

Chapter 1 - Introduction To Taxation

Student: _____

1. The FICA tax (Medicare component) on wages is *progressive* since the tax due increases as wages increase.

True False

2. The Federal estate and gift taxes are examples of *progressive* taxes.

True False

3. The Federal excise tax on cigarettes is an example of a *proportional* tax.

True False

4. Currently, the Federal income tax is less *progressive* than it ever has been in the past.

True False

5. A Federal excise tax is no longer imposed on admission to theaters.

True False

6. There is a Federal excise tax on hotel occupancy.

True False

7. The Federal gas-guzzler tax applies only to automobiles manufactured overseas and imported into the U.S.

True False

8. Like the Federal counterpart, the amount of the state excise taxes on gasoline varies from state to state.

True False

9. Not all of the states that impose a general sales tax also have a use tax.

True False

10. Sales made by mail order are not exempt from the application of a general sales (or use) tax.

True False

11. Two persons who live in the same state but in different counties may not be subject to the same general sales tax rate.

True False

12. States impose either a state income tax *or* a general sales tax, but not both types of taxes.

True False

13. A safe and easy way for a taxpayer to avoid local and state sales taxes is to make the purchase in a state that levies no such taxes.

True False

14. The principal objective of the FUTA tax is to provide some measure of retirement security.

True False

15. Currently, the tax base for the Social Security component of the FICA is *not* limited to a dollar amount.

True False

16. A parent employs his twin daughters, age 17, in his sole proprietorship. The daughters are *not* subject to FICA coverage.

True False

17. Unlike FICA, FUTA requires that employers comply with state as well as Federal rules.

True False

18. On transfers by death, the Federal government relies on an estate tax, while states impose an estate tax, an inheritance tax, both taxes, or neither tax.

True False

19. An inheritance tax is a tax on a decedent's right to pass property at death.

True False

20. One of the major reasons for the enactment of the Federal estate tax was to prevent large amounts of wealth from being accumulated within the family unit.

True False

21. Under Clint's will, all of his property passes to either the Lutheran Church or to his wife. No Federal estate tax will be due on Clint's death in 2013.

True False

22. Under the usual state inheritance tax, two heirs, a cousin and a son of the deceased, would not be taxed at the same rate.

True False

23. The annual exclusion, currently \$14,000, is available for gift and estate tax purposes.

True False

24. In 2012, José, a widower, sells land (fair market value of \$100,000) to his daughter, Linda, for \$50,000. José has made a taxable gift of \$50,000.

True False

25. Julius, a married taxpayer, makes gifts to each of his six children. A maximum of twelve annual exclusions could be allowed as to these gifts.

True False

26. One of the motivations for making a gift is to save on income taxes.

True False

27. Mona inherits her mother's personal residence, which she converts to a furnished rent house. These changes should affect the amount of *ad valorem* property taxes levied on the properties.

True False

28. A *fixture* will be subject to the *ad valorem* tax on *personalty* rather than the *ad valorem* tax on *realty*.

True False

29. Even if property tax rates are not changed, the amount of *ad valorem* taxes imposed on realty may not remain the same.

True False

30. The *ad valorem* tax on personal use personalty is more often avoided by taxpayers than the *ad valorem* tax on business use personalty.

True False

31. The formula for the Federal income tax on corporations is the same as that applicable to individuals.

True False

32. Tomas owns a sole proprietorship, and Lucy is the sole shareholder of a C corporation. In the current year both businesses make a net profit of \$60,000. Neither business distributes any funds to the owners in the year. For the current year, Tomas must report \$60,000 of income on his individual tax return, but Lucy is not required to report any income from the corporation on her individual tax return.

True False

33. Carol and Candace are equal partners in Peach Partnership. In the current year, Peach had a net profit of \$75,000 (\$250,000 gross income – \$175,000 operating expenses) and distributed \$25,000 to each partner. Peach must pay tax on \$75,000 of income.

True False

34. Rajib is the sole shareholder of Robin Corporation, a calendar year S corporation. Robin earned net profit of \$350,000 (\$520,000 gross income – \$170,000 operating expenses) and distributed \$80,000 to Rajib. Rajib must report Robin Corporation profit of \$350,000 on his Federal income tax return.

True False

35. Donald owns a 45% interest in a partnership that earned \$130,000 in the current year. He also owns 45% of the stock in a C corporation that earned \$130,000 during the year. Donald received \$20,000 in distributions from each of the two entities during the year. With respect to this information, Donald must report \$78,500 of income on his individual income tax return for the year.

True False

36. Quail Corporation is a C corporation with net income of \$125,000 during the current year. If Quail paid dividends of \$25,000 to its shareholders, the corporation must pay tax on \$100,000 of net income. Shareholders must report the \$25,000 of dividends as income.

True False

37. Eagle Company, a partnership, had a short-term capital loss of \$10,000 during the year. Aaron, who owns 25% of Eagle, will report \$2,500 of Eagle's short-term capital loss on his individual tax return.

True False

38. Don, the sole shareholder of Pastel Corporation (a C corporation), has the corporation pay him a salary of \$600,000 in the current year. The Tax Court has held that \$200,000 represents unreasonable compensation. Don must report a salary of \$400,000 and a dividend of \$200,000 on his individual tax return.

True False

39. Double taxation of corporate income results because dividend distributions are included in a shareholder's gross income but are not deductible by the corporation.

True False

40. Jake, the sole shareholder of Peach Corporation, a C corporation, has the corporation pay him \$100,000. For tax purposes, Jake would prefer to have the payment treated as dividend instead of salary.

True False

41. When Congress enacts a tax cut that is phased in over a period of years, revenue neutrality is achieved.

True False

42. A tax cut enacted by Congress that contains a *sunset provision* will make the tax cut temporary.

True False

43. The tax law provides various tax credits, deductions, and exclusions that are designed to encourage taxpayers to obtain additional education. These provisions can be justified on both economic and equity grounds.

True False

44. Various tax provisions encourage the creation of certain types of retirement plans. Such provisions can be justified on both economic and social grounds.

True False

45. To lessen, or eliminate, the effect of multiple taxation, a taxpayer who is subject to both foreign and U.S. income taxes on the same income is allowed either a deduction or a credit for the foreign tax paid.

True False

46. To mitigate the effect of the annual accounting period concept, the tax law permits the carryforward to other years of the excess charitable contributions of a particular year.

True False

47. Jason's business warehouse is destroyed by fire. As the insurance proceeds exceed the basis of the property, a gain results. If Jason shortly reinvests the proceeds in a new warehouse, no gain is recognized due to the application of the wherewithal to pay concept.

True False

48. As it is consistent with the wherewithal to pay concept, the tax law requires a seller to recognize gain in the year the installment sale occurs.

True False

49. A provision in the law that compels accrual basis taxpayers to pay a tax on prepaid income in the year received and *not* when earned is consistent with generally accepted accounting principles.

True False

50. As a matter of administrative convenience, the IRS would prefer to have Congress decrease (rather than increase) the amount of the standard deduction allowed to individual taxpayers.

True False

51. Federal excise taxes that are *no longer imposed* include:

- A. Tax on air travel.
- B. Tax on wagering.
- C. Tax on the manufacture of sporting equipment.
- D. Tax on alcohol.
- E. None of the above.

52. Taxes *not imposed* by the Federal government include:

- A. Tobacco excise tax.
- B. Customs duties (tariffs on imports).
- C. Tax on rent cars.
- D. Gas guzzler tax.
- E. None of the above.

53. Taxes levied by *both* states and the Federal government include:

- A. General sales tax.
- B. Custom duties.
- C. Hotel occupancy tax.
- D. Franchise tax.
- E. None of the above.

54. Taxes levied by *all* states include:

- A. Tobacco excise tax.
- B. Individual income tax.
- C. Inheritance tax.
- D. General sales tax.
- E. None of the above.

55. A use tax is imposed by:

- A. The Federal government and all states.
- B. The Federal government and a majority of the states.
- C. All states and not the Federal government.
- D. Most of the states and not the Federal government.
- E. None of the above.

56. A characteristic of FICA is that:

- A. It does not apply when one spouse works for the other spouse.
- B. It is imposed only on the employer.
- C. It provides a modest source of income in the event of loss of employment.
- D. It is administered by both state and Federal governments.
- E. None of the above.

57. A characteristic of FUTA is that:

- A. It is imposed on both employer and employee.
- B. It is imposed solely on the employee.
- C. Compliance requires following guidelines issued by both state and Federal regulatory authorities.
- D. It is applicable to spouses of employees but *not* to any children under age 18.
- E. None of the above.

58. Burt and Lisa are married and live in a common law state. Burt wants to make gifts to their four children in 2013. What is the maximum amount of the annual exclusion they will be allowed for these gifts?

- A. \$14,000.
- B. \$28,000.
- C. \$56,000.
- D. \$112,000.
- E. None of the above.

59. Property can be transferred within the family group by gift or at death. One motivation for preferring the gift approach is:

- A. To take advantage of the higher unified transfer tax credit available under the gift tax.
- B. To avoid a future decline in value of the property transferred.
- C. To take advantage of the per donee annual exclusion.
- D. To shift income to higher bracket donees.
- E. None of the above.

60. Which, if any, of the following transactions will *increase* a taxing jurisdiction's revenue from the *ad valorem* tax imposed on real estate?

- A. A resident dies and leaves his farm to his church.
- B. A large property owner issues a conservation easement as to some of her land.
- C. A tax holiday issued 10 years ago has expired.
- D. A bankrupt motel is acquired by the Red Cross and is to be used to provide housing for homeless persons.
- E. None of the above.

61. Which, if any, of the following transactions will *decrease* a taxing jurisdiction's *ad valorem* tax revenue imposed on real estate?

- A. A tax holiday is granted to an out-of-state business that is searching for a new factory site.
- B. An abandoned church is converted to a restaurant.
- C. A public school is razed and turned into a city park.
- D. A local university sells a dormitory that will be converted for use as an apartment building.
- E. None of the above.

62. Which, if any, of the following is a typical characteristic of an *ad valorem* tax on personalty?
- A. Taxpayer compliance is greater for personal use property than for business use property.
 - B. The tax on automobiles sometimes considers the age of the vehicle.
 - C. Most states impose a tax on intangibles.
 - D. The tax on intangibles generates considerable revenue since it is difficult for taxpayers to avoid.
 - E. None of the above.

63. Indicate which, if any, statement is *incorrect*. State income taxes:
- A. Can piggyback to the Federal version.
 - B. Cannot apply to visiting nonresidents.
 - C. Can decouple from the Federal version.
 - D. Can provide occasional amnesty programs.
 - E. None of the above.

64. State income taxes *generally* can be characterized by:
- A. The same date for filing as the Federal income tax.
 - B. No provision for withholding procedures.
 - C. Allowance of a deduction for Federal income taxes paid.
 - D. Applying only to individuals and not applying to corporations.
 - E. None of the above.

65. Juanita owns 60% of the stock in a C corporation that had a profit of \$200,000 in 2013. Carlos owns a 60% interest in a partnership that had a profit of \$200,000 during the year. The corporation distributed \$45,000 to Juanita, and the partnership distributed \$45,000 to Carlos. Which of the following statements relating to 2013 is *incorrect*?
- A. Juanita must report \$120,000 of income from the corporation.
 - B. The corporation must pay corporate tax on \$200,000 of income.
 - C. Carlos must report \$120,000 of income from the partnership.
 - D. The partnership is not subject to a Federal entity-level income tax.
 - E. None of the above.

66. Bjorn owns a 60% interest in an S corporation that earned \$150,000 in 2013. He also owns 60% of the stock in a C corporation that earned \$150,000 during the year. The S corporation distributed \$30,000 to Bjorn and the C corporation paid dividends of \$30,000 to Bjorn. How much income must Bjorn report from these businesses?
- A. \$0 income from the S corporation and \$30,000 income from the C corporation.
 - B. \$30,000 income from the S corporation and \$30,000 of dividend income from the C corporation.
 - C. \$90,000 income from the S corporation and \$0 income from the C corporation.
 - D. \$90,000 income from the S corporation and \$30,000 income from the C corporation.
 - E. None of the above.

67. Rachel is the sole member of an LLC, and Jordan is the sole shareholder of a C corporation. Both businesses were started in the current year, and each business has a long-term capital gain of \$10,000 for the year. Neither business made any distributions during the year. With respect to this information, which of the following statements is correct?

- A. The C corporation receives a preferential tax rate on the LTTCG of \$10,000.
- B. The LLC must pay corporate tax on taxable income of \$10,000.
- C. Jordan must report \$10,000 of LTTCG on his tax return.
- D. Rachel must report \$10,000 of LTTCG on her tax return.
- E. None of the above.

68. Norma formed Hyacinth Enterprises, a proprietorship, in 2013. In its first year, Hyacinth had operating income of \$400,000 and operating expenses of \$240,000. In addition, Hyacinth had a long-term capital loss of \$10,000. Norma, the proprietor of Hyacinth Enterprises, withdrew \$75,000 from Hyacinth during the year. Assuming Norma has no other capital gains or losses, how does this information affect her taxable income for 2013?

- A. Increases Norma's taxable income by \$157,000 (\$160,000 ordinary business income – \$3,000 long-term capital loss).
- B. Increases Norma's taxable income by \$150,000 (\$160,000 ordinary business income – \$10,000 long-term capital loss).
- C. Increases Norma's taxable income by \$75,000.
- D. Increases Norma's taxable income by \$160,000.
- E. None of the above.

69. Pablo, a sole proprietor, sold stock held as an investment for a \$40,000 long-term capital gain. Pablo's marginal tax rate is 33%. Loon Corporation, a C corporation, sold stock held as an investment for a \$40,000 long-term capital gain. Loon's marginal tax rate is 35%. What tax rates are applicable to these capital gains?

- A. 15% rate applies to Pablo and 35% rate applies to Loon.
- B. 15% rate applies to Loon and 33% rate applies to Pablo.
- C. 35% rate applies to Loon and 33% rate applies to Pablo.
- D. 15% rate applies to both Pablo and Loon.
- E. None of the above.

70. Lucinda is a 60% shareholder in Rhea Corporation, a calendar year S corporation. During the year, Rhea Corporation had gross income of \$550,000 and operating expenses of \$380,000. In addition, the corporation sold land that had been held for investment purposes for a short-term capital gain of \$30,000. During the year, Rhea Corporation distributed \$50,000 to Lucinda. With respect to this information, which of the following statements is correct?

- A. Rhea Corporation will pay tax on taxable income of \$200,000.
- B. Lucinda reports ordinary income of \$50,000.
- C. Lucinda reports ordinary income of \$120,000.
- D. Lucinda reports ordinary income of \$102,000 and a short-term capital gain of \$18,000.
- E. None of the above.

71. Elk, a C corporation, has \$370,000 operating income and \$290,000 operating expenses during the year. In addition, Elk has a \$10,000 long-term capital gain and a \$17,000 short-term capital loss. Elk's taxable income is:

- A. \$63,000.
- B. \$73,000.
- C. \$80,000.
- D. \$90,000.
- E. None of the above.

72. Flycatcher Corporation, a C corporation, has two equal individual shareholders, Nancy and Pasqual. In the current year, Flycatcher earned \$100,000 net profit and paid a dividend of \$10,000 to each shareholder. Regardless of any tax consequences resulting from their interests in Flycatcher, Nancy is in the 33% marginal tax bracket and Pasqual is in the 15% marginal tax bracket. With respect to the current year, which of the following statements is *incorrect*?

- A. Flycatcher cannot avoid the corporate tax altogether by paying out all \$100,000 of net profit as dividends to the shareholders.
- B. Nancy incurs income tax of \$1,500 on her dividend income.
- C. Pasqual incurs income tax of \$1,500 on his dividend income.
- D. Flycatcher pays corporate tax of \$22,250.
- E. None of the above.

73. Which of the following statements is *incorrect* about LLCs and the check-the-box Regulations?

- A. If a limited liability company with more than one owner does not make an election, the entity is taxed as a corporation.
- B. All 50 states have passed laws that allow LLCs.
- C. An entity with more than one owner and formed as a corporation cannot elect to be taxed as a partnership.
- D. If a limited liability company with one owner does not make an election, the entity is taxed as a sole proprietorship.
- E. A limited liability company with one owner can elect to be taxed as a corporation.

74. Both economic and social considerations can be used to justify:

- A. Favorable tax treatment for accident and health plans provided for employees and financed by employers.
- B. Disallowance of any deduction for expenditures deemed to be contrary to public policy (e.g., fines, penalties, illegal kickbacks, bribes to government officials).
- C. Various tax credits, deductions, and exclusions that are designed to encourage taxpayers to obtain additional education.
- D. Allowance of a deduction for state and local income taxes paid.
- E. None of the above.

75. Social considerations can be used to justify:

- A. Allowance of a credit for child care expenses.
- B. Allowing excess capital losses to be carried over to other years.
- C. Allowing accelerated amortization for the cost of installing pollution control facilities.
- D. Allowing a Federal income tax deduction for state and local sales taxes.
- E. None of the above.

76. Allowing a domestic production activities deduction for certain manufacturing income can be justified:

- A. As mitigating the effect of the annual accounting period concept.
- B. As promoting administrative feasibility.
- C. By economic considerations.
- D. Based on the wherewithal to pay concept.
- E. None of the above.

77. Provisions in the tax law that promote energy conservation and more use of alternative (non-fossil) fuels can be justified by:

- A. Political considerations.
- B. Economic and social considerations.
- C. Promoting administrative feasibility.
- D. Encouragement of small business.
- E. None of the above.

78. Which, if any, of the following provisions *cannot* be justified as mitigating the effect of the annual accounting period concept?

- A. Nonrecognition of gain allowed for involuntary conversions.
- B. Net operating loss carryback and carryover provisions.
- C. Carry over of excess charitable contributions.
- D. Use of the installment method to recognize gain.
- E. Carry over of excess capital losses.

79. Which, if any, of the following provisions of the tax law *cannot* be justified as promoting administrative feasibility (simplifying the task of the IRS)?

- A. Penalties are imposed for failure to file a return or pay a tax on time.
- B. Prepaid income is taxed in the year received and not in the year earned.
- C. Annual adjustments for indexation increases the amount of the standard deduction allowed.
- D. Casualty losses must exceed 10% of AGI to be deductible.
- E. A deduction is allowed for charitable contributions.

80. Taylor, a widow, makes cash gifts to her five married children (including their spouses) and to her seven grandchildren. What is the maximum amount Taylor can give for calendar year 2013 without using her unified transfer tax credit?

81. Several years ago, Logan purchased extra grazing land for his ranch at a cost of \$240,000. In 2013, the land is condemned by the state for development as a highway maintenance depot. Under the condemnation award, Logan receives \$600,000 for the land. Within the same year, he replaces the property with other grazing land. What is Logan's tax situation if the replacement land cost:

- a. \$210,000?
- b. \$360,000?
- c. \$630,000?
- d. Why?

82. Paige is the sole shareholder of Citron Corporation. During the year, Paige leases a building to Citron for a monthly rental of \$80,000. If the fair rental value of the building is \$60,000, what are the income tax consequences to the parties involved?

83. In 1985, Roy leased real estate to Drab Corporation for 20 years. Drab Corporation made significant capital improvements to the property. In 2005, Roy decides not to renew the lease and vacates the property. At that time, the value of the improvements is \$800,000. Roy sells the real estate in 2013 for \$1,200,000 of which \$900,000 is attributable to the improvements. How and when is Roy taxed on the improvements made by Drab Corporation?

84. During the current year, Skylark Company had operating income of \$420,000 and operating expenses of \$250,000. In addition, Skylark had a long-term capital loss of \$20,000, and a charitable contribution of \$5,000. How does Toby, the sole owner of Skylark Company, report this information on his individual income tax return under following assumptions?

- a. Skylark is an LLC, and Toby does not withdraw any funds from the company during the year.
- b. Skylark is an S corporation, and Toby does not withdraw any funds from the company during the year.
- c. Skylark is a regular (C) corporation, and Toby does not withdraw any funds from the company during the year.

85. Amber Company has \$100,000 in net income in 2013 before deducting any compensation or other payment to its sole owner, Alfredo. Assume that Alfredo is in the 33% marginal tax bracket. Discuss the tax aspects of each of the following independent arrangements. (Assume that any salaries are reasonable in amount and ignore any employment tax considerations.)

- a. Alfredo operates Amber Company as a proprietorship.
- b. Alfredo incorporates Amber Company and pays himself a salary of \$100,000 and no dividend.
- c. Alfredo incorporates Amber Company and pays himself a \$50,000 salary and a dividend of \$42,500 (\$50,000 – \$7,500 corporate income tax).

86. During the current year, Maroon Company had \$125,000 net profit from operations. Belinda, the sole owner of Maroon, is in the 33% marginal tax bracket. Determine the combined tax burden for Maroon and Belinda under the following independent situations. (Ignore any employment taxes.)

- a. Maroon Company is a C corporation and all of its after-tax income is distributed to Belinda.
- b. Maroon Company is a proprietorship and all of its after-tax income is withdrawn by Belinda.
- c. Maroon Company is an S corporation and all of its after-tax income is distributed to Belinda.

87. Due to the population change, the Goose Creek School District has decided to close one of its high schools. Since it has no further need of the property, the school is listed for sale. The two bids it receives are as follows:

United Methodist Church	\$1,700,000
Planet Motors	1,600,000

The United Methodist Church would use the property to establish a sectarian middle school. Planet, a well-known car dealership, would revamp the property and operate it as a branch location.

If you were a member of the School District board, what factors would you consider in evaluating the two bids?

88. Morgan inherits her father's personal residence including all of the furnishings. She plans to add a swimming pool and sauna to the property and rent it as a furnished house. What are some of the *ad valorem* property tax problems Morgan can anticipate?

89. In 2011, Deborah became 65 years old. In 2012 she added a swimming pool, and in 2013 she converted the residence to rental property and moved into an assisted living facility. Since 2010, Deborah's *ad valorem* property taxes have decreased once and increased twice. Explain.

90. A lack of compliance in the payment of use taxes can be resolved by several means. In this regard, comment on the following:

- a. Registration of automobiles.
- b. Reporting of Internet purchases on state income tax returns.

91. State and local governments are sometimes forced to find ways to generate additional revenue. Comment on the pros and cons of the following procedures:

- a. Decouple what would be part of the piggyback format of the state income tax.
- b. Tax amnesty provisions.
- c. Internet shaming.

92. In terms of revenue neutrality, comment on a tax cut enacted by Congress that:

- a. contains revenue offsets.
- b. includes a sunset provision.

93. The tax law contains various tax credits, deductions, and exclusions that are designed to encourage taxpayers to obtain additional education. On what grounds can these provisions be justified?

94. The tax law contains various provisions that encourage home ownership.

- a. On what basis can this objective be justified?
- b. Are there any negative considerations? Explain.

95. The tax law allows an income tax deduction (or a credit) for foreign income taxes. Explain why.

96. The tax law allows, under certain conditions, deferral of gain recognition for involuntary conversions.

- a. What is the justification for this relief measure?
- b. What happens if the proceeds are not entirely reinvested?

97. Compare the basic tax and nontax factors of doing business as a partnership, an S corporation, and a C corporation. Circle the correct answers.

	Column A	Column B	Column C
Tax Questions	Partnership	S Corporation	C Corporation
Who pays tax on the entity's income?	Partners	Shareholders	Shareholders
Are operating losses passed through to owners?	Partnership	S corporation	C Corporation
	Yes	Yes	Yes
	No	No	No
Are capital gains (losses) reported on owners' tax returns as such?	Yes	Yes	Yes
	No	No	No
Are distributions of profits taxable to owners?	Yes	Yes	Yes
	No	No	No
Nontax Factors	Partnership	S Corporation	C Corporation
Is the liability of owners limited?	Yes	Yes	Yes
	No	No	No
Is there free transferability of ownership interests?	Yes	Yes	Yes
	No	No	No

98. A taxpayer is considering the formation of a business that would derive some amounts of tax-exempt interest, qualified dividends, and capital gains. Explain how these income categories would be reported and taxed under the various types of entity forms discussed in the chapter. Consider the tax implications both to the entities and to their owners.

99. Adrian is the president and sole shareholder of Pigeon Corporation. He also lends money and rents a building to the corporation. Discuss how these business relationships between Adrian and Pigeon Corporation can help avoid double taxation. What limitations are there on the use of such relationships?

100. Nancy is a 40% shareholder and president of Robin Corporation, a regular corporation. The board of directors of Robin has decided to pay Nancy a \$75,000 bonus for the year based on her outstanding performance. The directors want to pay the \$75,000 as salary, but Nancy would prefer to have it paid as a dividend. If Robin Corporation is in the 34% marginal tax bracket and Nancy is in the 33% marginal tax bracket irrespective of the treatment of the bonus, discuss which form of payment would be most beneficial for each party. (Ignore any employment tax considerations.)

101. Dawn is the sole shareholder of Thrush Corporation, a C corporation. In the current year, Thrush earned \$350,000 and distributed \$75,000 to Dawn. Kirk is the sole shareholder of Swallow Corporation, an S corporation. In the current year, Swallow earned \$350,000 and distributed \$75,000 to Kirk. Contrast the tax treatment of Thrush Corporation and Dawn with the tax treatment of Swallow Corporation and Kirk.

102. What is a limited liability company? What favorable nontax and tax attributes does the LLC entity form offer taxpayers?

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22. Under the usual state inheritance tax, two heirs, a cousin and a son of the deceased, would not be taxed at the same rate.

TRUE

23. The annual exclusion, currently \$14,000, is available for gift and estate tax purposes.

FALSE

24. In 2012, José, a widower, sells land (fair market value of \$100,000) to his daughter, Linda, for \$50,000. José has made a taxable gift of \$50,000.

FALSE

25. Julius, a married taxpayer, makes gifts to each of his six children. A maximum of twelve annual exclusions could be allowed as to these gifts.

TRUE

26. One of the motivations for making a gift is to save on income taxes.

TRUE

27. Mona inherits her mother's personal residence, which she converts to a furnished rent house. These changes should affect the amount of *ad valorem* property taxes levied on the properties.

TRUE

28. A *fixture* will be subject to the *ad valorem* tax on *personalty* rather than the *ad valorem* tax on *realty*.

FALSE

29. Even if property tax rates are not changed, the amount of *ad valorem* taxes imposed on realty may not remain the same.

TRUE

30. The *ad valorem* tax on personal use personalty is more often avoided by taxpayers than the *ad valorem* tax on business use personalty.

TRUE

31. The formula for the Federal income tax on corporations is the same as that applicable to individuals.

FALSE

32. Tomas owns a sole proprietorship, and Lucy is the sole shareholder of a C corporation. In the current year both businesses make a net profit of \$60,000. Neither business distributes any funds to the owners in the year. For the current year, Tomas must report \$60,000 of income on his individual tax return, but Lucy is not required to report any income from the corporation on her individual tax return.

TRUE

33. Carol and Candace are equal partners in Peach Partnership. In the current year, Peach had a net profit of \$75,000 (\$250,000 gross income – \$175,000 operating expenses) and distributed \$25,000 to each partner. Peach must pay tax on \$75,000 of income.

FALSE

34. Rajib is the sole shareholder of Robin Corporation, a calendar year S corporation. Robin earned net profit of \$350,000 (\$520,000 gross income – \$170,000 operating expenses) and distributed \$80,000 to Rajib. Rajib must report Robin Corporation profit of \$350,000 on his Federal income tax return.

TRUE

35. Donald owns a 45% interest in a partnership that earned \$130,000 in the current year. He also owns 45% of the stock in a C corporation that earned \$130,000 during the year. Donald received \$20,000 in distributions from each of the two entities during the year. With respect to this information, Donald must report \$78,500 of income on his individual income tax return for the year.

TRUE

36. Quail Corporation is a C corporation with net income of \$125,000 during the current year. If Quail paid dividends of \$25,000 to its shareholders, the corporation must pay tax on \$100,000 of net income. Shareholders must report the \$25,000 of dividends as income.

FALSE

37. Eagle Company, a partnership, had a short-term capital loss of \$10,000 during the year. Aaron, who owns 25% of Eagle, will report \$2,500 of Eagle's short-term capital loss on his individual tax return.

TRUE

38. Don, the sole shareholder of Pastel Corporation (a C corporation), has the corporation pay him a salary of \$600,000 in the current year. The Tax Court has held that \$200,000 represents unreasonable compensation. Don must report a salary of \$400,000 and a dividend of \$200,000 on his individual tax return.

TRUE

39. Double taxation of corporate income results because dividend distributions are included in a shareholder's gross income but are not deductible by the corporation.

TRUE

40. Jake, the sole shareholder of Peach Corporation, a C corporation, has the corporation pay him \$100,000. For tax purposes, Jake would prefer to have the payment treated as dividend instead of salary.

TRUE

41. When Congress enacts a tax cut that is phased in over a period of years, revenue neutrality is achieved.

FALSE

42. A tax cut enacted by Congress that contains a *sunset provision* will make the tax cut temporary.

TRUE

43. The tax law provides various tax credits, deductions, and exclusions that are designed to encourage taxpayers to obtain additional education. These provisions can be justified on both economic and equity grounds.

FALSE

44. Various tax provisions encourage the creation of certain types of retirement plans. Such provisions can be justified on both economic and social grounds.

TRUE

45. To lessen, or eliminate, the effect of multiple taxation, a taxpayer who is subject to both foreign and U.S. income taxes on the same income is allowed either a deduction or a credit for the foreign tax paid.

TRUE

46. To mitigate the effect of the annual accounting period concept, the tax law permits the carryforward to other years of the excess charitable contributions of a particular year.

TRUE

47. Jason's business warehouse is destroyed by fire. As the insurance proceeds exceed the basis of the property, a gain results. If Jason shortly reinvests the proceeds in a new warehouse, no gain is recognized due to the application of the wherewithal to pay concept.

TRUE

48. As it is consistent with the wherewithal to pay concept, the tax law requires a seller to recognize gain in the year the installment sale occurs.

FALSE

49. A provision in the law that compels accrual basis taxpayers to pay a tax on prepaid income in the year received and *not* when earned is consistent with generally accepted accounting principles.

FALSE

50. As a matter of administrative convenience, the IRS would prefer to have Congress decrease (rather than increase) the amount of the standard deduction allowed to individual taxpayers.

FALSE

51. Federal excise taxes that are *no longer imposed* include:

- A. Tax on air travel.
- B. Tax on wagering.
- C. Tax on the manufacture of sporting equipment.
- D. Tax on alcohol.
- E.** None of the above.

52. Taxes *not imposed* by the Federal government include:

- A. Tobacco excise tax.
- B. Customs duties (tariffs on imports).
- C.** Tax on rent cars.
- D. Gas guzzler tax.
- E. None of the above.

53. Taxes levied by *both* states and the Federal government include:

- A. General sales tax.
- B. Custom duties.
- C. Hotel occupancy tax.
- D. Franchise tax.
- E.** None of the above.

54. Taxes levied by *all* states include:

- A.** Tobacco excise tax.
- B. Individual income tax.
- C. Inheritance tax.
- D. General sales tax.
- E. None of the above.

55. A use tax is imposed by:

- A. The Federal government and all states.
- B. The Federal government and a majority of the states.
- C. All states and not the Federal government.
- D.** Most of the states and not the Federal government.
- E. None of the above.

56. A characteristic of FICA is that:

- A. It does not apply when one spouse works for the other spouse.
- B. It is imposed only on the employer.
- C. It provides a modest source of income in the event of loss of employment.
- D. It is administered by both state and Federal governments.
- E.** None of the above.

57. A characteristic of FUTA is that:

- A. It is imposed on both employer and employee.
- B. It is imposed solely on the employee.
- C.** Compliance requires following guidelines issued by both state and Federal regulatory authorities.
- D. It is applicable to spouses of employees but *not* to any children under age 18.
- E. None of the above.

58. Burt and Lisa are married and live in a common law state. Burt wants to make gifts to their four children in 2013. What is the maximum amount of the annual exclusion they will be allowed for these gifts?

- A. \$14,000.
- B. \$28,000.
- C. \$56,000.
- D.** \$112,000.
- E. None of the above.

59. Property can be transferred within the family group by gift or at death. One motivation for preferring the gift approach is:

- A. To take advantage of the higher unified transfer tax credit available under the gift tax.
- B. To avoid a future decline in value of the property transferred.
- C.** To take advantage of the per donee annual exclusion.
- D. To shift income to higher bracket donees.
- E. None of the above.

60. Which, if any, of the following transactions will *increase* a taxing jurisdiction's revenue from the *ad valorem* tax imposed on real estate?

- A. A resident dies and leaves his farm to his church.
- B. A large property owner issues a conservation easement as to some of her land.
- C.** A tax holiday issued 10 years ago has expired.
- D. A bankrupt motel is acquired by the Red Cross and is to be used to provide housing for homeless persons.
- E. None of the above.

61. Which, if any, of the following transactions will *decrease* a taxing jurisdiction's *ad valorem* tax revenue imposed on real estate?

- A.** A tax holiday is granted to an out-of-state business that is searching for a new factory site.
- B. An abandoned church is converted to a restaurant.
- C. A public school is razed and turned into a city park.
- D. A local university sells a dormitory that will be converted for use as an apartment building.
- E. None of the above.

62. Which, if any, of the following is a typical characteristic of an *ad valorem* tax on personalty?
- A. Taxpayer compliance is greater for personal use property than for business use property.
 - B.** The tax on automobiles sometimes considers the age of the vehicle.
 - C. Most states impose a tax on intangibles.
 - D. The tax on intangibles generates considerable revenue since it is difficult for taxpayers to avoid.
 - E. None of the above.

63. Indicate which, if any, statement is *incorrect*. State income taxes:
- A. Can piggyback to the Federal version.
 - B.** Cannot apply to visiting nonresidents.
 - C. Can decouple from the Federal version.
 - D. Can provide occasional amnesty programs.
 - E. None of the above.

64. State income taxes *generally* can be characterized by:
- A.** The same date for filing as the Federal income tax.
 - B. No provision for withholding procedures.
 - C. Allowance of a deduction for Federal income taxes paid.
 - D. Applying only to individuals and not applying to corporations.
 - E. None of the above.

65. Juanita owns 60% of the stock in a C corporation that had a profit of \$200,000 in 2013. Carlos owns a 60% interest in a partnership that had a profit of \$200,000 during the year. The corporation distributed \$45,000 to Juanita, and the partnership distributed \$45,000 to Carlos. Which of the following statements relating to 2013 is *incorrect*?
- A.** Juanita must report \$120,000 of income from the corporation.
 - B. The corporation must pay corporate tax on \$200,000 of income.
 - C. Carlos must report \$120,000 of income from the partnership.
 - D. The partnership is not subject to a Federal entity-level income tax.
 - E. None of the above.

66. Bjorn owns a 60% interest in an S corporation that earned \$150,000 in 2013. He also owns 60% of the stock in a C corporation that earned \$150,000 during the year. The S corporation distributed \$30,000 to Bjorn and the C corporation paid dividends of \$30,000 to Bjorn. How much income must Bjorn report from these businesses?
- A. \$0 income from the S corporation and \$30,000 income from the C corporation.
 - B. \$30,000 income from the S corporation and \$30,000 of dividend income from the C corporation.
 - C. \$90,000 income from the S corporation and \$0 income from the C corporation.
 - D.** \$90,000 income from the S corporation and \$30,000 income from the C corporation.
 - E. None of the above.

67. Rachel is the sole member of an LLC, and Jordan is the sole shareholder of a C corporation. Both businesses were started in the current year, and each business has a long-term capital gain of \$10,000 for the year. Neither business made any distributions during the year. With respect to this information, which of the following statements is correct?

- A. The C corporation receives a preferential tax rate on the LTTCG of \$10,000.
- B. The LLC must pay corporate tax on taxable income of \$10,000.
- C. Jordan must report \$10,000 of LTTCG on his tax return.
- D.** Rachel must report \$10,000 of LTTCG on her tax return.
- E. None of the above.

68. Norma formed Hyacinth Enterprises, a proprietorship, in 2013. In its first year, Hyacinth had operating income of \$400,000 and operating expenses of \$240,000. In addition, Hyacinth had a long-term capital loss of \$10,000. Norma, the proprietor of Hyacinth Enterprises, withdrew \$75,000 from Hyacinth during the year. Assuming Norma has no other capital gains or losses, how does this information affect her taxable income for 2013?

- A.** Increases Norma's taxable income by \$157,000 (\$160,000 ordinary business income – \$3,000 long-term capital loss).
- B. Increases Norma's taxable income by \$150,000 (\$160,000 ordinary business income – \$10,000 long-term capital loss).
- C. Increases Norma's taxable income by \$75,000.
- D. Increases Norma's taxable income by \$160,000.
- E. None of the above.

69. Pablo, a sole proprietor, sold stock held as an investment for a \$40,000 long-term capital gain. Pablo's marginal tax rate is 33%. Loon Corporation, a C corporation, sold stock held as an investment for a \$40,000 long-term capital gain. Loon's marginal tax rate is 35%. What tax rates are applicable to these capital gains?

- A.** 15% rate applies to Pablo and 35% rate applies to Loon.
- B. 15% rate applies to Loon and 33% rate applies to Pablo.
- C. 35% rate applies to Loon and 33% rate applies to Pablo.
- D. 15% rate applies to both Pablo and Loon.
- E. None of the above.

70. Lucinda is a 60% shareholder in Rhea Corporation, a calendar year S corporation. During the year, Rhea Corporation had gross income of \$550,000 and operating expenses of \$380,000. In addition, the corporation sold land that had been held for investment purposes for a short-term capital gain of \$30,000. During the year, Rhea Corporation distributed \$50,000 to Lucinda. With respect to this information, which of the following statements is correct?

- A. Rhea Corporation will pay tax on taxable income of \$200,000.
- B. Lucinda reports ordinary income of \$50,000.
- C. Lucinda reports ordinary income of \$120,000.
- D.** Lucinda reports ordinary income of \$102,000 and a short-term capital gain of \$18,000.
- E. None of the above.

71. Elk, a C corporation, has \$370,000 operating income and \$290,000 operating expenses during the year. In addition, Elk has a \$10,000 long-term capital gain and a \$17,000 short-term capital loss. Elk's taxable income is:

- A. \$63,000.
- B. \$73,000.
- C. \$80,000.**
- D. \$90,000.
- E. None of the above.

72. Flycatcher Corporation, a C corporation, has two equal individual shareholders, Nancy and Pasqual. In the current year, Flycatcher earned \$100,000 net profit and paid a dividend of \$10,000 to each shareholder. Regardless of any tax consequences resulting from their interests in Flycatcher, Nancy is in the 33% marginal tax bracket and Pasqual is in the 15% marginal tax bracket. With respect to the current year, which of the following statements is *incorrect*?

- A. Flycatcher cannot avoid the corporate tax altogether by paying out all \$100,000 of net profit as dividends to the shareholders.
- B. Nancy incurs income tax of \$1,500 on her dividend income.
- C. Pasqual incurs income tax of \$1,500 on his dividend income.**
- D. Flycatcher pays corporate tax of \$22,250.
- E. None of the above.

73. Which of the following statements is *incorrect* about LLCs and the check-the-box Regulations?

- A. If a limited liability company with more than one owner does not make an election, the entity is taxed as a corporation.**
- B. All 50 states have passed laws that allow LLCs.
- C. An entity with more than one owner and formed as a corporation cannot elect to be taxed as a partnership.
- D. If a limited liability company with one owner does not make an election, the entity is taxed as a sole proprietorship.
- E. A limited liability company with one owner can elect to be taxed as a corporation.

74. Both economic and social considerations can be used to justify:

- A. Favorable tax treatment for accident and health plans provided for employees and financed by employers.
- B. Disallowance of any deduction for expenditures deemed to be contrary to public policy (e.g., fines, penalties, illegal kickbacks, bribes to government officials).
- C. Various tax credits, deductions, and exclusions that are designed to encourage taxpayers to obtain additional education.**
- D. Allowance of a deduction for state and local income taxes paid.
- E. None of the above.

75. Social considerations can be used to justify:

- A.** Allowance of a credit for child care expenses.
- B. Allowing excess capital losses to be carried over to other years.
- C. Allowing accelerated amortization for the cost of installing pollution control facilities.
- D. Allowing a Federal income tax deduction for state and local sales taxes.
- E. None of the above.

76. Allowing a domestic production activities deduction for certain manufacturing income can be justified:

- A. As mitigating the effect of the annual accounting period concept.
- B. As promoting administrative feasibility.
- C.** By economic considerations.
- D. Based on the wherewithal to pay concept.
- E. None of the above.

77. Provisions in the tax law that promote energy conservation and more use of alternative (non-fossil) fuels can be justified by:

- A. Political considerations.
- B.** Economic and social considerations.
- C. Promoting administrative feasibility.
- D. Encouragement of small business.
- E. None of the above.

78. Which, if any, of the following provisions *cannot* be justified as mitigating the effect of the annual accounting period concept?

- A.** Nonrecognition of gain allowed for involuntary conversions.
- B. Net operating loss carryback and carryover provisions.
- C. Carry over of excess charitable contributions.
- D. Use of the installment method to recognize gain.
- E. Carry over of excess capital losses.

79. Which, if any, of the following provisions of the tax law *cannot* be justified as promoting administrative feasibility (simplifying the task of the IRS)?

- A. Penalties are imposed for failure to file a return or pay a tax on time.
- B. Prepaid income is taxed in the year received and not in the year earned.
- C. Annual adjustments for indexation increases the amount of the standard deduction allowed.
- D. Casualty losses must exceed 10% of AGI to be deductible.
- E.** A deduction is allowed for charitable contributions.

80. Taylor, a widow, makes cash gifts to her five married children (including their spouses) and to her seven grandchildren. What is the maximum amount Taylor can give for calendar year 2013 without using her unified transfer tax credit?

\$221,000. \$14,000 (annual exclusion) × 17 donees = \$238,000.

81. Several years ago, Logan purchased extra grazing land for his ranch at a cost of \$240,000. In 2013, the land is condemned by the state for development as a highway maintenance depot. Under the condemnation award, Logan receives \$600,000 for the land. Within the same year, he replaces the property with other grazing land. What is Logan's tax situation if the replacement land cost:

- a. \$210,000?
- b. \$360,000?
- c. \$630,000?
- d. Why?

- a. The full realized gain of \$360,000 [\$600,000 (condemnation proceeds) – \$240,000 (cost of land)] must be recognized, as only \$210,000 was reinvested. The condemnation proceeds of \$600,000 exceed the amount reinvested by more than \$360,000.
- b. As only \$360,000 was reinvested in replacement property, \$240,000 (\$600,000 – \$360,000) of the gain must be recognized.
- c. As the full \$600,000 was reinvested, no realized gain need be recognized.
- d. If some of the gain is not reinvested, consistent with the wherewithal to pay concept there exists the ability to pay the tax.

82. Paige is the sole shareholder of Citron Corporation. During the year, Paige leases a building to Citron for a monthly rental of \$80,000. If the fair rental value of the building is \$60,000, what are the income tax consequences to the parties involved?

The rent charged by Paige is not "arms length"; as such, Citron Corporation's rent deduction is \$60,000 (not \$80,000). The \$20,000 difference is a nondeductible dividend distribution. For Paige, the change merely requires reclassification. Instead of \$80,000 of rent income, she has \$60,000 of rent income and \$20,000 of dividend income.

83. In 1985, Roy leased real estate to Drab Corporation for 20 years. Drab Corporation made significant capital improvements to the property. In 2005, Roy decides not to renew the lease and vacates the property. At that time, the value of the improvements is \$800,000. Roy sells the real estate in 2013 for \$1,200,000 of which \$900,000 is attributable to the improvements. How and when is Roy taxed on the improvements made by Drab Corporation?

Roy is not subject to taxation on the improvements until he disposes of the property (i.e., 2013). After a controversial Supreme Court decision years ago, Congress clarified the tax law to make it more consistent with the wherewithal to pay concept.

84. During the current year, Skylark Company had operating income of \$420,000 and operating expenses of \$250,000. In addition, Skylark had a long-term capital loss of \$20,000, and a charitable contribution of \$5,000. How does Toby, the sole owner of Skylark Company, report this information on his individual income tax return under following assumptions?

- a. Skylark is an LLC, and Toby does not withdraw any funds from the company during the year.
 - b. Skylark is an S corporation, and Toby does not withdraw any funds from the company during the year.
 - c. Skylark is a regular (C) corporation, and Toby does not withdraw any funds from the company during the year.
-
- a. A single-member LLC is taxed as a proprietorship. Consequently, Toby reports the \$170,000 operating profit, \$20,000 long-term capital loss, and \$5,000 charitable contribution on his individual return (Form 1040). The capital loss limitation applies to the LTCL.
 - b. Income, deductions, gains, and losses of an S corporation flow through to the shareholders. Separately stated items (e.g., LTCL and charitable contribution) retain their character at the shareholder level. Consequently, Toby reports the \$170,000 operating profit, \$20,000 long-term capital loss, and \$5,000 charitable contribution on his individual return (Form 1040). The capital loss limitation applies to the LTCL.
 - c. Shareholders of a regular (C) corporation report income from the corporation to the extent of dividends received. Therefore, Toby does not report any of Skylark's operating profit, long-term capital loss, or charitable contribution on his individual return. [Skylark Company would report taxable income of \$165,000 (\$170,000 operating profit – \$5,000 charitable contribution) on its corporate return (Form 1120). The net capital loss of \$20,000 is not deductible in the current year; rather, the loss is carried back three years and forward five years (as STCL).]

85. Amber Company has \$100,000 in net income in 2013 before deducting any compensation or other payment to its sole owner, Alfredo. Assume that Alfredo is in the 33% marginal tax bracket. Discuss the tax aspects of each of the following independent arrangements. (Assume that any salaries are reasonable in amount and ignore any employment tax considerations.)

- a. Alfredo operates Amber Company as a proprietorship.
- b. Alfredo incorporates Amber Company and pays himself a salary of \$100,000 and no dividend.
- c. Alfredo incorporates Amber Company and pays himself a \$50,000 salary and a dividend of \$42,500 (\$50,000 – \$7,500 corporate income tax).

- a. Alfredo's tax on \$100,000 at 33% \$33,000

b.	Amber's tax on \$100,000 at corporate rates	<u>\$22,250</u>
c.	Amber's tax on \$50,000 at corporate rates	\$ 7,500
	Alfredo's tax on \$42,500 dividend distributed at 15%	6,375
	Alfredo's tax on \$50,000 salary at 33%	<u>16,500</u>
	Total tax	<u>\$30,375</u>

86. During the current year, Maroon Company had \$125,000 net profit from operations. Belinda, the sole owner of Maroon, is in the 33% marginal tax bracket. Determine the combined tax burden for Maroon and Belinda under the following independent situations. (Ignore any employment taxes.)

- Maroon Company is a C corporation and all of its after-tax income is distributed to Belinda.
- Maroon Company is a proprietorship and all of its after-tax income is withdrawn by Belinda.
- Maroon Company is an S corporation and all of its after-tax income is distributed to Belinda.

- If Maroon Company is a C corporation, the \$125,000 is taxable at the corporate level (Form 1120), resulting in corporate tax of \$32,000 $[(\$50,000 \times 15\%) + (\$25,000 \times 25\%) + (\$25,000 \times 34\%) + (\$25,000 \times 39\%)]$. The after-tax dividend distribution of \$93,000 ($\$125,000 - \$32,000$) to Belinda results in tax of \$13,950 ($\$93,000 \times 15\%$). Total taxes amount to \$45,950 ($\$32,000 + \$13,950$).
- If Maroon Company is a proprietorship, there is no entity level Federal income tax. Instead, the income of the proprietorship is reported on Belinda's tax return (Form 1040), resulting in tax of \$41,250 ($\$125,000 \times 33\%$). Belinda's withdrawal of the after-tax income has no income tax consequences.
- Income, deductions, gains, and losses of an S corporation flow through to the shareholders. Consequently, Belinda reports the \$125,000 net profit on her individual return (Form 1040), resulting in tax of \$41,250 ($\$125,000 \times 33\%$). Distributions from S corporations are nontaxable to the shareholder (to the extent of stock basis).

87. Due to the population change, the Goose Creek School District has decided to close one of its high schools. Since it has no further need of the property, the school is listed for sale. The two bids it receives are as follows:

United Methodist Church	\$1,700,000
Planet Motors	1,600,000

The United Methodist Church would use the property to establish a sectarian middle school. Planet, a well-known car dealership, would revamp the property and operate it as a branch location.

If you were a member of the School District board, what factors would you consider in evaluating the two bids?

Although the bid from the United Methodist Church is higher, several other factors need to be considered. Does, for example, Goose Creek School district exempt property owned by churches from its *ad valorem* taxes? If so, losing this property from the tax base could prove very costly over the long run. Also, it is probable that income-producing property (such as a car dealership) would be taxed at a higher rate than that owned by a nonprofit organization (a school operated by a church). This assumes, of course, that the school would be taxed at all. The auto dealership also would generate sales tax.

88. Morgan inherits her father's personal residence including all of the furnishings. She plans to add a swimming pool and sauna to the property and rent it as a furnished house. What are some of the *ad valorem* property tax problems Morgan can anticipate?

The real estate taxes probably will increase for several reasons. The capital improvements and the conversion from residential to rental will trigger the increase. Furthermore, the furnishings may generate an *ad valorem* tax on personalty. (Depending on applicable law, furniture might not be subject to tax unless used for business purposes—such as in this case.)

89. In 2011, Deborah became 65 years old. In 2012 she added a swimming pool, and in 2013 she converted the residence to rental property and moved into an assisted living facility. Since 2010, Deborah's *ad valorem* property taxes have decreased once and increased twice. Explain.

The decrease probably came in 2011 when Deborah reached age 65. The increases probably occurred in 2012 when she added the pool and in 2013 when the residence was converted to rental property.

90. A lack of compliance in the payment of use taxes can be resolved by several means. In this regard, comment on the following:

- a. Registration of automobiles.
- b. Reporting of Internet purchases on state income tax returns.

- a. As reflected in Example 5 in the text, re-registration of a car purchased out-of-state is the occasion for the owner's home state to collect the use tax.
- b. Completing the state income tax return reminds (or forces) the taxpayer to pay use tax on out-of-state-purchases.

91. State and local governments are sometimes forced to find ways to generate additional revenue. Comment on the pros and cons of the following procedures:

- a. Decouple what would be part of the piggyback format of the state income tax.
- b. Tax amnesty provisions.
- c. Internet shaming.

- a. The decoupling process is easily accomplished as to new Federal tax changes that have never taken effect at the state level. Taxpayers are not apt to miss what they never have enjoyed.
- b. Tax amnesty provisions generate considerable revenue. It also unmasks many taxpayers who have not previously paid taxes. Now that the taxing jurisdiction is aware of their existence, they will tend to pay taxes in the future.
- c. By use of a public Web site, the taxing authority posts the names of those taxpayers that are delinquent as to various taxes (e.g., sales, income). This public humiliation (or threat of) very often results in compliance.

92. In terms of revenue neutrality, comment on a tax cut enacted by Congress that:

- a. contains revenue offsets.
- b. includes a sunset provision.

- a. Ideally, to achieve revenue neutrality all tax cuts should be accompanied by revenue offsets.
- b. A sunset provision does not account for the immediate revenue losses generated by a tax cut. It merely provides that such losses will not continue beyond a specified date when the tax cut expires and the former tax law is reinstated.

93. The tax law contains various tax credits, deductions, and exclusions that are designed to encourage taxpayers to obtain additional education. On what grounds can these provisions be justified?

Social and economic considerations. As to the latter, a better educated workforce carries a positive economic impact.

94. The tax law contains various provisions that encourage home ownership.

- a. On what basis can this objective be justified?
- b. Are there any negative considerations? Explain.

- a. Home ownership can be justified on economic and social grounds.
- b. Granting tax advantages to persons who are purchasing their homes places the taxpayers who rent at a disadvantage. The result is inequality in treatment.

95. The tax law allows an income tax deduction (or a credit) for foreign income taxes. Explain why.

The deduction (or a credit) for foreign income taxes can be justified on the grounds that it mitigates the double tax imposed on the same income.

96. The tax law allows, under certain conditions, deferral of gain recognition for involuntary conversions.

- a. What is the justification for this relief measure?
- b. What happens if the proceeds are not entirely reinvested?

- a. By recognizing that the taxpayer's relative economic situation has not changed and that he or she lacks the wherewithal to pay a tax, any recognition of realized gain is deferred.
- b. If the proceeds from an involuntary conversion are not fully reinvested in property that is similar or related in service or use, recognized gain results. Such recognized gain cannot exceed realized gain and will be limited to the amount of the proceeds not reinvested. Recognition is based on the notion that the taxpayer now has the wherewithal to pay the tax that results.

97. Compare the basic tax and nontax factors of doing business as a partnership, an S corporation, and a C corporation. Circle the correct answers.

	Column A	Column B	Column C
Tax Questions	Partnership	S Corporation	C Corporation
Who pays tax on the entity's income?	Partners Partnership	Shareholders S corporation	Shareholders C Corporation
Are operating losses passed through to owners?	Yes No	Yes No	Yes No
Are capital gains (losses) reported on owners' tax returns as such?	Yes No	Yes No	Yes No
Are distributions of profits taxable to owners?	Yes No	Yes No	Yes No
Nontax Factors	Partnership	S Corporation	C Corporation
Is the liability of owners limited?	Yes No	Yes No	Yes No
Is there free transferability of ownership interests?	Yes No	Yes No	Yes No

The correct answers are shaded.

Tax Questions	Column A Partnership	Column B S Corporation	Column C C Corporation
Who pays tax on the entity's income?	Partners	Shareholders	Shareholders
Are operating losses passed through to owners?	Partnership	S corporation	C Corporation
	Yes	Yes	Yes
	No	No	No
Are capital gains (losses) reported on owners' tax returns as such?	Yes	Yes	Yes
	No	No	No
Are distributions of profits taxable to owners?	Yes	Yes	Yes
	No	No	No
Nontax Factors	Partnership	S Corporation	C Corporation
Is the liability of owners limited?	Yes	Yes	Yes
	No	No	No
Is there free transferability of ownership interests?	Yes	Yes	Yes
	No	No	No

98. A taxpayer is considering the formation of a business that would derive some amounts of tax-exempt interest, qualified dividends, and capital gains. Explain how these income categories would be reported and taxed under the various types of entity forms discussed in the chapter. Consider the tax implications both to the entities and to their owners.

For certain business entity forms, the entity is not subject to a Federal income tax. This is the case with the sole proprietorship, partnership, and (generally) S corporation entity forms. The owners of these three entity forms would benefit from any preferential tax treatment associated with tax-exempt income (i.e., exclusion), qualified dividends (i.e., 20%/15%/0% tax rate), and capital gains (i.e., offset against capital losses and, in the case of LTCG, 20%/15%/0% tax rate). For a sole proprietorship, tax-exempt interest, qualified dividends, and capital gains would all retain their character and be reported as such on the proprietor's tax return (Form 1040, Schedule C). In the case of a partnership (including an LLC treated as a partnership) or S corporation, tax-exempt interest, qualified dividends, and capital gains would be separately reported items on the entity return and retain their character when reported (Schedule K-1) and taxed to the partner or shareholder. The partner or shareholder would include the tax-exempt interest, qualified dividends, and capital gains on the partner's or shareholder's tax return.

In the case of a regular (C) corporation, tax-exempt interest, qualified dividends, and capital gains would be reported as such on the corporate tax return (Form 1120). A corporation would exclude tax-exempt interest from gross income and offset capital gains against capital losses, but corporate taxpayers do not receive any preferential tax rate with respect to qualified dividends or LTCG. Further, the tax attributes of income do not pass through the corporation to the shareholders. Instead, corporate distributions to shareholders generally are taxed as dividend income.

99. Adrian is the president and sole shareholder of Pigeon Corporation. He also lends money and rents a building to the corporation. Discuss how these business relationships between Adrian and Pigeon Corporation can help avoid double taxation. What limitations are there on the use of such relationships?

As president of Pigeon Corporation, Adrian can have the corporation pay him a salary. As a creditor, he can have the corporation pay him interest on the loans. As a landlord, he can have the corporation pay him rent. All of these expenses can be deducted by the corporation. In order to avoid disallowance of any of these deductions at the corporate level, the payments to Adrian must be reasonable in amount. Payments deemed to be unreasonable in amount will be treated as corporate dividends to Adrian and nondeductible by Pigeon. However, to the extent the payments are reasonable in amount and deductible by Pigeon Corporation, the corporate tax is avoided on such amounts. The payments received by Adrian would be income (i.e., salary, interest, and rent) to him and taxed as such, but this would be the only tax incurred on such amounts (i.e., double taxation is avoided to the extent of any payments deductible by Pigeon).

100. Nancy is a 40% shareholder and president of Robin Corporation, a regular corporation. The board of directors of Robin has decided to pay Nancy a \$75,000 bonus for the year based on her outstanding performance. The directors want to pay the \$75,000 as salary, but Nancy would prefer to have it paid as a dividend. If Robin Corporation is in the 34% marginal tax bracket and Nancy is in the 33% marginal tax bracket irrespective of the treatment of the bonus, discuss which form of payment would be most beneficial for each party. (Ignore any employment tax considerations.)

Robin Corporation prefers treating the payment as salary, as a \$75,000 deduction for such would provide the corporation with a tax savings of \$25,500 [$\$75,000 \text{ (salary deduction)} \times 34\% \text{ (marginal tax rate)}$]. If, instead, the payment were treated as a dividend, none of the \$75,000 would be deductible by Robin.

Nancy prefers treating the payment as a dividend, as a preferential tax rate of 15% would apply to the \$75,000 and result in only \$11,250 of tax. If, instead, the payment were treated as salary, Nancy would incur tax of \$24,750 [$\$75,000 \text{ (salary)} \times 33\% \text{ (marginal tax rate)}$]. Thus, Nancy would save \$13,500 of tax if the payment were treated as a dividend instead of salary.

101. Dawn is the sole shareholder of Thrush Corporation, a C corporation. In the current year, Thrush earned \$350,000 and distributed \$75,000 to Dawn. Kirk is the sole shareholder of Swallow Corporation, an S corporation. In the current year, Swallow earned \$350,000 and distributed \$75,000 to Kirk. Contrast the tax treatment of Thrush Corporation and Dawn with the tax treatment of Swallow Corporation and Kirk.

A C corporation is a separate taxable entity; thus, Thrush Corporation is taxed on the \$350,000 of earnings. Income of a C corporation has no effect on the shareholders until such time a dividend is paid. When dividends are paid, shareholders must report dividend income on their tax returns. Thus, Dawn is taxed on \$75,000 of dividends and the 20%/15%/0% preferential tax rate applies with respect to the dividends.

Generally, an S is not subject to an entity level Federal income tax. Instead, the corporation's income, gains, deductions, and losses are passed through to and reported by the shareholders on their tax returns. Thus, Swallow reports the \$350,000 of earnings on its tax return (Form 1120S), but pays no income tax. Kirk is taxed on the \$350,000 of earnings from Swallow on his individual income tax return (Form 1040). Distributions from S corporations are not taxable to the shareholder (to the extent of stock basis). Thus, Kirk is not taxed on the \$75,000 distribution from Swallow.

102. What is a limited liability company? What favorable nontax and tax attributes does the LLC entity form offer taxpayers?

Similar to the corporate entity form, a limited liability company is an entity created under the laws of a specific state (or the District of the Columbia) and, pursuant to such laws, an LLC has the corporate feature of limited liability. This is the primary nontax characteristic that makes LLC status attractive. Other nontax attributes that are available with the LLC entity form include centralized management, continuity of life, and free transferability of ownership interests. Which of these nontax attributes are allowed will be dependent on the laws of the state of LLC organization. The principal tax advantage of the LLC entity form is the ability to avoid double taxation of the entity's profits. Most LLCs will be taxed as either partnerships (two or more owner LLCs) or sole proprietorships (one owner LLCs), although the check-the-box Regulations do provide the opportunity to have an LLC taxed as a corporation.