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**QUESTION 1**

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

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

A. Option A

B. Option B

C. Option C

D. Option D

Correct Answer: A

Choice "a" is correct. Direct material, direct labor, and factory overhead (applicable indirect costs) are capitalized with respect to inventory under the uniform capitalization rules for property acquired for resale.

Applicable indirect costs include depreciation and amortization, insurance, supervisory wages, utilities, spoilage and scrap, design expenses, repair and maintenance and rental of equipment and facilities (including offsite storage), some administrative costs, costs of bonus and other incentive plans, and indirect supplies and other materials (including repackaging costs).

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

QUESTION 2

During 1993 Kay received interest income as follows:

On U.S. Treasury certificates \$4,000 On refund of 1991 federal income tax 500

The total amount of interest subject to tax in Kay's 1993 tax return is:

A. \$4,500

B. \$4,000

C. \$500



D. \$0

Correct Answer: A

Choice "a" is correct. Interest income from U.S. obligations is generally taxable. Interest income on a federal tax refund is taxable, even though the refund itself is not taxed.

Choice "b" is incorrect. Interest income on a federal tax refund is taxable, even though the refund itself is not taxed.

Choice "c" is incorrect. Interest income from U.S. obligations is generally taxable.

Choice "d" is incorrect. Interest income from U.S. obligations is generally taxable. Interest income on a federal tax refund is taxable, even though the refund itself is not taxed.

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. In 1994, Joan received \$3,500 as beneficiary of the death benefit, which was provided by her brother's employer. Joan's brother did not have a nonforfeitable right to receive the money while living.

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. Life insurance proceeds received by reason of the death of the insured are not taxable income to the recipient.

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. In 1994, Joan received \$1,300 in unemployment compensation benefits. Her employer made a \$100 contribution to the unemployment insurance fund on her behalf.

- 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: F

"F" is correct. \$1,300. Unemployment compensation benefits are fully taxable (when received by the employee), but contributions made by the employer to the insurance fund are not taxable.

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.

QUESTION 6

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 7

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.

QUESTION 8

On December 1, 1997, Krest, a self-employed cash basis taxpayer, borrowed \$200,000 to use in her business. The loan was to be repaid on November 30, 1998. Krest paid the entire interest amount of \$24,000 on December 1, 1997. What amount of interest was deductible on Krest's 1997 income tax return?

- A. \$0
- B. \$2,000
- C. \$22,000
- D. \$24,000

Correct Answer: B

Choice "b" is correct. Cash basis taxpayers deduct interest in the year paid or the year to which the interest relates, whichever is later. Even though all of the interest on this loan was paid on December 1, 1997, only the interest relating to December 1997 can be deducted in 1997. The question does not give an interest rate, but because the loan is to be repaid in a lump sum at maturity, 1/12 of the interest, or \$2,000 applies to each month. Choice "a" is incorrect. Because \$2,000 of the interest relates to 1997, this amount is deductible in 1997. Choice "c" is incorrect. This is the amount that cannot be deducted until 1998, the year to which the interest relates. Be sure to read questions like this very carefully, because if you had simply misread the question as seeking the amount deductible in 1998, you would get the question wrong despite understanding the rule. Choice "d" is incorrect. Cash basis taxpayers can deduct interest in the year paid



or the year to which the interest relates, whichever is later, thus 11 months of the interest will not be deductible until 1998.

QUESTION 9

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.

QUESTION 10

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 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

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:

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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.

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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 13

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 14

Cobb, an unmarried individual, had an adjusted gross income of \$200,000 in 1990 before any IRA deduction, taxable social security benefits, or passive activity losses. Cobb incurred a loss of \$30,000 in 1990 from rental real estate in which he actively participated. What amount of loss attributable to this rental real estate can be used in 1990 as an offset against income from nonpassive sources?



- A. \$0
- B. \$12,500
- C. \$25,000
- D. \$30,000

Correct Answer: A

Choice "a" is correct. Cobb may not use any of the loss attributable to his rental real estate as an offset against income from nonpassive sources in 1990 because he does not qualify for the "Mom and Pop" exception. Under this exception, up to \$25,000 of passive losses and the deduction equivalent of tax credits that are attributable to rental real estate may be used as an offset against income from nonpassive sources. This \$25,000 allowance is reduced, but not below zero, by 50% of the amount by which the individual's modified AGI exceeds \$100,000. The \$25,000 is therefore completely phased out when modified AGI reaches \$150,000. Because Cobb's AGI was \$200,000, he did not qualify for the exception. Choices "b", "c", and "d" are incorrect. Rental activities are passive activities and generally are not allowed to use any of the loss attributable to the rental activity to offset any income produced from nonpassive sources. There is a limited exception in the case of losses from rental real estate in which the taxpayer actively participates, but Cobb did not qualify for it.

QUESTION 15

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 \$8,400 in gross receipts from their rental property during 1994. The expenses for the residential rental property were:

- 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: I

"I" is correct. \$2,500. Rental activity net income is reported on page one; the gross income (\$8,400) is fully reportable; and all deductions listed (total = \$5,900) are fully deductible for a net of \$2,500.

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