CPA-REGULATION$^{Q\&As}$

CPA Regulation

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QUESTION 1

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 2

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 received a $500 security deposit on their rental property in 1994. They are required to return the amount to the tenant.

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

"A" is correct. $0. The security deposit is not taxable income because the Moores are required to return it when the tenant leaves. If the deposit is applied to damages in a later tax year, the portion the Moores retain would be income to them in the year they retain the deposit, and the money they spend to repair the damage would be a deduction to them.

QUESTION 3

The rule limiting the allowability of passive activity losses and credits applies to:

A. Partnerships.

B. S corporations.

C. Personal service corporations.

D. Widely-held C corporations.

Correct Answer: C

Choice "c" is correct. The rule limiting the allowability of passive activity losses and credits applies to personal service corporations. Choice "a" is incorrect. The passive activity limitations apply to the various partners in the partnership as opposed to the partnership itself. Choice "b" is incorrect. The passive activity limitations apply to the various shareholders in the S corporation as opposed to the corporation itself. Choice "d" is incorrect. The passive activity rules do not apply to widely-held C corporations.

QUESTION 4

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 received $10,000, consisting of $5,000 each of principal and interest, when he redeemed a Series EE savings bond in 1994. The bond was issued in his name in 1990 and the proceeds were used to pay for Laura\\'s college tuition. Tom had not elected to report the yearly increases in the value of the bond.

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

"A" is correct. $0. Generally, if a taxpayer does not make an election to accrue interest income from Series EE bonds, the interest is taxable at the time the bonds are cashed. However, an exception applies in this case because Tom Moore meets the criteria (assume he was 24 years or older in 1990). Savings bonds is tax-exempt when:

(1)

It is used to pay for qualified higher-education expenses for the taxpayer, spouse, or dependents;

(2)

There is taxpayer or joint ownership with spouse;

(3)

The taxpayer is age 24 (or over) when the bonds are issued; and

(4)

The bonds are acquired after 1989.

QUESTION 5

Which of the following is subject to the Uniform Capitalization Rules of Code Sec. 263A?

A. Editorial costs incurred by a freelance writer.

B. Research and experimental expenditures.

C. Mine development and exploration costs.

D. Warehousing costs incurred by a manufacturing company with $12 million in annual gross receipts.

Correct Answer: D

Choice "d" is correct. Uniform capitalization rules apply to the following: (1) real or tangible personal property produced by the taxpayer for use in his or her trade or business; (2) real or tangible personal property produced by the taxpayer for sale to his or her customers; and (3) real or tangible personal property acquired by the taxpayer for resale, provided the taxpayer\\'s annual average gross receipts for the preceding three years exceeds $10,000,000. Warehousing costs incurred by a manufacturing company (making inventory for sale to its customers) are subject to the Uniform Capitalization Rules. Further, they are the only item on the list that is real or tangible personal property. In this case, the inventory is not acquired for resale (it is produced by the taxpayer for sale to his or her customers), so the fact that the annual sales are $12,000,000 does not matter in this case. The sales could have been less than $10,000,000 annually, and the Uniform Capitalization Rules would still have applied. Choices "a", "b", and "c" are incorrect, based on the above discussion.