CPA PassMaster Questions–Regulation 1
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Individual Taxation - Filing Status

CPA-04765 Type1 M/C A-D Corr Ans: D PM#2 R 1-01

1. CPA-04765 Released 2005 Page 8

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.

CPA-04765 Explanation
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.

CPA-05278 Type1 M/C A-D Corr Ans: A PM#18 R 1-01

2. CPA-05278 Released 2006 Page 8

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.

CPA-05278 Explanation
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.]

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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.

CPA-05293 Type1 M/C A-D Corr Ans: A PM#19 R 1-01

3. CPA-05293 Released 2006 Page 36

Barkley owns a vacation cabin that was rented to unrelated parties for 10 days during the year for $2,500. The cabin was used personally by Barkley for three months and left vacant for the rest of the year. Expenses for the cabin were as follows:

Real estate taxes	$1,000
Maintenance and utilities	$2,000

How much rental income (loss) is included in Barkley's adjusted gross income?

a. $0
b. $500
c. $(500)
d. $(1,500)

CPA-05293 Explanation
RULE: If a vacation residence is rented for less than 15 days per year, it is treated as a personal residence. The rental income is excluded from income, and mortgage interest (first or second home) and real estate taxes are allowed as itemized deductions. Depreciation, utilities, and repairs are not deductible.

Choice "a" is correct. Applying the rule above, if a vacation residence is rented for less than 15 days per year, it is treated as a personal residence. The rental income ($2,500 in this case) is excluded from income. A Schedule E is not filed for this property (i.e., no income is reported, the taxes are reported as itemized deductions, and the maintenance and utilities are not deductible), so the effect on AGI is zero.

Choice "b" is incorrect. This assumes that the property taxes are reported as itemized deductions but that the rental income ($2,500) less the maintenance and utilities ($2,000) are reported net on Schedule E. Per the above RULE, the rental income is excluded from income, and the maintenance and utilities are not deductible.

Choice "c" is incorrect. This assumes that all of the items shown are reported net on the Schedule E- $2,500 - $1,000 - $2,000 = ($500). Per the above RULE, the rental income is excluded from income, the maintenance and utilities are not deductible, and the property taxes are reported on Schedule A as an itemized deduction.

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

CPA-05302 Type1 M/C A-D Corr Ans: A PM#20 R 1-01

4. CPA-05302 Released 2006 Page 7

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.

CPA-05302 Explanation
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

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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.

Individual Taxation - Exemptions

CPA-01409 Type1 M/C A-D Corr Ans: C PM#1 R 1-02

5. CPA-01409 ARE May 95 #14 Page 11

In 19X4, Smith, a divorced person, provided over one half the support for his widowed mother, Ruth, and his son, Clay, both of whom are U.S. citizens. During 19X4, Ruth did not live with Smith. She received $9,000 in Social Security benefits. Clay, a 25 year-old full-time graduate student, and his wife lived with Smith. Clay had no income but filed a joint return for 19X4, owing an additional $500 in taxes on his wife's income. How many exemptions was Smith entitled to claim on his 19X4 tax return?

a. 4
b. 3
c. 2
d. 1

CPA-01409 Explanation

Choice "c" is correct. Smith is entitled to an exemption for himself. He is also entitled to an exemption for his mother Ruth (qualifying relative). Ruth has $9,000 in Social Security payments during 19X4, but since that is her only income, the Social Security is not taxable, and nontaxable income does not count in calculating whether an exemption can be taken for a dependent. Clay cannot be taken as a dependent because he filed a joint return with his wife. Since the joint return was filed for a purpose other than simply claiming a refund, the joint return prevents Smith from claiming an exemption for Clay. An exemption cannot be taken for Clay's wife because she filed a joint return with Clay. Smith is entitled to two exemptions.

Choice "a" is incorrect. Clay cannot be taken as a dependent because he filed a joint return with his wife. Since the joint return was filed for a purpose other than simply claiming a refund, the joint return prevents Smith from claiming an exemption for Clay. An exemption cannot be taken for Clay's wife because she filed a joint return with Clay.

Choice "b" is incorrect. Clay cannot be taken as a dependent because he filed a joint return with his wife. Since the joint return was filed for a purpose other than simply claiming a refund, the joint return prevents Smith from claiming an exemption for Clay. An exemption cannot be taken for Clay's wife because she filed a joint return with Clay.

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Choice "d" is incorrect. Smith is entitled to an exemption for his mother, Ruth. Ruth has $9,000 in Social Security payments during 19X4, but because that is her only income, the Social Security income is not taxable, and nontaxable income does not count in calculating whether an exemption can be taken for a dependent.

Individual Taxation - Gross Income

CPA-01387 Type1 M/C A-D Corr Ans: D PM#1 R 1-03

6. CPA-01387 ARE R02 #10 Page 22

Darr, an employee of Sorce C corporation, is not a shareholder. Which of the following would be included in a taxpayer's gross income?

a. Employer-provided medical insurance coverage under a health plan.
b. A $10,000 gift from the taxpayer's grandparents.
c. The fair market value of land that the taxpayer inherited from an uncle.
d. The dividend income on shares of stock that the taxpayer received for services rendered.

CPA-01387 Explanation
Choice "d" is correct. An individual receiving common stock for services rendered must recognize the fair market value as ordinary income. Any dividends received on that stock would also result in income recognition.

Choice "a" is incorrect. Employer-provided medical insurance is a tax-free fringe benefit.

Choices "b" and "c" are incorrect. Gifts and inheritances are both tax-free to the recipient. (Remember tax is often paid by the person giving the gift or the estate at death.)

CPA-01428 Type1 M/C A-D Corr Ans: C PM#2 R 1-03

7. CPA-01428 ARE R02 #2 Page 36

Adams owns a second residence that is used for both personal and rental purposes. During 2001, Adams used the second residence for 50 days and rented the residence for 200 days. Which of the following statements is **correct**?

a. Depreciation may not be deducted on the property under any circumstances.
b. A rental loss may be deducted if rental-related expenses exceed rental income.
c. Utilities and maintenance on the property must be divided between personal and rental use.
d. All mortgage interest and taxes on the property will be deducted to determine the property's net income or loss.

CPA-01428 Explanation
Choice "c" is correct. Because the second property was personally used more than 14 days, any net loss from the rental of the property will be disallowed.

All related expenses must be prorated between the personal use portion and the rental activity portion. Prorated depreciation is permitted for the rental activity.

CPA-01451 Type1 M/C A-D Corr Ans: D PM#6 R 1-03

8. CPA-01451 ARE R99 #2 Page 27

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:

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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

CPA-01451 Explanation

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	$281,750

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.

CPA-01479 Type1 M/C A-D Corr Ans: B PM#8 R 1-03

9. CPA-01479 ARE R98 #3 Page 27

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

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CPA-01479 Explanation
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.

CPA-01485 Type1 M/C A-D Corr Ans: C PM#10 R 1-03

10. CPA-01485 ARE May 95 #1 Page 39

Which payment(s) is(are) included in a recipient's gross income?

I. Payment to a graduate assistant for a part-time teaching assignment at a university. Teaching is not a requirement toward obtaining the degree.
II. A grant to a Ph.D. candidate for his participation in a university-sponsored research project for the benefit of the university.

a. I only.
b. II only.
c. Both I and II.
d. Neither I nor II.

CPA-01485 Explanation
Choice "c" is correct.

I. A payment to a student for a part-time teaching assignment is taxable income just as a payment for any other campus job would be. This is not a scholarship or fellowship.
II. There is no exclusion in the tax law for amounts paid to a degree candidate for participation in university-sponsored research.

CPA-01489 Type1 M/C A-D Corr Ans: D PM#11 R 1-03

11. CPA-01489 ARE Nov 94 #40 Page 31

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

	Marketing costs	*Off-site storage costs*
a.	Yes	Yes
b.	Yes	No
c.	No	No
d.	No	Yes

CPA-01489 Explanation
Choice "d" is correct. Under the uniform capitalization rules, purchasers of inventory for resale may deduct their marketing costs but must capitalize their off-site storage costs.

Choices "a", "b", and "c" are incorrect. Marketing costs are deductible, but off-site storage must be capitalized.

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CPA-01564 Type1 M/C A-D Corr Ans: C PM#12 R 1-03

12. CPA-01564 ARE May 94 #2 Page 21

In a tax year where the taxpayer pays qualified education expenses, interest income on the redemption of qualified U.S. Series EE Bonds may be excluded from gross income. The exclusion is subject to a modified gross income limitation and a limit of aggregate bond proceeds in excess of qualified higher education expenses. Which of the following is (are) true?

I. The exclusion applies for education expenses incurred by the taxpayer, the taxpayer's spouse, or any person whom the taxpayer may claim as a dependent for the year.
II. "Otherwise qualified higher education expenses" must be reduced by qualified scholarships not includible in gross income.

a. I only.
b. II only.
c. Both I and II.
d. Neither I nor II.

CPA-01564 Explanation
Choice "c" is correct. Interest earned on Series EE bonds issued after 1989 may qualify for exclusion. One requirement is that the interest is used to pay tuition and fees for the taxpayer, spouse, or dependent enrolled in higher education. The interest exclusion is reduced by qualified scholarships that are exempt from tax and other nontaxable payments received for educational expenses (other than gifts and inheritances).

CPA-01568 Type1 M/C A-D Corr Ans: A PM#13 R 1-03

13. CPA-01568 ARE May 94 #3 Page 21

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

CPA-01568 Explanation
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.

CPA-01596 Type1 M/C A-D Corr Ans: A PM#15 R 1-03

14. CPA-01596 ARE May 94 #5 Page 27

Rich is a cash basis self-employed air-conditioning repairman with 1993 gross business receipts of $20,000. Rich's cash disbursements were as follows:

Air conditioning parts	$2,500

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Yellow Pages listing	2,000
Estimated federal income taxes on self-employment income	1,000
Business long-distance telephone calls	400
Charitable contributions	200

What amount should Rich report as net self-employment income?

a. $15,100
b. $14,900
c. $14,100
d. $13,900

CPA-01596 Explanation
Choice "a" is correct. Deductions to arrive at net self-employed income include all necessary and ordinary expenses connected with the business. Estimated federal income tax payments are not an expense. Charitable contributions by an individual are only deductible as an itemized deduction on Schedule A. This assumes the contribution was not made with the "expectation of commensurate financial return."

Receipts	$20,000
Parts	(2,500)
Listing	(2,000)
Telephone	(400)
Net self-employment income	$15,100

Choice "b" is incorrect. Charitable contributions are an itemized deduction unless there is an expectation of commensurate financial return.

Choice "c" is incorrect. Federal income taxes paid are not a deductible expense.

Choice "d" is incorrect. Charitable contributions are an itemized deduction unless there is an expectation of commensurate financial return. Federal income taxes paid are not a deductible expense.

CPA-01603 Type1 M/C A-D Corr Ans: B PM#16 R 1-03

15. CPA-01603 ARE May 94 #15 Page 27

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

CPA-01603 Explanation
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.

CPA-01606 Type1 M/C A-D Corr Ans: D PM#17 R 1-03

16. CPA-01606 ARE May 94 #32 Page 47

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

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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

CPA-01606 Explanation
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.

CPA-01620 Type1 M/C A-D Corr Ans: B PM#21 R 1-03

17. CPA-01620 PII Nov 93 #24 Page 24

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

CPA-01620 Explanation
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.

CPA-01699 Type1 M/C A-D Corr Ans: C PM#23 R 1-03

18. CPA-01699 ARE R02 #6 Page 12

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

Guaranteed payment from services rendered to a partnership $50,000

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