ($2,250 x .25) = $5,718.75. Total tax: $5,718.75 + $13,750 = $19,468.75. If he incorporates, Sylvester will save $5,718.50 ($25,187.25 - $19,468.75) in taxes.

Reference table(s) required for solution (Individual income tax tables).

LO: 1.6

DIFFICULTY: Moderate

Other Objective Questions

1. Below is a list of items that are found in the tax models. Use **C** to identify items only found in the corporate tax model; use **I** to identify those items only found in the individual tax model; use **B** to identify those items found in both models.

\_\_\_\_\_ a. Gross income tax liability \_\_\_\_\_ f. Gross income

\_\_\_\_\_ b. Tax credits \_\_\_\_\_ g. Gross revenue

\_\_\_\_\_ c. Taxable income \_\_\_\_\_ h. Personal exemption

\_\_\_\_\_ d. Standard deduction \_\_\_\_\_ i. Cost of goods sold

\_\_\_\_\_ e. Adjusted gross income \_\_\_\_\_ j. Total income

ANSWER. 1. a. B b. B c. B d. I e. I f. B g. C h. I i. C j. C

LO: 1.5

DIFFICULTY: Moderate

2. Identify the following items with an **R** if it is a deduction **For** adjusted gross income. Identify with an **M** if it is a deduction **From** adjusted gross income.

\_\_\_\_\_ a. Moving expenses \_\_\_\_\_ f. State income taxes

\_\_\_\_\_ b. Medical expense \_\_\_\_\_ g. Gambling losses

\_\_\_\_\_ c. Charitable contribution \_\_\_\_\_ h. Health savings account contribution

\_\_\_\_\_ d. Alimony paid \_\_\_\_\_ i. Contribution to a pension plan

\_\_\_\_\_ e. Student loan interest \_\_\_\_\_ j. Theft loss

ANSWER. 2. a. R b. M c. M d. R e. R f. M g. M h. R i. R j. M

## LO: 1.5

DIFFICULTY: Moderate

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

**Note to Instructor:** Reference Tables for Corporate, Individual, and/or Trust Income Tax Rate Schedules required for certain problem solutions as indicated after the problem’s learning objective.

1. What is a tax?

a. a voluntary payment to the government for services received

b. a penalty

c. a fine

d. a forced payment to the government

ANSWER: d

LO: 1.1

DIFFICULTY: Easy

2. Which of the following is a tax?

a. Dog license

b. Parking fine

c. Water usage fee

d. Import duty

ANSWER: d

LO: 1.1

DIFFICULTY: Easy

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

a. Sales tax

b. Income tax

c. Gift tax

d. Estate tax

ANSWER: a

LO: 1.1

DIFFICULTY: Easy

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

a. Estate tax

b. Income tax

c. Gift tax

d. Use tax

ANSWER: d

LO: 1.1

DIFFICULTY: Easy

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

a. A tax on a person’s salary

b. A tax on stocks owned by the taxpayer

c. A tax on purchases made at a department store

d. A tax on property given to a grandchild

ANSWER: b

LO: 1.1

DIFFICULTY: Moderate

6. Which type of tax is a real property tax?

a. Income tax

b. Consumption tax

c. Wealth tax

d. Use tax

ANSWER: c

LO: 1.1

DIFFICULTY: Easy

7. When appreciated property is transferred, the gift tax is based on

a. replacement cost of the property

b. fair market value of the property on the date of the gift

c. the donor’s original cost of the property

d. the donor’s original cost increased by half of the appreciation

ANSWER: b

LO: 1.1

DIFFICULTY: Moderate

8. Which of the following types of taxes is levied by almost all states on some or all goods purchased?

a. Sales tax

b. Income tax

c. Property tax

d. Wealth transfer tax

ANSWER: a

LO: 1.1

DIFFICULTY: Easy

9. Which of the following statements is false?

a. Use taxes are assessed on out-of-state purchases used in the purchaser’s state.

b. The estate tax is based on the fair market value of property transferred at the owner’s death.

c. Tariffs are taxes levied on good and materials brought into a country.

d. Gift taxes are imposed on the recipient of the gift.

ANSWER: d

LO: 1.1

DIFFICULTY: Moderate

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

a. Excise tax

b. Income tax

c. Value added tax

d. Gift tax

ANSWER: c

LO: 1.1 & 1.2

DIFFICULTY: Easy

11. John earns $25,000 and pays $2,000 in taxes. Marcy earns $60,000 and pays $4,000 in taxes. How would you characterize this tax system?

a. A flat tax system

b. A proportional system

c. A regressive system

d. A progressive system

ANSWER: c

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

LO: 1.2

DIFFICULTY: Moderate

12. The Mercury Corporation must decide whether to invest in some new machinery for its business. Which tax rate is the most relevant for making this decision?

a. The average tax rate

b. The marginal tax rate

c. The nominal tax rate

d. The effective tax rate

ANSWER: b

LO: 1.2

DIFFICULTY: Moderate

13. Which of the following statements describes the correct relationship between marginal and average tax rates in a progressive tax system?

a. The marginal tax rate is higher than the average tax rate.

b. The average tax rate is higher than the marginal tax rate.

c. The marginal and average tax rates are the same.

d. The average tax rate will always be half of the marginal tax rate.

ANSWER: a

LO: 1.2

DIFFICULTY: Easy

14. Two married persons with moderately high incomes will pay more taxes than two single persons with the same income. This is commonly called:

a. vertical equity.

b. horizontal equity.

c. a marriage bonus.

d. a marriage penalty.

ANSWER: d

LO: 1.2

DIFFICULTY: Easy

15. Daniel is a single with taxable income of $40,000. What is his marginal tax rate?

a. 10%

b. 15%

c. 25%

d. 28%

ANSWER: c

Reference table(s) required for solution (Individual income tax tables).

LO: 1.2

DIFFICULTY: Easy

16. Charlotte is a head of household with taxable income of $40,000. What is her marginal tax rate?

a. 10%

b. 15%

c. 25%

d. 28%

ANSWER: b

Reference table(s) required for solution (Individual income tax tables).

LO: 1.2

DIFFICULTY: Easy

17. Ethan and Mia are married and file a joint tax return. Their taxable income is $200,000. What is their marginal tax rate?

a. 35%

b. 33%

c. 28%

d. 25%

ANSWER: c

Reference table(s) required for solution (Individual income tax tables).

LO: 1.2

DIFFICULTY: Easy

18. Abigail is married filing separately with taxable income of $200,000. What is her marginal tax rate?

a. 35%

b. 33%

c. 28%

d. 25%

ANSWER: b

Reference table(s) required for solution (Individual income tax tables).

LO: 1.2

DIFFICULTY: Easy

19. Kate received $130,000 in salary in 2015. What is her FICA tax if the Medicare rate is 1.45%, the Social Security rate is 6.2% on a maximum of $118,500 in 2015?

a. $7,347

b. $9,065

c. $9,232

d. $9,945

ANSWER: c

($130,000 x 1.45%) + ($118,500 x 6.2%) = $9,232

LO: 1.2

DIFFICULTY: Moderate

20. Alexander received $80,000 in salary in 2015. What is his FICA tax if the Medicare rate is 1.45%, the Social Security rate is 6.2% on the 2015 maximum of $118,500, and the FUTA rate is 6% on a $7,000 maximum?

a. $4,960

b. $6,120

c. $6,540

d. $10,920

ANSWER: b

$80,000 x (1.45% + 6.2%) = $6,120. FUTA is a separate tax.

LO: 1.2

DIFFICULTY: Hard

21. Ethan received $120,000 in salary in 2015. What is his FICA tax if the Medicare rate is 1.45%, the Social Security rate is 6.2% on the 2015 maximum of $118,500, and the FUTA rate is 6% on a $7,000 maximum?

a. $9,065

b. $9,087

c. $9,485

d. $9,507

ANSWER: b

($120,000 x 1.45%) + ($118,500 x 6.2%) = $9,087. FUTA is a separate tax.

LO: 1.2

DIFFICULTY: Hard

22. Which of the following are included in Adam Smith’s characteristics of a good tax?

a. Certainty

b. Economy

c. Convenience

d. All are included

e. None are included

ANSWER: d

LO: 1.3

DIFFICULTY: Easy

23. Which of the following best describes horizontal equity?

a. All taxpayers should pay some taxes on their incomes

b. As income increases, taxes should increase

c. Persons with equal incomes should pay the same amount of taxes

d. A person with capital gains should pay less tax than a person with the same amount of salary income

ANSWER: c

LO: 1.4

DIFFICULTY: Moderate

24. Which of the following best describes vertical equity?

a. All taxpayers should pay some taxes on their incomes

b. As income increases, taxes should increase

c. Persons with equal incomes should pay the same amount of taxes

d. A person with capital gains should pay less tax than a person with the same amount of salary income

ANSWER: b

LO: 1.4

DIFFICULTY: Moderate

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

a. The 13th Amendment to the Constitution

b. Public Law 1913

c. The 16th Amendment to the Constitution

d. An Act of Congress ratified by the states

ANSWER: c

LO: 1.4

DIFFICULTY: Easy

26. Current changes to the federal tax law are amendments to which of the following?

a. The Internal Revenue Code of 1913

b. The Internal Revenue Code of 1954

c. The Internal Revenue Code of 1986

d. The Internal Revenue Code of 2014

ANSWER: c

LO: 1.4

DIFFICULTY: Easy

27. Which of the following is an objective of taxation?

a. Raise revenue

b. Foster social goals

c. Stimulate the economy

d. All of the above

e. None of the above

ANSWER: d

LO: 1.4

DIFFICULTY: Easy

28. Which of these persons never pays taxes directly?

a. Individual

b. Partnership

c. C corporation

d. Fiduciary

ANSWER: b

LO: 1.5

DIFFICULTY: Easy

29. Which of the following nominal rates does not apply to a C corporation?

a. 10%

b. 15%

c. 25%

d. 35%

ANSWER: a

LO: 1.5

DIFFICULTY: Easy

30. Which of these entities is taxed directly on its income?

a. Limited Liability Company

b. C Corporation

c. Partnership

d. Sole Proprietorship

ANSWER: b

LO: 1.5

DIFFICULTY: Easy

31. What is an individual’s maximum annual deduction for capital losses?

a. $3,000

b. An amount equal to capital gains only

c. An amount equal to capital gains plus $3,000

d. Individuals cannot deduct capital losses

ANSWER: c

LO: 1.5

DIFFICULTY: Easy

32. What is a corporation’s annual deduction for capital losses?

a. $3,000

b. An amount equal to capital gains only

c. An amount equal to capital gains plus $3,000

d. Corporations cannot deduct capital losses

ANSWER: b

LO: 1.5

DIFFICULTY: Easy

33. Which of the following is never included in computing gross income?

a. Loss on stock sale

b. Social security benefits

c. Unemployment benefits

d. Gifts

ANSWER: d

LO: 1.5

DIFFICULTY: Easy

34. What is the gain or loss on the sale of an asset for $68,000 if the asset cost $185,000, depreciation expense deducted was $124,000, and there was a $19,000 major addition to the asset?

a. $0

b. $12,000 loss

c. $7,000 gain

d. $117,000 loss

ANSWER: b

[$6,000 – ($185,000 - $124,000 + $19,000)] = $12,000

LO: 1.5

DIFFICULTY: Moderate

35. Which of the following is normally not included in gross income?

a. Cash dividend

b. Corporate bond interest income

c. Stock dividend

d. All are included in gross income

e. None are included in gross income

ANSWER: c

LO: 1.5

DIFFICULTY: Moderate

36. What is George’s gross income if he has the following: Salary = $78,000; Dividends = $4,000; interest on city of San Francisco bonds = $2,000; a gain of $14,000 on a stock sale and a $4,000 loss on a small sole proprietorship that he owns.

a. $78,000

b. $84,000

c. $92,000

d. $96,000

ANSWER: c

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

LO: 1.5

DIFFICULTY: Moderate

37. Wilma and Barney are married and have 4 dependent children. What is the total amount of their personal and dependency exemptions for 2015?

a. $8,000

b. $16,000

c. $24,000

d. $36,400

ANSWER: c

[6 x $4,000 = $24,000]

LO: 1.5

DIFFICULTY: Easy

38. Sara is single and has no dependents. What is the total amount of her standard deduction and personal exemption for 2015?

a. 0

b. $4,000

c. $6,300

d. $10,300

ANSWER: d

($6,300 + $4,000 = $10,300)

LO: 1.5

DIFFICULTY: Easy

39. What is the marginal tax rate for a corporation with $110,000 of taxable income?

a. 15%

b. 25%

c. 34%

d. 39%

ANSWER: d

Reference table(s) required for solution (Corporate tax rate table).

LO 1.5

DIFFICULTY: Easy

40. What is the earliest year to which a corporation can carry a net operating loss realized in 2015?

a. 2014

b. 2013

c. 2012

d. 2011

ANSWER: b

LO: 1.5  
DIFFICULTY: Easy

41. Which of the following is not a tax credit allowed a corporation?

a. Foreign tax credit

b. Education credit

c. Investment tax credit

d. Alternative minimum tax credit

ANSWER: b

LO: 1.5

DIFFICULTY: Easy

42. How much income tax must the Benton Trust pay in 2015 if its taxable income (after all deductions) is $4,600?

a. $460

b. $690

c. $900

d. $1,240

ANSWER: c

[($2,500 x .15) + ($2,100 x .25)] = $900

Reference table(s) required for solution (trust income tax tables).

LO 1.5

DIFFICULTY: Easy

43. Hoku Corporation (a C corporation) had the following history of income and loss:

|  |  |
| --- | --- |
| Year | Income (Loss) |
| 2013 | $40,000 |
| 2014 | $70,000 |
| 2015 | ($10,000) |

How much of a tax refund can Hoku Corporation receive by carrying back its 2015 loss?

a. $1,500

b. $2,500

c. $3,500

d. None; it cannot carry its loss back

ANSWER: a

($10,000 x .15 marginal tax bracket for 2013 = $1,500)

LO 1.5

DIFFICULTY: Easy

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

a. $16,000

b. $20,000

c. $26,000

d. $30,000

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

LO: 1.5 & 6

DIFFICULTY: Moderate

45. Which of the following business entities does not file a separate tax return to report business operations?

a. Sole proprietorship

b. S corporation

c. C corporation

d. Partnership

ANSWER: a

LO: 1.6

DIFFICULTY: Easy

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

a. $20,000

b. $21,000

c. $23,000

d. $33,000

ANSWER: b

[$20,000 + (.2 x $15,000) – $2,000 = $21,000]

LO: 1.6

DIFFICULTY: Moderate

47. Which of the following business entities has no provision that limits some or all of the liability of the owner?

a. C Corporation

b. Sole Proprietorship

c. S Corporation

d. Limited Liability Company

ANSWER: b

LO: 1.6

DIFFICULTY: Easy

48. Terri owns a 50 percent interest in the TT Partnership. At the beginning of the year, her basis in her partnership interest was $75,000. The partnership reports a $40,000 loss for the year and distributes $4,000 cash to Terri. What is her basis in her partnership interest at the end of the year?

a. $111,000

b. $75,000

c. $51,000

d. $31,000

ANSWER: c

[$75,000 – (.5 x $40,000) - $4,000 = $51,000]

LO: 1.6

DIFFICULTY: Easy

49. Which of the following is not a characteristic of an S corporation?

a. Owners have limited liability

b. The corporation is taxed directly on operating income

c. The corporation can have no more than 100 shareholders

d. Shareholders must consent to the S election by the corporation

ANSWER: b

LO: 1.6

DIFFICULTY: Easy

50. In which of the following entities may an owner-employee benefit from all employee tax-free fringe benefits?

a. C Corporation

b. S Corporation

c. Partnership

d. Sole Proprietorship

ANSWER: a

LO: 1.6

DIFFICULTY: Easy

51. Which of the following is not a characteristic of both S corporations and partnerships?

a. Both are flow through entities

b. Owners increase basis for debt undertaken by S corporation or partnership

c. Both forms limit owner’s participation in tax-free fringe benefits

d. Owner’s increase basis for gains and decrease basis for losses

ANSWER: b

LO: 1.6

DIFFICULTY: Easy

52. Deazia is the sole proprietor of Baldwin Company that reported net income of $44,000 for the year. During the year she withdrew $20,000 from the business for personal use. How much income from the above must Deazia include in her taxable income for the year?

a. $20,000

b. $24,000

c. $44,000

d. $64,000

ANSWER: c

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

LO: 1.6

DIFFICULTY: Moderate

53. Jordan is the sole proprietor of Adams Company that reported net income of $57,000 for the year. During the year he withdrew $11,000 from the business for personal use. Jordan is in the 25% marginal tax bracket. How much income from the above must Jordan include in his taxable income for the year?

a. $68,000

b. $57,000

c. $14,250

d. $11,000

ANSWER: b

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

LO: 1.6

DIFFICULTY: Easy

54. Elena owns 25% of a partnership that reported net income of $100,000 for the year. During the year $5,000 was distributed to Elena from the partnership. How much should Elena include in her taxable income for the year?

a. $30,000

b. $25,000

c. $5,000

d. $0

ANSWER: b

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

LO: 1.6

DIFFICULTY: Moderate

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

a. $44,000

b. $29,000

c. $26,000

d. $44,000

ANSWER: c

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

LO: 1.6

DIFFICULTY: Moderate

56. Crystal invested $8,000 cash in CRK Partnership for a 30% general partnership interest. In its first year of operations, CRK lost $15,000. In its second year of operations, CRK lost an additional $14,000. How much of the second year’s losses can Crystal deduct in that year?

a. $700

b. $2,400

c. $3,500

d. $4,200

ANSWER: c

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

LO: 1.6

DIFFICULTY: Hard

57. Elena owns 40% of Martinez, Inc., a regular C corporation, that reported net income of $80,000 for the year. During the year $8,000 was distributed to Elena from the corporation. How much income from the corporation should Elena include in her taxable income for the year?

a. $40,000

b. $32,000

c. $8,000

d. $3,200

ANSWER: c

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

LO: 1.6

DIFFICULTY: Easy

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

a. $0

b. $4,000

c. $9,000

d. $10,000

ANSWER: a

Losses from C corporations do not flow through to shareholders.

LO: 1.6

DIFFICULTY: Moderate

59. Mason owns 45% of an S corporation that reported net income of $105,000 for the year. During the year, $20,000 was distributed to Mason from the corporation. How much should Mason include in his taxable income for the year?

a. $20,000

b. $47,250

c. $56,250

d. $67,250

ANSWER: b

$105,000 x 45% = $47,250.

LO: 1.6

DIFFICULTY: Easy

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

a. $40,000

b. $30,000

c. $20,000

d. $10,000

ANSWER: d

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

LO: 1.6

DIFFICULTY: Hard

61. Ian contributes $9,000 in exchange for a 30 percent interest in a C corporation. For 2014, the corporation reported a total loss of $35,000 and made no cash distributions. For 2015, the corporation reported net income of $45,000 and made a cash distribution to the shareholders. Ian received $5,000 of this cash distribution in 2015. Ian is in the 28% marginal tax bracket in both 2014 and 2015. How much income tax did Ian save for 2014 as a result of his share of loss from this corporation and how much income tax does Ian pay as a result of his ownership in the corporation for 2015?

a. zero tax savings in 2014 and $750 tax in 2015

b. zero tax savings in 2014 and $3,360 tax in 2015

c. $2,520 tax savings in 2014 and $3,360 tax in 2015

d. $2,520 tax savings in 2014 and $2,550 tax in 2015

e. $2,940 tax savings in 2014 and $3,780 tax in 2015

ANSWER: a

$750 in 2015 ($5,000 x 15%). A C corporation is not a flow-through entity. Ian is only taxed on the $5,000 dividends he received in 2015 using the 15% dividend rate.

LO: 1.6

DIFFICULTY: Hard

**Note to Instructor: The information provided for problems 62 – 73 is identical.**

Jerry and Matt decide to form a business. Jerry will contribute $4,200 for a 35% interest and Matt will contribute $7,800 for a 65% interest. The business will take out a $25,000 loan to cover the balance of their working capital needs. They expect that the business will have a loss of $38,000 for the first year. In the second year, the business will have a profit of $52,000 and it will distribute $5,200 to Matt and $2,800 to Jerry. Jerry is in the 33% marginal tax bracket and Matt is in the 28% marginal tax bracket. Their marginal tax brackets will not change as a result of profit or loss from this business.

62. What is Jerry’s income tax savings (rounded to the nearest dollar) for the first year if they organize the business as a partnership?

a. $0

b. $1,386

c. $4,274

d. $4,389

e. $4,655

ANSWER: c

Jerry’s share of the loss would be $13,300 ($38,000 x 35%) but the amount he can deduct in the first year is limited to his $12,950 basis [$4,200 invested + ($25,000 loan x 35%)]. The excess $350 loss is carried forward. His tax savings is $4,273.50 ($12,950 x 33%).

LO: 1.6

DIFFICULTY: Moderate

63. Jerry and Matt decide to form a business. Jerry will contribute $4,200 for a 35% interest and Matt will contribute $7,800 for a 65% interest. The business will take out a $25,000 loan to cover the balance of their working capital needs. They expect that the business will have a loss of $38,000 for the first year. In the second year, the business will have a profit of $52,000 and it will distribute $5,200 to Matt and $2,800 to Jerry. Jerry is in the 33% marginal tax bracket and Matt is in the 28% marginal tax bracket. Their marginal tax brackets will not change as a result of profit or loss from this business.

What is Matt’s income tax savings (rounded to the nearest dollar) for the first year if they organize the business as a partnership?

a. $0

b. $2,184

c. $6,734

d. $6,916

e. $24,050

ANSWER: c

Matt’s share of the loss would be $24,700 ($38,000 x 65%) but the amount he can deduct in the first year is limited to his $24,050 basis [$7,800 invested + ($25,000 loan x 65%)]. The excess $650 loss is carried forward. His tax savings is $6,734 ($24,050 x 28%).

LO: 1.6

DIFFICULTY: Moderate

64. Jerry and Matt decide to form a business. Jerry will contribute $4,200 for a 35% interest and Matt will contribute $7,800 for a 65% interest. The business will take out a $25,000 loan to cover the balance of their working capital needs. They expect that the business will have a loss of $38,000 for the first year. In the second year, the business will have a profit of $52,000 and it will distribute $5,200 to Matt and $2,800 to Jerry. Jerry is in the 33% marginal tax bracket and Matt is in the 28% marginal tax bracket. Their marginal tax brackets will not change as a result of profit or loss from this business. What is Jerry’s income tax savings (rounded to the nearest dollar) for the first year if they organize the business as an S corporation?

a. $0

b. $1,386

c. $4,274

d. $4,389

e. $4,655

ANSWER: b

Jerry’s share of the loss would be $13,300 ($38,000 x 35%) but the amount he can deduct in the first year is limited to his $4,200 basis ($4,200 invested). The excess $9,100 loss is carried forward. His tax savings is $1,386 ($4,200 x 33%).

LO: 1.6

DIFFICULTY: Moderate

65. Jerry and Matt decide to form a business. Jerry will contribute $4,200 for a 35% interest and Matt will contribute $7,800 for a 65% interest. The business will take out a $25,000 loan to cover the balance of their working capital needs. They expect that the business will have a loss of $38,000 for the first year. In the second year, the business will have a profit of $52,000 and it will distribute $5,200 to Matt and $2,800 to Jerry. Jerry is in the 33% marginal tax bracket and Matt is in the 28% marginal tax bracket. Their marginal tax brackets will not change as a result of profit or loss from this business. What is Matt’s income tax savings (rounded to the nearest dollar) for the first year if they organize the business as an S corporation?

a. $6,916

b. $5,320

c. $4,634

d. $2,184

e. $0

ANSWER: d

Matt’s share of the loss would be $24,700 ($38,000 x 65%) but the amount he can deduct in the first year is limited to his $7,800 basis ($7,800 invested). The excess $16,900 loss is carried forward. His tax savings is $2,184 ($7,800 x 28%).

LO: 1.6

DIFFICULTY: Moderate

66. Jerry and Matt decide to form a business. Jerry will contribute $4,200 for a 35% interest and Matt will contribute $7,800 for a 65% interest. The business will take out a $25,000 loan to cover the balance of their working capital needs. They expect that the business will have a loss of $38,000 for the first year. In the second year, the business will have a profit of $52,000 and it will distribute $5,200 to Matt and $2,800 to Jerry. Jerry is in the 33% marginal tax bracket and Matt is in the 28% marginal tax bracket. Their marginal tax brackets will not change as a result of profit or loss from this business. How much tax will Jerry pay in the second year (rounded to the nearest dollar) due to this business if they organize the business as a partnership?

a. $6,930

b. $6,006

c. $5,891

d. $3,927

e. $3,003

ANSWER: c

Jerry’s share of the profit would be $18,200 ($52,000 x 35%) but is reduced by his $350 loss ($13,300 share of first-year loss - $12,950 deductible first-year loss) that is carried forward to the second year. His tax is $5,891 [($18,200 - $350) x 33%].

LO: 1.6

DIFFICULTY: Moderate

67. Jerry and Matt decide to form a business. Jerry will contribute $4,200 for a 35% interest and Matt will contribute $7,800 for a 65% interest. The business will take out a $25,000 loan to cover the balance of their working capital needs. They expect that the business will have a loss of $38,000 for the first year. In the second year, the business will have a profit of $52,000 and it will distribute $5,200 to Matt and $2,800 to Jerry. Jerry is in the 33% marginal tax bracket and Matt is in the 28% marginal tax bracket. Their marginal tax brackets will not change as a result of profit or loss from this business. How much tax will Matt pay in the second year (rounded to the nearest dollar) due to this business if they organize the business as a partnership?

a. $10,920

b. $9,464

c. $9,282

d. $8,814

e. $4,732

ANSWER: c

Matt’s share of the profit would be $33,800 ($52,000 x 65%) but is reduced by his $650 loss ($24,700 share of first-year loss - $24,050 deductible first-year loss) that is carried forward to the second year. His tax is $9,282 [($33,800 - $650) x 28%].

LO: 1.6

DIFFICULTY: Moderate

68. What is Jerry’s basis at the end of the second year if they organize the business as a partnership?

a. $0

b. $6,300

c. $27,950

d. $15,050

e. $15,400

ANSWER: d

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

LO: 1.6

DIFFICULTY: Hard

69. Jerry and Matt decide to form a business. Jerry will contribute $4,200 for a 35% interest and Matt will contribute $7,800 for a 65% interest. The business will take out a $25,000 loan to cover the balance of their working capital needs. They expect that the business will have a loss of $38,000 for the first year. In the second year, the business will have a profit of $52,000 and it will distribute $5,200 to Matt and $2,800 to Jerry. Jerry is in the 33% marginal tax bracket and Matt is in the 28% marginal tax bracket. Their marginal tax brackets will not change as a result of profit or loss from this business. What is Matt’s basis at the end of the second year if they organize the business as a partnership?

a. $0

b. $11,700

c. $27,950

d. $28,600

e. $33,800

ANSWER: c

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

LO: 1.6

DIFFICULTY: Hard

70. Jerry and Matt decide to form a business. Jerry will contribute $4,200 for a 35% interest and Matt will contribute $7,800 for a 65% interest. The business will take out a $25,000 loan to cover the balance of their working capital needs. They expect that the business will have a loss of $38,000 for the first year. In the second year, the business will have a profit of $52,000 and it will distribute $5,200 to Matt and $2,800 to Jerry. Jerry is in the 33% marginal tax bracket and Matt is in the 28% marginal tax bracket. Their marginal tax brackets will not change as a result of profit or loss from this business. How much tax will Jerry pay in the second year (rounded to the nearest dollar) due to this business if they organize the business as an S corporation?

a. $6,930

b. $6,006

c. $3,927

d. $3,003

e. $0

ANSWER: d

Jerry’s share of the profit would be $18,200 ($52,000 x 35%) but is reduced by his $9,100 loss ($13,300 share of first-year loss - $4,200 deductible first-year loss) that is carried forward to the second year. $3,003 [($18,200 - $9,100) x 33%]. The distribution reduces basis but is not taxed.

LO: 1.6

DIFFICULTY: Moderate

71. Jerry and Matt decide to form a business. Jerry will contribute $4,200 for a 35% interest and Matt will contribute $7,800 for a 65% interest. The business will take out a $25,000 loan to cover the balance of their working capital needs. They expect that the business will have a loss of $38,000 for the first year. In the second year, the business will have a profit of $52,000 and it will distribute $5,200 to Matt and $2,800 to Jerry. Jerry is in the 33% marginal tax bracket and Matt is in the 28% marginal tax bracket. Their marginal tax brackets will not change as a result of profit or loss from this business. How much tax will Matt pay in the second year (rounded to the nearest dollar) due to this business if they organize the business as an S corporation?

a. $10,920

b. $9,464

c. $4,732

d. $3,276

e. $1,456

ANSWER: c

Matt’s share of the profit would be $33,800 ($52,000 x 65%) but is reduced by his $16,900 loss ($24,700 share of first-year loss - $7,800 deductible first-year loss) that is carried forward to the second year. $4,732 [($33,800 - $16,900) x 28%]. The distribution reduces basis but is not taxed.

LO: 1.6

DIFFICULTY: Hard

72. Jerry and Matt decide to form a business. Jerry will contribute $4,200 for a 35% interest and Matt will contribute $7,800 for a 65% interest. The business will take out a $25,000 loan to cover the balance of their working capital needs. They expect that the business will have a loss of $38,000 for the first year. In the second year, the business will have a profit of $52,000 and it will distribute $5,200 to Matt and $2,800 to Jerry. Jerry is in the 33% marginal tax bracket and Matt is in the 28% marginal tax bracket. Their marginal tax brackets will not change as a result of profit or loss from this business. What is Jerry’s stock basis at the end of the second year if they organize the business as an S corporation?

a. $0

b. $6,300

c. $27,950

d. $15,050

e. $15,400

ANSWER: b

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

LO: 1.6

DIFFICULTY: Hard

73. Jerry and Matt decide to form a business. Jerry will contribute $4,200 for a 35% interest and Matt will contribute $7,800 for a 65% interest. The business will take out a $25,000 loan to cover the balance of their working capital needs. They expect that the business will have a loss of $38,000 for the first year. In the second year, the business will have a profit of $52,000 and it will distribute $5,200 to Matt and $2,800 to Jerry. Jerry is in the 33% marginal tax bracket and Matt is in the 28% marginal tax bracket. Their marginal tax brackets will not change as a result of profit or loss from this business. What is Matt’s stock basis at the end of the second year if they organize the business as an S corporation?

a. $0

b. $11,700

c. $28,600

d. $33,800

e. $44,850

ANSWER: b

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

LO: 1.6

DIFFICULTY: Hard