

## REGULATION

CPA2903US3-40

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### About Updating Supplement Version 40.3.

Information that is only six months old is eligible to be tested on the CPA exam. Updating Supplement Version 40.3 is designed to bring the latest release of material to candidates using our products to prepare for the CPA exam in the Oct-Nov 2011 and Jan-Feb 2011 windows. Candidates with the 40<sup>th</sup> edition and corresponding software (version 14 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!***

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### 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.*

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### Other Sources of Information for Candidates

Due to significant changes to the exam, candidates with the 39<sup>th</sup> and earlier editions and corresponding software 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.

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### July, 2011, CSO References Change

The AICPA changed the reference list at the end of the REG CSO to include the following:

- Public Law 86-272
- Uniform Division of Income for Tax Purposes Act (UDITPA)
- Dodd-Frank Wall Street Reform & Consumer Protection Act of 2010

The AICPA also removed the AICPA Code of Professional Conduct and the AICPA Model Tax Curriculum from these references.

These changes are effective July 1, 2011, and apply to the CSO references only. They do not affect the current content or weight allocations specified in the CSOs.

### Coverage Related to Recently Added CSO References

While nominally eligible to be tested for some time, *Public Law 86-272* (PL 86-272) has not been tested explicitly in any disclosed question to date. It likely will appear on exams now that it has been named in the references following the CSO; however, it is unlikely to be tested heavily. It first was eligible to be tested in the **July-August 2011** exam window.

#### Public Law 86-272

PL 86-272 is a federal law that prohibits a state from imposing a net income tax if a company's only activities within a state are solicitation of orders for sales of tangible personal property which are sent outside the state for approval or rejection and are filled from outside the state.

- A. **Applicability:** This law was an effort to resolve inconsistent nexus guidance provided by the states. Originally intended as a temporary measure about 50 years ago, PL 86-272 also called for a study and report on state taxation by a congressional subcommittee. PL 86-272 does not resolve the issue for businesses that sell services and intangibles and for states that have business taxes that are not income taxes, such as gross receipts taxes. When a business is not covered by PL 86-272, the due process and commerce clause guidance (inconsistent among states) governs whether a state may tax a multistate business.
- B. **Physical Presence Guideline**
  1. **Applicable:** A physical-presence nexus standard was established in situations when a state imposes sales tax collection responsibilities on a remote vendor. The Supreme Court held that a physical presence was necessary for nexus.
  2. **Inapplicable:** Several court decisions have ruled that physical presence is relevant only for sales and use tax nexus. Some of these cases have held that "economic presence" (such as customers and intangibles) can create nexus. Thus, the current situation involving nexus is similar to that when PL 86-272 was passed, except with regard to sales of tangible personal property.

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While nominally eligible to be tested for some time, the *Uniform Division of Income for Tax Purposes Act* (UDITPA) has not been tested explicitly in any disclosed question to date. It likely will appear on exams now that it has been named in the references following the CSO; however, it is unlikely to be tested heavily. It first was eligible to be tested in the **July-August 2011** exam window.

#### Uniform Division of Income for Tax Purposes Act

The Uniform Division of Income for Tax Purposes Act is a uniform act that provides a method of dividing income for tax purposes among multiple tax jurisdictions. Not all states with income tax have adopted UDITPA. UDITPA applies to income from business activity that is neither income from a financial organization or a public utility nor an individual's income from providing personal services.

- A. **Terms**
  1. **Business Income:** Business income is income arising from transactions and activity in the regular course of the taxpayer's trade or business and includes income from tangible and intangible property if the acquisition, management, and disposition of the property constitute integral parts of the taxpayers' regular trade or business operations. Income from the disposition of property used in a trade or business of the taxpayer is includible within business income.
  2. **Non-business Income:** Non-business income is all income except business income.

3. Commercial Domicile: The main place from which the taxpayer directs or manages the trade or business.
- B. Allocation: Income is apportioned among all states (including foreign countries) that have jurisdiction to subject the taxpayer to a net income tax regardless of whether a state imposes a net income tax. If allocation using the method in the UDITPA does not represent fairly the extent of a taxpayer's business activity in a state, UDITPA allows another reasonable allocation method approved by each state's tax administrator on a case-by-case basis.
- C. Non-Business Income: Non-business income is allocated as follows.
1. Rents & Royalties: Rents and royalties from real property are allocated to the state of location. Rents and royalties from tangible personal property are allocated among the states to the extent of utilization (determined by daily use) or to the commercial domicile state if the taxpayer is not taxable in the state of utilization. If the location of utilization is unascertainable, it is deemed to be the state where the rent or royalty payer took possession. If the rent from mobile tangible property is calculated on a basis other than time, that basis may be used to determine the utilization allocation.
  2. Capital Gains: Capital gains and losses from real property are allocated to the state of location. Capital gains and losses from tangible personal property are allocated to the sale location or—if the taxpayer is not taxable in the state where the property was located when sold—the taxpayer's commercial domicile.
  3. Interest & Dividends: Interest and dividends are allocated to the commercial domicile state.
  4. Patent & Copyright Royalties: Patent and copyright royalties are allocated to the state of utilization (manufacturing or publication) or, if the taxpayer is not taxable in the state of utilization, the commercial domicile state.
- D. Three-Factor Formula: Business income is allocated to each state by multiplying total business income by a fraction particular to each state. The fraction's numerator is the property factor, the payroll factor, and the sales factor allocated to the state in question. The fraction's denominator is the total of these three factors across all jurisdictions.
1. Property Factor: The numerator of the property factor is the average value of the taxpayer's real and tangible personal property owned or rented and used in the state during the period. Owned property is valued at original cost. Rented property is valued at eight times the net annual rent (rent paid less rents received from sub-rentals). Through application to the states' tax administrators, other valuation methods are applicable if original cost is not ascertainable, if rent is so related to services that rent is ascertainable, or if actual rent is nominal or zero.
  2. Payroll Factor: The numerator of the payroll factor is the total compensation paid within the state during the period. Compensation is deemed paid within a state if the employee's service is performed entirely within the state, the service performed outside of a state is incidental to service within a state, or the base from which service is directed is not in any state in which some part of service is performed, but the employee's residence is within the state. (This is the same definition as in the Model Unemployment Compensation Act.)
  3. Sales Factor: The numerator of the sales factor is the total net sales (after discounts and returns) that produce business income (i.e., not capital gains that are non-business income) in the state during the period.

- a. Sales of tangible personal property are in the state where the purchaser receives shipment unless the taxpayer is not taxable in that state or the purchaser is the federal government. If the taxpayer is not taxable in the state of the purchaser's receipt or the purchaser is the federal government, sales of tangible personal property are allocated to the state from which the shipment is made.
- b. Other than sales of tangible personal property, sales are allocated to the state where the income-producing activity is performed, to the extent of cost of performance. In other words, if two-thirds of the cost of performance is incurred in State A, two-thirds of the sales receipts are allocated to State A.

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The *Dodd-Frank Wall Street Reform & Consumer Protection Act of 2010* (Dodd-Frank Act) became law in July, 2010; however, not all provisions were effective immediately. Some provisions become effective in July, 2011, making them first eligible to be tested in the **April-May 2012** exam window. Those provisions without effective dates delayed until July, 2011, first were eligible to be tested in the **July-August 2011** exam window.

#### Dodd-Frank Wall Street Reform & Consumer Protection Act of 2010

The Dodd-Frank Act enhances the financial regulatory structure, brings greater public transparency and market accountability to the financial system, and gives investors important protections and greater input into corporate governance.

#### A. Current Provisions

1. **Derivatives:** The Dodd-Frank Act overrides the Commodity Futures Modernization Act (CFMA) to provide a comprehensive framework for the regulation of the OTC swaps markets.
2. **Clearing & Settlement Agencies:** While most clearing agencies already are required to register with the SEC, credit default swap clearing agencies had an exemption from this registration. The Dodd-Frank Act gives the Federal Reserve Board new authority with respect to the risk management of clearing agencies designated as systemically important.
3. **Asset-Backed Securities:** Asset-backed securities (ABS) are created by buying and bundling loans—such as residential mortgage loans, commercial loans, or student loans—and creating securities backed by those assets, which then are sold to investors.
  - a. The Dodd-Frank Act prohibits an underwriter, placement agent, initial purchaser, sponsor—or any affiliate or subsidiary of any such entity—of an asset-backed security from engaging in any transaction that would involve or result in any material conflict of interest with respect to any investor in a transaction arising out of such activity for a period of one year after the date of the first closing of the sale of the asset-backed security.
  - b. The Dodd-Frank Act requires the SEC and various other agencies to prescribe rules to require that a securitizer retain an economic interest in a material portion of the credit risk for any asset that it transfers, sells, or conveys to a third party.
4. **Municipal Securities:** The Dodd-Frank Act requires the registration of municipal advisors with the SEC. In general terms, municipal advisors include financial advisors to states and local governments and obligated persons with respect to the issuance of municipal securities or the investment of bond proceeds; swap advisors to municipal issuers and conduit borrowers; and third-party solicitors of business (in connection with municipal securities products) for brokers, dealers, municipal securities dealers, other municipal

advisors, or investment advisers. The Dodd-Frank Act also includes a specific antifraud prohibition and imposes a fiduciary duty on municipal advisors.

5. Specialized Corporate Disclosure: The Dodd-Frank Act contains several specialized disclosure provisions, including the following.
  - a. Congo Origin: Annual disclosure as to whether any conflict minerals that are necessary to the functionality or production of a product of the entity originated in the Democratic Republic of the Congo or an adjoining country.
  - b. Mine Operator: Periodic disclosure by a mine operator, or an entity that has a subsidiary that is an operator, of information related to health and safety violations. Issuers must also disclose in their Form 8-K reports the receipt from MSHA of any imminent danger orders or notices indicating that a mine has a pattern or potential pattern of violating mandatory health or safety standards.
  - c. Extraction: Annual disclosure by issuers engaged in the commercial development of oil, natural gas, or minerals to disclose in an annual report certain payments made to the United States or a foreign government.
6. Study on Section 404 (b) of the Sarbanes-Oxley Act of 2002: The Dodd-Frank Act required the SEC to conduct a study to determine how to reduce the burden of complying with SOX Section 404(b) for companies whose market capitalization is between \$75 and \$250 million, while maintaining investor protections for such companies. This study must consider whether any methods of reducing the compliance burden or a complete exemption for such companies from SOX Section 404(b) compliance would encourage companies to list on exchanges in the United States in their initial public offerings.
  - a. The SEC concluded the following.
    - (1) The costs of SOX Section 404(b) have declined since the SEC first implemented the requirements of SOX Section 404, particularly in response to the 2007 reforms;
    - (2) Investors generally view the auditor's attestation on internal control over financial reporting (ICOFR) as beneficial;
    - (3) Financial reporting is more reliable when the auditor is involved with ICOFR assessments; and
    - (4) There is not conclusive evidence linking the requirements of Section 404(b) to listing decisions of the studied range of issuers.
  - b. The SEC staff recommended the following.
    - (1) Maintain existing investor protections of SOX Section 404(b) for accelerated filers, which have been in place since 2004 for domestic and 2007 for foreign private issuers.
    - (2) Encourage activities that have potential to further improve both effectiveness and efficiency of SOX Section 404(b) implementations.
7. Sarbanes-Oxley Act Amendment: The Dodd-Frank Act added Section 404(c) to the Sarbanes-Oxley Act.
  - a. Section 404(c) provides that Section 404(b) shall not apply with respect to any audit report prepared for an issuer that is neither a large accelerated filer nor an accelerated filer. On September 15, 2010, the SEC amended its rules to conform

them to the new Section 404(c) regulation. Prior to enactment of the Dodd-Frank Act, a non-accelerated filer would have been required to include an auditor attestation report on ICOFR in the annual report filed with the SEC for fiscal years ending on or after June 15, 2010.

- .b. The compliance dates for issuers are amended by the Dodd-Frank Act. Accelerated filers having a public float between \$75 and \$250 have been required to comply with Section 404(b) since 2004 (or for foreign private issuers, since 2007). In contrast, non-accelerated filers have never been required to comply with Section 404(b).

Exhibit 1: Amended Compliance Dates

	Filer Status	Management's Report	Auditor's Attestation
U.S. Filer	Large Accelerated Filer or Accelerated Filer	Annual reports for fiscal years ending on or after November 15, 2004	Annual reports for fiscal years ending on or after November 15, 2004
	Non-accelerated Filer	Annual reports for fiscal years ending on or after December 15, 2007	Exempt as a result of the Dodd-Frank Act
Foreign Private Issuer	Large Accelerated Filer or Accelerated Filer	Annual reports for fiscal years ending on or after July 15, 2006	Annual reports for fiscal years ending on or after July 15, 2007
	Non-accelerated Filer	Annual reports for fiscal years ending on or after December 15, 2007	Exempt as a result of the Dodd-Frank Act
U.S. Filer or Foreign Private Issuer	IPO	Second Annual Report	Second Annual Report

B. Provisions First Effective in July, 2011 (eligible to be tested in April-May 2012)

1. **Advisers to Hedge Funds and Other Private Funds:** The Dodd-Frank Act requires advisers to most private funds (hedge funds and private equity funds) register with the SEC. Historically, many of these advisers had been exempt from registration under the so-called "private adviser" exemption. The Dodd-Frank Act replaces this exemption with several narrower exemptions for advisers that exclusively advise venture capital funds and private fund advisers with less than \$150 million in assets under management in the United States. Foreign private advisers and advisers to licensed small business investment companies also are exempted.
2. **Whistleblower Program:** The Dodd-Frank Act provides that the SEC shall pay awards to eligible whistleblowers who voluntarily provide the SEC with original information that leads to a successful enforcement action yielding monetary sanctions of over \$1 million and expressly prohibits retaliation by employers against whistleblowers.
3. **Corporate Governance:** The Dodd-Frank Act contains numerous provisions which affect the governance of issuers, including the following.
  - a. Disclosure about advisory votes of shareholders about executive compensation and golden parachutes including specific disclosure of golden parachutes in merger proxies. Further, institutional investment managers subject to Section 13(f) of the Securities Exchange Act must report at least annually how they voted on these advisory shareholder votes.

- b. Disclosure about the role of, and potential conflicts involving, compensation consultants.
  - c. Additional disclosure about certain compensation matters, including pay-for-performance and the ratio between the CEO's total compensation and the median total compensation for all other company employees.
4. Credit-Rating Agencies: The Dodd-Frank Act enhances the SEC's enforcement mechanisms, and adds a number of requirements on nationally recognized statistical rating organizations (NRSROs). The Dodd-Frank Act also requires the SEC to adopt a number of new rules, involving the following.
- a. Annual reports on internal controls
  - b. Conflicts of interest with respect to sales and marketing practices
  - c. "Look-backs" when credit analysts leave the NRSRO
  - d. Fines and penalties
  - e. Disclosure of performance statistics
  - f. Application and disclosure of credit rating methodologies
  - g. Form disclosure of data and assumptions underlying credit ratings
  - h. Disclosure about third party due diligence
  - i. Analyst training and testing
  - j. Consistent application of rating symbols and definitions
  - k. Specific and additional disclosure for ratings related to ABS
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## Recent Tax Legislation

The *Small Business Jobs Act of 2010* (SBJA '10) became law on September 27, 2010, making it first eligible to be tested in the **April-May 2011** exam window.

## Small Business Jobs Act of 2010

- A. Self-Employment (SE) Tax: For 2010, self-employed taxpayers may deduct health insurance costs for themselves, their spouses, and dependents when determining SE tax.
- B. Section 179
  - 1. Increase: For 2010, the ceiling and phase-out threshold are increased to \$500,000 and \$2 million, respectively.
  - 2. Qualified Real Property: For 2010 and 2011, up to \$250,000 of qualified depreciable real property may be treated as Section 179 property.
    - a. Qualified real property must be acquired for use in the active conduct of a trade or business. Qualified real property is qualified leasehold improvement property, qualified restaurant property, and qualified retail improvement property.
    - b. Qualified real property is not:
      - (1) Used for lodging.
      - (2) Property used by governmental, foreign, or tax-exempt entities.
      - (3) Air conditioning or heating units.
    - c. Carryover amounts attributed to qualified real property cannot be expensed after 2011.
- C. Bonus Depreciation: The 50% bonus depreciation is extended to 2010 (2011 for certain assets).
- D. Listed Property
  - 1. Cell Phones: Cell phones placed in service in 2010 and later years are not listed property.
  - 2. Passenger Vehicles: For 2010, depreciation caps for new vehicles are increased by \$8,000, unless the taxpayer elects out of bonus depreciation.
- E. Start-Up Costs: For 2010 and 2011, the \$5,000 amount for start-up costs is increased to \$10,000 and the phase-out threshold is increased from \$50,000 to \$60,000.
- F. Credits
  - 1. Small Business Credits: Eligible credits have expanded carry-back provisions from 1 year to 5 years. (These details are likely beyond the scope of the exam.)
  - 2. AMT: Eligible small businesses may use general business credits to offset AMT in 2010.
- G. Qualified Small Business Stock (QSBS): For QSBS acquired after September 27, 2010, and before 2011, there is 100% gain exclusion for regular and alternative minimum tax for non-corporate taxpayers.

The *Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010* (TRUIRJCA '10) became law on December 17, 2010, making it first eligible to be tested in the **July-August 2011** exam window.

### Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010

#### A. Individual Provisions

1. Individual Income Tax Rate Reductions: The revised tax tables for 2010 are as follows.

Rate	MFJ & SS	Head of household	Single	MFS
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

For 2011:

Rate	MFJ & SS	Head of household	Single	MFS
10%	\$ 0 to \$ 17,000	\$ 0 to \$ 12,150	\$ 0 to \$ 8,500	\$ 0 to \$ 8,500
15%	\$ 17,001 to \$ 69,000	\$ 12,151 to \$ 46,250	\$ 8,501 to \$ 34,500	\$ 8,501 to \$ 34,500
25%	\$ 69,001 to \$139,350	\$ 46,251 to \$119,400	\$ 34,501 to \$ 83,600	\$ 34,501 to \$ 69,675
28%	\$139,351 to \$212,300	\$119,401 to \$193,350	\$ 83,601 to \$174,400	\$ 69,676 to \$106,150
33%	\$212,301 to \$379,150	\$193,351 to \$379,150	\$174,401 to \$379,150	\$106,151 to \$189,575
35%	Over \$379,150	Over \$379,150	Over \$379,150	Over \$189,575

- a. **Marriage Penalty Relief:** In 2010, the 15% regular income tax rate bracket for MFJ is twice the amount of an individual filing a single return. This provision was set to expire at the end of 2010. TRUIRJCA '10 extends this provision through 2012.
- b. **Reduced Tax Rate on Dividends:** For tax years beginning before 2011, an individual's qualified dividend income is taxed at rates of 0 and 15%. The provision allowing these reduced rates was set to expire at the end of 2010. TRUIRJCA '10 extends it through 2012.
- c. **Reduced Tax Rate on Capital Gains:** For tax years beginning before 2011, an individual's capital gains are taxed at rates of 0 and 15%. The provision allowing these reduced rates was set to expire at the end of 2010. TRUIRJCA '10 extends it through 2012.
2. **Individual Payroll Tax Rate Reduction:** FICA taxes are imposed up to a ceiling amount (\$106,800 in 2010 and 2011). Formerly, the rates were the same for employees and employers. A self-employment tax (comparable to the combined employee and employer portions) is paid by self-employed persons, with half of this amount (the amount representing the employer portion) allowed as an above-the-line deduction. TRUIRJCA '10 reduces the amount of the employee portion from 6.2% to 4.2% for 2011. Similarly, the self-employment (SE) tax is reduced. This does not affect the amount of the SE tax deduction which still is the amount representing the employer portion, but this deduction is now more than half of the total SE tax.
3. **Revised Alternative Minimum Tax (AMT) Exemption Amounts**

Year	MFJ & SS	HH & S	MFS
2010	\$72,450	\$47,450	\$36,225
2011	74,450	48,450	37,225

4. Employer-Provided Transportation and Parking Benefit Exclusion: Qualified transportation fringe benefits provided by an employer are excluded from taxable income for income tax and payroll tax purposes. For tax years prior to 2011, ARRA increased the combined monthly vanpooling and transit pass benefits limit of \$100 (adjusted for inflation) to match the monthly parking benefits limit of \$175 (adjusted for inflation). Both exclusions are \$230 for 2010. TRUIRJCA '10 extends this increase in the exclusion through 2011.
5. Education Provisions
  - a. Employer-Provided Educational Assistance Exclusion: This exclusion was set to expire at the end of 2010. TRUIRJCA '10 extends it through 2012.
  - b. Student Loan Interest: The increase in the amount of the phase-out ranges for this deduction was set to expire at the end of 2010. TRUIRJCA '10 extends it through 2012.
  - c. Coverdell Education Account: The following items were set to expire at the end of 2010. TRUIRJCA '10 extends them through 2012.
    - (1) The increase in the phase-out range.
    - (2) The expansion of qualified expenses to include elementary and secondary education.
    - (3) Revised age rules for special needs beneficiaries.
    - (4) Rules regarding contributions by corporations and other entities, the deemed timing of contributions, excess contributions, and coordination with education credits and qualified tuition plans.
  - d. American Opportunity Credit: The American Opportunity Credit refers to modifications to the Hope Credit that are applicable for 2009 and 2010. These modifications generally increased the amount of the credit. TRUIRJCA '10 extends these modifications through 2012.
  - e. Certain Expenses of Elementary and Secondary School Teachers Deduction: For tax years prior to 2010, an annual above-the-line deduction up to \$250 was allowed for qualified expenses for books, supplies, and equipment by an eligible educator. TRUIRJCA '10 extends this deduction through 2011.
  - f. Qualified Tuition and Related Expense Deduction: For tax years prior to 2010, an annual above-the-line deduction of up to \$4,000 was allowed for qualified tuition expenses. TRUIRJCA '10 extends this deduction through 2011.
6. Standard Deduction: In 2010, the basic standard deduction for MFJ is twice the amount of an individual filing a single return. This provision was set to expire at the end of 2010. TRUIRJCA '10 extends this provision through 2012.
7. Overall Limitation on Itemized Deductions and Personal Exemption Phase-outs: TRUIRJCA '10 eliminates the phase-outs for 2011 and 2012. The phase-outs already were eliminated for 2010.
8. State & Local Sales Tax Deduction: For tax years prior to 2010, taxpayers itemizing their deductions could deduct state and local sales taxes instead of state and local income taxes. TRUIRJCA '10 extends this deduction through 2011.
9. Mortgage Insurance Premiums: Certain premiums in connection with a mortgage insurance contract issued between January 1, 2007, and December 31, 2010, are deductible

as qualified residential interest. TRUIRJCA '10 extends the deduction to amounts attributable to 2011, but doesn't extend the eligible contract date.

10. Tax-Free Distributions From Individual Retirement Account (IRA) for Charitable Purposes: For tax years prior to 2010, otherwise taxable distributions from a traditional or Roth IRA that are qualified charitable distributions (distributions up to \$100,000 made from the IRA trustee directly to a qualified charity) may be excluded from gross income. TRUIRJCA '10 extends this exclusion through 2011.
11. Other Child & Dependent Credits
  - a. Child Tax Credit: This credit was set to expire at the end of 2010. TRUIRJCA '10 extends it through 2012. TRUIRJCA '10 eliminated the inflation-adjustment of the \$3,000 earned income threshold.
  - b. Adoption Credit & Employer-Provided Adoption Assistance Exclusion: The expansion provisions for this credit and exclusion were set to expire at the end of 2011. TRUIRJCA '10 extends them through 2012.
  - c. Employer-Provided Child-Care Tax Credit: This credit was set to expire at the end of 2010. TRUIRJCA '10 extends it through 2012.
  - d. Child & Dependent Care Tax Credit: The increased amounts of this credit were set to expire at the end of 2010. TRUIRJCA '10 extends the increases through 2012.
  - e. Earned Income Tax Credit (EIC): The temporary expansion provisions set by ARRA '09 for this credit were set to expire at the end of 2010. TRUIRJCA '10 extends them through 2012.
    - (1) TRUIRJCA '10 renews the increase in the beginning and ending points of the EIC phase-out for married taxpayers by \$5,000 over the amounts for other filing statuses through 2012.
    - (2) TRUIRJCA '10 renews the increased rate of 45% for taxpayers with three or more qualifying children through 2012.
    - (3) TRUIRJCA '10 repeals the prior-law provision that reduced an individual's EIC by the amount of alternative minimum tax liability through 2012.
12. Increased Standard Deduction Increase for State & Local Real Property Taxes: TRUIRJCA '10 did not extend the increased temporary standard deduction for state and local real property taxes.

## B. Property Provisions

1. Bonus Depreciation: TRUIRJCA '10 increased bonus depreciation to 100% for property placed in service between September 9, 2010, and December 31, 2011, inclusive (2012, for certain property). TRUIRJCA '10 extended 50% bonus depreciation for property placed in service in 2012 (2013, for certain property).
2. Section 179: TRUIRJCA '10 increased the ceiling and phase-out threshold for 2011 to \$250,000 and \$2 million and for 2012 to \$125,000 and \$500,000, respectively. Under previous law, the ceiling and phase-out threshold for 2013 currently remain at \$25,000 and \$200,000, respectively.

3. 15-Year Straight-Line Recovery: TRUIRJCA '10 allows 15-year straight-line recovery for qualified leasehold improvements, qualified restaurant buildings and improvements, and qualified retail improvements property placed in service in 2010 and 2011.
  4. Environmental Remediation Costs: TRUIRJCA '10 allows certain environmental remediation expenditures incurred in 2010 and 2011 that otherwise would be capitalized to be deductible in the year incurred.
  5. Qualified Small Business Stock (QSBS): TRUIRJCA '10 extends the 100% gain exclusion for regular and alternative minimum tax for non-corporate taxpayers to QSBS acquired in 2011.
- C. Transfer Tax Provisions
1. Estate & Gift Transfer Tax: For 2010, the estate tax is reinstated and the carry-over basis is replaced with the step-up basis. For 2010, the estate and the generation-skipping tax have an applicable exclusion amount of \$5 million. For 2010, the maximum estate rate is 35%. For 2010, the applicable gift tax exclusion amount is \$1 million and the maximum gift tax rate is 35%. For 2011 and 2012, the estate is reunified with the gift tax with an applicable exclusion amount of \$5 million and a maximum estate and gift tax rate of 35%. (Unless there is further legislation, the applicable exclusion amount in 2013 is \$1 million with a 55% rate.)
  2. Generation-Skipping Transfer Tax: For 2010 and 2011, the generation-skipping tax exclusion amount is \$5 million. For 2010, the generation-skipping tax rate is 0%. For 2011 and 2012, the generation-skipping tax rate is the highest estate and gift tax rate (35%).
  3. Election: For estates of decedents dying during 2010, the executor may elect zero estate tax as if TRUIRJCA '10 was not passed, with the beneficiaries receiving a carry-over basis instead of a step-up basis.
  4. Portability: Any applicable exclusion amount that remains unused at the death of a spouse dying in 2011 and later years generally is available for use by the surviving spouse. In other words, a married couple has a combined \$10 million exclusion, although only \$5 million may be excluded by the estate of the first spouse to die.
- D. Energy Provisions: The editors expect the energy provision extensions to be lightly tested, as these provisions apparently have been lightly tested in the past. These extensions generally expire at the end of 2011.
1. General Business Credit: TRUIRJCA '10 extends the biodiesel mixture credit, the biodiesel credit, the small agri-biodiesel producer credit, the refined coal facilities credit, the new energy-efficient home credit, the energy-efficient appliance credit, and (for property used in a trade or business) the alternative fuel vehicle refueling property credit. The energy-efficient home and appliance credits are paid to the producers of the energy-efficient property.
  2. Excise Tax Credits: TRUIRJCA '10 extends the excise tax credits and outlay payments for alternative fuel and alternative fuel mixtures.
  3. Other Credits: TRUIRJCA '10 extends the credits for non-business energy property and (for property not used in a trade or business) alternative fuel vehicle fuelling property.
  4. Grants in Lieu of Credits: TRUIRJCA '10 extends provisions allowing grants for specified energy property in lieu of tax credits.

5. Special Rule for Sales or Dispositions to Implement Federal Energy Regulatory Commission or State Electric Restructuring Policy for Qualified Electric Utilities: Gain is deferred from qualified electric transmission transactions ratably over an eight-year period, to the extent the amount realized is reinvested within four years.
  6. Percentage Depletion for Oil and Gas From Marginal Wells: TRUIRJCA '10 extends the suspension of the 100% net-income limitation for marginal production.
  7. Alcohol Used as Fuel: TRUIRJCA '10 extends provisions (the income tax credit, the excise tax credit, etc.) relating to alcohol used as fuel.
- E. Disaster Relief Provisions: The editors expect the disaster relief provision extensions to be lightly tested, as these geographically limited provisions apparently have been lightly tested in the past. These extensions generally expire at the end of 2011.
1. New York Liberty Zone: An aggregate of \$8 million on tax-exempt private activity bonds is authorized to finance the construction and repair of infrastructure within the Liberty Zone. TRUIRJCA '10 extends the deadline to issue these bonds to December 31, 2011.
  2. Gulf Opportunity Zones
    - a. Rehabilitation Credit: TRUIRJCA '10 extends the 26% or 13% credit for qualified rehabilitation expenditures relating to a certified historic structure or qualified rehabilitated building, respectively, incurred before 2012.
    - b. Low-Income Housing Credit: TRUIRJCA '10 extends the deadline to place low-income housing in service to December 31, 2011, for affected states to qualify for a high applicable state housing credit ceiling.
    - c. Gulf Opportunity Zone Bonds: Gulf Opportunity Zone Bonds have less stringent restrictions than typical bonds to qualify as tax-exempt. TRUIRJCA '10 extends the deadline to issue these bonds to December 31, 2011.
    - d. Bonus Depreciation: TRUIRJCA '10 extends the additional first year depreciation deduction equal to 50% of the adjusted basis of specified qualified Gulf Opportunity Zone extension property placed in service on or before December 31, 2011.
-

## Errata

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

### Chapter 37

Page 37-11 text, Exhibit 1: The \$10,350 and \$2,425 amounts should be \$11,725 and \$2,600, respectively; the amounts in the accompanying text are correct.

Page 37-17 text, Exhibit 2: The \$5,475 amount should be \$5,850; the amount in the accompanying text is correct.

Problem 37-4: The answers to item numbers 1 and 2 should be 'D' and 'C,' respectively. The explanations are correct.

### Chapter 43

Problem 43-1, MCQ #29 and #31: The explanations for these two questions are switched. Once switched, the answers and explanations are correct.

Problem 43-16: Item #8 should have the same answer and explanation as item #7. Items #9 through #16 are mislabeled as #8 through #15. With these changes, the answers and explanations are correct.

### Chapter 44

Problem 43-2, MCQ #59: The explanation should refer to Allen rather than Dole. The answer is correct.

### Chapter 47

Page 47-11 text, paragraph 2: The last sentence should read, "Returns are due April 15 for calendar-year partnerships."

### Chapter 48

Page 48-4 text, Section II, paragraph 1 should not include partnerships; paragraph 2 should include partnerships.

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

### Appendix A

Problem A: 4-2, Item #6. The answer should be "F," not "T." The explanation is correct.

### Appendix C

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

### Inflation-Adjusted Tax Amounts

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

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

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

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

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

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

Thus, the questions on the July-August 2011 and October-November 2011 CPA examinations should cover the law in effect for 2011. However, when it comes to taxes, the examiners repeatedly have tested the last full calendar year. The editors expect the July-August 2011 and the October-November 2011 CPA examination to cover the tax law in effect for 2010, not 2011, in those few questions where the year makes a difference. The editors expect the questions on the January-February 2012 and April-May 2012 CPA examinations to cover the tax law in effect for 2011.

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 2010 to 2011 as inflation was mild.

#### Individual Taxation

- A. Exemption: The personal exemption is \$3,650 for 2010 (\$3,700 for 2011).
- B. Standard Deduction & Personal & Dependency Exemption Phase-out: For 2010 and 2011, the standard deduction for an individual who may be claimed as a dependent by another taxpayer may not exceed the greater of either \$950 or the sum of \$300 and the individual's earned income. The personal and dependency exemption phase-out is eliminated for 2010 through 2012.

Filing Status	Standard Deduction		Additional Age & Blindness	
	2010	2011	2010	2011
Married Filing Jointly *	\$11,400	\$11,600	\$1,100	\$1,150
Single	5,700	5,800	1,400	1,450
Head of Household	8,400	8,500	1,400	1,450
Married Filing Separately	5,700	5,800	1,100	1,150

\* Also surviving spouse

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

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

<u>Filing Status</u>	<u>2010</u>	<u>2011</u>
Married filing jointly	\$105,100 to \$135,100	\$106,650 to \$136,650
All others	\$ 70,100 to \$ 85,100	\$ 71,100 to \$ 86,100

- E. Retirement Plans: Employees may defer up to \$49,000 in defined contribution plans for 2010 and 2011. The annual limit for defined benefit plan benefits is \$195,000 for 2010 and 2011.

- Section 401(k), Section 457, and SEP Plans: For 2010 and 2011, the maximum on elective deferrals is \$16,500. For 2010 and 2011, the maximum catch-up contributions are \$5,500 for Sections 401(k), 403(b), and 457 plans.
- SIMPLE Plans: For 2010 and 2011, 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 2010, the maximum Roth IRA contribution is phased out for taxpayers with AGI exceeding \$167,000 (MFJ), \$105,000 (single), and \$0 (MFS). In 2011, these maximums are \$169,000, \$107,000, and \$0, respectively. The traditional IRA deductibility phase-outs are as follows.

<u>Filing Status</u>	<u>2010</u>	<u>2011</u>
Married filing jointly	\$ 89,000 to \$109,000	\$ 90,000 to \$110,000
Single or Head of Household	\$ 56,000 to \$ 66,000	\$ 56,000 to \$ 66,000
Married filing separately	\$ 0 to \$ 10,000	\$ 0 to \$ 10,000
MFJ, nonparticipant spouse	\$167,000 to \$177,000	\$169,000 to \$179,000

- G. Health Savings Account: For 2010 and 2011, taxpayers can contribute up to the amount of the health plan's annual deductible, but not more than \$3,050 for individual coverage and \$6,150 for family coverage.
- H. Self-Employment & Social Security Taxes: The maximum income subject to the full self-employment and social security taxes is \$106,800 in 2010 and 2011.
- I. Earned Income Credit: For 2010, the earned income credit is denied if certain investment income is greater than \$3,100 (\$3,150 for 2011).
- J. Adoption Expense Credit: The maximum adoption expense credit is \$13,170 for 2010 (\$13,360 for 2011).
- K. Child Credit: The child credit is refundable to the extent of the greater of 15% of the taxpayer's earned income in excess of \$3,000 for 2010 or, for taxpayers with three or more qualifying children, the amount of Social Security taxes that exceeds the earned income credit. Please also see the coverage of TRUIRJCA '10.

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## Property Taxation

- A. Section 179: Please see the coverage of SBJA '10 and TRUIRJCA '10.
- B. Annual Gift Exclusion: For 2010 and 2011, the first \$13,000 of gifts to any person is not included in the total amount of taxable gifts made.
-

## Recently Released AICPA Questions

In May 2011, the AICPA released several questions labeled as “Year 2011 Disclosed Questions.” The AICPA assigned a “medium” difficulty level and a “hard” difficulty level to the REG sets the Bisk editors labeled “Problem 1” and “Problem 2” in this presentation, respectively.

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

**Problem 1** MULTIPLE-CHOICE QUESTIONS (medium)

1. Pursuant to Treasury Circular 230, which of the following statements about the return of a client's records is correct?
  - a. The client's records are to be destroyed upon submission of a tax return.
  - b. The practitioner may retain copies of the client's records.
  - c. The existence of a dispute over fees generally relieves the practitioner of responsibility to return the client's records.
  - d. The practitioner does not need to return any client records that are necessary for the client to comply with the client's federal tax obligations. (R/11, REG, #1, 9841)
2. According to the AICPA *Statements on Standards for Tax Services*, which of the following factors should a CPA consider in choosing whether to provide oral or written advice to a client?
  - a. Whether the client will seek a second opinion
  - b. The tax sophistication of the client
  - c. The likelihood that current tax litigation will impact the advice
  - d. The client's business acumen (R/11, REG, #2, 9842)
3. Louis, the volunteer treasurer of a nonprofit organization and a member of its board of directors, compiles the data and fills out its annual Form 990, *Return of Organization Exempt From Income Tax*. Under the Internal Revenue Code, Louis is **not** considered a tax return preparer because
  - a. He is a member of the board of directors.
  - b. The return does **not** contain a claim for a tax refund.
  - c. He is **not** compensated.
  - d. Returns for nonprofit organizations are exempt from the preparer rules. (R/11, REG, #3, 9843)
4. Under agency law, which of the following statements best describes ratification?
  - a. A principal's affirmation of an agent's authorized act
  - b. A principal's affirmation of an agent's unauthorized act
  - c. A principal's approval in advance of an agent's acts
  - d. A principal's disavowal of an agent's unauthorized act (R/11, REG, #4, 9844)
5. Pierce owed Duke \$3,000. Pierce contracted with Lodge to paint Lodge's house and Lodge agreed to pay Duke \$3,000 to satisfy Pierce's debt. Pierce painted Lodge's house but Lodge did not pay Duke the \$3,000. In a lawsuit by Duke against Pierce and Lodge, who will be liable to Duke?
  - a. Pierce only
  - b. Lodge only
  - c. Both Pierce and Lodge
  - d. Neither Pierce nor Lodge (R/11, REG, #5, 9845)

6. Under the Sales Article of the UCC, which of the following statements is correct regarding the creation of express warranties?
- Express warranties must contain formal words such as warranty or guarantee.
  - Express warranties must be part of the basis of the bargain between buyer and seller.
  - Express warranties are **not** enforceable if made orally.
  - Express warranties **cannot** be based on statements made in the seller's promotional materials. (R/11, REG, #6, 9846)
7. An individual taxpayer agreed to a finding of fraud on an income tax return filed two years ago. What is the maximum time limitation, if any, after which the IRS may **not** assess any additional taxes against the taxpayer for this tax return?
- One year
  - Two years
  - Three years
  - There is **no** time limitation (R/11, REG, #7, 9847)
8. In calculating the tax of a corporation for a short period, which of the following processes is correct?
- Divide current-year income by prior-year income, then multiply the result by prior-year tax.
  - Compute tax on short-period income, then multiply the result by 12 divided by the number of months in the short period.
  - Determine the average taxable income for the past three years, then multiply the result by the number of months in the short period divided by 12.
  - Annualize income and calculate the tax on annualized income, then multiply the computed tax by the number of months in the short period divided by 12. (R/11, REG, #8, 9848)
9. Which of the following costs are subject to the Uniform Capitalization Rules of Code Sec. 263A for manufactured tangible personal property?
- Off-site storage
  - Advertising
  - Research
  - Marketing (R/11, REG, #9, 9849)
10. A taxpayer purchased five acres of land for \$20,000 and placed in service other tangible business assets that cost \$100,000. Disregarding business income limitations and assuming that the annual Section 179 (*Election to Expense Certain Depreciable Business Assets*) limit is \$108,000, what maximum amount of cost recovery can the taxpayer claim this year?
- \$120,000
  - \$108,000
  - \$100,000
  - \$ 20,000 (R/11, REG, #10, 9850)
11. Hogan exchanged a business-use machine having an original cost of \$100,000 and accumulated depreciation of \$30,000 for business-use equipment owned by Baker having a fair market value of \$80,000 plus \$1,000 cash. Baker assumed a \$2,000 outstanding debt on the machine. What taxable gain should Hogan recognize?
- \$0
  - \$ 3,000
  - \$ 10,000
  - \$ 11,000 (R/11, REG, #11, 9951)

12. A married couple purchased their principal residence for \$300,000. They spent \$40,000 on improvements. After living in it for 10 years, the couple sold the home for \$650,000 and paid \$36,000 in real estate commissions. What gain should the couple recognize on their joint return?
- a. \$0
  - b. \$ 60,000
  - c. \$274,000
  - d. \$310,000
- (R/11, REG, #12, 9952)
13. Carter incurred the following expenses in the current year: \$500 for the preparation of a personal income tax return, \$100 for custodial fees on an IRA, \$150 for professional publications, and \$2,000 for union dues. Carter's current year adjusted gross income is \$75,000. Carter, who is not self-employed, itemizes deductions. What will Carter's deduction be for miscellaneous itemized deductions after any limitations in the current year?
- a. \$0
  - b. \$ 750
  - c. \$1,250
  - d. \$2,750
- (R/11, REG, #13, 9953)
14. Cole earned \$3,000 in wages, incurred \$1,000 in unreimbursed employee business expenses, paid \$400 as interest on a student loan, and contributed \$100 to a charity. What is Cole's adjusted gross income?
- a. \$3,000
  - b. \$2,600
  - c. \$2,500
  - d. \$1,600
- (R/11, REG, #14, 9954)
15. Doyle has gambling losses totaling \$7,000 during the current year. Doyle's adjusted gross income is \$60,000, including \$3,000 in gambling winnings. Doyle can itemize the deductions. What amount of gambling losses is deductible?
- a. \$0
  - b. \$3,000
  - c. \$5,800
  - d. \$7,000
- (R/11, REG, #15, 9955)
16. Which of the following statements about qualifying shareholders of an S corporation is correct?
- a. A general partnership may be a shareholder.
  - b. Only individuals may be shareholders.
  - c. Individuals, estates, and certain trusts may be shareholders.
  - d. Nonresident aliens may be shareholders.
- (R/11, REG, #16, 9956)
17. Absent an election to close the books, the allocation of nonseparately stated income or loss for an S corporation shareholder that changed her/his ownership interest during the year is computed based on which of the following ownership percentages?
- a. Ownership percentage at the end of the S corporation year
  - b. Ownership percentage computed on a per-share per-day basis
  - c. Ownership percentage at the beginning of the S corporation year
  - d. Ownership percentage determined as an average of the beginning and ending ownership percentages
- (R/11, REG, #17, 9957)

18. Lamont signed a promissory note in favor of Roth as part of Lamont's purchase of supplies from Roth. The note required that the \$10,000 be repaid 90 days from the date of the note. There were no conditions attached to repayment. Roth endorsed the note in blank and sold it to the bank. Lamont defaulted on the promissory note. The bank sought a judgment ordering Lamont to pay the bank. Under the Negotiable Instruments Article of the UCC, how will the court most likely rule?
- The court will direct Lamont to pay the bank because the promissory note was a negotiable instrument negotiated to the bank in due course.
  - The court will direct Lamont to pay the bank because the note was part of a transaction between merchants.
  - The court will **not** direct Lamont to pay the bank because the promissory note was a negotiable instrument negotiated with Roth.
  - The court will **not** direct Lamont to pay the bank because the promissory note was **not** a negotiable instrument. (R/11, REG, #18, 9958)
19. Simon, a C corporation, had a deficit in accumulated earnings and profits of \$50,000 at the beginning of the year and had current earnings and profits of \$10,000. At year end, Simon paid a dividend of \$15,000 to its sole shareholder. What amount of the dividend is reported as income?
- \$0
  - \$ 5,000
  - \$10,000
  - \$15,000 (R/11, REG, #19, 9959)
20. Campbell acquired a 10% interest in Vogue Partnership by contributing a building with an adjusted basis of \$40,000 and a fair market value of \$90,000. The building was subject to a \$60,000 mortgage that was assumed by Vogue. The other partners contributed cash only. The basis of Campbell's partnership interest in Vogue is
- \$84,000
  - \$34,000
  - \$30,000
  - \$0 (R/11, REG, #20, 9960)

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**Problem 2** MULTIPLE-CHOICE QUESTIONS (hard)

21. Under the position taken by a majority of the courts, to which third parties will an accountant who negligently prepares a client's financial report be liable?
- Only those third parties in privity of contract with the accountant
  - All third parties who relied on the report and sustained injury
  - Any foreseen or known third party who relied on the report
  - Any third party whose reliance on the report was reasonably foreseeable (R/11, REG, #21, 9961)
22. A company engaged a CPA to perform the annual audit of its financial statements. The audit failed to reveal an embezzlement scheme by one of the employees. Which of the following statements best describes the CPA's potential liability for this failure?
- The CPA's adherence to generally accepted auditing standards (GAAS) may prevent liability.
  - The CPA will **not** be liable if care and skill of an ordinary reasonable person was exercised.
  - The CPA may be liable for punitive damages if due care was **not** exercised.
  - The CPA is liable for any embezzlement losses that occurred before the scheme should have been detected. (R/11, REG, #22, 9962)

23. In which of the following types of action, brought against a CPA who issues an audit report containing an unqualified opinion on materially misstated financial statements, may a plaintiff prevail without proving reliance on the audit report?
- An action for common law fraud.
  - An action for common law breach of contract.
  - An action brought under Section 11 of the Securities Act of 1933.
  - An action brought under Rule 10b-5 of the Securities Exchange Act of 1934.
- (R/11, REG, #23, 9966)
24. Under the Negotiable Instruments Article of the UCC, the proper party to whom a check is presented for payment is
- The drawer
  - The maker
  - The holder
  - The drawee
- (R/11, REG, #24, 9964)
25. Under the Secured Transactions Article of the UCC, which of the following statements is correct regarding a security interest that has **not** attached?
- It is effective against the debtor, but **not** against third parties.
  - It is effective against both the debtor and third parties.
  - It is effective against third parties with unsecured claims.
  - It is **not** effective against either the debtor or third parties.
- (R/11, REG, #25, 9965)
26. Which of the following interests in real property gives the holder of that interest the greatest possessory interest in the property?
- Easement
  - Restrictive covenant
  - License
  - Fee simple
- (R/11, REG, #26, 9911)
27. Which of the following transactions is subject to registration requirements of the Securities Act of 1933?
- The public sale of stock of a trucking company regulated by the Interstate Commerce Commission
  - A public sale of municipal bonds issued by a city government
  - The issuance of stock by a publicly traded corporation to its existing shareholders because of a stock split
  - The public sale by a corporation of its negotiable 10-year notes
- (R/11, REG, #27, 9967)
28. In the current year, Essex sold land with a basis of \$80,000 to Yarrow for \$100,000. Yarrow paid \$25,000 down and agreed to pay \$15,000 per year, plus interest, for the next five years, beginning in the second year. Under the installment method, what gain should Essex include in gross income for the year of sale?
- \$25,000
  - \$20,000
  - \$15,000
  - \$ 5,000
- (R/11, REG, #28, 9968)

29. Sam's year 2 taxable income was \$175,000 with a corresponding tax liability of \$30,000. For year 3, Sam expects taxable income of \$250,000 and a tax liability of \$50,000. In order to avoid a penalty for underpayment of estimated tax, what is the minimum amount of year 3 estimated tax payments that Sam can make?
- \$30,000
  - \$33,000
  - \$45,000
  - \$50,000
- (R/11, REG, #29, 9969)

30. On January 1, Fast, Inc. entered into a covenant not to compete with Swift, Inc. for a period of five years, with an option by Swift to extend it to seven years. What is the amortization period of the covenant for tax purposes?
- 5 years
  - 7 years
  - 15 years
  - 17 years
- (R/11, REG, #30, 9970)

31. Decker sold equipment for \$200,000. The equipment was purchased for \$160,000 and had accumulated depreciation of \$60,000. What amount is reported as ordinary income under Code Sec. 1245?
- \$0
  - \$ 40,000
  - \$ 60,000
  - \$100,000
- (R/11, REG, #31, 9971)

32. Lobster, Inc. incurs the following losses on disposition of business assets during the year:

Loss on the abandonment of office equipment	\$ 25,000
Loss on the sale of a building (straight-line depreciation taken in prior years of \$200,000)	250,000
Loss on the sale of delivery trucks	15,000

What is the amount and character of the losses to be reported on Lobster's tax return?

- \$40,000 Section 1231 loss only
  - \$40,000 Section 1231 loss, \$50,000 long-term capital loss
  - \$40,000 Section 1231 loss, \$250,000 long-term capital loss
  - \$290,000 Section 1231 loss
- (R/11, REG, #32, 9972)
33. In the current year, a taxpayer reports the following items:

Salary	\$ 50,000
Income from partnership A, in which the taxpayer materially participates	20,000
Passive activity loss from partnership B	(40,000)

During the year, the taxpayer disposed of the interest in partnership B, which had a suspended loss carryover of \$10,000 from prior years. What is the taxpayer's adjusted gross income for the current year?

- \$20,000
  - \$30,000
  - \$60,000
  - \$70,000
- (R/11, REG, #33, 9973)

34. Stone owns 100% of an S corporation and materially participates in its operations. The stock basis at the beginning of the year is \$5,000. During the year, the corporation makes a distribution of \$3,500 and passes through a loss from operations of \$2,000 for the year. What loss can Stone deduct on Stone's personal tax return?
- a. \$0
  - b. \$1,500
  - c. \$2,000
  - d. \$5,500
- (R/11, REG, #34, 9974)
35. Farr, an unmarried taxpayer, had \$70,000 of adjusted gross income and the following deductions for regular income tax purposes:
- |   |          |
|---|----------|
| Home mortgage interest on a loan to acquire a principal residence | \$11,000 |
| Miscellaneous itemized deductions above the threshold limitation  | \$2,000  |
- What are Farr's total allowable itemized deductions for computing alternative minimum taxable income?
- a. \$0
  - b. \$ 2,000
  - c. \$11,000
  - d. \$13,000
- (R/11, REG, #35, 9975)
36. Robin, a C corporation, had revenues of \$200,000 and operating expenses of \$75,000. Robin also received a \$20,000 dividend from a domestic corporation and is entitled to a \$14,000 dividend-received deduction. Robin donated \$15,000 to a qualified charitable organization in the current year. What is Robin's contribution deduction?
- a. \$15,000
  - b. \$14,500
  - c. \$13,900
  - d. \$13,100
- (R/11, REG, #36, 9976)
37. "Hot assets" of a partnership would include which of the following?
- a. Cash
  - b. Unrealized receivables
  - c. Section 1231 assets
  - d. Capital assets
- (R/11, REG, #37, 9977)
38. George and Martha are equal partners in G&M Partnership. At the beginning of the current tax year, the adjusted basis of George's partnership interest was \$32,500, which included his share of \$40,000 of partnership liabilities. During the tax year, the following information applied to G&M:
- |  |          |
|--|----------|
| Operating loss                         | \$30,000 |
| Interest and dividend income           | 8,000    |
| Partnership liabilities at end of year | 24,000   |
- What was the basis of George's partnership interest at year end?
- a. \$13,500
  - b. \$21,500
  - c. \$29,500
  - d. \$43,500
- (R/11, REG, #38, 9978)

39. As a general partner in Greenland Associates, an individual's share of partnership income for the current tax year is \$25,000 ordinary business income and a \$10,000 guaranteed payment. The individual also received \$5,000 in cash distributions from the partnership. What income should the individual report from the interest in Greenland?
- a. \$ 5,000
  - b. \$25,000
  - c. \$35,000
  - d. \$40,000
- (R/11, REG, #39, 9979)

40. In the current year, when Hoben's tax basis in Lynz Partnership interest was \$10,000, Hoben received a *liquidating* distribution as follows:

	<u>Adjusted tax basis</u>	<u>Fair market value</u>
Marketable securities	\$ 5,000	\$ 5,000
Land	25,000	27,000

Lynz had no appreciated inventory, unrealized receivables, or properties that had been contributed by its partners. What was Hoben's recognized gain on the distribution?

- a. \$0
  - b. \$15,000
  - c. \$22,000
  - d. \$32,000
- (R/11, REG, #40, 9980)
-

**Problem 3 SIMULATION Partnership Operations**

ABC Advisors, LLP, is a partnership that provides computer consulting services on a calendar year, accrual basis. A, B, and C are equal partners and are calendar year, cash basis, individual partners. Each partner has sufficient basis in the partnership to cover all distributions and withdrawals made during the year.

Partner A is Partner B's father. Partner C is not related to either partner. For each of the partnership transactions shown below, select the appropriate tax treatment from the selection list. A tax treatment may be selected once, more than once, or not at all. (R/11, REG, #3, 9839)

Tax Treatments

- A. Deductible by the partnership and included as ordinary income by the partner.
- B. Deductible by the partnership in arriving at partnership ordinary business income.
- C. Includable by the partnership in arriving at partnership ordinary business income.
- D. Partners are not entitled to a deduction and decrease their basis in the partnership.
- E. Partners do not include the cash as income, but must reduce their basis in the partnership.
- F. Partners do not include the income, but increase their basis in the partnership.
- G. Related-party rules result in current nonrecognition of transaction.
- H. Treated as a separately stated item by the partnership and potentially deductible by the partners.
- I. Treated as separately stated item by the partnership, taxable to the partner.
- J. Treated partly as a separately stated section 1231 gain and partly as partnership ordinary business income.

<u>Transaction</u>	<u>Tax Treatment</u>
1. Partnership made a proportionate cash distribution.	
2. Partnership sold depreciable property at a gain in excess of the depreciation allowed on the property.	
3. Partnership claimed a section 179 deduction for depreciable property purchase during the year.	
4. Partnership made cash contributions to qualifying charities.	
5. Partnership sold an investment held for less than one year at a gain.	
6. Partnership paid for rental of office space.	
7. Partnership paid an outside consultant for services rendered.	
8. Partnership made a cash contribution to a foreign charity.	

**Problem 4 SIMULATION Office in Home**

A self-employed taxpayer who itemized deductions owns a home, of which 10% is used as the taxpayer's primary place of business.

In the table below, enter in the shaded cells in column C the amount to allocate to the taxpayer's Schedule C, *Profit or Loss from Business*. Then, in column D, enter the associated amount to be included on the taxpayer's Schedule A, *Itemized Deductions*. Enter income as positive values and losses and expenses as negative values. If a response is zero, enter a zero (0). (R/11, REG, #4, 9840)

<u>Income and expenses</u>	<u>Total amount</u>	<u>Amount allocated to Schedule C</u>	<u>Schedule A</u>
Gross receipts	\$ 50,000	1.	2.
Secretarial expenses	\$ 24,000	3.	4.
Supplies	\$ 200	5.	6.
Other business expenses	\$ 18,000	7.	8.
Expenses to related to the home			
Property insurance	\$ 5,000	9.	10.
Mortgage interest	\$ 24,000	11.	12.
Real estate taxes	\$ 10,000	13.	14.
Furnace repair	\$ 2,000	15.	16.
Kitchen remodeling	\$ 12,000	17.	18.
Utilities	\$ 6,000	19.	20.
Cleaning services	\$ 1,000	21.	22.
Depreciation (tax method for office portion only)	\$ 4,000	23.	24.
Net income or (loss)			

**Problem 5 SIMULATION Research**

During the year, a client purchased a gift for a spouse who became a citizen of the United States in the year subsequent to the gift. The gift was land on which the client intends to build a house. The client knows that there is some form of gift tax deduction allowed for gifts, but has further questions concerning how the gift affects the client and the client's spouse. Which section and subsection of the Internal Revenue Code defines the applicability of the marital deduction for gift tax in this situation?

(R/11, REG, #5, 10224)

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**Problem 1 MULTIPLE-CHOICE ANSWERS**

1. (b) Circular 230 permits the practitioner to retain copies of records returned to a client. Generally, a practitioner must return the client's records to the client promptly. Client records often are necessary for the client to comply with the client's federal tax obligations; they generally should be retained by the client until after the statute of limitations for the return expires, rather than destroyed when the return is submitted. Generally, a dispute over fees does not affect the practitioner's responsibility to return the client's records. (Bisk: 42-1-2; CSO: 1.1.1; 9841)

2. (b) An AICPA member should use judgment to ensure that tax advice provided to a taxpayer reflects professional competence and appropriately serves the taxpayer's needs. A member should use professional judgment about providing oral advice. Whether the client will seek a second opinion and the likelihood that current tax litigation will impact the advice make little difference as to whether oral advice is appropriate. While the client's business acumen generally would have some impact on the appropriateness of oral advice, the tax sophistication of the client generally would outweigh this consideration. For instance, oral advice often would be appropriate for a client with little tax sophistication, even if the client has little business acumen. **Editor's Note:** The editors do not expect a similarly ambiguous question to appear on future exams. (Bisk: 42-1-3; CSO: 1.1.2; 9842)

3. (c) The IRC generally defines a preparer as one who is paid to prepare a substantial portion of a return or claim for refund. Being a member of the board of directors does not change the preparer's status. The taxpayer's status does not influence the determination of the preparer's status. (Bisk: 42-1-1; CSO: 1.1.3; 9843)

4. (b) Ratification is the affirmation by a principal of acts performed either by one who is not an agent or unauthorized acts performed by an agent. Approval in advance of the act results in an authorized act. (Bisk: 38-2-2; CSO: 2.1.3; 9844)

5. (c) Duke is an intended creditor beneficiary of the contract. If a promisor fails to perform, a creditor beneficiary can either sue the promisor on the contract or recover the original obligation from the promisee, who remains secondarily liable. (Bisk: 33-5-1; CSO: 2.2.1; 9845)

6. (b) An express warranty may arise even if the seller does not use language such as "warranty" or "guarantee." An express warranty may be created in one of three ways: (1) affirmation of fact or promise made by the seller to the buyer that relates to the goods and becomes part of the basis of the bargain; (2) any description of the goods that is made part of the basis of the bargain; or (3) any sample or model that is made part of the basis of the bargain. An express warranty need not be in writing to be enforceable. (Bisk: 34-4-1; CSO: 2.3.1; 9846)

7. (d) In the case of a tax return involving fraud, there is no statute of limitations. (Bisk: 48-2-6; CSO: 3.2.7; 9847)

8. (d) The tax for a short period is determined using current year amounts and tax rates and the number of months in the short period. The current year amounts are annualized and used to determine an annualized tax amount. Then the annualized tax amount is adjusted for the short period. This results in tax comparable to the tax on entities with an annual period. As tax rates are progressive, computing tax on the short-year income and then adjusting for the time difference generally would result in less tax, encouraging entities to have short years. Prior-year amounts and tax rates are not used to determine the tax for a subsequent period, whether it is short or regular. (Bisk: 48-3-1; CSO: 3.3.0; 9848)

9. (a) Under the uniform capitalization (UNICAP) rules, the costs to purchase, assemble, produce, and store inventory are included among the costs to capitalize. Advertising and marketing are period costs. Some research and development costs may be capitalized and amortized, but this is optional and, further, is not required under the UNICAP rules. (Bisk: 48-3-1; CSO: 3.4.2; 9849)

10. (c) As the basis of the personal property placed in service is less than the annual Section 179 limit, the full amount of the personal property is deductible; a taxpayer may not deduct more than the basis of depreciable assets. Land is not depreciable. (Bisk: 44-2-2; CSO: 4.3.0; 9850)

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. If boot (money or other non-like-kind property) is received as part of the like-kind exchange, then gain is recognized to the extent of the lesser of the gain realized or the boot received. Hogan's basis in the machine was  $\$100,000 - \$30,000 = \$70,000$ . Hogan received boot of  $\$3,000$  ( $\$1,000$  cash and  $\$2,000$  debt relief). Hogan received total value of  $\$83,000$  (equipment worth  $\$80,000$  plus  $\$3,000$  boot). Hogan's realized gain is  $\$83,000 - \$70,000 = \$13,000$ ; however, Hogan recognizes only the boot received as taxable income as it is less than the realized gain. (Bisk: 44-3-5; CSO: 4.4.0; 9951)

12. (a) An exclusion of gain ( $\$500,000$  for married filing jointly status) generally is available to taxpayers who owned and occupied a home as a principal residence in two of the five years immediately preceding the sale. With basis of  $\$300,000 + \$40,000 = \$340,000$  and transaction costs of  $\$36,000$ , the couple's gain realized is  $\$650,000 - \$340,000 - \$36,000 = \$274,000$ , well under the maximum exclusion amount. (Bisk: 44-3-6; CSO: 4.5.0; 9952)

13. (c) Tax return preparation fees, custodial fees for investments, professional publications, and union dues all are miscellaneous itemized deductions ( $\$500 + \$100 + \$150 + \$2,000 = \$2,700$ ) subject to the 2% of gross income ( $\$75,000 \times 0.02 = \$1,500$ ) threshold limitation.  $\$2,700 - \$1,500 = \$1,200$  (Bisk: 43-4-8; CSO: 5.3.0; 9953)

14. (b) Adjusted gross income (AGI) is gross income less adjustments to arrive at AGI, such as interest on student loans ( $\$3,000 - \$400 = \$2,600$ ). Unreimbursed employee business expenses and charitable contributions are itemized deductions; itemized deductions are deducted from AGI. (Bisk: 43-3-1; CSO: 5.3.0; 9954)

15. (b) Gambling losses to the extent of gambling winnings are a miscellaneous itemized deduction not subject to the 2%-of-gross-income threshold limitation. (Bisk: 43-4-8; CSO: 5.3.0; 9855)

16. (c) Individuals, estates, certain trusts, and tax-exempt entities may be S corporation shareholders. Nonresident aliens, partnerships, corporations, and foreign trusts may not be S corporation shareholders. (Bisk: 46-10-2; CSO: 6.4.1; 9956)

17. (b) An S corporation's shareholder's *pro rata* share of each corporate item is computed on a daily basis according to the number of shares of stock held by the shareholder on each day of the corporation's taxable year. (Bisk: 46-10-4; CSO: 6.4.2; 9957)

18. (a) A note is a written promise to pay a stated sum of money. A negotiable note is a signed, unconditional promise to pay a certain sum of money, payable on demand or at a definite time to order or bearer. Lamont's note meets the requirements of a negotiable note (or instrument). The transfer of a negotiable instrument vests all of the transferor's rights in the transferee. Whether the transaction was between merchants does not influence the court's enforcement of the note. (Bisk: 35-1-3; CSO: 2.3.2; 9958)

19. (c) If current earnings and profits (E&P) is positive and accumulated E&P is negative, then distributions are treated as dividends to the extent of current E&P. (Bisk: 46-5-1; CSO: 6.3.1; 9959)

20. (d) The basis of the partner's interest resulting from a contribution of property is the sum of the amount of money contributed, the adjusted basis of property and services contributed, and any gain recognized by the partner. (Gain generally is involved in a contribution of services to the partnership.) A decrease in a partner's share of partnership liabilities is treated as a distribution of money to the partner; an increase in a partner's share of partnership liabilities is treated as a contribution of money by the partner. (Bisk: 47-2-1; CSO: 6.5.2; 9960)

Adjusted basis of building	\$ 40,000
Less: Debt relief	(60,000)
Partnership debt assumed ( $\$60,000 \times 10\%$ )	<u>6,000</u>
Initial basis of partnership interest (not below zero)	\$ 0

## Problem 2 MULTIPLE-CHOICE ANSWERS

21. (c) An accountant's tort liability to third parties for ordinary negligence normally extends only to those third parties whom the accountant knew (or should have known) would be users or beneficiaries of the accountant's work product. This conceivably is a greater set of people than third parties in privity of contract with the accountant, but generally less than all third parties who relied on the report and sustained injury. An answer that mentions known third parties rather than assuming all known third parties are foreseen parties is preferable. (Bisk: 42-4-2; CSO: 1.3.1; 9961)

22. (a) In determining the adequacy of an accountant's performance under the terms of a contract, the law imposes the profession's generally accepted accounting standards of competence and care. The accountant must demonstrate the average degree of learning and skill generally possessed by an accountant, rather than a general person. An accountant who breaches her/his contract with a client may be subject to liability for damages and losses that the client suffers as a direct result of the breach; punitive damages normally are not awarded for a breach of contract. An accountant would not be responsible for losses occurring **before** a scheme should have been detected. (Bisk: 42-3-1; CSO: 1.3.1; 9962)

23. (c) Under the Securities Act of 1933, an investor is required only to prove the existence of a false statement or material omission and that the securities purchased were offered through the inaccurate registration statement; reliance on the inaccurate statement doesn't need to be demonstrated. Under the Securities Exchange Act of 1934, an investor's burden of proof includes reliance on the inaccurate statement. In a common law action, a plaintiff must show that losses were caused by the accountant's fraud, negligence, or breach of contract—in other words, that the investor relied on the inaccurate statement. (Bisk: 42-4-2; CSO: 1.3.2; 9966)

24. (d) A check is a written order from one party (the drawer) directing a bank (the drawee) to pay a sum certain in money to the order of a third party or to bearer (the payee). The payee presents a check to the drawee, or bank. Makers are connected with notes, not checks or other drafts. (Bisk: 35-1-2; CSO: 2.3.2; 9964)

25. (d) Attachment is when a security interest becomes enforceable against the debtor only; without attachment, a security interest is not effective against the debtor. Perfection is when a security interest becomes enforceable against third parties. (Bisk: 36-1-2; CSO: 2.3.3; 9965)

26. (d) **Editor's Note:** As this question is coded to a topic covering the Uniform Commercial Code (UCC) and the UCC is inapplicable to real property, the editors do not expect a similar question to appear on future exams; real property was included in the former CSO explicitly. A fee simple is an estate of potentially infinite duration; there are no limitations on its inheritability nor is it subject to a power of divestment. By contrast, a leasehold is an estate of limited duration. An easement is the right to use, but not possess, another's real property, such as for pipe, cable, or access to another property. A license is permission to use the licensed property (software, public roads, patented design, etc.). A restrictive covenant is a legal obligation incorporated within a deed by the seller of real property upon all subsequent buyers. (Bisk: 33-1-1; CSO: 2.3.4; 9911)

27. (d) The Securities Act of 1933 exempts certain securities from its registration requirements. A corporation's 10-year notes offered in a public sale are not exempt. Exempted securities include those issued by domestic governments; securities regulated by another government agency, such as the Interstate Commerce Commission; and securities involved in no-sale transactions. (Bisk: 40-2-3; CSO: 2.5.1; 9967)

28. (d) The amount of gain that is taxable each year under the installment sale method is computed by multiplying the payments received that year by the gross-profit percentage. The gross-profit percentage is equal to the anticipated total gross profit to be received ( $\$100,000 - \$80,000 = \$20,000$ ) divided by the total contract price, or  $\$20,000 / \$100,000 = 20\%$ . In the year of sale, Essex would recognize  $\$25,000 \times 20\% = \$5,000$  of gain in gross income. (Bisk: 48-3-5; CSO: 3.4.4; 9968)

29. (b) With AGI greater than \$150,000, Sam must meet a safe harbor requirement of 110% of the prior year's tax. Sam's year 2 tax liability was \$30,000;  $\$30,000 \times 110\% = \$33,000$ . (Bisk: 48-2-5; CSO: 3.6.5; 9969)

30. (c) Covenants not to compete are intangible assets eligible for 15-year amortization. The duration of the covenant is irrelevant. (Bisk: 44-2-1; CSO: 4.3.0; 9970)

31. (c) On the sale of depreciable personal property, depreciation generally must be recaptured as ordinary income to the extent of a gain on the transaction. Decker's basis in the equipment is  $\$160,000 - \$60,000 = \$100,000$ . Decker's gain is  $\$200,000 - \$100,000 = \$100,000$ . As the depreciation is less than the gain, the entire amount of the depreciation is recaptured as ordinary income. (Bisk: 44-3-3; CSO: 4.1.0; 9971)

32. (d) Section 1231 property is depreciable property or land that is used in a trade or business. If the losses from sale or disposition of §1231 property exceed the gains, then the net loss is treated as an ordinary loss. All of the losses involve eligible property types, so Lobster's total net losses on Section 1231 property are  $\$25,000 + \$250,000 + \$15,000 = \$290,000$ . Depreciation is not subtracted from a loss to arrive at capital loss. (Bisk: 44-3-3; CSO: 4.5.0; 9972)

33. (a) Generally, passive activity losses (PAL) may be used only to offset passive activity income. Any PAL that cannot be used in the current year are suspended and carried forward indefinitely until there is sufficient income from passive activities to absorb them. Any PAL that remain suspended when the activity is sold in a taxable transaction may be deducted against both ordinary and portfolio income. (Bisk: 43-2-3; CSO: 5.2.0; 9973)

Salary	\$ 50,000
Partnership A income	20,000
Current PAL	(40,000)
PAL carryover	<u>(10,000)</u>
Gross income	\$ 20,000

34. (b) A shareholder may not deduct losses in excess of the basis in the S corporation's stock. Stone's basis is  $\$5,000 - \$3,500 = \$1,500$ . (Bisk: 46-10-5; CSO: 5.2.0; 9974)

35. (c) Mortgage interest due to home acquisition, casualty and theft losses, medical expenses subject to a 10% (rather than 7.5%) threshold limitation, charitable contributions, and miscellaneous itemized deductions not subject to the 2% threshold are allowed for alternative minimum tax (AMT) purposes. All otherwise allowable itemized deductions are AMT adjustments—in other words, not allowed for AMT purposes. (Bisk: 43-5-4; CSO: 5.9.0; 9975)

36. (b) A corporation's deduction for charitable contributions generally is limited to 10% of taxable income without regard to (1) the deduction for charitable contributions, (2) the dividend-received deduction, (3) any net operating loss carryback to that year, and (4) any capital loss carryback to that year. Robin's revenues of \$200,000 less the operating expenses of \$75,000 and plus \$20,000 dividend result in taxable income without regard to the dividend-received deduction of \$145,000.  $\$145,000 \times 0.10 = \$14,500$  (Bisk: 46-2-5; CSO: 6.3.1; 9976)

37. (b) "Hot assets" is slang for such items as unrealized receivables (accounts receivable of a cash-basis partnership) and appreciated inventory. (Bisk: 47-3-2; CSO: 6.5.1; 9977)

38. (a) George's adjusted basis is increased by his share of income ( $50\% \times \$8,000 = \$4,000$ ) and reduced by his share of losses ( $50\% \times \$30,000 = \$15,000$ ). A decrease in a partner's share of partnership

liabilities is treated as a distribution of money to the partner by the partnership. George's share of liabilities was  $\$40,000 \times 50\% = \$20,000$  at the beginning of the year and  $\$24,000 \times 50\% = \$12,000$  at the end of the year, so George's share of liabilities decreased  $\$8,000$  during the year. George's basis at year end is  $\$32,500 - \$15,000 + \$4,000 - \$8,000 = \$13,500$ . (Bisk: 47-2-3; CSO: 6.5.2; 9978)

39. (c) Each partner must account for a share of partnership income, gains, and losses. A partner is taxed on the distributive share regardless of actual distributions. In this case, the partner's income is the  $\$10,000$  guaranteed payment plus the  $\$25,000$  share of ordinary business income. The actual distributions generally are a return of investment or previously taxed partnership income and only rarely are taxable events. (Bisk: 47-1-2; CSO: 6.5.4; 9979)

40. (a) Generally, no gain is recognized by a partner in a liquidating distribution. Gain is recognized when cash received exceeds the partner's basis in the partnership. Gain is recognized when there is appreciated inventory, unrealized receivables, or properties that had been contributed by partners with a built-in gain. (Bisk: 47-2-4; CSO: 6.5.6; 9980)

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### Solution 3 SIMULATION SOLUTION

1. E

The individual partners are taxed on their distributive share of income regardless of actual distributions. The actual distributions rarely are taxable events, but merely a return of previous investment or previously taxed partnership income.

2. J

Separately reported items include gain (loss) from sales of certain business property and certain involuntary conversions [IRC §1231(b) property]. When property is disposed of, resulting in a §1231 gain, then some of the gain may have to be recaptured as ordinary income because of depreciation deductions that were previously taken.

3. H

Separately reported items include Section 179 deductions. The deductibility by each of the individual partners depends on the total amount of assets each partner has placed in service among all of his or her trades and businesses.

4. H

Separately reported items include charitable contributions. The deductibility by each of the individual partners depends on the total amount of contributions each partner made, each partner's carryovers from previous years, and each partner's adjusted gross income.

5. I

Separately reported items include investment gains. This is so the partner may determine limits such as how much portfolio loss may be offset as well as the maximum amount of deductible investment interest.

6. B

Rental on office space is part of the determination of the partnership's ordinary business income. There is no deduction or limitation on the individual level that requires this expense be separately stated.

7. B

The services of an outside consultant are part of the determination of the partnership's ordinary business income. There is no deduction or limitation on the individual level that requires this expense be separately stated.

8. D

Cash contributions to a foreign charity generally are not deductible on either a partnership or individual tax return; however, this outflow of resources does reduce the partners' bases in their partnership interests. (9839)

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#### **Solution 4** SIMULATION SOLUTION

1. 50,000

The gross income (or gross receipts) from an individual's trade or business less allowable deductions equals net self-employment income.

2. 0

Schedule A, *Itemized Deductions*, generally does not report income items.

3. (24,000)

All ordinary and necessary business expenses are allowed in determining net self-employment income. The gross income from an individual's trade or business less allowable deductions equals net self-employment income.

4. 0

Schedule A is for allowable personal deductions. Any ordinary and necessary business expenses should be deducted on Schedule C, not Schedule A.

5. (200)

All ordinary and necessary business expenses are allowed in determining net self-employment income. The gross income from an individual's trade or business less allowable deductions equals net self-employment income.

6. 0

Schedule A is for allowable personal deductions. Any ordinary and necessary business expenses should be deducted on Schedule C, not Schedule A.

7. (18,000)

All ordinary and necessary business expenses are allowed in determining net self-employment income. The gross income from an individual's trade or business less allowable deductions equals net self-employment income.

8. 0

Schedule A is for allowable personal deductions. Any ordinary and necessary business expenses should be deducted on Schedule C, not Schedule A.

9. (500)

All ordinary and necessary business expenses are allowed in determining net self-employment income. The gross income from an individual's trade or business less allowable deductions equals net self-employment income. The scenario does not provide any other means to allocate property insurance, so one must assume it is allocated based on the percentage of the home used as the place of business. Only 10% of the home is used as the taxpayer's primary place of business.  $\$5,000 \times 10\% = \$500$

10. 0

Property insurance is not an itemized deduction.

11. (2,400)

All ordinary and necessary business expenses are allowed in determining net self-employment income. The gross income from an individual's trade or business less allowable deductions equals net self-employment income. The scenario does not provide any other means to allocate mortgage interest, so one must assume it is allocated based on the percentage of the home used as the place of business. Only 10% of the home is used as the taxpayer's primary place of business.  $\$24,000 \times 10\% = \$2,400$

12. (21,600)

Mortgage interest generally is an allowable itemized deduction. That portion deductible on Schedule C may not be deducted on Schedule A also.  $\$24,000 - \$2,400 = \$21,600$

13. (1,000)

All ordinary and necessary business expenses are allowed in determining net self-employment income. The gross income from an individual's trade or business less allowable deductions equals net self-employment income. The scenario does not provide any other means to allocate real estate taxes, so one must assume it is allocated based on the percentage of the home used as the place of business. Only 10% of the home is used as the taxpayer's primary place of business.  $\$10,000 \times 10\% = \$1,000$

14. (9,000)

Real estate taxes generally are an allowable itemized deduction. That portion deductible on Schedule C may not be deducted on Schedule A also.  $\$10,000 - \$1,000 = \$9,000$

15. (200)

All ordinary and necessary business expenses are allowed in determining net self-employment income. The gross income from an individual's trade or business less allowable deductions equals net self-employment income. The scenario does not provide any other means to allocate the furnace repair expense, so one must assume it is allocated based on the percentage of the home used as the place of business. Only 10% of the home is used as the taxpayer's primary place of business.  $\$2,000 \times 10\% = \$200$

16. 0

Furnace repair expense generally is not allowed as an itemized deduction. Conceivably, it might be involved in calculating the amount of a casualty loss, but there is no indication that there was a casualty loss.

17. 0

All ordinary and necessary business expenses are allowed in determining net self-employment income. There is no indication that there is any business purpose behind the kitchen remodeling.

18. 0

Remodeling is not allowed as an itemized deduction, although the cost will increase the taxpayer's basis in the home.

19. (600)

All ordinary and necessary business expenses are allowed in determining net self-employment income. The gross income from an individual's trade or business less allowable deductions equals net self-employment income. The scenario does not provide any other means to allocate the utilities expense, so one must assume it is allocated based on the percentage of the home used as the place of business. Only 10% of the home is used as the taxpayer's primary place of business.  $\$6,000 \times 10\% = \$600$

20. 0

Utilities are not allowed as an itemized deduction.

21. (100)

All ordinary and necessary business expenses are allowed in determining net self-employment income. The gross income from an individual's trade or business less allowable deductions equals net self-employment income. The scenario does not provide any other means to allocate the cleaning services, so one must assume it is allocated based on the percentage of the home used as the place of business. Only 10% of the home is used as the taxpayer's primary place of business.  $\$1,000 \times 10\% = \$100$

22. 0

Cleaning services related to personal-use property generally are not allowed as an itemized deduction. Conceivably, the expense might be involved in calculating the amount of a casualty loss, but there is no indication that there was a casualty loss.

23. (3,000)

Depreciation is allowed for assets used in a trade or business, to the extent of net self-employment income. The net self-employment income before the depreciation deduction is \$3,000. The given information specifies that this is depreciation for the office portion only.

24. 0

Depreciation is allowed for assets used in a trade or business, not personal-use assets. Schedule A is for allowable personal deductions. Any ordinary and necessary business expenses should be deducted on Schedule C, not Schedule A. (9840)

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### Solution 5 SIMULATION SOLUTION

IRC Citation: §2523(i)

IRC §2523(i) states, "Disallowance of marital deduction where spouse not citizen. If the spouse of the donor is not a citizen of the United States—(1) no deduction shall be allowed under this section, (2) section 2503 (b) shall be applied with respect to gifts which are made by the donor to such spouse and with respect to which a deduction would be allowable under this section but for paragraph (1) by substituting '\$100,000' for '\$10,000,' and (3) the principles of sections 2515 and 2515A (as such sections were in effect before their repeal by the Economic Recovery Tax Act of 1981) shall apply, except that the provisions of such section 2515 providing for an election shall not apply. This subsection shall not apply to any transfer resulting from the acquisition of rights under a joint and survivor annuity described in subsection (f)(6)."

(10224)