PRACTICE EXAM 23: 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 200,000 dollars of inside basis. A buyer pays 68,000 dollars for a twenty-five percent interest. What special basis adjustment arises if a Section 754 election is in effect?

A. Sixty-eight thousand dollars, replacing the buyer's share entirely
B. Fifty thousand dollars, equal to the buyer's share of inside basis
C. Eighteen thousand dollars, available to that transferee partner alone
D. No adjustment, because inside and outside basis always correspond

2. A corporation has 40,000 dollars of capital gains and 95,000 dollars of capital losses. What is the treatment?

A. Three thousand dollars is deductible with the balance carried forward
B. The entire ninety-five thousand is deductible in the current year
C. Forty thousand is deductible and fifty-five thousand is carried over
D. Fifty-five thousand dollars is deductible against ordinary income

3. A corporation with an accumulated deficit of 90,000 dollars and current earnings of 48,000 dollars distributes 60,000 dollars. How much is a dividend?

A. Nothing, because the accumulated deficit exceeds current earnings

B. Sixty thousand dollars, the entire amount distributed
C. Forty-eight thousand dollars, the current earnings and profits
D. Twelve thousand dollars, the excess over current earnings

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. A capital interest received in exchange for services rendered
C. Appreciated real property that was previously held for investment
D. Equipment that is subject to an assumed nonrecourse liability

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

9. Which condition terminates a partnership under current law?

A. The partnership disposing of substantially all of its operating assets
B. No part of any business continuing to be carried on in partnership form
C. A transfer of fifty percent or more of the interests within a year
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. One hundred percent ownership by the transferring group of persons
C. Eighty percent of voting power and of each nonvoting class of shares
D. Eighty percent of the total value of all outstanding stock issued

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

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

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

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

A. A farming corporation with modest annual gross receipts figures
B. A tax shelter, regardless of the level of its annual gross receipts
C. A personal service corporation performing only legal services
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. Merchandise the owner withdrew from inventory for personal use
B. Freight charges incurred in acquiring the merchandise sold
C. Trade discounts allowed by the suppliers on their invoices
D. Storage costs for goods awaiting sale to future customers

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

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

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

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

22. Which discharge produces no cancellation of indebtedness income?

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

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

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

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

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

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

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

26. Which conversion is generally the most expensive to reverse?

A. A sole proprietorship incorporating under the nonrecognition rules
B. A C corporation liquidating to move assets into a pass-through
C. A partnership incorporating and then electing Subchapter S status
D. A C corporation electing to be taxed under Subchapter S rules

27. What does Schedule M-2 track for an S corporation?

A. Unappropriated retained earnings as for a C corporation
B. The reconciliation of book income to taxable income
C. The accumulated adjustments account and its related balances
D. The identity of shareholders owning twenty percent or more

28. Which worker is a statutory employee subject to FICA but not income tax withholding?

A. A full-time life insurance sales agent working for one company
B. A licensed real estate agent paid substantially on sales output
C. A direct seller of consumer products in the buyer's home
D. A qualified companion sitter placed through a placement service

29. Which per diem component may a self-employed taxpayer use?

A. The meal portion only, with lodging requiring substantiation

B. Both the meal and lodging portions of the published rate
C. The lodging portion only, with meals requiring substantiation
D. Neither portion, since all amounts must be fully substantiated

30. Which statement about percentage depletion is correct?

A. It may never exceed the property's remaining adjusted basis
B. It may continue after the property's basis is fully exhausted
C. It is available for timber but not for other natural resources
D. It is computed by allocating basis over the recoverable units

31. Which expenditure is excluded from organizational costs eligible for amortization?

A. Legal fees for drafting the corporate charter and bylaws
B. Fees paid to the state for incorporating the business
C. Costs of issuing and selling the corporation's own stock
D. Costs of holding the organizational meeting of directors

32. How is a payment to acquire a lease from a prior tenant recovered?

A. Deducted currently as an ordinary and necessary business expense
B. Added to the basis of improvements the tenant later constructs
C. Recovered only when the lease is surrendered or finally expires
D. Amortized ratably over the term of the acquired lease

33. Which replacement period applies to condemned business real property?

A. Two years from the close of the first year gain is realized
B. Four years, as with weather-related livestock dispositions
C. Three years from the close of the first year gain is realized
D. One hundred eighty days from receipt of the condemnation proceeds

34. Which transaction between related parties produces a permanently disallowed loss?

A. A guaranteed payment made for services actually rendered to the firm
B. A sale of investment property between a partnership and a majority partner
C. A distribution of property that has declined in market value
D. A contribution of depreciated property made to the partnership

35. Which arrangement produces a constructive dividend where the shareholder provides no services?

A. Reasonable salary paid for genuine services actually rendered
B. Repayment of principal on a properly documented shareholder loan
C. Rent paid at market rates for premises the shareholder owns
D. Personal use of corporate property without paying for that use

36. Which factor indicates behavioral control supporting employee status?

A. Training the worker in the business's own preferred procedures
B. A significant unreimbursed investment made by the worker
C. Genuine opportunity for the worker to realize profit or loss
D. Availability of the worker's services to the general market

37. How is an employer's employment tax deposit schedule determined?

A. By the number of employees on the payroll at the year end
B. By liability during a lookback period ending the preceding June
C. By the employer's liability during the current calendar quarter
D. By an election made on the first employment tax return filed

38. How long must general records supporting income and deductions be retained?

A. Four years after the tax becomes due or is actually paid
B. Six years from the end of the calendar year that is involved
C. Three years from the filing date or due date, whichever is later
D. Until the taxpayer disposes of the related business assets

39. Which item is added back in computing distributable net income?

A. The personal exemption allowed to the trust or the estate
B. Capital gains allocated to corpus during the taxable year
C. Expenses allocable to tax-exempt income that was received
D. Depreciation apportioned to the income beneficiaries

40. Which return does an exempt organization with modest receipts and assets file?

A. The full annual information return in every circumstance
B. The electronic notice available to very small organizations
C. The separate return required of all private foundations
D. The short-form return for smaller exempt organizations

41. Which contribution structure belongs to a savings incentive match plan?

A. Employer contributions only, with no elective deferrals permitted
B. Discretionary employer contributions under a written formula
C. Employee deferrals plus a mandatory match or nonelective amount
D. Employee deferrals only, with no employer contribution required

42. Which form does a farmer materially participating in the operation use?

A. The ordinary rental schedule used for real property income

B. A separate farm rental form for production-based rent
C. Schedule C, as with any other trade or business activity
D. Schedule F, reporting the farm profit or loss for the year

43. Which item is excluded from a partnership's ordinary business income on page one?

A. Repairs to the partnership's business operating premises
B. Charitable contributions made during the taxable year
C. Wages paid to employees who are not themselves partners
D. Utilities consumed at the entity's main operating location

44. Which condition must be satisfied for the de minimis safe harbor without a financial statement?

A. A written accounting policy in place at the start of the year
B. An election filed with an amended return for that same year
C. Expenditures exceeding a specified minimum dollar floor
D. Approval of the policy by the entity's own governing board

45. Which item is an unrealized receivable for hot asset purposes?

A. A note receivable already included in partnership income
B. Marketable securities held for investment by the partnership
C. Depreciation recapture potential in partnership equipment
D. Cash held in the partnership's ordinary operating accounts

46. Which requirement applies to the small taxpayer safe harbor for building expenditures?

A. Annual amounts must stay within a percentage of unadjusted basis
B. The building must have been placed in service within five years
C. The taxpayer must hold an applicable financial statement
D. The expenditures must relate solely to structural components

47. Which item is a permanent difference on the corporate reconciliation?

A. Accelerated depreciation exceeding book depreciation claimed
B. An allowance for doubtful accounts recorded for book purposes
C. An installment sale gain recognized fully for book purposes
D. Fines paid to a regulatory agency during the taxable year

48. Which item is separately stated because of an owner-level limitation?

A. Depreciation on machinery used in ordinary daily operations
B. Section 179 expense elected on qualifying business property
C. Rent paid for the entity's own business operating premises
D. Insurance premiums covering the entity's business property

49. Which condition must be met for a partnership allocation to be respected?

A. It must have substantial economic effect under the agreement
B. It must be agreed unanimously by all of the partners in writing
C. It must match each partner's relative capital contribution
D. It must be approved by the Service before the year begins

50. Which statement about a qualified subchapter S subsidiary is correct?

A. It files its own return separately from the parent corporation
B. It may be owned jointly by two or more S corporations
C. It is disregarded, with its items treated as the parent's own
D. It must have at least one shareholder other than the parent

51. Which item is reported as farm income carrying no basis?

A. Livestock purchased and resold within the same season
B. Equipment acquired secondhand and later sold at a profit
C. Feed purchased in bulk and resold to a neighboring farm
D. Produce raised on the farm and sold to a cooperative

52. Which election may a cash method farmer make on crop insurance proceeds?

A. To exclude the proceeds from gross income entirely
B. To defer the proceeds to the following taxable year
C. To spread the proceeds ratably across three following years
D. To treat the proceeds as a return of capital reducing basis

53. Which recovery period applies to a single-purpose agricultural structure?

A. Twenty years, as with general purpose farm buildings
B. Ten years under the modified accelerated cost recovery system
C. Fifteen years, as with land improvements and drainage tile
D. Thirty-nine years, as with nonresidential real property

54. Which statement about farm income averaging is correct?

A. It uses base year income only as a computational reference
B. It requires amending each of the three base year returns
C. It is available to corporations engaged in farming operations
D. It must be elected before the close of the current tax year

55. Which activity is not a rental activity under the passive loss rules?

A. A residential lease running twelve months to a single tenant

B. A commercial lease with annual renewal options for the tenant
C. A ground lease of undeveloped land running for twenty years
D. A property where average customer use is seven days or less

56. How does the special allowance for rental real estate losses phase out?

A. By one dollar for each dollar of income above the threshold
B. Proportionately across a band indexed annually for inflation
C. By fifty cents for each dollar of income above the lower threshold
D. It does not phase out for taxpayers who actively participate

57. Which payment is included in rental income at fair market value?

A. A refundable security deposit the landlord must eventually return
B. A tenant improvement the tenant funds for its own benefit
C. The landlord's own expenditure on maintaining the property
D. Property or services accepted by the landlord in place of rent

58. Which condition applies to a dwelling rented for fewer than fifteen days?

A. The income is excluded and no rental expenses are deductible
B. The income is reported with expenses allocated by days used
C. The income is reported and a rental loss may then be claimed
D. The income is excluded but expenses remain fully deductible

59. Which requirement applies to a trust's charitable contribution deduction?

A. The contribution must be within ten percent of taxable income
B. The instrument must authorize it and it must come from gross income
C. The recipient must be a qualifying public charity organization
D. All income beneficiaries must consent to the contribution made

60. Which election permits a January distribution to be treated as made in the prior year?

A. An election made by the beneficiaries on their own returns
B. An election made by the trustee alone within sixty days
C. The sixty-five day election made annually on the entity's return
D. An election taking effect automatically upon the distribution

61. Which organization must file the private foundation return regardless of size?

A. Any exempt organization with assets above a stated threshold
B. Every private foundation, whatever its receipts or assets
C. Any organization failing the public support test in one year
D. Only foundations making grants to foreign organizations

62. Which sanction permits correction of an insider transaction short of revocation?

A. The excise tax on failure to distribute minimum amounts
B. The tax on unrelated debt-financed rental income received
C. The penalty for failing to permit public inspection of returns
D. Intermediate sanctions imposed on excess benefit transactions

63. Which activity is excluded from unrelated business taxable income?

A. A business in which substantially all work is done by volunteers
B. Sale of advertising space in a regularly published journal
C. Operation of a retail store selling unrelated consumer goods
D. Rental of personal property under an equipment lease

64. Which requirement applies to public inspection of an exempt organization's filings?

A. Contributor names must always be disclosed by every organization
B. Only private foundations face any inspection requirement at all
C. The organization must make its three most recent returns available
D. Inspection is required only where the Service specifically directs

65. Which vesting rule applies to employee elective deferrals?

A. Three-year cliff vesting matching employer contributions
B. Six-year graded vesting matching employer contributions
C. Vesting only upon attainment of normal retirement age
D. Immediate and full vesting in every qualified retirement plan

66. Which plan condition triggers top-heavy status?

A. More than half of accrued benefits belonging to key employees
B. More than sixty percent of accrued benefits belonging to key employees
C. Any participation by an owner of more than five percent
D. Coverage of fewer than seventy percent of all the employees

67. Which arrangement is a prohibited transaction with a qualified plan?

A. Investing plan assets in publicly traded corporate stock
B. Paying reasonable fees to an independent plan administrator
C. Leasing property between the plan and the employer sponsor
D. Making employer contributions within the deduction limits

68. Which figure is used to compute the self-employed owner's plan deduction?

A. Net profit reduced by the deductible half of self-employment tax

B. Net profit before any adjustment whatever has been made
C. Gross receipts before deducting any of the business expenses
D. Net profit reduced by the entire self-employment tax paid

69. Which item does a more-than-two-percent S corporation shareholder include in wages?

A. Distributions received during the taxable year in cash
B. The shareholder's allocated share of ordinary business income
C. Employer-paid health insurance premiums for that shareholder
D. Repayment of principal on a loan made to the corporation

70. Which item must be reported consistently by buyer and seller on an asset sale?

A. The employment status of workers transferring with the business
B. The accounting method the buyer intends to adopt afterward
C. The seller's remaining net operating loss carryforwards
D. The allocation of purchase price across the defined asset classes

71. Which item is added to income in computing earnings and profits?

A. Charitable contributions in excess of the ten percent limit
B. The dividends received deduction claimed during the year
C. Capital losses disallowed because they exceed capital gains
D. Penalties assessed for late payment of employment taxes

72. Which tier applies first where an S corporation has accumulated earnings and profits?

A. The accumulated adjustments account, tax free within stock basis
B. Accumulated earnings and profits, taxed as an ordinary dividend
C. The other adjustments account holding tax-exempt income
D. The shareholder's remaining stock basis as return of capital

73. Which farm expense is deductible without any special percentage limitation?

A. Veterinary services provided to the productive breeding herd
B. Prepaid feed acquired well before the consumption season
C. Soil and water conservation expenditures made on farmland
D. Costs of clearing land for permanent agricultural use

74. Which condition exempts an organization from the annual filing requirement?

A. Gross receipts normally below fifty thousand dollars each year
B. Status as a church or an integrated auxiliary of a church
C. Status as a private foundation making only small grants
D. Operation for fewer than three consecutive taxable years

75. Which property is excluded from the tax on unrelated debt-financed income?

A. Rental real estate subject to an outstanding acquisition mortgage
B. Securities purchased on margin through a brokerage account
C. Property acquired subject to a seller-financed purchase note
D. Property used substantially for the organization's exempt purposes

76. Which item is a separately stated item on an S corporation return?

A. Repairs to the corporation's operating business premises
B. Wages paid to non-shareholder employees during the year
C. Charitable contributions made during the taxable year
D. Utilities consumed at the corporation's operating location

77. Which partner's distributive share is generally excluded from self-employment income?

A. A general partner's share of trade or business income
B. A guaranteed payment received for services actually rendered
C. A limited partner's share of trade or business income
D. A general partner's share of separately stated income items

78. Which item may convert an abandonment loss from ordinary to capital?

A. The partnership's use of the accrual method of accounting
B. Relief from any share of partnership liabilities on abandonment
C. The partner's status as a limited rather than general partner
D. The length of time the interest was held before abandonment

79. Which basis rule applies to property acquired by gift and later sold at a loss?

A. The donor's basis governs the loss computation in all cases
B. Fair market value at the gift date governs in every case
C. The donee elects whichever basis produces the larger loss
D. A special rule may produce neither gain nor loss on the sale

80. Which condition permits a corporation to deduct a bonus accrued to an unrelated employee?

A. Payment within two and a half months after the year closes
B. Payment before the last day of the accrual year itself
C. Written approval by every shareholder of the corporation
D. Inclusion of the amount in the employee's prior year wages

81. Which convention applies to residential rental property?

A. The half-year convention applied to most personal property

B. The mid-month convention regardless of the placement date
C. The mid-quarter convention where the threshold is exceeded
D. A full-year convention because the period exceeds ten years

82. Which election applies to an entire class of property rather than asset by asset?

A. The Section 179 expensing election on qualifying property
B. The election to capitalize rather than deduct a repair cost
C. The election out of bonus depreciation for the taxable year
D. The election to use the installment method on a sale

83. Which item reduces qualified business income for a partner?

A. Ordinary business income allocated on the Schedule K-1
B. Section 1231 gain treated as long-term capital gain
C. Interest income allocable to the partnership's business
D. Guaranteed payments received by that partner for services

84. What is the applicable percentage used within the qualified business income phase-in range?

A. The proportion of the way through the phase-in range
B. The ratio of qualified income to total taxable income
C. A flat fifty percent applied throughout the entire range
D. The ratio of W-2 wages to qualified business income earned

85. Which credit component covers part of the cost of establishing a new qualified plan?

A. The small employer pension plan startup costs credit
B. The work opportunity credit for targeted group hires
C. The employer credit for social security taxes paid on tips
D. The disabled access credit for accessibility expenditures

86. Which technique tests whether reported business receipts are complete?

A. Verifying that the balance sheet columns foot correctly
B. Reconciling depreciation to the detailed fixed asset ledger
C. Confirming retained earnings ties to the prior year figure
D. Comparing business-source deposits to reported gross receipts

87. Which change requires consent on Form 3115 rather than an amended return?

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

88. Which protection does voluntarily filing a method change request generally provide?

A. Elimination of any adjustment for prior taxable years
B. A refund of tax overpaid under the former method used
C. Audit protection for the earlier years that were affected
D. Waiver of the user fee otherwise payable on the request

89. Which self-rental arrangement is respected for tax purposes?

A. One where the rent charged is reasonable in amount
B. One where rent is set below market to reduce entity income
C. One where no written lease documents the arrangement
D. One where rent varies with the entity's annual profits

90. Which item is included in gross receipts without any reduction?

A. Amounts remaining after cost of goods sold has been subtracted
B. Net profit after all operating expenses have been deducted
C. Amounts collected in cash but excluding accrued receivables
D. Amounts received before any deduction, including cost of goods sold

91. Which item is a temporary book-tax difference?

A. Tax-exempt interest earned on municipal bond holdings
B. An installment sale gain recognized fully for book purposes
C. Fines paid for violating a regulatory requirement
D. Life insurance premiums where the entity is the beneficiary

92. Which condition must be satisfied for an involuntary conversion to qualify for deferral?

A. The proceeds must be reinvested in qualifying replacement property
B. The replacement property must be real property in every case
C. The taxpayer must have held the property for over one year
D. The conversion must have resulted from a government condemnation

93. Which loss may an individual carry back rather than only forward?

A. A general business loss from an active trade or business
B. A passive activity loss suspended in the current year
C. A farming loss, subject to a two-year carryback period
D. An excess business loss disallowed under the annual cap

94. Which requirement applies to listed property substantiation?

A. A summary reconstructed at the close of the taxable year

B. Approval of the mileage by a supervisor or company officer
C. Records of the amount, time, place, and business purpose
D. Retention of fuel receipts for every trip that was undertaken

95. Which deposit obligation arises where accumulated employment tax liability reaches the threshold?

A. Deposit within three business days of reaching the amount
B. Deposit by the fifteenth day of the following calendar month
C. Deposit together with the quarterly return when it is filed
D. Deposit by the next business day following that particular day

96. Which item must a partnership report to its partners by liability category?

A. The partnership's total assets at the close of the taxable year
B. Each partner's share of recourse and nonrecourse liabilities
C. Each partner's share of gross receipts for the taxable year
D. The partnership's aggregate depreciation for the taxable year

97. Which statement about a personal service corporation is correct?

A. It may adopt any fiscal year without establishing a purpose
B. It is confined to a calendar year absent a business purpose
C. It is exempt from the accumulated earnings tax entirely
D. It receives an enhanced accumulated earnings credit amount

98. Which condition must be met for an accountable plan reimbursement to be excluded from wages?

A. Substantiation within a reasonable period and return of excess
B. Payment of the reimbursement within the same calendar quarter
C. Approval of each expenditure by an officer before payment
D. Reimbursement at a rate not exceeding the federal per diem

99. Which item is excluded from inventoriable cost for a reseller?

A. Freight charges incurred in acquiring the merchandise held
B. Purchasing department costs allocable to the acquisitions
C. Handling and repackaging of goods held for eventual sale
D. Shipping supplies used to deliver goods out to customers

100. Which statement about cost depletion is correct?

A. It applies a statutory rate to gross income from the property
B. It may continue after the property's basis is fully exhausted
C. It allocates basis over recoverable units and never exceeds basis
D. It is available only to taxpayers extracting oil and gas

Practice Exam 23: Answer Key and Explanations

1. C — The buyer's share of inside basis is fifty thousand dollars while outside basis is the sixty-eight thousand actually paid. A Section 754 election permits an eighteen thousand dollar special adjustment that belongs to that transferee alone and does not affect the other partners. Without the election the disparity simply persists until disposition.

2. D — A corporation may deduct capital losses only against capital gains, with no allowance against ordinary income at all. Forty thousand offsets the gains and the remaining fifty-five thousand carries back three years and forward five. Carried losses are always treated as short-term regardless of their original character. The character conversion on carryover is a frequent trap.

3. B — Under the nimble dividend rule the two pools are tested separately, so positive current earnings support dividend treatment despite the accumulated deficit. Forty-eight thousand is a dividend and the deficit does not offset it. The remaining twelve thousand is a return of capital reducing basis, then capital gain. Netting the deficit against current earnings gives a wrong answer.

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

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

9. C — 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. 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 the same moment. The second is measured by share count rather than value, and failing either defeats the exchange.

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

14. A — 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. D — 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. 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 and capitalization. Crossing that threshold engages all three regimes at once.

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

22. 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.

23. C — The prescribed order begins with net operating losses, then general business credit carryovers, the minimum tax credit, capital loss carryovers, basis of property, passive activity carryovers, and finally foreign tax credits. The reduction equals the amount excluded rather than forgiven. Depreciable basis may be elected first instead. Both the exclusion and the reduction appear on a prescribed form.

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

25. D — 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. B — Liquidating a C corporation triggers gain at both the corporate and shareholder levels, which makes a C corporation holding appreciated assets practically impossible to unwind. Moving into corporate form is generally tax free. Electing S status is a simple election carrying only built-in gains exposure across five years. Appreciated assets make the C corporation structure effectively permanent.

27. C — For an S corporation the schedule tracks the accumulated adjustments account, accumulated earnings and profits, and the other adjustments account. Those balances directly determine whether distributions are tax free, dividends, or capital gain. Errors therefore carry shareholder consequences a C corporation's analysis simply does not. A C corporation's version carries no such shareholder consequence.

28. A — Statutory employees including certain agent and commission drivers, full-time life insurance agents, home workers, and travelling salespeople are subject to Social Security and Medicare withholding despite being independent contractors at common law. Real estate agents, direct sellers, and companion sitters are statutory nonemployees instead. The two categories are frequently confused in practice.

29. A — Self-employed taxpayers may use the meal portion of the published per diem allowance but must substantiate actual lodging cost. Owners of more than ten percent of a business face the same restriction. Time, place, and business purpose still require substantiation whatever method is used for amounts. Owners of more than ten percent face the identical restriction.

30. B — Percentage depletion applies a statutory rate to gross income from the property and may continue after basis is exhausted, which is why it must be tracked separately for earnings and profits purposes. Cost depletion allocates basis over recoverable units and can never exceed basis at all. The taxpayer claims whichever method produces the larger figure.

31. C — Expenses of issuing or selling stock are neither deductible nor amortizable; they reduce the proceeds of the issuance instead. Genuine organizational costs such as charter drafting, incorporation fees, and organizational meeting expenses qualify for the immediate deduction and amortization over one hundred eighty months. They reduce the proceeds of the issuance rather than income.

32. D — Lease acquisition costs including commissions, legal fees, and payments to a previous tenant are amortized ratably over the lease term, with renewal periods included in defined circumstances. Improvements to the leased property follow a separate rule and are depreciated over a period set by the improvement. Renewal periods are included in defined circumstances.

33. C — The ordinary involuntary conversion replacement period is two years from the close of the first year in which gain is realized, extended to three years for condemned real property held for business or investment. Weather-related sales of breeding livestock carry a separate four-year period extendable in drought. The extension recognises the difficulty of replacing real property.

34. B — No deduction is allowed for a loss on a sale or exchange between a partnership and a partner owning, directly or constructively, more than half the capital or profits interest. The disallowed loss may reduce the purchaser's later gain on resale, so the benefit belongs to the buyer. The benefit therefore belongs to the buyer rather than the seller.

35. D — Where an owner uses business property personally, the value is compensation if the owner is an employee and a constructive dividend if the owner provides no services. Either way the entity's deduction is reduced or its income increased. Personal use also lowers the qualified business use percentage. Recapture of excess depreciation may follow that reduction.

36. A — Training the worker in the business's own methods is a behavioral control indicator, as are detailed instructions about when, where, and how to work. Unreimbursed investment, profit or loss opportunity, and market availability are all financial control factors pointing toward independent contractor status. The right to control matters more than whether it is exercised.

37. B — The schedule is fixed by liability during the lookback period and does not change because current-year liability changes. An employer whose payroll doubles mid-year remains a monthly depositor unless accumulated liability reaches one hundred thousand dollars on any day, which requires a next-business-day deposit. That accumulation rule overrides the ordinary schedule entirely.

38. C — General records run three years from the filing date or due date, whichever is later, extended to six years where more than a quarter of gross income was omitted and kept indefinitely where no return was filed. Employment tax records follow a separate four-year rule instead. Employment tax records follow a separate four-year rule instead.

39. A — The computation adds back the distribution deduction and the personal exemption, subtracts capital gains allocable to corpus, and adds tax-exempt income net of allocable expenses. Corpus gains belong to the remainder beneficiary and are removed. The result approximates income available for current distribution. Corpus gains belong to the remainder beneficiary rather than the income one.

40. D — The short form is available where gross receipts are under two hundred thousand dollars and total assets under five hundred thousand dollars, and both conditions must be met. The electronic notice serves organizations with receipts normally at or below fifty thousand dollars measured across three years. Both conditions must be satisfied before the short form is available.

41. C — Employees make elective deferrals within a limit lower than ordinary deferral plans, and the employer must either match 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. All contributions vest immediately upon deposit into the plan.

42. D — A farmer materially participating in the operation reports on Schedule F. A landowner receiving production-based rent without materially participating uses a separate farm rental form, and one receiving fixed cash rent uses the ordinary rental schedule. Participation and the nature of the rent decide it. The distinction determines which schedule reports the income.

43. B — An item is separately stated where its separate treatment could affect an owner's tax liability differently than if buried in ordinary income. Charitable contributions face limits computed on each owner's own return. Repairs, ordinary wages, and utilities carry no partner-level variation and are aggregated. Each owner computes the limitation on their own return.

44. A — A taxpayer without an applicable financial statement must have a written accounting policy in place at the beginning of the tax year to use the safe harbor. The policy cannot be adopted retroactively when the return is prepared, so a policy written in March for a calendar year is too late.

45. C — The definition is broader than the name suggests. It captures rights to payment for goods delivered or services rendered not yet included in income, and it also captures depreciation recapture potential embedded in depreciable property. Heavily depreciated equipment therefore creates hot assets without receivables. Conventional receivables are not required for hot assets to exist.

46. A — A qualifying small taxpayer may elect to deduct amounts spent on a building with unadjusted basis at or below a statutory ceiling, provided total annual expenditures stay within the lesser of two percent of that basis or a dollar cap. The de minimis safe harbor is entirely separate. The two safe harbors carry entirely separate conditions.

47. D — Fines and penalties reduce book income and are never deductible for tax, so the difference never reverses. Depreciation timing, bad debt allowances, and installment sale gains all reverse in later periods and are temporary differences. Permanent differences change the effective rate the corporation bears. Permanent differences change the effective rate the corporation bears.

48. B — Section 179 expense is separately stated because the election and its dollar and income limitations operate at the owner level as well as the entity level. Routine depreciation, rent, and insurance carry no owner-level variation and are aggregated into ordinary business income on page one. Owner-level elections must be preserved separately on the statement.

49. A — An allocation stated in the partnership agreement is respected where it has substantial economic effect, or otherwise accords with the partners' interests in the partnership. An allocation shifting tax items without the corresponding economic benefit or burden is reallocated to reflect those interests. S corporations have no equivalent allocation flexibility at all.

50. C — Where an S corporation owns all the stock of a domestic corporation, it may elect to treat the subsidiary as a qualified subchapter S subsidiary. The subsidiary is then disregarded and its assets, liabilities, income, and deductions are treated as the parent's. Liability is isolated without a second entity. The subsidiary's items are treated as the parent's own throughout.

51. D — Raised produce and livestock carry no basis because the costs of raising them were deducted currently, so the entire sale price is income. Items purchased for resale are reported against their cost instead. This distinction determines the gross income figure on the farm schedule entirely. Costs of raising the produce were already deducted currently.

52. B — A cash method farmer may defer crop insurance and disaster payments to the following year where it can be established that income from the damaged crops would normally have been reported in that later year. A separate election permits deferral of weather-related livestock sales entirely. The deferral matches income to the period it would normally arise.

53. B — Single-purpose agricultural and horticultural structures are recovered over ten years. General farm buildings run twenty years, land improvements such as fences and drainage tile run fifteen, and farm machinery runs five. A farming business electing out of the interest limitation uses the alternative system. Farm machinery and breeding cattle instead run five years.

54. A — Base year income serves only as a computational reference, so the earlier returns are unaffected and need not be amended. The election averages farm income across the current year and three base years, is available only to individuals, and may be made on an amended return. It is available only to individuals and never to corporations.

55. D — An activity where the average period of customer use is seven days or less, or thirty days or less with significant personal services, is not a rental activity at all. It is tested under ordinary material participation standards instead, so a materially participating lodging operator may deduct losses. A materially participating lodging operator may therefore deduct losses.

56. C — The allowance reduces by fifty cents for each dollar of modified adjusted gross income above the lower end of the phase-out band and disappears entirely at the upper end. Because the band is not indexed for inflation, it reaches steadily further down the income scale each year. The band has never been adjusted since it was first enacted.

57. D — Property or services accepted in place of rent are included in rental income at fair market value. Rental income also captures rents received, advance rent, lease cancellation payments, and expenses the tenant pays on the landlord's behalf. Only refundable deposits escape inclusion until applied. Advance rent is likewise income when received by the landlord.

58. A — A dwelling used as a residence and rented for fewer than fifteen days produces a complete exclusion. The rental income is not reported at all and no rental expenses are deductible. Mortgage interest and property taxes remain available as itemized deductions in the ordinary way. This makes a short high-value rental effectively tax free.

59. B — A trust deducts charitable contributions without the percentage limitations applying to individuals, but only where the governing instrument authorizes the contribution and it is paid from gross income. The instrument's terms are therefore decisive, and an unauthorized contribution produces no deduction whatever. An unauthorized contribution produces no deduction whatever. The trustee cannot create a deduction the instrument withholds.

60. C — The election allows a distribution made within the first sixty-five days of a year to be treated as made on the last day of the preceding year. Because fiduciary brackets compress rapidly, shifting income to beneficiaries usually helps, and the decision follows the year's known results. Compressed fiduciary brackets make the shift usually worthwhile.

61. B — All private foundations file the private foundation return whatever their receipts or assets. Other organizations file the electronic notice, the short form, or the full return according to gross receipts and total assets measured on a three-year normally basis rather than any single year. Size never relieves a foundation of that filing obligation.

62. D — Where an insider receives more than fair value, intermediate sanctions impose excise taxes on the recipient and on managers who knowingly approved the transaction, permitting correction without revoking exemption. Private inurement by contrast is an absolute prohibition defeating exemption outright. Managers who knowingly approved the transaction are also taxed. Correction restores the organization without losing exemption.

63. A — Businesses where substantially all work is performed by volunteers are excluded, as are activities for the convenience of members, students, or patients and sales of donated merchandise. Advertising revenue, unrelated retail operations, and personal property rentals are all classic taxable activities. Convenience of members and donated merchandise are excluded too.

64. C — An exempt organization must make its three most recent annual returns and its exemption application available for inspection and provide copies on request. Contributor names and addresses may be withheld by organizations other than private foundations. Penalties accrue for each day out of compliance. The exemption application must be made available as well.

65. D — Employee elective deferrals vest immediately and fully in every plan, as do all contributions to simplified employee pensions and savings incentive match plans. Employer contributions to a qualified plan may instead follow a three-year cliff or six-year graded schedule as permitted. Employer contributions are the only ones following any schedule.

66. B — A plan in which more than sixty percent of accrued benefits belong to key employees is top-heavy and must provide a minimum contribution for non-key participants together with accelerated vesting. Coverage and nondiscrimination testing operate separately from this particular determination.

Accelerated vesting accompanies the minimum contribution requirement. Key employees are defined by ownership and officer status.

67. C — The prohibited list covers sale, exchange, or leasing of property, lending money or extending credit, furnishing goods, services, or facilities, transferring plan assets to a disqualified person, and self-dealing by a fiduciary. The employer is itself a disqualified person under the rules. The employer is itself a disqualified person under those rules.

68. A — Net earnings for plan purposes equal net profit reduced by the deductible half of self-employment tax. The stated plan rate is then converted by dividing it by one plus itself, so twenty-five percent becomes twenty percent, resolving the circularity the contribution creates. Two adjustments separate this from a naive computation entirely.

69. C — A shareholder owning more than two percent cannot exclude most fringe benefits. Premiums are included in Box 1 of the Form W-2, deducted by the corporation as compensation, and then claimed by the shareholder as the self-employed health insurance deduction on the individual return. The deduction is then claimed on the individual return itself.

70. D — The purchase price must be allocated across asset classes under a prescribed residual method, and both parties must report that allocation consistently. Buyers prefer asset purchases for the stepped-up basis, while sellers prefer entity sales producing capital gain rather than ordinary recapture. The residual method governs how the price is spread across classes.

71. B — The dividends received deduction reduces taxable income without any corresponding cash outflow, so it is added back in full. Excess charitable contributions, disallowed capital losses, and nondeductible penalties are all genuine economic outlays reducing the capacity to distribute earnings. The measure gauges economic capacity rather than taxable income. No cash leaves the corporation when the deduction is claimed.

72. A — The four tiers run in order: the accumulated adjustments account first, tax free to the extent of stock basis, then accumulated earnings and profits as a dividend, then remaining basis, then capital gain. An election permits reversing the first two tiers where exposure exists. Only the second tier reduces the shareholder's stock basis.

73. A — Veterinary services are ordinary operating costs deductible in the usual way, alongside seed, fertilizer, hired labour, rent, repairs, and breeding fees. Prepaid supplies face a fifty percent limit, conservation expenditures a twenty-five percent limit, and land clearing costs are capitalized. Land clearing costs are capitalized into the basis of the land.

74. B — Churches, their integrated auxiliaries, and conventions or associations of churches are exempt from the annual filing requirement entirely, as they are from applying for recognition. Organizations with small receipts still file the electronic notice, and three years of non-filing revokes exemption. Many apply anyway because donors expect the documentation. The exemption from applying runs alongside the filing relief.

75. D — Property substantially all of whose use is directly related to the exempt purpose is excluded from the debt-financed rules. Mortgaged rental real estate, margin securities, and seller-financed acquisitions all carry acquisition indebtedness and produce taxable income in proportion to that debt. Acquisition indebtedness is the decisive fact in every case.

76. C — Charitable contributions are separately stated because the limitations are computed on each shareholder's own return, so aggregating them would destroy information the shareholder needs. Routine repairs, wages, and utilities carry no shareholder-level variation and are aggregated into ordinary income. Aggregating them would destroy information the shareholder needs. The percentage limits operate at shareholder level entirely.

77. C — A limited partner's distributive share is generally excluded from self-employment income, while a general partner's share of trade or business income is included in full. Guaranteed payments for services remain subject to the tax for either type of partner without exception. A general partner includes the whole distributive share instead.

78. B — Abandonment ordinarily produces an ordinary loss because it is not a sale or exchange. Relief from even a small share of partnership liabilities converts the transaction into a deemed sale or exchange, making the loss capital. Questions here turn on whether liabilities existed. Questions here turn on whether liabilities were outstanding.

79. D — Gifted property takes the donor's basis for computing gain and the lower of that basis or value at the gift date for computing loss. Where the property sells between those two figures, the special rule produces no gain and no loss at all, which candidates frequently overlook. The dual-basis rule produces this unusual middle-ground outcome.

80. A — An accrual employer may deduct a bonus declared before year end and paid within two and a half months afterward, provided the liability was fixed and determinable at year end. The rule is unavailable where the recipient is a related party under the matching provisions. Related-party recipients defer the deduction until inclusion.

81. B — Residential rental and nonresidential real property both use the mid-month convention regardless of when in the month the property was placed in service, and both are always straight line. Personal property uses the half-year convention by default instead of this rule. Personal property instead uses the half-year convention by default.

82. C — Bonus depreciation applies automatically and is elected out of by class rather than asset by asset. A taxpayer wanting to expense some assets and depreciate others therefore needs the granularity of Section 179, which is elected affirmatively and may cover partial amounts. Section 179 alone permits asset-by-asset and partial elections.

83. D — Guaranteed payments are excluded from qualified business income on the same reasoning excluding S corporation reasonable compensation: both are payments for services rather than a share of profits. The partnership's deduction correspondingly reduces the ordinary income that does qualify. Both are payments for services rather than shares of profit. The entity deduction reduces qualifying ordinary income too.

84. A — The applicable percentage measures how far through the phase-in range the taxpayer sits. That percentage is multiplied by the excess amount, being the difference between the tentative deduction and the fully applied wage limit, and the product is subtracted from the tentative deduction. The phase-in produces a partial rather than total disallowance.

85. A — The credit covers a portion of the costs of establishing a new qualified plan, with an additional component for automatic enrolment features. It has become considerably more generous and is frequently overlooked. It shares the general business credit's single limitation and carryover regime. Component credits share one limitation and carryover regime.

86. D — Removing documented non-income deposits such as loan proceeds and owner transfers, then comparing the remainder against reported receipts, exposes income that never reached the books. A rollforward that ties proves only internal consistency of what was actually recorded. Loan proceeds and owner transfers must be removed before comparing. A tying rollforward proves consistency rather than completeness.

87. B — A method of accounting requires consistent treatment across at least two consecutive returns, so a single year's treatment is an error correctable by amendment. An impermissible method once adopted is changed only prospectively with consent, bringing forward a cumulative adjustment. Operational changes are not method changes at all under the rules.

88. C — A taxpayer voluntarily changing from an impermissible method generally receives audit protection for earlier years. A taxpayer whose impermissible method is discovered on examination does not, and the Service may impose the change with the entire adjustment falling into a single year. Examination-imposed change offers no such protection whatever. The whole adjustment may then fall into a single year.

89. A — A self-rental is respected where the rent is reasonable, with the business deducting it and the owner reporting rental income. An inflated or artificial rent between related parties is recharacterized. Net income from such an arrangement then becomes nonpassive while losses remain passive. Losses from the same arrangement nonetheless remain passive.

90. D — Gross receipts are the total amounts received or accrued from all sales and services measured before any deduction whatever, including cost of goods sold. Returns and allowances are subtracted separately to reach net sales. Statutory thresholds use this gross figure averaged over three years. Returns and allowances are subtracted separately afterward.

91. B — An installment gain is recognized in full for book purposes at sale but recognized for tax as payments are received, so the difference reverses over time. Tax-exempt interest, fines, and life insurance premiums where the entity is beneficiary never reverse and are permanent. Permanent differences instead change the effective rate borne.

92. A — Gain is recognized only to the extent proceeds exceed the cost of qualifying replacement property, so a taxpayer reinvesting everything recognizes nothing. Unlike like-kind exchanges the provision still reaches both real and personal property held for business or investment. The replacement period runs from the close of the realization year.

93. C — Farming losses retain a two-year carryback, which is the sole surviving exception to the rule that losses arising after 2017 carry forward only. Ordinary business losses, suspended passive losses, and disallowed excess business losses all move forward instead. All others move forward without any carryback being available. Disallowed excess losses become carryforwards the next year.

94. C — The taxpayer must establish the amount of each expense or the mileage, the time and place of travel, and the business purpose, ordinarily through a contemporaneous log. Estimates prepared during an examination carry little weight, and failure disallows the deduction entirely. Business relationship must also be shown wherever relevant. A contemporaneous log is the strongest form of evidence.

95. D — The amount must be deposited by the next business day, and a monthly depositor triggering the rule becomes a semiweekly depositor for the remainder of that year and the following one. Otherwise the lookback period fixes the schedule for the employer. A monthly depositor triggering it becomes semiweekly thereafter. The hundred thousand dollar figure triggers that obligation.

96. B — The Schedule K-1 reports each partner's share of recourse, qualified nonrecourse, and other nonrecourse liabilities. These figures determine outside basis, which determines loss deductibility, so an allocation error flows straight through to a wrong deduction on the partner's return. Recourse and nonrecourse liabilities follow different allocation rules. Outside basis in turn governs how much loss is deductible.

97. B — A personal service corporation is confined to a calendar year unless it establishes a business purpose for a different one, and a Section 444 election permits at most a three-month deferral with a minimum distribution requirement. It receives a reduced accumulated earnings credit. A Section 444 election carries a minimum distribution requirement.

98. A — An accountable plan requires a business connection, substantiation within a reasonable period, and return of any excess advance. Failure of any single condition converts the arrangement to a nonaccountable plan for all participants, making every payment taxable wages without offset. Employee business deductions are suspended under current law. Return of any excess advance is the third required condition.

99. D — Inventoriable cost includes the invoice price less trade discounts plus freight and other acquisition charges. Containers passing to the buyer with the goods are inventoriable, while shipping supplies used for outbound delivery are not. Purchasing and handling costs must be capitalized. Containers passing with the goods are inventoriable instead. Trade discounts reduce the invoice price before capitalization.

100. C — Cost depletion allocates basis over recoverable units and can never exceed the remaining basis in the property. Percentage depletion applies a statutory rate to gross income and may continue after basis is exhausted. The taxpayer claims whichever method produces the larger deduction. Percentage depletion is limited to half of taxable income from the property.