PRACTICE EXAM 18: ENROLLED AGENT PART 2 BUSINESSES SIMULATION (100 QUESTIONS)

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

1. A partnership has partners owning 40, 35, and 25 percent with year ends of December 31, March 31, and June 30. No two share a year end. Which year must it adopt?

A. March 31, the year end of the second largest partner
B. December 31, producing the least aggregate deferral
C. June 30, producing the longest deferral available
D. A calendar year, because the test cannot be satisfied

2. A business places 4,700,000 dollars of qualifying equipment in service during 2025 with ample taxable income. What Section 179 deduction is available?

A. One million eight hundred thousand dollars after the phase-out
B. Two million five hundred thousand dollars, the full annual limit
C. Four million seven hundred thousand dollars, the entire cost
D. No deduction, because placements exceed the phase-out threshold

3. A corporation's S election took effect on January 1, 2021. It sells an asset that appreciated before conversion in February 2026. What is the built-in gains consequence?

A. The tax applies at a reduced rate after five years elapse

B. No tax applies, because the recognition period has closed
C. The tax applies because appreciation existed at conversion
D. The tax applies only if the corporation distributes the proceeds

4. Kwame begins the year with 75,000 dollars of outside basis, is allocated 12,000 dollars of income, and his share of partnership liabilities falls by 18,000 dollars. What is his ending basis?

A. Fifty-seven thousand dollars, netting the liability against basis
B. Ninety-three thousand dollars, treating the decrease as income
C. Sixty-nine thousand dollars after the deemed distribution
D. Eighty-seven thousand dollars before the liability adjustment

5. A corporation reports 418,000 dollars of book income. It paid 92,000 dollars of federal tax, 6,000 dollars of fines, and had 9,000 dollars of disallowed meals, 14,000 dollars of tax-exempt interest, and 37,000 dollars of excess tax depreciation. What is taxable income?

A. Five hundred twenty-five thousand dollars before subtractions
B. Four hundred seventy-four thousand dollars after reconciliation
C. Four hundred eighteen thousand dollars, matching book income
D. Three hundred sixty-two thousand dollars after all adjustments

6. A partner receives a liquidating distribution of two parcels with carryover bases of 36,000 and 24,000 dollars when her outside basis is 45,000 dollars. What basis does she take in the first parcel?

A. Twenty-seven thousand dollars after proportionate reduction
B. Thirty-six thousand dollars, its full carryover basis
C. Twenty-two thousand five hundred dollars, allocated equally
D. Eighteen thousand dollars, the amount assigned to the second parcel

7. An employer has 42 full-time employees and part-time employees working 3,120 hours in a month. Is it an applicable large employer?

A. Yes, because full-time equivalents bring the total to sixty-eight
B. No, because only actual full-time employees are counted
C. No, because part-time hours are divided by one hundred thirty
D. Yes, but only the forty-two full-time employees are owed coverage

8. A partnership discovers an error on a return for a year subject to the centralized audit regime. What is the correction route?

A. Notify each partner to amend their own individual returns
B. Wait for examination and correct the error at that point
C. File an administrative adjustment request under its own procedures
D. File an amended Form 1065 with corrected Schedules K-1

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 domestic limited liability company with two or more members
D. A foreign entity whose members all enjoy limited liability

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 business changing its trade name and relocating premises
D. A sole proprietor taking on a partner and operating jointly

11. 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

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

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

13. Which distribution triggers gain to a partner?

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

14. Which condition terminates a partnership under current law?

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

15. Which requirement defines control for Section 351 purposes?

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

16. 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. A corporate debt security issued to the transferring shareholder
D. Additional shares received later through a stock split

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

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

18. 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

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

A. A personal guarantee of corporate borrowing from a bank
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 security for a corporate loan

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

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

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

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

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

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

23. 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

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

A. Cash contributed directly to the activity by the taxpayer
B. Nonrecourse financing obtained for an equipment leasing activity
C. The adjusted basis of property contributed to the activity

D. Borrowed amounts for which the taxpayer is personally liable

25. Which discharge produces no cancellation of indebtedness income?

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

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

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

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

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

28. 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

29. 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. Meals for every day of the trip at the fifty percent rate
D. Expenses at the destination directly attributable to business

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

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

31. 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

32. 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. Residential rental property acquired for letting to tenants
D. Qualified improvement property in a commercial building

33. 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. Only the portion attributable to bonus depreciation claimed
C. None, because equipment produces Section 1231 gain entirely
D. All depreciation previously allowed or allowable on that asset

34. 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

35. Which item is excluded from qualified business income?

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

36. Which business retains the 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

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

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

D. Twenty-year carryforward expiring where not fully absorbed

38. 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. Warranty reserves accrued for financial reporting purposes
D. Federal income tax expense recorded on the corporate books

39. 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

40. 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

41. 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

42. 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

43. 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 partnership, where liabilities increase each partner's outside basis
D. A sole proprietorship, where the owner bears personal liability

44. 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

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

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

46. 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

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

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

48. Which exemption amount applies to an estate?

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

49. 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

50. 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. Accumulating income rather than granting it out currently

D. Any part of net earnings benefiting a private insider

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

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

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

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

53. 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

54. 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

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

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

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

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

57. 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. Depreciation allocable to the rental use of the property
D. Property taxes allocable to the rental use of the dwelling

58. 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

59. Which disposition releases suspended passive losses in full?

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

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

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

61. 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

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

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

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

A. Each is tested independently against the original allocated loss
B. The passive activity rules are applied before the basis test
C. Each is tested against the amount surviving the previous hurdle

D. The excess business loss cap is applied before the at-risk test

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

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

65. 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

66. 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

67. 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

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

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

69. 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

70. 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

71. 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

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

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

73. 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 entirely to the rental use of the dwelling itself
D. Allocation using the total days the property was actually used

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

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

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

A. The activities are combined into one aggregate computation
B. Each activity is computed separately with no cross-offsetting permitted
C. Only the most profitable activity need be reported at all
D. Losses may offset the organization's exempt function income

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

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

D. The accumulated depreciation claimed on qualified property

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

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

78. 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

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

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

80. 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

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

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

82. 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. Conversion of the organization to private foundation status
C. A requirement to obtain a fresh determination letter only
D. Automatic revocation of exemption by operation of law

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

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

84. 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

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

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

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

A. Fertilizer applied to growing crops during the season
B. Soil and water conservation expenditures made on farmland
C. Prepaid feed acquired before the consumption season
D. Repairs to machinery used in ordinary field operations

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

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

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

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

89. 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

90. 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. Capital losses in excess of capital gains for the taxable year
D. Wages paid to employees during the loss year in question

91. 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

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

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

93. 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 also be used in reports to creditors and owners
C. The method must be combined with lower of cost or market
D. The method applies only to goods acquired after the election

94. 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. Neither is restored once reduced in an earlier taxable year
D. Debt basis is restored first, up to the amount previously reduced

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

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

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

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

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

98. Which item is a hot asset when a partner sells a partnership interest?

A. Cash held in the partnership's ordinary operating accounts
B. Depreciation recapture potential embedded in partnership equipment
C. Land held by the partnership purely for capital appreciation
D. Marketable securities held in a long-term investment portfolio

99. 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

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

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

Practice Exam 18: Answer Key and Explanations

1. B — No partner holds more than half, so no majority interest year exists, and the three principal partners share no common year end. The least aggregate deferral computation is therefore reached. Weighting each candidate by partner interests gives December thirty-first the smallest total at two point five five, so that year must be adopted by the partnership.

2. A — Placements exceed the four million dollar threshold by seven hundred thousand dollars, reducing the two million five hundred thousand dollar limit dollar for dollar to one million eight hundred thousand. The remaining two million nine hundred thousand dollars of basis is then eligible for bonus depreciation, which carries no dollar cap at all.

3. C — The recognition period runs five years from the first day of the first S year, so it closed at the end of 2025. A sale in February 2026 falls outside it entirely and escapes the tax. The identical sale in December 2025 would have been caught, which makes the date rather than the amount decisive.

4. D — The income allocation raises basis to eighty-seven thousand dollars. A decrease in a partner's share of partnership liabilities is treated as a distribution of money, so eighteen thousand dollars reduces basis to sixty-nine thousand. It belongs in the distribution step rather than the loss step of the ordering sequence. Placement in the ordering sequence changes the answer entirely.

5. C — Federal tax, fines, and the disallowed meal portion all reduced book income without being deductible, so they are added back. Tax-exempt interest is book income that is not taxable and excess tax depreciation is a deduction not recorded on the books, so both are subtracted. The result is four hundred seventy-four thousand dollars.

6. B — The combined carryover basis of sixty thousand dollars exceeds the forty-five thousand dollars of outside basis available, so the total must be reduced proportionately. The first parcel takes thirty-six thousand multiplied by forty-five over sixty, giving twenty-seven thousand dollars. The second parcel correspondingly takes eighteen thousand dollars of basis. The second parcel correspondingly takes eighteen thousand dollars.

7. A — Part-time hours are aggregated and divided by one hundred twenty, giving twenty-six full-time equivalents. Added to forty-two full-time employees the total is sixty-eight, comfortably above the threshold of fifty. Part-time employees count toward establishing status but are never owed an offer of coverage themselves. The threshold is fifty, and equivalents count toward reaching it.

8. D — A partnership subject to the centralized regime cannot file an amended return at all. It files an administrative adjustment request instead, which follows its own procedures and timing. Adjustments reach partners through statements rather than corrected Schedules K-1 for the original year. An option offering an amended partnership return is a distractor.

9. C — 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 election available. A foreign entity with universal limited liability defaults instead to corporate treatment. The foreign rules invert the domestic logic on this point.

10. D — A new number is required only where a genuinely new entity comes into existence. A sole proprietor taking on a partner creates a partnership, 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. 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 becomes the partner's basis in the interest. A profits interest is generally not taxable on receipt.

12. A — 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 explains why a limited partner's basis is typically supported by nonrecourse rather than recourse debt.

13. A — 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. Marketable securities are generally treated as money for this rule. Distributing publicly traded stock can therefore produce gain where distributing land cannot. Property simply absorbs basis rather than requiring it outright.

14. B — 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 schedules at all.

15. D — 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 once. The second is measured by share count rather than value, and failing either defeats the exchange.

16. C — 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, and loss is never recognized.

17. D — 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 reducing genuine capacity to distribute. The measure gauges economic capacity rather than taxable income.

18. 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 day the disqualifying transfer occurs. Eligibility is continuous rather than tested once. A later change in residence status terminates the election too.

19. B — Debt basis arises only from a direct loan creating genuine indebtedness running from the corporation to that shareholder. An actual economic outlay is required. A guarantee produces nothing until it is called and the shareholder actually pays. Pledging collateral and corporate third-party borrowing are likewise insufficient entirely. Corporate third-party borrowing never creates shareholder basis.

20. A — 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 it. Distributions reduce it only as far as zero. Losses by contrast may drive the balance below zero entirely.

21. C — 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 it also determines exemption from inventory accounting. That threshold also governs the uniform capitalization rules.

22. A — 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 amount. Freight is added into inventoriable cost, and trade discounts reduce the invoice price directly. The withdrawal is a personal item rather than a business cost.

23. 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 instead of being capitalized. The dividing line is whether goods await a buyer or move toward one.

24. B — 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 available. It reaches real property activities rather than equipment ventures.

25. D — 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 likewise produces nothing at all.

26. B — 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. Depreciable basis may be elected first instead. Both are reported on a prescribed form.

27. C — 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 falls on precisely the disallowed portion. The S corporation risk reverses entirely.

28. 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 destroys every one of these exemptions.

29. D — 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 during it. Foreign travel follows separate allocation rules with defined exceptions.

30. B — 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 instead. Food at an entertainment event qualifies only where separately stated.

31. 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 without offset. Employee business deductions are suspended, so no offset survives at all.

32. C — Residential rental property carries a twenty-seven and a half year 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 Section 179 eligible. Land is never depreciable and must be separated on acquisition.

33. D — Section 1245 recaptures all depreciation allowed or allowable as ordinary income before any Section 1231 treatment becomes available. The ordinary component equals the lesser of total depreciation claimed or total gain. Real property follows the gentler Section 1250 rule, which under current recovery methods usually recaptures nothing at all. Only the residual balance receives Section 1231 netting treatment.

34. 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. Equipment, vehicles, livestock, and partnership interests are excluded in every circumstance. Material describing equipment trade-ins reflects repealed law. Improved real property may be exchanged for unimproved property.

35. A — 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 entirely. Ordinary income from a domestic trade or business remains inside it.

36. B — 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 it above the threshold. Their absence is notable given their presence in similar provisions.

37. A — 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 limitation. A large carryforward cannot eliminate a year's liability entirely.

38. D — 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 borne. Bad debt allowances, accelerated depreciation, and warranty reserves all reverse in later periods and affect only timing. Temporary differences affect only when tax is paid, not how much.

39. 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. Candidates frequently apply the four-year spread symmetrically, which is wrong. The asymmetry encourages voluntary rather than forced correction. Voluntary correction also brings audit protection for earlier years.

40. 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 reasonable basis. The reporting condition defeats most claims in actual practice.

41. 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 first. No intent to defraud is required, and the liability survives bankruptcy.

42. 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 entirely. General records run three years and employment tax records four.

43. C — 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 entity level and never reach the shareholders. That contrast drives many practical entity selection decisions.

44. 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 owe substantial tax before collecting meaningful proceeds from the buyer. The timing mismatch is a recurring installment sale planning trap.

45. C — 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, becoming a separate taxable entity only upon the grantor's death. Its income and deductions are reported directly by the grantor.

46. 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 added back. Tax-exempt income net of allocable expenses is then added, producing a figure approximating distributable income. Corpus gains belong to the remainder beneficiary rather than the income one.

47. A — First-tier distributions are amounts of income required to be distributed currently, whether or not actually paid. 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 it. Second-tier beneficiaries share only whatever amount then remains.

48. D — 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. That makes them among the few figures safely memorized regardless of year. These amounts are fixed by statute rather than indexed for inflation.

49. 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 dedicate assets on dissolution. Both tests must be satisfied independently. Neither alone suffices to establish exempt status. The document must also avoid empowering substantial non-exempt activity.

50. D — 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 primary. Primary purpose marks the point where tax becomes outright revocation.

51. B — 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 entirely. A mortgage on investment property is therefore the decisive fact.

52. C — 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 it the post-year-end option.

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

54. 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. That separate limit carries an indefinite carryforward of excess.

55. B — 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 of the categorical rental rule. A materially participating lodging operator may therefore deduct losses.

56. A — 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. The taxpayer must additionally own at least ten percent of the activity. A management company handling operations does not defeat the standard.

57. C — 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 to later years rather than lapsing.

58. 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 or retained for damage. Lease cancellation payments are likewise income when they are received.

59. B — 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 related-party transfer triggers no release at all. A transfer to a controlled entity is likewise insufficient for release.

60. D — 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 from the limitation entirely. Floor plan financing interest is added into the same overall cap.

61. A — 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 of the enterprise. One plan therefore produces deductions in two different places.

62. A — 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 marketplace, and the credit runs for only two consecutive years. The credit phases out as headcount or average wages climb higher.

63. C — 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 one at all. The final disallowed excess becomes a net operating loss carryforward.

64. B — 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. Where capital is not material, genuine services or capital are required.

65. 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. A genuine purchase does not break the analysis at all. Candidates commonly assume a genuine purchase breaks the analysis.

66. 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. Both categories bear the unrelated business income tax alike. Both categories nevertheless remain subject to that particular tax.

67. 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 on that ground. Producing funds alone never establishes substantial relation at all.

68. B — 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, and furnishing services. Self-dealing by a plan fiduciary is separately prohibited outright. The employer is itself a disqualified person under the rules.

69. 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 of proceeds. Purpose of holding determines which of the two reliefs applies.

70. D — Averaging is available only to individuals, including partners and S corporation shareholders reporting farm income from those entities. C corporations may never elect it. Base year income serves only as a computational reference, so earlier returns are entirely unaffected by the election. The election may be made or changed on an amended return later.

71. 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 them. Licensure and ownership percentage form no part of the statutory test.

72. A — 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. Use of exactly fourteen days does not exceed the threshold and leaves the property outside it. Below it a rental loss may still be claimed.

73. D — The Service allocates using total days of use during the year. Some court decisions have instead permitted allocation across all days in the year, leaving a larger share available as itemized deductions. Examination answers follow the Service method unless a question directs otherwise. The two methods produce materially different rental loss figures.

74. C — Acquired intangibles are amortized ratably over fifteen years beginning with the month of acquisition. Actual or contractual life is disregarded, so a three-year covenant not to compete is still recovered over fifteen. No loss arises on disposing of one while others are retained. The disallowed loss attaches to the retained intangibles' basis instead.

75. B — 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 only. This prevents sheltering profitable operations behind unprofitable ones. Losses carry forward within their own separate activity silo.

76. A — 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 taxpayer claims whichever of the two limbs produces the larger figure. It counts only where still held and within its depreciable period.

77. B — 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 subtracted too. Both categories of item move in opposite directions on the schedule.

78. 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 regardless of payment. A trustee's failure to pay does not defer the beneficiary's tax.

79. A — 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. Estates apply only the gross income threshold instead. Meeting any single one of those conditions triggers the obligation.

80. 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 under this narrow carve-out. Ordinary investment advisory and custodial fees fall outside it.

81. B — 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, subject there to the eighty percent limitation. A loss stopped early never reaches the later hurdles in the sequence.

82. D — 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, and retroactive reinstatement demands reasonable cause. The rule catches the smallest organizations most often of all. Reinstatement requires a fresh application and the associated fee.

83. A — 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. Prompt correction does not cure the disqualification once it has occurred. It is far harsher than the excise tax applying to a qualified plan.

84. 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. All contributions to simplified employee pensions and savings incentive match plans likewise vest immediately on deposit. Top-heavy plans require accelerated vesting beyond these baselines. Employer contributions are the only ones following any schedule.

85. C — 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 of operation. The application itself remains valid; only its effective date shifts.

86. B — 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. The deduction is capped at twenty-five percent of gross farm income with indefinite carryforward. Only land actually used in farming qualifies for the deduction.

87. A — 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 each year.

88. C — The deduction cannot exceed aggregate taxable income from the active conduct of any trade or business. It can never create or increase a loss, and disallowed amounts carry forward indefinitely. Bonus depreciation carries no comparable income limitation at all. Bonus depreciation can instead generate a net operating loss. Disallowed amounts nevertheless carry forward indefinitely to later years.

89. A — 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 entry that bypassed the schedule. For an S corporation it tracks distribution taxability instead.

90. C — 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 limited to nonbusiness income received. Personal deductions therefore cannot generate a business carryover. Capital losses follow their own separate carryover regime entirely.

91. 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 always an S corporation faces no exposure whatever. Three consecutive years above the threshold are also required. A corporation always taxed as an S corporation faces no exposure.

92. D — 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 and affect only timing of tax. Permanent differences change the effective rate the corporation bears. Bad debt allowances and warranty reserves both reverse over time.

93. B — 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 consent to change. Lower of cost or market may not be combined with the method.

94. D — 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, protecting the shareholder's loan. Suspended losses become deductible again as that basis returns.

95. C — Tax-exempt income increases outside basis even though it is never taxed, preserving the exemption when the interest is disposed of. Nondeductible noncapital expenses form the exact mirror image, reducing basis despite producing no deduction at all for the partner. Both rules ensure disposition gain reflects economic results. Distributions and liability decreases both reduce outside basis.

96. A — 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 producing a carryforward to the following year. A loss stopped at any hurdle never reaches the next one at all.

97. A — 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 one defeats the election entirely. The partnership must also notify each partner within thirty days.

98. B — The definition of unrealized receivables reaches beyond conventional receivables to capture depreciation recapture potential in depreciable property. A partnership holding heavily depreciated equipment therefore carries hot assets. That portion of gain becomes ordinary income rather than capital gain. Even a partnership without conventional receivables carries them. That portion of the gain becomes ordinary rather than capital.

99. 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 each month. Part-time employees establish status but are never owed coverage. Equivalents are computed monthly and added to the full-time count.

100. D — A partnership subject to the centralized regime cannot amend and must file an administrative adjustment request instead. Adjustments reach partners through statements rather than corrected Schedules K-1. An S corporation may amend in the ordinary way, as may a partnership electing out. Timing and procedure differ from an ordinary amended return.