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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:

- 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 2

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 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 1992, Joan received an acre of land as an inter-vivos gift from her grandfather. At the time of the gift, the land had a fair market value of \$50,000. The grandfather's adjusted basis was \$60,000. Joan sold the land in 1994 to an unrelated third party for \$56,000.

- 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. Property received by gift has two bases: one for computing gain and another for computing loss. Joan's basis for gain is the grandfather's adjusted basis (\$60,000). Using this basis for gain, Joan has a loss of: $\$56,000 - \$60,000 = (\$4,000 \text{ loss})$. Joan's basis for loss is the fair market value of the property on the date of the gift (\$50,000). Using this basis for loss, Joan has a gain of: $\$56,000 - \$50,000 = \$6,000 \text{ gain}$. In this unusual situation, Joan has neither a gain nor a loss, although the transaction must be reported.

QUESTION 4

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 5

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.