

AICPA Released Questions from the
2022 Uniform CPA Exam
- Released April 2022 -

REGULATION



2022 AICPA Released Questions for REG

The Key gives the correct letter answer for each question.

Key: A

The numbering system indicates the AICPA Blueprint Representative Task and Skill Level for each question.

REG.CSO.20190701: REG.001.003.001

REG.SSO.20190701: Application:2

MULTIPLE CHOICE - MODERATE

A client claims to have driven 50,000 miles for business purposes during the preceding year and wishes to deduct all of the mileage. The CPA suspects that the client is overstating the amount of mileage actually driven for business purposes. According to Treasury Department Circular 230, the CPA should do which of the following?

- A. Deduct only the amount of mileage for business purposes that the CPA believes is reasonable.
- B. Make reasonable inquiries about the information supplied.
- C. Prepare the tax return without asking any questions.
- D. Put a note in the client's file indicating that the client made an oral declaration about mileage driven for business purposes.

Item ID: 68241

Key: B

REG.CSO.20210701: REG.001.001.001

REG.SSO.20210701: Remembering and Understanding:1

Treasury Circular 230 (Cir 230) allows that a CPA **may**, in good faith, **rely on information provided by a taxpayer** when preparing the client's tax return. The CPA has a duty to make reasonable inquiries about information that appears wrong or incomplete. Filing a return using incomplete information without making appropriate inquiries violates this duty.

Reliance is satisfied when the preparer believes the taxpayer's information is correct and properly documented (eg, the client assured the preparer that the miles driven were all for business purposes).

(Choices A, C, and D): Circular 230 does not require the preparer to deduct a reasonable amount, prepare the return without asking any questions, or simply add a note to the client's file.

Things to Remember:

Treasury Circular 230 (Cir 230) allows that a CPA **may**, in good faith, **rely on information provided by a taxpayer** when preparing the client's tax return. The CPA has a duty to make reasonable inquiries about information that appears wrong or incomplete.

The only entity that can censure a CPA or revoke a license to practice as a CPA is

- A. The National Association of State Boards of Accountancy.
- B. The state board of accountancy for the state in which the CPA practices.
- C. The Securities and Exchange Commission.
- D. The American Institute of Certified Public Accountants.

Item ID: 69941

Key: B

REG.CSO.20210701: REG.001.002.000

REG.SSO.20210701: Remembering and Understanding:1

Each state has a state board of accountancy that issues CPA licenses to engage in the practice of public accounting. In addition, each state has its own ethical conduct requirements and disciplinary rules for those licensed CPAs. However, most states base their code of professional conduct on the AICPA code of conduct, with additions and enhancements particular to that state.

Although a state's code of professional conduct may be based on the AICPA's code, **each state's board of accountancy** enforces that state's professional conduct code. This enforcement includes the **authority to** suspend or **revoke a CPA's license** for acts discreditable to the profession.

(Choices A, C, and D): The National Association of State Boards of Accountancy, Securities and Exchange Commission, and the American Institute of Certified Public Accountants do not censure CPAs or revoke licenses.

Things to Remember:

Each state's board of accountancy enforces that state's professional conduct code. This enforcement includes the authority to suspend or revoke a CPA's license for acts discreditable to the profession.

A CPA quickly prepares the financial statements for WSA Co. without noticing that an asset was inadvertently overstated on the balance sheet by 10%. An investor who had purchased stock in WSA based on the financial statements, lost \$10,000 as a result of the investment. The investor claims that WSA committed fraud. Which of the following is true concerning whether fraud was committed?

- A. Fraud was committed because the balance sheet is misstated.
- B. Fraud was **not** committed because the investor's damages are **not** material.
- C. Fraud was committed because the reliance was placed on the statements by the investor.
- D. Fraud was **not** committed because the misstatement was due to negligence.

Item ID: 64149

Key: D

REG.CSO.20210701: REG.001.004.001

REG.SSO.20210701: Application:2

Fraud is a common law principle of liability that **can be asserted against a CPA**. In addition to proving the other three elements of fraud (represented by RIMS), the **party suing the CPA** (ie, plaintiff) must **prove** the CPA had the **intent to deceive** (ie, scienter).

A CPA who proves that any element of RIMS did *not* happen can successfully defend a lawsuit based on common law fraud. As one defense, CPAs can argue that there was no scienter (ie, no intent to deceive) because the mistake was due to negligence instead of an intentional intent to deceive or gross negligence.

(Choices A, B, and C): All of these are elements for proving common law *negligence*, not fraud.

Things to Remember:

A CPA who proves that any element of common fraud (RIMS) did *not* happen can successfully defend a lawsuit based on common law fraud.

Under agency law, which of the following sets of categories refer to principals?

- A. Formal, mutual, and informal.
- B. Actual, express, and implied.
- C. General, special, and gratuitous.
- D. Disclosed, partially disclosed, and undisclosed.

Item ID: 64357

Key: D

REG.CSO.20210701: REG.002.001.001

REG.SSO.20210701: Remembering and Understanding:1

An agency relationship exists when one party (ie, agent) acts on behalf of another (ie, principal) in contractual dealings with a third party. The agent's liability for a contract it makes with a third party differs depending on the information the agent reveals about the principal.

- When the **principal's** identity is **fully disclosed**, **only** the **principal** is **liable** under any contract the agent makes with a third party.
- When the **principal is partially disclosed**, the third party knows there is a principal but does not know the principal's identity. In this case, **both** the **agent** and the **principal** are **liable** under any contract the agent makes with a third party.
- When the **principal is undisclosed**, the third party is led to believe the agent is acting on their own behalf. In this case, the **agent** is **liable** under any contract it makes with a third party. The principal is not liable but must indemnify the agent for its liability for the contract.

Choice A and C: These are not elements of categories of a principal.

Choice B: Actual, express, and implied refers to the type of authority an agent has.

Things to Remember:

There are three different types of principals in an agency relationship: 1) fully disclosed, 2) partially disclosed, and 3) undisclosed.

CJN Corp. contracts with James, Inc. to sell James's 130 acres of ocean-front property and requires James to submit the entire balance upon closing. CJN refuses to close the sale. James has which of the following remedies available to it?

- A. Compensatory damages or specific performance.
- B. Specific performance and compensatory damages.
- C. Consequential damages or punitive damages.
- D. Punitive damages and compensatory damages.

Item ID: 73687

Key: A

REG.CSO.20210701: REG.002.002.003

REG.SSO.20210701: Application:2

When a contract is breached, the injured party is usually entitled to recover only compensatory damages (ie, monetary damages). However, **when** the **subject matter** of the contract is **unique** (eg, real estate, patents, etc.) and monetary damages will not suffice, a **court** may **award** specific performance to the injured party. However, courts do *not* award *both* specific performance *and* compensatory damages because that would unjustly enrich the injured party **(Choice B)**.

A punitive damage award would enrich the injured party beyond the economic position of the original transaction in the contract. Therefore, it is not appropriate for breach of contract. However, punitive damages are awarded in cases involving a tort (eg, bodily injury) **(Choices C and D)**.

Things to Remember:

When a contract is breached, the injured party is usually entitled to recover only compensatory damages (ie, monetary damages). However, when the subject matter of the contract is unique (eg, real estate, patents, etc.) and monetary damages will not suffice, a court may award specific performance to the injured party. However, courts do not award both.

A U.S. citizen and an individual who is a resident and citizen of Australia want to form a business association to sell farm equipment in the United States. They want limited liability to the extent of their investments, to be taxed as a flow-through, and to both actively participate in management. Which of the following types of business organizations best fits their needs?

- A. S corporation.
- B. C corporation.
- C. Limited partnership (LP).
- D. Limited liability company (LLC).

Item ID: 63891

Key: D

REG.CSO.20210701: REG.002.005.001

REG.SSO.20210701: Remembering and Understanding:1

There are numerous types of business ownership. Although each has advantages and disadvantages, special consideration should be given to the **formation requirements, personal liability, and tax consequences** of each type.

For example, a C corporation is a standalone taxable entity. Owners are **not** responsible for a C corporation's debt. However, S corporations, P/S, and LLCs are taxed as **pass-through entities** (eg, the owners report their pro rata share of business income and separately stated items). Depending on the *type* of pass-through entity, the owner could be **personally liable** for all or some of the entity's debt.

Here, the individuals want a business structure that is taxed as a *flow-through entity*, which would exclude a C corporation (**Choice A**). Because one individual is **not** a U.S citizen or resident (ie, resident and citizen of Australia), an S corporation is *prohibited* (**Choice B**).

Both individuals also want to *actively participate in the management* and have *limited liability* to the extent of their investments. A limited P/S is comprised of general partners and limited partners. Only general partners may be active participants but have *unlimited personal liability* for the debts and obligations P/S. Therefore, a limited P/S would *not* meet the individuals' needs (**Choice C**).

However, an **LLC** allows all members to *participate* in the *management* and provides all members with *limited liability* the extent of their investment. Unless otherwise elected, an LLC with more than one member is *taxed as a P/S* (ie, flow-through entity). Therefore, only an **LLC meets all the requirements of the individuals.**

Things to remember:

A limited liability corporation allows all members to participate in the management of the business and provides all members with limited liability to the extent of their investment. Unless otherwise elected, an LLC with more than one member is taxed as a P/S (ie, flow-through entity.)

An accrual-basis taxpayer sold land for \$100,000 on July 1, year 1, and received \$20,000 cash and a note for \$80,000. The taxpayer's basis in the asset is \$60,000. What amount of gain, if any, should the taxpayer report for Year 1, if the transaction qualified under the installment sale method?

- A. \$0
- B. \$8,000
- C. \$20,000
- D. \$40,000

Item ID: 65531

Key: B

REG.CSO.20210701: REG.003.001.003

REG.SSO.20210701: Application:2

An **installment sale** occurs when a disposition of property has **at least one payment** received **after the close of the taxable year** in which the disposition occurs. A *portion* of the total gain is reported as *each* payment is received over the installment period (**Choice A**). This method allows taxpayers to spread a taxable gain from the sale of property over the number of payment installments, thus *temporarily* deferring some of the taxable gain.

For tax purposes, the installment sale method is *required* if there is a *gain* on the sale unless the taxpayer makes an election to opt out. The method does *not* apply to sales that result in a loss, or gains from the sale of inventory, and stocks and securities traded on an established securities market.

To determine the amount of income recognized each year, the **gross profit percentage** from the sale (ie, gross profit divided by sales price) is **multiplied by the payments** received. The **gross profit** is the *difference* between the *sales price* and the *adjusted tax basis* of the property sold.

In this scenario the gross profit on the sale of the land is \$40,000 (\$100,000 sales price – \$60,000 basis). The gross profit *percentage* is 40% (\$40,000 gross profit / \$100,000 sales price).

Because \$20,000 was received in the current year, the taxpayer reports an **\$8,000 gain** ($\$20,000 \times 40\%$) **(Choice C)**.

Note: *Generally, interest earned on an installment sale is reported as ordinary income as it is earned.*

(Choice D) A \$40,000 gain applies the gross profit percentage to the total \$100,000 sale price instead of the cash collected.

Things to remember:

When an installment sale occurs, the amount of income recognized each year equals the gross profit percentage (ie, gross profit divided by sales price) multiplied by the payments received. Gross profit is the difference between the sales price and the adjusted tax basis of the property sold.

A taxpayer purchased real property for \$20,000 and sold it the next year to their child for the fair market value of \$12,000. Later, the child sold the property to an unrelated party for \$15,000. What amount, if any, should be recognized by the child?

- A. \$5,000 loss.
- B. \$3,000 loss.
- C. \$0
- D. \$3,000 gain.

Item ID: 61025

Key: C

REG.CSO.20210701: REG.003.001.004

REG.SSO.20210701: Application:2

No loss deduction is permitted from the sale or exchange of property involving **related parties** (eg, family members). The loss disallowance is designed to prevent certain related taxpayers from creating tax losses from transactions that lack economic substance.

However, the **acquiring relative** may later **deduct the disallowed loss** against a gain on the subsequent sale of the property to an *unrelated* party. However, the amount of disallowed loss used may *not* reduce the subsequent realized gain below \$0 or increase a realized loss.

Here, a taxpayer sells property to their child for an \$8,000 loss (\$12,000 sales price – \$20,000 basis). Because the child is a related party **none of the \$8,000 loss** is recognized by the taxpayer. However, the child may use part of the disallowed loss against the \$3,000 gain incurred (\$15,000 sales price – \$12,000 basis) when the property is subsequently sold to an unrelated party (**Choice D**). The \$5,000 remaining disallowed loss (\$8,000 loss – \$3,000 used) is forfeited (**Choice A**).

(Choice B) A deductible loss of \$3,000 erroneously assumes the entire \$8,000 loss is recognized but limited by the maximum \$3,000 capital loss per year.

Things to remember:

A taxpayer cannot recognize a loss on the sale or exchange of property to a related party (eg, family member). However, the acquiring related party may deduct this loss from any gain

resulting from selling the property to an unrelated party. The deduction is limited to the amount of the gain.

An individual taxpayer made the following gifts: a \$100,000 house to the taxpayer's child, a \$50,000 automobile to a friend, \$40,000 cash to the taxpayer's spouse, and \$60,000 capital stock to a qualified charity. The taxpayer does not elect gift splitting. What is the total taxable gift before considering the gift tax annual exclusion?

- A. \$50,000
- B. \$150,000
- C. \$190,000
- D. \$210,000

Item ID: 63369

Key: B

REG.CSO.20210701: REG.003.003.000

REG.SSO.20210701: Application:2

A **gift** is a transfer of a present interest (eg, outright ownership of the property) to or on behalf of another individual where nothing, or less than full value, is expected in return. Examples include **cash and property transfers**, selling property at less than full value, and interest-free loans made during the lifetime of a taxpayer.

For tax purposes, an individual (ie, donor) may transfer gifts up to the current annual gift exclusion (ie, \$16,000, \$32,000 if splitting gifts) to a **single individual** (ie, donee) each year *without* incurring any tax consequences.

When determining the dollar amount of the annual gifts made, the donor uses the **fair market value** of the property on the *date of the gift*. Due to the *unlimited marital deduction*, **spouses** may transfer assets to one another *without* being considered gifts for tax purposes. **Qualified charities** are *not* individuals; therefore, those transfers are considered *charitable donations* and **not** subject to gift tax rules.

Here, a taxpayer made four gifts. The transfers to the spouse (\$40,000) and charity (\$60,000) are *not* subject to the gift tax rules. Accordingly, the taxpayer made gifts totaling **\$150,000** (\$100,000 house to child + \$50,000 automobile to friend) *before* the annual exclusion.

(Choice A) Taxable gifts of \$50,000 assumes that *only* the gift to the friend is a taxable gift.

(Choice C) A gift of \$190,000 erroneously includes the \$40,000 gift to the spouse.

(Choice D) Total taxable gifts of \$210,000 incorrectly includes the \$60,000 transfer to the charity.

Things to remember:

For tax purposes, an individual may transfer gifts up to the current annual gift exclusion to a single individual without gift tax consequences. Transfers to between spouses or to charitable organizations are not considered taxable gifts.

An individual taxpayer had the following transactions during the current year:

Workers' compensation payments	\$30,000
Damages received for slander	40,000
Loss on the sale of a personal residence	75,000
W-2 wages	80,000

What is the taxpayer's adjusted gross income?

- A. \$107,000
- B. \$110,000
- C. \$120,000
- D. \$147,000

Item ID: 75522

Key: C

REG.CSO.20210701: REG.004.001.000

REG.SSO.20210701: Application:2

For tax purposes, **gross income** is defined as "**all income** from whatever source derived." Because of the all-inclusive approach for gross income, taxpayers must rely on **statutory authority** found in the IRC to *exclude* an item from income. *Adjusted gross income* (AGI) is gross income less allowable adjustments.

Damages received for personal physical injury or physical sickness are specifically **excluded** from gross income to the extent the taxpayer did *not* take an itemized deduction for the expenses related to the injury or sickness. This exclusion applies to court-awarded damages as well as **to workers'**

compensation awards (Choice B). However, punitive damages for **injury to reputation** (eg, slander) and employment discrimination are **fully taxable**.

Generally, gains from the sale of **personal-used assets** (eg, personal residence) are taxable; however, losses are **not** deductible.

In this scenario, the workers' compensation is *nontaxable* and *no deduction* is permitted for the loss from the sale of the personal residence. Therefore, the taxpayer's **AGI is \$120,000** (\$40,000 damages for slander + \$80,000 W-2 wages).

(Choices A and D) AGI of \$107,000 and \$147,000 incorrectly includes the residence loss but limits the deduction to the maximum \$3,000 per year for capital losses. AGI of \$147,000 assumes all items are taxable and AGI of \$107,000 excludes the damages for slander.

Things to remember:

Gross income for tax purposes is defined as "all income from whatever source derived." There must be statutory authority provided in the IRC for a taxpayer to exclude an item from gross income, such as workers' compensation awards. Losses from personal-use assets are not deductible.

An individual taxpayer received a Schedule K-1, *Partner's Share of Income, Deductions, Credits, etc.* from a small partnership, in which the taxpayer owns a 50% interest. The qualified business income amount attributable to the taxpayer is \$70,000. That is the taxpayer's only qualified business income, and the taxpayer has no capital gains or other investments. Ignoring the W-2 limitation, what is the net amount of increase to taxable income from the partnership income?

- A. \$0
- B. \$14,000
- C. \$56,000
- D. \$70,000

Item ID: 502115

Key: C

REG.CSO.20210701: REG.004.003.000

REG.SSO.20210701: Application:2

The TCJA reduced the Federal income tax rate for C corporations which gives them a competitive advantage over other business entities (eg, partnerships, S corporations, sole proprietorships) that are generally taxed at the individual rates. To minimize this advantage, Congress established a **deduction for individuals**, trusts, and estates that have **qualified business income** (QBI) from a *qualified business* and meet certain *requirements*.

A partnership (P/S) is a pass-through entity where each partner reports their pro rata share of P/S income. Although a P/S creates QBI, the QBI *deduction* is *claimed* on the tax return of an *eligible individual*, trust, or estate. Subject to several limitations (eg, wage and property), the deduction is generally **20% of QBI** received. The deduction is available, regardless of whether a taxpayer itemize deductions or take the standard deduction.

In this scenario, the taxpayer's share of QBI is \$70,000 for which a 20% deduction is permitted **(Choice D)**. As a result, the **net increase** in taxpayer's income from the partnership is **\$56,000** as computed below.

Taxable partnership income	\$70,000
Less: 20% QBI deduction ($\$70,000 \times 20\%$)	(14,000)
Net increase in income	\$56,000

(Choice A) No change to taxable income incorrectly assumes the QBI equals 100% of the allocated P/S income.

(Choice B) The QBI deduction is \$14,000. It must be deducted from the allocated P/S income to determine the net increase.

Things to remember:

Subject to limitations, a deduction of up to 20% of qualified business income (QBI) is available to individuals, trusts, and estates. If eligible, the deduction is claimed on the tax return of the individual, trust, or estate that receives the QBI.

A taxpayer plans to sell the following assets:

- A home rented during the entire year by the taxpayer's tenant at a market rental rate.
- An automobile used by the taxpayer solely for recreational purposes.
- A show dog held by the taxpayer for hobby purposes.
- Common stock held by the taxpayer for investment purposes.

If the taxpayer projects a \$10,000 loss on each asset sale, then the losses will reduce adjusted gross income by what amount?

- A. \$30,000
- B. \$23,000
- C. \$20,000
- D. \$13,000

Item ID: 87335

Key: D

REG.CSO.20210701: REG.004.005.000

REG.SSO.20210701: Application:2

To prevent taxpayers from artificially creating tax losses or deducting losses that have no business purpose, there are limitations on the type and amount of losses an individual taxpayers may deduct. Examples of losses that are **nondeductible** include losses from personal-use assets (eg, personal residence, **automobile**) and nonbusiness **hobby losses**.

However, other losses are permitted but limited.

- Losses from *rental real estate activities* are deductible against ordinary income if either the real estate professional or active participation exceptions are met. For the active participation exception, a maximum of \$25,000 in losses is permitted a year (subject to modified AGI phase out).
- For individual taxpayers, the *net* loss from the sale of capital assets is limited to a \$3,000 deduction a year.

In this scenario, the taxpayer has a \$10,000 loss from each type of transaction. *Only* the losses from the **home rental**, and the **sale of common stock** are *deductible* losses. The \$10,000 rental loss is fully deductible since the taxpayer actively participates and the amount is less than

\$25,000. Because stock is a *capital asset*, the \$10,000 loss is *limited* to \$3,000. Accordingly, the total deductible loss is **\$13,000** (\$10,000 rental + \$3,000 stock).

Things to remember:

Limitations exist regarding the type and amount of losses an individual taxpayers may deduct. Nondeductible include losses from personal-use assets (eg, automobile) and nonbusiness hobby losses. The net loss from the sale of capital assets is limited to \$3,000 per year. Losses from rental activities are deductible against ordinary income if either the real estate professional or active participation exceptions are met.

Interest on a tax deficiency begins to accrue on the date on which

- A. The tax was due, without regard to extension of time to file.
- B. The tax was redetermined by the IRS upon audit.
- C. A court decision was entered in favor of the IRS.
- D. A notice of levy was mailed to the taxpayer.

Item ID: 66669

Key: A

REG.CSO.20210701: REG.004.007.000

REG.SSO.20210701: Remembering and Understanding:1

To encourage taxpayer compliance with payment of taxes, the IRS can **assess interest** and penalties on any tax that is **not paid** on or **before the last date required** for payment. **Interest is charged** on unpaid taxes from **the normal due date** to the date of payment *without* regard to filing extensions.

For example, a taxpayer that has a **tax deficiency** (ie, owes additional tax) associated with filing Form 1040 must pay the balance by April 15, the **normal due date** for the individual return regardless of whether the tax return is filed. If the taxpayer obtains an automatic 6-month extension, the extension is only for the filing of the tax return, not the payment of the tax or assessment of penalties and interest.

(Choices B and C) Interest *continues to accrue* on tax deficiencies from the original due date during an *IRS audit* or *court proceeding*. The date the tax was redetermined by the IRS or decided by a court decision taxpayer is irrelevant.

(Choice D) A notice of intent to levy informs the taxpayer that the tax is due within 10 days of the letter. However, the interest accrues from the original due date of the tax deficiency.

Things to remember:

For tax deficiencies, interest is charged on unpaid taxes from the normal due date of the tax return to the date of payment without regard to filing extensions.

As part of a liquidating distribution, a partner receives \$8,000 cash and land with a fair market value of \$12,000 and a basis of \$7,000. The partner's basis in the partnership prior to the distribution was \$10,000. What is the partner's basis in the land immediately after the distribution?

- A. \$2,000
- B. \$7,000
- C. \$8,000
- D. \$12,000

Item ID: 72083

Key: A

REG.CSO.20210701: REG.005.001.000

REG.SSO.20210701: Application:2

A **liquidating distribution** is a complete **termination** of a partner's **interest** in a partnership (P/S) (ie, outside basis reduced to \$0). The tax objective of a liquidating distribution is to **allocate** the partner's **outside basis** to the **assets received** as a **nontaxable** return of capital.

A partner's outside basis is reduced to \$0 by *allocating* the *basis* to the *distributed assets* in the following order: cash, unrealized receivables and inventory (ie, hot assets), and all other assets (eg, land). Generally, the assets have a **carryover basis** (not FMV) from the P/S (**Choice D**). When required, carryover basis is *adjusted* to absorb any remaining outside basis in the P/S (**Choice B**).

In this case, the partner's outside basis is first reduced by the \$8,000 cash (**Choice C**). Because a liquidating distribution generally results in no gain or loss, the basis of any other assets received must reduce the outside basis to \$0. Here the **\$2,000 remaining** outside basis (not the \$7,000 carryover basis) is **allocated to the land** as shown below.

Partner's outside basis	\$10,000
Less: Cash distributed	<u>(8,000)</u>
Remaining outside basis	\$2,000
Less: Basis assigned to the land	<u>(2,000)</u>
Partner's ending basis	\$0

Things to remember:

Liquidating distributions are treated as a return of capital and reduce a partner's basis in the partnership to \$0. The partner's basis is reduced first by distributed cash. Generally, the assets distributed have a carryover basis (not FMV) from partnership. When required, carryover basis is *adjusted* to absorb any remaining outside basis in the P/S.

In the current year, Anderson, Branch, and Campbell formed Orange Corp. Anderson transferred to the corporation land with an adjusted basis of \$90,000 and a fair market value of \$100,000; Branch transferred to the corporation equipment with an adjusted basis of \$50,000 and a fair market value of \$100,000; and Campbell will render services to the corporation. Each shareholder received 5,000 shares of Orange Corp. stock, worth a total of \$100,000. What amount of income must Campbell report as a result of this transfer?

- A. \$0
- B. \$10,000
- C. \$50,000
- D. \$100,000

Item ID: 61879

Key: D

REG.CSO.20210701: REG.005.003.003

REG.SSO.20210701: Application:2

When a shareholder contributes property (eg, cash, land, equipment) in exchange for stock, the transfer may be taxable or nontaxable, depending on the percentage of ownership control *after* the exchange. The transfer is **nontaxable** if one or more persons transfer *only* property and immediately after the exchange **own 80% or more** of the corporate stock. However, shares issued for services are *excluded* when determining the 80% ownership control test (eg, Campbell's shares).

Because **services** performed by the shareholder are *not* property, the **FMV** of stock (ie, \$100,000) received from providing services is reported as **taxable compensation** to the shareholder. The basis in the stock also equals the **FMV** of the shares received. Here, Campbell provided services to the corporation in exchange for 5,000 shares with FMV of \$100,000. Accordingly, the shareholder reports **\$100,000 as income. (Choices A, B, and C).**

Note: Because Campbell's shares were exchanged for services, those shares are excluded from the 80% test. Therefore, Anderson and Branch only own two-thirds, failing the 80% test.

Anderson and Branch's property contributions are reported at the FMV of the property on the date of contribution and are reported as a sale by each contributor.

Things to remember:

Because services performed by the shareholder in exchanged for stock are *not* property, the FMV of stock received for services is reported as taxable income. The shareholder's basis in the stock equals the FMV of the shares received.

Peach, Inc. files a consolidated federal income tax return with its 100%-owned domestic subsidiaries. In Year 2, members of the consolidated group reported net book income (loss) as follows:

Peach, Inc.	\$ 125,000
Apple, Inc.	45,000
Blueberry, Inc.	(100,000)

Apple paid \$50,000 in dividends to Peach in Year 2. The dividends are included in Peach's net income reported above. Based on the information provided, what is the group's consolidated taxable income for Year 2?

- A. \$20,000
- B. \$30,000
- C. \$35,000
- D. \$70,000

Item ID: 100743

Key: A

REG.CSO.20210701: REG.005.003.004

REG.SSO.20210701: Application:2

For federal tax purposes, only an **affiliated group of domestic C corporations** may elect to file a **consolidated corporate tax return** (ie, treated as a single taxable entity). One advantage of filing a consolidated return is offsetting one corporation's losses with another member's income.

An affiliated group is one or more corporations connected through **stock ownership** with:

- a *common parent corporation* directly owning *at least 80%* of the voting power and total value of stock in at least one other corporation, and
- all other includible members are at least 80% owned by the parent and/or other group members

The consolidated tax return reports the members' combined incomes, gains, deductions, and tax credits, including any offsetting losses. However, **intercompany transactions** (eg, **dividends**, sales) between consolidating members are considered self-dealing (ie, selling or paying to yourself) and are **not recognized** (ie, eliminated) on the consolidated tax return.

Here, the Peach Inc., Apple Inc., and Blueberry Inc. file a consolidate tax return. The **consolidated income is \$20,000** as computed below:

Peach, Inc. net income	\$125,000	
Less: Intercompany dividends received	(50,000)	\$75,000
Apple, Inc. net income*		45,000
Blueberry, Inc. net loss		<u>(100,000)</u>
Consolidated income		\$20,000
<i>*No adjustment is required because dividends paid are not reported on the income statement.</i>		

Things to remember:

An affiliated group of C corporations may elect to file a consolidated tax. Transactions between consolidating members (eg, intercompany dividends) are eliminated when calculating the consolidated tax income.

Which of the following shareholders is ineligible to own the stock of an S corporation?

- A. Domestic C corporation.
- B. Resident alien individual.
- C. Estate of a deceased U.S. citizen.
- D. Grantor trust created by a U.S. citizen.

Item ID: 64383

Key: A

REG.CSO.20210701: REG.005.004.001

REG.SSO.20210701: Remembering and Understanding: 1

S corporations were created to help small, family-owned businesses. Specifically, they provide the liability protection of a C corporation *without* the double taxation. Restrictions on ownership are designed to make S corporations available only to small businesses.

A corporation may elect to be treated as an S corporation (a flow-through entity) if it meets certain S corporation shareholder requirements:

- No more than 100 shareholders
- All shareholders must be **individuals, estates, or certain trusts** (ie, for the benefit of individuals) **(Choices C and D)**
- The individuals must be either a U.S. citizen or a **resident alien (Choice B)**.

Because a C corporation is **not** an individual, estate or trust, it may **not** be a shareholder in an S corporation. Examples of owning shares for the direct benefit of a person as a fiduciary, include the following: estates of a deceased U.S. citizen and a grantor trust created by a U.S. citizen or resident.

Things to remember:

One of the requirements for the S corporation election is that all shareholders must be individuals (either a U.S. citizen or a resident alien) or certain estates or trusts for the benefit of individuals. C corporations are ineligible to be a shareholder.

Which of the following conditions is sufficient for a partnership to change its otherwise required taxable year?

- A. The partners unanimously agree to a deferral of exactly six months.
- B. By majority vote, the partners agree to a deferral of exactly six months.
- C. The partnership prefers to use a calendar year in order to substantially defer the partners' tax liability.
- D. The partnership makes an election for a different taxable year, which has a deferral of exactly three months.

Item ID: 504563

Key: D

REG.CSO.20210701: REG.005.005.003

REG.SSO.20210701: Remembering and Understanding:1

Partnerships (P/S) are flow-through entities that allocate business income (loss) and separately stated items on a pro rata basis to the partners. To ensure the least amount of time for the potential deferral of income, a P/S generally must adopt the **tax year used by the majority partners** (ie, partners owning > 50% interest) if those partners have the *same* tax year.

- If there is **not** a majority interest tax year, a *tax year* used by all the *principal partners* can be used.
- If the principal partners do *not* have the *same* tax year, the *least aggregate deferral of income* is used to determine the P/S tax year.
- A tax year *other* than the normally required year can be used if the P/S provides a **valid business reason** (eg, ski resort with a natural business year ending May 31) or makes a *Section 444 election*. This election does *not* require a business reason, but **no more than three months' income deferral** from the *required* year end is allowed.

A partnership may *not* use a calendar year to substantially (ie, > three months) defer the partners' tax liability (**Choice C**). Any deferral may not exceed three months (ie, six months deferral is not permitted) (**Choices A and B**).

Things to remember:

Partnerships (P/S) generally must adopt the same tax year as the majority partners (ie, > 50%

interest). A different tax year is allowed if there is a valid business reason or the P/S makes a Section 444 election (ie, no more than three months' income deferral allowed).

For a not-for-profit organization with unrelated business income, the calculation of the unrelated business income tax is made upon

- A. All income from the organization.
- B. The gross receipts from the unrelated business, less related deductions.
- C. The gross receipts from unrelated business, less related deductions, plus interest and dividends.
- D. The gross receipts from unrelated business, less related deductions and donations of the organization, less program expenses.

Item ID: 99962

Key: B

REG.CSO.20210701: REG.005.008.002

REG.SSO.20210701: Remembering and Understanding:1

Any 501 (c) tax-exempt organization that receives **more than \$1,000** (ie, the statutory threshold permitted) of **unrelated business income** (UBI) must pay income taxes on the revenue. UBI is income obtained from the operations of **business activities not associated** with the exempt purpose of the organization (**Choice A**). To be UBI, the income must be earned on a *regular basis*.

For example, to raise additional funds, an exempt organization whose purpose is the prevention of cruelty to animals also provides pet boarding and grooming services. The income from these activities constitutes UBI.

The tax, which is designed to negate a tax-exempt entity's advantage over taxable businesses, is equal to the current corporate tax rate or trust rate, whichever is applicable. When computing the UBI subject to tax, the **gross income** from the unrelated business **less any related deductions** is used (**Choice D**). Interest and dividends (ie, passive income) are *not* considered UBI (**Choice C**).

Things to remember:

Any 501 (c) tax-exempt organization that receives more than \$1,000 of unrelated business income (UBI) must pay income taxes on the revenue. When computing the UBI subject to tax, gross income from the unrelated business less any related deductions is used.

2022 AICPA Released Questions for REG

The Key gives the correct letter answer for each question.

Key: A

The numbering system indicates the AICPA Blueprint Representative Task and Skill Level for each question.

REG.CSO.20190701: REG.001.003.001

REG.SSO.20190701: Application:2

MULTIPLE CHOICE - HARD

Which of the following individuals is acting as a tax return preparer under IRS regulations?

- A. A CPA who prepares a substantial portion of a claim for refund of tax for a client.
- B. A CPA who prepares a tax return for a taxpayer under the Volunteer Income Tax Assistance program.
- C. An employee of the tax department of a corporation who prepares a tax return on behalf of the corporation's wholly owned subsidiary.
- D. An employee of the tax department of a corporation who prepares a claim for refund on behalf of the corporation's parent company, which owns 100% of the corporation.

Item ID: 83770

Key: A

REG.CSO.20210701: REG.001.001.002

REG.SSO.20210701: Remembering and Understanding:1

A **tax return preparer** includes anyone (eg, a CPA) who **prepares** for compensation, or who employs one or more persons to prepare, all or a substantial portion of **any tax return or claim for refund**. The compensation can be either explicit (ie, for money) or implicit (ie, barter).

Note that a CPA is *not* classified as a tax return preparer if the CPA prepares a tax return for a family member or friend free of charge, or as a volunteer (**Choice B**). In addition, a CPA who prepares an entity's tax return or claim for refund as an employee is *not* considered to be a tax return preparer (**Choices C and D**).

Things to Remember:

A tax return preparer includes anyone (eg, a CPA) who prepares for compensation, or who employs one or more persons to prepare, all or a substantial portion of any tax return or claim for refund. The compensation can be either explicit (ie, for money) or implicit (ie, barter).

A taxpayer received a 90-day letter proposing a deficiency. The taxpayer challenged the proposed deficiency in the Small Cases Division of the U.S. Tax Court. If the taxpayer loses the case, then the decision is

- A. Appealable to the regular division of the U.S. Tax Court.
- B. Appealable to the United States District Court if the deficiency is paid.
- C. Appealable to the U.S. Court of Federal Claims if the deficiency is paid.
- D. Not appealable.

Item ID: 505932

Key: D

REG.CSO.20210701: REG.001.003.001

REG.SSO.20210701: Application:2

The IRS has a well-established process for settling tax disputes. After the IRS assesses a deficiency, it sends the taxpayer a 30-day letter explaining its reasoning along with a copy of the audit examination report. This gives the taxpayer 30 days to accept the proposed change, skip the appeal process, or request a conference with an appeals officer.

If the taxpayer disagrees with the appeal determination or does not respond to the 30-day letter, the IRS issues a notice of deficiency (ie, 90-day letter). The notice of deficiency gives a taxpayer with a United States address 90 days from the notice's mailing date to either pay the deficiency or file a petition with the U.S. Tax Court.

Taxpayers have the option of filing in the "regular" Tax Court or, for tax disputes of \$50,000 or less, the taxpayer can choose to file in the Small Cases Division of the U.S. Tax Court. The small tax cases path has simpler, less formal process. However, **decisions in the Small Cases Division are not appealable** by either the taxpayer or the IRS (**Choices A, B, and C**).

Things to Remember:

When disputing a tax issue after the IRS has issued a 90-day letter, taxpayers can choose to file the dispute in the Small Cases Division of the U.S. Tax Court. However, decisions in the Small Cases Division are not appealable by either the taxpayer or the IRS.

A reportable transaction is one with respect to which additional information is required to be included with a federal income tax return because the transaction is of a type, according to an IRS determination, that has

- A. A significant tax impact in the return year.
- B. The potential for tax avoidance or evasion.
- C. A potential impact on more than one taxpayer.
- D. A significant tax impact on future years' returns.

Item ID: 100020

Key: B

REG.CSO.20210701: REG.001.003.002

REG.SSO.20210701: Remembering and Understanding:1

Certain activities are listed as **reportable transactions** under the federal tax code and **must be disclosed** when the return is filed. The IRS has a list of transactions that have been determined to have the potential to be "**tax avoidance transactions**." These include all registered tax shelters as well as any special arrangement that changes reportable income by more than \$10 million. These transactions are reported on Form 8886.

(Choice A, C, and D): Significant tax impact, potential impact on more than one taxpayer, and impact on future years' returns are not criteria used to determine what types of transaction must be disclosed on Form 8886.

Things to Remember:

Certain activities are listed as reportable transactions under the federal tax code and must be disclosed on Form 8886 when the return is filed. The IRS has a list of transactions that have been determined to have the potential to be "tax avoidance transactions."

Brasher, who owns an office building, hires a real estate agent to find a buyer for the building. Shortly thereafter, Jaxson hires the same real estate agent to find an office building for purchase. If the agent sells Brasher's office building to Jaxson without disclosing the agency relationship with Brasher, the real estate agent has breached which of the following duties?

- A. Duty to inform.
- B. Duty of due diligence.
- C. Duty of obedience.
- D. Duty of loyalty.

Item ID: 61229

Key: D

REG.CSO.20210701: REG.002.001.002

REG.SSO.20210701: Application:2

An agency relationship exists when one party (ie, the agent) acts on behalf of another (ie, the principal) in contractual dealings with third parties. Once an agency relationship is established, the principal and agent owe duties to one another. The **duty of loyalty** dictates that the **agent** must **act solely** in the **interest of** the **principal** in matters concerning the principal's business.

In this scenario, the real estate agent has a conflict of interest when representing both the seller (Brasher) and buyer (Jaxson) in a transaction. For instance, a real estate agent's commission is typically based on a percentage of the sales price. If the agent represents both sides of the transaction, the agent might be tempted to artificially inflate the sales price in order to earn a higher commission.

(Choice A): The duty to inform is part of the duty of loyalty, but not a separate duty.

(Choice B): The duty of due diligence is part of the duty of reasonable care.

(Choice C): Agent's have a duty of obedience to the principal, however that was not the duty being breached in the scenario.

Things to Remember:

Once an agency relationship is established, the principal and agent owe duties to one another. The duty of loyalty dictates that the agent must act solely in the interest of the principal in

matters concerning the principal's business. An agent breaches its duty of loyalty when acting as agent for two principals who are transacting with one another,

Excusing performance of a contract due to very large unforeseen expenses **not** contemplated by the parties to the contract at the time of the formation of the contract is the definition of which of the following?

- A. Tender of performance.
- B. Anticipatory repudiation.
- C. Commercial impracticality.
- D. Impossibility of performance.

Item ID: 92429

Key: C

REG.CSO.20210701: REG.002.002.002

REG.SSO.20210701: Remembering and Understanding:1

There are certain defenses available to parties seeking to escape a contract. For instance, one or more of the parties may claim that the **contract is voidable** due to **commercial impracticality**. In essence the contract contains a "mistake" because it does not contain any provisions for how the parties should handle an unforeseen event (eg, a global pandemic).

Commercial impracticality is different than impossibility of performance. **A contract is voidable if it becomes commercially impractical to perform it.** A contract is *void* if it becomes impossible to perform (**Choice D**).

For example, assume a contract promoter contracts with a concert venue owner to provide a famous singer for a concert at the venue. Commercial impracticality occurs if pandemic protocols (eg, six feet distancing) reduce the audience size such that performing the concert would result in a substantial loss due to reduced ticket sales. In this case the parties have the *option* to cancel the contract. In contrast, the contract is impossible to perform if the famous singer dies.

(Choices A and B): Tender of performance and anticipatory repudiation are elements for determining when a contract may be voidable. However, they are not elements of determining when a contract is voidable due to a large, unforeseen expense not contemplated by the parties.

Things to Remember:

There are certain defenses available to parties seeking to escape a contract. For instance, one or more of the parties may claim that the contract is voidable due to commercial impracticality. In essence the contract contains a "mistake" because it does not contain any provisions for how the parties should handle an unforeseen event (eg, a global pandemic).

Funding from FICA contributions is provided to assist qualifying individuals in each of the following groups, **except**

- A. Retirees.
- B. Unemployed workers.
- C. Survivors of deceased workers.
- D. Elderly individuals requiring medical services or hospitalization.

Item ID: 92453

Key: B

REG.CSO.20210701: REG.002.004.000

REG.SSO.20210701: Remembering and Understanding:1

The Federal Insurance Contributions Act (FICA) imposes a tax paid equally by the employer and the employee based on the gross wages of the employee. Self-employed persons pay a combined employer-employee rate on net self-employment income.

Benefits associated with the FICA tax withheld and paid during an employee's (or a sole proprietor's) life are paid by the Social Security Administration to the following:

- retirees (eg, Social Security benefits) **(Choice A)**,
- survivors of deceased workers **(Choice C)**,
- individuals with a disability, and
- elderly individuals requiring medical services or hospitalization (eg, Medicare benefits) **(Choice D)**.

FICA should *not* be confused with *FUTA* (Federal unemployment tax Act) taxes. FUTA taxes are paid *only* by employers on applicable wages of employees. This tax is designed to help fund state workforce agencies to *fund unemployment benefits* for people who have lost their jobs (ie, **unemployed workers**).

Things to remember:

FICA contributions are paid by the employer and the employee. The purpose of this tax is to provide assistance to qualifying individuals such as retirees, survivors of deceased workers, and elderly individuals requiring medical services or hospitalization. FUTA taxes are used to provide unemployment benefits.

Smith owns vacant lot A, with a basis of \$10,000 and a fair market value of \$25,000. Jones owns lot B, with a basis of \$11,000 and a fair market value of \$22,000. Smith and Jones agree to trade lots, with Jones paying Smith \$3,000. After the exchange, what amount is Smith's basis in lot B?

- A. \$7,000
- B. \$10,000
- C. \$11,000
- D. \$22,000

Item ID: 68711

Key: B

REG.CSO.20210701: REG.003.001.001

REG.SSO.20210701: Application:2

In general, **no gain or loss** is currently recognized (ie, taxable) for a **like-kind exchange** of real property (eg, land, buildings) *held for investment* or used for business. A deferral of realized gains/losses is *mandatory* because the taxpayer's economic position has *not* changed.

If the **FMVs** of the properties exchanged are *not* equal, additional consideration known as *boot* (eg, cash) is required. Because boot is considered *unlike property*, its *receipt* changes the taxpayer's economic position, causing a **portion** of any unrealized **gain** to be currently **taxable**. The recognized gain is the *lesser* of the realized gain or total boot received.

Like most **basis** calculations, the basis of property acquired through a like-kind exchange reflects a taxpayer's cost in an asset given up adjusted for *increases* (eg, liabilities assumed, recognized gain) and **decreases** (eg, cash received).

Here, Smith gives up a lot with FMV of \$25,000 and receives a new lot with a FMV of only \$22,000. Accordingly, Smith receives a \$3,000 cash payment (ie, boot) to make the exchange equivalent. The boot triggers a realized gain equal to the *lesser* of the \$15,000 *realized* gain (\$22,000 FMV received + \$3,000 cash – \$10,000 basis) or \$3,000 *boot*.

Therefore, Smith's basis in the **lot acquired is \$10,000** computed as follows:

Basis of lot given up	\$10,000
Plus: Gain recognized (boot)	3,000
Less: Cash received	<u>(3,000)</u>
Basis of new lot acquired	\$10,000

Note: The \$10,000 basis in the new lot is the same as the basis in the old lot, reflecting no change in the overall economic position of the taxpayer outside of the recognized gain due to boot received.

Things to remember:

The adjusted basis of property acquired through a like-kind exchange of real property held for investment or used for business is the adjusted basis of the property given up + recognized gain – boot received. The recognized gain is the *lesser* of the realized gain or the boot received.

A taxpayer received an investment property from a former spouse as a result of a divorce. The former spouse had purchased the property for \$100,000 several years before they got married, and the fair market value of the property was \$175,000 at the time of the divorce. One year after receiving the property, the taxpayer obtained a loan secured by the property in the amount of \$50,000. One year after obtaining the loan, the taxpayer sold the property for \$190,000 and used the proceeds to repay the loan. What amount is the taxpayer's recognized tax gain from the sale of the property?

- A. \$15,000
- B. \$40,000
- C. \$90,000
- D. \$140,000

Item ID: 506626

Key: C

REG.CSO.20210701: REG.003.001.003

REG.SSO.20210701: Application:2

When taxpayers get divorced, the **division of marital assets** (a property settlement) is generally a **nontaxable** event (ie, *nontaxable* to recipient spouse and *nondeductible* by payor spouse). Property settlements may include any marital assets, such as cash, real estate, vehicles, and investments.

Because the transfer is deemed nontaxable, the **adjusted tax basis** (not FMV) of the property and the payor spouse's holding period **carry over** to the recipient spouse. At the time of the transfer, **no gain or loss** is recognized by either spouse. Instead, any gain or loss is recognized by the *recipient spouse* using the carryover basis when that spouse sells or disposes of the property.

In this scenario, the taxpayer's adjusted basis for the investment property received as a property settlement is the \$100,000 *carryover basis*. Because the transfer was *nontaxable*, *no gain or loss* is recognized at the time of the transfer but deferred until the property is later sold for \$190,000. Accordingly, the taxpayer's **gain from the sale of the property is \$90,000** (\$190,000 sales price – \$100,000 basis). The \$50,000 mortgage secured by the property has *no effect* on the basis or gain computation **(Choice B)**.

(Choice A) A \$15,000 gain uses the \$175,000 FMV of the investment property as basis.

(Choice D) A gain of \$140,000 uses the difference between the \$190,000 sales price and the \$50,000 mortgage.

Things to remember:

A property settlement in accordance with a divorce generally is nontaxable to the recipient spouse and nondeductible by the payor spouse. The property transferred to the recipient spouse has the payor's carryover basis (ie, adjusted tax basis) and holding period.

ABC Industries, a C corporation, was incorporated on March 1, Year 2, and elected a calendar year end. On April 15, Year 2, prior to commencing business operations, ABC purchased the assets of DEF Corp. for \$350,000. Of this amount, \$90,000 was allocated to goodwill. On May 1, Year 2, ABC commenced business operations. What amount of goodwill amortization can ABC claim on its Year 2 corporate tax return?

- A. \$4,000
- B. \$4,250
- C. \$5,000
- D. \$6,000

Item ID: 68535

Key: A

REG.CSO.20210701: REG.003.002.000

REG.SSO.20210701: Application:2

Generally, Section 197 intangible assets (eg, goodwill, patents, trademarks) are those *acquired* (not self-created) through the acquisition of a trade/business or investment. Using the **straight-line method, full-month** convention, the cost basis is **amortized** (ie, written off) **over 180 months (15 years)** regardless of the intangible asset's *useful life*.

Amortization begins with the **later** of the month the intangible is acquired *or* the month the intangible is placed in service (ie, May, Year 2). The tax treatment goodwill is *different* from accounting which tests for impairment of goodwill rather than amortizing it.

Here, the goodwill was acquired in April, Year 2. However, the business began operations on May 1, Year 2. The **later month of May** (ie, 8 months) is used for the Year 2 amortization calculations. ABC Inc., may claim **amortization of \$4,000** on its Year 2 return, computed as follows:

Annual amortization	$\$90,000 / 15 \text{ years} = \$6,000 \text{ per year}$
Year 2 amortization	$\$6,000 \times 8 \text{ months} / 12 \text{ months} = \$4,000$

(Choices B, C, and D) Amortization of \$4,250, \$5,000 and \$6,000 use the incorrect number of months. The \$4,250 uses 8.5 months (ie, April 15), the \$5,000 uses 10 months (ie, March 1) and the \$6,000 does not pro rate and uses the entire year.

Things to remember:

The cost basis of intangible assets (eg, goodwill, patents) is amortized using the straight-line method, full month convention, over 180 months (15 years) regardless of the intangible asset's useful life. Amortization begins with the later of the month the intangible is acquired or the month the intangible is placed in service.

A taxpayer loaned a friend \$10,000. The friend filed for bankruptcy last year, and the taxpayer was notified that he would receive \$0.20 on the dollar. In the current year, the taxpayer received \$1,500 as the final settlement. The loan is nonbusiness. How should the taxpayer report the loss?

- A. \$8,000 short-term capital loss last year and \$500 ordinary loss in the current year.
- B. \$8,000 short-term capital loss last year and \$500 capital loss in the current year.
- C. \$8,500 ordinary loss in the current year.
- D. \$8,500 short-term capital loss in the current year.

Item ID: 60647

Key: D

REG.CSO.20210701: REG.004.001.000

REG.SSO.20210701: Application:2

Nonbusiness bad debts write offs are always S/T capital losses.

Bona fide debt is an obligation established with (1) an **expectation** of a determinable amount of **repayment**, and (2) an **intent to enforce** the obligation. Should a bona fide debt become *partially* worthless, loss recognition is determined by whether the debt was created/acquired in connection with the taxpayer's trade or business.

Partial losses related to a *business* debt are recognized the year the loss is incurred; however, **partial losses** related to a **nonbusiness debt** (eg, personal loans) are generally **not allowed**. A *nonbusiness* debt is treated as a loss the year it becomes *wholly* worthless, such as receiving a *final settlement from bankruptcy*. Nonbusiness bad debt write offs are always treated as **short-term capital losses (Choices A, B, and C)**.

Because the taxpayer's debt is nonbusiness, **\$8,500** (\$1,500 amount received – \$10,000 amount of loan) is treated as a **short-term capital loss**.

Things to remember:

Taxpayers can recognize a short-term capital loss on *nonbusiness debt* only the year it becomes *wholly* worthless. The amount of the loss is the difference between the loan amount and the amount received, if any.

An S corporation pays one of its individual shareholders for services rendered to the S corporation, and a general partnership pays one of its partners for services rendered to the partnership. Which of the following statements is accurate regarding these payments?

- A. The S corporation should classify the payments as deductible wages reportable on Form W-2.
- B. The partnership should classify the payments as deductible wages reportable on Form W-2.
- C. The S corporation should classify the payments as nondeductible dividends reportable on Form 1099-DIV.
- D. The partnership should classify the payments as nondeductible partnership distributions reportable on Form K-1.

Item ID: 73329

Key: A

REG.CSO.20210701: REG.004.002.000

REG.SSO.20210701: Application:2

S corporations and partnerships (P/S) are **flow-through entities** (ie, items pass through pro-ratably to shareholders or partners) whose activities are divided between ordinary business income (loss) and separately stated items.

An **S corporation** must pay reasonable employee compensation (subject to employment taxes) to a **shareholder-employee** in return for the **services the employee provides**. The compensation paid is considered **deductible wages** when determining the corporation's ordinary business income (loss) and is **reported on a W-2 to the shareholder-employee**.

Payments that are based on a separate contractual relationship between a partner and P/S for services rendered by the partner are known as **guaranteed payments**. For tax purposes, guaranteed payments are treated as if they were made to a *nonpartner* and therefore, are *deductible* as an *expense* on the *P/S tax return* to determine business income (loss). Although *no* W-2 is issued, the payments are reported as taxable *ordinary income* to the partner on the partner's K-1 form **(Choices B and D)**.

(Choice C) S corporations do not issue Form 1099-DIV when shareholders receive distributions. Instead, distributions are reported on each shareholder's K-1 form.

Things to remember:

For S corporations, amounts paid to a shareholder-employee for services provided are deductible as wages and reported on Form W-2. Guaranteed payments made by a partnership to a partner for services are treated as ordinary income (not wages). The payments are reported on the partner's K-1 form.

Which of the following would be treated as passive activity income under the passive activity loss rules?

- A. Dividend income from a taxpayer's investment portfolio.
- B. Income from a taxpayer's limited partnership interest.
- C. Commission received from selling vacation property.
- D. Rental income from real estate in which the taxpayer materially participated as a real estate professional.

Item ID: 73027

Key: B

REG.CSO.20210701: REG.004.004.000

REG.SSO.20210701: Remembering and Understanding:1

Passive activity loss rules classify income and losses into *three categories*: active (eg, wages), portfolio (eg, interest, dividends), or passive (eg, limited partnership). **Passive income** includes trade or business activities in which the taxpayer does **not** materially participate (eg, **limited partnerships**) and generally all *rental activities*. The passive loss rules *limit* the deduction of losses from passive activities to the amount of passive income.

There are **two exceptions** regarding losses from *rental real estate activities* if certain requirements are met. The exceptions require that the taxpayer either **actively participates** in the rental activity or is considered a *real estate professional* (**Choice D**). However, if *neither* exception applies, the passive loss deduction is limited to passive income.

Here, the income from a taxpayer's **limited partnership interest** is considered passive income and subject to the passive activity rules. Limited partners by definition do *not* materially or actively participate in partnership activities.

(Choice A) Dividend income is considered portfolio income and therefore not considered a passive activity.

(Choice C) Commission received from selling vacation property is considered active income and not subject to the passive loss rules.

Things to remember:

Passive income includes trade or business activities in which the taxpayer does not materially participate (eg, limited partnerships) and generally all rental activities. There are two

exceptions regarding losses from rental real estate activities if certain requirements are met: (1) the taxpayer is an active participant or (2) is considered a real estate professional.

The spouse of a married taxpayer died on January 15, Year 1. The taxpayer's qualifying child moved to live with grandparents in their home on August 30, Year 2. If the taxpayer did **not** remarry before the end of Year 2, then which filing status should the taxpayer choose for year 2?

- A. Surviving spouse.
- B. Head of household.
- C. Married filing jointly.
- D. Married filing separately.

Item ID: 502015

Key: B

REG.CSO.20210701: REG.004.006.000

REG.SSO.20210701: Application:2

There are five filing statuses—primarily determined by a taxpayer's **marital status** (married or unmarried) on the **last day** of their **tax year**. Married taxpayers must file as either married filing jointly (MFJ) or married filing separately (**Choices C and D**). In the year of a spouse's death, the surviving taxpayer may still file as married.

Unmarried taxpayers must file as single, **head of household** (HOH), or qualifying widow(er) (ie, **surviving spouse**) depending on the circumstances. To qualify for HOH, the taxpayer must provide for more than half the cost of maintaining a home (eg, rent, utilities, groceries) in which at least one qualifying **dependent** (eg, child, relative) lives in for **more than half the year**.

Qualifying widow(er) filing status is available to a taxpayer for *two* years after the year of a spouse's death as long the taxpayer does not remarry. This status allows the taxpayer to retain the benefits of MFJ. The taxpayer must maintain a household in which at least one qualifying **child** lives in for the **entire year**.

Here, the child lived with the widowed taxpayer for 8 months (through August) and with the grandparents for 4 months. Because the child did *not* live with the taxpayer the *entire year*, the qualifying widow(er) filing status *not* available (**Choice A**). The next most advantageous filing status would be **HOH** which only requires the child live in the household for *more than half the year*.

Thing to remember:

Qualifying widow(er) (ie surviving spouse) filing status is available for two years after the death of a spouse. The taxpayer must maintain a household in which a qualifying *child* lives in for the *entire year*. Head of household filing status is available for unmarried taxpayers who paid for more than half the cost of maintaining a home in which a qualifying *dependent* lives in for *more than half the year*.

A company reported net income of \$400,000 on its Year 2 audited financial statements. The company reported \$240,000 in tax expenses to arrive at its net income for financial statement purposes in Year 2, as detailed below:

Federal income tax paid to the IRS	\$150,000
State income tax paid to state Q	50,000
Foreign income tax paid to country M	20,000
Property tax paid to state Q	15,000
Sales tax paid to state Q	5,000

The company will not take the foreign tax credit. What is the company's deduction for taxes paid on its Year 2 federal income tax return?

- A. \$70,000
- B. \$90,000
- C. \$170,000
- D. \$240,000

Item ID: 501255

Key: B

REG.CSO.20210701: REG.005.002.000

REG.SSO.20210701: Application:2

A company is allowed a **deduction** for **all ordinary and necessary expenses** paid or incurred in operating its trade or business. Examples include salaries, cost of goods sold, *taxes*, interest, rents, charitable contributions, employee benefits, and insurance.

However, for certain expenses (eg, foreign income taxes paid) a company is permitted to deduct the expense or elect a tax credit. If the *credit is elected*, then *no deduction* is allowed. The decision is generally based on whether the deduction or the credit produces the highest tax benefit.

Although businesses may deduct a wide variety of taxes, **no deduction for federal income taxes** is allowed when determining taxable income (**Choices C and D**). Deductible taxes include state and foreign income tax, property tax, sales tax, employment tax, and excise tax.

Here, the company decided to take the foreign tax deduction instead of the credit. Therefore, it may deduct all taxes with the exception of the federal income tax for a total of **\$90,000**.

State income tax paid to state Q	\$50,000
Foreign income tax paid to country M	20,000
Property tax paid to state Q	15,000
Sales tax paid to state Q	<u>5,000</u>
Deductible taxes	\$90,000

(Choice A) A deduction of \$70,000 excludes the \$20,000 foreign income taxes.

Things to remember:

A company may deduct all ordinary and necessary expenses paid or incurred (eg, taxes). When a deduction or a credit (eg, foreign income taxes) make be taken, if the credit is elected, then no deduction is allowed. Federal income taxes are never deductible.

A C corporation has a net loss from operations of \$500,000; a long-term capital gain of \$20,000; and a short-term capital loss of \$50,000 for the current year. What is the corporation's loss for the year?

- A. (\$530,000)
- B. (\$500,000)
- C. (\$497,000)
- D. (\$483,000)

Item ID: 63077

Key: B

REG.CSO.20210701: REG.005.003.001

REG.SSO.20210701: Application:2

In general, the disposition of a *capital asset* (eg, land, investments) results in a capital gain or loss. C corporations must *net* capital gains and losses (ie, capital losses may only offset capital gains). The netting process results in either an overall **net capital gain** or **net capital loss**.

If a C corporation has an overall net capital gain, that gain is reported as ordinary income. However, if a **net capital loss** results, **no deduction is allowed against** ordinary income. Instead, the corporation is required to *carry back* the loss *3 years* to offset (ie, reduce) any prior *capital gains*. Any remaining loss is then **carried forward** to offset future capital gains for up to 5 years.

Restricting the use of capital losses to offsetting capital gains prevents the corporation from significantly reducing taxable income in any single tax year by selling off its capital assets (eg, equipment) to substantially lower its taxes.

Here, the corporation has a *net capital loss* of \$30,000 (\$50,000 loss – \$20,000 gain) which is *not deductible*. It must be carried back and then forward to offset capital gains. Therefore, the corporation's loss is the **\$500,000 net loss from operations** (NOL). The NOL is carried forward indefinitely and may only offset up to 80% of taxable income.

Things to remember:

C corporations may use capital losses only to offset capital gains; no deduction is allowed for a net capital loss. Instead, the net capital loss is carried back 3 years and then carried forward 5 years to offset any capital gains. A net operating loss is carried forward indefinitely and may only offset up to 80% of taxable income.

Chris owns 25%, Tracy owns 35%, and Sam owns 40% of a business that has always been treated as an S corporation for federal income tax purposes. During the current year, \$500,000 of taxable income is generated.

Who is responsible for claiming the taxable income?

- A. The corporation.
- B. Chris, Tracy, and Sam, according to their profit distribution agreement.
- C. Chris, Tracy, and Sam, according to their percentage of ownership.
- D. Chris, Tracy, and Sam equally.

Item ID: 73061

Key: C

REG.CSO.20210701: REG.005.004.002

REG.SSO.20210701: Application:2

If certain requirements are met, a corporation may elect to be treated as an S corporation (a flow-through entity). S corporations provide the liability protection of a C corporation with the single level of taxation of a partnership.

As a **flow-through entity**, an S corporation *doesn't* pay entity-level income taxes (**Choice A**). Instead, an S corporation's ordinary business income (loss) and separately stated items are allocated according to the shareholders' **percentage of ownership** (eg, 25%, 35%, 40%) based on a per-share/per-day method (**Choice D**). The shareholders then include the reportable amounts on their personal tax returns and pay any taxes whether or not the profits are actually distributed.

(Choice B) A profit distribution agreement addresses when an S corporation makes distributions to the shareholders (eg, monthly, quarterly, year-end). Distributions, which are based on ownership, are generally nontaxable to extent of the shareholder basis.

Things to remember:

An S corporation's business income (loss) and separately stated items are allocated according to the shareholders' percentage of ownership based on a per-share/per-day method.

A C corporation made a proper S election and will be treated as an S corporation as of the first day of Year 2. In this case, the corporation is

- A. Subject to built-in gains tax for the 10-year period beginning with the first day of Year 2.
- B. Subject to built-in gains tax for the seven-year period beginning with the first day of Year 2.
- C. Not subject to built-in gains tax if Year 4 is the first year it sells assets that it held as a C corporation.
- D. Not subject to built-in gains tax if Year 7 is the first year it sells assets that it held as a C corporation.

Item ID: 505972

Key: D

REG.CSO.20210701: REG.005.004.005

REG.SSO.20210701: Remembering and Understanding:1

If certain requirements are met, a C corporation may elect to be treated as an S corporation (ie, a flow-through entity). The income or loss reported by an S corporation is allocated to the shareholders, who must pay tax on their pro rata share.

Although an S corporation is **not** subject to income taxes, other **corporate-level taxes** (eg, built-in gains [BIG], excessive net passive income) may apply if it was previously a C corporation. These taxes ensure that certain transactions do not escape taxation at the corporate level upon conversion to an S corporation.

The **BIG tax** applies when a C corporation elects S corporation status and the *fair market value* (FMV) of any asset held by the C corporation **exceeds** its *basis*. This difference is an **unrealized BIG** and represents the gain that would have been reported if the asset was sold prior to the S election.

The BIG tax *recognition period* is 5 years beginning once a C corporation officially converts into an S corporation (**Choices A and B**). If the asset is sold within **5 years** of electing S status, the gain is subject to the tax, assessed at the highest corporate rate (**Choice C**).

Things to remember:

The built-in-tax (BIG) tax applies when a C corporation elects S corporation status and the fair market value (FMV) of any asset held by the C corporation **exceeds** its basis. If a BIG asset is sold within 5 years of electing S status, the gain is subject to the tax, assessed at the highest corporate rate.

A partner controls 55% capital interest in a partnership and contributed six acres of land to the partnership. The property had a fair market value of \$41,000. The partner's basis in the property was \$35,000. Two years later, the partnership sold the land to an unrelated party for \$44,000. What amount of gain on the sale should be allocated to the partner that contributed the land?

- A. \$1,650
- B. \$2,700
- C. \$4,950
- D. \$7,650

Item ID: 60819

Key: D

REG.CSO.20210701: REG.005.005.004

REG.SSO.20210701: Application:2

When a partner contributes **appreciated property** (ie, FMV > partner's tax basis for the property) to a partnership (P/S) an **unrecognized built-in-gain** (ie, precontribution gain) exists. This gain is equal to the *difference* between the FMV and the property's tax basis on the contribution date.

The **contributing partner** is **allocated all** of the **unrecognized gain** when the P/S (1) *sells* the property or (2) distributes the property to another partner within 7 years. Any gain exceeding the unrecognized gain is *allocated* to **all** partners (including the contributing partner), based on their *percentage* of P/S interest (eg, 55%). This tax treatment prevents the *contributing* partner from shifting the unrecognized gain to other partners in the future.

Here, a partner, owning 55% of the P/S, contributed appreciated land with a \$6,000 unrecognized built-in-gain (\$41,000 FMV – \$35,000 basis). When the P/S sells the property for \$44,000, the total gain of \$9,000 (\$44,000 sale price – \$35,000 basis) is *divided* between the \$6,000 *built-in-gain* and the \$3,000 *appreciation* (\$44,000 sales – \$41,000 FMV) since the contribution. The *contributing* partner is allocated a **gain of \$7,650** as shown below.

Total gain (\$44,000 sale price – \$35,000 basis)	\$9,000
---	---------

100% of built-in-gain to contributing partner	<u>(6,000)</u>
Balance of gain allocated to all partners	\$3,000
Contributing partner's % ($\$3,000 \times 55\%$)	<u>(1,650)</u>
Balance to remaining partners	\$1,350
Contributing partner's total gain: $\$6,000 + \$1,650 = \$7,650$	

Things to remember:

A partner's contribution of appreciated property (FMV > partner's tax basis) to a partnership (P/S) results in an unrecognized built-in-gain. When the P/S sells the property, the built-in-gain is allocated to the contributing partner first. Any remaining gain is then allocated among all the partners according to percentage of P/S interest.

A partner received \$10,000 cash and an automobile with an adjusted basis of \$15,000 and a fair market value of \$5,000 from a partnership. The partner's basis in the partnership before the distribution was \$5,000. What amount, if any, was the partner's recognized gain?

- A. \$0
- B. \$5,000
- C. \$10,000
- D. \$20,000

Item ID: 73533

Key: B

REG.CSO.20210701: REG.005.005.006

REG.SSO.20210701: Application:2

When a partner receives a **nonliquidating** distribution of cash or property from a partnership (P/S), it is treated as a **nontaxable return of investment** to the extent of the **partner's basis**. Cash distributions are applied against a partner's basis first.

Because a P/S generally recognizes no gain or loss on distributions, the partner "steps into the shoes" of the P/S with respect to the *assets* distributed. Generally, the partner assumes a *carryover basis* (ie, the P/S adjusted tax basis) for assets. This treatment allows the partner to defer (ie, postpone) any gain or loss until the asset is later sold.

However, if *cash* distributions **exceed** a partner's basis, the excess is taxed as a **capital gain** to the partner. Property distributions (after considering cash distributions) that *exceed* a partner's *remaining* basis are **nontaxable** but assume a **basis** equal to the **remaining basis**, if any.

Here, the partner received a nonliquidating distribution of cash and an automobile. The \$10,000 cash distribution is applied against the partner's \$5,000 basis first, reducing the basis to \$0. The *remaining* **\$5,000** distribution (\$5,000 basis – \$10,000 cash distribution) is taxed as **capital gain**.

Although the partner's basis in the P/S is *reduced to \$0* after the cash distribution, the automobile distributed is still *nontaxable*. However, the partner has a *\$0 basis* in the automobile instead of the \$15,000 carryover basis.

Things to remember:

Nonliquidating partnership (P/S) distributions are generally treated as a nontaxable return of investment to the extent of a partner's basis. Cash distributions in excess of basis are taxed as a capital gain. Property distributions (after considering cash distributions) that exceed a partner's remaining basis are nontaxable.

Item 500479

Malin is married and files jointly. Last year, the IRS determined that the couple underpaid their tax liability due to fraud committed by Malin's spouse. What section and subsection of the Internal Revenue Code defines Malin's responsibility for the penalty related to the spouse's fraud?

Enter your response in the answer fields below. Guidance on correctly structuring your response appears above and below the answer fields.

Type the subsection here.

A correctly formatted IRC subsection is a lower case letter.

IRC§ ()

i Examples of correctly formatted IRC responses are IRC§1(a), IRC§56(a), IRC§25A(a), IRC§162(a), IRC§263A(a), IRC§1245(a), IRC§2032A(a) and IRC§1400Z-1(a).

Correct answer	IRC §6663(c)
Keyword search suggestions	Fraud, penalties, joint returns, underpayment
Solution	<p>Title 26. INTERNAL REVENUE CODE</p> <p>Subtitle F. Procedure and Administration</p> <p>Chapter 68. ADDITIONS TO THE TAX, ADDITIONAL AMOUNTS, AND ASSESSABLE PENALTIES</p> <p>Subchapter A. Additions to the Tax and Additional Amounts</p> <p>Part II. ACCURACY-RELATED AND FRAUD PENALTIES</p> <p>Section 6663 - Imposition of fraud penalty</p>
Excerpt	<p>Section 6663(c) Special rule for joint returns</p> <p>In the case of a joint return, this section shall not apply with respect to a spouse unless some part of the underpayment is due to the fraud of such spouse.</p>

Other considerations	None.
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Item: 507095

Scroll down to complete all parts of this task.

Patel & Company, CPAs, has been engaged to prepare the year 2 Form 1120S, U.S. Income Tax Return for an S Corporation, for Woodmere Corp., a calendar-year-end S corporation. Lawrence Black, controller of Woodmere, requested an explanation of the tax implications to both Woodmere and Samantha Diamond, one of the shareholders, resulting from the distribution of undeveloped land to Samantha.

You are a senior accountant with Patel & Company, CPAs, and were asked to review a draft letter prepared by a staff accountant to Woodmere. In addition to the draft letter below, the exhibits above include additional information related to Woodmere and the year 2 distribution of land, which should be used to review the draft letter.

To revise the document, click on each segment of underlined text below and select the needed correction, if any, from the list provided. If the underlined text is already correct, select [Original text] from the list.

Note: the exhibits are located at the end of the question.

Patel & Company, CPAs
745 Maple Street
Leston, OK 74862


December 27, year 2


Mr. Lawrence Black, CPA
Controller
Woodmere Corp.
943 Castlewall Avenue
Leston, OK 74862

Dear Lawrence:


We are responding to your inquiry regarding the tax implications of the year 2 distribution of land to Samantha Diamond, a 50% shareholder in Woodmere Corp. As discussed, Woodmere will not be making any elections regarding the distribution of the land and cash to its shareholders. A summary of how this distribution will impact the year 2 tax returns for both Woodmere and Samantha is included below.

Impact of distribution to Woodmere


We reviewed the documentation related to the land distribution to determine the potential tax ramifications to Woodmere. We have concluded that the distribution of the land to Samantha Diamond will result in the recognition of a tax gain to Woodmere of \$325,000, which will be reported on the year 2 Form 1120S. 

In addition, Woodmere's S corporation status will be immediately terminated, effective retroactively to January 2, year 1, if the fair market value of the land distributed exceeds 50% of the total tax basis of the land plus the anticipated year 2 cash distribution to Isaac. 

Impact of distribution to Samantha Diamond

The distribution of the 10 acres of land will result in a taxable corporate gain to be passed through, and Samantha's respective share will be reported on her year 2 individual tax return. The gain will be reported as a Section 1245 gain. 

Another consideration for this transaction is Samantha's tax basis in the land distributed to her. We have determined that Samantha's tax basis in the 10 acres of land is \$325,000. 

In conjunction with discussing the tax implications of the distribution to Samantha, it is important to determine Samantha's basis in Woodmere. As of January 1, year 2, Samantha's stock basis is \$305,825, before consideration of the distribution of land and year 2 income.  According to our calculations, the distribution will not exceed Samantha's basis at December 31, year 2.


If you have any questions regarding the above information, please contact me.

Sincerely,

Brandon

Brandon Patel, CPA
Patel & Company, CPAs

Response 1

We reviewed the documentation related to the land distribution to determine the potential tax ramifications to Woodmere. We have concluded that the distribution of the land to Samantha Diamond will result in the recognition of a tax gain to Woodmere of \$325,000, which will be reported on the year 2 Form 1120S. 

Choose an option below

- ☐ *[Original text]* We have concluded that the distribution of the land to Samantha Diamond will result in the recognition of a tax gain to Woodmere of \$325,000, which will be reported on the year 2 Form 1120S.
- ☐ We have concluded that the distribution of the land to Samantha Diamond will result in the recognition of a tax gain to Woodmere of \$325,000, which will be reported on Samantha's year 2 Schedule K-1.
- ☐ We have concluded that the distribution of the land to Samantha Diamond will result in the recognition of a tax gain to Woodmere of \$200,000, which will be reported on Samantha's year 2 Schedule K-1.
- ☐ We have concluded that the distribution of the land to Samantha Diamond will result in the recognition of a tax gain to Woodmere of \$200,000, which will be reported on the year 2 Form 1120S.

RESET

CANCEL

ACCEPT

Key

We reviewed the documentation related to the land distribution to determine the potential tax ramifications to Woodmere. **We have concluded that the distribution of the land to Samantha Diamond will result in the recognition of a tax gain to Woodmere of \$200,000, which will be reported on the year 2 Form 1120S.** ✓

Choose an option below

- ☐ *[Original text]* We have concluded that the distribution of the land to Samantha Diamond will result in the recognition of a tax gain to Woodmere of \$325,000, which will be reported on the year 2 Form 1120S.
- ☐ We have concluded that the distribution of the land to Samantha Diamond will result in the recognition of a tax gain to Woodmere of \$325,000, which will be reported on Samantha's year 2 Schedule K-1.
- ☐ We have concluded that the distribution of the land to Samantha Diamond will result in the recognition of a tax gain to Woodmere of \$200,000, which will be reported on Samantha's year 2 Schedule K-1.
- ☒ We have concluded that the distribution of the land to Samantha Diamond will result in the recognition of a tax gain to Woodmere of \$200,000, which will be reported on the year 2 Form 1120S.

RESET

CANCEL

ACCEPT

... to determine the potential tax ramifications to Woodmere. **We have concluded that the distribution of the land to Samantha Diamond will result in the recognition of a tax gain to Woodmere of \$200,000, which will be reported on the Year 2 Form 1120S.**


Guidance:

IRC Section 311(b)(1)(B) - Taxability of corporation on distribution

Generally, no gain or loss is recognized by an S corporation on the distribution of property in a nonliquidating distribution. However, if an S corporation distributes **appreciated property** (ie, FMV > basis), the corporation must recognize a **gain** as if the property were *sold* to the shareholder at its FMV.

Here, the S corporation made a nonliquidating distribution of appreciated undeveloped land that was not used in Woodmere's trade or business (ie, \$525,000 FMV > \$325,000 basis) (from Exhibits 1 and 2). Accordingly, Woodmere reports a **gain of \$200,000** (\$525,000 – \$325,000) on Form 1120S.

Response 2

In addition, Woodmere's S corporation status will be immediately terminated, effective retroactively to January 2, year 1, if the fair market value of the land distributed exceeds 50% of the total tax basis of the land plus the anticipated year 2 cash distribution to Isaac. 

Choose an option below

- ☐ *[Original text]* In addition, Woodmere's S corporation status will be immediately terminated, effective retroactively to January 2, year 1, if the fair market value of the land distributed exceeds 50% of the total tax basis of the land plus the anticipated year 2 cash distribution to Isaac.
- ☐ In addition, if the fair value of the property is greater than 20% of the fair market value of the corporation on the date of the distribution, the distribution will terminate Woodmere's S corporation status.
- ☐ In addition, this distribution will not have any impact on Woodmere's S corporation status since you are making an equal distribution of cash to Isaac.
- ☐ In addition, to ensure that you do not inadvertently terminate Woodmere's S corporation status, one-half of the land must be distributed to each shareholder.
- ☐ In addition, you inadvertently terminated Woodmere's S corporation status because you did not make an equal distribution to Isaac at the time the land was distributed to Samantha.

RESET

CANCEL

ACCEPT

Key

In addition, this distribution will not have any impact on Woodmere's S corporation status since you are making an equal distribution of cash to Isaac. 

Choose an option below

- ☐ *[Original text]* In addition, Woodmere's S corporation status will be immediately terminated, effective retroactively to January 2, year 1, if the fair market value of the land distributed exceeds 50% of the total tax basis of the land plus the anticipated year 2 cash distribution to Isaac.
- ☐ In addition, if the fair value of the property is greater than 20% of the fair market value of the corporation on the date of the distribution, the distribution will terminate Woodmere's S corporation status.
- ☒ In addition, this distribution will not have any impact on Woodmere's S corporation status since you are making an equal distribution of cash to Isaac.
- ☐ In addition, to ensure that you do not inadvertently terminate Woodmere's S corporation status, one-half of the land must be distributed to each shareholder.
- ☐ In addition, you inadvertently terminated Woodmere's S corporation status because you did not make an equal distribution to Isaac at the time the land was distributed to Samantha.

RESET

CANCEL

ACCEPT

In addition, this distribution will not have any impact on Woodmere's S corporation status since you are making an equal distribution of cash to Isaac.

Guidance:

IRC Section 1361(b)(1)(D) - S corporation defined

To be eligible to make an S election, a corporation may only have **one class of stock**. IRS regulations state that a corporation is treated as having only one class of stock if all outstanding shares of stock of the corporation confer *identical rights to distribution* and liquidation proceeds (eg, each shareholder receives an equivalent distribution).

Here, an equivalent cash distribution to the other shareholder, Isaac Elwood, is scheduled to be made before the end of Year 2 (from Exhibit 1). Therefore, the S status will **not** be terminated.

Response 3

The distribution of the 10 acres of land will result in a taxable corporate gain to be passed through, and Samantha's respective share will be reported on her year 2 individual tax return. The gain will be reported as a Section 1245 gain.

Choose an option below

- ☐ [Original text] The gain will be reported as a Section 1245 gain.
- ☐ The gain will be reported as a Section 1250 gain.
- ☐ The gain will be reported as an unrecaptured Section 1250 gain.
- ☐ The gain will be reported as a capital gain.
- ☐ The gain will be reported as ordinary business income.

RESET

CANCEL

ACCEPT

Key

The distribution of the 10 acres of land will result in a taxable corporate gain to be passed through, and Samantha's respective share will be reported on her year 2 individual tax return. The gain will be reported as a capital gain.

Choose an option below

- ☐ [Original text] The gain will be reported as a Section 1245 gain.
- ☐ The gain will be reported as a Section 1250 gain.
- ☐ The gain will be reported as an unrecaptured Section 1250 gain.
- ☒ The gain will be reported as a capital gain.
- ☐ The gain will be reported as ordinary business income.


RESET

CANCEL

ACCEPT

The gain will be reported as a capital gain.	
Guidance:	IRC Section 1221 - Capital asset defined
<p>When an S corporation recognizes a gain on the distribution of appreciated property, the <i>nature</i> of the gain depends on the <i>type of property</i>. Net Section 1231 gains received <i>capital gain</i> treatment. Section 1245 gain (ie, depreciation recapture) applies to Section 1231 depreciable personal property (eg, equipment) and Section 1250 gain (ie, depreciation recapture) applies to Section 1231 real property (eg, buildings). A capital asset is property owned by a taxpayer that is <i>not</i> inventory, a receivable, Section 1231 property, self-created intangible property, or consumable supplies.</p> <p>Here, Woodmere distributed appreciated undeveloped land that originally was acquired to be used in S corporation's trade or business and held > 1 year (from Exhibit 1). Therefore, it is considered a Section 1231 asset subject to Section 1250 recapture, if any. However, land is a nondepreciable asset. Therefore, Woodmere has a net Section 1231 gain with <i>no Section 1250</i> recapture and the gain receives capital gain treatment.</p>	

Response 4

Another consideration for this transaction is Samantha's tax basis in the land distributed to her. We have determined that Samantha's tax basis in the 10 acres of land is \$325,000. 

Choose an option below

- ☐ [Original text] We have determined that Samantha's tax basis in the 10 acres of land is \$325,000.
- ☐ We have determined that Samantha's tax basis in the 10 acres of land is \$425,000.
- ☐ We have determined that Samantha's tax basis in the 10 acres of land is \$525,000.
- ☐ We have determined that Samantha's tax basis in the 10 acres of land is \$625,000.
- ☐ We have determined that Samantha's tax basis in the 10 acres of land is \$725,000.

RESET

CANCEL

ACCEPT

Key

Another consideration for this transaction is Samantha's tax basis in the land distributed to her. We have determined that Samantha's tax basis in the 10 acres of land is \$525,000. ✓

Choose an option below

- ☐ [Original text] We have determined that Samantha's tax basis in the 10 acres of land is \$325,000.
- ☐ We have determined that Samantha's tax basis in the 10 acres of land is \$425,000.
- ☒ We have determined that Samantha's tax basis in the 10 acres of land is \$525,000.
- ☐ We have determined that Samantha's tax basis in the 10 acres of land is \$625,000.
- ☐ We have determined that Samantha's tax basis in the 10 acres of land is \$725,000.

RESET

CANCEL

ACCEPT

We have determined that Samantha's tax basis in the 10 acres of land is \$525,000.


Guidance:

IRC Section 301(d) - Distributions of property

Because the corporation has recognized the gain on property distributed in a nonliquidating distribution, the shareholder's **basis** for the property **equals** to the **FMV** on the date of the distribution.

Therefore, Samantha's basis in the undeveloped land is its **FMV of \$525,000** (from Exhibit 2).

Response 5

In conjunction with discussing the tax implications of the distribution to Samantha, it is important to determine Samantha's basis in Woodmere. As of January 1, year 2, Samantha's stock basis is \$305,825, before consideration of the distribution of land and year 2 income. 

Choose an option below

- ☐ *[Original text]* Samantha's stock basis is \$305,825, before consideration of the distribution of land and year 2 income.
- ☐ Samantha's stock basis is \$351,875, before consideration of the distribution of land and year 2 income.
- ☐ Samantha's stock basis is \$351,875, and her debt basis is \$1,000,000, before consideration of the distribution of land and year 2 income.
- ☐ Samantha's stock basis is \$251,875, before consideration of the distribution of land and year 2 income.
- ☐ Samantha's stock basis is \$251,875, and her debt basis is \$1,000,000, before consideration of the distribution of land and year 2 income.
- ☐ Samantha's stock basis is \$256,875, before consideration of the distribution of land and year 2 income.
- ☐ Samantha's stock basis is \$256,875, and her debt basis is \$1,000,000, before consideration of the distribution of land and year 2 income.
- ☐ Samantha's stock basis is \$305,825, and her debt basis is \$1,000,000, before consideration of the distribution of land and year 2 income.

RESET

CANCEL

ACCEPT

Key

In conjunction with discussing the tax implications of the distribution to Samantha, it is important to determine Samantha's basis in Woodmere. As of January 1, year 2, **Samantha's stock basis is \$251,875, before consideration of the distribution of land and year 2 income.** ✓

Choose an option below

- ☐ [Original text] Samantha's stock basis is \$305,825, before consideration of the distribution of land and year 2 income.
- ☐ Samantha's stock basis is \$351,875, before consideration of the distribution of land and year 2 income.
- ☐ Samantha's stock basis is \$351,875, and her debt basis is \$1,000,000, before consideration of the distribution of land and year 2 income.
- ☒ Samantha's stock basis is \$251,875, before consideration of the distribution of land and year 2 income.
- ☐ Samantha's stock basis is \$251,875, and her debt basis is \$1,000,000, before consideration of the distribution of land and year 2 income.
- ☐ Samantha's stock basis is \$256,875, before consideration of the distribution of land and year 2 income.

RESET

CANCEL

ACCEPT

As of January 1, Year 2...**Samantha's stock basis is \$251,875, before consideration of the distribution of land and Year 2 income.**

Guidance:

IRC Section 1366 - Pass-thru of items to shareholders
Treasury Regulation 1.1366-2(a)(2)(i) - Pass-thru of items to shareholders
IRC section 1367 - Adjustments to basis of stock of shareholders, etc.

Shareholders in S corporations have two bases: stock and debt. Both bases are important regarding the amount of losses than may be deducted by the shareholder. The **stock basis** consists of the shareholder's *initial investment* in the S corporation. This basis is *increased and/or decreased* each year based on the pass-through amounts from the S corporation reported to the shareholder on their Schedule K-1.

To establish debt basis, the S corporation's debt must be owed **directly** to the **shareholder**. A shareholder's *personal guarantee* of an S corporation's debts or loans to third parties does **not** create debt basis for the shareholder.

Here, Samantha's initial contribution is adjusted for the Year 1 pass-through items as shown below. The **stock basis is \$251,875** at the end of Year 1 and before consideration of the

distribution of land and Year 2 income (from Exhibit 1).

Initial cash contribution	\$150,000
Reported share of Year 1 ordinary business income	155,825
Reported share of Year 1 interest income	1,050
Reported share of Year 1 nondeductible expenses	(5,000)
Year 1 cash distribution	<u>(50,000)</u>
Year 1 ending basis	\$251,875

Samantha has **no debt basis** in the corporation because no personal loans were made. The personal guarantee given on the S corporation's \$2,000,000 bank loan does *not* create debt basis (from Exhibit 1).

Exhibits Information

Exhibits included in this item **1. Client Letter**

2. Attorney Letter

Exhibit for Item: 507095

Exhibit 1: Client Letter

December 20, Year 2

Dear Brandon:

We made a property distribution to Samantha Diamond in Year 2 and would like to know the tax implications of the transaction to Woodmere and Samantha. This letter contains background information on Woodmere's formation and the events prior to the distributions.

On January 2, Year 1, Woodmere Corp. was formed, and an election was made to be taxed as an S corporation for federal income tax purposes. Woodmere is a retailer of electronic products. Two individuals, Samantha Diamond and Isaac Elwood, each contributed \$150,000 in cash in exchange for 50% stock ownership interests in Woodmere. Also in year 1, Woodmere took out an interest-only \$2,000,000 loan from a local bank with payment due in full on December 31, Year 6; both shareholders personally guaranteed payment of this loan. Both Samantha and Isaac actively participate in the management of Woodmere.

On February 1, Year 1, Woodmere paid \$325,000 for 10 acres of undeveloped land, on which it planned to construct a distribution warehouse. However, before starting construction, a more suitable location was found with an existing warehouse. The undeveloped land was not used in Woodmere's trade or business. On March 1, Year 1, Woodmere entered into a 20-year lease of the existing warehouse and began business.

Information reported to each shareholder on each shareholder's year 1 Schedule K-1, Shareholder's Share of Income, Deductions, Credits, etc., included the following:

Ordinary business income	\$155,825
Interest income	\$1,050
Nondeductible expenses	\$5,000
Cash distribution	\$50,000

On November 3, Year 2, the undeveloped land (purchased on February 1, Year 1) was distributed to Samantha Diamond. An equivalent cash distribution to Isaac is scheduled to be made before the end of Year 2.

Please provide an explanation of the tax implications to both Woodmere and Samantha Diamond resulting from the distribution of undeveloped land.

Sincerely,

Lawrence

Lawrence Black
Controller

Exhibit for Item: 507095

Exhibit 2: Attorney Letter

Davis & Davis, Attorneys at Law

5613 Cedar Avenue

Leston, OK 74862

November 30, Year 2

Ms. Samantha Diamond
Woodmere Corp.
943 Castlewall Avenue
Leston, OK 74862

Dear Samantha:

Enclosed is the deed for 10 acres of land located on Greenston Street in Leston, OK. The transfer of this property to you was recorded with the county on November 3, Year 2.

Sincerely,

Reynaldo

Reynaldo Davis, Esq.

Brandon - we have an appraisal for the land dated November 3, Year 2, showing a fair market value of \$525,000. Please let me know if you need a copy of this appraisal for your records.

Item: 500851

Scroll down to complete all parts of this task.

The controller of Oak Corp., a calendar-year-end C corporation, asked you to determine how the sale of various assets should be reported. The controller provided you with the information below for the transactions in Year 7. Treat each sale as an independent transaction.

Using the information provided, complete the following table. For each sale in the table below: In column B, enter the gain or loss recognized on the sale of the asset. Enter gains as positive, whole values and losses as negative, whole values. If there is no gain or loss, enter a zero (0).

In column C, click in the cell and select from the option list provided the character of the gain or loss recognized. If there is no gain or loss, select "Not applicable."

	<i>A</i>	<i>B</i>	<i>C</i>
1	Transaction	Gain/loss recognized	Treatment of gain/loss
2	Oak sold 1,000 shares of Rose Corp. stock held for investment on June 15, year 7, for total proceeds of \$10,000. Oak originally purchased 500 shares of Rose Corp. stock on October 10, year 4, for a total cost of \$2,000. On July 15, year 6, there was a 4-for-1 stock split.	123 \$9,000	123 Long-term capital gain/loss
3	Equipment previously used in Oak's business with a useful life of five years for tax purposes was sold on September 20, year 7, for net proceeds of \$45,000. The equipment was originally purchased for \$57,000 on March 1, year 1.	123 \$45,000	123 Ordinary income/loss
4	Inventory was sold on December 15, year 7, for \$8,000. The inventory had a cost basis of \$12,000 and was subsequently written down to \$7,000 only for book purposes on December 31, year 6.	123 (\$4,000)	123 Ordinary income/loss
5	An automobile used in Oak's business was sold for its fair market value of \$15,000 on May 15, year 7, to a shareholder owning 60% of Oak's stock. The automobile was purchased by Oak for \$35,000 on February 1, year 4, and the tax basis on the date of sale was \$22,000.	123 \$0	123 Not applicable

Background information

There are three main types of business assets: ordinary income, Section 1231, and capital assets. Knowing the type of asset that a business sells, or disposes, is essential to ensuring the proper tax treatment of any *recognized* loss gain or loss

1. **Ordinary income assets** are generally current assets that were acquired or produced with the intention of being sold in the ordinary course of business (eg, inventory, receivables). All gains and losses are taxed at the ordinary tax rates.
2. **Section 1231 assets** are noncurrent business assets used in the trade or business and held *longer than one year*, whose eventual sale or disposal is only incidental to the business (eg, land, buildings, equipment). Gains and losses from these assets are netted. A net gain is treated as a *long-term capital gain* that can be used to offset net capital losses that otherwise might not have been deductible in the current year. A net loss is treated as an *ordinary loss*, so it is fully deductible.
3. **Capital assets** are *nonbusiness* assets that do not qualify as ordinary income or Section 1231 assets (eg, investments). Capital assets result in either a short-term (ie, held for \leq 1 year) or long-term (ie, held for $>$ 1 year) capital gain (loss).

Gains from Section 1231 assets that are depreciable personal property (eg, equipment, vehicles) are subject to **Section 1245 recapture**. Because the depreciation deductions were ordinary deductions, the tax code requires that the gains be reported as **ordinary income** to the extent of the **prior depreciation, or the gain realized**.

Because transactions with **related parties** (eg, shareholders) are not at arm's length, losses are **not** recognized. The related party may only use the loss to offset any gain realized (but not below zero) when the asset is later sold to an unrelated party.

Authoritative guidance:

IRC Section 267 - Losses, expenses, and interest with respect to transactions between related taxpayers

IRC section 1221 - Capital asset defined

IRC Section 1231 - Property used in the trade or business and involuntary conversions

IRC Section 1245 - Gain from dispositions of certain depreciable property

Row 2: Sale of 1,000 shares of Rose Coporation stock

Oak sold 1,000 shares of stock for \$10,000 in Year 7 that it owned since Year 4. Stock held as an investment is a *capital asset*. Because Oak owned the stock for $>$ one year, the result will be either a **long-term capital gain or loss**.

Oak purchased 500 shares for \$2,000. To determine the gain or loss, the stock must be adjusted for the 4-1 stock split that occurred in the previous year. After the split, Oak owns 2,000 shares (500 shares \times 4) with a basis of \$2,000 or \$1 per share.

If 1,000 shares are sold with a basis of \$1,000 ($\$1 \times 1,000$) for \$10,000, a **\$9,000 long term capital gain** results ($\$10,000 - \$1,000$).

Row 3: Sale of equipment

Equipment used in a business with a life > 1 year is a Section 1231 asset. If the equipment is sold at a *gain*, it is subject to **Section 1245 depreciation recapture** as **ordinary income**. The amount of Section 1245 recapture is the *lesser of the realized gain or the depreciation taken*.

Here equipment was sold for \$45,000 in Year 7 that was acquired in Year 1 for \$57,000. Since it had a 5-year useful life it would be *fully depreciated* in Year 7 (ie, depreciation taken equals \$57,000). Therefore, the adjusted basis would be \$0 at the time of the sale.

The gain on the sale is \$45,000 ($\$45,000$ proceeds $- \$0$ basis). Because the gain is less than the \$57,000 depreciation taken, the **\$45,000** is depreciation recaptured and reported as **ordinary income**.

Row 4: Sale of inventory

Inventory is an **ordinary income** producing asset. For tax purposes gains and losses must be realized in order to be recognized; therefore, the write-down of inventory for book purposes is *not* recognized for tax purposes.

Here, inventory was sold for \$8,000 that had a cost of \$12,000, resulting in a **\$4,000 ordinary loss**. The write down from \$12,000 to \$7,000 the prior year for book purposes has no effect on determining the loss for tax purposes.

Row 5: Sale of automobile to a shareholder

No loss may be recognized from sales between related parties such as corporation and its shareholder. The loss is deferred and may be used to offset any gain (but not below \$0) when the buyer sells the asset to an unrelated party.

Here, Oak sold an automobile to one of its shareholders for \$15,000. Since the tax basis (ie, cost less accumulated depreciation) was \$22,000 on the sale of the sale, Oak has \$7,000 ($\$15,000 - \$22,000$) realized loss of which **\$0 is recognized**.