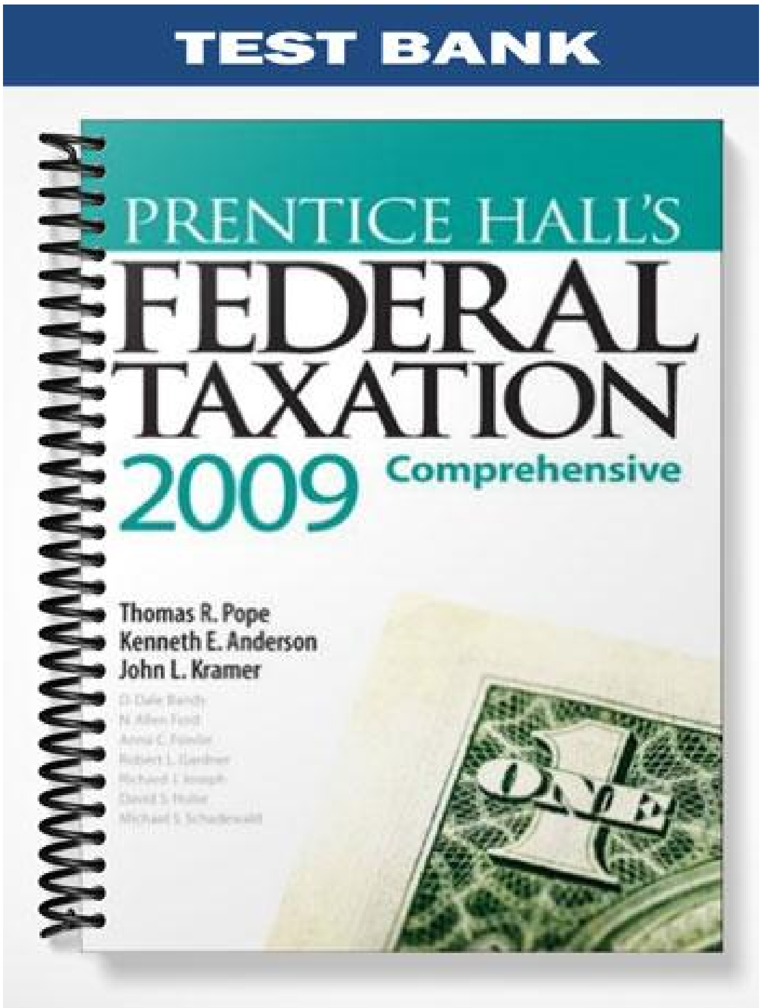
TEST BANK
PRENTICE HALL'S
FEDERAL
TAXATION
2009
Comprehensive
Thomas R. Pope
Kenneth E. Anderson
John L. Kramer
ONE

TEST ITEM FILE

Susan Anderson
Caroline Strobel

PRENTICE HALL'S FEDERAL TAXATION 2009:

Comprehensive

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Operations Specialist: Michelle Klein
Printer/Binder: Courier / Kendallville
Cover Printer: Phoenix Color Corp. / Hagerstown

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10 9 8 7 6 5 4 3 2 1

ISBN 978-0-13-606688-0
ISBN 0-13-606688-7

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Preface

The test bank provides approximately 2,400 true-false, multiple choice, short-answer, essay, and issue identification questions which can be used in the preparation of student examinations. Each question contains the correct answer and a page reference to the Prentice-Hall Federal Taxation, 2009: Comprehensive text. Many questions include a cross-reference to examples from the text and/or supporting calculations.

Also available for the 2009 Edition is TestGenEQ test management software. This new software is completely user-friendly and allows instructors to view, edit and add test questions; select questions randomly or manually; create tests using drag-and-drop or point-and-click transfer; and print in a variety of formats. The software includes a built-in Question Editor, which allows instructors to add or modify questions, and a Graphing tool, which enables instructors to insert graphics to customize exams. TestGen also has built-in utilities including a glossary of terms; a spell checker; and the QuizMaster program which allows you to set preferences for the availability of a test, customize grading scale, and view and print reports for students, classes, and courses. TestGen offers many options for organizing and displaying tests, and we hope this new software proves to be an invaluable resource for your testing needs.

The lecture outline computer files are available on line at http://www.prenhall.com/phtax. A password and userid is required, and can be obtained from your Prentice Hall representative. If you do not know your Prentice Hall representative you may call the Accounting & tax Hotline at 1-800-227-1816 or email acctng&tax_hotline@prenhall.com. (You may also request the files to be sent via email.)

We would appreciate receiving any corrections for subsequent revisions from those instructors who have adopted the text. In addition, we would appreciate suggestions for new problems or questions for the next Edition of this volume to enhance coverage of existing problem materials. Our thanks go out to those individuals who have alerted us to errors in the test bank for the previous editions. These errata items have been corrected in this test bank. If you locate what you believe to be an error, please submit the page with the error and the appropriate correction(s) to Dr. Kenneth E. Anderson. You may submit the correction to Dr. Anderson via mail, fax or email. Dr. Anderson's contact information is as follows: Department of Accounting and Business Law, University of Tennessee, Knoxville, Tennessee 37996-0560, (865) 974-1753. Fax: (865) 974-4631 or kea@utk.edu. A prompt reply will be provided concerning all possible errors.

Sincerely,

Kenneth E. Anderson
Thomas R. Pope
John L. Kramer

Chapter I1

An Introduction to Taxation

True-False

I1:1. The federal income tax is the dominant form of taxation by the federal government. T, p. I1-2.

I1:2. The Sixteenth Amendment permits the passage of a federal income tax. T, p. I1-2.

I1:3. When a change in the tax law is deemed necessary by Congress, the entire Internal Revenue Code must be revised. F, p. I1-3.

Solution: The federal income tax law is changed on an incremental basis.

I1:4. A progressive tax rate structure is one where the rate of tax increases as the tax base increases. T, p. I1-4.

I1:5. The terms "progressive tax" and "flat tax" are synonymous. F, p. I1-4.

Solution: A proportional tax and flat tax are synonymous.

I1:6. A proportional tax rate is one where the rate of the tax is the same for all taxpayers, regardless of income levels. T, p. I1-4.

I1:7. Regressive tax rates decrease as the tax base increases. T, p. I1-5.

I1:8. The marginal tax rate is useful in tax planning because it measures the tax effect of a proposed transaction. T, p. I1-5.

I1:9. A taxpayer's average tax rate is the tax rate applied to an incremental amount of taxable income that is added to the tax base. F, p. I1-5.

Solution: The marginal tax rate is the tax rate applied to an incremental amount of taxable income.

I1:10. If a taxpayer's total tax liability is $30,000, taxable income is $100,000, and economic income is $120,000, the average tax rate is 30 percent. T, p. I1-5.

I1:11. If a taxpayer's total tax liability is $4,000, taxable income is $20,000 and total economic income is $40,000, then the effective tax rate is 20 percent. F, p. I1-5.

Solution: The effective rate would be $4,000/$40,000 = 10 percent.

I1:12. Although each different type of taxpayer determines taxable income in the same manner, the determination of tax liability differs because of differing tax rate schedules. F, p. I1-7.

Solution: Each different type of taxpayer (individuals, corporations, etc.) computes taxable income in a slightly different manner.

I1:13. All states impose a state income tax which is generally based on an individual's federal adjusted gross income (AGI) with minor adjustments. F, p. I1-7.

Solution: While many states impose a state income tax, not all states do. In those states that do impose tax, the taxes vary greatly in both form and rates.

I1:14. The unified transfer tax system, comprised of the gift and estate taxes, is based upon the total property transfers an individual makes during lifetime and at death. T, p. I1-7.

I1:15. Gifts between spouses are generally exempt from transfer taxes. T, p. I1-8.

I1:16. The primary liability for payment of the gift tax is imposed upon the donee. F, p. I1-8.

Solution: The gift tax is imposed on the donor.

I1:17. For gift tax purposes, a $12,000 annual exclusion per donee is permitted. T, p. I1-8.

I1:18. Property is generally valued on an estate tax return at the fair market value at the date of death or alternate valuation date. T, p. I1-9.

I1:19. Property transferred to the decedent's spouse is exempt from the estate tax because of the estate tax marital deduction provision. T, p. I1-10.

I1:20. Gifts made during a taxpayer's lifetime may affect the amount of estate tax paid by the taxpayer's estate. T, p. I1-10.

I1:21. While federal and state income taxes as well as the federal gift and estate taxes are generally progressive in nature, property taxes are proportional. T, p. I1-12.

I1:22. The primary objective of the federal income tax law is to achieve various economic and social policy objectives. F, p. I1-14.

Solution: The primary objective of the federal income tax law is to raise revenues for government operations.

I1:23. The tax law encompasses administrative and judicial interpretations, such as Treasury regulations, revenue rulings, revenue procedures, and court decisions, as well as statutes. T, p. I1-14.

I1:24. Individuals are the principal taxpaying entities in the federal income tax system. T, p. I1-17.

I1:25. The various entities in the federal income tax system may be classified into two general categories, *taxpaying entities* (such as individuals and regular corporations) and *flow-through entities* such as sole proprietorships, partnerships, S corporations, and limited liability companies. T, p. I1-17.

I1:26. In 2008, dividends paid from most U.S. corporations are taxed at the same rate as the recipient's salaries and wages. F, p. I1-19.

I1:27. Flow-through entities do not have to file tax returns since they are not taxable entities. F, p. I1:20.

I1:28. S Corporations result in a single level of taxation. T, p. I1-22.

I1:29. In a limited liability partnership, a partner is liable for his or her own acts of negligence or misconduct. T, p. I1-23.

I1:30. Limited liability companies may elect to be taxed as corporations. T, p.I1-23.

I1:31. Limited liability company members (owners) are responsible for the liabilities of their limited liability company. F, p. I1-23.

I1:32. Generally, tax legislation is introduced first in the Senate and referred to the Senate Finance Committee. F, p. I1-24.

Solution: A tax bill is introduced in the House and referred to the Ways and Means Committee.

I1:33. The Internal Revenue Service is the branch of the Treasury Department responsible for administering the federal tax law. T, p. I1-26.

I1:34. Generally the statute of limitations is three years from the later of the date the tax return is filed or the due date. T, p. I1-28.

Multiple Choice

I1:35. Arthur pays tax of $3,000 on taxable income of $30,000 while taxpayer Barbara pays tax of $6,000 on $60,000. The tax is a

a. Progressive tax.
b. Proportional tax.
c. Regressive tax.
d. None of the above.

b, p. I1-4; I1-12 Example I:1-3. Solution: The tax rate is proportional because the 10% tax rate applies to both taxpayers regardless of their income level.

I1:36. Which of the following taxes is progressive?

a. Sales tax.
b. Excise tax.
c. Property tax.
d. Income tax.

d, p. I1-4, I1-12.

I1:37. Which of the following taxes is proportional?

a. Gift tax.
b. Income tax.
c. Sales tax.
d. Federal Insurance Contributions Act (FICA).

c, p.I1-4, I1-12.

I1:38. Which of the following taxes is regressive?

a. Federal Insurance Contributions Act (FICA).
b. Excise tax.
c. Property tax.
d. Gift tax.

a, p. I1-4, I1-12.

I1:39. Sarah contributes $20,000 to a church. Sarah's marginal tax rate is 35% while her average tax rate is 25%. After considering her tax savings, Sarah's contribution costs

a. $5,000.
b. $7,000.
c. $13,000.
d. $15,000.

c, p. I1-5, Example I:1-4. Solution: [$20,000 x (100% - 35%)] = $13,000.

I1:40. Helen, who is single, is considering purchasing a residence that will provide a $25,000 tax deduction for property taxes and mortgage interest. If her marginal tax rate is 25% and her effective tax rate is 20%, what is the amount of Helen's tax savings from purchasing the residence?

a. $5,000
b. $6,250
c. $11,250
d. $25,000

b, p. I1-5; Example I :1-4. Solution: $25,000 x .25 marginal rate = $6,250 tax savings.

I1:41. Charlotte pays $16,000 in tax deductible property taxes. Charlette's marginal tax rate is 25%, effective tax rate is 20% and average rate is 22%. Charlette's tax savings from paying the property tax is

a. $3,200.
b. $3,520.
c. $4,000.
d. $8,000.

c, p. I1-5. Solution: $16,000 x 0.25 = $4,000.

I1:42. Anne, who is single, has taxable income for the current year of $28,000 while total economic income is $33,000 resulting in a total tax of $3,822. Anne's average tax rate and effective tax rate are, respectively,

a. 13.65% and 11.58%
b. 15% and 11.58%
c. 11.58% and 13.65%.
d. 15% and 13.65%.

a, p. I1-6; Example I:1-5. Solution:

$3,822 ÷ $28,000 = 0.1365
$3,822 ÷ $33,000 = 0.1158

I1:43. The unified transfer tax system

a. imposes a single tax upon transfers of property during an individual's lifetime only.
b. imposes a single tax upon transfers of property during an individual's life and at death.
c. imposes a single tax upon transfers of property only at an individual's death.
d. none of above.

b, p. I1-7. Solution: The gift (transfers during life) tax and estate (transfers after death) tax systems are unified.

I1:44. When property is transferred, the gift tax is based on

a. replacement cost of the transferred property.
b. fair market value on the date of transfer.
c. the transferor's original cost of the transferred property.
d. the transferor's depreciated cost of the transferred property.

b, p. I1-8. Solution: The gift tax is based on the property's fair market value on the date of transfer.

I1:45. Paul makes the following property transfers in the current year

- $22,000 cash to his wife
- $34,000 cash to a qualified charity
- $120,000 house to his son
- $3,000 computer to an unrelated friend

The total of Paul's taxable gifts, assuming he does not elect gift splitting with his spouse, subject to the unified transfer tax is

a. $108,000.
b. $123,000.
c. $145,000.
d. $179,000.

a, p. I1-8; Example I:1-6. Solution: $120,000 - $12,000 = $108,000. The gift to the unrelated friend is below the $12,000 annual gift tax exclusion. The gifts to his wife and to the charity are not subject to gift tax.

I1:46. Charlie makes the following gifts in the current year: $25,000 to his spouse, $20,000 to his church, $18,000 to his nephew, and $25,000 to a friend. Assuming Charlie does not elect gift splitting with his wife, his taxable gifts in the current year will be

a. $13,000.
b. $19,000.
c. $27,000.
d. $40,000.

b, p. I1-8; Example I:1-6. Solution: ($18,000 - $12,000) + (25,000 - $12,000) = $19,000.

I1:47. Shaquille buys new cars for five of his friends. Each car cost $40,000. What is the amount of

Shaquille's taxable gifts?

a. $0
b. $140,000.
c. $188,000.
d. $200,000.

b, p. I1:8. Solution: (5 x 40,000) – (5 x 12,000) = 140,000

I1:48. In 2008, an estate is not taxable unless the sum of the taxable estate and taxable gifts made after 1976 exceeds

a. $1,500,000.
b. $2,000,000.
c. $3,500,000.
d. $5,000,000.

b, p. I1-9. Example I:1-7.

I1-49. Eric dies in the current year and has a gross estate valued at $1,500,000. The estate incurs funeral and administrative expenses of $100,000 and also pays off Eric's debts which amount to $250,000. Eric bequeaths $600,000 to his wife. Eric made no taxable transfers during his life. Eric's taxable estate will be

a. $550,000.
b. $900,000.
c. $1,150,000.
d. $1,500,000.

a, p. I1-10; Example I:1-8. Solution: ($1,500,000 - $100,000 - $250,000 - $600,000) = $550,000.

I1:50. Thomas dies in the current year and has a gross estate valued at $3,000,000. During his lifetime (but after 1976) Thomas had made taxable gifts of $400,000. The estate incurs funeral and administrative expenses of $100,000 and also pays off Thomas' debts which amount to $300,000. Thomas bequeaths $500,000 to his wife. What is the amount of Thomas' tax base, the amount on which the estate tax is computed?

a. $2,100,000
b. $2,500,000
c. $2,600,000
d. $3,400,000

b, p. I1-10; Example I:1-8. Solution: ($3,000,000 - $100,000 - $300,000 - $500,000 = $2,100,000 taxable estate + $400,000 gifts = $2,500,000 tax base).

I1:51. Denzel earns $120,000 this year through his job as a sales manager. What is his FICA tax?

a. $7,459.
b. $7,803.
c. $8,064.
d. $9,180.

c, p. I1-11 Solution: (102,000 x .062) + (120,000 x. .0145) = 8,064.

I1:52. Martha is self-employed in 2008. Her business profits are $140,000. What is her self-employment tax?

a. $15,606.
b. $16,708.
c. $21,420.
d. None of the above.

b, p. I1-11 Solution: (102,000 x .124) + (140,000 x .029) =16,708

I1:53. Which of the following statements is <u>incorrect</u>?

a. Property taxes are levied on real estate.
b. Excise taxes are assessed on items such as gasoline and telephone use.
c. Gift taxes are levied on the recipient of a gift.
d. The estate tax is based on the fair market value of property at death or the alternate
valuation date.

c, p. I1-8 to I1-11. Gift taxes are levied on the donor of a gift, not the recipient.

I1:54. Which of the following is <u>not</u> one of Adam Smith's canons of taxation?

a. equity
b. convenience
c. certainty.
d. paid by all citizens.

d, p. I1-11. Smith's canon's of taxation are equity, certainty, convenience and economy

I1:55. Horizontal equity means that

a. taxpayers with the same amount of income pay the same amount of tax.
b. taxpayers with larger amounts of income should pay more tax than taxpayer's with lower amounts of income.
c. all taxpayers should pay the same tax.
d. none of the above.

a, p. I1-12.

I1:56. Vertical equity means that

a. taxpayers with the same amount of income pay the same amount of tax.
b. taxpayers with larger amounts of income should pay more tax than taxpayer's with lower amounts of income.
c. all taxpayers should pay the same tax.
d. none of the above.

b, p. I1-12.

I1:57. All of the following are classified as flow-through entities for tax purposes except

a. partnerships
b. C corporations
c. S corporations
d. limited liability companies

b, p. I1-17. Solution: A C corporation is a taxpaying entity.

I1:58. Rocky and Charlie form RC Partnership as equal partners. Rocky contributes $100,000 into RC while Charlie contributes real estate with a fair market value of $100,000. During the current year, RC earned net income of $600,000. The partnership distributes $200,000 to each partner. The amount that Rocky should report on his individual tax return is

a. $0.
b. $100,000.
c. $200,000.
d. $300,000.

d, p. I1-21; Example I:1-18. Solution: Rocky must report 50% x $600,000 or $300,000, his share of partnership net income. The distribution of $200,000 is not taxable but rather nontaxable return of capital reducing Rocky's basis ($100,000 original investment + $300,000 share of income) by $200,000 to $200,000.

I1:59. AB Partnership earns $500,000 in the current year. Partners A and B are equal partners who do not receive any distributions during the year. How much income does partner A report from the partnership?

a. $0.
b. $250,000.
c. $500,000.
d. None of the above.

b, p. I1-21, Example I:1-18. $500,000 x .5 = $250,000.

I1:60. In an S corporation, shareholders

a. are taxed on their proportionate share of earnings.
b. are taxed only on dividends.
c. may allocate income among themselves in order to consider special contributions.
d. are only taxed on salaries.

a, p. I1-22.

I1:61. All of the following statements are true except

a. The net income earned by a sole proprietorship is reported on the owner's individual income tax return.
b. The net income of an S corporation is subject to double taxation because it is taxed at the entity level and dividends paid from the S corporation to individual shareholders are also taxed.
c. The net income of C corporation is subject to double taxation because it is taxed at the entity level and dividends paid from the C corporation to individual shareholders is also taxed.
d. LLCs are generally taxed as partnerships.

b, pp. I1-22 and I1-23. Solution: An S Corporation is a flow-through entity, not a taxable entity. The items of income/loss are allocated to each shareholder who pays tax on the items on their individual income tax returns.

I1:62. Which of the following is not an advantage of a limited liability company (LLC)?

a. limited liability for all members of a LLC.
b. ability to choose between taxation as a partnership or corporation.
c. double taxation.
d. all of the above are advantages of an LLC.

c, p. I1-22.

I1:63. What is a limited liability partnership?

a. It is the same as a limited partnership where the general partner has unlimited liability.
b. Partners have unlimited liability arising from his or her own acts of negligence or misconduct or similar acts of any person under his or her direct supervision.
c. All partners have limited liability regarding all partnership activities.
d. All partners have unlimited liability.

b, p. I1:23.

I1:64. The term "tax law" includes
- a. Internal Revenue Code.
- b. Treasury Regulations.
- c. Judicial decisions.
- d. all of the above

d, p. I1-24. Solution: The Code is a legislative source; the Regulations are an administrative source, and judicial decisions are judicial sources of tax law.

I1:65. Which of the following serves as the highest authority for tax research, planning, and compliance activities?
- a. Internal Revenue Code
- b. Income Tax Regulations
- c. Revenue Rulings
- d. Revenue Procedures

a, p. I1-24 and I1-25; Topic Review I:1-3.

I1:66. All of the following are executive (administrative) sources of tax law <u>except</u>
- a. Internal Revenue Code.
- b. Income Tax Regulations.
- c. Revenue Rulings.
- d. Revenue Procedures.

a, p. I1-25; Topic Review I:1-3. Solution: The Internal Revenue Code is a legislative source.

I1:67. Which of the following steps, related to a tax bill, occurs first?
- a. signature or veto by the President of the United States.
- b. consideration by the Senate.
- c. consideration by the House Ways and Means Committee.
- d. consideration by the Joint Conference Committee.

c, p. I1-24. Solution: Most tax legislation originates in the House of Representatives and is then referred to the House Ways and Means Committee.

I1:68. A tax bill introduced in the House of Representatives is then
- a. referred to the House Ways and Means Committee for hearings and approval.
- b. referred to the full House for hearings.
- c. forwarded to the Senate Finance Committee for consideration.
- d. voted upon by the full House.

a, p. I1-24. Solution: Most tax legislation originates in the House of Representatives and is then referred to the House Ways and Means Committee.

I1:69. When new tax legislation is being considered by Congress,

a. the tax bill will usually originate in the Senate.

b. different versions of the House and Senate bills are reconciled by the Speaker of the House and the President of the Senate.

c. different versions of the House and Senate bills are reconciled by a Joint Conference Committee.

d. after the President of the U.S. approves a tax bill, the Joint Conference Committee must then vote on passage of the bill.

c, p. I1-25. Solution: The Joint Conference Committee reconciles the House and Senate bills.

I1:70. The Senate equivalent of the House Ways and Means Committee is the Senate

a. Joint Committee on Taxation.

b. Ways and Means Committee.

c. Finance Committee.

d. Joint Conference Committee.

c, p. I1-25. Solution: The Senate Finance Committee considers tax legislation.

I1:71. When returns are processed, they are scored to determine their potential for yielding additional

tax revenues. This program is called

a. Taxpayer Compliance Measurement Program.

b. Discriminant Function System.

c. Standard Audit Program.

d. Field Audit Program.

b, p. I1-27.

I1:72. Which of the following individuals is most likely to be audited?

a. Lola has AGI of $35,000 from wages and uses the standard deduction.

b. Marvella has a $145,000 net loss from her unincorporated business (a horse farm). She also received $350,000 salary as a CEO of a corporation.

c. Melvin is retired and receives Social Security benefits.

d. Jerry is a school teacher with two children earning $45,000 a year. He also receives $200 in interest income on a bank account.

b, p. I1-27. Solution: Of those listed, the taxpayer with investments or trade or business expenses that produce significant losses, Marvella, is more likely to be audited.

I1:73. Alan files his 2008 tax return on April 1, 2009. His return contains no misstatements or omissions of income. The statute of limitations for changes to the return expires

a. April 1, 2012.
b. April 15, 2012.
c. April 15, 2015.
d. The statute of limitations never expires.

d, p.I1-28. The three-year statute applies.

I1-74. Peyton has adjusted gross income of $20,000,000 on his 2007 tax return, filed April 15, 2008. He accidentally failed to include $200,000 that he received for a television advertisement. How long does the IRS have to audit Peyton's federal tax return?

a. Until April 15, 2011.
b. Until April 15, 2012.
c. Until April 15, 2014.
d. The IRS can audit Peyton's return at any future date.

a, p. I1-28. The omission does not meet the 25% of reported income level, so the three-year statute still applies. Since the omission was accidental, the rules for fraud do not apply.

I1-75. Latashia reports $100,000 of taxable income on her 2008 tax return, filed April 15, 2009. She omits $30,000 of income, but the error was not fraudulent. When does the statute of limitations for examining her tax
return expire?

a. April 15, 2012.
b. April 15, 2015.
c. April 15, 2018.
d. It never expires.

d, p. I1-28. Solution: The six-year statute applies since over 25% of income was omitted.

I1:76 The IRS must pay interest on

a. All tax refunds.
b. Tax refunds paid later than 30 days after the due date.
c. Tax refunds paid later than 45 days after the due date.
d. The IRS never pays interest on tax refunds.

c, p. I1-28. Example I:1-27.