TT TEXTBOOK TESTBANKS

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Taxation for Business Entities: A Practical Approach 2026
Test Bank
Chapter 1: Basics of Business Entity Taxation

1) Which of the following correctly lists the four main stages in the lifecycle of a business entity?
A) Income Recognition – Asset Purchase – Tax Deduction – Closure
B) Startup funding – Business operations – Investment - Termination
C) Formation – Business operations – Distributions to owners – Liquidation or sale
D) Planning – Hiring employees – Paying taxes – Filing closure forms

Answer: C
Explanation: The first stage is the formation of the entity, when the owners contribute cash or assets to the entity in exchange for an ownership interest such as stock or a partnership interest. The second stage is the taxation of the operations of the business. The third stage is the distribution of profits to the owners. The fourth stage is when the entity ends, which can be a liquidating distribution to the owners or a sale by the owners of the business.
Diff: 1
Learning Objective: LO 1.1
AACSB / AICPA: Analytic / FC: Analysis; PC: None; BB: None
Bloom's: Knowledge
Time on Task: 2 min

2) Which of the following is not a question that arises when a business is formed?
A) What basis does each shareholder have in their stock?
B) What is each shareholder's realized gain or loss from the transaction?
C) Does the IRS approve of the business?
D) What basis does the corporation have in the assets received?

Answer: C
Explanation: Some of the tax issues that arise when a corporation is formed is: (1) What is each shareholder's realized gain or loss from the transaction? (2) Is each shareholder's realized gain or loss recognized? (3) Does the corporation recognize any gains or losses? (4) What basis does each shareholder have in their stock? (5) What basis does the corporation have in the assets received?. Approval of the business by the IRS is not a tax question that needs to be answered.
Diff: 2
Learning Objective: LO 1.1
AACSB / AICPA: Analytic / FC: Analysis; PC: None; BB: None
Bloom's: Knowledge
Time on Task: 2 min

3) Why are the topics of income, deductions, and property transactions much shorter in business entity taxation compared to individual taxation?
A) Business entities are not required to report income or deductions.
B) Business entities follow a completely different tax code from individuals.
C) The fundamental tax rules for income and deductions are generally the same for both individuals and business entities.
D) Business entities are only taxed on dividends and charitable contributions.

Answer: C
Explanation: The main reason is that the fundamental income tax rules related to income, deductions, and property transactions for businesses are generally the same rules as those for individuals.
Diff: 1
Learning Objective: LO 1.1
AACSB / AICPA: Analytic / FC: Analysis; PC: None; BB: None
Bloom's: Application
Time on Task: 2 min

4) Which of the following provides that a business is a distinct entity from its owners?
A) Entity theory
B) Operating distribution
C) Liquidating distribution
D) Business theory

Answer: A
Explanation: The entity theory provides that a business is a distinct entity from its owners.
Diff: 1
Learning Objective: LO 1.1
AACSB / AICPA: Analytic / FC: Analysis; PC: None; BB: None
Bloom's: Knowledge
Time on Task: 2 min

5) Once a business entity generates income,
A) the income is distributed to the owners as an operating distribution.
B) the income is distributed to the owners as a liquidating distribution.
C) the income is distributed to the owners when they request a distribution.
D) the income is owned by the entity.

Answer: D

Explanation: Under the entity theory, once a business entity has generated income, the income is owned by the entity. The business owners do not have access to the income until it is distributed to them. Furthermore, distributions are not automatically made.
Diff: 2
Learning Objective: LO 1.1
AACSB / AICPA: Analytic / FC: Analysis; PC: None; BB: None
Bloom's: Application
Time on Task: 3 min

6) An owner can terminate their interest in a business by
A) receiving an operating distribution.
B) receiving a liquidating distribution
C) selling their interests in the business.
D) Either B or C

Answer: D
Explanation: Owners can completely terminate their interests in a business by receiving a liquidating distribution or selling their ownership interests.
Diff: 1
Learning Objective: LO 1.1
AACSB / AICPA: Analytic / FC: Analysis; PC: None; BB: None
Bloom's: Knowledge
Time on Task: 2 min

7) Which of the following statements is correct?
A) A gain, loss, or neither will result when a liquidating distribution is made.
B) A gain or loss will result when a liquidating distribution is made.
C) A gain will result when a liquidating distribution is made.
D) A loss will result when a liquidating distribution is made.

Answer: A
Explanation: One of the tax issues that must be addressed when liquidating distributions are made is whether there is a gain or loss. There may be a gain, loss, or the distribution may be equal to the basis, resulting in no gain or loss.
Diff: 2
Learning Objective: LO 1.1
AACSB / AICPA: Analytic / FC: Analysis; PC: None; BB: None
Bloom's: Application
Time on Task: 3 min

8) Which of the following is not a separate business entity?

A) Corporation
B) Sole proprietorship
C) Limited liability partnership
D) Business trust

Answer: B
Explanation: All of the following are separate legal entities: corporation, general partnership, limited partnership, limited liability partnership, limited liability company, and business trust. A sole proprietorship is not a separate business entity
Diff: 1
Learning Objective: LO 1.1
AACSB / AICPA: Analytic / FC: Analysis; PC: None; BB: None
Bloom's: Knowledge
Time on Task: 2 min

9) Which of the following statements accurately compares general partnerships, limited partnerships, and limited liability partnerships?
A) All partners of each type of partnership are liable for damages committed by other partners.
B) All partnerships must have at least one general partner and one limited partner.
C) All partnerships must have one or more owners.
D) All partners of each type of partnership share profits, losses, and liquidation proceeds.

Answer: D
Explanation: All partners, regardless of the partnership entity type, share profits, losses, and liquidation proceeds. Only limited partnerships have both general and limited partners. Partners have limited liability in limited partnerships and limited liability partnerships, but not in general partnerships. All partnerships must have two or more owners.
Diff: 2
Learning Objective: LO 1.1
AACSB / AICPA: Analytic / FC: Analysis; PC: None; BB: None
Bloom's: Application
Time on Task: 4 min

10) Which of the following best describes a corporation?
A) A business that shares liability with its owners
B) A legal entity formed by a partnership agreement
C) A business that has met state requirements to become a distinct legal entity
D) A business structure that does not require state filing

Answer: C
Explanation: A corporation is a business that has met a state's requirements to organize as a legal entity that is distinct from its owners. In most states, the owners file articles of

incorporation with the state and elect a board of directors.
Diff: 1
Learning Objective: LO 1.1
AACSB / AICPA: Analytic / FC: Analysis; PC: None; BB: None
Bloom's: Knowledge
Time on Task: 2 min

11) A business for which two or more taxpayers own and operate the business, and there is at least one general partner and one limited partner, is a:
A) General partnership
B) Limited partnership
C) Limited liability partnership
D) Limited liability company

Answer: B
Explanation: A limited partnership is a business for which two or more taxpayers agree to own and operate the business, and to share profits, losses, and liquidation proceeds.
Diff: 1
Learning Objective: LO 1.1
AACSB / AICPA: Analytic / FC: Analysis; PC: None; BB: None
Bloom's: Knowledge
Time on Task: 2 min

12) To create a corporation, the owners must
A) risk their personal assets to the creditors of the corporation.
B) loan the corporation money.
C) elect a board of directors.
D) determine general vs. limited ownership status.

Answer: C
Explanation: In most states, the owners file articles of incorporation with the state and elect a board of directors.
Diff: 2
Learning Objective: LO 1.1
AACSB / AICPA: Analytic / FC: Analysis; PC: None; BB: None
Bloom's: Comprehension
Time on Task: 2 min

13) Which of the following is not a characteristic of a limited liability company?
A) Owners are known as members.
B) Professional service providers are required to organize as an LLC.
C) Articles of organization are filed to establish the entity.

D) All owners have limited liability.

Answer: B
Explanation: Articles of organization must be filed with the state in which the LLC is legally organized. Owners of an LLC are known as members. All members have limited liability. Many states do not allow professional service providers such as accountants and attorneys to organize as an LLC.
Diff: 2
Learning Objective: LO 1.1
AACSB / AICPA: Analytic / FC: Analysis; PC: None; BB: None
Bloom's: Comprehension
Time on Task: 3 min

14) Which entity type holds the rights to an individual's stake or interest in a business?
A) Business trust
B) Corporation
C) General partnership
D) Limited liability company

Answer: A
Explanation: A business trust is a legal entity that holds the rights to an individual's stake or interest in a business.
Diff: 1
Learning Objective: LO 1.1
AACSB / AICPA: Analytic / FC: Analysis; PC: None; BB: None
Bloom's: Knowledge
Time on Task: 1 min

15) What federal tax form is used when a corporation has not elected to be taxed as an S corporation?
A) Form 1041
B) Form 1065
C) Form 1120
D) Form 1120-S

Answer: C
Explanation: A corporation that does not elect S status is a C corporation and files Form 1120.
Diff: 1
Learning Objective: LO 1.1
AACSB / AICPA: Analytic / FC: Analysis; PC: None; BB: None
Bloom's: Knowledge
Time on Task: 1 min

16) Which of the following is not a business tax form?
A) Form 990
B) Form 1040
C) Form 1065
D) Form 1120

Answer: B
Explanation: All are forms used by entities except Form 1040, which is the tax form used by individuals.
Diff: 2
Learning Objective: LO 1.1
AACSB / AICPA: Analytic / FC: Analysis; PC: None; BB: None
Bloom's: Analysis
Time on Task: 2 min

17) Corporate tax returns are due ________.
A) two and one-half months after the end of the year
B) three and one-half months after the end of the year
C) A or B, depending on the entity's year-end
D) None of the above

Answer: C
Explanation: Corporate tax returns (other than those with a June 30 year-end) are due three and one-half months after the end of the tax year. Corporate tax returns with a June 30 year-end are due two and one-half months after the end of the year

Diff: 1
Learning Objective: LO 1.2
AACSB / AICPA: Analytic / FC: Analysis; PC: None; BB: None
Bloom's: Knowledge
Time on Task: 2 min

18) A request for extension filed on Form 7004 allows a taxpayer six additional months to ________.
A) pay the tax liability and file the return
B) pay the tax liability or file the return
C) file the return
D) pay the tax liability

Answer: C
Explanation: The extension of time is only to file the return. The entity must pay the taxes due

for the year by the original due date or the IRS will assess a late payment penalty. This provides taxpayers with more time to finalize their return for filing, but they do need to estimate their liability for the year to ensure they have paid the appropriate amount the original due date.
Diff: 1
Learning Objective: LO 1.2
AACSB / AICPA: Analytic / FC: Analysis; PC: None; BB: None
Bloom's: Knowledge
Time on Task: 2 min

19) In the prior year, ABC Company reported gross income of $200,000 on its tax return. It failed to include $10,000 of taxable income related to an accounting error. What is the applicable statute of limitations?
A) 2 years
B) 3 years
C) 6 years
D) Never expires

Answer: B
Explanation: If a return is filed and less than 25% of gross income is understated on the original tax return, the statute of limitations is three years from the later of the due date of the return or the date the return was filed. ABC’s understatement = $10,000/$200,000 = 5%. Since 5% is less than 25%, the statute of limitations is three (3) years.
Diff: 2
Learning Objective: LO 1.2
AACSB / AICPA: Analytic / FC: Analysis; PC: None; BB: None
Bloom's: Application
Time on Task: 3 min

20) In the prior year, XYZ, Inc. reported gross income of $200,000 on its tax return. XYZ deducted nondeductible expenses in the amount of $54,000 in error. XYZ did not fraudulently make the error. What is the applicable statute of limitations?
A) 2 years
B) 3 years
C) 6 years
D) Never expires

Answer: C
Explanation: If a return is filed and more than 25% of gross income is understated on the original tax return, the statute of limitations is six years from the later of the due date of the return or the date the return was filed. XYZ's understatement = $54,000/$200,000 = 27%. Since 27% is more than 25%, the statute of limitations is six (6) years.
Diff: 2

Learning Objective: LO 1.2
AACSB / AICPA: Analytic / FC: Analysis; PC: None; BB: None
Bloom's: Application
Time on Task: 3 min

21) In the prior year, Brightwell Company did not file its tax return. It was a start-up business with a minimal amount of taxable income in the amount of $5,000. What is the applicable statute of limitations?
A) 2 years
B) 3 years
C) 6 years
D) Never expires

Answer: D
Explanation: The statute of limitations never expires if an entity fails to file a return. Because Brightwell did not file its return, the statute of limitation is indefinite (i.e., no expiration date).
Diff: 2
Learning Objective: LO 1.2
AACSB / AICPA: Analytic / FC: Analysis; PC: None; BB: None
Bloom's: Application
Time on Task: 3 min

22) When the statute of limitations has expired, the period is referred to as a:
A) Closed year
B) Open year
C) Statute of assessment
D) Statute of limitations

Answer: A
Explanation: If the statute of limitations has expired, that year is a closed year.
Diff: 1
Learning Objective: LO 1.2
AACSB / AICPA: Analytic / FC: Analysis; PC: None; BB: None
Bloom's: Knowledge
Time on Task: 2 min

23) If a partnership filed its Form 1065 on February 22, Year 1, when will the statute of limitations expire?
A) February 22, Year 4
B) February 22, Year 5
C) March 15, Year 4
D) March 15, Year 5

Answer: C
Explanation: The statute of limitations is three years from the later of the due date of the tax return or the date the return was filed. Since the due date, May 15, Year 1, is later than the date filed, February 22, Year 1, the statute of limitations will expire three years from the due date, May 15, Year 4.
Diff: 2
Learning Objective: LO 1.2
AACSB / AICPA: Analytic / FC: Analysis; PC: None; BB: None
Bloom's: Application
Time on Task: 3 min

24) If a C corporation's Form 1120 was filed on May 17, Year 1, when will the statute of limitations expire?
A) May 17, Year 4
B) May 17, Year 5
C) April 15, Year 4
D) April 15, Year 5

Answer: A
Explanation: The statute of limitations is three years from the later of the due date of the tax return or the date the return was filed. Since the date filed, May 17, Year 1, is later than the due date, April 15, Year 1, the statute of limitations will expire three years from the date filed, May 17, Year 4.
Diff: 2
Learning Objective: LO 1.2
AACSB / AICPA: Analytic / FC: Analysis; PC: None; BB: None
Bloom's: Application
Time on Task: 3 min

25) What is the taxpayer penalty that is imposed when a taxpayer fails to file a required tax return on time?
A) Failure to file penalty
B) Underpayment of estimated tax
C) Failure to pay penalty
D) Accuracy penalty

Answer: A
Explanation: The taxpayer penalty that is imposed when a taxpayer fails to file a required tax return on time, including the extension period if an extension is timely filed, is the failure to file penalty.
Diff: 1

Learning Objective: LO 1.2
AACSB / AICPA: Analytic / FC: Analysis; PC: None; BB: None
Bloom's: Knowledge
Time on Task: 2 min

26) Atlas Corporation failed to file its tax return by the required due date of April 15, 2026. The return was filed on May 1, 2026, and the tax owed with the return was $2,000. How much is the failure to file penalty?
A) $50
B) $100
C) $500
D) $525

Answer: B
Explanation: The failure to file penalty is 5% per month of the tax due with the return, with a maximum penalty of 25% of the tax due. The minimum penalty is the lesser of $525 (2025) or the amount of tax due, but the provision does not apply if the tax return is filed within 60 days of the due date. Atlas filed its return 15 days late (less than 60 days), so the minimum penalty amount does not apply. Penalty = $2,000 tax due × 5% (1 month) = $100
Diff: 2
Learning Objective: LO 1.2
AACSB / AICPA: Analytic / FC: Analysis; PC: None; BB: None
Bloom's: Application
Time on Task: 3 min

27) Clearline Company failed to file its corporate tax return by the required due date of April 15, 2026. The return was filed on July 1, 2026, and the tax due with the return was $2,900. How much is the failure to file penalty?
A) $145
B) $435
C) $525
D) $725

Answer: C
Explanation: The failure to file penalty is 5% per month of the tax due with the return, with a maximum penalty of 25% of the tax due. The minimum penalty is the lesser of $525 (2025) or the amount of tax due, but the provision does not apply if the tax return is filed within 60 days of the due date. Clearline filed its return 76 days late (more than 60 days), so the minimum penalty amount applies. Regular penalty = $2,900 tax due × 15% (3 months) = $435. Since the minimum amount, $525, is larger than $435, the penalty is $525.
Diff: 2
Learning Objective: LO 1.2

AACSB / AICPA: Analytic / FC: Analysis; PC: None; BB: None
Bloom's: Application
Time on Task: 3 min

28) Whitestone, Inc. filed its tax return on December 15, 2025. It did not file for an automatic extension and owed $5,200 with the return. How much is the failure to file penalty?
A) $525
B) $1,300
C) $1,820
D) $2,080

Answer: B
Explanation: The failure to file penalty is 5% per month of the tax due with the return, with a maximum penalty of 25% of the tax due. Whitestone filed her return eight months late. Eight months multiplied by 5% per month is 40%, so the penalty will be the maximum penalty of 25%.
Penalty = $5,200 tax due × 25% (maximum penalty) = $1,300
Diff: 2
Learning Objective: LO 1.2
AACSB / AICPA: Analytic / FC: Analysis; PC: None; BB: None
Bloom's: Application
Time on Task: 3 min

29) Whitestone, Inc., an S corporation with 10 shareholders, filed its 2025 tax return on December 15, 2026. It did not file for an automatic extension. How much, if any, penalty is assessed on the entity?
A) $255
B) $2,040
C) $2,550
D) $20,400

Answer: D
Explanation: S corporations must pay a penalty equal to $255 (2025) per shareholder for each month, or part of a month, that the return is late. The penalty is assessed for no more than 12 months. Whitestone filed the return eight months late. Eight months multiplied by $255 is $2,040. $2,040 is the amount due per shareholder, so that amount multiplied by 10 shareholders equals a penalty in the amount of $20,400.
Diff: 2
Learning Objective: LO 1.2
AACSB / AICPA: Analytic / FC: Analysis; PC: None; BB: None
Bloom's: Application
Time on Task: 3 min

30) West Corporation, an S corporation with 10 shareholders, filed its tax return 15 months late. It did not file for an automatic extension. How much, if any, penalty is assessed on the entity?
A) $3,060
B) $3,825
C) $30,600
D) $38,250

Answer: C
Explanation: S corporations must pay a penalty equal to $255 (2025) per shareholder for each month, or part of a month, that the return is late. The penalty is assessed for no more than 12 months. West filed the return 15 months late, so the penalty is assessed on 12 months. Twelve months multiplied by $255 is $3,060. $3,060 is the amount due per shareholder, so that amount multiplied by 10 shareholders equals a penalty in the amount of $30,600.
Diff: 2
Learning Objective: LO 1.2
AACSB / AICPA: Analytic / FC: Analysis; PC: None; BB: None
Bloom's: Application
Time on Task: 3 min

31) Jackson Brothers, a partnership with two partners, filed its tax return six months late. An automatic extension was not filed. How much, if any, penalty is assessed on the entity?
A) $255
B) $510
C) $3,060
D) $6,120

Answer: C
Explanation: Partnerships must pay a penalty equal to $255 (2025) per partner for each month, or part of a month, that the return is late. The penalty is assessed for no more than 12 months. Jackson filed the return six months late. Six months multiplied by $255 is $1,530. $1,530 is the amount due per partner, so that amount multiplied by two partners and equals a penalty in the amount of $3,060.
Diff: 2
Learning Objective: LO 1.2
AACSB / AICPA: Analytic / FC: Analysis; PC: None; BB: None
Bloom's: Application
Time on Task: 3 min

32) Harlow Company made a $5,000 estimated tax payment on January 15, 2026, and filed its 2025 tax return timely on April 15, 2026. It made no other estimated tax payments. Its current year tax liability is $4,900, and the prior year tax liability was $4,600. Will Harlow be subject to an underpayment of estimated tax penalty?

A) Yes, because the amount paid throughout the year was less than the liability.
B) Yes, because the amount paid was paid at the end of the year and not throughout the year.
C) No, because she paid her entire tax liability by the fourth quarter estimate payment due date.
D) No, because she paid in her entire tax liability by the tax return due date.

Answer: B
Explanation: Harlow will be subject to the underpayment of estimated tax penalty. Estimated payments are required to be paid on income throughout the year (not all at the end of the year). Although Harlow paid 100% of the past year's tax liability, it did not make payments throughout the year. As a result, an underpayment of estimated tax penalty will apply.
Diff: 3
Learning Objective: LO 1.2
AACSB / AICPA: Analytic / FC: Analysis; PC: None; BB: None
Bloom's: Evaluation
Time on Task: 4 min

33) Which of the following is an exception to the underpayment of estimated tax penalty for corporations?
A) The tax due with the return is less than $500.
B) The tax payments made during the year were at least 90% of the past year's taxes.
C) The tax payments made during the year were at least 100% of that year's taxes.
D) The tax liability for the year is less than $1,000.

Answer: C
Explanation: The only exception that is stated correctly is that the tax payments made during the year were at least 100% of that year's taxes.
Diff: 2
Learning Objective: LO 1.2
AACSB / AICPA: Analytic / FC: Analysis; PC: None; BB: None
Bloom's: Application
Time on Task: 3 min

34) Benji Co. had taxable income of $150,000 and gross receipts of $500,000, which was earned evenly during the tax year. The total tax liability reported on the return is $31,500, and the prior year tax liability was $25,000. Benji paid estimated tax of $25,000 evenly throughout the year. How much is the underpayment of estimated tax penalty?
A) $0
B) $325
C) $525
D) $1,625

Answer: A

Explanation: Benji underpaid its taxes during the year by $6,500 ($31,500 - $25,000), but the following exception applies: Benji paid 100% of its previous year tax liability, which was $25,000 ($25,000 × 100%). Thus, penalty = $0.
Diff: 2

35) What is the taxpayer penalty that is imposed if a business fails to pay the tax reflected on the tax return by the due date?
A) Failure to file penalty
B) Underpayment of estimated tax penalty
C) Failure to pay penalty
D) Accuracy penalty

Answer: C
Explanation: If a business has not paid all the tax due by the filing deadline, the IRS will assess a failure to pay penalty.
Diff: 1
Learning Objective: LO 1.2
AACSB / AICPA: Analytic / FC: Analysis; PC: None; BB: None
Bloom's: Knowledge
Time on Task: 2 min

36) BC Company filed its tax return by April 15, but it paid the balance due of $3,000 on the return 60 days late on June 14. Assume the federal short-term interest rate is 4%. How much will the IRS assess BC for interest and penalties?
A) $30
B) $35
C) $50
D) $65

Answer: D
Explanation: BC will be subject to the failure to pay penalty and interest on the late payment. The penalty for failure to pay is 0.5% per month, but no larger than 25% total. Penalty = $3,000 tax due × 1% (2 months) = $30. The applicable interest rate is the federal short-term interest rate, 4%, plus 3%, so 7%. Interest = $3,000 tax due × 7% × 60/365 = $35. Total interest and penalties = $30 + $35 = $65
Diff: 2
Learning Objective: LO 1.2
AACSB / AICPA: Analytic / FC: Analysis; PC: None; BB: None
Bloom's: Application
Time on Task: 5 min

37) Watts, Inc. failed to file its tax return by April 15. The return was filed, and a payment for

the tax due in the amount of $4,000 was made, 68 days late on June 22. Assume the federal short-term interest rate is 4%. How much will the IRS assess Watts for interest and penalties?
A) $600
B) $652
C) $923
D) $1,052

Answer: B
Explanation: Moira will be subject to the failure to file and failure to pay penalties and interest on the late payment. The maximum combined penalty for failure to file and failure to pay is 5% per month (or portion thereof), but no larger than 25% total. Combined penalty = $4,000 tax due × 15% (3 months) = $600. Interest = $4,000 tax due × 7% × 68/365 = $52. Total interest and penalties = $600 + $52 = $652.
Diff: 3
Learning Objective: LO 1.2
AACSB / AICPA: Analytic / FC: Analysis; PC: None; BB: None
Bloom's: Evaluation
Time on Task: 5 min

38) The IRS may waive the failure to file and failure to pay penalties if a business has reasonable cause for failing to file or filing to pay. Which of the following is a reasonable cause?
A) Irregularities in mail delivery
B) Inability to pay the tax due
C) Staff shortage
D) Misplacement of accounting records

Answer: A
Explanation: The IRS can waive the failure to file and the failure to pay penalties if a business has a reasonable cause for failing to file or failing to pay. A reasonable cause is one outside the control of a business, such as irregularities in mail delivery, death or serious illness, unavoidable absence, or disaster.
Diff: 2
Learning Objective: LO 1.2
AACSB / AICPA: Analytic / FC: Analysis; PC: None; BB: None
Bloom's: Analysis
Time on Task: 2 min

39) A reasonable basis means that________.
A) at least one primary authority supports the taxpayer’s position and has not been overruled.
B) tax rules are disregarded without reasonable cause.
C) a taxpayer has a greater than 50% chance of succeeding if the taxpayer takes the position to court.

D) there is a great likelihood that a taxpayer's position would be supported if the matter were taken to court.

Answer: A
Explanation: A reasonable basis means that at least one primary authority supports the taxpayer's position and has not been overruled.
Diff: 1
Learning Objective: LO 1.2
AACSB / AICPA: Analytic / FC: Analysis; PC: None; BB: None
Bloom's: Knowledge
Time on Task: 2 min

40) What is an intentional disregard of rules and regulations without intent to defraud?
A) Inaccurate position
B) Negligence
C) Substantial understatement
D) Gross misvaluation

Answer: B
Explanation: Negligence is defined as an intentional disregard of rules and regulations without intent to defraud.
Diff: 1
Learning Objective: LO 1.2
AACSB / AICPA: Analytic / FC: Analysis; PC: None; BB: None
Bloom's: Knowledge
Time on Task: 2 min

41) Bubbly Company's 2023 return was audited by the IRS. Bubbly failed to recapture depreciation on the sale of its business assets. This resulted in an assessment of $25,000 in tax. Assuming his actions were negligent, not fraudulent, what is the accuracy penalty?
A) $5,000
B) $10,000
C) $12,500
D) $18,750

Answer: A
Explanation: The accuracy penalty imposed for negligence is 20% of the tax due to the inaccuracy. Penalty = $25,000 tax assessed × 20% = $5,000
Diff: 2
Learning Objective: LO 1.2
AACSB / AICPA: Analytic / FC: Analysis; PC: None; BB: None
Bloom's: Application

Time on Task: 5 min

42) Honeyfarm Corporation's 2023 return was audited by the IRS. Honeyfarm failed to report a portion of its income during the year. This resulted in an assessment of $50,000 in tax. Assuming the action was intentional and fraudulent, what is the accuracy penalty?
A) $10,000
B) $25,000
C) $37,500
D) $50,000

Answer: C
Explanation: The accuracy penalty imposed for fraud is 75% of the tax due to the inaccuracy.
Penalty = $50,000 tax assessed × 75% = $37,500
Diff: 2
Learning Objective: LO 1.2
AACSB / AICPA: Analytic / FC: Analysis; PC: None; BB: None
Bloom's: Application
Time on Task: 5 min

43) Sunny Corporation's 2023 return was audited by the IRS. The IRS determined that the basis of Sunny's asset sold during the year was $200,000. However, Sunny had reported a basis of $550,000 on the return. This increased its tax liability by $63,000. What is the misvaluation penalty?
A) $6,300
B) $12,600
C) $25,200
D) $47,250

Answer: B
Explanation: Misstatement = ($550,000 tax return value - $200,000 IRS value)/$200,000 IRS value = 175%. The misstatement is greater than 150% but less than 400%, so Sunny is subject to the substantial misvaluation penalty, which is 20% of the tax understatement. Penalty = $63,000 tax assessed × 20% = $12,600
Diff: 2
Learning Objective: LO 1.2
AACSB / AICPA: Analytic / FC: Analysis; PC: None; BB: None
Bloom's: Application
Time on Task: 5 min

44) Dime Company's 2023 return was audited by the IRS. The IRS determined that the basis of Dime's asset sold during the year was $10,000. However, Dime had reported a basis of $110,000 on the return. This increased its tax liability by $21,000. What is the misvaluation penalty?

A) $2,100
B) $4,200
C) $8,400
D) $15,750

Answer: C
Explanation: Misstatement = ($110,000 tax return value - $10,000 IRS value)/$10,000 IRS value = 1,000%. The misstatement is greater than 400%, so Dime is subject to the gross misvaluation penalty, which is 40% of the tax understatement. Penalty = $21,000 tax assessed × 40% = $8,400
Diff: 2
Learning Objective: LO 1.2
AACSB / AICPA: Analytic / FC: Analysis; PC: None; BB: None
Bloom's: Application
Time on Task: 5 min

45) The IRS may impose what type of penalties if tax fraud has occurred:
A) Civil and criminal
B) Civil and financial
C) Financial and criminal
D) Civil, financial, and criminal

Answer: D
Explanation: Accuracy penalties are civil and financial penalties only. For fraud, criminal penalties exist in addition to civil and financial penalties.
Diff: 1
Learning Objective: LO 1.2
AACSB / AICPA: Analytic / FC: Analysis; PC: None; BB: None
Bloom's: Knowledge
Time on Task: 5 min

46) When computing the amount realized from the sale of property, how are liabilities treated?
A) Liabilities assumed by the buyer reduce the seller's amount realized.
B) Liabilities assumed by the buyer are excluded from the amount realized.
C) Liabilities assumed by the buyer increase the seller's amount realized.
D) Only personal liabilities of the buyer affect the seller's amount realized.

Answer: C
Explanation: The liabilities assumed by the buyer increase the seller's amount realized.
Diff: 2
Learning Objective: LO 1.3
AACSB / AICPA: Analytic / FC: Analysis; PC: None; BB: None
Bloom's: Analysis

Time on Task: 3 min

47) Sunrise Rentals LLC sold a piece of equipment. The company received $12,000 in cash and a used trailer with a fair market value of $3,000. The buyer also assumed $5,000 of Sunrise Rentals' remaining loan on the equipment. Sunrise incurred $500 in selling expenses. What is Sunrise Rentals' amount realized on the sale?
A) $19,000
B) $19,500
C) $20,000
D) $20,500

Answer: B
Explanation: The amount realized is the sum of the cash received, $12,000, the fair market value of property received, $3,000, and liabilities assumed by the buyer, $5,000, less the selling expenses, $500. Therefore, the amount realized is $19,500 ($12,000 + $3,000 + $5,000 - $500).
Diff: 2
Learning Objective: LO 1.3
AACSB / AICPA: Analytic / FC: Analysis; PC: None; BB: None
Bloom's: Analysis
Time on Task: 4 min

48) Which of the following best describes how to calculate an asset's adjusted basis for tax purposes?
A) Original cost plus repairs and maintenance minus capital improvements
B) Original cost plus capital improvements minus accumulated depreciation
C) Fair market value plus capital improvements minus original cost
D) Purchase price plus accumulated depreciation minus selling expenses

Answer: B
Explanation: The adjusted basis equals the original cost plus capital improvements less accumulated depreciation.
Diff: 1
Learning Objective: LO 1.3
AACSB / AICPA: Analytic / FC: Analysis; PC: None; BB: None
Bloom's: Knowledge
Time on Task: 3 min

49) How is a realized gain or loss determined in a property transaction?
A) Amount realized less the adjusted basis
B) Amount realized plus the adjusted basis
C) Amount realized less the selling expenses
D) Adjusted basis less the selling expenses

Answer: A
Explanation: The realized gain or loss is calculated by subtracting the adjusted basis from the amount realized.
Diff: 1
Learning Objective: LO 1.3
AACSB / AICPA: Analytic / FC: Analysis; PC: None; BB: None
Bloom's: Knowledge
Time on Task: 3 min

50) Seabreeze Co. sold an asset with an adjusted basis of $20,000. The buyer paid $10,000 in cash, assumed a $15,000 mortgage, and Seabreeze paid $2,000 in selling expenses. What is Seabreeze's realized gain or loss on the sale?
A) $3,000 loss
B) $3,000 gain
C) $5,000 loss
D) $5,000 loss

Answer: B
Explanation: The amount realized is the sum of the cash received, the fair market value of property received, and liabilities assumed by the buyer, less the selling expenses, so $23,000 ($10,000 + $15,000 + $0 - $2,000). The realized gain or loss is calculated by subtracting the adjusted basis, $20,000, from the amount realized, $23,000, so this results in a realized gain of $3,000.
Diff: 2
Learning Objective: LO 1.3
AACSB / AICPA: Analytic / FC: Analysis; PC: None; BB: None
Bloom's: Application
Time on Task: 4 min

51) Which of the following statements is correct based on the tax treatment of gains and losses?
A) All realized gains are excluded from taxable income.
B) All realized gains and losses are recognized unless a tax law allows deferral or exclusion.
C) Realized losses are never recognized under the tax law.
D) Recognized gains are always greater than realized gains.

Answer: B
Explanation: All realized gains and losses are recognized by a business unless a tax law allows the gain or loss to be deferred or excluded.
Diff: 1

Learning Objective: LO 1.3
AACSB / AICPA: Analytic / FC: Analysis; PC: None; BB: None
Bloom's: Knowledge
Time on Task: 3 min

52) When a business does not recognize a realized gain or loss, how is it treated for tax purposes?
A) It is excluded, meaning it is never taxed.
B) It is deferred, meaning it will be taxed in a future year.
C) All realized gains and losses are recognized.
D) Either A or B

Answer: D
Explanation: All realized gains and losses are recognized by a business unless a tax law allows the gain or loss to be deferred or excluded.
Diff: 1
Learning Objective: LO 1.3
AACSB / AICPA: Analytic / FC: Analysis; PC: None; BB: None
Bloom's: Knowledge
Time on Task: 3 min

53) Magnolia Supply Co. sold equipment and realized a gain of $25,000. Under a tax-deferred transaction, only $10,000 of the gain is recognized in the current year. What is the deferred gain?
A) $10,000
B) $15,000
C) $25,000
D) $35,000

Answer: B
Explanation: The deferred gain or loss is calculated by subtracting the recognized gain or loss from the realized gain or loss, so the deferred gain is $15,000 ($25,000 - $10,000).
Diff: 2
Learning Objective: LO 1.3
AACSB / AICPA: Analytic / FC: Analysis; PC: None; BB: None
Bloom's: Application
Time on Task: 3 min

54) In a tax-deferred transaction, how is the basis of the new property generally determined?
A) It is equal to the fair market value of the new property received.
B) It is equal to the original cost of the old property, regardless of gain or loss.
C) It is the sum of the deferred gain and the fair market value of any boot received.
D) It is based on the adjusted basis of the property transferred, with adjustments for recognized

gain, boot, and debt relief.

Answer: D
Explanation: Basis in the new property received is determined either by 1) Adjusted basis in property transferred + recognized gain - FMV of boot received – basis in property received, or 2) FMV of property received – deferred gain + deferred loss.
Diff: 2
Learning Objective: LO 1.3
AACSB / AICPA: Analytic / FC: Analysis; PC: None; BB: None
Bloom's: Application
Time on Task: 3 min

55) In a tax-deferred transaction, how is the holding period of the new property determined?
A) It begins on the date the new property is received.
B) It includes only the time the new property is held after the exchange.
C) It includes the holding period of the property transferred in the exchange.
D) It resets if any gain is recognized in the transaction.

Answer: C
Explanation: For a tax-deferred transaction, the holding period of property received always includes the holding period of the property transferred.
Diff: 2
Learning Objective: LO 1.3
AACSB / AICPA: Analytic / FC: Analysis; PC: None; BB: None
Bloom's: Application
Time on Task: 3 min

56) Ellington Company exchanges property with an adjusted basis of $50,000 for stock worth $90,000 and receives $10,000 in cash (boot) in a transaction that qualifies for tax deferral. What is Ellington's deferred gain?
A) $10,000
B) $30,000
C) $40,000
D) $50,000

Answer: C
Explanation: First, the realized gain or loss is calculated as follows:

Cash	$10,000
Plus: FMV of property received	90,000
Plus: Liabilities assumed	0
Less: Selling expenses	0

Amount realized	100,000
Less: Adjusted basis	(50,000)
Realized gain or loss	50,000

Second, determine the recognized gain by taking the lower of the realized gain, $50,000, or FMV of boot received, $10,000), which results in a recognized gain of $10,000.

Third, determine the deferred gain as follows:

Realized gain	$50,000
Less: Recognized gain or loss	(10,000)
Deferred gain	$40,000

Diff: 2
Learning Objective: LO 1.3
AACSB / AICPA: Analytic / FC: Analysis; PC: None; BB: None
Bloom's: Application
Time on Task: 6 min

57) Which of the following represents a related-party relationship under the tax rules for businesses?
A) An individual who owns 25% of two unrelated C corporations
B) A partner who owns 60% of a partnership and sells property to the partnership
C) Two corporations with no overlapping ownership
D) An S corporation and a C corporation if a shareholder who owns 40% of the S corporation and 60% of the C corporation

Answer: B
Explanation: A partner and a partnership in which the partner owns, directly or indirectly, more than 50% of the partnership's capital interest or profits interest.
Diff: 2
Learning Objective: LO 1.3
AACSB / AICPA: Analytic / FC: Analysis; PC: None; BB: None
Bloom's: Application
Time on Task: 3 min

58) What does the disallowed loss from a related-party sale create?
A) Right of offset
B) Recognized capital loss
C) Recognized operating loss
D) Boot

Answer: A
Explanation: The disallowed loss from a related-party sale creates a right of offset.
Diff: 1
Learning Objective: LO 1.3
AACSB / AICPA: Analytic / FC: Analysis; PC: None; BB: None
Bloom's: Knowledge
Time on Task: 1 min

59) Nolan Corp. sells equipment to Evergreen LLC, a partnership in which Nolan Corp. owns 60% of the capital and profits interest. The equipment is sold for $22,000, and Nolan's adjusted basis in the equipment is $28,000. What amount and type of gain or loss does Nolan Corp. have?
A) $6,000 recognized loss
B) $6,000 deferred loss
C) $6,000 recognized gain
D) $6,000 deferred gain

Answer: B
Explanation: The realized gain or loss is the difference between the sales price and the cost basis, so a $6,000 loss ($28,000 - $22,000 = $6,000 loss). However, Since Nolan owns more than 50% of Evergreen, they are related parties. Therefore, the $6,000 loss is not recognized but instead deferred.
Diff: 2
Learning Objective: LO 1.3
AACSB / AICPA: Analytic / FC: Analysis; PC: None; BB: None
Bloom's: Application
Time on Task: 4 min

60) An S corporation sells a company vehicle to one of its shareholders who owns 60% of the value of the outstanding stock. The S corporation's adjusted basis in the vehicle is $18,000. However, the board agrees to sell the vehicles to the shareholder for $15,000, which is the comparable fair market value confirmed by a qualified appraisal. Calculate the right of offset, if any.
A) $0
B) $1,800
C) $3,000
D) $15,000

Answer: C
Explanation: The term related-party loss rules apply to individuals who have more than 50% ownership interest directly or indirectly in a business entity (Corporation or Partnership). Therefore, the vehicle sold to the 60% shareholder qualifies as a related-party transaction. Under

the related-party loss rules, the loss is disallowed. The disallowed loss from a related-party sale creates a right of offset. The right of offset is equal to the disallowed loss. The disallowed loss is calculated as the difference between the sales price and the adjusted basis, so $15,000 - $18,000 = ($3,000).
Diff: 2
Learning Objective: LO 1.3
AACSB / AICPA: Analytic / FC: Analysis; PC: None; BB: None
Bloom's: Application
Time on Task: 3 min

61) Murphy, Inc. sells the asset it purchased from a related-party transaction to an unrelated third party. The unrelated third-party sale created a realized gain of $20,000. The related-party transaction created a right of offset in the amount of $15,000. How much gain or loss will Murphy recognize?
A) $0 gain or loss
B) $5,000 gain
C) $15,000 gain
D) $20,000 gain

Answer: B
Explanation: Murphy can offset the realized gain from the unrelated-party sale by the right of offset, so the recognized gain is $5,000 ($20,000 - $15,000).
Diff: 2
Learning Objective: LO 1.3
AACSB / AICPA: Analytic / FC: Analysis; PC: None; BB: None
Bloom's: Application
Time on Task: 3 min

62) What are the three major asset classifications?
A) Capital, personal, and ordinary
B) Personal, ordinary, and Section 1231
C) Capital, personal, and Section 1231
D) Capital, ordinary, and Section 1231

Answer: D
Explanation: Every asset can be classified as either ordinary, Section 1231, or capital.
Diff: 1
Learning Objective: LO 1.3
AACSB / AICPA: Analytic / FC: Analysis; PC: None; BB: None
Bloom's: Knowledge
Time on Task: 1 min

63) Which of the following statements correctly identifies the classification of different types of assets?
A) Inventory is a capital asset.
B) Depreciable property used in a business for more than one year is a Section 1231 asset.
C) A copyright held by a company that created the work is a capital asset.
D) Goodwill is always a Section 1231 asset.

Answer: B
Explanation: Section 1231 assets are depreciable property and realty used in a trade or business that the business has owned for more than one year. Inventory and a copyright held by a company that created the work are ordinary assets. Goodwill is usually a capital asset.
Diff: 1
Learning Objective: LO 1.3
AACSB / AICPA: Analytic / FC: Analysis; PC: None; BB: None
Bloom's: Knowledge
Time on Task: 1 min

64) Nixa Company purchased the copyright for a software code. What type of asset is the copyright?
A) Capital
B) Personal
C) Ordinary
D) Section 1231

Answer: A
Explanation: Copyrights are capital assets when not held by the person who created the work.
Diff: 2
Learning Objective: LO 1.3
AACSB / AICPA: Analytic / FC: Analysis; PC: None; BB: None
Bloom's: Application
Time on Task: 1 min

65) Clearview Landscapes, a lawn care company, purchased a commercial lawn mower for its operations but sold it after only 6 months of use. How should this asset be classified for tax purposes?
A) Capital
B) Personal
C) Ordinary
D) Section 1231

Answer: C
Explanation: Depreciable property held for one year or less is considered an ordinary asset.

Diff: 2
Learning Objective: LO 1.3
AACSB / AICPA: Analytic / FC: Analysis; PC: None; BB: None
Bloom's: Application
Time on Task: 1 min

66) Which of the following assets would be classified as personalty for tax purposes?
A) A warehouse building permanently attached to land
B) Timber that has been cut and is ready for sale
C) A fence installed around a company-owned facility
D) Unextracted mineral deposits beneath a company's property

Answer: B
Explanation: Unextracted natural resources are considered to be attached to land and are treated as realty. However, once a natural resource is extracted, it becomes personalty. Since the timber has been cut and is ready to be sold, it is peronalty
Diff: 2
Learning Objective: LO 1.3
AACSB / AICPA: Analytic / FC: Analysis; PC: None; BB: None
Bloom's: Application
Time on Task: 1 min

67) Which asset is an example of realty?
A) In-ground irrigation system
B) Vehicle used to deliver products
C) Copyright
D) Furniture in the sales room

Answer: A
Explanation: Realty is land and any structures permanently attached to the land.
Diff: 2
Learning Objective: LO 1.3
AACSB / AICPA: Analytic / FC: Analysis; PC: None; BB: None
Bloom's: Application
Time on Task: 1 min

68) Why is the holding period of a business asset important for tax classification purposes?
A) It determines whether an asset is considered tangible or intangible.
B) It affects whether a business can claim depreciation on the asset.
C) It determines if a gain qualifies for long-term capital gain and Section 1231 treatment.
D) It affects whether the asset is classified as realty or personalty.

Answer: C
Explanation: The holding period of an asset helps determine tax consequences, such as long-term capital gain or Section 1231 treatment.
Diff: 2
Learning Objective: LO 1.3
AACSB / AICPA: Analytic / FC: Analysis; PC: None; BB: None
Bloom's: Application
Time on Task: 1 min

69) Joseph, Inc. owned equipment for 3 months. How much longer must it hold the equipment before he is eligible to be treated as Section 1231 property?
A) 0 months
B) 3 months and one day
C) 9 months and one day
D) 1 year and one day

Answer: C
Explanation: In order to be treated as Section 1231 property, the trade or business must hold the property for more than one year. Joseph already owned the equipment for 3 months; therefore, it must hold it for 9 months and one day to qualify as Section 1231 property.
Diff: 2
Learning Objective: LO 1.3
AACSB / AICPA: Analytic / FC: Analysis; PC: None; BB: None
Bloom's: Application
Time on Task: 2 min

70) How are casualty and theft gains and losses on business property held for more than one year treated when netting Section 1231 gains and losses?
A) All casualty and theft gains and losses are always combined with other Section 1231 gains and losses without separation.
B) If casualty and theft losses exceed gains, the net losses are treated as ordinary losses and not combined with Section 1231 gains and losses.
C) Net casualty and theft losses are treated as capital losses and combined with Section 1231 gains.
D) Casualty and theft gains and losses on business property held for more than one year are ignored for Section 1231 calculations.

Answer: B
Explanation: When netting Section 1231 gains and losses, all casualty and theft gains and losses on business property held for more than one year must be netted separately. Then, if the losses exceed the gains, they are treated as ordinary losses and gains and are not netted with other Section 1231 gains and losses. If the casualty and theft gains exceed the losses, the net gain is

combined with other Section 1231 gains and losses.
Diff: 2
Learning Objective: LO 1.4
AACSB / AICPA: Analytic / FC: Analysis; PC: None; BB: None
Bloom's: Analysis
Time on Task: 3 min

71) After net Section 1231 casualty and theft gains are netted with all other Section 1231 gains and losses, how are the net Section 1231 losses treated?
A) Ordinary loss
B) Disallowed loss
C) Short-term capital loss
D) Long-term capital loss

Answer: A
Explanation: The net Section 1231 casualty and theft gains are combined with all other Section 1231 gains and losses. If Section 1231 losses exceed Section 1231 gains, the net loss is deducted as an ordinary loss.
Diff: 2
Learning Objective: LO 1.4
AACSB / AICPA: Analytic / FC: Analysis; PC: None; BB: None
Bloom's: Analysis
Time on Task: 2 min

72) Which of the following statements accurately describes how the Section 1231 lookback rule applies to current year gains?
A) Current year Section 1231 gains are automatically treated as long-term capital gains regardless of prior-year losses.
B) Section 1231 gains are treated as capital gains to the extent of prior Section 1231 losses that have not been recaptured.
C) Current year Section 1231 gains are treated as ordinary income to the extent of unrecaptured Section 1231 losses from the five previous tax years.
D) Section 1231 gains are reduced by losses from the three prior years, and the remaining balance is treated as capital gain.

Answer: C
Explanation: The lookback rule provides that net Section 1231 gains must be offset by net Section 1231 losses from the five preceding tax years that have not already been recaptured. To the extent of these losses, the net Section 1231 gain is treated as ordinary income. Any remaining gain is treated as long-term capital gain.
Diff: 2

Learning Objective: LO 1.4
AACSB / AICPA: Analytic / FC: Analysis; PC: None; BB: None
Bloom's: Analysis
Time on Task: 3 min

73) Candy's Catering Co. recognized a $22,000 gain from the sale of commercial kitchen equipment, which she held for 4 years, and a casualty loss of $3,000 due to a fire that destroyed a delivery vehicle held for 13 months. Candy's has not recognized any Section 1231 losses in the preceding tax years. Calculate the tax treatment of these transactions.These are the only dispositions of Section 1231 assets this year. Disregarding depreciation recapture rules, what is the correct tax treatment of these transactions?
A) $19,000 capital gain
B) $22,000 capital gain; $3,000 ordinary loss
C) $22,000 ordinary income; $3,000 capital loss
D) $19,000 ordinary income

Answer: B
Explanation: Step 1 nets all casualty and theft gains and losses on business property held for more than one year. The $3,000 loss due to the vehicle fire is the only casualty loss realized by Candy. This loss is not netted with the other Section 1231 gain and would be treated as an ordinary loss. The $22,000 gain on equipment held for 4 years would qualify as Section 1231 gain and be treated as a long-term capital gain.
Diff: 2
Learning Objective: LO 1.4
AACSB / AICPA: Analytic / FC: Analysis; PC: None; BB: None
Bloom's: Application
Time on Task: 3 min

74) In Year 10, XYZ Company recognized a net Section 1231 gain of $40,000. Below is a list of the unrecaptured Section 1231 losses from prior years.

Year 8	$4,000
Year 7	$12,000
Year 4	$29,000
Year 2	$15,000

How would XYZ treat the Section 1231 gain realized in Year 10?
A) $40,000 capital gain
B) $40,000 ordinary income
C) $16,000 ordinary income; $24,000 long-term capital gain
D) $24,000 ordinary income; $16,000 long-term capital gain

Answer: C
Explanation: The lookback rule provides that net Section 1231 gains must be offset by net

Section 1231 losses from the five preceding tax years that have not already been recaptured. To the extent of these losses, the net Section 1231 gain is treated as ordinary income. Any remaining gain is treated as long-term capital gain. The five preceding tax years only include year's 7 & 8. The total net Section 1231 loss in the lookback period is $16,000 ($4,000 + $12,000). This is treated as ordinary income. The remaining $24,000 ($40,000 - $16,000) is treated as long-term capital gain.
Diff: 2
Learning Objective: LO 1.4
AACSB / AICPA: Analytic / FC: Analysis; PC: None; BB: None
Bloom's: Application
Time on Task: 4 min

75) Which of the following is classified as a Section 1245 asset?
A) A commercial office building held for more than one year
B) A plot of undeveloped land used in the business
C) A refrigerator used in a rental property for over a year
D) A personal vehicle used only for commuting

Answer: C
Explanation: Section 1245 assets include any tangible, depreciable, or amortizable property, other than land or buildings, that is used in a trade or business and that has been owned for more than one year.
Diff: 2
Learning Objective: LO 1.4
AACSB / AICPA: Analytic / FC: Analysis; PC: None; BB: None
Bloom's: Application
Time on Task: 2 min

76) When Section 1245 property is sold, the amount subject to depreciation recapture is:
A) The smaller of the total gain realized or the depreciation claimed over the asset's life.
B) The larger of the recognized gain or the depreciation taken in the past two years.
C) The smaller of the recognized gain or the total depreciation claimed on the asset.
D) The smaller of the recognized gain or the depreciation taken in the most recent year.

Answer: C
Explanation: The recapture for Section 1245 assets is the lesser of the recognized gain or all the depreciation taken on the asset.
Diff: 1
Learning Objective: LO 1.4
AACSB / AICPA: Analytic / FC: Analysis; PC: None; BB: None
Bloom's: Knowledge
Time on Task: 2 min

77) Once the Section 1245 depreciation recapture rule is applied, how is any remaining recognized gain treated?
A) Excluded from income
B) Treated as ordinary income
C) Treated as a short-term capital gain
D) Treated as a Section 1231 gain

Answer: D
Explanation: Gain in excess of the recaptured amount is treated as Section 1231 gain.
Diff: 1
Learning Objective: LO 1.4
AACSB / AICPA: Analytic / FC: Analysis; PC: None; BB: None
Bloom's: Knowledge
Time on Task: 2 min

78) Mercy, Inc. sold equipment with an adjusted basis of $22,000 for $55,000. The depreciation taken on the equipment over the years was $30,000. How much of the gain will be taxed at ordinary income rates?
A) $3,000
B) $25,000
C) $30,000
D) $33,000

Answer: C
Explanation: First, the recognized gain is calculated as the amount realized less the adjusted basis, which is $33,000 ($55,000 - $22,000). Equipment is a Section 1245 asset, so the recapture rules apply. The recapture for Section 1245 assets is the lesser of the recognized gain, $33,000 or all the depreciation taken on the asset, $30,000. Thus, $30,000 is treated as Section 1245 recapture. Section 1245 recapture is taxed as ordinary income.
Diff: 2
Learning Objective: LO 1.4
AACSB / AICPA: Analytic / FC: Analysis; PC: None; BB: None
Bloom's: Application
Time on Task: 4 min

79) Mercy, Inc. sold equipment with an adjusted basis of $22,000 for $55,000. The depreciation taken on the equipment over the years was $30,000. How much of the gain will be taxed as a Section 1231 gain?
A) $3,000
B) $25,000
C) $30,000

D) $33,000

Answer: A
Explanation: First, the recognized gain is calculated as the amount realized less the adjusted basis, which is $33,000 ($55,000 - $22,000). Equipment is a Section 1245 asset, so the recapture rules apply. The recapture for Section 1245 assets is the lesser of the recognized gain, $33,000 or all the depreciation taken on the asset, $30,000. Thus, $30,000 is treated as Section 1245 recapture. Any remaining gain is considered a Section 1231 gain, which is $3,000 ($33,000 - $30,000).
Diff: 2
Learning Objective: LO 1.4
AACSB / AICPA: Analytic / FC: Analysis; PC: None; BB: None
Bloom's: Application
Time on Task: 4 min

80) Pinecone, Inc. purchased the assets of Cedar Corp four years ago. The purchase included a customer list, to which Pinecone allocated $150,000 of the purchase price. In the current year, Pinecone sold the customer list for $210,000, after it had claimed $45,000 in amortization through the years. How much of the gain will be taxed at ordinary income rates?
A) $15,000
B) $45,000
C) $60,000
D) $105,000

Answer: B
Explanation: First, the recognized gain is calculated as the amount realized less the adjusted basis, which is $105,000 ($210,000 – ($150,000 - $45,000)). A customer list is an intangible asset, which is a Section 1245 asset, so the recapture rules apply. The recapture for Section 1245 assets is the lesser of the recognized gain, $105,000 or all the amortization taken on the asset, $45,000. Thus, $45,000 is treated as Section 1245 recapture and taxed at ordinary rates. Any remaining gain is considered a Section 1231 gain, which is $60,000 ($105,000 - $45,000).
Diff: 2
Learning Objective: LO 1.4
AACSB / AICPA: Analytic / FC: Analysis; PC: None; BB: None
Bloom's: Application
Time on Task: 4 min

81) Pinecone, Inc. purchased the assets of Cedar Corp four years ago. The purchase included a customer list, to which Pinecone allocated $150,000 of the purchase price. In the current year, Pinecone sold the customer list for $210,000, after it had claimed $45,000 in amortization through the years. How much of the gain will be taxed as a Section 1231 gain?
A) $15,000

B) $45,000
C) $60,000
D) $105,000

Answer: C
Explanation: First, the recognized gain is calculated as the amount realized less the adjusted basis, which is $105,000 ($210,000 – ($150,000 - $45,000)). A customer list is an intangible asset, which is a Section 1245 asset, so the recapture rules apply. The recapture for Section 1245 assets is the lesser of the recognized gain, $105,000 or all the amortization taken on the asset, $45,000. Thus, $45,000 is treated as Section 1245 recapture and taxed at ordinary rates. Any remaining gain is considered a Section 1231 gain, which is $60,000 ($105,000 - $45,000).
Diff: 2
Learning Objective: LO 1.4
AACSB / AICPA: Analytic / FC: Analysis; PC: None; BB: None
Bloom's: Application
Time on Task: 4 min

82) Which of the following assets is subject to Section 1250 depreciation recapture rules?
A) Personal home
B) Commercial warehouse
C) Business parking lot classified as land improvement
D) Manufacturing equipment

Answer: B
Explanation: Section 1250 recapture applies to only one type of asset - buildings.
Diff: 2
Learning Objective: LO 1.4
AACSB / AICPA: Analytic / FC: Analysis; PC: None; BB: None
Bloom's: Application
Time on Task: 2 min

83) When a Section 1250 asset is sold, the amount subject to depreciation recapture is:
A) The larger of the recognized gain or the depreciation claimed over the asset’s life.
B) The lesser of the recognized gain or the excess depreciation claimed on the asset.
C) The lesser of the total gain realized or the depreciation claimed over the asset’s life
D) The larger of the recognized gain or the depreciation taken in the most recent year.

Answer: B
Explanation: Section 1250 recapture is the lesser of the recognized gain or the excess depreciation.
Diff: 2
Learning Objective: LO 1.4

AACSB / AICPA: Analytic / FC: Analysis; PC: None; BB: None
Bloom's: Analysis
Time on Task: 2 min

84) How is excess depreciation on Section 1250 property calculated?
A) Total depreciation less straight-line depreciation
B) Recognized gain less straight-line depreciation
C) Recognized gain in excess of Section 1250 recapture
D) Straight-line depreciation less total depreciation

Answer: A
Explanation: Excess depreciation is depreciation taken in excess of the amount that would have been claimed under the straight-line depreciation method.
Diff: 2
Learning Objective: LO 1.4
AACSB / AICPA: Analytic / FC: Analysis; PC: None; BB: None
Bloom's: Analysis
Time on Task: 2 min

85) Max and Associates, a partnership, sells a building it used for 8 years for $750,000. Max originally paid $500,000 for the property and took straight-line depreciation of $130,000 over the 8 years. Determine the character of the recognized gain or loss on the sale.
A) $130,000 Section 1250 recapture, $0 unrecaptured Section 1250 gain, $250,000 Section 1231 gain,
B) $0 Section 1250 recapture, $130,000 unrecaptured Section 1250 gain, $250,000 Section 1231 gain
C) $0 Section 1250 recapture, $380,000 Section 1231 gain
D) $130,000 Section 1250 recapture, $250,000 unrecaptured Section 1250 gain, $0 Section 1231 gain

Answer: B
Explanation: The recognized gain is proceeds - (cost - accumulated depreciation); $750,000 - ($500,000 - $130,000) = $380,000 recognized gain. Buildings are subject to Section 1250 depreciation recapture rules. Since the only depreciation taken on the property was straight-line, there is no excess depreciation. Section 1250 recapture is the lesser of the recognized gain ($380,000) or excess depreciation ($0). The remaining gain of $380,000 ($380,000 - $0) is taxed as unrecaptured Section 1250 gain, up to the straight-line depreciation of $130,000. The gain in excess of the straight-line depreciation, $250,000 ($380,000 - $130,000) is taxed as Section 1231 gain.
Diff: 2
Learning Objective: LO 1.4
AACSB / AICPA: Analytic / FC: Analysis; PC: None; BB: None

Bloom's: Application
Time on Task: 5 min

86) Tootles, Inc., an S Corporation, sells a building it used for 15 years for $800,000. Tootles originally paid $400,000 for the property and elected to depreciate it using the 150% declining balance method, resulting in $180,000 in depreciation taken over the year. Straight-line depreciation would have been $120,000. Determine the character of the recognized gain or loss on the sale.
A) $60,000 Section 1250 recapture, $120,000 unrecaptured Section 1250 gain, $40,000 Section 1231 gain
B) $40,000 Section 1250 recapture, $120,000 unrecaptured Section 1250 gain, $60,000 Section 1231 gain
C) $0 Section 1250 recapture, $220,000 Section 1231 gain
D) $60,000 Section 1250 recapture, $160,000 unrecaptured Section 1250 gain, $0 Section 1231 gain

Answer: A
Explanation: The recognized gain is proceeds - (cost - accumulated depreciation); $800,000 - ($400,000 - $180,000) = $220,000 recognized gain. Buildings are subject to Section 1250 depreciation recapture rules. The excess depreciation is the depreciation taken less straight-line depreciation, so $60,000 ($180,000 - $120,000). Section 1250 recapture is the lesser of the recognized gain ($220,000) or excess depreciation ($60,000), so $60,000. The remaining gain of $160,000 ($220,000 - $60,000) is taxed as unrecaptured Section 1250 gain, up to the straight-line depreciation of $120,000. The gain in excess of the straight-line depreciation, $40,000 ($160,000 - $12,000) is taxed as Section 1231 gain.
Diff: 3
Learning Objective: LO 1.4
AACSB / AICPA: Analytic / FC: Analysis; PC: None; BB: None
Bloom's: Application
Time on Task: 7 min

87) When a C corporation sells Section 1250 property at a gain, how is the Section 291 recapture amount determined?
A) 100% of the total gain is recaptured as ordinary income under Section 291.
B) The excess of actual Section 1250 recapture over straight-line depreciation is multiplied by 25%.
C) The difference between Section 1245 recapture and actual Section 1250 recapture is multiplied by 20%
D) Section 291 replaces Section 1240 recapture for corporations and applies only to land

Answer: C
Explanation: For C corporations, the unrecaptured Section 1250 gain rule does not apply.

Instead, Section 291 depreciation recapture applies and is computed by assuming the property is actually Section 1245 property, as follows: Finding the difference between Section 1245 recapture, IF the property had been Section 1245 property less actual Section 1250 recapture and multiplying the difference by 20%.
Diff: 2
Learning Objective: LO 1.4
AACSB / AICPA: Analytic / FC: Analysis; PC: None; BB: None
Bloom's: Application
Time on Task: 2 min

88) Rainy, Inc., a C Corporation, sells a building it used for 12 years for $900,000. Rainy originally paid $650,000 for the property and took straight-line depreciation of $250,000 over the 12 years. Determine the character of the recognized gain or loss on the sale.
A) $50,000 Section 1250 recapture, $0 Section 291 recapture, $450,000 Section 1231 gain
B) $0 Section 1250 recapture, $0 Section 291 recapture, $500,000 Section 1231 gain
C) $50,000 Section 1250 recapture, $450,000 Section 291 recapture, $0 Section 1231 gain
D) $0 Section 1250 recapture, $50,000 Section 291 recapture, $450,000 Section 1231 gain

Answer: D
Explanation: The recognized gain is proceeds - (cost - accumulated depreciation); $900,000 - ($650,000 - $250,000) = $500,000 recognized gain. Buildings are subject to Section 1250 depreciation recapture rules. Since the only depreciation taken on the property was straight-line, there is no excess depreciation. Section 1250 recapture is the lesser of the recognized gain ($500,000) or excess depreciation ($0). The remaining gain of $500,000 ($500,000 - $0) is next taxed as Section 291 recapture and treated as ordinary income. If the building had been Section 1245 property, the Section 1245 recapture would have been $250,000, which is the lower of the depreciation claimed of $250,000 or the recognized gain of $500,000. The Section 291 recapture is computed as Section 1245 recapture IF the property had been Section 1245 property less the actual Section 1250 recapture, multiplied by 20%, so $50,000 (($250,000 - $0) x 20%). Finally, whatever gain from the disposition that remains is considered Section 1231 gain, so $450,000 ($500,000 - $50,000).
Diff: 3
Learning Objective: LO 1.4
AACSB / AICPA: Analytic / FC: Analysis; PC: None; BB: None
Bloom's: Application
Time on Task: 8 min

89) When reporting the sale of business assets on Form 4797, which of the following statements is correct?
A) Section 1231 gains from assets held for one year or less are reported in Part I of Form 4797.
B) Section 1245 and 1250 assets held for more than one year and sold at a gain are only reported in Part III and not included elsewhere on Form 4797.

C) Depreciation recapture from Section 1245 and Section 1250 assets is reported in Part II of Form 4797 as ordinary income.
D) Unrecaptured Section 1250 gain is reported on Form 4797, Part II, Lime 13.

Answer: C
Explanation: If the business asset sold was not held for more than one year, then the gain or loss is reported in Part II. Part II reports ordinary income and loss from the sale of these assets. Part II also reports the recapture of Section 1245 and Section 1250 assets.
Diff: 2
Learning Objective: LO 1.4
AACSB / AICPA: Analytic / FC: Analysis; PC: None; BB: None
Bloom's: Application
Time on Task: 3 min

90) Which of the following dispositions of Section 1250 property does not trigger depreciation recapture?
A) Sale of property at a gain to an unrelated party
B) Transfer of property by gift
C) Sale of property in a taxable exchange
D) Sale of property after full depreciation is claimed

Answer: B
Explanation: There are some transactions for which, if there is a sale or disposition of Section 1250 property, the recapture rules do not apply. Examples include gifts, death, charitable transfers, etc.
Diff: 1
Learning Objective: LO 1.4
AACSB / AICPA: Analytic / FC: Analysis; PC: None; BB: None
Bloom's: Knowledge
Time on Task: 2 min

91) Which type of business income is not eligible for the qualified business income deduction?
A) Sole proprietorship
B) Partnership
C) S corporation
D) C corporation

Answer: D
Explanation: QBI must be derived from a “qualified business,” which includes businesses conducted as sole proprietorships and flow-through income from partnerships, limited liability companies, and S corporations.
Diff: 1

Learning Objective: LO 1.5
AACSB / AICPA: Analytic / FC: Analysis; PC: None; BB: None
Bloom's: Knowledge
Time on Task: 2 min

92) Which of the following sources of income would be considered qualified business income for the qualified business income deduction?
A) Dividends
B) Sole proprietorship income
C) Compensation earned by an owner of an S corporation
D) Capital gains

Answer: B
Explanation: QBI must be derived from a “qualified business,” which includes businesses conducted as sole proprietorships and flow-through income from partnerships, limited liability companies, and S corporations. QBI does not include capital gains, dividends, interest, other investment items, compensation earned by an employee or an owner, or guaranteed payments made to a partner.
Diff: 2
Learning Objective: LO 1.5
AACSB / AICPA: Analytic / FC: Analysis; PC: None; BB: None
Bloom's: Analysis
Time on Task: 2 min

93) Which of the following rental real estate activities would count toward the 250-hour requirement for the QBI deduction?
A) Reviewing financial statements for rental property
B) Planning the construction of a new garage on the rental property
C) Advertising the property for rent on a real estate website
D) Traveling to and from the property to check on repairs

Answer: C
Explanation: Eligible service activities include advertising, negotiating and executing leases, verifying information in tenant applications, collecting rent, conducting daily operations, maintenance, and repair, managing the real estate, purchasing materials, and supervising employees and contractors.
Diff: 1
Learning Objective: LO 1.5
AACSB / AICPA: Analytic / FC: Analysis; PC: None; BB: None
Bloom's: Knowledge
Time on Task: 2 min

94) June, a single taxpayer, reported $190,000 of taxable income from her sole proprietorship, which is a specified service trade or business. She paid $25,000 in self-employment taxes and $7,500 in self-employment health insurance premiums. Assume the following modified taxable income threshold: tier 1 less than or equal to $197,300; tier 2 between $197,301 and $247,300; tier 3 greater than $247,300. Calculate the QBI deduction available to June.
A) $0
B) $34,000
C) $35,500
D) $38,000

Answer: B
Explanation: To calculate QBI, taxable income must be reduced by 50% of self-employment tax, self-employment health insurance premiums, and any retirement plan contributions based on the business income. June's QBI is $170,000 [$190,000 - ($25,000 × 50%) - $7,500]. June's QBI falls into tier 1 because her modified taxable income is less than $197,300. The QBI deduction is 20% of her QBI, so $34,000 ($170,000 × 20%).
Diff: 2
Learning Objective: LO 1.5
AACSB / AICPA: Analytic / FC: Analysis; PC: None; BB: None
Bloom's: Application
Time on Task: 5 min

95) Ellie is married and is a partner in a partnership, which provides specified services for purposes of the QBI deduction. For 2024, her QBI from the business is $112,000, and their modified taxable income is $540,000. Assume the following modified taxable income threshold: tier 1 less than or equal to $394,600; tier 2 between $394,601 and $494,600; tier 3 greater than $494,600. Calculate Ellie’s QBI deduction.
A) $0
B) $11,200
C) $22,400
D) $108,000

Answer: A
Explanation: Ellie’s modified taxable income amount places her and her husband in tier 3. Because of this, and the fact that her QBI is from a specified service trade or business, their QBI deduction is $0.
Diff: 2
Learning Objective: LO 1.5
AACSB / AICPA: Analytic / FC: Analysis; PC: None; BB: None
Bloom's: Application
Time on Task: 3 min

96) Luke is single and is the sole owner of an S corporation. During the current year, the taxable income of the business is $180,000. The business paid wages of $80,000 and had an unadjusted basis in qualified property of $125,000. Assume that Luke's not subject to any limitations based on his modified taxable income. What is Luke's QBI deduction?
A) $0
B) $36,000
C) $40,000
D) $90,000

Answer: B
Explanation: Since no limitations apply, Luke's QBI deduction is 20% of his QBI, or $36,000 ($180,000 x 20%).
Diff: 2
Learning Objective: LO 1.5
AACSB / AICPA: Analytic / FC: Analysis; PC: None; BB: None
Bloom's: Application
Time on Task: 3 min

97) Francis is single and is the sole owner of an S corporation that is considered a specified service trade or business for the purpose of the QBI deduction. During the current year, the taxable income for the business is $450,000. The business paid wages of $180,000 and had an unadjusted basis in qualified property of $250,000. Francis' modified taxable income is $500,000. Assume the following modified taxable income threshold: tier 1 less than or equal to $197,300; tier 2 between $197,301 and $247,300; tier 3 greater than $247,300. What is Francis' QBI deduction?
A) $0
B) $11,200
C) $22,400
D) $108,000

Answer: A
Explanation: Francis' modified taxable income amount places him in tier 3. Because of this, and the fact that his QBI is from a specified service trade or business, his QBI deduction is $0.
Diff: 2
Learning Objective: LO 1.5
AACSB / AICPA: Analytic / FC: Analysis; PC: None; BB: None
Bloom's: Application
Time on Task: 3 min

98) Zamuel, a sole proprietor, reported modified taxable income of $200,000, which includes $60,000 in capital gains, $15,000 in qualified dividend income, and $5,000 in interest income.

Calculate Zamuel's adjusted modified taxable income for the purposes of theQBI deduction.
A) $120,000
B) $125,000
C) $140,000
D) $200,000

Answer: B
Explanation: Adjusted modified taxable income = modified taxable income - net capital gain - qualified dividend income; $200,000 - $60,000 - $15,000 = $125,000
Diff: 2
Learning Objective: LO 5.5
AACSB / AICPA: Analytic / FC: Analysis; PC: None; BB: None
Bloom's: Application
Time on Task: 3 min

99) Bob is single and operates a sole proprietorship selling sporting goods. During the current year, the taxable income for the business is $310,000. The business paid wages of $60,000 and had an unadjusted basis in qualified property of $180,000. Bob’s modified taxable income is $500,000. Assume the following modified taxable income threshold: tier 1 less than or equal to $197,300; tier 2 between $197,301 and $247,300; tier 3 greater than $247,300. What is Bob’s QBI deduction?
A) $0
B) $19,500
C) $30,000
D) $62,000

Answer: C
Explanation: Bob is in tier 3, so he is subject to the full wage/property limit. With no limit, Bob’s QBI deduction is $62,000 ($310,000 x 20%). However, he is limited by the greater of 50% of wages, $30,000 ($60,000 x 50%), or 25% of wages + 2.5% of UBAI on qualified property, $19,500 ((25% x $60,000) + ($2.5% x $180,000)). The greater of the two is $30,000, which is less than the full QBI deduction, $62,000, so the final QBI deduction is $30,000.
Diff: 2
Learning Objective: LO 1.5
AACSB / AICPA: Analytic / FC: Analysis; PC: None; BB: None
Bloom's: Application
Time on Task: 6 min

100) Allison is single and operates a sole proprietorship selling household goods. During the current year, the taxable income for the business is $250,000. The business paid wages of $60,000 and had an unadjusted basis in qualified property of $120,000. Allison’s modified taxable income is $230,000. Assume the following modified taxable income threshold: tier 1 less

than or equal to $197,300; tier 2 between $197,301 and $247,300; tier 3 greater than $247,300. What is Allison's QBI deduction?
A) $0
B) $13,080
C) $36,920
D) $50,000

Answer: C
Explanation: Allison is in tier 2, so she is subject to the partial wage/property limit. With no limit, Allison's QBI deduction is $50,000 ($250,000 x 20%). However, she is limited by the greater of 50% of wages, $30,000 ($60,000 x 50%), or 25% of wages + 2.5% of UBAI on qualified property, $18,000 ((25% x $60,000) + ($2.5% x $120,000)), so $30,000. Since Allison's modified taxable income is in tier 2, the partial limitation applies. The partial percentage is 65.4% (($230,000 - $197,300)/$50,000). Applying the partial limitation, the reduction in QBI is $13,080 (($50,000 - $30,000) x 65.4%). Therefore, the final QBI deduction is $36,920 ($50,000 - $13,080).
Diff: 3
Learning Objective: LO 1.5
AACSB / AICPA: Analytic / FC: Analysis; PC: None; BB: None
Bloom's: Synthesis
Time on Task: 8 min

101) Alex is single and is the sole owner of an S corporation. During the current year, the taxable income of the business is $160,000. The business paid wages of $50,000 and had an unadjusted basis in qualified property of $200,000. Alex's modified taxable income is $140,000. What is Alex's QBI deduction? Assume Alex is in Tier 1 for the QBI deduction.
A) $0
B) $25,000
C) $28,000
D) $32,000

Answer: C
Explanation: Alex's QBI deduction is the lower of 20% of QBI, $32,000 ($160,000 x 20%), or 20% of adjusted modified taxable income, $28,000 ($140,000 x 20%), so $28,000
Diff: 2
Learning Objective: LO 1.5
AACSB / AICPA: Analytic / FC: Analysis; PC: None; BB: None
Bloom's: Application
Time on Task: 3 min

102) In the prior year, Happy Corporation filed its tax return but failed to include $15,000 of income. Without the income included, the gross income reported on the return was $210,000.

What is the applicable statute of limitations related to Hugo's return?

Answer: 3 years
Explanation: The statute of limitations is three years. If a return is filed and less than 25% of gross income is understated on the original tax return, the statute of limitations is three years from the later of the due date of the return or the date the return was filed. Happy’s understatement = $15,000/$210,000 = 7.14%. Since 7.14% is less than 25%, the statute of limitations is three (3) years.
Diff: 2
Learning Objective: LO 1.2
AACSB / AICPA: Analytic / FC: Analysis; PC: None; BB: None
Bloom's: Application
Time on Task: 3 min

103) If Brady Brothers filed its Form 1120 on March 3, Year 1, when will the statute of limitations expire?

Answer: April 15, Year 4
Explanation: The statute of limitations is three years from the later of the due date of the tax return or the date the return was filed. The due date, April 15, Year 1, is later than the date filed, March 3, Year 1, so the statute of limitations expires three (3) years after on April 15, Year 4.
Diff: 2
Learning Objective: LO 1.2
AACSB / AICPA: Analytic / FC: Analysis; PC: None; BB: None
Bloom's: Application
Time on Task: 3 min

104) ABC Company’s 2023 return was audited by the IRS and was assessed $20,000 in tax. Assuming its actions were negligent, not fraudulent, what is the accuracy penalty?

Answer: $4,000
Explanation: The accuracy penalty imposed for negligence is 20% of the tax due to the inaccuracy. Penalty = $20,000 tax assessed × 20% = $4,000
Diff: 2
Learning Objective: LO 1.2
AACSB / AICPA: Analytic / FC: Analysis; PC: None; BB: None
Bloom's: Application
Time on Task: 3 min

105) Cooper, Inc. failed to file its corporate tax return by the required due date of April 15, 2026. It filed on August 1, 2026, and owed tax of $5,500. How much is the failure to file penalty?

Answer: $1,100
Explanation: The failure to file penalty is 5% per month of the tax due with the return, with a maximum penalty of 25%. The minimum penalty is the lesser of $525 or the amount of tax due, but does not apply if the tax return is filed within 60 days of the due date. Cooper filed its return 108 days late (more than 60 days), so the minimum penalty amount applies. Regular penalty = $5,500 tax due × 20% (4 months) = $1,100. Since the minimum amount, $525, is less than $1,100, the penalty = $1,100.
Diff: 2
Learning Objective: LO 1.2
AACSB / AICPA: Analytic / FC: Analysis; PC: None; BB: None
Bloom's: Application
Time on Task: 3 min

106) In a prior year, Vehicles, Inc. donated a truck to a qualified charitable organization. On its return, $140,000 was deducted as the fair market value of the truck. Unfortunately, the IRS audited the return and determined the appropriate value of the truck was $50,000 and increased Vehicles' tax liability by $18,000. What is the misvaluation penalty?

Answer: $3,600
Explanation: Misstatement = ($140,000 tax return value - $50,000 IRS value)/$50,000 IRS value = 180%. The misstatement is greater than 150% but less than 400%, so Vehicles is subject to the substantial misvaluation penalty, which is 20% of the tax understatement. Penalty = $18,000 tax assessed × 20% = $3,600
Diff: 2
Learning Objective: LO 1.2
AACSB / AICPA: Analytic / FC: Analysis; PC: None; BB: None
Bloom's: Application
Time on Task: 4 min

107) Forgetful Corporation intended to file an automatic extension for its return but failed to do so. After realizing the error, the return was filed, along with a payment of $4,000 for the tax due, on July 15. Assume the federal short-term interest rate is 4%. How much will the IRS assess Forgetful for interest and penalties? (Round intermediate calculations and your answer to the whole dollar.)

Answer: $670
Explanation: Forgetful filed 91 days late, so it will be subject to the failure to file and failure to pay penalties and interest on the late payment. The maximum combined penalty for failure to file and failure to pay is 5% per month, but no larger than 25% total. Forgetful will also be subject to the minimum failure to file penalty in the amount of $525 since the return was filed 60 days after the due date.

Combined penalty = $4,000 tax due × 15% (3 months) = $600
$600 is more than the minimum penalty of $525, so penalty = $600
Interest = $4,000 tax due × 7% (4% + 3%) × 91/365 = $70
Total penalties and interest = $600 + $70 = $670
Diff: 3
Learning Objective: LO 1.2
AACSB / AICPA: Analytic / FC: Analysis; PC: None; BB: None
Bloom's: Evaluate
Time on Task: 4 min

108) Harborview Landscaping, Inc. sold a utility trailer and received $8,500 in cash and a riding mower valued at $2,200. The buyer of the utility trailer also assumed the $4,000 loan on the trailer. Harborview paid $300 in selling expenses. What is Harborview's amount realized on the sale?

Answer: $14,700
Explanation: The amount realized is the sum of the cash received, $8,500, the fair market value of property received, $2,200, and liabilities assumed by the buyer, $4,000, less the selling expenses, $300. Therefore, the amount realized is $14,700 ($8,500 + $2,200 + $4,000 - $300).
Diff: 2
Learning Objective: LO 1.3
AACSB / AICPA: Analytic / FC: Analysis; PC: None; BB: None
Bloom's: Analysis
Time on Task: 4 min

109) Maple Ridge LLC sold a piece of equipment for $12,000. In addition, the buyer assumed a $10,000 loan on the equipment. Maple Ridge paid $2,000 in selling expenses. The adjusted basis of the equipment was $16,000. What is Maple Ridge's realized gain or loss?

Answer: $4,000 gain
Explanation: The amount realized is the sum of the cash received, the fair market value of property received, and liabilities assumed by the buyer, less the selling expenses, so $20,000 ($12,000 + $10,000 - $2,000). The realized gain or loss is the amount realized, 20,000, less the adjusted basis, $16,000, so a $4,000 gain.
Diff: 2
Learning Objective: LO 1.3
AACSB / AICPA: Analytic / FC: Analysis; PC: None; BB: None
Bloom's: Analysis
Time on Task: 4 min

110) Maya Company transfers a capital asset it has owned for two years to Cardinal Corporation in a tax-deferred corporate formation. The asset has an adjusted basis of $70,000 and a fair

market value of $110,000. In exchange, Maya receives stock worth $90,000 and $20,000 in cash (boot).
a) What is Maya's deferred gain?
b) What is Maya's holding period in the stock?

Answer: a): $20,000; b) Two years
Explanation a): First, the realized gain or loss is calculated as follows:

Cash	$20,000
Plus: FMV of property received	90,000
Plus: Liabilities assumed	0
Less: Selling expenses	0
Amount realized	110,000
Less: Adjusted basis	(70,000)
Realized gain or loss	40,000

Second, determine the recognized gain by taking the lower of the realized gain, $40,000, or FMV of boot received, $20,000), which results in a recognized gain of $20,000.

Third, determine the deferred gain as follows:

Realized gain	$40,000
Less: Recognized gain or loss	(20,000)
Deferred gain	$20,000

Explanation b): Maya's holding period of the stock includes the holding period of the exchanged asset, so it is two years.
Diff: 3
Learning Objective: LO 1.3
AACSB / AICPA: Analytic / FC: Analysis; PC: None; BB: None
Bloom's: Evaluate
Time on Task: 8 min

111) On September 19th, Summit Inc. sells machinery owed for four years to Pinecrest Corp., a C corporation in which Summit owns 75% of the outstanding stock. The machinery is sold for $30,000, and Summit's adjusted basis in the machinery is $37,000
a) What is the amount of Summit's recognized gain or loss?
b) What is the amount of Summit's deferred gain or loss?
c) What is the amount of the right of offset?
d) When does Pinecrest's holding period in the machinery begin?

Answer: a) $0; b) $7,000; c) $7,000; d) Begins September 20
Explanation:
a) and b): The realized gain or loss is the difference between the sales price and the cost basis, so a $7,000 loss ($30,000 - $37,000 = $7,000 loss). However, Since Nolan owns more than 50% of Pinecrest, they are related parties. Therefore, the $7,000 loss is not recognized but instead deferred.
c): The right of offset is equal to the amount of realized loss, so $7,000.
d): Pincerest's holding period begins on the day after the date the taxpayer purchased the property from the related party and does not include the holding period of the seller

Diff: 2
Learning Objective: LO 1.3
AACSB / AICPA: Analytic / FC: Analysis; PC: None; BB: None
Bloom's: Application
Time on Task: 7 min

112) Atlas Corp. recognized a $10,000 loss from the sale of a delivery van, held for 6 years, a $25,000 gain on the sale of business real estate, held for 18 years, and a casualty gain of $3,000 on a business vehicle involved in an accident. Atlas has an unrecaptured Section 1231 loss in the amount of $7,000 from seven years ago, and these are the only dispositions of Section 1231 assets this year.
a) What amount of ordinary gain is recognized?
b) What amount of capital gain is recognized?

Answer: a) $0; b) $18,000
Explanation: Step 1 nets all casualty and theft gains and losses on business property held for more than one year. The $3,000 gain from the auto accident is the only casualty gain realized by Atlas. This gain is netted with the other Section 1231 gains. The $10,000 loss from the sale of the delivery van and the $25,000 gain on business equipment are depreciable business assets held for more than one year and, therefore, would qualify as Section 1231 gains and losses and are netted with the $3,000 casualty gain. Total gain of $18,000 ($25,000 - $10,000 + $3,000) would be taxed as long-term capital gains. The lookback provisions only look back 5 years. So, the unrecaptured Section 1231 loss from seven years ago is irrelevant.
Diff: 2
Learning Objective: LO 1.4
AACSB / AICPA: Analytic / FC: Analysis; PC: None; BB: None
Bloom's: Application
Time on Task: 6 min

113) In Year 20, Zilla, Inc. recognized a net Section 1231 gain of $25,000. It has the following unrecaptured net Section 1231 losses.

Year 19	$14,000 Section 1231 loss
Year 18	$5,000 Section 1231 loss
Year 15	$8,000 Section 1231 loss

a) What amount of ordinary gain is recognized?
b) What amount of capital gain is recognized?

Answer: a) $25,000; b) $0
Explanation: The lookback rule provides that net Section 1231 gains must be offset by net Section 1231 losses from the five preceding tax years that have not already been recaptured. To the extent of these losses, the net Section 1231 gain is treated as ordinary income. Any remaining gain is treated as long-term capital gain. The five preceding tax years include years 14, 18, and 19. The total net Section 1231 loss in the lookback period is $27,000 ($14,000 + $5,000 + $8,000). This is treated as ordinary income. Since this is in excess of the gain of $25,000, the entire amount is treated as ordinary income.
Diff: 2
Learning Objective: LO 1.4
AACSB / AICPA: Analytic / FC: Analysis; PC: None; BB: None
Bloom's: Application
Time on Task: 6 min

114) Edge LLC has a $62,000 recognized gain on Section 1245 property with related depreciation of $46,000. How much of the gain will be taxed as Section 1231?

Answer: $16,000
Explanation: The recapture for Section 1245 assets is the lesser of the recognized gain, $62,000, or all the depreciation taken on the asset, $46,000. Thus, $46,000 is treated as Section 1245 recapture. Section 1245 recapture is taxed as ordinary income, and the excess, $16,000 ($62,000 - $46,000), is taxed as Section 1231 gain.

115) Best Inc. sold office furniture used in its business for $40,000 after owning the furniture for three years. The original purchase price was $55,000, and Best had taken $29,000 in depreciation expense over the years on the furniture.
a) How much of the gain is taxed as ordinary income?
b) How much of the gain is taxed as Section 1231?

Answer: a) $14,000; b) $0
Explanation: First, the recognized gain is calculated as the amount realized less the adjusted basis, which is $14,000 ($40,000 – ($55,000 - $29,000)). Furniture is a Section 1245 asset, so the recapture rules apply. The recapture for Section 1245 assets is the lesser of the recognized gain, $14,000 or all the depreciation taken on the asset, $29,000. Thus, $14,000 is treated as Section 1245 recapture and taxed at ordinary rates. Any remaining gain is considered a Section 1231

gain, which is $0 ($14,000 - $14,000).
Diff: 2
Learning Objective: LO 1.4
AACSB / AICPA: Analytic / FC: Analysis; PC: None; BB: None
Bloom's: Application
Time on Task: 4 min

116) Melone Sisters, a partnership, purchased a building 10 years ago for $500,000. At the time, it elected to depreciate the building using the 150% double-declining balance method. It now sells the building for $700,000. Accumulated depreciation at the time of the sale was $150,000. Straight-line depreciation would have been $100,000.
a) What is the amount of Section 1250 recapture?
b) What is the amount of unrecaptured Section 1250 gain?
c) What is the amount of Section 1231 gain?

Answer: a) $50,000; b) $100,000; c) $200,000
Explanation: The recognized gain is proceeds - (cost - accumulated depreciation); $700,000 - ($500,000 - $150,000) = $350,000 recognized gain. Buildings are subject to Section 1250 depreciation recapture rules. The excess depreciation is the depreciation taken less straight-line depreciation, so $50,000 ($150,000 - $100,000). Section 1250 recapture is the lesser of the recognized gain ($350,000) or excess depreciation ($50,000), so $50,000. The remaining gain of $300,000 ($350,000 - $50,000) is taxed as unrecaptured Section 1250 gain, up to the straight-line depreciation of $100,000. The gain in excess of the straight-line depreciation, $200,000 ($300,000 - $100,000) is taxed as Section 1231 gain.
Diff: 3
Learning Objective: LO 1.4
AACSB / AICPA: Analytic / FC: Analysis; PC: None; BB: None
Bloom's: Application
Time on Task: 7 min

117) Tundra Corp., a C Corporation, sells a commercial warehouse it has used in business operations for 10 years. The building originally cost $800,000 and Tundra has taken $300,000 in straight-line depreciation over the 10 years. It sells the building for $1,100,000.
a) What is the amount of Section 1250 recapture?
b) What is the amount of Section 291 recapture?
c) What is the amount of Section 1231 gain?

Answer: a) $0; b) $60,000; c) $540,000
Explanation: The recognized gain is proceeds - (cost - accumulated depreciation); $1,100,000 - ($800,000 - $300,000) = $600,000 recognized gain. Buildings are subject to Section 1250 depreciation recapture rules. Since the only depreciation taken on the property was straight-line, there is no excess depreciation. Section 1250 recapture is the lesser of the recognized gain

($500,000) or excess depreciation ($0). The remaining gain of $500,000 ($500,000 - $0) is next taxed as Section 291 recapture and treated as ordinary income. If the building had been Section 1245 property, the Section 1245 recapture would have been $300,000, which is the lower of the depreciation claimed of $300,000 or the recognized gain of $500,000. The Section 291 recapture is computed as Section 1245 recapture IF the property had been Section 1245 property less the actual Section 1250 recapture, multiplied by 20%, so $60,000 (($300,000 - $0) x 20%). Finally, whatever gain from the disposition that remains is considered Section 1231 gain, so $540,000 ($600,000 - $60,000).
Diff: 3
Learning Objective: LO 1.4
AACSB / AICPA: Analytic / FC: Analysis; PC: None; BB: None
Bloom's: Application
Time on Task: 8 min

118) Nancy received a Schedule K-1 from a partnership reporting $81,000 in ordinary business income, a Form 1099-INT reporting $2,500 in interest income, and recognized $10,000 in capital losses. Calculate Nancy's qualified business income.

Answer: $81,000
Explanation: QBI must be derived from a *qualified business*, which includes businesses conducted as a sole proprietorship and flow-through income from partnerships, limited liability companies, and S corporations. It does not include performance of services by an employee, guaranteed payments to a partner, investment income or payments paid to a partner in a capacity other than servings as a partner. It does not include reasonable compensation paid to an owner. The only QBI Nancy has is the ordinary business income of $81,000 reported on the Schedule K-1 from a partnership.
Diff: 2
Learning Objective: LO 1.5
AACSB / AICPA: Analytic / FC: Analysis; PC: None; BB: None
Bloom's: Application
Time on Task: 2 min

119) Macy owns a sole proprietorship that has taxable income of $80,000 in the current year. Assume that Macy is not subject to any limitations based on her modified taxable income. What is Macy's QBI deduction?

Answer: $16,000
Explanation: Since no limitations apply, Macy's QBI deduction is 20% of his QBI, or $16,000 ($80,000 x 20%).
Diff: 2
Learning Objective: LO 1.5
AACSB / AICPA: Analytic / FC: Analysis; PC: None; BB: None

Bloom's: Application
Time on Task: 3 min

120) Marty is single and owns a sole proprietorship that is considered a specified service trade or business for the purpose of the QBI deduction. During the current year, the company had taxable income of $380,000, paid wages of $150,000, and had an unadjusted basis in qualified property of $300,000. Marty's modified taxable income is $326,000. Assume the following modified taxable income threshold: tier 1 less than or equal to $197,300; tier 2 between $197,301 and $247,300; tier 3 greater than $247,300. What is Francis' QBI deduction?

Answer: $0
Explanation: Marty's modified taxable income amount places him in tier 3. Because of this, and the fact that his QBI is from a specified service trade or business, his QBI deduction is $0.
Diff: 2
Learning Objective: LO 1.5
AACSB / AICPA: Analytic / FC: Analysis; PC: None; BB: None
Bloom's: Application
Time on Task: 3 min

121) Chrystal, a sole proprietor, reported modified taxable income of $80,000, which includes $4,000 in capital gains, $1,000 in interest income, and $9,000 in qualified dividend income. What is Chrystal's adjusted modified taxable income for the purposes of the Qualified Business Income Deduction?

Answer: $65,000
Explanation: Adjusted modified taxable income = modified taxable income - net capital gain - qualified dividend income; $80,000 - $4,000 - $9,000 = $65,000
Diff: 2
Learning Objective: LO 5.5
AACSB / AICPA: Analytic / FC: Analysis; PC: None; BB: None
Bloom's: Application
Time on Task: 3 min

122) Monique is single and the sole owner of an S corporation. During the current year, the taxable income for the business is $420,000. The business paid wages of $200,000 and had an unadjusted basis in qualified property of $250,000. Monique's modified taxable income is $390,000 . Assume the following modified taxable income threshold: tier 1 less than or equal to $197,300; tier 2 between $197,301 and $247,300; tier 3 greater than $247,300. What is Monique's QBI deduction?

Answer: $78,000

Explanation: Monique is in tier 3, so she is subject to the full wage/property limit. With no limit, Monique's QBI deduction is $84,000 ($420,000 x 20%). However, she is limited by the greater of 50% of wages, $100,000 ($200,000 x 50%), or 25% of wages + 2.5% of UBAI on qualified property, $56,250 (($25% x $200,000) + ($2.5% x $250,000)). The greater of the two is $100,000, which is more than the full QBI deduction, $84,000, so the deduction is not limited by the wage/property limit. However, the taxable income limitation applies. As a result, her final QBI deduction is the lesser of $84,000, or 20% of adjusted modified taxable income, $78,000 ($390,000 x 20%), so $78,000.
Diff: 3
Learning Objective: LO 1.5
AACSB / AICPA: Analytic / FC: Analysis; PC: None; BB: None
Bloom's: Application
Time on Task: 8 min

123) Maxwell is single and the sole owner of an S corporation. During the current year, the taxable income for the business is $230,000. The business paid wages of $70,000 and had an unadjusted basis in qualified property of $150,000. Maxwell's modified taxable income is $210,000. Assume the following modified taxable income threshold: tier 1 less than or equal to $197,300; tier 2 between $197,301 and $247,300; tier 3 greater than $247,300. What is Maxwell's QBI deduction?

Answer: $43,206
Explanation: Maxwell is in tier 2, so she is subject to the partial wage/property limit. With no limit, Maxwell's QBI deduction is $46,000 ($230,000 x 20%). However, she is limited by the greater of 50% of wages, $35,000 ($70,000 x 50%), or 25% of wages + 2.5% of UBAI on qualified property, $21,250 ((25% x $70,000) + ($2.5% x $150,000)), so $35,000. Since Maxwell's modified taxable income is in tier 2, the partial limitation applies. The partial percentage is 25.4% (($210,000 - $197,300)/$50,000). Applying the partial limitation, the reduction in QBI is $2,794 (($46,000 - $35,000) x 25.4%). Therefore, the final QBI deduction is $43,206 ($46,000 - $2,794).
Diff: 3
Learning Objective: LO 1.5
AACSB / AICPA: Analytic / FC: Analysis; PC: None; BB: None
Bloom's: Synthesis
Time on Task: 8 min

124) Wen is single and the owner of a sole proprietorship. During the current year, the taxable income of the business is $150,000. The business paid wages of $30,000 and had an unadjusted basis in qualified property of $25,000. Wen's modified taxable income is $90,000. What is Wen's QBI deduction assuming she is Tier 1?

Answer: $18,000

Explanation: Wen’s QBI deduction is the lower of 20% of QBI, $30,000 ($150,000 x 20%), or 20% of adjusted modified taxable income, $18,000 ($90,000 x 20%), so $18,000
Diff: 2
Learning Objective: LO 1.5
AACSB / AICPA: Analytic / FC: Analysis; PC: None; BB: None
Bloom's: Application
Time on Task: 3 min

125) What are the four stages of the business lifecycle?
Answer: (1) Formation of a Business, (2) Business Operations, (3) Operating Distributions to Owners, (4) Liquidating distributions to owners or sale of business
Explanation: The first stage is the formation of the entity, when the owners contribute cash or assets to the entity in exchange for an ownership interest such as stock or a partnership interest. The second stage is the taxation of the operations of the business. The third stage is the distribution of profits to the owners. The fourth stage is when the entity ends, which can be a liquidating distribution to the owners or a sale by the owners of the business.
Diff: 2
Learning Objective: LO 1.1
AACSB / AICPA: Analytic / FC: Analysis; PC: None; BB: None
Bloom's: Knowledge
Time on Task: 2 min

126) What theory provides that a business is a distinct entity from its owners?

Answer: Entity theory
Explanation: The entity theory provides that a business is a distinct entity from its owners. The entity theory is used by C corporations and for most S corporation transactions (except for the flow-through of income to S corporation shareholders)..
Diff: 2
Learning Objective: LO 1.1
AACSB / AICPA: Analytic / FC: Analysis; PC: None; BB: None
Bloom's: Knowledge
Time on Task: 2 min

127) Which type of distribution results in the recipient continuing to be an owner of the entity after the distribution?

Answer: Operating distribution
Explanation: If an operating distribution is made to the owners, then the recipient continues to be an owner after the distribution.
Diff: 2

Learning Objective: LO 1.1
AACSB / AICPA: Analytic / FC: Analysis; PC: None; BB: None
Bloom's: Application
Time on Task: 3 min

128) Which type of distribution results in the recipient no longer being an owner of the entity after the distribution?

Answer: Liquidating distribution
Explanation: If a liquidating distribution is made to the owners, then the recipient is no longer an owner after the distribution.
Diff: 2
Learning Objective: LO 1.1
AACSB / AICPA: Analytic / FC: Analysis; PC: None; BB: None
Bloom's: Application
Time on Task: 3 min

129) If an owner of a business does not create a separate business entity, what tax form is filed to report business income?

Answer: Schedule C, Form 1040
Explanation: If an owner does not create a separate business entity, then the owner will report as a sole proprietorship on Schedule C, Form 1040.

Diff: 2
Learning Objective: LO 1.1
AACSB / AICPA: Analytic / FC: Analysis; PC: None; BB: None
Bloom's: Knowledge
Time on Task: 3 min

130) The IRS can waive the failure to file and failure to pay penalties if the reason is one outside of the control of a business. This is called:

Answer: Reasonable cause
Explanation: The IRS can waive the failure to file and the failure to pay penalties if a business has a reasonable cause for failing to file or failing to pay. A reasonable cause is one outside the control of a business, such as irregularities in mail delivery, death or serious illness, unavoidable absence, or disaster.

Diff: 1
Learning Objective: LO 1.2
AACSB / AICPA: Analytic / FC: Analysis; PC: None; BB: None

Bloom's: Knowledge
Time on Task: 2 min

131) What is the amount of the penalty imposed for a corporation if there is a substantial understatement?

Answer: 20% of tax due
Explanation: A substantial understatement results when the understatement exceeds the lesser of 10% of the tax required to be shown on the return (or $10,000 if that is greater) or $10 million. The tax law imposes a penalty of 20% of the tax due.

Diff: 1
Learning Objective: LO 1.2
AACSB / AICPA: Analytic / FC: Analysis; PC: None; BB: None
Bloom's: Knowledge
Time on Task: 2 min

132) Land, buildings, and furniture used in a trade or business are examples of what types of assets.

Answer: Section 1231 assets
Explanation: Section 1231 assets are depreciable property and realty used in a trade or business that the business has owned for more than one year. Buildings and furniture are depreciable property and land is realty.

Diff: 2
Learning Objective: LO 1.3
AACSB / AICPA: Analytic / FC: Analysis; PC: None; BB: None
Bloom's: Knowledge
Time on Task: 2 min

133) The lesser of the recognized gain or all the depreciation taken on a Section 1231 asset is:

Answer: Section 1245 recapture
Explanation: The Section 1245 recapture is the lesser of the recognized gain or all depreciation taken on the asset.

Diff: 1
Learning Objective: LO 1.4
AACSB / AICPA: Analytic / FC: Analysis; PC: None; BB: None
Bloom's: Knowledge
Time on Task: 2 min

134) When calculating the Section 1250 recapture, the __________ is the depreciation claimed in excess of the amount that would have been claimed under the straight-line depreciation method.

Answer: Excess depreciation
Explanation: Excess depreciation is the depreciation claimed in excess of the amount that would have been claimed under the straight-line depreciation method.

Diff: 1
Learning Objective: LO 1.4
AACSB / AICPA: Analytic / FC: Analysis; PC: None; BB: None
Bloom's: Knowledge
Time on Task: 1 min

135) Name one type of income that does not qualify for the QBI deduction.

Answer: Capital gains and losses, dividends, interest income, certain other investment items, compensation earned by an employee or owner, guaranteed payments made to a partner.
Explanation: Qualified business income includes sole proprietorship income, partnership ordinary business income, and rental real estate income if certain conditions are met. It does not include Capital gains and losses, dividends, interest income, certain other investment items, compensation earned by an employee or owner, guaranteed payments made to a partner.

Diff: 1
Learning Objective: LO 1.5
AACSB / AICPA: Analytic / FC: Analysis; PC: None; BB: None
Bloom's: Knowledge

E1) Explain the four stages of the business lifecycle.

Answer: The first stage is the formation of the entity, when the owners contribute cash or assets to the entity in exchange for an ownership interest such as stock or a partnership interest. The second stage is the taxation of the operations of the business. The third stage is the distribution of profits to the owners. The fourth stage is when the entity ends, which can be a liquidating distribution to the owners or a sale by the owners of the business.
Diff: 2
Learning Objective: LO 1.1
AACSB / AICPA: Analytic / FC: Analysis; PC: None; BB: None
Bloom's: Knowledge
Section Reference: Sec. 14.1
Time on Task: 5 min

136) Explain the difference between operating and liquidating distributions.

Answer: When an operating distribution is made to owners, the recipients continue to be owners after the distribution. When a liquidating distribution is made, the recipients no longer own the entity after the distribution.
Diff: 2
Learning Objective: LO 1.1
AACSB / AICPA: Analytic / FC: Analysis; PC: None; BB: None
Bloom's: Application
Section Reference: Sec. 14.1
Time on Task: 5 min

137) Compare and contrast the different legal forms of business.

Answer: The primary legal forms include corporations, partnerships (general, limited, and limited liability), limited liability companies, and business trusts. Each form varies in terms of liability, management, formation requirements, and ownership structure.

The following is a summary chart showing similarities and differences for each entity type:

Entity Type	**Separate Entity**	**Limited Liability**	**Management**
Corporation	Yes	Yes	Board of Directors
General Partnership	No	All partners	All partners
Limited partnership	Yes	Yes, for limited partners No, for general partners	All partners
Limited liability partnership	Yes	Yes (partial liability)	All partners
Limited liability company	Yes	Yes	Members
Business trust	Yes	Yes	Trustee

Diff: 3
Learning Objective: LO 1.1
AACSB / AICPA: Analytic / FC: Analysis; PC: None; BB: None
Bloom's: Evaluation
Section Reference: Sec. 1.1
Time on Task: 10 min

138) You are advising a small business owner who recently sold several business assets. The assets include a company-owned building, a delivery van, a patent, and timber that was extracted and sold as lumber. The owner is unsure how these assets should be classified for tax purposes and how that classification could impact their tax treatment.

Explain how each of these assets should be classified as either realty or personalty. Be sure to distinguish between the different types of personalty and explain why clear classification is important for tax reporting.

Answer: To determine the correct tax treatment of the assets sold, we must first classify each one as either realty or personalty.

- Company-Owned building: This is considered realty because it is a structure permanently attached to land. Realty includes land and buildings, as well as other permanent structures like fences or silos.
- Delivery van: The van is personalty, specifically tangible personalty, because it has physical qualities and can be moved.
- Patent: A patent is classified as intangible property, a type of personalty. It has no physical form but represents an ownership right, which qualifies as an abstraction rather than a tangible asset.
- Timber (after extraction): Once extracted, timber is treated as personalty, even though it originated from land. Prior to extraction, it would have been considered realty, but extraction changes its classification. The extracted timber is a natural resource, which is a type of personalty.

Clear classification is essential because the distinction between realty and personalty can impact depreciation methods, gain or loss recognition, and tax rates under various asset rules. Misclassifying an asset could result in incorrect tax filings and penalties.

Diff: 3
Learning Objective: LO 1.3
AACSB / AICPA: Analytic / FC: Analysis; PC: None; BB: None
Bloom's: Evaluation
Section Reference: Sec. 1.1
Time on Task: 10 min

139) Explain what constitutes qualified business income for the purposes of the QBI deduction. In your answer, discuss the types of business entities that generate QBI, the types of income excluded from QBI, and any special considerations that apply to partners and owners.

Answer:

QBI refers to the net amount of income, gain, deduction, and loss from a qualified trade or business that is eligible for the QBI deduction. Only income from specific entities qualifies for the deduction, including income from sole proprietorships and flow-through entities, such as partnerships, LLCs, and S corporations.

Not all types of income are eligible for the QBI deduction. Income that is not eligible includes income from C corporations, capital gains and losses, dividends, interest, certain other investment items, compensation earned by an employee or an owner of a company, and guaranteed payments made to partners of partnerships.

A special consideration is that the taxpayer must generally conduct business activity in the United States. An additional consideration is related to specialized services. The QBI deduction is limited for specified service trade or businesses, which include services in the field of health, law, accounting, actuarial sciences, and more.

Diff: 3
Learning Objective: LO 1.3
AACSB / AICPA: Analytic / FC: Analysis; PC: None; BB: None
Bloom's: Evaluation
Section Reference: Sec. 1.1
Time on Task: 10 min