CPA-REGULATION Q&As

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QUESTION 1

Which of the following statements is the best definition of real property?

A. Real property is only land.

B. Real property is all tangible property including land.

C. Real property is land and intangible property in realized form.

D. Real property is land and everything permanently attached to it.

Correct Answer: D

Choice "d" is correct. Real property includes land and all items permanently affixed to the land (e.g.,

buildings, paving, etc.) Choice "a" is incorrect. Real property includes more than just the land (as per the

explanation above); it includes all items permanently affixed to land.

Choice "b" is incorrect. "All" tangible property could include moveable personal property and is therefore,

incorrect.

Choice "c" is incorrect. "Intangible property in realized form" is a distracter and a contradiction in terms.

QUESTION 2

Which of the following sales should be reported as a capital gain?

A. Sale of equipment.

B. Real property subdivided and sold by a dealer.

C. Sale of inventory.

D. Government bonds sold by an individual investor.

Correct Answer: D

Choice "d" is correct. Government bonds held by an individual investor are considered capital assets in the hands of the investor. When these types of security investments are sold, the resulting gain or loss is reported as capital. Choice "a" is incorrect. In this case, we must assume that the BEST answer is option "d" (as that option would ALWAYS result in capital gain or loss treatment) and that the examiners are assuming that the equipment is depreciable equipment that has been used in a business for over one year. [If the equipment had been considered a personal asset by the examiners and had sold for a gain, it would also be a capital asset that sold for a capital gain, and there would be two correct answers. Remember that the correct answer is the option that best answers the question.] Depreciable equipment used in a business and held for over one year falls under the category of Section 1245 property. When Section 1245 assets are sold at a gain, all the accumulated depreciation on the asset is recaptured as ordinary income (the same category as the depreciation expense was deducted against), and any remaining gain (typically, in practice, this is not the case, though, as the asset would have had to sell for an amount greater than its purchase price) is capital gain under Code Section 1231. [Note that Section 1245 applies only to gains. If the asset had sold for a loss, the loss would have been ordinary under Section 1231.] Choice "b" is incorrect. Real property sold by a dealer is considered inventory and results in ordinary income or ordinary losses upon sale. Inventory is not a capital asset and is not afforded the capital gain benefits. Choice "c" is incorrect. Inventory is not a capital asset and is not afforded the capital gain benefits. The sale of inventory results in ordinary income or loss (e.g., gross profit on sales) being reported on the tax return, as inventory is an asset held for sale in the ordinary course of business.

QUESTION 3

Tom and Joan Moore, both CPAs, filed a joint 1994 federal income tax return showing $70,000 in taxable income. During 1994, Tom\\'s daughter Laura, age 16, resided with Tom. Laura had no income of her own and was Tom\\'s dependent. Determine the amount of income or loss, if any that should be included on page one of the Moores\\' 1994 Form 1040. Tom\\'s 1994 wages were $53,000. In addition, Tom\\'s employer provided group-term life insurance on Tom\\'s life in excess of $50,000. The value of such excess coverage was $2,000.

A. $0

B. $500

C. $900

D. $1,000

E. $1,250

F. $1,300

G. $1,500

H. $2,000

I. $2,500

J. $3,000

K. $10,000

L. $25,000

M. $50,000

N. $55,000

O. $75,000

Correct Answer: A

"N" is correct. $55,000. The value of employer-provided group term life insurance for which the face amount exceeds $50,000 is taxable income to the insured employee and the $53,000 in wages would both be included on page one, Form 1040.

QUESTION 4

John and Mary were divorced in 1991. The divorce decree provides that John pay alimony of $10,000 per year, to be reduced by 20% on their child\\'s 18th birthday. During 1992, John paid $7,000 directly to Mary and $3,000 to Spring

College for Mary\\'s tuition. What amount of these payments should be reported as income in Mary\\'s 1992 income tax return?

A. $5,600

B. $8,000

C. $8,600

D. $10,000

Correct Answer: B

Choice "b" is correct. Alimony would be income to Mary while child support would not. Funds qualify as

child support only if 1) a specific amount is fixed or is contingent on the child\\'s status (e.g., reaching a

certain age), 2) it is paid solely for the support of minor children, and 3) it is payable by decree, instrument

or agreement. The actual use of the funds is irrelevant to the issue. In this case, $2,000 (20% ?$10,000)

qualifies as child support. The other $8,000 is alimony, which would be income to Mary.

Choice "a" is incorrect. Take 80% of the $10,000 paid, not 80% of the $7,000 received by Mary.

Choice "c" is incorrect. Only $8,000 would be alimony per the divorce decree (80% ?$10,000).

Choice "d" is incorrect. The 20% reduction when the child turns 18 makes 20% of the $10,000 payment, or

$2,000, child support, which is nontaxable to Mary.

QUESTION 5

Adams owns a second residence that is used for both personal and rental purposes. During 2001, Adams used the second residence for 50 days and rented the residence for 200 days. Which of the following statements is correct?

A. Depreciation may not be deducted on the property under any circumstances.

B. A rental loss may be deducted if rental-related expenses exceed rental income.

C. Utilities and maintenance on the property must be divided between personal and rental use.

D. All mortgage interest and taxes on the property will be deducted to determine the property\\'s net income or loss.

Correct Answer: C

Choice "c" is correct. Because the second property was personally used more than 14 days, any net loss

from the rental of the property will be disallowed.

All related expenses must be prorated between the personal use portion and the rental activity portion.

Prorated depreciation is permitted for the rental activity.

QUESTION 6

Tom and Joan Moore, both CPAs, filed a joint 1994 federal income tax return showing $70,000 in taxable income. During 1994, Tom\\'s daughter Laura, age 16, resided with Tom. Laura had no income of her own and was Tom\\'s dependent. Determine the amount of income or loss, if any that should be included on page one of the Moores\\' 1994 Form 1040. The Moores had no capital loss carryovers from prior years. During 1994, the Moores had the following stock transactions, which resulted in a net capital loss:

	Date acquired	Date sold	Sales price	Cost
Revco	2/1/93	3/17/94	$15,000	$25,000
Abbco	2/18/94	4/1/94	8,000	4,000

A. $0

B. $500

C. $900

D. $1,000

E. $1,250

F. $1,300

G. $1,500

H. $2,000

I. $2,500

J. $3,000

K. $10,000

L. $25,000

M. $50,000

N. $55,000

O. $75,000

Correct Answer: J

"J" is correct. $3,000. The capital loss on Revco ($10,000 loss) is added to the capital gain on Abbco ($4,000) to produce a net capital loss of ($6,000). The Moores can claim $3,000 of the loss on their 1994 income tax return and carry the balance forward to 1995.

QUESTION 7

For a cash basis taxpayer, gain or loss on a year-end sale of listed stock arises on the:

A. Trade date.

B. Settlement date.

C. Date of receipt of cash proceeds.

D. Date of delivery of stock certificate.

Correct Answer: A

Choice "a" is correct. Trade date.

Gain or loss on a year-end sale of listed stock arises on the trade date.

Rule: Whether on the cash or accrual method of accounting taxpayers who sell stock or securities on an

established securities market must recognize gains and losses on the trade date, rather than on the

settlement date.

Choices "b", "c", and "d" are incorrect, per the above rule.

QUESTION 8

The uniform capitalization method must be used by:

I. Manufacturers of tangible personal property.

II.

Retailers of personal property with $2 million dollars in average annual gross receipts for the 3 preceding years.

A.

I only.

B.

II only.

C.

Both I and II.

D.

Neither I nor II.

Correct Answer: A

Choice "a" is correct. I only.

Rule: The uniform capitalization rules apply to the following:

1.

Real or tangible personal property produced by the taxpayer for use in a trade or business.

2.

Real or tangible personal property produced by the taxpayer for sale to customers.

3.

Real or personal property acquired by the taxpayer for resale.

4.

However, the uniform capitalization rules do not apply to property acquired for resale if the taxpayer\\'s annual gross receipts for the preceding three tax years do not exceed $10,000,000 (not $2 million).

QUESTION 9

Rich is a cash basis self-employed air-conditioning repairman with 1993 gross business receipts of $20,000. Rich\\'s cash disbursements were as follows:

Yellow Pages listing	2,000
Estimated federal income taxes on self-employment income	1,000
Business long-distance telephone calls	400
Charitable contributions	200

What amount should Rich report as net self-employment income?

A. $15,100

B. $14,900 C. $14,100

D. $13,900

Correct Answer: A

Choice "a" is correct. Deductions to arrive at net self-employed income include all necessary and ordinary expenses connected with the business. Estimated federal income tax payments are not an expense. Charitable contributions by an individual are only deductible as an itemized deduction on Schedule A. This assumes the contribution was not made with the "expectation of commensurate financial return."

Receipts	$20,000
Parts	(2,500)
Listing	(2,000)
Telephone	(400)
Net self-employment income	$15,100

Choice "b" is incorrect. Charitable contributions are an itemized deduction unless there is an expectation of commensurate financial return.

Choice "c" is incorrect. Federal income taxes paid are not a deductible expense.

Choice "d" is incorrect. Charitable contributions are an itemized deduction unless there is an expectation of commensurate financial return. Federal income taxes paid are not a deductible expense.

QUESTION 10

Among which of the following related parties are losses from sales and exchanges not recognized for tax purposes?

A. Father-in-law and son-in-law.

B. Brother-in-law and sister-in-law.

C. Grandfather and granddaughter.

D. Ancestors, lineal descendants, and all in-laws.

Correct Answer: C

Choice "c" is correct. Losses from sales and exchanges are not recognized for tax purposes between grandfather and granddaughter. Rule: Losses are disallowed on sales between related parties. "Related" includes brothers and sisters, husband-wife, lineal descendants (father, son, grandfather), and entities that are more than 50% owned by individuals, corporations, trusts and/or partnerships.

Choices "a", "b", and "d" are incorrect, because losses from sales and exchanges are recognized for all "in-laws."

QUESTION 11

In evaluating the hierarchy of authority in tax law, which of the following carries the greatest authoritative value for tax planning of transactions?

A. Internal Revenue Code.

B. IRS regulations.

C. Tax court decisions.

D. IRS agents\\' reports.

Correct Answer: A

Note: This question is addressed in your Appendix D text materials. We are confident that our students

would be able to respond correctly over 85% of the time without any guidance on this topic. The answer is

rather obvious. Just by looking at the answer options, you will immediately notice that Option A is

presented in title case. This would be a quick sign that it may be the correct response. Further, we suspect

that most students would narrow the options down to "a" or "b" by simply using common sense.

While we are confident that our students would fare well on this question if it appeared on their exams, we

present the following detailed explanation of the answer options.

Choice "a" is correct. According to the IRS\\'s website under Tax Code, Regulations and Official Guidance,

the "federal tax law begins with the Internal Revenue Code (IRC), [which was] enacted by Congress in

Title 26 of the United States Code (26 U.S.C.)." The IRC holds the most authoritative value.

Choice "b" is incorrect. According to the IRS\\'s website under Tax Code, Regulations and Official Guidance,

the IRS regulations or "Treasury regulations (26 C.F.R.)-commonly referred to as Federal tax regulations-pick up where the Internal Revenue Code (IRC) leaves off by providing the official interpretation of the IRS by the U.S. Department of Treasury." Regulations give directions on how to apply the law outlined in the Internal Revenue Code. Regulations have the second most force and effect, second only to the IRC. Choice "c" is incorrect. Tax court decisions interpret the Internal Revenue Code. They do not have the authority of the IRC. Choice "d" is incorrect. The reports of IRS agents are used to report on specific taxpayer situations. IRS agents\\' reports apply the Internal Revenue Code, IRS regulations, and other forms of authoritative literature, but they do not hold the value that the IRC, the IRS regulations, or even tax court decisions have.

QUESTION 12

Barkley owns a vacation cabin that was rented to unrelated parties for 10 days during the year for $2,500. The cabin was used personally by Barkley for three months and left vacant for the rest of the year. Expenses for the cabin were as follows:

Real estate taxes $1,000 Maintenance and utilities $2,000

How much rental income (loss) is included in Barkley\\'s adjusted gross income?

A. $0

B. $500

C. $(500)

D. $(1,500)

Correct Answer: A

RULE: If a vacation residence is rented for less than 15 days per year, it is treated as a personal residence. The rental income is excluded from income, and mortgage interest (first or second home) and real estate taxes are allowed as itemized deductions. Depreciation, utilities, and repairs are not deductible.

Choice "a" is correct. Applying the rule above, if a vacation residence is rented for less than 15 days per year, it is treated as a personal residence. The rental income ($2,500 in this case) is excluded from income. A Schedule E is not filed for this property (i.e., no income is reported, the taxes are reported as itemized deductions, and the maintenance and utilities are not deductible), so the effect on AGI is zero. Choice "b" is incorrect. This assumes that the property taxes are reported as itemized deductions but that the rental income ($2,500) less the maintenance and utilities ($2,000) are reported net on Schedule E. Per the above RULE, the rental income is excluded from income, and the maintenance and utilities are not deductible. Choice "c" is incorrect. This assumes that all of the items shown are reported net on the Schedule E-$2,500 - $1,000 - $2,000 = ($500). Per the above RULE, the rental income is excluded from income, the maintenance and utilities are not deductible, and the property taxes are reported on Schedule A as an itemized deduction. Choice "d" is incorrect, per the above rule and discussion.

QUESTION 13

Clark bought Series EE U.S. Savings Bonds after 1989. Redemption proceeds will be used for payment of college tuition for Clark\\'s dependent child. One of the conditions that must be met for tax exemption of accumulated interest on these bonds is that the:

A. Purchaser of the bonds must be the sole owner of the bonds (or joint owner with his or her spouse).

B. Bonds must be bought by a parent (or both parents) and put in the name of the dependent child.

C. Bonds must be bought by the owner of the bonds before the owner reaches the age of 24.

D. Bonds must be transferred to the college for redemption by the college rather than by the owner of the bonds.

Correct Answer: A

Choice "a" is correct. One of the conditions that must be met for tax exemption of accumulated interest on the bonds is that the purchaser of the bonds must be the sole owner of the bonds (or joint owner with his or her spouse). Choice "b" is incorrect. The bonds must be bought and put in the name of the owner or co-owner, not in the name of the dependent child. Choice "c" is incorrect. The owner must be at least 24 years old before the bonds issue date. Choice "d" is incorrect. There is no requirement that the bonds must be transferred to the college for redemption by the college rather than by the owner of the bonds.

QUESTION 14

Smith made a gift of property to Thompson. Smith\\'s basis in the property was $1,200. The fair market value at the time of the gift was $1,400. Thompson sold the property for $2,500. What was the amount of Thompson\\'s gain on the disposition?

A. $0

B. $1,100

C. $1,300

D. $2,500

Correct Answer: C

Choice "c" is correct. The general rule for the basis on gifted property is that the donee receives the property with a rollover cost basis (equal to the donor\\'s basis). An exception exists where the fair market value of the property at the time of the gift is less than the donor\\'s basis. That is not the case in this question; thus, the calculation of the gain on the disposition of the property is:

Amount realized	$2,500
Basis	(1,200)
Gain recognized	$1,300

Choice "a" is incorrect. This choice could be correct if the facts of the question met the exception whereby no gain or loss is recognized when a donee sells gifted property for an amount between the donor\\'s basis and the fair market value at the date of the gift. Choice "b" is incorrect. This choice uses the basis as the fair market value of the property. Fair market value of property at date of death is used as the basis for inherited property, not gifted property. Choice "d" is incorrect. This choice assumes that Thompson\\'s basis is zero. His basis is $1,200 as indicated above.

QUESTION 15

Smith, an individual calendar-year taxpayer, purchased 100 shares of Core Co. common stock for $15,000 on December 15, 1992, and an additional 100 shares for $13,000 on December 30, 1992. On January 3, 1993, Smith sold the shares purchased on December 15, 1992, for $13,000. What amount of loss from the sale of Core\\'s stock is deductible on Smith\\'s 1992 and 1993 income tax returns?

	1992	1993
A.	$0	$0
B.	$0	$2,000
C.	$1,000	$1,000
D.	$2,000	$0

A. Option A

B. Option B

C. Option C

D. Option D

Correct Answer: A

Choice "a" is correct. In 1992, no sale of stock occurred so there would be no loss. In 1993, there is a $2,000 loss realized ($15,000 basis less $13,000 received), but it is not deductible because it is a wash sale. A wash sale occurs when a taxpayer sells stock at a loss and invests in substantially identical stock within 30 days before or after the sale. In this case, Smith reinvested in an additional 100 shares four days prior to selling 100 shares of the same stock at a loss. The $2,000 disallowed loss would, however, increase the basis of the new shares by $2,000.

Choice "b" is incorrect. The $2,000 loss realized in 1993 is disallowed under the wash sale rules.

Choice "c" is incorrect. In 1992, there is no loss since no shares were sold. In 1993, the $2,000 loss is

disallowed under the wash sale rules.

Choice "d" is incorrect. In 1992, there is no possible loss since no shares were sold.