PRACTICE EXAM 21: 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. Renata's outside basis is 88,000 dollars. In liquidation she receives 30,000 dollars cash, receivables worth 25,000 dollars, and inventory worth 20,000 dollars. What is the result?

A. No loss is recognized because distributions are generally nontaxable
B. A gain of thirteen thousand dollars arises on the cash received
C. The excess basis is added to the receivables and inventory received
D. A capital loss of thirteen thousand dollars is recognized on liquidation

2. A corporation had 1,150,000 dollars of tax in the prior year and expects 1,400,000 dollars this year. Which installments must be based on current year income?

A. The second, third, and fourth installments must use current year income
B. All four installments must use the current year figure throughout
C. Only the fourth installment must use the current year figure
D. None, because the prior year safe harbor remains fully available

3. A taxpayer deducted 18,000 and 22,000 dollars of ordinary Section 1231 losses within the past five years and now has a 60,000 dollar net Section 1231 gain. How is it characterized?

A. Sixty thousand dollars entirely as ordinary income for the year

B. Forty thousand ordinary and twenty thousand long-term capital
C. Sixty thousand dollars entirely as long-term capital gain
D. Twenty thousand ordinary and forty thousand long-term capital

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

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

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

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

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

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

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

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

8. Which distribution triggers gain to a partner?

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

9. 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 operating assets
D. The expiry of the term stated in the written partnership agreement

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

A. Every one of its partners must be an eligible type of person
B. The partnership must have fifty or fewer partners for the year
C. The partnership must obtain advance written consent from the Service
D. The partnership must have been in existence for three or more years

11. Which requirement defines control for Section 351 purposes?

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

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

A. Nonvoting common stock carrying identical economic entitlements
B. Additional shares received later through an ordinary stock split
C. A corporate debt security issued to the transferring shareholder
D. Voting common stock of the transferee corporation received

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

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

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

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

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

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

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

A. Separately stated income items reported on the Schedule K-1

B. Tax-exempt interest earned on municipal obligations held
C. Ordinary business income allocated among the shareholders
D. Gain recognized on distributing appreciated corporate property

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

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

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

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

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

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

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

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

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

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

22. 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 outstanding equipment loan
C. A supplier forgiving a trade payable owed by a solvent business
D. A lender reducing principal on an operating credit facility

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

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

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

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

25. 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 sole proprietorship

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

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

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

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

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

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

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

A. Land improvements such as fencing and drainage tile installed

B. Qualified improvement property within a commercial building
C. Residential rental property acquired for letting to tenants
D. Nonresidential real property used in a trade or business

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

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

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

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

32. 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

33. 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

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

A. Five-year carryback available to corporate taxpayers only
B. Twenty-year carryforward expiring where not fully absorbed
C. Indefinite carryforward with no carryback except for farming losses
D. Two-year carryback with a twenty-year carryforward as before

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

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

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

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

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

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

38. 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 that employed the workers in question
C. Only an officer owning a majority of the outstanding stock
D. Only the person formally designated as treasurer in the bylaws

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

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

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

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

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

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

42. Which figure determines applicable large employer status?

A. Full-time employees plus full-time equivalents in the preceding year

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

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

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

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

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

45. 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 that year
D. The beneficiary who received a distribution earliest in the year

46. Which exemption amount applies to an estate?

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

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

A. The public support test applied to the sources of its funding
B. The commensurate test applied to program expenditure levels
C. The operational test requiring operation primarily for exempt purposes
D. The organizational test applied to the entity's governing document

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

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

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

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

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

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

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

A. Cattle and horses that are held for breeding or dairy purposes
B. Breeding hogs maintained within the productive herd
C. Sheep and goats held for breeding and wool production
D. Poultry raised for eventual sale to processing plants

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

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

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

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

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

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

55. 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

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

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

57. Which disposition releases suspended passive losses in full?

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

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

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

59. 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 Schedule SE before computing the self-employment tax
C. On the business schedule as an ordinary operating expense
D. As an itemized deduction on Schedule A of the return

60. 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

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

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

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

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

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

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

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

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

65. 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

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

A. An owner of fifty percent or more of the sponsoring employer
B. Any participant who holds an account balance within the plan
C. Any beneficiary named to receive plan benefits upon death
D. Any vendor supplying goods or services to the employer

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

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

68. Which taxpayer may elect farm income averaging?

A. An exempt organization running an agricultural research station

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

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

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

70. 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 by the owner during the taxable year
D. Personal use exceeding one half of the days the property was rented

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

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

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

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

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

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

74. 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

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

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

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

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

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

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

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

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

79. 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

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

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

81. 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

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

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

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

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

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

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

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

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

86. 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

87. 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

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

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

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

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

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

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

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

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

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

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

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

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

94. 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

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

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

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

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

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

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

98. 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

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

A. Every one of its partners must be an eligible type of person
B. The partnership must have fifty or fewer partners for the year
C. The partnership must obtain advance consent from the Service
D. The partnership must have existed for three or more years

100. Which condition terminates a partnership under current law?

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

Practice Exam 21: Answer Key and Explanations

1. D — Loss may be recognized on a liquidating distribution where the partner receives nothing but money, unrealized receivables, and inventory. Renata receives exactly those three categories totalling seventy-five thousand dollars against eighty-eight thousand of basis, so thirteen thousand is recognized as a capital loss. A single parcel of land would have defeated recognition entirely.

2. B — A corporation with taxable income of one million dollars or more in any of the three preceding years is a large corporation. It may use the prior year safe harbor only for its first installment, and the remaining three must be based on current year income. Ordinary corporations may use the lesser figure throughout the year.

3. C — The lookback rule recharacterizes net Section 1231 gain as ordinary income to the extent of net Section 1231 losses deducted as ordinary in the five preceding years. Forty thousand dollars of such losses were deducted, so that much of the gain is ordinary. Only the residual twenty thousand receives capital gain treatment.

4. A — 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 at all. A foreign entity with universal limited liability defaults instead to corporate treatment.

5. B — 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 taxpayer in place.

6. D — 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.

7. 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 distinction explains why a limited partner's basis is typically supported by nonrecourse rather than recourse debt.

8. C — 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 happens to be. Marketable securities are generally treated as money for this rule. Distributing publicly traded stock can therefore produce gain where distributing land cannot.

9. 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. A two-partner buyout is the common pattern.

10. 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 ineligible partner defeats the election however small the partnership. Notification to each partner is required within thirty days.

11. C — 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, and failing either defeats the exchange.

12. 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, and loss is never recognized.

13. A — 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 to shareholders. The measure gauges economic capacity rather than taxable income.

14. B — 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.

15. 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.

16. C — 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, never below.

17. B — 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.

18. 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 it also determines exemption from inventory accounting and capitalization. Crossing the threshold engages all three regimes at once.

19. D — 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. The withdrawal is a personal item rather than a business cost.

20. C — 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 line is whether goods still await a buyer. Purchasing and handling costs are likewise capitalized into inventory.

21. C — 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.

22. B — 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.

23. A — 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 forgiven. Depreciable basis may be elected first instead. Both the exclusion and reduction appear on a prescribed form.

24. D — 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.

25. B — 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 exemption.

26. A — 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 exceptions.

27. 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 instead. Bundled invoices defeat the food deduction completely as well.

28. C — 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. Employee business deductions are suspended, so no offset survives.

29. D — 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.

30. B — 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 realized. Real property follows the gentler Section 1250 rule, which usually recaptures nothing under current methods. Only the residual balance receives Section 1231 netting treatment.

31. 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 property may be exchanged for unimproved property freely.

32. 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 domestic business income remains inside the definition.

33. 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 and lose it above the upper threshold. Their absence is notable given comparable provisions elsewhere.

34. 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 without any limitation. A large carryforward cannot eliminate a year's liability entirely.

35. 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 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 overall.

36. A — 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 forced correction. Voluntary correction also brings audit protection for earlier years.

37. D — 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.

38. 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 for the penalty to apply.

39. 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 records four.

40. 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.

41. B — 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.

42. A — 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 part-time hours divided by one hundred twenty. Part-time employees establish status but are never owed coverage. Equivalents are computed monthly and added to the count.

43. D — 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.

44. C — Capital gains allocable to corpus are subtracted because they belong to the remainder beneficiary rather than the income beneficiary. The distribution deduction and the personal exemption are 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 instead.

45. 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.

46. 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. That makes them among the few figures safely memorized regardless of year. Estates enjoy the largest of the three statutory exemptions.

47. D — 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, and neither alone suffices to establish exempt status. The document must avoid empowering substantial non-exempt activity.

48. 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.

49. 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.

50. D — 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, making it the post-year-end option. No extension of that October deadline is available at all.

51. A — 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 to qualify. Poultry is excluded from the provision by statute entirely, whatever the purpose. Animals held primarily for sale remain ordinary income property.

52. C — 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 of excess.

53. 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 provided. Such activities are tested under material participation standards instead. A materially participating lodging operator may deduct losses.

54. C — 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.

55. 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 before expenses do. That sequencing favours the taxpayer, since depreciation reduces basis only to the extent actually deducted. The disallowed amount carries forward.

56. 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 caused. Lease cancellation payments are likewise income when received.

57. 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 as passive. A gift, a partial disposition, or a transfer to a related party or controlled entity triggers no release.

58. B — 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 to later years. 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 cap.

59. 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.

60. 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 small business marketplace. The credit runs for only two consecutive years. The credit phases out as headcount or average wages climb.

61. B — 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. The final excess becomes a carryforward.

62. 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 practical control does not suffice at all. Where capital is not material, genuine services are required instead.

63. A — 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.

64. C — 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 additional taxes. Both categories nevertheless bear the unrelated business income tax. Both categories nevertheless bear that particular tax alike.

65. B — 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 the tax on that ground.

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

67. C — 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 across a region. Livestock held for sale instead qualifies for a one-year deferral of excess proceeds. Purpose of holding determines which of the two reliefs applies.

68. 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 whatever their farming activity. 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.

69. 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 and ownership percentage form no part of the test.

70. B — 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 at all. Below it a rental loss may be claimed.

71. 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, 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 rental loss figures.

72. A — 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.

73. 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 separate activity silo.

74. 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.

75. 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.

76. C — 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.

77. D — 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 test.

78. 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. Probate costs and preparation fees also fall inside the carve-out.

79. 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. A loss stopped early never reaches the later hurdles at all.

80. 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 of all.

81. 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. This is dramatically harsher than the excise tax applying to a qualified plan. Prompt correction does not cure it.

82. B — 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 any schedule.

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

84. D — 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 indefinite carryforward. Only land actually used in farming qualifies for the deduction.

85. D — 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.

86. 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 to later years. Bonus depreciation carries no comparable income limitation and can generate a loss. Disallowed amounts nevertheless carry forward indefinitely.

87. B — 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 during the year. For an S corporation it tracks distribution taxability instead.

88. 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 allowed only to the extent of nonbusiness income received that year. Personal deductions therefore cannot generate a business carryover.

89. 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.

90. 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. Those are temporary differences affecting only when tax is ultimately paid. Permanent differences change the effective rate borne overall.

91. A — 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.

92. 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 that basis returns.

93. D — 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. Both rules ensure disposition gain reflects economic rather than taxable results. Distributions and liability decreases both reduce outside basis.

94. 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. The disallowed remainder becomes a net operating loss carryforward to the following year. A loss stopped at any hurdle never reaches the next one.

95. C — 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 the capital gain a sale would otherwise produce. Even a partnership without conventional receivables carries them.

96. B — 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 that has validly elected out. Timing and procedure differ from an ordinary amended return.

97. C — Capital gains allocable to corpus are subtracted because they belong to the remainder beneficiary rather than the income beneficiary. The distribution deduction and the personal exemption are both added back. Tax-exempt income net of allocable expenses is then added, producing a figure approximating distributable income. Corpus gains belong to the remainder beneficiary instead.

98. 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 whether the accrual method becomes mandatory for a taxpayer. That threshold also governs inventory accounting and capitalization.

99. B — Electing out requires both that the partnership furnish one hundred or fewer Schedules K-1 and that every partner be an eligible type. Trusts, partnerships, disregarded entities, and nominees are all ineligible. A single ineligible partner defeats the election however small the partnership happens to be. The partnership must also notify each partner within thirty days.

100. D — Termination now occurs only where no part of any business, financial operation, or venture continues to be carried on by any partner in a partnership. Technical termination on a fifty percent transfer has been repealed entirely. Ownership changes no longer close the tax year or restart depreciation schedules. A two-partner buyout is the common terminating fact pattern.