PRACTICE EXAM 17: 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. Rashida transfers property with an 85,000 dollar adjusted basis to a corporation that assumes a 112,000 dollar mortgage on it. She receives all the stock. What gain does she recognize?

A. Twenty-seven thousand dollars, the excess of liabilities over basis
B. One hundred twelve thousand dollars, the full liability assumed
C. No gain, because assumed liabilities are never treated as boot
D. Eighty-five thousand dollars, equal to her adjusted basis

2. Tomas begins the year with 30,000 dollars of outside basis, receives a 30,000 dollar cash distribution, and is allocated a 22,000 dollar loss. What is the result?

A. The entire loss is suspended and carried forward indefinitely
B. The loss is fully deductible against his other business income
C. Twenty-two thousand of the distribution becomes taxable gain
D. Eight thousand dollars of the loss is currently deductible

3. An S corporation with 40,000 dollars in its accumulated adjustments account and 25,000 dollars of accumulated earnings and profits distributes 95,000 dollars to a shareholder whose stock basis is 60,000 dollars. What capital gain results?

A. Thirty thousand dollars, being the excess over the two accounts
B. Ten thousand dollars once all four tiers have been worked through
C. Fifty-two thousand dollars after the first two tiers are applied
D. No capital gain, because stock basis exceeds the distribution

4. A corporation has taxable income of 480,000 dollars computed before its charitable deduction and the dividends received deduction. It contributed 62,000 dollars to qualifying charities. What is deductible this year?

A. Thirty-one thousand dollars, being half of the contribution
B. One hundred twenty thousand dollars, the maximum permitted
C. Forty-eight thousand dollars, with fourteen thousand carried forward
D. Sixty-two thousand dollars, the full amount actually contributed

5. A calendar-year business places personal property in service costing 120,000 dollars in February, 95,000 dollars in July, and 180,000 dollars in November. Which convention applies?

A. The mid-quarter convention, because the fourth quarter share exceeds forty percent
B. The half-year convention, since no single quarter dominates
C. The mid-month convention, as with all real property placements
D. A full-year convention, because placements span three quarters

6. A corporation owning thirty percent of a domestic payer receives 200,000 dollars of dividends. What deduction is available before any taxable income limitation?

A. One hundred thirty thousand dollars at the sixty-five percent rate
B. One hundred thousand dollars at the fifty percent rate
C. Two hundred thousand dollars at the one hundred percent rate
D. No deduction, because the ownership threshold is not satisfied

7. Ingrid sells her partnership interest for 210,000 dollars when her outside basis is 140,000 dollars. Of the gain, 48,000 dollars is attributable to hot assets. How is the gain characterized?

A. Seventy thousand dollars entirely as ordinary income
B. Twenty-two thousand ordinary and forty-eight thousand capital
C. Forty-eight thousand ordinary and twenty-two thousand capital
D. Seventy thousand dollars entirely as long-term capital gain

8. Beckett reports 90,000 dollars of net profit on Schedule C and maintains a plan with a stated rate of twenty-five percent. Approximately what may he deduct for his own contribution?

A. Eighteen thousand dollars, twenty percent of the net profit
B. Sixteen thousand seven hundred dollars after both adjustments
C. Twenty-two thousand five hundred dollars, twenty-five percent of profit
D. Twenty thousand nine hundred dollars, using half the profit figure

9. Which entity is classified as a partnership by default with no election filed?

A. A domestic limited liability company having a single member
B. A business incorporated under a state incorporation statute
C. A foreign entity whose members all enjoy limited liability
D. A domestic limited liability company with two or more members

10. Which event obliges a business to obtain a new employer identification number?

A. A corporation electing to be taxed under Subchapter S
B. A partnership admitting several additional partners
C. A sole proprietor taking on a partner and operating jointly
D. A business changing its trade name and relocating premises

11. Which test does a partnership reach only after the majority interest year fails?

A. The common tax year of all of the partnership's principal partners
B. The least aggregate deferral computation across candidate years
C. The calendar year applied as a mandatory statutory fallback
D. The tax year of the partner with the largest capital account

12. Which contribution to a partnership produces immediate ordinary income?

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

13. Which liability allocation applies to a nonrecourse partnership liability?

A. Allocation to the partner bearing the economic risk of loss
B. Allocation according to the partners' shares of partnership profits
C. Allocation equally among all general and limited partners
D. Allocation in proportion to each partner's capital account

14. Which distribution triggers gain to a partner?

A. A distribution of appreciated land exceeding outside basis
B. A distribution of inventory exceeding the partner's basis
C. A distribution of equipment carrying depreciation recapture
D. Money distributed in excess of the partner's outside basis

15. Which condition terminates a partnership under current law?

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

D. The expiry of the term stated in the partnership agreement

16. Which requirement must a partnership meet to elect out of the centralized regime?

A. The partnership must have fifty or fewer partners in total
B. The partnership must obtain advance consent from the Service
C. Every partner must be an eligible type of person for that year
D. The partnership must have existed for at least three years

17. Which requirement defines control for Section 351 purposes?

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

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

A. Voting common stock of the transferee corporation received
B. Nonvoting common stock carrying identical economic rights
C. Additional shares received later through a stock split
D. A corporate debt security issued to the transferring 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
C. Nondeductible fines assessed by a regulatory authority
D. Life insurance premiums where the corporation is beneficiary

20. 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. A partnership holding a single share of the corporation's stock
D. An electing small business trust that has made its election

21. Which item establishes debt basis for an S corporation shareholder?

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

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

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

23. 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 distributed appreciated property
C. The corporation must have a prior C corporation history
D. The corporation must have elected S status within five years

24. 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

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

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

26. 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

27. Which discharge produces no cancellation of indebtedness income?

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

28. 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

29. Which risk attends compensation 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

30. 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

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

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

32. 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. Meals treated as compensation and included in employee wages
D. Entertainment such as tickets purchased for a business client

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

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

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

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

35. 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. Real property held for productive use in a trade or business
D. Breeding livestock exchanged for animals of the same sex

36. Which item is excluded from qualified business income?

A. Ordinary income from a domestic manufacturing partnership
B. Guaranteed payments received by a partner for services rendered
C. Rental income from a domestic trade or business activity
D. Section 179 expense allocated on the owner's Schedule K-1

37. Which business retains the deduction at any income level?

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

38. 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. Twenty-year carryforward expiring where not fully absorbed
D. Indefinite carryforward with no carryback except for farming losses

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

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

40. 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 property
C. Recognition ratably over four years beginning with the change year
D. Recognition only when the related property is disposed of

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

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

D. Reliance on published judicial precedent covering similar workers

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

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

43. Which record must be kept until the disposition year's limitations period expires?

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

44. Which entity form permits entity debt to support an owner's loss deduction?

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

45. 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

46. 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

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

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

48. 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 amounts paid out

49. 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

50. Which exemption amount applies to an estate?

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

51. 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

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

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

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

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

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

A. A savings incentive match plan for employees of a small firm
B. A simplified employee pension funded by the extended due date
C. A profit sharing plan adopted before the plan year closes

D. A defined benefit plan certified by an enrolled actuary

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

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

56. Which farm deduction is limited to fifty percent of other 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

57. 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

58. 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

59. 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

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

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

61. 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 transfer of the interest to a corporation the owner controls
D. A fully taxable disposition of the entire interest to an unrelated party

62. 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

63. 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

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

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

65. 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

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

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

67. 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. Attainment of the age of majority under applicable state law

D. Genuine ownership of a capital interest, however it was acquired

68. 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 terminates the partnership for federal income tax purposes
C. It is treated as a gift for family partnership purposes
D. It requires the partnership to obtain a new identification number

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

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

70. 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 regularly carried on by the organization
D. The activity must be conducted outside the organization's state

71. 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. Any vendor supplying goods to the employer's own business
D. An owner of fifty percent or more of the sponsoring employer

72. 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. Four years, extendable where drought persists across a region
C. One year, matching the ordinary deferral election period
D. Three years, as applies to condemned business real property

73. 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

74. 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

75. 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

76. 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 by the relative fair rental value of each period
C. Allocation using the total days the property was actually used
D. Allocation entirely to the rental use of the dwelling itself

77. 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

78. 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

79. 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

80. 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

81. 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. Any distribution actually paid out during the taxable year
D. Income required to be distributed currently under the instrument

82. 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

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

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

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

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

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

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

86. 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

87. 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

88. 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

89. 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

90. 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

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

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

92. Which schedule analyses unappropriated retained earnings?

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

93. 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

94. Which condition must exist for the passive investment income termination?

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

95. Which item is a permanent book-tax difference?

A. Life insurance proceeds received on a key employee policy
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

96. Which requirement accompanies a last-in, first-out inventory election?

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

97. 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

98. Which restoration ordering applies where both bases were reduced by losses?

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

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

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 share of nondeductible, noncapital expenses
D. The partner's distributive share of tax-exempt income for the year

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

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

Practice Exam 17: Answer Key and Explanations

1. A — Where liabilities assumed exceed the adjusted basis of property transferred, the excess is recognized as gain under Section 357(c). Here the excess is twenty-seven thousand dollars. The rule exists to prevent a negative stock basis arising. Rashida's stock basis becomes exactly zero, preserving the balance of her realized gain for later recognition.

2. B — Adjustments run in strict order: increases first, then distributions, then losses. The distribution absorbs the entire thirty thousand dollars of basis, leaving nothing behind. The twenty-two thousand dollar loss is therefore suspended in full and carried forward indefinitely. It becomes deductible only when Tomas restores basis by contribution, income allocation, or an increased liability share.

3. C — The four tiers run in order. Forty thousand comes from the adjustments account tax free, reducing basis to twenty thousand. Twenty-five thousand is then a dividend from earnings and profits, which does not touch basis. The next twenty thousand is a return of capital exhausting basis. The final ten thousand dollars is capital gain.

4. D — The limitation is ten percent of taxable income computed before the charitable deduction itself and before the dividends received deduction. Ten percent of four hundred eighty thousand is forty-eight thousand dollars. The remaining fourteen thousand dollars carries forward for five years. Excess contributions are used after the current year's amounts in each later year.

5. B — The fourth-quarter placements of one hundred eighty thousand dollars represent forty-five and six tenths percent of the three hundred ninety-five thousand dollar total. That exceeds the forty percent threshold, so the mid-quarter convention applies to all personal property placed in service that year. The test excludes real property and property expensed under Section 179.

6. A — The dividends received deduction is fifty percent below twenty percent ownership, sixty-five percent from twenty percent to under eighty percent, and one hundred percent at eighty percent or more. Thirty percent falls in the middle tier, giving one hundred thirty thousand dollars. A holding period requirement surrounding the ex-dividend date applies at every tier.

7. D — Total gain is seventy thousand dollars. Section 751 recharacterizes the portion attributable to unrealized receivables and inventory items as ordinary income, which is forty-eight thousand here. Only the residual twenty-two thousand receives capital gain treatment. Unrealized receivables also capture depreciation recapture potential embedded in the partnership's depreciable property. Recapture potential counts as an unrealized receivable.

8. C — Two adjustments separate the answer from a naive computation. Net earnings are first reduced by the deductible half of self-employment tax, giving roughly eighty-three thousand six hundred dollars. The stated rate is then converted, twenty-five divided by one hundred twenty-five giving twenty percent. The product is approximately sixteen thousand seven hundred dollars.

9. D — A domestic eligible entity with two or more members defaults to partnership classification where no election is filed. Disregarded treatment reaches only single-member domestic entities. A state-law corporation is a per se corporation with no classification election available. A foreign entity with universal limited liability defaults instead to corporate treatment under the inverted foreign rules.

10. C — A new number is required only where a genuinely new entity comes into existence. A sole proprietor taking on a partner creates a partnership, which is a different taxpayer entirely. An S election changes only how an existing corporation is taxed. Membership changes, name changes, and relocations all leave the same entity in place.

11. A — The hierarchy runs majority interest year first, then the common year of all principal partners owning five percent or more, and only then the least aggregate deferral computation. Each step is reached solely where the preceding one produces no answer. The arithmetic therefore comes last rather than first in the analysis.

12. B — Services are not property, so the nonrecognition provision does not shelter them at all. A capital interest received for services is compensation, taxable at the fair market value of the interest received. That value then becomes the partner's basis in the interest. A profits interest is generally not taxable on receipt.

13. B — A nonrecourse liability, for which no partner bears economic risk of loss, is generally allocated according to profit shares. A recourse liability goes instead to whoever actually bears that risk, ordinarily the general partners. This distinction explains why a limited partner's basis is typically supported by nonrecourse rather than recourse debt.

14. D — Gain arises only where money distributed exceeds outside basis. Property other than money simply absorbs basis rather than requiring it, so no gain results however appreciated it is. Marketable securities are generally treated as money for this rule. Distributing publicly traded stock can therefore produce gain where distributing land cannot.

15. A — 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. Ownership changes no longer close the tax year or restart depreciation. A two-partner buyout is the common pattern.

16. C — Electing out requires both that the partnership furnish one hundred or fewer Schedules K-1 and that every partner be an eligible type of person. Trusts, partnerships, disregarded entities, and nominees are all ineligible. A single ineligible partner defeats the election however small the partnership. Notification to each partner is required within thirty days.

17. A — Control requires at least eighty percent of the total combined voting power of all classes entitled to vote, and eighty percent of the total number of shares of each other class. Both prongs must hold at the same moment. The second is measured by share count rather than value. Failing either prong defeats the exchange for everyone.

18. D — Corporate securities such as long-term debt instruments are boot rather than stock. Nonqualified preferred stock carrying debt-like features is treated the same way despite its label. Only genuine stock qualifies for nonrecognition. Boot triggers gain equal to the lesser of realized gain or boot received, while loss is never recognized.

19. B — Tax-exempt interest is cash genuinely received and increases earnings and profits despite never entering taxable income. Life insurance proceeds and the dividends received deduction operate the same way. Federal income taxes, fines, and life insurance premiums are all real outlays. Each reduces the corporation's genuine capacity to distribute to shareholders.

20. C — 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. A single ineligible shareholder terminates the election on the very day the disqualifying transfer occurs. Eligibility is continuous rather than tested once. A later change in a shareholder's residence status terminates it too.

21. D — Debt basis arises only from a direct loan creating genuine indebtedness running from the corporation to that shareholder. An actual economic outlay is required before any basis exists. A guarantee produces nothing until it is called and the shareholder actually pays. Pledging collateral and corporate third-party borrowing are likewise insufficient.

22. B — Tax-exempt income does not increase the account and its related expenses do not reduce it, though both affect stock basis. The account tracks income already taxed once to shareholders. Ordinary income, separately stated income, and recognized gains all increase the balance. Distributions reduce it only as far as zero, while losses may drive it negative.

23. C — The tax reaches only appreciation economically present at conversion from C to S status, 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. Only post-conversion appreciation escapes the corporate layer entirely.

24. A — Tax shelters may never use the cash method whatever their size or receipts. Personal service corporations, farming corporations meeting the applicable conditions, and service businesses without inventories may all use it. The gross receipts test otherwise governs, and that same threshold also determines exemption from inventory accounting and capitalization. Crossing the threshold generally engages all three regimes at once.

25. B — Merchandise removed for personal use must be subtracted from purchases rather than deducted as a business expense. Treating it as an expense overstates cost of goods sold and understates gross profit by that same amount. Freight is instead added into inventoriable cost. Trade discounts reduce the invoice price directly rather than appearing separately.

26. D — Storage and warehousing of goods before sale is an indirect cost requiring capitalization. Purchasing, handling, quality control, production depreciation, and allocable overhead are treated identically. Selling, advertising, distribution to customers, and research and experimentation all remain currently deductible period costs. The dividing line is whether goods await a buyer or move toward one.

27. A — 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 income. Debt cancelled as a gift produces none either. Forgiveness of an amount that would have been deductible if paid produces nothing, since inclusion and deduction would simply offset one another.

28. C — The prescribed order begins with net operating losses, then 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 the amount forgiven. A taxpayer may elect to reduce depreciable basis first.

29. B — In a C corporation the danger runs toward compensation that is too high rather than too low. Excessive amounts paid to a shareholder-employee become dividends, which the corporation cannot deduct while the recipient remains fully taxable. Double taxation therefore falls on precisely the disallowed portion. The S corporation risk reverses entirely.

30. 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. That child stays exempt from unemployment tax until twenty-one. Spouses and parents remain subject to Social Security. Incorporating the business destroys every one of these exemptions.

31. C — Where a domestic trip is primarily personal, transportation to and from the destination is entirely nondeductible. Expenses at the destination directly attributable to business nevertheless remain deductible. Where the trip is primarily for business instead, transportation becomes fully deductible even though personal time is taken. Foreign travel follows separate allocation rules.

32. D — Entertainment produces no deduction at all regardless of business purpose, which captures tickets, club dues, and recreational outings alike. Business meals remain fifty percent deductible where the taxpayer or an employee is present. Meals at company-wide events and meals included in wages remain fully deductible. Bundled invoices defeat the food deduction.

33. A — 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 entirely. Failure of any single condition converts the whole arrangement for every participant. All payments then become taxable wages with no offsetting deduction available.

34. D — Residential rental property carries a twenty-seven and a half year recovery period while nonresidential real property runs thirty-nine years. Both are 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.

35. C — Section 1031 now applies exclusively to real property held for productive use in a trade or business or for investment. Real property is broadly like kind to other real property, so improved may be exchanged for unimproved. Equipment, vehicles, livestock, and partnership interests are excluded in every circumstance under current law.

36. B — Guaranteed payments are excluded on the same reasoning that excludes S corporation reasonable compensation, both being payments for services rather than a share of profits. Capital gains, dividends, investment interest, foreign income, and employee service income are likewise outside the definition. Ordinary domestic business income remains firmly inside it. Ordinary domestic business income remains inside it.

37. A — Engineering and architecture are conspicuously absent from the statutory list of specified service trades or businesses. Both therefore retain the deduction at any income level, subject only to the wage and property limitations. Consulting, accounting, and brokerage all appear on the list and lose the deduction above the upper threshold.

38. D — Losses arising after 2017 carry forward indefinitely with no carryback, except two years for qualifying farming losses. The deduction 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 and carry no percentage limitation at all.

39. C — Federal income tax reduces book income and is never deductible for tax, so the difference is permanent and never reverses. Permanent differences change the effective rate of tax the corporation bears. Bad debt allowances, accelerated depreciation, and warranty reserves all reverse in later periods and affect only timing. Those temporary differences affect only timing of tax.

40. C — A positive adjustment increasing income spreads ratably over four years beginning with the year of change. A negative adjustment decreasing income is taken entirely in that single year instead. Candidates frequently apply the four-year spread symmetrically, which is wrong. The asymmetry encourages voluntary rather than examination-forced correction of methods. Voluntary correction also brings audit protection for earlier years.

41. B — Relief requires reasonable basis, substantive consistency, and reporting consistency, all holding simultaneously. Failure to file the required information returns defeats the claim outright however reasonable the original basis was. Industry practice, a prior examination, and judicial precedent each supply acceptable grounds for the reasonable basis element itself. The reporting condition defeats most claims in practice.

42. A — The penalty reaches any responsible person, meaning anyone with the authority and duty to direct payment of the withheld amounts. It can reach officers, bookkeepers, and occasionally outside advisors. Wilfulness requires only knowledge that taxes were unpaid plus a decision to pay other creditors. No intent to defraud is needed.

43. B — Basis records must survive as long as the asset does, and then through the limitations period for the year of disposition. For real property that can mean several decades of retention. A taxpayer unable to substantiate basis on sale faces gain computed from a basis of zero. General records run only three years.

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

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

46. C — Status is determined by reference to the preceding calendar year, averaging full-time employees together with full-time equivalents. Full-time means thirty hours weekly or one hundred thirty monthly. Equivalents are aggregate part-time hours divided by one hundred twenty. Part-time employees establish status but are never owed coverage themselves. Part-time employees never trigger a shared responsibility payment.

47. A — 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. The trust is disregarded as a separate taxpayer, becoming a separate taxable entity only upon the grantor's death.

48. 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. Tax-exempt income net of allocable expenses is then added. The result approximates income economically available for current distribution. Corpus gains belong to the remainder beneficiary instead.

49. D — First-tier distributions are amounts of income required to be distributed currently, whether or not actually paid out. 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 then remains.

50. B — An estate receives six hundred dollars, a simple trust required to distribute all income currently receives three hundred, and a complex trust receives one hundred. These amounts are fixed by statute rather than indexed for inflation. That makes them among the few figures safely memorized regardless of the year tested.

51. A — The operational test examines actual activities, requiring operation primarily for exempt purposes. The separate organizational test examines the governing document, which must limit purposes and permanently dedicate assets on dissolution. Both tests must be satisfied independently before exemption is recognized. Neither alone suffices to establish exempt status. Neither test alone suffices to establish exempt status.

52. C — Private inurement is prohibited absolutely, with no threshold and no substantiality test applied. Any part of net earnings benefiting an insider defeats exemption outright. Lobbying is permitted provided it is not substantial. Unrelated business activity produces tax rather than revocation unless it becomes the primary purpose. Primary purpose marks where tax becomes outright revocation.

53. C — Debt-financed income is pulled into unrelated business taxable income in proportion to the outstanding acquisition indebtedness. This applies even where the income would otherwise be excluded as passive. Rents attributable to personal property or measured by tenant profits likewise lose the exclusion. A mortgage is therefore decisive. A mortgage on investment property is therefore decisive.

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

55. B — Cattle and horses held for draft, breeding, dairy, or sporting purposes require twenty-four months of holding. Other livestock including hogs, sheep, and goats require only twelve months. Poultry is excluded from the provision by statute entirely. Animals held primarily for sale remain ordinary income property regardless of period. Animals held primarily for sale remain ordinary income property.

56. D — Prepaid farm supplies are limited to fifty percent of other deductible farm expenses for the year. Exceptions apply for farmers meeting a substantial-business test or where unusual circumstances caused the excess. Soil and water conservation expenditures face a separate twenty-five percent of gross farm income limit with indefinite carryforward. That separate limit carries an indefinite carryforward.

57. C — An activity where the average period of customer use is seven days or less is not a rental activity at all. The same applies where use averages thirty days or less with significant personal services. Such activities are tested under material participation standards instead. A materially participating lodging operator may therefore deduct losses.

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

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

60. D — Expenses the tenant pays on the landlord's behalf are rental income when received. So are rents, advance rent, lease cancellation payments, and the value of property or services accepted instead of cash. A refundable deposit is not income until applied to unpaid rent or retained for damage. Lease cancellation payments are likewise income when received.

61. D — Release requires disposing of the entire interest in the activity in a fully taxable transaction to an unrelated party. The suspended losses then become deductible against non-passive income as well. A gift, a partial disposition, or a transfer to a related party or controlled entity triggers no release at all.

62. B — A partnership subject to the centralized regime cannot amend and must file an administrative adjustment request instead. Adjustments then reach partners through statements rather than corrected Schedules K-1. An S corporation may file an amended return in the ordinary way, as may a partnership validly electing out. Electing out demands both numerical and eligibility conditions.

63. A — The cap is the sum of business interest income, thirty percent of adjusted taxable income, and floor plan financing interest. Disallowed amounts carry forward indefinitely. A taxpayer meeting the gross receipts test governing accrual accounting and capitalization is exempt entirely, which removes it from most small business returns. Floor plan financing interest is added into the same cap.

64. C — The owner's own contribution is an adjustment to income rather than a business schedule expense. Deducting it on the business schedule would reduce net earnings a second time and understate self-employment tax. Contributions made for employees are properly a business expense. One plan therefore produces deductions in two places. Contributions for employees are properly a business expense.

65. B — Eligibility requires fewer than twenty-five full-time equivalent employees and average annual wages below an adjusted ceiling. The employer must pay at least half the premium cost under a qualifying arrangement. Enrolment must be through the small business marketplace. The credit runs for only two consecutive years. The credit phases out as headcount or average wages climb.

66. A — The hurdles operate in a fixed sequence, and each is tested against the amount that survived the previous one. Basis comes first, then at-risk, then passive activity, then the excess business loss cap. A loss stopped at any hurdle never reaches the next. The final excess becomes a loss carryforward.

67. D — 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 actual rights of ownership. Nominal title while the donor retains control does not suffice. Immaterial capital requires genuine services instead.

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

69. A — 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. Both categories nevertheless remain subject to the unrelated business income tax alike. Both categories bear the unrelated business income tax alike.

70. C — 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. Producing funds alone never establishes substantial relation. A single annual fundraising event escapes on that ground.

71. D — 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 excluded. The prohibition reaches sales, leasing, lending, furnishing services, and fiduciary self-dealing alike. Family members of those persons are likewise disqualified.

72. B — Weather-related sales of draft, breeding, and dairy animals may be treated as involuntary conversions with a four-year replacement period. That period is extended further by published notice where drought persists regionally. Livestock held for sale instead qualifies for a one-year deferral. Purpose of holding determines which relief applies. Ordinary sale livestock receives a one-year deferral instead.

73. A — Averaging is available only to individuals, including partners and S corporation shareholders reporting farm income from those entities. C corporations may never elect it whatever their activity. Base year income serves only as a computational reference, so earlier returns are unaffected. The election may be made on an amended return.

74. C — Both conditions must hold in the same taxable 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. More than seven hundred fifty hours must be devoted to those businesses. Licensure is irrelevant.

75. D — Exceeding the greater of fourteen days or ten percent of the days rented at fair value makes the property a residence. Deductions are then limited to rental income with no loss permitted, and disallowed amounts carry forward. Use of exactly fourteen days does not exceed the threshold and leaves it outside.

76. C — The Service allocates using total days of use during the year. Some court decisions have instead permitted allocation across all days in the year, which leaves a larger share available as itemized deductions and produces a larger rental loss. Examination answers follow the Service method unless directed otherwise. The two methods produce materially different loss figures.

77. B — Acquired intangibles are amortized ratably over fifteen years beginning with the month of acquisition. Actual or contractual life is disregarded entirely, 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.

78. D — Income and deductions must be computed separately for each unrelated trade or business. A loss from one activity therefore cannot offset income from another. Losses are trapped within their own activity and carried forward against that activity's future income. This prevents sheltering profitable operations behind unprofitable ones. Losses carry forward within their own activity silo.

79. B — Qualified property is measured at unadjusted basis immediately after acquisition, meaning original cost without reduction for depreciation. It counts only where still held and within its depreciable period at year end. The limb adds twenty-five percent of wages to a percentage of that figure. The larger limb controls. The taxpayer claims whichever of the two limbs produces more.

80. 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. Tax-exempt interest and life insurance proceeds are both nontaxable book income and subtracted too. Both categories move in opposite directions on the schedule.

81. D — First-tier distributions are amounts of income the instrument requires to be distributed currently, whether or not actually paid. 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 make the payment. Second-tier discretionary amounts are taxed only afterward.

82. B — The trust filing thresholds are disjunctive rather than cumulative. A return is required where the trust has any taxable income at all, or gross income of six hundred dollars or more, or any nonresident alien beneficiary. Meeting a single condition triggers the obligation. Estates apply only the gross income threshold.

83. C — 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. Fiduciary fees, probate costs, and return preparation fees for the entity all qualify. Ordinary investment advisory and custodial fees fall outside the carve-out entirely. Probate costs and preparation fees also fall inside it.

84. A — 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 to the taxpayer at all. It becomes a net operating loss carryforward to the following year, subject there to the eighty percent limitation instead. A loss stopped early never reaches the later hurdles at all.

85. B — Three consecutive years of non-filing revokes exemption automatically by operation of law. No notice is required, and revocation takes effect from the third year's due date. Reinstatement requires a fresh application and fee. Retroactive reinstatement additionally demands reasonable cause and all delinquent returns. The rule catches the smallest organizations most often.

86. C — The entire account ceases to be an individual retirement arrangement as of the first day of the year. That produces a deemed distribution of the whole balance rather than only the amount involved. This is dramatically harsher than the excise tax applying to a qualified plan. Prompt correction does not cure it.

87. D — Employer contributions must vest under a three-year cliff schedule or a six-year graded schedule. Employee elective deferrals vest immediately in every plan without exception. All contributions to simplified employee pensions and savings incentive match plans likewise vest immediately. Top-heavy plans require accelerated vesting beyond these baselines. Employer contributions are the only ones following a schedule.

88. 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. That leaves a taxable gap covering the intervening period. The application remains valid; only its effective date shifts. A taxable gap covers the intervening period of operation.

89. C — Soil and water conservation expenditures are deductible currently rather than capitalized, but only for land used in farming. The expenditure must be consistent with an approved conservation plan before any deduction is allowed. The deduction is capped at twenty-five percent of gross farm income, with excess carried forward indefinitely. Only land actually used in farming qualifies for the deduction.

90. 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 deferrals dollar for dollar up to three percent of compensation or contribute two percent nonelectively for every eligible employee. Both formulas are mandatory rather than discretionary.

91. A — The deduction cannot exceed aggregate taxable income from the active conduct of any trade or business. It can therefore never create or increase a loss for the taxpayer. Disallowed amounts carry forward indefinitely. Bonus depreciation carries no comparable income limitation and can instead generate a loss. Disallowed amounts carry forward indefinitely to later years.

92. D — Schedule M-2 runs from the opening balance, adds net income per books and other increases, and subtracts distributions and other decreases. The closing figure must agree with the equity section of Schedule L. A mismatch signals an equity entry that bypassed the schedule entirely during the year. For an S corporation it tracks distribution taxability instead.

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

94. B — Both conditions must be present: 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 faces no exposure whatever its investment holdings. Three consecutive years above the threshold are also required.

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

96. C — The conformity requirement obliges a taxpayer electing the method for tax purposes to use it in reports to shareholders, partners, and creditors. The tax benefit cannot be 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.

97. A — Nonrecourse financing carries no personal liability and is excluded from amounts at risk, though it does increase basis under the liability rules. This gap explains most cases where a taxpayer with apparently adequate basis cannot deduct a loss. Qualified nonrecourse real property financing is the narrow exception. It reaches real property activities rather than equipment.

98. C — Losses reduce stock basis first and debt basis second, while restoration in a later profitable year runs the opposite way. A net increase rebuilds debt basis up to the amount previously reduced before any stock basis is restored. This protects the shareholder's loan ahead of the equity investment. Suspended losses become deductible again as basis returns.

99. D — Tax-exempt income increases outside basis even though it is never taxed, which preserves the exemption when the interest is disposed of. Nondeductible noncapital expenses form the exact mirror image, reducing basis despite producing no deduction. Both rules ensure disposition gain reflects economic rather than taxable results. Distributions and liability decreases both reduce basis.

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