2002

SPECIAL ENROLLMENT

EXAMINATION

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PART 1

SPECIAL ENROLLMENT EXAMINATION BOOKLET

SEPTEMBER 25, 2002
9:00 A.M. TO 12:00 NOON

Individuals

Official Use Only
(Declassified After September 25, 2002)

Special Enrollment Examination

Part 1

Individuals

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, 2001. Unless otherwise stated, all questions relate to the calendar year 2001.

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. You will be allowed to keep your examination question books after completion of the examination. Scratch paper will be provided, but you may make necessary computations in the question books. Raise your hand to attract the monitor's attention when you need extra supplies or for permission to leave the room.

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, 2003.

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 question, 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 question book and retain it for purposes of your future comparison.

Part 1

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. Reba, age 88, and Charles, age 90, are married, live together, and file jointly. During 2001, they received interest income of $3,000, dividend income of $1,500, a pension of $10,000 and Social Security of $17,000. Reba and Charles are **not** required to file a tax return.

2. You must make estimated tax payments for 2001 if you expect to owe at least $1,000 in tax for 2001, after subtracting your withholding and credits, and you expect your withholding and credits to be less than the smaller of: (1) 90% of the tax to be shown on your 2001 tax return, or (2) 100% of the tax shown on your 2000 tax return (110% if AGI over $150,000).

3. If the taxpayer files his 2001 Form 1040/1040A by January 31, 2002, and pays the rest of the tax due, he does **not** need to make the estimated tax payment that would have been due on January 15, 2002.

4. If the taxpayer is a minister of a church, his earnings for the services he performs as a minister, whether he is an employee of his church or a self-employed person under the common law rules, are subject to self employment tax unless he has requested and received an exemption from the IRS, taken a vow of poverty, or is subject to the Social Security laws of a foreign country.

5. If a regulated investment company (mutual fund) or real estate investment trust (REIT) declares a dividend (including any exempt-interest dividend) in October, November, or December, payable to shareholders of record on a date in one of those months but actually pays the dividend during January of the next calendar year, the taxpayer is considered to have received the dividend on December 31.

6. Some mutual funds and REITs keep their long-term capital gains and pay tax on them. You must treat your share of these gains as distributions, even though you did not actually receive them.

7. You may receive a return of capital or a tax-free distribution in shares of stock or stock rights. These distributions are **not** treated the same as ordinary dividends or capital gain distributions.

8. Zenith Mortgage Co. offered John a 10% discount on his $100,000 mortgage if he would pay the mortgage in full. John paid Zenith Mortgage Co. $90,000 and his mortgage was cancelled. John has to report $10,000 as other income.

9. If you receive property by gift, your basis is always the donor's basis plus any gift taxes paid.

10. Ezekiel and Ruth sold their primary residence, which they purchased in 1990 for $250,000. They lived in the home until the date of sale. The home was sold for $675,000. Since the home was sold for more than $500,000, they are required to report the sale on their tax return.

11. If you hold a capital asset one year or less, the gain or loss from its disposition is short-term.

12. Generally, you cannot deduct any expenses for the cost of using an entertainment facility that you own, rent, or use for entertainment. Examples include a yacht, hunting lodge, fishing camp, swimming pool, tennis court, bowling alley, car, airplane, apartment, hotel suite, or home in a vacation resort.

13. During 2001, John was self-employed with a net income of $40,000. As an adjustment to income he can deduct the following: $2,000 IRA, $5,000 alimony, 50% of self-employment tax and 100% of self-employed health insurance premiums.

14. You can include medical expenses that you paid for a child before adoption, if the child qualified as your dependent when the medical services were provided, or when the expenses were paid.

15. Martha and Max have two children. Martha and Max each has earned income of $10,000. They decided to file separate returns, with each one of them claiming one child as a dependent. Neither one is eligible for the earned income credit (EIC) due to their married filing separate status.

16. Tom and Mary both were employed as bookkeepers during the year. Tom earned $25,000 and Mary earned $22,500. They had no other form of income. They paid $2,000 to the Child Care Nursery, Inc. for the care of their four-year old son. Tom and Mary filed a joint tax return claiming their son as a dependent. Based on the foregoing facts, they are entitled to a child-care credit.

17. You can claim the child-care credit on Form 1040EZ.

18. In 1995, Joan sold land for $100,000 that had cost $50,000. She received a down payment of $30,000 with the balance to be amortized over 10 years with interest of 8%. In 2001, Joan had to repossess the property due to the failure of the buyer to make payments. Joan has no tax consequences, as she now owns the land.

19. Ray, who is the principal owner of an engineering firm several years ago loaned $2,000 to a friend to be repaid on demand with interest at 6%. No payments of interest or principal had been made when the friend declared bankruptcy and this loan was discharged. Ray can write this off as a non-business bad debt including the accrued interest of $360. Ray files his tax returns on a cash basis.

20. Max, loaned his 16 year old son $2,000 to buy a car. At age 22, the son declared bankruptcy and he was discharged from all debt including the $2,000. This would be deductible by Max as a non-business bad debt.

Turn to the next page for Part 1, Section B.

Part 1

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. All of the following are requirements to claim head of household filing status **except**:

A. You are unmarried or considered unmarried on the last day of the year.
B. Your spouse did **not** live in your home during the last 6 months of the tax year.
C. Your parent must live in your home at least 6 months.
D. You paid more than half of the cost of keeping up your house for the entire year.

22. Filing Form 4868, Application for Automatic Extension of Time To File U.S. Individual Income Tax Return gives you:

A. An extension of time to pay the amount of taxes due.
B. A 4-month extension to file the tax return.
C. A penalty free period of 4 months if you cannot pay the taxes due by the filing date.
D. No interest on the amount due from the original due date of the return, which for most taxpayers is April 15.

23. Milton is 39 years old. He is divorced from his wife since March 1st of the tax year. They have two minor children. One child lives with Milton and the other child lives with the mother. The children have been with their respective parents from March through December of the tax year. Milton provides all of the support for the minor child living with him. The filing status with the lowest rate that Milton qualifies for is:

A. Married filing separately.
B. Single.
C. Head of household.
D. Married filing jointly.

24. Joe is 37 years old. His wife died during the tax year and he has not remarried. His deceased wife had no income. He has two minor children living with him. Joe paid all of the costs for keeping up his home for the tax year and he has paid for all of the support of his wife and these children. The filing status with the lowest tax rate which Joe qualifies for is:

A. Qualifying widower with dependent child.
B. Married filing separately.
C. Head of household.
D. Married filling jointly.

25. Sue must make estimated tax payments of $4,000 for the tax year. She makes the following payments:

- 1st Payment – credit of $1,000 from her previous year refund.
- 2nd Payment - $500 on April 20th
- 3rd Payment - $500 on May 31st
- 4th Payment - $1,000 on August 15th
- 5th Payment - $500 on October 15th.
- 6th Payment - $500 on December 30th

A. She has not made timely payments because her 2nd and 3rd payments were not made by April 15th.
B. She has not made timely payments because her 4th payment was not made by June 15th.
C. She has made timely estimated payments.
D. She has not made any timely payments because none of the payments were made by the required IRS schedule.

26. The following fringe benefits are non-taxable **except**:

A. A non-statutory option to buy or sell stock or other property as payment for your services when you receive the option or when you exercise the option.
B. The value of accident or health plan coverage provided to you by your employer.
C. Long-term care coverage contributions made by your employer to provide coverage for long-term care services.
D. Contributions by your employer to your medical savings account.

27. The following statements about dividends received from a dividend reinvestment plan are correct **except**:

A. Reinvested dividends are not taxable if **not** removed from the plan.
B. Reinvested dividends are taxable in the year paid.
C. Reinvested dividends are taxable and are added to the basis of the stock or mutual fund.
D. Reinvested dividends are treated as ordinary dividends.

28. If a taxpayer has capital gains dividends, but has no other capital gain:

A. Capital gain distributions must be put on Schedule B.
B. No Schedule D is required and the amount is put directly on the Form 1040.
C. Dividends and capital gains dividends may be added together on Schedule B.
D. It must be combined with interest on the Schedule B.

29. A taxpayer has both short-term capital loss and non-taxable distribution from an investment. The following statements are correct **except**:

A. The basis of the investment is reduced by the non-taxable distribution.
B. Non-taxable distribution is a return of capital invested.
C. Short-term capital loss reduces the basis of the investment.
D. Short-term capital losses have no effect on basis.

30. Passive activity rules apply to:

A. Closely held corporations.
B. Partnerships.
C. S corporations.
D. Grantor trusts.

31. You incurred the following expenditures in connection with your rental property. Which of them should be capitalized?

A. New roof.
B. Install new cabinets.
C. Pave driveway.
D. All of the above.

32. Which of the following would be considered passive activity income?

A. Alaska Permanent Funds dividends.
B. State, local, and foreign income tax refunds.
C. Personal service income.
D. None of the above.

33. You purchased a heating, ventilating and air conditioning (HVAC) unit for your rental property on December 15th. It was delivered on December 28th and was installed and ready for use on January 2nd. When should the HVAC unit be considered placed in service?

A. December 15th.
B. December 28th.
C. December 31st.
D. January 2nd.

34. Johnny has various investments. He earns interest and dividends on a certificate of deposit (CD), a savings account, mutual funds, corporate stocks and corporate bonds. Johnny files his tax returns using the cash method. The interest on the CD is rolled into a new CD with the old principal. He receives the interest from the corporate bonds and savings account on a semi-annual basis. The earnings from the mutual funds are not distributed and are used to purchase additional shares. The dividends from the corporate stocks are reinvested. What income does Johnny have to report currently?

A. Savings account and CD interest.
B. Corporate stock and mutual fund dividends.
C. Corporate bond and savings account interest.
D. All of the above.

35. Cost basis of property includes:

A. Certain settlement fees and other costs.
B. Sales taxes charged on the purchase.
C. Real estate taxes paid for seller without reimbursement.
D. All of the above.

36. Jennifer works for Joyce and received a parcel of land as payment for her services. Joyce's basis in the land was $6,000 and the land had a FMV of $10,000. Jennifer's basis in the land is:

A. $0
B. $6,000
C. $10,000
D. $4,000

37. Your basis in property you inherit from a decedent is generally one of the following:

A. The FMV of the property at the date of the individual's death.
B. The FMV on the alternate valuation date, if the personal representative for the estate chooses to use alternate valuation.
C. The decedent's adjusted basis in land to the extent of the value that is excluded from the decedent's taxable estate as a qualified conservation easement.
D. All of the above.

38. If you purchase stock of a small corporation meeting the requirements of Section 1244 (small business) stock, and you sell that stock at a loss, the loss from that stock will be reported as:

A. Long-term loss.
B. Ordinary loss.
C. Short-term loss.
D. Ordinary loss subject to limitations.

39. All of the following may be deducted by a taxpayer as a transportation expense **except**:

A. Getting from one workplace to another in the course of your business or profession.

B. Commuting expenses if you work during the commuting trip using your telephone to make business calls or have business associates ride with you to and from work and you have a business discussion in the car.

C. Visiting clients or customers after going to your office.

D. Going to a business meeting away from your regular workplace.

40. The following entertainment activities are considered to have substantial distractions that generally prevent one from actively conducting business **except**:

A. A meeting or discussion at a nightclub, theater, or sporting event.

B. A meeting or discussion during what is essentially a social gathering, such as a cocktail party.

C. Attending meetings at a convention or similar event, or at a trade or business meeting sponsored and conducted by a business or professional organization to further your trade or business.

D. A meeting with a group that includes persons who are not business associates at places such as cocktail lounges, country clubs, golf clubs, athletic clubs, or vacation resorts.

41. To meet your employer's reimbursement or allowance arrangement accountable plan, which of the following are the requirements of his accountable plan?

A. Your expenses must have a business connection.

B. You must adequately account to your employer for these expenses within a reasonable period of time.

C. You must return any excess reimbursement or allowance within a reasonable period of time.

D. All of the above.

42. The taxpayer may deduct the cost of medical expenses for the following items **except**:

A. Doctor prescribed drugs including birth control pills.

B. Controlled substances in violation of Federal law.

C. Laser eye surgery, contacts, eyeglasses, and hearing aids.

D. Guide dogs for the visually impaired and the cost of the dogs care.

43. All of the following capital improvements may be itemized and deducted as medical expenses **except**:

A. Cost of constructing wheelchair accessible ramps for your home.

B. Cost of modifying a car with special hand controls.

C. Lowering or modifying kitchen cabinets and equipment.

D. An elevator costing $8,000 that adds $8,000 to the appraised value of your home.

44. Contribution deductions may be limited to 20%, 30%, or 50% of your adjusted gross income. Organizations that qualify for the 50% limit include:

A. Churches and conventions of organizations of churches.

B. Educational organizations with regular faculty and curriculum and regularly enrolled students.

C. Hospitals and certain medical research organizations associated with these hospitals.

D. All of the above organizations.

45. If an involuntary conversion occurs when your property is destroyed, stolen, condemned, or disposed of under the threat of condemnation and you receive other property or money in payment, such as insurance or a condemnation award, which of the following statements is correct?

A. Gain or loss from an involuntary conversion of your property is usually recognized for tax purposes unless the property is your main home.

B. You may not have to report a gain on an involuntary conversion if you receive property that is similar or related in service or use to the converted property.

C. If you receive money or property that is not similar or related in service or use to the involuntarily converted property and you buy qualifying replacement property within a certain period of time, you can choose to postpone reporting the gain.

D. All of the above are true.

Turn to the next page for Part 1, Section C.

Part 1

Section C:
Questions 46 - 80

T*he 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. Dr. Steve and Joyce are married and have total income of $190,000, itemized deductions of $15,000, and exemptions totaling $5,800, leaving estimated taxable income of $169,200. For 2001 the tax on $169,200 would be $43,960. They have withholding of $36,960 during the year. In 2000 they paid a total of $42,000 in taxes for the year on an adjusted gross of $185,000. For 2001 they would need to make:

A. No estimated tax payments since they have withholding taxes.
B. Estimated payments of $2,604.
C. Estimated payments of $8,652.
D. Estimated payments of $5,040.

47. Mary and Fred filed a joint tax return. They have a son Fred, Jr. and a daughter Joan who are both teenagers and live at home. Fred. Jr. has interest income of $400 and Joan has interest income of $600. Mary's widowed mother has lived with them for the entire year. Mary's mother receives a pension of $3,000, interest income of $2,000 and dividends of $1,000. Mary and Fred fully support Mary's mother with the exception of her clothing, the balance of her income she invests. How many exemptions can Mary and Fred claim on their joint tax return?

A. 2
B. 3
C. 4
D. 5

48. Don and Joyce have adjusted gross income of $85,000. Their two children Mary, age14, and David, age 20 (completed his education in the prior year), lived with them all year. Mary had interest income of $300. David had interest income of $600 and wages of $6,500. The parents provided over 50% of the support of both children. How many exemptions can Don and Joyce claim?

A. 2
B. 3
C. 4
D. 1

49. To meet the dependency test of "Gross Income", the taxpayer had to consider the following income received by his mother who was 81 years of age: Social Security $3,600, municipal bond interest $2,200, corporate bond interest $1,200, stock dividends $900, rental income $1,200, rental expenses $200, and wages $600. The mother lived with the taxpayer the entire year. What is the correct gross income of the mother for this test?

A. $9,700
B. $2,900
C. $5,100
D. $3,900

50. A taxpayer has total tax in the previous year of $21,000. In this year, the taxpayer received a bonus and his tax increased $4,500. The taxpayer has long-term capital gain of $4,000 with a tax of $800. The taxpayer's withholding was increased to $23,700. To avoid a penalty for underpayment of estimated tax the taxpayer must:

A. Do nothing, since the withholding exceeds 100% of last year's tax.
B. Pay an additional $5,300 to equal 100% of tax due.
C. Do nothing, since the withholding exceeds 90% of the tax due this year.
D. Both A and C are correct.

51. John, a single taxpayer, received interest income of $40,000 consisting of the following: certificate of deposit $6,000 (which is reinvested), savings account $4,000, City of Glendale Municipal Bond $8,000, mortgage note $12,000, Cobb County Municipal Bond $7,000, and corporate bond $3,000. What is the amount of taxable interest income he will report on his Form 1040?

A. $40,000
B. $25,000
C. $19,000
D. $33,000

52. Gene and Claire are partners in a consulting business. Their gross receipts were $60,000 and their net profit was $45,000. In addition, Gene had wages of $25,000. They also had stock dividends of $2,000, City of Birmingham Bond interest of $4,000 and savings account interest of $1,000. What is their adjusted gross income?

A. $77,000
B. $92,000
C. $88,000
D. $73,000

53. John and Mary moved into your rental property and paid a $10,000.00 security deposit. You agreed to use this security deposit as their last month's rent. Additionally, they paid a painting contractor $2,500 to paint the interior. How much of these payments should be reported as rental income for this year?

- **A.** $0
- **B.** $5,000
- **C.** $10,000
- **D.** $12,500

54. John and Mary had a pipe burst in the basement of your rental home. They were unable to reach you on vacation. They had the plumber come out and repair the pipe and damage. They paid the plumber $575. They deducted $575 from their rent of $5,000. How much rent should be considered income that month?

- **A.** $5,000
- **B.** $4,425
- **C.** $5,575
- **D.** $5,745

55. You own a vacation home on Amelia Island, Florida, which you rented for 10 days in 2001. In 2001, rental expenses were $2,000 and rental income was $5,000. How much of the rental income should be reported on the tax return?

- **A.** $5,000
- **B.** $3,000
- **C.** $0
- **D.** $7,000

56. John, who is 63 years of age and single, has wages of $10,000, interest income of $3,000, dividends of $2,000, municipal bond interest of $3,000, state unemployment compensation of $4,000 and Social Security benefits of $4,000. What is John's adjusted gross income?

- **A.** $26,000
- **B.** $22,400
- **C.** $22,000
- **D.** $19,000

57. Joan and Jim had income from investments in 2001. They also earned a substantial amount in wages. Most of their dividends and interest is reinvested. The reinvested income included $2,000 in dividends from mutual funds, interest from savings account of $3,000, and interest from certificates of deposit of $4,000. Dividends from stocks of $5,000 was received and spent. Interest of $1,000 earned in 2001 on a loan from a friend was not received until the following year. How much interest and dividend income must Joan and Jim report on their tax return for 2001?

- **A.** $6,000
- **B.** $13,000
- **C.** $14,000
- **D.** $5,000

58. A taxpayer purchased a rental property for $100,000. The taxpayer gave $25,000 as a cash down payment and financed $75,000. Closing costs were $4,000 and points were $4,000. What is his basis in the property?

- **A.** $33,000
- **B.** $108,000
- **C.** $104,000
- **D.** $100,000

59. Reba gave Sari a rental property. Reba had purchased the property in 1990 for $60,000 and took $9,000 in depreciation. Reba's adjusted basis was $51,000. The fair market value of the rental house on the day of transfer was $72,000. Assuming no gift tax was paid, what is Sari's basis in the property?

- **A.** $72,000
- **B.** $60,000
- **C.** $51,000
- **D.** $63,000

60. Charles died and left his daughter Sue a commercial rental property. He purchased the property for $150,000 and had taken $45,000 in depreciation. The fair market value (FMV) on his death was $200,000. Six months after his death, the property was re-titled into Sue's name by the estate's representative. There was no alternative valuation done on the transfer. The FMV on that day was $210,000. Sue's basis in the property is:

- **A.** $210,000
- **B.** $200,000
- **C.** $150,000
- **D.** $125,000

61. SSB Tax Corporation declared and distributed a stock dividend of 1 share for each 4 shares held by each stockholder. Donn had 100 shares and received 25 additional shares.

A. The stock dividend is not taxable, since the stockholder did not receive cash.

B. The stock dividend is taxable for the fair market value of the shares received on the date of issue.

C. Donn purchased his 100 shares of stock for $5.00 per share. He must adjust the basis of the 125 shares to $4.00 a share.

D. This is non-taxable because it is a return of capital.

62. Milton spent $70,000 for a building that he used in his business. He made improvements at a cost of $20,000 and deducted depreciation of $10,000. He sold the building for $100,000 cash, and received property having a fair market value of $20,000. The buyer assumed Milton's real estate taxes of $3,000 and a mortgage of $17,000 on the building. Selling expenses were $4,000. The gain on the sale is:

A. $10,000

B. $56,000

C. $40,000

D. $52,000

63. Joe and Jean purchased their primary residence in 1975 for $100,000. While they lived there, they made renovations at a cost of $125,000. They lived there until July 1, 1998. On June 15, 2001, the residence was sold for $800,000. From July 1, 1998, until June 15, 2001, the home was unoccupied. Joe and Jean file a joint return, and they have never excluded a gain from the sale of another home. What is their maximum taxable gain?

A. $575,000

B. $0

C. $75,000

D. $200,000

64. Frances and George sold their principal residence for $1,000,000. They purchased the home in 1993 for $250,000. They incurred improvement costs of $100,000, real estate commissions of $60,000 and other settlement costs of $10,000. They lived in this home until the date of sale. Frances and George file a joint return and have not previously excluded a gain on another home. What is their maximum taxable gain?

A. $750,000

B. $140,000

C. $80,000

D. $150,000

65. George and Marie sold their primary residence in 2001 for $300,000. They purchased the home in 1982 for $100,000 and lived in the home until the sale. George was a salesman and used 1/6th of the home as a business office. He deducted 1/6th of all costs including depreciation since 1982. The original cost of $100,000 was assessed at $40,000 land, and $60,000 building. In taking depreciation for the office, George used the straight-line method with a 30-year life. What is George and Marie's realized gain on the sale of the business portion?

A. None

B. $200,000

C. $16,667

D. $40,000

66. Sue's father purchased 1,000 shares of ABC stock for $10 per share on December 30, 2000. Sue inherited the 1,000 shares of ABC stock from her father on September 15, 2001. The FMV at the time of the inheritance was $20 per share. On December 20, 2001, she sold the stock for $25 per share.

A. The gain of $15,000 is short-term capital gain.

B. The gain of $15,000 is long-term capital gain.

C. The gain of $5,000 is long-term capital gain.

D. The gain of $5,000 is short-term capital gain.

67. Larry purchased 100 shares of ABC stock on May 31, 2000, for $100 per share. On October 28, 2000, he sold the 100 shares for $90 per share. On November 22, 2000, his wife, Vickie, purchased 100 shares of ABC stock for $80 per share. Vickie held the stock until September 30, 2001. On that date, she sold the stock for $110 per share. They filed married filing separately on all returns.

A. Larry has a short-term loss of $1,000 on his 2000 tax return.

B. Vickie has short-term gain of $3,000 on her 2001 tax return.

C. Vickie will have a short-term gain of $3,000 on her 2001 tax return and Larry takes the short term loss $1,000 on his 2000 tax return.

D. Vickie will have a long-term gain of $2,000 on her 2001 tax return and Larry will not have any capital loss on his 2000 tax return.

68. Heather purchased 500 shares of Investment Growth Mutual Fund on February 15, 2000, for $10 per share. On January 31, 2001, she sold the 500 shares for $1.50 per share. Which of the following is correct?

- **A.** Heather will have a short-term capital loss of $4,250 on her 2001 tax return and she will be allowed to offset $4,250 of her earnings.
- **B.** Heather has short-term capital loss of $3,000 on her 2001 tax return.
- **C.** Heather will have a short-term capital loss of $4,250 on her 2001 tax return and will have to carry forward a short-term loss of $1,250 to her 2002 tax return.
- **D.** Heather will have a short-term capital loss of $4,250 on her 2001 tax return and will have to carry forward a long-term capital loss of $1,250 to her 2002 tax return.

69. Which one of the following criteria is used to determine a taxpayer's "tax home", if the taxpayer does not have a regular or main place of business or work?

- **A.** Taxpayer performs part of his business in the area surrounding his main home and uses that home for lodging while doing business in the area.
- **B.** Taxpayer has living expenses at his main home that are duplicated because his business requires him to be away from that home.
- **C.** Taxpayer has not abandoned the area in which both his traditional place of lodging and his main home are located; members of his family live at his main home; or he often uses that home for lodging.
- **D.** All of the above.

70. Maggie is 73 years of age. She received Social Security benefits of $8,000, which includes $500 for Medicare premiums. Withdrawals from her IRA were $16,000 and she received $22,000 from a pension. She also had other income of $14,000. How much is Maggie's adjusted gross income?

- **A.** $59,225
- **B.** $58,800
- **C.** $60,000
- **D.** $60,500

71. John is a self-employed carpenter. He reported a profit of $40,000 on his Schedule C. He had other taxable income of $10,000. He paid $4,000 for hospitalization insurance. He contributed $5,000 to a Keogh Plan. His self-employment tax was $5,652. He paid his former wife $3,000 in court-ordered alimony and $5,000 in child support. What is the amount John can deduct in arriving at AGI?

- **A.** $22,652
- **B.** $13,226
- **C.** $17,652
- **D.** $21,226

72. A taxpayer is a cash basis taxpayer. In 2001, he incurred the following medical expenses for himself and his daughter, Terry, whom he claims as a dependent on his tax return.

- $250 for glasses for Terry and $200 for glasses for himself;
- $800 for dental work for himself;
- $900 for hospital emergency services, of which $700 was paid by insurance;
- $1,250 for Terry's braces which he charged to his credit card in December 2001 and paid in January 2002;
- $300 for prescriptions for allergies;
- $1,500 medical insurance;

The taxpayer's medical expense deduction before limitations is?

- **A.** $5,200
- **B.** $4,500
- **C.** $4,200
- **D.** $3,950

73. Mary and George are both employed by H.T. Forest & Co. Her salary was $35,000 and his was $30,000. During the year they made the following interest payments: mortgage $8,000, car loan $2,000, home equity loan $3,000, and interest on margin account $4,000. In addition to their salaries, they had interest income of $1,500 and dividend income of $1,000. What is the amount that Mary and George will be able to deduct on Schedule A?

- **A.** $17,000
- **B.** $13,500
- **C.** $15,500
- **D.** $15,000

74. Keith and Margaret had adjusted gross income of $100,000. They had real estate taxes of $4,000, mortgage interest of $12,000, home equity loan interest of $6,000, and automobile loan interest of $3,000, second home mortgage interest of $4,000 and credit card interest of $2,000. The total allowable interest deduction is?

- **A.** $31,000
- **B.** $24,000
- **C.** $22,000
- **D.** $18,000

75. Johnny has been divorced for four years. He failed to make his alimony and support payments. The court ordered him to pay $1,500 as interest on the back alimony and support payments. He paid interest of $1,000 on a car loan, $2,500 on his outstanding credit card balance, $6,000 on a home equity loan and $10,000 on his mortgage. Other interest payments amounted to $2,500 on various appliance loan payments. How much is Johnny's deductible interest?

- **A.** $18,500
- **B.** $16,000
- **C.** $23,500
- **D.** $17,500

76. Jean and Robert have total wages of $95,000 plus interest income of $3,000 and dividends of $2,000. They paid mortgage interest of $7,000, car loan interest of $2,000, mobile home interest of $4,000, personal loan interest of $1,000 and margin interest of $6,000. How much interest can Jean and Robert deduct on Schedule A?

- **A.** $16,000
- **B.** $20,000
- **C.** $12,000
- **D.** $13,000

77. Marilyn and Joe have three children all under the age of ten. The twins, who are three years old, attended Pre-School Nursery, Inc., costing a total of $4,000. Johnny, who is nine, attended After-School Nursery, Inc. at a cost of $1,500. Marilyn has earned income of $14,000 and Joe earns $25,000. What amount of childcare expenses are to be used to determine the credit?

- **A.** $14,000
- **B.** $4,000
- **C.** $5,500
- **D.** $4,800

78. Harry sold 100 acres of land that he had owned for over 30 years. His original cost was $100,000. He sold the property for $500,000 and had settlement costs of $50,000. He received a $150,000 down payment with the balance to be paid over 10 years. His gross profit percentage is?

- **A.** 80%
- **B.** 70%
- **C.** 50%
- **D.** 60%

79. Margaret, a widow, sold 100 acres of land she and her husband paid $20,000 for in 1980. He died in 1995. As of the date of his death, the land was valued at $100,000 for estate tax purposes. Margaret sold the land for $200,000 on an installment basis. What is her gross profit percentage?

- **A.** 90%
- **B.** 70%
- **C.** 50%
- **D.** 60%

80. Ethel and George sold an investment property they purchased in 1993 for $300,000. The property was sold for $700,000 with a down payment of $140,000. What is the gross profit percentage?

- **A.** 57.14%
- **C.** 22.86%
- **C.** 28.57%
- **D.** None of the above.

End of Part 1.

2002

SPECIAL ENROLLMENT
EXAMINATION

IRS

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PART 2

SPECIAL ENROLLMENT EXAMINATION BOOKLET

September 25, 2002
1:30 p.m. to 4:30 p.m.

Sole Proprietorships And Partnerships

Official Use Only
(Declassified After September 25, 2002)

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, 2001. Unless otherwise stated, all questions relate to the calendar year 2001.

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. You will be allowed to keep your examination question books after completion of the examination. Scratch paper will be provided, but you may make necessary computations in the question books. Raise your hand to attract the monitor's attention when you need extra supplies or for permission to leave the room.

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, 2003.

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 question, 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 question book and retain it for purposes of your future comparison.

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. You adopt a tax year when you file your first tax return. You must adopt your first tax year by the due date (including extensions) for filing a return for that year.

2. Generally, you can use any combination of cash, accrual, and special methods of accounting if the combination clearly shows income and you use it consistently.

3. If you owe a business expense to a related party who uses the cash method of accounting,you will be able to deduct the expense if the relationship with that person ends before the expense is includible in the gross income of that person.

4. Generally, the basis of a patent you get for your invention is the cost of development, such as research and experimental expenditures (unless you deduct these as current business expenses), drawings, working models, and attorney and governmental fees.

5. When acquiring a sole proprietorship, a taxpayer must allocate the purchase price to the various assets acquired (equipment, building, intangible assets, land, etc.) based on the portion of the fair market value on the date of purchase of each asset.

6. A partially nontaxable exchange is an exchange in which you receive unlike property or money in addition to like kind property. The basis of the property you receive is the basis of the property you gave up decreased by any money you receive and any loss you recognize on the exchange.

7. If you acquire an asset in exchange for another asset and your basis for the new asset is calculated by using your basis in the old property, the holding period of the new property begins on the day of the exchange.

8. On February 1, 2001, Lucille acquired her replacement property before the sale of her rental was final. Lucille met all the time requirements for the exchange. Lucille transferred the replacement property to an exchange accommodation titleholder under a qualified exchange accommodation arrangement until she was able to finalize the sale of her rental property. She has a written agreement that was entered into within 5 days of the acquisition. This transaction generally will qualify for a tax-free exchange.

9. An inventory is necessary to clearly show income when the production of merchandise is an income-producing factor. If you must account for an inventory in your business, you must use an accrual method of accounting for your purchases and sales.

10. Patricia is a computer programmer and was laid off from Hard Drive Inc. due to downsizing. Hard Drive asked Patricia to work on a one-time project. They agreed to pay her a flat fee to create an advance product. The number of hours to complete this project is unknown and there is no guaranteed minimum payment for the hours spent. Hard Drive provides the specifications to Patricia for the product. Patricia uses her own high-end computer, and is not required to attend meetings held by the software engineering group. Patricia is an independent contractor.

11. A passenger automobile is any 4-wheeled vehicle made primarily for use on public streets, roads and highways and has an unloaded gross weight of not more than 6,000 lbs. Trucks and vans are classified as passenger automobiles if their weight is 6,000 lbs. or less when loaded.

12. The M&M partnership constructed a commercial building at a cost of $350,000. M&M borrowed $200,000 to help pay for the construction. The interest paid on the loan was $16,000. M&M also borrowed money to purchase a truck to be used in the business. The truck cost $30,000. M&M put $6,000 down and borrowed $24,000 and paid interest of $2,400. M&M can deduct $18,400 in interest expense on its tax return.

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

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

15. You can claim a casualty or theft loss of inventory, including items you hold for sale to customers, through the increase in the costs of goods sold by properly reporting your opening and closing inventories.

16. The amount you spend to board up your business against a storm is **not** part of your casualty loss.

17. Farm income averaging must be elected on a timely filed return (including extension) or later if the taxpayer receives approval from the Internal Revenue Service.

18. A domestic LLC with at least two members that does **not** file Form 8832 is classified as a partnership for Federal income tax purposes.

19. The partnership chooses how to treat the partner's share of foreign and U.S. possessions taxes, certain mining exploration expenses, and income from cancellation of debt.

20. Premiums for health insurance paid by a partnership on behalf of a partner for services as a partner are treated as guaranteed payments.

Turn to the next page for Part 2, Section B.

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 dates would **not** be considered the end of a tax year?
- **A.** The last Friday in June.
- **B.** September 30, 2001.
- **C.** April 15, 2001.
- **D.** December 31, 2001.

22. Which of the following accounting methods is **not** an acceptable method of reporting income and expenses?
- **A.** If an inventory is necessary to account for your income, you must use an accrual method for purchases and sales. You can use the cash method for all other items of income and expenses.
- **B.** If you use the cash method for figuring your income, you can use the accrual method for figuring your expenses.
- **C.** Any combination that includes the cash method is treated as the cash method.
- **D.** You can use different accounting methods for reporting business and personal items.

23. The total basis for all properties qualifying for nontaxable exclusion that you receive in a partially nontaxable exchange is the total adjusted basis of the properties you give up with the following adjustments, **except**:
- **A.** Any additional cost you incur.
- **B.** Any money you receive.
- **C.** Unlike property you receive up to its cost on the date of the exchange.
- **D.** Any gain you recognize on the exchange.

24. Phil and Don are equal partners in the Hilldale Company. Hilldale has a fiscal year ending on January 31. Phil and Don file their individual tax returns on a calendar year basis. For the tax year ending January 31, 2001, Hilldale had taxable income from the active conduct of its business of $100,000 of which $60,000 was earned in 2000. How much of their partnership taxable income should Phil and Don each include in computing their taxable income limit for the 2001 tax year?
- **A.** $50,000
- **B.** $20,000
- **C.** $30,000
- **D.** $0

25. The Foster & Graves Partnership values its inventory under lower of cost or market value method. Under this method, what is the value of the ending inventory?

Item	Cost	Market
M	150	175
N	175	180
O	220	200

- **A.** $525
- **B.** $555
- **C.** $545
- **D.** $520

26. The taxpayer is a merchant who has purchased inventory items. He withdrew some of these items for personal use. He must:
- **A.** Increase his sales by the cost of the items withdrawn.
- **B.** Reduce the cost of purchases by the cost of the personal use items.
- **C.** Reduce the cost of purchases by the fair market value of the personal use items.
- **D.** Reduce beginning inventory by the cost of the personal use items.

27. Payments made by a partnership to a partner that are determined without regard to the partnership income are called:
- **A.** Guaranteed payments
- **B.** Minimum payments
- **C.** Ordinary income
- **D.** Capital gains

28. Alex and Arthur are equal partners in the A&R Partnership. Alex receives a guaranteed payment of $ 5,000. The partnership had distributive net income (after deducting the guaranteed payment of $5,000) of $80,000. What amounts are subject to self employment tax?

	Alex	Arthur
A.	$37,500	$37,500
B.	$42,500	$42,500
C.	$40,000	$40,000
D.	$45,000	$40,000

29. Bob works on the loading dock for the Loaden Partnership from 7:00 am to 3:00 pm, Monday-Friday. Susan, the full-time secretary, works a 4-day week. Max, the bookkeeper, is the sole proprietor of the Books-I-Keep Accounting Service and is a licensed accountant. Max works a different schedule each week for Loaden but is very conscientious and reliable. How many of these individuals are considered employees?

A. 3
B. 2
C. 1
D. None.

30. A cafeteria plan is a written plan that allows employees to choose between receiving cash or taxable benefits instead of certain qualified benefits for which the law provides an exclusion from wages (deferral). Which of the following can be included in a cafeteria plan?

A. Life insurance premiums.
B. Membership dues to athletic facilities.
C. Out-of-pocket medical expenses.
D. Tuition reduction.

31. The Adams & Baker Partnership bought James' B&B restaurant, which was located in an exclusive section of town. The goodwill associated with the purchase of this business was valued at $60,000. Per Section 179, what is the number of years over which goodwill can be amortized?

A. 5 years.
B. 10 years.
C. 15 years.
D. 20 years.

32. The D&L Partnership bought a truck for $28,000 and a trailer for $4,000 on January 10, 1998, to be used in the business. D&L uses the straight-line method and a 5-year life to recover its cost for tangible property. In 1998 and 1999, D&L took depreciation of $6,400 and $4,600 respectively. In January 2000, D&L discovered that it under-claimed depreciation of $1,800 on its tax return for 1999. What can D&L do to recover the $1,800?

A. Claim $8,200 depreciation in 2000.
B. Make a pro-rata adjustment to the basis of the equipment.
C. Amend the tax return for 1999.
D. It can't be recovered.

33. The K&L Partnership owned the following tangible property. Which one is **not** considered listed property?

A. An automobile.
B. A cellular telephone.
C. A computer used for personal use 40% of the time.
D. A truck weighing 17,000 lbs designed to carry cargo.

34. Burt bought a 2001 BMW 525I for $64,000 on March 2, 2001. He will use the automobile 100% of the time in his business. The recovery period for passenger autos is 5 years. What is Burt's depreciation for the year 2001?

A. $12,800
B. $3,060
C. $3,200
D. $640

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

A. Geothermal deposits.
B. Gas and oil.
C. Timber.
D. Land.

36. Mary, a seamstress, made loans of $5,000 and $1,000 to Buttons & Bows and Thread Bare, respectively. Both of these establishments are partnerships. Mary also made a loan of $2,000 to her cousin Sarah, who was starting her own business as a proprietorship. The loans to both partnerships improved Mary's business, which was the reason Mary made the loans. If all three loans become uncollectible, what amount may Mary deduct as a business bad debt?

A. $5,000
B. $6,000
C. $1,000
D. $2,000

37. Bart, a partner in the B&A Partnership attended the Comdex Computer Convention in Las Vegas. The partnership repairs and upgrades commercial computers for business use. At the convention, a new advanced computer hard drive was introduced that would make current machines run faster and more efficiently. Bart is responsible for purchasing hard drives for the computers used in the partnership. Bart's travel expenses excluding meals, were $950. Part of that amount includes a rental car of $100 incurred to visit his mother and $50 for flowers and candy he bought for her. How much is deductible as a business expense?

A. $950
B. $900
C. $800
D. $850

38. When an employer reimburses an employee for meals under an accountable plan while the employee is away from home, the employer must:

A. Include 50% of the cost of meals as income to the employee.
B. Do nothing.
C. Deduct only 50% of the reimbursement on his/her tax return.
D. Add 100% of the meals as income to the employee.

39. In determining whether you are carrying on an activity for profit, all the facts and circumstances are taken into account. All of the following are factors to consider **except**:

A. You are carrying on two different business activities. When you combine the income and expenses together, you have a net profit.
B. Your losses are due to circumstances beyond your control.
C. You can expect to make a future profit from the appreciation of the assets used in the activity.
D. You were successful in making a profit in similar activities in the past.

40. All of the following statements about foregoing the net operating loss (NOL) carry-back period are correct **except**:

A. To make the election, you attach a statement to your tax return filed by the due date (including extensions) for the NOL year.
B. A taxpayer has three years to amend a prior year's return to include the election.
C. Once the election is made, the taxpayer cannot later revoke the election.
D. Once the election is made, you can use your NOL only in the 20 year carry-forward period.

41. Section 1245 property includes any property that is or has been subject to an allowance for depreciation or amortization. It includes all of the following types of property, **except**:

A. Office equipment.
B. Client files.
C. Building elevator.
D. Storage facilities.

42. A taxpayer suffered an $11,000 loss of inventory when his cooler malfunctioned. He had no insurance for this type of loss. He shows this loss on his tax return by:

A. Taking a bad debt deduction of $22,000, the amount he would have sold the inventory for.
B. Taking an ordinary loss on Form 4797 of $11,000.
C. Taking a business loss on his Schedule C as reflected by an increase of $11,000 in cost of goods sold.
D. Taking a loss of $11,000 as a bad debt on Schedule D.

43. If you sell more livestock 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. You must meet all of the following conditions to make the election **except**:

A. You can show that, under your usual business practices, you would not have sold the animals this year except for the weather-related conditions.
B. The weather-related conditions caused an area to be designated as eligible for assistance by the Federal government.
C. You use the accrual method of accounting.
D. Your principal trade or business is farming.

44. Qualified farmers have the following choices to file their tax return without incurring any penalties:

A. File and pay 100% of the tax due by March 1 each year.
B. File one estimated payment for two-thirds of the tax by January 15 and file and pay the balance by April 15.
C. File and pay the tax due by April 15 each year.
D. Both A and B.

45. If the partner's distributive share of a partnership item cannot be determined under the partnership agreement, it is determined by his or her interest in the partnership. The partnership interest is determined by taking into account all of the following items **except**:

- **A.** The partner's relative contributions to the partnership.
- **B.** The interests of all partners in economic profits and losses (if different from interests in taxable income or loss) and in cash flow and other nonliquidating distributions.
- **C.** The amount of the partnership's nonrecourse liabilities.
- **D.** The right of the partners to distributions of capital upon liquidation.

Turn to the next page for Part 2, Section C.

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. Mr. Jones has an adjusted gross income of $30,000 and itemized deductions of $6,000 for the 6-month period from January 1 through June 30, 2001. He is allowed to claim exemptions of $11,600 (4 people). Mr. Jones received an approved change to his tax year and he must file a short tax year return. What is the taxable income amount that he must compute his short year return on?

A. $12,400
B. $18,200
C. $36,400
D. $40,800

47. George purchased a business on May 31, 2001, for a lump sum price of $1,400,000. The values of the assets on the seller's books were as follows:

	Book Value	Fair Market Value
Cash	$200,000	$200,000
Land	$150,000	$150,000
Building	$300,000	$450,000
Equipment	$250,000	$300,000
Covenant Not to Compete	$0	$100,000

George did not assume any loans. What is his basis for goodwill and the equipment?

Goodwill	Equipment
A. $0	$300,000
B. $200,000	$300,000
C. $200,000	$350,000
D. $0	$350,000

48. Larry purchased an office building and land on February 1, 2001, for $1,000,000. No liabilities were assumed. The assessed value of the assets for real estate purposes at the time of the purchase were as follows:

	Assessed Value
Land	$300,000
Building	$500,000

What is the basis of the building?

A. $ 500,000
B. $ 600,000
C. $ 625,000
D. $ 700,000

49. Several years ago, you paid $150,000 to build your home on a lot that cost you $50,000. Before converting the property to rental use last year, you paid $30,000 for permanent improvements to the house. You received a $5,000 easement payment from the State of California for use of the land for a power line. The county indicates the FMV of the house is $250,000 and the land is $100,000. What is your basis for depreciation?

A. $150,000
B. $175,000
C. $180,000
D. $250,000

50. The Taft, Lincoln & Garfield partnership owned a vacant lot of land, which it used in its business. The partnership exchanged the lot for another vacant lot, which was used for business purposes. The adjusted basis of the old lot was $20,000 (FMV $31,000) and the adjusted basis of the new lot was $19,000 (FMV $30,000). The partnership incurred exchange expenses of $500 for attorney fees and $75 for deed fees to record the exchange. What is the basis of the new property on the books of the partnership?

A. $29,425
B. $20,000
C. $20,575
D. $19,575

51. Mike and Joe are equal partners in the Dandy Partnership. On January 1, 2000, the partnership, in a like-kind exchange, exchanged a building (adjusted basis $150,000) used for business for another building (adjusted basis $150,000) used for business. The new building had a mortgage of $25,000, which Dandy assumed, and unpaid real estate taxes of $2,600 which Dandy paid but was not reimbursed. What is the adjusted basis of the new building and what is the amount of depreciation assuming a 20-year life under the straight-line method?

Adjusted Basis	Depreciation
A. $150,000	$7,500
B. $152,600	$7,630
C. $175,000	$8,750
D. $177,600	$8,880

52. Fred exchanged his rental property with an adjusted basis of $220,000 and an FMV of $250,000 for a storefront worth $230,000 and paid $20,000 cash. Fred paid exchange costs of $15,000 from his personal checking account. The property given up had a mortgage of $100,000, that the other party in the trade assumed. Fred assumed a $90,000 liability on the new property. What is Fred's **recognized** gain?

A. $0
B. $15,000
C. $20,000
D. $25,000

53. David owned a car, which he used in his business for the past two years. Its adjusted basis was $13,500. David sells his car to a dealer for $14,500. He then buys a new car for $20,500 from the same dealer. What is David's basis in the new car?

A. $13,500
B. $14,500
C. $19,500
D. $20,500

54. Bill, a partner in Williams-Sonic, is a calendar-year taxpayer. Williams-Sonic's partnership year ends on June 30. For the partnership year ending June 30, 2001, Bill's distributive share of partnership profits is $4,000. On August 20, 2001, Bill dies and his estate succeeds to his partnership interest. For the partnership year ending June 30, 2002, Bill and his estate's distributive share is $6,000. What is Bill's self-employment income on Schedule E (Form 1040) for 2001?

A. $4,000
B. $5,000
C. $10,000
D. $7,000

55. The FX Partnership manufactures garden hoses for sale. In the month of January, its sales were $80,000. During that month, the partnership had:

Beginning inventory, January 1	$0
Raw materials purchased January 1	$35,000
Raw materials shipping costs	$1,585
Direct labor (production)	$27,000
Factory overhead	$6,000
Ending inventory, January 31	$10,000

What is the cost of goods sold for the FX Partnership for the month of January?

A. $58,000
B. $59,585
C. $69,585
D. $53,585

56. Matt and Jason, partners in the M & J Partnership began business on June 15, 2001. The business incurred the following expenses prior to June 15th:

- Purchase of a commercial building for $200,000.
- New electrical wiring $27,000.
- New plumbing at a cost of $75,000.
- Light fixtures, (not part of the wiring), replaced at a cost of $6,500. These light fixtures were of the same quality as the previous ones.

What is the cost of improvements?

A. $108,500
B. $200,000
C. $275,000
D. $102,000

57. Mark is an engineer for the Peterson LTD Partnership. Peterson has an accountable travel expense plan. Mark incurred $375 in travel expenses on a two-day business trip. When he returned to his tax home, he worked late and incurred $90 for meals. Mark gave his employer an adequate accounting within a reasonable time and did not have any excess reimbursement. What amount, if any, must be included in Mark's W-2?

A. $375
B. $465
C. $0
D. $90

58. Ray owns a delivery truck and delivers bread to retailers locally for the Gorman Bakery. He owns his delivery route. In 2001, Ray received a W-2 with gross wages of $30,000 in Box 1. Ray's Federal income tax rate is 15%. For the year 2001, Ray is considered what type of employee and had what amount withheld for Federal income tax (FIT)?

Employee Type	FIT
A. Statutory	$4,500
B. Common law	$4,500
C. Statutory	$0
D. Common law	$0

59. P&L Partnership purchased a building for commercial purposes on July 1, 2001, for $200,000. Carpeting was installed at a cost of $8,000 on August 30, 2001. Furniture was purchased at a cost of $10,000 on September 1, 2001. Legal fees of $700 and recording fees of $100 were incurred at the time the building was purchased. What is the cost basis of the building?

A. $218,800
B. $200,000
C. $200,800
D. $218,000

60. James is a 50% partner in the A&M Partnership. The partnership bought a truck for $24,000 in January 1998. James also owns a printing business that he operates part-time. In January 1998 he bought a color copier for $1,200. Both the truck and the copier qualify for Section 179 deduction, which was taken in 1998. Two years later the truck and the copier were converted to personal use. The truck has a 5-year life and the copier has a 3-year life. What amount should be recaptured as ordinary income if James used straight-line depreciation on all of the equipment he purchased? (For 1998, the Section 179 deduction limitation amount was $18,500.)

A. $7,600
B. $5,600
C. $13,200
D. $0

61. Mark, a 50% partner in the X&Y Partnership, uses the percentage method to compute his depletion allowance for the gas and oil property owned by the partnership. His allocable share of the property is $100,000. The fair market value of the property is $100,000 also. 65% of his taxable income for 2001 equals $65,000. The percentage depletion rate is 15% for natural gas and oil sold. X&Y is a small producer, and the average daily production does not exceed the depletable oil and gas quantity. Mark's share of the gross sale of oil and gas deposits was $30,000. What is Mark's depletion deduction for 2001?

A. $4,500
B. $9,750
C. $9,000
D. $5,250

62. The J&M partnership paid liability insurance on its building of $2,200 for the year 2001. This represents a premium for one year. J&M also prepaid fire insurance premiums of $2,400. The premium paid was for 2001 and 2002. What is the amount of insurance that J&M may deduct for 2001?

A. $2,200
B. $3,400
C. $4,600
D. $2,400

63. In 2001, Mark paid his first quarter real estate taxes of $1,400 on his personal home. Mark paid real estate taxes on his unemployed brother-in-law's home of $800. During the year, Mark was assessed a tax for trash pick-up of $165. He also paid a tax of $250 for improvements made by the town in his development, which increased the value of his property. Mark also withdrew the entire amount of $10,400 from his traditional IRA of which $2,400 was interest earned. Mark, in previous years, had taken deductions for his IRA contributions. Mark is 48 years old. What is deductible on his Form 1040 for real estate taxes and what is the tax penalty, if any, on the early withdrawal from his IRA?

Deductible Real Estate Tax on Schedule A	Tax on IRA
A. $1,400	$0
B. $1,400	$240
C. $8,000	$1,040
D. $1,400	$1,040

64. What is Sam's (a single taxpayer) net operating loss for the current year based on the following information?

• Wages from a part time job	$10,000
• Interest on savings	$500
• Net long term capital gain on sale of business asset	$5,000
• Net loss from business (Gross income $60,000 minus $80,000 expenses)	$20,000
• Net short term capital loss on stock sale	$3,000
• 2001 standard deduction	$4,550
• 2001 personal exemption	$2,900

A. $4,500
B. $5,000
C. $7,500
D. $14,950

65. A taxpayer sold his rental house for $190,000 on May 2001. The depreciation taken under ACRS was $67,840. If the taxpayer had used the straight-line method, the depreciation would have been $64,960. How much Section 1250 gain did this taxpayer have when the house was sold?

A. $2,880
B. $64,960
C. $67,840
D. $110,000

66. A used car lot owner sold an adjacent lot on June 9, 2001, for $125,000. He purchased this lot on August 6, 1998, for $65,000. He did not pave this lot or make any improvements to it. He paid $4,600 in closing costs at the sale. How much gain does he have, and what type of gain is it?

A. $55,400 Section 1250 gain.
B. $55,400 Section 1231 gain.
C. $4,600 Section 1245 gain, $50,800 Section 1231 gain.
D. $55,400 Schedule D gain.

67. Fred bought new office equipment four years ago for $1,000. In April, a fire destroyed the equipment. Fred estimates that it will cost $1,200 to replace the equipment. Fred estimates the fair market value of the equipment was $500. He had no insurance and at the time of the fire his adjusted basis was $437. What is Fred's business loss?

A. $1,200
B. $1,000
C. $500
D. $437

68. A farmer sold a 3-year old raised dairy cow for $600. It cost him $75 for shipping and commissions to sell the cow. He reports this sale as follows on his tax return:

A. A loss of $700 on his Schedule F because he believed it cost him $1,300 to raise the dairy cow.
B. A Section 1245 gain of $525 reported on Form 4797 Part III.
C. A gain of $525 reported on Schedule F as ordinary farm income.
D. A Section 1231 gain of $525 reported on Part I of Form 4797.

69. Sandy had the following total gross income for 2001:

Taxable interest	$45,000
Dividends	$1,000
Rental income (Schedule. E)	$1,500
Farm income (Schedule F)	$75,000
Gain from sale of farm animals	$5,000

How much of Sandy's gross income qualifies as gross income from farming?

A. $75,000
B. $80,000
C. $81,500
D. $127,500

70. F & J Partnership had the following income for the current year:

• Income from operations	$170,000
• Tax exempt interest	$10,000
• Dividends from foreign corporations	$5,000
• Net rental Income	$20,000

Partners Fred and Joe share the profits and losses equally. What is Fred's share of the partnership income (excluding all partnership items which must be accounted for separately)?

A. $85,000
B. $95,000
C. $97,500
D. $170,000

71. A partnership, in which Jane is a 50% owner had a profit of $80,000. The partnership agreement provides for a 50-50 sharing of income. Capital is a material income producing factor. During the year, Jane performed services worth $20,000. What is the total income Jane should report from the partnership?

A. $20,000
B. $40,000
C. $50,000
D. $80,000

72. Jason owns a 55% capital interest in ABC Partnership. His brother owns 60% interest in XYZ Partnership. ABC sold a piece of property with an adjusted basis of $50,000 and a fair market value of $55,000 to XYZ for $45,000. What is ABC's **recognized** loss?

A. $0
B. $ 5,000
C. $5,500
D. $10,000

73. Under a partnership agreement, June is to receive 40% of the partnership income but not less than $12,000 a year. The partnership has net income of $20,000. What is the guaranteed payment that the partnership can deduct in figuring its ordinary income on Page 1 of Form 1065?

A. $0
B. $3,200
C. $4,000
D. $8,000

74. Sharon's basis in S & P partnership is $185,000. In a complete liquidation of Sharon's interest in S & P, Sharon received the following:

	S & P's Basis	Fair Market Value
Cash	$5,000	$5,000
Building	$50,000	$100,000
Land	$40,000	$50,000

What is Sharon's basis in the building?

A. $50,000
B. $100,000
C. $116,667
D. $120,000

75. The adjusted basis in Carol's partnership interest is $50,000. She receives a distribution of $10,000 cash, land that has an adjusted basis of $30,000 and a FMV of $50,000.

What is Carol's adjusted basis in the land?

A. $20,000
B. $30,000
C. $40,000
D. $50,000

76. Mrs. Zee sold her 30% interest in LPM partnership for $50,000. The partnership reports income on the accrual basis. Mrs. Zee's adjusted basis in the partnership interest was $30,000. The partnership had no liabilities at the date of the sale. The partnership had the following assets at the time of Mrs. Zee's sale:

	Adjusted Basis	Fair Market Value
Cash	$10,000	$10,000
Accounts receivable	9,000	9,000
Inventory	7,000	10,000
Machinery & equipment	12,000	12,000
Accumulated depreciation	9,000	0
Land	80,000	100,000
Total assets	$109,000	$141,000

How much should Mrs. Zee report as capital gain and ordinary gain?

A. Capital gain $20,000; Ordinary gain $0
B. Capital gain $16,400; Ordinary gain $3.600
C. Capital gain $13,700; Ordinary gain $6,300
D. Capital gain $-0-; Ordinary gain $20,000

77. A company increased their research expenses by $3,600. What is the maximum credit they qualify for on their tax return for tax year 2001?

A. $360
B. $900
C. $2700
D. $720

78. In 2001, the M&E Partnership bought a new electric motor vehicle to be used in its delivery service business. The vehicle qualifies for the electric vehicle credit. The vehicle cost $50,000. No Section 179 deduction was taken in 2001. What is the electric vehicle credit for 2001?

A. $5000
B. $4000
C. $2500
D. $2000

79. The F&E Partnership spent $100,000 on eligible access expenditures that qualify for the disabled access credit. The partnership had gross receipts of $1 million and 30 full-time employees during the preceding tax year. What is the amount of the disabled access credit for the year 2001?

A. $5,000
B. $10,000
C. $250
D. $50,000

80. The Barrow and Jones partnership incurred qualified rehabilitation expenses of $50,000 on a certified historic structure. What is the Rehabilitation Investment Credit before tax limitations are applied?

A. $5,000
B. $10,000
C. $7,500
D. $6,000

End of Part 2.

2002

SPECIAL ENROLLMENT EXAMINATION

PART 3

SPECIAL ENROLLMENT EXAMINATION BOOKLET

SEPTEMBER 26, 2002
9:00 A.M. TO 12:00 NOON

Corporations (Including S Corporations), Fiduciaries, Estate and Gift Tax, and Trusts

IRS
Department of the Treasury
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Part 3
Catalog Number 32647X

Official Use Only
(Declassified After September 26, 2002)

Special Enrollment Examination

Part 3

Corporations (Including S Corporations), Fiduciaries, Estate and Gift Tax, and Trusts

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, 2001. Unless otherwise stated, all questions relate to the calendar year 2001.

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. You will be allowed to keep your examination question books after completion of the examination. Scratch paper will be provided, but you may make necessary computations in the question books. Raise your hand to attract the monitor's attention when you need extra supplies or for permission to leave the room.

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, 2003.

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 question, 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 question book and retain it for purposes of your future comparison.

Part 3

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. Unless specifically elected otherwise using Form 8832, a single member limited liability company will be classified as a corporation for Federal income tax purposes.

2. If you transfer property (or money and property) to a corporation solely in exchange for stock in that corporation (other than nonqualified preferred stock) and immediately thereafter you are in control of the corporation, the exchange is usually **not** taxable.

3. If a corporation cancels a shareholder's debt without repayment by the shareholder, the amount canceled is treated as a distribution to the shareholder.

4. If the Richards Corporation, a C corporation carries its capital losses from two or more years to the same year, the loss for the earliest year is deducted first. When that loss is completely absorbed, the loss from the next earliest year is then deducted, and so on.

5. Generally, a corporation must make estimated tax payments if it expects its income for the year to be $500 or more.

6. As long as 100% of the stockholders of a Corporation elect, in writing, to adopt Subchapter S status for their Corporation, generally such election will be valid for the current tax year if it is properly requested within 180 days of the start of the corporation's tax year.

7. An S Corporation is permitted to own a qualified Subchapter S subsidiary.

8. On January 1, 2001, Harbor, Inc., a calendar year S Corporation had three shareholders (Bob, Dave, and John). Bob owned 50% of the stock, while Dave and John each owned 25%. On July 1, 2001, Bob sold his stock equally to Dave and John. If at the end of the tax year the corporation has a net operating loss, and Dave and John's basis in their stock is sufficient, 50% of the net operating loss will flow through to Dave and 50% of the net operating loss will flow through to John.

9. Mary is the president of Should-A-Thought, Inc., a C-Corporation. She owns 48% of the corporate stock. From inception in 2000, the company has lost money. She feels that the company will continue to be unprofitable for the next 3-5 years. She wants to convert to an S Corporation to take advantage of the prior losses. If Should-A-Thought, Inc. timely files the proper form to elect to be an S Corporation prior losses of the company will flow through to Mary's personal income tax return.

10. The decedent was a cash basis taxpayer who had chosen not to report the interest each year from his series EE savings bonds that he purchased during his lifetime. The executor of his estate may elect to include on the decedent's final return all of the interest earned on the bonds before the decedent's death.

11. Payments received on an inherited installment obligation are never taxable to the beneficiary.

12. A carryover NOL that is passed through to a beneficiary is deducted on the beneficiary's return as a miscellaneous itemized deduction **not** subject to the 2% floor.

13. An estate tax return (Form 706) must be filed within 6 months after the date of the decedent's death, unless an extension of time to file is requested.

14. If an individual transfers title to property to one or more other individuals, but retains the right to the use of the property during his or her lifetime, the property will be included in his or her estate.

15. A decedent's funeral expenses may be taken as a deduction on Form 706, United States Estate (and Generation-Skipping Transfer) Tax Return.

16. Forrester gave his son $20,000 in stock that he had inherited from his father. His wife, Martha, gave no gifts during the year. Forrester is not required to file a gift tax return for the year of the gift.

17. A $20,000 gift to an unrelated individual who is 40 years younger than the donor is subject to both the gift tax and the generation-skipping transfer tax.

18. A trust that is required to distribute all of its income currently, is always classified as a simple trust.

19. The income of a grantor trust is reported on the grantor's return even if no distributions from the trust are made to the grantor.

20. A simple trust must file a tax return if it has gross income for the year of $600 or more.

Turn to the next page for Part 3, Section B.

Part 3
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 types of domestic business entities, formed after 1996, must be taxed as a corporation?
1. An association.
2. An insurance company.
3. Any business formed under state law that refers to itself as a corporation.
4. A single member limited liability company.

A. All of the above.
B. 1, 2 and 3 only.
C. 3 only.
D. 2 and 3 only.

22. John and Jim each own 5% of J&J Partnership, which was founded in 1990. J&J is a calendar year taxpayer. On March 20, 2002, they elected to be treated as a corporation for Federal tax purposes by filing a Form 8832. What is the earliest date that J&J can be treated as a corporation?
A. January 1, 2002.
B. March 20, 2002.
C. January 4, 2002.
D. January 1, 2003.

23. ABC Company, a corporate taxpayer, has a fiscal year ending September 30. The due date, excluding extension, for filing their return is:
A. January 15.
B. November 15.
C. December 1.
D. December 15.

24. Which of the following statements about a controlled group of corporations is true?
A. Members of a controlled group are entitled to only one accumulated earnings tax credit.
B. A parent corporation and its 80% owned subsidiary make up a controlled group.
C. All members of a controlled group need not use the parent's tax year.
D. All of the above.

25. Which of the following costs qualify as business "start-up costs"?
A. Deductible interest.
B. State and local taxes.
C. A survey of potential markets.
D. Research and experimental costs.

26. Which of the following costs would qualify as business "organizational costs"?
A. State incorporation fees.
B. State and local taxes.
C. Deductible interest.
D. None of the above.

27. Which of the following is an example of nonqualified preferred stock in a Section 351 transaction?
A. The holder of the stock has the right to require the issuer or a related person to redeem or buy the stock.
B. The issuer of the stock is required to redeem or buy the stock.
C. The dividend rate on the stock varies with reference to interest rates, commodity process, or similar indices.
D. All of the above.

28. Acme Corporation made payments during the year that are required to be reported to the IRS and the recipients on Form 1099-DIV in paper format. What are the due dates to file Form 1099-DIV?

	Filing date to IRS	Filing Date to Recipients
A.	February 28	January 31
B.	January 31	January 31
C.	March 15	March 15
D.	None of the above	

29. The Smart Corporation distributes an office building to Collin, a shareholder of the corporation. The fair market value of the building exceeds its basis to the corporation. Which of the following statements is true with regard to this transaction?
A. Smart Corporation realizes but does not recognize gain on this distribution.
B. Smart Corporation elects not to report the gain on this distribution.
C. Smart Corporation must recognize gain on this distribution.
D. Collin must recognize the losses on this distribution on his return as a shareholder.

30. Lantern Corporation is in the process of dissolving and has filed a request with the Internal Revenue Service (IRS) for a prompt assessment. Assuming all other requirements are met, if the request is granted, the period within which the IRS may assess a tax liability is shortened to how many months?
A. 24 months.
B. 18 months.
C. 36 months.
D. 12 months.

31. On January 1, 2001, Tom, Dick, and Harry were sole and equal shareholders of ABC, Inc., a calendar year C Corporation. On February 1, 2001, Tom sold all of his interest in the corporation to Dick. On March 1, 2001, Dick decides to convert the corporation to an S Corporation, effective January 1, 2001. Regarding the desired conversion, which of the following statements is true?

- **A.** Since Dick now owns over 51% of the corporation, he can unilaterally prepare and submit the proper election application, IRS Form 2553.
- **B.** Since the S Corporation election requires consent by 100% of the shareholders, both Dick and Harry must sign the application to elect to be treated as an S Corporation.
- **C.** Since Tom, Dick, and Harry were all shareholders as of January 1, 2001, all three must consent to elect to treat the corporation as an S Corporation.
- **D.** Since there was a change in stock ownership after the beginning of the Corporation's tax year, any election to treat the corporation as an S Corporation will not be effective earlier than January 1, 2002.

32. Previous years cash distributions to a shareholder have reduced his/her stock basis to zero in an S Corporation. How will any further cash distributions be treated for tax purposes if the company continues to have losses?

- **A.** It will be treated as a deemed sale of the shareholder's stock.
- **B.** It will be treated as a capital contribution to the corporation.
- **C.** It will receive passive activity loss treatment, subject to any limitations.
- **D.** It will be carried over indefinitely to be offset with future earnings.

33. On December 1, 2001, Bob elected to terminate his corporation's S status, effective January 1, 2002. Bob owns 55% of the corporation's stock. If Bob changes his mind, what is the earliest date that Bob could have his S Corporation status reinstated without IRS consent?

- **A.** January 1, 2004.
- **B.** December 1, 2006.
- **C.** January 1, 2007.
- **D.** Since election to terminate S Corporation status requires 100% of the outstanding shareholders' consent, the revocation is not valid and the S Corporation qualifies until properly terminated.

34. Allecia, a cash-basis taxpayer, died on July 15, 2001. Which of the following items of income are includible on her final return?

- **A.** Dividends of $20 that were declared on July 10 but not received in the mail until July 25.
- **B.** Interest of $500 earned on a savings account through July 15, but not posted to the account until July 31.
- **C.** Consulting income of $300. Allecia completed the job on July 2. The client mailed the payment on July 12, and the check arrived at Allecia's home on July 16.
- **D.** All of the above.

35. Which of the following is **not** an example of income in respect of a decedent?

- **A.** Wages earned before death, but unpaid at the time of death.
- **B.** A dividend check that was received by the decedent, but cashed after death.
- **C.** The taxable portion of an inherited IRA.
- **D.** The taxable portion of payments received on an inherited installment obligation.

36. Mark died on December 22, 1999. The executor of his estate chose a calendar year. In 2000, the estate had a tax liability of $2,000. It is expected that the estate will have an adjusted gross income of $43,000 and a tax liability of $3,000 in 2001. All of the income is from interest and dividends from which no tax was withheld. Which of the following statements regarding estimated tax payments for this estate are true?

- **A.** The executor does not need to make estimated tax payments because the estate is only in its third year of existence.
- **B.** The executor should make equal estimated payments totaling at least $2,000 (last year's tax liability) to avoid a penalty for underpayment of tax.
- **C.** The executor should make equal estimated payments totaling at least $3,000 to avoid the penalty for underpayment of tax.
- **D.** Because the 2001 tax liability is no more than $1,000 greater than the prior-year liability, no estimated tax payments are required.

37. On December 15, 2000, Kyle received a $10,000 distribution from his father's estate. On March 30, 2001, Kyle was issued Schedule K-1 for the estate's first fiscal year (February 1, 2000, through January 31, 2001). The Schedule K-1 from the estate showed taxable interest income of $200 and had no other entries. Based on the information above, which of the following statements are true?

- **A.** Kyle must report income of $10,000 on his 2001 return.
- **B.** Kyle must report $200 interest income on his 2001 return.
- **C.** Kyle may claim a deduction on Schedule A for a pro rata share of the estate tax that was paid by the estate.
- **D.** Both B and C.

38. Which of the following items are included in a decedent's gross estate?

- The decedent's IRA, where the decedent's spouse is the named beneficiary.
- A checking account with the decedent's daughter as joint tenants. The daughter's funds were used to set up the account.
- Assets held in the decedent's revocable grantor trust.

  - **A.** All of the assets are included in the decedent's estate.
  - **B.** The IRA and checking account are included in the decedent's estate.
  - **C.** The IRA and the assets in the revocable grantor trust are included in the decedent's estate.
  - **D.** None of the assets are included in the decedent's estate.

39. Which of the following items is **not** an allowable deduction on a decedent's estate tax return?

- **A.** Bequest to a surviving ex-spouse.
- **B.** Property taxes accrued before death but not paid until after death.
- **C.** Executor's fees for administering the estate.
- **D.** None of the items is allowed as a deduction against the decedent's estate.

40. Which of the following statements concerning the alternate valuation election is correct?

- **A.** The alternate valuation election may be made even if no estate tax will be paid if the election is not made.
- **B.** If the alternate valuation election is made, it is possible for some but not all of the assets to be included in the decedent's estate at a higher FMV than on the date of death.
- **C.** If the alternate valuation election is made, assets that are disposed of within 6 months of the decedent's death are generally valued on the date of death.
- **D.** None of the statements are correct.

41. The Ray Irrevocable Trust incurred a net operating loss (NOL) from normal business operations during its fourth, **non-final** year of existence. Ray's children are the income beneficiaries of the trust. Which of the following statements is correct concerning the (NOL)?

- **A.** The NOL is passed through to the beneficiaries and claimed on their returns.
- **B.** The NOL is carried back, or if elected, carried forward, under the same rules for individuals.
- **C.** The NOL is lost because excess deductions can only be passed through in the final year of a trust.
- **D.** The NOL can only be claimed in the final year of the trust.

42. Which of the following statements regarding gift splitting is correct?

- **A.** The couple must have been married at the time the gift was given, but either or both spouses may be remarried during the year.
- **B.** The couple must have been married at the time the gift was given and the spouse who gave the gift may not be remarried during the year.
- **C.** The couple need not be married at the time of the gift, but must be married by the end of the year.
- **D.** The couple must be married at all times during the year.

43. Edwin gave his grandson Todd $30,000. Todd is 15 years old and lives with his parents. Which of the following statements regarding the generation-skipping transfer tax is true?

- **A.** Because the gift is subject to the generation-skipping transfer tax, it is **not** subject to the regular gift tax.
- **B.** The gift is subject to both the regular gift tax and the generation-skipping transfer tax.
- **C.** The gift is **not** subject to the generation-skipping transfer tax because Todd's parents are still alive.
- **D.** If Edwin had transferred the funds into a trust solely for his grandson's benefit, the gift would **not** be subject to the generation-skipping transfer tax.

44. The Tom Trust requires that all trust income be distributed at least annually. There are no provisions for charitable contributions. To be treated as a simple trust, what must also be true?

- **A.** Trust income can consist of interest and dividends only.
- **B.** There were no distributions of corpus in the current year.
- **C.** All beneficiaries must be U.S citizens or resident aliens.
- **D.** All of the above

45. Which of the following statements regarding grantor trusts is true?

- **A.** A grantor of a grantor trust does not report income from the trust unless distributions are made from the trust.
- **B.** A grantor trust is a good way to shelter income.
- **C.** Income from a grantor trust is taxed to the grantor in the same manner as if no trust existed.
- **D.** All of the statements are true.

Turn to the next page for Part 3, Section C.

Part 3

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. ABC, Inc., a regular domestic corporation and calendar year taxpayer, had taxable income of $10,000 for the year 2001. Because the company's accountant was on vacation during the month of March 2002, the corporate income tax return was not filed in a timely manner and no extension was filed. The new accountant mailed the return on June 15, 2002. Disregarding any possible late payment penalty, and assuming no estimated tax payments were made, calculate the maximum failure to file penalty that could be assessed against ABC, Inc.

- **A.** $1,000
- **B.** $350
- **C.** $225
- **D.** $270

47. Robert transferred an office building that has an adjusted basis of $60,000 and a fair market value of $105,000 to the Wargo Corporation in exchange for 100% of Wargo Corporation stock and $10,000 cash. The building was subject to a mortgage of $25,000, which Wargo Corporation assumed. The fair market value of the stock was $75,000. Which is the amount of Robert's realized gain and recognized gain?

	Realized	Recognized
A.	$55,000	$30,000
B.	$50,000	$30,000
C.	$50,000	$10,000
D.	$35,000	$10,000

48. Bob and Sam transfer a building with a basis of $100,000 to the Redwood Corporation in exchange for 75% of each class of stock with a fair market value of $300,000. The other 25% of the stock was already issued to Betty. What is the gain, if any, that Bob, Sam, or the Redwood Corporation must recognize?

- **A.** Bob and Sam, none; Redwood Corporation none.
- **B.** Bob and Sam, none; Redwood Corporation $300,000.
- **C.** Bob and Sam, $200,000; Redwood Corporation none.
- **D.** Bob and Sam, none; Redwood Corporation $200,000.

49. Karen transferred property with an adjusted basis of $45,000 and fair market value of $50,000 to Holiday Corporation in exchange for 65% of Holiday Corporation's only class of stock. At the time of the transfer, the stock Karen received has a fair market value of $55,000. What is Holiday Corporation's basis in the property after the exchange?

- **A.** $ 0
- **B.** $45,000
- **C.** $55,000
- **D.** $60,000

50. Robert sold his Lebec Corporation stock to his sister Karen for $8,000. Robert's cost basis in the stock was $15,000. Karen later sold this stock to Dana, an unrelated party, for $15,500. What is Karen's **realized** gain?

- **A.** $500
- **B.** $7,000
- **C.** $7,500
- **D.** $0

51. Frank sold his Ranier Corporation stock to his sister Bernie for $8,000. Frank's cost basis in the stock was $15,000. Bernie later sold this stock to Wendy, an unrelated party, for $15,500. What is Bernie's **recognized** gain or loss?

- **A.** $500
- **B.** ($7,000)
- **C.** ($7,500)
- **D.** $0

52. During 2001 the NOGO Corporation had the following items of income and expenses:

• Income from operations	$50,000
• Dividend income from Cooper Corporation (a 10% owned corporation)	$90,000
• Expenses of operations	$40,000

What is the NOGO Corporation's dividends-received deduction, if any?

- **A.** $74,000
- **B.** $63,000
- **C.** $82,000
- **D.** $90,000

53. The Smith Corporation realized a long-term capital gain of $10,000, a short-term capital gain of $15,000 and a long-term capital loss of $27,000. What is the amount and character, if any, of carry back or carry forward that the Smith Corporation could deduct?

- **A.** $10,000 long-term gain.
- **B.** $15,000 short-term loss.
- **C.** $2,000 short-term loss.
- **D.** $25,000 long-term loss.

54. Bob transfers property worth $50,000 to the Acme Corporation and provides personal services worth $5,000 in exchange for stock valued at $55,000. Immediately after the exchange Bob owns 90% of Acme's outstanding stock. What is Bob's gain if any?

A. No capital gain, no ordinary income.
B. No capital gain, $5,000 ordinary income.
C. No capital gain, $50,000 ordinary income.
D. $5,000 capital gain, no ordinary income.

55. Bob and Frank buy an apartment building for $100,000. Both Bob and Frank organize the Acme Property Corporation when the apartment building has a fair market value of $500,000. They transfer the building to the corporation for all of its authorized capital stock, which has a par value of $500,000. What is the gain, if any, that Bob, Frank, or the Acme Property Corporation must **recognize**?

A. Bob $250,000, Frank $250,000, Acme Property Corporation $500,000.
B. Bob none, Frank none, Acme Property Corporation none.
C. Bob none, Frank none, Acme Property Corporation $500,000.
D. None of the above.

56. During the 2001 calendar year, the Baker Corporation distributed a dividend in the form of a building to its sole shareholder. The building has a fair market value of $60,000 and an adjusted basis of $20,000. The corporation has sufficient earnings and profits. Not considering any potential tax effect of any taxes on the distribution, the net effect of the transaction on earnings and profits is:

A. An increase of $ 40,000.
B. An increase of $20,000.
C. A decrease of $40,000.
D. A decrease of $20,000.

57. The Charlie Corporation, a calendar-year, accrual-basis taxpayer, distributed shares of the David Corporation stock to Charlie's employees in lieu of salaries. The salary expense would have been deductible as compensation if paid in cash. On the date of the payment, Charlie's adjusted basis in David Corporation's stock was $20,000 and the stock's fair market value was $100,000. What is the tax effect to Charlie Corporation?

A. $100,000 deduction.
B. $20,000 deduction.
C. $20,000 deduction and $80,000 recognized gain.
D. $100,000 deduction and $80,000 recognized gain.

58. The Richards Corporation distributed an airplane to its only shareholder, Bob. The airplane had a FMV of $75,000 and an adjusted basis to the Richards Corporation of $50,000. The airplane was subject to a secured loan of $90,000, which Bob assumed. What is the Richards Corporation's gain or loss on the distribution?

A. $0
B. $40,000
C. ($15,000)
D. $25,000

59. The Clutch Corporation decided to distribute shares of its own stock to its employees at year-end as a reward for a profitable year. Each employee was to receive 10 shares with a fair market value of $150 per share. Employees were offered a choice of cash or a stock dividend. What is the effect on the employees from this distribution?

A. Distributions of stock dividends and stock rights are tax-free to shareholders.
B. $1,500 taxable income to the employees who chose to receive cash and no effect on the employees who received stock.
C. $1,500 taxable income to each employee.
D. $750 tax-free, $750 taxable income.

60. As of December 31, 2001, John is a 50% shareholder of XYZ, Inc., an S Corporation, as well as a 75% shareholder of ABC, Inc., also an SCorporation. Both companies are calendar year taxpayers. Because of profitable years, each company elected to use the maximum depreciation deduction allowable under IRS Code Section 179 for the year. Assuming that each election was valid, what is the maximum amount of Section 179 deductions which can be passed through to John?

A. $40,000
B. $30,000
C. $24,000
D. None. Depreciation is not a pass through item.

61. Mary is the sole shareholder of A Company, Inc. (an S Corporation), as well as a 50% shareholder in B Company, Inc., also an S Corporation. During the 2001 tax year, both companies acquired qualified assets in order to take the IRS Code Section 179 election for the full allowable amount. Prior to the 2002 tax year, the companies had accumulated Section 179 deductions in the following amounts:

- Company A - $180,000
- Company B - $150,000

Calculate the maximum amount of Section 179 deduction Mary will be able to **recognize** on her personal income tax returns for the 2001 tax year.

A. $32,000
B. $48,000
C. $24,000
D. Nothing, because accumulated Section 179 deductions previously taken exceed the combined cumulative amount allowable of $200,000.

62. Bob and Sally, unmarried taxpayers, were equal sole shareholders of Lostalot, Inc., an S Corporation. The corporation realized a $50,000 operating loss for the tax year ending December 31, 2001. As of December 31, 2000, Bob's basis in his stock was $15,000 and Sally's was $5,000. During the 2001 tax year, Sally mortgaged her home for $25,000 and lent the money to the corporation. Although not personally liable, Bob told her not to worry and that if anything happened, he would help pay the mortgage debt. Calculate the amount of allowable loss deduction each shareholder would be able to **recognize** on their individual 2001 tax returns.

A. Bob $25,000 and Sally $25,000.
B. Bob $15,000 and Sally $5,000.
C. Bob $15,000 and Sally $30,000.
D. Bob $15,000 and Sally $25,000.

63. On January 1, 2001, Acme, Inc., a calendar year S Corporation, was owned by four individuals as follows: John: 50%, Bob: 25%, Dave: 20%, and Tom: 5%. On March 31, 2001, John sold his shares to Bob. On the same day Dave sold his shares to Tom. For the tax year ending December 31, 2001, the company realized an operating loss of $100,000. Assuming that all four had sufficient basis in their stock, calculate each shareholder's recognizable loss for the 2001 tax year. To assist in the calculation, assume a 360-day calendar year, with 30 days in each month.

A. John: $50,000, Bob: $25,000, Dave: $20,000, and Tom: $5,000.
B. John: $0, Bob: $75,000, Dave: $0, and Tom: $25,000.
C. John: $12,500, Bob: $62,500, Dave: $5,000, and Tom: $20,000.
D. John: $12,500, Bob: $56,200, Dave: $5,000, and Tom: $18,750.

64. Gary died on March 18, 2001. The estate tax year ends on December 31, 2001. The estate had the following items of income during the year:

Interest	$250
Dividends	$150
Stock sale-stock proceeds net of broker's commission	$10,000
Basis of the stock	$9,900

The estate made no distributions during 2001. Which of the following statements regarding the requirement to file a Form 1041 tax return are true?

A. The estate is **not** required to file a tax return.
B. The estate is required to file a tax return.
C. If the estate has expenses that reduce its income below $600, no estate tax return is required.
D. Both B and C.

65. From the information below, determine the taxable income on Janice's Form 1041.

Income		Expenses	
Taxable interest	$4,000	Attorney's fees	$1,500
Tax Exempt interest	$2,000	Funeral expenses	$5,000
Dividends	$3,000	Executor's fees	$ 500
Gain on sale of stock	$1,000		

A. $8,000
B. $5,800
C. $6,400
D. $2,000

66. From the information below, determine the taxable income on Form 1041 for Hal's estate for the 2001 calendar year.

Income		Expenses	
Taxable interest	$2,000	Attorney's fees	$5,000
Dividends	$3,000	Property taxes	$1,500
401(k) distribution	$50,000		

The property taxes had accrued prior to Hal's death. They were deducted on the estate's Form 706. The estate distributed $10,000 of taxable income to beneficiaries.

A. $38,500
B. $38,500
C. $39,600
D. $48,500

67. John, who was not married, died on October 12, 2001. He did not leave any of his assets to charity. Given the following information, may the executor of the estate make the alternate valuation election, and if so, what is the value of the gross estate on the alternate valuation date?

	FMV Date of Death	FMV Alternate Valuation
Residence	$1,000,000	$1,010,000
Installment note	$5,000	$500
Stock	$600,000	$350,000
Expenses	($450,000)	($300,000)

A. No, the election cannot be made.
B. Yes, the election can be made. The alternate value of the gross estate is $1,350,500.
C. Yes, the election can be made. The alternate value of the gross estate is $1,360,500.
D. Yes, the election can be made. The alternate value of the gross estate is $1,365,000.

68. Joseph died on November 2, 2001. Joseph left all of his assets, including an IRA, to his two sons equally. From the information below, determine if Joseph's sons qualify to claim an estate tax deduction on their returns when they report the taxable IRA distributions.

Assets and deductions	
• House (no mortgage)	$600,000
• Stocks	$30,000
• IRA-distributed	$400,000
• Administrative expenses	$60,000

A. No, because the amount of the taxable estate is less than $1,000,000.
B. Yes, because the amount of the income in respect of a decedent (the IRA) exceeds the estate's deductions.
C. Yes, because the gross estate exceeds $1,000,000.
D. No, because the amount of the income in respect of a decedent (the IRA) is less than $1,000,000.

69. Anissa is the sole beneficiary of her father's estate. The estate was closed ten months after her father's death, and the executor is filing one (first and final) Form 1041. After all expenses of the estate were paid, the following amounts were paid out to Anissa.

• Cash	$12,000
• IRA (decedent had no basis)	$300,000
• Wages paid after death	$6,000
• Stock	$75,000
• Life insurance	$150,000

How much, if any, of the payment will be reported on Anissa's Form 1040 Federal income tax return?

A. $0
B. $6,000
C. $306,000
D. $543,000

70. Alberta, who had not given taxable gifts in any prior year, gave her five children the following gifts in 2001.

A car to Richard	$14,000
Cash to Elizabeth	$12,000
Stock to John	$10,500
Stock to Jane	$9,500
Cash to Robert	$5,000

From the information above, determine the amount, if any, of taxable gifts given by Alberta.

A. $0
B. $1,000
C. $6,500
D. $41,000

71. Cassy, a single individual, has not been required to file a gift tax return in any prior year. In 2001, Cassy paid $12,000 tuition directly to State University for her sister, Andrea. She gave her brother $8,000 to pay medical bills for his daughter. She also donated $20,000 to the United Way. Must Cassy file a gift tax return?

A. No.
B. Yes, because the gift to her sister exceeded $10,000.
C. Yes, because the United Way donation exceeded $10,000.
D. Yes, because the total gifts she gave during the year exceeded $10,000.

72. John, who is not married, made the following transfers during 2001:

- $10,000 to his son Bradley
- $12,000 to his daughter Alexandria
- $7,000 political contribution
- $5,000 charitable contribution
- Car to his son Bradley ($22,000 basis; $15,000 FMV)
- Autographed baseball to his grandson Tommy ($75 basis; $500 FMV)

What is the gross amount of gifts that John will report on his 2001 Form 709 (before deductions) ?

A. $14,000
B. $32,000
C. $42,500
D. $49,500

73. Lace gave the following gifts during the year:

• Cash to her sister	$8,000
• Stocks to her brother	$12,000
• Cash to United Way	$15,000
• A car to her cousin	$16,000

Based on this information, what is the amount of taxable gifts given?

A. $0
B. $4,000
C. $8,000
D. $11,000

74. Margaret's 2001 Form 709, page 1 has the following entries:

• Tax on current-year gifts	$400,000
• Maximum unified credit	$220,550
• Credit used in prior years	$ 20,550

Based on this information, what is the balance due on Margaret's Form 709 Gift Tax Return this year?

A. $0
B. $179,450
C. $200,000
D. $379,450

75. Paul is the sole beneficiary of a trust that his father set up before his father's death. Given the following information, how much trust income, if any, must Paul report on his tax return?

• Adjusted total income	$ 9,000
• Adjusted tax exempt interest	$ 1,000
• Distributable net Income	$10,000
• Required distributions	$ 5,000
• Discretionary distributions	$ 2,500

A. $5,000
B. $6,750
C. $9,000
D. $10,000

76. The Alan Trust must distribute all of its income annually. Shown below are the trust's income and expenses for the year ($100 of the fiduciary fee is allocable to the nontaxable interest). Based on this information, how much taxable income will be passed through to the trust's beneficiaries?

• Taxable interest	$3,000
• Tax exempt interest	$1,000
• Fiduciary fee	$400

A. $2,600
B. $2,700
C. $3,000
D. $3,600

77. The MLN Trust had the following income and deductions.

• Taxable interest	$4,000
• Capital gain	$1,000
• Fiduciary fee	$500

Assuming that capital gains are allocable to corpus, determine the trust's distributable net income.

A. $3,500
B. $4,000
C. $4,500
D. $5,000

78. The MRY Trust has adjusted total income of $10,000. This amount includes a $1,000 capital loss. The trust had no tax exempt interest income for the year. From the information below, determine the trust's distributable net income.

A. $9,000
B. $10,000
C. $11,000
D. None of the above.

79. The JLB trust is a simple trust. Alan is the sole beneficiary of the trust. Capital gains are allocable to corpus. Based on the following information, what is the trust's distribution deduction?

• Interest	$1,700
• Dividends	$300
• Capital gains	$2,000
• Fiduciary fee	$1,000

A. $1,000
B. $1,500
C. $2,000
D. $3,000

80. The LMH trust is a simple trust. Given the following information, determine the trusts's distribution deduction.

• Adjusted total income	$15,000
• Adjusted tax exempt interest (Not included in total income)	$2,000
• Capital gain allocable to corpus	$3,000

A. $10,000
B. $12,000
C. $13,000
D. $15,000

End of Part 3.

2002

SPECIAL ENROLLMENT

EXAMINATION

IRS

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Internal Revenue Service

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PART 4

SPECIAL ENROLLMENT EXAMINATION BOOKLET

SEPTEMBER 26, 2002
1:30 P.M. TO 3:30 P.M.

Ethics, Recordkeeping Procedures, Appeal Procedures, Exempt Organizations, Retirement Plans, Practitioner Penalty Provisions, Research Materials and Collection Procedures

Official Use Only
(Declassified After September 26, 2002)

Special Enrollment Examination

Part 4

Ethics, Recordkeeping Procedures, Appeal Procedures, Exempt Organizations, Retirement Plans, Practitioner Penalty Provisions, Research Materials and Collection Procedures

Instructions:

The time allotted for this part of the examination is 2 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, 2001. Unless otherwise stated, all questions relate to the calendar year 2001.

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. You will be allowed to keep your examination question books after completion of the examination. Scratch paper will be provided, but you may make necessary computations in the question books. Raise your hand to attract the monitor's attention when you need extra supplies or for permission to leave the room.

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, 2003.

General Grading Information:

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

The examination is graded on the basis of correct answers. If more than one oval is darkened in answering a question, 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 question book and retain it for purposes of your future comparison.

Part 4

Section A:
Questions 1 - 40

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. John prepares tax returns. John is **not** an enrolled agent, enrolled actuary, CPA, or attorney. In 2000, new clients, Mr. and Mrs. Black, engage John to prepare their 1999 joint income tax return. John prepares the Black's 1999 joint income tax return and signs it as the preparer. This is the only return John has prepared for the Blacks. In March of 2001, Mr. and Mrs. Black received a notice from the IRS with regard to their 1998 joint income tax return. Mr. and Mrs. Black ask John to contact the IRS to resolve the matter with regard to their 1998 joint income tax return, but do not provide John with a power of attorney. John is **not** permitted to represent or advocate a position before the IRS on behalf of Mr. and Mrs. Black concerning their 1998 return.

2. Under Circular 230, an applicant who wishes to challenge the Director of Practice's denial of his or her application for enrollment is required to file a written appeal with the Secretary of the Treasury.

3. Ms. Smith hired Tom, an enrolled agent, to prepare her Federal income tax return for 2001. While gathering information to prepare the return, Tom discovered that although Ms. Smith was required to file Federal income tax returns for the 1999 tax year and the 2000 tax year under the Federal tax laws, she did not file these returns. Circular 230 requires that Tom promptly advise Ms. Smith that she did not comply with the Internal Revenue laws by failing to file her Federal income tax returns for the 1999 tax year and the 2000 tax year.

4. The Circular 230 requirement that a practitioner exercise due diligence in preparing, approving, and filing returns does **not** apply if the practitioner is merely assisting in preparing, approving, or filing returns.

5. A practitioner is subject to sanction under Circular 230 if he or she does not receive proper consent to represent conflicting interests before the IRS.

6. Circular 230 permits an enrolled agent to cash a taxpayer's refund check if the amount of the check is less than the amount of the total fee outstanding on the date the check is cashed.

7. Circular 230 does **not** contain separate rules for the preparation of tax shelter opinions.

8. Circular 230 never permits a practitioner to sign a return as a preparer if the return contains a frivolous position.

9. A criminal conviction under State law for embezzlement is **not** disreputable conduct under Circular 230 because the crime of embezzlement, although a crime involving dishonesty, is **not** a crime under the Federal revenue laws.

10. Circular 230 permits an individual charged with violating the regulations under Circular 230 to appear in person or to be represented by counsel or other representative.

11. To be timely, the respondent has 30 days from the date of the decision to appeal an initial decision ordering disbarment.

12. The Director of Practice is permitted to notify appropriate officers and employees of the IRS, interested departments and agencies of the Federal government and the State where a practitioner is licensed, that a practitioner has been disbarred or suspended from practice before the IRS.

13. During February 2001, Arnold's tax return for 1999 was selected for an IRS examination in Los Angeles, California. This is where Arnold lived, maintained his business in 1999 and had his accountant prepare his tax return. Late in 2000, Arnold moved to Biloxi, Mississippi and took his books and records with him. Arnold can request to have his case transferred to Biloxi, Mississippi.

14. The IRS has selected Frances' 2000 tax return for examination. The only item of inquiry in the IRS contact letter was for verification of charitable contributions. Frances' tax return for 1998 was also examined to verify her charitable contributions, and no change was proposed to her tax liability. If Frances advises the IRS representative that no change resulted in her tax return for 1998, the examination of her tax return for 2000 might be discontinued.

15. Holly filed a suit against her brother in a probate matter. Holly's attorney has issued a subpoena to the IRS Area Director where Holly resides to produce her brother's most recently-filed Federal income tax return. The Area Director must comply with the summons by producing the tax return of Holly's brother.

16. Karl had his 1999 income tax return examined resulting in adjustments. Karl has administratively appealed the adjustments. Some of them were sustained, resulting in an income tax deficiency in the amount of $45,000. Karl now wants to appeal his case to the U.S. Tax Court. He will handle the case himself since he cannot afford a lawyer. Karl is entitled to invoke the Small Tax Case procedure.

17. Ned's individual income tax return was under IRS examination. Five months before the expiration of the statute of limitations, the Revenue Agent wanted Ned to agree to extend the statute of limitations. Generally, the Revenue Agent must advise Ned that he has a right to refuse to extend the statute of limitations and if he does agree to an extension, the agreement can be restricted as to particular issues on the tax return.

18. Paul is a barber who prepares Federal tax returns during the tax-filing season. Paul charges $25.00 for each return. Paul qualifies as a return preparer.

19. Barbara is an enrolled agent who only prepares tax returns. One of her clients was audited by the IRS and a substantial income tax deficiency resulted. Barbara was determined by the IRS to be an income tax return preparer and a preparer penalty was assessed. Barbara can contest the validity of the penalty in Tax Court without making any payment of the penalty.

20. Donna is a secretary who prepares income tax returns during the tax filing season. Donna does not keep a copy of the returns she prepares but she does keep a record of her clients' names, identification numbers, tax year and type of return prepared. Donna is subject to a civil penalty in the amount of $50 for each copy of a tax return she does **not** retain up to a maximum of $25,000 for each year.

21. A power of attorney may be filed with the IRS by a facsimile transmission (FAX).

22. A power of attorney may **not** be used to authorize a recognized representative to receive the original of notices sent to the taxpayer by the IRS.

23. A checkbook can be used to keep records of both income and expenses. Taxpayers should also keep documents such as sales slips and expense receipts to support claimed income and deductions.

24. You should keep copy C of your W-2 for at least 7 years after you have filed your return.

25. ABC Partnership has several common law employees. The partnership contributes to their employee's retirement accounts. ABC will take the deduction for their contributions on their 1065 Partnership Income Tax Return.

26. Using your traditional IRA as security for a loan is a prohibited transaction.

27. A qualified plan can include a 401(k) plan only if the plan is both a profit-sharing plan and a money purchase plan in existence on June 27, 1974, with employee contributions.

28. Generally, if the excess contribution to a traditional IRA and any earnings on it are **not** withdrawn by the date the taxpayer's return is due (excluding extension), the taxpayer is subject to a 6% excise tax.

29. Alimony and separate maintenance is **not** treated as compensation for purposes of figuring an IRA contribution deduction.

30. Dorian owed income taxes, penalties and interest on his Federal income tax return for 1990. Since Dorian had no assets, he was not required to enter into any IRS installment agreement. However, during 1995, the IRS requested that Dorian enter into a waiver of the collection statute of limitations by extending it to December 31, 2015. Dorian signed the waiver. Dorian will be relieved of any remaining balance of tax obligation on December 31, 2002.

31. Lorie owed the IRS $150,000. Lorie owned a money market account with a major stock brokerage firm that had a value of $200,000. The IRS can force the brokerage firm to pay $150,000 from the account by serving a notice of lien on it.

32. Mr. Jones is filing his 1999 return in the year 2001. Mr. Jones can file his return electronically with the IRS.

33. While EFTPS-Direct and EFTPS-Through a Financial Institution are the primary payment methods for EFTPS, taxpayers may use the Same Day Payment method.

34. Taxpayers can make a tax payment using EFTPS without enrolling in the system.

35. Gail files her return electronically. Her Electronic Return Originator (ERO) must notify her if her return is rejected and results in a change of more that $25 total tax.

36. An Electronic Return Originator (ERO) does **not** have to advise their clients of the option to receive their return by direct deposit or paper check.

37. Taxpayers using EFTPS receive an immediate EFTPS acknowledgement number.

38. Individual taxpayers can schedule a year's worth of payments in advance using EFTPS.

39. Form 941, Employer's Quarterly Federal Tax Return, can be filed electronically, online or by telephone.

40. The 941 TeleFile program is available to any business taxpayer using a touch-tone telephone.

Turn to the next page for Part 4, Section B.

Part 4

Section B:
Questions 41 - 80

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

41. Who is authorized to practice before the IRS if they hold power of attorney?

A. Any person considered an enrolled agent under Circular 230, who is not currently under suspension or disbarment from practice before the IRS who files a written declaration that he or she is currently qualified as an enrolled agent and is authorized to represent the particular party on whose behalf he or she acts.

B. Any attorney who is **not** currently under suspension or disbarment from practice before the IRS who files a written declaration that he or she is currently qualified as an attorney and is authorized to represent the particular party on whose behalf he or she acts.

C. Both A and B.

D. Neither A or B.

42. Janet is not an enrolled agent, CPA, attorney, or enrolled actuary. In 1999, the president of Widgets-R-Us engaged Janet to prepare the company's 1998 Form 1120-S. Janet prepared the 1998 income tax return for Widgets-R-Us and signed it as the preparer. This is the only return Janet prepared for Widgets-R-Us. In December 2000, the IRS began an examination of Widgets-R-Us' 1997 and 1998 Federal income tax returns. Janet has a power of attorney to represent Widgets-R-Us for 1997 and 1998. Under Circular 230, Janet is permitted to represent Widgets-R-Us during the examination with regard to its:

A. 1997 Form 1120-S only.

B. 1998 Form 1120-S only.

C. 1997 and 1998 Forms 1120-S.

D. None of the above.

43. The IRS began an examination of Mr. Jones' 2000 income tax return. Mr. Jones hired Tyler, an enrolled agent and former IRS employee, to represent him before the IRS. Tyler wrote a memorandum to Mr. Jones outlining the issues that might be raised by the IRS and how to address these issues. Tyler correctly marked this memorandum as confidential and privileged under Section 7525 of the Internal Revenue Code. During the examination, the Revenue Officer assigned to the case asked Tyler for a copy of the memorandum. Mr. Jones, invoking the Section 7525 privilege, told Tyler not to disclose it to the Revenue Officer. Tyler is **not** required to provide the Revenue Officer with a copy of the memorandum because:

A. The Revenue Officer did not issue a summons requesting it.

B. Section 7525 extends the attorney client privilege to Federally authorized tax practitioners.

C. Circular 230 does not authorize officers or employees of the IRS to request any documents other than a tax return.

D. The IRS cannot request documents during an examination.

44. Ms. Smith hired Tom, an enrolled agent, to prepare her Federal income tax return for 2001. While gathering information to prepare the return, Tom discovered that Ms. Smith failed to file Federal income tax returns for the 1999 and 2000 tax years. Circular 230 requires that Tom do the following:

A. Promptly advise Ms. Smith that she did not comply with the Internal Revenue laws by failing to file Federal income tax returns for the 1999 and the 2000 tax years.

B. Refuse to prepare Ms. Smith's 2000 Federal income tax return unless she files her 1999 and 2000 Federal income tax returns.

C. Inform the IRS that Ms. Smith did not file Federal income tax returns for the 1999 and 2000 tax years.

D. Both B and C.

45. Failure to file an answer to a complaint instituting a proceeding for disbarment by the original or extended deadline constitutes:

- **A.** An admission of the allegations in the complaint and a waiver of a hearing.
- **B.** An error that can be corrected by filing the answer with the Administrative Law Judge within one year of the original (or extended) deadline.
- **C.** Grounds for criminal sanctions.
- **D.** Equitable estoppel against the practitioner.

46. How is a proceeding for violation of the regulations in Circular 230 instituted against an attorney, certified public accountant, enrolled agent, or enrolled actuary?

- **A.** An aggrieved taxpayer files a petition with the United States Tax Court stating a claim against the attorney, certified public accountant, enrolled agent, or enrolled actuary.
- **B.** The Commissioner of the IRS files a complaint against the attorney, certified public accountant, enrolled agent, or enrolled actuary with the United States Tax Court.
- **C.** The Director of Practice signs a complaint naming the attorney, certified public accountant, enrolled agent, or enrolled actuary and files the complaint in the Director's office.
- **D.** The Secretary of the Treasury files a complaint against the attorney, certified public accountant, enrolled agent, or enrolled actuary in the United States District Court for the District of Columbia.

47. Who presides over a hearing on a complaint for disbarment based on a violation of the laws or regulations governing practice before the IRS?

- **A.** The Commissioner of IRS.
- **B.** An Administrative Law Judge.
- **C.** A United States Tax Court Judge.
- **D.**The Secretary of the Treasury.

48. An appeal from the initial decision ordering disbarment is made to which of the following:

- **A.** The Secretary of the Treasury.
- **B.** The Administrative Law Judge.
- **C.** The United States District Court for the District of Columbia.
- **D.** The United States Tax Court.

49. Treasury Circular 230:

- **A.** Contains rules of conduct applicable to enrolled agents and enrolled actuaries, but not attorneys or certified public accountants.
- **B.** Contains rules regarding disciplinary actions for tax return preparers who are not enrolled agents, CPA's or attorneys
- **C.** Contains the rules regarding eligibility to become an enrolled agent and renewal of enrollment.
- **D.** All of the above.

50. Barry's individual income tax return for 1997 was examined by the IRS, which resulted in a tax assessment in the amount of $10,000. Thereafter, Barry discovered papers which he believed would show that the IRS determination was erroneous. Barry can claim a refund of income taxes as follows:

- **A.** Take a credit for the amount on his 1998 return.
- **B.** File Form 1045 Application for Tentative Refund.
- **C.** File an amended return within three years from the date he filed his original return for 1997, or two years from the date he paid the tax, whichever is later.
- **D.** Immediately sue for a refund in court.

51. Charlie had income tax withheld from his wages during 1998 in the amount of $5,000. Charlie filed an automatic extension of time to file his tax return for that year to August 16, 1999, together with making an additional payment in the amount of $2,000 with the extension. Charlie filed his tax return on November 15, 1999, and paid the balance shown to be due on the return of $1,000 on that date. Charlie discovered an error in his return on November 1, 2002. On that same date he filed a claim for refund in the amount of $6,000. Assuming the grounds set forth in the claim are proper, what refund can Charlie recover for 1998?

- **A.** $6,000
- **B.** $2,000
- **C.** $1,000
- **D.** $0

52. The examination of Greta's' tax return for 2000 resulted in adjustments creating a tax liability in the amount of $30,000. Greta does not believe she owes anything. A Notice of Proposed Income Tax Deficiency is issued to Greta, who wants to appeal the Revenue Agent's adjustments to the IRS Office of Appeals. Greta must file a written protest letter no later than which of the following periods?

- **A.** 10 days.
- **B.** 30 days.
- **C.** 90 days.
- **D.** None of the above.

53. Harry claimed gambling losses on his income tax return .The return was examined by the IRS and the losses were disallowed. Harry pursued an appeal before the IRS Appeals Office, which sustained the Revenue Agent's adjustment. Harry now wants to take his case to a judge. In which of the following courts can Harry file a tax action?

- **A.** United States Court of Federal Claims.
- **B.** United States District Court.
- **C.** United States Tax Court.
- **D.** All of the above.

54. Isaac's income tax return for 1999 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.

55. Julie, who lives in Washington, D.C., operated a business without books and records. Her business income and expenses were reported on Schedule C. Julie's tax return for 2000 was examined and substantial adjustments were proposed. Julie disagreed with the adjustments and wants to take her case directly to Tax Court. A Statutory Notice of Deficiency was issued to Julie by the IRS Area Director. Julie can file a petition for a Small Tax case before the U.S. Tax Court during which of the following periods beginning from the date of the issuance of the notice?

- **A.** 30 days.
- **B.** 90 days.
- **C.** 150 days.
- **D.** None of the above.

56. Louie is the sole shareholder of a perfume manufacturing corporation. The corporation's tax return was examined, resulting in unagreed adjustments which were appealed and sustained at the IRS Appeals Office. Louie still believes that the adjustments are erroneous and wants a judge to hear his reasons. The corporation timely files a petition in the U.S. Tax Court contesting the adjustments. At the beginning of the trial, the attorney for the corporation files a motion requesting the judge to order that the IRS has the burden to prove that its adjustments are not erroneous. Which of the following criteria must be satisfied before the burden of proof shifts to the IRS?

- **A.** The corporation must have maintained all records required and complied with all substantiation requirements under the Internal Revenue Code.
- **B.** The corporation must have cooperated with all reasonable requests by the revenue agent for information regarding the items being questioned on its return.
- **C.** The corporation had a net worth of $7,000,000 or less at the time the petition was filed in the Tax Court.
- **D.** All of the above.

57. Marty timely filed his Federal income tax return for 1997. It was selected for examination. During the course of the examination, the Revenue Agent first assigned to the case retired. A second Revenue Agent proposed adjustments to the tax return which Marty believed were erroneous. The second Revenue Agent was assigned to an extended training assignment. Before going on training, Marty and the second Revenue Agent orally agreed that the statute of limitations could be extended to December 31, 2001. Which of the following statements is applicable in order for the IRS to protect its rights?

- **A.** An assessment of income taxes must be made before December 31, 2001.
- **B.** A Statutory Notice of Deficiency must be mailed on or before December 31, 2001.
- **C.** A Statutory Notice of Deficiency must be mailed on or before April 15, 2001.
- **D.** The assessment of tax can be made at any time.

58. During the course of examining Ollie's income tax return, the Revenue Agent required information from third party sources. Which of the following provisions does **not** apply to the Revenue Agent giving Ollie reasonable notice before contacting third parties?

- **A.** Pending criminal investigation.
- **B.** Providing notice might result in reprisal against the contact.
- **C.** Ollie authorizes the contact.
- **D.** All of the above.

59. Ron's tax returns were examined for 1997, 1998, and 1999, all of which resulted in adjustments increasing income reported on Schedule C of the returns. The Revenue Agent determined that the failure to report the income was intentional. The Revenue Agent proposed a fraud penalty. The adjustment for each year was in the amount of $100,000. The fraud penalty for each year should be in which of the following amounts?

- **A.** $50,000
- **B.** $75,000
- **C.** $18,800
- **D.** $28,200

60. Jane is a Certified Public Accountant who specializes in preparing Federal tax returns. Which of the following returns would qualify Jane as an income tax return preparer?

- **A.** Estate or gift tax returns.
- **B.** Excise tax returns.
- **C.** Withholding tax returns.
- **D.** None of the above.

61. Willie is the owner of an accounting firm. One of Willie's employees prepares an income tax return for a client and opines that a deduction can be claimed for a bad debt. If the return is examined and the deduction is disallowed, Willie will **not** be subject to a preparer penalty under which of the following circumstances?

- **A.** The position on the return had a realistic possibility of being sustained on the merits.
- **B.** The position on the return had at least a one-in-three chance of being sustained on its merits.
- **C.** There is substantial authority to sustain the position taken on the return.
- **D.** All of the above.

62. Arnie is a Certified Public Accountant who prepares income tax returns for his clients. One of his clients submitted a list of expenses to be claimed on Schedule C of the tax return. Arnie qualifies as a return preparer and, as such, is required to comply with which one of the following conditions?

- **A.** Arnie is required to independently verify the client's information.
- **B.** Arnie can ignore implications of information known by him.
- **C.** Inquiry is not required if the information appears to be incorrect or incomplete.
- **D.** Appropriate inquiries are required to determine whether the client has substantiation for travel and entertainment expenses.

63. Ernie is a principal of an international CPA firm. One of the firm's clients owns seven businesses and is a member of over 100 flow-through entities. Several members of Ernie's firm assist in the preparation of the client's individual income tax return. Which one of the following must be met involving the member of the firm who qualifies as the return preparer?

- **A.** The signatory is the individual preparer who has the primary responsibility for the overall substantive accuracy of the reporting positions on the return.
- **B.** A photocopy of a manually signed copy of the return satisfies the manual signature requirement.
- **C.** If the individual preparer is physically unable to sign the return due to a disability, he/she can indicate "unable to sign" as the signature.
- **D.** All of the above.

64. Frankie is a truck driver who is also a licensed return preparer and specializes in preparing income tax returns claiming the Earned Income Credit (EIC). Frankie will not be subject to a preparer penalty for an erroneously claimed EIC if he complies with which one of the following?

- **A.** Completion of an eligibility checklist based upon information provided by the client.
- **B.** Completion of the computation worksheet for the EIC based upon information provided by the client.
- **C.** Knowledge or reason to know that the information used to determine eligibility for an amount of the EIC is correct.
- **D.** All of the above.

65. 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.

66. 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 enrolled agents.
- **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.

67. How long should you keep your tax records?

- **A.** 3 years if you owe additional tax.
- **B.** 7 years if you file a claim for a loss from worthless securities.
- **C.** No limit if you do not file a return.
- **D.** All of the above.

68. Amy, a self-employed consultant, contributes more to her profit-sharing plan than she can deduct for the year. Amy can carry over and deduct the excess in later years combined with her normal contributions. Her contribution in later years is limited to which of the following?

- **A.** 15% of the participating employee compensation.
- **B.** 10% of the participating employee compensation.
- **C.** 25% of the participating employee compensation.
- **D.** None of the above.

69. In December 2000, Gail worked for ABC Co. and participated in their retirement plan. On February 1, 2001, Gail was employed by XYZ Corp. which has a qualified retirement plan. On March 1, 2001, the ABC Co. plan administrator distributed to Gail her vested share of the plan. Gail was 42-years old at the time of distribution. What must Gail do in order to avoid paying taxes and penalties on her withdrawal?

- **A.** Deposit the plan funds in a local bank.
- **B.** Contribute the distribution to the XYZ Corp. plan within 60 days.
- **C.** Donate the plan funds to a charity.
- **D.** None of the above.

70. Which of the following are examples of prohibited transactions with a traditional IRA?

- **A.** Selling property to it.
- **B.** Using it as security for a loan.
- **C.** Buying property for personal use with your IRA funds.
- **D.** All of the above.

71. Your qualified 401(k) plan can include what type of contribution arrangement?

- **A.** Cash.
- **B.** Elective deferral.
- **C.** All the above.
- **D.** None of the above.

72. Joyce was recently divorced. Per a court order she must transfer her IRA to her ex-spouse. To avoid paying taxes on the withdrawal Joyce must do which of the following?

- **A.** Direct rollover.
- **B.** Change the name on the current account.
- **C.** Withdraw funds and deposit them into another qualified plan.
- **D.** All of the above.

73. George, a single taxpayer, has W-2 income of $31,000. During the 2000 tax year he contributed $2,500 to his traditional IRA. George has excess contributions of how much?

- **A.** $2,500
- **B.** $2,000
- **C.** $500
- **D.** None of the above.

74. Charles, a sole proprietor, contributes to his self-employed pension plan. Where will he take his deduction on his income tax return?

- **A.** Form 1040, Schedule C.
- **B.** Form 1040, Page 1.
- **C.** Form 1040, Schedule A.
- **D.** None of the above.

75. Which of the following is **not** considered earned compensation for IRA contribution purposes?

- **A.** Deferred compensation.
- **B.** Wages and salaries.
- **C.** Self-employment income.
- **D.** Commissions.

76. If distributions from your traditional IRA are less than the minimum required distribution for the year, you may have to pay an excise tax for that year on the amount not distributed as required. The excise tax is how much?

- **A.** 10%
- **B.** 40%
- **C.** 50%
- **D.** None of the above.

77. Winston turned 70 1/2 on June 1, 2000. What date must he receive his minimum distribution by?

- **A.** April 15, 2001.
- **B.** December 31, 2000.
- **C.** June 30, 2000.
- **D.** None of the above.

78. Sam timely filed his U.S. individual income tax return for calendar year 1993 without any extensions. The return showed a balance of income taxes due in the amount of $75,000. Sam has not paid his IRS liability nor has he entered into any installment agreement extending the statute of limitations or submitted any offer in compromise. The statute of limitations for collection of Sam's tax liability expires on which of the following dates?

- **A.** April 15, 1997.
- **B.** April 15, 2003.
- **C.** December 31, 2003.
- **D.** April 15, 2004.

79. Which fee arrangement described below is permissible for an electronic return originator (ERO)?

- **A.** Fees based on AGI from the tax return.
- **B.** Fees based on % of refund.
- **C.** Separate fees for direct deposits.
- **D.** None of the above.

80. A Form 1065 U.S. Partnership Return must be filed electronically or on magnetic media if the number of partners exceeds:

- **A.** 50
- **B.** 75
- **C.** 100
- **D.** 250

End of Part 4.