

REGULATION

CPA2903US2-38

TABLE OF CONTENTS

About Updating Supplement Version 38.2	2
Study Options Available to Candidates	2
Other Sources of Information for Candidates	2
Recent Tax Legislation	3
American Recovery and Reinvestment Act of 2009	3
Emergency Economic Stabilization Act of 2008	5
Inflation-Adjusted Tax Amounts	12
Errata	15
Exam Format Change	15
Recently Released AICPA Questions	16

We wish to thank the **American Institute of Certified Public Accountants** and the **Financial Accounting Standards Board** for permission to reprint the following copyright © materials:

1. Uniform CPA Examination Questions and Unofficial Answers, Copyright © American Institute of Certified Public Accountants, Inc., Harborside Financial Center, 201 Plaza Three, Jersey City, NJ 07311-3881
2. Accounting Research Bulletins, APB Opinions, APB Statements, and Code of Professional Conduct.
3. FASB Statements, Interpretations, and Statements of Financial Accounting Concepts (SFAC), Copyright © Financial Accounting Standards Board, 401 Merritt 7, P.O. Box 5116, Norwalk, CT 06856, U.S.A. Reprinted with permission. Copies of the complete documents are available from the FASB.
4. GASB Statements, Interpretations, and Technical Bulletins, Copyright © Governmental Accounting Standards Board, 401 Merritt 7, P.O. Box 5116, Norwalk CT 06856-5116.
5. Statements on Auditing Standards (SAS), Statements on Standards for Accounting and Review Services (SSARS), Statements on Standards for Accountants' Services on Prospective Financial Information, Statements on Standards for Attestation Engagements (SSAE), and Statements on Quality Control Standards (SQCS).
6. ISB Standards, Copyright © Independence Standards Board, 6th Floor, 1211 Avenue of the Americas, New York, NY 10036-8775

Copyright © 2009 by Bisk Education, Inc. Tampa, FL 33631-3028
 All rights reserved. Reproduction in any form is expressly prohibited.
 Printed in the United States of America.

This publication is designed to provide accurate and authoritative information in regard to the subject matter covered. It is sold with the understanding that the publisher is not engaged in rendering legal, accounting or other professional service. If legal advice or other expert assistance is required, the services of a competent professional person should be sought.—*From a Declaration of Principles jointly adopted by a Committee of the American Bar Association and a Committee of Publishers and Associations.*

ABOUT UPDATING SUPPLEMENT VERSION 38.2

Information that is only six months old is eligible to be tested on the CPA exam. Updating Supplement Version 38.2 is designed to bring the latest release of AICPA questions to candidates using our products to prepare for the CPA exam in the April-May 2009 and later exam windows. Candidates with the 38th edition and corresponding software (version 12 series) 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, audio lectures, and books.

*Purchase of software required. Call for complete details.

OTHER SOURCES OF INFORMATION FOR CANDIDATES

Candidates with the 37th edition and corresponding software also will need Updating Supplement Version 37.3. Updating Supplement Version 37.3 contains summaries of bankruptcy and tax changes and inflation-adjusted amounts. (Material in the version 37.3 updating supplement is incorporated within the 38th edition, as appropriate. Material in the version 38.1 updating supplement is incorporated within the version 38.2 updating supplement.)

Candidates with the 36th and earlier editions 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.

RECENT TAX LEGISLATION

The *American Recovery and Reinvestment Act of 2009* (ARRA '09) became law on February 17, 2009, making it first eligible to be tested in the **October-November 2009** exam window. Most of the tax provisions are effective for 2009. Informally, the examiners have indicated that they will not test these provisions until 2010.

American Recovery and Reinvestment Act of 2009

A. Individual Provisions

1. **Qualified Transit Fringe Benefits:** Effective March 2009, the amount of excluded transit benefits (transit passes and pooling) increased to \$230 per month through 2010 with an annual inflation adjustment. This makes excludable benefits for transit and parking benefits the same amount.
2. **Unemployment Compensation:** In 2009, \$2,400 of unemployment benefits are excluded from taxable income.
3. **New Vehicle Sales Tax Deduction:** New cars, motorcycles, and light trucks purchased between February 17, 2009, and December 31, 2009, allow most buyers to deduct the state and local sales and excise taxes attributable to the first \$49,500 of the purchase as an above-the-line deduction. This deduction is allowed against AMT. The deduction is phased out for single taxpayers with adjusted gross income of \$125,000 (\$250,000 for MFJ).
4. **Education Items**
 - a. For 2009 and 2010, qualified expenses for Section 529 plans include computers and related technology (Internet access charges and predominately educational software) for beneficiaries enrolled at a qualified educational institution.
 - b. **American Opportunity Tax Credit:** The Hope credit is renamed. For 2009 and 2010, the credit is increased, expanded, and made 40% refundable. It increases the maximum credit per student to \$2,500 (figured as 100% of the first \$2,000 and 25% of the second \$2,000). It extends eligibility to four years of postsecondary education as well as course materials, such as textbooks. Phase-out ranges now are \$80,000 to \$90,000 for single taxpayers (\$160,000 to \$180,000 for MFJ).
5. **AMT:** Private activity bonds issued in 2009 and 2010 are excluded from AMT. Also, exemptions increased for 2009.

<u>Filing status</u>	<u>Exemption</u>	<u>Phase-out Threshold</u>
Married filing jointly or Surviving spouse	\$70,950	\$150,000
Single or Head of household	\$46,700	\$112,500
Married filing separately	\$35,475	\$ 75,000

6. **Economic Recovery Payment:** For 2009 only, a person on a fixed income (social security recipient, disabled veteran, government retiree, etc.) is eligible for a \$250 payment.
7. **Making Work Pay Credit:** Retroactive to January 1, 2009, and expiring December 31, 2010, the Making Work Pay (MWP) credit is 6.2% of earned income up to a total of \$400 for individuals (\$800 for MFJ). This credit phases out at 2% of MAGI above \$75,000 for individuals (\$150,000 for MFJ). Economic Recovery Payments received reduce any MWP credit.
8. **First-Time Homebuyer Credit:** The maximum credit is increased to \$8,000 and extended to November 30, 2009. The repayment requirement is eliminated for houses purchased in 2009.
9. **Child Tax Credit:** For 2009 and 2010, a lower income threshold (\$3,000) for refundability of the child credit expands benefits for lower-income filers.

10. Earned Income Tax Credit: For 2009 and 2010, for taxpayers with three or more qualifying children, the credit is 45% of earned income. Also, the phase-out range for joint filers is increased by \$1,880 to eliminate any marriage penalty.

B. Property Provisions

1. Section 179: For 2009, the §179 expense deduction is \$250,000 for qualified property. For 2009, the limit is reduced by cost of §179 property placed in service during the year that exceeds \$800,000. (These are the same as the final amounts for 2008.)
2. Bonus Depreciation: The 50% bonus depreciation is extended through 2009. For certain property with a recovery period of 10 years or more, the 50% bonus depreciation is extended through 2010. For bonus depreciation, the regular dollar cap for new vehicles is raised by \$8,000. The option to accelerate research and AMT credits instead of taking bonus depreciation also is extended.
3. Qualified Small Business Stock: Exclusion of gain from the sale of qualified small business stock is increased to 75% for stock acquired from February 18, 2009, to December 31, 2010.
4. Energy Credits: ARRA '09 increases the residential energy property credit, the residential energy efficiency property credit, and the energy investment credit.

C. Small Business Provisions

1. Net Operating Loss (NOL) Carryback: A small business (average gross receipts of \$15 million or less) may carry back a 2008 NOL for up to five years. For a 2009 NOL, the regular two-year carry back period is in effect.
2. Discharge of Business Indebtedness: Qualified businesses may elect irrevocably to recognize income due to debt cancellation from January 1, 2009, to December 31, 2010, over a five-year period, starting in 2014.
3. Built-in Gains Tax: For 2009 and 2010, the recognition period for S corporation assets subject to built-in gains tax is reduced to seven years.
4. Work Opportunity Tax Credit: Employers who hire disconnected youth and unemployed veterans in 2009 and 2010 may be eligible to take this credit.
5. Safe Harbor Estimated Tax Payments: Eligible individuals may make estimated tax payments that equal 90% (instead of 100%) of the prior year's tax liability. Eligible individuals get more than 50% of their gross income from a small business (averaging fewer than 500 employees) and have adjusted gross income of less than \$500,000.
6. COBRA Payments: People involuntarily separated from employment from September 1, 2008, to December 31, 2009, may elect to have payments of 35% of COBRA coverage treated as full payment. The former employer makes up the difference and is reimbursed by crediting those payments against income taxes. Applicable limitations are beyond the scope of the exam.

D. Energy & Conservation Provisions

1. Residential Energy Credit: The \$500 cap is eliminated. The aggregate cap for 2009 and 2010 installations is \$1,500.
2. Residential Energy Efficiency Property Credit: ARRA '09 removes individual dollar caps on solar energy property, geothermal heat pumps, and wind energy property. ARRA '09 places a \$500 credit cap on qualified fuel cell property expenditures.
3. Qualified Plug-in Electric Drive Motor Vehicle Credit: The credit base will be reduced once a manufacturer sells 200,000 vehicles.

4. **Alternative Fuel Pump Credit:** ARRA '09 increased the credit to 50% (capped at \$50,000 for commercial and retail stations and \$2,000 for individuals) for property placed in service in 2009 and 2010. The 30% credit (now capped at \$200,000) continues to apply to hydrogen refueling property.
5. **Renewable Electricity Production Credit:** This credit is extended through 12-31-12 for wind and refined coal and through 12-31-13 for all other sources.
6. **Energy Investment Credit:** ARRA '09 removes the cap for qualified small wind energy property and removes the reduction of the credit available to taxpayers financing with private activity bond proceeds or subsidized energy financing.
7. **Investment Credit Election:** Instead of taking the production tax credit, ARRA '09 allows producers to treat qualified alternative energy facilities as energy property eligible for a 30% investment credit. (The production tax credit applies to electricity production from alternative energy sources by qualified facilities.)

The *Emergency Economic Stabilization Act of 2008* became law on law on October 3, 2008, making it first eligible to be tested in the **July-August 2009** exam window. Most of the tax provisions are effective for 2009 or retroactively for 2008. This summary probably is more detailed than the examiners will test.

Emergency Economic Stabilization Act of 2008

A. Individual Provisions

1. **AMT Exemption:** Exemptions increased for 2008.

<u>Filing status</u>	<u>Exemption</u>	<u>Phase-out Threshold</u>
Married filing jointly or Surviving spouse	\$69,950	\$150,000
Single or Head of household	\$46,200	\$112,500
Married filing separately	\$34,975	\$ 75,000

2. **AMT Credit**

- a. For 2008, the following nonrefundable personal credits can be used against both regular tax and AMT.
 - (1) Dependent Care Credit
 - (2) Elderly & Disabled Credit
 - (3) Child Credit
 - (4) Certain Home Mortgage Interest Credit
 - (5) Hope Scholarship & Lifetime Learning Credits
 - (6) Retirement Savings Credit
 - (7) Non-Business Energy Credits
 - (8) Residential Energy Efficiency Property Credit
 - (9) DC First-Time Homebuyer Credit
- b. **Long-Term Unused AMT Credits:** The AMT refundable credit is increased to the greater of either 50% of the long-term unused credit for that year or the amount of the AMT

refundable credit determined for the taxpayer's preceding year without regard to any interest and penalties paid.

- (1) For tax years ending before 01-01-08, any underpayment attributable to incentive stock options plus the interest and penalty is abated.
- (2) For the first two years beginning after 12-31-07, the AMT refundable credit and minimum tax credits are increased by 50% of the aggregate amount of the interest and penalties paid which would have, but for the payment of the penalties and interest, been abated.

3. Income Exclusions

- a. Home: The income exclusion for qualified principal residence debt is extended for three years through 12-31-12.
- b. Charity: The income exclusion for qualified charitable distributions from an IRA (regular or Roth or deemed IRA) of up to \$100,000 is extended for 2008 and 2009.
- c. Bicycle: Bike commuting reimbursements of \$20 per month are added as a qualified transportation fringe benefit. The reimbursement must be a qualified bicycle commuting reimbursement. Benefits provided through an elective salary reduction plan do not qualify. These provisions apply for tax years beginning after 12-31-08. The period for reimbursement is for a 15-month period starting on the first day of the calendar year during which the employee regularly rides to and from work. Covered expenses include bicycle purchase, bike accessories, bike repair and bike storage.

4. Deductions

- a. The \$500/\$1,000 increase in the standard deduction amount for real estate taxes is extended through 2009.
- b. The election to deduct state and local sales tax instead of state and local income taxes is extended through 2009.
- c. The qualified tuition and related expense deduction is extended through 12-31-09.
 - (1) \$4,000 for single AGIs of \$65,000 or less (\$130,000 if MFJ).
 - (2) \$2,000 for single AGIs of up to \$80,000 or less (\$160,000 if MFJ).
- d. The \$250 maximum AGI deduction for eligible educator expenses is extended to tax years beginning in 2008 and 2009.

5. Changes Relating to Children

- a. Refundable Child Tax Credit: For 2008, the child tax credit is refundable up to the extent of 15% of the taxpayers earned income in excess of \$8,500, up to the full credit amount. The taxpayer must have total regular and AMT tax liability less than the allowable child credit less nonrefundable credits previously taken.
- b. Qualified Child Definition: A "qualified" child meets the following tests.
 - (1) Relationship Test: Child, stepchild, siblings, stepsiblings or descendants, including adopted children and those lawfully placed for adoption.
 - (2) Abode Test: Child must have the same principal place of abode as the taxpayer for more than ½ of the year.

- (3) Age Test: Child must be younger than the taxpayer as well as under 19 or a student under 24 or permanently and totally disabled at the close of the year.
- (4) Support Test: Child must not have provided more than 50% of her/his own support for the year.
- (5) Joint Return Test: Child can't file a joint return for any year beginning during the taxpayer's calendar year, unless the filing is solely to claim a refund.
- (6) Tiebreaker Rules: The tiebreaker rules apply whenever more than one person can claim the child as a qualifying child. If the parents can claim the child as a qualifying child, but neither does, then another taxpayer can claim the child as a qualifying child, but only if that taxpayer's AGI is higher than the highest AGI of the child's parents.

B. Business Provisions

1. Deductions

- a. Qualified Leasehold Improvements & Restaurant Building Improvements: The 15-year period for qualified leasehold improvements and restaurant building improvements is extended to include property placed in service prior to 01-01-10.
- b. Qualified Retail Improvements: A 15-year recovery period is extended to qualified retail improvement property. If ADS is elected or required, the life is 39 years.
 - (1) Straight-line depreciation must be used.
 - (2) Neither Section 179 deduction nor bonus depreciation is permitted.
 - (3) Definition: Interior portion of nonresidential real estate open to the public or used in the retail trade of selling tangible personal property to the general public.
 - (a) Timing: Placed in service after 12-31-08 and before 01-01-11 and more than three years after the building was first placed in service.
 - (b) Excluded: Elevators and escalators, internal structural framework, structural components that benefit a common area, and improvements related to building enlargement.
- c. Farmers: Most farm machinery and equipment originally placed in service by the taxpayer in 2009 in a farming business will have a five-year recovery period.
- d. Biofuel: Taxpayers can expense 50% of a facility that produces cellulosic biofuel in addition to cellulosic ethanol, provided the facility is placed in service after 10-03-08 and before 01-01-13.
- e. Environmental Remediation: The election to expense environmental remediation costs is extended to expenses or expenditures paid or incurred before 01-01-10.
- f. Depletion: The suspension of the taxable income limit on the oil and gas percentage depletion allowance from marginal wells has been extended to include any tax years beginning after 12-31-08 and before 01-01-10.
- g. Executive Compensation Limitation: Limitations apply to financial institutions that sell troubled assets to the Treasury under the Troubled Asset Relief Program (TARP). Carryovers of unused deductions are permitted. All corporations of the same controlled group are treated as a single employer for these provisions. These provisions generally are effective for tax years ending on or after 10-03-08.

- (1) Limitations begin when a financial institution sells troubled assets directly to the Treasury and the Treasury takes a meaningful equity or debt position in the institution as a result. The limitations continue so long as the debt or equity position is in place.
 - (a) Compensation limits for senior executive officers that exclude incentives to take unnecessary and excessive risks threatening the institution's value.
 - (b) Recovery of any bonus or incentive paid to any senior executive officer based on earnings, gains, etc. that are later shown to be materially inaccurate.
 - (c) Prohibition of any golden parachute payment to any senior executive officers during the period Treasury holds the debt or equity position.
- (2) Where financial institutions sell troubled assets through a TARP-managed public auction and the purchases by the institution exceed \$300 million, compensation limitations apply:
 - (a) The maximum compensation is \$500,000, including commissions and incentive pay.
 - (b) The golden parachute rules include payments to executives of financial institutions participating in these auctions.
 - (c) There is a prohibition against the financial institution entering into any new employment contract with a senior executive officer providing for a golden parachute payment in the event of an involuntary termination, bankruptcy filing, insolvency, or receivership during the period during which the TARP authority is in place.

2. Credits

- a. Research Credit: The research credit is extended through 12-31-09, with the orphan drug credit still effective after 12-31-09.
- b. New Markets Credit: The new markets credit is extended through 2009.

C. Charitable Contributions

1. Basis: An S corporation's shareholder's basis reduction for a charitable contribution of appreciated property is limited to the pro rata share of the corporation's adjusted basis for tax years beginning before 01-01-09.
2. Computers: The special deduction for C corporations for qualified computers and computer technology is extended for contributions made during a taxable year beginning before 12-31-09.
3. Books: The special deduction for contributions of books to public schools by C corporations is extended through 12-31-09.
4. Food: The special deduction for charitable contributions of food inventory by any taxpayer engaged in a trade or business is extended through 12-31-09.

D. Energy & Conservation

1. Residential Energy Credit: The \$500 maximum residential energy credit is reinstated only for 2009. In addition to the formerly qualifying property (i.e., exterior doors, windows, insulation,

- etc.), stoves using renewable plant-derived fuel and asphalt roofs with cooling granules are added.
2. Residential Alternative Energy Credit: Extended through 2016. The credit can offset both regular and AMT, starting in 2008. Any unused credits can be carried forward.
 - a. Starting in 2009, the \$2,000 cap on the credit is removed on solar energy property and 30% of the expenditures qualify for the credit.
 - b. Small wind investment property (for use in connection with a dwelling) and geothermal heat pumps now qualify. Only 30% of the expenditures qualify for the credit.
 3. Qualified Plug-in Electric Drive Motor Vehicle Credit: The credit starts in 2009 and runs through 2014 for both individuals and businesses. Where the vehicle is used by a tax-exempt organization or government unit, the seller may claim the credit.
 - a. Qualified Plug-in Electric Drive Vehicle: Has a high-power battery for vehicle traction with at least four kilowatt hours of capacity; has an off-board source of energy to recharge the battery; and meets specified clean air act provisions.
 - b. Calculation: The credit is \$2,500 plus \$417 for each kilowatt hour of traction battery capacity in excess of four kilowatt hours. The maximum credit, dependent on gross vehicle weight, ranges from \$7,500 for a vehicle under 10,000 pounds to \$15,000 for a vehicle of 26,000 pounds.
 4. Alternative Fuel Pump Credit: The alternative fuel vehicle refueling property credit is extended through 12-31-10. The alternative fuel vehicle refueling property is expanded to include alternative fuel property other than hydrogen.
 5. Renewable Electricity Production Credit: The renewable electricity production credit is extended through 12-31-09 for wind and refined coal and through 12-31-10 for all other sources. The credit is extended to marine renewable energy sources.
 6. Energy Investment Credit: Various energy investment credits (solar energy, micro-turbine, qualified fuel cell) are extended through 12-31-16. The restrictions on public utility property eligibility are repealed. The cap on half kilowatt hour capacity is increased from \$500 to \$1,500 for fuel cell property. Combined heat and power property is now eligible for the 10% credit.
 7. New Energy Efficient Homes Credit: Extended through 12-31-09.
 8. Energy Efficient Appliances Credit: Extended through 12-31-10 with changed standards.
 9. Carbon Dioxide Capture Credit: Applicable to carbon dioxide recaptured after 10-03-08. The credit amounts are adjusted for inflation after 2009. A new credit of \$20 per metric ton of qualified CO₂ emissions captured and disposed of in a secure geological storage is created. A new credit of \$10 per metric ton of qualified CO₂ emissions captured and used as a tertiary injectant in a qualified enhanced oil or natural gas recovery project is created.
 10. The Biodiesel, Renewable Diesel & Alternative Fuel Credits: All credits for biodiesel, renewable diesel and alternative fuels have been extended until 12-31-09. The definitions of qualified fuels are expanded. No fuel produced outside the U.S. or its possessions for use as fuel outside the U.S. is eligible for the tax incentives.
 11. Energy-Efficient Commercial Building Property: The special deduction is extended to property placed in service before 01-01-14.
 12. Bonus Depreciation for Reuse and Recycling Property: There is a 50% bonus depreciation for qualified reuse and recycling property acquired and placed in service after 08-31-08. A taxpayer may elect out of claiming the bonus depreciation for a particular asset class. The use of the property must be original use with the taxpayer.

- E. **New Preparer Penalty Rules:** These provisions apply to returns prepared after 05-25-07, unless the position involves a tax shelter or reportable transaction, in which case the effective date is for returns prepared for tax years ending after 10-03-08.
1. There are now three categories of unreasonable positions to which the preparer penalty will apply.
 - a. **General (Undisclosed) Positions:** Avoid penalty by having substantial authority for the position.
 - b. **Disclosed Positions:** Avoid penalty by having reasonable basis and disclosure.
 - c. **Tax Shelters & Reportable Transactions:** Avoid penalty by meeting more-likely-than-not standard.
 2. The reasonable cause/good faith defense is still available.
- F. **Disaster Relief:** The limited applicability of the provisions make them unlikely to be tested in depth, particularly the ones limited by geography.
1. **Personal Casualty Losses:** There is a temporary increase in the \$100 limitation for each casualty or theft to \$500 for tax years beginning in 2009. Personal casualty losses arising from a federally declared disaster may be deducted without regard to the 10% of AGI limitation in 2008 and 2009. Other personal casualty losses remain subject to the 10% limit.
 - a. Starting in 2008, the standard deduction is increased by the net disaster deduction. This net disaster deduction also is allowed as a deduction for AMT purposes, although the standard deduction remains nondeductible for AMT purposes.
 - b. The waiver of the AGI limitations don't apply to any federally declared disaster occurring on or after 5-20-08 and before 08-01-08, which excludes the severe storms, tornados, or flooding in Arkansas, Illinois, Indiana, Iowa, Kansas, Michigan, Minnesota, Missouri, Nebraska, and Wisconsin.
 2. **NOLs Attributable to Federally Declared Disasters:** These provisions are effective for tax years beginning after 12-31-07 for disasters declared after 12-31-07. There is a five-year carryback for NOLs arising from qualified disaster losses. The qualifying five-year NOL is the taxpayer's NOL for the year in which the NOL occurs. All other NOLs remain subject to the general two-year rule. Carrybacks of these losses are exempt from the 90% of AMTI limitation.
 - a. A qualified disaster loss is one occurring in a disaster area that is attributable to a federally declared disaster occurring after 12-31-07 and before 01-01-10 plus the deduction for qualified disaster expenses. If less, it's the taxpayer's NOL.
 - b. Excluded from the definition is any property used as a golf course, country club, massage parlor, hot tub facility, suntan facility or any store with a principal business of selling off-premises alcoholic beverages or any property with 100 square feet or more used for gambling or animal racing.
 3. **Qualified Disaster Cost Expensing:** Qualified disaster expenses paid or incurred after 12-31-07 are deductible through 12-31-09. Where the expenditure would otherwise have to be capitalized, the deduction is treated as depreciation, to be recaptured upon disposition as IRC §1245 depreciation. Qualified disaster expenses meet the following criteria.
 - a. Otherwise chargeable to a capital account
 - b. Connected with trade or business or business related property

- c. Incurred in abating or controlling hazardous substances released as a result of a federally declared disaster, debris removal or structure demolition of business real property destroyed by the disaster, or the costs of repairing business property damaged by the disaster.
- 4. Increased Expensing for Qualified Disaster Property: These provisions are effective for property placed in service after 12-31-07 for disasters declared after that date. The property cannot also be treated as qualified zone property or qualified renewal property.
 - a. The deduction for qualified disaster assistance property is increased by the lesser of \$100,000 (to \$350,000 for 2008) or the cost of the property placed in service in the year.
 - b. The investment limitation is increased by the lesser of \$600,000 (to \$1,400,000 for 2008) or the cost of the property placed in service during the year.
 - c. Recapture will occur in the year the property ceases to be qualified disaster assistance property.
- G. Health Insurance Provisions: Parity for Mental Health & Substance Use Disorder Benefits: These provisions are effective for plan years beginning after 10-03-09. Group health plans of 51 or more employees that provide both medical and surgical benefits and mental health or substance use disorder benefits must apply the financial requirements to both benefits equally.

Editor's Note: 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.

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 2009 and October-November 2009 CPA examinations should cover the law in effect for 2009. However, the examiners repeatedly have tested the last full calendar year. The editors expect the July-August 2009 and the October-November 2009 CPA examination questions to ask about 2008, not 2009, in those few questions where the year makes a difference. The editors expect the questions on the January-February 2010 and April-May 2010 CPA examinations to cover the tax law in effect for 2009.

Inflation-Adjusted Tax Amounts

Note that some amounts (AMT exemption 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.

Individual Taxation

- A. Exemption: The personal exemption is \$3,650 for 2009 (\$3,500 for 2008).
- B. Standard Deduction & Personal & Dependency Exemption Phase-out: For 2009, the standard deduction for an individual who may be claimed as a dependent by another taxpayer may not exceed the greater of either \$950 (\$900 for 2008) or the sum of \$300 and the individual's earned income.

Filing Status	Standard Deduction		Personal & Dependency Exemption Phase-out		Additional Age & Blindness	
	2008	2009	2008	2009	2008	2009
Married Filing Jointly *	\$10,900	\$11,400	\$239,950	\$250,200	\$1,050	\$1,100
Single	5,450	5,700	159,950	166,800	1,350	1,400
Head of Household	8,000	8,350	199,950	208,500	1,350	1,400
Married Filing Separately	5,450	5,700	119,975	125,100	1,050	1,100

* Also surviving spouse

C. Overall Limitation on Itemized Deductions: For 2009, applies to an individual whose AGI exceeds \$166,800 (\$83,400 for a married taxpayer filing a separate return). For 2008, applies to an individual whose AGI exceeds \$159,950 (\$79,975 for MFS). For 2009 and 2008, the maximum reduction is at most 1/3 of the amount calculated before the reduction. [The overall limitation rule is applicable to the phase-out of itemized deductions. Candidates who are unfamiliar with the overall limitation rule should review the material on AGI in Chapter 44.]

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

<u>Filing Status</u>	<u>2008</u>	<u>2009</u>
Married filing jointly	\$100,650 to \$130,650	\$104,900 to \$134,900
All others	\$ 67,100 to \$ 82,100	\$ 69,950 to \$ 84,950

E. Retirement Plans: Employees may defer up \$49,000 in defined contribution plans for 2009 (\$46,000 for 2008). The limit for defined benefit plans is \$195,000 for 2009 (\$185,000 for 2008).

1. Section 401(k), Section 457, and SEP Plans: For 2009, the maximum on elective deferrals is \$16,500. For 2008, the maximum on elective deferrals is \$15,500.
2. SIMPLE Plans: For 2009, employees may defer up to the lesser of \$11,500 (\$10,500 for 2008) of elective contributions or 25% of annual compensation.
3. Catch-up Contributions: For 2009, the maximum catch-up contributions are \$5,500 for Sections 401(k), 403(b), and 457 plans, and \$2,500 (not a change) for SIMPLE plans. For 2008, the maximum catch-up contributions are \$5,000 for Sections 401(k), 403(b), and 457 plans, and \$2,500 for SIMPLE plans.

F. Individual Retirement Account (IRA) Phase-outs: In 2009, the maximum Roth IRA contribution is phased out for taxpayers with AGI exceeding \$166,000 (MFJ), \$105,000 (single), and \$0 (MFS). In 2008, these maximums are \$159,000, \$101,000, and \$0, respectively. The phase-out range for contributions of a non-active spouse are starts at \$166,000 for 2009 (\$159,000 for 2008). The active participant phase-outs are as follows.

<u>Filing Status</u>	<u>2009</u>	<u>2008</u>
Married filing jointly	\$89,000 to \$109,000	\$85,000 to \$105,000
Single or Head of Household	\$55,000 to \$ 65,000	\$53,000 to \$ 63,000
Married filing separately	\$0 to \$ 10,000	\$0 to \$ 10,000

G. Income Tax Rates: The individual tax rates are as follows for 2009.

<u>Rate</u>	<u>MFJ & SS</u>	<u>Head of household</u>	<u>Single</u>	<u>MFS</u>
10%	\$ 0 to \$ 16,700	\$ 0 to \$ 11,950	\$ 0 to \$ 8,350	\$ 0 to \$ 8,350
15%	\$ 16,701 to \$ 67,900	\$ 11,951 to \$ 45,500	\$ 8,351 to \$ 33,950	\$ 8,351 to \$ 33,950
25%	\$ 67,901 to \$137,050	\$ 45,501 to \$117,450	\$ 33,951 to \$ 82,250	\$ 33,951 to \$ 68,525
28%	\$137,051 to \$208,850	\$117,451 to \$190,200	\$ 82,251 to \$171,550	\$ 68,526 to \$104,425
33%	\$208,851 to \$372,950	\$190,201 to \$372,950	\$171,551 to \$372,950	\$104,426 to \$186,475
35%	Over \$372,950	Over \$372,950	Over \$372,950	Over \$186,475

H. AMT Exemption & Phase-out Schedule: The phase-out ceiling amounts are four times the exemption plus the phase-out threshold amount. (The 2008 exemption amounts are different than appear in the 38th edition book due to the *Emergency Economic Stabilization Act of 2008*.)

<u>Filing status</u>	<u>2009 Exemption</u>	<u>2008 Exemption</u>	<u>2009 & 2008 Phase-out Threshold</u>
Married filing jointly or Surviving spouse	\$45,000	\$69,950	\$150,000
Single or Head of household	\$33,750	\$46,200	\$112,500
Married filing separately	\$22,500	\$34,975	\$ 75,000

- I. Adoption Expense Credit: The maximum adoption expense credit is \$12,150 for 2009 (\$11,650 for 2008). It phases out starting at \$182,180 for 2009 (\$174,730 for 2008).
- J. Child Credit: The child credit is refundable to the extent of the greater of 15% of the taxpayer's earned income in excess of \$12,550 for 2009 (\$12,050 for 2008), or for taxpayers with three or more qualifying children, the amount of Social Security taxes that exceeds the earned income credit.
- K. Earned Income Credit: The earned income credit is denied if certain investment income is greater than \$3,100 in 2009 (\$2,950 in 2008).

	Number of Qualifying Children	Credit %	Base	Maximum Credit	Beginning Phase-out*	Complete Phase-out*
2008	0	7.65	\$ 5,720	\$ 438	\$ 7,160	\$12,880
	1	34.00	8,580	2,917	15,740	33,995
	2	40.00	12,060	4,824	15,740	38,646
2009	0	7.65	\$ 5,970	\$ 457	\$ 7,470	\$13,440
	1	34.00	8,950	3,043	16,420	35,463
	2	40.00	12,570	5,028	16,420	40,295

* For married filing jointly, add \$3,120 to each phase-out amount in 2009 (\$3,000 in 2008).

- L. Education Credit & Phase-out Threshold: For 2009 and 2008, the Hope Scholarship Credit is 100% of expenses not in excess of \$1,200 and 50% of such expenses in excess of \$1,200. The education credit phase-out range is as follows.

Filing Status	2009	2008
MFS	\$0	\$0
MFJ	\$100,000 to \$120,000	\$96,000 to \$116,000
Others	\$ 50,000 to \$ 60,000	\$48,000 to \$ 58,000

- M. Self-Employment & Social Security Taxes: The maximum income subject to the full self-employment and social security taxes is \$106,800 in 2009 (\$102,000 in 2008).
- N. Mileage Rates: The rate for automobile use for medical care travel or a qualified move is 24¢ per mile for 2009, 19¢ per mile for the first six months of 2008, and 27¢ for the last six months of 2008. The rate for charitable travel is 14¢ per mile for 2009 and 2008. The rate for business travel is 55¢ per mile for 2009, 50.5¢ per mile for the first six months of 2008, and 58.5¢ for the last six months of 2008.
- O. Health Savings Account: For 2009, taxpayers can contribute up to the amount of the health plan's annual deductible, but not more than \$3,000 (\$2,900 for 2008) for individual coverage and \$5,950 (\$5,800 for 2008) for family coverage.

Property Taxation

- A. Section 179: For 2008 and 2009, the §179 expense deduction is \$250,000 for qualified property. For 2008 and 2009, the limit is reduced by cost of §179 property placed in service during the year that exceeds \$800,000. (The 2009 amounts were changed by ARRA '09).
- B. Luxury Automobiles: For 2009 and 2008, the first year's depreciation on a luxury automobile generally is limited to \$10,960. For 2009 and 2008, the first year's depreciation on a luxury automobile on which the 50% additional first-year (bonus) depreciation deduction does not apply is limited to \$2,960.
-

Estates, Gifts & Trusts Taxation

- A. Funeral Trusts: The contribution limit is \$9,000 for contracts entered into for tax years before August 29, 2008. For tax years beginning after August 29, 2008, there is no limit on contributions.
- B. Annual Gift Exclusion: For 2009, the first \$13,000 (\$12,000 for 2008) of gifts to any person are not included in the total amount of taxable gifts made.

ERRATA**Chapter 32**

Question 56 (8290) on page 32-40 has an incorrect answer. The correct answer is 'a,' not 'c.' The correct explanation is, "When the auditor's opinion on the financial statements is *unaffected* by the adverse opinion on the effectiveness of internal control over financial reporting (ICFR), the report on ICFR should include the disclosure (or similar language) in "I." The disclosure (or similar language) in "II" should be included when the auditor's opinion on the financial statements *is affected* by the adverse opinion on the effectiveness of ICFR."

Chapter 43

Example 7 on page 43-11 has a typographical error in the table's first line in the first column. The 2009 date should be 2008.

Problem 43-3 on page 43-37 in the explanation to number 2 has a second sentence that should read, "The \$12,000 net Section 1231 gain in Year 1 is treated..." rather than, "The \$12,000 net Section 1231 gain in Year 2 is treated..." Item number 2 is mistakenly labeled item number 3 in this solution.

Chapter 44

Example 7 on page 44-17 should have the amount be \$5,000 per person in 2008.

Chapter 47

Problem 47-4 on page 47-18 has two typographical errors in the first paragraph. The 40% on the second line should be 50%. The \$14,000 on the third line should be \$15,000.

EXAM FORMAT CHANGE**Written Communication Task Format**

The AICPA is planning a change to the written communication task, but this change likely will not be implemented until 2010, at earliest.

Simulation Topics

Formerly, the AICPA examiners informally indicated that simulations would not cover business law topics. Technically, all REG topics were eligible to be tested in any format. Now, the AICPA informally indicates that business law topics are fair game for simulations. Due to the relatively small point value assigned to business law topics in the content specification outline, the editors do not expect the examiners to present many business law simulations.

RECENTLY RELEASED AICPA QUESTIONS

In September 2008 and April 2009, the AICPA released several questions labeled as "Year 2008 Disclosed Questions," and "Year 2009 Disclosed Questions," respectively. For both releases, the first problem was labeled "moderate" and the second problem was labeled "more difficult" by the AICPA examiners.

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 was that it would not be used for future exams; thus, candidates should not be surprised by obsolete 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 earned no 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 (30 to 40 minutes)

1. Taylor, an unmarried taxpayer, had \$90,000 in adjusted gross income for year 13. During year 13, Taylor donated land to a church and made no other contributions. Taylor purchased the land in year 1 as an investment for \$14,000. The land's fair market value was \$25,000 on the day of the donation. What is the maximum amount of charitable contribution that Taylor may deduct as an itemized deduction for the land donation for year 13?

- a. \$25,000
- b. \$14,000
- c. \$11,000
- d. \$0 (R/08, REG, 0048T, #1, 8658)

2. Forrest Corp. owned 100% of both the voting stock and total value of Diamond Corp. Both corporations were C corporations. Forrest's basis in the Diamond stock was \$200,000 when it received a lump sum *liquidating* distribution of property as a result of the redemption of all of Diamond stock. The property had an adjusted basis of \$270,000 and a fair market value of \$500,000. What amount of gain did Forrest recognize on the distribution?

- a. \$0
- b. \$ 70,000
- c. \$270,000
- d. \$500,000 (R/08, REG, 0743T, #2, 8659)

3. Nare, an accrual-basis, calendar-year taxpayer, owns a building that was rented to Mott under a 10-year lease expiring August 31, year 3. On January 2, year 1, Mott paid \$30,000 as consideration for canceling the lease. On November 1, year 1, Nare leased the building to Pine under a five-year lease. Pine paid Nare \$5,000 rent for each of the two months of November and December, and an additional \$5,000 for the last month's rent. What amount of rental income should Nare report in its year 1 income tax return?

- a. \$10,000
- b. \$15,000
- c. \$40,000
- d. \$45,000 (R/08, REG, 0787T, #3, 8660)

4. Molloy contributed \$40,000 in cash in exchange for a one-third interest in the RST Partnership. In the first year of partnership operations, RST had taxable income of \$60,000. In addition, Molloy received a \$5,000 distribution of cash and, at the end of the partnership year, Molloy had a one-third share in the \$18,000 of partnership recourse liabilities. What was Molloy's basis in RST at year end?

- a. \$ 55,000
- b. \$ 61,000
- c. \$ 71,000
- d. \$101,000 (R/08, REG, 0949T, #4, 8661)

5. Fern received \$30,000 in cash and an automobile with an adjusted basis and market value of \$20,000 in a proportionate liquidating distribution from EF Partnership. Fern's basis in the partnership interest was \$60,000 before the distribution. What is Fern's basis in the automobile received in the liquidation?

- a. \$0
- b. \$10,000
- c. \$20,000
- d. \$30,000 (R/08, REG, 0958T, #5, 8662)

6. Pope, a C corporation, owns 15% of Arden Corporation. Arden paid a \$3,000 cash dividend to Pope. What is the amount of Pope's dividend-received deduction?

- a. \$3,000
- b. \$2,400
- c. \$2,100
- d. \$0 (R/08, REG, 1141T, #6, 8663)

7. Under the Negotiable Instruments Article of the UCC, a holder in due course in a nonconsumer transaction takes a negotiable instrument free from which of the following defenses that may be asserted by a party with whom the holder in due course had **not** dealt?

- a. Fraud in the execution
- b. Discharge in an insolvency proceeding
- c. Breach of contract
- d. Infancy, to the extent that it is a simple contract defense (R/08, REG, 1153L, #7, 8664)

8. Dunn received 100 shares of stock as a gift from Dunn's grandparent. The stock cost Dunn's grandparent \$32,000 and it was worth \$27,000 at the time of the transfer to Dunn. Dunn sold the stock for \$29,000. What amount of gain or loss should Dunn report from the sale of the stock?

- a. \$0
- b. \$2,000 gain
- c. \$3,000 gain
- d. \$3,000 loss (R/08, REG, 1215T, #8, 8665)

9. Curator contracted to sell Train's painting. Train issued a \$10,000 note to Curator that was payable within 10 days after Curator sold Train's painting. Curator sold the painting on May 1. Train, alleging that the note was not a negotiable instrument, refused to pay the note. Under the Negotiable Instruments Article of the UCC, which of the following statements is correct regarding the status of the note?

- a. The note was **not** a negotiable instrument because it was **not** payable at a definite time.
- b. The note was **not** negotiable because it was subject to another writing.
- c. The note was negotiable because it was for a sum certain.
- d. The note was negotiable because it was conditioned on an event that took place. (R/08, REG, 1320L, #9, 8666)

10. U Co. had cash purchases and payments on account during the current year totaling \$455,000. U's beginning and ending accounts payable balances for the year were \$64,000 and \$50,000, respectively. What amount represents U's accrual basis purchases for the year?

- a. \$441,000
- b. \$469,000
- c. \$505,000
- d. \$519,000 (R/08, REG, 1490T, #10, 8667)

11. Under the Code of Professional Conduct of the AICPA, which of the following is required to be independent in fact and appearance when discharging professional responsibilities?

- a. A CPA in public practice providing tax and management advisory services
- b. A CPA in public practice providing auditing and other attestation services
- c. A CPA **not** in public practice
- d. All CPAs (R/08, REG, 2579L, #11, 8668)

12. Which of the following is a miscellaneous itemized deduction subject to the 2% of adjusted gross income floor?

- a. Gambling losses up to the amount of gambling winnings
- b. Medical expenses
- c. Real estate tax
- d. Employee business expenses (R/08, REG, A0044T, #12, 8669)

13. Which of the following transactions is subject to registration requirements of the Securities Act of 1933?

- a. The public sale by a corporation of its negotiable 10-year notes
- b. The public sale by a charitable organization of 10-year bearer bonds
- c. The sale across state lines of municipal bonds issued by a city
- d. Issuance of stock by a publicly-traded corporation to its shareholders because of a stock split (R/08, REG, A0211L, #13, 8670)

14. Which of the following items is a capital asset?

- a. An automobile for personal use
- b. Depreciable business property
- c. Accounts receivable for inventory sold
- d. Real property used in a trade or business (R/08, REG, A0221T, #14, 8671)

15. A C corporation has gross receipts of \$150,000, \$35,000 of other income, and deductible expenses of \$95,000. In addition, the corporation incurred a net long-term capital loss of \$25,000 in the current year. What is the corporation's taxable income?

- a. \$ 65,000
- b. \$ 87,000
- c. \$ 90,000
- d. \$115,000 (R/08, REG, A0388T, #15, 8672)

16. Which of the following professional bodies has the authority to revoke a CPA's license to practice public accounting?

- a. National Association of State Boards of Accountancy
- b. State board of accountancy
- c. State CPA Society Ethics Committee
- d. Professional Ethics Division of AICPA (R/08, REG, A0569L, #16, 8673)

17. Jagdon Corp.'s book income was \$150,000 for the current year, including interest income from municipal bonds of \$5,000 and excess capital losses over capital gains of \$10,000. Federal income tax expense of \$50,000 was also included in Jagdon's books. What amount represents Jagdon's taxable income for the current year?

- a. \$185,000
- b. \$195,000
- c. \$205,000
- d. \$215,000 (R/08, REG, A0577T, #17, 8674)

18. Which of the following acts by a CPA is a violation of professional standards regarding the confidentiality of client information?

- a. Releasing financial information to a local bank with the approval of the client's mail clerk
- b. Allowing a review of professional practice without client authorization
- c. Responding to an enforceable subpoena
- d. Faxing a tax return to a loan officer at the request of the client (R/08, REG, A0713L, #18, 8675)

19. A self-employed taxpayer had gross income of \$57,000. The taxpayer paid self-employment tax of \$8,000, health insurance of \$6,000, and \$5,000 of alimony. The taxpayer also contributed \$2,000 to a traditional IRA. What is the taxpayer's adjusted gross income?

- a. \$55,000
- b. \$50,000
- c. \$46,000
- d. \$40,000 (R/08, REG, A1498T, #19, 8676)

20. Which of the following is a prerequisite for the creation of an agency relationship?

- a. Consideration must be given.
- b. The agent must have capacity.
- c. The principal must have capacity.
- d. The consideration must be in writing. (R/08, REG, C02472R, #20, 8677)

Problem 2 MULTIPLE CHOICE QUESTIONS (30 to 40 minutes)

21. Which of the following areas of professional responsibility should be observed by a CPA **not** in public practice?

- | | <u>Objectivity</u> | <u>Independence</u> |
|----|--------------------|---------------------|
| a. | Yes | Yes |
| b. | Yes | No |
| c. | No | Yes |
| d. | No | No |
- (R/08, REG, 0805L, #21, 8678)

22. What is the standard that must be established to prove a violation of the anti-fraud provisions of Rule 10b-5 of the Securities Exchange Act of 1934?

- a. Negligence
- b. Intentional misconduct
- c. Criminal intent
- d. Strict liability (R/08, REG, 1141L, #22, 8679)

23. In June, Mullin, a general contractor, contracted with a town to renovate the town square. The town council wanted the project done quickly and the parties placed a clause in the contract that for each day the project extended beyond 90 working days, Mullin would forfeit \$100 of the contract price. In August, Mullin took a three-week vacation. The project was completed in October, 120 working days after it was begun. What type of damages may the town recover from Mullin?

- a. Punitive damages because taking a vacation in the middle of the project was irresponsible
- b. Compensatory damages because of the delay in completing the project
- c. Liquidated damages because of the clause in the contract
- d. No damages because Mullin completed performance (R/08, REG, 1237L, #23, 8680)

24. Baker is a partner in BDT with a partnership basis of \$60,000. BDT made a liquidating distribution of land with an adjusted basis of \$75,000 and a fair market value of \$40,000 to Baker. What amount of gain or loss should Baker report?

- a. \$35,000 loss
- b. \$20,000 loss
- c. \$0
- d. \$15,000 gain (R/08, REG, 1338T, #24, 8681)

25. Under the ethical standards of the profession, which of the following investments by a CPA in a corporate client is an indirect financial interest?

- a. An investment held in a retirement plan
- b. An investment held in a blind trust
- c. An investment held through a regulated mutual fund
- d. An investment held through participation in an investment club (R/08, REG, 1349L, #25, 8682)

26. Nolan designed Timber Partnership's new building. Nolan received an interest in the partnership for the services. Nolan's normal billing for these services would be \$80,000 and the fair market value of the partnership interest Nolan received is \$120,000. What amount of income should Nolan report?

- a. \$0
- b. \$ 40,000
- c. \$ 80,000
- d. \$120,000 (R/08, REG, 1375T, #26, 8683)

27. The CSU partnership distributed to each partner cash of \$4,000, inventory with a basis of \$4,000 and a fair market value (FMV) of \$6,000, and land with an adjusted basis of \$5,000 and an FMV of \$3,000 in a liquidating distribution. Partner Chang had an outside basis in Chang's partnership interest of \$12,000. In the second year after receiving the liquidating distribution, Chang sold the inventory for \$5,000 and the land for \$3,000. What income must Chang report upon the sale of these assets?

- a. \$0 gain or loss
- b. \$0 ordinary gain and \$1,000 capital loss
- c. \$1,000 ordinary gain and \$1,000 capital loss
- d. \$1,000 ordinary gain and \$0 capital loss (R/08, REG, 1455T #27, 8684)

28. A couple filed a joint return in prior tax years. During the current tax year, one spouse died. The couple has no dependent children. What is the filing status available to the surviving spouse for the first subsequent tax year?

- a. Surviving spouse
- b. Married filing separately
- c. Single
- d. Head of household

(R/08, REG, 1570T, #28, 8685)

29. Under the Negotiable Instruments Article of the UCC, which of the following defenses generally may be used against all holders of negotiable instruments?

- a. Breach of warranty
- b. Fraud in the inducement
- c. Minority of the maker
- d. Lack of consideration

(R/08, REG, 1992L, #29, 8686)

30. Commerce Corp. elects S corporation status as of the beginning of year 2000. At the time of Commerce's election, it held a machine with a basis of \$20,000 and a fair market value of \$30,000. In March of 2000, Commerce sells the machine for \$35,000. What would be the amount subject to the built-in gains tax.

- a. \$0
- b. \$ 5,000
- c. \$10,000
- d. \$15,000

(R/08, REG, 2009T, #30, 8687)

31. Rules issued under the Sarbanes-Oxley Act of 2002 restrict former members of an audit engagement team from accepting employment as a chief executive, chief financial or chief accounting officer, or controller of an audit client that files reports with the Securities and Exchange Commission. How many annual audit period(s) must be completed before such employment can be accepted?

- a. One
- b. Two
- c. Three
- d. Five

(R/08, REG, 2450L, #31, 8688)

32. Under the Documents of Title Article of the UCC, which of the following correctly describes the standard of liability that must be established to hold a warehouse liable for loss or damage to stored property?

- a. Strict liability
- b. Ordinary negligence
- c. Gross negligence
- d. Deliberate destruction or theft

(R/08, REG, 2516L, #32, 8689)

33. Chris, age five, has \$3,000 of interest income and no earned income this year. Assume the current applicable standard deduction is \$800, how much of Chris's income will be taxed at Chris's parents' maximum tax rate?

- a. \$0
- b. \$1,400
- c. \$2,200
- d. \$3,000

(R/08, REG, A0038T, #33, 8690)

34. Which of the following is allowed in the calculation of the taxable income of a simple trust?

- a. Exemption
- b. Standard deduction
- c. Brokerage commission for purchase of tax-exempt bonds
- d. Charitable contribution

(R/08, REG, A0209T, #34, 8691)

35. Which of the following statements about the child and dependent care credit is correct?

- a. The credit is nonrefundable.
- b. The child must be under the age of 18 years.
- c. The child must be a direct descendant of the taxpayer.
- d. The maximum credit is \$600.

(R/08, REG, A0502T, #35, 8692)

36. Martin filed a timely return on April 15. Martin inadvertently omitted income that amounted to 30% of his gross income stated on the return. The statute of limitations for Martin's return would end after how many years?

- a. 3 years
- b. 6 years
- c. 7 years
- d. Unlimited

(R/08, REG, A0987T, #36, 8693)

37. The individual partner rather than the partnership makes which of the following elections?

- a. Election to amortize organizational costs
- b. Nonrecognition treatment for involuntary conversions
- c. Code section 179 deductions for tangible personal property
- d. Whether to take a deduction or credit for taxes paid to foreign countries

(R/08, REG, A1046T, #37, 8694)

38. A taxpayer sold for \$200,000 equipment that had an adjusted basis of \$180,000. Through the date of the sale, the taxpayer had deducted \$30,000 of depreciation. Of this amount, \$17,000 was in excess of straight-line depreciation. What amount of gain would be recaptured under Section 1245 (Gain from Dispositions of Certain Depreciable Property)?

- a. \$13,000
- b. \$17,000
- c. \$20,000
- d. \$30,000

(R/08, REG, A1361T, #38, 8695)

39. Four years ago, a self-employed taxpayer purchased office furniture for \$30,000. During the current tax year, the taxpayer sold the furniture for \$37,000. At the time of the sale, the taxpayer's depreciation deductions totaled \$20,700. What part of the gain is taxed as long-term capital gain?

- a. \$0
- b. \$ 7,000
- c. \$20,700
- d. \$27,700

(R/08, REG, A1538T, #39, 8696)

40. One of the elections a new corporation must make is its choice of an accounting period. Which of the following entities has the most flexibility in choosing an accounting period?

- a. C corporation
- b. S corporation
- c. Partnership
- d. Personal service corporation

(R/08, REG, C00359R, #40, 8697)

Problem 3 MULTIPLE CHOICE QUESTIONS (30 to 40 minutes)

1. Which of the following actions by a CPA most likely violates the profession's ethical standards?

- a. Using a records-retention agency to store confidential client records
- b. Retaining client records after the client has demanded their return
- c. Arranging with a financial institution to collect notes issued by a client in payment of fees due
- d. Compiling the financial statements of a client that employed the CPA's spouse as a bookkeeper

(R/09, REG, 0001L, #1, 8851)

2. Under the liability provisions of Section 11 of the Securities Act of 1933, a CPA who certifies financial statements included in a registration statement generally will not be liable to a purchaser of the security

- a. Unless the purchaser can prove scienter on the part of the CPA
- b. Unless the purchaser can prove privity with the CPA
- c. If the CPA can prove due diligence
- d. If the financial statements were materially misstated

(R/09, REG, 0123L, #2, 8852)

3. Camp orally guaranteed payment of a loan Camp's cousin Wilcox had obtained from Camp's friend Main. The loan was to be repaid in 10 monthly payments. After making six payments, Wilcox defaulted on the loan and Main demanded that Camp honor the guaranty. Regarding Camp's liability to Main, Camp is

- Liable under the oral guaranty because the loan would be paid within one year
- Liable under the oral guaranty because Camp benefited by maintaining a personal relationship with Main
- Not liable under the oral guaranty because Camp's guaranty must be in writing to be enforceable
- Not liable under the oral guaranty because of failure of consideration

(R/09, REG, 0394L, #3, 8853)

4. During the current year, Mann, an unmarried U.S. citizen, made a \$5,000 cash gift to an only child and also paid \$25,000 in tuition expenses directly to a grandchild's university on the grandchild's behalf. Mann made no other lifetime transfers. Assume that the gift tax annual exclusion is \$12,000. For gift tax purposes, what was Mann's taxable gift?

- \$30,000
- \$25,000
- \$18,000
- \$0

(R/09, REG, 0553T, #4, 8854)

5. Wynn, a single individual age 60, sold Wynn's personal residence for \$450,000. Wynn had owned Wynn's residence, which had a basis of \$250,000, for six years. Within eight months of the sale, Wynn purchased a new residence for \$400,000. What is Wynn's recognized gain from the sale of Wynn's personal residence?

- \$0
- \$ 50,000
- \$ 75,000
- \$200,000

(R/09, REG, 0996T, #5, 8855)

6. George and Suzanne have been married for 40 years. Suzanne inherited \$1,000,000 from her mother. Assume that the annual gift-tax exclusion is \$12,000. What amount of the \$1,000,000 can Suzanne give to George without incurring a gift-tax liability?

- \$ 12,000
- \$ 24,000
- \$ 500,000
- \$1,000,000

(R/09, REG, 1129T, #6, 8856)

7. Kant, a cash-basis individual, owns and operates an office building. Kant received the following payments during the current year:

Current rents	\$30,000
Advance rents for the next year	10,000
Security deposits held in a segregated account	5,000
Lease cancellation payments	15,000

What amount is included in gross income?

- \$30,000
- \$40,000
- \$55,000
- \$60,000

(R/09, REG, 1166T, #7, 8857)

8. Webster, a C corporation, has \$70,000 in accumulated and no current earnings and profits. Webster distributed \$20,000 cash and property with an adjusted basis and fair market value of \$60,000 to its shareholders. What amount should the shareholders report as dividend income?

- \$20,000
- \$60,000
- \$70,000
- \$80,000

(R/09, REG, 1360T, #8, 8858)

9. Under the Secured Transactions Article of the UCC, for which of the following types of collateral must a financing statement be filed in order to perfect a purchase money security interest?

- Stock certificates
- Promissory notes
- Personal jewelry
- Inventory

(R/09, REG, 1578L, #9, 8859)

10. Under the Secured Transactions Article of the UCC, what secured transaction document must be signed by the debtor?

- Statement of assignment
- Security agreement
- Release of collateral
- Termination statement

(R/09, REG, 1891L, #10, 8860)

11. Ames and Roth form Homerun, a C corporation. Ames contributes several autographed baseballs to Homerun. Ames purchased the baseballs for \$500, and they have a total fair market value of \$1,000. Roth contributes several autographed baseball bats to Homerun. Roth purchased the bats for \$5,000, and they have a fair market value of \$7,000. What is Homerun's basis in the contributed bats and balls?

- \$0
- \$5,500
- \$6,000
- \$8,000 (R/09, REG, 1891T, #11, 8861)

12. Sandy is the sole shareholder of Swallow, an S corporation. Sandy's adjusted basis in Swallow stock is \$60,000 at the beginning of the year. During the year, Swallow reports the following income items:

Ordinary income	\$30,000
Tax-exempt income	5,000
Capital gains	10,000

In addition, Swallow makes a nontaxable distribution to Sandy of \$20,000 during the year. What is Sandy's adjusted basis in the Swallow stock at the end of the year?

- \$60,000
- \$70,000
- \$80,000
- \$85,000 (R/09, REG, 1965T, #12, 8862)

13. A \$100,000 increase in partnership liabilities is treated in which of the following ways?

- Increases each partner's basis in the partnership by \$100,000
- Increases the partners' bases only if the liability is nonrecourse
- Increases each partner's basis in proportion to their ownership
- Does not change any partner's basis in the partnership regardless of whether the liabilities are recourse or nonrecourse

(R/09, REG, 1999T, #13, 8863)

14. Under the Secured Transactions Article of the UCC, all of the following are needed to create an enforceable security interest, except

- A security agreement must exist.
- The secured party must give value.
- The debtor must have rights in the collateral.
- A financing statement must be filed.

(R/09, REG, 2151L, #14, 8864)

15. An individual received \$50,000 during the current year pursuant to a divorce decree. A check for \$25,000 was identified as annual alimony, checks totaling \$10,000 as annual child support, and a check for \$15,000 as a property settlement. What amount should be included in the individual's gross income?

- \$50,000
- \$40,000
- \$25,000
- \$0 (R/09, REG, A0730T, #15, 8865)

16. Bluff purchased equipment for business use for \$35,000 and made \$1,000 of improvements to the equipment. After deducting depreciation of \$5,000, Bluff gave the equipment to Russett for business use. At the time the gift was made, the equipment had a fair market value of \$32,000. Ignoring gift tax consequences, what is Russett's basis in the equipment?

- \$31,000
- \$32,000
- \$35,000
- \$36,000 (R/09, REG, A1487T, #16, 8866)

17. Dale was a 50% partner in D&P Partnership. Dale contributed \$10,000 in cash upon the formation of the partnership. D&P borrowed \$10,000 to purchase equipment. During the first year of operations, D&P had \$15,000 net taxable income, \$2,000 tax-exempt interest income, a \$3,000 distribution to each partner, and a \$4,000 reduction of debt. At the end of the first year of operation, what amount would be Dale's basis?

- \$16,500
- \$17,500
- \$18,500
- \$21,500 (R/09, REG, C03380R, #17, 8867)

18. The adjusted basis of Smith's interest in EVA partnership was \$230,000 immediately before receiving the following distribution in complete liquidation of EVA:

	<u>Basis to EVA</u>	<u>Fair market value</u>
Cash	\$150,000	\$150,000
Real estate	120,000	146,000

What is Smith's basis in the real estate?

- \$146,000
- \$133,000
- \$120,000
- \$ 80,000 (R/09, REG, C04320R, #18, 8868)

19. A CPA in public practice may not disclose confidential client information regarding auditing services without the client's consent in response to which of the following situations?

- A review of the CPA's professional practice by a state CPA society
 - A letter to the client from the IRS
 - An inquiry from the professional ethics division of the AICPA
 - A court-ordered subpoena or summons
- (R/09, REG, ZA0804L, #19, 8869)

20. An S corporation engaged in manufacturing has a year end of June 30. Revenue consistently has been more than \$10 million under both cash and accrual basis of accounting. The stockholders would like to change the tax status of the corporation to a C corporation using the cash basis with the same year end. Which of the following statements is correct if it changes to a C corporation?

- The year end will be December 31, using the cash basis of accounting.
 - The year end will be December 31, using the accrual basis of accounting.
 - The year end will be June 30, using the accrual basis of accounting.
 - The year end will be June 30, using the cash basis of accounting.
- (R/09, REG, ZA1555T, #20, 8870)

Problem 4 MULTIPLE CHOICE QUESTIONS (30 to 40 minutes)

21. Under which of the following circumstances is trust property with an independent trustee includible in the grantor's gross estate?

- The trust is revocable.
- The trust is established for a minor.
- The trustee has the power to distribute trust income.
- The income beneficiary disclaims the property, which then passes to the remainderman, the grantor's friend. (R/09, REG, 0620T, #21, 8871)

22. Brisk Corp. is an accrual-basis, calendar-year C corporation with one individual shareholder. At year end, Brisk had \$600,000 accumulated and current earnings and profits as it prepared to make its only dividend distribution for the year to its shareholder. Brisk could distribute either cash of \$200,000 or land with an adjusted tax basis of \$75,000 and a fair market value of \$200,000. How would the taxable incomes of both Brisk and the shareholder change if land were distributed instead of cash?

- | | <i>Brisk's
taxable income</i> | <i>Shareholder's
taxable income</i> |
|----|-----------------------------------|---|
| a. | No change | No change |
| b. | Increase | No change |
| c. | No change | Decrease |
| d. | Increase | Decrease |
- (R/09, REG, 0669T, #22, 8872)

23. Under the Negotiable Instruments Article of the UCC, which of the following parties has secondary liability on an instrument?

- An acceptor of a note
 - An issuer of a cashier's check
 - A drawer of a draft
 - A maker of a note
- (R/09, REG, 1247L, #23, 8873)

24. Train issued a note payable to Blake in payment of contracted services that Blake was to perform. Blake endorsed the note "pay to bearer" and delivered it to Reed in satisfaction of a debt owed Reed. Train refused to pay Reed on the note because Blake had not yet performed the services. Under the Negotiable Instruments Article of the UCC, must Train pay Reed?

- No, Train does not have to pay Reed until the services are performed.
 - No, Train does not have to pay Reed because the note was issued to Blake.
 - Yes, Train has to pay Reed because the note was converted into bearer paper.
 - Yes, Train has to pay Reed because Reed was a holder in due course.
- (R/09, REG, 1251L, #24, 8874)

25. Assuming appropriate disclosure is made, which of the following fee arrangements generally would be permitted under the ethical standards of the profession?

- A fee paid to the client's audit firm for recommending investment advisory services to the client
- A fee paid to the client's tax accountant for recommending a computer system to the client
- A contingent fee paid to the CPA for preparing the client's amended income tax return
- A contingent fee paid to the CPA for reviewing the client's financial statements

(R/09, REG, 1436L, #25, 8875)

26. Fox, the sole shareholder in Fall, a C corporation, has a tax basis of \$60,000. Fall has \$40,000 of accumulated positive earnings and profits at the beginning of the year and \$10,000 of current positive earnings and profits for the current year. At year end, Fall distributed land with an adjusted basis of \$30,000 and a fair market value (FMV) of \$38,000 to Fox. The land has an outstanding mortgage of \$3,000 that Fox must assume. What is Fox's tax basis in the land?

- \$38,000
- \$35,000
- \$30,000
- \$27,000

(R/09, REG, 1440T, #26, 8876)

27. Dart, a C corporation, distributes software over the Internet and has had average revenues in excess of \$20 million dollars per year for the past three years. To purchase software, customers key-in their credit card number to a secure web site and receive a password that allows the customer to immediately download the software. As a result, Dart doesn't record accounts receivable or inventory on its books. Which of the following statements is correct?

- Dart may use either the cash or accrual method of accounting as long as Dart elects a calendar year end.
- Dart may utilize any method of accounting Dart chooses as long as Dart consistently applies the method it chooses.
- Dart must use the accrual method of accounting.
- Dart may utilize the cash basis method of accounting until it incurs an additional \$10 million to develop additional software.

(R/09, REG, 1588T, #27, 8877)

28. Spinner, CPA, had audited Lasco Corp.'s financial statements for the past several years. Prior to the current-year's engagement, a disagreement arose that caused Lasco to change auditing firms. Lasco has demanded that Spinner provide Lasco with Spinner's working papers so that Lasco may show them to prospective auditors to help them prepare their bids for Lasco's audit engagement. Spinner refused and Lasco commenced litigation. Under the ethical standards of the profession, will Spinner be successful in refusing to turn over the working papers?

- Yes, because Spinner is the owner of the working papers.
- Yes, because Lasco is required to direct prospective auditors to contact Spinner to make arrangements to view the working papers in Spinner's office.
- No, because Lasco has a legitimate business reason for demanding that Spinner surrender the working papers.
- No, because it was Lasco's financial statements that were audited.

(R/09, REG, 1602L, #28, 8878)

29. The Simone Trust reported distributable net income of \$120,000 for the current year. The trustee is required to distribute \$60,000 to Kent and \$90,000 to Lind each year. If the trustee distributes these amounts, what amount is includible in Lind's gross income?

- \$0
- \$60,000
- \$72,000
- \$90,000

(R/09, REG, 1709T, #29, 8879)

30. Sands purchased 100 shares of Eastern Corp. stock for \$18,000 on April 1 of the prior year. On February 1 of the current year, Sands sold 50 shares of Eastern for \$7,000. Fifteen days later, Sands purchased 25 shares of Eastern for \$3,750. What is the amount of Sand's recognized gain or loss?

- \$0
- \$ 500
- \$1,000
- \$2,000

(R/09, REG, 1717T, #30, 8880)

31. Under the Negotiable Instruments Article of the UCC, which of the following instruments is classified as a promise to pay?

- A check
- A draft
- A trade acceptance
- A certificate of deposit

(R/09, REG, 1963L, #31, 8881)

32. Under Regulation D of the Securities Act of 1933, what is the maximum time period during which an exempt offering may be made?

- a. Three months
- b. Six months
- c. Twelve months
- d. Twenty-four months

(R/09, REG, 2289L, #32, 8882)

33. In April, A and B formed X Corp. A contributed \$50,000 cash, and B contributed land worth \$70,000 (with an adjusted basis of \$40,000). B also received \$20,000 cash from the corporation. A and B each receives 50% of the corporation's stock. What is the tax basis of the land to X Corp.?

- a. \$40,000
- b. \$50,000
- c. \$60,000
- d. \$70,000

(R/09, REG, A0104T, #33, 8883)

34. Which of the following is a capital asset?

- a. Inventory held primarily for sale to customers
- b. Accounts receivable
- c. A computer system used by the taxpayer in a personal accounting business
- d. Land held as an investment

(R/09, REG, A0122T, #34, 8884)

35. Aviary Corp. sold a building for \$600,000. Aviary received a down payment of \$120,000 as well as annual principal payments of \$120,000 for each of the subsequent four years. Aviary purchased the building for \$500,000 and claimed depreciation of \$80,000. What amount of gain should Aviary report in the year of sale using the installment method?

- a. \$180,000
- b. \$120,000
- c. \$ 54,000
- d. \$ 36,000

(R/09, REG, A0741T, #35, 8885)

36. Which of the following payments would require the donor to file a gift tax return?

- a. \$30,000 to a university for a spouse's tuition
- b. \$40,000 to a university for a cousin's room and board
- c. \$50,000 to a hospital for a parent's medical expenses
- d. \$80,000 to a physician for a friend's surgery

(R/09, REG, A1227T, #36, 8886)

37. Which of the following groups may elect to file a consolidated corporate return?

- a. A brother/sister-controlled group
- b. A parent corporation and all more-than-10%-controlled partnerships
- c. A parent corporation and all more-than-50%-controlled subsidiaries
- d. Members of an affiliated group

(R/09, REG, A1316T, #37, 8887)

38. A 33-year-old taxpayer withdrew \$30,000 (pre-tax) from a traditional IRA. The taxpayer has a 33% effective tax rate and a 35% marginal tax rate. What is the total tax liability associated with the withdrawal?

- a. \$10,000
- b. \$10,500
- c. \$13,000
- d. \$13,500

(R/09, REG, A1500T, #38, 8888)

39. A heavy equipment dealer would like to trade some business assets in a nontaxable exchange. Which of the following exchanges would qualify as nontaxable?

- a. The company jet for a large truck to be used in the corporation
- b. Investment securities for antiques to be held as investments
- c. A road grader held in inventory for another road grader
- d. A corporate office building for a vacant lot

(R/09, REG, A1731T, #39, 8889)

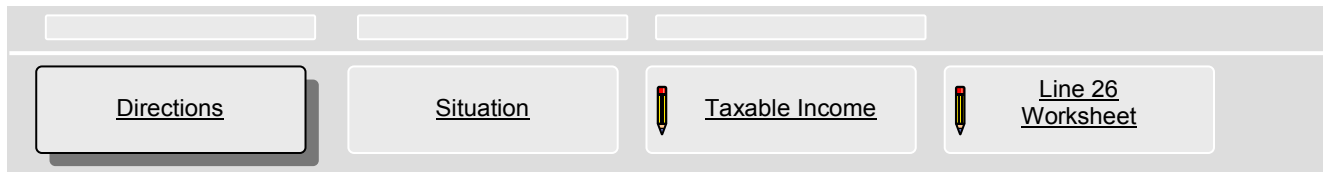
40. According to the AICPA Code of Professional Conduct, which of the following financial interests in the client during the period of the engagement impairs a CPA's independence?

- a. All direct and indirect financial interests
- b. Only direct financial interests
- c. Only direct and material indirect financial interests
- d. Only material financial interests

(R/09, REG, ZA0996L, #40, 8890)

SIMULATIONS

Problem 5



In the following simulation, you will be asked to complete various tasks. You may use the content in the **Information Tabs** to complete the tasks in the **Work Tabs**.

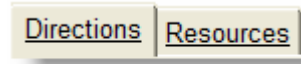
Information Tabs:

FIG. 1

- Go through each of the Information Tabs to familiarize yourself with the simulation content
- The Resources tab will contain information, including formulas and definitions, that may help you to complete the tasks
- Your simulation may have more Information Tabs than those shown in Fig. 1

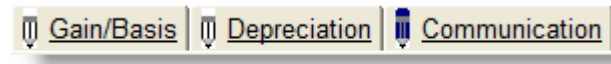
Work Tabs:

FIG. 2

- **Work Tabs**, to the right of the **Information Tabs**, contain the tasks for you to complete
- **Work Tabs** contain directions for completing each task—be sure to read these directions carefully
- The tab names in Fig. 2 are for illustration only—yours may differ
- Once you complete any part of a task, the pencil for that tab will be shaded (see **Communication** in Fig. 2)
- The shaded pencil does **NOT** indicate that you have completed the entire task
- You must complete all of the tasks in the **Work Tabs** to receive full credit

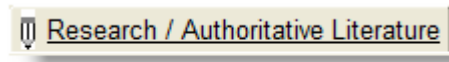
Research/Authoritative Literature Tab:

FIG. 3

- This tab contains both the Research task and the Authoritative Literature
- Detailed instructions for completing the Research task, and for using the Authoritative Literature, appear on this tab
- You may use the Authoritative Literature as a resource for completing other tasks

Note: If you believe you have encountered a software malfunction, report it to the test center staff immediately.

Editor's Note: This tab is one released by the AICPA.

(R/08, REG, #41, 8748)

Navigation tabs: [Directions](#), [Situation](#), [Taxable Income](#), [Line 26 Worksheet](#)

The Income Statement for the first year of operations of InterTax, Inc. is shown below.

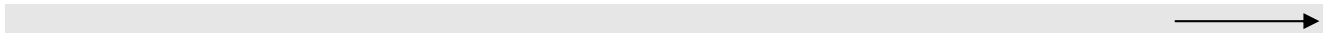
Income Statement/Tax Return

	<u>Tax</u>	<u>Book</u>
Income		
Consulting fees	\$1,880,000	\$1,880,000
Tax-exempt interest	0	2,400
Interest income on bank accounts	<u>16,400</u>	<u>16,400</u>
Total income	\$1,896,400	\$1,898,800
Expenses		
Organization expenses	\$ 5,707	\$ 15,600
Officer salaries	800,000	800,000
Salaries and wages	240,000	240,000
Rent	76,800	76,800
Utilities	12,000	12,000
Advertising	30,000	30,000
Repairs	2,000	2,000
Taxes	10,000	10,000
Employee benefits	2,000	2,000
Interest	10,000	10,000
Office supplies	7,000	7,000
Depreciation	<u>75,200</u>	<u>30,400</u>
Total expenses	\$1,270,707	\$1,235,800
Net income before contributions	625,693	663,000
Charitable contributions	<u>62,569</u>	<u>80,000</u>
Pre-tax income	563,124	583,000
Federal tax expense	<u>191,462</u>	<u>186,560</u>
Net income	<u>\$ 371,662</u>	<u>\$ 396,440</u>

Note: There were no shareholder distributions during the year.

Navigation tabs: [Directions](#), [Situation](#), [Taxable Income](#), [Line 26 Worksheet](#)

Complete Lines 1a – 30 on the IRS Form 1120, *U.S. Corporation Income Tax Return*, below for InterTax’s first year of operations. Use the worksheet on the next tab (Line 26 Worksheet) to calculate the value for Line 26.



Form **1120** U.S. Corporation Income Tax Return
 Department of the Treasury Internal Revenue Service
 For calendar year 2007 or tax year beginning _____, 2007, ending _____, 20 _____
 ▶ See separate instructions. OMB No. 1545-0123 **2007**

A Check if:
 1a Consolidated return (attach Form 851)
 b Life/nonlife consolidated return
 2 Personal holding co. (attach Sch. PH)
 3 Personal service corp. (see instructions)
 4 Schedule M-3 attached

Use IRS label. Otherwise, print or type.

Name _____
 Number, street, and room or suite no. If a P.O. box, see instructions. _____
 City or town, state, and ZIP code _____

B Employer identification number _____
C Date incorporated _____
D Total assets (see instructions) \$ _____

E Check if: (1) Initial return (2) Final return (3) Name change (4) Address change

Income	1a	Gross receipts or sales		b	Less returns and allowances		c	Bal ▶	1c	
	2	Cost of goods sold (Schedule A, line 8)							2	
	3	Gross profit. Subtract line 2 from line 1c							3	
	4	Dividends (Schedule C, line 19)							4	
	5	Interest							5	
	6	Gross rents							6	
	7	Gross royalties							7	
	8	Capital gain net income (attach Schedule D (Form 1120))							8	
	9	Net gain or (loss) from Form 4797, Part II, line 17 (attach Form 4797)							9	
	10	Other income (see instructions—attach schedule)							10	
	11	Total income. Add lines 3 through 10							▶ 11	
Deductions (See instructions for limitations on deductions.)	12	Compensation of officers (Schedule E, line 4)							12	
	13	Salaries and wages (less employment credits)							13	
	14	Repairs and maintenance							14	
	15	Bad debts							15	
	16	Rents							16	
	17	Taxes and licenses							17	
	18	Interest							18	
	19	Charitable contributions							19	
	20	Depreciation from Form 4562 not claimed on Schedule A or elsewhere on return (attach Form 4562)							20	
	21	Depletion							21	
	22	Advertising							22	
23	Pension, profit-sharing, etc., plans							23		
24	Employee benefit programs							24		
25	Domestic production activities deduction (attach Form 8903)							25		
26	Other deductions (attach schedule)							26		
27	Total deductions. Add lines 12 through 26							▶ 27		
28	Taxable income before net operating loss deduction and special deductions. Subtract line 27 from line 11									
29	Less: a Net operating loss deduction (see instructions)							29a		
	b Special deductions (Schedule C, line 20)							29b		
								29c		
30	Taxable income. Subtract line 29c from line 28 (see instructions)								30	
31	Total tax (Schedule J, line 10)								31	
Tax and Payments	32a	2006 overpayment credited to 2007	32a							
	b	2007 estimated tax payments	32b							
	c	2007 refund applied for on Form 4466	32c	()	d	Bal ▶	32d	
	e	Tax deposited with Form 7004							32e	
	f	Credits: (1) Form 2439				(2) Form 4136			32f	
										32g
33	Estimated tax penalty (see instructions). Check if Form 2220 is attached								33	
34	Amount owed. If line 32g is smaller than the total of lines 31 and 33, enter amount owed								34	
35	Overpayment. If line 32g is larger than the total of lines 31 and 33, enter amount overpaid								35	
36	Enter amount from line 35 you want: Credited to 2008 estimated tax ▶								Refunded ▶	36

Sign Here
 Under penalties of perjury, I declare that I have examined this return, including accompanying schedules and statements, and to the best of my knowledge and belief, it is true, correct, and complete. Declaration of preparer (other than taxpayer) is based on all information of which preparer has any knowledge.

Signature of officer _____ Date _____ Title _____
 May the IRS discuss this return with the preparer shown below (see instructions)? Yes No

Paid Preparer's Use Only
 Preparer's signature _____ Date _____ Check if self-employed Preparer's SSN or PTIN _____
 Firm's name (or yours if self-employed), address, and ZIP code _____ EIN _____ Phone no. () _____

For Privacy Act and Paperwork Reduction Act Notice, see separate instructions.

Cat. No. 11450Q

Form 1120 (2007)

Navigation bar with buttons: [Directions](#), [Situation](#), [Taxable Income](#), [Line 26 Worksheet](#)

Use the spreadsheet below to calculate the value to enter on Line 26 of Form 1120, *Other Deductions*. Choose each deductible item that contributes to this value by double-clicking on a shaded cell in Column A and choosing an appropriate item from the dropdown list. Then enter the appropriate value for that deduction in Column B. The total deduction will automatically calculate at the bottom of the worksheet. Transfer the total value to Line 26 of Form 1120 on the previous tab. Some of the items on the list and some of the shaded lines may not be used.

Line 26 Deduction Worksheet:

	A	B
1		
2		
3		
4		
5		
7	Total deductions (transfer to Line 26)	

Dropdown list:

- Charitable contributions
- Federal tax expense
- Organization expenses
- Officer salaries
- Salaries and wages
- Rent
- Utilities
- Advertising
- Repairs
- Taxes
- Employee benefits
- Interest
- Office supplies
- Depreciation

Navigation bar with buttons: [Schedules M-1 & M-2](#), [Communication](#), [Research](#)

Complete Schedules M-1 and M-2 on the IRS Form 1120, *U.S. Corporation Income Tax Return*, below for InterTax's first year of operations. Note: To use a formula in the spreadsheet, it must be preceded by an equal sign, e.g., =A1+B1.






Schedule L Balance Sheets per Books		Beginning of tax year		End of tax year	
		(a)	(b)	(c)	(d)
Assets					
1	Cash				
2a	Trade notes and accounts receivable				
b	Less allowance for bad debts	()	()	()	()
3	Inventories				
4	U.S. government obligations				
5	Tax-exempt securities (see instructions)				
6	Other current assets (attach schedule)				
7	Loans to shareholders				
8	Mortgage and real estate loans				
9	Other investments (attach schedule)				
10a	Buildings and other depreciable assets				
b	Less accumulated depreciation	()	()	()	()
11a	Depletable assets				
b	Less accumulated depletion	()	()	()	()
12	Land (net of any amortization)				
13a	Intangible assets (amortizable only)				
b	Less accumulated amortization	()	()	()	()
14	Other assets (attach schedule)				
15	Total assets				
Liabilities and Shareholders' Equity					
16	Accounts payable				
17	Mortgages, notes, bonds payable in less than 1 year				
18	Other current liabilities (attach schedule)				
19	Loans from shareholders				
20	Mortgages, notes, bonds payable in 1 year or more				
21	Other liabilities (attach schedule)				
22	Capital stock: a Preferred stock				
	b Common stock				
23	Additional paid-in capital				
24	Retained earnings—Appropriated (attach schedule)				
25	Retained earnings—Unappropriated				
26	Adjustments to shareholders' equity (attach schedule)				
27	Less cost of treasury stock	()	()	()	()
28	Total liabilities and shareholders' equity				

Schedule M-1 Reconciliation of Income (Loss) per Books With Income per Return
 Note: Schedule M-3 required instead of Schedule M-1 if total assets are \$10 million or more—see instructions

1	Net income (loss) per books		7	Income recorded on books this year not included on this return (itemize):	
2	Federal income tax per books			Tax-exempt interest \$	
3	Excess of capital losses over capital gains			-----	
4	Income subject to tax not recorded on books this year (itemize):			-----	
	-----			-----	
5	Expenses recorded on books this year not deducted on this return (itemize):		8	Deductions on this return not charged against book income this year (itemize):	
a	Depreciation \$		a	Depreciation \$	
b	Charitable contributions \$		b	Charitable contributions \$	
c	Travel and entertainment \$			-----	
	-----			-----	
6	Add lines 1 through 5		9	Add lines 7 and 8	
			10	Income (page 1, line 28)—line 6 less line 9	

Schedule M-2 Analysis of Unappropriated Retained Earnings per Books (Line 25, Schedule L)

1	Balance at beginning of year		5	Distributions: a Cash	
2	Net income (loss) per books			b Stock	
3	Other increases (itemize):			c Property	
	-----			-----	
	-----		6	Other decreases (itemize):	
4	Add lines 1, 2, and 3		7	Add lines 5 and 6	
			8	Balance at end of year (line 4 less line 7)	




 [Schedules M-1 & M-2](#)
 [Communication](#)
 [Research](#)

You are also the accountant for the company's CFO. Your client received the following notice from the Internal Revenue Service and sent it to you, asking for your assistance. As your client's CPA, write a letter to your client explaining the significance of the notice and telling them what information you need to respond to the IRS.

Type your communication in the response area below the horizontal line using the word processor provided.

REMINDER: Your response will be graded for both technical content and writing skills. Technical content will be evaluated for information that is helpful to the intended reader and clearly relevant to the issue. Writing skills will be evaluated for development, organization, and the appropriate expression of ideas in professional correspondence. Use a standard business memo or letter format with a clear beginning, middle, and end. Do not convey information in the form of a table, bullet point list, or other abbreviated presentation.

Department of the Treasury Internal Revenue Service	Date of Notice: Oct. 9, 2003 Form: 1040 Tax Period: Dec. 31, 2002
James Dugan 42 Chestnut Street Anytown, USA	
WE CHANGED THE INCOME REPORTED ON YOUR TAX RETURN YOU HAVE AN AMOUNT DUE	
We changed your 2002 return. As a result of these changes, you owe \$500. Our records show that you received a Form 1099-DIV from First Investors Brokerage showing ordinary dividend income in the amount of \$2,000. If you think we made a mistake, please reply to this letter no later than October 30, 2003.	

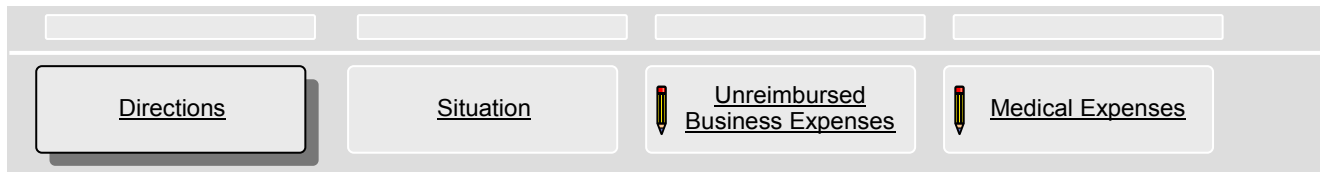
 [Schedules M-1 & M-2](#)
 [Communication](#)
 [Research](#)

Indicate your answer by selecting the related radio button.

Research Question: In the subsequent year, InterTax, Inc. sold one of its stock investments and realized a loss. What code section and subsection provide the authority regarding the treatment by corporate taxpayers of this realized loss?

Editor's Note: Database interface appeared here.

Problem 6



In the following simulation, you will be asked to complete various tasks. You may use the content in the **Information Tabs** to complete the tasks in the **Work Tabs**.

Information Tabs:

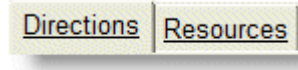


FIG. 1

- Go through each of the **Information Tabs** to familiarize yourself with the simulation content
- The **Resources** tab will contain information, including formulas and definitions, that may help you to complete the tasks
- Your simulation may have more **Information Tabs** than those shown in Fig. 1

Work Tabs:

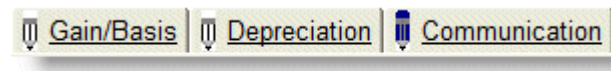


FIG. 2

- **Work Tabs**, to the right of the **Information Tabs**, contain the tasks for you to complete
- **Work Tabs** contain directions for completing each task—be sure to read these directions carefully
- The tab names in Fig. 2 are for illustration only—yours may differ
- Once you complete any part of a task, the pencil for that tab will be shaded (see **Communication** in Fig. 2)
- The shaded pencil does **NOT** indicate that you have completed the entire task
- You must complete all of the tasks in the **Work Tabs** to receive full credit

Research / Authoritative Literature Tab:



FIG. 3

- This tab contains both the Research task and the Authoritative Literature
- Detailed instructions for completing the Research task, and for using the Authoritative Literature, appear on this tab
- You may use the Authoritative Literature as a resource for completing other tasks

NOTE: If you believe you have encountered a software malfunction, report it to the test center staff immediately.



<u>Directions</u>	<u>Situation</u>	 <u>Unreimbursed Business Expenses</u>	 <u>Medical Expenses</u>
-------------------	------------------	---	---

Miller, age 38, is a single taxpayer and is the sales manager of Standard Co., an auto stereo dealer. Miller's adjusted gross income (AGI) for the year is \$67,000, which includes \$4,000 of gambling winnings.

Miller's job is to oversee the sales operations of Standard Co. Miller has a private office at the dealership and is responsible for attracting new customers and retaining current customers. As the sales manager, Miller has the authority to hire and discharge sales personnel.

During the year, Miller attended several trade shows. While at these shows, Miller entertained clients, met with manufacturers, and spent some time gambling. During the year, Miller incurred and can properly document \$5,000 of gambling losses.

Miller's mother incurred unreimbursed medical expenses during the year totaling \$4,200. Because she was unable to pay these medical expenses herself, Miller paid them on her behalf. Miller cannot claim the mother as a dependent solely because her gross income is \$10,000. (R/09, REG, #3, 8941)

Directions
Situation
 Unreimbursed Business Expenses
 Medical Expenses

During the year, Miller paid the business expenses shown in the following table. Miller’s employer did not reimburse any of these expenses. In column C of the table, enter the amounts that are reportable unreimbursed business expense deductions, subject to a statutory percentage limitation, if any. If none of a particular unreimbursed expense is a reportable business expense deduction, enter a zero for that expense in column C. The total amount deductible on Schedule A, *Itemized Deductions*, of Form 1040, *U.S. Individual Income Tax Return*, as unreimbursed employee business expenses will automatically calculate.

Note: Disregard all AGI limitations, if any, in completing the first section of this table. Then follow the instructions in the table in completing the second section.

	A	B	C
1	Expense	Amount	Amount reportable on Schedule A
2	Unreimbursed airfares	2,200	
3	Dry cleaning costs for business suits worn at dealership	440	
4	Cost of meals during which business was discussed with potential customers	820	
5	Entertainment for clients, immediately after a business discussion	770	
6	Purchase of tuxedo to wear to trade show functions	400	
7	Cost of a business gift to a client	50	
8	Total	4,680	

In the following section, indicate the dollar amount of the limitations, if any, that apply to the expenses above. Enter any limitation as a negative number.

11	Total amount from table above	
12	Other miscellaneous deduction—gambling losses	
13	AGI limitation (in dollars)	
14	Total amount deductible on Schedule A	

Directions	Situation	Unreimbursed Business Expenses	Medical Expenses

During the year, Miller paid the expenses shown in the following table. The amount of each expense shown in the table is net of any insurance reimbursements received. In column C of the table, enter the amounts that are reportable unreimbursed medical expense deductions, subject to a statutory percentage limitation, if any. If none of a particular unreimbursed expense is a reportable medical expense deduction, enter a zero for that expense in column C. The total amount deductible on Schedule A, *Itemized Deductions*, of Form 1040, *U.S. Individual Income Tax Return*, as medical expense will automatically calculate.

Note: Disregard all AGI limitations, if any, in completing the first section of this table. Then follow the instructions in the table in completing the second section.

	A	B	C
1	Expense	Amount	Amount reportable on Schedule A
2	Medical insurance premiums paid with after-tax dollars	2,650	
3	Disability insurance premiums	720	
4	Vision correction surgery	2,400	
5	Hair transplant procedure	900	
6	Chin enhancement surgery to improve appearance	3,100	
7	Mother's medical expenses paid by Miller during the year	4,200	
8	Total	13,970	

In the following section, indicate the dollar amount of the limitations, if any, that apply to the expenses above. Enter any limitation as a negative number.

11	Total amount from table above	
12	AGI limitation (in dollars)	
13	Total amount deductible on Schedule A	

Interest Expenses

Casualty Losses

Communication

Research





During the year, Miller made the interest payments shown in the following table. In column C of the table, enter the amounts that are reportable interest expense deductions, subject to a statutory percentage limitation, if any. If none of a particular payment is a reportable interest expense deduction, enter a zero for that expense in column C. The total amount deductible on Schedule A, *Itemized Deductions*, of Form 1040, *U.S. Individual Income Tax Return*, as interest expense will automatically calculate.

Note: Disregard all AGI limitations, if any, in completing the first section of this table. Then follow the instructions in the table in completing the second section.

	A	B	C
1	Interest payment	Amount	Amount reportable on Schedule A
2	Mortgage interest paid on principal residence	11,400	
3	Points on 30-year mortgage for the purchase of the principal residence paid on June 30 of the current year	4,200	
4	Mortgage interest paid on commercial rental property	2,150	
5	Interest paid on personal credit cards	470	
6	Interest paid to IRS for late filing of income tax return	25	
7	Interest paid on a \$50,000 home equity loan; the FMV of the home exceeds the acquisition indebtedness by \$70,000	475	
8	Total	18,720	

In the following section, indicate the dollar amount of the limitations, if any, that apply to the expenses above. Enter any limitation as a negative number.

11	Total amount from table above	
12	AGI limitation (in dollars)	
13	Total amount deductible on Schedule A	

 Interest Expenses
 Casualty Losses
 Communication
 Research

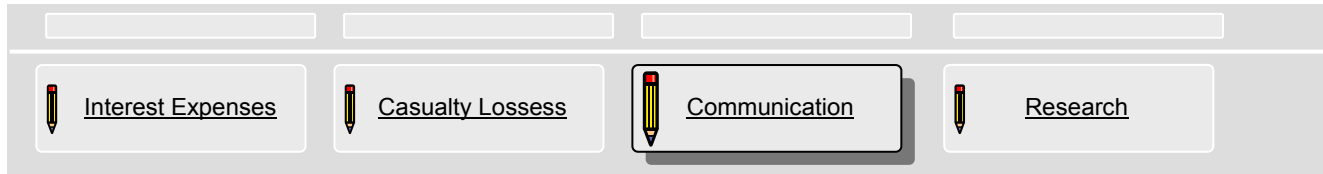
During the year, Miller suffered the losses shown in the following table. In column D of the table, enter the amounts that are reportable casualty losses, subject to a statutory percentage limitation, if any. If none of a loss suffered is a reportable casualty loss deduction, enter a zero for that expense in column D. The total amount deductible on Schedule A, *Itemized Deductions*, of Form 1040, *U.S. Individual Income Tax Return*, as a casualty loss will automatically calculate.

Note: Disregard all AGI limitations, if any, in completing the first section of this table. Then follow the instructions in the table in completing the second section.

	A	B	C	D
1	Loss suffered	Amount of loss	Insurance reimbursement	Amount reportable on Schedule A
2	Damage to articles stored in basement due to water heater explosion	8,200	1,000	
3	Repair costs to prevent further roof deterioration from water damage	1,200	-	
4	Cost to rebuild detached garage due to damage from termites	5,500	2,100	
5	Total	14,900	3,100	

In the following section, indicate the dollar amount of the limitations, if any, that apply to the expenses above. Enter any limitation as a negative number.

8	Total amount from table above	
9	Casualty nonpercentage floor (in dollars)	
10	AGI limitation (in dollars)	
11	Total amount deductible on Schedule A	



A new individual client just received a substantial refund of state income taxes paid last year. The client wants to know how this refund will be treated on this year’s federal income tax return. Write a letter to the client explaining that the answer depends on whether the client itemized deductions last year. Your explanation should include discussions of the following:

- Why the refund should not be included in this year’s income if the standard deduction was taken last year.
- The circumstances under which the refund would be only partially included in this year’s income if itemized deductions were taken last year.
- Why all of the refund must be included in income if itemized deductions were taken last year.

Type your communication in the response area below the horizontal line using the word processor provided.

REMINDER: Your response will be graded for both technical content and writing skills. Technical content will be evaluated for information that is helpful to the intended reader and clearly relevant to the issue. Writing skills will be evaluated for development, organization, and the appropriate expression of ideas in professional correspondence. Use a standard business memo or letter format with a clear beginning, middle, and end. Do not convey information in the form of a table, bullet point list, or other abbreviated presentation.



Research Question: Which section and subsection of the Internal Revenue Code describes the substantiation that a taxpayer must maintain in order to claim a valid business deduction for entertainment expenses?

Section & Subsection Answer § _____ ()



Solution 1: Moderate

1. (a) Generally, the fair market value of appreciated property donated to a qualified public charity may be deducted if it doesn't exceed 50% of the donor's AGI. $\$25,000 < (50\% \times \$90,000)$ (Chapter 44-4-6, CSO: 5.3.0)

2. (a) This event is a tax-free liquidation of a subsidiary. (Chapter 46-8-2, CSO: 6.2.5)

3. (d) Cancellation payments are rent to the landlord in the year received, so Nare must include the \$30,000 received in cancellation of Mott's lease. Even accrual basis taxpayers must include rent in income when received rather than when earned under the claim of right doctrine; Nare must include the \$5,000 received for the last month's rent. Nare also must include the \$10,000 for November and December. $\$30,000 + \$5,000 + \$10,000 = \$45,000$ (Chapter 44-2-3, CSO: 3.3.0)

4. (b) Molloy's adjusted basis is the original contribution plus a share of any taxable income and partnership liabilities less any distributions and a share of losses. (Chapter 47-2-1, CSO: 6.4.2)

Original basis	\$40,000
Plus: Share of income ($1/3 \times \$60,000$)	20,000
Less: Cash distribution	(5,000)
Plus: Share of liabilities ($1/3 \times \$18,000$)	<u>6,000</u>
Adjusted basis	\$61,000

5. (d) As this is a liquidating distribution, Fern's adjusted basis in the automobile is Fern's basis in the partnership interest after deducting the cash. Neither the property's fair market value nor its basis to the partnership are used in this calculation. $\$60,000 - \$30,000 = \$30,000$ (Chapter 47-2-2, CSO: 6.4.7)

6. (c) If a corporation owns less than 20% of another domestic corporation's stock, the corporate shareholder gets a 70% dividend-received deduction. $70\% \times \$3,000 = \$2,100$ (Chapter 46-2-3, CSO: 6.2.1)

7. (c) A holder in due course generally takes a negotiable instrument free from personal, but not real, defenses. A breach of contract is a personal defense. Fraud in the execution, discharge in an insolvency proceeding, and incapacity (infancy) are real defenses. (Chapter 36-4-2, CSO: 2.5.1)

8. (a) If the property is acquired by gift, then the basis to the donee is determined at the time of disposal. When the property is later disposed of in a taxable transaction at a price between the fair market

value at the date of the gift and the adjusted basis of the property in the hands of the donor, and the fair market value of the property at the date of the gift was less than the adjusted basis to the donor, then no gain or loss is recognized on the disposition. (Chapter 43-1-3, CSO: 4.5.0)

9. (a) Six prerequisites must be met to create a negotiable instrument: 1) the instrument must be in writing and signed by the maker (note) or drawer (draft or check); 2) the instrument must contain an unconditional promise or order to pay; 3) the amount of money must be a fixed amount; 4) the instrument must be made payable to order or to bearer (except for checks); 5) the instrument must be payable on demand or at a definite time; and 6) the promise or order may not have any other promise, order, obligation, or power given by the maker or drawer except as authorized by UCC Article 3. There is nothing in the given scenario to indicate the note was subject to another writing. The "sum certain" element is only one of several criteria. Conditions that already have been met still keep instruments from being negotiable, unless the holder can determine the event's occurrence from the face of the instrument. (Chapter 36-2-4, CSO: 2.5.1)

10. (a) With a beginning accounts payable (A/P) balance of \$64,000 and an ending A/P balance of \$50,000, there must have been \$14,000 more payments to suppliers than accrual-basis purchases. With both cash purchases and payments on account totaling \$455,000 and payments on account of \$14,000, $\$455,000 - \$14,000 = \$441,000$ of payments were for cash purchases. Editor's Note: This explanation assumes that all cash purchases are charged to the A/P account. The editors do not understand why this question was included in the REG exam section (rather than BEC) and do not expect a similar question to appear on future REG or BEC exams. (Chapter 46-4-1, CSO: 3.3.0)

11. (b) A CPA who provides auditing and other attestation services should be independent in fact and appearance. In providing all other services, an accountant should maintain objectivity and avoid conflicts of interest. A CPA need not be independent when providing tax and management advisory services. A CPA need not be independent when not in public practice. (Chapter 32-2-2, CSO: 1.1.0)

12. (d) An employee's unreimbursed business expenses are deductible as an itemized deduction from AGI. Section 67(a) states that miscellaneous itemized deductions are allowed only to the extent

they exceed 2% of AGI. Section 67(b) states that miscellaneous itemized deductions are those itemized deductions not listed in §67(b). Unreimbursed employee business expenses are not listed in §67(b). Medical expenses are subject to a 7.5% of AGI floor. Gambling losses to the extent of gambling winnings and real estate taxes are exempted specifically from the 2% of AGI floor. (Chapter 44-4-8, CSO: 5.3.0)

13. (a) The Securities Act of 1933 exempts certain securities from its registration requirements. Exempted securities include those issued by not-for-profit charitable organizations and domestic governmental organizations as well as stock given by the issuer to existing stockholders without a commission or other remuneration paid. (Chapter 40-2-3, CSO: 2.4.1)

14. (a) Section 1221 defines capital assets as property held by the taxpayer except for a number of items listed. Personal-use physical assets are not so listed. Section 1221 excludes depreciable and real property used in a business and accounts receivable from inventory sold from the definition of capital assets. (Chapter 43-3-2, CSO: 4.1.0)

15. (c) The taxable income is equal to the gross receipts plus other income less deductible expenses. A corporation may deduct capital losses only against capital gains. Individuals, but not corporations, may deduct up to \$3,000 of capital losses annually. Since there are no capital gains, the entire capital loss is disallowed. A capital gain, not a capital loss, would be added to arrive at taxable income. $\$150,000 + \$35,000 - \$95,000 = \$90,000$ (Chapter 46-2-6, CSO: 6.2.1)

16. (b) It is individual state boards of accountancy which have the authority to grant CPA licenses to practice public accounting, and, thus, ordinarily would be the bodies to suspend or revoke such licenses. The National Association of State Boards of Accountancy (NASBA), state CPA societies, and the AICPA (including their committees and divisions) do not have authority to grant, suspend, or revoke CPA licenses. (Chapter 32-1-1, CSO: 1.4.0)

17. (c) Municipal bond interest is included in book income, but is exempt from federal income tax (FIT). Capital losses greater than capital gains are included in determining book income, but are not

deductible for FIT purposes. FIT expense is included in determining book income, but is not deductible for FIT purposes. (Chapter 46-4-1, CSO: 6.2.1)

Book income	\$150,000
Less: Municipal bond interest (tax-exempt income)	(5,000)
Add: Excess capital losses over capital gains (nondeductible)	10,000
Add: FIT expense (nondeductible)	<u>50,000</u>
Taxable income	\$205,000

18. (a) ET 301 prohibits the disclosure of confidential information obtained in the course of a professional engagement without consent of the client, but does not prohibit review of a CPA's professional practices (including pertinent information) as a part of an AICPA authorized voluntary quality review program. While disclosing information at a client's request is allowed, mail clerks typically do not have authority to approve releases of financial information. ET 301 shall not be construed to affect in any way the member's obligation to comply with a validly issued and enforceable subpoena or summons, or to prohibit a member's compliance with applicable laws and government regulations. (Chapter 32-4-1, CSO: 1.6.0)

19. (d) Half of self-employment taxes paid, health insurance paid, alimony paid, and IRA contributions are all adjustments to arrive at adjusted gross income. There is no indication that the taxpayer does not qualify to claim these adjustments (health insurance available through an employer, alimony deemed child support or property settlement, or active participation in an employer retirement plan). $\$57,000 - (\frac{1}{2} \times \$8,000) - \$6,000 - \$5,000 - \$2,000 = \$40,000$. (Chapter 44-3-1, CSO: 5.3.0)

20. (c) A principal must have sufficient capacity to consent to the agency relationship. An agent need not possess legal capacity to contract because contracts properly negotiated as an agent will not bind the agent personally. Consideration is not necessary; a gratuitous agent is permissible. Generally, it is not necessary to have a written agency agreement; exceptions to this rule are if the agent's duties will involve the buying and selling of real property or if the agency agreement is to last more than one year. (Chapter 39-1-1, CSO: 2.1.1)

Solution 2: Difficult

21. (b) A CPA who provides auditing and other attestation services should be independent in fact and appearance. In providing all other services, an CPA should maintain objectivity and avoid conflicts of interest. (Chapter 32-5-1, CSO: 1.2.0)

22. (b) In order to recover a loss, a seller or purchaser of securities must prove the defendant acted with the intent to defraud (scienter). The SEC may base actions under Section 10(b) on a showing of reckless disregard of the truth (gross negligence) rather than establish specific fraudulent intent. The Rule 10b-5 standard is not negligence, criminal intent, or strict liability. (Chapter 40-3-3, CSO: 2.4.1)

23. (c) A liquidated damage is a specific amount provided in a contract to be recoverable in the event of breach. It is enforceable if actual damage would be difficult to assess and the amount appears reasonable at the time of contracting. If liquidated damages are excessive, a court may interpret them as a penalty and refuse enforcement. There are no punitive damages for a breach of contract. Compensatory damages are awarded to compensate for losses and lost profits suffered as a result of the breach; the town has not illustrated losses or lost profits suffered because of the breach. Failure to perform on time may be a material breach of contract, giving rise to an action for damages. (Chapter 34-7-2, CSO: 2.2.4)

24. (c) As this is a liquidating distribution, Baker's adjusted basis in the land is Baker's basis in the partnership interest. With the basis equal to the distribution, Baker has no gain. (Chapter 47-2-2, CSO: 6.4.7)

25. (c) If a member does not have the ability to direct investments, an investment in a client through a financial service product (such as a mutual fund) is considered an indirect financial interest and, hence, does not necessarily impair independence. Independence is considered impaired if a covered member owns stock in a client through an investment club, where presumably the member has the ability to direct investments, whether or not exercised, resulting in a direct financial interest. Independence is considered impaired even if a CPA has a material indirect financial interest in a client, whether or not it is placed in a blind trust. (Chapter 32-2-3, CSO: 1.2.0)

26. (d) Nolan has ordinary gross income from services rendered in an amount equal to the fair value

of the property received as compensation under §61 and §83. (Chapter 47-2-1, CSO: 6.1.0)

27. (c) The basis of property other than money distributed to a partner in a liquidating distribution is equal to the adjusted basis of the partner's interest in the partnership as reduced by any cash received by the partner. In the case of liquidating distributions, the basis of the partner's interest in the partnership (as reduced by cash received) is allocated first to any unrealized receivables and inventory items in an amount equal to the adjusted basis of such receivables and inventory. Chang's basis first is reduced by the partnership's basis in the cash. Chang's remaining basis is allocated first to the inventory, in which the partnership's basis is \$5,000. Sale of inventory generates ordinary income or loss. $\$5,000 - \$4,000 = \$1,000$ After considering the impact of cash and inventory distributions, Chang's basis in the partnership is $\$12,000 - \$4,000 - \$4,000 = \$4,000$. This \$4,000 becomes Chang's basis in the only remaining asset, the land. Sale of land generates capital gain or loss. $\$3,000 - \$4,000 = (\$1,000)$. (Chapter 47-2-2, CSO: 6.4.6)

28. (c) The surviving spouse status and the head of household status involve paying more than 50% to maintain a household that is the principal place of residence for the entire year of the taxpayer's child. Without such a child, an unmarried taxpayer's status is single. A spouse may file either married filing jointly or married filing separately in the year of the deceased spouse's death, but not in subsequent years. (Chapter 44-1-3, CSO: 5.4.0)

29. (c) A holder in due course generally takes a negotiable instrument free from personal, but not real, defenses. Incapacity (minority of the maker) is a real defense. A breach of warranty, fraud in the inducement, and lack of consideration are personal defenses. (Chapter 36-5-2, CSO: 2.5.1)

30. (c) There are some instances in which the S corporation is required to pay taxes at the corporate level, including built-in gains (the excess of the fair market value (FMV) of assets over their bases at the beginning of the first year in which the S corporation status is effective). The FMV at the beginning of the first year in which the S corporation status is effective is greater than the basis at that time. $\$30,000 - \$20,000 = \$10,000$ The FMV at the date of sale is not included in this calculation. (Chapter 46-10-4, CSO: 6.3.5)

31. (a) The final SEC rule (RIN 3235-A173, part II., A.) deems an accounting firm to lack independence with respect to an audit client if a former lead partner, former concurring partner, or any former member of the audit engagement team who provided more than ten hours of audit, review, or attest services to the issuer during the one-year period preceding the audit's initiation is employed by the issuer in a financial reporting oversight role. (Chapter 33-2-2, CSO: 1.2.0)

32. (b) A warehouse has a duty of care and is liable for loss or injury to goods caused by the failure to exercise such care as a reasonably careful person would exercise under like circumstances (ordinary negligence). A warehouse is not strictly liable for any loss on goods held in a warehouse. A claimant only need establish that a warehouse was negligent, not grossly negligent or that any destruction or theft was deliberate. (Chapter 36-9-5, CSO: 2.5.4)

33. (b) The net unearned income of a minor under the age of 14 is taxed at the parents' maximum tax rate to the extent it exceeds a threshold (\$800 in this question; \$900 in 2008) plus the greater of the threshold amount or itemized deductions related to the production of the unearned income. $\$3,000 - (\$800 + \$800) = \$1,400$ (Chapter 44-5-1, CSO: 5.5.0)

34. (a) Estates and trusts may have a personal exemption. A standard deduction is available to individuals, not estates or trusts. A simple trust is a trust that requires all income to be distributed each year, does not make any charitable contributions, and does not make any distributions except out of current income; all other trusts are complex. Expenses relating to tax-exempt income are not deductible. (Chapter 45-4-1, CSO: 6.5.2)

35. (a) Section 26 limits the amount of any credits allowed in Subpart A of Part IV of Subchapter A of Chapter 1 to the excess of the taxpayer's regular tax liability over the tentative minimum tax. The child and dependent care credit is allowed by §21 (in Subpart A). Thus, the child and dependent care credit is not refundable. A child of any age physically or mentally incapable of caring for her/himself is eligible. A dependant child qualifies without regard to descent. The maximum credit is $\$6,000 \times 35\% = \$2,160$. (Chapter 44-6-1, CSO: 5.5.0)

36. (b) Generally, all taxes must be assessed within three years after the later of the due date or

the filing date. If the taxpayer omitted more than 25% when reporting gross income, this period is extended to six years. (Chapter 44-1-4, CSO: 3.1.0)

37. (d) IRC §702 specifically lists foreign taxes paid as a separately reported item. The election to amortize organizational costs, involuntary conversion treatment, and §179 deduction are decided at the partnership level. (Chapter 47-1-2, CSO: 6.4.3)

38. (c) On a sale of depreciable personal property, ordinary income under §1245 generally is equal to the lesser of (1) the total gain realized or (2) the accumulated depreciation. $\$200,000 - \$180,000 = \$20,000 < \$30,000$ (Chapter 43-3-4, CSO: 4.5.0)

39. (b) On a sale of depreciable personal property, ordinary income under §1245 is generally equal to the lesser of (1) the total gain realized or (2) the accumulated depreciation. Section 1231 treats any remaining gain as a capital gain. As the furniture was purchased four years ago, the gain is long term. The §1245 gain and the remaining §1231 gain are computed as follows. (Chapter 43-3-2, CSO: 4.5.0)

Amount realized		\$ 37,000
Cost	\$ 30,000	
Less: Accum. depreciation	<u>(20,700)</u>	
Less: Adjusted basis		<u>(9,300)</u>
Total gain realized		\$ 27,700
Section 1245 (ordinary) gain (lesser of \$20,700 or \$27,700)		\$ 20,700
Section 1231 (capital) gain		<u>7,000</u>
Total gain realized		\$ 27,700

40. (a) For a C corporation, taxable income generally is computed on the basis of the taxpayer's annual accounting period, if it is a calendar or fiscal year. In this context, the term "annual accounting period" means the annual period on the basis of which the taxpayer regularly computes income in keeping the books. An S corporation generally is required to adopt a December 31 year end or a fiscal year that is the same as the fiscal year used by shareholders owning more than 50% of the corporation's stock. A partnership's taxable year generally is the same as that of its partners owning a majority interest in the partnership, unless a business purpose can be established for designating a different taxable year [IRC §706(b)(1)]. IRC §441(i)(1) states, "...the taxable year of any personal service corporation shall be the calendar year unless the corporation establishes, to the satisfaction of the Secretary, a business purpose for having a different period for its taxable year." (Chapter 43-6-2, CSO: 3.2.0)

Solution 3: Moderate

1. (b) Interpretation 501-1 generally requires an auditor to return a client's records after the client has demanded them. With adequate assurance of non-disclosure by a records-retention agency, use of such an agency does not violate confidentiality requirements. A CPA is not prohibited from collecting fees from clients. Compilation is a service that does not require the CPA's independence; also, the employment of the CPA's spouse as a bookkeeper (generally not considered a key employee) does not necessarily impair the CPA's independence. Editor's Note: Similar to question #17 (7862) in Chapter 32. (Bisk: 32-5-1; CSO: 1.1.0; Skill: Understanding)

2. (c) A CPA's defense of due diligence is established by proving that after reasonable investigation the CPA had a reasonable basis for the belief that the registration statement was accurate and complete. Under the Securities Act of 1933, a purchaser needs to prove the financial statements were materially misstated and that the security purchases were offered through the inaccurate registration statement, but need not prove the CPA's scienter or privity with the CPA. Editor's Note: Similar to question #17 (8438) in Chapter 33. (Bisk: 33-; CSO: 1.5.2; Skill: Understanding)

3. (c) The Statute of Frauds applies to promises to answer for the debt of another regardless of how long the debt is to be outstanding. When a surety contract is contemporaneous with the primary contract, there is no need for any separate consideration beyond that supporting the primary contract to bind the surety. Contracts that are entered into primarily for the benefit of the surety, rather than the debtor, are held to be outside of the Statute of Frauds; however, a personal relationship with the debtor is not sufficient to move the contract outside the Statute of Frauds applicability. (Bisk: 38-8-1; CSO: 2.2.1; Skill: Analysis)

4. (d) Transfers to a qualified educational or medical care provider for tuition or medical care, respectively, are exempt from gift tax. As the \$5,000 cash gift is well under the annual exclusion, Mann had no taxable gifts in the current year. (Bisk: 45-5-2; CSO: 5.8.0; Skill: Analysis)

5. (a) Generally, a single individual may exclude up to \$250,000 of the gain on the sale of a principal residence, regardless of whether a new home is purchased. The individual must have occupied the home as a principal residence in two of the five years immediately preceding a sale after 1997.

After 2008, the exclusion is *pro rata* for the non-qualifying use. There is no indication that Wynn did not meet the requirements for the maximum exclusion. As the gain was $\$450,000 - \$250,000 = \$200,000$, or less than the full exclusion, none of the gain is taxable income. (Bisk: 43-3-8; CSO: 4.5.0; Skill: Analysis)

6. (d) There is an unlimited marital deduction from taxable gifts. (Bisk: 45-5-5; CSO: 5.8.0; Skill: Analysis)

7. (c) Rent payments (including lease cancellation payments, nonrefundable deposits, and premiums) are taxable in the period received, regardless of the taxpayer's basis of accounting. Refundable security deposits are not rental income. $\$30K + \$10K + \$15K = \$55K$ (Bisk: 44-2-3; CSO: 3.3.0; Skill: Analysis)

8. (c) When a corporation distributes property to shareholders, the distribution is equal to the property's fair market value on the distribution date. The distribution amount is $\$20K + \$60K = \$80K$. The distributions are treated as dividends to the extent of E&P: in this case, \$70K. (Bisk: 46-5-2; CSO: 6.2.5; Skill: Analysis)

9. (d) Of these items, only inventory requires the financing statement to be filed for perfection of a purchase money security interest (PMSI). Inventory also may be perfected by possession. The only way to perfect a security interest in stock certificates or promissory notes is by possession. Perfection is automatic with a PMSI in consumer goods (personal jewelry). (Bisk: 37-2-2; CSO: 2.5.2; Skill: Understanding)

10. (b) A security interest is created when the debtor gives to the creditor possession of the collateral, a written security agreement signed by the debtor, or an authenticated security agreement. 'Statement of assignment' and 'termination statement' are not commonly used terms in this context. Generally, the creditor, not the debtor, would sign a release of collateral. (Bisk: 37-1-2; CSO: 2.5.3; Skill: Understanding)

11. (b) No gain or loss is recognized if property is transferred to a corporation solely in exchange for stock if, immediately after the transfer, the transferors are in control of the corporation. There is no indication that anyone other than Ames and Roth are in control of the corporation. The corporation's basis in the property is the transferor's adjusted basis plus any gain recognized by the transferor on

the transfer. $\$500 + \$5,000 = \$5,500$ (Bisk: 46-1-3; CSO: 6.2.5; Skill: Analysis)

12. (d) A shareholder's basis in S corporation stock is increased by all income (including tax-exempt income) and gains and reduced by distributions and losses (to the extent of basis). $\$60K + \$30K + \$5K + \$10K - \$20K = \$85K$ (Bisk: 46-10-7; CSO: 6.3.3; Skill: Analysis)

13. (c) An increase in partnership liabilities increases each partner's basis in proportion to his or her ownership, just as income, gains, and losses affect each partner's basis proportionately. The recourse or nonrecourse status of liability is important when determining when losses may offset taxable income, not when determining basis. (Bisk: 47-2-3; CSO: 6.4.5; Skill: Understanding)

14. (d) A security interest is created when the debtor and creditor enter into an agreement giving the creditor rights in the debtor's property as collateral for a debt; however, a security interest is not enforceable against the debtor until it attaches. Attachment occurs when three events occur: (1) value is given by the creditor; (2) debtor has rights in the collateral; and (3) the debtor gives the collateral into the creditor's possession, or gives the creditor a signed written security agreement, or provides an authenticated security agreement. A financing statement is filed for perfection, not attachment, of a security interest. (Bisk: 37-1-2; CSO: 2.5.3; Skill: Understanding)

15. (c) Alimony is included in gross income; child support and property settlements are not. Alimony must be (1) made pursuant to a divorce agreement; (2) consist of cash payments; (3) not be made to someone living in the same household; and (4) not continue after the recipient's death; (5) not be designated as anything other than alimony, such as child support or property settlement. Nothing in the given information indicates that the payments are mislabeled. (Bisk: 44-2-3; CSO: 5.1.0; Skill: Analysis)

16. (a) Bluff's basis at the time of the gift was the cost (including improvements) less any

depreciation ($\$35K + \$1K - \$5K = \$31K$). Ignoring gift tax consequences, if the fair market value exceeds the basis at the time of the gift, the donee's basis in the property is the donor's basis. (Bisk: 43-1-3; CSO: 4.2.0; Skill: Analysis)

17. (c) As a 50% partner, Dale's basis is changed by a *pro rata* share of changes in liabilities. Dale's basis is increased by a *pro rata* share of both taxable and tax-exempt income and decreased by distributions received. $\$10,000 + (50\% \times \$10,000) + (50\% \times \$15,000) + (50\% \times \$2,000) - \$3,000 - (50\% \times \$4,000) = \$18,500$ (Bisk: 47-2-3; CSO: 6.4.2; Skill: Analysis)

18. (d) Smith's basis in the property cannot exceed Smith's adjusted basis in the former partnership. After adjusting for the cash distribution, Smith's basis in the partnership is $\$230K - \$150K = \$80K$. (Bisk: ; CSO: 6.4.7; Skill: Analysis)

19. (b) A CPA may not disclose confidential client information regarding auditing services in a letter to the client from the IRS. A CPA's duty of non-disclosure does not apply when disclosure is made pursuant to a voluntary quality review, pursuant to a professional ethics division review, or in compliance with an enforceable subpoena or court order. Editor's Note: The editors are not sure how or why a CPA would disclose any information regarding auditing services in a letter from the client to the IRS and do not expect this question to appear on the exam in the future. (Bisk: 32-4-1; CSO: 1.6.0; Skill: Understanding)

20. (c) C corporations may choose either a calendar or a fiscal year. Once a tax year is established, an entity may change the period only with IRS consent. C corporations generally are barred from using the cash basis of accounting; exceptions exist for entities with annual gross receipts of less than \$1 million and personal service corporations with annual gross receipts of less than \$5 million. Neither of these exceptions applies in this case. (Bisk: 43-6-2; CSO: 3.3.0; Skill: Analysis)

Solution 4: Difficult

21. (a) To the extent that a decedent retained ownership of any property, it is included in the decedent's gross estate. Hence, a revocable trust is included in the grantor's gross estate. Trusts are irrevocable unless the grantor retains a revocation right. A presumably irrevocable trust for a minor

would not allow for ownership retention by the grantor. A trustee's power to distribute trust income does not affect ownership retention by the grantor. A presumably irrevocable trust with an income beneficiary who disclaims the property in favor of a remainderman other than the grantor would not allow

for ownership retention by the grantor. (Bisk: 45-5-4; CSO: 5.8.0; Skill: Understanding)

22. (b) As the land has a basis of less than its fair market value, if the land is distributed, the corporation recognizes gain on the land's disposition. If the cash is distributed, the corporation does not recognize any gain. A C corporation shareholder recognizes dividend income (to the extent of the E&P) for the fair value of the cash or property received. As E&P exceeds the distribution, the shareholder has the same dividend income regardless of whether cash or land is distributed. (Bisk: 46-5-2; CSO: 6.2.5; Skill: Judgment)

23. (c) Drawers and endorsers of negotiable instruments are parties that are secondary liable. A maker of a note and an acceptor (drawee) of a draft are primary parties. A cashier's check is a check drawn by a bank on itself. As a check is a special form of a draft, the issuer of a cashier's check is both the drawer and the drawee of a draft; thus, this issuer is primarily liable. (Bisk: 36-7-1; CSO: 2.5.1; Skill: Understanding)

24. (d) A holder in due course (HIDC) generally takes an instrument free from all personal defenses of any party with whom he or she has not dealt. There is nothing to suggest that Reed is not a HIDC: Reed apparently took the instrument for value in good faith without notice. The given facts do not indicate the note was contingent on Blake's performance. The given facts do not indicate the note was nonnegotiable, making the fact that Reed was not the original holder irrelevant. The status as bearer or order paper does not influence whether Train must pay Reed. (Bisk: 36-4-2; CSO: 2.5.1; Skill: Understanding)

25. (b) A CPA may recommend a product to a tax client, provided the fee paid to the CPA is disclosed to the client. A CPA may not recommend or refer any product or service to an audit client, for a fee. A CPA may not accept a fee contingent upon the outcome of an original or amended tax return or claim for refund or an audit or review of financial statements. (Bisk: 32-5-3; CSO: 1.1.0; Skill: Analysis)

26. (a) The shareholder's basis in the land is its fair market value (FMV) on the distribution date. The amount of any related debt does not influence the shareholder's basis in the land. The corporation's basis in the land before the distribution does not influence the shareholder's basis in the land. (Bisk: 46-5-2; CSO: 6.2.5; Skill: Analysis)

27. (c) C corporations generally are barred from using the cash basis of accounting; exceptions exist for entities with annual gross receipts of less than \$1 million and personal service corporations with annual gross receipts of less than \$5 million. Neither of these exceptions applies in this case. (Bisk: 43-6-2; CSO: 3.3.0; Skill: Understanding)

28. (a) Under common law and in the absence of an express agreement to the contrary, an accountant owns his or her work papers. There is no requirement that a former client direct prospective auditors to a previous auditor. While a CPA generally may not disclose work papers without the client's permission, there is no requirement for disclosure at the client's demand, despite the client's financial statement audit being the subject of the work papers. (Bisk: 33-3-1; CSO: 1.6.0; Skill: Analysis)

29. (c) A recipient's taxable income is the lesser of the amount of a *pro rata* share of distributable net income (DNI) or the distribution received. As total distributions (\$60K + \$90K = \$150K) were greater than DNI, Lind's portion of the DNI was $[\$90K / \$150K] \times \$120K = \$72K$. (Bisk: 45-4-2; CSO: 6.5.3; Skill: Analysis)

30. (c) A loss from the sale of securities is disallowed if substantially the same securities are purchased during a time period 30 days prior to or 30 days after the sale date. On February 1, Sands sold 50 shares at a loss of \$180/share – \$140/share = \$40/share. Sands purchased 25 shares of the same stock within 30 days of the sale date. The loss on 25 of the shares is disallowed in the current year, but the loss on the other 25 shares is allowed. $\$40/\text{share} \times 25 \text{ shares} = \$1,000$ (Bisk: 43-4-1; CSO: 4.5.0; Skill: Analysis)

31. (d) A certificate of deposit is a bank's written acknowledgment of the receipt of a stated sum of money with a promise to repay it. A draft is a written order from one person directing a second person. Both trade acceptances and checks are special forms of drafts. (Bisk: 36-1-2; CSO: 2.5.1; Skill: Understanding)

32. (c) Rules 504 and 505 of Regulation D of the 1933 Act permit companies to offer securities for sale without registration and disclosure requirements within a 12-month period. (Bisk: 40-2-4; CSO: 2.4.1; Skill: Understanding)

33. (c) No gain or loss is recognized if property is transferred to a corporation solely in exchange for stock if, immediately after the transfer, the

transferors are in control of the corporation. While the transferors are in control, B's receipt of boot (cash) triggers gain recognition to the lesser of the boot received (\$20K) or the gain realized (\$70K - \$40K = \$30K). The corporation's basis in the property is B's adjusted basis (\$40K) plus B's recognized gain (\$20K). (Bisk: 46-1-3; CSO: 6.2.5; Skill: Analysis)

34. (d) Section 1221 defines capital assets as property held by the taxpayer except for a number of items listed. Land held for investment is not so listed. Section 1221 excludes inventory, accounts receivable, and depreciable property used in a business from the definition of capital assets. (Bisk: 43-3-2; CSO: 4.1.0; Skill: Understanding)

35. (d) The amount of gain taxable each year of an installment sale is computed by multiplying the payments received that year by the gross profit percentage (total estimated gross profit / total contract price). The total estimated gross profit is the price (\$600K) less the adjusted basis (\$500K - \$80K = \$420K). $(\$180K / \$600K) \times \$120K = \$36K$ (Bisk: 43-3-3; CSO: 3.3.0; Skill: Analysis)

36. (b) As the \$40,000 payment for room and board is well over the annual exclusion amount of \$12,000, the donor must file a gift tax return. Transfers to qualified educational or medical care providers for tuition or medical care, respectively, are exempt from gift tax. Also, there is an unlimited marital deduction from taxable gifts. (Bisk: 45-5-2; CSO: 5.8.0; Skill: Understanding)

37. (d) Affiliated groups include only parent-subsidiary corporations. Both brother-sister

corporations and parent-subsidiary corporations are controlled groups. While controlled groups are treated as one corporation for purposes of income tax brackets, the AMT exemption, and the accumulated earnings credit, only affiliated groups may elect to file consolidated tax returns. Partnerships generally do not file consolidated returns with corporations. The percentage ownership of a controlled group is 80%, not 50%. (Bisk: 46-9-3; CSO: 6.2.4; Skill: Analysis)

38. (d) Any additional income will be taxed at the taxpayer's marginal tax rate. Unqualified distributions are subject to a 10% excise tax in addition to the regular income tax. $(35\% + 10\%) \times \$30,000 = \$13,500$ (Bisk: 44-3-2; CSO: 5.5.0; Skill: Analysis)

39. (d) A like-kind exchange is an exchange of property of the same nature or character (real property for real property or personal property for personal property). Like-kind exchange rules defer recognition of gain on the exchange for tax purposes, but do not apply to assets held as inventory, investment securities, or assets held for personal use. Editor's Note: The editors believe answers 'a' and 'd' to be equally valid. The editors do not expect this question to appear on the exam in the future. (Bisk: 43-3-2; CSO: 4.4.0; Skill: Judgment)

40. (c) Direct or material indirect financial interest in an audit client during the period of a professional engagement is held to impair a CPA's independence. (Bisk: 32-2-3; CSO: 1.2.0; Skill: Understanding)

Solution 5: Form 1120, Corporate Income Tax

Schedules M-1 & M-2 (1 point)

Taxable Income (2 points)

Line	1a	Gross receipts	1,880,000
	1c	Net receipts	1,880,000
	3	Gross profit	1,880,000
	5	Interest	16,400
	11	Total income	1,896,400
	12	Compensation of officers	800,000
	13	Salaries and wages	240,000
	14	Repairs and maintenance	2,000
	16	Rents	76,800
	17	Taxes and licenses	10,000
	18	Interest	10,000
	19	Charitable contributions	62,569
	20	Depreciation	75,200
	23	Advertising	30,000
	25	Employee benefit programs	2,000
	26	Other deductions	24,707
	27	Total deductions	1,333,276
	28	Taxable income before NOL & special	563,124
	30	Taxable income	563,124

Line 26 Worksheet (1 point)

	<u>A</u>	<u>B</u>
1	Organization expenses	5,707
2	Utilities	12,000
3	Office supplies	7,000
4		
5		
7	Total deductions (transfer to Line 26)	24,707

Schedule M-1

Line	1	Net income (loss) per books	396,440
	2	Federal income tax	186,560
	3	Excess of capital losses over capital gains	
	5	Expenses recorded on books not deducted on return	
	5a	Depreciation	0
	5b	Contributions carryover	17,431
	5d	Organization expenses	9,893
	5e		27,324
	6	Add Lines 1 through 5	610,324
	7	Income recorded on books this year not included on this return	
	7a	Tax-exempt interest	2,400
	7c		2,400
	8	Deductions on this return not charged against book income this year	
	8a	Depreciation	44,800
	8b	Contributions carryover	0
	8e		44,800
	9	Add Lines 7 and 8	47,200
	10	Income (Line 28, page 1)— Line 6 minus Line 9	563,124

Schedule M-2

Line 1	Balance at beginning of year	0
2	Net income (loss) per books	396,440
3c		0
4	Add Lines 1, 2 and 3	396,440
5a	Distributions: a) Cash	0
5b	b) Stock	
5c	c) Property	
6	Other decreases	
7	Add Lines 5 and 6	0
8	Balance at end of year	
	Line 4 less Line 7)	396,440

Communication (5 points)

October 10, 2003

James Dugan
42 Chestnut Street
Anytown, USA

Dear Mr. Dugan:

The October 9 notice of Late Filing & Payment of Taxes states that your 2002 return was incorrect. I believe the Internal Revenue Service is incorrect, but it is necessary to verify the accuracy of the facts as presented in the notice. I need copies of any documentation that you have from First Investors Brokerage. This includes account statements and transaction notices as well as any Form 1099.

Please deliver such documentation to my office the items described above no later than October 17, so I can resolve this matter as soon as possible. It is imperative that this issue be addressed by October 30, 2003, to avoid any additional interest and penalties that will begin to accrue if payment is not received by that date.

Sincerely,

Irma Preparer, C.P.A.

Editor's Note: The AICPA did not provide a solution for the contents of the Communication tab. This solution was developed by Bisk Education.

Research (1 point)

Code Section Answer: §1211(a)

Code §1211(a) states, "CORPORATIONS.—In the case of a corporation, losses from sales or exchanges of capital assets shall be allowed only to the extent of gains from such sales or exchanges."

Solution 6 (Schedule A, Itemized Deductions)**Unreimbursed Business Expenses Tab (estimated 1 point)**

1. \$2,200

Line 2: Transportation is a qualified employee business expense.

2. \$0

Line 3: While cleaning of uniforms may be deductible, cleaning of clothing suitable for personal use is not a qualified employee business expense.

3. \$410

Line 4: Only 50% of the cost of meals at which business is discussed with potential clients is a qualified employee business expense.

4. \$385

Line 5: Only 50% of the cost of entertainment immediately after a business discussion with clients is a qualified employee business expense.

5. \$0

Line 6: While uniforms may be deductible, clothing suitable for personal use is not a qualified employee business expense.

6. \$25

Line 7: A gift to a client, limited to \$25 per gift, is a qualified employee business expense.

7. \$4,000

Line 12: Gambling losses, to the extent of gambling winnings, are deductible as miscellaneous itemized deductions not subject to the 2% limitation.

8. \$1,340

Line 13: Unreimbursed employee business expenses are deductible as miscellaneous itemized deductions that, in aggregate, are subject to the 2% of adjusted gross income (AGI) limitation. $\$67,000 \times 2\% = \$1,340$

Medical Expenses Tab (estimated 1 point)

1. \$2,650

Line 2: Medical insurance premiums paid with after-tax dollars are a qualified medical expense.

2. \$0

Line 3: Disability insurance premiums are not a qualified medical expense.

3. \$2,400

Line 4: The cost of vision correction surgery is a qualified medical expense.

4. \$0

Line 5: The cost of most cosmetic surgery is not a qualified medical expense.

5. \$0

Line 6: The cost of most cosmetic surgery is not a qualified medical expense.

6. \$4,200

Line 7: The medical expenses of a medical dependent are a qualified medical expense. A medical dependent is someone who would otherwise qualify as a dependent except that he or she did not pass the gross income test.

7. \$4,225

Line 12: Medical expenses are deductible as an itemized deduction to the extent that the aggregate exceeds 7.5% of the taxpayer's AGI. $\$67,000 \times 7.5\% = \$5,025$; $\$9,250 - \$5,025 = \$4,225$

Interest Expenses Tab (estimated 1 point)

1. \$11,400

Line 2: Interest paid on a loan with the taxpayer's primary or secondary home as collateral is qualified acquisition interest expense to the extent that the debt does not exceed the lesser of \$1,000,000 or the home's fair market value.

2. \$4,200

Line 3: All of the points paid on the acquisition mortgage when a home is purchased are qualified interest expense in the year of the home purchase.

3. \$0

Line 4: Mortgage interest paid on rental property is not reported on Schedule A. Instead, it is reported on Schedule E.

4. \$0

Line 5: Personal interest, such as typically incurred on credit cards for purchases of assets for personal

use, is not interest expense qualified for a deduction. Interest expense reported on Schedule A is limited to home acquisition indebtedness, home equity indebtedness, and—to the extent of net investment income—investment indebtedness.

5. \$0

Line 6: Personal interest, such as a payment to the IRS on a late personal income tax return, is not interest expense qualified for a deduction.

6. \$4,200

Line 7: All of the points paid for the acquisition mortgage when a home is purchased are qualified interest expense in the year of the home purchase.

7. \$16,075

Line 12: Qualified interest expense is deductible as an itemized deduction without a specific limitation based on AGI.

Casualty Losses Tab (estimated 1 point)

1. \$7,200

Line 2: A sudden, unexpected, or unusual loss of property not connected with a trade of business or a transaction entered into for profit is allowable as a deduction to the extent the loss exceeds the gains from other personal casualties and thefts, subject to thresholds.

2. \$0

Line 3: A casualty loss must be due to a sudden, unexpected, or unusual cause. Water damage generally does not qualify as it is not sudden. Water damage due to a flood or hurricane would qualify as this would be sudden. Editor's Note: Presumably, this item is unconnected to the water heater explosion mentioned on line 2—a presumption reinforced by the description, "roof deterioration."

3. \$0

Line 4: A casualty loss must be due to a sudden, unexpected, or unusual cause. Damage due to termites is not sudden.

4. \$100

Line 9: Casualty and theft losses are deductible as an itemized deduction to the extent that the aggregate exceeds 10% of the taxpayer's AGI, after deducting a \$100 floor per event (not per damaged or stolen item).

5. \$400

Line 10: Casualty and theft losses are deductible as an itemized deduction to the extent that the aggregate exceeds 10% of the taxpayer's AGI, after deducting a \$100 floor per event (not per damaged or stolen item). $\$67,000 \times 10\% = \$6,700$; $\$7,200 - \$100 - \$6,700 = \400

Communication Tab (estimated 5 points)

Editor's Note: As the AICPA examiners declined to provide an unofficial solution for this element, the Bisk Education editors wrote this solution.

April 15, Year 3

Tom Neu
123 Elm Street
Anytown USA 99999

Re: State Income Tax Refund

Dear Mr. Neu:

The treatment of the refund of state income taxes paid last year depends on whether you itemized your deductions last year and, if so, the extent of your federal tax benefit from using these state income taxes to claim an itemized deduction.

If an expenditure for which a taxpayer received a federal **tax benefit** is refunded, the taxpayer must report the refund, to the extent of the federal tax benefit, as **income** in the year of **receipt**. The tax code **requires** this treatment rather than reducing the current year's total amount for that type of expenditure or amendment of a previous year's return.

If you claimed the **standard deduction**, then you received no federal tax benefit from overpayment of your state income taxes and, hence, the payment is merely a non-taxable refund of your overpayment.

On the other hand, if you claimed an itemized deduction for the amount of the overpayment, your federal income tax was reduced by the amount of the overpayment or, in other words, you received a federal tax benefit. In this case, there are two possibilities for the treatment of the refund: either **partially** or **fully** included in taxable income. In the following discussion, net state income tax is the total state income taxes paid less the overpayment.

If your itemized deductions for last year had been calculated using the net state income taxes and that

amount is **less** than last year's standard deduction, then the federal tax benefit is the **difference** between last year's standard deduction and the itemized deduction actually taken. Thus, only the **part** of the refund that provided the federal tax benefit would be included in taxable income.

If your itemized deductions for last year had been calculated using the net state income taxes and that amount still is the same or **greater** than last year's standard deduction, the full amount of the refund provided a federal tax benefit. Thus, the full amount of the refund must be included in income in the current year.

If this response doesn't address your concerns adequately, please contact me again regarding this issue.

Sincerely

Ima Preparer, CPA

Research Tab (estimated 1 point)

Answer: IRC Section 274(d)

IRC Section 274(d) states, "SUBSTANTIATION REQUIRED.—No deduction or credit shall be allowed—274(d)(1) under section 162 or 212 for any traveling expense (including meals and lodging while away from home), 274(d)(2) for any item with respect to an activity which is of a type generally considered to constitute entertainment, amusement, or recreation, or with respect to a facility used in connection with such an activity, 274(d)(3) for any expense for gifts, or 274(d)(4) with respect to any listed property (as defined in section 280F(d)(4)), unless the taxpayer substantiates by adequate records or by sufficient evidence corroborating the taxpayer's own statement (A) the amount of such expense or other item, (B) the time and place of the travel, entertainment, amusement, recreation, or use of the facility or property, or the date and description of the gift, (C) the business purpose of the expense or other item, and (D) the business relationship to the taxpayer of persons entertained, using the facility or property, or receiving the gift. The Secretary may by regulations provide that some or all of the requirements of the preceding sentence shall not apply in the case of an expense which does not exceed an amount prescribed pursuant to such regulations. This subsection shall not apply to any qualified nonpersonal use vehicle (as defined in subsection (i))."