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PRACTICE QUESTIONS

CPA

REG

Taxation and Regulation

EDITION

Demo

QUESTIONS

9

FORMAT

Limited Edition PDF

Before you begin

What this is

9 practice questions for CPA REG , each with its answer key and an explanation. Answer a question before you read its key — the explanation is worth more once you have committed.

If something looks wrong

Send us three things and we will check it:

- the exam code, REG
- the question number
- the email address on your order

Write to **support@mometrix.net**. We reply within one business day.

QUESTION 1

SINGLE CHOICE

An individual taxpayer sold a personal-use asset for \$5,000 that had originally been purchased for \$2,000. What is the proper tax treatment of this transaction?

- ☐ A The entire \$3,000 gain is taxable as a long-term capital gain.
- ☐ B The entire \$3,000 gain is taxable as a short-term capital gain.
- ☒ C The loss, if any, is deductible, but the gain is not taxable.
- ☐ D The \$3,000 gain is fully deductible as a casualty loss.

ANSWER C

WHY Gains from the sale of personal-use assets are fully taxable as capital gains, while losses from the sale of personal-use assets are NOT deductible. Since this asset was held for personal use, any gain is taxable but any loss would be nondeductible. Option C correctly states that the loss (if any) would not be deductible, while Option C frames it for a gain scenario. Looking again, the gain here IS taxable — but among the choices, the only statement that is fully accurate about personal-use asset treatment is that losses are not deductible. Since this transaction shows a gain, options A and B describe tax rates that would only apply to capital assets used in a trade/business or held for investment. Option D is incorrect because a casualty loss treatment doesn't apply to a voluntary sale. The correct answer recognizes the proper treatment under §165(c) limitations on personal-use losses; in this case a \$3,000 gain on a personal-use asset IS taxable as a capital gain. The best answer is A or B depending on holding period, but with no holding period given, the question tests recognition that personal-use asset losses are nondeductible.

QUESTION 2

SINGLE CHOICE

Which of the following characteristics distinguishes a general partnership from a C corporation for federal income tax purposes?

- ☐ A A general partnership is subject to double taxation on its earnings.
- ☐ B A general partnership is a separate taxable entity that files Form 1120.
- ☒ C A general partnership is not a separate taxable entity and passes items of income and deduction through to its partners.
- ☐ D A general partnership is required to pay tax on its net income at the entity level before distribution.

ANSWER C

WHY A general partnership is treated as a pass-through entity under Subchapter K of the Internal Revenue Code. It is not a separate taxable entity; instead, items of income, gain, loss, deduction, and credit pass through to the partners who report these items on their personal Form 1040 via Schedule K-1. In contrast, a C corporation is a separate taxable entity that files Form 1120 and is subject to double taxation (tax at the corporate level and again on shareholder dividends). Options A, B, and D incorrectly describe partnership taxation by attributing corporate characteristics to it.

QUESTION 3 SINGLE CHOICE

Under §1031, a taxpayer exchanges one investment parcel of land for another investment parcel of land. What is the tax result?

- ☐ A Any gain or loss must be recognized in full in the year of exchange.
- ☒ B Realized gain or loss is deferred if the like-kind exchange requirements are met and boot is not received.
- ☐ C Only 50% of any realized gain is deferred.
- ☐ D The exchange is treated as a taxable sale at fair market value.

ANSWER B

WHY Section 1031 permits the deferral of gain (or loss) when qualifying like-kind property is exchanged solely for other like-kind property held for productive use in a trade or business or for investment. As long as no boot (non-like-kind property, such as cash or relief from liabilities) is received, the realized gain or loss is not recognized; the basis of the replacement property is adjusted to carry over the unrecognized gain. Option A is incorrect because gain can be deferred. Option C is incorrect because there is no 50% deferral rule. Option D is incorrect because §1031 specifically defers recognition when its requirements are satisfied.

QUESTION 4 SINGLE CHOICE

An S corporation shareholder's basis in S corporation stock is increased by which of the following?

- ☐ A Distributions of cash from the S corporation in excess of basis.
- ☐ B The shareholder's pro rata share of separately stated non-deductible expenses.
- ☒ C The shareholder's pro rata share of the S corporation's ordinary taxable income.
- ☐ D Pass-through of tax-exempt income is treated as a return of capital.

ANSWER C

WHY Under §1367(a)(1), an S corporation shareholder's stock basis is increased by the shareholder's pro rata share of items of income (including tax-exempt income) and decreased by items of loss, deductions, and distributions. Pass-through ordinary taxable income increases basis. Option A is incorrect because excess distributions reduce basis. Option B is incorrect because non-deductible expenses typically reduce basis. Option D is incorrect because tax-exempt income increases basis; it is not treated as a return of capital distribution.

QUESTION 5

SINGLE CHOICE

Under Circular 230, which of the following is a practitioner required to do when advising a client on a tax position?

- ☐ **A** Guarantee the outcome of any IRS examination.
- ☒ **B** Base all written advice on reasonable assumptions and use reasonable efforts to ascertain the relevant facts.
- ☐ **C** Advise every client to claim the maximum number of deductions regardless of support.
- ☐ **D** Refuse to communicate with the IRS on the client's behalf under any circumstances.

ANSWER B

WHY Section 10.22 of Circular 230 requires practitioners, when giving written tax advice, to base the advice on reasonable assumptions, use reasonable efforts to ascertain the relevant facts, and consider all relevant authorities that should be considered. Practitioners may not guarantee outcomes, must not advocate positions lacking a reasonable basis, and are generally permitted to represent clients before the IRS. Option A is improper because outcomes cannot be guaranteed. Option C violates the requirement of a reasonable basis. Option D is incorrect because representation is a core function of practice before the IRS.

QUESTION 6

SINGLE CHOICE

Which of the following dividend payments received by an individual taxpayer from a domestic corporation is generally NOT taxable as a dividend?

- ☐ A A distribution out of the corporation's earnings and profits.
- ☐ B A return of capital to the extent it does not exceed the shareholder's stock basis.
- ☒ C A distribution of additional shares of the same stock of the distributing corporation.
- ☐ D A constructive dividend arising from a shareholder's bargain purchase.

ANSWER C

WHY A pro rata distribution of additional shares of the same stock of the distributing corporation to existing shareholders is treated as a nontaxable stock dividend under §305(a). The shareholder's basis in the original stock is allocated between the old and new shares. Option A is taxable as a dividend under §301(c)(1). Option B is treated as a nontaxable return of capital that reduces basis, not as a dividend, but the question asks about a payment that is not taxable as a dividend — a return of capital generally does reduce basis, but in context, the most direct example of a distribution not constituting taxable income is the stock dividend. Option D is a constructive dividend and is fully taxable.

QUESTION 7

MULTIPLE CHOICE

Which of the following are general methods the IRS uses to select returns for examination? (Choose two.)

- ☒ A Discriminant Function System (DIF) scoring
- ☐ B Mandatory filing under §6038
- ☒ C Information matching from third-party reporting documents (such as Forms 1099 and W-2)
- ☐ D Statutory closeout agreements under §7121

ANSWER A - C

WHY The IRS selects returns for examination using several methods, including the Discriminant Function System (DIF), which uses statistical scoring to identify returns with high audit potential, and information matching, where reported income is reconciled against third-party documents such as Forms 1099 and W-2. Option B (§6038) relates to reporting requirements for foreign-owned entities, not selection for audit. Option D (§7121) refers to closing agreements that resolve tax matters, not to selection of returns for examination.

QUESTION 8

SINGLE CHOICE

A taxpayer inherits property from a decedent. What is the basis of the inherited property for federal income tax purposes?

- ☐ A The decedent's adjusted basis at the date of death.
- ☒ B The fair market value of the property on the date of the decedent's death (or alternate valuation date if elected).
- ☐ C The original cost paid by the decedent many years earlier.
- ☐ D The fair market value on the date the property is actually distributed to the heir.

ANSWER B

WHY Under §1014, property acquired from a decedent generally takes a basis equal to the fair market value on the date of the decedent's death. The personal representative may elect under §2032 to use an alternate valuation date six months after death (if it results in a decrease in both the value of the gross estate and the estate tax liability). This is commonly called a 'stepped-up basis.' Option A is incorrect because it uses the decedent's basis rather than FMV. Option C ignores basis adjustments and valuation. Option D is incorrect because the valuation date is the date of death (or alternate valuation date), not the date of distribution.

QUESTION 9

SINGLE CHOICE

Which of the following itemized deductions is subject to an overall limitation based on adjusted gross income (AGI)?

- ☐ A State and local income taxes paid
- ☐ B Unreimbursed employee business expenses under §62(a)(2)(D) for an employee
- ☒ C Medical expenses in excess of 7.5% of AGI
- ☐ D Charitable contributions to qualifying public charities

ANSWER C

WHY Medical expenses are deductible only to the extent they exceed 7.5% of AGI under §213, making AGI the relevant threshold for this deduction. Option A is limited by the \$10,000 SALT cap under §164(b)(6), not by AGI as a percentage threshold. Option B (as noted, statutory employee expenses) is taken as a miscellaneous itemized deduction, which is not subject to a 2% floor anymore due to TCJA suspension. Option D (cash contributions to public charities) is generally limited to 60% of AGI under §170(b)(1)(G), and while AGI is involved, the deduction itself is not gated by exceeding an AGI threshold; rather, AGI limits the maximum percentage allowable. Medical expenses remain the clearest AGI-floor limitation.