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QUESTION 1

Freeman, a single individual, reported the following income in the current year:

Guaranteed payment from services rendered to a partnership $50,000 Ordinary income from a S corporation $20,000

What amount of Freeman\\'s income is subject to self-employment tax?

A. $0

B. $20,000

C. $50,000

D. $70,000

Correct Answer: C

Choice "c" is correct. Guaranteed payments are reasonable compensation paid to a partner for services rendered (or use of capital) without regard to his ratio of income. Earned compensation is subject to selfemployment tax. Payments not guaranteed are merely another way to distribute partnership profits. The ordinary income reported from an S corporation are taxable income to the individual or their own individual tax return but is not subject to self-employment tax. The ordinary income reported from a partnership may be subject to self-employment tax (if to a general partner).

QUESTION 2

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

A. Sale of equipment.

B. Real property subdivided and sold by a dealer.

C. Sale of inventory.

D. Government bonds sold by an individual investor.

Correct Answer: D

Choice "d" is correct. Government bonds held by an individual investor are considered capital assets in the hands of the investor. When these types of security investments are sold, the resulting gain or loss is reported as capital. Choice "a" is incorrect. In this case, we must assume that the BEST answer is option "d" (as that option would ALWAYS result in capital gain or loss treatment) and that the examiners are assuming that the equipment is depreciable equipment that has been used in a business for over one year. [If the equipment had been considered a personal asset by the examiners and had sold for a gain, it would also be a capital asset that sold for a capital gain, and there would be two correct answers. Remember that the correct answer is the option that best answers the question.] Depreciable equipment used in a business and held for over one year falls under the category of Section 1245 property. When Section 1245 assets are sold at a gain, all the accumulated depreciation on the asset is recaptured as ordinary income (the same category as the depreciation expense was deducted against), and any remaining gain (typically, in practice, this is not the case, though, as the asset would have had to sell for an amount greater than its purchase price) is capital gain under Code Section 1231. [Note that Section 1245 applies only to gains. If the asset had sold for a loss, the loss would have been ordinary under Section 1231.] Choice "b" is incorrect. Real property sold by a dealer is considered inventory and results in ordinary income or ordinary losses upon sale. Inventory is not a capital asset and is not afforded the capital gain benefits. Choice "c" is incorrect. Inventory is not a capital asset and is not afforded the capital gain benefits. The sale of inventory results in ordinary income or loss (e.g., gross profit on sales) being reported on the tax return, as inventory is an asset held for sale in the ordinary course of business.

QUESTION 3

Elm Corp. is an accrual-basis calendar-year C corporation with 100,000 shares of voting common stock issued and outstanding as of December 28, 1996. On Friday, December 29, 1996, Hall surrendered 2,000 shares of Elm stock to Elm in exchange for $33,000 cash. Hall had no direct or indirect interest in Elm after the stock surrender. Additional information follows:

Hall's adjusted basis in 2,000 shares of Elm on December 29, 1996 ($8 per share)	16,000
Elm's accumulated earnings and profits at January 1, 1996	25,000
Elm's 1996 net operating loss.	(7,000)

What amount of income did Hall recognize from the stock surrender?

A. $33,000 dividend.

B. $25,000 dividend.

C. $18,000 capital gain.

D. $17,000 capital gain.

Correct Answer: D

Choice "d" is correct. $17,000 capital gain. Amount realized:

Sale price of 2,000 shares of Elm shares	$33,000
Adjusted basis of stock (2,000 shares @ $8)	(16,000)
Gain realized	$17,000

Choices "a" and "b" are incorrect. Dividends are distributions of earnings. These proceeds are from the

sale of stock.

Choice "c" is incorrect, per above. Accumulated earnings and profits do not effect the gain calculation, they

only affect the taxability of dividends paid to shareholders.

QUESTION 4

In the current year Jensen had the following items:

Salary	$50,000
Inheritance	25,000
Alimony from ex-spouse	12,000
Child support from ex-spouse	9,000
Capital loss on investment stock sale	(6,000)

What is Jensen\\'s AGI for the current year?

A. $44,000

B. $59,000

C. $62,000

D. $84,000

Correct Answer: B

Choice "b" is correct. The question asks for AGI, but all of the items in the list are items of potential gross income. There are no adjustments included in the list; therefore, in this case, AGI is the same as gross income. The calculation is as follows:

Salary	$50,000
Inheritance	0 [not taxable]
Alimony from ex-spouse	12,000
Child support from ex-spouse	0 [not taxable]
Capital loss on investment stock sale	(3,000) [maximum deductible]
AGI	$59,000

Choices "a", "c", and "d" are incorrect, per the above calculation.

QUESTION 5

Doris and Lydia are equal partners in the capital and profits of Agee and Nolan, but are otherwise unrelated. The following information pertains to 300 shares of Mast Corp. stock sold by Lydia to Agee and Nolan:

Year of purchase	1980
Year of sale	1988
Basis (cost)	$9,000
Sales price (equal to fair market value)	$4,000

The amount of long-term capital loss that Lydia realized in 1988 on the sale of this stock was:

A. $5,000

B. $3,000

C. $2,500

D. $0

Correct Answer: A

Choice "a" is correct. $5,000 long term capital loss "realized" in 1988 by Lydia. Be careful, and always check the question being asked. In this case, the question is how much of a capital loss Lydia realized in 1988.

Sales price (FMV)	$4,000
Basis (cost)	(9,000)
Loss realized	(5,000)

Choice "b" is incorrect. $3,000 represents the portion of the $5,000 realized loss that would currently be recognized unless there were additional capital transactions resulting in gains. Remember that the deduction for capital losses for an individual is limited to $3,000 each year. Choice "c" is incorrect. $2,500 represents the pre-1986 portion of the $5,000 realized loss that would have given rise to a recognized loss. Pre-1986 law required $2 of net long term loss to give the benefit of $1 of tax deduction. Current law gives a dollar-for-dollar deduction limited to $3,000 in any year. Choice "d" is incorrect. $0 would have been the amount of loss recognized if Lydia owned more than a 50% interest in the partnership. Losses realized on transactions between a partnership and a partner owning more than a 50% interest are not deductible as the parties would be considered related and any realized loss would be disallowed.