CPA-REGULATION[Q&As]

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QUESTION 1

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 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 gain. In this unusual situation, Joan has neither a gain nor a loss, although the transaction must be reported.

QUESTION 2

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?

	Repackaging costs	Off-site storage costs
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 3

Parker, whose spouse died during the preceding year, has not remarried. Parker maintains a home for a dependent child. What is Parker\\'s most advantageous filing status?

A. Single.

B. Head of household.

C. Married filing separately.

D. Qualifying widow(er) with dependent child.

Correct Answer: D

Choice "d" is correct. A qualifying widow (er) is a taxpayer who may use the joint tax return standard deduction and rates (but not the exemption for the deceased spouse) for each of two taxable years following the year of death of his or her spouse, unless he or she remarries. The surviving spouse must maintain a household that, for the whole entire taxable year, was the principal place of abode of a son, stepson, daughter, or stepdaughter (whether by blood or adoption). The surviving spouse must also be entitled to a dependency exemption for such individual. Parker may file as a qualifying widow (er) since her spouse died in the previous tax year, she did not remarry and she maintained a home for a dependent child. Since, qualifying widow (er) is the most advantageous status and Parker qualifies, Parker would file as a qualifying widow (er). Choice "a" is incorrect. Even though Parker would qualify as single, filing single would give Parker a high tax liability than the qualifying widow (er) status and therefore is not most advantageous. Choice "b" is incorrect. Parker would not qualify as head of household for the first two years after the death of Parker\\'s spouse because one of the requirements for Head of Household status is that the taxpayer is NOT a surviving spouse. (Also, note that the likely reason for this requirement is that filing as Head of Household status would give the qualifying surviving spouse taxpayer a higher tax liability than the Qualifying Widow(er) status, which would be less advantageous.) Choice "c" is incorrect. Parker would not qualify to file married filing separately.

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

Allen owns 100 shares of Prime Corp., a publicly-traded company, which Allen purchased on January 1, 2001, for $10,000. On January 1, 2003, Prime declared a 2-for-1 stock split when the fair market value (FMV) of the stock was $120 per share. Immediately following the split, the FMV of Prime stock was $62 per share. On February 1, 2003, Allen had his broker specifically sell the 100 shares of Prime stock received in the split when the FMV of the stock was $65 per share. What amount should Allen recognize as long-term capital gain income on his Form 1040, U.S. Individual Income Tax Return, for 2003?

A. $300

B. $750

C. $1,500 D. $2,000

Correct Answer: C

Choice "c" is correct. The receipt of a nontaxable stock dividend will require the shareholder to spread the basis of his original shares over both the original shares and the new shares received, resulting in the same total basis but a lower basis per share of stock helD. Therefore, Allen\\'s total basis remains the same, $10,000, but is now split between 200 shares (a 2-for-1 split and he originally owned 100 shares). Therefore, his basis per share goes from $100/share ($10,000/100) to $50/share ($10,000/200). Consequently, his basis in the 100 shares sold is 100 x $50 = $5,000. Calculate his gain as follows:

Amount realized ($65 x 100)	$6,500
Adjusted Basis (5,000 - calculated above)	(5,000)
Realized & recognized gain	$1,500

Choices "a", "b", and "d" are incorrect.

QUESTION 6

John and Mary were divorced in 1991. The divorce decree provides that John pay alimony of $10,000 per year, to be reduced by 20% on their child\\'s 18th birthday. During 1992, John paid $7,000 directly to Mary and $3,000 to Spring College for Mary\\'s tuition. What amount of these payments should be reported as income in Mary\\'s 1992 income tax return?

A. $5,600

B. $8,000

C. $8,600

D. $10,000

Correct Answer: B

Choice "b" is correct. Alimony would be income to Mary while child support would not. Funds qualify as

child support only if 1) a specific amount is fixed or is contingent on the child\\'s status (e.g., reaching a

certain age), 2) it is paid solely for the support of minor children, and 3) it is payable by decree, instrument

or agreement. The actual use of the funds is irrelevant to the issue. In this case, $2,000 (20% ?$10,000)

qualifies as child support. The other $8,000 is alimony, which would be income to Mary.

Choice "a" is incorrect. Take 80% of the $10,000 paid, not 80% of the $7,000 received by Mary.

Choice "c" is incorrect. Only $8,000 would be alimony per the divorce decree (80% ?$10,000).

Choice "d" is incorrect. The 20% reduction when the child turns 18 makes 20% of the $10,000 payment, or

$2,000, child support, which is nontaxable to Mary.

QUESTION 7

Under a $150,000 insurance policy on her deceased father\\'s life, May Green is to receive $12,000 per year for 15 years. Of the $12,000 received in 1987, the amount subject to income tax is:

A. $0

B. $1,000

C. $2,000

D. $12,000

Correct Answer: C

Choice "c" is correct. $2,000.

Death benefit	$150,000
Amount received in 1987	$ 12,000
Less: Return of principal ($150,000 ÷ 15 years)	(10,000)
Taxable interest	$ 2,000

QUESTION 8

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	2,000
	$41,000

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 9

Fred Berk bought a plot of land with a cash payment of $40,000 and a mortgage of $50,000. In addition, Berk paid $200 for a title insurance policy. Berk\\'s basis in this land is:

A. $40,000

B. $40,200

C. $90,000

D. $90,200

Correct Answer: D

Choice "d" is correct. $90,200 is Berk\\'s basis in the land.

Rule: The basis of the property acquired will be the property\\'s cost consisting of the amount of cash paid

plus any amount of related debt assumed. Cost will be adjusted to reflect any additional costs incurred in

purchasing the property.

Cash payment	$40,000
Related debt	50,000
Purchase price	$90,000
Add: Cost of title policy	200
Total basis in the land	$90,200

Choices "a", "b", and "c" are incorrect, per the above rule.

QUESTION 10

Freeman, a single individual, reported the following income in the current year:

Guaranteed payment from services rendered to a partnership $50,000 Ordinary income from a S corporation $20,000

What amount of Freeman\\'s income is subject to self-employment tax?

A. $0

B. $20,000

C. $50,000

D. $70,000

Correct Answer: C

Choice "c" is correct. Guaranteed payments are reasonable compensation paid to a partner for services rendered (or use of capital) without regard to his ratio of income. Earned compensation is subject to selfemployment tax. Payments not guaranteed are merely another way to distribute partnership profits. The ordinary income reported from an S corporation are taxable income to the individual or their own individual tax return but is not subject to self-employment tax. The ordinary income reported from a partnership may be subject to self-employment tax (if to a general partner).

QUESTION 11

Doris and Lydia are equal partners in the capital and profits of Agee and Nolan, but are otherwise unrelated. The following information pertains to 300 shares of Mast Corp. stock sold by Lydia to Agee and Nolan:

Year of purchase	1980
Year of sale	1988
Basis (cost)	$9,000
Sales price (equal to fair market value)	$4,000

The amount of long-term capital loss that Lydia realized in 1988 on the sale of this stock was:

A. $5,000

B. $3,000

C. $2,500

D. $0

Correct Answer: A

Choice "a" is correct. $5,000 long term capital loss "realized" in 1988 by Lydia. Be careful, and always check the question being asked. In this case, the question is how much of a capital loss Lydia realized in 1988.

Sales price (FMV)	$4,000
Basis (cost)	(9,000)
Loss realized	(5,000)

Choice "b" is incorrect. $3,000 represents the portion of the $5,000 realized loss that would currently be recognized unless there were additional capital transactions resulting in gains. Remember that the deduction for capital losses for an individual is limited to $3,000 each year. Choice "c" is incorrect. $2,500 represents the pre-1986 portion of the $5,000 realized loss that would have given rise to a recognized loss. Pre-1986 law required $2 of net long term loss to give the benefit of $1 of tax deduction. Current law gives a dollar-for-dollar deduction limited to $3,000 in any year. Choice "d" is incorrect. $0 would have been the amount of loss recognized if Lydia owned more than a 50% interest in the partnership. Losses realized on transactions between a partnership and a partner owning more than a 50% interest are not deductible as the parties would be considered related and any realized loss would be disallowed.

QUESTION 12

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 13

Smith made a gift of property to Thompson. Smith\\'s basis in the property was $1,200. The fair market value at the time of the gift was $1,400. Thompson sold the property for $2,500. What was the amount of Thompson\\'s gain on the disposition?

A. $0

B. $1,100

C. $1,300

D. $2,500

Correct Answer: C

Choice "c" is correct. The general rule for the basis on gifted property is that the donee receives the property with a rollover cost basis (equal to the donor\\'s basis). An exception exists where the fair market value of the property at the time of the gift is less than the donor\\'s basis. That is not the case in this question; thus, the calculation of the gain on the disposition of the property is:

Amount realized	$2,500
Basis	(1,200)
Gain recognized	$1,300

Choice "a" is incorrect. This choice could be correct if the facts of the question met the exception whereby no gain or loss is recognized when a donee sells gifted property for an amount between the donor\\'s basis and the fair market value at the date of the gift. Choice "b" is incorrect. This choice uses the basis as the fair market value of the property. Fair market value of property at date of death is used as the basis for inherited property, not gifted property. Choice "d" is incorrect. This choice assumes that Thompson\\'s basis is zero. His basis is $1,200 as indicated above.

QUESTION 14

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 15

On February 1, 1993, Hall learned that he was bequeathed 500 shares of common stock under his father\\'s will. Hall\\'s father had paid $2,500 for the stock in 1990. Fair market value of the stock on February 1, 1993, the date of his father\\'s death, was $4,000 and had increased to $5,500 six months later. The executor of the estate elected the alternate valuation date for estate tax purposes. Hall sold the stock for $4,500 on June 1, 1993, the date that the executor distributed the stock to him. How much income should Hall include in his 1993 individual income tax return for the inheritance of the 500 shares of stock, which he received from his father\\'s estate?

A. $5,500

B. $4,000

C. $2,500 D. $0

Correct Answer: D

Choice "d" is correct. There is no income tax on the value of inherited property. The gain on the sale is the difference between the sales price of $4,500 and Hall\\'s basis. Hall\\'s basis is the alternate valuation elected by the executor. This is the value 6 months after date of death or date distributed if before 6 months. The property was distributed 4 months after death and the value that day ($4,500) is used for the basis. $4,500

-$4,500 = 0.

Choice "a" is incorrect. There is no income tax on the value of inherited property.

Choice "b" is incorrect. This is the basis of the stock if the alternate date had not been used. Heirs are not

taxed on inheritances. The income or loss results when inherited property is sold. Choice "c" is incorrect.

There is no income tax on the value of inherited property. The gain on the sale is the difference between

the sales price of $4,500 and Hall\\'s basis. Hall\\'s basis is the alternate valuation elected by the executor.