

Question 1 of 40

An expat U.S. citizen is living and working in a foreign country. This year, the expat reports the following foreign-source income on their Form 1040:

\$60,000 wages

\$20,000 dividend income

\$18,000 bonus

\$22,000 self-employment income

If this year's foreign earned income exclusion (FEIE) is capped at \$130,000, what amount of FEIE may the expat claim on this year's return?

A. \$98,000

B. \$100,000 ✓

C. \$102,000

D. \$120,000

Explanation:

Categories of income for foreign earned income exclusion

Earned	Unearned	Variable
<ul style="list-style-type: none">Salaries and wagesCommissionsBonusesProfessional feesTips	<ul style="list-style-type: none">DividendsInterestCapital gainsGambling winningsAlimonySocial Security benefitsPensionsAnnuities	<ul style="list-style-type: none">Business profitsRoyaltiesRentsScholarships and fellowships

U.S. citizens and resident aliens are generally taxed on their worldwide income. U.S. taxpayers who live and work abroad may elect to **exclude** up to an **inflation adjusted amount of foreign earned income**. However, U.S. government or agency employees may not claim this exclusion. For the exclusion to apply, the taxpayer's tax home must be in a foreign country.

Income qualifying for the **exclusion** must be **earned** (ie, not passive or investment income). Some types of income (eg, royalties) are considered *variable income*, which may be classified as earned or unearned, depending on the circumstances.

Foreign earned income includes foreign source wages, salaries, commissions, bonuses, tips, professional fees, and other forms of compensation for the rendering of personal services.

In this scenario, the expat's foreign earned income is **\$100,000** (\$60,000 wages + \$18,000 bonus + \$22,000 self-employment income). Because this amount is less than the \$130,000 cap, the expat may exclude the entirety of the foreign *earned* income.

(Choice A) An exclusion of \$98,000 erroneously includes dividend income and excludes self-employment income.

(Choice C) An exclusion of \$102,000 erroneously includes dividend income and excludes the bonus.

(Choice D) An exclusion of \$120,000 erroneously includes all the income items listed.

Things to remember:

Only earned income (not passive or investment income) from foreign sources is eligible for the foreign earned income exclusion. Earned income includes salaries, wages, commissions, bonuses, and self-employment income.

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Green, an employee of Argon Industries, earned a salary of \$60,000 in Year 2. In addition, the following two transactions between Green and Argon occurred in Year 2: Green received a bonus of 100 shares of publicly-traded stock worth \$13,000 with a basis to Argon of \$8,000, and Green purchased 1,000 shares of unrestricted Argon stock pursuant to a nonqualifying stock option plan for \$10 per share when stock was valued at \$25 per share. What amount of compensation should Argon report in Green's Form W-2 for Year 2?

A. \$60,000

B. \$73,000

C. \$88,000 ✓

D. \$93,000

Explanation:

Employee tax treatment of stock options		
	Incentive stock options (ISOs)	Nonqualified stock options (NQSOs)
Grant date	Not taxable	Not taxable
Exercise date	Not taxable (may trigger AMT)	FMV – Exercise price = Ordinary income (compensation)
Sales date (\leq 1 year after exercise)	N/A	Sales price – FMV on exercise date = Ordinary income/loss (short term)
Sales date ($>$ 1 year after exercise)	Sales price – Exercise price = Long-term capital gain/loss	Sales price – FMV on exercise date = Long-term capital gain/loss

AMT = alternative minimum tax.

Employees may receive equity-based compensation (eg, stock options, shares of stock) in addition to their cash compensation. The **FMV** of any **property received** (eg, shares of stock) is **included in compensation**.

Stock options allow the employee to purchase shares of their employer's stock at some point in the future at a predetermined price (ie, exercise price). Stock options are either incentive stock options (ISOs) or nonqualified stock options (NQSOs); the type of option determines the appropriate tax treatment.

For NQSOs, there are no tax consequences for the employee on the **grant date** or the vesting date. On the exercise date, the employee pays the exercise price to acquire the shares. The difference between the FMV on the date of exercise and the exercise price is the bargain element, which is **included in compensation**. Green's bargain element is \$15,000 $[(\$25 \text{ FMV} - \$10 \text{ exercise price}) \times 1,000 \text{ shares}]$.

In this scenario, the FMV of the bonus shares (\$13,000) will be included in compensation. Argon Industries' basis has no bearing on the amount reported in income. **Green's compensation is \$88,000**, as shown below:

Salary	\$60,000
FMV of stock bonus	13,000
Bargain element of NQSOs	<u>15,000</u>
Total compensation	<u>\$88,000</u>

(Choices A and B) Compensation of \$60,000 and \$73,000 ignore the bargain element from exercising the NQSOs. The former also fails to include the stock bonus.

(Choice D) Compensation of \$93,000 incorrectly uses the basis (\$8,000) of the stock bonus rather than the FMV (\$13,000). It also includes the FMV of the NQSO shares purchased ($\$25 \times 1,000 = \$25,000$) instead of the bargain element.

Things to remember:

The FMV of any property received is included in compensation. When employees exercise nonqualified stock options, they will pay the exercise price to acquire the shares. The bargain element (ie, difference between the FMV of the stock on the date of exercise and the exercise price) is included in the employee's compensation.

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A debtor must borrow funds to purchase a personal automobile. Which of the following scenarios would require imputed interest to be reported by the lender?

- A. The debtor receives \$5,000 as a gift loan from her father at 0% interest.
- B. The debtor enters into an \$11,000 compensation loan from her employer at 0% interest. ✓**
- C. The debtor borrows \$8,000 from her brother at 0% interest.
- D. The debtor borrows \$9,000 each from two friends in the same year at 0% interest.

Explanation:

IRC Section 7872 imputed interest rules	
Apply to:	No interest loans or below-market interest gift, compensation, corporation-shareholder, or tax avoidance loans
Do not apply to:	Loans incurred in acquiring property (other imputation rules may apply)
Exemptions & limitations	<ul style="list-style-type: none">• De minimis for \leq \$10,000 gift, compensation, and corporation-shareholder loans• Imputed interest limited to borrower's net interest income for \leq \$100,000 gift loans
Operation	Interest imputed based on applicable federal rate less any interest paid

Imputed interest rules, which result in **interest income** reported by a **lender**, affect **no interest** and **below-market interest loans** such as demand, gift, corporation-shareholder, and compensation (ie, employer-employee) loans.

Affected loans are generally characterized as arm's length transactions in which the lender is treated as making a loan at the applicable federal rate (AFR). Forgone interest (ie, the difference between calculated AFR interest and interest paid, if any) is characterized as 1) a gift to the borrower, followed by 2) a retransfer of this interest to the lender. The retransfer results in imputed interest income that must be reported by the lender over the life of the loan.

A de minimis exception applies to gift loans \leq \$10,000, which are exempted from the imputed interest rules (**Choices A and C**). The \leq \$10,000 de minimis exception also applies to compensation loans and corporation-shareholder loans. The \leq \$10,000 applies to aggregate loans *per lender* (**Choice D**).

In this scenario, although there is a de minimis exception for compensation loans, the **\$11,000 employer loan exceeds** the **\$10,000** de minimis ceiling. Therefore, imputed

interest income must be reported by the lender.

Things to remember:

When a taxpayer makes a below-market interest or no interest loan, interest must be imputed unless the loan is de minimis (ie, a gift, compensation loan, or corporation-shareholder loan \leq \$10,000). The taxpayer (lender) reports the imputed interest as interest income over the life of the loan.

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On January 1, Year 2, a individual lent \$110,000 to a friend as a gift loan to help the friend buy a home. The loan terms require the friend to repay the loan in three equal annual installments of \$30,000, with the first payment due on December 31, Year 2. The loan does not require payment of interest. For Year 2, what are the income tax consequences to the individual lender?

- A. The individual has no income tax consequences because no interest is due under the loan terms.
- B. The individual must recognize interest income because the loan was issued at a premium.
- C. The individual has no income tax consequences because the loan is de minimis.
- D. The individual must recognize interest income because interest income must be imputed. ✓**

Explanation:

IRC Section 7872 imputed interest rules	
Apply to:	No interest loans or below-market interest gift, compensation, corporation-shareholder, or tax avoidance loans
Do not apply to:	Loans incurred in acquiring property (other imputation rules may apply)
Exemptions & limitations	<ul style="list-style-type: none">• De minimis for \leq \$10,000 gift, compensation, and corporation-shareholder loans• Imputed interest limited to borrower's net interest income for \leq \$100,000 gift loans
Operation	Interest imputed based on applicable federal rate less any interest paid

Imputed interest rules, which result in **interest income** reported by a **lender**, affect **no interest** and **below-market interest loans** such as demand, gift, corporation-shareholder, and compensation (ie, employer-employee) loans.

Affected loans are generally characterized as arm's length transactions in which the lender is treated as making a loan at the applicable federal rate (AFR). **Forgone interest** (ie, the difference between calculated AFR interest and interest paid, if any) is characterized as 1) a gift to the borrower, followed by 2) a retransfer of this interest to the lender. The retransfer results in **imputed interest income** that must be reported by the lender over the life of the loan (**Choice A**).

A de minimis exception applies to gift loans exempted from the imputed interest rules (ie, \leq \$10,000) (**Choice C**). The \leq \$10,000 de minimis exception also applies to

compensation loans and corporation-shareholder loans. This exception applies per loan, not per borrower.

In this scenario, the individual must recognize **interest income** because interest **must be imputed** on the \$110,000 loan.

(Choice B) The loan at issue was not issued at a premium. In addition, issuing at a premium would not cause income recognition.

Things to remember:

Interest must be imputed when an lender makes a below-market interest or no interest loan, unless the loan is de minimis (\leq \$10,000 gift, compensation, or corporation-shareholder loan). The taxpayer (lender) reports the imputed interest as interest income over the life of the loan.

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A 22-year-old full-time student earned \$11,000 in salary and received \$9,000 in interest from corporate bonds. The bonds were a gift from the student's grandparents. The student's parents pay more than half of the student's support, including \$25,000 in tuition. Which of the following statements is correct regarding the student's current-year income tax?

- A. The student's salary income and **no** other income will be subject to the kiddie tax.
- B. A portion of the student's interest income and **no** other income will be subject to the kiddie tax. ✓**
- C. Both the student's salary and a portion of the interest income will be subject to the kiddie tax.
- D. Neither the student's salary nor the interest income will be subject to the kiddie tax.

Explanation:

Kiddie tax requirements

The kiddie tax applies to children meeting the following conditions:

1. The child has unearned income in excess of the threshold (double the standard deduction for a dependent child).
2. Either parent is alive at the end of the tax year.
3. The child does not file a joint tax return for the year.
4. The child is:
 - Under age 18 at the end of the tax year
 - 18 years old with earned income that does not exceed 50% of the child's support, or
 - A full-time student (age 19 to 23) with earned income that does not exceed 50% of the child's support.

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The kiddie tax was established to prevent wealthy taxpayers from transferring unearned income to family members with lower tax rates (eg, children, grandchildren) to avoid income taxes. The **kiddie tax** applies to children who meet certain requirements (eg, age, support received) and taxes the **child's net unearned income** (NUI) at the **greater of the parent's** tax rate or the **child's** tax rate.

NUI is calculated as unearned income minus a statutory threshold. Examples of unearned income include interest, dividends, and capital gains.

Because the student (ie, the child) in this scenario meets the following requirements, a portion of the student's interest income (ie, NUI) from the gifted bonds is subject to the kiddie tax (**Choices A, C, and D**).

- Student's unearned income (\$9,000 interest income) exceeds the statutory threshold

- At least one living parent
- Age 22 *and* a full-time student (ie, under 25) with earned income (\$11,000 salary) less than 50% of support

Things to remember:

The kiddie tax applies to children who meet certain requirements (eg, age, support received) and taxes the child's net unearned income at the greater of the parent's tax rate or the child's tax rate. Examples of unearned income include interest, dividends, and capital gains.

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In the current year, a U.S. citizen taxpayer reported \$100,000 of Spain-sourced interest income on which they paid \$15,000 in Spanish income tax. The taxpayer reported no foreign earned income. Additionally, the taxpayer reported \$200,000 of U.S. sourced compensation and paid \$50,000 in U.S. income tax on worldwide income. What is the maximum amount of foreign tax credit the taxpayer may claim in the current year?

- A. \$0
- B. \$15,000 ✓**
- C. \$16,667
- D. \$25,000

Explanation:

Foreign tax credit limitation calculation

$$\text{Limit} = \text{U.S. tax on worldwide income} \times \frac{\text{Foreign source taxable income}}{\text{Worldwide taxable income}}$$

The nonrefundable **foreign tax credit** (FTC) may **reduce U.S. income tax dollar for dollar** by a portion of **foreign taxes paid** on **foreign earned or unearned income** (**Choice A**). A taxpayer may claim the FTC only if the taxpayer does not deduct foreign taxes and does not use the same foreign earned income to claim the foreign earned income exclusion. The allowable FTC credit is **limited** if the U.S. effective tax rate **exceeds** the foreign effective rate. In this scenario, the FTC limit is \$16,667, calculated as follows:

$$\$16,667 \text{ limit} = \$50,000 \text{ U.S. taxes paid} \times \frac{\$100,000 \text{ Spanish interest income}}{(\$100,000 + \$200,000) \text{ worldwide income}}$$

Taxpayers may claim the **lesser** of the total **foreign taxes paid** (\$15,000) or the **calculated foreign tax credit limit** (\$16,667), which is **\$15,000** in this scenario (**Choice C**).

(Choice D) A FTC of \$25,000 erroneously excludes the Spanish interest in the limitation formula denominator. In addition, the FTC cannot be more than the foreign taxes paid.

Note: Individuals with only passive foreign income (eg, interest income) and foreign taxes less than \$301 (\$601 for joint returns) may elect to be exempt from the FTC limitation.

Things to remember:

The amount of a foreign tax credit is limited if the U.S. effective tax rate exceeds the

foreign effective rate. Taxpayers may claim the lesser of the foreign taxes paid or the calculated limitation.

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The parents of a three-year-old taxpayer gifted him stock when he was born. This year, the taxpayer has \$20,000 of qualified dividends, \$0 earned income, and \$4,000 of itemized deductions related to the dividends. Assuming the current dependent child standard deduction is \$1,350, how much of the taxpayer's dividends will be taxed at his parents' rate?

- A. \$1,350
- B. \$14,650 ✓**
- C. \$18,650
- D. \$20,000

Explanation:

Child's unearned income	–	Child's standard deduction	–	Greater of Child's standard deduction or Child's itemized deductions attributable to unearned income	=	Net unearned income
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The kiddie tax applies to children meeting certain conditions and affects a child's **net unearned income** (NUI). Examples of unearned income are interest, dividends, and capital gains.

NUI is calculated as **unearned income minus** 1) the child's standard deduction and 2) the **greater** of the child's **standard deduction or itemized deductions** attributable to unearned income. The result is net unearned income that is:

- tax-free up to the child's standard deduction, then
- taxed at the child's rate up to the child's standard deduction (or itemized deductions, if higher), and then
- taxed at the parents' rate as income in excess (of the NUI).

In this case, the child taxpayer has \$20,000 of unearned income and \$4,000 of related itemized deductions. The first \$1,350 is tax-free, and the next \$4,000 (the greater of the \$1,350 standard deduction or the \$4,000 itemized deductions) is taxed at the child's rate. The remaining **\$14,650 is taxed at the parents' rate**.

Gross unearned income	\$20,000
Less: Standard deduction for unearned income (not taxed)	(1,350)
Less: Itemized deductions (ie, \$4,000 is > \$1,350)	<u>(4,000)</u>

Net unearned income (taxed at parents' rate)

\$14,650

(Choice A) The child's standard deduction for determining NUI is \$1,350; this is not the amount of the NUI.

(Choice C) Dividend income of \$18,650 fails to subtract the child's itemized deductions to determine the amount taxed at the parents' rate.

(Choice D) Dividend income of \$20,000 erroneously treats all the income as NUI.

Things to remember:

The kiddie tax applies to children meeting certain conditions and is based on net unearned income (NUI) that is taxed at the parents' tax rate. NUI is calculated as unearned income less 1) the child's standard deduction and 2) the greater of child's standard deduction or itemized deductions attributable to unearned income.

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A child, age five, is claimed as a dependent on the parents' tax return. The child has \$3,000 of interest income, no earned income this year, and will file a tax return. Assuming the current applicable standard deduction is \$1,350, how much of the child's income will be taxed at the parents' tax rates?

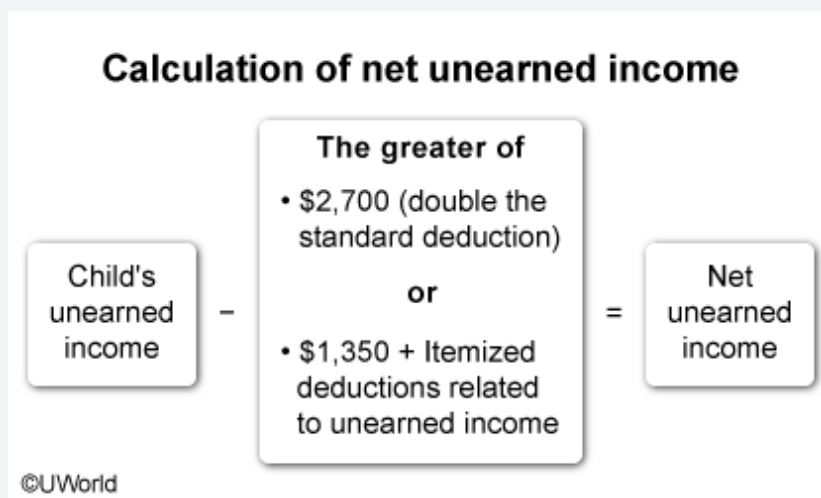
A. \$300 ✓

B. \$1,650

C. \$2,700

D. \$3,000

Explanation:



The kiddie tax was established to prevent wealthy taxpayers from avoiding taxes by transferring income-producing investments to their children, whose income might not be subject to tax or, if it was, might be taxed at lower rates. The kiddie tax applies to children meeting certain conditions and is based on **net unearned income** (NUI) taxed at the parents' income tax rates.

NUI is calculated as **unearned income minus a statutory threshold**. Currently, the threshold is the **greater of double the standard deduction** for a dependent child (\$2,700) or \$1,350 plus itemized deductions related to the production of the unearned income. Examples of unearned income are **interest, dividends, and capital gains**—excluding performance for services (eg, wages). The child has NUI of \$300 (\$3,000 unearned income – \$2,700) that is subject to the kiddie tax assessed at the parents' income tax rates (**Choices C and D**).

(Choice B) The child's *taxable income* is \$1,650 (\$3,000 – \$1,350 allowable standard deduction). The first \$1,350 of the taxable income is taxed at the child's normal tax rate, and the remaining \$300 (NUI) is taxed at the parents' income tax rates.

Note: The standard deduction is adjusted annually. Candidates are expected to use the amount provided in the question.

Things to remember:

The kiddie tax applies to children meeting certain conditions and is based on net unearned income (NUI) that is taxed at the parents' tax rates. NUI is calculated as unearned income minus a statutory threshold.

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Assuming a taxpayer itemizes deductions, which of the following statements about the effect of regular tax items on alternative minimum taxable income (AMTI) is correct?

- A. A regular tax casualty loss deduction requires no adjustment to AMTI. ✓**
- B. The state income tax deducted from regular taxable income requires no adjustment to AMTI.
- C. Qualified private activity bond interest is included in regular taxable income and decreases AMTI.
- D. A state income tax refund included in regular taxable income increases AMTI.

Explanation:

Alternative minimum tax preferences and adjustments

Tax preferences (Always add)	Private activity bond interest Excess intangible drilling costs Excess percentage depletion
Adjustments (Add or deduct)	+ Local and state income taxes or general sales tax, property taxes + Incentive stock options (market price – exercise price) ± Excess depreciation on personal property – Refunds of local and state income taxes included as income + Standard deduction

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The alternative minimum tax (AMT) was created to ensure that the highest-income taxpayers could not exploit tax deductions and benefits to avoid paying any federal income tax. Affected taxpayers **calculate** both **regular tax** (RT) and **AMT** and **pay** the **higher amount**.

AMT is calculated as a percentage of AMT income (AMTI), which is RT income (RTI) adjusted for items designated by statute that differ for AMT purposes. These items are as follows:

- **Tax preferences** (ie, permanent differences) always **increase AMTI** and **do not reverse** in later years
- **AMT adjustments** (ie, temporary differences) may either **increase** or **decrease AMTI** and **may reverse** in later years

Most RT items do not require adjustment because they are treated the same for AMT (eg, charitable contributions, **qualified casualty losses**, gambling losses).

(Choice B) If a taxpayer itemizes deductions, some portion of state and local taxes paid (eg, sales, real estate, income) is deductible for RT purposes. However, these taxes are not permitted for AMT and *increase* AMTI.

(Choice C) Private activity bond interest is excluded from RTI but *increases* AMTI.

(Choice D) If a state income tax refund is included in RTI, it should *decrease* AMTI.

Things to remember:

To calculate alternative minimum taxable income (AMTI), regular taxable income (RTI) is increased or decreased by statutorily designated tax preferences (which always increase AMTI) and AMT adjustments (which increase or decrease, as appropriate). Itemized deductions for state and local taxes increase AMTI. Private activity bond interest is excluded from RTI but increases AMTI. State tax refunds included in RTI decrease AMTI.

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Which of the following can be an advantage of a health care flexible spending account (FSA) over a health savings account (HSA)?

A. Low deductible insurance plans can be used. ✓

B. The account is portable if employment changes.

C. Unused funds can be invested and grow tax free.

D. Larger annual contributions are permitted.

Explanation:

When planning for the costs of future health care or dependent care, both flexible spending accounts (FSAs) and health savings accounts (HSAs) provide tax savings.

Contributions to the plans are made in **pretax dollars**, thus saving the taxpayer income taxes and FICA taxes. **Distributions** from the plans for qualifying medical costs are **tax-free**. However, there are significant differences between HSAs and FSAs:

- HSAs require that an individual have a *qualified high-deductible health care plan* (QHDHP) (ie, high out-of-pocket deductibles). They also permit larger annual contributions than FSAs (**Choice D**)
- The individual *owns* the HSA (ie, the account is portable), and any *unused* contributions at year end carry over and accumulate. The unused funds, which grow tax-free and may be invested, can be used to pay qualified medical expenses incurred in future years (**Choices B and C**)

Generally, an HSA is a better choice for individuals who are young and healthy with lower health care expenses. In such cases, there will likely be time for unused funds to accumulate before they are needed.

For individuals who anticipate **high** medical costs, an FSA may be a better choice. Unlike HSAs, which require a high-deductible plan, an **FSA** can be used with a **low-deductible health insurance plan**, allowing the insurance to cover medical costs sooner (ie, lower out-of-pocket deductibles). However, FSAs are use-it-or-lose-it plans; at year end, unused funds are generally forfeited.

Things to remember:

Both HSAs and FSAs provide tax savings. Contributions are made in pretax dollars, and distributions for qualified medical expenses are nontaxable. FSAs can be used with low-deductible insurance plans, whereas HSAs require a qualified high-deductible plan. Unused funds in an FSA are forfeited at year end. Because HSAs are owned by the individual, the account is portable and unused funds accumulate tax free.

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Millie, age six, has \$5,000 of long-term capital gain from stocks gifted to her by her parents and no earned income or itemized deductions attributable to unearned income this year. Assume the current dependent child standard deduction is \$1,350. How much of Millie's income will be taxed at her marginal tax rate?

A. \$0

B. \$1,350 ✓

C. \$2,300

D. \$5,000

Explanation:

Child's unearned income	–	Child's standard deduction	–	Greater of Child's standard deduction or Child's itemized deductions attributable to unearned income	=	Net unearned income
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The kiddie tax applies to children meeting certain conditions, and it affects a child's **net unearned income** (NUI). Examples of unearned income are interest, dividends, and capital gains.

NUI is calculated as **unearned income minus** 1) the child's standard deduction and 2) the **greater** of the child's **standard deduction or itemized deductions** attributable to unearned income. The result is unearned income that is:

- tax-free up to the child's standard deduction, then
- taxed at the child's rate up to the child's standard deduction (or itemized deductions, if higher), and then
- taxed at the parents' rate as income in excess (of the NUI).

In this case, Millie has \$5,000 of unearned income and no itemized deductions. The first \$1,350 is tax-free, and the **next \$1,350 is taxed at Millie's rate**, which is the preferential capital gain rate (**Choice A**). The remaining \$2,300 is taxed at the *parents'* tax rate (**Choice C**).

Gross unearned income	\$5,000
Less: Standard deduction for unearned income (<i>not taxed</i>)	(1,350)