



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

CPA Regulation

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### QUESTION 1

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.

Correct Answer: C

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.

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### QUESTION 2

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.

### QUESTION 3

A cash basis taxpayer should report gross income:

- A. Only for the year in which income is actually received in cash.
- B. Only for the year in which income is actually received whether in cash or in property.
- C. For the year in which income is either actually or constructively received in cash only.
- D. For the year in which income is either actually or constructively received, whether in cash or in property.

Correct Answer: D

Choice "d" is correct. A cash basis taxpayer should report gross income for the year in which income is either actually or constructively received, whether in cash or in property.

Choice "a" is incorrect. Income also be constructively received in property - not only actually in cash.

Choice "b" is incorrect. Income also be constructively received - not only actually. Choice "c" is incorrect. Income also be received in property - not only cash.

### QUESTION 4

Tom and Joan Moore, both CPAs, filed a joint 1994 federal income tax return showing \$70,000 in taxable income. During 1994, Tom's daughter Laura, age 16, resided with Tom. Laura had no income of her own and was Tom's dependent. Determine the amount of income or loss, if any that should be included on page one of the Moores' 1994 Form 1040. In 1992, Joan received an acre of land as an inter-vivos gift from her grandfather. At the time of the gift, the land had a fair market value of \$50,000. The grandfather's adjusted basis was \$60,000. Joan sold the land in 1994 to an unrelated third party for \$56,000.

- A. \$0
- B. \$500
- C. \$900
- D. \$1,000



- E. \$1,250
- F. \$1,300
- G. \$1,500
- H. \$2,000
- I. \$2,500
- J. \$3,000
- K. \$10,000
- L. \$25,000
- M. \$50,000
- N. \$55,000
- O. \$75,000

Correct Answer: A

"A" is correct. \$0. Property received by gift has two bases: one for computing gain and another for computing loss. Joan's basis for gain is the grandfather's adjusted basis (\$60,000). Using this basis for gain, Joan has a loss of: \$56,000 - \$60,000 = (\$4,000 loss). Joan's basis for loss is the fair market value of the property on the date of the gift (\$50,000). Using this basis for loss, Joan has a gain of: \$56,000 - \$50,000 = \$6,000 gain. In this unusual situation, Joan has neither a gain nor a loss, although the transaction must be reported.

**QUESTION 5**

Under a \$150,000 insurance policy on her deceased father's life, May Green is to receive \$12,000 per year for 15 years. Of the \$12,000 received in 1987, the amount subject to income tax is:

- A. \$0
- B. \$1,000
- C. \$2,000
- D. \$12,000

Correct Answer: C

Choice "c" is correct. \$2,000.

Death benefit	<u>\$150,000</u>
Amount received in 1987	\$ 12,000
Less: Return of principal (\$150,000 ÷ 15 years)	<u>(10,000)</u>
Taxable interest	<u>\$ 2,000</u>



### QUESTION 6

Which one of the following will result in an accruable expense for an accrual-basis taxpayer?

- A. An invoice dated prior to year end but the repair completed after year end.
- B. A repair completed prior to year end but not invoiced.
- C. A repair completed prior to year end and paid upon completion.
- D. A signed contract for repair work to be done and the work is to be completed at a later date.

Correct Answer: B

RULE: An accruable expense is one in which the services have been received/performed but have not been paid for by the end of the reporting period.

Choice "b" is correct. The facts indicate that a repair was completed prior to year end but not yet invoiced. If it has not yet been invoiced, it is assumed that it has also not yet been paid for. Therefore, this is a situation in which the repair expense would be accrued at year end. Services have been performed, but they have not been paid for, as they have not even been invoiced yet. Choice "a" is incorrect. If the repair was completed after year end, then the expense is not accruable, as the benefit of the services hasn't been received as of year end. The fact that the repair was invoiced prior to year end does not impact the situation. Choice "c" is incorrect. If a repair was completed and paid for prior to year end, no accrual is appropriate. On the accrual basis, the expense is taken in the year the repair is completed and the benefit is received. In this case, the account payable was also paid in the same year, but this has no effect on the expense. Choice "d" is incorrect. The facts indicate that the work is to be completed at a date later than year end. Therefore, the expense is not accruable at year end, as the benefit of the repair hasn't been received as of year end. It is reasonable that a signed contract for the repair work exists, but this has no effect on the accrual.

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### QUESTION 7

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.

Correct Answer: C

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).

**QUESTION 8**

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)

Correct Answer: A

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.

**QUESTION 9**

On December 31, 1989, a building owned by Pine Corp. was totally destroyed by fire. The building had fire insurance coverage up to \$500,000. Other pertinent information as of December 31, 1989 follows:

Building, carrying amount	\$520,000
Building, fair market value	550,000
Removal and clean-up cost	10,000

During January 1990, before the 1989 financial statements were issued, Pine received insurance proceeds of \$500,000. On what amount should Pine base the determination of its loss on involuntary conversion?



- A. \$520,000
- B. \$530,000
- C. \$550,000
- D. \$560,000

Correct Answer: B

Choice "b" is correct. \$530,000 basis of involuntary converted building.

Building carrying amount	\$520,000
Removal and clean up cost	<u>10,000</u>
Basis of involuntary conversion	\$530,000
Insurance proceeds	<u>(500,000)</u>
Loss on involuntary conversion	<u>\$ 30,000</u>

**QUESTION 10**

Among which of the following related parties are losses from sales and exchanges not recognized for tax purposes?

- A. Father-in-law and son-in-law.
- B. Brother-in-law and sister-in-law.
- C. Grandfather and granddaughter.
- D. Ancestors, lineal descendants, and all in-laws.

Correct Answer: C

Choice "c" is correct. Losses from sales and exchanges are not recognized for tax purposes between grandfather and granddaughter. Rule: Losses are disallowed on sales between related parties. "Related" includes brothers and sisters, husband-wife, lineal descendants (father, son, grandfather), and entities that are more than 50% owned by individuals, corporations, trusts and/or partnerships.

Choices "a", "b", and "d" are incorrect, because losses from sales and exchanges are recognized for all "in-laws."

**QUESTION 11**

Tom and Joan Moore, both CPAs, filed a joint 1994 federal income tax return showing \$70,000 in taxable income. During 1994, Tom's daughter Laura, age 16, resided with Tom. Laura had no income of her own and was Tom's





dependent. Determine the amount of income or loss, if any that should be included on page one of the Moores' 1994 Form 1040. Tom's 1994 wages were \$53,000. In addition, Tom's employer provided group-term life insurance on Tom's life in excess of \$50,000. The value of such excess coverage was \$2,000.

- A. \$0
- B. \$500
- C. \$900
- D. \$1,000
- E. \$1,250
- F. \$1,300
- G. \$1,500
- H. \$2,000
- I. \$2,500
- J. \$3,000
- K. \$10,000
- L. \$25,000
- M. \$50,000
- N. \$55,000
- O. \$75,000

Correct Answer: A

"N" is correct. \$55,000. The value of employer-provided group term life insurance for which the face amount exceeds \$50,000 is taxable income to the insured employee and the \$53,000 in wages would both be included on page one, Form 1040.

## QUESTION 12

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:

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

Correct Answer: A

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)
<b>Net self-employment income</b>	<u><u>\$15,100</u></u>

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.

**QUESTION 13**

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.

Correct Answer: C

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.

#### QUESTION 14

Porter was unemployed for part of the year. Porter received \$35,000 of wages, \$4,000 from a state unemployment compensation plan, and \$2,000 from his former employer's company-paid supplemental unemployment benefit plan. What is the amount of Porter's gross income?

- A. \$35,000
- B. \$37,000
- C. \$39,000
- D. \$41,000

Correct Answer: D

RULE: Gross income includes all income unless it is specifically excluded in the tax code.

Choice "d" is correct. Wages and all unemployment compensation are not excluded from being taxable; therefore, there are included in the taxpayer's gross income for tax purposes.

Wages received	\$35,000
State unemployment compensation	4,000
Employer's unemployment compensation plan	<u>2,000</u>
	<u>\$41,000</u>

Choice "a" is incorrect. All forms of unemployment compensation are included as part of gross income. Choice "b" is incorrect. The \$4,000 of state unemployment compensation received is included as part of gross income. Choice "c" is incorrect. The \$2,000 of his former employer's company-paid supplemental unemployment benefit plan is included as part of gross income.



**QUESTION 15**

Leker exchanged a van that was used exclusively for business and had an adjusted tax basis of \$20,000 for a new van. The new van had a fair market value of \$10,000, and Leker also received \$3,000 in cash. What was Leker's tax basis in the acquired van?

- A. \$20,000
- B. \$17,000
- C. \$13,000
- D. \$7,000

Correct Answer: B

Choice "b" is correct. \$17,000 is the tax basis in the van. The basis for like-kind exchanges is computed as follows: The general rule is the gain is recognized to the extent boot is received. As the transaction results in a loss to Leker (he received an asset worth \$10,000 plus \$3,000 cash less a \$20,000 tax basis equals \$7,000 loss) no gain is recognized and the \$3,000 received reduces his basis in the new asset. Choice "a" is incorrect. Basis must be reduced by non-like-kind assets (boot) received. Choice "c" is incorrect. For non-like-kind exchanges, the basis would be the FMV of the assets received (\$10,000 FMV plus \$3,000 Boot). However, because both assets have similar use, this is a like-kind exchange, which follows the rule above. Choice "d" is incorrect. The basis of the old property is used to calculate the basis of the new property, less any boot received.

Basis of old property  
Less: Boot received  
New basis

\$20,000  
(3,000)  
\$17,000

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