Question 1 of 36

During a major sports event, a taxpayer rented his primary residence to spectators for 10 days. The taxpayer's rental income and expenses were as follows:

Rental income	$10,000
Prorated mortgage and taxes	1,000
Advertising	500
Commissions	1,000

How much net rental income must the taxpayer report on the tax return?

A. $0 ✓

B. $7,500

C. $8,500

D. $10,000

Explanation:

	Rental of personal residence	Vacation home rental
Characteristics	Residence with minimal rental use	Residence with significant rental use
Rental use	Rent ≤ 14 days	Rent > 14 days AND Personal >14 days*
Income	Excluded	Included
Expenses	No	Rental expenses deductible

*Personal use exceeds greater of 14 days or 10% of rental days.

The treatment of rental income and expenses for a dwelling unit that is also used for **personal purposes** depends on the number of rental days. If a home is **rented** for **14 or fewer days** during the tax year, the property is considered a **personal residence**. Homes rented for more than 14 days (ie, significant rental) are considered vacation homes.

For personal residences, rental **income** is **excluded** from gross income, and **rental expenses** (eg, commissions, advertising) are **not deductible**. Property-related expenses (eg, mortgage interest, real property taxes) are *not allocated to rental use*.

In this scenario, the taxpayer's property is a personal residence because it was rented for 10 days. The rental income is excluded from income, and the rental expenses are not deductible. Had the property been rented for more than 14 days, it would be considered a vacation home, and $7,500 of rental income would be taxable **(Choice B)**.

(Choices C and D) Rental incomes of $8,500 and $10,000 incorrectly assume that the residence is a vacation home. The property was rented for fewer than 14 days; therefore, there are no tax consequences.

Things to remember:
A dwelling unit that is used as a home and is rented for 14 or fewer days during the tax year is considered a personal residence. Any rental income is excluded from income, and related rental expenses are not deductible.

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For the year ended December 31, Year 3, a C corporation reported an operating loss of $55,000 and the following additional items:

Net operating loss deduction (carryover from Year 2)	$13,400
Dividends received deduction	$6,600
Charitable contributions made during Year 3	$5,000

What is the corporation's net operating loss for Year 3?

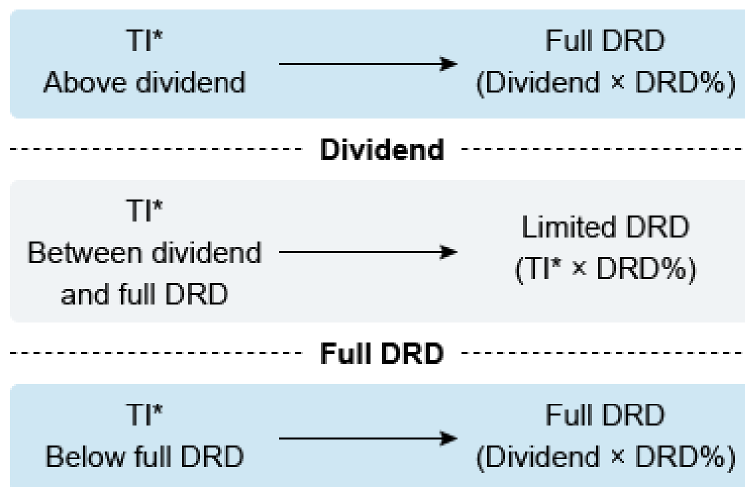
A. $75,000

B. $68,400

C. $61,600 ✓

D. $60,000

Explanation:



Many corporations are not profitable every year. If a corporation's allowable deductions exceed its gross income

for tax purposes, a net operating loss (NOL) is generated. **NOLs** are useful because they can **offset taxable income** (TI) in other tax years. However, NOL carryforwards from a prior year **cannot** be used in a **loss year** because there is **no TI** available to offset **(Choices A and B)**. Likewise, charitable contributions are limited to 10% of TI and are not deductible in a loss year.

The dividends-received deduction (DRD) allows C corporations to deduct a portion—generally 50%, 65%, or 100%—of dividends received from other domestic corporations, depending on ownership percentage. Normally, this deduction is limited by TI.

However, if taking the **full DRD** would **create or increase** an NOL, the **limitation** is **waived**, and the **full deduction** is **allowed**. Thus, the correct NOL for Year 3 is **$61,600** ($55,000 + $6,600).

(Choice D) An NOL of $60,000 is incorrect because it ignores the current-year DRD and treats the charitable contribution as deductible in the current year. Instead, the current-year DRD should increase the current-year loss, and unused charitable contributions are carried forward for five years.

Things to remember:
The full dividends-received deduction (DRD) may be claimed if taking the deduction results in or increases a net operating loss (NOL). However, NOL carryforwards can only offset taxable income (TI) in future years and cannot be used to create or increase another NOL.

Question 3 of 36

Wilson sold his factory to Glenn. As part of the contract, Glenn assumed the existing mortgage on the property which was held by Security Bank. Regarding the rights and duties of the parties, which of the following is correct?

A. The promise by Glenn need not be in writing to be enforceable by Security.

B. Security is a creditor beneficiary of Glenn's promise and can recover against him personally in the event of default. ✓

C. Security is a mere incidental beneficiary since it was not a party to the assignment.

D. Wilson has no further liability to Security.

Explanation:

(Choice A) This answer is incorrect because the Statute of Frauds would apply since the agreement involves the sale of an interest in land. Also, Glenn's promise would constitute a promise to answer for the debt of another. Consequently Glenn's promise must be in writing.

(Choice B) This answer is correct because Wilson intended to discharge his debt owed to Security by the agreement he entered into with Glenn. Since Wilson and Glenn obviously intended Security to benefit from their agreement, Security is a creditor beneficiary with the right to recover against Glenn personally in the event of a default.

(Choice C) This answer is incorrect because an incidental beneficiary is a third party whom the contract was not intended to benefit. Wilson and Glenn did intend to benefit Security; therefore, Security is not an incidental beneficiary.

(Choice D) This answer is incorrect because the fact that the buyer assumes personal liability on the mortgage does not release the seller, the original mortgagor. An assumption of the mortgage creates a surety relationship, with the buyer being the principal debtor and the seller acting as the surety. Wilson's liability is terminated only when Security, the mortgagee, specifically releases Wilson or when Glenn pays the mortgage in full.

Question 4 of 36

In which of the following circumstances will a tax return preparer **not** be assessed an understatement penalty for a reportable transaction on a tax return?

A. The position has a reasonable chance of being sustained.

B. The position has a high probability of being sustained.

C. The position has a more likely than not chance of being sustained. ✓

D. The position has enough substantial authority that it will be sustained.

Explanation:

Tax return preparer understatement penalties	
Probability of success	**Significance of threshold**
More likely than not > 50%	• Understatement penalty applies for **reportable transactions** that do not meet this threshold
Substantial authority ≈ 40%	• Understatement penalty applies for **undisclosed tax positions** that do not meet this threshold
Realistic possibility ≈ 33%	• AICPA SSTSs* require members to meet this threshold as a minimum for undisclosed tax positions
Reasonable basis ≈ 20%	• $5,000 penalty applies for positions that do not meet this threshold (ie, **frivolous** tax positions) • Positions meeting this threshold must be disclosed to avoid penalty

*Statements on Standards for Tax Services (no longer tested on CPA exam).

Certain activities are listed as reportable transactions (eg, tax shelters) under the federal tax code and must be formally disclosed in a tax return. Specific penalties apply to reportable transactions because the IRS has determined that they have the potential for abusive tax avoidance.

A tax return preparer (eg, CPA) can **avoid** an **understatement penalty** for a **reportable transaction** if it is **more likely than not** that the tax position taken in the tax return **will be upheld** if challenged. This is the highest threshold applied to tax positions (ie, > 50% likelihood).

(Choice A) A reasonable chance (ie, basis) threshold applies to frivolous tax positions (ie, not reportable transactions) that are adequately disclosed on the tax return and have a 20% chance of being sustained.

(Choice B) A high probability is not a defined threshold used in the tax preparer understatement penalty rules.

(Choice D) A substantial authority threshold requires a 40% likelihood that the tax position will be sustained on the merits. It applies to tax positions (eg, hobby losses) that are *not* disclosed on the tax return.

Things to remember:
A tax return preparer (eg, CPA) can avoid an understatement penalty for a reportable transaction (eg, tax shelters) if it is more likely than not that the tax position taken in the return will be upheld if challenged. This is the highest threshold applied to tax positions (ie, > 50% likelihood).

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Which of the following credits can result in a refund even if the individual had no income tax liability?

A. Lifetime learning credit

B. Credit for the elderly or the disabled

C. Earned income credit ✓

D. Adoption credit

Explanation:

(Choice A) The earned income credit is a refundable credit and can result in a refund even if the individual had no tax withheld from wages.

(Choice B) The earned income credit is a refundable credit and can result in a refund even if the individual had no tax withheld from wages.

(Choice C) The earned income credit is a refundable credit and can result in a refund even if the individual had no tax withheld from wages.

(Choice D) The earned income credit is a refundable credit and can result in a refund even if the individual had no tax withheld from wages.

Question 6 of 36

Which of the following actions requires an agent for a corporation to have a written agency agreement?

A. Purchasing office supplies for the principal's business.

B. Purchasing an interest in undeveloped land for the principal. ✓

C. Hiring an independent contractor to landscape the principal's land.

D. Hiring a debt collector to collect a business debt owed the principal.

Explanation:

Necessary to form an agency relationship	
Required	• Mutual consent ("meeting of the minds") • Legal capacity of principal (only) • Agent's ability to follow principal's instructions

May be required	• Written agreement if Statute of Frauds applies, such as in:
	  ◦ Real estate
	  ◦ Agency relationship to exceed 1 year
	  ◦ Suretyship

Not required	• Consideration • Legal capacity of agent

An agreement to enter an agency relationship must be in writing only if the statute of frauds (SOF)applies. Common **reasons why** the **SOF applies** in an agency relationship are:

- **Sale of goods for $500 or more:** The agent will enter contracts in the amount of $500 or more to sell goods. Contracts to purchase goods (eg, office supplies) when it is not apparent that the contracts will be for $500 or more are not enough to trigger SOF application **(Choice A)**.
- **Real estate:** The agent will be making **contracts** with third parties that **involve** the **purchase** or **sale** of **real estate**. However, the SOF does not apply solely because the contact *involves* real estate (eg, landscaping services) **(Choice C)**.
- **Suretyship:** The agent will enter suretyship agreements (ie, cosign or guarantee debt) on behalf of the principal. In that case, the SOF applies and the agency agreement must be in writing. However, merely hiring a debt collector to collect a debt does not involve suretyship **(Choice D)**.

Things to remember:

An agency agreement must be in writing if the statute of frauds (SOF) applies. Common reasons the SOF will apply to the agency agreement are that it involves the sale of

goods worth $500 or more, the purchase or sale of real estate, or suretyship (ie, cosigning or guaranteeing debt).

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Fender has a Schedule C auto repair business. In the first year of operations, Fender purchased diagnostic equipment that cost $75,000 and power tools that cost $10,000. Fender elected to expense the $10,000 of power tools in Year 1 according to Section 179 (Election to Expense Certain Depreciable Business Assets). Assume that Fender elected out of using bonus depreciation. Both the diagnostic equipment and power tools have a seven-year class life. The double-declining balance MACRS depreciation rates for seven-year property using half-year convention are as follows:

Recovery year	Depreciation rate
1	0.1429
2	0.2449
3	0.1749
4	0.1249
5	0.0893
6	0.0892
7	0.0893
8	0.0446

What amount of depreciation expense should Fender report in Year 2?

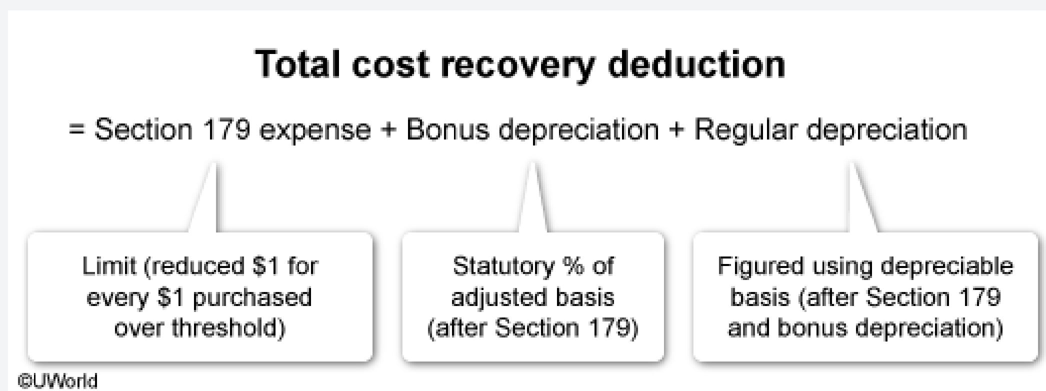
A. $10,717.50

B. $12,146.50

C. $18,367.50 ✓

D. $20,816.50

Explanation:



To incentivize investment and simplify recordkeeping, Section 179 and bonus depreciation allow taxpayers to fully or partially deduct certain depreciable property when placed in service. Accordingly, the initial depreciable basis of such property is adjusted by subtracting these additional first-year expenses. **Section 179** is applied **first**, **bonus**