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SPECIAL ENROLLMENT

EXAMINATION

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Part 2

SPECIAL ENROLLMENT EXAMINATION BOOKLET

September 22, 2004
1:30 p.m. TO 4:30 p.m.

Sole Proprietorships and Partnerships

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(Declassified after September 22, 2004)

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Special Enrollment Examination

Part 2

Sole Proprietorships And Partnerships

Instructions:

The time allotted for this part of the examination is 3 hours. No additional time will be granted. On your answer sheet in the spaces provided you should enter the following:

1. Print your name (First, M.I., Last).
2. Sign your name (First, M.I., Last).
3. Place of examination (City and State).
4. Date of this examination.
5. Print your name (Last, F.I., M.I.) in the boxes provided. Immediately below the boxes, darken the oval corresponding to the letter you have printed, as in the sample Name Grid. Darken only one oval in each column below a box in which you have printed a letter. Make no marks in the columns below boxes you have left blank.
6. Enter your candidate number and immediately below, darken the oval corresponding to each number you have entered.
7. Enter your Social Security Number and immediately below, darken the oval corresponding to each number you have entered.

Important:

The answer sheet should not be folded or torn since it will be machine graded.

Read the examination questions carefully. All references are to the Internal Revenue Code as amended through December 31, 2003. Unless otherwise stated, all questions relate to the calendar year 2003.

You will be given a No. 2 pencil by the monitor. Darken completely only one oval under the corresponding letter on the answer sheet. In making corrections, erase errors completely.

Scratch paper will be provided, but you may make necessary computations in the questions books. Raise your hand to attract the monitor's attention when you need extra supplies or for permission to leave the room.

!! New procedures!!
All materials must be turned in to the monitor before leaving the room:

Answer sheet: When you finish the examination, your answer sheet must be turned in to the monitor before leaving the room. You must turn in your answer sheet at the end of each test session or your test will not be graded and no credit received. **Answers noted in examination booklets will not be graded.** The examination will be graded in Washington, D.C., by the Office of Professional Responsibility, Internal Revenue Service. You will receive formal notification of your examination results on or about January 31, 2005.

Examination booklets, scratch paper: You must also turn in your examination booklet and scratch paper (used and unused). These materials will be mailed to you after the examination has been administered at all sites.

Challenges must be received by the Office of Professional Responsibility on or before **October 22, 2004.** Challenges must be on the form or in the format as prescribed on **www.irs.gov**

General Grading Information:

The questions in this examination have been assigned values of 1 to 3 points. All true or false questions have a value of 1 point each; the multiple choice questions in Section B have a value of 2 points each; and the multiple choice questions in Section C have a value of 3 points each.

The examination is graded on the basis of correct answers. If more than one oval is darkened in answering a questions, the answer will be considered incorrect.

The Service will include the answers with your formal notification of examination results. Therefore, you may want to mark your answers in this examination questions book and retain it for future comparison.

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Part 2
Section A:
Questions 1 – 20

The following statements are either true or false. Select the most appropriate answer and darken the oval under A for True or B for False.

1. A qualifying small business taxpayer can use the cash method of accounting even if they produce, purchase, or sell merchandise. To be a qualifying small business taxpayer, you must meet the gross receipts test of $1,000,000 for each prior tax year ending on or after December 31, 2000.

2. In a like-kind exchange, the taxpayer must identify the property to be received within 30 days after the date he transfers the property given up in the exchange. The property must be received by the earlier of the following dates; the 180th day after the date on which the taxpayer transfers the property given up in the exchange, or the due date, including extensions, for the tax return for the tax year in which the property given up occurs.

3. A vehicle used directly in the trade or business of transporting persons or property for hire is a passenger vehicle for listed property purposes.

4. A taxpayer using the cash method of accounting is entitled to a bad debt deduction if a client does not pay his bill.

5. If you and your spouse each have separate businesses, you may each give a $25 business gift to the same person.

6. If you are self-employed and you were eligible to participate in a health plan subsidized by your spouse's employer, you can deduct 100% of the premiums you paid in the year 2003 for health insurance established under your business for yourself and your family.

7. Charitable contributions made from your self-employed business account are deductible in full on Schedule C in the year of contribution.

8. When computing a net operating loss (NOL), capital losses in excess of capital gains may not be deducted.

9. A sale, exchange, or involuntary conversion of property held mainly for sale to customers is a Section 1231 transaction.

10. Marie, a calendar year taxpayer who is self-employed, lost $1,000 of inventory due to flooding of her warehouse in March 2003. Marie was not compensated for the loss by insurance or otherwise. Marie deducted the loss by adjusting her closing inventory when she filed her tax return for 2003. Marie followed a proper method to deduct this casualty loss.

11. When computing a deductible loss on business property destroyed by a casualty, a taxpayer must reduce the deductible loss by $100.

12. If you sell more livestock, including poultry, than you normally would in a year because of a drought, flood, or other weather-related condition, you may be able to postpone reporting the gain from selling the additional animals until the next year.

13. If a horse breeder is required by Section 447 to use the accrual method of accounting for tax purposes, it must capitalize breeding fees and allocate them to the cost basis of offspring.

14. The use of farm income averaging may create alternative minimum tax.

15. Generally, partnerships with 100 or less partners are not required to electronically file Forms 1065, Schedules K-1 and related forms.

16. Auto Body Express, LLC, a limited liability company, filed Form 1065 for calendar year 2003 on April 15th, 2004. The general partner was not available to sign the return so the in-house tax manager signed the return. The tax manager prepared the return, but is not a limited liability company member. Auto Body Express, LLC has timely filed its partnership return.

17. Generally, a limited partner does not have an economic risk of loss in partnership recourse liabilities.

18. Payments made by a partnership to a retiring partner over a 5-year period that are made in exchange for his/her interest in the partnership property are treated as a guaranteed payment.

19. The excess of the fair market value of a franchise over its cost at the date of the sale or exchange of a partnership asset is considered to be an unrealized receivable.

20. If an employer begins a new qualified defined benefit or defined contribution plan, SIMPLE plan, or simplified employee pension plan, the employer can receive a tax credit of 20% of the first $5,000 of qualified startup costs.

Turn the page for Part 2 , Section B.

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Part 2
Section B:
Questions 21 - 45

The following questions are multiple choice. Select the most appropriate answer and darken the oval under the corresponding letter on the answer sheet.

21. Which of the following statements is **not** correct?

A. Under an accrual method of accounting, you generally report income in the year earned and deduct or capitalize expenses in the year incurred.
B. Under an accrual method of accounting, you generally report receipt of an advance payment for services to be performed in a later tax year as income in the year you receive the payment.
C. Under an accrual method of accounting, business expenses and interest owed to a related person who uses the cash method of accounting are deductible when the all-events test has been met.
D. Under an accrual method of accounting, you can take a current deduction for taxes when economic performance occurs.

22. Which of the following property exchanges does **not** qualify as a like-kind exchange?

A. Exchange of city property for farm property
B. Exchange of partnership interests
C. Exchange of improved property for unimproved property
D. Exchange of an ownership in real estate for a thirty year lease in real estate

23. Which of the following amounts should be included as income to John?

A. John owns a rental house and the rental agreement directs the lessee to pay the $1,000 monthly rent to Michelle, his ex-wife.
B. The lessee erects a carport on the rental property without notifying John. Upon inspection, John estimates the value of the carport is approximately $2,000.
C. John ships goods on consignment to a vendor. The fair market value of the goods is $10,000.
D. The consignment vendor sells $3,000 of John's goods and places the proceeds in an escrow account controlled by the vendor.

24. Which of the following is **not** an acceptable inventory practice?

A. You claim a casualty or theft loss of inventory through the increase in the cost of goods sold by properly reporting your opening and closing inventories.
B. To properly value inventory at cost, reduce the invoice price of inventory by a trade discount.
C. Under the lower of cost or market method, compare the market value of each item on hand on the inventory date with its cost and use the lower of the two as its inventory value.
D. To properly value inventory at cost, include only the direct costs associated with each item.

25. Under the general rule, all of the following require you to capitalize rental expenses **except**:

A. You produce real or tangible personal property for sale to customers.
B. You produce real or tangible personal property for use in a trade or business or activity engaged in for profit.
C. Your rent increases during the lease.
D. You acquire property for resale and your average annual gross receipts are greater than $10,000,000.

26. The maximum section 179 expense you can elect to deduct for property you placed in service in tax years beginning after December 31, 2002 is:

A. $48,000
B. $75,000
C. $100,000
D. $24,000

27. All of the following qualify for the depletion deduction **except**:

A. Oil and gas
B. Timber.
C. Land
D. Geothermal deposits

28. Jennifer Jones, an attorney, made loans of $5,000 and $2,000 to two of her clients in order to keep their business. She also made a loan of $1,000 to her cousin John to whom she had provided free legal advice regarding the start of his own business. If all three loans become uncollectible, what amount may Jennifer deduct as a business bad debt?

A. $8,000
B. $1,000
C. $7,000
D. $2,000

29. With regard to deductible travel expenses when attending a convention, all of the following statements are correct **except**:

A. If you can show that your attendance benefits your trade or business, you can deduct your travel expenses if the expenses are reasonable.
B. You cannot deduct expenses for attending a convention, seminar or similar meeting held outside of the U.S. area unless the meeting is directly related to your trade or business.
C. If you establish that a meeting held on a cruise ship is directly related to your trade or business, you may be able to deduct expenses of up to $2,000 per trip.
D. You must reduce otherwise deductible travel expenses that you pay by the reimbursements not reported on your Form W-2 that you receive from others for these expenses.

30. To meet the directly related test for entertainment expenses, you must show which of the following:

A. You did engage in business with the person during the entertainment period.
B. The main purpose of the combined business and entertainment was the active conduct of business.
C. You had more than a general expectation of receiving income or some other specific business benefit at some future time.
D. All of the above.

31. Which of the following statements regarding deductible taxes is correct?

1) Local benefit taxes for business assets are deductible only if they are for maintenance, repair, or interest charges related to those benefits.

2) Real estate taxes on business property included in monthly mortgage payments placed in escrow **cannot** be deducted unless the lender actually paid the taxing authority.

3) Taxes on gasoline, diesel fuel and other motor fuels that you use in your business should be deducted as part of the cost of the fuel.

4) Any tax imposed by a state or local government on personal property used in your trade or business is deductible.

A. 1, 2 and 4
B. 2 and 4
C. 1 and 3
D. 1, 2, 3 and 4 (All of the above)

32. Regarding "other" business expenses, all of the following statements are correct **except**:

A. You may deduct your own education expenses, including certain related travel that is related to your trade or business.
B. Penalties you pay for late performance or nonperformance of a contract are generally deductible.
C. Legal fees paid to acquire a new office building must be added to the basis of the building and recovered through depreciation.
D. The cost of a license granted by a governmental unit or agency including issuances and renewals is a deductible business expense.

33. In determining whether an activity is engaged in for profit, the relevant facts and circumstances are taken into account. All of the following may indicate you are carrying on the activity for profit **except**:

A. You carry on the activity in a businesslike manner.
B. You depend on income from the activity for your livelihood.
C. You can expect to make a future profit from the appreciation of assets used in the activity.
D. Despite your lack of profitability, you continue to use the same methods of operation to prove that you are serious and the activity is not just a hobby.

34. A net operating loss (NOL) may be carried forward if a proper election is made. Which of the following statements about the election is **not** correct.

A. Once the election is made, you can use the net operating loss only in the 20-year carry-forward period.
B. To make the election, you attach a statement to your tax return filed by the due date (including extensions) for the net operating loss year.
C. Once the election is made to waive the carry back period for one net operating loss, it remains in effect for all subsequent net operating losses.
D. If you filed your return timely, but did not attach the election statement, you have 6 months from the due date of your original return (excluding extensions) to file the statement with an amended return for the net operating loss year.

35. Which of the following transactions is **not** a transaction that results in a gain or loss subject to section 1231 treatment?

A. Sales or exchanges of leaseholds
B. Sales or exchanges of cattle and horses
C. The sale of a copyright, literary, musical, or artistic composition that you created
D. Sales or exchanges of unharvested crops sold together with land to the same buyer

36. For tax year 2003, farm income averaging may be elected as a tax computation method:

A. Only before March 1 of the year following the end of the tax year
B. Anytime before the statute expires for the tax year of the election
C. After the due date of the return, but only when other changes are made to the return, such as an IRS audit adjustment
D. Only if you were engaged in farming in the election year and all of the base years

37. The Rising Moon Partnership with a fiscal year ending March 31 terminated the partnership on January 31, 2003. If no extension is filed by Rising Moon, by what date must they file their final Form 1065 U. S. Return of Partnership Income?

A. March 15, 2004
B. April 15, 2004
C. May 15, 2003
D. July 15, 2003

38. A domestic limited liability company with at least two members that does not file Form 8832, Entity Classification Election, is classified as:

A. An entity disregarded as an entity separate from its owner by applying the rules in regulations section 301.7701-3
B. A partnership
C. A corporation
D. A non-entity which requires members to report the income and related expenses on Form 1040

39. Members of a family can be partners. Family members generally will be recognized as partners if:

A. The partnership agreement states that they have a right to share in earnings and profits of the partnership.
B. Capital is not a material income-producing factor, they joined together in good faith for the conduct of a business, and they agreed that contributions of each entitle them to a share in the profits, and some capital or service has been (or is) provided by each partner.
C. Capital is a material income-producing factor, they acquired their capital interest in a bona fide transaction, actually own the partnership interest but allow the related partner to control the interest.
D. The partnership agreement designates who the partners are, what degree of service they will perform for the partnership and the extent to which they share in the profits, losses, and other attributes of the partnership.

40. Partnership A purchased a tract of land for investment for $50,000. They immediately sold the land to Partnership B for $70,000. The fair market value of the land at the time of sale was $75,000. Betty owns 50% of Partnership A. Betty owns 30% and her mother, Irene, owns 30% of Partnership B. All other partnership owners are not related to Betty, Irene, or each other. Identify the nature and the amount of gain (loss) Partnership A should properly report for tax for the year of the sale.

A. Partnership A should report a short-term capital gain of $20,000.
B. Partnership A should report an ordinary gain of $20,000 because the sale was made to a related party.
C. Partnership A may elect to defer the $20,000 capital gain on the sale of the property.
D. Partnership A should report $25,000 capital gain on the sale of the property.

41. Generally, no gain or loss is recognized by the partnership or a partner when the partner contributes property to the partnership, unless:

A. The partnership is being formed.
B. A gain is realized on the transfer of property to a partnership that would be treated as an investment company if the partnership were incorporated.
C. The partnership is already operating.
D. Unencumbered depreciable property is contributed.

42. Sharon provides services to a partnership in 2003 in exchange for a capital interest of 30% worth $25,000. Sharon's basis in the partnership is:

A. Zero since she exchanged services for her interest.
B. $25,000, which must be reported by her as income in the year of receipt if the interest is vested.
C. The present value of $25,000, computed over the lesser of Sharon's remaining life or the average remaining life of the other partners.
D. Considered a profits interest and has a zero basis.

43. A loss incurred from the abandonment of a partnership interest is an ordinary loss when:

A. The partner receives a de minimis or deemed distribution.
B. The partner's capital account reflects a positive balance.
C. The partner transfers the entire interest to a non-related party.
D. The transaction is not a sale or exchange and the partner has not received an actual or deemed distribution from the partnership.

44. Which of the following statements is **not** correct regarding the Electric Vehicle Credit?

A. A qualified electric vehicle has at least four wheels and is manufactured primarily for use on public streets, roads and highways.
B. A qualified electric vehicle is originally used by the purchaser.
C. A qualified electric vehicle can be modified from a non-electric vehicle.
D. A qualified electric vehicle is used predominantly in the United States.

45. In regards to the credit for Employer-Provided Childcare facilities and services, which of the following is **not** true?

A. The employer applies for the credit on Form 8882, Credit for Employer-Provided Child Care Facilities and Services.
B. The credit allows for 25% of qualified expenses paid for employee childcare.
C. The credit allows for 10% of qualified expenses paid for childcare resource and referral services.
D. The dollar amount of the credit is not limited.

Turn the page for Part 2, Section C.

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Part 2
Section C:
Questions 46—80

The following questions may require some computation. Select the most appropriate answer and darken completely the oval under the corresponding letter on the answer sheet.

46. The XYZ Partnership bought a business for $1,000,000 in January. Included in the purchase price were business assets as follows: certificate of deposit $100,000, accounts receivable of $200,000, and inventory of $300,000. Also purchased but not separately valued were an office building, land ,and going concern value. The real estate tax assessment was $300,000 and the buyer estimated the building was worth twice the land value. What values would you assign to the building, land and going concern?

	Building	Land	Going Concern
A.	$200,000	$100,000	$100,000
B.	$100,000	$200,000	$100,000
C.	$200,000	$200,000	$0
D.	$250,000	$150,000	$0

47. Bob purchased a building and land to use in his business for a price of $1,000,000. The land was valued at $300,000 (included in the price). He then incurred $90,000 to replace the roof of the building. The city replaced the sewage lines to his business and assessed Bob $20,000. Bob had been slow in getting insurance coverage on the real property and incurred a small fire loss of $10,000 which he plans to deduct on his business tax return. What is Bob's basis for depreciation **after** deducting the loss?

A. $1,100,000
B. $810,000
C. $800,000
D. $720,000

48. Joe traded a truck with adjusted basis of $10,000 and received a new truck with a fair market value of $9,000 and $1,500 cash. What is the basis of Joe's new truck?

A. $8,500
B. $10,500
C. $10,000
D. $9,000

49. Michael wants to convert his personal residence to a rental property. He paid $300,000 for the property and the allocation of value for tax assessment has always been 2/3 building and 1/3 land. Over the years he incurred $50,000 in permanent improvements to the house. He claimed a casualty loss deduction of $5,000 in one year. On the date of conversion the fair market value of the property was $600,000. What is the basis for depreciation of this rental?

A. $600,000
B. $345,000
C. $245,000
D. $400,000

50. Henry exchanged an apartment building with an adjusted basis of $750,000 for another apartment building. Both properties have a fair market value of $2,000,000. In addition, Henry paid legal fees of $10,000 for the exchange transaction. What is the basis for depreciation of Henry's acquisition?

A. $2,000,000
B. $750,000
C. $2,010,000
D. $760,000

51. Rebecca exchanges real estate held for investment with an adjusted basis of $400,000 and a mortgage of $100,000 for other real estate to be held for investment. The other party agrees to assume the mortgage. The fair market value of the real estate Rebecca receives is $500,000. She pays exchange expenses of $10,000. What amount of gain does Rebecca realize?

A. $100,000 gain
B. $190,000 gain
C. $90,000 gain
D. $200,000 gain

52. Mary is a calendar year, accrual basis taxpayer. She sold merchandise on December 30, 2003. She billed the customer in the first week of January, 2004. The billing was returned for insufficient postage and Mary sent a second bill in February, 2004. When should Mary include the sale in income?

A. January, 2004
B. March, 2004
C. December, 2003
D. February, 2004

53. James bought and placed in service computer equipment in 2003. He paid $15,000 cash and received a $3,000 trade-in allowance for his old computer equipment. James had an adjusted basis of $4,000 in the old computer equipment. He used both the old and new computer equipment 90% for business and 10% for personal purposes. His allowable section 179 expense deduction is:

A. $16,200
B. $13,500
C. $12,600
D. $15,000

54. In 2003, Judy placed in service a machine that cost $207,000. If she placed no other section 179 property in service during the year, how much is her section 179 maximum dollar limit?

A. $207,000
B. $24,000
C. $100,000
D. $48,000

55. In 2002, Katie Good, a sole proprietor of Good's Bike Shop, had gross income of $235,000, a bad debt deduction of $7,000 and other expenses of $65,850. She reported the business on the accrual method of accounting and used the specific charge-off method for bad debts. In 2003, she recovered $5,000 of the $7,000 bad debt deducted in 2002. How much will she claim in income and in what year?

A. $7,000 in 2003
B. Amend 2002 to eliminate bad debt deduction of $7,000
C. $5,000 in 2003
D. Amend 2002 to reduce bad debt deduction by $5,000

56. On June 30, 2003, Cindy, who uses the cash method of accounting, borrowed $30,000 from a bank to use in her business. Cindy was to repay the loan in one payment with $2,000 interest due on December 30, 2003. On December 30, 2003. The new loan was for $32,000 (the original unpaid loan and unpaid interest). How much can Cindy deduct as interest expense for 2003?

A. $2,000
B. $1,000
C. $0
D. $500

57. During 2003, Ms. Smith had the following expenditures relating to commercial real estate that she owns:

- County property tax, $1,975
- State property tax, $980
- Assessment for sewer construction, $1,500
- Charges or sewer and water service, $810

What is the amount Ms. Smith may deduct as real estate taxes on her commercial real estate for 2003?

A. $2,955
B. $4,455
C. $3,765
D. $5,265

58. Uma is engaged in a not-for-profit activity. The income and expenses of the activity are as follows:

Gross income	$3,300
Less Expenses:	
Real estate taxes	$600
Home mortgage interest	$1,000
Insurance	$500
Utilities	$600
Maintenance	$300
Depreciation on an automobile	$600
Depreciation on a machine	$300
Total expenses	$3,900
Loss	$600

The amount of allowable depreciation for the **machine only** is:

A. $200
B. $300
C. $0
D. $100

59. Stephanie owns and operates a small flower shop that generated a $7,000 loss in 2003. She sold some of the land she uses for the business at a $3,000 gain, and some business equipment at a loss of $1,000. She also earned $1,750 from her part-time job as a supermarket cashier. She earned $450 in interest on her personal savings account in 2003. Stephanie files as single and claims the standard deduction. Her exemption and standard deduction amounts for 2003 are $3,050 and $4,750 respectively. Her net operating loss (NOL) for 2003 is:

A. $2,250
B. $10,600
C. $2,800
D. $3,250

60. On December 31, 2003, Tom sold an apartment building for $230,000. He had purchased the building and placed it in service on July 31, 1993, for $200,000. The depreciation deducted as of December 31, 2002, was $75,000 of which $25,000 was excess of depreciation adjustments over depreciation using the straight-line method. In 2003, the depreciation deducted was $7,000 of which $2,000 was excess depreciation. What is the total capital gain and straight line depreciation?

A. $112,000
B. $27,000
C. $85,000
D. $55,000

61. Tom Thumb owned a greenhouse that was built on leased land. He used the greenhouse one half for business and one-half for personal uses. In 2003, the greenhouse was totally destroyed by a hurricane. The greenhouse cost $500,000 to build, had a fair market value of $300,000 and accumulated depreciation of $50,000 when it was destroyed. Tom received $250,000 from his insurance company in 2003 to reimburse him for the loss. Tom's adjusted gross income for 2003 is $54,000. What is the amount of Tom's deductible loss on the greenhouse for 2003?

A. $150,000
B. $144,500
C. $25,000
D. $94,500

62. Leonard Brown operated a cattle and grain farm in 2003. Leonard sold $42,000 of grain and $23,000 of cattle held for breeding purposes. Leonard also received patronage dividends from the local feed store of $432, feed assistance payments of $1,200, and $1,500 for haying a neighbor's meadow. Leonard should report the following on Schedule F of his federal income tax return for 2003:

A. $45,132
B. $67,700
C. $44,700
D. $66,932

63. John Jacobsen is a cash basis cattle rancher. In 2003, John sold 12 head of cattle for $9,600. The cattle were born on his ranch in 2000. During the 3 years that John used these cattle in his breeding operation, he spent $10,000 for feed and other expenses related to the cattle. How much is John's gain or loss for 2003, and where should he report the amount on his Federal income tax return?

- **A.** John should report a net gain of $9,600 on Part I, Form 4797.
- **B.** John should report a net loss of $400 on Part I, Form 4797.
- **C.** John should report $9,600 from the sale of the cattle on Part I, Schedule F.
- **D.** John should report a net loss of $400 on Part I, Schedule F.

64. Bobby Rice is an unincorporated grain farmer in Louisiana with a calendar year end. Bobby does not live or farm in a disaster area. Bobby computed an estimated tax liability of $25,000 for 2004. To avoid the failure to pay estimated tax penalty, Bobby should:

- **A.** Make his first 2004 estimated tax payment by March 1, 2005
- **B.** Pay all his 2004 estimated taxes by February 15, 2005 and file his tax return by April 15, 2005
- **C.** Include any alternative minimum tax he expects to owe in his calculation of 2004 estimated taxes
- **D.** Pay all of his 2004 estimated taxes by the due date of his return

65. Bytes, Ltd is a partnership formed by Warren Corporation, JCL Corporation, and Mike (an individual), to build and repair personal computers. The partners' profits interest in Bytes and their respective taxable year's are stated below. Assuming there is no business purpose for any particular year and no Section 444 election has been made, determine the partnership's required taxable year.

Partner	Profits & Capital Interests	Taxable Year End
Warren Corporation	25%	May
JCL Corporation	40%	August
Mike	35%	Calendar

- **A.** Since no business purpose to establish a particular year exists, the partnership must adopt the calendar taxable year.
- **B.** The partnership may adopt a taxable year ending either May 31 or August 31.
- **C.** Under the required tax year rules, the partnership must adopt a taxable year ending August 31.
- **D.** Under the required tax year rules, the partnership must adopt a calendar year.

66. Comfy Chairs Manufacturing, Ltd. Operates as a partnership and files Form 1065. Comfy manufactures inflatable lounge chairs. During tax year ended December 31, 2003, Comfy generated income and expenses as stated below. What is the correct amount of ordinary income (loss) from trade or business activities Comfy should report on Schedule K for 2003?

Employee wages	$15,000
Income from rental real estate	$20,000
Charitable contributions	$500
Cost of goods sold	$10,000
Income from chair sales	$75,000

- **A.** $65,000
- **B.** $69,500
- **C.** $50,000
- **D.** $30,000

67. Shizaam Bakery operates as a calendar year partnership. Shizaam's two partners, Kalla and Henry share profits and losses 60% and 40%, respectively. For tax year ended December 31, 2003, Shizaam had the following income and expense:

Gross sales	$270,000
Cost of goods sold	$80,000
Interest income from bank	$2,500
Wages	$50,000
Short-term capital loss	$5,000

Compute the partnership's ordinary income and flow through amounts to partners.

- **A.** Kalla- ordinary income $85,500 and short-term capital loss $3,000; Henry– ordinary income $57,000 and short -term capital loss $2,000
- **B.** Kalla- ordinary income $82,500; Henry- ordinary income $55,000
- **C.** Kalla- ordinary income $81,000, interest income 1,500 and short term capital loss $3,000; Henry- ordinary income $54,000, interest income 1,000 and short-term capital loss $2,000
- **D.** Kalla- ordinary income $84,000, interest income $1,500 and short-term capital loss $3,000; Henry- ordinary income $56,000, interest income $1,000 and short term capital loss $2,000

68. A partnership has $1,000 of nonrecourse liabilities and $500 of recourse liabilities. The recourse liabilities are attributable to Karen who is a 50% partner. Karen contributed property with a fair market value of $400 and an adjusted basis of $250 for her interest in the partnership. The first year of business the partnership incurred a $4,000 loss. How much of this loss, if any, may Karen deduct on her tax return?

- **A.** $250
- **B.** $1,250
- **C.** $1,750
- **D.** $2,000

69. Don and Warren formed an equal partnership to build drag-racing vehicles. Don contributed $5,000 in cash and Warren contributed a truck with a fair market value of $5,000 and an adjusted tax basis of $4,500. They plan to use the truck for hauling parts and cars. When Warren purchased the truck 1 year earlier, he elected to use the straight line method to depreciate the truck using the midmonth convention over its 5- year recovery period. The partnership should:

- **A.** Record the truck on the books at $5,000 and depreciate it using the allowable method and convention over a 5-year recovery period.
- **B.** Record the truck on the books at $5,000 and depreciate it over its remaining recovery period using the straight line method and midmonth convention.
- **C.** Record the truck on the books at $4,500 and depreciate it over its remaining recovery period using the straight line method and midmonth convention.
- **D.** Record the truck on the books at $4,500 and depreciate it using the allowable method and convention over a 5-year recovery period.

70. Greg and Elaine formed Spring Lawn, Ltd., a calendar year partnership in 2003, to provide yard maintenance to residential customers. Before they began operations in May 2003, they incurred legal fees of $2,000 and consulting expenses of $1,000 to draft the partnership agreement and file the required forms. They also paid a commission of $600 to a broker to market partnership interests. If duly elected, how much of these expenses may be deducted on Spring Lawn's partnership tax return for 2003?

- **A.** $600
- **B.** $0
- **C.** $480
- **D.** $400

71. John owns a residential contracting business. Capital is a material income-producing factor. John's services to the business for 2003 were worth $30,000. John's son, Alex is interested in eventually working in his father's business. On January 1, 2003, Alex receives a gift of 20% of his father's interest in the business. Alex performed no services for the business in 2003. If the resulting partnership had a profit of $100,000 for tax year 2003, how much of the partnership profit should be allocated to Alex?

- **A.** $20,000
- **B.** $35,000
- **C.** $50,000
- **D.** $14,000

72. Abercrombie Partnership sold a capital asset to Freeman Partnership at a loss of $50,000. Abercrombie had held the property for 5 months. Abercrombie is owned 30% by Doug, 30% by Fred, and 40% by Dale, Doug's brother. Freeman Partnership is owned 80% by ABC Corporation. Doug owns 25% of the stock of ABC Corporation and Dale's daughter, Deb, owns 60% of the stock of ABC Corporation. How much of the loss should Abercrombie allow for tax purposes on their tax return for the year of the sale?

- **A.** $50,000
- **B.** $3,000
- **C.** $0
- **D.** $35,000

73. Larkspur, a calendar year partnership, is owned equally by Nathan, Jerry, Jon, and Marty. The partnership agreement states that Nathan will receive 25% of the profit (loss) of the partnership with a minimum of $15,000 for his services to the partnership. The other partners are each to receive 25% of the profit (loss). The net income of the partnership without regard to the $15,000 minimum is $40,000 for 2003. The partnership should deduct a guaranteed payment of:

- **A.** $15,000
- **B.** $10,000
- **C.** $0
- **D.** $5,000

74. Patti and Kae formed a partnership in which they share income and loss equally. Kae contributes land on which there is a recourse mortgage of $18,000. The land has an adjusted basis to Kae of $15,000 and a fair market value of $20,000 at the time of the contribution. Patti contributes $2,000 to the partnership in cash. What amount of gain should Kae recognize as a result of the contribution of property?

- **A.** $0
- **B.** $9,000
- **C.** $5,000
- **D.** $2,000

75. Lori's outside basis in the Briar Patch Partnership at January 1, 2003, was $11,000. She is a 50% partner and shares profits and losses in the same ratio. For 2003, the partnership's ordinary business income was $40,000, tax-exempt interest income $200. Lori received a cash distribution from the partnership of $700 in 2003. If the partnership were to liquidate on December 31, 2003, what would be Lori's basis for determining gain or loss?

- **A.** $24,900
- **B.** $30,750
- **C.** $30,400
- **D.** $30,300

76. Greg, a partner in Masters Partnership, receives $1,000 cash and property worth $2,000 in which Masters has a basis of $1,500. Greg's outside basis at the time of the distribution is $20,000. The Partnership has assets of $40,000 and no outstanding liabilities. This distribution is at the end of the year after partnership income (loss) has been recorded. How much gain should Greg recognize on the distribution and what is his basis in the property received?

- **A.** Greg recognizes a gain of $500 on the property received and his basis in the property is $2,000.
- **B.** Greg recognizes gain of $1,500 on the property and cash received. His basis in the property received is $3,500.
- **C.** Greg recognizes no gain on the property received. His basis in the property received is $1,500.
- **D.** Greg recognizes a gain of $1,000. His basis in the property received is $1,500.

77. Mary and Jonah formed the Quaking Aspen Partnership. Mary contributed $25,000 in cash and Jonah contributed property with an adjusted basis of $40,000, with a fair market value of $25,000. Quaking Aspen sells the contributed property to an unrelated party 2 years after start up for $27,000. How much gain (loss) should the partnership recognize on the sale of the contributed property?

- **A.** $0
- **B.** $ 2,000 gain
- **C.** $15,000 loss
- **D.** $13,000 loss

78. Jacob contributes property with a fair market value of $7,000, adjusted basis of $4,000, and a mortgage of $1,000, which the partnership assumes, to a partnership for a 40% interest in the partnership. What is Jacob's basis in his partnership interest?

- **A.** $4,000
- **B.** $3,000
- **C.** $6,000
- **D.** $3,400

79. Abby sells her 50% interest in the ABC partnership to Marty for $1,000 cash. Her outside basis at that time is $775. The partnership has inventory and a capital asset with respective bases of $1,200 and $300 and respective fair market values of $1,500 and $450. Abby should properly recognize:

- **A.** Ordinary income of $300 and a capital loss of $75
- **B.** Capital gain of $225 on the sale of her partnership interest
- **C.** An ordinary gain of $225 since she received cash of at least that amount
- **D.** Ordinary income of $150 and a capital gain of $75

80. Paul owns and operates a gourmet food store as a sole proprietorship out of a building he also owns. Based on the following information regarding 2003, compute his self-employment income (for SE tax purposes) for 2003.

Gross receipts	$125,000
Cost of goods sold	$63,000
Utilities	$7,000
Real estate taxes	$1,500
Gain on sale of business truck	$2,000
Depreciation expense	$4,000
Section 179 deduction	$1,500
Mortgage interest on building	$8,000
Contributions to Keogh retirement plan	$2,000
Net operating loss from 2002	$15,000

- **A.** $25,000
- **B.** $27,000
- **C.** $38,000
- **D.** $40,000

End of Part 2.

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