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**QUESTION 1**

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:

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

Correct Answer: D

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	<u>\$281,750</u>



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.

QUESTION 2

Greller owns 100 shares of Arden Corp., a publicly-traded company, which Greller purchased on January 1, 2001, for \$10,000. On January 1, 2003, Arden 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 Arden stock was \$62 per share. On February 1, 2003, Greller had his broker specifically sell the 100 shares of Arden stock received in the split when the FMV of the stock was \$65 per share. What is the basis of the 100 shares of Arden sold?

- A. \$5,000
- B. \$6,000
- C. \$6,200
- D. \$6,500

Correct Answer: A

Choice "a" is correct. The receipt of a nontaxable stock dividend will require the shareholder to spread the basis of his original share 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, Greller 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 100 share is $100 \times \$50 = \$5,000$.

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

QUESTION 3

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.



Correct Answer: A

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 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.

QUESTION 4

DAC Foundation awarded Kent \$75,000 in recognition of lifelong literary achievement. Kent was not required to render future services as a condition to receive the \$75,000. What condition(s) must have been met for the award to be excluded from Kent's gross income?

I. Kent was selected for the award by DAC without any action on Kent's part.

II.

Pursuant to Kent's designation, DAC paid the amount of the award either to a governmental unit or to a charitable organization.

A.

I only.

B.

II only.

C.



Both I and II.

D.

Neither I nor II.

Correct Answer: C

Choice "c" is correct. Generally, the fair market value of prizes and awards is taxable income. However, an exclusion from income for certain prizes and awards applies where the winner is selected for the award without entering into a contest (i.e., without any action on their part) and then assigns the award directly to a governmental unit or charitable organization. Therefore, conditions "I" and "II" must be met in order for Ken to exclude the award from his gross income.

Choice "a" is incorrect. "II" is a necessary condition as well. See explanation above.

Choice "b" is incorrect. "I" is a necessary condition as well. See explanation above.

Choice "d" is incorrect. "I" and "II" are both necessary conditions. See explanation above.

QUESTION 5

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	<u>50,000</u>
Purchase price	\$90,000
Add: Cost of title policy	<u>200</u>
Total basis in the land	<u>\$90,200</u>

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

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