CPA-REGULATION Q&As

CPA Regulation

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QUESTION 1

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 2

Which of the following is subject to the Uniform Capitalization Rules of Code Sec. 263A?

A. Editorial costs incurred by a freelance writer.

B. Research and experimental expenditures.

C. Mine development and exploration costs.

D. Warehousing costs incurred by a manufacturing company with $12 million in annual gross receipts.

Correct Answer: D

Choice "d" is correct. Uniform capitalization rules apply to the following: (1) real or tangible personal property produced by the taxpayer for use in his or her trade or business; (2) real or tangible personal property produced by the taxpayer for sale to his or her customers; and (3) real or tangible personal property acquired by the taxpayer for resale, provided the taxpayer\\'s annual average gross receipts for the preceding three years exceeds $10,000,000. Warehousing costs incurred by a manufacturing company (making inventory for sale to its customers) are subject to the Uniform Capitalization Rules. Further, they are the only item on the list that is real or tangible personal property. In this case, the inventory is not acquired for resale (it is produced by the taxpayer for sale to his or her customers), so the fact that the annual sales are $12,000,000 does not matter in this case. The sales could have been less than $10,000,000 annually, and the Uniform Capitalization Rules would still have applied. Choices "a", "b", and "c" are incorrect, based on the above discussion.

QUESTION 3

The rule limiting the allowability of passive activity losses and credits applies to:

A. Partnerships.

B. S corporations.

C. Personal service corporations.

D. Widely-held C corporations.

Correct Answer: C

Choice "c" is correct. The rule limiting the allowability of passive activity losses and credits applies to personal service corporations. Choice "a" is incorrect. The passive activity limitations apply to the various partners in the partnership as opposed to the partnership itself. Choice "b" is incorrect. The passive activity limitations apply to the various shareholders in the S corporation as opposed to the corporation itself. Choice "d" is incorrect. The passive activity rules do not apply to widely-held C corporations.

QUESTION 4

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

Correct Answer: C

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. 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.

QUESTION 5

Which one of the following statements is correct with regard to an individual taxpayer who has elected to amortize the premium on a bond that yields taxable interest?

A. The amortization is treated as an itemized deduction.

B. The amortization is not treated as a reduction of taxable income.

C. The bond\\'s basis is reduced by the amortization.

D. The bond\\'s basis is increased by the amortization.

Correct Answer: C

Choice "c" is correct. The bond\\'s basis is reduced by the amortization of the premium.

Choice "a" is incorrect. For bonds acquired after 12/31/87, the amortization of the premium is an offset to

interest income on the bond rather than a separate interest deduction.

Choice "b" is incorrect. The amortization of the premium will reduce taxable income.

Choice "d" is incorrect. The bond\\'s basis will be decreased by the amortization.