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QUESTION 1

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:

•

The divorce agreement, executed in 1983, provides for Hall to receive \$3,000 per month, of which \$600 is designated as child support. After the child reaches 18, the monthly payments are to be reduced to \$2,400 and are to continue until remarriage or death. However, for the year 1990, Hall received a total of only \$5,000 from her former husband. Hall paid an attorney \$2,000 in 1990 in a suit to collect the alimony owed.

•

In June 1990, Hall's mother gifted her 100 shares of a listed stock. The donor's basis for this stock, which she bought in 1970, was \$4,000, and market value on the date of the gift was \$3,000. Hall sold this stock in July 1990 for \$3,500. The donor paid no gift tax.

•

During 1990, Hall spent a total of \$1,000 for state lottery tickets. Her lottery winnings in 1990 totaled \$200.

•

Hall earned a salary of \$25,000 in 1990. Hall was not covered by any type of retirement plan, but contributed \$2,000 to an IRA in 1990.

•

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.

•

Hall paid the following expenses in 1990 pertaining to the home that she owns: realty taxes, \$3,400; mortgage interest, \$7,000; casualty insurance, \$490; assessment by city for construction of a sewer system, \$910; interest of \$1,000 on a personal, unsecured bank loan, the proceeds of which were used for home improvements. Hall does not rent out any portion of the home.

What amount should be reported in Hall's 1990 return as alimony income?

A. \$36,000

B. \$28,800

C. \$5,000

D. \$0

Correct Answer: D

Choice "d" is correct. None of the payments received should be considered alimony income. Hall would only claim alimony income if total receipts from her former spouse exceeded \$7,200 (the required child support). Rule: In the event of payments consisting of both child support and alimony, child support obligations will be satisfied first.

| | |
|--|------------------|
| Amount designated as monthly child support | \$ 600 |
| Number of months | × 12 |
| Amount of required child support | <u>\$7,200</u> |
| Payments actually received | <u>(\$5,000)</u> |
| Amount of payments considered alimony | <u>\$ -0-</u> |

QUESTION 2

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 3

In the current year Jensen had the following items:

| | |
|---------------------------------------|----------|
| Salary | \$50,000 |
| Inheritance | 25,000 |
| Alimony from ex-spouse | 12,000 |
| Child support from ex-spouse | 9,000 |
| Capital loss on investment stock sale | (6,000) |

What is Jensen's AGI for the current year?

- A. \$44,000
- B. \$59,000
- C. \$62,000
- D. \$84,000

Correct Answer: B

Choice "b" is correct. The question asks for AGI, but all of the items in the list are items of potential gross income. There are no adjustments included in the list; therefore, in this case, AGI is the same as gross income. The calculation is as follows:

| | |
|---------------------------------------|------------------------------|
| Salary | \$50,000 |
| Inheritance | 0 [not taxable] |
| Alimony from ex-spouse | 12,000 |
| Child support from ex-spouse | 0 [not taxable] |
| Capital loss on investment stock sale | (3,000) [maximum deductible] |
| AGI | <u>\$59,000</u> |

Choices "a", "c", and "d" are incorrect, per the above calculation.

QUESTION 4

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.

QUESTION 5

Which one of the following will result in an accruable expense for an accrual-basis taxpayer?

- A. An invoice dated prior to year end but the repair completed after year end.
- B. A repair completed prior to year end but not invoiced.
- C. A repair completed prior to year end and paid upon completion.

D. A signed contract for repair work to be done and the work is to be completed at a later date.

Correct Answer: B

RULE: An accruable expense is one in which the services have been received/performed but have not been paid for by the end of the reporting period.

Choice "b" is correct. The facts indicate that a repair was completed prior to year end but not yet invoiced. If it has not yet been invoiced, it is assumed that it has also not yet been paid for. Therefore, this is a situation in which the repair expense would be accrued at year end. Services have been performed, but they have not been paid for, as they have not even been invoiced yet. Choice "a" is incorrect. If the repair was completed after year end, then the expense is not accruable, as the benefit of the services hasn't been received as of year end. The fact that the repair was invoiced prior to year end does not impact the situation. Choice "c" is incorrect. If a repair was completed and paid for prior to year end, no accrual is appropriate. On the accrual basis, the expense is taken in the year the repair is completed and the benefit is received. In this case, the account payable was also paid in the same year, but this has no effect on the expense. Choice "d" is incorrect. The facts indicate that the work is to be completed at a date later than year end. Therefore, the expense is not accruable at year end, as the benefit of the repair hasn't been received as of year end. It is reasonable that a signed contract for the repair work exists, but this has no effect on the accrual.

QUESTION 6

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 7

In a tax year where the taxpayer pays qualified education expenses, interest income on the redemption of qualified U.S. Series EE Bonds may be excluded from gross income. The exclusion is subject to a modified gross income limitation and a limit of aggregate bond proceeds in excess of qualified higher education expenses. Which of the following is (are) true?

- I. The exclusion applies for education expenses incurred by the taxpayer, the taxpayer's spouse, or any person whom the taxpayer may claim as a dependent for the year.
- II. "Otherwise qualified higher education expenses" must be reduced by qualified scholarships not includible in gross

income.

A. I only.

B. II only.

C. Both I and II.

D. Neither I nor II.

Correct Answer: C

Choice "c" is correct. Interest earned on Series EE bonds issued after 1989 may qualify for exclusion. One requirement is that the interest is used to pay tuition and fees for the taxpayer, spouse, or dependent enrolled in higher education. The interest exclusion is reduced by qualified scholarships that are exempt from tax and other nontaxable payments received for educational expenses (other than gifts and inheritances).

QUESTION 8

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 9

Porter was unemployed for part of the year. Porter received \$35,000 of wages, \$4,000 from a state unemployment compensation plan, and \$2,000 from his former employer's company-paid supplemental unemployment benefit plan. What is the amount of Porter's gross income?

A. \$35,000

B. \$37,000

C. \$39,000

D. \$41,000

Correct Answer: D

RULE: Gross income includes all income unless it is specifically excluded in the tax code.

Choice "d" is correct. Wages and all unemployment compensation are not excluded from being taxable; therefore, there are included in the taxpayer's gross income for tax purposes.

| | |
|---|-----------------|
| Wages received | \$35,000 |
| State unemployment compensation | 4,000 |
| Employer's unemployment compensation plan | <u>2,000</u> |
| | <u>\$41,000</u> |

Choice "a" is incorrect. All forms of unemployment compensation are included as part of gross income. Choice "b" is incorrect. The \$4,000 of state unemployment compensation received is included as part of gross income. Choice "c" is incorrect. The \$2,000 of his former employer's company-paid supplemental unemployment benefit plan is included as part of gross income.

QUESTION 10

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 11

On December 1, 1992, Michaels, a self-employed cash basis taxpayer, borrowed \$100,000 to use in her business. The loan was to be repaid on November 30, 1993. Michaels paid the entire interest of \$12,000 on December 1, 1992. What amount of interest was deductible on Michaels' 1993 income tax return?

- A. \$12,000
- B. \$11,000
- C. \$1,000
- D. \$0

Correct Answer: B

Choice "b" is correct. Prepaid interest must be prorated over the time for which payment is made. This is true for both cash and accrual basis taxpayers. The loan is for 1 month in 1992 and 11 months in 1993. Therefore, 1/12 of the interest is deductible in 1992 and 11/12, or \$11,000 is deductible in 1993.

Choices "a", "c", and "d" are incorrect. Prepaid interest must be prorated over the time for which payment is made. This is true for both cash and accrual basis taxpayers.

QUESTION 12

Under the uniform capitalization rules applicable to property acquired for resale, which of the following costs should be capitalized with respect to inventory if no exceptions are met?

| | <u>Marketing costs</u> | <u>Off-site storage costs</u> |
|----|------------------------|-------------------------------|
| A. | Yes | Yes |
| B. | Yes | No |
| C. | No | No |
| D. | No | Yes |

A. Option A

B. Option B

C. Option C

D. Option D

Correct Answer: D

Choice "d" is correct. Under the uniform capitalization rules, purchasers of inventory for resale may deduct their marketing costs but must capitalize their off-site storage costs.

Choices "a", "b", and "c" are incorrect. Marketing costs are deductible, but off-site storage must be capitalized.

QUESTION 13

Dale received \$1,000 in 1990 for jury duty. In exchange for regular compensation from her employer during the period of jury service, Dale was required to remit the entire \$1,000 to her employer in 1990. In Dale's 1990 income tax return, the \$1,000 jury duty fee should be:

A. Claimed in full as an itemized deduction.

B. Claimed as an itemized deduction to the extent exceeding 2% of adjusted gross income.

C. Deducted from gross income in arriving at adjusted gross income.

D. Included in taxable income without a corresponding offset against other income.

Correct Answer: C

Choice "c" is correct. The \$1,000 jury duty fee that was required to be remitted to the employer may be deducted from gross income in arriving at adjusted gross income. This, in effect, washes out the \$1,000 income she will have to report as part of gross income for the jury duty fees paid to her. Choices "a" and "b" are incorrect. The amount remitted is allowed as an adjustment in arriving at AGI, not as an itemized deduction. Choice "d" is incorrect. A corresponding offset is allowed against other income as an adjustment in arriving at AGI.

QUESTION 14

In which of the following situations may taxpayers file as married filing jointly?

- A. Taxpayers who were married but lived apart during the year.
- B. Taxpayers who were married but lived under a legal separation agreement at the end of the year.
- C. Taxpayers who were divorced during the year.
- D. Taxpayers who were legally separated but lived together for the entire year.

Correct Answer: A

RULE: In order to file a joint return, the parties must be MARRIED at the end of the year. Exception: If the parties are married but are LEGALLY SEPARATED under the laws of the state in which they reside, they cannot file a joint return (they will file either under the single or head of household filing status).

Choice "a" is correct. Per the above rule, taxpayers who are married but lived apart during the year are allowed to file a joint return for the year. The fact that they did not live together during the year has no bearing on the issue. Choice "b" is incorrect. Per the above rule, taxpayers who are married but lived under a legal separation agreement at the end of the year may not file a joint return. They will generally file either under the single or head of household filing status. Choice "c" is incorrect. Per the above rule, taxpayers who were divorced during the year may not file a joint return together, as they are not married at the end of the year. [Note, however, that they may become married again in the year and file a joint return with the new spouse.] Choice "d" is incorrect. Per the above rule, taxpayers who were legally separated but lived together for the entire year may not file a joint return. They will generally file either under the single or head of household filing status.

QUESTION 15

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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