CPA Exam Review Questions Provided Courtesy of Gleim CPA Review
1. Study Unit 6.1 [Source: CPA 21 REG-29]

**Required:** The expenses deducted to calculate net profit.

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

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Commission income</td>
<td>$100,000</td>
</tr>
<tr>
<td>Expenses:</td>
<td></td>
</tr>
<tr>
<td>Auto rentals</td>
<td>$2,000</td>
</tr>
<tr>
<td>Referral fees to other brokers (legal under state law)</td>
<td>$20,000</td>
</tr>
<tr>
<td>Referral fees to nonbrokers (illegal under state law)</td>
<td>$8,000</td>
</tr>
<tr>
<td>Parking fines</td>
<td>$200</td>
</tr>
</tbody>
</table>

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

**Explanation**

1. **Choice “D” is correct.** A deduction from gross income is allowed for all ordinary and necessary expenses paid or incurred during a tax year in carrying on a trade or business. An expenditure may be nondeductible if allowing the deduction would frustrate public policy. No amount can be deducted from gross income unless allowed by the Internal Revenue Code. Fines and penalties paid to a governmental entity and fees incurred that are deemed illegal by state laws are not deductible. Thus, net profit is $78,000 ($100,000 commission income – $2,000 auto rentals – $20,000 referral fees to other brokers).

2. Choice “A” is incorrect. Allowing a deduction for fines and penalties paid to a governmental entity and illegal bribes and kickbacks (i.e., fees incurred that are deemed illegal by state laws) would frustrate public policy. Therefore, such items are not deductible.
3. Choice “B” is incorrect. Allowing a deduction for fees incurred that are deemed illegal by state laws would frustrate public policy. Therefore, such fees are not deductible.

4. Choice “C” is incorrect. Allowing a deduction for fines and penalties paid to a governmental entity would frustrate public policy. Therefore, such fines and penalties are not deductible.
2. Study Unit 6.2 [Source: CPA 21 REG-13]

**Required:** The entity subject to the net investment income tax.

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.

**Explanation**

1. **Choice “A” is correct.** The tax is imposed on the lesser of an individual’s net investment income or any excess of modified adjusted gross income for the tax year over a specified threshold. This tax essentially applies FICA taxes to income that previously was not subject to the taxes. Net investment income tax applies to a resident of the U.S.

2. Choice “B” is incorrect. A domestic C corporation is not subject to the net investment income tax, just as FICA tax does not apply to a corporation’s income.

3. Choice “C” is incorrect. Net investment income tax does not apply to nonresident aliens.

4. Choice “D” is incorrect. Net investment income tax does not apply to trusts, just as FICA tax does not apply to a corporation’s income.
3. Study Unit 8.2 [Source: CPA 21 REG-10]

**Required:** The amount of passive activity income.

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

<table>
<thead>
<tr>
<th>Income Item</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Self-employment income</td>
<td>$50,000</td>
</tr>
<tr>
<td>Rental income</td>
<td>15,000</td>
</tr>
<tr>
<td>Dividend income</td>
<td>2,000</td>
</tr>
<tr>
<td>Long-term capital gain</td>
<td>1,500</td>
</tr>
<tr>
<td>Short-term capital loss</td>
<td>1,000</td>
</tr>
</tbody>
</table>

What amount is the taxpayer’s passive income?

A. $2,500  
B. $15,000  
C. $17,500  
D. $18,500

**Explanation**

1. Choice “B” is correct. A passive activity is either a trade or business in which the person does not materially participate or a rental activity. Passive activity rules do not apply to:
   1. Active income/loss/credit
   2. Portfolio income/loss/credit
   3. Casualty and theft losses, vacation home rental, qualified home mortgage interest, business use of home, or a working interest in an oil or gas well held through an entity that does not limit the person’s liability

   Therefore, the $15,000 rental income is the only income item listed that is considered passive income.

2. Choice “A” is incorrect. Dividend income and capital gain/loss items are considered portfolio income and are not passive income items.

3. Choice “C” is incorrect. Only rental income is considered passive income.

4. Choice “D” is incorrect. Dividend income and long-term capital gain are not considered passive income.
4. Study Unit 9.3 [Source: CPA 21 REG-26]

**Required:** The taxpayer’s maximum deduction for the current year.

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

<table>
<thead>
<tr>
<th>Date</th>
<th>Shares traded</th>
<th>Price/share</th>
</tr>
</thead>
<tbody>
<tr>
<td>May 15</td>
<td>1,000</td>
<td>$18</td>
</tr>
<tr>
<td></td>
<td>purchased</td>
<td></td>
</tr>
<tr>
<td>June 1</td>
<td>1,000</td>
<td>$12</td>
</tr>
<tr>
<td></td>
<td>purchased</td>
<td></td>
</tr>
<tr>
<td>June 10</td>
<td>1,000 sold</td>
<td>$10</td>
</tr>
</tbody>
</table>

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

**Explanation**

1. **Choice “A” is correct.** To prevent abusive transactions in which a taxpayer sells property at a loss but quickly repurchases the property, leaving the taxpayer in the position of still having the property but with the benefit of recognizing a loss, a current loss realized on a wash sale of securities is not recognized. A wash sale occurs when substantially the same securities are purchased within 30 days before or after being sold at a loss.
   1. The disallowed loss is added to the basis of the stock purchased in the wash sale.
   2. The holding period includes that of the originally purchased stock.
   3. Spouses are treated as one person.

   The stock sold on June 10 was purchased less than 30 days prior on May 15; therefore, the disallowed loss is added to the basis of the stock purchased in the wash sale.

2. **Choice “B” is incorrect.** The amount of $2,000 is representative of the $2 decrease in price from June 1 of $12 to June 10 of $10, which is not deductible.
3. Choice “C” is incorrect. An individual may deduct a net capital loss in the current year up to the lesser of $3,000 ($1,500 if MFS) or ordinary income. The amount of $3,000 is not deductible in this instance.

4. Choice “D” is incorrect. The amount of $8,000 is considered a realized loss and is added to the basis of the stock purchased on June 1.
5. Study Unit 10.5 [Source: CPA 21 REG-28]

**Required:** The item not allowed in determining gift tax liability.

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.

**Explanation**

1. **Choice “B” is correct.** The standard deduction is not allowed in determining the amount of taxable gifts. See below for the formula to calculate gift tax liability.

   GIFT AMOUNT
   
   FMV on date of gift, for
   
   All gifts in the calendar year
   
   - Exclusions
     
     Annual exclusion
     
     $15,000 per done
     
     Paid (directly) on behalf of
     
     Medical care
     
     Education tuition
   
   - Deductions
     
     Marital
     
     Charitable

   = TAXABLE GIFTS FOR CURRENT
   
   + Taxable gifts for prior years
   
   = TAXABLE GIFTS TO DATE
   
   × Tax Rate
   
   = TENTATIVE GIFT TAX
   
   - (Prior year’s gifts × Current tax
   
   - Applicable credit amount
   
   = GIFT TAX LIABILITY

2. **Choice “A” is incorrect.** The charitable contribution deduction is allowed in determining the amount of taxable gifts.
3. Choice “C” is incorrect. The gift tax annual exclusion is allowed in determining the amount of taxable gifts.

4. Choice “D” is incorrect. The marital deduction is allowed in determining the amount of taxable gifts.
6. Study Unit 13.6 [Source: CPA 21 REG-16]

**Required:** The state apportionment ratio for State B.

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:

<table>
<thead>
<tr>
<th></th>
<th>State A</th>
<th>State B</th>
</tr>
</thead>
<tbody>
<tr>
<td>Payroll expense</td>
<td>50%</td>
<td>50%</td>
</tr>
<tr>
<td>Sales</td>
<td>75%</td>
<td>25%</td>
</tr>
<tr>
<td>Net property value</td>
<td>25%</td>
<td>75%</td>
</tr>
</tbody>
</table>

What is the corporation’s Year 1 state apportionment ratio for State B?

A. 25%
B. 50%
C. 75%
D. 150%

**Explanation**

1. **Choice “B” is correct.** Once nexus is established, net income must be accurately allocated or apportioned among the various jurisdictions. The Uniform Division of Income for Tax Purposes Act provides a uniform method for allocating and apportioning a business’s income. The rules for the business’s nonbusiness income are different than those for the business’s business income. Allocation is used to identify nonbusiness income to a specific state or local taxing authority for income derived solely from assets held for investment purposes. Apportionment uses the formula below to calculate the average amount of business income a company brings in by conducting operations within the taxing state.

\[
\text{Property factor} + \frac{\text{Payroll factor} + \text{Sales factor}}{3}
\]

Therefore, the state apportionment ratio for State B is 50% \([(75\% + 50\% + 25\%) ÷ 3]\).
2. Choice “A” is incorrect. The corporation’s Year 1 state apportionment ratio for State B is calculated by averaging the sum of the three percentages of the payroll, sales, and property activities in State B; it is not based on the single factor of sales.

3. Choice “C” is incorrect. The average amount of business income a company brings in by conducting operations within the taxing state is calculated by dividing the three factors by the number of factors (i.e., 3), not by the number of states (i.e., 2), nor is it based on the single factor of net property value.

4. Choice “D” is incorrect. The ratio 150% is the numerator of the state apportionment formula and is required to be divided by 3 to calculate the actual apportionment ratio.
7. Study Unit 14.2 [Source: CPA 21 REG-36]

Required: The calculation of an S corporation shareholder’s stock basis.

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

Explanation

1. **Choice “A” is correct.** The adjusted basis of the shareholder’s stock is calculated at year end with increases for the shareholder’s pro rata share of all income items of the S corporation, including tax-exempt income, that are separately stated and any nonseparately stated income of the S corporation. The adjusted basis of the shareholder’s stock must also be decreased by the shareholder’s pro rata share of distributions by the S corporation. Owner B’s basis is $15,500 [$13,000 + ($100,000 × 50%) + ($5,000 × 50%) – $50,000].

2. Choice “B” is incorrect. Owner B has a 50% pro rata share of the ordinary business income and tax-exempt income of the S corporation.

3. Choice “C” is incorrect. The adjusted basis of the shareholder’s stock is calculated at year end with increases for the shareholder’s pro rata share of all income items of the S corporation, including tax-exempt income.

4. Choice “D” is incorrect. The shareholder’s basis is increased (not decreased) by the shareholder’s $2,500 ($5,000 × 50%) portion of the tax-exempt income.
Acknowledgement

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