Regulation

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Chapter Subjects of VOLUME 2—REGULATION

BUSINESS LAW & PROFESSIONAL RESPONSIBILITIES

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Chapter Two — SALES
Chapter Three — SECURED TRANSACTIONS
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Chapter One  
Contracts

ELEMENTS OF A CONTRACT

1. A contract is an agreement, a meeting of the minds.

2. A contract contains the following six essential elements:
   a. an offer
   b. an acceptance
   c. consideration
   d. in proper form (i.e. the Statute of Frauds may require a writing)
   e. for a lawful object
   f. by two or more competent parties

Memory Device: Only Accuracy Can Pass Law Candidates

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<td>2 or more Competent Parties</td>
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OFFERS AND ACCEPTANCES

1. An agreement requires both an Offer and an Acceptance

2. An Offer has 3 elements
   a. it must be seriously intended (the test is whether a reasonable person would consider it to be a serious offer)
   b. it must be communicated by either words or actions
   c. it must be definite in its terms (must include a price)

3. Advertisements and price quotes are not usually offers; they are invitations to deal

4. An Acceptance has 3 elements
   a. an acceptance must be unconditional - the offeree must comply with all of the offeror's terms or a counteroffer is created
   b. an acceptance must be communicated by words or actions (e.g. silence is rarely an acceptance unless there is a long course of dealing between the parties)
   c. an acceptance may only be accepted by the party to whom it's made (e.g. offeree cannot assign his/her right to accept to accept an offer to a 3rd party)
WHEN OFFERS END

1. **Counteroffers** end offers but they are only effective when they are received

   **Example:** A mails an offer to B on April 1 which is received on April 3. On April 3 B mails a counteroffer to A. On April 4 B changes her mind and telephones an acceptance. On April 5 the counteroffer arrives. There is a contract between A and B because the offer was accepted on April 4 before the counteroffer took effect.

   a. requests and inquiries are not counteroffers
   b. on the exam an inquiry will usually end in a question mark, not a period

2. **Rejections** end offers but they are only effective when received

3. **Revocations** end offers but they are only effective when received. Offeror may usually revoke anytime before acceptance even if (s)he promises the offer will be held open

   a. exception: Option Contracts can't be revoked
      1). the offeree pays consideration to keep offer open (note: there is no option contract until the consideration is actually paid by the offeree)
      2). counteroffers will not end an option contract

   **Example:** A pays X $1,000 for the right to buy X's house for the price of $250,000 anytime prior to June 1. An option contract has been created and X may not revoke the offer to sell for $250,000. If on May 1 A offers X $225,000 for the house, the option contract will not end and A will still have until June 1 to buy for $250,000

   b. exception: In UCC Sales Firm Offers are irrevocable without consideration if: made by a **merchant**, in **writing**, and a **guarantee** the offer will be held open

4. Offers end at the time stated (if no termination time is stated, it ends at reasonable time)

5. Death or insanity ends offers immediately, but does not end most contracts

   **Example:** X purchases goods on credit from A and dies prior to payment. The contract is still valid and X's estate owes A the balance of the purchase price

6. Destruction or sale of the subject matter will end an offer
   a. destruction of the subject matter ends the offer immediately
   b. sale of the subject only revokes the offer when the offeree learns of it, not when the subject is sold

WHEN ACCEPTANCES ARE EFFECTIVE

1. **MAILBOX RULE** (also called the deposited acceptance rule) an acceptance is valid when sent if the offeree uses either of the following means of communication:
   a. the express means (the form of communication the offeror said to use) **OR**
   b. any reasonable means if none is specified (the same means offeror used or faster)

   **Example:** A mails an offer to B without specifying how acceptances are to be sent. If B mails a valid acceptance, the acceptance is effective when sent. If B telegraphs an acceptance, it is still effective when sent because a telegram is faster than the mail. There would be a valid contract even if the acceptance were lost or never arrived.

   c. if a slower means of communication is used, it is valid when received
2. **Exceptions** when the mailbox rule does not apply
   a. if an offer states an acceptance must be received by a specified date, then the acceptance must be received by that date to be valid and cannot be effective when sent (*reason*: the offeree must comply with all of the offeror’s terms)
   b. if the offeree has sent a previous rejection of the offer, for a later acceptance to be effective it must be received before the prior rejection

### TYPES OF CONTRACTS

1. **Bilateral** and **Unilateral** contracts
   a. a bilateral contract is a promise for a promise (most contracts are bilateral)
   b. a unilateral contract is a promise for an act (*e.g.* a reward)
      1). *note*: the offeree must know of the reward to accept
      2). if the offeree has made a substantial start on performing a unilateral offer, the offeror cannot revoke the offer

2. **Requirement** and **Output** contracts
   a. in a requirement contract, one party agrees to purchase all their requirements from another. The contract is valid if the amounts requested are made in good faith and reasonable to normal amounts
   b. in an output contract, one party agrees to purchase the entire output of a factory or manufacturer. The contract is valid if the amounts are produced in good faith and reasonable to normal amounts

3. **Executed** and **Executory** contracts
   a. executed contracts are those that have been fully performed by both parties
   b. executory contracts are those that have not been fully performed by both

4. **Valid, Void** and **Voidable** contracts
   a. a valid contract is legally binding and enforceable against both parties
   b. a void contract is not enforceable against either party (*e.g.* it's not a legal contract)
   c. a voidable contract is a legal contract wherein one or both of the parties has the right to disaffirm or rescind the contract (*e.g.* minor contracts are voidable by the minor and most fraud is voidable by the injured party)

### ***CONSIDERATION***

1. An essential element of a contract is that it be supported by adequate consideration
   a. consideration is giving up of a legal right (*e.g.* something you’re legally free not to do)
   b. consideration must be mutually bargained for (*e.g.* one promise was given in exchange for the other party’s promise or act) and legally sufficient

2. Courts aren’t usually concerned with the adequacy of consideration, only that it be present for both parties
   a. thus, there is no requirement that the consideration be of equal value
   b. exception: courts will consider the adequacy of consideration if the contract is *unconscionable* (so grossly one sided that it shocks the conscience of a court)

3. Two cases where consideration is not present
   a. past consideration is no good (*e.g.* an employer promises a cash payment to a deceased employee’s family in recognition of the employee's years of service)
   b. there is no consideration when a party is already contractually or legally obligated to perform

4. Additional consideration is needed from both parties to modify a contract
   exception: in UCC Sales contracts can be modified without additional consideration
5. **Exceptions:** some promises are enforceable without any consideration:
   a. promises to donate to charity are often enforceable without consideration
   b. a written promise to pay a debt barred by the Statute of Limitations can be enforced without consideration
   c. **promissory estoppel:** a promise by one party relied upon by another can be enforced without consideration if the reliance was:
      1). **reasonable:** a reasonable person would have relied on the promise
      2). **detrimental:** party relying on the promise would be substantially harmed

***STATUTE OF FRAUDS***

1. There are 6 types of contracts that require some type of writing to be enforceable

<table>
<thead>
<tr>
<th>6</th>
<th>TYPES OF CONTRACTS = GRIPE + MARRIAGE</th>
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<tbody>
<tr>
<td>G</td>
<td>sale of <strong>Goods</strong> of $500 or more - the writing must state a quantity</td>
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<tr>
<td>R</td>
<td><strong>Real estate contracts</strong></td>
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<td>I</td>
<td>contracts <strong>Impossible</strong> to perform in 1 year - begin measuring from when the contract is made - not when performance is to begin</td>
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<td>P</td>
<td><strong>Promise</strong> to answer the debt of another</td>
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<td>E</td>
<td><strong>Executor's promise</strong> to be liable for the debt of an estate</td>
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<tr>
<td>Marriage</td>
<td>contracts where <strong>Marriage</strong> is the consideration</td>
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2. Any type of writing that states the major contract terms can satisfy the Statute of Frauds
   a. the writing need only be signed by one party but it is only enforceable against the one who signed
   b. the terms may be stated in more than one document

3. **Exceptions:** no writing is required even though it is one of the 6 types if:
   a. the contract is fully performed by both parties (executed)
   b. a contract impossible to perform in one year is enforceable without a writing if one side has fully performed (e.g. X orally promises an employee a $25,000 bonus, if the employee will remain with her for 4 years. If the employee works for X for the 4 years, X's oral promise is enforceable)
   c. an oral real estate contract is enforceable in two different cases:
      1). if the buyer is in possession of the land and has made a substantial payment or substantial improvements or
      2). if the seller has completely performed (e.g. delivered the deed to the buyer)
   d. a promise to answer the debt of another is enforceable if the **main or primary purpose** of the promise was to benefit the promisor and not the debtor

**Example:** X hires a contractor to build a house and the contractor subcontracts with a plumber. The plumber threatens to quit due to contractor's nonpayment. X, fearing the house will not be finished on time, orally promises to pay the plumber if the contractor doesn't. Although X's oral promise to pay the plumber is a promise to pay the debt of another, it is enforceable because the **main purpose** was to benefit X, not the contractor.)
COMPETENT PARTIES: MINORS, DRUNKS & THE INSANE

1. A contract must be made by two or more competent parties
   note: the exam normally tests competent parties with minors, drunks and the insane

2. Minors may disaffirm contracts anytime while a minor or a reasonable time thereafter (thus, minor contracts are voidable because the minor has the right to rescind)
   a. minors cannot disaffirm real estate contracts while they are still a minor
   b. minors cannot disaffirm necessary contracts (things like food, clothing or shelter)

3. To disaffirm a minor need only return what (s)he possesses or controls at that time

4. Minor may ratify a contract by words or actions (i.e. use of the object)
   a. minors can only ratify after becoming an adult; they can't ratify while still a minor
   b. minors must ratify the entire contract - they can't ratify part and disaffirm part

5. Minors may disaffirm contracts, but they are liable in damages for torts (civil wrongs)

   Example: A minor buys a car by misrepresenting that (s)he was an adult. After putting 200,000 miles on the car, the minor attempts to disaffirm. The minor may disaffirm the contract, but must pay damages for the tort of fraud.

6. A drunk may disaffirm only if (s)he was incapable of understanding what (s)he did

7. Insane may usually disaffirm, but once adjudicated insane all future contracts are void

ILLEGAL CONTRACTS

1. Illegal contracts are void - courts won't aid either party in an illegal contract

2. Failure to have a required license makes all your contracts void
   exception: the contract is enforceable if the license was a mere revenue raising measure

3. Covenants not to compete in a sale of business or employment contract are valid if reasonable. They must meet 3 tests of reasonableness:
   a. must be reasonably needed to protect a legitimate business interests
   b. must be reasonable as to time
   c. must be reasonable as to distance

***FRAUD*** and INNOCENT MISREPRESENTATIONS

1. Actual Fraud has 5 elements - MS RID

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2. **Constructive Fraud** - has the same 5 elements as actual fraud but the intent to deceive element is fulfilled by a **reckless disregard for the truth** (making a statement without knowing if the statement is true or false) not scienter - **MR RID**

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<th>5 Elements of Constructive Fraud = MR RID</th>
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3. Fraud in the execution is **void** (defrauded party didn't know a contract was made)

4. Fraud in the inducement (party knows they made a contract but one or more terms are misrepresented) makes a contract **voidable**. This means the injured party has 2 choices: 
   a. rescission: cancel the contract and restore parties to their former positions  
   b. or the injured party may accept the contract and sue in tort for money damages  
   c. note: in UCC Sales a party may rescind and sue for money damages

5. An Innocent Misrepresentation has 4 of the elements of fraud but no scienter or reckless disregard for the truth - the injured party may only rescind and cannot sue for damages - **MR ID**

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**MISTAKES, DURESS & UNDUE INFLUENCE**

1. Most mistakes have no effect on a contract. There are 2 exceptions: 
   a. mutual mistakes of **material facts** make a contract **voidable**  
   b. with **material** unilateral mistakes, one may disaffirm only if the other party knew or should have known a mistake was being made

2. Duress is forcing someone into a contract by wrongful acts or improper threats of violence, economic devastation or criminal action  
   a. to constitute duress, it must actually induce the other party to enter the contract  
   b. forcing someone into a contract by actual physical force makes the contract **void**  
   c. forcing someone into a contract by improper threats makes a contract **voidable**  
      1). threat of economic devastation or criminal prosecution is **voidable**  
      2). threat of civil litigation is **not** duress, only threat of criminal action

3. Undue Influence is an unfair use of a position of trust, confidence or affection to overcome another's free will in contract. It makes a contract **voidable**
**PAROL EVIDENCE RULE**

1. Evidence (oral or written) that contradicts a written contract is **inadmissible** in court
   a. evidence of what occurred prior to or during (contemporaneous with) the writing is inadmissible if it contradicts the written agreement
   b. **note:** may always introduce evidence of what took place after the date of the writing (even if it contradicts) because the parties may have agreed to change the writing
   c. writing must have been intended to be the complete contract between the parties

2. The parol evidence rule does not preclude the introduction of evidence if any of the following apply (evidence is admissible) **FAME**

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<th>Evidence is admissible if:</th>
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<td>F</td>
<td>can always introduce evidence of <strong>Fraud</strong> or other circumstances that would invalidate the contract (e.g. illegality, duress, undue influence)</td>
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<td>A</td>
<td>can always introduce evidence of what took place <strong>After</strong> the date of the contract even if the evidence contradicts the writing</td>
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<tr>
<td>M</td>
<td>can always introduce evidence of <strong>Mistakes</strong></td>
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<td>E</td>
<td>can always introduce evidence to <strong>Explain</strong> the writing or to clear up ambiguities - parol evidence rule only precludes the introduction of contradictory evidence</td>
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**THIRD PARTY BENEFICIARY CONTRACTS**

1. A & B make a contract with the intent of benefiting a third party

2. For a 3rd party to have rights under the contract they must have been an **intended beneficiary**. There are two types of intended beneficiaries
   a. **donee beneficiary** - someone you make a gift to (e.g. beneficiaries in most life insurance contracts are donee beneficiaries)
   b. **creditor beneficiary** - may sue either A or B or both if there is a breach

   **Example:** A owes X $500. A agrees to perform services for B for the sum of $500 with B to pay the money to X. If A performs the services and X does not receive the $500, X may sue either A or B or both of them because X is a creditor beneficiary

3. Incidental beneficiary obtain no rights under the contract

**ASSUMING & BUYING SUBJECT TO A MORTGAGE**

1. **Assuming a Mortgage:** buyer purchases land already encumbered by a mortgage
   a. buyer agrees to take over mortgage and the buyer is liable for the mortgage
   b. seller (original mortgagor) is still liable for mortgage
   c. the creditor (mortgagee) is a 3rd party creditor beneficiary and may sue either buyer or seller if there is a breach

2. **Buying Subject to a Mortgage:** buyer purchases land encumbered by a mortgage
   a. buyer doesn't agree to take over the mortgage and is not liable
   b. seller (original mortgagor) is the only one liable for mortgage
   c. buyer runs the risk of foreclosure if the seller doesn't pay
ASSIGNMENTS & DELEGATIONS

1. Most contract rights can be assigned and duties delegated
   a. a writing is not usually required to assign
   b. an assignment does not usually require consideration

2. Although there is a technical difference between an assignment and a delegation, an “assignment of all rights under the contract” is usually interpreted to be both an assignment of rights and a delegation of duties

3. You may not assign or delegate if the basic obligations of the parties would be changed

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4. Assignee or delegatee "stands in the shoes" of the assignor or delegator. They gain all of the assignor’s rights and have all of the assignor’s liability
   a. if there is a breach, both the assignee and the assignor are liable
   b. a defense that is good against the assignor is also good against the assignee

5. When a creditor assigns out his right to receive money (e.g. selling a receivable)
   a. if the debtor is notified of the assignment, debtor must pay assignee **not assignor**
   b. if the debtor isn’t notified and pays the assignor, the assignee may only collect from the assignor and may not collect from the debtor

6. An assignor makes certain implied warranties
   a. the claim assigned is valid (e.g. no fraud, duress, illegality, etc.)
   b. assignor has good title and all documents are genuine
   c. assignor has no knowledge of facts that would impair the value of the assignment
   d. assignor will do nothing to defeat or impair the assignment

PERFORMANCE & DISCHARGE OF CONTRACT DUTIES

1. **Discharge by performance or prevention of performance**
   a. performance or tender of performance of contractual duties discharges that party
   b. prevention of performance by one party is a material breach and discharges the other party

2. **Discharge by breach**
   a. a **material breach** by one side of a contract releases the other side from performing
   b. **exception:** if one party has **substantially performed**, no discharge occurs
      1). the breach must be **minor** (i.e. the party substantially performed)
      2). the breach must usually be **unintentional**
      3). breaching party may still collect under the contract, but **damages are subtracted for the minor breach**
   c. an **anticipatory breach** or **anticipatory repudiation** occurs when one party, before the time of performance, indicates they won't perform
      1). injured party may sue immediately **OR**
      2). wait until the time of performance and then sue if there is a breach

1-8
Example: A contractor agrees to build a house for $150,000 and complete construction by August 15. If the contractor informs the homeowner on July 15 that the house will not be completed on time, the homeowner may immediately sue the contractor on July 15, or wait until August 15 and sue if the house is not completed.

3. **Discharge by agreement**
   a. mutual rescission: both parties agree to cancel the contract
   b. in a novation, the parties agree to replace one party in a contract with a new party
      1). the creditor agrees to release the old party (i.e. old party is discharged)
      2). the creditor agrees to look only to the new party for performance

Example: $X$ owes $1^{st}$ National Bank $200,000 on a mortgage and is in default. $Y$ agrees to assume liability for the mortgage. If $1^{st}$ National agrees to release $X$ from the mortgage and look only to $Y$ for payment, a novation has occurred.

   c. in an Accord & Satisfaction the parties agree to change a contract by substituting a new performance for an existing one (frequently on the exam, a promise of a debtor to pay a lesser amount than what is owed at an earlier date)
      1). the Accord is the promise to change performance
      2). the Satisfaction is the satisfactory performance of the accord
      3). no discharge of the old contract until the accord is satisfactorily performed

Example: $X$ owes $Y$ $15,000 on a promissory note payable on December 1. $Y$ agrees to accept $12,000 on June 1 in full satisfaction of the debt. The Accord is the agreement to pay the lesser amount 6 months early. The debt will not be discharged until $X$ actually pays the $12,000. (Satisfaction).

4. **Discharge by operation of law**
   a. if a contract becomes absolutely impossible to perform, both parties are discharged (e.g. Death of a party to perform services discharges the personal service contract and destruction of the subject matter through no fault of either party discharges both parties)
   b. the statute of limitations limits the time which a law suit may be brought
      1). the statute of limitations does not discharge contractual obligations or make the contract void.
         It merely bars access to judicial remedies
      2). the time period is measured from the date of the breach, not the contract date and is usually six years in most states
      3). a debt barred by the statute of limitations can be revived in most states by a new written promise to pay by the debtor

5. A **condition** is an event whose occurrence may affect the promisor's duty to perform
   a. a condition precedent is an event that must occur before performance is due (e.g. $X$ agrees to purchase $Y$'s house for $200,000 providing that $X$ can obtain suitable financing within 60 days)
   b. a condition subsequent is an event that will terminate a duty to perform (e.g. in a sale or return, the buyer may terminate the contract within a specified period of time if not satisfied with the goods)
   c. concurrent conditions occur when the mutual duties of the parties are to take place at the same time (e.g. in UCC sales, unless otherwise agreed, the buyer's duty to pay and the seller's duty to deliver occur at the same time)
1. Compensatory damages are monetary damages to compensate for all harm done
   a. includes loss in value, consequential damages (e.g., lost profit or injury to property caused by the breach) and incidental damages (e.g., expenses to avoid further loss)
   b. punitive damages are rarely awarded for contract or sales breaches
   c. mitigation of damages: injured party is required to use reasonable efforts to keep damages low (e.g., if a buyer breaches, the seller should use reasonable efforts to resell the goods because this will lessen the amount of damages the buyer must pay)

2. Liquidated damages occur when the contract states what damages will be for a breach
   a. most often involves forfeiture of a down payment by a buyer if there is a breach
   b. the damages must be reasonable to the harm actually done and not a penalty

3. Specific performance is an equitable remedy where the breaching party is required by court order to perform the contractual duties as promised
   a. it is available only when money damages are an inadequate remedy
   b. thus, it may only be used with rare and unique property and never in personal service contracts (e.g., land or any "one of a kind item")
   c. if specific performance is available a party will recover either specific performance or compensatory damages, but not usually both

4. Rescission cancels the contract and restores the parties to their former position

5. Reformation: a court rewrites a contract to make it conform to the agreement of the parties
1. In order for an offer to confer the power to form a contract by acceptance, it must have all of the following elements except:
   a. Be communicated to the offeree and the communication must be made or authorized by the offeror.
   b. Be sufficiently definite and certain.
   c. Be communicated by words to the offeree by the offeror.
   d. Manifest an intent to enter into a contract.

2. On September 10, Harris, Inc., a new car dealer, placed a newspaper advertisement stating that Harris would sell 10 cars at its showroom for a special discount only on September 12, 13, and 14. On September 12, King called Harris and expressed an interest in buying one of the advertised cars. King was told that five of the cars had been sold and to come to the showroom as soon as possible. On September 13, Harris made a televised announcement that the sale would end at 10:00 p.m. that night. King went to Harris' showroom on September 14 and demanded the right to buy a car at the special discount. Harris had sold the 10 cars and refused King's demand. King sued Harris for breach of contract. Harris's best defense to King's suit would be that Harris:
   a. Offer was unenforceable.
   b. Advertisement was not an offer.
   c. Television announcement revoked the offer.
   d. Offer had not been accepted.

3. On February 12, Harris sent Fresno a written offer to purchase Fresno's land. The offer included the following provision: "Acceptance of this offer must be by registered or certified mail, received by Harris no later than February 18 by 5:00 p.m. CST." On February 18, Fresno sent Harris a letter accepting the offer by private overnight delivery service. Harris received the letter on February 19. Which of the following statements is correct?
   a. A contract was formed on February 19.
   b. Fresno's letter constituted a counteroffer.
   c. Fresno's use of the overnight delivery service was an effective form of acceptance.
   d. A contract was formed on February 18 regardless of when Harris actually received Fresno's letter.

4. On September 27, Summers sent Fox a letter offering to sell Fox a vacation home for $150,000. On October 2, Fox replied by mail agreeing to buy the home for $145,000. Summers did not reply to Fox. Do Fox and Summers have a binding contract?
   a. No, because Fox failed to sign and return Summers' letter.
   b. No, because Fox's letter was a counteroffer.
   c. Yes, because Summers' offer was validly accepted.
   d. Yes, because Summers' silence is an implied acceptance of Fox's letter.

5. Stable Corp. offered in a signed writing to sell Mix an office building for $350,000. The offer, which was sent by Stable on April 1, indicated that it would remain open until July 9. On July 5, Mix mailed a letter rejecting Stable's offer. On July 6, Mix sent a telegram to Stable accepting the original offer. The letter of rejection was received by Stable on July 8 and the telegram of acceptance was received by Stable on July 7. Which of the following is correct?
   a. Mix's telegram resulted in the formation of a valid contract.
   b. Mix's letter of July 5 terminated Stable's offer when mailed.
   c. Stable was not entitled to withdraw its offer until after July 9.
   d. Although Stable's offer on April 1 was a firm offer under the UCC, it will only remain open for three months.

6. Which of the following statements concerning the effectiveness of an offeree's rejection and an offeror's revocation of an offer is generally correct?
   An offeree's rejection is effective when:
   a. Received by offeror
   b. Sent by offeror
   c. Sent by offeree
   d. Received by offeror

   An offeror's revocation is effective when:
   a. Received by offeror
   b. Sent by offeror
7. The president of Deal Corp. wrote to Boyd, offering to sell the Deal factory for $300,000. The offer was sent by Deal on June 5 and was received by Boyd on June 9. The offer stated that it would remain open until December 20. The offer
a. Constitutes an enforceable option.
b. May be revoked by Deal any time prior to Boyd's acceptance.
c. Is a firm offer under the UCC but will be irrevocable for only three months.
d. Is a firm offer under the UCC because it is in writing.

Items 8 and 9 are based on the following information:
On March 1, Mirk Corp. wrote to Carr offering to sell Carr its office building for $280,000. The offer stated that it would remain open until July 1. It further stated that acceptance must be by telegram and would be effective only upon receipt.

8. For this question only, assume that Carr telegraphed its acceptance on June 28 and that it was received by Mirk on July 2. Which of the following statements is correct?
a. A contract was formed when Carr telegraphed its acceptance.
b. A contract was formed when Mirk received Carr's acceptance.
c. No contract was formed because three months had elapsed since the offer was made.
d. No contract was formed since the acceptance was received after July 1.

9. For this question only, assume that on May 10, Mirk mailed a letter to Carr revoking its offer of March 1. Carr did not learn of Mirk's revocation until Carr received the letter on May 17. Carr had already sent a telegram of acceptance to Mirk on May 14, which was received by Mirk on May 16. Which of the following statements is correct?
a. Carr's telegram of acceptance was effective on May 16.
b. Mirk's offer of March 1 was irrevocable and therefore could not be withdrawn prior to July 1.
c. Mirk's letter of revocation effectively terminated its offer of March 1 when mailed.
d. Carr's telegram of acceptance was effective on May 14.

10. On January 1, Lemon wrote Martin offering to sell Martin his ranch for $80,000 cash. Lemon's letter indicated that the offer would remain open until February 15 if Martin mailed $100 by January 10. On January 5, Martin mailed $100 to Lemon. On January 30, Martin telephoned Lemon stating that he would be willing to pay $60,000 for the ranch. Lemon refused to sell at that price and immediately placed the ranch on the open market. On February 6, Martin mailed Lemon a letter accepting the original offer to buy the ranch at $80,000. The following day, Lemon received Martin's acceptance. At that time the ranch was on the market for $100,000. Which of the following is correct?
a. Martin's mailing of $100 to Lemon on January 5 failed to create an option.
b. Martin's communication of January 30 automatically terminated Lemon's offer of January 1.
c. The placing of the ranch on the market by Lemon constituted an effective revocation of his offer on January 1.
d. Martin's letter of February 6 formed a binding contract based on the original terms of Lemon's January 1 letter.

11. On June 15, Peters orally offered to sell a used lawn mower to Mason for $125. Peters specified that Mason had until June 20 to accept the offer. On June 16, Peters received an offer to purchase the lawn mower for $150 from Bronson, Mason's neighbor. Peters accepted Bronson's offer. On June 17, Mason saw Bronson using the lawn mower and was told the mower had been sold to Bronson. Mason immediately wrote to Peters to accept the June 15 offer. Which of the following statements is correct?
a. Mason's acceptance would be effective when received by Peters.
b. Mason's acceptance would be effective when mailed.
c. Peters' offer had been revoked and Mason's acceptance was ineffective.
d. Peters was obligated to keep the June 15 offer open until June 20.
12. Nix sent Castor a letter offering to employ Castor as controller of Nix's automobile dealership. Castor received the letter on February 19. The letter provided that Castor would have until February 23 to consider the offer and, in the meantime, Nix would not withdraw it. On February 20, Nix, after reconsidering the offer to Castor, decided to offer the job to Vick, who accepted immediately. That same day, Nix called Castor and revoked the offer. Castor told Nix that an acceptance of Nix's offer was mailed on February 19. Under the circumstances,
   a. Nix's offer was irrevocable until February 23.
   b. No contract was formed between Nix and Castor because Nix revoked the offer before Nix received Castor's acceptance.
   c. Castor's acceptance was effective when mailed.
   d. Any revocation of the offer would have to be in writing because Nix's offer was in writing.

13. On April 1, Fine Corp. faxed Moss an offer to purchase Moss' warehouse for $500,000. The offer stated that it would remain open only until April 4 and that acceptance must be received to be effective. Moss sent an acceptance on April 4 by overnight mail and Fine received it on April 5. Which of the following statements is correct?
   a. No contract was formed because Moss sent the acceptance by an unauthorized method.
   b. No contract was formed because Fine received Moss' acceptance after April 4.
   c. A contract was formed when Moss sent the acceptance.
   d. A contract was formed when Fine received Moss' acceptance.

14. The mailbox rule generally makes acceptance of an offer effective at the time the acceptance is dispatched. The mailbox rule does not apply if:
   a. Both the offeror and offeree are merchants.
   b. The offer proposes a sale of real estate.
   c. The offer provides that an acceptance should not be effective until actually received.
   d. The duration of the offer is not in excess of three months.

15. Kay, an art collector, promised Hammer, an art student, that if Hammer could obtain certain rare artifacts within two weeks, Kay would pay for Hammer's postgraduate education. At considerable effort and expense, Hammer obtained the specified artifacts within the two-week period. When Hammer requested payment, Kay refused. Kay claimed that there was no consideration for the promise. Hammer would prevail against Kay based on
   a. Unilateral contract.
   b. Unjust enrichment.
   c. Public policy.
   d. Quasi contract.

16. Dye sent Hill a written offer to sell a tract of land located in Newtown for $60,000. The parties were engaged in a separate dispute. The offer stated that it would be irrevocable for 60 days if Hill would promise to refrain from suing Dye during this time. Hill promptly delivered a promise not to sue during the term of the offer and to forego suit if Hill accepted the offer. Dye subsequently decided that the possible suit by Hill was groundless and therefore phoned Hill and revoked the offer 15 days after making it. Hill mailed an acceptance on the 20th day. Dye did not reply. Under the circumstances,
   a. Dye's offer was supported by consideration and was not revocable when accepted.
   b. Dye's written offer would be irrevocable even without consideration.
   c. Dye's silence was an acceptance of Hill's promise.
   d. Dye's revocation, not being in writing, was invalid.

17. In determining whether the consideration requirement to form a contract has been satisfied, the consideration exchanged by the parties to the contract must be
   a. Of approximately equal value.
   b. Legally sufficient.
   c. Exchanged simultaneously by the parties.
   d. Fair and reasonable under the circumstances.
18. In deciding whether consideration necessary to form a contract exists, a court must determine whether
a. The consideration given by each party is of roughly equal value.
b. There is mutuality of consideration.
c. The consideration has sufficient monetary value.
d. The consideration conforms to the subjective intent of the parties.

19. Grove is seeking to avoid performing a promise to pay Brook $1,500. Grove is relying upon lack of consideration on Brook's part sufficient to support his promise. Grove will prevail if he can establish that
a. Prior to Grove promise, Brook had already performed the requested act.
b. Brook's only claim of consideration was the relinquishment of a legal right.
c. Brook's asserted consideration is worth only $400.
d. The consideration to be performed by Brook will be performed by a third party.

20. Which of the following will be legally binding despite lack of consideration?
   a. An employer's promise to make a cash payment to a deceased employee's family in recognition of the employee's many years of service.
   b. A promise to donate money to a charity on which the charity relied in incurring large expenditures.
   c. A modification of a signed contract to purchase a parcel of land.
   d. A merchant's oral promise to keep an offer open for 60 days.

21. Which of the following requires consideration to be binding on the parties?
   a. Material modification of contract involving the sale of real estate.
   b. Ratification of a contract by a person after reaching the age of majority.
   c. A written promise signed by a merchant to keep an offer to sell goods open for 10 days.
   d. Material modification of a sale of goods contract under the UCC.

22. In which of the following situations does the first promise serve as valid consideration for the second promise?
   a. A police officer's promise to catch a thief for a victim's promise to pay a reward.
   b. A builder's promise to complete a contract for a purchaser's promise to extend the time for completion.
   c. A debtor's promise to pay $500 for a creditor's promise to forgive the balance of a $600 liquidated debt.
   d. A debtor's promise to pay $500 for a creditor's promise to forgive the balance of a $600 disputed debt.

23. Carson agreed orally to repair Ives' rare book for $450. Before the work was started, Ives asked Carson to perform additional repairs to the book and agreed to increase the contract price to $650. After Carson completed the work, Ives refused to pay and Carson sued. Ives' defense was based on the Statute of Frauds. What total amount will Carson recover?
   a. $0
   b. $200
   c. $450
   d. $650

24. On June 1, 1992, Decker orally guaranteed the payment of a $5,000 note Decker's cousin owed Baker. Decker's agreement with Baker provided that Decker's guaranty would terminate in 18 months. On June 3, 1992, Baker wrote Decker confirming Decker's guaranty. Decker did not object to the confirmation. On August 23, 1992, Decker's cousin defaulted on the note and Baker demanded that Decker honor the guaranty. Decker refused. Which of the following statements is correct?
   a. Decker is liable under the oral guaranty because Decker did not object to Baker's June 3 letter.
   b. Decker is not liable under the oral guaranty because it expired more than one year after June 1.
   c. Decker is liable under the oral guaranty because Baker demanded payment within one year of the date the guaranty was given.
   d. Decker is not liable under the oral guaranty because Decker's promise was not in writing.
25. Dunne and Cook signed a contract requiring Cook to rebind 500 of Dunne's books at $.80 per book. Later, Dunne requested, in good faith, that the price be reduced to $.70 per book. Cook agreed orally to reduce the price to $.70. Under the circumstances, the oral agreement is
   a. Enforceable, but proof of it is inadmissible into evidence.
   b. Enforceable, and proof of it is admissible into evidence.
   c. Unenforceable, because Dunne failed to give consideration, but proof of it is otherwise admissible into evidence.
   d. Unenforceable, due to the statute of frauds, and proof of it is inadmissible into evidence.

26. Baker and Able signed a contract which required Able to purchase 600 books from Baker at $.90 per book. Subsequently, Able, in good faith, requested that the price of the books be reduced to $.80 per book. Baker orally agreed to reduce the price to $.80. Under the circumstances, the oral agreement is
   a. Unenforceable, because Abel failed to give consideration, but proof of it will be otherwise admissible into evidence.
   b. Unenforceable, due to the statute of frauds, and proof of it will be inadmissible into evidence.
   c. Enforceable, but proof of it will be inadmissible into evidence.
   d. Enforceable, and proof of it will be admissible into evidence.

27. Which of the following statements is true with regard to the Statute of Frauds?
   a. All contracts involving consideration of more than $500 must be in writing.
   b. The written contract must be signed by all parties.
   c. The Statute of Frauds applies to contracts that can be fully performed within one year from the date they are made.
   d. The contract terms may be stated in more than one document.

28. With regard to an agreement for the sale of real estate, the Statute of Frauds
   a. Does not require that the agreement be signed by all parties.
   b. Does not apply if the value of the real estate is less than $500.
   c. Requires that the entire agreement be in a single writing.
   d. Requires that the purchase price be fair and adequate in relation to the value of the real estate.

29. An oral contract to sell land will be enforceable if the
   a. Contract is capable of full performance within one year.
   b. Total sales price is less than $500.
   c. Buyer has made a part payment.
   d. Parties have fully performed the contract.

30. Nolan agreed orally with Train to sell Train a house for $100,000. Train sent Nolan a signed agreement and a downpayment of $10,000. Nolan did not sign the agreement, but allowed Train to move into the house. Before closing, Nolan refused to go through with the sale. Train sued Nolan to compel specific performance. Under the provisions of the Statute of Frauds,
   a. Train will win because Train signed the agreement and Nolan did not object.
   b. Train will win because Train made a downpayment and took possession.
   c. Nolan will win because Nolan did not sign the agreement.
   d. Nolan will win because the house was worth more than $500.

31. Sand orally promised Frost a $10,000 bonus, in addition to a monthly salary, if Frost would work two years for Sand. If Frost works for the two years, will the Statute of Frauds prevent Frost from collecting the bonus?
   a. No, because Frost fully performed.
   b. No, because the contract did not involve an interest in real estate.
   c. Yes, because the contract could not be performed within one year.
   d. Yes, because the monthly salary was the consideration for the contract.

32. Egan, a minor, contracted with Baker to purchase Baker's used computer for $400. The computer was purchased for Egan's personal use. The agreement provided that Egan would pay $200 down on delivery and $200 thirty days later. Egan took delivery and paid the $200 down payment. Twenty days later, the computer was damaged seriously as a result of Egan's negligence. Five days after the damage occurred and one day after Egan reached the age of majority, Egan attempted to disaffirm the contract with Baker. Egan will
   a. Be able to disaffirm despite the fact that Egan was not a minor at the time of disaffirmance.
   b. Be able to disaffirm only if Egan does so in writing.
   c. Not be able to disaffirm because Egan had failed to pay the balance of the purchase price.
   d. Not be able to disaffirm because the computer was damaged as a result of Egan's negligence.
33. Ruehl purchased a service station business from Lull. The purchase price included payment for Lull's goodwill. The agreement contained a covenant prohibiting Lull from competing with Ruehl in the service station business. Which of the following statements regarding the covenant is incorrect?
   a. The value to be assigned to it is the excess of the price paid over the seller's cost of all tangible assets.
   b. The time period for which it is to be effective must be reasonable.
   c. The restraint must be no more extensive than is reasonably necessary to protect the goodwill purchased by Ruehl.
   d. The geographic area to which it applies must be reasonable.

34. Kent, a 16-year old, purchased a used car from Mint Motors, Inc. Ten months later, the car was stolen and never recovered. Which of the following statements is correct?
   a. The car's theft is a de facto ratification of the purchase because it is impossible to return the car.
   b. Kent may disaffirm the purchase because Kent is a minor.
   c. Kent effectively ratified the purchase because Kent used the car for an unreasonable period of time.
   d. Kent may disaffirm the purchase because Mint, a merchant, is subject to the UCC.

35. All of the following are effective methods of ratifying a contract entered into by a minor except
   a. Expressly ratifying the contract after reaching the age of majority.
   b. Failing to disaffirm the contract within a reasonable time after reaching the age of majority.
   c. Ratifying the contract before reaching the age of majority.
   d. Impliedly ratifying the contract after reaching the age of majority.

36. Payne entered into a written agreement to sell a parcel of land to Stevens. At the time the agreement was executed, Payne had consumed alcoholic beverages. Payne's ability to understand the nature and terms of the contract was not impaired. Stevens did not believe that Payne was intoxicated. The contract is
   a. Void as a matter of law.
   b. Legally binding on both parties.
   c. Voidable at Payne's option.
   d. Voidable at Stevens' option.

37. West, an Indiana real estate broker, misrepresented to Zimmer that West was licensed in Kansas under the Kansas statute that regulates real estate brokers and requires all brokers to be licensed. Zimmer signed a contract agreeing to pay West a 5% commission for selling Zimmer's home in Kansas. West did not sign the contract. West sold Zimmer's home. If West sued Zimmer for nonpayment of commission, Zimmer would be
   a. Liable to West only for the value of services rendered.
   b. Liable to West for the full commission.
   c. Not liable to West for any amount because West did not sign the contract.
   d. Not liable to West for any amount because West violated the Kansas licensing requirements.

38. Mix entered into a contract with Small which provided that Small would receive $10,000 if he stole trade secrets from Mix's competition. Small performed his part of the contract by delivering the trade secrets to Mix. Mix refuses to pay Small for his services. Under what theory may Small recover?
   a. Quasi contract, in order to prevent the unjust enrichment of Mix.
   b. Promissory estoppel, since Small has changed his position to his detriment.
   c. None, due to the illegal nature of the contract.
   d. Express contract, since both parties bargained for and exchanged promises in forming the contract.

39. To establish a cause of action based on fraud in the inducement, one of the elements the plaintiff must generally prove is that
   a. It is impossible for the plaintiff to perform the terms of the contract.
   b. The contract is unconscionable.
   c. The defendant made a false representation of a material fact.
   d. There has been a mutual mistake of a material fact by the plaintiff and defendant.

40. To prevail in a common law action for fraud in the inducement, a plaintiff must prove that the
   a. Defendant was an expert with regard to the misrepresentations.
   b. Defendant made the misrepresentations with knowledge of their falsity and with an intention to deceive.
   c. Misrepresentations were in writing.
   d. Plaintiff was in a fiduciary relationship with the defendant.
41. The intent, or scienter, element necessary to establish a cause of action for fraud will be met if the plaintiff can show that the
a. Defendant made a misrepresentation with a reckless disregard for the truth.
b. Defendant made a false representation of fact.
c. Plaintiff actually relied on the defendant's misrepresentation.
d. Plaintiff justifiably relied on the defendant's misrepresentation.

42. Steele, Inc. wanted to purchase Kalp's distribution business. On March 15, 1990, Kalp provided Steele with copies of audited financial statements for the period ended December 31, 1989. The financial statements reflected inventory in the amount of $1,200,000. On March 29, 1990, Kalp discovered that the December 31 inventory was overstated by at least $400,000. On April 3, 1990, Steele, relying on the financial statements, purchased all of Kalp's business. On April 29, 1990, Steele discovered the inventory overstatement. Steele sued Kalp for fraud. Which of the following statements is correct?
   a. Steele will lose because it should not have relied on the inventory valuation in the financial statements.
   b. Steele will lose because Kalp was unaware that the inventory valuation was incorrect at the time the financial statements were provided to Steele.
   c. Steele will prevail because Kalp had a duty to disclose the fact that the inventory value was overstated.
   d. Steele will prevail but will not be able to sue for damages.

43. Sardy, a famous football player, was asked to autograph a pad of paper held by Maple. Unknown to Sardy, Maple had carefully concealed a contract for the sale of Sardy's home to Maple in the pad which Sardy signed. If Maple seeks to enforce the contract, Sardy's best defense to have the contract declared void would be
   a. Fraud in the inducement.
   b. Fraud in the execution.
   c. Mistake.
   d. Duress.

44. Maco, Inc. and Kent contracted for Kent to provide Maco certain consulting services at an hourly rate of $20. Kent's normal hourly rate was $90 per hour, the fair market value of the services. Kent agreed to the $20 rate because Kent was having serious financial problems. At the time the agreement was negotiated, Maco was aware of Kent’s financial condition and refused to pay more than $20 per hour for Kent’s services. Kent has now sued to rescind the contract with Maco, claiming duress by Maco during the negotiations. Under the circumstances, Kent will
   a. Win, because Maco refused to pay the fair market value of Kent’s services.
   b. Win, because Maco was aware of Kent’s serious financial problems.
   c. Lose, because Maco’s actions did not constitute duress.
   d. Lose, because Maco cannot prove that Kent, at the time, had no other offers to provide consulting services.

45. Johns leased an apartment from Olsen. Shortly before the lease expired, Olsen threatened Johns with eviction and physical harm if Johns did not sign a new lease for twice the old rent. Johns, unable to afford the expense to fight eviction, and in fear of physical harm, signed the new lease. Three months later, Johns moved and sued to void the lease claiming duress. The lease will be held
   a. Void because of the unreasonable increase in rent.
   b. Voidable because of Olsen's threat to bring eviction proceedings.
   c. Void because of Johns' financial condition.
   d. Voidable because of Olsen's threat of physical harm.

46. Carter owns a parcel of land. Smith, one of Carter's closest friends and an attorney, has persuaded Carter to sell the land to Smith at a price substantially below fair market value. At the time Carter sold the land he was resting in a nursing home recovering from a serious illness. If Carter desires to set aside the sale, which of the following causes of action is most likely to be successful?
   a. Duress.
   b. Undue influence.
   c. Fraud.
   d. Misrepresentation.
47. The primary distinction between an action based on innocent misrepresentation and an action based on common law fraud is that, in the former, a party need not allege and prove:
   a. That there has been a false representation.
   b. The materiality of the misrepresentation.
   c. Reasonable reliance on the misrepresentation.
   d. That the party making the misrepresentation had actual or constructive knowledge that it was false.

48. To prevail in a common law action for innocent misrepresentation, the plaintiff must prove:
   a. The defendant made the false statements with a reckless disregard for the truth.
   b. The misrepresentations were in writing.
   c. The misrepresentations concerned material facts.
   d. Reliance on the misrepresentations was the only factor inducing the plaintiff to enter into a contract.

49. If a buyer accepts an offer containing an immaterial unilateral mistake, the resulting contract will be:
   a. Void as a matter of law.
   b. Void at the election of the buyer.
   c. Valid as to both parties.
   d. Voidable at the election of the seller.

50. Paco Corp., a building contractor, offered to sell Preston several pieces of used construction equipment. Preston was engaged in the business of buying and selling equipment. Paco's written offer had been prepared by a secretary who typed the total price as $10,900, rather than $109,000, which was the approximate fair market value of the equipment. Preston, on receipt of the offer, immediately accepted it. Paco learned of the error in the offer and refused to deliver the equipment to Preston unless Preston agreed to pay $109,000. Preston has sued Paco for breach of contract. Which of the following statements is correct?
   a. Paco will not be liable because there has been a mutual mistake of fact.
   b. Paco will be able to rescind the contract because Preston should have known that the price was erroneous.
   c. Preston will prevail because Paco is a merchant.
   d. The contract between Paco and Preston is void because the price set forth in the offer is substantially less than the equipment's fair market value.

51. A building subcontractor submitted a bid for construction of a portion of a high-rise office building. The bid contained material computational errors. The general contractor accepted the bid with knowledge of the errors. Which of the following statements best represents the subcontractor’s liability?
   a. Not liable because the contractor knew of the errors.
   b. Not liable because the errors were a result of gross negligence.
   c. Liable because the errors were unilateral.
   d. Liable because the errors were material.

52. On April 6, Apple entered into a signed contract with Bean, by which Apple was to sell Bean an antique automobile having a fair market value of $150,000, for $75,000. Apple believed the auto was worth only $75,000. Unknown to either party the auto had been destroyed by fire on April 4. If Bean sues Apple for breach of contract, Apple’s best defense is:
   a. Unconscionability.
   b. Risk of loss had passed to Bean.
   c. Lack of adequate consideration.
   d. Mutual mistake.

53. Under the parol evidence rule, oral evidence will be excluded if it relates to:
   a. A contemporaneous oral agreement relating to a term in the contract.
   b. Failure of a condition precedent.
   c. Lack of contractual capacity.
   d. A modification made several days after the contract was executed.

54. Where the parties have entered into a written contract intended as the final expression of their agreement, which of the following agreements will be admitted into evidence because they are not prohibited by the parol evidence rule?

<table>
<thead>
<tr>
<th>Subsequent oral agreements</th>
<th>Prior written agreements</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>b. Yes</td>
<td>No</td>
</tr>
<tr>
<td>c. No</td>
<td>Yes</td>
</tr>
<tr>
<td>d. No</td>
<td>No</td>
</tr>
</tbody>
</table>
55. In negotiations with Andrews for the lease of Kemp’s warehouse, Kemp orally agreed to pay one-half of the cost of the utilities. The written lease, later prepared by Kemp’s attorney, provided that Andrews pay all of the utilities. Andrews failed to carefully read the lease and signed it. When Kemp demanded that Andrews pay all of the utilities, Andrews refused, claiming that the lease did not accurately reflect the oral agreement. Andrews also learned that Kemp intentionally misrepresented the condition of the structure of the warehouse during the negotiations between the parties. Andrews sued to rescind the lease and intends to introduce evidence of the parties’ oral agreement about sharing the utilities and the fraudulent statements made by Kemp. The parol evidence rule will prevent the admission of evidence concerning the

<table>
<thead>
<tr>
<th>Oral agreement regarding who pays the utilities by Kemp</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. Yes</td>
</tr>
<tr>
<td>b. No</td>
</tr>
<tr>
<td>c. Yes</td>
</tr>
<tr>
<td>d. No</td>
</tr>
</tbody>
</table>

56. Ferco, Inc., claims to be a creditor beneficiary of a contract between Bell and Allied Industries, Inc. Allied is indebted to Ferco. The contract between Bell and Allied provides that Bell is to purchase certain goods from Allied and pay the purchase price directly to Ferco until Allied’s obligation is satisfied. Without justification, Bell failed to pay Ferco and Ferco sued Bell. Ferco will

a. Not prevail, because Ferco lacked privity of contract with either Bell or Allied.
b. Not prevail, because Ferco did not give any consideration to Bell.
c. Prevail, because Ferco was an intended beneficiary of the contract between Allied and Bell.
d. Prevail, provided Ferco was aware of the contract between Bell and Allied at the time the contract was entered into.

57. Jones owned an insurance policy on her life, on which she paid all the premiums. Smith was named the beneficiary. Jones died and the insurance company refused to pay the insurance proceeds to Smith. An action by Smith against the insurance company for the insurance proceeds will be

a. Successful because Smith is a third party donee beneficiar.y.
b. Successful because Smith is a proper assignee of Jones’ rights under the insurance policy.
c. Unsuccessful because Smith was not the owner of the policy.
d. Unsuccessful because Smith did not pay any of the premiums.

58. Union Bank lent $200,000 to Wagner. Union required Wagner to obtain a life insurance policy naming Union as beneficiary. While the loan was outstanding, Wagner stopped paying the premiums on the policy. Union paid the premiums, adding the amounts paid to Wagner’s loan. Wagner died and the insurance company refused to pay the policy proceeds to Union. Union may

a. Recover the policy proceeds because it is a creditor beneficiary.
b. Recover the policy proceeds because it is a donee beneficiary.
c. Not recover the policy proceeds because it is not in privity of contract with the insurance company.
d. Not recover the policy proceeds because it is only an incidental beneficiary.

59. Rice contracted with Locke to build an oil refinery for Locke. The contract provided that Rice was to use United pipe fittings. Rice did not do so. United learned of the contract and, anticipating the order, manufactured additional fittings. United sued Locke and Rice. United is

a. Entitled to recover from Rice only, because Rice breached the contract.
b. Entitled to recover from either Locke or Rice because it detrimentally relied on the contract.
c. Not entitled to recover because it is a donee beneficiary.
d. Not entitled to recover because it is an incidental beneficiary.

60. Omega Corp. owned a factory that was encumbered by a mortgage securing Omega’s note to Eagle Bank. Omega sold the factory to Spear, Inc., which assumed the mortgage note. Later, Spear defaulted on the note, which had an outstanding balance of $15,000. To recover the outstanding balance, Eagle

a. May sue Spear only after suing Omega.
b. May sue either Spear or Omega.
c. Must sue both Spear and Omega.
d. Must sue Spear first and then proceed against Omega for any deficiency.

61. Wilk bought an apartment building from Dix Corp. There was a mortgage on the building securing Dix’s promissory note to Xeon Finance Co. Wilk took title subject to Xeon’s mortgage. Wilk did not make the payments on the note due Xeon and the building was sold at a foreclosure sale. If the proceeds of the foreclosure sale are less than the balance due on the note, which of the following statements is correct regarding the deficiency?
a. Xeon must attempt to collect the deficiency from Wilk before suing Dix.
b. Dix will not be liable for any of the deficiency because Wilk assumed the note and mortgage.
c. Xeon may collect the deficiency from either Dix or Wilk.
d. Dix will be liable for the entire deficiency.

62. Which of the following statements is(are) correct regarding a valid assignment?
I. An assignment of an interest in a sum of money must be in writing and must be supported by legally sufficient consideration.
II. An assignment of an insurance policy must be made to another party having an insurable interest in the property.

I. I only
II. II only.
III. Both I and II.
IV. Neither I nor II

63. Yost contracted with Egan for Yost to buy certain real property. If the contract is otherwise silent, Yost's rights under the contract are
a. Assignable only with Egan's consent.
b. Nonassignable because they are personal to Yost.
c. Nonassignable as a matter of law.
d. Generally assignable.

64. One of the criteria for a valid assignment of a sales contract to a third party is that the assignment must
a. Be supported by adequate consideration from the assignee.
b. Be in writing and signed by the assignor.
c. Not materially increase the other party's risk or duty.
d. Not be revocable by the assignor.

65. Wilcox Co. contracted with Ace Painters, Inc., for Ace to paint Wilcox’s warehouse. Ace, without advising Wilcox, assigned the contract to Pure Painting Corp. Pure failed to paint Wilcox's warehouse in accordance with the contract specifications. The contract between Ace and Wilcox was silent with regard to a party’s right to assign it. Which of the following statements is correct?

66. Generally, which of the following contract rights are assignable?

<table>
<thead>
<tr>
<th>Option contract rights</th>
<th>Malpractice insurance policy rights</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>b. Yes</td>
<td>No</td>
</tr>
<tr>
<td>c. No</td>
<td>Yes</td>
</tr>
<tr>
<td>d. No</td>
<td>No</td>
</tr>
</tbody>
</table>

67. Pix borrowed $80,000 from Null Bank. Pix gave Null a promissory note and mortgage. Subsequently, Null assigned the note and mortgage to Reed. Reed failed to record the assignment or notify Pix of the assignment. If Pix pays Null pursuant to the note, Pix will
a. Be primarily liable to Reed for the payments made to Null.
b. Be secondarily liable to Reed for the payments made to Null.
c. Not be liable to Reed for the payments made to Null because Reed failed to record the assignment.
d. Not be liable to Reed for the payments made to Null because Reed failed to give Pix notice of the assignment.

68. On February 1, Burns contracted in writing with Nagel to sell Nagel a used car. The contract provided that Burns was to deliver the car on February 15 and Nagel was to pay the $800 purchase price not later than March 15. On February 21, Burns assigned the contract to Ross for $600. Nagel was not notified. Which of the following statements is correct?

a. By making the assignment, Burns impliedly warranted Nagel would pay the full purchase price.
b. The assignment to Ross is invalid because Nagel was not notified.
c. Ross will be subject to any contract defenses Nagel could have raised against Burns.
d. By making the assignment, Burns impliedly warranted a lack of knowledge of any fact impairing the value of the assignment.
69. Wren purchased a factory from First Federal Realty. Wren paid 20% at the closing and gave a note for the balance secured by a 20-year mortgage. Five years later, Wren found it increasingly difficult to make payments on the note and defaulted. First Federal threatened to accelerate the loan and foreclose if Wren continued in default. First Federal told Wren to make payment or obtain an acceptable third party to assume the obligation. Wren offered the land to Moss, Inc. for $10,000 less than the equity Wren had in the property. This was acceptable to First Federal and at the closing Moss paid the arrearage, assumed the mortgage and note, and had title transferred to its name. First Federal released Wren. The transaction in question is a(an)
   a. Purchase of land subject to a mortgage.
   b. Assignment and delegation.
   c. Third party beneficiary contract.
   d. Novation.

70. Dell owed Stark $9,000. As the result of an unrelated transaction, Stark owed Ball that same amount. The three parties signed an agreement that Dell would pay Ball instead of Stark, and Stark would be discharged from all liability. The agreement among the parties is
   a. A novation.
   b. An executed accord and satisfaction.
   c. Voidable at Ball's option.
   d. Unenforceable for lack of consideration.

71. On May 25, 1991, Smith contracted with Jackson to repair Smith's cabin cruiser. The work was to begin on May 31, 1991. On May 26, 1991, the boat, while docked at Smith's pier, was destroyed by arson. Which of the following statements is correct with regard to the contract?
   a. Smith would not be liable to Jackson because of mutual mistake.
   b. Smith would be liable to Jackson for the profit Jackson would have made under the contract.
   c. Jackson would not be liable to Smith because performance by the parties would be impossible.
   d. Jackson would be liable to repair another boat owned by Smith.

72. Teller brought a lawsuit against Kerr ten years after an oral contract was made and eight years after it was breached. Kerr raised the statute of limitations as a defense. Which of the following allegations would be most important to Kerr's defense?
   a. The contract was oral.
   b. The contract could not be performed within one year from the date made.
   c. The action was not timely brought because the contract was entered into ten years prior to the commencement of the lawsuit.
   d. The action was not timely brought because the contract was allegedly breached eight years prior to the commencement of the lawsuit.

73. Which of the following statements correctly applies to a typical statute of limitations?
   a. The statute requires that a legal action for breach of contract be commenced within a certain period of time after the breach occurs.
   b. The statute provides that only the party against whom enforcement of a contract is sought must have signed the contract.
   c. The statute limits the right of a party to recover damages for misrepresentation unless the false statements were intentionally made.
   d. The statute prohibits the admission into evidence of proof of oral statements about the meaning of a written contract.

74. Ordinarily, in an action for breach of a construction contract, the statute of limitations time period would be computed from the date the
   a. Contract is negotiated.
   b. Contract is breached.
   c. Construction is begun.
   d. Contract is signed.

75. Which of the following statements is correct regarding the effect of the expiration of the period of the statute of limitations on a contract?
   a. Once the period of the statute of limitations has expired, the contract is void.
   b. The expiration of the period of the statute of limitations extinguishes the contract’s underlying obligation.
   c. A cause of action barred by the statute of limitations may not be revived.
   d. The running of the statute of limitations bars access to judicial remedies.
76. Which of the following actions will result in the discharge of a party to a contract?

<table>
<thead>
<tr>
<th>Prevention of performance</th>
<th>Accord and satisfaction</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. Yes</td>
<td>Yes</td>
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<tr>
<td>b. Yes</td>
<td>No</td>
</tr>
<tr>
<td>c. No</td>
<td>Yes</td>
</tr>
<tr>
<td>d. No</td>
<td>No</td>
</tr>
</tbody>
</table>

77. Under a personal services contract, which of the following circumstances will cause the discharge of a party’s duties?
   a. Death of the party who is to receive the services.
   b. Cost of performing the services has doubled.
   c. Bankruptcy of the party who is to receive the services.
   d. Illegality of the services to be performed.

78. Nagel and Fields entered into a contract in which Nagel was obligated to deliver certain goods to Fields by September 10. On September 3, Nagel told Fields that Nagel had no intention of delivering the goods required by the contract. Prior to September 10, Fields may successfully sue Nagel under the doctrine of
   a. Promissory estoppel.
   b. Accord and satisfaction.
   c. Anticipatory repudiation.
   d. Substantial performance.

79. Bing engaged Dill to perform personal services for $2,200 a month for a period of four months. The contract was entered orally on July 1, 1984, and performance was to commence September 1, 1984. On August 10, Dill anticipatorily repudiated the contract. As a result, Bing can
   a. Not assign his rights to damages under the contract to a third party.
   b. Obtain specific performance.
   c. Not enforce the contract against Dill since the contract is oral.
   d. Immediately sue for breach of contract.

80. Ames Construction Co. contracted to build a warehouse for White Corp. The construction specifications required Ames to use Ace lighting fixtures. Inadvertently, Ames installed Perfection lighting fixtures which are of slightly lesser quality than Ace fixtures, but in all other respects meet White's needs. Which of the following statements is correct?
   a. White's recovery will be limited to monetary damages because Ames' breach of the construction contract was not material.
   b. White will not be able to recover any damages from Ames because the breach was inadvertent.
   c. Ames did not breach the construction contract because the Perfection fixtures were substantially as good as the Ace fixtures.
   d. Ames must install Ace fixtures or White will not be obligated to accept the warehouse.

81. Kaye contracted to sell Hodges a building for $310,000. The contract required Hodges to pay the entire amount at closing. Kaye refused to close the sale of the building. Hodges sued Kaye. To what relief is Hodges entitled?
   a. Punitive damages and compensatory damages.
   b. Specific performance and compensatory damages.
   c. Consequential damages or punitive damages.
   d. Compensatory damages or specific performance.

82. Price signed a contract to sell Wyatt a parcel of land for $90,000. The entire sales price was payable at the closing. Price has decided to keep the land. If Wyatt commences an action against Price, what relief is Wyatt most likely to receive?
   a. Specific performance.
   b. Compensatory damages and specific performance.
   c. Punitive damages.
   d. Compensatory damages and punitive damages.

83. Jones, CPA, entered into a signed contract with Foster Corp. to perform accounting and review services. If Jones repudiates the contract prior to the date performance is due to begin, which of the following is not correct?
   a. Foster could successfully maintain an action for breach of contract after the date performance was due to begin.
   b. Foster can obtain a judgment ordering Jones to perform.
   c. Foster could successfully maintain an action for breach of contract prior to the date performance is due to begin.
   d. Foster can obtain a judgment for the monetary damages it incurred as a result of the repudiation.
84. Master Mfg., Inc. contracted with Accur Computer Repair Corp. to maintain Master's computer system. Master's manufacturing process depends on its computer system operating properly at all times. A liquidated damages clause in the contract provided that Accur pay $1,000 to Master for each day that Accur was late responding to a service request. On January 12, Accur was notified that Master's computer system failed. Accur did not respond to Master's service request until January 15. If Master sues Accur under the liquidated damage provision of the contract, Master will a. Win, unless the liquidated damage provision is determined to be a penalty. b. Win, because under all circumstances liquidated damage provisions are enforceable. c. Lose, because Accur's breach was not material. d. Lose, because liquidated damage provisions violate public policy.

85. To cancel a contract and to restore the parties to their original positions before the contract, the parties should execute a a. Novation b. Release c. Rescission d. Revocation

86. All of the following statements regarding compliance with the statute of frauds are correct except a. Any necessary writing must be signed by all parties against whom enforcement is sought. b. Contracts involving the sale of goods in an amount greater than $500 must be in writing. c. Contract terms must be contained in only one document. d. Contracts for which it is improbable to assume that performance will be completed within one year must be in writing.

87. Which of the following types of mistake will generally make a contract unenforceable and allow it to be rescinded? a. A unilateral mistake of fact. b. A mutual mistake of act. c. A unilateral mistake of value. d. A mutual mistake of value.

88. Which of the following contract rights can generally be assigned? a. The right to receive personal services. b. The right to receive a sum of money. c. The right of an insured to coverage under a fire insurance policy. d. A right whose assignment is prohibited by statute.
Chapter One: Contracts
Other Objective Format Questions

NUMBER 1

Number 1 consists of 10 items. Select the best answer for each item. Answer all items. Your grade will be based on the total number of correct answers.

On January 15, East Corp. orally offered to hire Bean, CPA, to perform management consulting services for East and its subsidiaries. The offer provided for a three-year contract at $10,000 per month. On January 20, East sent Bean a signed memorandum stating the terms of the offer. The memorandum also included a payment clause that hadn’t been discussed and the provision that Bean’s acceptance of the offer would not be effective unless it was received by East on or before January 25. Bean received the memorandum on January 21, signed, and mailed it back to East the same day. East received it on January 24. On January 23, East wrote to Bean revoking the offer. Bean received the revocation on January 25.

On March 1, East Corp. orally engaged Snow Consultants to install a corporate local area network system (LAN) for East’s financial operations. The engagement was to last until the following February 15 and East would pay Snow $5,000 twice a month. On March 15, East offered Snow $1,000 per month to assist in the design of East’s Internet homepage. Snow accepted East’s offer. On April 1, citing excess work, Snow advised East that Snow would not assist with the design of the homepage. On April 5, East accepted Snow’s withdrawal from the Internet homepage design project. On April 15, Snow notified East that Snow had assigned the fees due Snow on the LAN installation engagement to Band Computer Consultants. On April 30, East notified Snow that the LAN installation agreement was canceled.

Required:
Items 1 through 5 are based on the transaction between East Corp. and Bean. For each item, select the best answer from List I. An answer may be selected once, more than once, or not at all.

1. What was the effect of the event(s) that took place on January 20?
   - List I
     A. Acceptance of a counteroffer.
     B. Acceptance of an offer governed by the mailbox rule.
     C. Attempted acceptance of an offer.
     D. Attempted revocation of an offer.
     E. Formation of an enforceable contract.
     F. Formation of a contract enforceable only against East.
     G. Invalid revocation because of prior acceptance of an offer.
     H. Offer revoked by sending a revocation letter.
     I. Submission of a counteroffer.
     J. Submission of a written offer.

2. What was the effect of the event(s) that took place on January 21?
3. What was the effect of the event(s) that took place on January 23?
4. What was the effect of the event(s) that took place on January 24?
5. What was the effect of the event(s) that took place on January 25?
Items 6 through 10 are based on the transaction between East Corp. and Snow Consultants. For Each item, select the best answer from List II. An answer may be selected once, more than once, or not at all.

6. What was the effect of the event(s) that took place on March 1?
7. What was the effect of the event(s) that took place on March 15?
8. What was the effect of the event(s) that took place on April 5?
9. What was the effect of the event(s) that took place on April 15?
10. What was the effect of the event(s) that took place on April 30?

<table>
<thead>
<tr>
<th>List II</th>
</tr>
</thead>
<tbody>
<tr>
<td>A. Breach of contract.</td>
</tr>
<tr>
<td>B. Discharge from performance.</td>
</tr>
<tr>
<td>C. Enforceable oral contract modification.</td>
</tr>
<tr>
<td>D. Formation of voidable contract.</td>
</tr>
<tr>
<td>E. Formation of an enforceable contract.</td>
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<tr>
<td>F. Formation of a contract unenforceable under the Statute of Frauds.</td>
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<td>G. Invalid assignment.</td>
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<tr>
<td>H. Mutual rescission.</td>
</tr>
<tr>
<td>I. Novation.</td>
</tr>
<tr>
<td>J. Unilateral offer.</td>
</tr>
<tr>
<td>K. Valid assignment of rights.</td>
</tr>
<tr>
<td>L. Valid assignment of duties.</td>
</tr>
<tr>
<td>M. Valid assignment of rights and duties.</td>
</tr>
</tbody>
</table>

NUMBER 2

Number 2 consists of 15 items. Select the best answer for each item. Answer all items. Your grade will be based on the total number of correct answers.

On December 15, Blake Corp. telephoned Reach Consultants, Inc. and offered to hire Reach to design a security system for Blake's research department. The work would require two years to complete. Blake offered to pay a fee of $100,000 but stated that the offer must be accepted in writing, and the acceptance received by Blake no later than December 20.

On December 20, Reach faxed a written acceptance to Blake. Blake's offices were closed on December 20 and Reach's fax was not seen until December 21.

Reach's acceptance contained the following language:

"We accept your $1,000,000 offer. Weaver has been assigned $5,000 of the fee as payment for sums owed Weaver by Reach. Payment of this amount should be made directly to Weaver."

On December 22, Blake sent a signed memo to Reach rejecting Reach's December 20 fax but offering to hire Reach for a $75,000 fee. Reach telephoned Blake on December 23 and orally accepted Blake's December 22 offer.

Required:

a. Items 1 through 7 relate to whether a contractual relationship exists between Blake and Reach. For each item, determine whether the statement is True (T) or False (F).

1. Blake's December 15 offer had to be in writing to be a legitimate offer.
2. Reach's December 20 fax was an improper method of acceptance.
3. Reach's December 20 fax was effective when sent.
4. Reach's acceptance was invalid because it was received after December 20.
5. Blake's receipt of Reach's acceptance created a voidable contract.
6. Reach's agreement to a $1,000,000 fee prevented the formation of a contract.
7. Reach's December 20 fax was a counteroffer.

b. Items 8 through 12 relate to the attempted assignment of part of the fee to Weaver. Assume that a valid contract exists between Blake and Reach. For each item, determine whether the statement is True (T) or False (F).

8. Reach is prohibited from making an assignment of any contract right or duty.
9. Reach may validly assign part of the fee to Weaver.
10. Under the terms of Reach's acceptance, Weaver would be considered a third party creditor beneficiary.
11. In a breach of contract suit by Weaver, against Blake, Weaver would not collect any punitive damages.
12. In a breach of contract suit by Weaver, against Reach, Weaver would be able to collect punitive damages.

c. Items 13 through 15 relate to Blake's December 22 signed memo. For each item, determine whether the statement is True (T) or False (F).

13. Reach's oral acceptance of Blake's December 22 memo may be enforced by Blake against Reach.
14. Blake's memo is a valid offer even though it contains no date for acceptance.
15. Blake's memo may be enforced against Blake by Reach.

NUMBER 3

Suburban Properties, Inc. owns and manages several shopping centers.

On May 4, 1993, Suburban received from Bridge Hardware, Inc., one of its tenants, a signed letter proposing that the existing lease between Suburban and Bridge be modified to provide that certain utility costs be equally shared by Bridge and Suburban, effective June 1, 1993. Under the terms of the original lease, Bridge was obligated to pay all utility costs. On May 5, 1993, Suburban sent Bridge a signed letter agreeing to share the utility costs as proposed. Suburban later changed its opinion and refused to share in the utility costs.

On June 4, 1993, Suburban received from Dart Associates, Inc. a signed offer to purchase one of the shopping centers owned by Suburban. The offer provided as follows: a price of $9,250,000; it would not be withdrawn before July 1, 1993; and an acceptance must be received by Dart to be effective. On June 9, 1993, Suburban mailed Dart a signed acceptance. On June 10, before Dart had received Suburban's acceptance, Dart telephoned Suburban and withdrew its offer. Suburban's acceptance was received by Dart on June 12, 1993.

On June 22, 1993, one of Suburban's shopping centers was damaged by a fire, which started when the center was struck by lightning. As a result of the fire, one of the tenants in the shopping center, World Popcorn Corp., was forced to close its business and will be unable to reopen until the damage is repaired. World sued Suburban claiming that Suburban is liable for World's losses resulting from the fire. The lease between Suburban and World is silent in this regard.

Suburban has taken the following positions:
• Suburban's May 5, 1993, agreement to share equally the utility costs with Bridge is not binding on Suburban.
• Dart could not properly revoke its June 4 offer and must purchase the shopping center.
• Suburban is not liable to World for World's losses resulting from the fire.

Required:
In separate paragraphs, determine whether Suburban's positions are correct and state the reasons for your conclusions.
Victor Corp. engaged Bell & Co., CPAs, to audit Victor's financial statements for the year ended December 31, 1992. Victor is in the business of buying, selling, and servicing new and used construction equipment. While reviewing Victor's 1992 records, Bell became aware of the following disputed transactions:

- On September 8, Victor sent Ambel Contractors, Inc. a signed purchase order for several pieces of used construction equipment. Victor's purchase order described twelve different pieces of equipment and indicated the price Victor was willing to pay for each item. As a result of a mathematical error in adding up the total of the various prices, the purchase price offered by Victor was $191,000 rather than the correct amount of $119,000. Ambel, on receipt of the purchase order, was surprised by Victor's high price and immediately sent Victor a written acceptance. Ambel was aware that the fair market value of the equipment was approximately $105,000 to $125,000. Victor discovered the mistake in the purchase order and refused to purchase the equipment from Ambel. Ambel claims that Victor is obligated to purchase the equipment at a price of $191,000, as set forth in the purchase order.

- On October 8, a Victor salesperson orally contracted to service a piece of equipment owned by Clark Masons, Inc. The contract provided that for a period of 36 months, commencing November 1992, Victor would provide routine service for the equipment at a fixed price of $15,000, payable in three annual installments of $5,000 each. On October 29, Clark's president contacted Victor and stated that Clark did not intend to honor the service agreement because there was no written contract between Victor and Clark.

- On November 3, Victor received by mail a signed offer from GYX Erectors, Inc. The offer provided that Victor would service certain specified equipment owned by GYX for a two-year period for a total price of $81,000. The offer also provided as follows:

  "We need to know soon whether you can agree to the terms of this proposal. You must accept by November 15, or we will assume you can't meet our terms."

  On November 12, Victor mailed GYX a signed acceptance of GYX's offer. The acceptance was not received by GYX until November 17, and by then GYX had contracted with another party to provide service for its equipment. Victor has taken the position that GYX is obligated to honor its November 3 offer. GYX claims that no contract was formed because Victor's November 12 acceptance was not received timely by GYX.

- On December 19, Victor contracted in writing with Wells Landscaping Corp. The contract required Victor to deliver certain specified new equipment to Wells by December 31. On December 23, Victor determined that it would not be able to deliver the equipment to Wells by December 31 because of an inventory shortage. Therefore, Victor made a written assignment of the contract to Master Equipment, Inc. When Master attempted to deliver the equipment on December 31, Wells refused to accept it, claiming that Victor could not properly delegate its duties under the December 19 contract to another party without the consent of Wells. The contract is silent with regard to this issue.

**Required:**
State whether the claims of Ambel, Clark, GYX, and Wells are correct and give the reasons for your conclusions.
West Corp. is involved in the following disputes:

- On September 16, West's president orally offered to hire Dodd Consultants, Inc. to do computer consulting. The offer provided for a three-year contract at $5,000 per month. West agreed that Dodd could have until September 30 to decide whether to accept the offer. If Dodd chose to accept the offer, its acceptance would have to be received by September 30.

  On September 27, Dodd sent West a letter accepting the offer. West received the letter on October 2. On September 28, West's president decided that West's accounting staff could handle West's computer problems and notified Dodd by telephone that the offer was withdrawn. Dodd argued that West had no right to revoke its offer, and that Dodd had already accepted the offer by mail.

  Dodd claims that it has a binding contract with West because:

  - West's offer could not be revoked before September 30.
  - Dodd's acceptance was effective on September 27, when the letter accepting the offer was mailed.

West's president claims that if an agreement exists that agreement would not be enforceable against West because of the Statute of Frauds requirement that the contract be in writing.

- On March 1, West signed a lease with Abco Real Estate, Inc. for warehouse space. The lease required that West repair and maintain the warehouse. On April 14, West orally asked Abco to paint the warehouse. Despite the lease provision requiring West to repair and maintain the warehouse, Abco agreed to do so by April 30. On April 29, Abco advised West that Abco had decided not to paint the warehouse. West demanded that Abco paint the warehouse under the April 14 agreement. Abco refused and has taken the following positions:

  - Abco's April 14 agreement to paint the warehouse is not binding on Abco because it was a modification of an existing contract.
  - Because the April 14 agreement was oral and the March 1 lease was in writing, West would not be allowed to introduce evidence in any litigation relating to the April 14 oral agreement.

Required:

(a) State whether Dodd's claims are correct and give the reasons for your conclusions.

(b) State whether West's president's claim is correct and give the reasons for your conclusion.

(c) State whether Abco's positions are correct and give the reasons for your conclusions.
**NUMBER 6**

In a signed letter dated March 2, 1991, Stake offered to sell Packer a specific vacant parcel of land for $100,000. Stake had inherited the land, along with several apartment buildings in the immediate vicinity. Packer received the offer on March 4. The offer required acceptance by March 10 and required Packer to have the property surveyed by a licensed surveyor so the exact legal description of the property could be determined.

On March 6, Packer sent Stake a counteroffer of $75,000. All other terms and conditions of the offer were unchanged. Stake received Packer's counteroffer on March 8, and, on that day, telephoned Packer and accepted it. On learning that a survey of the vacant parcel would cost about $1,000, Packer telephoned Stake on March 11 requesting that they share the survey cost equally. During this conversation, Stake agreed to Packer's proposal.

During the course of the negotiations leading up to the March communications between Stake and Packer, Stake expressed concern to Packer that a buyer of the land might build apartment units that would compete with those owned by Stake in the immediate vicinity. Packer assured Stake that Packer intended to use the land for a small shopping center. Because of these assurances, Stake was willing to sell the land to Packer. Contrary to what Packer told Stake, Packer had already contracted conditionally with Rolf for Rolf to build a 48-unit apartment development on the vacant land to be purchased from Stake.

During the last week of March, Stake learned that the land to be sold to Packer had a fair market value of $200,000. Also, Stake learned that Packer intended to build apartments on the land. Because of this information, Stake sued Packer to rescind the real estate contract, alleging that:

- Packer committed fraud in the formation of the contract thereby entitling Stake to rescind the contract.
- Stake's innocent mistake as to the fair market value of the land entitles Stake to rescind the contract.
- The contract was not enforceable against Stake because Stake did not sign Packer's March 6 counteroffer.

**Required:**
State whether Stake's allegations are correct and give the reasons for your conclusions.

**NUMBER 7**

The following letters were mailed among Jacobs, a real estate developer, Snow, the owner of an undeveloped parcel of land, and Eljay Distributors, Inc., a clothing wholesaler interested in acquiring Snow's parcel to build a warehouse:

a. *January 21, 1990* -- Snow to Jacobs: "My vacant parcel (Lot 2, Birds Addition to Cedar Grove) is available for $125,000 cash; closing within 60 days. You must accept by January 31 if you are interested."
   This was received by Jacobs on January 31.

b. *January 29, 1990* -- Snow to Jacobs: "Ignore my January 21 letter to you; I have decided not to sell my lot at this time."
   This was received by Jacobs on February 3.

c. *January 31, 1990* -- Jacobs to Snow: "Per your January 21 letter, you have got a deal."
   Jacobs inadvertently forgot to sign the January 31 letter, which was received by Snow on February 4.

d. *February 2, 1990* -- Jacobs to Eljay: "In consideration of your promise to pay me $10,000, I hereby assign to you my right to purchase Snow's vacant lot (Lot 2, Birds Addition to Cedar Grove)."
   This was received by Eljay on February 5.

All of the letters were signed, except as noted above, and properly stamped and addressed.
Snow has refused to sell the land to Jacobs or Eljay, asserting that no contract exists because:

- Jacobs' acceptance was not received on a timely basis.
- Snow had revoked the January 21 offer.
- Jacobs' acceptance was not signed.
- Jacobs had no right to assign the contract to Eljay.

**Required:**
For each of Snow's assertions, indicate whether the assertion is correct, setting forth reasons for your conclusion.

**NUMBER 8**

On July 5, 1995, Korn sent Wilson a written offer to clear Wilson’s parking lot whenever it snowed through December 31, 1995. Korn’s offer stated that Wilson had until October 1 to accept.

On September 28, 1995, Wilson mailed Korn an acceptance with a request that the agreement continue through March, 1996. Wilson’s acceptance was delayed and didn’t reach Korn until October 3.

On September 29, 1995, Korn saw weather reports indicating that the snowfall for the season would be much heavier than normal. This would substantially increase Korn’s cost to perform under the offer.

On September 30, 1995, Korn phoned Wilson to insist that the terms of the agreement be changed. When Wilson refused, Korn orally withdrew the offer and stated that Korn would not perform.

**Required:**

a. State and explain the points of law that Korn would argue to show that there was no valid contract.
b. State and explain the points of law that Wilson would argue to show that there was a valid contract.
c. Assuming that a valid contract exists:
   1. Determine whether Korn breached the contract and the nature of the breach and
   2. State the common law remedies available to Wilson.

**NUMBER 9**

On April 1, Thorn and Birch negotiated the sale of Thorn’s shopping center to Birch for $2.1 million ($2 million for the buildings and $100,000 for the land). The parties orally agreed on the following terms:

- Birch would make a cash down payment of $600,000.
- Birch would give Thorn a $1.5 million first mortgage on the property to secure the balance of the purchase price.
- The contract would contain an anti-assignment clause prohibiting assignment of the contract of sale or the mortgage.
- The contract would contain a “time of the essence” clause requiring that the closing take place on June 1.

No discussion took place regarding any existing mortgages or liens on the property. On April 14, the parties signed a written contract containing the above provisions.

On April 20, Birch took out a $1.5 million fire insurance policy with Acme Fire Insurance Co. on the buildings. The policy contained a standard 80% coinsurance clause.
On April 25, a title insurance report ordered by Birch revealed that there was an existing $500,000 mortgage on the property that had been recorded the previous February. The title report failed to disclose another mortgage for $50,000 that had been given years earlier by a prior owner of the land and had not been recorded. Thorn was aware of the $500,000 mortgage but not the earlier mortgage. The title report also disclosed that there were unpaid property taxes outstanding.

On May 1, Thorn agreed to assign to a third party the prospective mortgage payments Thorn would receive from Birch.

When Birch received the title report and found out about Thorn’s assignment of the mortgage payments, Birch accused Thorn of breach of contract for failing to disclose the prior mortgages and for violating the anti-assignment clause in the contract. Birch also insisted on postponing the contract closing date.

Thorn and Birch were able to resolve their differences.

- Birch reduced the mortgage being given to Thorn and assumed the previously recorded mortgage.
- The closing took place on July 1.
- Thorn recorded Birch’s mortgage on July 5.
- The previously unrecorded mortgage was recorded on July 10.

On August 1, a fire caused $160,000 damage to the buildings. On that date, the fair market value of the buildings was $2 million. Acme contested payment of the claim, contending that Birch had no insurable interest in the buildings when the policy was taken out. Acme also contended that, even if Birch had an insurable interest, Birch would not be entitled to recover the entire amount of the loss because Birch is a coinsurer.

After the insurance issues were resolved and the buildings repaired, Birch stopped making payments on the mortgages and they were foreclosed. After payment of all foreclosure expenses, there was $1 million available to pay the outstanding mortgages. Thorn’s mortgage had a principal and accrued interest balance of $950,000. The mortgage recorded in February had a principal and accrued interest balance of $475,000. The mortgage recorded on July 10 had a principal and accrued interest of $60,000.

The above transactions took place in a notice-race jurisdiction.

Required:

a. 1. State whether there was an enforceable contract for the sale of real property and list the requirements necessary to form such a contract.
   2. State whether Thorn breached the contract by assigning the mortgage payments and give the reasons supporting your decision.
   3. State and explain the remedies available to Birch if a court determined that Thorn, in any way, breached the contract.

b. 1. Determine whether Acme’s contentions are correct and give the reasons for your conclusions.
   2. Compute the dollar amount to which Birch would be entitled if the policy was valid and show how this amount is arrived at.
   3. Determine which mortgage(s) has (have) priority, give the reasons for your decision, and state how the foreclosure proceeds would be distributed.

Note: Only the (a) requirement relates to Contract law. The (b) requirement relates to Property and Insurance law.
Chapter One: Contracts
Multiple Choice Answers

1. (c) Communication by words is not required as the communication can also be done by actions. Equally, the communication need not be directly made by the offeror to the offeree, as it could be communicated through a third party. Since an offer must be seriously intended, communicated, and definite in its terms, answers (a), (b) and (d) are incorrect.

2. (b) Advertisements and price quotes are not usually offers, they are invitations to deal. Answers (a), (c) and (d) are incorrect because no offer was made.

3. (b) Acceptances must be unconditional, complying with all of the offeror’s terms. This was a counteroffer because it was not sent by registered or certified mail and it was not received by February 18. Answers (a) and (d) are incorrect because no contract was formed. Answer (c) is incorrect because overnight delivery service was not registered or certified as required.

4. (b) Since Fox changed the terms of the offer, the letter was a counteroffer and not a valid acceptance. Answers (c) and (d) are incorrect because no contract was formed. Answer (a) is incorrect because Fox doesn’t have to sign and return an offer to accept.

5. (a) The offer was accepted by telegram before the offer was terminated. Answer (b) is incorrect because rejections are only effective when received, not when they are mailed. Answer (c) is incorrect because an offer can be revoked anytime before acceptance, even if it says it will be held open. Answer (d) is incorrect because firm offers only apply to sale of goods, not real estate.

6. (d) Both rejections and revocations are only effective when they are received. Answers (a), (b) and (c) indicate that one or both of them can be effective when sent.

7. (b) Offers can usually be revoked anytime before acceptance, even if it says it will be held open. Answer (a) is incorrect because an option requires consideration and none was given. Answers (c) and (d) are incorrect because firm offers only apply to sale of goods, not real estate.

8. (d) The offer stated it would only remain open until July 1 and that acceptances were only effective when received. This acceptance was received on July 2 after the offer had ended. Answers (a) and (b) are incorrect because no contract was formed. Answer (c) is incorrect because the offer did not end after three months, it ended on July 1.

9. (a) The acceptance was effective when it was received because the offeror required acceptances to be received. Answer (b) is incorrect because an offeror can usually revoke anytime before acceptance. Answer (c) is incorrect because revocations are only effective when received. Answer (d) is incorrect because the offeror required acceptances to be received.

10. (d) Martin paid consideration ($100) to keep the offer open until February 15 and thus had an option contract. His letter of February 6 accepted the original offer. Answer (a) is incorrect because he paid consideration and created an option. Answer (b) is incorrect because a counteroffer has no effect on an option contract. Answer (c) is incorrect because option contracts cannot be revoked by the offeror.

11. (c) Sale of the lawn mower ended the offer when Mason learned of it, thus the acceptance was ineffective. Answers (a) and (b) are incorrect because the acceptance was ineffective. Answer (d) is incorrect because the offeror can usually revoke anytime before acceptance.
12. (c) An acceptance is valid when sent under the "mailbox rule" if the offeree uses the same means of communication that the offeror did or a faster means. Answer (a) is incorrect because the offeror can usually revoke anytime before acceptance. Answer (b) is incorrect because revocations are only effective when received, which was after the acceptance had been mailed. Answer (d) is incorrect because revocations do not require a writing.

13. (b) The offer ended on April 4 and no acceptance had been received by that date as required by the offer. Answer (a) is incorrect because the use of overnight mail was not prohibited by the offer. Answer (c) is incorrect because the offer required acceptances to be received. Answer (d) is incorrect because the acceptance was received too late.

14. (c) If the offer requires acceptances to be received, then the mailbox rule cannot apply. Whether the parties are merchants, whether real estate is involved, and the duration of the offer have no effect on the mailbox rule, thus (a), (b) and (d) are incorrect.

15. (a) By the terms of the offer, acceptance could only be done by doing the required act. A promise in exchange for an act creates a unilateral contract. Answer (b) is incorrect because unjust enrichment is used when no contract exists, but the court will imply one to prevent a party from being unjustly enriched. Answer (c) is incorrect because public policy is not involved. Answer (d) is incorrect because quasi contract is used like unjust enrichment to imply a contract where none exists to prevent unfairness.

16. (a) Option contracts cannot be revoked because the offeree has paid consideration to keep the offer open. Agreeing not to sue is consideration because it is giving up of a legal right. Answer (b) is incorrect because option contracts require consideration to be irrevocable. Answer (c) is incorrect because silence is rarely an acceptance. Answer (d) is incorrect because revocations do not require a writing and option contracts cannot be revoked.

17. (b) Consideration must be legally sufficient. Answers (a) and (d) are incorrect because courts aren’t usually concerned with the adequacy of consideration. They will leave the parties to make their own deal. Answer (c) is incorrect because the consideration need not be exchanged simultaneously as, for example, in a credit sale.

18. (b) Consideration must be mutually bargained for. Answers (a) and (c) are incorrect because courts aren’t usually concerned with the adequacy of consideration. Answer (d) is incorrect because consideration need not conform to the subjective intent of the parties, it need only be the giving up of a legal right.

19. (a) Past consideration is no good. Answer (b) is incorrect because consideration is the giving up of a legal right. Answer (c) is incorrect because the adequacy of consideration is not usually important. Answer (d) is incorrect because consideration may be performed by third parties. (The law permits most contract duties to be delegated.)

20. (b) A promise to donate to charity needs no consideration. Answer (a) is incorrect because what was done in the past cannot be consideration. Answer (c) is incorrect because additional consideration from both parties would be needed to modify a real estate contract. Although firm offers in sales are irrevocable without consideration, the offer must be in writing. Thus, answer (d) is incorrect because the offer is oral.

21. (a) Additional consideration is needed from both parties to modify a real estate contract. Answer (b) is incorrect because consideration is not needed to ratify a minor’s contract. Answer (c) is incorrect because firm offers in sales are irrevocable without consideration. Answer (d) is incorrect because a sales contract can be modified without additional consideration.

22. (d) Since the debt is disputed, the promises of the creditor and the debtor to compromise are both giving up of a legal right. Answer (c) is incorrect because if the debt were liquidated (undisputed amount), the promise of the debtor to pay a lesser amount would not be something he would be legally free to do. He would be contractually obligated to pay the agreed amount. Answers (a) and (b) are incorrect because both the police officer and the builder were also already obligated to perform their promise.
23. (d) The Statute of Frauds does not apply to this contract. Although the sale of goods of $500 or more require some kind of writing, this is a contract for personal services not goods (repairing books). Answers (a), (b) and (c) are incorrect because they state Carson will receive less than the agreed amount based on the Statute of Frauds and it does not apply to this contract.

24. (d) A promise to answer the debt of another requires some kind of writing. Answer (a) is incorrect because although a signed writing is not needed in sales from a merchant who fails to object in 10 days to a confirming letter from another merchant, this is not a contract for sale of goods and this rule can not be used. Answers (b) and (c) are incorrect because this contract could have been completed in one year and thus, was not impossible to complete in one year.

25. (c) Since personal services are involved and not goods, the agreement to modify the original contract requires additional consideration from both parties to be enforceable and Dunne failed to give consideration. The parol evidence rule makes evidence that contradicts a written contract inadmissible, but permits the admissibility of events that took place subsequent to the writing even if it contradicts. Since the modification took place after the writing, it is admissible. The only answer that states it is unenforceable due to lack of consideration, but admissible into evidence is (c) and all other answers are incorrect.

26. (d) Since goods are involved, this contract can be modified without added consideration. Thus (a) is incorrect because it is enforceable. Since the modified price is less than $500, the Statute of Frauds would not apply and (b) is incorrect. Since the modification was made after the writing, the parol evidence would permit its admissibility and (c) is incorrect. The only answer that states it is enforceable and admissible is (d).

27. (d) Under the Statute of Frauds the contract terms may be stated in more than one document. Answer (a) is incorrect because only contracts for the sale of goods of $500 or more require a writing. Answer (b) is incorrect because the writing need only be signed by one party but it can only be enforced against the one who signed. Answer (c) is incorrect because it is contracts impossible to perform in one year that require a writing.

28. (a) The Statute of Frauds only requires the writing to be signed by one party, but it can only be enforced against the one who signed. Answer (b) is incorrect because all contracts involving real estate require a writing. Answer (c) is incorrect because the contract terms can be in more than one document. Answer (d) is incorrect because the Statute of Frauds has nothing to do with the adequacy of consideration.

29. (d) No writing is required for a real estate contract if the contract has been fully performed by both parties. Answer (a) is incorrect because most real estate contracts require a writing regardless of the time required for performance. Answer (b) is incorrect because sale of goods of less than $500 can be oral, but most real estate contracts regardless of price require a writing. Answer (c) is incorrect because the part payment must be substantial and the purchaser must usually be in possession for an oral real estate contract to be enforceable.

30. (b) An oral contract to buy land is enforceable when the purchaser is in possession and has made a substantial downpayment. Answer (a) is incorrect because although a sales exception exists if there is no objection between merchants to a confirming letter, no such exception exists for real estate. Answers (c) and (d) are incorrect because Nolan will not win due to the exception regarding possession and substantial downpayments.

31. (a) Although contracts impossible to perform in one year usually require a writing, an exception exists if one side has fully performed and all that remains is for the other side to pay money. Answers (c) and (d) are incorrect because of this exception. Answer (b) is incorrect because the lack of involvement of real estate is irrelevant to contracts impossible to perform in one year.

32. (a) Minors can usually disaffirm not only while a minor, but also a reasonable time thereafter. Answer (b) is incorrect because the disaffirmance need not be in writing. Answer (c) is incorrect because to disaffirm the minors need only return what they possess or control. They do not need to pay the remainder of the purchase price. Answer (d) is incorrect because although minors are liable in damages for their torts (like negligence), they can still disaffirm their contracts.
33. (a) Covenants not to compete in the sale of a business are valid if reasonably needed, reasonable as to time and reasonable as to distance. The only incorrect answer is (a).

34. (b) A minor can disaffirm anytime while a minor or a reasonable time thereafter. Answers (a) and (c) are incorrect because minors cannot ratify while a minor, they can only ratify after becoming an adult. Answer (d) is incorrect because UCC Sales does not control the right of the minor to disaffirm; it exists in contract law.

35. (c) A minor can only ratify a contract while an adult. Thus (c) is the only ineffective method of ratification because it occurred before reaching the age of majority. All the remaining answers occurred after reaching the age of majority.

36. (b) To disaffirm a drunk must be incapable of understanding what they did. Since Payne understood the nature and the terms of the contract, the contract was legally binding and not void or voidable.

37. (d) Failure to have a required license makes all of your contracts void, thus West is entitled to nothing. Answers (a) and (b) are incorrect because they state Zimmer would be liable for some amount. Answer (c) is incorrect because although the Statute of Frauds applies, it only requires a writing signed by the party to be charged. Since Zimmer signed, the contract could be enforced against him.

38. (c) Illegal contracts are void and courts won't aid either party. Answers (a), (b) and (d) are all incorrect because they indicate Small could recover under some legal theory.

39. (e) Fraud has five elements (MS RID): a material misrepresentation of fact, scienter which is an intent to deceive, reasonable reliance, an intent to rely and damages. The only answer that indicates an element of fraud is (c).

40. (b) Fraud has five elements (MS RID): a material misrepresentation of fact, scienter which is an intent to deceive, reasonable reliance, an intent to rely and damages. The only answer that indicates an element of fraud is (b).

41. (a) The intent to deceive or scienter element is met in constructive fraud by a reckless disregard for the truth. Answer (b) is incorrect because although fraud requires a material misrepresentation of fact, this relates to the first element of fraud (the M in MS RID), not the scienter element. Answers (c) and (d) relate to the reliance element in fraud, not scienter.

42. (c) Although a failure to disclose will not ordinarily suffice for fraud, a duty exists to correct a previous representation later found to be false. Once Kalp discovered the inventory was overstated, Kalp’s failure to correct the previous representation would constitute fraud. Answers (a) and (b) are incorrect because they indicate Steele will not prevail. Answer (d) is incorrect because an injured party can sue for damages when fraud exists.

43. (b) Fraud in the execution exists when the defrauded party doesn’t even know they made a contract as was the case with Sardy. Answer (a) is incorrect because with fraud in the inducement the injured party knows they are making a contract and Sardy did not know. Answers (c) and (d) are incorrect because all elements of fraud are present and thus it is not mistake or duress.

44. (c) Duress is not present because Maco did not force or coerce Kent to enter into the contract. Answers (a) and (b) are incorrect because mere refusal to pay fair market value or knowledge of financial problems does not constitute duress unless force or coercion is also present. Answer (d) is incorrect because the absence or presence of alternative employment is irrelevant to whether force or coercion is used.

45. (d) Duress requires a threat of force, criminal action, or economic devastation. Most duress makes a contract voidable. Answers (a), (b) and (c) are incorrect because they don’t involve the use of force or coercion. Equally, (a) and (c) would be incorrect because they state duress makes a contract void. Only forcing someone into a contract by actual physical force, not the threat of force, makes a contract void.
46. (b) Undue influence is the use of a position of trust, confidence or affection to overcome another’s free will in contract. Here, based on Carter’s illness and Smith’s position as an attorney, undue influence exists. Answer (a) is incorrect because no force was present. Answers (c) and (d) are incorrect because there is no indication any material misrepresentations were made.

47. (d) An innocent misrepresentation has four of the elements of fraud, but no scienter or reckless disregard. It requires a material misrepresentation of fact, reasonable reliance, an intent to rely and damages. It does not have scienter. Answers (a), (b) and (c) are elements of both fraud and innocent misrepresentations. Answer (d) relates to the scienter element and thus is only present with fraud.

48. (c) An innocent misrepresentation requires a material misrepresentation of fact. Answer (a) is incorrect because it does not require scienter and a reckless disregard for the truth fulfills scienter. Answer (b) is incorrect because the misrepresentation need not be in writing. Answer (d) is incorrect because although reliance is required, it does not have to be the only factor inducing the plaintiff to enter into the contract.

49. (c) In order for a mutual mistake or a unilateral mistake to affect the validity of a contract, the mistake must be material. Thus, with an immaterial mistake the contract would be valid and not void or voidable.

50. (b) A party making a unilateral mistake can disaffirm if the other party knew or should have known an error was being made. Since Preston was a merchant in such goods, Preston should have known that $10,900 for goods worth $109,000 was an error. Answer (a) is incorrect because there was not a mutual mistake. Only Paco made the error. Answer (c) is incorrect because Preston will not prevail. Answer (d) is incorrect because such an error does not make the contract void, it makes it voidable allowing the mistaken party to disaffirm.

51. (a) A party making a unilateral mistake can disaffirm if the other party knew or should have known an error was being made. Since the general contractor knew of the errors, the subcontractor may disaffirm and will not be liable. Answer (b) is incorrect because disaffirmance is permitted when the other party knew of the mistake even if the mistake was the result of gross negligence. Answers (c) and (d) are incorrect because they state the subcontractor is liable.

52. (d) A mutual mistake of a material fact makes a contract voidable. Both parties were mistaken as to the existence of the car and the mistake was material, thus the contract was voidable. Answer (a) is incorrect because failure to pay fair market value does not by itself make a contract unconscionable. Courts are not usually concerned with the adequacy of consideration. Answer (b) is incorrect because the car was destroyed when risk of loss was with Apple. Answer (c) is incorrect because courts aren’t usually concerned with the adequacy of consideration.

53. (a) The parol evidence rule makes evidence of what occurred prior to or contemporaneous with the writing inadmissible if it contradicts the writing. Answers (b) and (c) are incorrect because failure of a condition precedent (an event that must occur before performance is required) and lack of contractual capacity have no application to the parol evidence rule. Answer (d) is incorrect because the parol evidence rule does not exclude evidence of what occurred subsequent to the execution of the written contract.

54. (b) The parol evidence rule excludes evidence of what occurred prior to or contemporaneous with the execution of the written document. Evidence of what occurred subsequent to the writing is admissible. Thus subsequent oral agreements are admissible and prior written agreements are not.

55. (c) The parol evidence rule excludes evidence of what occurred prior to or contemporaneous with the execution of the written document. It does not exclude evidence of fraud. Thus, the oral agreement regarding the utilities is inadmissible (it occurred prior to the writing), but the fraud is admissible.

56. (c) Allied and Bell made a contract whereby Bell would buy Allied’s goods and pay the money to Ferco because Allied owed Ferco money. When two parties make a contract intending to benefit a third party creditor, the third party creditor beneficiary can sue either of the two parties and prevail. Answers (a) and (b) are incorrect because they state Ferco will not prevail. Answer (d) is incorrect because a creditor beneficiary need not be aware of the contract at the time it was entered into. He can find out about the contract afterwards and still prevail.
57. (a) **When two parties make a contract intending to benefit a third party, a third party beneficiary is created and receives rights under the contract.** Jones’ insurance contract intended to benefit Smith and Smith can collect under the contract. Since there was no consideration owed, Smith is a donee beneficiary not a creditor beneficiary. Answer (b) is incorrect because Jones was not an assignee, Jones was a beneficiary. Answers (c) and (d) are incorrect because they state Jones will lose and a beneficiary of a life insurance policy can certainly recover.

58. (a) Wagner’s insurance contract naming Union as beneficiary was intended to benefit Union. This makes Union a third party beneficiary and Union received rights under the contract. **Since the life insurance was to protect a loan, Union is a creditor beneficiary not a donee beneficiary.** Answer (b) is incorrect because it states Union is a donee beneficiary. Answers (c) and (d) are incorrect because they state Union will not recover.

59. (d) United can not recover because the contract between Rice and Locke was not intended to benefit United. Although United pipe fittings were to be used, the intent of Rice was to have the refinery built and the intent of Locke was to obtain employment. Thus, United is **an incidental beneficiary and receives no rights under the contract.** Answer (a) is incorrect because it states United can recover under the contract. Answer (b) is incorrect because detrimental reliance requires that a promise be made to United upon which they justifiably relied. No promise was made to United. Answer (c) is incorrect because United was not a donee beneficiary since there was no intent to benefit United.

60. (b) **When a buyer assumes a mortgage, both the buyer and the old mortgagor are liable.** Thus, Eagle can sue either Spear or Omega. Answer (a) is incorrect because Eagle can sue Spear before suing Omega or after or even sue them both at the same time. Since they are both liable, Eagle can select which of them it will sue. Answers (c) and (d) are incorrect because Eagle can select which of them to sue and is not required to sue both or to sue Spear first.

61. (d) **When a buyer purchases land subject to an existing mortgage, the buyer is not personally liable for the mortgage. Only the original mortgagor is liable.** Thus, only Dix the original mortgagor is liable and Wilk is not liable. Answers (a) and (c) are incorrect because Wilk is not liable. Answer (b) is incorrect because Dix is liable.

62. (d) **An assignment of contract rights requires neither a writing nor consideration, thus (I) is incorrect.** An insurance contract cannot usually be assigned, thus (II) is incorrect. Only answer (d) states that both are incorrect.

63. (d) **Most contracts can be assigned, unless by assigning the basic obligations of the parties would be changed.** Yost’s contract rights to buy the land can be assigned because the basic obligations would not be changed. The obligation to buy the land is not changed and the obligation to pay for the land is not changed. Answer (a) is incorrect because consent is not needed to assign. Answers (b) and (c) are incorrect because the contract can be assigned.

64. (c) **Most contracts can be assigned, unless by assigning the basic obligations of the parties would be changed. Materially increasing risk would change the obligations of the parties.** Answer (a) is incorrect because an assignment can be made without consideration (a gift). Answer (b) is incorrect because assignments do not require a writing unless the Statute of Frauds is involved. Answer (d) is incorrect because a contract right that has been assigned can be revoked if it was assigned without consideration (a gift).

65. (a) Since the assignor gains all of the assignee’s rights and liabilities, **if there is a breach both the assignor and the assignee are liable.** Thus, Ace is still liable even though they assigned the contract to Pure. Answer (b) is incorrect because notifying Wilcox of the assignment does not relieve Ace of liability. Only the release of Ace by Wilcox would relieve Ace of liability and that would be a novation. Answers (c) and (d) are incorrect because Ace could assign the contract. The basic obligation to paint the warehouse was not changed in that it did not involve special skill.

66. (b) **Most contracts can be assigned, unless by assigning the basic obligations of the parties would be changed. Materially increasing risk would change the obligations of the parties.** Assigning an option contract right would not change the basic obligations of the parties. **Assigning a malpractice insurance policy would change the basic obligations because the insurance company’s risk depends on who the insured is.** Most insurance contracts cannot be assigned.
67. (d) By failing to notify the debtor of the assignment, Reed, the assignee, can only collect the amount paid from the assignor, Null. Reed cannot collect the money from Pix. Answers (a) and (b) are incorrect because Pix has no liability. Answer (c) is incorrect because Reed does not need to record to hold the debtor liable, Reed just needs to notify Pix of the assignment.

68. (d) When an assignment occurs, the assignor impliedly warrants the assignee there is no knowledge of facts impairing the value of the assignment. Answer (a) is incorrect because there is no warranty of payment of a debt when a creditor assigns out the right to receive money. Answer (b) is incorrect because failure to notify the debtor does not make the assignment invalid. If, however, the debtor pays the old creditor, the assignee can only collect from the assignor. Answer (c) is incorrect because most defenses that are good against an assignor are good against the assignee.

69. (d) In a novation one party to a contract is replaced by a new party and the creditor releases the old party. The creditor, First Federal, agreed to release Wren and look only to Moss for performance. Answer (a) is incorrect because Moss assumed the mortgage, instead of buying subject to. Answers (b) and (c) are incorrect because in an assignment and in a third party beneficiary contract, Wren would still be liable and Wren was released from liability.

70. (a) In a novation one party to a contract is replaced by a new party and the creditor releases the old party. The creditor, Ball, released Stark and agreed to look only to Dell for payment. Answer (b) is incorrect because in an accord and satisfaction the party who is to perform is not replaced by a new party as is done with a novation. Answer (c) is incorrect because there is no basis for the agreements to be voidable. Answer (d) is incorrect because each party has promised something they are legally free not to do and thus, consideration is present. Dell promised to pay Ball, Stark promised to accept payment to Ball as payment for Dell’s debt to him and Ball promised to release Stark.

71. (c) Impossibility of performance will discharge contractual duties. It was impossible for Jackson to repair a boat that no longer existed and thus both Jackson and Smith are discharged from their contract obligations. Answer (a) is incorrect because there was no mutual mistake at the time the contract was made. Answers (b) and (d) are incorrect because both Smith and Jackson are discharged and no longer liable.

72. (d) The statute of limitations for contract actions in most states is 6 years from the date of the breach. It does not begin to run from the date the contract is made, thus (c) is incorrect. Answer (a) is incorrect because the enforceability of oral contracts concerns the Statute of Frauds, not the statute of limitations. Answer (b) also concerns the Statute of Frauds (contracts impossible to perform in 1 year), not the statute of limitations.

73. (a) The statute of limitations requires that a law suit be brought within a specified time after a breach occurs. Answers (b), (c) and (d) concern the statute of frauds, fraud and the parol evidence rule. They do not apply to the statute of limitations.

74. (b) The statute of limitations requires that a law suit be brought within a specified time after a breach occurs. Answers (a), (c) and (d) are incorrect because it is not computed from when the contract is negotiated, begun or signed.

75. (d) The statute of limitations limits the time period in which a law suit can be brought. It bars a party’s access to judicial remedies. Answers (a) and (b) are incorrect because it doesn’t make the contract void or discharge the underlying obligation, it merely bars access to a remedy. Answer (c) is incorrect because a debt barred by the statute of limitations can be revived by a new written promise to pay.

76. (a) Prevention of performance will discharge a party from a contract. With accord and satisfaction, the satisfaction is the performance of the accord and discharges the old contract. Thus, both prevention of performance and accord and satisfaction discharge a party to a contract.
77. **(d) Illegal contracts are void.** Thus, if a contract was legal when made and subsequently became illegal, the parties would be discharged from their duties. Answer (a) is incorrect because only death of the party to perform services results in a discharge, not death of the one to receive services. Answer (b) is incorrect because only the absolute impossibility of performance will discharge a party. Increased difficulty or increased cost of performance does not discharge a party. Answer (c) is incorrect because bankruptcy of the party to receive services does not result in a discharge, although bankruptcy of the one to perform services may very well result in a discharge.

78. **(c) An anticipatory repudiation occurs when one party, prior to the time of performance, states that they won’t perform the contract.** Nagel told Fields on September 3 that Nagel would not perform the contract on September 10. Answer (a) is incorrect because promissory estoppel involves detrimental reliance on the promise of another when there is no contract. Answer (b) is incorrect because an accord and satisfaction involves an agreement to substitute performance. Answer (d) is incorrect because substantial performance involves an unintentional breach of the contract in a minor area.

79. **(d) With an anticipatory repudiation the injured party can sue immediately or wait until the time of performance and then sue for breach.** Answer (a) is incorrect because most contract rights can be assigned. Answer (b) is incorrect because specific performance cannot be used in personal service contracts. Answer (c) is incorrect because no writing was required for this contract under the Statute of Frauds.

80. **(a) The doctrine of substantial performance provides that for an unintentional breach in a minor area, recovery is allowed.** Damages will be subtracted for the minor breach. Ames unintentionally breached in a minor area. White can only subtract monetary damages for the minor breach. Answer (b) is incorrect because White can subtract damages for the minor breach. Answer (c) is incorrect because Ames did have a minor breach. Answer (d) is incorrect because Ames can recover without installing the Ace fixtures.

81. **(d) Specific performance is available for unique property.** All real estate is considered to be unique. Thus, Hodge may use specific performance against Kaye. Hodge may choose to receive compensatory damages instead, a monetary award to compensate Hodge for the harm Kaye has done by breaching. Answers (a) and (c) are incorrect because punitive damages are rarely awarded. Answer (b) is incorrect because the award of the land and money for all harm done would ordinarily be "double" compensation. A party usually recovers specific performance or compensatory damages, but not both.

82. **(a) Specific performance is available for unique property.** All real estate is considered to be unique. Thus, Wyatt may use specific performance against Price. Answer (b) is incorrect because the award of the land and money for all harm done would ordinarily be "double" compensation. A party usually recovers specific performance or compensatory damages, but not both. Answers (c) and (d) are incorrect because punitive damages are rarely awarded.

83. **(b) Specific performance is only available for unique property and never for personal service contracts.** Thus, Foster could not use specific performance for this personal service contract. Answers (a) and (c) are incorrect because Jones repudiated prior to the time of performance. With an anticipatory breach Foster can sue immediately or wait until the time of performance and then sue. Answer (d) is incorrect because Foster can sue for monetary damages for breach of a personal service contract.

84. **(a) With a liquidated damage clause the parties agree in advance what damages will be if there is a breach. To be enforceable the amount must bear a reasonable relationship to the harm done and not be a penalty.** Thus, Master will win unless the amount is a penalty. Answer (b) is incorrect because liquidated damages that are unreasonable are not enforced. Answer (c) is incorrect because Accur’s breach was material due to the importance of the computer system. Answer (d) is incorrect because liquidated damages are enforceable if reasonable to the harm done.

85. **(c) When rescission occurs the contract is canceled and the parties are restored to their former position.** Answer (a) is incorrect because with a novation the contract is not canceled. In a novation one side is replaced and the new party will perform the contract. Answer (b) is incorrect because with a release one side is excused from performance but both sides are not restored to their original position. Answer (d) is incorrect because a revocation is when an offeror revokes an offer, not the canceling of a contract.
86. (c) **Contract terms must be contained in only one document, is not a requirement of the Statute of Frauds.** Answers (A), (B), and (D) are correct with regard to the Statute of Frauds.

87. (b) **A mutual mistake of fact is correct.** Generally, mistakes have no effect on a contract, with two exceptions: (1) mutual mistake of fact; or (2) material unilateral mistakes. In this question, the obvious answer (B). Answers (A), (C) and (D) will not allow a party to rescind a contract.

88. (b) **The right to receive a sum of money may be assigned.** There are four types of contracts that cannot be assigned: (1) Personal service contracts (so Answer (A) is incorrect); (2) Contracts that would increase risks or materially alter performance; (3) Contracts in which assignment is prohibited under the terms of the contract or by statute (therefore, Answer (D) is incorrect); and (4) insurance contracts (so Answer (C) is incorrect). This leaves Answer (B) as the only correct choice. (n.b., Generally, the right to receive money under a contract is assignable, even if the terms of the contract prohibit its assignment).
Chapter One: Contracts
Other Objective Format Answers

ANSWER 1

1. (J) On January 20, East sent a signed memorandum to Bean stating the terms of the offer. Thus, there was a submission of a written offer.

2. (C) Although Bean signed and mailed back the memorandum on January 21, this offer couldn’t be accepted until it was received. When an offer states that it must be received by a specified date, it must be received by that date to be effective and the mailbox rule cannot apply.

3. (D) On January 23, East wrote to Bean revoking the offer. Since a revocation is only effective when it is received, an attempted revocation occurred.

4. (E) On January 24, East received Bean’s signed acceptance of the memorandum. Since the revocation was not yet effective (hadn’t been received), a valid contract was formed on this date.

5. (G) On January 25, Bean received East’s revocation. An offeror can usually revoke an offer anytime before acceptance. The revocation was invalid because the offer had already been accepted on January 24.

6. (E) On March 1, East orally engaged Snow to install a LAN system. On this date a valid, enforceable contract was formed. The contract did not require a writing under the Statute of Frauds and there were no facts to indicate any reason for it to be voidable.

7. (E) On March 15, East offered Snow a contract to design East’s Internet homepage and Snow accepted. On this date a valid, enforceable contract was formed. The contract did not require a writing under the Statute of Frauds and there were no facts to indicate any reason for it to be voidable.

8. (H) On April 5, East accepted Snow’s withdrawal from the homepage design project. On this date the parties had agreed to a mutual rescission because they had both agreed to cancel their obligations under the contract.

9. (K) On April 15, Snow notified East of an assignment of fees due Snow for the LAN installation to Band. Snow did not delegate its duties to install the LAN system to Band. Indeed, Snow couldn’t assign or delegate its duties to a 3rd party. Personal service contracts calling for special skill or judgment cannot be assigned. Thus, a valid assignment of rights occurred, but not an assignment of duties.

10. (A) On April 30 East canceled the LAN installation contract. This was a breach of contract. To be specific, it was an anticipatory breach because East had repudiated the contract before the time of performance.

ANSWER 2

1. (F) Although contracts impossible to perform in one year require some kind of writing under the Statute of Frauds, there is no requirement that offers be in writing.

2. (F) The offer required that the acceptance be in writing and received by December 20. Reach’s faxed acceptance was a writing and it was received on December 20 and therefore was a proper method of acceptance.

3. (F) The fax was effective when received because the offer required acceptances to be received.

4. (F) Reach’s acceptance complied with the terms of the offer because it was in writing and received by December 20. The offer did not require that the acceptance had to be seen. It only required that it be received by the 20th.
5. (F) Reach’s acceptance did not create any contract, voidable or otherwise, because it was not unconditional. The offer specified a $100,000 fee and the acceptance changed this to $1,000,000. By not complying with Blake’s terms, no contract was created.

6. (T) or (F) The exam gave credit for either answer, an indication that the question was poorly drafted. The (T) answer was counted because changing of the fee would not be a valid acceptance in that it was not unconditional. Credit was also given for the (F) answer most likely under the theory that an obvious mistake had been made and it was the clear intent of Reach to accept the offer.

7. (T) Reach’s fax changed the terms of the original offer and was therefore a counteroffer.

8. (F) Most contract rights can be assigned as long as the basic obligations are not changed. The assignment of the right to receive money is permissible.

9. (T) Most contract rights can be assigned as long as the basic obligations are not changed. The assignment of the right to receive money is permissible.

10. (T) Since it was the clear intent of Reach to benefit Weaver because of a debt owed Weaver, a third party creditor beneficiary was created.

11. (T) Punitive damages are rarely awarded for contract or sales breaches.

12. (F) Punitive damages are rarely awarded for contract or sales breaches.

13. (F) A writing is required under the Statute of Frauds because this contract is impossible to complete in one year. The writing need only be signed by one party, but it can only be enforced against the one who signed. There is no writing signed by Reach and thus the contract can not be enforced against him.

14. (T) If an offer does not state how long it is to remain open, it ends after a reasonable time.

15. (T) A writing is required under the Statute of Frauds because this contract is impossible to complete in one year. The writing need only be signed by one party, but it can only be enforced against the one who signed. It can be enforced against Blake because there is a signed memo from Blake.

ANSWER 3

Suburban is correct concerning the agreement to share utility costs with Bridge. A modification of a contract requires consideration to be binding on the parties. Suburban is not bound by the lease modification because Suburban did not receive any consideration in exchange for its agreement to share the cost of utilities with Bridge.

Suburban is not correct with regard to the Dart offer. An offer can be revoked at any time prior to acceptance. This is true despite the fact that the offer provides that it will not be withdrawn prior to a stated time. If no consideration is given in exchange for this promise not to withdraw the offer, the promise is not binding on the offeror. The offer provided that Suburban's acceptance would not be effective until received. Dart's June 10 revocation terminated Dart's offer. Thus, Suburban's June 9 acceptance was not effective.

Suburban is correct with regard to World's claim. The general rule is that destruction of, or damage to, the subject matter of a contract without the fault of either party terminates the contract. In this case, Suburban is not liable to World because Suburban is discharged from its contractual duties as a result of the fire, which made performance by it under the lease objectively impossible.
ANSWER 4

Ambel is incorrect. The general rule is that when a party knows, or reasonably should know, that a mistake has been made in the making of an offer, the mistaken party will be granted relief from the offer. In this case, because Ambel was aware of the approximate fair market value of the equipment, it had reason to be aware of the mathematical error made by Victor and will not be allowed to take advantage of it.

Clark is correct. A contract that cannot by its terms be performed within one year from the date it is made must be evidenced by a writing that satisfies the requirements of the Statute of Frauds. The contract between Victor and Clark is not enforceable by Victor against Clark, because the contract was oral and provided for performance by the parties for longer than one year from the date the contract was entered into.

GYX is incorrect. An acceptance of an offer is effective when dispatched (in this case, when mailed), provided that the appropriate mode of communication is used. The general rule is that an offer shall be interpreted as inviting acceptance in any manner and by any medium reasonable in the circumstances. In this case, GYX made its offer by mail. An acceptance by mail, if properly addressed with adequate postage affixed, would be considered a reasonable manner and method of acceptance. Therefore, Victor's acceptance was effective (and a contract was formed) when the acceptance was mailed on November 12 and not when received by GYX on November 17.

Wells is incorrect. As a general rule, most contracts are assignable and delegable unless: prohibited in the contract, the duties are personal in nature, or the assignment or delegation is prohibited by statute or public policy. Victor was entitled to assign the contract to Master, because none of these exceptions apply to the contract.

ANSWER 5

(a) Dodd's claim, that West's offer could not be revoked before September 30, is incorrect. Offers can be revoked at any time before acceptance unless the offeror receives consideration to keep the offer open. West did not receive any consideration from Dodd in exchange for its promise to keep the offer open until September 30. Therefore, West effectively revoked its offer during the September 28 telephone conversation.

Dodd's claim, that the September 27 letter accepting West's offer was effective when mailed to West, is incorrect. The general rule is that an acceptance is effective when dispatched if the acceptance is made using a reasonable mode of communication. In this case, the offer required that the acceptance be received by West to be effective. Therefore, Dodd's acceptance could not have been effective until after the offer expired, because it was received after September 30.

(b) West's claim, that any agreement that existed between West and Dodd would not be enforceable against West because of the Statute of Frauds, is correct. The term of the agreement was for three years. The Statute of Frauds requires that contracts that cannot be performed within one year from the date made must be in writing. Because this was an oral contract for a period of three years, it would not be enforceable under the Statute of Frauds. Dodd's attempted acceptance of the offer would not be such a writing because it was not signed by West and could not be enforceable against West.

(c) Abco's first position, that the oral April 14 agreement regarding the painting of the warehouse is not binding, is correct. This agreement was intended to modify the existing lease between the parties. Under common law, agreements modifying existing contracts require consideration to be binding. Abco did not receive any consideration in exchange for its promise to paint the warehouse; therefore, the agreement is not enforceable against Abco.

Abco's second position, that evidence of the April 14 oral agreement could not be admitted into evidence, is incorrect. The parol evidence rule allows the admission of proof of a later oral agreement that modifies an existing written contract.
ANSWER 6

Stake's first allegation, that Packer committed fraud in the formation of the contract, is correct and Stake may rescind the contract. Packer had assured Stake that the vacant parcel would be used for a shopping center when, in fact, Packer intended to use the land to construct apartment units that would be in direct competition with those owned by Stake. Stake would not have sold the land to Packer had Packer's real intentions been known. Therefore, the elements of fraud are present:

- A false representation;
- Of a fact;
- That is material;
- Made with knowledge of its falsity and intention to deceive;
- That is justifiably relied on.

Stake's second allegation, that the mistake as to the fair market value of the land entitles Stake to rescind the contract, is incorrect. Generally, mistakes as to adequacy of consideration or fairness of a bargain are insufficient grounds to entitle the aggrieved party to rescind a contract.

Stake's third allegation, that the contract was not enforceable against Stake because Stake did not sign the counteroffer, is correct. The contract between Stake and Packer involves real estate and, therefore, the Statute of Frauds requirements must be satisfied. The Statute of Frauds requires that a writing be signed by the party against whom enforcement is sought. The counteroffer is unenforceable against Stake because Stake did not sign it. As a result, Stake is not obligated to sell the land to Packer under the terms of the counteroffer.

ANSWER 7

Snow's assertion that Jacobs' acceptance was not received on a timely basis is incorrect. Jacobs' January 31 acceptance was effective when dispatched (mailed) under the complete-when-posted doctrine because:

- The letter was an authorized means of communication (because Snow's offer was by mail); and
- The letter was properly stamped and addressed.

Therefore, Jacobs' acceptance was effective on January 31, the last possible day under Snow's January 21 offer.

Snow's assertion that the January 21 offer was effectively revoked is incorrect because a revocation is not effective until received. In this case, the revocation was effective on February 3, and Jacobs' acceptance was effective on January 31.

Snow's assertion that Jacobs' failure to sign the January 31 acceptance prevents the formation of a contract is incorrect. The Statute of Frauds, which applies to contracts involving interests in real estate, requires only the signature of the party to be charged with enforcement of the contract. Therefore, because Snow had signed the January 21 offer, which was accepted by Jacobs, the contract is enforceable against Snow.

Snow's assertion that Jacobs had no right to assign the contract is incorrect. Contract rights, including the right to purchase real estate, are generally assignable unless the assignment:

- Would materially increase the risk or burden of the obligor;
- Purports to transfer highly personal contract rights;
- Is validly prohibited by the contract; or
- Is prohibited by law.

None of these limitations applies to the assignment by Jacobs to Eljay.
ANSWER 8

a. Korn would argue two points of law to show there was no valid contract. Korn would argue that the July 5 offer was not accepted by Wilson before it was withdrawn on September 30. An offer can be withdrawn at any time before it is accepted even if it states that it will remain open for a definite period of time.

Korn would also argue that Wilson’s response of September 28 was not a valid acceptance because Wilson included additional terms and Wilson’s attempt to change the term of the contract was a rejection and a counteroffer.

b. Wilson would argue two points of law to show there was a valid contract. Wilson would argue that the mailing of the acceptance on September 28 was an effective acceptance under the mailbox rule. There is a valid contract because there was a valid acceptance before the offer was withdrawn.

Wilson would also argue that the attempt to extend the contract was not a condition of acceptance but a requested immaterial modification that did not negate the acceptance.

c. If a valid contract existed, Korn’s September 30 telephone call resulted in Korn’s anticipatory breach of the contract because Wilson could no longer rely on Korn performing.

Under common law, Wilson could either cancel the contract or sue to collect compensatory damages for the additional amount it would cost to obtain the services.

ANSWER 9

a. 1. There was an enforceable contract between Thorn and Birch. The requirements necessary to form an enforceable contract for the sale of real property are as follows:

An offer
An acceptance
Legally sufficient consideration
Parties who have the legal capacity to enter into a contract
A legal purpose
A written contract document

2. Thorn did not breach the contract by assigning the mortgage payments to a third party. The right to receive a sum of money may be assigned even when a contract contains an anti-assignment clause.

3. If a court determined that Thorn breached the contract, Birch would be entitled to sue for either compensatory damages or specific performance. Compensatory damages would reimburse Birch for all expenses as well as any additional amounts spent in obtaining substitute property as a result of Thorn’s actions. Specific performance would require Thorn to complete the sale of the property to Birch because each parcel of real property is unique.

b. 1. Acme’s first contention that Birch had no insurable interest in the property when the policy was issued is incorrect. Birch had an insurable interest in the property when the contract was signed, since a contract right is an insurable interest.

Acme’s second contention that Birch is a coinsurer is correct. Birch’s policy for $1.5 million is less than 80% of the value of the buildings.

2. Birch would recover $150,000 of the loss. This figure is computed by dividing the face value of the policy by 80% of the fair market value of the buildings and multiplying by the amount of the loss.

\[
\text{Face value of policy} \times \frac{\text{amount of loss}}{80\% \text{ of fair market value}} = \text{recovery}
\]

\[
\frac{$1,500,000}{.80} \times \frac{$160,000}{2,000,000} = $150,000
\]

3. The mortgage recorded in February would have first priority. In a notice-race jurisdiction, the first recorded mortgage has priority unless the holder of a later mortgage has knowledge of the earlier mortgage. Based on the facts presented, no one had notice of the earlier unrecorded mortgage and, consequently, it has no priority despite its being first in time. Accordingly, the February mortgage would be paid in full ($475,000) and the balance of the foreclosure proceeds ($525,000) would be paid to Thorn.
Chapter Two
Sales

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Chapter Two
Sales

FORMATION OF SALES CONTRACTS

1. Sales contracts are governed by Article 2 of the Uniform Commercial Code (UCC)
   a. the law of Sales applies only to goods: generally movable, tangible personal property (e.g., merchandise, timber when removed, growing crops and the unborn young of animals)
   b. general contract law governs real property contracts, personal service contracts and contracts for the sale of intangibles (e.g., stocks, bonds, patents)

2. In sales, a valid contract may be formed even though certain terms are omitted
   a. delivery, if unspecified, must be made in a reasonable time and in a single delivery (e.g., seller may not deliver the goods in installments)
   b. the place of delivery if none is stated is the seller’s place of business
   c. the price of the goods if none is stated is a reasonable price

3. In sales, an offer may be accepted in any reasonable manner
   a. between merchants, minor changes in an offer will be a valid acceptance
      1). the minor changes become part of the contract unless objected to
      2). if both are not merchants, the changes are merely proposals for change
      3). if either party says "no changes", then no changes are allowed
   b. under the mailbox rule, an acceptance is valid when sent if the offeree uses
      1). the express means of communication (the means the offeror said to use)
      2). any reasonable means if none is specified
   c. ordered goods may be accepted by prompt shipment or promise to ship (this is true even if the goods are nonconforming for seller has both accepted and breached)

4. Firm offers in UCC Sales are irrevocable without consideration
   a. firm offers have three elements - must be made by a merchant
      - must be in a signed writing
      - must guarantee it will be held open
   b. it is irrevocable for the time stated, but the maximum period is 3 months
   c. if no time is stated, offer is irrevocable for a reasonable time not to exceed 3 months

5. Modifications: in Sales you may modify a contract without added consideration
   a. a writing will be required if the price is modified to $500 or more
   b. the modification must be made in good faith

6. Auctions
   a. in an auction, the bids made are offers and the acceptance occurs when the auctioneer bangs the gavel and says sold
   b. a bidder may usually retract their bid any time prior to acceptance
   c. in an auction without reserve, goods must be sold to the highest bidder
   d. in an auction with reserve, the goods need not be sold to the highest bidder

PERFORMANCE OF THE PARTIES

1. Unless otherwise agreed, the basic obligations of a seller are to:
   a. hold conforming goods for the buyer
   b. give the buyer whatever notification is necessary for the buyer to take delivery
   c. if the agreed manner of delivery is impractical, the seller may substitute (e.g., The contract requires the goods to be ship by UPS and UPS is on strike. The seller may substitute with a different carrier, such as Federal Express.)
2. Unless otherwise agreed, the basic obligations of a buyer are to:
   a. accept and pay for conforming goods at time of receipt
   b. payment may be made in any normal manner to include payment by check
   c. buyer has the right to inspect prior to payment except in a C.O.D. sale
   d. buyer may still reject nonconforming goods after acceptance for substantial defects a reasonable inspection would not have shown

3. Buyer may reject nonconforming goods for any nonconformity because the UCC requires perfect tender by the seller (e.g. the goods must conform exactly to the contract)
   a. the buyer may reject all of the goods, some of the goods or none of the goods
   b. a rejection returns title to seller
   c. buyer must notify the seller within a reasonable time of rejection
      1). must give the seller a reasonable opportunity to correct the problem (cure) until the contract time has expired
      2). must give the seller a reasonable time to remove them
   d. merchant buyers must follow any reasonable instructions of the seller

4. Seller has absolute right to cure (i.e. correct nonconforming deliveries) by simply notifying the buyer that the problem will be corrected on time

5. All parties are required to act in good faith

6. An Anticipatory Repudiation occurs when either the buyer or seller states they won't perform prior to the performance time
   a. the injured party may sue immediately or wait until the performance time and sue
   b. an anticipatory breach may be retract if the injured party has not already canceled the contract or materially changed position

7. Adequate Assurance of Performance
   a. either party may demand a written assurance of performance when reasonable grounds for insecurity exist
   b. if not received within a reasonable time, the contract is considered repudiated (i.e. the buyer or seller would be released from the contract)

**SALES STATUTE OF FRAUDS**

1. Sale of goods of $500 or more require a writing which must specify a quantity

2. Exceptions when no writing required, even if the price is $500 or more
   a. if the seller has Specially manufactured goods for the buyer
   b. Payment of goods OR receipt of goods (note: with a part payment or a part receipt, the contract is only enforced for the part paid for or the part received)
   c. if a party Admits in court that (s)he made a contract, no writing is required
   d. Merchants confirming letter: between merchants if there is no objection in 10 days to a writing confirming an oral contract, both of the merchants are bound

Example: On May 1 X, a merchant, orders 5,000 widgets at $1.00 a widget from Acme, Inc. by phone. Delivery and payment are to made in four weeks. On May 5 Acme sends a fax to X confirming the oral sale. If there is no objection by X within 10 days, both Acme and X are bound because of the confirming letter exception.

**IMPLIED WARRANTIES - no oral or written words required**

1. Implied warranties are created automatically unless they are properly disclaimed
   a. thus, no written words or oral words are needed to create an implied warranty
   b. the 3 main categories of implied warranties are merchantability, title and fitness for a particular purpose
2. **Merchantability:**
   a. *merchant sellers* promise goods are fit and safe in normal uses
   b. if the buyer inspects the goods prior to purchase, there is no implied warranty of merchantability for obvious defects

3. There are **3 implied warranties of title**
   a. **good title:** all sellers impliedly promise good title and rightful transfer
   b. **encumbrances:** all sellers impliedly promise no unstated liens or attachments
   c. **infringements:** *merchant sellers* implicitly promise no patent or trademark violations (note: infringement warranty is not present on a sale made to a buyer's specifications)

4. **Fitness For A Particular Purpose**
   a. buyer must rely on seller to select suitable goods and the seller must know of the buyer's reliance
   b. if the buyer does rely, then the goods must fit for the buyer's specific purpose
   c. if the buyer inspects the goods prior to purchase, there is no implied warranty of fitness for a particular purpose for obvious defects

**DISCLAIMING IMPLIED WARRANTIES**

1. Any implied warranty may be disclaimed but the disclaimer must be conspicuous

2. There are **two ways to disclaim merchantability** and the disclaimer may be oral
   a. by an "as is" sale (e.g. no returns, goods are sold with all faults) **OR**
   b. by expressly telling the buyer there is no warranty of merchantability

3. To disclaim fitness for a particular purpose, a writing is required
   a. an "as is" sale would disclaim fitness for a particular purpose
   b. stating there are "no warranties beyond the description" disclaims fitness

4. To disclaim title requires very specific language, general language is ineffective
   a. seller must specifically tell the buyer that (s)he doesn't guarantee title
   b. not disclaimed by an "as is" sale or by disclaiming any and all warranties

5. A disclaimer is only effective for warranty actions. A seller cannot disclaim liability for personal injuries, negligence or strict liability in tort

**EXPRESS WARRANTIES**

1. A seller is liable for a breach of any express warranty
   a. an express warranty is any material misrepresentation of **fact**
   b. opinions and statements of value do not count unless they are made by experts
   c. a sale of goods by description, sample or model creates an express warranty that the goods will conform to the description, sample or model

2. Express warranties must be **part of the basis of the bargain** (played some part in buyer's decision to buy)

**RULES FOR RISK OF LOSS & TITLE**

1. Risk of loss and title cannot pass until existing goods have been identified to the contract
   a. identified goods are goods that have been marked, tagged or designated in some manner as goods for a specific buyer
   b. once existing goods have been identified, the most important factor in determining when risk of loss and title will pass is the agreement between the parties (e.g. the shipping terms of a contract)
2. There are 2 types of contracts involving transportation by carrier: **shipment contracts** and **destination contracts**
   a. with **shipment contracts**, risk of loss and title pass when the seller delivers goods to the carrier to go to buyer
   b. with **destination contracts**, risk of loss and title pass when the seller gets goods to the **specified destination and tenders delivery** (notifies the buyer the goods have arrived)
   c. when it is unclear which type of transportation is involved, the contract is presumed to be a **shipment contract**

3. With documents of title, risk of loss and title pass when buyer gets the document

4. If there is no transportation by a carrier or no documents of title are involved (i.e. seller uses his own truck to deliver instead of a carrier or delivery is at seller’s place of business)
   a. title passes as soon as the contract is made provided the goods are identified
   b. risk of loss with merchant sellers only passes when buyer takes possession
      e.g. $X$ buys a dryer from **Sears** on May 1, but doesn’t take possession until May 5. **Sears** has risk of loss until $X$ takes possession on May 5
   c. risk of loss with nonmerchants passes on tender of delivery
      e.g. $X$ buys a dryer from his neighbor at a yard sale on May 1 and asks if he can wait to take possession until May 5. The neighbor agrees. $X$ has risk of loss on May 1 because the neighbor tendered delivery on May 1.

5. With nonconforming goods, risk of loss is always on the seller but title passes to the buyer when the seller completes the delivery requirements

6. **Insurable interest**
   a. buyer gets an insurable interest when goods are identified (marked or tagged as goods for a specific buyer)
   b. seller has an insurable interest if the seller has title or any security interest in the goods

7. If seller has risk of loss and identified goods are damaged without either party's fault
   a. if totally destroyed, both buyer and seller are released from the contract
   b. if partially damaged, buyer may rescind or accept them with a price reduction
   c. if damaged after buyer has risk of loss, buyer must pay the full contract price

### SHIPPING TERMS

1. **F.O.B.** means free on board and fixes the place where title and risk of loss pass
   a. e.g. FOB seller's loading dock is a shipment contract (title and risk of loss would pass when goods are delivered to the carrier, **not** when the goods are on the loading dock)
   b. e.g. FOB buyer's loading dock is a destination contract (title and risk of loss would pass when the goods reach the destination and seller tenders delivery)

2. **CIF** means the price includes cost of the goods, insurance and freight (CIF is a shipment contract)

3. In sales there are **two types of trial sales** in which the buyer may return the goods
   a. in a **Sale On Approval** neither risk of loss nor title pass until buyer approves
   b. in a **Sale Or Return** the buyer gets risk of loss and title upon delivery
      1). buyer may still return the goods if unsatisfied
      2). if returned, risk of loss remains with the buyer until the seller has possession
   c. if it is unclear which trial sale is involved, it is a **sale on approval** if the goods were primarily for buyer's use and a **sale or return** if primarily for resale
POWER TO TRANSFER TITLE

1. Usually a buyer gets no better title than seller had to give (e.g., a thief cannot usually pass good title to a buyer).

2. **Exception:** entrusting occurs when a rightful owner transfers possession but not ownership of goods to a merchant and the merchant sells them by error.
   a. a good faith purchaser for value (innocent buyer) from the merchant gets good title.
   b. **note:** although the rightful owner has lost title to the goods, (s)he would still be able to sue the merchant for any losses.

3. **Exception:** one with voidable title can pass good title to a good faith purchaser for value (e.g., one who gets title by fraud may pass good title to an innocent buyer).

REMEDIES OF BUYER

1. Buyer may **sue to recover any damages**, but may **not** usually get punitive damages.

2. Buyer may **rescind** (cancel) and **sue for money damages**
   **note:** buyer must give seller reasonable notification of cancellation.

3. Buyer may **cover** (purchase suitable goods elsewhere) and charge seller for any loss
   **note:** with rapidly rising prices, buyer's failure to cover may reduce his damages.

4. Buyer can **recover goods** from the seller, but **only if** the goods are identified
   a. specific performance may be used with unique goods or if buyer cannot cover
   b. buyer may recover goods from an insolvent seller if the buyer has prepaid.

SELLER’S REMEDIES

1. If a buyer breaches the seller may use **any or all** of the remedies listed below.

2. The seller may **sue to recover damages**
   a. the seller may charge buyer for **any loss**, to include lost profits, reasonable expenses and storage fees but sellers may **not** usually collect punitive damages.
   b. the seller may collect the full contract price if the goods cannot be resold for any price or if risk of loss has passed to the buyer.

3. The seller may **resell** the goods and recover damages for any loss suffered
   a. **note:** seller must give the buyer reasonable notice of intent to resell
   b. if the goods are unfinished the seller may complete the manufacturing and sell them or sell the unfinished goods for salvage value, whichever is reasonable.

4. The seller may **rescind** (cancel) the contract and sue buyer for any damages.

5. The seller may stop delivery of goods upon a buyer’s breach.

6. If in a credit sale the seller discovers that the buyer is insolvent, the seller may
   a. stop delivery and demand cash (this turns a credit sale into a C.O.D. sale)
   b. the seller may reclaim goods already delivered to the buyer within 10 days of delivery (there is no time limit for reclamation if the buyer misrepresented solvency)
   c. seller may not reclaim the goods if the buyer has resold them to a 3rd party.
LIMITATION OF REMEDIES

1. The Statute of limitations states suit must commence within 4 years of the breach
   a. by agreement, the time may be limited to 1 year, but not less
   b. the time cannot be extended beyond 4 years
   c. the statute of limitations does not discharge contractual obligations or make the contract void. It merely bars access to judicial remedies.

2. Liquidated damages occur when the parties agree in advance what damage will be if there is a breach (e.g. forfeiture of down payment upon breach by buyer)
   a. the amount must be reasonable to the actual harm done and not a penalty
   b. if there is no agreed amount, the seller is entitled to 20% of the contract price or $500, whichever is smaller

STRICT LIABILITY IN TORT

1. Strict privity (old law) The parties to a contract are said to be in privity of contract
   a. originally only parties to the contract could sue for breach of contract
   b. thus, only the original buyer could sue and the buyer could only sue the original seller

2. In UCC Sales users and anyone reasonably affected by a product can sue (may not be excluded by sellers)

3. Negligence: those injured by goods may sue negligent sellers - must show 4 elements

<table>
<thead>
<tr>
<th>4 Elements of Negligence</th>
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<tbody>
<tr>
<td>Duty of care</td>
</tr>
<tr>
<td>Breach</td>
</tr>
<tr>
<td>Damages</td>
</tr>
<tr>
<td>Causality</td>
</tr>
</tbody>
</table>

4. Strict Liability in Tort is liability without regard to fault for defective products
   a. must show 5 elements

Mnemonic: Defective products cause unreasonably dangerous business changes

<table>
<thead>
<tr>
<th>Defective products</th>
<th>cause unreasonably dangerous business changes</th>
</tr>
</thead>
<tbody>
<tr>
<td>Defective products</td>
<td>must show a Defective product</td>
</tr>
<tr>
<td>Cause</td>
<td>must show the defect Caused injury</td>
</tr>
<tr>
<td>Unreasonably dangerous</td>
<td>must show the defect was Unreasonably dangerous to users and consumers</td>
</tr>
<tr>
<td>Business</td>
<td>must show seller was engaged in that Business (a merchant)</td>
</tr>
<tr>
<td>Changes</td>
<td>must show it reached user without substantial Changes in condition</td>
</tr>
</tbody>
</table>

b. negligence is irrelevant - no need to show seller failed to use reasonable care

c. privity is irrelevant - anyone injured may sue anyone in the chain of commerce (anyone involved in the business of selling that particular item)
Chapter Two: Sales
Multiple Choice Questions

1. The UCC Sales Article applies
   a. To a contract for personal services.
   b. To the sale of patents.
   c. To the sale of goods only if the buyer and seller are merchants.
   d. To the sale of specially manufactured goods.

2. Under the UCC Sales Article, which of the following statements is correct concerning a contract involving a merchant seller and a non-merchant buyer?
   a. Whether the UCC Sales Article is applicable does not depend on the price of the goods involved.
   b. Only the seller is obligated to perform the contract in good faith.
   c. The contract will be either a sale or return or sale on approval contract.
   d. The contract may not involve the sale of personal property with a price of more than $500.

3. Cookie Co. offered to sell Distrib Markets 20,000 pounds of cookies at $1.00 per pound, subject to certain specified terms for delivery. Distrib replied in writing as follows:
   "We accept your offer for 20,000 pounds of cookies at $1.00 per pound, weighing scale to have valid city certificate."

   Under the UCC
   a. A contract was formed between the parties.
   b. A contract will be formed only if Cookie agrees to the weighing scale requirement.
   c. No contract was formed because Distrib included the weighing scale requirement in its reply.
   d. No contract was formed because Distrib's reply was a counteroffer.

4. Under the Sales Article of the UCC, when a written offer has been made without specifying a means of acceptance but providing that the offer will only remain open for 10 days, which of the following statements represent(s) a valid acceptance of the offer?
   I. An acceptance sent by regular mail the day before the ten-day period expires that reaches the offeror on the eleventh day.
   II. An acceptance faxed the day before the ten-day period expires that reaches the offeror on the eleventh day, due to a malfunction of the offeror’s printer.

5. Under the Sales Article of the UCC, a firm offer will be created only if the
   a. Offer states the time period during which it will remain open.
   b. Offer is made by a merchant in a signed writing.
   c. Offeree gives some form of consideration.
   d. Offeree is a merchant.

6. An oral agreement concerning the sale of goods entered into without consideration is binding if the agreement
   a. Is a firm offer made by a merchant who promises to hold the offer open for 30 days.
   b. Is a waiver of the non-breaching party's rights arising out of a breach of the contract.
   c. Contradicts the terms of a subsequent written contract that is intended as the complete and exclusive agreement of the parties.
   d. Modifies the price in an existing, enforceable contract from $525 to $475.

7. On May 2, Mason orally contracted with Acme Appliances to buy for $480 a washer and dryer for household use. Mason and the Acme salesperson agreed that delivery would be made on July 2. On May 5, Mason telephoned Acme and requested that the delivery date be moved to June 2. The Acme salesperson agreed with this request. On June 2, Acme failed to deliver the washer and dryer to Mason because of an inventory shortage. Acme advised Mason that it would deliver the appliances on July 2 as originally agreed. Mason believes that Acme has breached its agreement with Mason. Acme contends that its agreement to deliver on June 2 was not binding. Acme's contention is
   a. Correct, because Mason is not a merchant and was buying the appliances for household use.
   b. Correct, because the agreement to change the delivery date was not in writing.
   c. Incorrect, because the agreement to change the delivery date was binding.
   d. Incorrect, because Acme's agreement to change the delivery date is a firm offer that cannot be withdrawn by Acme.
8. Under the Sales Article of the UCC, and unless otherwise agreed to, the seller’s obligation to the buyer is to
a. Deliver the goods to the buyer’s place of business.
b. Hold conforming goods and give the buyer whatever notification is reasonably necessary to enable the buyer to take delivery.
c. Deliver all the goods called for in the contract to a common carrier.
d. Set aside conforming goods for inspection by the buyer before delivery.

9. Yost Corp., a computer manufacturer, contracted to sell 15 computers to Ivor Corp., a computer retailer. The contract specified that delivery was to be made by truck to Ivor's warehouse. Instead, Yost shipped the computers by rail. When Ivor claimed that Yost did not comply with the contract, Yost told Ivor that there had been a trucker's strike when the goods were shipped. Ivor refused to pay for the computers. Under these circumstances, Ivor
a. Is obligated to pay for the computers because Yost made a valid substituted performance.
b. Is obligated to pay for the computers because title to them passed to Ivor when Ivor received them.
c. May return the computers and avoid paying for them because of the way Yost delivered them.
d. May return the computers and avoid paying for them because the contract was void under the theory of commercial impracticability.

10. Smith contracted in writing to sell Peters a used personal computer for $600. The contract did not specifically address the time for payment, place of delivery, or Peters' right to inspect the computer. Which of the following statements is correct?
a. Smith is obligated to deliver the computer to Peters' home.
b. Peters is entitled to inspect the computer before paying for it.
c. Peters may not pay for the computer using a personal check unless Smith agrees.
d. Smith is not entitled to payment until 30 days after Peters receives the computer.

11. Rowe Corp. purchased goods from Stair Co. that were shipped C.O.D. Under the Sales Article of the UCC, which of the following rights does Rowe have?
a. The right to inspect the goods before paying.
b. The right to possession of the goods before paying.
c. The right to reject nonconforming goods.
d. The right to delay payment for a reasonable period of time.

12. Kirk Corp. sold Nix an Ajax freezer, Model 24, for $490. The contract required delivery to be made by June 23. On June 12, Kirk delivered an Ajax freezer, Model 52, to Nix. Nix immediately notified Kirk that the wrong freezer had been delivered and indicated that the delivery of a correct freezer would not be acceptable. Kirk wishes to deliver an Ajax freezer, Model 24 on June 23. Which of the following statements is correct?
a. Kirk may deliver the freezer on June 23 without further notice to Nix.
b. Kirk may deliver the freezer on June 23 if it first seasonably notifies Nix of its intent to do so.
c. Nix must accept the non-conforming freezer but may recover damages.
d. Nix always may reject the non-conforming freezer and refuse delivery of a conforming freezer on June 23.

13. Under the Sales Article of the UCC, which of the following statements is correct?
a. The obligations of the parties to the contract must be performed in good faith.
b. Merchants and nonmerchants are treated alike.
c. The contract must involve the sale of goods for a price of more than $500.
d. None of the provisions of the UCC may be disclaimed by agreement.

14. On March 7, 1988, Wax Corp. contracted with Noll Wholesalers to supply Noll with specific electrical parts. Delivery was called for on June 3, 1988. On May 2, 1988, Wax notified Noll that it would not perform and that Noll should look elsewhere. Wax had received a larger and more lucrative contract on April 21, 1988, and its capacity was such that it could not fulfill both orders. The facts
a. Will prevent Wax from retracting its repudiation of the Noll contract.
b. Are not sufficient to clearly establish an anticipatory repudiation.
c. Will permit Noll to sue only after June 3, 1988, the latest performance date.
d. Will permit Noll to sue immediately after May 2, 1988, even though the performance called for under the contract was not due until June 3, 1988.
15. Under the Sales Article of the UCC, which of the following events will release the buyer from all its obligations under a sales contract?
   a. Destruction of the goods after risk of loss passed to the buyer.
   b. Impracticability of delivery under the terms of the contract.
   c. Anticipatory repudiation by the buyer that is retracted before the seller cancels the contract.
   d. Refusal of the seller to give written assurance of performance when reasonably demanded by the buyer.

16. To satisfy the UCC Statute of Frauds regarding the sale of goods, which of the following must generally be in writing?
   a. Designation of the parties as buyer and seller.
   b. Delivery terms.
   c. Quantity of the goods.
   d. Warranties to be made.

17. Greed Co. telephoned Stieb Co. and ordered 30 tables at $100 each. Greed agreed to pay 15% immediately and the balance within thirty days after receipt of the entire shipment. Greed forwarded a check for $450 and Stieb shipped 15 tables the next day, intending to ship the balance by the end of the week. Greed decided that the contract was a bad bargain and repudiated it, asserting the statute of frauds. Stieb sued Greed. Which of the following will allow Stieb to enforce the contract in its entirety despite the statute of frauds?
   a. Stieb shipped 15 tables.
   b. Greed paid 15% down.
   c. The contract is not within the requirements of the statute of frauds.
   d. Greed admitted in court that it made the contract in question.

18. Webstar Corp. orally agreed to sell Northco, Inc. a computer for $20,000. Northco sent a signed purchase order to Webstar confirming the agreement. Webstar received the purchase order and did not respond. Webstar refused to deliver the computer to Northco, claiming that the purchase order did not satisfy the UCC Statute of Frauds because it was not signed by Webstar. Northco sells computers to the general public and Webstar is a computer wholesaler. Under the UCC Sales Article, Webstar's position is
   a. Incorrect because it failed to object to Northco's purchase order.
   b. Incorrect because only the buyer in a sale-of-goods transaction must sign the contract.
   c. Correct because it was the party against whom enforcement of the contract is being sought.
   d. Correct because the purchase price of the computer exceeded $500.

19. Under the Sales Article of the UCC, which of the following statements is correct regarding the warranty of merchantability arising when there has been a sale of goods by a merchant seller?
   a. The warranty must be in writing.
   b. The warranty arises when the buyer relies on the seller's skill in selecting the goods purchased.
   c. The warranty cannot be disclaimed.
   d. The warranty arises as a matter of law when the seller ordinarily sells the goods purchased.

20. Under the UCC Sales Article, an action for breach of the implied warranty of merchantability by a party who sustains personal injuries may be successful against the seller of the product only when
   a. The seller is a merchant of the product involved.
   b. An action based on negligence can also be successfully maintained.
   c. The injured party is in privity of contract with the seller.
   d. An action based on strict liability in tort can also be successfully maintained.

Items 21 and 22 are based on the following:
On May 2, Handy Hardware sent Ram Industries a signed purchase order that stated, in part, as follows:

"Ship for May 8 delivery 300 Model A-X socket sets at current dealer price. Terms 2/10/net 30."

Ram received Handy's purchase order on May 4. On May 5, Ram discovered that it had only 200 Model A-X socket sets and 100 Model W-Z socket sets in stock. Ram shipped the Model A-X and Model W-Z sets to Handy without any explanation concerning the shipment. The socket sets were received by Handy on May 8.

21. Which of the following statements concerning the shipment is correct?
   a. Ram's shipment is an acceptance of Handy's offer.
   b. Ram's shipment is a counteroffer.
   c. Handy's order must be accepted by Ram in writing before Ram ships the socket sets.
   d. Handy's order can only be accepted by Ram shipping conforming goods.
22. Assuming a contract exists between Handy and Ram, which of the following implied warranties would result?

I. Implied warranty of merchantability.
II. Implied warranty of fitness for a particular purpose.
III. Implied warranty of title.

a. I only.
b. III only.
c. I and III only.
d. I, II, and III.

23. Under the UCC Sales Article, which of the following warranties requires the seller to be a merchant with respect to the goods being sold in order for the warranty to apply?

<table>
<thead>
<tr>
<th>Implied warranty of fitness for a particular purpose</th>
<th>Implied warranty of merchantability</th>
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<tbody>
<tr>
<td>a. Yes</td>
<td>Yes</td>
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<tr>
<td>b. No</td>
<td>No</td>
</tr>
<tr>
<td>c. Yes</td>
<td>No</td>
</tr>
<tr>
<td>d. No</td>
<td>Yes</td>
</tr>
</tbody>
</table>

24. Which of the following conditions must be met for an implied warranty of fitness for a particular purpose to arise in connection with a sale of goods?

I. The warranty must be in writing.
II. The seller must know that the buyer was relying on the seller in selecting the goods.

a. I only.
b. II only.
c. Both I and II.
d. Neither I nor II.

25. Wally, a CPA and a neighbor of Rita's, offered to sell Rita his power chain saw for $400. Rita stated that she knew nothing about chain saws but would buy the saw if it were capable of cutting down the trees in her backyard, which had an average diameter of five feet. Wally assured Rita that the saw "would do the job". Relying on Wally's assurance, Rita purchased the saw. Wally has created a warranty that

a. The saw is of an average fair quality.
b. The saw is fit for the ordinary purposes for which it is used.
c. The saw is capable of cutting the trees in Rita's backyard.
d. Is unenforceable because it is not in writing.

26. Vick bought a used boat from Ocean Marina that disclaimed "any and all warranties" in connection with the sale. Ocean was unaware the boat had been stolen from Kidd. Vick surrendered it to Kidd when confronted with proof of the theft. Vick sued Ocean. Who is likely to prevail and why?

a. Vick, because the implied warranty of title has been breached.
b. Vick, because a merchant cannot disclaim implied warranties.
c. Ocean, because of the disclaimer of warranties.
d. Ocean, because Vick surrendered the boat to Kidd.

27. Under the Sales Article of the UCC, the warranty of title

a. Provides that the seller cannot disclaim the warranty if the sale is made to a bona fide purchaser for value.
b. Provides that the seller deliver the goods free from any lien of which the buyer lacked knowledge when the contract was made.
c. Applies only if it is in writing and signed by the seller.
d. Applies only if the seller is a merchant.

28. Under the UCC Sales Article, the implied warranty of merchantability

a. May be disclaimed by a seller's oral statement that mentions merchantability.
b. Arises only in contracts involving a merchant seller and a merchant buyer.
c. Is breached if the goods are not fit for all purposes for which the buyer intends to use the goods.
d. Must be part of the basis of the bargain to be binding on the seller.

29. Under the UCC Sales Article, the warranty of title may be excluded by

a. Merchants or non-merchants provided the exclusion is in writing.
b. Non-merchant sellers only.
c. The seller's statements that it is selling only such right or title that it has.
d. Use of an "as is" disclaimer.
30. Larch Corp. manufactured and sold Oak a stove. The sale documents included a disclaimer of warranty for personal injury. The stove was defective. It exploded causing serious injuries to Oak's spouse. Larch was notified one week after the explosion. Under the UCC Sales Article, which of the following statements concerning Larch's liability for personal injury to Oak's spouse would be correct?
   a. Larch cannot be liable because of a lack of privity with Oak's spouse.
   b. Larch will not be liable because of a failure to give proper notice.
   c. Larch will be liable because the disclaimer was not a disclaimer of all liability.
   d. Larch will be liable because liability for personal injury cannot be disclaimed.

31. Which of the following factors result(s) in an express warranty with respect to a sale of goods?
   I. The seller's description of the goods as part of the basis of the bargain.
   II. The seller selects goods knowing the buyer's intended use.
   a. I only.
   b. II only.
   c. Both I and II.
   d. Neither I nor II.

32. An important factor in determining if an express warranty has been created is whether the
   a. Statements made by the seller became part of the basis of the bargain.
   b. Sale was made by a merchant in the regular course of business.
   c. Statements made by the seller were in writing.
   d. Seller intended to create a warranty.

33. Under the Sales Article of the UCC, most goods sold by merchants are covered by certain warranties. An example of an express warranty would be a warranty of
   a. Usage of trade.
   b. Fitness for a particular purpose.
   c. Merchantability.
   d. Conformity of goods to sample.

34. Under the Sales Article of the UCC, unless a contract provides otherwise, before title to goods can pass from a seller to a buyer, the goods must be
   a. Tendered to the buyer.
   b. Identified to the contract
   c. Accepted by the buyer.
   d. Paid for.

35. Under the Sales Article of the UCC, which of the following factors is most important in determining who bears the risk of loss in a sale of goods contract?
   a. The method of shipping the goods.
   b. The contract’s shipping terms.
   c. Title to the goods.
   d. How the goods were lost.

36. Under the Sales Article of the UCC and the United Nations Convention for the International Sale of Goods (CISG), absent specific terms in an international sales shipment contract, when will risk of loss pass to the buyer
   a. When the goods are delivered to the first carrier for transmission to the buyer.
   b. When the goods are tendered to the buyer.
   c. At the conclusion of the execution of the contract.
   d. At the time the goods are identified to the contract.

37. Cey Corp. entered into a contract to sell parts to Deck, Ltd. The contract provided that the goods would be shipped "F.O.B. Cey's warehouse." Cey shipped parts different from those specified in the contract. Deck rejected the parts. A few hours after Deck informed Cey that the parts were rejected, they were destroyed by fire in Deck's warehouse. Cey believed that the parts were conforming to the contract. Which of the following statements is correct?
   a. Regardless of whether the parts were conforming, Deck will bear the loss because the contract was a shipment contract.
   b. If the parts were nonconforming, Deck had the right to reject them, but the risk of loss remains with Deck until Cey takes possession of the parts.
   c. If the parts were conforming, risk of loss does not pass to Deck until a reasonable period of time after they are delivered to Deck.
   d. If the parts were nonconforming, Cey will bear the risk of loss, even though the contract was a shipment contract.

38. Bond purchased a painting from Wool, who is not in the business of selling art. Wool tendered delivery of the painting after receiving payment in full from Bond. Bond informed Wool that Bond would be unable to take possession of the painting until later that day. Thieves stole the painting before Bond returned. The risk of loss
   a. Passed to Bond at Wool's tender of delivery.
   b. Passed to Bond at the time the contract was formed and payment was made.
   c. Remained with Wool, because the parties agreed on a later time of delivery.
   d. Remained with Wool, because Bond had not received the painting.
39. Under the Sales Article of the UCC, which of the following events will result in the risk of loss passing from a merchant seller to a buyer?

<table>
<thead>
<tr>
<th>Tender of the goods</th>
<th>Use of the seller’s truck to deliver the goods</th>
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<tr>
<td>at the seller’s place of business</td>
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<tr>
<td>a. Yes</td>
<td>Yes</td>
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<tr>
<td>b. Yes</td>
<td>No</td>
</tr>
<tr>
<td>c. No</td>
<td>Yes</td>
</tr>
<tr>
<td>d. No</td>
<td>No</td>
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</table>

40. Pulse Corp. maintained a warehouse where it stored its manufacturing goods. Pulse received an order from Star. Shortly after Pulse identified the goods to be shipped to Star, but before moving them to the loading dock, a fire destroyed the warehouse and its contents. With respect to the goods, which of the following statements is correct?

a. Pulse has title but no insurable interest.

b. Star has title and an insurable interest.

c. Pulse has title and an insurable interest.

d. Star has title but no insurable interest.

41. Quick Corp. agreed to purchase 200 typewriters from Union Suppliers, Inc. Union is a wholesaler of appliances and Quick is an appliance retailer. The contract required Union to ship the typewriters to Quick by common carrier, "F.O.B. Union Suppliers, Inc. Loading Dock." Which of the parties bears the risk of loss during shipment?

a. Union, because the risk of loss passes only when Quick receives the typewriters.

b. Union, because both parties are merchants.

c. Quick, because title to the typewriters passed to Quick at the time of shipment.

d. Quick, because the risk of loss passes when the typewriters are delivered to the carrier.

42. Under the Sales Article of the UCC, in an F.O.B. place of shipment contract, the risk of loss passes to the buyer when the goods

a. Are identified to the contract.

b. Are placed on the seller’s loading dock.

c. Are delivered to the carrier.

d. Reach the buyer’s loading dock.

43. Risk of loss for the radios during shipment to Lazur would be on

a. Lazur, because the risk of loss passes when the radios are delivered to the carrier.

b. Wizard, because the risk of loss passes only when Lazur receives the radios.

c. Wizard, because it is a shipment contract.

d. Lazur, because title to the radios passes to Lazur at the time of shipment.

44. Under the UCC Sales Article

a. Title to the radios passes to Lazur at the time they are delivered to the carrier, even if the goods are nonconforming.

b. Lazur must inspect the radios at the time of delivery or waive any defects and the right to sue for breach of contract.

c. Wizard must pay the freight expense associated with the shipment of the radios to Lazur.

d. Lazur would have the right to reject any shipment if Wizard fails to notify Lazur that the goods have been shipped.

Items 45 through 47 are based on the following:

On May 2, Lace Corp., an appliance wholesaler, offered to sell appliances worth $3,000 to Parco, Inc., a household appliances retailer. The offer was signed by Lace's president, and provided that it would not be withdrawn before June 1. It also included the shipping terms: "F.O.B. Lace's warehouse." On May 29, Parco mailed an acceptance of Lace's offer. Lace received the acceptance June 2.

45. Which of the following statements is correct if Lace sent Parco a telegram revoking its offer, and Parco received the telegram on May 25?

a. A contract was formed on May 2.

b. Lace's revocation effectively terminated its offer of May 25.

c. Lace's revocation was ineffective because the offer could not be revoked before June 1.

d. No contract was formed because Lace received Parco's acceptance after June 1.

46. Risk of loss for the appliances will pass to Parco when they are

a. Identified to the contract.

b. Shipped by Lace.

c. Tendered at Parco's warehouse.

d. Accepted by Parco.
47. If Lace inadvertently ships the wrong appliances to Parco and Parco rejects them two days after receipt, title to the goods will
   a. Pass to Parco when they are identified to the contract.
   b. Pass to Parco when they are shipped.
   c. Remain with Lace until the goods are returned to Lace.
   d. Revert to Lace when they are rejected by Parco.

48. Which of the following statements applies to a sale on approval under the UCC Sales Article?
   a. Both the buyer and seller must be merchants.
   b. The buyer must be purchasing the goods for resale.
   c. Risk of loss for the goods passes to the buyer when the goods are accepted after the trial period.
   d. Title to the goods passes to the buyer on delivery of the goods to the buyer.

49. Jefferson Hardware ordered three hundred Ram hammers from Ajax Hardware. Ajax accepted the order in writing. On the final date allowed for delivery, Ajax discovered it did not have enough Ram hammers to fill the order. Instead, Ajax sent three hundred Strong hammers. Ajax stated on the invoice that the shipment was sent only as an accommodation. Which of the following statements is correct?
   a. Ajax's note of accommodation cancels the contract between Jefferson and Ajax.
   b. Jefferson's order can only be accepted by Ajax's shipment of the goods ordered.
   c. Ajax's shipment of Strong hammers is a breach of contract.
   d. Ajax's shipment of Strong hammers is a counter-offer and no contract exists between Jefferson and Ajax.

50. Under the UCC Sales Article, which of the following legal remedies would a buyer not have when a seller fails to transfer and deliver goods identified to the contract?
   a. Suit for specific performance.
   b. Suit for punitive damages.
   c. Purchase substitute goods (cover).
   d. Recover the identified goods

51. Under the Sales Article of the UCC, which of the following rights is (are) available to the buyer when a seller commits an anticipatory breach of contract?

<table>
<thead>
<tr>
<th>Demand</th>
<th>Assure</th>
<th>Cancel</th>
<th>Collect</th>
</tr>
</thead>
<tbody>
<tr>
<td>a.</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>b.</td>
<td>Yes</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td>c.</td>
<td>Yes</td>
<td>No</td>
<td>Yes</td>
</tr>
<tr>
<td>d.</td>
<td>No</td>
<td>Yes</td>
<td>Yes</td>
</tr>
</tbody>
</table>

52. Eagle Corporation solicited bids for various parts it uses in the manufacture of jet engines. Eagle received six offers and selected the offer of Sky Corporation. The written contract specified a price for 100,000 units, delivery on June 1 at Sky's plant, with payment on July 1. On June 1, Sky had completed a 200,000 unit run of parts similar to those under contract for Eagle and various other customers. Sky had not identified the parts to specific contracts. When Eagle's truck arrived to pick up the parts on June 1, Sky refused to deliver claiming the contract price was too low. Eagle was unable to cover in a reasonable time. Its production lines were in danger of shutdown because the parts were not delivered. Eagle would probably
   a. Have as its only remedy the right of replevin.
   b. Have the right of replevin only if Eagle tendered the purchase price on June 1.
   c. Have as its only remedy the right to recover dollar damages.
   d. Have the right to obtain specific performance.

53. Cara Fabricating Co. and Taso Corp. agreed orally that Taso would custom manufacture a compressor for Cara at a price of $120,000. After Taso completed the work at a cost of $90,000, Cara notified Taso that the compressor was no longer needed. Taso is holding the compressor and has requested payment from Cara. Taso has been unable to resell the compressor for any price. Taso incurred storage fees of $2,000. If Cara refuses to pay Taso and Taso sues Cara, the most Taso will be entitled to recover is
   a. $92,000.
   b. $105,000.
   c. $120,000.
   d. $122,000.
54. Under the Sales Article of the UCC, which of the following rights is available to a seller when a buyer materially breaches a sales contract?

<table>
<thead>
<tr>
<th>Right to cancel the contract</th>
<th>Right to recover damages</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>b. Yes</td>
<td>No</td>
</tr>
<tr>
<td>c. No</td>
<td>Yes</td>
</tr>
<tr>
<td>d. No</td>
<td>No</td>
</tr>
</tbody>
</table>

55. Under the Sales Article of the UCC, the remedies available to a seller when a buyer breaches a contract for the sale of goods may include

<table>
<thead>
<tr>
<th>Right to resell goods identified to the contract</th>
<th>Right to stop a carrier from delivering the goods</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>b. Yes</td>
<td>No</td>
</tr>
<tr>
<td>c. No</td>
<td>Yes</td>
</tr>
<tr>
<td>d. No</td>
<td>No</td>
</tr>
</tbody>
</table>

Items 56 and 57 are based on the following information:

On April 5, 1987, Anker, Inc. furnished Bold Corp. with Anker's financial statements dated March 31, 1987. The financial statements contained misrepresentations which indicated that Anker was solvent when in fact it was insolvent. Based on Anker's financial statements, Bold agreed to sell Anker 90 computers, "F.O.B. - Bold's loading dock." On April 14, Anker received 60 of the computers. The remaining 30 computers are in the possession of the common carrier and in transit to Anker.

56. If on April 28, Bold discovered that Anker was insolvent, then with respect to the computers delivered to Anker on April 14, Bold may
a. Reclaim the computers upon making a demand.
b. Reclaim the computers irrespective of the rights of any subsequent third party.
c. Not reclaim the computers since ten days have elapsed from its delivery.
d. Not reclaim the computers since it is entitled to recover the price of the computers.

57. With respect to the remaining 30 computers in transit, which of the following statements is correct if Anker refuses to pay Bold in cash and Anker is not in possession of a negotiable document of title covering the computers?

a. Bold may stop delivery of the computers to Anker since their contract is void due to Anker's furnishing of the false financial statements.
b. Bold may stop delivery of the computers to Anker despite the fact that title had passed to Anker.
c. Bold must deliver the computers to Anker on credit since Anker has not breached the contract.
d. Bold must deliver the computers to Anker since the risk of loss had passed to Anker.

58. To establish a cause of action based on strict liability in tort for personal injuries resulting from using a defective product, one of the elements the plaintiff must prove is that the seller (defendant) a. Failed to exercise due care.
b. Was in privity of contract with the plaintiff.
c. Defectively designed the product.
d. Was engaged in the business of selling the product.

59. High sues the manufacturer, wholesaler, and retailer for bodily injuries caused by a power saw High purchased. Which of the following statements is correct under strict liability theory?

a. Contributory negligence on High's part will always be a bar to recovery.
b. The manufacturer will avoid liability if it can show it followed the custom of the industry.
c. Privity will be a bar to recovery insofar as the wholesaler is concerned if the wholesaler did not have a reasonable opportunity to inspect.
d. High may recover even if he cannot show any negligence was involved.

60. Kent suffered an injury due to a malfunction of a chain saw he had purchased from Grey Hardware. The saw was manufactured by Dill Tool Corp. Kent has commenced an action against Grey and Dill based upon strict liability. Which of the following is a correct statement?

a. Dill will not be liable if it manufactured the saw in a nonnegligent manner.
b. Privity will not be a valid defense against Kent's suit.
c. The lawsuit will be dismissed since strict liability has not been applied in product liability cases in the majority of jurisdictions.
d. Kent's suit against Grey will be dismissed since Grey was not at fault.

61. To establish a cause of action based on strict liability in tort for personal injuries that result from the use of a defective product, one of the elements the injured party must prove is that the seller

a. Was aware of the defect in the product.
b. Sold the product to the injured party.
c. Failed to exercise due care.
d. Sold the product in a defective condition.
Chapter Two: Sales
Other Objective Format Questions

NUMBER 1

Number 1 consists of 5 items. Select the best answer for each item. Answer all items. Your grade will be based on the total number of correct answers.

On February 1, 1995, Grand Corp., a manufacturer of custom cabinets, contracted in writing with Axle Co., a kitchen contractor, to sell Axle 100 unique, custom-designed kitchen cabinets for $250,000. Axle had contracted to install the cabinets in a luxury condominium complex. The contract provided that the cabinets were to be ready for delivery by April 15 and were to be shipped F.O.B. sellers loading dock. On April 15, Grand had 85 cabinets complete and delivered them, together with 15 standard cabinets, to the trucking company for delivery to Axle. Grand faxed Axle a copy of the shipping invoice, listing the 15 standard cabinets. On May 1, before reaching Axle, the truck was involved in a collision and all the cabinets were damaged beyond repair.

Required:

Items 1 through 5 refer to the above fact pattern. For each item, determine whether A, B, or C is correct.

1. A. The contract between Grand and Axle was a shipment contract.
   B. The contract between Grand and Axle was a destination contract.
   C. The contract between Grand and Axle was a consignment contract.

2. A. The risk of loss for the 85 custom cabinets passed to Axle on April 15.
   B. The risk of loss for the 100 cabinets passed to Axle on April 15.
   C. The risk of loss for the 100 cabinets remained with Grand.

3. A. The contract between Grand and Axle was invalid because no delivery date was stated.
   B. The contract between Grand and Axle was voidable because Grand shipped only 85 custom cabinets.
   C. The contract between Grand and Axle was void because the goods were destroyed.

4. A. Grand’s shipment of the standard cabinets was a breach of the contract with Axle.
   B. Grand would not be considered to have breached the contract until Axle rejected the standard cabinets.
   C. Grand made a counteroffer by shipping the standard cabinets.

5. A. Axle is entitled to specific performance from Grand because of the unique nature of the goods.
   B. Axle is required to purchase substitute goods (cover) and is entitled to the difference in cost from Grand.
   C. Axle is entitled to punitive damages because of Grand’s intentional shipment of nonconforming goods.
NUMBER 2

Angler Corp., a food distributor, is involved in the following disputes:

• On September 8, Angler shipped the wrong grade of tuna to Mason Restaurants, Inc. under a contract that stated as follows: "F.O.B. - Angler's loading dock." During shipment, the tuna was destroyed in an accident involving the common carrier's truck. Mason has refused to pay for the tuna, claiming the risk of loss belonged to Angler at the time of the accident.

• On October 3, Angler shipped 100 bushels of peaches to Classic Foods, Inc., a retail grocer. Because of a delay in shipping, the peaches rotted. Classic elected to reject the peaches and notified Angler of this decision. Angler asked Classic to return the peaches at Angler's expense. Classic refused the request, claiming it had no obligation to do so.

• On October 23, Angler orally contracted to sell Regal Fast-Food 1,000 pounds of hamburger meat for $900. Delivery was to be made on October 31. On October 29, after Angler had shipped the hamburger meat to Regal, Regal sent Angler the following signed correspondence:

"We are not going to need the 1,000 pounds of meat we ordered on October 23. Don't ship."

Regal rejected the shipment and claimed it is not obligated to purchase the hamburger meat because there is no written contract between Angler and Regal.

Required:

a. State whether Mason's claim is correct and give the reasons for your conclusion.
b. State whether Classic's claim is correct and give the reasons for your conclusion.
c. State whether Regal's claim is correct and give the reasons for your conclusion.

NUMBER 3

On October 10, Vesta Electronics contracted with Zap Audio to sell Zap 200 18" stereo speakers. The contract provided that the speakers would be shipped F.O.B. seller's loading dock. The contract was silent as to when risk of loss for the speakers would pass to Zap. Delivery was to be completed by November 10.

On October 18, Vesta identified the speakers to be shipped to Zap and moved them to the loading dock. Before the carrier picked up the goods, a fire on Vesta's loading dock destroyed 50 of the speakers. On October 20, Vesta shipped, by common carrier, the remaining 150 18" speakers and 50 16" speakers. The truck carrying the speakers was involved in an accident resulting in damage to 25 of the 16" speakers. Zap received the 200 speakers on October 25, and on October 27 notified Vesta that 100 of the 18" speakers were being accepted but the rest of the shipment was being rejected. Zap also informed Vesta that, due to Vesta's failure to comply with the terms of the contract, Zap would contest paying the contract price and would sue for damages.

The above parties and transactions are subject to the Uniform Commercial Code (UCC).

Required:

Answer the following questions, and give the reasons for your conclusions.

a. 1. Who bears the risk of loss for the 50 destroyed 18" speakers?
   2. Who bears the risk of loss for the 25 damaged 16" speakers?
b. 1. Was Zap's rejection of the 16" speakers valid?
   2. Was Zap's acceptance of some of the 18" speakers valid?
c. Under the UCC, what duties are required of Zap after rejecting all or part of the shipment?
Debco Electronics, Inc. sells various brands of computer equipment to retail and business customers. An audit of Debco's 1991 financial statements has revealed the following transactions:

- On September 1, 1991, a Debco salesperson orally agreed to sell Rapid Computers, Inc. eight TMI computers for $11,000, to be delivered on October 15, 1991. Rapid sells computers to the general public. The Debco salesperson sent Rapid a signed confirmation of the sales agreement. Rapid received the confirmation on September 3, but did not respond to it. On October 15, 1991, Debco tendered delivery of the computers to Rapid. Rapid refused to accept delivery, claiming it had no obligation to buy the computers because it had not signed a contract with Debco.

- On October 12, 1991, Debco mailed TMI Computers, Inc. a signed purchase order for certain specified computers for delivery by November 30, 1991. The purchase order also stated the following:
  
  This purchase order will not be withdrawn on or before October 31, 1991. You must accept by that date or we will assume you cannot meet our terms. Ship F.O.B. - our loading dock.

  TMI received the purchase order on October 15, 1991.

- On October 25, Debco mailed the following signed correspondence to TMI, which TMI received on October 29:
  
  Cancel our October 12, 1991, purchase order. We have found a better price on the computers.

- On October 31, 1991, TMI mailed the following signed correspondence to Debco, which Debco received on November 3:
  
  We have set aside the computers you ordered and turned down other offers for them. Therefore, we will ship the computers to you for delivery by November 30, 1991, F.O.B. -- your loading dock with payment terms 2/10; net 30.

There were no further communications between TMI and Debco.

TMI shipped the computers on November 15, and Debco received them on November 29. Debco refused to accept delivery. In justifying its refusal to accept delivery, Debco claimed the following:

- Its October 25 correspondence prevented the formation of a contract between Debco and TMI;
- TMI's October 31 correspondence was not an effective acceptance because it was not received by Debco until November 3;
- TMI's October 31 correspondence was not an effective acceptance because it added payment terms to Debco's purchase order.
  
  Debco, Rapid, and TMI are located in a jurisdiction that has adopted the UCC.

Required:

a. State whether Rapid's claim is correct and give the reasons for your conclusions.

b. State whether Debco's claims are correct with regard to the transaction involving TMI and give the reasons for your conclusions.
**NUMBER 5**

Pharo Aviation, Inc., sells and services used airplanes. Sanders, Pharo's service department manager, negotiated with Secure Equipment Co. for the purchase of a used tug for moving airplanes in and out of Pharo's hangar. Secure sells and services tugs and related equipment. Sanders was unfamiliar with the various models, specifications, and capacities of the tugs sold by Secure; however, Sanders knew that the tug purchased needed to have the capacity to move airplanes weighing up to 10,000 pounds. Sanders and the sales representative discussed this specific need because Sanders was uncertain as to which tug would meet Pharo's requirements. The sales representative then recommended a particular make and model of tug. Sanders agreed to rely on the sales representative's advice and signed a purchase contract with Secure.

About a week after Sanders took delivery, the following occurred:
- Sanders determined that the tug did not have the capacity to move airplanes weighing over 5,000 pounds.
- Sanders was advised correctly by Maco Equipment Distributors, Inc., that Maco was the rightful owner of the tug, which it had left with Secure for repairs.

Pharo has commenced a lawsuit against Secure claiming that implied warranties were created by the contract with Secure and that these have been breached. Maco has claimed that it is entitled to the tug and has demanded its return from Pharo.

**Required:**
Answer each of the following questions, and set forth the reasons for your conclusions.

a. Were any implied warranties created by the contract between Pharo and Secure and, if so, were any of those warranties breached?

b. Is Maco entitled to the return of the tug?

**NUMBER 6**

John Barr purchased a new fork-lift for use in his business from Fiber Corp. Fiber designs, manufactures, and assembles fork-lifts, shipping them directly to customers throughout the U.S. The contract between Barr and Fiber contained a clause in fine print disclaiming "all warranties express or implied other than the limited warranty provided for on the face of this contract." The limited warranty included in the contract provided that "the buyer's sole and exclusive remedy shall be repair or replacement of defective parts and the seller shall not be liable for damages or personal injuries." The contract was a standard form used by Fiber, and as a matter of policy Fiber does not negotiate the terms and conditions of the contract with its customers.

Within one week of the purchase date, Barr was seriously injured when the steering wheel locked causing him to lose control of the fork-lift. Barr brings an action against Fiber for the personal injuries that he sustained based on the following causes of action:

- Negligence
- Breach of warranty
- Strict liability in tort

Fiber has asserted that the action brought by Barr should be dismissed due to the disclaimer.

**Required:** Answer the following, setting forth reasons for any conclusions stated.

(a) Discuss in separate paragraphs the prerequisites necessary to sustain each of the three causes of action asserted by Barr.

(b) Discuss the validity of the disclaimer with regard to the breach of warranty cause of action.
NUMBER 7

On May 1, Starr Corp., a manufacturer and supplier of computers, mailed a proposed contract to Magic, Inc., offering to sell 20 items of specified computer equipment for $18,000. Magic was engaged in the business of selling computers to the public. Magic accepted Starr's offer by executing and returning the contract to Starr. Starr failed to sign the contract.

On May 15, Starr advised Magic by telephone that, due to certain market conditions, the price of computer parts had increased. Therefore, in order to avoid a loss on the sale to Magic, Starr requested an increase in the sales price to $20,000, which was orally agreed to by Magic. On May 17, Starr sent to Magic a signed letter acknowledging this agreement. Magic did not respond to the letter.

On September 15, Starr notified Magic that the equipment was ready for delivery. Due to substantial changes in computer technology subsequent to May 15, Magic indicated that it no longer wanted the equipment and that it would not pay for it. Starr was unable to resell the computer equipment for any price despite its reasonable efforts to do so. Therefore, Starr commenced a breach of contract action against Magic. Magic asserted the following defenses:

- The May 1 written contract between Starr and Magic is not enforceable because of the statute of frauds.
- Even if the May 1 contract is enforceable, the May 15 oral agreement to change the price of the equipment is not enforceable because the agreement lacked consideration and failed to satisfy the statute of frauds.
- In any event, Starr is not entitled to recover the full sales price because the equipment is still in Starr's possession.

Required:
Discuss Magic's assertions, indicating whether each is correct or incorrect and setting forth the reasons for any conclusion stated.

NUMBER 8

Anker Corp., a furniture retailer, engaged Best & Co., CPAs, to audit Anker's financial statements for the year ended December 31, 1988. While reviewing certain transactions entered into by Anker during 1988, Best became concerned with the proper reporting of the following transactions:

- On September 8, 1988, Crisp Corp., a furniture manufacturer, signed and mailed a letter offering to sell Anker 50 pieces of furniture for $9,500. The offer stated it would remain open until December 20, 1988. On December 5, 1988, Crisp mailed a letter revoking this offer. Anker received Crisp's revocation the following day. On December 12, 1988, Anker mailed its acceptance to Crisp, and Crisp received it on December 13, 1988.

- On December 6, 1988, Dix Corp. signed and mailed a letter offering to sell Anker a building for $75,000. The offer stated that acceptance could only be made by certified mail, return receipt requested. On December 10, 1988, Anker telephoned Dix requesting that Dix keep the offer open until December 20, 1988 because it was reviewing Dix's offer. On December 12, 1988, Dix signed and mailed a letter to Anker indicating that it would hold the offer open until December 20, 1988. On December 19, 1988, Anker sent its acceptance to Dix by a private express mail courier. Anker's acceptance was received by Dix on December 20, 1988.
After reviewing the documents concerning the foregoing transactions, Best spoke with Anker's president who made the following assertions:

- The September 8, 1988 offer by Crisp was irrevocable until December 20, 1988, and therefore a contract was formed by Anker's acceptance on December 12, 1988.
- Dix's letter dated December 12, 1988 formed an option contract with Anker.
- Anker's acceptance on December 19, 1988 formed a contract with Dix.

**Required:**
In separate paragraphs, discuss the assertions made by Anker's president. Indicate whether the assertions are correct and the reasons therefore.

**NUMBER 9**

On June 1, Classic Corp., a manufacturer of desk chairs, orally agreed to sell 100 leather desk chairs to Rand Stores, a chain of retail furniture stores for $50,000. The parties agreed that delivery would be completed by September 1, and the shipping terms were "F.O.B. seller's loading dock". On June 5, Classic sent Rand a signed memorandum of agreement containing the terms orally agreed to. Rand received the memorandum on June 7 and made no response.

On July 31, Classic identified the chairs to be shipped to Rand and placed them on its loading dock to be picked up by the common carrier the next day. That night, a fire on the loading dock destroyed 50 of the chairs. On August 1, the remaining 50 chairs were delivered to the common carrier together with 50 vinyl chairs. The truck carrying the chairs was involved in an accident, resulting in extensive damage to 10 of the leather chairs and 25 of the vinyl chairs.

On August 10, the chairs were delivered to Rand. On August 12, Rand notified Classic that Rand was accepting 40 of the leather chairs and 10 of the vinyl chairs, but the rest of the shipment was being rejected. Rand also informed Classic that, due to Classic's failure to perform under the terms of the contract, Rand would seek all remedies available under the Sales Article of the UCC.

Classic contended that it has no liability to Rand and that the shipment was strictly an accommodation to Rand because Rand failed to sign the memorandum of agreement, thus preventing a contract from being formed.

The above parties and the transactions are governed by the provisions of the Sales Article of the UCC

**Required:**

a. Determine whether Classic's contention is correct and give the reasons for your conclusion.

b. Assuming that a valid contract exists between Classic and Rand, answer the following questions and give the reasons for your conclusions. Do not consider any possible liability owed by the common carrier.

1. Who bears the risk of loss for the 50 destroyed leather chairs?
2. Who bears the risk of loss for the 25 damaged vinyl chairs?
3. What is the earliest date that title to any of the chairs would pass to Rand?

c. With what UCC requirements must Rand comply to be entitled to recover damages from Classic?

d. Assuming that a valid contract exists between Classic and Rand, state the applicable remedies to which Rand would be entitled. Do not consider any possible liability owed by the common carrier.
Chapter 2: Sales
Multiple Choice Answers

1. (d) In order for UCC Sales to apply, the subject matter must be goods. Answers (a) and (b) are incorrect because neither personal services nor patents are goods. Answer (c) is incorrect because the UCC does not require the parties to be merchants for sales to apply, although UCC Sales does hold merchants to a higher standard in some cases.

2. (a) Whether UCC Sales applies depends on whether the subject matter is goods. It does not depend on the price of the goods. Answer (b) is incorrect because both buyer and seller must act in good faith. Answer (c) is incorrect because a sale is not required to be sale on approval or sale on return. Answer (d) is incorrect because a sale may be for more than $500.

3. (a) In UCC Sales with contracts between merchants an offeree can make minor changes and still have a valid acceptance. The requirement that the weighing scale have a valid city certificate would be a minor change and thus the acceptance is valid and a contract was formed. Answer (b) is incorrect because Cookie does not have to agree to the weighing scale requirement. Answers (c) and (d) are incorrect because a contract was formed and the minor changes were a valid acceptance.

4. (c) In Sales when no means of acceptance is specified, the acceptance is valid when sent if the offeree uses any reasonable means of communication. Acceptances sent by regular mail or by fax would both be reasonable means of communication. Both were sent on the 10th day of the 10 day period and would therefore be valid acceptances. Only answer (c) states both would be a valid acceptance.

5. (b) Under UCC Sales a firm offer must be made by a merchant, in writing, and guarantee it will be held open. The only answer that reflects these elements is (b). Answer (a) is incorrect because although the offer must guarantee it will be held open, it need not state the time period that it will be held open. If no time is stated, it would be good for a reasonable time not to exceed three months. Answer (c) is incorrect because firm offers are irrevocable without consideration. Answer (d) is incorrect because the one making the offer must be a merchant, not the offeree.

6. (d) In UCC Sales the contract can be modified without additional consideration from both parties. Answer (a) is incorrect because although firm offers in Sales are irrevocable without consideration, a firm offer must be in writing and this was not. Answer (b) is incorrect because a waiver by a party of the right to sue for breach is not a contract for sale of goods, but rather an action taken by only one party. Answer (c) is incorrect because evidence that contradicts a later written sales contract would be inadmissible under the parol evidence rule, not binding.

7. (c) In UCC Sales a contract can be modified without additional consideration from both parties. The agreement by Acme on May 5 to change the delivery date was binding without additional consideration. Answer (a) is incorrect because the agreement to modify is enforceable without regard to whether the parties are merchants or what use the goods will be put to. Answer (b) is incorrect because agreements to modify a sales contract do not require a writing unless the Statute of Frauds is involved. Since the sale was for less than $500, no writing was required. Answer (d) is incorrect because this was not a firm offer but rather a modification of an existing contract. Additionally, firm offers must be in writing and this was oral.

8. (b) Unless otherwise agreed, the basic obligation of the seller is to hold conforming goods for the buyer and give the buyer reasonable notification. Answer (a) and (c) are incorrect because unless specifically required by the contract the seller need not deliver the goods to the buyer’s place of business or transport the goods. All the seller is required to do is to hold conforming goods. Answer (d) is incorrect because the right to inspect is a right of the buyer. Inspection is not a delivery requirement of the seller.
9. (a) If the specified means of delivery becomes impractical, a seller has the right to substitute a different means of delivery. The truck strike made shipment by truck impractical and Yost’s substitution of delivery by rail was permissible. Answer (b) is incorrect because payment is not dependent on passage of title. If the goods were nonconforming title would pass to the buyer upon delivery, but the buyer would not be obligated to pay. Answers (c) and (d) are incorrect because the buyer may not return the goods when seller has made a proper substituted delivery.

10. (b) A buyer has the right to inspect prior to payment, except in a C.O.D. sale. Answer (a) is incorrect because the place of delivery if none is stated is the seller’s place of business. Answer (c) is incorrect because payment may be made by personal check. Answer (d) is incorrect because the seller is entitled to payment upon delivery, unless seller specifically agreed to credit terms.

11. (c) A buyer may always reject nonconforming goods. In a C.O.D. sale the buyer must pay before the buyer receives the goods or inspects, thus (a), (b) and (d) are incorrect.

12. (b) A seller has the right to cure, the right to correct nonconforming deliveries. If the seller can cure on time, the seller need only notify the buyer. Kirk can cure its nonconforming delivery by notifying Nix it will deliver the correct freezer by June 23. Answer (a) is incorrect because Kirk must notify Nix of its intent to cure. Answer (c) is incorrect because a buyer may reject nonconforming deliveries. Answer (d) is incorrect because Kirk has the right to cure.

13. (a) UCC Sales requires all parties to act in good faith. Answer (b) is incorrect because merchants are held to a higher standard in some cases. Answer (c) is incorrect because goods may be sold for less than $500. Answer (d) is incorrect because provisions of the UCC may be disclaimed. For example, implied warranties may be disclaimed if the disclaimer is conspicuous.

14. (d) An anticipatory repudiation occurs when one side states they will not perform before the time of performance. The injured party can sue immediately or wait until the time of performance and then sue. Wax told Noll prior to the time of performance that Wax would not perform. Thus, Noll can sue immediately and need not wait until June 3, making (d) correct and (b) and (c) incorrect. Answer (a) is incorrect because Wax may retract its repudiation as long as Noll hasn’t canceled the contract or materially changed position.

15. (d) A buyer is released from liability if the seller refuses to give written assurance of performance when reasonably demanded. Answer (a) is incorrect because risk of loss is with the buyer, the buyer is liable for all damage and would not be released. Answer (b) is incorrect because the seller may substitute a different means of delivery if the specified means becomes impractical. Answer (c) is incorrect because an anticipatory breach can be retracted as long as the injured party has not canceled the contract or materially changed position.

16. (c) The Statute of Frauds generally requires that the writing contain a quantity. It does not require the designation of buyer and seller, the delivery terms or the warranties to be made. Thus (a), (b) and (d) are incorrect.

17. (a) A writing is not required to enforce a contract for more than $500 if a merchant fails to object within ten days to a confirming letter sent by another merchant. Since Webstar and Northco are both merchants and Webstar failed to object to the purchase order sent by Northco, a writing signed by Webstar was not required under the Statute of Frauds. Answer (b) is incorrect because UCC Sales does not require that only the buyer sign. Usually only one party need sign (whether buyer or seller), but it can only be enforced against the one who signed. The failure of a merchant to object to a written confirmation is an exception to the rule that it can only be enforced against the one who signed and is the reason (c) and (d) are also incorrect.
19. (d) The warranty of merchantability is implied by law if the seller is a merchant. One who ordinarily sells the product purchased would be a merchant. Since merchantability is an implied warranty, no written or oral words are needed for it to arise making (a) incorrect. Answer (b) is incorrect because the implied warranty of fitness for a particular purpose arises when the buyer relies on seller to select goods, not the warranty of merchantability. Answer (c) is incorrect because merchantability, like all implied warranties, can be disclaimed.

20. (a) The implied warranty of merchantability arises if the seller is a merchant. Answers (b), (c) and (d) are incorrect because merchantability does not require a showing of negligence, privity or strict liability.

21. (a) Under UCC Sales a seller’s prompt shipment of goods is a valid acceptance, even if the goods are nonconforming. Ram’s nonconforming shipment was both a valid acceptance and a breach. Answer (b) is incorrect because it was a valid acceptance and not a counteroffer. Answer (c) is incorrect because the acceptance does not have to be in writing. Answer (d) is incorrect because a prompt shipment of nonconforming goods is both a valid acceptance and a breach.

22. (c) Since Ram is a merchant, the implied warranty of merchantability arises in this sale. Since all sellers impliedly promise good title, the warranty of title arises. For the implied warranty of fitness for a particular purpose to arise, the buyer must rely on the seller to select suitable goods and Handy did not rely on Ram to select suitable goods. Thus, the only correct answer is (c).

23. (d) Under UCC Sales only two implied warranties require the seller to be a merchant: the warranty of merchantability and the warranty against infringements. Fitness for a particular purpose does not require that the seller be a merchant. Thus, only answer (d) can be correct.

24. (b) For the implied warranty of fitness for a particular purpose to arise, the buyer must rely on the seller to select suitable goods and the seller must be aware of this. The warranty is implied by law and requires no special words, either written or oral. Thus, only answer (b) can be correct.

25. (c) For the implied warranty of fitness for a particular purpose to arise, the buyer must rely on the seller to select suitable goods. Rita relied on Wally’s assurance that this saw was capable of cutting the trees she described. Answers (a) and (b) are incorrect because merchantability requires goods to be of fair average quality and fit for ordinary uses. This warranty requires the seller be a merchant and Wally is not a merchant. Answer (d) is incorrect because fitness for a particular purpose is a warranty implied by law and no oral or written words are needed to create it.

26. (a) All sellers impliedly warrant good title. To disclaim this warranty the seller must specifically make the buyer aware that there is no guarantee of title. The warranty cannot be disclaimed by general language such as a disclaimer of “any and all warranties” or an “as is” sale. Ocean breached the warranty because Ocean did not have good title. Answers (b) is incorrect because any seller (including a merchant) can disclaim title. Answer (c) is incorrect because a disclaimer of “any and all warranties” is too general to effectively disclaim the warranty of title. Answer (d) is incorrect because fitness for a particular purpose is a warranty implied by law and no oral or written words are needed to create it.

27. (b) One of the three implied warranties of title is the warranty against encumbrances. This warranty impliedly promises no unstated liens, attachments or encumbrances. Of the three title warranties, only the warranty against infringements is made solely by merchants. Answer (a) is incorrect because title can be disclaimed if specific language is used. Answer (c) is incorrect because the warranties of title are implied by law and require no oral or written words. Answer (d) is incorrect because two of the warranties of title are made by all sellers, not just merchants.

28. (a) The warranty of merchantability may be disclaimed by either an “as is” sale or by specifically stating that there is no merchantability. The disclaimer may be oral. Answer (b) is incorrect because only the seller (not the buyer) need be a merchant. Answer (c) is incorrect because merchantability warrants that the goods are fit for normal uses, not for all uses. Answer (d) is incorrect because no implied warranty need be part of the basis of the bargain. Only an express warranty must be part of the basis of the bargain.
29. (c) To disclaim title the seller must use specific language to make the buyer aware that there is no guarantee of title. A statement that the seller is only selling what right or title it has would be specific enough. Answer (a) is incorrect because title can be disclaimed without a writing. Answer (b) is incorrect because both merchants and non-merchants can disclaim title if they use the right language. Answer (d) is incorrect because title cannot be disclaimed by general language as in an “as is” disclaimer.

30. (d) Liability for personal injury cannot be disclaimed. Answer (a) is incorrect because under UCC Sales privity is not a bar to recovery if the injured party was one reasonably affected by the product, such as Oak’s spouse. Answer (b) is incorrect because notification within one week was certainly proper notice. Answer (c) is incorrect because the disclaimer had no effect on Larch’s liability for personal injuries.

31. (a) A seller may be sued for breach of an express warranty for any material misrepresentation of fact. The misrepresentation must be part of the basis of the bargain. The warranty of fitness for a particular purpose requires that the buyer rely on the seller to select suitable goods and is an implied warranty, not an express warranty. Thus, the only correct answer is (a).

32. (a) A seller may be sued for breach of an express warranty for any material misrepresentation of fact. The misrepresentation must be part of the basis of the bargain. Answer (b) is incorrect because neither the seller nor the buyer needs to be a merchant for an express warranty to arise. Answer (c) is incorrect because an express warranty can be oral. Answer (d) is incorrect because an express warranty can be created by a seller’s material misrepresentation of fact even if the seller did not intend to create the warranty.

33. (d) An express warranty is created by a seller’s material misrepresentation of fact. Sale of goods by a description, sample or model also creates an express warranty that the goods will conform to the description sample or model.

34. (b) Neither title nor risk of loss can pass until existing goods have been identified to the contract (marked, tagged or in some manner identified as goods for a specific buyer). Answers (a), (c) and (d) are incorrect because title and risk of loss can pass prior to tender of delivery, acceptance or payment. For example, in a shipment contract where the buyer has 30 days to pay after delivery, title and risk of loss would pass when the goods were delivered to the carrier (even though no tender of delivery has been made and the goods have been neither accepted nor paid for).

35. (b) Once goods have been identified, the most important factor in determining when risk of loss will pass is the agreement of the parties. Answer (a) is incorrect because the type of carrier has no effect on when risk of loss passes. Answer (c) is incorrect because title may pass at a different time than risk of loss (e.g., with no transportation and no documents of title involved, title and risk of loss pass at different times). Answer (d) is incorrect because how the goods were lost will not usually affect when risk of loss passes.

36. (a) There are two types of contracts involving transportation by carrier: shipment contracts and destination contracts. In a shipment contract risk of loss and title pass when the seller delivers goods to the carrier to go to the buyer. Thus answer (a) is correct. Answers (b), (c) and (d) are incorrect because title does not pass when the goods are delivered to the buyer, when the contract is made or when the goods are identified.

37. (d) With nonconforming goods risk of loss is always on the seller, even in a shipment contract. Thus (d) is correct and (a) is incorrect. Answer (b) is incorrect because risk of loss for nonconforming goods is always on the seller. Risk of loss would not remain with the buyer, Deck, for any time. Answer (c) is incorrect because with conforming goods risk of loss in a shipment contract passes when the seller delivers the goods to a carrier, not when they are delivered to the buyer.

38. (a) When no transportation by carrier or documents of title are involved, risk of loss with nonmerchants passes on tender of delivery. Wool is not a merchant and Wool tendered delivery. Answer (b) is incorrect because title will pass at the time the contract is made, but risk of loss will only pass with tender of delivery. Answers (c) and (d) are incorrect because they state risk of loss remained with Wool.
39. (d) When no transportation by a carrier or documents of title are involved, risk of loss with merchant sellers only passes when the buyer takes possession of the goods. Risk of loss does not pass on tender of delivery (as it does with nonmerchants) and use of the seller’s truck will not cause risk of loss to pass. Thus, only answer (d) is correct.

40. (c) With a shipment contract, title and risk of loss pass when goods are delivered to the carrier to go to buyer. With destination contracts, title and risk of loss only pass when the goods reach the destination and are tendered to buyer. Although it is unclear whether a shipment or destination contract is present, the goods were destroyed in the seller’s warehouse before they ever got to the carrier. Thus, whether a shipment or destination contract, title and risk of loss are on the seller. Answers (b) and (d) are incorrect because Star, the buyer, does not have title. A seller has an insurable interest while the seller has a risk of economic loss. A buyer has an insurable interest when goods are identified. Since the seller had risk of economic loss and the goods were identified, both seller and buyer have an insurable interest. Answer (c) is correct and (a) is incorrect because the seller has both title and an insurable interest.

41. (d) With a shipment contract, title and risk of loss pass when the goods are delivered to a carrier to go to the buyer. The term F.O.B. seller’s loading dock would make this a shipment contract and risk of loss passed when the goods were delivered to the carrier. Answers (a) and (b) are incorrect because the risk of loss is not on Union, the seller. Answer (c) is incorrect because title does not determine who has risk of loss.

42. (c) With a shipment contract, title and risk of loss pass when goods are delivered to the carrier to go to buyer. Identifying the goods or placing them on the loading dock are not enough to pass title and risk of loss. They must be delivered to the carrier. Answer (d) is incorrect because requiring the goods to reach the buyer’s loading dock would make the contract a destination contract, not a shipment contract.

43. (a) With a shipment contract, title and risk of loss pass when the goods are delivered to a carrier to go to the buyer. The term F.O.B. seller’s loading dock would make this a shipment contract and title passed when the goods were delivered to the carrier. With nonconforming goods title passes to the buyer when seller completes the delivery requirements, in this case delivers the goods to the carrier. Answer (b) is incorrect because a buyer can revoke an acceptance for hidden defects a reasonable inspection would not show. Answer (c) is incorrect because F.O.B. fixes the seller’s place of last responsibility and this was F.O.B. seller’s loading dock. In a shipment contract, the buyer must pay the cost of freight. Answer (d) is incorrect because the buyer can reject for failure to notify in a shipment contract only if a material delay or loss resulted from the failure to notify.

44. (a) With a shipment contract, title and risk of loss pass when the goods are delivered to a carrier to go to the buyer. The term F.O.B. seller’s loading dock would make this a shipment contract and title passed when the goods were delivered to the carrier. With nonconforming goods title passes to the buyer when seller completes the delivery requirements, in this case delivers the goods to the carrier. Answer (b) is incorrect because a buyer can revoke an acceptance for hidden defects a reasonable inspection would not show. Answer (c) is incorrect because F.O.B. fixes the seller’s place of last responsibility and this was F.O.B. seller’s loading dock. In a shipment contract, the buyer must pay the cost of freight. Answer (d) is incorrect because the buyer can reject for failure to notify in a shipment contract only if a material delay or loss resulted from the failure to notify.

45. (c) Under UCC Sales a firm offer is irrevocable without consideration if made by a merchant, in writing and guaranteed it would be held open. Lace was a merchant, the offer was in writing and it did guarantee that it would be held open until June 1. Thus, the offer could not be revoked prior to June 1, making (c) correct and (b) incorrect. Answer (a) is incorrect because there was no acceptance on May 2 and a contract requires acceptance. Answer (d) is incorrect because of the mailbox rule. When the offeree uses a reasonable means of communication, the acceptance is valid when sent.

46. (c) Risk of loss in a destination contract passes when the goods reach the destination and are tendered to the buyer. F.O.B. buyer’s warehouse is a destination contract. Answers (a), (b) and (d) state that risk of loss will pass at some other time and are incorrect.

47. (d) With nonconforming goods, title passes to the buyer when the seller completes his delivery requirements. Upon rejection, title reverts back to the seller. Since the goods were rejected by Parco, title reverted to Lace at that time. All other answers indicate title passing at some other time and are therefore incorrect.

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48. (c) In a sale on approval, title and risk of loss only pass when the buyer approves or accepts. Answer (a) is incorrect because title and risk of loss pass upon approval whether the parties are merchants or not. Answer (b) is incorrect because the buyer’s purpose in purchasing the goods will not change when title and risk of loss pass in a sale on approval. If it was unclear whether a sale on approval or sale or return were involved, it would be considered a sale or return if purchased primarily for resale and not a sale on approval. Answer (d) is incorrect because title does not pass on delivery.

49. (c) Shipment of nonconforming goods is a breach by the seller, giving the buyer the right to reject. Answers (a), (b) and (d) are incorrect because shipment of nonconforming goods does not cancel the contract. Even if Ajax had not accepted the order in writing, their prompt shipment of nonconforming goods would be both a valid acceptance and a breach. It would create a contract and would not be a counteroffer.

50. (b) Neither the buyer nor the seller may usually collect punitive damages. Answer (a) is incorrect because specific performance may be used if the goods are unique or the buyer cannot reasonably cover. Answer (c) is incorrect because a buyer may cover, purchase suitable goods elsewhere and charge seller for any loss, when a seller breaches. Answer (d) is incorrect because a buyer may recover goods from a seller as long as the goods have been identified.

51. (b) Neither sellers nor buyers may usually collect punitive damages. Answers (a), (c) and (d) state that a buyer may collect punitive damages and are therefore incorrect. A buyer may rescind the contract and may also demand assurance of performance.

52. (d) The buyer can use specific performance or replevin when the seller breaches if the goods are unique or the buyer is unable to cover. Eagle was unable to cover within a reasonable time and may use specific performance. Answers (a) and (c) are incorrect because money damages and replevin are not the only remedy available. Specific performance is available. Answer (b) is incorrect because Eagle was not required to pay due to seller’s breach. This breach gave Eagle the right of specific performance and replevin.

53. (d) If the buyer breaches, the seller may resell, rescind and sue the buyer for any losses to specifically include lost profits, reasonable expenses and storage fees. A seller may collect the full contract price when cannot be resold for any price. Taso can recover the purchase price ($120,000) because the compressor cannot be resold for any price. Taso can also recover the storage fees ($2,000). Thus, only (d) is correct.

54. (a) If the buyer breaches, a seller may resell, rescind and sue the buyer for any loss to specifically include storage fees. Thus a seller may cancel the agreement (rescind) and also sue to recover damages. Only answer (a) is correct.

55. (a) If a buyer breaches, a seller may use any or all of the following remedies: sue to recover damages, reseil the goods, rescind the contract, and stop delivery of the goods. Only answer (a) is correct.

56. (a) If a seller in a credit sale discovers that the buyer is insolvent, the seller may stop delivery and demand cash. If the goods have already been delivered, the seller may reclaim them within ten days. If the buyer misrepresented solvency, the seller may reclaim them at any time while still in the buyer’s possession. Bold may reclaim the computers, even though more than ten days have passed, because of the buyer’s misrepresentation of solvency. Thus, (a) is correct and (c) and (d) are incorrect. Answer (b) is incorrect because if Anker had passed the goods on to a good faith purchaser for value, Bold could not reclaim them from the purchaser. Although Anker committed fraud, one who gets title by fraud can pass good title to an innocent purchaser.

57. (b) If a seller in a credit sale discovers that the buyer is insolvent, the seller may stop delivery and demand cash. Anker’s insolvency gives Bold the right to stop delivery and demand cash. Answer (a) is incorrect because the contract between Bold and Anker is not void. Anker’s insolvency merely gives the seller the right to turn a credit sale into a cash sale. Answers (c) and (d) are incorrect because Bold does not have to deliver the goods.
58. (d) To establish strict liability one must show a defective product, that caused injury, that was unreasonably dangerous, that seller was engaged in that business and that it reached the user without substantial change in condition. **Privity and negligence are irrelevant.** Answer (a) is incorrect because lack of due care is negligence and negligence is irrelevant. Answer (b) is incorrect because privity is irrelevant. Answer (c) is incorrect because although the product must be defective, the defect may involve something other than a design defect (i.e. defectively manufactured).

59. (d) To establish strict liability one must show a defective product, that caused injury, that was unreasonably dangerous, that seller was engaged in that business and that it reached the user without substantial change in condition. **Privity and negligence are irrelevant.** Since negligence is irrelevant, (d) is correct and (a) is incorrect. Answer (b) is incorrect because sellers of defective products are liable without regard to their fault (strict liability) and following the custom of the industry would be no defense. Answer (c) is incorrect because privity is irrelevant.

60. (b) To establish strict liability one must show a defective product, that caused injury, that was unreasonably dangerous, that seller was engaged in that business and that it reached the user without substantial change in condition. **Privity and negligence are irrelevant,** thus (b) is correct and (a) is incorrect. Answer (c) is incorrect because most jurisdictions have adopted strict liability. Answer (d) is incorrect because strict liability is liability without regard to fault.

61. (d) To establish strict liability one must show a defective product, that caused injury, that was unreasonably dangerous, that seller was engaged in that business and that it reached the user without substantial change in condition. Thus, the seller must have sold the product in a defective condition. There is no requirement that the seller be aware of the defect, thus (a) is incorrect. Answer (b) is incorrect because any seller involved in the sale of the product will be liable, not just the seller who sold to the injured party. Answer (c) is incorrect because failure to use due care is negligence and negligence is irrelevant in a strict liability suit.
Chapter Two: Sales
Other Objective Format Answers

ANSWER 1

1. (A) The contract stated goods were to be shipped F.O.B. sellers loading dock which is a shipment contract. The contract is not a destination or consignment contract.

2. (C) With nonconforming goods, risk of loss is always on the seller. The goods were nonconforming because Grand shipped 15 standard cabinets. Answers (a) and (b) are incorrect because they state risk of loss passed to Axle.

3. (B) Grand’s shipment of only 85 custom cabinets and 15 standard cabinets instead of the 100 custom cabinets required by the contract constituted a breach of contract. Axle may rescind the contract and sue for money damages for this breach, thus making the contract voidable. Answer (a) is incorrect because lack of a delivery date does not make a contract invalid. If no time of delivery is specified, the goods must be delivered within a reasonable time. Answer (c) is incorrect because destruction of goods does not render a sales contract void. Destruction of the goods will cause one of the parties (in this case, Grand) to bear the risk of loss.

4. (A) Grand’s shipment of only 85 custom cabinets and 15 standard cabinets instead of the 100 custom cabinets required by the contract constituted a breach of contract. Answer (b) is incorrect because the time of the seller’s breach does not depend on the buyer’s rejection. The seller’s breach occurred when the seller shipped goods that did not conform to the contract. Answer (c) is incorrect because shipment of nonconforming goods is a valid acceptance and a breach, not a counteroffer.

5. (A) Specific performance is available as a remedy to a buyer when goods are unique or if the buyer cannot reasonably cover. These were unique, custom designed cabinets. Answer (b) is incorrect because a buyer is not required to cover. Although cover is a remedy available to a buyer when a seller breaches, it is not mandatory. Answer (c) is incorrect because punitive damages are rarely awarded in contracts or sales.

ANSWER 2

a. Mason's claim, that the risk of loss for the tuna belonged to Angler, is correct. Because Angler shipped the wrong grade of tuna, risk of loss remained with Angler until either it cured by shipping conforming goods to Mason or Mason elected to accept the tuna despite the fact that it was nonconforming.

b. Classic's claim, that it was not obligated to return the peaches to Angler, is incorrect. Classic is a merchant because it deals with the type of goods that is the subject of its contract with Angler. Therefore, Classic has an obligation, on rejecting goods, to follow any reasonable instructions from Angler. Angler's request that Classic ship the peaches back to Angler at Angler's expense is a reasonable instruction.

c. Regal's claim, that it is not obligated to purchase the hamburger meat, is incorrect. Because the price of the hamburger meat exceeds $500, the Uniform Commercial Code (UCC) Statute of Frauds applies and the contract between Angler and Regal must be evidenced by a writing and:
   • Indicate that a contract for sale has been made;
   • Be signed by the party against whom enforcement is sought; and
   • Specify the quantity of goods sold.

Regal's correspondence to Angler, dated October 29, satisfies the UCC Statute of Frauds, so the contract will be enforceable against Regal.
ANSWER 3

a. 1. Vesta Electronics would bear the risk of loss for the 18" speakers destroyed by the fire on its loading dock. Even though Vesta identified and segregated the goods on its loading dock, the risk of loss remained with the seller because the contract's shipping terms "F.O.B. seller's loading dock" made it a shipping contract. Thus, risk of loss does not pass to Zap until the goods are delivered to the carrier.

2. The risk of loss for the 16" speakers also remained with Vesta. Even though the goods were delivered to the common carrier, risk of loss did not pass because Vesta shipped nonconforming goods.

b. 1. Zap may validly reject the 16" speakers because any buyer may reject nonconforming goods. To avoid potential liability, the rejection must be made within a reasonable time of receipt and must be communicated to the seller.

2. Zap may also validly accept some of the 18" speakers. A buyer may accept none, all, or any commercial unit of a shipment when nonconforming goods are shipped.

c. To be entitled to damages, Zap must comply with the UCC by notifying Vesta of the rejection of the goods within a reasonable time; acting in good faith with respect to the rejected goods by following any reasonable instructions of the seller; and giving Vesta the opportunity to cure until the contract time of performance expires.

ANSWER 4

a. Rapid's claim is incorrect. Both Debco and Rapid are merchants under the UCC because they both deal in the type of goods involved in the transaction (computers).

The UCC provides that a confirmation satisfies the Statute of Frauds, if an oral contract between merchants is:

- Confirmed in writing within a reasonable period of time, and
- The confirmation is signed by the party sending it and received by the other party.

Both parties are bound even though the party receiving the confirmation fails to sign it. This is correct unless the party receiving the confirmation submits a written objection within 10 days of receipt. Rapid will be bound even though it did not sign the confirmation because no written objection was made.

b. Debco's first claim, that its October 25 correspondence prevented the formation of a contract, is incorrect. Debco's October 12 purchase order will be regarded as a firm offer under the UCC because:

- Debco is a merchant.
- The purchase order is in writing and signed.
- The purchase order states that it will not be withdrawn for the time specified.

Because Debco's October 12 purchase order is considered a firm offer, Debco cannot revoke it, and its October 25 attempt to do so is ineffective.

Debco's second claim, that TMI's October 31 correspondence is not an effective acceptance because it was not received until November 3, is incorrect. An acceptance of an offer is effective when dispatched (in this case, when mailed), provided that an appropriate mode of communication is used. The UCC provides that an offer shall be construed as inviting acceptance in any manner and by any medium reasonable in the circumstances. In this case, Debco made its offer by mail, which, if adequately addressed with proper postage affixed, would be considered a reasonable manner and medium for acceptance. As a result, TMI's acceptance was effective when mailed on October 31.

Debco's third claim, that TMI's acceptance is not effective because it added payment terms to Debco's offer, is also incorrect. The UCC provides that a definite and timely expression of acceptance of an offer will form a contract, even if the terms of the acceptance are different from those in the offer, unless acceptance is expressly made conditional on accepting the different terms. Therefore, TMI's October 31 correspondence, which expressly stated that TMI would ship the computers ordered by Debco, was an effective acceptance, and a contract was formed despite the fact that TMI added payment terms.
**ANSWER 5**

a. Under the UCC Sales Article, the contract between Pharo and Secure creates the following implied warranties:
   - Implied warranty of merchantability;
   - Implied warranty of fitness for a particular purpose;
   - Implied warranty of title.

The implied warranty of merchantability requires the tug to be merchantable; that is, fit for the ordinary purpose intended. It is probable that the tug was fit for such ordinary purposes and, therefore, the implied warranty of merchantability was not breached.

The implied warranty of fitness for a particular purpose requires that the tug be fit for the particular purpose for which it was purchased. To show that the implied warranty of fitness for a particular purpose is present as a result of the contract, Pharo must show that:
   - Secure knew of the particular needs of Pharo;
   - Pharo relied on Secure to select a suitable tug;
   - Secure knew that Pharo was relying on Secure to select a tug suitable for Pharo's needs.

The implied warranty of fitness for a particular purpose has been breached because the tug was not suitable for Pharo's particular needs (i.e., to move airplanes weighing up to 10,000 pounds).

The implied warranty of title requires that:
   - Secure have good title;
   - The transfer to Pharo would be rightful;
   - The tug would be delivered free from any security interest or other lien.

The implied warranty of title has been breached because Maco was the rightful owner.

b. Maco will not be entitled to recover the tug from Pharo because:
   - Maco had entrusted the tug to Secure, which deals in similar goods;
   - That, as a result of such entrustment, Secure had the power to transfer Maco's rights to the tug to a buyer in the ordinary course of business;
   - Pharo was a buyer in the ordinary course of business because Pharo purchased the tug in good faith and without knowledge of Maco's ownership interest.

**ANSWER 6**

a. **Negligence.** In order to establish a cause of action based on negligence Barr must establish the following elements:
   - That the defendant owed a legal duty to the plaintiff.
   - That the defendant breached that duty.
   - That the plaintiff sustained an actual loss or damages.
   - That the breach of duty was the proximate cause of the plaintiff's actual loss or damages.

In determining if negligence is present the court will consider whether the defendant acted as a reasonably prudent person under the circumstances. Included in the reasonably prudent person test is whether the risk of harm was foreseeable.

**Breach of Warranty.** Since the sale of goods (the fork-lift) is involved in the contract, the UCC Sales Article applies. Because the seller would be regarded as a merchant, an implied warranty of merchantability is created. In order to establish a breach of this warranty, the plaintiff (Barr) must show:
   - That the fork-lift was not fit for the ordinary purposes intended and
   - That as a result of the breach of warranty, the plaintiff sustained a loss.
**Strict Liability in Tort.** Generally, the elements necessary to establish a cause of action based on strict liability in tort are as follows:

- That the product was in defective condition when it left the possession or control of the seller.
- That the product was unreasonably dangerous to the consumer or user.
- That the cause of the consumer's or user's injury was the defect.
- That the seller engaged in the business of selling such a product.
- That the product was one which the seller expected to and did reach the consumer or user without substantial changes in the condition in which it was sold.

Proof of fault is not a requirement to establish a cause of action in strict liability.

b. A proper disclaimer will permit the seller to exclude the implied warranty of merchantability. Under the facts, the disclaimer would appear to be invalid since a written disclaimer of the implied warranty of merchantability must be conspicuous and, arguably, the language in the contract is not acceptable under the UCC. In this case the disclaimer was in fine print and therefore not conspicuous. In addition, the disclaimer may be considered unconscionable since the contract was standardized and no bargaining of the terms of the contract was permitted. It should be pointed out that although consequential damages may be limited or excluded, in the case of consumer goods limitation of consequential damages for personal injuries is prima facie unconscionable. However, since the facts do not relate to consumer goods, such limitation of damages is not prima facie unconscionable but may be proved to be unconscionable.

**ANSWER 7**

Magic's first assertion, that the original contract between Starr and itself is not enforceable because of the statute of frauds, is incorrect. The sale of computer equipment is a transaction in goods and thus is governed by the UCC Sales Article. This Article provides that a contract for the sale of goods for the price of $500 or more is not enforceable unless there is some writing sufficient to indicate that a contract for sale has been made between the parties which is signed by the party against whom enforcement is sought. Since the sales price is $18,000, the statute of frauds applies. Magic's execution of the written contract will satisfy the statute of frauds since Magic is the party against whom enforcement of the contract is being sought.

Magic's second assertion, that the oral agreement to change the price of the equipment is not enforceable because the agreement lacked consideration and failed to satisfy the statute of frauds, is incorrect. Under the UCC Sales Article, an agreement to modify a contract for the sale of goods needs no consideration to be binding. However, the modification must meet the test of good faith, which is defined under the UCC as "honesty in fact in the conduct or transaction concerned and the observance of reasonable commercial standards of fair dealing in the trade." Based upon the facts, it appears that a shift in the market that will result in Starr bearing a loss on the sale to Magic will satisfy the requirement of good faith. In addition, the agreement modifying the sales price must meet the requirements of the statute of frauds if the contract, as modified, is within its provisions. Under the facts, the contract as modified by Magic and Starr, falls within the provisions of the statute of frauds and thus the statute of frauds must be satisfied. Magic's oral agreement to the modification is not sufficient to satisfy the statute of frauds. However, the statute of frauds will be satisfied if: both parties are merchants; a writing in confirmation of the agreement which is sufficient against the sender is received; the recipient receives the writing within a reasonable time; the recipient has reason to know the contents of the writing; and, the recipient fails to give written notice of objection to the contents of the writing within ten days after it is received. As the facts clearly indicate, the mailing of the signed letter by Starr to Magic on May 17 satisfied the aforementioned requirements and thus the modification agreement is enforceable.

Magic's third assertion that Starr is not entitled to recover the full sales price for the equipment is incorrect. The UCC provides that a seller may recover the price of goods identified to a contract and in the possession of the seller if the seller is unable after reasonable effort to resell them at a reasonable price or the circumstances reasonably indicate that such effort will be unavailing. Under the facts of the case at hand, Starr is entitled to recover the full sales price of $20,000 because the equipment could not be resold for any price.
The president's assertion that the September 8, 1988 offer by Crisp was irrevocable until December 20, 1988, and that, therefore, a contract was formed by Anker's acceptance on December 12, 1988, is incorrect. Because the offer made by Crisp involves a transaction in goods, i.e. furniture, the UCC Sales Article applies. The UCC Sales Article provides that an offer by a merchant to buy or sell goods in a signed writing which by its terms gives assurance that it will be held open is not revocable, for lack of consideration, during the time stated or, if no time is stated, for a reasonable time, but in no event may such period of irrevocability exceed three months. Under the facts of this case, Crisp's offer was a firm offer that could not be revoked because the offer was made by Crisp, a merchant, concerning the kind of goods being sold (furniture); was in writing and signed by Crisp; and stated that it would remain open until December 20, 1988. Despite the provision that the offer will remain open until December 20, 1988, a firm offer remains irrevocable for a three-month period. Therefore, Crisp's letter of revocation on December 5, 1988 did not terminate the firm offer because the three-month period had not yet expired. The revocation was effective on December 8, 1988, when the three-month period expired. Therefore, Anker's attempted acceptance on December 12, 1988 did not form a contract with Crisp. Instead, Anker's attempted acceptance is likely to be treated as an offer.

The president's assertion that Dix's December 12, 1988 letter formed an option contract is incorrect. To form an option contract, where the subject matter is real estate, all of the elements necessary to form a contract must be met. In this case, Anker did not furnish any consideration in return for Dix's promise to keep the offer open until December 20, 1988; therefore, an option contract was not formed.

The president's assertion that Anker's acceptance on December 19, 1988 formed a contract with Dix is incorrect. In general, acceptance of an offer is effective when it is dispatched. If, however, an offer specifically stipulates the method of communication to be utilized by the offeree, the acceptance to be effective must conform to that method. Thus, an acceptance by another method of communication is ineffective and no contract is formed. Under the facts of this case, Anker's acceptance on December 19, 1988 by a private express mail courier is ineffective, despite Dix's receipt of the acceptance on December 20, 1988, because Dix's offer specifically stipulated that acceptance could only be made by certified mail, return receipt requested. Instead, Anker's attempted acceptance is likely to be treated as a counteroffer.
ANSWER 9

a. Classic’s contention is incorrect. Under the provisions of the Sales Article of the UCC, a written memorandum stating that an agreement between merchants does not have to be signed by both parties. The contract is enforceable against Classic because Classic signed the memorandum and against Rand because Rand did not object to the memorandum within 10 days of receiving it.

b. 
1. Classic bears the risk of loss for the 50 leather chairs destroyed in the fire. Even though the goods were identified to the contract and placed on the loading dock, the risk of loss remains with Classic. The shipping terms “F.O.B. seller’s loading dock” provide that risk of loss remains with the seller until the goods are delivered to the common carrier. The 50 leather chairs destroyed in the fire had not yet been delivered to the carrier.

2. Classic bears the risk of loss for the damaged vinyl chairs. Even though the goods were delivered to the common carrier, the risk of loss did not pass to Rand because the vinyl chairs were nonconforming goods.

3. August 1 was the earliest date that title to any of the chairs passed to Rand. Title passed when goods identified to the contract were delivered to the carrier.

c. Under the Sales Article of the UCC, for Rand to be entitled to damages from Classic, Rand must comply with the following requirements:
   - Rand has to notify Classic of the rejection of the goods within a reasonable time.
   - Rand must act in good faith with respect to the rejected goods by following any reasonable instructions from Classic.
   - Rand must give Classic the opportunity to cure until the contract time of performance expires.

d. Rand would be entitled to the following remedies:
   - The right to cancel the contract
   - The right to cover
   - The right to recover monetary damages for nondelivery
FOUR DEFINITIONS

1. A Secured Transaction is an agreement between the creditor and debtor granting the creditor the right to reach specific personal property of the debtor if the debtor defaults.
   a. It is simply a debt secured by personal property.
   b. Article 9 of the UCC governs security interests in personal property.

2. Purchase Money Security Interest Creditor (PMSI Creditor) is a creditor who advances either money or credit to enable a debtor to obtain collateral and retains a security interest in the collateral.
   
   **Example:** 1st National Bank loans $3,000 to purchase a new computer for her office and takes a security interest in the computer. 1st National is a PMSI creditor.

   **Example:** Compuland sells X a $3,000 computer. X pays $1,000 down and signs a promissory note for the remainder and a security agreement in the computer. Compuland is a PMSI creditor because X obtained the computer with Compuland’s credit.

3. After Acquired Property Clause: The creditor takes as collateral property that is to be acquired by the debtor at a later date (used most often with inventory and equipment).

4. Security interests in Proceeds: Unless expressly excluded, a creditor automatically has a security interest in any proceeds from the sale of the collateral.

*** ATTACHMENT ***

1. Attachment is a creditor’s security interest that is valid against the debtor (i.e., without attachment a security interest is ineffective against the debtor).
   a. Attachment by itself only protects the creditor against the debtor, not 3rd parties.
   b. To have a security interest effective against 3rd parties the creditor must perfect.

2. There are three requirements or elements for attachment to occur.
   a. There must be an Agreement between the creditor and debtor providing for a security interest, which may be either written OR oral.
      1). A written agreement must be signed by the debtor (creditor's signature is not necessary) and contain a reasonable description of the collateral.
      2). An oral agreement is sufficient only if the creditor has possession of the collateral with the debtor's agreement (sometimes called a pledge).
   b. There must be some type of Value given by creditor (does not need to be present value - e.g., value may be an old or antecedent debt).
   c. The Debtor must have Rights in the collateral.

3. All three requirements must be met for attachment to occur.
   
   **Example:** On June 5, 1st National Bank loans $3,000 to purchase a new computer for her business. X contemporaneously signs a security agreement and a promissory note. On June 10, X buys the computer. Although the agreement was signed and the creditor extended value on June 5, attachment only occurred on June 10 because this was when the debtor first obtained rights in the collateral.
1. **Perfection** is the method by which a creditor insures the security interest is valid against most subsequent 3rd parties
   a. an unperfected creditor is unprotected against 3rd parties
   b. 3rd parties may include other creditors of the debtor asserting an interest in the collateral, debtor’s trustee in bankruptcy or buyers of the collateral from the debtor

2. There are three different methods of perfection available to a creditor
   a. perfection by possession
   b. perfection by filing a financing statement
   c. perfection by attachment

3. Perfection of motor vehicles other than those in a merchant's inventory
   a. in most states, a security interest in a motor vehicle (other than a dealer's inventory) may only be perfected by notation on the document of title
   b. thus, a creditor cannot perfect a security interest in a motor vehicle by filing unless it was part of a dealer's inventory

4. Perfection by Possession occurs when the creditor takes possession of the collateral with the debtor's agreement
   a. with money or instruments possession is the only way to perfect (e.g., with a negotiable instrument or a stock or bond, possession is the only way to perfect)
   b. the creditor must use due care in storing and maintaining the collateral

5. Perfection by Filing a Financing Statement
   a. filing gives constructive notice to subsequent 3rd parties of the security interest
   b. the financing statement must contain three items
      1). the names and addresses of the debtor and the creditor
      2). it must be signed by the debtor
      3). it must contain a general description of the type of collateral
   c. with accounts receivable or intangible property, filing is only way to perfect
   d. the filing is good for 5 years and can be renewed for another 5 years by filing a continuation statement
   e. Financing statement is filed with the Secretary of State

6. **Perfection By Attachment** is an automatic but very limited type of perfection
   a. PMSI Creditors in consumer goods are automatically perfected upon attachment without the necessity of filing a financing statement or taking possession
      1). the rationale for this rule is that the cost to a retail merchant of having to file for each and every credit sale would be economically prohibitive
      2). equally, consumer goods are rarely used twice as collateral; thus there are usually no further creditors to protect
   b. a creditor who perfects by attachment has priority over all subsequent creditors
   c. a creditor who perfects by attachment does not have priority over a consumer who purchases the collateral from the debtor without notice of the security interest
      1). to prevail the consumer buyer must be without notice of the security interest
      2). if the creditor had perfected by filing, they would prevail over the consumer purchaser from the debtor

**Example:** *Compuland* sells $X$ a $3,000 computer for his own personal use. $X$ pays $1,000 down and signs a promissory note and a security agreement for the remainder. *Compuland* has perfected even though they have not filed or taken possession because they are a PMSI creditor in consumer goods. If $X$ sold the computer to $Y$, who bought for her own use and had no notice of *Compuland*'s interest, *Compuland* would lose the collateral to $Y$. If *Compuland* had filed a financing statement, they would prevail over $Y.
7. Collateral perfected in one state and then moved to another state
   a. the collateral remains perfected for **four months** after arrival in the new state
   b. if not perfected within the four month period in the new state, it is no longer valid

**SECURED CREDITOR VS. A PURCHASER FROM DEBTOR**

1. A perfected creditor usually has priority over a purchaser of the collateral from debtor
   a. an unperfected creditor does not have priority over a bona fide purchaser for value without notice of the security interest
   b. if the purchaser has notice of the security interest, (s)he takes the collateral subject to the unperfected security interest

2. Two exceptions when a perfected creditor loses to a purchaser from the debtor
   a. one who perfects by attachment loses to a consumer purchaser without notice
   b. one who buys from a merchant **in ordinary course of business** takes free of all security interests even if they had notice of the security interest
      1). a buyer “in the ordinary course of business” is one making an ordinary purchase of goods from a merchant's inventory
      2). a buyer in the ordinary course of business may be a consumer and may even be another merchant
      3). a buyer from a nonmerchant is **not** a buyer in the ordinary course of business and would lose the collateral to a perfected creditor

*Example:* General Motors sells two Buick Regals to Automall, Inc. on credit and files a financing statement covering the two cars. Automall, Inc. sells one of the cars to a consumer and the other to a merchant who will use the car for business. Both the consumer and the merchant will take free of General Motors perfected security interest because they are **buyers in the ordinary course of business.**

**PRIORITIES WITH MULTIPLE CREDITORS**

1. There may be two or more creditors with a security interest in the same collateral
   a. creditors may be lien creditors (a creditor who has obtained a lien on the debtor's property by means of judicial process)
   b. a trustee in bankruptcy is counted as a lien creditor as of the bankruptcy filing date

2. A perfected creditor has priority over an unperfected creditor (**e.g.** a perfected creditor will always have priority over a creditor who has only attached - **unperfected is unprotected**)

3. If both creditors are perfected, the **general rule** is that the **first** creditor to file or perfect has priority over other creditors (**i.e.** the **first in time is first in line**)
   a. if the creditor filed a financing statement prior to attachment, the creditor has priority from the date of filing **not** the date of attachment
   b. lien creditor's place in line is based on the date of the lien
   c. trustee in bankruptcy's place in line is based on the date of the bankruptcy petition

4. **Exception:** A **PMSI Creditor** will have priority over an earlier perfected security interest if certain requirements are met
   a. a PMSI in **non-inventory collateral** has priority over prior security interests if:
      1). the creditor files within **10 days** of the debtor taking possession (**note:** although the UCC grants a 10 day grace period, most states have extended this period to 20 days to file after the debtor gets possession)
      2). the perfection relates back to the date the debtor took possession
Example: On May 1, 1st National Bank loans Acme hardware store $10,000 to make an improvement in the store. 1st National takes a security interest in all of Acme’s equipment and account's receivable and files a financing statement on May 2. On June 1 Acme buys and receives a cash register on credit from Beta Inc. to use in the business. Beta takes a written security interest in the cash register and files a financing statement on June 9. If Acme defaults to both 1st National and Beta, Beta will have priority even though Beta was the second to perfect. This is because Beta is a PMSI creditor in equipment who filed within 10 days of giving possession. Beta will be counted as perfected on June 1 the date Acme took possession because perfection relates back to the date the debtor took possession.

b. with inventory collateral, the PMSI creditor must do two things to have priority:
   1). before the debtor takes possession, the PMSI creditor must file
   2). before the debtor takes possession, the PMSI creditor must give written notice to prior perfected creditors

5. If neither creditor is perfected, then the first creditor to attach has priority

6. Mechanic's or Artisan's Lien is a lien for one who repairs or improves debtor's property
   a. it is superior to any security interests if mechanic is in possession of the goods
   b. public sale of the property to satisfy the debt is permitted after giving notice

3 REMEDIES OF A CREDITOR AFTER DEFAULT

1. A creditor may Repossess the collateral after default and sell or lease it
   a. repossession doesn't require a court order, but it must be done peacefully
   b. it may be sold at a public sale after proper notice is given and the creditor is permitted to bid on the item (the creditor may even buy the item)
   c. it may also be sold at a private sale after proper notice is given, but the creditor is not usually permitted to bid (there are exceptions when the creditor may bid)
   d. a debtor may redeem collateral repossessed as long as the debtor does so prior to sale and pays all creditors in full.
   e. a good faith purchaser for value takes free from that security interest and all subordinate liens (would not take free from any senior liens)
   f. order of payment after sale
      1). the sale expenses of the creditor
      2). the creditor's debt
      3). debts of subordinate creditors
      4). any surplus remaining after sale goes to debtor and the debtor remains liable for any deficiency

2. In Strict foreclosure, the creditor keeps the collateral but must cancel the entire debt
   a. the creditor must send written notice to the debtor and other creditors
   b. if the debtor or others object within 21 days, the creditor must sell the collateral
   c. if the debtor has paid 60% or more of the price of consumer goods, the creditor must sell the collateral within 90 days unless debtor waives this right

3. Sue debtor for debt and reduce the claim to a judgment
   a. unsecured creditors may get a judgment against the debtor and then attach property of the debtor (they are called judgment creditors)
   b. secured creditors may get a deficiency judgment if the collateral is insufficient to pay the full amount of the debt
Chapter Three: Secured Transactions

Multiple Choice Questions

1. Under the UCC Secured Transactions Article, which of the following after-acquired property may be attached to a security agreement given to a secured lender?
   
<table>
<thead>
<tr>
<th>Inventory</th>
<th>Equipment</th>
</tr>
</thead>
<tbody>
<tr>
<td>Yes</td>
<td>Yes</td>
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<tr>
<td>Yes</td>
<td>No</td>
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<tr>
<td>No</td>
<td>Yes</td>
</tr>
<tr>
<td>No</td>
<td>No</td>
</tr>
</tbody>
</table>

2. Under the Secured Transactions Article of the UCC, which of the following requirements is necessary to have a security interest attach?

<table>
<thead>
<tr>
<th>Debtor has rights in the collateral</th>
<th>Proper filing of a security agreement by the creditor</th>
<th>Value given</th>
</tr>
</thead>
<tbody>
<tr>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
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<tr>
<td>Yes</td>
<td>Yes</td>
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<tr>
<td>Yes</td>
<td>No</td>
<td>Yes</td>
</tr>
<tr>
<td>No</td>
<td>Yes</td>
<td>Yes</td>
</tr>
</tbody>
</table>

3. Under the UCC Secured Transactions Article, which of the following conditions must be satisfied for a security interest to attach?
   a. The debtor must have title to the collateral.
   b. The debtor must agree to the creation of the security interest.
   c. The creditor must be in possession of part of the collateral.
   d. The creditor must properly file a financing statement.

4. Under the UCC Secured Transactions Article, which of the following events will always prevent a security interest from attaching?
   a. Failure to have a written security agreement.
   b. Failure of the creditor to have possession of the collateral.
   c. Failure of the debtor to have rights in the collateral.
   d. Failure of the creditor to give present consideration for the security interest.

5. Which of the following requirements is not necessary in order to have a security interest attach?
   a. There must be a proper filing.
   b. Value must be given by the creditor.
   c. Either the creditor must take possession or the debtor must sign a security agreement that describes the collateral.
   d. The debtor must have rights in the collateral.

6. Winslow Co., which is in the business of selling furniture, borrowed $60,000 from Pine Bank. Winslow executed a promissory note for that amount and used all of its accounts receivable as collateral for the loan. Winslow executed a security agreement that described the collateral. Winslow did not file a financing statement. Which of the following statements best describes this transaction?
   a. Perfection of the security interest occurred even though Winslow did not file a financing statement.
   b. Perfection of the security interest occurred by Pine having an interest in accounts receivable.
   c. Attachment of the security interest did not occur because Winslow failed to file a financing statement.
   d. Attachment of the security interest occurred when the loan was made and Winslow executed the security agreement.

7. Attachment and perfection will occur simultaneously when
   a. The security agreement so provides.
   b. There is a purchase money security interest taken in inventory.
   c. Attachment is by possession.
   d. The goods are sold on consignment.

8. Burn Manufacturing borrowed $500,000 from Howard Finance Co., secured by Burn's present and future inventory, accounts receivable, and the proceeds thereof. The parties signed a financing statement that described the collateral and it was filed in the appropriate state office. Burn subsequently defaulted in the repayment of the loan and Howard attempted to enforce its security interest. Burn contended that Howard's security interest was unenforceable. In addition, Green, who subsequently gave credit to Burn without knowledge of Howard's security interest, is also attempting to defeat Howard's alleged security interest. The security interest in question is valid with respect to
   a. Both Burn and Green.
   b. Neither Burn nor Green.
   c. Burn but not Green.
   d. Green but not Burn.
9. Which of the following transactions would illustrate a secured party perfecting its security interest by taking possession of the collateral?
   a. A bank receiving a mortgage on real property.
   b. A wholesaler borrowing to purchase inventory.
   c. A consumer borrowing to buy a car.
   d. A pawnbroker lending money.

10. Grey Corp. sells computers to the public. Grey sold and delivered a computer to West on credit. West executed and delivered to Grey a promissory note for the purchase price and a security agreement covering the computer. West purchased the computer for personal use. Grey did not file a financing statement. Is Grey's security interest perfected?
   a. Yes, because Grey retained ownership of the computer.
   b. Yes, because it was perfected at the time of attachment.
   c. No, because the computer was a consumer good.
   d. No, because Grey failed to file a financing statement.

11. A secured creditor wants to file a financing statement to perfect its security interest. Under the UCC Secured Transactions Article, which of the following must be included in the financing statement?
   a. A listing or description of the collateral.
   b. An after-acquired property provision.
   c. The creditor’s signature.
   d. The collateral’s location.

12. If a manufacturer assigns 90% of its accounts receivable to a factor, perfection will occur by

<table>
<thead>
<tr>
<th>Filing a financing statement</th>
<th>Possession</th>
<th>Attachment</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. Yes</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td>b. Yes</td>
<td>No</td>
<td>No</td>
</tr>
<tr>
<td>c. No</td>
<td>No</td>
<td>Yes</td>
</tr>
<tr>
<td>d. No</td>
<td>Yes</td>
<td>No</td>
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</table>

13. Perfection of a security interest permits the secured party to protect its interest by
   a. Avoiding the need to file a financing statement.
   b. Preventing another creditor from obtaining a security interest in the same collateral.
   c. Establishing priority over the claims of most subsequent secured creditors.
   d. Denying the debtor the right to possess the collateral.

14. Under the UCC Secured Transactions Article, which of the following actions will best perfect a security interest in a negotiable instrument against any other party?
   a. Filing a security agreement.
   b. Taking possession of the instrument.
   c. Perfecting by attachment.
   d. Obtaining a duly executed financing statement.

15. Mars, Inc. manufactures and sells VCRs on credit directly to wholesalers, retailers, and consumers. Mars can perfect its security interest in the VCRs it sells without having to file a financing statement or take possession of the VCRs if the sale is made to
   a. Retailers.
   b. Wholesalers that sell to distributors for resale.
   c. Consumers.
   d. Wholesalers that sell to buyers in the ordinary course of business.

16. Larkin is a wholesaler of computers. Larkin sold 40 computers to Elk Appliance for $80,000. Elk paid $20,000 down and signed a promissory note for the balance. Elk also executed a security agreement giving Larkin a security interest in Elk's inventory, including the computers. Larkin perfected its security interest by properly filing a financing statement in the state of Whiteacre. Six months later, Elk moved its business to the state of Blackacre, taking the computers. On arriving in Blackacre, Elk secured a loan from Quarry Bank and signed a security agreement putting up all inventory (including the computers) as collateral. Quarry perfected its security interest by properly filing a financing statement in the state of Blackacre. Two months after arriving in Blackacre, Elk went into default on both debts. Which of the following statements is correct?
   a. Quarry's security interest is superior because Larkin's time to file a financing statement in Blackacre had expired prior to Quarry's filing.
   b. Quarry's security interest is superior because Quarry had no actual notice of Larkin's security interest.
   c. Larkin's security interest is superior even though at the time of Elk's default Larkin had not perfected its security interest in the state of Blackacre.
   d. Larkin's security interest is superior provided it repossesses the computers before Quarry does.
17. Sax purchased from Bosch Tools a new saw for his home workshop for cash. One week later, Sax was called by Cary Finance. Cary explained to Sax that it had been financing Bosch's purchases from the manufacturers and that to protect its interest it had obtained a perfected security interest in Bosch's entire inventory of hardware and power tools, including the saw which Sax bought. Cary further explained that Bosch had defaulted on a payment due to Cary, and Cary intended to assert its security interest in the saw and repossess it unless Sax was willing to make payment of $100 for a release of Cary's security interest. If Sax refuses to make the payment, which of the following statements is correct?

a. Even if Sax had both actual notice and constructive notice via recordation of Cary's interest, he will prevail if Cary seeks to repossess the saw.

b. Cary's security interest in the saw in question is invalid against all parties unless its filing specifically described and designated the particular saw Sax purchased.

c. Sax must pay the $100 or the saw can be validly repossessed and sold to satisfy the amount Bosch owes Cary and any excess paid to Sax.

d. Sax will not take free of Cary's security interest if he was aware of said interest at the time he purchased the saw.

18. Under the Secured Transaction Article of the UCC, which of the following purchasers will own consumer goods free of a perfected security interest in goods?

a. A merchant who purchased the goods for resale.

b. A merchant who purchased the goods for use in its business.

c. A consumer who purchases the goods from a consumer purchaser who gave the security interest.

d. A consumer who purchases the goods in the ordinary course of business.

19. On July 8, Ace, a refrigerator wholesaler, purchased 50 refrigerators. This comprised Ace’s entire inventory and was financed under an agreement with Rome Bank that gave Rome a security interest in all refrigerators on Ace’s premises, all future acquired refrigerators, and the proceeds of sales. On July 12, Rome filed a financing statement that adequately identified the collateral. On August 15, Ace sold one refrigerator to Cray for personal use and four refrigerators to Zone Co. for its business. Which of the following statements is correct?

a. The refrigerators sold to Zone will be subject to Rome’s security interest.

b. The refrigerator sold to Cray will not be subject to Rome’s security interest.

c. The security interest does not include the proceeds from the sale of the refrigerators to Zone.

d. The security interest may not cover after-acquired property even if the parties agree.

20. Acorn Marina, Inc. sells and services boat motors. On April 1, 1989, Acorn financed the purchase of its entire inventory with GAC Finance Company. GAC required Acorn to execute a security agreement and financing statement covering the inventory and proceeds of sale. On April 14, 1989, GAC properly filed the financing statement pursuant to the UCC Secured Transactions Article. On April 27, 1989, Acorn sold one of the motors to Wilks for use in his charter business. Wilks, who had once worked for Acorn, knew that Acorn regularly financed its inventory with GAC. Acorn has defaulted on its obligations to GAC. The motor purchased by Wilks is

a. Subject to the GAC security interest because Wilks should have known that GAC financed the inventory purchase by Acorn.

b. Subject to the GAC security interest because Wilks purchased the motor for a commercial use.

c. Not subject to the GAC security interest because Wilks is regarded as a buyer in the ordinary course of Acorn's business.

d. Not subject to the GAC security interest because GAC failed to file the financing statement until more than 10 days after April 1, 1989.

21. Under the UCC Secured Transactions Article, perfection of a security interest by a creditor provides added protection against other parties in the event the debtor does not pay its debts. Which of the following parties is not affected by perfection of a security interest?

a. Other prospective creditors of the debtor.

b. The trustee in a bankruptcy case.

c. A buyer in the ordinary course of business.

d. A subsequent personal injury judgment creditor.
22. Wine purchased a computer using the proceeds of a loan from MJC Finance Company. Wine gave MJC a security interest in the computer. Wine executed a security agreement and financing statement, which was filed by MJC. Wine used the computer to monitor Wine's personal investments. Later, Wine sold the computer to Jacobs, for Jacobs' family use. Jacobs was unaware of MJC's security interest. Wine now is in default under the MJC loan. May MJC repossess the computer from Jacobs?
   a. No, because Jacobs was unaware of the MJC security interest.
   b. No, because Jacobs intended to use the computer for family or household purposes.
   c. Yes, because MJC's security interest was perfected before Jacobs' purchase.
   d. Yes, because Jacobs' purchase of the computer made Jacobs personally liable to MJC.

23. Under the Secured Transactions Article of the UCC, what would be the order of priority for the following security interests in consumer goods?
   I. Financing agreement filed on April 1.
   II. Possession of the collateral by a creditor on April 10.
   III. Financing agreement perfected on April 15.
   a. I, II, III.
   b. II, I, III.
   c. II, III, I.
   d. III, II, I.

24. A party who filed a security interest in inventory on April 1, 1993, would have a superior interest to which of the following parties?
   a. A holder of a mechanic's lien whose lien was filed on March 15, 1993.
   d. A judgment lien creditor who filed its judgment on April 15, 1993.

25. Noninventory goods were purchased and delivered on June 15, 1993. Several security interests exist in these goods. Which of the following security interests has priority over the others?
   d. Purchase money security interest perfected June 24, 1993.

26. On June 15, Harper purchased equipment for $100,000 from Imperial Corp. for use in its manufacturing process. Harper paid for the equipment with funds borrowed from Eastern Bank. Harper gave Eastern a security agreement and financing statement covering Harper's existing and after-acquired equipment. On June 21, Harper was petitioned involuntarily into bankruptcy under Chapter 7 of the Federal Bankruptcy Code. A bankruptcy trustee was appointed. On June 23, Eastern filed the financing statement. Which of the parties will have a superior security interest in the equipment?
   a. The trustee in bankruptcy, because the filing of the financing statement after the commencement of the bankruptcy case would be deemed a preferential transfer.
   b. The trustee in bankruptcy, because the trustee became a lien creditor before Eastern perfected its security interest.
   c. Eastern, because it had a perfected purchase money security interest without having to file a financing statement.
   d. Eastern, because it perfected its security interest within the permissible time limits.

27. Roth and Dixon both claim a security interest in the same collateral. Roth's security interest attached on January 1, 1989, and was perfected by filing on March 1, 1989. Dixon's security interest attached on February 1, 1989, and was perfected on April 1, 1989, by taking possession of the collateral. Which of the following statements is correct?
   a. Roth's security interest has priority because Roth perfected before Dixon perfected.
   b. Dixon's security interest has priority because Dixon's interest attached before Roth's interest was perfected.
   c. Roth's security interest has priority because Roth's security interest attached before Dixon's security interest attached.
   d. Dixon's security interest has priority because Dixon is in possession of the collateral.

28. On May 2, Safe Bank agreed to loan Tyler Corp. $50,000. Tyler signed a security agreement and financing statement covering its existing equipment. On May 4, Safe filed the financing statement. On May 7, State Bank loaned Tyler $60,000. State had notified Safe on May 5 of its intention to make the loan. Tyler signed a security agreement and financing statement covering the same existing equipment. On May 8, State filed the financing statement. On May 10, Safe loaned Tyler $50,000. If Tyler defaults on
both loans, who will have a priority security interest in the equipment?

a. State, since it was the first to perfect its security interest.
b. State, since it properly notified Safe prior to making the loan.
c. Safe, since it was the first to file.
d. Safe, since it has a purchase money security interest in the equipment which was perfected within the permissible time limits.

29. Under the UCC Secured Transactions Article, what is the order of priority for the following security interests in store equipment?

II. Security interest attached on April 1, 1994.
III. Purchase money security interest attached April 11, 1994 and perfected by filing on April 20, 1994.

a. I, III, II.
b. II, I, III.
c. III, I, II.
d. III, II, I.

Items 30 and 31 are based on the following information:

On June 3, Muni Finance loaned Page Corp. $20,000 to purchase four computers for use in Page's trucking business. Page contemporaneously executed a promissory note and security agreement. On June 7, Page purchased the computers with the $20,000, obtaining possession that same day. On June 10, Mort, a judgment creditor of Page, levied on the computers.

30. Which of the following statements is correct?

a. Muni failed to qualify as a purchase money secured lender.
b. Muni's security interest attached on June 3.
c. Muni's security interest attached on June 7.
d. Muni's security interest did not attach.

31. If Muni files a financing statement on June 11, which of the parties will have a priority security interest in the computers?

a. Mort, since he lacked notice of Muni's security interest.
b. Mort, since Muni failed to file before Mort levied on the computers.
c. Muni, since its security interest was perfected within the permissible time limits.
d. Muni, since its security interest was automatically perfected upon attachment.

32. A typewriter, which was subject to a prior UCC security interest, was delivered to Ed Fogel for repair. Fogel is engaged in the business of repairing typewriters. However, the owner of the typewriter now refuses to pay for the services performed by Fogel. The state in which Fogel operates his business has a statute which gives Fogel a mechanics lien on the typewriter. Fogel's mechanics lien

a. Takes priority over a prior perfected security interest under all circumstances.
b. Is subject to a prior perfected purchase money security interest under all circumstances.
c. Is subject to a prior unperfected security interest where the statute is silent as to priority.
d. Takes priority over a prior perfected security interest unless the statute expressly provides otherwise.

33. Under the UCC Secured Transactions Article, if a debtor is in default under a payment obligation secured by goods, the secured party has the right to

Peacefully Sell the goods
repossess the Reduce the and apply the goods without claim to a proceeds toward judicial process judgment the debt

a. Yes Yes Yes
b. No Yes Yes
c. Yes Yes No
d. Yes No Yes

Items 34 and 35 are based on the following information:

Foxx purchased a stereo for personal use from Dix Audio, a retail seller of appliances. Foxx paid 30% of the $600 sales price and agreed to pay the balance in 12 equal principal payments plus interest. Foxx executed a security agreement giving Dix a security interest in the stereo. Dix properly filed a financing statement immediately. After making six payments Foxx defaulted.
34. If Dix takes possession of the stereo, it
a. Must dispose of the stereo at a public sale.
b. Must dispose of the stereo within 90 days after
taking possession or be liable to the debtor.
c. May retain possession of the stereo, thereby
discharging Foxx of any deficiency.
d. May retain possession of the stereo and collect
any deficiency plus costs from Foxx.

35. If after making the third installment payment,
Foxx sold the stereo to Lutz for personal use, who
would have a superior interest in the stereo assuming
Lutz lacked knowledge of Dix's security interest?
a. Dix, since it filed a financing statement.
b. Dix, since more than 30% of the purchase price
had been paid.
c. Lutz, since title passed from Foxx to Lutz.
d. Lutz, since he purchased without knowledge of
Dix's security interest and for personal use.

Items 36 and 37 are based on the following:
Drew bought a computer for personal use from Hale
Corp. for $3,000. Drew paid $2,000 in cash and
signed a security agreement for the balance. Hale
properly filed the security agreement. Drew defaulted
in paying the balance of the purchase price. Hale
asked Drew to pay the balance. When Drew refused,
Hale peacefully repossessed the computer.

36. Under the UCC Secured Transactions Article,
which of the following remedies will Hale have?
a. Obtain a deficiency judgment against Drew for
the amount owed.
b. Sell the computer and retain any surplus over the
amount owed.
c. Retain the computer over Drew's objection.
d. Sell the computer without notifying Drew.

37. Under the UCC Secured Transactions Article,
which of the following rights will Drew have?
a. Redeem the computer after Hale sells it.
b. Recover the sale price from Hale after Hale sells
the computer.
c. Force Hale to sell the computer.
d. Prevent Hale from selling the computer.

38. Under the Secured Transactions Article of the
UCC, which of the following remedies is available to
a secured creditor when a debtor fails to make a
payment when due?

<table>
<thead>
<tr>
<th>Proceed against the collateral</th>
<th>Obtain a general judgment against the debtor</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>b. Yes</td>
<td>No</td>
</tr>
<tr>
<td>c. No</td>
<td>Yes</td>
</tr>
<tr>
<td>d. No</td>
<td>No</td>
</tr>
</tbody>
</table>

39. Under the UCC Secured Transactions Article,
which of the following statements is correct
concerning the disposition of collateral by a secured
creditor after a debtor's default?
a. A good faith purchaser for value and without
knowledge of any defects in the sale takes free
of any subordinate liens or security interests.
b. The debtor may not redeem the collateral after
the default.
c. Secured creditors with subordinate claims retain
the right to redeem the collateral after the
collateral is sold to a third party.
d. The collateral may only be disposed of at a
public sale.

40. Bonn, a secured party, sells collateral at a private
sale to a good faith purchaser for value after the
debtor defaults. Which of the following statements is
correct under the UCC Secured Transactions Article?
a. In all cases, the collateral will remain subject to
the security interests of subordinate lien creditors.
b. The security interest under which the sale was
made and any security interest or lien subordinate
to it will be discharged.
c. In all cases, Bonn may not buy the collateral at a
private sale.
d. Bonn will be entitled to receive a first priority in
the sale proceeds.
Chapter Three: Secured Transactions
Other Objective Format Questions

NUMBER 1
Under the Secured Transaction Article of the UCC, any transaction intended to establish a security interest in personal property is governed by requirements for the creation and satisfaction of that interest.

Required:
Items 1 through 5 relate to situations involved in the creation and/or satisfaction of a security interest. For each item, select the effect that will result from each situation from List I. An answer may be selected once, more than once, or not at all.

1. The security interest obtained by a creditor who lends money to a debtor to purchase goods used in the debtor’s business will be
2. A seller of consumer goods who obtains an oral security agreement from a purchaser in the ordinary course of business will have
3. A creditor who is transferred collateral to hold as security by a debtor, pursuant to agreement, will have
4. A creditor who files a financing statement would, at the most, have
5. A creditor who files a financing statement on October 15 will have a priority over another creditor who has a signed but unfiled security agreement dated October 1 because of

List I - Effect
A. An attached security interest
B. A priority due to attachment
C. A priority due to perfection
D. A priority due to chronological order
E. A purchase money security interest
F. A security interest in receivables
G. A security interest perfected by filing
H. A security interest perfected without filing
I. No security interest

NUMBER 2
Number 2 consists of 6 items. Select the best answer for each item. Answer all items. Your grade will be based on the total number of correct answers.

On January 2, 1994, Gray Interiors Corp., a retailer of sofas, contracted with Shore Furniture Co. to purchase 150 sofas for its inventory. The purchase price was $250,000. Gray paid $50,000 cash and gave Shore a note and security agreement for the balance. On March 1, 1994, the sofas were delivered. On March 10, 1994, Shore filed a financing statement.

On February 1, 1994, Gray negotiated a $1,000,000 line of credit with Float Bank, pledged its present and future inventory as security, and gave Float a security agreement. On February 20, 1994, Gray borrowed $100,000 from the line of credit. On March 5, 1994, Float filed a financing statement.

On April 1, 1994, Dove, a consumer purchaser in the ordinary course of business, purchased a sofa from Gray. Dove was aware of both security interests.
Required:

Items 1 through 6 refer to the above fact pattern. For each item, determine whether A, B, or C is correct.

1. Shore’s security interest in the sofas attached on
   B. March 1, 1994.
   C. March 10, 1994.

2. Shore’s security interest in the sofas was perfected on
   B. March 1, 1994.
   C. March 10, 1994.

3. Float’s security interest in Gray’s inventory attached on
   A. February 1, 1994.
   B. March 1, 1994.
   C. March 5, 1994.

4. Float’s security interest in Gray’s inventory was perfected on
   A. February 1, 1994.
   C. March 5, 1994.

5. A. Shore’s security interest has priority because it was a purchase money security interest.
   B. Float’s security interest has priority because Float’s financing statement was filed before Shore’s.
   C. Float’s security interest has priority because Float’s interest attached before Shore’s.

6. A. Dove purchased the sofa subject to Shore’s security interest.
   B. Dove purchased the sofa subject to both the Shore and Float security interests.
   C. Dove purchased the sofa free of either the Shore or Float security interests.

NUMBER 3

Mead, a junior member of a CPA firm's audit staff, was assigned to assist in auditing Abco Electronics, Inc.'s financial statements. Abco sells various brands of computer equipment to the general public, and to distributors who sell the equipment to retail customers for personal and business use. One of Mead's assignments was to evaluate the following transactions:

- On September 1, Abco sold a CDM computer out of its inventory to Rice, who intended to use it for business purposes. Rice paid 25% of the purchase price and executed and delivered to Abco a promissory note for the balance. A security agreement was signed only by the Abco sales representative. Abco failed to file a financing statement. Rice is in default under the promissory note. Rice claimed that Abco does not have an effective security interest in the computer because Rice did not sign the security agreement, and because Abco did not file a financing statement.

- On August 18, Abco sold a computer to Baker, who intended to use it for business inventory and accounts payable control, and payroll processing. Baker paid 20% of the purchase price and executed and delivered to Abco a promissory note for the balance and a security agreement covering the computer. Abco filed a financing statement on August 27. On August 25, Baker borrowed $5,000 from Condor Finance Co., giving Condor a promissory note for the loan amount and a security agreement covering the computer. Condor filed a financing statement on August 26. Baker defaulted on the promissory note given to Abco and its obligation to Condor. Condor has asserted that its security interest in the computer is superior to Abco's.

Required:
State whether the claims of Rice and Condor are correct and give the reasons for your conclusions.
**NUMBER 4**

Wizard Computer Co. sells computers to the general public. On April 30, Wizard financed the purchase of its computer inventory with National Bank. Wizard executed and delivered a promissory note and a security agreement covering the inventory. National filed a financing statement on the same day.

On May 1, Wizard sold a computer out of its inventory to Kast, who intended to use it to do some household budgeting. Kast made a 10% downpayment toward the purchase price. Kast executed and delivered to Wizard a promissory note for the balance and a security agreement covering the computer. Kast was aware that Wizard financed its inventory with National. Wizard did not file a financing statement.

On May 6, Kast, who was dissatisfied with the computer, sold it on credit to Marc, who intended to use it to assist in family budgeting. Marc, who was unaware that Kast had purchased the computer on credit, paid 25% of the purchase price and executed and delivered to Kast a promissory note for the balance and a security agreement covering the computer. Kast did not file a financing statement.

On May 12, Marc borrowed $6,000 from Alcor Finance. Marc gave Alcor a promissory note for the loan amount and a security agreement covering the computer and other household appliances owned by Marc. Alcor did not file a financing statement.

Marc failed to pay Alcor or Kast. In turn, Kast has been unable to pay Wizard. On June 2, Wizard defaulted on its obligation to National.

Kast and Marc take the following positions:
- **Kast** asserts that the computer was purchased from Wizard free of National's security interest.
- **Marc** asserts that the computer was purchased from Kast free of Wizard's security interest.
- **Marc** asserts that Alcor's security interest is unenforceable against Marc because Alcor failed to file a financing statement.

**Required:**
For each assertion, indicate whether it is correct, and set forth the reasons for your conclusion.

**NUMBER 5**

Despard Finance Company is a diverse, full-line lending institution. Its "Problems & Potential Litigation" file revealed the following disputes involving loans extended during the year of examination:

- **Despard** loaned Fish $4,500 to purchase a $5,000 video recording system for his personal use. A note, security agreement, and financing statement, which was promptly filed, were all executed by Fish. Unknown to Despard, Fish had already purchased the system from Zeals Department Stores the previous day for $5,000. The terms were 10% down, the balance monthly, payable in three years, and a written security interest granted to Zeals. Zeals did not file a financing statement until default.
- **Despard** loaned Moderne Furniture Co. $13,000 to purchase certain woodworking equipment. Moderne did so. A note, security agreement, and financing statement were executed by Moderne. As a result of an oversight the financing statement was not filed until 30 days after the loan-purchase by Moderne. In the interim Moderne borrowed $11,000 from Apache National Bank using the newly purchased machinery as collateral for the loan. A financing statement was filed by Apache five days prior to Despard's filing.

**Required:** Answer the following, setting forth reasons for any conclusions stated.
What are the priorities among the conflicting security interests in the same collateral claimed by Despard and the other lenders?
NUMBER 6

Dunn & Co., CPAs, is auditing the 1987 financial statements of its client, Safe Finance. While performing the audit, Dunn learned of certain transactions that occurred during 1987 that may have an adverse impact on Safe's financial statements. The following transactions are of most concern to Dunn:

- On May 5, Safe sold certain equipment to Lux, who contemporaneously executed and delivered to Safe a promissory note and security agreement covering the equipment. Lux purchased the equipment for use in its business. On May 8, City Bank loaned Lux $50,000, taking a promissory note and security agreement from Lux that covered all of Lux's existing and after-acquired equipment. On May 11, Lux was involuntarily petitioned into bankruptcy under the liquidation provisions of the Bankruptcy Code and a trustee was appointed. On May 12, City filed a financing statement covering all of Lux's equipment. On May 14, Safe filed a financing statement covering the equipment it had sold to Lux on May 5.

- On July 10, Safe loaned $600,000 to Cam Corp., which used the funds to refinance existing debts. Cam duly executed and delivered to Safe a promissory note and a security agreement covering Cam's existing and after-acquired inventory of machine parts. On July 12, Safe filed a financing statement covering Cam's inventory of machine parts. On July 15, Best Bank loaned Cam $200,000. Contemporaneous with the loan, Cam executed and delivered to Best a promissory note and security agreement covering all of Cam's inventory of machine parts and any after-acquired inventory. Best had already filed a financing statement covering Cam's inventory on June 20, after Best agreed to make the loan to Cam. On July 14, Dix, in good faith, purchased certain machine parts from Cam's inventory and received delivery that same day.

Required: Define a purchase money security interest. In separate paragraphs, discuss whether Safe has a priority security interest over:

- The trustee in Lux's bankruptcy with regard to the equipment sold by Safe on May 5.
- City with regard to the equipment sold by Safe on May 5.
- Best with regard to Cam's existing and after-acquired inventory of machine parts.
- Dix with regard to the machine parts purchased on July 14 by Dix.

NUMBER 7


Required:
As the auditor on this engagement, write a memo to the partner-in-charge identifying, explaining and stating your conclusions about the legal issues pertaining to the security interest.

The memo should address:

- When Crane’s security interest was perfected and whether it had priority over Acorn’s security interest.
Chapter Three:  Secured Transactions

Multiple Choice Answers

1. (a) With an after-acquired property clause, the creditor takes as collateral property that the debtor will acquire at a later date. It is most often used with inventory and equipment. Thus, only (a) is correct.

2. (c) Three elements are required for attachment: an agreement between the debtor and the creditor, value must be given by the creditor and the debtor must have rights in the collateral. A proper filing of a security agreement is not needed for attachment. It is one of the three ways to perfect. Thus, only (c) is correct.

3. (b) Three elements are required for attachment: an agreement between the debtor and the creditor, value must be given by the creditor and the debtor must have rights in the collateral. The first element requires the debtor to agree to a security interest. Answer (a) is incorrect because the debtor must have rights in the collateral, but need not have title. Answer (c) is incorrect because possession by the creditor is not required when a written security agreement exists. Answer (d) is incorrect because filing is not required for attachment. It is one of the three ways to perfect.

4. (c) Three elements are required for attachment: an agreement between the debtor and the creditor, value must be given by the creditor and the debtor must have rights in the collateral. Failure of the debtor to have rights in the collateral will always prevent attachment. Answer (a) is incorrect because a written security agreement is not required when the creditor has possession with the debtor’s agreement. Answer (b) is incorrect because possession by the creditor is not required when a written security agreement exists. Answer (d) is incorrect because the creditor need only give value, not present consideration.

5. (a) Three elements are required for attachment: an agreement between the debtor and the creditor, value must be given by the creditor and the debtor must have rights in the collateral. A proper filing is not required for attachment. It is one of the three ways to perfect. Answers (b), (c) and (d) reflect elements of attachment.

6. (d) Three elements are required for attachment: an agreement between the debtor and the creditor, value must be given by the creditor and the debtor must have rights in the collateral. Attachment occurred when the loan was made because an executed agreement was present, Pine gave value by making the loan and the debtor certainly had rights in the collateral since the collateral was all of the debtor’s receivables. Answers (a) and (b) are incorrect because filing is the only way to perfect with accounts receivable and no filing occurred. Answer (c) is incorrect because filing is not required for attachment. It is one of the three ways to perfect.

7. (c) There are only three different ways to perfect: by possession, by filing and perfection by attachment. Possession will not only create the security agreement required for attachment, but will also result in perfection. Thus when attachment is by possession, attachment and possession occur simultaneously. Note that they would also occur simultaneously when perfection by attachment occurs. Answer (a) is incorrect because perfection will not occur merely because the security agreement so provides. You must perfect by one of the three methods. Answer (b) is incorrect because no possession or filing occurred and perfection by attachment requires a PMSI creditor in consumer goods, not a PMSI creditor in inventory. Thus, no perfection occurred. Answer (d) is incorrect because no possession, filing or perfection by attachment occurred and therefore there is no perfection.

8. (a) A creditor with a security interest will have rights against a debtor when attachment has occurred. Three elements are required for attachment: an agreement between the debtor and the creditor, value must be given by the creditor and the debtor must have rights in the collateral. Howard will have rights against Burn (debtor), because there was a written security agreement, value was given by Howard ($500,000) and the debtor had rights in the collateral (inventory and accounts receivable). When two creditors are fighting over the same collateral, usually the first creditor to perfect wins. Since Howard perfected by filing before Green gave credit, Howard’s security interest has priority over Green. The only answer stating the security interest is valid with respect to both Burn and Green is (a).
9. (d) With perfection by possession, the creditor lends money secured by possession of the debtor’s personal property. A pawnbroker lends money secured by possession of personal property of the debtor. Answer (a) is incorrect because the bank does not take possession of the land with a mortgage. Answer (b) is incorrect because with money being borrowed to purchase inventory, possession of the inventory is by the debtor, not the creditor. Answer (c) is incorrect because with car loans, the debtor has possession of the car, not the creditor.

10. (b) There are only three different ways to perfect: by possession, by filing and perfection by attachment. Since Grey sold on credit, Grey did not take possession. Grey did not file. Perfection by attachment occurs when there is a PMSI creditor in consumer goods (frequently on the exam it is a store selling goods on credit to consumers). Grey did perfect by attachment because Grey was a PMSI creditor (Grey sold the computer on credit) in consumer goods (West bought for his own personal use). Answer (a) is incorrect because retention of ownership is not one of the three ways to perfect. Answers (c) and (d) are incorrect because Grey is perfected by attachment.

11. (a) A financing statement must be signed by the debtor, contain a description of the collateral and the addresses of the parties. It does not require an after-acquired property clause (although it may have one), the creditor’s signature or the location of the collateral. Thus the only correct answer is (a).

12. (b) With accounts receivable the only way to perfect is by filing. Perfection cannot be by possession since there is nothing to possess. Accounts receivable is intangible property. Perfection cannot be by attachment since that requires a PMSI creditor in consumer goods. Accounts receivable are not consumer goods. Thus the only correct answer is (b).

13. (c) A secured creditor perfects to provide protection against most subsequent third parties. This is the reason that with two secured creditors in the same collateral, the first creditor to perfect usually wins. Thus, perfection does establish a priority over the claims of most subsequent creditors. Answer (a) is incorrect because filing a financing statement is one of the three ways to perfect. Answer (b) is incorrect because perfection merely allows a creditor a priority over subsequent parties. Another creditor may still obtain a security interest in collateral that is already perfected, they will just have a lower priority in most cases. Answer (d) is incorrect because with perfection by filing or attachment, the debtor may have possession of the collateral.

14. (b) With negotiable instruments, possession is the only way to perfect. Answers (a), (c) and (d) are incorrect because they state there are other ways to perfect with negotiable instruments.

15. (c) There are only three different ways to perfect: by possession, by filing and perfection by attachment. Perfection by attachment occurs when there is a PMSI creditor in consumer goods (frequently on the exam it is a store selling goods on credit to consumers). Since Mars is a PMSI creditor (Mars sells VCRs on credit), they can only perfect without filing or taking possession by selling to consumers. Answers (a), (b) and (d) are incorrect because retailers and wholesalers are not consumers.

16. (c) If collateral that has been perfected is moved to a new state, it remains perfected for four months after arriving in the new state. Larkin perfected in Whiteacre. When the collateral was moved to Blackacre, Larkin’s perfected interest remained effective for four months after it arrived in Blackacre. When Elk defaulted two months after arriving in Blackacre, Larkin’s perfected security interest was still effective and would have priority over Quarry because Larkin filed prior to Quarry. Answer (a) is incorrect because Larkin’s time to file had not expired. Answer (b) is incorrect because filing provides constructive notice of the security interest. Actual notice is not required. Answer (d) is incorrect because repossession is not required for Larkin to have priority.

17. (a) One who buys from a merchant in the ordinary course of business takes free of all security interests, even if they had notice of the security interest. Sax purchased the saw from a merchant in the ordinary course of business and will therefore take free of Cary’s security interest regardless of notice (either actual or constructive). Thus (a) is correct and (d) is incorrect. Answer (b) is incorrect because, for a financing statement to be valid, it need only contain a general description of the type of collateral. It does not require a specific description. For example, the inventory of a hardware store would be a sufficient description. You would not need to list each specific piece of hardware. Answer (c) is incorrect because Sax took free of Cary’s security interest and need not pay anything.
18. (d) One who buys from a merchant in the ordinary course of business takes free of all security interests, even if they had notice of the security interest. Answers (a) and (b) are incorrect because there is no indication that the goods were bought from a merchant. The answers only state they were bought by a merchant. Answer (c) is also incorrect because the goods were not bought from a merchant.

19. (b) One who buys from a merchant in the ordinary course of business takes free of all security interests, even if they had notice of the security interest. The purchaser does not need to be a consumer. They may also buy for business purposes as long as they are buying in the ordinary course of business. Both Zone and Cray bought from a merchant (Ace) and therefore took free of Rome’s security interest. Thus, (b) is correct and (a) is incorrect. Answer (c) is incorrect because a creditor automatically has a security interest in the proceeds of the sale of his collateral unless expressly excluded. Answer (d) is incorrect because a security interest may include an after-acquired property clause and usually does with inventory.

20. (c) One who buys from a merchant in the ordinary course of business takes free of all security interests, even if they had notice of the security interest. The purchaser does not need to be a consumer. They may also buy for business purposes as long as they are buying in the ordinary course of business. Wilks bought the motor from a merchant for business purposes and therefore took free of GAC’s security interest even though Wilks knew of the security interest. Answer (a) is incorrect because one who buys from a merchant takes free of security interests regardless of notice. Answer (b) is incorrect because Wilks can buy for business purposes and still take free of security interests. Answer (d) is incorrect because Wilks prevails regardless of GAC’s date of filing.

21. (c) One who buys from a merchant in the ordinary course of business takes free of all security interests, even if they had notice of the security interest. Answers (a), (b) and (d) are incorrect because a prior perfected creditor will have priority over other creditors, a trustee in bankruptcy and personal injury judgment creditor. A prior perfected creditor has priority over most other creditors (including the trustee in bankruptcy who is acting for creditors), unless a PMSI creditor is involved.

22. (c) Usually a prior perfected creditor has priority over a purchaser from the debtor. Specifically, one who buys from a nonmerchant would lose to a creditor who had previously filed. Jacobs bought the computer from Wine, who was not a merchant and MJC had previously filed. Thus, MJC has priority over Jacobs and may repossess. Answer (a) is incorrect because filing provided constructive notice to Jacobs and actual notice is not required. Answer (b) is incorrect because even a consumer who buys from a nonmerchant loses to a creditor who had previously filed. Answer (d) is incorrect because Jacobs is not personally liable to MJC.

23. (a) Usually the first creditor to file or perfect has priority, unless a PMSI creditor is involved. There are no PMSI creditors involved. One can perfect by filing, by possession or by attachment. Filing of a financing statement on April 1 was the first to perfect, taking of possession on April 10 would be the second to perfect and the creditor who perfected on April 15 would be third. Since there are no PMSI creditors involved, the order of priority is I, II, III. Only answer (a) reflects this order.

24. (d) Usually the first creditor to file or perfect has priority, unless a PMSI creditor is involved. A secured creditor who perfected by filing on April 1 would have priority over a judgment lien creditor who filed on April 15 because they were the first to file. Answers (a) and (b) are incorrect because these creditors filed before April 1. Answer (c) is incorrect because one who purchases in the ordinary course of business takes free of all security interests.

25. (d) A PMSI creditor in noninventory collateral who files within ten days of giving possession will have priority over other creditors. Since the goods were delivered on June 15, the purchase money security interest creditor perfected within the 10 day grace period and would have a priority over all other creditors. Thus, answers (a), (b) and (c) are incorrect. Additionally, answers (a) and (b) are incorrect because attachment is only effective against the debtor and has no bearing on other creditors.
26. (d) A PMSI creditor in noninventory collateral who files within ten days of giving possession will have priority over other creditors. Eastern is a PMSI creditor in equipment because Eastern expressly loaned the money to purchase that equipment. The debtor received possession on June 15 and Eastern filed within ten days on June 23. Thus, Eastern will have priority over the trustee in bankruptcy, even though the date of the filing of bankruptcy was June 21, two days earlier. Answers (a) and (b) are incorrect because the trustee in bankruptcy does not have priority over a PMSI creditor who took correct action. Answer (c) is incorrect because the only way for Eastern to perfect was by filing. Eastern did not take possession and perfection by attachment requires consumer goods, not business equipment.

27. (a) Usually the first creditor to file or perfect has priority over other creditors, unless a PMSI creditor is involved. Roth perfected before Dixon. There is no indication that either creditor was a PMSI creditor. Answers (b) and (c) are incorrect because attachment is only effective against a debtor and has no bearing on other creditors. Answer (d) is incorrect because Roth perfected before Dixon took possession.

28. (c) Usually the first creditor to file or perfect has priority over other creditors, unless a PMSI creditor is involved. Neither Safe nor State is a PMSI creditor because the collateral (existing equipment) was not expressly bought with their money or credit. Since Safe filed on May 4 and State filed on May 8, Safe had priority by being the first to file. Note that Safe is counted as being perfected on May 4 (the date Safe filed), not on May 10 (the date Safe loaned the money). Answers (a) and (b) are incorrect because State does not have priority. Answer (d) is incorrect because Safe was not a PMSI creditor.

29. (c) A PMSI creditor in noninventory collateral who files within ten days of giving possession will have priority over other creditors. Thus, (III) has the top priority. Attachment is only effective against a debtor and has no bearing on other creditors. Thus, (II) has the lowest priority, not having been perfected. (I) would have priority over a creditor who had only attached, but would not have priority over the PMSI creditor. The only answer that reflects this order is (c).

30. (c) Three elements are required for attachment: an agreement between the debtor and the creditor, value must be given by the creditor and the debtor must have rights in the collateral. There is no attachment until all three have occurred. On June 3 Page signed the security agreement and Muni gave value by loaning $20,000. Page only had rights in the collateral on June 7, the date of purchase. Thus, attachment occurred on June 7 and (b) and (d) are incorrect. Answer (a) is incorrect because the money was expressly loaned to purchase the computers, making Muni a PMSI creditor.

31. (c) A PMSI creditor in noninventory collateral who files within ten days of giving possession will have priority over other creditors. Muni was a PMSI creditor because the money Muni loaned was expressly to purchase the computers. The computers were equipment to Page and Muni filed within ten days. Thus, Muni has priority over Mort, the judgment creditor. Answers (a) and (b) are incorrect because Mort does not have priority over Muni. Answer (d) is incorrect because perfection by attachment can only occur with consumer goods and the computers were equipment to Page.

32. (d) A mechanics lien has priority over previously perfected security interests as long as the mechanic is in possession of the goods and state law does not provide otherwise. Answer (a) is incorrect because a mechanics lien does not have priority in a state that expressly provides otherwise and it does not have priority when the mechanic is not in possession. Answer (b) is incorrect because a mechanics lien has priority over a prior perfected security interest in most cases. Answer (c) is incorrect because a mechanics lien will have priority if there is no specific state statute to the contrary.

33. (a) If the debtor defaults the creditor may peacefully repossess the collateral without going to court, may sue the debtor for debt and get a judgment and may sell the goods and apply the proceeds to the debt. The only answer that states all three are permissible is (a).
34. **(b) If the debtor has paid 60% or more of the price of consumer goods, a creditor who has repossessed must sell the collateral within 90 days unless the debtor waives this right.** Foxx had paid 60% or more of the $600 price. Foxx paid 30% down ($180) and made 6 of 12 payments ($210). A stereo for personal use is consumer goods. Thus Dix must sell within 90 days. Answer (a) is incorrect because Dix may sell at a public or private sale. Answers (c) and (d) are incorrect because Dix may not retain the goods unless Foxx waives the right to require sale.

35. **(a) Usually a prior perfected creditor has priority over a purchaser from the debtor. Specifically, one who buys from a nonmerchant would lose to a creditor who had previously filed.** Lutz bought the stereo from Foxx, who was not a merchant and Dix had previously filed. Thus, Dix has the superior interest because of a previous filing. Answer (b) is incorrect because the fact that 30% of the purchase price was paid would not allow Dix to prevail. Answers (c) and (d) are incorrect because Dix may not retain the goods unless Foxx waives the right to require sale.

36. **(a) If a debtor defaults the creditor may peacefully repossess the collateral and sell it. If the proceeds of the sale are insufficient to pay for the debt owed, the creditor has the right to sue the debtor for a deficiency judgment.** Answer (b) is incorrect because any surplus over the amounts owed and expenses must go to the debtor. Answer (c) is incorrect because Drew has paid 60% or more of the price of consumer goods and therefore Hale must sell. Answer (d) is incorrect because the creditor must notify the debtor if the creditor is going to sell the collateral.

37. **(c) If the debtor has paid 60% or more of the price of consumer goods, the creditor must sell unless the debtor waives this right.** Drew paid $2,000 of the $3,000 price and the computer was consumer goods because it was bought for Drew’s personal use. Thus, Drew may force a sale. Answer (a) is incorrect because Drew does not have the right to redeem after sale. Answer (b) is incorrect because after sale the debtor only receives the surplus (if any) after all creditor debts and expenses are paid. Answer (d) is incorrect because if the debtor defaults, the creditor may peacefully repossess and sell.

38. **(a) After default the creditor may peacefully repossess the collateral and obtain a judgment against the debtor.** The only answer indicating both may be done is (a).

39. **(a) A sale of repossessed collateral to a good faith purchaser for value discharges that security interest and all subordinate liens.** Answer (b) is incorrect because a debtor may redeem collateral repossessed as long as the debtor does so prior to sale and pays all creditors. Answer (c) is incorrect because a sale discharges that security interest and all subordinate liens. Answer (d) is incorrect because after repossession, the creditor may sell the collateral at a public or private sale.

40. **(b) A sale of repossessed collateral to a good faith purchaser for value discharges that security interest and all subordinate liens.** Thus (b) is correct and (a) is incorrect. Answer (c) is incorrect because although a creditor may not usually bid at a private sale, some exceptions exist (for example, if the collateral has a standard market price the creditor can bid). Answer (d) is incorrect because Bonn will only receive a first priority if Bonn’s security interest is superior to all other security interests and this not indicated in the problem. Thus, Bonn may or may not receive first priority.
Chapter Three: Secured Transactions
Other Objective Format Answers

ANSWER 1

1. (E) A creditor who advances money to a debtor to obtain collateral and retains a security interest in the collateral is a purchase money security interest creditor.

2. (I) The security agreement between the debtor and the creditor may be written or oral. An oral agreement is only sufficient if the creditor has possession (sometimes called a pledge). There is no security interest because there was no written security agreement and the creditor did not have possession of the collateral.

3. (H) There are three different ways to perfect: by possession, by filing a financing statement and by attachment. Perfection by possession occurs when the creditor takes possession of the collateral with the debtor’s agreement, as in 3. Thus, a security interest was perfected without filing.

4. (G) There are three different ways to perfect: by possession, by filing a financing statement and perfection by attachment. A creditor who files a financing statement has perfected by filing.

5. (C) A perfected creditor has priority over an unperfected creditor. There are three different ways to perfect: by possession, by filing a financing statement and perfection by attachment. A creditor who files a financing statement on October 15 has perfected by filing. A creditor with only a signed but unfiled security agreement has not perfected by any of the three methods. Thus, the creditor who filed on October 15 will have a priority due to perfection over the unperfected creditor.

ANSWER 2

1. (B) Three elements are required for attachment: an agreement between the debtor and the creditor, value must be given by the creditor and the debtor must have rights in the collateral. All three requirements must be met for attachment to occur. The agreement between Gray and Shore occurred on January 2 and Gray had rights in the sofa on that date. However, the value given by Shore was the sofas Shore sold on credit. The sofas were delivered on March 1. Thus, only on March 1 were all three requirements met.

2. (C) There are only three different ways to perfect: by possession, by filing a financing statement and perfection by attachment. Shore filed a financing statement on March 10 and perfected on that date.

3. (A) Three elements are required for attachment: an agreement between the debtor and the creditor, value must be given by the creditor and the debtor must have rights in the collateral. All three requirements must be met for attachment to occur. The agreement between Gray and Float occurred on February 1. The value given by Float was the $1,000,000 line of credit, which was given on February 1. Since the collateral involved was Gray’s inventory, Gray certainly had rights in the collateral on February 1. Thus, on February 1 attachment occurred.

4. (C) There are only three different ways to perfect: by possession, by filing a financing statement and perfection by attachment. Float filed a financing statement on March 5 and perfected on that date.

5. (B) Usually the first creditor to perfect has priority over other creditors. Float was the first creditor to perfect. A PMSI Creditor can have priority over an earlier perfected security interest if certain requirements are met. Shore is a PMSI Creditor because Gray obtained the sofas with Shore’s credit. To have priority over an earlier perfected security interest, a PMSI Creditor in inventory collateral must file before the debtor takes possession and give written notice to creditors ahead of him. Shore filed after the sofas were delivered and never gave notice to Float. Since Shore did not meet the requirements to have priority as a PMSI Creditor, Float has priority because Float filed first.

6. (C) One who buys from a merchant in the ordinary course of business takes free of all security interests, even if they had notice of the security interest. Dove is a consumer in the ordinary course of business, who purchased the sofa from Gray, a merchant. Even though Dove was aware of both security interests, Dove acquired the sofa free of either the Shore or Float security interest.
**ANSWER 3**

Rice's assertion that Abco does not have an effective security interest in the CDM computer purchased by Rice is correct. For Abco to have an enforceable security interest in the collateral, the security interest claimed must have attached. Attachment requires that:

- The secured party (Abco) has given value;
- The debtor (Rice) has rights in the collateral; and
- The debtor (Rice) has executed and delivered to the creditor (Abco) a security agreement covering the collateral.

In this case, all but one of the requirements are met. The security agreement is ineffective because it was not signed by the debtor (Rice). Abco's failure to perfect its security interest by filing a financing statement would have no effect on the enforceability of the security interest against Rice.

Condor's assertion that its security interest in the computer is superior to Abco's is incorrect. Both Condor's and Abco's security interests are perfected. Condor's security interest was perfected when it filed its financing statement on August 26. Because Abco's security interest was a purchase money security interest in collateral other than inventory, its security interest was perfected at the time of the sale to Baker (August 18), provided it filed a financing statement at the time Baker took possession of the computer or within the UCC time period for perfection. Abco's security interest was perfected on August 18 before Condor's was perfected (on August 26), because Abco filed a financing statement within the applicable UCC time period. Therefore, Abco's security interest is superior to Condor's.

**ANSWER 4**

Kast's assertion that the computer was purchased from Wizard free of National's security interest is correct. Kast, as a buyer in the ordinary course, purchased the computer free of any security interest given by Wizard. The fact that Kast was aware of the existence of National's security interest does not affect this conclusion.

Marc's assertion that the computer was purchased from Kast free of Wizard's security interest is correct. Marc purchased the computer from Kast free of Wizard's security interest because:

- Marc had no knowledge of the security interest;
- Marc was buying the computer for household use;
- Wizard's security interest had not been perfected by filing prior to Marc's purchase.

Marc's assertion that Alcor's security interest is unenforceable against Marc because Alcor failed to file a financing statement is incorrect. On attachment of Alcor's security interest, it became enforceable against Marc. Attachment has occurred because:

- The secured party (Alcor) gave value;
- The debtor (Marc) has rights in the collateral;
- The debtor (Marc) has executed and delivered a security agreement covering the collateral to the creditor (Alcor).

Alcor's failure to perfect its security interest has no effect on the enforceability of the security interest against Marc.
**ANSWER 5**

- Zeals has priority over Despard regarding the competing security interests of the parties. Zeals is a purchase money secured party involving the sale of consumer goods. As such, the security interest is enforceable against other creditors of the buyer without the necessity of a filing. Despard would also attempt to assert a purchase money security interest in the goods, but this is questionable at best since the money advanced was obviously not used for the purchase of the goods. Even if Despard qualified as a purchase money secured party, Despard was second in point of time. The fact that it filed does not change the priority, since filing was not required to perfect the interest in the consumer goods (the video system).

- Apache has priority over Despard in this instance. Although Despard was the first to advance credit and qualified as a purchase money lender, it was second in time to perfect its security interest. The subject matter of the sale was equipment, and filing is required to perfect Despard's security interest. The purchase money lender has the benefit of a 10-day grace period for filing. Despard's security interest was not perfected until it filed, which was after the grace period and five days after Apache's filing.

**ANSWER 6**

A purchase money security interest is an interest in personal property or fixtures that secures payment or performance of an obligation and that is (1) taken or retained by the seller of the collateral to secure all or part of its price, or (2) taken by a person who by making advances or incurring an obligation gives value to enable the debtor to acquire rights in or the use of collateral if such value is in fact so used.

Safe's security interest has priority over the rights of the trustee in bankruptcy. The UCC Article on Secured Transactions states that a lien creditor includes a trustee in bankruptcy from the date of the filing of the petition. Under the general rule, an unperfected security interest is subordinate to the rights of a person who becomes a lien creditor before the security interest is perfected. However, if the secured party files with respect to a purchase money security interest before or within 10 days after the debtor receives possession of the collateral, he takes priority over the rights of a lien creditor that arise between the time the security interest attaches and the time of filing. Under the facts of our case, Safe has a purchase money security interest in the equipment because the security interest was taken by Safe to secure the price. Therefore, because Safe filed a financing statement on May 14 (within 10 days after Lux received possession of the equipment) it has a priority security interest over the trustee in bankruptcy (lien creditor) whose claim arose between the time the security interest attached (May 5) and the time of filing (May 14).

Safe has a priority security interest in the equipment over City. A purchase money security interest in collateral other than inventory has priority over a conflicting security interest in the same collateral if the purchase money security interest is perfected at the time the debtor receives possession of the collateral or within 10 days thereafter. Because Safe has a purchase money security interest in the equipment that was perfected by filing a financing statement on May 14 (within 10 days after Lux received possession of the equipment on May 5), Safe has a priority security interest over City despite City's perfection of its security interest on May 12.

Best's security interest in the inventory has priority over Safe's security interest. In general, conflicting perfected security interests rank according to priority in time of filing or perfection. Priority dates from the time a filing is first made covering the collateral or the time the security interest is first perfected, whichever is earlier, provided that there is no period thereafter when there is neither a filing nor perfection. In this case, because both Best's and Safe's security interests were perfected by filing, the first to file (Best) will have a priority security interest. The fact that Best filed a financing statement prior to making the loan will not affect Best's priority.

Safe will not have a priority security interest over Dix because Dix is a buyer in the ordinary course of business and will take free of Safe's perfected security interest. Dix is a buyer in the ordinary course of business because Dix acted in good faith when purchasing the machine parts in the regular course of Cam's business. The UCC Article on Secured Transactions states that a buyer in the ordinary course of business takes free of a security interest created by his seller even though the security interest is perfected and even though the buyer knows of its existence. Therefore, Dix will take the machine parts purchased from Cam's inventory on July 14, free from Safe's security interest which was perfected on July 12.
ANSWER 7

To:
From:

I have identified and explained the issues and offer my conclusions on the legal issues pertaining to the security interest:

- Was Crane’s security interest perfected and does it have priority over Acorn’s security interest?

The perfection of the security interest relates back to the date Harper took possession of the tractor (collateral) (October 5, 1995) because the security interest was a non-inventory purchase money security interest, and the financing statement was filed on October 10, 1995 (within the statutory filing period). Accordingly, Crane’s security interest has priority over Acorn’s security interest despite Acorn’s earlier filing on October 9, 1995.
Chapter Four
Negotiable Instruments

TYPES OF NEGOTIABLE INSTRUMENTS ................................................................. 4-1

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Chapter Four
Negotiable Instruments

*** TYPES OF NEGOTIABLE INSTRUMENTS ***

1. A Note or Promissory note is an unconditional written promise by a maker to pay a certain sum of money to a payee. (It is a promise to pay)
   a. the maker is the issuer and the one promising to pay
   b. the payee is the party that is to receive the money
   c. a time note is payable at a specified time in the future
   d. a demand note is payable on demand (payable immediately on presentation)

2. A Certificates of Deposit is a note signed by a bank acknowledging the receipt of money and promising to repay with interest (i.e. It is a bank promissory note)

3. A Draft is a written instrument in which a drawer unconditionally orders a specified drawee to pay a certain sum of money to a payee. (an order to a 3rd party to pay)
   a. the three parties are the Drawer (the issuer), the Payee (the party to receive the money), and the Drawee (the party that is ordered to pay the payee)
   b. sight drafts are drafts payable on demand (payable immediately on presentation)
   c. time drafts are drafts payable at a specified time in the future

4. A check is a special type of draft with two additional requirements
   a. the drawee must be a bank
   b. the check must be payable on demand (payable immediately on presentation)
   c. a cashier's check is a bank check and the bank is both the drawer and drawee

5. A Trade Acceptance is a draft by a seller ordering a buyer to pay the seller or some 3rd party at a future time (it is an order to a 3rd party to pay)
   a. a trade acceptance results in the buyer having additional time to pay for goods
   b. the seller is usually both the drawer and the payee of the instrument
   c. the buyer is the drawee and accepts by signing in lower left hand corner of the instrument
   d. the seller is secondarily liable on the instrument and the buyer becomes primarily liable on the date that they accept

6. Investment Securities (stocks and bonds) & Documents of Title (warehouse receipts and bills of lading) are not Commercial Paper but they follow many of the same rules

*** 5 ELEMENTS OF NEGOTIABILITY***

1. In order for an instrument to be a negotiable instrument, it must meet the 5 elements of negotiability (a nonnegotiable instrument is governed by the law of contracts)
   a. it must be in writing Signed by the maker or drawer
   b. it must be an Unconditional promise or order
   c. it must be payable in a certain sum of Money
   d. it must be payable to Bearer or Order
   e. it must be payable on Demand or at a definite time
The written instrument must be **Signed** by the maker or the drawer:

a. a signature is any type of mark made with an intent to validate the writing

b. e.g. the signature may be printed, stamped, typed or even done in pencil

3. The promise or order must be **Unconditional** or the instrument is nonnegotiable

a. an instrument is **not negotiable** if it is **subject to** another agreement or **contingent** upon a specified occurrence
   1) reference may be made to another agreement without affecting negotiability
   2) but if it is **subject to** the agreement or **contingent upon** satisfactory completion of the agreement then it is nonnegotiable

b. **exception**: an instrument can be **subject to implied or constructive conditions** and be negotiable. It must be subject to an express condition to destroy negotiability

**Example:** The statement "this note arises out of a contract between the parties dated May 13, 2000 for the purchase of a 2000 Ford Taurus to be delivered on May 20, 2000" would not affect negotiability, for it is a mere reference to the contract. If it were "subject to all the terms of said contract" or "contingent upon satisfactory completion of said contract," it would be nonnegotiable. However, if it stated it was "subject to all implied conditions of said contract," it would be negotiable.

c. references to collateral or security are permissible and do not prevent negotiability

d. provisions as to consideration are permissible and do not prevent negotiability

4. The instrument must be payable in a fixed amount of **Money**

a. it must be **payable in money and nothing else** but money
   1) money may be any type of legal tender to include foreign currency
   2) e.g. an instrument payable in money or stock is not negotiable
   3) the instrument cannot require doing anything additional to the payment of money (e.g. an instrument payable in money and services is not negotiable)

b. it **must be** payable in a **fixed amount**. The following are permissible and will **not** prevent the amount from being a fixed amount
   1) collection costs, to specifically include attorney's fees upon default
   2) provisions as to interest (e.g. variable interest rate provision is negotiable as is an instrument stating it is payable with interest but without specifying the rate)
   3) it is a fixed amount even if the words and numbers differ (the words control)

5. The instrument must be payable to **Bearer** or to **Order**, the magic words of negotiability

a. an instrument that is bearer paper names no specific payee and can be transferred without endorsement, just like cash. **Examples** of bearer paper:
   1) payable "to bearer" or "to the order of the bearer"
   2) payable "to a specified party or the bearer" (e.g. to James Dokes or bearer)
   3) payable "to cash" or "to the order of cash"
4). an instrument that omits the name of a payee is a negotiable bearer instrument (e.g. "pay to the order of ___________") is negotiable and payable to bearer

b. order paper is an instrument payable to a designated party and requires that party's endorsement for further negotiation. **Examples** of order paper:

1). pay "to the order of James Dokes"

2). pay "to Jane Jart or her order"

c. if it is not payable to bearer or order, it is nonnegotiable (e.g. pay to Jane Jart)

d. **exception**: checks do not have to be payable to order or bearer to be negotiable

6. The instrument must be payable on Demand or at a definite time

a. an instrument is payable on demand when it must be paid upon the holder's request

1). it is payable on demand if no time of payment is specified

2). it is payable on demand if it is payable "at sight" or "at presentment"

b. an instrument may also be payable at a definite time in the future. **Examples**:

1). negotiable if it is payable "on or before June 1" (thus prepayment is allowed)

2). negotiable if it is payable "30 days after presentment or 30 days after sight"

3). negotiable if it is payable at a fixed time subject to acceleration

4). negotiable if it may be extended from a definite time to an other definite time (e.g. payable May 1 and Maker may elect to extend the date to June 1)

c. an instrument may be postdated, antedated, or undated and be negotiable

d. it is not negotiable if the date of payment can not be determined

1). e.g. not negotiable if it was payable "10 days after X's death" or payable "10 days after the sale of my house"

2). e.g. not negotiable if it was payable "30 days after date" and undated. Note it would be negotiable if it had been dated

7. Once an instrument is negotiable on its front, it is always negotiable

a. thus, nothing placed on the back of the instrument will prevent further negotiation

b. e.g. an endorsement on the back of an instrument does not have to contain the magic words of negotiability "payable to bearer or pay to the order of"

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**NEGOTIATION**

1. Negotiation is transferring Commercial Paper to a 3rd party, a **holder** (note: the transfer of a nonnegotiable instrument is an assignment and is governed by contract law)

2. Negotiation of bearer paper requires mere transfer of possession

a. voluntary transfer of an instrument requires mere delivery

b. because bearer paper can be transferred without endorsement, anyone in possession of bearer paper qualifies as a holder (e.g. even a finder or a thief)

3. Negotiation of order paper requires both delivery and endorsement by the proper parties

a. thus, to be a holder a party must have both possession and a proper endorsement

b. if order paper is transferred without a required endorsement, the immediate transferee has the right to an unqualified endorsement by the transferor

4. All endorsements are either **Blank endorsements** or **Special endorsements**

a. in a **Blank endorsement**, the payee signs without naming a new payee

1). e.g. an instrument endorsed Sadie Brown is a blank endorsement as is Janet Jart, without recourse because no new payee was named

2). a **blank endorsement** always makes the instrument **bearer paper**

3). holder of an instrument with a blank endorsement may write a new payee above the blank endorsement and convert it to order paper
b. in a **Special endorsement**, the payee signs and names a new payee
   1). **e.g.** *Pay to John Jones* (signed) *Betty Brown* is a special endorsement (**note**: the words of negotiability "*Pay to the order of John Jones*" were not needed)
   2). a **special endorsement** always makes the instrument **order paper** (thus, the endorsement of the new payee is required for further negotiation)

5. In a **Restrictive endorsement** the payee adds a restriction or condition, **but** doesn't prevent further negotiation or transfer of the instrument
   a. **e.g.** "*Bill Bates, for deposit only*" or "*Mickey Finn, for collection only*"
   b. **note:** "*Bill Bates, for deposit only*" is both a **blank** and a **restrictive** endorsement

6. In a **Qualified endorsement** the payee adds the words "**without recourse**" either before or after their name for the purpose of limiting their legal liability
   a. it eliminates contract liability for the endorser (**no guarantee of payment**)
   b. it does not eliminate the warranty liability of the endorser
   c. it doesn't destroy negotiability or prevent further negotiation or transfer of the instrument

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**CONTRACT LIABILITY**

1. **Contract liability** is a **guarantee of payment** of the instrument
   a. **contract liability** is imposed **only from signing** the instrument or having an authorized agent sign the instrument (**e.g.** one who transfers without endorsement has no contract liability because (s)he didn't sign)
      1). an agent with authority who signs an instrument for a principal and indicates (s)he is an agent is not liable on the instrument, only the principal is liable
      2). if an agent with authority signs an instrument without indicating that (s)he is an agent, only the agent has contract liability on the instrument
   b. parties with contract liability are either primary or secondary liable
   c. liability extends to the immediate transferee and all subsequent transferees

2. **Primary liable** parties are the parties first expected to pay on the instrument
   a. **Makers** of notes are primarily liable (they are the first one expected to pay)
   b. **Drawee** of a draft is primarily liable, but only after they accept or certify the draft
      **note:** the drawee has **no liability** until they accept or certify and once the drawee accepts or certifies they are called an **acceptor**
      1). an acceptance must be written on the draft, but it can be typed, stamped, signed, etc.
      2). certification of a check by a bank is a guarantee by the bank of payment
         a). there is no obligation for a drawee to certify a check
         b). if the bank does certify, all prior parties are released from liability
         c). the party who requested the check to be certified is secondarily liable when they negotiate the check in the future

3. **Secondary liable** parties are those who are liable if the primarily liable party fails to pay when the instrument is presented
   a. **Drawers are secondarily liable**
      1). they become liable if the drawee fails to pay (dishonor) and their liability does not require notice of dishonor
      2). they aren’t primarily liable because the drawee was the 1st one expected to pay
   b. **Endorsers are secondarily liable**
      1). To become liable, the instrument must be dishonored and they must be given notice of dishonor
      2). **exception:** a qualified endorser (endorses "without recourse") is not secondarily liable and does not guarantee payment
4. Time period in which uncertified checks should be presented
   a. must present within 30 days to hold drawers liable
   b. must present within 7 days to hold endorsers liable

WARRANTY LIABILITY -- of any transferor of Commercial Paper

1. Any party who transfers commercial paper for consideration makes five warranties
   a. warrant they have good title and the right to enforce the instrument
   b. warrant all signatures on the instrument are genuine or authorized (i.e. no forgeries)
   c. warrant the instrument has not been materially altered (this usually involves raising the dollar amount on the exam)
   d. they warrant no knowledge of any insolvency proceeding against the issuer
   e. they warrant that the instrument is not subject to any valid defense or claim of another party

2. If the transfer is made by endorsement, these five warranties are made to the immediate transferee and to all subsequent transferees

3. If the transfer is made without endorsement
   a. warranties are only made to the immediate transferee, not subsequent transferees
   b. one who transfers without endorsement has warranty liability to the immediate transferee, but does not have contract liability

ACCOMMODATION PARTIES

1. An accommodation party is a surety who lends their name to commercial paper to facilitate it being cashed
   a. they have contract liability like any other party because they have signed the instrument, except to the party they accommodated
   b. they do not have warranty liability

2. Accommodation endorsers are secondarily liable (except to the one accommodated)
   a. they are sometimes called an anomalous endorser
   b. an accommodation endorser is not in the chain of title

3. An accommodation party signing on behalf of a maker is primarily liable

***HOLDERS IN DUE COURSE***

1. A Holder is one who possesses a negotiable instrument with all necessary endorsements

2. A Holder In Due Course (HIDC) is anyone who satisfies four requirements
   a. transferee must be a Holder of a negotiable instrument (i.e. must have possession of a negotiable instrument containing all necessary endorsements)
   b. transferee must give present Value, not future value. Present value may include:
      1). taking an instrument as payment for an antecedent debt (debt already exists)
      2). taking the instrument in exchange for another negotiable instrument
      3). acquiring the instrument as security for a debt or obligation
   c. transferee must have good Faith (i.e. the holder acted honestly)
   d. Without notice of any problems, defenses or questions of its authenticity (e.g. the instrument is overdue, missing signatures, forgeries, material alterations or holder is specifically told there is a problem such as a refusal to make payment)

3. The principal advantage of being an HIDC is that the HIDC takes the instrument free of personal defenses in nonconsumer transactions and only loses to real defenses
   a. Real Defenses are defenses that beat an HIDC - I'M BIFF
Infancy - to the extent it is a defense to a contract

Material Alterations - exception: it is not a real defense against an HIDC if the drawer was negligent

Bankruptcy when debt is discharged

Illegality or adjudicated Insanity - or any other defense which would render a contract void

Fraud in the execution only
- an HIDC will beat fraud in the inducement

Forgery (duress is sometimes a real defense but only if it makes an instrument void)

b. Personal Defenses: all other defenses are personal and an HIDC beats them in nonconsumer transactions (e.g. no consideration, fraud in the inducement, mistakes, etc.)

c. an HIDC's favored position is limited in consumer credit transactions
   1). involves a consumer who buys defective goods from a dealer or is defrauded by a dealer and pays for the goods with a negotiable instrument
   2). the consumer may use the defense that the goods were defective or the defense of fraud against the dealer and also against an HIDC

4. Shelter Provision: Holder Under Holder In Due Course (HUHIDC) - anyone who takes from an HIDC gets all of the rights of an HIDC, even if they are not an HIDC

Example: X obtains a check from A by means of fraud in the inducement and transfers the check to an HIDC. The HIDC transfers the check to Z who knows of the fraud. Z can collect on the check from A even though Z knew of the fraud because Z is a Holder Under a Holder In Due Course (HUHIDC) and acquired all of the HIDC's rights.

FORGERY RULES

1. The forger is always liable

2. With forgery of the drawer's name: if the forger is missing, the drawee is liable upon acceptance and payment of the instrument

3. With forgery of the payee's name: most often good title does not pass
   a. if the forger is missing, the first one the forger passed it to is liable
   b. this is because anyone who transfers Commercial Paper warrants that all signatures are genuine

4. In two cases forgery of the payee's name does pass good title: the impostor case and the fictitious payee case
   a. impostor rule - if a drawer issues a check to an impostor, the forgery by the impostor of the real payee's name will pass good title to all subsequent parties
      1). the maker or drawer is liable and can only collect from the impostor
      2). e.g. Evil Doer tells A he is Bob Dole and induces A to loan him $500 by check. Evil forges Dole's name on the check and cashes it at 1st National Bank. A is liable for the loss and cannot collect from 1st National.
b. **fictitious payee rule** - usually involves a dishonest agent or employee who induces the employer to issue a check to a nonexistent person. The dishonest agent endorses the fictitious payee's name, cashes the check and pockets the money.

1. the maker or drawer is liable and can only collect from the agent
2. e.g. *Evil Agent* induces his boss to issue a check to *Aristotle Goldberg* (a nonexistent person). *Evil* endorses *Aristotle*'s signature and cashes the check at *1st National Bank*. The boss is liable for the loss and cannot collect from *1st National* due to the fictitious payee rule.

### DISCHARGE FROM LIABILITY

1. **Payment in full** by a party to the holder of the instrument discharges that party
   a. **exception**: if the party making payment knows the holder stole the instrument, there is no discharge
   b. **tender of full payment** only discharges a party from subsequent interest and collection costs and is not a discharge from the face amount of the instrument

2. **Intentional cancellation or destruction** of the instrument by the holder discharges all parties (e.g. intentionally writing "paid in full" across the face of the instrument)
   a. there is no discharge for accidental destruction of the instrument
   b. cancellation of one endorser's name discharges that party and no one else

3. A **written renunciation** delivered by a holder to a party, discharges that party
   a. an oral renunciation of a party's liability does not discharge that party
   b. a written renunciation is ineffective against an HIDC without notice

4. A **material alteration** fraudulently made discharges all parties adversely affected (on the exam a fraudulent material alteration usually involves raising the dollar amount)
   a. a material alteration is a complete defense against an ordinary holder
   b. a subsequent HIDC may always enforce the instrument as originally written

**Example:** *X* receives a check from *Y* for $75, which was written with due care. *X* skillfully raises the dollar amount to $750. If *X* attempts to collect on the instrument, *Y* would be completely discharged because *Y* was adversely affected. If, however, *X* transfers it to an HIDC. The HIDC may collect $75, the original amount, from *Y*.

   c. if the fraudulent material alteration was made possible by the maker's or drawer's negligence, then an HIDC or any other good faith payor may enforce the instrument in its altered form

**Example:** *X* gives *Y* a "blank check" for services to be performed by *Y*. The total amount to be paid is unknown, but it is agreed that it is not to exceed $750. *Y* fills in the amount for $1,500 and transfers it to *Z*, an HIDC. *Z* may collect $1,500 from *X*.

5. A holder who unjustifiably releases collateral discharges any party to the extent they are adversely affected by the release

6. Certification of a check by a bank discharges all prior parties

7. An unexcused delay in presentment discharges all prior endorsers
Chapter Four: Negotiable Instruments
Multiple Choice Questions

1. Under the Commercial Paper Article of the UCC, which of the following documents would be considered an order to pay?

   I. Draft
   II. Certificate of deposit

   a. I only.
   b. II only.
   c. Both I and II.
   d. Neither I nor II.

2. A company has in its possession the following instrument:

   $500  Dayton, Ohio   October 2, 1987
   Sixty days after date I promise to pay to the order of
   Cash
   Five hundred Dollars
   at Miami, Florida
   Value received with interest at the rate of nine percent per annum.
   This instrument is secured by a conditional sales contract.

   No. 11   Due December 1, 1987  Craig Burke
   Craig Burke

   This instrument is
   b. A negotiable bearer note.
   c. A negotiable time draft.
   d. A non-negotiable note since it states that it is secured by a conditional sales contract.

3. To: Middlesex National Bank
   Nassau, NY

   Pay to the order of Robert Silver $4,000.00
   Four Thousand and xx/100 Dollars
   on October 1, 1994

   Lynndexter
   Lynn Dexter
This instrument is a
a. Draft.
b. Postdated check.
c. Trade acceptance.
d. Promissory note.

4. Assuming each of the following is negotiable, which qualifies as a draft under the UCC Commercial Paper Article?
a. A warehouse receipt.
b. A demand promissory note.
d. A trade acceptance.

5. An instrument reads as follows:

<table>
<thead>
<tr>
<th>Pay to the Order of Donald Kent, Fifteen days after date, $100.00</th>
</tr>
</thead>
<tbody>
<tr>
<td>One hundred and no/100 Dollars</td>
</tr>
<tr>
<td>Union Corp. Ridgefield, Connecticut</td>
</tr>
<tr>
<td>re: down payment on auto purchase</td>
</tr>
<tr>
<td>Dale Cox</td>
</tr>
</tbody>
</table>

The instrument
a. Is non-negotiable since it incorporates the auto purchase transaction by reference.
b. Is a negotiable time draft.
c. Is a negotiable sight draft.
d. Is a non-negotiable trade acceptance.

6. A bank issues a negotiable instrument that acknowledges receipt of $50,000. The instrument also provides that the bank will repay the $50,000 plus 8% interest per annum to the bearer 90 days from the date of the instrument. The instrument is a
a. Certificate of deposit.
b. Time draft.
c. Trade or banker's acceptance.
d. Cashier's check.

7. A trade acceptance is an instrument drawn by a
a. Seller obligating the seller or designee to make payment.
b. Buyer obligating the buyer or designee to make payment.
c. Seller ordering the buyer or designee to make payment.
d. Buyer ordering the seller or designee to make payment.
8. Frank Supply Co. held the following instrument:

<table>
<thead>
<tr>
<th>Clark Novelties, Inc.</th>
<th>April 12, 1986</th>
</tr>
</thead>
<tbody>
<tr>
<td>29 State Street</td>
<td></td>
</tr>
<tr>
<td>Spokane, Washington</td>
<td></td>
</tr>
</tbody>
</table>

Pay to the order of Frank Supply Co. on April 30, 1986
ten thousand and 00/100 dollars ($10,000).

Smith Industries, Inc.

J. C. Kahn
J. C. Kahn, President

ACCEPTED: Clark Novelties, Inc.
BY: Mitchell Clark
Mitchell Clark, President

Date: April 20, 1986

As a result of an audit examination of this instrument which was properly endorsed by Frank to your client, it may be correctly concluded that
a. Smith was primarily liable on the instrument prior to acceptance.
b. The instrument is non-negotiable and thus no one has rights under the instrument.
c. No one was primarily liable on the instrument at the time of issue, April 12, 1986.
d. Upon acceptance, Clark Novelties, Inc. became primarily liable and Smith was released from all liability.

9. Which of the following negotiable instruments is subject to the UCC Commercial Paper Article?
   b. Installment note payable on the first day of each month.
   c. Warehouse receipt.
   d. Bill of lading payable to order.

10. Assuming each of the following instruments is negotiable, which qualifies as commercial paper?
    b. Investment securities endorsed in blank.
    c. Foreign currency.
    d. A foreign draft.

11. Although the scope of the Uniform Commercial Code is broad insofar as inclusion of instruments within the definition of commercial paper, it excludes certain instruments from its coverage. Which of the following is not commercial paper?
    a. A promissory note payable 30 days after presentment for payment.
    b. A draft which is an order to pay.
    c. A negotiable certificate of deposit issued by a bank.
    d. An investment security which is payable to bearer.
12. A secured promissory note would be nonnegotiable if it provided that
   a. Additional collateral must be tendered if there is a decline in market value of the original collateral.
   b. Upon default, the maker waives a trial by jury.
   c. The maker is entitled to a 5% discount if the note is prepaid.
   d. It is subject to the terms of the mortgage given by the maker to the payee.

13. Under the Commercial Paper Article of the UCC, for an instrument to be negotiable it must
   a. Be payable to order or bearer.
   b. Be signed by the payee.
   c. Contain references to all agreements between the parties.
   d. Contain necessary conditions of payment.

14. Union Co. possesses the following instrument:

   Holt, MT   $4,000   April 15, 1990
   Fifty days after date, or sooner, the undersigned promises to pay to the order of
   Union Co.
   Four Thousand Dollars
   at Salem Bank, Holt, MT
   Ten percent interest per annum.
   This instrument is secured by the maker's business inventory.
   EASY, INC.
   BY:  Thomas Foy
   Thomas Foy, President

   Assuming all other requirements of negotiability are satisfied, this instrument is
   a. Not negotiable because of a lack of a definite time for payment.
   b. Not negotiable because the amount due is unspecified.
   c. Negotiable because it is secured by the maker's inventory.
   d. Negotiable because it is payable in a sum certain in money.

15. The following instrument is in the possession of Bill North:

   On May 30, 1989, I promise to pay Bill North, the bearer of this document, $1,800.
   Joseph Peppers
   RE:  Auto Purchase Contract

   This instrument is
   a. Non-negotiable because it is undated.
   b. Non-negotiable because it is not payable to order or bearer.
   c. Negotiable even though it makes reference to the contract out of which it arose.
   d. Negotiable because it is payable at a definite time.
16. Your client has in its possession the following instrument:

FAIR FOOD WHOLESALERS, INC.
23 Woodrow Wilson Hayes Lane
Columbus, Ohio

On demand the undersigned promises to pay to

Bearer

$1,200.00

Twelve hundred & ten/100's

Dollars

Fair Food Wholesalers, Inc.

By James Duff
James Duff, President

For: _________________

The instrument is
a. A non-negotiable promissory note.
b. Non-negotiable because the instrument is incomplete.
c. A negotiable time draft.
d. Negotiable despite the inconsistency between the amount in words and the amount in numbers.

17. An instrument reads as follows:

$10,000     Ludlow, Vermont    February 1, 1993
I promise to pay to the order of Custer Corp. $10,000 within 10 days after the sale of my two-carat diamond ring. I pledge the sale proceeds to secure my obligation hereunder.

R. Harris
R. Harris

Which of the following statements correctly describes the above instrument?
a. The instrument is nonnegotiable because it is not payable at a definite time.
b. The instrument is nonnegotiable because it is secured by the proceeds of the sale of the ring.
c. The instrument is a negotiable promissory note.
d. The instrument is a negotiable sight draft payable on demand.

18. Which of the following conditions, if present on an otherwise negotiable instrument, would affect the instrument's negotiability?
a. The instrument is payable six months after the death of the maker.
b. The instrument is payable at a definite time subject to an accelerated clause in the event of a default.
c. The instrument is postdated.
d. The instrument contains a promise to provide additional collateral if there is a decrease in value of the existing collateral.
19. Below is a copy of a note Prestige Properties obtained from Tim Hart in connection with Hart's purchase of land located in Hunter, MT. The note was given for the balance due on the purchase and was secured by a first mortgage on the land.

```
$200,000.00 Hunter, MT
November 30, 1989

For value received, six years after date, I promise to pay to the order of Prestige Properties TWO HUNDRED THOUSAND and 00/100 DOLLARS with interest at 11% compounded annually until fully paid. This instrument arises out of the sale of land located in MT and the law of MT is to be applied to any question which may arise. It is secured by a first mortgage on the land conveyed. It is further agreed that
1. Maker will pay the costs of collection including attorney's fees upon default.
2. Maker may repay the amount outstanding on any anniversary date of this note.

Tim Hart
Tim Hart
```

This note is a
a. Nonnegotiable promissory note because it is secured by a first mortgage.
b. Negotiable promissory note.
c. Nonnegotiable promissory note because it permits prepayment and requires the maker's payment of the costs of collection and attorney's fees.
d. Negotiable investment security under the UCC.

20. Under the Commercial Paper Article of the UCC, which of the following circumstances would prevent a promissory note from being negotiable?
   a. An extension clause that allows the maker to elect to extend the time for payment to a date specified in the note.
   b. An acceleration clause that allows the holder to move up the maturity date of the note in the event of default.
   c. A person having a power of attorney signs the note on behalf of the maker.
   d. A clause that allows the maker to satisfy the note by the performance of services or the payment of money.

21. Ed Moss has a negotiable draft in his possession. The draft was originally payable to the order of John Davis. The instrument was endorsed as follows:

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>(1)</td>
<td>Carl Bass</td>
</tr>
<tr>
<td>(2)</td>
<td>John Davis</td>
</tr>
<tr>
<td>(3)</td>
<td>Pay to the order of Nix &amp; Co.</td>
</tr>
<tr>
<td>(4)</td>
<td>Pay to Ed Moss, without recourse, Nix &amp; Co. per Jane Kirk, President</td>
</tr>
<tr>
<td>(5)</td>
<td>For deposit, Ed Moss</td>
</tr>
</tbody>
</table>

Which of the following is correct regarding the above endorsements?
   a. Number 1 prevents further negotiation since Bass is not the payee.
   b. Number 2 does not change the instrument to bearer paper since it was originally payable to the order of Davis.
   c. Number 4 eliminates all the contractual liability of the endorser.
   d. Number 5 prevents any further negotiation.
22. West Corp. received a check that was originally made payable to the order of one of its customers, Ted Burns. The following endorsement was written on the back of the check:

Ted Burns, without recourse, for collection only

Which of the following describes the endorsement?

<table>
<thead>
<tr>
<th></th>
<th>Special</th>
<th>Restrictive</th>
</tr>
</thead>
<tbody>
<tr>
<td>a.</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>b.</td>
<td>No</td>
<td>No</td>
</tr>
<tr>
<td>c.</td>
<td>No</td>
<td>Yes</td>
</tr>
<tr>
<td>d.</td>
<td>Yes</td>
<td>No</td>
</tr>
</tbody>
</table>

23. The following endorsements appear on the back of a negotiable promissory note payable to Lake Corp.

Pay to John Smith only
Frank Parker, President of Lake Corp.

John Smith

Pay to the order of Sharp, Inc., without recourse, but only if Sharp delivers computers purchased by Mary Harris by March 15, 1993
Mary Harris

Sarah Sharp, President of Sharp, Inc.

Which of the following statements is correct?

a. The note became nonnegotiable as a result of Parker's endorsement.
b. Harris' endorsement was a conditional promise to pay and caused the note to be nonnegotiable.
c. Smith's endorsement effectively prevented further negotiation of the note.
d. Harris' signature was not required to effectively negotiate the note to Sharp.

24. The following endorsements appear on the back of a negotiable promissory note made payable "to bearer." Clark has possession of the note.

Pay to Sam North
Alice Fox

Sam North
(without recourse)

Which of the following statements is correct?

a. Clark's unqualified endorsement is required to further negotiate the note.
b. To negotiate the note, Clark must have given value for it.
c. Clark is not a holder because North's qualified endorsement makes the note nonnegotiable.
d. Clark can negotiate the note by delivery alone.
25. In order to negotiate bearer paper, one must
   a. Endorse the paper.
   b. Endorse and deliver the paper with consideration.
   c. Deliver the paper.
   d. Deliver and endorse the paper.

26. The following note was executed by Elizabeth Quinton on April 17, 1990, and delivered to Ian Wolf:

   (Face)
   April 17, 1990
   On demand, the undersigned promises to pay to the order of Ian Wolf
   Seven Thousand and 00/100 ---------------------------------------- DOLLARS
   Elizabeth Quinton
   Elizabeth Quinton

   (Back)
   ____________________________
   Ian Wolf
   Ian Wolf
   Pay: George Vernon
   ____________________________
   Samuel Thorn
   Samuel Thorn
   Pay: Alan Yule
   ____________________________
   George Vernon
   George Vernon
   ____________________________
   Alan Yule
   Alan Yule

   In sequence, beginning with Wolf's receipt of the note, this note is properly characterized as what type of commercial paper?
   a. Bearer, bearer, order, order, order.
   b. Order, bearer, order, order, bearer.
   c. Order, order, bearer, order, bearer.
   d. Bearer, order, order, order, bearer.
27. Jim Bass is in possession of a negotiable promissory note made payable "to bearer." Bass acquired the note from Mary Frank for value. The maker of the note was Fred Jackson. The following endorsements appear on the back of the note:

```
Sam Peters
Pay Jim Bass
Mary Frank
Jim Bass
(without recourse)
```

Bass presented the note to Jackson, who refused to pay it because he was financially unable to do so. Which of the following statements is correct?

a. Peters is **not** secondarily liable on the note because his endorsement was unnecessary for negotiation.

b. Peters is **not** secondarily liable to Bass.

c. Frank will probably **not** be liable to Bass unless Bass gives notice to Frank of Jackson's refusal to pay within a reasonable time.

d. Bass would have had secondary liability to Peters and Frank if he had **not** qualified his endorsement.

28. Under the Commercial Paper Article of the UCC, which of the following statements best describes the effect of a person endorsing a check "without recourse"?

a. The person has **no** liability to prior endorsers.

b. The person makes **no** promise or guarantee of payment on dishonor.

c. The person gives **no** warranty protection to later transferees.

d. The person converts the check into order paper.

29. A check has the following endorsements on the back:

```
Paul Folk
without recourse

George Hopkins
payment guaranteed

Ann Quarry
collection guaranteed

Rachel Ott
```

Which of the following conditions occurring subsequent to the endorsements would discharge all of the endorsers?

a. Lack of notice of dishonor.

b. Late presentment.

c. Insolvency of the maker.

d. Certification of the check.
30. Under the negotiable Instruments Article of the UCC, when an instrument is endorsed "Pay to John Doe" and signed "Faye Smith," which of the following statements is (are) correct?

<table>
<thead>
<tr>
<th>Payment of the instrument is guaranteed</th>
<th>The instrument can be further negotiated</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>b. Yes</td>
<td>No</td>
</tr>
<tr>
<td>c. No</td>
<td>Yes</td>
</tr>
<tr>
<td>d. No</td>
<td>No</td>
</tr>
</tbody>
</table>

31. One of the requirements to qualify as a holder of a negotiable bearer check is that the transferee must

- Receive the check that was originally made payable to bearer.
- Take the check in good faith.
- Give value for the check.
- Have possession of the check.

32. Under the Commercial Paper Article of the UCC, which of the following requirements must be met for a transferee of order paper to become a holder?

- Possession
- Endorsement of transferor

a. I only.
b. II only.
c. Both I and II.
d. Neither I nor II.

33. Under the Commercial Paper Article of the UCC, which of the following requirements must be met for a person to be a holder in due course of a promissory note

- The note must be payable to bearer.
- The note must be negotiable.
- All prior holders must have been holders in due course.
- The holder must be the payee of the note.

34. The value requirement in determining whether a person is a holder in due course with respect to a check will **not** be satisfied by the taking of the check

- As security for an obligation to the extent of the obligation.
- As payment for an antecedent debt.
- In exchange for another negotiable instrument.
- In exchange for a promise to perform services in the future.

35. A purchaser of a negotiable instrument would **least** likely be a holder in due course if, at the time of purchase, the instrument is

- Purchased at a discount.
- Collateral for a loan.
- Payable to bearer on demand.
- Overdue by three weeks.

36. Under the Commercial Paper Article of the UCC, which of the following circumstances would prevent a person from becoming a holder in due course of an instrument?

- The person was notified that payment was refused.
- The person was notified that one of the prior endorsers was discharged.
- The note was collateral for a loan.
- The note was purchased at a discount.

37. A maker of a note will have a real defense against a holder in due course as a result of any of the following conditions **except**

- Discharge in bankruptcy.
- Forgery.
- Fraud in the execution.
- Lack of consideration.

38. Under the Commercial Paper Article of the UCC, in a nonconsumer transaction, which of the following are real defenses?

<table>
<thead>
<tr>
<th>Material alteration</th>
<th>Discharge in bankruptcy</th>
<th>Breach of contract</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. No</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>b. Yes</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td>c. No</td>
<td>No</td>
<td>Yes</td>
</tr>
<tr>
<td>d. Yes</td>
<td>No</td>
<td>No</td>
</tr>
</tbody>
</table>

39. To the extent that a holder of a negotiable promissory note is a holder in due course, the holder takes the note free of which of the following defenses?

- Minority of the maker where it is a defense to enforcement of a contract.
- Forgery of the maker's signature.
- Discharge of the maker in bankruptcy.
- Nonperformance of a condition precedent.
**Items 40 through 43** are based on the following:

On February 15, 1993, P.D. Stone obtained the following instrument from Astor Co. for $1,000. Stone was aware that Helco, Inc. disputed liability under the instrument because of an alleged breach by Astor of the referenced computer purchase agreement. On March 1, 1993, Willard Bank obtained the instrument from Stone for $3,900. Willard had no knowledge that Helco disputed liability under the instrument.

<table>
<thead>
<tr>
<th>February 12, 1993</th>
</tr>
</thead>
<tbody>
<tr>
<td>Helco, Inc. promises to pay to Astor Co. or bearer the sum of $4,900 (four thousand four hundred and 00/100 dollars) on March 12, 1993 (maker may elect to extend due date to March 31, 1993) with interest thereon at the rate of 12% per annum</td>
</tr>
<tr>
<td>HELCO, INC.</td>
</tr>
<tr>
<td>By: <strong>A.J. Help</strong></td>
</tr>
<tr>
<td>A.J. Help, President</td>
</tr>
<tr>
<td>Reference: Computer purchase agreement dated February 12, 1993</td>
</tr>
</tbody>
</table>

The reverse side of the instrument is endorsed as follows:

<table>
<thead>
<tr>
<th>Pay to the order of Willard Bank, without recourse</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>P.D. Stone</strong></td>
</tr>
<tr>
<td>P.D. Stone</td>
</tr>
</tbody>
</table>

40. The instrument is a
   a. Promissory note.
   b. Sight draft.
   c. Check.
   d. Trade acceptance.

41. The instrument is
   a. Nonnegotiable, because of the reference to the computer purchase agreement.
   b. Nonnegotiable, because the numerical amount differs from the written amount.
   c. Negotiable, even though the maker has the right to extend the time for payment.
   d. Negotiable, when held by Astor, but nonnegotiable when held by Willard Bank.

42. Which of the following statements is correct?
   a. Willard Bank cannot be a holder in due course because Stone's endorsement was without recourse.
   b. Willard Bank must endorse the instrument to negotiate it.
   c. Neither Willard Bank nor Stone are holders in due course.
   d. Stone's endorsement was required for Willard Bank to be a holder in due course.

43. If Willard Bank demands payment from Helco and Helco refuses to pay the instrument because of Astor's breach of the computer purchase agreement, which of the following statements would be correct?
   a. Willard Bank is not a holder in due course because Stone was not a holder in due course.
   b. Helco will not be liable to Willard Bank because of Astor's breach.
   c. Stone will be the only party liable to Willard Bank because he was aware of the dispute between Helco and Astor.
   d. Helco will be liable to Willard Bank because Willard Bank is a holder in due course.
44. A holder in due course will take free of which of the following defenses?
   a. Infancy, to the extent that it is a defense to a simple contract.
   b. Discharge of the maker in bankruptcy.
   c. A wrongful filling-in of the amount payable that was omitted from the instrument.
   d. Duress of a nature that renders the obligation of the party a nullity.

45. Industrial Factors, Inc., discounted a $4,000 promissory note, payable in two years, for $3,000. It paid $1,000 initially and promised to pay the balance ($2,000) within 30 days. Industrial paid the balance within the 30 days, but before doing so learned that the note had been obtained originally by fraudulent misrepresentation in connection with the sale of land which induced the maker to issue the note. For what amount will Industrial qualify as a holder in due course?
   a. None because the 25% discount is presumptive or prima facie evidence that Industrial is not a holder in due course.
   b. $1,000.
   c. $3,000.
   d. $4,000.

46. A $5,000 promissory note payable to the order of Neptune is discounted to Bane by blank endorsement for $4,000. King steals the note from Bane and sells it to Ott who promises to pay King $4,500. After paying King $3,000, Ott learns that King stole the note. Ott makes no further payment to King. Ott is
   a. A holder in due course to the extent of $5,000.
   b. An ordinary holder to the extent of $4,500.
   c. A holder in due course to the extent of $3,000.
   d. An ordinary holder to the extent of $0.

47. Bond fraudulently induced Teal to make a note payable to Wilk, to whom Bond was indebted. Bond delivered the note to Wilk. Wilk negotiated the instrument to Monk, who purchased it with knowledge of the fraud and after it was overdue. If Wilk qualifies as a holder in due course, which of the following statements is correct?
   a. Monk has the standing of a holder in due course through Wilk.
   b. Teal can successfully assert the defense of fraud in the inducement against Monk.
   c. Monk personally qualifies as a holder in due course.
   d. Teal can successfully assert the defense of fraud in the inducement against Wilk.

48. Under the Negotiable Instrument Article of the UCC, which of the following parties will be a holder but not be entitled to the rights of a holder in due course?
   a. A party who, knowing of a real defense to payment, received an instrument from a holder in due course.
   b. A party who found an instrument payable to bearer.
   c. A party who received, as a gift, an instrument from a holder in due course.
   d. A party who, in good faith and without notice of any defect, gave value for an instrument.

49. Dodger fraudulently induced Tell to issue a check to his order for $900 in payment for some nearly worthless securities. Dodger took the check and artfully raised the amount from $900 to $1,900. He promptly negotiated the check to Bay who took it in good faith and for value. Tell, upon learning of the fraud, issued a stop order to its bank. Which of the following is correct?
   a. Dodger has a real defense which will prevent any of the parties from collecting anything.
   b. The stop order was ineffective against Bay since it was issued after the negotiation to Bay.
   c. Bay as a holder in due course will prevail against Tell but only to the extent of $900.
   d. Had there been no raising of the amount by Dodger, the bank would be obligated to pay Bay despite the stop order.

50. Cobb gave Garson a signed check with the amount payable left blank. Garson was to fill in, as the amount, the price of fuel oil Garson was to deliver to Cobb at a later date. Garson estimated the amount at $700, but told Cobb it would be no more than $900. Garson did not deliver the fuel oil, but filled in the amount of $1,000 on the check. Garson then negotiated the check to Josephs in satisfaction of a $500 debt with the $500 balance paid to Garson in cash. Cobb stopped payment and Josephs is seeking to collect $1,000 from Cobb. Cobb's maximum liability to Josephs will be
   a. $0
   b. $500
   c. $900
   d. $1,000
51. Hunt has in his possession a negotiable instrument which was originally payable to the order of Carr. It was transferred to Hunt by a mere delivery by Drake, who took it from Carr in good faith in satisfaction of an antecedent debt. The back of the instrument reads as follows, "Pay to the order of Drake in satisfaction of my prior purchase of a new video calculator, signed Carr." Which of the following is correct?

a. Hunt has the right to assert Drake's rights, including his standing as a holder in due course and also has the right to obtain Drake's signature.
b. Drake's taking the instrument for an antecedent debt prevents him from qualifying as a holder in due course.
c. Carr's endorsement was a special endorsement; thus Drake's signature was not required in order to negotiate it.
d. Hunt is a holder in due course.

52. Robb, a minor, executed a promissory note payable to bearer and delivered it to Dodsen in payment for a stereo system. Dodsen negotiated the note for value to Mellon by delivery alone and without endorsement. Mellon endorsed the note in blank and negotiated it to Bloom for value. Bloom's demand for payment was refused by Robb because the note was executed when Robb was a minor. Bloom gave prompt notice of Robb's default to Dodsen and Mellon. None of the holders of the note were aware of Robb's minority. Which of the following parties will be liable to Bloom?

<table>
<thead>
<tr>
<th></th>
<th>Dodsen</th>
<th>Mellon</th>
</tr>
</thead>
<tbody>
<tr>
<td>a.</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>b.</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td>c.</td>
<td>No</td>
<td>No</td>
</tr>
<tr>
<td>d.</td>
<td>No</td>
<td>Yes</td>
</tr>
</tbody>
</table>

53. Susan Town, on receiving the above instrument, struck Betty Ash's endorsement. Under the Commercial Paper Article of the UCC, which of the endorsers of the above instrument will be completely discharged from secondary liability to later endorsers of the instrument?

a. Ann Tyler
b. Mary Thomas
c. Betty Ash
d. Susan Town

54. Which of the following actions does not discharge a prior party to a commercial instrument?

a. Good faith payment or satisfaction of the instrument.
b. Cancellation of that prior party's endorsement.
c. The holder's oral renunciation of that party's liability.
d. The holder's intentional destruction of the instrument.

55. Under the Negotiable Instruments Article of the UCC, an instrument will be precluded from being negotiable if the instrument

a. Fails to state the place of payment.
b. Is made subject to another agreement.
c. Fails to state the underlying consideration.
d. Is undated.

56. Ball borrowed $10,000 from Link. Ball, unable to repay the on its due date, fraudulently induced Park to purchase a piece of worthless costume jewelry for $10,000. Ball had Park write a check for that amount naming Link as the payee. Ball gave the check to Link in satisfaction of the debt Ball owed Link. Unaware of Ball’s fraud, Link cashed the check. When Park discovered Ball’s fraud, Park demanded that Link repay the $10,000. Under the Negotiable Instruments Article of the UCC, will Link be required to repay Park?

a. No, because Link is a holder in due course of the check.
b. No, because Link is the payee of the check and had no obligation on the check once it is cashed.
c. Yes, because Link is subject to Park’s defense of fraud in the inducement.
d. Yes, because Link, as the payee of the check, take it subject to all claims.
Chapter Four: Negotiable Instruments
Other Objective Questions

NUMBER 1

Number 1 consists of 5 items. Select the best answer for each item. Answer all items. Your grade will be based on the total number of correct answers.

Under the Negotiable Instruments Article of the UCC, a note must conform to certain requirements to be negotiable. Similarly, a note's negotiability may be restricted or prevented.

Required:
Items 1 through 5 are examples of terms, conditions, and indorsements that may appear on a note. For each item, select the effect each term, condition, or indorsement would have on the note's negotiability from List I. An answer may be selected once, more than once, or not at all.

List I - Effect on Negotiability
A. Has no effect on negotiability.
B. Restricts negotiability.
C. Must be negotiated by delivery.
D. Must be indorsed to be negotiated.
E. Results in nonnegotiability.

1. The note is postdated.  
   - List I - Effect on Negotiability
     - B. Restricts negotiability.

2. No place of payment is indicated on the note.  
   - List I - Effect on Negotiability
     - D. Must be indorsed to be negotiated.

3. The note is payable to the order of a named individual.  
   - List I - Effect on Negotiability
     - E. Results in nonnegotiability.

4. The note is indorsed "For Collection."

5. The note is payable in either money or goods.

NUMBER 2

Number 2 consists of 2 parts. Part A consists of 5 items and Part B consists of 8 items. Select the best answer for each item. Answer all items. Your grade will be based on the total number of correct answers.

During an audit of Trent Realty Corp.'s financial statements, Clark, CPA, reviewed the following instruments:

A. Instrument 1.

$300,000                        Belle, MD
September 15, 1993

For value received, ten years after date, I promise to pay to the order of Dart Finance Co. Three Hundred Thousand and 00/100 dollars with interest at 9% per annum compounded annually until fully paid.

This instrument arises out of the sale of land located in MD.

It is further agreed that:
1. Maker will pay all costs of collection including reasonable attorney fees.
2. Maker may prepay the amount outstanding on any anniversary date of this instrument.

G. Evans
G. Evans
The following transactions relate to Instrument 1.

- On March 15, 1994, Dart endorsed the instrument in blank and sold it to Morton for $275,000.
- On July 10, 1994, Evans informed Morton that Dart had fraudulently induced Evans into signing the instrument.
- On August 15, 1994, Trent, which knew of Evans' claim against Dart, purchased the instrument from Morton for $50,000.

Required:
Items 1 through 5 relate to Instrument 1. For each item, select from List I the correct answer. An answer may be selected once, more than once, or not at all.

1. Instrument 1 is a (type of instrument)
2. Instrument 1 is (negotiability)
3. Morton is considered a (type of ownership)
4. Trent is considered a (type of ownership)
5. Trent could recover on the instrument from (liable party(s))

List I
A. Draft
B. Promissory Note
C. Security Agreement
D. Holder
E. Holder in due course
F. Holder with rights of a holder in due course under the Shelter Provision
G. Negotiable
H. Nonnegotiable
I. Evans, Morton, and Dart
J. Morton and Dart
K. Only Dart
B.

Instrument 2.

Front

To: Pure Bank
Upton, VT

April 5, 1994
Pay to the order of M. West $1,500.00
One Thousand Five Hundred and 00/100
Dollars on May 1, 1994

W. Fields

Back

M. West
Pay to C Larr
7. Keetin

C. Larr
without recourse

W. Fields

Required:

**Items 6 through 13** relate to Instrument 2. For each item, select from List II the correct answer. An answer may be selected once, more than once, or not at all.

6. Instrument 2 is a (type of instrument)

7. Instrument 2 is (negotiability)

8. West's endorsement makes the instrument (type of instrument)

9. Keetin's endorsement makes the instrument (type of instrument)

10. Larr's endorsement makes the instrument (type of instrument)

11. West's endorsement would be considered (type of endorsement)

12. Keetin's endorsement would be considered (type of endorsement)

13. Larr's endorsement would be considered (type of endorsement)

*List II*

A. Bearer paper
B. Blank
C. Check
D. Draft
E. Negotiable
F. Nonnegotiable
G. Note
H. Order paper
I. Qualified
J. Special
Number 3 consists of 6 items. Select the best answer for each item. Answer all items. Your grade will be based on the total number of correct answers.

Items 1 through 6 are based on the following documents:

**Document I (face)**

April 1, 1994

On demand, the undersigned promises to pay to the order of

MARK EDEN

Three Thousand Two Hundred and NO/100 ($3,300.00).dollars

Alice Long

**Document I (back)**

Mark Eden
Pay Joyce Noon
Harold Storm

**Document II (face)**

April 15, 1994

On May 1, 1994, or sooner, pay to the order of

EDWARD THARP

Two Thousand and NO/100 ($2,000.00).dollars

To: Henry Gage
100 East Way
Capital City, ND

**Document II (back)**

Edward Tharp
Nancy Ferry
without recourse
Ann Archer

**Required:**

Items 1 through 6 relate to the nature and negotiability of the above documents and the nature of several of the endorsements. For each item select from List A the response that best completes that statement. A response may be selected more than once.

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Document I is a (type of instrument)</td>
<td>A. Blank</td>
</tr>
<tr>
<td>2. Document II is a (type of instrument)</td>
<td>B. Check</td>
</tr>
<tr>
<td>3. Document I is (negotiability)</td>
<td>C. Draft</td>
</tr>
<tr>
<td>4. Document II is (negotiability)</td>
<td>D. Negotiable</td>
</tr>
<tr>
<td>5. The endorsement by Mark Eden is (type of endorsement)</td>
<td>E. Nonnegotiable</td>
</tr>
<tr>
<td>6. The endorsement by Nancy Ferry is (type of endorsement)</td>
<td>F. Promissory Note</td>
</tr>
<tr>
<td></td>
<td>G. Qualified</td>
</tr>
<tr>
<td></td>
<td>H. Special</td>
</tr>
</tbody>
</table>
NUMBER 4

Williams Co. provides financial consulting services to the business community. On occasion, Williams will purchase promissory notes from its clients. The following transactions involving promissory notes purchased by Williams have resulted in disputes:

Williams purchased the following promissory note from Jason Computers, Inc.:

```
JANUARY 3, 1992

For value received, Helco Distributors Corp. promises to pay $3,000 to the order of Jason Computers, Inc. with such payment to be made out of the proceeds of the resale of the computer components purchased this day from Jason Computers, Inc. and to be used as part of the customized computer systems sold to our customers. Payment shall be made two weeks after such proceeds become available.

J. Helco
J. Helco, President
```

Helco executed and delivered the note to Jason in payment for the computer components referred to in the note. Jason represented to Helco that all the components were new when, in fact, a large number of them were used and had been reconditioned. Williams was unaware of this fact at the time it acquired the note from Jason for $2,000. Jason endorsed and delivered the note to Williams in exchange for the $2,000 payment. Williams presented the promissory note to Helco for payment. Helco refused to pay, alleging that Jason misrepresented the condition of the components. Helco also advised Williams that the components had been returned to Jason within a few days after Helco had taken delivery.

Williams commenced an action against Helco, claiming that:

• the note is negotiable;

• Williams is a holder in due course; and

• Helco cannot raise Jason's misrepresentation as a defense to payment of the note.

Williams Co. purchased a negotiable promissory note from Oliver International, Inc. that Oliver had received from Abco Products Corp., as partial payment on the sale of goods by Oliver to Abco. The maker of the note was Grover Corp., which had executed and delivered the note to Abco as payment for services rendered by Abco. When Oliver received the note from Abco, Oliver was unaware of the fact that Grover disputed its obligation under the note because Grover was dissatisfied with the quality of the services Abco rendered. Williams was aware of Grover's claims at the time Williams purchased the note from Oliver. The reverse side of the note was endorsed as follows:

```
Pay to the order of Oliver

F. Smith
F. Smith, President of Abco Products Corp.

Pay to the order of Williams Co. without recourse

N. Oliver
N. Oliver, President of Oliver International, Inc.
```
When the promissory note became due Williams demanded that Grover pay the note. Grover refused, claiming that Abco breached its contractual obligations to Grover and that Williams was aware of this fact at the time Williams acquired the note. Williams immediately advised both Abco and Oliver of Grover's refusal to pay and demanded payment from Oliver in the event Grover fails to pay the note.

Required:
Answer the following questions and give the reasons for your conclusions.

a. Are Williams' claims correct regarding the Helco promissory note?

b. Is Grover correct in refusing to pay its note?

c. What are the rights of Williams against Oliver in the event Grover is not required to pay its note?

NUMBER 5

Rustic Equipment, Inc. manufactures lathes and other woodworking equipment. It sells these products to hardware stores, often on credit. Rustic usually requires its credit customers to place large signs in their stores indicating that Rustic products are made available through financing provided by Rustic.

On February 1, 1992, Rustic sold and delivered five lathes to Friendly Hardware Corp. for $25,000. Friendly sells woodworking tools and equipment, among other things, to the general public. Friendly made a 10% downpayment and delivered a promissory note for the balance, along with a security agreement and a financing statement covering the lathes. Rustic properly filed the financing statement on February 9, 1992. Rustic required Friendly to display a sign in its store indicating that Rustic provided financing for the lathes.

On February 6, 1992, Friendly borrowed $100,000 from National Bank, and gave National a promissory note, a security agreement, and a financing statement covering Friendly's inventory, fixtures, and equipment. Friendly intended to use the loan proceeds to remodel its store. National properly filed the financing statement on February 7, 1992. National was not aware of Rustic's security interest in the lathes included in Friendly's inventory.

On March 8, 1992, Friendly sold one of the Rustic lathes to Karry, whose hobby was woodworking. Karry paid 20% of the purchase price, and gave Friendly a promissory note for the balance and a security agreement covering the lathe. Karry, at the time of the purchase, saw the sign publicizing the financing arrangement between Rustic and Friendly. Friendly did not file a financing statement.

The following is the promissory note Karry gave to Friendly:

<table>
<thead>
<tr>
<th>March 8, 1992</th>
</tr>
</thead>
<tbody>
<tr>
<td>I promise to pay Friendly Hardware Corp. or bearer</td>
</tr>
<tr>
<td>$900.00, with interest thereon at 12% per annum.</td>
</tr>
<tr>
<td>S.J. Karry</td>
</tr>
<tr>
<td>Maker</td>
</tr>
<tr>
<td>Reference: Sale of Lathe</td>
</tr>
<tr>
<td>Invoice #6734</td>
</tr>
</tbody>
</table>

4Q-19
On March 10, 1992, Friendly delivered Karry's promissory note, without endorsement, to Queen Bank in exchange for $750. Queen, a holder in due course, was unaware that Karry had advised Friendly that the lathe was not operating properly and that Karry had no intention of paying the note. Queen then delivered the note to Abcor Factors, Inc. in exchange for $800. At the time Abcor acquired the note from Queen, it knew that Karry disputed any obligation under the note because the lathe was not working properly.

Friendly has experienced serious financial difficulties and defaulted on its obligations to Rustic and National. Abcor has demanded that Karry pay the note given to Friendly, but Karry has refused to do so.

Rustic and Karry have taken the following positions:

- Rustic claims that its security interest in the lathes, including the one sold to Karry, is superior to that of National and that Karry purchased the lathe subject to Rustic's security interest.

- Karry refuses to honor the note held by Abcor claiming that:
  - It is nonnegotiable because it is not payable at a definite time and it references the sales invoice.
  - Abcor has no rights under the note because it was not endorsed by Friendly.
  - Abcor was aware of Karry's claim that the lathe was not working properly and, therefore, took the note subject to that claim.

**Required:**
State whether the claims of Rustic and Karry are correct and give the reasons for your conclusions.
NUMBER 6

River Oaks is a wholesale distributor of automobile parts. River Oaks received the promissory note shown below from First Auto, Inc., as a security for payment of a $4,400 auto parts shipment. When River Oaks accepted the note as collateral for the First Auto obligation, River Oaks was aware that the maker of the note, Hillcraft, Inc., was claiming that the note was unenforceable because Alexco Co. had breached the license agreement under which Hillcraft had given the note. First Auto had acquired the note from Smith in exchange for repairing several cars owned by Smith. At the time First Auto received the note, First Auto was unaware of the dispute between Hillcraft and Alexco. Also, Smith, who paid Alexco $3,500 for the note, was unaware of Hillcraft's allegations that Alexco had breached the license agreement.

**PROMISSORY NOTE**

Date: 1/14/90

Hillcraft, Inc. promises to pay to Alexco Co. or bearer the sum of $4,400 Four Thousand and 00/100 Dollars on or before May 15, 1991 (maker may elect to extend due date by 30 days) with interest thereon at the rate of 9½% per annum.

Hillcraft, Inc.

By: P.J. Hill

P.J. Hill, President

Reference: Alexco Licensing Agreement

The reverse side of the note was endorsed as follows:

Pay to the order of First Auto without recourse

E. Smith

E. Smith

Pay to the order of River Oaks Co.

First Auto

By: G. First

G. First, President

First Auto is now insolvent and unable to satisfy its obligation to River Oaks. Therefore, River Oaks has demanded that Hillcraft pay $4,400, but Hillcraft has refused, asserting:

- The note is nonnegotiable because it references the license agreement and is not payable at a definite time or on demand.
- River Oaks is not a holder in due course of the note because it received the note as security for amounts owed by First Auto.
- River Oaks is not a holder in due course because it was aware of the dispute between Hillcraft and Alexco.
- Hillcraft can raise the alleged breach by Alexco as a defense to payment.
- River Oaks has no right to the note because it was not endorsed by Alexco.
- The maximum amount that Hillcraft would owe under the note is $4,000, plus accrued interest.

**Required:** State whether each of Hillcraft's assertions are correct and give the reasons for your conclusions.
NUMBER 7

Prince, Hall, & Charming, CPAs, has been retained to examine the financial statements of Hex Manufacturing Corporation. Shortly before beginning the examination for the year ended December 31, 1986, Mr. Prince received a telephone call from Hex's president indicating that he thought some type of embezzlement was occurring because the corporation's cash position was significantly lower than in prior years. The president then requested that Prince immediately undertake a special investigation to determine the amount of embezzlement, if any.

After a month of investigation, Prince uncovered an embezzlement scheme involving collusion between the head of payroll and the assistant treasurer. The following is a summary of Prince's findings:

- The head of payroll supplied the assistant treasurer with punched time cards for fictitious employees. The assistant treasurer prepared invoices, receiving reports, and purchase orders for fictitious suppliers. The assistant treasurer prepared checks for the fictitious employees and suppliers which were signed by the treasurer. Then, either the assistant treasurer or the head of payroll would endorse the checks and deposit them in various banks where they maintained accounts in the names of the fictitious payees. All of the checks in question have cleared Omega Bank, the drawee.

- The embezzlement scheme had been operating for 10 months and more than $120,000 had been embezzled by the time the scheme was uncovered. The final series of defalcations included checks payable directly to the head of payroll and the assistant treasurer. These checks included skillful forgeries of the treasurer's signature that were almost impossible to detect. This occurred while the treasurer was on vacation. These checks have also cleared Omega Bank, the drawee.

**Required:**

Answer the following, setting forth reasons for any conclusions stated.

Will Hex or Omega bear the loss with respect to the following categories of checks:

a. those which were signed by the treasurer but payable to fictitious payees?

b. those which include the forged signature of the treasurer?
On October 30, 1995, Dover, CPA, was engaged to audit the financial records of Crane Corp., a tractor manufacturer. During the review of notes receivable, Dover reviewed a promissory note given to Crane by Jones Corp., one of its customers, in payment for a tractor. The note appears below.

(Face)                                                                                                              (Back)
July 18, 1995
Sixty (60) days from date, the undersigned promises to
Pay to the order of Jones Corp.
Twenty Thousand and 00/100 ($20,000……dollars at West Bank

OVAL CORP.
By: G.J. Small, Pres.

Jones Corp.
Without Recourse
R. Mall
By: R. Mall, Pres.
Crane Corp.
For Collection

Payment Refused

On the note's due date, Crane deposited the note for collection and was advised by the bank that Oval had refused payment. After payment was refused, Crane contacted Oval. Oval told Crane that Jones fraudulently induced Oval into executing the note and that Jones knew about Oval's claim before Jones indorsed the note to Crane.

Required:
As the auditor on this engagement, write a memo to the partner-in-charge identifying, explaining and stating your conclusions about the legal issues pertaining to the note.

The memo should address:

- Whether Crane is a holder in due course
- Whether Oval will be required to pay the note
- Whether Jones is liable to pay the note
Chapter 4: Negotiable Instruments
Multiple Choice Answers

1. (a) A draft is a written instrument in which a drawer unconditionally orders a specified drawee to pay a certain sum of money to a payee. Thus, a draft is an order to pay. A certificate of deposit is a note signed by a bank acknowledging the receipt of money and promising to repay with interest. All notes, including a certificate of deposit, are a promise made by that party to pay, not an order for a 3rd party to pay. Only answer (a) states a draft is an order to pay, but a certificate of deposit is not.

2. (b) To be negotiable an instrument must be signed by maker or drawer, be unconditional, be payable in a certain sum of money, be payable to bearer or order and be payable on demand or at a definite time. This instrument meets all five requirements. It is a note because it is a two party deal with Craig Burke promising to pay ("I promise to pay"). It is bearer paper because it is pay to the order of cash. Thus the instrument is a negotiable bearer note. Answer (a) is incorrect because it is negotiable as soon as all five tests are met. It is negotiable now, but not payable until December 1. Answer (c) is incorrect because a draft is a three party deal and there are not three parties. Answer (d) is incorrect because reference to collateral or security will not prevent an instrument from being negotiable.

3. (a) The instrument is a draft because it is a three party deal whereby Lynn Dexter ordered Middlesex National Bank to pay Robert Silver. Answer (b) is incorrect because a check is a type of a draft, drawn on a bank and payable on demand. This instrument was drawn on September 15 and payable on October 1 and therefore was not payable on demand. Answer (c) is incorrect because a trade acceptance is drawn by a seller ordering a buyer to pay. The seller is usually both the drawer and payee and the buyer is the drawee who accepts in the lower left hand corner of the instrument. This instrument reflects none of these requirements. Answer (d) is incorrect because a note is a two party deal and this has three parties.

4. (d) Trade acceptances are one of the types of drafts under Article 3, the Commercial Paper article of the UCC. Answers (a) and (c) are incorrect because documents of title to include warehouse receipts are not commercial paper. They are governed by Article 7 not Article 3. Answer (b) is not correct because a promissory note is commercial paper, but notes are not drafts.

5. (b) To be negotiable an instrument must be signed by maker or drawer, be unconditional, be payable in a certain sum of money, be payable to bearer or order and be payable on demand or at a definite time. This instrument meets all five requirements. It is a draft because three parties are involved. Dale Cox ordered Union Corp. to pay Donald Kent. It is a time draft because it is payable at a definite time in the future. Thus, this is a negotiable time draft. Answer (a) is incorrect because a reference to the reason the instrument is written (as a down payment) will not make an instrument non-negotiable. If it was subject to another agreement it would be non-negotiable. Answer (c) is incorrect because a sight draft is payable on demand and this is payable at a definite time in the future. Answer (d) is incorrect because it is negotiable and it is not a trade acceptance. The seller is not both the drawer and the payee and the buyer did not accept in the lower left hand corner.

6. (a) A certificate of deposit is an acknowledgment by a bank of receipt of money with the promise to repay with interest. Since it is a type of a note, there are only two parties involved. Answers (b), (c) and (d) are incorrect because a time draft, a trade acceptance or banker’s acceptance and a cashier’s check are all types of drafts and need three parties.

7. (c) A trade acceptance is drawn by a seller ordering the buyer to pay. Answer (a) is incorrect because a trade acceptance obligates the buyer to pay, not the seller. Answers (b) and (d) are incorrect because a trade acceptance is drawn by a seller, not a buyer.
8. (c) To be negotiable an instrument must be signed by maker or drawer, be unconditional, be payable in a
certain sum of money, be payable to bearer or order and be payable on demand or at a definite time. This
instrument meets all five requirements. It is a draft. Smith Industries is the drawer, Frank Supply Co. is the
payee and Clark Novelties is the drawer. The drawer, Clark Novelties, became primarily liable on the date of
acceptance, April 20. Since the drawer is secondarily liable, no one was primarily liable on the date of issuance,
April 12. Answer (a) is incorrect because the drawer, Smith, is secondarily liable, not primarily liable. Answer (b) is
incorrect because the instrument is negotiable. Answer (d) is incorrect because Smith is the drawer and has
secondary liability and must pay upon presentment and notice of dishonor if Clark does not.

9. (b) Installment notes are one of the types of commercial paper under Article 3 of the UCC. Answers (c) and
(d) are incorrect because documents of title to include warehouse receipts and bills of lading are not
commercial paper. They are governed by Article 7 not Article 3. Answer (a) is incorrect because investment
securities to include bonds are not commercial paper. They are governed by Article 8, not Article 3.

10. (d) A draft is one type of commercial paper under Article 3 of the UCC. Answer (a) is incorrect because
documents of title are not commercial paper. They are governed by Article 7, not Article 3. Answer (b) is
incorrect because investment securities are not commercial paper. They are governed by Article 8, not Article 3.
Answer (c) is incorrect because currency is not commercial paper, although commercial paper must be payable in
currency.

11. (d) An investment security is not commercial paper. It is governed by Article 8 of the UCC, not Article 3.
Answers (a), (b) and (c) are incorrect because notes, drafts and certificates of deposit are all types of commercial
paper under Article 3.

12. (d) For an instrument to be negotiable, it must be an unconditional promise or order. If it is subject to
another agreement or transaction it is non-negotiable. Answer (a) is incorrect because references to collateral
will not prevent negotiability unless it is subject to the terms of that collateral. Answer (b) is incorrect because
waiver of trial by jury does not make the note conditional and thus does not affect negotiability. Answer (c) is
incorrect because prepayment will not prevent negotiability.

13. (a) To be negotiable an instrument must be signed by maker or drawer, be unconditional, be payable in a
certain sum of money, be payable to bearer or order and be payable on demand or at a definite time. Thus,
for an instrument to be negotiable it must be payable to order or to bearer. (Note: checks may omit the word
"order" and still be negotiable.) Answer (b) is incorrect because it is the maker or drawer that must sign, not the
payee. Answer (c) is incorrect because there is no requirement that the instrument contain any reference to agree-
ments between the parties to be negotiable. Answer (d) is incorrect because an instrument must be unconditional
to be negotiable and may not contain necessary conditions of payment.

14. (d) To be negotiable an instrument must be signed by maker or drawer, be unconditional, be payable in a
certain sum of money, be payable to bearer or order and be payable on demand or at a definite time. This
instrument meets all five requirements and must be payable in a certain sum of money. Answer (a) is incorrect
because "fifty days after date, or sooner" and dated April 15, is a definite enough time. Answer (b) is incorrect
because $4,000 plus ten percent interest is a certain enough sum of money. Answer (c) is incorrect because reference to collateral or security does not make a instrument negotiable, nor will it prevent negotiability.

15. (b) To be negotiable an instrument other than a check must be payable to bearer or order. This instrument
is not negotiable because it is not payable to bearer or order. It is not payable to bearer because by its terms it is
only payable to Bill North. It is not payable to order because the word order is missing. Answer (a) is incorrect
because an instrument with no date is considered to be payable upon demand and therefore negotiable. Answers (c)
and (d) are incorrect because the instrument is not negotiable.
16. (d) To be negotiable an instrument must be signed by maker or drawer, be unconditional, be payable in a certain sum of money, be payable to bearer or order and be payable on demand or at a definite time. This instrument meets all five requirements. Specifically, an instrument is negotiable if the amount in words and the amount in numbers differ. The amount in words controls. Answer (a) is incorrect because the instrument is negotiable. Answer (b) is incorrect because an instrument need not state the reason that it is being written to be negotiable. Thus, the blank line after the word "For" will not prevent negotiability. Answer (c) is incorrect because this instrument is a note ("the undersigned promises to pay"), not a draft.

17. (a) To be negotiable an instrument must be payable on demand or at a definite time. Payment "10 days after the sale of my two carat diamond ring" is neither on demand nor at a definite time. Answer (b) is incorrect because reference to collateral or security will not prevent an instrument from being negotiable. Answers (c) and (d) are incorrect because the instrument is not negotiable.

18. (a) To be negotiable an instrument must be payable on demand or at a definite time. Payment six months after the death of the maker is neither on demand nor at a definite time. Answer (b) is incorrect because an acceleration clause will not prevent negotiability. Answer (c) is incorrect because a postdated instrument would still be payable at a definite time and would therefore be negotiable. Answer (d) is incorrect because reference to collateral or security will not prevent negotiability.

19. (b) To be negotiable an instrument must be signed by maker or drawer, be unconditional, be payable in a certain sum of money, be payable to bearer or order and be payable on demand or at a definite time. This instrument meets all five requirements. It is a note because it is a two party deal ("I promise to pay"). Answer (a) is incorrect because reference to collateral or security will not prevent negotiability. Answer (c) is incorrect because neither prepayment nor payment of collection costs will prevent negotiability. Answer (d) is incorrect because this is payable in a certain sum of money and thus is a negotiable promissory note. It is not an investment security.

20. (d) To be negotiable an instrument must be payable in a certain sum of money. It must be money and nothing else. Payment by "services or by the payment of money" would make the instrument non-negotiable. Answer (a) is incorrect because payment at a definite time and extension to another definite time will not prevent negotiability. Answer (b) is incorrect because acceleration clauses will not prevent negotiability. Answer (c) is incorrect because a power of attorney is a written authorization for one to act on behalf of another. An agent with a valid power of attorney could properly sign on behalf of the maker of a note.

21. (c) Endorsing "without recourse" is a qualified endorsement and eliminates all contract liability. Answers (a) and (d) are incorrect because nothing placed on the back of a negotiable instrument will prevent further negotiation. Specifically (a) is incorrect because Carl Bass is an accommodation endorser who added his name to this instrument so it could be cashed. Accommodation endorsers facilitate negotiation, rather than preventing it. Answer (b) is incorrect because the mere signature of John Davis to an instrument payable to John Davis is a blank endorsement. A blank endorsement makes the instrument bearer paper. Answer (d) is incorrect because "for deposit" is a restrictive endorsement and does not prevent further negotiation.

22. (c) Signing without endorsing to a specified party is a blank endorsement, not special. "Without recourse" is a qualified endorsement. "For collection only" is a restrictive endorsement. Thus, this is a blank, qualified and restrictive endorsement. The only answer that reflects this is (c).

23. (d) The first endorsement on the back made the instrument payable to John Smith. John’s signature without endorsing to a specified party was a blank endorsement that made the instrument bearer paper. Bearer paper can be negotiated by delivery alone and therefore the signature of Mary Harris was not required. Answers (a) and (b) are incorrect because once an instrument is negotiable on its front, nothing placed on the back will make it nonnegotiable. Answer (c) is incorrect because endorsing "without recourse" is a qualified endorsement and doesn’t prevent further negotiation.
24. (d) The first endorsement on the back made the instrument payable to Sam North. The only other endorsement is Sam North’s signature without endorsing to a specified party. This made the note bearer paper and it can be negotiated by delivery alone. Answer (a) is incorrect because Clark’s signature would only be required if someone made the note payable to Clark. Answer (b) is incorrect because to negotiate bearer paper requires only delivery. To be an HIDC Clark would have to have given value, but Clark can negotiate the note without being an HIDC. Answer (c) is incorrect because “without recourse” is a qualified endorsement and doesn’t make the note nonnegotiable. Once a note is negotiable on its front, nothing placed on the back will make it nonnegotiable.

25. (c) To negotiate bearer paper requires mere delivery. It does not require an endorsement or consideration. The only answer that reflects this is (c).

26. (b) On Wolf’s receipt of the note, it was "pay to the order of Ian Wolf" which is order paper. When Wolf signed without endorsing to a specified party, it was a blank endorsement which made the instrument bearer paper. The next endorsement was to pay George Vernon (signed) Samuel Thorn, which was a special endorsement making the instrument order paper. George Vernon endorsed to make the note payable to Alan Yule. This is a special endorsement which makes the instrument order paper. The last signature is Alan Yule without endorsing to a specified party. This is a blank endorsement which makes the note bearer paper. The only answer that reflects this sequence is (b).

27. (c) An endorser, such as Mary Frank, has secondary liability. Secondary liability means the endorser is liable only after presentment and notice of dishonor. Thus, Bass would have to give Frank notice of dishonor to hold her secondarily liable. Answers (a) and (b) are incorrect because by signing the instrument Peters has contract liability, whether his signature was required or not. All endorsers, with the exception of a qualified endorser, have secondary liability to subsequent transferees. Thus, Peters is secondarily liable to both Frank and Bass. Answer (d) is incorrect because an endorser only has secondary liability to subsequent parties, not prior parties like Peters and Frank.

28. (b) Contract liability is liability from signing the instrument and is a guarantee of payment. One who endorses "without recourse" (a qualified endorser) has no contract liability and therefore makes no guarantee of payment. Although a qualified endorsement eliminates contract liability, it does not eliminate warranty liability. Answer (a) and (c) are incorrect because a qualified endorser does have warranty liability. Answer (d) is incorrect because to convert a check to order paper it must be endorsed to a specified party. Endorsing "without recourse" does not endorse an instrument to a specified party.

29. (d) Certification of a check by a bank discharges all prior parties. Answers (a) and (b) are incorrect because presentment and notice of dishonor are not needed for one who guarantees payment. Thus, George Hopkins would not be discharged. Answer (c) is incorrect because insolvency of the maker would release just the maker from liability, not endorsers.

30. (a) Contract liability is liability from signing the instrument and is a guarantee of payment. Faye Smith signed the instrument as an unqualified endorser and therefore has contract liability and guaranteed payment. Since the instrument was endorsed "Pay to John Doe", the instrument is order paper and may be further negotiated by delivery and John’s endorsement. The only answer that reflects that payment is guaranteed and that the instrument may be further negotiated is (a).

31. (d) To be a holder one need only have possession of a negotiable bearer instrument. Answer (a) is incorrect because one could receive a check that was payable to order and still be a holder. Answers (b) and (c) are incorrect because they relate to elements required to be a holder in due course, not requirements to be a holder.

32. (c) A holder is simply one who possesses a negotiable instrument. Negotiation of order paper requires delivery plus an endorsement. Thus, both possession and a proper endorsement are required under the Commercial Paper Article for one to be a holder of order paper. Only answer (c) states both are required.
33. (b) To be a holder in due course, one must have possession of a negotiable instrument and meet three additional tests: give present value, in good faith and without notice of any problems. Answer (a) is incorrect because one may be a holder in due course of order paper. The note does not need to be payable to bearer. Answers (c) and (d) are incorrect because one can be an HIDC without all prior holders being an HIDC and without being the payee. As long as the note is negotiable and the three tests are met, the holder is an HIDC.

34. (d) The value requirement can only be met by the giving of present value, not future value. Thus, the promise to perform services in the future is not the giving of present value. Answers (a), (b) and (c) are incorrect because they all involve some form of giving present value.

35. (d) Specifically, notice that an instrument was overdue by three weeks would prevent a party from being an HIDC. Answer (a) is incorrect because commercial paper is almost always purchased at a discount. There is always risk the issuer may not be able to pay. The mere fact that it was sold at a discount would not put a party on notice that there was a problem. Answers (b) and (c) are incorrect because a negotiable instrument may be given as collateral for a loan and may be payable to bearer without affecting whether a party is an HIDC.

36. (a) To be an HIDC, a party must take the instrument without notice of any problems. If a holder was notified that payment was refused, they would certainly have notice that there was a problem. Answer (b) is incorrect because notification that one of the prior endorsers was discharged would not constitute notification that there was a problem. Only that party would be discharged and the instrument could still be valid. Answer (c) is incorrect because a negotiable note may be given as collateral for a loan and may be payable to bearer without affecting whether a party is an HIDC. Answer (d) is incorrect because commercial paper is almost always purchased at a discount. There is always risk the issuer may not be able to pay. Thus purchase at a discount does not constitute a problem.

37. (d) Real defenses that would beat an HIDC include Infancy, Material alterations, Bankruptcy, Insanity when adjudicated, Forgery, and Fraud in the execution (I'M BIFF). Duress may be a real defense if it would make the contract void. Bankruptcy, forgery and fraud in the execution are all real defenses, making (a), (b) and (c) incorrect. Lack of consideration is not a real defense.

38. (b) Real defenses that would beat an HIDC include Infancy, Material alterations, Bankruptcy, Insanity when adjudicated, Forgery, and Fraud in the execution (I'M BIFF). Duress may be a real defense if it would make the contract void. A breach of contract is not a real defense. Only answer (b) states that Material alterations and Bankruptcy are real defenses, but breach of contract is not.

39. (d) Real defenses that would beat an HIDC include Infancy, Material alterations, Bankruptcy, Insanity when adjudicated, Forgery, and Fraud in the execution (I'M BIFF). Duress may be a real defense if it would make the contract void. Infancy, forgery and bankruptcy are all real defenses, making (a), (b) and (c) incorrect. Nonperformance of a condition precedent is not a real defense.

40. (a) The instrument is a promissory note because it is a promise to pay. Helco is promising to pay Astor or bearer. Answers (b) and (c) are incorrect because both a sight draft and a check are types of drafts, wherein a drawer orders a drawee to pay a payee. Helco did not order a third party to pay, they promised to pay. Answer (d) is incorrect because a trade acceptance is also a type of a draft and this is a promissory note.

41. (c) To be negotiable an instrument must be signed by maker or drawer, be unconditional, be payable in a certain sum of money, be payable to bearer or order and be payable on demand or at a definite time. This instrument meets all five requirements. Specifically, an instrument is negotiable if the maker has the right to extend payment from one definite time to another definite time (March 12 to March 31). Answer (a) is incorrect because a note may make reference to the reason it was written without making it nonnegotiable. If the note had said it was subject to the terms of the computer agreement it would be nonnegotiable. Answer (b) is incorrect because it is still negotiable if the words and numbers differ. The words would control. Answer (d) is incorrect because once a note is negotiable on its front, it is always negotiable. An endorsement on the back to Willard would not make it nonnegotiable.
42. (b) Since Stone endorsed the note "pay to the order of Willard Bank, without recourse", it is order paper. **Order paper requires delivery plus an endorsement for negotiation.** Thus, Willard must endorse the note to negotiate it. Answer (a) is incorrect because "without recourse" is a qualified endorsement and does not prevent a party from being an HIDC. Since Willard paid present value ($3,900), in good faith and without notice of any problems, Willard is an HIDC and (c) is also incorrect. Answer (d) is incorrect because a note payable to "Astor or bearer" is bearer paper and can be negotiated by delivery alone. Thus, the absence of Stone’s endorsement would not prevent Willard from being an HIDC because it would not be missing a signature.

43. (d) An HIDC in nonconsumer transactions takes the instrument free of all personal defenses and only loses to a real defense. Willard Bank is an HIDC because the note is negotiable and Willard paid present value ($3,900), in good faith and without notice of any problems (to specifically include the alleged breach of the computer contract). The alleged breach of the computer contract is a personal defense and not a real defense. Thus, Helco is liable to Willard because Willard is an HIDC. Answer (a) is incorrect because Willard is an HIDC. Answer (b) is incorrect because the breach is a personal defense and Willard was without notice. Answer (c) is incorrect because Helco is liable to Willard.

44. (c) Real defenses that would beat an HIDC include Infancy, Material alterations, Bankruptcy, Insanity when adjudicated, Forgery, and Fraud in the execution (I'M BIFF). Duress may be a real defense if it would make the contract void. Answers (a), (b) and (d) are incorrect because infancy, bankruptcy and duress that would make a contract void are real defenses that would defeat an HIDC. The wrongful filling-in of the amount payable that was omitted from the instrument would be a material alteration due to the negligence of the drawer. If the drawer is negligent, the HIDC can collect whatever amount is filled-in. Thus, the HIDC would take free of this defense.

45. (b) Industrial can only qualify as an HIDC for $1,000. **When Industrial paid the $1,000 present value was given, Industrial had good faith and they had no knowledge of any problems at that time.** Answer (a) is incorrect because the mere fact that the note was purchased at a discount does not give notice that there is a problem. A note is almost always purchased at a discount because there is always risk the maker may default. Answers (c) and (d) are incorrect because when the final $2,000 payment was made by Industrial there was knowledge of fraud and thus, Industrial no longer qualified as an HIDC and can only collect $1,000.

46. (c) Ott is an HIDC to the extent of $3,000. **When the $3,000 was paid Ott had given present value, in good faith and without notice of any problems.** Once Ott learned of the theft, Ott had notice of a defense and no longer qualified as an HIDC. Only HIDC’s take free of a personal defense like theft and Ott can, therefore, only recover the $3,000 and no other amount.

47. (a) Since Wilk is an HIDC, Wilk would take the instrument free of the personal defense of fraud. The only type of fraud that defeats an HIDC is fraud in the execution and that is not present. Thus, answer (d) is incorrect. **Since Monk acquired the note from Wilk, Monk will have the standing of an HIDC under the shelter rule** and will also take the note free of the defense of fraud. One who takes from an HIDC gets all of the rights of an HIDC. Thus, answer (a) is correct and (b) is incorrect. Answer (c) is incorrect because an HIDC must be without notice of problems and Monk knew of the fraud.

48. (b) To be a holder, one need only possess a negotiable instrument with all necessary endorsements. To be a holder in due course one must possess a negotiable instrument, give present value, in good faith and without notice of any problems or defenses. Answer (d) is incorrect because one who gave value for the instrument, in good faith and without notice of any defects is a holder in due course. Answers (a) and (c) are incorrect because anyone who takes from a holder in due course acquires the rights of a holder in due course, even if they do not qualify as a holder in due course. Answer (b) is correct because one who found a bearer instrument cannot be a holder in due course (they did not give value for the instrument). Likewise, they did not acquire the rights of an HIDC because they did not acquire it from an HIDC.
49. (c) With a material alteration of the amount to be paid, an HIDC can only collect the original, unaltered amount where no negligence of the drawer is involved. If the drawer were negligent, an HIDC could collect the altered amount. Bay is an HIDC because Bay gave present value, in good faith and without notice of any problems. Since there is no indication that Tell was negligent, Bay can only collect the original amount of $900 and not $1,900. Answer (a) is incorrect because Bay can collect the original amount of $900. Answer (b) and (d) are incorrect because a bank must obey a customer’s order to stop payment. If the stop payment order were improper, Bay only has an action against the drawer not the bank.

50. (d) With a material alteration of the amount to be paid, an HIDC can only collect the original, unaltered amount where no negligence of the drawer is involved. If the drawer were negligent, an HIDC could collect the altered amount. Bay is an HIDC because Bay gave present value, in good faith and without notice of the alteration. Cobb was negligent in giving Garson a blank check and thus, would be liable to Josephs for the full $1,000. Answers (a), (b) and (c) are incorrect because Josephs can collect the full $1,000.

51. (a) Drake is an HIDC because Drake paid present value (antecedent debt), in good faith and without notice of any problems. The back of the instrument contained an endorsement from Carr to “pay to the order of Drake”. This made the instrument order paper and Drake was required to deliver and endorse the instrument to negotiate it, making (c) incorrect. Drake transferred it to Hunt by mere delivery without endorsement. Hunt can not be an HIDC because the instrument is missing Drake’s signature, thus making answer (d) incorrect. Hunt has the standing of an HIDC under the shelter rule because Drake was an HIDC. Additionally, when one transfers without endorsement and their signature is needed, their immediate transferee has the right to their unqualified endorsement. Thus, Hunt has the right to Drake’s signature, making (a) correct. Answer (b) is incorrect because taking an instrument in satisfaction of an antecedent debt does qualify as present value.

52. (d) Dodson negotiated a bearer note to Mellon without endorsement and by mere delivery. One who transfers without endorsement has no contract liability and makes warranties only to their immediate transferee. Thus, Dodson has no contract liability and no warranty liability to Bloom. Mellon transferred the note to Bloom by blank endorsement. Thus, Mellon has secondary liability to Bloom as an endorser and became liable upon presentment and notice of dishonor. Only answer (d) reflects this liability.

53. (c) Canceling or crossing out a prior party’s endorsement discharges that endorser from liability to later endorsers. Thus, the crossing out of Betty Ash’s endorsement released her from secondary liability to later endorsers. Answers (a), (b) and (d) are incorrect because the crossing out of a party’s endorsement only releases that party. It does not release any other endorser.

54. (c) An oral renunciation of that party’s liability does not discharge that party. Answers (a), (b) and (d) are incorrect because good faith payment, cancellation of a prior party’s endorsement and the intentional destruction of the instrument by the holder all will result in a discharge of a prior party.

55. (b) Under the Negotiable Instruments Article of the UCC, an instrument will be precluded from being negotiable if the instrument is made subject to another agreement. A negotiable instrument must be unconditional. An instrument that is subject to another agreement is non-negotiable. Answer (A) – failure to state place of payment; Answer (C) – failure to state the underlying consideration; and Answer (D) – undated, are not required elements of negotiability.

56. (a) – Link will not be required to repay Park because Link is a holder in due course of the check. A party is a holder in due course of the negotiable instrument by satisfying four requirements: (1) Link must actually be a holder of the instrument; (2) the instrument must give current value (in this case, $10,000); (3) there is not bad faith on Link or Part; and (4) Link has no notice of any problems with the instrument such as doubts as to authenticity of the instrument. Answer (A) is the only correct answer.
Chapter Four: Negotiable Instruments
Other Objective Answers

ANSWER 1

1. (A) An instrument may be postdated, antedated, or undated and be negotiable. Thus, the fact that the note is postdated has no effect on negotiability.

2. (A) To be negotiable, a note must be signed by the maker, be unconditional, be payable in a certain sum of money, be payable to order or bearer and be payable on demand or at a definite time. There is no requirement that the place of payment be stated. Thus, failure to state the place of payment has no effect on negotiability.

3. (D) Negotiation of order paper requires both delivery and endorsement by the proper parties. Thus, a note payable to the order of a specified party must be endorsed to be negotiated.

4. (B) A note endorsed "For Collection" is a restrictive endorsement because the endorser has added a restriction. Thus, the endorsement restricts negotiability.

5. (E) To be negotiable, a note must be payable in money and nothing else but money. Thus, a note payable in money or goods would be nonnegotiable.

ANSWER 2

1. (B) The instrument is a promissory note because it is a promise to pay. Evans is promising to pay to the order of Dart ("I promise to pay").

2. (G) To be negotiable a note must be signed by the maker, be unconditional, be payable in a certain sum of money, be payable to order or bearer and be payable on demand or at a definite time. This note meets all five requirements.

3. (E) To be an HIDC one must be a holder of a negotiable instrument, pay present value, have good faith and without notice of any problems. When Morton obtained the note, Morton paid present value ($275,000), with good faith and no knowledge of the fraud. Thus, Morton qualified as an HIDC.

4. (F) Under the Shelter Provision, one who takes from an HIDC acquires all of the rights of an HIDC. Trent acquired the note from Morton, an HIDC, and therefore acquired all of the rights of an HIDC. Trent would not be an HIDC because Trent knew of the fraud and thus was aware of a problem.

5. (I) Morton, as an HIDC, acquired the note free of personal defenses and would only lose to a real defense. Real defenses include Infancy, Material alterations, Bankruptcy, Insanity when adjudicated, Forgery and Fraud in the execution (I'M BIFF). Duress can be a real defense if it would make the contract void. This fraud is fraud in the inducement and not fraud in the execution and thus the defense is not available against Morton. Morton can thus recover from Evans (the maker of the note) and Dart (an endorser). Since Trent acquired all of Morton’s rights under the Shelter Provision, Trent can also recover from Evans and Dart. Additionally, Trent can recover from Morton because Trent acquired the note from Morton.

6. (D) The instrument is a draft because it is a three party deal. Fields is ordering Pure Bank to pay to the order of M. West. It is not a check because checks are drafts drawn on a bank and payable on demand. Although this is drawn on a bank, it was drawn on April 5 and payable on May 1 and thus, is not payable on demand.
7. **(E)** To be negotiable a draft must be signed by the drawer, be unconditional, be payable in a certain sum of money, be payable to order or bearer and be payable on demand or at a definite time. This draft meets all five requirements.

8. **(A)** A blank endorsement is a signature without endorsing to a specified party. A blank endorsement makes the instrument bearer paper. M. West endorsed with a mere signature and did not endorse to a specified party. Thus, it is bearer paper.

9. **(H)** A special endorsement is an endorsement to a specified party and makes the instrument order paper. Keeton endorsed to a specified party ("Pay to C. Larr") and thus, it is order paper.

10. **(A)** A blank endorsement is a signature without endorsing to a specified party. A blank endorsement makes the instrument bearer paper. Larr did not endorse the instrument to a specified party, thus it is bearer paper.

11. **(B)** A blank endorsement is a signature without endorsing to a specified party. M. West endorsed with a mere signature and did not endorse to a specified party. Thus, it is a blank endorsement.

12. **(J)** A special endorsement is an endorsement to a specified party. Keeton endorsed to a specified party ("Pay to C. Larr"). Thus, it is a special endorsement.

13. **(I)** A qualified endorsement endorses with the words "without recourse." Larr endorsed with the words "without recourse." Thus, it is a qualified endorsement.

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**ANSWER 3**

1. **(F)** The instrument is a promissory note because it is a two party deal whereby Alice Long promises to pay to the order of Mark Eden ("the undersigned promises to pay").

2. **(C)** The instrument is a draft because it is a three party deal whereby Patricia Rite is ordering Henry Gage to pay to the order of Edward Tharp. It is not a check because a check is a type of a draft drawn on a bank and payable on demand. The drawee, Henry Gage, is not a bank.

3. **(D)** To be negotiable a note must be signed by the maker, be unconditional, be payable in a certain sum of money, be payable to order or bearer and be payable on demand or at a definite time. This note meets all five requirements.

4. **(D)** To be negotiable a draft must be signed by the drawer, be unconditional, be payable in a certain sum of money, be payable to order or bearer and be payable on demand or at a definite time. This draft meets all five requirements.

5. **(A)** A blank endorsement is a signature without endorsing to a specified party. Mark Eden endorsed with a mere signature and did not endorse to a specified party. Thus, it is a blank endorsement.

6. **(G)** A qualified endorsement endorses with the words "without recourse." Ferry endorsed with the words "without recourse." Thus, it is a qualified endorsement.
ANSWER 4

a. Williams' first claim that the promissory note is negotiable is incorrect. The note is nonnegotiable because:

- It is not payable at a definite time or on demand because payment is not required until two weeks after an event, the occurrence of which is uncertain.

- The note is only payable out of the proceeds of the resale of the computer components making the promise to pay the note conditional. This is referred to as the "particular fund doctrine."

Williams' second claim that it is a holder in due course is incorrect. Although Williams is a holder of the instrument, it cannot be a holder in due course because the instrument is nonnegotiable.

Williams' third claim that Helco cannot raise Jason's misrepresentation as a defense to payment of the note is incorrect. This defense is a personal defense and would not be valid against a holder in due course. Williams only has the rights of an assignee of the Helco note. It has no better rights than Jason. Thus, Helco can raise Jason's misrepresentation as a defense.

b. Grover is incorrect in refusing to pay its note. Williams took the note with notice of Grover's defense and, therefore, could not be a holder in due course in its own right. Williams took the note from Oliver, who was a holder in due course. Therefore, under the "shelter provision" of the UCC Commercial Paper Article, Williams has the rights of a holder in due course even though Williams was aware of it.

c. Williams will be unable to collect from Oliver in the event Grover is not required to pay the note. Oliver was unaware of the claims of Grover, its endorsement was without recourse and violated no transfer warranties. Therefore, Williams does not have any right to recover from Oliver.

ANSWER 5

Rustic's first claim, that its security interest is superior to National's is incorrect. Rustic's security interest was perfected at the time it filed its financing statement, February 9, 1992, because it was a purchase money security interest in inventory. National filed its financing statement on February 7, 1992; therefore, National's security interest was perfected before, and is superior to, Rustic's security interest.

Rustic's second claim, that Karry purchased the lathe subject to Rustic's security interest, is incorrect. Karry, as a buyer in the ordinary course of Friendly's business, purchased the lathe free of any security interest given by Friendly. The fact that Karry was aware of Rustic's security interest does not affect this conclusion.

Karry's first claim, that the note is nonnegotiable, is incorrect. For a promissory note to be negotiable, it must be payable on demand or at a definite time. An instrument is payable on demand when it states that it is so payable, or when it provides no specific time for payment. Therefore, the note would be considered payable on demand.

Also, Karry's promissory note is negotiable despite the reference to the sales invoice because the reference does not make the note subject to the sales contract; rather, the reference only notes the existence of the invoice.

Karry's second claim, that Abcor has no rights to Karry's note because Friendly did not endorse it, is incorrect. The note is a bearer instrument because it is made payable to Friendly or bearer. Bearer instruments may be negotiated by delivery of the instrument alone.
Karry's third claim, that Abcor took the note subject to Karry's dispute with Friendly, is incorrect. Karry's dispute with Friendly was a personal defense to Karry. Even though Abcor took the note knowing of Karry's dispute and, therefore, could not ordinarily be a holder in due course, Abcor did take the note from Queen, which was a holder in due course. Under the "shelter provision" of the UCC Commercial Paper Article, Abcor has the rights of a holder in due course even though it does not qualify as one. As a result, Abcor did not take the note subject to Karry's personal defense, despite knowing of Karry's claim.

**ANSWER 6**

Hillcraft's first assertion, that the note is nonnegotiable because it references the license agreement and is not payable at a definite time or on demand, is incorrect. The note is negotiable despite the reference to the license agreement because it does not make the note subject to the terms of the agreement; rather, the reference is regarded only as a recital of its existence.

Also, Hillcraft's right to extend the time for payment does not make the note nonnegotiable because the extension period is for a definite period of time.

Hillcraft's second assertion, that River Oaks is not a holder in due course (HDC) because it received the note as security for an existing debt and, therefore, did not give value for it, is incorrect. Under the UCC Commercial Paper Article, a holder does give value for an instrument when it is taken in payment of, or as a security for, an antecedent claim.

Hillcraft's third assertion, that River Oaks is not an HDC because River Oaks was aware of Alexco's alleged breach of the license agreement, is correct. If a holder of a note is aware of a dispute when it acquires the note, that holder cannot be an HDC because it took with notice.

Hillcraft's fourth assertion, that it can raise the alleged breach by Alexco as a defense to payment of the note, is incorrect. Even though River Oaks is not an HDC under the UCC "shelter provision," it is entitled to the protection of an HDC because it took the instrument from First Auto, which was an HDC. Therefore, River Oaks did not take the note subject to Hillcraft's defense based on the alleged breach by Alexco. Hillcraft's defense is considered a personal defense and can only be used by Hillcraft against Alexco.

Hillcraft's fifth assertion, that River Oaks has no right to the note because it was not endorsed by Alexco, is incorrect. River Oaks acquired rights to the Hillcraft note without Alexco's endorsement because the note was a bearer instrument as a result of it being payable to "Alexco Company or bearer." A bearer instrument can be negotiated by delivery alone.

Hillcraft's final assertion, that the maximum amount Hillcraft would owe under the note is $4,000, plus accrued interest, is correct. If there is a conflict between a number written in numerals and also described by words, the words take precedence. Therefore, Hillcraft's maximum potential principal liability is $4,000 under the note.

**ANSWER 7**

a. **Checks paid to fictitious payees.** Hex will bear the ultimate loss on these items (the fictitious or non-existent "employees" and the fictitious suppliers). As a general rule, forged signatures of drawers and forged endorsements are real defenses which are valid even against a holder in due course. However, when some of these activities are engaged in by the employees of an employer-drawer of the checks, a different rule is applied. Essentially, this rule negates these real defenses in certain cases thereby shifting the loss to the employer-drawer. The key rule is contained in the Uniform Commercial Code's Article on Commercial Paper which deals with "Impostors; Signature of Payee." In essence, this rule makes the endorsement or signature of the agent or employee of the drawer (Hex) "effective" where the agent has supplied the drawer the name of the payee intending the latter to have no such interest.
Insofar as Omega is concerned, it will be treated as if it had honored valid orders to pay and need not refund to Hex the amounts it paid. The orders are valid since the forged endorsements are not treated as unauthorized.

b. Checks which contain the forged signature of the treasurer. From the facts it is apparent that the treasurer had the authority to sign checks and not the assistant treasurer or head of payroll. Thus, the forging of the treasurer's signature was an "unauthorized signature" under the UCC.

As to these checks, the UCC provides that such signatures are wholly inoperative since the guilty parties had no authority to sign the treasurer's or any other authorized party's name as the drawer on behalf of Hex.

As between Hex and Omega, there is an obligation on the part of the bank to know the signatures of its drawer-depositors. Since Omega has paid the items it cannot recoup the loss from Hex. However, the bank has two possible ways to escape liability to Hex. First, it can resort to the UCC section which imposes upon a customer to whom items (checks) are returned, a duty to exercise reasonable care and promptness in discovering and reporting unauthorized signatures. Another possibility is to establish negligence on the part of Hex which substantially contributed to the forgeries. Unless the bank can demonstrate that one of these exceptions apply, it will bear the loss.

ANSWER 8

To:

From:

I have identified and explained the issues and offer my conclusions on the legal issues pertaining to the attached note.

• Is Crane a holder in due course?

Crane is a holder in due course because Crane took a negotiable note for value, in good faith, and without knowledge of any defenses by the maker. The later disclosure that Oval has a personal defense against Jones does not affect that status as a holder in due course.

• Will Crane be able to collect from Jones?

Crane should be able to collect from Oval because Oval’s defense is personal and a holder in due course is not subject to personal defenses.

• Will Crane be able to collect from Jones?

Crane should be able to collect from Jones despite Jones’ qualified indorsement (without recourse) of the note. Jones was aware of Oval’s defense of fraud at the time Jones indorsed the note to Crane. This knowledge is a breach of the implied transfer warranty against defenses. Accordingly, Jones’ qualified indorsement does not prevent Crane from collecting the note from Jones.
Chapter Five
Documents of Title

DOCUMENTS OF TITLE

1. Documents of title are written documents covering goods being transported or stored. There are two types tested on the exam: warehouse receipts and bills of lading.

2. **Warehouse receipts** are documents issued by a warehouser acknowledging receipt and storage of the goods specified in the document.
   a. A warehouse receipt must contain the following: (Who, what, where, when, how much and signed)
      1. Who: must state if the goods are to be delivered to bearer, to a specified party, or to the order of a specified party
      2. What: must state a description of the goods
      3. Where: must state the location of the warehouse
      4. When: must state the date the receipt was issued
      5. How much: must state any applicable fees
      6. Signed: must be signed by the warehouser or authorized agent
   b. Warehouse receipts do not need to be issued by bonded and licensed warehousers
   c. Warehouse receipts are a receipt, a contract for storage and a document of title.

3. **Bills of lading** are documents issued by carriers for receipt of goods to be transported.
   a. They are a receipt, a contract for transportation and a document of title
   b. The consignor is the person delivering the goods to the carrier
   c. The consignee is the person to whom the carrier is to deliver the goods

4. A document of title is negotiable if by its terms goods are to be delivered to bearer or the order of a named party (as with commercial paper it must be to bearer or order).
   a. If the document of title is negotiable, ownership of the document is tantamount to ownership of goods represented by the document
   b. If it is nonnegotiable, it is a mere receipt and contract for storage or transportation
   c. A party obtaining a negotiable document of title may obtain greater rights than one obtaining a nonnegotiable document (see due negotiation in note 7. below)

5. As with commercial paper, negotiation of a document of title depends on whether the document is bearer document or order.
   a. A bearer document of title requires mere delivery for negotiation
   b. An order document of title requires delivery plus a proper endorsement.
      e.g., An order document of title with the forged endorsement of the payee would not pass good title because there was not a proper endorsement (the rules for forgery of documents of title are similar to forgery rules for commercial paper)

6. Delivery requirements with documents of title.
   a. With a negotiable document of title the carrier or warehouser is required to deliver the goods to whomever is legally in possession of the document (or to a party designated by the holder) and must obtain possession of the original document.
      1. With bearer documents of title the goods must be delivered only to the party possessing the bearer document or to one designated by that party
      2. With order documents of title: goods must be delivered only to the order of that party or to one holding a document properly endorsed by that party
      3. Failure to take possession: delivery of goods to a party with a missing document of title (absent a court order) makes the carrier or warehouser liable to any party injured by the misdelivery.
b. with a nonnegotiable document, goods must be delivered to the party named in the document, not the one legally in possession of the document
1). e.g. with a nonnegotiable bill of lading (called straight bills) goods are to be delivered to the party named in the document (the consignee)
2). with nonnegotiable bills of lading the carrier's only concern is that the goods are delivered to the party named in the document (no need to take possession of the document)

7. Obtaining a negotiable document of title by due negotiation is very similar to the concept of obtaining commercial paper by a holder in due course
a. if one obtains a negotiable document of title by due negotiation, it is duly negotiated and (s)he obtains special rights, just like a holder in due course obtains special rights
b. the requirements for due negotiation are also similar. For a document to be duly negotiated it must meet the following requirements
1). must give present value for the document of title (unlike a holder in due course, present value cannot include an antecedent debt)
2). must take in good faith
3). without any notice of an adverse claim or defense
4). the purchaser must obtain it in the regular course of business or financing and may not obtain it as payment or settlement of a debt
c. the purchaser by due negotiation of a negotiable document takes the document free of most adverse claims and defenses of the bailee or 3rd parties
1). exception: a thief or finder of goods cannot obtain a document of title to the goods and then transfer good title to the document and the goods it represents
2). most of the defenses that would defeat a holder in due course (infancy, material alterations, bankruptcy, adjudicated insanity or illegality, fraud in the execution and forgery) will defeat a purchaser by due negotiation.

e.g. with a material alteration of a document of title, it will most often be enforced in its original form even against a purchaser by due negotiation. If it was altered due to the negligence of the issuer (filling in a space left blank), it maybe enforced in its altered form

8. The transferor of a negotiable document of title for value make 3 warranties to the immediate purchaser
a. document is genuine
b. transfer is effective and rightful
c. transferor has no knowledge of any facts that would impair the validity or worth of the document

9. When goods are covered by a document of title, title and risk of loss only pass when the buyer gets the document

10. Rights and liabilities of warehousers and carriers
a. both warehousers and common carriers may limit their liability by contract
b. warehousers are liable for negligence (lack of due care), but are not strictly liable
1). if the goods are lost, stolen or damaged while in the warehouser’s possession the warehouser is presumed by law to have been at fault
2). the warehouser is not liable if the warehouser can prove it was not his/her fault
c. common carriers are strictly liable for loss or damage to goods regardless of fault (unless the goods were damaged due to the fault of the shipper or by act of God)
d. both are liable for misdelivery of goods to a good faith purchaser of the document
e. both may commingle fungible goods (goods in which any unit is treated as the equivalent of any other unit, like wheat, oil, or coal of the same quality)
f. both have a lien for charges and expenses on goods in their possession
1). may be enforced by selling the goods at a public or private sale after notice
2). lien may be enforced against a purchaser of the document of title
Chapter Five: Documents of Title
Multiple Choice Questions

1. Under the Documents of Title Article of the UCC, which of the following terms must be contained in a warehouse receipt?
   I. A statement indicating whether the goods received will be delivered to the bearer, to a specified person or to a specified person or his/her order.
   II. The location of the warehouse where the goods are stored.
   a. I only.
   b. II only.
   c. Both I and II.
   d. Neither I nor II.

2. Under the UCC, a warehouse receipt
   a. Is negotiable if, by its terms, the goods are to be delivered to bearer or to the order of a named person.
   b. Will not be negotiable if it contains a contractual limitation on the warehouser's liability.
   c. May qualify as both a negotiable warehouse receipt and negotiable commercial paper if the instrument is payable either in cash or by the delivery of goods.
   d. May be issued only by a bonded and licensed warehouser.

3. Under the UCC, a bill of lading
   a. Will never be enforceable if altered.
   b. Is issued by a consignee of goods.
   c. Will never be negotiable unless it is endorsed.
   d. Is negotiable if the goods are to be delivered to bearer.

4. A negotiable bill of lading
   a. Is one type of commercial paper as defined by the Uniform Commercial Code.
   b. Can give certain good faith purchasers greater rights to the bill of lading or the goods than the transferor had.
   c. Can not result in a loss to the owner if lost or stolen, provided prompt notice is given to the carrier in possession of the goods.
   d. Does not give the rightful possessor the ownership of the goods.

5. The procedure necessary to negotiate a document of title depends principally on whether the document is
   a. An order document or a bearer document.
   b. Issued by a bailee or a consignee.
   c. A receipt for goods stored or goods already shipped.
   d. A bill of lading or a warehouse receipt.

6. Which of the following statements is correct concerning a bill of lading in the possession of Major Corp. that was issued by a common carrier and provides that the goods are to be delivered “to bearer”?
   a. The carrier's lien for any unpaid shipping charges does not entitle it to sell the goods to enforce the lien.
   b. The carrier will not be liable for delivering the goods to a person other than Major.
   c. The carrier may require Major to endorse the bill of lading prior to delivering the goods.
   d. The bill of lading can be negotiated by Major by delivery alone and without endorsement.

7. Burke stole several negotiable warehouse receipts from Grove Co. The receipts were deliverable to Grove's order. Burke endorsed Grove's name and sold the warehouse receipts to Federated Wholesalers, a bona fide purchaser. In an action by Federated against Grove,
   a. Grove will prevail, because Burke cannot validly negotiate the warehouse receipts.
   b. Grove will prevail, because the warehouser must be notified before any valid negotiation of a warehouse receipt is effective.
   c. Federated will prevail, because the warehouse receipts were converted to bearer instruments by Burke's endorsement.
   d. Federated will prevail, because it took the negotiable warehouse receipts as a bona fide purchaser for value.
8. Under the Document of Title Article of the UCC, which of the following statements is(are) correct regarding a common carrier's duty to deliver goods subject to a negotiable, bearer bill of lading?

I. The carrier may deliver the goods to any party designated by the holder of the bill of lading.
II. A carrier, who, without court order, delivers goods to a party claiming the goods under a missing negotiable bill of lading is liable to any person injured by the misdelivery.

a. I only.
b. II only.
c. Both I and II.
d. Neither I nor II.

9. Which of the following statements is correct concerning a common carrier that issues a bill of lading stating that the goods are to be delivered "to the order of Ajax"?

a. The carrier's lien on the goods covered by the bill of lading for storage or transportation expenses is ineffective against the bill of lading's purchaser.
b. The carrier may not, as a matter of public policy, limit its liability for the goods by the terms of the bill.
c. The carrier must deliver the goods only to Ajax or to a person who presents the bill of lading properly endorsed by Ajax.
d. The carrier would have liability only to Ajax because the bill of lading is nonnegotiable.

10. Under a nonnegotiable bill of lading, a carrier who accepts goods for shipment must deliver the goods to

a. Any holder of the bill of lading.
b. Any party subsequently named by the seller.
c. The seller who was issued the bill of lading.
d. The consignee of the bill of lading.

11. Under the Documents of Title Article of the UCC, a negotiable document of title is “duly negotiated” when it is negotiated to

a. Any holder by indorsement.
b. Any holder by delivery
c. A holder who takes the document in payment of a money obligation
d. A holder who takes the document for value, in good faith, and without notice of any defense or claim to it.

12. Which of the following is not a warranty made by the seller of a negotiable warehouse receipt to the purchaser of the document?

a. The document transfer is fully effective with respect to the goods it represents.
b. The warehouseman will honor the document.
c. The seller has no knowledge of any facts that would impair the document's validity.
d. The document is genuine.

13. Bell Co. owned 20 engines which it deposited in a public warehouse on May 5, receiving a negotiable warehouse receipt in its name. Bell sold the engines to Spark Corp. On which of the following dates did the risk of loss transfer from Bell to Spark?

a. June 11 - Spark signed a contract to buy the engines from Bill for $19,000. Delivery was to be at the warehouse.
b. June 12 - Spark paid for the engines.
c. June 13 - Bell negotiated the warehouse receipt to Spark.
d. June 14 - Spark received delivery of the engines at the warehouse.

14. Field Corp. issued a negotiable warehouse receipt to Hall for goods stored in Field's warehouse. Hall's goods were lost due to Field's failure to exercise such care as a reasonably careful person would under the circumstances. The state in which this transaction occurred follows the UCC rule with respect to a warehouseman's liability for lost goods. The warehouse receipt is silent on this point. Under the circumstances, Field is

a. Liable because it is strictly liable for any loss.
b. Liable because it was negligent.
c. Not liable because the warehouse receipt was negotiable.
d. Not liable unless Hall can establish that Field was grossly negligent.

15. Woody Pyle, a public warehouseman, issued Merlin a negotiable warehouse receipt for fungible goods stored. Pyle

a. May not limit the amount of his liability for his own negligence.
b. Will be absolutely liable for any damages in the absence of a statute or a provision on the warehouse receipt to the contrary.
c. May commingle Merlin's goods with similar fungible goods of other bailors.
d. Is obligated to deliver the goods to Merlin despite Merlin's improper refusal to pay the storage charges due.
Chapter Five: Documents of Title
Multiple Choice Answers

1. (c) Warehouse receipts must contain the following (who, what, where, when, how much and signed): who is to receive the goods (must state if the goods are to be delivered to bearer, to a specified party, or to the order of a specified party), what (must state a description of the goods), where (must state the location of the warehouse), when (must state the date the receipt was issued), how much (must state applicable fees), and signed (must be signed by the warehouser or authorized agent). Since the warehouse receipt must indicate if the goods will be delivered to bearer, to as specified party, or to the order of a specified party and must also include the location of the warehouse, only answer (c) is correct.

2. (a) A document of title is negotiable if by its terms goods are to be delivered to bearer or to the order of a named party. Answer (b) is incorrect because a warehouser may limit their liability in contract (and frequently do limit their liability) without making the warehouse receipt non-negotiable. Answer (c) is incorrect because commercial paper must be payable in a certain sum of money and nothing else. It can not be payable in money or goods. Equally, a warehouse receipt requires delivery of goods and nothing else. It can not be goods or money. Answer (d) is incorrect because a warehouse receipt may be issued by one who is not a bonded and licensed warehouser.

3. (d) A bill of lading is negotiable if by its terms goods are to be delivered to bearer or to the order of a named party. Answer (a) is incorrect because most often with material alterations of documents of title, the document is enforceable against the issuer as it was originally written. Answer (b) is incorrect because the consignee is the one to whom the goods are to be delivered, not the one who issued the bill of lading. Bills of lading are issued by a carrier. Answer (c) is incorrect because a bill of lading is negotiable if goods are to be delivered to bearer and a bearer document does not require an endorsement.

4. (b) The holder of a bill of lading that has been duly negotiated acquires the document free of defenses available against their transferor. To have due negotiation requires present value, good faith, without notice of a defense or claim, and in the regular course of business or financing. Thus, certain holders can have greater rights than their transferors. Answer (a) is incorrect because commercial paper must be payable in a certain sum of money and a bill of lading is not payable in money. Answer (c) is incorrect because anyone in possession of a negotiable bearer document of title is entitled to receive the goods from the carrier. Thus, prompt notice to a carrier of theft or loss of a bearer bill of lading can result in a loss to the owner. Answer (d) is incorrect because rightful possession of a document of title does give true ownership to the goods.

5. (a) A document of title is negotiable if by its terms goods are to be delivered to bearer or to the order of a named party. To negotiate a bearer document requires mere delivery. To negotiate an order document requires delivery plus a proper endorsement. Thus, the procedures necessary to negotiate a document of title principally depend on whether the document is an order document or bearer document. All other answers reflect other criteria and are incorrect.

6. (d) A document of title is negotiable if by its terms goods are to be delivered to bearer or to the order of a named party. To negotiate a bearer document requires mere delivery. Since the bill of lading provided that goods were to be delivered to bearer, Major can negotiate by delivery alone without endorsement. Thus, (d) is correct and (c) is incorrect. Answer (a) is incorrect because a carrier has a lien for charges on goods in its possession which can be enforced by a public or private sale of the goods. Answer (b) is incorrect because the carrier is liable if goods deliverable to bearer are delivered to anyone but the party possessing the bearer document. Since Major possess a bearer bill of lading, the goods must be delivered to Major.
7. (a) Forgery of a named party in a warehouse receipt payable to order does not pass good title. It is not duly negotiated. Since the warehouse receipt was deliverable to the order of Grove, Burke’s forgery of Grove’s name would not be a valid negotiation and Grove will prevail. Answer (b) is incorrect because there is no requirement to notify a warehouser prior to negotiation. Answers (c) and (d) are incorrect because Federated will not prevail. Additionally, the warehouse receipt cannot be validly negotiated without Grove’s proper endorsement and both answers indicate that Burke’s forgery would be a valid endorsement.

8. (c) I is correct because a negotiable bearer bill of lading must be delivered only to the party possessing the bearer document or to one designated by that party. II is correct because the carrier must take possession of the bill of lading upon delivery. Failure to take possession of the document makes the carrier liable to any party to whom it has been properly negotiated. Only answer (c) states both are correct.

9. (c) A bill of lading stating that goods are to be delivered to the order of a named party requires the carrier to deliver the goods to that party or to a proper endorsee of that party. Thus, the goods must be delivered to Ajax or an endorsee of Ajax. Answer (a) is incorrect because a carrier’s lien for charges and expenses on goods in its possession is enforceable against a purchaser. Answer (b) is incorrect because a carrier or warehouser may limit their liability by contract. Answer (d) is incorrect because a bill of lading is negotiable if by its terms goods are to be delivered to bearer or to the order of a named party. Since this bill of lading required goods to be delivered to the order of Ajax, it was negotiable.

10. (d) The consignee of a bill of lading is the party to whom the goods are to be delivered. The carrier is required to deliver the goods to the consignee. Answer (a) is incorrect because a non-negotiable bill of lading requiring delivery to a specified party, requires delivery by the carrier to that party and not a mere holder. Answer (b) is incorrect because the goods must be delivered to the party that was named in the document or to a proper endorsee of that party. The goods aren’t delivered to the party named by the seller if that party is not the one named in the document or a proper endorsee. Answer (c) is incorrect because the goods aren’t delivered to the seller, but to the party named in the document or a proper endorsee.

11. (d) A negotiable document of title is duly negotiated if the holder gives present value for the document, takes it in good faith, without any notice of any adverse claim or defense and in the regular course of business or financing. It is not duly negotiated if it was taken as payment or settlement of a debt. Answers (a) and (b) are incorrect because it is not just holders who take by indorsement or delivery, but only those who give present value, take in good faith and without notice of claims or defenses. Answer (c) is incorrect because it is not duly negotiated if taken in payment of a debt.

12. (b) There are three warranties made by transferors of negotiable documents of title: that the document is genuine, that transfer is effective and rightful and that the transferee has no knowledge of any facts that would impair the validity of the document. Answers (a), (c) and (d) are warranties made by a seller of a negotiable warehouse receipt.

13. (c) With negotiable warehouse receipts, title and risk of loss pass only when the buyer gets the document. Thus, risk of loss would only pass to Spark when Bell negotiated the warehouse receipt on June 13.

14. (b) A warehouser is liable for their negligence, which is lack of due care. Since Field failed to exercise reasonable care, Field is liable for negligence. Answer (a) is incorrect because a warehouser is not strictly liable. They are not an insurer. Answers (c) and (d) are incorrect because they state Field is not liable under certain circumstances. A warehouser is always liable for their negligence.

15. (c) Fungible goods are goods in which any one unit of the goods is treated as the equivalent of any other unit of the goods. Examples of fungible goods would be a silo of wheat or corn of similar quality or a storage tank filled with a like grade of oil. A warehouser may commingle fungible goods of different bailors, because one unit is the same as any other. Answer (a) is incorrect because warehousers may limit their liability in contract. Answer (b) is incorrect because a warehouser is not strictly liable. Answer (d) is incorrect because a warehouser has a lien for charges and expenses on goods in its possession. This lien can be enforced by selling the goods at a public or private sale. Thus, Pyle is not obligated to deliver the goods to Merlin if storage fees are due.
Chapter Six
Agency

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Chapter Six
Agency

AGENCY FORMATION

1. An agent is anyone authorized to act on behalf of another (a principal)
   a. any person has the capacity to be an agent (e.g. minors can be agents)
   b. e.g. all partners, corporate officers and employees are agents
   c. independent contractors may or may not be agents
      1). they are not subject to the same degree of control as an employee
      2). the distinction is important because a principal is not liable for the torts of an independent contractor, but can be liable for the torts of an employee
      3). e.g. an accountant performing an audit is an independent contractor

2. An agency requires an agreement (a meeting of minds) but not consideration
   a. if consideration is present the agency is subject to contract law
   b. an agency created without consideration is a gratuitous agency (i.e. a volunteer)

3. An agency does not require a writing in most cases
   a. exceptions: agency to buy land and those impossible to perform in one year would require a writing
   b. a power of attorney is a written authorization of agency
      1). it need only be signed by the principal, not the agent
      2). the agent doesn't have to be an attorney for there to be a power of attorney
      3). it usually limits the agent's authority to specific transactions

DUTIES OF AN AGENT TO A PRINCIPAL

1. An agent owes a principal the duty of obedience:
   a. the duty to act only as authorized by the principal
   b. e.g. must obey all of the principal's reasonable instructions, but not illegal instructions

2. An agent owes the principal the duty of diligence and due care: the agent must act as a reasonably prudent agent under the circumstances

3. An agent has a duty to inform the principal: inform the principal of all relevant facts the agent knows or should know are of interest to the principal

4. An agent has the duty to account to the principal:
   a. must maintain and provide the principal with a complete account of all money and property received or spent on the principal's behalf
   b. must keep the principal’s property separate from his/her own (i.e. can’t commingle)

5. An agent owes the principal a fiduciary duty of utmost loyalty and good faith: must act solely in the principal's best interest in connection with the business
   a. agent must be free of conflicts of interest unless disclosed and the principal consents (e.g. may not compete with the principal, act for a competitor or represent the principal in transactions in which (s)he has a personal interest without the principal’s consent)
   b. must fully disclose any interest that is adverse to the principal
   c. cannot disclose confidential information to others both while an agent and even after the agency is terminated
   d. must account to the principal for any monetary benefits gained while acting on the principal's behalf (e.g. may not accept unauthorized kickbacks or bribes)
   e. note: the principal does not owe the agent a fiduciary duty of loyalty
6. An agent who breaches any of the required duties may be terminated for cause and
   a. is liable to the principal for losses sustained due to the agent's breach
   b. is liable to the principal for any secret profits made
   c. loses the right to be compensated

**DUTIES OF A PRINCIPAL TO AN AGENT**

1. The principal has the duty to compensate the agent according to the agreement
   a. if the compensation is unspecified, the agent is entitled to reasonable compensation
   b. gratuitous agents are not entitled to compensation
   c. must maintain a complete account of any money or property due to the agent

2. The principal has a duty to reimburse an agent for authorized payments made by the agent and authorized expenses of the agent

3. The principal has a duty to indemnify the agent for any losses suffered by the agent while acting in the principal's interest

**TERMINATION OF AGENCY**

1. Most agencies are terminable at will
   a. i.e. principal can revoke an agent’s authority at any time and the agent may give notice to the principal at any time that (s)he renounces the agency
   b. but if the termination results in a contract breach, the principal is liable for damages

   **Example:** P employs A to work for 1 year. After 3 months, P wrongfully fires A without cause. P has the power to terminate the agency, but is liable to A in damages for the breach of contract.

2. The following events automatically terminate an agency relationship by operation of law:
   a. death or insanity of the principal or the agent ends the agency immediately, even if the other was unaware of the death or insanity
   b. bankruptcy of the principal ends an agency immediately
     note: bankruptcy of the agent does not usually end the agency unless the agent's financial condition was essential to the agency
   c. loss or destruction of a subject matter directly relating to the agent's authority (e.g. a realtor's authority to sell a house is terminated if the house is destroyed)
   d. loss of a license or failure to obtain a license required for the agency
   e. breach of an agent’s duty of loyalty terminates the agent’s authority
   f. illegality: if the agency becomes illegal, the agency is terminated

3. **Agency coupled with an interest:** the agent has a vested interest in the property which is the subject matter of the agency
   a. usually on the exam the principal will make a party an agent solely to pay off a debt that the principal owes the agent
      e.g. P owes A $500 and gives A written authority to collect the $500 from a tenant who owes P $500 rent. A is an agent coupled with an interest
   b. neither death, insanity nor bankruptcy will terminate an agency coupled with an interest
   c. the principal cannot terminate this agency, only the agent can

4. Notice required upon termination of the agency relationship
   a. when the agency is terminated, the agent's actual authority ends
   b. the principal must still give some type of notice to 3rd parties to terminate the agent's apparent authority (the appearance that the agent is authorized)
      1). principal must give actual notice to old customers
      2). principal must give constructive notice to new customers (e.g. publish it)
c. no notice of termination is required if the agency is terminated by operation of law (e.g. death, insanity, bankruptcy of the principal, etc.)

**2 TYPES OF AUTHORITY: actual & apparent authority**

1. **Actual or real authority:** the principal conveys to the agent the right and power to act on the principal's behalf with 3rd parties. Actual authority may be express or implied
   a. **express authority:** principal expressly tells the agent, (s)he has authority
   b. **implied authority:** agent's authority is inferred from the principal's conduct (e.g. an agent has implied authority to do what is needed to accomplish assigned tasks)

2. **Apparent authority or agency by estoppel:** the principal gives the appearance to 3rd parties that an agent is authorized
   a. the principal is liable to 3rd parties if an agent acted with apparent authority, but the principal may hold the agent liable for exceeding his/her authority
   b. the test for apparent authority is was it reasonable for the 3rd party to believe the agent was authorized
   c. **disregard secret instructions** given to the agent by the principal unless the instructions were known to the 3rd party

**Example:** P hires A to sell farm equipment, but instructs A not to sell a tractor. P has a meeting with interested buyers and states A has complete authority to sell his farm equipment. Nothing is said about the restriction on selling the tractor. X, unaware of the restriction, buys the tractor from A. Although A has no actual authority to sell the tractor, A does have apparent authority. The fact that P told A not to sell the tractor is irrelevant because this restriction was unknown to X.

**CONTRACT LIABILITY TO 3RD PARTIES**

1. The principal is liable for all contracts made by an agent if:
   a. the agent acted with authority (either real or apparent authority)
   b. the agent acted without authority on behalf of the principal and the principal **ratifies** the agent’s unauthorized contract

2. Ratification of an unauthorized contract binds the principal and the 3rd party
   a. the principal must have knowledge of all material facts to ratify
   b. the principal's ratification may be implied from his/her actions (e.g. the principal accepts the benefits of an unauthorized contract with knowledge of the facts)

**Example:** A makes an unauthorized contract with a customer on P’s behalf and accepts a check as a down payment. A leaves the written contract and the check on P’s desk. When P cashes the check, P has impliedly ratified the contract by accepting the benefits.

   c. the 3rd party may withdraw from an unauthorized contract prior to ratification, but may not withdraw after ratification
   d. to ratify the principal must have been in existence at the time the agent acted (e.g. corporations cannot ratify contracts made by promoters before they existed)
   e. for ratification to occur, the agent must have indicated that (s)he was acting on behalf of a principal (thus, an undisclosed principals cannot ratify)
   f. once the principal ratifies, (s)he cannot revoke the ratification

3. An agent is liable for all unauthorized contracts
4. An agent is not usually liable for authorized contracts unless acting for an undisclosed or partially disclosed principal
**UNDISCLOSED PRINCIPAL**

1. **Undisclosed Principal:** The agent makes contract in his own name while really acting for a secret principal (The 3rd party does not know an agency exists and believes the agent is the principal)
   a. the agent has the same actual authority as an agent for a disclosed principal, but the agent cannot have apparent authority
   b. 3rd party may elect to hold either the principal or the agent liable on the contract
   c. 3rd party may not disaffirm the contract because of an undisclosed principal
   d. an undisclosed principal cannot ratify

   **Example:** P hires A to purchase goods on her behalf and instructs A not to reveal that he is acting on her behalf. A buys goods from X in his own name for P's benefit. P is an undisclosed principal and X may elect to hold either P or A liable on the contract. X may not disaffirm the contract merely because there was a secret principal

2. **Partially Disclosed Principal:**
   a. agent reveals (s)he is making a contract for a principal, but does not reveal the principal's identity
   b. 3rd party may elect to hold either the principal or the agent liable on the contract

**TORT LIABILITY TO 3RD PARTIES**

1. A principal is liable for his/her own tortious conduct
   a. e.g. the principal directs the agent to commit a tort
   b. e.g. the principal is negligent in hiring agents or instructing agents

2. **Doctrine of respondeat superior:** a principal is liable for all torts committed by an agent, if the agent was acting within the scope of the agency
   **note:** a principal is not liable for the torts of an independent contractor
   a. the agent must have acted in the scope of the agency (i.e. done something reasonably connected with the job)
   b. the agent is liable even if the act was unauthorized (e.g. an agent acting within the scope of the agency flagrantly disregards instructions)
   c. illegal acts are not usually considered to be within the scope of the agency, but may be if the agent was doing something in connection with their job
   d. a principal who is held liable for an agent’s unauthorized tort has the right of indemnification against the agent

3. Agents and independent contractors are personally liable to 3rd parties for their torts, whether authorized or unauthorized

4. Employees injured in scope of their employment may collect Worker's Compensation benefits, even if they were negligent

   **Example:** A is employed by P at P's gas station and instructed not to smoke while pumping gas. A negligently lights a cigarette while pumping gas, causing an explosion which injures a customer and A. P is liable to the customer under respondeat superior because A was acting in the scope of employment. P has the right to be indemnified by A if P is required to pay the customer for A’s tort. A is also liable to the customer. A may collect Worker's Compensation because the injury was job related.
Chapter Six: Agency
Multiple Choice Questions

1. Generally, a disclosed principal will be liable to third parties for its agent's unauthorized misrepresentations if the agent is an

<table>
<thead>
<tr>
<th></th>
<th>Employee</th>
<th>Independent Contractor</th>
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<tr>
<td>a. Yes</td>
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<td>b. Yes</td>
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<td>c. No</td>
<td>Yes</td>
<td></td>
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<tr>
<td>d. No</td>
<td>No</td>
<td></td>
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</tbody>
</table>

2. A principal and agent relationship requires a
a. Written agreement.
b. Power of attorney.
c. Meeting of the minds and consent to act.
d. Specified consideration.

3. Which of the following actions requires an agent for a corporation to have a written agency agreement?
   a. Purchasing office supplies for the principal's business.
   b. Purchasing an interest in undeveloped land for the principal.
   c. Hiring an independent general contractor to renovate the principal's office building.
   d. Retaining an attorney to collect a business debt owed the principal.

4. Wok Corp. has decided to expand the scope of its business. In this connection, it contemplates engaging several agents. Which of the following agency relationships is within the statute of frauds and thus should be contained in a signed writing?
   a. A sales agency where the agent normally will sell goods which have a value in excess of $500.
   b. An irrevocable agency.
   c. An agency which is of indefinite duration but which is terminable upon one month's notice.
   d. An agency for the forthcoming calendar year which is entered into in mid-December of the prior year.

5. Noll gives Carr a written power of attorney. Which of the following statements is correct regarding this power of attorney?
   a. It must be signed by both Noll and Carr.
   b. It must be for a definite period of time.
   c. It may continue in existence after Noll's death.
   d. It may limit Carr's authority to specific transactions.

6. Young Corp. hired Wilson as a sales representative for six months at a salary of $5,000 per month plus 6% of sales. Which of the following statements is correct?
   a. Young does not have the power to dismiss Wilson during the six-month period without cause.
   b. Wilson is obligated to act solely in Young's interest in matters concerning Young's business.
   c. The agreement between Young and Wilson is not enforceable unless it is in writing and signed by Wilson.
   d. The agreement between Young and Wilson formed an agency coupled with an interest.

7. Which of the following statements represent(s) a principal's duty to an agent who works on a commission basis?
   I. The principal is required to maintain pertinent records, account to the agent, and pay the agent according to the terms of the agreement.
   II. The principal is required to reimburse the agent for all authorized expenses incurred unless the agreement calls for the agent to pay expenses out of the commission.
   a. I only.
   b. II only.
   c. Both I and II.
   d. Neither I nor II.

8. Dent is an agent for Wein pursuant to a written agreement with a three-year term. After two years of the term, Wein decides that he would like to terminate the relationship with Dent. Wein may terminate the relationship
   a. Without cause, but may be held liable for breach of contract.
   b. Even if Dent is an agent coupled with an interest.
   c. Without cause, but may be held liable for the intentional interference with an existing contract.
   d. Only if Dent breaches the fiduciary duties owed to Wein.

9. Thorp was a purchasing agent for Ogden, a sole proprietor, and had express authority to place purchase orders with Ogden's suppliers. Thorp placed an order with Datz, Inc. on Ogden's behalf after Ogden was declared incompetent in a judicial proceeding. Thorp was aware of Ogden's incapacity. Which of the following statements is correct concerning Ogden's liability to Datz?
a. Ogden will be liable because Datz was not informed of Ogden's incapacity.
b. Ogden will be liable because Thorp acted with express authority.
c. Ogden will not be liable because Thorp's agency ended when Ogden was declared incompetent.
d. Ogden will not be liable because Ogden was a nondisclosed principal.

10. Trent was retained, in writing, to act as Post's agent for the sale of Post's memorabilia collection. Which of the following statements is correct?
I. To be an agent, Trent must be at least 21 years of age.
II. Post would be liable to Trent if the collection was destroyed before Trent found a purchaser.

a. I only
b. II only
c. Both I and II.
d. Neither I nor II.

11. Pell is the principal and Astor is the agent in an agency coupled with an interest. In the absence of a contractual provision relating to the duration of the agency, who has the right to terminate the agency before the interest has expired?

<table>
<thead>
<tr>
<th>Pell</th>
<th>Astor</th>
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<tbody>
<tr>
<td>a. Yes</td>
<td>Yes</td>
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<td>b. No</td>
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<td>c. No</td>
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<tr>
<td>d. Yes</td>
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12. Bolt Corp. dismissed Ace as its general sales agent and notified all of Ace's known customers by letter. Young Corp., a retail outlet located outside of Ace's previously assigned sales territory, had never dealt with Ace. Young knew of Ace as a result of various business contacts. After his dismissal, Ace sold Young goods, to be delivered by Bolt, and received from Young a cash deposit for 20% of the purchase price. It was not unusual for an agent in Ace's previous position to receive cash deposits. In an action by Young against Bolt on the sales contract, Young will
a. Lose, because Ace lacked any implied authority to make the contract.
b. Lose, because Ace lacked any express authority to make the contract.
c. Win, because Bolt's notice was inadequate to terminate Ace's apparent authority.
d. Win, because a principal is an insurer of an agent's acts.

13. Generally, an agency relationship is terminated by operation of law in all of the following situations except the
a. Principal's death.
b. Principal's incapacity.
c. Agent's renunciation of the agency.
d. Agent's failure to acquire a necessary business license.

14. Frost's accountant and business manager has the authority to
a. Mortgage Frost's business property.
b. Obtain bank loans for Frost.
c. Insure Frost's property against fire loss.
d. Sell Frost's business.

15. The apparent authority of a partner to bind the partnership in dealing with third parties
a. Will be effectively limited by a formal resolution of the partners of which third parties are aware.
b. Will be effectively limited by a formal resolution of the partners of which third parties are unaware.
c. Would permit a partner to submit a claim against the partnership to arbitration.
d. Must be derived from the express powers and purposes contained in the partnership agreement.

________________

Items 16 and 17 are based on the following information:

Able, on behalf of Pix Corp., entered into a contract with Sky Corp., by which Sky agreed to sell computer equipment to Pix. Able disclosed to Sky that she was acting on behalf of Pix. However, Able had exceeded her actual authority by entering into the contract with Sky.

16. If Pix does not want to honor the contract, it will nonetheless be held liable if Sky can prove that
a. Able had apparent authority to bind Pix.
b. Able believed she was acting within the scope of her authority.
c. Able was an employee of Pix and not an independent contractor.
d. The agency relationship between Pix and Able was formalized in a signed writing.
17. If Pix wishes to ratify the contract with Sky, which of the following statements is correct?
   a. Pix must notify Sky that Pix intends to ratify the contract.
   b. Able must have acted reasonably and in Pix's best interest.
   c. Able must be a general agent of Pix.
   d. Pix must have knowledge of all material facts relating to the contract at the time it is ratified.

18. An agent will usually be liable under a contract made with a third party when the agent is acting on behalf of a(n)
<table>
<thead>
<tr>
<th>Disclosed principal</th>
<th>Undisclosed principal</th>
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<tbody>
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<td>a. Yes</td>
<td>Yes</td>
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<td>b. Yes</td>
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<td>c. No</td>
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19. Sol, an agent for May, made a contract with Simon which exceeded Sol's authority. If May wishes to hold Simon to the contract, May must prove that
   a. Sol was May's general agent even though Sol exceeded his authority.
   b. Sol believed he was acting within the scope of his authority.
   c. Sol was acting in the capacity of an agent for an undisclosed principal.
   d. May ratified the contract before withdrawal from the contract by Simon.

20. When an agent acts for an undisclosed principal, the principal will not be liable to third parties if the
   a. Principal ratifies a contract entered into by the agent.
   b. Agent acts within an implied grant of authority.
   c. Agent acts outside the grant of actual authority.
   d. Principal seeks to conceal the agency relationship.

21. When a valid contract is entered into by an agent on the principal’s behalf, in a nondisclosed principal situation, which of the following statements concerning the principal’s liability is correct?
<table>
<thead>
<tr>
<th>The principal may be held liable once disclosed</th>
<th>The principal must ratify the contract to be held liable</th>
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<tbody>
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<td>a. Yes</td>
<td>Yes</td>
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<td>b. Yes</td>
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<td>c. No</td>
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22. Easy Corp. is a real estate developer and regularly engages real estate brokers to act on its behalf in acquiring parcels of land. The brokers are authorized to enter into such contracts, but are instructed to do so in their own names without disclosing Easy’s identity or relationship to the transaction. If a broker enters into a contract with a seller on Easy's behalf,
   a. The broker will have the same actual authority as if Easy's identity had been disclosed.
   b. Easy will be bound by the contract because of the broker's apparent authority.
   c. Easy will not be liable for any negligent acts committed by the broker while acting on Easy's behalf.
   d. The broker will not be personally bound by the contract because the broker has express authority to act.

23. Parc contracted with Furn Brothers Corp. to buy hotel furniture and fixtures on behalf of Global Motor House, a motel chain. Global instructed Parc to use Parc’s own name and not to disclose to Furn that Parc was acting on Global’s behalf. Who is liable to Furn on this contract?
<table>
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<tr>
<th>Parc</th>
<th>Global</th>
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<td>a. Yes</td>
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<td>b. No</td>
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<td>c. Yes</td>
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<td>d. No</td>
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24. Which of the following rights will a third party be entitled to after validly contracting with an agent representing an undisclosed principal?
   a. Disclosure of the principal by the agent.
   b. Ratification of the contract by the principal.
   c. Performance of the contract by the agent.
   d. Election to void the contract after disclosure of the principal.

25. If an agent has, within the scope of the agency relationship, committed both negligent and intentional acts resulting in injury to third parties, the principal
   a. May be liable even if the agent's acts were unauthorized.
   b. May effectively limit its liability to those third parties if the agent has signed a disclaimer absolving the principal from liability.
   c. Will be liable under the doctrine of respondeat superior only for the intentional acts.
   d. Will never be criminally liable unless it actively participated in the acts.
26. Neal, an employee of Jordan, was delivering merchandise to a customer. On the way, Neal's negligence caused a traffic accident that resulted in damages to a third party's automobile. Who is liable to the third party?

<table>
<thead>
<tr>
<th>Neal</th>
<th>Jordan</th>
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27. Part agreed to act as Young’s agent to sell Young’s land. Part was instructed to disclose that Part was acting as an agent but not to disclosed Young’s identity. Part contracted with Rice for Rice to purchase the land. After Rice discovered Young’s identity, Young refused to fulfill the contact. Who does Rice have a cause of action against?

<table>
<thead>
<tr>
<th>Part</th>
<th>Young</th>
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<td>Yes</td>
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<td>a.</td>
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Chapter Six: Agency
Other Objective Format Questions

NUMBER 1

Items 1 through 5 are based on the following:

Lace Computer Sales Corp. orally contracted with Banks, an independent consultant, for Banks to work part-time as Lace’s agent to perform Lace’s customers’ service calls. Banks, a computer programmer and software designer, was authorized to customize Lace’s software to the customers’ needs on a commission basis, but was specifically told not to sell Lace’s computers.

On September 15, Banks made a service call on Clear Co. to repair Clear’s computer. Banks had previously called on Clear, customized Lace’s software for Clear, and collected cash payments for the work performed. During the call, Banks convinced Clear to buy an upgraded Lace computer for a price much lower than Lace would normally charge. Clear had previously purchased computers from other Lace agents and had made substantial cash down payments to the agents. Clear had no knowledge that the price was lower than normal. Banks received a $1,000 cash down payment and promised to deliver the computer the next week. Banks never turned in the down payment and left town. When Clear called the following week to have the computer delivered, Lace refused to honor Clear’s order.

Required:
Items 1 through 5 relate to the relationship between the parties. For each item, select from List I whether only statement I is correct, whether only statement II is correct, whether both statements I and II are correct, or whether neither statement I nor II is correct.

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<th>List I</th>
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<td>a. I only.</td>
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<td>b. II only.</td>
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<tr>
<td>c. Both I and II.</td>
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<tr>
<td>d. Neither I nor II.</td>
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</table>

1. I. Lace’s agreement with Banks had to be in writing for it to be a valid agency agreement.
   II. Lace’s agreement with Banks empowered Banks to act as Lace’s agent.

2. I. Clear was entitled to rely on Banks implied authority to customize Lace’s software.
   II. Clear was entitled to rely on Banks’ express authority when buying the computer.

3. I. Lace’s agreement with Banks was automatically terminated by Bank’s sale of the computer.
   II. Lace must notify Clear before Bank’s apparent authority to bind Lace will cease.

4. I. Lace is not bound by the agreement made by Banks with Clear.
   II. Lace may unilaterally amend the agreement made by Banks to prevent a loss on the sale of the computer to Clear.

5. I. Lace, as a disclosed principal, is solely contractually liable to Clear.
   II. Both Lace and Banks are contractually liable to Clear.
NUMBER 2

Prime Cars, Inc., buys and sells used automobiles. Occasionally Prime has its salespeople purchase used cars from third parties without disclosing that the salesperson is in fact buying for Prime's used car inventory. Prime's management believes better prices can be negotiated using this procedure. One of Prime's salespeople, Peterson, entered into a contract with Hallow in accordance with instructions from Prime's sales manager. The car was to be delivered one week later. After entering into the contract with Hallow, and while driving back to Prime's place of business, Peterson was involved in an automobile accident with another vehicle. Peterson's negligence, and the resulting collision, injured Mathews, the driver of the other car involved in the accident.

Prime terminated Peterson's employment because of the accident. Following Prime's general business practices, Prime published an advertisement in several trade journals that gave notice that Peterson was no longer employed by Prime. Shortly thereafter, Peterson approached one of Prime's competitors, Bagley Autos, Inc., and contracted to sell Bagley several used cars in Prime's inventory. Bagley's sales manager, who frequently purchased cars out of Prime's inventory from Peterson, paid 25% of the total price to Peterson, with the balance to be paid ten days later when the cars were to be delivered. Bagley's sales manager was unaware of Peterson's termination. Prime refused to deliver the cars to Bagley or to repay Bagley's down payment, which Prime never received from Peterson.

Prime also refused to go through with the contract entered into by Peterson with Hallow. Mathews sued both Peterson and Prime for the injuries sustained in the automobile accident. Bagley sued Prime for failing to deliver the cars or return the down payment paid to Peterson.

Required: Answer each of the following questions, setting forth the reasons for your conclusions.

a. What rights does Hallow have against Prime or Peterson?
b. Will Mathews prevail in the lawsuit against Prime and Peterson?
c. Will Bagley prevail in its lawsuit against Prime?

NUMBER 3

Exotic Pets, Inc. hired Peterson to be the manager of one of its stores. Exotic sells a wide variety of animals. Peterson was given considerable authority by Exotic to operate the store, including the right to buy inventory. Peterson was told that any inventory purchase exceeding $2,000 required the approval of Exotic's general manager.

On June 1, 1992, Peterson contracted with Creatures Corp. to buy snakes for $3,100. Peterson had regularly done business with Creatures on Exotic's behalf in the past, and on several occasions had bought $1,000 to $1,750 worth of snakes from Creatures. Creatures was unaware of the limitation on Peterson's authority to buy inventory.

Peterson occasionally would buy, for Exotic, a certain breed of dog from Premier Breeders, Inc., which was owned by Peterson's friend. Whenever Exotic bought dogs from Premier, Premier paid Peterson 5% of the purchase price as an incentive to do more business with Premier. Exotic's management was unaware of these payments to Peterson.

On June 30, 1992, Mathews went to the Exotic store managed by Peterson to buy a ferret. Peterson allowed Mathews to handle one of the ferrets. Peterson knew that this particular ferret had previously bitten one of the store's clerks. Mathews was bitten by the ferret and seriously injured.

On July 23, 1992, Peterson bought paint and brushes for $30 from Handy Hardware. Peterson charged the purchase to Exotic's account at Handy. Peterson intended to use the paint and brushes to repaint the pet showroom. Exotic's management had never specifically discussed with Peterson whether Peterson had the authority to charge purchases at Handy. Although Exotic paid the Handy bill, Exotic's president believes Peterson is obligated to reimburse Exotic for the charges.
On August 1, 1992, Exotic's president learned of the Creatures contract and advised Creatures that Exotic would neither accept delivery of the snakes, nor pay for them, because Peterson did not have the authority to enter into the contract.

Exotic's president has also learned about the incentive payments Premier made to Peterson.

Exotic has taken the following positions:

- It is not liable to Creatures because Peterson entered into the contract without Exotic's consent.
- Peterson is obligated to reimburse Exotic for the charges incurred by Peterson at Handy Hardware.
- Peterson is liable to Exotic for the incentive payments received from Premier.

Mathews has sued both Peterson and Exotic for the injuries sustained from the ferret bite.

**Required:**

a. State whether Exotic's positions are correct and give the reasons for your conclusions.

b. State whether Mathews will prevail in the lawsuit against Exotic and Peterson and give the reasons for your conclusions.
Chapter Six: Agency
Multiple Choice Answers

1. (b) A principal is liable for all torts of their agents if the agent was acting in the scope of their agency. A misrepresentation is a tort and employees are agents. Thus, a principal is usually liable for misrepresentations of employees. An independent contractor is not an agent because they are not subject to the same degree of control. A principal is not usually liable for torts of independent contractors because of the lack of control the principal has over their actions. Only answer (b) reflects liability for the employee’s actions, but not for the independent contractor.

2. (c) An agency requires an agreement, a meeting of the minds. The principal gives the agent consent to act. Answer (a) is incorrect because an agency is not one of the agreements requiring a writing under the statute of frauds (GRIPE + marriage). Answer (b) is incorrect because an agency does not require a power of attorney. Although a power of attorney is one type of agency, most agencies do not involve a power of attorney. Answer (d) is incorrect because agency does not require consideration. A volunteer is a gratuitous agent who does not receive consideration.

3. (b) The statute of frauds only requires a writing for contracts for sale of goods of $500 or more, real estate, contracts impossible to perform in one year, a promise to answer the debt of another, an executor’s promise to be personally liable for the debt of an estate and contracts where marriage is the consideration (GRIPE + marriage). An agency to purchase land would require a writing. The remaining answers (a), (c) and (d) do not require a writing under the statute of frauds.

4. (d) The statute of frauds only requires a writing for contracts for sale of goods of $500 or more, real estate, contracts impossible to perform in one year, a promise to answer the debt of another, an executor’s promise to be personally liable for the debt of an estate and contracts where marriage is the consideration (GRIPE + marriage). An agency entered into in mid-December and to last for the entire next year would be impossible to perform in one year and would require a writing. Answer (a) is incorrect because although the sales contracts of $500 or more would need a writing, the agency would not need to be in writing. Answer (b) is incorrect because an irrevocable agency does not require a writing under the statute of frauds. Answer (c) is incorrect because an agency which is terminable upon one month’s notice is not impossible to perform in one year.

5. (d) A power of attorney usually limits an agent’s authority to specific transactions. Answer (a) is incorrect because a power of attorney need only be signed by the principal, not the principal and the agent. Answer (b) is incorrect because a power of attorney may be for an indefinite period of time. Answer (c) is incorrect because death of the principal terminates most agencies, to specifically include a power of attorney.

6. (b) Because an agent owes a fiduciary duty of loyalty to their principal, they must act solely in the principal’s best interests in matters concerning their business. Answer (a) is incorrect because most agencies are terminable at will and therefore Young does have the power to dismiss Wilson without cause. Answer (c) is incorrect because only an agency to buy land or one impossible to perform in one year would require a writing under the statute of frauds (GRIPE + marriage). Answer (d) is incorrect because with an agency coupled with an interest the principal makes a party their agent solely to pay off a debt that the principal owes the agent. There is no indication that Wilson was hired by Young solely to pay off a debt that Wilson owed Young.

7. (c) Unless otherwise agreed, the principal has a duty to compensate an agent according to the agreement. Where the agreement calls for compensation by commission a principal would be required to maintain records relating to commissions owed, account to the agent for such commissions and pay the agent. A principal also owes a duty to reimburse an agent for money spent in the principal’s service. Only answer (c) reflects that both duties would be owed.
8. (a) Most agencies are terminable at will by either party. Although the power exists to terminate the agency at will, **if a breach of contract results the breaching party would have to pay damages.** Thus Wein, the principal, may terminate this agency without cause but may be held liable for breaching the terms of the contract. Answer (b) is incorrect because an exception to the rule that agencies may be terminated at will by either party is an agency coupled with an interest. A principal may not terminate an agency coupled with an interest. Answer (c) is incorrect because intentional interference with an existing contract is a tort committed by an outside party who interferes with a contract between the two parties who made the contract. Wein is not an outside party, but rather one of the two parties who made the contract. Answer (d) is incorrect because the principal may terminate the agency at will, even if the agent has not breached the fiduciary duties owed.

9. (c) **Death or insanity of either the principal or the agent will end an agency immediately.** Once Ogden, the principal, was declared insane, the agency relationship between Thorp and Ogden ended. Since the agency was terminated automatically by operation of law, Ogden would not be liable for the contract. Answers (a) and (b) are incorrect because Ogden is not liable. Answer (d) is incorrect because Thorp’s express authority ended when Ogden was declared incompetent, not because Ogden was an undisclosed principal.

10. (d) An agent is anyone authorized to act on behalf of another. **Minors may be agents,** making statement (I) incorrect. An **agency relationship is terminated by operation of law if a subject matter that directly relates to the agent’s authority is destroyed.** Statement (II) is incorrect because destruction of the collection directly related to the agent’s authority to sell and therefore terminated the agency. Post would not be liable because the agency was terminated by operation of law.

11. (b) An agency coupled with an interest cannot be terminated by the principal, but it **can be terminated by the agent.** Thus, only answer (b) can be correct.

12. (c) **If an agent is terminated, a principal must give actual notice to old customers and published notice to new ones.** Failure of the principal to give proper notice gives an agent apparent authority to make contracts with customers and subjects the principal to liability. Bolt failed to give published notice of Ace’s termination, although they did give notice to old customers. Thus, Ace had apparent authority to make contracts with new customers who were aware that Ace was Bolt’s agent. Young (a new customer) knew of Ace, and thus Bolt is liable because their notice was inadequate. Answers (a) and (b) are incorrect because Young would win not lose. Additionally, although Ace had no implied or express authority, Ace did have apparent authority. Answer (d) is incorrect because a principal is not an insurer of an agent’s acts.

13. (c) Answers (a), (b) and (d) are incorrect because **death or insanity of either party and loss of a license required for the agency ends the agency immediately by operation of law.** Answer (c) is correct because **when an agent terminates the relationship (in this case by renunciation), the agent still has apparent authority to act on the principal’s behalf.** This apparent authority would continue until the principal gave actual notice to old customers and published notice to new ones.

14. (c) **An agent has implied authority to do what is necessary to accomplish assigned tasks.** An accountant and business manager would have the implied authority to insure property against fire loss. Answers (a), (b) and (d) are incorrect because mortgaging the principal’s business property, obtaining loans for the principal and selling the principal’s business would all exceed the implied authority of an accountant and business manager.

15. (a) **Apparent authority depends on how things appear to a third party dealing with the agent.** Usually if it appears the agent was authorized, apparent authority will exist. If a partner’s authority was expressly limited by a resolution and the third party knew of the resolution, apparent authority would not exist. The third party would know that the partner’s authority was limited. Answer (b) is incorrect because if the third party was unaware of the resolution, it would still appear that the partner was authorized. This is why secret instructions should be disregarded in apparent authority cases unless the instructions are known to the third party. Answer (c) is incorrect because partnership law requires unanimous consent of all partners to submit a claim to arbitration. Answer (d) is incorrect because apparent authority depends on how things appear to third parties, not on the express provisions of the partnership agreement. The express provisions would be express authority.
16. (a) A principal is liable for contracts made by an agent on behalf of the principal if the agent had actual authority or apparent authority. Although Able exceeded her actual authority, Pix can still be liable if Able had apparent authority. Answer (b) is incorrect because a principal’s liability for contracts made by an agent depends on the agent having some type of authority to make the contract or on the principal ratifying the unauthorized contract. Even if Able believed she had authority, if this belief was incorrect and no apparent or actual authority existed and Pix did not ratify, Pix would not be liable. Answer (c) is incorrect because a principal would not be liable for an employee’s contract if the employee had no authority and the principal did not ratify. Answer (d) is incorrect because Pix can be held liable if Able had apparent authority, regardless of whether the agency is in writing or not.

17. (d) In order for a principal to effectively ratify an agent’s unauthorized contract, the principal must have knowledge of all material facts. Answer (a) is incorrect because ratification does not require notification of the third party by the principal. Answer (b) is incorrect because a principal can ratify an unauthorized contract even if the agent acted unreasonably and not in the principal’s best interest. Answer (c) is incorrect because a principal can ratify the actions of one who was not an agent at all.

18. (c) An agent is not usually liable for authorized contracts unless acting for an undisclosed or partially disclosed principal. Only answer (c) reflects that an agent for an undisclosed principal would be liable for an authorized contract, but an agent for an disclosed principal would not be liable.

19. (d) A principal is liable for contracts made by an agent in their behalf if the agent had some type of authority (actual or apparent). If the contract was unauthorized the principal will only be liable if the principal ratifies. The principal must ratify prior to the third party’s withdrawal from the contract. Thus, if May ratifies prior to Simon’s withdrawal, Simon will be bound by the contract. Answers (a), (b), and (c) are incorrect because either authority or ratification is required for there to be a valid contract. The mere fact that Sol was a general agent does not necessarily give Sol apparent or implied authority. Thus answer (a) is incorrect. Equally, the mere fact that Sol believed he was acting with authority does not necessarily give Sol apparent or implied authority. Thus answer (b) is incorrect. An agent for an undisclosed principal who exceeds his authority does not have actual authority or implied authority. He cannot have apparent authority because it doesn’t appear that he was acting for another. Since there is no authority, answer (c) is incorrect.

20. (c) A principal is liable for acts done by an agent on their behalf if the agent had some type of authority (actual or apparent). An agent for an undisclosed principal can only have actual authority and cannot have apparent authority. There can be no apparent authority because it does not appear that the agent was acting for another. Thus, the principal will not be liable if the agent acted outside the grant of actual authority. Answers (a) is incorrect because an undisclosed cannot ratify. Answer (b) is incorrect because an agent acting with implied authority has actual authority. Answer (d) is incorrect because an undisclosed principal is liable for authorized acts, even if they seek to conceal the agency relationship.

21. (b) In an undisclosed principal situation, the 3rd party may elect to hold either the principal or the agent liable on the contract. Since an undisclosed principal cannot ratify, ratification is not required (or even possible) to hold the principal liable. Only answer (b) states the principal may be liable once disclosed, but does not have to ratify.

22. (a) An agent for an undisclosed principal has the same actual authority as an agent for a disclosed principal (the authority they were expressly given by the principal). The brokers were agents for an undisclosed principal and thus had the same actual authority they would have had if Easy’s authority had been disclosed. Answer (b) is incorrect because an agent for an undisclosed principal cannot have apparent authority. It does not appear that they were authorized to act on behalf of another. Answer (c) is incorrect because a principal is liable for all torts committed by their agents while the agents were acting in the scope of their agency (respondeat superior). Answer (d) is incorrect because both the agent for an undisclosed principal and the principal are liable if there is a breach.

23. (c) If an agent for an undisclosed principal makes an authorized contract, both the agent and the principal are liable if there is a breach. The principal is liable because the contract is authorized. The agent is liable because they made the contract in their own name without disclosing they were acting for another. Only (c) states that both are liable.
24. **(c)** If an agent for an undisclosed principal makes an authorized contract, both the agent and the **principal are liable** if there is a breach. Thus, the third party may require performance by either the agent or the principal. Answer (a) is incorrect because the third party is not entitled to disclosure of the principal. The agent would violate the terms of the agency if they disclosed the principal. Answer (b) is incorrect because the third party is not entitled to ratification by the principal. With an authorized contract, there is no need for ratification because the principal is liable. Additionally, an undisclosed principal cannot ratify. Answer (d) is incorrect because a third party cannot disaffirm a contract just because there is an undisclosed principal.

25. **(a)** A **principal is liable for all torts committed by their agents while the agent is acting within the scope of their agency**. Even if an agent does an unauthorized act, they can be doing something in connection with their job and thus be acting within the scope of their agency. Answer (b) is incorrect because a written disclaimer would not prevent the principal from being liable to third parties for an agent’s tort committed while the agent was acting within the scope of the agency. Answer (c) is incorrect because a principal is liable for an agent’s negligent act that results in harm if done within the scope of the agency. Answer (d) is incorrect because a principal may be liable for an agent’s criminal act if it was done within the scope of the agency, even without the active participation of the principal. For example, a bouncer at a bar who used excessive force in removing a customer would have committed a criminal act (a battery) and acted within the scope of the agency (done something in connection with their job).

26. **(b)** A **principal is liable for all torts committed by their agents while the agent is acting within the scope of their agency**. Jordan is liable for the negligence of Neal, the agent, because Neal was delivering Jordan’s merchandise and was therefore acting within the scope of the agency. Neal is also liable for his negligence. The only answer that states both are liable is (b).

27. **(a)** **Rice may file an action against Part or Young is correct.** Generally, the principal is liable for all contracts of the agent, entered into on the principal’s behalf, if the agent acted within the scope of his or her authority. In this case, the agent acted within the scope of his authority, so Young is liable and Rice may proceed with an action against Young. With regard to Part, in the case of an undisclosed or a partially disclosed principal, the agent is liable on the contract at Rice’s option.
Chapter Six: Agency
Other Objective Format Answers

ANSWER 1

1. (B) Statement I is incorrect because only agencies to buy land and those impossible to perform in one year require a writing under the statute of frauds. Statement II is correct because an agent is anyone authorized to act on behalf of another. Banks was authorized by Lace to make service calls and to customize Lace's software for Lace customers. Thus, Banks was empowered to act as Lace’s agent.

2. (A) Statement I is correct because implied authority is the authority necessary to accomplish assigned tasks. One of Banks’ assigned tasks was to customize software for customers. Clear could rely on Bank’s implied authority to customize software. Statement II is incorrect because express authority occurs when the principal expressly tells the agent they are authorized. Banks was told not to sell computers. Thus, there was no express authority.

3. (B) An agency will terminate automatically by operation of law upon the death or insanity of the principal or agent, upon the bankruptcy of the principal, upon loss or destruction of a subject matter directly related to the agent’s authority and upon loss of a license required for the agency. An agency is not terminated automatically by the commission of an unauthorized act by the agent. Thus, statement I is incorrect. Statement II is correct because notice is required to terminate an agent’s apparent authority. Actual notice is required for old customers (like Clear). Thus, Lace must notify Clear before Banks apparent authority to bind Lace will cease.

4. (D) Statement I is incorrect because Banks had apparent authority to sell the computer. It was reasonable for Clear to believe Banks was authorized in that Clear had previously dealt with Banks as an agent of Lace and Clear had previously bought computers from other Lace agents by making cash deposits. Lace will be bound by Banks’ agreement with Clear because of apparent authority. Statement II is incorrect because a party that is liable on a contract may not unilaterally amend it.

5. (A) Statement I is correct and statement II is incorrect because the contract was authorized due to Banks’ apparent authority. Principals are liable for contracts made with apparent authority. Agents are not liable to 3rd parties for authorized contracts unless acting for an undisclosed principal. Although Banks would be liable to Lace for breach of his contractual duty, Banks is not contractually liable to Clear.

ANSWER 2

(a) Peterson was acting for an undisclosed principal (Prime) with regard to the contract with Hallow. Peterson was acting with actual authority; therefore, Prime is liable to Hallow. Peterson is also liable to Hallow because agents acting on behalf of undisclosed principals are liable to the third parties on the contracts they enter into with such third parties on behalf of the principal. Hallow, however, cannot collect damages from both Peterson and Prime and must make an election between them.

(b) At the time of the accident, Peterson was acting within the scope of employment because the conduct engaged in (that is, entering into a contract with Hallow) was authorized by Prime. Prime, therefore, will be liable to Mathews because the accident occurred within the scope of Peterson's employment.

Peterson will also be liable to Mathews because all persons are liable for their own negligence.
(c) Peterson's actual authority to enter into contracts on Prime's behalf ceased on termination of employment by Prime. Peterson, however, continued to have apparent authority to bind Prime because:
- Peterson was acting ostensibly within the scope of authority as evidenced by past transactions with Bagley;
- Bagley was unaware of Peterson's termination.

The trade journal announcement was not effective notice to terminate Peterson's apparent authority in relation to Bagley because:
- Prime was obligated to give actual notice to Bagley that Peterson was no longer employed;
- Actual notice is required because of Bagley's past contact with Peterson while Peterson was employed by Prime.

ANSWER 3

(a) Exotic's first position is incorrect. Although Peterson lacked actual authority to bind Exotic to the Creatures contract, from Creatures' perspective Peterson did have apparent authority to do so. Peterson was a store manager and had previously contracted with Creatures on Exotic's behalf. Creatures would not be bound by the limitation on Peterson's authority unless Creatures was aware of it.

Exotic's second position is incorrect. Although Peterson did not have express authority to charge purchases at Handy Hardware. Peterson had the implied authority as store manager to enter into contracts incidental to the express grant of authority to act as manager. Buying paint and brushes to improve Exotic's store would fall within Peterson's implied grant of authority.

Exotic's third position is correct. An agent owes a duty of loyalty to his or her principal. An agent may not benefit directly or indirectly from an agency relationship at the principal's expense. If an agent receives any profits from the principal/agent relationship without the consent of the principal, the agent must pay the profits to the principal. In this case, Peterson's incentive payments constituted a violation of Peterson's fiduciary duty to Exotic. Peterson must turn over all incentive payments to Exotic.

(b) Peterson was negligent by allowing Mathews to handle a ferret that Peterson knew was dangerous. An employer is held liable for the torts of its employees if the tort occurs within the scope of employment and if the employee is subject to the employer's control. At the time of the accident, Peterson was acting within the scope of employment and subject to Exotic's control because this conduct occurred while on the job, during normal working hours, and with the intention of benefiting Exotic. Exotic, therefore, will be liable to Mathews because the accident occurred within the scope of Peterson's employment.

Peterson also will be liable to Mathews because all persons are liable for their own negligence.
# Chapter Seven

## Bankruptcy

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Chapter Seven
Bankruptcy

BANKRUPTCY OVERVIEW:

The Debtor files for bankruptcy on May 1. May 1 is the filing date and the order for relief.

<table>
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<th>Property of the Debtor</th>
<th>As of the Filing Date</th>
<th>After the Filing Date</th>
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<tr>
<td></td>
<td>Most of the property goes to the Trustee to pay creditors</td>
<td>Debtor keeps - not covered by the bankruptcy</td>
</tr>
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</table>

| Debts of the Debtor    | Most debts are discharged (exceptions exist) | New debts - not covered by the bankruptcy |

Note: The current version of the United States Bankruptcy Code includes modifications by the Bankruptcy Abuse and Consumer Protection Act of 2005. This Act, although designed primarily to affect consumer bankruptcy proceedings, also affects any non-consumer bankruptcy filing as well.

MEANS TEST:

A recent amendment to the Bankruptcy Code requires a Means Test for all consumer debtors. The means test uses the monthly income statement, now required for consumer debtors under Chapters 7, 11 and 13, and monthly living expense standards published by the Internal Revenue Service as part of their Offer in Compromise program. If the average monthly income of the debtor for the six months prior to the bankruptcy filing exceeds the IRS published living expenses, the filing is presumed to be abusive and may be dismissed.

4 TYPES OF BANKRUPTCY

1. **CH. 7 Voluntary**: debtor voluntarily files for liquidation and a trustee is appointed
   a. the petition must include:
      1). a list of all secured and unsecured creditors
      2). a list of all property owned by debtor
      3). a list of property claimed by debtor to be exempt
   b. a husband and wife may file jointly for a voluntary bankruptcy
   c. the order for relief is the same date as the filing date
   d. a solvent person may file for voluntary bankruptcy (one need only have debts)
   e. For consumer debtors:
      1.) a statement of monthly income and a calculation for the means test
      2.) a copy of the debtor’s tax return for the tax year immediately preceding the bankruptcy filing must be filed with the bankruptcy court within seven days of the bankruptcy filing.
   f. case may be converted to a Chapter 11 or Chapter 13

2. **CH. 7 Involuntary**: creditors file to force a liquidation and a trustee is appointed
   a. with 12 or more creditors: there must be three or more creditors to file owed $13,475 or more in aggregate in unsecured claims (e.g. \( X \) has 21 creditors and owes \( A \) $8,000, \( B \) $3,000 and \( C \) $4,000 in unsecured claims. \( A, B \) and \( C \) may file because they are owed more than $13,475 in aggregate in unsecured claims)
   b. with less than 12 creditors: one or more creditors may file owed $13,475 or more in unsecured claims (e.g. \( X \) has 11 creditors and owes \( A \) an unsecured debt of $14,000, \( A \) alone may file. If \( A \) were only owed $9,000, additional creditors would need to join in the filing to meet the $13,475 requirement)
c. by 3 or more secured creditors having aggregate claims in excess of $10,000 more than the value of the lien on any property used to secure payment of the debt.

d. if the petition is uncontested by debtor, the order for relief and the filing date are the same date

e. if the petition is opposed by debtor, the order for relief is granted only after a hearing rules the debtor was insolvent based on either of the following tests
   1). Equitable Insolvency (debtor was not generally paying debts when due) or
   2). a custodian was appointed or took possession of most of the debtor's property within 120 days preceding the filing
   3). do not use Insolvency in the Bankruptcy Sense as a test for insolvency (i.e. do not use assets minus liabilities as the test)

f. in an involuntary petition, creditors may be required to post monetary bonds
   1). debtor can regain the use of property by posting a monetary bond
   2). damages (to specifically include compensatory damages, court costs, attorney's fees and even punitive damages in some cases) may be awarded to the debtor if the petition is dismissed and creditors had improperly filed against the debtor

g. an involuntary petition cannot be filed against farmers, charities, insurance companies, banks, and savings and loans

3. CH. 11 Reorganization: restructures the debtor's debts so (s)he may continue to operate the business - no liquidation occurs
   a. eligible debtors include individuals, partnerships and corporations (but NOT trusts)
   b. For consumer debtors:
      1). a statement of monthly income and a calculations for the means test.
      2). a copy of the debtor’s tax return for the tax year immediately preceding the bankruptcy filing must be filed with the bankruptcy court within seven days of the bankruptcy filing.
   c. the filing may be voluntary (by the debtor) or involuntary (by the creditors)
   d. a trustee is not required, but may be appointed if requested by creditors
      1). trustee will only be appointed for cause (fraud, gross mismanagement, etc.)
      2). if no trustee is appointed, debtor performs the tasks that the trustee would
   e. a plan restructuring the debts is submitted to a committee of unsecured creditors
      1). debtor has exclusive rights to submit the plan for 120 days after the order for relief, unless a trustee has been appointed (afterwards creditors may file a plan)
      2). the plan divides the debtor's creditors into classes and specifies how each class of claims will be treated
      3). each class of claims has an opportunity to accept the plan
      4). plan is accepted by creditors when 50% or more of the creditors of that class actually voting representing at least 2/3 of the dollar amount owed approve
      5). plan is accepted by shareholders when shareholders representing 2/3 of the dollar amount owed of those actually voting approve
   f. the plan must also be confirmed by the court and once confirmed the debtor is discharged from all debts that arose prior to confirmation except as otherwise provided for in the plan (i.e. debtor pays debts according to the plan and any debt not covered by the plan is discharged)
      1). cram down: court forces creditors to accept a plan that has been accepted by only one class of claims. The plan must be fair and equitable
      2). certain creditors must be paid in full before the plan can be confirmed. These include expenses for administration of the bankruptcy case, gap creditors, claims for wages and employee benefits and claims for consumer deposits

4. CH. 13 Adjustment of debts of individuals: allows individuals and sole proprietors to file a repayment plan to adjust their debts (not available to corporations or partnerships)
   a. debtor must have a regular income and unsecured debts of less than $336,900 and secured debts of less than $1,010,650
   b. the filing can only be voluntary (no involuntary petitions are permitted)
c. For consumer debtors:
   1). a statement of monthly income and a calculation for the means test.
   2). a copy of the debtor’s tax return for the tax year immediately preceding the bankruptcy filing must be filed with the bankruptcy court within seven days of the bankruptcy filing.

d. a trustee is required but no liquidation occurs

e. debtor submits one of two types of plans (only the debtor may file the plan)
   1). a composition of debts which reduces the total amount owed or
   2). an extension plan which extends the time in which the debtor will pay all of his/her debts in full

f. only the court approves the plan (creditors do not vote) - approval requires
   1). unsecured creditors must not receive less than under a Ch. 7 filing
   2). secured creditors either accept the plan or the debtor surrenders all of their collateral to them
   3). a determination by the court that the debtor can comply with the plan and make payments

5. Filing for bankruptcy
   a. the following may not file under Chapter 7 RIMBS

| R | Railroads (but may file under Chapter 11) |
| I | Insurance Companies (cannot file under Chapter 11) |
| M | Municipalities (cannot file under Chapter 11) |
| B | Banks including credit unions (cannot file under Chapter 11) |
| S | Savings and Loans (cannot file under Chapter 11) |

b. filing under Chapter 7, 11 or 13 acts as an Automatic Stay - stops all collection efforts by creditors (e.g. if a creditor pursuant to a legal judgment is garnishing the debtor's wages, filing for bankruptcy would stop the garnishment)
   1). filing does not stop alimony, maintenance or child support collection
   2). filing does not stop criminal actions
   3). filing does not stop investigations or actions by a securities self-regulatory organization of the debtor's business, nor ban any remedial actions by said organization (i.e., delisting a stock).
   4). filing does not stop intersection of tax refunds
   5). filing does not stop the suspension or restriction of driver's licenses or professional or occupational licenses by appropriate regulatory authorities
   6). For cases other than a Chapter 7, filed by a single or a joint debtor within one year of dismissal of a previous case, the automatic stay will expire 30 days after the filing of the subsequent case.

PROPERTY INCLUDED IN DEBTOR'S ESTATE

1. Property of the debtor as of the filing date goes to the trustee to pay creditors (this includes proceeds and profits from that property even if gained after the filing date)
   a. certain benefits are exempt (social security, disability, unemployment and veteran’s benefits)
   b. alimony and child support are exempt
   c. things necessary to live are exempt up to certain specified dollar limits (e.g. debtor's home, a car, household furnishings and goods, jewelry, tools of debtor's trade, burial plot, etc.)
   d. payments from pensions and annuity plans are exempt
   e. generally, educational IRA’s are exempt up to $1,000,000
   f. IRA’s up to $1,000,000
2. Property gained by the debtor after the filing is not included in the debtor's estate (the debtor keeps this property) **with 3 exceptions:**
   a. property gained **within 180 days** after filing **by divorce** goes to the trustee
   b. property gained **within 180 days** after filing **by inheritance** goes to the trustee
   c. property gained **within 180 days** after filing **by insurance** goes to the trustee

3. With **leases**, the trustee has a choice
   a. trustee may **reject** the lease, **assume and retain** or **assume and assign** the lease
   b. if the lease is not assumed within 60 days after the order for relief, it is rejected

4. The trustee also can add property to the debtor's estate by disaffirming preferential transfers, fraudulent conveyances or statutory liens

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### 3 AVOIDING POWERS OF A TRUSTEE

1. The trustee has the power to avoid **preferential transfers** if 5 tests are met (**TANIM**). A preferential transfer is preferring one creditor over others

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<th><strong>T</strong></th>
<th><strong>TANIM</strong></th>
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<tr>
<td>T</td>
<td>must have a <strong>Transfer</strong> of property by a debtor that benefits a creditor</td>
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<tr>
<th><strong>A</strong></th>
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<tr>
<td>A</td>
<td>transfer must have been for an <strong>Antecedent debt</strong> - an existing overdue debt</td>
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<td>- new debts are not antecedent debts (a contemporaneous exchange for new value)</td>
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<td>- payment of current bills in the ordinary course of business are not antecedent debts</td>
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<td>- consumer debts of $600 or less are not antecedent debts</td>
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<td></td>
<td>- for non-consumer debtors, debts of $5000 or less are not considered antecedent</td>
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<td>- under ordinary business terms</td>
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<tr>
<td>N</td>
<td>transfer must have been made within <strong>Ninety days</strong> of the filing date</td>
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<td>- may be up to one year prior to filing if creditor was an insider</td>
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<th><strong>TANIM</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td>I</td>
<td>transfer must have been made while the debtor was <strong>Insolvent</strong></td>
</tr>
<tr>
<td></td>
<td>- insolvency is normally presumed if the transfer was made within 90 days</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th><strong>M</strong></th>
<th><strong>TANIM</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td>M</td>
<td>creditor received <strong>More</strong> than (s)he would have received in bankruptcy</td>
</tr>
</tbody>
</table>

**Example:** X has $190,000 in debts and owes her sister an unsecured debt of $7,000. On April 1 X pays her sister in full and files for bankruptcy on June 15. There is only $8,000 available to pay all other creditors. This is a **preferential transfer** because the $7,000 payment benefited her sister, was for an antecedent debt, occurred within 90 days of filing, occurred while X was insolvent and it resulted in the sister getting more than she would have in bankruptcy. **Note:** even if the payment was made six months prior to filing, it would still be a **preferential transfer** because the sister was an insider.

2. The trustee may avoid a **fraudulent conveyance**: a phony property transfer by a debtor for the purpose of hiding the property from creditors
   a. indications of a fraudulent conveyance include a secret transfer, the debtor retaining an equitable interest in the property or debtor remaining in possession
   b. trustee may disaffirm a fraudulent conveyance if it is done within 2 years of filing

**Example:** debtor gives a valuable antique car to X 6 months prior to filing for bankruptcy with the understanding that X will return the car to the debtor 6 months after bankruptcy has ended. The purpose is to prevent the trustee from obtaining the car.

3. The trustee has the power to avoid certain **statutory liens** that were unperfected as of the date of the bankruptcy or took effect as of the date of the bankruptcy
**10 CATEGORIES OF DEBTS**

1. Debts are paid in the order of their priority (**DAM - WEG - CTFI**)
   a. all debts within a category are paid in full before paying lower priority debts (e.g., all category #1 debts are paid in full before any category #2 debts, etc.)
   b. if there is insufficient money to pay all debts in full within a given category, each debt within that category receives a pro rata share of the available funds

<table>
<thead>
<tr>
<th>D</th>
<th># 1 – Domestic Support Obligations</th>
<th>owed to a spouse, former spouse, or child of the debtor or their assignee.</th>
</tr>
</thead>
<tbody>
<tr>
<td>A</td>
<td># 2 - Administrative Costs</td>
<td>of the bankruptcy proceedings (e.g., filing fees, trustee's fees, costs of recovering property, etc.)</td>
</tr>
</tbody>
</table>
| M | # 3 - Middleman Debts            | debts occurring after the filing but before the order of relief
    |                                 | - sometimes referred to as "gap creditors" |
| W | # 4 - Wages, salaries or commissions unpaid | must be earned within 180 days prior to filing and the maximum priority is $10,950 per employee |
| E | # 5 - Employee Benefit Plan contributions | must be for services performed within 180 days prior to filing and the maximum priority is $10,950 per employee |
| G | # 6 - Grain Producers & Fishermen | for claims against grain storage facilities and fish processing plants and the maximum priority is $5,400 per individual |
| C | # 7 - Consumer Deposits           | for goods and services not received and the maximum priority is $2,425 per consumer |
| T | # 8 - Taxes unpaid                | includes both state and federal income taxes and property taxes |
| F | # 9 – Federal Depository Institution | – a commitment by a debtor to a federal depository institution’s regulatory agency to maintain the capital of the institution. |
| I | #10 – Death or Personal Injury Claims | resulting from the operation of a motor vehicle or vessel while intoxicated from the use of alcohol, a drug, or other substance. |

<table>
<thead>
<tr>
<th>#11 – All other Debts (secured and unsecured)</th>
</tr>
</thead>
<tbody>
<tr>
<td>- Secured creditors are paid first</td>
</tr>
<tr>
<td>- Creditors who are timely are paid first</td>
</tr>
<tr>
<td>- Creditors who file late are paid only after all those who timely filed.</td>
</tr>
</tbody>
</table>

**DISCHARGE**

1. Upon completion of bankruptcy under Ch. 7, the debtor receives a discharge from most of their debts (**note**: corporations and partnerships are denied a discharge in bankruptcy)

2. Certain actions by the debtor will preclude a discharge (i.e. none of the debtor’s debts will be discharged). Actions that result in a **denial of discharge** include:
   a. the debtor received a previous discharge within six years of filing
   b. the debtor unjustifiably failed to keep or preserve adequate books and records
   c. the debtor attempted to hide assets from creditor within one year of filing
   d. in the bankruptcy proceeding the debtor made false oath, a false claim
   e. refused to obey a lawful court order or refused to satisfactorily explain a loss of assets
3. Even if a discharge is granted, certain **debts** are **excepted from discharge**
   a. **unscheduled debts** where the creditor had no notice of bankruptcy
   b. debts resulting from **Fraud, embezzlement, larceny or breach of fiduciary duty**
   c. debts concerning **alimony, maintenance and child support**
   d. debts from causing **willful and malicious injury** to others (**note:** debts from negligently causing injury to other are dischargeable)
   e. **taxes** owed within 3 years of filing
   f. **educational loans** made or guaranteed by the government
   g. debts from causing personal injury from **driving while intoxicated**
   h. debts of **$1,150 or more** within 60 days of filing are presumed nondischargeable if for **luxury goods** owed a single creditor or for **credit card cash advances**

4. A court may revoke a bankruptcy discharge upon request of the trustee or a creditor within one year for any of the following:
   a. discharge was gained by the debtor's **fraud**
   b. debtor **fraudulently** failed to report acquisition of property
   c. debtor's refusal to testify or obey a lawful court order
   d. debtor failed to answer correctly material questions on the bankruptcy petition
Chapter Seven: Bankruptcy
Multiple Choice Questions

1. Which of the following statements is correct concerning the voluntary filing of a petition in bankruptcy?
   a. If the debtor has 12 or more creditors, the unsecured claims must total at least $12,300.
   b. The debtor must be insolvent.
   c. If the debtor has less than 12 creditors, the unsecured claims must total at least $12,300.
   d. The petition may be filed jointly by spouses.

2. Which of the following conditions, if any, must a debtor meet to file a voluntary bankruptcy petition under Chapter 7 of the Federal Bankruptcy Code?
   a. Yes Yes
   b. Yes No
   c. No Yes
   d. No No

3. Which of the following requirements must be met for creditors to file an involuntary bankruptcy petition under Chapter 7 of the Federal Bankruptcy Code?
   a. The debtor must owe one creditor more than $10,775.
   b. The debtor has not been paying its bona fide debts as they become due.
   c. There must not be more than 12 creditors.
   d. At least one fully secured creditor must join in the petition.

4. Unger owes a total of $50,000 to eight unsecured creditors and one fully secured creditor. Quincy is one of the unsecured creditors and is owed $12,500. Quincy has filed a petition against Unger under the liquidation provisions of Chapter 7 of the Federal Bankruptcy Code. Unger has been unable to pay debts as they become due. Unger’s liabilities exceed Unger’s assets. Unger has filed papers opposing the bankruptcy petition. Which of the following statements regarding Quincy’s petition is correct?
   a. It will be dismissed because the secured creditor failed to join in the filing of the petition.
   b. It will be dismissed because three unsecured creditors must join in the filing of the petition.
   c. It will be granted because Unger’s liabilities exceed Unger’s assets.
   d. It will be granted because Unger is unable to pay Unger’s debts as they become due.

5. A party involuntarily petitioned into bankruptcy under Chapter 7 of the Federal Bankruptcy Code who succeeds in having the petition dismissed could recover

<table>
<thead>
<tr>
<th>Court costs and attorney’s fees</th>
<th>Compensatory damages</th>
<th>Punitive damages</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. Yes</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>b. Yes</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td>c. No</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>d. Yes</td>
<td>No</td>
<td>No</td>
</tr>
</tbody>
</table>

Items 6 and 7 are based on the following:

Strong Corp. filed a voluntary petition in bankruptcy under the reorganization provisions of Chapter 11 of the Federal Bankruptcy Code. A reorganization plan was filed and agreed to by all necessary parties. The court confirmed the plan and a final decree was entered.

6. Which of the following parties ordinarily must confirm the plan?

<table>
<thead>
<tr>
<th>1/2 of the secured creditors</th>
<th>2/3 of the shareholders</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>b. Yes</td>
<td>No</td>
</tr>
<tr>
<td>c. No</td>
<td>Yes</td>
</tr>
<tr>
<td>d. No</td>
<td>No</td>
</tr>
</tbody>
</table>

7. Which of the following statements best describes the effect of the entry of the court’s final decree?

a. Strong Corp. will be discharged from all its debts and liabilities.
   b. Strong Corp. will be discharged only from the debts owed creditors who agreed to the reorganization plan.
   c. Strong Corp. will be discharged from all its debts and liabilities that arose before the date of confirmation of the plan.
   d. Strong Corp. will be discharged from all its debts and liabilities that arose before the confirmation of the plan, except as otherwise provided in the plan, the order of confirmation, or the Bankruptcy Code.
8. Robin Corp. incurred substantial operating losses for the past three years. Unable to meet its current obligations, Robin filed a petition for reorganization under Chapter 11 of the Federal Bankruptcy Code. Which of the following statements is correct?
   a. The creditors’ committee must select a trustee to manage Robin’s affairs.
   b. The reorganization plan may only be filed by Robin.
   c. A creditors’ committee, if appointed, will consist of unsecured creditors.
   d. Robin may continue in business only with the approval of a trustee.

9. A reorganization under Chapter 11 of the Federal Bankruptcy Code requires all of the following except the
   a. Liquidation of the debtor.
   b. The filing of a reorganization plan.
   c. Confirmation of the reorganization plan by the court.
   d. Opportunity for each class of claims to accept the reorganization plan.

10. Which of the following statements is correct with respect to the reorganization provisions of Chapter 11 of the Federal Bankruptcy Code?
    a. A trustee must always be appointed.
    b. The debtor must be insolvent if the bankruptcy petition was filed voluntarily.
    c. A reorganization plan may be filed by a creditor anytime after the petition date.
    d. The commencement of a bankruptcy case may be voluntary or involuntary.

11. Under Chapter 11 of the Federal Bankruptcy Code, which of the following actions is necessary before the court may confirm a reorganization plan?
    a. Provision for full payment of administration expenses.
    b. Acceptance of the plan by all classes of claimants.
    c. Preparation of a contingent plan of liquidation.
    d. Appointment of a trustee.

12. The Bankruptcy Code provides that a debtor is entitled to claim as exempt property the right to receive

<table>
<thead>
<tr>
<th>Social security benefits</th>
<th>Disability benefits</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. No</td>
<td>No</td>
</tr>
<tr>
<td>b. Yes</td>
<td>No</td>
</tr>
<tr>
<td>c. Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>d. No</td>
<td>Yes</td>
</tr>
</tbody>
</table>

13. Which of the following assets would be included in a debtor’s bankruptcy estate in a liquidation proceeding?
    a. Proceeds from a life insurance policy received 90 days after the petition was filed.
    b. An inheritance received 270 days after the petition was filed.
    c. Property from a divorce settlement received 365 days after the petition was filed.
    d. Wages earned by the debtor after the petition was filed.

14. On June 5, 20X8, Gold rented equipment under a four-year lease. On March 8, 20X9, Gold was petitioned involuntarily into bankruptcy under the Federal Bankruptcy Code’s liquidation provisions. A trustee was appointed. The fair market value of the equipment exceeds the balance of the lease payments due. The trustee
    a. May reject the equipment lease because the fair market value of the equipment exceeds the balance of the lease payments due.
    b. May elect to assume the equipment lease.
    c. Must assume the equipment lease because its term exceeds one year.
    d. Must assume and subsequently assign the equipment lease.

15. Under the liquidation provisions of Chapter 7 of the Federal Bankruptcy Code, which of the following statements applies to a person who has voluntarily filed for and received a discharge of bankruptcy?
    a. The person will be discharged from all debts.
    b. The person can obtain another voluntary discharge in bankruptcy under Chapter 7 after three years have elapsed from the date of the prior filing.
    c. The person must surrender for distribution to the creditors amounts received as an inheritance, if the receipt occurs within 180 days after filing the bankruptcy petition.
    d. The person is precluded from owning or operating a similar business for two years.

16. Which of the following transfers by a debtor, within ninety days of filing for bankruptcy, could be set aside as a preferential payment?
    a. Making a gift to charity.
    b. Paying a business utility bill.
    c. Borrowing money from a bank secured by giving a mortgage on business property.
    d. Prepaying an installment loan on inventory.
17. One of the elements necessary to establish that a preferential transfer has been made under the Bankruptcy Code by the debtor to a creditor is that the
a. Debtor was insolvent at the time of the transfer.
b. Creditor was an insider and the transfer occurred within 90 days of the filing of the bankruptcy petition.
c. Transfer was in fact a contemporaneous exchange for new value given to the debtor.
d. Transfer was made by the debtor with actual intent to hinder, delay, or defraud other creditors.

Items 18 through 20 are based on the following:
On February 28, 20X2, Master, Inc., had total assets with a fair market value of $1,200,000 and total liabilities of $990,000. On January 15, 20X2, Master made a monthly installment note payment to Acme Distributors Corp., a creditor holding a properly perfected security interest in equipment having a fair market value greater than the balance due on the note. On March 15, 20X2, Master voluntarily filed a petition in bankruptcy under the liquidation provisions of Chapter 7 of the Federal Bankruptcy Code. One year later, the equipment was sold for less than the balance due on the note to Acme.

18. If a creditor challenged Master’s right to file, the petition would be dismissed
a. If Master had less than 12 creditors at the time of filing.
b. Unless Master can show that a reorganization under Chapter 11 of the Federal Bankruptcy Code would have been unsuccessful.
c. Unless Master can show that it is unable to pay its debts in the ordinary course of business or as they come due.
d. If Master is an insurance company.

19. If Master’s voluntary petition is filed properly,
a. Master will be entitled to conduct its business as a debtor-in-possession unless the court appoints a trustee.
b. A trustee must be appointed by the creditors.
c. Lawsuits by Master’s creditors will be stayed by the Federal Bankruptcy Code.
d. The unsecured creditors must elect a creditors’ committee of three to eleven members to consult with the trustee.

20. Master’s payment to Acme could
a. Be set aside as a preferential transfer because the fair market value of the collateral was greater than the installment note balance.
b. Be set aside as a preferential transfer unless Acme showed that Master was solvent on January 15, 20X2.
c. Not be set aside as a preferential transfer because Acme was oversecured.
d. Not be set aside as a preferential transfer if Acme showed that Master was solvent on March 15, 20X2.

Items 21 through 23 are based on the following information:
Knox operates an electronics store as a sole proprietor. On April 5, 20X8, Knox was involuntarily petitioned into bankruptcy under the liquidation provisions of the Bankruptcy Code. On April 20, a trustee in bankruptcy was appointed and an order for relief was entered. Knox’s non-exempt property has been converted to cash, which is available to satisfy the following claims and expenses as may be appropriate:

Claims and expenses
Claim by Dart Corp. (one of Knox’s suppliers) for computers ordered on April 6, 20X8, and delivered on credit to Knox on April 10, 20X8. $20,000
Fee earned by the bankruptcy trustee $15,000
Claim by Boyd for a deposit given to Knox on April 1, 20X8, for a computer Boyd purchased for personal use but that had not yet been received by Boyd $1,500
Claim by Noll Co. for the delivery of stereos to Knox on credit. The stereos were delivered on March 4, 20X8, and a financing statement was properly filed on March 5, 20X8. These stereos were sold by the trustee with Noll’s consent for $7,500, their fair market value. $5,000
Fees earned by the attorneys for the bankruptcy estate. $10,000
Claims by unsecured general creditors. $1,000

The cash available for distribution includes the proceeds from the sale of the stereos.
21. What amount will be distributed to the trustee as a fee if the cash available for distribution is $15,000?
   a. $6,000
   b. $9,000
   c. $10,000
   d. $15,000

22. What amount will be distributed to Boyd if the cash available for distribution is $50,800?
   a. $480
   b. $800
   c. $900
   d. $1,500

23. What amount will be distributed to Dart if the cash available for distribution is $41,000?
   a. $10,100
   b. $11,000
   c. $16,000
   d. $20,000

Items 24 through 29 are based on the following:
Dart, Inc., a closely held corporation, was petitioned involuntarily into bankruptcy under the liquidation provisions of Chapter 7 of the Federal Bankruptcy Code. Dart contested the petition.

Dart has not been paying its business debts as they became due, has defaulted on its mortgage loan payments, and owes back taxes to the IRS. The total cash value of Dart’s bankruptcy estate after the sale of all assets and payment of administration expenses is $100,000.

Dart has the following creditors:
- Fracon Bank is owed $75,000 principal and accrued interest on a mortgage loan secured by Dart’s real property. The property was valued at $70,000 and sold, in bankruptcy, for $70,000.
- The IRS has a $12,000 recorded judgment for unpaid corporate income tax.
- JOG Office Supplies has an unsecured claim of $3,000 that was timely filed.
- Nanstar Electric Co. has an unsecured claim of $1,200 that was not timely filed.
- Decoy Publications has a claim of $14,000, of which $2,000 is secured by Dart’s inventory that was valued and sold, in bankruptcy, for $2,000. The claim was timely filed.

24. Which of the following creditors must join in the filing of the involuntary petition?
   I. JOG Office Supplies
   II. Nanstar Electric Co.
   III. Decoy Publications
   a. I, II and III.
   b. II and III.
   c. I and II.
   d. III only.

25. Which of the following statements would correctly describe the result of Dart’s opposing the petition?
   a. Dart will win because the petition should have been filed under Chapter 11.
   b. Dart will win because there are not more than 12 creditors.
   c. Dart will lose because it is not paying its debts as they become due.
   d. Dart will lose because of its debt to the IRS.

26. Which of the following events will follow the filing of the Chapter 7 involuntary petition?
   - A stay against creditor collection goes into effect
   - A trustee will be appointed
   a. Yes Yes
   b. Yes No
   c. No Yes
   d. No No

For Items 27 through 29 assume that the bankruptcy estate was distributed.

27. What dollar amount would Nanstar Electric Co. receive?
   a. $0
   b. $800
   c. $1,000
   d. $1,200

28. What total dollar amount would Fracon Bank receive on its secured and unsecured claims?
   a. $70,000
   b. $71,180
   c. $74,000
   d. $75,000
29. What dollar amount would the IRS receive?
   a. $0
   b. $8,000
   c. $10,000
   d. $12,000

30. In a voluntary bankruptcy proceeding under Chapter 7 of the Federal Bankruptcy Code, which of the following claims incurred within 180 days prior to filing will be paid first?
   a. Unsecured federal taxes.
   b. Utility bills up to $1,000.
   c. Voluntary contributions to employee benefit plans.
   d. Employee vacation and sick pay up to $4,300 per employee.

31. Which of the following types of claims would be paid first in the distribution of a bankruptcy estate under the liquidation provisions of Chapter 7 of the Federal Bankruptcy Code if the petition was filed July 15, 20X3?
   a. A secured debt properly perfected on March 20, 20X3.
   b. Inventory purchased and delivered August 1, 20X3.
   c. Employee wages due April 30, 20X3.
   d. Federal tax lien filed June 30, 20X3.

32. Rolf, an individual, filed a voluntary petition in bankruptcy. A general discharge in bankruptcy will be denied if Rolf
   a. Negligently made preferential transfer to certain creditors within 90 days of filing the petition.
   b. Unjustifiably failed to preserve Rolf’s books and records.
   c. Filed a fraudulent federal income tax return two years prior to filing the petition.
   d. Obtained a loan by using financial statements that Rolf knew were false.

33. Under the liquidation provisions of Chapter 7 of the federal Bankruptcy Code, a debtor will be denied a discharge in bankruptcy if the debtor
   a. Fails to list a creditor.
   b. Owes alimony and child support payments.
   c. Cannot pay administration expenses.
   d. Refuses to adequately explain a loss of assets.

34. Eagle Corp. is a general creditor of Dodd. Dodd filed a petition in bankruptcy under the liquidation provisions of the Bankruptcy Code. Eagle wishes to have the bankruptcy court either deny Dodd a general discharge or not have its debt discharged. The discharge will be granted and it will include Eagle’s debt even if
   a. Dodd filed for and received a previous discharge in bankruptcy under the liquidation provisions within five years of the filing of the present petition.
   b. Eagle’s debt is unscheduled.
   c. Eagle was a secured creditor not fully satisfied from the proceeds obtained on disposition of the collateral.
   d. Dodd unjustifiably failed to preserve the records from which Dodd’s financial condition might be ascertained.

35. Which of the following claims will not be discharged in bankruptcy?
   a. A claim that arises from alimony or maintenance.
   b. A claim that arises out of the debtor’s breach of a contract.
   c. A claim brought by a secured creditor that remains unsatisfied after the sale of the collateral.
   d. A claim brought by a judgment creditor whose judgment resulted from the debtor’s negligent operation of a motor vehicle.

36. Larson, an unemployed carpenter, filed for voluntary bankruptcy on August 14, 20X9. Larson’s liabilities are listed below.
   Credit card charges due May 2, 20X8 $3,000
   Bank loan incurred June 20X9 5,000
   Medical expenses incurred June 20X2 7,000
   Alimony due during 20X7 1,000

   Under the provisions of Chapter 7 of the Federal Bankruptcy Code, Larson’s discharge will not apply to the unpaid
   a. Credit card charges.
   b. Bank loan.
   c. Medical expenses.
   d. Alimony.

37. A claim will not be discharged in a bankruptcy proceeding if it
   a. Is brought by a secured creditor and remains unsatisfied after receipt of the proceeds from the disposition of the collateral.
   b. Is for unintentional torts that resulted in bodily injury to the claimant.
   c. Arises from an extension of credit based upon false representations.
   d. Arises out of the breach of a contract by the debtor.
38. In general, which of the following debts will be discharged under the voluntary liquidation provisions of Chapter 7 of the Federal Bankruptcy Code?

a. A debt due to the negligence of the debtor arising before filing the bankruptcy petition.

b. Alimony payments owed the debtor’s spouse under a separation agreement entered into two years before the filing of the bankruptcy petition.

c. A debt incurred more than 90 days before the filing of the bankruptcy petition and not disclosed in the petition.

d. Income taxes due within two years before the filing of the bankruptcy petition.

39. Which of the following acts by a debtor could result in a bankruptcy court revoking the debtor’s discharge?

I. Failure to list one creditor.

II. Failure to answer correctly material questions on the bankruptcy petition.

a. I only.

b. II only.

c. Both I and II.

d. Neither I nor II.
Chapter Seven: Bankruptcy
Multiple Choice Answers

1. (d) With a voluntary filing for bankruptcy, the petition may be jointly filed by a husband and wife. Answers (a) and (c) are incorrect because the unsecured claims need not total $13,475. This is a requirement of involuntary bankruptcy. In voluntary bankruptcy, all the debtor needs are debts of any amount, regardless of the number of creditors. Answer (b) is incorrect because the debtor may file even if solvent. All the debtor needs are debts of any amount. Insolvency is a requirement of involuntary bankruptcy.

2. (d) To file for a voluntary bankruptcy all the debtor needs are debts of any amount. There is no requirement of insolvency or that there be three or more creditors. Thus, only answer (d) is correct.

3. (b) The test of insolvency in an involuntary bankruptcy is that the debtor has not been paying his/her debts as they become due or that a custodian was appointed or took possession of most of the debtor’s property within 120 days before the filing. With twelve or more creditors, at least three must file having unsecured claims totaling $13,475 or more. With less than twelve, only one or more need file having unsecured claims totaling $13,475 or more. Answer (b) is correct because one of the tests for an involuntary bankruptcy is that the debtor was not generally paying debts as they became due. Answer (a) is incorrect because a debtor may have three creditors who have unsecured claims totaling $13,475 without having any one creditor owed more than $13,475. Answer (c) is incorrect because the debtor may have more than twelve creditors, in which case at least three must file. Answer (d) is incorrect because a secured creditor is not required to join in the filing. In fact, it is only unsecured claims that count towards the $13,475 requirement.

4. (d) The test of insolvency in an involuntary bankruptcy is that the debtor has not been paying his/her debts as they become due or that a custodian was appointed or took possession of most of the debtor’s property within 120 days before the filing. With twelve or more creditors, at least three must file having unsecured claims totaling $13,475 or more. With less than 12 creditors, only one or more need file having unsecured claims totaling $13,475 or more. Since Unger was unable to pay debts as they became due, a test for insolvency has been met. Since Unger had less than 12 creditors, only one creditor owed $13,475 or more was needed to properly file. Quincy was owed $14,000, and therefore properly filed. Answers (a) and (b) are incorrect because the bankruptcy petition will be granted, not dismissed. Answer (c) is incorrect because the test for insolvency is not assets minus liabilities.

5. (a) If an involuntary petition in bankruptcy is dismissed and the debtor can show that the creditors’ filing was improper, damages may be awarded the debtor for any harm done. Specifically, these damages may include court costs, punitive damages and attorney’s fees. Only answer (a) states that all of these may be awarded. Note: punitive damages are rarely awarded. Bankruptcy is one of the only areas on the CPA exam where punitive damages can be a correct response.

6. (d) In a Chapter 11 reorganization, the plan is submitted to committees of unsecured creditors and stockholders. The plan is not submitted to 1/2 of the secured creditors. Acceptance of the plan requires approval of 50% or more of any class of creditors actually voting representing at least 2/3 of the dollar amount owed. It also requires approval by shareholders representing 2/3 of the dollar amount owed of those actually voting. It does not require approval of 2/3 of the shareholders, but rather 2/3 of the dollar amount owed. Additionally, it is not 2/3 of the dollar amount for all shareholders, but only 2/3 of the dollar amount of those voting.

7. (d) After the court’s final decree, the debtor is discharged from all debts that arose prior to confirmation, except as otherwise provided for in the plan. Answer (a) is incorrect because the debtor is not discharged from all debts. The debtor is only discharged from those that occurred prior to the confirmation and is not discharged from debts where the plan has specifically required some payment. Answer (b) is incorrect because the debtor is discharged from all debts that arose prior to confirmation unless the plan specified otherwise. Discharge is not limited to only the debts of creditors accepting the plan. Answer (c) is incorrect because there is no discharge of debts for which the plan has required some payment.
8. (c) In a reorganization, the debtor submits the plan to a committee of unsecured creditors. Answers (a) and (d) are incorrect because a trustee is not required in a reorganization. Thus, a trustee need not be selected by the creditors’ committee and the plan does not require approval of a trustee. Answer (b) is incorrect because a plan may also be filed by the creditors or the trustee if one was appointed, after 120 days.

9. (a) A liquidation occurs under Chapter 7, but does not occur under a Chapter 11 reorganization. Answers (b), (c) and (d) are incorrect because a filing of a reorganization plan, confirmation of the plan by the court and the opportunity for each class of claims to accept the plan are all provisions of a reorganization.

10. (d) The commencement of a Chapter 11 reorganization may be either voluntary or involuntary. Answer (a) is incorrect because a trustee is not required in a reorganization, although the creditors may request that one be appointed. Answer (b) is incorrect because there is no requirement that the debtor be insolvent in a voluntary reorganization. Answer (c) is incorrect because the debtor has exclusive rights to file the plan for 120 days after the order for relief.

11. (a) A reorganization plan will not be confirmed by the court until provisions are made for full payment of administration costs. Answer (b) is incorrect because acceptance of the plan is not required by all classes of claimants. Answer (c) is incorrect because liquidation does not occur in a reorganization and therefore no contingency plan of liquidation is required. Answer (d) is incorrect because appointment of a trustee is not required for a reorganization.

12. (c) Property of the debtor as of the filing date goes to the trustee to pay creditors. Social security benefits and disability benefits are specifically exempt. Only answer (c) states that both social security benefits and disability benefits are exempt property.

13. (a) Property gained by the debtor after the filing, the debtor may keep. Specific exceptions include property gained by divorce, inheritance and insurance within 180 days after the filing, which go to the trustee for creditors. Thus, answer (a) is correct because it is life insurance and was within 180 days after filing. Answers (b) and (c) are incorrect because the inheritance and the divorce settlement were received more than 180 days after filing. Answer (d) is incorrect because most property (to include wages) gained by the debtor after filing, the debtor gets to keep.

14. (b) A trustee may reject a lease, assume and retain a lease, or assume and assign a lease. If the trustee does not take any action in 60 days, the lease is rejected. Answer (b) is correct because the trustee may elect not to assume the lease. Answers (a), (c) and (d) are incorrect because a trustee does have a choice with leases and may reject the lease.

15. (c) Property gained by the debtor after the filing, the debtor may keep. Specific exceptions include property gained by divorce, inheritance and insurance within 180 days after the filing, which go to the trustee for creditors. Thus, property received as an inheritance within 180 days after filing must be surrendered for distributions to creditors. Answer (a) is incorrect because certain debts are excepted from discharge in bankruptcy (unscheduled debts, fraud, alimony and child support, willful and malicious injury and taxes owed within three years of filing, etc.). Answer (b) is incorrect because six years must elapse before another discharge in bankruptcy may occur. Answer (d) is incorrect because a person may own a similar business immediately after obtaining a discharge in bankruptcy.

16. (d) A preferential transfer requires that five tests be met (TANIM): a Transfer that benefited a creditor, for an Antecedent debt, made within Ninety days prior to filing (up to 1 year prior to filing if the creditor was an insider), made while the debtor was Insolvent and the creditor wound up with More than they would have received in bankruptcy. Prepaying an installment loan within ninety days of filing would benefit a creditor, would be for an antecedent debt, would be within ninety days, would be presumed to have been made while the debtor was insolvent (since it occurred within 90 days) and prepayment certainly allowed the creditor to get more than they would have received in bankruptcy. Answer (a) is incorrect because making a gift to charity would not be an antecedent debt. Answer (b) is incorrect because paying a utility bill would constitute payment of a current bill in the ordinary course of business and would be exempt. Additionally, it would probably be a consumer debt of less
than $600. Answer (c) is incorrect because borrowing money secured by a mortgage would not be an antecedent
debt, but rather a new debt (a contemporaneous exchange for new value).

17. (a) A preferential transfer requires that five tests be met (TANIM): a Transfer that benefited a creditor, for
an Antecedent debt, made within Ninety days prior to filing (up to 1 year prior to filing if the creditor was an
insider), made while the debtor was Insolvent and the creditor wound up with More than they would have received
in bankruptcy. Thus, it requires that debtor was insolvent at the time of transfer. Answer (b) is incorrect
because the creditor need not be an insider if the transfer was made within 90 days. Answer (c) is incorrect because
a contemporaneous exchange for new value is not an antecedent debt. Answer (d) is incorrect because a transfer
made by a debtor to hinder, delay or defraud creditors is not a requirement for a preferential transfer. Such a transfer
would be a fraudulent transfer and may be set aside by the trustee if it occurred within one year prior to the filing.

18. (d) An insurance company, a bank or a savings and loan can not file for bankruptcy under either Chapter
7 or Chapter 11. Thus, if Masters was an insurance company the petition for a voluntary bankruptcy under Chapter
7 would be dismissed. Answers (a) and (c) are incorrect because all a debtor needs to voluntarily file for bankruptcy
are debts of any amount. There are no required number of creditors or the requirement of the inability to pay debts
as they become due (as there is in involuntary bankruptcy). Answer (b) is incorrect because Chapter 7 does not
require the debtor to show that a reorganization would be unsuccessful.

19. (c) Filing of a bankruptcy petition acts as an automatic stay of all collection efforts with the exception of
alimony, child support and criminal actions. Thus, lawsuits by Master’s creditors will be stayed. Answer (a) is
incorrect because Master may only continue its business under a reorganization, not under a Chapter 7 voluntary
bankruptcy. Answer (b) is incorrect because the interim trustee is appointed by the court, not the creditors. Answer
(d) is incorrect because there is no requirement that the unsecured creditors elect a creditors committee, although
they may do so if they choose.

20. (c) A preferential transfer requires that five tests be met (TANIM): a Transfer that benefited a creditor, for
an Antecedent debt, made within Ninety days prior to filing (up to 1 year prior to filing if the creditor was an
insider), made while the debtor was Insolvent and the creditor wound up with More than they would have received
in bankruptcy. The transfer to Acme was not preferential. Acme was a properly perfected secured creditor. Master’s
payment on January 15 was a payment of a current bill in the ordinary course of business and was therefore not an antecedent
debt. The mere fact that the debt was over-secured, would not make this a preferential transfer or an improper security interest. Many first mortgages on real estate involve debts that are over-
secured, for example. Answers (a) and (b) are incorrect because this payment is not a preferential payment. Answer
(d) is incorrect because the debtor must be insolvent on the date of the transfer (January 15), not the date of the
filing (March 15).

21. 22 and 23. ANALYSIS. There are eleven categories of debts (DAM-WEG-CTFI), the ten enumerated
categories plus the general creditors divided into secured and unsecured claims. All category 1 debts are paid first,
then category 2 debts are paid, and so on. The order of priority is: (1) Domestic support obligations; (2)
Administrative costs of the bankruptcy, (3) Middleman debts (gap creditors); (4) Wages unpaid: (5)
Employee benefits unpaid; (6) Grain producers and fisherman unpaid; (7) Consumer creditor deposits unpaid;
(8) Taxes unpaid; (9) Federal depository institution commitments unpaid; (10) Death or injury from
intoxicated operation of a motor vehicle; then (11) Secured debts, followed by all other debts. Dart would be
a category 3 (Middleman) debt, because the debt occurred after the filing but before the order for relief. The
trustee’s fee would be a category 2 debt because it is an administrative cost of the bankruptcy proceeding. The
claim by Boyd was a category 7 debt because it was a deposit for consumer goods. Noll was a properly
perfected secured creditor and thus is a category 11 debt. The fees earned by the attorney are a category 2
debt because they are an administrative cost of the bankruptcy proceeding. Claims by unsecured general creditors
would also be a category 11 debts, but they would be payable after the secured creditors.

21. (b) Based on the prior analysis, the trustee’s fee is a category 2 debt in the amount of $15,000 and the
attorney’s fee is a category 2 debt in the amount of $10,000. If there is only $15,000 available for distribution for
category 2 claims, then the amount available for the trustee would be 15/25 or 60% of the available cash ($15,000).
The correct answer is $9,000, which is choice (b).
22. **(d)** Based on the prior analysis, the trustee would receive $15,000 and the attorney would receive $10,000 as category 2 debts. Leaving $25,800. Next would be the claim by Dart as a category 3 creditor in the amount of $20,000, leaving $5,800 available to pay lower priority debts. The next priority item would be Boyd as a category 7 debt. Since the amount of Boyd’s claim is $1,500 and that does not exceed the cash available, Boyd would receive the full $1,500.

23. **(c)** Based on the prior analysis, the trustee would receive $15,000 and the attorney would receive $10,000 as category 2 debts. Leaving $16,000. Next would be the claim by Dart as a category 3 (Middleman) creditor in the amount of $20,000. Since there is only $16,000 available to pay category 3 debts, Dart would receive the entire $16,000.

24. **(d)** In an involuntary bankruptcy, if the debtor has less than twelve creditors, only one or more creditors are required to file, owed $13,475 or more in unsecured claims. Dart had five creditors. Decoy was owed $14,000, of which $2,000 was secured and the balance of $12,000 was unsecured. Thus, Decoy could not file alone because there were less than twelve creditors, but Decoy did not meet the requirement of $13,475 in unsecured claims. Answers (a) and (b) are incorrect because either JOG or Nanstar must join in Decoy's filing, but both are not required. Answer (c) is incorrect because the value of JOG and Nanstar's claims combined do not satisfy the $13,475 requirement. The only correct answer is (d).

25. **(c)** The test for involuntary bankruptcy is either not generally paying debts as they become due or that a custodian was appointed or took possession of most of the debtor’s property within 120 days preceding the filing. Dart would lose because they were not paying their debts when due. Answer (a) is incorrect because the petition could have been filed under either Chapter 7 or Chapter 11 if the debtor was not paying debts when due. Answer (b) is incorrect because with less than twelve creditors only one or more are required to file having unsecured claims of $10,775 or more. There is no requirement that the debtor have twelve or more creditors. Answer (d) is incorrect because the mere fact that the IRS has a judgment does not mean that the debtor was not generally paying debts when due.

26. **(a)** Upon filing of a petition for involuntary bankruptcy the court will appoint an interim trustee. Filing will also act as an automatic stay and stop all collection efforts with the exception of alimony, child support and criminal actions. Only answer (a) reflects that a trustee will be appointed and a stay against creditor collection proceedings will go into effect.

27, 28 and 29 **ANALYSIS.** There are eleven categories of debts (DAM-WEG-CTFI), the ten enumerated categories plus the general creditors divided into secured and unsecured claims. All category 1 debts are paid first, then category 2 debts are paid and, so on. The order of priority is: (1) Domestic support obligations; (2) Administrative costs of the bankruptcy; (3) Middleman debts (gap creditors); (4) Wages unpaid: (5) Employee benefits unpaid; (6) Grain producers and fisherman unpaid; (7) Consumer creditor deposits unpaid; (8) Taxes unpaid; (9) Federal depository institution commitments unpaid; (10) Death or injury from intoxicated operation of a motor vehicle; then (11) Secured debts, followed by all other debts. The IRS would be a category 8 debt and will receive the first $12,000. The next items in priority would be the category 11 secured creditors, then the unsecured creditors. Fracon would be a secured creditor for the $70,000 sales price of the property. Decoy would be a secured creditor for the $2,000 of their secured claim. This leaves $16,000 left to pay the unsecured creditors. Fracon is owed $5,000 of the deficiency, and Decoy is owed $12,000 its deficiency. JOG is owed $3,000 and Nanstar is owed $1,200. The total amount of unsecured claims is $21,200.

27. **(a)** Based on prior analysis Nanstar will receive nothing. As a creditor who did not timely file, Nanstar would only be paid after all other creditors listed were paid in full. There is insufficient funds to pay the other four creditors in full. Only answer (a) reflects that Nanstar will receive nothing.

28. **(b)** Based on the prior analysis, Fracon would receive ($5,000/$21,200) of the $5,000 it is owned on the unsecured claim, which is $1180. When combined with the amount paid on the secured claim ($70,000), Fracon would receive a total of $71,180.

29. **(d)** Based on the prior analysis, the IRS is a category 8 debt, which is the highest priority item in this case. Therefore the IRS would receive the full $12,000 owed.
30. (d) There are eleven categories of debts (DAM-WEG-CTFI), the ten enumerated categories plus the general creditors divided into secured and unsecured claims. All category 1 debts are paid first, then category 2 debts are paid, and so on. The order of priority is: (1) Domestic support obligations; (2) Administrative costs of the bankruptcy, (3) Middleman debts (gap creditors); (4) Wages unpaid: (5) Employee benefits unpaid; (6) Grain producers and fisherman unpaid; (7) Consumer creditor deposits unpaid; (8) Taxes unpaid; (9) Federal depository institution commitments unpaid; (10) Death or injury from intoxicated operation of a motor vehicle; then (11) Secured debts, followed by all other debts. Unsecured federal taxes would be a category eight debt. Utility bills would be a category eleven debt. Voluntary contributions to employee benefit plans would be a category five debt. The employee vacation and sick pay would be wages, since they are compensation. Unpaid wages earned within 180 days of filing are a category four debt and would have highest priority.

31. (b) There are eleven categories of debts (DAM-WEG-CTFI), the ten enumerated categories plus the general creditors divided into secured and unsecured claims. All category 1 debts are paid first, then category 2 debts are paid, and so on. The order of priority is: (1) Domestic support obligations; (2) Administrative costs of the bankruptcy, (3) Middleman debts (gap creditors); (4) Wages unpaid: (5) Employee benefits unpaid; (6) Grain producers and fisherman unpaid; (7) Consumer creditor deposits unpaid; (8) Taxes unpaid; (9) Federal depository institution commitments unpaid; (10) Death or injury from intoxicated operation of a motor vehicle; then (11) Secured debts, followed by all other debts. The inventory purchased on August 1, 20X3 was a category 3 claim (Middleman) and would be the first item paid. The employee wages are a category 4 claim. The federal tax lien is a category 8 claim. The secured debt is a category 11 claim.

32. (b) A denial in discharge can occur for an unjustifiable failure to keep adequate books and records, having received a previous discharge in bankruptcy within six years of filing, attempting to hide assets within one year of filing, making false oath or claim in the bankruptcy proceeding and refusing to obey a lawful court order or refusing to satisfactorily explain a loss of assets. Only answer (b) (unjustifiable failure to keep adequate books and records) states a grounds for denial of discharge.

33. (d) A denial in discharge can occur for refusing to obey a lawful court order or refusing to satisfactorily explain a loss of assets, an unjustifiable failure to keep adequate books and records, having received a previous discharge in bankruptcy within six years of filing, attempting to hide assets within one year of filing, and making false oath or claim in the bankruptcy proceeding. Only answer (d) (refusing to adequately explain a loss of assets) states a grounds for denial of discharge.

34. (c) A secured creditor is only protected as to the value of their collateral. If the collateral is insufficient to satisfy their debt, they are a category ten creditor for the deficiency and the debt is dischargeable. Thus, Eagle’s debt would be discharged even if the sale of the collateral was insufficient to pay the debt. Answers (a) and (d) are incorrect because receiving a previous discharge within six years of filing and unjustifiable failure to keep adequate books and records are grounds for a denial of discharge. Answer (b) is incorrect because an unscheduled debt (where the creditor has no notice of bankruptcy) is excepted from discharge.

35. (a) Debts excepted from discharge in bankruptcy include unscheduled debts where the creditor has no notice of the bankruptcy, fraud, alimony and child support, debts from causing willful and malicious injury to others and taxes owed within three years of filing. Thus, a claim arising from alimony or maintenance would not be discharged. Answer (b) is incorrect because debts for breach of contract are dischargeable. Answer (c) is incorrect because secured creditors are only protected as to the value of their collateral. Answer (d) is incorrect because only claims from causing willful and malicious injury are excepted from discharge, not debts from negligently causing injury.

36. (d) Debts excepted from discharge in bankruptcy include unscheduled debts where the creditor has no notice of the bankruptcy, fraud, alimony and child support, debts from causing willful and malicious injury to others and taxes owed within three years of filing. Thus, a claim arising from alimony would not be discharged. Answers (a), (b) and (c) are incorrect because debts for credit card charges, bank loans and medical expenses are all dischargeable in bankruptcy.
37. (c) Debts excepted from discharge in bankruptcy include unscheduled debts where the creditor has no notice of the bankruptcy, fraud, alimony and child support, debts from causing willful and malicious injury to others and taxes owed within three years of filing. A claim arising from an extension of credit based on false representations would be fraud and would not be dischargeable. Answer (a) is incorrect because secured creditors are only protected as to the value of their collateral. Answer (b) is incorrect because only claims from causing willful and malicious injury are excepted from discharge, not debts from negligently causing injury. Answer (d) is incorrect debts for breach of contract are dischargeable.

38. (a) Debts excepted from discharge in bankruptcy include unscheduled debts where the creditor has no notice of the bankruptcy, fraud, alimony and child support, debts from causing willful and malicious injury to others and taxes owed within three years of filing. Debts due to the debtor’s negligence would be dischargeable. Answers (b), (c) and (d) are incorrect because alimony, unscheduled debts and taxes due within three years of the filing are not dischargeable.

39. (b) A court may revoke a discharge in bankruptcy granted within one year for fraud by the debtor in obtaining the discharge, fraudulently failing to report acquisition of property, refusal of the debtor to testify or obey a lawful court order, or failure to answer correctly material questions on the bankruptcy petition. Failure to list one creditor would not be a ground for revocation of discharge, it is a debt excepted to discharge (if the creditor had no notice of the bankruptcy proceeding). Only answer (b) states that failure to list one creditor is not a ground for revoking a discharge, but failure to correctly answer material questions on the bankruptcy petition is a proper ground for revocation.
SURETY RELATIONSHIP

1. A Surety is one who promises to pay a creditor if the debtor defaults.

2. Statute of Frauds: a signed writing is required for a Surety’s promise to be enforceable (a promise to answer the debt of another require a writing under the Statute of Frauds).

3. Consideration:
   a. if the Surety, the Creditor, and the Debtor are all created at same time no additional consideration is required. Consideration is already present.
   
   Example: On June 1, Creditor agrees to loan Debtor $5,000 and Debtor agrees to repay with interest within six months. At the same time, Surety agrees to pay if Debtor defaults. There is consideration because each party has promised to do something (Creditor has agreed to loan money, Debtor to repay and Surety to pay upon default) and each promise binds the others.
   
   b. if the Surety comes in after the debtor/creditor relationship is created, the Surety’s promise must be supported by new consideration.

   Example: Two weeks after Creditor loans Debtor $5,000, Surety promises to pay if Debtor defaults. There is no consideration for Surety’s promise because there is no other promise to bind it. The promises of Creditor and Debtor may not be used to bind Surety’s promise because they occurred in the past and past consideration is no good. Thus, Surety’s promise is unenforceable unless new consideration is given.

RIGHTS OF A SURETY

1. Subrogation:
   a. once a Surety pays the Creditor in full, (s)he gets all of Creditor's rights.
   b. e.g. if the Creditor was a secured creditor, full payment by the Surety would give the Surety the standing of a secured creditor.

2. Reimbursement: the right of the Surety to recover from the Debtor any money the Surety had to pay the Creditor due to the Debtor’s default.
   a. the right of reimbursement only occurs after the Surety has had to pay the Creditor.
   b. the Surety may only be reimbursed for the amount the Surety had to pay.

3. Exoneration: the right of a Surety to get a court order that Debtor pay prior to default
   a. the right of exoneration is the Surety’s right against the Debtor, not the Creditor.
   b. e.g. the Surety will still be required to pay the Creditor if the Debtor defaults.

COSURETIES

1. Cosuretors: two or more sureties of same debt (even if unaware of each other)

2. Cosuretors are joint and severally liable if the debtor defaults (i.e. creditor can sue any of the cosuretors or all of the cosuretors).
3. **Right of Contribution:** once one cosuretor pays, (s)he may receive a pro rata share or contribution from all other cosuretors (**contribution is only available to cosuretors**)
   a. the proportionate liability of each cosuretor is shown by this formula:

   \[
   \frac{\text{amount guaranteed by individual cosuretor}}{\text{amount guaranteed by all the cosureties}} \times \text{amount paid to the creditor}
   \]

   b. **Example:** C loans D $90,000 and G, H and I agree to be cosuretors. The maximum liability of each is: G $60,000, H $30,000 and I $90,000. After making payments D defaults and I pays the entire balance of $60,000. I would receive $20,000 from G (60/180 X 60) and $10,000 from H (30/180 X 60).

c. if a cosuretor’s obligation is discharged in bankruptcy, their dollar amount should not be considered in determining the pro rata share of the other cosuretors (**e.g.** same example as in 3b. above except that G’s debts including his surety obligation were discharged in bankruptcy. If I pays $60,000 to the creditor, I would receive $15,000 from H (30/120 X 60).

### RIGHTS OF CREDITOR AFTER DEFAULT

1. Creditor may do any of the following in any order after the Debtor defaults
   a. the Creditor may immediately demand payment from the Surety
   b. the Creditor may immediately demand payment from the Debtor
   c. the Creditor may immediately go after collateral if there is any

2. **Exception:** guarantor of collection or conditional guarantor
   a. a guarantor of collection promises to pay only after the Creditor exhausts all remedies against the Debtor (**e.g.** Creditor may be required to demand payment from the Debtor, go after collateral if there is any, sue the Debtor and obtain a judgment, then try to collect the judgment before requiring the guarantor of collection to pay)
   b. Creditor must give notice of default to the guarantor of collection

### DEFENSES OF A SURETY VS. A CREDITOR

1. Lack of a writing or lack of consideration are good defenses for a Surety

2. Payment or tender of performance by Debtor is **always** a good defense for a Surety (**e.g.** Debtor offers to pay in full on time and Creditor refuses to accept payment)

3. Fraud by the Creditor is a good defense for the Surety
   a. **fraud by Debtor is not** a good defense unless Creditor was aware of the fraud
   b. **e.g.** Debtor makes fraudulent inducements to get Surety’s promise to pay upon default. Creditor is aware of the fraud, but doesn’t say anything. Surety may use Debtor’s fraud as a defense only because Creditor was aware of the fraud.

4. Surety may usually use any defense to the contract available to Debtor, **except** defenses that are personal to the Debtor
   a. **e.g.** a surety may not use the debtor's incapacity due to **infancy** or incapacity due to **insanity** as a defense and may not use the debtor’s **bankruptcy** as a defense
   b. **exception:** if debtor disaffirms the contract with the creditor due to infancy or insanity and returns the consideration received from the creditor, surety is not liable
5. Any action by Creditor which increases the Surety’s risk, releases the Surety to the extent of the risk unless 
the Creditor expressly reserved rights against the Surety
a. **e.g.** modification of the Debtor’s obligation by Creditor which increases Surety’s risk releases the 
Surety unless Creditor expressly reserved rights against the Surety
b. **e.g.** a binding extension of time by the Creditor totally releases the Surety unless the Creditor 
expressly reserved rights against the Surety
   - **note:** if the Creditor does not agree to extend time but merely delays on collection, the Surety is not 
     released
c. **e.g.** a release of collateral by a Creditor without the Surety’s consent, releases the Surety up to the 
   value of the collateral
d. release of one Cosuretor by a Creditor without the consent of other Cosuretors, releases the 
   Cosuretors by the amount of **contribution** they could have collected
   1). **e.g.** C loans D $80,000. X and Y agree to be cosuretors with each agreeing to be liable for full 
   $80,000. C releases X without the consent of Y. C may only collect $40,000 from Y (not 
   $80,000) because C increased Y’s risk by $40,000. Y can no longer get a $40,000 contribution 
   from X.
   2). if Creditor reserved rights against the other cosuretors, they are not released
e. if the Creditor releases the Debtor without the Surety’s consent, the Surety is released unless the 
   Creditor expressly reserved rights against the Surety

### CREDITOR DEBT COLLECTION REMEDIES

1. When a debtor fails to pay a debt, a creditor may sue the debtor and obtain a judgment
2. Creditor **pre-judgment remedies**: actions by a creditor prior to receiving a judgment to prevent the debtor 
   from transferring or disposing of assets
   a. **Writ of Attachment**: places a lien on debtor’s property so the property will be available to satisfy a 
      judgment
      1). requires a hearing before a judge before it is granted
      2). the creditor may be required to post a bond to compensate the debtor should the creditor lose 
         the lawsuit
   b. **Pre-judgment garnishment**: places a lien on property of the debtor that is in the hands of a 3rd party 
      so the property will be available to satisfy a judgment
      1). usually used on an employer or a bank in which debtor has an account
      2). the property remains with the 3rd party until the judgment is obtained
3. Creditor **post-judgment remedies**: actions by a creditor after getting a judgment
   a. **Writ of Execution**: issued by a court to a creditor upon obtaining a judgment
      1). served by a sheriff on the debtor demanding payment of the judgment
      2). if it is returned "unsatisfied" the creditor can order a levy on the debtor’s property and 
         force a public sale
      3). all liens on a debtor’s property require public notice be given to the debtor prior to the 
         property being sold to satisfy a debt
   b. **Garnishment**: creditor collects money from debtor’s wages or bank accounts (there are limits on 
      amounts that can be deducted from any one pay check)
4. **Fraudulent conveyance** - Phony transfer of property by a debtor to stop creditors from attaching it 
   (transferee is expected to return property to debtor at a later time)
   a. creditors may still attach the property, upon proof the transfer was fraudulent
   b. indications of a fraudulent conveyance include:
      1). debtor remains in possession even though the property was transferred
      2). debtor retains an equitable interest in the property
      3). the transfer was done secretly
DEBTOR DEBT COLLECTION REMEDIES

1. **Composition of Creditors:** an agreement between a debtor and creditors to discharge the debtor’s debts in return for payment of less than the total amount owed
   a. the debts are not discharged until the debtor completes the agreed payments
   b. a composition of creditors is only binding on the creditors who agree to it

2. **Assignment For Benefit Of Creditors:** a voluntary transfer of some or all of the debtor’s property to a trustee for payment of creditors on a pro rata basis
   a. the assignment does not require the agreement of other creditors
   b. the assignment does not discharge the debtor’s debts, it merely insures equal treatment of creditors
   c. it protects property that was assigned from attachment by the creditors

3. **Equity Receiverships:** a court appoints a receiver (a disinterested 3rd party) to collect the debtor’s assets and income and distribute them as the court directs
   a. creditors and stockholders can petition the court to appoint a receiver
   b. the inability of the debtor to pay debts as they become due is a key factor in the court’s decision to appoint a receiver

4. **Fair Debt Collection Practices Act** makes illegal abusive, deceptive and unfair debt collection by collection agencies (only covers collection agencies, not the original creditor)
   a. prohibited practices include:
      1). disclosing the debt to 3rd parties
      2). communicating with debtor at unreasonable times or communicating with the debtor if (s)he has an attorney
      3). use of harassing, oppressive or abusive conduct or false representations
   b. upon written demand, the collection agency must stop all contact with the debtor
   c. the Act is enforced by the Federal Trade Commission
   d. debtors may sue for money damages for violation of the Act

5. The following federal laws also govern consumer credit transactions:
   a. **Equal Credit Opportunity Act** prohibits discriminating against applicants for credit on the basis of race, color, religion, sex, marital status, national origin or age
   b. **Truth-In-Lending Act** covers consumer loans and credit sales but does not cover business or agricultural credit transactions
      1). requires creditor to give consumer a written statement of contract credit terms (e.g. interest rates, sales charges, required credit life insurance, etc.)
      2). charges and interest rates must be quoted in an annual percentage rate (APR)
      3). must inform consumers about how the finance charge is computed
   c. **Fair Credit Billing Act** governs consumer complaints about billing errors and requires creditors to explain or correct errors
   d. **Credit Card Fraud Act**
      1). prohibits possessing unauthorized credit cards and counterfeiting credit cards
      2). limits to $50 a consumer’s liability for unauthorized use of a credit card

6. Certain property of the debtor is exempt from attachment or garnishment
   a. **Homestead exemption** - protects Debtor’s residence from attachment by creditors (exception: the homestead exemption does not apply to Mortgagees)
   b. IRS tax liens may also be used against a debtor’s homestead and against the debtor’s personal property
   c. Social Security benefits are exempt from attachment or garnishment
Chapter Eight: Surety and Debt Collection Remedies

Multiple Choice Questions

1. A party contracts to guaranty the collection of the debts of another. As a result of the guaranty, which of the following statements is correct?
   a. The creditor may proceed against the guarantor without attempting to collect from the debtor.
   b. The guaranty must be in writing.
   c. The guarantor may use any defenses available to the debtor.
   d. The creditor must be notified of the debtor's default by the guarantor.

2. When a principal debtor defaults and a surety pays the creditor the entire obligation, which of the following remedies gives the surety the best method of collecting from the debtor?
   a. Exoneration.
   b. Contribution.
   c. Subrogation.
   d. Attachment.

3. Queen paid Pax & Co. to become the surety on a loan which Queen obtained from Squire. The loan is due and Pax wishes to compel Queen to pay Squire. Pax has not made any payments to Squire in its capacity as Queen's surety. Pax will be most successful if it exercises its right to
   a. Reimbursement (Indemnification).
   b. Contribution.
   c. Exoneration.
   d. Subrogation.

4. Which of the following rights does one cosurety generally have against another cosurety?
   a. Exoneration.
   b. Subrogation.
   c. Reimbursement.
   d. Contribution.

5. West promised to make Noll a loan of $180,000 if Noll obtained sureties to secure the loan. Noll entered into an agreement with Carr, Gray, and Pine to act as co-sureties on his loan from West. The agreement between Noll and the co-sureties provided for compensation to be paid to each of the co-sureties. It further indicated that the maximum liability of each co-surety would be as follows: Carr $180,000, Gray $60,000, and Pine $120,000. West accepted the commitment of the sureties and made the loan to Noll. After paying nine installments totaling $90,000, Noll defaulted. Gray's debts (including his surety obligation to West on the Noll loan) were discharged in bankruptcy. Subsequently, Carr properly paid the entire debt outstanding of $90,000. What amounts may Carr recover from the co-sureties?
   \[ \begin{array}{ll}
   \text{Gray} & \text{Pine} \\
   \text{a.} & $0 \\
   \text{b.} & $0 \\
   \text{c.} & $15,000 \\
   \text{d.} & $30,000
   \end{array} \]

6. Lane promised to lend Turner $240,000 if Turner obtained sureties to secure the loan. Turner agreed with Rivers, Clark, and Zane for them to act as co-sureties on the loan from Lane. The agreement between Turner and the co-sureties provided that compensation be paid to each of the co-sureties. It further indicated that the maximum liability of each co-surety would be as follows: Rivers $240,000, Clark $80,000, and Zane $160,000. Lane accepted the commitments of the sureties and made the loan to Turner. After paying ten installments totaling $100,000, Turner defaulted. Clark's debts, including the surety obligation to Lane on the Turner loan, were discharged in bankruptcy. Later, Rivers properly paid the entire outstanding debt of $140,000. What amount may Rivers recover from Zane?
   a. $0
   b. $56,000
   c. $70,000
   d. $84,000

7. Ivor borrowed $420,000 from Lear Bank. At Lear's request, Ivor entered into an agreement with Ash, Kane, and Queen for them to act as co-sureties on the loan. The agreement between Ivor and the co-sureties provided that the maximum liability of each co-surety was: Ash, $84,000; Kane, $126,000; and Queen, $210,000. After making several payments, Ivor defaulted on the loan. The balance was $280,000. If Queen pays $210,000 and Ivor subsequently pays $70,000, what amounts may Queen recover from Ash and Kane?
   a. $0 from Ash and $0 from Kane.
   b. $42,000 from Ash and $63,000 from Kane.
   c. $70,000 from Ash and $70,000 from Kane.
   d. $56,000 from Ash and $84,000 from Kane.

8Q-1
8. Nash, Owen, and Polk are co-sureties with maximum liabilities of $40,000, $60,000 and $80,000, respectively. The amount of the loan on which they have agreed to act as co-sureties is $180,000. The debtor defaulted at a time when the loan balance was $180,000. Nash paid the lender $36,000 in full settlement of all claims against Nash, Owen, and Polk. The total amount that Nash may recover from Owen and Polk is
   a. $0
   b. $24,000
   c. $28,000
   d. $140,000

9. Which of the following rights does a surety have?

<table>
<thead>
<tr>
<th>Right to compel</th>
<th>Right to compel</th>
</tr>
</thead>
<tbody>
<tr>
<td>the creditor to</td>
<td>the creditor to</td>
</tr>
<tr>
<td>collect from the</td>
<td>proceed against</td>
</tr>
<tr>
<td>principal debtor</td>
<td>the principal</td>
</tr>
<tr>
<td>debtor's collateral</td>
<td>debtor's collateral</td>
</tr>
</tbody>
</table>
   a. Yes           | Yes             |
   b. Yes           | No              |
   c. No            | Yes             |
   d. No            | No              |

10. Burns borrowed $240,000 from Dollar Bank as additional working capital for his business. Dollar required that the loan be collateralized to the extent of 20%, and that an acceptable surety for the entire amount be obtained. Surety Co. agreed to act as surety on the loan and Burns pledged $48,000 of negotiable bearer bonds. Burns defaulted. Which of the following statements is correct?
   a. Dollar must first liquidate the collateral before it can proceed against Surety.
   b. Surety is liable in full immediately upon default by Burns, but will be entitled to the collateral upon satisfaction of the debt.
   c. Dollar must first proceed against Burns and obtain a judgment before it can proceed against the collateral.
   d. Surety may proceed against Burns for the full amount of the loan even if Surety settles with Dollar for a lower amount.

11. Soros and Ace have agreed, in writing, to act as guarantors of collection on a debt owed by Pepper to Towns, Inc. The debt is evidenced by a promissory note. If Pepper defaults, Towns will be entitled to recover from Soros and Ace unless
   a. Soros and Ace are in the process of exercising their rights against Pepper.
   b. Soros and Ace prove that Pepper was insolvent at the time the note was signed.
   c. Pepper dies before the note is due.
   d. Towns has not attempted to enforce the promissory note against Pepper.

12. A release of a co-surety by the creditor
   a. Will have no effect on the obligation of the other co-surety.
   b. Will release the other co-surety entirely.
   c. Will release the other co-surety to the extent that his right to contribution has been adversely affected.
   d. Need not be a binding release in order to affect the rights of the parties.

13. Wright cosigned King’s loan from Ace Bank. Which of the following events would release Wright from the obligation to pay the loan?
   a. Ace is seeking payment of the loan only from Wright.
   b. King is granted a discharge in bankruptcy.
   c. Ace is paid in full by King’s spouse.
   d. King is adjudicated mentally incompetent.

14. Which of the following acts always will result in the total release of a compensated surety?
   a. The creditor changes the manner of principal debtor’s payment.
   b. The creditor extends the principal debtor’s time to pay.
   c. The principal debtor’s obligation is partially released.
   d. The principal debtor’s performance is tendered.

15. Green was unable to repay a loan from State Bank when due. State refused to renew the loan unless Green provided an acceptable surety. Green asked Royal, a friend, to act as surety on the loan. To induce Royal to agree to become a surety, Green fraudulently represented Green's financial condition and promised Royal discounts on merchandise sold at Green's store. Royal agreed to act as surety and the loan was renewed. Later, Green's obligation to State was discharged in Green's bankruptcy. State wants to hold Royal liable. Royal may avoid liability
   a. If Royal can show that State was aware of the fraudulent representations.
   b. If Royal was an uncompensated surety.
   c. Because the discharge in bankruptcy will prevent Royal from having a right of reimbursement.
   d. Because the arrangement was void at the inception.
16. Which of the following defenses would a surety be able to assert successfully to limit the surety's liability to a creditor?
   a. A discharge in bankruptcy of the principal debtor.
   b. A personal defense the principal debtor has against the creditor.
   c. The incapacity of the surety.
   d. The incapacity of the principal debtor.

17. Ingot Corp. lent Flange $50,000. At Ingot's request, Flange entered into an agreement with Quill and West for them to act as compensated co-sureties on the loan in the amount of $100,000 each. Ingot released West without Quill's or Flange's consent, and Flange later defaulted on the loan. Which of the following statements is correct?
   a. Quill will be liable for 50% of the loan balance.
   b. Quill will be liable for the entire loan balance.
   c. Ingot's release of West will have no effect on Flange's and Quill's liability to Ingot.
   d. Flange will be released for 50% of the loan balance.

18. Which of the following events will release a noncompensated surety from liability?
   a. Release of the principal debtor's obligation by the creditor but with the reservation of the creditor's rights against the surety.
   b. Modification by the principal debtor and creditor of their contract that materially increases the surety's risk of loss.
   c. Filing of an involuntary petition in bankruptcy against the principal debtor.
   d. Insanity of the principal debtor at the time the contract was entered into with the creditor.

19. A debtor may attempt to conceal or transfer property to prevent a creditor from satisfying a judgment. Which of the following actions will be considered an indication of fraudulent conveyance?

<table>
<thead>
<tr>
<th>Debtor remaining in possession after conveyance</th>
<th>Secret conveyance</th>
<th>Debtor retains an equitable benefit in the property conveyed</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. Yes</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>b. No</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>c. Yes</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td>d. Yes</td>
<td>No</td>
<td>Yes</td>
</tr>
</tbody>
</table>

20. Which of the following will enable a creditor to collect money from a debtor's wages?
   a. An order of receivership.
   b. An order of garnishment.
   c. A writ of execution.
   d. A writ of attachment.

21. Which of the following prejudgment remedies would be available to a creditor when a debtor owns no real property?

<table>
<thead>
<tr>
<th>Writ of attachment</th>
<th>Garnishment</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>b. Yes</td>
<td>No</td>
</tr>
<tr>
<td>c. No</td>
<td>Yes</td>
</tr>
<tr>
<td>d. No</td>
<td>No</td>
</tr>
</tbody>
</table>

22. A homestead exemption ordinarily could exempt a debtor's equity in certain property from post-judgment collection by a creditor. To which of the following creditors will this exemption apply?

<table>
<thead>
<tr>
<th>Valid home mortgage lien</th>
<th>Valid IRS Tax lien</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>b. Yes</td>
<td>No</td>
</tr>
<tr>
<td>c. No</td>
<td>Yes</td>
</tr>
<tr>
<td>d. No</td>
<td>No</td>
</tr>
</tbody>
</table>

23. Under the Federal Fair Debt Collection Practices Act, which of the following would a collection service using improper debt collection practices be subject to?
   a. Abolishment of the debt.
   b. Reduction of the debt.
   c. Civil lawsuit for damages for violating the Act.
   d. Criminal prosecution for violating the Act.

24. The Federal Credit Card Fraud Act protects a credit card holder from loss by
   a. Restricting the interest rate charged by the credit card company.
   b. Limiting the card holder's liability for unauthorized use.
   c. Requiring credit card companies to issue cards to qualified persons.
   d. Allowing the card holder to defer payment of the balance due on the card.

25. Which of the following actions between a debtor and its creditors will generally cause the debtor's release from its debts?

<table>
<thead>
<tr>
<th>Composition of creditors</th>
<th>Assignment for the benefit of creditors</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>b. Yes</td>
<td>No</td>
</tr>
<tr>
<td>c. No</td>
<td>Yes</td>
</tr>
<tr>
<td>d. No</td>
<td>No</td>
</tr>
</tbody>
</table>
26. Which of the following statements is(are) correct regarding debtors’ rights?

I. State exemption statutes prevent all of a debtor’s personal property from being sold to pay a federal tax lien.
II. Federal social security benefits received by a debtor are exempt from garnishment by creditors.

a. I only.
b. II only.
c. Both I and II.
d. Neither I nor II.

27. Which of the following liens generally require(s) the lienholder to give notice of legal action before selling the debtor’s property to satisfy the debt?

<table>
<thead>
<tr>
<th>Mechanic’s lien</th>
<th>Artisan’s lien</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>b. Yes</td>
<td>No</td>
</tr>
<tr>
<td>c. No</td>
<td>Yes</td>
</tr>
<tr>
<td>d. No</td>
<td>No</td>
</tr>
</tbody>
</table>
Chapter Eight
Surety and Debt Collection Remedies
Other Objective Format Questions

NUMBER 1

Part b. Mars Finance Company was approached by Grant, the president of Hoover Corp., for a loan of $25,000 for Hoover. After careful evaluation of Hoover's financial condition, Mars decided it would not make the loan unless the loan was collateralized or guaranteed by one or more sureties for a total of $30,000. Hoover agreed to provide collateral in the form of a security interest in Hoover's equipment. The initial valuation of the equipment was $20,000 and Hoover obtained Victory Surety Company as a surety for the additional $10,000. Prior to the granting of the loan, the final valuation on the equipment was set at $15,000 and Mars insisted on additional surety protection of $5,000. Grant personally assumed this additional surety obligation. Hoover has defaulted and Mars first proceeded against the collateral, which was sold for $17,000. It then proceeded against Victory for the balance. Victory paid the $8,000 and now seeks a $4,000 contribution from Grant.

Grant asserts the following defenses and arguments in order to avoid or limit his liability:

- That he is not liable since Mars elected to proceed against the collateral.
- That Mars by suing Victory for the deficiency, released him.
- That he is not a co-surety because Victory did not know of his existence until after default and his surety obligation was not assumed at the same time nor was it equal in amount; hence, there is no right of contribution.
- That in no event is he liable for the full $4,000 sought by Victory.

Required:

Answer the following, setting forth reasons for any conclusions stated.

Discuss in separate paragraphs each of the above defenses asserted by Grant and indicate the amount of Grant's liability.
Beach, a 17-year old minor, entered into an installment contract to purchase a travel agency from Reid. The purchase price included the fair market value of the tangible assets and an agreed upon value for goodwill. At the time the contract was entered into, Beach misrepresented his age to Reid, claiming that he was 19. The age of majority in their jurisdiction was 18. Since Reid was unsure of Beach's financial position, Reid requested that Beach obtain a surety. Therefore, Beach entered into an agreement for Abel to act as a surety on the installment contract. Beach knowingly induced Abel to become a surety by supplying Abel with false financial statements. The contract also provided that Reid was to receive a substantial payment in consideration of his agreement not to operate a travel agency within a one mile radius of Beach's travel agency for a period of two years. After 19 months, Reid opened a new travel agency across the street from Beach's business. Within one month thereafter, Beach lost nearly all of his clients to Reid, and Beach defaulted on the installment payments, causing the entire amount owed to Reid to become due. Reid has brought an action against Beach and Abel to recover all monies due him.

Beach claims he is not liable on the contract since:

- He was only 17 years old at the time the contract with Reid was signed.
- The clause prohibiting Reid from competing with him is legally valid and therefore Reid's violation of such clause constitutes a breach of the sale contract.

Abel claims that he is not liable to Reid since:

- He was induced into becoming a surety by Beach's fraud.
- Beach was 17 years old at the time the contract with Reid was entered into.
- Reid breached the sale contract by failing to comply with the express clause prohibiting competition with Beach.

**Required:**

Answer the following, setting forth reasons for any conclusions stated.

Assuming the contract is not divisible, discuss in separate paragraphs the assertions of Beach and Abel, indicating first whether such claims are correct.
Chapter Eight: Surety and Debt Collection Remedies

Multiple Choice Answers

1. (b) All promises to answer the debt of another require a writing under the statute of frauds. Since a guarantor of collection promises to pay the debts of the debtor after the creditor has first exhausted all remedies against the debtor, the promise must be in writing. Answer (a) is incorrect because the guarantor of collection only promises to pay after the creditor has first exhausted all rights against the debtor. Answer (c) is incorrect because a guarantor of collection may not use defenses that are personal to the debtor (infancy, insanity and bankruptcy). Answer (d) is incorrect because the guarantor of collection must receive notice of default from the creditor. The creditor is not required to receive notice of default from the guarantor. The creditor is required to give notice of default to the guarantor.

2. (c) The right of subrogation allows the surety to gain the creditor’s rights, once the creditor has been paid in full. Subrogation would give a surety not only their own right to collect from the debtor (reimbursement), but also additional rights that the creditor might have had. Answer (a) is incorrect because exoneration would simply give a surety a court order demanding that the debtor pay. Exoneration does not confer additional collection rights against the debtor. Answer (b) is incorrect because contribution is only available to one co-suretor against other co-suretors. It is not available against the debtor. Answer (d) is incorrect because attachment is the right of all creditors to place a lien on a debtor’s property so it will be available to satisfy a judgment. Subrogation is the better answer because it is specific to surety’s collection rights against a debtor and gives the surety additional rights.

3. (c) Exoneration is the right of a surety prior to payment to get a court order demanding that the debtor pay. Exoneration is the only right the surety may use prior to payment. Reimbursement (the right of a surety to recover from the debtor payments made to the creditor) only occurs after payment by the surety. Subrogation (the right of the surety to gain the creditor’s rights once the surety makes full payment) only occurs after payment by the surety. Contribution (the right of a co-suretor to receive a pro rata contribution from other co-suretors for amounts paid to the creditor) only occurs after payment by the co-surety. Since Pax the surety has not made any payments to the creditor, the only right Pax can successfully assert is the right of exoneration. Thus, only answer (c) is correct.

4. (d) The right of contribution is the right of a co-suretor to receive a pro rata contribution from other co-suretors for payments made to the creditor. Thus, one co-suretor is entitled to the right of contribution against other co-suretors. Answers (a) is incorrect because exoneration is the right of a surety to obtain a court order requiring a debtor to pay prior to default. Exoneration is available against the debtor, not a co-surety. Answer (b) is incorrect because subrogation is the right of a surety to obtain all of the creditor’s rights once the surety has paid the creditor in full. The surety does not acquire another co-suretor’s rights. Answer (c) is incorrect because reimbursement is the right of the surety to collect from the debtor if the surety has to pay. It is available against the debtor, not a co-surety.

5. (b) A co-suretor has the right to receive a pro rata contribution from other co-suretors for payments made to the creditor (right of contribution). Carr (a co-suretor) paid $90,000 to the creditor and thus may receive a pro rata contribution from other co-suretors (Gray and Pine). The debts of Gray, to specifically include his surety obligation, were discharged in bankruptcy. Thus, Carr can recover nothing from Gray since the debt was discharged in bankruptcy. Answers (c) and (d) are incorrect because nothing may be recovered from Gray. Since Pine’s obligation was $120,000 and Carr’s obligation was $180,000, Pine’s pro rata share of the $90,000 payment Carr made to the creditor would be $36,000 (120/300 times $90,000 = $36,000). Thus answer (b) is correct and answer (a) is incorrect.

6. (b) A co-suretor has the right to receive a pro rata contribution from other co-suretors for payments made to the creditor (right of contribution). Rivers (a co-suretor) paid $140,000 to the creditor and thus may receive a pro rata contribution from other co-suretors (Clark and Zane). The debts of Clark, to specifically include the surety obligation, were discharged in bankruptcy. Thus, Rivers can recover nothing from Clark since the debt was discharged in bankruptcy. Since Zane’s obligation was $160,000 and River’s obligation was $240,000, Zane’s pro rata share of the $140,000 payment Rivers made to the creditor would be $56,000 (160/400 times $140,000 = $56,000). Thus answer (b) is correct and answers (a), (c) and (d) are incorrect.
7. (b) A cosuretor has the right to receive a pro rata contribution from other cosuretors for payments made to the creditor (right of contribution). Queen (a cosuretor) paid the creditor $210,000 and thus may receive a pro rata contribution from other cosuretors (Ash and Kane). The obligations of the cosuretors were Queen ($210,000), Ash ($84,000) and Kane ($126,000). Ash’s pro rata share of the $210,000 payment would be $42,000 ($84/420 times $210,000 = $42,000). Kane’s pro rata share of the $210,000 payment would be $63,000 ($126/420 times $210,000 = $63,000). Only answer (b) reflects these amounts.

8. (c) A cosuretor has the right to receive a pro rata contribution from other cosuretors for payments made to the creditor (right of contribution). Nash (a cosuretor) paid the creditor $36,000 and thus may receive a pro rata contribution from other cosuretors (Owen and Polk). The obligations of the cosuretors were Nash ($40,000), Owen ($60,000) and Polk ($80,000). Owen’s pro rata share of the $36,000 payment would be $12,000 ($60/180 times $36,000 = $12,000). Polk’s pro rata share of the $36,000 payment would be $16,000 ($80/180 times $36,000 = $16,000). The total contribution from Owen and Polk would be $28,000 ($12,000 plus $16,000 = $28,000). Only answer (c) reflects this amount.

9. (d) Upon the debtor’s default the creditor may do any of the following in any order: immediately demand payment from the surety, immediately demand payment from the debtor or go after the collateral (if there is any). Thus, a surety may not compel a creditor to first collect from the debtor or first go after the collateral. The creditor may demand payment from the surety prior to exercising these rights. Thus, only answer (d) is correct.

10. (b) Upon the debtor’s default the creditor may do any of the following in any order: immediately demand payment from the surety, immediately demand payment from the debtor or go after the collateral (if there is any). Thus, Surety Co. was immediately liable for the full amount when the debtor defaulted. Subrogation allows the surety to obtain the creditor’s rights upon full payment. Dollar Bank was a secured creditor with negotiable bonds as collateral. Once Surety makes full payment, Surety can obtain the creditor’s rights to the collateral. Answers (a) and (c) are incorrect because the creditor is not required to first liquidate the collateral or proceed against the debtor. The creditor may proceed immediately against the surety or immediately against the collateral. Answer (d) is incorrect because a surety may only recover from the debtor the amount the surety paid (reimbursement).

11. (d) A guarantor of collection promises to pay a creditor for a debtor’s default only after the creditor has first exhausted all other remedies against the debtor. Since Sorus and Ace are guarantors of collection, Towns must first attempt to enforce the promissory note against the debtor. Answer (a) is incorrect because the creditor’s right to collect from the guarantor of collection depends on the creditor first exhausting all rights against the debtor. The creditor’s right to payment does not depend on the guarantor first exhausting all rights against the debtor. Answer (b) is incorrect because the guarantor may not use defenses that are personal to the debtor (infancy, insanity and bankruptcy). Answer (c) is incorrect because death of the debtor does not relieve the debtor’s estate from liability for the debt. Thus, the creditor would still have to try and collect the debt from the debtor’s estate prior to recovery from the guarantors of collection.

12. (c) A release of a cosuretor by the creditor will release the other cosuretors to the extent that their right of contribution has been adversely affected. Answer (a) is incorrect because it does have an effect to the extent that the right of contribution has been adversely affected. Answer (b) is incorrect because the other cosuretors are not totally released. They are only released to the extent that their right of contribution has been adversely affected. Answer (d) is incorrect because the release would have to be a binding release to adversely affect the right of contribution.

13. (c) A surety only promises to pay if the debtor defaults. Payment is full by the debtor or by another on behalf of the debtor would mean the debtor was not in default. Thus, payment in full by the debtor’s wife would cause the surety not to be liable. Answer (a) is incorrect because the creditor is not required to seek payment from the debtor after default. The creditor may choose to only require payment from the surety. Answers (b) and (d) are incorrect because a surety may not use defenses that are personal to the debtor, like bankruptcy and insanity.
14. (d) Refusal of the creditor to accept tender of payment in full by the debtor is always a good defense of the surety and will result in a total release. Answer (a) is incorrect because a change in the manner of payment would only release a surety if the change caused more risk for the surety. Additionally, it would not totally release the surety. It would only release the surety to the extent of the increased risk. Answer (b) is incorrect because an extension of time to pay is not always a defense. It would not be a good defense if the surety approved the extension in advance or if the extension was not binding. Answer (c) is incorrect because a partial release of the debtor’s obligation would only partially release the surety (release only to the extent of the increased risk).

15. (a) Fraud by the creditor is a good defense for the surety. Fraud by the debtor is not a good defense for the surety against the creditor unless the surety can show the creditor was aware of the debtor’s fraud. Green (the debtor) induced Royal to act as a surety by a fraudulent representation of financial condition. Thus, Royal can only use the debtor’s fraud as a defense to payment of the creditor if Royal can show the creditor was aware of the fraudulent representations. Answer (b) is incorrect because the liability of a surety is not usually affected by whether the surety was compensated or uncompensated. Answer (c) is incorrect because a surety may not use defenses that are personal to the debtor like bankruptcy. Answer (d) is incorrect because only fraud in the execution (tricking someone so badly they didn’t even know they made a contract) makes an arrangement void at the inception. Since Royal knew he was making a contract, no fraud in the execution exists.

16. (c) A surety may not use defenses that are personal to the debtor. Such defenses include infancy, insanity and bankruptcy. A surety may use his/her own insanity or incapacity as a defense. Thus, answer (c) is correct and answers (a), (b) and (d) are incorrect.

17. (a) A release of one cosuretor by a creditor without the consent of the others will release the other cosuretors to the extent that their right of contribution has been adversely affected. Ingot (the creditor) released West (one cosuretor) without the consent of Quill (the other cosuretor). Each cosuretor agreed to guarantee the loan for $100,000. Since the loan was only $50,000, each cosuretor had guaranteed full payment in the event of default. Without the release of West, Quill would have been liable for the entire loan balance, but could have recovered 50% of this amount from West by the right of contribution. Thus, the release of West increased Quill’s risk by 50% and Quill will only be liable for 50% of the loan balance. Answer (b) is incorrect because Quill is only liable for 50% of the loan balance. Answer (c) is incorrect because the release of West does have the effect of releasing Quill from 50% of the loan balance. Answer (d) is incorrect because release of a cosuretor does not increase a debtor’s risk. Thus, Flange is still liable for the entire loan balance.

18. (b) Any action by the creditor which increases the surety’s risk releases the surety to the extent of the increased risk. Thus, modification of the debtor’s contract which materially increased the surety’s risk would result in a release of the surety. Answer (a) is incorrect because a release of the debtor’s obligation with a reservation of rights against the surety does not release the surety. Answers (c) and (d) are incorrect because the surety may not use defenses that are personal to the debtor like bankruptcy and insanity.

19. (a) A fraudulent conveyance is a fake transfer of property by a debtor to stop creditors from attaching it. The transferee is expected to return the property to the debtor at a later date. Indications of a fraudulent conveyance would include: the debtor remaining in possession of the property after conveyance, debtor retains an equitable interest in the property or the conveyance was done secretly. Only answer (a) states that all three are an indication of a fraudulent conveyance.

20. (b) Garnishment is the debt collection remedy a creditor uses to collect money from a debtor’s wages. Answer (a) is incorrect because a receivership involves the appointment by a court of a receiver to collect the debtor’s assets and income and distribute them as the court directs. Answer (c) is incorrect because a writ of execution is issued by a court to a judgment creditor. A writ of execution is then served on the debtor by a sheriff demanding payment of the judgment. Answer (d) is incorrect because a writ of attachment places a lien on a debtor’s property so the property will be available to satisfy the judgment.

21. (a) Both a writ of attachment (putting a lien on debtor’s property so it’s available if a judgment is obtained) and garnishment (used on employee’s wages or a bank in which the debtor has an account) are prejudgment remedies that are available against personal property of the debtor. Thus, only answer (a) is correct.
22. (d) A homestead exemption protects the equity a debtor has in a residence from being attached by a creditor. It is not valid against a mortgagee or a valid IRS tax lien. Only answer (d) indicates that it would not be valid against a mortgagee or a valid IRS tax lien.

23. (c) The Fair Debt Collection Practices Act (FDCPA) regulates the collection of debts by collection agencies. The FDCPA is enforced by the Federal Trade Commission and provides for civil lawsuits for damages by debtors harmed. Answers (a), (b) and (d) are incorrect because the FDCPA does not provide for abolishment of the debt, reduction of the debt or for criminal prosecution for violations.

24. (b) The Federal Credit Card Fraud Act prohibits possessing unauthorized credit cards and counterfeiting credit cards and limits to $50 a consumer's liability for unauthorized use of a credit card. Thus, (b) is correct. Answer (a) is incorrect because state usury laws restrict the amount of interest that can be charged, not the Federal Credit Card Fraud Act. Answer (c) is incorrect because it is the Equal Credit Opportunity Act that prohibits discriminating on the basis of race, color, sex, marital status, religion or national origin in credit applications, not the Federal Credit Card Fraud Act. Answer (d) is incorrect because there is no federal or state law that mandates a credit card company allow the card holder to defer payment of the balance due.

25. (b) Both a composition of creditors and an assignment for benefit of creditors are alternatives to bankruptcy for the debtor. In a composition of creditors, the debtor and the creditors agree to discharge the debts owed upon a payment of an agreed amount by the debtor. The debts aren’t discharged until the debtor completes the payment. In an assignment for the benefit of creditors the debtor transfers property to a trustee to pay creditors on a pro rata basis. Such an assignment doesn’t discharge the debtor’s debts. Thus only a composition of creditors discharges the debtor’s debts and only answer (b) is correct.

26. (b) Statement I is incorrect because a debtor’s personal property (and their residence) may be sold to pay a valid federal tax lien. Statement II is correct because Social security benefits are exempt from attachment or garnishment.

27. (a) All liens require public notice be given to a debtor prior to the property being sold to satisfy a debt. Thus, both a mechanic’s lien (a lien in favor of one who repairs the debtor’s property) and an artisan’s lien (a lien in favor of one who improves a debtor’s property) require notice to be given to debtor.
ANSWER 1

Part b.

Grant is incorrect in his first three assertions and correct in connection with his fourth assertion for the following reasons:

- The law is clear regarding the right to collateral and its effect between the creditor and the surety. The creditor has the right to resort to any available collateral. Resort to the collateral by the creditor in no way affects the creditor's right to proceed against a surety or sureties for the balance.

- A creditor may choose to sue one or more of the sureties without impairing his rights against those not sued. Similarly, he has the right to sue one surety if he wishes, and such a choice does not release the surety who was not sued insofar as the rights of his fellow surety to seek contribution. Suing one but not all of the sureties does not constitute a release by the creditor.

- All of the defenses asserted in the fact situation are invalid. Grant is a co-surety since he is answering for the same debt as Victory, and there is a right of contribution which Victory may assert against Grant.

- Since Grant's surety undertaking was one-third of the combined surety undertakings, he is liable for $2,666.67 only and not the full $4,000.
Beach's minority at the time the contract with Reid was entered into will not be a valid defense. Despite Beach's misrepresentation of his age, the agreement with Reid was voidable at Beach's option while Beach was a minor. However, Beach's use and operation of the travel agency for at least seven months after reaching majority constituted an implied ratification of the contract. Some states may construe Beach's mere failure to disaffirm the contract within a reasonable time after reaching majority to be a ratification of the contract. Furthermore, a small number of states provide that minority is not a defense where the minor has entered into a business contract.

Beach's assertion that he is not liable due to Reid's violation of the contract clause prohibiting Reid from competing with Beach is correct because violation of the non-competition covenant is a material breach of the contract. Since the case at issue involves the sale of a business including its goodwill, the legal validity of a clause prohibiting competition by the seller is determined by its reasonableness regarding the time and geographic area covered. Each case must be considered on its own facts, with a determination of what is reasonable under the particular circumstances. It appears that, according to the facts of this case, the prohibition against Reid's operating a competing travel agency within a one mile radius of Beach's travel agency for two years is reasonable.

Abel's claim that he is not liable to Reid because of Beach's fraud in supplying him with false financial statements is incorrect. Although a creditor has a duty to disclose to the surety all material facts that would increase the surety's risk, the breach of such duty is not a valid defense of the surety if the creditor lacks knowledge of such facts. Therefore, unless Abel can show that Reid knew or had reason to know of the fraud committed by Beach, Abel will not be relieved of his surety undertaking.

Abel's claim that he is not liable to Reid because of Beach's minority is without merit. Beach's minority is a personal defense that in a proper case may be exercised only at Beach's option. Therefore, whether Beach has the power to disaffirm his contract with Reid will have no effect on Abel's surety obligations to Reid.

Abel's assertion that his liability to Reid will be discharged because of Reid's failure to comply with the express contractual promise not to compete with Beach is correct. Unlike the defense of the principal debtor's minority, a material breach of the underlying contract between the principal debtor and creditor may be properly asserted by the surety. The creditor's failure to perform in accordance with the material terms of the underlying contract without justification will discharge the principal debtor's obligation to perform, thereby increasing the risk of the principal debtor's non-performance. Thus, the surety will also be discharged from liability due to his own increased risk of loss on the surety contract. It seems clear that Reid's opening of a travel agency across the street from Beach's business after only 19 months constituted a material breach of the sale contract. Therefore, Abel will be discharged from his surety obligation.
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Chapter Nine
Non-Corporate Entities

SOLE PROPRIETORSHIPS

This is the simplest form of business organization and the easiest to begin and to terminate.

The proprietor furnishes all the capital, receives all the profits and owns all the property of the proprietorship. Proprietors can sue and be sued. Their personal assets are at risk. The proprietor is taxed as an individual and reports sales and expenses on Schedule C of Form 1040 for Federal tax purposes.

Proprietorships do not necessarily do business in their owner’s name. If not, they may be required under state law to file a d/b/a “doing business as” disclosure.

A proprietorship endures at the will of the owner, but is automatically terminated upon the proprietor’s death.

Advantage: Simplicity, ability to do business across state or national boundaries.

Disadvantage: Lack of capital and management skills and depth.

PARTNERSHIPS

Summary of Significant Changes in the Revised Uniform Partnership Act (RUPA) Which Simplify Partnership Law

Prior law generally viewed partnerships as a collection of the partners and perhaps a legal entity. RUPA states that a general partnership is a legal entity that can own and convey property, and sue and be sued in its own name. Under RUPA, a partnership is an entity distinct from its partners resulting in greater partnership stability. No partner has an interest in specific partnership property.

Partnerships do not have perpetual existence like corporations, but nearly so since the partnership continues in existence when one or more partners leave. Formerly, the partnership was dissolved by the exit, for whatever reason, of any partner.

RUPA is a default act, meaning that it generally applies in situations not covered in the partnership agreement. The partnership agreement, however, may not override the default rule to eliminate a partner’s duty of loyalty or obligation of good faith and fair dealing, or unreasonably reduce a partner’s duty of care.

In most states, requirements are specified for filing, amending and canceling partnership agreements. However, there are no required filings under RUPA.

Generally, filing may be made for:
1. a statement of partnership authority
2. a statement of denial of partnership authority
3. a statement of dissociation
4. a statement of dissolution
5. a statement of merger

Partners are jointly and severally liable for all partnership obligations. Property taken by a partner improperly from a third party is the responsibility of the partnership even if the partnership never received the property.

A partnership agreement may be in writing, oral or implied. The partnership has no duty to have books and records; however, if the partnership does have books and records, they must be maintained at the partnership’s principal
office. Partners have the right to partnership information, including inspection of books and records, if any, under reasonable circumstances.

Creditors of a partner may attach the interest of a partner, but may not attach specific partnership property. Creditors may be assigned rights to a partner’s interest, but have no rights to partnership property, only earnings and/or distributions made to the debtor partner. Creditors assigned rights to a partner’s profits are responsible for the income taxes thereon, whether cash is distributed or not.

GENERAL PARTNERSHIPS

1. A partnership is an association of two or more co-owners of a business for profit.
   a. Must have two or more persons (can be a person, corporation, partnership, estate, trust, joint venture, or government agency). Person includes any commercial entity that is legal.
   b. Must have co-ownership of a business:
      1) Two key factors are sharing of profits and sharing of management.
      2) The parties must be co-owners of a business, not co-owners of property.
   c. Must be a business operated for profit (e.g. social clubs, religious organizations or associations are not partnerships).

2. A partnership is formed by an agreement of all partners to conduct the business.
   a. The partnership agreement may be oral, implied or in writing:
      1) Partnerships impossible to perform in one year require a writing (e.g., A, B and C form ABC partnership and agree that it will not terminate for 5 years.)
      2) Limited partnerships and limited liability companies require a writing.
      3) A written partnership agreement (sometimes called the articles of partnership) can only be amended by unanimous consent of all partners.
   b. If a partner breaches the partnership agreement, (s)he is liable.

3. A partnership may also be created from the conduct of the parties (e.g., if two or more parties are co-owners of a business and share profits, they may be a partnership even though they did not consider themselves to be a partnership).

4. Under RUPA, a partnership is considered to be a separate entity.
   a. It is subject to Worker's Compensation, FICA, FUTA, etc.
   b. It is a separate entity for ownership of property (e.g. ABC partnership may own real estate in the name of the partnership).
   c. Assets of the firm are considered separate and distinct from the assets of individual partners.
   d. Partnerships do not pay income tax. They file an information return on Form 1065 reporting sales, expenses, and partnership income. All items of partnership income or loss flow through to the individual returns of the partners.
   e. Unlike a corporation, a partnership does not have perpetual existence and the departure of a partner does not ordinarily dissolve the partnership. (see section on dissolution and dissociation)

GENERAL PARTNERS’ RESPONSIBILITIES

1. Partners in a general partnership have unlimited personal liability
   a. General partners are **jointly liable** for all partnership debts and contract obligations (joint liability means all partners must be sued as a group).
   b. They are **jointly and severally** liable for all partnership torts (joint and several liability means all partners may be sued as a group or sued individually).

2. General partners are agents of the partnership and agents of each other.
   a. Partners owe the same duties that all agents do.
      1) Owe a duty of **Obedience** to partnership agreements.
      2) Owe a duty of **Due care** to fellow partners and the partnership.
3) Owe a duty to **Inform** their fellow partners of relevant facts.
4) Owe a duty to **Account** for all money and property received or expended.
5) Owe a fiduciary duty of **Loyalty** to the partnership and each other (e.g., cannot compete with the partnership or make a profit at the expense of the partnership).

b. When acting with **real or apparent authority**, each partner can impose contract liability on the partnership and on their fellow partners.
c. Any partner committing a tort while acting on partnership business imposes tort liability on himself, the partnership and fellow partners (**respondeat superior**).
d. Each must give **actual notice** to old customers and **published notice to new customers** upon their termination from the partnership.

**PARTNER’S RIGHTS**

1. **Each partner has an equal right to participate in the management of the business, unless the partners specifically agree otherwise.**
   a. Most decisions require only a majority vote.
   b. Unless otherwise agreed, the following require unanimous consent of all partners:
      1). admit new general partners or new limited partners
      2). transfer partnership property to others
      3). change a written partnership agreement
      4). change the capital of the firm
      5). admit liability in a law suit (confess a judgment) or submit a claim to arbitration
      6). make a fundamental change in partnership business to specifically include selling the partnership's goodwill

2. **Each partner has an equal right to share in distributions, unless otherwise agreed.**
   a. Unless otherwise agreed, profits and losses are split equally:
      1). The partners may specify an unequal division of profits and losses (e.g. A, B and C agree profits and losses will be split 60% for A, 30% for B and 10% for C).
      2). If a division of profits is specified but not losses, losses will follow profits.
   b. Unless otherwise agreed, a partner is not entitled to compensation

3. **Each partner has the right to be reimbursed for loans and advances made to the partnership and for payments made on behalf of the partnership plus interest.**
   a. Partners also have the right to be indemnified for liability incurred while properly acting on behalf of the partnership.
   b. A partner entitled to repayment is only paid after all other creditors are paid.

4. **All partners and limited partners have the right to full information about the partnership.**
   a. They have the right to inspect and copy books and records at reasonable times.
   b. A partner has the right to demand a formal account (a complete review of all financial transactions of the partnership, including financial statements).
      1). An accounting is granted when circumstances make it just and reasonable.
      2). e.g. breach of fiduciary duties or wrongful exclusion from the partnership.

5. **Each partner is a co-owner of partnership property.**
   a. Each has an equal right to use partnership property for partnership purposes, but has no right to use it for any other purpose without the consent of other partners.
   b. A partner cannot transfer or assign his/her individual interest in partnership property to others. No partner has an individual interest in partnership property.
   c. Partnership property may not be attached by an individual partner's creditors.
   d. If a partner dies, partnership property remains as partnership property (entity concept), not the heirs. A deceased partner’s interest is part of his/her estate. A partner’s estate has no continuing interest in the business.
6. **Power of dissociation**
   A partner has the right to dissociate him/herself from the partnership. Dissociated partner must serve notice to the remaining partners of dissociation and is responsible for all partnership acts and debts up until dissociation. Third parties must be made aware of dissociation. If not, the dissociated partner is liable for third parties damaged on the assumption of partner’s continuance in the partnership.

7. **The “In Kind” Rule**
   Partners have the right to receive cash distributions (profits or liquidation payments) and may not be paid “in kind” unless otherwise agreed. Partners similarly have no right to demand payment in kind. Creditors may be paid “in kind” if agreed.

**ASSIGNING A PARTNERSHIP INTEREST**

1. Any general or limited partner may assign or sell their partnership interest.
   a. An assignment does not dissolve partnership.
   b. Thus, the assignor remains a partner and is still liable for partnership debts.
   c. The consent of other partners is not required, unless otherwise agreed.

2. The assignee does not become a partner without the consent of all other partners.
   a. The **only right** an assignee gets is the right to receive assignor's share of profits if any (e.g. assignee does not have a right to vote, manage or to inspect partnership books).
   b. The assignee is not liable for the assignor's share of losses.

3. A creditor of an individual partner may obtain from a court a **charging order** against an individual partner’s share of profits. This is the **only right** the creditor receives.
   a. The creditor cannot attach the partner’s interest in partnership property.
   b. A charging order does not cause a dissolution of the partnership.
   c. A charging order does not make the creditor a partner and does not allow the creditor to vote, participate in management or obtain partnership information.
   d. A charging order gives the creditor essentially the same rights as an assignee.
   e. Assignees are entitled to partnership profits, and are responsible for the income taxes thereon. Profits with no money being distributed are a deterrent to charging orders.

**PARTNER DISSOCIATION**
Dissociation is the act of a partner leaving the partnership. Dissociation will lead to either a buyout of the partner’s interest, or dissolution and winding up of the partnership.

A partner is dissociated from a partnership upon the occurrence of any of the following events:

1. The partnership’s having notice of the partner’s express will to withdraw as a partner or on a later date specified by the partner;
2. An event agreed to in the partnership agreement as causing the partner’s dissociation;
3. The partner’s expulsion pursuant to the partnership agreement;
4. The partner’s expulsion by the unanimous vote of the other partners if:
   a. it is unlawful to continue with that partner.
   b. there has been a transfer of the partner’s transferable interest or a court order charging the partner’s interest.
   c. Within 90 days after the partnership notifies a corporate partner that it will be expelled because of dissolution, revoked charter or its right to conduct business has been suspended.
   d. A partnership that is a partner has been dissolved and its business is being wound up.
5. On application by the partnership or another partner, the partner’s expulsion by judicial determination because:
   a. The partner engaged in wrongful conduct.
   b. The partner committed a material breach of the partnership agreement.
   c. Conduct by partner makes it not practical to continue with that partner.

6. The partner
   a. Becoming a debtor in bankruptcy
   b. Executing an assignment for creditors
   c. Potential or actual appointment of custodian of all or mostly all of partner’s property. Partner has 90 days to stay appointment of trustee, receiver or liquidator.

7. In the case of a partner who is an individual,
   a. Partner’s death.
   b. The appointment of a guardian for the partner; or
   c. Judicial determination that partner is not capable of carrying on duties under partnership agreement.

8. Transfer of the entire transferable interest in a trust or estate that is a partner.

A partner has the power to dissociate at any time, rightfully or wrongfully. It is wrongful only if

1. It is a breach of the partnership agreement.

2. For a term partnership or partnership for a particular undertaking before completion of term or undertaking; e.g., partner who is chief engineer of a bridge project quits when bridge is 50% complete.
   a. The partner withdraws by express will, except if the partner dissociating follows within 90 days of another partner’s dissociation by death or otherwise it is not wrongful.
   b. A partner is expelled by judicial determination.
   c. The partner is a debtor in bankruptcy.

A partner who wrongfully dissociates is liable to the partnership and to the other partners for damages caused by the dissociation.

Note above that item 2 is a default rule in RUPA applying only if the issue is not addressed in the partnership agreement.

Effect of Partner’s Dissociation
1. The right to participate in management terminates.
2. The partner’s duty of loyalty terminates.
3. The partner’s duty of loyalty and care continue only with regard to matters arising and events occurring before dissociation.

PURCHASE OF DISSOCIATED PARTNER’S INTEREST

If dissociation occurs without resulting in dissolution, the partnership has the right to continue the business and the dissociated partner has the right to be paid the value of his interest. In this case the buyout is mandatory. The buyout may be by the partnership, one or more remaining partners or a third party acceptable to the remaining partners.

The buyout price is the amount, on the date of dissociation, as if the assets of the partnership were sold at a price equal to the greater of liquidation value or going concern value without the departing partner. The partnership must pay interest from the date of dissociation to the date of payment. This is a default rule. If the partnership agreement fixes the method of calculating payment, that will be used.

The partnership may offset against the buyout price all amounts due from the dissociated partner including amounts due for wrongful dissociation.
If the dissociated partner does not agree with the partnership’s stipulated buyout price and no agreement is reached after 120 days, the dissociated partner shall receive the partnership’s offer in cash as the undisputed minimum value and may thereafter bring suit to achieve a higher buyout price.

**DISSOCIATED PARTNER’S LIABILITY TO OTHER PERSONS**

A partner who dissociates without causing a dissolution is liable as a partner to the other party in a transaction entered into by the partnership before dissociation for a period of two years after dissociation.

Further, for a period of two years a dissociating partner is liable to third parties if they act after dissociation believing that the departed partner is a member of the partnership. A statement of dissociation operates conclusively as constructive notice to third parties 90 days after filing.

**EVENTS CAUSING DISSOLUTION AND WINDING UP OF PARTNERSHIP BUSINESS**

A partnership is dissolved and its business must be wound up under any of the following:

1. Notice from a partner they wish to withdraw in a partnership at will and that partner has not dissociated prior to such notice. “Partnership at will” means a partnership in which the partners have not agreed to remain partners until the expiration of a definite term or the completion of a particular undertaking.

2. For term partnerships:
   a. Within 90 days after a partner’s dissociation by death or otherwise, and at least half the remaining partners express their will to dissolve and wind up the business.
   b. The express will of all the partners to wind up the business.
   c. Expiration of the term or completion of the undertaking.

3. An event occurs agreed to in the partnership agreement resulting in the winding up of the business.

4. An event that makes it unlawful for all or substantially all of the business to continue.

5. On application by a partner, a judicial determination that continuation of the business is not practical.

6. On application by a transferee of a partner’s transferable interest, a judicial determination that it is equitable to wind up the business.

A partnership continues after dissolution only for the purpose of winding up its business. After winding up is complete, the partnership is terminated.

At any time after dissolution of a partnership and before the winding up is completed, all the partners, including any dissociating partner other than a wrongfully dissociating partner, may waive the right to have the business wound up and the partnership terminated.

In that event, the partnership resumes as if dissolution had not occurred. In this process, third parties are protected.

A partnership is bound by a partner’s act after dissolution that is necessary for winding up partnership affairs, or would have bound the partnership before dissolution if the other party did not have notice of the dissolution.

Note: Third parties are assumed to have notice 90 days after the filing of a Statement of Dissolution.
DISTRIBUTION UPON DISSOLUTION – GENERAL PARTNERSHIPS

Creditors have first claim on partnership assets. Partners who are creditors have equal claim with other creditors under RUPA; however, since partners are responsible for partnerships debts, creditors in reality are paid first.

The second order of distribution is to settle partner’s accounts with credit balances (equity) with no distinction being made between capital and/or profits.

Finally, partners who have debit balances in their capital account are required to contribute the balance. If a partner does not/or cannot (e.g. bankruptcy) contribute sufficient funds to erase a debit balance, the remaining partners are liable.

LIMITED PARTNERSHIPS

1. A limited partnership is a partnership of two or more parties formed in compliance with a state statute with the express purpose of permitting limited partners to share in partnership profits without the risk of personal liability.
   a. There must be one or more general partners and one or more limited partners:
      1). A general partner in a limited partnership has the same rights and duties that a general partner in a general partnership has.
      2). A limited partner has few duties and limited liability.
   b. But, a general partner may also be a limited partner in the same partnership.
   c. A certificate of limited partnership must be filed with the state and must contain:
      1). the name and address of the limited partnership, which must include the words "limited partnership"
      2). the names, addresses and signatures of all general partners
      3). the latest date the limited partnership will dissolve
      4). the name and address of its registered agent
   d. The certificate of limited partnership must be amended if a new general partner is admitted or withdraws or if any information in the certificate becomes untrue.

2. Liability in a limited partnership:
   a. General partners have unlimited personal liability.
   b. Limited partners have no liability beyond their capital contribution:
      1). A limited partner’s promise to contribute capital must be in writing.
      2). Limited partners are liable for any capital contribution not made.
   c. Limited partners have no right to take part in the control or day-to-day management of the partnership:
      1). If they do participate in daily management, they are personally liable to any party reasonably believing they were a general partner.
      2). rationale: If you give the appearance to others that you are a general partner, then you are liable like a general partner (apparent authority).
      3). If the partnership name includes a limited partner’s name, the limited partner is also liable to any creditor who didn't know they were a limited partner.
   d. Limited partners may vote on the following without incurring liability:
      1). dissolution of the limited partnership
      2). fundamental changes in the limited partnership (e.g. sale of substantially all assets of the limited partnership or a major change in the nature of the business)
      3). admission or removal of a general or limited partner
      4). amending the certificate of limited partnership

3. Unless otherwise agreed, admitting new general or limited partners requires the unanimous written consent of all limited and general partners.
4. Limited and general partners may be secured or unsecured creditors of the partnership.

5. Limited partners have the right to inspect and copy partnership books and records to specifically include the right to receive copies of any partnership tax returns.

2001 LIMITED PARTNERSHIP ACT

- A limited partner is one who is designated as a limited partner in the partnership agreement.
- A general partner is one who is designated as a general partner in the partnership agreement.

LIMITED PARTNERSHIP

- Commonly referred to a “domestic” limited partnership. The act encompasses all prior limited partnerships which were designated as such under prior acts.
- It is of the essence of a limited partnership to have two classes of partners. Accordingly, there must be at least one limited and one general partner. The act provides that a limited partnership dissolves if its sole general partner or sole limited partner dissociates and the limited partnership fails to admit a replacement within 90 days. Two partners are required under the Act.
- Limited partnership means an entity having one or more general partners and one or more limited partners which is formed under the Act by two or more persons.
- Partnership agreement means the partnership agreement whether oral or implied, in a record or in any combination, concerning the limited partnership.
- Person means an individual, corporation, business trust, estate, trust, partnership, limited liability company, association, joint venture, government, government subdivision, agency, or instrumentality, public corporation, or any other legal or commercial entity.
- Person dissociated as a general partner means a person dissociated as a general partner of a limited partnership. Likewise with respect to limited partners.

LIMITED LIABILITY COMPANY (LLC)

1. A Limited Liability Company (LLC) is a cross between a partnership and a corporation and has been recognized in virtually every state in the U.S.
   a. Most states require at least 2 members to form an LLC.
   b. A few states permit a one person LLC.

2. A Limited Liability Company differs from other business forms in three key areas:
   a. LIABILITY ADVANTAGE: Unlike partners, LLC owners (called members) have no personal liability beyond the amount of their investment in most cases (their limited liability is similar to a limited partner or corporate stockholder).
   b. PARTICIPATE IN MANAGEMENT: An LLC owner may fully participate in management like partners (unlike limited partners or corporate stockholders who have limited management rights).
   c. FEDERAL TAX ADVANTAGE: An LLC can have the same federal tax advantage of a partnership or S corporation (i.e. not subject to taxation on both the entity and profits distributed to members, like a corporation)

3. An LLC must file its articles of organization with the state:
   a. Its name must clearly indicate the limited liability of its owners (e.g. use L.L.C., L.C., "limited company" or "limited liability company" after its name)
   b. The agreement between LLC members governing the operation of the LLC is called an operating agreement (like a partnership agreement) and is not filed with the state.
4. There are two main methods of managing an LLC:
   a. An LLC may be member managed.
      1). Unless otherwise agreed, each member has an equal right to manage.
      2). Each member has both actual and apparent authority to bind the LLC.
   b. An LLC may be managed by managers elected by the members.
      1). The managers do not need to be members.
      2). Members have no actual or apparent authority to bind the LLC unless the member is also a manager.
      3). LLC managers have the same limited liability as LLC members.

5. LLC members have the following rights:
   a. The right to profits, losses and other distributions:
      1). Operating agreement determines how profits, losses and distributions are made.
      2). If nothing is said profits, losses and distributions are typically made on the basis of contributions made by members (not equally as in a partnership).
   b. Unless otherwise agreed, a member has the right to assign her interest in the LLC;
      1). The assignment doesn’t dissolve the LLC.
      2). The assignee doesn’t become a member of the LLC.
      3). The assignee only receives the right to receive assignor’s share of distributions.

6. Dissolution of an LLC:
   a. An LLC is dissolved in much the same manner as a partnership.
   b. e.g. An LLC is automatically dissolved when a member ceases to be associated with the company (referred to as dissociation) by withdrawal, death, bankruptcy, etc.
   c. In most states remaining members may continue the business by unanimous consent.

OTHER UNINCORPORATED ASSOCIATIONS

1. A joint venture is a business association of two or more owners acting together for profit for a limited purpose and for limited duration
   a. joint ventures are usually for a single project whereas a partnership involves an ongoing business
   b. joint ventures are treated as a partnership in most cases by the law

2. A Limited Liability Partnership (LLP) is a cross between a general partnership and a limited partnership and has been adopted in over 36 states
   a. an LLP is treated by the law as a general partnership for almost all purposes (e.g. partners in an LLP are general partners, partners are jointly liable for partnership contract debts and an LLP is taxed as a partnership)
   b. in an LLP partners have limited liability like a limited partner in one case only, for the negligence, wrongful acts or misconduct of other partners
      1). some states extend this limited liability to include acts of employees or agents
      2). two states (New York and Minnesota) limit a partner's liability to all obligations of the LLP
   c. exceptions: in most states a partner is still liable for his/her own misconduct and the misconduct of those acting under the partner's direct management or control
   d. as with a limited partnership, an LLP must file with the state and its name must clearly indicate it is a limited liability partnership (i.e. use LLP or Limited Liability Partnership after its name)

3. A Business Trust or Massachusetts Trust is a trust that has been established to operate a business for profit. It has three essential characteristics:
   a. the trust estate is for the purpose of operating a business for profit.
   b. each trust beneficiary receives a certificate evidencing ownership in the trust which is freely transferable.
c. trustees have the right to manage the business free from the beneficiaries' control
   1). as long as the beneficiaries have no control over management of the business, they are not
      personally liable.
   2). if the trustees are elected or can be removed by the beneficiaries, the trust is treated as a
      partnership and the beneficiaries are personally liable.

4. An unincorporated, nonprofit association is an association of two or more parties for social or charitable
   purposes.
   a. It is not a partnership because it is not done for profit.
   b. Members are not personally liable for an undertaking unless they authorized or assented to it.
Chapter Nine: Non-Corporate Entities
Multiple Choice Questions

1. Which of the following requirements must be met to have a valid partnership exist?
   
   I. Co-ownership of all property used in a business.
   II. Co-ownership of a business for profit.
   
   a. I only.
   b. II only.
   c. Both I and II.
   d. Neither I nor II.

2. When parties intend to create a partnership that will be recognized under the Revised Uniform Partnership Act, they must agree to

   Conduct a business for profit       Share gross receipts from a business
   
   a. Yes                          Yes
   b. Yes                          No
   c. No                           Yes
   d. No                           No

3. Which of the following is not necessary to create an express partnership?
   
   a. Execution of a written partnership agreement.
   b. Agreement to share ownership of the partnership.
   c. Intention to conduct a business for profit.
   d. Intention to create a relationship recognized as a partnership.

4. Generally, under the Revised Uniform Partnership Act, a partnership has which of the following characteristics?

   Unlimited duration  Obligation for payment of federal income tax
   
   a. Yes                     Yes
   b. Yes                     No
   c. No                      Yes
   d. No                      No

5. Which of the following statements is correct concerning liability when a partner in a general partnership commits a tort while engaged in partnership business?
   
   a. The partner committing the tort is the only party liable.
   b. The partnership is the only party liable.
   c. Each partner is jointly and severally liable.
   d. Each partner is liable to pay an equal share of any judgment.

6. Under the Revised Uniform Partnership Act, which of the following statements concerning the powers and duties of partners in a general partnership is(are) correct?

   I. Each partner is an agent of every other partner and acts as both a principal and an agent in any business transaction within the scope of the partnership agreement.
   II. Each partner is subject to joint liability on partnership debts and contracts.
   
   a. I only.
   b. II only.
   c. Both I and II.
   d. Neither I nor II.

7. Locke and Vorst were general partners in a kitchen equipment business. On behalf of the partnership, Locke contracted to purchase 15 stoves from Gage. Unknown to Gage, Locke was not authorized by the partnership agreement to make such contracts. Vorst refused to allow the partnership to accept delivery of the stoves and Gage sought to enforce the contract. Gage will

   a. Lose, because Locke's action was not authorized by the partnership agreement.
   b. Lose, because Locke was not an agent of the partnership.
   c. Win, because Locke had express authority to bind the partnership.
   d. Win, because Locke had apparent authority to bind the partnership.
8. The apparent authority of a partner to bind the partnership in dealing with third parties
a. Must be derived from the express powers and purposes contained in the partnership agreement.
b. Will be effectively limited by a formal resolution of the partners of which third parties are unaware.
c. May allow a partner to bind the partnership to representations made in connection with the sale of goods.
d. Would permit a partner to submit a claim against the partnership to arbitration.

9. Which of the following statements is(are) usually correct regarding general partners’ liability?
I. All partners are jointly and severally liable for partnership torts.
II. All general partners are liable only for those partnership obligations they actually authorized.
   a. I only.
   b. II only.
   c. Both I and II.
   d. Neither I nor II.

10. Which of the following statements is correct regarding a limited partnership?
   a. The general partner must make a capital contribution.
   b. It can only be created pursuant to a statute providing for the formation of limited partnerships.
   c. It can be created with limited liability for all partners.
   d. At least one general partner must also be a limited partner.

11. Which of the following statements is correct with respect to a limited partnership?
   a. A limited partner may not be an unsecured creditor of the limited partnership.
   b. A general partner may not also be a limited partner at the same time.
   c. A general partner may be a secured creditor of the limited partnership.
   d. A limited partnership can be formed with limited liability for all partners.

12. Which of the following statements regarding a limited partner is(are) generally correct?

<table>
<thead>
<tr>
<th>The limited partner</th>
<th>The limited partner</th>
</tr>
</thead>
<tbody>
<tr>
<td>is subject to</td>
<td>has the right to</td>
</tr>
<tr>
<td>personal liability</td>
<td>participate in the control</td>
</tr>
<tr>
<td>for partnership debts</td>
<td>of the partnership</td>
</tr>
<tr>
<td>a. Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>b. Yes</td>
<td>No</td>
</tr>
<tr>
<td>c. No</td>
<td>Yes</td>
</tr>
<tr>
<td>d. No</td>
<td>No</td>
</tr>
</tbody>
</table>

13. In general, which of the following statements is correct with respect to a limited partnership?
   a. A limited partner has the right to obtain from the general partner(s) financial information and tax returns of the limited partnership.
   b. A limited partnership can be formed with limited liability for all partners.
   c. A limited partner may not also be a general partner at the same time.
   d. A limited partner may hire employees on behalf of the partnership.

14. In general, which of the following statements is correct with respect to a limited partnership?
   a. A limited partner will be personally liable for partnership debts incurred in the ordinary course of the partnership's business.
   b. A limited partner is unable to participate in the management of the partnership in the same manner as general partners and still retain limited liability.
   c. A limited partner's death or incompetency will cause the partnership to dissolve.
   d. A limited partner is an agent of the partnership and has the authority to bind the partnership to contracts.
15. Which of the following statements is correct concerning the similarities between a limited partnership and a corporation?
   a. Each is created under a statute and must file a copy of its certificate with the proper state authorities.
   b. All corporate stockholders and all partners in a limited partnership have limited liability.
   c. Both are recognized for federal income tax purposes as taxable entities.
   d. Both are allowed statutorily to have perpetual existence.

16. Cass is a general partner in Omega Company's general partnership. Which of the following unauthorized acts by Cass will bind Omega?
   a. Submitting a claim against Omega to arbitration.
   b. Confessing a judgment against Omega.
   c. Selling Omega's goodwill.
   d. Leasing office space for Omega.

17. Which of the following statements is correct regarding the division of profits in a general partnership when the written partnership agreement only provides that losses be divided equally among the partners? Profits are to be divided
   a. Based on the partners' ratio of contribution to the partnership.
   b. Based on the partners' participation in day to day management.
   c. Equally among the partners.
   d. Proportionately among the partners.

18. The partnership agreement for Owen Associates, a general partnership, provided that profits be paid to the partners in the ratio of their financial contribution to the partnership. Moore contributed $10,000, Noon contributed $30,000, and Kale contributed $50,000. For the year ended December 31, 1993, Owen had losses of $180,000. What amount of the losses should be allocated to Kale?
   a. $40,000
   b. $60,000
   c. $90,000
   d. $100,000

Items 19 and 20 are based on the following:
Dowd, Elgar, Frost, and Grant formed a general partnership. Their written partnership agreement provided that the profits would be divided so that Dowd would receive 40%; Elgar, 30%; Frost 20%; and Grant, 10%. There was no provision for allocating losses. At the end of its first year, the partnership had losses of $200,000. Before allocating losses, the partners' capital account balances were: Dowd, $120,000; Elgar, $100,000; Frost, $75,000; and Grant, $11,000. Grant refuses to make any further contributions to the partnership. Ignore the effects of federal partnership tax law.

19. What would be Grant's share of the partnership losses?
   a. $9,000
   b. $20,000
   c. $39,000
   d. $50,000

20. After losses were allocated to the partners' capital accounts and all liabilities were paid, the partnership's sole asset was $106,000 in cash. How much would Elgar receive on dissolution of the partnership?
   a. $37,000
   b. $40,000
   c. $47,500
   d. $50,000

21. Which of the following statements best describes the effect of the assignment of an interest in a general partnership?
   a. The assignee becomes a partner.
   b. The assignee is responsible for a proportionate share of past and future partnership debts.
   c. The assignment automatically dissolves the partnership.
   d. The assignment transfers the assignor’s interest in partnership profits and surplus.
22. Cobb, Inc., a partner in TLC Partnership, assigns its partnership interest to Bean, who is not made a partner. After the assignment, Bean asserts the rights to

I. Participate in the management of TLC.
II. Cobb's share of TLC's partnership profits.

Bean is correct as to which of these rights?

a. I only.
b. II only.
c. I and II.
d. Neither I nor II.

23. Unless the partnership agreement prohibits it, a partner in a general partnership may validly assign rights to

<table>
<thead>
<tr>
<th>Partnership property</th>
<th>Partnership distributions</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>b. Yes</td>
<td>No</td>
</tr>
<tr>
<td>c. No</td>
<td>Yes</td>
</tr>
<tr>
<td>d. No</td>
<td>No</td>
</tr>
</tbody>
</table>

24. The partners of College Assoc., a general partnership, decided to dissolve the partnership and agreed that none of the partners would continue to use the partnership name. Under the Revised Uniform Partnership Act, which of the following events will occur on dissolution of the partnership?

<table>
<thead>
<tr>
<th>Each partner's existing liability would be discharged</th>
<th>Each partner's apparent authority would continue</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>b. Yes</td>
<td>No</td>
</tr>
<tr>
<td>c. No</td>
<td>Yes</td>
</tr>
<tr>
<td>d. No</td>
<td>No</td>
</tr>
</tbody>
</table>

25. Which of the following statements about the form of the DFV partnership agreement is correct?

a. It must be in writing because the partnership was to last for longer than one year.
b. It must be in writing because partnership profits would not be equally divided.
c. It could be oral because the partners had explicitly agreed to do business together.
d. It could be oral because the partnership did not deal in real estate.

26. Vick's share of the undistributed losses will be

a. $0
b. $1,000
c. $9,000
d. $10,000

27. If Frey died before the partnership terminated

a. Downs and Vick, as a majority of the partners, would have been able to continue the partnership.
b. The partnership would have continued until the five year term expired.
c. The partnership would automatically dissolve.
d. Downs and Vick would have Frey's interest in the partnership.

28. A joint venture is a(an)

a. Association limited to no more than two persons in business for profit.
b. Enterprise of numerous co-owners in a nonprofit undertaking.
c. Corporate enterprise for a single undertaking of limited duration.
d. Association of persons engaged as co-owners in a single undertaking for profit.

29. Unless otherwise provided in a general partnership agreement, which of the following statements is correct when a partner dies?

<table>
<thead>
<tr>
<th>The deceased partner's executor would automatically become a partner</th>
<th>The deceased partner's estate would be free from any partnership liabilities</th>
<th>The partnership would be dissolved automatically</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. Yes</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>b. Yes</td>
<td>No</td>
<td>No</td>
</tr>
<tr>
<td>c. No</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td>d. No</td>
<td>No</td>
<td>No</td>
</tr>
</tbody>
</table>

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9Q-4
30. Park and Graham entered into a written partnership agreement to operate a retail store. Their agreement was silent as to the duration of the partnership. Park wishes to dissolve the partnership. Which of the following statements is correct?
   a. Park may dissolve the partnership at any time.
   b. Unless Graham consents to a dissolution, Park must apply to a court and obtain a decree ordering the dissolution.
   c. Park may not dissolve the partnership unless Graham consents.
   d. Park may dissolve the partnership only after notice of the proposed dissolution is given to all partnership creditors.

31. Ted Fein, a partner in the ABC Partnership, wishes to withdraw from the partnership and sell his interest to Gold. All of the other partners in ABC have agreed to admit Gold as a partner and to hold Fein harmless for the past, present, and future liabilities of ABC. A provision in the original partnership agreement states that the partnership will continue upon the death or withdrawal of one or more of the partners. The agreement to hold Fein harmless for all past, present, and future liabilities of ABC will
   a. Prevent partnership creditors from holding Fein personally liable only as to those liabilities of ABC existing at the time of Fein's withdrawal.
   b. Prevent partnership creditors from holding Fein personally liable for the past, present, and future liabilities of ABC.
   c. Not affect the rights of partnership creditors to hold Fein personally liable for those liabilities of ABC existing at the time of his withdrawal.
   d. Permit Fein to recover from the other partners only amounts he has paid in excess of his proportionate share.

32. Lark, a partner in DSJ, a general partnership, wishes to withdraw from the partnership and sell Lark's interest to Ward. All of the other partners in DSJ have agreed to admit Ward as a partner and to hold Lark harmless for the past, present, and future liabilities of DSJ. As a result of Lark's withdrawal and Ward's admission to the partnership, Ward
   a. Acquired only the right to receive Ward's share of DSJ profits.
   b. Has the right to participate in DSJ's management.
   c. Is personally liable for partnership liabilities arising before and after being admitted as a partner.
   d. Must contribute cash or property to DSJ to be admitted with the same rights as the other partners.

33. Dill was properly admitted as a partner in the ABC Partnership after purchasing Ard's partnership interest. Ard immediately withdrew from the partnership. The partnership agreement states that the partnership will continue on the withdrawal or admission of a partner. Unless the partners otherwise agree,
   a. Dill's personal liability for partnership debts incurred before Dill was admitted will be limited to Dill's interest in partnership property.
   b. Ard will automatically be released from personal liability for partnership debts incurred before Dill's admission.
   c. Ard will be permitted to recover from the other partners the full amount that Ard has paid on account of partnership debts incurred before Dill's admission.
   d. Dill will be subjected to unlimited personal liability for partnership debts incurred before being admitted.

34. On dissolution of a general partnership, distributions will be made on account of:
   I. Partners' capital accounts
   II. Amounts owed partners with respect to profits
   III. Amounts owed partners for loans to the partnership
   in the following order.
   a. III, I, II.
   b. I, II, III.
   c. II, III, I.
   d. III, II, I.

35. Long, Pine, and Rice originally contributed $100,000, $60,000, and $20,000, respectively, to form the LPR Partnership. Profits and losses of LPR are to be distributed 1/2 to Long, 1/3 to Pine, and 1/6 to Rice. After operating for one year, LPR's total assets on its books are $244,000, total liabilities to outside creditors are $160,000 and total capital is $84,000. The partners made no withdrawals. LPR has decided to liquidate. If all of the partners are solvent and the assets of LPR are sold for $172,000
   a. Rice will personally have to contribute an additional $8,000.
   b. Pine will personally have to contribute an additional $4,000.
   c. Long, Pine, and Rice will receive $6,000, $4,000, and $2,000, respectively, as a return of capital.
   d. Long and Pine will receive $28,000 and $4,000, respectively, and Rice will have to contribute an additional $20,000.
36. Eller, Fort, and Owens do business as Venture Associates, a general partnership. Trent Corp. brought a breach of contract suit against Venture and Eller individually. Trent won the suit and filed a judgment against both Venture and Eller. Trent will generally be able to collect the judgment from
   a. Partnership assets only.
   b. The personal assets of Eller, Fort, and Owens only.
   c. Eller's personal assets only after partnership assets are exhausted.
   d. Eller's personal assets only.
Chapter Nine: Non-Corporate Entities
Other Objective Questions

NUMBER 1

Number 1 consists of 5 items. Select the best answer for each item. Answer all items. Your grade will be based on the total number of correct answers.

Items 1 through 5 are based on the following:

On March 1, 1995, Grove, Plane, and Range formed Techno Associates, a general partnership. They made capital contributions to the partnership as follows: Grove contributed $125,000; Plane contributed $250,000; and Range contributed $500,000. They prepared and executed a written partnership agreement that provided that profits would be shared equally, that the partnership would last for five years, and that the partnership use a calendar year for accounting purposes. There was not provision as to how losses would be allocated not was there any provision regarding the continued use of the partnership name in the event of dissolution.

- On April 1, 1996, Range assigned Range’s partnership interest to Blank. Blank notified Grove and Plane that Blank wanted to participate in the partnership business and vote on partnership issues.
- On June 10, 1996, a judgment was entered against Techno in a suit for breach of contract.
- On December 31, 1996, Grove resigned from the partnership.
- During the year-end closing, it was established that Techno had incurred an operating loss in 1996 as a result of the judgment. It was also established that Techno, being unable to pay its debts as they became due, was insolvent.
- On May 1, 1997, Techno filed for bankruptcy.

The Revised Uniform Partnership Act applies.

Required:
For Items 1 through 3, select the correct answer from List I. An answer may be selected once, more than once, or not at all.

1. What would be Range’s liability for Techno’s 1996 operating loss?
2. What would be Blank’s liability for Techno’s 1996 operating loss?
3. What would be Groves’s liability for Techno’s 1996 operating loss?

<table>
<thead>
<tr>
<th>List I</th>
</tr>
</thead>
<tbody>
<tr>
<td>(A) No personal liability.</td>
</tr>
<tr>
<td>(B) Liability limited to the amount contributed to the partnership.</td>
</tr>
<tr>
<td>(C) Liability limited to the amount in the capital account.</td>
</tr>
<tr>
<td>(D) Full personal liability for up to one-third of the total amount of the partnership debt.</td>
</tr>
<tr>
<td>(E) Full personal liability for up to the total amount of the partnership debt.</td>
</tr>
</tbody>
</table>
For Item 4, select the correct answer from List II.

4. As of January 1, 1997, who were the partners in Techno?

<table>
<thead>
<tr>
<th>List II</th>
</tr>
</thead>
<tbody>
<tr>
<td>(A) Blank and Plane.</td>
</tr>
<tr>
<td>(B) Plane and Range.</td>
</tr>
<tr>
<td>(C) Blank, Plane, and Grove.</td>
</tr>
<tr>
<td>(D) Grove, Plane, and Range.</td>
</tr>
<tr>
<td>(E) Blank, Grove, Plane, and Range.</td>
</tr>
</tbody>
</table>

For Item 5, select the correct answer from List III.

5. On May 1, 1997, what was the status of Techno?

<table>
<thead>
<tr>
<th>List III</th>
</tr>
</thead>
<tbody>
<tr>
<td>(A) Dissolved.</td>
</tr>
<tr>
<td>(B) Liquidated.</td>
</tr>
<tr>
<td>(C) Terminated.</td>
</tr>
</tbody>
</table>

NUMBER 2

Number 2 consists of 6 items. Select the best answer for each item. Answer all items. Your grade will be based on the total number of correct answers.

In 1992, Anchor, Chain, and Hook created ACH Associates, a general partnership. The partners orally agreed that they would work full time for the partnership and would distribute profits based on their capital contributions. Anchor contributed $5,000; Chain $10,000; and Hook $15,000.

For the year ended December 31, 1993, ACH Associates had profits of $60,000 that were distributed to the partners. During 1994, ACH Associates was operating at a loss. In September 1994, the partnership dissolved.

In October 1994, Hook contracted in writing with Ace Automobile Co. to purchase a car for the partnership. Hook had previously purchased cars from Ace Automobile Co. for use by ACH Associates partners. ACH Associates did not honor the contract with Ace Automobile Co. and Ace Automobile Co. sued the partnership and the individual partners.

Required:

Items 1 through 6 refer to the above facts. For each item, determine whether (A) or (B) is correct.

1. 
   A. The ACH Associates oral partnership agreement was valid.
   B. The ACH Associates oral partnership agreement was invalid because the partnership lasted for more than one year.

2. 
   A. Anchor, Chain, and Hook jointly owning and conducting a business for profit establishes a partnership relationship.
   B. Anchor, Chain, and Hook jointly owning income producing property establishes a partnership relationship.
3. 
A. Anchor's share of ACH Associates' 1993 profits was $20,000.
B. Hook's share of ACH Associates' 1993 profits was $30,000.

4. 
A. Anchor's capital account would be reduced by 1/3 of any 1994 losses.
B. Hook's capital account would be reduced by 1/2 of any 1994 losses.

5. 
A. Ace Automobile Co. would lose a suit brought against ACH Associates because Hook, as a general partner, has no authority to bind the partnership.
B. Ace Automobile Co. would win a suit brought against ACH Associates because Hook's authority continues during dissolution.

6. 
A. ACH Associates and Hook would be the only parties liable to pay any judgment recovered by Ace Automobile Co.
B. Anchor, Chain, and Hook would be jointly and severally liable to pay any judgment recovered by Ace Automobile Co.

**NUMBER 3**

Best Aviation Associates is a general partnership engaged in the business of buying, selling and servicing used airplanes. Best's original partners were Martin and Kent. They formed the partnership on January 1, 1992, under an oral partnership agreement which provided that the partners would share profits equally. There was no agreement as to how the partners would share losses. At the time the partnership was formed, Martin contributed $320,000 and Kent contributed $80,000.

On December 20, 1993, Kent assigned Kent's partnership interest in Best to Green. On December 31, 1993, Kent advised Martin of the assignment to Green. On January 11, 1994, Green contacted Martin and demanded to inspect the partnership books and to participate in the management of partnership affairs, including voting on partnership decisions.

On January 13, 1994, it was determined that Best had incurred an operating loss of $160,000 in 1993. Martin demanded that Kent contribute $80,000 to the partnership to account for Kent's share of the loss. Kent refused to contribute.

On January 28, 1994, Laco Supplies, Inc., a creditor of Best, sued Best and Martin for unpaid bills totaling $92,000. Best had not paid the bills because of a cash shortfall caused by the 1993 operating loss.

Martin has taken the following positions:

- Green is not entitled to inspect the partnership books or participate in the management of the partnership.
- Only the partnership is liable for the amounts owed to Laco, or, in the alternative, Martin's personal liability is limited to 50% of the total of the unpaid bills.
Kent has taken the following positions:

- Only Martin is liable for the 1993 operating loss because of the assignment to Green of Kent's partnership interest.
- Any personal liability of the partners for the 1993 operating loss should be allocated between them on the basis of their original capital contributions.

Required:

a. Determine whether Martin's positions are correct and state the reasons for your conclusions.

b. Determine whether Kent's positions are correct and state the reasons for your conclusions.

**NUMBER 4**

Smith, Edwards, and Weil formed Sterling Properties Limited Partnership to engage in the business of buying, selling and managing real estate. Smith and Edwards were general partners. Weil was a limited partner entitled to 50% of all profits.

Within a few months of Sterling's formation, it became apparent to Weil that Smith and Edwards' inexperience was likely to result in financial disaster for the partnership. Therefore, Weil became more involved in day-to-day management decisions. Weil met with prospective buyers and sellers of properties; assisted in negotiating partnership loans with its various lenders; and took an active role in dealing with personnel problems. Things continued to deteriorate for Sterling, and the partners began blaming each other for the partnership's problems.

Finally, Smith could no longer deal with the situation, and withdrew from the partnership. Edwards reminded Smith that the Sterling partnership agreement specifically prohibited withdrawal by a general partner without the consent of all the other partners. Smith advised Edwards and Weil that she would take no part in any further partnership undertaking and would not be responsible for partnership debts incurred after this withdrawal.

With Sterling on the verge of collapse, the following situations have occurred:

- Weil demanded the right to inspect and copy the partnership's books and records and Edwards refused to allow Weil to do so, claiming that Weil's status as a limited partner precludes that right.
- Anchor Bank, which made a loan to the partnership prior to Smith's withdrawal, is suing Sterling and each partner individually, including Smith, because the loan is in default. Weil denied any liability based on his limited partner status. Smith denies liability based on her withdrawal.
- Edwards sued Smith for withdrawing from the partnership and is uncertain about the effect of her withdrawal on the partnership.
- Weil wants to assign his partnership interest to Fred Alberts, who wants to become a substitute limited partner. Weil is uncertain about his right to assign this interest to Alberts and, further, the right of Albert's to become a substitute limited partner. Edwards contends that Edwards' consent is necessary for the assignment or the substitution of Alberts as a limited partner and that without this consent any such assignment would cause a dissolution of the partnership. The Sterling partnership agreement and certificate are silent in this regard.
Required:
Answer the following questions, setting forth reasons for the conclusions stated.

a. Is Weil entitled to inspect and copy the books and records of the partnership?

b. Are Weil and/or Smith liable to Anchor Bank?

c. Will Edwards prevail in the lawsuit against Smith for withdrawing from the partnership?

d. What is the legal implication to the partnership of Smith's withdrawal?

e. Can Weil assign his partnership interest to Alberts?

f. Can Edwards prevent the assignment to Alberts or the substitution of Alberts as a limited partner?

g. What rights does Alberts have as assignee of Weil's partnership interest?

h. What effect does an assignment have on the partnership?

NUMBER 5

Prime Cars Partnership is a general partnership engaged in the business of buying, selling, and servicing used cars. Prime's original partners were Baker and Mathews, who formed the partnership three years ago under a written partnership agreement, which provided that:

- Profits and losses would be allocated 60% to Baker and 40% to Mathews.

- Baker would be responsible for supervising Prime's salespeople and for purchasing used cars for inventory. Baker could not, without Mathews' consent, enter into a contract to purchase more than $15,000 worth of used cars at any one time.

- Mathews would be responsible for supervising Prime's service department.

On May 1, 1990, Baker entered into a contract on Prime's behalf with Jaco Auto Wholesalers, Inc. to purchase 11 used cars from Jaco for a total purchase price of $40,000. Baker's agreement with Jaco provided that the cars would be delivered to Prime on September 1. Baker did not advise Mathews of the terms and conditions of the contract with Jaco. Baker had regularly done business with Jaco on behalf of Prime in the past, and on several occasions had purchased $12,000 to $15,000 of used cars from Jaco. Jaco was unaware of the limitation on Baker's authority.

Baker also frequently purchased used cars for Prime from Top Auto Auctions, Ltd., a corporation owned by Baker's friend. Whenever Prime purchased cars from Top, Baker would personally receive up to 5% of the total purchase price from Top as an incentive to do more business with Top. Baker did not tell Mathews about these payments.

On August 1, 1990, Baker and Mathews agreed to admit KYA Auto Restorers, Inc. as a partner in Prime to start up and supervise a body shop facility. KYA made a $25,000 capital contribution and Prime's partnership agreement was amended to provide that Prime's profits and losses would be shared equally by the partners.

On September 1, 1990, Mathews learned of the Jaco contract and refused to accept delivery of the cars. Mathews advised Jaco that Baker had entered into the contract without Mathews' consent as required by their agreement. Jaco has demanded a payment of $10,000 from Prime for Jaco's lost profits under the contract.
Mathews has also learned about the incentive payments made to Baker by Top.

Mathews has taken the following positions:

- Prime is not liable to Jaco because Baker entered into the contract without Mathews' consent.
- In any event, Mathews is not liable to Jaco for more than 40% of Jaco's lost profits because of the original partnership provisions concerning the sharing of profits and losses.
- Baker is liable to Mathews for any liability incurred by Mathews under the Jaco contract.
- Baker is liable to Prime for accepting the incentive payments from Top.

KYA contends that none of its $25,000 capital contribution should be applied to the Jaco liability and that, in any event, KYA does not have any responsibility for the obligation.

**Required:**

a. State whether Mathews' positions are correct and give the reasons for your conclusions.
b. State whether KYA's contentions are correct and give the reasons for your conclusions.
Chapter Nine: Non-Corporate Entities
Multiple Choice Answers

1. (b) A partnership is an association of two or more co-owners of a business for profit. Thus, (II) is a requirement of a partnership. It is not necessary that each piece of property used in the business be co-owned by all the partners. For example, the partnership may lease equipment from a third party or may use property that is owned by one partner and not others. Thus (I) is not a requirement of a partnership.

2. (b) A partnership is an association of two or more co-owners of a business for profit. Thus, to create a partnership, the parties must intend to conduct a business for profit. It is not necessary to share gross receipts from a business to form a partnership. Indeed, partners share net receipts, not gross receipts.

3. (a) A partnership is not one of the six types of contracts that require a writing under the statute of frauds (GRIPE + marriage). Only a partnership impossible to perform in one year and a limited partnership would require a writing. Answers (b), (c) and (d) are incorrect because co-ownership of a business for profit and with the intent to create a partnership are all necessary requirements to create an express partnership.

4. (d) A partnership is not usually considered to be a separate legal entity. Specifically, a partnership does not pay federal income tax. A partnership does not have perpetual existence like a corporation. Only answer (d) states no unlimited duration for a partnership and no obligation to pay federal income tax.

5. (c) Partners are agents of the partnership and each other. Thus, agency rules apply. If a partner commits a tort while acting in the scope of partnership business, the partner would be liable, the partnership would be liable and all other partners would be liable (respondeat superior). Partners are joint and severally liable for all partnership torts. Answers (a) and (b) are incorrect because the partner committing the tort, the partnership and all other partners would be liable. Answer (d) is incorrect because each partner would be personally liable for the whole amount of any judgment, not just an equal share.

6. (c) Statement I is correct because partners are agents of the partnership and agents of each other. Since partners are co-owners of the business, when a partner acts on behalf of the business the partner is acting as both a principal and as an agent. Statement II is correct partners are jointly liable on all partnership debts and contract obligations. This means all partners must be sued as a group.

7. (d) Partners are agents of the partnership and each other. Thus, a partner can bind the partnership and fellow partners to a contract if the partner had actual authority or apparent authority. Although Locke exceeded Locke’s actual authority, the partnership will still be liable based on Locke’s apparent authority. Apparent authority depends on how things appear to third parties. It was reasonable for Gage to believe that a partner, like Locke, could purchase 15 stoves for the business. Since it appeared to Gage that Locke was authorized, Gage will win based on apparent authority. Thus (d) is correct and (a) is incorrect. Answer (b) is incorrect because Locke was an agent of the partnership. Answer (c) is incorrect because Locke did not have express authority. The partnership agreement expressly stated Locke was not authorized to make such contracts.

8. (c) Partners are agents of the partnership and each other. A partner acting with real or apparent authority can impose contract liability on the partnership and on their fellow partners. Thus, a partner selling goods with either real or apparent authority would bind the partnership. Answer (a) is incorrect because apparent authority depends on how things appear to third parties, not on the express provisions of the partnership agreement. Answer (b) is incorrect because if a partner’s authority was expressly limited by a resolution and the third party was unaware of the resolution, it may still appear that the partner was authorized. In such a case, apparent authority would exist. Answer (d) is incorrect because partnership law requires unanimous consent of all partners to submit a claim to arbitration.
9. (a) Statement I is correct because partners are jointly and severally liable for all partnership torts. This is because partners are agents of the partnership and each other. If a partner commits a tort while acting in the scope of the agency, the principal is liable. Statement II is incorrect because general partners are jointly liable for all partnership debts and contract obligations whether they actually authorized them or not. Additionally, partners are agents of the partnership and each other and therefore can be liable for actions sanctioned not only by actual authority, but also by apparent authority.

10. (b) To form a limited partnership in a state, there must be a special state statute that permits limited partnerships. The limited partnership must file a certificate of limited partnership with the state. Answer (a) is incorrect because a general partner is not required to make a capital contribution. Answer (c) is incorrect because a limited partnership must have at least one general partner and general partners are personally liable for all partnership debts. Answer (d) is incorrect because a general partner may also be a limited partner in the same partnership at the same time, a general partner is not required to also be a limited partner.

11. (c) Both general and limited partners may be creditors of a limited partnership. A general partner may be either a secured or an unsecured creditor and so may a limited partner. Thus, (c) is correct and (a) is incorrect. Answer (b) is incorrect because a general partner may also be a limited partner in the same partnership at the same time. Answer (d) is incorrect because a limited partnership must have at least one general partner and general partners are personally liable for all partnership debts.

12. (d) Limited partners have no personal liability beyond their investment, thus they are not personally liable. Limited partners may not take part in the control of the partnership. If they do, they are liable like general partners to anyone reasonably believing they were a general partner. The only answer that reflects that they are not personally liable and may not take part in control of the partnership is (d).

13. (a) The law gives to all investors the right to inspect books and records at reasonable times. Stockholders, general partners and limited partners all have this right. Thus, a limited partner may obtain financial information to include tax returns. Answer (b) is incorrect because a limited partnership must have at least one general partner and general partners are personally liable for all partnership debts. Answer (c) is incorrect because a limited partnership must have at least one general partner in the same partnership at the same time. Answer (d) is incorrect because a limited partner may not take part in the control of the partnership.

14. (b) Limited partners may not take part in the control of the partnership. If they do, they are liable like general partners to anyone reasonably believing they were a general partner. Thus, a limited partner may not participate in the management of the partnership in the same manner as general partners without losing their limited liability. Answer (a) is incorrect because limited partners are not personally liable for partnership debts. Answer (c) is incorrect because changes in limited partners do not dissolve the partnership. Only changes in general partners cause the dissolution of the partnership. Answer (d) is incorrect because limited partners are not agents of the partnership, only general partners are agents of the partnership.

15. (a) Both a limited partnership and a corporation are created pursuant to state statutes and both must file with the secretary of state. Answer (b) is incorrect because a general partner in a limited partnership is personally liable for partnership debts. Equally, corporate law permits piercing of the corporate veil and holding stockholders personally liable in certain situations. Answer (c) is incorrect because a limited partnership is not recognized as a taxable entity for federal income tax purposes. Answer (d) is incorrect because only a corporation has perpetual existence.

16. (d) Answers (a), (b) and (c) are incorrect because it takes unanimous consent of all partners to submit a claim to arbitration, to confess a judgment (admit liability in a lawsuit) and to sell the partnership’s goodwill. Answer (d) is correct because leasing office space for the partnership by a partner would be within the partner’s apparent authority. Since it would be reasonable to believe that a partner could lease space, the partnership would be bound.

17. (c) Each partner has an equal right to share in profits and losses, unless otherwise agreed. Thus, profits are to be divided equally among the partners when the agreement is silent on the matter. Answers (a), (b) and (d) are incorrect because profits are not divided based on capital contributions, on management participation or proportionally. Profits are divided equally.
18. **(d) If a division of profits is specified** in a partnership agreement, **but not** a division of losses, **losses will be divided in the same manner as profits**. The partnership agreement for Owen specified that profits were to split according to capital contributions (Moore - $10,000, Noon - $30,000 and Kale - $50,000). Therefore, losses must be split the same way. With losses of $180,000, Kale’s share of the loss would be $100,000 (5/9 of $180,000) and only (d) reflects this amount.

19. **(b) If a division of profits is specified** in a partnership agreement, **but not** a division of losses, **losses will be divided in the same manner as profits**. This partnership agreement specified that profits were to be split Dowd - 40%, Elgar - 30%, Frost - 20% and Grant - 10%. Therefore losses must be split the same way. With losses of $200,000 and Grant’s share being 10%, Grant’s share of the losses would be $20,000. Only answer (b) reflects this amount.

20. **(a) The order of distribution upon dissolution is to pay creditors, then pay back loans made by the partners, then pay back capital contributions.** All liabilities have been paid and there were not any loans made by the partners. The next order of distribution is to pay back capital contributions. The partners share of losses was allocated to their capital accounts. Dowd contributed $120,000 and had a 40% share of the $200,000 loss ($80,000). Thus, Dowd is due $40,000 ($120,000 minus $80,000). Elgar contributed $100,000 and had a 30% share of a $200,000 loss ($60,000). Thus, Elgar is due $40,000 ($100,000 minus $60,000). Frost contributed $75,000 and had a 20% share of a $200,000 loss ($40,000). Thus, Frost is due $35,000 ($75,000 minus $40,000). Grant contributed $35,000 and had a 10% share of a $200,000 loss ($20,000). Thus, Grant should contribute $9,000 because of the negative balance ($11,000 minus $20,000). Grant has refused to contribute the $9,000, thus each partner must proportionately share in this shortfall. Dowd’s proportionate share is 4/9 of $9,000 ($4,000), Elgar’s is 1/3 of $9,000 ($3,000) and Frost’s is 2/9 of $9,000 ($2,000) Final payment would be Dowd $36,000 ($40,000 minus $4,000), Elgar $37,000 ($40,000 minus $3,000) and Frost $33,000 ($35,000 minus $2,000) equaling the $106,000 available. The only answer that reflects that Elgar receives $37,000 is (a).

21. **(d) An assignment of a general partnership interest confers on the assignee only the right to receive the assignor’s share of profits, if any.** Answer (a) is incorrect because the assignee does not become a partner without the consent of all other partners. Answer (b) is incorrect because the assignor is still liable for debts and the assignee is not liable. Answer (c) is incorrect because an assignment does not dissolve the partnership.

22. **(b) An assignee of a partner’s interest in a partnership does not become a substitute partner.** The assignee receives no rights other than the right to receive the assignor’s share of profits, if any. Thus, Bean received the right to Cobb’s share of profits, but did not receive the right to participate in the management of the partnership. Only answer (b) reflects the right to profits, but not the right to participate in management.

23. **(c) A partner may validly assign the right to receive partnership distributions.** The assignee would only receive the right to receive the assignor’s share of profits, if any. A partner may not validly assign rights to specific partnership property because it takes unanimous consent of all partners to transfer partnership property to others. Only answer (c) reflects the right to assign distributions, but not the right to assign partnership property.

24. **(c) Partners are agents of the partnership and each other.** Thus, agency rules apply. If a partnership dissolves, partners must give actual notice to old customers and published notice to new ones. Failure of a partner to give proper notice would give a partner apparent authority to act on behalf of the partnership with customers who were unaware of the dissolution. Although dissolution would discharge a partner’s actual authority, it does not discharge a partner’s apparent authority. Only answer (c) reflects that a partner’s liability is not automatically discharged by dissolution and that apparent authority would continue.

25. **(a) A partnership impossible to complete in one year would require a writing under the statute of frauds.** The partners agreed the partnership was not to be terminated for five years and thus, a writing was required. Answer (b) is incorrect because how profits are to be divided has no bearing on whether a writing is required. Answers (c) and (d) are incorrect because a writing was required for this partnership and thus, the partnership could not be oral.

26. **(c) If a division of profits is specified** in a partnership agreement, **but not** a division of losses, **losses will be divided in the same manner as profits.** This partnership agreement specified that profits were to be split Downs - 40%, Frey
and Vick - 30% each. Therefore, losses will be split the same way. Vick has a 30% share of a $30,000 loss or $9,000. Only answer (c) reflects this amount.

27. (a) Under RUP, if a majority of the partners agree to continue the partnership, they may do so and the partnership is not dissolved. Answer (b) is incorrect because the partnership agreement merely states that the partnership will not end for five years, inferring that it may go beyond five years. Answer (c) is incorrect because one of the significant changes under RUPA is that a partnership is an entity in itself and the departure of a partner does not automatically dissolve the partnership. In a two-person partnership, the departure of one partner would dissolve the partnership, since a partnership must have two persons. Answer (d) is incorrect because Frey’s interest becomes part of his estate; however, the estate cannot become a partner without the consent of all the other partners, which is unlikely. The estate’s interest is similar to that of an assignee.

28. (d) Joint ventures are a business association of two or more co-owners acting together for profit for a limited purpose and for a limited duration. They are usually for a single undertaking. Joint ventures are treated as a partnership in most cases by the law. Answer (a) is incorrect because a joint venture may have more than two persons. Answer (b) is incorrect because the co-owners must act together for profit. Answer (c) is incorrect because a joint venture is not a corporate enterprise.

29. (d) A partner’s estate does not become a partner unless agreed to by all the other partners. The estate is responsible for all partnership liabilities up until the partner’s death. The partnership would not automatically dissolve if a majority of the remaining partners agree to continue.

30. (a) Park may dissolve the partnership at any time. Since there are only two partners, the departure of Park leaves only one partner. A partnership requires two partners operating a business for profit.

31. (c) A partner is personally liable for all partnership debts that occurred while he was a partner. Fein was a member of the ABC partnership and was personally liable for all debts of ABC that occurred while he was a partner. The agreement to hold Fein harmless was made by the other partners and not by the creditors. The agreement to hold Fein harmless does not relieve Fein from liability to creditors, it merely gives Fein the right to recover any amounts he may have to pay to the creditors from the other partners. Answers (a) and (b) are incorrect because the creditors are not prevented from holding Fein liable for debts that occurred while Fein was a partner. Answer (d) is incorrect because the hold harmless agreement allows Fein to recover from the other partners all amounts he may have to pay to creditors, not just the amount in excess of his proportionate share.

32. (b) Everything in a partnership is equal unless otherwise agreed. This includes the right to participate in management. Since the partners agreed to admit Ward as a partner, Ward has the right to participate in management. Answer (a) is incorrect because Ward has an equal right in all partnership matters unless the partners specifically agree otherwise. An assignee acquires only the right to receive their assignor’s share of profits. Ward was more than an assignee, Ward was a partner. Answer (c) is incorrect because Ward is only personally liable for partnership debts that occur after (s)he is admitted as a partner. Ward would not be personally liable for debts that occurred prior to becoming a partner. Answer (d) is incorrect because a partner is not required to contribute cash or property to become a partner. They may contribute services or they may not contribute anything.

33. (a) An incoming partner is not personally liable for partnership debts occurring prior to becoming a partner. However, an incoming partner’s interest in partnership property can be attached by creditors. Thus, the liability of Dill (the incoming partner) would be limited to Dill’s interest in partnership property. Answer (b) is incorrect because a departing partner is personally liable for all partnership debts that occurred while (s)he was a partner. Answer (c) is incorrect because Ard cannot recover from the other partners the full amount that Ard paid creditors unless the other partners specifically agreed to hold Ard harmless. There was no hold harmless agreement given to Ard. Answer (d) is incorrect because Dill is only personally liable for partnership debts that occur after (s)he is admitted as a partner. Dill would not be personally liable for debts that occurred prior to becoming a partner.

34. (a) Upon dissolution of a general partnership the following order of distribution occurs: first creditors are paid, second partners are repaid for any loans or advances made to the partnership, third capital contributions are paid and lastly profits are split. Only answer (a) reflects this order of distribution.
35. (a) Upon dissolution of a general partnership the following order of distribution occurs: first creditors are paid, second partners are repaid for any loans or advances made to the partnership, third capital contributions are paid and lastly profits are split. Creditors are owed $160,000, there are no loans made by partners and a total of $180,000 is due for capital contributions (Long - $100,000, Pine - $60,000 and Rice - $20,000). Thus, $340,000 is needed to pay creditors and capital contributions ($180,000 + $160,000). Of the $340,000 needed, only $172,000 is available from the sale of assets. This leaves a shortfall of $168,000 ($340,000 minus $172,000 = $168,000). Long’s share of the shortfall is 1/2 of $168,000 or $84,000. Thus, Long will receive his capital contribution ($100,000) minus his share of the shortfall ($84,000), or $16,000. Pine’s share of the shortfall is 1/3 of $168,000 or $56,000. Thus Pine will receive his capital contribution ($60,000) minus his share of the shortfall ($56,000), or $4,000. Rice’s share of the shortfall is 1/6 of $168,000 or $28,000. Rice will receive his capital contribution ($20,000) minus his share of the shortfall ($28,000) leaving a negative balance of $8,000. Thus, Rice will have to contribute an additional $8,000. The only answer that reflects this distribution is (a).

36. (c) Partnership creditors can only go after a partner personally after all partnership assets are first exhausted. Thus, Trent can only go after the personal assets of Eller after the partnership assets are exhausted. Answer (a) and (b) are incorrect because a creditor can collect a judgment from both partnership assets and from partners personally. Answer (d) is incorrect because partnership creditors must first exhaust partnership assets before they can go after a partner personally.
Chapter Nine: Non-Corporate Entities
Other Objective Answers

ANSWER 1

1. (E) Partners in a general partnership have unlimited personal liability to 3rd parties for all partnership debts, contract obligations and torts. Although Range assigned Range’s interest to Blank on April 1, Range (the assignor) remained a general partner and remained liable for partnership debt. Since Range was a general partner, Range has full or unlimited liability for the total amount of the partnership debt. Answer (A) is incorrect because Range is liable. Answers (B) and (C) are incorrect because Range’s liability is not limited. It is unlimited. Answer (D) is incorrect because Range has liability for all of the debt as to 3rd parties, not just 1/3. **Between the partners** (Range, Grove and Plane), Range’s liability would be for 1/3 of the debt, but not as to 3rd parties.

2. (A) Blank has no personal liability for the 1996 operating loss because Blank was not a partner. On April 1, Range assigned Range’s interest to Blank. Blank (the assignee) cannot become a partner without the consent of Grove and Plane. Blank only acquired the right to receive Range’s share of profits and is not liable for Range’s share of losses. Answers (B), (C), (D) and (E) are incorrect because they state Blank has liability.

3. (E) Partners in a general partnership have unlimited personal liability to 3rd parties for all partnership debts, contract obligations and torts. Since Grove was a general partner, Grove has full or unlimited liability for the total amount of the partnership debt. Answer (A) is incorrect because Grove is liable. Answers (B) and (C) are incorrect because Grove’s liability is not limited. It is unlimited. Answer (D) is incorrect because Grove has liability for all of the debt as to 3rd parties, not just 1/3. **Between the partners** (Range, Grove and Plane), Grove’s liability would be for 1/3 of the debt, but **not as to 3rd parties**.

4. (B) On January 1, 1997, Plane and Range were the partners of Techno. Grove was not a partner because Grove resigned on December 31, 1996. Blank was not a partner because an assignee cannot become a partner without the consent of the remaining partners. Range remained a partner because an assignment does not dissolve the partnership and the assignor (Range) remains a partner. Plane had not resigned, so Plane was also a partner.

5. (A) On May 1, 1997, Techno was dissolved. Bankruptcy of the partnership will automatically dissolve the partnership by operation of law. Answer (B) is incorrect because Techno was not liquidated on May 1. Liquidation or winding up occurs when there is a final settlement of all partnership affairs (e.g. complete unfinished business, collection of receivables, payment of creditors and distribution of assets). On May 1, none of that had occurred. Answer (C) is incorrect because termination occurs upon the completion of liquidation or winding up. Since Techno had not yet been liquidated, Techno could not have been terminated.

ANSWER 2

1. (A) A partnership is not one of the six types of contracts that require a writing under the statute of frauds (GRIPE + marriage). Only a partnership impossible to perform in one year would require a writing. This partnership did last for more than one year, but it could have been dissolved before the year was up. Thus, it was not impossible to perform in one year and the partnership agreement may be oral, making (A) correct and (B) incorrect.

2. (A) A partnership is two or more co-owners of a business for profit. Answer (B) is incorrect because the mere joint ownership of income producing property does not necessarily establish a partnership. A non-profit association, for example, can have joint ownership of income producing property, but it would not be a business conducted for profit.

3. (B) It was agreed that profits would be split based on capital contributions. Anchor contributed $5,000 (1/6), Chain contributed $10,000 (1/3) and Hook contributed $15,000 (1/2). With profits of $60,000, the distribution would be Anchor - $10,000 (1/6 of $60,000), Chain - $20,000 (1/3 of $60,000) and Hook - $30,000 (1/2 of $60,000). Thus, (B) is correct and (A) is incorrect.
4. (B) If a division of profits is specified in a partnership agreement, but not a division of losses, losses will be divided in the same manner as profits. This partnership agreement specified that profits were to be split based on capital contributions. Anchor contributed $5,000 (1/6), Chain contributed $10,000 (1/3) and Hook contributed $15,000 (1/2). Thus, any losses would be allocated 1/6 to Anchor, 1/3 to Chain and 1/2 to Hook. Only answer (B) reflects this allocation.

5. (B) Partners are agents of the partnership and each other. Thus, agency rules apply. If a partnership dissolves, partners must give actual notice to old customers and published notice to new ones. Failure of a partner to give proper notice would give a partner apparent authority to act on behalf of the partnership with customers who were unaware of the dissolution. Although dissolution would discharge a partner’s actual authority, it does not discharge a partner’s apparent authority. Ace was an old customer, having previously sold cars to Hook for the partnership. Ace did not receive any notice of the dissolution. Thus Hook had apparent authority to bind the partnership to a contract with Ace even though dissolution had previously occurred, making (B) correct and (A) incorrect.

6. (B) Each partner is personally liable for all partnership debts. Thus, Anchor, Chain and Hook are jointly and severally liable to pay any judgment recovered by Ace. Answer (A) is incorrect because Anchor and Chain individually would also be liable for the judgment.

ANSWER 3

a. Martin's first position that Green is not entitled to inspect the partnership books or participate in partnership management is correct. Green, as an assignee of Kent's partnership interest, is entitled to receive Kent's share of partnership profits only. Green is not entitled, as an assignee of Kent's partnership interest, to inspect the partnership records or to participate in the management of the partnership.

Martin's second position that only the partnership is responsible for the debt owed Laco is incorrect. Although the partnership is primarily liable for the unpaid bills, both Martin and Kent, as Best's partners, are personally liable for the unpaid amount of the debt. Laco will be entitled to seek recovery against Martin or Kent for the full amount owed.

b. Kent's first position that only Martin is liable for the 1993 operating loss because of the assignment of Kent's partnership interest to Green is incorrect. A partner's assignment of a partnership interest does not terminate that partner's liability for the partnership's losses and debts.

Kent's second position that any personal liability of the partners for the 1993 operating loss should be allocated on the basis of their original capital contributions is incorrect. The 1993 loss will be allocated in the same way that profits were to be allocated between the parties, that is, equally, because Martin and Kent had not agreed on the method for allocating losses between themselves.

ANSWER 4

a. Weil is entitled to inspect and copy Sterling's books and records. A limited partner such as Weil has the right to have the partnership books kept at the principal place of business of the partnership and to inspect and copy them at all times.

b. Generally, limited partners are not liable to partnership creditors except to the extent of their capital contribution. In Weil's case, however, he will probably be liable to Anchor Bank in the same manner as Sterling's general partners because he has taken part in the control of the business of the partnership and, therefore, has lost his limited liability. Smith, as a general partner, would also be personally liable to Anchor because liability was incurred prior to withdrawal.

c. Edwards will likely prevail in his lawsuit against Smith for withdrawing because the partnership agreement specifically prohibits a withdrawal by a general partner without the consent of the other partners. Therefore, Smith has breached the partnership agreement and will be liable to Edwards for any damages resulting from Smith's withdrawal.
d. The withdrawal (retirement) of a general partner disables the partnership unless the remaining general partners continue the business of the partnership under a right to do so provided in the limited partnership certificate, or unless all partners consent.

e. Weil is free to assign his limited partnership interests to Alberts in the absence of any prohibitions in the Sterling partnership agreement or certificate.

f. Alberts, however, cannot be a substitute limited partner without the consent of the remaining general partner, Edwards.

g. Therefore, Alberts, as an assignee of Weil's limited partnership interest, may not exercise any rights of a partner. Alberts is entitled only to any distributions from Sterling to which Weil would have been entitled.

h. Finally, the assignment by Weil of his partnership interest does not cause a dissolution of the partnership.

**ANSWER 5**

a. 1. Mathews' first position is incorrect. A partner is considered an agent of the partnership in carrying out its usual business. In this case, Baker lacked actual authority to bind Prime to the Jaco contract; however, Baker did have, from Jaco's perspective, apparent authority to do so because of the general character of Prime's business and, more important, because Baker had previously purchased cars from Jaco on Prime's behalf. Jaco was not bound by the limitation on Baker's authority unless Jaco was aware of it.

2. Mathews' second position is also incorrect. As a general rule, a partner is liable for the debts of the partnership, and a third party is not bound by the profit and loss sharing agreements between partners because the third party is not a party to the partnership agreement. Therefore, Jaco can look to Prime's assets and Mathews' personal assets to satisfy the obligation.

3. Mathews' third position is correct. A partner is liable to other partners for any liability associated with contracts entered into ostensibly on behalf of the partnership but outside the partner's actual authority. In this case, because Baker violated the agreement with Mathews concerning the $15,000 limitation on used car purchases, Baker will be liable to Mathews for any liability that Mathews may have to Jaco.

4. Mathews' fourth position is also correct. A partner owes a fiduciary duty (that is, a duty of loyalty) to the partnership and every other partner. A partner may not benefit directly or indirectly at the expense of the partnership. A partner must account to the partnership for any benefits derived from the partnership's business without the consent or knowledge of the other partners. In this case, Baker was not entitled to accept and retain the incentive payments made by Top. Doing so violated Baker's fiduciary duty to Prime and Mathews. Baker must account to Prime for all the incentive payments received.

b. KYA's contention that its $25,000 capital contribution cannot be used to satisfy Prime's obligation to Jaco is incorrect. A new partner is liable for partnership liabilities that arose prior to the new partner's admission, but the liability is limited to the partner's capital contribution and interest in partnership property. Therefore, KYA's liability is limited to its capital contribution and its interest as a partner in Prime's assets.
Chapter Ten
Corporations – Subchapter C

FORMATION

1. Corporations are formed by **promoters**
   a. promoters owe a fiduciary duty to subscribers, future stockholders and the corporation
   b. promoters are not agents of the corporation because the corporation has not yet been formed (you cannot be an agent for a principal that doesn't yet exist)

2. Pre-incorporation contracts (made by promoters for the corporation to be formed)
   a. promoters are primarily liable for pre-incorporation contracts made on behalf of the corporation and they remain primarily liable for these contracts
      1). promoters are not primarily liable if there is a **novation** (e.g. the corporation assumes the promoter's contract and the creditor releases the promoter)
      2). promoters are not primarily liable if the contract expressly negates liability (e.g. the contract states only the corporation will be liable upon adoption)
   b. the corporation is only liable for pre-incorporation contracts when it adopts the contract or knowingly accepts the benefits of the contract
      1). once the corporation adopts the contract, both the corporation and the promoter are liable, unless there is a novation
      2). the corporation cannot ratify a promoter's pre-incorporation contract because the promoter is not an agent of the corporation

3. Corporations are formed in compliance with a state's incorporation statute by filing a copy of the articles of incorporation with the Secretary of State
   a. the articles of incorporation **must contain**:
      1). provisions as to **stock** including the amount of authorized shares, the par value of stock and the classes of stock (i.e. which stock has voting rights)
      2). names: to include the name of the corporation, the registered agent and the names and addresses of all incorporators (those signing the articles of incorporation)
      3). address of corporation's initial registered office and address of all incorporators
   b. amending the articles of incorporation requires passage of a resolution by a majority of the board of directors and approval by a majority of the stockholders

4. Promptly after incorporation, the corporation must hold an **organizational meeting** to adopt the corporate bylaws, appoint officers and transact other necessary business
   a. the bylaws govern the internal management of the corporation
   b. bylaws may be adopted by either the incorporators or the board of directors
   c. the bylaws do not have to be filed with the state and are not part of the articles of incorporation

5. If a corporation is defectively formed, one of the following may apply:
   a. it is a **de jure corporation** if it has **substantially complied** with the state's incorporation statute and its validity cannot be challenged even by the state
   b. it is a **de facto corporation** if it has **not substantially complied** with the state's incorporation statute, but made a good faith attempt to do so and exercised corporate power in the belief a corporation was formed
      1). its validity can only be challenged by the state
      2). neither 3rd parties nor the corporation itself may attack its validity
   c. most states simply provide that filing of the articles is conclusive proof of corporate existence
      1). its validity can only be challenged by the state
      2). only those acting as or on behalf of a corporation who knew there was no incorporation are liable
ATTRIBUTES OF CORPORATIONS

1. The chief attributes and advantages of a corporation are:
   a. it is a separate legal entity apart from shareholders (e.g., it may sue and be sued, make contracts and its property belongs to the corporation not shareholders)
   b. limited liability for shareholders (i.e., usually no liability beyond their investment)
   c. shares of a corporation are freely transferable, unless restricted by contract
      note: if restricted, the restrictions on transfer must be stated on the stock certificate
   d. a corporation has perpetual existence (e.g., death or withdrawal of a stockholder or a director will not terminate a corporation)
   e. it has centralized management
      1). stockholders elect the board of directors who are responsible for overall management of the corporation (e.g., they adopt the bylaws)
      2). the board of directors appoints officers who run the day-to-day affairs
      3). stockholders have no right to manage unless they are officers or directors

2. Disadvantages of the corporate form
   a. corporations have a greater degree of governmental supervision
   b. corporations may have a tax disadvantage (e.g., the corporation itself is taxed and the profits that are distributed to the stockholders are taxed again)
   c. the costs of incorporating and operating the corporation may be greater

3. Different types of corporations
   a. a foreign corporation is one doing business in any state other than its state of incorporation (it is a domestic corporation in its state of incorporation)
      1). must obtain a certificate of authority from the Secretary of State in any state it is doing business (i.e., it must file, pay fees, and name a resident agent)
      2). failure to register may make the corporation liable for fines and preclude the corporation from suing anyone in that state
   b. professional corporations require a special state statute and the professional shareholder is still liable for negligence to clients
   c. a publicly held corporation is owned by a large number of stockholders
   d. a closely held corporation is owned by a relatively small number of stockholders, frequently relatives or friends, and transfer of stock is frequently restricted

MERGERS & CONSOLIDATIONS

1. In a merger two corporations join together and one of them survives (e.g., A and B combine and A is the name of the surviving entity)

2. In a consolidation two corporations join together and a new entity is formed (e.g., A and B combine and X emerges)

3. The merger or consolidation must be approved by the board of directors, the stockholders, and the Secretary of State
   a. a formal plan of merger is submitted to and approved by a majority of the board of directors of each corporation
   b. a copy of the approved plan is submitted to and approved by a majority of the stockholders of each corporation (note: as a practical matter they must receive notice of the time, date and place in order to be able to vote)
   c. dissenting shareholders may buy out of the corporation at fair market value
      1). this is called a right of appraisal or dissenters' rights
      2). must file a written objection prior to the vote, vote against merger and make a written demand for the corporation to purchase their stock
   d. the plan is submitted to the Secretary of State who will issue a certificate of merger upon approval
STOCKHOLDERS RIGHTS & LIABILITIES

1. Stockholders have no personal liability for corporate debts beyond the amount of their investment in most cases
   a. a stockholder is liable for failure to pay present value for their stock
   b. piercing the corporate veil is disregarding the corporate entity and holding a stockholder personally liable. The corporate veil may be pierced for:
      1). fraud, illegality or wrong doing
      2). undercapitalization of the corporation when it was formed
      3). commingling of corporate and personal funds

2. Stockholders (unless also officers or directors) have limited management rights:
   a. they elect board of directors (note: they do not elect the officers)
   b. stockholders also have the right to approve by a majority of votes cast fundamental changes in the corporation
      1). e.g. mergers, consolidations and compulsory share exchanges
      2). e.g. sale or lease of substantially all of the corporation’s assets (not buying substantially all of another corporation’s assets for it may not be a major change to the acquiring corporation)
      3). e.g. amending the articles of incorporation
      4). e.g. dissolution
   c. stockholders have dissenters' rights or a right of appraisal: the right to buy out of the corporation at fair market value for fundamental changes in the corporation
      1). dissenters' rights are available for
      a). mergers, consolidations and compulsory share exchanges
      b). sale or lease of substantially all of the corporation’s assets
      c). any amendment to the articles of incorporation that materially and adversely affects stockholders’ rights concerning their shares
      2). stockholders must file a written objection prior to the vote, vote against the action and make a written demand for the corporation to purchase their stock
   d. if a corporation owns 90% or more of the shares of a subsidiary corporation, the subsidiary may be merged into the parent corporation by approval of only the parent corporation’s board of directors (called a short-form merger)
      1). approval is not required by the stockholders of the parent or the subsidiary corporation's stockholders or board of directors
      2). the stockholders of the subsidiary corporation would have dissenters’ rights
      3). stockholders of the parent corporation do not have dissenters rights because there has been no fundamental change in their rights

3. Stockholders can inspect corporate books and records at reasonable times
   a. to do so they must make a written demand upon the corporation
   b. the demand must be made in good faith and for a proper purpose (e.g. no right to obtain corporate information for personal business purposes or to obtain the names and addresses of stockholders for the purpose of selling the list)
   c. inspection may be done by the stockholder or an agent and copies can be made

4. Preemptive right is the right of a stockholder to purchase a proportionate amount of a new issue equal to his/her percentage of ownership (e.g. with preemptive rights a 40% stockholder may purchase up to 40% of a new issue)
   a. preemptive rights may be granted or precluded by the corporation
   b. even if granted by the corporation, preemptive rights are not available for
      1). treasury stock
      2). stock traded for property or services
      3). stock issued to compensate officers, directors or employees
      4). stock issued within 6 months of incorporation
5. **Derivative suit** is a lawsuit brought by a large group of stockholders on behalf of the corporation to enforce a corporate right
   a. prior to suing, a demand must first be made on the board of directors for action
   b. suit is brought in the name of the corporation for a harm to corporation
      1). e.g. derivative suits may be brought to recover damages for management’s ultra vires acts, a managerial breach of duty or to recover improper dividends
      2). derivative suits must be brought for a corporate harm and not to enforce personal stockholder rights (e.g. compel payment of a proper declared dividend, compel inspection of books or records, force dissolution, etc.)
   c. if successful, the recovery goes to corporation

6. Stockholders usually owe no fiduciary duty to others, but a majority stockholder may owe a fiduciary duty to fellow stockholders

7. **Stockholder voting agreements**: in most states stockholders may agree among themselves how they will vote (e.g. A and B agree to vote for each other as directors)
   a. in most states stockholder voting agreements must be in writing to be valid
   b. they are used frequently in closely held corporations to restrict transfer of shares

8. Upon dissolution stockholders are entitled to a proportionate share of corporate assets after all creditors have been paid

**FINANCING THE CORPORATION**

1. Corporations may be financed by debt securities, equity securities or retained earnings

2. **Debt securities or bonds** create a creditor-debtor relationship between the bondholder and the corporation (bondholders are not owners of the corporation)
   a. bonds may be secured by property or unsecured (called debentures)
   b. most bonds pay a fixed rate of interest, but **income bonds** condition interest payment on corporate earnings
   c. **convertible bonds** can be exchanged for other securities of the corporation, usually preferred or common stock

3. **Equity securities** evidence an ownership interest in the corporation and are commonly called shares or stock (usually they are common stock or preferred stock)
   a. **authorized shares** are the amount of stock legally permitted to be issued by articles of incorporation (e.g. if ABC, Inc. is only authorized to issue 500 shares, it can not issue more than 500 shares without amending its articles of incorporation)
   b. **issued shares** are shares that have been distributed to stockholders
   c. **outstanding shares** are shares that are currently in stockholders' hands
   d. **treasury stock** is stock that has been issued but is not currently outstanding (it has been reacquired by the corporation)
      1). there are no preemptive rights with treasury stock
      2). there are no voting rights and no dividends with treasury stock
      3). a corporation may not reacquire treasury stock if it would cause insolvency
      4). it may be distributed as a stock dividend or resold by the corporation at any price (even less than par value) without liability to purchasers
   e. **stock options** are an option to purchase a corporation's equity shares
   f. **warrants** are stock options that are evidenced by a certificate

4. Consideration required for shares of stock
   a. stock may be paid for by cash, tangible property, intangible property or services
      1). directors determine the value to be placed on consideration received for shares
      2). absent fraud, the decision of the board of directors is conclusive
b. **par value shares** are shares that the corporation must sell at par value or higher
   1). if par value stock is sold at less than par it is **watered stock** and an initial purchaser is liable for the difference in price (e.g., In the initial issue of $100 par value stock, X buys 10 shares at $75 per share. X is liable for $250.)
   2). subsequent purchasers are also liable if they had notice the stock was sold for less than par

c. **no par value shares** may be issued for any adequate amount set by the directors (in most states the judgment of directors as to adequacy is conclusive absent fraud)

5. Classes of equity shares
   a. **common stock** has no special contract rights or preferences over other stock
      1). may be divided into one more classes with differing rights (e.g., although at least one class of common stock must have voting rights, there may also be a class of common stock that doesn't have voting rights)
      2). usually common stockholders have the exclusive right to elect the directors
   b. **preferred stock** is stock that has special rights over other classes of stock as to dividends and/or liquidation
      1). the dividend preference means that the preferred stockholder must be paid dividends before any dividends may be paid to common stockholders
      2). **cumulative preferred stock** has dividend carryovers to future years if the dividends are not paid in any given year (note: no dividend on common stock may be paid until all cumulative dividend arrearages are paid)

6. **Blue sky laws** are state laws governing stock sales

**DIVIDENDS**

1. Dividends are declared by the board of directors
   a. there is no inherent right to stockholders for dividends
      1). even preferred stockholders have no inherent right to a dividend
      2). a court will only order a dividend to be paid if the decision of the board of directors not to declare dividends was a clear abuse of discretion
   b. no dividends may be paid if it would make the corporation insolvent
      1). some states only allow dividends from earned surplus (retained earnings)
      2). Revised Model Business Corporation Act prohibits dividends if assets are less than liabilities (called the **net assets test**)
   c. directors are personally liable for any wrongfully declarations of dividends

2. Once properly declared and communicated to stockholders, a cash dividend becomes a debt of corporation and cannot be revoked
   a. a cash dividend may be validly revoked at the same meeting at which it was declared because no communication was made to stockholders
   b. a shareholder who receives a dividend that was illegally or fraudulently made
      1). must repay the dividend if they had knowledge of the fraud or illegality
      2). must repay the dividend if the dividend made the corporation insolvent even if the stockholder had no knowledge of the fraud
      3) need not repay the dividend if the stockholder had no knowledge of the fraud and the corporation is solvent
   c. once declared the stockholders become unsecured creditors of the corporation

3. A stock dividend is a distribution of additional stock to stockholders
   a. stock dividend does not reduce the assets of the corporation and doesn't increase the stockholder's percentage of ownership or wealth (e.g., stock dividends have no effect on earnings and profits for federal income tax purposes)
   b. a stock dividend is not considered a distribution and may be revoked by the board after declaration unless it has already been distributed
DIRECTORS & OFFICERS

1. Directors handle overall corporate management and set corporate policy
   a. directors do not have the power to bind the corporation when acting individually, only when acting as a board
   b. unless specifically authorized directors are not usually paid a salary, but where it is authorized the board of directors can fix their own compensation and that of officers
   c. directors can be removed by the stockholders at a special meeting
   d. directors can be removed by a court action brought by stockholders or by the corporation for fraud, dishonesty, or gross abuse of discretion

2. Officers handle day-to-day affairs and are selected by the board of directors
   a. officers are agents of the corporation and owe the duties all agents do (e.g. duty of obedience, duty of due care, duty to inform and duty to account and duty of loyalty)
   b. they may be removed by the board at any time, with or without cause
   c. if removal breaches their employment contract the corporation is liable

3. Business judgment rule
   a. directors and officers are not liable for decisions if they acted reasonably, in good faith and without an interest in the subject matter (i.e. no conflicts of interest)
   b. directors may usually rely on reports of officers or agents

4. Officers and directors are liable if negligent (failure to use due care)

5. Officers and directors are fiduciaries of the corporation and its stockholders
   a. they must act solely in the best interest of the corporation
      1). they may not usurp corporate opportunities that belong to the corporation for their own personal use
      2). they cannot compete with the corporation
   b. they must make a full disclosure to the corporation of any personal financial interest they have in any transaction where the corporation is a party
      1). they may make a personal profit on a contract with their corporation by making a full disclosure and not participating in the approval process
      2). absent pre-approval, an officer or director may make a personal profit only if the contract is fair and reasonable to corporation

6. Indemnification is reimbursement of an officer or director by a corporation for personal liability incurred while acting in their corporate capacity
   a. if the officer or director wins the lawsuit and is found not to be liable
      1). in many states they may be indemnified by corporation for legal expenses
      2). under the Revised Model Business Corporation Act they must be indemnified
   b. if found to be liable in the lawsuit
      1). indemnification requires court approval in some states
      2). under the Revised Model they may still be indemnified by the corporation if they acted in good faith in the best interests of the corporation unless they received an unjustified financial benefit

DISSOLUTION

1. Voluntary dissolution requires
   a. passage of a resolution to dissolve by a majority of the board of directors
   b. and approval by a majority of the stockholders voting

2. A corporation can be involuntarily dissolved by administrative or judicial action:
a. in an **administrative dissolution** the Secretary of State gives written notice of dissolution if deficiencies are not remedied within 60 days (e.g., failure to pay franchise taxes, failure to file annual report or lack of a registered agent or office)
b. a **judicial dissolution** may be brought by the State, stockholders or creditors
   1). the State can request a court dissolution if the charter was obtained by fraud or if the corporation has exceeded or abused its legal authority
   2). stockholders can request court dissolution if the corporation is hopelessly deadlocked, acting illegally or oppressively, or for waste of corporate assets
   3). creditors can request court dissolution if the corporation is insolvent

3. Upon dissolution, first the creditors of the corporation are paid and then the remaining assets of the corporation are distributed on a pro rata basis among the shareholders

**S CORPORATIONS**

The shareholders of corporations may consent to be treated under Subchapter S of the Internal Revenue Code. These are referred to as S Corporations, or sometimes Subchapter S Corporations. The corporate structure itself does not change. In fact, most of the language addressing what is referred to as the C Corporations remains intact. What is now changed is how the entity is taxed. While much is written about the distinctions between the taxation of a partnership and an S Corporation, the flow-through nature of the items of income, deductions, credits and losses is quite similar to that of a partnership.

**ELIGIBILITY**

In order to be a qualified S Corporation, there are strict limitations which must be adhered to. Failure to maintain compliance with these provisions generally means the termination of S Corporation status.

**SHAREHOLDER REQUIREMENTS**

The maximum number of shareholders is 100. For purposes of this test, a husband and wife are considered one shareholder. **Eligible** shareholders include:

- Individuals
- Estates of a decedent and bankruptcy estates
- Grantor trusts, voting trusts, qualified Subchapter S trusts, and "electing small business trusts"

**Ineligible** shareholders include:

- Partnerships (could circumvent the number of shareholder rules)
- Corporations
- Certain trusts
- Non-resident aliens

**CLASSES OF STOCK**

An S Corporation is only allowed one class of stock. This means an S Corporation cannot have common and preferred stock. However, it is possible to have voting and non-voting common stock as long as the rights as to shareholder distributions and liquidations are identical.

**DEBT INSTRUMENTS**

In general, debt instruments (amounts payable to the shareholders whether they are straight debt or deferred compensation) are not considered a second class of stock. A safe harbor exists for unwritten loans from the corporation to the shareholder if the amount is under $10,000.
PASSIVE INVESTMENT INCOME LIMITATION
If, prior to becoming an S Corporation, a corporation has accumulated earnings and profits, the Code imposes a passive investment income limitation. If that corporation has passive investment income in excess of 25% of gross receipts for three consecutive taxable years, the S Corporation election is terminated as of the beginning of the next year. Included in the definition of passive investment income is interest, dividends, capital gains and rents (unless significant duties are performed by the corporation as landlord).

ELECTION PROCEDURES
In order to make a valid S Corporation election, all the shareholders must consent in writing. Form 2553 must be filed by the 15th day of the third month of the year in which the election is to be valid, or anytime during the preceding year. For a new corporation, that date begins the first day (1) the corporation has shareholders, (2) acquires assets or (3) starts business. The election is not made every year.

Example 5: K Corporation has been in existence since 1980. On March 12, 2003, R, the corporation’s sole shareholder consents to be taxed as an S Corporation. R must file Form 2553 with the Internal Revenue Service by March 15, 2003 in order to be treated as an S Corporation for the 2003 calendar year.

LOSS OF THE S CORPORATION ELECTION
In general, the S Corporation election remains in effect until it is revoked. The revocation may be voluntary or involuntary. A voluntary revocation may be made when the shareholders of the majority of the shares simply consent to the termination. To be valid for that year, the revocation must be filed by the 15th day of the third month of the taxable year.

An involuntary termination occurs when the S Corporation no longer qualifies due to one of the following factors:

- The number of shareholders exceed 100
- An additional class of stock is issued
- The corporation fails the passive investment income limitation
- A nonresident shareholder becomes a shareholder

After the election has been terminated, the general rule is that the shareholders must wait five years before a new election can be made. However, the IRS is allowed to make exception to this rule under the following conditions:

- There is an ownership change of more than 50% of the stock after the first year of the termination.
- The event causing the termination was not reasonably in the control of the majority of the shareholders or the S Corporation.
Chapter Ten: Corporations – Subchapter C
Multiple Choice Questions

1. Rice is a promoter of a corporation to be known as Dex Corp. On January 1, 1985, Rice signed a nine-month contract with Roe, a CPA, which provided that Roe would perform certain accounting services for Dex. Rice did not disclose to Roe that Dex had not been formed. Prior to the incorporation of Dex on February 1, 1985, Roe rendered accounting services pursuant to the contract. After rendering accounting services for an additional period of six months pursuant to the contract, Roe was discharged without cause by the board of directors of Dex. In the absence of any agreements to the contrary, who will be liable to Roe for breach of contract?
   a. Both Rice and Dex.
   b. Rice only.
   c. Dex only.
   d. Neither Rice nor Dex.

2. Which of the following provisions must a for-profit-corporation include in its Articles of Incorporation to obtain a corporate charter?
   I. Provision for issuance of voting stock.
   II. Name of the corporation.
   a. I only.
   b. II only.
   c. Both I and II.
   d. Neither I nor II.

3. Under the Revised Model Business Corporation Act, which of the following must be contained in a corporation’s articles of incorporation?
   a. Quorum voting requirements.
   b. Names of stockholders.
   c. Provisions for issuance of par and non-par shares.
   d. The number of shares the corporation is authorized to issue.

4. Absent a specific provision in its articles of incorporation, a corporation’s board of directors has the power to do all of the following, except
   a. Repeal the bylaws.
   b. Declare dividends.
   c. Fix compensation of directors.
   d. Amend the articles of incorporation.

5. Which of the following facts is(are) generally included in a corporation’s articles of incorporation?

<table>
<thead>
<tr>
<th>Name of registered agent</th>
<th>Number of authorized shares</th>
</tr>
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<tbody>
<tr>
<td>a. Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>b. Yes</td>
<td>No</td>
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<tr>
<td>c. No</td>
<td>Yes</td>
</tr>
<tr>
<td>d. No</td>
<td>No</td>
</tr>
</tbody>
</table>

6. Under the Revised Model Business Corporation Act, which of the following statements regarding a corporation’s bylaws is(are) correct?
   I. A corporation’s initial bylaws shall be adopted by either the incorporators or the board of directors.
   II. A corporation’s bylaws are contained in the articles of incorporation.
   a. I only
   b. II only.
   c. Both I and II.
   d. Neither I nor II.

7. Which of the following statements best describes an advantage of the corporate form of doing business?
   a. Day to day management is strictly the responsibility of the directors.
   b. Ownership is contractually restricted and is not transferable.
   c. The operation of the business may continue indefinitely.
   d. The business is free from state regulation.

8. Destiny Manufacturing, Inc., is incorporated under the laws of Nevada. Its principal place of business is in California and it has permanent sales offices in several other states. Under the circumstances, which of the following is correct?
   a. California may validly demand that Destiny incorporate under the laws of the state of California.
   b. Destiny must obtain a certificate of authority to transact business in California and the other states in which it does business.
   c. Destiny is a foreign corporation in California, but not in the other states.
   d. California may prevent Destiny from operating as a corporation if the laws of California differ regarding organization and conduct of the corporation’s internal affairs.
9. Which of the following statements is a general requirement for the merger of two corporations?
   a. The merger plan must be approved unanimously by the stockholders of both corporations.
   b. The merger plan must be approved unanimously by the boards of both corporations.
   c. The absorbed corporation must amend its articles of incorporation.
   d. The stockholders of both corporations must be given due notice of a special meeting, including a copy or summary of the merger plan.

10. Under the Revised Model Business Corporation Act, a merger of two public corporations usually requires all of the following except
   a. A formal plan of merger.
   b. An affirmative vote by the holders of a majority of each corporation’s voting shares.
   c. Receipt of voting stock by all stockholders of the original corporations.
   d. Approval by the board of directors of each corporation.

11. The limited liability of a stockholder in a closely-held corporation may be challenged successfully if the stockholder
   a. Undercapitalized the corporation when it was formed.
   b. Formed the corporation solely to have limited personal liability.
   c. Sold property to the corporation.
   d. Was a corporate officer, director, or employee.

12. The corporate veil is most likely to be pierced and the shareholders held personally liable if
   a. The corporation has elected S corporation status under the Internal Revenue Code.
   b. The shareholders have commingled their personal funds with those of the corporation.
   c. An ultra vires act has been committed.
   d. A partnership incorporates its business solely to limit the liability of its partners.

13. Which of the following actions may be taken by a corporation’s board of directors without stockholder approval?
   a. Purchasing substantially all of the assets of another corporation.
   b. Selling substantially all of the corporation’s assets.
   c. Dissolving the corporation.
   d. Amending the articles of incorporation.

14. A corporate stockholder is entitled to which of the following rights?
   a. Elect officers.
   b. Receive annual dividends.
   c. Approve dissolution.
   d. Prevent corporate borrowing.

15. Under the Revised Model Business Corporation Act, which of the following actions by a corporation would entitle a stockholder to dissent from the action and obtain payment of the fair value of his/her shares?
   I. An amendment to the articles of incorporation that materially and adversely affects rights in respect of a dissenter’s shares because it alters or abolishes a preferential right of the shares.
   II. Consummation of a plan of share exchange to which the corporation is a party as the corporation whose shares will be acquired, if the stockholder is entitled to vote on the plan.

   a. I only.
   b. II only.
   c. Both I and II.
   d. Neither I nor II.

16. A parent corporation owned more than 90% of each class of the outstanding stock issued by a subsidiary corporation and decided to merge that subsidiary into itself. Under the Revised Model Business Corporation Act, which of the following actions must be taken?
   a. The subsidiary corporation’s board of directors must pass a merger resolution.
   b. The subsidiary corporation’s dissenting stockholders must be given an appraisal remedy.
   c. The parent corporation’s stockholders must approve the merger.
   d. The parent corporation’s dissenting stockholders must be given an appraisal remedy.

17. A stockholder’s right to inspect books and records of a corporation will be properly denied if the stockholder
   a. Wants to use corporate stockholder records for a personal business.
   b. Employs an agent to inspect the books and records.
   c. Intends to commence a stockholder’s derivative suit.
   d. Is investigating management misconduct.
18. To which of the following rights is a stockholder of a public corporation entitled?
   a. The right to have annual dividends declared.
   b. The right to vote for the election of officers.
   c. The right to a reasonable inspection of corporate records.
   d. The right to have the corporation issue a new class of stock.

19. Under the Revised Model Business Corporation Act, when a corporation’s bylaws grant stockholders preemptive rights, which of the following rights is(are) included in that grant?
   The right to purchase a proportionate share of newly-issued stock
   The right to a proportionate share of corporate assets remaining on corporate dissolution
   a. Yes Yes
   b. Yes No
   c. No Yes
   d. No No

20. For what purpose will a stockholder of a publicly held corporation be permitted to file a stockholders’ derivative suit in the name of the corporation?
   a. To compel payment of a properly declared dividend.
   b. To enforce a right to inspect corporate records.
   c. To compel dissolution of the corporation.
   d. To recover damages from corporate management for an ultra vires management act.

21. Which of the following statements is correct regarding the fiduciary duty?
   a. A director’s fiduciary duty to the corporation may be discharged by merely disclosing his self-interest.
   b. A director owes a fiduciary duty to the shareholders but not to the corporation.
   c. A promoter of a corporation to be formed owes no fiduciary duty to anyone, unless the contract engaging the promoter so provides.
   d. A majority shareholder as such may owe a fiduciary duty to fellow shareholders.

22. Which of the following securities are corporate debt securities?

<table>
<thead>
<tr>
<th>Convertible bonds</th>
<th>Debenture bonds</th>
<th>Warrants</th>
</tr>
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<tbody>
<tr>
<td>a. Yes</td>
<td>Yes</td>
<td>Yes</td>
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<td>b. Yes</td>
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<td>c. Yes</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td>d. No</td>
<td>Yes</td>
<td>Yes</td>
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</table>

23. An owner of common stock will not have any liability beyond actual investment if the owner
   a. Paid less than par value for stock purchased in connection with an original issue of shares.
   b. Agreed to perform future services for the corporation in exchange for original issue par value shares.
   c. Purchased treasury shares for less than par value.
   d. Failed to pay the full amount owed on a subscription contract for no-par shares.

24. In general, which of the following statements concerning treasury stock is correct?
   a. A corporation may not reacquire its own stock unless specifically authorized by its articles of incorporation.
   b. On issuance of new stock, a corporation has pre-emptive rights with regard to its treasury stock.
   c. Treasury stock may be distributed as a stock dividend.
   d. A corporation is entitled to receive cash dividends on its treasury stock.

25. Ambrose purchased 400 shares of $100 par value original issue common stock from Minor Corporation for $25 a share. Ambrose subsequently sold 200 of the shares to Harris at $25 a share. Harris did not have knowledge or notice that Ambrose had not paid par. Ambrose also sold 100 shares of this stock to Gable for $25 a share. At the time of this sale, Gable knew that Ambrose had not paid par.
   a. The creditors can hold Ambrose liable for $30,000.
   b. If $25 a share was a fair value for the stock at the time of issuance, Ambrose will have no liability to the creditors.
   c. Since Harris acquired the shares by purchase, he is not liable to the creditors, and his lack of knowledge or notice that Ambrose paid less than par is immaterial.
   d. Since Gable acquired the shares by purchase, he is not liable to the creditors, and the fact that he knew Ambrose paid less than par is immaterial.
26. Which of the following rights is a holder of a public corporation’s cumulative preferred stock always entitled to?
   a. Conversion of the preferred stock into common stock.
   b. Voting rights.
   c. Dividend carryovers from years in which dividends were not paid, to future years.
   d. Guaranteed dividends.

27. West owns 5,000 shares of $7 cumulative preferred stock of Sky Corp. During the first year of operations, cash dividends of $7 per share were declared on Sky’s preferred stock but were never paid. In the second year of operations, dividends on Sky’s preferred stock were neither declared nor paid. If Sky is dissolved, which of the following statements is correct?
   a. West will have priority over the claims of Sky’s debenture bond owners.
   b. West will have priority over the claims of Sky’s unsecured judgment creditors.
   c. Sky will be liable to West as an unsecured creditor for $35,000.
   d. Sky will be liable to West as an unsecured creditor for $70,000.

28. Johns owns 400 shares of Abco Corp. cumulative preferred stock. In the absence of any specific contrary provisions in Abco’s articles of incorporation, which of the following statements is correct?
   a. Johns is entitled to convert the 400 shares of preferred stock to a like number of shares of common stock.
   b. If Abco declares a cash dividend on its preferred stock, Johns becomes an unsecured creditor of Abco.
   c. If Abco declares a dividend on its common stock, Johns will be entitled to participate with the common stock shareholders in any dividend distribution made after preferred dividends are paid.
   d. Johns will be entitled to vote if dividend payments are in arrears.

29. Price owns 2,000 shares of Universal Corp.’s $10 cumulative preferred stock. During its first year of operations, cash dividends of $5 per share were declared on the preferred stock but were never paid. In the second year, dividends on the preferred stock were neither declared nor paid. If Universal is dissolved, which of the following statements is correct?
   a. Universal will be liable to Price as an unsecured creditor for $10,000.
   b. Universal will be liable to Price as a secured creditor for $20,000.
   c. Price will have priority over the claims of Universal’s bond owners.
   d. Price will have priority over the claims of Universal’s unsecured judgment creditors.

30. Carr Corp. declared a 7% stock dividend on its common stock. The dividend
   a. Must be registered with the SEC pursuant to the Securities Act of 1933.
   b. Is includable in the gross income of the recipient taxpayers in the year of receipt.
   c. Has no effect on Carr’s earnings and profits for federal income tax purposes.
   d. Requires a vote of Carr’s stockholders.

31. All of the following distributions to stockholders are considered asset or capital distributions, except
   a. Liquidating dividends.
   b. Stock splits.
   c. Property distributions.
   d. Cash dividends.

32. Jane Cox, a shareholder of Mix Corp., has properly commenced a derivative action against Mix’s Board of Directors. Cox alleges that the Board breached its fiduciary duty and was negligent by failing to independently verify the financial statements prepared by management upon which Smart & Co., CPAs, issued an unqualified opinion. The financial statements contained inaccurate information which the Board relied upon in committing large sums of money to capital expansion. This resulted in Mix having to borrow money at extremely high interest rates to meet current cash needs. Within a short period of time, the price of Mix Corp. stock declined drastically. Which of the following statements is correct?
a. The Board is strictly liable, regardless of fault, since it owes a fiduciary duty to both the corporation and the shareholders.
b. The Board is liable since any negligence of Smart is automatically imputed to the Board.
c. The Board may avoid liability if it acted in good faith and in a reasonable manner.
d. The Board may avoid liability in all cases where it can show that it lacked scienter.

33. Generally, officers of a corporation
a. Are elected by the shareholders.
b. Are agents and fiduciaries of the corporation, having actual and apparent authority to manage the business.
c. May be removed by the board of directors without cause only if the removal is approved by a majority vote of the shareholders.
d. May declare dividends or other distributions to shareholders as they deem appropriate.

34. Under the Revised Model Business Corporation Act, a corporate director is authorized to
a. Rely on information provided by the appropriate corporate officer.
b. Serve on the board of directors of a competing business.
c. Sell control of the corporation.
d. Profit from insider information.

35. Knox, president of Quick Corp., contracted with Tine Office Supplies, Inc., to supply Quick’s stationery on customary terms and at a cost less than that charged by any other suppliers. Knox later informed Quick’s board of directors that Knox was a majority stockholder in Tine. Quick’s contract with Tine is
a. Void because of Knox’s self-dealing.
b. Void because the disclosure was made after execution of the contract.
c. Valid because of Knox’s full disclosure.
d. Valid because the contract is fair to Quick.

36. Under the Revised Model Business Corporation Act, which of the following statements is correct regarding corporate officers of a public corporation?
a. An officer may not simultaneously serve as a director.
b. A corporation may be authorized to indemnify its officers for liability incurred in a suit by stockholders.
c. Stockholders always have the right to elect a corporation’s officers.
d. An officer of a corporation is required to own at least one share of the corporation’s stock.

37. Which of the following must take place for a corporation to be voluntarily dissolved?
a. Passage by the board of directors of a resolution to dissolve.
b. Approval by the officers of a resolution to dissolve.
c. Amendment of the certificate of incorporation.
d. Unanimous vote of the stockholders.

38. Which of the following would be grounds for the judicial dissolution of a corporation on the petition of a shareholder?
a. Refusal of the board of directors to declare a dividend.
b. Waste of corporate assets by the board of directors.
c. Loss operations of the corporation for three years.
d. Failure by the corporation to file its federal income tax returns.

S CORPORATIONS

39. Which one of the following will render a corporation ineligible for S corporation status?
a. One of the stockholders is a decedent's estate.
b. One of the stockholders is a bankruptcy estate.
c. The corporation has both voting and nonvoting common stock issued and outstanding.
d. The corporation has 105 stockholders.

40. Which of the following conditions will prevent a corporation from qualifying as an S Corporation?
a. The corporation has both common and preferred stock.
b. The corporation has one class of stock with different voting rights.
c. One shareholder is an estate.
d. One shareholder is a grantor trust.

41. Village Corp., a calendar year corporation, began business in 1990. Village made a valid S Corporation election on December 5, 2003, with the unanimous consent of its shareholders. The eligibility requirements for S status continued to be met throughout 2004. On what date did Village's S status become effective?

42. On February 10, 2003, Ace Corp., a calendar year corporation, elected S corporation status and all shareholders consented to the election. There was no change in shareholders in 2003. Ace met all eligibility requirements for S status during the preelection portion of the year. What is the earliest date on which Ace can be recognized as an S corporation?

43. Bristol Corp. was formed as a C corporation on January 1, 1980, and elected S corporation status on January 1, 1986. At the time of the election, Bristol had accumulated C corporation earnings and profits which have not been distributed. Bristol has had the same 25 shareholders throughout its existence. In 2003 Bristol's S election will terminate if it
   a. Increases the number of shareholders to 100.
   b. Adds a decedent's estate as a shareholder to the existing shareholders.
   c. Takes a charitable contribution deduction.
   d. Has passive investment income exceeding 90% of gross receipts in each of the three consecutive years ending December 31, 2002.

44. An S corporation has 30,000 shares of voting common stock and 20,000 shares of non-voting common stock issued and outstanding. The S election can be revoked voluntarily with the consent of the shareholders holding, on the day of the revocation,
   \[
   \begin{array}{c|c|c}
   
   Shares of voting stock & Shares of nonvoting stock \\
   \hline
   a. & 0 & 20,000 \\
   b. & 7,500 & 5,000 \\
   c. & 10,000 & 16,000 \\
   d. & 20,000 & 0 \\
   \end{array}
   \]

45. After a corporation's status as an S corporation is revoked or terminated, how many years is the corporation generally required to wait before making a new S election, in the absence of IRS consent to an earlier election?
   a. 1
   b. 3
   c. 5
   d. 10

46. Tau Corp. which has been operating since 1980, has an October 31 year end, which coincides with its natural business year. On May 15, 2003, Tau filed the required form to elect S corporation status. All of Tau's shareholders consented to the election, and all other requirements were met. The earliest date that Tau can be recognized as an S corporation is

47. Which of the following is not a requirement for a corporation to elect S corporation status?
   a. Must be a member of a controlled group.
   b. Must confine stockholders to individuals, estates, and certain qualifying trusts.
   c. Must be a domestic corporation.
   d. Must have only one class of stock.

48. If a calendar-year S corporation does not request an automatic six-month extension of time to file its income tax return, the return is due by
   a. January 31
   b. March 15
   c. April 15
   d. June 30

49. A corporation that has been an S corporation from its inception may
<table>
<thead>
<tr>
<th>Have both passive and nonpassive income</th>
<th>Be owned by a bankruptcy estate</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. No</td>
<td>Yes</td>
</tr>
<tr>
<td>b. Yes</td>
<td>No</td>
</tr>
<tr>
<td>c. No</td>
<td>No</td>
</tr>
<tr>
<td>d. Yes</td>
<td>Yes</td>
</tr>
</tbody>
</table>

50. For the taxable year ended December 31, Elk Inc., an S corporation, had net income per books of $54,000, which included $45,000 from operations and a $9,000 net long-term capital gain. During the year, $22,500 was distributed to Elk's three equal stockholders, all of whom are on a calendar-year basis. On what amounts should Elk compute its income and capital gain taxes?
<table>
<thead>
<tr>
<th>Ordinary income</th>
<th>Long-term capital gain</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. $31,500</td>
<td>$ 0</td>
</tr>
<tr>
<td>b. $22,500</td>
<td>$ 0</td>
</tr>
<tr>
<td>c. $ 0</td>
<td>$9,000</td>
</tr>
<tr>
<td>d. $ 0</td>
<td>$ 0</td>
</tr>
</tbody>
</table>
51. If an S corporation has no accumulated earnings and profits, the amount distributed to a shareholder
a. Must be returned to the S corporation.
b. Increases the shareholder's basis for the stock.
c. Decreases the shareholder's basis for the stock.
d. Has no effect on the shareholder's basis for the stock.

52. The Haas Corp., a calendar year S corporation, has two equal shareholders. For the year ended December 31, 2003, Haas had taxable income and current earnings and profits of $60,000, which included $50,000 from operations and $10,000 from investment interest income. There were no other transactions that year. Each shareholder's basis in the stock of Haas will increase by
a. $50,000
b. $30,000
c. $25,000
d. $0

53. Bern Corp., an S corporation, had an ordinary loss of $36,500 for the year ended December 31, 2003. At January 1, 2003, Meyer owned 50% of Bern's stock. Meyer held the stock for 40 days in 2003 before selling the entire 50% interest to an unrelated third party. Meyer's basis for the stock was $10,000. Meyer was a full-time employee of Bern until the stock was sold. Meyer's share of Bern's 2003 loss was
a. $0
b. $2,000
c. $10,000
d. $18,250

54. An S corporation is not permitted to take a deduction for
a. Compensation of officers.
b. Interest paid to individuals who are not stockholders of the S corporation.
c. Charitable contributions.
d. Employee benefit programs established for individuals who are not stockholders of the S corporation.

55. An S corporation may deduct
a. Charitable contributions within the percentage of income limitation applicable to corporations.
b. Net operating loss carryovers.
c. Foreign income taxes.
d. Compensation of officers.

56. Zinco Corp. was a calendar year S corporation. Zinco's S status terminated on April 1, 2003, when Case Corp. became a shareholder. During 2003 (365-day calendar year), Zinco had nonseparately computed income of $310,250. If no election was made by Zinco, what amount of the income, if any, was allocated to the S short year for 2003?
  a. $233,750
  b. $155,125
  c. $76,500
  d. $0

57. As of January 1, 2003, Kane owned all the 100 issued shares of Manning Corp., a calendar year S corporation. On the 41st day of 2003, Kane sold 25 of the Manning shares to Rodgers. For the year ended December 31, 2003 (a 365-day calendar year), Manning had $73,000 in nonseparately stated income and made no distributions to its shareholders. What amount of nonseparately stated income from Manning should be reported on Kane's 2003 tax return?
  a. $56,750
  b. $54,750
  c. $16,250
  d. $0

58. With regard to S corporations and their stockholders, the "at risk" rules applicable to losses
a. Depend on the type of income reported by the S corporation.
b. Are subject to the elections made by the S corporation's stockholders.
c. Take into consideration the S corporation's ratio of debt to equity.
d. Apply at the shareholder level rather than at the corporate level.

59. An S corporation's accumulated adjustments account, which measures the amount of earnings that may be distributed tax-free,
  a. Must be adjusted downward for the full amount of federal income taxes attributable to any taxable year in which the corporation was a C corporation.
  b. Must be adjusted upward for the full amount of federal income taxes attributable to any taxable year in which the corporation was a C corporation.
  c. Must be adjusted upward or downward for only the federal income taxes affected by capital gains or losses, respectively, for any taxable year in which the corporation was a C corporation.
  d. Is not adjusted for federal income taxes attributable to a taxable year in which the corporation was a C corporation.
60. An S corporation may
a. Have both common and preferred stock.
b. Have a corporation as a shareholder.
c. Be a member of an affiliated group.
d. Have as many as 100 shareholders.

61. Brooke, Inc., an S corporation, was organized on January 2, 2003, with two equal stockholders who materially participate in the S corporation's business. Each stockholder invested $5,000 in Brooke's capital stock, and each loaned $15,000 to the corporation. Brooke then borrowed $60,000 from a bank for working capital. Brooke sustained an operating loss of $90,000 for the year ended December 31, 2003. How much of this loss can each stockholder claim on his 2003 income tax return?

62. A shareholder's basis in the stock of an S corporation is increased by the shareholder's pro rata share of income from

<table>
<thead>
<tr>
<th>Tax-exempt interest</th>
<th>Taxable interest</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. No</td>
<td>No</td>
</tr>
<tr>
<td>b. No</td>
<td>Yes</td>
</tr>
<tr>
<td>c. Yes</td>
<td>No</td>
</tr>
<tr>
<td>d. Yes</td>
<td>Yes</td>
</tr>
</tbody>
</table>

63. Under the Revised Model Business Corporation Act, which of the following conditions is necessary for a corporation to achieve a successful voluntary dissolution?

a. Successful application to the secretary of state in which the corporation holds its primary place of business.
b. A recommendation of dissolution by the board of directors and approval by a majority of all shareholders entitled to vote.
c. Approval by the board of directors of an amendment to the certificate of incorporation calling for the dissolution of the corporation.
d. Unanimous approval of the board of directors and two-thirds vote of all shareholders entitled to vote on a resolution of voluntary dissolution.
Chapter Ten: Corporations – Subchapter C
Other Objective Questions

NUMBER 1

Mill, Web and Trent own all the outstanding and issued voting common stock of Sack Corp. Mill owns 40%, Web own 30%, and Trent owns 30%. They also executed a written stockholders agreement in which Mill, Web, and Trent agreed to vote for each other as directors of Sack.

At the initial meeting of the incorporators, Mill, Web, and Trent were elected to the board of directors together with three non-stockholders. At the initial board of directors meeting, Mill, Web, and Trent were appointed as officers of the corporation and given three-year employment contracts.

During its first year of operations, Sack began experiencing financial difficulties, which caused disagreements among Mill, Web, and Trent as to how the business should be operated.

At the next annual stockholders’ meeting, Mill was not elected to the board of directors. The new board fired Mill in a management reorganization despite there being two years left on the employment contract. The board, reasonably relying on assurances from Web and Trent regarding financial statements Web and Trent knew to be materially misstated, declared and paid a dividend that caused Sack to become insolvent.

Required:

For Items 1 through 5, select the correct answer from List I. An answer may be selected once, more than once, or not at all.

1. According to the stockholders’ agreement, what party(ies) must be elected as director(s) of Sack?

2. According to the stockholders’ agreement, what party(ies) must be appointed as officer(s) of Sack?

3. What party(ies) is (are) liable to Mill for Mill’s firing?

4. What party(ies) must return the dividend to the corporation?

5. What party(ies) would be liable for declaring the illegal dividend?

<table>
<thead>
<tr>
<th>List I</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. Mill only.</td>
</tr>
<tr>
<td>b. Web only.</td>
</tr>
<tr>
<td>c. Trent only.</td>
</tr>
<tr>
<td>d. Mill and Web only.</td>
</tr>
<tr>
<td>e. Mill and Trent only.</td>
</tr>
<tr>
<td>f. Web and Trent only.</td>
</tr>
<tr>
<td>g. Mill, Web, and Trent.</td>
</tr>
<tr>
<td>h. Neither Mill, Web, nor Trent.</td>
</tr>
<tr>
<td>i. All directors.</td>
</tr>
<tr>
<td>j. Sack Corp.</td>
</tr>
</tbody>
</table>
Drain Corp. has two classes of stock: 100,000 shares of authorized, issued, and outstanding voting common stock; and 10,000 shares of authorized, issued and outstanding nonvoting 5% cumulative, nonparticipating preferred stock with a face value of $100 per share. In 1994, Drain’s officers and directors intentionally allowed pollutants to be discharged by Drain’s processing plant. These actions resulted in Drain having to pay penalties. Solely as a result of these penalties, no dividends were declared for the years ended December 31, 1994 and December 31, 1995. The total amount Drain paid in penalties was $1,000,000. In 1995, Drain was able to recover the full amount of the penalties from an insurance company that had issued Drain a business liability policy. Drain’s directors refused to use this money to declare a dividend and decided to hold the $1,000,000 in a special fund to pay future bonuses to officers and directors.

**Required:**

**Items 1 through 6** refer to the above fact pattern. For each item, select the correct answer that completes the statement.

1. The actions by Drain’s officers and directors in allowing pollutants to be discharged generally would be considered a violation of the
   
   A. Available for distribution as a dividend  I. Liable to the corporation for $1,000,000
   B. Fiduciary duty to prevent losses  J. Property dividend
   C. Cash dividend  K. Stock dividend
   D. Fiduciary duty of care  L. Surplus or earnings held for expansion
   E. Fiduciary duty of loyalty  M. $5.00
   F. Illegal dividend  N. $9.00
   G. Immune from liability  O. $10.00
   H. Liable for abuse of discretion  P. $18.00

2. A stockholder’s derivative suit, if successful, probably would result in the officers and directors being

3. A stockholder’s derivative suit, if successful, probably would result in the $1,000,000 being considered

4. If the $1,000,000 was distributed to the stockholders in 1995, the distribution would be characterized as a

5. If the $1,000,000 was distributed in 1995, each share of the 5% cumulative preferred stock would receive

6. If the $1,000,000 was distributed in 1995, each share of voting common stock would receive
NUMBER 3

In 1990, Amber Corp., a closely-held corporation, was formed by Adams, Frank, and Berg as incorporators and stockholders. Adams, Frank, and Berg executed a written voting agreement which provided that they would vote for each other as directors and officers. In 1994, stock in the corporation was offered to the public. This resulted in an additional 300 stockholders. After the offering, Adams holds 25%, Frank holds 15%, and Berg holds 15% of all issued and outstanding stock. Adams, Frank, and Berg have been directors and officers of the corporation since the corporation was formed. Regular meetings of the board of directors and annual stockholders meetings have been held.

Required:

Items 1 through 6 refer to the formation of Amber corp. and the rights and duties of its stockholders, directors, and officers. For each item, determine whether (a), (b), or (c) is correct.

1. a. Amber Corp. must be formed under a state’s general corporation statute.
   b. Amber Corp.’s Articles of Incorporation must include the names of all stockholders.
   c. Amber Corp. must include its corporate bylaws in the incorporation documents filed with the state.

2. Amber Corp.'s initial bylaws ordinarily would be adopted by its
   a. Stockholders.
   b. Officers.
   c. Directors.

3. Amber Corp.'s directors are elected by its
   a. Officers.
   b. Outgoing directors.
   c. Stockholders.

4. Amber Corp.'s officers ordinarily would be elected by its
   a. Stockholders.
   b. Directors.
   c. Outgoing officers.

5. Amber Corp.'s day-to-day business ordinarily would be operated by its
   a. Directors.
   b. Stockholders.
   c. Officers.

6. a. Adams, Frank, and Berg must be elected as directors because they own 55% of the issued and outstanding stock.
   b. Adams, Frank, and Berg must always be elected as officers because they own 55% of the issued and outstanding stock.
   c. Adams, Frank, and Berg must always vote for each other as directors because they have a voting agreement.
NUMBER 4

Edwards, a director and a 10% stockholder in National Corp., is dissatisfied with the way National’s officers, particularly Olsen, the president, have been operating the corporation. Edwards has made many suggestions that have been rejected by the board of directors, and has made several unsuccessful attempts to have Olsen removed as president.

National and Grand Corp. had been negotiating a merger that Edwards has adamantly opposed. Edwards has blamed Olsen for initiating the negotiation and has urged the board to fire Olsen. National’s board refused to fire Olsen. In an attempt to defeat the merger, Edwards approached Jenkins, the president of Queen Corp., and contracted for Queen to purchase several of National’s assets. Jenkins knew Edwards was a National director, but had never done business with National. When National learned of the contract, it notified Queen that the contract was invalid.

Edwards filed an objection to the merger before the stockholders’ meeting called to consider the merger proposal was held. At the meeting, Edwards voted against the merger proposal.

Despite Edwards’ efforts, the merger was approved by both corporations. Edwards then orally demanded that National purchase Edwards’ stock, citing the dissenters rights provision of the corporation’s by-laws, which reflects the Model Business Corporation Act.

National’s board has claimed National does not have to purchase Edwards’ stock.

As a result of the above:
- Edwards initiated a minority stockholder’s action to have Olsen removed as president and to force National to purchase Edwards’ stock.
- Queen sued National to enforce the contract and/or collect damages.
- Queen sued Edwards to collect damages.

Required:

Answer the following questions and give the reasons for your answers.

a. Will Edwards be successful in a lawsuit to have Olsen removed as president?

b. Will Edwards be successful in a lawsuit to have National purchase the stock?

c. 1. Will Queen be successful in a lawsuit against National?
   2. Will Queen be successful in a lawsuit against Edwards?

NUMBER 5

On May 12, 1987, West purchased 6% of Ace Corp.’s outstanding $3 cumulative preferred stock and 7% of Ace’s outstanding common stock. These are the only two classes of stock authorized by Ace’s charter. Both classes of stock are traded on a national stock exchange. Ace uses the calendar year for financial reporting purposes.

During 1987 and 1988, Ace neither declared dividends nor recorded dividends in arrears as a liability on its books. West was disturbed about this and, on February 8, 1989, sent a written demand to examine Ace’s books and records to determine Ace’s financial condition. Ace has refused to permit West to examine its books and records.

As a result of the foregoing, West has made the following assertions:

- Ace should have recorded the dividends in arrears for 1987 and 1988 as a liability that, in effect, would treat West as a general creditor to the extent of the dividends in arrears.
- West is entitled to examine Ace’s books and records.

Required: In separate paragraphs, discuss West’s assertions. Indicate whether such assertions are correct and the reasons therefor. Do not consider securities laws.
NUMBER 6

Walsh is evaluating two different investment opportunities. One requires an investment of $100,000 to become a limited partner in a limited partnership that owns a shopping center. The other requires an investment of $100,000 to purchase 3% of the voting common stock of a corporation engaged in manufacturing. Walsh is uncertain about the advantages and disadvantages of being a limited partner versus being a shareholder. The issues of most concern to Walsh are:

• The right to transfer a limited partnership interest versus shares of stock.
• The liability as a limited partner versus that of a shareholder for debts incurred by a limited partnership or a corporation.
• The right of a limited partner versus that of a shareholder to participate in daily management.
• The right of a limited partner to receive partnership profits versus the right of a shareholder to receive dividends from a corporation.

Required:
Briefly identify and discuss the basic differences and similarities in the formation of a limited partnership and a corporation. Discuss in separate paragraphs the issues raised by Walsh. (Ignore tax and securities laws.)

NUMBER 7

Cox is a disgruntled shareholder of Hall, Inc. She has owned 6% of the voting stock for several years. Hall is a corporation with 425 shareholders. However, the members of the Hall family own 65% of the corporate stock, dominate the board, and are the principal officers of the corporation. There is one minority board member. Recently, there have been major changes in Hall’s board and its officers as the older generation of the family has relinquished the management in favor of the next generation of Halls. It is the action of this new board and management that has caused Cox to contemplate taking drastic action against the current board and officers.

Specifically, she objects to the following:

• The board has drastically cut the dividend payments on the common stock. The board’s explanation is that additional funds for expansion or acquisitions are critical for the growth of the corporation. The earnings have been increasing at a rate of 10% per year during this period. Cox claims that the real reason for the dividend cut is to force minority shareholders such as herself to sell. This claim is based on conjecture on her part. Cox is considering an action against the board to compel reinstatement of the prior dividend payout.

• The board also decided to sell 5,000 shares of treasury stock at $10 a share to raise additional capital. The stock in question had originally been sold at $16 a share and had a $12 par value. It was reacquired at $13 per share. Cox first alleges that the corporation is prohibited from acquiring its own shares without specific authorization in the articles of incorporation. The articles of incorporation are silent on this matter. Cox also asserts that the corporation is prohibited from selling the shares at a price less than par.

• Substantial salaries are paid to the officers of the corporation. Salaries of the newcomers have been increased at an annual rate of 10%, which is far in excess of raises voted by the old board. Cox has evidence to show that the corporation’s salary scale has risen from the top 50% to the top 33-1/3% of salaries paid by similar corporations in the industry. Cox asserts that based upon the recipients’ ages, experience and contribution to the corporation, they are so grossly overpaid that the payments constitute a waste of corporate assets. Cox demands that the salary increases be repaid.

• The board has become factionalized because of hostility within the Hall family. Cox claims that this acrimony has generated useless debate and bickering and is counterproductive to the continued success of Hall, Inc. The majority has threatened to oust the opposition at the next election of the board. Cox claims that all of these actions are seriously impairing the effective management of the corporation and she is contemplating seeking a court-ordered dissolution of Hall.

Required: Answer the following, setting forth reasons for any conclusions stated.
Discuss the merits of each of the above claims and indicate the probable outcome of any court action taken by Cox personally or taken by her for and on behalf of the corporation.
Chapter Ten: Corporations – Subchapter C
Multiple Choice Answers

1. (a) Promoters are primarily liable on pre-incorporation contracts they make. They remain primarily liable, even if the corporation accepts the contract. Rice (the promoter) is primarily liable for the contract made with Roe. The corporation, by using Roe’s services for six months after incorporation, had impliedly accepted the contract and would be liable also. The only answer that indicates that both Rice and Dix are liable is (a).

2. (c) The articles of incorporation must contain provisions as to stock to specifically include the amount of authorized shares, the par value of the stock and the classes of the stock to include which stock has voting rights. It must also contain the names of the corporation, its registered agent, and all incorporators. Only answer (c) reflects that both provisions as to the issuance of voting stock and the name of the corporation must be included.

3. (d) The articles of incorporation must contain provisions as to stock to specifically include the amount of authorized shares, the par value of the stock and the classes of the stock to include which stock has voting rights. Answers (a) and (b) are incorrect because the articles of incorporation need not contain quorum voting requirements or the names of stockholders. Answer (c) is incorrect because although the par value of stock will be listed if there is par value stock, there is no requirement that there be par value stock or no par value stock.

4. (d) Stockholders get to vote on fundamental changes in the corporation. This specifically includes the right to vote on mergers and consolidations, dissolution and amending the articles of incorporation. Thus, the board of directors would not have the power to amend the articles of incorporation because it would require stockholder approval. Answers (a), (b) and (c) are incorrect because directors do have the power to repeal the bylaws, declare dividends and fix their own compensation.

5. (a) The articles of incorporation must contain provisions as to stock to specifically include the amount of authorized shares. It must also contain the names of the corporation, its registered agent, and all incorporators. Only answer (a) states that the articles of incorporation must contain the name of the registered agent and the number of authorized shares.

6. (a) The bylaws of a corporation govern the corporation’s internal management. The bylaws may be adopted by either the incorporators or the board of directors; thus I is a correct statement. The bylaws are not filed with the state as are the articles of incorporation. Thus, II is not a correct statement because the bylaws are not contained in the articles of incorporation.

7. (c) One of the advantages of the corporate form is that a corporation has perpetual existence and therefore may continue to do business indefinitely. Answer (a) is incorrect because it is the officers, not the directors, that are responsible for day to day management. Answer (b) is incorrect because another advantage of the corporation is that shares of a corporation are freely transferable, unless specifically restricted by contract. Answer (d) is incorrect because a disadvantage of the corporate form is a greater degree of governmental supervision.

8. (b) A foreign corporation is one doing business in any state other than their state of incorporation. A foreign corporation must obtain a certificate of authority from each state in which they do business. Thus, Destiny is a foreign corporation in California because they were incorporated in Nevada and they were doing business in California. Destiny must obtain a certificate of authority from California and all other states in which it does business. Answer (a) is incorrect because incorporation is not required merely because a corporation is doing business in a state. Answer (c) is incorrect because Destiny is a foreign corporation in any state in which it does business. Answer (d) is incorrect because Destiny as a Nevada corporation is only required to comply with Nevada’s requirements for incorporation and not California’s requirements.
9. (d) A merger of two corporations requires the approval of a majority of both boards of directors and the approval of a majority of the voting stockholders of both corporations. The corporations must submit a copy of the merger plan to all stockholders and provide notice of the time and the place of the meeting at which the vote will occur. Answers (a) and (b) are incorrect because unanimous approval is not required by either the stockholders or the directors. Answer (c) is incorrect because the absorbed corporation no longer exists and, thus, has no articles of incorporation to amend.

10. (c) A merger of two corporations requires the approval of a majority of both boards of directors and the approval of a majority of the voting stockholders of both corporations. The corporations must submit a copy of the merger plan to all stockholders and provide notice of the time and the place of the meeting at which the vote will occur. Answers (a), (b) and (d) are incorrect because a formal plan of merger is required, it must be submitted to the stockholders and receive approval of the majority of those voting and it must receive the approval of a majority of the board of directors. Answer (c) is correct because receipt of voting stock by all stockholders of both corporations is not required.

11. (a) A stockholder may be held personally liable for corporate debts (piercing the corporate veil). Specifically this may be done by a showing of fraud, undercapitalization of the corporation and commingling of corporate and personal funds by the stockholder. Thus, the corporate veil may be pierced if the stockholder undercapitalized the corporation when it was formed. Answer (b) is incorrect because one of the principal reasons for choosing the corporate form over others is to obtain limited personal liability. It is not grounds to pierce the corporate veil. Answers (c) and (d) are incorrect because the mere fact that a stockholder sold property to the corporation or was an officer, director or employee is insufficient grounds to pierce the corporate veil.

12. (b) A stockholder may be held personally liable for corporate debts (piercing the corporate veil). Specifically this may be done by a showing of fraud, undercapitalization of the corporation and commingling of corporate and personal funds by the stockholder. Thus, the corporate veil may be pierced if the stockholder commingled their personal funds with those of the corporation. Answers (a), (c) and (d) are incorrect because choosing S corporation status, commission of an ultra vires act and incorporation to obtain limited personal liability are all insufficient grounds to pierce the corporate veil.

13. (a) Stockholders get to vote on fundamental changes in the corporation. This specifically includes the right to vote on mergers, consolidations, compulsory share exchanges, sale of substantially all of the corporation’s assets (but not buying all of another corporation’s assets), dissolutions and amending the articles of incorporation. Selling substantially all of the corporation’s assets, dissolving the corporation and amending the articles of incorporation are all examples of fundamental changes that would require stockholder approval. Answer (a) is correct because purchasing substantially all of the assets of another corporation may be a minor matter to the acquiring corporation and thus not constitute a fundamental change requiring a stockholder vote.

14. (c) Stockholders get to vote on fundamental changes in the corporation. This specifically includes the right to vote on mergers, consolidations, compulsory share exchanges, sale of substantially all of the corporation’s assets (but not buying all of another corporation’s assets), dissolutions and amending the articles of incorporation. Answer (a) is incorrect because stockholders do not get to elect officers. They elect directors. Answer (b) is incorrect because there is no inherent right to receive dividends. Answer (d) is incorrect because stockholders cannot prevent corporate borrowing. Corporate borrowing need not involve a fundamental change in the corporation and stockholders may only vote on fundamental changes.

15. (c) Stockholders have dissenters’ rights or a right of appraisal for certain fundamental changes in the corporation. Such changes include mergers, consolidations, compulsory share exchanges, sale of substantially all of the corporation’s assets (but not buying all of another corporation’s assets) and any amendment to the articles of incorporation that materially and adversely affects stockholders’ rights concerning their shares. I is a correct statement because dissenters’ rights would be available for an amendment that materially and adversely affected a preferential right of the stockholders’ shares. II is a correct statement because dissenters’ rights are available for mergers and consolidations and would thus be available if a corporation’s shares were being acquired by another business.
16. (b) **When a corporation owns 90% or more of the shares of a subsidiary** corporation, the subsidiary may be merged into the parent corporation without the approval of the stockholders of either the parent corporation or the subsidiary corporation and without the approval of the subsidiary corporations board of directors. This is called a short-form merger. Thus, answers (a) and (c) are incorrect. In a short-form merger **stockholders of the subsidiary corporation have dissenters’ rights**, but the stockholders of the parent corporation do not. Thus, answer (b) is correct and answer (d) is incorrect.

17. (a) **A stockholder has the right to inspect books and records** of the corporation at reasonable times and upon written demand. They **lose this right if they have an improper motive**. Obtaining corporate information for use in a personal business would be an improper motive. Answer (b) is incorrect because the stockholder may use an agent to inspect. Answers (c) and (d) are incorrect because commencing a derivative suit on behalf of the corporation and investigating management misconduct both have the proper motive of attempting to protect their investment.

18. (c) **A stockholder has the right to inspect books and records of the corporation at reasonable times and upon written demand.** Answer (a) is incorrect because there is no inherent right to dividends for stockholders. Answer (b) is incorrect because stockholders elect directors, not officers. Officers are appointed by the directors. Answer (d) is incorrect because stockholders do not generally have the right to participate in management. They have only two management rights: electing directors and voting on fundamental changes in the corporation. They do not have the right to have the corporation issue a new class of stock as this is not a fundamental change in the corporation.

19. (b) **By definition, preemptive rights are the right of a stockholder to purchase a proportionate amount of a new issue equal to his/her percentage of ownership.** Although stockholders have the right upon dissolution to a proportionate share of corporate assets after all creditors have been paid, this is not preemptive rights.

20. (d) **A derivative suit is a law suit brought by a large group of stockholders on behalf of the corporation to enforce a corporate right. Derivative suits may specifically be brought to recover damages for management’s ultra vires acts. A derivative suit must be brought for a corporate harm and cannot be brought to enforce personal stockholder rights.** Answers (a), (b) and (c) are incorrect because compelling payment of a properly declared dividend, inspecting corporate records and compelling dissolution of the corporation are personal rights of stockholders and not a harm to the corporation itself.

21. (d) **Although stockholders usually do not owe a fiduciary duty to others, a majority stockholder may owe a fiduciary duty to fellow stockholders.** This is due to the fact that a majority stockholder is in a position of control. Answer (b) is incorrect because a director owes a fiduciary duty of loyalty to the corporation and to the stockholders. Answer (a) is incorrect because disclosure by itself will not discharge a director’s fiduciary duty of loyalty. Answer (c) is incorrect because a promoter owes a duty of loyalty to subscribers, future stockholders and the corporation.

22. (c) **Debt securities or bonds create a creditor-debtor relationship between the bondholder and the corporation and they are not an ownership interest in the corporation. Convertible bonds can be exchanged for other corporate securities. Debenture bonds are unsecured bonds.** Since both convertible bonds and debenture bonds are types of bonds, they are debt securities. Warrants are stock options that are evidenced by a certificate. **Stock options are equity securities and are not debt securities.**

23. (c) **Treasury stock can be sold by the corporation at a price that is less than par value.** Thus, one who purchased treasury stock for less than par value would not be liable. If par value stock was purchased at less than par in connection with an original issue, it would be watered stock and the purchaser would be liable or the difference in price. Thus, (a) is incorrect. Answer (b) is incorrect because a stockholder must pay present value for stock. An agreement to perform future services in exchange for stock would leave the stockholder liable until the future services were performed. Answer (d) is incorrect because a stockholder must pay present value for stock. Failure to pay the full amount owed on a subscription contract would leave the stockholder liable for the amount unpaid.

24. (c) **Treasury stock may be distributed as a stock dividend.** Answer (a) is incorrect because a corporation may purchase treasury stock as long as it has the surplus funds to do so. The power to purchase does not require specific
authorization by the articles of incorporation. Answer (b) is incorrect because there are no pre-emptive rights with treasury stock. Answer (d) is incorrect because there are no cash dividends paid on treasury stock.

25. (a) If par value stock is sold at less than par in an original issue, the stock is watered stock and the purchaser is liable for the difference between the amount paid and the par value. All other purchasers with notice that the stock was being sold for less than par value would also be liable for the difference in price. Ambrose purchased 400 shares of $100 par value stock in an original issue for $25 a share. Ambrose is therefore liable for $75 per share, the difference between the $25 per share paid and $100 par value. The total amount of Ambrose’s liability would be $75 times the 400 shares purchased, or $30,000. Thus, answer (a) is correct and (b) is incorrect. Answer (c) is incorrect because subsequent purchasers are only liable if they had notice that the stock was being sold for less than par. The lack of notice by Harris would be material. Answer (d) is incorrect because Gable’s purchase with knowledge that the stock was sold at less than par would make Gable liable.

26. (c) Cumulative preferred stock entitles the holder to a dividend carryover to future years if the dividend is not paid in any given year. Answer (a) is incorrect because it does not permit the holder to convert preferred stock into common stock. Answer (b) is incorrect because cumulative preferred stock is usually non-voting. Answer (d) is incorrect because no stockholder has an inherent or guaranteed right to dividends.

27. (c) Once a dividend is duly declared by the board of directors, the stockholders become unsecured creditors of the corporation. Since $7 per share dividend on Sky’s preferred stock was declared and West owned 5,000 shares, Sky is liable to West as an unsecured creditor for $35,000 ($7 times 5,000 shares). Answers (a) and (b) are incorrect because West as an unsecured creditor does not have a priority over any other creditor. Answer (d) is incorrect because no other dividends were declared on the preferred stock. Thus, West is only entitled to $35,000, not $70,000.

28. (b) Once a dividend is duly declared by the board of directors, the stockholders become unsecured creditors of the corporation. Thus, once Abco declares a cash dividend, Johns became an unsecured creditor of Abco. Answer (a) is incorrect because a preferred stockholder is not entitled to convert preferred stock into common stock unless this right is specifically authorized. Answer (c) is incorrect because Johns is a holder of cumulative preferred stock, not participating preferred stock. Only participating preferred stock shareholders may participate with common stock shareholders on dividend distributions. Answer (d) is incorrect because cumulative preferred stock is usually non-voting stock. Whether voting or non-voting depends on the stock, not whether dividend payments are in arrears.

29. (a) Once a dividend is duly declared by the board of directors, the stockholders become unsecured creditors of the corporation. Since Universal declared a $5 per share dividend on their preferred stock and Price owned 2,000 shares, Universal would be liable to Price as an unsecured creditor for $10,000 ($5 per share times 2,000 shares). Answer (b) is incorrect because Price is not a secured creditor. Additionally, Price is not entitled to $20,000 because no other dividends were declared. Answers (c) and (d) are incorrect because Price is an unsecured creditor and does not have a priority over any other creditor.

30. (c) Stock dividends have no effect on earnings or profits of a corporation for federal income tax purposes. Answer (a) is incorrect because a stock dividend is a "no sale transaction" wherein a corporation is dealing exclusively with existing shareholders without payment of a commission. No sale transactions are exempt from registration under the Securities Act of 1933. Answer (b) is incorrect because stock dividends are not usually treated as gross income for federal tax purposes. Answer (d) is incorrect because dividends are declared by the board and do not require stockholder approval. Stockholders may only vote to elect directors and on fundamental changes in the corporation.

31. (b) A stock split is a type of stock dividend and neither reduces the assets of a corporation nor increases the stockholder’s percentage of ownership. It is not considered a distribution and does not distribute assets. Thus, it cannot be considered an asset or capital distribution. Answer (a) is incorrect because a liquidating dividend is a distribution of capital assets to stockholders. Answer (c) and (d) are incorrect because both property distributions and cash distributions involve distribution of assets to stockholders. One distributes the assets in property and the other in cash.
32. (c) Under the business judgment rule, directors and officers are not liable if they acted reasonably and in good faith. Thus, the Mix’s board may avoid liability by showing that it acted in good faith and in a reasonable manner. Answer (a) is incorrect because a director is not strictly liable. Answer (b) is incorrect because the negligence of the CPA firm is not automatically imputed to the board. The board may usually rely on the reports of officers and agents (like a CPA firm’s report). Answer (d) is incorrect because the board can be liable without proof of scienter (intent to deceive). A director is liable for negligence, which does not require proof of scienter.

33. (b) Officers are agents of the corporation and are therefore fiduciaries. All agents can have actual and apparent authority. Answer (a) is incorrect because stockholders elect directors, not the officers. Answer (c) is incorrect because stockholders do not have the right to vote on removal of officers. They may only vote on the election of directors and on fundamental matters. Answer (d) is incorrect because directors declare dividends, not officers.

34. (a) Directors may rely on reports of officers or agents. Answers (b) and (d) are incorrect because a director is a fiduciary and must act solely in the corporation’s best interest. Serving on the board of a competing company and profiting from insider information would be a breach of a director’s fiduciary duty of loyalty. Answer (c) is incorrect because a director does not own control of the corporation, the majority stockholders do. Since the director does not own control of the corporation, the director can not sell control of the corporation.

35. (d) An officer or director may make a personal profit on a contract with their own corporation if they make a full disclosure and do not participate in the approval process. Absent pre-approval, they may do so only if the contract is fair and reasonable to the corporation. Knox did not receive pre-approval for the stationery contract. However, since the price charged by Knox was less than any other supplier, the contract was fair to Quick and would be valid. Answers (a) and (b) are incorrect because the contract was valid. Answer (c) is incorrect because the disclosure was only made after the contract. Without pre-approval the contract could only be valid if it was fair and reasonable.

36. (b) Under the Revised Model Business Corporation Act a corporation may indemnify an officer or director for liability incurred in a suit by stockholders if they acted in good faith in the best interests of the corporation. Answer (a) is incorrect because an officer may also be a director. This is a common occurrence in business. Answer (c) is incorrect because stockholders elect directors, not officers. Answer (d) is incorrect because an officer is not required to own stock.

37. (a) Voluntary dissolution requires both a resolution to dissolve by the board of directors and approval by a majority of the stockholders. Answer (b) is incorrect because dissolution does not require approval by the officers. Answer (c) is incorrect because dissolution does not require an amendment to the articles of incorporation. Once the corporation is dissolved there is no need for the articles of incorporation. Answer (d) is incorrect because dissolution requires approval by a majority of the stockholders, not a unanimous vote.

38. (b) An involuntary dissolution may be forced by stockholders for waste of corporate assets. Answers (a), (c) and (d) are incorrect because refusal of a board to declare dividends, loss operations for three years, and failure to file federal income tax are insufficient grounds for an involuntary dissolution.

39. (d) The maximum number of shareholders allowed in an S Corporation is 100.

40. (a) An S Corporation is allowed only one class of stock. That stock may, however, have different voting rights.

41. (b) Since the shareholders of Village Corporation did not make the consent by March 15, 2003, the election takes effect on January 1, 2004 (the next year).

42. (d) Since the shareholders of Ace Corporation made the consent by March 15, 2003, the election takes effect on January 1, 2003 (the current year).

43. (d) An S Corporation may have 75 shareholders. It may also have a decedent's estate as a shareholder. However, if it has accumulated C Corporation earnings and profits, then violating the passive income rules for three consecutive years will cause the termination of the S Corporation status.
44. (c) 10,000 and 16,000. What is needed is a majority of the voting and nonvoting shares to revoke the election. In this problem the total number of shares is 50,000, therefore more than 25,000 is needed. Only answer (c) with 26,000 shares qualifies.

45. (c) 5 years. Once an S Corporation is revoked or terminated, the corporation generally may not re-elect for five years without IRS consent to an earlier election.

46. (c) November 1, 2003. In order to make a valid S Corporation election, all the shareholders must consent in writing. Form 2553 must be filed by the 15th day of the third month of the year in which the election is to be valid, or anytime during the preceding year. Since the election was not made by January 15, 2003, the election is effective for the following tax year beginning November 1, 2003.

47. (a) An S Corporation has restrictions on its shareholders, must be a domestic corporation and have only one class of stock. However, it does not need to be a member of a controlled group.

48. (b) March 15. This is same as for a regular C Corporation. The 15th day of the third month following the close of the taxable year.

49. (d) Yes and Yes. Since the corporation was always an S Corporation (and therefore cannot have any accumulated C Corporation earnings) the passive income is not an issue. A shareholder may be a bankruptcy estate.

50. (d) $0 and $0. An S Corporation is a pass-through entity. The ordinary income and long-term capital gains flow-through to its shareholders.

51. (c) Distributions to a shareholder decrease the shareholder's basis.

52. (b) $30,000. A shareholder in an S Corporation must recognize his proportionate share of income, deductions, credits and losses. In addition, the amounts of income reported by Haas Corporation will cause each shareholder's basis to increase by their share of the income (50% of $60,000, or $30,000). Recognize that the total income of $60,000 is passed through to the shareholders in their separate components of ordinary income and interest income. Also note that any tax-exempt income, while not present in this problem, also increases a shareholder's basis.

53. (b) $2,000. Meyer's share of the $36,500 loss is based upon two factors: (1) his share of the corporate stock and (2) the length of time holding the stock. As a 50% shareholder for 40 days, Meyer's loss is determined as follows:

\[
\frac{36,500}{365 \text{ days}} = 100 \text{ per day per shareholder} \\
100 \times 40 \text{ days} = 4,000 \text{ loss for 40 days} \\
4,000 \text{ loss} \times 50\% \text{ ownership} = 2,000.
\]

54. (c) Charitable contributions are separately stated items which are not allowed as deductions in the determination of ordinary income. Separately stated items are passed through to the individual shareholders to be used on their own returns. In this case, if the shareholder was an individual, the charitable contribution would be claimed as an itemized deduction on Schedule A. Unlike a partnership compensating its partners, the compensation of a corporation's officers is allowable as a deduction.

55. (d) An S Corporation may deduct the compensation paid to its officers in determining its ordinary income. The charitable contributions, net operating losses and foreign income taxes represent flow-through items which are required to be separately statedly on the shareholders' K-1.

56. (c) $76,500. Zinco must allocate a prorata share of the income to the S Corporation's short year. The allocation is based upon the 90 days Zinco was an S Corporation.

\[
\frac{310,250}{365 \text{ days}} = 850 \text{ per day} \\
850 \times 90 \text{ days} = 76,500
\]
57. (a) $56,750. Kane's share of the $73,000 income is based upon two factors: (1) his share of the corporate stock and (2) the length of time holding the stock. As a 100% shareholder for 40 days, and then as a 75% shareholder for 325 days, Kane's share of the income is determined as follows:

**Step 1**  
$73,000 ÷ 365 days = $200 per day  
$200 × 40 days = $8,000 (as sole shareholder)

**Step 2**  
$73,000 ÷ 365 days = $200 per day  
$200 × 325 days = $65,000 total income  
$65,000 × 75% ownership = $48,750

**Step 3**  
Share of income as 100% shareholder  $ 8,000  
Share of income as 75% shareholder  48,750  
Total reported income by Kane  $ 56,750

58. (d) Similar to the rules for a partnership, the "at risk" rules are determined at the shareholder level rather than at the corporate level.

59. (d) The payment of federal income taxes which are attributable to when the corporation was a C Corporation, would be reflected in the Accumulated Earnings and Profits account, not the Accumulated Adjustments Account. The AAA account measures the undistributed earnings of the S Corporation.

60. (d) A S Corporation may have up to 100 shareholders. However, it may not have both common and preferred stock; have a corporation as a shareholder; or be a member of an affiliated group (at least 80%).

61. (b) $20,000. When a corporation incurs liabilities, the individual shareholders do not necessarily share in the responsibility to pay these liabilities. One characteristic of a corporation is limited liability. However, even if a shareholder was personally responsible for a debt (the shareholder guaranteed a bank loan), the shareholder's basis is not increased for the liability. This is a major difference from the rules related to partnerships. If, however, the shareholder lends money to the corporation, the shareholder's basis is increased by that amount. The basis of each shareholder determines the amount of the loss they can claim. Their basis is determined as follows:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Initial investment</td>
<td>$ 5,000</td>
</tr>
<tr>
<td>Personal loan</td>
<td>15,000</td>
</tr>
<tr>
<td>Total basis</td>
<td>$ 20,000</td>
</tr>
</tbody>
</table>

62. (d) A shareholder's basis is increased by the interest from both taxable and tax-exempt interest.

63. (b) Corporations require a recommendation by the board of directors and approval by a majority of all shareholders entitled to vote. Contrast this with a partnership, which requires the unanimous consent of all partners.
Chapter Ten: Corporations – Subchapter C
Other Objective Answers

ANSWER 1

1. (G) Stockholder voting agreements are valid in most states if they are in writing. Mill, Web and Trent agreed in writing to vote for each other as directors. Thus, according to the stockholders’ agreement Mill, Web and Trent must be elected as directors.

2. (H) There was no agreement made as to appointment of officers in the stockholder voting agreement of Mill, Web and Trent. Thus, neither Mill, Web nor Trent must be appointed as officers.

3. (J) Mill was appointed as an officer of Sack Corp. and given a three year employment contract. Officers may be removed by the board at any time, with or without cause. If their removal breaches an employment contract, it is the corporation that is liable. Since Mill’s termination breached his employment contract, Sack Corp. is liable.

4. (G) Although cash dividends properly declared and communicated to stockholders cannot usually be revoked, an exception exists where fraud or illegality is involved. A stockholder who receives a dividend that was fraudulently or illegally made must repay the dividend if they had knowledge of the fraud. Thus Web and Trent must repay the dividend because they had knowledge of the fraud. Also, directors are personally liable to the corporation for wrongful declarations of dividends. Thus, Web and Trent would be liable to repay the corporation for the wrongful distribution. Additionally, a dividend must be repaid if the dividend made the corporation insolvent even if the stockholder had no knowledge of the fraud. Thus, Mill must also repay the dividend because it made Sack become insolvent.

5. (F) Directors are personally liable for wrongful declarations of dividends. Since Web and Trent were the parties that knew the financial statements were materially misstated and assured the other board members of the accuracy of the financial statements, they would be liable. Mill was not a member of the board at this time, so Mill is not liable. The other directors are not liable because they reasonably relied on the assurances of Web and Trent. Directors are not liable for decisions when they act reasonably and in good faith (business judgment rule).

ANSWER 2

1. (E) The actions of the officers and directors in regards to the pollutants would generally be considered a violation of their duty of loyalty to the corporation. Directors and officers are agents of the corporation and therefore owe the corporation a fiduciary duty of loyalty. As such, they must act solely in the best interests of the corporation. Intentionally allowing the discharge of pollutants was not in the best interest of the corporation and resulted in $1,000,000 penalty to the corporation. There are only two other answers that would be grammatically correct. Answer (d), fiduciary duty of care, relates to the liability of a director or officer for negligence, which is lack of due care. This is an incorrect choice because the actions of the officers and directors was intentional, not negligent. Answer (b), fiduciary duty to prevent losses, is incorrect because there is no fiduciary duty to prevent losses.

2. (H) A successful shareholder derivative suit would probably result in the directors and officers being liable for abuse of discretion. The decision not to pay dividends was solely the result of the $1,000,000 in penalties. The board’s decision to use the $1,000,000 recovered from the insurance company for future bonuses, and not for dividends, is a clear abuse of discretion. The only other choice that would be grammatically correct is (I), liable to the corporation for $1,000,000. This choice is incorrect because the corporation has received the $1,000,000 from the insurance company and, therefore, was not harmed by $1,000,000.
3. **(A)** A successful shareholder derivative suit would probably result in the $1,000,000 being considered available for distribution as a dividend. To allow the $1,000,000 to be used for bonuses would be financially rewarding the officers and directors for their illegal actions. The only other choice that would be grammatically correct is (L), surplus or earnings held for expansion. This would not be a likely choice of a court in that the sole reason dividends were not distributed was because of the $1,000,000 in penalties.

4. **(C)** If the $1,000,000 were distributed in 1995, it would be characterized as a cash dividend. The only other answers that are grammatically correct are (J) property dividend and (K) stock dividend. The distribution of cash is a cash dividend and not property or stock.

5. **(O)** The cumulative preferred stockholders are entitled to dividend carryovers if dividends are not paid in a given year. Thus they are entitled to dividends in both 1994 and 1995. 5% of $100 face value would equal $5 for each year for a total of $10. Only answer (O) reflects $10.

6. **(N)** There are 10,000 shares of preferred stock which will receive a dividend of $10 per share for a total of $100,000. This leaves $900,000 remaining to be distributed to the common stockholders. With 100,000 shares of common stock outstanding, each share will receive a dividend of $9. Only answer (N) reflects $9.

**ANSWER 3**

1. **(A)** A Corporation must be formed pursuant to a state statute. Answer (b) is incorrect because the names of the stockholders need not be contained in the articles of incorporation. The only names that are required in the articles of incorporation are the names of all incorporators, the name of the registered agent and the name of the corporation. Answer (c) is incorrect because the bylaws need not be included in the incorporation documents.

2. **(C)** The bylaws are adopted by the board of directors of the corporation, usually at the organizational meeting. Directors are in charge of setting overall corporate policy. Answer (a) is incorrect because stockholders do not vote on the bylaws. Stockholders elect the board of directors and get to vote on fundamental changes in the corporation (mergers and consolidations, dissolution and amending the articles of incorporation). Answer (b) is incorrect because the officers do not adopt the bylaws, the directors do. Officers handle day-to-day affairs. Overall policy is set by the directors.

3. **(C)** Stockholders elect the board of directors. Answers (a) and (b) are incorrect because directors are not selected by the officers or by outgoing directors.

4. **(B)** The officers of a corporation are selected by the board of directors. Answers (a) and (c) are incorrect because officers are not selected by the stockholders or the outgoing officers.

5. **(C)** The day-to-day affairs of a corporation are handled by its officers. Answer (a) is incorrect because directors handle the overall management of the corporation and set corporate policy. Answer (b) is incorrect because stockholders do not handle day-to-day affairs. They only may vote on fundamental changes in the corporation or to elect the board of directors.

6. **(C)** Adams, Frank and Berg executed a written contract that they would vote for each other as directors. Thus, they are required by contract to do so. Answer (a) is incorrect because there is no requirement that majority stockholders must serve as directors. If the majority stockholders did not choose to be directors, they need only vote for others to insure that they were not elected. Answer (b) is incorrect because there is no requirement that majority stockholders must serve as officers.
ANSWER 4

a. Edwards will not win the suit to have Olsen removed as president. The right to hire and fire officers is held by the board of directors. Individual stockholders, regardless of the size of their holding, have no vote in the selection of officers. Individual stockholders may exert influence in this area by voting for directors at the annual stockholders’ meeting.

b. Edwards will lose the suit to have National purchase the stock. A stockholder who dissents from a merger may require the corporation to purchase his or her shares if the statutory requirements are met and would be entitled to the fair value of the stock (appraisal remedy). To compel the purchase, Edwards would have had to file an objection to the merger before the stockholders meeting at which the merger proposal was considered, vote against the merger proposal, and make a written demand that the corporation purchase the stock at an appraised price. Edwards will lose because the first two requirements were met but Edwards failed to make a written demand that the corporation purchase the stock.

c. 1. Queen will lose its suit against National to enforce the contract, even though Edwards was a National director. Jenkins may have assumed that Edwards was acting as National’s agent, but Edwards had no authority to contract with Queen. A director has a fiduciary duty to the stockholders of a corporation but, unless expressly authorized by the board of directors or the officers of the corporation, has no authority to contract on behalf of the corporation. There is no implied agency authority merely by being a director.

2. Queen will win its suit against Edwards because Edwards had no authority to act for National. Edwards will be personally liable for Queen’s damages.

ANSWER 5

West’s assertion that Ace should have recorded the dividends in arrears for 1987 and 1988 as a liability is incorrect. A shareholder of cumulative preferred stock is entitled to receive all dividend arrearages plus any dividends for the current year before any dividends may be distributed to the shareholders of common stock. However, preferred stock represents a contribution of capital, not a debt of the corporation, and until a dividend is declared, a shareholder of cumulative preferred stock is not a creditor of the corporation. Thus, Ace was correct in not classifying the dividend arrearages as a liability because a dividend was not declared by Ace’s board of directors. Ace should disclose the dividend arrearages in notes to its financial statements.

West’s assertion that West is entitled to examine Ace’s book and records is correct. A shareholder, upon written demand, is entitled to examine, at reasonable times, the books and records of the corporation, so long as the examination is for a proper purpose (in good faith). If the corporation refuses to permit the examination, the shareholder may obtain a court order compelling access to the books and records.

ANSWER 6

A limited partnership is formed by two or more persons under a state’s limited partnership statute, having as members one or more general partners and one or more limited partners. Two or more persons desiring to form a limited partnership must execute a certificate of limited partnership that must be filed in the office of the secretary of state, or other appropriate state or local office. A corporation may be formed only under a state incorporation statute that requires that one or more incorporators sign articles of incorporation which must be filed with the secretary of state.

Unless otherwise provided in the partnership agreement, or other agreements among the partners, a limited partnership interest is assignable in whole or in part. Similarly, in the absence of a restriction in the corporation’s organizational documents or other agreements among the shareholders, shares of stock are freely transferable.
A limited partner’s liability for partnership debts is generally limited to the partner’s investment (capital contribution) in the partnership if the interest is fully paid and non-assessable and the partner does not participate in the daily management of the business. Likewise, a shareholder’s liability for a corporation’s debts is generally limited to the shareholder’s investment (capital contribution) in the corporation.

A limited partner cannot participate in the daily operations of the partnership’s business without losing limited liability. A shareholder who is not also an officer or a director cannot participate in the daily operations of the corporation’s business. However, a shareholder owning voting stock has the right to vote for a board of directors, which will manage the business affairs of the corporation. The board of directors elects officers to run the daily operations of the corporation.

A limited partner is entitled to receive a share of the partnership’s profits in the manner provided in the partnership agreement. On the other hand, whether a shareholder receives dividends is generally within the discretion of the board of directors.

**ANSWER 7**

The action to compel reinstatement of prior dividends would fail. The declaration of dividends is a matter within the discretion of the board of directors. There are very few instances in which the board’s discretion will be disturbed, and the facts of this problem are not within any of them unless Cox can prove the fraudulent purpose of the board, which she asserts.

The predominant rule gives a corporation the right to acquire its own shares. Such purchase may be made only to the extent of unreserved and unrestricted earned surplus. Capital surplus may be used only if the articles of incorporation so provide or if there is an affirmative majority vote by shareholders. The law and the facts indicate that in all probability there was no problem from the standpoint of the proper source of funds. With respect to the sale below par value there is no requirement to sell treasury shares at par value. The corporation laws require only that newly issued shares be sold at or above par value.

Cox’s action to demand repayment of the salary increases would fail. The board of directors has broad discretionary power to fix salaries of officers, even if the officers also are members of the board. The courts have supported the board’s determination of salary unless the amounts are grossly unreasonable. A 10 percent per year raise and the fact that the salaries are within the upper one-third of those paid by other similar corporations do not suggest salaries that would likely be found unreasonable and a waste of corporate assets.

Cox’s action for dissolution would fail. The courts have power to dissolve a corporation in an action by a shareholder when the directors are deadlocked in the management of the corporate affairs and the shareholders are unable to break the deadlock. To obtain a court-ordered dissolution Cox must also prove that irreparable injury to the corporation is being suffered or is threatened. None of these facts are present. The fact that there is bitterness and animosity does not constitute a deadlock of the management. The corporation is continuing to increase its earnings at a 10 percent per year rate. Courts are loath to grant an order for an involuntary dissolution even if there is a serious deadlock, provided the corporation continues to be a viable economic entity.
Chapter Eleven
Securities Acts and Antitrust Regulation

FEDERAL SECURITIES REGULATION

1. There are two main federal laws regulating securities
   a. the Securities Act of 1933
   b. the Securities Exchange Act of 1934

2. Securities are broadly interpreted, including almost any type of multi-state investment contract
   a. examples: securities include stocks, stock options, warrants, bonds, debentures, collateral-trust certificates, investment contracts and limited partnership interests
   b. they do not include general partnership interests or certificates of deposit

3. Both acts are administered by the Securities Exchange Commission (SEC)
   a. SEC may suspend or revoke trading or registration for fraud or other legality
   b. SEC has the power to conduct investigations to determine violations (e.g. may subpoena witnesses and also books and records)
   c. SEC does not prosecute criminal violations (the Department of Justice does) or issue injunctions (only a court may issue an injunction)

4. States also have laws regulating securities (called "blue sky" laws)

LIABILITY UNDER '33 & '34

1. Criminal liability: both '33 and '34 have criminal sanctions providing for fines, imprisonment or both for willful violations

2. Civil liability under Section 11 of '33 - permits suits for money damages against the issuer, directors or partners of the issuer, those signing the registration statement and experts (e.g. lawyers and accountants). The plaintiff MUST SHOW:
   a. the plaintiff acquired the stock (they do not need to be the initial purchaser)
   b. the plaintiff suffered a loss
   c. there was a material misrepresentation or material omission of fact in the registration statement
   d. no scienter or reliance need be proven by the plaintiff
   e. the defendant is liable unless (s)he can prove
      1). it was not his/her fault (called the due diligence defense)
      2). issuers are strictly liable and may not use the due diligence defense
   f. suit must be brought within one year of discovery of the misrepresentation and within 3 years of the offering date

3. Civil liability under Section 10b and rule 10b(5) of '34 (Anti-Fraud Section) and Section 18 (liability for false or misleading statements in filed reports) permits suits for money damages against anyone involved with the stock even if the securities are exempt from registration. The plaintiff MUST SHOW:
   a. the plaintiff was a buyer or seller of the stock (stock does not need to be registered under '33 or '34, as the anti fraud section applies even if the stock is exempt)
   b. the plaintiff suffered a loss
   c. there was a material misrepresentation or omission of fact
   d. the plaintiff must show scienter or a reckless disregard for the truth (i.e. must show an intent to deceive, mere negligence is not enough)
   e. the plaintiff must show reliance
   f. suit must be brought within one year of discovery of the misrepresentation and within three years of the date of violation
g. the wrongful act must have been accomplished through the mail, any other use of interstate commerce, or through a national securities exchange

**Note:** Under Section 10b and 18 of '34 the plaintiff must prove both scienter and reliance. Under Section 11 of '33 neither scienter nor reliance need be proven.

### 2 MAIN REQUIREMENTS OF THE SECURITY ACT OF 1933

1. **The basic purpose of ’33 is to provide investors with information**
   a. there are no guarantees of the accuracy of the information by the SEC
   b. there are no assurances against loss
   c. there is no evaluation by the SEC of the offering's financial merits
   d. there is no need to evaluate or give assurances, as issuers are strictly liable if the information is inaccurate and someone suffers a loss

2. **The main requirements** of the Securities Act of 1933 are
   a. the issuer must **file a registration statement** with the SEC
   b. the issuer must **give a prospectus** to investors
   c. the 2 requirements apply if 4 tests are met: **IPIE**

<table>
<thead>
<tr>
<th>Must file a registration statement &amp; give a prospectus if</th>
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3. **The first requirement is to file a registration statement** with the SEC
   a. only **issuers, underwriters, or dealers** are required to file
      1). issuers are the company or corporation issuing the stock
      2). underwriters are those who purchased securities from the issuer for the purpose of distributing them to the public
      3). a dealer is one in the business of offering securities issued by another
   b. **controlling persons**
      1). controlling persons are anyone with significant say in management
      2). they are counted as issuers or underwriters for sales of a significant amount of their stock within a 2 year period (e.g. stock may have to be reregistered)
   c. issuers cannot sell until the effective date (usually 20 days after filing)
      1). **before filing** the issuer may not make any sales or any offers to sell (either written or oral), but they may publish a notice of a proposed offering (contains only the name of the issuer and a basic description of the security)
      2). **during the 20 day waiting period** the issuer may make oral offers to sell the securities and limited written announcements (no written offers to sell)
         a). e.g. a preliminary prospectus (called a red herring) during the 20 day period (gives essentially the same information as a final prospectus)
         b). e.g. may make "tombstone ads" naming the security, its price and by whom orders will be executed (tombstone ads makes known the availability of a prospectus)

**Example:** In an initial sale of stock **ABC, Inc.** files a registration statement with the SEC on June 1. Before the filing date on June 1, **ABC** may only publish a notice of the proposed offering. During the waiting period between June 1 and June 21, **ABC** may make oral offers to sell and limited written announcements (e.g. preliminary prospectus and tombstone ads). **ABC** may not sell the securities or make written offers to sell until the effective date, which is 20 days later on June 21.

d. registration statement contains 4 items: **PANS**
Prospectus - a part of the registration statement

Audited financial statements

Names - of the issuer, directors and underwriters

Securities information - data about the issuer's properties and business both currently and historically - full details about the securities being offered to include management - the principal purposes for which the offering proceeds will be used

4. The second requirement is to give a prospectus to investors
   a. it contains much of the same information as the registration statement
   b. its purpose is to enable investors to make an informed decision

5. Failure to file a registration statement or provide investors with a prospectus
   a. Section 12 of ‘33 imposes strict liability upon issuers for failure to do either
   b. purchasers may recover the full purchase price paid for the stock plus interest

REGISTRATION EXEMPTIONS UNDER ‘33 - I DANCE

<table>
<thead>
<tr>
<th>EXEMPTIONS FROM REGISTRATION UNDER ‘33</th>
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<tbody>
<tr>
<td>I Intrastate offerings - everything must take place in 1 state</td>
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<tr>
<td>D Reg. D - 504, 505 and 506</td>
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<tr>
<td>A Reg. A - simplified registration if $5 million or less with in 12 month period</td>
</tr>
<tr>
<td>N No sale transactions - issuer deals exclusively with existing stockholders without a commission</td>
</tr>
<tr>
<td>C Casual sales by ordinary investors - not an issuer, underwriter or dealer</td>
</tr>
<tr>
<td>E Exempted securities - those by banks, governments, common carriers &amp; not-for-profit groups</td>
</tr>
</tbody>
</table>

1. Intrastate offerings are exempt - everything must take place in one state
   a. the issuer must be from that state and do 80% or more of their business in that state
   b. the securities may only be sold or offered to residents of that state
   c. resale is restricted for 9 months after the last sale to only residents of that state

Example: ABC, Inc. is an Iowa corporation doing 90% of its business in Iowa. ABC is making a securities offering solely to Iowa residents and will restrict resale for 9 months to Iowa residents. This is an intrastate offering and ABC need not register.

2. Regulation D
   a. Regulation D is 3 different exemptions: 504, 505 and 506
   b. for all 3 you must notify the SEC within 15 days of the first sale
<table>
<thead>
<tr>
<th>Maximum Dollar Amount that may be sold</th>
<th>504</th>
<th>505</th>
<th>506</th>
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<tr>
<td>Up to $1,000,000 and must be sold in a 12 month period</td>
<td>Between $1,000,000 and $5,000,000 and must be sold in a 12 month period</td>
<td>More than $5,000,000 and it may be sold over more than 12 months (also called Private Placements)</td>
<td></td>
</tr>
<tr>
<td>Solicitation</td>
<td>Permitted</td>
<td>None permitted</td>
<td>None permitted</td>
</tr>
<tr>
<td>Restrictions on Resale</td>
<td>No Restriction</td>
<td>Issuer must use due care to insure purchaser will hold for long term investment and not resale (2 years or more)</td>
<td>Issuer must use due care to insure purchaser will hold for long term investment and not resale (2 years or more)</td>
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<tr>
<td>Type and Number of Investor</td>
<td>No Restriction</td>
<td>Unlimited Accredited Investors (Bank, Ins. Co., Investment Co., an Officer or Director of the issuer and millionaires)</td>
<td>Unlimited Accredited Investors</td>
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<tr>
<td></td>
<td>Any type of Investor</td>
<td>35 or less Unaccredited Investors</td>
<td>35 or less Unaccredited Investors</td>
</tr>
<tr>
<td></td>
<td>Any Number of Investor</td>
<td>Disclosure is required if unaccredited investors to include audited financial statements or balance sheets</td>
<td>Disclosure is required if unaccredited investors to include audited financial statements or balance sheets</td>
</tr>
<tr>
<td>Disclosure</td>
<td>No Restriction</td>
<td>Disclosure is not Required</td>
<td>Disclosure is not Required</td>
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</table>

3. **Regulation A:** simplified registration is permitted for small issues if:
   a. the amount of stock to be sold in a 12 month period is **$5 million or less**
   b. an offering circular or offering statement (not a prospectus) is filed with the SEC and given to offerees and purchasers

4. **"No Sale" Transactions:** securities are issued by an issuer exclusively to existing stockholders without the payment of a commission
   e.g. a stock split need not be registered because it is issued exclusively to existing stockholders without the payment of a commission

5. **Casual sale** by ordinary investors are exempt (not an issuer, underwriter or dealer)

6. The following are exempted securities and need not be registered
   a. securities issued by banks and savings and loans associations
   b. securities issued by governments (e.g. municipal bonds)
   c. securities issued by common carriers regulated by the Interstate Commerce Commission (e.g. railroads and trucking companies)
   d. securities issued by not-for-profit groups (e.g. charitable or religious groups)
   e. insurance policies and annuity contracts (note: securities issued by insurance companies do have to be registered)
   f. short term commercial paper that matures in 9 months or less

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**REGISTRATION REQUIRED UNDER '34**

1. National stock exchanges, brokers, dealers and national securities associations must register with the SEC and their activities are regulated.
2. Two types of issuers must register their securities with the SEC under '34 (they are called reporting companies)
   a. any issuer whose stock is traded on a national stock exchange or
   b. issuers with assets of more than $10 million and equity securities held by at least 500 shareholders and traded in interstate commerce

3. The registration statement filed by reporting companies must include
   a. nature of the issuer's business and its financial structure
   b. the different classes of securities of the issuer
   c. names of officers, directors and stockholders owning 10% or more stock
   d. any bonus and profit-sharing arrangements
   e. balance sheets and profit and loss statements for the past 3 years

**REQUIRED REPORTS UNDER '34**

1. There are 3 types of Periodic Reports required under the '34 Act
   a. annual reports (Form 10-K) which are filed with SEC within 90 days of the end of the fiscal year and must include audited financial statements
   b. quarterly reports (Form 10-Q) which are filed with SEC and includes unaudited financial statements
   c. current reports (Form 8-K) which are filed within 5 to 15 days of the end of month in which certain specified events occur
      1). must report newly appointed officers or changes in auditors
      2). must report changes in the amount of securities
      3). must report changes in corporate control

2. Periodic Reports (10-K, 10-Q and 8-K) must be filed with the SEC by two different types of issuers
   a. reporting companies
      1). issuers whose stock is sold on national stock exchanges
      2). issuers with 500 or more shareholders & more than $10 million in assets
   b. issuers who have made a registered offering under '33

3. Other required reports involving reporting companies under '34 - 5% TIP

<table>
<thead>
<tr>
<th>5%</th>
<th>5% or more owners of voting stock</th>
<th>in reporting companies must file background information with the SEC and the issuer (information about the purchaser, source of their money and their purpose in buying)</th>
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<tbody>
<tr>
<td>T</td>
<td>Tender offers</td>
<td>for reporting companies must be reported by the one making the tender offer (an offer to buy stock of a corporation at a specified price for a specified time)</td>
</tr>
<tr>
<td>I</td>
<td>Insider trading</td>
<td>all officers, directors, 10% or more owners, and experts (accountants and attorneys) of reporting companies must report all stock purchases and sales to SEC</td>
</tr>
<tr>
<td>P</td>
<td>Proxy statements and proxy solicitations</td>
<td>involving reporting companies must be reported (proxy statements and proxy solicitations must be filed with the SEC at least 10 days before being sent and must be given to all stockholders)</td>
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</table>
SARBANES-OXLEY ACT OF 2002

1. Creates a new organization called the Public Company Accounting Oversight Board (PCAOB) whose main function is to set auditing standards, independence and quality control standards as well as rules for preparation of audit reports.

   The PCAOB takes over the responsibility of setting auditing standards from the Auditing Standards Board which is part of the AICPA.

2. The Act applies to all U.S. and non-U.S. public companies (not privately owned) that have registered securities (debt or equity) with the SEC under the 1934 Securities Exchange Act.

3. Section 906 of the Act requires that CEOs and CFOs must certify that their companies’ annual and quarterly financial reports/statements are accurate and not misleading.

4. Section 302 of the Act requires the above officers to certify and maintain effective internal controls for their companies and to disclose quarterly all significant internal control deficiencies to their auditors and the companies’ audit committees. This section of the Act also requires the reporting of any fraud (material or not) involving employees or management to the auditors and audit committee.

5. Section 404 of the Act dictates that annual reports must contain an evaluation of the company’s internal controls by the company, to which the auditor must attest and report on. The auditor’s report on internal controls must assess their effectiveness and the company’s procedures for financial reporting.

6. The Act also makes it illegal for public companies to give personal loans to or for any director or executive officer of that company. This is an amendment to the Securities Exchange Act of 1934.

7. The penalties for violating the above rules for officers are significant.
   a. Any officer who knows that the above certifications do not comply with SEC requirements (i.e., a “defective” certification) can be fined up to $1,000,000 or face imprisonment up to ten years, or both. In addition, any officer who willfully violates these certification requirements, e.g. purposefully issues a false financial statement, can be fined up to $5,000,000 and/or face up to twenty years in prison.
   b. The SEC can freeze payments to officers and directors during an investigation of wrongdoings and stop individuals from serving as an officer or director of a public company who is deemed unfit.
   c. CFOs and CEOs must forfeit any incentive-based compensation, bonuses, and profits from company stock sales covering a 12-month period before and during the restatement of financial statements due to omissions or misstatements of material facts even if the wrongdoing was not by them, e.g., it was done by another officer or employee.

8. The Act speeds up reporting of insider trading of their own company’s securities to two days and requires that such reports be made electronically, in an effort to speed up public notification of the information. In addition, if a company covered by the Act has an internet site, the reports of insider trading must be posted.

9. Additional disclosure of all material off-balance sheet financing and transactions (i.e. guarantee contracts) is now required in the MD&A section, including information about the credit and market risk, business purpose, and effect on liquidity of the off-balance sheet financing.

10. Similar to and including the required disclosures of material off-balance sheet financing and transactions, companies are required to make more disclosures of financial and non-financial information so that the public can better assess risk. If a company’s annual and quarterly financial reports certified by CEOs and CFOs turn out to be inaccurate or misleading, the company is now required to issue a restatement of such reports.

11. Any presentation of pro forma information must not contain any untrue statement of material facts or be misleading by the omission of material facts, and must be reconciled with financial statements prepared in
accordance with GAAP. This requirement extends to all pro forma financial information if included in press releases, supplemental financial reports, or other statements made on behalf of the company.

12. The attorneys for public companies are now required to report to the CEO or Chief Legal Counsel any material violations of securities laws or breach of fiduciary duties. If the CEO or Chief Legal Counsel does not take action, an attorney with knowledge of violation or breach must then report these violations to the audit committee.

Antitrust Regulation—Limiting the Power of Corporations and Preventing Monopolies

“I do not expect to see monopoly restrain itself.”

Woodrow Wilson

Interstate Commerce Act (1887) and Sherman Antitrust Act (1890)

In the late 1800’s, businesses sought to control “price wars” that were the inevitable result of competition. Businesses’ answer to price wars was the formation of pools, which were illegal “restraint of trade” arrangements where a group of competitors agreed not to undercut each other. This was only the beginning as trusts and corporate mergers consolidated power of an industry into the select hands of a few, leaving the smaller businessman out in the cold. The result was instead of numerous businesses competing in a particular industry, there might be several or even one dominating the market (monopoly). An example of this was Standard Oil Company, which was a trust of over 40 corporations which dominated the oil industry in the late 1800’s. There was fear that these large corporations would establish monopolies over a particular industry. Consequently, there was a strong public outcry against these powerful monopolies of business which were seen as contradictory to American democracy. The government increased its regulation of industry. In 1887 Congress passed the Interstate Commerce Act to control the sometimes exorbitant railroad rates being set for hauling freight. The antitrust movement next targeted corporations who could conspire with competitors to fix pricing, or through trusts and corporate mergers create monopolies. The Sherman Antitrust Act in 1890 (named for Ohio Senator John Sherman) declared, “Every contract, combination in the form of trust or otherwise; or conspiracy, in restraint of trade or commerce among the several States, or with foreign nations, is hereby declared to be illegal.” For those who violated the act, they could be fined as much as $5,000 or imprisoned for as long as one year.

In 1904 President Theodore Roosevelt, “the trust-buster,” pressed for the dissolution of the Northern Securities Company which had a monopoly on Western transportation. The Supreme Court successfully applied the Sherman Act, and Northern Securities was dissolved.

Clayton Antitrust Act-1914

The Clayton Antitrust Act of 1914 (The Clayton Act) was a follow-up to the Sherman Antitrust Act. Its purpose was to further stifle the possible abuse of power by large corporations. The act prohibits mergers or the acquisition of stock if the intent is to vanquish the competition and create a monopoly over an industry. The act also prevented price discrimination, such as cutting prices in a particular area with the purpose of eliminating competitors, or favoring one purchaser over another in terms of pricing of goods of like grade and quality.

The act states, “It shall be unlawful for any person engaged in commerce, in the course of such commerce, either directly or indirectly, to discriminate in price between different purchasers of commodities of like grade and quality.”

The Clayton Act also defended labor unions which were coming under attack by corporations since the Sherman Act. Corporations interpreted the Sherman Act to mean that labor unions were “in restraint of trade” and therefore in violation of the Sherman Act. The Supreme Court supported this interpretation in a 1908 ruling. The Clayton Act set the record straight and declared that labor unions were exempt from prosecution under the Sherman Act. According to the Clayton Act, “Nothing contained in the antitrust laws shall be construed to forbid the existence and operation of labor (unions).”
**Robinson-Patman Act-1936**

The Robinson-Patman Act strengthened the laws against price discrimination set forth in the Clayton Act. The Robinson-Patman Act covers *interstate commerce* and prevents companies from charging different prices to purchasers in an effort to injure or eliminate competition. **Buyers** can also be found liable for price discrimination by inducing sellers to grant price discounts. By preventing price discrimination, the act helps to protect small businesses which may not receive the same discounts for similar quantities as larger competitors. For instance, if a cereal-producing company offered discounts for 100,000 units to certain grocery store chains but not independent ones, then it could be in violation of the Robinson-Patman Act. If the court finds that the independent stores are directly injured by this price discrimination, the cereal company could face fines.

The Robinson-Patman Act states, “It shall be unlawful for any person engaged in commerce (in the United States), in the course of such commerce, either directly or indirectly, to **discriminate in price** between different purchasers of commodities of **like grade and quality**…where the effect of such discrimination may be substantially to lessen competition or tend to create a monopoly in any line of commerce, or to **injure, destroy, or prevent competition** with any person who either grants or knowingly receives the benefit of such discrimination, or with customers of either of them.”

**Note:** The U.S. Department of Justice, a state attorney general (when authorized by a state antitrust law), a private party (such as a competitor) and the **Federal Trade Commission** (FTC) are examples of agencies or individuals who can bring antitrust suits. The Federal Trade Commission was created in 1914 to ensure that markets operate fairly.

**Note:** Examples of those exempt from Federal Antitrust Laws are patents, copyrights, labor unions, professional baseball and intrastate commerce.

**Celler-Kefauver Antimerger Act-1950**

This act was an amendment to the Clayton Antitrust Act that prohibited companies from buying a competitor’s assets if the effect was to reduce competition. This act served to strengthen laws which prevented corporations from forming monopolies.


This antitrust regulatory act gives federal agencies time to review acquisitions and mergers. The standard time period is 30 days for review, but the FTC can request additional time should it deem necessary. Should a company seek to acquire another valued at more than 15 million (or 15 percent of stock), they are required to report this plus other pertinent information to antitrust regulatory agencies. Recent changes to the law increased the monetary amount to **50 million** to account for inflation.

**Example:** Barnes and Noble, Inc. recently announced a purchase of the Ingram Book Company (a book distributor). As required under the **Hart-Scott-Rodino Act**, the merger was filed with the **Federal Trade Commission** for review. A number of booksellers protested this **vertical merger** and the FTC requested additional time to review the situation. Ultimately, the FTC ruled that the merger would be in violation of antitrust laws and the acquisition was halted. In the FTC’s opinion, the merger would have significantly hurt the competition in the bookselling industry.
Chapter Eleven
Securities Acts and Antitrust Regulation
Multiple Choice Questions

1. Under the Securities Exchange Act of 1934, which of the following types of instruments is excluded from the definition of "securities"?
   a. Investment contracts.
   b. Convertible debentures.
   c. Nonconvertible debentures.
   d. Certificates of deposit.

2. Which of the following is least likely to be considered a security under the Securities Act of 1933?
   a. Stock options.
   b. Warrants.
   c. General partnership interests.
   d. Limited partnership interests.

3. Under the registration requirements of the Securities Act of 1933, which of the following items is(are) considered securities?

<table>
<thead>
<tr>
<th>Investment contracts</th>
<th>Collateral-trust certificates</th>
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<tbody>
<tr>
<td>Yes</td>
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<td>Yes</td>
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<td>No</td>
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4. Under the Securities Exchange Act of 1934, a corporation with common stock listed on a national stock exchange
   a. Is prohibited from making private placement offerings.
   b. Is subject to having the registration of its securities suspended or revoked.
   c. Must submit Form 10-K to the SEC except in those years in which the corporation has made a public offering.
   d. Must distribute copies of Form 10-K to its stockholders.

5. Under the Securities Exchange Act of 1934, the SEC is responsible for all of the following activities except
   a. Requiring disclosure of facts concerning offerings of securities listed on national securities exchanges.
   b. Prosecuting criminal violations of federal securities laws.
   c. Regulating the activities of securities brokers.
   d. Investigating securities fraud.

6. If securities are exempt from the registration provisions of the Securities Act of 1933, any fraud committed in the course of selling such securities can be challenged by

<table>
<thead>
<tr>
<th>SEC</th>
<th>Person defrauded</th>
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<tr>
<td>Yes</td>
<td>Yes</td>
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<td>Yes</td>
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7. Universal Corp. intends to sell its common stock to the public in an interstate offering that will be registered under the Securities Act of 1933. Under the Act,
   a. Universal can make offers to sell its stock before filing a registration statement, provided that it does not actually issue stock certificates until after the registration is effective.
   b. Universal’s registration statement becomes effective at the time it is filed, assuming the SEC does not object within 20 days thereafter.
   c. A prospectus must be delivered to each purchaser of Universal’s common stock unless the purchaser qualifies as an accredited investor.
   d. Universal’s filing of a registration statement with the SEC does not automatically result in compliance with the "blue-sky" laws of the states in which the offering will be made.

8. A plaintiff wishes to recover damages from the issuer for losses resulting from material misstatements in a securities registration statement. In order to be successful, one of the elements the plaintiff must prove is that the
   a. Plaintiff was in privity of contract with the issuer or that the issuer knew of the plaintiff.
   b. Plaintiff acquired the securities.
   c. Issuer acted negligently.
   d. Issuer acted fraudulently.

9. One of the elements necessary to recover damages if there has been a material misstatement in a registration statement filed under the Securities Act of 1933 is that the
   a. Issuer and plaintiff were in privity of contract with each other.
   b. Issuer failed to exercise due care in connection with the sale of the securities.
   c. Plaintiff gave value for the security.
   d. Plaintiff suffered a loss.
10. The registration of a security under the Securities Act of 1933 provides an investor with
a. A guarantee by the SEC that the facts contained in the registration statement are accurate.
b. An assurance against loss resulting from purchasing the security.
c. Information on the principal purposes for which the offering’s proceeds will be used.
d. Information on the issuing corporation’s trade secrets.

11. Under the Securities Act of 1933, an initial offering of securities must be registered with the SEC, unless
a. The offering is made through a broker-dealer licensed in the states in which the securities are to be sold.
b. The offering prospectus makes a fair and full disclosure of all risks associated with purchasing the securities.
c. The issuer’s financial condition meets certain standards established by the SEC.
d. The type of security or the offering involved is exempt from registration.

12. Dee is the owner of 12% of the shares of common stock of D & M Corporation which she acquired in 1975. She is the treasurer and a director of D & M. The corporation registered its securities in 1984 and made a public offering pursuant to the Securities Act of 1933. If Dee decides to sell part of her holdings in D & M, the shares
a. Would be exempt from registration since the corporation previously registered them within three years.
b. Must be registered regardless of the amount sold or manner in which they are sold.
c. Would be exempt from registration because she is not an issuer.
d. Must be registered if Dee sells 50% of her shares through her broker to the public.

13. Which of the following facts will result in an offering of securities being exempt from registration under the Securities Act of 1933?
   a. The securities are nonvoting preferred stock.
   b. The issuing corporation was closely held prior to the offering.
   c. The sale or offer to sell the securities is made by a person other than an issuer, underwriter, or dealer.
   d. The securities are AAA-rated debentures that are collateralized by first mortgages on property that has a market value of 200% of the offering price.

Items 14 and 15 are based on the following:
World Corp. wanted to make a public offering of its common stock. On May 10, World prepared and filed a registration statement with the SEC. On May 20, World placed a "tombstone ad" announcing that it was making a public offering. On May 25, World issued a preliminary prospectus and the registration statement became effective on May 30.

14. On what date may World first make oral offers to sell the shares?
   a. May 10.
   b. May 20.
   c. May 25.
   d. May 30.

15. On what date may World first sell the shares?
   a. May 10.
   b. May 20.
   c. May 25.
   d. May 30.

16. A preliminary prospectus, permitted under SEC Regulations, is known as the
   a. Unaudited prospectus.
   b. Qualified prospectus.
   c. "Blue-sky" prospectus.
   d. "Red-herring" prospectus.

17. A tombstone advertisement
   a. May be substituted for the prospectus under certain circumstances.
   b. May contain an offer to sell securities.
   c. Notifies prospective investors that a previously-offered security has been withdrawn from the market and is therefore effectively "dead".
   d. Makes known the availability of a prospectus.

18. Which of the following statements concerning the prospectus required by the Securities Act of 1933 is correct?
   a. The prospectus is a part of the registration statement.
   b. The prospectus should enable the SEC to pass on the merits of the securities.
   c. The prospectus must be filed after an offer to sell.
   d. The prospectus is prohibited from being distributed to the public until the SEC approves the accuracy of the facts embodied therein.
19. Under the Securities Act of 1933, which of the following statements most accurately reflects how securities registration affects an investor?
   a. The investor is provided with information on the stockholders of the offering corporation.
   b. The investor is provided with information on the principal purposes for which the offering’s proceeds will be used.
   c. The investor is guaranteed by the SEC that the facts contained in the registration statement are accurate.
   d. The investor is assured by the SEC against loss resulting from purchasing the security.

20. Which of the following requirements must be met by an issuer of securities who wants to make an offering by using shelf registration?

<table>
<thead>
<tr>
<th>Original registration statement must be kept updated</th>
<th>The offeror must be a first-time issuer of securities</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>b. Yes</td>
<td>No</td>
</tr>
<tr>
<td>c. No</td>
<td>Yes</td>
</tr>
<tr>
<td>d. No</td>
<td>No</td>
</tr>
</tbody>
</table>

21. Which of the following transactions will be exempt from the full registration requirements of the Securities Act of 1933?
   a. All intrastate offerings.
   b. All offerings made under Regulation A.
   c. Any resale of a security purchased under a Regulation D offering.
   d. Any stockbroker transaction.

22. Which of the following statements concerning an initial intrastate securities offering made by an issuer residing in and doing business in that state is correct?
   a. The offering would be exempt from the registration requirements of the Securities Act of 1933.
   b. The offering would be subject to the registration requirements of the Securities Exchange Act of 1934.
   c. The offering would be regulated by the SEC.
   d. The shares of the offering could not be resold to investors outside the state for at least one year.

23. In order to raise $375,000, Penn Corp. is offering its securities under Rule 504 of Regulation D of the Securities Act of 1933. Under Rule 504, the offering:
   a. Must be sold to accredited investors.
   b. Can not be sold to more than 35 non-accredited investors.
   c. Can be sold to an unlimited number of accredited and non-accredited investors.
   d. Will not subject the issuer to the antifraud provisions of the Securities Act of 1933.

24. Data, Inc. intends to make a $375,000 common stock offering under Rule 504 of Regulation D of the Securities Act of 1933. Data:
   a. May sell the stock to an unlimited number of investors.
   b. May not make the offering through a general advertising.
   c. Must offer the stock for a period of more than 12 months.
   d. Must provide all investors with a prospectus.

25. Regulation D of the Securities Act of 1933:
   a. Restricts the number of purchasers of an offering to 35.
   b. Permits an exempt offering to be sold to both accredited and non-accredited investors.
   c. Is limited to offers and sales of common stock that do not exceed $1.5 million.
   d. Is exclusively available to small business corporations as defined by Regulation D.

Items 26 and 27 are based on the following:

Pix Corp. is making a $6,000,000 stock offering. Pix wants the offering exempt from registration under the Securities Act of 1933.

26. Which of the following provisions of the Act would Pix have to comply with for the offering to be exempt?
   a. Regulation A.
   b. Regulation D, Rule 504.
   c. Regulation D, Rule 505.
   d. Regulation D, Rule 506.

27. Which of the following requirements would Pix have to comply with when selling the securities?
   a. No more than 35 investors.
   b. No more than 35 non-accredited investors.
   c. Accredited investors only.
   d. Non-accredited investors only.
28. Frey, Inc. intends to make a $2,000,000 common stock offering under Rule 505 of Regulation D of the Securities Act of 1933. Frey
a. May sell the stock to an unlimited number of investors.
b. May make the offering through a general advertising.
c. Must notify the SEC within 15 days after the first sale of the offering.
d. Must provide all investors with a prospectus.

29. Under Regulation D of the Securities Act of 1933, which of the following conditions apply to private placement offerings? The securities
a. Cannot be sold for longer than a six month period.
b. Cannot be the subject of an immediate unregistered reoffering to the public.
c. Must be sold to accredited institutional investors.
d. Must be sold to fewer than 20 nonaccredited investors.

30. For an offering to be exempt under Regulation D of the Securities Act of 1933, Rules 505 and 506 each require that
a. The SEC will be notified within 10 days of the first sale.
b. The offering be made without general advertising.
c. All accredited investors receive the issuer’s financial information.
d. There be a maximum of 35 investors.

31. An offering made under the provisions of Regulation A of the Securities Act of 1933 requires that the issuer
a. File an offering circular with the SEC.
b. Sell only to accredited investors.
c. Provide investors with the prior four years’ audited financial statements.
d. Provide investors with a proxy registration statement.

32. Which of the following securities is exempt from registration under the Securities Act of 1933?
a. Shares of nonvoting common stock, provided their par value is less than $1.00.
b. A class of stock given in exchange for another class by the issuer to its existing stockholders without the issuer paying a commission.
c. Limited partnership interests sold for the purpose of acquiring funds to invest in bonds issued by the United States.
d. Corporate debentures that were previously subject to an effective registration statement, provided they are convertible into shares of common stock.

33. Which of the following securities is exempt from the registration requirements of the Securities Act of 1933?
a. Common stock with no par value.
b. Warrants to purchase preferred stock.
c. Bonds issued by a charitable foundation.
d. Convertible debentures issued by a corporation.

34. Exemption from registration under the Securities Act of 1933 would be available for
a. Promissory notes maturing in 12 months.
b. Securities of a bank.
c. Limited partnership interests.
d. Corporate bonds.

35. The Securities Act of 1933 provides an exemption from registration for

<table>
<thead>
<tr>
<th>Bonds issued by a municipality for governmental purposes</th>
<th>Securities issued by a not-for-profit charitable organization</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. Yes</td>
<td>Yes</td>
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<tr>
<td>b. Yes</td>
<td>No</td>
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<tr>
<td>c. No</td>
<td>Yes</td>
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<tr>
<td>d. No</td>
<td>No</td>
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</tbody>
</table>

36. Which of the following securities would be regulated by the provisions of the Securities Act of 1933?
a. Securities issued by not-for-profit, charitable organizations.
b. Securities guaranteed by domestic governmental organizations.
c. Securities issued by savings and loan associations.
d. Securities issued by insurance companies.

37. Pace Corp. previously issued 300,000 shares of its common stock. The shares are now actively traded on a national securities exchange. The original offering was exempt from registration under the Securities Act of 1933. Pace has $2,500,000 in assets and 425 shareholders. With regard to the Securities Exchange Act of 1934, Pace is
a. Required to file a registration statement because its assets exceed $2,000,000 in value.
b. Required to file a registration statement even though it has fewer than 500 shareholders.
c. Not required to file a registration statement because the original offering of its stock was exempt from registration.
d. Not required to file a registration statement unless insiders own at least 5% of its outstanding shares of stock.
38. The registration provisions of the Securities Exchange Act of 1934 require disclosure of all of the following information except the
a. Names of owners of at least five (5) percent of any class of nonexempt equity security.
b. Bonus and profit-sharing arrangements.
c. Financial structure and nature of the business.
d. Names of officers and directors.

Items 39 and 40 are based on the following:
Integral Corp. has assets in excess of $4 million, has 350 stockholders, and has issued common and preferred stock. Integral is subject to the reporting provisions of the Securities Exchange Act of 1934. For its 1991 fiscal year, Integral filed the following with the SEC: quarterly reports, an annual report, and a periodic report listing newly appointed officers of the corporation. Integral did not notify the SEC of stockholder "short swing" profits; did not report that a competitor made a tender offer to Integral’s stockholders; and did not report changes in the price of its stock as sold on the New York Stock Exchange.

39. Under SEC reporting requirements, which of the following was Integral required to do?
a. Report the tender offer to the SEC.
b. Notify the SEC of stockholder "short swing" profits.
c. File the periodic report listing newly appointed officers.
d. Report the changes in the market price of its stock.

40. Under the Securities Exchange Act of 1934, Integral must be registered with the SEC because
a. It issues both common and preferred stock.
b. Its shares are listed on a national stock exchange.
c. It has more than 300 stockholders.
d. Its shares are traded in interstate commerce.

41. Which of the following statements is correct concerning corporations subject to the reporting requirements of the Securities Exchange Act of 1934?

42. Adler, Inc. is a reporting company under the Securities Exchange Act of 1934. The only security it has issued is voting common stock. Which of the following statements is correct?
a. Because Adler is a reporting company, it is not required to file a registration statement under the Securities Act of 1933 for any future offerings of its common stock.
b. Adler need not file its proxy statements with the SEC because it has only one class of stock outstanding.
c. Any person who owns more than 10% of Adler’s common stock must file a report with the SEC.
d. It is unnecessary for the required annual report (Form 10K) to include audited financial statements.

43. Which of the following persons is not an insider of a corporation subject to the Securities Exchange Act of 1934 registration and reporting requirements?
a. An attorney for the corporation.
b. An owner of 5% of the corporation’s outstanding debentures.
c. A member of the board of directors.
d. A stockholder who owns 10% of the outstanding common stock.

44. Which of the following factors, by itself, requires a corporation to comply with the reporting requirements of the Securities Exchange Act of 1934?
a. Six hundred employees.
b. Shares listed on a national securities exchange.
c. Total assets of $2 million.
d. Four hundred holders of equity securities.
45. Which of the following events must be reported to the SEC under the reporting provisions of the Securities Exchange Act of 1934?

<table>
<thead>
<tr>
<th>Tender offers</th>
<th>Insider trading</th>
<th>Soliciting proxies</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. Yes</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>b. Yes</td>
<td>Yes</td>
<td>No</td>
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<tr>
<td>c. Yes</td>
<td>No</td>
<td>Yes</td>
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<td>d. No</td>
<td>Yes</td>
<td>Yes</td>
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</table>

46. Under the Securities Act of 1933, which of the following statements is correct concerning a public issuer of securities who has made a registered offering?

a. The issuer is required to distribute an annual report to its stockholders.
b. The issuer is subject to the proxy rules of the SEC.
c. The issuer must file an annual report (Form 10-K) with the SEC.
d. The issuer is not required to file a quarterly report (Form 10-Q) with the SEC, unless a material event occurs.

47. Which of the following situations would require Link to be subject to the reporting provisions of the 1934 Act?

<table>
<thead>
<tr>
<th>Shares listed on a national securities exchange</th>
<th>More than one class of stock</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. Yes</td>
<td>Yes</td>
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<td>b. Yes</td>
<td>No</td>
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<tr>
<td>c. No</td>
<td>Yes</td>
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<tr>
<td>d. No</td>
<td>No</td>
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</table>

48. Which of the following documents must Link file with the SEC?

<table>
<thead>
<tr>
<th>Quarterly reports (Form 10-Q)</th>
<th>Proxy statements</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>b. Yes</td>
<td>No</td>
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<tr>
<td>c. No</td>
<td>Yes</td>
</tr>
<tr>
<td>d. No</td>
<td>No</td>
</tr>
</tbody>
</table>

49. Which of the following reports must also be submitted to the SEC?

<table>
<thead>
<tr>
<th>Report by any party making a tender offer to purchase Link's stock</th>
<th>Report of proxy solicitations by Link stockholders</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. Yes</td>
<td>Yes</td>
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<tr>
<td>b. Yes</td>
<td>No</td>
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<tr>
<td>c. No</td>
<td>Yes</td>
</tr>
<tr>
<td>d. No</td>
<td>No</td>
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50. Wool, Inc., is a reporting company under the Securities Exchange Act of 1934. The only security it has issued is its voting common stock. Which of the following statements is correct?

a. It is unnecessary for the required annual report (Form 10K) to include audited financial statements.
b. Any person who owns more than 5% of Wool’s common stock must file a report with the SEC.
c. Because Wool is a reporting company, it is not required to file a registration statement under the Securities Act of 1933 for any future offerings of its common stock.
d. Wool need not file its proxy statements with the SEC because it has only one class of stock outstanding.

51. The reporting and registration provisions of the Securities Exchange Act of 1934

a. Do not require registration by a corporation if its stock was originally issued under an offering exempt from registration under the Securities Act of 1933.
b. Do not require registration by a corporation unless its stock is listed on a national securities exchange.
c. Require a corporation reporting under the Act to register any offering of its securities under the Securities Act of 1933.
d. Require a corporation reporting under the Act to file its proxy statements with the SEC even if it has only one class of stock outstanding.
52. The antifraud provisions of Rule 10b-5 of the Securities Exchange Act of 1934
a. Apply only if the securities involved were registered under either the Securities Act of 1933 or the Securities Exchange Act of 1934.
b. Require that the plaintiff show negligence on the part of the defendant in misstating facts.
c. Require that the wrongful act must be accomplished through the mail, any other use of interstate commerce, or through a national securities exchange.
d. Apply only if the defendant acted with intent to defraud.

53. Corporations that are exempt from registration under the Securities Exchange Act of 1934 are subject to the Act’s
a. Antifraud provisions.
b. Proxy solicitation provisions.
c. Provisions dealing with the filing of annual reports.

54. Under the Sarbanes-Oxley Act of 2002, which of the following is not correct?
a. CEOs must certify that their companies’ annual financial statements are accurate and not misleading.
b. CFOs must certify that their company has an effective internal control system.
c. CEOs have to disclose all instances of fraud (even if immaterial) to their auditors.
d. CEOs and CFOs can still receive personal loans from their companies as long as the audit committee of the Board of Directors approves of them.

55. Which of the following penalties cannot be imposed by the SEC under the Sarbanes-Oxley Act?
a. Officers can be fined up to $1,000,000 and/or 10 years in jail for a “defective certification” of their company’s financial statements.
b. The SEC can freeze payments to officers and directors during an investigation of wrongdoing.
c. CEOs and CFOs may be forced to forfeit profits from stock sales in their company stock if their financial statements are false and must be restated.
d. Officers will be forced to resign by the SEC for certifying financial statements with immaterial errors.

56. Under the Sarbanes-Oxley Act of 2002, which of the following is not required of accountants preparing annual reports of public companies?
a. Auditor must include an assessment of management’s evaluation of its internal controls.
b. Auditor must evaluate management’s internal controls.
c. Auditor must perform an analysis of how the company’s internal controls compare to the controls of similarly situated companies.
d. Auditor must report on the company’s financial reporting procedures.

57. Which of the following requirements are not imposed by the Sarbanes-Oxley Act on public companies?
a. Reports of insider trading of the company’s securities must be made within one day.
b. Reports of insider trading must be posted on the company’s internet site, if it has one.
c. Reports of insider trading must be made electronically.
d. If reports of insider trading reveal that a company’s recent financial statements misstated material facts, the company must issue a supplemental financial report.

58. In order to comply with the Sarbanes-Oxley Act of 2002, which of the following are required of financial statements made by public companies? 1) they must include all material off-balance sheet liabilities and transactions; 2) they must not omit any material information; 3) they must be certified by the company’s CEO and CFO.
a. 2 and 3 but not 1.
b. 1 and 3 but not 2.
c. 3 but not 1 or 2.
d. 1, 2 and 3.

59. Which of the following is not true about presentation of “pro forma” financial information under the Sarbanes-Oxley Act?
a. The information must be technically accurate.
b. The information must not be misleading through omission of material facts.
c. The information must be prepared in accordance with GAAP.
d. The information must be reconciled with company financial statements.
60. The Sherman Antitrust Act
a. created the Securities and Exchange Commission.
b. declared illegal attempts at restraint of trade.
c. created the Federal Trade Commission.
d. protects workers from unfair labor practices.

61. Which one of the following transactions would be considered a violation of the Robinson-Patman Act?
a. The sale of goods of like quality at different prices to two different wholesalers, both of whom are located outside the United States.
b. The sale of goods of like quality within the United States at different prices based on cost differences related to the method of delivery.
c. The sale of goods of like quality within the United States at different prices to two different wholesalers: all parties are located within the same state.
d. The sale of goods of like quality within the United States but across state lines at different prices to two different wholesalers in the same geographic area.

62. Which one of the following is not exempted from federal antitrust regulation?
a. Labor unions and professional baseball
b. Intrastate commerce.
c. Patents and copyrights.
d. Telecommunications companies.

63. Labor Unions were subject to prosecution under the Sherman Antitrust Act. Which subsequent act protected labor unions from antitrust regulations?
a. The Robinson Patman Act
b. Taft-Hartley Act
c. The Clayton Antitrust Act
d. The Occupational Safety and Health Act

64. Which one of the following antitrust laws prohibits price discrimination and other exclusionary practices that may put certain firms at a competitive advantage over other firms in the same market?
c. Sherman Act.
d. Robinson-Patman Act.

65. The Clayton Act of 1914 prohibits
a. closed-shop labor unions.
b. sellers’ price discrimination.
c. group boycotts.
d. oligopolies.

66. The acquisition of a retail shoe store by a shoe manufacturer is an example of
a. vertical integration.
b. a conglomerate.
c. market extension.
d. product extension.

67. The Sherman Antitrust Act of 1890 prohibits
a. price discrimination, tying contracts, anti-competitive mergers, and interlocking directorates.
b. unfair competition and deceptive business practices.
c. mergers without prior notification to the Justice Department
d. restraint of trade and monopoly.

68. The Antitrust Improvement Act of 1976 (the Hart-Scott-Rodino Act)
a. requires pre-approval from the Federal Trade Commission for interlocking directorates.
b. prohibits price discrimination.
c. requires notification prior to a merger.
d. prohibits state suits on behalf of consumers against price fixing.
Chapter Eleven
Securities Acts and Antitrust Regulation
Other Objective Questions

NUMBER 1

Number 1 is based on the following information. Questions Number 1 consists of Items 1 through 15.

Butler Manufacturing Corp. planned to raise capital for a plant expansion by borrowing from banks and making several stock offerings. Butler engaged Weaver, CPA, to audit its December 31, 1989, financial statements. Butler told Weaver that the financial statements would be given to certain named banks and included in the prospectuses for the stock offerings.

In performing the audit, Weaver did not confirm accounts receivable and, as a result, failed to discover a material overstatement of accounts receivable. Also, Weaver was aware of a pending class action product liability lawsuit that was not disclosed in Butler’s financial statements. Despite being advised by Butler’s legal counsel that Butler’s potential liability under the lawsuit would result in material losses, Weaver issued an unqualified opinion on Butler’s financial statements.

In May 1990, Union Bank, one of the named banks, relied on the financial statements and Weaver’s opinion in giving Butler a $500,000 loan.

Butler raised an additional $16,450,000 through the following stock offerings, which were sold completely:

- June 1990 – Butler made a $450,000 unregistered offering of Class B nonvoting common stock under Rule 504 of Regulation D of the Securities Act of 1933. This offering was sold over two years to 30 nonaccredited investors and 20 accredited investors by general solicitation. The SEC was notified eight days after the first sale of this offering.

- September 1990 – Butler made a $10,000,000 unregistered offering of Class A voting common stock under Rule 506 of Regulation D of the Securities Act of 1933. This offering was sold over two years to 200 accredited investors and 30 nonaccredited investors through a private placement. The SEC was notified 14 days after the first sale of this offering.

- November 1990 – Butler made a $6,000,000 unregistered offering of preferred stock under Rule 505 of Regulation D of the Securities Act of 1933. This offering was sold during a one-year period to 40 nonaccredited investors by private placement. The SEC was notified 18 days after the first sale of this offering.

Shortly after obtaining the Union loan, Butler began experiencing financial problems but was able to stay in business because of the money raised by the offerings. Butler was found liable in the product liability suit. This resulted in a judgment Butler could not pay. Butler also defaulted on the Union loan and was involuntarily petitioned into bankruptcy. This caused Union to sustain a loss and Butler’s stockholders to lose their investments.

As a result:

- The SEC claimed that all three of Butler’s offerings were made improperly and were not exempt from registration.
Number 1 consists of 15 items. Select the best answer for each item.

Required:

a. Items 1 through 5 are questions related to the June 1990 offering made under Rule 504 of Regulation D of the Securities Act of 1933. For each item, answer (Y) or (N).

1. Did the offering comply with the dollar limitation of Rule 504?
2. Did the offering comply with the method of sale restrictions?
3. Was the offering sold during the applicable time limit?
4. Was the SEC notified timely of the first sale of the securities?
5. Was the SEC correct in claiming that this offering was not exempt from registration?

b. Items 6 through 10 are questions related to the September 1990 offering made under Rule 506 of Regulation D of the Securities Act of 1933. For each item, answer (Y) or (N).

6. Did the offering comply with the dollar limitation of Rule 506?
7. Did the offering comply with the method of sale restrictions?
8. Was the offering sold to the correct number of investors?
9. Was the SEC notified timely of the first sale of the securities?
10. Was the SEC correct in claiming that this offering was not exempt from registration?

c. Items 11 through 15 are questions related to the November 1990 offering made under Rule 505 of Regulation D of the Securities Act of 1933. For each item, answer (Y) or (N).

11. Did the offering comply with the dollar limitation of Rule 505?
12. Was the offering sold during the applicable time limit?
13. Was the offering sold to the correct number of investors?
14. Was the SEC notified timely of the first sale of the securities?
15. Was the SEC correct in claiming that this offering was not exempt from registration?

NUMBER 2

Items 1 through 5 are based on the following:

Coffee Corp., a publicly-held corporation, wants to make an $8,000,000 exempt offering of its shares as a private placement offering under Regulation D, Rule 506, of the Securities Act of 1933. Coffee has more than 500 shareholders and assets in excess of $1 billion, and has its shares listed on a national exchange.

Required:

Items 1 through 5 relate to the application of the provisions of the Securities Act of 1933 and the Securities Exchange Act of 1934 to Coffee Corp. and the offering. For each item, select from List I whether only statement I is correct, whether only statement II is correct, whether both statements I and II are correct, or whether neither statement I nor II is correct.

<table>
<thead>
<tr>
<th>List I</th>
</tr>
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<tbody>
<tr>
<td>a. I only.</td>
</tr>
<tr>
<td>b. II only.</td>
</tr>
<tr>
<td>c. Both I and II.</td>
</tr>
<tr>
<td>d. Neither I nor II.</td>
</tr>
</tbody>
</table>
1. I. Coffee Corp. may make the Regulation D, Rule 506, exempt offering.
   II. Coffee Corp., because it is required to report under the Securities Exchange Act of 1934, may not make an exempt offering.

2. I. Shares sold under a Regulation D, Rule 506, exempt offering may only be purchased by accredited investors.
   II. Shares sold under a Regulation D, Rule 506, exempt offering may be purchased by any number of investors provided there are no more than 35 non-accredited investors.

3. I. An exempt offering under Regulation D, Rule 506, must not be for more than $10,000,000.
   II. An exempt offering under Regulation D, Rule 506, has no dollar limit.

4. I. Regulation D, Rule 506, requires that all investors in the exempt offering be notified that for nine months after the last sale no resale may be made to a nonresident.
   II. Regulation D, Rule 506, requires that the issuer exercise reasonable care to assure that purchasers of the exempt offering are buying for investment and are not underwriters.

5. I. The SEC must be notified by Coffee Corp. within 5 days of the first sale of the exempt offering securities.
   II. Coffee Corp. must include an SEC notification of the Exempt offering securities in Coffee’s next filed Quarterly Report (Form 10-Q).

**NUMBER 3**

One of your firm’s clients, Fancy Fashions, Inc., is a highly successful, rapidly expanding company. The company is owned predominantly by the Munn family and key corporate officers. Although additional funds would be available on a short-term basis from its bankers, this would only represent a short-term solution to the company’s need for capital to fund its expansion plans. In addition, the interest rates being charged are not appealing. Therefore, John Munn, Fancy’s chairman of the board, in consultation with the other shareholders, has decided to explore raising additional equity capital of approximately $4.5 to $5 million which will provide the funds necessary to continue the growth and expansion of the company. This will be Fancy’s first offering to persons other than the Munn family and key management personnel.

At a meeting of Fancy’s major shareholders, its attorneys and a CPA from your firm, the advantages and disadvantages of “going public” and registering an offering of its stock were discussed. One of the participants suggested that Regulation D under the Securities Act of 1933 might be a preferable alternative.

**Required:** Answer the following, setting forth reasons for any conclusions stated.

a. What are the elements or factors which will determine whether Fancy’s offering is required to be registered pursuant to the provisions of the Securities Act of 1933?

b. Assume there is a public offering for $5 million and, as a result, more than 500 persons own shares of Fancy. What implications, if any, will these facts have in respect to the Securities Exchange Act of 1934?

c. What federal civil and criminal liabilities may apply in the event that Fancy sells the securities without a registration and an exemption to registration is not available?

d. Discuss the exemption applicable to offerings of up to $5 million (under Rule 505 of Regulation D) in terms of:
   1. What are the two kinds of and the number of investors who may participate?
   2. Are audited financial statements required?
   3. What restrictions apply to the manner or way the securities may be sold?
NUMBER 4

Perry, a staff accountant with Orleans Associates, CPAs, reviewed the following transactions engaged in by Orlean’s two clients: World Corp. and Unity Corp.

WORLD CORP.
During 1994, World Corp. made a $4,000,000 offering of its stock. The offering was sold to 50 nonaccredited investors and 150 accredited investors. There was a general advertising of the offering. All purchasers were provided with material information concerning World Corp. The offering was completely sold by the end of 1994. The SEC was notified 30 days after the first sale of the offering.

World did not register the offering and contends that the offering and any subsequent resale of the securities are completely exempt from registration under Regulation D, Rule 505, of the Securities Act of 1933.

UNITY CORP.
Unity Corp. has 750 equity stockholders and assets in excess of $100,000,000. Unity’s stock is traded on a national stock exchange. Unity contends that it is not a covered corporation and is not required to comply with the reporting provisions of the Securities Exchange Act of 1934.

Required:
a. 1. State whether World is correct in its contention that the offering is exempt from registration under Regulation D, Rule 505, of the Securities Act of 1933. Give the reason(s) for your conclusion.
   2. State whether World is correct in its contention that on subsequent resale the securities are completely exempt from registration. Give the reason(s) for your conclusion.

b. 1. State whether Unity is correct in its contention that it is not a covered corporation and is not required to comply with the reporting requirements of the Securities Exchange Act of 1934 and give the reason(s) for your conclusion.
   2. Identify and describe two principal reports a covered corporation must file with the SEC.
Chapter Eleven
Securities Acts and Antitrust Regulation
Multiple Choice Answers

1. (d) Under the Securities Exchange Act of 1934 securities are broadly interpreted to include almost any type of multi-state investment contract. They include stocks, bonds, warrants, stock options, debentures, collateral-trust certificates, investment contracts and limited partnership interests. They do not include general partnership interests or certificates of deposit. Thus, certificates of deposit are specifically excluded from the definition of securities. Answers (a), (b) and (c) are incorrect because investment contracts and debentures are considered to be securities.

2. (c) Under the Securities Act of 1933 securities are broadly interpreted to include almost any type of multi-state investment contract. They include stocks, bonds, warrants, stock options, debentures, collateral-trust certificates, investment contracts and limited partnership interests. They do not include general partnership interests or certificates of deposit. Thus, general partnership interests are not considered to be securities. Answers (a), (b) and (d) are incorrect because stock options, warrants and limited partnership interests are considered to be securities.

3. (a) Under the Securities Act of 1933, securities are broadly interpreted and include almost any type of multi-state investment contract. They include stocks, bonds, warrants, stock options, debentures, collateral-trust certificates, investment contracts and limited partnership interests. Thus, both investment contracts and collateral-trust certificates are considered securities. Only answer (a) states that both are considered securities.

4. (b) Under the Securities Exchange Act of 1934 the Securities and Exchange Commission (SEC) has the power to suspend or revoke either registration or trading of any corporation’s stock. Thus, the SEC could suspend or revoke the registration of a corporation sold on a national stock exchange. Answer (a) is incorrect because a corporation required to be registered under the 1934 Act may still make a private placement under section 506 of Regulation D of the Securities Act of 1933. Answer (c) is incorrect because Form 10-K must be filed with the SEC every year, not just those years in which no public offering has been made. Answer (d) is incorrect because Form 10-K is filed with the SEC, not distributed to the stockholders.

5. (b) The SEC does not prosecute criminal violations, the Department of Justice does. Answer (a) is incorrect because under the Securities Exchange Act of 1934, reporting companies must file a registration statement with the SEC including the nature of the issuer’s business, its financial structure, the names of officers and directors, the names of stockholders owning 10% or more stock and bonus and profit-sharing arrangements. Since any issuer whose stock is sold on a national stock exchange is a reporting company, '34 does require disclosure of facts concerning offerings of securities listed on national stock exchanges. Answer (c) is incorrect because security brokers must register with the SEC and their activities are regulated. Answer (d) is incorrect because the SEC not only has the power to investigate fraud, they also may suspend or revoke trading or registration for fraud.

6. (a) The Securities and Exchange Commission (SEC) has broad powers to investigate any violations of federal securities law to specifically include fraud. A defrauded party may sue under Section 10b-5 (Antifraud Section) and recover monetary damages by showing they were a purchaser or seller of stock, they suffered a loss, a material misrepresentation of fact, scienter and reliance. Only answer (a) states that both the SEC and the person defrauded may challenge fraud committed in the sale of securities.

7. (d) Each state has laws regulating the issuance and sale of securities. Generically these are called "blue-sky" laws. Thus, a corporation registering under the Securities Act of 1933 must also comply with the "blue-sky" laws of the states in which the offering is made. Answer (a) is incorrect because Universal can only make offers to sell after the filing date. Answer (b) is incorrect because the registration statement becomes effective 20 days after the filing unless the SEC objects. Answer (c) is incorrect because where registration is required, a prospectus must be given to investors even if they are accredited.
8. (b) To recover damages under Section 11 of the Securities Act of 1933, the plaintiff must prove that: (s)he acquired securities subject to registration, suffered a loss and there was a material misrepresentation or omission of fact in the registration statement. Thus, the plaintiff must prove (s)he acquired the securities. Answers (a), (c) and (d) are incorrect because the plaintiff does not need to prove privity, negligence or fraud.

9. (d) To recover damages under Section 11 of the Securities Act of 1933, the plaintiff must prove that: (s)he acquired securities subject to registration, suffered a loss and there was a material misrepresentation or omission of fact in the registration statement. Thus, the plaintiff must prove (s)he suffered a loss. Answers (a), (b) and (c) are incorrect because the plaintiff does not need to prove privity, lack of due care or that (s)he paid value for the security.

10. (c) One of the basic purposes of the Securities Act of 1933 is to provide investors with information, not a guarantee of accuracy or assurance against loss. Specifically the registration statement would contain detailed financial data about the issuer and the securities to include the principal purposes for which the offering proceeds will be used. Answer (a) is incorrect because there is no guarantee of accuracy for the facts contained in the registration statement. Answer (b) is inaccurate because there is no assurance against loss. Answer (d) is inaccurate because an investor is not given information on the corporation’s trade secrets.

11. (d) Under the Securities Act of 1933 a corporation issuing securities must file a registration statement and give a prospectus to investors if: Interstate commerce or the mails were used to make the offering, there was a Public sale, an Issuer, underwriter or dealer made the offering and an Exemption was not available (IPIE). Thus, registration with the SEC is not required if an applicable exemption is available. Answer (a) is incorrect because there is no guarantee of accuracy for the facts contained in the registration statement. Answer (b) is inaccurate because there is no assurance against loss. Answer (d) is inaccurate because neither disclosure of risks nor the issuer’s financial condition will exempt an issuer from a required registration.

12. (d) Registration is required under the Securities Act of 1933 for public sale of securities made by an issuer, underwriter or dealer. However, controlling persons (those with a significant say in management) are counted as issuers and must register if they sell a significant amount of their stock. As an officer, director and 12% owner Dee has a significant say in management and therefore would be required to register as an issuer if 50% of her shares were sold to the public by a broker. Answers (a) and (c) are incorrect because neither disclosure of risks nor the issuer’s financial condition will exempt an issuer from a required registration.

13. (c) Under the Securities Act of 1933 exemptions from registration are available for Intrastate offerings, Regulation D, Regulation A, "No sale" transactions, Casual sales by ordinary investors (anyone not an issuer, underwriter or dealer) and Exempted securities (those issued by banks, governments, common carriers, non-profit groups, insurance policies and short term commercial paper) (I DANCE). Thus a sale of securities by a person other than an issuer, underwriter or dealer would be exempt from registration. Answers (a), (b) and (d) are incorrect because there is no exemption for nonvoting preferred stock, closely held corporations or AAA-rated debentures collateralized by first mortgages on property with a market value of 200% of the offering price.

14. (a) The two main requirements under the Securities Act of 1933 are to file a registration statement with the SEC and give a prospectus to investors for most public sales of securities. Issuers cannot sell the securities until the effective date (usually 20 days after the filing date). However, issuers may make limited written announcements and oral offers to sell on or after the filing date and prior to the effective date. Thus, World may first make oral offers to sell the shares on the filing date, May 10. Only answer (a) so states.

15. (d) The two main requirements under the Securities Act of 1933 are to file a registration statement with the SEC and give a prospectus to investors for most public sales of securities. Issuers cannot sell the securities until the effective date (usually 20 days after the filing date). Thus, World may only sell the shares on May 30, the effective date. Only answer (d) so states.
16. (d) A preliminary prospectus is known as a "red-herring" prospectus. It is called a "red-herring" because the cover page contains in red ink and large, bold print the words "preliminary prospectus" and the information that the registration statement has not yet become effective. Answers (a), (b) and (c) are incorrect because the preliminary prospectus is not known as an unaudited prospectus, a qualified prospectus or a "blue-sky" prospectus.

17. (d) A tombstone advertisement names the security, the price it will be sold at and by whom orders will be executed. It makes known the availability of a prospectus. Answer (a) is incorrect because it makes known the availability of the prospectus. It may not be substituted for the prospectus. Answer (b) is incorrect because it does not contain an offer to sell, although it does make known the name of the party who will execute sales. Answer (c) is incorrect because it does not notify investors that a previously offered security is now "dead".

18. (a) The registration statement filed with the SEC contains a Prospectus. Audited financial statements, Names (of the issuer, directors and underwriters) and detailed financial data about the Securities (PANS). Thus, the prospectus is part of the registration statement. Answers (b) and (d) are incorrect because the SEC does not pass on the merits of the offering or approve the accuracy of the facts contained in the registration statement. Answer (c) is incorrect because an offer to sell may only be made after the registration statement has been filed (containing the prospectus), not the reverse.

19. (b) The registration statement filed with the SEC contains a Prospectus. Audited financial statements, Names (of the issuer, directors and underwriters) and detailed financial data about the Securities to specifically include the principal purposes for which the offering's proceeds will be used (PANS). Answer (a) is incorrect because the registration statement does not provide an investor with information about stockholders. Answers (c) and (d) are incorrect because the SEC does not guarantee the accuracy of the facts contained in the registration statement or provide an assurance against loss.

20. (b) With a shelf registration under the Securities Act of 1933, a registration statement is filed but the issuer is going to delay sale to some future date. The information contained in the original registration must be continually updated. Shelf registration is only available to established issuers who have previously filed under the '34 Act. Only answer (b) states that the information must be updated and the issuer may not be a first time issuer.

21. (b) Under the Securities Act of 1933 exemptions from registration are available for Intrastate offerings, Regulation D, Regulation A, "No sale" transactions, Casual sales by ordinary investors (anyone not an issuer, underwriter or dealer) and Exempted securities (those issued by banks, governments, common carriers, non-profit groups, insurance policies and short term commercial paper) (I DANCE). All Regulation A offerings are exempt from full registration because under all Regulation A offerings the issuer is permitted to file a shorter, simpler and less expensive registration. Answer (a) is incorrect because not all intrastate offerings are exempt. Only intrastate offerings where the issuer does 80% or more of their business in that state and resale is restricted for nine months to residents of that state are exempt. Answer (c) is incorrect because resale is restricted for two years under Rules 505 and 506 of Regulation D. Answer (d) is incorrect because stockbroker transactions are not one of the specified exemptions under the Securities Act of 1933.

22. (a) Under the Securities Act of 1933 exemptions from registration are available for Intrastate offerings, Regulation D, Regulation A, "No sale" transactions, Casual sales by ordinary investors (anyone not an issuer, underwriter or dealer) and Exempted securities (those issued by banks, governments, common carriers, non-profit groups, insurance policies and short term commercial paper) (I DANCE). Thus, an intrastate offering made by an issuer residing in and doing business in that state would be exempt from registration. Answer (b) is incorrect because only reporting companies (those sold on national stock exchanges and those with 500 or more stockholders and $10 million or more in assets) are required to register under the Securities Exchange Act of 1934. There is no indication that there is a reporting company. Answer (c) is incorrect because the offering would be exempt. Answer (d) is incorrect because resale is restricted for nine months to nonresidents, not one year.

23. (c) Under Rule 504 of Regulation D an offering may be made to any type and any number of investors. Thus, the offering can be sold to an unlimited number of accredited and unaccredited investors. Answers (a) and (b) are incorrect because the offering may be sold to an unlimited number of non-accredited investors. Answer (d) is incorrect because the antifraud provisions of the Securities Act of 1933 apply to even an exempt sale of securities.
24. **(a)** Under Rule 504 of Regulation D any offering may be made to any type and any number of investors. Thus, the offering can be sold to an unlimited number of investors. Answer (b) is incorrect because general advertising is permitted under Rule 504 (although it is not permitted under Rule 505 and 506). Answer (c) is incorrect because the stock may not be offered for a period of more than 12 months. Answer (d) is incorrect because a prospectus is only given when registration is required. Rule 504 of Regulation D is an exemption from registration.

25. **(b)** Under Rules 504, 505 and 506 of Regulation D, an exempt offering may be sold to both accredited and nonaccredited investors. Under 504 the offering may be sold to any type and any number of investors. Under 505 and 506 the offering may be sold to 35 or less nonaccredited investors and unlimited accredited investors. Answer (a) is incorrect because the number of purchasers is not restricted to 35. Answer (c) is incorrect because Rule 505 permits sales between $1 and $5 million and Rule 506 permits private placements of unlimited dollar amounts over $5 million. Answer (d) is incorrect because Regulation D is not exclusively available to small business corporations.

26. **(d)** Rule 504 of Regulation D covers offerings of up to $1 million in a 12 month period. Rule 505 covers offerings of between $1 million and $5 million during a 12 month period. **Rule 506 covers offerings of more than $5 million.** Thus, with an offering of $6 million Pix would have to comply with Rule 506 of Regulation D and not Rules 504 or 505. Answer (a) is incorrect because Regulation A is limited to offerings of $5 million or less in a 12 month period.

27. **(b)** Under Rule 506 of Regulation D, offering may be made to an unlimited number of accredited investors, but only 35 or less nonaccredited investors. Answer (a) is incorrect because Pix may sell to more than 35 accredited purchasers. Answers (c) and (d) are incorrect because Pix may sell to both accredited and nonaccredited investors.

28. **(c)** Under Rule 505 of Regulation D (as well as Rules 504 and 506), the SEC must be notified within 15 days of the first sale. Answer (a) is incorrect because 505 only permits sale to an unlimited number of accredited investors. There may only be 35 or less unaccredited investors. Answer (b) is incorrect because general advertising is not permitted under Rule 505 or 506. It is only permitted under Rule 504. Answer (d) is incorrect because a prospectus is only given when registration is required. Rule 505 of Regulation D is an exemption from registration and no prospectus is required.

29. **(b)** A private placement offering is governed by Rule 506 of Regulation D. Rule 506 requires that the issuer insure that investors hold for long term investment (two years or more) and not for resale. Thus securities sold under a private placement cannot be immediately reoffered to the public in an unregistered sale. Answer (a) is incorrect because the offering may be for a period longer than six months. Answers (c) and (d) are incorrect because the securities may be sold to 35 or less nonaccredited investors.

30. **(b)** Rules 505 and 506 of Regulation D do not permit general advertising, although Rule 504 does permit solicitation. Answer (a) is incorrect because the SEC must be notified within 15 days of the first sale, not 10. Answer (c) is incorrect because Rules 505 and 506 only require disclosure of financial information to nonaccredited investors, not accredited investors. Answer (d) is incorrect because Rules 505 and 506 permit an unlimited number of accredited investors. It is only unaccredited investors that must be 35 or less.

31. **(a)** Under Regulation A of the Securities Act of 1933, simplified registration is permitted if the amount of stock to be sold in a 12 month period is $5 million or less. **An offering circular or offering statement is filed with the SEC instead of a prospectus.** Answer (b) is incorrect because there is no restriction on the type or number of investors under Regulation A. Answer (c) is incorrect because there is no requirement to provide the prior four years’ audited financial statements. Answer (d) is incorrect because a proxy registration statement is a requirement of a reporting company under the Securities Exchange Act of 1934 and is not a requirement of Regulation A.
32. (b) Under the Securities Act of 1933 exemptions from registration are available for intrastate offerings, Regulation D, Regulation A, "no sale" transactions, casual sales by ordinary investors (anyone not an issuer, underwriter or dealer) and exempted securities (those issued by banks, governments, common carriers, non-profit groups, insurance policies and short term commercial paper) (I DANCE). An exemption for a "no sale" transaction occurs when an issuer exchanges securities exclusively with existing stockholders without the payment of a commission. Thus an exemption would be available if a class of stock was given in exchange for another class by an issuer to its existing stockholders without paying a commission. Answers (a), (c) and (d) are incorrect because there is no exemption available for nonvoting common stock with a par value of less than $1.00, for limited partnership interests to acquire funds to purchase United States bonds or for previously registered corporate debentures that are convertible into common stock.

33. (c) Under the Securities Act of 1933 certain securities are exempt from registration. These include securities issued by banks (and savings and loans), governments (for a governmental purpose), common carriers, non-profit groups, insurance policies and short term commercial paper (matures in nine months or less). Thus bonds issued by a charitable foundation would be exempt from registration. Answers (a), (b) and (d) are incorrect because there is no exemption available for common stock with no par value, for warrants to purchase preferred stock or for convertible debentures.

34. (b) Under the Securities Act of 1933 certain securities are exempt from registration. These include securities issued by banks (and savings and loans), governments (for a governmental purpose), common carriers, non-profit groups, insurance policies and short term commercial paper (matures in nine months or less). Thus securities of a bank are exempt from registration. Answer (a) is incorrect because only commercial paper maturing in nine months or less is exempt, not twelve months. Answers (c) and (d) are incorrect because there is no exemption for either limited partnership interests or corporate bonds and both are specifically counted as securities.

35. (a) Under the Securities Act of 1933 certain securities are exempt from registration. These include securities issued by banks (and savings and loans), governments (for a governmental purpose), common carriers, non-profit groups, insurance policies and short term commercial paper (matures in nine months or less). Thus bonds issued by a municipality for governmental purposes and securities issued by a not-for-profit charity are exempt. Only answer (a) reflects that both are exempt.

36. (d) Under the Securities Act of 1933 certain securities are exempt from registration. These include securities issued by banks (and savings and loans), governments (for a governmental purpose), common carriers, non-profit groups, insurance policies and short term commercial paper (matures in nine months or less). Answers (a), (b) and (c) are incorrect because securities issued by a not-for-profit charity, securities guaranteed by governmental organizations and securities issued by savings and loans would be exempt. Securities issued by insurance companies are not exempt, although insurance policies and annuity contracts are exempt.

37. (b) Under the Securities Exchange Act of 1934 the securities of reporting companies must be registered. Reporting companies include those with securities sold on a national stock exchange and those with 500 or more shareholders and more than $10 million in assets. Since Pace’s securities are actively traded on a national stock exchange, Pace must file a registration statement even though it has less than 500 shareholders. Answer (a) is incorrect because it is corporations with more than $10 million in assets (and 500 or more shareholders) that must register, not those with assets exceeding $2 million. Answer (c) and (d) are incorrect because Pace is required to file a registration statement.

38. (a) Under the Securities Exchange Act of 1934 the registration statement must include the nature of the reporting company’s business and its financial structure, the different classes of securities of the issuer, the names of its officers and directors, the names of stockholders owning 10% or more stock and any bonus and profit-sharing provisions. The registration statement does not need to include the names of owners of at least 5% of any class of nonexempt equity security. Thus, only answer (a) is correct.
39. (c) Reporting companies under the Securities Exchange Act of 1934 are required to file current reports to specifically include reports on newly appointed officers. Answer (a) is incorrect because only the competitor making the tender offer must report to the SEC, not Integral. Answer (b) is incorrect because the stockholders making the "short swing" profits must report to the SEC, not Integral. Answer (d) is incorrect because there is no requirement to report the market price of stock to the SEC.

40. (b) Under the Securities Exchange Act of 1934 the securities of reporting companies must be registered. Reporting companies include those with securities sold on a national stock exchange or those with 500 or more shareholders and more than $10 million in assets. Integral must be registered with the SEC because Integral’s stock is sold on the New York Stock Exchange. Answers (a), (c) and (d) are incorrect because only those corporations with securities sold on national exchanges or those with 500 or more shareholders and more than $10 million in assets must register with the SEC.

41. (d) Form 8-K must be filed with the SEC within 5 to 15 days of the close of the month in which certain materially important events occur. Answer (a) is incorrect because the annual report (form 10-K) must include audited financial statements. Answer (b) is incorrect because the annual report is filed with the SEC within 90 days of the end of the fiscal year. Answer (c) is incorrect because a quarterly report (form 10-Q) must be filed by all reporting companies, regardless of whether they are registered under the Securities Act of 1933.

42. (c) Any 5% or more owner of a reporting company’s stock must file background information with the SEC and the issuer to include information about the purchaser, the source of their money and their purpose in purchasing. Answer (a) is incorrect because there is no exemption available under the Securities Act of 1933 for reporting companies. Answer (b) is incorrect because all reporting companies must file proxy statements with the SEC. Answer (d) is incorrect because the annual report (form 10-K) must include audited financial statements.

43. (b) Under the insider trading provisions of the Securities Exchange Act of 1934 all stock sales and purchases of a reporting company’s stock by an officer, director, 10% or more owner, accountants and attorneys of the reporting company must be reported to the SEC. Thus, the owner of 5% of a corporation’s outstanding debentures would not be an insider. Answers (a), (c) and (d) are incorrect because an attorney, a director and a 10% owner are insiders.

44. (b) Under the Securities Exchange Act of 1934 reporting companies must comply with the reporting provisions. Reporting companies include those with securities sold on a national stock exchange or those with 500 or more shareholders and more than $10 million in assets. Thus, having shares listed on a national stock exchange would require a corporation to comply with the reporting requirements of the Securities Exchange Act of 1934. Answers (a), (c) and (d) are incorrect because 600 employees, assets of $2 million or 400 holders of equity securities would not make a corporation a reporting company.

45. (a) Tender offers, insider trading and solicitation of proxies must all be reported to the SEC under the reporting provisions of the Securities Exchange Act of 1934. The only answer that reflects that all three must be reported is (a).

46. (c) Periodic reports (10-K, 10-Q and 8-K) must be filed with the SEC by 2 different types of issuers: reporting companies (those sold on national stock exchanges and those with 500 or more stockholders and more than $10 million in assets) and issuers who have made a registered offering under ‘33. Thus a corporation registered under the 1933 Act must file an annual report (form 10-K) with the SEC. Answer (a) is incorrect because form 10-K is filed with the SEC, not given to the stockholders. Answer (b) is incorrect because an issuer registered under the 1933 Act is not required to report proxy solicitations, that is a requirement of reporting companies under ‘34. Answer (d) is incorrect because form 10-Q is reported quarterly and does not depend upon the occurrence of a specified material event. Form 8-K is required to be filed upon the occurrence of a specified material event.

47. (b) Under the Securities Exchange Act of 1934 reporting companies are subject to the reporting provisions. Reporting companies include those with securities sold on a national stock exchange or those with 500 or more shareholders and more than $10 million in assets. Shares listed on a national stock exchange would subject Link to the reporting provisions of the 1934 Act, but not the fact that Link had more than one class of stock. Thus only answer (b) is correct.
48. (a) Reporting companies under the Securities Exchange Act of 1934 must file both quarterly reports (form 10-Q) and proxy statements with the SEC. Thus only answer (a) is correct.

49. (a) Under the Securities Exchange Act of 1934, there must be submitted to the SEC a report by any party making a tender offer to purchase a reporting company’s stock and a report of proxy solicitations by shareholders of reporting companies. Thus only answer (a) is correct.

50. (b) Under the reporting provisions of the Securities Exchange Act of 1934, any 5% or more owner of a reporting company’s stock must file background information with the SEC to include information about the purchaser, the source of their money and their purpose in purchasing. Since Wool is a reporting company, any 5% or more owner must file this information with the SEC. Answers (a) and (d) are incorrect because reporting companies must file both annual reports (form 10-K) with audited financial statements and must file proxy statements with the SEC. Answer (c) is incorrect because there is no exemption from registration under the Securities Act of 1933 for reporting companies.

51. (d) Under the Securities Exchange Act of 1934, a reporting company is required to file its proxy statements with the SEC regardless of the number of classes of stock it may have. Answer (a) is incorrect because registration is required of issuers with securities sold on a national stock exchange or those with 500 or more shareholders and more than $10 million in assets, even if they were exempt from registration under the Securities Act of 1933. Answer (b) is incorrect because those with 500 or more shareholders and more than $10 million in assets are required to register even if the shares are not sold on a national stock exchange. Answer (c) is incorrect because being a reporting company does not automatically require registration under the Securities Act of 1933.

52. (c) Rule 10b-5 of the Securities Exchange Act of 1934 applies to anyone who buys or sells stock even if exempt from registration as long as the wrongful act was accomplished through the mail, any other use of interstate commerce, or through a national securities exchange. Answer (a) is incorrect because registration under either the 1933 Act or the 1934 Act is not required for Rule 10b-5 to apply. Answer (b) is incorrect because a showing of negligence is insufficient. The plaintiff must prove an intent to deceive or a reckless disregard for the truth on the part of the defendant. Answer (d) is incorrect because a showing of a reckless disregard for the truth would be sufficient to subject a party to liability. A showing of an intent to defraud (scienter) would not be required in this case.

53. (a) The Antifraud provision of the Securities Exchange Act of 1934 applies to anyone who buys or sells stock even if exempt from registration as long as the wrongful act was accomplished through the mail, any other use of interstate commerce, or through a national securities exchange. Answers (b), (c) and (d) are incorrect because proxy solicitation provisions, annual reports and periodic audits apply only to reporting companies and would not apply to corporations that were exempt from registration.

54. (d) The Sarbanes-Oxley Act disallows personal loans to company officers or directors. The Act does impose a number of certification requirements on the CEO and CFO of a public company as noted in answers (a), (b), and (c).

55. (d) The Sarbanes-Oxley Act of 2002 does not require officers to resign for immaterial errors, although the SEC does have authority to force company officers to resign in instances of material errors in financial reports they certify.

56. (c) The Sarbanes-Oxley Act of 2002 does not require a comparison of a company’s internal controls with other companies within annual reports; however, (a) (b) and (d) are correct because the Act does impose on accountants who audit the annual reports of public companies the responsibilities to evaluate both a company’s internal controls and its own assessment of those controls, as well as an assessment of the company’s financial reporting procedures.

57. (a) Under Sarbanes-Oxley, reports of insider trading of a company’s securities must be made within two days. Thus, (a) is not true because it supposes that companies have a responsibility to report within a smaller time period. (b) and (c) are both true because they are required by SOX as ways to speed up public notification of insider
trading. (d) is true because companies are required to supplement financial reports that contain untruths or omit material facts.

58. (d) Answer (d) is correct because under the Sarbanes-Oxley Act of 2002, financial statements made by public companies (1) must include all material off-balance sheet transactions; (2) must be accurate, without untruths and without omission of material facts; and (3) must be certified by the company’s CEO and CFO.

59. (c) “Pro forma” financial information is financial information not prepared in accordance with GAAP. Thus, (c) is the correct choice because pro forma financial information cannot, by definition, be prepared in accordance with GAAP. Although pro forma information is disfavored, the SEC recognizes it may sometimes play an important role, so long as it is (a) accurate and (b) does not tend to mislead by omitting material facts. Any pro forma information presented on behalf of a company must (d) be reconciled with its periodic financial reports.

60. (b) The Sherman Antitrust Act declared illegal attempts at restraint of trade.

61. (d) The sale of goods of like quality within the United States but across state lines at different prices to two different wholesalers in the same geographic area would be considered a violation of the Robinson-Patman Act. Answer (a) is incorrect because it deals with wholesalers outside of the U.S. which are not covered by the Act. Answer (b) is incorrect because of the extenuating circumstance of delivery costs. Answer (c) is incorrect because it is intrastate commerce which is not covered by the Robinson Patman Act.

62. (d) Telecommunications companies are not exempt from antitrust regulation. The others are exempt.

63. (c) The Clayton Antitrust Act protected labor unions from prosecution under the Sherman Antitrust Act. Under the Sherman Antitrust Act, corporations had identified labor unions in “restraint of trade” and prosecuted them. Choice (a) is incorrect; the Robinson-Patman Act strengthened price discrimination laws in the Clayton Act. Choice (b) is incorrect since the Taft-Hartley Act dealt with limiting the power of unions. Choice (d) is an unrelated answer.

64. (d) The Robinson-Patman Act specifically addresses price discrimination. Price differences must have a legitimate reason, such as cost savings, to be legal. Answer (a) is not correct; the Celler-Kefauver Act is concerned with acquisitions that may lessen competition, not price discrimination. Answer (b) is not correct; the Federal Trade Commission Act is concerned with a variety of activities that lessen competition in inter-state commerce. Answer (c) is not correct; the Sherman Act relates to monopolization and activities that restrain trade, but not specifically price discrimination.

65. (b) The Clayton Act of 1914 specifically prohibits price discrimination between different buyers, which is sellers’ price discrimination.

66. (a) The acquisition of a retail shoe store by a shoe manufacturer is an example of vertical integration. Answer (b) is incorrect. The acquisition of a retail shoe store by a shoe manufacturer is not an example of a conglomerate. A conglomerate merger involves two companies in completely unrelated industries. Answer (c) is incorrect. The acquisition of a retail shoe store by a shoe manufacturer is not an example of market extension. Answer (d) is incorrect; the acquisition of a retail shoe store by a shoe manufacturer is not an example of product extension.

67. (d) The Sherman Antitrust Act of 1890 prohibits restraint of trade and monopoly. Answer (a) is incorrect because the Sherman Antitrust Act of 1890 does not prohibit price discrimination, tying contracts, anti-competitive mergers, and interlocking directorates. Answer (b) is incorrect because the Sherman Act does not prohibit unfair competition and deceptive business practices. Answer (c) is incorrect; the Sherman Act does not prohibit mergers without prior notification to the Justice Department.

68. (c) The Antitrust Improvement Act of 1976 (Hart-Scott-Rodino Act) requires a notification prior to a merger. Choice (a) is incorrect since the Antitrust Improvement Act of 1976 does not require pre-approval from the FTC for interlocking directorates. Choice (b) is incorrect since the Antitrust Improvement Act does not prohibit price discrimination. Choice (d) is incorrect; the Antitrust Improvement Act of 1976 does not prohibit state suits on behalf of consumers against price fixing.
Chapter Eleven: Securities Acts
Other Objective Answers

ANSWER 1

1. (Y) Rule 504 of the Securities Act of 1933 permits sales of securities of up to $1 million within a 12 month period. Since this sale was for $450,000, it did comply with the dollar limitation.

2. (Y) Rule 504 of the Securities Act of 1933 permits general solicitation in sale of securities. Thus the offering did comply with the method of sale restrictions. (Answer changed by author to comply with recent changes in the law.)

3. (N) Rule 504 of the Securities Act of 1933 requires that the securities be sold within a 12 month period. Since the securities were sold over a two year period, the offering was not sold during the applicable time limit.

4. (Y) Rule 504 of the Securities Act of 1933 requires that the SEC be notified within 15 days of the first sale. Since the SEC was notified 8 days after the first sale, the SEC was timely notified.

5. (Y) Since the offering was not made within a 12 month period, the offering was not exempt from registration.

6. (Y) Rule 506 of the Securities Act of 1933 permits an unlimited dollar amount of securities to be sold. Thus, the offering complied with the dollar limitation of 506 because there is no dollar limitation.

7. (Y) Rule 506 of the Securities Act of 1933 permits sales by private placements and therefore the sale complied with the method of sale restriction.

8. (Y) Rule 506 of the Securities Act of 1933 permits sales to an unlimited number of accredited investors, but limits sales to 35 or less nonaccredited investors. Since the sale was to 200 accredited and 30 nonaccredited investors, the number of investors was proper.

9. (Y) Rule 506 of the Securities Act of 1933 requires that the SEC be notified within 15 days of the first sale. Since the SEC was notified 14 days after the first sale, the SEC was timely notified.

10. (N) Since the offering complied with all applicable requirements of Rule 506, the SEC was not correct in claiming the offering was not exempt.

11. (N) Rule 505 of the Securities Act of 1933 permits sales of securities of between $1 million and $5 million within a 12 month period. Since this offering exceeded $5 million, the offering did not comply with the dollar limitation of 505.

12. (Y) Rule 505 requires that the securities be sold within a 12 month period. Since the securities were sold within one year, the offering was sold during the applicable time limit.

13. (N) Rule 505 of the Securities Act of 1933 permits sales to an unlimited number of accredited investors, but limits sales to 35 or less nonaccredited investors. Since the sale was made to 40 nonaccredited investors, the offering was not sold to the proper number of investors.

14. (N) Rule 505 of the Securities Act of 1933 requires that the SEC be notified within 15 days of the first sale. Since the SEC was notified 18 days after the first sale, the SEC was not timely notified.

15. (Y) The SEC was correct that this offering was not exempt under Rule 505 because $6 million exceeded the dollar limitation, there were too many nonaccredited investors and the SEC was not notified within 15 days of the first sale.
ANSWER 2

1. (A) To be eligible for a private placement exempt offering under Rule 506 of Regulation D Coffee Corp. may sell more $5,000,000 (there is no maximum amount), without solicitation, must use due care to insure that purchasers will hold for long term investment and not resale (2 years or more), may sell to an unlimited number of accredited investors and 35 or less unaccredited investors and must make disclosures to these investors (to include audited financial statements) if there are one or more unaccredited investors. The SEC must be notified within 15 days of the first sale. As long as Coffee complies with these requirements, Coffee may make an exempt offering under Rule 506 of Regulation D. There are no facts given to indicate that Coffee cannot comply with these requirements. Thus, statement I is correct. Statement II is incorrect because reporting companies under the Securities Exchange Act of 1934 are not prohibited from making exempt offerings under the Securities Act of 1933.

2. (B) Under Rule 506 of Regulation D, Coffee may sell to an unlimited number of accredited investors and 35 or less unaccredited investors. Statement I is incorrect because Coffee may sell to 35 or less unaccredited investors. Statement II is correct.

3. (B) Under Rule 506 of Regulation D, Coffee may sell more than $5,000,000. There is no upper limit to the amount that Coffee may sell under Rule 506. Statement I is incorrect because an exempt offering may be for more than $10,000,000 under Rule 506. Statement II is correct because sales of unlimited dollar amounts are permitted under Rule 506.

4. (B) Statement I is incorrect because there is no restriction on resale for 9 months to nonresidents under Regulation D, Rule 506. It is the intrastate offering exemption under the Securities Act of 1933 that restricts resale for 9 months to residents of that state. Under Rule 506 of Regulation D no resale is permitted for 2 years to residents or nonresidents. Statement II is correct because under Rule 506 of Regulation D, an issuer must use due care to insure purchasers will hold for long term investment (2 years or more) and not resale. Since underwriters are those who purchase securities from the issuer for resale, the issuer must use due care to insure that purchasers are buying for investment and are not underwriters.

5. (D) Under Regulation D for Rules 504, 505 and 506 the issuer must notify the SEC within 15 days of their first sale. Statement I is incorrect because the SEC must be notified within 15 days, not 5 days. Statement II is incorrect because the issuer is not required to notify the SEC of there first sale in the next filed quarterly report. It must be done within 15 days.

ANSWER 3

a. There are four elements or factors to be considered in determining whether an offering of securities is subject to the registration requirements of the Securities Act of 1933. These are:
   • The use of interstate commerce, e.g., the mails, in connection with the offer to sell or the sale of securities.
   • The offering of said securities is to the "public".
   • The offering or sale is made by an issuer, controlling person, or "statutory" underwriter.
   • There is no relevant exemption available.

b. Since the sale of equity securities results in more than 500 persons owning Fancy stock, coupled with the fact that Fancy will have more than $5 million of assets, the corporation will be subject to the full application of the Securities Exchange Act of 1934. As such, it will be required to register pursuant to the Act and thereby become subject to the Act’s reporting, insider trading, proxy, and other requirements.

c. The Securities Act of 1933 provides that where there is a violation of the Act as a result of the failure to file a registration statement, the parties responsible shall be liable upon tender of the securities purchased for the amount paid, plus interest, less any distributions received. Damages are recoverable even if the party no longer owns the securities. Criminal penalties of a fine or imprisonment or both are applicable to any person who willfully violates the Securities Act of 1933.
**d.** An offering pursuant to Regulation D is exempt from registration. Regulation D is intended to permit exemption from registration of limited offers and sales by small businesses in need of capital.

1. There are two kinds of investors under Rule 505 of Regulation D: accredited investors as defined in the Regulation and all others who are designated as non-accredited investors. An unlimited number of accredited investors is permitted, but a maximum of 35 non-accredited investors is permitted.

2. Under Rule 505, if non-accredited investors are involved and Fancy is a non-reporting company under the Securities Exchange Act of 1934, it must supply audited financial statements for one year. If an audit of the most recent year would involve unreasonable effort or expense, an audited balance sheet only, dated within 120 days of the start of the offering, is permitted.

3. Rule 505 prohibits any general solicitation or general advertising of the securities within a 12-month period.

**ANSWER 4**

**a.**

1. World is incorrect in its first contention that the offering is exempt from registration under Regulation D, Rule 505, of the Securities Act of 1933. World did not comply with the requirements of Rule 505 for the following reasons: the offering was sold to more than 35 nonaccredited investors; there was a general advertising of the offering; and the SEC was notified more than 15 days after the first sale of the offering.

2. World is also incorrect in its second contention that the securities of the offering would be completely exempt from registration if the offering were exempt. Securities originally purchased under a Regulation D limited offering exemption are restricted securities. They must be registered prior to resale unless sold subject to another exemption.

**b.**

1. Unity is incorrect in its contention that it is not required to comply with the reporting requirements of the Securities Exchange Act of 1934. Unity must comply because it has more than 500 stockholders and total assets in excess of $5,000,000. Alternately, Unity must comply because its shares are traded on a national securities exchange.

2. A covered corporation must file the following reports with the SEC: Quarterly Reports (10-Q’s); Annual Reports (10-K’s); and Current Reports (8-K’s). These reports are intended to provide a complete, current statement of all business operations and matters affecting the value of the corporation’s securities.
Chapter Twelve
Regulation of Employment

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Chapter Twelve  
Regulation of Employment

**WORKER’S COMPENSATION**

1. State worker's compensation laws require that employees receive benefits if they are injured in the scope of their employment (e.g., injured in connection with the job)
   a. benefits are based on the employee's injury, not on the employee's pay
   b. injuries are broadly interpreted and include almost any injury or disease that was **job related** (e.g., include not only physical injuries received, but also occupational diseases and employment aggravation of pre-existing problems)
   c. travel to and from work is not usually considered to be in the scope of employment  

2. The employer must provide coverage to all eligible employees
   a. independent contractors and agricultural workers are not covered
   b. worker's compensation cannot be waived by employee

3. The **employer is strictly liable** without regard to fault (the only requirement is that the employee was injured in the scope of employment)
   a. negligence (even gross negligence) by the employee or by a fellow employee will not bar recovery (e.g., X is injured on the job due to negligence in failing to adhere to written safety procedures. X can collect worker's compensation.)
   b. an employee's assumption of the risk will not bar recovery
   c. exceptions: fighting, intoxication, and self-inflicted wounds will bar recovery

4. The employer provides for insurance to pay for benefits (i.e., the employee does not pay)
   a. the employer may purchase private insurance or
   b. the employer may be self-insured or
   c. the employer may make payments to a state insurance fund

5. Worker's compensation benefits are the employee's exclusive remedy against the employer (e.g., the employee may not sue the employer even if the employer's negligence was the cause of the employee's injury)
   a. **exception:** employees intentionally injured by the employer may sue the employer
   b. **exception:** if the employer's insurance is inadequate to pay the benefit, the employee may sue the employer (negligence by the employee or fellow employees and assumption of the risk cannot be used as defenses)

6. Worker's compensation does not preclude suit against 3rd parties causing the injury
   a. if the lawsuit against the 3rd party is successful, the insurance carrier is entitled to be reimbursed for any duplication of the workers' compensation benefits paid
   b. e.g., X collects $5,000 in Worker's compensation benefits for a job-related injury. X sues a 3rd party for negligently causing the injury and collects $125,000. The Worker's compensation insurance carrier may recover from X the $5,000 it paid in Worker's compensation benefits.
FEDERAL UNEMPLOYMENT TAX ACT (FUTA)

1. Provides unemployment benefits to those unemployed through no fault of their own
   a. benefits vary from state to state (each state administers its own unemployment compensation system under federal guidelines and standards)
   b. generally to receive benefits an employee:
      1). must have worked for an employer for a certain specified time
      2). must be actively seeking new employment (be willing and able to work)
      3). exception: the self-employed are not eligible for benefits
   c. the benefits to an unemployed employee are based on the employee's wages and the length of time they are unemployed (thus, the total amount of benefits received may actually exceed the amount contributed to his/her account)

2. State systems are funded by taxes paid by employers (it is not paid by the employee)
   a. the tax is imposed on employers who paid $1,500 or more in wages during any calendar quarter or had 1 or more employees for 20 weeks in a calendar year
   b. the tax is deductible by employer and is not deductible by the employee
   c. tax is currently 6.2% of only the first $7,000 in wages
   d. a credit is available to employers against the federal unemployment tax for contributions made to state unemployment funds (credit may not exceed 5.4%)

FEDERAL INSURANCE CONTRIBUTIONS ACT (FICA)

1. Social Security (FICA) provides for the following benefit programs
   a. Old-Age and Survivors Insurance (OASI)
   b. Disability Insurance (DI)
   c. Hospitalization Insurance (HI, Medicare, not Medicaid)
   d. Supplemental Security Income (SSI)

2. The FICA tax is imposed upon employers, employees and the self-employed

3. The employee's tax is a percentage of their wages (e.g., for 2010 the rate is 6.2% of the first $108,600 in wages for OASDI and 1.45% of all wages for Medicare)
   a. wages include almost all types of earned compensation from employment (e.g., annual proceeds from an annuity or interest earned on bonds are not subject to the FICA tax because they are not wages)
   b. the employee's tax is withheld by employer from the employee's wages
      1). failure to withhold makes the employer liable for employee's tax, but the employer can require reimbursement by the employee if they must pay
      2). if the employer voluntarily pays the employee's FICA tax, it is deductible by the employer as a business expense

4. The employer must match the employee's payment
   a. employer submits the employee's tax and their payment to the federal government
      1). there are penalties for failure to make timely FICA deposits
      2). there are penalties for failure to supply their federal taxpayer ID number
   b. the tax is deductible by the employer, but not by the employee

5. The corresponding tax rate for self-employment income (e.g., from a partnership or work as an independent contractor) in 2010 is 12.4% of the first 108,600 in net earnings for OASDI and 2.9% of net earnings for Medicare (as if the taxpayer were both employer and employee).
   a. the Self-Employment Contributions Act tax imposes FICA taxes on the self-employed
   b. the tax is based on net earnings, not gross earnings, to align it with FICA taxes
c. ½ of the self-employment tax is deductible as an adjustment to gross income, because an employee does not pay income tax on the FICA taxes paid by its employer
d. there is no tax if net earnings are less than $400

6. Benefits vary greatly depending on the program
   a. an individual may collect more than was contributed to their account and may even receive benefits if nothing was contributed (e.g., a minor child who had nothing contributed to her account may receive survivor benefits)
   b. up to 85% of benefits may be taxable if certain income levels are exceeded
   c. retirement benefits may be reduced if earned income exceeds a threshold level
      1) no limit on earnings once an individual reaches full retirement age (as defined by the Social Security Administration)
      2) in 2010, individuals receiving retirement benefits under the age of 66 have benefits reduced by $1 for every $2 earned over $14,160
      3) if individual reaches full retirement age during year, benefits are still reduced – in 2010, $1 for every $3 earned over $37,680 (calculated monthly) until month individual turns 66
      4) unearned income (e.g., private pension plan) does not reduce benefits

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**EMPLOYEE RETIREMENT INCOME SECURITY ACT (ERISA)**

1. ERISA regulates existing pension plans
   a. ERISA doesn't require pension plans be established
   b. ERISA does not set benefit levels for existing pension plans

2. ERISA requires that information be furnished employees and beneficiaries
   a. e.g. they must receive a summary of the pension plan
   b. e.g. they must receive an annual report

3. ERISA establishes standards for pension plan funding, investment of pension funds and other financial controls to avoid mismanagement
   a. e.g. it imposes fiduciary duties on pension fund managers
   b. e.g. it prohibits employers from unduly delaying an employee's participation

4. Before the Pension Protection Act of 2006, which went into effect in 2008, ERISA required the maintenance of a “funding standard account” which tracked benefits paid and credited for contributions and required employer contributions to bring balance up to $0, if necessary.
   a. with respect to single employer pension plans, the Pension Protection Act replaced the need for a “funding standard account” with a requirement that a plan be fully funded
   b. multi-employer pension plans must still track benefit payments and credit contributions with a “funding standard account”

4A. Funding for pensions may be either contributory (the employee contributes) or noncontributory (the employer provides all the funds)
   a. an employee's right to their own contributions must vest immediately
   b. Under the Pension Protection Act, after 2007 the contributions of employers must vest completely after three years of employment, or at six years’ employment if they vest partially in graded percentage installments (e.g. 20% per year)

5. ERISA guarantees payment of certain benefits if a defined benefit plan is terminated, through a federally chartered corporation (the Pension Benefit Guaranty Corporation)

6. ERISA has both civil remedies (e.g. civil suits by pension participants or beneficiaries) and criminal penalties for violations

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**OCCUPATIONAL SAFETY & HEALTH ACT (OSHA)**

12-3
1. OSHA's purpose is to provide, as far as possible, a safe and healthy work environment
   a. OSHA is administered by the Occupational Safety & Health Administration (also abbreviated OSHA) of the Labor Department
   b. OSHA applies to all employers engaged in a business that affects interstate commerce (exempt from coverage is the U.S. government and the 50 states)

2. OSHA has the power to establish standards and promulgate rules and regulations governing workplace safety
   a. it may inspect the workplace for violations
      1). employees may report violations and request OSHA inspections
      2). employers cannot retaliate against employees for reporting violations
      3). an employer may require a search warrant by OSHA prior to inspection requiring OSHA to show probable cause (e.g. probable cause might consist of an abnormally high accident rate or reported violations)
   b. it requires record keeping and reporting by employers of job-related injuries
   c. OSHA does not develop safety equipment
   d. if an accident results in death or 5 or more employees are injured in one occurrence
      1). Department of Labor must be notified within 48 hours
      2). an inspection of the workplace is mandatory

3. Penalties: OSHA can issue citations, impose fines and civil penalties or obtain injunctions
   a. upon finding a violation, OSHA issues a written citation, a proposed penalty (e.g. OSHA may impose fines) and a correction date
      1). the citation becomes final after 15 working days unless contested
      2). citations may be appealed to an administrative board and then to a court
   b. OSHA can obtain temporary injunctions if there is an imminent risk of great harm
   c. criminal penalties of a fine, imprisonment or both may be imposed for a willful violation resulting in death

4. OSHA permits state regulation of workplace safety and health under federal supervision (OSHA sets minimum standards only, the states may exceed these limits)

**EMPLOYMENT DISCRIMINATION**

1. **Title VII of the Civil Rights Act** prohibits discrimination based on race, color, religion, sex (to include sexual harassment) or national origin in employment, but does not cover age discrimination
   a. Title VII applies to:
      1). employers and labor unions with 15 or more workers and engaging in an industry affecting interstate commerce
      2). employment agency employees and referrals done by employment agencies (e.g. an agency may not make referrals based on race)
      3). employees of the federal, state or local governments
      4). intentional and unintentional discrimination (i.e. an employer has discriminated if the effect of policies results in discrimination, even if that was not the intent)
   b. Title VII has been amended to prohibit discrimination on the basis of pregnancy or child birth (Pregnancy Discrimination Act) and requires employers to treat pregnancy like a temporary disability
   c. Title VII is administered and enforced by the Equal Employment Opportunity Commission (EEOC) which can permit private law suits or sue the employer itself
      1). individuals file a complaint with the EEOC (or a state agency) which investigates the charge and attempts conciliation, if appropriate
      2). the EEOC may issue a right-to-sue letter enabling the plaintiff to sue
   d. remedies for violation of Title VII may include:
      1). reinstatement of employee with back pay, compensatory damages, punitive damages and attorney's fees
      2). the EEOC may even enjoin the employer from future discrimination
2. **Age Discrimination in Employment Act (ADEA)** is EEOC administered and prohibits discrimination based on age of individuals 40 or older (ADEA has no upper age limit)
   a. ADEA applies to employers and labor unions with 20 or more workers and engaging in an industry affecting interstate commerce and employment agency employees and referrals done by employment agencies
   b. ADEA prohibits mandatory retirement of those under 70 unless there is a reasonable business necessity (e.g. airline pilots, police and firemen)
   c. remedies may include injunctive relief, unpaid back pay and overtime, liquidated damages equal to the amount of any award, but do not include punitive damages or early retirement.

3. **Equal Pay Act** is EEOC administered and prohibits sex discrimination regarding pay
   a. it requires that women receive equal pay for doing work equal to that done by men
      1). the work must involve equal effort, equal skill, equal responsibility and similar working conditions
      2). equals means substantially the same, not identical
   b. employer may have a pay disparity based on seniority, merit or the quantity of production (e.g. pay based on piecework)
   c. the Equal Pay Act permits suits for back pay and permits an equal amount to be awarded as liquidated damages. Injunctions against the employer are also permitted.

4. **Discrimination of the disabled**
   a. **Rehabilitation Act Of 1973** applies to Federal agencies and employers with federal contracts of over $10,000 and requires affirmative action to hire qualified disabled workers (e.g. those with either mental or physical disabilities)
   b. **Americans With Disabilities Act (ADA)** is EEOC administered and prohibits discrimination against qualified workers with disabilities (either mental or physical)
      1). ADA applies to employers and labor unions with 15 or more workers and engaging in an industry affecting interstate commerce
      2). qualified employees are those who can perform the basic job either without accommodation or with reasonable accommodations (e.g. by making existing jobs readily accessible or by providing new equipment)
      3). ADA requires public transportation systems be accessible to the disabled
      4). ADA requires public accommodations be accessible to the disabled

5. **Valid defenses to alleged employment discrimination**
   a. **Bona Fide Occupational Qualification (BFOQ)** defense: discrimination on the basis of sex, religion, national origin or age is permissible if it is reasonably necessary for the business in question
      1). e.g. a designer could hire only women to model female clothing, a kosher restaurant could hire only Jewish chefs and an airline could refuse to employ pilots over the age of 65
      2). the BFOQ defense is not available for race or color discrimination
      3). if the employer can show a BFOQ, claimants will still prevail if they can show a nondiscriminatory alternative practice exists
   b. discrimination based on a professionally developed ability test is permissible
   c. discrimination based on seniority or a merit system may be permissible
   d. discrimination based on national security reasons

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**FEDERAL FAIR LABOR STANDARDS ACT (FLSA)**

1. **FLSA** prohibits oppressive child labor and provides wage and hour standards

2. **FLSA** prohibits oppressive child labor by employers affecting interstate commerce (virtually all)
   a. for nonagricultural jobs, 14 is the minimum age to work
      1). youths 18 and older may perform any job for unlimited hours
      2). youths 16 and 17 may perform any nonhazardous job for unlimited hours
      3). youths 14 and 15 may only work in nonmanufacturing, nonhazardous jobs for limited hours outside of school time
3. **FLSA requires a minimum wage (currently $7.25 an hour as of July 24, 2009)**
   a. a minimum wage of $4.25 an hour is permitted for youths under 20 years of age during the first 90 days of their employment
   b. employees may be paid by piece rate, by salary, by commission or some other rate, but the amount paid must yield at least the minimum wage per hour rate
   c. FLSA minimum wage does not preempt states from setting a minimum wage which is higher

4. **FLSA requires overtime pay of at least 1.5 times the regular rate of pay for work in excess of 40 hours in a workweek**
   a. FLSA does not require time and a half for work over 8 hours a day or work on Saturday, Sunday, or holidays (only for work in excess of 40 hours in a week)
   b. overtime pay may not be waived by the employee
   c. employees pay may be based on an hourly rate, a weekly rate, a monthly rate or some other basis, but the employee must receive 1.5 times their regular rate for work in excess of 40 hours in a workweek

5. **Exemptions from wage and hour standards**
   a. employees **exempt from both overtime and minimum wage** provisions include administrative and professional employees, elementary and secondary school teachers, outside sales employees, fishermen, and casual baby-sitters
   b. employees **exempt from overtime pay provisions only** include employees of railroads and airlines, taxi drivers, domestic service workers living in the employer's home, farm workers and motion picture theater employees
   c. skilled computer professionals are also exempt from overtime pay provisions if they are compensated at an hourly rate of $27.63 or higher or a weekly salary of $455 or higher

6. **FLSA is enforced by the Department of Labor which has the power to:**
   a. initiate both civil and criminal actions for violations
   b. conduct hearings and investigations and subpoena witnesses, books and records
   c. issue wage orders requiring employers to pay wages found due plus an equal amount as liquidated damages
   d. obtain an injunction to restrain employers from violating the act

### FAMILY AND MEDICAL LEAVE ACT (FMLA)

1. **FMLA entitles employees to take 12 weeks of **unpaid, job-protected leave** in 1 year**
   a. to be eligible an employee must have worked for at least 12 months and for at least 1,250 hours during those 12 months
   b. the family and medical reasons permitting 12 weeks unpaid leave include:
      1). birth and care of a newborn child of the employee
      2). placement with the employee of an adopted child or foster care
      3). care of an immediate family member with a serious health condition
      4). a serious medical condition making the employee unable to work
   c. the Act only applies to employers with 50 or more employees
   d. key employees (those paid in the top 10% of employer’s workforce) are excluded from coverage

2. **Job protection provisions for an employee returning from FMLA leave include:**
   a. maintenance of all group health insurance benefits
   b. having their original job restored or an equal job with equal pay and benefits
3. FMLA permits private law suits for violations and the Department of Labor may bring action in court to compel compliance

**CONSOLIDATED BUDGET RECONCILIATION ACT (COBRA)**

1. If employee voluntarily quits or is terminated, health insurance coverage can be retained by employee for 18 months at employee's expense
   a. if the employee is disabled, the coverage can be extended for 29 months
   b. the coverage must be the same as when the employed worked (e.g. if family members were covered, then they are also covered after termination)
   c. the worker has 60 days from the date that the insurance coverage stops to decide whether to retain the coverage at their expense

2. An employer does not have to provide coverage if the employee becomes covered under a spouse’s insurance plan or under a different plan with a new employer

**WORKER ADJUSTMENT & RETRAINING NOTIFICATION ACT**

1. The Worker Adjustment and Retraining Notification Act (WARN) requires that employers give 60 days advance notice of mass layoffs or plant closings
   a. state and local officials must also be notified
   b. the 60 day time period is reduced in emergency situations or with a failing company

2. The Act applies to employers with 100 or more employees

**UNION AND EMPLOYEE RELATIONS**

Since the early 1900’s, the right for employees to form unions and negotiate with employers for better wages and working conditions was protected through legislation (National Labor Relations Act or Wagner Act). This increased the power of labor unions in America. However, it also increased the possible abuses of power by labor unions against individual workers. Subsequent regulations sought to limit the increasing power of labor unions.

**Taft-Hartley Act**

This act helped stifle the growing power of unions and their possible discrimination against workers. Labor unions were forbidden under the act from restraining or coercing employees in the exercise of their rights. Unions could not force an employer to discriminate against an employee. The act eliminated closed shops in which employers were bound by contract to hire only members of the union. The Taft-Hartley Act did not eliminate union shops, which can require employees to become members of the union within 30 days under a collective bargaining agreement. What the Taft-Hartley Act did do was provide states the opportunity to outlaw union shops at their own discretion. This would come in the form of right-to-work laws enacted by individual states.

**Right-to-Work Laws**

Labor unions vigorously resisted states that attempted to enact right-to-work laws. Unions saw non-compulsory membership as reducing their power and limiting influence in negotiations for higher wages. In 1958 six states (Kansas, California, Colorado, Idaho, Ohio and Washington) attempted to pass right-to-work laws. According to President Dwight D. Eisenhower, “Leaders of organized labor fought them tooth and claw.” Of those six states, only
Kansas (and years later Idaho) saw right-to-work laws pass. Currently, 22 states have right-to-work laws. In states that have passed right-to-work laws, employees are not required to join a union at any point in their employment. These right-to-work laws allow an employee to not join a union, but still be represented in union’s negotiation with management without paying fees. Non-union employees in right-to-work states are sometimes referred to as free riders. In states without right-to-work laws, employees may be bound to join a union shop within a time period no less than 30 days of employment.

Example: In 1994, the NFL players’ association sued to get several players from the Washington, D.C. football team suspended for not paying their union dues. The court ruled that since the players practiced in neighboring Virginia (a right-to-work state), that was their place of employment. Therefore, the players were not required to pay fees to the union. Had the court ruled that Washington, D.C. (which does not have right-to-work laws) was their place of employment, the players would be required to pay union fees or face suspension. Needless to say, one must be wary of state laws when it comes to labor union issues.

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1 Right to work states include Alabama, Arizona, Arkansas, Florida, Georgia, Guam, Idaho, Iowa, Kansas, Louisiana, Mississippi, Nebraska, Nevada, North Carolina, North Dakota, Oklahoma, South Carolina, South Dakota, Tennessee, Texas, Utah, Virginia, Wyoming
Chapter Twelve
Regulation of Employment
Multiple Choice Questions

1. Silk was employed by Rosco Corp. as a chauffeur. While in the course of employment, Silk was involved in an automobile accident with Lake who was employed by Stone Corp. as a truck driver. While making a delivery for Stone, Lake negligently drove through a red light causing the accident with Silk. Both Silk and Lake have received workers' compensation benefits as a result of the accident. Silk
a. Is precluded from suing Lake since both are covered under workers' compensation laws.
b. Is precluded from suing Stone if Stone complied fully with the state's workers' compensation laws.
c. Can recover in full against Lake only, but must reimburse the workers' compensation carrier to the extent the recovery duplicates benefits already obtained under workers' compensation laws.
d. Can recover in full against Lake or Stone, but must reimburse the workers' compensation carrier to the extent the recovery duplicates benefits already obtained under workers' compensation laws.

2. Which of the following claims is(are) generally covered under workers’ compensation statutes?

<table>
<thead>
<tr>
<th>Occupational disease</th>
<th>Employment aggravated pre-existing disease</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>b. Yes</td>
<td>No</td>
</tr>
<tr>
<td>c. No</td>
<td>Yes</td>
</tr>
<tr>
<td>d. No</td>
<td>No</td>
</tr>
</tbody>
</table>

3. An employee will generally be precluded from collecting full worker's compensation benefits when the injury is caused by

<table>
<thead>
<tr>
<th>Noncompliance with the employer's rules</th>
<th>An intentional, self-inflicted action</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. No</td>
<td>No</td>
</tr>
<tr>
<td>b. Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>c. No</td>
<td>Yes</td>
</tr>
<tr>
<td>d. Yes</td>
<td>No</td>
</tr>
</tbody>
</table>

4. Generally, which of the following statements concerning workers' compensation laws is correct?

a. The amount of damages recoverable is based on comparative negligence.
b. Employers are strictly liable without regard to whether or not they are at fault.
c. Workers' compensation benefits are not available if the employee is negligent.
d. Workers' compensation awards are payable for life.

5. Which of the following provisions is basic to all workers' compensation systems?

a. The injured employee must prove the employer's negligence.
b. The employer may invoke the traditional defense of contributory negligence.
c. The employer's liability may be ameliorated by a co-employee's negligence under the fellow-servant rule.
d. The injured employee is allowed to recover on strict liability theory.

6. Workers' Compensation Acts require an employer to

a. Provide coverage for all eligible employees.
b. Withhold employee contributions from the wages of eligible employees.
c. Pay an employee the difference between disability payments and full salary.
d. Contribute to a federal insurance fund.

7. Kroll, an employee of Acorn, Inc., was injured in the course of employment while operating a forklift manufactured and sold to Acorn by Trell Corp. The forklift was defectively designed by Trell. Under the state's mandatory workers' compensation statute, Kroll will be successful in

<table>
<thead>
<tr>
<th>Obtaining workers' compensation benefits</th>
<th>A negligence action against Acorn</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>b. Yes</td>
<td>No</td>
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<tr>
<td>c. No</td>
<td>Yes</td>
</tr>
<tr>
<td>d. No</td>
<td>No</td>
</tr>
</tbody>
</table>
8. Taxes payable under the Federal Unemployment Tax Act (FUTA) are
   a. Calculated as a fixed percentage of all compensation paid to an employee.
   b. Deductible by the employer as a business expense for federal income tax purposes.
   c. Payable by employers for all employees.
   d. Withheld from the wages of all covered employees.

9. For the entire year 1993, Ral Supermarket, Inc. conducted its business operations without any permanent or full-time employees. Ral employed temporary and part-time workers during each of the 52 weeks in the year. Under the provisions of the Federal Unemployment Tax Act (FUTA), which of the following statements is correct regarding Ral's obligation to file a federal unemployment tax return for 1993?
   a. Ral must file a 1993 FUTA return only if aggregate wages exceeded $100,000 during 1993.
   b. Ral must file a 1993 FUTA return because it had at least one employee during at least 20 weeks of 1993.
   c. Ral is obligated to file a 1993 FUTA return only if at least one worker earned $50 or more in any calendar quarter of 1993.
   d. Ral does not have to file a 1993 FUTA return because it had no permanent or full-time employees in 1993.

10. Which of the following payments are deducted from an employee's salary?

<table>
<thead>
<tr>
<th>Unemployment compensation insurance</th>
<th>Worker's compensation insurance</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. Yes</td>
<td>Yes</td>
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<tr>
<td>b. Yes</td>
<td>No</td>
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<tr>
<td>c. No</td>
<td>Yes</td>
</tr>
<tr>
<td>d. No</td>
<td>No</td>
</tr>
</tbody>
</table>

11. An unemployed CPA generally would receive unemployment compensation benefits if the CPA
   a. Was fired as a result of the employer's business reversals.
   b. Refused to accept a job as an accountant while receiving extended benefits.
   c. Was fired for embezzling from a client.
   d. Left work voluntarily without good cause.

12. In general, which of the following statements is correct with respect to unemployment compensation?
   a. An employee who is unable to work because of a disability is entitled to unemployment compensation.
   b. An individual who has been discharged from employment because of work-connected misconduct is ineligible for unemployment compensation.
   c. The maximum period during which unemployment compensation may be collected is uniform throughout the United States.
   d. The maximum amount of weekly unemployment compensation payments made by a state is determined by federal law.

13. The Federal Unemployment Tax Act (FUTA)
   a. Requires both the employer and employee to pay FUTA taxes, although the amounts to be paid by each are different.
   b. Does not apply to businesses with fewer than 35 employees.
   c. Does not apply to employers that conduct business only in one state and employ only residents of that state.
   d. Allows the employer to take a credit against the FUTA tax if contributions are made to a state unemployment fund.

14. Which of the following statements is not correct concerning federal unemployment insurance?
   a. Federal law provides general guidelines, standards, and requirements for the program.
   b. The states administer the benefit payments under the program.
   c. The program is funded by taxes imposed on employers and employees.
   d. The federal unemployment tax is calculated as a fixed percentage of each covered employee's salary up to a stated maximum.

15. Under the Federal Insurance Contributions Act (FICA) which of the following acts will cause an employer to be liable for penalties?

<table>
<thead>
<tr>
<th>Failure to supply taxpayer identification numbers</th>
<th>Failure to make timely FICA deposits</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>b. Yes</td>
<td>No</td>
</tr>
<tr>
<td>c. No</td>
<td>Yes</td>
</tr>
<tr>
<td>d. No</td>
<td>No</td>
</tr>
</tbody>
</table>
16. Which of the following types of income is subject to taxation under the provisions of the Federal Insurance Contributions Act (FICA)?
   a. Interest earned on municipal bonds.
   b. Capital gains of $3,000.
   c. Car received as a productivity award.
   d. Dividends of $2,500.

17. The social security tax base is calculated on
   b. A self-employed person's gross income from self-employment.
   c. An employee's gross wages less the deduction permitted for contributions to an individual retirement account.
   d. An employee's taxable income.

18. Tower drives a truck for Musgrove Produce, Inc. The truck is owned by Musgrove. Tower is paid on the basis of a formula that takes into consideration the length of the trip, cargo, and fuel consumed. Tower is responsible for repairing or replacing all flat tires. Musgrove is responsible for all other truck maintenance. Tower drives only for Musgrove. If Tower is a common law employee and not an independent contractor, which of the following statements is correct?
   a. All social security retirement benefits are fully includible in the determination of Tower's federal taxable income if certain gross income limitations are exceeded.
   b. Musgrove remains primarily liable for Tower's share of FICA taxes if it fails to withhold and pay the taxes on Tower's wages.
   c. Musgrove would not have to withhold FICA taxes if Tower elected to make FICA contributions as a self-employed person.
   d. Bonuses or vacation pay that are paid to Tower by Musgrove are not subject to FICA taxes because they are not regarded as regular compensation.

19. Under the Federal Insurance Contributions Act (FICA), all of the following are considered wages except
   a. Contingent fees.
   b. Reimbursed travel expenses.
   c. Bonuses.
   d. Commissions.

20. An employer who fails to withhold Federal Insurance Contributions Act (FICA) taxes from covered employees' wages, but who pays both the employer and employee shares would
   a. Be entitled to a refund from the IRS for the employees' share.
   b. Be allowed no federal tax deduction for any payments.
   c. Have a right to be reimbursed by the employees for the employees' share.
   d. Owe penalties and interest for failure to collect the tax.

21. Which of the following forms of income, if in excess of the annual exempt amount, will cause a reduction in a retired person's social security benefits?
   a. Annual proceeds from an annuity.
   b. Director's fees.
   c. Pension payments.
   d. Closely held corporation stock dividends.

22. Syl Corp. does not withhold FICA taxes from its employees' compensation. Syl voluntarily pays the entire FICA tax for its share and the amounts that it could have withheld from the employees. The employees' share of FICA taxes paid by Syl to the IRS is
   a. Deductible by Syl as additional compensation that is includible in the employees' taxable income.
   b. Not deductible by Syl because it does not meet the deductibility requirement as an ordinary and necessary business expense.
   c. A nontaxable gift to each employee, provided that the amount is less than $1,000 annually to each employee.
   d. Subject to prescribed penalties imposed on Syl for its failure to withhold required payroll taxes.

23. Which of the following statements is correct with respect to social security taxes and benefits?
   a. A self-employed individual with net earnings of $35,000 will pay more tax than an employee with wages of $35,000.
   b. Both employees and self-employed individuals are subject to social security taxes based on their respective gross wages or gross earnings from self-employment.
   c. To the extent the amount received as retirement benefits is less than the amount contributed to the social security fund by the individual, it will never be included in the individual's adjusted gross income for federal income tax purposes.
   d. An individual whose gross income exceeds certain maximum limitations is required to include the entire amount received as disability benefits in the computation of the individual's adjusted gross income for federal income tax purposes.
24. Under the Federal Insurance Contributions Act (FICA) and the Social Security Act (SSA),
a. Persons who are self-employed are not required to make FICA contributions.
b. Employees who participate in private retirement plans are not required to make FICA contributions.
c. Death benefits are payable to an employee's survivors only if the employee dies before reaching the age of retirement.
d. The receipt of earned income by a person who is also receiving social security benefits may result in a reduction of such benefits.

25. Under the Employee Retirement Income Security Act of 1974 (ERISA), which of the following areas of private employer pension plans is(are) regulated?

<table>
<thead>
<tr>
<th>Employee vesting</th>
<th>Plan funding</th>
</tr>
</thead>
<tbody>
<tr>
<td>Yes</td>
<td>Yes</td>
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<tr>
<td>Yes</td>
<td>No</td>
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<tr>
<td>No</td>
<td>Yes</td>
</tr>
<tr>
<td>No</td>
<td>No</td>
</tr>
</tbody>
</table>

26. Which of the following statements correctly describes the funding of noncontributory pension plans?
a. All of the funds are provided by the employees.
b. All of the funds are provided by the employer.
c. The employer and employee each provide 50% of the funds.
d. The employer provides 90% of the funds, and each employee contributes 10%.

27. Under the provisions of the Employee Retirement Income Security Act of 1974 (ERISA), which of the following statements is correct?
a. Employees are entitled to have an employer established pension plan.
b. Employers are prevented from unduly delaying an employee's participation in a pension plan.
c. Employers are prevented from managing retirement plans.
d. Employees are entitled to make investment decisions.

28. Which of the following statements is correct regarding the scope and provisions of the Occupational Safety and Health Act (OSHA)?
a. OSHA requires employers to provide employees a workplace free from risk.
b. OSHA prohibits an employer from discharging an employee for revealing OSHA violations.
c. OSHA may inspect a workplace at any time regardless of employer objection.
d. OSHA preempts state regulation of workplace safety.

29. Which of the following statements is(are) correct regarding the authority of the Occupational Safety and Health Administration (OSHA)?
I. OSHA is authorized to establish standards that protect employees from exposure to substances that may be harmful to their health.
II. OSHA is authorized to develop safety equipment and require employers to instruct employees in its use.
a. I only.
b. II only.
c. Both I and II.
d. Neither I nor II.

30. Under which of the following conditions is an on-site inspection of a workplace by an investigator from the Occupational Safety and Health Administration (OSHA) permissible?
a. Only if OSHA obtains a search warrant after showing probable cause.
b. Only if the inspection is conducted after working hours.
c. At the request of employees.
d. After OSHA provides the employer with at least 24 hours notice of the prospective inspection.

31. Which of the following is a violation of the equal employment opportunity laws or civil rights laws?
a. Discrimination by an employer on the basis of national origin where there are bona fide occupational qualifications reasonably necessary to normal operations.
b. Denial of employment to individuals due to their inability to obtain security clearance where the employer is working under government security programs.
c. Hiring on the basis of a professionally developed test that bears a relationship to the job when a less discriminatory effect on employment is not feasible.
d. Referral by an employment agency based on race, in response to an employer's specific request to refer based on race.

32. Under Title VII of the 1964 Civil Rights Act, which of the following forms of discrimination is not prohibited?
a. Sex.
b. Age.
c. Race.
d. Religion.
33. Under the Federal Age Discrimination in Employment Act, which of the following practices would be prohibited?

<table>
<thead>
<tr>
<th>Practise</th>
<th>a.</th>
<th>b.</th>
<th>c.</th>
<th>d.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Termination of employees between the ages of 65 and 70 for cause</td>
<td>Yes</td>
<td>Yes</td>
<td>No</td>
<td>No</td>
</tr>
<tr>
<td>Compulsory retirement of employees below the age of 65</td>
<td>Yes</td>
<td>Yes</td>
<td>No</td>
<td>No</td>
</tr>
</tbody>
</table>

34. Under the Age Discrimination in Employment Act, which of the following remedies is(are) available to a covered employee?

<table>
<thead>
<tr>
<th>Remedies</th>
<th>a.</th>
<th>b.</th>
<th>c.</th>
<th>d.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Early retirement</td>
<td>Yes</td>
<td>Yes</td>
<td>No</td>
<td>No</td>
</tr>
<tr>
<td>Back pay</td>
<td>Yes</td>
<td>Yes</td>
<td>No</td>
<td>No</td>
</tr>
</tbody>
</table>

35. Under the federal Age Discrimination in Employment Act, which of the following practices is prohibited?

a. Termination of employees between the ages of 65 and 70 for cause.
b. Mandatory retirement of any employee.
c. Unintentional age discrimination.
d. Termination of employees as part of a rational business decision.

36. Under the provisions of the Americans With Disabilities Act of 1990, in which of the following areas is a disabled person protected from discrimination?

<table>
<thead>
<tr>
<th>Area</th>
<th>a.</th>
<th>b.</th>
<th>c.</th>
<th>d.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Public transportation</td>
<td>Yes</td>
<td>Yes</td>
<td>No</td>
<td>No</td>
</tr>
<tr>
<td>Privately operated public</td>
<td>Yes</td>
<td>No</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td>accommodations</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

37. Which of the following Acts prohibit(s) an employer from discriminating among employees based on sex?

<table>
<thead>
<tr>
<th>Act</th>
<th>a.</th>
<th>b.</th>
<th>c.</th>
<th>d.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Equal Pay Act</td>
<td>Yes</td>
<td>Yes</td>
<td>No</td>
<td>No</td>
</tr>
<tr>
<td>Title VII of the Civil</td>
<td>Yes</td>
<td>No</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td>Rights Act</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

38. Stephens is an employee of the Jensen Manufacturing Company, a multi-state manufacturer of roller skates. The plant in which he works is unionized and Stephens is a dues paying union member. Which statement is correct insofar as the Federal Fair Labor Standards Act is concerned?

a. The Act allows a piece-rate method to be employed in lieu of the hourly-rate method where appropriate.
b. Jensen is permitted to pay less than the minimum wage to employees since they are represented by a bona fide union.
c. The Act sets the maximum number of hours that an employee can work in a given day or week.
d. The Act excludes from its coverage the employees of a labor union.

39. Under the Fair Labor Standards Act, if a covered, nonexempt employee works consecutive weeks of 45, 42, 38, and 33 hours, how many hours of overtime must be paid to the employee?

a. 0  
b. 7  
c. 18 
d. 20

40. Which of the following employees are exempt from the minimum and maximum hour provisions of the Fair Labor Standards Act?

a. Children.
b. Railroad and airline employees.
c. Members of a union recognized as the bargaining agent by the National Labor Relations Board.
d. Office workers.

41. Under the Fair Labor Standards Act the Secretary of Labor does not have the power to

a. Issue subpoenas compelling attendance by a witness and the production of records by an employer.
b. Conduct investigations regarding practices subject to the Act.
c. Issue a wage order which requires an employer to pay wages found to be due and owing under the Act.
d. Issue injunctions to restrain obvious violations of the Act.
42. Which of the following statements is correct under the Federal Fair Labor Standards Act?
   a. Some workers may be included within the minimum wage provisions but exempt from the overtime provisions.
   b. Some workers may be included within the overtime provisions but exempt from the minimum wage provisions.
   c. All workers are required to be included within both the minimum wage provisions and the overtime provisions.
   d. Possible exemptions from the minimum wage provisions and the overtime provisions must be determined by the union contract in effect at the time.

43. Under the Federal Fair Labor Standards Act, which of the following would be regulated?

<table>
<thead>
<tr>
<th>Minimum wage</th>
<th>Overtime in the workweek</th>
<th>Number of hours</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. Yes</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>b. Yes</td>
<td>No</td>
<td>Yes</td>
</tr>
<tr>
<td>c. Yes</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td>d. No</td>
<td>Yes</td>
<td>Yes</td>
</tr>
</tbody>
</table>

44. Under the Fair Labor Standards Act, which of the following pay bases may be used to pay covered, nonexempt employees who earn, on average, the minimum hourly wage?

<table>
<thead>
<tr>
<th>Hourly</th>
<th>Weekly</th>
<th>Monthly</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. Yes</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>b. Yes</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td>c. Yes</td>
<td>No</td>
<td>Yes</td>
</tr>
<tr>
<td>d. No</td>
<td>Yes</td>
<td>Yes</td>
</tr>
</tbody>
</table>

45. When verifying a client's compliance with statutes governing employees' wages and hours, an auditor should check the client's personnel records against relevant provisions of which of the following statutes?

46. Under the Federal Consolidated Budget Reconciliation Act of 1985 (COBRA), when an employee voluntarily resigns from a job, the former employee's group health insurance coverage that was in effect during the period of employment with the company
   a. Automatically ceases for the former employee and spouse, if the resignation occurred before normal retirement age.
   b. Automatically ceases for the former employee's spouse, but continues for the former employee for an 18-month period at the former employer's expense.
   c. May be retained by the former employee at the former employee's expense for at least 18 months after leaving the company, but must be terminated for the former employee's spouse.
   d. May be retained for the former employee and spouse at the former employee's expense for at least 18 months after leaving the company.

UNION-EMPLOYEE RELATIONS

47. State laws that make it illegal to require union membership as a condition for getting or holding a job are known as
   a. fair trade laws.
   b. fair employment laws.
   c. right-to-work laws.
   d. open shop laws.

48. An employee residing in a right-to-work state
   a. is not represented in labor union-management negotiations without joining the union.
   b. is not required to join the union
   c. is required to join the union in order to maintain employment.
   d. must join the union within a time period no less than 30 days after employment.

49. A factory moves from a non-right-to-work state to a right-to-work state, and the union continues to represent the employees. In the right-to-work state,
   a. the employees can be forced to join the union before they start to work.
   b. the employees can be forced to join the union after thirty days on the job.
   c. the employees can decide not to be involved with the union.
   d. the employees can be forced to make payments to the union.
Chapter Twelve  
Regulation of Employment 
Multiple Choice Answers

1. (d) Silk can recover in full against Lake because the accident was due to Lake’s negligence. Silk can also recover against Stone, Lake’s employer. A principal is liable for all torts committed by their agents, while the agent was acting within the scope of their authority. Since Lake was making a delivery at the time of the accident, Lake was acting within the scope of authority and Stone will be liable. **An employee may recover workers’ compensation benefits and sue third parties, but the workers’ compensation carrier is subrogated to the recovery and will recover back any duplication of the workers’ compensation benefits received.** Thus Silk can recover from Lake or Stone, but must reimburse the workers’ compensation carrier for any duplicate benefits received. Answers (a) and (b) are incorrect because an employee may sue third parties and receive workers’ compensation benefits. The employee is only precluded from suing the employer, not third parties, like Lake or Stone. Answer (c) is incorrect because Silk may also recover in full against Stone.

2. (a) Employees will receive **workers’ compensation benefits** if injured in the scope of employment. **Injuries are broadly interpreted and include almost any injury or disease that is job related.** Occupational diseases and employment aggravation of a pre-existing disease are specifically included. Thus, only answer (a) is correct.

3. (c) Employees will receive **workers’ compensation benefits** if injured in the scope of employment. **Noncompliance with the employer’s rules will not bar recovery** because the employee’s negligence is irrelevant. However, **workers compensation benefits are not provided for self-inflicted wounds.** Only answer (c) indicates that noncompliance with rules will not bar recovery, but a self-inflicted wound will.

4. (b) Employees will receive **workers’ compensation benefits** if injured in the scope of employment. The **employer is strictly liable without regard to fault.** Answers (a) and (c) are incorrect because negligence by the employee will not bar recovery or change the amount of the award. Answer (d) is incorrect because workers’ compensation awards may be in the form of a lump sum and, thus, not be payable for life.

5. (d) Employees will receive **workers’ compensation benefits** if injured in the scope of employment. The **employer is strictly liable without regard to fault.** Answers (a), (b) and (c) are incorrect because negligence will not bar recovery. Negligence is irrelevant. Thus, the employee does not need to prove the employer negligent, the defense of contributory negligence by the employee is not available and the liability of the employer is not changed by the negligence of a co-employee.

6. (a) Employees will receive **workers’ compensation benefits** if injured in the scope of employment. An **employer must provide coverage to all eligible employees.** Answer (b) is incorrect because an employer withholds employee contributions with social security, not workers’ compensation. Answer (c) is incorrect because workers’ compensation benefits are based on the injury, not on the employee’s pay. Answer (d) is incorrect because an employer does not contribute to a federal insurance fund (there is no federal insurance fund). Employers may purchase private workers’ compensation insurance, be self-insured or make payments to a state insurance plan.

7. (b) Employees will receive **workers’ compensation benefits** if injured in the scope of employment. Since Kroll was injured in the course of employment, Kroll will receive workers’ compensation benefits. Worker compensation benefits are usually the **employee’s exclusive remedy against the employer.** Thus Kroll may not bring a negligence action against Acorn, the employer. Only answer (b) states Kroll will receive worker compensation benefits, but may not sue the employer.
8. (b) Taxes under the Federal Unemployment Tax Act are paid by the employer, not the employee. **As a business expense, the tax is deductible by the employer.** Answer (a) is incorrect because the taxes are a fixed percentage of each employee’s salary up to a stated maximum, not all compensation paid. Answer (c) is incorrect because it does not provide for all employees. It applies only to employers who paid $1,500 in wages during any calendar quarter or had one or more employees for twenty weeks during a calendar year. Answer (d) is incorrect because the tax is paid by employers, not employees.

9. (b) The Federal Unemployment Tax Act applies to employers who paid $1,500 in wages during any calendar quarter or had one or more employees for twenty weeks during a calendar year. Thus, Ral must file a 1993 FUTA return because it had at least one employee during at least 20 weeks of 1993. Answers (a) and (c) are incorrect because filing does not require that aggregate wages exceed $100,000 during a year and does not require that one worker earned $50 or more in any calendar quarter. Answer (d) is incorrect because Ral must file.

10. (d) Neither unemployment compensation insurance nor workers’ compensation insurance is withheld from an employee’s salary, as is done with social security. Only answer (d) states that neither are withheld.

11. (a) The Federal Unemployment Tax Act provides unemployment benefits to those who are unemployed through no fault of their own. Thus an unemployed CPA who was fired due to the employer’s business reversals would receive unemployment benefits. Answers (c) and (d) are incorrect because getting fired for embezzling or voluntarily quitting would not constitute being unemployed through no fault of the employee. Answer (b) is incorrect because one may not refuse to accept appropriate employment and still receive unemployment benefits.

12. (b) The Federal Unemployment Tax Act provides unemployment benefits to those who are unemployed through no fault of their own. Thus an employee discharged for work-connected misconduct may not receive unemployment benefits. Answer (a) is incorrect because an employee unable to work because of a disability would receive disability benefits, not unemployment benefits. Additionally, an employee must be willing and able to work to receive unemployment benefits and a disabled person would not be able to work. Answers (c) and (d) are incorrect because the states administer the benefit payments under the program and state variations occur.

13. (d) The Federal Unemployment Tax Act allows an employer to take a credit against the FUTA tax if contributions are made to a state unemployment fund. Answer (a) is incorrect because the tax is paid by the employer, not the employee. Answers (b) and (c) are incorrect because the act applies to all employers who paid $1,500 in wages during any calendar quarter or had one or more employees for twenty weeks during a calendar year. Thus the act can apply to businesses with fewer than 35 employees and those who operate solely in one state.

14. (c) Taxes under the Federal Unemployment Tax Act are paid by the employer, not the employee. Answers (a) and (b) are incorrect because federal law does provide general guidelines, standards and requirements for FUTA and the states administer the benefit payments under the program. Answer (d) is incorrect because the FUTA tax is calculated as a fixed percentage of each employee’s salary up to a stated maximum.

15. (a) FICA taxes are paid by both the employee and the employer. The employer submits the employee’s tax and their matching contribution to the federal government. **Penalties apply for failure to make timely FICA deposits and for failure to supply taxpayer identification numbers.** Only answer (a) states penalties apply to both.

16. (c) The Federal Insurance Contribution Act taxes are paid by both the employer and the employee. The employee’s portion is based on the employee’s wages, which is broadly interpreted to include almost all types of compensation received from employment. Thus a car received as a productivity award would be counted as wages and subject to the taxation provisions. Answers (a), (b) and (d) are incorrect because interest earned on bonds, capital gains and dividends are not compensation received from employment.

17. (a) The social security tax base is calculated on a self-employed person’s net profit, not gross income. Thus (a) is correct and (b) is incorrect. Answer (c) is incorrect because the tax is based on net profit, not gross wages. Also, there is no allowable deduction for contributions to a retirement account. Answer (d) is incorrect because the tax is only based on income received from employment. Taxable income can include income received from source other than employment.
18. (b) The **FICA tax** is paid by both the employer and the employee. The employee’s portion is withheld from the employee’s wages by the employer. **Failure of the employer to withhold and pay the employee’s share makes the employer primarily liable for the employee’s portion.** Answer (a) is incorrect because not all social security benefits are taxable, only a maximum of 85% is taxable. Answers (c) is incorrect because Tower is not a self-employed person, but an employee. Musgrove must withhold FICA taxes. Answer (d) is incorrect because bonus and vacation pay are subject to FICA taxes in that they are compensation received from employment.

19. (b) The **Federal Insurance Contribution Act taxes** are paid by both the employer and the employee. The employee’s portion is based on the employee’s wages, which is broadly interpreted to include almost all types of compensation received from employment. **Reimbursed travel expenses are not counted as wages.** Answers (a), (c) and (d) are incorrect because contingent fees, bonuses and commissions are types of compensation received from employment.

20. (c) The **FICA tax** is paid by both the employer and the employee. The employee’s portion is withheld from the employee’s wages by the employer. **Failure of the employer to withhold and pay the employee’s share makes the employer primarily liable for the employee’s portion.** The employer has the right to be reimbursed by the employee if the employer pays the employee’s share. Answers (a) and (b) are incorrect because an employer who paid an employee’s share of the FICA tax would not be entitled to an IRS refund and would be entitled to a tax deduction. Answer (d) is incorrect because penalties and interest are due if the employer fails to remit the FICA tax. Penalties and interest are not due for failure to collect the tax.

21. (b) **Social security benefits can be reduced if the earned income exceeds a threshold level.** Unearned income will not reduce benefits. Thus, director’s fees in excess of the annual exempt amount would cause a reduction in benefits because the fees would be earned income. Answers (a), (c) and (d) are incorrect because annuity proceeds, pension payments and stock dividends are not earned income.

22. (a) The **FICA tax** is paid by both the employer and the employee. The employee’s portion is withheld from the employee’s wages by the employer. **If the employer voluntarily pays the employee’s share, it would be deductible by the employer and would be includable in the employee’s taxable income as additional compensation received from employment.** Thus (a) is correct and (b) is incorrect. Answer (c) is incorrect because it is not a gift, but additional compensation and therefore taxable. Answer (d) is incorrect because there is no penalty on an employer who voluntarily pays the employee’s FICA tax.

23. (a) The tax rate for the self-employed is **15.3% of the first $106,800 in wages.** An employee’s tax rate is **7.65% of the first $106,800 in wages.** Thus a self-employed individual with net earnings of $35,000 would pay more FICA tax then an employee with wages of $35,000. Answer (b) is incorrect because the self-employed FICA tax is based on net earnings, not gross. Answer (c) is incorrect because a portion of the benefits may be included in adjusted gross income. Answer (d) is incorrect because only a portion of disability benefits may be included in adjusted gross income, not the entire amount.

24. (d) **Social security benefits can be reduced if the earned income of an individual is too high.** Unearned income will not reduce benefits. Thus, the receipt of earned income by an individual receiving retirement benefits may result in a reduction of such benefits. Answer (a) is incorrect because the self-employed must contribute to FICA. Answer (b) is incorrect because employees participating in private retirement plans must still contribute to FICA. Answer (c) is incorrect because death benefits can be paid if the employee dies after reaching the age of retirement.

25. (a) The Employment Retirement Income Security Act (**ERISA**) regulates existing pension plans. ERISA establishes standards for pension plan funding, investment of pension funds and other financial controls to avoid mismanagement. ERISA provides that an employee’s right to their own contributions must vest immediately and their right to their employer’s contributions vest after a certain specified number of years of employment (usually between 3 and 6 years). Thus, ERISA regulates both employee vesting and plan funding.

26. (b) **Noncontributory pension plans are plans where the employer contributes all of the funds and none are contributed by the employee.** Thus answers (a), (c) and (d) are incorrect, and answer (b) is correct.
27. (b) The Employment Retirement Income Security Act (ERISA) regulates existing pension plans. ERISA does not require that pension plans be established. Employers are prevented from unduly delaying an employee’s participation in an existing plan. Answer (a) is incorrect because ERISA does not require that a pension plan be established. Answer (c) is incorrect because there is no prohibition under ERISA for employer managed pension plans. Answer (d) is incorrect because ERISA does not mandate that employees be allowed to make investment decisions.

28. (b) The Occupational Safety and Health Administration (OSHA) may inspect a workplace on their own or at the request of an employee. Employers are prohibited from retaliating against employees for reporting violations. Thus an employer may not discharge an employee for revealing OSHA violations. Answer (a) is incorrect because although OSHA establishes safety and health standards for workplaces, it does not require that the workplace be free from risk. Answer (c) is incorrect because an employer may require OSHA to obtain a search warrant prior to an inspection. Answer (d) is incorrect because OSHA does not preempt state regulation of workplace safety. OSHA sets minimum standards only and the states may exceed these standards.

29. (a) The Occupational Safety and Health Administration (OSHA) has the power to establish standards and promulgate rules and regulations governing workplace safety. As such, OSHA can establish standards that protect employees from exposure to substances harmful to their health. OSHA does not develop safety equipment.

30. (c) The Occupational Safety and Health Administration (OSHA) may inspect a workplace on their own or at the request of an employee. Answer (a) is incorrect because OSHA may inspect a workplace without a search warrant if the employer does not object. It is only upon the objection of the employer that a search warrant is required. Answer (b) is incorrect because inspections may be conducted during working hours. Answer (d) is incorrect because OSHA is not required to give employers 24 hour notice prior to inspection.

31. (d) Title VII of the Civil Rights Act prohibits discrimination in employment based on race, color, religion, sex or national origin. Title VII specifically applies to referrals done by employment agencies. Thus, referral by an employment agency based on race, in response to an employer’s specific request to refer based on race would be a violation. Answer (a) is incorrect because it is permissible for an employer to discriminate on the basis of national origin, religion or sex if there is a bona fide occupational qualification (a reasonable business necessity). Answers (b) and (c) are incorrect because discrimination is permissible for national security and based on a professionally developed ability test.

32. (b) Title VII of the Civil Rights Act prohibits discrimination in employment based on race, color, religion, sex or national origin. Title VII does not prohibit discrimination based on age, the Age Discrimination Employment Act (ADEA) does. Answers (a), (c) and (d) are incorrect because Title VII does prohibit discrimination based on sex, race and religion.

33. (b) Under the Age Discrimination in Employment Act (ADEA) mandatory retirement below the age of 70 is prohibited unless there is a reasonable business necessity (bona fide occupational qualification). Workers may be terminated at any age for sufficient cause. Only answer (b) states compulsory retirement below the age of 65 is prohibited, but termination of employees between 65 and 70 for cause is not.

34. (c) Under the Age Discrimination in Employment Act (ADEA) mandatory retirement below the age of 70 is prohibited unless there is a reasonable business necessity (bona fide occupational qualification). Remedies may include injunctive relief and unpaid back pay, but do not include punitive damages or early retirement. Only answer (c) states back pay is available as a remedy, but early retirement is not.

35. (c) The Age Discrimination in Employment Act (ADEA) prohibits discrimination based on age of individuals 40 or older. The provisions of ADEA apply whether the discrimination is intentional or unintentional. Answer (a) is incorrect because employees can be terminated for cause at any age. Answer (b) is incorrect because ADEA does not prohibit the mandatory retirement of all employees. Mandatory retirement of employees under 70 is permissible if there is a reasonable business necessity, such as with airline pilots, police and firemen. Answer (d) is incorrect because ADEA only prohibits age discrimination. It does not prohibit all termination of employees and certainly would not prohibit termination based on a rational business decision, such as termination based on the closing of a plant.
36. (a) Under the provisions of the Americans With Disabilities Act, the disabled are protected from discrimination in public transportation and public accommodations. Only answer (a) reflects that both are prohibited.

37. (a) Title VII of the Civil Rights Act prohibits discrimination based on race, color, religion, sex or national origin in employment. The Equal Pay For Equal Work Act provides protection beyond Title VII and requires that women receive equal pay for doing work equal to that done by men. Thus, both acts prohibit discrimination in employment based on sex.

38. (a) The Federal Fair Labor Standards Act (FFLSA) provides for a minimum wage and time and a half for work over 40 hours in a week. Employees may be paid by a piece-rate method in lieu of the hourly-rate method where appropriate. Answers (b) and (d) are incorrect because employees represented by a labor union are covered under FFLSA and are specifically required to be paid at least a minimum wage. Answer (c) is incorrect because FFLSA provides for time and a half for work of over 40 hours in a week. It does not specify the maximum hour an individual can work in a day or week.

39. (b) The Federal Fair Labor Standards Act (FFLSA) provides for 1.5 times the regular rate for work in excess of 40 hours in a week. Of the four weeks worked, only two of the weeks were in excess of 40 hours (the 45 hour week and the 42 hour week). Thus, the employee would be paid 7 hours of overtime, which is answer (b).

40. (b) The Federal Fair Labor Standards Act (FFLSA) provides for a minimum wage and time and a half for work over 40 hours in a week. Railroad and airline employees are exempt from the overtime provisions. Answers (a), (c) and (d) are incorrect because children, union members and office workers are covered under both the minimum wage and the overtime provisions of FFLSA.

41. (d) The Federal Fair Labor Standards Act (FFLSA) is enforced by the Department of Labor. The Department of Labor has the power to initiate both civil and criminal actions for violations, conduct hearings and investigations, subpoena witnesses and records and issue wage orders requiring employers to pay wages found due. The Department of Labor does not have the power under the FFLSA to issue injunctions. Only a court would have the power to issue injunctions. Answers (a), (b) and (c) are incorrect because the Department of Labor does have the power under FFLSA to issue subpoenas, conduct investigations and issue wage orders.

42. (a) Under the Federal Fair Labor Standards Act (FFLSA) some workers may be included within the minimum wage provisions, but exempt from the overtime provisions. These workers would include taxi cab drivers, railroad and airline employees. Answer (b) is incorrect because there are no workers excluded from minimum wage provisions, but included within overtime provisions. Answer (c) is incorrect because agricultural workers, outside salesmen, professional workers, seasonal workers and those in the fishing industry are partially or fully excluded from both minimum wage and overtime provisions. Answer (d) is incorrect because exemptions from minimum wage and overtime provisions are determined by Congress, not determined by union contract.

43. (a) The Federal Fair Labor Standards Act (FFLSA) provides for a minimum wage and time and a half for work over 40 hours in a week. It also regulates the employment of children and limits the number of hours certain children may work in a week. Thus, the FFLSA regulates minimum wage, overtime and the number of hours in the workweek. Only answer (a) states that all three are regulated under the FFLSA.

44. (a) Under the Fair Labor Standards Act, an employee’s pay may be based on any type of basis (piece rate, salary, commission, hourly, weekly, monthly, etc.) as long as the amount paid will yield the equivalent of minimum wage per hour rate and as long as the employee receives 1.5 times their regular rate for work in excess of 40 hours in a workweek. Only answer (a) states that pay may be based on an hourly rate, a weekly rate and a monthly rate.

45. (b) The Federal Fair Labor Standards Act (FFLSA) provides for a minimum wage and time and a half for work over 40 hours in a week. Thus, when checking compliance with wage and hour statutes, the Federal Fair
Labor Standards Act should be examined. Answers (a), (c) and (d) are incorrect because wages and hours are not regulated by the National Labor Relations Act, The Taft-Hartley Act or the Americans With Disabilities Act.

46. **(d) Under the Federal Consolidated Budget Reconciliation Act (COBRA) an employee who voluntarily quits may retain health insurance coverage for themselves and their spouse for at least 18 months at their expense.** Answers (a), (b) and (c) are incorrect because coverage does not automatically cease for the former employee and spouse, it may be retained for 18 months at the former employee’s expense.

47. **(c) State laws that make it illegal to require union membership as a condition for getting or holding a job are known as right-to-work laws.**

48. **(b) An employee in a right-to-work state is not required to join a union.** Choice (a) is not correct because in right-to-work states employees must still be represented in union-management negotiations without joining the union. Choice (c) is not correct because in a right-to-work state, union membership is non-compulsory. Choice (d) is not correct because there is no requirement to join unions in a right-to-work state. In a non-right to work state employees may be required to join the union within a time period no less than 30 days.

49. **(c) The National Labor Relations Act of 1935, also known as the Wagner Act, gives the employees the right to associate with, join or form labor unions.** Right-to-work states allow individuals to work for a unionized employer without being compelled to join the union or pay dues. Answer (a) is incorrect since the employees cannot be forced to join the union in a right-to-work state. Answer (b) is incorrect since the employees cannot be forced to join the union even after 30 days on the job in a right-to-work state. Answer (d) is incorrect since the employees cannot be forced to make payments to the union in a right-to-work state.
Chapter Thirteen
Accountant's Legal Liability

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Chapter Thirteen
Accountant's Legal Liability

LIABILITY TO CLIENTS

1. Accountants are liable for any breach of their personal service contracts with clients
   a. they may not delegated these duties without the client's permission
   b. the accountant is not entitled to any compensation for material breaches
   c. the nature and limitations of the contract may be stated in an engagement letter

2. Accountants are liable to clients for negligence in performance of their duties
   a. negligence has 4 elements - these must be known

<table>
<thead>
<tr>
<th>4 Elements of Negligence</th>
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<tbody>
<tr>
<td>Duty of care</td>
</tr>
<tr>
<td>the accountant owed a duty of due care to the party harmed</td>
</tr>
<tr>
<td>Breach</td>
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<tr>
<td>the accountant breached by failing to use due care</td>
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<tr>
<td>- failed to act like a reasonably prudent accountant under the circumstances</td>
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<tr>
<td>- usually means failed to follow GAAS or GAAP unless following GAAS or GAAP would make the report misleading</td>
</tr>
<tr>
<td>Damages</td>
</tr>
<tr>
<td>some type of harm was suffered</td>
</tr>
<tr>
<td>Causality</td>
</tr>
<tr>
<td>the damages were caused by the accountant's breach</td>
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</tbody>
</table>

b. accountants are not insurers or guarantors of the accuracy of their reports (e.g. an accountant does not guarantee they will detect all acts of fraud or embezzlement)

3. Accountants are liable to clients for fraud, either actual or constructive
   a. actual fraud has 5 elements (MS RID) - these must be known

<table>
<thead>
<tr>
<th>5 Elements of Fraud - MS RID</th>
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</thead>
<tbody>
<tr>
<td>M Must have Material Misrepresentation of fact</td>
</tr>
<tr>
<td>S Must have Scienter - intent to deceive</td>
</tr>
<tr>
<td>(misrepresentation was made intentionally or knowingly)</td>
</tr>
<tr>
<td>R Must have Reasonable Reliance (justifiable reliance)</td>
</tr>
<tr>
<td>I Must have Intent to rely</td>
</tr>
<tr>
<td>D Must have Damages - liable to anyone suffering a loss</td>
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b. constructive fraud or gross negligence has all 5 elements of actual fraud, but scienter is taken care of by a reckless disregard for the truth (MR RID)

<table>
<thead>
<tr>
<th>5 Elements of Constructive Fraud - MR RID</th>
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<tbody>
<tr>
<td>M Must have Material Misrepresentation of fact</td>
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<tr>
<td>R Must have Reckless disregard for the truth (e.g. making a statement without knowing if it is true or false)</td>
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<tr>
<td>R Must have Reasonable Reliance (justifiable reliance)</td>
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<td>I Must have Intent to rely</td>
</tr>
<tr>
<td>D Must have Damages - liable to anyone suffering a loss</td>
</tr>
</tbody>
</table>
4. An accountant may not disclose confidential client information without the consent of the client
   a. a CPA cannot turn over confidential information to a purchaser of the CPA's practice, but they may allow the purchaser to review the material prior to purchase
   b. at common law and in Federal law, an accountant must disclose confidential client information if it is subpoenaed and relevant to a court case
   c. **exception:** a number of states have adopted laws granting some form of accountant client privilege to clients (not to the accountant)
      1). only the client may protect the confidentiality of this information
      2). e.g. the accountant may not refuse to disclose the privileged material if the client has consented to disclosure
   d. an accountant must reveal confidential client information to a state CPA quality control panel, even in a jurisdiction recognizing the accountant-client privilege

5. Working papers of an accountant are also confidential and may not be disclosed without the consent of the client
   a. working papers are the property of the accountant, not the client (although a client does have the right of access to the working papers)
   b. an accountant must submit working papers if subpoenaed and relevant to a court case, unless in a state recognizing the accountant-client privilege
   c. an accountant must submit working papers to a state CPA quality control panel, even in a jurisdiction recognizing the accountant-client privilege
   d. working papers may be transferred to the surviving partner on the death of a partner in a CPA firm

**LIABILITY TO THIRD PARTIES AT COMMON LAW**

1. An accountant's liability to a client for negligence is based the failure of the accountant to perform contractual duties with due care

2. Thus, many courts restrict the right of 3rd parties to sue accountants for negligence because they are not in **privity of contract** with the accountant (i.e. there is no contract between the accountant and the 3rd party. This is called the **privity defense**)
   a. thus, to be liable to a 3rd party for negligence there must be privity of contract
   b. leading case in this area is **Ultramares Corp. Vs Touche** 255 NY 170 (1931) which held an accountant is only liable for negligence to parties in privity and to 3rd parties primarily intended to be benefited by the accountant's work
      1). to be liable the accountant must know the specific name of the party relying on his work and the purpose for which the work will be used
      2). this is called the **primary benefit test**

   **Example:** X negligently prepares financial statements for a client that overestimates the client's financial position. X knew the financial statements would be used to obtain a loan from 1st National Bank. 1st National makes the loan based on X's financial statements and the client files for bankruptcy. X is liable for negligence to 1st National because the bank was primarily intended to be benefited and X knew the bank would rely on the work. **Note:** If X knew the financial statements would be used to obtain loans from banks but did not specifically know that 1st National would rely on them, X would not be liable to 1st National under Ultramares.

3. Most states have expanded Ultramares to make accountant's liable for negligence to **foreseen users and any foreseen class of users**
   a. under this rule accountants are liable for negligence to 3rd parties that are members of a group the accountant knew would rely on their work
   b. **thus,** it is not necessary to know the specific name of the third party, just that they were a member of a group that would rely on the accountant's work
c. e.g. X knew the financial statements would be used to obtain a loan from 1st National Bank, but didn't know the financial statements would also be used to obtain a loan from 2nd National Bank. X would be liable to 2nd National for negligence because 2nd National was a member of a group (banks) that X knew would rely on the financial statements.

4. Limitations on use of the privity defense
   a. privity is only a defense to negligence actions. It is never a defense to fraud, or to actions against the accountant under the Securities Acts of 1933 and 1934.
   b. privity is only a defense to negligence actions by 3rd parties, not clients (i.e. a client does have privity of contract with the accountant)

**LIABILITY UNDER SECURITIES ACT OF 1933**

1. '33 requires a registration statement filed with the SEC containing audited financial statements prepared by public accountants for public sales of securities

2. Civil liability for accountants under Section 11 of '33 - accountants are liable for material misrepresentations or omissions of fact in the registration statement. The plaintiff MUST SHOW:
   a. the plaintiff acquired the stock (they do not need to be the initial purchaser)
   b. the plaintiff suffered a loss
   c. there was a material misrepresentation or material omission of fact in the registration statement
   d. that's all plaintiff need show: no scienter, reliance or negligence need be proven by plaintiff
   e. the accountant is liable unless (s)he can prove
      1). it was not his/her fault through the due diligence defense (e.g. accountant followed GAAS or GAAP)
      2). plaintiff knew the misrepresentation was false
   f. suit must be brought within one year of discovery of the misrepresentation and within 3 years of the offering date

3. Accountants are criminally liable for willful violations under Section 24 and may be fined up to $10,000 and/or imprisoned for up to 5 years (e.g. willfully made material misrepresentations in the registration statement)

**LIABILITY UNDER SECURITIES EXCHANGE ACT OF 1934**

1. '34 generally covers stock sold on national stock exchanges in interstate commerce and requires reports and financial statements prepared by public accountants

2. Civil liability under Section 10b and rule 10b(5) of '34 (Anti-Fraud Section) accountants are liable for material misrepresentations or omissions of fact in the purchase or sale of any security and Civil liability under Section 18 of '34 accountants are liable for false or misleading statements of material facts in reports filed with the SEC (e.g. Form 10K or Form 10Q) - for both the plaintiff MUST SHOW:
   a. the plaintiff was a buyer or seller of the stock
   b. the plaintiff suffered a loss
   c. there was a material misrepresentation or omission of fact
   d. the plaintiff must show scienter or a reckless disregard for the truth
      1). note: proof of negligence is insufficient, must show an intent to deceive
      2). accountants can defend by showing they acted with good faith
   e. the plaintiff must show reliance
   f. suit must be brought within one year of discovery of the misrepresentation and within three years of the date of violation

Note: Under Section 10b and 18 of '34 the plaintiff must prove both scienter and reliance. Under Section 11 of '33 neither scienter nor reliance need be proven.
3. Accountants are **criminally liable** for willful violations of Section 10b and Section 18 of ’34 may be fined and/or imprisoned
   a. individual accountants may be fined $1,000,000 and imprisoned up to 10 years
   b. accounting firms may be fined up to $2,500,000

**PRIVATE SECURITIES LITIGATION REFORM ACT OF 1995**

1. Auditors who audit financial statements under Securities Exchange Act of 1934 must establish procedures to detect and identify:
   a. fraud or illegal acts having a material direct effect on the financial statements
   b. related party transactions having a material effect on the financial statements
   c. whether there is substantial doubt the company can continue as a going concern

2. Upon discovering fraud or illegality, the auditor must report:
   a. first to management and management’s audit committee unless inconsequential
   b. second to the board of directors if failure to take remedial action would:
      1). warrant departure from the standard audit report or
      2). warrant the auditor’s resignation

3. The **board must report to the SEC within 1 business day** and give a copy of the notice to the auditor
   a. if the board fails to report to the SEC the auditor must either resign or
   b. supply the SEC with a copy of the report to the board within 1 business day
   c. if the accountant resigns following failure of the board to report to the SEC, the accountant must notify the SEC and supply the SEC with a copy of the report within one business day

4. Accountants are civilly liable for failure to comply with this act, but may not be privately sued for reporting to the SEC

**SARBANES-OXLEY ACT OF 2002**

The Sarbanes-Oxley Act also known as the Public Company Accounting Reform and Investor Protection Act has and will continue to have a far-reaching impact on the accounting and auditing profession. The key provisions are as follows:

1. The Act creates the Public Company Accounting Oversight Board (PCAOB) which is a nonprofit corporation, not a federal agency. Violation of the PCAOB’s rules is considered a violation of the Securities Exchange Act of 1934 with all of its penalties.

2. The Board consists of five members; two must be or were CPAs. None of the Board members can receive any compensation from CPA firms. The Board regulates accounting firms that audit public companies that register with the SEC not private companies.

3. The main functions of the Board are as follows:
   a. Register and conduct inspections of public accounting firms. It is important to note that peer reviews are replaced by the Board’s review. The Board has the power to discipline nonconforming CPA firms.
   b. Establish auditing standards, quality control, independence standards, and audit report format and design. The Board may and has adopted a number of auditing standards already in practice.
   c. Regulate non-audit services CPA firms perform for clients, e.g., firms can no longer serve as both consultants and auditors for the same public company, nor may they become independent auditors of a public company within 10 years of being employed in a consulting capacity.
   d. Require accounting firms to have a second partner review and approve each audit report. Also require firms to issue a report on the examination of a company’s internal control structure and a description of material weaknesses.
4. The Act establishes new rules and criminal penalties involving the retention of audit and review workpapers.
   a. Auditors cannot falsify or destroy records to impede official investigations
   b. Auditors must retain workpapers for five years (sometimes seven years)
   c. Provides for significant fines and/or imprisonment up to twenty years.
   d. The rules apply to auditors, attorneys, consultants, and company employees.

5. The Act requires that any material services provided by an accounting firm must be pre-approved by the company’s audit committee and fees for those services must be disclosed to investors and shareholders. However, the Act makes it illegal for a public accounting firm to provide the following services:
   a. Actuarial services
   b. Appraisal or bookkeeping
   c. Broker-dealer or investment services
   d. Financial information systems design or implementation
   e. Internal audit services
   f. Management functions and related consulting services
   g. Note that the Act does allow firms to provide tax services and other non-prohibited services as long as the audit board approves
   h. It is important to again note that the Act does not restrict auditors from performing these services to private companies or to non-audit clients.

6. The Act increases accountant liability and responsibility because auditors are now required to establish and implement procedures to uncover fraud and illegal activity of a client. The accountant’s civil liability is proportional to the degree of responsibility related to their own carelessness or their involvement in improper activities, however an accountant who prepares an audit report may not escape liability for inaccuracy for sections completed by other accountants, unless the report specifically states what accountant was responsible for what parts.

7. The Act allows the audit partner and the audit partner who reviews the audit, only five consecutive years to audit a particular company. Note that if the public company has hired an employee of the auditing firm to be CEO, CFO, or CAO within the previous year, the audit firm is precluded from doing the audit for that public company.

8. The SEC is authorized to discipline auditors or firms. The SEC can use censure or may even temporarily or permanently bar them from practice and audit work for the following reasons: lack of qualifications, improper professional conduct and/or willful violation of securities laws or regulations.

9. The Act requires that the auditors report only to a company’s audit committee and only “independent directors” can serve on the audit committee.

10. Annual reports being filed by a public company which contain financial statements need to incorporate all material corrections and adjustments by CPA firms. Furthermore, auditors must report to the audit committee “critical accounting policies” and material weaknesses in a company’s internal controls.

11. The Act also requires public companies and their CEOs and CFOs to do the following:
   a. Disclose whether the company has adopted a code of ethics.
   b. Prohibit actions that mislead or fraudulently manipulate the auditors.
   c. Name the “financial experts” who serve on the companies’ audit committee.
   d. Prohibit the company making or modifying personal loans to officers or directors with few exceptions.
   e. As noted in the Federal Securities Chapter, CEOs and CFOs must now certify the following:
      • They have signed and reviewed the report and the financial statements “fairly represent” in all material respects the financial condition and results of operations of their company, and
      • Company’s report does not omit any material facts and does not contain any untrue statements of material facts, and
      • Officers have internal control systems in place which allows for a true and honest certification of financial statements by them. If there were any material deficiencies in internal control, officers must disclose them to the auditors.
Chapter Thirteen: Accountant’s Legal Liability
Multiple Choice Questions

1. When CPAs fail in their duty to carry out their contracts for services, liability to clients may be based on

<table>
<thead>
<tr>
<th>Breach of contract</th>
<th>Strict liability</th>
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<tbody>
<tr>
<td>a. Yes</td>
<td>Yes</td>
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<td>b. Yes</td>
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<td>c. No</td>
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<td>d. No</td>
<td>Yes</td>
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2. Ritz Corp. wished to acquire the stock of Stale, Inc. In conjunction with its plan of acquisition Ritz hired Fein, CPA, to audit the financial statements of Stale. Based on the audited financial statements and Fein’s unqualified opinion, Ritz acquired Stale. Within six months, it was discovered that the inventory of Stale had been overstated by $500,000. Ritz commenced an action against Fein. Ritz believes that Fein failed to exercise the knowledge, skill, and judgment commonly possessed by CPAs in the locality, but is not able to prove that Fein either intentionally deceived it or showed a reckless disregard for the truth. Ritz also is unable to prove that Fein had any knowledge that the inventory was overstated. Which of the following two causes of action would provide Ritz with proper bases upon which Ritz would most likely prevail?

b. Negligence and gross negligence.
c. Negligence and fraud.
d. Gross negligence and breach of contract.

3. Sun Corp. approved a merger plan with Cord Corp. One of the determining factors in approving the merger was the financial statements of Cord that were audited by Frank & Co., CPAs. Sun had engaged Frank to audit Cord’s financial statements. While performing the audit, Frank failed to discover certain irregularities that later caused Sun to suffer substantial losses. For Frank to be liable under common law negligence, Sun at a minimum must prove that Frank

a. Knew of the irregularities.
b. Failed to exercise due care.
c. Was grossly negligent.
d. Acted with scienter.

4. When performing an audit, a CPA will most likely be considered negligent when the CPA fails to

a. Detect all of a client’s fraudulent activities.
b. Include a negligence disclaimer in the CPA’s engagement letter.
c. Warn a client of known internal control weaknesses.
d. Warn a client’s customers of embezzlement by the client’s employees.

5. Cable Corp. orally engaged Drake & Co., CPAs, to audit its financial statements. Cable’s management informed Drake that it suspected the accounts receivable were materially overstated. Though the financial statements Drake audited included a materially overstated accounts receivable balance, Drake issued an unqualified opinion. Cable used the financial statements to obtain a loan to expand its operations. Cable defaulted on the loan and incurred a substantial loss.

If Cable sues Drake for negligence in failing to discover the overstatement, Drake’s best defense would be that Drake did not

a. Have privity of contract with Cable.
b. Sign an engagement letter.
c. Perform the audit recklessly or with an intent to deceive.
d. Violate generally accepted auditing standards in performing the audit.

6. A CPA’s duty of due care to a client most likely will be breached when a CPA

b. Gives a client incorrect advice based on an honest error of judgment.
c. Fails to give tax advice that saves the client money.
d. Fails to follow generally accepted auditing standards.
7. Which of the following statements best describes whether a CPA has met the required standard of care in conducting an audit of a client’s financial statements?
   a. The client’s expectations with regard to the accuracy of audited financial statements.
   b. The accuracy of the financial statements and whether the statements conform to generally accepted accounting principles.
   c. Whether the CPA conducted the audit with the same skill and care expected of an ordinarily prudent CPA under the circumstances.
   d. Whether the audit was conducted to investigate and discover all acts of fraud.

8. In general, the third party (primary) beneficiary rule as applied to a CPA’s legal liability in conducting an audit is relevant to which of the following causes of action against a CPA?

<table>
<thead>
<tr>
<th>Fraud</th>
<th>Negligence</th>
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<tr>
<td>Yes</td>
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<td>Yes</td>
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9. Hark, CPA, failed to follow generally accepted auditing standards in auditing Long Corp.’s financial statements. Long’s management had told Hark that the audited statements would be submitted to several banks to obtain financing. Relying on the statements, Third Bank gave Long a loan. Long defaulted on the loan. In a jurisdiction applying the *Ultramares* decision, if Third sues Hark, Hark will
   a. Win because there was no privity of contract between Hark and Third.
   b. Lose because Hark knew that banks would be relying on the financial statements.
   c. Win because Third was contributorily negligent in granting the loan.
   d. Lose because Hark was negligent in performing the audit.

10. Under the "Ultramares" rule, to which of the following parties will an accountant be liable for negligence?

<table>
<thead>
<tr>
<th>Parties in privity</th>
<th>Foreseen parties</th>
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<td>Yes</td>
<td>Yes</td>
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11. In a common law action against an accountant, lack of privity is a viable defense if the plaintiff
   a. Is the client’s creditor who sues the accountant for negligence.
   b. Can prove the presence of gross negligence that amounts to a reckless disregard for the truth.
   c. Is the accountant’s client.
   d. Bases the action upon fraud.

12. Which of the following statements is generally correct regarding the liability of a CPA who negligently gives an opinion on an audit of a client’s financial statements?
   a. The CPA is only liable to those third parties who are in privity of contract with the CPA.
   b. The CPA is only liable to the client.
   c. The CPA is liable to anyone in a class of third parties who the CPA knows will rely on the opinion.
   d. The CPA is liable to all possible foreseeable users of the CPA’s opinion.

13. Which of the following is the best defense a CPA firm can assert in a suit for common law fraud based on its unqualified opinion on materially false financial statements?
   a. Contributory negligence on the part of the client.
   b. A disclaimer contained in the engagement letter.
   c. Lack of privity.
   d. Lack of scienter.

14. If a CPA recklessly departs from the standards of due care when conducting an audit, the CPA will be liable to third parties who are unknown to the CPA based on
   a. Negligence.
   b. Gross negligence.
   c. Strict liability.
   d. Criminal deceit.

15. Which of the following elements, if present, would support a finding of constructive fraud on the part of a CPA?
   a. Gross negligence in applying generally accepted auditing standards.
   b. Ordinary negligence in applying generally accepted accounting principles.
   c. Identified third party users.
   d. Scienter.
16. Under common law, which of the following statements most accurately reflects the liability of a CPA who fraudulently gives an opinion on an audit of a client’s financial statements?
   a. The CPA is liable only to third parties in privity of contract with the CPA.
   b. The CPA is liable only to known users of the financial statements.
   c. The CPA probably is liable to any person who suffered a loss as a result of the fraud.
   d. The CPA probably is liable to the client even if the client was aware of the fraud and did not rely on the opinion.

17. If a stockbroker sues a CPA for common law fraud based on false statements contained in the financial statements audited by the CPA, which of the following, if present, would be the CPA’s best defense?
   a. The stockholder lacks privity to sue.
   b. The false statements were immaterial.
   c. The CPA did not financially benefit from the alleged fraud.
   d. The contributory negligence of the client.

18. A CPA firm issues an unqualified opinion on financial statements not prepared in accordance with GAAP. The CPA firm will have acted with scienter in all the following circumstances except where the firm
   a. Intentionally disregards the truth.
   b. Has actual knowledge of fraud.
   c. Negligently performs auditing procedures.
   d. Intends to gain monetarily by concealing fraud.

19. Ford & Co., CPAs, issued an unqualified opinion on Owens Corp.’s financial statements. Relying on these financial statements, Century Bank lent Owens $750,000. Ford was unaware that Century would receive a copy of the financial statements or that Owens would use them to obtain a loan. Owens defaulted on the loan.
   To succeed in a common law fraud action against Ford, Century must prove, in addition to other elements, that Century was
   a. Free from contributory negligence.
   b. In privity of contract with Ford.
   c. Justified in relying on the financial statements.
   d. In privity of contract with Owens.

20. Which of the following statements is correct regarding a CPA’s working papers? The working papers must be
   a. Transferred to another accountant purchasing the CPA’s practice even if the client hasn’t given permission.
   b. Transferred permanently to the client if demanded.
   c. Turned over to any government agency that requests them.
   d. Turned over pursuant to a valid federal court subpoena.

21. In a jurisdiction having an accountant-client privilege statute, to whom may a CPA turn over workpapers without a client’s permission?
   a. Purchaser of the CPA’s practice.
   b. State tax authorities.
   c. State court.
   d. State CPA society quality control panel.

22. A CPA is permitted to disclose confidential client information without the consent of the client to
   I. Another CPA who has purchased the CPA’s tax practice.
   II. Another CPA firm if the information concerns suspected tax return irregularities.
   III. A state CPA society voluntary quality control review board.
   a. I and III only.
   b. II and III only.
   c. II only.
   d. III only.

23. Thorp, CPA, was engaged to audit Ivor Co.’s financial statements. During the audit Thorp discovered that Ivor’s inventory contained stolen goods. Ivor was indicted and Thorp was subpoenaed to testify at the criminal trial. Ivor claimed accountant-client privilege to prevent Thorp from testifying. Which of the following statements is correct regarding Ivor’s claim?
   a. Ivor can claim an accountant-client privilege only in states that have enacted a statute creating such a privilege.
   b. Ivor can claim an accountant-client privilege only in federal courts.
   c. The accountant-client privilege can be claimed only in civil suits.
   d. The accountant-client privilege can be claimed only to limit testimony to audit subject matter.
24. A CPA’s working papers  
   a. Need **not** be disclosed under a federal court subpoena.  
   b. Must be disclosed under an IRS administrative subpoena.  
   c. Must be disclosed to another accountant purchasing the CPA’s practice even if the client hasn’t given permission.  
   d. Need **not** be disclosed to a state CPA society quality review team.

25. Which of the following statements is correct with respect to ownership, possession, or access to a CPA firm’s audit working papers?  
   a. Working papers may **never** be obtained by third parties unless the client consents.  
   b. Working papers are **not** transferable to a purchaser of a CPA practice unless the client consents.  
   c. Working papers are subject to the privileged communication rule which, in most jurisdictions, prevents any third-party access to the working papers.  
   d. Working papers are the client’s exclusive property.

26. Which of the following statements concerning an accountant’s disclosure of confidential client data is generally correct?  
   a. Disclosure may be made to any state agency without subpoena.  
   b. Disclosure may be made to any party on consent of the client.  
   c. Disclosure may be made to comply with an IRS audit request.  
   d. Disclosure may be made to comply with Generally Accepted Accounting Principles.

27. To which of the following parties may a CPA partnership provide its working papers, without being lawfully subpoenaed or without the client's consent?  
   a. The IRS.  
   b. The FASB.  
   c. Any surviving partner(s) on the death of a partner.  
   d. A CPA before purchasing a partnership interest in the firm.

28. Holly Corp. engaged Yost & Co., CPAs, to audit the financial statement to be included in a registration statement Holly was required to file under the provisions of the Securities Act of 1933. Yost failed to exercise due diligence and did not discover the omission of a fact material to the statements. A purchaser of Holly’s securities may recover from Yost under Section 11 of the Securities Act of 1933 only if the purchaser  
   a. Brings a civil action within one year of the discovery of the omission and within three years of the offering date.  
   b. Proves that the registration statement was relied on to make the purchase.  
   c. Proves that Yost was negligent.  
   d. Establishes privity of contract with Yost.

29. Which of the following statements is correct with regard to a suit against Larson and the client by a purchaser of the securities under Section 11 of the Securities Act of 1933?  
   a. The purchaser must prove that Larson was negligent in conducting the audit.  
   b. The purchaser must prove that Larson knew of the material misstatements.  
   c. Larson will **not** be liable if it had reasonable grounds to believe the financial statements were accurate.  
   d. Larson will be liable unless the purchaser did **not** rely on the financial statements.

30. In a suit by a purchaser against Larson for common law negligence, Larson’s best defense would be that the  
   a. Audit was conducted in accordance with generally accepted auditing standards.  
   b. Client was aware of the misstatements.  
   c. Purchaser was **not** in privity of contract with Larson.  
   d. Identity of the purchaser was **not** known to Larson at the time of the audit.
31. In a suit by a purchaser against Larson for common law fraud, Larson's best defense would be that
a. Larson did not have actual or constructive knowledge of the misstatements.
b. Larson's client knew or should have known of the misstatements.
c. Larson did not have actual knowledge that the purchaser was an intended beneficiary of the audit.
d. Larson was not in privity of contract with its client.

Items 32 through 35 are based on the following:
Dart Corp. engaged Jay Associates, CPAs, to assist in a public stock offering. Jay audited Dart’s financial statements and gave an unqualified opinion, despite knowing that the financial statements contained misstatements. Jay’s opinion was included in Dart’s registration statement. Larson purchased shares in the offering and suffered a loss when the stock declined in value after the misstatements became known.

32. In a suit against Jay and Dart under the Section 11 liability provisions of the Securities Act of 1933, Larson must prove that
a. Jay knew of the misstatements.
b. Jay was negligent.
c. The misstatements contained in Dart’s financial statements were material.
d. The unqualified opinion contained in the registration statement was relied on by Larson.

33. If Larson succeeds in the Section 11 suit against Dart, Larson would be entitled to
a. Damages of three times the original public offering price.
b. Rescind the transaction.
c. Monetary damages only.
d. Damages, but only if the shares were resold before the suit was started.

34. In a suit against Jay under the anti-fraud provisions of Section 10(b) and Rule 10b-5 of the Securities Exchange Act of 1934, Larson must prove all of the following except
a. Larson was an intended user of the false registration statement.
b. Larson relied on the false registration statement.
c. The transaction involved some form of interstate commerce.
d. Jay acted with intentional disregard of the truth.

35. If Larson succeeds in the Section 10(b) and Rule 10b-5 suit, Larson would be entitled to
a. Only recover the original public offering price.
b. Only rescind the transaction.
c. The amount of any loss caused by the fraud.
d. Punitive damages.

Items 36 and 37 are based on the following:
Under the liability provisions of Section 11 of the Securities Act of 1933, a CPA may be liable to any purchaser of a security for certifying materially misstated financial statements that are included in the security’s registration statement.

36. Under Section 11, a CPA usually will not be liable to the purchaser
a. If the purchaser is contributorily negligent.
b. If the CPA can prove due diligence.
c. Unless the purchaser can prove privity with the CPA.
d. Unless the purchaser can prove scienter on the part of the CPA.

37. Under Section 11, which of the following must be proven by a purchaser of the security?

<table>
<thead>
<tr>
<th>Reliance on the financial statements</th>
<th>Fraud by the CPA</th>
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<tbody>
<tr>
<td>a. Yes</td>
<td>Yes</td>
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<td>b. Yes</td>
<td>No</td>
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<td>c. No</td>
<td>Yes</td>
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<tr>
<td>d. No</td>
<td>No</td>
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38. Under Section 11 of the Securities Act of 1933, which of the following standards may a CPA use as a defense?

<table>
<thead>
<tr>
<th>Generally accepted accounting principles</th>
<th>Generally accepted fraud detection standards</th>
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<tbody>
<tr>
<td>a. Yes</td>
<td>Yes</td>
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<td>b. Yes</td>
<td>No</td>
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<td>c. No</td>
<td>Yes</td>
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<tr>
<td>d. No</td>
<td>Yes</td>
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</table>
39. Under the provisions of Section 10(b) and Rule 10b-5 of the Securities Exchange Act of 1934, which of the following activities must be proven by a stock purchaser in a suit against a CPA?
I. Intentional conduct by the CPA designed to deceive investors.
II. Negligence by the CPA.
   a. I only.
   b. II only.
   c. Both I and II.
   d. Neither I nor II.

40. For a CPA to be liable for damages under the anti-fraud provisions of Section 10(b) and Rule 10b-5 of the Securities Exchange Act of 1934, a plaintiff must prove all of the following except that
   a. The plaintiff relied on the financial statements audited by the CPA.
   b. The CPA violated generally accepted auditing standards.
   c. There was a material misrepresentation of fact in the financial statements audited by the CPA.
   d. The CPA acted with scienter.

41. Jay and Co., CPAs, audited the financial statements of Maco Corp. Jay intentionally gave an unqualified opinion on the financial statements even though material misstatements were discovered. The financial statements and Jay’s unqualified opinion were included in a registration statement and prospectus for an original public offering of Maco stock. Which of the following statements is correct regarding Jay’s liability to a purchaser of the offering under Section 10(b) and Rule 10b-5 of the Securities Exchange Act of 1934?
   a. Jay will be liable if the purchaser relied on Jay’s unqualified opinion on the financial statements.
   b. Jay will be liable if Jay was negligent in conducting the audit.
   c. Jay will not be liable if the purchaser’s loss was under $500.
   d. Jay will not be liable if the misstatement resulted from an omission of a material fact by Jay.

42. Under the antifraud provisions of Section 10(b) of the Securities Exchange Act of 1934, a CPA may be liable if the CPA acted
   a. Negligently.
   b. With independence.
   c. Without due diligence.
   d. Without good faith.

43. Ocean and Associates, CPAs, audited the financial statements of Drain Corporation. As a result of Ocean’s negligence in conducting the audit, the financial statements included material misstatements. Ocean was unaware of this fact. The financial statements and Ocean’s unqualified opinion were included in a registration statement and prospectus for an original public offering of stock by Drain. Sharp purchased shares in the offering. Sharp received a copy of the prospectus prior to the purchase but did not read it. The shares declined in value as a result of the misstatements in Drain’s financial statements becoming known. Under which of the following Acts is Sharp most likely to prevail in a lawsuit against Ocean?

<table>
<thead>
<tr>
<th>Securities Exchange Act of 1934, Section 10(b), Rule 10b-5</th>
<th>Securities Act of 1933, Section 11</th>
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<tbody>
<tr>
<td>a. Yes</td>
<td>Yes</td>
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<td>b. Yes</td>
<td>No</td>
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<tr>
<td>c. No</td>
<td>Yes</td>
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<tr>
<td>d. No</td>
<td>No</td>
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44. The Sarbanes-Oxley Act allows auditors to perform which of the following non-audit services for a public company while performing an audit?
   a. Internal audit services
   b. Bookkeeping services
   c. Tax services
   d. Design of a financial accounting system

45. According to the Sarbanes-Oxley Act, which of the following Boards is responsible for regulating CPA firms that audit public companies?
   a. Auditing Standards Board
   b. State Boards of Public Accounting
   c. Public Company Accounting Oversight Board
   d. Public Oversight Board
Chapter Thirteen: Accountant’s Legal Liability
Other Objective Questions

NUMBER 1

Number 1 consists of 6 items. Select the best answer for each item. Answer all items. Your grade will be based on the total number of correct answers.

Items 1 through 6 are based on the following:

Under Section 11 of the Securities Act of 1933 and Section 10(b), Rule 10b-5 of the Securities Exchange Act of 1934, a CPA may be sued by a purchaser of registered securities.

Required:
Items 1 through 6 relate to what a plaintiff who purchased securities must prove in a civil liability suit against a CPA. For each item, determine whether the statement must be proven under Section 11 of the Securities Act of 1933, under Section 10(b), Rule 10b-5, of the Securities Exchange Act of 1934, both Acts, or neither Act.

- If the item must be proven only under Section 11 of the Securities Act of 1933, answer (A).
- If the item must be proven only under Section 10(b), Rule 10b-5, of the Securities Exchange Act of 1934, answer (B).
- If the item must be proven under both Acts, answer (C).
- If the item must be proven under neither of the Acts, answer (D).

Only Section 11  Only Section 10(b)  Both  Neither
(A)  (B)  (C)  (D)

The plaintiff security purchaser must allege or prove:

1. Material misstatements were included in a filed document.
2. A monetary loss occurred.
3. Lack of due diligence by the CPA.
4. Privity with the CPA.
5. Reliance on the document.
6. The CPA had scienter.

NUMBER 2

Verge Associates, CPAs, were retained to perform a consulting service engagement by Stone Corp. Verge contracted to advise Stone on the proper computers to purchase. Verge was also to design computers to purchase. Verge was also to design computer software that would allow for more efficient collection of Stone’s accounts receivable. Verge prepared the software programs in a manner that allowed some of Stone’s accounts receivable to be erroneously deleted from Stone’s records. As a result, Stone’s expense to collect these accounts was increased greatly.

During the course of the engagement, a Verge partner learned from a computer salesperson that the computers Verge was recommending to Stone would be obsolete within a year. The salesperson suggested that Verge recommend a newer, less expensive model that was more efficient. Verge intentionally recommended, and Stone purchased, the more expensive model. Verge received a commission from the computer company for inducing Stone to purchase that computer.

Stone sued Verge for negligence and common law fraud.
Required:

a. State whether Stone will be successful in its negligence suit against Verge and describe the elements of negligence shown in the above situation that Stone should argue.

b. State whether Stone will be successful in its fraud suit against Verge and describe the elements of fraud shown in the above situation that Stone should argue.

NUMBER 3

Dill Corp. was one of three major suppliers who sold raw materials to Fogg & Co. on credit. Dill became concerned over Fogg’s ability to pay its debts. Payments had been consistently late and some checks had been returned, marked "insufficient funds". In addition, there were rumors concerning Fogg’s solvency. Dill decided it would make no further sales to Fogg on credit unless it received a copy of Fogg’s current, audited financial statements. It also required Fogg to assign its accounts receivable to Dill to provide security for the sales to Fogg on credit.

Clark & Wall, CPAs, was engaged by Fogg to perform an examination of Fogg’s financial statements upon which they subsequently issued an unqualified opinion. Several months later, Fogg defaulted on its obligations to Dill. At this point, Dill was owed $240,000 by Fogg. Subsequently, Dill discovered that only $60,000 of the accounts receivable that Fogg had assigned to Dill as collateral was collectible.

Dill has commenced a lawsuit against Clark & Wall. The complaint alleges that Dill has incurred a $180,000 loss as a result of negligent or fraudulent misrepresentations contained in the audited financial statements of Fogg. Specifically, it alleges negligence, gross negligence, and actual and/or constructive fraud on the part of Clark & Wall in the conduct of the audit and the issuance of an unqualified opinion.

State law applicable to this action follows the majority rule with respect to the accountant’s liability to third parties for negligence. In addition, there is no applicable state statute which creates an accountant-client privilege. Dill demanded to be provided a copy of the Fogg workpapers from Clark & Wall who refused to comply with the request claiming that they are privileged documents. Clark & Wall has asserted that the entire action should be dismissed because Dill has no standing to sue the firm because of the absence of any contractual relationship with it, i.e., a lack of privity.

Required: Answer the following, setting forth reasons for any conclusions stated.

a. Will Clark & Wall be able to avoid production of the Fogg workpapers based upon the assertion that they represent privileged communications?

b. What elements must be established by Dill to show negligence on the part of Clark & Wall?

c. What is the significance of compliance with GAAS in determining whether the audit was performed negligently?

d. What elements must be established by Dill to show actual or constructive fraud on the part of Clark & Wall?
**NUMBER 4**

Butler Manufacturing Corp. planned to raise capital for a plant expansion by borrowing from banks and making several stock offerings. Butler engaged Weaver, CPA, to audit its December 31, 1989, financial statements. Butler told Weaver that the financial statements would be given to certain named banks and included in the prospectuses for the stock offerings.

In performing the audit, Weaver did not confirm accounts receivable and, as a result, failed to discover a material overstatement of accounts receivable. Also, Weaver was aware of a pending class action product liability lawsuit that was not disclosed in Butler’s financial statements. Despite being advised by Butler’s legal counsel that Butler’s potential liability under the lawsuit would result in material losses, Weaver issued an unqualified opinion on Butler’s financial statements.

In May 1990, Union Bank, one of the named banks, relied on the financial statements and Weaver’s opinion in giving Butler a $500,000 loan. Butler raised an additional $16,450,000 through stock offerings.

Shortly after obtaining the Union loan, Butler began experiencing financial problems but was able to stay in business because of the money raised by the offerings. Butler was found liable in the product liability suit. This resulted in a judgment Butler could not pay. Butler also defaulted on the Union loan and was involuntarily petitioned into bankruptcy. This caused Union to sustain a loss and Butler’s stockholders to lose their investments.

As a result:
- Union sued Weaver for
  - Negligence
  - Common Law Fraud
- The stockholders who purchased Butler’s stock through the offerings sued Weaver, alleging fraud under Section 10(b) and Rule 10b-5 of the Securities Exchange Act of 1934.

These transactions took place in a jurisdiction providing for accountant’s liability for negligence to known and intended users of financial statements.

**Required:** Answer the following questions and give the reasons for your conclusions:

a. Will Union be successful in its suit against Weaver for:
   1. Negligence?
   2. Common law fraud?

b. Will the stockholders who purchased Butler’s stock through the 1990 offerings succeed against Weaver under the anti-fraud provisions of Section 10(b) and Rule 10b-5 of the Securities Exchange Act of 1934?

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**NUMBER 5**

Sleek Corp. is a public corporation whose stock is traded on a national securities exchange. Sleek hired Garson Associates, CPAs, to audit Sleek’s financial statements. Sleek needed the audit to obtain bank loans and to make a public stock offering so that Sleek could undertake a business expansion program.

Before the engagement, Fred Hedge, Sleek’s president, told Garson’s managing partner that the audited financial statements would be submitted to Sleek’s banks to obtain the necessary loans.

During the course of the audit, Garson’s managing partner found that Hedge and other Sleek officers had embezzled substantial amounts of money from the corporation. These embezzlements threatened Sleek’s financial stability. When these findings were brought to Hedge’s attention, Hedge promised that the money would be repaid and begged that the audit not disclose the embezzlements.
Hedge also told Garson’s managing partner that several friends and relatives of Sleek’s officers had been advised about the projected business expansion and proposed stock offering, and had purchased significant amounts of Sleek’s stock based on this information.

Garson submitted an unqualified opinion on Sleek’s financial statements, which did not include adjustments for or disclosures about the embezzlements and insider stock transactions. The financial statements and audit report were submitted to Sleek’s regular banks including Knox Bank. Knox, relying on the financial statements and Garson’s report, gave Sleek a $2,000,000 loan.

Sleek’s audited financial statements were also incorporated in a registration statement prepared under the provisions of the Securities Act of 1933. The registration statement was filed with the SEC in conjunction with Sleek’s public offering of 100,000 shares of its common stock at $100 per share.

An SEC investigation of Sleek disclosed the embezzlements and the insider trading. Trading in Sleek’s stock was suspended and Sleek defaulted on the Knox loan.

As a result, the following legal actions were taken:
- Knox sued Garson.
- The general public purchaser of Sleek’s stock offerings sued Garson.

**Required:** Answer the following questions and give the reasons for your conclusions.

a. Would Knox recover from Garson for fraud?
b. Would the general public purchasers of Sleek’s stock offerings recover from Garson
   1. Under the liability provisions of Section 11 of the Securities Act of 1933?
   2. Under the anti-fraud provisions of Rule 10b-5 of the Securities Exchange Act of 1934?

**NUMBER 6**

Astor Inc. purchased the assets of Bell Corp. A condition of the purchase agreement required Bell to retain a CPA to audit Bell’s financial statements. The purpose of the audit was to determine whether the unaudited financial statements furnished to Astor fairly presented Bell’s financial position. Bell retained Salam & Co., CPAs, to perform the audit.

While performing the audit, Salam discovered that Bell’s bookkeeper had embezzled $500. Salam had some evidence of other embezzlements by the bookkeeper. However, Salam decided that the $500 was immaterial and that the other suspected embezzlements did not require further investigation. Salam did not discuss the matter with Bell’s management. Unknown to Salam, the bookkeeper had, in fact, embezzled large sums of cash from Bell. In addition, the accounts receivable were significantly overstated. Salam did not detect the overstatement because of Salam’s inadvertent failure to follow its audit program.

Despite the foregoing, Salam issued an unqualified opinion on Bell’s financial statements and furnished a copy of the audited financial statements to Astor. Unknown to Salam, Astor required financing to purchase Bell’s assets and furnished a copy of Bell’s audited financial statements to City Bank to obtain approval of the loan. Based on Bell’s audited financial statement, City loaned Astor $600,000.

Astor paid Bell $750,000 to purchase Bell’s assets. Within six months, Astor began experiencing financial difficulties resulting from the undiscovered embezzlements and overstated accounts receivable. Astor later defaulted on the City loan.

City has commenced a lawsuit against Salam based on the following causes of action:
- Constructive fraud
- Negligence

**Required:** In separate paragraphs, discuss whether City is likely to prevail on the causes of action it has raised, setting forth reasons for each conclusion.
Astor Electronics, Inc., is engaged in the business of marketing a wide variety of computer-related products throughout the United States. Astor’s officers decided to raise $1,000,000 by selling shares of Astor’s common stock in an exempt offering under Regulation D of the Securities Act of 1933. In connection with the offering, Astor engaged Apple & Co., CPAs, to audit Astor’s 1989 financial statements. The audited financial statements, including Apple’s unqualified opinion, were included in the offering memorandum given to prospective purchasers of Astor’s stock. Apple was aware that Astor intended to include the statements in the offering materials.

On Astor’s financial statements, certain inventory items were reported at a cost of $930,000 when, in fact, they had a fair market value of less than $100,000 because of technological obsolescence. Apple accepted the assurances of Astor’s controller that cost was the appropriate valuation, despite the fact that Apple was aware of ongoing sales of the products at prices substantially less than cost. All of this was thoroughly documented in Apple’s working papers.

Musk purchased 10,000 shares of Astor’s common stock in the Regulation D offering at a total price of $300,000. In deciding to make the purchase, Musk had reviewed the audited financial statements of Astor that accompanied the other offering materials and Musk was impressed by Astor’s apparent financial strength.

Shortly after the stock offering was completed, Astor’s management discovered that the audited financial statements reflected the materially overstated valuation of the company’s inventory. Astor advised its shareholders of the problem.

Musk, upon receiving notice from Astor of the overstated inventory amount, became very upset because the stock value was now substantially less than what it would have been had the financial statements been accurate. In fact, the stock is worth only about $200,000.

Musk has commenced an action against Apple alleging that Apple is liable to Musk based on the following causes of action:

- Common law fraud.
- Negligence.
- A violation of Section 10(b) and Rule 10b-5 of the Securities Exchange Act of 1934.

During the course of the litigation, Apple has refused to give to Musk its working papers pertaining to the Astor audit, claiming that these constituted privileged communications. The state in which the actions have been commenced has no accountants’ privileged communication statute.

The state law applicable to this action follows the Ultramares decision with respect to accountants’ liability to third parties for negligence or fraud.

Apple has also asserted that the actions should be dismissed because of the absence of any contractual relationship between Apple and Musk, i.e., a lack of privity.

**Required:** Answer the following, setting forth reasons for any conclusions stated.

**a.** Will Apple be required to give Musk its working papers?

**b.** What elements must be established by Musk to support his cause of action based on negligence?

**c.** What elements must be established by Musk to support his cause of action based on a Rule 10b-5 violation?

**d.** Is Apple’s assertion regarding lack of privity correct with regard to Musk’s causes of action for negligence and fraud?
Dredge Corp. engaged Crew, a CPA licensed by a state board of accountancy, to perform an audit of Dredge’s financial statements so that Dredge could obtain a large capital improvement loan. During the audit, Bold, Dredge’s CFO, asked Crew to accept a consulting engagement to assist Dredge with the installation of a new computerized accounting system. Crew accepted the consulting engagement and performed it simultaneously with the audit.

While performing the audit, Crew discovered material misstatements in Dredge’s financial statements resulting from management fraud committed by Bold. Crew notified Bold of the discovery and was told to disregard it or Crew would lose the consulting engagement. Believing the consulting engagement would be lost, Crew intentionally did not notify Dredge’s audit committee of the fraud, and rendered an unqualified opinion on Dredge’s financial statements.

Dredge submitted to Ocean Bank the materially misstated financial statements together with Crew’s auditor’s report. Ocean relied on the opinion in agreeing to finance Dredge’s capital improvement.

While performing the consulting engagement, Crew failed to discover that Dredge’s new computerized accounting system had insufficient control procedures because Crew omitted steps in order to complete the engagement on time. The insufficient control procedures had allowed and were allowing employees to steal from the corporation.

As a result of Bold’s fraud, Dredge defaulted on the Ocean loan and was petitioned into bankruptcy under Chapter 11 of the Federal Bankruptcy Code.

The following events resulted from the above situation:

- Dredge Corp. reported Crew’s actions to the state board of accountancy that licensed Crew.
- Dredge Corp. sued Crew for negligence in performing the consulting engagement.
- Ocean Bank sued Crew for common law fraud for giving an unqualified opinion on Dredge’s financial statements.

**Required:**

a. 1. Determine whether or not Crew violated the profession’s standards in the areas of independence (when accepting the engagement), due care, and acts discreditable to the profession, and give reasons for your conclusions.
   
   2. State the actions the state board of accountancy may take against Crew.

b. 1. State the outcome of Dredge Corp.’s suit against Crew for negligence in performing the consulting engagement, and give the reasons for your conclusion.
   
   2. State the outcome of Ocean Bank’s suit against Crew for common law fraud for giving an unqualified opinion on Dredge’s financial statements, and give the reasons for your conclusion.

**Note:** Only the (b) requirement relates to Accountant’s Legal Liability. The (a) requirement relates to Professional Responsibility.
NUMBER 9

Wolf is an audit client of Dunbar Associates, CPAs. Wolf is a reporting company under the provisions of the Securities Exchange Act of 1934. In 1997, Wolf’s audit committee engaged Dunbar to perform litigation support services. The services were completed in January 1997, and Dunbar billed Wolf in February 1997.

In February 1998, Dunbar began its annual audit of Wolf’s financial statements. During the course of the audit, Dunbar discovered that Wolf’s officers had committed management fraud. The officers’ fraud had resulted in material misstatements in the financial statements that were to be submitted to the SEC with Wolf’s annual report (Form 10-K). In March 1998, Dunbar issued an auditor’s report containing an unqualified opinion on the financial statements. As of that date, Wolf had not paid Dunbar’s outstanding February 1997 bill.

Required:

a. State whether Dunbar committed any violations of the standards of the profession in the areas of independence and due care. Explain your conclusions and indicate what, if any, additional actions Dunbar should have taken.


Note: Only the (b) requirement relates to Accountant’s Legal Liability. The (a) requirement relates to Professional Responsibility.
Chapter Thirteen: Accountant's Legal Liability
Multiple Choice Answers

1. (b) Accountants may be liable for contract breaches, negligence, fraud, violation of the Securities Act of 1933 or violation of the Securities Exchange Act of 1934. Accountants are not strictly liable. Only answer (b) indicates that an accountant’s failure to carry out a contract for services would subject the accountant to breach of contract actions, but would not make the accountant strictly liable.

2. (a) Liability for actual fraud requires proof of scienter, an intent to deceive. With constructive fraud or gross negligence the scienter element is met by a reckless disregard for the truth. Since Ritz cannot prove that Fein intentionally deceived or showed a reckless disregard for the truth, Ritz would not prevail in either an action for fraud or gross negligence. Answers (b), (c) and (d) are incorrect because Ritz will not prevail in an action for fraud or gross negligence. For negligence a plaintiff must prove a duty of care, breach (lack of due care), damages and causality. Failure of Fein to exercise the skill and care possessed of CPA’s in the locality would constitute a failure to use due care and would make Fein liable for negligence. It would also be a breach of the contract for services that Fein had with Ritz. Thus answer (a) is correct.

3. (b) Liability for negligence requires proof of four elements: duty of care, breach (lack of due care), damages and causality. Thus Sun must prove Frank failed to exercise due care. Answer (a) is incorrect because knowledge is not an element of negligence. Answer (c) is incorrect because gross negligence is constructive fraud. Fraud requires an element of intent and negligence does not. Answer (d) is incorrect because scienter is the intent element of fraud and negligence does not require proof of intent.

4. (c) Liability for negligence requires proof of four elements: duty of care, breach (lack of due care), damages and causality. Failure to warn a client of known internal control weaknesses would constitute lack of due care and would subject an accountant to liability for negligence. Answer (a) is incorrect because due care does not require an accountant to detect all fraud. The accountant is not a guarantor. Answer (b) is incorrect because a negligence disclaimer does not relieve an accountant from liability for negligence. Answer (d) is incorrect because an accountant may not usually reveal a client’s information to others without the client’s permission. The accountant has a duty to inform the client of embezzlement by employees, not a duty to inform the client’s customers.

5. (d) Liability for negligence requires proof of four elements: duty of care, breach (lack of due care), damages and causality. Lack of due care is failure to act like a reasonably prudent accountant and most often means the accountant failed to follow GAAS or GAAP. Thus Drake’s best defense to a negligence action would be that Drake did not violate generally accepted auditing standards (GAAS). Answer (a) is incorrect because privity (no direct or contractual relationship) is only a defense to negligence actions by third parties. Cable is Drake’s client and therefore there is a contractual relationship. Answer (b) is incorrect because an accountant can be liable for negligence to a client regardless of whether an engagement letter is signed. Answer (c) is incorrect because fraud requires proof of an intent to deceive (actual fraud) or a reckless disregard for the truth (constructive fraud). Negligence does not require proof of intent.

6. (d) Liability for negligence requires proof of four elements: duty of care, breach (lack of due care), damages and causality. Lack of due care is failure to act like a reasonably prudent accountant and most often means the accountant failed to follow GAAS or GAAP. Thus the due care required of an accountant to a client would be most likely breached by a failure to follow generally accepted auditing standards (GAAS). Answer (a) is incorrect because submission of an oral report instead of a written report does not constitute failure to use due care. Answers (b) and (c) are incorrect because an honest error of judgment and a failure to give tax advice may be made by a reasonably prudent accountant. Lack of due care only occurs when an accountant fails to do what a reasonably prudent accountant would do.
7. (c) Liability for negligence requires proof of four elements: duty of care, breach (lack of due care), damages and causality. Lack of due care is failure to act like a reasonably prudent accountant and most often means the accountant failed to follow GAAS or GAAP. Thus an accountant would not meet the required standard of care for audits if (s)he failed to conduct the audit with the same skill and care of an ordinarily prudent CPA under the circumstances. Answer (a) is incorrect because the standard of care required for audits is that of a reasonably prudent accountant and normally means following GAAS. The standard of care does not depend on the client’s expectations. Answer (b) is incorrect because an audit must conform to generally accepted auditing standards (GAAS). Financial statements must conform to generally accepted accounting principals (GAAP). Answer (d) is incorrect because due care in audits does not require an accountant to detect all fraud. The accountant is not a guarantor.

8. (d) Accountants are not usually liable to third parties for negligence because of lack of privity (no direct or contractual relationship). **Privity is only a defense to negligence actions by third parties.** An exception to the privity defense is the third party beneficiary rule which states accountants are liable for negligence to third parties they knew would rely on their work. The privity defense and the third party beneficiary exception are only relevant to negligence actions, not fraud or constructive fraud. Thus only answer (d) is correct.

9. (a) Many courts restrict the right of 3rd parties to sue accountants for negligence because they are not in privity of contract (they have no contract with the accountant). The leading case in this area is **Ultramares Corp. vs. Touche 255 NY 170 (1931).** Under the "Ultramares" rule an accountant was liable for negligence only to parties in privity and to 3rd parties primarily intended to be benefited by the accountant’s work. Where there was no privity, the accountant was only liable if the accountant knew the specific name of the 3rd party relying on their work and the purpose for which the work would be used. Third Bank was not in privity with Hark. Although Hark knew that banks as a group would rely on the financial statements, Hark did not specifically know that Third Bank would rely on the financial statement. Thus Hark would win if sued by Third for negligence in a jurisdiction following the Ultramares decision because there was no privity of contract and due to the lack of specific knowledge of Third by Hark. Answer (b) is incorrect because Ultramares requires specific knowledge of the third party relying on the information, not merely knowledge of a group that would rely. Answer (c) is incorrect because there are no facts to indicate that Third Bank was contributorily negligent. Additionally, Hark would win due to lack of specific knowledge of Third, not because of any actions by Third. Answer (d) is incorrect because Hark will not lose, even though Hark was negligent.

10. (b) Many courts restrict the right of 3rd parties to sue accountants for negligence because they are not in privity of contract (they have no contract with the accountant). The leading case in this area is **Ultramares Corp. vs. Touche 255 NY 170 (1931).** Under the "Ultramares" rule an accountant was liable for negligence only to parties in privity and to 3rd parties primarily intended to be benefited by the accountant’s work. Where there was no privity, the accountant was only liable if the accountant knew the specific name of the 3rd party relying on their work and the purpose for which the work would be used. The 3rd party under "Ultramares" must be more than foreseen, their identity must be specifically known. Thus, under the "Ultramares" rule, accountants are liable for negligence to parties in privity, but are not liable to foreseen parties.

11. (a) Accountants are not usually liable to third parties for negligence because of lack of privity (no direct or contractual relationship). **Privity is only a defense to negligence actions by third parties and is never a defense to fraud.** Thus, lack of privity is a viable defense for a negligence suit brought against an accountant by a client’s creditor, a third party. Answers (b) and (d) are incorrect because lack of privity is never a defense to fraud or gross negligence (constructive fraud). Answer (c) is incorrect because there is a contractual relationship between an accountant and a client and thus privity is present.

12. (c) Accountants are not usually liable to third parties for negligence because of lack of privity (no direct or contractual relationship). Privity is only a defense to negligence actions by third parties, not clients. **Most states have expanded an accountant’s liability to 3rd parties for negligence to 3rd parties that were members of a group the accountant knew would rely on their work,** making answer (c) correct. Answer (a) is incorrect because accountants can be liable for negligence to clients as well as 3rd parties. Answer (b) is incorrect because accountants can be liable to 3rd parties (if they had reason to know the 3rd party would rely on their work in most states) as well as clients. Answer (d) is incorrect because accountants are not liable to all possible foreseeable users. They are only liable to those they had reason to know would rely on their work.
13. (d) Fraud has five elements: a material misrepresentation, scienter (intent to deceive), reliance, an intent to rely and damages (MS RID). Lack of scienter would be a good defense to a suit for fraud. Answers (a) and (b) are incorrect because neither a client’s contributory negligence nor a disclaimer would be valid defenses to fraud. Answer (c) is incorrect because privity is only a defense to negligence actions by third parties and never a defense to fraud.

14. (b) Constructive fraud or gross negligence has five elements: a material misrepresentation, a reckless disregard for the truth, reliance, an intent to rely and damages (MR RID). An accountant who recklessly departed from audit standards of due care would therefore be liable for gross negligence. Answer (a) is incorrect because constructive fraud requires a showing of gross negligence, not ordinary negligence. Answers (c) and (d) are incorrect because a reckless departure from due care is not strict liability or criminal deceit.

15. (a) Constructive fraud or gross negligence has five elements: a material misrepresentation, a reckless disregard for the truth, reliance, an intent to rely and damages (MR RID). Since constructive fraud is also known as gross negligence, a showing of gross negligence would support a finding of constructive fraud. Answer (b) is incorrect because constructive fraud requires a showing of gross negligence, not ordinary negligence. Answer (c) is incorrect because with either actual or constructive fraud, a party is liable to whomever suffered damages as a result of the fraud. The plaintiff need not be an identified third party user. Answer (d) is incorrect because an actual fraud element (MS RID). With constructive fraud, the scienter element is met by a reckless disregard for the truth (MR RID).

16. (c) Actual fraud has five elements: a material misrepresentation, scienter (intent to deceive), reliance, an intent to rely and damages (MS RID). One who commits fraud would be liable to anyone who suffered a loss as a result of the fraud. Answers (a) is incorrect because privity is not a defense to an action for fraud. Answer (b) is incorrect because a party committing fraud is liable to anyone suffering a loss as a result, not just liable to known users. Answer (d) is incorrect because reliance is an element of fraud and therefore must be proven for fraud to exist.

17. (b) Actual fraud has five elements: a material misrepresentation, scienter (intent to deceive), reliance, an intent to rely and damages (MS RID). There can be no fraud if the misrepresentation is immaterial. Answer (a) is incorrect because privity is not a defense to negligence actions by third parties and never a defense to fraud. Answers (c) and (d) are incorrect because neither a lack of financial benefit to the defrauder nor contributory negligence by the client is a defense to fraud.

18. (c) In actual fraud the scienter element is shown by intent to deceive, which is making the misrepresentation intentionally or knowingly. In constructive fraud or gross negligence the scienter element is met by showing a reckless disregard for the truth. The scienter element is met by a showing of gross negligence, but would not be present by a showing of ordinary negligence. Answer (a) is incorrect because a reckless disregard for the truth satisfies the scienter element. Answers (b) and (d) are incorrect because actual knowledge of fraud or an intent to monetarily gain by concealing fraud are acts intentionally done or done knowingly and therefore constitute scienter.

19. (c) Actual fraud has five elements: a material misrepresentation, scienter (intent to deceive), reliance, an intent to rely and damages (MS RID). The reliance element requires that the plaintiff reasonably or justifiably relied on the misrepresentation. Answer (a) is incorrect because contributory negligence of the plaintiff is not a defense to fraud. Answers (b) and (d) are incorrect because privity is only a defense to negligence actions by third parties and never a defense to fraud.
20. (d) If an accountant’s workpapers are subpoenaed, the accountant must usually produce them. Thus, an accountant’s workpapers must be turned over pursuant to a valid federal court subpoena. Answer (a) is incorrect because an accountant may not turn over workpapers to a purchaser of a CPA’s practice without the client’s consent. Answer (b) is incorrect because workpapers are the property of the accountant, not the client. Therefore, an accountant is not required to permanently transfer workpapers upon a client’s demand. Answer (c) is incorrect because workpapers are confidential and may not be disclosed to others without the client’s consent. Although a government agency may subpoena workpapers if they are relevant to a court case, an accountant may not turn them over merely upon request.

21. (d) A CPA must turn over workpapers to a state CPA society quality control panel, even in a jurisdiction that recognizes the accountant-client privilege. Answer (a) is incorrect because an accountant may not turn over workpapers to a purchaser of a CPA’s practice without the client’s consent. Answers (b) and (c) are incorrect because an accountant may not turn over workpapers to either state tax authorities or state courts in a jurisdiction with the accountant-client privilege.

22. (d) A CPA may not disclose confidential client information to others without the client’s consent. Thus, confidential client information may not be revealed to a purchaser of a CPA’s practice or to another CPA firm for suspected tax irregularities. A CPA must reveal confidential client information to a state CPA society voluntary quality control review board, even without the consent of the client. Only answer (d) so states.

23. (a) If an accountant is subpoenaed to testify in a court case concerning confidential client information, the accountant must usually testify. An accountant would not be required to testify in a jurisdiction that recognizes the accountant-client privilege. Therefore, Ivor (the client) can claim an accountant-client privilege only if a state statute has been enacted creating such a privilege. Answers (b) is incorrect because there is no accountant-client privilege at federal law. Answer (c) is incorrect because in jurisdictions that recognize the accountant-client privilege, the accountant could not testify in either civil or criminal cases without the consent of the client. Answer (d) is incorrect because in jurisdictions that recognize the accountant-client privilege, the privilege extends all accountant-client communications, not just to audits.

24. (b) If an accountant’s workpapers are subpoenaed, the accountant must usually produce them. Thus, an accountant’s workpapers must be disclosed under an IRS administrative subpoena. Answer (a) is incorrect because workpapers would have to be disclosed under a federal court subpoena. Answer (c) is incorrect because workpapers may not be turned over to a purchaser of a CPA’s practice without the consent of the client. Answer (d) is incorrect because an accountant must disclose workpapers to a state CPA society quality review team, even in a jurisdiction that recognizes the accountant-client privilege.

25. (b) A CPA may not disclose confidential client information to others without the client’s consent. Thus, confidential client information may not be revealed to a purchaser of a CPA’s practice unless the client consents. Answers (a) and (c) are incorrect because accountants must disclose workpapers even if the client objects, when subpoenaed by third parties as relevant information to a court action. Answer (d) is incorrect because workpapers belong to the accountant, not the client.

26. (b) An accountant may not disclose confidential client information to others without the client’s consent. However, with the proper consent of the client an accountant may disclose confidential client information. Answers (a) and (c) are incorrect because an accountant may not disclose confidential client information without the consent of the client to a state agency or the IRS absent a proper subpoena. Answer (d) is incorrect because disclosure may not be made to comply with GAAP.

27. (c) Workpapers may be provided to the surviving partner in a CPA firm without subpoena or consent of the client. Answers (a) and (b) are incorrect because submission of workpapers without the consent of the client to either the IRS or the FASB would require a proper subpoena. Answer (d) is incorrect because workpapers may not be disclosed to third parties without the consent of the client.
28. (a) Under Section 11 of the Securities Act of 1933 all the plaintiff need prove is that (s)he acquired the stock, (s)he suffered a loss and there was a material misrepresentation or material omission of fact in the financial statement. The statute of limitations for a section 11 action is one year from the discovery of the misrepresentation and within three years of the offering date. Thus, the purchaser must bring civil suit within this time period. Answers (b), (c) and (d) are incorrect because the plaintiff need not show reliance, negligence or privity of contract under Section 11.

29. (c) Under Section 11 of the Securities Act of 1933 all the plaintiff need prove is that (s)he acquired the stock, (s)he suffered a loss and there was a material misrepresentation or material omission of fact in the financial statement. The accountant will be liable unless (s)he can prove it was not his/her fault through the due diligence defense. Thus Larson will not be liable if Larson had reasonable grounds to believe the financial statements were accurate because Larson would have exercised due diligence. Answers (a), (b) and (d) are incorrect because the plaintiff is not required to show negligence, knowledge of the misrepresentation by the accountant and privity under Section 11.

30. (a) Liability for negligence requires proof of four elements: duty of care, breach (lack of due care), damages and causality. Lack of due care is failure to act like a reasonably prudent accountant and most often means the accountant failed to follow GAAS or GAAP. Thus Larson’s best defense to a negligence action would be that the audit was conducted in accordance with GAAS. Answer (b) is incorrect because knowledge or awareness of the misrepresentation by the client would not totally excuse Larson from liability for negligence. It may constitute contributory negligence on the part of the client, but this would only serve to lessen the damages the client could recover. Answers (c) and (d) are incorrect because in the majority of jurisdictions an accountant is liable for negligence to third parties that are members of a group the accountant knew would rely on his/her work. Larson knew that the financial statements would be used by purchasers of the stock as a group, thus neither privity nor knowledge of the specific identity of the purchasers was required.

31. (a) Actual fraud has five elements: a material misrepresentation, scienter (intent to deceive), reliance, an intent to rely and damages (MS RID). Constructive fraud or gross negligence has five elements: a material misrepresentation, a reckless disregard for the truth, reliance, an intent to rely and damages (MR RID). If Larson did not have actual or constructive knowledge of the misrepresentation, the intent element would be missing and no fraud would exist. Answer (b) is incorrect because whether the client knew or should have known of the misrepresentation, Larson will still be liable for fraud as long as the client reasonably relied on the misrepresentation. Answer (c) is incorrect because Larson is liable to anyone who suffered damages as a result of his/her fraud, not just those Larson knew of. Answer (d) is incorrect because privity is only a defense to negligence actions by third parties and never a defense to fraud.

32. (c) Under Section 11 of the Securities Act of 1933 all the plaintiff need prove is that (s)he acquired the stock, (s)he suffered a loss and there was a material misrepresentation or material omission of fact in the financial statement. The accountant will be liable unless (s)he can prove it was not his/her fault through the due diligence defense. Thus Larson would have to prove that the misstatements contained in the financial statements were material. Answers (a), (b) and (d) are incorrect because a plaintiff need not prove knowledge of the misstatements by the accountant, negligence or reliance under Section 11.

33. (c) Under Section 11 of the Securities Act of 1933 a successful plaintiff will recover monetary damages for the loss suffered. Answer (a) is incorrect because the plaintiff does not recover three times the offering price. Answer (b) is incorrect because the plaintiff may not rescind the transaction. Answer (d) is incorrect because the plaintiff will recover money for the loss suffered whether the shares were resold or not.

34. (a) Under Section 10(b) of the Securities Exchange Act of 1934 a plaintiff must show: that (s)he acquired or sold the stock, suffered a loss, a material misrepresentation or omission of fact, scienter (or a reckless disregard for the truth) and reliance. As with the Securities Act of 1933, there must be a showing that the transaction involved some form of interstate commerce. Answers (b), (c) and (d) are incorrect because reliance, involvement of interstate commerce and scienter (or reckless disregard for the truth) are all elements that must be proven under 10(b). Answer (a) is correct because there is no requirement that the plaintiff be the intended user.
35. (c) Under Section 10(b) of the Securities Exchange Act of 1934 a successful plaintiff will recover monetary damages for the loss suffered. Answer (a) is incorrect because the plaintiff recovers for the loss suffered, not the original offering price. Answer (b) is incorrect because the plaintiff may not rescind the transaction. Answer (d) is incorrect because punitive damages are not awarded.

36. (b) Under Section 11 of the Securities Act of 1933 all the plaintiff need prove is that (s)he acquired the stock, (s)he suffered a loss and there was a material misrepresentation or material omission of fact in the financial statement. The accountant will be liable unless (s)he can prove it was not his/her fault through the due diligence defense. Thus a CPA will not usually be liable to a purchaser if the CPA can prove due diligence. Answer (a) is incorrect because the contributory negligence of the purchaser is not relevant under Section 11. Answer (c) is incorrect because privity is only a defense to negligence actions by third parties, not to suit under Section 11. Answer (d) is incorrect because proof of scienter is not required of a purchaser under Section 11.

37. (d) Under Section 11 of the Securities Act of 1933 all the plaintiff need prove is that (s)he acquired the stock, (s)he suffered a loss and there was a material misrepresentation or material omission of fact in the financial statement. No scienter or reliance need be proven. Fraud requires proof of a material misrepresentation, scienter, reliance, an intent to rely and damages. Since neither scienter nor reliance need be proven under Section 11, fraud need not be proven and reliance need not be proven. Only answer (d) states neither need be shown.

38. (b) Under Section 11 of the Securities Act of 1933 all the plaintiff need prove is that (s)he acquired the stock, (s)he suffered a loss and there was a material misrepresentation or material omission of fact in the financial statement. The accountant will be liable unless (s)he can prove it was not his/her fault through the due diligence defense. Proof that the accountant followed generally accepted accounting principles would constitute a showing of due diligence and could, therefore, be used as a defense. Since generally accepted fraud detection standards do not exist, they could not be used as a defense.

39. (a) Under Section 10(b) of the Securities Exchange Act of 1934 a plaintiff must show: that (s)he acquired or sold the stock, suffered a loss, a material misrepresentation or omission of fact, scienter (or a reckless disregard for the truth) and reliance. Intentional conduct by the CPA designed to defraud (scienter) must be proven. There is no requirement to prove negligence of the CPA under 10(b). Only answer (a) indicates that an intentional act to deceive is required, but negligence is not.

40. (b) Under Section 10(b) of the Securities Exchange Act of 1934 a plaintiff must show: that (s)he acquired or sold the stock, suffered a loss, a material misrepresentation or omission of fact, scienter (or a reckless disregard for the truth) and reliance. Answers (a), (c) and (d) are incorrect because proof of reliance, proof of material misrepresentations of fact and proof of scienter are all elements of 10(b). Proof of violation of generally accepted auditing standards is not required. This would normally constitute negligence and proof of negligence is an insufficient showing under 10(b). An intent to deceive (scienter) must be shown, not negligence.

41. (a) Under Section 10(b) of the Securities Exchange Act of 1934 a plaintiff must show: that (s)he acquired or sold the stock, suffered a loss, a material misrepresentation or omission of fact, scienter (or a reckless disregard for the truth) and reliance. The financial statement contained material misrepresentations, which were intentionally made by Jay (scienter). Jay would be liable under 10(b) to any purchaser who relied on the financial statements and suffered a loss. Answer (b) is incorrect because negligence is not an element of 10(b). Answer (c) is incorrect because Jay would be liable for any loss suffered if the elements are proven for a 10(b) action, even if the dollar amount was less than $500. Answer (d) is incorrect because liability may stem from either material misrepresentations or material omissions of fact.
42. (d) Under Section 10(b) of the Securities Exchange Act of 1934 a plaintiff must show: that (s)he acquired or sold the stock, suffered a loss, a material misrepresentation or omission of fact, scienter (or a reckless disregard for the truth) and reliance. Scienter is an intent to deceive and requires an intentional act or its equivalent, a reckless disregard for the truth. The only intentional act that would constitute an intent to deceive would be acting without good faith. Answer (a) is incorrect because negligence is not an intentional act. Answer (b) is incorrect because acting with independence is not acting with an intent to deceive. An accountant is required to act with independence when performing an audit or other attestation service. Answer (c) is incorrect because acting without due diligence is a negligent action. It is not an intentional action. A defense for an accountant under Section 11 of the Securities Act of 1933 is to show that the accountant acted with due diligence. There is no due diligence defense for ’34.

43. (c) Under Section 11 of the Securities Act of 1933 all the plaintiff need prove is that (s)he acquired the stock, (s)he suffered a loss and there was a material misrepresentation or material omission of fact in the financial statement. No scienter or reliance need be proven. Sharp would most likely prevail under Section 11 of ’33 because Sharp can prove purchase of the shares, a loss and a material misrepresentation in the financial statements. This is all that is required of a purchaser under Section 11. Under Section 10(b) of the Securities Exchange Act of 1934, a plaintiff must show: that (s)he acquired or sold the stock, suffered a loss, a material misrepresentation or omission of fact, scienter (or a reckless disregard for the truth) and reliance. Sharp is not likely to succeed under Section 10(b) because Ocean did not intentionally make the misrepresentation and thus scienter is missing. Additionally, since Sharp did not read the material misrepresentations, there was no reliance. Only answer (c) indicates success under Section 11 and failure under Section 10(b).

44. (c) The 2002 Sarbanes-Oxley Act disallowed auditors from performing a number of non-audit services for a public company. Tax services are allowed as long as the company’s audit committee approves. Note that all of these services can be performed by auditors of a private company because only public companies are covered by this Act.

45. (c) The Sarbanes-Oxley Act established a new nonprofit agency called the Public Company Accounting Oversight Board to regulate CPA firms that audit public companies.
Chapter Thirteen: Accountant’s Legal Liability
Other Objective Answers

ANSWER 1

Analysis for 1 through 6: Under Section 11 of the Securities Act of 1933 all the plaintiff need prove is that (s)he acquired the stock, (s)he suffered a loss and there was a material misrepresentation or material omission of fact in the financial statement. No scienter or reliance need be proven. Under Section 10(b) of the Securities Exchange Act of 1934 a plaintiff must show: that (s)he acquired or sold the stock, suffered a loss, a material misrepresentation or omission of fact, scienter (or a reckless disregard for the truth) and reliance.

1. (C) Both Section 11 of the Securities Act of 1933 and Section 10(b) of the Securities Exchange Act of 1934 require proof of a material misrepresentation or material omission of fact.

2. (C) Both Section 11 of the Securities Act of 1933 and Section 10(b) of the Securities Exchange Act of 1934 require proof that a monetary loss occurred.

3. (D) Section 11 of the Securities Act of 1933 does not require the purchaser to prove lack of due diligence by the CPA, but the CPA may defend by showing due diligence. Section 10(b) does not require the purchaser to prove lack of due diligence by the CPA.

4. (D) Neither Section 11 of the Securities Act of 1933 nor Section 10(b) of the Securities Exchange Act of 1934 requires proof of privity. Privity is only a defense to negligence actions by third parties.

5. (B) Section 11 of the Securities Act of 1933 does not require proof of reliance, but Section 10(b) of the Securities Exchange Act of 1934 does.

6. (B) Section 11 of the Securities Act of 1933 does not require proof of scienter, but Section 10(b) of the Securities Exchange Act of 1934 does.

ANSWER 2

a. Stone will be successful in its negligence suit against Verge. The elements of negligence are as follows:
   • duty of care owed
   • breach of the duty
   • loss caused by the breach of duty

Verge Associates, CPAs, owed a duty to its client, Stone Corp., to perform the consulting services engagement in a competent manner with the expertise necessary to perform the engagement. Verge breached this duty by incompetently preparing the computer software programs. As a result of the breach, Stone sustained damages through increased accounts receivable collection costs.

b. Stone will be successful in its fraud suit against Verge. The elements of fraud are as follows:
   • false representation of a material fact
   • done intentionally or with gross negligence
   • justifiable reliance by the plaintiff
   • resultant damages sustained by the plaintiff

Verge Associates falsely represented that it was recommending the best possible computer to Stone when, in fact, it was recommending an inferior product. The computer to be purchased was material to the entire engagement. Verge made its recommendation knowing that a better, less expensive computer was available. Stone, as Verge’s client, justifiably relied on Verge’s recommendation. Stone was damaged because it spent more money for an inferior computer.
ANSWER 3

a. No. Since there is no accountant-client privilege recognized at common law and there is no applicable state statute which creates an accountant-client privilege, Clark & Wall will be required to produced its workpapers. Furthermore, the right to assert the accountant-client privilege generally rests with the client and not with the accountant.

b. The elements necessary to establish a cause of action for negligence against Clark & Wall are:
   • A legal duty to protect the plaintiff (Dill) from unreasonable risk.
   • A failure by the defendant (Clark & Wall) to perform or report on an engagement with the due care or competence expected of members of its profession.
   • A causal relationship, i.e., that the failure to exercise due care resulted in the plaintiff’s loss.
   • Actual damage or loss resulting from the failure to exercise due care.

In addition to the foregoing, Dill must be able to establish that it is within a known and intended class of third party beneficiaries in order to recover damages from Clark & Wall for negligence. This is necessary because Clark & Wall has asserted that it is not in privity of contract with Dill.

c. The primary standards against which the accountant’s conduct will be tested are GAAS. Such standards are generally known as "the custom of the industry." Failure by Clark & Wall to meet the standards of the profession will undoubtedly result in a finding of negligence. However, meeting the standard of the profession will not be conclusive evidence that Clark & Wall was not negligent, although it is of significant evidentiary value.

d. The requirements to establish actual or constructive fraud on the part of Clark & Wall are:
   1. A false representation of fact by the defendant (Clark & Wall).
   2. For actual fraud, knowledge by the defendant (Clark & Wall) that the statement is false (scienter) or that the statement is made without belief that it is truthful. Constructive fraud may be inferred from gross negligence or a reckless disregard for the truth.
   3. An intention to have the plaintiff (Dill) rely upon the false statement.
   4. "Justifiable" reliance upon the false statement.
   5. Damage resulting from said reliance.

ANSWER 4

a. 1. Union Bank will be successful in its negligence suit against Weaver. To be successful in a lawsuit for accountant’s negligence there must be:
   • duty
   • breach
   • plaintiff must be known intended user
   • reliance
   • loss

   Weaver was negligent in performing the audit by failing to confirm accounts receivable, which resulted in failing to discover the overstatement of accounts receivable. Weaver’s failure to confirm accounts receivable was a violation of Weaver’s duty to comply with generally accepted auditing standards. Weaver knew that Union would receive the financial statements and was thereby an intended user. Union relied on Weaver’s opinion in granting the loan and, as a result, suffered a loss.

2. Union will be successful in its common-law fraud suit against Weaver. To be successful in a lawsuit for common law fraud there must be:
   • an intentional material misstatement or omission
   • reliance
   • loss
Weaver was grossly negligent for failing to qualify its opinion after being advised of Butler’s potential material losses from the product liability lawsuit by legal counsel. Weaver will be liable to anyone who relied on Weaver’s opinion and suffered a loss as a result of this fraudulent omission.

b. Butler’s stockholders who purchased stock under the 1990 offerings will also be successful in their suit against Weaver under Section 10(b) and Rule 10b-5 of the Securities Exchange Act of 1934. Under the Act stock purchaser must show:
   • intentional material misstatement or omission (scienter)
   • reliance
   • loss

Weaver’s failure to qualify its opinion for Butler’s potential legal liability was material and done intentionally (scienter). Weaver will be liable for losses sustained by the purchasers who relied on Weaver’s opinion.

**ANSWER 5**

a. Knox would recover from Garson for fraud. The elements of fraud are: the misrepresentation of a material fact (because Garson issued an unqualified opinion on misleading financial statements, Garson’s opinion did not include adjustments for or disclosures about the embezzlements and insider stock transactions); with knowledge or scienter (because Garson was aware of the embezzlements and insider stock transactions); and a loss sustained by Knox (because of Sleek’s default on the loan).

b. 1. The general public purchasers of Sleek’s stock offerings would recover from Garson under the liability provisions of Section 11 of the Securities Act of 1933. Section 11 of the Act provides that anyone, such as an accountant, who submits or contributes to a registration statement or allows material misrepresentations or omissions to appear in a registration statement is liable to anyone purchasing the security who sustains a loss. Under the facts presented, Garson could not establish a "due diligence" defense to a Section 11 action because it knew that the registration statement failed to disclose material facts.

b. 2. The general public purchasers of Sleek’s stock offerings would also recover from Garson under the anti-fraud provisions of Section 10(b) and Rule 10b-5 of the Securities Exchange Act of 1934. Under Rule 10b-5, Garson’s knowledge that the registration statement failed to disclose a material fact, such as the insider trading and the embezzlements, is considered a fraudulent action. The omission was material. Garson’s action was intentional or, at a minimum, a result of gross negligence or recklessness (scienter). These purchasers relied on Garson’s opinion on the financial statements and incurred a loss.
ANSWER 6

City is likely to prevail against Salam based on constructive fraud. To establish a cause of action for constructive fraud, City must prove that:

- Salam made a materially false statement of fact.
- Salam lacked a reasonable ground for belief that the statement was true. Constructive fraud may be inferred from evidence of gross negligence or recklessness.
- Salam intended another to rely on the false statement.
- City justifiably relied on the false statement.
- Such reliance resulted in damages or injury.

Under the facts of this case, Salam is likely to be liable to City based on constructive fraud. Salam made a materially false statement of fact by rendering an unqualified opinion on Bell’s financial statements. Salam lacked a reasonable ground for belief that the financial statements were fairly presented by recklessly departing from the standards of due care in that it failed to investigate other embezzlements, despite having knowledge of at least one embezzlement, and did not notify Bell’s management of the matter. Salam intended that others rely on the audited financial statements. City justifiably relied on the audited financial statements in deciding to loan Astor $600,000 and damages resulted evidenced by Astor’s default on the City loan.

City is not likely to prevail against Salam based on negligence. In order to establish a cause of action for negligence against Salam, City must prove that:

- Salam owed a legal duty to protect City.
- Salam breached that legal duty by failing to perform the audit with the due care or competence expected of members of the profession.
- City suffered actual losses or damages.
- Salam’s failure to exercise due care proximately caused City to suffer damages.

The facts of this case establish that Salam was negligent by not detecting the overstatement of accounts receivable because of its inadvertent failure to follow its audit program. However, Salam will not be liable to City for negligence because Salam owed no duty to City. This is the case because Salam was not in privity of contract with City, and the financial statements were neither audited by Salam for the primary benefit of City, nor was City within a known and intended class of third party beneficiaries who were to receive the audited financial statements.

ANSWER 7

a. Yes. Since there is no accountant-client privilege recognized at common law and there is no applicable state statute creating such a privilege, Apple will be required to produce its working papers. Furthermore, the right to assert the accountant-client privilege, when applicable, generally rests with the client and not with the accountant.

b. The elements necessary to establish negligence are:

- A legal duty to protect the plaintiff (Musk) from unreasonable risk.
- A failure by the defendant (Apple) to perform or report on an engagement with the due care or competence expected of members of its profession.
- A causal relationship, i.e., that the failure to exercise due care resulted in the plaintiff’s loss.
- Actual damage or loss resulting from the failure to exercise due care.
c. The elements necessary to establish a violation of Rule 10b-5 include:

- A material misstatement or omission.
- The material misstatement or omission made by the defendant (Apple) with knowledge (scienter). Reckless disregard for the truth may constitute scienter.
- Justifiable reliance on the misstatement or omission.
- The reliance being in connection with the purchase or sale of a security.

d. Apple is not in privity of contract with Musk because there is no direct contractual relationship between them. Therefore, in the absence of other factors, Apple would not be liable to Musk for Apple’s alleged negligence based on the *Ultramares* decision. However, the privity defense would not protect Apple if Musk could prove that Apple had committed actual or constructive fraud (that is, Apple owes a duty to all persons, including third persons, to practice its profession in a non-fraudulent manner).

**ANSWER 8**

a. 1. Crew did not violate the profession’s standards regarding independence when the engagements were accepted. A CPA may perform consulting services simultaneously with an audit engagement. Crew violated the profession’s standards in failing to perform the consulting engagement and the audit with due care. Crew acted without due care by failing to discover the insufficient control procedures because of omitting steps in the engagement and by issuing an unqualified opinion on the financial statements.

   Crew committed acts discreditable to the profession by failing to notify Dredge’s audit committee of the material misstatements contained in the financial statements, failing to disclose Bold’s fraudulent activities, and profiting from withholding the information.

a. 2. The state board of accountancy may permanently revoke Crew’s license to practice or may suspend or restrict it for a period of time. If suspended or restricted, Crew may be required to take additional CPE courses as a condition of reinstatement.

b. 1. Dredge Corp. will be successful in its negligence suit against Crew. Crew owed a duty of care to Dredge to perform the consulting engagement according to the standards of the profession. Crew breached that duty by failing to discover that there were insufficient control procedures in Dredge’s new computerized accounting system. Dredge was damaged by Crew’s breach of duty because the insufficient control procedures had allowed and were continuing to allow employees to steal.

b. 2. Ocean Bank will be successful in its common law fraud suit against Crew. Crew intentionally issued an unqualified opinion on Dredge’s materially misstated financial statements. The financial statements and Crew’s accountant’s report were submitted to Ocean. Ocean justifiably relied on Crew’s unqualified opinion in agreeing to finance Dredge’s capital improvement. Ocean was damaged as a result of Dredge’s default on the loan, which was caused by the fraud.
ANSWER 9

a. Dunbar did not violate the standards of the profession in the area of independence by accepting the litigation support services engagement. A CPA may perform litigation support services for an attest client at the same time the CPA performs the audit. However, when Dunbar did not receive payment of the bill for the litigation support services within one year and prior to issuing the audit report, Dunbar’s independence was impaired. Dunbar should not have issued the report.

Dunbar violated the standards of the profession in the area of due care in two ways. First, Dunbar did this by knowingly and intentionally giving an unqualified opinion on the materially misstated financial statements.

Second, Dunbar also violated due care by failing to comply with the standards of the profession regarding the discovery of management fraud. Under the standards of the profession, Dunbar on discovering the fraud committed by Wolf’s officers, should have reported it directly to Wolf’s audit committee. Dunbar should have insisted that the financial statements be revised.

If the client did not revise the financial statements, Dunbar should have issued a nonstandard report or withdrawn from the engagement. Dunbar should have reported its action (in either case) to the client’s board of directors. If the client did not advise the SEC of Dunbar’s findings and did not promptly notify Dunbar that the SEC had been advised, Dunbar should have notified the SEC. By failing to take these steps, Dunbar violated due care.

b. Dunbar will likely be found to have violated the antifraud provisions of Section 10(b) and Rule 10b-5 of the Securities Exchange Act of 1934. Specifically, Dunbar contributed to the filing with the SEC of written material (Form 10-K) containing misstatements of material facts.

Dunbar will also likely be found to have violated the provisions of both the 1934 Act and the provisions of the Private Securities Litigation Reform Act of 1995. Specifically, Dunbar failed to withdraw from the engagement and notify the SEC of the material illegal acts committed by Wolf’s officers.
Chapter One
Filing Status and Exemptions, Filing Requirements and Penalties

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Chapter One
Filing Status and Exemptions, Filing Requirements and Penalties

OVERVIEW TO INDIVIDUAL TAXATION

The taxation of individuals starts with a very basic formula:

\[
\text{Gross income} \quad \text{Minus deductions} \quad \text{Equals taxable income}
\]

In our first four chapters, you will examine what makes up the gross income and allowable deductions of individuals. The CPA examination will test you on various components of the income and deductions, as well as various methods of determining the tax and a host of tax credits.

This very basic formula will expand as you are introduced to various classifications of deductions. You will be exposed to limitations on certain deductions based upon thresholds or ceilings, as well as phaseouts for exemptions and special rates. To be sure, there is a lot of complexity. But in the end, it comes back to income minus deductions equals taxable income.

In broad terms, gross income includes all items of income, unless specifically excluded by the Internal Revenue Code. By contrast, nothing is deductible unless specifically allowed by the Code. As a result, you will find that Chapter 2, which deals with inclusions and exclusions of income, is relatively short in comparison to the size of Chapters 3 and 4, which deal with the various deductions.

To help you better understand Chapter 1 and what lies ahead, follow through this simple example.

**Example 1:** K is single, aged 63 and earned $12,000 working part-time. In addition, K earned interest income of $1,300 and dividend income of $1,050. K also received social security benefits this year of $2,000. K does not itemize her deductions.

K’s **taxable income for 2010** is computed as follows:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Salary income</td>
<td>$12,000</td>
</tr>
<tr>
<td>Interest income</td>
<td>1,300</td>
</tr>
<tr>
<td>Dividend income</td>
<td>1,050</td>
</tr>
<tr>
<td>Total gross income</td>
<td>14,350</td>
</tr>
<tr>
<td>Less: Standard deduction</td>
<td>(5,700)</td>
</tr>
<tr>
<td>Less: Personal exemption</td>
<td>(3,650)</td>
</tr>
<tr>
<td>Taxable income</td>
<td>$ 5,000</td>
</tr>
</tbody>
</table>

K’s **gross income**, as more fully explained in Chapter 2, is comprised of salary, interest and dividend income. Social security benefits are not included in gross income unless they pass a threshold test as you will learn about later. Since K does not “itemize” her deductions, she is allowed a standard amount of deductions. You will learn more about itemized deductions in Chapter 4. For 2010, the **standard deduction** is $5,700 for single taxpayers. The amount of the standard deduction is based upon the filing status of the taxpayer. This is addressed in this chapter. The other deduction is the **personal exemption** and for 2010 it is $3,650. This, too, is discussed in this chapter.
This is the most comprehensive problem you need to understand in this chapter. Now let’s look at the taxpayer’s Filing Status and Exemptions in detail.

**FILING STATUS**

There are five filing statuses available to individual taxpayers. A taxpayer may choose any status he qualifies for. Since filing status determines your tax rate structure (See Chapter 5 for the complete rate structure) and the amount of your standard deduction, choosing the proper filing status is important in minimizing your taxes.

1. **Single, or unmarried.** If a taxpayer is unmarried on the last day of the tax year, or is separated by a decree of divorce or separate maintenance, that taxpayer is considered single. Assuming the taxpayer does not qualify for a more favorable filing status such as head of household, or qualifying widower, the taxpayer must file as a single taxpayer.

2. **Married Filing Jointly.** To qualify for this status, the taxpayer must be married as of the last day of the year. In the event of the death of the spouse during the year, the spouse need only be alive on the first day of that year in order to qualify as being married for the entire year. Taxpayers are prohibited from filing jointly if their spouse is a non-resident alien or they have different tax year-ends from one another. Couples filing jointly may use different accounting methods in filing their joint return. A further discussion of these accounting methods can be found in Chapter 5. For federal tax purposes, a marriage means only a legal union between a man and a woman as husband and wife.

3. **Married Filing Separately.** Married taxpayers may elect to file separate returns for a number of reasons. Issues of privacy, disclosure of tax returns by public officials, and possible tax planning in the shifting of deductions are some reasons as to why this status is available. In filing a separate return, both taxpayers must agree to either claiming (splitting) the standard deduction, or itemizing their deductions. One cannot itemize and the other claim the standard deduction.

4. **Head of Household.** This status is available to an unmarried taxpayer who:
   
   1. maintains a household and provides for more than 50% of the year the cost for
   2. your qualifying child (see page 5) or **any other relative who is a dependent**
      (as is discussed under exemptions) as a member of his household.

   In determining the cost of maintaining the household, you would include the cost of the food consumed in the home, as well as mortgage interest and real estate taxes (or rent), utilities and repairs. A special exception to this rule is that the taxpayer’s parents are not required to live with the taxpayer. The taxpayer must maintain more than 50% of the parent’s home, or more than 50% of their nursing home costs, in order to qualify. The parent must also qualify as the taxpayer’s dependent.

5. **Qualifying widow(er) with dependent child.** This is also referred to as surviving spouse. If your spouse dies during the taxable year, you are entitled to file married, filing jointly for that year. In the two years following the death of your spouse, the taxpayer may elect qualifying widow(er) if:

   1. The taxpayer has not remarried, and
   2. maintains more than 50% of the cost of the home where,
   3. the dependent child resides for the entire year.
STANDARD DEDUCTION

Once the determination of the appropriate filing status has been made, the amount of the standard deductions are as follows:

<table>
<thead>
<tr>
<th>Filing Status</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>2010</td>
<td></td>
</tr>
<tr>
<td>Single, or unmarried</td>
<td>$5,700</td>
</tr>
<tr>
<td>Married, filing jointly</td>
<td>11,400</td>
</tr>
<tr>
<td>Married, filing separately</td>
<td>5,700</td>
</tr>
<tr>
<td>Head of household</td>
<td>8,400</td>
</tr>
<tr>
<td>Qualifying widow(er)</td>
<td>11,400</td>
</tr>
</tbody>
</table>

You do not need to memorize these amounts. On past exams the candidate has been provided with these amounts as needed. You should, however, understand how amounts change in relation to one another. For example, married filing separately is exactly one-half of the married filing jointly. Qualifying widower provides a larger deduction than head of household. This relationship is important should the examiners ask you to determine what the most beneficial filing status is.

ADDITIONAL STANDARD DEDUCTION

There is an additional standard deduction available to the taxpayer who is 65 years or older, or blind. The additional standard deduction is added to the regular standard deduction in the determination of taxable income. The amounts are as follows:

<table>
<thead>
<tr>
<th>Filing Status</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>2010</td>
<td></td>
</tr>
<tr>
<td>Single or head of household</td>
<td>$1,400</td>
</tr>
<tr>
<td>Married or surviving spouse</td>
<td>1,100</td>
</tr>
</tbody>
</table>

Example 2: K is single, 67 and blind. For 2010, she is entitled to a total standard deduction of:

- Regular standard deduction: $5,700
- Additional standard deductions:
  - 65 or over: $1,400
  - Blind: $1,400
- Total standard deduction: $8,500
**EXEMPTIONS**

The second deduction introduced in the illustrative Example 1 was the exemption. For 2010, the allowable deduction for an exemption is $3,650. Exemptions are divided into two types: Personal and Dependency. On the exam, you need to carefully read the each question to determine whether the examiners are asking you about total exemptions, personal exemptions, or dependency exemptions.

**PERSONAL EXEMPTIONS**

**General Rule**

In general, each taxpayer is entitled to one personal exemption when filing their return. When a taxpayer files married filing jointly, they are entitled to two personal exemptions. Even when married filing separately, the taxpayer may claim two personal exemptions provided that the spouse has no gross income and is not the dependent of another taxpayer.

**Exceptions**

No exemption amount is allowed for a taxpayer who is allowed to be claimed as a dependent of another taxpayer.

**Example 3:** K is allowed to claim P, her ten year old son, as her dependent. If P files his return, he is not entitled to a personal exemption because K is allowed to claim P.

---

**DEPENDENCY EXEMPTIONS**

**General Rule**

When filing a return, a taxpayer is allowed an exemption of $3,650 for each person who qualifies as a dependent. It is available for a qualifying child or qualifying relative.

**Qualifying Child**

A qualifying child must meet 4 tests:

- Support test
- Relationship test
- Age Test
- Abode Test

**1. Support Test:** The dependent must not be self-supporting. This basically means that the dependent must receive more than 50% of their support from the taxpayer. Support includes, but is not limited to room and board, medical expenses, tuition payments, and purchasing of capital assets such as a car. In determining the percentage, the total support is based upon the amounts expended.

**Example 4:** If K paid $4,000 for her son’s room, board and medical costs; and her son earned and saved $1,000 from his paper route, K would have provided 100% of his support. Since his earnings were saved and not used for his support, they are not considered in determining his total support requirement.
2. **Relationship Test:** A qualifying child means
   1. Son or daughter, or descendant (grandchild)
   2. Adopted child or stepchild
   3. Eligible foster child
   4. Brother or sister
   5. Half brother or half sister
   6. Step brother or step sister
   7. Or descendents of any of the above

3. **Age Test:** A qualifying child must be under the age of 19, or if they are a full-time student, under the age of 24. A student is full-time if they are enrolled for five months during the year.

4. **Abode Test:** A qualifying child must live with the taxpayer for more than one-half of the year. Temporary absences such as being away at school count as being with the taxpayer.

### Qualifying Relative

A qualifying relative must meet 3 tests:

- **Support test**
- **Relationship test**
- **Gross income**

1. **Support test:** Previously covered.

2. **Relationship Test:** A qualifying relative means
   1. Father, mother, or ancestor (grandparent)
   2. Stepfather or stepmother
   3. Nephew or niece
   4. Uncle or aunt
   5. In-laws: Son, daughter, father, mother, brother or sister
   6. None of the above, but only if the individual is a member of the taxpayer’s household for the entire year. On the exam this could be a good friend of the family, like an “Uncle Charlie” who is really not an uncle, but lives with you for the entire year as his principal abode.

   **Caution:** Cousins are not considered a relationship unless they meet the sixth criteria.

3. **Gross Income Test:** The dependent’s gross income must be less than the exemption amount. For 2010, this amount is $3,650.

### Additional Rules

In addition to the above rules, for both the qualifying child and qualifying relative, there are two additional tests.

1. **Joint Return Test:** The dependent does not file a joint return with his spouse (if married). If dependent is not required to file a joint return, but does so only to receive a refund of withheld taxes, then this does not disqualify the child as a dependent.

**Example 5:** K’s son P is 20 years old, married to M and does not attend college. K provides 80% of P and M’s support. P and M earned $2,000 working and are not required to file a return. P and M file a return only to receive back the $60 withheld in federal income taxes. P does not violate the joint return test. K may claim P and M as her dependents.
2. Citizenship Test: The dependent must be a citizen or resident of the United States, or resident of Canada or Mexico.

EXCEPTIONS TO DEPENDENCY RULES

Frequently tested exceptions to the general dependency rules are as follows:

Multiple Support Agreements: In determining support, it is not unusual that one taxpayer alone does not provide more than 50% support of a dependent. Suppose several adult children support an elderly parent for part of a year, yet no one provides more than 50% of their support. When this occurs, taxpayers may enter into a multiple support agreement to allow one of the eligible taxpayers to claim them as dependent. To qualify under the multiple support agreement, the rules state:

1. Those party to the agreement must meet the other four dependency requirements.
2. To be entitled to the deduction, you must contribute more than 10% of the support.
3. No one party contributes more than 50% of the support.
4. The written consent must be filed with the return.

Support of Divorced or Separated Parents: In general, the custodial parent is entitled to the dependency deduction regardless of the amount of support provided. For agreements after 1984, the non-custodial parent is entitled to the dependency exemption only if written consent is given by the custodial parent. For agreements before 1985, the non-custodial parent must contribute at least $600 towards the support of the child in order to claim the exemption.

FILING REQUIREMENTS

Individuals must file a tax return if certain levels of gross income have been received by the taxpayer. Generally, that level represents the appropriate standard deduction plus the exemption amount.

Example 6: A single taxpayer claiming the standard deduction would be required to file a return for 2010 if his gross income exceeded $9,350.

<table>
<thead>
<tr>
<th>2010</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Standard deduction</td>
<td>$ 5,700</td>
</tr>
<tr>
<td>Personal exemptions</td>
<td>3,650</td>
</tr>
<tr>
<td>Threshold for filing</td>
<td>$ 9,350</td>
</tr>
</tbody>
</table>

Using the standard deduction and exemption amounts previously discussed, you can easily determine the filing requirements for taxpayers under the age of 65* as follows:

<table>
<thead>
<tr>
<th>2010</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Single</td>
<td>$ 9,350</td>
</tr>
<tr>
<td>Married, filing jointly</td>
<td>18,700</td>
</tr>
<tr>
<td>Married, filing separately**</td>
<td>3,650</td>
</tr>
<tr>
<td>Head of household</td>
<td>12,050</td>
</tr>
<tr>
<td>Surviving spouse</td>
<td>15,050</td>
</tr>
</tbody>
</table>

* Note that for taxpayers 65 or older, or blind, add the additional standard deduction ($1,400 or $1,100) as appropriate.

** Note that for married, filing separately, the filing threshold is only the exemption amount. The low threshold is because of the rule related to both spouses using the same election as to the standard or itemized deductions. This, in essence, forces a return to be filed.
WHEN TO FILE
Tax returns (Form 1040) are due on or before the 15th day of the fourth month following the close of the taxable year. For most taxpayers who file on a calendar year, this means April 15th. Effective for the 2010 tax year, a taxpayer may request an extension of up to six months of time to file their return. *A copy of both pages of Form 1040 is presented at the end of this chapter.*

STATUTE OF LIMITATIONS

General Rule
Once a return is filed, the government can audit the return at any time during the three year period beginning on the latest of (1) the date the return was filed, or (2) the due date of the return. This is the same time period a taxpayer has to amend a tax return as well.


Omission of Income
When there is an understatement of gross income by at least 25% of the amount reported on the return, the statute extends from three years to six years.

Example 9: K reported gross income of $20,000 from her salary but failed to report $6,000 she received as an award. K believed that the award was not taxable, but it really was. Since she omitted at least 25% of the amount report on her return (25% of $20,000, or $5,000), the IRS has a six year period to audit the return.

Fraudulent Return
When a taxpayer files a fraudulent return, the statute of limitations does not begin to run. The return may be audited at any time.

Failure to File a Return
Should a taxpayer fail to file a return, the statute does not begin to run. Once the tax return is filed, the statute runs from that date.

Other Statute Provisions
In requesting a refund for prior taxes paid, the statute is the later of (1) the three year period, or (2) two years from the date the tax was paid. The taxpayer would file Form 1040X to amend a tax return previously filed.

If the nature of the refund is from a bad debt or worthless security, the statute is seven years rather than three years.
1-8
<table>
<thead>
<tr>
<th>Section</th>
<th>Description</th>
</tr>
</thead>
</table>
| Tax and Credits | 38 Amount from line 37 (adjusted gross income)  
39a If you were born before January 2, 1946, check □. If you were blind before January 2, 1946, check □. Total boxes checked □  
39b If your spouse itemizes on a separate return or you were a dual-status alien, check here □  
40 Itemized deductions (from Schedule A) or your standard deduction (see instructions)  
41 Subtract line 40 from line 38  
42 Exemptions. Multiply $3,650 by the number on line 8d.  
43 Taxable income. Subtract line 42 from line 41. If line 42 is more than line 41, enter -0-.  
44 Tax (see instructions). Check if any tax is from: a □ Form(s) 8814 b □ Form 4972  
45 Alternative minimum tax (see instructions). Attach Form 8251  
46 Add lines 44 and 45  
47 Foreign tax credit. Attach Form 1116 if required □  
48 Credit for child and dependent care expenses. Attach Form 2441  
49 Education credits from Form 8863, line 23  
50 Retirement savings contributions credit. Attach Form 8810  
51 Child tax credit (see instructions) □  
52 Residential energy credits. Attach Form 5695  
53 Other credits from Form: a □ 8880 b □ 8815 c □  
54 Add lines 47 through 53. These are your total credits  
55 Subtract line 54 from line 45. If line 54 is more than line 45, enter -0-.  
56 Self-employment tax. Attach Schedule SE  
57 Unreported social security and Medicare tax from Form: a □ 4137 b □ 8812  
58 Additional tax on IRAs, other qualified retirement plans, etc. Attach Form 5329 if required □  
59 a □ Form(s) W-2, box 9 b □ Schedule H c □ Form 5405, line 16 □  
60 Add lines 56 through 59. This is your total tax □  
61 Federal income tax withheld from Forms W-2 and 1099  
62 2010 estimated tax payments and amount applied from 2009 return □  
63 Making work pay credit. Attach Schedule M □  
64a Earned income credit (EIC) □  
64b Non-taxable combat pay election □  
65 Additional child tax credit. Attach Form 8812 □  
66 American opportunity credit from Form 8863, line 14 □  
67 First-time homebuyer credit from Form 8949, line 10 □  
68 Amount paid with request for extension to file □  
69 Excess social security and tier 1 RRTA tax withheld □  
70 Credit for federal tax on fuels. Attach Form 4136 □  
71 Credits from Form: a □ 2439 b □ 8839 c □ 8815 □  
72 Add lines 61, 62, 63, 64a, and 65 through 71. These are your total payments □  
73 Refund □  
74a Amount of line 73 you want refunded to you. If Form 8888 is attached, check here □  
75 Direct deposit? □  
75a Routing number □  
75b Account number □  
76 Amount you owe. Subtract line 72 from line 60. For details on how to pay, see instructions □  
77 Estimated tax penalty (see instructions) □  
78 Third Party Designee □  
78a Designee's name □  
78b Phone no. □  
78c Personal identification number (PIN) □  
79 Sign Here □  
79a Your signature □  
79b Date □  
79c Your occupation □  
79d Daytime phone number □  
79e Spouse's signature. If a joint return, both must sign. □  
79f Date □  
79g Spouse's occupation □  
80 Paid Preparer Use Only □  
80a Print/Type preparer's name □  
80b Preparer's signature □  
80c Date □  
80d Check □ if self-employed □  
80e PTIN □  
80f Firm's name □  
80g Firm's EIN □  
80h Firm's address □  
80i Phone no. □ |
Chapter One — Questions
Filing Status and Exemptions, Filing Requirements and Penalties

Filing Status

1. John and Mary Arnold are a childless, married couple who lived apart (alone in homes maintained by each) the entire year. On December 31, 2010, they were legally separated under a decree of separate maintenance. Which of the following is the only filing status choice available to them when filing for 2010?
   a. Single.
   b. Head of household.
   c. Married filing separate return.
   d. Married filing joint return.

2. A husband and wife can file a joint return even if
   a. The spouses have different tax years, provided that both spouses are alive at the end of the year.
   b. The spouses have different accounting methods.
   c. Either spouse was a nonresident alien at any time during the tax year, provided that at least one spouse makes the proper election.
   d. They were divorced before the end of the tax year.

3. During 2010 Robert Moore, who is 50 years old and unmarried, maintained his home in which he and his widower father, age 75, resided. His father had $4,000 interest income from a savings account and also received $2,400 from social security during 2010. Robert provided 60% of his father's total support for 2010. What is Robert's filing status for 2010, and how many exemptions should he claim on his tax return?
   a. Head of household and 2 exemptions.
   b. Single and 2 exemptions.
   c. Head of household and 1 exemption.
   d. Single and 1 exemption.

4. Murray Richman, who is 60 years old and unmarried, was the sole support of his aged mother. His mother was a resident of a home for the aged for the entire year and had no income. What is Richman's filing status, and how many exemptions should he claim on his tax return?
   a. Head of household and 2 exemptions.
   b. Single and 2 exemptions.
   c. Head of household and 1 exemption.
   d. Single and 1 exemption.

5. Emil Gow's wife died in 2008. Emil did not remarry, and he continued to maintain a home for himself and his dependent infant child during 2009 and 2010, providing full support for himself and his child during these years. For 2010, Emil's filing status is
   a. Single.
   b. Head of household.
   c. Qualifying widower with dependent child.
   d. Married filing joint return.

6. Which of the following is(are) among the requirements to enable a taxpayer to be classified as a "qualifying widow(er)"?
   I. A dependent has lived with the taxpayer for six months.
   II. The taxpayer has maintained the cost of the principal residence for six months.
   a. I only.
   b. II only.
   c. Both I and II.
   d. Neither I nor II.

Exemptions

7. Mark Erickson, age 46, filed a joint return for 2010 with his wife Helen, age 24. Their son John was born on December 16, 2010. Mark provided 60% of the support for his 72-year-old widowed mother until April 10, 2010, when she died. His mother's only income was from social security benefits totaling $2,200 during 2010. How many exemptions should the Erickson's claim on their 2010 tax return?
   a. 2.
   b. 3.
   c. 4.
   d. 5.
8. Jim and Kay Ross contributed to the support of their two children, Dale and Kim, and Jim's widowed parent, Grant. For 2010, Dale, a 19-year old full-time college student, earned $4,500 as a baby-sitter. Kim, a 23-year old bank teller, earned $12,000. Grant received $5,000 in dividend income and $4,000 in nontaxable social security benefits. Grant, Dale, and Kim are U.S. citizens and were over one-half supported by Jim and Kay. How many exemptions can Jim and Kay claim on their 2010 joint income tax return?
   a. Two.
   b. Three.
   c. Four.
   d. Five.

9. Mr. and Mrs. Brook, both age 62, filed a joint return for this taxable year. They provided all the support for their son who is 19, legally blind, and who had no income. Their daughter, age 21 and a full-time student at a university, had $4,200 of income and provided 70% of her own support. How many exemptions should Mr. and Mrs. Brook have claimed on their joint income tax return?
   a. 5.
   b. 4.
   c. 3.
   d. 2.

10. Albert and Lois Stoner, age 66 and 64, respectively, filed a joint tax return for this taxable year. They provided all of the support for their blind 19-year-old son, who has no gross income. Their 23-year-old daughter, a full-time student until her graduation on June 14, earned $2,000, which was 40% of her total support during the year. Her parents provided the remaining support. The Stoner's also provided the total support of Lois' father, who is a citizen and life-long resident of Peru. How many exemptions can the Stoner's claim on their income tax return?
   a. 4.
   b. 5.
   c. 6.
   d. 7.

11. During the year, Sam Dunn provided more than half the support for his wife, his father's brother, and his cousin. Sam's wife was the only relative who was a member of Sam's household. None of the relatives had any income, nor did any of them file an individual or a joint return. All of these relatives are U.S. citizens. Which of these relatives should be claimed as a dependent or dependents on Sam's return?
   a. Only his wife.
   b. Only his father's brother.
   c. Only his cousin.
   d. His wife, his father's brother, and his cousin.

12. Mary Dunn provided 20% of her own support; the remaining 80% was provided by her three sons as follows:
   - Bill: 15%
   - Jon: 25%
   - Tom: 40%
   Assume that a multiple support agreement exists and that the brothers will sign multiple support declarations as required. Which of the brothers is eligible to claim the mother as a dependent?
   a. None of the brothers.
   b. Tom only.
   c. Jon or Tom only.
   d. Bill, Jon or Tom.

13. Sara Hance, who is single and lives alone in Idaho, has no income of her own and is supported in full by the following persons:

<table>
<thead>
<tr>
<th>Amount of Support</th>
<th>Percent of Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Alma (an unrelated friend)</td>
<td>$2,400</td>
</tr>
<tr>
<td>Ben (Sara's brother)</td>
<td>$2,150</td>
</tr>
<tr>
<td>Carl (Sara's son)</td>
<td>$450</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$5,000</strong></td>
</tr>
</tbody>
</table>

   Under a multiple support agreement, Sara's dependency exemption can be claimed by
   a. No one.
   b. Alma.
   c. Ben.
   d. Carl.

14. Joe and Barb are married, but Barb refuses to sign a 2010 joint return. On Joe's separate 2010 return, an exemption may be claimed for Barb if
   a. Barb was a full-time student for the entire 2010 school year.
   b. Barb attaches a written statement to Joe's income tax return, agreeing to be claimed as an exemption by Joe for 2010.
   c. Barb was under the age of 19.
   d. Barb had no gross income and was not claimed as another person's dependent in 2010.
15. In 2010, Smith, a divorced person, provided over one half the support for his widowed mother, Ruth, and his son, Clay, both of whom are U.S. citizens. During 2010, Ruth did not live with Smith. She received $9,000 in social security benefits. Clay, a full-time graduate student, and his wife lived with Smith. Clay had no income but filed a joint return for 2010, owing an additional $500 in taxes on his wife's income. How many exemptions was Smith entitled to claim on his 2010 tax return?
   a. 4.
   b. 3.
   c. 2.
   d. 1.

16. Al and Mary Lew are married and filed a joint 2010 income tax return in which they validly claimed the personal exemption for their dependent 17-year old daughter, Doris. Since Doris earned $5,900 in 2010 from a part-time job at the college she attended full-time, Doris was also required to file a 2010 income tax return. What amount was Doris entitled to claim as a personal exemption in her 2010 individual income tax return?
   a. $0
   b. $900
   c. $3,500
   d. $5,450

17. For head of household filing status, which of the following costs are considered in determining whether the taxpayer has contributed more than one-half the cost of maintaining the household?

<table>
<thead>
<tr>
<th>Food consumed</th>
<th>Value of services rendered in the home</th>
</tr>
</thead>
<tbody>
<tr>
<td>in the home</td>
<td>by the taxpayer</td>
</tr>
<tr>
<td>a. Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>b. No</td>
<td>No</td>
</tr>
<tr>
<td>c. Yes</td>
<td>No</td>
</tr>
<tr>
<td>d. No</td>
<td>Yes</td>
</tr>
</tbody>
</table>

18. Nell Brown's husband died in 2007. Nell did not remarry, and continued to maintain a home for herself and her dependent infant child during 2008, 2009, and 2010, providing full support for herself and her child during these three years. For 2010, Nell's filing status is
   a. Single.
   b. Married filing joint return.
   c. Head of household.
   d. Qualifying widow with dependent child.

Filing Requirements and Penalties

19. A calendar-year taxpayer files an individual tax return for 2007 on March 20, 2008. The taxpayer neither committed fraud nor omitted amounts in excess of 25% of gross income on the tax return. What is the latest date that the Internal Revenue Service can assess tax and assert a notice of deficiency?
   c. April 15, 2011.
   d. April 15, 2010.

20. Leo Mann, a calendar-year taxpayer, filed his 2007 individual income tax return on March 15, 2008, and attached a check for the balance of tax due as shown on the return. On June 15, 2008, Leo discovered that he had failed to include, in his itemized deductions, $1,000 interest on his home mortgage. In order for Leo to recover the tax that he would have saved by utilizing the $1,000 deduction, he must file an amended return no later than
   c. April 15, 2011.

21. On April 15, 2005, a married couple filed their joint 2004 calendar-year return showing gross income of $120,000. Their return had been prepared by a professional tax preparer who mistakenly omitted $45,000 of income, which the preparer in good faith considered to be nontaxable. No information with regard to this omitted income was disclosed on the return or attached statements. By what date must the Internal Revenue Service assert a notice of deficiency before the statute of limitations expires?
   a. April 15, 2011.
   c. April 15, 2008.

22. Richard Baker filed his 2002 individual income tax return on April 15, 2003. On December 31, 2004, he learned that 100 shares of stock that he owned had become worthless in 2002. Since he did not deduct this loss on his 2002 return, Baker intends to file a claim for refund. This refund claim must be filed no later than April 15
   b. 2006.
   c. 2009.
   d. 2010.
23. A claim for refund of erroneously paid income taxes, filed by an individual before the statute of limitations expires, must be submitted on Form
   a. 1139
   b. 1045
   c. 1040X
   d. 843

24. Harold Thompson, a self-employed individual, had income transactions for 2009 (duly reported on his return filed in April 2010) as follows:

   Gross receipts   $400,000
   Less cost of goods sold and deductions   $320,000
   Net business income   $  80,000
   Capital gains       36,000
   Gross income   $116,000

   In March 2011 Thompson discovers that he had inadvertently omitted some income on his 2009 return and retains Mann, CPA, to determine his position under the statute of limitations. Mann should advise Thompson that the six-year statute of limitations would apply to his 2009 return only if he omitted from gross income an amount in excess of
   a. $20,000
   b. $29,000
   c. $100,000
   d. $109,000

25. If an individual paid income tax in 2010 but did not file a 2010 return because his income was insufficient to require the filing of a return, the deadline for filing a refund claim is
   a. Two years from the date the tax was paid.
   b. Two years from the date a return would have been due.
   c. Three years from the date the tax was paid.
   d. Three years from the date a return would have been due.

26. A married couple filed their joint 2007 calendar-year return on March 15, 2008 and attached a check for the balance of tax due as shown on the return. On June 15, 2009, the couple discovered that they had failed to include $2,000 of home mortgage interest in their itemized deductions. In order for the couple to recover the tax that they would have saved by using the $2,000 deduction, they must file an amended return no later than
   c. April 15, 2011.

27. In which of the following situations may taxpayers file as married filing jointly?
   a. Taxpayers who were married but lived apart during the year.
   b. Taxpayers who were married but lived under a legal separation agreement at the end of the year.
   c. Taxpayers who were divorced during the year.
   d. Taxpayers who were legally separated but lived together for the entire year.

28. A couple filed a joint return in prior tax years. During the current tax year, one spouse died. The couple has no dependent children. What is the filing status available to the surviving spouse for the first subsequent tax year?
   a. Surviving spouse.
   b. Married filing separately.
   c. Single.
   d. Head of household.

29. Martin filed a timely return on April 15. Martin inadvertently omitted income that amounted to 30% of his gross income stated on the return. The statute of limitations for Martin’s return would end after how many years?
   a. 3 years.
   b. 6 years.
   c. 7 years.
   d. Unlimited.
Chapter One — Answers
Filing Status and Exemptions, Filing Requirements
and Penalties

1. (a) Single. A taxpayer’s filing status is determined on the last day of the taxable year. On December 31, 2010, John and Mary were legally separated under a decree of separate maintenance and therefore, not married. Since they did not have a child, they would not qualify as head of household. Single is the only status available.

2. (b) Husbands and wives cannot file a joint return if they have different tax years, if one is a non-resident alien, or they were divorced as of the end of the year. They are not, however, required to use the same accounting methods.

3. (d) Single and 1 exemption. Robert does not qualify for head of household because his father does not qualify as his dependent. His father does not qualify as his dependent because as a qualified relative he fails the gross income test. The gross income of $4,000 from the interest income exceeds the exemption amount of $3,650 for 2010. Social security is not a component of gross income at this income level.

4. (a) Murray qualifies as head of household because he is (1) unmarried; (2) maintains support for his mother at a home for the aged (parents do not have to reside in the taxpayer’s home); and (3) may claim his mother as his dependent.

5. (c) Qualifying widower with dependent child. This is sometimes referred to as surviving spouse. In the year of death, Emil would have filed married, filing jointly. However, for the two years after that, Emil qualifies for this status provided he (1) has not remarried and (2) maintains a home for himself and a dependent child.

6. (d) Neither I nor II. In order to qualify as qualifying widower (or surviving spouse), your child must qualify as your dependent and must reside with you for the entire year. Also, you must maintain more than 50% of the cost of your household for the entire year.

7. (c) 4. Mark is entitled to two personal exemptions and two dependency exemptions. Their new son qualifies because he was born before the end of the year. His mother qualifies because he met the support test until she died and she did not violate the gross income test. Social security benefits are not considered gross income at this income level.

8. (b) 3. Jim and Kay may claim two personal exemptions for themselves and one dependency exemption for Dale. The children, Dale and Kim, and the father, Grant, meet the support and relationship. Dale is not under 19, but under 24 and is a full-time student. Therefore he is a qualified child and there is no gross income test. Kim is also under 24, but is not a full-time student. Therefore, Kim is not a qualified child but a qualified relative and needs to pass the gross income test. Her $12,000 in babysitting income is not less than the 2010 exemption amount of $3,650 and she does not qualify. Grant is the parent and therefore is a qualifying relative. He has gross income of $5,000 and does not qualify either.

9. (c) 3. The Brooks are allowed two personal exemptions and one dependency exemption for their son. Their daughter does not qualify because of the support test. There is no exception to the support test (even though she is a full-time student).

10. (a) 4. The Stoners are allowed two personal exemptions and two dependency exemptions for their children. Stoner’s father does not qualify because he fails the citizenship test. Note there are no extra exemptions because the taxpayer, or dependents are 65 and over, or blind.

11. (b) Father’s brother. This question specifically asks about the dependency exemption, not the personal. Sam’s uncle qualifies because he satisfies the relationship test and therefore does not need to be a member of the household. Sam’s cousin does not qualify as a dependent because he is not a relative and as a result must be a member of the household for the entire year, which he was not.
12. (d) Bill, Jon or Tom. Classic multiple support problem. All three sons are qualified to claim Mom as their dependent but no one person contributes more than 50%. Since each son contributed more than 10% of her support, each is eligible to claim her.

13. (c) Ben. Only Ben and Carl are initially qualified to claim Sara as a dependent. Ben and Carl contribute $2,600 of the $5,000 for a combined percentage of 52%. However, since Carl contributes less than 10%, he is not eligible to claim her as a dependent. Only Ben is eligible. Note that Alma cannot be party to this arrangement because she is not related to Sara. Sara would have to reside with Alma for the entire year in order to qualify under the relationship test.

14. (d) By definition. This would be a personal exemption on Joe’s return.

15. (c) Smith is entitled to one personal exemption and one dependency exemption for his mother Ruth. A mother does not have to live with the taxpayer to be considered a dependent. Clay was required to file a return (they owed additional taxes) and therefore cannot be claimed as a dependent even though the other tests were met.

16. (a) $0. Since Al and Mary were allowed to claim Doris as their dependent, Doris is not entitled to a personal exemption for herself when she files.

17. (c) In determining the cost of maintaining the household, you would include the cost of the food consumed in the home, as well as mortgage interest and real estate taxes (or rent), utilities and repairs. The value of services is not included.

18. (c) Nell qualifies as head of household because she is not married, maintains a household and provides for more than 50% of the year the cost for her child. The filing status of qualifying widow is available only for the two tax years after the year of her husband’s death.

19. (c) April 15, 2011. The three-year statute runs from the date the return was filed, or April 15th, whichever is later.

20. (c) April 15, 2011. The three-year statute runs from the date the return was filed, or April 15th, whichever is later. Filing an amended return does not extend the statute of limitations.

21. (a) April 15, 2011. Whereas the taxpayer mistakenly omitted more than 25% of the gross income reported on the return, the statute increases to six years. The six-year statute runs from the date the return was filed, or April 15th, whichever is later.

   Gross income reported $120,000  
   Statute percentage 25%  
   Underreporting threshold $30,000  
   Amount not reported $45,000  

22. (d) 2010. A refund claim due to worthless stock carries a seven year statute. The seven-year statute runs from the date the return was filed, or April 15th, whichever is later.

23. (c) Form 1040X. This is the individual amended return form. Form 1139 is a claim for refund for corporations; Form 1045 is for refunds due to operating loss carrybacks; and Form 843 is for refunds due to overpayment of employment, gift and estate taxes.
24. (d) $109,000. The six year statute applies if the taxpayer omits more than 25% of the gross income reported on the return. Gross income represents:

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Gross receipts</td>
<td>$400,000</td>
</tr>
<tr>
<td>Capital gain</td>
<td>36,000</td>
</tr>
<tr>
<td>Gross income</td>
<td>436,000</td>
</tr>
<tr>
<td>Statutory rate</td>
<td>25%</td>
</tr>
<tr>
<td>Threshold</td>
<td>$109,000</td>
</tr>
</tbody>
</table>

25. (a) In requesting a refund for prior taxes paid, the statute is the later of (1) the three year period, or (2) two years from the date the tax was paid. Since no return was filed, it would two years from when the tax was paid.

26. (c) April 15, 2011. In requesting a refund for prior taxes paid, the statute is the later of (1) the three year period, or (2) two years from the date the tax was paid. The statute begins running on the due date of the return or the date the return was filed, whichever is later. In this case, even though the taxpayer filed on March 15, 2008, the statute does not begin to run until April 15, 2008. The taxpayer would file Form 1040X to amend the tax return.

27. (a) The married filing jointly status is only allowed for taxpayers who are still married as of the last day of the year. Since answer c indicates that the taxpayer is divorced, that eliminates that response. However, taxpayers who are still married but live under a legal separation agreement are not considered married for tax purposes. Therefore, answers b and d are not viable either.

28. (c) Single. The taxpayer is unmarried for the entire year, and since the spouse does not have any dependent children, the spouse would not qualify as head of household or surviving spouse.

29. (b) 6 years. The six year statute applies if the taxpayer omits more than 25% of the gross income reported on the return.
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Chapter Two
Income – Inclusions and Exclusions

GROSS INCOME
As a general rule, the Internal Revenue Code defines gross income as all income, from whatever source derived. Included in this broad definition of income is compensation for services, business income, property transactions, interest, dividends, rents, royalties, alimony, annuities, pensions, and discharge of indebtedness. This is not an all inclusive group, nor are all the items listed always fully included as gross income. If an item is to be excluded from gross income, there must be a specific code section excluding it. On the exam, you need to be aware of these exceptions because the examiners will concentrate on these areas.

Also, the receipt of cash is not necessarily a prerequisite to the recognition of income. Receiving property with a fair market value of $100 for services rendered is included the same as receiving $100 in cash. See Chapter 5 for a full discussion of the methods of accounting for income and deductions.

EMPLOYEE COMPENSATION
An employee receives compensation in a number of ways. Some compensation is fully taxable, some is fully excluded, and some is partially excluded. Gross income that is fully included in gross income typically includes salaries and wages, bonuses, and commissions. Besides paying for compensation directly, an employee may receive other benefits which may or may not be taxable.

Employee Fringe Benefits

Health Insurance Premiums and Benefits: The premiums paid by an employer for an employee's health insurance coverage are not included as gross income, nor are any of the benefits received from the policy. The non-taxable benefits can be for the employee, spouse, or dependent. This also generally applies to long-term care benefits as well.

Group-term Life Insurance: An employer may provide an employee with group-term life insurance coverage of up to $50,000 as a non-taxable fringe benefit. The cost of coverage in excess of the $50,000 is considered income to the employee.

Death Benefits: There is no exclusion for death benefits paid to an employee's family.

Cafeteria Plans: Companies may offer a variety of non-taxable benefits which an employee may choose from, similar to a cafeteria. There is generally no minimum waiting period for employees to take advantage of this plan.

Employee Discounts: Allowed as a tax-free benefit when the discount on services is not greater than 20% and when the discount on purchases is not below the employer's cost.

De minimis Fringe Benefits: Refers to non-taxable benefits such as subsidized eating facilities when a plant is located in a remote location; occasional use of the company copy machine; use of company typing services, etc.

Moving Expense Reimbursements: These reimbursements are no longer reported as gross income to the extent that the amount represents a qualified moving expense as described in Chapter 3.

Reimbursed Expenses: When an employee incurs expenses on behalf of his employer, and the amount of the expenditure is reimbursed by the employer after the employee makes an adequate accounting, that amount is not income to the employee. However, if the employee merely receives a monthly draw and is not required to provide an adequate accounting, that amount is included as gross income.
Qualified Transportation Benefits: Employers may provide employees with a transit pass for the use of mass transit. The employee may exclude the value of up to $230 per month. In addition, employers may provide free parking of up to $230 in value per month. And for those taxpayers who bicycle to work, the employer may provide up to $20 per month tax free.

Qualified Employer-Provided Educational Assistance: For undergraduate studies only, the amounts paid by the employer under a qualified plan for tuition, fees, books and supplies is excluded up to an annual amount per employee of $5,250.

Dependent Day Care and Adoption Expenses: An employee may exclude, up to $5,000 per year, the cost of child and dependent care services paid by the employer to enable the employee to work. The exclusion may not exceed the earned income of the spouse with the lesser income when the taxpayer is married. In addition, an employee may exclude up to $12,170 of qualified adoption expenses.

INTEREST INCOME
Interest earned by a taxpayer is generally included as gross income. Interest income is reported on Schedule B and typically represents interest on savings accounts, certificates of deposits, tax refunds, loans by the taxpayer, bonds and other investments. Investments include federal obligations such as U. S. Treasury Certificates and Savings Bonds. However, there are special provisions and various elections a taxpayer may make to defer or exclude from gross income the interest from certain federal obligations. Such provisions are discussed later.

Interest is recognized by cash basis taxpayer when it is credited to his account. Accrual based taxpayers recognize the income when earned. Occasionally, a taxpayer may receive a gift when opening up a savings account or certificate of deposit. The fair market value of that gift is also included as interest income.

Municipal Bond Interest: Interest on state and municipal obligations is excluded from gross income. Also excluded is interest on obligations of a possession of the United States, such as Puerto Rico. Tax refunds are not considered to be obligations of the state and any interest earned on the refunds are fully taxable. Also, any gain from the sale of municipal obligations is included in gross income.

U. S. Savings Bonds: Series E (before 1980) and Series EE (after 1979) Savings Bonds are issued at a discount, do not pay out interest, but are redeemed for fixed amounts in the future. The difference between the purchase price and the redemption price is recognized as interest income. Whereas the interest is not recognized until the bonds are redeemed, there is a deferral available to taxpayers. In addition, the Series E Bonds may be exchanged for Series HH Bonds and the interest deferred even further.

A taxpayer, however, may elect to recognize the interest income rather than waiting until redemption. Once this method is elected, it must be used for all future years unless the change is approved by the Commissioner.

Educational Savings Bonds: In an effort to assist parents in affording the spiraling cost of higher education, Congress passed a law stating that the interest earned on U. S. Savings Bonds is excluded from gross income if certain restrictions are met. For the exclusion to apply:

- At the time of issuance, the individual to whom the bonds are issued must be at least 24 years old.
- All the proceeds must be used for the qualified higher educational expenses (tuition and fees) of the taxpayer, his spouse or dependent.
- Qualified higher education expenses must be reduced by other scholarships or veterans’ benefits received.
- At the time of redemption, the taxpayer's Modified Adjusted Gross Income (MAGI) does not exceed the specified limit described below. (MAGI is the adjusted gross income before the foreign earned income exclusion and Educational Savings Bond Interest Exclusion itself).
- This is not available to those electing married filing separately.
Note that these bonds are not being bought by the parent and held in the child's name. That is a completely different tax planning strategy. Also note that a grandparent or uncle cannot buy the bonds to have this rule apply unless the child they are buying for is their dependent.

Limitations on the Exclusion: In computing the limitation referred to above, there are two limitations which must be observed.

- If the total amount from the redemption (both principal and interest) exceeds the qualified higher education expenses, then there is a pro-rata reduction in the amount of interest that can be excluded.
- For married taxpayers, if their MAGI in 2010 exceeds $105,100, the exclusion from is phased-out on a pro-rata basis over the next $30,000. If the taxpayer is single, the MAGI amount is $70,100 and the range is over $15,000.

The MAGI limitation imposed by Congress severely reduces the appeal of this provision. Those who qualify without limitation, may not be able to afford to purchase the bonds. Those who are financially able to afford them will not qualify.

Other Provisions:
Interest on Veterans Administration insurance dividends left on deposit with the Veterans Administration is also excluded from gross income.

DIVIDENDS
Dividends represent distributions from a corporation's earnings and profits, and are generally fully included as gross income. Dividends are reported on Schedule B. When a corporation makes a distribution in excess of its earnings and profits, the excess represents a return of the investor's cost or basis. See Chapter 9 for a full discussion.

For 2010, qualifying dividends will be taxed at the long-term capital gains rates. This means a taxpayer in the 10% or 15% tax bracket will be taxed at 0% and a taxpayer in the 25% bracket or higher will be taxed at 15%. In order to be qualifying the taxpayer must have held the stock (in a domestic corporation) for at least 60 days. The dividend is still reported on Schedule B but is taxed on Schedule D.

Dividends received on a life insurance policy generally do not represent income, but rather represent a return of a premium. Also, the receipt of a stock dividend is generally excluded from income. However, if the taxpayer has the option to receive cash (or other property) instead of stock, the shareholder will recognize dividend income to equal to the fair market value of the distribution.

RENTS AND ROYALTIES
Amounts received from rental property, less the related rental expenses are included as gross income. Also, royalties from books, articles, reproductions, oil and gas, etc., are included as gross income. These amounts are reported on Schedule E - Supplementary Income and Loss, along with other items of income from sources such as S Corporations, Partnerships and Trusts.

Any increase in the value of the rental property as the result of improvements made by the lessee are generally excluded from the lessor's gross income. However, if the improvements were made in lieu of rent, the fair market value of the improvements would be included as gross income.

The lessee may also provide the lessor with a security deposit. A security deposit does not represent gross income as a right of return exists to the lessee at the end of the lease. However, a prepayment of the last month's rent does represent gross income in the year received.

SELF-EMPLOYED BUSINESS INCOME
Income from carrying on a trade or business on an unincorporated basis is reported on Schedule C. This is typical income from services provided (consulting, tax returns, etc.) See Chapter 3 for the various business deductions.
ALIMONY AND SEPARATE MAINTENANCE PAYMENTS

When a married couple obtains a divorce, there is generally a requirement for one spouse to support the other. These payments are referred to as alimony (or separate maintenance payments if they are legally separated). In general, these payments are deductible by the payor spouse, and included as income by the spouse receiving them. Should the spouse also have children, there may be an element of the payment which includes child support. Child support is not a taxable to the recipient.

If the agreement further calls for the division of marital property, such as a house, investments and other property, this division, or transfer is not a taxable event. In addition, if the division of marital property includes the continuation of the mortgage payments, this amount will not be considered alimony because the mortgage payments will not terminate at the death of the former spouse. Because of the various tax consequences of these different transactions, it is important for the taxpayer as well as the IRS to be able to clearly identify what a transaction is so that both parties treat the transaction consistently.

Payments made under **written decrees and agreements after 1984** are considered to be alimony only if:

- Payments are made in cash (distinguishes it from property).
- Agreement does not state the payments are not alimony (directly or indirectly).
- The former couple are not members of the same household during the time of the payments.
- The former couple do not file a joint return.
- Payments stop after the death of the payee spouse.

**Example 1:** B and D were married and have one child who resides with D. They are now divorced under an agreement dated 2006. They do not reside together. B is required to pay D $2,000 per month until D dies. Of the $2,000 payment, $400 is designated in the agreement as child support. Therefore, $1,600 is considered alimony and is included in D's gross income.

**Example 2:** C and E were married and have one child who resides with E. They are now divorced under an agreement dated 2006. They do not reside together. C is required to pay E $2,000 per month until E dies. The written decree states the payment decreases to $1,600 after the child reaches age 21. Indirectly, the decree states that $400 is not alimony. Therefore, $1,600 is considered alimony and is included in E's gross income.

If payments made during the year are **less than the payments required** by the written decree or agreement, in determining the amount of alimony, payments are first allocated to the non-alimony (child support), and then the alimony. You do not pro-rate the payments.

**Example 3:** B and D were married and have one child who resides with D. They are now divorced under an agreement dated 2006. They do not reside together. B is required to pay D $2,000 per month until D dies. Of the $2,000 payment, $400 is designated as child support. However, B only made 10 payments totaling $20,000 during the year.

<table>
<thead>
<tr>
<th>Total payments made</th>
<th>$ 20,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Amount not alimony:</td>
<td></td>
</tr>
<tr>
<td>12 months @ 400</td>
<td>-4,800</td>
</tr>
<tr>
<td>Alimony component</td>
<td>$ 15,200</td>
</tr>
</tbody>
</table>

Because the alimony payments are deductible by the payor, certain taxpayers have attempted to obtain tax advantages by structuring the agreement to make large payments in the early years and smaller payments in subsequent years. Theoretically, a high income tax-bracket payor could make a very large payment to the payee who may be in a low bracket in the year of, or year after the divorce. A $50,000 payment could result in a
significant, overall net tax savings. To prevent what is referred to as front-loading, agreements signed after 1986 state that if payments made in the first or second year exceed $15,000, alimony recapture may exist for the excess amount over an average. The computations are beyond the scope of the exam, but this concept is not. Alimony recapture effectively causes a reduction in the gross income recognized by the payee spouse and a reduction in the deduction claimed by the payor spouse. The payor's deduction for making alimony payments is addressed in Chapter 3.

Finally, alimony is considered to be earned income to the recipient. This is important because the earned income of the contributor determines the allowable IRA contribution. Remember this as you review the IRA deduction in Chapter 3.

**Full Inclusion -- Other Topics**

**Gambling Winnings:** Amounts received from gambling winnings, lotteries, etc., are included in gross income. Gambling losses are deductible only to the extent of the earnings. See Chapter 4.

**Jury Duty Pay:** Compensation received while performing jury duty is included in gross income

**Unemployment Compensation:** Various states provide benefits to unemployed workers for a set period of time. The first $2,400 of unemployment benefits received in 2009 were excluded from gross income, but all benefits are included in 2010.

**Partial Exclusion or Limitations**

**Social Security Benefits:** In general, these benefits are excluded from gross income. However, when a taxpayer's modified adjusted gross income (or provisional income) exceeds a base amount, they may have to include 50% to 85% of their social security benefits as gross income. The provisional income represents adjusted gross income plus tax-exempt income and one-half of the social security benefits received. However, if the taxpayer has the higher level of provisional income, 85% of the benefits will be included. For married taxpayers filing separately, there is no base amount and 85% of all benefits received will be taxed. The base amounts for the provisional income test and benefit inclusion rate are as follows:

<table>
<thead>
<tr>
<th>Filing Status</th>
<th>0% Taxed</th>
<th>50% Taxed</th>
<th>85% Taxed</th>
</tr>
</thead>
<tbody>
<tr>
<td>Single or head of household</td>
<td>Up to $25,000</td>
<td>$25,000 to $34,000</td>
<td>Over $34,000</td>
</tr>
<tr>
<td>Married</td>
<td>Up to $32,000</td>
<td>$32,000 to $44,000</td>
<td>Over $44,000</td>
</tr>
</tbody>
</table>

**Annuity Contracts and Pensions:** Annuities represent an investment whereby the taxpayer contributes a sum of money to an organization and receives over time a return of his investment and interest. The issue is generally the proration of the cost, or basis of the investment, over the stream of payments. The allowable methodology is a straight-line recovery of the cost. If the annuity continues after the recovery of cost, the entire payments represent income. However, if the annuitant dies before recovering the cost of the investment, the unrecovered cost is treated as a miscellaneous itemized deduction, not subject to the 2% floor (See Chapter 4).

**Example 4:** Y invests $40,000 in annuity that will pay her $12,000 per year for the next 5 years. Her expected payout is $60,000. During the year, Y receives $12,000 of which $8,000 is a nontaxable return of her investment and the $4,000 is recognized as income.

| Original investment         | $40,000 |
| Number of years             | 5 years |
| Annual recovery of $8,000   |         |

$12,000 less recovery of $8,000 = $4,000 income
**Tax Benefit Rule:** When a taxpayer claims a deduction in one year, and receives a refund in the subsequent year, the amount of the refund must be reported as income. However, if claiming the deduction did not result in a tax benefit, then the refund is not taxable.

**Example 5:** In filing his 2010 tax return, J claimed $5,000 in medical deductions. Because of his threshold limitation of $4,500 (AGI of $60,000 times the medical limitation of 7.5%), J was only able to deduct $500 of the $5,000. Late in 2011, J received a $800 refund from his health insurance company due to a disputed bill he paid in 2010. Of the $800, the first $500 represents income because J received a tax benefit by being able to deduct $500 of the expenses. The balance of $300 is not included as income because J never received a tax benefit from the expense.

**Prizes and Awards:** The fair market value of prizes and awards is generally included as gross income. This includes prizes from game shows, door prizes and employer awards. However, an employee achievement award may be excluded if it is based upon length of service or safety, and does not exceed $400, or $1,600 if it is under a qualified plan. In order for other awards to be excluded from gross income, the award must meet all the following criteria:

- The award is for recognition of religious, charitable scientific, artistic, literary or civic achievement.
- The taxpayer was selected without any action on his part to enter the contest.
- There is no requirement for the taxpayer to render services in the future.
- The taxpayer contributes the award to a nonprofit organization or qualified governmental unit.

**Discharge of Indebtedness:** When a taxpayer is obligated to pay a mortgage, loan or other indebtedness, and the lender discharges the taxpayer from the obligation, the amount of the discharge generally represents ordinary income. However, if the taxpayer is insolvent or bankrupt at the time of the discharge, it will not be income. Another exception exists for individuals who are released from indebtedness related to qualified real property business indebtedness. Rather than recognizing income, the taxpayer may reduce the basis of the real property.

There is an exclusion for students with student loans. If the forgiveness is contingent upon the student fulfilling a work requirement in the state, the forgiveness of debt will not constitute gross income.

**Foreign Income:** When a taxpayer earns income from working in a foreign country, there is an exclusion available which is limited to the lesser of $91,500 or the foreign earned income. In addition, a taxpayer may exclude a housing allowance for amounts up to 16% of the exclusion amount. In addition, the taxable portion of the foreign income is now taxable under the stacking rate provisions which effectively consider the tax exemption portion of the foreign earned income in the computation of the tax. When the US taxpayer is not present in the foreign country for a full year, the amount is prorated on a daily basis. In general, there are two different tests to determine the exclusion:

- **Bona Fide Resident Test:** Must be a resident for a full taxable year.
- **Physical Presence Test:** Must be physically present in the foreign country at least 330 days in a consecutive 12 month period.

**Armed Services:** There are various benefits available to members of the Armed Services. In particular is the exclusion of pay from gross income when enlisted men are serving in combat areas. For officers, the exclusion is only on the first $500 of pay per month. The housing allowance for the servicemen is also excluded.
Qualified Tuition Programs: There is a new tax-deferred college savings vehicle. This provision allows tax-favored treatment to the various qualified state tuition programs. There are a number of limitations, similar to the rules for IRAs.

Full Exclusion

Inheritances and Gifts: In general, the amount received from an estate as an inheritance, or as a gift out of detached generosity, is excluded from gross income.

Life Insurance: The proceeds from a life insurance policy by reason of death of the insured are excluded from gross income. If, however, the taxpayer elects to receive the payments under an installment arrangement rather than a lump sum payment, the interest component is included as gross income. See annuities for computations.

Personal Injury: A taxpayer receiving amounts from workers compensation, accident and health insurance claims, lawsuits for personal injuries and disability benefits are not included as gross income. However, a lawsuit settlement for lost wages would be included in gross income.

Scholarships: Payments made to an individual to be used for tuition and fees (such as books, supplies and fees), are excluded from gross income. The individual must be a degree candidate at a higher educational institution for study. Payments for room and board, or compensation for services rendered such as for a teaching or research assistant are not excluded. These payments are treated as earned income to the individual.

Rental Value of Parsonage: Amounts received by an ordained minister designated as a housing allowance is excluded to the extent of the actual costs of maintaining the parsonage.
Chapter Two — Questions
Income – Inclusions and Exclusions

1. James Martin received the following compensation and fringe benefits from his employer during this year:

Salary $50,000
Year-end bonus 10,000
Medical insurance premiums paid by employer 1,000
Reimbursement for moving expenses 6,200
(Actual allowable moving expenses incurred were $6,200)

What amount of the preceding payments should be included in Martin's gross income?

a. $60,000.
b. $61,000.
c. $66,200.
d. $67,200.

2. Perle, a dentist, billed Wood $600 for dental services. Wood paid Perle $200 cash and built a bookcase for Perle's office in full settlement of the bill. Wood sells comparable bookcases for $350. What amount should Perle include in taxable income as a result of this transaction?

a. $0
b. $220
c. $550
d. $600

3. Benedict Atley, who is single, was out of work in the early months of this taxable year and received $5,200 of unemployment benefits from his state of residence. His adjusted gross income was $22,500 excluding the $5,200 of unemployment benefits. Assuming that Atley had no other items of income or adjustments to gross income, what amount must Atley report as adjusted gross income on his income tax return?

a. $22,500.
b. $23,750.
c. $25,300.
d. $27,700.

4. Under a “cafeteria plan” maintained by an employer,

a. Participation must be restricted to employees, and their spouses and minor children.
b. At least three years of service are required before an employee can participate in the plan.
c. Participants may select their own menu of benefits.
d. Provision may be made for deferred compensation other than 401(k) plans.

5. This year, Joan accepted and received a $10,000 award for outstanding civic achievement. Joan was selected without any action on her part, and no future services are expected of her as a condition of receiving the award. What amount is Joan required to include in her income in connection with this award?

a. $0
b. $4,000
c. $5,000
d. $10,000

6. Leon Wren, an electrician, was injured in an accident during the course of his employment. As a result of injuries sustained, he received the following payments during the year:

<table>
<thead>
<tr>
<th>Payment</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Damages for personal injuries</td>
<td>$8,000</td>
</tr>
<tr>
<td>Workmen's compensation</td>
<td>3,000</td>
</tr>
<tr>
<td>Reimbursement from his employer's accident and health plan for medical expenses paid by Wren</td>
<td>1,200</td>
</tr>
</tbody>
</table>

The amount to be included in Wren's gross income should be

a. $0.
b. $1,200.
c. $3,000.
d. $12,200.
7. During the current year Hal Leff sustained a serious injury in the course of his employment. As a result of this injury, Hal received the following payments during the year:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Workers' compensation</td>
<td>$2,400</td>
</tr>
<tr>
<td>Reimbursement from his employer's accident and health plan for medical expenses paid by Hal and not deducted by him</td>
<td>$1,800</td>
</tr>
<tr>
<td>Damages for personal injuries</td>
<td>$8,000</td>
</tr>
</tbody>
</table>

The amount to be included in Hal's gross income for the current year should be
a. $12,200  
b. $8,000  
c. $1,800  
d. $0

8. The following information is available for Ann Drury for this year:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Salary</td>
<td>$36,000</td>
</tr>
<tr>
<td>Premiums paid by employer on group-term life insurance in excess of $50,000</td>
<td>$500</td>
</tr>
<tr>
<td>Proceeds from state lottery</td>
<td>$5,000</td>
</tr>
</tbody>
</table>

How much should Drury report as gross income on her tax return?

a. $36,000  
b. $36,500  
c. $41,000  
d. $41,500

9. David Hetnar is covered by a $90,000 group-term life insurance policy of which his wife is the beneficiary. Hetnar's employer pays the entire cost of the policy, for which the uniform annual premium is $8 per $1,000 of coverage. How much of this premium is taxable to Hetnar?

a. $0  
b. $320  
c. $360  
d. $720

10. Sam Mitchell, a calendar-year taxpayer, purchased an annuity contract for $3,600 that would pay him $120 a month beginning on January 1 of this calendar year. His expected return under the contract is $10,800. How much of this annuity is excludable from gross income for this taxable year?

a. $0  
b. $480  
c. $960  
d. $1,440

11. Seymour Thomas named his wife Penelope the beneficiary of a $100,000 (face amount) insurance policy on his life. The policy provided that upon his death, the proceeds would be paid to Penelope with interest over her present life expectancy, which was calculated at 25 years. Seymour died on January 1 of this year and Penelope received a payment of $5,200 from the insurance company. What amount should she include in her gross income for the year?

a. $200  
b. $1,200  
c. $4,200  
d. $5,200

12. Howard O'Brien, an employee of Ogden Corporation, died on June 30, 2010. During July Ogden made employee death payments of $10,000 to his widow, and $10,000 to his 15-year-old son. What amounts should be included in gross income by the widow and son in their respective tax returns?

<table>
<thead>
<tr>
<th></th>
<th>Widow</th>
<th>Son</th>
</tr>
</thead>
<tbody>
<tr>
<td>Proceeds</td>
<td>$5,000</td>
<td>$5,000</td>
</tr>
</tbody>
</table>

13. Charles and Marcia are married cash-basis taxpayers. They had interest income this taxable year as follows:

- $500 interest on federal income tax refund.
- $600 interest on state income tax refund.
- $800 interest on federal government obligations.
- $1,000 interest on state government obligations.

What amount of interest income is taxable on Charles and Marcia's joint income tax return for this taxable year?

a. $500  
b. $1,100  
c. $1,900  
d. $2,900
14. During 2010 Kay received interest income as follows:

On U.S. Treasury certificates $4,000
On refund of 2009 federal income tax 500

The total amount of interest subject to tax in Kay's 2010 tax return is
a. $4,500
b. $4,000
c. $500
d. $0

15. Daniel Kelly received interest income from the following sources:

New York Port Authority bonds $1,000
Puerto Rico Commonwealth bonds 1,800

What portion of such interest is tax exempt?

a. $0
b. $1,000
c. $1,800
d. $2,800

16. In 2010 Uriah Stone received the following interest payments:

- Interest of $400 on refund of federal income tax for 2008.
- Interest of $300 on award for personal injuries sustained in an automobile accident during 2005.
- Interest of $1,500 on municipal bonds.
- Interest of $1,000 on United States savings bonds (Series HH).

What amount, if any, should Stone report as interest income on his 2010 tax return?

a. $0
b. $700
c. $1,700
d. $3,200

17. During 2010, Clark received the following interest income:

On Veterans Administration insurance dividends left on deposit with the V.A. $20
On state income tax refund 30

What amount should Clark include for interest income in his 2010 return?

a. $50
b. $30
c. $20
d. $0

18. Clark bought Series EE U.S. Savings Bonds after 1989. Redemption proceeds will be used for payment of college tuition for Clark's dependent child. One of the conditions that must be met for tax exemption of accumulated interest on these bonds is that the

a. Purchaser of the bonds must be the sole owner of the bonds (or joint owner with his or her spouse).
b. Bonds must be bought by a parent (or both parents) and put in the name of the dependent child.
c. Bonds must be bought by the owner of the bonds before the owner reaches the age of 24.
d. Bonds must be transferred to the college for redemption by the college rather than by the owner of the bonds.

19. In a tax year where the taxpayer pays qualified education expenses, interest income on the redemption of qualified U.S. Series EE Bonds may be excluded from gross income. The exclusion is subject to a modified gross income limitation and a limit of aggregate bond proceeds in excess of qualified higher education expenses. Which of the following is (are) true?

I. The exclusion applies for education expenses incurred by the taxpayer, the taxpayer's spouse, or any person whom the taxpayer may claim as a dependent for the year.
II. "Otherwise qualified higher education expenses" must be reduced by qualified scholarships not included in gross income.

a. I only.
b. II only.
c. Both I and II.
d. Neither I nor II.
20. In July 1995, Dan Farley leased a building to Robert Shelter for a period of fifteen years at a monthly rental of $1,000 with no option to renew. At that time the building had a remaining estimated useful life of twenty years.

Prior to taking possession of the building, Shelter made improvements at a cost of $18,000. These improvements had an estimated useful life of twenty years at the commencement of the lease period. The lease expired on June 30, 2010 at which point the improvements had a fair market value of $2,000. The amount that Farley, the landlord, should include in his gross income for 2010 is
a. $6,000
b. $8,000
c. $10,000
d. $18,000

21. Paul Bristol, a cash basis taxpayer, owns an apartment building. The following information was available for 2010:

- An analysis of the 2010 bank deposit slips showed recurring monthly rents received totaling $50,000.
- On March 1, 2010, the tenant in apartment 2B paid Bristol $2,000 to cancel the lease expiring on December 31, 2010.
- The lease of the tenant in apartment 3A expired on December 31, 2010, and the tenant left improvements valued at $1,000. The improvements were not in lieu of any rent required to have been paid.

In computing net rental income for 2010, Bristol should report gross rents of
a. $50,000
b. $51,000
c. $52,000
d. $53,000

22. Amy Finch had the following cash receipts during 2010:

Net rent on vacant lot used by a car dealer (lessee pays all taxes, insurance, and other expenses on the lot) $6,000

Advance rent from lessee of above vacant lot, such advance to be applied against rent for the last two months of the 5-year lease $1,000

How much should Amy include in her 2010 taxable income for rent?

23. Nare, an accrual-basis taxpayer, owns a building which was rented to Mott under a ten-year lease expiring August 31, 2012. On January 2, 2010, Mott paid $30,000 as consideration for canceling the lease. On November 1, 2010, Nare leased the building to Pine under a five-year lease. Pine paid Nare $10,000 rent for the two months of November and December, and an additional $5,000 for the last month's rent. What amount of rental income should Nare report in its 2010 income tax return?

a. $10,000
b. $15,000
c. $40,000
d. $45,000

24. Ace Rentals Inc., an accrual-basis taxpayer, reported rent receivable of $35,000 and $25,000 in its 2010 and 2009 balance sheets, respectively. During 2010, Ace received $50,000 in rent payments and $5,000 in nonrefundable rent deposits. In Ace's 2010 corporate income tax return, what amount should Ace include as rent revenue?

a. $50,000
b. $55,000
c. $60,000
d. $65,000

25. Hall, a divorced person and custodian of her 12-year old child, filed her 2010 federal income tax return as head of a household. She submitted the following information to the CPA who prepared her 2010 return:

- The divorce agreement, executed in 1996, provides for Hall to receive $3,000 per month, of which $600 is designated as child support. After the child reaches 18, the monthly payments are to be reduced to $2,400 and are to continue until remarriage or death. However, for the year 2010, Hall received a total of only $5,000 from her former husband. Hall paid an attorney $2,000 in 2010 in a suit to collect the alimony owed.

What amount should be reported in Hall's 2010 return as alimony income?

a. $36,000
b. $28,800
c. $5,000
d. $0
26. Ed and Ann Ross were divorced in January 2010. In accordance with the divorce decree, Ed transferred the title in their home to Ann in 2010. The home, which had a fair market value of $150,000, was subject to a $50,000 mortgage that had 20 more years to run. Monthly mortgage payments amount to $1,000. Under the terms of settlement, Ed is obligated to make the mortgage payments on the home for the full remaining 20-year term of the indebtedness, regardless of how long Ann lives. Ed made 12 mortgage payments in 2010. What amount is taxable as alimony in Ann's 2010 return?
   a. $0
   b. $12,000
   c. $100,000
   d. $112,000

27. Richard and Alice Kelley lived apart during 2010 and did not file a joint tax return for the year. Under the terms of the written separation agreement they signed on July 1, 2010, Richard was required to pay Alice $1,500 per month of which $600 was designated as child support. He made six such payments in 2010. Additionally, Richard paid Alice $1,200 per month for the first six months of 2010, no portion of which was designated as child support. Assuming that Alice has no other income, her tax return for 2010 should show gross income of
   a. $0.
   b. $5,400.
   c. $9,000.
   d. $12,600.

28. John and Mary were divorced in 2000. The divorce decree provides that John pay alimony of $10,000 per year, to be reduced by 20% on their child's 18th birthday. During 2010, John paid $7,000 directly to Mary and $3,000 to Spring College for Mary's tuition. What amount of these payments should be reported as income in Mary's 2010 income tax return?
   a. $5,600.
   b. $8,000.
   c. $8,600.
   d. $10,000.

29. With regard to the inclusion of social security benefits in gross income, for the 2010 tax year, which of the following statements is correct?
   a. The social security benefits in excess of provisional income are included in gross income.
   b. The social security benefits in excess of one half the provisional income are included in gross income.
   c. One half of the social security benefits is the maximum amount of benefits to be included in gross income.
   d. The maximum amount of social security benefits included in gross income is 85%.

30. Blake, a single individual age 67, had 2010 adjusted gross income of $60,000 exclusive of social security benefits. Blake received social security benefits of $8,400 and interest of $1,000 on tax-exempt obligations during 2010. What amount of social security benefits is included in Blake's 2010 taxable income?
   a. $0
   b. $4,200
   c. $7,140
   d. $8,400

31. In January of this year, Judy Howard was awarded a postgraduate fellowship grant of $4,800 by a tax-exempt educational organization. Ms. Howard is not a candidate for a degree and was awarded the grant to continue her research. The grant is for a two-year period but was paid in full on July 1 of this year. What amount should be included in her gross income for this taxable year?
   a. $0.
   b. $1,200.
   c. $2,400.
   d. $4,800.

32. Majors, a candidate for a graduate degree, received the following scholarship awards from the university in 2010:
   • $10,000 for tuition, fees, books, and supplies required for courses.
   • $2,000 stipend for research services required by the scholarship.

   What amount of the scholarship awards should Majors include as taxable income in 2010?
   a. $12,000
   b. $10,000
   c. $2,000
   d. $0
33. Which payment(s) is(are) included in a recipient’s gross income?

I. Payment to a graduate assistant for a part-time teaching assignment at a university. Teaching is not a requirement toward obtaining the degree.

II. A grant to a Ph.D. candidate for his participation in a university-sponsored research project for the benefit of the university.

a. I only.
b. II only.
c. Both I and II.
d. Neither I nor II.

34. Arthur Mends, age 19, is a full-time student at Gordon College and a candidate for a bachelor’s degree. During the year he received the following payments:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>State scholarship for tuition for ten months</td>
<td>$4,200</td>
</tr>
<tr>
<td>Loan from college financial aid office</td>
<td>1,000</td>
</tr>
<tr>
<td>Cash support from parents</td>
<td>2,000</td>
</tr>
<tr>
<td>Cash dividends on qualified investments</td>
<td>500</td>
</tr>
<tr>
<td>Cash prize awarded in contest</td>
<td>300</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$8,000</strong></td>
</tr>
</tbody>
</table>

What is his adjusted gross income?

a. $700.
b. $800.
c. $5,000.
d. $8,000.

35. Clark filed form 1040EZ for the 2009 taxable year. In July 2010, Clark received a state income tax refund of $900, plus interest of $10, for overpayment of 2009 state income tax. What amount of the state tax refund and interest is taxable in Clark’s 2010 federal income tax return?

a. $0
b. $10
C. $900
d. $910

36. With regard to John's and Emma's filing status for 2010, Emma should file

a. As a single individual, and a separate return should be filed for John as unmarried head of household.
b. As a qualifying widow, and a separate return should be filed for John as married head of household.
c. As a qualifying widow, and a separate return should be filed for John as a single deceased individual.
d. A joint return including John, as married taxpayers.

37. How much taxable interest was received by John and Emma?

a. $0
b. $300
c. $1,000
d. $1,300

38. How much of the group life insurance proceeds should be excluded from taxable income?

a. $0
b. $5,000
c. $50,000
d. $60,000

39. How much of the employee death benefit should be excluded from taxable income?

a. $0
b. $4,500
c. $5,000
d. $7,500

40. Paul is a graduate of State University in Texas. To pay for his tuition, Paul borrowed $20,000 in local government loans. As an inducement to practice his profession in Texas, the local government forgives 25% of his loan each year he practices in the state. Assuming that Paul practices in Texas for the entire year, he must recognize how much gross income?

a. $0
b. $5,000.
c. $10,000.
d. $20,000.
Items 41 through 44 are based on the following data:
Amy Finch had the following cash receipts during 2010:

Interest on Veterans Administration insurance dividends left on deposit with the V.A. $ 10
Interest on state income tax refund 18
Net rent on vacant lot used by a car dealer (lessee pays all taxes, insurance, and other expenses on the lot) 6,000
Advance rent from lessee of above vacant lot, such advance to be applied against rent for the last two months of the 5-year lease in 2015 1,000
Dividend from a mutual insurance company on a life insurance policy 500
Dividend on listed corporation stock; payment date by corporation was December 30, 2009, but Amy received the dividend in the mail on January 2, 2010 875
Gross amount of state lottery winnings (Amy spent $900 on state lottery tickets and $700 on pari-mutual bets during the year at the state off-track betting parlor, for which she has full documentation) 2,400

41. How much should Amy include in her 2010 taxable income for interest?
   a. $0
   b. $10
   c. $18
   d. $28

42. How much should Amy include in her 2010 taxable income for rent?
   a. $7,000
   b. $6,800
   c. $6,200
   d. $6,000

43. How much should Amy report for dividend income for 2010?
   a. $1,375
   b. $875
   c. $500
   d. $0

44. How much should Amy include in taxable "Other Income" for her 2010 state lottery winnings?
   a. $2,400
   b. $1,700
   c. $1,500
   d. $800

Released and Author Constructed Questions

45. Klein, a master's degree candidate at Briar University, was awarded a $12,000 scholarship from Briar in 2010. The scholarship was used to pay Klein's 2010 university tuition and fees. Also in 2010, Klein received $5,000 for teaching two courses at a nearby college. What amount is includible in Klein's 2010 gross income?
   a. $0
   b. $5,000
   c. $12,000
   d. $17,000

46. Ace Corporation provides free parking at the company garage to its employees as a part of its fringe benefit package. The fair value of the parking is $290 per month. Because not all of the employees take advantage of the free parking, the company offers them a cash equivalent of $200 per month. Assuming that an employee takes advantage of the parking fringe benefit for the entire year, how much will he recognize in gross income for 2010.
   a. $0
   b. $720
   c. $2,400
   d. $3,300

47. Pierre, a United States citizen, was a bonafide resident of France for all of 2010. During the year, he received a total of $100,000 in foreign earned income. For 2010, how much income may Pierre exclude from gross income?
   a. $70,000
   b. $76,000
   c. $91,500
   d. $100,000
48. During the current year, Ash had the following cash receipts:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Wages</td>
<td>$13,000</td>
</tr>
<tr>
<td>Interest income from U.S. Treasury Bonds</td>
<td>$350</td>
</tr>
<tr>
<td>Workers compensation following</td>
<td>$8,500</td>
</tr>
</tbody>
</table>

What is the total amount that must be included in gross income on Ash’s income tax return?

a. $13,000
b. $13,350
c. $21,500
d. $21,850

49. Which of the following conditions must present in a post-1984 divorce agreement for a payment to qualify as deductible alimony?

I. Payments must be in cash
II. The payments must end at the recipient’s death

a. I only
b. II only
c. Both I and II
d. Neither I nor II

50. Chrisp, a freelance photographer, uses the cash method of business. The tax year ends on December 31. Which of the following should not be included in the determination of Chrisp’s gross income for the year?

a. Chrisp owns controlling shares of a closely held corporation and is planning to delay the bonus from the corporation until January of the next year. The bonus was authorized on December 15 of the current year and may be drawn at any time.
b. Chrisp received a check from a client on December 28 of the current year for a family portrait produced on December 22 of the current year. The check was dated December 23 of the current year but was not deposited until January 4 of the following year.
c. A client notified Chrisp on December 27 of the current year that a check was ready. The check was not picked up until January 4 of the following year.
d. Chrisp received a dividend check on January 4 of the following year. The dividends were declared payable on December 30 of the current year.

51. Porter was unemployed for part of the year. Porter received $35,000 of wages, $4,000 from a state unemployment compensation plan, and $2,000 from his former employer’s company-paid supplemental unemployment benefit plan. What is the amount of Porter’s gross income?

a. $35,000
b. $37,000
c. $38,600
d. $41,000

52. Nare, an accrual-basis taxpayer, owns a building which was rented to Mott under a ten-year lease expiring August 31, year 3. On January 2, year 1, Mott paid $30,000 as consideration for canceling the lease. On November 1, year 1, Nare leased the building to Pine under a five-year lease. Pine paid Nare $5,000 rent for each of the two months of November and December, and an additional $5,000 for the last month's rent. What amount of rental income should Nare report in its year 1 income tax return?

a. $10,000
b. $15,000
c. $40,000
d. $45,000
Chapter Two — Answers
Income – Inclusions and Exclusions

1. (a) $60,000. Only the salary and year-end bonus are included as gross income. Medical insurance premiums paid by the employer are non-taxable fringe benefits. The reimbursement of qualified moving expenses is no longer included in income.

2. (c) $550. Gross income includes the fair market value of property received, not just cash. Perle must include:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash received</td>
<td>$200</td>
</tr>
<tr>
<td>Bookcases - FMV</td>
<td>$350</td>
</tr>
<tr>
<td>Total income</td>
<td>$550</td>
</tr>
</tbody>
</table>

3. (d) $27,700. Unemployment benefits are fully taxable in 2010. His gross income includes:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Current adjusted gross income</td>
<td>$22,500</td>
</tr>
<tr>
<td>Add: Taxable unemployment benefits</td>
<td>$5,200</td>
</tr>
<tr>
<td>New adjusted gross income</td>
<td>$27,700</td>
</tr>
</tbody>
</table>

4. (c) Cafeteria plans allow employees to choose benefits. There are no minimum service requirements as in a retirement plan.

5. (d) $10,000. Awards for outstanding civic achievement can be excluded from gross income. If the awards are made in connection with religious, charitable, scientific, educational, literary or civic nature; and the recipient must be selected without any action on her part; no future services were expected; and the award is assigned over to a charity, it would be excluded. The only thing Joan did not do was assign the award to a charity.

6. (a) $0. All items are excluded from gross income.

7. (d) $0. A taxpayer receiving amounts from workers compensation, accident and health insurance claims, lawsuits for personal injuries and disability benefits are not included as gross income. However, a lawsuit settlement for lost wages would be included in gross income.

8. (d) $41,500. Salary, premiums paid (or the IRS determined cost of) for term life insurance in excess of $50,000, and gambling winnings are all components of gross income.

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Salary</td>
<td>$36,000</td>
</tr>
<tr>
<td>Premiums on excess insurance</td>
<td>500</td>
</tr>
<tr>
<td>Gambling winnings</td>
<td>$5,000</td>
</tr>
<tr>
<td>Total</td>
<td>$41,500</td>
</tr>
</tbody>
</table>

9. (b) $320. The cost of premiums for group-term life insurance in excess of $50,000 is included as gross income. With $90,000 in total policy coverage, there is $40,000 in excess coverage. At a premium cost of $8 per thousand, the amount of income to be recognized is 40 times $8 or $320.

10. (b) $480. Under an annuity contract, the taxpayer may exclude a pro-rata share of the cost, or basis in the investment. Sam’s total cost is $3,600; his expected return is $10,800; and his current year receipts are $1,440 (12 months @ $120 per month).

   \[
   \text{Current receipts} \times \left( \frac{\text{Investment}}{\text{Expect Return}} \right) = \text{Excluded, tax-free return} \\
   \$1,440 \times \$3,600 \quad = \quad \$480
   \]
11. (b) $1,200. A lump sum distribution of life insurance is generally not included as gross income. However, when the proceeds are not being paid out immediately, but are paid over a 25 year period, there is an element of interest that must be recognized. The non-taxable recovery is determined on a straight-line basis. $100,000 divided by 25 years for a non-taxable recovery of $4,000 per year.

<table>
<thead>
<tr>
<th>Receipt of payment</th>
<th>$5,200</th>
</tr>
</thead>
<tbody>
<tr>
<td>Excluded portion</td>
<td>-4,000</td>
</tr>
<tr>
<td>Taxable portion</td>
<td>$1,200</td>
</tr>
</tbody>
</table>

12. (d) Widow $10,000 - Son $10,000. The exclusion of death benefits paid to an employee’s family has been repealed.

13. (c) $1,900. Only interest on the state obligation is excluded from income.

14. (a) $4,500. Interest on federal obligations is generally included in gross income as well as interest on a tax refund.

15. (d) $2,800. Interest on state and municipal obligations is excluded from gross income. Also excluded is interest on obligations of a possession of the United States, such as Puerto Rico.

16. (c) $1,700. Interest on state and municipal obligations is excluded from gross income. However, interest on the other obligations is included in gross income:

<table>
<thead>
<tr>
<th>Interest on tax refund</th>
<th>$400</th>
</tr>
</thead>
<tbody>
<tr>
<td>Interest on special award</td>
<td>300</td>
</tr>
<tr>
<td>Interest on Series HH Bond</td>
<td>1,000</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>$1,700</td>
</tr>
</tbody>
</table>

17. (b) $30. Interest on Veterans Administration insurance dividends left on deposit with the Veterans Administration, are excluded from gross income. However, tax refunds are not considered to be obligations of the state and any interest earned on the refunds are fully taxable.

18. (a) In order for the interest from Series EE US Savings Bonds to be excluded from gross income, the purchaser must be the owner of the bonds and be at least 24 years old. The bonds are not held in the dependent's name nor are they transferred to the college for redemption.

19. (c) The expenses can be incurred for the taxpayer, spouse or dependent, and must be reduced by any scholarships or veteran’s benefits.

20. (a) $6,000. Any increase in the value of the rental property as the result of improvements made by the lessee are generally excluded from the lessor’s gross income. However, if the improvements were made in lieu of rent, the fair market value of the improvements would be included as gross income. In this instance, none of the $18,000 would be included. Farley would only recognize $6,000 (the six months of rent at $1,000 per month).

21. (c) $52,000. The rental income would include the recurring monthly rents of $50,000 plus the $2,000 for the cancellation of the lease. Any increase in the value of the rental property as the result of improvements made by the lessee are generally excluded from the lessor’s gross income.

22. (a) $7,000. The gross rent would include the net rent of $6,000 on the vacant lot as well as the advance rent which is designated as rent against the last two months of the lease. The advance rent is not considered to be a security deposit.
23. (d) $45,000. The gross rent would include all three items:

- Payment for canceling lease $ 30,000
- Rent payment for two months 10,000
- Last month’s rent payment 5,000

Total rental income $ 45,000

24. (d) $65,000. In this problem, you must determine how rental income Ace Rentals, Inc., (accrual based entity) earned. In addition, it initially appears that the lessee has provided Ace with a security deposit which would not have to be included in gross income. However, because it is a nonrefundable rent deposit, it is included in gross income. (A security deposit generally does not represent gross income as a right of return exists to the lessee at the end of the lease.) The computation of the rental income is as follows:

- Rent receivable 2010 $ 35,000
- Rent receivable 2009 -25,000
- Increase in receivable 10,000
- Rent collected during 2010 50,000
- Nonrefundable rent deposits 5,000

Total rental income $ 65,000

25. (d) $0. If the alimony and child support payments made during the year are less than the payments required by the written decree or agreement, in determining the amount of alimony, payments are first allocated to the non-alimony (child support), and then the alimony. You do not pro-rate the payments. Hall’s husband was required to pay her $3,000 per month. Of the $3,000 payment, $600 is designated as child support. However, Hall’s husband only paid $5,000 during 2010. The $5,000 does not even cover the required child support; therefore, there is no alimony income.

- Total payments made $ 5,000
- Amount not alimony: 12 months @ $600 -7,200
- Alimony component $ -0-

26. (a) $0. If the agreement further calls for the division of marital property, such as a house, investments and other property, this division, or transfer is not a taxable event. In addition, if the division of marital property includes the continuation of the mortgage payments, this amount will not be considered alimony because the mortgage payments will not terminate at the death of the former spouse.

27. (b) $5,400. The written agreement was not signed until July 1, 2010. Therefore the first six payments which were not paid pursuant to a written agreement are not considered alimony and are not included in gross income. Of the payments made after July 1, $600 was designated as being not alimony (child support).

- Total monthly payment $ 1,500
- Amount not alimony -600
- Monthly alimony $ 900
- Months in the year 6
- Total gross income $ 5,400

2S-3
28. (b) $8,000. The written agreement states that 20% of the payments are not alimony. Since John met his obligations during the year, $8,000 is included as gross income.

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash payments</td>
<td>$ 7,000</td>
</tr>
<tr>
<td>Tuition payments</td>
<td>3,000</td>
</tr>
<tr>
<td>Total cash payments</td>
<td>10,000</td>
</tr>
<tr>
<td>Percentage not alimony</td>
<td>20%</td>
</tr>
<tr>
<td>Total gross income</td>
<td>$ 8,000</td>
</tr>
</tbody>
</table>

29. (d) 85% is the maximum rate. Answer (c) (50%) is the old law. Answers (a) and (b) are incorrect variations of the new law. See the section in the text for the detailed rules.

30. (c) $7,140. This could be a comprehensive problem testing the 85% maximum inclusion of social security benefits. A candidate who understands the provisional income base will quickly note that the taxpayer is far in excess of any limitation and the maximum would apply. Therefore, the quick answer is:

$ 8,400 X 85% = $7,140

31. (d) $4,800. Judy was not a degree candidate.

32. (c) $2,000. As a degree candidate, the “scholarship” of $10,000 for tuition, fees, books and supplies is excluded from gross income. The “scholarship” of $2,000 for the stipend is compensation for services rendered and is included as earned income.

33. (c) By definition.

34. (b) $800. Only the $500 cash dividend and the $300 cash prize are included in gross income. As a degree candidate, the tuition scholarship is excluded. Loans and support from parents are not components of gross income.

35. (b) $10. Only the interest income from the state income tax refund is taxable. Under the tax benefit rule, a state income tax refund is included in gross income only if recipient derived a tax benefit from the state income tax payment. Since the taxpayer had filed a Form 1040EZ in 2009, we know that Clark did not itemize his deductions, but rather claimed the standard deduction. Therefore, Clark never received a tax benefit for any state taxes paid.

36. (d) Joint return. A joint return is allowed to be filed in the year of the death of a spouse. The qualifying widow status would not be appropriate because she does not have a dependent child.

37. (b) $300. The fair market value of the gift for opening the savings account is treated as interest income and is included as gross income. The interest from the municipal bonds is excluded.

38. (d) $60,000. The entire life insurance proceeds received as a lump sum are excluded from gross income.

39. (a) $0. There is no exclusion of death benefits paid to an employee's family.

40. (a) $0. There is an exclusion for students with student loans. If the forgiveness is contingent upon the student fulfilling a work requirement in the state, the forgiveness of debt will not constitute gross income.

41. (c) $18. Only the interest income from the state income tax refund is taxable. The interest from the dividends on the insurance policy from the Veteran’s Administration are not taxable.

42. (a) $7,000. Amy must recognize the $6,000 net rent on the vacant lot as well as the $1,000 advance rent of the last two months of the lease. A refundable security deposit (not part of this problem) would not be included in taxable income.
43. (b) $875. Amy must recognize dividend income on the corporate stock in 2010. Amy should not have recognized the 2009 corporate dividend in 2009 because even though it was paid to her in 2009, she did not have access to it until 2010. She did not constructively receive the payment in 2009. The dividends from mutual life insurance policies, however, represent a return of a premium and are generally excluded from gross income.

44. (a) $2,400. This full amount of her lottery winnings is included in income as “Other Income.” Any allowable losses from gambling would be treated as itemized deductions (if she itemized), and are more fully discussed in Chapter 4. The gambling losses are not offset with the winnings to come up with a “net gambling income.”

45. (b) $5,000. As a degree candidate, the “scholarship” of $12,000 awarded by the college to pay tuition and fees is excluded from gross income. The $5,000 fee for teaching two courses is compensation for services rendered and is included in gross income.

46. (b) $720. The employee fringe benefit of free parking is excluded from gross income (up to a maximum amount of $230 per month). Note that the law provides that providing the employee the excess of the fair value ($290) over the monthly exclusion amount ($230) will cause the difference of $60 to be included as gross income. Thus 12 months @ $60 per month, or $720 is income.

47. (c) $91,500. The foreign income exclusion is $91,500. Whereas the foreign source income exceeds that amount, the taxpayer is entitled to the full exclusion of $91,500.

48. (b) $13,350. A taxpayer receiving amounts from workers compensation, accident and health insurance claims, lawsuits for personal injuries and disability benefits are not included as gross income. However, the wages and interest from US Treasury bonds are fully taxable.

49. (c) Both conditions must be met, by definition.

50. (d) This is a poorly phrased question but it focuses on the doctrine of constructive receipt. In answers a-c, Chrisp has constructively received the income in the current year. In d, the income would be recognized in the following year.

51. (d) $41,000. All items are includible in gross income. The $2,400 exclusion was for 2009 only.

52. (d) $45,000. The gross rent would include all three items:

<table>
<thead>
<tr>
<th>Payment for canceling lease</th>
<th>$ 30,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Rent payment for two months</td>
<td>$ 10,000</td>
</tr>
<tr>
<td>Last month’s rent payment</td>
<td>$ 5,000</td>
</tr>
<tr>
<td>Total rental income</td>
<td>$ 45,000</td>
</tr>
</tbody>
</table>
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Deductions For Adjusted Gross Income

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Chapter Three
Deductions for Adjusted Gross Income

CLASSIFICATION OF DEDUCTIONS

In Chapter 1, the basic definition of taxable income was introduced as gross income minus deductions equals taxable income. In this chapter, we expand that basic definition into the two broad classifications of deductions an individual taxpayer may have. A comparison showing the expansion of the statutory framework is below:

<table>
<thead>
<tr>
<th>Chapter 1</th>
<th>Chapters 3 &amp; 4</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gross Income</td>
<td>Gross Income</td>
</tr>
<tr>
<td>Minus: Deductions</td>
<td>Minus: Deductions for Adjusted Gross Income</td>
</tr>
<tr>
<td>Taxable Income</td>
<td>Adjusted Gross Income</td>
</tr>
<tr>
<td></td>
<td>Minus: Itemized or Standard Deduction</td>
</tr>
<tr>
<td></td>
<td>Minus: Exemptions</td>
</tr>
<tr>
<td></td>
<td>Taxable Income</td>
</tr>
</tbody>
</table>

The distinction between those deductions allowed in arriving at adjusted gross income and those deductions subtracted from adjusted gross income is critical for a number of reasons. First, a number of income items look to adjusted gross income as a starting point for the inclusion computation. For example, in Chapter 2 the Social Security benefits would be taxable if you exceeded a threshold base using a modified adjusted gross income amount.

Second, a number of deductions in this chapter, such as the Individual Retirement Account (IRA) or the rental loss deduction, will look to the adjusted gross income as a threshold for phasing out deductions.

Third, a number of itemized deductions covered in Chapter 4 will look to adjusted gross income as a base for computing the upper limit (ceiling) tests or threshold tests. For example, only qualified medical expenses in excess of 7.5% of adjusted gross income are allowed as an itemized deduction.

This chapter organizes the deductions for adjusted gross income by three major topics: (1) those deductions available to all taxpayers; (2) those available only to self-employed taxpayers in a trade or business; and (3) those related to passive and rental losses. Please review the first page of Form 1040 at the end of Chapter 1 to see the various deductions, or Adjustments to Income beginning on line 23.

<table>
<thead>
<tr>
<th>General</th>
<th>Self-employed</th>
<th>Passive</th>
</tr>
</thead>
<tbody>
<tr>
<td>Individual Retirement Accounts</td>
<td>Trade or business expenses</td>
<td>Passive losses</td>
</tr>
<tr>
<td>Moving expenses</td>
<td>Hobby losses</td>
<td>Rental losses</td>
</tr>
<tr>
<td>Forfeiture penalties</td>
<td>Casualty losses</td>
<td>At risk rules</td>
</tr>
<tr>
<td>Alimony</td>
<td>Depreciation &amp; amortization</td>
<td></td>
</tr>
<tr>
<td>Jury duty pay</td>
<td>Section 179 election</td>
<td></td>
</tr>
<tr>
<td>Student loan interest</td>
<td>Self-employment tax</td>
<td></td>
</tr>
<tr>
<td>Health Savings Account</td>
<td>Self-employed health insurance</td>
<td></td>
</tr>
<tr>
<td>Tuition and fees</td>
<td>Retirement accounts</td>
<td></td>
</tr>
<tr>
<td>Educators expenses</td>
<td>Health Savings Accounts</td>
<td></td>
</tr>
</tbody>
</table>

There are also some other deductions, such as capital losses and bad debts, that are used in calculating adjusted gross income. Those will be covered in Chapter 6.
GENERAL DEDUCTIONS

INDIVIDUAL RETIREMENT ACCOUNT DEDUCTION
Contributions to an Individual Retirement Account (IRA) are deductible in determining adjusted gross income. The amount allowable as a deduction is the lesser of $5,000, or the taxpayer’s earned income. If the taxpayer is married, each is entitled to an IRA, subject to the same earned income limitation. Alimony received by the spouse is treated as earned income for the purposes of this test. For a married couple with a non-working spouse, a spousal IRA of $5,000 is allowed for the non-working spouse provided the combined earned income of the couple exceeds the total contributed. For taxpayers age 50 and older, the contribution ceiling is raised to $6,000.

In order for the IRA to be deductible, it must be paid during the taxable year, or by the due date of the return. Individuals may contribute up to the age of 70.

Active Participation in Employer Provided Plan
If the taxpayer, or the taxpayer’s spouse is an active participant in an employer provided retirement plan, including a Keogh or SEP plan, then the deduction may be disallowed.

• If the taxpayer(s) adjusted gross income (AGI) does not exceed $56,000 if single or $89,000 if married, then the deduction is fully allowed.
• If the taxpayer’s AGI is in excess of those limits, the IRA deduction is reduced on a pro-rata basis over the next $10,000 if single and $20,000 if married. However, there is a $200 floor (minimum) if the AGI is not above the phaseout range.

Example 1: W is single and earned a salary of $58,000 during 2010. This is his only income. W is an active participant in his company’s retirement plan. W contributes $5,000 into an IRA during 2010.

\[
\begin{align*}
5,000 \times \frac{(58,000 - 56,000)}{10,000} &= 1,000 \text{ disallowed}
\end{align*}
\]

Thus, W may deduct only $4,000 of his $5,000 contribution.

Note: If W’s AGI was $48,000, he could deduct the entire $5,000 IRA contribution because his AGI is under the $55,000. If his AGI was $70,000, none of the IRA would be deductible because he exceeded the $10,000 phase-out range.

Also, when an individual’s spouse is an active participant in an employer-sponsored retirement plan, the IRA deduction for such an individual (the non-participant) is phased-out only for married couples with AGI between $167,000 and $177,000.

There is a 10% penalty for the early withdrawal (age 59 ½) of an IRA, however, that 10% tax will not apply to amounts withdrawn for "qualified higher education expenses" or "first time homebuyer expenses."

ROTH IRAs
A taxpayer can make a nondeductible IRA (Roth IRA) contribution of up to $5,000 per year. For taxpayers age 50 and older, the contribution ceiling is raised to $6,000. There are many interesting provisions, but generally:

• contributions may be made by individuals who are 70 1/2 years and older
• there are no mandatory distribution rules
• there are no restrictions due to the active participation rule
There are some limitations. For example, the phase-out range for allowing the contribution is as follows:

<table>
<thead>
<tr>
<th>Status</th>
<th>Range</th>
</tr>
</thead>
<tbody>
<tr>
<td>Married, filing jointly</td>
<td>$167,000 - $177,000</td>
</tr>
<tr>
<td>Single</td>
<td>$105,000 - $120,000</td>
</tr>
</tbody>
</table>

When distributions are made from a Roth IRA, the distributions are free of taxes and penalties assuming that the taxpayer has maintained the IRA for 5 years or more, and the distribution:

- was made on or after the taxpayer attains the age of 59 1/2.
- was paid to the beneficiary upon the death of the taxpayer
- was made on account of the taxpayer becoming disabled
- was made for first-time homebuyer expenses (up to a maximum of $10,000)

**COVERDELL EDUCATION SAVINGS ACCOUNT (CESA)**

Taxpayers can make nondeductible contributions of up to $2,000 for each beneficiary under the age of 18 to a CESA. The contribution is phased-out for individuals with adjusted gross income beginning at $95,000 for single taxpayers and $190,000 for married taxpayers filing a joint return. Generally, when distributions are made from a CESA, the distributions are free of taxes and penalties to the extent that proceeds are used for qualified education expenses (tuition, fees, room and board) of the beneficiary. The exclusion now extends to primary and secondary school education, as well as to computers, educational software and Internet access. The exclusion is also available in any year in which the American Opportunity Credit or Lifetime Learning Credit (Chapter 5) is claimed.

**MOVING EXPENSES**

A deduction is allowed for the qualified costs of moving in connection with starting work at a new place of business. This deduction is not restricted to only employees, but is available to self-employed individuals as well. In determining the allowability of the deduction there are two tests: Time and Distance.

**Time:** Basically, the taxpayer must be an employee at the new location for at least 39 weeks after the move.

**Distance:** The distance from the taxpayer’s old residence to the new job must be at least 50 miles farther than the distance from the old residence to the old job. Notice that where the new residence is located is not relevant.

Qualified moving expenses include the reasonable costs of:
- Moving the household goods and personal belongings
- Traveling enroute from the old residence to the new residence. Meals are not allowed.

A high-level summary appears below:

**Tax issue**

- Distance test ................................................................. 50 miles
- Expense classification ................................................. Deduction for AGI
- Direct moving costs....................................................... Allowed
- Mileage rate................................................................. 16.5 cents per mile
- Meals during the move.................................................. Not allowed
- Indirect costs (househunting, temporary living)............ Not allowed
- Qualified moving cost reimbursement .......................... Not included
PENALTY ON EARLY WITHDRAWAL OF SAVINGS
When a taxpayer invests in a long-term savings account or certificate of deposit, the rate is generally higher than a conventional savings account. The long-term commitment provides the higher rate. However, should the holder withdraw the funds prematurely, the bank assesses a penalty which effectively reduces the rate of interest earned on the investment. Because the bank must report the total interest earned as gross income, the tax code allows a deduction for any penalty assessed for this early withdrawal. The net effect of the deduction is to reduce the reported interest income down to the net amount received. The penalty is deducted in the year assessed, which may not coincide with the year that the bulk of the interest is earned.

Example 2: Y invests $100,000 in a one year certificate of deposit on March 31, 2010. For the year ended December 31, 2010, Y reports interest earned of $3,000. On January 10, 2011, Y withdraws the money before the maturity date and is assessed a penalty of $2,000 by the bank. Y must report the $3,000 of interest income in 2010, and deduct the penalty of $2,000 in 2011, even though the penalty effectively pertains to the 2010 interest income. You do not restate the 2010 income for the 2011 penalty.

ALIMONY DEDUCTION
A deduction is allowed for alimony payments made under a written decree of divorce or separate maintenance. See Chapter 2 for a complete analysis of what is deductible and what is not.

JURY DUTY PAY
If a taxpayer is called for jury duty for an extended period of time, they may receive jury duty pay. This is included as income. The amount of pay is usually very low, so employers frequently continue to pay their employees while serving on the jury, with the stipulation that any jury pay they receive be returned to the employer. The payment of the jury duty pay to the employer is a deduction allowed in arriving at adjusted gross income.

STUDENT LOAN INTEREST
A taxpayer is allowed a deduction for interest paid on qualified educational loans. Qualified educational loans include indebtedness for higher education, such as tuition, fees, room and board of the taxpayer, spouse, or dependent. The deduction is allowed to a maximum of $2,500 in 2010. Similar to other deductions, there is a phase-out range of deductibility as follows:

<table>
<thead>
<tr>
<th>Filing status</th>
<th>AGI Range</th>
<th>Deduction</th>
</tr>
</thead>
<tbody>
<tr>
<td>Single</td>
<td>$65,000 or less</td>
<td>$4,000</td>
</tr>
<tr>
<td></td>
<td>$65,000 - $80,000</td>
<td>$2,000</td>
</tr>
<tr>
<td>Married</td>
<td>$130,000 or less</td>
<td>$4,000</td>
</tr>
<tr>
<td></td>
<td>$130,000 - $160,000</td>
<td>$2,000</td>
</tr>
</tbody>
</table>

TUITION AND FEES DEDUCTION
A taxpayer is allowed a deduction for qualified tuition and related expenses paid during the year for the taxpayer, his spouse and dependent. Unlike the Education Credits, books, supplies and equipment are also included as qualified expenses. If the taxpayer claims a deduction for the tuition and fees, they may not use the amount for the determination of the Education Credit. These deductions and phase-outs are as follows:

<table>
<thead>
<tr>
<th>Filing status</th>
<th>AGI Range</th>
<th>Deduction</th>
</tr>
</thead>
<tbody>
<tr>
<td>Single</td>
<td>$65,000 or less</td>
<td>$4,000</td>
</tr>
<tr>
<td></td>
<td>$65,000 - $80,000</td>
<td>$2,000</td>
</tr>
<tr>
<td>Married</td>
<td>$130,000 or less</td>
<td>$4,000</td>
</tr>
<tr>
<td></td>
<td>$130,000 - $160,000</td>
<td>$2,000</td>
</tr>
</tbody>
</table>
EDUCATOR EXPENSES
A taxpayer who is an eligible educator is allowed a deduction of up to $250 for qualified expenses paid in teaching grades K-12 for at least 900 hours during the school year. Qualified expenses are for supplies, equipment, etc., used in the classroom by the teacher. If taxpayers are married and file a joint return, both are entitled to a $250 amount.

SELF-EMPLOYED TAXPAYERS (IN A TRADE OR BUSINESS)
Gross income from a taxpayer’s trade or business, minus the allowable trade or business expenses equals self-employment income. Self-employment income includes those activities where the taxpayer is conducting a trade or business. Preparing tax returns, consulting, operating a repair service, or being the director of a business are examples of carrying on a business. Being named as an executor of an estate and receiving a fee is not considered income for self-employment purposes.

According to Code Section 162, a cash basis taxpayer may deduct all ordinary and necessary expenses paid in carrying on their trade or business. On the exam, when you are told what business a taxpayer is in, think about what the ordinary and necessary expenses of that business would be. Certain expenses, however, are subject to various limitations while others are not deductible at all.

BUSINESS MEALS & ENTERTAINMENT
The ordinary and necessary expenses paid for business meals and entertainment are deductible if they are (1) directly related or (2) associated with your trade or business. The expense may not be lavish and the taxpayer must be present at the meal. In general, you may only deduct 50% of your business related meals and entertainment expenses.

BUSINESS GIFTS
A deduction is allowed for the cost of business gifts. However, the maximum per gift is $25 per person per year. A gift to the spouse of a client is deemed to be a gift to the client if there is no business relationship with the spouse.

CLUB DUES AND MEMBERSHIP FEES
No deduction is allowed for dues or membership fees in any club organized for business, pleasure, recreation, or other social purpose. Exceptions have been carved out for chamber of commerce dues, etc.

SUBSTANTIATION
A taxpayer is required to provide substantiation for business expenses. The IRS requires substantiation for expenditures of $75 or more.

PERSONAL EXPENSES
The payment of personal expenses through the self-employed taxpayer’s business account does not make the expense deductible. Typical expenditures that you may see on the CPA exam which are not deductible by a self-employed business are:

- Estimated federal or state income tax payments.
- Salary to the owner. This is a personal draw, not a deductible expense.
- Charitable contributions. This is a personal deduction, not a business deduction.

HOBBY LOSS RULES
In order to claim a deduction, the taxpayer must be carrying on a trade or business. There is the assumption that the taxpayer is engaged in the activity for profit. It is not unusual that business activities do not always generate a profit, especially in start-up situations, difficult market times, redeveloping periods, etc. However, when the activity has an element of pleasure in it, IRS may view the activity as if it were not engaged in for profit, and disallow any losses from that activity.
Historically, activities such as horse racing, dog breeding, stamp collecting, and log cabin sales/building, do not generate any short-term profit. IRS frequently views the loss as a lack of profit motive or intent, and disallows the losses. Section 183 of the Code has provided rules for who has to prove the profit intent. The presumptive rule states that if an activity shows a profit in at least three of the last five years, the IRS has the burden of proof to show the taxpayer is not in a trade or business, and that the loss is personal and non-deductible. If it shows a profit in less than the three years, the taxpayer has the burden to prove that he is in a trade or business and the losses are deductible. (The rule for horses is two out of seven years rather than five.)

Income from the hobby is reported as other income and the deductions are reported on Schedule A as a miscellaneous itemized deduction. They are not reported on Schedule C.

NET OPERATING LOSSES
When an individual’s allowable deductions exceed its gross income, a net operating loss (NOL) exists. An NOL is generally carried back 2 years, then forward 20 years. However, may elect to waive the carryback requirement by filing such election with a timely filed return. However, for the 2009 tax year, the taxpayer may carryback the loss 3, 4 or 5 years.

However, Congress passed another act for 2010 that allows the 3, 4 or 5 year carryback for all taxpayers but limits the amount of an NOL that a taxpayer elects to carry back to the 5th taxable year preceding the taxable year of the loss to 50 percent of the taxpayer’s taxable income for the carryback taxable year. The excess of the amount of the loss over 50 percent of the taxable income for the carryback taxable year is carried to later taxable years.

CASUALTY LOSS DEDUCTION
If a taxpayer in business has a loss from a casualty such as fire, storm, shipwreck, or theft, a deduction is allowed for the decrease in value, or its adjusted basis, whichever is less, minus any insurance reimbursement. As a business loss, this is fully deductible and not subject to the $100 floor and 10% of adjusted gross income test required for a personal casualty loss.

COST RECOVERY AND DEPRECIATION EXPENSE
A deduction is allowed for the exhaustion, wear and tear of personal and real property. Assets placed in service after 1986 are under the Modified Accelerated Cost Recovery System (MACRS). Under MACRS, assets have class lives and no salvage value. MACRS. The most popular class lives on the exam are:

- 5 year: Automobiles & light trucks, computers and R & D property
- 7 year: Office furniture and equipment
- 27.5 years: Residential rental property
- 39 years: Non-residential (commercial) property

Assets under the 5 and 7 year classes are recovered under the double declining balance method. Assets under the 27.5 and 39 year classes are recovered under the straight-line method.

In addition, the cost of the assets are recovered (depreciated) using three basic conventions, or methods:

- Half-year: For personal property, with a half year recovery in the first and last year.
- Mid-quarter: For personal property when more than 40% of all property purchases occur in the last quarter of the year. Rates are adjusted to reflect a mid-quarter start point.
- Mid-month: For residential and commercial real estate, recovery starts in the middle of the month the property was placed in service.
Example 3: J purchases a computer for $10,000 on September 1, 2010. This is a five year class asset. The straight-line rate would have been 20%. Double the straight-line rate is 40%. The MACRS deduction for year 1 and 2 are

Year 1  $10,000 X 40% = $4,000 X 50% (for the half-year) = $2,000
Year 2  $10,000 - $2,000 = $8,000 X 40% = $3,200.

(Hint: The cost of $10,000 declines by the $2,000 recovery of year 1 to $8,000. The balance is recovered using the 40% rate.) This method is described here since MACRS tables have not been provided on past exams.

Example 4: J purchases commercial real estate, exclusive of land, for $304,200 on September 8, 2010. This is a 39 year class asset. The straight-line method is used. Under the mid-month convention, the cost recovery would be one-half of a month for September and three full months until the end of the year.

Cost of the building $ 304,200
Recovery period 39 yrs
Annual cost recovery $ 7,800
Monthly cost recovery $ 650
Months of cost recovery 3.5 mths
2010 cost recovery $ 2,275

The cost recovery for listed property is limited to a maximum each year. For automobiles placed in service in 2010, the maximum deduction by year is:

First year $ 3,060
Second year 4,900
Third year 2,950
Following years 1,775

Example 5: During 2010, P purchases a new automobile for business at a cost of $30,000. The automobile is used 100% for business. The automobile is five year property. The first year MACRS depreciation would be $6,000 ($30,000 X 20%), except that this is listed property. The maximum first year cost recovery is $3,060. See Bonus Depreciation below for an exception.

If P used the car only 80% for business, his deduction would be 80% of $3,060, or $2,448.

BONUS DEPRECIATION
For the 2010 tax year, Congress extended the new bonus depreciation provision, allowing taxpayers to claim 50% of the cost of qualifying assets as depreciation before deducting the MACRS depreciation. While it is called Bonus depreciation, it is not extra depreciation. It simply accelerates the depreciation deduction allowed into the first year.
The bonus depreciation reduces the basis of the asset before the current year’s MACRS deduction is determined. The taxpayer may elect out of this bonus depreciation. This is a mandatory provision but the taxpayer may elect out.

For luxury automobiles placed in service in 2010, the bonus depreciation increases the deduction to $11,060, which includes a maximum of $8,000 in bonus depreciation plus the listed vehicle limitation of $3,060.

**Example 6**: Melinda acquires $40,000 of computer equipment for her business in 2010. She does not elect out of the 50% bonus depreciation. Her total deduction would be $24,000 and would be comprised of $20,000 of bonus depreciation and $4,000 of MACRS depreciation. Computations are as follows:

<table>
<thead>
<tr>
<th>Cost</th>
<th>$40,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bonus depreciation @ 50%</td>
<td>-20,000</td>
</tr>
<tr>
<td>Remaining basis</td>
<td>20,000</td>
</tr>
<tr>
<td>MACRS 1st year (for 5 year property)</td>
<td>20%</td>
</tr>
<tr>
<td>MACRS depreciation</td>
<td>$4,000</td>
</tr>
</tbody>
</table>

**SECTION 179 ELECTIONS**
At the election of the taxpayer, for 2010 up to $500,000 of qualifying property may be immediately expensed rather than capitalizing the asset and depreciating it over its useful life. This is an annual election and has the following limits:

- The amount expensed cannot exceed the taxable income from that trade or business
- The amount of qualifying property purchased cannot exceed $2,000,000 in the year. If it does, the $500,000 is reduced dollar for dollar for every dollar above $2,000,000.

**Example 7**: Q purchased four computers for $12,000 and wished to make a Section 179 election. The taxable income from his service business is $4,000 before this election. Q may **elect** to expense the entire $12,000, but only $4,000 will be **allowed** as a current year deduction under Section 179. The disallowed amount of $8,000 may be carried over indefinitely until the taxpayer has taxable business income.

**Example 8**: P purchased $2,007,000 of equipment during 2010 and wants to make a Section 179 election. His taxable income is $650,000. Since the amount of qualifying property purchased exceeds $2,000,000 by $7,000, then P must reduce the $500,000 by the excess of $7,000. His Section 179 election is limited to $493,000.

**AMORTIZATION EXPENSE**
Amortization is the cost of recovering intangible assets such as leasehold improvements and other Section 197 intangibles. The cost of the Section 197 intangibles may be amortized over a 15 year life on a straight-line basis. A partial listing of these assets are:

- Goodwill
- Going concern value
- Covenants not to compete
- Customer lists
- Technological know-how
- Franchise, trademark or trade name
ONE-HALF OF THE SELF-EMPLOYMENT TAX
A deduction is allowed for one-half of the self-employment tax paid. The logic behind the allowance of one-half of the tax is that it is, in essence, the matching portion of the social security tax an employer would have to pay on its employees. The actual computation of the self-employment tax is shown in Chapter 5.

SELF-EMPLOYED HEALTH INSURANCE DEDUCTION
A deduction is allowed for 100% of the cost of premiums paid for medical insurance by the self-employed taxpayer in 2010. This includes insurance on the taxpayer, spouse and dependents. This deduction is not allowed if the taxpayer is eligible to participate in an employer sponsored health plan of the taxpayer or the spouse.

SELF-EMPLOYED RETIREMENT PLANS
A deduction is allowed for contributions made to the self-employed taxpayer’s qualified retirement plan.

In general, the allowable contribution into a Keogh plan is the lesser of (1) $49,000 or 100% of the net earnings from self-employment after being reduced by the Keogh contribution and one-half of the self-employment tax. The actual contribution is not due until the due date of the return.

<table>
<thead>
<tr>
<th>Example 9:</th>
<th>Y is self-employed and had self-employed income of $30,000 for the year. His self-employment tax was $4,238 and wants to make a $10,000 contribution to his Keogh Plan.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Self-Employed net income</td>
<td>$30,000</td>
</tr>
<tr>
<td>Less: 50% of self-employment tax</td>
<td>-2,119</td>
</tr>
<tr>
<td>Net after contribution</td>
<td>$17,881</td>
</tr>
</tbody>
</table>

The $10,000 contribution is allowed

Various other self-employed retirement plans, including a profit sharing plans and the Simplified Employee Pension (SEP) plan allow a contribution up to 20% of the net earnings from self-employment but not to exceed $49,000.

HEALTH SAVINGS ACCOUNT
Qualified participants are able to deduct contributions made into this plan for health care. The limitation on the deduction is calculated on a month by month basis. It is the lesser of 1/12th of the annual deductible amount under a high deductible insurance plan or $3,000 for a single individual (or $5,950 for a married couple). Amounts are then paid out of the plan for qualified medical expenses. Amounts not paid for medical costs are included as gross income and subject to a 10% penalty. Taxpayer age 55 and above may increase the deduction by $1,000.

PASSIVE ACTIVITY AND RENTAL LOSSES

GENERAL RULE
Losses from passive activities are deductible only to the extent of passive income. Passive losses may not be offset against active income (salaries, wages, etc.) or portfolio income (interest, dividends, etc.). This passive loss limitation applies to individuals, personal service and closely held corporations. A closely held corporation is defined as a corporation where more than 50% of the stock is owned, directly or indirectly, by not more than 5 individuals. The losses are suspended until passive income is generated, or eventually deducted when the investment is disposed of. Passive losses are reported on Form 8582.
PASSIVE ACTIVITY DEFINED
A passive activity is defined as any trade or business, or income producing activity, where the taxpayer does not materially participate. Material participation assumes that the taxpayer is involved on a regular, continuous and substantial basis. One test issued by IRS in their 1988 regulations identified that more than 500 hours in a year qualified as in material participation.

Example 10: P is a full-time employee and earns $70,000 as an electrical engineer for a large corporation. P also invested $10,000 in a start-up venture to design and manufacturer cyberspace headgear. P spends 90 hours per year (weekends and one week of his vacation time) managing this business. P’s share of the current year’s loss of this venture was $8,000. This loss is considered to be from a passive activity and cannot be deducted against his ordinary income of $70,000.

RENTAL ACTIVITY
The Code also defines all rental activities as passive activities, unless this is the taxpayer’s business. However, an exception to the “no loss is allowed” rule exists for rental activity losses of up to $25,000 per year. To qualify the taxpayer must:

- actively participate in the activity and
- own 10% or more of the activity.

Active participation means participating in the management decisions, but is not as involved as the regular, continuous and substantial basis under the passive loss regulations.

In addition to the $25,000 limitation, there is an additional limitation as to the amount of the deductible loss when the taxpayer’s adjusted gross income exceeds a threshold amount. The $25,000 maximum loss against ordinary income, is reduced by 50% of the excess of their adjusted gross income over $100,000. The loss is completely phased out at $150,000. The disallowed loss is carried over indefinitely.

Example 11: R is a full-time employee and earns $120,000 as a controller for a large corporation. R actively participates as a 30% owner of real estate located nearby. During the year, R’s share of the rental loss is $30,000. R has no other rental or passive activities.

R first reduces the $30,000 rental loss to the maximum of $25,000. The excess of $5,000 is suspended. The $25,000 is then limited by the AGI test. His AGI exceeds the $100,000 by $20,000, thus the disallowed portion is determined as follows:

\[
\frac{20,000}{50,000} \times 25,000 = 10,000
\]

R is allowed a current deduction against ordinary income of $15,000 ($25,000 - $10,000 disallowed portion). The $15,000 disallowed portion is carried forward indefinitely. Next year, the carried forward components are added to any new losses and the same tests are applied.
AT RISK LIMITATIONS
The at-risk limitations override all the previous tests of deductibility. Simply put, if a taxpayer is not at risk for the loss, then no deduction is allowed. The at-risk rules take precedent over all other rules.

**Example 12:** Q invests $10,000 in a business venture. Q's liability in this venture is limited to his investment of $10,000. During the year, the venture generates a loss, of which Q's share is $23,000. The most Q may claim as a loss for the current year is $10,000, because he is not at-risk for anything beyond his initial investment. Once the at-risk limitation is determined, the taxpayer would then test the $10,000 for passive loss restrictions, etc.

**Example 13:** Same facts as in Example 11 except that Q had passive income of $12,000 from another investment. Q could deduct only the $10,000 loss against the $12,000 passive income. Even though Q’s total passive loss was $23,000, the at-risk limitations prevent any more than $10,000 to be offset against any income at this time.
Chapter Three — Questions  
Deductions for Adjusted Gross Income

General Deductions

1. Sol and Julia Crane are married, and filed a joint return for 2010. Sol earned a salary of $120,000 from his job at Troy Corp., where Sol is covered by his employer’s pension plan. In addition, Sol and Julia earned interest of $3,000 on their joint savings account. Julia is not employed, and the couple had no other income. On January 15, 2011, Sol contributed $5,000 to an IRA for himself, and $5,000 to an IRA for his spouse. The allowable IRA deduction in the Cranes’ 2010 joint return is
   a. $0  
   b. $5,000  
   c. $6,000  
   d. $10,000

2. For 2010, Val and Pat White filed a joint return. Val earned $35,000 in wages and was covered by his employer’s qualified pension plan. Pat was unemployed and received $5,000 in alimony payments for the first 4 months of the year before remarrying. The couple had no other income. Each contributed $5,000 to an IRA account. The allowable IRA deduction on their 2010 joint tax return is
   a. $10,000  
   b. $6,000  
   c. $5,000  
   d. $0

3. For the taxable year Fred and Wilma Todd reported the following items of income:

   Fred | Wilma
   ----|------
   Salary | $40,000 |  
   Interest income | 1,000 | $ 200
   Cash prize won on T.V. game show | — | 8,800

   Fred | Wilma
   ----|------
   $41,000 | $9,000

Fred is not covered by any qualified retirement plan and he and Wilma established individual retirement accounts during the year. Assuming a joint return is filed, what is the maximum amount that they can be allowed for contributions to their individual retirement accounts?
   a. $0  
   b. $5,000  
   c. $6,000  
   d. $10,000

4. Grey, a calendar year taxpayer, was employed and resided in New York. On February 2, 2010, Grey was permanently transferred to Florida by his employer. Grey worked full-time for the entire year. In 2010, Grey incurred and paid the following unreimbursed expenses in relocating.

   Lodging and travel expenses while moving | $1,000
   Pre-move househunting costs | 1,200
   Costs of moving household furnishings and personal effects | 1,800

   What amount was deductible as moving expense on Grey’s 2010 tax return?
   a. $4,000  
   b. $2,800  
   c. $1,800  
   d. $1,000

5. The unreimbursed direct moving expenses of an employee who takes a new job 100 miles away from a previous residence and place of employment are
   a. Fully deductible from gross income in arriving at adjusted gross income.  
   b. Deductible only as miscellaneous itemized deductions subject to a 2% floor.  
   c. Fully deductible only as itemized deductions.  
   d. Not deductible.

6. In 2010, Barlow moved from Chicago to Miami to start a new job, incurring costs of $1,200 to move household goods and $2,500 in temporary living expenses. Barlow was not reimbursed for any of these expenses. What amount should Barlow deduct for moving expenses as a deduction from gross income?
   a. $1,200  
   b. $2,700  
   c. $3,000  
   d. $3,700
7. Marc Clay was unemployed for the entire year 2009. In January 2010, Clay obtained full-time employment 60 miles away from the city where he had resided during the ten years preceding 2010. Clay kept his new job for the entire year 2010. In January 2010, Clay paid direct moving expenses of $300 in relocating to his new city of residence, but he received no reimbursement for these expenses. In his 2010 income tax return, Clay's direct moving expenses are
   a. Not deductible.
   b. Fully deductible only if Clay itemizes his deductions.
   c. Fully deductible from gross income in arriving at adjusted gross income.
   d. Deductible subject to a 2% threshold if Clay itemizes his deductions.

8. For the year ended December 31, 2010, Elmer Shaw earned $3,000 interest at Prestige Savings Bank, on a time savings account scheduled to mature in 2011. In January 2011, before filing his 2010 income tax return, Shaw incurred a forfeiture penalty of $1,500 for premature withdrawal of the funds from his account. Shaw should treat this $1,500 forfeiture penalty as a
   a. Penalty not deductible for tax purposes.
   b. Deduction from gross income in arriving at 2011 adjusted gross income.
   c. Deduction from 2011 adjusted gross income, deductible only if Shaw itemizes his deductions for 2010.
   d. Reduction of interest earned in 2010, so that only $1,500 of such interest is taxable on Shaw's 2010 return.

9. For the year ended December 31, 2010, Don Raff earned $1,000 interest at Ridge Savings Bank on a certificate of deposit scheduled to mature in 2011. In January 2011, before filing his 2010 income tax return, Raff incurred a forfeiture penalty of $500 for premature withdrawal of the funds. Raff should treat this $500 forfeiture penalty as a
   a. Reduction of interest earned in 2010, so that only $500 of such interest is taxable on Raff's 2010 return.
   b. Deduction from 2011 adjusted gross income, deductible only if Raff itemizes his deductions for 2011.
   c. Penalty not deductible for tax purposes.
   d. Deduction from gross income in arriving at 2011 adjusted gross income.

10. With regard to alimony in connection with a 2010 divorce, which of the following statements is true?
   a. Alimony may be paid either in cash or in property.
   b. Alimony must terminate at the death of the payee spouse.
   c. The divorced couple may be members of the same household at the time alimony is paid.
   d. Alimony may be deductible by the payor spouse to the extent that payment is contingent on the status of the divorced couple's child.

11. Art Hollender was divorced from his wife Diane in 2009. Under the terms of the divorce decree, he was required to make the following periodic payments each month to his former wife who retained custody of their children:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Alimony</td>
<td>$600</td>
</tr>
<tr>
<td>Child support</td>
<td>400</td>
</tr>
</tbody>
</table>

For 2010 his only income was his salary of $40,000, and he paid only ten payments of $1,000 per month to his former wife under the terms of the divorce decree. What is his 2010 adjusted gross income?
   a. $30,000.
   b. $32,800.
   c. $34,800.
   d. $40,000.

12. Dale received $1,000 for jury duty. In exchange for regular compensation from her employer during the period of jury service, Dale was required to remit the entire $1,000 to her employer. In Dale's income tax return, the $1,000 jury duty fee should be
   a. Claimed in full as an itemized deduction.
   b. Claimed as an itemized deduction to the extent exceeding 2% of adjusted gross income.
   c. Deducted from gross income in arriving at adjusted gross income.
   d. Included in taxable income without a corresponding offset against other income.

13. Which allowable deduction can be claimed in arriving at an individual's adjusted gross income?
   a. Alimony payment.
   b. Charitable contribution.
   c. Personal casualty loss.
   d. Unreimbursed business expense of an outside salesperson.
14. Gilda Bach is a cash basis self-employed consultant. For the year she determined that her net income from self-employment was $80,000. In reviewing her books you determine that the following items were included as business expenses in arriving at the net income of $80,000:

- Salary drawn by Gilda Bach $20,000
- Estimated federal self-employment and income taxes paid 6,000
- Malpractice insurance premiums 4,000
- Cost of attending professional seminar 1,000

Based upon the above information, what should Gilda Bach report as her net self-employment income?

a. $91,000.

b. $105,000.

c. $106,000.

d. $110,000.

15. Rich is a cash basis self-employed air-conditioning repairman with gross business receipts of $20,000. Rich's cash disbursements were as follows:

- Air conditioning parts $2,500
- Yellow Pages Listing 2,000
- Estimated federal income taxes on self-employment income 1,000
- Business long-distance telephone calls 400
- Charitable contributions 200

What amount should Rich report as net self-employment income?

a. $15,100

b. $14,900

c. $14,100

d. $13,900

16. Alex Berger, a retired building contractor, earned the following income during the year:

- Director's fee received from Keith Realty Corp. $600
- Executor's fee received from the estate of his deceased sister 7,000

Berger's self-employment income is

a. $0.

b. $600.

c. $7,000.

d. $7,600.

17. During the holiday season, Barmin Corporation gave business gifts to 16 customers. The value of the gifts, which were not of an advertising nature, was as follows:

- 4 @ $ 10
- 4 @ $ 25
- 4 @ $ 50
- 4 @ $100

Barmin can deduct as a business expense a total of:

a. $0.

b. $140.

c. $340.

d. $740.

18. The self-employment tax is

a. Fully deductible as an itemized deduction.

b. Fully deductible in determining net income from self-employment.

c. One-half deductible from gross income in arriving at adjusted gross income.

d. Not deductible.

19. Davis, a sole proprietor with no employees, has a Keogh profit-sharing plan to which he may contribute 15% of his annual earned income. For this purpose, "earned income" is defined as net self-employment earnings reduced by the


b. Self-employment tax.

c. Self-employment tax and one-half of the deductible Keogh contribution.

d. Deductible Keogh contribution and one-half of the self-employment tax.

20. On December 1, 2009, Michaels, a self-employed cash basis taxpayer, borrowed $100,000 to use in her business. The loan was to be repaid on November 30, 2010. Michaels paid the entire interest of $12,000 on December 1, 2009. What amount of interest was deductible on Michaels' 2010 income tax return?

a. $12,000

b. $11,000

c. $1,000

d. $0
21. Browne, a self-employed taxpayer, had 2010 business net income of $100,000 prior to any expense deduction for equipment purchases. In 2010, Browne purchased and placed into service, for business use, office machinery costing $30,000. This was Browne's only 2010 capital expenditure. Browne's business establishment was not in an economically distressed area. Browne made a proper and timely expense election to deduct the maximum amount. Browne was not a member of any pass through entity. What is Browne's deduction under the election?
   a. $10,000
   b. $24,000
   c. $25,000
   d. $30,000

22. Under the modified accelerated cost recovery system (MACRS) of depreciation for property placed in service after 1986, which statement is false?
   a. Used tangible depreciable property is excluded from the computation.
   b. Salvage value is ignored for purposes of computing the MACRS deduction.
   c. Straight-line depreciation is allowable.
   d. The recovery period for depreciable realty must be at least 27.5 years.

23. On August 1, 2010, Graham purchased and placed into service an office building costing $264,000 including $30,000 for the land. What was Graham's MACRS deduction for the office building in 2010?
   a. $9,600
   b. $6,000
   c. $3,600
   d. $2,250

24. With regard to depreciation computations made under the general MACRS method, the half-year convention provides that
   a. One-half of the first year's depreciation is allowed in the year in which the property is placed in service, regardless of when the property is placed in service during the year, and a half-year's depreciation is allowed for the year in which the property is disposed of.
   b. The deduction will be based on the number of months the property was in service, so that one-half month's depreciation is allowed for the month in which the property is placed in service and for the month in which it is disposed of.
   c. Depreciation will be allowed in the first year of acquisition of the property only if the property is placed in service no later than June 30 for calendar-year corporations.
   d. Depreciation will be allowed in the last year of the property's economic life only if the property is disposed of after June 30 of the year of disposition for calendar-year corporations.

25. How is the depreciation deduction of nonresidential real property, placed in service in 2010, determined for regular tax purposes using MACRS?
   a. Straight-line method over 40 years.
   b. 150% declining-balance method with a switch to the straight-line method over 27.5 years.
   c. 150% declining-balance method with a switch to the straight-line method over 39 years.
   d. Straight-line method over 39 years.

26. In 2010, Roe Corp. purchased and placed in service a machine to be used in its manufacturing operations. This machine cost $2,021,000. Assuming it has taxable income of $600,000, what portion of the cost may Roe elect to treat as an expense under Section 179 rather than as a capital expenditure?
   a. $99,000
   b. $250,000
   c. $479,000
   d. $500,000

27. Paul and Lois Lee, both age 50, are married and filed a joint return for 2010. Their 2010 adjusted gross income was $80,000, including Paul's $75,000 salary. Lois had no income of her own. Neither spouse was covered by an employer-sponsored pension plan. What amount could the Lees contribute to IRAs for 2010 to take advantage of their maximum allowable IRA deduction in their 2010 return?
   a. $0
   b. $4,000
   c. $8,000
   d. $10,000
Rental Income & Passive Losses

28. Mort Gage, a cash basis taxpayer, is the owner of an apartment building containing 10 identical apartments. Gage resides in one apartment and rents out the remaining units. The following information is available for the current year.

- Gross rents: $21,600
- Fuel: 2,500
- Maintenance and repairs (rental apartments): 1,200
- Advertising for vacant apartments: 300
- Depreciation of building: 5,000

What amount should Gage report as net rental income?

a. $12,600.
b. $13,350.
c. $13,500.
d. $17,600.

29. Emil Gow owns a two-family house which has two identical apartments. Gow lives in one apartment and rents out the other. In 2010, the rental apartment was fully occupied and Gow received $7,200 in rent. During the year ended December 31, 2010, Gow paid the following:

- Real estate taxes: $6,400
- Painting of rental apartment: 800
- Annual fire insurance premium: 600

In 2010, depreciation for the entire house was determined to be $5,000. What amount should Gow include in his adjusted gross income for 2010?

a. $2,900
b. $800
c. $400
d. $100

30. Cobb, an unmarried individual, had an adjusted gross income of $200,000 in 2010 before any IRA deduction, taxable social security benefits, or passive activity losses. Cobb incurred a loss of $30,000 in 2010 from rental real estate in which he actively participated. What amount of loss attributable to this rental real estate can be used in 2010 as an offset against income from nonpassive sources?

a. $0
b. $12,500
c. $25,000
d. $30,000

31. The rule limiting the allowability of passive activity losses and credits applies to

a. Partnerships.
b. S corporations.
c. Personal service corporations.
d. Widely-held C corporations.

32. If an individual taxpayer's passive losses and credits relating to rental real estate activities cannot be used in the current year, then they may be carried

a. Back three years, but they cannot be carried forward.
b. Forward up to a maximum period of 15 years, but they cannot be carried back.
c. Back three years or forward up to 15 years, at the taxpayer's election.
d. Forward indefinitely or until the property is disposed of in a taxable transaction.

33. With regard to the passive loss rules involving rental real estate activities, which one of the following statements is correct?

a. The term "passive activity" includes any rental activity without regard as to whether or not the taxpayer materially participates in the activity.
b. Gross investment income from interest and dividends not derived in the ordinary course of a trade or business is treated as passive activity income that can be offset by passive rental activity losses when the "active participation" requirement is not met.
c. Passive rental activity losses may be deducted only against passive income, but passive rental activity credits may be used against tax attributable to nonpassive activities.
d. The passive activity rules do not apply to taxpayers whose adjusted gross income is $300,000 or less.

34. Don Wolf became a general partner in Gata Associates on January 1, 2010 with a 5% interest in Gata's profits, losses, and capital. Gata is a distributor of auto parts. Wolf does not materially participate in the partnership business. For the year ended December 31, 2010, Gata had an operating loss of $100,000. In addition, Gata earned interest of $20,000 on a temporary investment. Gata has kept the principal temporarily invested while awaiting delivery of equipment that is presently on order. The principal will be used to pay for this equipment. Wolf's passive loss for 2010 is

a. $0
b. $4,000
c. $5,000
d. $6,000
35. On December 1, 2010, Krest, a self-employed cash basis taxpayer, borrowed $200,000 to use in her business. The loan was to be repaid on November 30, 2011. Krest paid the entire interest amount of $24,000 on December 1, 2010. What amount of interest was deductible on Krest's 2010 income tax return?

- $0
- $2,000
- $22,000
- $24,000

36. Dick and Mary are married and file a joint return for 2010. For the year, their AGI is $120,000. Dick and Mary make a $2,000 contribution to a Coverdell Education Savings Account (CESA) their dependent daughter Emily. Which of the following statements is not true.

- The distributed earnings from the CESA contribution will be excluded from gross income.
- The exclusion is also available for any year the HOPE or Life Time Learning credit is claimed.
- Room and board expenses constitute qualified education expenses if enrolled on at least a half-time basis.
- The contributions are tax deductible.

37. In order to attend college, Horace borrowed $20,000 from a local bank at an annual rate of 8% in order to pay for tuition, fees, room and board at college. The loan was not secured by his residence. During 2010, Horace paid $1,600 in interest expense to the bank. In filing his 2010 return, Horace has AGI of $40,000. Horace may claim a deduction for the interest paid of:

- $0
- $1,000
- $1,600
- $2,500

38. A calendar year individual is eligible to contribute to a deductible IRA. The taxpayer obtained a six month extension to file until October 15th but did not file his return until November 1st. What is the latest date that an IRA contribution can be made in order to qualify as a deduction on the prior year’s return?

- October 15th
- April 15th
- August 15th
- November 1st

39. A self-employed taxpayer had gross income of $57,000. The taxpayer paid self employment taxes of $8,000, health insurance of $6,000, and $5,000 of alimony. The taxpayer also contributed $2,000 to a traditional IRA. What is the taxpayer’s adjusted gross income?

- $55,000
- $50,000
- $46,000
- $40,000
Chapter Three — Answers
Deductions for Adjusted Gross Income

1. (b) $5,000. No deduction is allowed for Sol because Sol was covered by an employer plan and their adjusted gross income for 2010 was in excess of $109,000 (the $89,000 base plus the phase-out range of $20,000). However, Julia is entitled to a full spousal IRA of $5,000 since their combine AGI does not exceed $167,000.

2. (a) $10,000. Even though Val was covered by an employer plan, their combined adjusted gross income for the year did not exceed the base of $89,000 where the IRA deduction starts its phase-out. While not needed for the earned income test, the alimony received by Pat may be treated as earned income for the purpose of determining the allowability of IRA contribution.

3. (d) $10,000. Fred’s earned income of $40,000 allows him a deductible IRA contribution of $5,000. Wilma has no earned income, but is entitled to the spousal IRA deduction of $5,000. Fred was not covered by a plan so therefore there is no concern related to their adjusted gross income.

4. (b) $2,800. Qualified moving expenses include only the direct costs of moving. The pre-move house-hunting costs are no longer deductible. Also, note that these are no longer an itemized deduction, but rather a deduction for adjusted gross income.

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Lodging &amp; travel enroute</td>
<td>$1,000</td>
</tr>
<tr>
<td>Costs of moving household</td>
<td>$1,800</td>
</tr>
<tr>
<td><strong>Total deduction</strong></td>
<td><strong>$2,800</strong></td>
</tr>
</tbody>
</table>

5. (a) Unreimbursed direct moving expenses of an employee are fully deductible from gross income in arriving at adjusted gross income. The distance test of 50 miles is also satisfied.

6. (a) $1,200. Qualified moving expenses include only the direct costs of moving. The temporary living expenses are no longer deductible. Also, note that these are no longer an itemized deduction, but rather a deduction for adjusted gross income.

7. (c) Unreimbursed direct moving expenses of an employee are fully deductible from gross income in arriving at adjusted gross income. The distance test of 50 miles and the time test of at least 39 weeks are also satisfied.

8. (b) Forfeiture penalties, or premature withdrawal penalties, are deductions for adjusted gross income. The taxpayer will be required to recognize all the interest earned on the investment in 2010 even though he will not receive it all in 2011 due to the penalty. The penalty must be reported in the year paid regardless of what period the interest was earned.

9. (d) Forfeiture penalties, or premature withdrawal penalties, are deductions from gross income in arriving at adjusted gross income. The taxpayer will be required to recognize all the interest earned on the investment in 2010 even though he will not receive it all in 2011 due to the penalty. The penalty must be reported in the year paid regardless of what period the interest was earned.

10. (b) Alimony payments must stop at the death of the payee spouse. Alimony must be paid in cash and not property, the former couple may not be members of the same household, and the payments may not be contingent (child support).
11. (c) $34,800. Only the alimony payments are allowed as a deduction for adjusted gross income. However, since Art only paid ten of his required twelve payments, the amount that is deemed to be child support for the year is determined first, then the alimony.

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Total payments made</td>
<td>$ 10,000</td>
</tr>
<tr>
<td>Amount not alimony:</td>
<td></td>
</tr>
<tr>
<td>12 months @ $400</td>
<td>-4,800</td>
</tr>
<tr>
<td>Alimony component</td>
<td>$ 5,200</td>
</tr>
<tr>
<td>Salary</td>
<td>$ 40,000</td>
</tr>
<tr>
<td>Less: alimony</td>
<td>-5,200</td>
</tr>
<tr>
<td>Adjusted gross income</td>
<td>$ 34,800</td>
</tr>
</tbody>
</table>

12. (c) The remittance of jury duty pay to an employer is a return of the employee’s salary. This is a deduction from gross income in arriving at adjusted gross income.

13. (a) Only the alimony. Charitable contributions, personal casualty losses and unreimbursed employee expenses are all itemized deductions.

14. (c) $106,000. Not all of the items subtracted by Gilda are deductible for the determination of self-employment income. The malpractice insurance and seminar costs are both fully deductible as trade or business expenses. However, the “salary” is really a draw against her net earnings, and the estimated tax payments are personal payments and are non-deductible.

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Gilda’s net income</td>
<td>$ 80,000</td>
</tr>
<tr>
<td>Add back non-deductible:</td>
<td></td>
</tr>
<tr>
<td>Salary or draw</td>
<td>20,000</td>
</tr>
<tr>
<td>Estimated tax payments</td>
<td>6,000</td>
</tr>
<tr>
<td>Self-employment income</td>
<td>$ 106,000</td>
</tr>
</tbody>
</table>

15. (a) $15,100. To determine the self-employment business income, Rich must subtract the expenses paid to carry on his trade or business from his business gross income. The estimated income taxes and charitable contributions are personal and not deductible. His net self-employed income is determined as follows:

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Gross business income</td>
<td>$ 20,000</td>
</tr>
<tr>
<td>Less: Business expenses:</td>
<td></td>
</tr>
<tr>
<td>Air conditioner parts</td>
<td>-2,500</td>
</tr>
<tr>
<td>Yellow Pages Listings</td>
<td>-2,000</td>
</tr>
<tr>
<td>Telephone expense</td>
<td>-400</td>
</tr>
<tr>
<td>Self-employment income</td>
<td>$ 15,100</td>
</tr>
</tbody>
</table>

16. (b) $600. Director's fees are included as self-employed income. The executor’s fee is a component of gross income, but is not considered to be income for self-employment purposes. Being an executor is not considered to be a trade or business.
17. (c) $340. The deduction for business gifts is limited to $25 per customer.

<table>
<thead>
<tr>
<th>Gifts</th>
<th>Cost</th>
</tr>
</thead>
<tbody>
<tr>
<td>4 gifts @ $10</td>
<td>$ 40</td>
</tr>
<tr>
<td>12 gifts @ $25</td>
<td>300</td>
</tr>
<tr>
<td><strong>Total deduction</strong></td>
<td><strong>$ 340</strong></td>
</tr>
</tbody>
</table>

18. (c) One-half of the self-employment tax is allowed as a deduction from gross income in arriving at adjusted gross income.

19. (d) Earned income for the purpose of determining the Keogh profit-sharing contribution is the self-employment earnings reduced by the deductible Keogh contribution itself (circular reasoning) and one-half of the self-employment tax.

20. (b) $11,000. The amount of $12,000 paid in 2009 covered a twelve month period beginning December 1 of that year. $1,000 would have been deducted in 2009 and the prepaid balance of $11,000 deductible in 2010. The interest must be prorated.

21. (d) $30,000. In 2010, the maximum Section 179 deduction is $500,000. Brown’s cost of the qualifying equipment is only $30,000 and he is not limited in his deduction because he has taxable income of $100,000, well in excess of the $30,000 of the qualifying property. Also, he is not limited since he did not place in service qualifying assets in excess of $2,000,000.

22. (a) Salvage value is ignored. New and used property qualify, straight-line is allowable, and the general recovery periods of realty are 27.5 and 39 years.

23. (d) $2,250. The MACRS recovery period for commercial property is 39 years. Utilizing the straight-line, mid-month convention, the deduction covers one-half of August and all of September through December for a total of 4.5 months. The deduction is calculated as follows:

<table>
<thead>
<tr>
<th>Cost of the building &amp; land</th>
<th>$ 264,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Less: cost of land</td>
<td>-30,000</td>
</tr>
<tr>
<td>Depreciable property</td>
<td>234,000</td>
</tr>
<tr>
<td>Recovery period</td>
<td>39 yrs</td>
</tr>
<tr>
<td>Annual cost recovery</td>
<td>$ 6,000</td>
</tr>
<tr>
<td>2010 recovery 4.5/12 months</td>
<td>$ 2,250</td>
</tr>
</tbody>
</table>

24. (a) This statement is true. Watch out for those problems where more than 40% of the property is placed in service during the last quarter of the year. In those situations, the mid-quarter convention is required.

25. (d) Non-residential rental property is depreciation using the straight-line method over 39 years.

26. (c) $479,000. Under the general rule of Section 179, Roe may elect to immediately expense up to $500,000 of the cost of qualified property placed in service during the year. Roe, however, is limited in how much qualifies because they placed property in service in excess of $2,000,000. Therefore, Roe must reduce the $500,000 on a dollar-by-dollar basis by the excess over $2,000,000 dollar for dollar, or in this case $21,000. Roe's portion of cost which qualifies under Section 179 is therefore $479,000. ($500,000 - 21,000).

27. (d) $10,000. Since neither Paul nor Lois was covered by an employer-sponsored plan, they are not subject to any phase-out provisions. Paul is allowed a deductible IRA contribution of $5,000. Though Lois has no earned income, she is entitled to the spousal IRA deduction of $5,000. The maximum allowable IRA deduction is $5,000 plus $5,000 or $10,000.
28. (b) $13,350. This question requires an allocation of some common operating costs of the apartment between rental and personal. The rental costs are deductible while the personal are not.

<table>
<thead>
<tr>
<th>Gross rents</th>
<th>Total</th>
<th>90%</th>
<th>10%</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>$ 21,600</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Less:</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Fuel</td>
<td>2,500</td>
<td>2,250</td>
<td>250</td>
</tr>
<tr>
<td>Maintenance &amp; repairs</td>
<td>1,200</td>
<td>1,200</td>
<td>0</td>
</tr>
<tr>
<td>Advertising expense</td>
<td>300</td>
<td>300</td>
<td>0</td>
</tr>
<tr>
<td>Depreciation</td>
<td>5,000</td>
<td>4,500</td>
<td>500</td>
</tr>
<tr>
<td>Total expenses</td>
<td>9,500</td>
<td>8,250</td>
<td>750</td>
</tr>
<tr>
<td>Net rental income</td>
<td>12,600</td>
<td>$ 13,350</td>
<td></td>
</tr>
</tbody>
</table>

29. (c) $400. This question requires an allocation of some common operating costs of the apartment between rental and personal. The rental costs are deductible while the personal are not.

<table>
<thead>
<tr>
<th>Gross rents</th>
<th>Total</th>
<th>50%</th>
<th>50%</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>$ 7,200</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Less:</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Real estate taxes</td>
<td>6,400</td>
<td>3,200</td>
<td>3,200</td>
</tr>
<tr>
<td>Painting of rental unit</td>
<td>800</td>
<td>800</td>
<td>0</td>
</tr>
<tr>
<td>Fire insurance cost</td>
<td>600</td>
<td>300</td>
<td>300</td>
</tr>
<tr>
<td>Depreciation</td>
<td>5,000</td>
<td>2,500</td>
<td>2,500</td>
</tr>
<tr>
<td>Total expenses</td>
<td>12,800</td>
<td>6,800</td>
<td></td>
</tr>
<tr>
<td>Net rental income</td>
<td></td>
<td></td>
<td>$ 400</td>
</tr>
</tbody>
</table>

30. (a) $0. Rental activities are classified as passive activities. In general, passive losses are only allowed to the extent of passive income. An exception to the law allows an individual to deduct up to $25,000 per year in rental losses. In Cobb’s case, his $30,000 rental loss would first be limited to $25,000, with the $5,000 balance suspended until future years. However, for those individuals with adjusted gross income in excess of $100,000, the allowable deduction is reduced by 50% of that excess. After a range of $50,000, the deduction is fully eliminated. Since Cobb’s adjusted gross income is over $150,000, the loss is fully phased-out. The otherwise allowable deduction of $25,000 is not allowed in the current year and is carried over to future years.

31. (c) The passive activity rules apply to personal service corporations, as well as individuals, trusts, estate and closely held corporations. Widely held corporations are exempted from this provision. Logically, partnerships and S Corporation are not subject to these rules due to the “flow-through” nature of the separately stated items.

32. (d) There is an unlimited carryforward period. They may be used to offset future passive income, or deducted in the year the property is finally disposed of in a taxable transaction.

33. (a) By definition.

34. (c) $5,000. This problem focuses in on the determination of the passive loss and the subsequent netting that takes place with any other form of income. The company has a passive loss of $100,000 and portfolio income of $20,000. Portfolio income generally can not be used to offset passive losses. Therefore, Wolf's share of the passive loss is 5% of $100,000 or $5,000. (Note the question does not ask how much of the loss can be used as a current deduction. Assuming no other passive gains, the answer would be zero.)
35. (b) $2,000. The amount of $24,000 paid in 2010 covered a twelve month period beginning December 1 of that year. $2,000 is allowable as a deduction in 2010, and the balance is treated as a prepaid amount for 2011. The interest must be prorated.

36. (d) Contributions to a Coverdell are never deductible. However, the CESA does provide for tax-free accumulation of earnings. It can be used in conjunction with the HOPE or Lifetime Learning Credit.

37. (c) 1,600. An above the line deduction (not an itemized) is allowed for interest paid on debt incurred to pay for higher education costs. While not an issue in this problem, the amount is limited to $2,500.

38. (b) April 15th. In order to be deductible for the prior year, contributions must be made no later than the original due date of the return.

39. (d) $40,000. The adjusted gross income is comprised of:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gross income</td>
<td>$57,000</td>
</tr>
<tr>
<td>Less: ½ self employment tax</td>
<td>-4,000</td>
</tr>
<tr>
<td>S/E health insurance</td>
<td>-6,000</td>
</tr>
<tr>
<td>Alimony</td>
<td>-5,000</td>
</tr>
<tr>
<td>Traditional IRA</td>
<td>-2,000</td>
</tr>
<tr>
<td>Adjusted gross income</td>
<td><strong>$40,000</strong></td>
</tr>
</tbody>
</table>
Chapter Four
Deductions From Adjusted Gross Income

STANDARD VS. ITEMIZED DEDUCTIONS

MEDICAL EXPENSES
General
Reimbursements
Capital Expenditures
Nursing Home and Special Schools
Transportation and Lodging
Self-Employed Health Insurance Deduction

TAXES
State & Local Taxes
Real Estate Taxes
Personal Property Taxes
Foreign Taxes

INTEREST DEDUCTION
Qualified Residence Interest
Acquisition Indebtedness
Home Equity Indebtedness
Points
Mortgage Insurance Premium
Investment Interest Expense

CHARITABLE CONTRIBUTIONS

CASUALTY LOSSES

MISCELLANEOUS 2% DEDUCTIONS

OTHER MISCELLANEOUS DEDUCTIONS

LIMITATION ON DEDUCTIONS

SCHEDULE A - ITEMIZED DEDUCTIONS
Chapter Four
Deductions From Adjusted Gross Income

STANDARD VS. ITEMIZED DEDUCTIONS

Rather than claiming the standard deduction, a taxpayer may elect to itemize their deductions instead. The election to itemize is made by attaching Schedule A to Form 1040 when the taxpayer files the return. Schedule A is reproduced at the end of this chapter. This decision needs to be based upon the total amount of allowable itemized deductions as compared to the standard deduction for that taxpayer. (See Chapter 1 for the various standard deductions by filing status.) The following example highlights the election process:

Example 1: T is single and has no dependents. His only source of income is a salary of $50,000. During 2010 he paid state income taxes of $3,000, qualified mortgage interest of $7,000 and made allowable contributions of $2,000. In preparing his return, T is unsure as to whether to claim the standard deduction or itemize his deductions.

Answer: As a single (unmarried) taxpayer who is not a head of household or qualifying widower, T is allowed a standard deduction of $5,700 in 2010. His allowable itemized deductions are:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>State income taxes</td>
<td>$3,000</td>
</tr>
<tr>
<td>Mortgage interest</td>
<td>7,000</td>
</tr>
<tr>
<td>Charitable contributions</td>
<td>2,000</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$12,000</strong></td>
</tr>
</tbody>
</table>

Since T’s itemized deductions of $12,000 exceed the standard deduction of $5,700, he would obtain a larger deduction by electing to itemize his deductions.

In deciding whether or not to make the election, it is important to understand what transactions qualify as allowable itemized deductions. That is the focus of this chapter.

MEDICAL EXPENSES

A taxpayer may deduct medical expenses paid for the diagnosis, cure, mitigation, treatment, or prevention of disease, or for the purpose of affecting any structure or function of the body. In order for the expenditures to be deductible, they must be:

- Paid for the care of the taxpayer, spouse or dependents (not just the taxpayer’s child)
- The deductible portion must exceed 7.5% of adjusted gross income.

Typical qualifying expenses include, but are not limited to medical insurance payments, doctor and hospital bills, prescription drugs, dental and eye care expenses (including contact lenses). Costs of maintaining special equipment needed for the care of the dependent, such as wheelchairs, ramps, and elevators, are allowable as well. Payments for long-term care services and insurance premiums for long-term care (on a limited basis) will also be classified as medical expenses subject to the 7.5% AGI threshold.

Expenditures for the overall general health of the taxpayer, such as vitamins or health clubs, and elective cosmetic surgery are not deductible. However, “necessary” cosmetic surgery, such as that required to correct a congenital deformity would be allowed.

Medical expenses are deductible in the year actually paid. Charging the medical expense to your credit card during the year is also considered as being paid even if you do not pay the credit card bill until the following year.
Reimbursements
The deductible medical expenses must be reduced by any insurance reimbursements received during the year. If the reimbursement is received in the following year, then it must be reported in the following year as gross income, up to the extent of the tax benefit received by the taxpayer in the year of the deduction.

Example 2: T pays medical insurance premiums of $4,000 and doctors and hospital bills of $3,000 in 2010. His adjusted gross income of $40,000. He is reimbursed $1,000 in 2010 from the insurance company. His medical deduction is:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Medical insurance</td>
<td>$ 4,000</td>
</tr>
<tr>
<td>Doctors and hospitals</td>
<td>3,000</td>
</tr>
<tr>
<td>Total payments</td>
<td>7,000</td>
</tr>
<tr>
<td>Less: reimbursements</td>
<td>-1,000</td>
</tr>
<tr>
<td>Expenses before limitation</td>
<td>6,000</td>
</tr>
<tr>
<td>Less: AGI threshold limitation: 7.5% of $40,000</td>
<td>-3,000</td>
</tr>
<tr>
<td>Allowable deductions</td>
<td>$ 3,000</td>
</tr>
</tbody>
</table>

Example 3: If T was not reimbursed the $1,000 until 2011, his 2010 deduction would increase to $4,000 and he would have to recognize the $1,000 insurance reimbursement as gross income in 2010.

Capital Expenditures
When it is necessary to make medical expenditures of a capital nature, they are deductible only to the extent that there is not a corresponding increase in the fair market value of the property. For the purpose of installing wheelchair ramps and widening hallways, etc., there is deemed to be no increase in value of the property and the expenditure is fully deductible.

Example 4: S installs an elevator for his dependent mother at a cost of $17,000 at the advice of the physician due to her ailing heart. The fair value of S’s house increases by $13,000 as a result. S may deduct the excess cost over the increase in value ($4,000) as a medical expense.

Nursing Home & Special Schools
Nursing home costs are deductible medical expenses when the condition of the patient requires medical or nursing attention. The deductible costs may also include the cost of staying at that facility.

In addition, expenses related to tuition, room and board, as well as the cost of medical care may be deductible if the principal reason for sending a dependent to a special school is that school’s special resources for treating that specific sickness or disease.

Transportation and Lodging
The cost of transportation for medical treatment, which includes a parent’s cost if they are accompanying a child, is allowed as a deduction. In lieu of computing the out-of-pocket costs of using your own vehicle, in 2010 taxpayers are allowed to deduct 16.5 cents per mile, plus parking and tolls. A deduction for overnight lodging is allowed provided:

- The lodging is primarily for and essential to medical care
- Medical care is provided by a doctor in a licensed hospital
- Lodging cost is not lavish or extravagant
- There is no element of personal pleasure, recreation or vacation
- The amount of the deduction cannot exceed $50 per night
Self-Employed Health Insurance Deduction
In Chapter 3, the deduction for 100% of the health insurance for self-employed individuals was discussed. In computing the allowable itemized deduction for medical insurance, you are not entitled to that deduction as an itemized deduction if you claimed it as a deduction for adjusted gross income. However, effective in 2010, the taxpayer is allowed to deduct the amount in determining the self-employment tax.

TAXES
A deduction is allowed for state, local and foreign taxes paid during the year. There are no itemized deductions for any federal income taxes paid except for rare situations such as the environmental tax and the allocable share of a decedent’s estate tax. In order for the taxes to be deductible, they must be the taxpayer’s own tax obligation. Contrast this with medical expenses where the payment of a dependent’s medical expenses were deductible. The deductible taxes are:

STATE & LOCAL TAXES
Payments for state and local income taxes made are deductible in the year paid, regardless of the tax period the tax pertains to. An individual making estimated tax payments for the 2010 tax year would generally make four payments throughout the year. Typically three payments would be paid within the 2010 year, (April 15th, June 15th and September 15th) and the last payment on January 15th 2011. Only the three payments made in 2010 would qualify as a 2010 deduction. The last payment made in early 2011 would be deductible in 2011, even though it was for the 2010 income tax obligation. Likewise, late payments of balances due from prior years are deductible in the year of payment. State and local taxes withheld from an employee’s paycheck are deemed as having been paid during the year. In addition, a taxpayer may now elect to deduct either their state and local income taxes or their sales and use taxes as an itemized deduction. This may be appropriate for those taxpayers living in a state not imposing an income tax, such as Florida.

The deduction for sales and excise tax of new vehicles has been repealed for 2010.

REAL ESTATE TAXES
Taxes paid on the ownership of real property, wherever situated, are allowed as a deduction. This would include the tax on the taxpayer’s residence(s), land, and vacation homes, both domestic and foreign. Should the real property be rental or even part rental, the real estate taxes allocable to that portion must be shown as a rental expense, not an itemized deduction.

Real estate tax payments are usually periodic, such as semi-annually or quarterly. If a taxpayer purchases or sells real property during the year, the deduction must be apportioned based upon the number of days of ownership.

Example 5: On March 15th, P paid $1,800 in real estate taxes on his residence, which covered the period from January 1st until June 30th. On May 1st he sold his residence to R. Since P held the property for four months, he may only deduct two thirds (four months of the six months) of real estate taxes paid.

The additional standard deduction for a non-itemizer to increase their standard deduction by the lessor of the real estate taxes paid or $500 if single, or $1,000 if married has been repealed for 2010.
PERSONAL PROPERTY TAXES
A tax on personal property is deductible if the tax is based upon the value of the property and is assessed on an annual basis. Typically, once a year a city or town will assess a personal property tax on a taxpayer’s motor vehicle or boat based upon its assessed or fair market value. That is a deductible tax. A flat fee, such as a registration fee of $50 per year, is not deductible.

FOREIGN TAXES
When a taxpayer has income from foreign sources, there is frequently a tax paid to that foreign country. Very often that tax is withheld at its source, such as on interest or dividends. In computing one’s taxes, the taxpayer has an option of treating the taxes paid to that foreign country as either a credit against his US taxes, or a deduction. Since the value of a tax credit is greater than that of a deduction, the credit is more frequently elected, but a deduction is allowable. See Chapter 5 for additional information on the foreign tax credit.

INTEREST DEDUCTION
A taxpayer is allowed an itemized deduction for payments of qualified residence interest and investment interest. Similar to state taxes, it must be on the taxpayer’s indebtedness. Interest on personal indebtedness is no longer allowable as a deduction.

QUALIFIED RESIDENCE INTEREST
Interest paid on loans for the acquisition of a qualified residence or a home equity loan generally qualify for the deduction. A qualified residence represents the taxpayer’s principal residence plus any other one. This second residence may be a vacation home, yacht or mobile home. The taxpayer may have more than two residences, and each year select which one is his second residence for tax purposes.

Acquisition indebtedness includes the cost of acquiring, constructing and substantially improving the residence of the taxpayer. In computing the interest deduction, the aggregate of indebtedness for both residences cannot exceed:

- $1,000,000 if married filing jointly, or single
- $ 500,000 if married filing separately

To determine the allowable deduction on borrowings in excess of this amount, the interest expense must be prorated.

Example 6: K purchased her first personal residence for $1,500,000 and borrowed $1,200,000. During the year, she paid $90,000 in interest on the mortgage. She may deduct only $75,000 as qualified residence interest. The balance of $15,000 is non-deductible personal interest.

\[
\frac{90,000 \times \frac{1,000,000}{1,200,000}}{\text{deductible}} = 75,000
\]

Home equity indebtedness (borrowing) is usually used for personal, or non-deductible reasons such as college tuition, vacations, etc. In order to be deductible, the borrowings against a taxpayer’s residence that are not classified as acquisition indebtedness, must be:

- Limited to the fair market value of the residence less any acquisition indebtedness, or
- $100,000, whichever is less, and
- Be secured by the residence
Points paid for obtaining a loan as it relates to acquisition indebtedness are fully deductible in the year paid. Points are a percentage of the borrowing. One point on an $80,000 mortgage equals $800. Points represent an adjustment to the interest rate, and not a service charge or a finders fee. For example, a bank may charge an interest rate of 7% with no points being paid by the borrower, or offer a rate of 6.75% with the borrower paying one point. Points paid on a refinancing are not immediately deductible in full. They must be capitalized and amortized on a straight-line basis over the life of the new loan.

There is also a deduction for mortgage insurance premiums paid for contracts issued since 2008. It is limited for taxpayers whose AGI exceed $50,000 if single or $100,000 if married. A penalty for the late payment or the pre-payment of a mortgage is generally deductible as mortgage interest expense.

INVESTMENT INTEREST EXPENSE

When a taxpayer borrows money to acquire investments, the interest expense is classified as investment interest expense. The general rule is that the investment interest expense is allowed only to the extent of the net investment income. Any unused investment interest expense is carried over to future years. There is no limitation on the carryforward. Investment income includes interest, dividends, and royalties, but usually not capital gains unless the taxpayer makes special elections. From investment income, you then subtract the allowable investment expenses, excluding the interest expense. These investment expenses are subject to a 2% threshold and are described later in this chapter.

Example 7: Late in 2010, K borrowed $30,000 to invest in securities. During the year 2010 she paid $400 in interest expense on the loan. There was no investment income. K cannot deduct the interest expense for 2010.

Example 8: During 2011, K earned $4,000 in dividends on her investment; paid $2,500 in interest expense on the loan; and had allowable investment expenses of $100. Her allowable interest expense is $2,900, comprised of the $400 carryforward from 2010 and the $2,500 current year interest expense. The $2,900 does not exceed the current year’s net investment interest income of $3,900 ($4,000 less $100), and is fully deductible.

Note: Interest on borrowings to acquire tax-exempt securities are non-deductible.

CHARITABLE CONTRIBUTIONS

A deduction is allowed for a charitable contribution or gift paid during the year to a qualified organization. Qualified organizations include churches, or other religious organizations, educational organizations, medical or research organizations, and literary organizations. Federal, state and local organizations qualify as well if the gift is made solely for public purposes. A taxpayer is considered to have paid a charitable contribution if it was charged to his credit card account during the taxable year.

In determining the allowable deduction, there are limitations based upon the taxpayer’s adjusted gross income, the type of gift and carryovers.

- In general, contributions cannot exceed 50% of the taxpayer’s adjusted gross income for the year
- Contributions to organizations that are not “50% organizations”, such as a fraternal order, certain private nonoperating foundations, veterans’ organizations, etc., cannot exceed 30% of the taxpayer’s adjusted gross income.
- Contributions of appreciated long-term capital gain property to a 50% organization at its fair market value are limited to 30% of adjusted gross income. If the taxpayer elects to deduct the contribution using cost instead of fair market value, the limitation rises back to 50%. Short-term capital gain property is limited to cost.
- Contributions of appreciated long-term capital gain property to a 30% organization at its fair market value are limited to 20% of adjusted gross income.
- Limitations follow a hierarchy. 50% contributions are allowed first, then the 30% contributions.
• Unreimbursed out-of-pocket costs are allowed as deductions. This includes travel at an optional 14 cents per mile, plus parking and tolls.
• Purchases of items (at an auction, fair, etc.) in excess of their fair market value give rise to a deduction, but only for the excess paid over its fair market value. A taxpayer making a $25 contribution and receiving a book with a fair market value of $15, has made a charitable contribution of $10.
• Unused charitable contributions due to the 50%, 30% and 20% limitations are carried over for a maximum of 5 years. In determining the allowable deduction for the current year, you first must consider the current year contributions, then the carryovers. Carryovers may expire if the taxpayer ignores the ordering of deduction.
• For gifts of $250 or more, **written substantiation** is required on a contemporaneous basis, otherwise, no deduction is allowed.

Example 9: Q made a cash contribution of $5,000 to his church which was substantiated in writing and his wife contributed stock with a fair market value of $12,000 and an adjusted basis of $2,000 to her college. The contributions are to qualified 50% organizations. Their adjusted gross income for the year was $30,000.

In determining the current year’s allowable contribution it is important to heed the limitations. The overall limitation is 50% of their $30,000 AGI or $15,000, but the components and carryforwards are complicated.

**Step 1.** Determine the overall 50% limitation:

<table>
<thead>
<tr>
<th>Adjusted gross income</th>
<th>$ 30,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Overall contribution limitation</td>
<td>50%</td>
</tr>
<tr>
<td>Maximum allowed this year</td>
<td>$ 15,000</td>
</tr>
</tbody>
</table>

**Step 2.** Determine what is used up by qualifying 50% contributions. The residual is available for the 30% contributions:

<table>
<thead>
<tr>
<th>Maximum allowable</th>
<th>$ 15,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Less: Contributions qualifying under 50% rule</td>
<td>-5,000</td>
</tr>
<tr>
<td>Available for 30% limitation</td>
<td>$ 10,000</td>
</tr>
</tbody>
</table>

**Step 3.** Determine the deductibility of the stock contribution with a $12,000 FMV. The maximum allowable on the stock is 30% of their adjusted gross income, or $9,000.

<table>
<thead>
<tr>
<th>Adjusted gross income</th>
<th>$ 30,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Contribution limitation for FMV</td>
<td>30%</td>
</tr>
<tr>
<td>Maximum allowed this year</td>
<td>$ 9,000</td>
</tr>
</tbody>
</table>

Even though the stock had a fair market value of $12,000, and there was still $10,000 available in under the 50% limitation test in Step 2, we determined that the 30% limitation was the true limiting factor because only $9,000 of the property contribution was allowed. Therefore:

**Total allowable contributions:**

<table>
<thead>
<tr>
<th>Cash contributions</th>
<th>$ 5,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Stock - FMV (limited)</td>
<td>$ 9,000</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$14,000</strong></td>
</tr>
</tbody>
</table>

The $3,000 carryover ($12,000 less the $9,000 allowed) arises from the long-term capital property and will be subject to the 30% test each year until it is utilized or expires in five years.
CASUALTY LOSSES

A taxpayer may deduct a loss for a personal casualty loss. A casualty loss is sudden and unexpected, and may include a theft loss as well. To determine the allowable loss:

1. Determine the lesser of the decrease in the fair market value of the asset destroyed, or its adjusted basis.
2. Subtract from that event, a floor of $100 ($500 for 2009)
3. Combine all personal casualties for the year together.
4. The allowable deduction is the amount that exceeds 10% of the taxpayer’s adjusted gross income.

Example 11: John is single and has adjusted gross income of $30,000 for the year. During the year, his boat was totally destroyed during a storm. The boat had a fair market value of $17,000 at the time of the storm. Its adjusted basis was $14,000. The insurance company reimbursed John $10,000 for the loss.

Answer:
The adjusted basis ($14,000) is less than the decrease in the fair market value ($17,000); therefore, that is the starting point.

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Lessor of adjusted basis or decrease in FMV</td>
<td>$14,000</td>
</tr>
<tr>
<td>Less: insurance reimbursement</td>
<td>(10,000)</td>
</tr>
<tr>
<td>Less: statutory floor</td>
<td>(100)</td>
</tr>
<tr>
<td>Threshold limitation of 10% of adjusted gross income</td>
<td>(3,000)</td>
</tr>
<tr>
<td>Allowable deduction</td>
<td>$ 900</td>
</tr>
</tbody>
</table>

MISCELLANEOUS 2% DEDUCTIONS

There are a number of employee related expenses which, if unreimbursed by the employer, are allowed as itemized deductions. In addition, there are a number of deductible expenses related to investments, tax determination and trade or businesses. These expenses are grouped together as what is referred to as miscellaneous itemized deductions, and they are deductible, only to the extent that they exceed 2% of adjusted gross income.

A brief summary of these deductions follows:

- Tax preparation fees and other fees for the determination of tax (audit representation, appraisals, etc.). However, preparation of a will is not deductible.
- Job hunting expenses
- Professional dues, including union dues
- Uniforms, safety clothing, etc., not otherwise usable by the taxpayer
- Business tools
- Investment expenses such as safety deposit boxes, investment publications and fees
- IRA custodial fees
- Hobby losses (to the extent of hobby income as reported as Other Income on line 21)
- Unreimbursed employee expenses (mileage, 50% of business meals & entertainment, etc.)
- Education costs to maintain or improve a taxpayer’s existing skills, but not to prepare them for a new job
OTHER MISCELLANEOUS DEDUCTIONS

Apart from the categories of allowable expenses already described, there are some other miscellaneous deductions allowed that are not subject to a threshold of 2% of adjusted gross income.

1. Gambling losses: Deductible up to the extent of gambling winnings. There is no carryover of any unused losses.
2. Impairment related work expenses
3. Unrecovered investment in an annuity
4. Federal estate tax on income in respect of the decedent

LIMITATION ON DEDUCTIONS

If a taxpayer’s adjusted gross income exceeded a specified threshold, there was a reduction or cutback on the amount of the allowable itemized deductions. This has been phased out over the years and in 2010 has been eliminated. There is no reduction or cutback in 2010.
### Itemized Deductions

**Medical and Dental Expenses**

<table>
<thead>
<tr>
<th>Line</th>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Medical and dental expenses (see instructions)</td>
<td>1</td>
</tr>
<tr>
<td>2</td>
<td>Enter amount from Form 1040, line 38</td>
<td>2</td>
</tr>
<tr>
<td>3</td>
<td>Multiply line 2 by 7.5% (.075)</td>
<td>3</td>
</tr>
<tr>
<td>4</td>
<td>Subtract line 3 from line 1, if line 3 is more than line 1, enter -0-</td>
<td>4</td>
</tr>
</tbody>
</table>

**Taxes You Paid**

<table>
<thead>
<tr>
<th>Line</th>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>5</td>
<td>State and local (check only one box):</td>
<td>5</td>
</tr>
<tr>
<td></td>
<td>a. Income taxes, or</td>
<td></td>
</tr>
<tr>
<td></td>
<td>b. General sales taxes</td>
<td></td>
</tr>
<tr>
<td>6</td>
<td>Real estate taxes (see instructions)</td>
<td>6</td>
</tr>
<tr>
<td>7</td>
<td>New motor vehicle taxes from line 11 of the worksheet on back. (For certain vehicles purchased in 2009). Skip this line if you checked box 5b</td>
<td>7</td>
</tr>
<tr>
<td>8</td>
<td>Other taxes. List type and amount</td>
<td>8</td>
</tr>
<tr>
<td>9</td>
<td>Add lines 5 through 8</td>
<td>9</td>
</tr>
</tbody>
</table>

**Interest You Paid**

<table>
<thead>
<tr>
<th>Line</th>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>10</td>
<td>Home mortgage interest and points reported to you on Form 1098</td>
<td>10</td>
</tr>
<tr>
<td>11</td>
<td>Home mortgage interest not reported to you on Form 1098. If paid to the person from whom you bought the home, see instructions and show that person’s name, identifying no. and address.</td>
<td>11</td>
</tr>
</tbody>
</table>

**Gifts to Charity**

<table>
<thead>
<tr>
<th>Line</th>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>16</td>
<td>Gifts by cash or check. If you made any gift of $250 or more, see instructions.</td>
<td>16</td>
</tr>
<tr>
<td>17</td>
<td>Other than by cash or check. If any gift of $250 or more, see instructions. You must attach Form 8283 if over $500.</td>
<td>17</td>
</tr>
<tr>
<td>18</td>
<td>Carryover from prior year</td>
<td>18</td>
</tr>
<tr>
<td>19</td>
<td>Add lines 16 through 18</td>
<td>19</td>
</tr>
</tbody>
</table>

**Casualty and Theft Losses**

<table>
<thead>
<tr>
<th>Line</th>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>20</td>
<td>Casualty or theft loss(es). Attach Form 4684. (See instructions.)</td>
<td>20</td>
</tr>
</tbody>
</table>

**Job Expenses and Certain Miscellaneous Deductions**

<table>
<thead>
<tr>
<th>Line</th>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>21</td>
<td>Unreimbursed employee expenses—job travel, union dues, job education, etc. Attach Form 2106 or 2106-EZ if required. (See instructions)</td>
<td>21</td>
</tr>
<tr>
<td>22</td>
<td>Tax preparation fees</td>
<td>22</td>
</tr>
<tr>
<td>23</td>
<td>Other expenses—investment, safe deposit box, etc. List type and amount</td>
<td>23</td>
</tr>
<tr>
<td>24</td>
<td>Add lines 21 through 23</td>
<td>24</td>
</tr>
<tr>
<td>25</td>
<td>Enter amount from Form 1040, line 38</td>
<td>25</td>
</tr>
<tr>
<td>26</td>
<td>Multiply line 25 by 2% (.02)</td>
<td>26</td>
</tr>
<tr>
<td>27</td>
<td>Subtract line 26 from line 24. If line 26 is more than line 24, enter -0-</td>
<td>27</td>
</tr>
</tbody>
</table>

**Other Miscellaneous Deductions**

<table>
<thead>
<tr>
<th>Line</th>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>28</td>
<td>Other—from list in instructions. List type and amount</td>
<td>28</td>
</tr>
</tbody>
</table>

**Total Itemized Deductions**

<table>
<thead>
<tr>
<th>Line</th>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>29</td>
<td>Add the amounts in the far right column for lines 4 through 28. Also, enter this amount on Form 1040, line 40</td>
<td>29</td>
</tr>
</tbody>
</table>

**Other**

<table>
<thead>
<tr>
<th>Line</th>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>30</td>
<td>If you elect to itemize deductions even though they are less than your standard deduction, check here.</td>
<td>30</td>
</tr>
</tbody>
</table>

---

For Paperwork Reduction Act Notice, see Form 1040 instructions.
Medical Deductions

1. Mr. and Mrs. Sloan incurred the following expenses on December 15, 2010, when they adopted a child:

<table>
<thead>
<tr>
<th>Expense</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Child's medical expenses</td>
<td>$5,000</td>
</tr>
<tr>
<td>Legal expenses</td>
<td>$8,000</td>
</tr>
<tr>
<td>Agency fee</td>
<td>$2,000</td>
</tr>
</tbody>
</table>

Before consideration of any "floor" or other limitation on deductibility, what amount of the above expenses may the Sloans deduct on their 2010 joint income tax return?

a. $15,000  
b. $13,000  
c. $10,000  
d. $5,000

2. Tom and Sally White, married and filing joint income tax returns, derive their entire income from the operation of their retail stationery shop. Their 2010 adjusted gross income was $100,000. The Whites itemized their deductions on Schedule A for 2010. The following unreimbursed cash expenditures were among those made by the Whites during 2010:

<table>
<thead>
<tr>
<th>Expense</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Repair and maintenance of motorized wheelchair for physically handicapped dependent child</td>
<td>$ 600</td>
</tr>
<tr>
<td>Tuition, meals, and lodging at special school for physically handicapped dependent child in an institution primarily for the availability of medical care, with meals and lodging furnished as necessary incidents to that care</td>
<td>$ 8,000</td>
</tr>
</tbody>
</table>

Without regard to the adjusted gross income percentage threshold, what amount may the Whites claim in their 2010 return as qualifying medical expenses?

a. $8,600  
b. $8,000  
c. $600  
d. $0

3. Jim and Nancy Walton had adjusted gross income of $35,000. During the year they paid the following medical related expenses:

<table>
<thead>
<tr>
<th>Expense</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Medicines and drugs</td>
<td>$ 300</td>
</tr>
<tr>
<td>Doctors</td>
<td>2,700</td>
</tr>
<tr>
<td>Health Club membership (recommended by the family doctor for general health care)</td>
<td>400</td>
</tr>
<tr>
<td>Medical care insurance</td>
<td>280</td>
</tr>
</tbody>
</table>

How much may the Waltons utilize as medical expenses in calculating itemized deductions?

a. $1,930.  
b. $1,530.  
c. $655.  
d. $0.

4. In 2010 Wells paid the following expenses:

<table>
<thead>
<tr>
<th>Expense</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Premiums on an insurance policy against loss of earnings due to sickness or accident</td>
<td>$3,000</td>
</tr>
<tr>
<td>Physical therapy after spinal surgery</td>
<td>2,000</td>
</tr>
<tr>
<td>Premium on an insurance policy that covers reimbursement for the cost of prescription drugs</td>
<td>500</td>
</tr>
</tbody>
</table>

In 2010 Wells recovered $1,500 of the $2,000 that she paid for physical therapy through insurance reimbursement from a group medical policy paid for by her employer. Disregarding the adjusted gross income percentage threshold, what amount could be claimed on Wells’ 2010 income tax return for medical expenses?

a. $4,000  
b. $3,500  
c. $1,000  
d. $500

5. Ruth and Mark Cline are married and will file a joint 2010 income tax return. Among their expenditures during 2010 were the following discretionary costs that they incurred for the sole purpose of improving their physical appearance and self-esteem:
Face lift for Ruth, performed by a licensed surgeon $5,000
Hair transplant for Mark, performed by a licensed surgeon 3,600

Disregarding the adjusted gross income percentage threshold, what total amount of the aforementioned doctors' bill may be claimed by the Clines in their 2010 return as qualifying medical expenses?

a. $0
b. $3,600
c. $5,000
d. $8,600

6. Which one of the following expenditures qualifies as a deductible medical expense for tax purposes?
   a. Vitamins for general health not prescribed by a physician.
   b. Health club dues.
   c. Transportation to physician's office for required medical care.
   d. Mandatory employment taxes for basic coverage under Medicare A.

7. John Stenger, a cash basis taxpayer, had adjusted gross income of $35,000 in 2010. During the year he incurred and paid the following medical expenses:

Drugs and medicines prescribed by doctors $ 300
Health insurance premiums 750
Doctors' fees 2,550
Eyeglasses 75
$3,675

Stenger received $900 in 2010 as reimbursement for a portion of the doctors' fees. If Stenger were to itemize his deductions, what would be his allowable net medical expense deduction?

a. $0
b. $150
c. $1,050
d. $2,475

8. During 2010 Scott charged $4,000 on his credit card for his dependent son's medical expenses. Payment to the credit card company had not been made by the time Scott filed his income tax return in 2011. However, in 2010, Scott paid a physician $2,800 for the medical expenses of his wife, who died in 2009. Disregarding the adjusted gross income percentage threshold, what amount could Scott claim in his 2010 income tax return for medical expenses?

a. $0
b. $2,800
c. $4,000
d. $6,800

Taxes as a Deduction

9. Seth Parker, a self-employed individual, paid the following taxes this year:

Federal income tax $5,000
State income tax 2,000
Real estate taxes on land in South America 900
State sales taxes 500
Federal self-employment tax 800
State unincorporated business tax 200

What amount can Parker claim as an itemized deduction for taxes paid?

a. $7,500.
b. $4,400.
c. $3,600.
d. $2,900.

10. In 2010 Lyons paid $3,000 to the tax collector of Maple Township for realty taxes on a two-family house owned by Lyons' mother. Of this amount, $1,400 covered back taxes for 2009 and $1,600 was in payment of 2010 taxes. Lyons resides on the second floor of the house, and his mother resides on the first floor. In Lyons' itemized deductions on his 2010 return, what amount may Lyons claim for realty taxes?

a. $0
b. $1,500
c. $1,600
d. $3,000

11. Mr. and Mrs. Donald Curry's real property tax year is on a calendar-year basis, with payment due annually on August 1. The realty taxes on their home amounted to $1,200 in 2010, but the Curry's did not pay any portion of that amount since they sold the house on April 1, 2010, four months before payment was due. However, realty taxes were prorated on the closing statement. Assuming that they owned no other real property during the year, how much can the Curry's deduct on Schedule A of Form 1040 for real estate taxes in 2010?

a. $0
b. $296.
c. $697.
d. $1,200.
12. During 2010 Jack and Mary Bronson paid the following taxes:

Taxes on residence (for period January 1 to September 30, 2010) $2,700
State motor vehicle tax on value of the car 360

The Bronsons sold their house on June 30, 2010 under an agreement in which the real estate taxes were not prorated between the buyer and sellers. What amount should the Bronsons deduct as taxes in calculating itemized deductions for 2010?

a. $1,800
b. $2,160
c. $2,700
d. $3,060

13. George Granger sold a plot of land to Albert King on July 1, 2010. Granger had not paid any realty taxes on the land since 2008. Delinquent 2009 taxes amounted to $600, and 2010 taxes amounted to $700. King paid the 2009 and 2010 taxes in full in 2010, when he bought the land. What portion of the $1,300 is deductible by King in 2010?

a. $353
b. $700
c. $953
d. $1,300

14. Sara Harding is a cash basis taxpayer who itemizes her deductions. The following information pertains to Sara's state income taxes for the taxable year 2010:

Withheld by employer in 2010 $2,000
Payments on 2010 estimate:
   April 15, 2010 300
   June 15, 2010 300
   September 15, 2010 300
   January 15, 2011 300 1,200
Total paid and withheld $3,200
Actual tax, per state return 3,000
Overpayment $200

There was no balance of tax or refund due on Sara's 2009 state tax return. How much is deductible for state income taxes on Sara's 2010 federal income tax return?

a. $2,800.
b. $2,900.
c. $3,000.
d. $3,200.

15. Matthews was a cash basis taxpayer whose records showed the following:

2010 state and local income taxes withheld $1,500
2010 state estimated income taxes paid December 30, 2010 400
2010 federal income taxes withheld 2,500
2010 state and local income taxes paid April 17, 2011 300

What total amount was Matthews entitled to claim for taxes on her 2010 Schedule A of Form 1040?

a. $4,700
b. $2,200
c. $1,900
d. $1,500

16. In 2010, Farb, a cash basis individual taxpayer, received an $8,000 invoice for personal property taxes. Believing the amount to be overstated by $5,000, Farb paid the invoiced amount under protest and immediately started legal action to recover the overstatement. In June, 2011, the matter was resolved in Farb's favor, and he received a $5,000 refund. Farb itemizes his deductions on his tax returns. Which of the following statements is correct regarding the deductibility of the property taxes?

a. Farb should deduct $8,000 in his 2010 income tax return and should report the $5,000 refund as income in his 2011 income tax return.
b. Farb should not deduct any amount in his 2010 income tax return and should deduct $3,000 in his 2011 income tax return.
c. Farb should deduct $3,000 in his 2010 income tax return.
d. Farb should not deduct any amount in his 2010 income tax return when originally filed, and should file an amended 2010 income tax return in 2011.

**Interest Deduction**

17. For regular tax purposes, with regard to the itemized deduction for qualified residence interest, home equity indebtedness incurred this year

a. Includes acquisition indebtedness secured by a qualified residence.
b. May exceed the fair market value of the residence.
c. Must exceed the taxpayer's net equity in the residence.
d. Is limited to $100,000 on a joint income tax return.
18. The Browns borrowed $20,000, secured by their home, to pay their son's college tuition. At the time of the loan, the fair market value of their home was $400,000, and it was unencumbered by other debt. The interest on the loan qualifies as
a. Deductible personal interest.
b. Deductible qualified residence interest.
c. Nondeductible interest.
d. Investment interest expense.

19. On January 2, 1990, the Philips paid $50,000 cash and obtained a $200,000 mortgage to purchase a home. In 2010 they borrowed $15,000 secured by their home, and used the cash to add a new room to their residence. That same year they took out a $5,000 auto loan.

The following information pertains to interest paid in 2010:
- Mortgage interest $17,000
- Interest on room construction loan 1,500
- Auto loan interest 500

For 2010, how much interest is deductible, prior to any itemized deduction limitations?
a. $17,000
b. $17,500
c. $18,500
d. $19,000

20. Robert and Judy Parker made the following payments during this taxable year:
- Interest on a life insurance policy loan (the related policy on Robert's life was purchased in 1950) $1,200
- Interest on home mortgage 3,600
- Penalty payment for prepayment of home mortgage on October 4, of this taxable year 900

How much can the Parkers utilize as interest expense in calculating itemized deductions?
a. $5,700.
b. $4,980.
c. $4,500.
d. $3,600.

21. The 2010 deduction by an individual taxpayer for interest on investment indebtedness is
a. Limited to the investment interest paid in 2010.
b. Limited to the taxpayer's 2010 interest income.
c. Limited to the taxpayer's 2010 net investment income.
d. Not limited.

22. During the taxable year, Carmine Gross purchased the following long-term investments at par:
- $5,000 general obligation bonds of Lane City (wholly tax exempt)
- $5,000 debentures of Rigor Corporation on which Carmine received $500 interest income

He financed these purchases by obtaining a loan from the National Bank for $10,000. For the year he paid the following amounts as interest expense:
- National Bank $ 800
- Interest on mortgage 2,000
- Interest on installment purchases 200

What should be the amount that Gross can deduct as interest expense?
a. $2,200.
b. $2,400.
c. $2,800.
d. $3,000.

23. Phil and Joan Crawley made the following payments during 2010:
- Interest on bank loan (loan proceeds were used to purchase United States savings bonds Series H) $4,000
- Interest on home mortgage for period April 1 to December 31, 2010 2,700
- Points paid to obtain conventional mortgage loan on April 1, 2010 900

Income of $4,500 was received on savings bonds in 2010. What is the maximum amount that the Crawleys can utilize as interest expense in calculating itemized deductions for 2010?
a. $3,600.
b. $4,900.
c. $6,700.
d. $7,600.
Charitable Contributions

24. Judy Bishop had adjusted gross income of $35,000 and itemizes her deductions. Additional information is available as follows for this year:

- Cash contribution to church: $2,500
- Purchase of an art object at her church bazaar (with a fair market value of $500 on date of purchase): 800
- Donation of used clothes to Goodwill Charities (fair value evidenced by receipt received): 400

What is the maximum amount Bishop can claim as a deduction for charitable contributions?
- a. $2,800.
- b. $3,200.
- c. $3,300.
- d. $3,400.

25. Spencer, who itemizes deductions, had adjusted gross income of $60,000 in 2010. The following additional information is available for 2010:

- Cash contribution to church: $4,000
- Purchase of an art object at church bazaar (with a fair market value of $800 on the date of purchase): 1,200
- Donation of used clothing to Salvation Army (fair value evidenced by receipt received): 600

What is the maximum amount Spencer can claim as a deduction for charitable contributions in 2010?
- a. $5,400
- b. $5,200
- c. $5,000
- d. $4,400

26. Eugene and Linda O'Brien had adjusted gross income of $30,000. Additional information is available as follows for this year:

- Cash contribution to church: $1,500
- Tuition paid to parochial school: 1,200
- Contribution to a qualified charity made by a bank credit card charge on December 14. The credit card obligation was paid in January of the next year: 250
- Cash contribution to needy family: 100

What is the maximum amount of the above that they can utilize in calculating itemized deductions for this year?
- a. $1,500.
- b. $1,750.
- c. $2,700.
- d. $3,050.

27. Moore, a single taxpayer, had $50,000 in adjusted gross income for 2010. During 2010 she contributed $18,000 to her church. She had a $10,000 charitable contribution carryover from her 2009 church contribution. What was the maximum amount of properly substantiated charitable contributions that Moore could claim as an itemized deduction for 2010?
- a. $10,000
- b. $18,000
- c. $25,000
- d. $28,000

28. Y's adjusted gross income this year is $30,000. He made cash contribution to the following organizations: Church $15,000; United Fund $5,000 and Salvation Army $3,000. Y's maximum contribution deduction this year is:
- a. $6,000.
- b. $9,000.
- c. $15,000.
- d. $2,000.

29. Charitable contributions subject to the 50-percent limit that are not fully deductible in the year made may be
- a. Neither carried back nor carried forward.
- b. Carried back three years or carried forward fifteen years.
- c. Carried forward five years.
- d. Carried forward indefinitely until fully deductible.

30. Ruth Lewis has adjusted gross income of $100,000 for this year and itemizes her deductions. On September 1, she made a contribution to her church of stock held for investment for two years which cost $10,000 and had a fair market value of $70,000. The church sold the stock for $70,000 on the same date. Assume that Lewis made no other contributions during the year and made no special election in regard to this contribution on her tax return. How much should Lewis claim as a charitable contribution deduction?
- a. $50,000.
- b. $30,000.
- c. $20,000.
- d. $10,000.
31. Stewart Samaritan had adjusted gross income of $22,000 this year. During the year he made the following contributions to recognized charitable organizations:

- $5,000 cash.
- 1,000 shares of Able Corporation common stock (acquired in 1972 at a cost of $1,600) with a fair market value of $7,000 on the date of the contribution.

What amount can Samaritan claim as a deduction for charitable contributions for the year?

a. $6,600.
b. $11,000.
c. $11,600.
d. $12,000.

32. Don and Cynthia Wallace filed a joint return in which they reported adjusted gross income of $35,000. During the year they made the following contributions to qualified organizations:

Land (stated at its current fair market value) donated to church for new building site $22,000
Cash contributions to church 300
Cash contributions to the local community college 200

Assuming that the Wallaces did not elect to reduce the deductible amount of the land contribution by the property's appreciation in value, how much can they claim as a deduction for charitable contributions on their tax return?

a. $10,800.
b. $11,000.
c. $17,500.
d. $22,500.

33. On December 15, 2010, Donald Calder made a contribution of $500 to a qualified charitable organization, by charging the contribution on his bank credit card. Calder paid the $500 on January 20, 2011 upon receipt of the bill from the bank. In addition, Calder issued and delivered a promissory note for $1,000 to another qualified charitable organization on November 1, 2010, which he paid upon maturity six months later. If Calder itemizes his deductions, what portion of these contributions is deductible in 2010?

a. $0
b. $500
c. $1,000
d. $1,500

Miscellaneous 2% Deductions

34. Which of the following is not a miscellaneous itemized deduction?

a. An individual's tax return preparation fee.
b. Education expense to meet minimum entry level education requirements at an individual's place of employment.
c. An individual's subscription to professional journals.
d. Custodial fees for a brokerage account.

35. Which expense, both incurred and paid during the year, can be claimed as an itemized deduction subject to the two-percent-of-adjusted-gross-income floor?

a. Employee's unreimbursed business car expense.
b. One-half of the self-employment tax.
c. Employee's unreimbursed moving expense.
d. Self-employed health insurance.

36. Cathy Glover, an employee of Lawrence Inc., incurs $4,000 of unreimbursed business related meals and entertainment expenses. She also had unreimbursed auto expenses of $750 with respect to her employment this year. In addition, she incurred $600 of qualifying expenses looking for a new job. Her A.G.I. for the year is $80,000. Her allowable miscellaneous itemized deductions are:

a. $4,550.
b. $3,350.
c. $2,950.
d. $1,750.

37. Harold Brodsky is an electrician employed by a contracting firm. His adjusted gross income is $25,000. During the current year he incurred and paid the following expenses:

Use of personal auto for company business (reimbursed by employer for $200) $300
Specialized work clothes 550
Union dues 600
Cost of income tax preparation 150
Preparation of will 100

If Brodsky were to itemize his personal deductions, what amount should he claim as miscellaneous deductible expenses?

a. $800
b. $900
c. $1,500
d. $1,700

Casualty Losses
38. In 2010, Joan Frazer's residence was totally destroyed by fire. The property had an adjusted basis and a fair market value of $130,000 before the fire. During 2010, Frazer received insurance reimbursement of $120,000 for the destruction of her home. Frazer's 2009 adjusted gross income was $70,000. Frazer had no casualty gains during the year. What amount of the fire loss was Frazer entitled to claim as an itemized deduction on her 2010 tax return?
   a. $2,500
   b. $2,900
   c. $8,600
   d. $10,000

   Items 39 and 40 are based on the following selected 2010 information pertaining to Sam and Ann Hoyt, who filed a joint federal income tax return for the calendar year 2010. The Hoyts had adjusted gross income of $34,000 and itemized their deductions for 2010. Among the Hoyt's cash expenditures during 2010 were the following:

   $2,500 repairs in connection with 2010 fire damage to the Hoyt residence. This property has a basis of $50,000. Fair market value was $60,000 before the fire and $55,000 after the fire. Insurance on the property had lapsed prior to the fire for nonpayment of premium.

   $800 appraisal fee to determine amount of fire loss.

   39. What amount of fire loss were the Hoyts entitled to deduct as an itemized deduction on their 2010 return?
      a. $5,000
      b. $2,500
      c. $1,500
      d. $1,100

   40. The appraisal fee to determine the amount of Hoyts' fire loss was
      a. Deductible from gross income in arriving at adjusted gross income.
      b. Subject to the 2% of adjusted gross income floor for miscellaneous itemized deductions.
      c. Deductible after reducing the amount by $500.
      d. Not deductible.

41. The following information pertains to Cole's personal residence, which sustained casualty fire damage in 2010:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Adjusted basis</td>
<td>$150,000</td>
</tr>
<tr>
<td>Fair market value immediately before the fire</td>
<td>200,000</td>
</tr>
<tr>
<td>Fair market value immediately after the fire</td>
<td>180,000</td>
</tr>
<tr>
<td>Fire damage repairs paid for by Cole in 2010</td>
<td>10,000</td>
</tr>
</tbody>
</table>

   The house was uninsured. Before consideration of any "floor" or other limitation on tax deductibility, the amount of this 2010 casualty loss was
   a. $30,000
   b. $20,000
   c. $10,000
   d. $0

42. Nelson Harris had an adjusted gross income of $60,000. During the year his personal summer home was completely destroyed by a cyclone. Pertinent data with respect to the home follows:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cost basis</td>
<td>$39,000</td>
</tr>
<tr>
<td>Value before casualty</td>
<td>45,000</td>
</tr>
<tr>
<td>Value after casualty</td>
<td>3,000</td>
</tr>
</tbody>
</table>

   Harris was partially insured for his loss and he received a $15,000 insurance settlement. What is Harris' allowable casualty loss deduction?
   a. $17,500
   b. $17,900
   c. $26,500
   d. $27,000

Review Questions

Items 43 through 48 are based on the following data:

Roger Efron, who is single and has no dependents, earned a salary of $50,000 in 2010, and had an adjusted gross income of $60,000. Roger is an active participant in a qualified noncontributory pension plan. Roger itemized his deductions on his 2010 income tax return. Among Roger's 2010 cash expenditures were the following:

Real estate taxes on Roger's condominium $4,000
Contribution to a traditional individual retirement account ($200 interest was earned on this IRA in 2010) 5,000
Dental expenses 700
Premium on Roger's life insurance policy 600
Medical insurance premiums 500
Contribution to candidate for public office 300
Legal fee for preparation of Roger's will 200
Customs duties 80
City dog license fee 10

In addition, Roger suffered a casualty loss of $400 in 2010 due to storm damage.

43. How much could Roger deduct for the contribution to his individual retirement account in arriving at his adjusted gross income?
   a. $0.
   b. $2,500.
   c. $3,000.
   d. $4,000.

44. How much could Roger deduct for medical and dental expenses?
   a. $0.
   b. $150.
   c. $700.
   d. $1,200.

45. How much could Roger deduct for taxes?
   a. $4,000.
   b. $4,010.
   c. $4,080.
   d. $4,090.

46. How much could Roger deduct for miscellaneous deductions?
   a. $0.
   b. $200.
   c. $600.
   d. $800.

47. How much could Roger deduct for the casualty loss?
   a. $0.
   b. $100.
   c. $300.
   d. $400.

48. How much of a credit could Roger offset against his income tax, for his contribution to a candidate for public office?
   a. $0.
   b. $50.
   c. $100.
   d. $150.

Items 49 through 53 are based on the following:

Alex and Myra Burg, married and filing joint income tax returns, derive their entire income from the operation of their retail candy shop. Their 2010 adjusted gross income was $50,000. The Burgs itemized their deductions on Schedule A for 2010. The following unreimbursed cash expenditures were among those made by the Burgs during 2010:

- Repair and maintenance of motorized wheelchair for physically handicapped dependent child $300
- Tuition, meals, and lodging at special school for physically handicapped dependent child in the institution primarily for the availability of medical care, with meals and lodging furnished as necessary incidents to that care 4,000
- State income tax 1,200
- Self-employment tax 7,650
- Four tickets to a theatre party sponsored by a qualified charitable organization; not considered a business expense; similar tickets would cost $25 each at the box office 160
- Repair of glass vase accidentally broken in home by dog; vase cost $500 in 2008; fair value $600 before accident and $200 after accident 90
- Fee for breaking lease on prior apartment residence located 20 miles from new residence 500
- Security deposit placed on apartment at new location 900

49. Without regard to the adjusted gross income percentage threshold, what amount may the Burgs claim as qualifying medical expenses?
   a. $40
   b. $300
   c. $4,000
   d. $4,300

50. What amount should the Burgs deduct for taxes in their itemized deductions on Schedule A?
   a. $1,200
   b. $3,825
   c. $5,025
   d. $7,650

51. What amount should the Burgs deduct for gifts to charity in their itemized deductions on Schedule A?
52. Without regard to the $500 "floor" and the adjusted gross income percentage threshold, what amount should the Burgs deduct for the casualty loss in their itemized deductions on Schedule A?
   a. $0
   b. $90
   c. $300
   d. $400

53. What amount should the Burgs deduct for moving expenses in their itemized deductions on Schedule A?
   a. $0
   b. $500
   c. $900
   d. $1,400

Released and Author Constructed Questions

54. Jackson owns two residences. The second residence, which has never been used for rental purposes, is the only residence that is subject to a mortgage. The following expenses were incurred for the second residence in 2010.

   Mortgage interest $5,000
   Utilities 1,200
   Insurance 6,000

   For regular income tax purposes, what is the maximum amount allowable as a deduction for Jackson's second residence in 2010?
   a. $6,200 in determining adjusted gross income.
   b. $11,000 in determining adjusted gross income.
   c. $5,000 as an itemized deduction.
   d. $12,200 as an itemized deduction.

55. Jimet, an unmarried taxpayer, qualified to itemize 2010 deductions. Jimet's 2010 adjusted gross income was $30,000 and he made a $2,000 cash donation directly to a needy family. In 2010, Jimet also donated stock, valued at $3,000, to his church. Jimet had purchased the stock four months earlier for $1,500. What was the maximum amount of the charitable contribution allowable as an itemized deduction on Jimet's 2010 income tax return?
   a. $0
   b. $1,500

56. In 2010, Wood's residence had an adjusted basis of $150,000 and it was destroyed by a tornado. An appraiser valued the decline in market value at $175,000. Later that same year, Wood received $130,000 from his insurance company for the property loss and did not elect to deduct the casualty loss in an earlier year. Wood's 2010 adjusted gross income was $60,000 and he did not have any casualty gains.

   What total amount can Wood deduct as a 2010 itemized deduction for the casualty loss, after the application of the threshold limitations?
   a. $39,000
   b. $38,900
   c. $13,900
   d. $13,500

57. Deet, an unmarried taxpayer, qualified to itemize 2010 deductions. Deet's 2010 adjusted gross income was $40,000 and he made a $1,500 substantiated cash donation directly to a needy family. Deet also donated art, valued at $11,000, to a local art museum. Deet had purchased the art work two years earlier for $2,000.

   What was the maximum amount of the charitable contribution allowable as an itemized deduction on Deet's 2010 income tax return?
   a. $12,500
   b. $11,000
   c. $3,500
   d. $2,000

58. Kristen uses her personal automobile for volunteer work for her church. During 2010, she drove 1,000 miles on behalf of her church. In addition, Kristen made a $3,000 cash contribution to the church. Assuming her AGI is $40,000, her allowable charitable contribution is:
   a. $3,000
   b. $3,120
   c. $3,140
   d. $3,150
59. Taylor, an unmarried taxpayer, had $90,000 in adjusted gross income for the 2010. During the 2010, Taylor donated land to a church and made no other contributions. Taylor purchased the land in 1988 as an investment for $14,000. The land’s fair market value was $25,000 on the day of the donation. What is the maximum amount of the charitable contribution that Taylor may deduct as an itemized deduction for the land donation for 2010?

a. $25,000  
b. $14,000  
c. $11,000  
d. $0

60. Carroll, an unmarried taxpayer with a an adjusted gross income of $100,000, incurred and paid the following unreimbursed medical expenses for the year:

- Doctor bills resulting from a serious fall: $5,000
- Cosmetic surgery that was necessary to correct a congenital deformity: $15,000

Carroll had no medical insurance. For regular income tax purposes, what was Carroll’s maximum allowable medical expense deduction, after the applicable threshold limitation, for the year?

a. $0  
b. $12,500  
c. $15,000  
d. $20,000

61. Melinda lives in a state that does not impose a state income tax. During 2010, she purchased many personal items and paid $2,500 in state sales tax. The maximum amount Melinda may deduct is:

a. $0  
b. $2,500 deduction for AGI  
c. $2,500 deduction from AGI  
d. none of the above

62. The Rites are married, file a joint income tax return, and qualify to itemize their deductions in the current year. Their adjusted gross income for the year was $55,000, and during the year they paid the following taxes:

- Real estate taxes on personal residence: $2,000
- Ad valorem tax on personal automobile: $500
- Current-year state and city income taxes withheld from paycheck: $1,000

What total amount of the expense should the Rites claim as an itemized deduction on their current-year joint income tax return?

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

63. Which of the following is a miscellaneous itemized deduction subject to the 2% of adjusted gross income floor?

a. Gambling losses up to the amount of gambling winnings  
b. Medical expenses  
c. Real estate tax  
d. Employee business expenses

64. Taylor, an unmarried taxpayer, had $90,000 in adjusted gross income for year 13. During year 13, Taylor donated land to a church and made no other contributions. Taylor purchased the land in year 1 as an investment for $14,000. The land’s fair market value was $25,000 on the day of the donation. What is the maximum amount of charitable contribution that Taylor may deduct as an itemized deduction for the land for year 13?

a. $25,000  
b. $14,000  
c. $11,000  
d. $0
Chapter Four — Answers
Deductions From Adjusted Gross Income

1. (d) $5,000. Only the medical expenses of the adopted child qualify. Legal expenses and the agency fee are not deductible expenses. The medical expenses would be subject to a floor of 7.5% of their adjusted gross income.

2. (a) $8,600. The costs of maintenance of a wheelchair for a handicapped dependent child is fully deductible as well as the expenses related to tuition, room and board, and the cost of medical care when the principal reason for sending a dependent to a special school is that school’s special resources for treating that specific sickness or disease.

3. (c) $655. The following expenses qualify as deductible medical expenses:

<table>
<thead>
<tr>
<th>Item</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Medicines and drugs</td>
<td>$300</td>
</tr>
<tr>
<td>Doctors</td>
<td>2,700</td>
</tr>
<tr>
<td>Medical insurance</td>
<td>280</td>
</tr>
<tr>
<td>Total expenses</td>
<td>$3,280</td>
</tr>
<tr>
<td>Less: AGI limitation:</td>
<td></td>
</tr>
<tr>
<td>$35,000 x 7.5%</td>
<td>-2,625</td>
</tr>
<tr>
<td>Allowable deduction</td>
<td>$655</td>
</tr>
</tbody>
</table>

The health club membership is for general health and is non-deductible.

4. (c) $1,000. The qualified medical expenses include the $2,000 for physical therapy and the $500 premium for insurance on the prescription drugs, less the reimbursement. The cost of insurance for lost wages is not a deductible expense.

<table>
<thead>
<tr>
<th>Item</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Physical therapy</td>
<td>$2,000</td>
</tr>
<tr>
<td>Premium on insurance</td>
<td>500</td>
</tr>
<tr>
<td>Total before reimbursement</td>
<td>2,500</td>
</tr>
<tr>
<td>Less: reimbursement</td>
<td>-1,500</td>
</tr>
<tr>
<td>Deductible expenses</td>
<td>$1,000</td>
</tr>
</tbody>
</table>

5. (a) Expenditures for the overall general health of the taxpayer, such as vitamins or health clubs, and elective cosmetic surgery are not deductible. The face-lift and hair transplant would be classified as elective cosmetic surgery and therefore, not deductible.

6. (c) The cost of transportation for medical treatment, which includes a parent’s cost if they are accompanying a child, is allowed as a deduction. Expenditures for the overall general health of the taxpayer, such as vitamins or health clubs, and cosmetic surgery are not deductible.

7. (b) $150. The qualified medical expenses include the medicine and drugs, health insurance premiums, doctors fees and eyeglasses, less the reimbursement on the doctors fees received during the year.

<table>
<thead>
<tr>
<th>Item</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Drugs and medicine</td>
<td>$300</td>
</tr>
<tr>
<td>Health insurance premiums</td>
<td>750</td>
</tr>
<tr>
<td>Doctors’ fees</td>
<td>2,550</td>
</tr>
<tr>
<td>Eyeglasses</td>
<td>75</td>
</tr>
<tr>
<td>Total before reimbursement</td>
<td>3,675</td>
</tr>
<tr>
<td>Less: reimbursement</td>
<td>-900</td>
</tr>
<tr>
<td>Expenses before limitation</td>
<td>$2,775</td>
</tr>
<tr>
<td>Less: AGI limitation:</td>
<td></td>
</tr>
<tr>
<td>$35,000 x 7.5%</td>
<td>-2,625</td>
</tr>
<tr>
<td>Allowable deduction</td>
<td>$150</td>
</tr>
</tbody>
</table>
8. (d) $6,800. Scott can deduct the $4,000 cost of his dependent’s son medical expenses which he charged and the $2,800 he paid for his spouse’s medical expenses even though they were for the preceding year when she died. Charging on a credit card constitutes a payment, even though the taxpayer did not pay off the credit card until the subsequent year.

9. (d) $2,900. Parker may deduct the following taxes:

<table>
<thead>
<tr>
<th></th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>State income taxes</td>
<td>$2,000</td>
</tr>
<tr>
<td>Real estate taxes on land</td>
<td>$900</td>
</tr>
<tr>
<td>Total</td>
<td>$2,900</td>
</tr>
</tbody>
</table>

Sales taxes are not deductible, unless a taxpayer elects to claim them in lieu of the state income tax. One-half of the self-employment tax as well as the unincorporated business tax are deductions for adjusted gross income, not itemized deductions.

10. (a) $0. Lyons paid taxes on property that he does not own. There is no deduction.

11. (b) $296. When real property is sold during the year, the real estate tax must be apportioned between the buyer and seller based upon the number of days owned. Computations are as follows:

<table>
<thead>
<tr>
<th></th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Annual real estate taxes paid</td>
<td>$1,200</td>
</tr>
<tr>
<td>Days in the year</td>
<td>365</td>
</tr>
<tr>
<td>Real estate tax per day</td>
<td>$3.28</td>
</tr>
<tr>
<td>Days owned by Curry</td>
<td>90</td>
</tr>
<tr>
<td>Real estate tax deduction</td>
<td>$296</td>
</tr>
</tbody>
</table>

12. (b) $2,160. When real property is sold during the year, the real estate tax must be apportioned between the buyer and seller based upon the number of days owned. Computations are as follows:

<table>
<thead>
<tr>
<th></th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Annual real estate taxes paid</td>
<td>$2,700</td>
</tr>
<tr>
<td>Owned for 2/3 of the period</td>
<td>$2/3</td>
</tr>
<tr>
<td>Real estate tax deduction</td>
<td>$1,800</td>
</tr>
<tr>
<td>Add: personal property tax</td>
<td>$360</td>
</tr>
<tr>
<td>Total deductible taxes</td>
<td>$2,160</td>
</tr>
</tbody>
</table>

13. (a) $353. When real property is sold during the year, the real estate tax must be apportioned between the buyer and seller based upon the number of days owned. Computations are as follows:

<table>
<thead>
<tr>
<th></th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Annual real estate taxes paid</td>
<td>$700</td>
</tr>
<tr>
<td>Days in the year</td>
<td>365</td>
</tr>
<tr>
<td>Real estate tax per day</td>
<td>$1.92</td>
</tr>
<tr>
<td>Days owned by King</td>
<td>183</td>
</tr>
<tr>
<td>Real estate tax deduction</td>
<td>$353</td>
</tr>
</tbody>
</table>

14. (b) $2,900. The deductible state income taxes are those actually paid or withheld during 2010.

<table>
<thead>
<tr>
<th></th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>State income taxes withheld</td>
<td>$2,000</td>
</tr>
<tr>
<td>Estimated payments:</td>
<td></td>
</tr>
<tr>
<td>April 15, 2010</td>
<td>300</td>
</tr>
<tr>
<td>June 15, 2010</td>
<td>300</td>
</tr>
<tr>
<td>September 15, 2010</td>
<td>300</td>
</tr>
<tr>
<td>Total deduction</td>
<td>$2,900</td>
</tr>
</tbody>
</table>
15. (c) $1,900. The deductible taxes are those state income taxes actually paid or withheld during 2010.

State income taxes withheld $  1,500
Estimated state payment 400
Total itemized deduction $  1,900

The 2010 state income taxes paid in 2011 will be deductible in 2011. Federal income taxes are not deductible.

16. (a) Farb is allowed a deduction in the year that the taxes are paid.

17. (d) Home equity indebtedness is limited to $100,000. It may not exceed the fair market value of the house less the acquisition indebtedness or the $100,000, whichever is less.

18. (b) Qualified residence interest includes acquisition indebtedness and home equity indebtedness. For the interest on home equity indebtedness to be deductible, the loan must be secured by the residence, and be the lesser of 100,000 or the fair market value of the house ($400,000) minus the acquisition indebtedness (none).

19. (c) $18,500. Both the mortgage and the construction loan qualify as acquisition indebtedness. The interest on those loans is fully deductible. The interest on the loan for the personal auto which was not secured by the residence is non-deductible.

Mortgage interest $  17,000
Construction loan 1,500
Total deductible interest $  18,500

20. (c) $4,500. Both the mortgage and the prepayment penalty are considered to be qualified residence interest and fully deductible. The interest on the life insurance is personal and non-deductible.

Mortgage interest $  3,600
Prepayment penalty 900
Total deductible interest $  4,500

21. (c) By definition.

22. (b) $2,400. Whereas one-half of the $800 interest expense from National Bank was related to the purchase of tax-exempt securities, one-half of the interest is clearly non-deductible. The other half ($400) is deductible only to the extent of the net investment income, which in this problem is $500, and thus fully deductible. The mortgage interest is fully deductible and the personal installment loan interest in non-deductible.

National Bank 50% $     400
Mortgage interest 2,000
Total deductible interest $  2,400
23. (d) $7,600. Interest on the loan to purchase the bonds is deductible because the net investment income of $4,500 exceeds the $4,000 investment interest expense. The interest on the home mortgage and related points are qualified residence interest.

24. (b) $3,200. The cash contributions to the church and the fair market value of clothing are allowed as deductions. Purchasing an item at a price greater than the fair market value allows the taxpayer a deduction for the excess only. The art object’s purchase price of $800, less its fair market value of $500 results in a $300 contribution.

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash contribution to church</td>
<td>$2,500</td>
</tr>
<tr>
<td>Excess of purchase price over fair value of art object</td>
<td>300</td>
</tr>
<tr>
<td>Clothing donation</td>
<td>400</td>
</tr>
<tr>
<td>Total deduction</td>
<td>$3,200</td>
</tr>
</tbody>
</table>

25. (c) $5,000. The cash contributions to the church and the fair market value of clothing are allowed as deductions. Purchasing an item at a price greater than the fair market value allows the taxpayer a deduction for the excess only. The art object’s purchase price of $800, less its fair market value of $500 results in a $300 contribution.

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash contribution to church</td>
<td>$4,000</td>
</tr>
<tr>
<td>Excess of purchase price over fair value of art object</td>
<td>400</td>
</tr>
<tr>
<td>Clothing donation</td>
<td>600</td>
</tr>
<tr>
<td>Total deduction</td>
<td>$5,000</td>
</tr>
</tbody>
</table>

26. (b) $1,750. The cash contributions to the church and qualified charity are fully deductible in this year. Payment with a credit card qualifies in the year the charge was made. Tuition to a parochial school is not deductible. A needy family is not a qualified charity and therefore, non-deductible.

27. (c) $25,000. The maximum allowed for charitable contributions in a given year is 50% of their adjusted gross income. In determining the composition of the $25,000 deduction for this year, the current year contribution is considered first and $7,000 of the carryover next.

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Current year contribution</td>
<td>$18,000</td>
</tr>
<tr>
<td>Carryover from prior year</td>
<td>10,000</td>
</tr>
<tr>
<td>Contributions available</td>
<td>$28,000</td>
</tr>
<tr>
<td>Taxpayer’s adjusted gross income</td>
<td>$50,000</td>
</tr>
<tr>
<td>Contribution limitation</td>
<td>50%</td>
</tr>
<tr>
<td>Maximum allowed this year</td>
<td>$25,000</td>
</tr>
</tbody>
</table>

28. (c) $15,000. The maximum allowed for charitable contributions in a given year is 50% of Y’s adjusted gross income. All charities listed are 50% charities.

<table>
<thead>
<tr>
<th>Church</th>
<th>$15,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>United Fund</td>
<td>5,000</td>
</tr>
<tr>
<td>Salvation Army</td>
<td>3,000</td>
</tr>
<tr>
<td>Contributions available</td>
<td>$23,000</td>
</tr>
<tr>
<td>Taxpayer’s adjusted gross income</td>
<td>$30,000</td>
</tr>
<tr>
<td>Contribution limitation</td>
<td>50%</td>
</tr>
<tr>
<td>Maximum allowed this year</td>
<td>$15,000</td>
</tr>
</tbody>
</table>

The excess of $8,000 is carried over for a five year period.
29. (c) These excess contributions are only carried forward for five years.

30. (b) $30,000. When a contribution of appreciated property is made, the deduction allowed is for fair market value of the property. The deduction, however, is limited to 30% of the taxpayers adjusted gross income unless a special election is made to use the cost of the property rather than the fair market value. Whereas there was no special election, the deduction is limited to $100,000 X 30%, or $30,000. The excess of $40,000 is carried over for five years and is still subject to the 30% limitation each year.

31. (b) $11,000. Stewart’s contributions include cash and the fair market value of property. In determining the current year’s allowable contribution, the maximum allowable is limited to 50% of his adjusted gross income, or $11,000. However, the computations are actually more involved because of the capital gain property.

**Step 1.** Determine the overall 50% limitation:

\[
\begin{align*}
\text{Stewart’s adjusted gross income} & \quad 22,000 \\
\text{Overall contribution limitation} & \quad 50\% \\
\text{Maximum allowed this year} & \quad 11,000
\end{align*}
\]

**Step 2.** Determine how much is used up by qualifying 50% contributions. The residual is available for the 30% contributions:

\[
\begin{align*}
\text{Maximum allowable} & \quad 11,000 \\
\text{Less: Contributions qualifying under 50% rule} & \quad 5,000 \\
\text{Available for 30% limitation} & \quad 6,000
\end{align*}
\]

**Step 3.** Determine the deductibility of the stock contribution with a $7,000 FMV:

\[
\begin{align*}
\text{Stewart’s adjusted gross income} & \quad 22,000 \\
\text{Contribution limitation for FMV} & \quad 30\% \\
\text{Maximum allowed this year} & \quad 6,600
\end{align*}
\]

The $7,000 FMV stock contribution is limited by the 30% test in Step 3 to $6,600 and by the 50% test in Step 2 to a maximum of $6,000. The excess of $1,000 ($7,000 less the $6,000 allowed) is carried over for five years, and is subject to the same percentage limitations in the carryovers. The final contribution is comprised of:

\[
\begin{align*}
\text{Total allowable contributions:} & \\
\text{Cash contributions} & \quad 5,000 \\
\text{Stock - FMV (limited)} & \quad 6,000 \\
\text{Total} & \quad 11,000
\end{align*}
\]

32. (b) $11,000. The Wallace’s contributions include cash of $500 and the fair market value of property. In determining the current year’s allowable contribution, the maximum allowable on the land is limited to 30% of their adjusted gross income, or $10,500.

\[
\begin{align*}
\text{Total allowable contributions:} & \\
\text{Cash contributions} & \quad 500 \\
\text{Land - FMV (limited)} & \quad 10,500 \\
\text{Total} & \quad 11,000
\end{align*}
\]

33. (b) A taxpayer is considered to have paid a charitable contribution if it was charged to his credit card account during the taxable year.
34. (b) In order to qualify as a deduction, educational costs must be paid to maintain or improve existing skills, not prepare the taxpayer for a new job.

35. (a) Only the unreimbursed employee business car expense. All others qualify, at least in part, for a deduction for adjusted gross income, not an itemized deduction.

36. (d) $1,750. Unreimbursed employee expenses are subject to a threshold of 2% of adjusted gross income. Also, business meals and entertainment are now only 50% deductible.

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Business meals &amp; entertainment</td>
<td>$ 2,000</td>
</tr>
<tr>
<td>Automobile expenses</td>
<td>750</td>
</tr>
<tr>
<td>Job hunting expenses</td>
<td>600</td>
</tr>
<tr>
<td>Total</td>
<td>$ 3,350</td>
</tr>
<tr>
<td>Less: 2% of AGI ($80,000)</td>
<td>-1,600</td>
</tr>
<tr>
<td>Allowable deductions</td>
<td>$ 1,750</td>
</tr>
</tbody>
</table>

37. (b) $900. Unreimbursed employee expenses are subject to a threshold of 2% of adjusted gross income. The amounts paid for the preparation of the will are non-deductible.

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Business use of auto,</td>
<td></td>
</tr>
<tr>
<td>less $200 reimbursement</td>
<td>$ 100</td>
</tr>
<tr>
<td>Specialized work clothes</td>
<td>550</td>
</tr>
<tr>
<td>Union dues</td>
<td>600</td>
</tr>
<tr>
<td>Income tax preparation</td>
<td>150</td>
</tr>
<tr>
<td>Total</td>
<td>$ 1,400</td>
</tr>
<tr>
<td>Less: 2% of AGI ($25,000)</td>
<td>-500</td>
</tr>
<tr>
<td>Allowable deductions</td>
<td>$ 900</td>
</tr>
</tbody>
</table>

38. (b) $2,900. The personal casualty loss deduction is determined taking the lessor of decrease in the FMV of the property or its basis; less the insurance reimbursement; subject to a $100 floor; and then subject to 10% of the taxpayer’s adjusted gross income. With the FMV and basis being identical, the computations are:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Decrease in the FMV</td>
<td>$ 130,000</td>
</tr>
<tr>
<td>Less: reimbursement</td>
<td>-120,000</td>
</tr>
<tr>
<td>Loss by taxpayer</td>
<td>10,000</td>
</tr>
<tr>
<td>Less: $100 floor</td>
<td>-100</td>
</tr>
<tr>
<td>Less: AGI limitation</td>
<td></td>
</tr>
<tr>
<td>$70,000 X 10%</td>
<td>-7,000</td>
</tr>
<tr>
<td>Allowable casualty loss</td>
<td>$ 2,900</td>
</tr>
</tbody>
</table>

39. (d) $1,500. The personal casualty loss deduction is determined taking the lessor of decrease in the FMV of the property or its basis; less the insurance reimbursement; subject to a $100 floor; and then subject to 10% of the taxpayer’s adjusted gross income. The decrease in value was from $60,000 to $55,000, or $5,000. This is less than the basis of the property.

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Decrease in the FMV</td>
<td>$ 5,000</td>
</tr>
<tr>
<td>Less: reimbursement</td>
<td>0</td>
</tr>
<tr>
<td>Loss by taxpayer</td>
<td>5,000</td>
</tr>
<tr>
<td>Less: $100 floor</td>
<td>-100</td>
</tr>
<tr>
<td>Less: AGI limitation</td>
<td></td>
</tr>
<tr>
<td>$34,000 X 10%</td>
<td>-3,400</td>
</tr>
<tr>
<td>Allowable casualty loss</td>
<td>$ 1,500</td>
</tr>
</tbody>
</table>
40. (b)  The cost of the appraisal is cost used in the determination of the tax, and is allowed as a miscellaneous itemized deduction, subject to the 2% limitation.

41. (b)  $20,000. The personal casualty loss deduction is determined taking the lessor of decrease in the FMV of the property or its basis; less the insurance reimbursement; subject to a $100 floor; and then subject to 10% of the taxpayer’s adjusted gross income. The decrease in value of $20,000 ($200,000 less $180,000) was less than the basis of the property.

<table>
<thead>
<tr>
<th>Decrease in the FMV</th>
<th>$ 20,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Less: reimbursement</td>
<td>-0</td>
</tr>
<tr>
<td>Loss by taxpayer</td>
<td>$ 20,000</td>
</tr>
</tbody>
</table>

42. (b)  $17,900. The personal casualty loss deduction is determined taking the lessor of decrease in the FMV of the property or its basis; less the insurance reimbursement; subject to a $100 floor; and then subject to 10% of the taxpayer’s adjusted gross income. The decrease in fair market value was $42,000 ($45,000 down to $3,000) and the cost basis was $39,000. Therefore, using the cost basis, the computations are:

<table>
<thead>
<tr>
<th>Cost basis of the house</th>
<th>$ 39,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Less: reimbursement</td>
<td>-15,000</td>
</tr>
<tr>
<td>Loss by taxpayer</td>
<td>24,000</td>
</tr>
<tr>
<td>Less: $100 floor</td>
<td>-100</td>
</tr>
<tr>
<td>Less: AGI limitation</td>
<td>60,000 X 10%</td>
</tr>
<tr>
<td>Allowable casualty loss</td>
<td>$ 17,900</td>
</tr>
</tbody>
</table>

43. (c)  $3,000. A single taxpayer who is an active participant in qualified pension plan cannot fully deduct an IRA contribution if his adjusted gross income is in excess of $56,000. $60,000-56,000 = $4,000. $4,000/$10,000 or 40% is phased out. Therefore, $5,000 times 40% = $2,000 phase-out. So of the $5,000 contribution, he may deduction $5,000-$2,000 or $3,000.

44. (a)  $0. Unreimbursed medical expenses are deductible only to the extent that they exceed 7.5% of adjusted gross income. Roger’s threshold is $60,000 X 7.5% for a total of $4,500. Roger’s qualifying medical expenses of $1,200 (medical insurance of $500 and dental expenses of $700) are less than the threshold, thus non-deductible.

45. (a)  $4,000. Only the real estate taxes on the condominium are deductible. The customs duties and city licenses are non-deductible fees.

46. (a)  $0. There are no miscellaneous deductions.

47. (a)  $0. The casualty loss of $400 will not exceed the $100 floor and the 10% of adjusted gross income test.

48. (a)  $0. There is no tax credit for contributions to political candidates.

49. (d)  $4,300. The costs of maintenance of a wheelchair for a handicapped dependent child is fully deductible as well as the expenses related to tuition, room and board, and the cost of medical care when the principal reason for sending a dependent to a special school is that school’s special resources for treating that specific sickness or disease.

50. (a)  $1,200. State income taxes are allowed as an itemized deduction. One-half of the self-employment tax is allowed as a deduction for adjusted gross income, but not as an itemized deduction.
51. (c) $60. The charitable contribution is the excess of the purchase price of the ticket over its fair market value. The Burgs paid $160 for tickets that had a fair market value of $100 (four @ $25 each). The excess of $60 is the allowable deduction.

52. (a) $0. This does not meet the definition of a casualty loss.

53. (a) $0. The expenses of moving are now a deduction for adjusted gross income, not an itemized deduction. Even so, the fee for breaking the lease and security deposit are not deductible anyhow.

54. (c) $5,000. A taxpayer is entitled to deduct the acquisition indebtedness (mortgage) interest on his primary and secondary residence. Unless the other expenses listed were related to rental property, they are not allowed as a deduction. Not included in the problem was real estate taxes. These would have been allowed as an itemized deduction.

55. (b) $1,500. In determining the charitable contribution deduction, the amount paid directly to a needy family does not qualify. The amount of the allowable deduction for the stock held for only 4 months is limited to cost, which is the $1,500.

56. (c) $13,900. The personal casualty loss deduction is determined taking the lessor of decrease in the FMV of the property or its basis; less the insurance reimbursement; subject to a $100 floor; and then subject to 10% of the taxpayer’s adjusted gross income. With the adjusted basis being lower than decrease in FMV, the computations are:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Adjusted basis in the FMV</td>
<td>$150,000</td>
</tr>
<tr>
<td>Less: reimbursement</td>
<td>-130,000</td>
</tr>
<tr>
<td>Loss by taxpayer</td>
<td>20,000</td>
</tr>
<tr>
<td>Less: $100 floor</td>
<td>-100</td>
</tr>
<tr>
<td>Less: AGI limitation</td>
<td></td>
</tr>
<tr>
<td>$60,000 X 10%</td>
<td>-6,000</td>
</tr>
<tr>
<td>Allowable casualty loss</td>
<td>$13,900</td>
</tr>
</tbody>
</table>

57. (b) $11,000. The taxpayer is entitled to deduct the fair market value of the art work since it was held for two years and qualifies as long-term. In determining the charitable contribution deduction, the amount paid directly to a needy family does not qualify.

58. (c) $3,140. Effective in 2010, the standard mileage rate is 14 cents per mile for charitable purposes. Therefore, her deduction will be based upon 1,000 miles @ $.14 or $140, plus the $3,000 for a total of $3,140.

59. (a) $25,000. When a contribution of appreciated property is made, the deduction allowed is for fair market value of the property, which is $25,000. The deduction, however, is limited to 30% of the taxpayer’s adjusted gross income. In Taylor’s case, her adjusted gross income of $90,000 times the 30% rate provides a maximum deduction of $27,000. Since the fair market value ($25,000) is less than the limitation amount ($27,000), the fair market value is the amount of the allowable deduction.
60. (b) $12,500. Both the doctor bills and “necessary” cosmetic surgery are allowed as medical deductions. The computations are as follows:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Doctor bills</td>
<td>$5,000</td>
</tr>
<tr>
<td>Necessary surgery</td>
<td>$15,000</td>
</tr>
<tr>
<td>Total expenses</td>
<td>$20,000</td>
</tr>
<tr>
<td>Less: AGI limitation</td>
<td></td>
</tr>
<tr>
<td>$100,000 x 7.5%</td>
<td>-$7,500</td>
</tr>
<tr>
<td>Allowable deduction</td>
<td>$12,500</td>
</tr>
</tbody>
</table>

61. (c) $2,500 deduction from AGI. Melinda may elect to deduct either the state income tax (none) or the sales tax effective for tax year 2010. Since she paid no state income tax, $2,500 as an itemized deduction is the correct answer.

62. (d) $3,500. Real estate taxes are deductible wherever the property is situated. A personal property tax (automobile) based upon value is deductible as are state and local income taxes withheld from paychecks.

63. (d) Only the employee business expenses are subject to the 2% floor. Gambling losses are not subject to a percentage of AGI, but rather to the extent of gambling winnings. Medical expenses are subject to a 7.5% floor and real estate taxes are not subject to any floor.

64. (a) $25,000. The deduction is generally limited to the lesser of fair market value of the gift ($25,000) or 30% of the adjusted gross income ($90,000 x 30% = $27,000). The taxpayer may elect to claim the basis of the gift instead of the fair market value and not be subject to any percentage test, but in this situation, that would result in a deduction of only $14,000.
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Chapter Five
Accounting Methods and Periods, and
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ACCOUNTING METHODS

GENERAL
A taxpayer may report income and deductions under the method that he regularly keeps his books and records. However, if the IRS does not believe that the books and records accurately reflect the taxable income of the taxpayer, the IRS may change that method. There are also approved methods, subject to restrictions, that the IRS allows.

CASH METHOD
Under the cash method of accounting, income is recognized income when the taxpayer actually receives the cash, or it is constructively received. Deductions are allowed when the cash is paid. This method is not limited solely to the receipt and payment of cash. The receipt, or payment, may be in the form of goods or services using the fair market value.

The cash method is not available to those taxpayers where inventory is a material income producing factor. Where inventory is such a factor, the accrual method must be used. It is also not available to C Corporations, unless their sales are less than $5 million per year.

Under the cash method, certain prepaid expenses may be allowed as a current year deduction if the deferral period is less than a year. Also, charging an item to the taxpayer’s credit card constitutes a payment in the year charged, even though the taxpayer does not pay the credit card company until the following year. Purchases of fixed assets for cash, however, are not treated as expenses. These assets must be capitalized, and deductions are allowed through cost recovery (depreciation).

Prepaid income, or deferred revenue is usually recognized in the year of receipt even though it is not earned until next year. An exception from income treatment is the receipt of a security deposit where the amount will be returned to the tenant at the end of the lease.

ACCRUAL METHOD
Under the accrual method of accounting, income is recognized when earned and expenses when incurred. The general rule addressing the concept of “recognized when earned or incurred” states that:

- All of the events fixing the taxpayer’s right to receive the income, or create the liability have occurred, and
- The amount can be determined with reasonable accuracy.

The issue of reasonable accuracy allows the taxpayer to file a return even when there is some degree of uncertainty as to the actual receipt of income or the payment of expense. Under this premise, when the actual amount is determined in a later year, an amended return is not required.

When inventory is a material income producing factor, the taxpayer must report the actual sales, and determine the cost of goods sold by taking into consideration inventory and accounts payable.
**Example 1:** T has a retail store and during the year the actual sales were $400,000. T’s beginning and ending inventory was $30,000 and $45,000 respectively. Cash purchases during the year totaled $310,000 and his trade payables at the beginning and end of the year were $28,000 and $31,000 respectively. T must report the following gross profit.

<table>
<thead>
<tr>
<th>Sales</th>
<th>$ 400,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cost of goods sold:</td>
<td></td>
</tr>
<tr>
<td>Beginning inventory</td>
<td>30,000</td>
</tr>
<tr>
<td>Purchases*</td>
<td>313,000</td>
</tr>
<tr>
<td>Goods available for sale</td>
<td>343,000</td>
</tr>
<tr>
<td>Ending inventory</td>
<td>-45,000</td>
</tr>
<tr>
<td>Cost of goods sold</td>
<td>298,000</td>
</tr>
<tr>
<td><strong>Gross profit on sales</strong></td>
<td><strong>$ 102,000</strong></td>
</tr>
</tbody>
</table>

(*Hint: Cash purchases of $310,000 plus ending trade payables of $31,000 minus beginning trade payables of $28,000 equals net purchases under the accrual method of $313,000.)

**HYBRID METHOD**

The taxpayer maintaining an inventory is required to use the accrual method for reporting the gross profit on sales. However, for the other expenses such as selling and administrative, the taxpayer may use the cash method.

**CONSTRUCTIVE RECEIPT**

Even though a taxpayer does not actually receive the cash, they may still have to recognize income under the constructive receipt doctrine. This doctrine states that income is to be recognized when the money or property is made available to the taxpayer and there are no real limitations to the taxpayer receiving it.

**Example 2:** Z performed cleaning services during November 2010 and billed the client $500. The client paid Z the $500 on December 28, but Z refused to accept payment and asked to be paid in 2011 instead. Z has constructively received the income in 2010 and must include it in income.

**Example 3:** W is a shareholder of a Fortune 500 company. On December 31, 2010, the company declared and paid a dividend on their stock. The company mailed W a dividend check for $200 on that date. W received the check on January 4, 2011. W did not have access to the funds until 2011. W does not include this as 2010 income.

**INSTALLMENT SALES**

When a taxpayer sells property and recognizes a gain, the taxpayer does not have to recognize the entire gain from the sale if at least one payment is received in the year after the sale. Under the “where-with-all-to-pay concept”, the gain is recognized on a pro-rata basis based upon the receipt of the sale proceeds. This is not an elective provision, it is automatic. If you want to recognize all of the income in the year of the sale, you must elect out by reporting the entire gain in the year of the sale.

To determine the recognized gain for the year:

\[
\text{Recognized gain} = \left( \frac{\text{Total gain}}{\text{Total contract price}} \right) \times \text{Payments received during year}
\]
Example 4: In 2009, D sells property to B for $40,000. D’s cost in the asset was $30,000, thus a $10,000 gain is to be recognized. D is to receive $20,000 in 2009, and $10,000 in both 2010 and 2011. Under the installment sale provision D would recognize $5,000 in 2009, and $2,500 in each of 2010 and 2011.

<table>
<thead>
<tr>
<th>Gain Year</th>
<th>Gain</th>
<th>$10,000 (\frac{\text{Gain}}{\text{Total Price}}) \times $20,000 = $5,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>2009 gain</td>
<td>$10,000 (\frac{\text{Gain}}{\text{Total Price}}) \times $20,000 = $5,000</td>
<td></td>
</tr>
<tr>
<td>2010 &amp; 2011 gain</td>
<td>$10,000 (\frac{\text{Gain}}{\text{Total Price}}) \times $10,000 = $2,500</td>
<td></td>
</tr>
</tbody>
</table>

Should the buyer assume any indebtedness on the property being sold, then the denominator should reflect that as a reduction from the overall selling price or contract price. The installment sale provisions are not available for the ordinary gain on the sale of inventory or depreciation recapture from the sale of depreciable property. That gain is recognized immediately.

COMPLETED CONTRACT SALES

When a taxpayer is involved in a project which extends beyond the tax year, it may be possible to defer the gain on the project until it is complete. The completed contract method usually is associated with home builders, commercial contractors, road construction, etc. Costs associated with the contract are accumulated as an asset until the project is complete. At that time, the total revenue and costs associated with that project are recognized for tax purposes. In order to qualify, the company’s gross receipts must not exceed $10 million.

The alternative is the percentage of completion method. Here, the taxpayer recognizes income on a pro-rata basis as the job progresses.

Example 5: ELK Company builds commercial projects, and during the current year expended $3,000,000 in material, labor and overhead on their only project. The total revenue at completion will be $6,000,000 and it is estimated that it will take $1,500,000 to complete the project.

Under the completed contract method, no income or expense would be recognized in the current year because the job is not complete. Under the percentage of completion method, ELK would recognize $1,000,000 in income, determined as follows:

\[
\frac{\text{Costs incurred to date}}{\text{Estimated at completion}} \times \text{Total revenue} = \frac{\$3,000,000}{\$4,500,000} \times \$6,000,000 = \$4,000,000
\]

\[
\text{Total revenue to be recognized} = \$4,000,000
\]
\[
\text{Cost of construction} = 3,000,000
\]
\[
\text{Income recognized} = \$1,000,000
\]
ACCOUNTING PERIODS

In general, a taxpayer may select a year-end to coincide with the method used to maintain his books and records. However, most individual taxpayers use a calendar year due to the record keeping complexities. (S Corporations and partnerships have other restrictions which are addressed in later chapters) The length of the tax year cannot exceed 12 months. However, it is permissible for a taxpayer to use a 52 or 53 week year to coincide with the natural business cycle.

Example 6: J is a grocer and is open Monday through Saturday. J elects to have his tax year end on the last Saturday in December to coincide with his business cycle. Some years this results in a 52 week year, and others a 53 week year.

Once a year-end is selected, the taxpayer must obtain written consent from the IRS in order to change. The request is filed on Form 1128 and is due on or before the 15th day of the second month following the desired year-end. This results in what is referred to as a short period. The income from the short period must be annualized to determine the appropriate tax effect.

Example 7: SSC Academy has a December 31 (calendar) year-end and wishes to change to June 30th to coincide with their natural year-end. They must file the request no later than August 15th, and if approved, file a short period return covering the period from January 1 until June 30.

COMPUTATION OF AN INDIVIDUAL'S TAX LIABILITY AND CREDITS

GENERAL

Once the taxable income of an individual has been determined, the computation of tax is required. After the tax is computed, a reduction for payments and credits is made to determine if the individual has a refund or balance due. See page two of Form 1040 at the back of Chapter 1 for a complete look at the taxes and credits.

The summary of the major tax computations, credits and payments, is as follows:

- **Taxable income**
- **Tax (regular)**
- **Alternative minimum tax**
- **Less:**
  - Child and dependent care credit
  - Child tax credit
  - Elderly credit
  - Education credits
  - Foreign tax credit
  - Residential energy credits
- **Plus:**
  - Self-employment tax
  - Penalty tax on IRAs and pensions
- **Less:**
  - Withholding taxes
  - Estimated tax payments
  - Earned income credit
  - **Excess Social Security tax**
- **Refund or balance due**
REGULAR COMPUTATION

In computing the amount of tax, taxpayers with taxable income of less than $100,000 may use the Tax Tables. If you are required to calculate the tax on the exam, you will use the rates, not the tax tables. Please refer to the 2010 Rate Schedules for the different filing statuses on the last page of this chapter.

The rate schedule for an unmarried taxpayer (single), shows that the tax is 10% for the first $8,357 of taxable income; 15% on the amount from $8,375 through $34,000 of taxable income and 25% on the taxable income from $34,000 through $82,400, and so on. The highest marginal tax bracket for an individual is 35%.

**Example 8:** W is single and has taxable income of $44,000. His tax is computed as follows:

<table>
<thead>
<tr>
<th>Income Range</th>
<th>Tax Rate</th>
<th>Tax Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>$8,370</td>
<td>10%</td>
<td>$837</td>
</tr>
<tr>
<td>$25,625</td>
<td>15%</td>
<td>3,844</td>
</tr>
<tr>
<td>$10,000</td>
<td>25%</td>
<td>2,500</td>
</tr>
<tr>
<td>$44,000</td>
<td></td>
<td>$7,181</td>
</tr>
</tbody>
</table>

The rate that the taxpayer is taxed on for the incremental amount of income is called the marginal tax bracket. Therefore, W is in the 25% marginal tax bracket. W’s average tax rate is 16.3% ($7,181/$44,000).

DEPENDENT CHILD

In preparing the return for a dependent child, no personal exemption is allowed. This is because someone has already claimed the child as a dependent. Another important factor is that the dependent’s standard deduction is limited to the amount of earned income, plus $300 (but not to exceed $5,700) or $950, whichever is greater.

**Example 9:** S is 16 and is properly claimed as a dependent on his parent’s return. During 2010, S earned $6,700 working in a supermarket. He has no other income.

<table>
<thead>
<tr>
<th>Income Type</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gross income</td>
<td>$6,700</td>
</tr>
<tr>
<td>Standard deduction</td>
<td>-5,700</td>
</tr>
<tr>
<td>Taxable income</td>
<td>$1,000</td>
</tr>
<tr>
<td>Tax @ 10%</td>
<td>$100</td>
</tr>
</tbody>
</table>

**Example 10:** T is 18 and is properly claimed as a dependent on his parents return. During 2010, T earned $2,000 working at a retail store. He has interest income of $400.

<table>
<thead>
<tr>
<th>Income Type</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gross income</td>
<td>$2,400</td>
</tr>
<tr>
<td>Standard deduction</td>
<td>-2,300</td>
</tr>
<tr>
<td>Taxable income</td>
<td>$100</td>
</tr>
<tr>
<td>Tax @ 10%</td>
<td>$10</td>
</tr>
</tbody>
</table>

The standard deduction is the earned income of $2,000 plus $300.
KIDDIE TAX
When a child who is claimed as a dependent has net unearned income in excess of $1,900, the tax on the excess will be taxed at the parent’s rate. The computations are somewhat complicated due to the use of the exemptions and standard deduction, but the thrust of the law is to counter the tax planning technique of shifting income producing property (investments) down to a child where it will be subject to a lower tax rate. At the child’s level, effectively the first $950 of income is not subject to tax because of the standard deduction, the second $950 is taxed at the child’s rate and the excess is taxed at the parent’s rate.

Example 11: N, age 4, received $5,000 in interest and dividends during 2010. N had no itemized deductions. N’s parents are in the 25% tax bracket.

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total unearned income</td>
<td>$5,000</td>
</tr>
<tr>
<td>Less: Standard deduction</td>
<td>-950</td>
</tr>
<tr>
<td>Amount subject to tax</td>
<td>4,050</td>
</tr>
<tr>
<td>Less: Amount taxed at child’s rate</td>
<td>-950</td>
</tr>
<tr>
<td>Amount taxed at parent’s rate</td>
<td>$3,100</td>
</tr>
</tbody>
</table>

Tax on child’s portion:
- $950 x 10% = $95

Tax on parental portion:
- $3,100 x 25% = 775

Total tax = $865

As an option to performing the above calculations and filing a return for their child, parents may pay an additional $95 tax plus claim the unearned income in excess of $1,900 on their return. To elect this, the gross income must be from interest and dividends only, and must be less than $9,500.

PHASE-OUT OF EXEMPTIONS
In determining the tax for high-income taxpayers, the deduction for exemptions have been phased-out or eliminated. However, that provision has been repealed for 2010.

INCOME AVERAGING FOR FARMERS
A taxpayer engaged in the farming business may now elect to use income averaging to compute his tax. In determining income, the farmer may include the gain from the sale of farming business property.
ALTERNATIVE MINIMUM TAX

GENERAL
To ensure that individuals pay their fair share of taxes, a taxpayer may be subject to an alternative minimum tax (AMT). The AMT is the excess of the tentative minimum tax over the regular tax. The process to determine the AMT is to first identify the various tax preferences or adjustments which were properly elected and planned for by the taxpayer, and then, effectively, disallow them.

The framework for calculating the AMT is as follows:

\[
\text{Taxable income} \pm \text{adjustments} \\
\text{Plus the tax preferences} \\
\text{Equals AMTI} \\
\text{Less the exemption amount} \\
\text{Equals the AMT base} \\
\text{Multiplied by the AMT tax rate} \\
\text{Equals the tentative minimum tax} \\
\text{Less the regular tax} \\
\text{Equals the AMT}
\]

ADJUSTMENTS
In general, adjustments can be positive or negative, and are the result of timing differences in the tax treatment of certain items. For example, excess MACRS depreciation over the longer, slower AMT depreciation method of ADS (alternative depreciation system) will result in a positive adjustment that increases the alternative minimum taxable income. However, after the asset has been fully recovered under MACRS, there will still be depreciation under the AMT method, which will cause a negative adjustment and decrease AMTI.

The AMT adjustments, with a very brief explanation, include:

- Circulation expenditures - Must be capitalized and expensed over three years, not immediately.
- Depreciation - Excess MACRS of real property over ADS of 40 years straight-line.
- Depreciation - Excess MACRS of personal property over ADS 150% DDB.
- Differences in Recognized Gains or Losses - Because of depreciation changes, tax bases are different.
- Pollution Control Facilities Amortization - Excess of straight-line, 60 months over ADS.
- Passive Activity Losses - Uses a different taxable income level for determining losses.
- Completed Contract Method - Must use percentage of completion instead.
- Incentive Stock Options - Excess of FMV over exercise price.
- Net Operating Loss - Must be modified.

The following itemized deductions are also adjustments, and are limited in their deductibility for AMT purposes:

- Medical Expenses - Must exceed 10% of AGI instead of 7.5%.
- Taxes - State, local foreign and property - Not allowed.
- Mortgage Interest - Limited to acquisition interest, excludes home equity interest.
- Certain Investment Interest Expense - Not allowed.
- Miscellaneous 2% Deductions - Not allowed.
- Standard Deduction - Not allowed.
- Exemption Amount - Not allowed.
**TAX PREFERENCES**

Tax preferences are always added to taxable income, never subtracted. The preferences are:

- Interest income on private activity bonds (bonds issued in 2010 are not considered to be tax preference items for AMT purposes).
- Excess accelerated depreciation over straight-line on pre-87 real property.
- Excess accelerated depreciation over straight-line on leased pre-87 personal property.
- Excess amortization over depreciation on pre-87 certified pollution control facilities.
- Percentage depletion beyond the property's adjusted basis.
- Excess intangible drilling costs, reduced by 65% of net income from oil, gas and geothermal activity.
- 42% of the excluded gain from the sale of certain small business stock.

**EXEMPTION AMOUNT**

After adding and subtracting the adjustments, and adding the tax preferences to taxable income, a taxpayer is allowed an exemption from the AMTI. The exemption amounts, by filing status, are as follows:

- **Single** $47,450
- **Married, filing jointly** $72,450
- **Married, filing separately** $36,225

However, these exemptions are phased-out (at a rate of 25% over the excess) if the taxpayers AMTI before the exemption exceeds the following thresholds:

- **Single** $112,500
- **Married, filing jointly** $150,000
- **Married, filing separately** $75,000

**Example 13:** R & S are married and file a joint return. R & S had AMTI (before the exemption amount) of $270,000. Their exemption amount would be only $42,450 ($72,450 less phase-out of $30,000):

<table>
<thead>
<tr>
<th>AMTI</th>
<th>$270,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Threshold for phase-out</td>
<td>$150,000</td>
</tr>
<tr>
<td>Excess over threshold</td>
<td>$120,000</td>
</tr>
<tr>
<td>Phase-out rate</td>
<td>25%</td>
</tr>
<tr>
<td>Exemption phaseout</td>
<td>$30,000</td>
</tr>
</tbody>
</table>

**THE AMT TAX RATE**

There is a two-tier tax rate for determining the tentative minimum tax.

<table>
<thead>
<tr>
<th>AMT Base Amount</th>
<th>AMT Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>$0 up to $175,000</td>
<td>26%</td>
</tr>
<tr>
<td>$175,000 and up</td>
<td>28%</td>
</tr>
</tbody>
</table>
Example 14: During the year, K earned a significant amount of income and took advantage of many tax preferences and accelerated depreciation, and paid a large amount of real estate taxes, income taxes and home equity interest. K calculated her income tax liability under the regular method to be only $17,000. K then heard about the alternative minimum tax from a CPA candidate and after hours of calculations, she determined that her AMT base amount was $205,000.

Tentative minimum tax computation:

<table>
<thead>
<tr>
<th>Range</th>
<th>Tax Rate</th>
<th>Tax Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>First $175,000</td>
<td>26%</td>
<td>$45,500</td>
</tr>
<tr>
<td>Next $30,000</td>
<td>28%</td>
<td>8,400</td>
</tr>
<tr>
<td>K's regular income tax</td>
<td></td>
<td>17,000</td>
</tr>
<tr>
<td>Alternative minimum tax</td>
<td></td>
<td>$36,900</td>
</tr>
</tbody>
</table>

K was stunned. Remember that the alternative minimum tax is the excess of the tentative minimum tax over the regular tax.

SELF-EMPLOYMENT TAX

If a taxpayer has earnings from self-employment of at least $400, a self-employment tax must be paid on earnings. The self-employment tax is equivalent to the employee’s share and the employer’s share of the Social Security and Medicare taxes withholding tax. The rate for Social Security tax is 6.2% and Medicare is 1.45% for a total of 7.65%. A taxpayer is subject to the Social Security tax on earnings up to $106,800 in 2010. For Medicare there is no ceiling. Since the taxpayer is employing himself, these rates must be doubled to a total rate of 15.3%.

Later in Chapter 7, you will see that guaranteed payments to a partner and a partner’s share of ordinary income is also subject to the self-employment. However, in Chapter 11, you will discover that a shareholder’s share of the ordinary income is not subject to the self-employment tax.

In order to provide the self-employed taxpayer with a benefit for paying the “employer’s share” of the taxes required to be paid, there are two special provisions:

- Before calculating the tax, the net earnings are reduced by 7.65%, and
- One-half of the self-employment tax is allowed as a deduction for adjusted gross income (Chapter 3).

Example 15: J is self-employed and has $30,000 of net earnings from self-employment. His self-employment tax is determined as follows:

<table>
<thead>
<tr>
<th>Net earnings</th>
<th>$30,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Reduction percentage</td>
<td>92.35%</td>
</tr>
<tr>
<td>Computational base</td>
<td>$27,705</td>
</tr>
<tr>
<td>Self-employment tax rate</td>
<td>15.3%</td>
</tr>
<tr>
<td>Self-employment tax</td>
<td>$4,239</td>
</tr>
</tbody>
</table>
COMPUTATION OF TAX CREDITS

GENERAL
Tax credits generally reduce the amount of tax shown on the return. Most credits require special calculations to determine the amount of the credit and several are based upon the taxpayer’s filing status. Most tax credits are called non-refundable credits because they can only reduce the tax to zero. One credit in this section (earned income credit) is a refundable credit. This credit provides the taxpayer with relief beyond reducing the tax liability to actually generating a refund, even if no taxes were ever paid.

Example 16: Y has no taxable income this year and has no tax liability. Y qualifies for an elderly credit of $60. Y cannot utilize the credit because it is a non-refundable credit and it cannot reduce his tax below zero. If Y’s $60 credit was a refundable credit (such as the earned income credit), Y would receive a refund of $60, even though Y had no tax liability nor made any payments.

EARNED INCOME CREDIT
This credit provides qualifying taxpayers with relatively low levels of income a credit against their tax liability. This is the only refundable credit. The nature of the credit is to encourage the taxpayer to “earn” income, rather than receive “non-earned” benefits. The credit computation excludes interest, dividends and alimony from the computation. While the credit was only for taxpayers with at least one child residing with them for over one-half of the year, it has been expanded to those without children, as is discussed later.

The credit is subject to phase-out limitations based upon the AGI and number of qualifying children of the taxpayer. The phase-outs and computations are beyond the scope of the exam. In order to qualify, the child must be a son, daughter, stepson, stepdaughter or foster child of the taxpayer; must reside with the taxpayer as their principal place of abode; and must be under age 19, or 24 if a full-time student. In addition, the taxpayer cannot have investment income in excess of $3,100.

For 2010, the maximum credit for a taxpayer with qualifying children is as follows:

<table>
<thead>
<tr>
<th>Number of Qualifying Children</th>
<th>Maximum Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>One</td>
<td>$3,050</td>
</tr>
<tr>
<td>Two or more</td>
<td>$5,036</td>
</tr>
<tr>
<td>Three or more</td>
<td>$5,666</td>
</tr>
</tbody>
</table>

Taxpayers, between the ages of 25 and 64, without children, and who are not the dependents of another taxpayer, may qualify for the earned income credit. The maximum amount for 2010 is $457.

CHILD TAX CREDIT
Taxpayers are able to claim a child credit for each qualifying child under the age of 17. For 2010, the credit is $1,000 per child. In general, the child must be a child or direct descendant of the taxpayer and the taxpayer must be able to claim the child as his dependent. There is a threshold limitation. The credit is reduced by $50 for each $1,000 (or part thereof) of modified adjusted gross income over the following:

<table>
<thead>
<tr>
<th>Filing Status</th>
<th>Modified Adjusted Gross Income</th>
</tr>
</thead>
<tbody>
<tr>
<td>Single</td>
<td>$75,000</td>
</tr>
<tr>
<td>Married filing jointly</td>
<td>110,000</td>
</tr>
<tr>
<td>Married filing separately</td>
<td>55,000</td>
</tr>
</tbody>
</table>

The credit has an additional feature in that if it exceeds the taxpayer’s income tax for that year, the excess may be refunded if the taxpayer has three or more qualifying children, similar to the earned income credit.
EDUCATIONAL TAX CREDITS

AMERICAN OPPORTUNITY CREDIT (modified HOPE CREDIT)
Taxpayers may elect to take a tax credit for tuition, fees and course materials paid during the first four years of postsecondary education. The credit is limited the lessor of the amounts paid or $2,500, and 40% of the credit may be used as a refundable credit. The credit is 100% of the first $2,000 and then 25% of the next $2,000 of qualifying expenditures. The credit has higher AGI limitations than the old Hope Credit. The phaseout begins at $80,000 for single taxpayers and $160,000 for married filing jointly.

LIFETIME LEARNING CREDIT
Taxpayers may elect to take a nonrefundable tax credit for qualified tuition and related expenses for undergraduate, graduate and professional degree courses. The credit is the lesser of $2,000, or 20% of up to $10,000 in qualified tuition and fees. Unlike the American Opportunity Credit, the taxpayer may claim this over an unlimited number of years. However, this credit is not based upon the number of qualifying students. The maximum credit per year is $2,000.

There are some limitations to both the Hope Scholarship Credit and the Lifetime Learning Credit. The phase-out range (credits are reduced on a pro-rata basis) for allowing the credits is as follows:

<table>
<thead>
<tr>
<th>Phase-out range</th>
</tr>
</thead>
<tbody>
<tr>
<td>Married, filing jointly</td>
</tr>
<tr>
<td>Single</td>
</tr>
</tbody>
</table>

The credit is not available for married taxpayers filing separately.

DEPENDENT CARE CREDIT
This credit applies to those taxpayers who pay for dependent or child care in order for them to work. To be eligible, the taxpayer must maintain a household for a dependent, age 12 or under, or any dependent of spouse who is physically or mentally incapacitated. The credit ranges from 35% down to 20%, based upon the AGI of the taxpayer. The credit is reduced by 1% point for each $2,000 of AGI over $15,000. The 20% credit is reached when AGI exceeds $43,000.

When computing the credit, there are two other restrictions. First, the maximum amount of qualifying expenses per child is $3,000 for one; and $6,000 for two or more. Second, the maximum amount cannot exceed the earned income of the spouse with the lower earnings. For purposes of this test, alimony counts as earned income as does a deemed amount of $250 per month per child ($3,000 per year) for full-time students.

ADOPTION CREDIT
A taxpayer is entitled to a credit for qualifying adoption expenses. For the year 2010, the credit has been increased to $13,170. The qualifying expenses include all reasonable and necessary expenses, costs and fees associated with the adoption. There is a $40,000 phase-out range of the credit based upon the taxpayers modified adjusted gross income. The phase-out begins at $182,520 and ends at $222,520.

RETIREMENT SAVINGS CONTRIBUTION CREDIT
This non-refundable credit is designed for low-income taxpayers. If a single taxpayer with adjusted gross income of under $16,750 makes a traditional IRA or Roth IRA contribution during the year, the taxpayer is allowed a credit of 50% of the amount of the contribution. The maximum contributions amount to calculate the credit on is $2,000. For married taxpayers the adjusted gross income level is $33,000. There are various credit rates in place for different levels of income and filing statuses, but the credit is fully eliminated when the single AGI reaches $27,750 and the married AGI reaches $55,500.
ELDERLY CREDIT
A credit is provided to the elderly and disabled to provide a form of relief from taxation. The credit applies to taxpayers 65 or older. It is also available to those under 65, provided they are retired with a total and permanent disability.

To determine the credit, start with an initial base amount (per Section 37) of $5,000 for a single taxpayer or $7,500 for married filing jointly. This amount needs to be reduced by

1. any social security benefits, and
2. one-half of the excess AGI over $7,500 if single or $10,000 if married.

This is the “qualifying income.” The credit is the lesser of 15% of their qualifying income, or the amount of tax on the return.

Example 18: M is 70, single and retired. During the year he earned $3,000 from his pension and $1,000 in interest on his savings. M has no tax liability. M also received $1,500 in social security benefits.

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Section 37 amount</td>
<td>$ 5,000</td>
</tr>
<tr>
<td>Less: Social Security benefits</td>
<td>-1,500</td>
</tr>
<tr>
<td>Credit base</td>
<td>$ 3,500</td>
</tr>
<tr>
<td>Elderly credit rate</td>
<td>15%</td>
</tr>
<tr>
<td>Elderly credit</td>
<td>$ 525</td>
</tr>
</tbody>
</table>

Note: This credit is only allowed to offset taxes. His taxes are zero, therefore no credit is allowed.

FOREIGN TAX CREDIT
Individual taxpayers are taxed in the United States on their worldwide income. The taxpayers are entitled to a tax credit for income taxes paid to foreign countries. This prevents double taxation of the same income. The foreign tax credit cannot exceed the lesser of the amount of the foreign taxes paid or the pro-rata share of US taxes on the foreign income. The limitation is determined as follows:

\[
\frac{\text{Income from foreign sources}}{\text{Worldwide income}} \times \text{US taxes paid} = \text{Foreign tax credit}
\]

Example 19: K has taxable income of $50,000, of which $1,000 was dividends earned on an investment in a foreign country. K paid $300 in income taxes to that foreign country. Prior to the determination of the foreign tax credit, K’s US income tax was $10,000.

\[
\frac{\$1,000}{\$50,000} \times \$10,000 = \$200 \text{ maximum foreign tax credit}
\]

The foreign tax credit is $200 (the lesser of $200 or the amount paid of $300). The excess of $100 may be carried back two years and then forward five years.
EXCESS SOCIAL SECURITY TAXES

A taxpayer is generally subject to Social Security and Medicare taxes. For 2010, the Social Security tax of 6.2% is imposed on wages up to $106,800 per year for a maximum of $6,622, while the Medicare tax of 1.45% has no limit. Earnings above the threshold are not subject to the tax. Should an employee change jobs during the year, the new employer must withhold the Social Security and Medicare tax, subject to the same limitations again. It is possible for taxpayers to have extra Social Security taxes withheld because of this. This excess may be claimed as a credit against any taxes due.

Example 20: During 2010, G worked for ABC Company for six months and earned $50,000 in salary. Social Security taxes of $3,100 were withheld. In July, G began work for a new company and earned $60,000 for the balance of the year. Social Security taxes of $3,720 were withheld on those earnings. The maximum wages on which Social Security taxes may be withheld is $106,800 for a total of $6,622. Therefore, G is entitled to a refundable credit of $198 for 2010, determined as follows:

<table>
<thead>
<tr>
<th>Actual Social Security withholdings:</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Job #1</td>
<td>3,100</td>
</tr>
<tr>
<td>Job #2</td>
<td>3,720</td>
</tr>
<tr>
<td>Total withholdings</td>
<td>6,820</td>
</tr>
<tr>
<td>Maximum social security tax</td>
<td>6,622</td>
</tr>
<tr>
<td>Excess withholdings</td>
<td>198</td>
</tr>
</tbody>
</table>

FIRST TIME HOMEBUYER CREDIT

There is a tax credit equal to 10% of the purchase price of a home but not to exceed $8,000 for first time home buyers. For married taxpayers filing separately the amount is $4,000. If two or more unrelated individuals purchase a home, the $8,000 may be allocated using any reasonable method. To qualify, the home must be purchased before May 1, 2010.

ESTIMATED INCOME TAX PAYMENTS

An individual must make estimated payments if he expects that the underpayment after withholdings and tax credits is at least $1,000 and more than 10% of the amount of the tax shown on the return. The tax payments are remitted with Form 1040-ES and are due in equal installments on the 15th day of the 4th, 6th, and 9th month of the tax year, and the 1st month of the filing year. In order to avoid any penalty on the underpayment of taxes, an individual must make payments equal to:

- 90% of their current year’s tax.
- 100% of their prior year’s tax.
- 110% of their prior year's tax if the prior year's AGI exceeds $150,000.
- Annualized income installment method computation.
## 2010 TAX RATE SCHEDULE

### Joint Returns and Surviving Spouses

<table>
<thead>
<tr>
<th>If taxable income is:</th>
<th>The tax is:</th>
</tr>
</thead>
<tbody>
<tr>
<td>Not over $16,750</td>
<td>10% of taxable income</td>
</tr>
<tr>
<td>Over $16,750 but not over $68,000</td>
<td>$1,675 plus 15% of the excess over $16,750</td>
</tr>
<tr>
<td>Over $68,000 but not over $137,300</td>
<td>$9,352.50 plus 25% of the excess over $68,000</td>
</tr>
<tr>
<td>Over $137,300 but not over $209,250</td>
<td>$26,687.50 plus 28% of the excess over $137,300</td>
</tr>
<tr>
<td>Over $209,250 but not over $373,650</td>
<td>$46,833.50 plus 33% of the excess over $209,250</td>
</tr>
<tr>
<td>Over $373,650</td>
<td>$101,085.50 plus 35% of the excess over $373,650</td>
</tr>
</tbody>
</table>

### Unmarried Individuals (Single)

<table>
<thead>
<tr>
<th>If taxable income is:</th>
<th>The tax is:</th>
</tr>
</thead>
<tbody>
<tr>
<td>Not over $8,375</td>
<td>10% of taxable income</td>
</tr>
<tr>
<td>Over $8,375 but not over $34,000</td>
<td>$837.50 plus 15% of the excess over $8,375</td>
</tr>
<tr>
<td>Over $34,000 but not over $82,400</td>
<td>$4,681.25 plus 25% of the excess over $34,000</td>
</tr>
<tr>
<td>Over $82,400 but not over $171,850</td>
<td>$16,781.25 plus 28% of the excess over $82,400</td>
</tr>
<tr>
<td>Over $171,850 but not over $373,650</td>
<td>$41,827.25 plus 33% of the excess over $171,850</td>
</tr>
<tr>
<td>Over $373,650</td>
<td>$108,421.25 plus 35% of the excess over $373,650</td>
</tr>
</tbody>
</table>

### Heads of Households

<table>
<thead>
<tr>
<th>If taxable income is:</th>
<th>The tax is:</th>
</tr>
</thead>
<tbody>
<tr>
<td>Not over $11,950</td>
<td>10% of taxable income</td>
</tr>
<tr>
<td>Over $11,950 but not over $45,500</td>
<td>$1,195 plus 15% of the excess over $11,950</td>
</tr>
<tr>
<td>Over $45,500 but not over $117,650</td>
<td>$6,235.00 plus 25% of the excess over $45,500</td>
</tr>
<tr>
<td>Over $117,650 but not over $190,550</td>
<td>$24,260.00 plus 28% of the excess over $117,650</td>
</tr>
<tr>
<td>Over $190,550 but not over $373,650</td>
<td>$44,672.00 plus 33% of the excess over $190,550</td>
</tr>
<tr>
<td>Over $373,650</td>
<td>$105,095.00 plus 35% of the excess over $373,650</td>
</tr>
</tbody>
</table>

### Married Individuals Filing Separately

<table>
<thead>
<tr>
<th>If taxable income is:</th>
<th>The tax is:</th>
</tr>
</thead>
<tbody>
<tr>
<td>Not over $8,375</td>
<td>10% of taxable income</td>
</tr>
<tr>
<td>Over $8,375 but not over $34,000</td>
<td>$837.50 plus 15% of the excess over $8,375</td>
</tr>
<tr>
<td>Over $34,000 but not over $68,650</td>
<td>$4,681.25 plus 25% of the excess over $34,000</td>
</tr>
<tr>
<td>Over $68,650 but not over $104,625</td>
<td>$13,343.75 plus 28% of the excess over $68,650</td>
</tr>
<tr>
<td>Over $104,625 but not over $186,825</td>
<td>$23,416.75 plus 33% of the excess over $104,625</td>
</tr>
<tr>
<td>Over $186,825</td>
<td>$50,542.75 plus 35% of the excess over $186,825</td>
</tr>
</tbody>
</table>
Chapter Five — Questions
Accounting Methods and Periods, and
Computation of Tax Liability and Tax Credits

ACCOUNTING METHODS & PERIODS

1. A cash-basis taxpayer should report gross income
   a. For the year in which income is either actually or constructively received, whether in cash or in property.
   b. For the year in which income is either actually or constructively received in cash only.
   c. Only for the year in which income is actually received whether in cash or in property.
   d. Only for the year in which income is actually received in cash.

2. Alex Burg, a cash basis taxpayer, earned an annual salary of $80,000 at Ace Corp. in 2010, but elected to take only $50,000. Ace, which was financially able to pay Burg's full salary, credited the unpaid balance of $30,000 to Burg's account on the corporate books in 2010, and actually paid this $30,000 to Burg on April 30, 2011. How much of the salary is taxable to Burg in 2010?
   a. $50,000.
   b. $60,000.
   c. $65,000.
   d. $80,000.

   __________

Items 3 through 6 are based on the following data:
Carl Tice, an employee of Canova Corp., received a salary of $50,000 from Canova in 2010. Also in 2010, Carl bought 100 shares of Nolan Corp. common stock from Canova for $30 a share, when the market value of the Nolan stock was $50 a share. Canova had paid $20 a share for the Nolan stock in 1975. In addition, Carl owned a building which he leased to Boss Co. on January 1, 2010, for a five-year term at $500 a month. Boss paid Carl $8,000 in 2010 to cover the following:

Rent for January to December 2010 $6,000
Advance rent for January 2011 500
Security deposit, to be applied against the final three months' rent in the fifth year of the lease 1,500

Carl also received the following dividends in 2010, from:

<table>
<thead>
<tr>
<th>Company</th>
<th>Dividend Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Mutual Life Insurance Co.</td>
<td>$300</td>
</tr>
<tr>
<td>General Merchandise Corp.</td>
<td>$400</td>
</tr>
<tr>
<td>Second National Bank, Inc.</td>
<td>$800</td>
</tr>
</tbody>
</table>

On July 1, 2010, Carl sold for $9,500, on the open market, a $10,000 face value 10-year, noncallable, Doe Corp. bond. This bond was part of an original issue by Doe on July 1, 2008, and was purchased by Carl on that date, at a discount of $1,200, for a net price of $8,800.

3. How much should Carl report on his 2010 income tax return as compensation income received from Canova?
   a. $50,000.
   b. $51,000.
   c. $52,000.
   d. $53,000.

4. How much rent income should Carl report in his 2010 income tax return for the amounts paid to him by Boss?
   a. $6,000.
   b. $6,500.
   c. $7,500.
   d. $8,000.

5. How much dividend income should Carl report in his 2010 income tax return?
   a. $400.
   b. $1,100.
   c. $1,200.
   d. $1,500.

6. What is Carl's long-term capital gain in 2010, on the sale of the Doe bond?
   a. $0.
   b. $460.
   c. $700.
   d. $1,200.
7. On December 15, 2010, Donald Calder made a contribution of $500 to a qualified charitable organization by charging the contribution on his bank credit card. Calder paid the $500 on January 20, 2011, upon receipt of the bill from the bank. In addition, Calder issued and delivered a promissory note for $1,000 to another qualified charitable organization on November 1, 2010, which he paid upon maturity six months later. If Calder itemizes his deductions, what portion of these contributions is deductible in 2010?
   a. $0.
   b. $500.
   c. $1,000.
   d. $1,500.

8. In 2009, Farb, a cash basis individual taxpayer, received an $8,000 invoice for personal property taxes. Believing the amount to be overstated by $5,000, Farb paid the invoiced amount under protest and immediately started legal action to recover the overstatement. In November 2010, the matter was resolved in Farb's favor, and he received a $5,000 refund. Farb itemizes his deductions on his tax returns. Which of the following statements is correct regarding the deductibility of the property taxes?
   a. Farb should deduct $8,000 in his 2009 income tax return and should report the $5,000 refund as income in his 2010 income tax return.
   b. Farb should not deduct any amount in his 2009 income tax return and should deduct $3,000 in his 2010 income tax return.
   c. Farb should deduct $3,000 in his 2009 income tax return.
   d. Farb should not deduct any amount in his 2009 income tax return when originally filed, and should file an amended 2009 income tax return in 2010.

9. Unless the Internal Revenue Service consents to a change of method, the accrual method of tax reporting is mandatory for a sole proprietor when there are

<table>
<thead>
<tr>
<th>Accounts receivable for services rendered</th>
<th>Year-end merchandise inventories</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>b. Yes</td>
<td>No</td>
</tr>
<tr>
<td>c. No</td>
<td>No</td>
</tr>
<tr>
<td>d. No</td>
<td>Yes</td>
</tr>
</tbody>
</table>

10. Dr. Chester is a cash basis taxpayer. His office visit charges are usually paid on the date of visit or within one month. However, services rendered outside the office are billed weekly, and are usually paid within two months as patients collect from insurance companies. Information relating to this year is as follows:

| Cash received at the time of office visits          | $35,000 |
| Collections on accounts receivable                 | 130,000 |
| Accounts receivable, January 1                      | 16,000  |
| Accounts receivable, December 31                    | 20,000  |

Dr. Chester's gross income from his medical practice for the taxable year is
   a. $165,000.
   b. $169,000.
   c. $181,000.
   d. $185,000.

11. For a cash basis taxpayer, gain or loss on a year-end sale of listed stock arises on the
   a. Trade date.
   b. Settlement date.
   c. Date of receipt of cash proceeds.
   d. Date of delivery of stock certificate.

12. Carl Slater was the sole proprietor of a high-volume drug store which he owned for 25 years before he sold it to Statewide Drug Stores, Inc., in 2010. Besides the $800,000 selling price for the store's tangible assets and goodwill, Slater received a lump sum of $60,000 in 2010 for his agreement not to operate a competing enterprise within ten miles of the store's location, for a period of six years. How will the $60,000 be taxed to Slater?
   a. As $60,000 ordinary income in 2010.
   b. As $60,000 short-term capital gain in 2010.
   c. As $60,000 long-term capital gain in 2010.
   d. As ordinary income of $10,000 a year for six years.

**COMPUTATION OF TAX LIABILITY AND CREDITS**

13. The alternative minimum tax (AMT) is computed as the
   a. Excess of the regular tax over the tentative AMT.
   b. Excess of the tentative AMT over the regular tax.
   c. The tentative AMT plus the regular tax.
   d. Lesser of the tentative AMT or the regular tax.
14. In 2010, Don Mills, a single taxpayer, had $70,000 in taxable income before personal exemptions. Mills had no tax preferences. His itemized deductions were as follows:

State and local income taxes $5,000
Home mortgage interest on loan to acquire residence 6,000
Miscellaneous deductions that exceed 2% of adjusted gross income 2,000

What amount did Mills report as alternative minimum taxable income before the AMT exemption?

a. $72,000
b. $75,000
c. $77,000
d. $83,000

15. Alternative minimum tax preferences include

<table>
<thead>
<tr>
<th>Tax exempt interest from private activity bonds issued during 1994</th>
<th>Charitable contributions of appreciated capital gain property</th>
</tr>
</thead>
<tbody>
<tr>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td>No</td>
<td>Yes</td>
</tr>
<tr>
<td>No</td>
<td>No</td>
</tr>
</tbody>
</table>

16. The credit for prior year alternative minimum tax liability may be carried

a. Forward for a maximum of 5 years.
b. Back to the 3 preceding years or carried forward for a maximum of 5 years.
c. Back to the 3 preceding years.
d. Forward indefinitely.

17. Which of the following credits is a combination of several tax credits to provide uniform rules for the current and carryback-carryover years?

a. General business credit.
b. Foreign tax credit.
c. Minimum tax credit.
d. Enhanced oil recovery credit.

18. To qualify for the child care credit on a joint return, at least one spouse must

<table>
<thead>
<tr>
<th>Have an adjusted gross income of $10,000 or less</th>
<th>Be gainfully employed when related expenses are incurred</th>
</tr>
</thead>
<tbody>
<tr>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>No</td>
<td>No</td>
</tr>
<tr>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td>No</td>
<td>Yes</td>
</tr>
</tbody>
</table>

19. Nancy and Dennis Martin are married and file a joint income tax return. Both were employed during the year and earned the following salaries:

Dennis $32,000
Nancy 14,000

In order to enable Nancy to work, she incurred at-home child care expenses of $6,000 for their two-year-old daughter and four-year-old son. What is the amount of the child care credit they can claim?

a. $400.
b. $960.
c. $1,200.
d. $2,800.

20. Nora Hayes, a widow, maintains a home for herself and her two dependent preschool children. Nora's earned income and adjusted gross income was $29,000. She paid work-related expenses of $3,000 for a housekeeper to care for her children. How much can Nora claim for child care credit?

a. $0.
b. $480.
c. $600.
d. $840.

21. Which of the following credits can result in a refund even if the individual had no income tax liability?

a. Credit for prior year minimum tax.
b. Elderly and permanently and totally disabled credit.
c. Earned income credit.
d. Child and dependent care credit.
22. Kent qualified for the earned income credit in 2010. This credit could result in a
a. Refund even if Kent had no tax withheld from wages.
b. Refund only if Kent had tax withheld from wages.
c. Carryback or carryforward for any unused portion.
d. Subtraction from adjusted gross income to arrive at taxable income.

23. Amos Kettle, a single taxpayer, age 66, filed his income tax return and reported an adjusted gross income of $6,000. He received a total of $1,200 in Social Security benefits for the year and has no other excluded pension or annuity amounts. What amount can Kettle claim as a tax credit for the elderly?
   a. $180.
   b. $195.
   c. $570.
   d. $900.

24. Melvin Crane is 66 years old, and his wife, Matilda, is 65. They filed a joint income tax return this year, reporting an adjusted gross income of $7,800, on which they paid a tax of $60. They received $1,250 from social security benefits. How much can they claim on Schedule R of Form 1040 as a credit for the elderly?
   a. $0.
   b. $60.
   c. $938.
   d. $375.

25. An employee who has had social security tax withheld in an amount greater than the maximum for a particular year, may claim
   a. Such excess as either a credit or an itemized deduction, at the election of the employee, if that excess resulted from correct withholding by two or more employers.
b. Reimbursement of such excess from his employers, if that excess resulted from correct withholding by two or more employers.
c. The excess as a credit against income tax, if that excess resulted from correct withholding by two or more employers.
d. The excess as a credit against income tax, if that excess was withheld by one employer.

26. Chris Baker's adjusted gross income on her 2010 tax return was $160,000. The amount covered a 12-month period. For the 2010 tax year, Baker may avoid the penalty for the underpayment of estimated tax if the timely estimated tax payments equal the required annual amount of
   I. 90% of the tax on the return for the current year, paid in four equal installments.
   II. 100% of prior year's tax liability, paid in four equal installments.
   a. I only.
b. II only.
c. Both I and II.
d. Neither I nor II.

27. Krete, an unmarried taxpayer with income exclusively from wages, filed her initial income tax return for the 2010 calendar year. By December 31, 2010, Krete's employer had withheld $16,000 in federal income taxes and Krete had made no estimated tax payments. On April 15, 2011, Krete timely filed an extension request to file her individual tax return and paid $300 of additional taxes. Krete's 2010 income tax liability was $16,500 when she timely filed her return on April 30, 2011, and paid the remaining income tax liability balance. What amount would be subject to the penalty for the underpayment of estimated taxes?
   a. $0
   b. $200
   c. $500
   d. $16,500

28. Jim and Mary are married and file a joint return for 2010. They have one child, Jennifer, who is 7 years old. Assuming their modified AGI for 2010 is $105,000, calculate their Child Tax Credit.
   a. $0
   b. $400
   c. $600
   d. $1,000
29. Bob and Carol are married and file a joint return for 2010. During 2010, they paid $5,500 in qualified adoption expenses for their new son Joshua, who is 7 years old. The amount of the adoption credit for the year is:
   a. $0
   b. $5,000
   c. $5,500
   d. $13,170

30. Bill is single and has modified AGI of $40,000 for 2010. Bill paid $4,000 in tuition for his daughter Kate to attend State University in her freshman year. Determine the amount of Bill’s American Opportunity Credit for the year.
   a. $600
   b. $1,200
   c. $1,800
   d. $2,500

31. Steve is single and has modified AGI of $44,000 for 2010. Steve paid $6,000 in tuition to attend graduate school at State University. Determine the amount of Steve’s Lifetime Learning Credit.
   a. $0
   b. $600
   c. $1,200
   d. $6,000

32. Tom is 45 years old and has a dependent daughter Denise. During 2010, Tom took three premature distributions from his IRA account. The first distribution was $6,000 and was used as a down-payment on his first home. The second distribution was $10,000 and was used to pay off his credit card balances. The third distribution was $8,000 and was used to pay for tuition for his daughter Denise who is attending State University. Tom will be subject to a 10% early withdrawal penalty tax of:
   a. $0
   b. $1,000
   c. $1,600
   d. $2,400

33. Which of the following statements about the child and dependent care credit is correct?
   a. The credit is nonrefundable.
   b. The child must be under the age of 18 years.
   c. The child must be a direct descendant of the taxpayer.
   d. The maximum credit is $600.

34. U Co had cash purchases and payments on account during the current year totaling $455,000. U’s beginning and ending balances for the year were $64,000 and $50,000, respectively. What amount represents U’s accrual basis purchases for the year?
   a. $441,000
   b. $469,000
   c. $505,000
   d. $519,000

35. Dart, a C corporation, distributes software over the Internet and has had average revenues in excess of $20 million dollars per year for the past three years. To purchase software, customers key-in their credit card number to a secure web site and receive a password that allows the customer to immediately download the software. As a result, Dart doesn’t record accounts receivable or inventory on its books. Which of the following statements is correct?
   a. Dart may use either the cash or accrual method as long as Dart elects a calendar year end.
   b. Dart may utilize any method of accounting Dart chooses as long as Dart consistently applies the method it chooses.
   c. Dart must use the accrual method of accounting.
   d. Dart may utilize the cash basis method of accounting until it incurs an additional $10 million to develop additional software.

36. Aviary Corp sold a building for $600,000. Aviary received a down payment of $120,000 as well as annual principal payments of $120,000 for each of the subsequent four years. Aviary purchased the building for $500,000 and claimed depreciation of $80,000. What amount of gain should Aviary report in the year of sale using the installment method?
   a. $180,000
   b. $120,000
   c. $54,000
   d. $36,000
Chapter Five — Answers
Accounting Methods and Periods, and
Computation of Tax Liability and Tax Credits

1. (a) Cash-basis taxpayers report income when it is constructively received. This applies to cash as well as the fair market value of property.

2. (d) $80,000. Alex constructively received the $80,000 salary in 2010. This amount was credited to him, there were no restrictions on his account, and he elected to take only $50,000 rather than the full $80,000.

3. (c) $52,000. Carl reports compensation income of his salary plus value of bargain element of the stock purchase. The difference of $20 per share between the market value ($50) and his purchase price ($30) is treated as compensation.

<table>
<thead>
<tr>
<th>Compensation:</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Salary</td>
<td>$ 50,000</td>
</tr>
<tr>
<td>Stock purchase:</td>
<td></td>
</tr>
<tr>
<td>100 shares @ $20</td>
<td>2,000</td>
</tr>
<tr>
<td></td>
<td>$ 52,000</td>
</tr>
</tbody>
</table>

4. (d) $8,000. In general, all rent received, which includes any prepaid rent as well as the last month’s rent is included as gross income. Security deposits, however, are generally not because of the right of return. In this problem, the security deposit is actually the last three months’ rent and should be included as gross income.

5. (c) $1,200. Dividends on preferred and common stock are generally included as dividend income. Dividends on life insurance policies are simply a return of your premium and are nontaxable.

<table>
<thead>
<tr>
<th>Dividends</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>- preferred stock</td>
<td>$ 400</td>
</tr>
<tr>
<td>- common stock</td>
<td>800</td>
</tr>
<tr>
<td>Total</td>
<td>$ 1,200</td>
</tr>
</tbody>
</table>

6. (b) $460. To determine the gain, you must first determine the basis of the investment. The original issue discount of $1,200 ($10,000 less purchase price of $8,800) represents an adjustment to the interest rate. This discount must be recognized, pro-ratably over the life of the bond. For each year, Carl must recognize interest income of $120, which is $1,200 divided by 10 years. By recognizing interest, the taxpayer increases his basis in the investment.

<table>
<thead>
<tr>
<th>Selling price</th>
<th>$9,500</th>
</tr>
</thead>
<tbody>
<tr>
<td>Original basis</td>
<td>$ 8,800</td>
</tr>
<tr>
<td>Increase in basis:</td>
<td></td>
</tr>
<tr>
<td>2 years @ $120</td>
<td>240</td>
</tr>
<tr>
<td>Adjusted basis</td>
<td>9,040</td>
</tr>
<tr>
<td>Long-term capital gain</td>
<td>460</td>
</tr>
</tbody>
</table>

7. (b) $500. In general, a cash basis taxpayer is allowed a deduction in the year paid. The charging on a credit card qualifies as being paid in 2010 even though the taxpayer does not pay the credit card company until 2011. The issuance and delivery of a promissory note does not give rise to a deduction until it is paid.

8. (a) Farb is entitled to a deduction of $8,000 in 2009 because he paid the contested liability and it remained contested until after the end of the year. Upon settling the issue, Farb must report as income, the recovery of the previously deducted excess $5,000.

9. (d) When a taxpayer maintains inventories, they must use the accrual method of accounting.

10. (a) $165,000. As a cash basis taxpayer, Dr. Chester reports the amounts actually received during the year.

| Cash received - office visits | $ 35,000 |
| Cash received - receivables   | 130,000   |
| Total income                  | $165,000  |
11. (a) Trade date. This is true for a cash or an accrual based taxpayer.

12. (a) $60,000 ordinary income. Even though the covenant is for six years, it is all recognized when received. Payments for covenants not to compete are always classified as ordinary income.

13. (b) By definition

14. (c) $77,000. Adjustments to taxable income before personal exemptions for the purpose of the alternative minimum tax include an add-back for state and local taxes as well as miscellaneous deductions in excess of the 2% floor.

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Taxable income, before personal exemptions</td>
<td>$70,000</td>
</tr>
<tr>
<td>Adjustments:</td>
<td></td>
</tr>
<tr>
<td>State and local taxes</td>
<td>5,000</td>
</tr>
<tr>
<td>Excess miscellaneous deductions</td>
<td>2,000</td>
</tr>
<tr>
<td><strong>Total Adjustments</strong></td>
<td><strong>$77,000</strong></td>
</tr>
</tbody>
</table>

15. (b) The interest from private activity bonds are not included in taxable income, but are considered in the determination of the alternative minimum tax as a preference item. Charitable contributions are allowed as an itemized deduction and are not considered to be a preference item for individuals.

16. (d) The credit for prior year alternative minimum tax credit may be carried forward indefinitely.

17. (a) The general business credit incorporates the limitations for the jobs credit, research credit, disabled access credit, low income housing credit and the investment credit.

18. (d) In order to qualify for the child care credit, both spouses must be gainfully employed. The credit calculation looks to the lesser of the qualifying expenditures or earned income of the spouse with the least amount of earnings. The adjusted gross income threshold of $15,000 is used to determine the percentage of the credit. Once a taxpayer passes the $15,000 threshold, the credit percentage begins decreasing from the maximum of 35% to 20%, but does not disappear.

19. (c) $1,200. Seeing their adjusted gross income exceeds $43,000, the Martin’s child care credit percentage is 20%. Qualifying expenditures cannot exceed $3,000 per child. With two children, a total of $6,000 times the rate of 20% will yield a credit of $1,200.

20. (d) $840. Nora’s adjusted gross income exceeds $15,000 by $14,000. Therefore, her child care credit percentage is 28%. (35% less 7% due to the 1% reduction for every $2,000 over $15,000) Qualifying expenditures cannot exceed $3,000 per child. Nora has two children which means her qualifying expenditures are the lesser of $6,000 or $3,000 (the amount she actually paid). Her credit $3,000 times 28% or $840.

21. (c) The earned income credit is the only refundable credit.

22. (a) The earned income credit is the only refundable credit, which means Kent could receive a refund even if he had no taxes withheld.

23. (c) $570. In computing the credit, the elderly credit considers all types of income. Starting with an initial base amount of $5,000 for a single taxpayer, this Section 37 amount needs to be reduced by social security benefits. There are no other adjustments because adjusted income is not in excess of $7,500.

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Section 37 amount</td>
<td>$5,000</td>
</tr>
<tr>
<td>Less: Social Security</td>
<td>-1,200</td>
</tr>
<tr>
<td>Credit base</td>
<td>$3,800</td>
</tr>
<tr>
<td>Elderly credit rate</td>
<td>15%</td>
</tr>
<tr>
<td>Elderly credit</td>
<td>$570</td>
</tr>
</tbody>
</table>

Note: This credit is only allowed to offset taxes. His taxes are not given in the problem.

24. (b) $60. The elderly credit is limited to the amount of the tax liability, which is $60. However, you must first determine if a credit is even allowable, otherwise zero may be your answer. In computing the credit, the elderly
credit considers all types of income. Starting with an initial base amount of $7,500 for a married taxpayer, this Section 37 amount needs to be reduced by social security benefits. There are no other adjustments because their adjusted income is not in excess of $10,000.

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Section 37 amount</td>
<td>$7,500</td>
</tr>
<tr>
<td>Less: Social Security</td>
<td>-$1,250</td>
</tr>
<tr>
<td>Credit base</td>
<td>$6,250</td>
</tr>
<tr>
<td>Elderly credit rate</td>
<td>15%</td>
</tr>
<tr>
<td>Elderly credit</td>
<td>$937</td>
</tr>
</tbody>
</table>

The Crane’s actual tax liability is $60. Therefore, the credit is limited to $60.

25. (c) The excess social security tax withheld can be claimed as a credit against income tax only if it is the result of correct overwithholding due to having two or more employers in a taxable year.

26. (a) Only the estimated payments in Proposal I will allow Baker to avoid the penalty. The safe harbor of paying 100% of the prior year’s tax is no longer available for taxpayers with adjusted gross income of more than $150,000. The new safe harbor for those individuals is 110% of the prior year’s tax.

27. (a) In order to avoid any penalty on the underpayment of tax, a taxpayer must pay at least 90% of the current year’s tax. Whereas the income tax liability was $16,500, the $16,000 of withholdings plus the $300 of additional taxes paid with the extension, clearly exceed the 90% threshold.

28. (d) $1,000 A Child Tax Credit of $1,000 is allowed in 2010 for those taxpayers having qualifying children under the age of 17. Therefore, Jim and Mary qualify with the 7 year old dependent. They do not exceed the $110,000 threshold for any phase-outs.

29. (c) $5,500. The adoption credit is limited to the lessor of the amount paid for qualified adoption expenses or $13,170 per child.

30. (d) $2,500. The American Opportunity Credit is allowed based upon the lessor of the amount paid or 100% of the first $2,000 of tuition, fees and course materials, plus 25% of the next $2,000 for a maximum of $2,500.

31. (c) $1,200. The Lifetime Learning Credit is equal to 20% of the tuition and fees paid up to a maximum of $2,000. Steve’s tuition is $6,000 at 20% = $1,200.

32. (b) $1,000. The 10% premature distribution tax will only be assessed on the $10,000 withdrawal used to pay off credit card balances. Withdrawals for qualified education expenses and qualified first-time home buyers are no longer subject to the 10% premature distribution tax.

33. (a) The child and dependent care credit is not refundable. The child must be under the age of 13, a dependent and not necessarily a direct descendant (a broader definition) and the maximum credit is $1,200 (for 2 or more children).

34. (a) $441,000. To determine the accrual basis purchases from cash basis records, you must take the cash paid during the year for purchases, then add any unpaid purchases at year end, and then subtract out the amounts paid for the beginning of the year payables. Therefore in our problem, $455,000 plus $50,000 less $64,000 = $441,000.

35. (c) As a large C corporation, Dart must use the accrual method accounting.
36. (d) $36,000. Under the installment method, Aviary will recognize income on a pro-rata basis based upon the cash received and the gross profit percentage. Aviary’s total cost of $500,000 less the depreciation of $80,000, results in an adjusted basis of $420,000. Then, comparing the selling price of $600,000 with the adjusted basis of $420,000, yields a gain of $180,000 or 30% of the selling price. Since the current year’s receipt is $120,000, the formula to calculate the recognized gain is:

\[
\text{Current receipts} \times \left( \frac{\text{Gross Profit}}{\text{Total Return}} \right) = \text{Recognized Gain}
\]

\[
\frac{120,000}{600,000} \times 180,000 = 36,000
\]
Chapter Six
Capital Transactions

GENERAL RULE................................................................................................................................. 6-1
   Long-term vs. Short-term
   Netting Process
   Related Party Transactions
   Wash Sales
   Trade Date/Settlement Date
   Section 1244
   Worthless Securities
   Bad Debts

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   Adjustment to Basis for Gift Taxes Paid
   Property Received by Inheritance
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   Involuntary Conversions

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Chapter Six
Capital Transactions

GENERAL RULE
When a taxpayer sells or exchanges property, a realized gain or loss is determined for the difference between the amount realized and the property’s adjusted basis. A realized gain or loss is generally recognized for tax purposes, unless one of the many provisions addressed within this chapter excludes it.

The amount realized from the sale or exchange of property usually represents its selling price. On the sale, the taxpayer often receives cash, or other property having a fair market value. Sometimes, the taxpayer may be relieved of an obligation, such as a mortgage. These are all considered part of the amount realized.

The property’s adjusted basis is frequently its cost. If the property is real estate, it might include increases for improvements as well as decreases for depreciation allowed over the years. If the property was received as a gift or inheritance, there are special basis rules which are covered later.

Example 1: K sells her automobile to W for $10,000. K receives $4,000 in cash and a stock investment worth $6,000 from W. K had purchased the automobile last year for $8,000 and does not use it for business. K’s realized gain is determined as follows:

<table>
<thead>
<tr>
<th>Amount realized:</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
</tr>
<tr>
<td>FMV of securities</td>
</tr>
<tr>
<td>Total amount realized</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Less: adjusted basis</th>
</tr>
</thead>
<tbody>
<tr>
<td>Realized gain</td>
</tr>
</tbody>
</table>

K’s realized gain would also be her recognized gain, unless there is a specific tax provision that causes the gain not to be recognized.

LONG-TERM vs. SHORT-TERM
The sale of property held for more than one year is classified as long-term. For property held for not more than one year, it is short-term. The holding period classification is important because long-term capital gains are generally taxed at a lower rate than the short-term capital gains that are treated as ordinary income. The long-term capital gain rates for 2010 are either 0% or 15%.

The tax rates, as described in Chapter 5, are shown below with a comparison to the long-term capital gains rates.

<table>
<thead>
<tr>
<th>Ordinary Income Rates</th>
<th>Capital Gain Rates</th>
</tr>
</thead>
<tbody>
<tr>
<td>10%</td>
<td>0%</td>
</tr>
<tr>
<td>15%</td>
<td>0%</td>
</tr>
<tr>
<td>25%</td>
<td>15%</td>
</tr>
<tr>
<td>28%</td>
<td>15%</td>
</tr>
<tr>
<td>33%</td>
<td>15%</td>
</tr>
<tr>
<td>35%</td>
<td>15%</td>
</tr>
</tbody>
</table>

For gains on the sale of real estate, the rates differ slightly. For any long-term capital gain that is attributable to the recapture of depreciation (Section 1250), the maximum rate is 25%. Also, the new law does not change the 28% tax rate on the sale of collectibles, nor does it impact C Corporations.
NETTING PROCESS
In summarizing a taxpayer’s capital activity for the year, it is important to group the gains and losses correctly. This is due to the various tax treatments and limitations affecting capital transactions. The hierarchy for netting capital transactions is:

- Net all the short-term transactions.
- Net all the long-term transactions.
- Net the net transactions, if possible.

If the net short-term capital gains exceed the net long-term capital losses, the result is taxed as ordinary income. If the net long-term capital gains exceed the net short-term capital losses, the result is taxed at the long-term capital gain rate. If the capital losses (regardless of holding period) exceed the capital gains, then up to $3,000 may be deducted from ordinary income in that year. (For taxpayers who are married filing separately, the amount allowed is $1,500.) Any loss in excess of $3,000 is carried forward indefinitely, and will retain its original (short-term or long-term) character.

Example 2: For 2010, T has a long-term capital gain of $4,000; long-term capital loss of $2,000; short-term capital gain of $2,000; and a short-term capital loss of $8,000. T also has adjusted gross income of $30,000 before this transaction.

| Step 1: Net the short transactions: | Capital gain | 2,000 |
|                                    | Capital loss | -8,000 |
|                                    | Net short-term loss | -6,000 |

| Step 2: Net the long-term transactions: | Capital gain | 4,000 |
|                                         | Capital loss | -2,000 |
|                                         | Net long-term gain | 2,000 |

| Step 3: Net the net transactions | Net short-term losses | -6,000 |
|                                 | Net long-term gain | 2,000 |
|                                 | Net short-term loss | -4,000 |

| Step 4: Check for any limitations | Maximum deductible | 3,000 |

| Step 5: Determine any carryovers | Total short-term capital loss | 4,000 |
|                                   | Utilized in current year | -3,000 |
|                                   | Carryover (short-term) | 1,000 |

Therefore, T’s adjusted gross income will be $30,000 less the $3,000, or $27,000.

RELATED PARTY TRANSACTIONS
When a taxpayer enters into a sale or exchange of property with a related party, the general rule is that no loss is recognized. The disallowed loss, however, is suspended until the related party disposes of the property. If the property is subsequently sold for a gain, the disallowed loss may be used to offset the gain. If, instead, the property is subsequently sold for a loss, the disallowed loss is never recognized.

The brief definition of a related party from Code Section 267 includes:

- Members of your family (brothers, sisters, spouse, ancestors and lineal descendants)
- Your corporation if you own more than 50% of the stock
- Your partnership if you have more than a 50% interest
- Your trust if you are a beneficiary or fiduciary

6-2
Example 3: F sells stock to his daughter D for $6,000. F had purchased the stock three years ago at a cost of $10,000. D later sells the stock for (A) $5,000, (B) $11,000 and (C) $8,000. (This example contrasts three different sales)

<table>
<thead>
<tr>
<th></th>
<th>A</th>
<th>B</th>
<th>C</th>
</tr>
</thead>
<tbody>
<tr>
<td>F’s initial sale</td>
<td>$6,000</td>
<td>$6,000</td>
<td>$6,000</td>
</tr>
<tr>
<td>F’s adjusted basis</td>
<td>-10,000</td>
<td>-10,000</td>
<td>-10,000</td>
</tr>
<tr>
<td>F’s realized &amp; disallowed loss</td>
<td>$ -4,000</td>
<td>$ -4,000</td>
<td>$ -4,000</td>
</tr>
<tr>
<td>D’s sale</td>
<td>$5,000</td>
<td>$11,000</td>
<td>$8,000</td>
</tr>
<tr>
<td>D’s basis</td>
<td>6,000</td>
<td>6,000</td>
<td>6,000</td>
</tr>
<tr>
<td>D’s realized gain or loss</td>
<td>$ -1,000</td>
<td>$ 5,000</td>
<td>$ 2,000</td>
</tr>
<tr>
<td>F’s disallowed loss</td>
<td>0</td>
<td>4,000</td>
<td>2,000</td>
</tr>
<tr>
<td>D’s recognized gain or loss</td>
<td>$ -1,000</td>
<td>$ 1,000</td>
<td>$ 0</td>
</tr>
</tbody>
</table>

In the first scenario, the selling price is less than D’s basis, and her realized loss of $1,000 is recognized. Her father’s disallowed loss is never recognized. In the second situation, the selling price is greater than D’s basis, and all of her father’s $4,000 disallowed loss can be used to partially offset the $5,000 gain. In the third situation, the selling price is again above D’s basis, but only by $2,000. Therefore only $2,000 of her father’s disallowed loss can be used to offset the gain, and the balance of his loss is never recognized.

WASH SALES
If a taxpayer sells, and repurchases substantially identical stock within thirty days of the sale, any loss on the transaction is disallowed. This is called a wash sale. The situation frequently occurs when a taxpayer sells securities that have gone down in value just prior to the end of the year in order to recognize a loss for tax purposes. The taxpayer usually believes that the decrease in value is only temporary, and goes out and repurchases the same securities right after the end of the year. In essence, nothing has really happened economically. The taxpayer owns the same securities he did just a few days ago.

The wash sale rules apply only to losses and not to gains. The thirty day period runs before and after the sale. Any real loss on the sale and repurchase of the stock is added to the basis of the new stocks acquired.

TRADE DATE/SETTLEMENT DATE
When a stock transaction takes place, there are usually two critical dates. The trade date is the day the transaction actually takes place and is the one used for tax purposes. The settlement date usually occurs a few days after the trade date, and is when the paperwork is completed, the money is transferred, etc. It is not the date to use for tax purposes.

SECTION 1244
Most stock transactions result in a recognized capital gain or loss. A long-term capital gain provides a favorable rate, while net capital losses are limited to $3,000 per year. There is one category of stock that allows an even better capital gain treatment and gives the taxpayer a larger loss deduction. This is called Section 1244 stock. Section 1244 stock can only be issued by a small business corporation and must be the original issue. A small business corporation is one that does not have stock in excess of $1 million in the initial offering. What makes the stock attractive is that ordinary losses of up to $100,000 per year (if married filing jointly, or $50,000 if single) can be deducted as an ordinary loss. Any losses beyond that amount are treated as capital losses.
Example 4: F Corporation issued qualified stock under Section 1244 to T, its sole shareholder for $100,000. Three years later in 2010, T sold the stock to M for $35,000. Assume T is single and in 2010 his only other income is a salary of $75,000.

| Selling price | $ 35,000 |
| Adjusted basis | 100,000 |
| Recognized loss | 65,000 |

**Character of the loss**

| Section 1244 loss | $ 50,000 |
| Capital loss | 15,000 |
| **Total** | $ 65,000 |

T recognizes a $65,000 loss on the transaction, of which $50,000 is ordinary and fully deducted against his salary. There is also a $15,000 capital loss, of which only $3,000 is currently deductible. The balance of $12,000 is carried forward indefinitely.

T’s adjusted gross income is as follows:

| Salary | $ 75,000 |
| Section 1244 loss | -50,000 |
| Capital loss | -3,000 |
| Adjusted gross income | $ 22,000 |

In addition to the benefit of an ordinary loss deduction, the Revenue Reconciliation Act of 1993 allows a non-corporate taxpayer a 50% gain exclusion on qualified small business stock purchased after August 10, 1993 under Section 1202. If the stock is held for at least 5 years, only 50% of the gain is taxed at the capital gain rate.

**WORTHLESS SECURITIES**

Instead of an actual sale or exchange, sometimes a security held for investment simply becomes worthless and has no value. When that occurs, the property is deemed to have been sold on the last day of the taxable year. The effect of this rule would be to possibly convert a short-term capital loss into a long-term capital loss.

Example 5: R purchased stock in G Corporation on September 20, 2010. On March 20, 2011, R was notified that G Corporation was insolvent and the stock was worthless. Even though R held the stock only six months before it became worthless, it is deemed sold as of December 31, 2011, and therefore the holding period for the loss is long-term (more than a year).

**BAD DEBTS**

When a taxpayer extends credit to another taxpayer in the form of a loan, and then the loan becomes uncollectible, a deduction is allowed. When an accrual based taxpayer sells goods and services in exchange for a receivable, and the receivable becomes uncollectible, a deduction is allowed. The character of the deduction is based upon whether the bad debt is a business or non-business bad debt.

A business bad debt results from the taxpayer being in the business of lending money or the rendering goods and services in exchange for the receivable. These bad debts are treated as an ordinary loss in the year incurred.

A non-business bad debt is always treated as a short-term capital loss. Whereas a deduction may be allowed for the partial worthlessness of a business bad debt, no such deduction is allowed on the partial worthlessness of a non-business bad debt.
BASIS COMPUTATIONS

PROPERTY RECEIVED BY GIFT
In general, when a taxpayer receives property as a gift, the basis of the property is transferred from the donor to the donee. In addition, the holding period of the property “tacks over” to the donee. This general rule applies when the fair market value of the gift exceeds the adjusted basis of the property transferred.

When the fair market value of the property is less than the adjusted basis of the property, the donee’s basis will be the donor’s basis only for the purpose of determining a gain. For the purposes of determining a loss, the donee’s basis will be the fair market value of the property. At any selling price between the fair market value and the adjusted basis the result is no gain or loss.

Example 6: T gives S land with a fair market value of $40,000 and an adjusted basis of $32,000. T had purchased the land on March 15, 1990. S’s basis in the land is $32,000 and his holding period begins on March 15, 1990.

Example 7: V gives W land with a fair market value of $40,000 and an adjusted basis of $65,000. Determine the gain or loss if W sells the land for (A) $30,000; (B) $45,000; and (C) $75,000.

<table>
<thead>
<tr>
<th>Selling price</th>
<th>A</th>
<th>B</th>
<th>C</th>
</tr>
</thead>
<tbody>
<tr>
<td>W’s adjusted basis</td>
<td>40,000</td>
<td>45,000</td>
<td>65,000</td>
</tr>
<tr>
<td>Realized gain (loss)</td>
<td>$(10,000)</td>
<td>$0</td>
<td>$10,000</td>
</tr>
</tbody>
</table>

ADJUSTMENT TO BASIS FOR GIFT TAXES PAID
When a taxpayer makes a gift of property, that transfer may be subject to a gift tax. If the donor pays a gift tax on a transfer, then the basis of the property received by the donee is increased by a prorata share of the gift tax paid.

Example 8: Referring to Example 6, assume that T paid $4,000 in gift taxes on the transfer to S. The increase in the fair market value of the property was $8,000 ($40,000 - $32,000). The gift tax paid of $4,000 times the appreciation over the fair market value represents the gift tax adjustment.

$$
\frac{\$4,000 \times \$8,000}{\$40,000} = \$800
$$

Donor’s adjusted basis $32,000
Add: Gift tax adjustment 800
Donee’s adjusted basis $32,800

PROPERTY RECEIVED BY INHERITANCE
In general, when a taxpayer receives property as an inheritance (from a decedent), the basis of the property is its fair market value as of the date of death. The holding period is automatically long-term for the purpose of determining gain or loss on the subsequent sale by the beneficiary. For 2010 there are some new limitations on the step up basis to the fair market value, but that should be beyond the scope of the exam. The maximum step is $1.3 million to a
non-spouse with an additional $3 million to the spouse. If all goes to the spouse, the step-up cannot exceed $4.3 million.

If the executor elects the alternate valuation date, the basis of the property will be the value on the date six months after the date of death. However, if the alternate valuation date is elected and property is distributed prior to the six month date, then the property is valued as of the date of distribution. See Chapter 12 for more details.

Example 9: T dies and bequeaths land with a fair market value of $140,000 and an adjusted basis of $40,000 to his son S. T had purchased the land on March 15, 1980. S’s basis in the land will be $140,000 and his holding period is long-term. If S sells the land in three months for $150,000, the gain will be long-term even though S only held the land for three months.

<table>
<thead>
<tr>
<th>Selling price</th>
<th>$150,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>S’s basis</td>
<td>140,000</td>
</tr>
<tr>
<td>Realized gain</td>
<td>$10,000</td>
</tr>
</tbody>
</table>

STOCK DIVIDENDS
In general, the receipt of a stock dividend by a shareholder is non-taxable. If a common stock dividend is received on the common stock, then the basis of the stock received is determined by merely allocating the existing basis of the common stock to the new total number of common shares currently held. If a preferred stock dividend is received on the common stock, then the basis of the preferred stock is determined by allocating the existing basis of the common stock to the common stock and the new preferred stock based upon the relative fair market of all the stock.

Some stock dividends may be taxable. For example, if the taxpayer has the option of receiving either a stock dividend or cash dividend, that dividend will be taxable to the shareholder to the extent of the fair market value of the stock received. The income recognized will then be the basis of the stock dividend.

NON-TAXABLE TRANSACTIONS
In general, no gain or loss is recognized on the exchange of property of a like kind. It is not unusual for a taxpayer to trade-in one vehicle for another vehicle, or exchange one machine for another. Congress believes that when there is no real change in the type of the asset being used, that no gain or loss should be recognized. However, the receipt of cash or other property as part of a like-kind exchange, could cause the recognition of gain. Exchanges which qualify for this treatment include:

- Property held for productive use or investment - referred to as like-kind exchanges
- Common stock for common stock of the same corporation, or preferred for preferred
- Common stock for assets being transferred assuming 80% control after the transfer - See Chapter 8
- Partnership interest for assets being transferred - See Chapter 7

LIKE-KIND EXCHANGES
In order to qualify for like-kind treatment, the property being exchanged must be of a like kind. In general, real property may be exchanged for real property. Personal property may be exchanged for personal property. However, personalty cannot be exchanged for realty on a tax-free basis. Except for the tax-free exchange of common for common and preferred for preferred, the exchange of other securities do not qualify as like-kind exchanges.

When property other than of a like-kind is involved in a transfer, the receipt of this other property is considered boot and may cause the recognition of gain. The amount of the recognized gain, however, cannot exceed the amount of realized gain.
The basis of property received in a like-kind exchange is the basis of the property being transferred by the taxpayer. If any gain is recognized, the basis is increased by that amount. If the taxpayer receives boot, basis must be allocated first to the boot and then to the transferred property.

**Example 10:** F exchanges equipment used in his business that has a fair market value of $10,000 and an adjusted basis of $6,000 with T. T transfers like-kind property to F worth $10,000 and an adjusted basis of $8,000.

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fair market value of property received by F</td>
<td>$10,000</td>
</tr>
<tr>
<td>Adjusted basis of property transferred to T</td>
<td>$6,000</td>
</tr>
<tr>
<td>Realized gain</td>
<td>$4,000</td>
</tr>
<tr>
<td>Recognized gain</td>
<td>$0</td>
</tr>
</tbody>
</table>

No gain or loss is recognized on this like-kind exchange. F’s basis in the new property is his original $6,000.

**Example 11:** Assume the same facts as in Example 10 except that the fair value of T’s property was only $9,000. Since F is giving up an asset worth $10,000 and only receiving an asset worth $9,000, T agrees to give F $1,000 in cash. The cash is considered other property, or boot.

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fair market value of property received by F</td>
<td>$9,000</td>
</tr>
<tr>
<td>Cash, or boot received</td>
<td>$1,000</td>
</tr>
<tr>
<td>Total amount realized</td>
<td>$10,000</td>
</tr>
<tr>
<td>Adjusted basis of property transferred to T</td>
<td>$6,000</td>
</tr>
<tr>
<td>Realized gain</td>
<td>$4,000</td>
</tr>
<tr>
<td>Recognized gain</td>
<td>$1,000</td>
</tr>
</tbody>
</table>

The $1,000 in boot received causes $1,000 of the $4,000 realized gain to be recognized. The basis of the new property is $6,000, and is determined as follows:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Original basis in the property</td>
<td>$6,000</td>
</tr>
<tr>
<td>Plus: gain recognized</td>
<td>$1,000</td>
</tr>
<tr>
<td>Total basis</td>
<td>$7,000</td>
</tr>
<tr>
<td>Less: basis in cash received</td>
<td>-$1,000</td>
</tr>
<tr>
<td>Basis of equipment</td>
<td>$6,000</td>
</tr>
</tbody>
</table>
SALE OF PRINCIPAL RESIDENCE

With regards to the sale of a taxpayer’s principal residence, any taxpayer, regardless of age, who has owned and used their home as a principal residence for at least 2 of the last 5 years before the sale, can exclude from income up to $250,000 of the gain on the sale ($500,000 if married and filing a joint return). This exclusion is no longer available only once in the taxpayer’s lifetime, but can be used repeatedly, although no more frequently than every two years.

If a taxpayer maintains his residence for less than two years, the amount of the exclusion is pro-rated if the sale is due to a change in place of employment, health or unforeseen circumstances.

Example 12: J is single and has always lived in his house. J sells his residence on May 10, 2010 for $225,000 and incurs selling expenses and commission of $15,000. J originally purchased the house in 1954 for $30,000 and has paid $20,000 for capital improvements.

<table>
<thead>
<tr>
<th>Selling price</th>
<th>$225,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Less:</td>
<td></td>
</tr>
<tr>
<td>Original cost</td>
<td>$30,000</td>
</tr>
<tr>
<td>Improvements</td>
<td>20,000</td>
</tr>
<tr>
<td>Selling expenses</td>
<td>15,000</td>
</tr>
<tr>
<td>Realized gain</td>
<td>65,000</td>
</tr>
<tr>
<td>New Section 121 exclusion</td>
<td>-160,000</td>
</tr>
<tr>
<td>Recognized gain</td>
<td>$0</td>
</tr>
</tbody>
</table>

IN VOLUNTARY CONVERSIONS

If a taxpayer’s property is involuntarily converted (fire, flood, etc.), no gain is recognized to the extent that the insurance proceeds are reinvested in similar property within a replacement period. The replacement period is two years, after the end of the taxable year in which the event occurs. The period for real property is three years.

CAPITAL ASSETS AND SECTION 1231 ASSETS

Capital assets include investment property and property held for personal use. Typical personal assets include investments, furniture, jewelry, and the personal residence. However, capital assets do not include:

- Inventory (stock in trade)
- Depreciable property or real estate used in the trade or business
- Accounts receivable
- Copyrights
- Covenant not to compete

If items, such as depreciable property and real estate used in a trade or business, are excluded from the definition of capital assets, then why is it that the sale of this property yields capital gains? The answer is Section 1231.

Section 1231 is the Code Section that recharacterizes the gain from the sale of the depreciable property as capital even though it has been exempted from the capital asset classification. Apart from any depreciation recapture, the gain from the sale of depreciable property will result in long-term capital gain treatment provided that the asset is
held for more than one year. However, if the property is sold at a loss, the loss is ordinary, not capital, and is fully deductible.

**RECAPTURE RULES**

When a taxpayer sells property used in a trade or business, or property used for the production of income, the gain is the difference between the selling price and the adjusted basis. The adjusted basis is usually made up of the original cost less any depreciation. The depreciation claimed by the taxpayer gives rise to an ordinary deduction, not a capital deduction (loss). Therefore, logic dictates (as does Section 1245) that if a gain is recognized on the sale of the property, and some of the gain is attributable to the depreciation claimed, then that portion of the gain should be treated as ordinary income.

**Personal property** - any gain attributable to the depreciation taken is classified as ordinary income.

**Real property** - any gain attributable to excess of accelerated depreciation over straight-line depreciation is treated as ordinary income. However, if the property is held for one year or less, all the depreciation will be recaptured as ordinary income, not just the excess.

**Example 13:** W operates a machine shop and sold a piece of machinery used in his trade or business for $20,000. W purchased the asset three years ago at a cost of $18,000 and claimed depreciation of $12,000 during the past three years. W will recognize a total gain of $14,000 on the sale. The character of the gain is determined under Section 1245 for the depreciation recapture and Section 1231 for the capital gain treatment.

<table>
<thead>
<tr>
<th>Selling price</th>
<th>$ 20,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Adjusted basis:</td>
<td></td>
</tr>
<tr>
<td>Original cost</td>
<td>$18,000</td>
</tr>
<tr>
<td>Acc. depreciation</td>
<td>-12,000</td>
</tr>
<tr>
<td>Adjusted basis</td>
<td>-6,000</td>
</tr>
<tr>
<td>Recognized gain</td>
<td>$ 14,000</td>
</tr>
</tbody>
</table>

**Character of the gain:**

**Ordinary income** recaptured
under Section 1245
$ 12,000

**Capital gain** under
Section 1231
2,000

**Total gain**
$ 14,000
CAPITAL GAINS AND LOSSES

Items 1 and 2 are based on the following:
Conner purchased 300 shares of Zinco stock for $30,000 in 1980. On March 23, 2010, Conner sold all the stock to his daughter Alice for $20,000, its then fair market value. Conner realized no other gain or loss during 2010. On April 26, 2010, Alice sold the 300 shares of Zinco for $25,000.

1. What amount of the loss from the sale of Zinco stock can Conner deduct in 2010?
   a. $0
   b. $3,000
   c. $5,000
   d. $10,000

2. What was Alice's recognized gain or loss on her sale?
   a. $0
   b. $5,000 long-term gain.
   c. $5,000 short-term loss.
   d. $5,000 long-term loss.

3. Lee qualified as head of a household for 2010 tax purposes. Lee's 2010 taxable income was $100,000, exclusive of capital gains and losses. Lee had a net long-term loss of $8,000 in 2010. What amount of this capital loss can Lee offset against 2010 ordinary income?
   a. $0
   b. $3,000
   c. $4,000
   d. $8,000

4. For the 2010 year, Michael King reported salary and taxable interest income of $40,000. His capital asset transactions during the year were as follows:

   Long-term capital gains $2,000
   Long-term capital losses (8,000)
   Short-term capital gains 1,000

   King should report adjusted gross income of
   a. $35,000.
   b. $37,000.
   c. $39,000.
   d. $40,000.

5. Paul Beyer, who is unmarried, has taxable income of $30,000 exclusive of capital gains and losses and his personal exemption. In 2010, Paul incurred a $1,000 net short-term capital loss and a $5,000 net long-term capital loss. His capital loss carryover to 2011 is
   a. $5,000 long-term loss.
   b. $3,000 long-term loss.
   c. $6,000 short-term loss.
   d. $3,000 short-term loss.

6. Among which of the following related parties are losses from sales and exchanges not recognized for tax purposes?
   c. Grandfather and granddaughter.
   d. Ancestors, lineal descendants, and all in-laws.

7. In 2008, Fay sold 100 shares of Gym Co. stock to her son, Martin, for $11,000. Fay had paid $15,000 for the stock in 2007. Subsequently in 2010, Martin sold the stock to an unrelated third party for $16,000. What amount of gain from the sale of the stock to the third party should Martin report on his 2010 income tax return.
   a. $0
   b. $1,000
   c. $4,000
   d. $5,000

8. Smith, an individual calendar-year taxpayer, purchased 100 shares of Core Co. common stock for $15,000 on December 15, 2009, and an additional 100 shares for $13,000 on December 30, 2009. On January 3, 2010, Smith sold the shares purchased on December 15, 2009, for $13,000. What amount of loss from the sale of Core's stock is deductible on Smith's 2009 and 2010 income tax returns:
   a. $0 $0
   b. $0 $2,000
   c. $1,000 $1,000
   d. $2,000 $0
9. Fred Berk bought a plot of land with a cash payment of $40,000 and a purchase money mortgage of $50,000. In addition, Berk paid $200 for a title insurance policy. Berk's basis in this land is
   a. $40,000
   b. $40,200
   c. $90,000
   d. $90,200

10. In 2010, Joan Reed exchanged commercial real estate that she owned for other commercial real estate plus cash of $50,000. The following additional information pertains to this transaction:

   **Property given up by Reed**
   - Fair market value: $500,000
   - Adjusted basis: $300,000

   **Property received by Reed**
   - Fair market value: $450,000

   What amount of gain should be recognized in Reed's 2010 income tax return?
   a. $200,000
   b. $100,000
   c. $50,000
   d. $0

11. Al Eng owns 55% of the outstanding stock of Rego Corp. During 2010, Rego sold a trailer to Eng for $10,000. The trailer had an adjusted tax basis of $12,000, and had been owned by Rego for three years. In its 2010 income tax return, what is the allowable loss that Rego can claim on the sale of this trailer?
   a. $0
   b. $2,000 ordinary loss.
   c. $2,000 Section 1231 loss.
   d. $2,000 Section 1245 loss.

12. For a cash basis taxpayer, gain or loss on a year-end sale of listed stock arises on the
   a. Trade date.
   b. Settlement date.
   c. Date of receipt of cash proceeds.
   d. Date of delivery of stock certificate.

13. For assets acquired in 2010, the holding period for determining long-term capital gains and losses is more than
   a. 18 months.
   b. 12 months.
   c. 9 months.
   d. 6 months.

14. Joe Hall owns a limousine for use in his personal service business of transporting passengers to airports. The limousine's adjusted basis is $40,000. In addition, Hall owns his personal residence and furnishings, that together cost him $280,000. Hall's capital assets amount to
   a. $320,000
   b. $280,000
   c. $40,000
   d. $0

15. In March 2010, Ruth Lee sold a painting for $25,000 that she had bought for her personal use in 1991 at a cost of $10,000. In her 2010 return, Lee should treat the sale of the painting as a transaction resulting in
   a. Ordinary income.
   b. Long-term capital gain.
   c. Section 1231 gain.
   d. No taxable gain.

16. A 2010 capital loss incurred by a married couple filing a joint return
   a. Will be allowed only to the extent of capital gains.
   b. Will be allowed to the extent of capital gains, plus up to $3,000 of ordinary income.
   c. May be carried forward up to a maximum of five years.
   d. Is not an allowable loss.

17. For a married couple filing a joint return, the excess of net long-term capital loss over net short-term capital gain is
   a. Reduced by 50% before being deducted from ordinary income.
   b. Limited to a maximum deduction of $3,000 from ordinary income.
   c. Allowed as a carryover against future capital gains up to a maximum period of five years.
   d. Not deductible from ordinary income.

18. Which of the following is a capital asset?
   a. Delivery truck.
   b. Goodwill.
   c. Land used as a parking lot for customers.
   d. Treasury stock, at cost.
19. Olive Bell bought a house for use partially as a residence and partially for operation of a retail gift shop. In addition, Olive bought the following furniture:

Kitchen sets and living room pieces for the residential portion $ 8,000
Showcases and tables for the business portion 12,000

How much of this furniture comprises capital assets?

a. $0  
b. $8,000  
c. $12,000  
d. $20,000

GIFTS AND INHERITANCES

Items 20 through 22 are based on the following data:
In 2007, John Cote bought 100 shares of a listed stock for $2,400. In 2010, when the fair market value was $2,200, John gave the stock to his brother, David. No gift tax was due.

20. If David sells this stock for $2,600, his basis is
   a. $0.  
b. $2,200.  
c. $2,400.  
d. $2,600.

21. If David sells this stock for $2,000, his basis is
   a. $0.  
b. $2,000.  
c. $2,200.  
d. $2,400.

22. If David sells this stock for $2,300, his reportable gain or loss is
   a. $0.  
b. $100 loss.  
c. $100 gain.  
d. $2,300 gain.

23. On July 1, 2010, Thomas Rich acquired certain stocks with a fair market value of $22,000 by gift from his father. The stocks had been acquired by the father on April 1, 2007, at a cost of $40,000. Thomas sold all the stocks for $28,000 on December 12, 2010. What amount should Thomas report as capital gain or loss on his tax return as a result of the above?
   a. $0.  
b. $2,400 gain.  
c. $6,000 gain.  
d. $12,000 loss.

Items 24 through 26 are based on the following data:
In 2007, Iris King bought a diamond necklace for her own use, at a cost of $10,000. In 2010, when the fair market value was $12,000, Iris gave this necklace to her daughter, Ruth. No gift tax was due.

24. Ruth's holding period for this gift
   a. Starts in 2010.  
c. Depends on whether the necklace is sold by Ruth at a gain or at a loss.  
d. Is irrelevant because Ruth received the necklace for no consideration of money or money's worth.

25. This diamond necklace is a
   a. Capital asset.  
b. Section 1231 asset.  
c. Section 1245 asset.  
d. Section 1250 asset.

26. If Ruth sells this diamond necklace in 2010 for $13,000, Ruth's recognized gain would be
   a. $3,000  
b. $2,000  
c. $1,000  
d. $0

27. On January 10, 2007, Martin Mayne bought 3,000 shares of Hance Corporation stock for $300,000. The fair market values of this stock on the following dates were as follows:
   December 31, 2009 $210,000
   March 31, 2010 240,000
   June 30, 2010 270,000

   Martin died on December 31, 2009, bequeathing this stock to his son, Philip. The stock was distributed to Philip on March 31, 2010. The alternate valuation date was elected for Martin's estate. Philip's basis for this stock is
   a. $210,000.  
b. $240,000.  
c. $270,000.  
d. $300,000.
28. On June 1, 2010, Ben Rork sold 500 shares of Kul Corp. stock. Rork had received this stock on May 1, 2010, as a bequest from the estate of his uncle, who died on March 1, 2010. Rork's basis was determined by reference to the stock's fair market value on March 1, 2010. Rork's holding period for this stock was
   a. Short-term.
   b. Long-term.
   c. Short-term if sold at a gain; long-term if sold at a loss.
   d. Long-term if sold at a gain; short-term if sold at a loss.

29. On February 1, 2010, Hall learned that he was bequeathed 500 shares of common stock under his father's will. Hall's father had paid $2,500 for the stock in 1990. Fair market value of the stock on February 1, 2010, the date of his father's death, was $4,000 and had increased to $5,500 six months later. The executor of the estate elected the alternate valuation date for estate tax purposes. Hall sold the stock for $4,500 on June 1, 2010, the date that the executor distributed the stock to him. How much income should Hall include in his 2010 individual income tax return for the inheritance of the 500 shares of stock which he received from his father's estate?
   a. $5,500
   b. $4,000
   c. $2,500
   d. $0

30. If Laura sells the 500 shares of Liba stock in 2010 for $5,000, her basis is
   a. $5,000
   b. $4,000
   c. $3,000
   d. $0

31. If Laura sells the 500 shares of Liba stock in 2010 for $2,000, her basis is
   a. $4,000
   b. $3,000
   c. $2,000
   d. $0

32. If Laura sells the 500 shares of Liba stock in 2010 for $3,500, what is the reportable gain or loss in 2010?
   a. $3,500 gain.
   b. $500 gain.
   c. $500 loss.
   d. $0.

33. Fred Zorn died on January 5, 2010, bequeathing his entire $2,000,000 estate to his sister, Ida. The alternate valuation date was validly elected by the executor of Fred's estate. Fred's estate included 2,000 shares of listed stock for which Fred's basis was $380,000. This stock was distributed to Ida nine months after Fred's death. Fair market values of this stock were:
   At the date of Fred's death $400,000
   Six months after Fred's death 450,000
   Nine months after Fred's death 480,000

   Ida's basis for this stock is
   a. $380,000
   b. $400,000
   c. $450,000
   d. $480,000

**STOCK DIVIDENDS**

   a. No gain or loss since the stock dividend was nontaxable.
   b. $500 of long-term capital gain.
   c. $1,000 of long-term capital gain.
   d. $5,500 of long-term capital gain.

35. On January 5, 2007, Norman Harris purchased for $6,000, 100 shares of Campbell Corporation common stock. On July 8 of this year he received a nontaxable stock dividend of 10 shares of Campbell Corporation $100 par value preferred stock. On that date, the market values per share of the common and preferred stock were $75 and $150, respectively. Harris' tax basis for the common stock after the receipt of the stock dividend is
   a. $2,000.
   b. $4,500.
   c. $5,000.
   d. $6,000.
Items 36 and 37 are based on the following data:
In January 2010, Joan Hill bought one share of Orban Corp. stock for $300. On March 1, 2010, Orban distributed one share of preferred stock for each share of common stock held. This distribution was nontaxable. On March 1, 2010, Joan's one share of common stock had a fair market value of $450, while the preferred stock had a fair market value of $150.

36. After the distribution of the preferred stock, Joan's bases for her Orban stocks are

<table>
<thead>
<tr>
<th>Common</th>
<th>Preferred</th>
</tr>
</thead>
<tbody>
<tr>
<td>$300</td>
<td>$0</td>
</tr>
<tr>
<td>$225</td>
<td>$75</td>
</tr>
<tr>
<td>$200</td>
<td>$100</td>
</tr>
<tr>
<td>$150</td>
<td>$150</td>
</tr>
</tbody>
</table>

37. The holding period for the preferred stock starts in
c. September 2010.

38. On July 1, 2007, Lila Perl paid $90,000 for 450 shares of Janis Corp. common stock. Lila received a nontaxable stock dividend of 50 new common shares in August 2010. On December 20, 2010, Lila sold the 50 new shares for $11,000. How much should Lila report in her 2010 return as long-term capital gain?

a. $0
b. $1,000
c. $2,000
d. $11,000

SALE OF RESIDENCE

Items 39 and 40 are based on the following data:
Gary Barth, who is unmarried, owns a house which has been his principal residence for the past ten years. Gary sells this house and moves to a rental apartment on May 1, 2009. He has no intention of buying another residence at any time in the future, but wishes to avail himself of the one-time exclusion of gain on the sale of his house.

39. What is the minimum age Gary must attain in order to avail himself of the exclusion of gain on sale of his house?

a. 55.
b. 65.
c. 70.
d. none of the above

40. What is the maximum amount allowable for this type of exclusion?

a. 40% of long-term gain.
b. $125,000.
c. $250,000.
d. $500,000.

41. In January 2010, Davis purchased a new residence for $200,000. During that same month he sold his former residence for $80,000 and paid the realtor a $5,000 commission. The former residence, his first home, had cost $65,000 in 1990. Davis added a bathroom for $5,000 in 1991. What amount of gain is recognized from the sale of the former residence on Davis' 2010 tax return?

a. $15,000
b. $10,000
c. $5,000
d. $0

42. George Adams owned an apartment building containing 4 identical apartments. He occupied one apartment as his principal residence and rented the other three. He acquired the building in 1981 at a cost of $60,000 and has taken depreciation of $8,000 on the rented portion. On January 1, 2010, he sold the building for $80,000, incurring selling expenses of $4,000 and purchased a new residence for $45,000 in February 2010. What should Adams report as his recognized gain resulting from the sale of his principal residence?

a. $0.
b. $2,000.
c. $4,000.
d. $6,000.

43. The following information pertains to the sale of Al Oran's principal residence:

- Date of sale: January 2010
- Date of purchase: May 1979
- Net sales price: $260,000
- Adjusted basis: $70,000

In April 2010, Oran (age 70) bought a smaller residence for $90,000. What amount of gain should Oran recognize on the sale of his residence?

a. $0.
b. $45,000.
c. $190,000.
d. $260,000.
44. Ryan, age 53, is single with no dependents. In March 2010, Ryan's principal residence was sold for the net amount of $400,000 after all selling expenses. Ryan bought the house in 1984 and occupied it until sold. On the date of sale, the house had a basis of $80,000. Ryan does not intend to buy another residence. What is the maximum exclusion of gain on sale of the residence that may be claimed in Ryan's 2010 income tax return?
   a. $320,000
   b. $250,000
   c. $125,000
   d. $0

LIKE KIND EXCHANGES

45. In a "like-kind" exchange of an investment asset for a similar asset that will also be held as an investment, no taxable gain or loss will be recognized on the transaction if both assets consist of
   a. Convertible debentures.
   b. Convertible preferred stock.
   c. Partnership interests.
   d. Rental real estate located in different states.

46. The following information pertains to the acquisition of a six-wheel truck by Sol Barr, a self-employed contractor:

   Cost of original truck traded in $20,000
   Book value of original truck at trade-in date 4,000
   List price of new truck 25,000
   Trade-in allowance for old truck 6,000
   Business use of both trucks 100%

   The new truck will be depreciated as 5-year MACRS property. The basis of the new truck is
   a. $27,000.
   b. $25,000.
   c. $23,000.
   d. $19,000.

47. On July 1 of this year, Louis Herr exchanged an office building having a fair market value of $400,000, for cash of $80,000 plus an apartment building having a fair market value of $320,000. Herr's adjusted basis for the office building was $250,000. How much gain should Herr recognize in his income tax return?
   a. $0.
   b. $80,000.
   c. $150,000.
   d. $330,000.

48. On July 1 of this year, Riley exchanged investment real property, with an adjusted basis of $160,000 and subject to a mortgage of $70,000, and received from Wilson $30,000 cash and other investment real property having a fair market value of $250,000. Wilson assumed the mortgage. What is Riley's recognized gain on the exchange?
   a. $30,000.
   b. $70,000.
   c. $90,000.
   d. $100,000.

49. On October 1 of this year, Donald Anderson exchanged an apartment building, having an adjusted basis of $375,000 and subject to a mortgage of $100,000, for $25,000 cash and another apartment building with a fair market value of $550,000 and subject to a mortgage of $125,000. The property transfers were made subject to the outstanding mortgages. What amount of gain should Anderson recognize on the exchange?
   a. $0.
   b. $25,000.
   c. $125,000.
   d. $175,000.

50. An office building owned by Elmer Bass was condemned by the state on January 2, 2010. Bass received the condemnation award on March 1, 2010. In order to qualify for nonrecognition of gain on this involuntary conversion, what is the last date for Bass to acquire qualified replacement property?
   a. August 1, 2011.

SECTION 1231 ASSETS AND RECAPTURE RULES

51. Platt owns land that is operated as a parking lot. A shed was erected on the lot for the related transactions with customers. With regard to capital assets and Section 1231 assets, how should these assets be classified?

<table>
<thead>
<tr>
<th>Land</th>
<th>Shed</th>
</tr>
</thead>
<tbody>
<tr>
<td>Capital</td>
<td>Capital</td>
</tr>
<tr>
<td>Section 1231</td>
<td>Section 1231</td>
</tr>
<tr>
<td>Capital</td>
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</tbody>
</table>
52. Mike Karp owns machinery, with an adjusted basis of $50,000, for use in his carwashing business. In addition, Karp owns his personal residence and furniture, which together cost him $100,000. The capital assets amount to
a. $0.

b. $50,000.
c. $100,000.
d. $150,000.

53. John Thayer purchased an apartment building on January 1, 2004, for $200,000. The building was depreciated on the straight-line method. On December 31, 2010, the building was sold for $220,000, when the asset balance net of accumulated depreciation was $170,000. On his 2010 tax return, Thayer should report
a. Section 1231 gain of $20,000 and ordinary income of $30,000.
b. Section 1231 gain of $30,000 and ordinary income of $20,000.
c. Ordinary income of $50,000.
d. Section 1231 gain of $50,000.

54. On December 31, 2010, Mark sold machinery for $48,000. The machinery which had been purchased on January 1, 2007, for $40,000 had an adjusted basis of $28,000 on the date of sale. For 2010 Mark should report
a. A section 1231 gain of $20,000.
b. Ordinary income of $20,000.
c. A section 1231 gain of $12,000 and ordinary income of $8,000.
d. A section 1231 gain of $8,000 and ordinary income of $12,000.

55. On January 2, 2008, Bates Corp. purchased and placed into service 7-year MACRS tangible property costing $100,000. On December 31, 2010, Bates sold the property for $102,000, after having taken $47,525 in MACRS depreciation deductions. What amount of the gain should Bates recapture as ordinary income?

a. $0
b. $2,000
c. $47,525
d. $49,525

56. Leker exchanged a van that was used exclusively for business and had an adjusted tax basis of $20,000 for a new van. The new van had a fair market value of $10,000, and Leker also received $3,000 in cash. What was Leker's tax basis in the acquired van?

a. $20,000
b. $17,000
c. $13,000
d. $7,000

57. On September 8, 2010, Arthur and Anne Marie sell their personal residence for $390,000. The couple purchased the residence in 1985 at a cost of $100,000. In addition, they made capital improvements of $30,000 during the years. They do not plan on replacing the residence within two years. In filing their 2010 tax return, they may exclude from gross income:

a. $0-
b. $125,000
c. $250,000
d. $260,000

58. Bill, age 61, is single and owns a residence which he purchased in 1971 for $30,000. During 2005, he married Paula, age 60. Paula had previously sold her residence in 2004, just prior to their marriage and utilized her one-time exclusion of $125,000. In 2010, when Bill and Paula file a joint return, Bill sells his residence for $300,000. In filing the return, they may exclude from gross income:

a. $0-
b. $125,000
c. $250,000
d. $270,000

59. On October 1, 2009, Ashley acquires her principal residence for $200,000. On June 1, 2010, due to a change in place of her employment, she sells the residence for $230,000. Determine the amount which can be excluded from income on the sale of the residence.

a. $0-
b. $10,000
c. $20,000
d. $30,000

6Q-7
60. In 2010, Bach sold a painting for $50,000 purchased for his personal use in 2004 at a cost of $20,000. In Bach’s 2010 income tax return, the sale of the painting should be treated as a transaction resulting in
a. No taxable gain.
b. Section 1231 (capital gain-ordinary loss rule) gain.
c. Long-term capital gain.
d. Ordinary income.

61. Daven inherited property from a parent. The property had an adjusted basis to the parent of $1,600,000. It was valued at $2,000,000 at the date of death and valued $1,800,000 six months after the date of death. The executor elected the alternative valuation date. What is Daven’s basis in the property?

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

63. Carter purchased 100 shares of stock for $50 per share. Ten years later, Carter died on February 1 and bequeathed the 100 shares of stock to a relative, Boone, when the stock had a market price of $100 per share. One year later, on April 1, the stock split 2 for 1. Boone gave 100 shares of the stock to another of Carter’s relatives, Dixon, on June 1 that same year, when the market value of the stock was $150 per share. What was Dixon’s basis in the 100 shares of stock when acquired on June 1?

64. A heavy equipment dealer would like to trade some business assets in a nontaxable exchange. Which of the following exchanges would qualify as nontaxable?

65. Starr, a self-employed individual, purchased a piece of equipment for use in Starr’s business. The costs associated with the acquisition of the equipment were:

<table>
<thead>
<tr>
<th>Item</th>
<th>Cost</th>
</tr>
</thead>
<tbody>
<tr>
<td>Purchase price</td>
<td>$55,000</td>
</tr>
<tr>
<td>Delivery charges</td>
<td>725</td>
</tr>
<tr>
<td>Installation charges</td>
<td>300</td>
</tr>
<tr>
<td>Sales tax</td>
<td>3,400</td>
</tr>
</tbody>
</table>

What is the depreciable basis of the equipment?

66. Wynn, a single individual age 60, sold Wynn’s personal residence for $450,000. Wynn had owned Wynn’s residence, which had a basis of $250,000, for six years. Within eight months of the sale, Wynn purchased a new residence for $400,000. What is Wynn’s recognized gain from the sale of Wynn’s personal residence?

67. Bluff purchased equipment for business use for $35,000 and made $1,000 of improvements to the equipment. After deducting depreciation of $4,000, Bluff gave the equipment to Russett for business use. At the time the gift was made, the equipment had a fair market value of $32,000. Ignoring gift tax consequences, what is Russett’s basis in the equipment?

68. Sands purchased 100 shares of Eastern Corp. stock for $18,000 on April 1 of the prior year. On February 1 of the current year, Sands sold 50 shares of Eastern for $7,000. Fifteen days later, Sands purchased 25 shares of Eastern for $3,750. What is the amount of Sand’s recognized gain or loss?
   a. $0.
   b. $500.
   c. $1,000.
   d. $2,000

69. Which of the following is a capital asset?
   a. Inventory held primarily for sale to customers.
   b. Accounts receivable.
   c. A computer system used by the taxpayer in a personal accounting business.
   d. Land held as an investment.
Chapter Six — Answers
Capital Transactions

1. (a) $0. The selling price of $20,000 is less than Conner’s adjusted basis of $30,000, resulting in a realized loss of $10,000. Because of Section 267, the realized loss is not recognized (or deducted). This is a related party transaction between a father and his daughter.

2. (a) $0. When Alice purchased the stock, her basis was $20,000. When she sells the stock for $25,000, she normally would recognize a $5,000 gain. However, since a loss deduction was denied on the original sale from Conner to his daughter, that unused loss may be used to offset any gain on a subsequent sale. Therefore, $5,000 of the $10,000 realized loss from question #1 may be used to offset the $5,000 gain, and no gain needs to be recognized by Alice.

3. (b) $3,000. When capital losses exceed capital gains, an individual taxpayer may offset up to $3,000 in ordinary income. The excess of $5,000 ($8,000 less the $3,000) may be carried forward to future periods.

4. (b) $37,000. The procedure for determining the net capital position at the end of the year is to net the long transactions, net the short transactions and net the nets.

| Gross income before capital transactions | $40,000 |
| Capital transactions: | |
| Long-term capital loss | $(8,000) |
| Long-term capital gain | 2,000 |
| Net long-term capital loss | (6,000) |
| Short-term capital gain | 1,000 |
| Net long-term capital loss | (5,000) |
| Limit on capital losses | (3,000) |
| Adjusted gross income | $37,000 |

5. (b) $3,000 long-term loss. Paul has a total of $6,000 in capital losses and no capital gains. The maximum capital loss allowed after netting is $3,000. In determining the loss deduction, the short-term capital losses are used first and the long-term capital losses second. Therefore, the entire $1,000 short-term capital loss is utilized and $2,000 of the long-term capital loss, leaving $3,000 of the long-term loss available for carryforward purposes.

6. (c) Grandfather and granddaughter. Section 267 defines related parties as members of a family which include a taxpayer's brothers and sisters, spouse, ancestors and lineal descendants. The grandfather and granddaughter are an ancestor and lineal descendant.

7. (b) $1,000. This problem is comprised of two transactions. First, Fay’s original selling price of $11,000 to her son Martin is less than her adjusted basis of $15,000, resulting in a realized loss of $4,000. Because of Section 267, the realized loss is not recognized. Second, Martin’s sale of the stock to an unrelated third party would generally result in a capital gain of $5,000 ($16,000 less his basis of $11,000). However, since a loss deduction was denied on the original sale from Fay to her son, that unused loss may be used to offset any gain on a subsequent sale. Therefore, Fay’s $4,000 disallowed loss may be used to partially offset the $5,000 gain, leaving a recognized gain of only $1,000.

8. (a) $0 and $0. This is called a wash sale. It exists when an individual buys and sells substantially identical securities within a 30 day period. The disallowed loss of $2,000 is added to the basis of the shares purchased on December 15th.

9. (d) $90,200. The basis of the property is determined as follows:

| Cash downpayment | $40,000 |
| Purchase money mortgage | 50,000 |
| Title insurance policy | 200 |
| Total basis | $90,200 |
10. (c) $50,000. The general rule in a like-kind exchange is that no gain is recognized. However, when a taxpayer receives boot (cash or unlike property), the boot causes a gain to be recognized to lesser of the realized gain or the boot received. In this problem, the realized gain is computed as follows:

<table>
<thead>
<tr>
<th>Description</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fair market value of new real estate</td>
<td>$450,000</td>
</tr>
<tr>
<td>Cash received (boot)</td>
<td>$50,000</td>
</tr>
<tr>
<td>Amount realized</td>
<td>500,000</td>
</tr>
<tr>
<td>Less adjusted basis of old apartment</td>
<td>(300,000)</td>
</tr>
<tr>
<td>Realized gain</td>
<td>$200,000</td>
</tr>
</tbody>
</table>

Recognized gain (limited to lesser of the cash received) $50,000

11. (a) $0. The realized loss of $2,000 on the transaction is not recognized because Eng is a related party. When a shareholder owns more than 50% of a corporation’s stock, he is considered to be a related party under Section 267, and the losses are disallowed.

12. (a) For purposes of determining the gain or loss for tax purposes, the trade date is used.

13. (b) 12 months. By definition, the holding period for determining whether a capital transaction qualifies for long-term is more than 12 months.

14. (b) $280,000. Hall's personal residence and furnishings are capital assets. Equipment used in a trade or business is not a capital asset.

15. (b) The painting is for personal use and is considered to be a capital asset. Her holding period is more than one year. Therefore, the gain of $15,000 on the sale will be classified as a long-term capital gain.

16. (b) Capital losses are used first to offset capital gains. Once the capital gains are offset, the net capital loss is then used to reduce ordinary income up to $3,000. The excess over $3,000 may be carried over indefinitely.

17. (b) Capital losses are used first to offset capital gains. Once the capital gains are offset, the net capital loss is then used to reduce ordinary income up to $3,000. The excess over $3,000 may be carried over indefinitely.

18. (b) Goodwill. The delivery truck and land used as a parking lot are excluded from capital assets. A company's treasury stock is a reduction of stockholder's equity, not a capital asset.

19. (b) $8,000. Capital assets include property held for personal use, such as the kitchen sets and living room pieces. However, the showcases and tables used in a trade or business are excluded from the definition of capital assets.

20. through 22. When a gift of property is made, the general rule is that the basis and holding period of the donor tacks over to the donee. However, when the fair market value of the gift is less than the adjusted basis of the property, the rules change. If the property is sold for a gain, the cost basis is used. If the property is sold for a loss (as compared with the donor's basis), the basis is the lesser of the fair market value or the "gain" basis. If the selling price is between the fair market value and adjusted basis, no gain or loss is recognized.

<table>
<thead>
<tr>
<th></th>
<th>#20</th>
<th>#21</th>
<th>#22</th>
</tr>
</thead>
<tbody>
<tr>
<td>Selling price</td>
<td>$2,600</td>
<td>$2,000</td>
<td>$2,300</td>
</tr>
<tr>
<td>“Adjusted basis”</td>
<td>2,400</td>
<td>2,200</td>
<td>2,300</td>
</tr>
<tr>
<td>Gain (loss)</td>
<td>200</td>
<td>(200)</td>
<td>-0-</td>
</tr>
<tr>
<td>Answer</td>
<td>(c)</td>
<td>(c)</td>
<td>(a)</td>
</tr>
</tbody>
</table>
23. (a) $0. When a gift of property is made, the general rule is that the basis and holding period of the donor tacks over to the donee. However, when the fair market value of the gift is less than the adjusted basis of the property, the rules change. If the property is sold for a gain, the cost basis is used. If the property is sold for a loss (as compared with the donor's basis), the basis is the lesser of the fair market value or the "gain" basis. If the selling price is between the fair market value and adjusted basis, no gain or loss is recognized.

24. (b) Starts in 2007. When a gift of property is made, the general rule is that the basis and holding period of the donor tacks over to the donee. Ruth's basis would be $10,000.

25. (a) Capital asset. By definition

26. (a) $3,000. Using the carryover basis as described in question #24:

| Selling price | $13,000 |
| Basis         | 10,000  |
| Recognized gain | $ 3,000 |

27. (b) $240,000. Assuming that a proper alternative valuation date was elected (overall value of the estate decreases and the estate tax liability decreases) then the date of the distribution, not the alternative valuation date, determines the valuation of the asset.

28. (b) Long-term. Even though the holding period appears to be only one month, the holding period for property received from a decedent is automatically long-term.

29. (d) $0. Hall's basis in the stock received from his father's estate will be the fair market value as of the distribution date because the executor elected the alternative valuation date. Hall's selling price of the $4,500 is identical to the adjusted basis of $4,500, and therefore no income or gain is included.

30 - 32. These three questions ask about basis, and gain or loss. The answers below show more computations than are required in the problem. When a gift of property is made, the general rule is that the basis and holding period of the donor tacks over to the donee. However, when the fair market value of the gift is less than the adjusted basis of the property, the rules change. If the property is sold for a gain, the cost basis is used. If the property is sold for a loss (as compared with the donor's basis), the basis is the lesser of the fair market value or the "gain" basis. If the selling price is between the fair market value and adjusted basis, no gain or loss is recognized.

<table>
<thead>
<tr>
<th></th>
<th>#30</th>
<th>#31</th>
<th>#32</th>
</tr>
</thead>
<tbody>
<tr>
<td>Selling price</td>
<td>$ 5,000</td>
<td>$ 2,000</td>
<td>$3,500</td>
</tr>
<tr>
<td>&quot;Adjusted basis&quot;</td>
<td>4,000</td>
<td>3,000</td>
<td>3,500</td>
</tr>
<tr>
<td>Gain (loss)</td>
<td>1,000</td>
<td>(1,000)</td>
<td>0-</td>
</tr>
<tr>
<td>Answer</td>
<td>(b)</td>
<td>(b)</td>
<td>(d)</td>
</tr>
</tbody>
</table>

33. (c) $450,000. Ida's basis in the stock received from his brother's estate will be the fair market value as of the alternate valuation date because the executor elected the alternate valuation date. The rule for electing the alternate valuation date requires that the overall taxable estate be reduced from the valuation at the date of death. We can assume that if the executor made a valid election, then the overall estate decreased, even though the value of this specific item increased.
34. (c) $1,000 of long-term capital gain. Whereas Greene received a nontaxable stock dividend of the same stock, the original basis of his 450 shares of Acme must be allocated to all the shares he now possesses. In addition, the holding period tacks to the original purchase of July 1, 2007, thus making this transaction long-term.

<table>
<thead>
<tr>
<th>Original basis</th>
<th>$ 45,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Number of shares:</td>
<td></td>
</tr>
<tr>
<td>Original</td>
<td>450</td>
</tr>
<tr>
<td>Dividends</td>
<td>50</td>
</tr>
<tr>
<td>Total</td>
<td>500 Shares</td>
</tr>
<tr>
<td>Basis per share</td>
<td>$ 90</td>
</tr>
<tr>
<td>Selling price</td>
<td>$ 5,500</td>
</tr>
<tr>
<td>Basis of shares sold:</td>
<td></td>
</tr>
<tr>
<td>50 shares @ $90</td>
<td>4,500</td>
</tr>
<tr>
<td>Long-term capital gain</td>
<td>$ 1,000</td>
</tr>
</tbody>
</table>

35. (c) $5,000. Whereas Harris received a nontaxable stock dividend of different stock (preferred stock, not common), the original basis of $6,000 from his 100 shares of common stock must be allocated to all the shares he now owns using the fair market value as of the date of distribution.

<table>
<thead>
<tr>
<th></th>
<th>Total</th>
<th>Ratio</th>
<th>Basis</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fair market value - common</td>
<td>100 shares @ $ 75</td>
<td>$ 7,500</td>
<td>5/6</td>
</tr>
<tr>
<td>Fair market value - preferred</td>
<td>10 shares @ $150</td>
<td>1,500</td>
<td>1/6</td>
</tr>
<tr>
<td></td>
<td>$ 9,000</td>
<td></td>
<td>$6,000</td>
</tr>
</tbody>
</table>

36. (b) $225 and $75. Whereas Hill received a nontaxable stock dividend of different stock (preferred stock, not common), the original basis of $300 from her 1 share of common stock must be allocated to the preferred share she now owns using the fair market value as of the date of distribution.

<table>
<thead>
<tr>
<th></th>
<th>Total</th>
<th>Ratio</th>
<th>Basis</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fair market value - common</td>
<td>1 share @ $ 450</td>
<td>$ 450</td>
<td>3/4</td>
</tr>
<tr>
<td>Fair market value - preferred</td>
<td>1 share @ $150</td>
<td>150</td>
<td>1/4</td>
</tr>
<tr>
<td></td>
<td>$ 600</td>
<td></td>
<td>$ 300</td>
</tr>
</tbody>
</table>

37. (a) January 2010. Hill's holding period for the preferred stock begins on the date she acquired the common stock.

38. (c) $2,000 of long-term capital gain. Whereas Lila received a nontaxable stock dividend of the same stock, the original basis of her 450 shares of Janis must be allocated to all the shares she now possesses. In addition, the holding period tacks to the original purchase of July 1, 2007, thus making this transaction long-term.

<table>
<thead>
<tr>
<th>Original basis</th>
<th>$ 90,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Number of shares:</td>
<td></td>
</tr>
<tr>
<td>Original</td>
<td>450</td>
</tr>
<tr>
<td>Dividend</td>
<td>50</td>
</tr>
<tr>
<td>Total</td>
<td>500 Shares</td>
</tr>
<tr>
<td>Basis per share</td>
<td>$ 180</td>
</tr>
<tr>
<td>Selling price</td>
<td>$ 11,000</td>
</tr>
<tr>
<td>Basis of shares sold:</td>
<td></td>
</tr>
<tr>
<td>50 shares @ $180</td>
<td>9,000</td>
</tr>
<tr>
<td>Long-term capital gain</td>
<td>$ 2,000</td>
</tr>
</tbody>
</table>
39. (d) None of the above. There is no age limitation.

40. (c) $250,000. By definition.

41. (d) $0. Under the new law, a single taxpayer excludes up to a maximum of $250,000. Since his realized gain was $5,000, no gain is recognized. To determine the realized gain on the sale of a personal residence, use the following steps:

\[
\begin{align*}
\text{Selling price of old residence} & \quad \$80,000 \\
\text{Less: selling expenses} & \quad (5,000) \\
\text{Adjusted selling price} & \quad \$75,000 \\
\text{Less: Adjusted basis} & \\
\text{Original cost of residence} & \quad \$65,000 \\
\text{Add: Bathroom addition} & \quad 5,000 \\
\text{Basis of residence sold} & \quad \$70,000 \\
\text{Realized gain} & \quad \$\ 5,000
\end{align*}
\]

42. (a) $0. Under the new law, a single taxpayer excludes up to a maximum of $250,000. Since his realized gain was $4,000, no gain is recognized. Because this apartment building was used 25% for personal use and 75% for rental use, an allocation of selling price and costs is needed. Note that there is no reduction in the basis of the property which is used as his principal residence. Depreciation only pertains to the rental portion.

\[
\begin{align*}
\text{25\%} & \\
\text{Total} & \quad \$80,000 & \quad \$20,000 \\
\text{Personal} & \quad (4,000) & \quad (1,000) \\
\text{Selling price} & \quad 76,000 & \quad 19,000 \\
\text{Adjusted basis} & \quad 60,000 & \quad 15,000 \\
\text{Realized gain} & \quad \$\ 4,000 \\
\text{Recognized gain} & \quad \$\ 0
\end{align*}
\]

43. (a) $0. A single taxpayer may exclude up to a maximum of $250,000. Since his realized gain was only $190,000, no gain is recognized. His realized gain of $190,000 is determined by the net sales price of $260,000 less the adjusted basis of $70,000.

44. (b) $250,000. Under the new law, a single taxpayer excludes up to a maximum of $250,000. His realized gain was $320,000. Therefore, he would recognize a $70,000 gain.

45. (d) Rental real estate. Property held for productive use in a business or for investment qualifies for like-kind exchanges which are nontaxable. The convertible bonds, preferred stock and partnership interests do not qualify.
46. (c) $23,000. This is a like-kind exchange and no gain or loss is recognized. The basis of the new property represents the adjusted basis of the property transferred plus any cash paid.

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Adjusted basis of old truck</td>
<td>$4,000</td>
</tr>
<tr>
<td>Plus cash paid at trade-in:</td>
<td></td>
</tr>
<tr>
<td>List price</td>
<td>$25,000</td>
</tr>
<tr>
<td>Less trade-in</td>
<td>(6,000)</td>
</tr>
<tr>
<td>Basis of new truck</td>
<td>$23,000</td>
</tr>
</tbody>
</table>

47. (b) $80,000. The general rule in a like-kind exchange is that no gain is recognized. However, when a taxpayer receives boot (cash or unlike property), the boot causes a gain to be recognized to lesser of the realized gain or the boot received. In this problem, the realized gain is computed as follows:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fair market value of new apartment</td>
<td>$320,000</td>
</tr>
<tr>
<td>Cash received (boot)</td>
<td>80,000</td>
</tr>
<tr>
<td>Amount realized</td>
<td>400,000</td>
</tr>
<tr>
<td>Less adjusted basis of old apartment</td>
<td>(250,000)</td>
</tr>
<tr>
<td>Realized gain</td>
<td>$150,000</td>
</tr>
<tr>
<td>Recognized gain (limited to lesser of the cash received)</td>
<td>$80,000</td>
</tr>
</tbody>
</table>

48. (d) $100,000. The general rule in a like-kind exchange is that no gain is recognized. However, when a taxpayer receives boot (cash or unlike property such as the release of a mortgage), the boot causes a gain to be recognized to lesser of the realized gain or the boot received. In this problem, the realized gain is computed as follows:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fair market value of new investment</td>
<td>$250,000</td>
</tr>
<tr>
<td>Cash received (boot)</td>
<td>30,000</td>
</tr>
<tr>
<td>Release of mortgage</td>
<td>70,000</td>
</tr>
<tr>
<td>Amount realized</td>
<td>350,000</td>
</tr>
<tr>
<td>Less adjusted basis of old apartment</td>
<td>(160,000)</td>
</tr>
<tr>
<td>Realized gain</td>
<td>$190,000</td>
</tr>
<tr>
<td>Recognized gain (limited to lesser of the boot received)</td>
<td>$100,000</td>
</tr>
</tbody>
</table>

49. (b) $25,000. The general rule in a like-kind exchange is that no gain is recognized. However, when a taxpayer receives boot (cash or unlike property such as the release of a mortgage), the boot causes a gain to be recognized to lesser of the realized gain or the boot received. Because the taxpayer assumed a larger mortgage than he was relieved of, the release of the mortgage is not considered boot. The boot in this transaction is limited to cash received. In this problem, the realized gain is computed as follows:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fair market value of new apartment</td>
<td>$550,000</td>
</tr>
<tr>
<td>Less mortgage assumed</td>
<td>(125,000)</td>
</tr>
<tr>
<td>Cash received (boot)</td>
<td>25,000</td>
</tr>
<tr>
<td>Release of mortgage</td>
<td>100,000</td>
</tr>
<tr>
<td>Amount realized</td>
<td>550,000</td>
</tr>
<tr>
<td>Less adjusted basis of old apartment</td>
<td>(375,000)</td>
</tr>
<tr>
<td>Realized gain</td>
<td>$175,000</td>
</tr>
<tr>
<td>Recognized gain (limited to lesser of the boot received)</td>
<td>$25,000</td>
</tr>
</tbody>
</table>
50. (d) The replacement period is three years after the close of the taxable year in which the gain is realized (which was 2010). The gain would therefore be realized in the year 2012.

51. (d) By definition. Land and depreciable property used in a trade or business are not, by definition, capital assets. However, Section 1231 gives them capital treatment.

52. (c) $100,000. Depreciable property used in a trade or business is not, by definition, capital assets. Only Karp’s personal residence is a capital asset.

53. (d) Section 1231 gain of $50,000. The building is a Section 1231 asset. None of the gain is ordinary because the depreciation, or cost recovery, was under the straight-line method. (There was no excess over straight-line.)

<table>
<thead>
<tr>
<th>Selling price of building</th>
<th>$220,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Adjusted basis of building</td>
<td>$170,000</td>
</tr>
<tr>
<td>Realized Section 1231 gain</td>
<td>$ 50,000</td>
</tr>
</tbody>
</table>

54. (d) Section 1231 gain of $8,000 and ordinary income of $12,000. Section 1245 requires that a taxpayer must recapture as ordinary income that portion of the gain to the extent of depreciation taken. The problem does not specifically tell the candidate that $12,000 was taken in depreciation. By starting with the original cost of the machinery ($40,000) and comparing it to its adjusted basis of $28,000, it can be assumed that the difference of $12,000 in the depreciation taken,

<table>
<thead>
<tr>
<th>Selling price of machinery</th>
<th>$48,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Adjusted basis of machinery</td>
<td>$28,000</td>
</tr>
<tr>
<td>Realized gain</td>
<td>$20,000</td>
</tr>
</tbody>
</table>

Character of gain:

<table>
<thead>
<tr>
<th>Ordinary (Up to depreciation taken)</th>
<th>$12,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Section 1231 (Excess gain over cost)</td>
<td>$8,000</td>
</tr>
<tr>
<td></td>
<td>$20,000</td>
</tr>
</tbody>
</table>

55. (c) $47,525. Section 1245 requires that a taxpayer must recapture as ordinary income, that portion of the gain to the extent of any depreciation taken. The basis of the property at the time of the sale must be determined first, then the total gain, then the character of the gain, as presented below:

<table>
<thead>
<tr>
<th>Original cost</th>
<th>$ 100,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Less: depreciation allowed</td>
<td>$47,525</td>
</tr>
<tr>
<td>Adjusted basis</td>
<td>$ 52,475</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Selling price of equipment</th>
<th>$102,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Adjusted basis of the equipment</td>
<td>$52,475</td>
</tr>
<tr>
<td>Realized gain</td>
<td>$49,525</td>
</tr>
</tbody>
</table>

Character of the gain:

| Ordinary (up to the depreciation taken) | $47,525 |
| Capital                                | $ 2,000 |
|                                      | $ 49,525 |
56. (b) $17,000. The general rule in a like-kind exchange is that no gain or loss is recognized. However, if the taxpayer receives boot (cash), the boot can cause the recognition of a realized gain, but not a loss. Therefore, the receipt of cash impacts the problem by reducing the basis.

<table>
<thead>
<tr>
<th>Fair market value</th>
<th>$10,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>of new van</td>
<td></td>
</tr>
<tr>
<td>Cash</td>
<td>3,000</td>
</tr>
<tr>
<td>Amount realized</td>
<td>13,000</td>
</tr>
<tr>
<td>Less adjusted basis of old van</td>
<td>(20,000)</td>
</tr>
<tr>
<td>Realized loss</td>
<td>7,000</td>
</tr>
</tbody>
</table>

Therefore, the tax basis of the old van ($20,000) is allocated to the cash ($3,000) and the new van ($17,000).

57. (d) $260,000. For married taxpayers who sell their principal residence after May 6, 2005, they may exclude up to $500,000 of the income from that sale. For this taxpayer, the amount of the income is $260,000.

<table>
<thead>
<tr>
<th>Gross selling price</th>
<th>$390,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cost</td>
<td>$100,000</td>
</tr>
<tr>
<td>Improvements</td>
<td>30,000</td>
</tr>
<tr>
<td>Total basis</td>
<td>130,000</td>
</tr>
<tr>
<td>Amount realized on sale</td>
<td>$260,000</td>
</tr>
</tbody>
</table>

58. (d) $270,000. Under prior law, when a taxpayer married another taxpayer who had previously elected the one-time exclusion it was uncertain as to whether that would taint the one-time election for the new married couple. Current law allows each taxpayer in a married, filing jointly return the $250,000 amount. Therefore the entire $270,000 ($300,000-270,000) may be excluded.

59. (d) $30,000. Even though Ashley did not own the residence for the entire two years, she is entitled to a pro-rata exclusion amount for the amount of time she owned the house. Her exclusion is based upon:

<table>
<thead>
<tr>
<th>Exclusion amount</th>
<th>$250,000 X 8/24 = $83,333</th>
</tr>
</thead>
<tbody>
<tr>
<td>Selling price</td>
<td>$230,000</td>
</tr>
<tr>
<td>Cost</td>
<td>-200,000</td>
</tr>
<tr>
<td>Amount realized</td>
<td>$30,000</td>
</tr>
<tr>
<td>Amount recognized</td>
<td>-.00</td>
</tr>
</tbody>
</table>

60. (c) Long-term capital gain. Since the painting was sold for more than its cost basis, then the result will be a taxable gain whether it is personal or not. The painting is not section 1231 property because it is not depreciable property used in the taxpayer’s trade or business. And generally, to qualify as ordinary income, the painting would have to be inventory held primarily for the sale to customers in the ordinary trade or business.

61. (c) $1,800,000. The general rule is that the basis of inherited property is property’s fair market value as of the date of death of the decedent, or the alternative valuation date six months after the date of death, if elected by the executor. Thus, in this case, it would be the alternative valuation date’s value of $1,800,000.

62. (d) The correct answer is the investment in government bonds held by the individual investor. Sale of equipment results in Section 1231 gains. Real property that is subdivided represents inventory, and the sale of that results in ordinary income. And the sale of inventory is certainly ordinary income in answer c.
63. (a) $5,000. The general rule is that the basis of inherited property is property’s fair market value as of the date of death of the decedent. Therefore, the basis of the stock to Boone will be the $100 per share for all 100 shares, or $10,000. When the stock splits 2 for 1, the basis splits as well so now Boone owns 200 shares with a basis of $50 per share for the same $10,000. When Boone gifts 100 shares to Dixon on June 1st, Boone’s basis tacks over to Dixon since the FMV at the date of the gift is greater than the tax basis. Accordingly, Dixon’s basis is 100 shares at a basis of $50 per share, or $5,000.

64. (d) Property held for investment use such as land and a corporate office building qualify for non-taxable exchanges. The other exchanges are excluded from the non-taxable exchange provisions.

65. (d) $59,425. The general rule is that the basis for purchased property represents all the costs required to get the asset ready for its intended use. In this case, all of the costs are required to get the equipment ready and place it in service.

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Purchase price</td>
<td>$55,000</td>
</tr>
<tr>
<td>Delivery charges</td>
<td>725</td>
</tr>
<tr>
<td>Installation fees</td>
<td>300</td>
</tr>
<tr>
<td>Sales tax</td>
<td>3,400</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$59,425</strong></td>
</tr>
</tbody>
</table>

66. (a) $0. A single taxpayer may exclude up to a maximum of $250,000. Since his realized gain was only $200,000 no gain is recognized. His realized gain of $200,000 is determined by the net sales price of $450,000 less the adjusted basis of $250,000.

67. (b) $32,000. The basis is comprised of:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Purchase price</td>
<td>$35,000</td>
</tr>
<tr>
<td>Improvements</td>
<td>1,000</td>
</tr>
<tr>
<td>Less depreciation</td>
<td>-4,000</td>
</tr>
<tr>
<td><strong>Total basis</strong></td>
<td><strong>$32,000</strong></td>
</tr>
</tbody>
</table>

68. (c) $1,000. This is called a wash sale. It exists when an individual buys and sells substantially identical securities within a 30 day period. Half of the 100 shares purchased for $18,000 were sold for $7,000. This results in a loss of $2,000 ($7,000 - $9,000). However, 15 days later, 25 of those 50 shares were repurchased. Therefore one half of the loss is recognized and the other half is not currently allowed, but instead added to the basis the shares purchased.

69. (d) By definition, capital assets do not include inventory, accounts receivable or equipment used in a trade or business. Land held as an investment is the only capital asset.
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Partnerships

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  Allowable Tax Years
  Filing Requirements

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Chapter Seven
Partnerships

NATURE AND CHARACTERISTICS

GENERAL
The Internal Revenue Code defines a partnership as an association of two or more persons carrying on a trade or business, financial operation or venture. The partnership includes a syndicate, group, pool, joint venture, or other unincorporated organization. A partnership must not be a corporation, trust, or estate. An eligible entity would “check the box” on the partnership tax return to indicate the desire to be taxed as a partnership.

A partnership is not a taxpaying entity, but rather a conduit, which flows items of income, gain, loss, deduction and credit through down to the partners. The allocation of these items is usually based upon a written partnership agreement. However, in absence of an agreement, the items would be allocated under a pro-rata basis according to the capital interests.

While the laws of the various state dictate how a partnership operates, there tend to be four basic types of partnerships:

General partnership: Here the partners share in the profits and losses of the partnership. General partners can be held personally liable for the debts of the partnership.

Limited partnership: Must have at least one general partner. The limited partners exposure to the partnership debt is limited to their capital accounts. Limited partners usually have little to say in the running of the partnership operations.

Limited liability partnerships: These partnerships are largely used in the service professionals such as legal and accounting. A LLP partner is not liable for the acts of the other partners.

Limited liability company: This is taxed as a partnership but has a structure similar to that of a corporation. The owner(s) may participate in management while limiting their personal liability. May have one owner in some states.

AGGREGATE VS. ENTITY THEORY
A partnership is a group of taxpayers, joined together with one another, yet each partner treats their proportionate share of income, deduction, gain, loss, and credit as if it were their own. This is called the aggregate, or conduit theory. However, filing a partnership return as a single entity, and making certain elections at the partnership level, such as depreciation methods, inventory methods, installment gain and Section 179 elections, indicate that the partnership is also an entity and not just a collection of individual partners.

ORGANIZATION COSTS AND SYNDICATION FEES
Costs incurred related to the creation of the partnership (organizational costs), such as accounting and legal fees, are generally not initially deductible, but are instead capitalized. The partnership then amortizes these costs on a straight-line basis over a period of not less than 180 months.
In addition, a partnership may be able to immediately expense up to $5,000 of such expenditures. This $5,000 amount, however, is phased out on a dollar for dollar basis for organizational expenditures exceeding $50,000.

Costs associated with the selling of limited partnerships and joint ventures are neither deductible or amortizable. These fees are usually the marketing, registration and underwriting fees are subtracted from the proceeds of such issuances.

ALLOWABLE TAX YEARS
A partner must report income and deductions in the tax year that includes the last day of the partnership year. Because a partnership may easily defer income from one year to another merely by adopting a fiscal year end different from that of its partners, Congress and IRS have established a series of rules limiting the availability of certain year ends.

Briefly the hierarchy for year-end selection is as follows:
1. The year-end of the majority of the partners.
2. The year-end of the principal partners.
3. The year-end resulting in the “least aggregate deferral” of income.

If the selection of the fiscal year-end using the rules above is not acceptable, the partnership may select a year-end under one of these three alternatives:
1. Establish that a business purpose exists, usually supported by cyclical income.
2. Establish a natural business tax year following the IRS procedures where gross receipts of 25% or more were recognized in a two month period for three consecutive years.
3. Select a tax year where no more than three months of partnership income is deferred from the required tax year.

FILING REQUIREMENTS
A partnership is required to file Form 1065 each year. The return is due by the 15th day of the 4th month following the end of the taxable year. For a calendar year partnership, this means April 15th. Failure to file a timely return results in a penalty of $50 per month, per partner. The maximum number of months over which the penalty may be applied is five. A partnership may request an automatic five month extension by timely filing Form 7004. On the following page is a copy of Form 1065.
**U.S. Return of Partnership Income**

**Principal Business Activity**
- Name of partnership

**Principal Product or Service**
- Number, street, and room or suite no. If a P.O. box, see the instructions.

**Business Code Number**
- City or town, state, and ZIP code

**Employee Identification Number**
- Date business started

**Check applicable boxes**
- Initial return
- Final return
- Name change
- Address change
- Amended return
- Technical termination - also check (1) or (2)

**Check accounting method**
- Cash
- Accrual
- Other (specify)

**Number of Schedules K-1**
Attach one for each partner who was a partner at any time during the tax year.

**Check if Schedules C and M-3 are attached**

---

**Caution**: Include only trade or business income and expenses on lines 1a through 22 below. See the instructions for more information.

### Income

1a. Gross receipts or sales
1b. Less returns and allowances
2. Cost of goods sold (Schedule A, line 8)
3. Gross profit. Subtract line 2 from line 1c
4. Ordinary income (loss) from other partnerships, estates, and trusts (attach statement)
5. Net farm profit (loss) (attach Schedule F (Form 1060))
6. Net gain (loss) from Form 4797, Part II, line 17 (attach Form 4797)
7. Other income (loss) (attach statement)
8. Total income (loss). Combine lines 3 through 7

### Deductions

9. Salaries and wages (other than to partners) (less employment credits)
10. Guaranteed payments to partners
11. Repairs and maintenance
12. Bad debts
13. Rent
14. Taxes and licenses
15. Interest
16a. Depreciation (if required, attach Form 4562)
16b. Less depreciation reported on Schedule A and elsewhere on return
17. Depletion (Do not deduct oil and gas depletion.)
18. Retirement plans, etc.
19. Employee benefit programs
20. Other deductions (attach statement)
21. Total deductions. Add the amounts shown in the far right column for lines 9 through 20
22. Ordinary business income (loss). Subtract line 21 from line 8

---

**Sign Here**

Signature of general partner or limited liability company member manager

Date

**Paid Preparer Use Only**

Print/Type preparer's name
Preparer's signature
Date
Check if self-employed
PTIN

Firm's name
Firm's address
Phone no.

For Paperwork Reduction Act Notice, see separate instructions.
FORMATION - CONTRIBUTIONS OF PROPERTY

GENERAL RULE FOR CONTRIBUTIONS OF PROPERTY
When a partner transfers property to a partnership in exchange for a partnership interest, the general rule is that no gain or loss is recognized. There is a carryover of basis to the partnership of the property transferred by the partner as well as a carryover of basis to the partner’s new interest in the partnership. The carryover also pertains to the holding period of the property contributed. The logic behind this non-taxable transfer is that only the form of ownership of the property transferred has changed.

Example 1: On January 1, 2010, K contributes land with a fair market value of $40,000 and an adjusted basis of $15,000 to KL partnership, in exchange for a 50% interest worth $40,000. K purchased the land in 1980 for the $15,000. L contributes cash of $40,000 on the same day. No gain or loss is recognized by either the partnership, or to the partners on the exchange. K’s tax basis in the partnership is $15,000. The partnership’s basis in the land is $15,000 even though the fair market value is $40,000. K’s holding period for her partnership interest is long-term (since 1980) and the partnership’s holding period for the land is also long-term. L’s tax basis is $40,000. His holding period begins January 1, 2010.

CONTRIBUTIONS OF PROPERTY WHEN LIABILITIES ARE ASSUMED BY THE PARTNERSHIP
When a partner transfers property to a partnership that is subject to liabilities which the partnership assumes, the general rule is that no gain or loss is recognized. The amount of liabilities assumed by the other partners as a result of the transfer, reduce the tax basis of the contributing partner. However, if the assumption of the liabilities of the other partners is greater than the contributing partner’s basis in the property, this would result in a gain.

Example 2: Assume in Example 1 that the land contributed by K was subject to a mortgage of $20,000, and that the partnership assumed the mortgage. No gain or loss is recognized by either the partnership or K. Her tax basis in the partnership is now $5,000. That is comprised of her basis in the land of $15,000 less the 50% share of the $20,000 mortgage assumed by L as a partner. L’s basis is now $50,000, which is comprised of $40,000 from his cash contribution plus $10,000 from the assumption of debt. The basis of the land in the partnership is still $15,000.

<table>
<thead>
<tr>
<th>Basis of property transferred</th>
<th>15,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Less: liabilities assumed by other partners</td>
<td>(10,000)</td>
</tr>
<tr>
<td>Basis of K's partnership interest</td>
<td>5,000</td>
</tr>
</tbody>
</table>

Example 3: Assume the same facts as in Example 2, except that the mortgage being assumed by the partnership is $40,000. K must recognize a gain of $5,000 and her tax basis in the partnership is now zero. Her basis in the land was $15,000, however, the other partner assumed $20,000 of the mortgage. This would result in a negative basis of $5,000 to K. Since a negative basis is not allowed, K recognizes a $5,000 gain and restores her basis in the partnership to zero. L’s basis is now $60,000 ($40,000 plus $20,000 assumption of debt).
SERVICES RENDERED IN EXCHANGE FOR A PARTNERSHIP INTEREST
When a partner performs services in exchange for a partnership interest, the partner must recognize ordinary income to the extent of the fair market value of the interest received. The partner’s basis in the partnership will be equal to the amount of income recognized.

OPERATIONS OF THE PARTNERSHIP AND BASIS COMPUTATIONS

GENERAL RULE
Each year when the partnership files the Form 1065, it reports each partner’s allocable share of income, deductions, gains, losses and credits on Schedule K-1. In preparing the return, it is necessary to group items into separately stated and non-separately stated items.

SEPARATELY AND NON-SEPARATELY STATED ITEMS
Separately stated items are those items which when treated at the partner’s level, could have a special tax treatment or limitation. Grouping them together could circumvent the tax laws. For example, since an individual taxpayer can only deduct charitable contributions up to 50% of his adjusted gross income, any charitable contributions made by the partnership must be reported separately to the partner in order that these be grouped with other contributions the partner may have made individually. Only then can the 50% test truly be tested. Likewise, on an individual basis, net capital losses can only be deducted to a maximum of $3,000 per year, and all Section 179 elections cannot exceed the maximum allowed per taxpayer ($500,000 in 2010). Other separately stated items include, but are not limited to:

- Portfolio income, such as interest, dividends and royalties
- Investment interest expense
- Personal expenses such as medical insurance
- AMT preference and adjustment items
- Passive activities, including rental activities
- Intangible drilling costs
- Taxes paid to foreign countries
- Tax-exempt income

All other items of income and expense that are not separately stated are netted together at the partnership level to determine ordinary income. Refer back to the Form 1065 on page 2. Notice that line 22 is the amount of ordinary income.

After the determination of ordinary income (or loss) and of each separately stated item, the amounts flows through proportionately to each partner on a K-1 based upon the partner’s percentage interest in the capital, profits and losses. It is also possible to allocate certain items in a different percentage so long as the allocation has substantial economic effect. A partial first page of Form K-1 is presented on the next page:
### Part I  Information About the Partnership

<table>
<thead>
<tr>
<th>A</th>
<th>Partnership's employer identification number</th>
</tr>
</thead>
<tbody>
<tr>
<td>B</td>
<td>Partnership's name, address, city, state, and ZIP code</td>
</tr>
</tbody>
</table>

### Part II  Information About the Partner

<table>
<thead>
<tr>
<th>C</th>
<th>Partner's identifying number</th>
</tr>
</thead>
<tbody>
<tr>
<td>D</td>
<td>Partner's name, address, city, state, and ZIP code</td>
</tr>
</tbody>
</table>

### Part III  Partner's Share of Current Year Income, Deductions, Credits, and Other Items

<p>| | | | | | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Ordinary business income (loss)</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2</td>
<td>Net rental real estate income (loss)</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>3</td>
<td>Other rental income (loss)</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>4</td>
<td>Guaranteed payments</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>5</td>
<td>Interest income</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>6a</td>
<td>Ordinary dividends</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>6b</td>
<td>Qualified dividends</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>7</td>
<td>Royalties</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>8</td>
<td>Net short-term capital gain (loss)</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>9a</td>
<td>Net long-term capital gain (loss)</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>9b</td>
<td>Collectibles (28%) gain (loss)</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>9c</td>
<td>Unrecaptured section 1231 gain</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>10</td>
<td>Net section 1250 gain (loss)</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>11</td>
<td>Other income (loss)</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>12</td>
<td>Section 179 deduction</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>13</td>
<td>Other deductions</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>14</td>
<td>Self-employment earnings (loss)</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>15</td>
<td>Credits</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>16</td>
<td>Foreign transactions</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>17</td>
<td>Alternative minimum tax (AMT) items</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>18</td>
<td>Tax-exempt income and non-deductible expenses</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>19</td>
<td>Distributions</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>20</td>
<td>Other information</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

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Cat. No. 28396D  Schedule K-1 (Form 8865) 2010

Form IRS Use Only
ALLOCATING OF INCOME ITEMS AND THE RELATED BASIS COMPUTATION
The items of income cause an increase in the basis of the partner’s interest, while the deductions and losses cause reductions. In no case may the basis of a partner’s interest be less than zero. In allocating the items, income items are allocated first.

Example 4: For 2010, KL partnership had ordinary income of $20,000, a long-term capital gain of $10,000 and tax-exempt interest of $4,000. K and L are still equal partners, and K’s basis at the beginning of the year was $3,000. K’s basis will increase by $17,000 (50% of the $20,000, $10,000 and $4,000) to $20,000. K will recognize $10,000 as ordinary income and $5,000 as a long-term capital gain. Her $2,000 share of the tax-exempt interest is not taxable, but does increase her tax basis.

ALLOCATING OF LOSSES AND DEDUCTIONS AND THE RELATED BASIS COMPUTATION
Items of losses and deductions cause a decrease in the partner’s basis. Non-deductible items decrease a partner’s basis as well. Since a partner’s basis cannot be reduced below zero, it may be necessary to pro-rate items of losses and deductions until sufficient basis exists. Note that in addition to basis limitations, a partner may be subject to at risk and passive loss limitations at the partner level. See Chapter 5 for a fuller discussion.

Example 5: Assume in Example 4 that K’s share of the ordinary income was only $7,000 and there was no capital gain or exempt income. Assume her beginning basis was still $3,000 and that there was a charitable contribution of $9,000 and a Section 179 election of $6,000. Her basis is first increased by the ordinary income of $7,000 to $10,000. The most she can now reduce her basis by is $10,000. K must prorate the deductions and suspend the excess to future periods until she has sufficient basis. K’s basis cannot be negative.

<table>
<thead>
<tr>
<th>Deductions</th>
<th>Ratio</th>
<th>Basis</th>
<th>Allowed</th>
<th>Suspended</th>
</tr>
</thead>
<tbody>
<tr>
<td>Charitable contribution</td>
<td>9,000</td>
<td>3/5</td>
<td>$10,000</td>
<td>$6,000</td>
</tr>
<tr>
<td>Section 179 election</td>
<td>6,000</td>
<td>2/5</td>
<td>$10,000</td>
<td>$4,000</td>
</tr>
<tr>
<td></td>
<td>$15,000</td>
<td></td>
<td>$10,000</td>
<td>$10,000</td>
</tr>
</tbody>
</table>

GUARANTEED PAYMENTS
Payments made between a partnership and a partner oftentimes represent withdrawals of the partner’s capital. However, some payments represent a payment for services rendered by that partner (similar to salary expense), or for the use of that partner’s capital (similar to interest expense). These payments are called guaranteed payments and are similar to a pre-distribution of partnership ordinary income. Guaranteed payments are subject to the self-employment tax as is a general partner’s share of the ordinary income. Guaranteed payments have no net effect on the taxpayer’s basis as their basis increases as they recognize the income and their basis decreases for the same amount as they receive the cash distribution.
**Example 6:** K and L have agreed to split the income and loss of the partnership in half. However, K works at the business each day, while L resides in Florida and does not work. The partnership has agreed to pay K $40,000 per year as a guaranteed payment for her work. During 2010, the partnership has gross income of $300,000 and business expenses of $210,000 before this guaranteed payment to K. This resulted in a profit of $90,000. There were no other items of income or deduction. In computing the allocation of income, the first $40,000 is allocated to K as a guaranteed payment. The balance of $50,000 is allocated based upon the profit and loss sharing ratio of 50%. Therefore, K reports $65,000 of ordinary income and L $25,000 of ordinary income.

| Ordinary income before guaranteed payment | $90,000 |
| Less: Guaranteed payment to K | $40,000 |
| Ordinary income to be allocated | $50,000 |
| K's share | $25,000 |

Summary:
- K's share (40,000 + 25,000) | $65,000 |
- L's share | $25,000 |
- $90,000 |

Should the partnership adopt a fiscal year-end, only those payments made for the fiscal year ended in the partner’s tax year are included as ordinary income.

**LIABILITIES**

When a partnership incurs liabilities, the individual partners share in the responsibility to pay these liabilities. Because the partners are at-risk, the tax code allows an increase in the basis of a partner’s interest for their proportionate share of the debt. Should the liability be non-recourse, (which means the holder of the debt has no recourse against the partner), this generally does not increase their basis.

**Example 7:** During 2010, the CDE partnership is formed and each partner contributes $5,000. On December 31, 2010, the partnership borrows $12,000 for working capital purposes. The basis of the three equal partners, C, D and E, would be increased by their share ($4,000) of the recourse debt. Their ending basis, assuming no other transactions, would be $9,000 each.

**Example 8:** If in Example 7, the borrowing was to purchase land and the debt was non-recourse, there would be no increase in the basis of the partners.
PARTNER WITHDRAWALS
During the course of the year, partners typically withdraw capital in anticipation of their earnings. Generally, these withdrawals do not represent income to the partner. A partner is taxed on his share of the partnership income, not on what is withdrawn. The withdrawals do, however, reduce the basis of the partner's interest. When computing the balance in a partner's account, withdrawals are subtracted out before losses and deductions are.

Should a partner withdraw more than the balance in the capital account, the excess will be treated as a capital gain.

DEALINGS BETWEEN THE PARTNERS AND PARTNERSHIP
In general, transactions between a partner and the partnership are treated as if they were not related parties, and were conducted at an arm’s length basis. However, when a partner owns, directly or indirectly, more than 50% of a partnership’s capital, losses even at an arm’s length are disallowed.

If a partner owns more than 50% of a partnership’s capital, any gain from the sale of property between the partnership and partner must be recognized as ordinary income, unless the property is a capital asset to both the partnership and partner. Then the gain is capital.

SALE OR EXCHANGE OF A PARTNERSHIP INTEREST
When a partner sells their partnership interest, the difference between the amount realized and the adjusted basis of the interest represents the gain or loss. The amount realized typically involves the receipt of cash and the release of any partnership liabilities that partner had assumed by being a partner. The adjusted basis involves updating the activity to the date of sale for all the items of income, deductions, withdrawals, liabilities, etc.

After the recognized gain is determined, the character of the gain must be determined. In general, the gain or loss from the sale of a partnership interest is capital, but if the underlying assets in the partnership are those assets which if sold produce ordinary income, then the gain from the sale of that part of the partner's interest must be classified as ordinary. These assets are referred to as “hot assets” or Section 751 assets. Briefly, the hot assets include unrealized receivables, inventory and depreciation recapture. Congress enacted this provision to insure that partners would not escape ordinary income taxation merely by selling off their interests in the partnership rather than the assets.
**Example 9:** The EFG Partnership has three equal partners and the following balance sheet on June 30, 2010.

<table>
<thead>
<tr>
<th></th>
<th>Basis</th>
<th>FMV</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>10,000</td>
<td>10,000</td>
</tr>
<tr>
<td>Accounts receivable</td>
<td>-0-</td>
<td>6,000</td>
</tr>
<tr>
<td>Inventory</td>
<td>6,000</td>
<td>9,000</td>
</tr>
<tr>
<td>Land</td>
<td>5,000</td>
<td>14,000</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>21,000</td>
<td>39,000</td>
</tr>
<tr>
<td>Liabilities</td>
<td>3,000</td>
<td>3,000</td>
</tr>
<tr>
<td>Capital:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Partner E</td>
<td>8,000</td>
<td>12,000</td>
</tr>
<tr>
<td>Partner F</td>
<td>4,000</td>
<td>12,000</td>
</tr>
<tr>
<td>Partner G</td>
<td>6,000</td>
<td>12,000</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>21,000</td>
<td>39,000</td>
</tr>
</tbody>
</table>

Partner G sells his interest to H for $12,000 cash, plus H assumes G’s share of the partnership liabilities.

1. **First determine the gain recognized by G.**

   **Amount realized by G:**
   
   Cash received: $12,000
   
   Release of debt (1/3 of $3,000): 1,000
   
   **Total**: 13,000

   **Adjusted basis of G:**
   
   Capital tax basis: 6,000
   
   Share of liabilities at June 30, 2010: 1,000
   
   **Total**: 7,000

   **Recognized gain**: $6,000

2. **Then determine the character of the gain:**

<table>
<thead>
<tr>
<th></th>
<th>Basis</th>
<th>FMV</th>
<th>Gain</th>
<th>Character</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>10,000</td>
<td>10,000</td>
<td>-0-</td>
<td>-0-</td>
</tr>
<tr>
<td>Accounts receivable</td>
<td>-0-</td>
<td>6,000</td>
<td>6,000</td>
<td>2,000</td>
</tr>
<tr>
<td>Inventory</td>
<td>6,000</td>
<td>9,000</td>
<td>3,000</td>
<td>1,000</td>
</tr>
<tr>
<td>Land</td>
<td>5,000</td>
<td>14,000</td>
<td>9,000</td>
<td>3,000</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>21,000</td>
<td>39,000</td>
<td>18,000</td>
<td>6,000</td>
</tr>
</tbody>
</table>
DISTRIBUTIONS TO PARTNERS

NON-LIQUIDATING DISTRIBUTIONS

As discussed under withdrawals, the general rule is that no gain is recognized on a cash withdrawal by a partner, unless the cash exceeds the adjusted basis of the partner’s interest. A similar rule applies to distributions of property other than cash. When a partnership makes an “in-kind” distribution (property) to a partner, no gain or loss is recognized. Remember to update the partner’s basis to the time just prior to the distribution. This includes reducing it for any cash distributions made first.

If the adjusted basis of the property (being distributed) in the hands of the partnership is less than or equal to the adjusted basis of the partner prior to the distribution, then the property retains its partnership basis and the partner's interest in the partnership is correspondingly reduced.

Example 10: K has a basis of $16,000 in the KL partnership at the time a non-liquidating distribution is made to her. The property being distributed is $1,000 in cash and land with a basis of $12,000 and fair market value of $30,000. K’s basis is first reduced by the $1,000 cash received, leaving her a basis of $15,000. Since she has sufficient basis remaining, the land retains the partnership basis of $12,000 and her basis in the partnership is reduced to $3,000.

<table>
<thead>
<tr>
<th>K's basis</th>
<th>$16,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Less: cash received</td>
<td>(1,000)</td>
</tr>
<tr>
<td>Basis available</td>
<td>15,000</td>
</tr>
<tr>
<td>Land's basis</td>
<td>12,000</td>
</tr>
<tr>
<td>Remaining basis</td>
<td>$ 3,000</td>
</tr>
</tbody>
</table>

However, if the adjusted basis of the property (being distributed) in the hands of the partnership is greater than the adjusted basis of the partner prior to the distribution, then the property receives that partner’s basis and the partner's interest in the partnership is reduced to zero.

Example 11: Same facts as in Example 10 except that K’s basis is now $10,000. K’s basis is first reduced by the $1,000 cash received, leaving her a basis of $9,000. Since she does not have sufficient basis remaining to absorb the partnership’s basis in the land of $12,000, the land picks up her remaining basis of $9,000. The excess basis of $3,000 stays with the partnership which may make certain elections well beyond the scope of the CPA exam.

<table>
<thead>
<tr>
<th>K's basis</th>
<th>$10,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Less: cash received</td>
<td>(1,000)</td>
</tr>
<tr>
<td>Basis available</td>
<td>9,000</td>
</tr>
<tr>
<td>Land's basis limited</td>
<td>9,000</td>
</tr>
<tr>
<td>Remaining basis</td>
<td>$ 0</td>
</tr>
</tbody>
</table>

If the partner receives a partnership distribution of property which had a precontribution gain within 7 years of being contributed, such gain will be recognized. There are also special rules pertaining to disproportionate (or non-pro-rata) distributions and the distribution of hot assets. These too, are generally beyond the scope of the exam.
LIQUIDATING DISTRIBUTIONS

In a liquidating distribution, the partner’s interest is being terminated. When the distribution is cash only, gain or loss will be recognized. The character of the gain or loss will be capital unless there are Section 751 assets.

If cash and property is distributed in a liquidating distribution, cash reduces the partner’s basis first, then the property distributed takes a substituted basis equal to that partner’s remaining basis. Assuming there is basis remaining after the reduction for the cash distribution, no gain or loss is recognized.

Should the property being allocated include Section 751 assets, the partner’s basis should be allocated to those assets next. If the partner does not have sufficient basis remaining to allocate to the Section 751 assets, a capital loss is recognized for the shortfall. Any non-Section 751 assets would get no basis. However, if there is any remaining partner basis after Section 751 allocation, the remaining basis is allocated to the non-Section 751 assets and no gain or loss is recognized.

Example 12: On December 31, 2010, K, a 50% partner has an adjusted basis in the KL partnership of $10,000. The KL partnership’s only assets are cash of $12,000 and land with a basis of $9,000 and fair market value of $12,000 and land. There are no partnership liabilities. K receives a liquidating cash distribution from the partnership of $12,000. K will recognize a capital gain of $2,000.

<table>
<thead>
<tr>
<th>Cash distribution</th>
<th>$12,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>K's basis</td>
<td>10,000</td>
</tr>
<tr>
<td>Capital gain</td>
<td>$  2,000</td>
</tr>
</tbody>
</table>

Example 13: Same facts as Example 12 except that K receives the land instead of the cash. No gain is recognized at the partnership level even though the fair value of the land is $12,000 and the basis is only $9,000. No gain is recognized by K even though she is receiving an asset worth $12,000 when her basis is only $10,000. The basis of the land in the hands of K is now a substituted $10,000.

Example 14: If the land in Example 13 was inventory (a Section 751 asset) instead, a capital loss of $1,000 is recognized by the partner for the difference between the adjusted basis of the inventory in the partnership and the remaining adjusted basis of the partner.

TERMINATION OF A PARTNERSHIP

There are a number of events that signal the end of a partnership.

1. No part of any business, financial operation, or venture of the partnership continues to be carried on by any of its partners in a partnership, or
2. Within a 12-month period there is a sale or exchange of 50% or more of the total interest in partnership capital and profits, or
3. The partners consent to terminate, or
4. The partnership converts to an LLC.

At that time, the taxable year closes and a final return must be filed for that period. The partners may also simply consent to terminate the partnership as well. If the partnership continues in operations after a change of at least 50%, then there is a deemed distribution and a hypothetical re-contribution of assets to the partnership.
Chapter Seven — Questions  
Partnerships

**FORMATION OF THE PARTNERSHIP**

1. Eng contributed the following assets to a partnership in exchange for a 50% interest in the partnership's capital and profits:

   - **Cash** $50,000
   - **Equipment:**
     - Fair market value 35,000
     - Carrying amount (adjusted basis) 25,000

   The basis for Eng's interest in the partnership is
   a. $37,500  
   b. $42,500  
   c. $75,000  
   d. $85,000

2. The following information pertains to property contributed by Gray on July 1, 2010, for a 40% interest in the capital and profits of Kag & Gray, a partnership:

<table>
<thead>
<tr>
<th>Adj usted basis</th>
<th>Fair market value</th>
</tr>
</thead>
<tbody>
<tr>
<td>$24,000</td>
<td>$30,000</td>
</tr>
</tbody>
</table>

   After Gray’s contribution, Kag & Gray’s capital totaled $150,000. What amount of gain was reportable in Gray’s 2010 return on the contribution of property to the partnership?
   a. $0  
   b. $6,000  
   c. $30,000  
   d. $36,000

3. Lee inherited a partnership interest from Dale. The adjusted basis of Dale's partnership interest was $50,000, and its fair market value on the date of Dale's death (the estate valuation date) was $70,000. What was Lee's original basis for the partnership interest?
   a. $70,000  
   b. $50,000  
   c. $20,000  
   d. $0

4. The holding period of a partnership interest acquired in exchange for a contributed capital asset begins on the date
   a. The partner is admitted to the partnership.  
   b. The partner transfers the asset to the partnership.

c. The partner's holding period of the capital asset began.  

d. The partner is first credited with the proportionate share of the partnership capital.

5. On January 2, 2010, Black acquired a 50% interest in New Partnership by contributing property with an adjusted basis of $7,000 and a fair market value of $9,000, subject to a mortgage of $3,000. What was Black's basis in New at January 2, 2010?
   a. $3,500  
   b. $4,000  
   c. $5,500  
   d. $7,500

6. Strom acquired a 25 percent interest in Ace Partnership by contributing land having an adjusted basis of $16,000 and a fair market value of $50,000. The land was subject to a $24,000 mortgage, which was assumed by Ace. No other liabilities existed at the time of the contribution. What was Strom's basis in Ace?
   a. $0  
   b. $16,000.  
   c. $26,000.  
   d. $32,000.

7. On June 1, 2010, Kelly received a 10% interest in Rock Co., a partnership, for services contributed to the partnership. Rock's net assets at that date had a basis of $70,000 and a fair market value of $100,000. In Kelly's 2010 income tax return, what amount must Kelly include as income from transfer of partnership interest?
   a. $7,000 ordinary income.  
   b. $7,000 capital gain.  
   c. $10,000 ordinary income.  
   d. $10,000 capital gain.

8. Barker acquired a 50% interest in Kode Partnership by contributing $20,000 cash and a building with an adjusted basis of $26,000 and a fair market value of $42,000. The building was subject to a $10,000 mortgage which was assumed by Kode. The other partners contributed cash only. The basis of Barker's interest in Kode is
   a. $36,000  
   b. $41,000  
   c. $52,000  
   d. $62,000
9. At partnership inception, Black acquires a 50% interest in Decorators Partnership by contributing property with an adjusted basis of $250,000. Black recognizes a gain if

I. The fair market value of the contributed property exceeds its adjusted basis.

II. The property is encumbered by a mortgage with a balance of $100,000.

   a. I only.
   b. II only.
   c. Both I and II.
   d. Neither I nor II.

10. On January 4, 2010, Smith and White contributed $4,000 and $6,000 in cash, respectively, and formed the Macro General Partnership. The partnership agreement allocated profits and losses 40% to Smith and 60% to White. In 2010, Macro purchased property from an unrelated seller for $10,000 cash and a $40,000 mortgage note that was the general liability of the partnership. Macro's liability

   a. Increases Smith's partnership basis by $16,000.
   b. Increases Smith's partnership basis by $20,000.
   c. Increases Smith's partnership basis by $24,000.
   d. Has no effect on Smith's partnership basis.

11. Hart's adjusted basis in Best Partnership was $9,000 at the time he received the following nonliquidating distributions of partnership property:


<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$ 5,000</td>
</tr>
<tr>
<td>Land</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Adjusted basis 7,000</td>
</tr>
<tr>
<td></td>
<td>Fair market value 10,000</td>
</tr>
</tbody>
</table>

What was the amount of Hart's basis in the land?

   a. $0
   b. $4,000
   c. $7,000
   d. $10,000

12. Ola Associates is a limited partnership engaged in real estate development. Hoff, a civil engineer, billed Ola $40,000 in 2010 for consulting services rendered. In full settlement of this invoice, Hoff accepted a $15,000 cash payment plus the following:


<table>
<thead>
<tr>
<th>Fair market value</th>
<th>Carrying amount on Ola's books</th>
</tr>
</thead>
<tbody>
<tr>
<td>Ola</td>
<td>Surveying equipment</td>
</tr>
<tr>
<td></td>
<td>3% limited partnership interest in Ola</td>
</tr>
<tr>
<td></td>
<td>Surveying equipment</td>
</tr>
</tbody>
</table>

What amount should Hoff, a cash-basis taxpayer, report in his 2010 return as income for the services rendered to Ola?

   a. $15,000
   b. $28,000
   c. $32,000
   d. $40,000

13. The holding period of property acquired by a partnership as a contribution to the contributing partner's capital account

   a. Begins with the date of contribution to the partnership.
   b. Includes the period during which the property was held by the contributing partner.
   c. Is equal to the contributing partner's holding period prior to contribution to the partnership.
   d. Depends on the character of the property transferred.

14. In 2010, Dave Burr acquired a 20% interest in a partnership by contributing a parcel of land. At the time of Burr's contribution, the land had a fair market value of $35,000, an adjusted basis to Burr of $8,000, and was subject to a mortgage of $12,000. Payment of the mortgage was assumed by the partnership. Burr's basis for his interest in the partnership is

   a. $0
   b. $5,600
   c. $8,000
   d. $23,000

15. When a partner's share of partnership liabilities increases, that partner's basis in the partnership

   a. Increases by the partner's share of the increase.
   b. Decreases by the partner's share of the increase.
   c. Decreases, but not to less than zero.
   d. Is not affected.
16. Alt Partnership, a cash basis calendar year entity, began business on October 1, 2010. Alt incurred and paid the following in 2010:

Legal fees to prepare the partnership agreement $14,000
Accounting fees to prepare the representations in offering materials 15,000

Alt elected to amortize costs. What was the maximum amount that Alt could deduct on the 2010 partnership return?

a. $0.
b. $5,000
c. $5,150.
d. $29,000

17. The method used to depreciate partnership property is an election made by

a. The partnership and must be the same method used by the "principal partner."
b. The partnership and may be any method approved by the IRS.
c. The "principal partner."
d. Each individual partner.

18. Under Section 444 of the Internal Revenue Code, certain partnerships can elect to use a tax year different from their required tax year. One of the conditions for eligibility to make a Section 444 election is that the partnership must

a. Be a limited partnership.
b. Be a member of a tiered structure.
c. Choose a tax year where the deferral period is not longer than three months.
d. Have less than 35 partners.

19. Which one of the following statements regarding a partnership's tax year is correct?

a. A partnership formed on July 1 is required to adopt a tax year ending on June 30.
b. A partnership may elect to have a tax year other than the generally required tax year if the deferral period for the tax year elected does not exceed three months.
c. A "valid business purpose" can no longer be claimed as a reason for adoption of a tax year other than the generally required tax year.
d. Within 30 days after a partnership has established a tax year, a form must be filed with the IRS as notification of the tax year adopted.

20. Without obtaining prior approval from the IRS, a newly formed partnership may adopt

a. A taxable year which is the same as that used by one or more of its partners owning an aggregate interest of more than 50% in profits and capital.
b. A calendar year, only if it comprises a 12-month period.
c. A January 31 year end if it is a retail enterprise, and all of its principal partners are on a calendar year.
d. Any taxable year that it deems advisable to select.

21. Dale's distributive share of income from the calendar-year partnership of Dale & Eck was $50,000 in 2010. On December 15, 2010, Dale, who is a cash-basis taxpayer, received a $27,000 distribution of the partnership's 2010 income, with the $23,000 balance paid to Dale in May 2011. In addition, Dale received a $10,000 interest-free loan from the partnership in 2010. This $10,000 is to be offset against Dale's share of 2011 partnership income. What total amount of partnership income is taxable to Dale in 2010?

a. $27,000
b. $37,000
c. $50,000
d. $60,000

22. The partnership of Felix and Oscar had the following items of income during the taxable year:

Income from operations $156,000
Tax-exempt interest income 8,000
Dividends from foreign corporations 6,000
Net rental income 12,000

What is the total ordinary income of the partnership?

a. $156,000.
b. $162,000.
c. $174,000.
d. $168,000.
23. On January 2, 2010, Arch and Bean contribute cash equally to form the JK Partnership. Arch and Bean share profits and losses in a ratio of 75% to 25%, respectively. For 2010, the partnership's ordinary income was $40,000. A distribution of $5,000 was made to Arch during 2010. What is Arch's share of taxable income for 2010?
   a. $5,000
   b. $10,000
   c. $20,000
   d. $30,000

24. In computing the ordinary income of a partnership, a deduction is allowed for
   a. Contributions to recognized charities.
   b. Dividends received from qualifying domestic corporations.
   c. Short-term capital losses.
   d. Guaranteed payments to partners.

**BASIS OF PARTNER’S INTEREST AND SHARE OF LOSS**

25. Gray is a 50% partner in Fabco Partnership. Gray's tax basis in Fabco on January 1, 2010, was $5,000. Fabco made no distributions to the partners during 2010, and recorded the following:

<table>
<thead>
<tr>
<th>Category</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Ordinary income</td>
<td>$20,000</td>
</tr>
<tr>
<td>Tax exempt income</td>
<td>8,000</td>
</tr>
<tr>
<td>Portfolio income</td>
<td>4,000</td>
</tr>
</tbody>
</table>

What is Gray's tax basis in Fabco on December 31, 2010?
   a. $21,000
   b. $16,000
   c. $12,000
   d. $10,000

26. The partnership of Martin & Clark sustained an ordinary loss of $84,000 in 2010. The partnership, as well as the two partners, are on a calendar-year basis. The partners share profits and losses equally. At December 31, 2010, Clark had an adjusted basis of $36,000 for his partnership interest, before consideration of the 2010 loss. On his individual income tax return for 2010, Clark should deduct an
   a. Ordinary loss of $36,000.
   b. Ordinary loss of $42,000.
   c. Ordinary loss of $36,000 and a capital loss of $6,000.
   d. Capital loss of $42,000.

27. A contributed $23,000 and B contributed $5,000 on January 1st of this current year, to form a partnership. Profits and losses are to be shared equally. Each withdrew $3,000 during the year. The partnership's operating loss this year is $7,000. B's share of the loss allowable to him this year is:
   a. $500.
   b. $7,000.
   c. $2,000.
   d. $3,500.

28. Beck and Nilo are equal partners in B&N Associates, a general partnership. B&N borrowed $10,000 from a bank on an unsecured note, thereby increasing each partner's share of partnership liabilities. As a result of this loan, the basis of each partner's interest in B&N was
   a. Increased.
   b. Decreased.
   c. Unaffected.
   d. Dependent on each partner's ability to meet the obligation if called upon to do so.

29. At the beginning of 2010, Paul owned a 25% interest in Associates partnership. During the year, a new partner was admitted and Paul's interest was reduced to 20%. The partnership liabilities at January 1, 2010, were $150,000, but decreased to $100,000 at December 31, 2010. Paul's and the other partners' capital accounts are in proportion to their respective interests. Disregarding any income, loss or drawings for the year, the basis of Paul's partnership interest at December 31, 2010, compared to the basis of his interest at January 1, 2010 was
   a. Decreased by $37,500.
   b. Increased by $20,000.
   c. Decreased by $17,500.
   d. Decreased by $5,000.

30. On January 1, 2010, John Pierce acquired a 10% interest in the Saratoga and Company partnership for a cash investment of $20,000. In 2010 the partnership reported an ordinary loss of $40,000 of which Pierce's distributive share was $4,000. On January 1, 2010, the partnership had no liabilities; however, during 2010 the partnership had the following transactions:
   - A $50,000 loan from the Second National Bank due June 30, 2011.
   - A $100,000 nonrecourse loan (secured by inventory) from the Union Finance Company due December 31, 2011.
Before allocation of the operating loss, what should be the tax basis of Pierce's partnership interest at December 31, 2010, for determining the amount of loss he can share in?

a. $16,000.
b. $25,000.
c. $21,000.
d. $31,000.

31. Lewis & Clark, partners, have a P & L ratio of 2:1. For the year the partnership return showed a net S.T.C.L. of $3,000 and a net L.T.C.G. of $15,000. Lewis also had a personal net S.T.C.L. of $2,000. What is the net capital gain that should be included in Lewis' taxable income on his return?

a. $3,000.
b. $3,500.
c. $6,000.
d. $10,000.

32. Clark and Lewis are partners who share profits and losses 60% and 40% respectively. The tax basis of each partner's interest in the partnership as of December 31, 2009, was as follows:

<table>
<thead>
<tr>
<th>Partner</th>
<th>Basis</th>
</tr>
</thead>
<tbody>
<tr>
<td>Clark</td>
<td>$24,000</td>
</tr>
<tr>
<td>Lewis</td>
<td>$18,000</td>
</tr>
</tbody>
</table>

During 2010 the partnership had ordinary income of $50,000 and a long-term capital loss of $10,000 from the sale of securities. There were no distributions to the partners during 2010. What is the amount of Lewis' tax basis as of December 31, 2010?

a. $33,000.
b. $34,000.
c. $38,000.
d. $42,000.

33. Which of the following limitations will apply in determining a partner's deduction for that partner's share of partnership losses?

<table>
<thead>
<tr>
<th>At-risk</th>
<th>Passive loss</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. Yes</td>
<td>No</td>
</tr>
</tbody>
</table>
b. No     | Yes           |
c. Yes    | Yes           |
d. No     | No            |

34. White has a one-third interest in the profits and losses of Rapid Partnership. Rapid's ordinary income for the 2010 calendar year is $30,000, after a $3,000 deduction for a guaranteed payment made to White for services rendered. None of the $30,000 ordinary income was distributed to the partners. What is the total amount that White must include from Rapid as taxable income in his 2010 tax return?

a. $3,000.
b. $10,000.
c. $11,000.
d. $13,000.

35. Under the Internal Revenue Code sections pertaining to partnerships, guaranteed payments are payments to partners for

a. Payments of principal on secured notes honored at maturity.
b. Timely payments of periodic interest on bona fide loans that are not treated as partners' capital.
c. Services or the use of capital without regard to partnership income.
d. Sales of partners' assets to the partnership at guaranteed amounts regardless of market values.

36. Guaranteed payments made by a partnership to partners for services rendered to the partnership, that are deductible business expenses under the Internal Revenue Code, are

I. Deductible expenses on the U.S. Partnership Return of Income, Form 1065, in order to arrive at partnership income (loss).
II. Included on Schedules K-1 to be taxed as ordinary income to the partners.

a. I only.
b. II only.
c. Both I and II.
d. Neither I nor II.
37. A partnership owned by Joe Meeker and Taylor Corporation has a fiscal year ending March 31. Meeker files his tax return on a calendar-year basis. The partnership paid Meeker a guaranteed salary of $500 per month during the calendar year 2009 and $750 a month during the calendar year 2010. After deducting this salary, the partnership realized ordinary income of $40,000 for the year ended March 31, 2010, and $60,000 for the year ended March 31, 2011. Meeker's share of the profits is the salary paid to him plus 30% of the partnership profits after deducting this salary. For 2010 Meeker should report taxable income of:
   a. $18,750.
   b. $20,250.
   c. $21,000.
   d. $22,500.

38. Nash and Ford are partners in a calendar year partnership and share profits and losses equally. For the current year, the partnership had book income of $80,000 which included the following deductions:

   Guaranteed salaries to partners:
   Nash $35,000
   Ford  25,000
   Contributions                     5,000

What amount should be reported as ordinary income on the partnership return?
   a. $80,000.
   b. $85,000.
   c. $140,000.
   d. $145,000.

39. A guaranteed payment by a partnership to a partner for services rendered, may include an agreement to pay

I. A salary of $5,000 monthly without regard to partnership income.
II. A 25 percent interest in partnership profits.

   a. I only.
   b. II only.
   c. Both I and II.
   d. Neither I nor II.

40. Evan, a 25% partner in Vista Partnership, received a $20,000 guaranteed payment in 2010 for deductible services rendered to the partnership. Guaranteed payments were not made to any other partner. Vista's 2010 partnership income consisted of:

   Net business income before guaranteed payments $80,000
   Net long-term capital gains  10,000

What amount of income should Evan report from Vista Partnership on her 2010 tax return?
   a. $37,500
   b. $27,500
   c. $22,500
   d. $20,000

41. Dunn and Shaw are partners who share profits and losses equally. In the computation of the partnership's 2010 book income of $100,000, guaranteed payments to partners totaling $60,000 and charitable contributions totaling $1,000 were treated as expenses. What amount should be reported as ordinary income on the partnership's 2010 return?
   a. $100,000
   b. $101,000
   c. $160,000
   d. $161,000

42. Debra Wallace and Joan Pedersen are equal partners in the capital and profits of Wallace & Pedersen, but are otherwise unrelated. On August 1 of this taxable year, Wallace sold 100 shares of Kiandra Mining Corporation stock to the partnership for its fair market value of $7,000. Wallace had bought the stock in 1975 at a cost of $10,000. What is Wallace's recognized loss on the sale of this stock?
   a. $0.
   b. $1,500 long-term capital loss.
   c. $3,000 long-term capital loss.
   d. $3,000 ordinary loss.

43. On December 1, 2010, Alan Younger, a member of a three-man equal partnership, bought securities from the partnership for $27,000, their market value. The securities were acquired by the partnership for $15,000 on July 1, 2010. By what amount will this transaction increase Younger's taxable income for 2010?
   a. $0.
   b. $1,600.
   c. $4,000.
   d. $12,000.
44. Edward owns a 70% interest in the capital and profits of the partnership of Edward and Moore. During 2010 Edward purchased a piece of surplus machinery from the partnership for $5,000. On the date of sale the machinery had an adjusted basis to the partnership of $8,000. For the year ended December 31, 2010, the partnership's net income was $50,000 after recording the loss on sale of machinery. Assuming that there were no other partnership items to be specially reported, what is Edward's distributive share of the partnership's ordinary income for 2010?

<table>
<thead>
<tr>
<th>Amount Type of gain</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. $25,000 Ordinary income</td>
</tr>
<tr>
<td>b. $25,000 Capital gain</td>
</tr>
<tr>
<td>c. $40,000 Ordinary income</td>
</tr>
<tr>
<td>d. $40,000 Capital gain</td>
</tr>
</tbody>
</table>

Items 48 and 49 are based on the following:

The personal service partnership of Allen, Baker & Carr had the following cash basis balance sheet at December 31, 2010:

<table>
<thead>
<tr>
<th>Assets</th>
<th>Adjusted basis per books</th>
<th>Market value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$102,000 $102,000</td>
<td></td>
</tr>
<tr>
<td>Unrealized accounts receivable</td>
<td>-- $420,000</td>
<td></td>
</tr>
<tr>
<td>Totals</td>
<td>$102,000 $522,000</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Liability and Capital</th>
</tr>
</thead>
<tbody>
<tr>
<td>Note payable</td>
</tr>
<tr>
<td>Capital accounts:</td>
</tr>
<tr>
<td>Allen</td>
</tr>
<tr>
<td>Baker</td>
</tr>
<tr>
<td>Carr</td>
</tr>
<tr>
<td>Totals</td>
</tr>
</tbody>
</table>

45. In March 2010, Lou Cole bought 100 shares of a listed stock for $10,000. In May 2010, Cole sold this stock for its fair market value of $16,000 to the partnership of Rook, Cole & Clive. Cole owned a one-third interest in this partnership. In Cole's 2010 tax return, what amount should be reported as short-term capital gain as a result of this transaction?

<table>
<thead>
<tr>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. $6,000</td>
</tr>
<tr>
<td>b. $4,000</td>
</tr>
<tr>
<td>c. $2,000</td>
</tr>
<tr>
<td>d. $0</td>
</tr>
</tbody>
</table>

SALE OF PARTNERSHIP INTEREST

46. Which of the following should be used in computing the basis of a partner's interest acquired from another partner?

<table>
<thead>
<tr>
<th>Cash paid by transferee to transferor</th>
<th>Transferee's share of partnership liabilities</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. No</td>
<td>Yes</td>
</tr>
<tr>
<td>b. Yes</td>
<td>No</td>
</tr>
<tr>
<td>c. No</td>
<td>No</td>
</tr>
<tr>
<td>d. Yes</td>
<td>Yes</td>
</tr>
</tbody>
</table>

47. On November 30, 2010, Diamond's adjusted basis for his one-third interest in the capital and profits of Peterson and Company was $95,000 ($80,000 capital account plus $15,000 share of partnership liabilities). On that date Diamond sold his partnership interest to Girard for $120,000 cash and the assumption of Diamond's share of the partnership liabilities. What amount and type of gain should Diamond recognize in 2010 from the sale of his partnership interest?

48. What was the total amount realized by Carr on the sale of his partnership interest?

<table>
<thead>
<tr>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. $174,000</td>
</tr>
<tr>
<td>b. $154,000</td>
</tr>
<tr>
<td>c. $140,000</td>
</tr>
<tr>
<td>d. $134,000</td>
</tr>
</tbody>
</table>

49. What amount of ordinary income should Carr report in his 2011 income tax return on the sale of his partnership interest?

<table>
<thead>
<tr>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. $0</td>
</tr>
<tr>
<td>b. $20,000</td>
</tr>
<tr>
<td>c. $34,000</td>
</tr>
<tr>
<td>d. $140,000</td>
</tr>
</tbody>
</table>
50. On December 31, 2010, after receipt of his share of partnership income, Clark sold his interest in a limited partnership for $30,000 cash and relief of all liabilities. On that date, the adjusted basis of Clark's partnership interest was $40,000, consisting of his capital account of $15,000 and his share of the partnership liabilities of $25,000. The partnership has no unrealized receivables or inventory. What is Clark's gain or loss on the sale of his partnership interest?
   a. Ordinary loss of $10,000.
   b. Ordinary gain of $15,000.
   c. Capital loss of $10,000.
   d. Capital gain of $15,000.

**DISTRIBUTION OF PARTNERSHIP ASSETS**

**NON-LIQUIDATING DISTRIBUTIONS**

51. Day's adjusted basis in LMN Partnership interest is $50,000. During the year Day received a nonliquidating distribution of $25,000 cash plus land with an adjusted basis of $15,000 to LMN, and a fair market value of $20,000. How much is Day's basis in the land?
   a. $10,000
   b. $15,000
   c. $20,000
   d. $25,000

52. Fred Elk's adjusted basis of his partnership interest in Arias & Nido was $30,000. Elk received a current nonliquidating distribution of $12,000 cash, plus property with a fair market value of $26,000 and an adjusted basis to the partnership of $14,000. How much is Elk's basis for the distributed property?
   a. $18,000
   b. $14,000
   c. $26,000
   d. $30,000

53. Hart's adjusted basis of his interest in a partnership was $30,000. He received a nonliquidating distribution of $24,000 cash plus a parcel of land with a fair market value and partnership basis of $9,000. Hart's basis for the land is
   a. $9,000
   b. $6,000
   c. $3,000
   d. $0

54. Dean is a 25 percent partner in Target Partnership. Dean's tax basis in Target on January 1, 2010, was $20,000. At the end of 2010, Dean received a nonliquidating cash distribution of $8,000 from Target. Target's 2010 accounts recorded the following items:

- Municipal bond interest income: $12,000
- Ordinary income: 40,000

What was Dean's tax basis in Target on December 31, 2010?
   a. $15,000.
   b. $23,000.
   c. $25,000.
   d. $30,000.

55. Curry's adjusted basis in Vantage Partnership was $5,000 at the time he received a nonliquidating distribution of land. The land had an adjusted basis of $6,000 and a fair market value of $9,000 to Vantage. What was the amount of Curry's basis in the land?
   a. $9,000
   b. $6,000
   c. $5,000
   d. $1,000

56. Stone's basis in Ace Partnership was $70,000 at the time he received a nonliquidating distribution of partnership capital assets. These capital assets had an adjusted basis of $65,000 to Ace, and a fair market value of $83,000. Ace had no unrealized receivable, appreciated inventory, or properties which had been contributed by its partners. What was Stone's recognized gain or loss on the distribution?
   a. $18,000 ordinary income.
   b. $13,000 capital gain.
   c. $5,000 capital loss.
   d. $0.

**Items 57 and 58** are based on the following:

The adjusted basis of Jody's partnership interest was $50,000 immediately before Jody received a current distribution of $20,000 cash and property with an adjusted basis to the partnership of $40,000 and a fair market value of $35,000.

57. What amount of taxable gain must Jody report as a result of this distribution?
   a. $0.
   b. $5,000.
   c. $10,000.
   d. $20,000.
58. What is Jody's basis in the distributed property?
   a. $0.
   b. $30,000.
   c. $35,000.
   d. $40,000.

**LIQUIDATING DISTRIBUTIONS**

59. The basis to a partner of property distributed “in kind” in complete liquidation of the partner’s interest is the
   a. Adjusted basis of the partner’s interest increased by any cash distributed to the partner in the same transaction.
   b. Adjusted basis of the partner’s interest reduced by any cash distributed to the partner in the same transaction.
   c. Adjusted basis of the property to the partnership.
   d. Fair market value of the property.

60. In 1985, Lisa Bara acquired a one-third interest in Dee Associates, a partnership. In 2010, when Lisa's entire interest in the partnership was liquidated, Dee's assets consisted of the following: cash, $20,000; tangible property with a basis of $46,000 and a fair market value of $40,000. Dee had no liabilities. Lisa's adjusted basis for her one-third interest was $22,000. Lisa received cash of $20,000 in liquidation of her entire interest. What was Lisa's recognized loss in 2010 on the liquidation of her interest in Dee?
   a. $0.
   b. $2,000 short-term capital loss.
   c. $2,000 long-term capital loss.
   d. $2,000 ordinary loss.

61. At December 31, 2010, Max Curcio's adjusted basis in the partnership of Madura & Motta was $36,000. On December 31, 2010, Madura & Motta distributed cash of $6,000 and a parcel of land to Curcio in liquidation of Curcio's entire interest in the partnership. The land had an adjusted basis of $18,000 to the partnership and a fair market value of $42,000 at December 31, 2010. How much is Curcio's basis in the land?
   a. $0
   b. $12,000
   c. $30,000
   d. $36,000

62. The Choate, Hamm and Sloan partnership's balance sheet on a cash basis at Sept. 30 of the current year was as follows:

<table>
<thead>
<tr>
<th>Assets</th>
<th>Basis</th>
<th>F.M.V.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$12,000</td>
<td>$12,000</td>
</tr>
<tr>
<td>Accounts receivable</td>
<td>-0-</td>
<td>48,000</td>
</tr>
<tr>
<td>Land</td>
<td>63,000</td>
<td>90,000</td>
</tr>
</tbody>
</table>

   $75,000 | $150,000 |

**Equities**

| Notes payable | $30,000 | $30,000 |
| Choate, capital | 15,000 | 40,000 |
| Hamm, capital  | 15,000 | 40,000 |
| Sloan, capital | 15,000 | 40,000 |

   $75,000 | $150,000 |

If Choate withdraws under an agreement whereby he takes one-third of each of the three assets and assumes $10,000 of the notes payable, he should report:
   a. $9,000 capital gain.
   b. $9,000 ordinary gain.
   c. $16,000 ordinary gain and $9,000 capital gain.
   d. No gain or loss.

**Items 63 and 64** are based on the following data:

Mike Reed, a partner in Post Co., received the following distribution from Post:

<table>
<thead>
<tr>
<th>Post's basis</th>
<th>Fair market value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$11,000</td>
</tr>
<tr>
<td>Land</td>
<td>5,000</td>
</tr>
</tbody>
</table>

Before this distribution, Reed's basis in Post was $25,000.

63. If this distribution were nonliquidating, Reed's recognized gain or loss on the distribution would be
   a. $11,000 gain.
   b. $9,000 loss.
   c. $1,500 loss.
   d. $0.

64. If this distribution were in complete liquidation of Reed's interest in Post, Reed's basis for the land would be
   a. $14,000
   b. $12,500
   c. $5,000
   d. $1,500
65. For tax purposes, a retiring partner who receives retirement payments ceases to be regarded as a partner
   a. On the last day of the taxable year in which the partner retires.
   b. On the last day of the particular month in which the partner retires.
   c. The day on which the partner retires.
   d. Only after the partner's entire interest in the partnership is liquidated.

66. On June 30, 2010, Berk retired from his partnership. At that time, his capital account was $50,000 and his share of the partnership's liabilities was $30,000. Berk's retirement payments consisted of being relieved of his share of the partnership liabilities and receipt of cash payments of $5,000 per month for 18 months, commencing July 1, 2010. Assuming Berk makes no election with regard to the recognition of gain from the retirement payments, he should report income therefrom of

<table>
<thead>
<tr>
<th>2010</th>
<th>2011</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. $13,333</td>
<td>$26,667</td>
</tr>
<tr>
<td>b. 20,000</td>
<td>20,000</td>
</tr>
<tr>
<td>c. 40,000</td>
<td>--</td>
</tr>
<tr>
<td>d. --</td>
<td>40,000</td>
</tr>
</tbody>
</table>

**TERMINATION OF PARTNERSHIP**

67. A partnership is terminated for tax purposes
   a. Only when it has terminated under applicable local partnership law.
   b. When at least 50% of the total interest in partnership capital and profits changes hands by sale or exchange within 12 consecutive months.
   c. When the sale of partnership assets is made only to an outsider, and not to an existing partner.
   d. When the partnership return of income (Form 1065) ceases to be filed by the partnership.

68. Cobb, Danver, and Evans each owned a one-third interest in the capital and profits of their calendar-year partnership. On September 18, 2010, Cobb and Danver sold their partnership interests to Frank, and immediately withdrew from all participation in the partnership. On March 15, 2011, Cobb and Danver received full payment from Frank for the sale of their partnership interests. For tax purposes, the partnership a. Terminated on September 18, 2010.
   b. Terminated on December 31, 2010.
   c. Terminated on March 15, 2011.
   d. Did not terminate.

69. David Beck and Walter Crocker were equal partners in the calendar-year partnership of Beck & Crocker. On July 1, 2010, Beck died. Beck's estate became the successor in interest and continued to share in Beck & Crocker's profits until Beck's entire partnership interest was liquidated on April 30, 2011. At what date was the partnership considered terminated for tax purposes?
   a. April 30, 2011.

70. On November 1, 2010, Kerry and Payne, each of whom was a 20% partner in the calendar-year partnership of Roe Co., sold their partnership interests to Reed who was a 60% partner. For tax purposes, the Roe Co. partnership a. Was terminated as of November 1, 2010.
   b. Was terminated as of December 31, 2010.
   c. Continues in effect until a formal partnership dissolution notice is filed with the IRS.
   d. Continues in effect until a formal partnership dissolution resolution is filed in the office of the county clerk where Roe Co. had been doing business.

71. On January 3, 2010, the partners' interests in the capital, profits, and losses of Able Partnership were:

<table>
<thead>
<tr>
<th>% of capital, profits and losses</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dean 25%</td>
</tr>
<tr>
<td>Poe 30%</td>
</tr>
<tr>
<td>Ritt 45%</td>
</tr>
</tbody>
</table>

On February 4, 2010, Poe sold her entire interest to an unrelated party. Dean sold his 25% interest in Able to another unrelated party on December 20, 2010. No other transactions took place in 2010. For tax purposes, which of the following statements is correct with respect to Able?
   d. Able did not terminate.
72. Curry's sale of her partnership interest causes a partnership termination. The partnership's business and financial operations are continued by the other members. What is(are) the effect(s) of the termination?

I. There is a deemed distribution of assets to the remaining partners and the purchaser.

II. There is a hypothetical recontribution of assets to a new partnership.

a. I only.
b. II only.
c. Both I and II.
d. Neither I nor II.

Released and Author Constructed Questions

Questions 73 and 74 are based on the following:

Jones and Curry formed Major Partnership as equal partners by contributing the assets below:

<table>
<thead>
<tr>
<th>Asset</th>
<th>Adjusted basis</th>
<th>Fair market value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Jones</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cash</td>
<td>$45,000</td>
<td>$45,000</td>
</tr>
<tr>
<td>Curry</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Land</td>
<td>30,000</td>
<td>57,000</td>
</tr>
</tbody>
</table>

The land was held by Curry as a capital asset, subject to a $12,000 mortgage, that was assumed by Major.

73. What was Curry's initial basis in the partnership interest?
   a. $45,000
   b. $30,000
   c. $24,000
   d. $18,000

74. What was Jones' initial basis in the partnership interest?
   a. $51,000
   b. $45,000
   c. $39,000
   d. $33,000

75. Basic Partnership, a cash-basis calendar year entity, began business on February 1, 2010. Basic incurred and paid the following in 2010:

Filing fees incident to the creation of the partnership $3,600
Accounting fees to prepare the representations in offering materials 12,000

Basic elected to amortize costs. What was the maximum amount that Basic could deduct on the 2010 partnership return?
   a. $15,600
   b. $11,000
   c. $3,600
   d. $660

76. On January 1, 2010, Kane was a 25% equal partner in Maze General Partnership, which had partnership liabilities of $300,000. On January 2, 2010, a new partner was admitted and Kane's interest was reduced to 20%. On April 1, 2010, Maze repaid a $100,000 general partnership loan. Ignoring any income, loss, or distributions for 2010, what was the net effect of the two transactions on Kane's tax basis in Maze partnership interest?
   a. Has no effect.
   b. Decrease of $35,000.
   c. Increase of $15,000.
   d. Decrease of $75,000.

77. Under which of the following circumstances is a partnership that is not an electing large partnership considered terminated for income tax purposes?

I. Fifty-five percent of the total interest in partnership capital and profits is sold within a 12-month period.
II. The partnership's business and financial operations are discontinued.

   a. I only.
   b. II only.
   c. Both I and II.
   d. Neither I nor II.
78. Freeman, a single individual, reported the following in the current year:

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

What amount of Freeman’s income is subject of the self-employment tax?

a. $-0-

b. $20,000
c. $50,000
d. $70,000

79. Peters has a one-third interest in the Spano Partnership. During the year, Peters received a $16,000 guaranteed payment, which was deductible by the partnership, for services rendered to Spano. Spano reported an operating loss of $70,000 before the guaranteed payment. What is (are) the net effect(s) of the guaranteed payment?

I. The guaranteed payment increases Peters’s tax basis in Spano by $16,000.
II. The guaranteed payment increases Peters’s ordinary income by $16,000

a. I only

b. II only
c. Both I and II
d. Neither I nor II

80. Kerr and Marcus form KM Partnership with a cash contribution of $80,000 from Kerr and a property contribution of land from Marcus. The land has a fair market value of $80,000 and an adjusted basis of $50,000 at the date of contribution. Kerr and Marcus are equal partners. What is Marcus’s basis immediately after the formation?

a. $0

b. $50,000
c. $65,000
d. $80,000

81. Smith received a one-third interest of a partnership by contributing $3,000 in cash, stock with a fair market value of $5,000 and a basis of $2,000, a new computer that cost Smith $2,500. Which of the following amounts represents Smith’s basis in the partnership?

a. $10,500

b. $7,500
c. $5,500
d. $3,000

82. A partnership had four partners. Each partner contributed $100,000 cash. The partnership reported income for the year of $80,000 and distributed $10,000 to each partner. What was each partner’s basis in the partnership at the end of the current year?

a. $170,000

b. $120,000
c. $117,500
d. $110,000

83. Which of the following is an advantage of forming a limited liability company (LLC) as opposed to a partnership?

a. The entity may avoid taxation.
b. The entity may have any number of owners.
c. The owner may participate in management while limiting personal liability.
d. The entity may make disproportionate allocations and distributions to members.

84. Molloy contributed $40,000 in cash in exchange for a one-third interest in the RST Partnership. In the first year of partnership operations, RST had taxable income of $60,000. In addition, Molloy received a $5,000 distribution of cash and, at the end of the partnership year, Molloy had a one-third share in the $18,000 of partnership recourse liabilities. What was Molloy’s basis in RST at year-end?

a. $55,000

b. $61,000
c. $71,000
d. $101,000
85. The CSU partnership distributed to each partner cash of $4,000, inventory with a basis of $4,000 and a fair market value (FMV) of $6,000, and land with a basis of $5,000 and a FMV of $3,000 in a liquidating distribution. Partner Chang had an outside basis in Chang’s partnership interest of $12,000. In the second year after receiving the liquidating distribution, Chang sold the inventory for $5,000 and the land for $3,000. What income must Chang report upon the sale of these assets?
   a. $0 gain or loss.
   b. $0 ordinary gain and $1,000 capital loss.
   c. $1,000 ordinary gain and $1,000 capital loss.
   d. $1,000 ordinary gain and $0 capital loss.

86. Nolan designed Timber Partnership’s new building. Nolan received an interest in the partnership for services. Nolan’s normal billing for these services would be $80,000 and the fair market value of the partnership interest Nolan received is $120,000. What amount of income should Nolan report?
   a. $0
   b. $40,000
   c. $80,000
   d. $120,000

87. Baker is a partner in BDT with a partnership basis of $60,000. BDT made a liquidating distribution of land with an adjusted basis of $75,000 and a fair market value of $40,000 to Baker. What amount of gain or loss should Baker report?
   a. $35,000 loss
   b. $20,000 loss
   c. $0
   d. $15,000 gain

88. Fern received $30,000 in cash and an automobile with an adjusted basis and fair market value of $20,000 in a proportionate liquidating distribution from EF Partnership. Fern’s basis in the partnership interest was $60,000 before the distribution. What is Fern’s basis in the automobile he received in the liquidation?
   a. $0
   b. $10,000
   c. $20,000
   d. $30,000

89. A $100,000 increase in partnership liabilities is treated in which of the following ways?
   a. Increases each partner’s basis in the partnership by $100,000.
   b. Increases the partners’ bases only if the liability is nonrecourse.
   c. Increases each partner’s basis in proportion to their ownership.
   d. Does not change any partner’s basis in the partnership regardless of whether the liabilities are recourse or nonrecourse.

90. Dale was a 50% partner in the D&P Partnership. Dale contributed $10,000 in cash upon the formation of the partnership. D&P borrowed $10,000 to purchase equipment. During the first year of operations, D&P had $15,000 net taxable income, $2,000 tax-exempt interest income, a $3,000 distribution to each partner, and a $4,000 reduction of debt. At the end of the first year of operation, what amount would be Dale’s basis?
   a. $16,500
   b. $17,500
   c. $18,500
   d. $21,500

91. The adjusted basis of Smith’s interest in EVA partnership was $230,000 immediately before receiving the following distribution in complete liquidation of EVA.

<table>
<thead>
<tr>
<th>Basis</th>
<th>Fair market value to EVA</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$150,000</td>
</tr>
<tr>
<td>Land</td>
<td>120,000</td>
</tr>
</tbody>
</table>

What is Smith’s basis in the real estate?
   a. $146,000
   b. $133,000
   c. $120,000
   d. $80,000
Chapter Seven — Answers
Partnerships

1. (c) $75,000. There is a carryover basis from the contributed property (cash of $50,000 and the adjusted basis of the equipment of $25,000). In general, no gain or loss is recognized in the case of a contribution of property in exchange for a partnership interest. Even though there is a realized gain of $10,000 on the equipment, no gain is recognized, and therefore, there is no additional increase in basis.

2. (a) $0. In general, no gain or loss is recognized in the case of a contribution of property in exchange for a partnership interest. The amount of the total capital in the partnership is not relevant for the determination of the gain.

3. (a) $70,000. The basis of property in the hands of a person acquiring it from a decedent is the fair market value of the property at the decedent’s death, unless an alternative valuation date is elected.

4. (c) The holding period of the partner’s interest in the partnership is the same as the holding period of the property contributed to the partnership. There is a carryover of both the basis and holding period.

5. (c) $5,500. A partner’s basis of an interest in the partnership is the basis of the property transferred, less any liabilities assumed by the other partners. The basis of the property transferred by Black into the partnership was $7,000, less the liability of $1,500 (50% of the $3,000) assumed by the other partners. You may also compute it as:

<table>
<thead>
<tr>
<th>Basis of property transferred</th>
<th>7,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Less: total liabilities assumed by partnership</td>
<td>(3,000)</td>
</tr>
<tr>
<td>Plus: liability assumed by Black as 50% partner</td>
<td>1,500</td>
</tr>
<tr>
<td>Basis of partnership interest</td>
<td>5,500</td>
</tr>
</tbody>
</table>

6. (a) $0. The basis of an interest in the partnership is the basis of the property transferred, less any liabilities assumed by the other partners. The basis of the land transferred by Strom into the partnership was $16,000, less the liability of $18,000 (75% of the $24,000) assumed by the other partners. This, however, would result in a negative basis of $2,000. Since a partner’s basis cannot be negative, a $2,000 gain must be recognized by Strom, thus increasing his basis to zero.

7. (c) $10,000 ordinary income. When a partner renders services in exchange for a partnership interest, the partner must recognize ordinary income equal to the fair market value of the partnership interest received. This is computed as 10% of the $100,000.

8. (b) $41,000. A partner’s basis of an interest in the partnership is the basis of the property transferred, less any liabilities assumed by the other partners. The basis of the property transferred by Barker into the partnership was $20,000 for the cash, $26,000 for the building, less the liability of $5,000 (50% of the $10,000) assumed by the other partners. You may also compute it as:

| Basis of property transferred: |
|-------------------------------|-------|
| Cash                          | 20,000 |
| Building                      | 26,000 |
|                              | 46,000 |
| Less: Liabilities assumed by partnership | -10,000 |
|                              | 36,000 |
| Plus: Liability assumed by Barker (50%) | 5,000 |
|                              | 41,000 |
9. (d) In general, no gain or loss is recognized in the case of a contribution of property in exchange for a partnership interest. When the partnership assumes the liability on property contributed by a partner, no gain results when the liability is less than the adjusted basis of the property.

10. (a) $16,000. An increase in general liabilities to a partnership will increase each partner's basis by their share of the partnership account. Since Smith is a 40% partner, Smith's basis will be increased by 40% of $40,000, or $16,000.

11. (b) $4,000. In a non-liquidating distribution to a partner, any cash received is first used to reduce that partner’s basis. Then, any in-kind property distributed by the partnership to the partner decreases that partner’s basis by the adjusted basis of that property, but only to the extent of the partner’s remaining basis. Hart’s basis prior to the distribution was $9,000. After the $5,000 cash distribution, Hart’s partnership basis was only $4,000. Even though the fair market value of the land in the partnership was $10,000 and the basis was $7,000, Hart’s basis in the land will be limited to his remaining basis in the partnership, or $4,000. No gain or loss is recognized on this transaction. Hart’s eventual sale of the property in the future will trigger the gain due to the low basis allocated at this time.

12. (c) $32,000. Hoff must recognize cash plus the fair market value of the other property received in this transaction. Whereas Hoff is a cash basis taxpayer, the difference between the invoice rendered of $40,000 and the $32,000, is not recognized as a bad debt since the $40,000 of income was never recognized originally.

13. (b) When a partner transfers in property to a partnership, the holding period of that property in the hands of the contributing partner transfers over to the partnership.

14. (a) $0. A partner’s basis of an interest in the partnership is the basis of the property transferred, less any liabilities assumed by the other partners. Burr is a 20% partner, and as a result the other partners will be liable for $9,600 (80% of the $12,000 mortgage) of the debt being assumed. Since the $9,600 exceeds the basis of $8,000 in the property, Burr must recognize a $1,600 gain on this transfer. His basis in the partnership is as follows:

<table>
<thead>
<tr>
<th>Basis of land transferred $8,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Plus: Gain recognized 1,600</td>
</tr>
<tr>
<td>Less: Liabilities assumed by other partners -9,600</td>
</tr>
<tr>
<td>Ending basis $ 0</td>
</tr>
</tbody>
</table>

15. (a) Whereas partners are individually liable on their share of the partnership debt, an increase in the partnership liabilities results in a proportionate increase in their partnership basis.

16. (c) $5,150 In general, the organization costs of $14,000 incurred in 2010 can be amortized over a period of not less than 180 months assuming a timely election has been made. The $15,000 for accounting fees would be charged to capital, and not amortized. The partnership may elect to immediate expense up to $5,000 of the $14,000 and then amortize the balance of $9,000 over 180 months, providing $50 per month of amortization. Since there are three months included in 2010, or $150, the total expense is therefore $5,150.

17. (b) This election is made by the partnership. There is no requirement to adopt the depreciation method used by the principal partner. See discussion on Aggregate vs. Entity Theory.

18. (c) Section 444 allows a deferral period for certain partnerships of up to three months.

19. (b) Because a partnership may easily defer income from one year to another merely by adopting a fiscal year end different from that of its partners, Congress and IRS have established a series of rules limiting the availability of certain year ends. Briefly the hierarchy for year-end selection is as follows:

1. The year-end of the majority of the partners.
2. The year-end of the principal partners.
3. The year-end resulting in the “least aggregate deferral” of income.
If the selection of the fiscal year-end using the rules above is not acceptable, the partnership may select a year-end under one of these three alternatives:
1. Establish that a business purpose exists, usually supported by cyclical income.
2. Establish a natural business tax year following the IRS procedures where gross receipts of 25% or more were recognized in a two month period for three consecutive years.
3. Select a tax year where no more than three months of partnership income is deferred from the required tax year.

In this problem, the only correct answer is the last alternative listed, selecting a tax year where no more than three months of partnership income is deferred.

20. (a) See answer #19 above for a full discussion regarding the selection of year-ends. This question is answered by the first criteria that states the partnership must choose the same year-end as the majority of the partners.

21. (c) $50,000. Dale must report his distributive share of income, regardless of whether the amount is distributed or not. The distributions generally serve to reduce the partner’s basis and not cause the recognition of income, unless a cash distribution in excess of the partner’s basis is made.

22. (a) $156,000. Partnership ordinary income from its business activity is determined by subtracting the non-separately stated business deductions from its non-separately stated income. In this problem, tax-exempt interest, dividends from foreign corporations and net rental income are all separately stated and not netted against ordinary income. Each of these three items are separately stated since they have a special effect on the partner on his individual return.

23. (d) $30,000. Arch’s share of the ordinary income is 75% of the $40,000 partnership ordinary income. The distributions generally serve to reduce the partner’s basis and not cause the recognition of income. The $5,000 cash distribution is not in excess of Arch’s capital account.

24. (d) In determining the amount of ordinary income to allocate to the partners, guaranteed payments must first be subtracted and allocated to that partner. The other three items listed in the question represent items which must be separately stated.

25. (a) $21,000. Gray’s tax basis starts with his beginning basis and includes his proportionate share of the following items of income. Note that a partner’s tax basis is affected by items which are non-taxable as well as taxable.

```
Gray’s opening tax basis                              $5,000
Fabco Partnership 2010 income:
  Ordinary income                                      $20,000
  Tax exempt income                                    8,000
  Portfolio income                                     4,000
  Total partnership income                             32,000
Gray’s 50% share of the partnership income            16,000
Gray’s tax basis on December 31, 2010                 $21,000
```

26. (a) $36,000 ordinary loss. A partner can deduct losses only to the extent of his basis in his partnership interest at the end of the year. Any additional losses (in this case $6,000) are suspended at the partner level until there is sufficient basis, oftentimes obtained through additional capital contributions, loans, or partnership income.

27. (c) $2,000. A partner can deduct losses only to the extent of his basis in his partnership interest at the end of the year. The partner’s basis is first reduced by any withdrawals during the year before the determination of any losses. Any additional losses (in this case $1,500) are suspended until the partner has sufficient basis.
28. (a) Increased. A partner’s basis in his partnership interest is increased by his share of the partnership liabilities.

29. (c) $17,500 decrease. A partner’s basis in his partnership interest is increased or decreased by his share of the partnership liabilities at the end of the year. By analyzing the change in liabilities and the partner’s percentage of interest from the beginning to the end of the year, the decrease in basis of $17,500 can be seen below.

<table>
<thead>
<tr>
<th></th>
<th>Jan 1, 2010</th>
<th>Dec. 31, 2010</th>
</tr>
</thead>
<tbody>
<tr>
<td>Partnership liabilities</td>
<td>$150,000</td>
<td>$100,000</td>
</tr>
<tr>
<td>Paul’s partnership interest</td>
<td>25%</td>
<td>20%</td>
</tr>
<tr>
<td>Paul’s interest through liabilities</td>
<td>$37,500</td>
<td>$20,000</td>
</tr>
</tbody>
</table>

30. (b) $25,000. A partner can deduct losses only to the extent of his basis in his partnership interest at the end of the year. A partner’s basis in his partnership interest is increased by his share of the partnership liabilities at the end of the year. In computing Pierce’s basis through liabilities, non-recourse debt is not included. Therefore, his basis is equal to his initial basis of $20,000, plus his 10% proportionate share of the liability of $50,000, or another $5,000.

31. (c) $6,000. This problem integrates the flow-through nature of partnership activity with that of the individual partner. The partner’s 2/3 share of the net STCL of $3,000 and the 2/3 share of the net LTCG of $15,000 are combined with Lewis’ personal net STCL of $2,000.

<table>
<thead>
<tr>
<th></th>
<th>Lewis’</th>
</tr>
</thead>
<tbody>
<tr>
<td>Partnership level:</td>
<td>Total</td>
</tr>
<tr>
<td>STCL</td>
<td>$3,000</td>
</tr>
<tr>
<td>LTCG</td>
<td>15,000</td>
</tr>
<tr>
<td>Lewis’ 2/3 share</td>
<td>(2,000)</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Individual level:</th>
</tr>
</thead>
<tbody>
<tr>
<td>STCL 100%</td>
</tr>
<tr>
<td>Lewis’ net capital gain reported as taxable income</td>
</tr>
</tbody>
</table>

32. (b) $34,000. The partner’s ending basis is the beginning basis, plus his proportionate share of the ordinary income less his share of the capital loss. In computing Lewis’ basis, there is no $3,000 limitation on capital losses.

Lewis’ opening tax basis                    $18,000
Add: 40% share of partnership ordinary income 20,000
Less: 40% share of partnership capital loss   (4,000)
Lewis’ tax basis on December 31, 2010         $34,000

33. (c) In determining the deductibility of a partner’s losses, there is a limitation to the amount of the loss to which the partner is a risk for. In addition, the partner is also subject to the passive loss restrictions. These limitations are determined at the partner level and not the partnership level.
34. (d) $13,000. In determining the amount of ordinary income to allocate to the partners, guaranteed payments must first be subtracted and allocated to that partner. The balance is then allocated according to the agreement. Any distributions or withdrawals generally have no impact on the amount of taxable income recognized by the partner.

| Ordinary income before guaranteed payment | $33,000 |
| Less: Guaranteed payment to White | (3,000) |
| Ordinary income to be allocated | 30,000 |
| White’s share (1/3) | $10,000 |

Total recognized by White:
- Guaranteed payment: $3,000
- Share of ordinary income: $10,000
- Total taxable income: $13,000

35. (c) By definition.

36. (c) By definition. There is a separate line on page one of the partnership’s Form 1065 for this deduction. Guaranteed payments must be reported as ordinary income on the partner’s Form K-1. Note the examiner’s questioning as to the form that an item is reported on.

37. (a) $18,750. Partners report their share of the partnership income in the year that the partnership ends its fiscal year. For 2010, Meeker would report his share of the ordinary income for the fiscal year ended March 31, 2010. In addition, Meeker would report the guaranteed payments for the fiscal year ended March 31, 2010, even though he received some in 2009. Meeker would not report any of the guaranteed payments for fiscal 2011 even though nine payments were actually received by him in 2010.

| Partnership income, March 31, 2010 | $40,000 @ 30% (Meeker’s share) | $12,000 |
| Guaranteed payments: | |
| April 1, 2009 – December 31, 2009 | 9 months @ $500 | 4,500 |
| January 1, 2010 – March 31, 2010 | 3 months @ $750 | 2,250 |
| Total share of taxable income | 18,750 |

38. (b) $85,000. Book income should include the deductions for guaranteed payments and contributions. However, for the computation of ordinary income, only guaranteed payments are allowed. The contributions represent a separately stated item and are not deductible in computing ordinary income.

| Income per books | $ 80,000 |
| Add back contributions | $ 5,000 |
| Ordinary income | $85,000 |

39. (a) A payment for service rendered by a partner without regard to their interest in partnership profits is treated as a guaranteed payment.
40. (a) $37,500. In determining the amount of ordinary income to allocate to the partners, guaranteed payments must first be subtracted and allocated to that partner. The balance is then allocated according to the agreement. Any distributions or withdrawals generally have no impact on the amount of taxable income recognized by the partner.

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Ordinary income before guaranteed payment</td>
<td>$80,000</td>
</tr>
<tr>
<td>Less: Guaranteed payment to Evan</td>
<td>(20,000)</td>
</tr>
<tr>
<td>Ordinary income to be allocated</td>
<td>60,000</td>
</tr>
<tr>
<td>Evan’s 25% of ordinary income</td>
<td>$15,000</td>
</tr>
</tbody>
</table>

Total recognized by Evan:

- Guaranteed payment: $20,000
- Share of ordinary income (above): $15,000
- Share of long-term capital gain (25%): $2,500
- Total taxable income: $37,500

41. (b) $101,000. In determining the amount of ordinary income to allocate to the partners, guaranteed payments must first be subtracted and allocated to that partner. The balance is then allocated according to the agreement. In this problem, the guaranteed payments and charitable contributions have already been subtracted out in coming up with the $100,000. The charitable contributions of $1,000 are not allowed as a deduction in determining the ordinary income, and accordingly, must be added back. Therefore, the answer is:

- Partnership book income: $100,000
- Add: Charitable contributions: $1,000
- Ordinary income: $101,000

42. (c) $3,000 long-term capital loss. Since the stock was sold at its fair market value and the partner’s ownership interest was not in excess of 50%, the transaction is treated as if it were with an unrelated party. Therefore, the $3,000 loss (Selling price of $7,000 less the cost of $10,000) is recognized.

43. (c) $4,000. The gain of $12,000 on the sale of securities (selling price of $27,000 less the cost basis of $15,000) must be recognized by the partnership. Younger must recognize his proportionate share of the gain, which is one third of the $12,000 or $4,000.

44. (d) $37,100. When a partner owns a partnership interest of more than 50%, any losses are disallowed. Since the loss of $3,000 was deducted in coming up with the partnership’s “net income”, it must be added back before determining Edward’s 70% share of the income.

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>“Net income” after the loss</td>
<td>$50,000</td>
</tr>
<tr>
<td>Add back disallowed loss</td>
<td>$3,000</td>
</tr>
<tr>
<td>Ordinary income to allocate</td>
<td>53,000</td>
</tr>
<tr>
<td>Edward’s percentage share</td>
<td>70%</td>
</tr>
<tr>
<td>Edward’s share of ordinary income</td>
<td>$37,100</td>
</tr>
</tbody>
</table>

45. (a) $6,000. In general, transactions between a partner and the partnership are treated as if they were not related parties, and were conducted at an arm’s length basis. However, when a partner owns, directly or indirectly, more than 50% of a partnership’s capital, losses even at an arm’s length are disallowed. In this transaction, Cole has a gain which is fully recognized because it is a sale, not a transfer. Cole’s holding period for the stock is short-term. The gain is determined as follows:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Selling price of stock to partnership</td>
<td>$16,000</td>
</tr>
<tr>
<td>Cole’s adjusted basis</td>
<td>$10,000</td>
</tr>
<tr>
<td>Short-term capital gain</td>
<td>$ 6,000</td>
</tr>
</tbody>
</table>
46. (d) In acquiring a partner’s interest, both the amount paid by the new partner and any liabilities assumed by the new partner are to be used in the determination of that partner’s basis. In addition, the amounts received by the selling partner, and the release of any liabilities are used in the determination of the overall selling price by that partner.

47. (d) $40,000 capital gain. The sale of a partnership interest results in capital gain unless there are any “hot assets” (assets that cause the recognition of ordinary income such as unrealized receivables, inventory or depreciation recapture). There is no mention of these in the problem. Determination of the amount realized and the adjusted basis does include the assumption of liabilities as illustrated below.

Selling price:
- Cash: $120,000
- Liabilities assumed: $15,000
- Amount realized: $135,000

Partner’s adjusted basis:
- Capital interest: $80,000
- Share of liabilities: $15,000
- Adjusted basis: $95,000
- Capital gain: $40,000

48. (a) $174,000. The amount realized from the sale equals the amount of cash received ($154,000) plus Carr’s share of the liabilities (1/3 of $60,000) assumed by Dole.

49. (d) $140,000. The sale of a partnership interest results in capital gain unless there are any “hot assets” (assets that cause the recognition of ordinary income such as unrealized receivables, inventory or depreciation recapture). In this problem, there are unrealized receivables (tax basis zero, but fair market value of $420,000). Carr has no basis in the unrealized receivables. These Section 751 assets will cause Carr to recognize ordinary income to the extent of his proportionate interest in the receivables. In allocating the gain between ordinary and capital, the sales proceeds are first allocated to the Section 751 assets.

<table>
<thead>
<tr>
<th>Allocation of Gain</th>
<th>Total</th>
<th>Ordinary</th>
<th>Capital</th>
</tr>
</thead>
<tbody>
<tr>
<td>Amount realized (from above)</td>
<td>$174,000</td>
<td>$140,000</td>
<td>$34,000</td>
</tr>
<tr>
<td>Carr’s adjusted basis</td>
<td>34,000</td>
<td>-0-</td>
<td>34,000</td>
</tr>
<tr>
<td>Gain to be recognized</td>
<td>$140,000</td>
<td>$140,000</td>
<td>-0-</td>
</tr>
</tbody>
</table>

50. (d) Capital gain of $15,000. The sale of a partnership interest results in capital gain unless there are any “hot assets.” The problem states that the partnership has no unrealized receivables or inventory. Determination of the amount realized and the adjusted basis does include the assumption of liabilities as illustrated.

Selling price:
- Cash: $30,000
- Liabilities assumed: $25,000
- Amount realized: $55,000

Partner’s adjusted basis:
- Capital interest: $15,000
- Share of liabilities: $25,000
- Adjusted basis: $40,000
- Capital gain: $15,000
51. (b) $15,000. In a non-liquidating distribution to a partner, any cash received is first used to reduce that partner’s basis. Then, any in-kind property distributed by the partnership to the partner decreases that partner’s basis by the adjusted basis of that property, but only to the extent of the partner’s remaining basis. Prior to the distribution, Day’s basis was $50,000. After the $25,000 cash distribution, Day still had a $25,000 basis in his partnership interest. The land received by Day would have the same basis of $15,000 that it had in the partnership because Day had sufficient basis to allocate to the land.

52. (b) $14,000. In a non-liquidating distribution to a partner, any cash received is first used to reduce that partner’s basis. Then, any in-kind property distributed by the partnership to the partner decreases that partner’s basis by the adjusted basis of that property, but only to the extent of the partner’s remaining basis. Elk’s basis prior to the distribution was $30,000. After the $12,000 cash distribution, Elk still had an $18,000 basis in his partnership interest. The property received by Elk would have the same basis of $14,000 that it had in the partnership because Elk had sufficient basis in the partnership to allocate to the property.

53. (b) $6,000. In a non-liquidating distribution to a partner, any cash received is first used to reduce that partner’s basis. Then, any in-kind property distributed by the partnership to the partner decreases that partner’s basis by the adjusted basis of that property, but only to the extent of the partner’s remaining basis. Hart’s basis prior to the distribution was $30,000. After the $24,000 cash distribution, Hart’s partnership basis was only $6,000. Even though the basis and fair market value of the land in the partnership was $9,000, Hart’s basis in the land will be limited to his remaining basis in the partnership, or $6,000. No gain or loss is recognized on this transaction. Hart’s eventual sale of the property in the future will trigger the gain due to the low basis allocated at this time.

54. (c) $25,000. First, Dean’s tax basis must be updated for activity incurred during 2010. His basis begins at $20,000 and is increased by $13,000 for his 25% share of the interest and ordinary income. Then, Dean's basis is reduced by the non-liquidating cash distribution, leaving a December 31, 2010 basis of $25,000.

<table>
<thead>
<tr>
<th>Partnership activity:</th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Municipal bond interest</td>
<td>$12,000</td>
<td></td>
</tr>
<tr>
<td>Ordinary income</td>
<td>40,000</td>
<td></td>
</tr>
<tr>
<td>Tax basis before</td>
<td></td>
<td>33,000</td>
</tr>
<tr>
<td>non-liquidating distribution</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Non-liquidating cash</td>
<td></td>
<td>(8,000)</td>
</tr>
<tr>
<td>distribution</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Dean’s tax basis, ending</td>
<td></td>
<td>25,000</td>
</tr>
</tbody>
</table>

55. (c) $5,000. In a non-liquidating distribution to a partner involving only in-kind property, the adjusted basis of the property distributed by the partnership to the partner decreases that partner’s basis by the adjusted basis of that property, but only to the extent of the partner’s remaining basis. Curry’s basis prior to the distribution was $5,000. Even though the adjusted basis of the land was $6,000 and the fair market value of the land was $9,000, Curry’s basis in the land will be limited to his remaining basis in the partnership, or $5,000. No gain or loss is recognized on this transaction.

56. (d) $0. The general rule is that no gain or loss is recognized on a non-liquidating distribution, unless cash is being distributed in excess of basis. In a non-liquidating distribution to a partner, any cash received is first used to reduce that partner’s basis. Then, any in-kind property distributed by the partnership to the partner decreases that partner’s basis by the adjusted basis of that property, but only to the extent of the partner’s remaining basis. Prior to the distribution, Stone’s basis was $70,000. There was no cash distributed. The capital assets received by Stone would have the same basis of $65,000 that they had in the partnership because Stone had sufficient basis ($70,000) to allocate to the capital assets. No gain or loss is recognized.

57. (a) $0. The general rule is that no gain or loss is recognized on a non-liquidating distribution, unless cash is being distributed in excess of basis. In this problem, Jody’s basis was $50,000 immediately before the distribution. Whereas the cash distributed of $20,000 was less than her basis, no gain is recognized.
58. (b) $30,000. In a non-liquidating distribution to a partner, any cash received is first used to reduce that partner’s basis. Then, any in-kind property distributed by the partnership to the partner decreases that partner’s basis by the adjusted basis of that property, but only to the extent of the partner’s remaining basis. Jody’s basis prior to the distribution was $50,000 as just described. After the $20,000 cash distribution, Jody’s partnership basis was $30,000. Even though the basis and fair market value of the property in the partnership was $40,000 and $35,000 respectively, Jody’s basis in the property will be limited to her remaining basis in the partnership of $30,000. No gain or loss is recognized on this transaction. Jody’s eventual sale of the property in the future will trigger the gain due to the low basis allocated at this time.

59. (b) In a complete liquidation of a partner’s interest, the remaining adjusted basis of a partner’s interest after a reduction for any cash received, is the adjusted basis of the in-kind property received.

60. (c) $2,000 long-term capital loss. Lisa received a liquidating cash distribution of $20,000 in exchange for her partnership interest. At the time of the distribution, Lisa’s adjusted basis of her 1/3 interest was $22,000. Since she held her interest longer that one year, she recognizes a $2,000 long-term capital loss.

61. (c) $30,000. In a complete liquidation of a partner’s interest, the remaining adjusted basis of a partner’s interest after a reduction for any cash received, is the adjusted basis of the in-kind property received. Curcio’s basis before the liquidating distribution was $36,000. The cash distribution reduces his remaining basis to $30,000 which is allocated to the land.

62. (d) No gain or loss. In a complete liquidation, no gain is recognized by the partner unless the partner receives cash in excess of his basis (1/3 of the cash is $4,000 which is less than his basis), or there is a disproportionate distribution of Section 751 property (Choate took 1/3, or a pro-rata share of each of the three assets).

63. (d) $0. The general rule is that no gain or loss is recognized on a non-liquidating distribution, unless cash is being distributed in excess of basis. In this problem, Reed's basis was $25,000 immediately before the distribution. Whereas the cash distributed of $11,000 was less than his basis, no gain is recognized on that part of the transaction. Then, any in-kind property distributed by the partnership to the partner decreases that partner’s basis by the adjusted basis of that property, but only to the extent of the partner’s remaining basis. Reed's basis after the $11,000 cash distribution was $14,000. The land would receive the same basis as it was in the partnership ($5,000). No gain or loss is recognized on this entire transaction.

64. (a) $14,000. In a complete liquidation, no gain is recognized by the partner unless the partner receives cash in excess of his basis or there is a disproportionate distribution of Section 751 property. For the purpose of determining basis, the hierarchy is first, his basis is reduced by any cash received, then any Section 751 assets. His remaining basis is allocated to the other property received.

<table>
<thead>
<tr>
<th>Reed's basis</th>
<th>$ 25,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Less: cash received</td>
<td>-11,000</td>
</tr>
<tr>
<td>Remaining basis allocated to land</td>
<td>$ 14,000</td>
</tr>
</tbody>
</table>

65. (d) A retiring partner ceases to be a partner only after his entire interest in the partnership has been liquidated.

66. (d) 2011 - $40,000. Berk has two different transactions which need to be addressed in the determination of the income. He receives $30,000 in retirement payments in 2010 and $60,000 in 2011. In addition he is relieved of partnership debt of $30,000. In total, Berk receives $120,000 between the cash payments and release of debt. At the time of the agreement, Berk’s basis is $80,000, which is comprised of his capital account and his share of the liabilities. The question is when is the $40,000 ($120,000 amount realized less adjusted basis of $80,000) recognized. The release of debt in 2010 reduces his basis from $80,000 to $50,000. The next six payments of $5,000 each received in 2010 reduce Berk’s basis to $20,000. In 2011, Berk receives $60,000 in payments when his basis is only $20,000. The excess payments of $40,000 over his basis represent the income to be reported in 2011.

67. (b) By definition.
68. (a) On September 18, 2010, at least 50% of the total interest in the partnership’s capital and profits changed. This terminates the partnership. In addition, Frank is no longer conducting the business as a partnership.

69. (a) April 30, 2011. Even though Beck owned at least 50% of the partnership, the death of a partner generally does not terminate the partnership. Since the estate of Beck became the successor partner, the partnership exists until the deceased partner's interest is liquidated.

70. (a) November 1, 2010. On this date, Reed owned the entire interest in the entity, and it was no longer a partnership.

71. (b) December 20, 2010. On December 20, 2010, at least 50% of the total interest in the partnership’s capital and profits changed. This terminates the partnership.

72. (c) When a termination occurs, there is a deemed distribution of assets to the remaining partners and the purchaser as well as a hypothetical recontribution of assets to a new partnership.

73. (c) $24,000. A partner’s basis of an interest in the partnership is the basis of the property transferred, less any liabilities assumed by the other partners. The basis is determined as follows:

<table>
<thead>
<tr>
<th>Basis of property transferred</th>
<th>$ 30,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Less: total liabilities assumed</td>
<td>-12,000</td>
</tr>
<tr>
<td></td>
<td>18,000</td>
</tr>
<tr>
<td>Plus: liabilities assumed</td>
<td>6,000</td>
</tr>
<tr>
<td>Basis of partnership interest</td>
<td>$ 24,000</td>
</tr>
</tbody>
</table>

74. (a) $51,000. A partner’s basis of an interest in the partnership is the basis of the property transferred, plus any liabilities assumed. As a 50% partner, Jones assumes 50% of the mortgage transferred by Jones. The basis is determined as follows:

<table>
<thead>
<tr>
<th>Basis of property transferred</th>
<th>$ 45,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Plus: liabilities assumed</td>
<td>6,000</td>
</tr>
<tr>
<td>Basis of partnership interest</td>
<td>$ 51,000</td>
</tr>
</tbody>
</table>

75. (c) $3,600. Organization costs incurred in 2010 can be amortized over a period of not less than 180 months assuming a proper and timely election has been made. However, the partnership may elect to immediate expense up to $5,000 since the expenditures are less than $50,000. Therefore, the maximum they can deduct is $3,600. The accounting fees for the offering materials are charged to the capital account and are neither deductible or amortizable.

76. (b) Decrease of $35,000. Kane’s basis is determined by reference to his percentage interest in the partnership liabilities. At the beginning of the year, his basis was 25% of the $300,000 debt for a total of $75,000. During the year, there was a decrease in the liabilities of $100,000 and his basis was reduced to 20%. His ending tax basis was 20% of the $200,000 or $40,000. Therefore, there was a net decrease of $35,000.

77. (c) By definition, either of these events could terminate a partnership.

78. (c) $50,000. Guaranteed payments are subject to the self-employment tax. A shareholder’s share of the ordinary income is not subject to the self-employment tax. (See Chapter 11 for S Corporations).

79. (b) A guaranteed payment is similar to a pre-distribution of partnership ordinary income and accordingly is recognized as ordinary income by Peters. The receipt of the guaranteed payment has no net effect on Peter’s basis.

80. (b) $50,000. There is a carryover basis from the contributed property of $50,000. In general, no gain or loss is recognized in the case of a contribution of property in exchange for a partnership interest.
81. (b) $7,500. A partner’s basis in the partnership is the basis of the property transferred, less any liabilities assumed by the other partners. There were no liabilities transferred in this problem. The basis of the property transferred by Barker into the partnership was $3,000 for the cash, $2,000 for the stock and $2,500 for the new computer.

Basis of property transferred:
- Cash $ 3,000
- Stock 2,000
- New computer 2,500
- $ 7,500

82 (d) $110,000. A partner’s basis at the end of the year equals the beginning basis, plus the partner’s share of the income of loss, less any distributions. Since we can assume there are 4 equal partners, each partner’s share of the $80,000 of income is $20,000. The partner’s ending basis in the partnership is as follows:

- Beginning basis $ 100,000
- Plus: Share of partnership income 20,000
- Less: Distributions -10,000
- Ending basis $110,000

83. (c) All owners of an LLC C may participate in the management of the company while only general partners (not limited partners) may participate in the management of a partnership.

84 (b) $61,000. A partner’s basis at the end of the year equals the beginning basis, plus the partner’s share of the income of loss and their share of any liabilities, less any distributions. Since Molloy has a one-third interest, his share of the $60,000 of income is $20,000. The partner’s ending basis in the partnership is as follows:

- Beginning basis $ 40,000
- Plus: Share of partnership income 20,000
- Plus: Share of partnership liabilities 6,000
- Less: Distributions -5,000
- Ending basis $61,000

85. (c) $1,000 ordinary gain and $1,000 capital loss. In a complete liquidation of a partner’s interest, first reduce the partner’s basis by any cash received, followed by the reductions of property, assigning the partner’s basis to the basis of the assets being received in the hierarchy discussed earlier. For Partner Chang, his basis prior to the distribution is $12,000. The $4,000 in cash distributed reduces his basis to $8,000. Next, the inventory comes out at its adjusted basis of $4,000, leaving a remaining basis of $4,000 which is assigned to the land. Then, upon the sale of the property received, the inventory is sold at a gain of $1,000 ($5,000 less $4,000 basis). The gain is ordinary since it is the sale of inventory used in the trade or business. The land is sold for a $1,000 loss ($3,000 less the $4,000 basis), and this is treated as a capital loss.
86. (d) $120,000. When a partner renders services in exchange for a partnership interest, the partner must recognize ordinary income equal to the fair market value of the partnership interest received and not the value of the services rendered.

87. (c) No gain or loss. In a complete liquidation, no gain is recognized by the partner unless the partner receives cash in excess of his basis. In this situation, the taxpayer’s basis in the partnership of $60,000 will transfer over to the land. Any gain or loss will be recognized when the partners disposes of the land at a later date.

88. (d) $30,000. In a complete liquidation of a partner’s interest, first reduce the partner’s basis by any cash distributed. Then, reduce the partner’s basis for any property received, assigning the remaining partner’s basis to the assets received. Partner Fern’s basis prior to the distribution was $60,000. The $30,000 in cash distributed reduces his basis to $30,000. Next, the automobile is assigned his remaining basis of $30,000 even though the automobile has a FMV of $20,000.

89. (c) An increase in general liabilities to a partnership will increase each partner's basis by their share of the partnership account.

90 (c) $18,500. A partner’s basis at the end of the year equals the beginning basis, plus the partner’s share of the income of loss and their share of any liabilities, less any distributions. Since Dale is a 50% partner, his share of the $15,000 of income is $7,500 and $2,000 tax-exempt interest income is $1,000. The partner’s ending basis in the partnership is as follows:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Beginning basis</td>
<td>$10,000</td>
</tr>
<tr>
<td>Plus: Share of partnership taxable income</td>
<td>7,500</td>
</tr>
<tr>
<td>Plus: Share of the tax-exempt interest</td>
<td>1,000</td>
</tr>
<tr>
<td>Plus: Share of partnership liabilities</td>
<td>5,000</td>
</tr>
<tr>
<td></td>
<td>23,500</td>
</tr>
<tr>
<td>Less: Share in reduction in debt</td>
<td>-2,000</td>
</tr>
<tr>
<td>Less: Distribution</td>
<td>-3,000</td>
</tr>
<tr>
<td>Ending basis</td>
<td>$18,500</td>
</tr>
</tbody>
</table>

91. (d) $80,000. In a complete liquidation, no gain is recognized by the partner unless the partner receives cash in excess of his basis or there is a disproportionate distribution of Section 751 property. For the purpose of determining basis, the hierarchy is first, his basis is reduced by any cash received, then any Section 751 assets (in this case none). His remaining basis is allocated to the other property received.

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Smith’s basis</td>
<td>$230,000</td>
</tr>
<tr>
<td>Less: cash received</td>
<td>-150,000</td>
</tr>
<tr>
<td>Remaining basis allocated to land</td>
<td>$ 80,000</td>
</tr>
</tbody>
</table>
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C Corporations

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Chapter Eight  
C Corporations

NATURE AND CHARACTERISTICS

GENERAL

A corporation is a separate taxpaying entity. Shareholders contribute assets or services in exchange for stock which represents the ownership of the corporation. A corporation has its own rate structure, files its own return, and makes its own elections apart from its shareholders.

CHECK THE BOX REGULATIONS

Since the Treasury Department’s “check-the-box” regulations took effect, a taxpayer selects the tax status of the entity without a concern over the attributes it possesses. For example, an entity with two or more owners can elect to be treated as either a partnership or a corporation. Likewise, an entity with only one owner can elect to be treated as a sole proprietorship or a corporation. The election is made on Form 8832.

Should no election be made, the default is a that a two or more person entity will be treated as a partnership and a single person entity will be treated as a sole proprietorship.

ORGANIZATION COSTS AND STOCK ISSUANCE COSTS

Costs incurred related to the creation of the corporation (organizational costs), such as accounting and legal fees, are generally not deductible, but are instead capitalized. The corporation may amortize the costs on a straight-line basis over a period of not less than 180 months. Prior to this law change, costs were amortized under the 60 month provision.

In addition, for organizational expenditures incurred a corporation may be able to immediately expense up to $5,000 of such expenditures. This $5,000 amount, however, is phased out on a dollar for dollar basis for organizational; expenditures exceeding $50,000.

Costs associated with the issuance of stock and securities are neither deductible or amortizable. These fees are usually the marketing, registration and underwriting fees associated with selling corporation stock.

Example 1: On January 1, 2010, Arielle forms Red Corporation and pays $53,000 in organization expenditures. Red Corporation may elect to immediately expense $2,000 of the organizational expenditures. The $53,000 exceeds the $50,000 threshold by $3,000, this reducing the maximum $5,000 election to $2,000. The remaining $51,000 ($53,000 less the $2,000) may be amortized over the 180 month period.

ALLOWABLE TAX YEARS

A corporation generally has no restrictions on the selection of a year end. There are special rules for Personal Service Corporations and S Corporations, and those are addressed in the next chapter.

FILING REQUIREMENTS

A corporation is required to file Form 1120 each year. The return is due by the 15th day of the 3rd month following the end of the taxable year. For a calendar year corporation the due date is March 15th. A corporation may request a six month extension by timely filing Form 7004. Pages 1 and 5 of Form 1120 appear at the end of this chapter.
FORMATION - CONTRIBUTIONS OF PROPERTY

GENERAL RULE FOR CONTRIBUTIONS OF PROPERTY
When a taxpayer transfers property to a corporation solely in exchange for stock, the general rule under Section 351 is that no gain or loss is recognized, provided that the shareholder(s) is in control after the transfer. Control is defined as owning at least 80% of the corporation. There is a carryover of basis to the corporation of the property transferred by the shareholder as well as a carryover of basis to the shareholder’s stock in the corporation. The carryover also pertains to the holding period of the property contributed. The logic behind this non-taxable transfer is that only the form of ownership of the property transferred has changed.

Example 2: On January 1, 2010, K & L form a corporation with the following transfers. K contributes land with a fair market value of $40,000 and an adjusted basis of $15,000 to KL Corporation, in exchange for 50% of the stock worth $40,000. K had purchased the land in 1980 for the $15,000. L contributes cash of $40,000 on the same day. This is a typical Section 351 transaction.

No gain or loss is recognized by either the corporation, or to the shareholders on the exchange. K’s tax basis in the corporation is $15,000. The corporation’s basis in the land is $15,000. K’s holding period for her stock is long-term (since 1980) and the corporation’s holding period for the land is also long-term. L’s tax basis is $40,000 and her holding period begins January 1, 2010.

CONTRIBUTIONS OF PROPERTY WHEN BOOT IS RECEIVED
When a shareholder transfers property to a corporation in exchange for stock and other property, the other property constitutes boot and may cause the recognition of gain. (The receipt of boot will not cause the recognition of any loss). The first step is to determine if there is any realized gain on the transfer.

Example 3: Assume that in Example 2 the land contributed by K had a fair market value of $45,000, and that the corporation paid K $5,000 in order that K’s net contribution was worth $40,000. The $5,000 cash is considered to be boot and will cause the recognition of $5,000 of the $30,000 realized gain.

Amount realized:

<table>
<thead>
<tr>
<th>FMV of stock received</th>
<th>$ 40,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash (boot)</td>
<td>5,000</td>
</tr>
<tr>
<td>Total amount realized</td>
<td>45,000</td>
</tr>
<tr>
<td>Less: Adjusted basis</td>
<td>-15,000</td>
</tr>
<tr>
<td>Realized gain</td>
<td>$ 30,000</td>
</tr>
<tr>
<td>Recognized gain</td>
<td>$ 5,000</td>
</tr>
</tbody>
</table>

K’s basis is still the $15,000, which is her initial basis in the land of $15,000, plus the gain recognized of $5,000 for a total of $20,000. The cash received gets a basis of $5,000, leaving $15,000 as her interest in the corporation.
CONTRIBUTIONS OF PROPERTY WHEN LIABILITIES ARE ASSUMED BY THE CORPORATION
When a shareholder transfers property to a corporation that is subject to liabilities which the corporation assumes, the general rule is that no gain or loss is recognized. The amount of liabilities assumed by the corporation as a result of the transfer reduces the tax basis of the contributing shareholder. However, if the assumption of the liabilities is greater than the contributing shareholder’s basis in the property, then the excess over the basis is considered boot and will result in a gain to the shareholder.

Example 4: Assume that in Example 1 the land contributed by K was subject to a mortgage of $10,000, and that the corporation assumed the mortgage. Since the mortgage is less than the adjusted basis of the land ($40,000), it is not treated as boot. No gain or loss is recognized by either the corporation or K on the transfer. Her tax basis in the corporation is now $5,000. That is comprised of her basis in the land of $15,000 less the $10,000 mortgage assumed by the corporation. The basis of the land in the corporation is still $15,000.

Example 5: Assume the same facts as in Example 4, except that the mortgage being assumed by the corporation is $20,000. K must recognize a gain of $5,000 because the liability assumed ($20,000) is greater than the adjusted basis in the land ($15,000). K's tax basis in the corporation is now zero and is determined as follows. Her basis in the land was $15,000, it is increased by the gain recognized of $5,000 and then decreased by the mortgage assumed ($20,000) by the corporation.

SERVICES RENDERED IN EXCHANGE FOR A CORPORATION’S STOCK
When a shareholder performs services in exchange for stock, the shareholder must recognize ordinary income to the extent of the fair market value of the stock received. The shareholder’s basis in the corporation will be equal to the amount of income recognized.

TAXATION OF A CORPORATION
The taxation of a corporation follows the same basic framework of that of an individual. Income minus deductions equals taxable income. Unlike an individual, a corporation is not allowed a standard deduction or any personal exemptions. However, there are some special deductions and limitations a corporation must be aware of. Four major corporate differences include:

- Charitable contributions
- Net operating losses
- Capital gains & losses
- Dividends received deduction

CHARITABLE CONTRIBUTIONS
A corporation is allowed a deduction for charitable contributions. However, the timing and the limitation of deduction is different from that of the individual. With regards to timing, the general rule is that in order to be deductible, the contribution must be paid during the taxable year. However, an accrual based taxpayer is allowed a deduction for contributions paid on or before the 15th day of the third month following the close of the taxable year if the Board of Directors authorizes the contribution prior to the end of the year.
As to the **limitation**, contributions are limited to 10% of a corporation’s adjusted taxable income. The adjusted taxable income is taxable income without regard to:

- The charitable contribution itself
- Any net operating loss carryback
- Any capital loss carryback
- Any dividends received deduction

Any excess charitable contribution is carried forward for five years. In determining the allowable contribution for any given year, the current contribution is considered first, then any carryforward.

**NET OPERATING LOSSES**

When a corporation’s allowable deductions exceed its gross income, a net operating loss (NOL) exists. An NOL is generally carried back 2 years, then forward 20 years. A corporation, however, may elect to waive the carryback requirement by filing such election with a timely filed return. However, for the 2009 tax year, small businesses with gross receipts of less than $15 million, the corporation may carryback the loss 3, 4 or 5 years.

In November 2010, Congress passed another act that allows the 3, 4 or 5 year carryback for all taxpayers but limits the amount of an NOL that a taxpayer elects to carry back to the 5th taxable year preceding the taxable year of the loss to 50 percent of the taxpayer’s taxable income for the carryback taxable year. The excess of the amount of the loss over 50 percent of the taxable income for the carryback taxable year is carried to later taxable years.

**CAPITAL GAINS & LOSSES**

Corporate taxpayers, unlike individual taxpayers, receive **no special tax rate** for capital gains. Net capital gains are treated as ordinary income. In addition, corporate taxpayers **may not deduct** any net capital losses. Capital losses may only be used to offset capital gains. Excess net capital losses, regardless of whether they are long or short-term, are carried back and forward as **short-term capital losses**. The carryback period is 3 years and carryforward period is 5 years.

**DIVIDENDS RECEIVED DEDUCTION**

When a corporation makes a distribution with regards to its stock, the distribution (or dividend) comes from the corporation’s after-tax income. The dividend distribution is generally taxed to the shareholder. This is referred to as **double taxation**. If the shareholder is another corporation, then that corporation would pay taxes on the dividend received and then with its after-tax income, distributes a dividend to its shareholders. This would result in **triple taxation**. To prevent this from occurring, Congress enacted the dividends received deduction (DRD). The DRD is classified as a special deduction and is based upon the percentage of stock ownership in the corporation. The deduction percentages to memorize for the exam are:

- 70% of the dividend received from less than 20% companies
- 80% of the dividend received from at least 20% and less than 80% owned companies
- 100% of the dividend received from at least 80% owned companies

The deduction, however, is limited to the same percentage of taxable income without regard to the dividend received deduction. This limitation is overridden if the DRD creates or increase the corporation’s net operating loss. However, there is no limitation on the 100% DRD. Another limitation to the DRD is that no DRD is allowed if the stock is held for 45 days or less.
Example 6: Given the following independent situations, determine the dividend received deduction when the corporations own 50% of the stock of the dividend paying corporation.

<table>
<thead>
<tr>
<th></th>
<th>A Corp</th>
<th>B Corp</th>
<th>C Corp</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales</td>
<td>$400,000</td>
<td>$400,000</td>
<td>$400,000</td>
</tr>
<tr>
<td>Cost of sales</td>
<td>-$250,000</td>
<td>-$250,000</td>
<td>-$250,000</td>
</tr>
<tr>
<td>Gross margin</td>
<td>150,000</td>
<td>150,000</td>
<td>150,000</td>
</tr>
<tr>
<td>Dividends</td>
<td>100,000</td>
<td>100,000</td>
<td>30,000</td>
</tr>
<tr>
<td>Total income</td>
<td>250,000</td>
<td>250,000</td>
<td>180,000</td>
</tr>
<tr>
<td>Operating expenses</td>
<td>-$100,000</td>
<td>-$170,000</td>
<td>-$200,000</td>
</tr>
<tr>
<td>Income before DRD</td>
<td>150,000</td>
<td>80,000</td>
<td>-20,000</td>
</tr>
<tr>
<td>DRD</td>
<td>-$80,000</td>
<td>-$64,000</td>
<td>-$24,000</td>
</tr>
<tr>
<td>Taxable income (loss)</td>
<td>$ 70,000</td>
<td>$ 16,000</td>
<td>$ -44,000</td>
</tr>
</tbody>
</table>

Solutions:

A Corporation: The general rule applies. 80% of the dividend received is allowed as a deduction.

B Corporation: The exception applies. 80% of the taxable income before the DRD ($64,000) is less than 80% of the dividend received ($80,000), therefore the $64,000 is used. Using the $80,000 does not generate a NOL.

C Corporation: The corporation has a net operating loss before the determination of the DRD. The DRD of $24,000 will increase the net operating loss, and therefore overrides the exception.

OTHER VARIOUS CORPORATE DIFFERENCES

KEYMAN LIFE INSURANCE
When the corporation is the beneficiary of a life insurance policy on an officer or keyman, no deduction is allowed for premiums paid on that policy. However, upon the death of an officer, the amount of the life insurance proceeds received by the corporation is not considered taxable income.

BAD DEBTS
A corporation is only allowed to deduct bad debts actually written off during the year. No longer is the allowance method of recognizing bad debt expense allowable for any entity.

MANUFACTURER’S DEDUCTION
There is a relatively new deduction for manufacturing companies. While we include it here for corporations, it is also available for individuals, partnerships, estates and trusts. The deduction is computed by multiplying 6% times the lesser of company’s Qualified Production Income or Taxable Income. The deduction, however, is limited to 50% of the company’s W-2 wages.

DEALINGS BETWEEN THE SHAREHOLDERS AND CORPORATION
In general, transactions between a shareholder and the corporation are treated as if they were not related parties, and were conducted at an arm’s length basis. However, when a shareholder owns, directly or indirectly, more than 50% of a corporation’s capital, all losses, even at an arm’s length basis, are disallowed.

In addition, if a shareholder owns 50% or more of a corporation’s capital, any gain from the sale of property between the corporation and shareholder must be recognized as ordinary income. If the property is a capital asset to both the corporation and shareholder, then the gain is capital.
SCHEDULE M-1
RECONCILIATION OF INCOME PER BOOKS WITH INCOME PER RETURN

Because a corporation follows generally accepted accounting principles for financial purposes which frequently differ from tax provisions, it is necessary to reconcile a corporation's book income to its taxable income. This is required of corporations and is presented on Schedule M-1, located on page 4 of Form 1120. In performing a book to tax reconciliation, you must identify those items of income and deduction which differ from book to tax. It is important to note that Schedule M-1 reconciles book income to taxable income before the special deductions (dividends received deduction and net operating loss deduction).

A typical exam fact pattern provides either book income or taxable income as a starting point, and requires the candidate to determine the other. Going from book income to taxable income, the adjustments might look as follows:

<table>
<thead>
<tr>
<th>Net income per books</th>
</tr>
</thead>
<tbody>
<tr>
<td>Add:</td>
</tr>
<tr>
<td>Federal income taxes</td>
</tr>
<tr>
<td>Excess capital loss (carried forward)</td>
</tr>
<tr>
<td>Excess charitable contributions (carried forward)</td>
</tr>
<tr>
<td>Keyman life insurance premiums</td>
</tr>
<tr>
<td>Disallowed municipal interest expense</td>
</tr>
<tr>
<td>Disallowed business meals &amp; entertainment expenses</td>
</tr>
<tr>
<td>Non-deductible penalties</td>
</tr>
<tr>
<td>Subtract:</td>
</tr>
<tr>
<td>Municipal interest income</td>
</tr>
<tr>
<td>Keyman life insurance proceeds</td>
</tr>
<tr>
<td>Allowable capital loss carryforward from prior years</td>
</tr>
<tr>
<td>Allowable contribution carryforward from prior years</td>
</tr>
<tr>
<td>Taxable income</td>
</tr>
</tbody>
</table>

Example 7: During 2010, Z Corporation had net income per books of $60,000. Given the following fact pattern, determine Z Corporation’s taxable income.

Included in income was sales of $500,000; tax-exempt income of $20,000; and proceeds from officers life insurance of $50,000. Deductions from gross income included business meals and entertainment of $40,000; penalties of $2,000; and a $5,000 capital loss.

<table>
<thead>
<tr>
<th>Income per books</th>
<th>$60,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Add back:</td>
<td></td>
</tr>
<tr>
<td>50% business meals &amp; entertainment</td>
<td>20,000</td>
</tr>
<tr>
<td>Penalties</td>
<td>2,000</td>
</tr>
<tr>
<td>Capital loss</td>
<td>5,000</td>
</tr>
<tr>
<td></td>
<td>87,000</td>
</tr>
<tr>
<td>Subtract:</td>
<td></td>
</tr>
<tr>
<td>Tax-exempt income</td>
<td>-20,000</td>
</tr>
<tr>
<td>Proceeds from officer’s like insurance</td>
<td>-50,000</td>
</tr>
<tr>
<td>Taxable income</td>
<td>$17,000</td>
</tr>
</tbody>
</table>
SCHEDULE M-2
ANALYSIS OF UNAPPROPRIATED RETAINED EARNINGS

Similar to the reconciliation of book to tax income, it is also necessary to analyze the activity in unappropriated retained earnings. This appears on Form 1120, page 4 and is called Schedule M-2. The major increases in retained earnings would be net income plus any refund of prior year's tax. Typical decreases include dividends paid and reserves for contingencies and other appropriations.

SCHEDULE M-3
NET INCOME RECONCILIATION FOR CORPORATIONS WITH TOTAL ASSETS OF $10 MILLION OR MORE

This schedule asks certain questions about the corporation's financial statements and reconciles the consolidated financial statement group to the income statement for the U.S. consolidated tax group. It is a three page schedule is should be beyond the scope of the CPA exam other than general identification.
### U.S. Corporation Income Tax Return

**For calendar year 2010 or tax year beginning**, 2010, ending 2010

#### Income

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gross receipts or sales</td>
<td></td>
</tr>
<tr>
<td>Cost of goods sold (Schedule A, line 3)</td>
<td>2</td>
</tr>
<tr>
<td>Gross profit. Subtract line 2 from line 1c</td>
<td>3</td>
</tr>
<tr>
<td>Dividends (Schedule C, line 19)</td>
<td>4</td>
</tr>
<tr>
<td>Interest</td>
<td>5</td>
</tr>
<tr>
<td>Gross rents</td>
<td>6</td>
</tr>
<tr>
<td>Gross royalties</td>
<td>7</td>
</tr>
<tr>
<td>Capital gains/net income (attach Schedule D (Form 1120))</td>
<td>8</td>
</tr>
<tr>
<td>Net gain or (loss) from Form 4797, Part II, line 17 (attach Form 4797)</td>
<td>9</td>
</tr>
<tr>
<td>Other income (see instructions—attach schedule)</td>
<td>10</td>
</tr>
<tr>
<td><strong>Total income</strong>. Add lines 3 through 10</td>
<td>11</td>
</tr>
</tbody>
</table>

#### Deductions (See instructions for limitations on deductions)

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Compensation of officers (Schedule E, line 4)</td>
<td>12</td>
</tr>
<tr>
<td>Salaries and wages (less employment credits)</td>
<td>13</td>
</tr>
<tr>
<td>Repairs and maintenance</td>
<td>14</td>
</tr>
<tr>
<td>Bad debts</td>
<td>15</td>
</tr>
<tr>
<td>Rents</td>
<td>16</td>
</tr>
<tr>
<td>Taxes and licenses</td>
<td>17</td>
</tr>
<tr>
<td>Interest</td>
<td>18</td>
</tr>
<tr>
<td>Charitable contributions</td>
<td>19</td>
</tr>
<tr>
<td>Depreciation from Form 4562 not claimed on Schedule A or elsewhere on return (attach Form 4562)</td>
<td>20</td>
</tr>
<tr>
<td>Depletion</td>
<td>21</td>
</tr>
<tr>
<td>Advertising</td>
<td>22</td>
</tr>
<tr>
<td>Pension, profit-sharing, etc., plans</td>
<td>23</td>
</tr>
<tr>
<td>Employee benefit programs</td>
<td>24</td>
</tr>
<tr>
<td>Domestic production activities deduction (attach Form 8803)</td>
<td>25</td>
</tr>
<tr>
<td><strong>Other deductions (attach schedule)</strong></td>
<td>26</td>
</tr>
<tr>
<td><strong>Total deductions</strong>. Add lines 12 through 26</td>
<td>27</td>
</tr>
<tr>
<td>Taxable income before net operating loss deduction and special deductions. Subtract line 27 from line 11</td>
<td>28</td>
</tr>
</tbody>
</table>

#### Taxable income. Subtract line 28 from line 26 (see instructions)

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>2009 overpayment credited to 2010</td>
<td>33</td>
</tr>
<tr>
<td>2010 estimated tax payments</td>
<td>33a</td>
</tr>
<tr>
<td>2010 refund applied for on Form 4466</td>
<td>33b</td>
</tr>
<tr>
<td>Tax deposited with Form 7004</td>
<td>33c</td>
</tr>
<tr>
<td>Credits: (1) Form 243</td>
<td>33e</td>
</tr>
<tr>
<td>(2) Form 4130</td>
<td>33f</td>
</tr>
<tr>
<td>Estimated tax penalty (see instructions). Check if Form 2220 is attached</td>
<td>34</td>
</tr>
<tr>
<td>Amount owed. If line 32h is smaller than the total of lines 31 and 33, enter amount owed</td>
<td>35</td>
</tr>
<tr>
<td>Overpayment. If line 32h is larger than the total of lines 31 and 33, enter amount overpaid</td>
<td>36</td>
</tr>
</tbody>
</table>

#### Sign Here

<table>
<thead>
<tr>
<th>Description</th>
<th>Signature of officer</th>
<th>Date</th>
<th>Title</th>
</tr>
</thead>
<tbody>
<tr>
<td>Paid Preparer Use Only</td>
<td>Print/Type preparer's name</td>
<td>Preparer's signature</td>
<td>Date</td>
</tr>
</tbody>
</table>

For Paperwork Reduction Act Notice, see separate instructions.
### Schedule L  Balance Sheets per Books

<table>
<thead>
<tr>
<th>Assets</th>
<th>Beginning of tax year</th>
<th>End of tax year</th>
</tr>
</thead>
<tbody>
<tr>
<td>1 Cash</td>
<td></td>
<td></td>
</tr>
<tr>
<td>2a Trade notes and accounts receivable</td>
<td>(a)</td>
<td>(c)</td>
</tr>
<tr>
<td>b Less allowance for bad debts</td>
<td>(b)</td>
<td>(d)</td>
</tr>
<tr>
<td>3 Inventories</td>
<td></td>
<td></td>
</tr>
<tr>
<td>4 U.S. government obligations</td>
<td></td>
<td></td>
</tr>
<tr>
<td>5 Tax-exempt securities (see instructions)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>6 Other current assets (attach schedule)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>7 Loans to shareholders</td>
<td></td>
<td></td>
</tr>
<tr>
<td>8 Mortgages and real estate loans</td>
<td></td>
<td></td>
</tr>
<tr>
<td>9 Other investments (attach schedule)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>10a Buildings and other depreciable assets</td>
<td></td>
<td></td>
</tr>
<tr>
<td>b Less accumulated depreciation</td>
<td>(a)</td>
<td>(c)</td>
</tr>
<tr>
<td>11a Depreciable assets</td>
<td></td>
<td></td>
</tr>
<tr>
<td>b Less accumulated depletion</td>
<td>(b)</td>
<td>(d)</td>
</tr>
<tr>
<td>12 Land (net of any amortization)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>13a Intangible assets (amortizable only)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>b Less accumulated amortization</td>
<td>(c)</td>
<td>(d)</td>
</tr>
<tr>
<td>14 Other assets (attach schedule)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>15 Total assets</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

### Liabilities and Shareholders' Equity

<table>
<thead>
<tr>
<th>Liabilities and Shareholders' Equity</th>
<th>Beginning of tax year</th>
<th>End of tax year</th>
</tr>
</thead>
<tbody>
<tr>
<td>16 Accounts payable</td>
<td></td>
<td></td>
</tr>
<tr>
<td>17 Mortgages, notes, bonds payable in less than 1 year</td>
<td></td>
<td></td>
</tr>
<tr>
<td>18 Other current liabilities (attach schedule)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>19 Loans from shareholders</td>
<td></td>
<td></td>
</tr>
<tr>
<td>20 Mortgages, notes, bonds payable in 1 year or more</td>
<td></td>
<td></td>
</tr>
<tr>
<td>21 Other liabilities (attach schedule)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>22 Capital stock:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>a Preferred stock</td>
<td></td>
<td></td>
</tr>
<tr>
<td>b Common stock</td>
<td></td>
<td></td>
</tr>
<tr>
<td>23 Additional paid-in capital</td>
<td></td>
<td></td>
</tr>
<tr>
<td>24 Retained earnings—Appropriated (attach schedule)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>25 Retained earnings—Unappropriated</td>
<td></td>
<td></td>
</tr>
<tr>
<td>26 Adjustments to shareholders' equity (attach schedule)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>27 Less cost of treasury stock</td>
<td></td>
<td></td>
</tr>
<tr>
<td>28 Total liabilities and shareholders' equity</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

### Schedule M-1  Reconciliation of Income (Loss) per Books With Income per Return

**Note:** Schedule M-3 required instead of Schedule M-1 if total assets are $10 million or more—see instructions.

<table>
<thead>
<tr>
<th>Income recorded on books this year not included in return (itemize):</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Tax-exempt interest: $</td>
<td></td>
</tr>
</tbody>
</table>

Deductions on this return not charged against book income this year (itemize):

| Depreciation: $                                                |           |
| Charitable contributions: $                                    |           |

Add lines 7 and 8.

**Income (page 1, line 28) — Line 6 less line 9**

### Schedule M-2  Analysis of Unappropriated Retained Earnings per Books (Line 25, Schedule L)

| Balance at beginning of year |                      |                 |
| Net income (loss) per books |                      |                 |
| Other increases (itemize)    |                      |                 |

Add lines 1, 2, and 3.

| Distributions: |           |
| Cash:          |           |
| Stock:         |           |
| Property:      |           |

Add lines 5 and 6.

**Balance at end of year (line 4 less line 7)**

---

Form 1120 (2019)
Chapter Eight — Questions
C Corporations

FORMATION OF CORPORATION

1. To qualify for tax-free incorporation, a sole proprietor must be in control of the transferee corporation immediately after the exchange of the proprietorship's assets for the corporation's stock. "Control" for this purpose means ownership of stock amounting to at least
a. 50.00%.
b. 51.00%.
c. 66.67%.
d. 80.00%.

2. Stone, a cash basis taxpayer, incorporated her CPA practice this year. No liabilities were transferred. The following assets were transferred to the corporation:

<table>
<thead>
<tr>
<th>Asset</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash (checking account)</td>
<td>$ 500</td>
</tr>
<tr>
<td>Computer equipment</td>
<td></td>
</tr>
<tr>
<td>Adjusted basis</td>
<td>30,000</td>
</tr>
<tr>
<td>Fair market value</td>
<td>34,000</td>
</tr>
<tr>
<td>Cost</td>
<td>40,000</td>
</tr>
</tbody>
</table>

Immediately after the transfer, Stone owned 100% of the corporation's stock. The corporation's total basis for the transferred assets is
a. $30,000
b. $30,500
c. $34,500
d. $40,500

3. Adams, Beck, and Carr organized Flexo Corp. with authorized voting common stock of $100,000. Adams received 10% of the capital stock in payment for the organizational services that he rendered for the benefit of the newly formed corporation. Adams did not contribute property to Flexo and was under no obligation to be paid by Beck or Carr. Beck and Carr transferred property in exchange for stock as follows:

<table>
<thead>
<tr>
<th></th>
<th>Adjusted basis</th>
<th>Fair market value</th>
<th>Percentage of Flexo stock acquired</th>
</tr>
</thead>
<tbody>
<tr>
<td>Beck</td>
<td>5,000</td>
<td>20,000</td>
<td>20%</td>
</tr>
<tr>
<td>Carr</td>
<td>60,000</td>
<td>70,000</td>
<td>70%</td>
</tr>
</tbody>
</table>

What amount of gain did Carr recognize from this transaction?

a. $40,000
b. $15,000
c. $10,000
d. $0

4. Mr. Breck and Mr. Witt decide to form a corporation on January 2. Mr. Breck contributes a building, in which he has an adjusted basis of $10,000, worth $25,000 on the market. Mr. Witt contributes $25,000 in cash to the corporation. In exchange for these properties the corporation issues its entire capital stock equally to Mr. Breck and Mr. Witt. What is the basis of the building to the corporation?

a. $10,000.
b. $15,000.
c. $25,000.
d. $35,000.

5. Jenkins transferred land to his controlled corporation for stock of the corporation worth $20,000 and cash of $20,000. The basis of the property to him was $15,000 and it was subject to a $10,000 mortgage which the corporation assumed. Jenkins must report a gain of

a. $10,000.
b. $20,000.
c. $30,000.
d. $35,000.

6. Roberta Warner and Sally Rogers formed the Acme Corporation on October 1 of this year. On the same date Warner paid $75,000 cash to Acme for 750 shares of its common stock. Simultaneously, Rogers received 100 shares of Acme's common stock for services rendered. How much should Rogers include as taxable income for this taxable year, and what will be the basis of her stock?

<table>
<thead>
<tr>
<th></th>
<th>Taxable income</th>
<th>Basis of stock</th>
</tr>
</thead>
<tbody>
<tr>
<td>a.</td>
<td>--0--</td>
<td>--0--</td>
</tr>
<tr>
<td>b.</td>
<td>--0--</td>
<td>$10,000</td>
</tr>
<tr>
<td>c.</td>
<td>$10,000</td>
<td>--0--</td>
</tr>
<tr>
<td>d.</td>
<td>$10,000</td>
<td>$10,000</td>
</tr>
</tbody>
</table>
7. Clark and Hunt organized Jet Corp. with authorized voting common stock of $400,000. Clark contributed $60,000 cash. Both Clark and Hunt transferred other property in exchange for Jet stock as follows:

<table>
<thead>
<tr>
<th>Other property</th>
<th>Adjusted basis</th>
<th>Fair value</th>
<th>Percentage acquired</th>
</tr>
</thead>
<tbody>
<tr>
<td>Clark</td>
<td>$ 50,000</td>
<td>$100,000</td>
<td>40%</td>
</tr>
<tr>
<td>Hunt</td>
<td>120,000</td>
<td>240,000</td>
<td>60%</td>
</tr>
</tbody>
</table>

What was Clark's basis in Jet stock?

a. $0  
b. $100,000  
c. $110,000  
d. $160,000

8. Jones incorporated a sole proprietorship by exchanging all the proprietorship's assets for the stock of Nu Co., a new corporation. To qualify for tax-free incorporation, Jones must be in control of Nu immediately after the exchange. What percentage of Nu's stock must Jones own to qualify as "control" for this purpose?

a. 50.00%  
b. 51.00%  
c. 66.67%  
d. 80.00%

9. Feld, the sole stockholder of Maki Corp., paid $50,000 for Maki's stock in 1991. In 2010, Feld contributed a parcel of land to Maki but was not given any additional stock for this contribution. Feld's basis for the land was $10,000, and its fair market value was $18,000 on the date of the transfer of title. What is Feld's adjusted basis for the Maki stock?

a. $50,000  
b. $52,000  
c. $60,000  
d. $68,000

10. The costs of organizing a corporation in 2010

a. May be deducted in full in the year in which these costs are incurred even if paid in later years.  
b. May be deducted only in the year in which these costs are paid if over $5,000 in total  
c. May be immediately expensed if less than $5,000.  
d. Are nondeductible capital expenditures.

11. Brown Corp., a calendar-year taxpayer, was organized and actively began operations on July 1, 2010, and incurred the following costs:

- Legal fees to obtain corporate charter: $41,000  
- Commission paid to underwriter: $26,000  
- Other stock issue costs: $10,000

Brown wishes to expense its organizational costs over the shortest period allowed for tax purposes. In 2010, what amount should Brown deduct for the amortization of organizational expenses?

a. $4,100  
b. $6,200  
c. $8,700  
d. $41,000

12. Which of the following costs are amortizable organizational expenditures?

a. Professional fees to issue the corporate stock.  
b. Printing costs to issue the corporate stock.  
c. Legal fees for drafting the corporate charter.  
d. Commissions paid by the corporation to an underwriter.

13. Filo, Inc. began business on July 1, 2010, and elected to file its income tax returns on a calendar-year basis. The following expenditures were incurred in organizing the corporation:

<table>
<thead>
<tr>
<th>Date</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>August 1, 2010</td>
<td>$300</td>
</tr>
<tr>
<td>September 3, 2010</td>
<td>$600</td>
</tr>
</tbody>
</table>

The maximum allowable deduction for amortization of organization expense in 2010 is

a. $30  
b. $60  
c. $90  
d. $900

**CAPITAL TRANSACTIONS**

14. This year, Mud Corporation sold 1,000 shares of its $10 par value common stock for $20,000. The stock had originally been issued in 1980 for $12 a share and was reacquired by Mud in 1983 for $15 a share. For the tax year, Mud Corporation should report a long-term capital gain of

a. $0.  
b. $5,000.  
c. $8,000.  
d. $10,000.
15. The following information pertains to treasury stock sold by Lee Corp. to an unrelated broker in 2010:

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Proceeds received</td>
<td>$50,000</td>
</tr>
<tr>
<td>Cost</td>
<td>30,000</td>
</tr>
<tr>
<td>Par value</td>
<td>9,000</td>
</tr>
</tbody>
</table>

What amount of capital gain should Lee recognize in 2009 on the sale of this treasury stock?

a. $0  
b. $8,000  
c. $20,000  
d. $30,500

16. During 2010, Ral Corp. exchanged 5,000 shares of its own $10 par common stock for land with a fair market value of $75,000. As a result of this exchange, Ral should report in its 2010 tax return

a. $25,000 Section 1245 gain.  
b. $25,000 Section 1231 gain.  
c. $25,000 ordinary income.  
d. No gain.

17. Gilbert Manufacturing Company, in need of additional factory space, exchanged 10,000 shares of its common stock with a par value of $100,000 for a building with a fair market value of $120,000. On the date of the exchange the stock had a market value of $130,000. How much and what type of gain or loss should Gilbert report on this transaction?

a. No gain or loss.  
b. $10,000 capital loss.  
c. $20,000 capital gain.  
d. $20,000 section 1231 gain.

18. A corporation's capital losses are

a. Deductible only to the extent of the corporation's capital gains.  
b. Deductible from the corporation's ordinary income to the extent of $3,000.  
c. Carried back three years and forward 15 years.  
d. Forfeited if the corporation had no capital gains in the year in which the capital losses were incurred.

19. When a corporation has an unused net capital loss that is carried back or carried forward to another tax year,

a. It retains its original identity as short-term or long-term.  
b. It is treated as a short-term capital loss whether or not it was short-term when sustained.  
c. It is treated as a long-term capital loss whether or not it was long-term when sustained.  
d. It can be used to offset ordinary income up to the amount of the carryback or carryover.

20. What is Bell's net capital-loss deduction and what is the capital-loss carryover to 2011 respectively?

a. $0 and $5,000.  
b. $1,000 and $3,000.  
c. $1,000 and $4,000.  
d. $2,500 and $2,500.

21. How will the 2010 capital-loss carryover be treated in Bell's 2011 income tax return?

a. Ordinary loss.  
b. Section 1231 loss.  
c. Long-term capital loss.  
d. Short-term capital loss.

22. A C corporation's net capital losses are

a. Carried forward indefinitely until fully utilized.  
b. Carried back 3 years and forward 5 years.  
c. Deductible in full from the corporation's ordinary income.  
d. Deductible from the corporation's ordinary income only to the extent of $3,000.

23. Capital assets include

a. A corporation's accounts receivable from the sale of its inventory.  
b. Seven-year MACRS property used in a corporation's trade or business.  
d. A corporate real estate developer's unimproved land that is to be subdivided to build homes, which will be sold to customers.
24. Baker Corp., a calendar year C corporation, realized taxable income of $36,000 from its regular business operations for calendar year 2010. In addition, Baker had the following capital gains and losses during 2010:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Short-term capital gain</td>
<td>$8,500</td>
</tr>
<tr>
<td>Short-term capital loss</td>
<td>(4,000)</td>
</tr>
<tr>
<td>Long-term capital gain</td>
<td>1,500</td>
</tr>
<tr>
<td>Long-term capital loss</td>
<td>(3,500)</td>
</tr>
</tbody>
</table>

Baker did not realize any other capital gains or losses since it began operations. What is Baker's total taxable income for 2010?

a. $46,000  
b. $42,000  
c. $40,500  
d. $38,500

25. Bruce Williams owns 55% of the outstanding stock of Flextool Corporation. Flextool sold a machine to Williams for $40,000. The machine had an adjusted tax basis of $46,000, and had been owned by Flextool for three years. What is the allowable loss that Flextool can claim in its income tax return?

a. $0  
b. $6,000 ordinary loss.  
c. $6,000 Section 1231 loss.  
d. $6,000 Section 1245 loss.

**TAXATION OF A CORPORATION**

26. In the case of a corporation that is not a financial institution, which of the following statements is correct with regard to the deduction for bad debts?

a. Either the reserve method or the direct charge-off method may be used, if the election is made in the corporation’s first taxable year.  
b. On approval from the IRS, a corporation may change its method from direct charge-off to reserve.  
c. If the reserve method was consistently used in prior years, the corporation may take a deduction for a reasonable addition to the reserve for bad debts.  
d. A corporation is required to use the direct charge-off method rather than the reserve method.

27. For the year ended December 31, 2010, Kelly Corp. had net income per books of $300,000 before the provision for Federal income taxes. Included in the net income were the following items:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dividend income from an unaffiliated domestic taxable corporation (taxable income limitation does not apply and there is no portfolio indebtedness)</td>
<td>$50,000</td>
</tr>
<tr>
<td>Bad debt expense (represents the increase in the allowance for doubtful accounts)</td>
<td>80,000</td>
</tr>
</tbody>
</table>

Assuming no bad debt was written off, what is Kelly's taxable income for the year ended December 31, 2010?

a. $250,000  
b. $330,000  
c. $345,000  
d. $380,000

28. Micro Corp., a calendar year, accrual basis corporation, purchased a 5-year, 8%, $100,000 taxable corporate bond for $108,530, on July 1, 2010, the date the bond was issued. The bond paid interest semiannually. Micro elected to amortize the bond premium. For Micro's 2010 tax return, the bond premium amortization for 2010 should be

I. Computed under the constant yield to maturity method.  
II. Treated as an offset to the interest income on the bond.

a. I only.  
b. II only.  
c. Both I and II.  
d. Neither I nor II.

29. Banks Corp., a calendar year corporation, reimburses employees for properly substantiated qualifying business meal expenses. The employees are present at the meals, which are neither lavish nor extravagant, and the reimbursement is not treated as wages subject to withholdings. For 2010, what percentage of the meal expense may Banks deduct?

a. 0%  
b. 50%  
c. 80%  
d. 100%
30. Axis Corp. is an accrual basis calendar year corporation. On December 13, 2010, the Board of Directors declared a two percent of profits bonus to all employees for services rendered during 2010 and notified them in writing. None of the employees own stock in Axis. The amount represents reasonable compensation for services rendered and was paid on March 13, 2011. Axis' bonus expense may a. Not be deducted on Axis' 2010 tax return because the per share employee amount cannot be determined with reasonable accuracy at the time of the declaration of the bonus. b. Be deducted on Axis' 2010 tax return. c. Be deducted on Axis' 2011 tax return. d. Not be deducted on Axis' tax return because payment is a disguised dividend.

31. Tapper Corp., an accrual basis calendar year corporation, was organized on January 2, 2010. During 2010, revenue was exclusively from sales proceeds and interest income. The following information pertains to Tapper:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Taxable income before charitable contributions for the year ended December 31, 2010</td>
<td>$500,000</td>
</tr>
<tr>
<td>Tapper's matching contribution to employee-designated qualified universities made during 2010</td>
<td>10,000</td>
</tr>
<tr>
<td>Board of Directors' authorized contribution to a qualified charity authorized December 1, 2010, and made February 1, 2011</td>
<td>30,000</td>
</tr>
</tbody>
</table>

What is the maximum allowable deduction that Tapper may take as a charitable contribution on its tax return for the year ended December 31, 2010? a. $0 b. $10,000 c. $30,000 d. $40,000

32. Dowell Corporation had operating income of $100,000, after deducting $6,000 for contributions, but not including dividends of $10,000 received from nonaffiliated domestic taxable corporations. How much is the base amount to which the percentage limitation should be applied in computing the maximum allowable deduction for contributions? a. $106,000 b. $107,500 c. $110,000 d. $116,000

33. In 2010, Garland Corp. contributed $40,000 to a qualified charitable organization. Garland's 2010 taxable income before the deduction for charitable contributions was $410,000. Included in that amount is a $20,000 dividends-received deduction. Garland also had carryover contributions of $5,000 from the prior year. In 2010, what amount can Garland deduct as charitable contributions? a. $40,000 b. $41,000 c. $43,000 d. $45,000

34. In 2010, Cable Corp., a calendar year C corporation, contributed $80,000 to a qualified charitable organization. Cable's 2010 taxable income before the deduction for charitable contributions was $820,000 after a $40,000 dividends-received deduction. Cable also had carryover contributions of $10,000 from the prior year. In 2010, what amount can Cable deduct as charitable contribution? a. $90,000 b. $86,000 c. $82,000 d. $80,000

35. If a corporation's charitable contributions exceed the limitation for deductibility in a particular year, the excess a. Is not deductible in any future or prior year. b. May be carried back or forward for one year at the corporation's election. c. May be carried forward to a maximum of five succeeding years. d. May be carried back to the third preceding year.
36. In 2010, Stewart Corp. properly accrued $5,000 for an income item on the basis of a reasonable estimate. In 2011, after filing its 2010 federal income tax return, Stewart determined that the exact amount was $6,000. Which of the following statements is correct?
   a. No further inclusion of income is required as the difference is less than 25% of the original amount reported and the estimate had been made in good faith.
   b. The $1,000 difference is includable in Stewart's 2011 income tax return.
   c. Stewart is required to notify the IRS within 30 days of the determination of the exact amount of the item.
   d. Stewart is required to file an amended return to report the additional $1,000 of income.

37. The uniform capitalization method must be used by
   I. Manufacturers of tangible personal property.
   II. Retailers of personal property with $2 million dollars in average annual gross receipts for the 3 preceding years.
   a. I only.
   b. II only.
   c. Both I and II.
   d. Neither I nor II.

38. Lyle Corp. is a distributor of pharmaceuticals and sells only to retail drug stores. During 2010, Lyle received unsolicited samples of nonprescription drugs from a manufacturer. Lyle donated these drugs in 2010 to a qualified exempt organization and deducted their fair market value as a charitable contribution. What should be included as gross income in Lyle's 2010 return for receipt of these samples?
   a. Fair market value.
   b. Net discounted wholesale price.
   c. $25 nominal value assigned to gifts.
   d. $0.

39. Gero Corp. had operating income of $160,000, after deducting $10,000 for contributions to State University, but not including dividends of $2,000 received from nonaffiliated taxable domestic corporations.

   In computing the maximum allowable deduction for contributions, Gero should apply the percentage limitation to a base amount of

40. If a corporation's charitable contributions exceed the limitation for deductibility in a particular year, the excess
   a. May be carried back to the third preceding year.
   b. May be carried forward to a maximum of five succeeding years.
   c. May be carried back or forward for one year at the corporation's election.
   d. Is not deductible in any future or prior year.

41. Acorn, Inc. had the following items of income and expense this taxable year:

   Sales $500,000
   Cost of sales 250,000
   Dividends received 25,000

   The dividends were received from a corporation of which Acorn owns 30%. In Acorn's corporate income tax return, what amount should be reported as income before special deductions?
   a. $525,000
   b. $505,000
   c. $275,000
   d. $250,000

42. The corporate dividends-received deduction
   a. Must exceed the applicable percentage of the recipient shareholder's taxable income.
   b. Is affected by a requirement that the investor corporation must own the investee's stock for a specified minimum holding period.
   c. Is unaffected by the percentage of the investee's stock owned by the investor corporation.
   d. May be claimed by S corporations.

43. This taxable year, Trapp, Inc., had $400,000 of gross profit from operations and $160,000 of dividends from Von Corporation in which Trapp had a 25% ownership interest. Trapp's operating expenses totaled $410,000. What is Trapp's dividends received deduction?
   a. $80,000.
   b. $128,000.
   c. $136,000.
   d. $120,000.
44. In 2010, Best Corp., an accrual-basis calendar year C corporation, received $100,000 in dividend income from the common stock that it held in an unrelated domestic corporation. The stock was not debt-financed, and was held for over a year. Best recorded the following information for 2010:

<table>
<thead>
<tr>
<th>Loss from Best's operations</th>
<th>($ 10,000)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dividends received</td>
<td>100,000</td>
</tr>
<tr>
<td>Taxable income (before dividends-received deduction)</td>
<td>$ 90,000</td>
</tr>
</tbody>
</table>

Best's dividends-received deduction on its 2010 tax return was

a. $100,000
b. $80,000
c. $70,000
d. $63,000

45. During 2010, Nale Corp. received dividends of $1,000 from a 10%-owned taxable domestic corporation. When Nale computes the maximum allowable deduction for contributions in its 2010 return, the amount of dividends to be included in the computation of taxable income is

a. $0
b. $200
c. $300
d. $1,000

46. In 2010, Ryan Corp. had the following income:

<table>
<thead>
<tr>
<th>Income from operations</th>
<th>$300,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dividends from unrelated taxable domestic corporations less than 20% owned</td>
<td>2,000</td>
</tr>
</tbody>
</table>

Ryan had no portfolio indebtedness. In Ryan's 2010 taxable income, what amount should be included for the dividends received?

a. $400
b. $600
c. $1,400
d. $1,600

47. In 2010, Daly Corp. had the following income:

<table>
<thead>
<tr>
<th>Profit from operations</th>
<th>$100,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dividends from 20%-owned taxable domestic corporation</td>
<td>1,000</td>
</tr>
</tbody>
</table>

In Daly's 2010 taxable income, how much should be included for the dividends received?

a. $0
b. $200
c. $800
d. $1,000

48. For the year ended December 31, 2010, Atkinson, Inc. had gross business income of $160,000 and dividend income of $100,000 from unaffiliated domestic corporations that are at least 20%-owned. Business deductions for 2010 amounted to $170,000. What is Atkinson's dividends received deduction for 2010?

a. $100,000
b. $80,000
c. $70,000
d. $63,000

49. In its first year of operation, Commerce Corporation had a gross profit from operations of $360,000 and deductions of $500,000 excluding any special deductions. Commerce also received dividends of $100,000 from a 30%-owned unaffiliated domestic corporation. What is the net operating loss for that year?

a. $34,000
b. $40,000
c. $55,000
d. $120,000

50. Kisco Corp.'s taxable income for 2010 before taking the dividends received deduction was $70,000. This includes $10,000 in dividends from an unrelated taxable domestic corporation. Given the following tax rates, what would Kisco's income tax be before any credits?

<table>
<thead>
<tr>
<th>Partial rate table</th>
<th>Tax rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>Up to $50,000</td>
<td>15%</td>
</tr>
<tr>
<td>Over $50,000 but not over $75,000</td>
<td>25%</td>
</tr>
</tbody>
</table>

- a. $10,000
- b. $10,750
- c. $12,500
- d. $15,750
51. For the year ended December 31, 2010, Taylor Corp. had a net operating loss of $165,000. Taxable income for the earlier years of corporate existence, computed without reference to the net operating loss, was as follows:

<table>
<thead>
<tr>
<th>Year</th>
<th>Taxable Income</th>
</tr>
</thead>
<tbody>
<tr>
<td>2005</td>
<td>$5,000</td>
</tr>
<tr>
<td>2006</td>
<td>$10,000</td>
</tr>
<tr>
<td>2007</td>
<td>$20,000</td>
</tr>
<tr>
<td>2008</td>
<td>$30,000</td>
</tr>
<tr>
<td>2009</td>
<td>$40,000</td>
</tr>
</tbody>
</table>

If Taylor makes no special election to waive the net operating loss carryback, what amount of net operating loss will be available to Taylor for the year ended December 31, 2011?

a. $200,000  
b. $130,000  
c. $110,000  
d. $65,000

52. When a corporation has an unused net capital loss that is carried back or carried forward to another tax year, what should be its taxable income?

a. It retains its original identity as short-term or long-term.  
b. It is treated as a short-term capital loss whether or not it was short-term when sustained.  
c. It is treated as a long-term capital loss whether or not it was long-term when sustained.  
d. It can be used to offset ordinary income up to the amount of the carryback or carryover.

53. Would the following expense items be reported on Schedule M-1 of the corporation income tax return showing the reconciliation of income per books with income per return?

<table>
<thead>
<tr>
<th>Interest incurred on loan to carry</th>
<th>Provision for state corporation income tax</th>
</tr>
</thead>
<tbody>
<tr>
<td>U.S. obligations</td>
<td></td>
</tr>
<tr>
<td>a. Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>b. No</td>
<td>No</td>
</tr>
<tr>
<td>c. Yes</td>
<td>No</td>
</tr>
<tr>
<td>d. No</td>
<td>Yes</td>
</tr>
</tbody>
</table>

54. Dale Corporation's book income before federal income taxes was $520,000 for the year ended December 31, 2010. Dale was organized four years earlier. Organization costs of $360,000 are being written off over a ten-year period for financial statement purposes. For tax purposes these costs are being written off over the minimum allowable period. For the year ended December 31, 2010, Dale's taxable income was:

a. $468,000  
b. $494,000  
c. $520,000  
d. $546,000

55. For the taxable year, Apollo Corporation had net income per books of $1,200,000. Included in the determination of net income were the following items:

<table>
<thead>
<tr>
<th>Item</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Interest income on municipal bonds</td>
<td>$40,000</td>
</tr>
<tr>
<td>Gain on settlement of life insurance policy</td>
<td>$200,000</td>
</tr>
<tr>
<td>Interest paid on loan to purchase municipal bonds</td>
<td>$8,000</td>
</tr>
<tr>
<td>Provision for federal income tax</td>
<td>$524,000</td>
</tr>
</tbody>
</table>

What should Apollo report as its taxable income?

a. $1,492,000  
b. $1,524,000  
c. $1,684,000  
d. $1,692,000

56. In 2010, Cape Co. reported book income of $140,000. Included in that amount was $50,000 for meals and entertainment expense and $40,000 for federal income tax expense. In Cape's Schedule M-1 of Form 1120, which reconciles book income and taxable income, what amount should be reported as taxable income?

a. $190,000  
b. $180,000  
c. $205,000  
d. $140,000
57. For the year ended December 31, 2010, Maple Corp.'s book income, before federal income tax, was $100,000. Included in this $100,000 were the following:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Provision for state income tax</td>
<td>$1,000</td>
</tr>
<tr>
<td>Interest earned on U.S. Treasury Bonds</td>
<td>$6,000</td>
</tr>
<tr>
<td>Interest expense on bank loan to purchase U.S. Treasury Bonds</td>
<td>$2,000</td>
</tr>
</tbody>
</table>

Maple's taxable income for 2010 was
a. $96,000  
b. $97,000  
c. $100,000  
d. $101,000

58. For the year ended December 31, 2010, Bard Corp.'s income per accounting records, before federal income taxes, was $450,000 and included the following:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>State corporate income tax refunds</td>
<td>$4,000</td>
</tr>
<tr>
<td>Life insurance proceeds on officer's death</td>
<td>$15,000</td>
</tr>
<tr>
<td>Net loss on sale of securities bought for investment in 2002</td>
<td>$20,000</td>
</tr>
</tbody>
</table>

Bard's 2010 taxable income was
a. $435,000  
b. $451,000  
c. $455,000  
d. $470,000

59. Norwood Corporation is an accrual-basis taxpayer. For the year ended December 31, 2010, it had book income before tax of $500,000 after deducting a charitable contribution of $100,000. The contribution was authorized by the Board of Directors in December 2010 but was not actually paid until March 1, 2011. How should Norwood treat this charitable contribution for tax purposes to minimize its 2010 taxable income?

a. It cannot claim a deduction in 2010, but must apply the payment against 2011 income.
b. Make an election claiming a deduction for 2010 of $25,000 and carry the remainder over a maximum of five succeeding tax years.
c. Make an election claiming a deduction for 2010 of $60,000 and carry the remainder over a maximum of five succeeding tax years.
d. Make an election claiming a 2010 deduction of $100,000.

60. Lake Corp., an accrual-basis calendar year corporation, had the following 2010 receipts:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>2011 advanced rental payments where the lease ends in 2011</td>
<td>$125,000</td>
</tr>
<tr>
<td>Lease cancellation payment from a 5-year lease tenant</td>
<td>$50,000</td>
</tr>
</tbody>
</table>

Lake had no restrictions on the use of the advance rental payments and renders no services. What amount of income should Lake report on its 2010 tax return?

a. $0  
b. $50,000  
c. $125,000  
d. $175,000

61. Ram Corp.'s operating income for the year ended December 31, 2010 amounted to $100,000. Also in 2010, a machine owned by Ram was completely destroyed in an accident. This machine's adjusted basis immediately before the casualty was $15,000. The machine was not insured and had no salvage value.

In Ram's 2010 tax return, what amount should be deducted for the casualty loss?

a. $5,000  
b. $5,400  
c. $14,900  
d. $15,000

62. For the first taxable year in which a corporation has qualifying research and experimental expenditures, the corporation

a. Has a choice of either deducting such expenditures as current business expenses, or capitalizing these expenditures.
b. Has to treat such expenditures in the same manner as they are accounted for in the corporation's financial statements.
c. Is required to deduct such expenditures currently as business expenses or lose the deductions.
d. Is required to capitalize such expenditures and amortize them ratably over a period of not less than 60 months.
63. Olex Corporation's books disclosed the following data for the calendar year:

- Retained earnings at beginning of year: $50,000
- Net income for year: $70,000
- Contingency reserve established at end of year: $10,000
- Cash dividends paid during year: $8,000

What amount should appear on the last line of reconciliation Schedule M-2 of Form 1120?

- a. $102,000
- b. $120,000
- c. $128,000
- d. $138,000

64. Barbaro Corporation's retained earnings at January 1, 2010, were $600,000. During 2010 Barbaro paid cash dividends of $150,000 and received a federal income tax refund of $26,000 as a result of an IRS audit of Barbaro's 2006 tax return. Barbaro's net income per books for the year ended December 31, 2010, was $274,900 after deducting federal income tax of $183,300. How much should be shown in the reconciliation schedule M-2 of Form 1120, as Barbaro's retained earnings at December 31, 2010?

- a. $443,600
- b. $600,900
- c. $626,900
- d. $750,900

65. How are a C Corporation's net capital losses used?

- a. Deducted from the corporation's ordinary income only to the extent of $3,000.
- b. Carried back three years and forward five years.
- c. Deductible in full from the corporation's ordinary income.
- d. Carried forward 15 years.

66. On January 2, 2010, Tek Corp., an accrual-basis calendar-year C Corporation, purchased all the assets of a sole proprietorship, including $60,000 in goodwill. Tek's 2010 reported book income before federal income taxes was $400,000. A $1,500 deduction for annual amortization of goodwill was taken based on a 40-year amortization period. What should be the amount of Tek's 2010 taxable income, as reconciled on Tek's Schedule M-1 of Form 1120, U.S. Corporation Income Tax Return?

- a. $389,500
- b. $397,500
- c. $400,000
- d. $401,500

67. The building was subject to a $10,000 mortgage that was assumed by Ace. What amount of gain did Lind recognize on the exchange?

- a. $0
- b. $10,000
- c. $42,000
- d. $52,000

68. What was Ace's basis in the building?

- a. $30,000
- b. $40,000
- c. $72,000
- d. $82,000

69. What was Lind's basis in Ace stock?

- a. $82,000
- b. $40,000
- c. $30,000
- d. $0

70. On January 2 of the current year, Shaw Corp., an accrual-basis, calendar-year C corporation, purchased all the assets of a sole proprietorship, including $300,000 in goodwill. Current-year federal income tax expense of $110,100 and $7,500 for annual amortization of goodwill based upon a 40-year amortization period, were deducted to arrive at Shaw’s reported book income of $239,200. What should be the amount of Shaw's current-year taxable income, as reconciled on Shaw’s Schedule M-1 of Form 1120, U.S. Corporate Income Tax Return?

- a. $239,200
- b. $329,300
- c. $336,800
- d. $349,400
71. Pope, a C corporation, owns 15% of Arden Corporation. Arden paid a $3,000 cash dividend to Pope. What is the amount of Pope’s dividend received deduction?
   a. $3,000
   b. $2,400
   c. $2,100
   d. $0

72. A C corporation has gross receipts of $150,000, $35,000 of other income, and deductible expenses of $95,000. In addition, the corporation incurred a net long-term capital loss of $25,000 in the current year. What is the corporation’s taxable income?
   a. $65,000
   b. $87,000
   c. $90,000
   d. $115,000

73. Jagdon Corp’s book income was $150,000 for the current year, including interest income from municipal bonds of $5,000 and excess capital losses over capital gains of $10,000. Federal income tax expense of $50,000 was also included in Jagdon’s books. What amount represents Jagdon’s taxable income for the current year?
   a. $185,000
   b. $195,000
   c. $205,000
   d. $215,000

74. Ames and Roth form Homerun, a C corporation. Ames contributes several autographed baseballs to Homerun. Ames purchased the baseballs for $500, and they have a total fair market value of $1,000. Roth contributes several autographed baseball bats to Homerun. Roth purchased the bats for $5,000 and they have a fair market value of $7,000. What is Homerun’s basis in the contributed bats and balls?
   a. $0
   b. $5,500
   c. $6,000
   d. $8,000

75. In April, A and B formed X Corporation. A contributed $50,000 cash, and B contributed land worth $70,000 (with an adjusted basis of $40,000). B also received $20,000 cash from the corporation. A and B each receive 50% of the corporation’s stock. What is the basis of the land to X Corporation?
   a. $40,000
   b. $50,000
   c. $60,000
   d. $70,000
1. (d) 80%. By definition.

2. (b) $30,500. The corporation receives a transfer basis of property contributed in a tax-free exchange for stock. The basis is determined as follows:

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$ 500</td>
</tr>
<tr>
<td>Computer - adjusted</td>
<td>30,000</td>
</tr>
<tr>
<td>Total</td>
<td>$30,500</td>
</tr>
</tbody>
</table>

3. (d) $0. This transaction meets the criteria that when shareholders transfer property to a corporation solely in exchange for stock, no gain or loss is recognized. The transferors of property (Beck and Carr) are in control (90% ownership) immediately after the transfer. The fact that Adams did not transfer in property does not taint the transaction for Beck and Carr because their ownership was at least 80%. If the question was how much income Adams must recognize, it would be $10,000 of ordinary income.

4. (a) $10,000. The corporation receives a transfer basis of property contributed in a tax-free exchange for stock. Mr. Breck and Mr. Witt have 100% control after the transfer. There is a carryover of both the basis and holding period.

5. (b) $20,000. Jenkins received stock, cash and the release of debt from the transfer. When boot accompanies the transfer, it causes the recognition of any realized gain. Since the liability is not in excess of the basis of the property, it does not cause any additional gain to be recognized.

\[
\begin{array}{|c|c|}
\hline
\text{Amount realized:} & \\
\text{Cash received} & $20,000 \\
\text{FMV of stock} & 20,000 \\
\text{Release of debt} & 10,000 \\
\hline
\text{Total amount realized} & 50,000 \\
\text{Less: adjusted basis of land} & -15,000 \\
\text{Realized gain} & $35,000 \\
\hline
\text{Recognized to the extent of boot (cash) received} & $20,000 \\
\hline
\end{array}
\]

6. (d) $10,000. When a shareholder performs services in exchange for corporation stock, the shareholder must recognize ordinary income to the extent of the fair market value of the stock received. This will also be the basis of Rogers’ stock.

7. (c) $110,000. This transaction meets the criteria that when shareholders transfer property to a corporation solely in exchange for stock (at least 80% control), no gain or loss is recognized. Clark’s basis is comprised of the cash as well as the basis of the property transferred.

\[
\begin{array}{|c|c|}
\hline
\text{Cash transferred} & $60,000 \\
\text{Basis of property transferred} & 50,000 \\
\hline
\text{Total basis} & $110,000 \\
\hline
\end{array}
\]

8. (d) 80%. When a taxpayer transfers property to a corporation solely in exchange for stock, the general rule under Section 351 is that no gain or loss is recognized, provided that the shareholder(s) is in control after the transfer. Control is defined as owning at least 80% of the corporation.
9. (c) $60,000. When a taxpayer transfers property to a corporation solely in exchange for stock, the general rule under Section 351 is that no gain or loss is recognized, provided that the shareholder(s) is in control after the transfer. Control is defined as owning at least 80% of the corporation. Whereas Feld owns 100% he meets the control test. There is also a carryover of basis to the corporation of the property transferred by the shareholder. Therefore, his basis is as follows:

<table>
<thead>
<tr>
<th>Tender's original basis</th>
<th>$ 50,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Additional basis from transfer</td>
<td>10,000</td>
</tr>
<tr>
<td>Total adjusted basis of stock</td>
<td>$ 60,000</td>
</tr>
</tbody>
</table>

10. (c) Costs incurred related to the creation of the corporation, such as accounting and legal fees, are not deductible, but are instead capitalized. The corporation may expense these if less than $5,000. Amounts in excess of $5,000 are to be amortized over a period of not less than 180 months. Costs associated with a stock offering, however, are neither deductible nor amortizable. These fees are usually the marketing, registration and underwriting fees associated with selling of the shares.

11. (b) $6,200. Organization costs can be amortized over a period of not less than 180 months assuming a proper and timely election has been made. The organization costs of $41,000 are first reduced by $5,000 which may be expensed immediately. Then the balance of $36,000 would be divided by 180 months and provide for $200 per month of amortization. The amount for the current year would be six months, or $1,200 plus the $5,000 for a total of $6,200. The $35,000 for underwriter fees and other stock issue costs of $10,000 would be charged to capital, and not amortized.

12. (c) The fees paid for underwriter fees and other stock issue costs would generally be charged to capital, and not amortized.

13. (d) $900. Organization costs are generally amortized over a period of not less than 180 months assuming a proper and timely election has been made. However, a corporate taxpayer may elect to immediately expense up to $5,000 assuming the total organizational expenditures do not exceed $50,000.

14. (a) $0. No gain or loss is recognized by a corporation on the sale or exchange of its own stock.

15. (a) $0. No gain or loss is recognized by a corporation on the sale or exchange of its own stock.

16. (d) No gain. No gain or loss is recognized by a corporation on the sale or exchange of its own stock.

17. (a) $0. No gain or loss is recognized by a corporation on the sale or exchange of its own stock.

18. (a) Capital losses can only be offset against capital gains. The $3,000 loss pertains to individuals and the carry forward is five years, not fifteen.

19. (b) By definition.

20. (a) $0 and $5,000. The net long-term capital loss is first netted against the net short-term capital gain, resulting in a net capital loss of $5,000. This amount is available as a five year carryforward. No carryback exists because it is the first year of operations.

21. (d) Short-term capital loss. All capital loss carryovers and carrybacks are treated as short-term.

22. (b) Capital losses may only be used to offset capital gains. Excess net capital losses, regardless of whether they are long or short-term, are carried back and forward as short-term capital losses. The carryback period is 3 years and carryforward period is 5 years.

23. (c) Capital assets do not include accounts receivable, property used in a taxpayer’s trade or business or land which is to be subdivided and sold (inventory).
24. (d) $38,500. The net capital gains of $2,500 are added to taxable income from operations of $36,000 to determine total taxable income of $38,500. There is no difference in the tax rates for capital gains, unlike an individual. Baker Corporation must first net its capital transactions together as follows:

<table>
<thead>
<tr>
<th>Capital Gain/Loss</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Short-term capital gain</td>
<td>$8,500</td>
</tr>
<tr>
<td>Short-term capital loss</td>
<td>-$4,000</td>
</tr>
<tr>
<td>Net short-term capital gain</td>
<td>$4,500</td>
</tr>
<tr>
<td>Long-term capital gain</td>
<td>$1,500</td>
</tr>
<tr>
<td>Long-term capital loss</td>
<td>-$3,500</td>
</tr>
<tr>
<td>Net long-term capital loss</td>
<td>-$2,000</td>
</tr>
<tr>
<td>Net short-term capital gain</td>
<td>$2,500</td>
</tr>
</tbody>
</table>

25. (a) $0. This sale has a realized loss of $6,000. However, because this is a related party transaction, no loss is recognized. The shareholder owns more than 50% of the stock.

26. (d) The reserve method of providing for bad debts is no longer allowed for tax purposes. The direct write-off method is now required.

27. (c) $345,000. The dividends received deduction is 70% of the dividend for a total of $35,000. The reserve method is no longer allowed for recording of the bad debt expense. Therefore, Kelly Corporation's taxable income should be:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Unadjusted taxable income</td>
<td>$300,000</td>
</tr>
<tr>
<td>Add: Disallowed bad debts</td>
<td>80,000</td>
</tr>
<tr>
<td>Less: Dividends received deduction</td>
<td>-35,000</td>
</tr>
<tr>
<td>Taxable income</td>
<td>$345,000</td>
</tr>
</tbody>
</table>

28. (c) Both I and II. This is the acceptable method to recognize interest income on a bond.

29. (b) 50%. By definition. This percentage was 80% in prior years.

30. (b) An accrual of bonuses will be allowed as a deduction provided that the employees are not shareholders and it is paid within two and one-half months of the tax year-end. The amount of 2% does not appear to be unreasonable.

31. (d) $40,000. The two contributions are both fully deductible. Since Tapper was an accrual based taxpayer, the authorization of the Board was by December 31 and the payment before March 15th. The $40,000 is under the limitation of 10% of the taxable income of $500,000.

32. (d) $116,000. The base amount to determine the contribution limit is taxable income, without regard to the charitable contribution itself and the dividends received deduction. In this problem the DRD has not yet been computed and does not need to be. However, the dividends of $10,000 are not included in the operating income, and must be added in.

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Operating income</td>
<td>$100,000</td>
</tr>
<tr>
<td>Add: Dividend income</td>
<td>10,000</td>
</tr>
<tr>
<td>Add: Contributions</td>
<td>6,000</td>
</tr>
<tr>
<td>Base amount</td>
<td>$116,000</td>
</tr>
</tbody>
</table>

33. (c) $43,000. The contributions available for use in 2009 total $45,000. This is comprised of the current year contribution of $40,000 plus the carryover of $5,000. To determine the allowable portion, the base amount must be determined. The base is taxable income, without regard to the charitable contribution itself and the dividends received deduction (DRD).
Unadjusted taxable income $ 410,000
Add back the DRD 20,000
Base amount  $430,000
Contribution limitation % 10%
Maximum deduction $ 43,000

(The excess of $2,000 ($45,000 less the current year deduction of $43,000) is from the $5,000 carryover portion, and may be carried forward no longer than four more years.)

34. (b) $86,000. The contributions available for use in current year total $90,000. This is comprised of the current year contribution of $80,000 plus the carryover of $10,000. To determine the allowable portion, the base amount must be determined. The base is taxable income, without regard to the charitable contribution itself and the dividends received deduction (DRD).

Unadjusted taxable income $ 820,000
Add back the DRD 40,000
Base amount  $860,000
Contribution limitation % 10%
Maximum deduction $ 86,000

(The excess of $4,000 ($90,000 less the current year deduction of $86,000) is from the $10,000 carryover portion, and may be carried forward no longer than four more years.)

35. (c) Any excess charitable contribution is carried forward for five years. In determining the allowable contribution for any given year, the current contribution is considered first, and then any carryforward.

36. (b) In determining its taxable income, a taxpayer may use a reasonable estimate to accrue items when the exact amount is not known. Since Stewart properly accrued the $5,000 of income for 2010, and did not discover the exact amount until 2011, the additional $1,000 of income is recognized in 2011.

37. (a) The uniform capitalization method generally pertains to those companies engaged in manufacturing or constructing real or personal property. The uniform capitalization rules do not apply to small retailers whose average annual gross receipts do not exceed $10,000,000 for the 3 preceding years.

38. (a) Lyle must include, as gross income, the fair market value of the unsolicited samples of the nonprescription drugs (inventory) they received from the manufacturer because they later donated the items as a charitable contribution. Correspondingly, they are allowed a charitable deduction equal to the fair market value of the inventory contributed.

39. (a) $172,000. The base amount to determine the contribution limit is taxable income, without regard to the charitable contribution itself and the dividends received deduction. In this problem the DRD has not yet been computed and does not need to be. However, the dividends of $2,000 are not included in the operating income, and must be added in.

Operating income $ 160,000
Add: Dividend income 2,000
Add: Contributions 10,000
Base amount  $172,000

40. (b) Any excess charitable contribution is carried forward for five years. In determining the allowable contribution for any given year, the current contribution is considered first, and then any carryforward.

41. (c) $275,000. This is a deceiving question. Since the dividends received deduction is classified as a special deduction, the income before special deductions is merely the income less the expenses.
Sales $500,000
Cost of sales 250,000
Gross profit 250,000
Dividends 25,000
Total income $275,000

42. (b) In order to qualify for the dividends received deduction, a corporation must own the stock for more than 45 days.

43. (d) $120,000. To determine the dividends received deduction:

| Gross profit | $400,000 |
| Dividends | 160,000 |
| Total income | 560,000 |
| Operating expenses | -410,000 |
| Taxable income before DRD | $150,000 |

Limitation tests:
(1) 80% of 160,000 = $128,000
(2) 80% of 150,000 = $120,000

The lesser of 80% of the (1) dividends received or (2) taxable income is used. Therefore the $120,000 is the DRD for this year. (Note: Using the $128,000 will not cause a net operating loss.)

44. (d) $63,000. As an unrelated corporation, we assume that the ownership is less than 20%, thus resulting in a 70% dividends received deduction. To determine the dividends received deduction, the limitations must be tested as follows:

| Operating loss | $-10,000 |
| Dividend income | 100,000 |
| Taxable income before DRD | $90,000 |

Limitation tests:
(1) 70% of 100,000 = $70,000
(2) 70% of 90,000 = $63,000

The lesser of 70% of the (1) dividends received or (2) taxable income is used. Therefore the $63,000 is the DRD for this year. (Note: Using the $70,000 will not cause a net operating loss.)

45. (d) $1,000. The base amount to determine the contribution limit is taxable income, **without** regard to the charitable contribution itself and the dividends received deduction.

46. (b) $600. As an unrelated corporation (less than 20%) the investment qualifies for a 70% dividends received deduction. To determine the dividends received deduction, the limitations must be tested as follows:

| Operating income | $300,000 |
| Dividend income | 2,000 |
| Taxable income before DRD | $302,000 |

Limitation tests:
(1) 70% of 2,000 = $1,400
(2) 70% of 302,000 = $211,400
The lesser of 70% of the (1) dividends received or (2) taxable income is used. Therefore the $1,400 is the DRD for this year. Therefore, the net amount of the dividends to be included in the computation of taxable income is:

<table>
<thead>
<tr>
<th>Dividend income</th>
<th>$ 2,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dividend received deduction</td>
<td>-1,400</td>
</tr>
<tr>
<td>Amount included in taxable income</td>
<td>$ 600</td>
</tr>
</tbody>
</table>

47. (b) $600. When the dividend income is from a 20% owned company, the investment qualifies for a 80% dividends received deduction. To determine the dividends received deduction, the limitations must be tested as follows:

<table>
<thead>
<tr>
<th>Operating income</th>
<th>$ 100,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dividend income</td>
<td>1,000</td>
</tr>
<tr>
<td>Taxable income before DRD</td>
<td>$ 101,000</td>
</tr>
</tbody>
</table>

Limitation tests:
1. 80% of 1,000 = $ 800
2. 80% of 101,000 = $ 80,800

The lesser of 80% of the (1) dividends received or (2) taxable income is used. Therefore the $800 is the DRD for this year. Therefore, the net amount of the dividends to be included in the computation of taxable income is:

<table>
<thead>
<tr>
<th>Dividend income</th>
<th>$ 1,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dividend received deduction</td>
<td>-800</td>
</tr>
<tr>
<td>Amount included in taxable income</td>
<td>$ 200</td>
</tr>
</tbody>
</table>

48. (b) $72,000. To determine the dividends received deduction:

<table>
<thead>
<tr>
<th>Gross business income</th>
<th>$ 160,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dividends</td>
<td>100,000</td>
</tr>
<tr>
<td>Total income</td>
<td>260,000</td>
</tr>
<tr>
<td>Operating expenses</td>
<td>-170,000</td>
</tr>
<tr>
<td>Taxable income before DRD</td>
<td>$ 90,000</td>
</tr>
</tbody>
</table>

Limitation tests:
1. 80% of 100,000 = $80,000
2. 80% of 90,000 = $72,000

The lesser of 80% of the (1) dividends received or (2) taxable income is used. Therefore the $72,000 is the DRD for this year. (Note: Using the $80,000 will not cause a net operating loss.)

49. (d) $120,000. The DRD based upon the dividend received will increase the NOL in this problem, this overriding the 80% test on the taxable income limitation.

<table>
<thead>
<tr>
<th>Gross profit</th>
<th>$ 360,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dividends</td>
<td>100,000</td>
</tr>
<tr>
<td>Total income</td>
<td>460,000</td>
</tr>
<tr>
<td>Operating expenses</td>
<td>-500,000</td>
</tr>
<tr>
<td>NOL before DRD</td>
<td>-40,000</td>
</tr>
<tr>
<td>DRD (80% of 100,000)</td>
<td>80,000</td>
</tr>
<tr>
<td>Net operating loss</td>
<td>$-120,000</td>
</tr>
</tbody>
</table>

50. (b) $10,750. The unadjusted taxable income must be reduced by the 70% dividends received deduction. The rates are then applied per the rate schedule.

<table>
<thead>
<tr>
<th>Unadjusted taxable income</th>
<th>$ 70,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Less: 70% DRD</td>
<td>-7,000</td>
</tr>
<tr>
<td>Taxable income</td>
<td>$ 63,000</td>
</tr>
</tbody>
</table>
Tax computation:

<table>
<thead>
<tr>
<th>First 50,000 @ 15%</th>
<th>$ 7,500</th>
</tr>
</thead>
<tbody>
<tr>
<td>Next $13,000 @ 25%</td>
<td>3,250</td>
</tr>
<tr>
<td>Total tax</td>
<td>$10,750</td>
</tr>
</tbody>
</table>

51. (d) $65,000. For 2010, taxpayers may elect to carry net operating losses up to 5 years. Carrying back the $165,000 five years utilizes $105,000 of the loss, leaving $65,000 to be carried forward.

52. (d) Capital losses may only be used to offset capital gains. Excess net capital losses, regardless of whether they are long or short-term, are carried back and forward as short-term capital losses. The carryback period is 3 years and carryforward period is 5 years.

53. (b) Both of these items are allowable deductions in computing taxable income, therefore no items would appear on Schedule M-1 which reconciles book and tax income.

54. (d) $532,000. The organizational costs may be written-off on a straight-line basis over a 180 month (15 year) period. That would result in an annual deductible expense of $24,000. ($360,000 divided by 5 years). The restated taxable income is as follows:

<table>
<thead>
<tr>
<th>Book income</th>
<th>$ 520,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Add: Book amortization (10 years)</td>
<td>36,000</td>
</tr>
<tr>
<td>Less: Tax amortization (15 years)</td>
<td>-24,000</td>
</tr>
<tr>
<td>Taxable income</td>
<td>$ 532,000</td>
</tr>
</tbody>
</table>

55. (a) $1,492,000. The items listed in the problem are not included in gross income nor deductible, as appropriate. The following steps are necessary to reconcile book income to tax income:

<table>
<thead>
<tr>
<th>Book income</th>
<th>$ 1,200,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Add: Non-deductible interest expense</td>
<td>8,000</td>
</tr>
<tr>
<td>Non-deductible federal income taxes</td>
<td>524,000</td>
</tr>
<tr>
<td>Less: Non-taxable life insurance proceeds</td>
<td>-40,000</td>
</tr>
<tr>
<td>Taxable income</td>
<td>$ 1,492,000</td>
</tr>
</tbody>
</table>

56. (c) $205,000. Schedule M-1 would show the following:

<table>
<thead>
<tr>
<th>Book income</th>
<th>$ 140,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Add: Non-deductible meals (50%)</td>
<td>25,000</td>
</tr>
<tr>
<td>Non-deductible federal income taxes</td>
<td>40,000</td>
</tr>
<tr>
<td>Taxable income</td>
<td>$ 205,000</td>
</tr>
</tbody>
</table>

57. (c) $100,000. The book income is actually equal to Maple Corporation’s taxable income. The state income tax provision is an allowable deduction; the interest earned on U.S. Treasury Bonds is fully included as gross income; and the interest expense on the bank loan to purchase the U.S. Treasury Bonds is fully deductible.

58. (c) $455,000. To reconcile the reported book income to taxable income, there are certain adjustments which need to be made:

<table>
<thead>
<tr>
<th>Book income</th>
<th>$ 450,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Add: Non-deductible loss on sale of investments</td>
<td>20,000</td>
</tr>
<tr>
<td></td>
<td>470,000</td>
</tr>
<tr>
<td>Less: Non-taxable life insurance proceeds</td>
<td>-15,000</td>
</tr>
<tr>
<td>Taxable income</td>
<td>$ 455,000</td>
</tr>
</tbody>
</table>

The state income tax refunds are properly recorded in both book and taxable income.
59. (c) $60,000. The charitable contribution is deductible in the 2010 year since it was voted by the Board by December 31, 2010 and paid by March 15th. The base to perform the 10% test for the current year deductibility is before the charitable contribution.

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Book income</td>
<td>$500,000</td>
</tr>
<tr>
<td>Add: Charitable contributions</td>
<td>$100,000</td>
</tr>
<tr>
<td>Contribution base</td>
<td>$600,000</td>
</tr>
<tr>
<td>Contribution limit percentage</td>
<td>10%</td>
</tr>
<tr>
<td>Contribution allowed in current year</td>
<td>$60,000</td>
</tr>
</tbody>
</table>

60. (d) $175,000. Regardless of whether the taxpayer uses the cash or accrual method of accounting, advance rental payments (not security deposits) must be included in gross income. Likewise, a lease cancellation payment is also included in gross income.

61. (d) $15,000. If a taxpayer in business has a loss from a casualty such as fire, storm, shipwreck, or theft, a deduction is allowed for the decrease in value, or its adjusted basis, whichever is less, minus any insurance reimbursement. As a business loss, this is fully deductible and not subject to the $500 floor and 10% of adjusted gross income test required for a personal casualty loss.

62. (a) The corporation may elect to either deduct these expenditures as a current business expense or capitalize them and amortize them.

63. (a) $102,000. An analysis of retained earnings per the tax return is similar to that for financial accounting.

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Beginning retained earnings</td>
<td>$50,000</td>
</tr>
<tr>
<td>Add: Net income for the year</td>
<td>70,000</td>
</tr>
<tr>
<td>Less: Dividends paid</td>
<td>-8,000</td>
</tr>
<tr>
<td>Less: Contingency reserve</td>
<td>-10,000</td>
</tr>
<tr>
<td>Ending retained earnings</td>
<td>$102,000</td>
</tr>
</tbody>
</table>

Note that the contingency reserve is not a deduction, but rather an allocation of retained earnings.

64. (d) $750,900. An analysis of retained earnings per the tax return is similar to that for financial accounting.

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Beginning retained earnings</td>
<td>$600,000</td>
</tr>
<tr>
<td>Add: Net income for the year</td>
<td>274,900</td>
</tr>
<tr>
<td>Add: Federal income tax refund</td>
<td>26,000</td>
</tr>
<tr>
<td>Less: Dividends paid</td>
<td>-150,000</td>
</tr>
<tr>
<td>Ending retained earnings</td>
<td>$750,900</td>
</tr>
</tbody>
</table>

Note: The refund of federal income taxes paid is an add back to retained earnings because in prior years only the book income (which is net of taxes) is added to retained earnings. This is an adjustment to the retained earnings of the company.

65. (b) Capital losses may only be used to offset capital gains. Any excess capital losses, may be carried back three years and forward five.

66. (b) $397,500. This is a difficult question because it requires the understanding of both book versus tax differences, and the rules for amortizing intangible assets. In Chapter 3, we discuss that intangible assets are amortized over a fifteen year period for tax purposes. This is different than for book purposes which is frequently a forty year period. Since the book amortization is less than tax amortization, a Schedule M-1 adjustment is necessary. Here’s the result:
Net income per books  $ 400,000

Tax amortization:

$ 60,000 / 15 years = $ 4,000

Book amortization:

$ 60,000 / 40 years = 1,500

Difference  - 2,500

Taxable income  $ 397,500

67. (a) $ -0-  When a taxpayer transfers property to a corporation solely in exchange for stock, the general rule under Section 351, is that no gain or loss is recognized provided that the shareholders are in control after the transfer. Control is defined as at least 80% of the corporation. Whereas the amount of liabilities assumed by the corporation do not exceed the basis of the property transferred, no gain is recognized on the assumption of the debt.

68. (b) $40,000. When a shareholder transfers property to a corporation in exchange for stock under Section 351, there is a carryover of basis to the corporation. The basis would be increased by any gain recognized by the shareholder, which in this case is zero.

69. (c) $30,000. Referring to the answers above, Lind’s basis in Ace’s stock is determined by the basis of the property transferred, less any liabilities assumed.

Basis of the building transferred  $ 40,000
Less: mortgage assumed by Ace Corp  - 10,000
Lind’s basis  $ 30,000

70. (c) According to Section 197, goodwill may be amortized over a 15-year period for tax purposes (See Chapter 3 for depreciation and amortization rules). Therefore the appropriate tax deduction for the goodwill is $300,000 divided by 15 years of $20,000. The book-to-tax reconciliation is as follows:

| Book income | $ 239,000 |
| Add: Federal income tax | 110,000 |
| Add: Book amortization | 7,500 |
| Subtotal | 356,800 |
| Less: Tax amortization | -20,000 |
| Taxable income | $ 336,800 |

71. (c) $2,100. Whereas Pope owns less than 20% of Arden Corporation, this results in a 70% dividends received deduction. $3,000 times 70% equals a $2,100 deduction.

72. (c) $90,000. There is no deduction for capital losses, other than for them to offset capital gains. Therefore the corporation’s taxable income is:

| Sales | $ 150,000 |
| Other income | 35,000 |
| Total income | 185,000 |
| Deductible expenses | -95,000 |
| Taxable income | $ 90,000 |

73. (c) $205,000. The items listed in the problem are not included in gross income nor deductible, as appropriate. The following steps are necessary to reconcile book income to tax income:

| Book income | $ 150,000 |
| Add: Federal income taxes | 50,000 |
| Excess capital losses over capital gains | 10,000 |
| | 210,000 |
| Less: Tax-exempt municipal bonds | -5,000 |
| Taxable income | $ 205,000 |
74. (b) $5,500. Homerun’s basis in the property will be the same basis as the contributing shareholders as the transaction qualifies under Section 351.

A’s basis in the baseballs $ 500
B’s basis in the bats 5,000
Homerun’s basis $ 5,500

75. (c) $60,000. This is a difficult problem with several steps. B receives both stock and cash, which gives rise to gain recognition. Then, the recognized gain causes the basis of the land to increase in the corporation.

**Amount realized:**
- Cash received $ 20,000
- FMV of stock 50,000
- Total amount realized 70,000
- Less: adjusted basis of land -40,000
- Realized gain $ 30,000
- Recognized to the extent of boot (cash) received by B $ 20,000

**Determination of basis**
- Original basis of land $ 40,000
- Gain recognized by B 20,000
- Total amount realized $ 60,000
# Chapter Nine
Tax Computation & Controlled Groups

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<th>Page</th>
</tr>
</thead>
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</tr>
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<td></td>
</tr>
<tr>
<td>Research Credits</td>
<td></td>
</tr>
<tr>
<td>Disabled Access</td>
<td></td>
</tr>
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</tr>
</tbody>
</table>
Chapter Nine
Tax Computation and Controlled Groups

COMPUTATION OF CORPORATE TAX LIABILITY AND CREDITS

GENERAL
Once taxable income has been determined for the corporation, the computation of tax is required. After the tax is computed, a reduction for payments and credits is made to determine if the corporation has a refund or balance due.

The summary of the flow of the basic tax computations, credits and payments, is as follows:

- Taxable income
- Tax (regular)
- Plus: Alternative minimum tax
- Less: Credits foreign taxes or business credits
- Plus: Personal holding tax (Chapter 10)
- Environmental tax
- Less: Estimated tax payments
- Refund or balance due

REGULAR COMPUTATION
A corporation is taxed on its taxable income based upon three basic rates: 15%, 25% and 34%. The rates are increased by what are referred to surcharges or surtaxes, to make corporations give back the benefit of receiving a lower rate at the lower levels of income. Because of the 1% surtax on income over $10,000,000, the highest tax bracket for corporations is 35%. The full corporate rate structure is presented below:

- On the first $50,000 15%
- From $50,000, but not over $75,000 25%
- From $75,000, but not over $100,000 34%
- From $100,000, but not over $335,000 39%
- From $335,000 but not over $10,000,000 34%
- From $10,000,000, but not over $15,000,000 35%
- From $15,000,000, but not over $18,333,333 38%
- Over $18,333,333 35%

**Example 12:** W Corporation has taxable income of $60,000. Their tax is computed as follows:

<table>
<thead>
<tr>
<th>Calculation</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>$50,000 X 15%</td>
<td>$7,500</td>
</tr>
<tr>
<td>$10,000 X 25%</td>
<td>$2,500</td>
</tr>
<tr>
<td>Total tax</td>
<td>$10,000</td>
</tr>
</tbody>
</table>

ALTERNATIVE MINIMUM TAX
To ensure that corporation taxpayers pay their fair share of taxes, there is a corporate alternative minimum tax (AMT). It is similar to the individual AMT in concept discussed in Chapter 5. The process to determine this AMT is, identify the various tax preferences or adjustments (all available in the tax code) which were properly elected and planned for, and effectively disallow them.
The corporate AMT has been repealed for small corporations (SC). A corporation with average annual gross receipts of less than $7.5 million for the three-year period beginning after December 31, 1994, qualifies as an SC.

Major rates and/or differences from the individual AMT computations include:

<table>
<thead>
<tr>
<th>AMT issue</th>
<th>Corporate</th>
<th>Individual</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tax rate</td>
<td>20%</td>
<td>26 - 28%</td>
</tr>
<tr>
<td>Exemption amount</td>
<td>$40,000</td>
<td>$70,950 (married)</td>
</tr>
<tr>
<td>Phaseout begins</td>
<td>$150,000</td>
<td>$150,000</td>
</tr>
<tr>
<td>Preferences</td>
<td>Contributions</td>
<td>Not a preference</td>
</tr>
<tr>
<td>Adjustments</td>
<td>No adjustment</td>
<td>Itemized deductions</td>
</tr>
<tr>
<td>Adjustments</td>
<td>ACE</td>
<td>No ACE</td>
</tr>
</tbody>
</table>

The framework for calculating the AMT, assuming no operating losses is as follows:

1. Taxable income
2. Plus or minus the AMT adjustments
3. Plus the tax preferences
   - Equals pre-adjustment AMTI before ACE adjustment
4. Plus or minus 75% of difference between ACE and AMTI
   - Equals AMTI after the ACE adjustment
5. Less the exemption amount
   - Equals the AMT base
6. Multiplied by the 20% tax rate
   - Equals the tentative minimum tax
7. Less the regular tax
     - Equals the AMT

**AMT ADJUSTMENTS**

The adjustments to taxable income are similar to the ones discussed in Chapter 5. In general, adjustments can be positive or negative, and are the result of timing differences in the tax treatment of certain items. For example, excess MACRS depreciation over the longer, slower AMT depreciation method of ADS (alternative depreciation system) will result in a positive adjustment that increases the alternative minimum taxable income. However, after the asset has been fully recovered under MACRS, there will still be depreciation under the AMT method, which will cause a negative adjustment and decrease AMTI.

The AMT adjustments, with a very brief explanation, include:

- Circulation expenditures - Must be capitalized and expensed over three years, not immediately.
- Depreciation - Excess MACRS of real property over ADS of 40 years straight-line.
- Depreciation - Excess MACRS of personal property over ADS 150% DDB.
- Differences in Recognized Gains or Losses - Because of depreciation changes, tax bases are different.
- Pollution Control Facilities Amortization - Excess of straight-line, 60 months over ADS.
- Passive Activity Losses - Uses a different taxable income level for determining losses.
- Completed Contract Method - Must use percentage of completion instead.
- Incentive Stock Options - Excess of FMV over exercise price.
- Net Operating Loss - Must be modified.
In addition, corporations are subject to the adjusted current earnings adjustment (ACE), which is discussed separately further on. Note that since a corporation does not have itemized deductions there are no adjustments needed for **itemized deductions**.

**TAX PREFERENCES**

Tax preferences are always added to taxable income, never subtracted. The preferences are:

- Interest income on private activity bonds, unless issued in 2009 or 2010.
- Excess accelerated depreciation over straight-line on pre-87 real property
- Excess accelerated depreciation over straight-line on leased pre-87 personal property
- Excess amortization over depreciation on pre-87 certified pollution control facilities
- Percentage depletion beyond the property's adjusted basis.
- Excess intangible drilling costs, reduced by 65% of net income from oil, gas and geothermal activity

**THE ACE ADJUSTMENT**

In calculating the AMTI, there may be an ACE adjustment. ACE is similar to Earnings and Profits which was discussed in Chapter 8. The ACE adjustment is designed to bring the corporation's income closer to economic reality. The ACE adjustment can be both positive and negative. A positive adjustment is equal to 75% of the Adjusted Current Earnings (ACE) over the AMTI before the ACE adjustment. However, the negative adjustment can only be to the extent of any previous positive adjustments. Any unused negative ACE adjustments cannot be carried forward. The comprehensive, but not exclusive list of ACE adjustments include:

- Interest income on other tax-free bonds than private activity
- Life insurance proceeds
- LIFO inventory adjustment
- Depreciation - straight-line over a longer year
- The 70% dividends received deduction, but not the 80% and 100%
- The amortization expense of organization costs

**Example 13:** L Corporation started operations in 2008. They computed their Adjusted Current Earnings (ACE) and alternative minimum taxable income before the ACE (pre-AMTI) for the following three years. Determine the ACE adjustment for the three years.

<table>
<thead>
<tr>
<th></th>
<th>2008</th>
<th>2009</th>
<th>2010</th>
</tr>
</thead>
<tbody>
<tr>
<td>Adjusted Current Earnings</td>
<td>3,000</td>
<td>4,000</td>
<td>5,000</td>
</tr>
<tr>
<td>Pre-adjustment AMTI</td>
<td>2,000</td>
<td>6,000</td>
<td>2,000</td>
</tr>
<tr>
<td>Excess ACE over pre-AMTI</td>
<td>1,000</td>
<td>-2,000</td>
<td>3,000</td>
</tr>
<tr>
<td>75% of the excess</td>
<td>750</td>
<td>-1,500</td>
<td>2,250</td>
</tr>
<tr>
<td>ACE adjustment</td>
<td>750</td>
<td>-750</td>
<td>2,250</td>
</tr>
</tbody>
</table>

**2008** - In L's first year of operations, the excess ACE yields a 750 positive adjustment.

**2009** - In year 2, there is a negative adjustment of 1,500. However, since the positive adjustments through 2008 were only 750, L can only reduce its AMTI by 750. There is no carryforward of the unused negative adjustment.

**2010** - In 2010, there is a positive adjustment of 2,250. (If this was a negative adjustment, none would be allowed because there are no positive adjustments remaining.)
EXEMPTION AMOUNT
After adding and subtracting the adjustments, adding the tax preferences to taxable income and adding the ACE adjustment, the corporation is allowed an exemption from the AMTI. The exemption amount for the corporation is $40,000. However, this exemption is phased-out (at a rate of 25% over the excess) if the corporation's AMTI before the exemption exceeds $150,000.

Example 14: For 2010, J Corporation's regular tax on its taxable income was $19,500. J Corporation also had AMTI (before the exemption amount) of $170,000. Calculate the alternative minimum tax.

1. J Corporation's exemption amount for 2010 would be only $35,000 ($40,000 less phase-out of $5,000):

<table>
<thead>
<tr>
<th>AMTI</th>
<th>$170,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Threshold for phase-out</td>
<td>150,000</td>
</tr>
<tr>
<td>Excess over threshold</td>
<td>20,000</td>
</tr>
<tr>
<td>Phase-out rate</td>
<td>25%</td>
</tr>
<tr>
<td>Exemption phaseout</td>
<td>$5,000</td>
</tr>
</tbody>
</table>

2. Calculation of the tax:

<table>
<thead>
<tr>
<th>AMTI</th>
<th>$170,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Exemption ($40,000-$5,000)</td>
<td>35,000</td>
</tr>
<tr>
<td>Tax base 135,000</td>
<td></td>
</tr>
<tr>
<td>AMT tax rate</td>
<td>20%</td>
</tr>
<tr>
<td>Tentative minimum tax</td>
<td>27,000</td>
</tr>
<tr>
<td>Regular tax</td>
<td>19,500</td>
</tr>
<tr>
<td>Alternative minimum tax</td>
<td>$7,500</td>
</tr>
</tbody>
</table>

ENVIRONMENTAL TAX
The environmental tax is .12% of the excess of the corporate modified alternative minimum taxable income over $2,000,000.

COMPUTATION OF TAX CREDITS
FOREIGN TAX CREDIT
Corporate taxpayers are taxed in the United States on their worldwide income. The taxpayers are entitled to a tax credit for income taxes paid to foreign countries. This prevents double taxation of the same income. However, the foreign tax credit cannot exceed the lessor of the amount of the foreign taxes paid (foreign source income times the foreign tax rate) or the pro-rata share of US taxes on the foreign income. The computation of the pro-rata share is as follows:

\[
\text{Income from foreign sources} \times \frac{\text{US taxes paid}}{\text{Worldwide income}} = \text{Foreign tax}
\]
GENERAL BUSINESS CREDITS
The General Business Credits (described below) are limited in total to 25% of the regular tax liability that exceeds $25,000, or the tentative minimum tax, whichever is greater. Any excess is available for a 1 year carryback and a 20 year carryforward. There a numerous tax credits. A few of the more popular ones are listed below.

WORK OPPORTUNITY TAX CREDIT & WELFARE TO WORK CREDIT
This credit is designed to encourage employment of targeted groups. Some of these groups include:

- Economically disadvantage youths, convicts and Vietnam veterans
- Vocational rehabilitation referrals
- Qualified summer youth employees

The Work Opportunity credit is generally 40% of the first $6,000 or wages paid during the first twelve months of employment. For the summer youth employees, the maximum wages is not $6,000, but rather $3,000 for a maximum credit of $1,200. The Welfare to Work credit is 35% of the first $10,000 wages paid to a qualified employee.

HEALTH PREMIUM CREDIT
Under the 2010 Patient Protection and Affordable Care Act, there is a new tax credit for small businesses. The maximum credit is 35 percent of premiums paid in 2010 by eligible small business employers and 25 percent of premiums paid by eligible employers that are tax-exempt organizations. According to the IRS, the credit is specifically targeted to help small businesses and tax-exempt organizations that primarily employ low and moderate income workers. It is generally available to employers that have fewer than 25 full-time equivalent (FTE) employees paying wages averaging less than $50,000 per employee per year. Because the eligibility formula is based in part on the number of FTEs, not the number of employees, many businesses will qualify even if they employ more than 25 individual workers.

RESEARCH CREDITS
This credit is designed to encourage research in the United States. There are two credits. The incremental credit is based upon 20% of the excess amount of qualified research over a base amount. The basic research credit, also a 20% credit, is available for qualified corporations making payments to qualified organizations over a base amount.

DISABLED ACCESS
This credit is available to small business, and is 50% of the eligible disable access expenditures that exceed $250. The maximum credit is $5,000.

ESTIMATED INCOME TAX PAYMENTS
A corporation must make installment payments if it expects the estimated tax, after credits, to be at least $500. The tax payments are due on the 15th day of the 4th, 6th, 9th and 12th month of the year.

In order to avoid any penalty on the underpayment of taxes, the corporation must make payments equal to:

- 100% of its current year’s tax
- 100% of its prior year’s tax
- Annualized income installment method computation

However, in order to rely on paying 100% of the prior year tax, the taxpayer must have a prior year tax. For example, a corporation with no tax liability in 2010 due to a NOL, must pay 100% of the current year's tax to avoid the penalty. “Paying zero”, which was 2010's tax, does not qualify per Revenue Ruling 92-54.
CONTROLLED GROUPS

GENERAL
Because corporations are provided various tax incentives, creative individuals attempt to take an unfair advantage of these incentives by forming multiple corporations. If the multiple corporations have common ownership, they are identified as controlled groups. The two controlled groups are parent-subsidiary and brother-sister. If a group of corporations (two or more) are classified as a controlled group, they are limited to:

- One surtax exemption (for example, the first $50,000 of income which is taxed at 15%) must be allocated to the related corporations.
- One Section 179 election amount
- One accumulated earnings credit ($250,000 or $150,000) must be allocated to the related corporations.
- One $40,000 alternative minimum tax credit must be allocated to the related corporations.

PARENT-SUBSIDIARY CONTROLLED GROUP
When one or more corporations are connected through the stock ownership with a common parent corporation, a parent-subsidiary controlled group may exist. The rule is that if at least 80% of the total voting power or value of all classes of stock in a chain is owned by one or more of the other corporations, and the common parent owns at least 80% of the stock of at least one of the other corporations in the controlled group, then a parent-subsidiary control group exists.

Example 8: Red Corporation owns 80% of White Corporation. Red and White are considered to be a parent and subsidiary.

Example 9: Assume further that Red Corporation also owns 20% of Blue Corporation, and that White Corporation owns 60% Blue Corporation. Red, White and Blue would be considered members of a parent-subsidiary group as Red is deemed to own 80% of Blue (20% directly and 60% through White). There is no reduction in the percentage of ownership in Blue because Red only owns 80% of White. (You do not multiply 80% times 60% and include only 48%).

BROTHER-SISTER CORPORATIONS
If two or more corporations are owned by the same parents (individuals, trusts or estates), they may be classified as brother-sister corporations. A brother-sister relationship exists if the shareholder group of five or fewer persons meets an 80% and 50% ownership test.

- The 80% test is met if the shareholder group owns at least 80% of the total ownership of the corporation.
- The 50% test is met if there is more than 50% common ownership by the shareholder group in each corporation.

Example 10: Bill owns 25% of Blue Corporation and 65% of Gold Corporation. Dave owns 60% of Blue Corporation and 35% of Gold Corporation. Blue and Gold are brother-sister corporations. Bill and Dave own at least 80% of Blue and Gold, and have common ownership of 60%.

<table>
<thead>
<tr>
<th>Shareholder</th>
<th>Blue</th>
<th>Gold</th>
<th>Common</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bill</td>
<td>25%</td>
<td>65%</td>
<td>25%</td>
</tr>
<tr>
<td>Dave</td>
<td>60%</td>
<td>35%</td>
<td>35%</td>
</tr>
<tr>
<td>Total</td>
<td>85%</td>
<td>100%</td>
<td>60%</td>
</tr>
</tbody>
</table>
Example 11: Fran owns 55% of Blue Corporation and 100% of Grey Corporation. Steve owns 45% of Blue Corporation. Blue and Grey are not brother-sister corporations. Even though it appears that they own at least 80% of Blue and Grey, they are not part of a shareholder group because Steve does not own any stock in Grey. Fran does meet the common ownership test in Blue and Grey, but alone does not meet the 80% test.

<table>
<thead>
<tr>
<th>Shareholder</th>
<th>Blue</th>
<th>Grey</th>
<th>Common</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fran</td>
<td>55%</td>
<td>100%</td>
<td>55%</td>
</tr>
<tr>
<td>Steve</td>
<td>45%</td>
<td>0%</td>
<td>0%</td>
</tr>
<tr>
<td>Total</td>
<td>100%</td>
<td>100%</td>
<td>55%</td>
</tr>
</tbody>
</table>

CONSOLIDATED RETURNS
An affiliated group of corporations is allowed to file a consolidated return rather than each corporation filing a separate return. An affiliated group includes one or more chains of corporations where the parent corporation owns directly at least 80% of one of the corporations and at least 80% of each corporation in the group is owned directly by one or more of the other corporations in the group. Once the election is made to file on a consolidated basis, it is binding for future returns. The advantages of filing a consolidated return include:

- The ability to offset losses of one company against another's profits
- The deferral of income on intercompany transactions
- The elimination of intercompany dividends

The major disadvantage of filing on a consolidated basis is the deferral of any intercompany losses until the property is sold to an outside party.

UNCERTAIN TAX POSITIONS
If a corporation has taken a position on its current or prior year’s tax returns and the corporation has taken a reserve for that position in its audited financial statements prepared under generally accepted accounting positions, then the taxpayer must disclose that position on the Form 1120 – UTP. For 2010, the threshold for filing is a corporation with asset equal or exceeding $100 million.
### Schedule J  Tax Computation (see instructions)

1. Check if the corporation is a member of a controlled group (attach Schedule O (Form 1120)).
2. Income tax. Check if a qualified personal service corporation (see instructions).
3. Alternative minimum tax (attach Form 4626).
4. Add lines 2 and 3.
5a. Foreign tax credit (attach Form 1118).
   b. Credit from Form 8834, line 29.
   c. General business credit (attach Form 3800).
   d. Credit for prior year minimum tax (attach Form 8837).
   e. Bond credits from Form 8812.

6. Total credits. Add lines 5a through 5e.
7. Subtract line 6 from line 4.
8. Personal holding company tax (attach Schedule PH (Form 1120)).
9. Other taxes. Check if from: Form 4255, Form 8611, Form 8697, Form 8834, Form 8902, Other (attach schedule).

10. Total tax. Add lines 7 through 9. Enter here and on page 1, line 31.

### Schedule K  Other Information (see instructions)

2. See the instructions and enter the:
   b. Business activity.
   c. Product or service.

3. Is the corporation a subsidiary in an affiliated group or a parent-subsidiary controlled group? Yes, No.
   If “Yes,” enter name and EIN of the parent corporation.

4. At the end of the tax year:
   a. Did any foreign or domestic corporation, partnership (including any entity treated as a partnership), trust, or tax-exempt organization own directly 20% or more of, or own, directly or indirectly, 50% or more of the total voting power of all classes of the corporation’s stock entitled to vote? If “Yes,” complete Part I of Schedule G (Form 1120) (attach Schedule G).
   b. Did any individual or estate own directly 20% or more, or own, directly or indirectly, 50% or more of the total voting power of all classes of the corporation’s stock entitled to vote? If “Yes,” complete Part II of Schedule G (Form 1120) (attach Schedule G).

5. At the end of the tax year, did the corporation:
   a. Own directly 20% or more, or own, directly or indirectly, 50% or more of the total voting power of all classes of stock entitled to vote of any foreign or domestic corporation not included on Form 851, Affiliations Schedule? For rules of constructive ownership, see instructions. If “Yes,” complete (i) through (iv).

<table>
<thead>
<tr>
<th>(i) Name of Corporation</th>
<th>(ii) Employer Identification Number or EIN</th>
<th>(iii) Country of Incorporation</th>
<th>(iv) Percentage Owned in Voting Stock</th>
</tr>
</thead>
</table>
Chapter Nine — Questions
Corporate Tax Computation and Controlled Groups

REGULAR TAX COMPUTATION

1. Kisco Corp.'s taxable income for 2010 before taking the dividends received deduction was $70,000. This includes $10,000 in dividends from an unrelated taxable domestic corporation. Given the following tax rates, what would Kisco's income tax be before any credits?

<table>
<thead>
<tr>
<th>Partial rate table</th>
<th>Tax rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>Up to $50,000</td>
<td>15%</td>
</tr>
<tr>
<td>Over $50,000 but not over $75,000</td>
<td>25%</td>
</tr>
</tbody>
</table>

a. $10,000  
b. $10,750  
c. $12,500  
d. $15,750

ALTERNATIVE MINIMUM TAX

Items 2 through 11 refer to a corporation's need to determine if it will be subject to the alternative minimum tax. Determine whether the statement is true (T) or False (F).

2. The method of depreciation for commercial real property to arrive at alternative minimum taxable income before the adjusted current earnings (ACE) adjustment, is the straight-line method.  
   T

3. The corporate exemption amount reduces the alternative minimum taxable income.  
   F

4. The ACE adjustment can be a positive or negative amount.  
   T

5. Depreciation on personal property to arrive at alternative minimum taxable income before the ACE adjustment is straight-line over the MACRS recovery period.  
   T

6. The alternative minimum tax is the excess of the tentative minimum tax over the regular tax liability.  
   T

7. Municipal bond interest, other than from private activity bonds, is includable as income in arriving at alternative minimum taxable income before the ACE adjustment.  
   T

8. The maximum corporate exemption amount for minimum tax purposes is $150,000.  
   T

9. The 70% dividends received deduction is available to determine ACE.  
   T

10. Municipal bond interest is includable income to determine ACE.  
    T

11. The method of depreciation for personal property placed in service after 1989 for determining ACE is the sum-of-the-years'-digits method.  
    T

12. Rona Corp.'s 2010 alternative minimum taxable income was $200,000. The exempt portion of Rona's 2010 alternative minimum taxable income was
   a. $0
   b. $12,500
   c. $27,500
   d. $52,500
   T

13. The credit for prior year alternative minimum tax liability may be carried
   a. Forward for a maximum of 5 years.  
   b. Back to the 3 preceding years or carried forward for a maximum of 5 years.  
   c. Back to the 3 preceding years.  
   d. Forward indefinitely.  
   T

14. If a corporation's tentative minimum tax exceeds the regular tax, the excess amount is
   a. Carried back to the first preceding taxable year.  
   b. Carried back to the third preceding taxable year.  
   c. Payable in addition to the regular tax.  
   d. Subtracted from the regular tax.  
   T

15. Eastern Corp., a calendar year corporation, was formed January 3, 2010, and on that date placed five-year property in service. The property was depreciated under the general MACRS system. Eastern did not elect to use the straight-line method. The following information pertains to Eastern:

   Eastern's 2010 taxable income $300,000

   Adjustment for the accelerated depreciation taken on 2010 five-year property 1,000

   2010 tax-exempt interest from specified private activity bonds issued before 2009 5,000
21. This year, Bell Corporation had worldwide taxable income of $675,000 and a tentative United States income tax of $270,000. Bell's taxable income from business operations in Country A was $300,000, and foreign income taxes imposed were $135,000 stated in United States dollars.

How much should Bell claim as a credit for foreign income taxes on its United States income tax return?

a. $0.
b. $75,000.
c. $120,000.
d. $135,000.

22. A corporation may reduce its regular income tax by taking a tax credit for

a. Dividends-received exclusion.
b. Foreign income taxes.
c. State income taxes.
d. Accelerated depreciation.

ESTIMATED PAYMENTS & PENALTIES

23. Blink Corp., an accrual basis calendar year corporation, carried back a net operating loss for the tax year ended December 31, 2010. Blink's gross revenues have been under $500,000 since inception. Blink expects to have profits for the tax year ending December 31, 2011. Which method(s) of estimated tax payment can Blink use for its quarterly payments during the 2011 tax year to avoid underpayment of federal estimated taxes?

I. 100% of the preceding tax year method
II. Annualized income method

a. I only.
b. Both I and II.
c. II only.
d. Neither I nor II.

24. Jackson Corp., a calendar year corporation, mailed its 2010 tax return to the Internal Revenue Service by certified mail on Friday, March 11, 2011. The return, postmarked March 11, 2011, was delivered to the Internal Revenue Service on March 18, 2011. The statute of limitations on Jackson's corporate tax return begins on

c. March 16, 2011.
d. March 18, 2011.
25. A corporation's penalty for underpaying federal estimated taxes is
a. Not deductible.
b. Fully deductible in the year paid.
c. Fully deductible if reasonable cause can be established for the underpayment.
d. Partially deductible.

26. In 2010, Brun Corp. properly accrued $10,000 for an income item on the basis of a reasonable estimate. In 2011, Brun determined that the exact amount was $12,000. Which of the following statements is correct?
a. Brun is required to file an amended return to report the additional $2,000 of income.
b. Brun is required to notify the IRS within 30 days of the determination of the exact amount of the item.
c. The $2,000 difference is includable in Brun's 2011 income tax return.
d. No further inclusion of income is required as the difference is less than 25% of the original amount reported and the estimate had been made in good faith.

27. A civil fraud penalty can be imposed on a corporation that underpays tax by
a. Omitting income as a result of inadequate recordkeeping.
b. Failing to report income it erroneously considered not to be part of corporate profits.
c. Filing an incomplete return with an appended statement, making clear that the return is incomplete.
d. Maintaining false records and reporting fictitious transactions to minimize corporate tax liability.

28. Bass Corp., a calendar year C corporation, made qualifying 2010 estimated tax deposits based on its actual 2009 tax liability. On March 15, 2011, Bass filed a timely automatic extension request for its 2010 corporate income tax return. Estimated tax deposits and the extension payment totaled $7,600. This amount was 95% of the total tax shown on Bass' final 2010 corporate income tax return. Bass paid $400 additional tax on the final 2010 corporate income tax return filed before the extended due date. For the 2010 calendar year, Bass was subject to pay
I. Interest on the $400 tax payment made in 2011.
II. A tax delinquency penalty.
a. I only.
b. II only.
c. Both I and II.
d. Neither I nor II.

29. Edge Corp., a calendar year C corporation, had a net operating loss and zero tax liability for its 2010 tax year. To avoid the penalty for underpayment of estimated taxes, Edge could compute its first quarter 2011 income tax payment using the

<table>
<thead>
<tr>
<th>Annualized income method</th>
<th>Preceding year method</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>b. Yes</td>
<td>No</td>
</tr>
<tr>
<td>c. No</td>
<td>Yes</td>
</tr>
<tr>
<td>d. No</td>
<td>No</td>
</tr>
</tbody>
</table>

30. A corporation's tax year can be reopened after all statutes of limitations have expired if
I. The tax return has a 50% nonfraudulent omission from gross income.
II. The corporation prevails in a determination allowing a deduction in an open tax year that was taken erroneously in a closed tax year.
a. I only.
b. II only.
c. Both I and II.
d. Neither I nor II.

31. A penalty for understated corporate tax liability can be imposed on a tax preparer who fails to
a. Audit the corporate records.
b. Examine business operations.
c. Copy all underlying documents.
d. Make reasonable inquiries when taxpayer information appears incorrect.

32. When computing a corporation's income tax expense for estimated income tax purposes, which of the following should be taken into account?

<table>
<thead>
<tr>
<th>Corporate tax credits</th>
<th>Alternative minimum tax</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. No</td>
<td>No</td>
</tr>
<tr>
<td>b. No</td>
<td>Yes</td>
</tr>
<tr>
<td>c. Yes</td>
<td>No</td>
</tr>
<tr>
<td>d. Yes</td>
<td>Yes</td>
</tr>
</tbody>
</table>
CONSOLIDATED RETURNS

33. With regard to consolidated tax returns, which of the following statements is correct?
a. Operating losses of one group member may be used to offset operating profits of the other members included in the consolidated return.
b. Only corporations that issue their audited financial statements on a consolidated basis may file consolidated returns.
c. Of all intercompany dividends paid by the subsidiaries to the parent, 70% are excluded from taxable income on the consolidated return.
d. The common parent must directly own 51% or more of the total voting power of all corporations included in the consolidated return.

34. In the filing of a consolidated tax return for a corporation and its wholly owned subsidiaries, intercompany dividends between the parent and subsidiary corporations are
a. Not taxable.
b. Included in taxable income to the extent of 20%.
c. Included in taxable income to the extent of 80%.
d. Fully taxable.

35. The minimum total voting power that a parent corporation must have in a subsidiary's stock in order to be eligible for the filing of a consolidated return is
a. 20%
b. 50%
c. 51%
d. 80%

36. In 2010, Portal Corp. received $100,000 in dividends from Sal Corp., its 80%-owned subsidiary. What net amount of dividend income should Portal include in its 2010 consolidated tax return?
a. $100,000
b. $80,000
c. $70,000
d. $0

37. When a consolidated return is filed by an affiliated group of includable corporations connected from inception through the requisite stock ownership with a common parent,
a. Intercompany dividends are excluded to the extent of 80%.
b. Operating losses of one member of the group offset operating profits of other members of the group.
c. The parent's basis in the stock of its subsidiaries is unaffected by the earnings and profits of its subsidiaries.
d. Each of the subsidiaries is entitled to an accumulated earnings tax credit.

38. Potter Corp. and Sly Corp. filed consolidated tax returns. In January 2009, Potter sold land, with a basis of $60,000 and a fair value of $75,000, to Sly for $100,000. Sly sold the land in December 2010 for $125,000. In its 2010 and 2009 tax returns, what amount of gain should be reported for these transactions in the consolidated return?

<table>
<thead>
<tr>
<th>Year</th>
<th>Amount</th>
<th>Year</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>2010</td>
<td>$50,000</td>
<td>2009</td>
<td>$0</td>
</tr>
<tr>
<td>2010</td>
<td>$75,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>2010</td>
<td>$125,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>2009</td>
<td>$40,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>2009</td>
<td>$25,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>2009</td>
<td>$0</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

39. Able Corporation and Baker Corporation file a consolidated return on a calendar-year basis. In 2000, Able sold land to Baker for its fair market value of $50,000. At the date of sale, Able had an adjusted basis in the land of $35,000 and had held the land for several years as an investment. Baker held the land primarily for sale to its customers in the ordinary course of its business and sold it to a customer in early 2010 for $60,000. As a result of the sale of the land in 2010, the corporations should report on their consolidated return
a. $10,000 ordinary gain.
b. $25,000 ordinary gain.
c. $25,000 long-term capital gain.
d. $15,000 long-term capital gain and $10,000 ordinary gain.

40. Bank Corp. owns 80% of Shore Corp.'s outstanding capital stock. Shore's capital stock consists of 50,000 shares of common stock issued and outstanding. Shore's 2010 net income was $140,000. During 2010, Shore declared and paid dividends of $60,000. In conformity with generally accepted accounting principles, Bank recorded the following entries in 2010:

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Investment in Shore Corp. common stock</td>
<td>$112,000</td>
</tr>
<tr>
<td>Equity in earnings of subsidiary</td>
<td>$112,000</td>
</tr>
<tr>
<td>Cash</td>
<td>48,000</td>
</tr>
<tr>
<td>Investment in Shore Corp. common stock</td>
<td>48,000</td>
</tr>
</tbody>
</table>
In its 2010 consolidated tax return, Bank should report dividend revenue of
a. $48,000
b. $14,400
c. $9,600
d. $0

41. Page Corp. owns 80% of Saga Corp.'s outstanding capital stock. Saga's capital stock consists of 50,000 shares of common stock issued and outstanding. Saga's 2010 net income was $70,000. During 2009 Saga declared and paid dividends of $30,000. In conformity with generally accepted accounting principles, Page recorded the following entries in 2009:

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Investment in Saga Corp.</td>
<td></td>
</tr>
<tr>
<td>common stock</td>
<td>$56,000</td>
</tr>
<tr>
<td>Equity in earnings of</td>
<td></td>
</tr>
<tr>
<td>subsidiary</td>
<td>$56,000</td>
</tr>
<tr>
<td>Cash</td>
<td>24,000</td>
</tr>
<tr>
<td>Investment in Saga Corp.</td>
<td></td>
</tr>
<tr>
<td>common stock</td>
<td>24,000</td>
</tr>
</tbody>
</table>

In its 2010 consolidated tax return, Page should report dividend revenue of
a. $0
b. $4,800
c. $7,200
d. $24,000

42. Dana Corp. owns stock in Seco Corp. For Dana and Seco to qualify for the filing of consolidated returns, at least what percentage of Seco’s total voting power and total value of stock must be directly owned by Dana?

<table>
<thead>
<tr>
<th>Total voting power</th>
<th>Total value of stock</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. 51%</td>
<td>51%</td>
</tr>
<tr>
<td>b. 51%</td>
<td>80%</td>
</tr>
<tr>
<td>c. 80%</td>
<td>51%</td>
</tr>
<tr>
<td>d. 80%</td>
<td>80%</td>
</tr>
</tbody>
</table>

Released and Author Constructed Questions

43. Sunex Co., an accrual-basis, calendar-year domestic C corporation, is taxed on its worldwide income. In the current year, Sunex’s U.S. tax liability on its domestic and foreign source is $60,000 and no prior-year foreign income taxes have been carried forward. Which factor(s) may affect the amount of Sunex’s foreign tax credit available in its current-year corporate income tax return?

<table>
<thead>
<tr>
<th>Income source</th>
<th>Foreign tax rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>b. Yes</td>
<td>No</td>
</tr>
<tr>
<td>c. No</td>
<td>Yes</td>
</tr>
<tr>
<td>d. No</td>
<td>No</td>
</tr>
</tbody>
</table>

44. Jans, an individual, owns 80% and 100% of the total value and voting power of A and B Corps, respectively, which in turn own the following (both value and voting power):

<table>
<thead>
<tr>
<th>Ownership</th>
<th>A Corp</th>
<th>B Corp</th>
</tr>
</thead>
<tbody>
<tr>
<td>C Corp</td>
<td>80%</td>
<td>-0%</td>
</tr>
<tr>
<td>D Corp</td>
<td>-0%</td>
<td>100%</td>
</tr>
</tbody>
</table>

All companies are C corporations except B Corp., which had elected S status since inception. Which of the following statements is correct with respect to the companies’ ability to file a consolidated return?

a. A, C, and D may file as a group.
b. A and C may not file as a group, and B and D may not file as a group.
c. A and C may file as a group, and B and D may file as a group.
d. A and C may file as a group, and B and D may not file as a group.

45. Which of the following groups may elect to file a consolidated corporate return?

a. A brother/sister controlled group.
b. A parent corporate and all more-than-10%-controlled partnerships.
c. A parent corporation and all more-than-50%-controlled subsidiaries.
d. Members of an affiliated group.
Chapter Nine — Answers
Corporate Tax Computations and Controlled Groups

1. (b) $10,750. The unadjusted taxable income must be reduced by the 70% dividends received deduction. The rates are then applied per the rate schedule.

   Unadjusted taxable income $70,000
   Less: 70% DRD -7,000
   Taxable income $63,000

   Tax computation:
   First 50,000 @ 15% $7,500
   Next $13,000 @ 25% 3,250
   Total tax $10,750

2. True. By definition.

3. True. It is the last reduction before the actual tax calculation and the amount is $40,000.

4. True. However, the amount of negative adjustments cannot exceed the amount of previous positive adjustments.

5. False. The length of the period is over the ADR (Asset Depreciation Range) system, not MACRS.


7. False. Municipal bond interest excluded from taxable income, which is the starting point for determining the alternative minimum taxable income.

8. False. The amount of the corporate exemption is $40,000. The $150,000 pertains to the base of the phase-out on the exemption.

9. False. If available means deductible, then the answer is false. The 70% dividends received deduction increases pre-adjusted AMTI in arriving at ACE. The 80% and 100% DRDs do not.

10. True. While it does not directly increase AMTI through taxable income, it does increase ACE, which may be added back as a positive adjustment.

11. False. The method used is the alternative depreciation system, which is the straight-line rate.

12. (c) $27,500. The corporate exemption amount is $40,000, less 25% of the amount by which the AMTI exceeds $150,000.

   AMTI before exemption $200,000
   Base amount before phase-out 150,000
   Excess over base 50,000
   Phase-out percentage 25%
   Phaseout amount $12,500
   Exemption $40,000
   Less: phaseout ($12,500)
   Allowable exemption $27,500
13. (d) Forward indefinitely. There are no carryback provisions or limits on the carryforward. For individuals, the credit is computed only on those items which arise due to timing issues, not exclusions. For corporations, it is computed for both.

14. (c) This is the alternative minimum tax. It is the additional amount over the regular tax.

15. (a) 306,000. The alternative minimum taxable income before the ACE adjustment starts with taxable income and adds back certain tax preferences and adjustments. For Eastern Corporation, it is determined as follows:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Taxable income</td>
<td>$300,000</td>
</tr>
<tr>
<td>Add: Tax preference:</td>
<td></td>
</tr>
<tr>
<td>Tax-exempt interest</td>
<td>5,000</td>
</tr>
<tr>
<td>Add: Adjustment:</td>
<td></td>
</tr>
<tr>
<td>Excess depreciation</td>
<td>1,000</td>
</tr>
<tr>
<td>AMTI before ACE adjustment</td>
<td>$306,000</td>
</tr>
</tbody>
</table>

16. (c) Accelerated depreciation on pre-87 real property to the extent of the excess over straight-line depreciation is a tax preference.

17. (b) Accelerated depreciation on pre-87 (ACRS) real property to the extent of the excess over straight-line depreciation is a tax preference.

18. (a) The foreign tax credit reduces a corporation’s tax. State taxes are deductions, and the political contributions and excess contributions are non-deductible.

19. (b) The earned income credit is only available to individuals.

20. (a) This is an election made by the corporation.

21. (c) $120,000. Corporate taxpayers are taxed in the US on their worldwide income. The taxpayers are entitled to a tax credit for income taxes paid to foreign countries. This prevents double taxation of the same income. The foreign tax credit cannot exceed the lessor of the amount of the foreign taxes paid ($135,000), or the pro-rata share of US taxes on the foreign income. The limitation is determined as follows:

\[
\text{Income from foreign sources} \quad $300,000 \times \frac{270,000}{675,000} = $120,000
\]

22. (b) Corporate taxpayers are taxed in the US on their worldwide income. The taxpayers are entitled to a tax credit for income taxes paid to foreign countries. The other items do not qualify for credits, but rather deductions.

23. (c) Blink can only use the annualized method. In order to rely on the prior year’s tax, there must be a tax liability for that prior year (Revenue Ruling 92-54). Since the company had a net operating loss in 2010, it can be assumed that there was no tax in that year.

24. (c) March 16, 2011. The statute begins the day after the due date of the return or the date the return was filed, whichever is later. The mailing date is considered the date filed.

25. (a) Not deductible. A penalty for violation of the law is not deductible.

26. (c) When Brun Corporation accrued the $10,000 of income, that amount was based upon a reasonable estimate. Since the estimate was fixed and reasonably determinable, the difference of $2,000 will be recorded as income in 2011 when received. There is no requirement to file an amended 2010 return.

27. (d) A civil fraud penalty may be imposed on a corporation for maintaining false records and reporting fictitious transactions to minimize corporate tax liability. A penalty of up to 75% of the portion of the underpayment attributable to fraud may be assessed.
28. (a) A corporation must make installment payments if it expects the estimated tax, after credits, to be at least $500. The tax payments are due on the 15th day of the 4th, 6th, 9th and 12th month of the year. In order to avoid any penalty on the underpayment of taxes, the corporation must make payments equal to:

- 100% of its current year’s tax
- 100% of its prior year’s tax
- Annualized income installment method computation

Whereas Bass made estimates based upon 100% of its prior year’s tax, no penalties will be assessed, and only interest on the $400 underpayment will be assessed.

29. (b) A corporation must make installment payments if it expects the estimated tax, after credits, to be at least $500. The tax payments are due on the 15th day of the 4th, 6th, 9th and 12th month of the year. In order to avoid any penalty on the underpayment of taxes, the corporation must make payments equal to:

- 100% of its current year’s tax
- 100% of its prior year’s tax
- Annualized income installment method computation

However, in order to rely on paying 100% of the prior year's tax, the taxpayer must have a prior year's tax. For example, a corporation with no tax liability in 2009 due to a NOL, must pay 100% of the current year's tax to avoid the penalty. Paying “zero,” which was 2009's tax, does not qualify per Revenue Ruling 92-54.

30. (b) In the unusual situation that a corporation prevails in a determination allowing a deduction in an open tax year that was taken erroneously in a closed year, a corporation’s tax year can be reopened after all the statutes of limitations have expired. A 50% nonfraudulent omission of income only extends the statute from 3 years to 6 years.

31. (d) A tax preparer is not required to audit the corporate records, examine business operations, or copy all underlying documents. However, a penalty may be assessed if the preparer fails to make reasonable inquiries when the taxpayer’s information appears incorrect.

32. (d) A corporation must make installment payments if it expects the estimated tax, after credits, to be at least $500. The estimated tax includes all taxes, including the alternative minimum tax.

33. (a) A major advantage of filing a consolidated return is the ability to offset operating losses of one group member with operating profits of other members. Intercompany dividends are fully eliminated on a consolidated income tax return.

34. (a) Not taxable. Intercompany dividends are fully eliminated on a consolidated income tax return.

35. (d) 80%. By definition. The 80% test is applied either on a direct basis with the subsidiary, or in a chain of related companies.

36. (d) $0. Intercompany dividends are fully eliminated on a consolidated income tax return.
37. (b) A major advantage of filing a consolidated return is the ability to offset operating losses of one group member with operating profits of other members. Intercompany dividends are fully eliminated on a consolidated income tax return. Only one accumulated earnings credit is available to the parent and subsidiaries.

38. (d) $65,000 and $0. In the filing of consolidated returns, any gains or losses realized on sales within the consolidated group are deferred until the eventual sale to an outside party. The basis and holding period is transferred to the acquiring company. Therefore, the $40,000 realized gain from the 2009 sale is not recognized until 2010. The computations for determining the gains are:

<table>
<thead>
<tr>
<th>Transaction</th>
<th>2009</th>
<th>2010</th>
</tr>
</thead>
<tbody>
<tr>
<td>Selling price</td>
<td>$100,000</td>
<td>$125,000</td>
</tr>
<tr>
<td>Adjusted basis</td>
<td>60,000</td>
<td>100,000</td>
</tr>
<tr>
<td>Realized gain</td>
<td>$40,000</td>
<td>25,000</td>
</tr>
<tr>
<td>Deferred gain recognized</td>
<td>40,000</td>
<td></td>
</tr>
<tr>
<td>Total recognized gain</td>
<td></td>
<td>$65,000</td>
</tr>
</tbody>
</table>

39. (d) $15,000 long-term capital gain and $10,000 ordinary gain. In the filing of consolidated returns, any gains or losses realized on sales within the consolidated group are deferred until the eventual sale to an outside party. The basis and holding period are transferred to the acquiring company. Therefore, the $15,000 realized gain from the 2000 sale is not recognized until 2010. One important issue in this problem is that the character of the 2000 gain is capital because it was held for investment. Baker, however, held the land as inventory. Baker’s share of the gain will result in ordinary income while Able’s gain will be capital. The computations for determining the gains are:

<table>
<thead>
<tr>
<th>Transaction</th>
<th>2000</th>
<th>2010</th>
</tr>
</thead>
<tbody>
<tr>
<td>Selling price</td>
<td>$50,000</td>
<td>$65,000</td>
</tr>
<tr>
<td>Adjusted basis</td>
<td>35,000</td>
<td>50,000</td>
</tr>
<tr>
<td>Realized gain</td>
<td>$15,000</td>
<td>10,000</td>
</tr>
<tr>
<td>Deferred gain recognized</td>
<td></td>
<td>15,000</td>
</tr>
<tr>
<td>Total recognized gain</td>
<td></td>
<td>$25,000</td>
</tr>
</tbody>
</table>

40. (d) $0. In a consolidated return, any dividends received from a member of an affiliated group (at least 80%) are eliminated as part of the consolidation and therefore no income is reported.

41. (a) $0. In a consolidated return, any dividends received from a member of an affiliated group (at least 80%) are eliminated as part of the consolidation and, therefore, no income is reported.

42. (d) 80% and 80%. An affiliated group of corporations is allowed to file a consolidated return rather than each corporation filing a separate return. An affiliated group includes one or more chains of corporations where the parent corporation owns directly at least 80% of the voting stock or total value of the stock of one of the corporations and at least 80% of each corporation in the group is owned directly by one or more of the other corporations in the group.

43. (a) Yes and Yes. Corporate taxpayers are taxed in the United States on their worldwide income. The taxpayers are entitled to a tax credit for income taxes paid to foreign countries. This prevents double taxation of the same income. The foreign tax credit cannot exceed the lesser of the amount of the foreign taxes paid (foreign source income times the foreign tax rate) or the pro-rata share of US taxes on the foreign income.

44. (d) In order to be a member of a controlled group, you must be a C corporation. Since B Corporation is an S Corporation, then it cannot be a member. Nor can D Corporation be tied to A and C Corporation since B Corporation owns all of D Corporation’s stock.

45. (a) Only members of an affiliated group may elect to file a consolidated return. The percentage threshold for corporations is at least 80% ownership of one corporation by another.
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Corporate Distributions and Other Matters

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NON-LIQUIDATING DISTRIBUTIONS TO SHAREHOLDERS  

GENERAL RULE  
The general rule is that a distribution made to a shareholder with regard to his stock is considered dividend income. For purposes of measuring the income, the fair market value of the property, not its adjusted basis is used. Distributions are taxable to the extent of the earnings and profits (E & P) available in the corporation. A corporation’s E & P is similar in concept to its retained earnings. E & P represents the corporation’s ability to pay dividends. When a distribution exceeds the available E & P, the excess represents a return of the shareholder’s basis in their stock. If that amount exceeds the basis, the excess is treated as capital gain. Thus, distributions are treated as follows:  

- Dividend income (to the extent of E & P)  
- Return of basis  
- Capital gain  

IMPACT ON THE SHAREHOLDER  
Earnings and profits are divided into two parts: accumulated E & P (old E & P) and current E & P. When a distribution is made during the year, the corporation determines the amount of the available earnings and profits as of the time of the distribution. The rules for applying accumulated and current E & P to the distributions is as follows:  

- If the current E & P is positive and the accumulated E & P is negative, the distribution is treated as coming from the current E & P.  
- If the current E & P is negative and the accumulated E & P is positive, the corporation nets the two as of the date of the distribution. If there is positive E & P at that time, the distribution is treated as a dividend to that extent. If there is negative E & P at that time, the distribution is treated as a return of capital, or basis.  
- If there are distributions made throughout the year, the current E & P is allocated on a prorata basis. However, accumulated E & P is allocated to the distributions in a chronological order.  

Example 1: D Corporation has accumulated E & P of $2,000 and current E & P of $5,000. D Corporation distributes $15,000 to its sole shareholder. The shareholder’s basis in her stock is $3,000. Determine the tax implications of the distribution.  

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Accumulated E &amp; P</td>
<td>$2,000</td>
</tr>
<tr>
<td>Current E &amp; P</td>
<td>5,000</td>
</tr>
<tr>
<td>Total available E &amp; P</td>
<td>$7,000</td>
</tr>
<tr>
<td>Distribution to shareholder</td>
<td>$15,000</td>
</tr>
<tr>
<td>Dividend income</td>
<td>-7,000</td>
</tr>
<tr>
<td>Return of capital</td>
<td>8,000</td>
</tr>
<tr>
<td>Basis in stock</td>
<td>-3,000</td>
</tr>
<tr>
<td>Capital gain</td>
<td>$5,000</td>
</tr>
</tbody>
</table>

Both the accumulated and current E & P are positive and they are added together. The first $7,000 of the $15,000 is dividend income (to the extent of E & P). The excess of $8,000 is then applied to the $3,000 stock basis, which leaves $5,000 as a capital gain. There is no basis remaining in the shareholder’s stock after the distribution.
IMPACT ON THE CORPORATION
When a corporation makes a distribution of cash to its shareholders, no gain or loss is recognized by the corporation. The amount of the distribution then reduces the E & P. However, when the corporation distributes appreciated property, the excess of the fair market value over its basis is treated as gain. The income recognized causes an increase in the corporation’s current E & P. The fair market value of the distribution then reduces the E & P. Remember, E & P must be brought up to date before the determination of how the distribution is taxable is made.

Example 2: T Corporation has accumulated E & P of $50,000, and currently has no current E & P. T Corporation distributes land with a fair market value of $40,000 and an adjusted basis of $30,000 to its sole shareholder.

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Fair market value</td>
<td>$40,000</td>
</tr>
<tr>
<td>Adjusted basis</td>
<td>$30,000</td>
</tr>
<tr>
<td>Gain recognized</td>
<td>$10,000</td>
</tr>
<tr>
<td></td>
<td>$50,000</td>
</tr>
<tr>
<td>Current E &amp; P (gain)</td>
<td>$10,000</td>
</tr>
<tr>
<td>Available E &amp; P at the time of distribution</td>
<td>$60,000</td>
</tr>
<tr>
<td>Less: Distributions - FMV</td>
<td>$40,000</td>
</tr>
<tr>
<td>Ending E &amp; P</td>
<td>$20,000</td>
</tr>
</tbody>
</table>

T Corporation recognizes $10,000 of income from the distribution which correspondingly increases E & P. The E & P is then reduced by the fair market value of the distribution.

LIQUIDATING DISTRIBUTIONS TO SHAREHOLDERS

GENERAL
In a liquidating distribution, the shareholder’s stock is being returned to the corporation in exchange for assets. This is similar to the transaction that began the corporation, but varies significantly in the tax treatment. Rather than the general rule that no gain or loss is recognized, the general rule under Section 331 states that a gain or loss is recognized. In addition to gain recognition at the shareholder level, the liquidating corporation also recognizes a gain or loss. The tax treatment to the corporation is as if the property was sold at its fair market value. The character of the gain (ordinary versus capital) must also be determined in order to properly compute any taxes due.

In determining the gain or loss at the shareholder level, the fair market value of the property received by the shareholder, less any liabilities assumed represents the amount realized. On the exam this usual represents cash, accounts receivable, inventory and land.

EXCEPTIONS
When the shareholder is another corporation which is at least 80% owned by the parent, no gain or loss is recognized on the liquidation. Instead, the basis of the assets being transferred become the basis to the parent as well as any tax attributes such as excess charitable contributions, loss carryforwards, etc.

EXPENSES OF LIQUIDATION
In preparing for and completing a liquidation, it is normal to incur certain legal and accounting fees. These costs are expenses under Section 162 and treated -as ordinary and necessary expenses. However, if there are any costs associated with the disposition of certain assets, such as a broker’s fee for selling real estate, those expenses are used to reduce the gain on the disposition of the property rather than expenses of carrying on a trade or business.
Example 3: On December 31, 2010, K, the sole shareholder has an adjusted basis in the KL corporation of $10,000. The KL Corporation’s only assets are cash of $12,000 and land with a basis of $9,000 and fair market value of $12,000. There are no corporate liabilities. K receives a liquidating cash distribution of $12,000 plus the land.

Impact to the Corporation: KL Corporation will recognize a gain of $3,000 from the distribution of the land to K (FMV of $12,000 less its adjusted basis of $9,000).

Impact to the Shareholder: Assuming KL Corporation distributes the entire $12,000 in cash and the land at the fair market value of $12,000. The result is a $14,000 recognized gain to K.

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash distributed</td>
<td>$12,000</td>
</tr>
<tr>
<td>FMV of land</td>
<td>$12,000</td>
</tr>
<tr>
<td>Amount realized</td>
<td>$24,000</td>
</tr>
<tr>
<td>Less: K's adjusted basis</td>
<td>-$10,000</td>
</tr>
<tr>
<td>Recognized gain</td>
<td>$14,000</td>
</tr>
</tbody>
</table>

REORGANIZATIONS
When stock or securities of one corporation are exchanged for stock, securities and/or assets of another corporation, the transaction may qualify as a tax-free exchange if they are “party to a reorganization.” Benefits of a qualified reorganization include the carryover of unused tax attributes such as net operating losses. Under the Internal Revenue Code, the various types of reorganization include:

Type A  A statutory merger or consolidation. For example, in a merger a corporation would transfer some of its stock for all the assets and liabilities of a (T) target corporation, and then the target corporation would distribute that stock to its shareholders and liquidate.

Type B  One corporation (P) acquires at least 80% of the stock of another corporation (T), solely in exchange for stock. In essence, stock for stock. The voting stock of P goes to T's shareholders and T remains as a sub of P.

Type C  This is a stock for asset transaction. Only “substantially all” (not all) of the assets of T need to be acquired in this transaction for P's voting stock. T then transfers the voting stock it received from P and its remaining assets to its shareholders in a complete liquidation.

Type D  Typically a divisive reorganization where a transfer of part of the transferor corporation’s assets to a controlled corporation, and then distributed to the shareholders. Usually called spin-offs, split-offs or split-ups.

Type E  A recapitalization or change to the capital structure.

Type F  A mere change in the identity, form or place of the organization.

Type G  Assets are transferred to another corporation in a bankruptcy situation.

PERSONAL SERVICE CORPORATIONS
A corporation will be classified as a personal service corporation (PSC) when (1) its principal activity is the performance of personal services (accountants, actuaries, attorneys, architects, etc.) and (2) its owners-employees own more than 10% of the stock. A PSC generally must use calendar year-end, but may request a fiscal year similar to an S Corporation or partnership, if it can establish a business purpose or does not result in a deferral period of more than three months. A PSC is also limited in certain deductions for its owner-employee, and is taxed at the highest corporate marginal tax bracket.
PERSONAL HOLDING COMPANIES

GENERAL
When an individual shareholder receives a dividend from an investment, the individual pays a tax on the dividend distributions. If the shareholder is a corporation, however, it may deduct anywhere from 70% to 100% of the dividend as a dividends received deduction. In addition, because a corporation is initially subject to low marginal tax rates, it is possible for an individual in a high income tax bracket to shift other investments to their corporation to shelter that income from taxation. To prevent any possible abuses, Congress enacted a personal holding company status to certain corporations that are very closely held and receive significant amounts of unearned income.

A personal holding company is assessed a tax penalty at a 15% rate on its undistributed personal holding company income (UPHCI). This tax is in addition to the regular income tax. A company that meets the following two tests is classified as a personal holding company:

- **Five or fewer** shareholders own more than 50% of the value of the outstanding stock at any time during the last half of the taxable year, and
- **60% or more** of the corporation’s adjusted ordinary gross income (AOGI) is unearned income, such as interest, dividends, rents, royalties or personal service income.

If there are nine or fewer shareholders, the company automatically meets the shareholder test. For purposes of the test, the constructive ownership rules are very broad. Family attribution includes the taxpayer’s spouse, brothers, sisters, ancestors and decedents. Stock owned by a corporation, partnership, estate or trust are deemed to be owned proportionately by the shareholders, partners, or beneficiaries.

In performing the unearned income test, rental income may be excluded if (1) it represents 50% or more of the company’s AOGI and (2) the company pays out dividends equal to at least the amount that the nonrent personal holding company income exceeds 10% of the ordinary gross income.

In calculating the UPHCI, no deduction is allowed for the dividends received deduction. However, a deduction is allowed for federal income taxes, excess charitable contributions and dividends paid. For the purpose of this deduction, the definition of dividends paid is greatly expanded to include:

- Dividends paid during the year,
- Dividends paid within 2 1/2 months of the end of the year,
- Consent dividends, and
- Deficiency dividends

The deduction for dividends paid within 2 1/2 months of the end of the year cannot exceed 20% of the dividends actually paid during the year. Consent dividends represent hypothetical distributions to shareholders. No distribution is actually made. The shareholder recognizes the income and a corresponding increase in the shareholder’s basis is recognized. The consent must be filed with the return, and is treated as if it occurred on the last day of the year. Deficiency dividends are delayed distributions, usually paid within 90 days of a court determination of PHC deficiency.

Unlike the accumulated earnings tax, the PHC tax is a self-assessed tax. Also, a company may qualify as a PHC in one year and not another. Therefore, each year a company must go through the two tests to determine if they are a PHC.
ACCUMULATED EARNINGS TAX

GENERAL
A corporation is first taxed on its earnings at the corporate level, and then the shareholder is then taxed again when the income is distributed as a dividend. To avoid this double taxation, corporations often accumulate rather than distribute earnings. To encourage corporations to distribute and not accumulate earnings, Section 531 imposes a penalty tax on unreasonable accumulations of earnings.

Penalty tax rate - The accumulated earnings penalty tax is 15% of the accumulated taxable income, or ATI. This is in addition to the regular income tax. The penalty rate is designed to encourage corporation not to accumulate the earnings. This is not a self-assessed tax as is the personal holding company tax. This penalty tax is assessed by the Internal Revenue Service.

The term accumulated taxable income (ATI) is a misnomer, because it refers to the current year’s addition to the accumulated earnings, not the total accumulated earnings as the name suggests. Briefly, accumulated taxable income is determined by:

\[
\text{Taxable income} \\
\text{Plus:} \quad \text{Dividend received deduction} \\
\text{Net operating loss} \\
\text{Capital loss carryover or carrybacks} \\
\text{Less:} \quad \text{Charitable contributions over 10\% limit} \\
\text{Capital loss adjustment} \\
\text{Federal income taxes} \\
\text{Dividend paid deduction} \\
\text{Accumulated earnings credit}
\]

The dividends paid deduction includes those dividends paid during the year plus those paid two and one-half months after the close of the year. In addition, shareholders may consent to a dividend by filing a statement. No cash is actually distributed, but the shareholder recognizes income and a corresponding contribution to capital is recorded. The consent dividend increases the dividends paid deduction and usually is used to prevent IRS from assessing the penalty. This is not a self-imposed tax.

The accumulated earnings credit is the greater of:
1. the reasonable needs of the business less the accumulated earnings and profits of prior years,
   or
2. $250,000 less the accumulated earnings and profits of prior years.

For certain service businesses such as consulting, accounting and architecture, the minimum credit is $150,000 rather than $250,000.

Reasonable needs of the business are defined as the business’s reasonably anticipated needs and must be specific, definite and feasible. Typical needs include:

- Working capital
- Capital improvements or replacement
- Loans to suppliers
- Reserve for a lawsuit
- Debt retirement

The accumulated earnings tax cannot be imposed on a Personal Holding Company. Nor is there any minimum shareholder requirement.
Example 4: Falcon Corporation manufactures trophies. For the year ended December 31, 2009, the company had accumulated earnings and profits of $232,000. Its 2010 taxable income was $40,000 and its federal income taxes were $6,000. In addition, the company paid $5,000 in dividends during 2010 and paid $1,000 on March 6, 2011. An analysis of the reasonable needs of the business showed a requirement of $240,000. How much is their accumulated earnings tax exposure for 2010?

Solution:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Taxable income</td>
<td>$40,000</td>
</tr>
<tr>
<td>Less: Federal income tax</td>
<td>(6,000)</td>
</tr>
<tr>
<td>Dividends paid deduction</td>
<td>(6,000)</td>
</tr>
<tr>
<td>Accumulated earnings credit</td>
<td>(18,000)</td>
</tr>
<tr>
<td></td>
<td>10,000</td>
</tr>
<tr>
<td>Penalty tax rate</td>
<td>15%</td>
</tr>
<tr>
<td>Accumulated earnings tax</td>
<td>$1,500</td>
</tr>
</tbody>
</table>
Chapter Ten — Questions
Corporate Distributions and Other Matters

DISTRIBUTIONS

1. Kent Corp. is a calendar year, accrual basis C corporation. In 2010, Kent made a nonliquidating distribution of property with an adjusted basis of $150,000 and a fair market value of $200,000 to Reed, its sole shareholder. The following information pertains to Kent:

Reed's basis in Kent stock at
January 1, 2010                     $500,000
Accumulated earnings and
profits at January 1, 2010        125,000
Current earnings and profits
for 2010                           60,000

What was taxable as dividend income to Reed for 2010?

a. $60,000
b. $150,000
c. $185,000
d. $200,000

2. The following information pertains to Lamb Corp.:

Accumulated earnings and profits
at January 1, 2010                  $  60,000
Earnings and profits for the year
ended December 31, 2010              80,000
Cash distributions to individual
stockholders during 2010              180,000

What is the total amount of distributions taxable as dividend income to Lamb's stockholders in 2010?

a. $180,000
b. $140,000
c. $ 80,000
d. $0

3. On January 1, 2010, Kee Corp., a C corporation, had a $50,000 deficit in earnings and profits. For 2010 Kee had current earnings and profits of $10,000 and made a $30,000 cash distribution to its stockholders. What amount of the distribution is taxable as dividend income to Kee's stockholders?

a. $30,000
b. $20,000
c. $10,000
d. $0

4. Nyle Corp. owned 100 shares of Beta Corp. stock that it bought in 1991 for $9 per share. In 2010, when the fair market value of the Beta stock was $20 per share, Nyle distributed this stock to a noncorporate shareholder. Nyle's recognized gain on this distribution was

a. $2,000
b. $1,100
c. $900
d. $0

Items 5 through 7 are based on the following:

A Corporation distributes to its sole stockholder property having a basis to the corporation of $10,000 and a FMV of $25,000. Assume that the basis of the shareholder's stock is $22,000. Assume also that accumulated earnings and profits after recognizing the gain on distribution was $20,000.

5. What amount is taxable to the shareholder as a dividend?

a. None.
b. $10,000.
c. $20,000.
d. $25,000.

6. What amount is taxable to the shareholder as capital gain?

a. None.
b. $3,000.
c. $5,000.
d. $15,000.

7. What is the basis of the stock to the shareholder after the distribution?

a. None.
b. $17,000.
c. $19,000.
d. $22,000.
8. The following information pertains to Dahl Corp.:

Accumulated earnings and profits at January 1, 2010 $120,000
Earnings and profits for the year ended December 31, 2010 160,000
Cash distributions to individual stockholders during 2010 360,000

What is the total amount of distributions taxable as dividend income to Dahl's stockholders in 2010?

a. $0  
b. $160,000  
c. $280,000  
d. $360,000

9. Dahl Corp. was organized and commenced operations in 1990. At December 31, 2010, Dahl had accumulated earnings and profits of $9,000 before dividend declaration and distribution. On December 31, 2010, Dahl distributed cash of $9,000 and a vacant parcel of land to Green, Dahl's only stockholder. At the date of distribution, the land had a basis of $5,000 and a fair market value of $40,000. What was Green's taxable dividend income in 2010 from these distributions?

a. $9,000  
b. $14,000  
c. $44,000  
d. $49,000

10. On June 30, 2010, Ral Corporation had retained earnings of $100,000. On that date, it sold a plot of land to a noncorporate stockholder for $50,000. Ral had paid $40,000 for the land in 1987, and it had a fair market value of $80,000 when the stockholder bought it. The amount of dividend income taxable to the stockholder in 2010 is

a. $0  
b. $10,000  
c. $20,000  
d. $30,000

11. On December 1, 2010, Gelt Corporation declared a dividend and distributed to its sole shareholder, as a dividend in kind, a parcel of land that was not an inventory asset. On the date of the distribution, the following data were available:

<table>
<thead>
<tr>
<th>Description</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Adjusted basis of land</td>
<td>$ 6,500</td>
</tr>
<tr>
<td>Fair market value of land</td>
<td>14,000</td>
</tr>
<tr>
<td>Mortgage on land</td>
<td>5,000</td>
</tr>
</tbody>
</table>

For the year ended December 31, 2010, Gelt had earnings and profits of $30,000 without regard to the dividend distribution. By how much should the dividend distribution reduce the earnings and profits for 2010?

a. $1,500  
b. $6,500  
c. $9,000  
d. $14,000

12. Tank Corp., which had earnings and profits of $500,000, made a nonliquidating distribution of property to its shareholders in 2010 as a dividend in kind. This property, which had an adjusted basis of $20,000 and a fair market value of $30,000 at the date of distribution, did not constitute assets used in the active conduct of Tank's business. How much gain did Tank recognize on this distribution?

a. $30,000  
b. $20,000  
c. $10,000  
d. $0

LIQUIDATIONS

13. A corporation was completely liquidated and dissolved during the year. The filing fees, professional fees, and other expenditures incurred in connection with the liquidation and dissolution are

a. Deductible in full by the dissolved corporation.
bi. Deductible by the shareholders and not by the corporation.
cc. Treated as capital losses by the corporation.
d. Not deductible either by the corporation or shareholders.

14. What is the usual result to the shareholders of a distribution in complete liquidation of a corporation?

a. No taxable effect.
b. Ordinary gain to the extent of cash received.
c. Ordinary gain or loss.
d. Capital gain or loss.

15. Krol Corp. distributed marketable securities in redemption of its stock in a complete liquidation. On the date of distribution, these securities had a basis of $100,000 and a fair market value of $150,000. What gain does Krol have as a result of the distribution?

a. $0  
b. $50,000 capital gain.  
c. $50,000 Section 1231 gain.  
d. $50,000 ordinary gain.
16. Edgewood Corporation was liquidated in 2010 by Roberts, its sole shareholder. Pursuant to the liquidation, Roberts' stock in Edgewood was canceled and he received the following assets on July 15, 2010:

<table>
<thead>
<tr>
<th></th>
<th>Basis to Edgewood</th>
<th>Fair market value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$40,000</td>
<td>$40,000</td>
</tr>
<tr>
<td>Accounts receivable</td>
<td>20,000</td>
<td>20,000</td>
</tr>
<tr>
<td>Inventory</td>
<td>30,000</td>
<td>45,000</td>
</tr>
<tr>
<td>Land</td>
<td>50,000</td>
<td>75,000</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$140,000</strong></td>
<td><strong>$180,000</strong></td>
</tr>
</tbody>
</table>

How much gain should be recognized by Edgewood Corporation on the liquidation?

a. $0.
b. $15,000.
c. $25,000.
d. $40,000.

17. Lark Corp. and its wholly-owned subsidiary, Day Corp., both operated on a calendar year. In January of this taxable year, Day adopted a plan of complete liquidation. Two months later, Day paid all of its liabilities and distributed its remaining assets to Lark. These assets consisted of the following:

- Cash: $50,000
- Land (at cost): 10,000

Fair market value of the land was $30,000. Upon distribution of Day's assets to Lark, all of Day's capital stock was canceled. Lark's basis for the Day stock was $7,000. Lark's recognized gain on receipt of Day's assets in liquidation was

a. $0.
b. $50,000.
c. $53,000.
d. $73,000.

18. At January 1, 2010, Pearl Corp. owned 90% of the outstanding stock of Sesos. Both companies were domestic corporations. Pursuant to a plan of liquidation adopted by Sesos in March 2010, Sesos distributed all of its property in September, 2010, in complete redemption of all its stock, when Sesos's accumulated earnings equaled $18,000. Sesos had never been insolvent. Pursuant to the liquidation, Sesos transferred to Pearl a parcel of land with a basis of $10,000 and a fair market value of $40,000. How much gain must Sesos recognize in 2010 on the transfer of this land to Pearl?

a. $0.
b. $18,000.
c. $27,000.
d. $30,000.

19. Ridge Corp., a calendar year C corporation, made a nonliquidating cash distribution to its shareholders of $1,000,000 with respect to its stock. At that time, Ridge's current and accumulated earnings and profits totaled $750,000 and its total paid-in capital for tax purposes was $10,000,000. Ridge had no corporate shareholders. Ridge's cash distribution

I. Was taxable as $750,000 in ordinary income to its shareholders.

II. Reduced its shareholders' adjusted bases in Ridge stock by $250,000.

a. I only.
b. II only.
c. Both I and II.
d. Neither I nor II.

20. When a parent corporation completely liquidates its 80%-owned subsidiary, the parent (as stockholder) will ordinarily

a. Be subject to capital gains tax on 80% of the long-term gain.
b. Be subject to capital gains tax on 100% of the long-term gain.
c. Have to report any gain on liquidation as ordinary income.
d. Not recognize gain or loss on the liquidating distributions.

21. Carmela Corporation had the following assets on January 2, 2010, the date on which it adopted a plan of complete liquidation:

<table>
<thead>
<tr>
<th></th>
<th>Adjusted basis</th>
<th>Fair-market value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Land</td>
<td>$75,000</td>
<td>$150,000</td>
</tr>
<tr>
<td>Inventory</td>
<td>$43,500</td>
<td>$66,000</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$118,500</strong></td>
<td><strong>$216,000</strong></td>
</tr>
</tbody>
</table>

The land was sold on June 30, 2010 to an unrelated party at a gain of $75,000. The inventory was sold to various customers during 2010 at an aggregate gain of $22,500. On December 10, 2010, the remaining asset (cash) was distributed to Carmela's stockholders, and the corporation was liquidated. What is Carmela's recognized gain in 2010?

a. $0
b. $22,500
c. $75,000
d. $97,500
REORGANIZATIONS

22. Par Corp. acquired the assets of its wholly owned subsidiary, Sub Corp., under a plan that qualified as a tax-free complete liquidation of Sub. Which of the following of Sub's unused carryovers may be transferred to Par?

<table>
<thead>
<tr>
<th>Excess charitable contributions</th>
<th>Net operating loss</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. No</td>
<td>Yes</td>
</tr>
<tr>
<td>b. Yes</td>
<td>No</td>
</tr>
<tr>
<td>c. No</td>
<td>No</td>
</tr>
<tr>
<td>d. Yes</td>
<td>Yes</td>
</tr>
</tbody>
</table>

23. Corporations A and B combine in a qualifying reorganization, and form Corporation C, the only surviving corporation. This reorganization is tax-free to the

<table>
<thead>
<tr>
<th>Shareholders</th>
<th>Corporation</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>b. Yes</td>
<td>No</td>
</tr>
<tr>
<td>c. No</td>
<td>No</td>
</tr>
<tr>
<td>d. No</td>
<td>Yes</td>
</tr>
</tbody>
</table>

24. Pursuant to a plan of reorganization adopted this year, Daly Corporation exchanged property with an adjusted basis of $100,000 for 1,000 shares of the common stock of Galen Corporation. The 1,000 shares of Galen common stock had a fair market value of $110,000 on the date of the exchange. As a result of this exchange, what is Daly's recognized gain and what is its basis in the Galen common stock, respectively?

a. $0 and $100,000.
b. $0 and $110,000.
c. $10,000 and $100,000.
d. $10,000 and $110,000.

25. Jaxson Corp. has 200,000 shares of voting common stock issued and outstanding. King Corp. has decided to acquire 90 percent of Jaxson's voting common stock solely in exchange for 50 percent of its voting common stock and retain Jaxson as a subsidiary after the transaction. Which of the following statements is true?

a. King must acquire 100 percent of Jaxson stock for the transaction to be a tax-free reorganization.
b. The transaction will qualify as a tax-free reorganization.
c. King must issue at least 60 percent of its voting common stock for the transaction to qualify as a tax-free reorganization.
d. Jaxson must surrender assets for the transaction to qualify as a tax-free reorganization.

26. In a type B reorganization, as defined by the Internal Revenue Code, the

I. Stock of the target corporation is acquired solely for the voting stock of either the acquiring corporation or its parent.
II. Acquiring corporation must have control of the target corporation immediately after the acquisition.

a. I only.
b. II only.
c. Both I and II.
d. Neither I nor II.

27. Pursuant to a plan of corporate reorganization adopted in July 2010, Gow exchanged 500 shares of Lad Corp. common stock that he had bought in January 1991 at a cost of $5,000 for 100 shares of Rook Corp. common stock having a fair market value of $6,000. Gow's recognized gain on this exchange was

a. $1,000 long-term capital gain.
b. $1,000 short-term capital gain.
c. $1,000 ordinary income.
d. $0.

28. Ace Corp. and Bate Corp. combine in a qualifying reorganization and form Carr Corp., the only surviving corporation. This reorganization is tax-free to the

<table>
<thead>
<tr>
<th>Shareholders</th>
<th>Corporation</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>b. Yes</td>
<td>No</td>
</tr>
<tr>
<td>c. No</td>
<td>Yes</td>
</tr>
<tr>
<td>d. No</td>
<td>No</td>
</tr>
</tbody>
</table>

29. Which one of the following is a corporate reorganization as defined in the Internal Revenue Code?

a. Mere change in place of organization of one corporation.
b. Stock redemption.
c. Change in depreciation method from accelerated to straight-line.
d. Change in inventory costing method from FIFO to LIFO.
30. With regard to corporate reorganizations, which one of the following statements is correct?
   a. A mere change in identity, form, or place of organization of one corporation does not qualify as a reorganization.
   b. The reorganization provisions can not be used to provide tax-free treatment for corporate transactions.
   c. Securities in corporations not parties to a reorganization are always "boot."
   d. A "party to the reorganization" does not include the consolidated company.

31. Which one of the following is not a corporate reorganization as defined in the Internal Revenue Code?
   a. Stock redemption.
   b. Recapitalization.
   c. Mere change in identity.
   d. Statutory merger.

PERSONAL HOLDING COMPANY TAX

32. The personal holding company tax
   a. Is imposed on corporations having 50 or more equal stockholders.
   b. Applies regardless of the extent of dividend distributions.
   c. Should be self-assessed by filing a separate schedule along with the regular tax return.
   d. May apply if at least 20% of the corporation's gross receipts constitute passive investment income.

33. Where passive investment income is involved, the personal holding company tax may be imposed
   a. On both partnerships and corporations.
   b. On companies whose gross income arises solely from rentals, if the lessors render no services to the lessees.
   c. If more than 50% of the company is owned by five or fewer individuals.
   d. On small business investment companies licensed by the Small Business Administration.

34. Acme Corp. has two common stockholders. Acme derives all of its income from investments in stocks and securities, and it regularly distributes 51% of its taxable income as dividends to its stockholders. Acme is a
   a. Corporation subject to tax only on income not distributed to stockholders.
   b. Corporation subject to the accumulated earnings tax.
   c. Regulated investment company.
   d. Personal holding company.

35. Edge Corp. met the stock ownership requirements of a personal holding company. What sources of income must Edge consider to determine if the income requirements for a personal holding company have been met?
   I. Interest earned on tax-exempt obligations.
   II. Dividends received from an unrelated domestic corporation.
   a. I only.
   b. II only.
   c. Both I and II.
   d. Neither I nor II.

36. Zero Corp. is an investment company authorized to issue only common stock. During the last half of 2010, Edwards owned 450 of the 1,000 outstanding shares of stock in Zero. Another 350 shares of stock outstanding were owned, 10 shares each, by 35 shareholders who are neither related to each other nor to Edwards. Zero could be a personal holding company if the remaining 200 shares of common stock were owned by
   a. An estate where Edwards is the beneficiary.
   c. A partnership where Edwards is not a partner.
   d. Edwards' cousin.

37. Cromwell Investors, Inc., has ten unrelated equal stockholders. For the year, Cromwell's adjusted gross income comprised the following:
   Dividends from domestic taxable corporations $10,000
   Dividends from savings and loan associations on passbook savings accounts 1,000
   Interest earned on notes receivable 5,000
   Net rental income 3,000

   The corporation paid no dividends during the taxable year. Deductible expenses totaled $4,000 for the year. Cromwell's liability for personal holding company tax for the year will be based on undistributed personal holding company income of
   a. $0.
   b. $3,500.
   c. $6,500.
   d. $15,000.
38. Kane Corp. is a calendar year domestic personal holding company. Which deduction(s) must Kane make from its taxable income to determine undistributed personal holding company income prior to the dividend-paid deduction?

<table>
<thead>
<tr>
<th>Federal income taxes</th>
<th>Net long-term capital gain less related federal income taxes</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>b. Yes</td>
<td>No</td>
</tr>
<tr>
<td>c. No</td>
<td>Yes</td>
</tr>
<tr>
<td>d. No</td>
<td>No</td>
</tr>
</tbody>
</table>

39. Benson, a singer, owns 100% of the outstanding capital stock of Lund Corp. Lund contracted with Benson, specifying that Benson was to perform personal services for Magda Productions, Inc., in consideration of which Benson was to receive $50,000 a year from Lund. Lund contracted with Magda, specifying that Benson was to perform personal services for Magda, in consideration of which Magda was to pay Lund $1,000,000 a year. Personal holding company income will be attributable to:
   a. Benson only.
   b. Lund only.
   c. Magda only.
   d. All three contracting parties.

40. The personal holding company tax
   a. Qualifies as a tax credit that may be used by partners or stockholders to reduce their individual income taxes.
   b. May be imposed on both corporations and partnerships.
   c. Should be self-assessed by filing a separate schedule with the regular tax return.
   d. May be imposed regardless of the number of equal stockholders in a corporation.

41. The personal holding company tax may be imposed
   a. As an alternative tax in place of the corporation's regularly computed tax.
   b. If more than 50% of the corporation's stock is owned, directly or indirectly, by more than ten stockholders.
   c. If at least 60% of the corporation's adjusted ordinary gross income for the taxable year is personal holding company income, and the stock ownership test is satisfied.
   d. In conjunction with the accumulated earnings tax.

42. Kee Holding Corp. has 80 unrelated equal stockholders. For the year ended December 31, 2010, Kee's income comprised the following:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net rental income</td>
<td>$1,000</td>
</tr>
<tr>
<td>Commissions earned on sales of franchises</td>
<td>$3,000</td>
</tr>
<tr>
<td>Dividends from taxable domestic corporations</td>
<td>$90,000</td>
</tr>
</tbody>
</table>

Deductible expenses for 2010 totaled $10,000. Kee paid no dividends for the past three years. Kee's liability for personal holding company tax for 2010 will be based on:
   a. $12,000
   b. $11,000
   c. $9,000
   d. $0

**ACCUMULATED EARNINGS TAX**

43. The accumulated earnings tax can be imposed
   a. Regardless of the number of stockholders of a corporation.
   b. On personal holding companies.
   c. On companies that make distributions in excess of accumulated earnings.
   d. On both partnerships and corporations.

44. In determining accumulated taxable income for the purpose of the accumulated earnings tax, which one of the following is allowed as a deduction?
   a. Capital loss carryover from prior year.
   b. Dividends-received deduction.
   c. Net operating loss deduction.
   d. Net capital loss for current year.

45. The accumulated earnings tax
   a. Depends on a stock ownership test based on the number of stockholders.
   b. Can be avoided by sufficient dividend distributions.
   c. Is computed by the filing of a separate schedule along with the corporation's regular tax return.
   d. Is imposed when the entity is classified as a personal holding company.

46. The minimum accumulated earnings credit is
   a. $150,000 for all corporations.
   b. $150,000 for nonservice corporations only.
   c. $250,000 for all corporations.
   d. $250,000 for nonservice corporations only.
47. Kari Corp., a manufacturing company, was organized on January 2, 2010. Its 2010 federal taxable income was $400,000 and its federal income tax was $100,000. What is the maximum amount of accumulated taxable income that may be subject to the accumulated earnings tax for 2010 if Kari takes only the minimum accumulated earnings credit?
   a. $300,000
   b. $150,000
   c. $50,000
   d. $0

48. Daystar Corp., which is not a mere holding or investment company, derives its income from consulting services. Daystar had accumulated earnings and profits of $45,000 at December 31, 2009. For the year ended December 31, 2010, it had earnings and profits of $215,000 and a dividends-paid deduction of $15,000. It has been determined that $20,000 of the accumulated earnings and profits for 2010 is required for the reasonable needs of the business. How much is the available accumulated earnings credit at December 31, 2010?
   a. $105,000.
   b. $205,000.
   c. $150,000.
   d. $250,000.

49. Dart Corp., a calendar year domestic C corporation, is not a personal holding company. For purposes of the accumulated earnings tax, Dart has accumulated taxable income for 2010. Which step(s) can Dart take to eliminate or reduce any 2010 accumulated earnings tax?
   I. Demonstrate that the "reasonable needs" of its business require the retention of all or part of the 2010 accumulated taxable income.
   II. Pay dividends by March 15, 2011.
   a. I only.
   b. II only.
   c. Both I and II.
   d. Neither I nor II.

50. The accumulated earnings tax can be imposed
   a. On both partnerships and corporations.
   b. On companies that make distributions in excess of accumulated earnings.
   c. On personal holding companies.
   d. Regardless of the number of stockholders in a corporation.

51. The accumulated earnings tax does not apply to
   a. Corporations that have more than 100 stockholders.
   b. Personal holding companies.
   c. Corporations filing consolidated returns.
   d. Corporations that have more than one class of stock.

52. The accumulated earnings tax
   a. Should be self-assessed by filing a separate schedule along with the regular tax return.
   b. Applies only to closely held corporations.
   c. Can be imposed on S corporations that do not regularly distribute their earnings.
   d. Can not be imposed on a corporation that has undistributed earnings and profits of less than $150,000.

Released and Author Constructed Questions

53. Mintee Corp., an accrual-basis calendar-year C corporation, had no corporate shareholders when it liquidated in 2010. In cancellation of all their Mintee stock, each Mintee shareholder received in 2010, a liquidating distribution of $2,000 cash and land with a tax basis of $5,000 and a fair market value of $10,500. Before the distribution, each shareholder's tax basis in Mintee stock was $6,500. What amount of gain should each Mintee shareholder recognize on the liquidating distribution?
   a. $0
   b. $500
   c. $4,000
   d. $6,000

54. Elm Corp. is an accrual-basis calendar-year C corporation with 100,000 shares of voting common stock issued and outstanding as of December 28, 2010. On Friday, December 29, 2010, Hall surrendered 2,000 shares of Elm stock to Elm in exchange for $33,000 cash. Hall had no direct or indirect interest in Elm after the stock surrender. Additional information follows:

Hall's adjusted basis in 2,000 shares of
Elm on December 29, 2010 ($8 per share) $16,000

Elm's accumulated earnings and profits at
January 1, 2010 25,000

Elm's 2010 net operating loss (7,000)
58. Webster, a C corporation, has $70,000 in accumulated and no current earnings and profits. Webster distributed $20,000 in cash and property with an adjusted basis and fair market value of $60,000 to its shareholders. What amount should the shareholders report as dividend income?
   a. $20,000  
b. $60,000  
c. $70,000  
d. $80,000

59. Brisk Corporation is an accrual basis, calendar year C corporation with one individual shareholder. At year-end, Brisk had $600,000 accumulated and current earnings and profits as it prepared to make its only dividend distribution for the year to its shareholder. Brisk could distribute either cash of $200,000 or land with an adjusted tax basis of $75,000 and a fair market value of $200,000. How would the taxable income of both Brisk and the shareholder change if land were distributed instead of cash?
   a. No change No change  
b. Increase No change  
c. No change Decrease  
d. Increase Decrease

60. Fox, the sole shareholder in Fall, a C corporation, has a tax basis of $60,000. Fall has $40,000 of accumulated positive earnings and profits at the beginning of the year and $10,000 of current positive earnings and profits for the current year. At year end, Fall distributed land with an adjusted basis of $30,000 and a fair market value (FMV) of $38,000 to Fox. The land has an outstanding mortgage of $3,000 that Fox must assume. What is Fox’s tax basis in the land?
   a. $38,000  
b. $35,000  
c. $30,000  
d. $27,000
Chapter Ten — Answers
Corporate Distributions and Other Matters

1. (c) $185,000. In a non-liquidating distribution, dividend income is recognized only to the extent of the earnings and profits of the corporation. Any excess of the distribution over the E & P represents a return of the taxpayer's basis in his stock. Reed must recognize dividend income of $185,000.

   Beginning E & P       $ 125,000
   Current E & P        60,000
   Available E & P      $ 185,000

   Shareholder distribution $ 200,000
   Dividend income - (E & P) -185,000
   Return of basis       $  15,000

2. (b) $140,000. In a non-liquidating distribution, dividend income is recognized only to the extent of the earnings and profits of the corporation. Any excess of the distribution over the E & P represents a return of the taxpayer's basis in his stock. Lamb must recognize dividend income of $140,000.

   Beginning E & P       $  60,000
   Current E & P        80,000
   Available E & P      $ 140,000

   Shareholder distribution $ 180,000
   Dividend income - (E & P) -140,000
   Return of basis       $  40,000

3. (c) $10,000. When there is an accumulated deficit and positive current earnings, the distribution is deemed to come out of the current earnings first. (There is no netting of the accumulated deficit and current E & P). Kee must recognize $10,000 of dividend income. The balance is a return of the taxpayer's basis in his stock.

   Shareholder distribution $ 30,000
   Dividend income - (E & P) -10,000
   Return of basis          $  20,000

4. (b) $1,100. When a corporation makes a distribution of property other than cash to a shareholder, any excess of the fair market value over the adjusted basis, or cost, will be recognized as a gain.

   Fair market value of distribution $ 2,000
   Adjusted basis of property         900
   Gain on distribution               $ 1,100

5. (c) $20,000. In a non-liquidating distribution, dividend income is recognized only to the extent of the earnings and profits of the corporation. Any excess of the distribution over the E & P represents a return of the taxpayer's basis in his stock. In this comprehensive problem, the shareholder recognizes $20,000 in dividend income; receives a $5,000 tax-free return of his basis (investment) and his new basis is $17,000.
<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Available E &amp; P</td>
<td>$20,000</td>
</tr>
<tr>
<td>Shareholder distribution</td>
<td>$25,000</td>
</tr>
<tr>
<td>Dividend income - (E &amp; P)</td>
<td>-20,000</td>
</tr>
<tr>
<td>Return of basis</td>
<td>$5,000</td>
</tr>
<tr>
<td>Original shareholder basis</td>
<td>$22,000</td>
</tr>
<tr>
<td>Return of capital</td>
<td>-5,000</td>
</tr>
<tr>
<td>Ending basis after distribution</td>
<td>$17,000</td>
</tr>
</tbody>
</table>

6. (a) None. See #5.

7. (b) $17,000. See #5.

8. (c) $280,000. In a non-liquidating distribution, dividend income is recognized only to the extent of the earnings and profits of the corporation. Any excess of the distribution over the E & P represents a return of the taxpayer's basis in his stock. Lamb must recognize dividend income of $280,000. The excess of $80,000 is a return of capital.

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Beginning E &amp; P</td>
<td>$120,000</td>
</tr>
<tr>
<td>Current E &amp; P</td>
<td>160,000</td>
</tr>
<tr>
<td>Available E &amp; P</td>
<td>$280,000</td>
</tr>
<tr>
<td>Shareholder distribution</td>
<td>$360,000</td>
</tr>
<tr>
<td>Dividend income - (E &amp; P)</td>
<td>-280,000</td>
</tr>
<tr>
<td>Return of basis</td>
<td>$80,000</td>
</tr>
</tbody>
</table>

9. (c) $44,000. In a non-liquidating distribution, dividend income is recognized only to the extent of the earnings and profits of the corporation. However, when a corporation distributes property to a shareholder, the corporation must recognize any gain to the extent of the excess of the fair market value of the property over its adjusted basis. In this problem, the fair market of $40,000 exceeds the adjusted basis of $5,000 by $35,000. This gain increases the company's E & P.

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash distribution</td>
<td>$9,000</td>
</tr>
<tr>
<td>Fair market value of land</td>
<td>40,000</td>
</tr>
<tr>
<td>Total distribution</td>
<td>$49,000</td>
</tr>
<tr>
<td>Beginning E &amp; P</td>
<td>$9,000</td>
</tr>
<tr>
<td>Amount recognized on land</td>
<td>35,000</td>
</tr>
<tr>
<td>Available E &amp; P</td>
<td>$44,000</td>
</tr>
</tbody>
</table>

10. (d) $30,000. When a corporation has dealings with its own shareholders, transactions must be conducted on an arm's length basis. By selling the property to the shareholder for less than the fair market value, the shareholder has received a disguised dividend to the extent the difference. Since there is sufficient E & P, the calculations are as follows:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fair market value of property</td>
<td>$80,000</td>
</tr>
<tr>
<td>Amount paid for by shareholder</td>
<td>-50,000</td>
</tr>
<tr>
<td>Constructive dividend</td>
<td>$30,000</td>
</tr>
</tbody>
</table>

11. (a) $1,500. When a corporation makes a distribution of property other than cash to a shareholder, any excess of the fair market value of the distribution over the adjusted basis will be recognized as a gain. However, the impact to the corporation's earnings and profits require an increase based upon any gain recognized; a increase for the release of any indebtedness; and a decrease for the fair market value of the property being distributed.
Fair market value of property $ 14,000  
Adjusted basis -6,500  
Recognized gain $ 7,500  

Impact on E & P:  
Recognized gain $ 7,500  
Release of debt 5,000  
Less: FMV of distribution -14,000  
Overall decrease in E & P $ 1,500  

12. (c) $10,000. When a corporation makes a distribution of property other than cash to a shareholder, any excess of the fair market value over the adjusted basis will be recognized as a gain.

Fair market value of property $ 30,000  
Adjusted basis -20,000  
Recognized gain $ 10,000  

13. (a) The fees and expenditures incurred in connection with the liquidation are deducted in full as a corporate expense.

14. (d) This is the general rule. The shareholder is exchanging stock for the assets of the corporation. The amount realized by the shareholder usually includes cash and the fair market value of any property. The shareholder's basis in the stock is then subtracted from the amount realized to determine the capital gain or loss.

15. (b) $50,000 capital gain. A corporation recognizes a gain on the distribution of appreciated property in excess of its adjusted basis.

16. (d) $40,000. A corporation recognizes a gain on the distribution of appreciated property in excess of its adjusted basis.

Fair market value $ 180,000  
Adjusted basis -140,000  
Recognized gain $ 40,000  

17. (a) $0. Even though the fair market value of the assets distributed ($80,000) exceeded the basis of Day's stock held by Lark, no gain or loss is recognized. The liquidation of a subsidiary into its parent is non-taxable.

18. (a) $0. No gain or loss is recognized on the liquidation of a subsidiary into its parent.

19. (c) Both I and II. In a non-liquidating distribution, dividend income is recognized only to the extent of the earnings and profits of the corporation. Any excess of the distribution over the E & P represents a return of the taxpayer's basis in his stock.

20. (d) No gain or loss is recognized on the liquidation of a subsidiary into its parent.

21. (d) $97,500. When a corporation adopts a plan of liquidation, the difference between the selling price of the assets and their adjusted basis is recognized as a gain, even if the corporation then distributes the remaining cash to the shareholders. The total gain is determined as:

Gain on the sale of land $ 75,000  
Gain on the sale of inventory 22,500  
Total recognized gain $ 97,500
22. (d) Under a qualified plan of tax-free liquidation, the tax attributes of the acquired corporation transfer over to the acquiring corporation. This allows the parent to utilize the excess charitable contributions and net operating losses.

23. (a) This is a statutory merger and qualifies as a tax-free reorganization. It is tax-free to both the shareholders and the corporation.

24. (a) $0 and $100,000. No gain or loss is recognized when a corporation exchanges property pursuant to a plan of reorganization solely in exchange for stock in another corporation. Daly's basis in the Galen Corporation stock is the basis of the transferred property, or $100,000.

25. (b) This is Type B reorganization. King acquired control (at least 80%) of Jaxson's stock in exchange for part of its own stock.

26. (c) By definition. The control test means at least 80%.

27. (d) $0. No gain or loss is recognized by an individual, if pursuant to a plan of corporate reorganization, the taxpayer exchanges stock of one corporation for another.

28. (a) Yes and Yes. This qualifies as a Type A reorganization and is non-taxable to both the shareholders and corporation.

29. (a) A mere change in the place of organization of one corporation qualifies as a Type F reorganization. The other answers listed are not reorganizations, but rather changes in accounting methods.

30. (c) In general, when securities in corporations which are not party to the reorganization are exchanged, they are treated as boot.

31. (a) A stock redemption is not considered to be a corporate reorganization. A recapitalization (Type E); mere change in identity (Type F); and statutory merger (Type A) are reorganizations.

32. (c) The personal holding company status is self-assessed. It is imposed on corporations with a limited number of shareholders; dividend distributions are critical in determining the tax; and investment income must be at least 60%.

33. (c) The rule is that 5 or fewer shareholders cannot own more than 50% of the corporation's stock.

34. (d) Acme Corporation meets the shareholder test (5 or fewer shareholders cannot own more than 50% of the corporation's stock) and the passive investment income test (60% or more of its AOGI is PHCI). The investment income is 100%. The fact that it distributes dividends does not change its classification.

35. (b) Dividends are considered personal holding company income, but tax-exempt interest is excluded.

36. (a) Through the attribution rules, Edwards is deemed to own the shares of stock held by the estate naming him as the beneficiary. This gives Edwards 650 shares of stock. With this ownership, Zero Corporation meets the shareholder test.

\[ 650 > 50\% \text{ of } 1000 \]

37. (a) $0. The corporation is not a PHC because it fails the shareholder test. More than 50% of the value of the stock is not owned by five or fewer shareholders.

38. (a) In calculating the UPHCI, no deduction is allowed for the dividends received deduction. However, a deduction is allowed for federal income taxes, excess charitable contributions and dividends paid. In addition, a deduction is allowed for the net long-term capital gain, which is not included as personal holding company income.
39. (b) Personal holding company income includes unearned income, such as interest, dividends, rents, royalties or personal service income. Since Benson owns 25% or more of the corporation, and he has the right to assign the income, the amount is considered to be Lund's PHCI.

40. (c) A personal holding company is self-assessed at a rate of 15% on its undistributed personal holding company income (UPHCI). A separate schedule is attached to the return.

41. (c) A company that meets the following two tests is classified as a personal holding company:

- **Five or fewer** shareholders own more than 50% of the value of the outstanding stock at any time during the last half of the taxable year, and
- **60% or more** of the corporation's adjusted ordinary gross income (AOGI) is unearned income, such as interest, dividends, rents, royalties or personal service income.

42. (d) $0. Kee Holding does not meet the shareholder test because it has 80 unrelated equal shareholders. To be classified as a PHC, there must be **five or fewer** shareholders who own more than 50% of the value of the outstanding stock at any time during the last half of the taxable year. Therefore, it is not a personal holding company.

43. (a) Unlike the personal holding company tax, there is no minimum number of shareholders requirement.

44. (d) In determining a current year's ATI, the net capital loss which is not allowed in determining taxable income is allowed to determine a company's dividend paying ability. The other three items are actually add-backs (not deductions) in determining the ATI.

45. (b) The thrust of the accumulated earnings tax is to require companies to pay out dividends and not retain them. By making sufficient dividend distributions of current earnings, a company can avoid the penalty tax.

46. (d) $250,000. This is the amount for nonservice corporations. For service corporations the amount is $150,000.

47. (c) $50,000. In order to determine the corporation's accumulated taxable income, several adjustments are needed. One is the reduction for federal income taxes paid. The other is the amount of the accumulated earnings credit. Whereas the company is in its first year of operations, the full $250,000 for nonservice corporations is available.

\[
\begin{align*}
\text{Taxable income} & \quad \$400,000 \\
\text{Less: Federal income taxes} & \quad -100,000 \\
\text{Minimum AE credit} & \quad -250,000 \\
\text{Accumulated taxable income} & \quad \$50,000
\end{align*}
\]

48. (a) $105,000. A service business is allowed a minimum accumulated earnings credit of $150,000. As of December 31, 2009, the corporation had used $45,000 of the $150,000. This would leave an available balance of $105,000 for 2010. (The amount of earnings needed by the corporation was only $20,000, and this is far less than the minimum.)

49. (c) Both I and II. Dart can eliminate or reduce the accumulated earnings tax through the **dividends paid deduction**, which includes those dividends paid during the year plus those paid two and one-half months after the close of the year. It may also be eliminated or reduced by the **accumulated earnings credit**, which is the greater of:

1. the reasonable needs of the business less the accumulated earnings and profits of prior years, or
2. $250,000 less the accumulated earnings and profits of prior years.
50. (d) Unlike the personal holding company tax, there is **no minimum number of shareholders** requirement.

51. (b) The accumulated earnings tax cannot be assessed on personal holding companies.

52. (d) A service business is allowed a minimum accumulated earnings credit of $150,000, while a manufacturing company is allowed up to $250,000.

53. (d) $6,000. Since this is a liquidating distribution, the total amount realized less the shareholder’s basis represents the recognized capital gain.

<table>
<thead>
<tr>
<th>Amount realized:</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$ 2,000</td>
</tr>
<tr>
<td>Land - FMV</td>
<td>10,500</td>
</tr>
<tr>
<td><strong>Total amount realized</strong></td>
<td>12,500</td>
</tr>
<tr>
<td>Less: Shareholder’s basis</td>
<td>-6,500</td>
</tr>
<tr>
<td><strong>Recognized capital gain</strong></td>
<td>$ 6,000</td>
</tr>
</tbody>
</table>

54. (d) $17,000 capital gain. This is a complete redemption of a shareholder’s stock and qualifies as a liquidating distribution. Since it is a liquidating distribution, the amount realized less the shareholder’s basis represents the recognized capital gain. The accumulated and current earnings and profits is irrelevant in this problem.

| Amount realized (cash) | $ 33,000 |
| Less: Shareholder’s basis | -16,000 |
| **Recognized capital gain** | $ 17,000 |

55. (a) Costs of liquidation are considered to be deductible ordinary and necessary business expenses of the corporation.

56. (b) $175,000 long-term capital gain. This is a classic example of a redemption of stock in complete termination of a shareholder’s interest in a corporation under Section 302(b)(3). As a result the difference between the redemption price of $200,000 and the shareholder’s cost basis of $25,000 is a long-term capital gain.

57. (a) $0. When the shareholder is another corporation which is at least 80% owned by the parent, no gain or loss is recognized on the liquidation. Instead, the basis of the assets being transferred over become the basis to the parent.

58. (c) $70,000. In a non-liquidating distribution, dividend income is recognized only to the extent of the earnings and profits of the corporation. Any excess of the distribution ($80,000) over the E & P ($70,000) represents a return of the taxpayer’s basis in his stock. The shareholders must recognize dividend income of $70,000. While not part of the problem, the excess of $10,000 is a return of capital.

| Cash distribution       | $ 20,000 |
| Property distribution   | 60,000   |
| **Total distribution**  | $ 80,000 |
| **Available E & P**     | $ 70,000 |

59. (b) Increase and No Change. When a corporation makes a distribution of property other than cash to a shareholder, any excess of the fair market value ($200,000) over the adjusted basis, or cost ($75,000), will be recognized as a gain ($125,000). The shareholder recognizes dividend income based upon the fair market value of what he receives, which is $200,000 in either case.

60. (a) $38,000. When a corporation makes a distribution of property to a shareholder, the fair market value of the property distributed becomes the basis of the property in the hands of the shareholder. The assumption of the mortgage cause a reduction in the dividend income recognized by the shareholder, but it does not reduce the basis of the property in the hands of the shareholder.
Chapter Eleven
S Corporations

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   Eligibility
   Shareholder requirements
   Classes of stock
   Debt instruments
   Passive investment income limitation
   Election procedures
   Loss of the S corporation election

OPERATIONS OF THE S CORPORATION AND BASIS COMPUTATIONS..................................................11-2
   General rule
   Separately and non-separately stated items
   Allocation of income items and the related basis computation
   Allocation of losses and deductions and the related basis computation
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   Built-in Gains Tax
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   LIFO Recapture Tax

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Chapter Eleven
S Corporations

S CORPORATIONS
The shareholders of corporations may consent to be treated under Subchapter S of the Internal Revenue Code. These are referred to as S Corporations, or sometimes Subchapter S Corporations. The corporate structure itself does not change. In fact, most of the language addressing what is referred to as the C Corporations remains intact. What is now changed is how the entity is taxed. While much is written about the distinctions between the taxation of a partnership and an S Corporation, the flow-through nature of the items of income, deductions, credits and losses is quite similar to that of a partnership.

ELIGIBILITY
In order to be a qualified S Corporation, there are strict limitations which must be adhered to. Failure to maintain compliance with these provisions generally means the termination of S Corporation status.

SHAREHOLDER REQUIREMENTS
The maximum number of shareholders is 100. For purposes of this test, family members (ancestors, descendants, spouses and former spouses) can elected to be considered as one shareholder. Eligible shareholders include:

- Individuals
- Estates of a decedent and bankruptcy estates
- Grantor trusts, voting trusts, qualified Subchapter S trusts, and "electing small business trusts"

Ineligible shareholders include:

- Partnerships (could circumvent the number of shareholder rules)
- Corporations
- Certain trusts
- Non-resident aliens

CLASSES OF STOCK
An S Corporation is only allowed one class of stock. This means an S Corporation cannot have common and preferred stock. However, it is possible to have voting and non-voting common stock as long as the rights as to shareholder distributions and liquidations are identical.

DEBT INSTRUMENTS
In general, debt instruments (amounts payable to the shareholders whether they are straight debt or deferred compensation) are not considered a second class of stock. A safe harbor exists for unwritten loans from the corporation to the shareholder if the amount is under $10,000.

PASSIVE INVESTMENT INCOME LIMITATION
If, prior to becoming an S Corporation, a corporation has accumulated earnings and profits, the Code imposes a passive investment income limitation. If that corporation has passive investment income in excess of 25% of gross receipts for three consecutive taxable years, the S Corporation election is terminated as of the beginning of the next year. Included in the definition of passive investment income is interest, dividends, capital gains and rents (unless significant duties are performed by the corporation as landlord).

ELECTION PROCEDURES
In order to make a valid S Corporation election, all the shareholders must consent in writing. Form 2553 must be filed by the 15th day of the third month of the year in which the election is to be valid, or anytime during the preceding year. For a new corporation, that date begins the first day (1) the corporation has shareholders, (2) acquires assets or (3) starts business. The election is not made every year.
Example 1: K Corporation has been in existence since 1980. On March 12, 2010, R, the corporation’s sole shareholder consents to be taxed as an S Corporation. R must file Form 2553 with the Internal Revenue Service by March 15, 2010 in order to be treated as an S Corporation for the 2010 calendar year.

LOSS OF THE S CORPORATION ELECTION
In general, the S Corporation election remains in effect until it is revoked. The revocation may be voluntary or involuntary. A voluntary revocation may be made when the shareholders of the majority of all the shares simply consent to the termination. To be valid for that year, the revocation must be filed by the 15th day of the third month of the taxable year.

An involuntary termination occurs when the S Corporation no longer qualifies due to one of the following factors:

- The number of shareholders exceed 100.
- An additional class of stock is issued
- The corporation fails the passive investment income limitation
- A nonresident shareholder becomes a shareholder

After the election has been terminated, the general rule is that the shareholders must wait five years before a new election can be made. However, the IRS is allowed to make exception to this rule under the following conditions:

- There is an ownership change of more than 50% of the stock after the first year of the termination.
- The event causing the termination was not reasonably in the control of the majority of the shareholders or the S Corporation.

OPERATIONS OF THE S CORPORATION AND BASIS COMPUTATIONS
GENERAL RULE
Each year when the corporation files Form 1120S, it reports each shareholder’s allocable share of income, deductions, gains, losses and credits on Schedule K-1. In preparing the return, it is necessary to group items into separately stated and non-separately stated items.

SEPARATELY AND NON-SEPARATELY STATED ITEMS
Separately stated items are those items which when treated at the shareholder’s level, could have a special tax treatment or limitation. Grouping them together as ordinary income could circumvent the tax laws. For example, since an individual taxpayer can only deduct charitable contributions up to 50% of his adjusted gross income, any charitable contributions made by the corporation must be reported separately to the shareholder in order that these be grouped with other contributions the shareholder may have made individually. Only then can the 50% test truly be tested. Likewise, on an individual basis, net capital losses can only be deducted to a maximum of $3,000 per year, and all Section 179 elections cannot exceed $250,000 in 2010 in the aggregate. Other separately stated items include, but are not limited to:

- Portfolio income, such as stock, dividends and royalties
- Investment stock expense
- Personal expenses such as medical insurance
- AMT preference and adjustment items
- Passive activities, including rental activities
- Intangible drilling costs
- Taxes paid to foreign countries
- Tax-exempt income
All other items of income and expense that are not separately stated are netted together at the corporation level to determine ordinary income. Refer to the Form 1120S and K-1 at the end of the chapter. Notice that line 21 is the amount of ordinary income. Ordinary income is not subject to the self-employment tax.

After the determination of ordinary income (or loss) and of each separately stated item, the amounts flow through proportionately to each shareholder on a K-1 based upon the shareholder’s percentage stock in the corporation. If stock is sold during the year, the ordinary income (or loss) and separately stated items are allocated to the shareholder based upon the length of time owning the stock. Notice the similarities to the Form K-1 for partnerships in Chapter 7.

**ALLOCATION OF INCOME ITEMS AND THE RELATED BASIS COMPUTATION**

The items of income cause an increase in the basis of the shareholder’s stock, while the deductions and losses cause reductions. In no case may the basis of a shareholder’s stock be less than zero. In allocating the items, income items are allocated first.

**Example 2:** For 2010, KL Corporation had ordinary income of $20,000, a long-term capital gain of $10,000 and tax-exempt interest of $4,000. K and L are still equal shareholders, and K’s basis at the beginning of the year was $3,000. K’s basis will increase by $17,000 (50% of the $20,000, $10,000 and $4,000) to $20,000. K will recognize $10,000 as ordinary income and $5,000 as a long-term capital gain. Her $2,000 share of the tax-exempt interest is not taxable, but does increase her tax basis.

**ALLOCATION OF LOSSES AND DEDUCTIONS AND THE RELATED BASIS COMPUTATION**

Items of losses and deductions cause a decrease in the shareholder’s basis. Non-deductible items decrease a shareholder’s basis as well. Since a shareholder’s basis cannot be reduced below zero, it may be necessary to pro-rate items of losses and deductions until sufficient basis exists.

**Example 3:** Assume that in Example 6, K's share of the ordinary income was only $7,000 and there was no capital gain or exempt income. Assume her beginning basis was still $3,000 and that her share of separately stated items included a charitable contribution of $9,000 and a Section 179 election of $6,000. Her basis is first increased by the ordinary income of $7,000 to $10,000. The most she can now reduce her basis by is $10,000. K must prorate the deductions and suspend the excess to future periods until she has sufficient basis. K's basis cannot be negative.

<table>
<thead>
<tr>
<th>Deductions</th>
<th>Ratio</th>
<th>Basis</th>
<th>Allowed</th>
<th>Suspended</th>
</tr>
</thead>
<tbody>
<tr>
<td>Charitable contribution</td>
<td>9,000</td>
<td>3/5</td>
<td>$10,000</td>
<td>$6,000</td>
</tr>
<tr>
<td>Section 179 election</td>
<td>6,000</td>
<td>2/5</td>
<td>$10,000</td>
<td>4,000</td>
</tr>
<tr>
<td>$15,000</td>
<td></td>
<td></td>
<td>$10,000</td>
<td></td>
</tr>
</tbody>
</table>

**SHAREHOLDER COMPENSATION & FRINGE BENEFITS**

Unlike partnerships, S Corporations may claim a deduction for compensation paid to the shareholders. Payments must be made by the last day of the taxable year in order to be deducted in that year. However, fringe benefits such as health insurance for shareholders owning 2% or more of the S Corporation’s stock are not allowed as deductions and are treated as income to the shareholder.
LIABILITIES
When a corporation incurs liabilities, the individual shareholders do not necessarily share in the responsibility to pay these liabilities. One characteristic of a corporation is limited liability. However, even if a shareholder was personally responsible for a debt (the shareholder guaranteed a bank loan), the shareholder's basis is not increased for the liability. This is a major difference from the rules related to partnerships. If, however, the shareholder lends money to the corporation, the shareholder's basis is increased by that amount. Contrawise, a repayment of a shareholder's loan reduces that shareholder's tax basis.

Example 4: During 2010, the DEF Corporation is formed and each shareholder contributes $5,000. On December 31, 2010, the corporation borrows $12,000 for working capital purposes. Each of the shareholders personally guarantees the loan at the bank. The basis of the three equal shareholders, D, E and F, will not be increased by their share ($4,000) of the recourse debt. Their ending basis would be $5,000 each.

Example 5: If in Example 8, shareholder D personally loaned the $12,000 to the corporation instead, D's tax basis would increase by the $12,000 to $17,000. There would be no increase in the basis of the other shareholders.

SHAREHOLDER DISTRIBUTIONS
During the course of the year, shareholders typically withdraw capital in anticipation of their earnings to pay income taxes and for other reasons. Generally, these withdrawals do not represent income to the shareholder. A shareholder is taxed on his share of the corporation income, not on what is withdrawn. The withdrawals do, however, reduce the basis of the shareholders stock. When computing the balance in a shareholders account, withdrawals are subtracted out before losses and deductions are.

Should a shareholder withdraw more than the balance in the capital account, the excess will be treated as a capital gain. It is also important to note that these withdrawals are viewed as dividends. Therefore, shareholders should only withdraw (receive distributions) equal to their proportionate share of stock.

Example 6: H and J are 50% shareholders of HJ Corporation (an S Corporation). During 2010, H received distributions of $10,000 while J received only $4,000. The IRS may try to terminate the S Corporation status on the grounds that there are two classes of stock. One class provides the shareholder with a larger "dividend" than the other.
S CORPORATION TAXES

In general, an S Corporation is not subject to federal income taxes. However, if the S Corporation was previously a C Corporation, then there are several tax traps the corporation should be aware of:

- Built-in gains tax
- Net passive income tax
- LIFO recapture tax

BUILT-IN GAINS TAX

An S Corporation that was previously a C Corporation with C Corporation earnings, may be subject to a built-in gains tax for the appreciation in assets not yet realized, up until the point of the conversion from C to S. The character of the gain recognized will be the basis of the underlying assets when the assets are sold. For the built-in gains tax to apply, the sale of the assets must take place within 7 years of the conversion from the C Corporation to the S Corporation. Prior to 2009, the period of time was 10 years.

Example 7: The EFG Corporation, a C Corporation, has the following assets on June 30, 2010, the date of the S Corporation election.

<table>
<thead>
<tr>
<th>Basis</th>
<th>FMV</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>10,000</td>
</tr>
<tr>
<td>Accounts receivable</td>
<td>6,000</td>
</tr>
<tr>
<td>Inventory</td>
<td>9,000</td>
</tr>
<tr>
<td>Land</td>
<td>14,000</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>39,000</strong></td>
</tr>
</tbody>
</table>

On the date of the election, there is a built-in gain to the old C Corporation equal to $18,000. This represents the gain that would be recognized if the assets were sold on that date for $39,000 as compared to their adjusted basis of $21,000. The character of the gain would be $6,000 ordinary from the "collection" of accounts receivable; $3,000 ordinary from the "sale" of inventory; and $9,000 capital from the "sale" of land. The gain would be recognized at the highest corporate rate when the assets are actually sold or exchanged.

NET PASSIVE INCOME TAX

An S Corporation that was previously a C Corporation with C Corporation earnings, may be subject to a tax when the total net passive investment income exceeds 25% of the total gross receipts. Passive investment income typically includes dividends, interest, rents and royalties.

LIFO RECAPTURE

An S Corporation that was previously a C Corporation with C Corporation earnings, may be subject to a tax when it maintained its inventory under the LIFO method prior to electing S Corporation status. The recapture amount is the difference between LIFO and FIFO. The amount of tax is payable in four equal annual installments.
**U.S. Income Tax Return for an S Corporation**

**Form 1120S**

Department of the Treasury
Internal Revenue Service

**2010**

For calendar year 2010 or tax year beginning , 2010, ending , 20.

**A** S election effective date

<table>
<thead>
<tr>
<th>TYPE OR PRINT</th>
<th>D Employer identification number</th>
</tr>
</thead>
<tbody>
<tr>
<td>Name</td>
<td></td>
</tr>
<tr>
<td>Number, street, and room or suite no. If a P.O. box, see instructions.</td>
<td></td>
</tr>
<tr>
<td>City or town, state, and ZIP code</td>
<td></td>
</tr>
<tr>
<td>E Date incorporated</td>
<td></td>
</tr>
<tr>
<td>F Total assets (see instructions)</td>
<td></td>
</tr>
</tbody>
</table>

**B** Business activity code number (see instructions)

**C** Check if Sch. M-3 attached □ □

**G** Is the corporation electing to be an S corporation beginning with this tax year? □ Yes □ No

If "Yes," attach Form 2553 if not already filed

**H** Check if:

(1) □ Final return
(2) □ Name change
(3) □ Address change
(4) □ Amended return
(5) □ S election termination or revocation

**I** Enter the number of shareholders who were shareholders during any part of the tax year

Caution, include only trade or business income and expenses on lines 1a through 21. See the instructions for more information.

<table>
<thead>
<tr>
<th>Income</th>
<th>1a Gross receipts or sales</th>
<th>b Less returns and allowances</th>
<th>c Bal</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td></td>
<td>10</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
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</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Compensation of officers</th>
<th>7</th>
</tr>
</thead>
<tbody>
<tr>
<td>Salaries and wages (less employment credits)</td>
<td>8</td>
</tr>
<tr>
<td>Repairs and maintenance</td>
<td>9</td>
</tr>
<tr>
<td>Bad debts</td>
<td>10</td>
</tr>
<tr>
<td>Rents</td>
<td>11</td>
</tr>
<tr>
<td>Taxes and license</td>
<td>12</td>
</tr>
<tr>
<td>Interest</td>
<td>13</td>
</tr>
<tr>
<td>Depreciation not claimed on Schedule A or elsewhere on return (attach Form 4562)</td>
<td>14</td>
</tr>
<tr>
<td>Do not deduct oil and gas depletion</td>
<td>15</td>
</tr>
<tr>
<td>Advertising</td>
<td>16</td>
</tr>
<tr>
<td>Pension, profit-sharing, etc., plans</td>
<td>17</td>
</tr>
<tr>
<td>Employee benefit programs</td>
<td>18</td>
</tr>
<tr>
<td>Other deductions (attach statement)</td>
<td>19</td>
</tr>
<tr>
<td>Total deductions. Add lines 7 through 19</td>
<td>20</td>
</tr>
</tbody>
</table>

**21** Ordinary business income (loss). Subtract line 20 from line 6.

<table>
<thead>
<tr>
<th>Deductions (see instructions for limitations)</th>
<th>21</th>
</tr>
</thead>
<tbody>
<tr>
<td>Excess net passive income or LIFO recapture tax</td>
<td>22a</td>
</tr>
<tr>
<td>Tax from Schedule D (Form 1120S)</td>
<td>22b</td>
</tr>
<tr>
<td>Add lines 22a and 22b (see instructions for additional taxes)</td>
<td>22c</td>
</tr>
<tr>
<td>2010 estimated tax payments and 2009 overpayment credited to 2010</td>
<td>23a</td>
</tr>
<tr>
<td>Tax deposited with Form 7004</td>
<td>23b</td>
</tr>
<tr>
<td>Credit for federal tax paid on fuels (attach Form 4136)</td>
<td>23c</td>
</tr>
<tr>
<td>Add lines 23a through 23c</td>
<td>23d</td>
</tr>
<tr>
<td>Estimated tax penalty (see instructions). Check if Form 2220 is attached</td>
<td>24</td>
</tr>
<tr>
<td>Amount owed. If line 23d is smaller than the total of lines 22c and 24, enter amount owed</td>
<td>25</td>
</tr>
<tr>
<td>Overpayment. If line 23d is larger than the total of lines 22c and 24, enter amount overpaid</td>
<td>26</td>
</tr>
<tr>
<td>Enter amount from line 26 credited to 2011 estimated tax</td>
<td>27</td>
</tr>
</tbody>
</table>

**Sign Here**

[Signature of officer]

Date

Title

**Paid Preparer Use Only**

Print/Type preparer’s name

Preparer’s signature

Date

Check if self-employed

PTIN

Firm’s name

Firm’s EIN

For Paperwork Reduction Act Notice, see separate instructions.

Cat. No. 15510H

Form 1120S (2010)
# Schedule K-1
(Form 1120S)

## Part I
**Information About the Corporation**

<table>
<thead>
<tr>
<th>A</th>
<th>Corporation's employer identification number</th>
</tr>
</thead>
<tbody>
<tr>
<td>B</td>
<td>Corporation's name, address, city, state, and ZIP code</td>
</tr>
<tr>
<td>C</td>
<td>IRS Center where corporation filed return</td>
</tr>
</tbody>
</table>

## Part II
**Information About the Shareholder**

<table>
<thead>
<tr>
<th>D</th>
<th>Shareholder's identifying number</th>
</tr>
</thead>
<tbody>
<tr>
<td>E</td>
<td>Shareholder’s name, address, city, state, and ZIP code</td>
</tr>
</tbody>
</table>

## Part III
**Shareholder's Share of Current Year Income, Deductions, Credits, and Other Items**

<p>| | | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Ordinary business income (loss)</td>
<td></td>
</tr>
<tr>
<td>2</td>
<td>Net rental real estate income (loss)</td>
<td></td>
</tr>
<tr>
<td>3</td>
<td>Other net rental income (loss)</td>
<td></td>
</tr>
<tr>
<td>4</td>
<td>Interest income</td>
<td></td>
</tr>
<tr>
<td>5a</td>
<td>Ordinary dividends</td>
<td></td>
</tr>
<tr>
<td>5b</td>
<td>Qualified dividends</td>
<td></td>
</tr>
<tr>
<td>6</td>
<td>Royalties</td>
<td></td>
</tr>
<tr>
<td>7</td>
<td>Net short-term capital gain (loss)</td>
<td></td>
</tr>
<tr>
<td>8a</td>
<td>Net long-term capital gain (loss)</td>
<td></td>
</tr>
<tr>
<td>8b</td>
<td>Collectibles (39%) gain (loss)</td>
<td></td>
</tr>
<tr>
<td>8c</td>
<td>Unrecaptured section 1250 gain</td>
<td></td>
</tr>
<tr>
<td>9</td>
<td>Net section 1231 gain (loss)</td>
<td></td>
</tr>
<tr>
<td>10</td>
<td>Other income (loss)</td>
<td></td>
</tr>
<tr>
<td>11</td>
<td>Section 179 deduction</td>
<td></td>
</tr>
<tr>
<td>12</td>
<td>Other deductions</td>
<td></td>
</tr>
<tr>
<td>13</td>
<td>Credits</td>
<td></td>
</tr>
<tr>
<td>14</td>
<td>Foreign transactions</td>
<td></td>
</tr>
<tr>
<td>15</td>
<td>Alternative minimum tax (AMT) items</td>
<td></td>
</tr>
<tr>
<td>16</td>
<td>Items affecting shareholder basis</td>
<td></td>
</tr>
<tr>
<td>17</td>
<td>Other information</td>
<td></td>
</tr>
</tbody>
</table>

* See attached statement for additional information.
Chapter Eleven — Questions
S Corporations

S CORPORATIONS

1. Which one of the following will render a corporation ineligible for S corporation status?
   a. One of the stockholders is a decedent's estate.
   b. One of the stockholders is a bankruptcy estate.
   c. The corporation has both voting and nonvoting common stock issued and outstanding.
   d. The corporation has 105 stockholders.

2. Which of the following conditions will prevent a corporation from qualifying as an S Corporation?
   a. The corporation has both common and preferred stock.
   b. The corporation has one class of stock with different voting rights.
   c. One shareholder is an estate.
   d. One shareholder is a grantor trust.

3. Village Corp., a calendar year corporation, began business in 1990. Village made a valid S Corporation election on December 5, 2010, with the unanimous consent of its shareholders. The eligibility requirements for S status continued to be met throughout 2011. On what date did Village's S status become effective?
   c. December 5, 2010.
   d. December 5, 2011.

4. On February 10, 2010, Ace Corp., a calendar year corporation, elected S corporation status and all shareholders consented to the election. There was no change in shareholders in 2010. Ace met all eligibility requirements for S status during the pre-election portion of the year. What is the earliest date on which Ace can be recognized as an S corporation?

5. Bristol Corp. was formed as a C corporation on January 1, 1980, and elected S corporation status on January 1, 1986. At the time of the election, Bristol had accumulated C corporation earnings and profits which have not been distributed. Bristol has had the same 25 shareholders throughout its existence. In 2010 Bristol's S election will terminate if it
   a. Increases the number of shareholders to 100.
   b. Adds a decedent's estate as a shareholder to the existing shareholders.
   c. Takes a charitable contribution deduction.
   d. Has passive investment income exceeding 90% of gross receipts in each of the three consecutive years ending December 31, 2009.

6. An S corporation has 30,000 shares of voting common stock and 20,000 shares of non-voting common stock issued and outstanding. The S election can be revoked voluntarily with the consent of the shareholders holding, on the day of the revocation,

<table>
<thead>
<tr>
<th>Shares of voting stock</th>
<th>Shares of nonvoting stock</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. 0</td>
<td>20,000</td>
</tr>
<tr>
<td>b. 7,500</td>
<td>5,000</td>
</tr>
<tr>
<td>c. 10,000</td>
<td>16,000</td>
</tr>
<tr>
<td>d. 20,000</td>
<td>0</td>
</tr>
</tbody>
</table>

7. After a corporation's status as an S corporation is revoked or terminated, how many years is the corporation generally required to wait before making a new S election, in the absence of IRS consent to an earlier election?
   a. 1
   b. 3
   c. 5
   d. 10

8. Tau Corp. which has been operating since 1980, has an October 31 year end, which coincides with its natural business year. On May 15, 2010, Tau filed the required form to elect S corporation status. All of Tau's stockholders consented to the election, and all other requirements were met. The earliest date that Tau can be recognized as an S corporation is
   d. November 1, 2011.
9. Which of the following is not a requirement for a corporation to elect S corporation status?
   a. Must be a member of a controlled group.
   b. Must confine stockholders to individuals, estates, and certain qualifying trusts.
   c. Must be a domestic corporation.
   d. Must have only one class of stock.

10. If a calendar-year S corporation does not request an automatic six-month extension of time to file its income tax return, the return is due by
   a. January 31
   b. March 15
   c. April 15
   d. June 30

11. A corporation that has been an S corporation from its inception may

<table>
<thead>
<tr>
<th>Have both passive and nonpassive income</th>
<th>Be owned by a bankruptcy estate</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. No</td>
<td>Yes</td>
</tr>
<tr>
<td>b. Yes</td>
<td>No</td>
</tr>
<tr>
<td>c. No</td>
<td>No</td>
</tr>
<tr>
<td>d. Yes</td>
<td>Yes</td>
</tr>
</tbody>
</table>

12. For the taxable year ended December 31, Elk Inc., an S corporation, had net income per books of $54,000, which included $45,000 from operations and a $9,000 net long-term capital gain. During the year, $22,500 was distributed to Elk's three equal stockholders, all of whom are on a calendar-year basis. On what amounts should Elk compute its income and capital gain taxes?

<table>
<thead>
<tr>
<th>Ordinary income</th>
<th>Long-term capital gain</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. $31,500</td>
<td>$ 0</td>
</tr>
<tr>
<td>b. $22,500</td>
<td>$ 0</td>
</tr>
<tr>
<td>c. $ 0</td>
<td>$9,000</td>
</tr>
<tr>
<td>d. $ 0</td>
<td>$ 0</td>
</tr>
</tbody>
</table>

13. If an S corporation has no accumulated earnings and profits, the amount distributed to a shareholder
   a. Must be returned to the S corporation.
   b. Increases the shareholder's basis for the stock.
   c. Decreases the shareholder's basis for the stock.
   d. Has no effect on the shareholder's basis for the stock.

14. The Haas Corp., a calendar year S corporation, has two equal shareholders. For the year ended December 31, 2010, Haas had taxable income and current earnings and profits of $60,000, which included $50,000 from operations and $10,000 from investment interest income. There were no other transactions that year. Each shareholder's basis in the stock of Haas will increase by
   a. $50,000
   b. $30,000
   c. $25,000
   d. $0

15. Bern Corp., an S corporation, had an ordinary loss of $36,500 for the year ended December 31, 2010. At January 1, 2010, Meyer owned 50% of Bern's stock. Meyer held the stock for 40 days in 2010 before selling the entire 50% interest to an unrelated third party. Meyer's basis for the stock was $10,000. Meyer was a full-time employee of Bern until the stock was sold. Meyer's share of Bern's 2010 loss was
   a. $0
   b. $2,000
   c. $10,000
   d. $18,250

16. An S corporation is not permitted to take a deduction for
   a. Compensation of officers.
   b. Interest paid to individuals who are not stockholders of the S corporation.
   c. Charitable contributions.
   d. Employee benefit programs established for individuals who are not stockholders of the S corporation.

17. An S corporation may deduct
   a. Charitable contributions within the percentage of income limitation applicable to corporations.
   b. Net operating loss carryovers.
   c. Foreign income taxes.
   d. Compensation of officers.
18. Zinco Corp. was a calendar year S corporation. Zinco's S status terminated on April 1, 2010, when Case Corp. became a shareholder. During 2010 (365-day calendar year), Zinco had nonseparately computed income of $310,250. If no election was made by Zinco, what amount of the income, if any, was allocated to the S short year for 2010?
a. $233,750
b. $155,125
c. $76,500
d. $0

19. As of January 1, 2010, Kane owned all the 100 issued shares of Manning Corp., a calendar year S corporation. On the 41st day of 2010, Kane sold 25 of the Manning shares to Rodgers. For the year ended December 31, 2010 (a 365-day calendar year), Manning had $73,000 in nonseparately stated income and made no distributions to its shareholders. What amount of nonseparately stated income from Manning should be reported on Kane's 2010 tax return?
a. $56,750
b. $54,750
c. $16,250
d. $0

20. With regard to S corporations and their stockholders, the "at risk" rules applicable to losses
a. Depend on the type of income reported by the S corporation.
b. Are subject to the elections made by the S corporation's stockholders.
c. Take into consideration the S corporation's ratio of debt to equity.
d. Apply at the shareholder level rather than at the corporate level.

21. An S corporation's accumulated adjustments account, which measures the amount of earnings that may be distributed tax-free,
a. Must be adjusted downward for the full amount of federal income taxes attributable to any taxable year in which the corporation was a C corporation.
b. Must be adjusted upward for the full amount of federal income taxes attributable to any taxable year in which the corporation was a C corporation.
c. Must be adjusted upward or downward for only the federal income taxes affected by capital gains or losses, respectively, for any taxable year in which the corporation was a C corporation.
d. Is not adjusted for federal income taxes attributable to a taxable year in which the corporation was a C corporation.

22. An S corporation may
a. Have both common and preferred stock.
b. Have a corporation as a shareholder.
c. Be a member of an affiliated group.
d. Have as many as 100 shareholders.

23. Brooke, Inc., an S corporation, was organized on January 2, 2010, with two equal stockholders who materially participate in the S corporation's business. Each stockholder invested $5,000 in Brooke's capital stock, and each loaned $15,000 to the corporation. Brooke then borrowed $60,000 from a bank for working capital. Brooke sustained an operating loss of $90,000 for the year ended December 31, 2010. How much of this loss can each stockholder claim on his 2010 income tax return?
a. $5,000
b. $20,000
c. $45,000
d. $50,000

24. A shareholder's basis in the stock of an S corporation is increased by the shareholder's pro rata share of income from

<table>
<thead>
<tr>
<th>Tax-exempt interest</th>
<th>Taxable interest</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. No</td>
<td>No</td>
</tr>
<tr>
<td>b. No</td>
<td>Yes</td>
</tr>
<tr>
<td>c. Yes</td>
<td>No</td>
</tr>
<tr>
<td>d. Yes</td>
<td>Yes</td>
</tr>
</tbody>
</table>

25. Lane Inc., an S Corporation, pays single coverage health insurance premiums of $4,800 per year and family coverage of $7,200 per year. Mill is a ten percent shareholder-employee in Lane. On Mill’s behalf, Lane pays Mill’s family coverage under the health insurance plan. What amount of insurance premiums is includible in Mill’s gross income?

a. $ -0-
b. $ 720
c. $ 4,800
d. $ 7,200
26. Beck Corp., has been a calendar-year S corporation since its inception. On January 1, 2010, Lazur and Lyle each owned 50% of the Beck stock, in which their respective tax bases were $12,000 and $9,000. For the year ended December 31, 2010, Beck had $81,000 in ordinary income business income and $10,000 in tax-exempt income. Beck made a $51,000 cash distribution to each shareholder on December 31, 2010. What was Lazur’s tax basis in Beck after the distribution?

a. $1,500  
b. $6,500  
c. $52,500  
d. $57,500

27. One of the elections a new corporation must make is its choice of an accounting period. Which of the following entities has the most flexibility in choosing an accounting period?

a. C corporation  
b. S Corporation  
c. Partnership  
d. Personal service corporation

28. Commerce Corporation elects S corporation status as of the beginning of year 2010. At the time of Commerce’s election, it held a machine with a basis of $20,000 and a fair market value of $30,000. In March of 2010, commerce sells the machine for $35,000. What would be the amount subject to the built-in gains tax?

a. $0  
b. $5,000  
c. $10,000  
d. $15,000

29. Sandy is the sole shareholder of Swallow, an S corporation. Sandy’s adjusted basis in Swallow stock is $60,000 at the beginning of the year. During the year, Swallow reports the following income items:

- Ordinary income $30,000
- Tax-exempt income $5,000
- Capital gains $10,000

In addition, Swallow makes a nontaxable distribution to Sandy of $20,000 during the year. What is Sandy’s adjusted basis in the Swallow stock at the end of the year?

a. $60,000.  
b. $70,000.  
c. $80,000.  
d. $85,000.
Chapter Eleven — Answers
S Corporations

1. (d) The maximum number of shareholders allowed in an S Corporation is 100.

2. (a) An S Corporation is allowed only one class of stock. That stock may, however, have different voting rights.

3. (b) Since the shareholders of Village Corporation did not make the consent by March 15, 2010, the election takes effect on January 1, 2011 (the next year).

4. (d) Since the shareholders of Ace Corporation made the consent by March 15, 2010, the election takes effect on January 1, 2010 (the current year).

5. (d) An S Corporation may have 100 shareholders. It may also have a decedent's estate as a shareholder. However, if it does have accumulated C Corporation earnings and profits, then violating the passive income rules of having passive investment gross receipts in excess of 25% of the total gross receipts for three consecutive years will cause the termination of the S Corporation status.

6. (c) 10,000 and 16,000. What is needed is a majority of the voting and nonvoting shares to revoke the election. In this problem the total number of shares is 50,000, therefore more than 25,000 is needed. Only answer (c) with 26,000 shares qualifies.

7. (c) 5 years. Once an S Corporation is revoked or terminated, the corporation generally may not re-elect for five years without IRS consent to an earlier election.

8. (c) November 1, 2010. In order to make a valid S Corporation election, all the shareholders must consent in writing. Form 2553 must be filed by the 15th day of the third month of the year in which the election is to be valid, or anytime during the preceding year. Since the election was not made by January 15, 2010, the election is effective for the following tax year beginning November 1, 2010.

9. (a) An S Corporation has restrictions on its shareholders, must be a domestic corporation and have only one class of stock. However, it does not need to be a member of a controlled group.

10. (b) March 15. This is same as for a regular C Corporation. The 15th day of the third month following the close of the taxable year.

11. (d) Yes and Yes. Since the corporation was always an S Corporation (and therefore cannot have any accumulated C Corporation earnings) the passive income is not an issue. A shareholder may be a bankruptcy estate.

12. (d) $0 and $0. An S Corporation is a pass-through entity. The ordinary income and long-term capital gains flow-through to its shareholders.

13. (c) Distributions to a shareholder decrease the shareholder's basis.

14. (b) $30,000. A shareholder in an S Corporation must recognize his proportionate share of income, deductions, credits and losses. In addition, the amounts of income reported by Haas Corporation will cause each shareholder's basis to increase by their share of the income (50% of $60,000, or $30,000). Recognize that the total income of $60,000 is passed through to the shareholders in their separate components of ordinary income and interest income. Also note that any tax-exempt income, while not present in this problem, also increases a shareholder's basis.
15. (b) $2,000. Meyer's share of the $36,500 loss is based upon two factors: (1) his share of the corporate stock and (2) the length of time holding the stock. As a 50% shareholder for 40 days, Meyer's loss is determined as follows:

$36,500 ÷ 365 days = $100 per day per shareholder

$100 × 40 days = $4,000 loss for 40 days

$4,000 loss × 50% ownership = $2,000.

16. (c) Charitable contributions are separately stated items which are not allowed as deductions in the determination of ordinary income. Separately stated items are passed through to the individual shareholders to be used on their own returns. In this case, if the shareholder was an individual, the charitable contribution would be claimed as an itemized deduction on Schedule A. Unlike a partnership compensating its partners, the compensation of a corporation's officers is allowable as a deduction.

17. (d) An S Corporation may deduct the compensation paid to its officers in determining its ordinary income. The charitable contributions, net operating losses and foreign income taxes represent flow-through items which are required to be separately stated on the shareholders' K-1.

18. (c) $76,500. Zinco must allocate a prorata share of the income to the S Corporation's short year. The allocation is based upon the 90 days Zinco was an S Corporation.

$310,250 ÷ 365 days = $850 per day

$850 × 90 days = $76,500

19. (a) $56,750. Kane's share of the $73,000 income is based upon two factors: (1) his share of the corporate stock and (2) the length of time holding the stock. As a 100% shareholder for 40 days, and then as a 75% shareholder for 325 days, Kane's share of the income is determined as follows:

**Step 1**

$73,000 ÷ 365 days = $200 per day

$200 × 40 days = $8,000 (as sole shareholder)

**Step 2**

$73,000 ÷ 365 days = $200 per day

$200 × 325 days = $65,000 total income

$65,000 × 75% ownership = $48,750

**Step 3**

Share of income as 100% shareholder $ 8,000
Share of income as 75% shareholder 48,750
Total reported income by Kane $ 56,750

20. (d) Similar to the rules for a partnership, the "at risk" rules are determined at the shareholder level rather than at the corporate level.

21. (d) The payment of federal income taxes which are attributable to when the corporation was a C Corporation, would be reflected in the Accumulated Earnings and Profits account, not the Accumulated Adjustments Account. The AAA account measures the undistributed earnings of the S Corporation.

22. (d) A S Corporation may have up to 100 shareholders. However, it may not have both common and preferred stock; have a corporation as a shareholder; or be a member of an affiliated group (at least 80%).
23. (b) $20,000. When a corporation incurs liabilities, the individual shareholders do not necessarily share in the responsibility to pay these liabilities. One characteristic of a corporation is limited liability. However, even if a shareholder was personally responsible for a debt (the shareholder guaranteed a bank loan), the shareholder's basis is not increased for the liability. This is a major difference from the rules related to partnerships. If, however, the shareholder lends money to the corporation, the shareholder's basis is increased by that amount. The basis of each shareholder determines the amount of the loss they can claim. Their basis is determined as follows:

<table>
<thead>
<tr>
<th>Initial investment</th>
<th>$ 5,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Personal loan</td>
<td>15,000</td>
</tr>
<tr>
<td>Total basis</td>
<td>$ 20,000</td>
</tr>
</tbody>
</table>

24. (d) A shareholder's basis is increased by the interest from both taxable and tax-exempt interest.

25 (d) $7,200. Fringe benefits such as health insurance for shareholders owning 2% or more of the S Corporation’s stock are not allowed as deductions and are treated as income to the shareholder.

26. (b) $6,500. Lazur’s beginning basis is increased by his proportionate share of the income items and reduced by the distribution. The fact that some of the income is tax-exempt is not relevant for the purpose of determining basis.

<table>
<thead>
<tr>
<th>Beginning basis</th>
<th>$ 12,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Add: 50% share of ordinary income</td>
<td>40,500</td>
</tr>
<tr>
<td>Add: 50% share of tax-exempt income</td>
<td>5,000</td>
</tr>
<tr>
<td>Subtotal</td>
<td>57,500</td>
</tr>
<tr>
<td>Less: Distribution</td>
<td>-51,000</td>
</tr>
<tr>
<td>Ending basis</td>
<td>$ 6,500</td>
</tr>
</tbody>
</table>

27. (a) C corporation. A C corporation is a separate tax paying entity, and as such, may choose whatever year end it desires. A partner and shareholder of a partnership or S corporation must report income and deductions in the tax year that includes the last day of that entity. Because these entities may easily defer income from one year to another merely by adopting a fiscal year end different from that of its owners, Congress and IRS have established a series of rules limiting the availability of certain year ends. Personal service corporations are required to have calendar year ends for similar reasons.

28. (c) $10,000. An S Corporation that was previously a C Corporation, may be subject to a built-in gains tax for the appreciation in assets not yet realized, up until the point of the conversion from C to S. For Commerce Corporation, there was a realized gain of $10,000 (FMV of $30,000 less the adjusted basis of $20,000) at the time of the election. This problem assumes that Commerce was a C corporation with earnings and profits prior to the S corporation election.

29. (d) $85,000. Sandy’s beginning basis is increased by her proportionate share (in this case 100%) of the income items and reduced by the distribution. The fact that some of the income is tax-exempt is not relevant for the purpose of determining basis.

<table>
<thead>
<tr>
<th>Beginning basis</th>
<th>$ 60,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Add: 100% share of ordinary income</td>
<td>30,000</td>
</tr>
<tr>
<td>Add: 100% share of tax-exempt income</td>
<td>5,000</td>
</tr>
<tr>
<td>Add: 100% share of capital gain income</td>
<td>10,000</td>
</tr>
<tr>
<td>Subtotal</td>
<td>105,000</td>
</tr>
<tr>
<td>Less: Distribution</td>
<td>-20,000</td>
</tr>
<tr>
<td>Ending basis</td>
<td>$ 85,000</td>
</tr>
</tbody>
</table>
Chapter Twelve
Taxation of Gifts, Estates and Fiduciaries, and Not for Profit Organizations

THE TRANSFER OF WEALTH

The federal tax laws impose a tax of the accumulation and transfer of wealth. This is separate from the taxation of income which has been the subject of the past eleven chapters. If a taxpayer maintains or controls assets in excess of a base amount on the date of death, a federal estate tax is levied on the estate. To avoid being assessed an estate tax, taxpayers frequently attempt to distribute their assets prior to their death. The transfer of these assets during their lifetime may be subject to the gift tax.

Perhaps the most sweeping change in the area of estate and gift taxation occurred in 1976 when Congress voted to combine the gifting of assets and the estate laws together. Viewed as a life-long plan to redistribute wealth, Congress unified the laws pertaining to the accumulation and distribution of wealth. Put simply, a taxpayer would be assessed a progressive tax on their taxable estate and on their cumulative gifts. To provide relief to the relatively small estates, the law provided a unified credit to be used to offset the tax. For 2010, however, there was an elimination of the estate tax. Much of the language pertaining to estates has been left in place in the tax code, so in this text and some problems we will be referring to the 2009 estate tax law to illustrate these concepts. But remember, there is no estate tax for 2010. In 2009, the unified credit was $1,455,800 for an exemption equivalent of $3,500,000. This means that if a person has a taxable estate of $3,500,000, the tax would be $1,455,800 and there would be a (unified) credit equal to $1,455,800 which would eliminate the tax in its entirety.

The unified transfer rates (for estates and gifts) are included at the end of the chapter for your review. Similar to individual and corporate taxes, the rates are progressive. For taxable estates up to $10,000 the rate is only 18%, yet on estates in excess of $1,500,000, the 2009 marginal rate is 45%. The cumulative and progressive nature of the unified transfer tax and the unified credit as it applies to estates and gifts is illustrated below:

Example 1: B died on December 6, 2009. On the date of death, B’s taxable estate was $3,500,000. In addition, since 1980, B made taxable gifts totaling $100,000 and paid no gift taxes. Calculate B’s estate tax:

<table>
<thead>
<tr>
<th>Taxable estate</th>
<th>$3,500,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Taxable gifts</td>
<td>100,000</td>
</tr>
<tr>
<td>Tentative tax base</td>
<td>$3,600,000</td>
</tr>
<tr>
<td>Tax on the first $2,000,000</td>
<td>$780,800</td>
</tr>
<tr>
<td>Tax on the next $1,600,000</td>
<td></td>
</tr>
<tr>
<td>$1,600,000 @ 45%</td>
<td>720,000</td>
</tr>
<tr>
<td>Estate tax</td>
<td>1,500,800</td>
</tr>
<tr>
<td>Less: Unified credit</td>
<td>-1,455,800</td>
</tr>
<tr>
<td>Estate tax payable</td>
<td>$45,000</td>
</tr>
</tbody>
</table>

Note that the cumulative taxable gifts made during B’s lifetime are included in the overall estate tax calculation. Notice also the progressive nature of the tax from the table and the use of the unified credit in reducing the tax payable.
ESTATE TAXATION

The gross estate of a decedent, who is a citizen or resident of the United States, includes the fair market value of their property and their right to control property, wherever situated, as of the date of death. Deductions are allowed for various expenses and debts of the estate. As previously mentioned, any taxable gifts made after 1976 are added to the estate in order to determine the unified transfer tax. This is then reduced by any gift taxes paid and the unified credit. The flow of this is as follows:

Gross estate
Less: Allowable deductions
Taxable estate
Plus: Post-76 taxable gifts
Tentative tax base

Tentative Unified Transfer Tax
Less: Gift taxes paid
Less: Unified Credit and other credits
Estate tax liability

GROSS ESTATE

Included in the gross estate is the property which the taxpayer has an interest in. Items typically included are:

- Cash
- Investments
- Real estate
- Personal property
- Life insurance proceeds

The proceeds of a life insurance policy are included in the gross estate if:

- the decedent possessed an incident of ownership at death, and
- they are received by the estate or, by another for the benefit of the estate.

If a taxpayer owns property jointly, only the portion of the property related to the taxpayer’s own contribution is included. However, if the taxpayer is married, 50% of the property is included.

The executor may also elect to value the estate at an alternate date, rather than at the date of death. This alternate valuation date is 6 months after the date of death, and must result in a lowering of the gross estate and the estate tax liability. If the alternate valuation date is elected, and any property is distributed prior to that date, that property is valued as of the distribution date.

There is, however, a special rule relating to certain transfers. When a decedent acquires appreciated property as a gift within one year of their death, and the property then passes back to that donor or that donor’s spouse upon death, then the basis stays at the basis as it was in the hands of the decedent. There is no step-up in basis.
ALLOWABLE DEDUCTIONS
Various deductions are allowed the estate in determining its taxable amount. These deductions include:

- Administrative expenses - ordinary and necessary, commissions, etc.
- Funeral expenses
- Debts of the estate, including medical bills
- Other claims against the estate
- Charitable contributions - only if provided in the will and it is a qualified charity.
- The unlimited marital deduction, if married - only for property passing to the spouse.
- State estate tax deduction

The executor may waive the right to claim certain expenses on the estate return if favor of claiming them as a deduction on the fiduciary return which may be required for income activity after the date of death.

UNIFIED CREDIT AND OTHER CREDITS
The unified credit of $1,455,800 is the equivalent to the tax on the first $3,500,000 of a taxable estate for 2009. This unified credit is allowed to all decedents. There is no longer a state estate tax credit. Instead, there is now a deduction for state estate taxes paid.

FILING REQUIREMENTS
An estate return (Form 706) is required to be filed within 9 months after the date of death. A return is not required to be filed unless the value of the gross estate exceeds $3,500,000 for 2009, less any taxable gifts made during their lifetime.

GIFT TAXATION
Gifting is a common event amongst taxpayers. A parent may give a child money for the downpayment of a house as a wedding present. A boyfriend may give an engagement ring to his fiancee. A grandparent may pay for a grandchild’s education. A wife may give investments to her husband. A parent lend money at a low or no interest rate. All these are transfers, and may be subject to taxation under the gift tax laws.

- A gift is made out of detached generosity. Nothing is expected in return. This is not the payment for services or any future benefits.
- A gift may also be a transfer to another person for less than the fair market value of the property.
- A taxpayer may exclude from gift taxation, up to $13,000 per year, per donee. This is referred to as a non-taxable gift.
- Husbands and wives may elect to split their gifts to take advantage of the $13,000 exclusion.
- Gifts between a husband and wife are fully excluded because of the unlimited marital deduction.

Example 2: G, a widower, gives his single daughter $15,000 as a downpayment on her first house. The first $13,000 is excluded and represents a non-taxable gift. The balance of $2,000 is a taxable gift.

Example 3: J, a widower, gives his daughter and her husband $10,000 each as a downpayment on their first house. The $20,000 in gifts represent two $10,000 non-taxable gifts. J could have given non-taxable gifts of up to $26,000 to his daughter and her husband (or $13,000 each).
Example 4: K sold his son an acre of land for $60,000. The land was worth $100,000. K has made a $40,000 gift to his son (the difference between the fair market value and the selling price). For gift tax purposes, K could exclude $13,000, leaving a $27,000 taxable gift.

Example 5: L and M are married and file a joint return. L has no assets, but M has investments worth $750,000. M gives her daughter a $30,000 gift. The $30,000 gift represents a $13,000 non-taxable gift and a $17,000 taxable gift from M. However, L and M may elect to split the gift. The result would be $26,000 in non-taxable gifts and a $4,000 taxable gift even though L did not actually make a gift.

Example 6: N and O are married and file a joint return. N has an investment portfolio worth $2,000,000 while O has, effectively, no assets. N gives his spouse $500,000. This gift qualifies for the unlimited marital deduction and is fully non-taxable.

VALUATION OF THE GIFT
In determining the amount of the gift for gift tax purposes, the taxpayer uses the fair market value, not the adjusted basis of the gift. However, for income tax purposes the general rule is that the adjusted basis of the gifted property and the related holding period transfers over from the donor to the donee. (See Chapter 6 for the rules related to basis).

Payments of medical expenses made directly to a medical facility are not considered to be taxable gifts, nor are tuition payments made directly to an educational institution. Gifts to charity are also excluded and are treated as a deduction for income tax purposes.

In order to qualify for the $13,000 exclusion, the gift must be for a present interest in property, not a future interest. An exception exists for a gift made to a child under the age of 21 where the child does not have access to the funds (both the principal and interest) until they reach age 21.

Example 7: R leaves a future interest in an investment trust to his brother M who is 40 years old. M will receive the principal and interest from the trust upon R’s death. The present value of the $2,000,00 investment trust using the IRS tables is $625,000. There is no $13,000 gift tax exclusion because this is a future interest. The entire $625,000 is a taxable gift.

Example 8: T’s uncle needed medical care. T decided she would provide $50,000 for her uncle’s care. If T simple gives her uncle the $50,000, it would result in a $37,000 ($50,000 less the $13,000). But, if T paid the hospital directly for her uncles care, then the entire $50,000 would be a non-taxable gift.
THE PROGRESSIVE AND CUMULATIVE NATURE OF THE TAX

The unified transfer tax (gift tax) is progressive and cumulative. As the taxable gifts are made over the years, they are accumulated and a new cumulative tax is determined at a progressively higher tax rate. (Please refer again to the rates at the end of the chapter for this next example). However, the maximum cumulative gift tax exclusion is limited to $1,000,000, unlike the estate tax limit of $3,500,000.

Example 9: K first began making gifts to her son in 2009 after she won the lottery. During 2009, K made the first gift to her son of $52,000. During 2010, K made another gift of $52,000. Exclusive of the unified credit, determine the gift tax.

<table>
<thead>
<tr>
<th>Year</th>
<th>Gift</th>
<th>Taxable Gift</th>
<th>Tax on Taxable Gift</th>
</tr>
</thead>
<tbody>
<tr>
<td>2009</td>
<td>$52,000</td>
<td>$40,000</td>
<td>$8,200</td>
</tr>
<tr>
<td>2010</td>
<td>$53,000</td>
<td>$40,000</td>
<td>$18,200</td>
</tr>
</tbody>
</table>

Notice that her gift tax on the first is $8,200, yet the tax jumps to $10,000 on the second identical taxable gift due to the cumulative and progressive nature of the tax.

GENERATION SKIPPING TRANSFERS

For transfer made from a grandparent to a grandchild, it is possible to defer the recognition of tax for two generations by having that transfer skip a generation. To prevent such a deferral, Congress instituted a tax on what are referred to these Generation Skipping Transfers. While the number of years that constitute a generation is not hard and fast, the intent is to prevent the avoidance of the estate tax through by-passing a generation. Similar to the estate tax, this has been repealed for 2010. The use of trusts may be used to skip a generation, but an easier example is called a direct skip, which is illustrated below.

Example 10: In 2009, Alan wants to make a $1,000,000 gift to his grandson Paul. Assuming that Alan is wealthy, has made taxable gifts in the past and has used up his unified credit, this gift would be subject to a 45% gift tax. But, since the gift skips a generation, the $1,000,000 would also be subject to the Generation Skipping Transfer Tax (GSTT) which is the highest marginal estate tax or 45%. In addition, the GSTT is also considered to be part of the gift, so the gift tax will actually be calculated on the $1,000,000 plus the $450,000 GSTT. The combined GSTT tax and the Gift Tax will actually exceed the $1,000,000 gift!
FILING REQUIREMENTS
Gift tax returns (Form 709) are required to be filed on an annual basis if a taxable gift is made during the taxable year. The Form 709 is due on April 15th. If a gift is made for less than the $13,000 exclusion, or it qualifies for the marital deduction, then no return is required. If the taxpayer is married, there is not married filing jointly gift tax return. Each taxpayer (husband and wife) files their own gift tax return. Also, a gift tax return is not required for a gift to a charitable organization unless a gift tax return is required to be filed for other gifts.

INCOME TAXATION OF FIDUCIARIES
Separate from the unified transfer tax previously discussed, the estate may also be subject to an income tax on the earnings after the date of death. For example, once the taxpayer dies, any income producing property is frequently held for the benefit of the beneficiaries. Until it is distributed, an income tax must be paid on the income.

Apart from an income tax on an estate, a trust may also be subject to tax. A trust is a legal entity that holds title to property for its beneficiaries. In general, trusts are either simple or complex. A simple trust is required to distribute all its income to its beneficiaries each year. A simple trust should not have any taxable income and is not allowed a deduction for charitable contributions. A complex trust is any other trust. It is allowed a deduction for charitable contributions and may also distribute principal.

In determining the taxable income for an estate or a trust (the fiduciary), the basic definition is income minus deductions equals taxable income.

- Any income distributed to the beneficiary is allowed as a deduction to prevent double taxation. The beneficiary recognizes the income (which is reported on a K-1 similar to that of a partnership), and the fiduciary receives the corresponding deduction. See DNI discussion below for limitations.
- A personal exemption is allowed as well. The amounts are:

<table>
<thead>
<tr>
<th>Type</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Simple Trust</td>
<td>$300</td>
</tr>
<tr>
<td>Complex Trust</td>
<td>$100</td>
</tr>
<tr>
<td>Estate</td>
<td>$600</td>
</tr>
</tbody>
</table>

DISTRIBUTABLE NET INCOME
The amount of income that is taxable to the beneficiary is limited to the amount of distributable net income (DNI). This is regardless of the amount that is actually distributed to the beneficiary. In determining the DNI, no deduction is allowed for the personal exemption. In general, capital gains and losses are also excluded from the computation. Tax-exempt interest is included on a limited basis.

TAX RATES
The income tax rates for estates and trusts for the 2010 year are:

<table>
<thead>
<tr>
<th>If taxable income is:</th>
<th>Then the tax is:</th>
</tr>
</thead>
<tbody>
<tr>
<td>Over --- but not over ---</td>
<td>of the amount over ---</td>
</tr>
<tr>
<td>$ 0</td>
<td>$ 0</td>
</tr>
<tr>
<td>2,300</td>
<td>2,300</td>
</tr>
<tr>
<td>5,350</td>
<td>5,350</td>
</tr>
<tr>
<td>8,200</td>
<td>8,200</td>
</tr>
<tr>
<td>11,200</td>
<td>11,200</td>
</tr>
<tr>
<td>$345.00</td>
<td>$345.00</td>
</tr>
<tr>
<td>$1,107.50</td>
<td>$1,107.50</td>
</tr>
<tr>
<td>$1,905.50</td>
<td>$1,905.50</td>
</tr>
<tr>
<td>$2,895.50</td>
<td>$2,895.50</td>
</tr>
<tr>
<td>15%</td>
<td>15%</td>
</tr>
<tr>
<td>+ 25%</td>
<td>+ 25%</td>
</tr>
<tr>
<td>+ 25%</td>
<td>+ 25%</td>
</tr>
<tr>
<td>+ 25%</td>
<td>+ 25%</td>
</tr>
<tr>
<td>+ 25%</td>
<td>+ 25%</td>
</tr>
</tbody>
</table>

12-6
FILING REQUIREMENTS
A fiduciary is required to file Form 1041 on the 15th day of the fourth month following the close of the taxable year. An estate may adopt a calendar year, or may choose a fiscal year beginning on the date of the decedent’s death. However, trusts are required to file on a calendar year basis. The gross income filing requirements for an estate and trust is $600 or more. If a trust has less than $600 of gross income, but has taxable income, it must also file.

TAXATION OF EXEMPT ORGANIZATIONS
The Internal Revenue Code exempts certain types of organizations from taxation. These organizations must:

* Provide for the common good
* Be a not-for-profit entity
* Its net earnings do not benefit its members
* It does not exert political influence

The Internal Revenue Code classifies these organization under Section 501. For example, an educational institution is a 501(c)(3) organization, while a social club is under 501(c)(7). Being classified as an exempt organization generally allows the organization to be a qualified organization so that donors may deduct any charitable contributions. Exemption organizations also receive a discount on postal rates and may be exempt from state and local taxes. Also, tax exempt organizations and Indian Tribes may maintain 401(k) plans.

Exempt organizations include, but are not limited to:

* Churches
* US Government organizations
* Chambers of commerce, business leagues, labor organizations, etc.
* Social clubs, recreation clubs if supported by membership dues, fees, etc.
* Private foundations
* Educational, research, medical, scientific and charitable organizations
* Condominium associations

In order to obtain an exempt status classification, the organization must request a determination from the Internal Revenue Service. The organization applying may be a corporation or a trust. Churches are not required to file a written request. Generally, they will file a request on Form 1023 or Form 1024. Once qualified, they must maintain their status and not engage in prohibited transactions. For example, lobbying to exert political influence may cause the loss of exempt status of an otherwise qualified organization, if the lobbying is deemed to be substantial.

Certain organizations cannot qualify as exempt organizations. They include:

* An organization created to influence legislation
* A feeder organization organized primarily for profit
* An organization that provides athletic facilities and equipment, to foster national and international sports competition
UNRELATED BUSINESS INCOME
Simply because an exempt organization conducts a trade or business, it does not negate its not-for-profit status. For example, an exempt organization may conduct the following activities:

* The activity utilizes volunteers conducting substantially all the work
* The activity sells merchandise received as contributions (Goodwill thrift shops)
* The activity is for the convenience of the employees, students, members, etc. (Bookstore)
* The activity is for employee unions, selling trade materials, work clothes, etc.

However, an organization may have what is referred to as unrelated business income (UBI) if it regularly conducts the activity which is not related to the exempt purpose and the activity produces income. Selling products to the general public and providing non-exempt services are possible examples.

There are exceptions to the UBI classification. The distribution of low cost items of $5 or less such as pens, stickers, etc., for purposes of solicitation is not an unrelated activity. Exchanging or the renting of membership lists is not an unrelated activity. A popular exam question pertains to bingo games. A qualified bingo game is not an unrelated business if:

* The game is legal under state and local law, and
* Commercial bingo games are generally not allowed in the area.

TAX ON UNRELATED BUSINESS INCOME
When it is determined that there is UBI, the entity is taxed on its UBI only if the UBI exceeds $1,000. The rate of tax on UBI is the corporate rate if the organization is a corporation, and the trust rate if the entity is a trust. The organization must make estimated tax payments as required by that entity (i.e., quarterly).

PRIVATE FOUNDATIONS
An organization may be classified as a private foundation. Private foundations are governed by a written charter and are generally required to distribute their net earnings during the year, or be subject to an excise tax on it. A foreign corporation may be a private foundation. The definition of a private organization is more of a default provision. The Code states that an organization described in Section 501(c)(3) which is not one of the following is a private foundation:

* Churches, their integrated auxiliaries, and conventions or associations
* Organizations with less than $5,000 in receipts
* An educational organization or medical research
* Organizations operated exclusively for testing public safety
* Organizations which are broadly supported by the general public or government units.

By broadly supported, the organization must receive more than one-third of its support from external sources (the general public, government units, churches, educational institutions, etc.) and less than one-third from internal support (investment income and unrelated business income).

FILING REQUIREMENTS
An exempt organization (with the exception of churches, federal agencies, and organizations with receipts which do not exceed $25,000) is required to file Form 990 by the 15th day of the fifth month after the close of their year. A penalty of $10 per day is assessed for late filing. An extension of three months is available by filing Form 2758. If the organization has UBI of at least $1,000, it is required to file Form 990-T as well. A private foundation must file Form 990-PF.
The following is the tax rate schedule for estates and gifts for 2009

**UNIFIED TRANSFER TAX RATES**

For Transfers Made in 2009

<table>
<thead>
<tr>
<th>If the Amount with Respect to Which the Tentative Tax to Be Computed Is:</th>
<th>The Tentative Tax Is:</th>
</tr>
</thead>
<tbody>
<tr>
<td>Not over $10,000</td>
<td>18% of such amount</td>
</tr>
<tr>
<td>Over $10,000 but not over $20,000</td>
<td>$1,800 plus 20% of the excess over $10,000</td>
</tr>
<tr>
<td>Over $20,000 but not over $40,000</td>
<td>$3,800 plus 22% of the excess over $20,000</td>
</tr>
<tr>
<td>Over $40,000 but not over $60,000</td>
<td>$8,200 plus 24% of the excess over $40,000</td>
</tr>
<tr>
<td>Over $60,000 but not over $80,000</td>
<td>$13,000 plus 26% of the excess over $60,000</td>
</tr>
<tr>
<td>Over $80,000 but not over $100,000</td>
<td>$18,200 plus 28% of the excess over $80,000</td>
</tr>
<tr>
<td>Over $100,000 but not over $150,000</td>
<td>$23,800 plus 30% of the excess over $100,000</td>
</tr>
<tr>
<td>Over $150,000 but not over $250,000</td>
<td>$38,800 plus 32% of the excess over $150,000</td>
</tr>
<tr>
<td>Over $250,000 but not over $500,000</td>
<td>$70,800 plus 34% of the excess over $250,000</td>
</tr>
<tr>
<td>Over $500,000 but not over $750,000</td>
<td>$155,800 plus 37% of the excess over $500,000</td>
</tr>
<tr>
<td>Over $750,000 but not over $1,000,000</td>
<td>$248,300 plus 39% of the excess over $750,000</td>
</tr>
<tr>
<td>Over $1,000,000 but not over $1,250,000</td>
<td>$345,800 plus 41% of the excess over $1,000,000</td>
</tr>
<tr>
<td>Over $1,250,000 but not over $1,500,000</td>
<td>$448,300 plus 43% of the excess over $1,250,000</td>
</tr>
<tr>
<td>Over $1,500,000</td>
<td>$555,800 plus 45% of the excess over $1,500,000</td>
</tr>
</tbody>
</table>
Form 706
United States Estate (and Generation-Skipping Transfer) Tax Return

1a Decedent's first name and middle initial (and maiden name, if any)  1b Decedent's last name  2 Decedent's Social Security No.

3a County, state, and ZIP code, or foreign country, of legal residence (domicile) at time of death  3b Year domicile established  4 Date of birth  5 Date of death

6a Name of executor (see page 5 of the instructions)  6b Executor's address (number and street including apartment or suite no.; city, town, or post office; state; and ZIP code) and phone no.

6c Executor's social security number (see page 5 of the instructions)  Phone no.: ( )

7a Name and location of court where will was probated or estate administered  7b Case number

8 If decedent died testate, check here □ and attach a certified copy of the will.  9 If you extended the time to file this Form 706, check here □

10 If Schedule R-1 is attached, check here □

<p>| | | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Total gross estate less exclusion (from Part 5—Recapitulation, page 3, item 12)</td>
<td></td>
</tr>
<tr>
<td>2</td>
<td>Tentative total allowable deductions (from Part 5—Recapitulation, page 3, item 22)</td>
<td></td>
</tr>
<tr>
<td>3a</td>
<td>Tentative taxable estate (before state death tax deduction) (subtract line 2 from line 1)</td>
<td></td>
</tr>
<tr>
<td>b</td>
<td>State death tax deduction</td>
<td></td>
</tr>
<tr>
<td>c</td>
<td>Taxable estate (subtract line 3b from line 3a)</td>
<td></td>
</tr>
<tr>
<td>4</td>
<td>Adjusted taxable gifts (total taxable gifts within the meaning of section 2503) made by the decedent after December 31, 1976, other than gifts that are includible in decedent’s gross estate (section 2001(b))</td>
<td></td>
</tr>
<tr>
<td>5</td>
<td>Add lines 3c and 4</td>
<td></td>
</tr>
<tr>
<td>6</td>
<td>Tentative tax on the amount on line 5 from Table A on page 4 of the instructions</td>
<td></td>
</tr>
<tr>
<td>7</td>
<td>Total gift tax paid or payable with respect to gifts made by the decedent after December 31, 1976, including gift taxes by the decedent’s spouse for such spouse’s share of split gifts (section 2513) only if the decedent was the donor of these gifts and they are includible in the decedent’s gross estate (see instructions)</td>
<td></td>
</tr>
<tr>
<td>8</td>
<td>Gross estate tax (subtract line 7 from line 6)</td>
<td></td>
</tr>
<tr>
<td>9</td>
<td>Maximum unified credit (applicable credit amount) against estate tax</td>
<td></td>
</tr>
<tr>
<td>10</td>
<td>Adjustment to unified credit (applicable credit amount). (This adjustment may not exceed $6,000. See page 6 of the instructions.)</td>
<td></td>
</tr>
<tr>
<td>11</td>
<td>Allowable unified credit (applicable credit amount) (subtract line 10 from line 9)</td>
<td></td>
</tr>
<tr>
<td>12</td>
<td>Subtract line 11 from line 8 (but do not enter less than zero)</td>
<td></td>
</tr>
<tr>
<td>13</td>
<td>Credit for foreign death taxes (from Schedule(s) P). (Attach Form(s) 706-CE.)</td>
<td></td>
</tr>
<tr>
<td>14</td>
<td>Credit for tax on prior transfers (from Schedule Q)</td>
<td></td>
</tr>
<tr>
<td>15</td>
<td>Total credits (add lines 13 and 14)</td>
<td></td>
</tr>
<tr>
<td>16</td>
<td>Net estate tax (subtract line 15 from line 12)</td>
<td></td>
</tr>
<tr>
<td>17</td>
<td>Generation-skipping transfer (GST) taxes payable (from Schedule R, Part 2, line 10)</td>
<td></td>
</tr>
<tr>
<td>18</td>
<td>Total transfer taxes (add lines 16 and 17)</td>
<td></td>
</tr>
<tr>
<td>19</td>
<td>Prior payments. Explain in an attached statement</td>
<td></td>
</tr>
<tr>
<td>20</td>
<td>Balance due (or overpayment) (subtract line 19 from line 18)</td>
<td></td>
</tr>
</tbody>
</table>

Under penalties of perjury, I declare that I have examined this return, including accompanying schedules and statements, and to the best of my knowledge and belief, it is true, correct, and complete. Declaration of preparer other than the executor is based on all information of which preparer has any knowledge.

Sign Here

Signature of executor

Date

Signature of executor

Date

Preparer’s signature

Date  Check if self-employed □  Preparer’s SSN or PTIN

Firm’s name (or yours if self-employed), address, and ZIP code

EIN □

Phone no.: ( )

For Privacy Act and Paperwork Reduction Act Notice, see page 30 of the separate instructions for this form.
Form 709
United States Gift (and Generation-Skipping Transfer) Tax Return
(For gifts made during calendar year 2010)

Part 1 — General Information
1. Donor's first name and middle initial
2. Donor's last name
3. Donor's social security number
4. Address (number, street, and apartment number)
5. Legal residence (domestic)
6. City, state, and ZIP code
7. Citizenship (see instructions)

8. If the donor died during the year, check here □ and enter date of death .
9. If you extended the time to file this Form 709, check here □.
10. Enter the number of donees listed on Schedule A. Count each person only once. □
11a. Have you (the donor) previously filed a Form 709 (or 709-A) for any other year? If "No," skip line 11b.
11b. If the answer to line 11a is "Yes," has your address changed since you last filed Form 709 (or 709-A)?

Part 2 — General Information
12. Gifts by husband or wife to third parties. Do you consent to have the gifts (including generation-skipping transfers) made by you and by your spouse to third parties during the calendar year considered as made one-half by each of you? (See instructions.) If the answer is "Yes," the following information must be furnished and your spouse must sign the consent shown below. If the answer is "No," skip lines 13–18 and go to Schedule A.

Consenting spouse's signature □
Date □

Part 2 — Tax Computation
1. Enter the amount from Schedule A, Part 4, line 11 □
2. Enter the amount from Schedule B, line 1 □
3. Total taxable gifts. Add lines 1 and 2 □
4. Tax computed on amount on line 3 (see Table for Computing Gift Tax in separate instructions) □
5. Tax computed on amount on line 2 (see Table for Computing Gift Tax in separate instructions) □
6. Balance. Subtract line 5 from line 4 □
7. Maximum unified credit (nonresident aliens, see instructions) □
8. Enter the unified credit against tax allowable for all prior periods (from Sch. B, line 1, col. C) □
9. Balance. Subtract line 8 from line 7. Do not enter less than zero □
10. Enter 20% (20) of the amount allowed as a specific exemption for gifts made after September 6, 1976, and before January 1, 1977 (see instructions) □
11. Balance. Subtract line 10 from line 9. Do not enter less than zero □
12. Unified credit. Enter the smaller of line 6 or line 11 □
13. Credit for foreign gift taxes (see instructions) □
14. Total credits. Add lines 12 and 13 □
15. Balance. Subtract line 14 from line 8. Do not enter less than zero □
17. Total tax. Add lines 15 and 16 □
18. Gift and generation-skipping transfer taxes prepaid with extension of time to file □
19. If line 18 is less than line 17, enter balance due (see instructions) □
20. If line 18 is greater than line 17, enter amount to be refunded □

Sign Here

Signature of donor □
Date □

Paid Preparer Use Only
Print/Type preparer's name □
Preparer's signature □
Date □
Check □ if self-employed □

For Disclosure, Privacy Act, and Paperwork Reduction Act Notice, see the separate instructions for this form. Cat. No. 1678E Form 709 (2010)
### U.S. Income Tax Return for Estates and Trusts 2010

**Form 1041**

**Type of entity (see instructions):**
- [ ] Decedent's estate
- [ ] Simple trust
- [ ] Complex trust
- [ ] Qualified disability trust
- [ ] FBRT (5 percent or less)
- [ ] Grantor trust
- [ ] Bankruptcy estate-Cl. 7
- [ ] Bankruptcy estate-Ch. 11
- [ ] Pooled income fund

**For calendar year 2010 or fiscal year beginning (2010, and ending):**

**Name of estate or trust:**

**Name and title of fiduciary:**

**Number, street, and room or suite no. (If a P.O. box, see page 16 of the instructions):**

**City or town, state, and ZIP code:**

**Check here if the estate or filing trust made a section 645 election:**

**Number of schedules K-1 attached (see instructions):**

**Check applicable boxes:**
- [ ] Initial return
- [ ] Final return
- [ ] Amended return
- [ ] Change in fiduciary's name
- [ ] Change in fiduciary's address

#### Income

1. **Interest income:**
   - 1a. Total ordinary dividends
   - 1b. Qualified dividends allocable to:
     - 1b1. Beneficiaries
     - 1b2. Estate or trust
   - 1c. Business income (losses)
      - 1c1. Attach Schedule C or C-EZ (Form 1040)
      - 1c2. Estate or trust
   - 1d. Capital gain (losses)
      - 1d1. Attach Schedule D (Form 1041)
   - 1e. Rents, royalties, partnerships, other estates and trusts, etc.
      - 1e1. Attach Schedule E (Form 1040)
   - 1f. Farm income (losses)
      - 1f1. Attach Schedule F (Form 1040)
   - 1g. Ordinary gain (loss)
      - 1g1. Attach Form 4797
   - 1h. Other income
      - 1h1. List type and amount
   - 1i. **Total income:** Combine lines 1, 2a, and 3 through 8

2. **Taxes:**
   - 2a. Federal income tax withheld
   - 2b. Other taxes
   - 2c. Social security tax withheld
   - 2d. Medicare tax withheld

3. **Fiduciary fees:**

4. **Charitable deduction (from Schedule A, line 7):**

5. **Attorney, accountant, and return preparer fees:**

6. **Other deductions not subject to the 2% floor (attach schedule):**
   - 6a. Allowable miscellaneous itemized deductions subject to the 2% floor
   - 6b. Add lines 10 through 15b
   - 6c. Adjusted total income or (loss), Subtract line 16 from line 9

7. **Income distribution deduction (from Schedule B, line 15):**

8. **Estate tax deduction including certain generation-skipping taxes (attach computation):**

9. **Exemption:**

10. **Add lines 18 through 20:**

11. Taxable income. Subtract line 21 from line 17. If a loss, see page 23 of the instructions

12. **Total tax:** (from Schedule G, line 7)

13. **Payments:**
   - 24a. 2010 estimated tax payments and amount applied from 2009 return
   - 24b. Estimated tax payments allocated to beneficiaries (from Form 1041-T)
   - 24c. Subtract line 24b from line 24a
   - 24d. Tax paid with Form 7004 (see page 24 of the instructions)
   - 24e. Federal income tax withheld. If any is from Form(s) 1099, check
   - 24f. Other payments: f Form 2439 (g Form 4138); Total

14. **Total payments. Add lines 24c through 24e, and 24h:**

15. **Estimated tax penalty (see page 24 of the instructions):**

16. **Tax due:**
   - If line 25 is smaller than the total of lines 23 and 26, enter amount owed
   - If line 25 is larger than the total of lines 23 and 26, enter amount overpaid

17. **Amount of line 25 to be a. Credited to 2011 estimated tax:**

18. **Refunded:**

**Sign Here**

Signature of fiduciary or officer representing fiduciary

**Date**

**EIN of fiduciary if a financial institution**

**Paid Preparer Use Only**

Preparer's name

Preparer's signature

Date

Check if self-employed

Preparer's EIN

Preparer's phone number

For Paperwork Reduction Act Notice, see the separate instructions.
Chapter Twelve — Questions
Taxation of Gifts, Estates and Fiduciaries, and Not for Profit Organizations

GIFT AND ESTATE TAXATION

1. Under the unified rate schedule for 2009,
   a. Lifetime taxable gifts are taxed on a non-cumulative basis.
   b. Transfers at death are taxed on a non-cumulative basis.
   c. Lifetime taxable gifts and transfers at death are taxed on a cumulative basis.
   d. The gift tax rates are 5% higher than the estate tax rates.

2. What amount of a decedent's taxable estate is effectively tax-free if the maximum unified estate and gift credit is taken for 2009?
   a. $555,800
   b. $780,800
   c. $2,000,000
   d. $3,500,000

Items 3 through 5 are based on the following data:
Alan Curtis, a U.S. citizen, died on March 1 of this year, leaving a gross estate with a fair market value of $3,900,000 at the date of death. Under the terms of Alan's will, $375,000 was bequeathed outright to his widow, free of all estate and inheritance taxes. The remainder of Alan's estate was left to his mother. Alan made no taxable gifts during his lifetime.

3. Disregarding extensions of time for filing, within how many months after the date of Alan's death is the federal estate tax return due?
   a. 2½
   b. 3½
   c. 9
   d. 12

4. In computing the taxable estate, the executor of Alan's estate should claim a marital deduction of
   a. $250,000
   b. $375,000
   c. $1,000,000
   d. $1,400,000

5. If the executor of a decedent's estate elects the alternate valuation date and none of the property included in the gross estate has been sold or distributed, the estate assets must be valued as of how many months after the decedent's death?
   a. 12
   b. 9
   c. 6
   d. 3

6. Eng and Lew, both U.S. citizens, died in 2009. Eng made taxable lifetime gifts of $100,000. Lew made no lifetime gifts. At the dates of death, Eng's gross estate was $300,000, and Lew's gross estate was $400,000. A federal estate tax return must be filed for
   a. No No
   b. No Yes
   c. Yes No
   d. Yes Yes

7. Which of the following credits may be offset against the gross estate tax to determine the 2009 net estate tax of a U.S. citizen?
   a. Yes Yes
   b. No No
   c. No Yes
   d. Yes No

8. The following are the fair market values of Wald's assets at the date of death:
   Personal effects and jewelry $150,000
   Land bought by Wald with Wald's funds five years prior to death and held with Wald's sister as joint tenants with right of survivorship 900,000

The executor of Wald's estate did not elect the alternate valuation date. The amount included as Wald's gross estate is
   a. $150,000
   b. $550,000
   c. $900,000
   d. $1,050,000
9. Fred and Amy Kehl, both U.S. citizens, are married. All of their real and personal property is owned by them as tenants by the entirety or as joint tenants with right of survivorship. The gross estate of the first spouse to die:
   a. Includes 50% of the value of all property owned by the couple, regardless of which spouse furnished the original consideration.
   b. Includes only the property that had been acquired with the funds of the deceased spouse.
   c. Is governed by the federal statutory provisions relating to jointly held property, rather than by the decedent's interest in community property vested by state law, if the Kehls reside in a community property state.
   d. Includes one-third of the value of all real estate owned by the Kehls, as the dower right in the case of the wife or curtesy right in the case of the husband.

10. In connection with a "buy-sell" agreement funded by a cross-purchase insurance arrangement, business associate Adam bought a policy on Burr's life to finance the purchase of Burr's interest. Adam, the beneficiary, paid the premiums and retained all incidents of ownership. On the death of Burr, the insurance proceeds will be:
   a. Included in Burr's gross estate, if Burr owns 50% or more of the stock of the corporation.
   b. Included in Burr's gross estate only if Burr had purchased a similar policy on Adam's life at the same time and for the same purpose.
   c. Included in Burr's gross estate, if Adam has the right to veto Burr's power to borrow on the policy that Burr owns on Adam's life.
   d. Excluded from Burr's gross estate.

11. Which of the following is (are) deductible from a decedent's gross estate?

   I. Expenses of administering and settling the estate.
   II. State inheritance or estate tax.

   a. I only.
   b. II only.
   c. Both I and II.
   d. Neither I nor II.

12. Bell, a cash basis calendar year taxpayer, died on June 1, 2010. In 2010, prior to her death, Bell incurred $2,000 in medical expenses. The executor of the estate paid the medical expenses, which were a claim against the estate, on July 1, 2010. If the executor files the appropriate waiver, the medical expenses are deductible on:

a. The estate tax return.
b. Bell's final income tax return.
c. The estate income tax return.
d. The executor's income tax return.

13. With regard to the federal estate tax, the alternate valuation date:

   a. Is required to be used if the fair market value of the estate's assets has increased since the decedent's date of death.
   b. If elected on the first return filed for the estate, may be revoked in an amended return provided that the first return was filed on time.
   c. Must be used for valuation of the estate's liabilities if such date is used for valuation of the estate's assets.
   d. Can be elected only if its use decreases both the value of the gross estate and the estate tax liability.

14. Proceeds of a life insurance policy payable to the estate's executor, as the estate's representative, are:

   a. Included in the decedent's gross estate only if the premiums had been paid by the insured.
   b. Included in the decedent's gross estate only if the policy was taken out within three years of the insured's death under the "contemplation of death" rule.
   c. Always included in the decedent's gross estate.
   d. Never included in the decedent's gross estate.

15. In 1991, Edwin Ryan bought 100 shares of a listed stock for $5,000. In June 2010, when the stock's fair market value was $7,000, Edwin gave this stock to his sister, Lynn. No gift tax was paid. Lynn died in October 2010, bequeathing this stock to Edwin, when the stock's fair market value was $9,000. Lynn's executor did not elect the alternate valuation. What is Edwin's basis for this stock after he inherits it from Lynn's estate?

   a. $0
   b. $5,000
   c. $7,000
   d. $9,000

16. On July 1, 2010, Vega made a transfer by gift in an amount sufficient to require the filing of a gift tax return. Vega was still alive in 2011. If Vega did not request an extension of time for filing the 2010 gift tax return, the due date for filing was:

   b. April 15, 2011.
17. In 2010, Sayers, who is single, gave an outright gift of $50,000 to a friend, Johnson, who needed the money to pay medical expenses. In filing the 2010 gift tax return, Sayers was entitled to a maximum exclusion of
a. $0
b. $12,000
c. $13,000
d. $50,000

18. When Jim and Nina became engaged in April, Jim gave Nina a ring that had a fair market value of $50,000. After their wedding in July, Jim gave Nina $75,000 in cash so that Nina could have her own bank account. Both Jim and Nina are U.S. citizens. What was the amount of Jim’s marital deduction?

   a. $38,000
   b. $75,000
   c. $114,000
   d. $125,000

19. Blake transferred a corporate bond this year with a face amount and fair market value of $20,000 to a trust for the benefit of her 16-year-old child. Annual interest on this bond is $2,000, which is to be accumulated in the trust and distributed to the child on reaching the age of 21. The bond is then to be distributed to the donor or her successor-in-interest in liquidation of the trust. Present value of the total interest to be received by the child is $8,710. The amount of the gift that is excluded from taxable gifts is
a. $20,000
b. $12,000
c. $8,710
d. $0

20. Steve and Kay Briar, U.S. citizens, were married for the entire calendar year. During the 2010 year, Steve gave a $30,000 cash gift to his sister. The Briars made no other gifts. They each signed a timely election to treat the $30,000 gift as made one-half by each spouse. Disregarding the unified credit and estate tax consequences, what amount of the gift is taxable to the Briars?
   a. $30,000
   b. $10,000
c. $6,000
d. $4,000

21. Which of the following requires filing a gift tax return, if the transfer exceeds the available annual gift tax exclusion?
   a. Medical expenses paid directly to a physician on behalf of an individual unrelated to the donor.
   b. Tuition paid directly to an accredited university on behalf of an individual unrelated to the donor.
   c. Payments for college books, supplies, and dormitory fees on behalf of an individual unrelated to the donor.
   d. Campaign expenses paid to a political organization.

22. Jan, an unmarried individual, gave the following outright gifts during the 2010 year:

<table>
<thead>
<tr>
<th>Donee</th>
<th>Amount</th>
<th>Use by donee</th>
</tr>
</thead>
<tbody>
<tr>
<td>Jones</td>
<td>$15,000</td>
<td>Down payment on house</td>
</tr>
<tr>
<td>Craig</td>
<td>14,000</td>
<td>College tuition</td>
</tr>
<tr>
<td>Kande</td>
<td>5,000</td>
<td>Vacation trip</td>
</tr>
</tbody>
</table>

Jan's exclusions for gift tax purposes should total
a. $29,000
b. $31,000
c. $33,000
d. $34,000

TAXATION OF FIDUCIARIES

23. Ordinary and necessary administration expenses paid by the fiduciary of an estate are deductible
   a. Only on the fiduciary income tax return (Form 1041) and never on the federal estate tax return (Form 706).
   b. Only on the federal estate tax return and never on the fiduciary income tax return.
   c. On the fiduciary income tax return only if the estate tax deduction is waived for these expenses.
   d. On both the fiduciary income tax return and the estate tax return by adding a tax computed on the proportionate rates attributable to both returns.

24. Ross, a calendar-year, cash basis taxpayer who died in June 2010, was entitled to receive a $10,000 accounting fee that had not been collected before the date of death. The executor of Ross' estate collected the full $10,000 in July 2010. This $10,000 should appear in
   a. Only the decedent's final individual income tax return.
   b. Only the estate's fiduciary income tax return.
   c. Only the estate tax return.
   d. Both the fiduciary income tax return and the estate tax return.
25. With regard to estimated income tax, estates
   a. Must make quarterly estimated tax payments starting
      no later than the second quarter following the one in
      which the estate was established.
   b. Are exempt from paying estimated tax during the
      estate's first two taxable years.
   c. Must make quarterly estimated tax payments only if
      the estate's income is required to be distributed
      currently.
   d. Are not required to make payments of estimated tax.

26. An executor of a decedent's estate that has only U.S.
   citizens as beneficiaries is required to file a fiduciary
   income tax return, if the estate's gross income for the
   year is at least
   a. $100
   b. $300
   c. $600
   d. $650

27. The charitable contribution deduction on an estate's
   fiduciary income tax return is allowable
   a. If the decedent died intestate.
   b. To the extent of the same adjusted gross income
      limitation as that on an individual income tax return.
   c. Only if the decedent's will specifically provides for
      the contribution.
   d. Subject to the 2% threshold on miscellaneous
      itemized deductions.

28. Raff died in 2010 leaving her entire estate to her
    only child. Raff's will gave full discretion to the estate's
    executor with regard to distributions of income. For
    2010 the estate's distributable net income was $15,000,
    of which $9,000 was paid to the beneficiary. None of
    the income was tax exempt. What amount can be
    claimed on the estate's 2010 fiduciary income tax return
    for the distributions deduction?
   a. $0
   b. $6,000
   c. $9,000
   d. $15,000

Items 29 and 30 are based on the following:

Lyon, a cash basis taxpayer, died on January 15, 2010. In
2010, the estate executor made the required periodic
distribution of $9,000 from estate income to Lyon's sole
heir. The following pertains to the estate's income and
disbursements in 2010:

<table>
<thead>
<tr>
<th>2010 Estate Income</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>$20,000</td>
<td>Taxable interest</td>
</tr>
<tr>
<td>10,000</td>
<td>Net long-term capital gains allocable to corpus</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>2010 Estate Disbursements</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>$5,000</td>
<td>Administrative expenses attributable to taxable income</td>
</tr>
</tbody>
</table>

29. For the 2010 calendar year, what was the estate's
   distributable net income (DNI)?
   a. $15,000.
   b. $20,000.
   c. $25,000.
   d. $30,000.

30. Lyon's executor does not intend to file an extension
   request for the estate fiduciary income tax return. By
   what date must the executor file the Form 1041, U.S.
   Fiduciary Income Tax Return, for the estate's 2010
   calendar year?
   b. April 15, 2011.
   d. September 15, 2011.

31. A distribution from estate income, that was
    currently required, was made to the estate's sole
    beneficiary during its calendar year. The maximum
    amount of the distribution to be included in the
    beneficiary's gross income is limited to the estate's
    a. Capital gain income.
    b. Ordinary gross income.
    c. Distributable net income.
    d. Net investment income.

32. A distribution to an estate's sole beneficiary for the
    2010 calendar year equaled $15,000, the amount
    currently required to be distributed by the will. The
    estate's 2010 records were as follows:

<table>
<thead>
<tr>
<th>Estate income</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>$40,000</td>
<td>Taxable interest</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Estate disbursements</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>$34,000</td>
<td>Expenses attributable to taxable interest</td>
</tr>
</tbody>
</table>
What amount of the distribution was taxable to the beneficiary?
a. $40,000
b. $15,000
c. $6,000
d. $0

33. The 2010 standard deduction for a trust or an estate in the fiduciary income tax return is
a. $0
b. $100
c. $300
d. $600

34. Which of the following fiduciary entities are required to use the calendar year as their taxable period for income tax purposes?

<table>
<thead>
<tr>
<th>Estates</th>
<th>Trusts (except those that are tax exempt)</th>
</tr>
</thead>
<tbody>
<tr>
<td>a.</td>
<td>Yes</td>
</tr>
<tr>
<td>b.</td>
<td>No</td>
</tr>
<tr>
<td>c.</td>
<td>Yes</td>
</tr>
<tr>
<td>d.</td>
<td>No</td>
</tr>
</tbody>
</table>

EXEMPT ORGANIZATIONS

35. To qualify as an exempt organization other than a church or an employees' qualified pension or profit-sharing trust, the applicant
a. Cannot operate under the "lodge system" under which payments are made to its members for sick benefits.
b. Need not be specifically identified as one of the classes on which exemption is conferred by the Internal Revenue Code, provided that the organization's purposes and activities are of a nonprofit nature.
c. Is barred from incorporating and issuing capital stock.
d. Must file a written application with the Internal Revenue Service.

36. To qualify as an exempt organization, the applicant
a. May be organized and operated for the primary purpose of carrying on a business for profit, provided that all of the organization's net earnings are turned over to one or more tax exempt organizations.
b. Need not be specifically identified as one of the classes upon which exemption is conferred by the Internal Revenue Code, provided that the organization's purposes and activities are of a nonprofit nature.
c. Must not be classified as a social club.
d. Must not be a private foundation organized and operated exclusively to influence legislation pertaining to protection of the environment.

37. Carita Fund, organized and operated exclusively for charitable purposes, provides insurance coverage, at amounts substantially below cost, to exempt organizations involved in the prevention of cruelty to children. Carita's insurance activities are
a. Exempt from tax.
b. Treated as unrelated business income.
c. Subject to the same tax provisions as those applicable to insurance companies.
d. Considered "commercial-type" as defined by the Internal Revenue Code.

38. Which of the following exempt organizations must file annual information returns?

a. Churches.
b. Internally supported auxiliaries of churches.
c. Private foundations.
d. Those with gross receipts of less than $5,000 in each taxable year.

39. The private foundation status of an exempt organization will terminate if it
a. Becomes a public charity.
b. Is a foreign corporation.
c. Does not distribute all of its net assets to one or more public charities.
d. Is governed by a charter that limits the organization's exempt purposes.

40. Which of the following statements is correct regarding the unrelated business income of exempt organizations?

a. If an exempt organization has any unrelated business income, it may result in the loss of the organization's exempt status.
b. Unrelated business income relates to the performance of services, but not to the sale of goods.
c. An unrelated business does not include any activity where all the work is performed for the organization by unpaid volunteers.
d. Unrelated business income tax will not be imposed if profits from the unrelated business are used to support the exempt organization's charitable activities.
41. Which of the following activities regularly carried out by an exempt organization will not result in unrelated business income?
   a. The sale of laundry services by an exempt hospital to other hospitals.
   b. The sale of heavy duty appliances to senior citizens by an exempt senior citizen's center.
   c. Accounting and tax services performed by a local chapter of a labor union for its members.
   d. The sale by a trade association of publications used as course materials for the association's seminars which are oriented towards its members.

42. An incorporated exempt organization subject to tax on its unrelated business income
   a. Must make estimated tax payments if its tax can reasonably be expected to be $100 or more.
   b. Must comply with the Code provisions regarding installment payments of estimated income tax by corporations.
   c. Must pay at least 70% of the tax due as shown on the return when filed, with the balance of tax payable in the following quarter.
   d. May defer payment of the tax for up to nine months following the due date of the return.

43. The filing of a return covering unrelated business income
   a. Is required of all exempt organizations having at least $1,000 of unrelated business taxable income for the year.
   b. Relieves the organization of having to file a separate annual information return.
   c. Is not necessary if all of the organization's income is used exclusively for charitable purposes.
   d. Must be accompanied by a minimum payment of 50% of the tax due as shown on the return, with the balance of tax payable six months later.

44. During 2010, Help, Inc., an exempt organization, derived income of $15,000 from conducting bingo games. Conducting bingo games is legal in Help's locality and is confined to exempt organizations in Help's state. Which of the following statements is true regarding this income?
   a. The entire $15,000 is subject to tax at a lower rate than the corporate income tax rate.
   b. The entire $15,000 is exempt from tax on unrelated business income.
   c. Only the first $5,000 is exempt from tax on unrelated business income.
   d. Since Help has unrelated business income, Help automatically forfeits its exempt status for 2006.

45. An organization that operates for the prevention of cruelty to animals will fail to meet the operational test to qualify as an exempt organization if
   a. Computed at corporate income tax rates.
   b. Computed at rates applicable to trusts.
   c. Credited against the tax on recognized capital gains.
   d. Abated.

46. The organization that directly participates in any political campaign
   a. Engages in insubstantial nonexempt activities
   b. Yes
   c. No
   d. Yes

47. Which one of the following statements is correct with regard to unrelated business income of an exempt organization?
   a. An exempt organization that earns any unrelated business income in excess of $100,000 during a particular year will lose its exempt status for that particular year.
   b. An exempt organization is not taxed on unrelated business income of less than $1,000.
   c. The tax on unrelated business income can be imposed even if the unrelated business activity is intermittent and is carried on once a year.
   d. An unrelated trade or business activity that results in a loss is excluded from the definition of unrelated business.
48. The organizational test to qualify a public service charitable entity as tax exempt requires the articles of organization to

I. Limit the purpose of the entity to the charitable purpose.

II. State that an information return should be filed annually with the Internal Revenue Service.

a. I only.
   b. II only.
   c. Both I and II.
   d. Neither I nor II.

49. Which of the following activities regularly conducted by a tax exempt organization will result in unrelated business income?

I. Selling articles made by handicapped persons as part of their rehabilitation, when the organization is involved exclusively in their rehabilitation.

II. Operating a grocery store almost fully staffed by emotionally handicapped persons as part of a therapeutic program.

a. I only.
   b. II only.
   c. Both I and II.
   d. Neither I nor II.

51. Under the provisions of a decedent's will, the following cash disbursements were made by the estate's executor:

I. A charitable bequest to the American Red Cross.
II. Payment of the decedent's funeral expenses.

What deduction(s) is(are) allowable in determining the decedent's taxable estate?

a. I only.
   b. II only.
   c. Both I and II.
   d. Neither I nor II.

52. Astor, a cash-basis taxpayer, dies on February 3. During the year, the estate’s executor made a distribution of $12,000 from the estate income to Astor’s sole heir and adopted a calendar year to determine the estate’s taxable income. The following additional information pertains to the estate’s income and disbursements for the year:

<table>
<thead>
<tr>
<th>Estate income:</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Taxable interest</td>
<td>$65,000</td>
</tr>
<tr>
<td>Net long-term capital gains allocable to corpus</td>
<td>5,000</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Estate disbursements</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Administrative expenses allocable to taxable income</td>
<td>14,000</td>
</tr>
<tr>
<td>Charitable contributions from gross income to a public charity per the will</td>
<td>9,000</td>
</tr>
</tbody>
</table>

For the calendar year, what was the estate’s distributable net income (DNI)?

a. $39,000
   b. $42,000
   c. $58,000
   d. $65,000

53. For income tax purposes, the estate’s initial taxable period for a decedent who dies on October 24:

a. May be either a calendar year, or a fiscal year beginning on the date of the decedent’s death.
   b. Must be a fiscal year beginning on the date of the decedent’s death.
   c. May be either a calendar year, or a fiscal year beginning on October 1 of the year of the decedent’s death.
   d. Must be a calendar year beginning on January 1 of the year of the decedent’s death.
54. Which of the following is allowed in the calculation of the taxable income of a simple trust?
   a. Exemption
   b. Standard deduction
   c. Brokerage commission for the purchase of tax-exempt bonds
   d. Charitable contribution

55. During the current year, Mann, an unmarried U.S. citizen, made a $5,000 cash gift to an only child and also paid $25,000 in tuition expenses directly to a grandchild’s university on her grandchild’s behalf. Mann made no other lifetime transfers. Assume that the gift tax annual exclusion is $13,000. For gift tax purposes, what was Mann’s taxable gift?
   a. $30,000
   b. $25,000
   c. $17,000
   d. $0

56. George and Suzanne have been married for 40 years. Suzanne inherited $1,000,000 from her mother. Assume that the annual gift-tax exclusion is $13,000. What amount of the $1,000,000 can Suzanne give to George without incurring a gift-tax liability?
   a. $13,000
   b. $24,000
   c. $500,000
   d. $1,000,000

57. Under which of the following circumstances is trust property with an independent trustee includible in the grantor’s gross estate?
   a. The trust is revocable.
   b. The trust is established for a minor.
   c. The trust has the power to distribute trust income.
   d. The income beneficiary disclaims the property, which then passes to the remainderman, the grantor’s friend.

58. The Simone Trust reported distributable net income of $120,000 for the current year. The trustee is required to distribute $60,000 to Kent and $90,000 to Lind each year. If the trustee distributes these amounts, what amount is includible in Lind’s gross income?
   a. $0
   b. $60,000
   c. $72,000
   d. $90,000

59. Which of the following payments would require the donor to file a gift tax return?
   a. $30,000 to a university for a spouse’s tuition.
   b. $40,000 to a university for a cousin’s room and board.
   c. $50,000 to a hospital for a parent’s medical expenses.
   d. $80,000 to a physician for a friend’s surgery.

60. Maple Avenue Assembly, a tax-exempt religious organization, operates an outreach program for the poor in its community. A candidate for the local city council has endorsed Maple’s anti-poverty program. Which of the following activities is(are) consistent with Maple's tax-exempt status?
   I. Endorsing the candidate to members.
   II. Collecting contributions from members for the candidate.
   a. I only.
   b. II only.
   c. Both I and II.
   d. Neither I nor II

61. Hope is a tax-exempt religious organization. Which of the following activities is (are) consistent with Hope’s tax-exempt status?
   I. Conducting weekend retreats for business organizations
   II. Providing traditional burial services that maintain the religious beliefs of its members.
   a. I only
   b. II only
   c. Both I and II
   d. Neither I nor II
Chapter Twelve — Answers
Taxation of Gifts, Estates and Fiduciaries, and Not for Profit Organizations

1. (c) Taxable gifts made over a lifetime are taxed on a cumulative basis at progressive rates. The lifetime gifts are added to the transfers at death, and taxed at progressive rates.

2. (d) $3,500,000. The unified estate tax credit for 2009 is $1,455,800. The credit is equivalent to the tax on a $3,500,000 taxable estate.

3. (c) 9 months. The estate tax return (Form 706) must be filed 9 months after the date of death, unless an extension is granted.

4. (b) $375,000. Only the value of the property bequeathed outright to his wife qualifies for the marital deduction.

5. (c) 6. An executor may elect to value the estate on the alternate valuation date which is 6 months after the date of death. Any property distributed before this date is valued as of the date of distribution. The property remaining in the estate is valued as of this alternate valuation date.

6. (a) The requirement to file an estate return in 2009 is a gross estate plus cumulative taxable gifts of $3,500,000. Neither Eng or Lew exceed $3,500,000.

<table>
<thead>
<tr>
<th></th>
<th>Eng</th>
<th>Lew</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cumulative taxable gifts</td>
<td>$100,000</td>
<td>$0</td>
</tr>
<tr>
<td>Gross estate</td>
<td>$300,000</td>
<td>$400,000</td>
</tr>
<tr>
<td>Total</td>
<td>$400,000</td>
<td>$400,000</td>
</tr>
</tbody>
</table>

7. (d) The unified credit is allowed, but it is the amount of the gift taxes paid on the post-1976 gifts, not the gift tax credit.

8. (d) $1,050,000. The amount included in the gross estate is all the property owned by Wald at his death. This includes his personal effects as well as the land. Even though the land is jointly held with his sister (not his spouse), it will be totally included in his estate because Wald paid for the land with his own funds. To exclude the land, or part of it, Wald's sister would have to prove she contributed to the purchase of the property.

9. (a) The gross estate of a married couple includes 50% of the value of all jointly held property. Who furnished the consideration is only an issue when the property is held jointly with a non-spouse.

10. (d) Life insurance is included in your estate when you retain an incident of ownership. Adam purchased the policy, retained ownership and paid the premiums. Burr had no ownership interest, and accordingly it is excluded from his estate.

11. (c) The expenses of administering and settling the estate are deductible expenses. In addition, the state estate taxes paid now only qualify as a deduction, not a credit.

12. (b) Bell's final income tax return. The medical expense will be allowed as a deduction from income rather than be an estate deduction. Based upon the taxpayer's marginal tax bracket, this may result in a tax savings.

13. (d) The executor may elect to value the estate at an alternate date, rather than at the date of death. This alternate valuation date is 6 months after the date of death, and must result in a lowering of the gross estate and the estate tax liability.
14. (c) The proceeds of a life insurance policy are included in the gross estate if the decedent possessed an incident of ownership at death, and they are received by the estate or, by another for the benefit of the estate.

15. (b) When a decedent acquires appreciated property as a gift within one year of their death, and the property then upon death passes back to that donor or that donor’s spouse, then the basis stays at the basis as it was in the hands of the decedent. There is no step-up in basis.

16. (b) April 15, 2011. The gift tax return (Form 709) must be filed by April 15, 2011 unless an extension is granted.

17. (c) $13,000. The maximum gift exclusion is $13,000 per year, per donee. An exception does exist for the payment of medical expenses, but only if the payment is made directly to the medical provider. If that were the case, the entire $50,000 would have been excluded.

18. (b) $75,000. The marital deduction only applies to transfers between a husband and wife. Only the $75,000 in cash was transferred while they were married. While not required for the problem, the gift of the ring results in a $37,000 taxable gift to Nina.

<table>
<thead>
<tr>
<th>Fair market value of ring</th>
<th>$ 50,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Annual exclusion</td>
<td>-13,000</td>
</tr>
<tr>
<td>Taxable gift</td>
<td>$ 37,000</td>
</tr>
</tbody>
</table>

19. (d) $0. Even though the child is receiving a future interest in the trust and this appears to meet the exception, no gift tax exclusion exists because only the interest is being turned over to the child upon reaching age 21. The principal reverts back to the donor.

20. (d) $4,000. The Briar’s election to treat the $30,000 as a split gift means that each is treated as if they a $15,000 gift. Since each would be eligible for the $13,000 exclusion, there would be two taxable gifts of $2,000 each ($15,000 less the $13,000 exclusion).

21. (c) In order for the transfer to be excluded from the gift tax rules, the payment must be for tuition, not college books, supplies and dormitory fees.

22. (b) This problem states the gifts were paid outright to the individual. Therefore, each gift is subject to the gift tax rules.

<table>
<thead>
<tr>
<th>Donee</th>
<th>Amount</th>
<th>Exclusion</th>
</tr>
</thead>
<tbody>
<tr>
<td>Jones</td>
<td>$ 15,000</td>
<td>$ 13,000</td>
</tr>
<tr>
<td>Craig</td>
<td>14,000</td>
<td>13,000</td>
</tr>
<tr>
<td>Kande</td>
<td>5,000</td>
<td>5,000</td>
</tr>
</tbody>
</table>

$ 31,000

Note that if the college tuition was paid directly to the college, all $14,000 could have been excluded.

23. (c) The ordinary and necessary administrative expenses of an estate may be deducted on the estate return or the fiduciary return, but not both. The estate tax deduction is waived by attaching a statement to the fiduciary return indicating the expense has not already been claimed as a deduction on the estate return.

24. (d) This must be reported on both. As a cash basis taxpayer, Ross would recognized income up until his date of death. Cash received after that date is taxed to his estate "as income in respect of the decedent." Ross's estate must file a fiduciary return showing the $10,000 income. The $10,000 will also be reported as an asset in Ross's estate tax return, not as income but as an asset. (Note: If Ross had received this on the day he died, he would have included this on his final return and it would still be an asset of his estate.)

25. (b) Estates are not required to make estimated tax payments until two years after the date of death.
26. (c) $600. The threshold for filing of a fiduciary return of an estate is the amount of the estate personal exemption of $600. $100 is the exemption of a simple trust and $300 is the exemption for the complex trust. The $650 is the standard deduction which is not available to a fiduciary.

27. (c) In order for the charitable contribution to be deductible on the estate's fiduciary return, the decedent's will must specifically state it. The limitations in answers (b) and (d) do not exist for an estate.

28. (c) $9,000. The amount distributed to the beneficiary by the estate is allowed as a deduction from income provided it does not exceed the distributable net income. The $9,000 distribution is less than the $15,000 DNI.

29. (a) $15,000. The distributable net income (DNI) is equal to:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Taxable interest</td>
<td>$20,000</td>
</tr>
<tr>
<td>Allowable deductions</td>
<td>-$5,000</td>
</tr>
<tr>
<td>Distributable net income</td>
<td>$15,000</td>
</tr>
</tbody>
</table>

30. (b) April 15, 2011. The return is due by the 15th day of the fourth month after the close of the taxable year. The fiduciary has a calendar year-end of December 31.

31. (c) By definition.

32. (c) The amount of income that is taxable to the beneficiary is limited to the amount of distributable net income (DNI). This is regardless of the amount that is actually distributed to the beneficiary. In this problem, the estate income of $40,000 less the expenses of $34,000 results in distributable net income of $6,000.

33. (a) There is no standard deduction for a trust or an estate in the fiduciary return. There are, however, personal exemptions of $100 for a complex trust; $300 for a simple trust; and $600 for an estate.

34. (d) An estate is not required to use a calendar year-end, but may adopt one. However, all trusts are generally required to use the calendar year-end.

35. (d) In order to qualify the organization must file a written application with the Internal Revenue Service. Churches and pension/profit sharing trusts are not required to file the request.

36. (d) An exempt organization cannot be a private foundation organized and operated exclusively to influence legislation. Operating at a profit and turning it over to non-profits is clearly incorrect. Exempt organizations must be identified (i.e., 501(c)(7)) and they can be social clubs.

37. (a) Because this entity was organized exclusively to provide below cost services to exempt organizations it is not deemed to be engaged in an unrelated business activity. The entity has a charitable function and is exempt from tax.

38. (c) Private foundations are required to file a return regardless of the amount of their receipts.

39. (a) By definition, a private foundation is a non-profit organization under 501(c)(3) that is not a public charity. A private foundation may be a foreign corporation. It may be assessed an excise tax for not distributing its net assets, but it will not be terminated. The foundation must be governed by a charter.

40. (c) Activity specifically exempted from unrelated business income is the business where all the work is performed for the organization by volunteers.

41. (d) The sale of publications of course material for seminars to members of a trade association appears to be substantially related to the organization's exempt purposes, and will not result in unrelated business income.
42. (a) As a corporation, it will be taxed at the corporate rates.

43. (a) The unrelated business income is reported on Form 990-T and is due on the 15th day of the 5th month following the end of the tax year, along with the annual Form 990.

44. (b) The amount is exempt because a business is not considered to be substantially related with respect to income from conducting games of chance in a locality where such activity is legal for exempt organizations only.

45. (b) As a corporation, the exempt organization follows the corporate quarterly estimated tax rules.

46. (c) Any organization created to influence legislation is not able to qualify as an exempt organization. However, a non-substantial part of an organization's activities may be in non-exempt activity without a loss of exempt status.

47. (b) There is no tax on unrelated business income of less than $1,000. Unrelated business income generates a tax, not a loss in exempt status, plus the business must be conducted on a regular basis.

48. (a) While an information is generally required when gross receipts are in excess of $25,000, it is not required that the articles of organization state that the return be filed annually with the IRS.

49. (d) By definition, neither of these activities will result in unrelated business income.

50. (b) $4,500. The distributable net income (DNI) is equal to:

\[
\begin{align*}
\text{Taxable interest income} & \quad 4,000 \\
\text{Taxable dividend income} & \quad 2,000 \\
\text{Less: allowable deductions} & \quad 6,000 \\
\text{Distributable net income} & \quad 4,500
\end{align*}
\]

51. (c) Various deductions are allowed the estate in determining its taxable amount. Charitable contributions are allowed, but only if provided in the will and it is to a qualified charity. Also, funeral expenses are allowed.

52. (b) $42,000. The distributable net income (DNI) is equal to:

\[
\begin{align*}
\text{Taxable interest income} & \quad 65,000 \\
\text{Less: allowable deductions} & \quad 14,000 \\
\text{Administrative expenses} & \quad 9,000 \\
\text{Distributable net income} & \quad 42,000
\end{align*}
\]

53. (a) By definition. For income tax purposes, an estate may adopt a calendar year, or may choose a fiscal year beginning on the date of the decedent’s death.

54. (a) Exemption. An exemption of $300 is allowed as a deduction. Trusts are not allowed a standard deduction. The brokerage commission would be added to the cost of buying the securities. A simple trust is not allowed a charitable contribution, but a complex trust is.

55. (a) $0. The first gift of $5,000 outright gift is not taxable due to the $13,000 gift tax exclusion. The $25,000 gift of tuition is fully excluded because the payment is for tuition and is paid directly to the university.

56. (d) $1,000,000. There is an unlimited marital exclusion of gifts from one spouse to another. The $1,000,000 is not relevant in this problem. The amount could have been $5,000,000 and the unlimited exclusion still applies.

57. (a) When a trust is revocable, the grantor can change, alter or terminate the trust at any time. Therefore, the trust is includable in the grantor’s estate.
58. (c) When the distributable net income has been determined ($120,000) and the distribution is greater than the DNI, then in order to determine the taxable income to include in the beneficiary’s income, you must pro-rate the distribution. Since Lind received 60% of the distribution, then 60% of the $120,000, or $72,000 is included as taxable income.

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
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</thead>
<tbody>
<tr>
<td>Kent distribution</td>
<td>$ 60,000</td>
</tr>
<tr>
<td>Lind distribution</td>
<td>90,000</td>
</tr>
<tr>
<td>Total distribution</td>
<td>$150,000</td>
</tr>
</tbody>
</table>

Lind $60,000/$150,000 x $120,000 = $72,000

59. (b) The $40,000 gift to a university for a cousin’s room and board (not tuition) less the $13,000 exclusion would result in a taxable gift and require the filing of a gift tax return.

60. (d) Neither of these activities are consistent (allowable) with Maple’s tax-exempt status.

61. (b) II only. Burial services that maintain the religious beliefs of its members would be consistent with Hope’s tax-exempt status. Conducting seminars would not be and should be classified as unrelated business income.
Chapter Thirteen
Professional Responsibilities from a Tax Perspective

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Chapter Thirteen  
Professional Responsibilities from a Tax Perspective

OVERVIEW

In this area, the examiners have stated that they will test knowledge and understanding of professional responsibilities of certified public accountants. Professional ethics questions relate to tax practice issues and are based on the AICPA Code of Professional Conduct, Treasury Department Circular 230, and rules and regulations for tax return preparers.

In addition to demonstrating knowledge and understanding of these topics, candidates are required to demonstrate the skills required to apply that knowledge in performing their responsibilities as certified public accountants. To demonstrate such knowledge and skills, candidates will be expected to perform the following tasks:

• Identify situations that might be unethical or a violation of professional standards, perform research and consultations as appropriate, and determine the appropriate action.

• Recognize potentially unethical behavior of clients and determine the impact on the tax services being performed.

• Demonstrate the importance of identifying and adhering to requirements, rules, and standards that are established by licensing boards within their state, and which may place additional professional requirements specific to their state of practice.

ETHICAL STANDARDS

From a tax standpoint, a CPA’s conduct is governed by the Treasury Department Circular 230 and AICPA’s Statements on Standards for Tax Services.

Treasury Department Circular 230

Circular 230 contains the rules governing the recognition of attorneys, certified public accountants and enrolled agents representing taxpayers before the Internal Revenue Service. The entire document is 43 pages long and contains material beyond the scope of the exam. Below are the actual regulations with their reference numbers to areas you should be familiar with. While we recommend that you read the entire Circular 230, these are the pertinent sections.

§ 10.20 Information to be furnished.
(a) To the Internal Revenue Service.
(1) A practitioner must, on a proper and lawful request by a duly authorized officer or employee of the Internal Revenue Service, promptly submit records or information in any matter before the Internal Revenue Service unless the practitioner believes in good faith and on reasonable grounds that the records or information are privileged.

§ 10.21 Knowledge of client’s omission.
A practitioner who, having been retained by a client with respect to a matter administered by the Internal Revenue Service, knows that the client has not complied with the revenue laws of the United States or has made an error in or omission from any return, document, affidavit, or other paper which the client submitted or executed under the revenue laws of the United States, must advise the client promptly of the fact of such noncompliance, error, or omission.

The practitioner must advise the client of the consequences as provided under the Code and regulations of such noncompliance, error, or omission.
§ 10.22 Diligence as to accuracy.
(a) In general. A practitioner must exercise due diligence —
(1) In preparing or assisting in the preparation of, approving, and filing tax returns, documents, affidavits, and other papers relating to Internal Revenue Service matters;
(2) In determining the correctness of oral or written representations made by the practitioner to the Department of the Treasury; and
(3) In determining the correctness of oral or written representations made by the practitioner to clients with reference to any matter administered by the Internal Revenue Service.

(b) Reliance on others. Except as provided in §§ 10.34, 10.35 and 10.37, a practitioner will be presumed to have exercised due diligence for purposes of this section if the practitioner relies on the work product of another person and the practitioner used reasonable care in engaging, supervising, training, and evaluating the person, taking proper account of the nature of the relationship between the practitioner and the person.

§ 10.27 Fees.
(a) In general. A practitioner may not charge an unconscionable fee in connection with any matter before the Internal Revenue Service.
(b) Contingent fees —
(1) Except as provided in paragraphs (b)(2), (3), and (4) of this section, a practitioner may not charge a contingent fee for services rendered in connection with any matter before the Internal Revenue Service.
(2) A practitioner may charge a contingent fee for services rendered in connection with the Service’s examination of, or challenge to —
(i) An original tax return; or
(ii) An amended return or claim for refund or credit where the amended return or claim for refund or credit was filed within 120 days of the taxpayer receiving a written notice of the examination of, or a written challenge to the original tax return.
(3) A practitioner may charge a contingent fee for services rendered in connection with a claim for credit or refund filed solely in connection with the determination of statutory interest or penalties assessed by the Internal Revenue Service.
(4) A practitioner may charge a contingent fee for services rendered in connection with any judicial proceeding arising under the Internal Revenue Code.

§ 10.28 Return of client’s records.
(a) In general, a practitioner must, at the request of a client, promptly return any and all records of the client that are necessary for the client to comply with his or her Federal tax obligations. The practitioner may retain copies of the records returned to a client. The existence of a dispute over fees generally does not relieve the practitioner of his or her responsibility under this section. Nevertheless, if applicable state law allows or permits the retention of a client’s records by a practitioner in the case of a dispute over fees for services rendered, the practitioner need only return those records that must be attached to the taxpayer’s return. The practitioner, however, must provide the client with reasonable access to review and copy any additional records of the client retained by the practitioner under state law that are necessary for the client to comply with his or her Federal tax obligations.

(b) For purposes of this section — Records of the client include all documents or written or electronic materials provided to the practitioner, or obtained by the practitioner in the course of the practitioner’s representation of the client, that preexisted the retention of the practitioner by the client. The term also includes materials that were prepared by the client or a third party (not including an employee or agent of the practitioner) at any time and provided to the practitioner with respect to the subject matter of the representation. The term also includes any return, claim for refund, schedule, affidavit, appraisal or any other document prepared by the practitioner, or his or her employee or agent, that was presented to the client with respect to a prior representation if such document is necessary for the taxpayer to comply with his or her current Federal tax obligations. The term does not include any return, claim for refund, schedule, affidavit, appraisal or any other document prepared by the practitioner or the practitioner’s firm, employees or agents if the practitioner is withholding such document pending the client’s performance of its contractual obligation to pay fees with respect to such document.

§ 10.29 Conflicting interests.
(a) Except as provided by paragraph (b) of this section, a practitioner shall not represent a client before the Internal Revenue Service if the representation involves a conflict of interest. A conflict of interest exists if —
(1) The representation of one client will be directly adverse to another client; or
(2) There is a significant risk that the representation of one or more clients will be materially limited by the practitioner’s responsibilities to another client, a former client or a third person, or by a personal interest of the practitioner.

§ 10.31 Negotiation of taxpayer checks.
A practitioner who prepares tax returns may not endorse or otherwise negotiate any check issued to a client by the government in respect of a Federal tax liability.

§ 10.34 Standards with respect to tax returns and documents, affidavits and other papers.
(b) Documents, affidavits and other papers —
(1) A practitioner may not advise a client to take a position on a document, affidavit or other paper submitted to the Internal Revenue Service unless the position is not frivolous.
(2) A practitioner may not advise a client to submit a document, affidavit or other paper to the Internal Revenue Service —
(i) The purpose of which is to delay or impede the administration of the Federal tax laws; or
(ii) That is frivolous; or
(iii) That contains or omits information in a manner that demonstrates an intentional disregard of a rule or regulation unless the practitioner also advises the client to submit a document that evidences a good faith challenge to the rule or regulation.
(c) Advising clients on potential penalties —
(1) A practitioner must inform a client of any penalties that are reasonably likely to apply to the client with respect to
(i) A position taken on a tax return if —
(A) The practitioner advised the client with respect to the position; or
(B) The practitioner prepared or signed the tax return; and
(ii) Any document, affidavit or other paper submitted to the Internal Revenue Service.
(2) The practitioner also must inform the client of any opportunity to avoid any such penalties by disclosure, if relevant, and of the requirements for adequate disclosure.
(3) This paragraph (c) applies even if the practitioner is not subject to a penalty under the Internal Revenue Code with respect to the position or with respect to the document, affidavit or other paper submitted.
(d) Relying on information furnished by clients. A practitioner advising a client to take a position on a tax return, document, affidavit or other paper submitted to the Internal Revenue Service, or preparing or signing a tax return as a preparer, generally may rely in good faith without verification upon information furnished by the client. The practitioner may not, however, ignore the implications of information furnished to, or actually known by, the practitioner, and must make reasonable inquiries if the information as furnished appears to be incorrect, inconsistent with an important fact or another factual assumption, or incomplete.

AICPA Statements on Standards for Tax Services

There are 7 AICPA Statements on Standard for Tax Services. Many of these standards are similar to the rules contained in Circular 230, but in general, these standards are slightly higher than what is required by the Treasury Department. The standards and interpretations of these standards can easily be found on the AICPA’s website, but a summary of the standards is presented below.

SSTS #1 Tax Return Positions – Similar to Circular 230 §10.34, a member should not sign a return unless the realistic possibility standard is met. It involves not only IRS filings, but any filings with state and local governments. However, if the position fails to meet the realistic possibility standard, is not frivolous and is adequately disclosed, the member may sign the return.

SSTS #2 Answers to Questions on Returns – A member should make a reasonable effort to obtain from the taxpayer the information necessary to provide appropriate answers to all questions on a tax return before signing as a preparer. Some question must be answered to form a complete return, such as the method of accounting—cash or accrual? Other questions, such as the Presidential Election Contribution question, have no impact on the determination of tax and may not be deemed to be a violation of this standard.
SSTS #3 Certain Procedural Aspects of Preparing Returns – Before preparing or sign a return, a member should examine or verify certain supporting data or to consider information related to another taxpayer when preparing a taxpayer’s tax return. A member may in good faith, rely upon information received from the taxpayer or third party (such as a W-2), but if the information appears to be incorrect, incomplete or inconsistent, additional inquiries should be made.

SSTS #4 Use of Estimates – It is proper to use estimates in preparing a return. The responsibility to provide this estimated data lies with the taxpayer, not the member. Members should take care that in the presentation, an estimate not take on the appearance of being exact. Estimating charitable contributions to be $1,000 may be acceptable, but making them $1,025 so they don’t look suspicious, is not acceptable.

SSTS #5 Departure from a Positions Previously Concluded in An Administrative Proceeding or Court Decisions – Should a taxpayer be audited on a certain position and the IRS prevails, a member should recommend that the taxpayer follow the IRS’s or court’s position on subsequent filings.

SSTS #6 Knowledge of Error: Return Preparation and Administrative Proceedings – Similar to Circular 230 § 10.21 Knowledge of client’s omission. The term error is expanded to include any position, omission, or method of accounting that is, at the time of filing, fails to meet the realistic possibility standard.

SSTS #7 Form and Content of Advice to Taxpayers – There is no standard format required, but members should use precautionary language in communicating with their clients.

PENALTIES ON PREPARERS

The exam routinely tests candidates on their responsibility as return preparers. The number of penalties which may be assessed on a paid preparer is staggering and would take pages to simply list, let alone describe. A summary will follow, but the thrust of the law addresses the professional due diligence which should be evident as we prepare returns.

Logically, not signing returns, endorsing client refund checks, not providing tax return copies, or willfully understating a tax liability are acts that should be penalized. A return preparer’s responsibilities also limit the disclosure or use of a client’s tax return. A preparer is allowed, however, to disclose information for quality review, the electronic filing processor, and a governing state agency or court.

Let your sound professional judgment dictate your answer on the exam if you do not remember all the issues.

PROCEDURAL PENALTIES

- $50 for failure to furnish a copy of the return to the taxpayer
- $50 for failure to maintain copy, or list of returns prepared
- $50 for failure to sign a return
- $50 for failure to include preparer’s identification number
- $500 for the endorsement of refund checks payable to taxpayer

OTHER PENALTIES

- $250 for understating a taxpayer’s tax liability due to an unrealistic position
- $1,000 for a willful attempt to understate taxes, including reckless or intentional disregard

Besides penalties, tax preparers may be barred from practicing before the IRS if they do not comply with the provisions of Circular 230. Two major provisions include:

1. Tax preparer should promptly advise the taxpayer of any error or omission on a return, or lack of compliance with any federal tax law.
2. Tax preparer should exercise due diligence in the preparation of returns and in any representations to the IRS or taxpayers.
TAX RESEARCH

The ability of CPAs to perform tax research is now a required part of the CPA exam. Today’s CPA is frequently in the field, working at a client’s site when interesting tax issues arise. Gone are the days when the CPA would write down the issue, return to the office and then research the matter in the firm’s tax library. More often than not, the CPA will log-on to the internet and begin an immediate search of an electronic database.

When it comes to research, the Content Specifications of the new CPA indicate that a candidate should be able to:

- Identify the issues
- Locate the authority
- Communicate the results

Identify the issues

Most clients do not talk to us in tax language. When they ask us if they can write something off, they rarely say, is this an allowable deduction under Section 162? Instead, we must discuss and identify the nature of the transaction and then begin a search to locate relevant pieces of authority. The first step is to identify keywords.

Take for example, a question as to whether a taxpayer can deduct a bonus paid to their employee. If we simply ask an electronic database what can we “deduct”, this will result in thousands of “hits” in our database. However, if we couple that request with keywords, such as bonus or compensation, we may be able to narrow our search dramatically. Research can be a painstaking task, but with experience you will become proficient for the exam.

Try a free Trial and Demo at http://www.riahome.com to get a feel for what research looks and feels like. This will save you valuable time on the exam.

Locate the authority

When a taxpayer claims a deduction or excludes an element of income on a tax return, the decision needs to be based upon authority. Most of us know that medical expenses are allowed as a deduction, but does cosmetic surgery count as a qualified medical expenses. At first glance, you may remember hearing something about it from your tax class, but what does the Internal Revenue Code or Regulations or Revenue Ruling say about it. You may be surprised at the answer. Remembering a professor’s lecture or story is good, but that is not authority.

Authority is found in the following areas:

Internal Revenue Code
Passed by Congress and signed into law by the President, the Internal Revenue Code is the authority we typically look to. The Internal Revenue Code is found in Title 26 of the U.S. Laws, and is further broken down into subtitles, chapters, subchapters, parts, subparts, sections, subsections, paragraphs and subparagraphs. It is the highest level of authority. Most of your research on the exam should be focused on code sections and sub-sections.

Regulations
Regulations are interpretations of the Internal Revenue Code issued by the Treasury Department. Regulations can be proposed, temporary or final, and generally carry the full weight of law. Regulations are usually proceeded by the number 1, so if you were citing a regulation for business expenses, it may look like Treasury Regulation 1.162-1.

Revenue Rulings
Similar to regulations, rulings represent official pronouncements of the National Office of the IRS. They are generally written in response to a request by a taxpayer in a given situation. The Revenue Rulings provide us guidance on how the IRS may act on a similar set of facts.
Court Cases
Court cases may be beyond the scope of the exam, but represent important authority from our judicial system. Briefly, the courts settle disputes between the IRS and the taxpayer. If one of the parties does not like the result at the lower court, they may be able to appeal the decision to an Appeals Court, and in certain cases, they may appeal that decision up to the Supreme Court.

Communicate the Results
Once your research is complete, you need to effectively communicate what you have found. While there are many styles to present research memos they all seem to contain three critical elements:

- What are the Facts?
- What is the Law or Authority?
- What is your Conclusion or Recommendation?

Work on writing brief memos. Read several court cases and get the feel for what a well research and written case looks like. Cases generally follow the above format.

Look to the exam for guidance as to the structure of your memo. Make sure you cover all the points they ask for.
Chapter Thirteen — Professional Responsibilities from a Tax Perspective

1. A tax return preparer is subject to a penalty for knowingly or recklessly disclosing corporate tax return information, if the disclosure is made
   a. To enable a third party to solicit business from the taxpayer.
   b. To enable the tax processor to electronically compute the taxpayer's liability.
   c. For peer review.
   d. Under an administrative order by a state agency that registers tax return preparers.

2. Which, if any, of the following could result in penalties against an income tax return preparer?
   I. Knowing or reckless disclosure or use of tax information obtained in preparing a return.
   II. A willful attempt to understate any client's tax liability on a return or claim for refund.
   a. Neither I nor II.
   b. I only.
   c. II only.
   d. Both I and II.

3. A tax return preparer may disclose or use tax return information without the taxpayer's consent to
   a. Facilitate a supplier's or lender's credit evaluation of the taxpayer.
   b. Accommodate the request of a financial institution that needs to determine the amount of taxpayer's debt to it, to be forgiven.
   c. Be evaluated by a quality or peer review.
   d. Solicit additional nontax business.

4. Morgan, a sole practitioner CPA, prepares individual and corporate income tax returns. What documentation is Morgan required to retain concerning each return prepared?
   a. An unrelated party compliance statement.
   b. Taxpayer's name and identification number or a copy of the tax return.
   c. Workpapers associated with the preparation of each tax return.
   d. A power of attorney.

5. Which of the following acts constitute(s) grounds for a tax preparer penalty?
   I. Without the taxpayer’s consent, the tax preparer disclosed taxpayer income tax return information under an order from a state court.
   II. At the taxpayer’s suggestion, the tax preparer deducted the expenses of the taxpayer’s personal domestic help as a business expense on the taxpayer’s individual tax return.
   a. I only
   b. II only
   c. Both I and II
   d. Neither I nor II

6. While preparing a client’s individual federal tax return, the CPA noticed that there was an error in the previous year’s tax return that was prepared by another CPA. The CPA has which of the following responsibilities to his client?
   a. Inform the client and recommend corrective action.
   b. Inform the client and the previous CPA in writing, and leave it to their discretion whether a correction should be made.
   c. Discuss the matter verbally with the former CPA and suggest that corrective action be taken by the client.
   d. Notify the IRS if the error could be considered fraudulent or could involve other taxpayers.

7. Identify the item below that does not describe information a preparer must maintain about every return prepared:
   A. The taxpayer’s name and taxpayer identification number.
   B. The date the return or claim for refund was prepared.
   C. The taxable year of the taxpayer (or nontaxable entity) for whom the return was prepared.
   D. The type of return or claim for refund prepared.

8. A representative who signs a Form 2848, Power of Attorney, declares under penalty of perjury that he or she is aware of which of the following:
   A. The federal income tax regulations.
   B. The regulations in Treasury Department Circular No. 230.
   C. Recent tax law developments that relate to the tax matter(s) listed on line3 of the Form 2848.
   D. All of the above.
9. Which of the following statements is correct with respect to a client’s request for records of the client that are necessary for the client to comply with his or her Federal tax obligations?
A. The practitioner may never return records of the client to the client even if the client requests prompt return of the records.
B. The existence of a dispute over fees always relieves the practitioner of his or her responsibility to return records of the client to the client.
C. The practitioner must, at the request of the client, promptly return the records of the client to the client unless applicable state law provides otherwise.
D. The practitioner must, at the request of the client, return the records of the client to the client within three months of receiving the request.

10. A tax professional can recommend a position on the client's tax return as long as the position is:
A. Reasonable.
B. Not frivolous.
C. Adequately disclosed.
D. All of the above.

11. Sandra, a tax professional, prepares Linda’s income tax return. Linda sold some stock in a corporation and believes the proceeds of the stock are all a return to capital, and therefore, not included in her gross income. After research, Sandra determines that there is reasonable basis for Linda’s position, but she does not believe there is a realistic possibility of success on the merits. Under what circumstances can Sandra sign Linda’s return if the proceeds are not included in income reported on the return?
A. If the position is not frivolous and is adequately disclosed on the return.
B. If Sandra documents her disagreement with Linda’s position and keeps it in her file.
C. If Linda agrees in writing not to dispute any IRS challenge to the position.
D. Under no circumstances.

12. Circular 230, §10.34 discusses standards for advising clients with respect to tax return positions and for preparing or signing returns. Which of the statements below is true?
A. A practitioner may not sign a tax return as a preparer if the practitioner determines that the tax return contains a position that does not have a realistic possibility of being sustained on its merits (the realistic possibility standard) unless the position is not frivolous and is adequately disclosed to the Internal Revenue Service.
B. A practitioner advising a client to take a position on a tax return, or preparing or signing a tax return as a preparer, must inform the client of the penalties reasonably likely to apply to the client with respect to the position advised, prepared, or reported.
C. A practitioner advising a client to take a position on a tax return, or preparing or signing a tax return as a preparer, generally may rely in good faith without verification upon information furnished by the client. The practitioner may not, however, ignore the implications of information furnished to, or actually known by, the practitioner, and must make reasonable inquiries if the information as furnished appears to be incorrect, inconsistent with an important fact or another factual assumption, or incomplete.
D. All of the above.

13. Isaac’s income tax return was examined. This resulted in an income tax deficiency in the amount of $50,000 from two $25,000 adjustments. The Revenue Agent determined that Isaac was negligent involving the first adjustment and proposed an accuracy-related penalty. The second adjustment was discovered by the Revenue Agent based upon a disclosure statement in the tax return and did not relate to a tax shelter. What is the amount of penalty that the Revenue Agent can propose?
A. $2,500
B. $5,000
C. $10,000
D. None of the above.

14. A frivolous income tax return is one that does not include enough information to figure the correct tax or that certain information clearly showing that the tax that was reported is substantially incorrect. If a taxpayer files a frivolous return, which penalty applies specifically to the taxpayer for the frivolous return?
A. $50 for failure to supply your social security number.
B. 20% of the underpayment, reduced for those items for which there was adequate disclosure made.
C. $500 frivolous return penalty, applied in addition to any other applicable penalty or penalties.
D. $100 for the failure to furnish the tax shelter registration number.

15. If there is an underpayment of tax on your return due to fraud, how much is the penalty added to your tax?
A. 20 % of the underpayment due to fraud
B. 20% of the underpayment, reduced for those items for which there was adequate disclosure
C. $500 added to any other penalty provided by law
D. 75% of the underpayment due to fraud
16. An accuracy-related penalty applies to the portion of tax underpayment attributable to
   I. Negligence or a disregard of the tax rules or regulations.
   II. Any substantial understatement of income tax.

   a. I only.
   b. II only.
   c. Both I and II.
   d. Neither I nor II.

17. A power of attorney is required in all of the following circumstances except:
   A. To furnish information at the request of the IRS.
   B. Authorize the extension of the statute of limitations.
   C. Execute a closing agreement under Sec. 7121.
   D. Receive a refund check.

18. A taxpayer must use a power of attorney to do which of the following?
   A. Authorize an individual to prepare the taxpayer’s return
   B. Authorize an individual to represent a taxpayer at a conference with the IRS.
   C. Authorize the IRS to disclose tax information to an individual.
   D. Authorize an individual to provide information to the IRS.

19. Which of the following is correct regarding a refund check?
   A. Form 2848, Power of Attorney, may be used to authorize cashing of a refund check.
   B. Form 2848, Power of Attorney, may be used to authorize receipt a refund check.
   C. Form 8821, Tax Information Authorization must be signed before a refund check may be applied to a fee for electronic filing.
   D. Both Form 2848 and Form 8821 must be used to authorize cashing a refund check.

20. What is the purpose of the Centralized Authorization File (CAF) number?
   A. Before the PTIN, this was the number a preparer would use to sign an electronically filed return.
   B. The CAF number is another means of tracking tax professionals.
   C. Use of the CAF number allows IRS to verify an individual’s authority to represent the taxpayer before the IRS.
   D. None of the above.

21. Sam is the sole shareholder in an S corporation. The S corporation was examined and the IRS proposed a $30,000 deficiency. What must Sam do to request an Appeals conference?
   A. File a formal written protest.
   B. Pay the deficiency.
   C. Hire a federally authorized tax practitioner to represent the S corporation.
   D. Nothing because he is eligible for the small case procedure.

22. After the issuance of a Statutory Notice of Deficiency, failure to timely file a petition with Tax Court will result in which of the following?
   A. The Internal Revenue Service will issue a 30-day letter.
   B. The Internal Revenue Service will assess the tax it says the taxpayer owes.
   C. The Internal Revenue Service will issue a 90-day letter.
   D. You will be required to post a deposit before being allowed to request an extension for time to file a petition.

23. A disagreement with the Internal Revenue Service can be taken to the United States Tax Court if:
   A. It pertains to income tax.
   B. A statutory notice of deficiency has been issued.
   C. A petition is filed within 90 days from the date a statutory notice of deficiency is mailed (150 days if it is addressed to the taxpayer outside the United States).
   D. All of the above.

24. In evaluating the hierarchy of authority in tax law, which of the following carries the greatest authoritative value for tax planning of transactions?
   a. Internal Revenue Code
   b. IRS regulations
   c. Tax Court decisions
   d. IRS agents’ reports
1. (a) A return preparer’s responsibilities limit the disclosure or use of a client’s tax return. A preparer is allowed to disclose information for quality review, the electronic filing processor, and a governing state agency.

2. (d) Both I and II. The first violation listed carries a penalty of $250, while the second carries $1,000.

3. (c) A return preparer’s responsibilities limit the disclosure or use of a client’s tax return. A preparer is allowed to disclose information for quality review.

4. (b) The CPA is required to maintain a list of the taxpayer’s name and identification number, or a copy of the tax return. Failure to do so may result in a preparer penalty. The other answers are nice to have, but are not required to be retained.

5. (b) A return preparer’s responsibilities limit the disclosure or use of a client’s tax return. A preparer is allowed to disclose information for quality review, the electronic filing processor, and a governing state agency or court. However, claiming a business expense for domestic help is taking a unrealistic position or possible even a willful attempt to understate taxes and therefore subject to a penalty.

6. (a) Circular 230 governs our practice before the Internal Revenue Service. As preparers, when we discover an error on a previously filed return, our obligation is to promptly inform the client and recommend (not require) that the client take corrective action.

7. (b) A preparer does not need to maintain the date the return was prepared. The other items are required.

8. (b) Circular 230 contains the rules of conduct a tax preparer should follow. When executing a Form 2848, the representative declares under the penalty of perjury that he or she is aware of those regulations in Circular 230.

9. (c) Under Circular 230 a tax preparer must provide a taxpayer a copy of the tax return when the return is ready for filing. The question of documentation often comes up when a return is ready for filing and the practitioner has not been paid for the service. The practitioner must release the information to the client that is necessary to comply with filing the return, but does not have to release any workpapers prepared by the tax preparer himself.

10. (a) A tax professional may not recommend a position that is unreasonable, frivolous, or not adequately disclosed.

11(a) As a tax preparer, a practitioner advising a client on a tax position may rely in good faith without verification from the client as long as the position is not frivolous and has a realistic possibility of being sustained on its own merits. The position should be adequately disclosed to the IRS to avoid penalty if the position does not meet the realistic possibility standard and only the reasonable basis standard is met.

12 (d) As a tax preparer, a practitioner advising a client on a tax position may rely in good faith without verification from the client as long as the position is not frivolous and has a realistic possibility of being sustained on its own merits. The position should be adequately disclosed to the IRS to avoid penalty. The practitioner must make reasonable inquiries if the information furnished appears to be incorrect, inconsistent or incomplete. The preparer should inform the client of penalties likely to apply to the client with respect to the position advised, reported or prepared.

13 (b) The first $25,000 adjustment is subject to a 20% penalty (or $5,000) due to negligence or disregard of rules and regulations which would include - failure to make reasonable efforts to comply with the tax law, including failure to keep adequate records or to use ordinary and reasonable care in the preparation of the return. The second adjustment, because it was adequately disclosed, is not subject to a penalty.
14 (c) For filing a frivolous return, there is an additional $500 penalty assessed.

15 (d) If there is an underpayment of tax on your return due to fraud, the IRS can assess a penalty of 75% on the underpayment.

16 (c) An accuracy related penalty may be assessed for either (1) negligence or a disregard of the tax rules or regulations, or (2) any substantial understatement of income tax.

17 (a) A Power of Attorney Form 2848 is required to authorize the IRS to extend the statute of limitations, execute a closing agreement under Section 7121 at the conclusion of an audit and to receive a refund check for a client. Form 2848 is not necessary to furnish information to the IRS upon their request, that should be done as a matter of course.

18, (b) Form 2848 is needed to authorize an individual to represent the taxpayer at a conference with the IRS. A Power of Attorney Form 2848 is not needed to prepare a client’s tax return, authorize the IRS to disclose information to an individual (this can be done on the face of the return – below Box 76) or to furnish information to the IRS upon their request, that should be done as a matter of course.

18 (b) The power of attorney is needed to represent a taxpayer at a conference with the IRS.

19. (b) Power of Attorney Form 2848 can be used to authorize the receipt of a refund check for a client – say for example the client will be out of town and does not want the check to sit in their mailbox for a while. In no instances does the Form 2848 or Form 8821 authorize the cashing or endorsing of a refund check for a client.

20 (c) The Centralized Authorization Number (CAF) is used by the IRS to verify an individual’s authority to represent the taxpayer before the IRS. The CAF number represents a file that contains information regarding the type of authorization a taxpayer has given their representative.

21 (a) If the proposed tax liability is more than $25,000 or if the taxpayer is an S-Corp or partnership, a written protest must be filed with the IRS to request an appeals conference within 30 days of the notice.

22. (b) A taxpayer has three options when a Statutory Notice of Deficiency is received:
   1. Petition tax court within 90 days,
   2. Pay the tax then file a claim for refund, or
   3. Take no action and the IRS will assess a tax.

23. (d) A disagreement with the IRS can be taken to United States Tax Court under the following circumstances
   1. It pertains to income tax,
   2. A statutory notice of deficiency has been issued by the IRS, and
   3. A petition is filed within 90 days from the date a statutory notice of deficiency is mailed (150 days if it is addressed to the taxpayer outside of the US).

24. (a) The Internal Revenue Code. Passed by Congress and signed into law by the President, it represents the highest level of authority. The regulations represent the Treasury Department’s interpretation of the Code. The Tax Court decisions generally address whether the law has been properly applied to the facts of the case.
Appendix

WHAT IS IN THE APPENDIX?

This Appendix contains twelve past CPA problems updated to reflect current tax law. Problems 1 through 6 deal with individuals, Problems 7 through 10 deal with corporations and Problem 11 deals with partnerships. Our last problem is actually a recent Simulation complete with the answers. We have included the past problems, although not called simulations, as the content of these problems is extremely pertinent to the exam. We have retained them in their original exam format. It is quite possible you will see a variation of these very same problems on your exam.

TIMING

Many of these problems include an estimate as to the amount of time needed to answer the problem. In practice, you should be finished well within the recommended time frame because of the repetitive nature of your review. During the exam these estimates are good indicators. Look for these estimates and make sure you jot down your start time for a section, as well as the anticipated stopping time so that you don’t spend too much or too little time on an area.

HIGH LEVEL SUMMARY OF APPENDIX PROBLEMS

<table>
<thead>
<tr>
<th>Individuals</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Problem 1</strong> is a matching problem where you select the proper tax treatment for a listing of twenty-five transactions. Notice that the tax treatment sometimes includes which tax form an item may be reported on.</td>
</tr>
<tr>
<td><strong>Problem 2</strong> has 31 parts and has you answering questions on individual filing status, exemptions, gross income inclusion and deductions using various letters as well as true/false answers. Note that there are very few numerical calculations or responses in this problem.</td>
</tr>
<tr>
<td><strong>Problem 3</strong> has 29 parts and requires both numerical responses and true/false answers, similar to Problem 2.</td>
</tr>
<tr>
<td><strong>Problem 4</strong> is a released problem and is comprised of three distinct parts. The first nine questions ask the appropriate tax treatment on a variety of transactions. The next ten questions require a numerical response, but the response is limited to 13 different possibilities. This is like a 13 part multiple choice answer. The third component solely tests the exemption provisions.</td>
</tr>
<tr>
<td><strong>Problem 5</strong> is comprised of twenty other objective style questions. The first five review what is included in an individual's gross estate, while the last five question what is deductible.</td>
</tr>
<tr>
<td><strong>Problem 6</strong> contains nine questions, looking at the tax preparer’s role and the Internal Revenue Service.</td>
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</tbody>
</table>
Corporations

**Problem 7** requires that the candidate determine if a transaction increases, decreases or has no effect on the corporation’s taxable income and once determined, what that amount is. The emphasis on the first four questions is on Schedule M items.

**Problem 8** has 28 parts and has very few numerical responses. The candidate responds to questions such as to whether an item is fully deductible, partially deductible, or not deductible at all; whether a statement is true or false; etc. There are also five questions on the corporate alternative minimum tax.

**Problem 9** is a relatively short S Corporation problem. Its emphasis is on the flow through nature of the items of income and deductions, as well as S Corporation eligibility.

**Problem 10** is under the old problem format but represents a good comprehensive corporate tax problem. When you attack this problem, envision ways the examiners could ask you the same questions under the Simulation approach.

Partnerships

**Problem 11** is a part of Problem 2 from the November 94 exam. The problem deals with partnerships and requires an unusual three part multiple choice format answer as well as true/false responses. Notice the emphasis on partnership distributions. Do not ignore these questions.

Appendix Problems

**PROBLEM 1 (Estimated time 40 to 50 minutes)**

**Problem Number 1** consists of 25 items. Select the best answer for each item. **Answer all items.** Your grade will be based on the total number of correct answers.

Green is self-employed as a human resources consultant and reports on the cash basis for income tax purposes. Listed on the following page are Green's 2010 business and nonbusiness transactions, as well as possible tax treatments.

**Required:**
For each of Green's transactions (Items 1-25), select the appropriate tax treatment. A tax treatment may be selected once, more than once, or not at all.
Transactions

1. Retainer fees received from clients.
2. Oil royalties received.
3. Interest income on general obligation state and local government bonds.
4. Interest on refund of federal taxes.
5. Death benefits from term life insurance policy on parent.
7. Share of ordinary income from an investment in a limited partnership reported in Form 1065, Schedule K-1.
8. Taxable income from rental of a townhouse owned by Green.
9. Prize won as a contestant on a TV quiz show.
10. Payment received for jury service.
11. Dividends received from mutual funds that invest in tax-free government obligations.
12. Qualifying medical expenses not reimbursed by insurance.
13. Personal life insurance premiums paid by Green.
14. Expenses for business-related meals where clients were present.
15. Depreciation on personal computer purchased in 2010 used for business.
16. Business lodging expenses, while out of town.
17. Subscriptions to professional journals used for business.
19. Qualifying contributions to a simplified employee pension plan.
20. Election to expense business equipment purchased in 2010.
21. Qualifying alimony payments made by Green.
22. Subscriptions for investment-related publications.

Transactions - continued

23. Interest expense on a home-equity line of credit for an amount borrowed to finance Green's business.
24. Interest expense on a loan for an auto used 75% for business.
25. $100,000 gain on sale of residence.

Tax Treatments

a. Taxable as other income on Form 1040.
b. Reported in Schedule B—Interest and Dividend Income.
c. Reported in Schedule C as trade or business income.
d. Reported in Schedule E—Supplemental Income and Loss.
e. Not taxable.
f. Fully deductible on Form 1040 to arrive at adjusted gross income.
g. Fifty percent deductible on Form 1040 to arrive at adjusted gross income.
h. Reported in Schedule A—Itemized Deductions (deductibility subject to threshold of 7.5% of adjusted gross income).
i. Reported in Schedule A—Itemized Deductions (deductibility subject to threshold of 2% of adjusted gross income)
j. Reported in Form 4562—Depreciation and Amortization and deductible in Schedule A—Itemized Deductions (deductibility subject to threshold of 2% of adjusted gross income).
k. Reported in Form 4562—Depreciation and Amortization, and deductible in Schedule C—Profit or Loss from Business.
l. Fully deductible in Schedule C—Profit or Loss from Business.
m. Partially deductible in Schedule C—Profit or Loss from Business.
n. Schedule D—Capital Gains and Losses.
o. Not deductible.
PROBLEM 2 (Estimated time—25 to 40 minutes)

Problem Number 2 consists of 31 items. Select the best answer for each item. Answer all items. Your grade will be based on the total number of correct answers.

Mrs. Vick, a 40-year-old cash basis taxpayer, earned $45,000 as a teacher and $5,000 as a part-time real estate agent in 2010. Mr. Vick, who died on July 1, 2010, had been permanently disabled on his job and collected state disability benefits until his death. For all of 2010 and 2011, the Vick's residence was the principal home of both their 11-year old daughter Joan and Mrs. Vick's unmarried cousin, Fran Phillips, who had no income in either year. During 2010, Joan received $200 a month in survivor social security benefits that began on August 1, 2010, and will continue at least until her 18th birthday. In 2010 and 2011, Mrs. Vick provided over one-half the support for Joan and Fran, both of whom were US citizens. Mrs. Vick did not remarry. Mr. and Mrs. Vick received the following in 2010:

<table>
<thead>
<tr>
<th>Income Source</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Earned income</td>
<td>$50,000</td>
</tr>
<tr>
<td>State disability benefits</td>
<td>1,500</td>
</tr>
<tr>
<td>Interest on:</td>
<td></td>
</tr>
<tr>
<td>Refund from amended tax return</td>
<td>50</td>
</tr>
<tr>
<td>Savings account &amp; certificates of deposit</td>
<td>350</td>
</tr>
<tr>
<td>Municipal bonds</td>
<td>100</td>
</tr>
<tr>
<td>Gift</td>
<td>3,000</td>
</tr>
<tr>
<td>Pension benefits</td>
<td>900</td>
</tr>
<tr>
<td>Jury duty pay</td>
<td>200</td>
</tr>
<tr>
<td>Gambling winnings</td>
<td>450</td>
</tr>
<tr>
<td>Life insurance proceeds</td>
<td>5,000</td>
</tr>
</tbody>
</table>

Additional information:

- Mrs. Vick received the $3,000 cash gift from her uncle.
- Mrs. Vick received the pension distributions from a qualified pension plan, paid for exclusively by her husband's employer.
- Mrs. Vick had $100 in gambling losses in 2010.
- Mrs. Vick was the beneficiary of the life insurance policy on her husband's life. She received a lump-sum distribution. The Vicks had paid $500 in premiums.
- Mrs. Vick received Mr. Vick's accrued vacation pay of $500 in 2011.
For items 1 and 2, determine and select from the choices below, BOTH the filing status and the number of exemptions for each item.

**Filing Status**
S  Single
M  Married filing joint
H  Head of household
Q  Qualifying widow with dependent child

**Exemptions**
1
2
3
4

1. Determine the filing status and the number of exemptions that Mrs. Vick can claim on the 2010 federal income tax return, to get the most favorable tax results.

   Filing Status?_____   Exemptions?_____ 

2. Determine the filing status and the number of exemptions that Mrs. Vick can claim on the 2011 federal income tax return to get the most favorable tax results, if she solely maintains the costs of her home.

   Filing Status?_____   Exemptions?_____ 

For items 3 through 9, determine the amount, if any, that is taxable and should be included in Adjusted Gross Income (AGI) on the 2010 federal income tax return filed by Mrs. Vick.

**Numeric responses**

3. State disability benefits   ____   ____   ____   ____
4. Interest income   ____   ____   ____   ____
5. Pension benefits   ____   ____   ____   ____
6. Gift   ____   ____   ____   ____
7. Life insurance proceeds   ____   ____   ____   ____
8. Jury duty pay   ____   ____   ____   ____
9. Gambling winnings   ____   ____   ____   ____
During 2010 the following payments were made or losses were incurred. For items 10 through 23, select the appropriate tax treatment. A tax treatment may be selected once, more than once, or not at all.

**Payments and Losses**

___10.   Premiums on Mr. Vick's personal life insurance policy.

___11.   Penalty on Mrs. Vick's early withdrawal of funds from a certificate of deposit.

___12.   Mrs. Vick's substantiated cash donation to the American Red Cross.

___13.   Payment of estimated state income taxes.

___14.   Payment of real estate taxes on the Vick home.

___15.   Loss on the sale of the family car.

___16.   Cost in excess of the increase in value of residence, for the installation of a stairlift in January 2010, related directly to the medical care of Mr. Vick.

___17.   The Vick's health insurance premiums for hospitalization coverage.

___18.   CPA fees to prepare the 2009 tax return.

___19.   Amortization over the life of the loan of points paid to refinance the mortgage at a lower rate on the Vick home.

___20.   One-half the self-employment tax paid by Mrs. Vick.

___21.   Mrs. Vick's $100 in gambling losses.

___22.   Mrs. Vick's union dues.

___23.   2009 federal income tax paid with the Vick's tax return on April 15, 2010.

**Tax Treatment**

A.   Not deductible.

B.   Deductible in Schedule A-Itemized Deductions, subject to threshold of 7.5% of adjusted gross income.

C.   Deductible in Schedule A-Itemized Deductions, subject to threshold of 2% of adjusted gross income.

D.   Deductible on page 1 of Form 1040 to arrive at adjusted gross income.

E.   Deductible in full in Schedule A-Itemized Deductions.

F.   Deductible in Schedule A-Itemized Deductions, subject to threshold of 50% of adjusted gross income.
For items 24 through 31, determine whether the statement is true (T) or false (F) regarding the Vick’s' 2010 income tax return.

___24. The funeral expenses paid by Mr. Vick's estate is a 2010 itemized deduction.
___25. Any federal estate tax on the income in respect of decedent, to be distributed to Mrs. Vick, may be taken as a miscellaneous itemized deduction not subject to the 2% of adjusted gross income floor.
___26. A casualty loss deduction on property used in Mrs. Vick's part-time real estate business is reported as an itemized deduction.
___27. The Vicks' income tax liability will be reduced by the credit for the elderly or disabled.
___28. The CPA preparer is required to furnish a completed copy of the 2010 income tax return to Mrs. Vick.
___29. Since Mr. Vick died during the year, the income limitation for the earned income credit does not apply.
___30. Mr. Vick's accrued vacation pay, at the time of his death, is to be distributed to Mrs. Vick in 2011. This income should be included in the 2010 Federal income tax return.
___31. The Vicks paid alternative minimum tax in 2010. The amount of alternative minimum tax that is attributable to "deferral adjustments and preferences" can be used to offset the alternative minimum tax in the following years.

PROBLEM 3 (Estimated time—25 to 40 minutes)

Problem Number 3 consists of 29 items. Select the best answer for each item. Answer all items.

Tom and Joan Moore, both CPAs, filed a joint 2010 federal income tax return showing $70,000 in taxable income. During 2010, Tom's daughter Laura, age 16, resided with Tom's former spouse. Laura had no income of her own and was not Tom's dependent.

Required:
a. For Items 1 through 10, determine the amount of income or loss, if any, that should be included on page one of the Moore's 2010 Form 1040.

1. The Moores had no capital loss carryovers from prior years. During 2010 the Moores had the following stock transactions which resulted in a net capital loss:

<table>
<thead>
<tr>
<th>Date acquired</th>
<th>Date sold</th>
<th>Sales price</th>
<th>Cost</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revco</td>
<td>Feb 1, 2008</td>
<td>March 17, 2010</td>
<td>$15,000</td>
</tr>
<tr>
<td>Abbco</td>
<td>Feb 18, 2010</td>
<td>April 1, 2010</td>
<td>$8,000</td>
</tr>
</tbody>
</table>

Numeric ___ ___ ___ ___
2. In 2003, Joan received an acre of land as an inter-vivos gift from her grandfather. At the time of the gift, the land had a fair market value of $50,000. The grandfather's adjusted basis was $60,000. Joan sold the land in 2010 to an unrelated third party for $56,000.

3. The Moores received a $500 security deposit on their rental property in 2010. They are required to return the amount to the tenant.

4. Tom's 2010 wages were $53,000. In addition, Tom's employer provided group-term life insurance on Tom's life in excess of $50,000. The cost of such excess coverage was $2,000.

5. During 2010, the Moores received a $2,500 federal tax refund and a $1,250 state tax refund for 2009 overpayments. In 2009, the Moores were not subject to the alternative minimum tax and were not entitled to any credit against income tax. The Moores' 2009 adjusted gross income was $80,000 and itemized deductions were $1,450 in excess of the standard deduction. The state tax deduction for 2009 was $2,000.

6. In 2010, Joan received $1,300 in unemployment compensation benefits. Her employer made a $100 contribution to the unemployment insurance fund on her behalf.

7. The Moores received $8,400 in gross receipts from their rental property during 2010. The expenses for the residential rental property were:

<table>
<thead>
<tr>
<th>Expense</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bank mortgage interest</td>
<td>$1,200</td>
</tr>
<tr>
<td>Real estate taxes</td>
<td>700</td>
</tr>
<tr>
<td>Insurance</td>
<td>500</td>
</tr>
<tr>
<td>MACRS depreciation</td>
<td>3,500</td>
</tr>
</tbody>
</table>

8. The Moores received a stock dividend in 2010 from Ace Corp. They had the option to receive either cash or Ace stock with a fair market value of $900 as of the date of distribution. The par value of the stock was $500.

9. In 2010, Joan received $3,500 as beneficiary of the death benefit which was provided by her brother's employer. Joan's brother did not have a nonforfeitable right to receive the money while living.

10. Tom received $10,000, consisting of $5,000 each of principal and interest, when he redeemed a Series EE savings bond in 2010. The bond was issued in his name in 1990 and the proceeds were used to pay for Laura's college tuition. Tom had not elected to report the yearly increases in the value of the bond.
Required:

b. For Item 11, determine the amount of the adjustment, if any, to arrive at adjusted gross income.

11. As required by a 1990 divorce agreement, Tom paid an annual amount of $8,000 in alimony and $10,000 in child support during 2010.

Numeric __ __ __ __ __

Required:

c. During 2010, the following events took place. For Items 12 to 23, select the appropriate tax treatment from the Tax Treatment List. A tax treatment may be selected once, more than once, or not all.

**Tax Treatments:**

(A) Not deductible on Form 1040.

(B) Deductible in full in Schedule A-Itemized Deductions.

(C) Deductible in Schedule A-Itemized Deductions, subject to a threshold of 7.5% of adjusted gross income.

(D) Deductible in Schedule A-Itemized Deductions, subject to a limitation of 50% of adjusted gross income.

(E) Deductible in Schedule A-Itemized Deductions, subject to a $100 floor and a threshold of 10% of adjusted gross income.

(F) Deductible in Schedule A-Itemized Deductions, subject to a threshold of 2% of adjusted gross income.

**Events:**


___13. Payment of a personal property tax based on the value of the Moores' car.

___14. Used clothes were donated to church organizations.

___15. Premiums were paid covering insurance against Tom's loss of earnings.

___16. Tom paid for subscriptions to accounting journals.

___17. Interest was paid on a $10,000 home-equity line of credit secured by the Moores' residence. The fair market value of the home exceeded the mortgage by $50,000. Tom used the proceeds to purchase a sailboat.

___18. Amounts were paid in excess of insurance reimbursement for prescription drugs.

___19. Funeral expenses were paid by the Moores for Joan's brother.

___20. Theft loss was incurred on Joan's jewelry in excess of insurance reimbursement. There were no 2010 personal casualty gains.

___21. Loss on the sale of the family's sailboat.
___22. Interest was paid on the $300,000 acquisition mortgage on the Moores' home. The mortgage is secured by their home.

___23. Joan performed free accounting services for the Red Cross. The estimated value of the services was $500.

Required:
d. For Items 24 to 29, indicate if the statement is True (T) or False (F) regarding the Moores' 2010 tax return.

___24. For 2010, the Moores were subject to the phaseout of half their personal exemptions for regular tax because their adjusted gross income was $75,000.

___25. The Moores' unreimbursed medical expenses for AMT had to exceed 10% of adjusted gross income.

___26. The Moores' personal exemption amount for regular tax was not permitted for determining 2010 AMT.

___27. The Moores paid $1,200 in additional 2010 taxes when they filed their return on April 15, 2011. Their 2010 federal tax withholdings equaled 100% of 2009 tax liability. Therefore, they were not subject to the underpayment of tax penalty.

___28. The Moores, both being under age 50, were subject to an early withdrawal penalty on their IRA withdrawals used for medical expenses.

___29. The Moores were allowed an earned income credit against their 2010 tax liability equal to a percentage of their wages.

PROBLEM 4

Problem Number 4 consists of 3 parts. Part A consists of 9 items, Part B consists of 10 items, and Part C consists of 1 item. Select the best answer for each item.

a. The Internal Revenue Service is auditing Oate's 2010 Form 1040 – Individual Income Tax Return. During 2010, Oate, an unmarried custodial parent, had one dependent three-year-old child and worked in a CPA firm. For 2010, Oate, who had adjusted gross income of $40,000, qualified to itemize deductions and was subject to federal income tax liability.

Required:
For Items 1 through 9, select from the following list of tax treatments the appropriate tax treatment. A tax treatment may be selected once, more than once, or not at all.

Tax Treatments:
A. Not deductible on Form 1040.
B. Deductible in full on Schedule A – Itemized Deductions.
C. Deductible in Schedule A – Itemized Deductions subject to a limitation of 50% of adjusted gross income.
D. Deductible in Schedule A – Itemized Deductions as miscellaneous deduction subject to a threshold of 2% of adjusted gross income.
E. Deductible in Schedule A – Itemized Deductions as miscellaneous deduction NOT subject to a threshold of 2% of adjusted gross income.
F. Deductible on Schedule E – Supplemental Income and Loss.
G. A credit is allowable.
1. In 2010, Oate paid $900 toward continuing education courses and was not reimbursed by her employer.

2. For 2010, Oate had a $30,000 cash charitable contribution carryover from her 2009 cash donation to the American Red Cross. Oate made no additional charitable contributions in 2010.

3. During 2010, Oate had investment interest expense that did not exceed her net investment income.

4. Oate's 2010 lottery ticket losses were $450. She had no gambling winnings.

5. During 2010, Oate paid $2,500 in real property taxes on her vacation home, which she used exclusively for personal use.

6. In 2010, Oate paid a $500 premium for a homeowner's insurance policy on her principal residence.

7. For 2010, Oate paid $1,500 to an unrelated babysitter to care for her child while she worked.

8. In 2010, Oate paid $4,000 interest on the $60,000 acquisition mortgage of her principal residence. The mortgage is secured by Oate's home.

9. During 2010, Oate paid $3,600 real property taxes on residential rental property in which she actively participates. There was no personal use of the rental property.

b. Frank and Dale Cumack are married and filing a joint 2010 income tax return. During 2010, Frank, 65, was retired from government service and Dale, 55, was employed as a university instructor. In 2010, the Cumacks contributed all of the support to Dale's father, Jacques, an unmarried French citizen and French resident who had no gross income.

Required:
For Items 10 through 19, select the correct amount of income, loss, or adjustment to income that should be recognized on page 1 of the Cumacks' 2010 Form 1040 – Individual Income Tax Return to arrive at the adjusted gross income for each separate transaction. A response may be selected once, more than once, or not at all.

Any information contained in an item is unique to that item and is not to be incorporated in your calculations when answering other items.

Amounts:

A. $0
B. $1,000
C. $2,000
D. $2,250
E. $3,000
F. $4,000
G. $5,000
H. $9,000
I. $10,000
J. $25,000
K. $30,000
L. $125,000
M. $150,000
10. During 2010, Dale received a $30,000 cash gift from her aunt.

11. Dale contributed $5,000 to her Individual Retirement Account (IRA) on January 15, 2011. In 2010, she earned $60,000 as a university instructor. During 2010, the Cumacks were not active participants in an employer's qualified pension or annuity plan.

12. In 2010, the Cumacks received a $1,000 federal income tax refund.

13. During 2010, Frank, a 50% partner in Diske General Partnership, received a $4,000 guaranteed payment from Diske for services that he rendered to the partnership that year.

14. In 2010, Frank received $10,000 as beneficiary of his deceased brother's life insurance policy.

15. Dale's employer pays 100% of the cost of all employees' group term life insurance under a qualified plan. Policy cost is $5 per $1,000 of coverage. Dale's group term life insurance coverage equals $450,000.

16. In 2010, Frank won $5,000 at a casino and had $2,000 in gambling losses.

17. During 2010, the Cumacks received $1,000 interest income associated with a refund of their prior years' federal income tax.

18. In 2010, the Cumacks sold their first and only residence for $200,000. They purchased their home in 1985 for $50,000 and have lived there since then. There were no other capital gains, losses, or capital loss carryovers.

19. In 2010, Zeno Corp. declared a stock dividend and Dale received one additional share of Zeno common stock for three shares of Zeno common stock that she held. The stock that Dale received had a fair market value of $9,000. There was no provision to receive cash instead of stock.

c. Frank and Dale Cumack are married and filing a joint 2010 income tax return. During 2010, Frank, 65, was retired from government service and Dale, 55, was employed as a university instructor. In 2010, the Cumacks contributed all of the support to Dale's father, Jacques, an unmarried French citizen and French resident who had no gross income.

Required:
For Item 20, determine whether the Cumacks overstated, understated, or correctly determined the number of both personal and dependency exemptions.

Selections:
O. Overstated the number of both personal and dependency exemptions.

U. Understated the number of both personal and dependency exemptions.

C. Correctly determined the number of both personal and dependency exemptions.

20. The Cumacks claimed 3 exemptions on their 2010 joint income tax return.
PROBLEM 5

Problem Number 5 consists of 2 parts concerning federal estate and gift taxation. Part A consists of 5 items and Part B consists of 5 items. Select the best answer for each item. Answer all items.

Items 1 through 5 are based on the following fact pattern:

Before his death, Remsen, a U.S. citizen, made cash gifts of $7,000 each to his four sisters. In 2010, Remsen also paid $2,000 in tuition directly to his grandchild's university on the grandchild's behalf. Remsen made no other lifetime transfers. Remsen died on January 19, 2010, and was survived by his wife and only child, both of whom were U.S. citizens. The Remsens did not live in a community property state.

At his death, Remsen owned:

Cash        $ 650,000
Marketable securities
(Fair market value)       900,000
Life insurance policy with Remsen's wife
named as the beneficiary (fair market value)    500,000

Under the provisions of Remsen's will, the net cash, after payment of executor's fees and medical and funeral expenses, was bequeathed to Remsen's son. The marketable securities were bequeathed to Remsen's spouse. During 2010, Remsen's estate paid:

Executor's fees to distribute the decedent's property
(deducted on the fiduciary tax return) $  15,000
Decedent's funeral expenses 25,000

The estate's executor extended the time to file the estate tax return.

On January 3, 2011, the estate's executor paid $10,000 for the decedent’s medical expense incurred in 2010 and filed the extended estate tax return.

Required:

a. For Items 1 through 5, identify the federal tax treatment for each item. An answer may be selected once, more than once, or not at all.

Estate Tax Treatments:  
F. Fully includible in Remsen's gross estate.  
P. Partially includible in Remsen's gross estate.  
N. Not includible in Remsen's gross estate.

___1. What is the estate tax treatment of the $7,000 cash gift to each sister? 
___2. What is the estate tax treatment of the life insurance proceeds?  
___3. What is the estate tax treatment of the marketable securities?  
___4. What is the estate tax treatment of the $2,000 tuition payment?  
___5. What is the estate tax treatment of the $650,000 cash?
Required:
b. For Items 6 through 10, identify the federal estate tax treatment for each item. An answer may be selected once, more than once, or not at all.

_Estate Tax Treatments:_

G. Deductible from Remsen's gross estate to arrive at Remsen's taxable estate.

I. Deductible on Remsen's 2010 individual income tax return.

E. Deductible on either Remsen's estate tax return or Remsen's 2010 individual income tax return.

N. Not deductible on either Remsen's estate tax return or Remsen's 2010 individual income tax return.

___ 6. What is the estate tax treatment of the executor's fees?

___ 7. What is the estate tax treatment of the cash bequest to Remsen's son?

___ 8. What is the estate tax treatment of the life insurance proceeds paid to Remsen's spouse?

___ 9. What is the estate tax treatment of the funeral expenses?

___ 10. What is the estate tax treatment of the $10,000 of the year 2010 medical expense incurred before the decedent's death and paid by the executor on January 3, 2011?

**PROBLEM 6**

_Problem Number 6_ consists of 9 items. Select the best answer for each item. Answer all items. Your grade will be based on the total number of correct answers.

A CPA sole practitioner has tax preparers' responsibilities when preparing tax returns for clients.

Required:
_Items 1 through 9_ each represent an independent factual situation in which a CPA sole practitioner has prepared and signed the taxpayer's income tax return. For each item, select from the following list the correct response regarding the tax preparer's responsibilities. A response may be selected once, more than once, or not at all.

**Answer List:**

P. The tax preparer's action constitutes an act of tax preparer misconduct subject to the Internal Revenue Code penalty.

E. The Internal Revenue Service will examine the facts and circumstances to determine whether the reasonable cause exception applies; the good faith exception applies; or both exceptions apply.

N. The tax preparer's action does not constitute an act of tax preparer misconduct.
1. The tax preparer disclosed taxpayer income tax return information under an order from a state court, without the taxpayer's consent.

2. The tax preparer relied on the advice of an advisory preparer to calculate the taxpayer's tax liability. The tax preparer believed that the advisory preparer was competent and that the advice was reasonable. Based on the advice, the taxpayer had understated income tax liability.

3. The tax preparer did not charge a separate fee for the tax return preparation and paid the taxpayer the refund shown on the tax return less a discount. The tax preparer negotiated the actual refund check for the tax preparer's own account after receiving power of attorney from the taxpayer.

4. The tax preparer relied on information provided by the taxpayer regarding deductible travel expenses. The tax preparer believed that the taxpayer's information was correct but inquired about the existence of the travel expense records. The tax preparer was satisfied by the taxpayer's representations that the taxpayer had adequate records for the deduction. Based on this information, the income tax liability was understated.

5. The taxpayer provided the tax preparer with a detailed check register to compute business expenses. The tax preparer knowingly overstated the expenses on the income tax return.

6. The tax preparer disclosed taxpayer income tax return information during a quality review conducted by CPAs. The tax preparer maintained a record of the review.

7. The tax preparer relied on incorrect instructions on an IRS tax form that were contrary to the regulations. The tax preparer was not aware of the regulations nor the IRS announcement pointing out the error. The understatement was immaterial as a result of the isolated error.

8. The tax preparer used income tax return information without the taxpayer's consent to solicit additional business.

9. The tax preparer knowingly deducted the expenses of the taxpayer's personal domestic help as wages paid in the taxpayer's business on the taxpayer's income tax return.

PROBLEM 7

**Problem Number 7** consists of 11 items about C Corporations. Select the **best** answer for each item. Answer all items. Your grade will be based on the total number of correct answers.


**Required:**

**Items 1 through 4** each require **two** responses:

a. For each item below, determine the amount of Capital's 2010 Schedule M-1 adjustment necessary to reconcile book income to taxable income.

b. In addition, determine if the Schedule M-1 adjustment necessary to reconcile book income to taxable income increases, decreases, or has no effect on Capital's 2010 taxable income. An answer may be selected once, more than once, or not at all.
**Selections:**

**I.** Increases Capital's 2010 taxable income.

**D.** Decreases Capital's 2010 taxable income.

**N.** Has no effect on Capital's 2010 taxable income.

___1.  At its corporate inception in 2009, Capital incurred and paid $40,000 in organizational costs for legal fees to draft the corporate charter. In 2009, Capital correctly elected, for book purposes, to amortize the organizational expenditures over 40 years and for the minimum required period on its federal income tax return to maximize the deduction. For 2010, Capital amortized $1,000 of the organizational costs on its books.

    Numeric __ __ __ __

___2.  Capital's 2010 disbursements included $10,000 for reimbursed employees' expenses for business meals and entertainment. The reimbursed expenses met the conditions of deductibility and were properly substantiated under an accountable plan. The reimbursement was not treated as employee compensation.

    Numeric __ __ __ __

___3.  Capital's 2010 disbursements included $15,000 for life insurance premium expense paid for its executives as part of their taxable compensation. Capital is neither the direct nor the indirect beneficiary of the policy, and the amount of the compensation is reasonable.

    Numeric __ __ __ __

___4.  In 2010, Capital increased its allowance for uncollectible accounts by $10,000. No bad debt was written off in 2010.

    Numeric __ __ __ __


Required:

**c.** For Items 5 and 6, determine if the following items are fully taxable, partially taxable, or nontaxable for regular income tax purposes on Sunco's 2010 federal income tax return. An answer may be selected once, more than once, or not at all.

**Selections:**

**F.** Fully taxable for regular income tax purposes on Sunco's 2010 federal income tax return.

**P.** Partially taxable for regular income tax purposes on Sunco's 2010 federal income tax return.

**N.** Nontaxable for regular income tax purposes on Sunco's 2010 federal income tax return.

___5.  In 2010, Sunco received dividend income from a 35%-owned domestic corporation. The dividends were not from debt-financed portfolio stock, and the taxable income limitations did not apply.

___6.  In 2010, Sunco received a $2,800 lease cancellation payment from a three-year lease tenant.
Quest Corp., an accrual-basis calendar-year C corporation, timely filed its 2010 federal income tax return on Monday, March 15, 2011.

**Required:**

d. **For Items 7 and 8,** determine if the following items are fully deductible, partially deductible, or nondeductible for regular income tax purposes on Quest's 2010 federal income tax return. An answer may be selected once, more than once, or not at all.

**Selections:**

F. Fully deductible for regular income tax purposes on Quest's 2010 federal income tax return.

P. Partially deductible for regular income tax purposes on Quest's 2010 federal income tax return.

N. Nondeductible for regular income tax purposes on Quest's 2010 federal income tax return.

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___7. Quest's 2010 taxable income before charitable contributions and dividends-received deduction was $200,000. Quest's Board of Directors authorized a $38,000 contribution to a qualified charity on December 1, 2010. The payment was made on February 1, 2011. All charitable contributions were properly substantiated.

___8. During 2010, Quest was assessed and paid a $300 uncontested penalty for failure to pay its 2009 federal income taxes on time.

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**Required:**

**e. For Items 9 through 11,** determine if each item, taken separately, contributes to overstating, understating, or correctly stating Gelco's 2010 alternative minimum taxable income (AMTI) prior to the adjusted current earnings adjustment (ACE). An answer may be selected once, more than once, or not at all.

**Selections:**

O. Overstating Gelco's 2010 AMTI prior to the ACE.

U. Understating Gelco's 2010 AMTI prior to the ACE.

C. Correctly stating Gelco's 2010 AMTI prior to the ACE.

---

___9. For regular tax purposes, Gelco deducted the maximum MACRS depreciation on seven-year personal property placed in service on January 1, 2010. Gelco made no Internal Revenue Code Section 179 election to expense the property in 2010.

___10. For regular income tax purposes, Gelco depreciated nonresidential real property placed in service on January 1, 2010, under the general MACRS depreciation system for a 39-year depreciable life.

___11. Gelco excluded state highway construction general obligation bond interest income earned in 2010 for regular income tax and alternative minimum tax (AMT) purposes.
PROBLEM 8 (Estimated time—45 to 55 minutes)

Problem Number 8 consists of 28 items. Select the best answer for each item. Answer all items. Your grade will be based on the total number of correct answers.

Reliant Corp., an accrual basis calendar-year C corporation, filed its 2010 federal income tax return on March 15, 2011.

Required:
The following two responses are required for each of the Items 1 through 6.

a. Determine the amount of Reliant's 2010 Schedule M-1 adjustment.

b. Indicate if the adjustment (I) increases, (D) decreases, or (N) has no effect, on Reliant's 2010 taxable income.

1. Reliant's disbursements included reimbursed employees' expenses in 2010 for travel of $100,000, and business meals of $30,000. The reimbursed expenses met the conditions of deductibility and were properly substantiated under an accountable plan. The reimbursement was not treated as employee compensation.

   Numeric __ __ __ __ __  Letter ______

2. Reliant's books expensed $7,000 in 2010 for the term life insurance premiums on the corporate officers. Reliant was the policy owner and beneficiary.

   Numeric __ __ __ __ __  Letter ______

3. Reliant's books indicated an $18,000 state franchise tax expense for 2010. Estimated state tax payments for 2010 were $15,000.

   Numeric __ __ __ __ __  Letter ______

4. Book depreciation on computers for 2010 was $10,000. These computers, which cost $50,000, were placed in service on January 2, 2009. Tax depreciation used MACRS with the half-year convention. No election was made to expense part of the computer cost or to use a straight-line method or the alternative depreciation system. The company elects out of any bonus depreciation.

   Numeric __ __ __ __ __  Letter ______

5. For 2010, Reliant's books showed a $4,000 short-term capital gain distribution from a mutual fund corporation and a $5,000 loss on the sale of Retro stock that was purchased in 1998. The stock was an investment in an unrelated corporation. There were no other 2010 gains or losses and no loss carryovers from prior years.

   Numeric __ __ __ __ __  Letter ______

6. Reliant's 2010 taxable income before the charitable contribution and the dividends received deductions was $500,000. Reliant's books expensed $15,000 in board-of-director authorized charitable contributions that were paid on January 5, 2011. Charitable contributions paid and expensed during 2010 were $35,000. All charitable contributions were properly substantiated. There were no net operating losses or charitable contributions that were carried forward.

   Numeric __ __ __ __ __  Letter ______

Required:

c. For Items 7 through 11, indicate if the expenses are (F) fully deductible, (P) partially deductible, or (N) nondeductible for regular tax purposes on Reliant's 2010 federal income tax return. All transactions occurred during 2010.
7. Reliant purchased theater tickets for its out of town clients. The performance took place after Reliant's substantial and bona fide business negotiations with its clients.

8. Reliant accrued advertising expenses to promote a new product line. Ten percent of the new product line remained in ending inventory.

9. Reliant incurred interest expense on a loan to purchase municipal bonds.

10. Reliant paid a penalty for the underpayment of 2009 estimated taxes.

11. On December 9, 2010, Reliant's board of directors voted to pay a $500 bonus to each non-stockholder employee for 2010. The bonuses were paid on February 3, 2011.

**Required:**

d. For Items 12 through 16, indicate if the following items are (F) fully taxable, (P) partially taxable, or (N) nontaxable for regular tax purposes on Reliant's 2010 federal income tax return. All transactions occurred during 2010.

Items 12 and 13 are based on the following:
Reliant filed an amended federal income tax return for 2008 and received a refund that included both the overpayment of the federal taxes and interest.

12. The portion of Reliant's refund that represented the overpayment of the 2008 federal taxes.

13. The portion of Reliant's refund that is attributable to the interest on the overpayment of federal taxes.

14. Reliant received dividend income from a mutual fund that solely invests in municipal bonds.

15. Reliant, the lessor, benefited from the capital improvements made to its property by the lessee in 2009. The lease agreement is for one year ending December 31, 2010, and provided for a reduction in rental payments by the lessee in exchange for the improvements.

16. Reliant collected the proceeds on the term life insurance policy on the life of a debtor who was not a shareholder. The policy was assigned to Reliant as collateral security for the debt. The proceeds exceeded the amount of the debt.

**Required:**
e. For Items 17 through 21, indicate if the following (I) increase, (D) decrease, or (N) have no effect on Reliant's 2010 alternative minimum taxable income (AMTI) prior to the adjusted current earnings adjustment (ACE).

17. Reliant used the 70% dividends-received deduction for regular tax purposes.

18. Reliant received interest from a state's general obligation bonds.

19. Reliant used MACRS depreciation on seven-year personal property placed into service January 3, 2010, for regular tax purposes. No expense or depreciation election was made.

20. Depreciation on nonresidential real property placed into service on January 3, 2010, was under the general MACRS depreciation system for regular tax purposes.

21. Reliant had only cash charitable contributions for 2010.
Required:
f. For Items 22 through 28, indicate if the statement is true (T) or false (F) regarding Reliant's compliance with tax procedures, tax credits and the alternative minimum tax.

___22. Reliant's exemption for alternative minimum tax is reduced by 20% of the excess of the alternative minimum taxable income over $150,000.

___23. The statute of limitations on Reliant's fraudulent 2003 federal income tax return expires six years after the filing date of the return.

___24. The statute of limitations on Reliant's 2008 federal income tax return, which omitted 30% of gross receipts, expires 2 years after the filing date of the return.

___25. The targeted job tax credit may be combined with other business credits to form part of Reliant's general business credit.

___26. Reliant incurred qualifying expenditures to remove existing access barriers at the place of employment in 2010. As a small business, Reliant qualifies for the disabled access credit.

___27. Reliant's tax preparer, a CPA firm, may use the 2010 corporate tax return information to prepare corporate officers' tax returns without the consent of the corporation.

___28. Reliant must file an amended return for 2010 within 1 year of the filing date.

PROBLEM 9 (Estimated time—5 to 10 minutes)
Problem Number 9 consists of 6 items. Select the best answer for each item. Answer all items.


Required:
a. For Items 1 through 4, determine the amount, if any, using the fact pattern for each item.

1. Assume the following facts:

Lan's 2010 books recorded the following items:

<table>
<thead>
<tr>
<th>Item</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gross receipts</td>
<td>$7,260</td>
</tr>
<tr>
<td>Interest income on investments</td>
<td>50</td>
</tr>
<tr>
<td>Charitable contributions</td>
<td>1,000</td>
</tr>
<tr>
<td>Supplies</td>
<td>1,120</td>
</tr>
</tbody>
</table>

What amount of net business income should Lan report on its 2010 Form 1120S, U.S. Income Tax Return for an S Corporation, Schedule K?

Numeric __ __ __ __ __
2. Assume the following facts:

As of January 3, 2010, Taylor and Barr each owned 100 shares of the 200 issued shares of Lan stock. On January 31, 2010, Taylor and Barr each sold 20 shares to Pike. No election was made to terminate the tax year. Lan had net business income of $14,520 for the year ended December 31, 2010, and made no distributions to its shareholders. Lan's 2010 calendar year had 363 days.

What amount of net business income should have been reported on Pike's 2010 Schedule K-1 from Lan? (2010 is a 363-day tax year.) Round the answer to the nearest hundred.

Numeric __ __ __ __ __

3. Assume the following facts:

Pike purchased 40 Lan shares on January 31, 2010, for $4,000. Lan made no distributions to shareholders, and Pike's 2010 Schedule K-1 from Lan reported:

| Ordinary business loss | ($1,000) |
| Municipal bond interest income | 150 |

What was Pike's basis in his Lan stock at December 31, 2010?

Numeric __ __ __ __ __

4. Assume the following facts:

On January 3, 2010, Taylor and Barr each owned 100 shares of the 200 issued shares of Lan stock. Taylor's basis in Lan shares on that date was $10,000. Taylor sold all of his Lan shares to Pike on January 31, 2010, and Lan made a valid election to terminate its tax year. Taylor's share of ordinary income from Lan prior to the sale was $2,000. Lan made a cash distribution of $3,000 to Taylor on January 30, 2010.

What was Taylor's basis in Lan shares for determining gain or loss from the sale to Pike?

Numeric __ __ __ __ __

**Required:**

b. For **Items 5 and 6**, indicate if the item is True (T) or False (F) regarding Lan's S corporation status.

____ 5. Lan issues shares of both preferred and common stock to shareholders at inception on January 3, 2010. This will **not** affect Lan's S corporation eligibility.

____ 6. Lan, an S corporation since inception, has passive investment income for 3 consecutive years following the year a valid S corporation election takes effect. Lan's S corporation election is terminated as of the first day of the fourth year.
PROBLEM 10 (Estimated time—40 to 50 minutes)

Following is Ral Corp.’s condensed income statement, before federal income tax, for the year ended December 31, 2010:

Sales $1,000,000  
Cost of sales 700,000  
Gross profit 300,000  
Operating expenses 220,000  
Operating income 80,000  
Other income (loss):  
Interest $ 5,200  
Dividends 19,200  
Net long-term capital loss (6,400)  
Income before federal income tax $ 98,000

Additional information:
Interest arose from the following sources:  
U.S. Treasury notes $ 3,000  
Municipal arbitrage bonds 2,000  
Other municipal bonds 200  
Total interest $ 5,200

Dividends arose from the following sources:  

<table>
<thead>
<tr>
<th>Taxable domestic corporation</th>
<th>Date stock acquired</th>
<th>Percent owned by Ral</th>
<th>Percent owned by Ral</th>
</tr>
</thead>
<tbody>
<tr>
<td>Clove Corp.</td>
<td>7-1-88</td>
<td>30.0</td>
<td>$7,000</td>
</tr>
<tr>
<td>Ramo Corp.</td>
<td>9-1-90</td>
<td>10.0</td>
<td>6,000</td>
</tr>
<tr>
<td>Sol Corp. (stock sold 1/10/09)</td>
<td>12-1-08</td>
<td>5.0</td>
<td>1,000</td>
</tr>
<tr>
<td>Real Estate Investment Trust</td>
<td>6-1-95</td>
<td>1.0</td>
<td>2,700</td>
</tr>
<tr>
<td>Mutual Fund Corp. (capital gains dividends only)</td>
<td>4-1-93</td>
<td>0.1</td>
<td>400</td>
</tr>
<tr>
<td>Money Market Fund (invests only in interest-paying securities)</td>
<td>3-1-92</td>
<td>0.1</td>
<td>2,100</td>
</tr>
<tr>
<td>Total dividends</td>
<td></td>
<td></td>
<td>$19,200</td>
</tr>
</tbody>
</table>

Operating expenses include the following:  
- Bonus of $5,000 paid to Ral’s sales manager on January 31, 2011. This bonus was based on a percentage of Ral’s 2010 sales and was computed on January 25, 2011, under a formula in effect in 2010.  
- Estimate of $10,000 for bad debts. Actual bad debts for the year amounted to $8,000.  
- Keyman life insurance premiums of $4,000. Ral is the beneficiary of the policies.  
- State income taxes of $12,000.

During 2010, Ral made estimated federal income tax payments of $35,000. These payments were debited to prepaid tax expense on Ral’s books.

Ral does not exercise significant influence over Clove and accordingly did not use the equity method of accounting for this investment.

Ral declared and paid dividends of $11,000 during 2010.
Corporate income tax rates are as follows:

<table>
<thead>
<tr>
<th>Taxable income</th>
<th>Pay</th>
<th>% on excess</th>
<th>Of the amount</th>
<th>over—</th>
</tr>
</thead>
<tbody>
<tr>
<td>$ 0—$ 50,000</td>
<td>$ 0</td>
<td>15</td>
<td>$ 0</td>
<td>50,000</td>
</tr>
<tr>
<td>50,000— 75,000</td>
<td>7,500</td>
<td>25</td>
<td>75,000</td>
<td></td>
</tr>
<tr>
<td>75,000— 100,000</td>
<td>13,750</td>
<td>34</td>
<td>100,000</td>
<td></td>
</tr>
<tr>
<td>100,000— 335,000</td>
<td>22,250</td>
<td>39</td>
<td>335,000</td>
<td></td>
</tr>
<tr>
<td>335,000— ...........</td>
<td>113,900</td>
<td>34</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Ral was not subject to the alternative minimum tax in 2010.

Required:

a. Prepare a schedule of Ral’s 2010 taxable income.
b. Compute Ral’s 2010 federal income tax and the amount of tax overpaid or payable.
c. Prepare a reconciliation of Ral’s income per books with income per return.

PROBLEM 11 (Estimated time—5 to 10 minutes)

This problem consists of 8 items. Select the best answer for each item. Answer all items. Your grade will be based on the total number of correct answers.

During 1990, Adams, a general contractor, Brinks, an architect, and Carson, an interior decorator, formed the Dex Home Improvement General Partnership by contributing the assets below.

<table>
<thead>
<tr>
<th>Partner</th>
<th>Asset</th>
<th>Fair value</th>
<th>Adjusted basis</th>
<th>% of partner share in capital, profits &amp; losses</th>
</tr>
</thead>
<tbody>
<tr>
<td>Adams</td>
<td>Cash</td>
<td>$40,000</td>
<td>$40,000</td>
<td>50%</td>
</tr>
<tr>
<td>Brinks</td>
<td>Land</td>
<td>$12,000</td>
<td>$21,000</td>
<td>20%</td>
</tr>
<tr>
<td>Carson</td>
<td>Inventory</td>
<td>$24,000</td>
<td>$24,000</td>
<td>30%</td>
</tr>
</tbody>
</table>

The land was a capital asset to Brinks, subject to a $5,000 mortgage, which was assumed by the partnership.

For items 1 and 2, determine and select the initial basis of the partner's interest in Dex.

1. Brinks' initial basis in Dex is
   A. $21,000
   B. $12,000
   C. $8,000

2. Carson's initial basis in Dex is
   A. $25,500
   B. $24,000
   C. $19,000

During 2010, the Dex partnership breaks even but decides to make distributions to each partner.
For items 3 through 8, determine whether the statement is true (T) or false (F).

___3. A nonliquidating cash distribution may reduce the recipient partner's basis in his partnership interest below zero.

___4. A nonliquidating distribution of unappreciated inventory reduces the recipient partner's basis in his partnership interest.

___5. In a liquidating distribution of property other than money, where the partnership's basis of the distributed property exceeds the basis of the partner's interest, the partner's basis in the distributed property is limited to his pre-distribution basis in the partnership interest.

___6. Gain is recognized by the partner who receives a nonliquidating distribution of property, where the adjusted basis of the property exceeds his basis in the partnership interest before the distribution.

___7. In a nonliquidating distribution of inventory, where the partnership has no unrealized receivables or appreciated inventory, the basis of inventory that is distributed to a partner cannot exceed the inventory's adjusted basis to the partnership.

___8. The partnership's nonliquidating distribution of encumbered property to a partner who assumes the mortgage, does not affect the other partners' bases in their partnership interests.
Appendix Answers

ANSWER 1

1. (c) Retainer fees are reported on Schedule C which is where trade or business income is presented. Retainer fees, even though they may not be “earned”, still represent gross income to a cash basis taxpayer.

2. (d) Oil royalties are reported along with income from rents, trusts, estates, partnerships and S Corporations on Schedule E, which is called Supplemental Income and Loss.

3. (e) Interest income on general obligations of the state and local obligations is not included in gross income.

4. (b) Interest earned on refunds of federal income taxes (as well as state income taxes) is included in gross income.

5. (e) This is a pure exclusion and is not taxable.

6. (b) Interest income on US Treasury bonds is included in gross income.

7. (d) A partner’s share of partnership ordinary income is reported on Schedule E. Watch out for other components of income, such as interest, which must be reported on Schedule B.

8. (d) Rental income is reported on Schedule E.

9. (a) Prizes, as well as awards, are included in gross income. Prizes are reported "other income" on page one of Form 1040.

10. (a) Jury duty pay is included as gross income. The pay is reported on page one of Form 1040 as "other income."

11. (e) Dividends received from mutual funds that invest solely in tax-free government obligations are not taxable to the recipient.

12. (h) Unreimbursed medical expenses are reported on Schedule A--Itemized Deductions, subject to a threshold of 7.5% of adjusted gross income.

13. (o) Personal life insurance premiums are personal and non-deductible.

14. (m) This is a business deduction reported on Schedule C--Profit or Loss From Business. Only 50% of the expenditure is allowed as a deduction. Remember, Green is self-employed and not an employee.

15. (k) Depreciation on personal computers used in a trade or business is allowed as a deduction against business income as reported on Schedule C. Depreciation expense is reported on Form 4562 - Depreciation and Amortization. Note that this is also listed property and limitations might exist (but not in this problem).

16. (l) These travel expenses (expenses incurred while out of town) are fully deductible business expenses and are reported on Schedule C.

17. (l) These business expenses are fully deductible and reported on Schedule C.

18. (g) 50% of the self-employment taxes paid are allowed as a deduction for adjusted gross income.
19. (f) Qualifying contributions to a simplified employee pension plan are fully deductible on Form 1040 in arriving at adjusted gross income. They are not business expenses reported on a Schedule C. Also the word qualifying assumes that the % limitation has been met in calculating the qualifying amount.

20. (k) Section 179 states that a taxpayer may elect to expense up to $500,000 of qualifying tangible personal property. This is reported on Form 4562 - Depreciation and Amortization.

21. (f) Qualifying alimony payments are fully deductible by Green on Form 1040 in arriving at adjusted gross income. Qualifying assumes no front loading, etc.

22. (i) Subscriptions for investment related publications are allowable as investment expenses. They are reported on Schedule A--Itemized deductions and are subject to a threshold of 2% of adjusted gross income.

23. (l) The interest on the home equity loan would be reported as a deduction on Schedule C because the loan was used for Green's trade or business.

24. (m) Because the automobile is used 75% for business, only 75% of the interest would be deductible on Schedule C. The balance of 25% is non-deductible because it is personal interest.

25. (e) A single taxpayer may exclude up to $250,000 of he gain on the sale of his principal residence.

**ANSWER 2**

1. M and 4. When a taxpayer’s spouse dies during the year, the taxpayer retains the married filing jointly status for the year. The number of exemptions include two personal exemptions and two dependency exemptions. A personal exemption is allowed for Mr. Vick even though he died during the year. The two dependency exemptions include Joan and Fran. The survivor benefits received by her daughter Joan do not disqualify her. Fran qualifies as a dependent even though he does not meet the relationship test. Fran is a resident in the taxpayer’s home for the whole year, has income less than the exemption amount, is a US citizen and the taxpayer provides more than 50% of his support.

2. Q and 3. In 2011, Mrs. Vick can no longer file a joint return because she is not married for this tax year. She does qualify, however, for Qualifying Widow with dependent child. Also, since her husband was not alive during 2011, there is no exemption for him. There are no changes in the dependents.

**Note:** The answers to items 3 through 9 are presented in the four digit numeric response format.

3. 0,000. These are not taxable.

4. 0,400. Interest income on federal and state income tax returns is included as gross income as well as interest on savings accounts and certificates of deposit. Interest from municipal bonds is not included.

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Refund from amended tax return</td>
<td>$ 50</td>
</tr>
<tr>
<td>Savings accounts &amp; CD’s</td>
<td>350</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$ 400</strong></td>
</tr>
</tbody>
</table>

5. 0,900. These are fully included.

6. 0,000. Gifts are not included as gross income.

7. 0,000. Lump sum distributions from life insurance policies are not included as gross income.

8. 0,200. Fully included.
9.  0,450. Fully included. Watch for any gambling losses to be used as itemized deductions (not as direct offsets to gross income).

10.  (A) There is no deduction for premium payments on personal life insurance.

11.  (D) Penalties for premature withdrawals on certificates of deposit are deductions for adjusted gross income.

12.  (F) Charitable contributions are itemized deductions and reported on Schedule A. They are generally subject to a ceiling (not threshold) of not more than 50% of adjusted gross income.

13.  (E) A deduction is allowed for state income tax payments made during the year. They are reported as an itemized deduction with no limitation.

14.  (E) A deduction is allowed for real estate tax payments made during the year. They are reported as an itemized deduction with no limitation.

15.  (A) A personal loss, other than a casualty loss, is not deductible.

16.  (B) Qualified medical expenses, such as chairlift, are allowed as an itemized deduction to the extent that they exceed the threshold of 7.5% of adjusted gross income. Note that it is only the excess of cost over the increase in the fair market value that is the qualified medical expense.

17.  (B) Qualified medical expenses, such as health insurance premiums, are allowed as an itemized deduction to the extent that they exceed the threshold of 7.5% of adjusted gross income.

18.  (C) Clearly one of our more favorite deductions. Fees for the determination of a tax are allowed as an itemized deduction, subject to a threshold of 2% of adjusted gross income. These are grouped in with “Miscellaneous Deductions”.

19.  (E) Points paid under a refinancing are not immediately deductible, but must be amortized over the life of the loan. The amortized portion is fully deductible and is reported on Schedule A.

20.  (D) A taxpayer may deduct 50% of the self-employment taxes paid as a deduction in arriving at adjusted gross income.

21.  (E) Gambling losses are allowed as an itemized deduction to the extent of the gambling income. Since the losses were only $100 and the gambling income was $450, the entire loss is allowed. These are not subject to the 2% test.

22.  (C) Union dues are treated as “Miscellaneous Deductions” on Schedule A, and are subject to a threshold of 2% of adjusted gross income.

23.  (A) There is no deduction allowed for federal income taxes paid.

24.  (F) This is a deduction on Mr. Vick’s estate return.

25.  (T) This is an election which can be made.

26.  (F) A business casualty loss is a deduction for adjusted gross income, not an itemized deduction.

27.  (F) Even though Mr. Vick was disabled, they clearly exceed the income threshold level and would not qualify.

28.  (T) This is one of the preparer’s responsibilities.
29. (F) There is no exception for the income limitation.

30. (F) The vacation pay paid in the following year should be recognized by Mr. Vick’s estate as income in respect of a decedent. Mr. Vick had earned it and the estate had an enforceable right to receive it.

31. (F) Deferral adjustments can be both positive and negative. The adjustment itself may carry over to future periods in terms of reversal and offset future adjustments, thus reducing the alternative minimum taxable income. However, any adjustments due to these timing differences (as opposed to exclusions) result in alternative minimum tax credits which may be carried forward indefinitely to offset future regular tax, not the alternative minimum tax.

ANSWER 3

Note: The answers to Items 1 through 11 are presented in the five digit numeric response format as is required on the exam.

1. 03,000. The Moore’s stock transactions result in an overall net capital loss of $6,000, of which a maximum of $3,000 is currently deductible. The stock transactions are as follows:

<table>
<thead>
<tr>
<th>Stock</th>
<th>Type</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revco</td>
<td>Long-term loss</td>
<td>$-10,000</td>
</tr>
<tr>
<td>Abbco</td>
<td>Short-term gain</td>
<td>4,000</td>
</tr>
<tr>
<td></td>
<td>Net capital loss</td>
<td>$-6,000</td>
</tr>
</tbody>
</table>

2. 00,000. When the fair market value of the property is less than the adjusted basis of the property, the donee’s basis will be the donor’s basis only for the purpose of determining a gain. For the purposes of determining a loss, the donee’s basis will be the fair market value of the property. At any selling price between the fair market value and the adjusted basis the result is no gain or loss.

3. 00,000. The receipt of a security deposit is not considered to be gross income. The receipt of the last month’s rent, however, would be classified as gross income.

4. 55,000. Gross income includes Tom’s wages and the value of the group term life insurance in excess of $50,000.

<table>
<thead>
<tr>
<th>Income</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tom’s salary</td>
<td>$53,000</td>
</tr>
<tr>
<td>Value of excess coverage</td>
<td>2,000</td>
</tr>
<tr>
<td>Total income</td>
<td>$55,000</td>
</tr>
</tbody>
</table>

5. 01,250. When a taxpayer claims a deduction for state income taxes paid in one year, and receives a refund of those taxes in a subsequent year, the taxpayer must recognize that amount as income if there was a tax benefit received. Since Tom’s itemized deductions exceeded the standard deduction by $1,450, and the state tax deduction of $2,000 was part of that excess, the receipt of $1,250 (being less than the excess of $1,450) must be included as income. A federal income tax refund is not included because there is no corresponding deduction allowed for federal income taxes.

6. 01,300. Unemployment compensation benefits are included in gross income only to the extent they exceed $2,400 in 2010.
7. 02,500. The amount of income from rental activities is determined as follows:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Rental income</td>
<td>$8,400</td>
</tr>
<tr>
<td>Bank mortgage interest</td>
<td>1,200</td>
</tr>
<tr>
<td>Real estate taxes</td>
<td>700</td>
</tr>
<tr>
<td>Insurance</td>
<td>500</td>
</tr>
<tr>
<td>MACRS depreciation</td>
<td>3,500</td>
</tr>
<tr>
<td>Total deductions</td>
<td>5,900</td>
</tr>
<tr>
<td>Rental income</td>
<td>$2,500</td>
</tr>
</tbody>
</table>

8. 00,900. Since the taxpayer had the option to receive either cash or stock, the Moore’s must recognize dividend income equal to the fair market value of the stock received, or $900.

9. 03,500. The receipt of employee death benefits are no longer excluded from gross income.

10. 05,000. In general, the interest on redeemed Series EE U.S. savings bonds used to pay for college education can be excluded from gross income. However, the proceeds must be used for the qualified higher educational expenses (tuition and fees) of the taxpayer, his spouse or dependent. Laura is not Tom’s dependent.

11. 08,000. The payment of alimony is a deduction in determining adjusted gross income.

12. (A) If a taxpayer sells, and repurchases substantially identical stock within thirty days of the sale, any loss on the transaction is disallowed. This is called a wash sale.

13. (B) A tax on personal property is deductible (as an itemized deduction on Schedule A) if the tax is based upon the value of the property and is assessed on an annual basis.

14. (D) An itemized deduction, subject to a limitation of 50% of adjusted gross income, is allowed for charitable contributions. The amount allowed would be the fair market value of the clothing.

15. (A) Payment of premiums for insurance covering lost earnings does not qualify as an itemized deduction.

16. (F) A deduction is allowed, subject to a threshold of 2%, for business related publications. Tom is a CPA and the accounting journals would be related to his trade or business as an employee.

17. (B) Interest paid on loans for the acquisition of a qualified residence or a home equity loan generally qualifies as an itemized deduction. The home equity loan of $10,000 (which is under the $100,000 limitation) is also less than the excess of the fair market value over the original mortgage. The use of the proceeds to buy a sailboat does not disqualify the transaction.

18. (C) The unreimbursed portion of the prescription drugs qualifies as an itemized deduction, subject to a threshold of 7.5% of adjusted gross income.

19. (A) Funeral expenses are nondeductible personal expenses.

20. (E) A theft loss on Joan’s jewelry would be classified as a personal loss and qualify as an itemized deduction, subject to a $500 floor and a threshold of 10% of adjusted gross income.

21. (A) A loss on the sale of a personal item, such as a sailboat, is a nondeductible personal expense.
22. (B) Interest paid on loans for the acquisition of a qualified residence or a home equity loan generally qualifies as an itemized deduction. Whereas the amount of the acquisition indebtedness ($300,000) is less than the $1,000,000 limitation and is secured by the real estate, the deduction is fully allowed.

23. (A) There is no deduction allowed for the value of accounting services (or any other service) provided for a charitable organization.

24. (F) The phaseout of personal exemptions has been repealed for 2010.

25. (T) In determining the Moore’s taxable income, the threshold for medical expenses was 7.5%. However, for the purposes of determining the alternative minimum tax (AMT), the threshold rises to 10%.

26. (T) In determining the Moore’s taxable income, a deduction is allowed for the personal exemption. However, for the purposes of determining the alternative minimum tax (AMT), no deduction is allowed.

27. (T) In order to avoid any penalty on the underpayment of taxes, an individual must make payments equal to:
   - 90% of their current year’s tax
   - 100% of their prior year’s tax.
   - 110% of their prior year's tax if the prior year's AGI exceeds $150,000.
   - Annualized income installment method computation

28. (F) When taxpayers withdraw amounts from their IRA’s prior to age 59 1/2, they are generally subject to a 10% early withdrawal penalty. There is a provision to exempt withdrawals for medical purposes from this penalty.

29. (F) This credit provides qualifying taxpayers with relatively low levels of income a credit against their tax liability, or a refund, if in excess of their liability. The Moore’s income of $75,000 as stated in question #24, is far beyond the phase-out range.

**ANSWER 4**

1. (D) This qualifies as a deductible employee expense, subject to a threshold limitation of 2% of AGI. However, it may be a deduction for AGI as well, but that was not an option for answers.

2. (C) Charitable contribution carryovers are subject to the same 50% AGI limitation.

3. (B) Investment interest expense is allowed as an itemized to the extent of the net investment income. Any excess is allowed as a carryforward.

4. (A) Gambling losses are only allowed to the extent of gambling winnings. Therefore, no deduction allowed this year. There are no carryforwards.

5. (B) Real estate taxes are fully allowed as an itemized deduction. There is no limitation for a second home, etc., as there is for mortgage interest.

6. (A) This is a personal expense. No deduction allowed.

7. (G) This qualifies for the dependent care credit.

8. (B) As acquisition indebtedness (mortgage) interest, this qualifies as an itemized deduction.

9. (F) Because this property is used for rental purposes, the real estate taxes paid are offset against the rental income from the property, and reported on Schedule E.
10. (A) $ 0-. Receipt of a bonafide gift does not constitute gross income.

11. (E) $ 5,000. When a taxpayer is not an active participant in an employer-sponsored plan, there are no threshold limitations. In addition, the limitations for non-covered spouse have changed subsequent to the inclusion of this Released problem. Note – the taxpayer may elect to contribute up to $6,000 since she is 55 years old.

12. (A) $ 0-. Since there was never a tax deduction obtained for the federal income taxes paid, there is consequently, no income to be recognized.

13. (F) $ 4,000. Guaranteed payments are includible in gross income because they represent a pre-distribution of a partners earnings for the year. There is the assumption that the partnership is a calendar year partnership. See Chapter 7’s discussion of guaranteed payments.

14. (A) $ 0-. The receipt of life insurance proceeds is generally non-taxable.

15. (C) $ 2,000. A company can provide up to $50,000 of group term life insurance to its employees on a tax-free basis. For any coverage beyond the $50,000, the employee must recognize the cost of providing the coverage as additional income.

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total insurance coverage</td>
<td>$ 450,000</td>
</tr>
<tr>
<td>Less: $50,000 exclusion</td>
<td>-50,000</td>
</tr>
<tr>
<td>Excess over the base</td>
<td>$ 400,000</td>
</tr>
<tr>
<td>Cost per $1,000 of coverage</td>
<td>$ 5</td>
</tr>
<tr>
<td>Total gross income</td>
<td>$ 2,000</td>
</tr>
</tbody>
</table>

16. (G) $5,000. This is an easy question, but a difficult answer. Even though gambling losses may be deducted to the extent of gambling winnings, this question asks for income and deductions up through adjusted gross income. Since the loss deduction is an itemized deduction, only the $5,000 income is considered in this answer.

17. (B) $ 1,000. Interest income is gross income, even if associated with a federal income tax refund.

18. (A) $ 0-. The Cumacks may exclude up to $500,000 of the gain from the sale of their principal residence. Their realized gain is only $150,000 ($200,000 less the basis of $50,000), therefore the entire gain is excludable.

19. (A) Since there was no provision to receive either stock or cash, then the stock dividend is tax-free.

20. (O) Frank and Dale are entitled to two personal exemptions on their return. No deduction is allowed for Jacques, Dales’s father, because he is a French citizen and a French resident.
ANSWER 5

1. (N) These gifts of $7,000 fall under the $13,000 exclusion and are not includible in the gross estate.

2. (F) Proceeds of a life insurance policy are includible in the gross estate if the decedent possessed an incident of ownership at death.

3. (F) Since Remsen owned the marketable securities at death, they are includible in his estate.

4. (N) This may be excluded from his estate since the payment was made directly to the institution.

5. (F) Since Remsen owned the cash at death, they are includible in his estate.

6. (N) The executor fees cannot be deducted on the estate return because they are already being deducted on the fiduciary return.

7. (N) There is no deduction on the estate return for payments to a beneficiary, unless it qualifies as a marital deduction. Since this is his son, it obviously does not apply.

8. (G) This qualifies for the unlimited marital deduction.

9. (G) Funeral expenses are allowable deductions in determining the taxable estate.

10. (E) The executor made elect to treat this as either an estate tax deduction or a federal income tax deduction.

ANSWER 6

1. (N) Disclosing taxpayer information under a court order is allowed.

2. (E) This appears to be a realistic position to take by the preparer.

3. (P) This is clearly an act subject to penalty.

4. (N) The preparer is taking a realistic position and appears to have applied due diligence.

5. (P) When a preparer knowingly understates a taxpayer’s liability, they are subject to the penalty.

6. (N) Disclosing taxpayer information during a quality review is allowed.

7. (E) Because the preparer relied on information presented by the IRS, and was not aware of information to the contrary, the exception applies.

8. (P) This is clearly an act subject to penalty.

9. (P) This appears to be a willful attempt to understated taxes, therefore subject to a penalty.
ANSWER 7

1. (D) 1,333. Organization cost, when properly elected, are amortized over a period of not less than fifteen years after a maximum of $5,000 is written off. There is a book to tax difference of:

To determine the tax amortization:

$40,000 - $5,000 first year write-off = $35,000 to be amortized

Annual amortization

$ 35,000 / 15 years = $ 2,333

Book amortization

$ 40,000 / 40 years = -1,000

Excess of tax over book

$ 1,333

2. (I) 5,000. Employee expenses for business meals and entertainment are allowable only to the extent of 50% of the expenditure. Therefore, the reimbursements of $10,000, which are fully deductible for book purposes are only deductible to the extent of $5,000 for tax purposes, thus increasing taxable income by $5,000.

3. (N) 000. When a corporation is the beneficiary of a life insurance policy on an officer or key employee, no deduction is allowed for the premiums paid. Since Capital is not the beneficiary, the deduction is allowable. No book to tax difference.

4. (I) 10,000. For tax purposes, only the direct write-off of bad debts is allowed in determining taxable income. Therefore, the increase in the allowance of $10,000 is not allowed for tax purposes and must be added back to net income.

5. (P) Since Sunco owns 35% of the stock of a domestic corporation, Sunco is entitled to an 80% dividends received deduction. Without doing the computations and testing for limits, Sunco would only be taxable on approximately 20% of the dividend.

6. (F) This is simply treated as income in the year received.

7. (P) The general rule is that the contribution must be authorized by the Board of Directors by the end of the end, and paid by the 15th day of the third month following the end of the year. Having met that provision, the current year’s limitation on the $38,000 contribution is 10% of the corporation’s adjusted taxable income ($200,000), or $20,000.

8. (N) No deduction is allowed for penalties.

9. (U) For AMTI purposes, seven-year personal property must be depreciated over a longer period of time, resulting in a smaller amount of annual depreciation. A proper adjustment will cause AMTI to be higher. Since these three questions assume that if no adjustment/preference is identified, how will this impact AMTI, the proper answer is Understated.

10. (U) For AMTI purposes, 39-year non-residential property must be depreciated over a longer period of time, resulting in a smaller amount of annual depreciation. A proper adjustment will cause AMTI to be higher. Since these three questions assume that if no adjustment/preference is identified, how will this impact AMTI, the proper answer is Understated.

11. (C) Only interest income on private activity bonds would be treated as a tax preference and require an adjustment. However, the excluded interest would be an ACE adjustment, but your question asks for the AMTI prior to ACE.
Note: The answers to Items 1 through 6 have dual answers. They are presented in the five digit numeric response format and followed by the appropriate letter response.

1. 15,000 / (I) Only 50% of business meals are deductible. The travel expenses are fully deductible. The disallowed expense of $15,000 increases taxable income.

2. 07,000 / (I) Premiums paid for the life insurance of corporate officers are not deductible when the beneficiary is the corporation. (Likewise, the receipt of the insurance proceeds upon the death of an officer would not be taxable as income.) The disallowed expense causes an increase in taxable income.

3. 00,000 / (N) A state franchise tax expense is a fully deductible item. The estimated tax payments of only $15,000 assumes an accrual of $3,000 which is proper in coming up with the full $18,000. No adjustment is needed.

4. 06,000 / (D) The MACRS depreciation for 2010 would be $16,000, resulting in an additional deduction of $6,000. This decreases the taxable income. The computer is five year property and the straight-line rate is 20%. MACRS uses double the straight-line rate, or 40% of the declining balance. (Alternatively, the second year MACRS rate is 32% of the original cost of $50,000.)

   Original cost $50,000
   First year MACRS:
   $50,000 X 40% X ½ year -10,000
   Remaining balance $40,000
   Second year MACRS:
   $40,000 X 40% $16,000

5. 01,000 / (I) There is a net capital loss of $1,000 from these two transactions. A corporation cannot deduct a net capital loss. It can, however, carry the loss back three years and forward five. The disallowed loss increases taxable income this year.

6. 00,000 / (N) Charitable contributions authorized by the Board by December 31 and paid by March 15 are allowed as current deductions by accrual corporations. The total contributions of $50,000 do not exceed the ceiling which is exactly 10% of $500,000 (taxable income without regard to the charitable contributions and dividends received deduction). No adjustment is needed.

7. (P) Only 50% of entertainment expenses are deductible.

8. (F) The expense relates to products which are predominantly sold. No proration required.

9. (N) No deduction is allowed for interest expense incurred to purchase tax-free bonds.

10. (N) Penalties for violating laws are not deductible business expenses.

11. (F) Bonuses for non-shareholder employees, properly accrued are deductible if paid within two and one-half months after the year-end.

12. (N) The federal income taxes paid are not deductions, nor is the refund of them taxable.

13. (F) Interest income on the federal refund is fully taxable.

14. (N) Interest from a municipal bond is tax-free. The “dividends” are derived solely from the municipal bond interest.
15. (F) The reduction in the lease agreement due to capital improvements causes the recognition of income.

16. (P) The portion of the life insurance which equaled the debt is a tax-free return of basis. The excess is treated as income to the corporation.

17. (N) The 70% dividends-received deduction is not an adjustment, but does represent an ACE adjustment.

18. (N) Only private activity bonds are preference items if issued before 2010. The state’s general obligation bond interest (not private activity) is an ACE adjustment.

19. (I) The acceptable method uses 150% declining balance over a longer ADR life, where MACRS uses 200% declining balance.

20. (I) Commercial real property is depreciated using a straight-line rate over a longer period than MACRS.

21. (N) Cash contributions have no alternative minimum tax impact, only the contributions of appreciated property.

22. (F) The reduction is 25% of the amount over $150,000.

23. (F) There is no statute on fraudulent returns.

24. (F) The statute for an omission of more than 25% is six years from the date the return was filed or the due date of the return, whichever is later.

25. (T) This is one of the general business credits.

26. (T) This is a credit allowed to small businesses.

27. (T) The CPA may use them for certain restricted uses.

28. (F) Reliant may file an amended return up to three years after the filing of the return.

ANSWER 9

1. 06,140. The amount of net business income, or ordinary income as is more appropriate, represents:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gross receipts</td>
<td>$ 7,260</td>
</tr>
<tr>
<td>Less: Supplies expense</td>
<td>-1,120</td>
</tr>
<tr>
<td>Ordinary income</td>
<td>$ 6,140</td>
</tr>
</tbody>
</table>

In the computation of ordinary income, you must exclude any separately stated items which possess special characteristics. In this problem, interest income is separately stated because it is portfolio income; and charitable contributions are excluded because of the percentage limitation of the shareholder’s adjusted gross income.
2. 02,700. Whereas there was no election to terminate the tax year, the income of an S Corporation is allocated on a per-share, per-day approach. Because the S Corporation was formed on January 3 the problem states that there are 363 days. Therefore, the computation is as follows:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Ordinary income</td>
<td>$14,520</td>
</tr>
<tr>
<td>Divided by # of days</td>
<td>363</td>
</tr>
<tr>
<td>Per day ordinary income</td>
<td>40</td>
</tr>
<tr>
<td>Number of shares</td>
<td>200</td>
</tr>
<tr>
<td>Ordinary income per-day, per share</td>
<td>$0.20</td>
</tr>
</tbody>
</table>

Because Pike purchased his 40 shares on January 31, he has held the shares for 334 days. His share of the ordinary income is therefore:

\[
40 \text{ shares} \times 334 \text{ days} \times \$0.20 = \$2,672.
\]

As required in the problem, this answer rounded up to the nearest $100 is now $2,700.

3. 03,150. An S Corporation’s shareholder’s basis needs to take into consideration any pass-through items and distributions occurring during the year. The items of income are allocated first (even the tax-exempt income from the municipal bonds increase basis), and the items of deductions next. Pike has sufficient basis to absorb the loss. Pike’s basis is determined as follows:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Beginning basis</td>
<td>$4,000</td>
</tr>
<tr>
<td>Pike’s share of interest income</td>
<td>150</td>
</tr>
<tr>
<td>Pike’s share of the ordinary loss</td>
<td>-1,000</td>
</tr>
<tr>
<td>Ending basis</td>
<td>$3,150</td>
</tr>
</tbody>
</table>

4. 09,000. An S Corporation’s shareholder’s basis needs to take into consideration any pass-through items and distributions occurring during the year. The items of income are allocated first and the items of deductions next. A shareholder’s basis is then reduced by any distributions, but not below zero. Taylor’s basis is determined as follows:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Beginning basis</td>
<td>$10,000</td>
</tr>
<tr>
<td>Taylor’s share of ordinary income</td>
<td>2,000</td>
</tr>
<tr>
<td>Taylor’s cash distribution</td>
<td>-3,000</td>
</tr>
<tr>
<td>Ending basis</td>
<td>$9,000</td>
</tr>
</tbody>
</table>

5. (F) The eligibility requirements restrict an S Corporation to only one class of stock. Having both common and preferred stock violates that provision.

6. (F) There is a provision that if an S Corporation has passive investment income for 3 consecutive years following the year a valid S Corporation takes effect, the S Corporation election will terminate. However, that is only if there are C Corporation accumulated earnings and profits. Whereas Lan has been an S Corporation since inception, it could not have an C Corporation earnings and profits; this provision does not apply.
The following answers are the AICPA’s Unofficial Answers to the problem. The format in response “a” is slightly different from the way we present the material in the text and the way a tax return is prepared. An illustration of this is their “net approach” of reporting the dividend income. For example, Clove Corporation’s dividends qualify for the 80% dividends received deduction, thus only 20% is included. At Lambers CPA Review Course we feel that this may be confusing and ultimately lead to wrong answers if limitations are exceeded, etc. Dividend income should be reported at the gross amount and then the dividends received deduction should be calculated and deducted later on as a special deduction. Regardless, follow the flow of their answer in part “a” because the examiners may revert to a similar format on future exams and this will help prepare you for them. Parts "b" and "c" are presented in a format consistent with our text.

a.  

**Ral Corp.**

**SCHEDULE OF TAXABLE INCOME**

*For the Year Ended December 31, 2010*

<table>
<thead>
<tr>
<th>Item</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales</td>
<td>$1,000,000</td>
</tr>
<tr>
<td>Cost of sales</td>
<td>700,000</td>
</tr>
<tr>
<td>Gross profit</td>
<td>300,000</td>
</tr>
<tr>
<td>Expenses:</td>
<td></td>
</tr>
<tr>
<td>Per books</td>
<td>$220,000</td>
</tr>
<tr>
<td>Excess of estimated over actual bad debts</td>
<td>$2,000</td>
</tr>
<tr>
<td>Keyman life insurance premiums</td>
<td>4,000</td>
</tr>
<tr>
<td></td>
<td>6,000</td>
</tr>
<tr>
<td></td>
<td>214,000</td>
</tr>
<tr>
<td>Balance before other income</td>
<td>86,000</td>
</tr>
<tr>
<td>Dividend income:</td>
<td></td>
</tr>
<tr>
<td>Clove Corp. ($7,000 × 20%)</td>
<td>$1,400</td>
</tr>
<tr>
<td>Ramo Corp. ($6,000 × 30%)</td>
<td>1,800</td>
</tr>
<tr>
<td>Sol Corp. ($1,000 × 100%)</td>
<td>1,000</td>
</tr>
<tr>
<td>Real Estate Investment Trust (fully taxable)</td>
<td>2,700</td>
</tr>
<tr>
<td>Money Market Fund (fully taxable)</td>
<td>2,100</td>
</tr>
<tr>
<td></td>
<td>$ 9,000</td>
</tr>
<tr>
<td>Interest income</td>
<td>5,000</td>
</tr>
<tr>
<td></td>
<td>14,000</td>
</tr>
<tr>
<td>Taxable income</td>
<td>100,000</td>
</tr>
</tbody>
</table>

Note 1: The $400 capital gain distribution is netted against the $6,400 in capital losses, resulting in a net capital loss of $6,000 which is not allowed as a deduction. See part c for this reconciling item.

Note 2: Since the stock in Sol Corporation was not held for at least 45 days, the dividends received deduction is not available.

b.  

**Ral Corp.**

**COMPUTATION OF FEDERAL INCOME TAX**

*For the Year Ended December 31, 2010*

<table>
<thead>
<tr>
<th>Calculation</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Taxable income</td>
<td>$100,000</td>
</tr>
<tr>
<td>Income tax</td>
<td></td>
</tr>
<tr>
<td>[$13,750 + (34% × $25,000)]</td>
<td>$ 22,250</td>
</tr>
<tr>
<td>Estimated tax paid</td>
<td>35,000</td>
</tr>
<tr>
<td>Overpayment</td>
<td>12,750</td>
</tr>
</tbody>
</table>
### RECONCILIATION OF INCOME PER BOOKS WITH INCOME PER RETURN

*For the Year Ended December 31, 2010*

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Income per books</td>
<td>$98,000</td>
</tr>
<tr>
<td>Excess of capital losses over capital gains</td>
<td>6,000</td>
</tr>
<tr>
<td>Expenses recorded on books not deducted on return:</td>
<td></td>
</tr>
<tr>
<td>Bad debts</td>
<td>$2,000</td>
</tr>
<tr>
<td>Life insurance premiums</td>
<td>4,000</td>
</tr>
<tr>
<td><strong>Subtotal</strong></td>
<td><strong>$110,000</strong></td>
</tr>
<tr>
<td>Income recorded on books not included on return:</td>
<td></td>
</tr>
<tr>
<td>Dividends</td>
<td>$9,800</td>
</tr>
<tr>
<td>Interest</td>
<td>200</td>
</tr>
<tr>
<td><strong>Subtotal</strong></td>
<td><strong>10,000</strong></td>
</tr>
<tr>
<td><strong>Taxable income</strong></td>
<td><strong>$100,000</strong></td>
</tr>
</tbody>
</table>

### ANSWER 11

1. (C) $8,000. In 1990 when the partnership was formed, Brink’s basis would have been his transferred basis in the land, adjusted for any change in the liabilities. Brink was relieved of the $5,000 mortgage on the land, but as partner became liable for his share (20%) of the partnership debt ($5,000).

   Original basis in land  | $12,000
   Less: debt transferred | -5,000
   Plus: debt assumed      | +1,000
   **Initial basis**       | **$8,000**

2. (A) $25,500. In 1990 when the partnership was formed, Carson’s basis would have been his transferred basis in the inventory, adjusted for any change in the liabilities. As a partner, Carson assumed 30% of the partnership debt ($5,000).

   Original basis in inventory | $ 24,000
   Plus: liabilities assumed (30%) | 1,500
   **Initial basis**            | **$25,500**

3. (F) A partner’s basis cannot be reduced below zero. Cash distributions in excess of basis will cause the recognition of gain.

4. (T) The nonliquidating distribution reduces the partner’s basis dollar for dollar, but not below zero.

5. (T) Basis must be allocated to the non-cash property received when the basis of the partnership property exceeds the partner’s basis prior to the distribution. No gain is recognized.

6. (F) See item 5 above.

7. (T) See item 4 above.

8. (F) When a partner is no longer liable for partnership debt, there is a reduction in that partner’s basis. (This is just the opposite of when a partner’s basis is increased by their share of the partnership debt.)
# Regulation

## Schedule A, Itemized Deductions

(2106, Medical, Interest, Casualty)

<table>
<thead>
<tr>
<th>Itemized Deductions</th>
<th>Line No.</th>
<th>Code</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Medical Expenses</td>
<td>1</td>
<td>2106</td>
<td></td>
</tr>
<tr>
<td>Medical Insurance</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Interest</td>
<td>2</td>
<td>2106</td>
<td></td>
</tr>
<tr>
<td>Casualty</td>
<td>3</td>
<td>2106</td>
<td></td>
</tr>
<tr>
<td>Total</td>
<td>4</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

For Paperwork Reduction Act Notice, see Form 1040 instructions.

Cat. No. 71140C

Schedule A (Form 1040)
Miller, age 38, is a single taxpayer and is the sales manager of Standard Co., an auto stereo dealer. Miller’s adjusted gross income (AGI) for the year is $67,000, which includes $4,000 of gambling winnings.

Miller’s job is to oversee the sales operations of Standard Co. Miller has a private office at the dealership and is responsible for attracting new customers and retaining current customers. As the sales manager, Miller has the authority to hire and discharge sales personnel.

During the year, Miller attended several trade shows. While at these shows, Miller entertained clients, met with manufacturers, and spent some time gambling. During the year, Miller incurred losses and can properly document $5,000 of gambling losses.

Miller’s mother incurred unreimbursed medical expenses during the year totaling $4,200. Because she was unable to pay these medical expenses herself, Miller paid them on her behalf. Miller cannot claim the mother as a dependent solely because her gross income is $10,000.
**TAB 3 - Unreimbursed Business Expenses**

During the year, Miller paid the business expenses shown in the following table. Miller’s employer did not reimburse any of these expenses. In column C of the table, enter the amounts that are reportable unreimbursed business expense deductions, subject to a statutory percentage limitation, if any. If none of a particular unreimbursed expense is a reportable business expense deduction, enter a zero for that expense in column C. The total amount deductible on Schedule A, *Itemized Deductions*, of Form 1040, *U.S. Individual Income Tax Return*, as unreimbursed employee business expenses will automatically calculate.

**Note:** Disregard all AGI limitations, if any, in completing the first section of this table. Then follow the instructions in the table in completing the second section.

<table>
<thead>
<tr>
<th></th>
<th>Expense</th>
<th>Amount</th>
<th>Amount reportable on Schedule A</th>
</tr>
</thead>
<tbody>
<tr>
<td>2</td>
<td>Unreimbursed airfares</td>
<td>2,200</td>
<td></td>
</tr>
<tr>
<td>3</td>
<td>Dry cleaning costs for business suits worn at dealership</td>
<td>440</td>
<td></td>
</tr>
<tr>
<td>4</td>
<td>Cost of meals during which business was discussed with potential customers</td>
<td>820</td>
<td></td>
</tr>
<tr>
<td>5</td>
<td>Entertainment for clients, immediately after a business discussion</td>
<td>770</td>
<td></td>
</tr>
<tr>
<td>6</td>
<td>Purchase of tuxedo to wear to trade show functions</td>
<td>400</td>
<td></td>
</tr>
<tr>
<td>7</td>
<td>Cost of a business gift to a client</td>
<td>50</td>
<td></td>
</tr>
<tr>
<td>8</td>
<td>Total</td>
<td>4,680</td>
<td></td>
</tr>
</tbody>
</table>

In the following section, indicate the dollar amount of the limitations, if any, that apply to the expenses above. Enter any limitation as a negative number.

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>11</td>
<td>Total amount from table above</td>
</tr>
<tr>
<td>12</td>
<td>Other miscellaneous deduction - gambling losses</td>
</tr>
<tr>
<td>13</td>
<td>AGI limitation (in dollars)</td>
</tr>
<tr>
<td>14</td>
<td>Total amount deductible on Schedule A</td>
</tr>
</tbody>
</table>
**TAB 4 – Medical Expenses**

During the year, Miller paid the expenses shown in the following table. The amount of each expense shown in the table is net of any insurance reimbursements received. In column C of the table, enter the amounts that are reportable unreimbursed medical expense deductions, subject to a statutory percentage limitation, if any. If none of a particular unreimbursed expense is a reportable medical expense deduction, enter a zero for that expense in column C. The total amount deductible on Schedule A, *Itemized Deductions*, of Form 1040, *U.S. Individual Income Tax Return*, as medical expense will automatically calculate.

**Note:** Disregard all AGI limitations, if any, in completing the first section of this table. Then follow the instructions in the table in completing the second section.

<table>
<thead>
<tr>
<th></th>
<th>A</th>
<th>B</th>
<th>C</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td><strong>Expense</strong></td>
<td><strong>Amount</strong></td>
<td><strong>Amount reportable on Schedule A</strong></td>
</tr>
<tr>
<td>2</td>
<td>Medical insurance premiums paid with after-tax dollars</td>
<td>2,650</td>
<td></td>
</tr>
<tr>
<td>3</td>
<td>Disability insurance premiums</td>
<td>720</td>
<td></td>
</tr>
<tr>
<td>4</td>
<td>Vision correction surgery</td>
<td>2,400</td>
<td></td>
</tr>
<tr>
<td>5</td>
<td>Hair transplant procedure</td>
<td>900</td>
<td></td>
</tr>
<tr>
<td>6</td>
<td>Chin enhancement surgery to improve appearance</td>
<td>3,100</td>
<td></td>
</tr>
<tr>
<td>7</td>
<td>Mother’s medical expenses paid by Miller during the year</td>
<td>4,200</td>
<td></td>
</tr>
<tr>
<td>8</td>
<td>Total</td>
<td>13,970</td>
<td></td>
</tr>
</tbody>
</table>

In the following section, indicate the dollar amount of the limitations, if any, that apply to the expenses above. Enter any limitation as a negative number.

<table>
<thead>
<tr>
<th></th>
<th>A</th>
<th>B</th>
<th>C</th>
</tr>
</thead>
<tbody>
<tr>
<td>11</td>
<td>Total amount from table above</td>
<td></td>
<td></td>
</tr>
<tr>
<td>12</td>
<td>AGI limitation (in dollars)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>13</td>
<td>Total amount deductible on Schedule A</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
**TAB 5 – Interest Expenses**

During the year, Miller made the interest payments shown in the following table. In column C of the table, enter the amounts that are reportable interest expense deductions, subject to a statutory percentage limitation, if any. If none of a particular payment is a reportable interest expense deduction, enter a zero for that expense in column C. The total amount deductible on Schedule A, *Itemized Deductions*, of Form 1040, *U.S. Individual Income Tax Return*, as interest expense will automatically calculate.

**Note:** Disregard all AGI limitations, if any, in completing the first section of this table. Then follow the instructions in the table in completing the second section.

<table>
<thead>
<tr>
<th></th>
<th>A</th>
<th>B</th>
<th>C</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Interest payment</td>
<td>Amount</td>
<td>Amount reportable on Schedule A</td>
</tr>
<tr>
<td>2</td>
<td>Mortgage interest paid on principal residence</td>
<td>11,400</td>
<td></td>
</tr>
<tr>
<td>3</td>
<td>Points on 30-year mortgage for the purchase of the principal residence paid on June 30 of the current year</td>
<td>4,200</td>
<td></td>
</tr>
<tr>
<td>4</td>
<td>Mortgage interest paid on commercial rental property</td>
<td>2,150</td>
<td></td>
</tr>
<tr>
<td>5</td>
<td>Interest paid on personal credit cards</td>
<td>470</td>
<td></td>
</tr>
<tr>
<td>6</td>
<td>Interest paid to IRS for late filing of income tax return</td>
<td>25</td>
<td></td>
</tr>
<tr>
<td>7</td>
<td>Interest paid on a $50,000 home equity loan; the FMV of the home exceeds the acquisition indebtedness by $70,000</td>
<td>475</td>
<td></td>
</tr>
<tr>
<td>8</td>
<td>Total</td>
<td>18,720</td>
<td></td>
</tr>
</tbody>
</table>

In the following section, indicate the dollar amount of the limitations, if any, that apply to the expenses above. Enter any limitation as a negative number.

<p>| | | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>11</td>
<td>Total amount from table above</td>
<td></td>
</tr>
<tr>
<td>12</td>
<td>AGI limitation (in dollars)</td>
<td></td>
</tr>
<tr>
<td>13</td>
<td>Total amount deductible on Schedule A</td>
<td></td>
</tr>
</tbody>
</table>
**TAB 6 – Casualty Losses**

During the year, Miller suffered the losses shown in the following table. In column D of the table, enter the amounts that are reportable casualty losses, subject to a statutory percentage limitation, if any. If none of a loss suffered is a reportable casualty loss deduction, enter a zero for that expense in column D. The total amount deductible on Schedule A, *Itemized Deductions*, of Form 1040, *U.S. Individual Income Tax Return*, as a casualty loss will automatically calculate.

Note: Disregard all AGI limitations, if any, in completing the first section of this table. Then follow the instructions in the table in completing the second section.

<table>
<thead>
<tr>
<th>Loss suffered</th>
<th>Amount of loss</th>
<th>Insurance reimbursement</th>
<th>Amount reportable on Schedule A</th>
</tr>
</thead>
<tbody>
<tr>
<td>Damage to articles stored in basement due to water heater explosion</td>
<td>8,200</td>
<td>1,000</td>
<td></td>
</tr>
<tr>
<td>Repair costs to prevent further roof deterioration from water damage</td>
<td>1,200</td>
<td>-</td>
<td></td>
</tr>
<tr>
<td>Cost to rebuild detached garage due to damage from termites</td>
<td>5,500</td>
<td>2,100</td>
<td></td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>14,900</strong></td>
<td><strong>3,100</strong></td>
<td></td>
</tr>
</tbody>
</table>

In the following section, indicate the dollar amount of the limitations, if any, that apply to the expenses above. Enter any limitation as a negative number.

<table>
<thead>
<tr>
<th></th>
<th>Amount from table above</th>
<th>Casualty nonpercentage floor (in dollars)</th>
<th>AGI limitation (in dollars)</th>
<th>Total amount deductible on Schedule A</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>8</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>9</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>10</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>11</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

**TAB 7 – Communication**

A new individual client just received a substantial refund of state income taxes paid last year. The client wants to know how this refund will be treated on this year’s federal income tax return. Write a letter to the client explaining that the answer depends on whether the client itemized deductions last year. Your explanation should include discussions of the following:

- Why the refund should not be included in this year’s income if the standard deduction was taken last year.
- The circumstances under which the refund would be only partially included in this year’s income if itemized deductions were taken last year.
- Why all of the refund must be included in income if itemized deductions were taken last year.

Type your communication in the response area below the horizontal line using the word processor provided.

REMINDER: Your response will be graded for both technical content and writing skills. Technical content will be evaluated for information that is helpful to the intended reader and clearly relevant to the issue. Writing skills will be evaluated for development, organization, and the appropriate expression of ideas in professional correspondence. Use a standard business memo or letter format with a clear beginning, middle, and end. Do not convey information in the form of a table, bullet point list, or other abbreviated presentation.
Which section and subsection of the Internal Revenue Code describes the substantiation that a taxpayer must maintain in order to claim a valid business deduction for entertainment expenses?

**Answer:** ____________