

REGULATION

CPA2903US1-39

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ABOUT UPDATING SUPPLEMENT VERSION 39.1

Information that is only six months old is eligible to be tested on the CPA exam. Updating Supplement Version 39.1 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 2010 and later exam windows. Candidates with the 39th edition and corresponding software (version 13 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 38th edition and corresponding software also will need Updating Supplement Version 38.3. Updating Supplement Version 38.3 contains summaries of bankruptcy and tax changes and inflation-adjusted amounts. (Material in the version 38.3 updating supplement is incorporated within the 39th edition, as appropriate.)

Candidates with the 37th 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.

NEW AICPA EXAMINATION WEB SITE

In May, 2010, the AICPA examiners changed their web site to <http://www.aicpa.org/BecomeACPA/CPAExam/Pages/CPAExam.aspx>. Browsers set to www.cpa-exam.org are re-directed to the new address.

RECENT TAX LEGISLATION

The *Worker, Homeownership & Business Assistance Act of 2009* (WHBA '09) became law on November 6, 2009, making it first eligible to be tested in the **July-August 2010** exam window. Given the limited and temporary nature of the tax provisions in this legislation, it is unlikely to be tested heavily.

Worker, Homeownership & Business Assistance Act of 2009

A. Provisions Effective in 2009 and 2010

1. NOL Carryback: Most taxpayers (except certain taxpayers getting federal government assistance the under EESA '08) may elect to increase the carryback period for an applicable NOL up to five years instead of two years. An NOL for any tax year ending after December 31, 2007, and beginning before January 1, 2010, is applicable. Generally, an election may be made for only one tax year, but an eligible small business that made or makes an election under the IRC in effect before November 6, 2009, may make an election for two years with an NOL instead of only one.
 - a. The amount of the NOL that can be carried back to the fifth tax year before the loss year (referred to as the fifth year for the rest of this discussion) may not be more than 50% of taxable income for that year determined without taking into account any NOL for the loss year or for any tax year after the loss year.
 - b. The amount of the NOL otherwise carried to tax years after the fifth year is adjusted to take into account that the NOL could offset only 50% of the taxable income for the fifth year.
 - c. The 90% limitation on the use of any alternative tax NOL deduction attributable to the carryback of an applicable NOL for which the extended carryback period is elected also is suspended.
 - d. A taxpayer may revoke an election to waive the carryback period with respect to an applicable NOL or an applicable loss from operations for a tax year ending before November 6, 2009, by the extended due date for filing the tax return for the taxpayer's last tax year beginning in 2009.
2. First-Time Homebuyer Tax Credit (FTHTC)
 - a. The FTHTC is extended to apply to a principal residence purchased (1) before May 1, 2010; and (2) before July 1, 2010, by a taxpayer who enters into a written binding contract before May 1, 2010, to close on the purchase of the principal residence before July 1, 2010.
 - b. Eligible Taxpayers: For purchases after November 6, 2009:
 - (1) The FTHTC phases out for individual taxpayers with modified adjusted gross income (AGI) between \$125,000 and \$145,000 (\$225,000 and \$245,000 for MFJ) for the year of purchase.
 - (2) The taxpayer or the taxpayer's spouse must be 18 years old on the purchase date.
 - (3) The taxpayer must not be able to be claimed as a dependent by another taxpayer for the tax year of purchase.
 - (4) A taxpayer (and, if married, the taxpayer's spouse) who has maintained the same principal residence for any 5-consecutive year period during the 8-year period ending on the date of the purchase of a subsequent principal residence is treated for FTHTC purposes as a first-time homebuyer of that subsequent

principal residence. The maximum allowable credit for such taxpayers is \$6,500 (\$3,250 for a married individual filing separately).

- c. Eligible Property: For purchases after November 6, 2009:
 - (1) The purchase price may not exceed \$800,000.
 - (2) The property may not be acquired from a person related to the taxpayer or the taxpayer's spouse, if married.
 - d. A taxpayer may elect to treat a qualifying home purchase after 2008 as made on December 31 of the calendar year preceding the purchase for purposes of claiming the credit on the prior year's tax return.
 - e. For returns for tax years ending after November 6, 2009, the FTHTC is not allowed unless the taxpayer attaches a properly executed copy of the settlement statement used to complete the purchase to the tax return.
 - f. For returns for tax years ending after Apr. 8, 2008, WHBA '09 expands the definition of mathematical or clerical error so that IRS may assess additional tax without issuing a deficiency notice for certain items related to the FTHTC, such as failure to report FTHTC recapture and failure to attach to the return a properly executed copy of the settlement statement.
3. Conduit Entity Penalty: The base amount on which a penalty is computed for a failure to file either a partnership or S corporation return for a tax year beginning after December 31, 2009, is increased to \$195 per owner.

B. Provisions Effective in 2011 and Later Years (not eligible to be tested on 2010 exams)

- 1. E-filing by Preparers: For returns filed after December 31, 2010, WHBA '09 mandates electronic filing of individual, estate, and trust income tax returns by preparers except those who neither prepare nor reasonably expect to prepare more than nine such returns in a calendar year.
- 2. Corporate Estimated Tax: For large corporations (\$1 billion or more in assets), the required payment of estimated tax that would have been due in July, August, or September of 2014 before WHBA '09 is increased by 33%. The amount of the next required installment is reduced correspondingly to reflect the amount of the increase in the earlier installment.

The *Department of Defense Appropriations Act of 2010* (DODA '10) became law on December 19, 2009, making it first eligible to be tested in the **July-August 2010** exam window. Given the limited and temporary nature of the tax provision in this legislation, it is unlikely to be tested.

Department of Defense Appropriations Act of 2010

COBRA-Subsidy Employer Credit: The 65% COBRA premium subsidy from 2009 is continued.

- 1. Original: The original subsidy applied to employees who elected COBRA health plan continuation coverage and were involuntarily terminated between August 31, 2008, and January 1, 2010. Eligible employees could elect a 65% subsidy of COBRA premiums for up to 9 months. The former employer recovered the other 65% of the premiums as a credit on its quarterly employment tax return.
- 2. Duration: DODA '10 adds up to another 6 months of subsidy (for a total of up to 15 months).

3. Eligible Employees: DODA '10 expands coverage to include employees who are involuntarily terminated in January or February of 2010.

The *Hiring Incentives to Restore Employment Act of 2010* (HIRE '10) became law in March, 2010, making it first eligible to be tested in the **October-November 2010** exam window. The revenue-raising provisions are likely beyond the scope of the AICPA exam.

Hiring Incentives to Restore Employment Act of 2010

A. Stimulus Provisions

1. Payroll Tax Exemption: Private-sector employers who hire a worker who had not been employed for more than 40 hours in the last 60 days are exempt from paying the employer's share of the 6.2% of Social Security payroll tax for that employee for the remainder of 2010. The new hire may not replace another employee unless the first one was fired for cause or left voluntarily. One employee may not qualify the employer for both the payroll tax exemption and the Work Opportunity Credit; the employer must choose one benefit.
2. Retained Worker Credit: For tax years ending after March 18, 2010, employers may claim the lesser of 6.2% of wages or \$1,000 per qualifying employee. A qualifying employee was employed for at least 52 weeks and had wages during the last 26 weeks were at least 80% of the wages for the first 26 weeks of that period.
3. Section 179: The \$250,000 and \$800,000 amounts in effect for 2009 continue for 2010, rather than the previously legislated \$134,000 and \$530,000 amounts.
4. Specified Tax Credit Bonds: For certain bonds issued after March 18, 2010, an issuer may make an irrevocable election on or before the issue date to receive a payment directly from the IRS instead of providing a tax credit to the bondholder. Qualified bonds include new clean renewable energy bonds, qualified energy conservation bonds, qualified zone academy bonds, and qualified school construction bonds.

B. Revenue-Raising Provisions

1. Foreign Asset Nondisclosure Penalty: For tax years starting after March 18, 2010, individuals must report foreign financial assets valued at \$50,000 or more. Noncompliance penalties start at \$10,000.
2. Underpayment Due to Foreign Asset Nondisclosure: For tax years starting after March 18, 2010, a penalty of 40% of any understatement of tax due to an undisclosed foreign financial asset applies.
3. Foreign Asset Statute of Limitations: For tax years starting after March 18, 2010, and other returns for which the assessment period has not expired as of March 18, 2010, the limitations periods is six years for omissions of items that exceed \$5,000 and are attributable to reportable foreign assets. The statute of limitations does not begin until the taxpayer files the information return disclosing the reportable foreign assets.
4. PFIC Reporting: Effective on March 18, 2010, each U.S. citizen or resident who is a shareholder of a passive foreign investment company (PFIC) must file an annual information return containing information specified by the IRS, unless exempted by the IRS. Meeting this requirement does not necessarily fulfill the requirement to report foreign financial assets valued at \$50,000 or more, unless the IRS exercises its regulatory authority to avoid duplicative reporting.
5. Electronic Filing: For returns with a due date (determined without regard to extensions) after March 18, 2010, HIRE '10 creates an exception to the general annual 250 returns threshold for

electronic filing. The IRS is allowed to issue regulations requiring filing on magnetic media for any return filed by a financial institution with respect to any taxes withheld by it for which it is personally liable.

6. **Foreign Trust Clarifications:** Effective on March 18, 2010, HIRE '10 codifies the existing Treasury regulation that treats a foreign trust as having a U.S. beneficiary if any current, future, or contingent beneficiary of the trust is a U.S. person. HIRE '10 also clarifies that a foreign trust will be treated as having a U.S. beneficiary if (1) any person has discretion to determine the beneficiaries of the trust unless the terms of the trust specifically identify the class of beneficiaries and none of those beneficiaries are U.S. persons or (2) any written oral or other agreement could result in a beneficiary of the trust being a U.S. person. As a final clarification, the Act clarifies that the use of any trust property will be treated as a payment from the trust in the amount of the fair market value of such use.
 - **Pre-HIRE '10 Law:** Under present law, a U.S. taxpayer is treated as the owner of the property transferred to a foreign trust if the trust has a U.S. beneficiary. An existing Treasury regulation treats a foreign trust as having a U.S. beneficiary if any current, future, or contingent beneficiary of the trust is a U.S. person. Some taxpayers take positions in conflict with this regulation.
7. **Foreign Trust Transfers:** For transfers of property after March 18, 2010, HIRE '10 provides that if a U.S. person directly or indirectly transfers property to a foreign trust (other than a trust established for deferred compensation or a charitable trust), the IRS may treat the trust as having a U.S. beneficiary unless the transferor can demonstrate to the IRS's satisfaction that under the terms of the trust: (a) no part of the trust may be paid or accumulated during the year for the benefit of a U.S. person, (b) that if the trust were terminated during the year, no part of the trust could be paid to a U.S. person, and (c) that the transferor provides any additional information as the IRS requires for such transfers.
8. **Foreign Trust Nondisclosure Minimum Penalty:** For notices and returns required to be filed after December 31, 2009, HIRE '10 imposes a minimum penalty of \$10,000 on a failure to file an information return with respect to certain transactions involving foreign trusts. Despite this minimum, the penalties imposed on taxpayers for failing to file an information return with respect to a foreign trust may not exceed the amount required to be disclosed on the return.
 - **Pre-HIRE '10 Law:** A taxpayer that fails to file an information return with respect to certain transactions involving foreign trusts (e.g., the creation of a foreign trust, the transfer of money or property to a foreign trust, or the death of a U.S. owner of a foreign trust) is subject to a penalty of 35% of the amount required to be disclosed on such return; however, if the IRS uncovers the existence of an undisclosed foreign trust, but is unable to determine the amount required to be disclose on such return, it is unable to impose a penalty.
9. **Dividend Equivalents:** For payments made on or after September 14, 2010, HIRE '10 treats dividend equivalents as dividends from U.S. sources, including for purposes of withholding rules. A dividend equivalent is any substitute dividend made pursuant to a securities lending or a sale-repurchase transaction that (directly or indirectly) is contingent upon, or determined by reference to, the payment of a dividend from sources within the U.S. or any payment made under a specified notional principal contract that directly or indirectly is contingent upon, or determined by reference to, the payment of a dividend from sources within the U.S. A dividend equivalent also includes any other payment that the IRS determines is substantially similar to such a payment. Under this rule, the IRS may conclude that payments under certain forward contracts or other financial contracts that reference stock of U.S. corporations, for example, are dividend equivalents.

- C. Long-Term Future Provisions (not eligible to be tested in 2010 or 2011)
1. Foreign-Market Bearer Bond Sanction: Effective starting with bonds issued after March 18, 2012, HIRE '10 extends many sanctions already applicable to bearer bonds that are marketed to domestic investors to bearer bonds that are marketed to foreign investors.
 2. Withholding on Foreign Bank Accounts: Effective starting with payments made in 2013, HIRE '10 imposes a 30% withholding tax on certain income from U.S. financial assets held by a foreign financial institution unless the institution agrees to disclose: (a) the identity of a foreign entity that has substantial U.S. owners or a U.S. individual with an account at the institution or its affiliates and (b) the account balance, gross receipts and gross withdrawals/payments from such account annually.
 3. Reporting on Owners of Foreign Entities: Effective starting with payments made in 2013, HIRE '10 requires foreign corporations, partnerships, and trusts to provide withholding agents with the name, address, and tax identification number of any U.S. individual that is a substantial owner of the foreign entity. Withholding agents must report this information to the U.S. Treasury Department. Any withholding agent making a qualified payment to a foreign entity that does not comply with these requirements must withhold tax at a rate of 30%. HIRE '10 exempts certain foreign corporations from these reporting requirements and grants the Treasury Department with regulatory authority to exclude other recipients that pose a low risk of tax evasion.
 4. Corporate Estimated Tax: For large corporations (\$1 billion or more in assets), the required payment of estimated tax under the Corporate Estimated Tax Shift Act is increased by 23%. Under the Corporate Estimated Tax Shift Act, the amount of any required installment of corporate estimated tax that is otherwise due in July, August, or September 2014 was 134.75% of the amount otherwise due, so the rate now is 157.75%.
 5. World Wide Interest Allocation: HIRE '10 delays the effective date of the worldwide interest allocation rules for three years, until tax years beginning after December 31, 2020, with the dates for making the worldwide affiliated group (WAG) election and the financial institution group election delayed correspondingly.
 - Pre-HIRE '10 Law: For tax years beginning after December 31, 2017, an election was to be available under which interest could be allocated among foreign and domestic corporations on a worldwide basis. Under this election, the common parent of a WAG could determine the taxable income of each domestic corporation which is a member of the group by allocating and apportioning the interest expense of each member as if all members of the WAG were a single corporation.

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

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

A. Immediate Provisions

1. New Therapies: For expenses starting in 2009 and later, a two-year temporary credit applies to encourage investments in new therapies to prevent, diagnose, and treat acute and chronic disease, subject to an overall \$2 billion ceiling.

2. Healthcare Professional Exclusion: Starting in 2009 and later, payments made under any state loan repayment or loan forgiveness program designed to increase availability of healthcare in underserved areas are excluded from gross income.
3. Insurance Sponsor Credit: For 2010 and later, a credit is available for eligible small employers who offer health care insurance to employees. Eligible employers have no more than 25 full-time equivalent employees (FTEEs) whose annual average full-time equivalent wages (AFTEWs) are no more than \$50,000. For the full credit, employers must have no more than 10 FTEEs with AFTEWs of no more than \$25,000. The wage limits are inflation-adjusted starting in 2014.
4. Excluded Coverage: Starting on March 30, 2010, the exclusion from income for health coverage extends to coverage for a child (under age 27 at the end of the year) of an employee or self-employed person.
5. Adoption Provisions: For tax years starting in 2010 and later, the adoption tax credit and adoption assistance exclusion are increased by \$1,000 and extended to 2011. The credit is changed to be refundable.

B. Near-Term Future Provisions (eligible to be tested in 2011)

1. Medical Expense Definition Further Restricted: For tax years starting in 2011 and later, flexible spending account, health reimbursement account, health savings account, and Archer medical savings account reimbursements for medicines are limited to prescribed medicines and insulin. (Currently, over-the-counter medicines may be eligible for reimbursement.)
2. Non-Qualifying HSA or MSA Distributions: For tax years starting in 2011 and later, the surtaxes for health savings account (HSA) and Archer medical savings account (MSA) non-qualifying distributions are increased to 20%.
3. Simple Cafeteria Plan: For tax years starting in 2011 and later, a Simple Cafeteria Plan is available with eased participation restrictions to encourage small businesses to provide tax-free benefits to employees. Self-employed individuals qualify as employees for this purpose.
4. Reporting: Starting in 2011, employers must disclose the value of health care insurance benefits on each employee's annual Form W-2. For tax years starting in 2014 and later, greater detail must be supplied to both the covered individual and the IRS.

C. Long-Term Future Provisions (not eligible to be tested in 2010 or 2011)

1. Itemized Deductions: For tax years starting in 2013 and later, the threshold for taxpayers age 64 and younger for medical deductions is 10%, rather than 7.5%.
2. Additional Hospital Insurance Tax: For tax years starting in 2013 and later, the hospital insurance tax rate increases for high-income taxpayers by 0.9% for earnings over certain non-inflation-adjusted thresholds.
3. Unearned Income Medicare Contribution: For tax years starting in 2013 and later, a 3.8% surtax will apply to net investment income of high-income taxpayers. Like current FICA, this surtax is not deductible for federal income tax purposes.
4. Health FSA Contribution Limits: For tax years starting in 2013 and later, annual contributions to health FSA under cafeteria plans are limited to \$2,500. This ceiling will be inflation-adjusted starting in 2014.
5. Employer Deduction for Part D Coverage: For tax years starting in 2013 and later, the deduction for employers who maintain prescription drug plans for their retirees who are eligible for Medicare Part D will be eliminated.

6. **Uninsured Penalty:** For tax years ending after 2013, non-exempt U.S. residents must maintain minimum essential health insurance coverage or pay a penalty. Citizens residing outside of the U.S., people exempt for religious reasons, and those who cannot afford coverage are exempt. Unaffordable coverage is defined as a contribution for employer-sponsored coverage or the lowest cost plan in the local Insurance Exchange that exceeds 8% of household income.
7. **Low-Income Insurance Exchange Participation Credit:** For tax years ending after 2013, credits are available for individual with incomes up to 400% of the federal poverty level who obtain health care coverage through an Insurance Exchange that are not eligible for Medicaid, employer-sponsored coverage, or other acceptable coverage.
8. **Employer Responsibilities:** For months beginning after December 31, 2013, an applicable large employer not offering adequate affordable coverage for all its full-time employees will be subject to a penalty if any full-time employee is certified as having purchased health insurance through a qualified state exchange. In this context, an applicable large employer generally is one that employed an average of at least 50 full-time employees during the preceding calendar year and a qualified state exchange is one which a premium tax credit or cost-sharing reduction is allowed or paid to the employee. Also, an applicable large employer that offers, for any month, its full-time employees and their dependents the opportunity to enroll in minimum essential coverage under an employer sponsored plan will be subject to a penalty if any full-time employee is enrolled in health insurance coverage purchased through a qualified state exchange.
9. **Free-Choice Vouchers:** After December 31, 2013, employers offering minimum essential coverage through an eligible employer-sponsored plan and paying a portion of that coverage must provide qualified employees with a voucher whose value can be applied to purchase of a health plan through the Insurance Exchange. The value of the voucher is equal to the dollar value of the employer contribution to the employer-offered health plan and is not includable in the employee's income to the extent it is used for the purchase of health plan coverage. An individual receiving a voucher is disqualified from receiving any tax credit or cost sharing credit for the purchase of a plan in the Insurance Exchange. Similarly, if any employee receives a free-choice voucher, the employer is not assessed a shared responsibility payment on behalf of that employee.
 - a. Qualified employees do not participate in the employer's health plan;
 - b. Qualified employees' required contribution for employer-sponsored minimum essential coverage (if they participated in the plan) would exceed 8%, but would not exceed 9.8% of household income; and
 - c. Qualified employees' total household income does not exceed 400% of the poverty line for the family.
10. **Corporate Estimated Tax:** For large corporations (\$1 billion or more in assets), the required payment of estimated tax for July, August, and September of 2014 is increased by 15.75%.
11. **High-Cost Employer-Sponsored Health Coverage:** For tax years starting in 2018 and later, a 40% nondeductible excise tax is levied on insurance companies and plan administrators for plans to the extent that the annual premium exceeds certain thresholds. The thresholds will be automatically increase if the inflation rate for group medical premiums between 2010 and 2018 is higher than the 2010 Congressional Budget Office estimates

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 2010 and October-November 2010 CPA examinations should cover the law in effect for 2010. However, when it comes to taxes, the examiners repeatedly have tested the last full calendar year. The editors expect the July-August 2010 and the October-November 2010 CPA examination to cover the tax law in effect for 2009, not 2010, in those few questions where the year makes a difference. The editors expect the questions on the January-February 2011 and April-May 2011 CPA examinations to cover the tax law in effect for 2010.

Note that some amounts (Section 179 amounts, etc.) are favorite targets of economic stimulus legislation and, thus, are particularly subject to change. Lately, these amounts have been provided in released questions. Many amounts did not change from 2009 to 2010 as inflation was mild.

Individual Taxation

- A. Exemption: The personal exemption is \$3,650 for 2009 and 2010.
- B. Standard Deduction & Personal & Dependency Exemption Phase-out: For 2009 and 2010, the standard deduction for an individual who may be claimed as a dependent by another taxpayer may not exceed the greater of either \$950 or the sum of \$300 and the individual's earned income. The personal and dependency exemption phase-out is eliminated for 2010 and later tax years.

Filing Status	Standard Deduction		Additional Age & Blindness	
	2010	2009	2010	2009
Married Filing Jointly *	\$11,400	\$11,400	\$1,100	\$1,100
Single	5,700	5,700	1,400	1,400
Head of Household	8,400	8,350	1,400	1,400
Married Filing Separately	5,700	5,700	1,100	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 2009, the maximum reduction is at most 1/3 of the amount calculated before the reduction. [Candidates who are unfamiliar with the overall limitation rule should review the material on itemized deductions in Chapter 44.] The overall limitation on itemized deductions is eliminated for 2010 and later tax years.

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

<u>Filing Status</u>	<u>2010</u>	<u>2009</u>
Married filing jointly	\$105,100 to \$135,100	\$104,900 to \$134,900
All others	\$ 70,100 to \$ 85,100	\$ 69,950 to \$ 84,950

E. Retirement Plans: Employees may defer up \$49,000 in defined contribution plans for 2009 and 2010. The annual limit for defined benefit plan benefits is \$195,000 for 2009 and 2010.

1. Section 401(k), Section 457, and SEP Plans: For 2009 and 2010, the maximum on elective deferrals is \$16,500. For 2009 and 2010, the maximum catch-up contributions are \$5,500 for Sections 401(k), 403(b), and 457 plans.
2. SIMPLE Plans: For 2009 and 2010, employees may defer up to the lesser of \$11,500 of elective contributions or 25% of annual compensation. The \$2,500 catch-up contribution limit for SIMPLE plans is not inflation adjusted.

F. Individual Retirement Account (IRA) Phase-outs: In 2009, the maximum Roth IRA contribution is phased out for taxpayers with AGI exceeding \$166,000 (MFJ), \$105,000 (single), and \$0 (MFS). In 2010, these maximums are \$167,000, \$105,000, and \$0, respectively. The phase-out range for contributions of a non-active spouse starts at \$166,000 for 2009 (\$167,000 for 2010). The active participant phase-outs are as follows.

<u>Filing Status</u>	<u>2010</u>	<u>2009</u>
Married filing jointly	\$89,000 to \$109,000	\$89,000 to \$109,000
Single or Head of Household	\$56,000 to \$ 66,000	\$55,000 to \$ 65,000
Married filing separately	\$0 to \$ 10,000	\$0 to \$ 10,000

G. 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 (\$3,050 for 2010) for individual coverage and \$5,950 (\$6,150 for 2010) for family coverage.

H. Income Tax Rates: The individual tax rates are as follows for 2010.

<u>Rate</u>	<u>MFJ & SS</u>	<u>Head of household</u>	<u>Single</u>	<u>MFS</u>
10%	\$ 0 to \$ 16,750	\$ 0 to \$ 11,950	\$ 0 to \$ 8,375	\$ 0 to \$ 8,375
15%	\$ 16,751 to \$ 68,000	\$ 11,951 to \$ 45,550	\$ 8,376 to \$ 34,000	\$ 8,376 to \$ 34,000
25%	\$ 68,001 to \$137,300	\$ 45,551 to \$117,650	\$ 34,001 to \$ 82,400	\$ 34,001 to \$ 68,650
28%	\$137,301 to \$209,250	\$117,651 to \$190,550	\$ 82,401 to \$171,850	\$ 68,651 to \$104,625
33%	\$209,251 to \$373,650	\$190,551 to \$373,650	\$171,851 to \$373,650	\$104,626 to \$186,825
35%	Over \$373,650	Over \$373,650	Over \$373,650	Over \$186,825

I. Self-Employment & Social Security Taxes: The maximum income subject to the full self-employment and social security taxes is \$106,800 in 2009 and 2010.

J. Adoption Expense Credit: The maximum adoption expense credit is \$12,150 for 2009 (\$13,170 for 2010). It phases out starting at \$182,180 for 2009 (\$182,520 for 2010). Editor's Note: The inflation-adjusted amount for 2010 is \$12,170. The Health Care Act increased this by \$1,000, for a total of \$13,170.

K. Child Credit: The child credit is refundable to the extent of the greater of 15% of the taxpayer's earned income in excess of \$3,000 for 2009 and 2010 or, for taxpayers with three or more qualifying children, the amount of Social Security taxes that exceeds the earned income credit.

- L. Earned Income Credit: For 2009 and 2010, the earned income credit is denied if certain investment income is greater than \$3,100. The 2010 amounts are subject to further change.

	Number of Qualifying Children	Credit %	Base	Maximum Credit	Beginning Phase-out*	Non-MFJ Complete Phase-out	MFJ Complete Phase-out
2010	0	7.65	\$ 5,980	\$ 457	\$ 7,480	\$13,460	\$18,470
	1	34.00	8,970	3,050	16,450	35,535	40,545
	2	40.00	12,590	5,036	16,450	40,363	45,373
	3	45.00	12,590	5,666	16,450	43,352	48,362
2009	0	7.65	\$ 5,970	\$ 457	\$ 7,470	\$13,440	\$18,440
	1	34.00	8,950	3,043	16,420	35,463	40,463
	2	40.00	12,570	5,028	16,420	40,295	45,295
	3	45.00	12,570	5,657	16,420	43,279	48,279

* For married filing jointly, add \$5,000 to each beginning phase-out amount in 2009 and 2010.

Property Taxation

- A. Section 179: For 2009 and 2010, the §179 expense deduction is \$250,000 for qualified property. For 2009 and 2010, the limit is reduced by cost of §179 property placed in service during the year that exceeds \$800,000.
- B. Annual Gift Exclusion: For 2009 and 2010, the first \$13,000 of gifts to any person is not included in the total amount of taxable gifts made.

INFLATION-ADJUSTED BANKRUPTCY AMOUNTS

The Bankruptcy Reform Act of 1994 provides that for 1998 and each 3-year interval ending April 1 thereafter, bankruptcy dollar amounts are adjusted for inflation. In accordance with the examiners' stated policy, the April 1, 2010, changes are not eligible to be tested on the AICPA exam until six months after their effective date. Thus, they are first eligible to be tested in the **October-November 2010** exam window.

Revision of Certain Bankruptcy Dollar Amounts Prescribed Under Section 104(b)

- A. Chapter 13: Chapter 13 is limited to an individual who has regular income, less than \$360,375 of unsecured debts, and less than \$1,081,400 of secured debts (formerly \$336,900 and \$1,010,650, respectively).
- B. Involuntary Bankruptcy: Aggregate claims must be at least \$14,425 (formerly \$13,475).
- C. Means Test: The means test amounts are now \$7,025 and \$11,725 (formerly \$6,575 and \$10,950).
- D. Priority Claims: Priority claim amounts are now:
1. Unpaid wages and unpaid employee benefits of \$11,725 (formerly \$10,950).
 2. Claims of fishermen or farm producers against debtors who operate fish produce or grain storage facilities up to \$5,775 (formerly \$5,400).
 3. Deposits for consumer goods of \$2,600 (formerly \$2,425).

- E. Federal Exemptions: The revised exemptions include:
1. Up to \$21,625 of real or personal property of the residence used by the debtor or the debtor's dependent(s) (formerly \$20,200).
 2. Up to a \$3,450 interest in one motor vehicle (formerly \$3,225).
 3. Household goods, furnishings, clothing, appliances, books, animals, and crops, that are held primarily for the personal, family, or household use of the debtor or the debtor's dependent(s) but not to exceed \$550 in value in any particular item (formerly \$525).
 4. Up to \$1,450 in jewelry held primarily for the personal, family, or household use of the debtor or the debtor's dependent(s) (formerly \$1,350).
 5. Up to \$1,150 in any property (formerly \$1,075).
 6. Up to \$2,175 in any implements, professional books, or tools of the trade of the debtor or the debtor's dependent(s) (formerly \$2,025).
 7. Up to \$11,525 in any accrued dividend or interest under, or loan value of, any unmatured life insurance contract owned by the debtor and insuring either the debtor or an individual of whom the debtor is a dependent(s) (formerly \$10,775).
 8. Up to \$1,171,650 in tax-exempt retirement accounts (formerly \$1,095,000).
 9. Up to \$5,850 in qualified education savings accounts and pre-purchased tuition credits (formerly \$5,475).
- F. Homestead Exemption: The revised homestead exemption limit for recent residents of a state is \$146,450 (formerly \$136,875).
- G. Discharge Exception: The revised exceptions include:
1. Luxury goods totaling more than \$600 based on consumer open-end credit (formerly \$550).
 2. Cash advances totaling more than \$875 based on consumer open-end credit (formerly \$825).
- H. Preference: The revised preference minimum is \$5,850 (formerly \$5,475).
-

UPCOMING EXAM CHANGES

The following information is provided merely to satisfy curiosity, rather than from a need for CPA candidates to know it for the July-August 2010 or October-November 2010 examination window. Both the new exam format and the new content specification outline will be implemented in **January-February 2011** examination window.

The information presented here is intended to give candidates an overall idea of what the January-February 2011 and later exams will be like. Candidates should check the AICPA's web site 45 days before their exam for the most recent information.

Multiple-Choice Questions

Initially, FAR and AUD will have three testlets of 30 questions each; REG and BEC will have three testlets of 24 questions each. Adaptive testing eventually may allow for fewer questions for some candidates.

Written Communications

Only the BEC exam section will have written communications. Typically, there will be three communications in a single testlet. These responses will to be graded by a combination of human and machine graders. The score will focus primarily on writing skills. The content must be on topic to earn the full point value, but the examiners plan to focus on testing content in the objective response questions.

Task-Based Simulations

The FAR, AUD, and REG exam sections will have task-based simulations: seven each in FAR and AUD and six in REG. These will be smaller in scope and more numerous than the current case-based simulations. Work tabs will include a scenario relating to the questions as well as the questions. Resource and help tabs also may be available; the information on these help tabs will be particular to the individual simulation.

At least one simulation in the FAR, AUD, and REG exam sections will be a research question, probably for one point. While the skills tested remain the same, the interface will change.

AICPA Tutorial

The AICPA provides a web-based tutorial for the exam. Expect the examiners to post tutorials and sample tests for the new exam format and new CSO by November, 2010.

Content Specification Outline

A new Content Specification Outline (CSO) and a new Skill Specification Outline (SSO) have been issued by the examiners. There is no need for CPA candidates sitting for the July-August 2010 or October-November 2010 examination windows to be familiar with this CSO and SSO.

The new CSO and SSO are available now on the examiner's web-site. Bear in mind, becoming familiar with the new CSO does not count as review for the July-August 2010 or October-November 2010 examination windows. As the January-February 2011 examination window approaches, Bisk Education will issue an updating supplement with the new CSO.

ERRATA

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.

Chapter 33

Problem 33-7, question 5: The phrase "Public Company Accounting Oversight Board" should replace instances of "SEC" in the question and explanation.

Chapter 36

Problem 36-1, questions 8 and 9: The answers and explanations to these two questions are switched.

Chapter 38

Page 38-2 text: The descriptions of the equity sense and the bankruptcy code sense of insolvency are switched.

Problem 38-3, question 12 explanation: The calculation should read, "...\$2,500 [(\$30,000 – \$25,000) × 50%] for a total of \$27,500." The answer is correct.

Chapter 44

Problem 44-1, question 34: The answer should be 'b,' not 'd.' The explanation is correct.

Chapter 45

Page 45-13 text: The graphic has a former amount of \$12,000, as opposed to the current amount of \$13,000 correctly noted in the accompanying text.

RECENTLY RELEASED AICPA QUESTIONS

In April 2010, the AICPA released several questions labeled as “Year 2010 Disclosed Questions.” Unlike in previous years, there was no indication as to the skill category or the difficulty of the two sets of questions.

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

Problem 1 MULTIPLE-CHOICE QUESTIONS

1. According to the AICPA Code of Professional Conduct, in which of the following circumstances may a CPA serve on a company’s board of directors?
 - a. The CPA audits a bank to which the company has applied for financing, and board approval is required for said financing to occur.
 - b. The CPA is asked by the company to test the internal controls of the company and offers compensation to the CPA for said services.
 - c. The CPA does **not** audit the company and has **no** other business connection with the company.
 - d. The CPA performs attestation services for a nonpublic company. (R/10, REG, A1132L, #1, 9401)

2. How many audits of public companies per year does a CPA firm that is registered with the Public Company Accounting Oversight Board (PCAOB) have to perform before it receives an annual inspection from the PCAOB?
 - a. One audit
 - b. More than 10 audits
 - c. More than 50 audits
 - d. More than 100 audits (R/10, REG, A1025L, #2, 9402)

3. What defense must an accountant establish to be absolved from civil liability under Section 18 of the Securities Exchange Act of 1934 for false or misleading statements made in reports or documents filed under the Act?
 - a. Lack of gross negligence
 - b. Exercise of due care
 - c. Good faith and lack of knowledge of the statement’s falsity
 - d. Lack of privity with an injured party (R/10, REG, 2407L, #3, 9403)

4. In which of the following situations is there a violation of client confidentiality under the AICPA Code of Professional Conduct?
 - a. A member discloses confidential client information to a court in connection with arbitration proceedings relating to the client.
 - b. A member discloses confidential client information to a professional liability insurance carrier after learning of a potential claim against the member.
 - c. A member whose practice is primarily bankruptcy discloses a client’s name.
 - d. A member uses a records retention agency to store clients’ records that contain confidential client information. (R/10, REG, A0780L, #4, 9404)

5. On December 1, Gem orally contracted with Mason for Mason to manage Gem's restaurant for one year starting the following January 1. They agreed that Gem would pay Mason \$40,000 and that Mason would be allowed to continue to work for Gem if "everything worked out." On June 1, Mason quit to take a better paying job, alleging that the contract violated the statute of frauds. What will be the outcome of a suit by Gem for breach of contract?
- Gem will win because the contract was executory.
 - Gem will win because the contract was for services **not** goods.
 - Gem will lose because the contract could **not** be performed within one year.
 - Gem will lose because the contract required payment of more than \$500.
- (R/10, REG, 1131L, #5, 9405)
6. Which of the following bonds are an obligation of a surety?
- Convertible bonds
 - Debenture bonds
 - Municipal bonds
 - Official bonds
- (R/10, REG, 2419L, #6, 9406)
7. According to the Securities Act of 1933, which of the following statements is correct regarding an issuer of securities?
- All securities issuers must provide potential investors with a prospectus containing specified information.
 - An issuer is permitted to advertise an initial offering of securities only through distribution of the prospectus.
 - All securities issuers must register the securities offering with the Securities and Exchange Commission (SEC).
 - If an issuer sells a security and fails to meet certain disclosure requirements, the purchaser may sell it back to the issuer and recover the price paid.
- (R/10, REG, A0373L, #7, 9407)
8. Which of the following circumstances best describes a landlord's constructive eviction of a tenant who has a written lease for the property?
- The landlord changes the lock and refuses to give the tenant a new key.
 - The landlord starts a legal proceeding against the tenant for failure to pay rent.
 - The landlord sues the tenant because the tenant complained to a government agency about the condition of the premises.
 - The landlord refuses to provide utilities to the tenant.
- (R/10, REG, 1953L, #8, 9408)
9. A calendar-year individual filed an income tax return on April 1. This return can be amended **no** later than
- Four months and 15 days after the end of the calendar year
 - Ten months and 15 days after the end of the calendar year
 - Three years, three months, and 15 days after the end of the calendar year
 - Three years after the return was filed
- (R/10, REG, C00819R, #9, 9409)
10. In the absence of an election to adopt an annual accounting period, the required tax year for a partnership is
- A tax year that results in the greatest aggregate deferral of income
 - A calendar year
 - A tax year of one or more partners with a more than 50% interest in profits and capital
 - A tax year of a principal partner having a 10% or greater interest
- (R/10, REG, PC1270, #10, 9410)

11. In the current year Tatum exchanged farmland for an office building. The farmland had a basis of \$250,000, a fair market value (FMV) of \$400,000, and was encumbered by a \$120,000 mortgage. The office building had an FMV of \$350,000 and was encumbered by a \$70,000 mortgage. Each party assumed the other's mortgage. What is the amount of Tatum's recognized gain?
- a. \$0
 - b. \$ 50,000
 - c. \$ 100,000
 - d. \$ 150,000
- (R/10, REG, 1614T, #11, 9411)
12. Danielson invested \$2,000,000 in DEC, a qualified small business corporation. Six years later, Danielson sold all of the DEC stock for \$16,000,000, and purchased an office building with the proceeds. Danielson had not previously excluded any gain on the sale of small business stock. What is Danielson's taxable gain after the exclusion?
- a. \$0
 - b. \$6,000,000
 - c. \$7,000,000
 - d. \$9,000,000
- (R/10, REG, 1564T, #12, 9412)
13. Robbe, a cash basis single taxpayer, reported \$50,000 of adjusted gross income last year and claimed itemized deductions of \$5,500, consisting solely of \$5,500 of state income taxes paid last year. Robbe's itemized deduction amount, which exceeded the standard deduction available to single taxpayers for last year by \$1,150, was fully deductible and it was not subject to any limitations or phase-outs. In the current year, Robbe received a \$1,500 state tax refund relating to the prior year. What is the proper treatment of the state tax refund?
- a. Include none of the refund in income in the current year
 - b. Include \$1,150 in income in the current year
 - c. Include \$1,500 in income in the current year
 - d. Amend the prior-year's return and reduce the claimed itemized deductions for that year
- (R/10, REG, 1201T, #13, 9413)
14. Lane, a single taxpayer, received \$160,000 in salary, \$15,000 in income from an S Corporation in which Lane does not materially participate, and a \$35,000 passive loss from a real estate rental activity in which Lane materially participated. Lane's modified adjusted gross income was \$165,000. What amount of the real estate rental activity loss was deductible?
- a. \$0
 - b. \$15,000
 - c. \$25,000
 - d. \$35,000
- (R/10, REG, 0979T, #14, 9414)
15. Which of the following disqualifies an individual from the earned income credit?
- a. The taxpayer's qualifying child is a 17-year-old grandchild.
 - b. The taxpayer has earned income of \$5,000.
 - c. The taxpayer's five-year-old child lived in the taxpayer's home for only eight months.
 - d. The taxpayer has a filing status of married filing separately.
- (R/10, REG, A0042T, #15, 9415)
16. Which of the following can be an advantage of a limited liability company over an S corporation?
- a. Double taxation of profits is avoided.
 - b. Owners receive limited liability protection.
 - c. Appreciated property can be distributed tax-free to an owner.
 - d. Incentive stock options can be used to compensate owners.
- (R/10, REG, C02688R, #16, 9416)

17. Quigley, Roberk, and Storm form a corporation. Quigley exchanges \$25,000 of legal fees for 30 shares of stock. Roberk exchanges land with a basis of \$10,000 and a fair market value of \$100,000 for 60 shares of stock. Storm exchanges \$10,000 cash for 10 shares of stock. What amount of income should each shareholder recognize?

	<u>Quigley</u>	<u>Roberk</u>	<u>Storm</u>
a.	\$0	\$0	\$0
b.	\$25,000	\$90,000	\$0
c.	\$25,000	\$90,000	\$10,000
d.	\$0	\$90,000	\$0

(R/10, REG, A0223T, #17, 9417)

18. Tap, a calendar-year S corporation, reported the following items of income and expense in the current year:

Revenue	\$44,000
Operating expenses	20,000
Long-term capital loss	6,000
Charitable contributions	1,000
Interest expense	4,000

What is the amount of Tap's ordinary income?

- a. \$13,000
b. \$19,000
c. \$20,000
d. \$24,000

(R/10, REG, 1668T, #18, 9418)

19. During the current year, a trust reports the following information:

Dividends	\$10,000
Interest from corporate bonds	12,000
Tax-exempt interest from state bonds	4,000
Capital gain (allocated to corpus)	2,000
Trustee fee (allocated to corpus)	6,000

What is the trust's accounting income?

- a. \$22,000
b. \$26,000
c. \$28,000
d. \$34,000

(R/10, REG, A1457T, #19, 9419)

20. Mackenzie is the grantor of a trust over which Mackenzie has retained a discretionary power to receive income. Kelly, Mackenzie's child, receives all taxable income from the trust unless Mackenzie exercises the discretionary power. To whom is the income earned by the trust taxable?

- a. To the trust to the extent it remains in the trust
b. To Mackenzie because he has retained a discretionary power
c. To Kelly as the beneficiary of the trust
d. To Kelly and Mackenzie in proportion to the distributions paid to them from the trust

(R/10, REG, 0858T, #20, 9420)

Problem 2 MULTIPLE-CHOICE QUESTIONS

21. Smith, CPA, is a partner of Johnson Accounting Firm. Johnson audited the books of Hometown Bank. Smith's independence would be impaired under which of the following circumstances?

- a. Smith is a director of Hometown Bank.
b. Smith has a collateralized automobile loan with Hometown Bank.
c. Smith had an account with Hometown Bank two years ago.
d. Smith and a Hometown Bank board member belong to the same church.

(R/10, REG, A0544L, #21, 9421)

22. Which of the following is a correct statement about the circumstances under which a CPA firm may or may **not** disclose the names of its clients without the clients' express permission?
- a. A CPA firm may disclose this information if the practice is limited to bankruptcy matters, so that prospective clients with similar concerns will be able to contact current clients.
 - b. A CPA firm may disclose this information if the practice is limited to performing asset valuations in anticipation of mergers and acquisitions.
 - c. A CPA firm may disclose this information **unless** disclosure would suggest that the client may be experiencing financial difficulties.
 - d. A CPA firm may **not** disclose this information because the identity of its clients is confidential information. (R/10, REG, A0786L, #22, 9422)
23. Lawson, a CPA, discovers material noncompliance with a specific Internal Revenue Code (IRC) requirement in the prior-year return of a new client. Which of the following actions should Lawson take?
- a. Wait for the statute of limitations to expire
 - b. Discuss the requirements of the IRC with the client and recommend that client amend the return
 - c. Contact the IRS and discuss courses of action
 - d. Contact the prior CPA and discuss the client's exposure (R/10, REG, A1097L, #23, 9423)
24. Able, CPA, was engaged by Wedge Corp. to audit Wedge's financial statements. Wedge intended to use the audit report to obtain a \$10 million loan from Care Bank. Able and Wedge's president agreed that Able would give an unqualified opinion on Wedge's financial statements in the audit report even though there were material misstatements in the financial statements. Care refused to make the loan. Wedge then gave the audit report to Ranch to encourage Ranch to purchase \$10 million worth of Wedge common stock. Ranch reviewed the audit report and relied on it to purchase the stock. After the purchase, Able's agreement with Wedge's president was revealed. As a result, Wedge stock lost half its value and Ranch sued Able for fraud. What will be the result of Ranch's suit?
- a. Ranch will win because Able intentionally gave an unqualified opinion on Wedge's materially misstated financial statements.
 - b. Ranch will win because Able is strictly liable for errors made in auditing Wedge's financial statements.
 - c. Ranch will lose because Ranch is **not** a foreseen user of Able's audit report.
 - d. Ranch will lose because Ranch is **not** in privity with Able. (R/10, REG, 0912L, #24, 9424)
25. Which of the following terms best describes the relationship between a corporation and the CPA it hires to audit corporate books?
- a. Employer and employee
 - b. Employer and independent contractor
 - c. Master and servant
 - d. Employer and principal (R/10, REG, A0346L, #25, 9425)
26. Card communicated an offer to sell Card's stereo to Bend for \$250. Which of the following statements is correct regarding the effect of the communication of the offer?
- a. Bend should immediately accept or reject the offer to avoid liability to Card.
 - b. Card is **not** obligated to sell the stereo to Bend until Bend accepts the offer.
 - c. Card is required to mitigate any loss Card would sustain in the event Bend rejects the offer.
 - d. Bend may **not** reject the offer for a reasonable period of time. (R/10, REG, 1504L, #26, 9426)
27. Worker's compensation benefits are available to which of the following parties?
- a. Only those employees injured while working on workplace premises
 - b. Only those employees injured while working within the scope of employment
 - c. All agents injured while commuting to and from work
 - d. All agents injured while using the employer's automobile for personal use (R/10, REG, A0303L, #27, 9427)

28. Under the Negotiable Instruments Article of the UCC, which of the following statements is correct regarding a check?
- A check is a promise to pay money.
 - A check is an order to pay money.
 - A check does **not** need to be payable on demand.
 - A check does **not** need to be drawn on a bank.

(R/10, REG, 2469L, #28, 9428)

29. A tax preparer has advised a company to take a position on its tax return. The tax preparer believes that there is a 75% possibility that the position will be sustained if audited by the IRS. If the position is not sustained, an accuracy-related penalty and a late-payment penalty would apply. What is the tax preparer's responsibility regarding disclosure of the penalty to the company?
- The tax preparer is responsible for disclosing both penalties to the company.
 - The tax preparer is responsible for disclosing only the accuracy-related penalty to the company.
 - The tax preparer is responsible for disclosing only the late-payment penalty to the company.
 - The tax preparer has **no** responsibility for disclosing any potential penalties to the company, because the position will probably be sustained on audit.

(R/10, REG, PC309, #29, 9429)

30. Sackett Corporation had a beginning inventory of 10,000 units, which were purchased in the prior year as follows:

	<u>Units</u>	<u>Unit Price</u>
September	4,000	\$2.00
October	4,000	\$2.10
December	2,000	\$2.30

In the current year, Sackett purchases an additional 12,000 units (7,000 in June at \$2.50 and 5,000 in November at \$2.70) and sells 16,000 units. Using the FIFO method, what is Sackett's ending inventory?

- \$12,200 (4,000 @ \$2.00 and 2,000 @ \$2.10)
 - \$13,000 (4,000 @ \$2.10 and 2,000 @ \$2.30)
 - \$15,600 (6,000 @ \$2.60 - average of \$2.50 and \$2.70)
 - \$16,000 (5,000 @ \$2.70 and 1,000 @ \$2.50)
31. Terry, a taxpayer, purchased stock for \$12,000. Later, Terry sold the stock to a relative for \$8,000. What amount is the relative's gain or loss?
- \$2,000 loss
 - \$0
 - \$2,000 gain
 - \$4,000 gain

(R/10, REG, 1747T, #30, 9430)

(R/10, REG, A0289T, #31, 9431)

32. Winkler, a CPA, provided accounting services to a client, Thompson. On December 15 of the same year, Thompson gave Winkler 100 shares of Foster Corp. as compensation for services. The adjusted basis of the stock was \$4,000, and its fair market value at the time of transfer was \$5,000. Two months later, Winkler sold the stock on February 15 for \$7,500. What is the amount that Winkler should recognize as gain on the sale of stock?
- \$0
 - \$1,000
 - \$2,500
 - \$5,000

(R/10, REG, A0133T, #32, 9432)

33. Which of the following should be included when determining adjusted gross income?

- Alimony received
- Compensation for injuries or sickness
- Rental value of parsonages
- Tuition scholarship

(R/10, REG, A0888T, #33, 9433)

34. An individual starts paying student loan interest in the current year. How many years may the individual deduct a portion of the student loan interest?
- a. Current year only
 - b. Five years
 - c. Ten years
 - d. Duration of time that interest is paid (R/10, REG, A0268T, #34, 9434)
35. A taxpayer's spouse dies in August of the current year. Which of the following is the taxpayer's filing status for the current year?
- a. Single
 - b. Qualified widow(er)
 - c. Head of household
 - d. Married filing jointly (R/10, REG, C00804R, #35, 9435)
36. Which of the following entities must pay taxes for federal income tax purposes?
- a. General partnership
 - b. Limited partnership
 - c. Joint venture
 - d. C corporation (R/10, REG, A1530T, #36, 9436)
37. Quail, Inc. manufactures consumer products and sells them to distributors. Quail advertises its products to increase sales and enhance the value of its trade name. What is the appropriate tax treatment for the advertising costs?
- a. Amortize the costs over 15 years
 - b. Amortize the costs over 36 months
 - c. Amortize the costs over 60 months
 - d. Deduct the costs currently as ordinary and necessary business expenses (R/10, REG, 1222T, #37, 9437)
38. On June 30, Gold and Silver are calendar-year C corporations. The corporations have merged, with Gold as a subsidiary of Silver. Silver owns 85% of Gold's voting stock and fair market value (FMV). Which of the following tax return filings would be appropriate for the two companies?
- a. Two separate returns, because Silver owns at least 80% of both the voting stock and FMV of Gold
 - b. Two separate returns, because the merger took place before the close of the second quarter
 - c. A consolidated return, because Silver owns at least 80% of both the voting stock and FMV of Gold
 - d. A consolidated return, because the merger took place before the close of the second quarter (R/10, REG, C00364R, #38, 9438)
39. Stone Corp. has been an S corporation since inception. In each of year 1, year 2, and year 3, Stone made distributions in excess of each shareholder's basis. Which of the following statements is correct concerning these three years?
- a. In year 1 and year 2 only, the excess distributions are taxed as capital gain.
 - b. In year 1 only, the excess distributions are tax free.
 - c. In year 3 only, the excess distributions are taxed as capital gain.
 - d. In all three years, the excess distributions are taxed as capital gains. (R/10, REG, C00904R, #39, 9439)
40. Brown, a 50% partner in Brown & White, received a distribution of \$12,500 in the current year. The partnership's income for the year was \$25,000. What is the character of the payment that Brown received?
- a. Partial liquidation
 - b. Liquidating distribution
 - c. Disproportionate distribution
 - d. Current distribution (R/10, REG, A1029T, #40, 9440)

SIMULATION

Problem 3 Corporate Tax

Directions Situation E&P Determination Distribution

Testlet 1 of 1 Time Remaining 4 hours 14 minutes

Copy Paste Calculator Sheet Help Unsplit Split Horiz Split Vert Done

Directions Situation Resources E and P Determination Distribution Communication Research / Authoritative Literature

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:

Directions Resources

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:

Gain/Basis Depreciation Communication

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:

Research / Authoritative Literature

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.

Directions Situation E&P Determination Distribution

Alaska, Inc. is an accrual-basis C corporation that was incorporated on January 1, year 1. At the end of year 2, the corporation is considering converting to an S corporation. Alaska is required to determine its accumulated earnings and profits prior to conversion. The company has already calculated book net income, taxable income, and prior-year accumulated earnings and profits, and is now attempting to calculate the company's current earnings and profits. (R/10, REG, #3, 9441)

Directions
 Situation
 E&P Determination
 Distribution

For purposes of this task, assume that all items of income and expense have been properly reported by Alaska on Form 1120, *U.S. Corporation Income Tax Return*, for the appropriate years. Starting with taxable income as a benchmark, indicate the effect of each of the following items in the calculation of current-year earnings and profits by placing a check in the correct column next to each item. Be sure a column is checked for each item.

	Item	Add to taxable income (increase E&P)	Subtract from taxable income (decrease E&P)	No effect on E&P
1.	Unrealized losses at the end of the year on securities owned.	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
2.	Federal income taxes accrued and paid during the year.	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
3.	Gain on prior year installment sale recognized in the current year.	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
4.	Nondeductible portion of meals and entertainment expenses.	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
5.	State tax refunds from prior year received in current year.	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
6.	Increase in cash surrender value of life insurance policies owned by the company.	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>

Directions
 Situation
 E&P Determination
 Distribution

In year 4, Alaska is still a C corporation. Accumulated earnings and profits at the end of year 3 were \$61,000. Current earnings and profits for year 4 are \$24,000. During year 4, Alaska made two distributions on the dates indicated in column A of the table below. Allocate the distributions indicated in column B among columns C, D, and E. Round all answers to the nearest dollar.

Distribution dates	Distribution amounts	Current E&P	Accumulated E&P at 12/31/year 3	Excess distribution
3/31/year 4	58,000	7.	8.	9.
9/30/year 4	33,000	10.	11.	12.
Totals	91,000	24,000	61,000	6,000

Underwood, a 20% shareholder in Alaska, has a stock basis of \$700 at the beginning of year 4. Complete the following table to indicate the characterization of the Alaska distributions to Underwood during year 4. Round all answers to the nearest dollar.

Underwood's total distribution	Dividend income	Return of capital	Capital gain
13.	14.	15.	16.

Communication Research/
Authoritative
Literature

Alaska’s controller, who has no tax background, was reviewing the corporate income tax return and does not understand why taxable income, as reported on the return, does not agree to net income before tax, as reported on the financial statements. Prepare a memo to the controller explaining the purpose of Schedule M-1, *Reconciliation of Income (Loss) per Books with Income per Return*, and provide an explanation for two items that would most likely appear on a corporation’s Schedule M-1.

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.

Spelling Undo Redo Cut Copy Paste

Memorandum

To: Controller
Subject: Schedule M-1, *Reconciliation of Income (Loss) per Books with Income per Return*

Navigation bar with search boxes and tabs: **Communication** and **Research/ Authoritative Literature**.

Alaska, Inc. uses MACRS for income tax purposes. However, MACRS is not allowed in determining the company’s current and accumulated earnings and profits. Which code section and subsection provides guidance on the effect of depreciation on earnings and profits?

Step 2 - Search | History | Search Result | Advanced Search | Help

Search: **SEARCH ALL** **SEARCH WITHIN**

Table of Contents
Authoritative Literature

Uniform CPA Examination Authoritative Literature

To access the Authoritative Literature:
Click on Table of Contents folders at left to locate and open appropriate documents
OR
Perform a search for a particular topic by entering text in the text box above. Use the buttons to the right and links above the text box to perform more detailed or advanced searches.

Step 3 - Answer
There are currently no choices available because no document has been selected. Use the pane to the left to navigate to a document that has choices.

Section & Subsection Answer: §____(____)

Solution 1 MULTIPLE-CHOICE ANSWERS

1. (c) A CPA may not be associated with attest clients. A CPA may not audit a client providing services to a company with which the CPA (by being a director) is associated. Depending on the terms of the engagement, testing internal controls may be an attestation service; this answer is second best in comparison to the answer with no association. Whether the company is public or nonpublic is irrelevant to the ban on association with attest clients. (Bisk: 32-2-3; CSO: 1.1.0)
2. (d) The PCAOB annually inspects firms that audit more than 100 public clients. It inspects other registered firms at least once every three years, unless they withdraw their registrations. (Bisk: 33-2-2; CSO: 1.4.0)
3. (c) Liability under the 1934 Act requires proof that the accountant made a false or misleading statement with the intent to deceive or defraud. An accountant's good faith and lack of knowledge of the statement's falsity is a valid defense. (Bisk: 33-2-2; CSO: 1.5.2)
4. (c) Rule 202 of the AICPA Code of Professional Conduct requires a member to serve the client's interest by seeking to accomplish the objectives established by the understanding with the client while maintaining integrity and objectivity. Disclosure of a client's name by a member whose practice is primarily bankruptcy might lead others to assume the worst; their consequential actions could harm the client. The code does not limit disclosure in court proceedings. With appropriate safeguards, a member may use confidential information to defend against potential client claims and use a record retention agency to store confidential information. (Bisk: 32-6-3; CSO: 1.6.0)
5. (c) The Statute of Frauds requires written evidence for contracts that cannot be performed within one year from the contract date. The term "executory" reflects the incomplete performance of the parties under the contract. If anything, the executory status of the contract weakens Gem's case, rather than strengthening it. If the Statute of Frauds is applicable, the fact that services rather than goods are the contract subject is irrelevant to the suit's outcome. The \$500 threshold applies to contracts for the sale of goods, not services. (Bisk: 34-2-7; CSO: 2.2.1)
6. (d) An official bond is a contract whereby a surety guarantees the faithful performance of duties by a public official. Convertible bonds are debt instruments that the holder's may convert into the issuer's stock. Debenture bonds are debt instruments that are unsecured by any specific property. Municipal bonds are debt instruments of a municipality. (Bisk: 38-4-1; CSO: 2.3.1)
7. (d) Prior to the issuance of any non-exempt security, the 1933 Act requires a registration statement to be filed with the SEC. The statement contains information necessary to enable potential investors to determine the desirability of the offered securities. In no case may the amount recovered under the 1933 Act exceed the price at which the security was offered to the public. An issuer issuing securities only to accredited investors under Regulation D need not provide a prospectus to potential investors. Once a registration statement and prospectus are filed with the SEC, an issuer may announce (in other words, advertise) a proposed offering. No prospectus is needed for verbal offers or agreements to sell or buy entered into during the waiting period. Many securities are exempt from registration. (Bisk: 40-2-5; CSO: 2.4.1)
8. (d) Constructive eviction involves failing to maintain the property in a habitable condition. Changing a lock and not providing the new key to the tenant and a legal proceeding against the tenant for failure to pay rent are actual evictions. Suing a tenant over complaints to a government agency is not necessarily eviction. (Bisk: 42-3-2; CSO: 2.6.0)
9. (c) Generally, all taxes must be assessed within three years after the later of the due date or the filing date. (April 15 is three months and 15 days after the end of the previous year.) Individuals have the same deadline when amending returns. (Bisk: 44-1-4; CSO: 3.1.0)
10. (c) A partnership's tax 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. A partnership can elect to use a fiscal year instead of a calendar year as long as the fiscal year does not result in a deferral period greater than 3 months; this doesn't mean the greatest aggregate deferral is required. Only if neither partners owning a majority interest nor principal partners have the same taxable year does the

partnership adopt a calendar year. Only if partners owning a majority interest do not have the same taxable year does the partnership adopt the taxable year of its principal partners. (Bisk: 47-1-1; CSO: 3.2.0)

11. (b) No gain or loss is recognized on a like-kind exchange of property held for productive use in a trade or business or for investment, if the property received is either held for productive use in a trade or business or for investment. (Bisk: 43-3-7; CSO: 4.4.0)

12. (c) A non-corporate taxpayer who holds qualified small-business stock for more than 5 years is allowed to exclude 50% of any gain on the sale or exchange of the stock. $(\$16,000,000 - \$2,000,000) \times 50\% = \$7,000,000$ (Bisk: 43-4-3; CSO: 4.5.0)

13. (b) If a taxpayer obtains a refund for which a prior tax benefit was received, then this refund is included in gross income to the extent of the tax benefit. While the refund was for \$1,500, only \$1,150 of that amount resulted in a tax benefit. (Bisk: 44-2-3; CSO: 5.1.0)

14. (b) All rental activities are deemed to be passive activities. Generally, passive activity losses may be used only to offset passive activity income, rather than ordinary or portfolio income. Rental activity exceptions exist for some real estate professionals and up to \$25,000 of losses from rental activities for taxpayers with AGI under \$100,000. There is no indication that Lane qualifies for either of these exceptions. (Bisk: 44-2-3; CSO: 5.2.0)

15. (d) Married taxpayers must file jointly to qualify for the earned income credit (EIC). A qualifying child generally must be less than 19, not 17, years old. Any descendant may qualify as a qualifying child. Phase outs for the EIC start well above \$5,000 of earned income. A qualifying child must live with the taxpayer in the United States for merely more than half of the year. (Bisk: 44-6-1; CSO: 5.5.0)

16. (c) An S corporation distribution of property is equal to its fair market value; any distributions in excess of the shareholder's basis in the stock are treated as gain from the sale of stock. A partnership distribution of property results in the partner holding property with the same basis as it had to the partnership, limited to the partner's basis in the partnership. An S corporation and a LLC both avoid double taxation of profits. An S corporation and a LLC both provide limited liability protection to their owners. An S corporation and a LLC both may provide for additional equity as compensation for owners. (Bisk: 47-1-1; CSO: 6.1.0)

17. (b) When property is acquired such that the property itself is an item of gross income (e.g., Quigley receives stock as payment), the cost basis (the fair market value of the property) is the amount included in gross income. The exchange of cash for stock is a non-taxable event. 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; control is defined for purposes of these rules as owning 80% of the voting power and 80% of the nonvoting stock. As Roberk's exchange does not meet these conditions, the event is treated as a sale of the land at a gain of \$90,000. (Bisk: 46-1-3; CSO: 6.2.5)

18. (c) Nonseparately stated income is netted with corresponding expenses at the corporate level and then passed through to shareholders. Separately stated items retain their original character as they pass through to shareholders; any limitations are computed at the shareholder level instead of at the corporate level. Separately stated items include capital losses and charitable contributions. $\$44K - \$20K - \$4K = \$20K$ (Bisk: 46-10-4; CSO: 6.3.2)

19. (b) The general rule is that ordinary receipts are treated as income, while extraordinary receipts are treated as additions to principal. Editor's Note: The question does not ask for the trust's net income. $\$10K + \$12K + \$4K = \$26K$ (Bisk: 45-3-3; CSO: 6.4.7)

20. (b) As the grantor retains an interest in the trust property, the related income is taxable to the grantor. (Bisk: 45-1-1; CSO: 6.5.3)

Solution 2 MULTIPLE-CHOICE ANSWERS

21. (a) Some relationships are deemed to impair independence. Such relationships include director, officer, employee, or acting in any capacity equivalent to that of a member of management. (Bisk: 32-2-2; CSO: 1.2.0)

22. (c) Rule 202 of the AICPA Code of Professional Conduct requires a member to serve the client's interest by seeking to accomplish the objectives established by the understanding with the client while maintaining integrity and objectivity. Disclosure of a client's name by a member whose practice is primarily bankruptcy or mergers and acquisitions could lead others to assume the worst; their consequential actions could harm the client. (Bisk: 32-6-3; CSO: 1.1.0)

23. (b) IRS regulations require a tax practitioner who knows the client has made an error or omission from any return or document which the client submitted to advise the client of the consequences of non-compliance. IRS regulations prohibit discussing disclosure of a client's information except as necessary for return preparation and filing. (Bisk: 43-5-1; CSO: 1.3.0)

24. (a) Under common law, an auditor may be liable to a third party for fraud in the auditor's report regardless of whether the third party is a foreseen user of the report. A plaintiff need not show privity in a fraud case. Honest inaccuracies and judgmental errors will not give rise to liability so long as the auditor exercised reasonable care in performing the work. (Bisk: 33-1-3; CSO: 1.5.0)

25. (b) An independent contractor is one who contracts to do a particular job for another and is subject to the control or supervision of the employer only as to the result. An employee's (or servant's) physical conduct in the performance of the work is subject to the right of control by the employer (or master or principal). (Bisk: 39-3-1; CSO: 2.1.1)

26. (b) If Bend accepts the offer, Card is obligated to sell the stereo to Bend. An offer does not create a contract; hence, there is obligation on neither Card nor Bend unless the offer is accepted. Card may mitigate Card's loss due to Bend's, but is not required to do so. Bend may reject an offer immediately. (Bisk: 34-2-1; CSO: 2.1.1)

27. (b) Workers' compensation covers work-related injuries, whether on the employer's premises or off-site. Independent contractors generally are not eligible for workers' compensation benefits. Coverage usually does not extend to commuting or personal activities. (Bisk: 41-2-1; CSO: 2.4.2)

28. (b) A check is a draft drawn on a financial institution and payable on demand. A draft is a written order from one person directing a second person to pay a sum certain in money to the order of a third person. A note is a written promise to pay a stated sum of money. Editor's Note: While a check need not be drawn on a bank *per se*, as it may be drawn on another financial institution, the response that a check is an order to pay money is the best of the choices. (Bisk: 36-1-2; CSO: 2.5.1)

29. (a) A tax preparer is required to inform the client of penalties that are reasonably likely to apply to the client with respect to a position advised, prepared, or reported. (Bisk: 43-5-2; CSO: 3.1.0)

30. (d) The first-in, first-out (FIFO) method of accounting for inventory bases the cost of ending inventory on the last units purchased. The last inventory purchases were in November and June. In November, 5,000 units of the 6,000 units ending inventory were purchased at \$2.70. In June, 7,000 units were purchased at \$2.50; this purchase includes 1,000 of the 6,000 units ending inventory. $(5,000 \text{ units} \times \$2.70) + (1,000 \times \$2.50) = \$16,000$ The \$12,200 answer indicates use of the last-in, first-out method. The \$13,000 answer indicates that the current year purchases were ignored. The \$15,600 answer indicates use of a questionable averaging method. (Bisk: 43-6-2; CSO: 3.4.0)

31. (b) No loss is recognized with respect to sales or exchanges between related parties. Further, the relative would not recognize a gain or loss until a transfer of the stock to an unrelated party. (Bisk: 43-3-6; CSO: 4.2.0)

32. (c) Winkler recognized gross income on receipt of the stock at its fair market value; the fair market value on receipt also is the stock's basis to Winkler. The gain on sale is the sale price less the basis ($\$7,500 - \$5,000 = \$2,500$). (Bisk: 43-1-1; CSO: 4.5.0)

33. (a) Amounts received pursuant to a divorce or separate maintenance agreement are included in gross income by the recipient. Adjusted gross income is based on gross income. Compensation for injuries or sickness is excluded from gross income. The value of housing provided by religious institutions to parsons, priests, etc., is excluded from gross income. Tuition scholarships are excluded from gross income. (Bisk: 44-2-3; CSO: 5.1.0)

34. (d) There is no limit to the duration of the time that student loan interest is deductible. (Bisk: 44-3-1; CSO: 5.3.0)

35. (d) A joint return may be filed when one or both spouses died during the tax year. A joint return may not be filed with the deceased spouse if the surviving spouse remarries before the end of the year in which the deceased spouse died. (Bisk: 44-1-3; CSO: 5.4.0)

36. (d) C corporations pay tax. While general partnerships, limited partnerships, and joint ventures file information tax returns, these entities generally do not pay taxes themselves. (Bisk: 47-1-1; CSO: 6.1.0)

37. (d) All reasonable, ordinary, and necessary expenses incurred in the furtherance of trade or business are subtracted directly from gross income, including advertising expense. (Bisk: 46-2-1; CSO: 6.2.1)

38. (c) A controlled group exists when one corporation owns more than 80% of the total value of all classes of the stock of another corporation; controlled groups file consolidated returns. To file a consolidated return, a parent must own at least 80% of a subsidiary's stock. To file a consolidated return, the date of the merger must take place before the end of the tax year. (Bisk: 46-9-2; CSO: 6.2.4)

39. (d) Entities that have been S corporations since inception are without accumulated earnings and profits (E&P). For S corporations without accumulated E&P, distributions are tax-free to the extent of the shareholder's basis in the stock; any excess distributions are treated as gain from the sale of stock. (Bisk: 46-10-7; CSO: 6.3.4)

40. (d) A current distribution is a distribution of current income. Brown has claim to 50% of the current income ($\$25,000 \times 0.50 = \$12,500$) of the partnership. A partial liquidation would involve a distribution of more than Brown's claim to current income. A liquidating distribution would include an amount equal to all of Brown's claim on the current income plus Brown's claim on equity. A disproportionate distribution is one where partners do not receive a *pro rata* share of income, expense, gain, and loss items. (Bisk: 47-2-2; CSO: 6.4.6)

SIMULATION

Solution 3

E&P Determination

1. No effect on E&P

Unrealized losses on securities impact neither taxable income nor the corporation's economic ability to pay dividends.

2. Subtract from taxable income (decrease E&P)

Federal income taxes do not impact taxable income, but they do reduce the corporation's economic ability to pay dividends.

3. Subtract from taxable income (decrease E&P)

A gain on a prior year sale recognized in the current year for tax purposes was previously recognized for E&P purposes. Correspondingly, current taxable income must be reduced to arrive at E&P or the amount would be counted twice.

4. Subtract from taxable income (decrease E&P)

The nondeductible portion of meal and entertainment expense will not impact taxable income, but it does reduce the corporation's economic ability to pay dividends.

5. No effect on E&P

An accrual-basis taxpayer has no any recognition of taxable income due to a refund. Nor does a refund affect the corporation's economic ability to pay dividends differently than already recognized to arrive at taxable income.

6. Add to taxable income (increase E&P)

The increase in the cash surrender value of life insurance policies owned by the company is not an event that triggers recognition of taxable income; however, it does increase the corporation's economic ability to pay dividends.

Distribution

7. \$15,297

Current E&P is allocated on a *pro rata* basis to the distributions made during the year. The current E&P portion of the March distribution is $\$24,000 \times (\$58,000 / \$91,000) = \$15,297$.

8. \$42,703

Current E&P is allocated on a *pro rata* basis to the distributions made during the year. Accumulated E&P is applied in the order of distributions. The current E&P portion of the March distribution is $\$24,000 \times (\$58,000 / \$91,000) = \$15,297$. There is sufficient accumulated E&P to cover the rest of the March distribution ($\$58,000 - \$15,297 = \$42,703$).

9. \$0

Current E&P is allocated on a *pro rata* basis to the distributions made during the year. Accumulated E&P is applied in the order of distributions. The current E&P portion of the March distribution is $\$24,000 \times (\$58,000 / \$91,000) = \$15,297$. There is sufficient accumulated E&P to cover the rest of the March distribution ($\$58,000 - \$15,297 = \$42,703$), so there were no excess distributions in March.

10. \$8,703

Current E&P is allocated on a *pro rata* basis to the distributions made during the year. The current E&P portion of the September distribution is $\$24,000 \times (\$33,000 / \$91,000) = \$8,703$. Alternatively, since the current E&P portion of the March distribution already is known, $\$24,000 - \$15,297 = \$8,703$.

11. \$18,297

Current E&P is allocated on a *pro rata* basis to the distributions made during the year. Accumulated E&P is applied in the order of distributions. The current E&P portion of the March distribution is $\$24,000 \times (\$58,000 / \$91,000) = \$15,297$. There is accumulated E&P to cover the rest of the March distribution ($\$58,000 - \$15,297 = \$42,703$), leaving accumulated E&P at $(\$61,000 - \$42,703) \$18,297$. The current E&P portion of the September distribution is $\$24,000 - \$15,297 = \$8,703$. There is not sufficient accumulated E&P to cover the remainder ($\$33,000 - \$8,703 = \$24,297$) of the September distribution, so the remainder of the accumulated E&P is exhausted.

12. \$6,000

Current E&P is allocated on a *pro rata* basis to the distributions made during the year. Accumulated E&P is applied in the order of distributions. The current E&P portion of the March distribution is $\$24,000 \times (\$58,000 / \$91,000) = \$15,297$. There is accumulated E&P to cover the rest of the March distribution ($\$58,000 - \$15,297 = \$42,703$), leaving accumulated E&P at $(\$61,000 - \$42,703) \$18,297$. The current E&P portion of the September distribution is $\$24,000 - \$15,297 = \$8,703$. There is not sufficient accumulated E&P to cover the remainder ($\$33,000 - \$8,703 = \$24,297$) of the September distribution, so the remainder of the accumulated E&P is exhausted. The remaining ($\$24,297 - \$18,297$) \$6,000 is excess distribution.

13. \$18,200

As a 20% shareholder, Underwood is entitled to 20% of distributions. $20\% \times \$91,000 = \$18,200$

14. \$17,000

The dividends are the distributions that are not excess distributions ($\$91,000 - \$6,000 = \$85,000$). As a 20% shareholder, Underwood is entitled to 20% of dividends. $20\% \times \$85,000 = \$17,000$

15. \$700

Excess distributions are either a return of capital or capital gain. As a 20% shareholder, Underwood share of the excess distribution is \$1,200. ($20\% \times \$6,000$) The return of capital is limited to Underwood's \$700 basis in the stock.

16. \$500

Excess distributions are either a return of capital or capital gain. As a 20% shareholder, Underwood share of the excess distribution is \$1,200. ($20\% \times \$6,000$) The return of capital is limited to Underwood's \$700 basis in the stock; the remainder of the excess distribution is capital gain. $\$1,200 - \$700 = \$500$

Communication

To: Controller

From: Schedule M-1, *Reconciliation of Income (Loss) per Books with Income per Return*

The rules governing preparation of financial statements are developed with the goal of fairly representing the economic events affecting an entity during a specific period of time and the cumulative effect of such events. These rules are developed mainly by the accounting profession considering the needs of decision makers likely to use the financial statements. The guiding principles here include matching expenses with corresponding revenues and providing information with some forecast value. Also, there is some attempt to have a minimum of rules that are cohesive.

The rules governing determination of taxable income are developed by successive sessions of Congress, presidential administrations, and court interpretations with many goals. These goals include raising revenue, collecting revenue when taxpayers have cash to pay it, facilitating administrative feasibility, controlling the economy, and encouraging specified activities or social change. In this task, lawmakers are influenced by special interests and political expediency. While the rules involved in preparing financial statements are extensive, the extreme volume of the tax code is well known—producing a minimum of rules that are cohesive is not a high priority with lawmakers.

One item that most corporations will have differing between the financial statements and the tax return is federal income tax expense. Income taxes certainly are an expense that financial statement users expect to see on the income statement as a deduction to arrive at net income. In contrast, federal income taxes are not deductible to arrive at taxable income for federal purposes.

Another item that commonly is different is municipal bond interest income. Municipal bond interest income certainly belongs on an income statement; however, such income generally is not taxable.

Editor's Note: The AICPA did not provide a solution for the contents of the Communication tab. This solution was developed by Bisk Education. The examples used in this sample solution certainly were not the only ones acceptable to the examiners.

Research/Authoritative Literature

IRC Citation: §312(k)

IRC §312(k) states, "EFFECT OF DEPRECIATION ON EARNINGS AND PROFITS.—312(k)(1) GENERAL RULE.—For purposes of computing the earnings and profits of a corporation for any taxable year beginning after June 30, 1972, the allowance for depreciation (and amortization, if any) shall be deemed to be the amount which would be allowable for such year if the straight line method of depreciation had been used for each taxable year beginning after June 30, 1972. 312(k)(2) EXCEPTION.—If for any taxable year a method of depreciation was used by the taxpayer which the Secretary has determined results in a reasonable allowance under section 167(a) and which is the unit-of-production method or other method not expressed in a term of years, then the adjustment to earnings and profits for depreciation for such year shall be determined under the method so used (in lieu of the straight line method). 312(k)(3) EXCEPTION FOR TANGIBLE PROPERTY.— 312(k)(3)(A) IN GENERAL.—Except as provided in subparagraph (B), in the case of tangible property to which section 168 applies, the adjustment to earnings and profits for depreciation for any taxable year shall be determined under the alternative depreciation system (within the meaning of section 168(g)(2)). 312(k)(3)(B) TREATMENT OF AMOUNTS DEDUCTIBLE UNDER SECTION 179, 179A, 179B, 179C, 179D, or 179E.—For purposes of computing the earnings and profits of a corporation, any amount deductible under section 179, 179A, 179B, 179C, 179D, or 179E shall be allowed as a deduction ratably over the period of 5 taxable years (beginning with the taxable year for which such amount is deductible under section 179, 179A, 179B, 179C, 179D, or 179E, as the case may be). 312(k)(4) CERTAIN FOREIGN CORPORATIONS.—The provisions of paragraph (1) shall not apply in computing the earnings and profits of a foreign corporation for any taxable year for which less than 20 percent of the gross income from all sources of such corporation is derived from sources within the United States. 312(k)(5) BASIS ADJUSTMENT NOT TAKEN INTO ACCOUNT.—In computing the earnings and profits of a corporation for any taxable year, the allowance for depreciation (and amortization, if any) shall be computed without regard to any basis adjustment under section 50(c)."
