PRACTICE EXAM 12: 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. Which arrangement does not create a partnership for federal tax purposes?

A. Two persons jointly owning a building and merely dividing the rent received
B. Two contractors agreeing informally to split the proceeds of a shared job
C. Two persons carrying on a venture together and sharing in the profits
D. Two persons operating a retail business without any written agreement

2. Which entity has no classification election available to it at all?

A. A domestic limited liability company having several members
B. A foreign entity whose members all enjoy limited liability
C. A general partnership organized under state partnership law
D. A business incorporated under a state incorporation statute

3. Which limitation applies once an eligible entity has changed its classification?

A. No further change is permitted for twenty-four months
B. No further change is generally permitted for sixty months
C. A further change requires consent of every entity member
D. A further change requires payment of a substantial user fee

4. Which event requires a business to obtain a new employer identification number?

A. A corporation electing to be taxed under Subchapter S provisions
B. A partnership admitting several new partners while continuing business
C. A sole proprietor taking on a partner and beginning to operate jointly
D. A business changing its registered trade name and relocating premises

5. Which deferral does a Section 444 election permit?

A. No more than six months measured back from the required year end
B. No more than three months measured back from the required year end
C. Any period the owners unanimously agree to adopt in writing
D. No more than twelve months from the entity's date of formation

6. Which activity uses a relaxed two-of-seven-years profit presumption?

A. Breeding, training, showing, or racing of horses by the taxpayer
B. Commercial farming producing row crops for sale at market
C. Charter fishing operated from a vessel owned by the taxpayer
D. Antique dealing conducted from a permanent retail location

7. Which item is business income notwithstanding that no cash was received?

A. Capital contributed to the business by its owner during the year
B. Loan proceeds deposited into the business operating account
C. A transfer of funds from the owner's personal savings account
D. Goods or services accepted in a barter exchange arrangement

8. Which basis does a partnership take in property contributed by a partner?

A. The fair market value of the property on the contribution date
B. The average of adjusted basis and fair market value at contribution
C. The contributing partner's adjusted basis, carried over unchanged
D. Zero until the property is placed in service by the partnership

9. Which item increases a partner's outside basis?

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

10. Which loss limitation is tested first for a partner claiming a K-1 loss?

A. The basis limitation measured by the partner's outside basis
B. The at-risk limitation excluding most nonrecourse financing
C. The passive activity limitation for nonparticipating partners
D. The excess business loss limitation applying in the aggregate

11. Which distribution may produce a recognized loss to a partner?

A. A current distribution of cash exceeding the partner's outside basis
B. A liquidating distribution consisting solely of money, receivables, and inventory
C. A liquidating distribution that includes a parcel of business land
D. A current distribution of appreciated business machinery

12. Which item is a hot asset for characterizing gain on a partnership interest sale?

A. Cash held in the partnership's ordinary operating bank accounts

B. Land held by the partnership purely for capital appreciation
C. Marketable securities held in a long-term investment portfolio
D. Depreciation recapture potential embedded in partnership equipment

13. Which condition terminates a partnership under current law?

A. A transfer of fifty percent or more of the interests within a year
B. The partnership disposing of substantially all its operating assets
C. The expiry of the stated term in the partnership agreement
D. No part of any business continuing to be carried on in partnership form

14. Where are the cancellation of debt exclusions applied for a partnership?

A. At the partner level, against each partner's own circumstances
B. At the partnership level before any allocation to the partners
C. At whichever level produces the smaller taxable amount overall
D. At the partnership level for bankruptcy and partner level for insolvency

15. Which requirement must be met for a partnership to elect out of the centralized regime?

A. The partnership must have fifty or fewer partners for the taxable year
B. The partnership must obtain advance written consent from the Service
C. Every partner must be an eligible type and there must be no more than one hundred statements
D. The partnership must have been in existence for three or more years

16. Which requirement defines control for Section 351 purposes?

A. Eighty percent of the total value of all outstanding stock issued
B. Eighty percent of voting power and eighty percent of each nonvoting class
C. Fifty-one percent of the total combined voting power alone
D. One hundred percent ownership by the transferring group of persons

17. Which item received in a Section 351 exchange constitutes boot?

A. Nonqualified preferred stock carrying a mandatory redemption right
B. Voting common stock issued by the transferee corporation
C. Nonvoting common stock with identical economic entitlements
D. Additional shares received later through a stock split

18. Which liability treatment applies where a shareholder borrows against property days before transferring it?

A. Only the excess of liabilities over property basis produces gain
B. The liability reduces stock basis with no gain arising at all
C. The transaction fails Section 351 entirely and is fully taxable
D. The entire liability assumed is treated as boot received by the shareholder

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

A. Federal income taxes actually paid during the taxable year
B. Tax-exempt interest received on municipal bond holdings during the year
C. Nondeductible fines assessed by a regulatory authority
D. Life insurance premiums where the corporation is the beneficiary

20. Which distribution tier reduces a shareholder's stock basis?

A. The dividend to the extent of available earnings and profits
B. The capital gain arising once stock basis has been exhausted
C. The tax-free return of capital arising after the dividend tier
D. A distribution of appreciated property at its fair market value

21. Which shareholder makes a corporation ineligible to elect S status?

A. An estate of a shareholder who died during the taxable year
B. A resident alien holding lawful permanent resident status
C. An electing small business trust that has made its election
D. A partnership holding a single share of the corporation's stock

22. Which stock difference creates a second class defeating an S election?

A. A difference in voting rights between two classes of common stock
B. A difference in transfer restrictions imposed by shareholder agreement
C. A difference in rights to distribution and liquidation proceeds
D. A difference in the par value assigned to the shares on issue

23. Which item creates debt basis for an S corporation shareholder?

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

24. Which restoration ordering applies where both bases were previously reduced?

A. Debt basis is restored first, up to the amount previously reduced
B. Stock basis is restored first because equity ranks ahead of debt
C. Both are restored proportionately to their earlier reductions
D. Neither is restored once reduced in an earlier taxable year

25. Which condition must exist for the built-in gains tax to reach a disposition?

A. The corporation must have more than one hundred shareholders
B. The corporation must have a prior C corporation history before conversion
C. The corporation must have distributed appreciated property
D. The corporation must have elected S status within five years

26. Which taxpayer may never use the cash method of accounting?

A. A tax shelter, regardless of the level of its gross receipts
B. A personal service corporation performing legal services
C. A farming corporation with modest annual gross receipts
D. A service business holding no inventories at any point

27. Which item is subtracted from purchases in computing cost of goods sold?

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

28. Which requirement accompanies an election of the last-in, first-out method?

A. The election must be renewed annually on each timely filed return
B. The method must be combined with lower of cost or market valuation
C. The method applies only to goods acquired after the election year
D. The method must also be used in reports to creditors and owners

29. Which cost must be capitalized into inventory under the uniform capitalization rules?

A. Distribution of completed goods to the purchasing customers
B. Advertising expenditures promoting the finished product line
C. Research and experimental costs for developing new products

D. Warehousing of finished goods still awaiting sale to customers

30. Which amount is excluded from a taxpayer's at-risk figure?

A. Nonrecourse financing obtained for an equipment leasing activity
B. Cash contributed directly to the activity by the taxpayer
C. The adjusted basis of property contributed to the activity
D. Borrowed amounts for which the taxpayer is personally liable

31. Which attribute is reduced first following an excluded cancellation of debt?

A. The basis of depreciable property held in the business
B. Capital loss carryovers from earlier taxable years
C. Net operating loss carryovers available to the taxpayer
D. Foreign tax credit carryovers accumulated to that date

32. Which compensation risk arises in a closely held C corporation?

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

33. Which family employment arrangement escapes Social Security and Medicare tax?

A. A child aged sixteen employed by a parent's sole proprietorship
B. A spouse employed by the other spouse's sole proprietorship
C. A parent employed by an adult child's sole proprietorship
D. A child aged twenty employed by a parent's proprietorship

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

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

35. Which expense produces no deduction whatever under current law?

A. Business meals taken with a client at a nearby restaurant
B. Meals provided at a company-wide recreational gathering
C. Entertainment such as tickets purchased for a business client
D. Meals treated as compensation and included in employee wages

36. Which condition converts an accountable plan into a nonaccountable one?

A. Reimbursing employees more than once each calendar month
B. Requiring receipts for expenditures below a stated amount
C. Reimbursing meals at the fifty percent deductible rate
D. Permitting employees to retain any unspent travel advances

37. Which property is recovered over twenty-seven and a half years?

A. Residential rental property acquired for letting to tenants
B. Nonresidential real property used in a trade or business
C. Land improvements such as fencing and drainage tile
D. Qualified improvement property in a commercial building

38. Which gain is recaptured as ordinary income on the sale of business equipment?

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

39. Which property still qualifies for like-kind exchange treatment?

A. Business equipment traded in on a replacement machine
B. A partnership interest exchanged for another such interest
C. Breeding livestock exchanged for animals of the same sex
D. Real property held for productive use in a trade or business

40. Which item is excluded from qualified business income?

A. Ordinary income from a domestic manufacturing partnership
B. Rental income from a domestic trade or business activity
C. Reasonable compensation paid to an S corporation shareholder
D. Section 179 expense allocated on the owner's Schedule K-1

41. Which business retains the qualified business income deduction at any income level?

A. A consulting practice advising corporate management clients
B. An engineering firm providing structural design services
C. An accounting firm preparing tax and audit engagements
D. A brokerage firm dealing in securities for its own clients

42. Which carryover applies to a net operating loss arising after 2017?

A. Two-year carryback with a twenty-year carryforward as before
B. Five-year carryback available to corporate taxpayers only
C. Indefinite carryforward with no carryback except for farming losses

D. Twenty-year carryforward expiring where not fully absorbed

43. Which difference between book and taxable income never reverses?

A. Federal income tax expense recorded on the corporate books
B. An allowance for doubtful accounts recorded for book purposes
C. Accelerated depreciation exceeding the book depreciation figure
D. Warranty reserves accrued for financial reporting purposes

44. Which treatment applies to a positive Section 481(a) adjustment?

A. Recognition entirely in the taxable year the change occurs
B. Recognition over the remaining useful life of the affected property
C. Recognition only when the related property is finally disposed of
D. Recognition ratably over four years beginning with the change year

45. Which condition defeats statutory relief from worker reclassification liability?

A. Failure to file the required information returns for those workers
B. Reliance on long-standing practice in a significant industry segment
C. Reliance on a prior examination raising no classification issue
D. Reliance on published judicial precedent covering similar workers

46. Which person may be assessed the trust fund recovery penalty?

A. Only the corporation that employed the workers in question
B. Only an officer owning a majority of the outstanding stock
C. Only the person formally designated treasurer in the bylaws
D. Any responsible person who wilfully failed to remit the withheld taxes

47. Which record must be retained until the disposition year's limitations period expires?

A. Payroll registers for employees who have since departed
B. Bank statements supporting deposits made during the year
C. Records establishing the basis of business property held
D. Copies of information returns furnished to contractors

48. Which entity form permits entity-level debt to support an owner's loss deduction?

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

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

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

50. Which figure determines applicable large employer status?

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

51. Which trust is disregarded for federal income tax purposes?

A. A grantor trust where the grantor retained a power to revoke
B. A complex trust accumulating income at the trustee's discretion
C. A simple trust distributing all of its income currently
D. An electing small business trust holding operating shares

52. Which item is subtracted in computing distributable net income?

A. The personal exemption allowed to the fiduciary entity
B. Capital gains allocable to corpus for the taxable year
C. Tax-exempt income net of its allocable expenses incurred
D. The distribution deduction claimed for the amounts paid out

53. Which beneficiary absorbs distributable net income before any other?

A. The remainder beneficiary succeeding to the trust corpus
B. The beneficiary receiving the largest total distribution
C. The beneficiary who received a distribution earliest in the year
D. The beneficiary entitled to income required to be distributed currently

54. Which exemption amount applies to a complex trust?

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

55. Which test examines what an exempt organization actually does?

A. The operational test requiring operation primarily for exempt purposes
B. The organizational test applied to the governing document
C. The public support test applied to the sources of funding

D. The commensurate test applied to program expenditure levels

56. Which conduct defeats charitable exemption absolutely with no threshold?

A. Conducting an unrelated trade or business on a regular basis
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

57. Which passive income is nevertheless taxable to an exempt organization?

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

58. Which plan must generally be established by the first of October?

A. A simplified employee pension funded by the extended due date
B. A savings incentive match plan for employees of a small firm
C. A profit sharing plan adopted before the close of the plan year
D. A defined benefit plan certified by an enrolled actuary

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

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

60. Which farm deduction is limited to fifty percent of other deductible farm expenses?

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

61. 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. One where the average period of customer use is six days
D. A commercial lease carrying annual renewal options for tenants

62. Which requirement accompanies the special rental real estate allowance?

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

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

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

64. Which item is rental income when the landlord receives it?

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

65. 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

66. 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. Gain recognized on distributing appreciated corporate property
D. Tax-exempt interest earned on municipal obligations held

67. 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

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

A. Business interest income plus thirty percent of adjusted taxable income
B. Fifty percent of the taxpayer's gross receipts for the year
C. Twenty percent of the taxpayer's qualified business income

D. The amount of interest actually paid rather than merely accrued

69. Where does a self-employed owner deduct their own retirement 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

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

A. Employment of at least twenty-five full-time equivalent workers
B. Payment of the entire premium cost for every covered employee
C. Availability across an unlimited number of consecutive years
D. Enrolment through the small business health options marketplace

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

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

72. 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

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

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

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

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

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

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

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

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

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

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

78. Which taxpayer may elect farm income averaging?

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

79. 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

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

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

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

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

D. Allocation entirely to the rental use of the dwelling itself

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

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

83. 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 permitted

84. 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 fair market value of qualified property at its acquisition
C. The unadjusted basis of qualified property immediately after acquisition
D. The accumulated depreciation claimed on qualified property

85. 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

86. 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

87. 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. Ownership of assets exceeding six hundred dollars in value
C. Existence of more than one beneficiary under the instrument
D. Any taxable income for the year, whatever the gross amount

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

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

89. 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. The disallowed excess becomes a net operating loss carryforward
D. It applies to corporations and to individuals on identical terms

90. Which consequence follows three consecutive years of failing to file the annual return?

A. Automatic revocation of exemption by operation of law
B. A per-day penalty accruing until the delinquent returns are filed
C. Conversion of the organization to private foundation status
D. A requirement to obtain a fresh determination letter only

91. 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. A penalty equal to ten percent of the balance is imposed
D. The entire account ceases to be an arrangement for that year

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

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

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

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

94. Which farm expenditure requires consistency with an approved conservation plan?

A. Fertilizer applied to growing crops during the season
B. Prepaid feed acquired before the consumption season
C. Soil and water conservation expenditures made on farmland

D. Repairs to machinery used in ordinary field operations

95. Which condition must a savings incentive match plan employer satisfy?

A. It must have fewer than twenty-five full-time equivalent employees
B. It must have one hundred or fewer employees and no other qualified plan
C. It must maintain at least one other qualified retirement plan
D. It must contribute a discretionary amount determined annually

96. Which item does an owner deduct outside the business schedule entirely?

A. Wages paid to employees of the business during the year
B. Rent paid for premises used in the business operations
C. Insurance premiums covering business property and liability
D. The owner's own contribution to the business retirement plan

97. Which figure caps the Section 179 deduction beyond its stated dollar limits?

A. Gross receipts of the business for the taxable year in question
B. Aggregate taxable income from the active conduct of any business
C. The taxpayer's adjusted gross income before taking the deduction
D. The total basis of all property placed in service that year

98. Which schedule analyses unappropriated retained earnings?

A. Schedule M-2, which must agree with the balance sheet equity
B. Schedule L, presenting beginning and ending balance sheets
C. Schedule M-1, reconciling book income to taxable income
D. Schedule G, identifying substantial stock ownership interests

99. Which item is excluded in computing an individual's net operating loss?

A. Ordinary business losses from an active trade or business
B. Depreciation claimed on property used in the business
C. Wages paid to employees during the loss year in question
D. Capital losses in excess of capital gains for the taxable year

100. Which statement about the sequence of loss limitations is correct?

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

Practice Exam 12: Answer Key and Explanations

1. A — Mere co-ownership of property does not create a partnership, and dividing rent without providing services to occupants falls on the co-ownership side of that line. A partnership exists where two or more persons carry on a trade, business, or venture and divide the profits, and no writing or registration is ever required for that.

2. D — An entity organized under a state incorporation statute is a per se corporation and cannot elect partnership or disregarded classification, its only remaining choice being whether to elect S status. Limited liability companies, general partnerships, and most foreign entities are eligible entities free to elect classification affirmatively on the prescribed form.

3. B — An election generally locks the classification for sixty months measured from the effective date rather than the filing date. Two exceptions apply: the rule does not reach an entity's initial classification at formation, and the Service may permit an earlier change where more than half the ownership interests have since changed hands.

4. C — A new number is required only where a new entity comes into existence, and a sole proprietor taking on a partner creates a partnership, which is a different taxpayer entirely. An S election, changes in partnership membership, name changes, and relocations all leave the same taxpayer in place and require nothing.

5. B — The election permits a deferral period of no more than three months measured backward from the required year end, so an entity required to use December may elect September, October, or November but no earlier. Partnerships and S corporations making it compute a required payment, while personal service corporations face a distribution requirement.

6. A — Activities consisting primarily of breeding, training, showing, or racing horses use the relaxed two-of-seven test, while all other activities use three profitable years out of five consecutive years ending with the year in question. A form may be filed to postpone the determination until the presumption period has fully run.

7. D — Bartered goods and services are included at the fair market value of what was received, so a contractor accepting accounting services in exchange for renovation work has income equal to the value of those services. Capital contributions, loan proceeds, and personal transfers all increase the bank balance without producing any income.

8. C — The partnership takes a carryover basis equal to the contributor's adjusted basis immediately before the contribution, while the partner separately takes a substituted basis in the interest received. Fair market value plays no role in either computation, and any appreciation is preserved rather than recognized on the transfer itself. The partner's holding period tacks for capital and Section 1231 assets.

9. C — Tax-exempt income increases basis despite never being taxed, which preserves the exemption when the interest is eventually disposed of. Distributions, decreases in liability share, and nondeductible noncapital expenses all reduce basis, the last being the exact mirror image of the tax-exempt income rule operating in reverse. Both rules ensure disposition gain reflects economic rather than taxable results.

10. A — The four hurdles operate in a fixed sequence and basis is tested first, so only the amount surviving that limitation is then measured against amounts at risk, then against passive income, and finally against the excess business loss cap. A loss stopped at any hurdle never reaches the next one at all.

11. B — Loss may be recognized only on a liquidating distribution and only where the partner receives nothing but money, unrealized receivables, and inventory. A single item of other property absorbs the remaining basis and defeats recognition entirely, while cash exceeding basis in a current distribution produces gain rather than any loss.

12. D — The definition of unrealized receivables reaches beyond conventional receivables to capture depreciation recapture potential embedded in depreciable property. A partnership holding heavily depreciated equipment therefore carries hot assets, and the portion of gain attributable to them becomes ordinary income rather than the capital gain a sale would otherwise produce. The distinction converts apparent capital gain into ordinary income.

13. D — Termination now occurs only where no part of any business, financial operation, or venture continues to be carried on by any partner in a partnership. Technical termination on a fifty percent transfer has been repealed entirely, so ownership changes alone no longer close the tax year or require a short-period return.

14. A — Cancellation income flows through as a separately stated item and the bankruptcy, insolvency, and other exclusions are tested against each partner's own position. An insolvent partnership provides no relief to a solvent partner, so two partners receiving identical allocations from the same discharge can reach entirely opposite conclusions. The partnership's own solvency position is entirely beside the point.

15. C — Electing out requires both that the partnership furnish one hundred or fewer Schedules K-1 and that every partner be an eligible type. Trusts, partnerships, disregarded entities, and nominees are all ineligible, and a single ineligible partner defeats the election however small the partnership happens to be. The numerical threshold alone is never sufficient on its own.

16. B — Control requires at least eighty percent of the total combined voting power of all voting classes and at least eighty percent of the total number of shares of each other class. Both prongs must hold simultaneously, and the second is measured by share count within each class rather than by aggregate value.

17. A — Nonqualified preferred stock, broadly meaning preferred carrying debt-like features such as a mandatory redemption right, is treated as boot despite being labelled stock, as are corporate debt securities. Only genuine stock qualifies for nonrecognition, and boot triggers gain equal to the lesser of realized gain or the boot received. Loss is never recognized under the provision regardless of boot.

18. D — Where the principal purpose of the assumption is avoidance of federal income tax, or there is no bona fide business purpose, the entire liability becomes boot rather than merely the excess over basis. Borrowing against unencumbered property shortly before transfer and retaining the proceeds is the classic targeted pattern. A mortgage incurred years earlier to acquire the property is unaffected.

19. B — Tax-exempt interest is cash genuinely received and increases earnings and profits despite never entering taxable income, as do life insurance proceeds and the dividends received deduction. Federal income taxes, nondeductible fines, and life insurance premiums are all real outlays reducing the capacity to distribute to shareholders. The measure gauges real capacity to distribute rather than taxable income.

20. C — Only the second tier, the tax-free return of capital, reduces stock basis. The dividend tier does not touch basis at all, and the third tier arises only once basis has already been driven to zero. Reducing basis by the entire distribution produces a wrong figure that appears among the answer choices.

21. D — Eligible shareholders are limited to individuals who are citizens or resident aliens, estates, certain qualifying trusts, and some exempt organizations. Partnerships and corporations may never hold shares, and a single ineligible shareholder terminates the election on the very day the disqualifying transfer occurs rather than at year end. Eligibility is continuous rather than tested once at election.

22. C — The one class of stock requirement looks to identical rights in distribution and liquidation proceeds. Differences in voting rights are expressly permitted, making voting and nonvoting common the standard succession structure, while preferred stock carrying a priority dividend creates a second class and defeats the election immediately on issue. Straight debt within the published safe harbor is respected as debt.

23. B — 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. Payment under a guarantee creates basis only when it is made.

24. A — Losses reduce stock basis first and debt basis second, while restoration in a later profitable year runs in the opposite direction. A net increase rebuilds debt basis up to the amount previously reduced before any stock basis is restored, which protects the shareholder's loan ahead of the equity investment made.

25. B — The tax reaches only appreciation economically present at conversion from C to S status and disposed of within a five-year recognition period beginning on the first day of the first S year. A corporation that has always been an S corporation faces no exposure whatever the appreciation in its assets.

26. A — Tax shelters may never use the cash method whatever their size, while personal service corporations, farming corporations meeting applicable conditions, and service businesses without inventories may all use it where they fall below the gross receipts test that also governs inventory accounting and capitalization requirements. The same threshold governs inventory accounting and capitalization alike.

27. C — Merchandise removed for personal use must be subtracted from purchases, since treating it as a business expense or ignoring it entirely overstates cost of goods sold and understates gross profit by that same amount. Freight is added into inventoriable cost, and trade discounts reduce the invoice price directly instead. The withdrawal is a personal item rather than a business cost.

28. D — The conformity requirement obliges a taxpayer electing the method for tax purposes to use it in reports to shareholders, partners, and creditors, preventing the tax benefit being claimed while higher earnings are shown to a lender. The election applies until the Service consents to a change of method. Lower of cost or market may not be combined with the method.

29. D — Storage and warehousing of goods before sale is an indirect cost requiring capitalization, along with purchasing, handling, quality control, production depreciation, and allocable overhead. Selling, advertising, distribution to customers, research and experimentation, and non-production administration all remain currently deductible period costs falling outside the requirement. The dividing line is whether goods await a buyer or move toward one.

30. A — Nonrecourse financing carries no personal liability and is excluded from amounts at risk, though it does increase basis under the liability sharing rules. Qualified nonrecourse financing secured by real property is the narrow exception, available only to real property activities rather than to equipment or other ventures. The activity's own assets pledged as security add no real exposure.

31. C — The prescribed order runs net operating losses, general business credit carryovers, the minimum tax credit, capital loss carryovers, basis of property, passive activity carryovers, and finally foreign tax credits. The reduction equals the amount excluded rather than forgiven, and depreciable basis may be elected first instead. Both are reported on the prescribed form accompanying the return.

32. B — 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. The S corporation risk reverses entirely toward understated compensation being recharacterized as wages. Double taxation therefore falls on precisely the disallowed portion.

33. A — A child under eighteen employed by a parent's sole proprietorship, or by a partnership in which every partner is a parent, is exempt from Social Security and Medicare tax and remains exempt from unemployment tax until twenty-one. Spouses and parents stay subject to Social Security, and incorporating destroys all exemptions.

34. B — 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 instead, transportation becomes fully deductible even though some personal time happens to be taken during the trip.

35. C — Entertainment produces no deduction at all regardless of business purpose, which captures tickets, club dues, and recreational outings. Business meals remain fifty percent deductible where the taxpayer or an employee is present, and food at an entertainment event qualifies only where separately stated on the invoice. Club dues and recreational outings fall under the same prohibition.

36. D — An accountable plan requires a business connection, substantiation within a reasonable period, and return of any excess advance. Allowing employees to keep unspent advances defeats the third condition, and failure of any single condition converts the arrangement for every participant, making all payments taxable wages without offsetting deduction. Employee business deductions are suspended, so no offset survives.

37. A — Residential rental property carries a twenty-seven and a half year period while nonresidential real property runs thirty-nine years, both recovered straight line under the mid-month convention regardless of placement date. Land improvements run fifteen years, as does qualified improvement property, which is additionally eligible for Section 179 expensing. Land is never depreciable and must be separated on acquisition.

38. B — 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 above straight line. Under current recovery methods that usually amounts to nothing at all.

39. D — Section 1031 now applies exclusively to real property held for productive use in a trade or business or for investment, and real property is broadly like kind to other real property. Equipment, livestock, and partnership interests are excluded in every circumstance under current law without any exception. Material describing equipment trade-ins reflects law repealed years ago.

40. C — Reasonable compensation is wages rather than qualified business income and is excluded, as are guaranteed payments to partners on identical reasoning. Capital gains, dividends, investment interest, and foreign income are also excluded, while ordinary income from a domestic trade or business remains firmly inside the definition. Employee service income is likewise outside the definition entirely.

41. B — Engineering and architecture 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, while consulting, accounting, and brokerage all appear on the list and lose it. The wage and property limitations nevertheless continue to apply.

42. C — Losses arising after 2017 carry forward indefinitely with no carryback, except two years for farming losses, and the deduction in any year is capped at eighty percent of taxable income computed without the loss and without the qualified business income deduction. Pre-2018 losses are used first without limitation. Pre-2018 losses are used first and carry no percentage limitation.

43. A — Federal income tax reduces book income and is never deductible for tax, so the difference is permanent 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 paid. Permanent differences change the effective rate the corporation bears.

44. D — A positive adjustment increasing income spreads ratably over four years beginning with the year of change, while a negative adjustment decreasing income is taken entirely in that year. The asymmetry softens the cost of correcting a favourable but impermissible method and encourages voluntary rather than examination-forced correction. Voluntary correction also brings audit protection for earlier years.

45. A — Relief requires reasonable basis, substantive consistency, and reporting consistency, all holding at once. Failure to file information returns defeats the claim outright however reasonable the original basis was. Industry practice, a prior examination, and judicial precedent are each acceptable grounds for the reasonable basis element itself. All three conditions must hold simultaneously for relief to apply.

46. D — The penalty reaches any responsible person, meaning anyone with the authority and duty to direct payment, which may include officers, bookkeepers, and occasionally outside advisors. Wilfulness requires only knowledge that taxes were unpaid plus a decision to pay other creditors, with no intent to defraud required. The liability survives dissolution and is not discharged in bankruptcy.

47. C — Basis records must survive as long as the asset does and then through the limitations period for the year of disposition, which for real property can run several decades. A taxpayer unable to substantiate basis on sale faces gain computed from a basis of zero, an expensive recordkeeping failure. Basis of zero is presumed where the records cannot be produced.

48. B — 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 entity level and never reach shareholders. A guarantee alone produces no basis until it is actually paid.

49. D — 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. Only the remaining gain spreads across the installment payments.

50. C — 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 themselves. Equivalents are aggregate part-time hours divided by one hundred twenty.

51. A — Where the grantor retains specified powers, including a power to revoke, the trust is disregarded and its income, deductions, and credits are reported directly by the grantor. A revocable living trust is a grantor trust by definition, files no separate return during the grantor's life, and becomes separate at death.

52. B — 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 income economically available for distribution. The result approximates income economically available for distribution.

53. D — 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 second-tier discretionary amount is taxed. A trustee's failure to make the required payment does not defer the beneficiary's tax on that amount. Second-tier beneficiaries share only whatever amount then remains.

54. B — The exemption is one hundred dollars for a complex trust, three hundred for a simple trust required to distribute all income currently, 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 year.

55. A — The operational test examines actual activities, requiring operation primarily for exempt purposes, while the separate organizational test examines the governing document, which must limit purposes, avoid empowering substantial non-exempt activity, and permanently dedicate assets on dissolution. Both must be satisfied independently before exemption can be recognized. Neither test alone is sufficient to establish exempt status.

56. 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 becomes the organization's primary purpose. Primary purpose marks the point where tax becomes revocation.

57. 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. A mortgage on investment property is therefore the decisive fact.

58. B — The savings incentive match plan must generally be established by October first for the year it is to be effective, a deadline carrying no extension whatever. A simplified employee pension may instead be established and funded as late as the extended return due date, making it the only post-year-end option.

59. C — 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 throughout. Poultry is excluded from the provision by statute in every case.

60. D — Prepaid farm supplies are limited to fifty percent of other deductible farm expenses, with exceptions for farmers meeting a substantial-business test or where unusual circumstances caused the excess. Soil and water conservation expenditures instead face a twenty-five percent of gross farm income limit with indefinite carryforward. A substantial-business test provides the principal available exception.

61. C — 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.

62. B — 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.

63. D — 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 outright.

64. A — 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. A refundable deposit is the notable exception to inclusion here.

65. C — Release requires disposing of the entire interest in the activity in a fully taxable transaction to an unrelated party, after which 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.

66. D — 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.

67. 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 validly electing out of the regime, may file an amended return with corrected statements in the ordinary way. Electing out demands both numerical and eligibility conditions.

68. A — 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.

69. 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 for employees are properly a business expense, so one plan yields deductions in two places. Contributions made for employees are properly a business expense.

70. D — 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 figures rise. The credit phases out as headcount or average wages climb.

71. B — 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. The final disallowed excess becomes a net operating loss carryforward.

72. C — Where capital is a material income-producing factor, a family member owning a genuine capital interest is recognized even if 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 the interest. Where capital is not material, genuine services or capital are required.

73. B — 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 remains inside the family partnership regime. Candidates commonly assume a genuine purchase breaks the analysis, and it does not.

74. D — 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. Both categories nevertheless bear the unrelated business income tax.

75. A — 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 generates. Producing funds alone never establishes substantial relation.

76. C — 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 fiduciary self-dealing alike. Family members of those persons are likewise disqualified persons.

77. A — 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 instead qualifies for a one-year deferral of the excess proceeds received. Ordinary sale livestock instead receives a one-year deferral election.

78. D — Averaging is available only to individuals, including 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 returns are unaffected, and the election may be made on an amended return. C corporations may never elect farm income averaging at all.

79. 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 that year. Licensure and ownership percentage form no part of the statutory test.

80. B — 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 it.

81. A — 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.

82. B — 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.

83. 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.

84. C — 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. The taxpayer claims whichever of the two limbs produces more.

85. A — Nondeductible penalties reduced book income and are never deductible for tax, 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 nontaxable book income items. Both categories of item move in opposite directions on the schedule.

86. 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 taxed even where the trustee failed to pay. A trustee's failure to pay does not defer the beneficiary's tax.

87. D — 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 use only the gross income test.

88. B — 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 qualify, while ordinary investment advisory fees generally do not. Probate costs and return preparation fees also fall inside the carve-out.

89. C — The limitation is the last of four hurdles, applied after basis, at-risk, and passive activity have each been tested. 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. The eighty percent limitation then governs its later use.

90. A — Three consecutive years of non-filing revokes exemption automatically by operation of law, with no notice required and effect from the third year's due date. Reinstatement requires a fresh application and fee, and the rule catches smallest organizations most often since those filing the electronic notice overlook it. Retroactive reinstatement requires reasonable cause and all delinquent returns.

91. D — 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 occurs.

92. B — 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 baselines. Top-heavy plans require accelerated vesting beyond these baselines.

93. A — 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 recognized status. The application itself remains valid; only its effective date shifts.

94. C — 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 years. Prepaid supplies face a separate fifty percent limitation instead.

95. B — The plan is available to employers with no more than one hundred employees who maintain no other qualified plan. The employer must either match dollar for dollar up to three percent of compensation or contribute two percent nonelectively for every eligible employee, and all contributions vest immediately on deposit. Both formulas are mandatory rather than discretionary each year.

96. D — The owner's own contribution is an adjustment to income on the front of the return rather than a business schedule expense, because deducting it there would reduce net earnings again and understate self-employment tax. Contributions made on behalf of employees are properly a business expense of the enterprise. Deducting it on the business schedule would understate self-employment tax.

97. B — The deduction cannot exceed aggregate taxable income from the active conduct of any trade or business, so it can never create or increase a loss, and disallowed amounts carry forward indefinitely. Bonus depreciation carries no comparable income limitation and can generate a net operating loss instead. Bonus depreciation carries no comparable income limitation at all.

98. A — Schedule M-2 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 equity section of Schedule L. For an S corporation it instead tracks balances governing distribution taxability. A mismatch signals an equity entry that bypassed the schedule.

99. D — Capital losses exceeding capital gains are excluded because they follow their own carryover regime. The computation also excludes the net operating loss deduction itself and the qualified business income deduction, and allows nonbusiness deductions only to the extent of nonbusiness income received during that year. Personal deductions cannot therefore generate a business carryover.

100. C — The four hurdles operate in a fixed sequence and each is tested against the amount that survived the previous one rather than the original loss. Basis is tested first, then at-risk, then passive activity, then the excess business loss cap, whose disallowed remainder becomes a net operating loss carryforward. A loss stopped at any hurdle never reaches the next one.