PRACTICE EXAM 11: ENROLLED AGENT PART 2 BUSINESSES SIMULATION (100 QUESTIONS)

This simulation mirrors the structure of the IRS Special Enrollment Examination, Part 2 - Businesses. It contains 100 multiple-choice questions with four answer options, weighted to the official domain proportions: 35 questions on Business Entities and Considerations, 44 on Business Tax Preparation, and 21 on Specialized Returns and Taxpayers. Allow 3 hours and 30 minutes. All questions relate to tax year 2025 and to the law as amended through December 31, 2025. The scaled passing score on the actual examination is 500 on a scale of 200 to 800. Answer every question; there is no penalty for a wrong answer.

1. A partnership is formed without any written agreement between the parties. What is the federal tax consequence?

A. No partnership exists until an agreement is executed in writing
B. The arrangement defaults to a joint venture excluded from filing
C. The partnership exists and must file a return regardless of documentation
D. Each participant reports only amounts personally received as wages

2. Which default classification applies to a foreign eligible entity whose members all have limited liability?

A. An association taxable as a corporation under the foreign default rules
B. A partnership, following the domestic multi-member default rule
C. Disregarded as an entity separate from its principal owner
D. A foreign trust governed by the grantor trust provisions

3. Which taxpayer is not required to obtain an employer identification number?

A. A partnership carrying on an active trade or business
B. A corporation filing its first annual income tax return

C. An employer withholding tax on payments to a nonresident alien
D. A sole proprietor with no employees, excise obligations, or pension plan

4. Which test does a partnership reach only after the majority interest year produces no answer?

A. The least aggregate deferral computation across the candidates
B. The tax year of all of the partnership's principal partners
C. The calendar year applied as a mandatory statutory default
D. The tax year used by the partner holding the largest capital

5. Which condition must exist for the profit presumption to arise under the hobby rules?

A. Profit in any two years during the life of the activity
B. Profit in every year since the activity commenced operations
C. Profit exceeding the taxpayer's other sources of income
D. Profit in three of five consecutive years ending with the year at issue

6. Which reporting threshold applies to Form 1099-MISC for payments made during 2025?

A. Two thousand dollars per payee for the calendar year
B. Six hundred dollars per payee for the calendar year
C. Ten dollars per payee regardless of the payment category
D. Twenty thousand dollars together with two hundred transactions

7. Which item is included in a partner's initial outside basis?

A. The partner's share of partnership liabilities at the date of contribution
B. The fair market value of the partnership interest received
C. The partnership's inside basis in all of its underlying assets
D. The projected value of the partner's future distributive shares

8. Which contribution to a partnership produces immediate ordinary income to the contributor?

A. Appreciated real property held for investment purposes
B. Cash contributed on the formation of the partnership
C. A capital interest received in exchange for services rendered
D. Equipment subject to an assumed nonrecourse liability

9. Which item increases a partner's outside basis despite never being taxed?

A. The partner's distributive share of tax-exempt income for the year
B. A cash distribution received during the taxable year
C. A decrease in the partner's share of partnership liabilities
D. The partner's share of nondeductible noncapital expenses

10. Which loss limitation is tested immediately after the basis limitation?

A. The passive activity limitation applying to nonparticipating owners
B. The excess business loss limitation applying in the aggregate
C. The capital loss limitation applying to individual taxpayers
D. The at-risk limitation, which excludes most nonrecourse financing

11. Which payment to a partner is determined without regard to partnership income?

A. A distributive share of ordinary business income for the year
B. A guaranteed payment for services or for the use of capital
C. A distribution of cash reducing the partner's outside basis
D. A repayment of capital previously contributed to the firm

12. Which consequence follows a sale of sixty percent of partnership interests within twelve months?

A. The partnership terminates and files a short-period return
B. The partnership must restart depreciation on all of its assets
C. The partnership continues with no termination for tax purposes
D. The partnership must obtain a new employer identification number

13. Which portion of gain on the sale of a partnership interest is ordinary income?

A. The portion attributable to the partnership's cash on hand
B. The portion attributable to appreciation in partnership land
C. The portion attributable to unrealized receivables and inventory items
D. The entire gain wherever the partnership holds any inventory

14. Which authority does a partnership representative hold under the centralized audit regime?

A. Authority shared jointly with the partners holding a majority interest
B. Authority limited to receiving notices on the partnership's behalf
C. Authority to settle only where all affected partners consent first
D. Exclusive authority to bind the partnership and every one of its partners

15. Which partner type is eligible where a partnership elects out of the centralized audit regime?

A. A grantor trust established by one of the partners
B. An S corporation, counting each of its shareholders toward the limit
C. A single-member limited liability company holding an interest
D. Another partnership holding a minority profits interest

16. Which item is treated as boot in a Section 351 exchange?

A. A corporate debt security issued to the transferring shareholder
B. Voting common stock of the transferee corporation received
C. Nonvoting common stock carrying identical economic rights

D. Additional shares received later in a stock split by the issuer

17. Which figure limits gain recognition where boot is received in a Section 351 exchange?

A. The greater of the realized gain or the boot actually received
B. The full amount of the realized gain in every circumstance
C. The fair market value of the stock received in the exchange
D. The lesser of the realized gain or the boot actually received

18. Which liability treatment applies on a Section 351 transfer with a genuine business purpose?

A. The entire liability assumed becomes boot received by the shareholder
B. The liability increases the shareholder's basis in the stock received
C. The liability reduces stock basis and is generally not treated as boot
D. The liability is disregarded entirely in every basis computation

19. Which threshold defines a parent-subsidiary controlled group?

A. Fifty percent of the total value of the subsidiary's stock
B. Eighty percent of total combined voting power or of total value
C. Eighty percent of voting power and of each nonvoting class
D. One hundred percent ownership of the subsidiary's shares

20. Which item increases a corporation's earnings and profits?

A. The dividends received deduction claimed during the taxable year
B. Federal income taxes paid during the taxable year
C. Nondeductible penalties assessed by a regulatory authority
D. Premiums on policies where the corporation is the beneficiary

21. Which rule applies where current earnings and profits are positive but accumulated earnings show a deficit?

A. The distribution is a dividend to the extent of current earnings and profits
B. The deficit is netted first, so no dividend arises at all
C. The distribution is a tax-free return of capital in every case
D. The distribution produces capital gain from a deemed stock sale

22. Which redemption test is measured at the corporate rather than shareholder level?

A. The substantially disproportionate redemption test
B. The partial liquidation test requiring a genuine business contraction
C. The complete termination of shareholder interest test
D. The not essentially equivalent to a dividend test

23. Which corporation is subject to the accumulated earnings tax?

A. One meeting both the ownership and passive income tests
B. One with more than half its receipts derived from services
C. One accumulating earnings beyond reasonable needs to avoid shareholder tax
D. One retaining any earnings at the close of the taxable year

24. Which shareholder disqualifies a corporation from electing S status?

A. An estate of a shareholder who died during the taxable year
B. A resident alien with lawful permanent resident status
C. An electing small business trust holding a block of shares
D. A nonresident alien holding a single share of the corporation

25. Which contribution creates debt basis for an S corporation shareholder?

A. A direct loan of funds from the shareholder to the corporation
B. A personal guarantee of corporate borrowing from a bank
C. Corporate borrowing from an unrelated commercial lender
D. Personal assets pledged as security for a corporate loan

26. Which allocation method must an S corporation apply to its income?

A. Allocation in proportion to each shareholder's adjusted stock basis
B. Strictly pro rata allocation computed per share and per day
C. Special allocation where the economic effect is substantial
D. Allocation as the shareholders agree in a written accord

27. Which item does not increase an S corporation's accumulated adjustments account?

A. Ordinary business income allocated to the shareholders
B. Separately stated income items reported on Schedule K-1
C. Gain recognized on a distribution of appreciated property
D. Tax-exempt interest received on municipal bond holdings

28. Which condition must exist before the passive investment income termination applies?

A. Passive income exceeding half of the corporation's gross receipts
B. At least five shareholders holding a majority of the stock
C. Accumulated earnings and profits carried over from C corporation years
D. An S election made within the preceding three taxable years

29. Which method must a taxpayer use where average gross receipts exceed the threshold?

A. The accrual method of accounting for the business activity

B. The cash method with inventories treated as supplies
C. A hybrid method combining cash and accrual elements
D. The completed contract method for all long-term contracts

30. Which item is subtracted from purchases in the cost of goods sold computation?

A. Freight charges incurred in acquiring the merchandise sold
B. Merchandise the owner withdrew from inventory for personal use
C. Trade discounts allowed by suppliers on their invoices
D. Storage costs for goods awaiting sale to future customers

31. Which cost remains currently deductible rather than capitalized into inventory?

A. Storage of finished goods still awaiting sale to buyers
B. Quality control inspection during the production process
C. Purchasing department costs allocable to acquiring goods
D. Distribution of finished goods to the purchasing customers

32. Which amount counts toward a taxpayer's at-risk figure?

A. Borrowed amounts for which the taxpayer is personally liable
B. Nonrecourse financing obtained for an equipment activity
C. Amounts protected by a stop-loss or similar arrangement
D. Property used in the activity pledged as loan security

33. Which discharge of indebtedness produces no income to the debtor?

A. A creditor writing off a portion of an equipment loan balance
B. A supplier forgiving a trade payable owed by a solvent business
C. A purchase price reduction agreed with a solvent buyer by the seller
D. A lender reducing the principal on an operating credit facility

34. Which exclusion takes priority over all others where several might apply?

A. The exclusion measured by the taxpayer's insolvency amount
B. The exclusion for discharge in a Title 11 bankruptcy case
C. The exclusion for qualified real property business indebtedness
D. The exclusion for qualified farm indebtedness discharged

35. Which risk attends compensation in a closely held C corporation?

A. Understated amounts being recharacterized as taxable wages
B. All compensation becoming nondeductible where any excess exists
C. Compensation being capitalized rather than deducted currently
D. Excessive amounts being recharacterized as nondeductible dividends

36. Which family employment arrangement is exempt from federal unemployment tax?

A. A child aged twenty-two employed by a parent's proprietorship
B. Any family member employed by a family S corporation
C. A spouse employed by the other spouse's sole proprietorship
D. A child aged twenty-five employed by a parent's partnership

37. Which arrangement is recharacterized as a conditional sales contract?

A. A lease at prevailing market rents for comparable premises
B. A lease requiring the tenant to maintain the leased property
C. A lease where title passes automatically at the end of the term
D. A lease renewable annually at the option of either party

38. Which travel expense remains deductible where a domestic trip is primarily personal?

A. Expenses at the destination directly attributable to business
B. Round-trip transportation to and from the chosen destination
C. Lodging for the entire duration of the trip undertaken
D. Meals for every day of the trip at the fifty percent rate

39. Which meal remains fully deductible rather than subject to the fifty percent limit?

A. A meal with a client at a restaurant close to the office
B. A meal furnished on the premises for the employer's convenience
C. A meal purchased during deductible overnight business travel
D. A meal treated as compensation and included in employee wages

40. Which vehicle rule permanently bars use of the standard mileage rate?

A. Using the vehicle for more than fifteen thousand miles in a year
B. Claiming Section 179 expensing or accelerated depreciation on the vehicle
C. Leasing rather than purchasing the vehicle outright at the start
D. Claiming actual expenses in the second year of business use

41. Which interest expense is deductible as business interest?

A. Interest on a loan secured by business assets but spent personally
B. Interest prepaid covering the following three taxable years
C. Interest on amounts borrowed to purchase municipal obligations
D. Interest on a residence-secured loan whose proceeds funded operations

42. Which expenditure requires capitalization under the improvement standard?

A. Routine repainting of an office suite between successive tenancies

B. A material addition increasing the capacity of an existing building
C. Replacement of individual worn parts in operating machinery
D. Cleaning and patching of a worn interior floor surface

43. Which safe harbor requires a written accounting policy in place at the start of the year?

A. The routine maintenance safe harbor for building systems
B. The small taxpayer safe harbor for building expenditures
C. The de minimis safe harbor for tangible property expenditures
D. The partial disposition election for replaced components

44. Which property is eligible for Section 179 expensing?

A. A fire protection system installed on nonresidential real property
B. Land acquired for the construction of a distribution warehouse
C. The structural shell of a newly constructed office building
D. Residential rental property acquired during the taxable year

45. Which gain is recaptured as ordinary income on the disposal of business equipment?

A. Only depreciation claimed above the straight line amount
B. Only the portion attributable to bonus depreciation claimed
C. None, since equipment produces Section 1231 gain entirely
D. All depreciation previously allowed or allowable on that asset

46. Which deadline governs identification of replacement property in a deferred exchange?

A. One hundred eighty days from the transfer of that property
B. Ninety days from the closing of the relinquished property sale
C. Forty-five days from the transfer of the relinquished property
D. The due date of the return including any extensions filed

47. Which item is excluded from the definition of qualified business income?

A. Guaranteed payments received by a partner for services rendered
B. Ordinary income from a domestic manufacturing partnership
C. Rental income from a domestic trade or business activity
D. Section 1231 gain treated as ordinary loss for the year

48. Which business is not a specified service trade or business?

A. An accounting firm preparing tax and audit engagements
B. An architecture practice designing commercial structures
C. A consulting practice advising corporate management
D. A brokerage firm dealing in securities for clients

49. Which figure caps a post-2017 net operating loss deduction?

A. Fifty percent of adjusted gross income for the carryover year
B. One hundred percent of taxable income without any limitation
C. The amount of business income reported for that same year
D. Eighty percent of taxable income computed before the loss deduction

50. Which item is a permanent difference on the book-tax reconciliation?

A. An allowance for doubtful accounts recorded for book purposes
B. Life insurance proceeds received on a key employee policy
C. Accelerated depreciation exceeding the book depreciation figure
D. Warranty reserves accrued for financial reporting purposes

51. Which schedule must agree with the equity section of the balance sheet?

A. The reconciliation of book income to taxable income
B. The schedule identifying substantial stock ownership
C. The analysis of unappropriated retained earnings
D. The detail separating permanent and temporary differences

52. Which change requires consent rather than correction by amended return?

A. An impermissible treatment applied consistently across two returns
B. A mathematical error in computing one year's depreciation
C. A transposition error in reporting gross receipts once
D. An omission of a single deductible expense in one year

53. Which figure on a partnership Schedule K-1 determines loss deductibility?

A. The partnership's gross receipts for the taxable year
B. The partner's share of liabilities reported by category
C. The partnership's total assets at the close of the year
D. The identity of the designated partnership representative

54. Which factor indicates behavioral control supporting employee status?

A. A significant unreimbursed investment made by the worker
B. Genuine opportunity for the worker to realize profit or loss
C. Detailed instructions about when, where, and how the work is performed
D. Availability of the worker's services to the general market

55. Which record retention period applies to employment tax records?

A. Three years from the date the related return was filed

B. Six years from the close of the calendar year involved
C. Until the related employees have permanently left the business
D. Four years after the tax becomes due or is paid, whichever is later

56. Which entity form permits an owner's share of entity debt to support losses?

A. A partnership, where liabilities increase each partner's outside basis
B. An S corporation, where guarantees establish shareholder basis
C. A C corporation, where losses flow through to its shareholders
D. A sole proprietorship, where the owner bears personal liability

57. Which item is recognized entirely in the year of an installment sale?

A. Depreciation recapture income arising on the property disposed of
B. Capital gain attributable to the appreciated land component
C. Interest income accruing on the outstanding deferred balance
D. Gain deferred and reported as the payments are actually collected

58. Which figure determines whether an employer is an applicable large employer?

A. Full-time employees counted on the last day of the current year
B. Total employees appearing on the payroll at any point in the year
C. Full-time employees averaged across the current calendar year
D. Full-time employees plus full-time equivalents in the preceding year

59. Which trust files no separate return during the grantor's lifetime?

A. A complex trust accumulating income at trustee discretion
B. A revocable living trust, being a grantor trust by definition
C. A simple trust distributing all of its income currently
D. An electing small business trust holding operating shares

60. Which adjustment is made in computing distributable net income?

A. The distribution deduction is subtracted from taxable income
B. Tax-exempt income is excluded from the computation entirely
C. Capital gains allocable to corpus are subtracted from the total
D. The personal exemption is subtracted for a second time

61. Which beneficiary is taxed on income required to be distributed but never paid?

A. The second-tier beneficiary receiving discretionary amounts
B. The first-tier beneficiary entitled to that mandatory income
C. The remainder beneficiary succeeding to the trust corpus
D. No beneficiary, because nothing was actually distributed

62. Which exemption amount applies to a simple trust?

A. Three hundred dollars for the taxable year in question
B. Six hundred dollars, matching the amount allowed an estate
C. One hundred dollars, matching the complex trust amount
D. No exemption is available to a simple trust at any time

63. Which period governs retroactive recognition of an organization's exemption?

A. Twelve months from the close of the organization's first year
B. Thirty-six months from the date operations first commenced
C. Six months from the date the governing document was adopted
D. Twenty-seven months from the end of the month of formation

64. Which conduct defeats charitable exemption absolutely?

A. Conducting an unrelated trade or business regularly
B. Attempting to influence legislation to a limited degree
C. Any part of net earnings benefiting a private insider
D. Accumulating income rather than granting it out currently

65. Which return must every private foundation file regardless of size?

A. The electronic notice available to the smallest organizations
B. The private foundation return, whatever its receipts or assets
C. The short form for organizations below the asset threshold
D. The full annual return required of larger public charities

66. Which passive income loses its exclusion from unrelated business taxable income?

A. Rents from real property subject to acquisition indebtedness
B. Dividends received on marketable equity securities held
C. Interest earned on the organization's operating reserves
D. Royalties received under a trademark licensing arrangement

67. Which plan permits establishment as late as the extended return due date?

A. A savings incentive match plan for employees of a small firm
B. A profit sharing plan adopted before the plan year closes
C. A simplified employee pension arrangement for the business
D. A defined benefit plan requiring actuarial certification

68. Which vesting schedule may apply to employer contributions in a qualified plan?

A. Five-year cliff vesting or ten-year graded vesting

B. Immediate full vesting in every circumstance without exception
C. Vesting only upon attaining normal retirement age under the plan
D. Three-year cliff vesting or six-year graded vesting

69. Which consequence follows a prohibited transaction in an individual retirement arrangement?

A. An excise tax applies only to the amount actually involved
B. Contributions are suspended for the following three years
C. The entire account ceases to be an arrangement for that year
D. A penalty equal to ten percent of the balance is imposed

70. Which livestock requires twenty-four months of holding for Section 1231 treatment?

A. Cattle and horses held for breeding or dairy purposes
B. Breeding hogs maintained in the farmer's productive herd
C. Sheep and goats held for breeding and wool production
D. Poultry raised for eventual sale to processing operations

71. Which farm deduction is capped at twenty-five percent of gross farm income?

A. Prepaid feed and seed acquired before the growing season
B. Soil and water conservation expenditures made on farmland
C. Veterinary services provided to productive breeding stock
D. Depreciation on machinery used in ordinary field operations

72. Which activity falls outside the per se passive rental classification?

A. A twelve-month residential lease to a single family tenant
B. A ground lease of undeveloped land running twenty years
C. A commercial lease carrying annual renewal options
D. One where the average period of customer use is six days

73. Which requirement accompanies the special rental real estate loss allowance?

A. Material participation exceeding five hundred hours in the year
B. Qualification as a real estate professional for that same year
C. Ownership of the property for more than twenty-four months
D. Active participation together with at least ten percent ownership

74. Which expense is disallowed first where the vacation home limitation applies?

A. Depreciation allocable to the rental use of the property
B. Mortgage interest allocable to the rental use portion
C. Utilities and repairs allocable to the rental use portion
D. Property taxes allocable to the rental use of the dwelling

75. Which item constitutes rental income when the landlord receives it?

A. A refundable security deposit held pending lease expiry
B. Expenses the tenant pays on the landlord's own behalf
C. A tenant improvement funded by the tenant for its own use
D. The landlord's own outlay on maintaining the rented property

76. Which disposition releases suspended passive losses in full?

A. A gift of the whole interest to an adult child of the owner
B. A sale of half the interest to an unrelated third-party purchaser
C. A fully taxable disposition of the entire interest to an unrelated party
D. A transfer of the interest to a corporation the owner controls

77. Which item does not increase the accumulated adjustments account?

A. Ordinary business income allocated to the shareholders
B. Separately stated income items reported on Schedule K-1
C. Tax-exempt interest earned on municipal obligations held
D. Gain recognized on distributing appreciated corporate property

78. Which entity may file an amended return with corrected owner statements?

A. A partnership subject to the centralized partnership audit regime
B. An S corporation correcting an error on a previously filed return
C. A partnership that has not validly elected out of that regime
D. A partnership furnishing more than one hundred Schedules K-1

79. Which figure caps the business interest deduction where no exemption applies?

A. Fifty percent of the taxpayer's gross receipts for the year
B. Twenty percent of the taxpayer's qualified business income
C. The amount of interest actually paid rather than merely accrued
D. Business interest income plus thirty percent of adjusted taxable income

80. Where does a self-employed owner deduct their own retirement plan contribution?

A. As an adjustment to income on the front of the individual return
B. On the business schedule as an ordinary operating expense
C. On Schedule SE before computing the self-employment tax
D. As an itemized deduction on Schedule A of the return

81. Which requirement applies to the small employer health insurance credit?

A. Employment of at least twenty-five full-time equivalent workers

B. Enrolment through the small business health options marketplace
C. Payment of the entire premium cost for every covered employee
D. Availability across an unlimited number of consecutive years

82. Which statement about the four loss limitation hurdles is correct?

A. Each is tested independently against the original allocated loss
B. The passive activity rules are applied before the basis test
C. The excess business loss cap is applied before the at-risk test
D. Each is tested against the amount surviving the previous hurdle

83. Which condition recognizes a family member as a partner where capital is material?

A. Contribution of services of substantial value to the business
B. Acquisition of the interest by purchase for full consideration
C. Genuine ownership of a capital interest, however it was acquired
D. Attainment of the age of majority under applicable state law

84. Which treatment applies to a purchase of a partnership interest between family members?

A. It is treated as a gift for family partnership purposes
B. It is respected as an arm's length sale in every circumstance
C. It terminates the partnership for federal income tax purposes
D. It requires the partnership to obtain a new identification number

85. Which excise tax reaches private foundations but not public charities?

A. A tax on income from unrelated business activities conducted
B. A tax on failure to distribute a minimum amount annually
C. A tax on reasonable compensation paid to organization officers
D. A tax on contributions received from a single substantial donor

86. Which element must be present for unrelated business taxable income to arise?

A. The activity must produce net income rather than a loss
B. The activity must involve sales of tangible merchandise
C. The activity must be conducted outside the organization's state
D. The activity must be regularly carried on by the organization

87. Which person is a disqualified person for prohibited transaction purposes?

A. An owner of fifty percent or more of the sponsoring employer
B. Any participant holding an account balance within the plan
C. Any beneficiary designated to receive benefits upon death
D. Any vendor supplying goods to the employer's own business

88. Which replacement period applies to breeding livestock sold because of drought?

A. Two years from the close of the year the gain is realized
B. One year, matching the ordinary deferral election period
C. Four years, extendable where drought persists across a region
D. Three years, as applies to condemned business real property

89. Which taxpayer may elect farm income averaging?

A. An individual partner reporting farm income on a Schedule K-1
B. A C corporation engaged in commercial crop production
C. An exempt organization running an agricultural research station
D. A trust holding farmland leased out to an operating tenant

90. Which condition must a real estate professional satisfy besides the hours test?

A. Ownership of at least ten percent of each rental activity held
B. Active participation in management decisions during the year
C. More than half of personal services in real property businesses
D. Licensure as a real estate agent or broker within the state

91. Which use makes a dwelling a residence under the vacation home rules?

A. Personal use of exactly fourteen days during the taxable year
B. Any personal use whatever during the taxable year in question
C. Personal use exceeding half the days the property was rented
D. Personal use exceeding the greater of fourteen days or ten percent of rental days

92. Which allocation method does the Service apply to vacation home interest and taxes?

A. Allocation across all three hundred sixty-five days of the year
B. Allocation using the total days the property was actually used
C. Allocation by the relative fair rental value of each period
D. Allocation entirely to the rental use of the dwelling itself

93. Which statement about a Section 197 intangible is correct?

A. It is amortized over its stated contractual term where that is shorter
B. It is deducted in full in the year the intangible is acquired
C. It is amortized over fifteen years regardless of its actual life
D. It is recovered only upon disposition of the entire business

94. Which requirement applies where an organization conducts several unrelated businesses?

A. The activities are combined into one aggregate computation

B. Only the most profitable activity need be reported at all
C. Losses may offset the organization's exempt function income
D. Each activity is computed separately with no cross-offsetting allowed

95. Which figure is used in the property limb of the wage and property limitation?

A. The adjusted basis of qualified property at the close of the year
B. The unadjusted basis of qualified property immediately after acquisition
C. The fair market value of qualified property at its acquisition
D. The accumulated depreciation claimed on qualified property

96. Which item is added back to book income on the reconciliation schedule?

A. Nondeductible penalties recorded as expense on the books
B. Tax-exempt interest earned on municipal bond holdings
C. Life insurance proceeds received on a key employee policy
D. Excess of tax depreciation over the book depreciation figure

97. Which item is a first-tier distribution from a trust?

A. A discretionary distribution of corpus to a remainder beneficiary
B. A distribution made within sixty-five days of the year's close
C. Income required to be distributed currently under the instrument
D. Any distribution actually paid out during the taxable year

98. Which condition triggers a trust's obligation to file an income tax return?

A. Distribution of any amount to a beneficiary during the year
B. Any taxable income for the year, whatever the gross amount
C. Ownership of assets exceeding six hundred dollars in value
D. Existence of more than one beneficiary under the instrument

99. Which cost survived the suspension of miscellaneous itemized deductions for a trust?

A. Fiduciary fees that would not have arisen but for the trust
B. Investment advisory fees of a kind individuals commonly pay
C. Custodial charges on a conventional brokerage account held
D. Management fees on rental property held purely for investment

100. Which statement about the excess business loss limitation is correct?

A. The disallowed excess is permanently lost to the taxpayer
B. It is tested before the basis and at-risk limitations apply
C. It applies to corporations and to individuals on identical terms
D. The disallowed excess becomes a net operating loss carryforward

Practice Exam 11: Answer Key and Explanations

1. C — A partnership exists federally when two or more persons carry on a trade, business, or venture and divide the profits, and no writing, filing, or state registration is required for that to happen. Two contractors agreeing informally to split the proceeds of a job have formed one whether or not either would ever use the word partnership.

2. A — Foreign defaults invert the domestic logic entirely. Where every member of a foreign eligible entity enjoys limited liability, corporate treatment is the default, whereas a domestic multi-member entity in the identical position still defaults to partnership. Questions on this point are framed as foreign fact patterns precisely because the outcome is counterintuitive.

3. D — A number is required where the taxpayer has employees, operates as a partnership or corporation, files employment or excise returns, withholds on payments to a nonresident alien, or maintains a qualified plan. A sole proprietor meeting none of those conditions may report under a Social Security number, though many obtain one voluntarily.

4. B — The hierarchy runs majority interest year first, then the common year of all principal partners owning five percent or more, then the least aggregate deferral computation. Each step is reached only where the preceding one produces no answer, so the computation is performed last rather than first in the sequence of tests.

5. D — Profit in three of five consecutive years creates a presumption that the activity is engaged in for profit, shifting the burden to the Service. The presumption is rebuttable rather than conclusive, and activities consisting primarily of breeding, training, showing, or racing horses use a relaxed test of two profitable years out of seven instead.

6. B — The threshold for miscellaneous payments remains six hundred dollars for the tested year. Recent legislation raised it to two thousand dollars, but only for payments made after December 31, 2025, which is outside the year examined here. The twenty thousand dollar and two hundred transaction figure belongs to a different reporting regime entirely.

7. A — Initial outside basis equals money contributed, plus the adjusted basis of any property contributed, plus the partner's share of partnership liabilities, less any liabilities of the partner assumed by the partnership. Fair market value of the interest plays no part, and a purchased interest instead takes a cost basis in the ordinary way.

8. C — Services are not property, so the nonrecognition provision does not shelter them. A capital interest received for services is compensation, taxable at the fair market value of the interest received, which then becomes the partner's basis. A profits interest is treated far more favourably and is generally not taxable on receipt.

9. A — Tax-exempt income increases basis even though it is never taxed, which preserves the exemption when the interest is eventually disposed of. Nondeductible noncapital expenses form the mirror image, reducing basis despite producing no deduction at all. Both rules exist so that eventual disposition gain reflects economic rather than merely taxable results.

10. D — The four hurdles operate in a fixed sequence: basis, then at-risk, then passive activity, then the excess business loss cap. Only the amount surviving the basis limitation is measured against amounts at risk, and a loss stopped at any hurdle never reaches the next one in the sequence at all.

11. B — The defining characteristic of a guaranteed payment is the absence of any link to profitability. A payment of a fixed sum to a managing partner regardless of results is a guaranteed payment, while a payment measured as a share of net profits is a distributive share instead, and the two carry different consequences entirely.

12. C — Technical termination has been repealed, so a sale of fifty percent or more of the interests no longer terminates a partnership. The tax year continues uninterrupted, depreciation schedules are unaffected, and no short-period return is required. Termination now occurs only where no part of any business continues in partnership form at all.

13. C — Section 751 recharacterizes the portion of gain attributable to unrealized receivables and inventory as ordinary income, with only the balance treated as capital gain. Unrealized receivables also capture depreciation recapture potential, so a partnership holding heavily depreciated equipment carries hot assets even without conventional receivables outstanding at all. A partnership with only depreciated equipment still carries hot assets.

14. D — The representative holds exclusive authority to act in any proceeding and binds the partnership and every partner. The representative need not be a partner but must have a substantial presence in the United States. Individual partners have no independent right to notice, participation, or contest, a sharp departure from the regime this one replaced.

15. B — Eligible partners are individuals, C corporations, S corporations, foreign entities treated as C corporations, and estates of deceased partners. Where a partner is an S corporation, each of its shareholders counts toward the hundred-statement limit. Trusts, partnerships, disregarded entities, and nominees are ineligible, and a single one defeats the election.

16. A — Corporate securities such as long-term debt instruments are boot rather than stock, as is nonqualified preferred stock carrying debt-like features. Only genuine stock qualifies for nonrecognition, and receiving boot triggers gain equal to the lesser of realized gain or boot received, while loss is never recognized regardless of the boot involved.

17. D — Gain is recognized in an amount equal to the lesser of realized gain or boot received, computed property by property where several assets are transferred. Netting the properties together first produces the wrong answer wherever one of them carries a loss, since boot landing on a loss property produces no recognized gain.

18. C — Assumption of a liability is generally not treated as money received and therefore is not boot; it reduces the shareholder's stock basis instead. Gain arises only where liabilities exceed the total basis of property transferred, or where a tax avoidance purpose converts the whole liability into boot received on the exchange.

19. B — A parent-subsidiary group requires ownership of at least eighty percent of total combined voting power or at least eighty percent of total value, a disjunctive test contrasting sharply with the conjunctive two-pronged control test governing Section 351. The chain may extend through multiple tiers, each link tested at the same threshold.

20. A — The dividends received deduction reduces taxable income without any corresponding cash outflow, so it is added back in full. Federal income taxes, nondeductible penalties, and life insurance premiums where the corporation is beneficiary are all genuine economic outlays reducing the capacity to distribute and therefore decrease earnings and profits. The measure gauges real capacity to distribute rather than taxable income.

21. A — Under the nimble dividend rule the two pools are tested separately, so positive current earnings and profits support dividend treatment even where accumulated earnings show a deficit, and the deficit does not offset the current amount. Netting them would give the wrong answer, which is always among the options offered.

22. B — The partial liquidation test is measured at the corporate level and generally requires a genuine contraction of the business. The other three routes to exchange treatment examine the shareholder's proportionate interest before and after, and all four are applied only after constructive ownership rules attribute shares held by relatives. Attribution rules are applied before every one of the four tests.

23. C — The tax reaches a corporation permitting earnings to accumulate beyond the reasonable needs of the business for the purpose of avoiding tax at the shareholder level. It is asserted by the Service on examination rather than self-reported, and it cannot apply in a year the corporation is a personal holding company.

24. D — Nonresident aliens are ineligible shareholders, as are partnerships, corporations, and most trusts. Estates, resident aliens, and qualifying trusts are all permitted holders. Eligibility is continuous rather than tested once, so a shareholder who later becomes a nonresident alien terminates the election on the day that status changes. Partnerships and corporations may never hold shares at all.

25. A — Debt basis arises only from a direct loan creating genuine indebtedness running from the corporation to that shareholder, which requires an actual economic outlay. A guarantee, a pledge of personal collateral, and corporate third-party borrowing all produce nothing until the shareholder actually pays and becomes a creditor of the corporation.

26. B — Allocation is strictly pro rata on a per share, per day basis, and special allocations are prohibited entirely, which is the sharpest structural contrast with partnerships. Where shares change hands mid-year the annual total is divided by the number of days and each day's amount assigned to whoever held the shares.

27. D — Tax-exempt income does not increase the account and its related expenses do not decrease it, though both items affect stock basis. Ordinary income, separately stated income, and recognized gains all increase it. Distributions reduce it only as far as zero, while losses may drive the balance negative in a poor year.

28. C — Both conditions are required: passive investment income exceeding twenty-five percent of gross receipts for three consecutive years, and accumulated earnings and profits carried over from C corporation years. A corporation that has always been an S corporation may hold entirely passive investments indefinitely without any exposure on this ground. Three consecutive years above the threshold are required as well.

29. A — The accrual method is required where average annual gross receipts exceed the applicable threshold, and that same test governs exemption from the uniform capitalization rules and from inventory accounting. A taxpayer crossing the threshold generally becomes subject to all three regimes at once rather than to only one of them.

30. B — Merchandise removed for personal use must be subtracted from purchases, since treating it as a business expense or ignoring it entirely would overstate cost of goods sold and understate gross profit by that amount. Freight is added to inventoriable cost, and trade discounts reduce the invoice price directly instead. Freight is instead added into the inventoriable cost of goods.

31. D — Distribution of goods to customers remains currently deductible while storage and warehousing of goods awaiting sale must be capitalized, the dividing line being whether goods are awaiting a buyer or moving toward one. Quality control and purchasing costs are both capitalized as indirect costs under the uniform capitalization rules. Purchasing and handling costs are likewise capitalized into inventory.

32. A — Amounts at risk include cash contributed, the adjusted basis of property contributed, and borrowed amounts for which the taxpayer is personally liable or has pledged property not used in the activity. Nonrecourse financing, loss-protected amounts, and the activity's own assets pledged as security are all excluded from the computation. The activity's own assets pledged as security add no exposure.

33. C — A purchase price reduction agreed between the original seller and a solvent buyer not in bankruptcy is treated as an adjustment to basis rather than as income. Debt cancelled as a gift, contributed to capital, or representing an amount that would have been deductible if paid likewise produces no cancellation income.

34. B — Discharge in a Title 11 bankruptcy case is excluded in full and takes priority over every other exclusion including insolvency. The insolvency exclusion is capped by the amount of insolvency rather than the amount forgiven, so a discharge that restores solvency produces taxable income for the excess above that figure.

35. D — In a C corporation the danger runs toward compensation that is too high, since excessive amounts paid to a shareholder-employee become dividends, nondeductible by the corporation while remaining fully taxable to the recipient and producing double taxation on precisely the disallowed portion. The S corporation risk reverses entirely. The S corporation risk runs toward understated wages instead.

36. C — A spouse employed by a sole proprietorship is exempt from unemployment tax while remaining subject to Social Security and Medicare. A child under twenty-one enjoys the same unemployment exemption, and under eighteen is additionally exempt from Social Security. Incorporating the business destroys every one of these exemptions entirely. Incorporating the business destroys every one of these exemptions.

37. C — An arrangement is recharacterized where payments build equity, most clearly where title passes automatically at term end, where a nominal purchase option exists, or where payments materially exceed fair rental value. The recharacterized arrangement produces depreciation and interest deductions for the occupant rather than a current rent deduction. Fair rental value is the benchmark against which payments are measured.

38. A — Where a domestic trip is primarily personal, transportation to and from the destination is entirely nondeductible, but expenses at the destination directly attributable to business remain deductible. Where the trip is primarily for business, transportation becomes fully deductible even though some personal time happens to be taken. Business expenses at the destination survive in either case.

39. D — Meals treated as compensation and included in an employee's wages remain fully deductible, as do meals sold to customers in the ordinary course and meals at company-wide recreational events. Meals furnished on the premises for the employer's convenience are subject to the fifty percent limit rather than being fully deductible.

40. B — A taxpayer who has claimed Section 179 expensing or accelerated depreciation on a vehicle may never use the standard mileage rate for that vehicle in any later year. The rate is also unavailable where five or more vehicles operate simultaneously, and it must generally be elected in the first year to preserve flexibility.

41. D — Interest is allocated according to the use of the borrowed funds rather than the property securing the loan, so a residence-secured loan deployed in business produces business interest. A loan secured by business assets and spent personally produces nondeductible personal interest, and tracing governs the answer in both directions. Prepaid interest must instead be capitalized and spread over time.

42. B — Capitalization is required for a betterment, a restoration, or an adaptation to a new or different use, and a material addition increasing capacity is a betterment. Routine painting, cleaning, patching, and replacing worn parts all keep property in ordinarily efficient operating condition and remain currently deductible repairs instead. Restoration and adaptation are the other two capitalization triggers.

43. C — A taxpayer without an applicable financial statement must have a written accounting policy in place at the beginning of the tax year to use the de minimis safe harbor, and it cannot be adopted retroactively when the return is prepared. The other provisions each carry their own separate and distinct conditions.

44. A — Qualifying property includes tangible personal property, off-the-shelf software, qualified improvement property, and roofs together with heating, ventilation, fire protection, and security systems installed on nonresidential real property. Land is never depreciable at all, and the building structure itself remains outside the provision at thirty-nine years. Qualified improvement property carries a fifteen-year recovery period.

45. D — Section 1245 recaptures all depreciation allowed or allowable as ordinary income before any Section 1231 treatment becomes available, so the ordinary component equals the lesser of depreciation claimed or total gain. Real property follows the gentler Section 1250 rule, recapturing only amounts claimed in excess of straight line. Under current recovery methods that usually amounts to nothing.

46. C — Replacement property must be identified within forty-five days of transferring the relinquished property, and the exchange must close within one hundred eighty days or by the return due date including extensions, whichever comes first. Both deadlines are strict, and failing either converts the intended exchange into a fully taxable sale.

47. A — Guaranteed payments are excluded on the same reasoning that excludes S corporation reasonable compensation: both are payments for services rather than a share of business profits. Capital gains, dividends, investment interest, foreign income, and income from performing services as an employee are all likewise outside the definition entirely. Employee service income is likewise outside the definition.

48. B — Architecture and engineering are conspicuously absent from the statutory list despite appearing in comparable provisions elsewhere in the Code. Both retain the deduction at any income level, subject only to the wage and property limitations. Accounting, consulting, and brokerage all appear on the list and lose it above the threshold.

49. D — The deduction is capped at eighty percent of taxable income computed without the net operating loss deduction itself and without the qualified business income deduction. Computing eighty percent of income already reduced by the loss produces a circular and wrong answer that is offered as a standard distractor. Pre-2018 losses are used first and carry no percentage limitation.

50. B — Life insurance proceeds are book income that is never taxable, so the difference never reverses and changes the effective rate the corporation bears. Bad debt allowances, accelerated depreciation, and warranty reserves all reverse in later periods and are temporary differences affecting only when tax is ultimately paid. Permanent differences change the effective rate the corporation bears.

51. C — The retained earnings analysis runs from the opening balance, adds book income and other increases, and subtracts distributions and other decreases to reach a closing figure that must tie to the balance sheet. A mismatch indicates a distribution recorded directly against equity or an undisclosed prior period adjustment. A mismatch signals an equity entry that bypassed the schedule.

52. A — A method of accounting requires consistent treatment across at least two consecutive returns, so a single year's treatment is an error correctable by amendment. An impermissible method once adopted is changed only prospectively with consent, and the cumulative effect of all prior years is brought forward as an adjustment. Voluntary correction also brings audit protection for earlier years.

53. B — A partner's share of recourse, qualified nonrecourse, and other nonrecourse liabilities determines outside basis, which in turn determines how much loss may be deducted. These categories are substantive rather than informational, and an error in the allocation flows straight through to a wrong deduction on the partner's own return. Recourse and nonrecourse liabilities follow entirely different rules.

54. C — Detailed instructions about the timing, location, and method of work are behavioral control indicators, along with training and evaluation systems directed at method rather than result. Unreimbursed investment, profit or loss opportunity, and market availability are all financial control factors pointing toward independent contractor status instead. The right to control matters more than whether it is exercised.

55. D — Employment tax records must be kept four years after the tax becomes due or is paid, whichever is later. General records run three years from filing, extended to six where more than a quarter of gross income was omitted, and kept indefinitely where no return was filed or the return was fraudulent.

56. A — A partner's share of partnership liabilities increases outside basis whoever the lender happens to be, which supports early loss deductions in a leveraged venture. An S corporation shareholder gains basis only from a direct loan, and C corporation losses trap at the entity level and never reach the shareholders at all.

57. A — Recapture income is recognized in full in the year of sale even where the seller receives little or no cash that year, with only the remaining gain spread across the installment payments. A seller of heavily depreciated equipment can therefore owe substantial tax before collecting meaningful proceeds from the buyer.

58. D — Status is determined by the preceding calendar year, averaging full-time employees together with full-time equivalents. Full-time means thirty hours weekly or one hundred thirty monthly, and equivalents are aggregate part-time hours divided by one hundred twenty. Part-time employees establish status but are never owed coverage nor trigger a payment. Equivalents are aggregate part-time hours divided by one hundred twenty.

59. B — A retained power to revoke is itself a triggering power, so a revocable living trust is a grantor trust by definition. Its income, deductions, and credits are reported directly by the grantor and it is disregarded as a separate taxpayer, becoming a separate taxable entity only upon the grantor's death.

60. C — Capital gains allocable to corpus are subtracted because they belong to the remainder beneficiary rather than the income beneficiary. The distribution deduction and the personal exemption are both added back, and tax-exempt income net of allocable expenses is added, producing a figure approximating the income economically available for distribution. The result approximates income economically available for distribution.

61. B — First-tier distributions are amounts of income required to be distributed currently, whether or not actually paid, and they absorb distributable net income before any discretionary amount is taxed. A trustee's failure to make the required payment does not defer the beneficiary's tax on the amount the instrument obliges. Second-tier beneficiaries share only whatever amount then remains.

62. A — The exemption is three hundred dollars for a simple trust required to distribute all income currently, one hundred for a complex trust, and six hundred for an estate. These amounts are fixed by statute rather than indexed for inflation, making them among the few figures safely memorized regardless of the year tested.

63. D — Filing within twenty-seven months of the end of the month of formation produces recognition retroactive to the date of formation. A later filing produces recognition only prospectively from the application date, leaving a taxable gap covering the intervening period during which the organization operated without any recognized exempt status. The application itself remains valid; only its effective date shifts.

64. C — Private inurement is prohibited absolutely with no threshold and no substantiality test, so any part of net earnings benefiting an insider defeats exemption outright. Lobbying is permitted within limits, and unrelated business activity produces tax rather than revocation unless it grows into the organization's primary purpose over time. Primary purpose marks where tax becomes outright revocation.

65. B — All private foundations file the private foundation return whatever their receipts or assets. Other organizations file the electronic notice, the short form, or the full return according to gross receipts and total assets, measured on a three-year normally basis rather than tested in any single year alone. Receipts are measured on a three-year averaged basis instead.

66. A — Debt-financed income is pulled into unrelated business taxable income in proportion to the outstanding acquisition indebtedness even where it would otherwise be excluded as passive. Rents attributable to personal property or measured by the tenant's profits likewise lose the exclusion, making a mortgage the decisive fact in these questions. A mortgage on investment property is therefore the decisive fact.

67. C — A simplified employee pension may be established and funded as late as the extended due date of the return, making it the only meaningful option for a business reaching year end with nothing in place. A savings incentive match plan must generally be established by the first of October with no extension.

68. D — Employer contributions must vest under a three-year cliff or a six-year graded schedule. Employee elective deferrals vest immediately in every plan, as do all contributions to simplified employee pensions and savings incentive match plans, while a top-heavy plan requires accelerated vesting beyond these ordinary baselines. Top-heavy plans require accelerated vesting beyond these baselines.

69. C — The entire account ceases to be an individual retirement arrangement as of the first day of the year, producing a deemed distribution of the whole balance. This is dramatically harsher than the excise tax applying to a qualified plan, and prompt correction does not cure the disqualification once it has occurred.

70. A — Cattle and horses held for draft, breeding, dairy, or sporting purposes require twenty-four months, while other livestock including hogs, sheep, and goats require only twelve months. Poultry is excluded from the provision by statute entirely, and animals held primarily for sale remain ordinary income property regardless of period. Poultry is excluded from the provision by statute in every case.

71. B — Soil and water conservation expenditures are deductible currently rather than capitalized, but only for land used in farming, only where consistent with an approved conservation plan, and only up to twenty-five percent of gross farm income, with any excess carried forward indefinitely to later taxable years rather than lost. Prepaid supplies face a separate fifty percent limitation instead.

72. D — An activity where the average period of customer use is seven days or less, or thirty days or less with significant personal services, is not a rental activity at all and is tested under ordinary material participation standards. This is why a materially participating short-term lodging operator may deduct losses.

73. D — Active participation is a materially lower standard than material participation, requiring only bona fide involvement in decisions such as approving tenants and authorizing repairs, and it survives the use of a management company. The taxpayer must additionally own at least ten percent of the activity being claimed. A management company handling operations does not defeat it.

74. A — The ordering places interest and taxes first, operating expenses second, and depreciation last, so depreciation is always the item disallowed where rental income runs out. That sequencing favours the taxpayer, since depreciation reduces basis only to the extent actually deducted and the disallowed amount carries forward. Disallowed depreciation carries forward rather than being lost.

75. B — Expenses the tenant pays on the landlord's behalf are rental income, as are rents received, advance rent, lease cancellation payments, and the fair market value of property or services accepted instead of cash. A refundable deposit is not income until applied to unpaid rent or retained for damage caused. A refundable deposit is the notable exception to inclusion here.

76. C — Release requires disposing of the entire interest in the activity in a fully taxable transaction to an unrelated party, after which the suspended losses become deductible against non-passive income. A gift, a partial disposition, or a transfer to a related party or controlled entity triggers no release whatever. Related-party and controlled-entity transfers never trigger release.

77. C — Tax-exempt income does not increase the account and its related expenses do not reduce it, though both items affect stock basis. Ordinary income, separately stated income, and recognized gains all increase the balance, while distributions reduce it only as far as zero and losses may drive it negative. Distributions reduce the account only as far as zero, never below.

78. B — A partnership subject to the centralized regime cannot amend and must file an administrative adjustment request instead, with adjustments reaching partners through statements. An S corporation, or a partnership that has validly elected out of the regime, may file an amended return with corrected statements in the ordinary way. Electing out demands both numerical and eligibility conditions.

79. D — The cap is the sum of business interest income, thirty percent of adjusted taxable income, and floor plan financing interest, with disallowed amounts carried forward indefinitely. A taxpayer meeting the gross receipts test that also governs accrual accounting and capitalization is exempt from the limitation altogether. Floor plan financing interest is added into the same overall cap.

80. A — The owner's own contribution is an adjustment to income rather than a business schedule expense, because deducting it on the business schedule would reduce net earnings again and understate self-employment tax. Contributions made on behalf of employees are properly a business expense, so one plan produces deductions in two places.

81. B — Eligibility requires fewer than twenty-five full-time equivalent employees, average annual wages below an adjusted ceiling, payment of at least half the premium cost under a qualifying arrangement, and enrolment through the small business marketplace. The credit runs for only two consecutive years and phases out as headcount or wages rise.

82. D — The hurdles operate in a fixed sequence and each is tested against the amount that survived the previous one, never against the original loss. Basis comes first, then at-risk, then passive activity, then the excess business loss cap, whose disallowed remainder becomes a net operating loss carryforward to the following year.

83. C — Where capital is a material income-producing factor, a family member owning a genuine capital interest is recognized even if the interest was acquired by gift. The interest must be real, with the donee holding the rights of ownership rather than nominal title while the donor retains practical control over it.

84. A — A purchase between family members is treated as a gift for these rules regardless of what was actually paid, so a parent selling an interest to a child at full market value nonetheless remains within the family partnership regime. Candidates commonly assume a genuine purchase breaks the analysis, and it does not.

85. B — Private foundations face excise taxes on net investment income, self-dealing with disqualified persons, failure to distribute a minimum amount, excess business holdings, jeopardizing investments, and taxable expenditures. Public charities face none of these, though both categories remain subject to the unrelated business income tax alike. Both categories nevertheless bear the unrelated business income tax.

86. D — Three elements must all be present: a trade or business, regularly carried on, and not substantially related to the exempt purpose other than through producing funds. A single annual fundraising event is not regularly carried on and escapes the tax entirely, whatever revenue that event happens to generate. Producing funds alone never establishes substantial relation.

87. A — Disqualified persons include plan fiduciaries, the employer, employee organizations, owners of half or more of the employer, and members of their families. Ordinary participants, named beneficiaries, and unrelated vendors are all excluded. The prohibition reaches sales, leasing, lending, furnishing services, and self-dealing by a fiduciary. Family members of those persons are likewise disqualified.

88. C — Weather-related sales of draft, breeding, and dairy animals may be treated as involuntary conversions with a four-year replacement period, extended further by published notice where drought conditions persist regionally. Livestock held for sale rather than these purposes instead qualifies for a one-year deferral of the excess proceeds. Ordinary sale livestock instead receives a one-year deferral election.

89. A — Averaging is available only to individuals, which includes partners and S corporation shareholders reporting farm income from those entities, and never to C corporations. Base year income serves only as a computational reference so those earlier returns are unaffected, and the election may be made on an amended return. C corporations may never elect farm income averaging at all.

90. C — Both conditions must hold in the same year: more than half of all personal services performed in any trade or business must be in real property trades or businesses in which the taxpayer materially participates, together with more than seven hundred fifty hours devoted to those businesses during that year.

91. D — Exceeding the greater of fourteen days or ten percent of days rented at fair value makes the property a residence, limiting deductions to rental income with no loss permitted and disallowed amounts carried forward. Use of exactly fourteen days does not exceed the threshold and leaves the property outside the limitation.

92. B — The Service allocates using total days of use, while some court decisions have permitted allocation across all days in the year, leaving a larger share available as itemized deductions and producing a larger rental loss. Examination answers follow the Service method unless a question expressly directs otherwise. The two methods produce materially different rental loss figures.

93. C — Acquired intangibles are amortized ratably over fifteen years beginning with the month of acquisition, without regard to actual or contractual life, so a three-year covenant not to compete is still recovered over fifteen. No loss is recognized on disposing of one where others from the same acquisition are retained. The disallowed loss attaches to the retained intangibles' basis.

94. D — Income and deductions must be computed separately for each unrelated trade or business, so a loss from one cannot offset income from another. Losses are trapped within their own activity and carried forward against that same activity's future income, preventing profitable operations being sheltered behind unprofitable ones. Losses carry forward within their own separate activity silo.

95. B — Qualified property is measured at unadjusted basis immediately after acquisition, meaning original cost without reduction for depreciation, for property still held and within its depreciable period at year end. The limb adds twenty-five percent of wages to two and a half percent of that figure, and the larger limb controls.

96. A — Nondeductible penalties reduced book income and are never deductible for tax purposes, so they are added back. Excess tax depreciation is a deduction taken for tax but not recorded on the books and is subtracted, as are tax-exempt interest and life insurance proceeds, both being nontaxable book income items. Both categories of item move in opposite directions on the schedule.

97. C — First-tier distributions are amounts of income the instrument requires to be distributed currently, whether or not actually paid, and they absorb distributable net income before any second-tier discretionary amount is taxed. A beneficiary entitled to mandatory income is therefore taxed even where the trustee failed to pay it. A trustee's failure to pay does not defer the beneficiary's tax.

98. B — The trust thresholds are disjunctive, so a return is required where the trust has any taxable income at all, or gross income of six hundred dollars or more, or any beneficiary who is a nonresident alien. Meeting a single condition triggers the obligation, while estates apply only the gross income test.

99. A — Costs paid in connection with administering the entity that would not have been incurred if the property were not held in trust survived the suspension and remain fully deductible. Fiduciary fees, probate costs, and return preparation fees for the entity all qualify, while ordinary investment advisory fees generally do not.

100. D — The limitation is the last of four hurdles, applied after basis, at-risk, and passive activity have each been tested in turn. The disallowed excess is not lost; it becomes a net operating loss carryforward to the following year, where it becomes subject to the eighty percent of taxable income limitation instead.