## Question 1 of 34

In a liquidating distribution, a partner receives $8,000 cash and land with a fair market value of $5,000 and a basis of $1,000.  The partner's basis in the partnership prior to the distribution was $10,000.  What is the partner's basis in the land immediately after the distribution?

**A.** $1,000

**B.** **$2,000** ✓

**C.** $5,000

**D.** $8,000

**Explanation:**

| **Liquidating distribution in a partnership interest (proportionate distribution)** | | |
|---|---|---|
| **Order of allocation** | **Distributed property** | **Partner's basis in property** |
| **Step 1** | Money (ie, cash, debt relief, and marketable securities) | Amount received* |
| **Step 2** | Hot assets (ie, inventory and unrealized receivables) | Lesser of partnership's basis in the hot assets or partner's remaining outside basis |
| **Step 3** | Other assets | Partner's basis in partnership − Money − Hot assets |

*Cash does not have a basis, but the amount reduces the partner's basis available to be allocated among other assets.

A **liquidating distribution** is a complete **termination** of a partner's **interest** in a partnership.

When there is a liquidating distribution, a partner's outside basis is reduced to $0 by allocating the basis to the distributed assets in the following order: money, then hot assets (ie, inventory and unrealized receivables), and then all other assets (eg, land).  That is, any outside basis left over after accounting for money received is assigned proportionately to hot assets up to the partnership's basis in those assets.  Finally, any remaining outside basis is assigned proportionately to any remaining assets.

In this case, the partner's outside basis is first reduced by the $8,000 cash **(Choice D)**. Then, the **$2,000** remaining outside basis is **allocated** to the **land**.

**(Choice A)** The receiving partner's basis in *hot assets* is limited by the partnership's basis in those assets. This is not the case for other assets (eg, land). The partnership's basis in the land does not carry over to the partner.

**(Choice C)** The FMV of distributed assets is generally taken as the basis of those assets by an owner receiving a liquidating distribution from a *corporation*, not a partnership.

**Things to remember:**
Liquidating distributions reduce a partner's basis in a partnership to $0. The partner's outside basis is reduced first by distributed money and then allocated proportionately to hot assets up to the partnership's basis in those assets. Finally, any remaining outside basis is assigned proportionately to any remaining assets.

## Question 2 of 34

A person without dependents is **least** likely to benefit from which of the following types of insurance?

**A.** Disability.

**B.** Long-term care.

**C. Term life.** ✓

**D.** Whole life.

**Explanation:**

| Whole vs term life insurance | | |
|---|---|---|
| | **Whole** | **Term** |
| **Premiums** | • Fixed<br>• Not tax deductible to insured<br>• Generally higher | • Fixed<br>• Not tax deductible to insured<br>• Generally lower |
| **Cash value** | • Grows with premium payments and interest<br>• May be cashed out if policy is canceled<br>• Goes to beneficiary if insured dies<br>• Can borrow tax free from cash value | • None |
| **Benefit** | • Usually tax free to beneficiary | • Usually tax free to beneficiary |
| **Coverage period** | • Permanent (or until canceled) | • Fixed period (eg, 20 years) |
| **Accelerated death benefit** | • With serious illness<br>• Common | • With serious illness<br>• Rare |

Life insurance provides a cash benefit to a beneficiary in the event of the death of the insured. There are two main types of life insurance—whole and term.

**Term life** covers a time period specified in the policy. For example, those who expect to retire at age 65 may take out a 20-year term life policy at age 45 to help their **beneficiaries replace** the insured person's earned **income** if the insured dies, but the policy holders receive no benefit during their lifetime. If a **beneficiary** is **not dependent** on income earned by the insured, term life insurance is **unlikely** to be **worth** the **cost**.

Whole life, in contrast, is active until the insured dies or the policy is canceled. Unlike term life, whole life builds a cash value that is returned to the policy holders if they terminate the policy. Many whole life policies include an accelerated death benefit that allows the policy holder to receive a portion of the death benefit in the event of a serious (usually terminal) illness, but it is rare in term life policies **(Choice D)**.

**(Choice A)** If insured individuals are unable to work due to a disability, disability insurance can help them meet their financial needs.

**(Choice B)** Long-term care insurance allows insured individuals to pay for their own personal and medical care if they become unable to care for themselves.

**Things to remember:**
Term life insurance provides a death benefit to the beneficiary if the insured dies within a specified period of time. Because it does not have any cash value and does not usually have an accelerated death benefit, it is unlikely to benefit individuals without dependents.

## Question 3 of 34

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 |
|---|---|---|---|---|---|---|

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 (*not taxed*) | (1,350) |

| | |
|---|---|
| **Less: Greater of standard deduction or itemized deductions (taxed at child's rate)** | **(1,350)** |
| Net unearned income (taxed at parents' rate) | $2,300 |

**(Choice D)** Income of $5,000 erroneously taxes all of the unearned income at the child's preferential rate.

**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 the child's standard deduction or itemized deductions attributable to unearned income.

## Question 4 of 34

On December 31, after receipt of his share of partnership income, Clark sold his interest in a limited partnership for $30,000 cash and relief of all liabilities. On that date, the adjusted basis of Clark's partnership interest was $40,000, consisting of his capital account of $15,000 and his share of the partnership liabilities of $25,000. The partnership has no unrealized receivables or substantially appreciated inventory. What is Clark's gain or loss on the sale of his partnership interest?

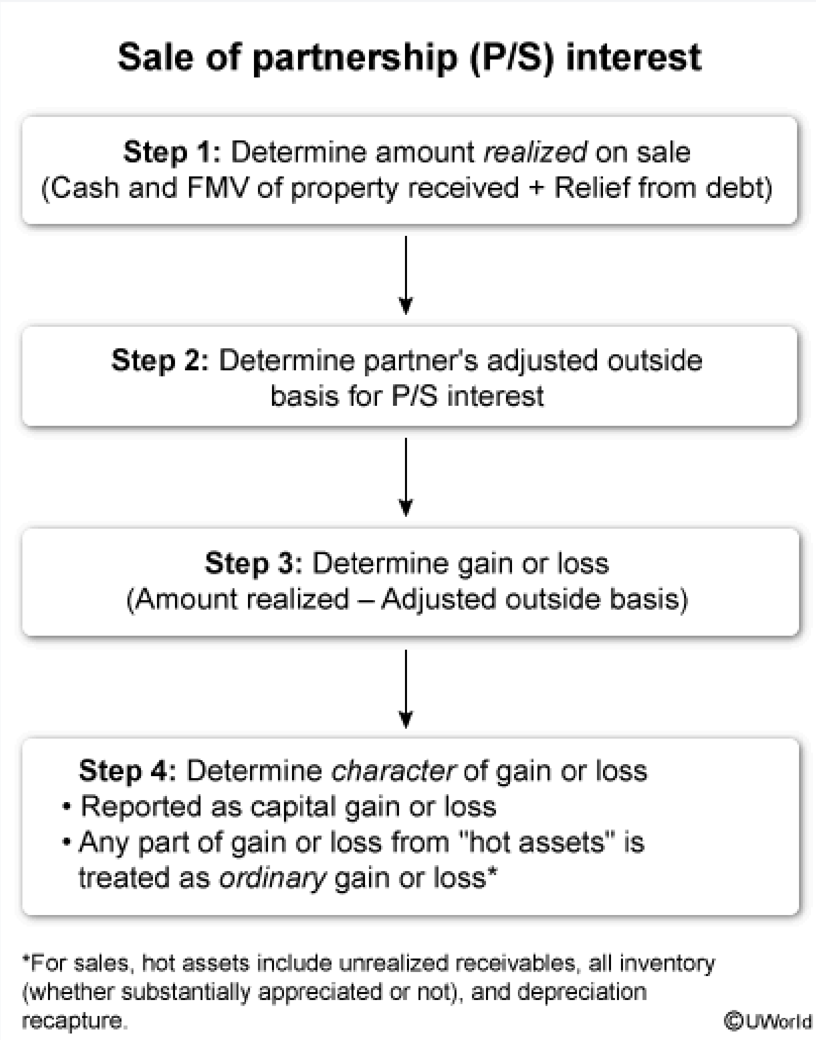
**A.** Ordinary loss of $10,000.

**B.** Ordinary gain of $15,000.

**C.** Capital loss of $10,000.

**D. Capital gain of $15,000.** ✓

**Explanation:**




When a partner **sells** their partnership (P/S) interest, the recognized gain or loss on the sale is calculated by subtracting the partner's adjusted **outside basis** in the P/S from the **realized amount**. The realized amount is the **sum** of all **economic benefits received** by the selling partner, including debt relief, which is treated as additional cash received.

Generally, the sale of a P/S interest is a **capital gain or loss** because the P/S interest is a capital asset.  However, if the P/S has *unrealized ordinary income assets* (hot assets) (eg, unrealized receivables, appreciated inventory) at the time of sale, the partner has effectively converted ordinary income to capital gains.  To prevent this, the gain (loss) on the sale must be reported as **ordinary** to the **extent** of the **unrealized ordinary income assets**, if any, at the time of sale.

In this scenario, the amount realized on the sale is $55,000 ($30,000 cash + $25,000 relief of liabilities).  Because Clark's adjusted basis in the P/S interest is $40,000, a $15,000 gain ($55,000 − $40,000) is recognized.  Because there are *no* unrealized ordinary income assets, the **$15,000 is a capital gain**, not ordinary gain **(Choice B)**.

*Note:  Only general partners are normally liable for P/S debt.  Although the question does not specify what type of partner Clark is, if the partner is relieved of debt, it is treated as part of the amount realized on the sale.*

**(Choices A and C)**  Capital and ordinary losses of $10,000 fail to include the relief of the $25,000 liabilities in the amount realized.

**Things to remember:**
When a partner sells their partnership (P/S) interest, the recognized capital gain or loss on the sale is calculated by subtracting the partner's adjusted outside basis in the P/S from the amount realized.  However, the gain or loss is treated as ordinary to the extent of the unrealized ordinary income assets, if any, at the time of sale.

## Question 5 of 34

A taxpayer's property with an adjusted basis of $75,000 and fair market value of $105,000 was condemned by the state. The taxpayer received $100,000 from the state as compensation for the property, and six months after the condemnation purchased a replacement property for $100,000. What are the tax consequences of this transaction?

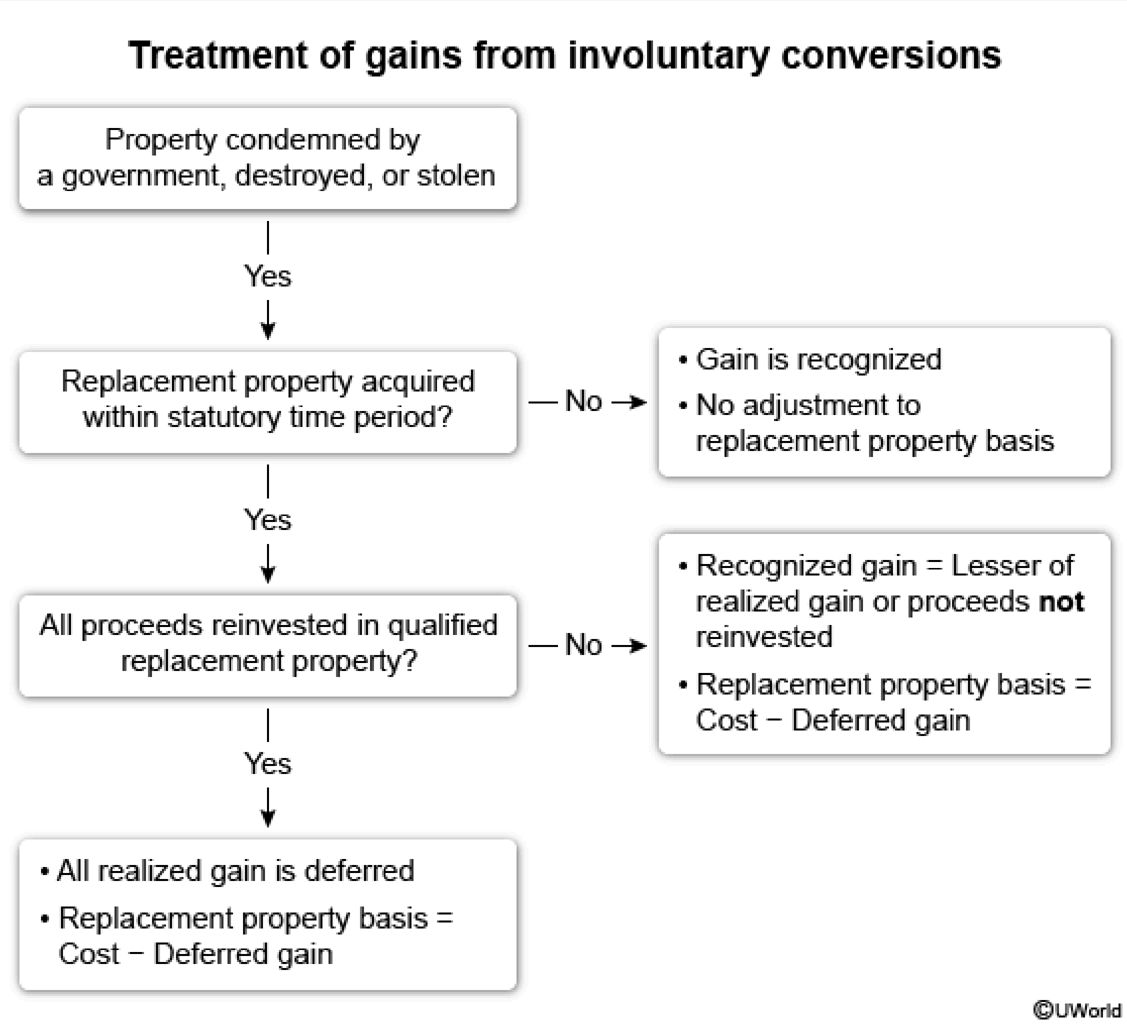
**A. No gain is recognized, and the basis in the new property is $75,000.** ✓

**B.** No gain is recognized, and the basis in the new property is $100,000.

**C.** A gain of $25,000 is recognized, and the basis in the new property is $100,000.

**D.** A gain of $30,000 is recognized, and the basis in the new property is $100,000.

**Explanation:**




An involuntary conversion occurs when a taxpayer's property is partially or wholly destroyed (eg, fire, weather), stolen, or seized (eg, eminent domain by a government). A direct conversion occurs when replacement property is provided to the taxpayer. An indirect conversion happens when the taxpayer receives a monetary settlement.

For indirect conversion, an election can be made allowing part or all the **gain** to be **deferred** (ie, postponed) if the taxpayer acquires **qualified replacement property** within the statutory **time limit**. This period is generally two years but is extended to **three years** in the case of **condemnation** or eminent domain. The deferral is permitted because taxpayers are not in control of an involuntary conversion and using the proceeds to acquire replacement property places them in a position of not having funds to pay taxes.

However, taxpayers will **recognize realized gain** to the extent the **proceeds** received are **not reinvested** in qualified replacement property. The **basis** of the **replacement property** is its **cost less** any **deferred gain**.

In this scenario, the taxpayer acquired replacement property within the statutory *three-year period* and reinvested *all* the *proceeds*. Therefore, the realized gain of $25,000 ($100,000 amount realized − $75,000 adjusted basis) is *deferred*. **No gain** is recognized. The **basis** in the replacement property is **$75,000** ($100,000 cost − $25,000 deferred gain).

**Things to remember:**
When an involuntary conversion occurs, part or all the gain may be deferred if qualified replacement property is acquired within the statutory time limit. However, taxpayers will recognize gain to the extent the proceeds are *not* reinvested in replacement property. The basis of the replacement property is its cost less any deferred gain.