

# CPA-REGULATION<sup>Q&As</sup>

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**QUESTION 1**

During 2001, Adler had the following cash receipts:

Wages	\$18,000
Interest Income from investments in municipal bonds	400
Unemployment compensation	1,500

What is the total amount that must be included in gross income on Adler's 2001 income tax return?

- A. \$18,000
- B. \$18,400
- C. \$19,500
- D. \$19,900

Correct Answer: C

Choice "c" is correct. The wages of \$18,000 and unemployment compensation are both includable in gross income on Adler's 2001 income tax return.

Choice "a" is incorrect. The unemployment compensation must be included in gross income.

Choice "b" is incorrect. Municipal bond interest income is excluded from gross income and the unemployment compensation must be included in gross income.

Choice "d" is incorrect. Municipal bond interest income is excluded from gross income.

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**QUESTION 2**

In 19X4, Smith, a divorced person, provided over one half the support for his widowed mother, Ruth, and his son, Clay, both of whom are U.S. citizens. During 19X4, Ruth did not live with Smith. She received \$9,000 in Social Security benefits. Clay, a 25 year-old full-time graduate student, and his wife lived with Smith. Clay had no income but filed a joint return for 19X4, owing an additional \$500 in taxes on his wife's income. How many exemptions was Smith entitled to claim on his 19X4 tax return?

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

Correct Answer: C

Choice "c" is correct. Smith is entitled to an exemption for himself. He is also entitled to an exemption for his mother Ruth (qualifying relative). Ruth has \$9,000 in Social Security payments during 19X4, but since that is her only income, the Social Security is not taxable, and nontaxable income does not count in calculating whether an exemption can be taken for a dependent. Clay cannot be taken as a dependent because he filed a joint return with his wife. Since the joint return was filed for a purpose other than simply claiming a refund, the joint return prevents Smith from claiming an exemption for Clay. An exemption cannot be taken for Clay's wife because she filed a joint return with Clay. Smith is entitled to two exemptions. Choice "a" is incorrect. Clay cannot be taken as a dependent because he filed a joint return with his wife. Since the joint return was filed for a purpose other than simply claiming a refund, the joint return prevents Smith from claiming an exemption for Clay. An exemption cannot be taken for Clay's wife because she filed a joint return with Clay. Choice "b" is incorrect. Clay cannot be taken as a dependent because he filed a joint return with his wife. Since the joint return was filed for a purpose other than simply claiming a refund, the joint return prevents Smith from claiming an exemption for Clay. An exemption cannot be taken for Clay's wife because she filed a joint return with Clay. Choice "d" is incorrect. Smith is entitled to an exemption for his mother, Ruth. Ruth has \$9,000 in Social Security payments during 19X4, but because that is her only income, the Social Security income is not taxable, and nontaxable income does not count in calculating whether an exemption can be taken for a dependent.

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### QUESTION 3

Which payment(s) is(are) included in a recipient's gross income?

I. Payment to a graduate assistant for a part-time teaching assignment at a university. Teaching is not a requirement toward obtaining the degree.

II.

A grant to a Ph.D. candidate for his participation in a university-sponsored research project for the benefit of the university.

A.

I only.

B.

II only.

C.

Both I and II.

D.

Neither I nor II.

Correct Answer: C

Choice "c" is correct.

I. A payment to a student for a part-time teaching assignment is taxable income just as a payment for any other campus job would be. This is not a scholarship or fellowship. II. There is no exclusion in the tax law for amounts paid to a degree candidate for participation in university-sponsored research.

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### QUESTION 4

Baum, an unmarried optometrist and sole proprietor of Optics, buys and maintains a supply of eyeglasses and frames to sell in the ordinary course of business. In 1999, Optics had \$350,000 in gross business receipts and its year-end inventory was not subject to the uniform capitalization rules. Baum's 1999 adjusted gross income was \$90,000 and Baum qualified to itemize deductions. During 1999, Baum recorded the following information: Business expenses:

Optics cost of goods sold	\$35,000
Optics rent expense	\$28,000
Liability insurance premium on Optics	\$ 5,250
Other expenditures:	
Baum's self-employment tax	\$29,750
Baum's self-employment health insurance	\$ 8,750
Insurance premium on personal residence. In 1999, Baum's home was totally destroyed by fire. The furniture had an adjusted basis of \$14,000 and a fair market value of \$11,000. During 1999, Baum collected \$3,000 in insurance reimbursement and had no casualty gains during the year.	\$ 2,625
Qualified 1999 mortgage interest on a loan to acquire a personal residence	\$52,500
Annual interest on a \$70,000, 5-year home equity loan. The loan was secured by Baum's home, obtained January 2, 1999. The fair market value of the home exceeded the mortgage and the home equity loan by a substantial amount. The proceeds were used to purchase a car for personal use.	\$ 3,500
Points prepaid on January 2, 1999 to acquire the home equity loan	\$ 1,400
Real estate taxes on personal residence	\$ 2,200
Estimated payments of 1999 federal income taxes	\$13,500
Local property taxes on the car value, used exclusively for personal use	\$ 300

What amount should Baum report as 1999 net earnings from self-employment?

- A. \$243,250
- B. \$252,000
- C. \$273,000
- D. \$281,750

Correct Answer: D

Choice "d" is correct. Baum should report \$281,750 as 1999 net earnings from self-employment (line 12 of the Form 1040), calculated as follows:

Gross business receipts	\$350,000
Cost of goods sold	(35,000)
Rent expense	(28,000)
Liability insurance premium	(5,250)
Net earnings on Schedule C	<u>\$281,750</u>

Choices "a", "b", and "c" are incorrect. Self-employment tax and self-employment health insurance expenses are adjustments from total gross income. They are not deducted from self-employment earnings (i.e., not reported net on line 12 of the Form 1040). Note: There are many distracters in this question, all relating to items that are either

deductible as part of itemized deductions or not deductible. Be careful to read the requirement of the question before spending unnecessary time on the question. The statement that Baum's year-end inventory was not subject to the uniform capitalization rules is a distracter as well. There is not enough information given in the facts to apply the rules if he had been subject to them.

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#### QUESTION 5

Hall, a divorced person and custodian of her 12-year old child, filed her 1990 federal income tax return as head of a household. She submitted the following information to the CPA who prepared her 1990 return:

- In 1990, Hall sold an antique that she bought in 1980 to display in her home. Hall paid \$800 for the antique and sold it for \$1,400, using the proceeds to pay a court ordered judgment.

The \$600 gain that Hall realized on the sale of the antique should be treated as:

- A. Ordinary income.
- B. Long-term capital gain.
- C. An involuntary conversion.
- D. A nontaxable antiquities transaction.

Correct Answer: B

Choice "b" is correct. The gain should be treated as a long-term capital gain because the property was held for more than one year and was sold for more than it cost. Choice "a" is incorrect. Because Hall was not in the business of selling antiques, the profit from the sale will be treated as a gain from the disposition of a capital asset, not ordinary income. Choice "c" is incorrect. This transaction does not qualify as an involuntary conversion. In order to be treated as an involuntary conversion, the transaction must result from a condemnation of property or a destruction or loss from theft or casualty. Choice "d" is incorrect. An obvious distracter.

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