



# CPA-REGULATION<sup>Q&As</sup>

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### QUESTION 1

Don Wolf became a general partner in Gata Associates on January 1, 1989, with a 5% interest in Gata's profits, losses, and capital. Gata is a distributor of auto parts. Wolf does not materially participate in the partnership business. For the year ended December 31, 1989, Gata had an operating loss of \$100,000. In addition, Gata earned interest of \$20,000 on a temporary investment. Gata has kept the principal temporarily invested while awaiting delivery of equipment that is presently on order. The principal will be used to pay for this equipment. Wolf's passive loss for 1989 is:

- A. \$0
- B. \$4,000
- C. \$5,000
- D. \$6,000

Correct Answer: C

Choice "c" is correct. Wolf's passive loss for 1989 is \$5,000 (\$100,000 operating loss  $\times$  5% interest in partnership).

Choice "a" is incorrect. Wolf did not materially participate in the partnership, so the loss was passive.

Choice "b" is incorrect. Wolf's passive loss of \$5,000 could not be reduced by his distributive share of the partnership's "interest income" totaling \$1,000. Interest income is considered "portfolio income," and neither the partnership nor a partner can offset it against passive losses.

Choice "d" is incorrect. No items of income or deduction from portfolio income or activities in which the taxpayer materially participates may be combined or offset with passive losses unless the activity generating the loss is completely disposed of in a taxable transaction.

### QUESTION 2

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 3

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	<u>\$1,300</u>

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 4

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.

Correct Answer: D

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.)

#### QUESTION 5

Conner purchased 300 shares of Zinco stock for \$30,000 in 1980. On May 23, 1994, Conner sold all the stock to his daughter Alice for \$20,000, its then fair market value. Conner realized no other gain or loss during 1994. On July 26, 1994, Alice sold the 300 shares of Zinco for \$25,000.

What amount of the loss from the sale of Zinco stock can Conner deduct in 1994?

- A. \$0
- B. \$3,000
- C. \$5,000
- D. \$10,000

Correct Answer: A

Choice "a" is correct. Even though Conner has a realized loss of \$10,000 on this transaction he cannot deduct the loss since it was incurred in a transaction with his daughter, a related party. Choice "b" is incorrect. \$3,000 is the limit on deductible net capital losses. However, Conner cannot deduct this loss, since it was incurred in a transaction with his daughter, a related party. Choice "c" is incorrect. Conner's realized loss on the sale is \$10,000 (\$20,000 proceeds less \$30,000 basis). However, Conner cannot deduct this loss, since it was incurred in a transaction with his daughter, a related party. Choice "d" is incorrect. \$10,000 is Conner's realized loss on the sale. However, Conner cannot deduct this loss, since it was incurred in a transaction with his daughter, a related party.

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