

Regulation 1
Class Questions

1. CPA-01404

Which of the following is (are) among the requirements to enable a taxpayer to be classified as a "qualifying widow(er)"?

- I. A dependent has lived with the taxpayer for six months.
 - II. The taxpayer has maintained the cost of the principal residence for six months.
- a. I only.
 - b. II only.
 - c. Both I and II.
 - d. Neither I nor II.

CPA-01404

Choice "d" is correct. The requirements that enable a taxpayer to be classified as a "qualifying widow(er)" are:

- 1) The taxpayer's spouse died in one of the two previous years and the taxpayer did not remarry in the current tax year,
- 2) The taxpayer has a child who can be claimed as a dependent,
- 3) This child lived in the taxpayer's home for all of the current tax year,
- 4) The taxpayer paid over half the cost of keeping up a home for the child,
- 5) The taxpayer could have filed a joint return in the year the spouse died.

2. CPA-01421

Joe and Barb are married, but Barb refuses to sign a 1992 joint return. On Joe's separate 1992 return, an exemption may be claimed for Barb if:

- a. Barb was a full-time student for the entire 1992 school year.
- b. Barb attaches a written statement to Joe's income tax return, agreeing to be claimed as an exemption by Joe for 1992.
- c. Barb was under the age of 19.
- d. Barb had no gross income and was not claimed as another person's dependent in 1992.

CPA-01421

Choice "d" is correct. If a married individual files a separate return, a personal exemption may be claimed for his or her spouse if the spouse has no gross income and is not claimed as a dependent of another taxpayer.

Choice "a" is incorrect. The spouse does not have to be a full-time student.

Choice "b" is incorrect. The wife does not have to attach a written statement agreeing to be claimed by her husband.

Choice "c" is incorrect. The spouse does not have to be under the age of 19.

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3. CPA-01415

Jim and Kay Ross contributed to the support of their two children, Dale and Kim, and Jim's widowed parent, Grant. For 20X7, Dale, a 19-year old full-time college student, earned \$4,500 as a baby-sitter. Kim, a 23-year old bank teller, earned \$12,000. Grant received \$5,000 in dividend income and \$4,000 in nontaxable Social Security benefits. Grant and Kim are U.S. citizens and were over one-half supported by Jim and Kay, but neither of the two currently reside with Jim and Kay. Dale's main place of residence is with Jim and Kay, and he is currently on a temporary absence to attend school. How many exemptions can Jim and Kay claim on their 20X7 joint income tax return?

- a. Two
- b. Three
- c. Four
- d. Five

CPA-01415

Choice "b" is correct. Taxpayers are now entitled to an exemption for each qualifying child and qualifying relative (two tests are "CARES" or "SUPPORT"). For Dale, he does meet the residency requirement because there is an exception for a temporary absence while attending school. Therefore, he is a qualifying child under the CARES test. Kim does not qualify as a qualifying child (CARES test) because, although she is under age 24, she is not a full-time student. Therefore, the income limitations of the SUPPORT test apply, and she does not qualify under that test either. Likewise, Grant's taxable income of \$5,000 exceeds the minimum. Thus, 3 total exemptions can be claimed (Jim, Kay, and Dale).

4. CPA-01609

Perle, a dentist, billed Wood \$600 for dental services. Wood paid Perle \$200 cash and built a bookcase for Perle's office in full settlement of the bill. Wood sells comparable bookcases for \$350. What amount should Perle include in taxable income as a result of this transaction?

- a. \$0
- b. \$200
- c. \$550
- d. \$600

CPA-01609

Choice "c" is correct. The \$200 cash received plus the \$350 fair market value of the bookcase received must be included in income by Perle, for a total of \$550. The income is based on the value in money or fair market value of property received by Perle, not the \$600 billed.

Choice "a" is incorrect. Perle must report taxable income as a result of this transaction.

Choice "b" is incorrect. The \$350 fair market value of the bookcase received is also income for Perle.

Choice "d" is incorrect. The income is based on the total value received by Perle, not the \$600 billed.

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5. CPA-01610

Charles and Marcia are married cash-basis taxpayers. In 20X8, they had interest income as follows:

- \$500 interest on federal income tax refund.
- \$600 interest on state income tax refund.
- \$800 interest on federal government obligations.
- \$1,000 interest on state government obligations.

What amount of interest income is taxable on Charles and Marcia's 20X8 joint income tax return?

- a. \$500
- b. \$1,100
- c. \$1,900
- d. \$2,900

CPA-01610

Choice "c" is correct. The \$500 interest on federal income tax refund, the \$600 interest on state income tax refund, and the \$800 interest on federal government obligations are taxable, for a total of \$1,900. The \$1,000 interest on *state* government obligations is normally not taxable.

Choice "a" is incorrect. The \$600 interest on state income tax refund and the \$800 interest on federal government obligations is also taxable.

Choice "b" is incorrect. The \$800 interest on federal government obligations is also taxable.

Choice "d" is incorrect. The \$1,000 interest on *state* government obligations is normally not taxable.

6. CPA-01636

Clark filed Form 1040EZ for the 20X8 taxable year. In July 20X9, Clark received a state income tax refund of \$900 plus interest of \$10, for overpayment of 20X8 state income tax. What amount of the state tax refund and interest is taxable in Clark's 20X9 federal income tax return?

- a. \$0
- b. \$10
- c. \$900
- d. \$910

CPA-01636

Choice "b" is correct. Except for interest from state and local government bonds, interest income is fully taxable, so the \$10 is included in income. Filing Form 1040EZ means that Clark did not itemize in the prior year, and therefore, did not deduct any state income taxes last year. Under the tax benefit rule, the refund is not taxable this year since Clark did not deduct the tax last year.

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7. CPA-01433

Which of the following conditions must be present in a post-1984 divorce agreement for a payment to qualify as deductible alimony?

- I. Payments must be in cash or its equivalent.
 - II. The payments must end at the recipient's death.
- a. I only.
 - b. II only.
 - c. Both I and II.
 - d. Neither I nor II.

CPA-01433

Choice "c" is correct. Among the requirements for payments to be classified as alimony are the following two:

- 1. Payment must be in cash or its equivalent.
- 2. Payments cannot extend beyond the death of the payee-spouse.

Note: The requirements for payments to be considered alimony (income) are the same as for payments to be alimony (deductions).

8. CPA-01438

Which of the following costs is **not** included in inventory under the Uniform Capitalization rules for goods manufactured by the taxpayer?

- a. Research.
- b. Warehousing costs.
- c. Quality control.
- d. Taxes excluding income taxes.

CPA-01438

Choice "a" is correct. Uniform Capitalization rules provide guidelines with respect to capitalizing or expensing certain costs. With regard to inventory, direct materials, direct labor, and factory overhead should be capitalized as part of the cost of inventory. Warehousing costs, quality control and taxes, excluding income taxes, are all considered factory overhead items. The research should be expensed.

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9. CPA-01472

Baker, a sole proprietor CPA, has several clients that do business in Spain. While on a four-week vacation in Spain, Baker took a five-day seminar on Spanish business practices that cost \$700. Baker's round-trip airfare to Spain was \$600. While in Spain, Baker spent an average of \$100 per day on accommodations, local travel, and other incidental expenses, for total expenses of \$2,800. What amount of educational expense can Baker deduct on Form 1040 Schedule C, "Profit or Loss From Business"?

- a. \$700
- b. \$1,200
- c. \$1,800
- d. \$4,100

CPA-01472

Choice "b" is correct. Baker can deduct \$1,200 as educational expenses on Baker's Form 1040 Schedule C, calculated as follows:

Direct educational expenses	\$ 700 [cost of the course]
Daily expenses for 5-day seminar	<u>500</u> [\$100 per day × 5]
Total educational expenses	<u>\$1,200</u>

Rule: If foreign travel is primarily personal in nature (e.g., a vacation), none of the travel expenses (e.g., round trip airfare) incurred will be allowable business deductions, even if the taxpayer was involved in business activities while in the foreign country.

Note: It does not appear that the examiners are attempting to trick candidates on the classification of the business expenses as travel or educational. It appears that the purpose of the question is to test the candidate's ability to recognize when expenses are deductible and when they are not deductible business expenses.

Choice "a" is incorrect, as the expenses for the 5-day period Baker attended the seminar were directly related to being in Spain for the additional period of time and are allowable business deductions.

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

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10. CPA-01614

Nare, an accrual-basis taxpayer, owns a building which was rented to Mott under a ten-year lease expiring August 31, 1998. On January 2, 1992, Mott paid \$30,000 as consideration for cancelling the lease. On November 1, 1992, Nare leased the building to Pine under a five-year lease. Pine paid Nare \$10,000 rent for the two months of November and December, and an additional \$5,000 for the last month's rent. What amount of rental income should Nare report in its 1992 income tax return?

- a. \$10,000
- b. \$15,000
- c. \$40,000
- d. \$45,000

CPA-01614

Choice "d" is correct. Prepaid rent is income when received even for an accrual-basis taxpayer. The \$30,000 received as consideration for cancelling the lease is in substitution for rental payments and is thus rental income. The \$5,000 prepaid for the last month's rent is also rental income.

Choice "a" is incorrect. The \$30,000 received as consideration for cancelling the lease is in substitution for rental payments and is thus rental income. The \$5,000 prepaid for the last month's rent is also rental income.

Choice "b" is incorrect. The \$30,000 is in substitution of rental payments and is thus rental income.

Choice "c" is incorrect. The \$5,000 prepaid for the last month's rent would also be rental income.

11. CPA-01571

With regard to the inclusion of social security benefits in gross income, for the 20X8 tax year, which of the following statements is correct?

- a. The social security benefits in excess of modified adjusted gross income are included in gross income.
- b. The social security benefits in excess of one half the modified adjusted gross income are included in gross income.
- c. Eighty-five percent of the social security benefits is the maximum amount of benefits to be included in gross income.
- d. The social security benefits in excess of the modified adjusted gross income over a threshold amount are included in gross income.

CPA-01571

Choice "c" is correct. For tax years after 1993, the amount of social security benefits that is taxed is dependent on whether the combined income (AGI plus interest on tax-exempt bonds and 50% of the social security benefits) is greater than a threshold amount. If the combined income is less than the threshold, the amount taxed is the lesser of 1) 50% of the benefits or 2) 50% of the excess of the combined income over the threshold. If the combined income is greater than the threshold, the amount taxed is the lesser of 1) amount calculated above plus 85% of the excess of the combined income over the threshold or 2) 85% of the benefits. Thus, 85% of the benefits is the maximum amount of benefits that may be included in gross income.

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12. CPA-01482

Klein, a master's degree candidate at Briar University, was awarded a \$12,000 scholarship from Briar in 20X8. The scholarship was used to pay Klein's 20X8 university tuition and fees. Also in 20X8, Klein received \$5,000 for teaching two courses at a nearby college. What amount is includible in Klein's 20X8 gross income?

- a. \$0
- b. \$5,000
- c. \$12,000
- d. \$17,000

CPA-01482

Choice "b" is correct. Scholarships are nontaxable for degree seeking students to the extent that the proceeds are spent on tuition, fees, books and supplies. The \$5,000 for teaching courses is taxable compensation for services delivered.

Choice "a" is incorrect. The \$5,000 for teaching courses is taxable compensation for services delivered.

Choice "c" is incorrect. The scholarship is not taxable because Klein is a degree seeking student and used the proceeds for tuition and fees. Furthermore, the \$5,000 for teaching courses is taxable compensation for services delivered.

Choice "d" is incorrect. The scholarship is not taxable because Klein is a degree seeking student and used the proceeds for tuition and fees.

13. CPA-01442

During 20X9, Ash had the following cash receipts:

Wages	\$13,000
Interest income from U.S. Treasury bonds	350
Workers' compensation following a job related injury	8,500

What is the total amount that must be included in gross income on Ash's 20X9 income tax return?

- a. \$13,000
- b. \$13,350
- c. \$21,500
- d. \$21,850

CPA-01442

Choice "b" is correct. The total amount that must be included in gross income is \$13,350 (\$13,000 in wages plus \$350 in interest income on U.S. Treasury bonds).

Rule: Wages and interest on U.S. Treasury bonds are includible in gross income and must be reported as part of gross income on a taxpayer's income tax return.

Rule: Damages for personal injury (i.e., workers' compensation for a job-related injury) are specifically excluded from gross income.

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

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14. CPA-01761

Platt owns land that is operated as a parking lot. A shed was erected on the lot for the related transactions with customers. With regard to capital assets and Section 1231 assets, how should these assets be classified?

- | | <u>Land</u> | <u>Shed</u> |
|----|--------------|--------------|
| a. | Capital | Capital |
| b. | Section 1231 | Capital |
| c. | Capital | Section 1231 |
| d. | Section 1231 | Section 1231 |

CPA-01761

Choice "d" is correct. Because the parking lot and the shed constitute real estate and depreciable assets used in a trade or business, they are not capital assets per the definition below.

Note: The parking lot and shed will fall under Section 1231 (provided they are used in the business over 12 months) and possibly Section 1250 and 1245, respectively, upon sale of the assets.

Capital assets are defined as all property held by the taxpayer, **except**:

1. Property normally included in inventory or held for sale to customers in the ordinary course of business.
2. Depreciable property and real estate used in business.
3. Accounts and notes receivable arising from sales or services in the taxpayer's business.
4. Copyrights, literary, musical or artistic compositions.
5. Treasury stock.

15. CPA-01736

Hall, a divorced person and custodian of her 12-year old child, filed her 20X9 federal income tax return as head of a household. She submitted the following information to the CPA who prepared her 20X9 return:

In June 20X9, Hall's mother gifted her 100 shares of a listed stock. The donor's basis for this stock, which she bought in 1990, was \$4,000, and market value on the date of the gift was \$3,000. Hall sold this stock in July 20X9 for \$3,500. The donor paid no gift tax. What was Hall's reportable gain or loss in 20X9 on the sale of the 100 shares of stock gifted to her?

- a. \$0
- b. \$500 gain.
- c. \$500 loss.
- d. \$1,000 loss.

CPA-01736

Choice "a" is correct.

Rule: The basis of property received as a gift in the hands of the donee depends on whether the selling price of the property is more or less than the basis for gain or loss.

If the property is sold at a gain, the basis to the donee is the same as it would be in the hands of the donor. If the property is sold at a loss, the basis to the donee is the same as it would be in the hands of the donor or the FMV of the property at the date of the gift, whichever is lower. In some cases, such as this fact situation, there is neither gain nor loss on the sale of the gift, because the selling price is less than the basis for gain and more than the basis for loss.

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16. CPA-01669

If the executor of a decedent's estate elects the alternate valuation date and none of the property included in the gross estate has been sold or distributed, the estate assets must be valued as of how many months after the decedent's death?

- a. 12
- b. 9
- c. 6
- d. 3

CPA-01669

Choice "c" is correct.

Rule: The executor can elect to use an alternate valuation date rather than the decedent's date of death to value the property included in the gross estate. The alternate date is generally six months after the decedent's death or the earlier date of sale or distribution.

Note: The valuation of the assets in an estate impacts the recipient as basis of the inherited assets.

17. CPA-01671

In December 20X1, Davis, a single taxpayer, purchased a new residence for \$200,000. Davis lived in the new residence continuously from 20X1 until selling the new residence in July 20X7 for \$455,000. What amount of gain is recognized from the sale of the residence on Davis' 20X7 tax return?

- a. \$455,000
- b. \$255,000
- c. \$5,000
- d. \$0

CPA-01671

Choice "c" is correct. Provided Davis has lived in his home for a total of 2 years out of the 5 years preceding his sale of his residence, as a single taxpayer he may exclude up to \$250,000 of gain on its sale. The basis on the residence sold in 20X7 is equal to its cost (\$200,000).

Selling Price	\$455,000
Less: Basis	<u>(200,000)</u>
Realized Gain	255,000
Less: Excluded Amount	<u>(250,000)</u>
Recognized Gain	<u>\$ 5,000</u>

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18. CPA-01747

In 20X9, Joan Reed exchanged commercial real estate that she owned for other commercial real estate plus cash of \$50,000. The following additional information pertains to this transaction:

<u>Property given up by Reed</u>	
Fair market value	\$500,000
Adjusted basis	300,000
<u>Property received by Reed</u>	
Fair market value	450,000

What amount of gain should be recognized in Reed's 20X9 income tax return?

- a. \$200,000
- b. \$100,000
- c. \$50,000
- d. \$0

CPA-01747

Choice "c" is correct. \$50,000 is Reed's recognized gain in 20X9.

Rule: Gain is only recognized on an exchange of "like-kind" property for the lesser of the amount of "gain realized" or the amount of "boot" received in the exchange.

Fair market value of property received	\$450,000
Amount of cash ("boot") received	<u>50,000</u>
Total amount realized	\$500,000
Basis of property given up	<u>300,000</u>
Gain realized	<u>\$200,000</u>
Gain recognized*	<u>\$ 50,000</u>

* Gain recognized is the **lesser** of the amount of "**gain realized**" or amount of the "**boot**" received.

19. CPA-01742

In a "like-kind" exchange of an investment asset for a similar asset that will also be held as an investment, no taxable gain or loss will be recognized on the transaction if both assets consist of:

- a. Convertible debentures.
- b. Convertible preferred stock.
- c. Partnership interests.
- d. Rental real estate located in different states.

CPA-01742

Choice "d" is correct. No taxable gain or loss will be recognized on a like-kind exchange if both assets are tangible property. Rental real estate located in different states qualifies for a like-kind exchange.

Choices "a", "b", and "c" are incorrect. In order to meet the "like-kind exchange" requirements for nonrecognition of gain or loss, the property exchanged must be tangible property. Convertible debentures, convertible preferred stock, and partnership interests are not considered tangible property.

Exception: If the same class of stock of the same corporation is exchanged, it will qualify for "substituted basis."