

REGULATION

CPA2903US2-41

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About Updating Supplement Version 41.2

Information that is only six months old is eligible to be tested on the CPA exam. Updating Supplement Version 41.2 is designed to bring the latest release of material to candidates using our products to prepare for the CPA exam in the Jul-Aug 2012 and Oct-Nov 2012 windows. Candidates with the 41st edition and corresponding software (versions 14.3, 14.4, 14.5, and 14.6) will find the information in this supplement more than adequate for these exam windows.

When new information first becomes available, the examiners tend to test new or changed portions of concepts lightly. Coverage of information after that point may increase, if it is in a heavily tested area. Do not fall into the trap of attaching undue significance to new information merely because it is new.

Remember, with the information and techniques in our material, passing the exam is an attainable goal. ***Adhere to a reasonable study plan—and pass the first time!***

Study Options Available to Candidates

As every candidate's needs are different, Bisk Education offers a variety of CPA Review formats and packages that are guaranteed* to help you pass the CPA exam on your next sitting. Options include: our Online CPA Review with structured Internet classes and our self-study CPA Review utilizing multimedia CD-ROM software, video programs, and books.

**Purchase of software required. Call for complete details.*

Other Sources of Information for Candidates

Candidates with the 40th edition and corresponding software (versions 14.0, 14.1, and 14.2) also will need Updating Supplement Version 40.3. Updating Supplement Version 40.3 contains summaries of tax changes and inflation-adjusted amounts. (Material in the version 40.3 updating supplement is incorporated within the 41st edition, as appropriate.)

Due to significant changes to the exam, candidates with the 39th and earlier editions and corresponding software (version 13.3 and lower) are strongly encouraged to purchase new materials. Candidates choosing to use previous editions of our books must accept responsibility for adequately updating their materials. Candidates should consider the strain that this will add to the already time-consuming process of studying for the exam. Material in the related updating supplements may be reviewed to determine the nature and quantity of information that has changed from one edition to another. Contact a customer service representative at 1-800-280-9718 to order new materials or the version 39.3 updating supplement.

Recent Tax Legislation

The *Temporary Payroll Tax Cut Continuation Act of 2011* (TPTCCA '11) became law on December 23, 2011, making it first eligible to be tested in the **Jul-Aug 2012** exam window. It is merely an extension (for two months) of the same payroll tax holiday as in effect for 2011.

Temporary Payroll Tax Cut Continuation Act of 2011

- A. Self-Employment & Social Security Taxes: For January through February 2012, the employee rate is reduced to 4.2%, extending the payroll tax holiday period of 2011 for two more months.
 - 1. Coordination.
 - a. Self-Employment Tax Deduction for AGI: The IRC §164(f) income tax deduction allowed for tax years beginning in 2012 is computed at the rate of 59.6% of the OASDI tax paid, plus one half of the HI tax paid.
 - b. Net Earnings From Self Employment: The two-percentage-point reduction is not taken into account in determining the IRC §1402 SECA tax deduction allowed for determining the amount of the net earnings from self-employment for 2012.
 - 2. Recapture Provisions: These provisions are moot with the passage of MCTRJCA '12. Accordingly, they are not covered.
- B. Employer Taxes: The employer rate remains the same, at 6.2%.

The *Middle Class Tax Relief and Job Creation Act of 2012* (MCTRJCA '12) became law on February 22, 2012, making it first eligible to be tested in the **Oct-Nov 2012** exam window.

Middle Class Tax Relief and Job Creation Act of 2012

- A. Payroll Tax Holiday Period: The payroll tax holiday period is extended throughout 2012.
- B. Repealed Accelerations in Estimated Tax Payments for Large Corporations: These likely are beyond the scope of the exam. Basically, the same due dates as previously in effect are again in effect.

The *Patient Protection and Affordable Care Act*, commonly known as the *Health Care Act* (HCA '10), became law on March 23, 2010. The *Health Care & Education Reconciliation Act of 2010* (HCERA '10) became law on March 30, 2010. This made these laws first eligible to be tested in the **October-November 2010** exam window, except for those provisions that become effective in 2011 and future years. Several provisions are excluded from this summary as being well beyond the scope of the CPA exam. To the depth tested by the exam, most of the provisions become effective for tax years ending after December 31, 2012.

Health Care Act of 2010 as modified by the Health Care & Education Reconciliation Act of 2010

- A. Immediate Provisions (eligible to be tested on the exam)
 - 1. New Therapies: For expenses starting in 2009 and later, a two-year temporary credit applies to encourage investments in new therapies to prevent, diagnose, and treat acute and chronic disease, subject to an overall \$2 billion ceiling.

2. Healthcare Professional Exclusion: Starting in 2009 and later, payments made under any state loan repayment or loan forgiveness program designed to increase availability of healthcare in underserved areas are excluded from gross income.
 3. Insurance Sponsor Credit: For 2010 and later, a credit is available for eligible small employers who offer health care insurance to employees. Eligible employers have no more than 25 full-time equivalent employees (FTEEs) whose annual average full-time equivalent wages (AFTEWs) are no more than \$50,000. For the full credit, employers must have no more than 10 FTEEs with AFTEWs of no more than \$25,000. The wage limits are inflation-adjusted starting in 2014.
 4. Excluded Coverage: Starting on March 30, 2010, the exclusion from income for health coverage extends to coverage for a child (under age 27 at the end of the year) of an employee or self-employed person.
 5. Adoption Provisions: For tax years starting in 2010 and later, the adoption tax credit and adoption assistance exclusion are increased by \$1,000 and extended to 2011. The credit is changed to be refundable.
 6. Medical Expense Definition Further Restricted: For tax years starting in 2011 and later, flexible spending account, health reimbursement account, health savings account, and Archer medical savings account reimbursements for medicines are limited to prescribed medicines and insulin. (Currently, over-the-counter medicines may be eligible for reimbursement.)
 7. Non-Qualifying HSA or MSA Distributions: For tax years starting in 2011 and later, the surtaxes for health savings account (HSA) and Archer medical savings account (MSA) non-qualifying distributions are increased to 20%.
 8. Simple Cafeteria Plan: For tax years starting in 2011 and later, a Simple Cafeteria Plan is available with eased participation restrictions to encourage small businesses to provide tax-free benefits to employees. Self-employed individuals qualify as employees for this purpose.
 9. Reporting: Starting in 2011, employers must disclose the value of health care insurance benefits on each employee's annual Form W-2. For tax years starting in 2014 and later, greater detail must be supplied to both the covered individual and the IRS.
- B. Long-Term Future Provisions (not eligible to be tested in 2012 or the first two windows of 2013)
1. Itemized Deductions: For tax years starting in 2013 and later, the threshold for taxpayers age 64 and younger for medical deductions is 10%, rather than 7.5%.
 2. Additional Hospital Insurance Tax: For tax years starting in 2013 and later, the hospital insurance tax rate increases for high-income taxpayers by 0.9% for earnings over certain non-inflation-adjusted thresholds.
 3. Unearned Income Medicare Contribution: For tax years starting in 2013 and later, a 3.8% surtax will apply to net investment income of high-income taxpayers. Like current FICA, this surtax is not deductible for federal income tax purposes.
 4. Health FSA Contribution Limits: For tax years starting in 2013 and later, annual contributions to health FSA under cafeteria plans are limited to \$2,500. This ceiling will be inflation-adjusted starting in 2014.

5. **Employer Deduction for Part D Coverage:** For tax years starting in 2013 and later, the deduction for employers who maintain prescription drug plans for their retirees who are eligible for Medicare Part D will be eliminated.
 6. **Uninsured Penalty:** For tax years ending after 2013, non-exempt U.S. residents must maintain minimum essential health insurance coverage or pay a penalty. Citizens residing outside of the U.S., people exempt for religious reasons, and those who cannot afford coverage are exempt. Unaffordable coverage is defined as a contribution for employer-sponsored coverage or the lowest cost plan in the local Insurance Exchange that exceeds 8% of household income.
 7. **Low-Income Insurance Exchange Participation Credit:** For tax years ending after 2013, credits are available for individual with incomes up to 400% of the federal poverty level who obtain health care coverage through an Insurance Exchange that are not eligible for Medicaid, employer-sponsored coverage, or other acceptable coverage.
 8. **Employer Responsibilities:** For months beginning after December 31, 2013, an applicable large employer not offering adequate affordable coverage for all its full-time employees will be subject to a penalty if any full-time employee is certified as having purchased health insurance through a qualified state exchange. In this context, an applicable large employer generally is one that employed an average of at least 50 full-time employees during the preceding calendar year and a qualified state exchange is one which a premium tax credit or cost-sharing reduction is allowed or paid to the employee. Also, an applicable large employer that offers, for any month, its full-time employees and their dependents the opportunity to enroll in minimum essential coverage under an employer sponsored plan will be subject to a penalty if any full-time employee is enrolled in health insurance coverage purchased through a qualified state exchange.
 9. **Free-Choice Vouchers:** After December 31, 2013, employers offering minimum essential coverage through an eligible employer-sponsored plan and paying a portion of that coverage must provide qualified employees with a voucher whose value can be applied to purchase of a health plan through the Insurance Exchange. The value of the voucher is equal to the dollar value of the employer contribution to the employer-offered health plan and is not includable in the employee's income to the extent it is used for the purchase of health plan coverage. An individual receiving a voucher is disqualified from receiving any tax credit or cost sharing credit for the purchase of a plan in the Insurance Exchange. Similarly, if any employee receives a free-choice voucher, the employer is not assessed a shared responsibility payment on behalf of that employee.
 - a. Qualified employees do not participate in the employer's health plan;
 - b. Qualified employees' required contribution for employer-sponsored minimum essential coverage (if they participated in the plan) would exceed 8%, but would not exceed 9.8% of household income; and
 - c. Qualified employees' total household income does not exceed 400% of the poverty line for the family.
 10. **High-Cost Employer-Sponsored Health Coverage:** For tax years starting in 2018 and later, a 40% nondeductible excise tax is levied on insurance companies and plan administrators for plans to the extent that the annual premium exceeds certain thresholds. The thresholds will be automatically increase if the inflation rate for group medical premiums between 2010 and 2018 is higher than the 2010 Congressional Budget Office estimates.
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Errata

If you find items in the Bisk materials that you believe are ambiguous or in error, please contact the Bisk Education editors (editor@cpaexam.com) with full details.

Chapter 44

Solution 44-5, Item #3: The answer should be, "\$8,000," not "\$9,000." The explanation is correct.

Chapter 45

Page 45-10, Paragraph B, 1, b: The text should read, "A limitation formerly was placed on the aggregate contributions that could be made to all qualified funeral trusts for one beneficiary. For contracts entered into in tax years ending before August 30, 2008, the limit was \$9,000," not "A limitation is placed on the aggregate contributions that may be made to all qualified funeral trusts for one beneficiary. For contracts entered into in 2008, the limit is \$9,000."

Page 45-14, Paragraph C: The text should read, "\$1,000 or more," not "more than \$1,000."

Chapter 48

Solution 48-14, Item #1: The answer should be "T," not "F." The explanation should read, "Partnership income tax returns are due by the 15th day of the fourth month following the close of the tax year. For calendar-year entities, this is April 15."

Appendix A

Solution 4-3, Item #7: The answer is correct. The last sentence in the explanation should read, "That portion of self-employment tax that corresponds to an employer's share of FICA is allowed as a deduction for arriving at adjusted gross income."

Appendix C

Solution C-22: The answer should be "TS §700.02," not "TS §700.04." The explanation is correct.

Inflation-Adjusted Tax Amounts

Most of the amounts here are to forestall candidate curiosity, rather than to supply information needed for the exam. Recall the questions in the book and software and notice how few of them require knowledge of specific amounts. Bisk Education recommends that candidates not concentrate on particular tax amounts, especially amounts particular to one year. The examiners are unlikely to concentrate on the amounts, let alone the differences between inflation-adjusted amounts.

From the AICPA's *Uniform CPA Examination Candidate Bulletin*:

Accounting and auditing pronouncements are eligible to be tested on the Uniform CPA Examination in the window beginning six months after a pronouncement's effective date, unless early application is permitted.

When early application is permitted, the new pronouncement is eligible to be tested in the window beginning six months after the issuance date. In this case, both the old and new pronouncements may be tested until the old pronouncement is superseded.

For the federal taxation area, the Internal Revenue Code and federal tax regulations in effect six months before the beginning of the current window may be tested on the Uniform CPA Examination.

For all other materials covered in the Regulation and Business Environment and Concepts sections, material eligible to be tested includes federal laws in the window beginning six months after their effective date and uniform acts in the window beginning one year after their adoption by a simple majority of the jurisdictions.

Thus, the questions on the July-August 2012 and October-November 2012 CPA examinations should cover the law in effect for 2012. However, when it comes to taxes, the examiners repeatedly have tested the last full calendar year. The editors expect the July-August 2012 and the October-November 2012 CPA examination to cover the tax law in effect for 2011, not 2012, in those few questions where the year makes a difference. The editors expect the questions on the January-February 2013 and April-May 2013 CPA examinations to cover the tax law in effect for 2012.

Note that some amounts (Section 179 amounts, etc.) are favorite targets of economic stimulus legislation and, thus, are particularly subject to change. Lately, these amounts have been provided in released questions. Several amounts did not change from 2011 to 2012 as inflation was mild.

Individual Taxation

- A. Exemption: The personal exemption is \$3,800 for 2012 (\$3,700 for 2011).
- B. Standard Deduction & Personal & Dependency Exemption Phase-out: For 2012 and 2011, the standard deduction for an individual who may be claimed as a dependent by another taxpayer may not exceed the greater of either \$950 or the sum of \$300 and the individual's earned income. The personal and dependency exemption phase-out is eliminated for 2010 through 2012.

Filing Status	Standard Deduction		Additional Age & Blindness	
	2012	2011	2012	2011
Married Filing Jointly *	\$11,900	\$11,600	\$1,150	\$1,150
Single	5,950	5,800	1,450	1,450
Head of Household	8,700	8,500	1,450	1,450
Married Filing Separately	5,950	5,800	1,150	1,150

* Also surviving spouse

- C. Overall Limitation on Itemized Deductions: The overall limitation on itemized deductions is eliminated for 2010 through 2012, and reinstated in full for 2013 and later tax years.

D. Savings Bond Phase-out: The savings bond phase-outs are as follows.

<u>Filing Status</u>	<u>2012</u>	<u>2011</u>
Married filing jointly	\$109,250 to \$139,250	\$106,650 to \$136,650
All others	\$ 72,850 to \$ 87,850	\$ 71,100 to \$ 86,100

E. Retirement Plans: Employees may defer up to \$50,000 in defined contribution plans for 2012 (\$49,000 for 2011). The annual limit for defined benefit plan benefits is \$200,000 for 2012 (\$195,000 for 2011).

1. Section 401(k), Section 457, and SEP Plans: For 2012, the maximum on elective deferrals is \$17,000 (\$16,500 for 2011). For 2011 and 2012, the maximum catch-up contributions are \$5,500 for Sections 401(k), 403(b), and 457 plans.
2. SIMPLE Plans: For 2011 and 2012, employees may defer up to the lesser of \$11,500 of elective contributions or 25% of annual compensation. The \$2,500 catch-up contribution limit for SIMPLE plans is not inflation adjusted.

F. Individual Retirement Account (IRA) Phase-outs: In 2012, the maximum Roth IRA contribution is phased out for taxpayers with AGI exceeding \$183,000 (MFJ) \$125,000 (single), and \$0 (MFS). In 2011, these maximums are \$179,000, \$122,000, and \$0, respectively. The traditional IRA deductibility phase-outs are as follows.

<u>Filing Status</u>	<u>2012</u>	<u>2011</u>
Married filing jointly	\$ 92,000 to \$112,000	\$ 90,000 to \$110,000
Single or Head of Household	\$ 58,000 to \$ 68,000	\$ 56,000 to \$ 66,000
Married filing separately	\$ 0 to \$ 10,000	\$ 0 to \$ 10,000
MFJ, nonparticipant spouse	\$173,000 to \$183,000	\$169,000 to \$179,000

G. Individual Income Tax Rates: The tax tables for 2012 are as follows.

<u>Rate</u>	<u>MFJ & SS</u>	<u>Head of household</u>	<u>Single</u>	<u>MFS</u>
10%	\$ 0 to \$ 17,400	\$ 0 to \$ 12,400	\$ 0 to \$ 8,700	\$ 0 to \$ 8,700
15%	\$ 17,401 to \$ 70,700	\$ 12,401 to \$ 47,350	\$ 8,701 to \$ 35,350	\$ 8,701 to \$ 35,350
25%	\$ 70,701 to \$142,700	\$ 47,351 to \$122,300	\$ 35,351 to \$ 85,650	\$ 35,351 to \$ 71,350
28%	\$142,701 to \$217,450	\$122,301 to \$198,050	\$ 85,651 to \$178,650	\$ 71,351 to \$108,725
33%	\$217,451 to \$388,351	\$198,051 to \$388,351	\$178,651 to \$388,351	\$108,726 to \$194,175
35%	Over \$388,350	Over \$388,350	Over \$388,350	Over \$194,175

H. Self-Employment & Social Security Taxes: The maximum income subject to the full self-employment and social security taxes is \$110,100 in 2012 (\$106,800 in 2011). For 2012 and 2011, the employee rate is 4.2%.

I. Earned Income Credit: For 2012, the earned income credit is denied if certain investment income is greater than \$3,200 (\$3,150 for 2011). The following table is for 2011.

<u>Qualifying Children</u>	<u>Credit Rate</u>	<u>Computed on Earned Income of</u>	<u>Maximum Credit</u>	<u>Start of Phase-out</u>	<u>Non-MFJ Complete Phase-out</u>	<u>MFJ Complete Phase-out</u>
0	7.65%	\$ 6,070	\$ 464	\$ 7,590*	\$13,660	\$18,740
1	34.00%	9,100	3,094	16,690*	36,052	41,132
2	40.00%	12,780	5,112	16,690*	40,964	46,044
3	45.00%	12,780	5,751	16,690*	43,998	49,078

*For MFJ taxpayers, these amounts are increased by \$5,080.

- J. Adoption Expense Credit: The maximum adoption expense credit is \$12,260 for 2012 (\$13,360 for 2011).
 - K. Child Credit: The child credit is refundable to the extent of the greater of 15% of the taxpayer's earned income in excess of \$3,000 for 2011 and 2012 or, for taxpayers with three or more qualifying children, the amount of Social Security taxes that exceeds the earned income credit.
 - L. FICA: In 2012, the ceiling for the wages used for computing the Social Security tax increases to \$110,100 (\$106,800 in 2011).
-

Property Taxation

- A. Section 179: For 2012, the aggregate cost of Section 179 property that a taxpayer may elect to expense is \$139,000 (\$500,000 for 2011), reduced by the cost of all Section 179 property placed into service during the year exceeding \$560,000 (\$2,000,000 for 2011). Since these amounts became particularly prone to change by stimulus legislation, the examiners have provided the amounts in those exam questions released that required their use.
 - B. Annual Gift Exclusion: For 2012 and 2011, the first \$13,000 of gifts to any person is not included in the total amount of taxable gifts made.
 - C. Unified Estate & Gift Tax Exclusion: For gifts made and estates of decedents dying in 2012, the basic exclusion amount is estimated at \$5,120,000 (\$5,000,000 in 2011).
 - D. Generation-Skipping Transfer Tax Exemption: For transfers in 2012, the exemption amount is estimated at \$5,120,000 (\$5,000,000 in 2011).
-

Recently Released AICPA Questions

In April 2012, the AICPA released several questions labeled as “Year 2012 Disclosed Questions.” The AICPA assigned a “medium” difficulty level and a “hard” difficulty level to the REG sets the Bisk editors labeled “Problem 1” and “Problem 2” in this presentation, respectively.

The REG questions and the related unofficial solutions are reproduced here, along with the exclusive Bisk Education explanations. The criteria for release of a question include that it would not be used for future exams; thus, candidates should not be surprised by obsolete or incorrect questions. The AICPA did not state whether these questions were assigned points on any exam or whether they merely were questions being pre-tested that never earned points. These questions are intended only as a study aid and should not be used to predict the content of future exams. It is extremely unlikely that released questions will appear on future examinations. The Bisk editors are aware that several of these questions are close to questions already in our materials.

Problem 1 MULTIPLE-CHOICE QUESTIONS (medium)

1. On January 1 of the current year, Locke Corp., an accrual-basis calendar-year C corporation, had \$30,000 in accumulated earnings and profits. For the current year, Locke had current earnings and profits of \$20,000, and made two \$40,000 cash distributions to its shareholders, one in April and one in September. What amount of the distributions is classified as dividend income to Locke's shareholders?
 - a. \$0
 - b. \$20,000
 - c. \$50,000
 - d. \$80,000(R/12, REG, #1, 89801)

2. Gem Corp. purchased all the assets of a sole proprietorship, including the following intangible assets:

Goodwill	\$50,000
Covenant not to compete	13,000

For tax purposes, what amount of these purchased intangible assets should Gem amortize over the specific statutory cost recovery periods?

- a. \$63,000
 - b. \$50,000
 - c. \$13,000
 - d. \$0
- (R/12, REG, #2, 89802)

4. Nichol Corp. gave gifts to 15 individuals who were customers of the business. The gifts were not in the nature of advertising. The market values of the gifts were as follows:

5 gifts @ \$15 each
 9 gifts @ \$30 each
 1 gift @ \$100

What amount is deductible as business gifts?

- a. \$0
 b. \$ 75
 c. \$325
 d. \$445

(R/12, REG, #4, 89804)

5. Under the Sales Article of the UCC, which of the following requirements must be met for a writing to be an enforceable contract for the sale of goods?
- a. The writing must contain a term specifying the price of the goods.
 b. The writing must contain a term specifying the quantity of the goods.
 c. The writing must contain the signatures of all parties to the writing.
 d. The writing must contain the signature of the party seeking to enforce the writing.

(R/12, REG, #5, 89805)

6. When do title and risk of loss for conforming goods pass to the buyer under a shipment contract covered by the Sales Article of the UCC?
- a. When the goods are identified and designated for shipment
 b. When the goods are given to a common carrier
 c. When the goods arrive at their destination
 d. When the goods are tendered to the buyer at their destination

(R/12, REG, #6, 89806)

7. Davidson was transferred from Chicago to Atlanta. In connection with the transfer, Davidson incurred the following moving expenses:

Moving the household goods	\$2,000
Temporary living expenses in Atlanta	400
Lodging on the way to Atlanta	100
Meals	40

What amount may Davidson deduct if the employer reimbursed Davidson \$2,000 (not included in Form W-2) for moving expenses?

- a. \$100
 b. \$120
 c. \$500
 d. \$520

(R/12, REG, #7, 89807)

8. Under the Secured Transactions article of the UCC, when does a security interest become enforceable?
- a. A contract is executed between a debtor and a secured party under which the debtor gives the secured party rights in collateral if the debtor violates any of the terms contained in the contract.
 b. The debtor and the secured party execute a security agreement describing the transfer of the collateral and, after doing so, the secured party files it with the requisite agency.
 c. The debtor and the secured party execute a security agreement describing the transfer of collateral from seller to buyer and the secured party retains possession of the agreement.
 d. The value has been given, the secured party receives a security agreement describing the collateral authenticated by the debtor, and the debtor has rights in the collateral

(R/12, REG, #8, 89808)

9. Which of the following is **not** considered a primary authoritative source when conducting tax research?
- Internal Revenue Code
 - Tax Court cases
 - IRS publications
 - Treasury regulations (R/12, REG, #9, 89809)
10. Turner, Reed, and Sumner are equal partners in TRS partnership. Turner contributed land with an adjusted basis of \$20,000 and a fair market value (FMV) of \$50,000. Reed contributed equipment with an adjusted basis of \$40,000 and an FMV of \$50,000. Sumner provided services worth \$50,000. What amount of income is recognized as a result of the transfers?
- \$50,000
 - \$60,000
 - \$90,000
 - \$150,000 (R/12, REG, #10, 89810)
11. An individual taxpayer reports the following items for the current year:
- | | |
|---|----------|
| Ordinary income from partnership A, operating a movie theater in which the taxpayer materially participates | \$70,000 |
| Net loss from partnership B, operating an equipment rental business in which the taxpayer does not materially participate | (9,000) |
| Rental income from building rented to a third party | 7,000 |
| Short-term capital gain from sale of stock | 4,000 |
- What is the taxpayer's adjusted gross income for the year?
- \$70,000
 - \$72,000
 - \$74,000
 - \$77,000 (R/12, REG, #11, 89811)
12. Which of the following statements is correct regarding the liability of a CPA for services performed?
- A CPA's work is **not** guaranteed to be accurate even though the CPA acted in a reasonably competent and professional manner.
 - A CPA is negligent for exercising only that degree of care a reasonably competent CPA would exercise under the circumstances.
 - A CPA's liability for negligence extends only to the client and **no** further.
 - A CPA's liability for fraud extends only to the client and **no** further. (R/12, REG, #12, 89812)
13. On February 1, year 1, a taxpayer purchased an option to buy 1,000 shares of XYZ Co. for \$200 per share. The taxpayer purchased the option for \$50,000, which was to remain in effect for six months. The market declined, and the taxpayer let the option lapse on August 1, year 1. The taxpayer would report which of the following as a capital loss on the year 1 income tax return?
- \$50,000 long term
 - \$50,000 short term
 - \$150,000 long term
 - \$200,000 short term (R/12, REG, #13, 89813)

14. A taxpayer lived in an apartment building and had a two-year lease that began 16 months ago. The taxpayer's landlord wanted to sell the building and offered the taxpayer \$10,000 to vacate the apartment immediately. The taxpayer's lease on the apartment was a capital asset but had no tax basis. If the taxpayer accepted the landlord's offer, the gain or loss would be which of the following?
- An ordinary gain
 - A short-term capital loss
 - A long-term capital gain
 - A short-term capital gain
- (R/12, REG, #14, 89814)
15. While preparing a partnership tax return, the accountant discovered that ABC Partnership distributed property to Anne, a partner, in a nonliquidating transfer. No money was distributed to Anne during the year, the property was in the partnership for over five years, and no debt was attached to the property. Anne had a basis in her partnership interest of \$10,000. The partnership had an adjusted basis of \$20,000 in the property distributed to Anne. Which of the following are the tax consequences to Anne?
- \$0 gain, basis in the partnership is reduced to \$0, and basis in the property received is \$10,000
 - \$0 gain, basis in the partnership is reduced to \$0, and basis in the property received is \$20,000
 - \$10,000 gain, basis in the partnership is reduced to \$0, and basis in the property received is \$20,000
 - \$10,000 gain, basis in the partnership is unchanged, and basis in the property received is \$20,000
- (R/12, REG, #15, 89815)
16. In year 1, a taxpayer sold real property for \$200,000, receiving \$100,000 at closing and \$100,000 plus accrued interest at the prime rate in the next year. The buyer also assumed a \$50,000 mortgage on the property. The taxpayer's adjusted basis was \$75,000, and the taxpayer incurred \$10,000 of selling expenses. If this transaction qualifies for installment sale treatment, what is the gross profit on the sale?
- \$115,000
 - \$125,000
 - \$165,000
 - \$175,000
- (R/12, REG, #16, 89816)
17. An IRS agent has just completed an examination of a corporation and issued a "no change" report. Which of the following statements about that situation is correct?
- The taxpayer may **not** amend the tax return for that taxable year.
 - The IRS generally does **not** reopen the examination except in cases involving fraud or other similar misrepresentation.
 - The IRS may **not** reopen the examination.
 - The IRS may **not** examine any other tax return of the corporation for a period of one year.
- (R/12, REG, #17, 89817)
18. Which of the following statements is correct regarding the deductibility of an individual's medical expenses?
- A medical expense paid by credit card is deductible in the year the credit card bill is paid.
 - A medical expense deduction is allowed for payments made in the current year for medical services received in earlier years.
 - Medical expenses, net of insurance reimbursements, are disregarded in the alternative minimum tax calculation.
 - A medical expense deduction is **not** allowed for Medicare insurance premiums.
- (R/12, REG, #18, 89818)

19. Under Treasury Circular 230, which of the following actions of a CPA tax advisor is characteristic of a best practice in rendering tax advice?
- Requesting written evidence from a client that the fee proposal for tax advice has been approved by the board of directors
 - Recommending to the client that the advisor's tax advice be made orally instead of in a written memorandum
 - Establishing relevant facts, evaluating the reasonableness of assumptions and representations, and arriving at a conclusion supported by the law and facts in a tax memorandum
 - Requiring the client to supply a written representation, signed under penalties of perjury, concerning the facts and statements provided to the CPA for preparing a tax memorandum
- (R/12, REG, #19, 89819)
20. A CPA prepared a tax return for a client who will receive a refund check. The client is traveling abroad and asked the CPA to pick up the check at the client's home address. Under Treasury Circular 230, any of the following actions, if taken by the CPA relating to the refund check, would be a violation of the rules of practice before the Internal Revenue Service, **except**
- Endorsing the check and depositing it into the client's bank account
 - Holding the check for safe keeping and awaiting the client's return
 - Holding the check until the client is billed, then endorsing and depositing the check into the CPA's account as payment for the bill
 - Endorsing the check and depositing it into an escrow account for the client's benefit
- (R/12, REG, #20, 89820)
-

Problem 2 MULTIPLE-CHOICE QUESTIONS (hard)

21. Which of the following statements is correct regarding a limited liability company's operating agreement?
- It must be filed with a central state agency.
 - It must be in writing.
 - It is designed to forestall and resolve disputes among the owners.
 - It is necessary for a limited liability company to exist.
- (R/12, REG, #21, 89821)
22. An individual taxpayer earned \$10,000 in investment income, \$8,000 in noninterest investment expenses, and \$5,000 in investment interest expense. How much is the taxpayer allowed to deduct on the current-year's tax return for investment interest expenses?
- \$0
 - \$2,000
 - \$3,000
 - \$5,000
- (R/12, REG, #22, 89822)
23. Upon her grandfather's death, Jordan inherited 10 shares of Universal Corp. stock that had a fair market value of \$5,000. Her grandfather acquired the shares in 1995 for \$2,500. Four months after her grandfather's death, Jordan sold all her shares of Universal for \$7,500. What was Jordan's recognized gain in the year of sale?
- \$2,500 long-term capital gain
 - \$2,500 short-term capital gain
 - \$5,000 long-term capital gain
 - \$5,000 short-term capital gain
- (R/12, REG, #23, 89823)

24. Able and Baker are equal members in Apple, an LLC. Apple has elected not to be treated as a corporation. Able contributes \$7,000 cash and Baker contributes a machine with a basis of \$5,000 and a fair market value of \$10,000, subject to a liability of \$3,000. What is Apple's basis for the machine?
- a. \$ 2,000
 - b. \$ 5,000
 - c. \$ 8,000
 - d. \$ 10,000
- (R/12, REG, #24, 89824)
25. In the current year, Fitz, a single taxpayer, sustained a \$48,000 loss on Code Sec. 1244 stock in JJJ Corp., a qualifying small business corporation, and a \$20,000 loss on Code Sec. 1244 stock in MMM Corp., another qualifying small business corporation. What is the maximum amount of loss that Fitz can deduct for the current year?
- a. \$50,000 capital loss
 - b. \$68,000 capital loss
 - c. \$18,000 ordinary loss and \$50,000 capital loss
 - d. \$50,000 ordinary loss and \$18,000 capital loss
- (R/12, REG, #25, 89825)
26. The answer to each of the following questions would be relevant in determining whether a tuition payment made on behalf of another individual is excludible for gift tax purposes, **except**:
- a. Was the tuition payment made for a part-time student?
 - b. Was the qualifying educational organization located in a foreign country?
 - c. Was the tuition payment made directly to the educational organization?
 - d. Was the tuition payment made for a family member?
- (R/12, REG, #26, 89826)
27. For which of the following entities is the owner's basis increased by the owner's share of profits and decreased by the owner's share of losses but is **not** affected by the entity's bank loan increases or decreases?
- a. S corporation
 - b. C corporation
 - c. Partnership
 - d. Limited liability company
- (R/12, REG, #27, 89827)
28. Under the Secured Transactions Article of the UCC, which of the following security agreements does **not** need to be in writing to be enforceable?
- a. A security agreement collateralizing a debt of **less** than \$500
 - b. A security agreement where the collateral is highly perishable or subject to wide price fluctuations
 - c. A security agreement where the collateral is in the possession of the secured party
 - d. A security agreement involving a purchase money security interest
- (R/12, REG, #28, 89828)
29. Under the Secured Transactions Article of the UCC, which of the following items can usually be **excluded** from a filed original financing statement?
- a. The name of the debtor
 - b. The address of the debtor
 - c. A description of the collateral
 - d. The amount of the obligation secured
- (R/12, REG, #29, 89829)

30. A sole proprietorship incorporated on January 1 and elected S corporation status. The owner contributed the following assets to the S corporation:

	<u>Basis</u>	<u>Fair market value</u>
Machinery	\$ 7,000	\$ 8,000
Building	11,000	100,000
Cash	1,000	1,000

Two years later, the corporation sold the machinery for \$4,000 and the building for \$110,000. The machinery had accumulated depreciation of \$2,000, and the building had accumulated depreciation of \$1,000. What is the built-in gain recognized on the sale?

- a. \$100,000
 b. \$99,000
 c. \$6,000
 d. \$0 (R/12, REG, #30, 89830)
31. Which of the following statements is correct regarding disclosure of client working papers prepared by a CPA?
- a. Working papers may **not** be transferred to another accountant without the client's permission.
 b. Working papers may **not** be turned over to a CPA quality review team without the client's permission.
 c. Working papers may **not** be disclosed under a federal court subpoena without the client's permission.
 d. Working papers may **not** be disclosed to any third parties without the client's permission. (R/12, REG, #31, 89831)
32. Which of the following items must be separately stated on Form 1120S, *U.S. Income Tax Return for a Corporation, Schedule K-1*?
- a. Mark-to-market income
 b. Unearned revenue
 c. Section 1245 gain
 d. Gain or loss from the sale of collectibles (R/12, REG, #32, 89832)
33. In which of the following circumstances does the three-year statute of limitations on additional tax assessments apply?
- a. A taxpayer willfully attempts to evade tax in filing income tax returns.
 b. A taxpayer inadvertently omits from gross income an amount in excess of 25% of the gross income stated on the income tax return.
 c. A taxpayer inadvertently overstates deductions equal to 15% of gross income.
 d. The IRS files a substitute income tax return when it learns that a taxpayer failed to file a return. (R/12, REG, #33, 89833)
34. Brenda, employed full time, makes beaded jewelry as a hobby. In year 2, Brenda's hobby generated \$2,000 of sales, and she incurred \$3,000 of travel expenses. What is the proper reporting of the income and expenses related to the activity?
- a. Sales of \$2,000 are reported in gross income, and \$2,000 of expenses are reported as an itemized deduction subject to the 2% limitation.
 b. Sales of \$2,000 are reported in gross income, and \$3,000 of expenses are reported as an itemized deduction subject to the 2% limitation.
 c. Sales and expenses are netted, and the net loss of \$1,000 is reported as an itemized deduction **not** subject to the 2% limitation.
 d. Sales and expenses are netted and deducted for AGI. (R/12, REG, #34, 89834)

35. On their joint tax return, Sam and Joann had adjusted gross income (AGI) of \$150,000 and claimed the following itemized deductions:
- Interest of \$15,000 on a \$100,000 home equity loan to purchase a motor home
 - Real estate tax and state income taxes of \$18,000
 - Unreimbursed medical expenses of \$15,000 (prior to AGI limitation)
 - Miscellaneous itemized deductions of \$5,000 (prior to AGI limitation)
- Based on these deductions, what would be the amount of AMT add-back adjustment in computing alternative minimum taxable income?
- a. \$21,750
 - b. \$23,750
 - c. \$35,000
 - d. \$38,750
- (R/12, REG, #35, 89835)
36. Tax return preparers can be subject to penalties under the Internal Revenue Code for failure to do any of the following, **except**
- a. Sign a tax return as a preparer
 - b. Disclose a conflict of interest
 - c. Provide a client with a copy of the tax return
 - d. Keep a record of returns prepared
- (R/12, REG, #36, 89836)
37. A CPA assists a taxpayer in tax planning regarding a transaction that meets the definition of a tax shelter as defined in the Internal Revenue Code. Under the AICPA *Statements on Standards for Tax Services*, the CPA should inform the taxpayer of the penalty risks **unless** the transaction, at the minimum, meets which of the following standards for being sustained if challenged?
- a. More likely than not
 - b. Not frivolous
 - c. Realistic possibility
 - d. Substantial authority
- (R/12, REG, #37, 89837)
38. The Uniform Capitalization Rules of Code Sec. 263A apply to retailers whose average gross receipts for the preceding three years exceed what amount?
- a. \$ 1,000,000
 - b. \$ 2,500,000
 - c. \$ 5,000,000
 - d. \$ 10,000,000
- (R/12, REG, #38, 89838)
39. Which Senate committee considers new tax legislation?
- a. Budget
 - b. Finance
 - c. Appropriations
 - d. Rules and Administration
- (R/12, REG, #39, 89839)
40. Ashley needs to endorse a check that had been endorsed by two other individuals prior to Ashley's receipt of the check. Ashley does not want to have surety liability, so Ashley endorses the check "without recourse." Under the Negotiable Instruments Article of the UCC, which of the following types of endorsement did Ashley make?
- a. Blank
 - b. Special
 - c. Qualified
 - d. Restrictive
- (R/12, REG, #40, 89840)

Problem 3 SIMULATION Basis—Gains & Losses

Green, an individual taxpayer, who is not a day trader, has requested assistance from a CPA to calculate year 2 gains and/or losses on the sale of various shares of stock. For each of the following transactions, calculate the correct gain or loss and enter the amount in the shaded box in the "Gain or loss" column. Enter losses as values with negative signs. Brokerage commissions are included in the figures below. If a response is zero, enter a zero (0). (R/12, REG, #41, 89886)

	Year 2 transactions	Gain or loss
1.	Sold 200 shares of Y Corp. stock at \$14 per share. Green received the 200 shares as a gift from his brother, three years ago, at the time that the shares had a fair market value of \$10 per share. Green's brother purchased the stock for \$16 per share.	
2.	Sold 200 shares of Y Corp. stock at \$22 per share. Green received the 200 shares as a gift from his brother, three years ago, at the time that the shares had a fair market value of \$26 per share. Green's brother purchased the stock for \$16 per share.	
3.	Sold 450 shares of Z Corp. stock at \$40 per share. Green received the 450 shares from his aunt's estate as a bequest. The fair market value of the stock at the date of his aunt's death was \$32 per share and did not change in the subsequent year. His aunt originally purchased the stock for \$20 per share.	
4.	Sold 1,225 shares of ABC Corp. stock at \$9 per share. Green purchased 600 shares several years ago at \$30 per share. Three years ago, when the stock price was \$21, there was a 2-for-1 stock split and two years ago, when the stock price was \$25, there was a 3-for-2 stock split. No other shares were sold by Green prior to year 2.	
5.	Sold 500 shares of XYZ Corp. stock at \$20 per share. Green purchased these shares two years prior at \$22 per share. Three weeks subsequent to the sale, Green purchased 100 shares of XYZ stock at \$18 per share.	
6.	Sold 1,600 shares of BX Corp. stock at \$4 per share. Green received these shares as a gift from his sister four years ago. The fair market value of the shares at the date of the gift was \$7 per share. Green's sister inherited this stock from her stepmother's estate. At the date of her death, seven years ago, the fair market value of this stock was \$3 per share. The stepmother purchased this stock for \$1 per share 10 years prior to her death.	
7.	Sold 2,000 shares of TWX Corp. stock at \$8 per share. Green received 4,000 shares of TWX in a tax-free transaction for 2,000 shares of WTX Corp. stock he purchased in the prior year for \$2 per share.	

Problem 4 SIMULATION C Corporation Taxable Income

Action, Inc. is a calendar year-end, accrual-basis C corporation. For each independent situation below, calculate line 30, taxable income (loss) of Form 1120, *U.S. Corporation Income Tax Return*. Column A lists preliminary taxable income excluding additional tax return items shown in column B. Enter the taxable income (loss) in the associated shaded cells. (R/12, REG, #42, 89887)

	Preliminary taxable income (loss)	Additional tax return item(s)	Line 30 taxable income (loss)
1	\$100,000	\$20,000 of charitable contributions	
2	\$160,000	\$15,000 of charitable contributions	
3	\$200,000	\$10,000 of charitable contributions, and \$20,000 of dividends from less-than-20%-owned domestic corporations	
4	\$250,000	\$40,000 of dividends received from a 45%-owned domestic corporation	
5	\$ 80,000	\$10,000 of dividends received from a 10%-owned domestic corporation, and a \$20,000 net operating loss carryover from the prior year	
6	\$(40,000)	\$5,000 of charitable contributions and \$10,000 of dividends received from a 15%-owned domestic corporation	
7	\$(20,000)	\$200,000 of dividends received from a 25%-owned domestic corporation	

Problem 5 SIMULATION Research

Jami and Son Corp. is engaged in two businesses, one a retail chain and the other a plastics manufacturing business. The controller would like to use a different accounting method for the retail chain than for the plastics manufacturing business. What section and subsection of the Internal Revenue Code states whether this is an acceptable practice? (R/12, REG, #43, 89888)

Problem 1 MULTIPLE-CHOICE ANSWERS

1. (c) Corporate distributions are taxable to the extent of earnings and profits (E&P). $\$30,000 + \$20,000 = \$50,000$ (Bisk: 46-5-1; CSO: 6.3.4; 89801)

2. (a) Purchased goodwill and covenants not to compete both qualify for amortization over a uniform 15-year straight-line amortization period. $\$50,000 + \$13,000 = \$63,000$ (Bisk: 44-2-1; CSO: 4.3.0; 89802)

3. (b) A corporation's deduction for charitable contributions generally is limited to 10% of taxable income. $\$200,000 \times 10\% = \$20,000$ Contributions authorized during the year and paid before the return's due date qualify as deductions in the year authorized for corporations on the accrual basis of accounting. Any contributions that are not deductible currently because of the 10% rule may be carried forward for five years. (Bisk: 46-2-5; CSO: 6.3.1; 89803)

4. (c) The deduction for gifts to clients is limited to \$25 per gift. $(5 \text{ gifts} \times \$15/\text{gift}) + [(9 \text{ gifts} + 1 \text{ gift}) \times \$25/\text{gift}] = \$325$ (Bisk: 46-4-1; CSO: 6.3.1; 89804)

5. (b) A contract for the sale of goods is valid even though some terms are left open, if the parties intended to form a contract and there is a reasonably certain basis for giving an appropriate remedy. When the price is not agreed upon by the parties, the contract price is deemed to be a "reasonable price at the time of delivery." Under both the UCC and common law (the Statute of Frauds), a contract need not contain the signature of the party seeking to enforce it. (Bisk: 34-1-2; CSO: 2.3.1; 89805)

6. (b) Under a shipment contract, title and risk of loss pass when the seller puts goods in the possession of the carrier. Under a destination contract, the seller must bear the risk and cost of transporting goods to the named destination; title passes on tender at destination. If the goods are not to be moved and there is no delivery of a document of title, title and risk of loss pass when the goods are identified. (Bisk: 34-1-3; CSO: 2.3.1; 89806)

7. (a) An employee may deduct moving expenses incurred in connection with the commencement of work at a new principal place of employment. Allowable expenses include the cost of moving household goods and travel expenses, including lodging en route. Reimbursement received from an employer for qualified moving expenses are excluded from the employee's income; however, the same expense cannot be both reimbursed and deducted from income. Disallowed expenses include temporary living expenses and meal expenses. (Bisk: 43-3-4; CSO: 5.3.0; 89807)

8. (d) A security interest is enforceable against the debtor when it attaches. Attachment occurs when all three qualifying events (in any order) occur: (1) the debtor has rights in the collateral, (2) value is given by the secured party, and (3) a security interest is created. A security interest may be created in three ways, one of which is that the debtor gives the secured party an authenticated security agreement. (Bisk: 36-1-2; CSO: 2.3.3; 89808)

9. (c) IRS publications are interpretations of primary authoritative sources. When a bill becomes law, it is incorporated into the Internal Revenue Code (IRC). Cases in most courts may set precedent and, thus, create judicial law. Under authority granted by Congress, the U.S. Treasury issues regulations that interpret the IRC. (Bisk: 48-1-1; CSO: 3.8.1; 89809)

10. (a) The contribution of property to a partnership generally doesn't result in the recognition of income. When services are contributed for a partnership interest, the contributing partner recognizes earned income. (Bisk: 47-2-1; CSO: 6.5.1; 89810)

11. (c) A passive activity is a trade or business activity in which the taxpayer does not materially participate. In addition, most rental activities are deemed to be passive activities. Generally, passive activity losses may be used only to offset passive activity income. All of the rental income is offset by the net loss from Partnership B. The ordinary income from Partnership A and the short-term capital gain are included in adjusted gross income $(\$70,000 + \$4,000 = \$74,000)$. (Bisk: 43-2-3; CSO: 5.2.0; 89811)

12. (a) Honest inaccuracies and judgmental errors will not give rise to negligence liability so long as the accountant exercised reasonable care in performing the work. Negligence is the failure to exercise that degree of care that a reasonable person would exercise under the same or similar circumstances. Under certain circumstances, an accountant may be held liable for negligence and fraud to persons who are not clients. (Bisk: 42-3-1; CSO: 1.3.1; 89812)

13. (b) As the taxpayer did not buy the shares, the loss cannot be greater than the \$50,000 spent to purchase the option. The option was held for less than one year; clearly, the loss is short term. (Bisk: 44-3-2; CSO: 4.5.0; 89813)

14. (c) The sale of capital assets generate capital gains rather than ordinary income. As the taxpayer held the asset for longer than a year, the gain is long term. (Bisk: 44-3-2; CSO: 4.5.0; 89814)

15. (a) Generally, no gain or loss is recognized by a partner on the distribution of money or other property by the partnership to the partner. The basis of property (other than money) distributed to a partner in a nonliquidating distribution is equal to the basis of such property in the partnership's hands immediately before the distribution; however, the basis to the partner of the property distributed may not exceed the basis of the partner's interest in the partnership before the distribution. While the basis to the partnership is \$20,000, the basis to Anne is limited to \$10,000—her basis in her partnership interest before the distribution. Anne's basis in her partnership interest is reduced to zero by this distribution. (Bisk: 47-2-2; CSO: 6.5.6; 89815)

16. (c) The amount realized in the transaction includes the cash payments of \$200,000 and debt relief of \$50,000 less the selling expenses of \$10,000. The gross profit—or gain—is the difference between the amount realized in the transaction and the adjusted basis of the property relinquished (\$240,000 – \$75,000 = \$165,000). (Bisk: 48-3-5; CSO: 3.3.0; 89816)

17. (b) As a practical matter, the IRS generally does not reexamine a return that has been audited already, but it is not prohibited from doing so. Provided the time to amend a return has not lapsed, the taxpayer may amend a return that has been audited. Auditing one return does not restrict the IRS from auditing another return by the same taxpayer. (Bisk: 48-2-2; CSO: 3.2.2; 89817)

18. (b) An itemized deduction is allowed for payments (net of reimbursements) made in the current year for qualified medical services received in earlier years. The expense is deductible in the year a credit card is charged, regardless of when the credit card bill is paid. Medical expenses in excess of 10% (net of reimbursements) are deductible for alternative minimum tax purposes. Premiums for medical insurance, including Medicare, qualify as medical expenses. (Bisk: 43-4-3; CSO: 5.3.0; 89818)

19. (c) Circular 230 (and sound judgment) promotes establishing relevant facts, evaluating the reasonableness of assumptions and representations, arriving at a conclusion supported by the law and facts, and documenting conclusions in rendering tax advice. Written evidence from a client regarding fee approval by the board of directors is not required by Circular 230. The advisor's tax advice should be made orally only when, in the advisor's judgment, it is appropriate to do so. Written representations regarding the facts and statements provided to the CPA for preparing a tax memorandum are not required by Circular 230. (Bisk: 42-1-1; CSO: 1.1.1; 89819)

20. (b) An income tax return preparer may hold a taxpayer's check for safe-keeping. IRC Section 6695 states that a preparer shall pay a penalty for each check issued to a taxpayer and endorsed or otherwise negotiated by the tax preparer. (Bisk: 42-1-1; CSO: 1.1.2; 89820)

Problem 2 MULTIPLE-CHOICE ANSWERS

21. (c) LLC members commonly enter into an operating agreement—a private contract among the members that generally outlines how they will conduct the business. Generally, the members or organizers of an LLC must file written articles of organization (as opposed to an operating agreement) with the Secretary of State and the clerk of the court in the county of the principal place of business. (Bisk: 39-8-2; CSO: 2.6.2; 89821)

22. (b) An individual taxpayer may deduct investment interest expense up to the amount of net investment income as an itemized deduction. For this purpose, net investment income is investment income less noninterest investment expenses (\$10,000 – \$8,000 = \$2,000). (Bisk: 43-4-5; CSO: 5.3.0; 89822)

23. (a) As Jordan inherited the shares, her holding period is long term. Jordan's basis in the inherited property is the fair market value on the date of death, unless the estate's executor elects the alternative valuation date (AVD). $\$7,500 - \$5,000 = \$2,500$ **Editor's Note:** If Jordan's grandfather died in 2010, and the executor elected not to have the estate taxed, Jordan's basis and holding period basically would be that of her grandfather; however, this election was available only for the estates of decedents dying in 2010, and is unlikely to be tested. (Bisk: 44-1-4; CSO: 4.2.0; 89823)

24. (b) As Apple elected not to be treated as a corporation, it is treated as a partnership. The basis of a partnership in a contributed asset generally is the contributing partner's basis in the asset at the contribution date. (Bisk: 47-2-1; CSO: 6.5.2; 89824)

25. (d) Up to \$50,000 in losses on Section 1244 stock annually (per taxpayer) may be treated as an ordinary loss, offsetting ordinary income rather than offsetting capital gain. The remaining losses are capital losses. (Bisk: 44-4-2; CSO: 4.5.0; 89825)

26. (d) An unlimited exclusion from gift tax is permitted for tuition expenses of full-time or part-time students paid on behalf of another individual directly to a qualifying educational organization providing the education. A tuition payment made after December 31, 1981, directly to a foreign educational institution, is exempt from gift tax under Code Section 2503(e). **Editor's Note:** The editors believe options 'a' and 'b' also are correct. As three of these options are not relevant in determining whether a tuition payment is deductible for gift tax purposes, the editors do not expect a similar question on future exams. If you encounter an incorrect question during the actual exam, report it to the examiners in accordance with the examiners' instructions. (Bisk: 44-5-3; CSO: 4.7.2; 89826)

27. (a) An S corporation shareholder's initial basis in the S corporation's stock is increased by the shareholder's *pro rata* share of non-separately stated income, separately stated income, and depletion in excess of basis in the property as well as reduced by the shareholder's *pro rata* share of losses, separately stated deduction items, distributions not reported as income by the shareholder, and nondeductible expenses of the corporation. (Bisk: 46-10-5; CSO: 6.1.2; 89827)

28. (d) Attachment occurs when all three qualifying events (in any order) occur: (1) the debtor has rights in the collateral, (2) value is given by the secured party, and (3) a security interest is created. A security interest may be created in three ways: (1) the debtor and creditor acknowledge the creation of a security interest in an agreement signed by the debtor, (2) the collateral is in the possession of the secured party, or (3) the debtor gives the secured party an authenticated security agreement. The dollar amount is of little consequence. Whether the collateral is highly perishable or subject to wide price fluctuations is of little consequence. The presence of a purchase money security interest will not make the agreement enforceable unless the creditor has writing signed by the debtor or possession of the collateral. (Bisk: 36-1-1; CSO: 2.3.3; 89828)

29. (d) A security agreement must contain (1) the debtor's name and address, (2) the creditor's name and address, (3) the collateral's description, and (4) the debtor's signature. Oddly enough, the amount of the obligation is not required. (Bisk: 36-1-1; CSO: 2.3.3; 89829)

30. (d) An S corporation has a built-in gain when the FMV of contributed assets exceeds their bases at the beginning of the first year. Built-in gain is recognized by the contributing owner if realized within a specified period starting with the entity's formation; with a sole shareholder, built-in gain is not an issue, as there are no non-contributing owners. (Bisk: 46-10-4, also see 47-2-4; CSO: 6.4.5; 89830)

31. (a) Professional ethics discourage disclosure by an accountant of confidential information. Exceptions exist, such as when disclosure is pursuant to a quality review under AICPA authorization or in response to an AICPA trial board request, at the client's request, and when disclosure is in compliance with an enforceable subpoena or court order. (Bisk: 42-5-1; CSO: 1.3.3; 89831)

32. (d) Separately stated income retains its original character as it passes through to shareholders; shareholders treat this income in accordance with its original character. Net capital gain attributable to collectibles is taxed at a maximum rate of 28%. Mark-to-market income, unearned revenue, and Section 1245 gain are treated as ordinary income items. (Bisk: 46-10-4, also see 44-3-2; CSO: 6.4.2; 89832)

33. (c) Generally, the IRS may assess taxes from the later of three years from the return's due date or filing date. If a taxpayer omits more than 25% of gross income inadvertently or in good faith, the statute of limitations runs for six years. In the case of willful evasion, there is no time limit. When a taxpayer has not filed, there is no filing date and, hence, no time limit. (Bisk: 48-2-6; CSO: 3.2.7; 89833)

34. (a) All income is included in gross income unless specifically exempted. Schedule C is for determining the net income or loss from a trade or business, i.e., an activity engaged in for profit. The expenses of a hobby activity are allowable only to the extent of income from that activity; hobby expenses are deductible as miscellaneous itemized deductions subject to the 2%-of-adjusted-gross-income threshold. Any remaining hobby expenses are not deductible. (Bisk: 43-4-8; CSO: 5.3.0; 89834)

35. (d) For purposes of AMT, most itemized deductions are added back to regular taxable income; exceptions are medical expenses using a 10%, rather than a 7.5%, threshold; miscellaneous itemized deductions **not** subject to the 2% threshold; home acquisition interest expense; and investment interest expense. One must assume that the miscellaneous itemized deductions in the scenario are subject to the 2%-of-AGI limitation, as they are labeled "prior to AGI limitation." **Editor's Note:** The assumption that the miscellaneous itemized deductions in the scenario are subject to the 2%-of-AGI limitation is not one we are sure the examiners would make in a similar question. (Bisk: 43-5-4; CSO: 5.9.0; 89835)

Home equity loan interest		\$ 15,000
Real estate and state income taxes		18,000
Medical expenses @7.5% threshold [$\$15,000 - (\$150,000 \times 7.5\%)$]	3,750	
Less: Medical expenses @10% threshold [$\$15,000 - (\$150,000 \times 10\%)$]	<u>0</u>	3,750
Miscellaneous itemized deductions [$\$5,000 - (\$150,000 \times 2\%)$]		<u>2,000</u>
Total add-back adjustment		\$ 38,750

36. (b) A tax return preparer must keep either a copy of the return or a list of names, identification numbers, and tax years for three years following the close of the return period. A tax return preparer will incur a penalty for each failure to provide a client with a copy of an income tax return and for each failure to sign a tax return as a preparer. The IRS does not require disclosure of a conflict of interest for tax preparation. (Bisk: 42-1-1; CSO: 1.1.3; 89836)

37. (a) The more-likely-than-not standard is a greater than 50% likelihood that the position will be upheld if challenged. The substantial-authority standard is an approximately 40% likelihood that the position will be upheld. SSTS No. 7, Interpretation No. 1-2, Illustration 2 and the corresponding conclusion state, "The relevant tax code imposes penalties on taxpayers for underpayments attributable to tax shelters as defined in such code unless the taxpayer concludes that a position taken on a tax return associated with such a tax shelter is more likely than not the correct position. In assisting the taxpayer in tax planning, the member should inform the taxpayer of the penalty risks associated with the tax return position recommended with respect to any plan under consideration if that position satisfies the substantial authority standard, but does not satisfy the more likely than not standard." The realistic-possibility-of-success standard generally is an approximately 1-in-3 likelihood that a position will be upheld. The not-frivolous standard is very low. (Bisk: 42-1-3; CSO: 1.1.1; 89837)

38. (d) In the case of property purchased for resale, a taxpayer is exempt from UNICAP requirements if its average gross receipts for the preceding three years are \$10 million or less. (Bisk: 48-3-3; CSO: 3.4.2; 89838)

39. (b) Tax bills approved by the House of Representatives are considered by the Senate Finance Committee. The Senate Committee on Budget drafts annual budget plans. The Senate Committee on Appropriations is responsible for all discretionary spending legislation. The Senate Committee on Rules and Administration is charged with the administration of congressional buildings, senate rules, and credentials of members, including contested elections. (Bisk: 48-1-1; CSO: 3.1.0; 89839)

40. (c) A qualified indorsement usually is characterized by writing "without recourse" on the instrument. This disclaims the endorser's secondary liability to pay the instrument in the event it is dishonored. A blank indorsement is when the transferor's signature appears alone; this converts order paper to bearer paper. A special indorsement specifies the person to whose order the instrument is now payable; this converts bearer paper to order paper. A restrictive indorsement (such as, "for deposit only" or "pay any bank") requires a transferee who is not a bank to give value consistent with the restriction in order to become a holder for value; banks may ignore restrictive indorsements except for those made by their immediate transferors. (Bisk: 35-3-3; CSO: 2.3.2; 89840)

Problem 3 SIMULATION SOLUTION

1. \$0

As the stock was a gift of devalued property, its basis to Green is determined at the time of disposal. As the sale price was between the basis to the donor and the fair market value (FMV) at the date of the gift, no gain or loss is recognized.

2. \$1,200

As the stock was a gift of appreciated property, its basis to Green is the basis to the donor. $200 \text{ shares} \times (\$22/\text{share} - \$16/\text{share}) = \$1,200$

3. \$3,600

Typically, the basis of inherited property is the FMV of the property on the date of the decedent's death. $450 \text{ shares} \times (\$40/\text{share} - \$32/\text{share}) = \$3,600$

4. (\$1,225)

Green purchased 600 shares at $\$30/\text{share} = \$18,000$. After the 2-for-1 ($600 \times 2 = 1,200$) stock split, Green had 1,200 shares. After the 3-for-2 ($1,200 \times 3/2 = 1,800$) stock split; Green had 1,800 shares. At the sale, Green's basis per share was $\$18,000 / 1,800 \text{ shares} = \$10/\text{share}$. $1,225 \text{ shares} \times (\$9/\text{share} - \$10/\text{share}) = (\$1,225)$

5. (\$800)

A loss from the sale of stock is disallowed if substantially the same stock is purchased during a time period beginning 30 days prior to the sale and ending 30 days after that date. Green's loss on 100 shares is not allowed as Green purchased 100 shares three weeks after the sale. $400 \text{ shares} \times (20/\text{share} - \$22/\text{share}) = (\$800)$

6. \$1,600

Typically, the basis of inherited property is the FMV of the property on the date of the decedent's death. Green's sister's basis in the inherited stock was $\$3/\text{share}$. As the stock was a gift of appreciated property, its basis to Green is the basis to the donor. $1,600 \text{ shares} \times (\$4/\text{share} - \$3/\text{share}) = \$1,600$

7. \$14,000

Green's basis in the TWX stock received in a tax-free exchange is Green's basis of the property surrendered—the WTX stock. Green's total basis in the WTX stock surrendered was 2,000 shares \times \$2/share = \$4,000. Green's basis in the TWX shares was \$4,000 / 4,000 shares = \$1/share. 2,000 shares \times (\$8/share – \$1/share) = \$14,000 (Bisk: 44-3-2; CSO: 4.5.0; 89886)

Problem 4 SIMULATION SOLUTION

1. \$90,000

A corporation's deduction for charitable contributions generally is limited to 10% of taxable income without regard to the deduction for charitable contributions, the dividend-received deduction (DRD), any net operating loss (NOL) carry-back to that year, and any capital loss carry-back to that year. In this case, the charitable contribution deduction is limited to 10% \times \$100K = \$10K. \$100K – \$10K = \$90K

2. \$145,000

A corporation's deduction for charitable contributions generally is limited to 10% of taxable income without regard to the deduction for charitable contributions, the DRD, any NOL carry-back to that year, and any capital loss carry-back to that year. In this case, the charitable contribution deduction is limited to 10% \times \$160K = \$16K; this is more than the contributions made. \$160K – \$15K = \$145K

3. \$196,000

A corporation's deduction for charitable contributions generally is limited to 10% of taxable income without regard to the deduction for charitable contributions, the DRD, any NOL carry-back to that year, and any capital loss carry-back to that year. In this case, the charitable contribution deduction is limited to 10% \times \$200K = \$20K; this is more than the contributions made. C corporations are entitled to a DRD for dividends received from domestic corporations; the deduction is limited to a percentage of the dividend received based on the ownership percentage. In this case, ownership of the other corporation is less than 20%, so the percentage limit is 70%; 70% \times \$20K = \$14K. Generally, the DRD is limited to the percentage limit of taxable income without regard to the DRD; this limitation [(200K – 10K + 20K) \times 70% = \$147K] does not apply in this case. \$200K – \$10K + \$20K – \$14K = \$196K

4. \$258,000

C corporations are entitled to a DRD; the deduction is limited to a percentage of the dividend received based on the ownership percentage. In this case, ownership of the other corporation is from 20% to less than 80%, so the percentage limit is 80%; 80% \times \$40K = \$32K. Generally, the DRD is limited to the percentage limit of taxable income without regard to the DRD; this limitation [(250K + 40K) \times 80% = \$232K] does not apply in this case. \$250K + \$40K – \$32K = \$258K

5. (\$63,000)

Editor's Note: The editors disagree with the AICPA's unofficial solution of \$63,000 loss; we believe the correct solution is \$63,000 income. C corporations are entitled to a DRD; the deduction is limited to a percentage of the dividend received based on the ownership percentage. In this case, ownership of the other corporation is less than 20%, so the percentage limit is 70%; 70% \times \$10K = \$7K. Generally, the DRD is limited to the percentage limit of taxable income without regard to the DRD; this limitation [(80K – \$20K + 10K) \times 70% = \$49K] does not apply in this case. Normally, a NOL may be carried back 2 years and forward 20. \$80K – \$20K + \$10K – \$7K = \$63K

6. (\$37,000)

A corporation's deduction for charitable contributions generally is limited to 10% of taxable income without regard to the deduction for charitable contributions, the DRD, any NOL carry-back to that year, and any capital loss carry-back to that year. In this case, the charitable contribution deduction is not currently allowed because there is a loss [(\$40K) + \$10K = (\$30K)]. C corporations are entitled to a DRD; the deduction is limited to a percentage of the dividend received based on the ownership percentage. In this case, ownership of the other corporation is less than 20%, so the percentage limit is 70%; $70\% \times \$10K = \$7K$. Generally, the DRD is limited to the percentage limit (70%) of taxable income without regard to the DRD; however, when a NOL (\$30K) exists before the DRD is subtracted, the taxable income limitation is not applicable. $(\$40K) + \$10K - \$7K = (\$37K)$

7. \$36,000

C corporations are entitled to a DRD; the deduction is limited to a percentage of the dividend received based on the ownership percentage. In this case, ownership of the other corporation is from 20% to less than 80%, so the percentage limit is 80%; $80\% \times \$200K = \$160K$. Generally, the DRD is limited to the percentage limit of taxable income [(\$20K) + \$200K = \$180K] without regard to the DRD; in this case, the taxable income limitation is $\$180K \times 80\% = \$144K$. $(\$20K) + \$200K - \$144K = \$36K$

(Bisk: 46-2-3; CSO: 6.3.1; 89887)

Problem 5 SIMULATION SOLUTION

IRC Citation: §446(d)

IRC §446(d) states, "TAXPAYER ENGAGED IN MORE THAN ONE BUSINESS—A taxpayer engaged in more than one trade or business may, in computing taxable income, use a different method of accounting for each trade or business."

(Bisk: 48-1-1; CSO: 3.1.8; 89888)