**Chapter 7. Investments-Homework**

**Assume the “current year” is 2017, unless a question indicates another year.**

|  |
| --- |
| **LO 1. Explain how interest income and dividend income are taxed.** |

What is the market rate of interest for a bond issue which sells for **less** than its par value?

|  |  |  |
| --- | --- | --- |
| **a.** | Less than rate stated on the bond. | **C** |
| **b.** | Equal to rate stated on the bonds |
| **c.** | Higher than rate stated on the bond. |
| **d.** | Rate is independent of rate stated on the bonds. |

On January 1, Year 1, Local Corp. received a loan from an investor in the amount of $165,289.26. The loan matures on December 31, Year 2. At that time Local Corp. will pay the maturity value of $200,000. Assume the interest rate is 10%. Assume interest is compounded annually under the loan contract and under the income tax law. How much income is recognized by the investor for Year 2?

|  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- |
| **a.** | $16,528.93 | **b.** | $17,355.37 | **c.** | $18,181.82 | **d.** | Other | **C** |

On January 1, Year 1, Singapore Corporation purchased Fay Corp. 9% bonds with a face amount of $400,000 for $375,422, to yield 10%. The bonds are dated January 1, Year 1, mature on December 31, Year 10, and pay interest annually on December 31. Singapore uses the interest method of amortizing discount. What is Singapore’s interest revenue for **Year 2**?

|  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- |
| **a.** | $40,000 | **b.** | $37,542 | **c.** | $36,000 | **d.** | $37,696 | **D** |

Which of the following types of interest income is not taxed as it is earned?

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| **a.** | interest from savings accounts | **c.** | interest from money market accounts | D |
| **b.** | original issue discounts on corporate bonds | **d.** | accrued market discount on bonds |

The amount of interest income a taxpayer recognizes when he redeems a U.S. savings bond is:

|  |  |  |
| --- | --- | --- |
| **a.** | the excess of the taxpayer's basis in the bonds over the bond proceeds | **C** |
| **b.** | the bond proceeds |
| **c.** | the excess of the bond proceeds over the taxpayer's basis in the bonds |
| **d.** | the taxpayer's basis in the bonds |

Which of the following is not a tax advantage of a Series EE Saving Bond?

|  |  |  |
| --- | --- | --- |
| **a.** | taxes are paid as the original issue discount on the bond is amortized | **A** |
| **b.** | interest earned is exempt from state taxation |
| **c.** | taxes on the interest income may be deferred until the bond is cashed in at maturity |
| **d.** | interest is exempt from federal taxation when used for qualifying educational expenses |
| **e.** | None of the above |

When a bond is purchased in the secondary bond market at a discount, the amount of discount

treated as interest income when the bond is sold prior to maturity is the: 

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| **a.** | market premium | **d.** | accrued market discount | D |
| **b.** | market discount | **e.** | None of the above |
| **c.** | accrued market premium |

(§ 301) On January 1, Year1, Ernie started Local Corp. (a C corp.) with an investment of $100,000 for 100% of the stock. In Year1, Local had after-tax income of $40,000 and paid no dividend.   
In Year 2, Local had after-tax income of $40,000. Earnings and profits equal after-tax income for Local.   
Local made a distribution of $90,000 to Ernie on December 31, Year 2.   
How much dividend income does Ernie report for Year 2?

|  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- |
| **a.** | $0.00 | **b.** | $40,000 | **c.** | $80,000 | **d.** | $90,000 | **C** |

|  |
| --- |
| **LO 2. Compute the tax consequences associated with the disposition of capital   assets, including the netting process for calculating gains and losses.  Include Capital gains/losses, unrecaptured sec. 1250 gain, collectibles, loss limits, related party sales, wash sales.** |

(§ 1221) All of the following are capital assets, except

|  |  |  |
| --- | --- | --- |
| **a.** | Personal residence. | **C** |
| **b.** | Land held for investment. |
| **c.** | Pickup truck used in a business. |
| **d.** | Corporate bonds held for investment purposes. |
| **e.** | A hand-written letter by Ronald Reagan held in a private collection. |

When selling stocks, which method of calculating basis provides the greatest

opportunity for minimizing gains or increasing losses?

|  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- |
| **a.** | LIFO | **b.** | FIFO | **c.** | Weighted average | **d.** | Specific identification | **D** |

Long-term capital gains can be taxed at a maximum rate of:

|  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- |
| **a.** | 15 percent | **b.** | 25 percent | **c.** | 28 percent | **d.** | All of the above | **D** |

(§1221) Which of the following is a capital asset?

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| **a.** | Personal residence. | **b.** | Machinery used in manufacturing a product. | **A** |
| **c.** | Inventory. | **d.** | Real estate used in business operations. |

(§1211) An individual had AGI of $100,000, before considering the following:

|  |  |
| --- | --- |
| Long-term capital gain of | $3,000 |
| Short-term capital loss of | (8,000) |

What is her adjusted gross income?

|  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
| **a.** | $96,000 | **b.** | $97,000 | **c.** | $98,000 | **d.** | $93,000 | **e.** | $94,000 | **B** |

Sue is single and earns a salary of $200,000 per year.   
Sue claims the standard deduction and one personal exemption for **the current year.**   
She had short-term capital gain of $10,000 and a short-term capital loss of $8,000.   
What tax rate will apply to her net capital gain?

|  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
| **a.** | 5% | **b.** | 10% | **c.** | 15% | **d.** | 25% | **e.** | 33% | **E** |

Kevin bought 200 shares of Intel stock on January 1 for $50 per share with a brokerage fee of $100. Then, Kevin sold all 200 shares for $75 per share on December 12. The brokerage fee on the sale was $150. What is the amount of the gain/loss Kevin must report on his federal income tax return?

|  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
| **a.** | $4,500 | **b.** | $4,750 | **c.** | $5,000 | **d.** | $5,250 | **e.** | Other | **B** |

**Amount Realized = (200 shares x $75) - $150 = $14,850; Adjusted Basis = (200 shares x $50) + $100 = $10,100; Gain = $14,850 - $10,100 = $4,750.**

George bought the following amounts of Stock A over the years:

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
|  | **Year bought** | **Month bought** | **Day bought** | **Number of Shares** | **Adjusted Basis** |
| Stock A | 1986 | November | 21 | 1,000 | $24,000 |
| Stock A | 1992 | March | 18 | 500 | 9,000 |
| Stock A | 2001 | May | 22 | 750 | 27,000 |

This year, he sold 1,200 of his shares of Stock A for $38 per share.

How much gain/loss will George have to recognize if he uses the FIFO method for the shares sold?

|  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
| **a.** | $7,800 | **b.** | $18,000 | **c.** | $20,000 | **d.** | $22,000 | **e.** | Other | **B** |

**George will recognize $18,000 of long-term capital gain. This is the amount realized of $45,600 (i.e. $38 per shares multiplied by 1,200 shares) less the adjusted basis of $27,600. The adjusted basis is calculated under the FIFO method. This means the 1,200 shares sold were the first 1,200 purchased. Therefore the 1,200 sold were the 1,000 shares purchased on 11/21/1986 (basis of $24,000) and 200 of the shares purchased on 3/18/1992 (basis of $3,600 which is calculated by taking the $9,000 total basis divided by 500 shares purchased multiplied by the 200 shares sold).**

**Continue the preceding question.** How much gain/loss will George have to recognize if he told his

broker to sell all 750 shares from the 5/22/2001 purchase and 450 shares from the 11/21/1986 purchase?

|  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
| **a.** | $7,800 | **b.** | $18,000 | **c.** | $20,000 | **d.** | $22,000 | **e.** | Other | **A** |

**George’s long-term capital gain is $7,800. This is the amount realized of $45,600 (i.e. $38 per shares multiplied by 1,200 shares) less the adjusted basis of $37,800. The adjusted basis is calculated under the specific identification method. George identified that the shares sold were the 750 purchased on 5/22/2001 (basis of $27,000) and 450 of the shares purchased on 11/21/1986 (basis of $10,800 or $24,000 total basis divided by 1,000 shares purchased multiplied by the 450 shares sold).**

If an individual taxpayer's marginal tax rate is 35 percent and he holds the following

assets for more than a year, which gains will be taxed at the highest rate at the time of sale?

|  |  |  |
| --- | --- | --- |
| **a.** | gains from investment land | **C** |
| **b.** | gains from personal-use property |
| **c.** | gains from a coin collection |
| **d.** | gains from the sale of qualified small business stock held for 3 years |
| **e.** | gains attributable to tax depreciation taken on real property |

Ann invests in stock. Each stock is a capital asset.

|  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- |
| Ann (single, no dependent). Annual salary | | | | $ 134,050 |  |  |
| Itemized deduction -Charity | | | | $10,000 |  |  |
| Itemized deduction- Home Mortgage Interest | | | | $20,000 |  |  |
| Exemption | | | | $4,050 |  |  |
| Taxable Income, before items below. | | | | $100,000 |  |  |
|  | **Date** | **Date** | **Total** | **Total** |  |  |
| **Asset** | **Acquired** | **Sold** | **Cost** | **Selling Price** |  |  |
| ABC Stock | 2017 | 2017 | $10,000 | $16,000 |  |  |
| DEF Stock | 2017 | 2017 | $10,000 | $5,000 |  |  |
| GHI Stock | 2007 | 2017 | $10,000 | $11,000 |  |  |
| KLM Stock | 2007 | 2017 | $10,000 | $16,000 |  |  |
| NOP Stock | 2007 | 2017 | $10,000 | $6,000 |  |  |

As shown above, Ann is single and has no dependent. She has a salary of $134,050.   
She claims one exemption for herself, and total itemized deductions of $30,000.   
This results in taxable income of $100,000, before considering gains and losses from sales of stock.   
When you take into account the stock sales shown above, what is her taxable income for the year?

|  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
| **a.** | $106,000 | **b.** | $105,000 | **c.** | $104,000 | **d.** | $107,000 | **e.** | Other | **C** |

Continue preceding question.

What is Ann's total federal income tax for the year, before considering any tax credits (nearest dollar)?

|  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
| **a.** | $21,990 | **b.** | $22,890 | **c.** | $22,590 | **d.** | $21,767 | **e.** | Other | **D** |

Continue preceding question. Assume the NOP stock was sold for $1,000 (not $6,000).   
What is her taxable income under this revised assumption?

|  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
| **a.** | $99,000 | **b.** | $96,000 | **c.** | $100,000 | **d.** | $97,000 | **e.** | $95,000 | **A** |

(§ 1221, 1231, 1211) An individual had AGI of $100,000 for the current year, before considering the following:

|  |  |
| --- | --- |
| Long-term capital gain of | $3,000 |
| Short-term capital loss of | (7,000) |
| Gain from sale of business land (owned 2 years) | 1,000 |

What is her adjusted gross income for the current year?

|  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
| **a.** | $96,000 | **b.** | $99,000 | **c.** | $98,000 | **d.** | $97,000 | **e.** | $94,000 | **D** |

(§1211) The maximum amount of capital losses an individual may deduct against ordinary income per year is:

|  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
| **a.** | $3,000 | **b.** | $5,000 | **c.** | Zero | **d.** | There is no maximum | **e.** | Other | **A** |

(§ 1221, 1231, 1211) Taxpayer had AGI of $100,000, before considering the following:

|  |  |
| --- | --- |
| Long-term capital gain of | $3,000 |
| Short-term capital loss of | (9,000) |
| Loss sale of land used in business (owned 2 years) | (4,000) |

What is her adjusted gross income?

|  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
| **a.** | $96,000 | **b.** | $97,000 | **c.** | $93,000 | **d.** | $100,000 | **e.** | Other amount | **C** |

Taxpayer earns $400,000 per year as CEO of a corporation. Taxpayer is single.   
Her exemptions and itemized deductions total $20,000.   
She bought stock for $30,000 on October 5, Year 1. The stock is now worth $40,000.   
She is considering selling the price on September 30, Year 2, or waiting until October 10, Year 2.  
 She does not expect the selling price to change in the next few weeks. Ignore selling commissions.   
How much federal income tax will she save by waiting and selling the stock on October 10?

|  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
| **a.** | $0 | **b.** | $1,500 | **c.** | $2,000 | **d.** | $2,500 | **e.** | Other | **C** |

Mike has the following capital gains and losses for the current year:

|  |  |
| --- | --- |
| Long-term capital loss | $(15,000) |
| Long-term capital gain | 6,000 |
| Short-term capital loss | (10,000) |
| Short-term capital gain | 12,000 |

What is Mike's net capital gain or loss for the year?

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| **a.** | Net long-term capital loss of $9,000. | **b.** | Net short-term capital gain of $2,000. | **C** |
| **c.** | Net long-term capital loss of $7,000. | **d.** | Net short-term capital gain of $1,000. |
| **e.** | Net long-term capital loss of $3,000. |  |  |

In the current year, Norris, an individual, has $50,000 of ordinary income, a Net Short Term Capital Loss (NSTCL) of $10,000 and a Net Long Term Capital Gain (NLTCG) of $2,800.   
From his capital gains and losses, Norris reports:

|  |  |  |
| --- | --- | --- |
| **a.** | an offset against ordinary income of $10,000 | **E** |
| **b.** | an offset against ordinary income of $3,000 and a NSTCL carryforward of $7,000 |
| **c.** | an offset against ordinary income of $2,800 and a NSTCL carryforward of $7,200 |
| **d.** | an offset against ordinary income of $3,000 and a NSTCL carryforward of $7,200 |
| **e.** | an offset against ordinary income of $3,000 and a NSTCL carryforward of $4,200 |

**$2,800 NLTCG -$10,000 NSTCL = $7,200 NSTCL; Use $3,000 NSTCL to reduce ordinary income leaving $4,200 as a NSTCL carryforward.**

Barbara operates a proprietorship that had taxable income of $60,000 per year, before taking into account any Section 1231 gains or losses. She had these Section 1231 gains and losses:

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| **Section 1231** | **Year 1** | **Year 2** | **Year 3** | **Year 4** |
| **gain (loss)** | $60,000 | (45,000) | $50,000 | $15,000 |

How will Barbara treat the $15,000 gain in year 4?

|  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- |
|  | **Ordinary Income** | **Capital Gain** |  | **Ordinary Income** | **Capital Gain** |  | **B** |
| **a.** | $5,000 | $0 | **c.** | $5,000 | $10,000 |  |
| **b.** | $0 | $15,000 | **d.** | $10,000 | $5,000 |  |

(§ 1245) Big corporation purchased equipment for $400,000 in 2012.   
This year, Big sold that equipment for $390,000, when accumulated depreciation was $30,000.   
The company should report the sale as:

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
| **a.** | Ordinary income of $20,000. | **c.** | Sec. 1231 gain of $20,000. |  | **A** |
| **b.** | Capital gain of $20,000. | **d.** | Ordinary income of $30,000. |

(§ 1(h)) Bob purchased an apartment building for $550,000 in several years ago. **This year,** Bob sold the apartment building to an unrelated party for $540,000. Accumulated Depreciation (straight-line) was $60,000. Bob had taxable income of $400,000 before considering the results of this sale.   
What is Bob’s federal income tax rate on the gain from this sale?

|  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
| **a.** | 5% | **b.** | 10% | **c.** | 15% | **d.** | 25% | **d** | 33% |  | **D** |

Mary Jane is single and earns a salary of $200,000 per year. Sue claims the standard deduction and one personal exemption for **the current year.** She has no other income, except for her capital gains.  
She had a long-term capital gain of $10,000 and a short-term capital loss of $8,000.   
What tax rate will apply to her net capital gain?

|  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
| **a.** | 5% | **b.** | 10% | **c.** | 15% | **d.** | 25% | **e.** | 33% | **C** |

In the current year, Tim has a short-term capital loss of $9,000 and a long-term capital gain of $1,500. Due to these transactions Tim reports

|  |  |  |  |
| --- | --- | --- | --- |
| **a.** | A capital loss deduction of $3,000 and a loss carryforward of $4,500. |  | **A** |
| **b.** | A capital loss deduction of $3,000 and a loss carryforward of $6,000. |  |
| **c.** | A capital loss deduction of $9,000. |  |
| **d.** | A capital loss deduction of $3,000 and a loss carryforward of $7,500. |  |
| **e.** | A capital loss deduction of $7,500 |  |

(§ 1244) Mr. Jones is single. He has provided the following information

|  |  |  |  |
| --- | --- | --- | --- |
| **Date** | **Transaction** | **Description** | **Amount** |
| **2000** | Bought stock in small business (§1244) corporation | Cost of stock | $500,000 |
| **2017** | Sold same stock (above) | Selling price | 300,000 |
| **2017** | Total other income (salary) | Salary | 150,000 |

What is his adjusted gross income for **2017**?

|  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
| **a.** | $150,000 | **b.** | $100,000 | **c.** | $97,000 | **d.** | $47,000 | **e.** | Other amount | **C** |

(§ 267(a)) **In April of the current year**, **Pam** sold stock with a basis of $15,000 to **Lisa** (her sister) for $10,000 (its FMV). Later in the year, **Lisa** sold the stock to her neighbor, **Niki**, for $8,000.  
How much loss does **Pam** deduct?

|  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
| **a.** | $0 | **b.** | $2,000 | **c.** | $5,000 | **d.** | $7,000 |  | **A** |

(§ 267(d)) **In April of the current year, Pam** sold stock with a basis of $15,000 to **Lisa** (her sister) for $10,000 (its FMV). Later in the year, **Lisa** sold this stock to her neighbor, **Niki**, for $16,000.   
How much gain does **Lisa** report?

|  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
| **a.** | $6,000 | **b.** | $5,000 | **c.** | $1,000 | **d.** | $0 |  | **C** |

Lisa sells some stock she purchased several years ago for $10,000 to her brother Bart for $8,000.   
One year later Bart sells the stock for $12,000. The tax consequences to Lisa and Bart are:

|  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
|  | **Lisa** | **Bart** |  | **Lisa** | | | **Bart** |  | **C** |
| **a.** | $2,000 loss | $4,000 gain | **c.** | | No gain or loss | $2,000 gain | |  |
| **b.** | No gain or loss | $4,000 gain | **d.** | | $2,000 gain | No gain or loss | |  |

(§ 1091) Ms. Rich had the following transactions in GM Corp. common stock.

|  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- |
| **Asset-Stock** | **Date bought** | **Year bought** | **Transaction** | **Number** | **Description** | **Amount** |
| GM Corp. | January 2 | 2004 | Bought: | 4,000 shares | Cost | $20,000 |
| GM Corp. | December 31 | 2017 | Sold: | 4,000 shares | Selling Price | $12,000 |
| GM Corp. | January 2 | 2018 | Bought: | 3,000 shares | Cost | $9,000 |

How much loss may she deduct for 2017 and what is the basis of the stock bought in 2018?

|  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- |
|  | **Loss** | **Basis** |  |  | **Loss** | **Basis** |  | **D** |
| **a.** | $2,000 | $9,000 |  | **c.** | $0 | $15,000 |
| **b.** | $0 | $9,000 |  | **d.** | $2,000 | $15,000 |

(§ 1091) When the wash sale rules apply, the realized loss is:

|  |  |  |
| --- | --- | --- |
| **a.** | recognized at time of sale | **D** |
| **b.** | not recognized at time of sale |
| **c.** | recognized at time of sale and added to basis of the newly acquired stock |
| **d.** | not recognized at time of sale and added to basis of the newly acquired stock |
| **e.** | not recognized at time of sale and subtracted from the basis of the newly acquired stock |

Ms. Fresh bought 1,000 shares of IBM Corporation stock for $5,000 on January 15, Year 1.   
On December 31, Year 4 she sold all 1,000 shares of her IBM stock for $4,500. Based on a hot tip from her friend, she bought 1,000 shares of IBM stock for $3,000 on January 23, Year 5.   
What is her recognized loss on her Year 4 sale and her basis in her 1000 shares bought in Year 5?

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| **a.** | $-0- LTCL and $3,500 basis | **b.** | $200 LTCL and $3,300 basis | **A** |
| **c.** | $300 LTCL and $3,200 basis | **d.** | $400 LTCL and $3,100 basis |
| **e.** | $500 LTCL and $3,000 basis |  |  |

**$4,500 amount realized from IBM sale - $5,000 tax basis in IBM shares = $500 realized loss on sale of IBM stock. Loss is not currently deductible because the IBM shares were reacquired within 30 days of the original sale (wash sale). $500 nondeductible loss from original IBM sale + $3,000 purchase price for new IBM shares = $3,500 tax basis in new IBM shares.**

Sylvia owns 1,000 shares of Sidney Sails, Inc., for which she paid $18,000 several years ago.   
On March 15 of current year, she bought 400 additional shares for $5,000. Sylvia sold the original   
1,000 shares for $13,500 on April 1 of the current year. These are her only stock transactions this year.   
Sylvia's capital loss deduction for the current year and her basis in the new shares are:

|  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- |
|  | **Capital Loss** | **Basis** |  |  | **Capital Loss** | **Basis** |  | **B** |
| **a.** | $3,000 | $5,000 |  | **c.** | $4,500 | $5,000 |
| **b.** | $2,700 | $6,800 |  | **d.** | $3,000 | $6,800 |

|  |
| --- |
| **LO 3. Describe common sources of tax-exempt investment income and   explain the rationale for exempting some investments from taxation.** |

An investor owns municipal bonds with a cost, par value, and a FMV of $200,000. These bonds pay 6% interest. A friend has suggested that the investor sell these bonds and invest in corporate bonds.

The investor is in the 40% marginal tax bracket. (Ignore state income taxes.) What return would this   
investor have to earn on corporate bonds in order to be just as well off as he is now with municipal bonds?

|  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
| **a.** | 6% | **b.** | 7.685% | **c.** | 8.333% | **d.** | 8.571% | **e.** | 10% |  | **E** |

An investor owns municipal bonds having a cost, par value, and FMV of $200,000. The bonds   
pay 6% interest. A friend has suggested that the investor sell these bonds and invest in corporate bonds. The investor is in the 25% marginal tax bracket. (You may ignore state income taxes.)   
What return would this investor have to earn on corporate bonds in order to be just as   
well off as he is now with the municipal bonds?

|  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
| **a.** | 6% | **b.** | 7.685% | **c.** | 8.00% | **d.** | 8.571% | **e.** | 10% |  | **C** |

John, a single taxpayer, received interest income of $40,000 consisting of the following:

|  |  |
| --- | --- |
| Certificate of deposit | $6,000 |
| Savings account interest | 4,000 |
| City of Charlotte Bond interest | 8,000 |
| Mortgage note | 12,000 |
| Mecklenburg County bond interest | 7,000 |
| Corporate bond interest | 3,000 |

What is the amount of interest will he include in income on his Form 1040?

|  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
| **a.** | $40,000 | **b.** | $25,000 | **c.** | $19,000 | **d.** | $33,000 | **e.** | Other |  | **B** |

What explicit tax rate would keep Jason indifferent between purchasing a municipal bond with a 3.0 percent return and a taxable bond with a 4.5 percent before-tax return? (Round your answer to the nearest percent)

|  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
| **a.** | 25% | **b.** | 30% | **c.** | 33% | **d.** | 36% | **e.** | Other | **C** |

**.045 x (1 - tax rate) = .03; tax rate = 33 percent.**

|  |
| --- |
| **LO 4. Calculate the deduction for portfolio investment-related expenses,   including investment expenses and investment interest expense.** |

Unused investment interest expense:

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| **a.** | expires after the current year | **b.** | is carried back two years | **D** |
| **c.** | is carried forward twenty years | **d.** | is carried forward indefinitely |

When calculating net investment income, gross investment income includes:

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| **a.** | interest income | **b.** | net short-term capital gains | **E** |
| **c.** | net long-term capital losses | **d.** | royalty income |
| **e.** | All of the above |  |  |

Investment interest expense does not include:

|  |  |  |
| --- | --- | --- |
| **a.** | interest expense from loans to purchase municipal bonds | **A** |
| **b.** | interest expense from loans to purchase corporate bonds |
| **c.** | interest expense from loans to purchase stocks. |

Joe has a marginal tax rate of 35 percent and decides to make the election to include long-term capital gains and qualified dividends as investment income.   
What rate must Joe use when calculating the tax on these two items?

|  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
| **a.** | 15% | **b.** | 25% | **c.** | 28% | **d.** | 35% | **e.** | Other | **D** |

Doug and Sue Click file a joint tax return and decide to itemize their deductions. The Clicks income for the year consists of $90,000 in salary, $2,000 interest income, $800 long-term capital loss. The Clicks expenses for the year consist of $1,500 investment interest expense. The Clicks marginal tax rate is 35%. What is the amount of their investment interest expense deduction for the year?

|  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
| **a.** | $1,200 | **b.** | $1,500 | **c.** | $2,000 | **d.** | $2,300 | **e.** | Other | **A** |

**$2,000 + ($800) = $1,200 <= investment interest expense ($1,500).**

 Bob Brain files a single tax return and decides to itemize his deductions. Bob's income for the year consists of $75,000 of salary, $3,000 long-term capital gain, and $1,500 interest income. Bob's expenses for the year consists of $800 investment advice fees, $700 unreimbursed employee business expenses (a miscellaneous itemized deduction), and $250 tax return preparation fees.   
What is Bob's actual deduction for miscellaneous itemized deductions?

|  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
| **a.** | Zero | **b.** | $1,590 | **c.** | $1,500 | **d.** | $1,750 | **e.** | $160 | **E** |

**($75,000 + $3,000 + $1,500) x .02 = $1,590; ($800 + $700 + $250) - $1,590 = $160.**

|  |
| --- |
| **LO 5. Understand the distinction between portfolio investments and passive investments and apply tax basis, at-risk, and passive activity loss limits to losses from passive investments.** |

Michelle is an active participant in the rental condominium property she owns. During the year, the property generates a ($30,000) loss; however, Michelle has sufficient tax basis and at-risk amounts to absorb the loss. If Michelle has $115,000 of salary, $10,000 of long-term capital gains, $3,000 of dividends, and no additional sources of income or deductions, how much loss can Michelle deduct?

|  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
| **a.** | Zero | **b.** | $4,000 | **c.** | $11,000 | **d.** | $15,000 | **e.** | Other | **C** |

**$25,000 (exception) - $14,000 (phase-out: ($128,000 - $100,000) x .5) = $11,000.**

Sam and Sue file a joint income tax return. Sam received wages of $125,000. Sue actively participated in a rental real estate activity in which she had a $30,000 loss. They are not realtors. They had no other income. How much of the rental loss may they deduct on their income tax return for the year?

|  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- |
| **a.** | $0 | **b.** | $12,500 | **c.** | $15,000 | **d.** | $25,000 | **B** |

Neil owns a 50% interest in a limited partnership that operates an apartment complex.   
During the current year, the partnership generates a taxable rental loss of $42,000. Neil's other sources of income are salary of $55,000 and interest of $18,000. What is Neil's deductible loss from the apartment?

|  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
| **a.** | $ - 0 - | **b.** | $18,000 | **c.** | $21,000 | **d.** | $25,000 | **e.** | Other |  | **A** |

In the current year, Marci worked two "jobs." She performed financial consulting activities for   
1,000 hours and real estate development and rental activities for 1,200 hours. Her real estate activities   
produced a loss of $35,000. Her financial consulting generated a net business income of $40,000.   
How much of the loss can Marci deduct against her financial consulting income?

|  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
| **a.** | $ - 0 - | **b.** | $17,500 | **c.** | $25,000 | **d.** | $35,000 | **e.** | $40,000 |  | **D** |

Kit is an engineering professor at Southern College. Her annual salary is $110,000. She owns   
two 3-unit apartment buildings near the university. Because of the proximity to campus,   
Kit actively manages the property. During the current year, the rental property produced a $29,500 loss. How much of the loss may Kit deduct for the current year?

|  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
| **a.** | $ - 0 - | **b.** | $14,750 | **c.** | $20,000 | **d.** | $25,000 | **e.** | $29,500 |  | **C** |

Karl has the following income (loss) during the current year:

|  |  |
| --- | --- |
| Net business income | $45,500 |
| Dividends and interest | 12,000 |
| Actively managed rental property | (34,000) |

What is Karl's adjusted gross income for this year?

|  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
| **a.** | $23,500 | **b.** | $31,400 | **c.** | $32,500 | **d.** | $45,500 | **e.** | $57,500 |  | **C** |

Mary and Philip purchased an apartment building in January of the current year, which they actively manage. During the current year, the apartment building generated a loss of $35,000.   
Their other income is as follows:

|  |  |
| --- | --- |
| Salaries | $70,000 |
| Dividends and interest | 8,000 |
| Loss from limited partnership acquired last year | (4,000) |

What is Mary and Philip's adjusted gross income?

|  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
| **a.** | $49,000 | **b.** | $53,000 | **c.** | $74,000 | **d.** | $78,000 | **e.** | Other |  | **B** |