AICPA Released Questions from the 2021 Uniform CPA Exam

- Released April 2021 -

REGULATIONS

2021 AICPA Released Questions for FAR

The Key gives the correct letter answer for each question.

Key: A

The numbering system indicates the AICPA Blueprint Representative Task and Skill Level for each question.

REG.CSO.20190701: REG.001.001.002

REG.SSO.20190701: Remembering and Understanding:1

MULTIPLE CHOICE – MODERATE

According to Treasury Circular 230, which of the following rules related to the prompt disposition of pending matters before the IRS applies to CPAs?

A. Practitioners may request an extension of time of **not** more than five years related to the disposition of matters pending before the IRS to avoid any preparer penalties.

B. Practitioners will be held responsible for any of the client's interest and penalties related to the unreasonable delay of matters pending before the IRS.

C. Practitioners may **not** unreasonably delay the prompt disposition of matters pending before the IRS.

D. Practitioners must ensure that matters are concluded within three years of the date of formal notification concerning any matters pending before the IRS.

Treasury Circular 230 requirements apply to all written forms of Federal tax advice. The Circular provides the rules which govern practicing before the U.S. Internal Revenue Service (IRS).

Treasury Circular 230 Rule 10.23 addresses the prompt disposition of pending matters before the IRS, and states that “A practitioner may not unreasonably delay the prompt disposition of any matter before the IRS”.

There is no mention of the time frame in which pending matters must be disposed of. Nor is there any mention of interest and penalties related to an unreasonable delay in pending matters.

Item ID: 69879

Key: C

REG.CSO.20190701: REG.001.001.001

REG.SSO.20190701: Remembering and Understanding:1

Which of the following situations could result in a preparer penalty assessed by the IRS?

A. Preparer does **not** sign the tax return.

B. Preparer inadvertently transposes two digits on a return, and the error results in an understatement of income by $90.

C. Preparer takes an aggressive but realistic tax position that results in a decrease of tax.

D. Taxpayer tells the preparer that the taxpayer's income is $40,000, whereas it is actually $60,000.

A **tax return preparer** includes anyone who prepares for compensation, or who employs one or more persons to prepare, all or a substantial portion of any tax return or claim for refund.

There are several special obligations imposed on paid tax return preparers. Penalties for failure to comply with such obligations apply under IRC Sec. 6695, and include:

- The preparer **must sign** the **preparer's declaration** on the tax return and provide their preparer tax identification number (ie, PTIN).
- The return must be timely filed and a copy must be provided to the taxpayer.
- The preparer must retain either documentation of the taxpayer's name and tax identification number or a copy of the prepared return for three years.
- The preparer must make reasonable inquiries about the existence of such support where appropriate.

A preparer may be held responsible for errors in the preparation of the return but may escape liability based on exceptions for good faith or reasonable cause (eg, transposition errors). For example, if the taxpayer stated their income was $40,000, the preparer can normally rely on that information.

Aggressive but realistic tax positions do not result in a penalty provided there is adequate disclosure of the questionable position and there was a reasonable basis for the position. However, the preparer must sign the return or potentially incur a penalty by the IRS.

Item ID: 64781
Key: A
REG.CSO.20190701: REG.001.001.002
REG.SSO.20190701: Remembering and Understanding:1

Under the Internal Revenue Code, a CPA who was engaged in the business of preparing tax returns could incur a penalty for disclosing taxpayer information without the taxpayer's formal consent in which of the following circumstances?

A. The information was disclosed in the client's state and local tax returns that the CPA prepared.

B. The information was disclosed in the client's electronically filed tax return.

C. The information was disclosed pursuant to an attorney's solicitation request.

D. The information was disclosed pursuant to a court order.

Information that is obtained from a client in connection with the preparation of their tax return is confidential. The preparer is not permitted to reveal this information to third parties without the consent of the taxpayer, except in limited circumstances.

The most important exceptions are:

- To respond to a valid government order (eg, criminal matters and tax shelters)
- As part of a quality control peer review program
- To permit the electronic preparation or submission of the taxpayer's return
- To secure legal advice from an attorney (eg, solicitation request)

Item ID: 61661
Key: C
REG.CSO.20190701: REG.001.004.002
REG.SSO.20190701: Application:2

Which of the following events will always terminate an agent's apparent authority?

A. The principal's death.

B. The principal revoking the relationship.

C. The agent's renunciation of the relationship.

D. Both the principal and agent agree to terminate the relationship.

An **agency relationship** exists when one party **acts on behalf of another** for contractual obligations. An agent **must have authority** from the principal in order to act on the principal's behalf. There are three ways an agent may obtain this authority, one of which is apparent authority.

For example, the principal takes an action that creates the appearance to third parties that the agent has certain authority. This could result from hiring someone to a position that normally has great authority (eg, vice president), or where the customs of the profession provide certain authority.

Once an agent has authority, it can be terminated in the following ways:

Agreement – The parties originally contracted for the agency to last a period of time that has elapsed, or the parties mutually agree to terminate an agency of indefinite duration.

Unilateral – The principal dismisses the agent, or the agent resigns. Normally, either party has the power to terminate the agency at any time, even in breach of contract.

Operation of law – The agency terminates due to a provision of the law. These include **death of agent or principal**, insanity, illegality and destruction of the subject matter. The death or insanity of a party will not affect the enforceability of contracts made before such an event.

Item ID: 64691
Key: A
REG.CSO.20190701: REG.002.001.001
REG.SSO.20190701: Remembering and Understanding:1

Which of the following contracts is governed by the Sales Article of the UCC?

A. A sale of stock on the stock exchange.

B. Construction of a house by a professional builder.

C. A sale of a used car by a nonmerchant.

D. A sale of an acre of land by a real estate agent.

Article 2 of the UCC (Uniform Commercial Code) deals with contracts for the **sale of goods** (tangible personal property that is moveable) derived from statutory law, not real property (eg, an acre of land) or services (eg, construction of a house by a professional) which are covered by common law.

The seller of the goods may be a merchant or a **nonmerchant**. A merchant is a dealer in the goods involved in the transaction.

The UCC specifically excludes investment securities (eg, stock) from the definitions of "goods." Therefore, a contract for the sale of stock is not covered by Article 2 of the UCC. Contracts involving the sale of stock exchange are covered by other laws such as Article 8 of the UCC and the Securities and Exchange Act of 1934

Item ID: 61597
Key: C
REG.CSO.20190701: REG.002.002.001
REG.SSO.20190701: Application:2

Two CPAs organized their business as a general partnership. Which of the following advantages may have played a role in their selection of the general partnership form under the Revised Uniform Partnership Act?

A. The partnership form of business organization allowed them to form their business without the requirement of filing organizational documents with a government agency.

B. The partners' risk of loss from the business is limited to the amount of capital each invested in the business.

C. The partnership has a perpetual life that is **not** affected by a partner's expulsion or withdrawal.

D. The partnership can raise capital with sale of common stock.

A general partnership is an association between two or more persons to operate a business as co-owners for profit (nonprofit associations such as charitable organizations do not qualify). The establishment of a partnership can result from an agreement that is written, oral, or implied. One of the strongest advantages of a general partnership is that n**o government approval** is needed for the **creation of a partnership**, and there are no special filings required.

Partners have *joint and several liability* on the contracts and debts (voluntary) made by the partnership with third parties. If the partnership breaches a contract, the third party must attempt to recover damages out of partnership assets first, then may access the *personal assets* of the partners for remaining amounts owed.

The partnership has a perpetual life that is **not** affected by a partner's expulsion or withdrawal, provided there are two or more partners. However, as is the case here, if there are only two partners, expulsion or withdrawal of one partner dissolves the partnership. The remaining partner is not able to continue the partnership because partnerships must have at least two partners.

Partnerships are not permitted to sell common stock.

Item ID: 64311
Key: A
REG.CSO.20190701: REG.002.005.001
REG.SSO.20190701: Application:2

During the current year, an individual taxpayer completed the following stock transactions related to Alpha Corp. stock:

Date	Shares traded	Price/share
May 15	1,000 purchased	$18
June 1	1,000 purchased	$12
June 10	1,000 sold	$10

The 1,000 shares sold on June 10 had been purchased on May 15. What is the maximum amount, if any, that the taxpayer can deduct in the current year?

A. $0

B. $2,000

C. $3,000

D. $8,000

Losses from **wash sales** are not deductible. If an asset that has been sold at a **loss** is **repurchased** within **30 days** (*before or after*) of the sale, the **loss** may **not** be **deducted**, but is added to the basis of the repurchased asset. This also applies to purchases of substantially identical assets in the 30 days before or after the sale.

Here, the taxpayer sold 1,000 shares on June 10 for a realized loss of $8,000 ($10,000 amount realized − $18,000 adjusted basis). However, this is a **wash sale** as the taxpayer repurchased the same shares 9 days prior (June 1). Therefore, the taxpayer will **recognize no loss** on this transaction.

The disallowed loss will be added to the basis of the shares purchased on June 1 ($12,000 purchase price + $8,000 disallowed loss = $20,000).

Item ID: 71815
Key: A
REG.CSO.20190701: REG.003.001.003
REG.SSO.20190701: Application:2

Hull and Black are partners in a partnership. Hull has a 60% interest in the partnership's capital and profits. In year 1, Hull purchased stock for $20,000 and decided to sell the stock to the partnership at the fair market value of $8,000 in year 5. What is Hull's recognized long-term capital loss in year 5?

A. $0

B. $3,000

C. $7,200

D. $12,000

Losses on transactions between **related-parties** are **not deductible**. In addition to familial relationships, related parties also include sales between a majority owner and an entity, including a **majority partner** and a **partnership**.

Here, Hull realized a loss of $12,000 ($8,000 amount realized − $20,000 adjusted basis) on the sale of stock to the partnership. However, because Hull is a majority partner (60% capital and profits interest), the loss is disallowed (ie, no loss recognized).

Item ID: 62903
Key: A
REG.CSO.20190701: REG.003.001.004
REG.SSO.20190701: Application:2

In determining the amount of taxable gifts, the Internal Revenue Code allows each of the following, **except** the

A. Charitable contribution deduction.

B. Standard deduction.

C. Gift tax annual exclusion.

D. Marital deduction.

Taxes may be owed by those who transfer large amounts of their wealth to others during their lifetime and upon their death, based on the unified transfer tax. Transfers made during their lifetime are reported on gift tax returns (Form 709).

The amount of taxable gifts is **gross gifts less deductions/exclusions**.

Gifts include:

- Transfers of cash or property.
- Sales of property at a bargain price to another family member.
- Loans to family members on which a fair rate of interest is not charged.
- Trusts established for others in which income and/or corpus will eventually go to someone other than the taxpayer.

Deductions and exclusions include:

- Support for minors.
- **Marital deduction**.
- Payment of medical expenses or tuition of another, provided payment is made directly to health care or education provider.
- Transfers to qualified **charitable** organizations.
- Annual **gift tax exclusion** ($15,000 for 2021).

The standard deduction applies to individual tax returns, not gift tax returns.

Item ID: 71105
Key: B
REG.CSO.20190701: REG.003.003.002
REG.SSO.20190701: Remembering and Understanding:1

A real estate broker reported the following business income and expenses for the current year:

Commission income	$100,000
Expenses:	
Auto rentals	2,000
Referral fees to other brokers (legal under state law)	20,000
Referral fees to nonbrokers (illegal under state law)	8,000
Parking fines	200

What amount should be reported as net profit on Schedule C, *Profit or Loss from Business*?

A. $69,800

B. $70,000

C. $77,800

D. $78,000

Salaries and wages, including commissions, are reported when cash or other consideration is received. Deductible business expenses include all *legal* costs of running a business, such as auto rentals and referral fees. Parking fines are not deductible as they are not considered a cost of doing business.

The real estate broker should report **net profit of $78,000** ($100,000 - $2,000 - $20,000) on Schedule C, *Profit or Loss from Business*.

Item ID: 60687
Key: D
REG.CSO.20190701: REG.004.002.000
REG.SSO.20190701: Application:2

Jefferson's investment income consisted of $2,000 in interest from a U.S. Treasury bond and $1,000 interest from a municipal bond. Jefferson also paid $4,000 in investment interest expense. Assuming that Jefferson itemizes, what amount can Jefferson deduct for investment interest expense?

A. $1,000

B. $2,000

C. $3,000

D. $4,000

Investment interest income consists of interest payments, dividends, capital gains, and rental income. It does not include state and/or local **municipal bond interest.** All other government interest is taxable (eg, U.S. Treasury bonds).

Investment interest expenses include interest paid on a loan where the proceeds of the loan were used to purchase property held for investment. It also includes accounting and legal fees for investment advice and services, as well as safe deposit box fees.

Investment interest expense is offset against taxable interest income. Since Jefferson only has $2,000 of taxable investment interest, they can only **deduct $2,000** of investment interest expense. This is only an option if Jefferson decides to forego the standard deduction (which is $12,550 for single filers in 2021).

Item ID: 64217
Key: B
REG.CSO.20190701: REG.004.003.000
REG.SSO.20190701: Application:2

Which of the following statements about treatment of net passive activity losses of an individual is correct?

A. Passive activity losses in excess of passive activity income are permanently disallowed.

B. Net passive activity losses can be offset against portfolio income in the current year.

C. Net passive activity losses are suspended and carried forward to offset passive income of future years.

D. A taxpayer can elect either to offset net passive activity losses against active and portfolio income or to carry the losses forward to future years.

Passive income is collected from business activities that require no material active involvement (such as a limited partner or rental activities). Passive losses are **limited to passive income only**. There is no carryback option available, but net passive losses can be **carried forward indefinitely**. They can offset future passive income or gains on the sale of the activity.

Passive activity rules also allow up to $25,000 in passive losses to be deducted against ordinary income if modified adjusted gross income (MAGI) is $100,000 or less. The deduction is subject to phase outs of $1 for every $2 of MAGI above $100,000, until $150,000 when it is completely phased out.

Portfolio income consists of money received from investments such as dividends, interest, and capital gains, as well as royalties received from investment property.

Item ID: 62995
Key: C
REG.CSO.20190701: REG.004.004.000
REG.SSO.20190701: Remembering and Understanding:1

Which of the following is true about the taxation of a partner in a partnership?

A. Partners must include their share of partnership capital gains as ordinary income on their personal income tax returns.

B. If a partner's loss is limited in one tax year because of the at-risk rules, it may be carried forward to a later year, subject to that year's at-risk computation.

C. Passive activity losses may be used to offset both passive activity income and portfolio income.

D. A partner's loss is limited to the fair market value of their partnership interest.

A partnership (P/S) is an association between two or more parties to operate a business for profit. Partnerships do not pay income taxes but are required to file annual information returns (Form 1065), reporting partnership income and the allocation of that income to the various partners.

Since the items will be reported on the tax returns of the partners, the partnership must segregate items that have special treatment on the partners' tax returns. The partnership prepares a Schedule K that summarizes the partnership's ordinary income and then separately lists all items that are not ordinary (ie, separately stated items). Examples of separately stated items are dividends, capital gains and losses, and tax-exempt interest.

A Schedule K-1 is prepared for each partner showing that partner’s allocated share of all items (ie, ordinary business income/loss and separately stated items) on the Schedule K. The separately stated items *retain their character* on the partners' tax return (eg, capital gains are treated as capital gains, not ordinary income).

Ordinary losses are only deductible to the extent they meet the basis, at-risk, and passive activity limitations. Losses are only deductible to the extent the partner has basis (amount invested) in the partnership, *not FMV*. Losses are further limited by the partner's amount at-risk. Finally, if the activity is passive, the losses are limited to the partner's *passive income*.

Any **losses** that are **suspended** based on these limitations are **carried forward** to future years until the partner has **sufficient** basis, **at-risk amounts**, or passive income.

Item ID: 64299
Key: B
REG.CSO.20190701: REG.004.005.000
REG.SSO.20190701: Application:2

A partner receives the following as part of a liquidating distribution:

	Basis	FMV
Cash	$12,000	$12,000
Accounts receivable (A/R)	0	4,000
Land	8,000	3,000
Total	$20,000	$19,000

The partner's basis in the partnership immediately prior to the distribution is $25,000. What is the partner's basis in the A/R and the land immediately after the liquidating distribution?

A. A/R: $4,000, land: $3,000.

B. A/R: $0, land: $13,000.

C. A/R: $13,000, land: $0.

D. A/R: $0, land: $8,000.

A **liquidating distribution** is the settlement of the partner’s entire interest in the business (ie, partner’s **basis must be reduced to $0**). In general, the objective of the liquidation rules is to allocate all of the partner's basis in the partnership to the assets the partner receives. A secondary objective is to keep the basis of the assets the same inside and outside the partnership. It may be impossible to achieve both objectives simultaneously.

The partner's basis in the partnership is first reduced by the basis allocated to cash, unrealized receivables, and inventory. Any remaining basis is allocated to other property received. The partner's basis in cash, unrealized receivables, and inventory is always equal to the partnership's basis in the assets (ie, carryover basis).

The partner's basis in the A/R after the liquidating distribution is $0 as the partnership had $0 basis in A/R. The partner’s post-distribution basis in land is $13,000 ($25,000 partnership basis - $12,000 cash - $0 basis in A/R).

Item ID: 72089
Key: B
REG.CSO.20190701: REG.005.001.000
REG.SSO.20190701: Application:2

A C corporation has the following capital gains and capital losses for years 1 and 2:

	Capital Gains	Capital Losses
Year 1	$250,000	$300,000
Year 2	425,000	350,000

If the C corporation had **no** capital gains or losses prior to year 1, what is the minimum net capital gain that can be reported for year 2?

A. $25,000

B. $50,000

C. $75,000

D. $425,000

When a corporation sells assets that are held for investment, the difference between the tax bases and proceeds from sale are recognized as capital gains and losses, taxed at the regular 21% corporate tax rate.

Capital losses for corporations are **deductible only to the extent of capital gains** (ie, NET capital losses are not deductible).

- A corporation's net capital losses can be carried back 3 years and then forward 5 years to offset capital gains in those years.
- All loss carrybacks and carryforwards are considered short term (S/T).

Capital losses of $250,000 are deductible for Year 1 (the extent of the capital gains). The remaining $50,000 ($300,000 Y1 capital loss - $250,000 Y1 capital gain) can be carried forward (CF) to Year 2. For Year 2, **net capital gains are $25,000** ($425,000 - $350,000 - $50,000 CF).

Item ID: 504555
Key: A
REG.CSO.20190701: REG.005.002.000
REG.SSO.20190701: Application:2

The following information relates to three corporations, Mauve, Teal, and Fuchsia:

Stockholders	Mauve	Teal	Fuchsia
Adams	10%	18%	22%
Jefferson	40%	22%	0%
Washington	50%	0%	0%
Brook	0%	33%	70%
Smith	0%	27%	8%
Total	100%	100%	100%

None of the corporations has made a subchapter S election. Which of the following statements about the corporations is true?

A. All three corporations must file a consolidated return.

B. All three corporations can elect to file a consolidated return.

C. Two of the three corporations can elect to file a consolidated return.

D. None of the corporations can file a consolidated return.

An **affiliated group** of corporations may **elect** to file a **consolidated tax return** instead of filing separately. An affiliated group is one or more chains of includible corporations connected through stock ownership, with a **common parent corporation owning at least 80%** of the voting power and total value of stock in at least one other includible corporation.

If one corporation has control (80%+), consolidated returns may be prepared. Here, there is no affiliated group as there is no *corporation* that owns at least 80% of another corporation.

Item ID: 87816
Key: D
REG.CSO.20190701: REG.005.003.004
REG.SSO.20190701: Application:2

An S corporation is owned equally by A and B, whose respective stock bases at the beginning of the year are $12,000 and $13,000. During the year, the corporation had $100,000 in ordinary business income and $5,000 in tax-exempt income. The corporation distributed $50,000 to each shareholder for the year. What is owner B's stock basis at year end?

A. $15,500

B. $15,000

C. $13,000

D. $10,500

S corporation income is allocated to shareholders who report their shares on their personal tax returns (flow-through entity). Separately stated items (SSI) are reported separately from the S corporation's ordinary income/deductions because they are subject to different limitations when reported on the individual tax return (ie, 1040). Tax-exempt income is an SSI.

Any SSI items are passed through according to their percentage of ownership. If there is no change in ownership during the year, use the percentage of stock owned to determine the amount passed though.

While tax-exempt income is not taxable, it does increase basis. If the income did not increase basis, it would become taxable income on disposition of the S corporation interest in the form of a larger gain or a smaller loss.

Owner B's ending stock basis is $15,500, calculated as follows:

	A's basis	**B's basis**
Beginning balance	$12,000	$13,000
Ordinary income (50/50)	50,000	50,000
Tax-exempt income (50/50)	2,500	2,500
Distribution	(50,000)	(50,000)
Ending basis	$14,500	**$15,500**

Item ID: 63503

Key: A

REG.CSO.20190701: REG.005.004.003

REG.SSO.20190701: Application:2

J and K formed a general partnership by contributing $10,000 each. The partnership incurred a loss of $30,000 in year 1, income of $6,000 in year 2, and income of $10,000 in year 3. What is the adjusted basis for tax purposes of each partner's interest in the partnership at the end of each year?

	Year 1	Year 2	Year 3
A.	($5,000)	($2,000)	$3,000
B.	$0	$0	$0
C.	$0	$0	$3,000
D.	$5,000	$2,000	($3,000)

A partner's basis generally equals the amount the partner has "at risk" in the partnership. A partner's basis is not identical to the partner's Equity/Capital since a partner's basis includes the partner's share of partnership liabilities to creditors and the partner's capital account does not.

Basis is increased by contributions of assets, borrowings and other debt incurred by the partnership, and allocations of partnership income. Basis is reduced for asset distributions, allocation of partnership losses, and repayments of debt.

Partnership basis can never decline below $0. Any losses that would cause the basis to go below $0 are suspended and carried forward to the next year. The adjusted basis of each partner's interest in the end of each year is $0, $0, and $3,000, calculated as follows:

	Partner basis	**Suspended Loss**
Beginning balance	$ 0	
Contributions	10,000	
Year 1 loss	(15,000)	
Adjusted basis, Year 1	**$ 0**	**($5,000)**
Year 2 income	3,000	
Less carryover loss from Year 1	(5,000)	3,000
Adjusted basis, Year 2	**$ 0**	**($2,000)**
Year 3 income	5,000	
Less carryover loss from Year 1	(2,000)	2,000
Adjusted basis, Year 3	**$ 3,000**	**$0**

Item ID: 62557
Key: C
REG.CSO.20190701: REG.005.005.002
REG.SSO.20190701: Application:2

Partner A has a 40% interest in ABC partnership, with a basis of $40,000. ABC increased its liabilities by $125,000. What is Partner A's basis in ABC as a result of the increase in liabilities?

A. ($10,000)

B. $0

C. $40,000

D. $90,000

A partner's basis generally equals the amount the partner has "at risk" in the partnership. **Basis is increased** by contributions of assets, borrowings and other **debt incurred by the partnership**, and allocations of partnership income. Basis is reduced for asset distributions, allocation of partnership losses, and repayments of debt.

Because a partnership does not have liability protection, the partners may ultimately be responsible for the debt of the partnership. As a result, a partner's basis in a partnership is increased for their share of the debt.

Partnership basis can never decline below $0. Any losses that would cause the basis to go below $0 are suspended and carried forward to the next year.

Partner A's basis in ABC is increased by their share of the partnership's debt. Partner A's basis as a result of the increase is liabilities **is $90,000** [$40,000 + (40% × $125,000)].

Item ID: 62477
Key: D
REG.CSO.20190701: REG.005.005.005
REG.SSO.20190701: Application:2

MULTIPLE CHOICE – HARD

An individual taxpayer rejected the IRS examiner's findings in an audit of the taxpayer's tax return. What will the IRS do in response to the taxpayer's rejection?

A. Issue a 30-day letter.

B. Begin immediate collection action.

C. Issue a statutory notice of deficiency.

D. Refer the case to the IRS Independent Office of Appeals.

The IRS has a well-established process for settling tax disputes. After the **IRS assesses** a **deficiency** and the **taxpayer disagrees**, the **IRS** then **sends** the taxpayer a **30-day letter** explaining its reasoning along with a copy of the audit examination report. This gives the taxpayer 30 days to accept the proposed change, skip the appeal process, or request a conference with an appeals officer.

If the taxpayer disagrees with the appeal determination or does not respond to the 30-day letter, then the IRS issues a notice of deficiency (ie 90-day letter). The 90-day letter gives the taxpayer 90 days (150 days for nonresident taxpayers) to either pay the deficiency or file a petition with the U.S. Tax Court.

Although *not explained* in the 90-day letter, there is an alternative to petitioning the U.S. Tax Court. Taxpayers can pay the deficiency and then file a claim for refund with the IRS. The IRS will invariably deny the refund claim. At that point, the taxpayer can sue the IRS for the refund in the U.S. Court of Federal Claims or U.S. Federal District Court.

Item ID: 502531
Key: A
REG.CSO.20190701: REG.001.003.001
REG.SSO.20190701: Application:2

Each of the following constitutes substantial authority for a taxpayer to take a tax position, **except:**

A. A determination letter conclusion in which the taxpayer is named.

B. A technical advice memorandum conclusion in which the taxpayer is named.

C. An affirmative statement in a revenue agent's report with respect to a prior year of the taxpayer.

D. A private letter ruling in which the taxpayer is named and that is inconsistent with a subsequently issued Treasury Regulation.

Taxpayers can rely on any IRS interpretation of their specific tax that specifically mentions the taxpayer. If the IRS interpretation is favorable to the position the taxpayer plans to take in a tax return, then the taxpayer can rely on that IRS interpretation as substantial authority for that position.

A private letter ruling (PLR) is formal interpretations of how the IRS feels the then current tax laws should be applied to the taxpayer's situation. The taxpayer can rely on this interpretation to take a tax position in a tax return. The IRS will be required to follow the PLR. However, if subsequent Treasury Regulations are issued that are inconsistent with the PLR, the PLR is no longer valid. In the tax rules hierarchy Treasury Regulations command higher authority than a PLR.

Item ID: 92519
Key: D
REG.CSO.20190701: REG.001.003.004
REG.SSO.20190701: Remembering and Understanding:1

Sumner is an accountant accused of negligence by a client. Which of the following defenses should Sumner argue?

A. Actual fraud was lacking.

B. The negligence was **not** the proximate cause of the client's losses.

C. Contributory negligence negates liability for a client's losses.

D. Scienter was lacking.

Accounting services are performed under a contract between the accountant and the client. For this reason, the most obvious liability facing an accountant is common law negligence due to breach of contract (eg, failing to fulfill the terms of the agreement). The **party suing** (ie, plaintiff) the **accountant** for **common law negligence must** prove five elements: causal relationship, absence of due care, material misstatement, privity, and suffered a loss.

As a defense, the CPA can attempt to prove any one of these elements is *not* present. Therefore, if the **CPA proves** that the **negligence** was **not** the **proximate cause** (ie, main cause) of the plaintiff's loss, the **plaintiff loses** the negligence case.

A client's contributory and comparative negligence (D1879) would not eliminate a CPA's negligence. Instead, it would reduce the amount of damages the CPA is required to pay. For example, assuming the client's contributory negligence is 50% and total loss is $100,000, the CPA is liable for only $50,000.

Proving lack of actual fraud or scienter (ie, the intention to mislead) is not a defense for negligence.

Item ID: 73485
Key: B
REG.CSO.20190701: REG.001.004.001
REG.SSO.20190701: Remembering and Understanding:1

A business entered into a contract with a construction company to remodel the office of the business. The contract called for the remodeling to be completed by October 1, year 1. On July 1, year 1, the construction company sent an email to the business informing the business that it will not finish the job. What recourse does the business have?

A. The business can consider the construction company to be in breach of contract on July 1, year 1, and immediately seek remedies.

B. The business can consider the construction company to be in breach on July 1, year 1, but **cannot** seek remedies until October 1, year 1.

C. The business **cannot** consider the construction company to be in breach of contract until October 1, year 1, and may **not** seek any remedies until then.

D. The business must notify the construction company on or after July 1, year 1, of its intent to hold the contractor in breach, and the contractor has 30 days to respond before the contract is breached.

Anticipatory breach of contract occurs when **one party** (the construction company) **informs** the **other party** to the contract (the business) that **performance will not occur** (ie, will breach the contract). At this point the non-breaching party (the business) can cancel the contract or immediately sue for damages.

In this scenario, the construction company informed was supposed to complete the office remodel by October 1 of year 1. One July 1, year 1 the construction company notified the business that it would not meet the October 1 deadline. At that point, the construction company is in anticipatory breach of the contract. Therefore, on July 1, Year 1 the business can consider the construction company to be in breach of contract, and immediately seek remedies.

Item ID: 82542
Key: A
REG.CSO.20190701: REG.002.002.003
REG.SSO.20190701: Application:2

Which of the following statements regarding a creditor's rights against a surety is correct?

A. The surety is primarily liable to the creditor.

B. A surety does **not** have the right of subrogation.

C. The creditor must collect payment from the surety through a wage garnishment.

D. The creditor must first attempt to collect the debt from the primary debtor before being able to collect from the surety.

A suretyship is an arrangement in which a surety, either as cosigner or guarantor, agrees to be answerable to a creditor for a claim against another person (eg, a debtor). Basically, the surety will make sure that the creditor is paid if the debtor is unable to pay the loan. Therefore, the **surety** is **primarily liable** to the **creditor**.

If the surety pays the debt on behalf of the debtor, one right the surety has is the right of subrogation against the debtor. That is, the surety "steps in the shoes" of the original creditor and can then pursue legal options against the debtor for repayment.

Wage garnishment against a surety is never an option for a creditor.

If the surety only guaranteed the debt, then the creditor must first attempt to collect the debt from the primary debtor before being able to collect from the surety (as guarantor). However, if the surety is a co-signer on the debt, the creditor can collect directly from the surety (as co-signer) without first attempting to collect from the debtor.

Item ID: 82872
Key: A
REG.CSO.20190701: REG.002.003.001
REG.SSO.20190701: Remembering and Understanding:1

A seven-person partnership lacks a partnership agreement. Under the Revised Uniform Partnership Act, how many votes are required to approve an extraordinary transaction of partnership business?

A. Four votes.

B. Five votes.

C. Six votes.

D. Seven votes.

Under the Revised Uniform Partnership Act, general partners have the right to participate in the management of the partnership. In effect, the partners are mutual agents and principals for one another. Therefore, they have the power to make binding contracts to transact partnership business on the partnership's behalf (ie, agency power). For such contracts, each general partner has joint and several liability. This is true even when the partnership lacks a partnership agreement.

However**, certain actions** that either are **outside** the **normal course of business** (ie, extraordinary transactions) or significantly affect each partner's liability **require** the **unanimous consent** of **all partners** (here, all seven votes). Examples of extraordinary transactions that require unanimous consent include:

- Admitting a new partner
- Guaranteeing the debts of a third party (suretyship)
- Admitting to or submitting a legal claim in court or arbitration
- Sale (outside the normal course of business) or pledge of partnership property
- Transactions with third parties who knew a partner's actual authority was exceeded.

Item ID: 63867
Key: D
REG.CSO.20190701: REG.002.005.002
REG.SSO.20190701: Remembering and Understanding:1

A taxpayer received a painting valued at $8,000 as a gift. The donor purchased the painting a year earlier for $4,500 and paid no gift tax on the transfer. Nine months later, the taxpayer sold the painting for $9,000. What is the amount and classification of the capital gain?

A. $1,000 short-term.

B. $1,000 long-term.

C. $4,500 short-term.

D. $4,500 long-term.

When a taxpayer receives a **gift** of **appreciated property**, the cost basis and acquisition date of the property to the donee is the same as for the donor (**carryover basis** and **carryover holding period**).

If the donor pays gift taxes on a gift, the portion of the tax paid attributable to the appreciation in the property's value at the date of the gift over the donor's basis is added to the donee's basis.

In this scenario, the taxpayer received appreciated property ($8,000 FMV versus $4,500 basis) and the donor did not pay gift tax. Therefore, the taxpayer will have carryover basis ($4,500) and holding period (one year before the gifting date). The taxpayer will recognize a **$4,500 gain** ($9,000 amount realized − $4,500 adjusted basis) classified as **long-term** (one year carryover + 9 months).

Item ID: 60933
Key: D
REG.CSO.20190701: REG.003.001.001
REG.SSO.20190701: Application:2

A taxpayer's property with an adjusted basis of $75,000 and fair market value of $105,000 was condemned by the state. The taxpayer received $100,000 from the state as compensation for the property, and six months after the condemnation purchased a replacement property for $100,000. What are the tax consequences of this transaction?

A. No gain is recognized, and the basis in the new property is $75,000.

B. No gain is recognized, and the basis in the new property is $100,000.

C. A gain of $25,000 is recognized, and the basis in the new property is $100,000.

D. A gain of $30,000 is recognized, and the basis in the new property is $100,000.

An involuntary conversion occurs when a taxpayer's property is partially or whole destroyed, stolen, or seized (eg, eminent domain by a government). A direct conversion occurs when replacement property is provided to the taxpayer. An indirect conversion occurs when the taxpayer receives a monetary settlement.

In an indirect conversion, the **gain** may be **deferred** if qualified **replacement property** is **acquired** within the statutory **time limit**. This period is generally two years and extended to **three years** in the case of **condemnation** or eminent domain.

Taxpayers will recognize realized gain to the extent that the proceeds are not reinvested in qualified property. The **basis** of the **replacement property** is the **fair market value** of the new property **less** any **deferred gain**.

In this scenario, the taxpayer acquired replacement property within the three year period. Therefore, the realized gain of $25,000 ($100,000 amount realized − $75,000 adjusted basis) is deferred. No gain is recognized. The basis in the replacement property is $75,000 ($100,000 fair market value − $25,000 deferred gain).

Item ID: 68813
Key: A
REG.CSO.20190701: REG.003.001.002
REG.SSO.20190701: Application:2

In the current year, Madison inherited investment property from a parent's estate with a fair market value of $200,000. The parent had a basis in the asset of $100,000. Madison sold the property for $150,000 in the year the parent died. What is Madison's gain or loss on the sale?

A. $50,000 short-term gain.

B. $50,000 long-term gain.

C. $50,000 short-term loss.

D. $50,000 long-term loss.

The receipt of an inheritance is nontaxable. The **basis** for **inherited property** is the basis used to determine estate taxes for the decedent. Usually, this is **fair market value** (FMV) on the **date of death**. The **holding period** for inherited property is **always long-term**.

In this scenario, Madison recognizes a **$50,000 loss** ($150,000 amount realized − $200,000 FMV on the date of death). As the property was inherited, the holding period is **long-term**.

Item ID: 73627
Key: D
REG.CSO.20190701: REG.003.001.003
REG.SSO.20190701: Application:2

A taxpayer employed full time as an engineer has the following income items:

Self-employment income	$50,000
Rental income	15,000
Dividend income	2,000
Long-term capital gain	1,500
Short-term capital loss	1,000

What amount is the taxpayer's passive income?

A. $2,500

B. $15,000

C. $17,500

D. $18,500

For tax purposes, income is categorized into one of three categories: passive activity income, portfolio income, or active business income. **Passive income** is from activities in which the taxpayer is **not** a **material participant**. Portfolio income is from investments (eg, dividends, interest, capital gains and losses). Active business income is from sources where the taxpayer is a material participant.

Rental income is **generally passive** unless the taxpayer actively participates in the management of the property. Dividend income and capital gains and losses are portfolio income. Self-employment income is active business income. Therefore, the taxpayer has $15,000 of passive income.

Item ID: 82574
Key: B
REG.CSO.20190701: REG.004.001.000
REG.SSO.20190701: Application:2

A taxpayer reported the following in a tax year:

Salary	$122,000
Capital gain dividends	3,700
Partnership short-term capital loss	(6,300)

The taxpayer acquired the partnership interest during the year in exchange for a capital contribution of $2,750, and there were no additional items affecting the taxpayer's basis in the partnership. What is the taxpayer's adjusted gross income for the year?

A. $119,400

B. $122,000

C. $122,700

D. $122,950

Salary is always included in adjusted gross income. Capital gains and capital losses must be netted. Individual taxpayers may deduct up to $3,000 of capital losses each year. Any remaining losses are carried forward indefinitely.

A partnership is a flow-through entity. The ordinary business income or loss and separately stated items are passed through to the partners who report the items on their tax returns. Losses allocated to a partner are **only deductible** to the extent the partner meets three hurdles: **basis**, at-risk amount, and passive activity limits.

In this scenario, the partner paid **$2,750** for the partnership interest, which then becomes the taxpayer's **basis** in the partnership. The taxpayer can **only deduct $2,750** of the $6,300 capital loss due to the **basis limit**.

Therefore, the taxpayer's adjusted gross income is $122,950 ($122,000 salary + $3,700 capital gain dividend - $2,750 capital loss from the partnership after basis limitation).

Item ID: 502563
Key: D
REG.CSO.20190701: REG.004.005.000
REG.SSO.20190701: Application:2

Which of the following taxpayers would **not** qualify for the filing status of head of household?

A. A single taxpayer whose spouse died in the preceding tax year and who has a dependent child living in the household.

B. A married taxpayer with a dependent child in the household who has lived apart from the taxpayer's spouse for the entire year due to abandonment.

C. A single taxpayer who provides over one-half of the support for a dependent parent in a nursing home but does **not** have a qualifying child in the household.

D. A single taxpayer who provides one-half of the support for a dependent child who has lived almost the entire year at a U.S. university while pursuing an undergraduate degree.

On every return, the taxpayer(s) must select the filing status, which is used to determine the tax rates on income and the value of various deductions, thresholds, and limitations.

To qualify for **head of household** (HOH) status, the taxpayer must meet **two** conditions. The taxpayer must **not be married** at **year end** (or **considered unmarried** because the spouse left **6 months** or more before year end, **and**

The taxpayer must **maintain** a **home** as the principal place of residence for over 50% of the year (other than for **temporary absences** for illness or **education**) and provide more than 50% of the costs of maintaining a household for:

- Dependent qualifying relative living with the taxpayer, include uncle, aunt, nephew, niece or certain step-relatives and in-laws. Other relatives and unrelated persons may be dependents if they live with the taxpayer for the entire year, but NOT qualify them as HOH.
- "Qualifying child", stepchild, or grandchild living with the taxpayer (must be a dependent).
- **Parent** must be a dependent but **need not live** with the taxpayer.

Qualifying widow status is available to **unmarried taxpayers** whose spouse died in the **prior two years** and with whom they qualified to file a joint return in the year of death. The widow must provide over 50% of the cost of maintaining a principal residence of a **dependent child**.

Here, a single taxpayer whose spouse died in the preceding tax year who has a dependent child living in the household would be a **qualifying widow**.

Item ID: 502131
Key: A
REG.CSO.20190701: REG.004.006.000
REG.SSO.20190701: Application:2

Which of the following can be subject to the net investment income tax?

A. An individual who is a resident of the U.S.

B. A domestic C corporation.

C. A nonresident alien.

D. A trust whose unexpired interests are devoted to a charitable purpose.

A surtax called the Unearned Income Medicare Contribution Tax (ie, net investment income tax [NIIT]) is imposed on the unearned income of **individuals**, **estates**, and **trust**. The tax is only assessed on **U.S. citizens** and **resident aliens** with net investment income exceeding certain thresholds (around $200,000 for single taxpayers). While trusts are generally subject to the tax, **trusts** that are **exempt from income tax**, grantor trusts, and perpetual care trusts are exempt from the NIIT.

The tax does not apply to C corporations or nonresident aliens. A trust whose interests are devoted to charitable purposes are exempt from income taxes and therefore exempt from the NIIT.

Item ID: 77052
Key: A
REG.CSO.20190701: REG.004.007.000
REG.SSO.20190701: Remembering and Understanding:1

A C corporation incurred a $438,000 capital loss in year 4 and has the following tax information:

	Year 4	Year 3	Year 2	Year 1
Capital gain (loss)	($438,000)	$11,000	$21,000	$ 0
Taxable income (loss)	750,000	31,000	17,000	25,000

What amount of capital loss is available for carryover to future tax years?

A. $406,000

B. $410,000

C. $427,000

D. $438,000

Capital gains and losses must be netted to determine a net capital gain or net capital loss. **C corporations** cannot deduct a capital loss against ordinary income. **Capital losses** are **carried back** to offset net capital gains in one of the **previous three** tax years, and then **carried forward** to offset net capital gains in the next **five years**. The losses must first be carried back to the third prior year (eg, a loss in Y4 is first carried back to Y1) and any remaining loss is carried forward.

However, when a loss is carried back to a prior year, it *cannot* create a *net operating loss* in the prior year. In this scenario, Year 2 would have a net operating loss of $4,000 ($17,000 taxable income - $21,000 capital gain) without the capital gain. Therefore, only $17,000 of capital gain is available for offsetting the Year 4 capital loss.

The Year 4 loss is first carried back to Year 1 with no capital gain. The loss then offsets $17,000 from Year 2 leaving $421,000 to carry to Year 3. The Year 3 capital gain of $11,000 is offset leaving **$410,000** of capital loss to carry forward to Year 5.

Item ID: 502183
Key: B
REG.CSO.20190701: REG.005.003.002
REG.SSO.20190701: Application:2

Lark owns 10% of Baltic Corp., a calendar year-end C corporation. On June 30, year 2, Baltic made a $250,000 pro-rata cash distribution to its stockholders. Baltic had a $40,000 deficit in accumulated earnings and profits on January 1, year 2, and current earnings and profits for year 2 as follows:

1st quarter	$110,000
2nd quarter	(10,000)
3rd quarter	80,000
4th quarter	60,000
	$240,000

What portion of Lark's June 30 distribution would be classified as a nontaxable return of capital, assuming that Lark's tax basis in Baltic stock is $20,000?

A. $1,000

B. $5,000

C. $15,000

D. $19,000

Distributions made by corporations to its shareholders are generally **taxable** as **dividends** to the **extent** of **Earnings & Profits (E&P)**. Any **remaining distributions** reduce the investor's basis in their shares as a **nontaxable return of capital**. Any dividends beyond basis are capital gains.

E&P is separated into current E&P (CEP) for the current year and accumulated E&P (AEP) for the undistributed earnings and profits from all prior years.

Distributions are **dividends** up to the amount of **CEP**. Any distributions in excess of CEP are dividends up to the **balance** of **AEP**.

In this scenario, Baltic made a distribution of $250,000. The distribution is a dividend up to the amount of CEP ($240,000). AEP is negative, so the remaining distribution ($10,000) is a nontaxable return of capital (ROC). For each shareholder, 4% ($10,000 ROC / $250,000 distribution) of the distribution is a nontaxable ROC. Lark owns 10% and received a $25,000 distribution. Lark reports **$1,000** ($25,000 × .04) as a nontaxable return of capital.

Item ID: 66405
Key: A
REG.CSO.20190701: REG.005.003.003
REG.SSO.20190701: Application:2

A C corporation conducted all of its business activities in States A and B and generated $1 million of pretax income in year 1. The tax rate is 10% in State A and 5% in State B. Both states apportion the taxable income of multistate corporations by employing an equally-weighted three-factor apportionment formula. Neither state allows a tax deduction for state corporate income taxes. At the end of year 1, the corporation reported the following percentages for its activities in each state for the purpose of calculating the state apportionment factors:

	State A	State B
Payroll expense	50%	50%
Sales	75%	25%
Net property value	25%	75%

What is the corporation's year 1 state apportionment ratio for State B?

A. 25%

B. 50%

C. 75%

D. 150%

Corporations operating in multiple states are required to **apportion** their **business income** among the states in which they operate. States set their apportionment formula based on three factors: **sales**, **payroll**, and **property**. Many states use an **equally weighted three-factor** formula. However, some states are shifting to a single sales-factor formula.

The equally weighted three-factor formula **adds** each of the **three factors** and **divides** by **three** to arrive at the apportionment factor.

In this scenario, State B has an apportionment factor of **50%** [(.50 + .25 + .75) / 3].

Item ID: 65721
Key: B
REG.CSO.20190701: REG.005.003.005
REG.SSO.20190701: Application:2

Which of the following events may result in termination of S corporation status for a company?

A. The company issued shares to an estate.

B. The company issued shares to a qualified profit-sharing plan.

C. The company issued shares to a partnership in which all the partners are U.S. citizens.

D. The company issued two series of the same class of stock with identical liquidating and distribution rights but different voting rights.

A corporation may elect to be treated as an S corporation (a flow-through entity) if it meets certain S corporation requirements:

- All shareholders must be individuals, estates, or certain trusts (ie, for the benefit of individuals).
- The individuals must be either citizens or residents of the U.S.
- C corporations, S corporations, partnerships, limited liability companies, and big trusts are not permitted to be shareholders.

In addition to ownership restrictions, S corporations must be domestic corporations and must have only one class of stock (ie, each share must have equal distribution and liquidation rights). Differences in voting rights do not constitute a separate class of stock.

Item ID: 64283
Key: C
REG.CSO.20190701: REG.005.004.001
REG.SSO.20190701: Remembering and Understanding:1

Two partners each have a 50% interest in the partnership's capital and profits. The December 31, year 3, balance sheet for the partnership is listed below.

	Adjusted Basis	Fair Market Value
Cash	$ 25,000	$ 25,000
Land	75,000	375,000
Total Assets	$100,000	$400,000

	Adjusted Basis	Fair Market Value
Capital A	$ 50,000	$200,000
Capital D	50,000	200,000
Total Capital	$100,000	$400,000

On January 1, year 4, one partner purchased half of the other partner's interest in the partnership for $100,000. A valid Section 754 election is in place. What is the adjusted tax basis of the partnership's assets after this transaction?

A. $100,000

B. $175,000

C. $200,000

D. $400,000

A partnership may file a Sec. 754 election to adjust the basis of partnership property whenever there is a transfer of a partnership interest (eg, sale or exchange). When this **election** is in effect, the **partnership** must **increase/decrease** its **inside basis** in partnership assets to make the new partner's outside basis equal to their share of inside basis in partnership property.

Partner A paid $100,000 for a 25% interest (1/2 of a 50% interest). The inside basis associated with the 25% interest was $25,000 ($100,000 adjusted basis of assets × 25%). Therefore, the Section 754 adjustment is $75,000 ($100,000 purchase price - $25,000 adjusted basis). The adjusted basis in the assets after the transaction is **$175,000** ($100,000 adjusted basis + $75,000 Section 754 adjustment).

Item ID: 100669
Key: B
REG.CSO.20190701: REG.005.005.007
REG.SSO.20190701: Application:2

Which of the following statements is true about the taxation of trusts?

A. The basis of property donated to a trust is fair market value at date of gift.

B. Distributed income is subject to double taxation.

C. The income that is passed through to a beneficiary has the same tax attributes in the hands of the beneficiary as when it is received by the trust.

D. The trust's income is taxed at a flat rate.

Trusts are separate legal entities created by grantors. Assets transferred to a trust have carryover basis.

Trusts are subject to single taxation. The trust pays tax on undistributed income and the beneficiaries pay tax on distributions. As such, **distributions** passed through to **beneficiaries retain** its **character** and **tax attributes**. Trusts are subject to a progressive tax rate structure.

Note: Trusts are no longer tested as of July 2021.

Item ID: 64307
Key: C
REG.CSO.20190701: REG.005.007.001
REG.SSO.20190701: Remembering and Understanding:1

TASK BASED SIMULATIONS

Item: **500084**

Scroll down to complete all parts of this task.

A federal income tax paid preparer who is a CPA prepared a return for an individual client who wanted to minimize taxable income. The preparer took undisclosed tax return positions that effectively reduced income by $80,000 and for which the preparer did not perform research to determine whether there was a reasonable position. The preparer charged a fee of $1,250 and filed the return after obtaining the appropriate signature.

The return was selected for audit by the Internal Revenue Service. At the conclusion of the audit, the IRS disallowed the tax return position that effectively reduced income by $80,000. The IRS determined that the amount of underpayment related to the income was $26,000. Because the preparer was unable to find support for the positions taken on the return, the IRS prevailed in court actions against the preparer for fraud.

Consult the authoritative literature regarding this situation. For the violations listed in the table below, enter the penalties that apply to the preparer. In column B, enter the maximum applicable penalty amount in dollars; in column C, enter the maximum applicable term of imprisonment in years. Independently evaluate each violation and determine each penalty. If no penalty amount or prison term applies, enter a zero (0) in the appropriate cell.

	A	B	C
1	**Violation**	**Maximum penalty amount**	**Maximum term of imprisonment**
2	Understatement of tax liability due to an unreasonable position	$1,000	0
	If a tax return preparer knew (or should have known) of the unreasonable position, the maximum penalty is the greater of $1,000 or 50% of the income derived by the preparer. Derived income is the fee charged to the client ($1,250). 50% of $1,250 is $625, so the maximum penalty would be $1,000. There is no jail time (IRC §6694(a)(1)(B).		
3	Willful attempt to understate tax liability	$5,000	0
	The maximum penalty for a willful attempt to understate the tax liability is $5,000 or 75% of the derived income of the preparer. Derived income is the fee charged to the client ($1,250). 75% of $1,250 is $937.50, so the maximum penalty would be $5,000. There is no jail time (IRC §6694(b)(1)(A).		
4	Aiding and abetting an understatement of tax liability	$1,000	0
	The maximum penalty for aiding and abetting an understatement of tax liability is $1,000, with no jail time (IRC §6701(b)(1).		
5	Willfully delivers false or fraudulent returns	$10,000	1
	The maximum penalty for anyone who will fully delivers or discloses fraudulent or false material is $10,000 or imprisonment of not more than 1 year, or both (IRC §7207).		

6	Willfully subscribes a return under penalties of perjury	$100,000	3
	Any person who receives, withholds, destroys, mutilates, or falsifies records, or makes a false statement, related to the condition of the taxpayer liable in respect to the tax is guilty of a felony. The maximum fine is $100,000 and/or not more than 3 years in prison (IRC §7206(5)(B).		
7	Accuracy-related penalty on underpayments	$0	0
	Accurancy-related penalties are assessed on the taxpayer, not the tax preparer (IRC §6662(a).		

Exhibits Information

There are no exhibits for this item.

Blueprint Information

CSO: 001.001.002

Skill: Application

Representative task: Recall situations that would result in federal tax return preparer penalties.

Item: **500511**

On March 13, Folder purchased 100 shares of Straddle Co. stock for $57 per share. On April 5, Folder sold the shares for $50. Folder later purchased 50 shares of Straddle for $55 per share on April 12. Which section and subsection of the Internal Revenue Code determines the basis of Folder's shares purchased on April 12?

Enter your response in the answer fields below. Guidance on correctly structuring your response appears above and below the answer fields.

Type the subsection here.

A correctly formatted IRC subsection is a lower case letter.

IRC§ 1091 (d)

Examples of correctly formatted IRC responses are IRC§1(a), IRC§56(a), IRC§25A(a), IRC§162(a), IRC§263A(a), IRC§1245(a), IRC§2032A(a) and IRC§1400Z-1(a).

U.S. Code § 1091(d)

UNADJUSTED BASIS IN CASE OF WASH SALE OF STOCK

If the property consists of stock or securities the acquisition of which (or the contract or option to acquire which) resulted in the nondeducibility (under this section or corresponding provisions of prior internal revenue laws) of the loss from the sale or other disposition of substantially identical stock or securities, then the basis shall be the basis of the stock or securities so sold or disposed of, increased or decreased, as the case may be, by the difference, if any, between the price at which the property was acquired and the price at which such substantially identical stock or securities were sold or otherwise disposed of.

Exhibits Information

There are no exhibits for this item.

Blueprint Information

CSO: 003.001.001

Skill: Application

Note: There is no specific representative task associated with research prompts.

Item: **502063**

Scroll down to complete all parts of this task.

Fasta Partnership, LP, a limited partnership, was formed on January 1, year 2. Individuals Thomas Green and Judith Smith each contributed cash for an interest in the partnership. Fasta operates a clothing manufacturing business and has a calendar year end.

Green, the general partner, has a 60% ownership interest and actively participates in the management of the business on a daily basis. Green bears the economic risk of loss relating to all of Fasta's outstanding liabilities, except for Fasta's loan payable to Smith.

Smith, the limited partner, has a 40% ownership interest and does not actively participate in the operations of the partnership. Smith is not obligated to restore any negative capital accounts upon liquidation of the partnership.

A letter from Green and a copy of Fasta's adjusted tax trial balance for the year ended December 31, year 3, can be found in the exhibits above.

For each item requested below, enter the applicable amount in the appropriate cell as a positive, whole value. If a response is zero, enter a zero (0).

Explanations:

Item	Amount
Green's share of ordinary business income or loss for year 3	$55,200

Income and separately stated items reported by the partnership are allocated to the partners on Schedules K-1. The partners then include their share of the income on their personal tax returns and pay tax on the income, even if it is not distributed.

The activities of the partnership are divided between ordinary business net income/loss and separately stated items. Separately stated items are not part of ordinary business income/loss because they receive special tax treatment on the partner's tax return.
Interest income is the only separately stated item. The interest expense paid to Midland Bank is ordinary business interest. Ordinary business income is calculated below:

			Green	Smith
Sales Revenue		$455,000		
Less: Ordinary expenses				
COGS	(117,000)			
Salary expense	(192,000)			
Depreciation	(26,000)			
General & administrative	(20,000)			

Real estate taxes	(6,000)			
Interest expense	(2,000)	(363,000)		
Ordinary business income		$92,000	**$55,200**	$36,800
			60%	**40%**

Smith's share of net separately stated income or deduction items for year 3	$400

Interest income is the only separately stated item. The interest expense paid to Midland Bank is ordinary business interest. After calculating ordinary business income and the separately stated items, the amounts are allocated to the partners based on their profit interests. Green is allocated 60% and Smith is allocated 40%, as shown below:

			Green	**Smith**
Sales Revenue		$455,000		
Less: Ordinary expenses				
COGS	(117,000)			
Salary expense	(192,000)			
Depreciation	(26,000)			
General & administrative	(20,000)			
Real estate taxes	(6,000)			
Interest expense	(2,000)	(363,000)		
Ordinary business income		$92,000	$55,200	$36,800
			60%	**40%**
Separately Stated Items				
Interest income		$1,000	$600	**$400**

Green's share of bank debt at December 31, year 3	$46,000

During the year, a portion of the principal balance on the Midland Bank loan was repaid. The outstanding balance at the end of the year was $46,000 ($6,000 current liability + $40,000 long-term debt). Per the information provided, Green bears the economic risk of loss for all liabilities. Therefore, the entire $46,000 debt will be allocated to Green.

Smith's share of bank debt at December 31, year 3	$0

During the year, a portion of the principal balance on the Midland Bank loan was repaid. The outstanding balance at the end of the year was $46,000 ($6,000 current liability + $40,000 long-term debt). Per the information provided, Green bears the economic risk of loss for all liabilities. Therefore, the entire $46,000 debt will be allocated to Green and $0 will be allocated to Smith, a limited partner.

Green's share of accounts payable at December 31, year 3	$25,000

Per the information provided, Green bears the economic risk of loss for all liabilities. Therefore, the entire accounts payable balance of $25,000 is allocated to Green and $0 is allocated to Smith.

Smith's share of accounts payable at December 31, year 3	$0
Per the information provided, Green bears the economic risk of loss for all liabilities. Therefore, the entire accounts payable balance of $25,000 is allocated to Green and $0 is allocated to Smith.	
Green's share of partner loan to Fasta at December 31, year 3	$0
As Smith loaned $15,000 *directly to Fasta*, the entire balance is allocated to Smith and $0 is allocated to Green.	
Smith's share of partner loan to Fasta at December 31, year 3	$15,000
As Smith loaned $15,000 *directly to Fasta*, the entire balance is allocated to Smith and $0 is allocated to Green.	

Blueprint Information

CSO: 005.005.005

Skill: Analysis

Representative task: Analyze the impact of partnership liabilities as they relate to the general partners and limited partners for federal income tax purposes.

Exhibits Information

Exhibits included in this item	**1. Client Letter** **2. Adjusted Tax Trial Balance**

Exhibit for Item: **502063**

Exhibit 1: **Client Letter**

Fasta Partnership, LP
923 Silver Way
Pedricktown, WY 82600

January 15, year 4

Dear CPA:

Enclosed is a copy of our tax basis trial balance as of December 31, year 3. All book/tax differences have been properly reflected.

The following information relates to transactions that occurred during year 3:

- On December 31, year 3, Judith Smith loaned Fasta $15,000. Interest on the loan is calculated at a market rate.
- On July 1, year 3, Fasta borrowed $50,000 from Midland Bank to purchase equipment. The loan has a 10-year term, and interest is calculated at a market rate. Payments are due monthly and began on September 1, year 3. Based on the loan documents, this is a recourse liability.
- Depreciation expense has been calculated using MACRS. In addition, Fasta decided not to elect a Section 179 deduction for year 3.
- Interest income of $1,000 was received on Fasta's savings account throughout the year.

Please contact me if you have any additional questions regarding the trial balance.

Sincerely,

Thomas Green
Thomas Green
Fasta Partnership, LP
General Partner

Exhibit for Item: **502063**

Exhibit 2: **Adjusted Tax Trial Balance**

Fasta Partnership, LP
Year Ended December 31, year 3
Adjusted Tax Trial Balance

		Year 3	
Account number	**Account description**	**Debit**	**Credit**
1000	Cash	55,000	
1200	Accounts receivable	22,000	
1400	Inventory	33,000	
1600	Machinery and equipment	70,000	
1625	Building	243,000	
1650	Accumulated depreciation		38,000
1675	Land	27,000	
1700	Prepaid expenses	3,000	
2000	Accounts payable		25,000
2100	Loan payable to partner - Judith Smith		15,000
2400	Current portion of long-term debt - Midland Bank		6,000
2500	Long-term debt - Midland Bank		40,000
3000	Partners' capital		236,000
4000	Sales revenue		455,000
4200	Cost of goods sold	117,000	
4500	Interest income		1,000
5000	Salary expense and employee benefits	192,000	
5500	Depreciation expense	26,000	
6200	General and administrative expenses	20,000	
6400	Real estate taxes	6,000	
7000	Interest expense - Midland Bank	2,000	
	Profit for the year	93,000	