



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

CPA Regulation

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**QUESTION 1**

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 2

Ryan, age 57, is single with no dependents. On July 1, 1997, Ryan's principal residence was sold for the net amount of \$500,000 after all selling expenses. Ryan bought the house in 1963 and occupied it until sold. On the date of sale, the house had a basis of \$180,000. Ryan does not intend to buy another residence. What is the maximum exclusion of gain on sale of the residence that may be claimed in Ryan's 1997 income tax return?

- A. \$320,000
- B. \$250,000
- C. \$125,000
- D. \$0

Correct Answer: B

Choice "b" is correct. \$250,000 maximum exclusion from taxable income.

Rule: An individual may exclude from income up to \$250,000 gain provided that the property was the taxpayer's primary residence for 2 of the last 5 years. Married taxpayers may exclude gains up to \$500,000.

Choice "a" is incorrect. \$320,000. Ryan, age 57, was not married. Thus, his exclusion was limited to \$250,000.

Choice "c" is incorrect. The \$125,000 exclusion was old law and eliminated for sales after 5/6/97.

Choice "d" is incorrect, per the above rule.

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## QUESTION 3

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.

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#### QUESTION 4

Conner purchased 300 shares of Zinco stock for \$30,000 in 1980. On May 23, 1994, Conner sold all the stock to his daughter Alice for \$20,000, its then fair market value. Conner realized no other gain or loss during 1994. On July 26, 1994, Alice sold the 300 shares of Zinco for \$25,000.

What was Alice's recognized gain or loss on her sale?

A. \$0

B. \$5,000 long-term gain.

C. \$5,000 short-term loss.

D. \$5,000 long-term loss.

Correct Answer: A

Choice "a" is correct. Alice has a realized gain of \$5,000 on the transaction: \$25,000 sales price less \$20,000 purchase price. However, she can reduce the gain, but not below zero, by the amount of loss her father could not deduct on the sale to her. Thus, Alice can reduce her gain by up to \$10,000, but not below zero. Here, the gain is \$5,000, so it is reduced to zero. Conner should have sold the stock in the open market so that he could deduct the entire loss. Alice could then have purchased the stock in the open market. Choice "b" is incorrect. \$5,000 is Alice's realized long-term gain on the sale. However, she can reduce the gain, but not below zero, by the amount of loss her father could not deduct on the sale to her. Choice "c" is incorrect. Alice has a realized gain of \$5,000 on the sale. However, since she is related to Conner, her holding period includes his holding period. Therefore, her realized gain is long-term. In addition, she can reduce the gain, but not below zero, by the amount of loss her father could not deduct on the sale to her. Choice "d" is incorrect. Alice can reduce the gain by the amount of loss her father could not deduct on the sale to her. However, she cannot reduce the gain below zero.

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#### QUESTION 5

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.

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