# PRACTICE EXAM 27: ENROLLED AGENT PART 2 BUSINESSES SIMULATION (100 QUESTIONS)

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

**1.** Which hour threshold satisfies material participation on its own?

A. Two hundred fifty hours in any trade or business activity
B. Five hundred hours of participation during the taxable year
C. One hundred hours where no other individual participates more
D. Seven hundred fifty hours across all business activities

**2.** Which prior-year test establishes material participation in the current year?

A. Participation in any two of the ten immediately preceding years
B. Participation in the immediately preceding year alone
C. Material participation in five of the preceding ten taxable years
D. Participation in any two of the three immediately preceding years

**3.** Within what period must a Section 83(b) election be made?

A. Thirty days from the date the property is transferred
B. Ninety days from the date the property vests fully
C. By the due date of the return for the year of transfer
D. At any time before the restrictions on the property lapse

**4.** Which risk accompanies making the Section 83(b) election?

A. Tax paid on value never received if the property is forfeited
B. The property becomes ineligible for capital gain treatment later
C. The employer loses its own deduction for the compensation
D. The holding period restarts when the restrictions finally lapse

**5.** Which condition must a farmer meet for the qualified farm indebtedness exclusion?

A. The farmer must be insolvent immediately before the discharge
B. Half of gross receipts for three prior years must be from farming
C. The debt must be secured by farmland rather than equipment
D. The lender must be a related party to the farming operation

**6.** Which figure is used for depreciation when personal property is converted to business use?

A. The lesser of adjusted basis or fair market value at conversion
B. The original cost of the property when it was first acquired
C. The fair market value at conversion regardless of original cost
D. The adjusted basis without regard to any decline in value

**7.** Which distributions are tax free during the post-termination transition period?

A. No distributions, since the corporation is now a C corporation
B. Distributions of property but not distributions of cash
C. Cash distributions within the adjustments account and stock basis
D. All distributions regardless of the corporation's account balances

**8.** Which waiting period generally applies after an S election terminates?

A. Five taxable years before a new election may be made
B. Three taxable years before a new election may be made
C. One taxable year before a new election may be made
D. No waiting period applies where the termination was voluntary

**9.** Which entity is exempt from estimated tax for its first two taxable years?

A. An estate, together with certain grantor trusts after death
B. Any trust whose income is distributed currently to beneficiaries
C. Any partnership beginning operations during the taxable year
D. A corporation making its first S election during the year

**10.** Which deduction is available to a recipient of income in respect of a decedent?

A. A deduction for the full amount of the item received
B. A deduction for estate tax attributable to that income item
C. A deduction for the decedent's own income tax liability paid
D. A deduction for the administration expenses of the estate

**11.** Which assets may be combined into a general asset account?

A. Assets sharing only the same recovery period regardless of class
B. Assets acquired from a single vendor in one transaction
C. Assets of the same class, period, convention, and service year
D. Any assets the taxpayer chooses to group for convenience

**12.** Which treatment applies to reforestation expenditures?

A. Deduction up to a stated amount with the remainder amortized

B. Full capitalization into the basis of the timber property
C. Immediate deduction of the entire amount in every case
D. Amortization over the useful life of the timber stand

**13.** Which item does Section 1032 provide for a corporation?

A. No gain or loss on dealing in its own capital stock
B. A deduction for amounts paid to repurchase its own shares
C. Capital gain treatment on issuing stock above par value
D. Ordinary income where stock is issued below its stated value

**14.** Which item does a corporation exclude when a nonshareholder contributes capital?

A. Contributions from customers made in exchange for services
B. Government contributions and civic group inducements to locate
C. Nothing, since all contributions to capital are now taxable income
D. Any contribution regardless of the contributor's relationship

**15.** Which factor supports treating a shareholder advance as debt rather than equity?

A. A ratio of advances to equity far exceeding industry norms
B. Advances made in proportion to each shareholder's holdings
C. A fixed maturity date with a definite obligation to repay
D. Repayment dependent entirely on the corporation's profitability

**16.** Which consequence follows recharacterization of a shareholder loan as equity?

A. Interest payments become nondeductible constructive dividends
B. The corporation deducts the payments as compensation instead
C. The advance becomes a tax-free return of the shareholder's capital
D. The shareholder recognizes a capital loss on the recharacterization

**17.** Which condition permits a worthless stock deduction for a subsidiary?

A. The subsidiary must have filed a formal bankruptcy petition
B. The parent must own at least fifty percent of the shares
C. The stock must become wholly worthless within the taxable year
D. The parent must dispose of the shares in a taxable sale

**18.** Which requirement applies to a corporate division under Section 355?

A. Both corporations must conduct an active business for five years
B. The distributing corporation must be publicly traded before the split
C. The distribution must be pro rata among all the shareholders
D. The businesses must operate in unrelated industries afterward

**19.** Which item must a partnership maintain to support special allocations?

A. Capital accounts maintained under the prescribed regulatory rules
B. A separate bank account for each partner's share of receipts
C. Annual appraisals of every asset the partnership holds
D. Unanimous written consent of all partners to each allocation

**20.** Which provision requires income allocation when partnership minimum gain decreases?

A. The ceiling rule limiting allocations of built-in gain
B. The minimum gain chargeback allocating gain to affected partners
C. The qualified income offset applying to unexpected distributions
D. The substantiality test measuring after-tax economic effect

**21.** Which payment is treated as made to a partner acting other than as a partner?

A. A payment for services rendered in a capacity outside the partnership
B. A guaranteed payment for the use of the partner's capital
C. A distributive share allocated under the partnership agreement
D. A liquidating distribution of the partner's entire interest

**22.** Which item does the ceiling rule limit in a partnership allocation?

A. The amount a partner may contribute in any single taxable year
B. The number of special allocations permitted in an agreement
C. Allocations to non-contributing partners of built-in gain items
D. The total depreciation the partnership may claim on all property

**23.** Which item does a corporation face on making an excess parachute payment?

A. Loss of the deduction plus an excise tax on the recipient
B. A deduction spread across the executive's remaining service years
C. Ordinary income to the corporation equal to the excess amount
D. A requirement to withhold at the highest individual rate

**24.** Which item does the employer deduct on exercise of a nonqualified stock option?

A. The option's value at the grant date rather than on exercise
B. The spread the employee includes in income on exercise
C. Nothing, since option grants never produce an employer deduction
D. The full exercise price the employee pays for the shares

**25.** Which item triggers an employer deduction for restricted stock units?

A. The date the units vest and the shares are actually delivered

B. The date the units are granted to the employee initially
C. The date the employee makes a Section 83(b) election
D. The date the employee eventually sells the delivered shares

**26.** Which special timing rule applies to nonqualified deferred compensation for payroll tax?

A. Payroll tax applies at grant regardless of vesting or payment
B. Payroll tax never applies to nonqualified deferred amounts
C. Payroll tax applies when the amount vests, not when it is paid
D. Payroll tax applies only when the amounts are actually distributed

**27.** Which item does the alternative depreciation system require for a farming business electing out?

A. Longer recovery periods for property with a ten-year period or more
B. Immediate expensing of all property placed in service that year
C. Recomputation of depreciation claimed in all prior open years
D. Use of the declining balance method for all farm machinery

**28.** Which property may qualify for bonus depreciation despite being previously used?

A. Used property acquired from a related party to the taxpayer
B. Used property acquired from an unrelated party and new to the taxpayer
C. No used property qualifies under any circumstances at all
D. Used property only where it was previously leased by the taxpayer

**29.** Which item does a taxpayer depreciate for replacement property in a like-kind exchange?

A. The carryover basis over the remaining period plus excess separately
B. The entire basis of the replacement property over a fresh period
C. Only the additional cash the taxpayer paid in the exchange
D. Nothing until the replacement property is eventually sold

**30.** Which expenditure may be amortized over sixty months as a pollution control facility?

A. The cost of remediating contamination caused by prior operations
B. Fines paid for exceeding permitted emission levels in a year
C. A certified treatment facility added to a plant in operation before 1976
D. Any environmental expenditure incurred by a manufacturing business

**31.** Which item is a qualified commercial clean vehicle for the business credit?

A. Any vehicle meeting the fuel economy standards for its class
B. A vehicle meeting the propulsion and battery capacity requirements
C. Any vehicle acquired for use in a trade or business activity
D. Any vehicle purchased from a qualified domestic manufacturer

**32.** Which item does the deduction for energy efficient commercial buildings require?

A. Certification that prescribed energy savings have been achieved
B. Installation of solar panels on the building's roof surface
C. Ownership of the building for at least five taxable years
D. Location of the building within a designated energy zone

**33.** Which method values inventory under lower of cost or market?

A. Comparison by major category of goods rather than item by item
B. Comparison of each separate item's cost against its market value
C. Comparison of total inventory cost against total market value
D. Comparison against the highest price obtained in the prior year

**34.** Which goods may be valued below cost even without a market decline?

A. Subnormal goods that are unsalable at ordinary prices
B. Goods held longer than twelve months in inventory
C. Goods purchased from a supplier who has since ceased trading
D. Goods for which the taxpayer holds excess quantities

**35.** Which threshold governs the additional Medicare tax withholding obligation?

A. Wages exceeding a stated amount paid by that single employer
B. The employee's total compensation from all employers combined
C. The employee's household income including a spouse's wages
D. The Social Security wage base applicable for the calendar year

**36.** Which item does an employer owe no matching contribution on?

A. Tips employees report to the employer during the year
B. Taxable fringe benefits included in the employee's wages
C. The additional Medicare tax withheld from higher-paid employees
D. Regular wages paid to a full-time employee during the year

**37.** Which item must an exempt organization file where it has unrelated business income?

A. A separate application to conduct the unrelated activity
B. No additional return, since the annual return covers it
C. The exempt organization business income tax return
D. An amended annual information return reporting the activity

**38.** Which item may an exempt organization deduct against unrelated business income?

A. A specific deduction of one thousand dollars against the total

B. The full amount of its exempt function expenditures
C. Contributions received from donors during the taxable year
D. The salaries of all officers regardless of their duties

**39.** Which treatment applies to a net operating loss from one unrelated business?

A. Immediate refund of tax paid in the preceding taxable year
B. Carryforward usable only against that same activity's income
C. Deduction against the organization's exempt function income
D. Deduction against income from all unrelated activities combined

**40.** Which item does a business deduct for fertilizer and lime applied to farmland?

A. Nothing, since soil enrichment is always a capital expenditure
B. The cost, where the taxpayer elects to deduct rather than capitalize
C. One quarter of the cost annually across four taxable years
D. The cost only where the land was acquired in the same year

**41.** Which requirement applies to a simplified employee pension contribution?

A. Contributions may vary at the employer's complete discretion
B. Employees must contribute a matching amount from their own pay
C. The same percentage of compensation for every eligible employee
D. Contributions must be made at the same dollar amount for everyone

**42.** Which feature distinguishes a savings incentive match plan from a simplified employee pension?

A. The match plan permits employee elective deferrals as well
B. Only the match plan permits an employer contribution at all
C. Only the pension permits contributions after the year ends
D. The pension requires immediate vesting while the match does not

**43.** Which item may a qualified plan offer to allow after-tax contributions?

A. A loan feature repaid through payroll deduction each period
B. A designated Roth account within the plan's own structure
C. A rollover feature permitting transfers from outside the plan
D. A hardship distribution provision for immediate financial need

**44.** Which item does an employer consider before adopting a plan with a service requirement?

A. The interaction with long-term part-time employee coverage rules
B. The requirement that all employees vest immediately in benefits
C. The prohibition on excluding any employee from participation
D. The obligation to contribute the same dollar amount for everyone

**45.** Which item does an employer report where it maintains a qualified plan?

A. The annual return and report for the employee benefit plan
B. A copy of the plan document with each year's tax return
C. The identity of every participant on the corporate return
D. A separate application for continued qualification annually

**46.** Which condition must a trust satisfy to deduct amounts set aside for charity?

A. The amounts must be paid to a public charity rather than to a foundation
B. The trust must obtain a court order approving the charitable set-aside
C. The governing instrument must authorize the set-aside on a permanent basis
D. The trust must distribute the amounts within that same taxable year

**47.** Which item does a fiduciary use to report income to a beneficiary?

A. An information return reporting distributions as dividends
B. A statement of account prepared under state fiduciary law
C. The beneficiary's share reported on the fiduciary Schedule K-1
D. A letter identifying the amount distributed during the year

**48.** Which item determines the character of income distributed to a beneficiary?

A. Ordinary income character regardless of the underlying source
B. The proportionate character of the entity's own income items
C. The character elected by the fiduciary on the entity's return
D. The character of the assets the beneficiary already holds

**49.** Which item does an estate use to reduce the tax on income in respect of a decedent?

A. The decedent's own unused net operating loss carryforwards
B. A step-up in basis applied to the underlying income right
C. The deduction for estate tax attributable to that income item
D. The exclusion for amounts received under a life insurance policy

**50.** Which item does a business consider in choosing between a plan and a pension arrangement?

A. Whether the business expects to remain profitable for five years
B. Whether the owner intends to sell the business within a decade
C. Whether the business operates in more than one state jurisdiction
D. Whether the owner wants employees to contribute from their own pay

**51.** Which item does a real estate professional election combine?

A. Rental activities with the taxpayer's non-rental businesses

B. All rental real estate interests treated as one single activity
C. Only rentals located within a single state jurisdiction
D. Rental income with the taxpayer's portfolio investment income

**52.** Which consequence follows failing to make that aggregation election?

A. Material participation must be established for each property separately
B. The taxpayer loses real estate professional status entirely
C. All rental losses become permanently nondeductible thereafter
D. The rentals are automatically grouped with the taxpayer's business

**53.** Which requirement applies to substantiating vehicle mileage?

A. A record showing mileage, date, destination, and business purpose
B. A log reconstructed at the close of the taxable year suffices
C. Only the total annual mileage driven for business purposes
D. An estimate based on the taxpayer's typical weekly pattern

**54.** Which item is a capital expenditure rather than a repair for a vehicle?

A. Routine servicing performed at the manufacturer's intervals
B. An engine rebuild materially extending the vehicle's useful life
C. Replacement of tyres worn through ordinary business use
D. Repair of damage caused by an ordinary road collision

**55.** Which item may a business elect to treat as a single unit of property?

A. Assets grouped in a general asset account for depreciation
B. All property located at a single business premises
C. Property acquired from a single supplier in one transaction
D. Property financed under a single loan agreement

**56.** Which item does a taxpayer recognize on a qualifying disposition from such an account?

A. No gain or loss until the account itself is finally terminated
B. Capital gain measured against the original acquisition cost
C. Gain or loss computed against the asset's own adjusted basis
D. Ordinary income equal to the entire disposition proceeds

**57.** Which item does an accrual taxpayer include for a disputed receivable?

A. The full amount claimed regardless of the dispute's existence
B. The amount not genuinely in dispute between the parties
C. Nothing until the dispute is finally resolved between the parties
D. Half the disputed amount pending the outcome of the dispute

**58.** Which relief applies where a taxpayer repays an amount previously included?

A. A deduction or credit computed under the claim of right relief
B. An amended return for the year the amount was originally included
C. No relief, since the earlier inclusion was correct when made
D. A carryback of the repayment to the year of original receipt

**59.** Which item is a deduction rather than a credit for foreign taxes paid?

A. The taxpayer's election to deduct rather than credit the amounts
B. The mandatory treatment where the taxpayer is a partnership
C. The required treatment for all corporate taxpayers alike
D. The only treatment available where the taxes exceed the limitation

**60.** Which item does a partnership report to a partner about foreign taxes?

A. The partner's share of foreign taxes as a separately stated item
B. Nothing, because the partnership claims the credit itself
C. The partner's share of foreign source income only
D. The partnership's own credit computation for the taxable year

**61.** Which item does a business report on acquiring an interest in a foreign partnership?

A. The information return for certain foreign partnership interests
B. Nothing, since foreign partnerships file their own returns
C. Only distributions actually received during the taxable year
D. Only the acquisition price paid for the acquired interest

**62.** Which item does the participation exemption reach for a corporate shareholder?

A. Dividends from a foreign corporation regardless of ownership level
B. The foreign source portion of dividends from a specified corporation
C. All dividends received from any foreign corporation whatever
D. Only dividends the corporation reinvests in the payer's business

**63.** Which item must a taxpayer file where foreign financial accounts exceed the threshold?

A. The report of foreign bank and financial accounts
B. An amended return for each year the accounts were held
C. A statement attached to the business income tax return only
D. A separate application for permission to hold the accounts

**64.** Which item does the specified foreign financial asset statement cover?

A. Only assets held directly rather than through an entity

B. Only assets producing income during the taxable year
C. Foreign accounts and other specified assets above the thresholds
D. Only accounts held at institutions outside the United States

**65.** Which item does a business consider when a worker is engaged through an intermediary?

A. Whether the business retains the right to control the worker
B. The number of hours the worker performs each week
C. The intermediary's own classification of the worker involved
D. Whether the worker holds a professional licence or certification

**66.** Which item does the reporting requirement for third-party network transactions cover?

A. Payments settled through a third-party network above the threshold
B. Every payment a business receives through any electronic means
C. Only payments received from customers outside the United States
D. Only payments a business makes rather than payments received

**67.** Which item does a business do where an information return it received is incorrect?

A. Contact the payer and request a corrected information return
B. Report the incorrect figure and claim an offsetting deduction
C. Ignore the form entirely and report only its own records
D. File an amended return for the preceding taxable year

**68.** Which item does the matching program compare?

A. The taxpayer's deductions against industry average ratios
B. The taxpayer's return against a random statistical sample
C. Information returns filed by payers against the recipient's return
D. The taxpayer's return against returns filed in prior years

**69.** Which item does an S corporation include in the other adjustments account?

A. Losses allocated to shareholders exceeding their stock basis
B. Tax-exempt income together with its related nondeductible expenses
C. Distributions made to shareholders during the taxable year
D. Accumulated earnings and profits from prior C corporation years

**70.** Which item does a shareholder's stock basis reflect that the adjustments account does not?

A. Distributions received during the current taxable year
B. Separately stated income items reported on the statement
C. Tax-exempt income and its related nondeductible expenses
D. Ordinary business income allocated during the taxable year

**71.** Which item does an S corporation shareholder do where losses exceed both bases?

A. Carry the excess forward indefinitely until basis is restored
B. Deduct the excess against other income from any source
C. Treat the excess as a capital loss in the current taxable year
D. Reduce the corporation's own accumulated adjustments account

**72.** Which item may a shareholder elect regarding the ordering of basis reductions?

A. To reduce basis by nondeductible expenses after losses
B. To reduce debt basis before stock basis in each taxable year
C. To defer all basis reductions until the stock is disposed of
D. To allocate reductions between stock and debt proportionately

**73.** Which condition must a business meet to use the cash method despite holding inventory?

A. Average annual gross receipts below the applicable threshold
B. Inventory representing under ten percent of total assets held
C. Written consent from the Service before adopting the method
D. Inventory purchased entirely within the current taxable year

**74.** Which item does a small business treat inventory as under that relief?

A. An immediate deduction regardless of when the goods are sold
B. Non-incidental materials and supplies or per its own book method
C. A capital asset recovered only on the eventual disposition
D. A prepaid expense amortized over the following twelve months

**75.** Which item does the uniform capitalization exemption follow?

A. A separate test based on the value of inventory held
B. An election filed with the first return the business files
C. The number of employees the business maintains during the year
D. The same gross receipts test governing the accrual method

**76.** Which item does a taxpayer include in the gross receipts test computation?

A. Receipts for the current taxable year alone measured at year end
B. Receipts for the three taxable years preceding the current year
C. Receipts for the five taxable years preceding the current year
D. Receipts projected for the following three taxable years

**77.** Which item does a partnership use to determine a partner's interest in the partnership?

A. The partner's original capital contribution when admitted

B. All facts and circumstances relating to the economic arrangement
C. The partner's stated percentage in the partnership agreement alone
D. The proportion of guaranteed payments the partner receives

**78.** Which item does the substantiality requirement examine?

A. Whether the partnership has sufficient assets to satisfy it
B. Whether the allocation was approved by a majority of partners
C. Whether after-tax positions improve without economic consequence
D. Whether the allocation is documented in a written agreement

**79.** Which item does a partnership allocate under the alternate test for economic effect?

A. Allocations supported by a qualified income offset provision
B. Allocations to partners with unlimited deficit restoration obligations
C. Allocations of nonrecourse deductions to any chosen partner
D. Allocations that partners unanimously agree to in writing

**80.** Which item does a partner recognize on contributing encumbered property?

A. Gain where the liability relief exceeds the partner's outside basis
B. Gain equal to the entire liability the partnership assumes
C. No gain in any circumstance, since contributions are tax free
D. Ordinary income equal to the property's built-in appreciation

**81.** Which item does a partnership consider in allocating recourse liabilities?

A. The partners' relative shares of partnership profits each year
B. The constructive liquidation analysis identifying who bears loss
C. The proportion of capital each partner originally contributed
D. The order in which the partners were admitted to the firm

**82.** Which item does the excess business loss threshold apply to?

A. Only losses from businesses in which the taxpayer participates
B. Only losses from passive activities the taxpayer holds
C. The aggregate of all trades or businesses taken together
D. Each separate trade or business the taxpayer conducts

**83.** Which item does a married couple filing jointly apply to the excess business loss?

A. A single threshold amount shared between the two spouses
B. Separate thresholds computed independently for each spouse
C. No threshold, since the limitation applies only to single filers
D. A threshold reduced by half where only one spouse has a business

**84.** Which item does a taxpayer carry forward where the excess business loss applies?

A. A passive activity loss released only on complete disposition
B. A net operating loss subject to the percentage limitation
C. A capital loss subject to the annual three thousand dollar limit
D. A suspended at-risk amount released as exposure increases

**85.** Which item does an estate use to elect a fiscal year?

A. The filing of its first income tax return using that year
B. An election filed within nine months of the date of death
C. Consent of every beneficiary named in the will
D. Court approval of the administration timetable

**86.** Which item does the sixty-five day election apply to?

A. Income earned during the first sixty-five days of the year
B. Expenses paid during the first sixty-five days of the year
C. Distributions made during the first sixty-five days of the year
D. Beneficiary elections made within sixty-five days of year end

**87.** Which item does a complex trust deduct that a simple trust does not?

A. Administration expenses incurred during the taxable year
B. Depreciation on property producing rental income
C. Amounts of corpus actually distributed during the year
D. The personal exemption available to fiduciary entities

**88.** Which item does a beneficiary of a complex trust report first?

A. Second-tier discretionary distributions received during the year
B. First-tier income required to be distributed currently
C. Corpus distributions received before any income amounts
D. Tax-exempt interest before any taxable income items

**89.** Which item does an exempt organization risk by paying excessive rent to an insider?

A. A requirement to distribute the excess to another charity
B. Immediate loss of exemption with no intermediate remedy
C. Excise taxes on the recipient and on knowing managers
D. Conversion into a taxable corporation for that year

**90.** Which item does a private foundation face on making a grant to an individual?

A. A requirement that the grant be matched by another foundation

B. A requirement to report the grant on a separate excise return
C. A taxable expenditure unless grant procedures were pre-approved
D. An absolute prohibition on any grant to an individual person

**91.** Which item does expenditure responsibility require of a granting foundation?

A. A guarantee from the recipient that funds will be repaid
B. Approval of the grant by the state charity regulator
C. A pre-grant inquiry, written agreement, and reporting on use
D. Matching contributions from unrelated public sources

**92.** Which item does a supporting organization avoid by its relationship to a public charity?

A. Classification and taxation as a private foundation
B. The requirement to file any annual information return
C. The unrelated business income tax on trading activity
D. The prohibition on political campaign intervention

**93.** Which item does a farmer include in gross income on receiving a patronage dividend?

A. Nothing, since patronage dividends are a return of capital
B. Only amounts exceeding the farmer's own purchases from the cooperative
C. The cash and the stated amount of qualified written notices
D. Only the cash portion, with qualified written notices excluded

**94.** Which item does a farmer elect on receiving a nonqualified written notice?

A. No election is available, since inclusion occurs on redemption
B. To include the amount currently rather than upon redemption
C. To treat the notice as a capital contribution to the cooperative
D. To spread the inclusion across the following three taxable years

**95.** Which item does a farmer deduct where livestock die from disease?

A. The fair market value of the animal at the date of death
B. The animal's adjusted basis, which for raised livestock is zero
C. The replacement cost of an equivalent animal purchased
D. The projected income the animal would have produced

**96.** Which item does a farmer report on selling raised breeding livestock?

A. Ordinary income equal to the entire sale proceeds received
B. Capital gain reduced by the accumulated cost of raising it
C. Section 1231 gain equal to the entire sale proceeds received
D. No gain, since the costs of raising were previously deducted

**97.** Which item does the required holding period for raised breeding cattle turn on?

A. The date the animal was first used for breeding purposes
B. The date the animal reached maturity for market purposes
C. The date the animal first entered the productive herd
D. The date the animal was born on the farmer's own property

**98.** Which item does a farmer use to average income across base years?

A. An amended return for each of the three base years involved
B. A separate election form filed before the year commences
C. The schedule applying elected farm income against base year brackets
D. The ordinary tax computation with a reduced rate applied

**99.** Which item may a farmer not include in elected farm income?

A. Gain on selling farm machinery used in the operation
B. Gain on selling land used in the farming business
C. Income from raising and selling farm produce grown
D. Income from a farm rental where the owner participates

**100.** Which item does a farming corporation face that an individual farmer does not?

A. A prohibition on using the cash method of accounting entirely
B. Ineligibility to elect farm income averaging in any year
C. A requirement to capitalize all preproductive period costs
D. Exclusion from the Section 1231 treatment of breeding stock

## Practice Exam 27: Answer Key and Explanations

**1. C —** Participation exceeding five hundred hours satisfies the first and most commonly used test outright. A separate test requires more than one hundred hours where no other individual participates more, and another aggregates significant participation activities of over one hundred hours each to exceed five hundred combined. Significant participation activities aggregate to the same threshold.

**2. D —** Material participation in any five of the ten immediately preceding years satisfies the test for the current year. A separate rule applies to personal service activities, where material participation in any three preceding years suffices regardless of current involvement in the business. Personal service activities use any three preceding years instead.

**3. A —** The election must be filed within thirty days of the transfer, and the deadline cannot be extended. It brings the value at grant less any amount paid into income immediately, starting the capital holding period. No deduction arises if the property is later forfeited. No deduction arises if the property is later forfeited entirely.

**4. B —** The election accelerates income into the grant year, and if the property is later forfeited no deduction is allowed for the amount previously included. The taxpayer therefore pays tax on value never ultimately received, which is the central trade-off in making the election at all. Acceleration is the price paid for starting the holding period.

**5. C —** The exclusion requires debt incurred directly in the trade or business of farming, at least half of aggregate gross receipts for the three preceding years from farming, and a qualified person as lender.

Related party lenders and sellers of the property do not qualify as such. Sellers of the property do not qualify as a lender here.

**6. A —** The depreciable basis is the lesser of adjusted basis or fair market value at the conversion date, which prevents converting a personal decline in value into business depreciation. That same lower figure also governs any loss computed on a later sale of the property. A personal decline in value cannot become business depreciation.

**7. D —** Cash distributions during the transition period are tax free to the extent of the accumulated adjustments account and the shareholder's stock basis, allowing previously taxed income to be withdrawn. Property distributions do not qualify, and the period generally runs one year after termination. The period generally runs one year after the termination date.

**8. B —** A corporation whose election terminates generally may not elect again for five taxable years without the consent of the Service. Consent is more readily given where the termination was inadvertent or resulted from a change not within the corporation's own control. Consent comes more readily where the termination was inadvertent.

**9. B —** An estate, and a trust that was treated as owned by the decedent and received the residue, are exempt from estimated tax for taxable years ending within two years of the death. The relief recognizes the practical difficulty of estimating during early administration. Early administration makes reliable estimation genuinely difficult.

**10. C —** The recipient may deduct the federal estate tax attributable to the item as an itemized deduction not subject to the two percent floor. Without the relief the same value would bear both estate tax and income tax with no adjustment between them at all. Without it the same value would bear both taxes untempered.

**11. D —** A general asset account groups assets sharing the same asset class, recovery period, depreciation method, convention, and placed in service year. On disposing of an asset from the account, proceeds are ordinary income and no loss is recognized unless a qualifying election is made. A qualifying election permits recognizing loss on disposition.

**12. A —** A taxpayer may deduct up to ten thousand dollars per qualified timber property annually and amortize the remainder over eighty-four months. The rules apply separately to each qualified timber property, so a taxpayer with several properties may claim the deduction for each. Each qualified timber property is treated separately for this.

**13. A —** A corporation recognizes no gain or loss on receiving money or property in exchange for its own stock, including treasury stock. That principle applies whether the stock is issued at a premium or a discount and regardless of subsequent movements in the share price. Treasury stock transactions are covered by the same principle.

**14. C —** Contributions to capital by governmental entities and civic groups as an inducement to locate in an area are generally excluded from income, though the corporation reduces the basis of property acquired with the funds. Customer contributions in exchange for services are ordinary income. Basis of property acquired with the funds is reduced instead.

**15. D —** Debt characterization is supported by a written unconditional promise, a fixed maturity, a stated interest rate, creditor remedies, and repayment not contingent on earnings. Proportionality to shareholdings, thin capitalization, and profit-dependent repayment all point toward equity treatment instead. Creditor remedies and a stated rate also support debt status. Profit-dependent repayment points strongly toward equity instead.

**16. B —** Recharacterizing a loan as equity converts interest payments into constructive dividends, which the corporation cannot deduct while the shareholder remains fully taxable. Repayments of principal likewise become distributions rather than the tax-free return of a loan advance. Principal repayments likewise become distributions instead. The shareholder nevertheless remains fully taxable on receipt.

**17. D —** A worthless stock deduction requires complete worthlessness within the year, evidenced by an identifiable event. Where the parent owns at least eighty percent and the subsidiary's gross receipts are predominantly operational, the loss is ordinary rather than capital, which materially improves the outcome. An identifiable event must evidence the complete worthlessness.

**18. B —** A tax-free division requires both corporations to be engaged in an active trade or business conducted throughout the five-year period before the distribution, distribution of control, a corporate business purpose, and that the transaction not serve as a device for distributing earnings. The transaction must not be a device for distributing earnings.

**19. A —** Substantial economic effect requires capital accounts maintained under the regulations, liquidation according to positive capital account balances, and either a deficit restoration obligation or a qualified income offset. Failing any of these throws the allocation back onto the partners' interests test. Failing any condition throws it onto the partners' interests test.

**20. C —** A minimum gain chargeback allocates income to partners who previously received nonrecourse deductions when partnership minimum gain decreases. Without it those deductions would lack economic effect, since no partner bears the economic burden of a nonrecourse liability in the first place. No partner bears the economic burden of nonrecourse liabilities.

**21. A —** Where a partner transacts with the partnership in a non-partner capacity, the payment is treated as made to an unrelated party, so the partnership deducts or capitalizes it and the partner reports it as ordinary income independent of the partnership's own results. The partnership deducts or capitalizes it as with any outsider.

**22. D —** The ceiling rule prevents allocating more depreciation or gain to non-contributing partners than the partnership actually has, which can leave book and tax allocations mismatched. The remedial and curative allocation methods exist specifically to correct distortions the ceiling rule creates. Remedial and curative methods correct distortions it creates. Book and tax allocations can therefore remain mismatched.

**23. B** — Excess parachute payments contingent on a change in control are nondeductible by the corporation, and the recipient bears a twenty percent excise tax in addition to ordinary income tax. The rules reach only certain corporations and exempt small business corporations meeting defined conditions. Small business corporations meeting conditions are exempt.

**24. C** — The employer deducts the same amount the employee includes, being the spread between fair market value and exercise price at exercise. An incentive stock option by contrast produces no employer deduction unless the employee makes a disqualifying disposition of the shares. Incentive options produce no deduction absent a disqualifying sale.

**25. B** — Restricted stock units produce income and a matching employer deduction when the shares are delivered on vesting. No Section 83(b) election is available because units are a mere promise rather than transferred property, which distinguishes them from restricted stock awards. Units are a promise rather than transferred property currently. No Section 83(b) election is available for that reason.

**26. D** — Social Security and Medicare tax apply when the deferred amount vests, which is often long before payment. Applying the tax at vesting frequently means the wage base is already exceeded by other compensation, so only Medicare tax applies to the deferred amount. The wage base is often already exceeded by other compensation.

**27. A** — A farming business electing out of the business interest limitation must use the alternative system for property with a recovery period of ten years or more, meaning longer lives and straight line recovery. The election is irrevocable, so the trade-off requires careful modelling first. The election is irrevocable, so modelling is essential first.

**28. C** — Bonus depreciation now reaches used property provided the taxpayer did not previously use it and did not acquire it from a related party or in certain carryover basis transactions. That extension made bonus depreciation available on most ordinary business acquisitions of equipment. That extension reaches most ordinary equipment acquisitions. Carryover basis transactions are also excluded from it.

**29. B** — The exchanged basis continues to be depreciated over the relinquished property's remaining recovery period using the same method, while any excess basis from additional consideration is treated as newly placed in service. An election permits treating the whole amount as new property instead. An election permits treating the whole amount as new property.

**30. D** — A certified pollution control facility added to a plant that was in operation before a specified date may be amortized over sixty months, with certification required from state and federal authorities. Remediation costs and fines follow entirely separate rules with different outcomes. Certification from state and federal authorities is required.

**31. C** — The credit reaches vehicles meeting defined propulsion and battery capacity requirements, acquired for use or lease in a trade or business rather than resale. The amount is the lesser of a percentage of basis or the incremental cost over a comparable vehicle, subject to caps. The amount is capped by reference to the vehicle's weight class.

**32. A** — The deduction requires certification by a qualified individual that the installed systems achieve the prescribed reduction in energy costs against a reference standard. The deduction reduces the property's basis and the amount varies with the savings achieved and prevailing wage compliance. Prevailing wage compliance affects the amount available. The deduction reduces the property's basis correspondingly.

**33. C** — Lower of cost or market is applied item by item rather than to the inventory in aggregate, which produces a lower valuation because declines are recognized while offsetting increases are not. Market generally means replacement cost, bounded by a ceiling and a floor. Market generally means replacement cost within a floor and ceiling.

**34. A** — Goods that are unsalable at normal prices or unusable in the ordinary way because of damage, imperfection, or similar causes may be valued at bona fide selling price less disposition cost. Mere age, supplier status, or overstocking does not justify writing inventory down. Damage or imperfection rather than age must cause the problem.

**35. B** — An employer must withhold the additional Medicare tax on wages above the stated amount it pays, without regard to the employee's filing status or other employers. Any resulting over or under withholding is reconciled by the employee on their own individual return. Over or under withholding is reconciled on the individual return.

**36. D** — The additional Medicare tax is an employee-only levy with no employer matching contribution, unlike ordinary Social Security and Medicare tax. The employer's obligation is limited to withholding it correctly once the wage threshold is crossed for that employee during the year. Ordinary Social Security and Medicare tax remain matched normally.

**37. D** — An organization with gross unrelated business income of one thousand dollars or more must file the business income tax return in addition to its annual information return. It must also make estimated tax payments where the expected liability reaches the applicable threshold. Estimated payments become due above the applicable threshold.

**38. A** — A specific deduction of one thousand dollars is allowed against unrelated business taxable income. Directly connected expenses are deductible, and charitable contributions may be deducted within a percentage limitation, but exempt function costs and donor contributions have no place in the computation. Directly connected expenses remain deductible against the income.

**39. C** — Because income and deductions are computed separately for each unrelated trade or business, a loss carries forward only against that same activity's future income. Losses arising before the separate computation rules took effect may still be used against total unrelated business income. Pre-existing losses may still offset total unrelated income.

**40. B** — A taxpayer may elect to deduct the cost of fertilizer, lime, and similar materials applied to enrich land used in farming, rather than capitalizing amounts benefiting more than one year. The election applies to the year made and continues unless changed with consent. The election continues in later years unless changed with consent.

**41. D** — Contributions must bear the same relationship to compensation for every eligible employee, so the percentage rather than the dollar amount must match. The employer may vary the percentage from year to year or skip a year entirely, which gives genuine flexibility in uneven years. The percentage may vary year to year or be skipped entirely.

**42. B** — A savings incentive match plan permits employee elective deferrals alongside the mandatory employer contribution, while a simplified employee pension is funded entirely by the employer. Both vest immediately, and only the pension may be established and funded after the year has closed. Only the pension may be established after the year has closed.

**43. C** — A designated Roth account permits after-tax elective deferrals with qualified distributions later excluded from income. It sits within the same plan and shares the elective deferral limit, so a participant divides one annual limit between traditional and Roth contributions as they choose. One annual elective deferral limit covers both account types.

**44. A** — Rules requiring coverage of long-term part-time employees limit how effectively a service requirement excludes regular part-time staff. An employer relying on a service condition to hold down cost may find those employees becoming eligible for elective deferrals notwithstanding the plan's stated requirement. Elective deferral eligibility may arise despite the condition.

**45. A** — The employer files the annual return and report for the plan, with the form varying by plan size and type. A one-participant plan files only once assets exceed a threshold, which is a meaningful administrative advantage for a small plan in its early years. The form varies by plan size and by the type of plan.

**46. D** — A set-aside deduction, available principally to estates and to trusts created before a specified date, requires that the amount be permanently set aside for charitable purposes under the governing instrument. Ordinary trusts deduct only amounts actually paid during the year. Ordinary trusts deduct only amounts actually paid out. It is available principally to estates and older trusts.

**47. B** — The fiduciary reports each beneficiary's share of income, deductions, and credits on the Schedule K-1 accompanying the fiduciary return. Character flows through, so tax-exempt interest, capital gains, and qualified dividends retain their nature in the beneficiary's hands. Tax-exempt interest and capital gains retain their character. Qualified dividends likewise pass through with their character.

**48. C** — Distributions carry out income proportionately across the entity's classes of income unless the governing instrument or local law specifically allocates otherwise. A beneficiary receiving a distribution therefore reports a proportionate slice of ordinary income, tax-exempt interest, and other classes. Local law may specifically allocate classes differently. Each beneficiary reports a proportionate slice of each class.

**49. C** — The deduction for estate tax attributable to income in respect of a decedent is available to whoever includes that income, whether the estate or a beneficiary. There is no basis step-up for such items, which is precisely why the deduction exists at all. No basis step-up applies to such items in any circumstance.

**50. D** — The central practical question is whether employees should be able to defer their own compensation, which a savings incentive match plan and a deferral plan permit but a simplified employee pension does not. Administrative burden and the timing of establishment then follow behind that choice. Administrative burden and establishment timing follow behind.

**51. B** — The election treats all interests in rental real estate as one activity, so material participation is tested across the combined holdings rather than property by property. It is binding for later years unless a material change in facts occurs and is disclosed with the return. A material change in facts must be disclosed to regroup them.

**52. A** — Without the election each rental property is a separate activity requiring its own material participation test, which is nearly impossible for a taxpayer holding several properties. Real estate professional status itself is unaffected, but the practical benefit largely disappears without aggregation. Testing property by property defeats most multi-property owners. Real estate professional status itself remains unaffected.

**53. B** — Adequate records must show the mileage for each business use, the date, the destination, and the business purpose, ordinarily through a contemporaneous log. Records made at or near the time of use carry far greater weight than a reconstruction prepared during an examination. Records made near the time of use carry far greater weight.

**54. C** — An expenditure materially adding to value or appreciably prolonging useful life is capitalized. Ordinary servicing, tyre replacement, and repair restoring the vehicle to its prior condition are deductible, though a casualty repair interacts with any casualty loss deduction already claimed. Casualty repairs interact with any loss deduction already claimed. Value added or useful life prolonged is the governing test.

**55. A** — A general asset account election groups qualifying assets and simplifies both depreciation and disposition accounting. On disposing of an asset the full proceeds are ordinary income with no loss recognized, unless the taxpayer makes a qualifying disposition election for that particular asset. Disposition accounting is simplified alongside the depreciation. Qualifying disposition elections remain available per asset.

**56. D** — A qualifying disposition election permits removing the asset from the account and computing gain or loss against its own unadjusted basis less depreciation allowed. Without that election the general rule applies and the full proceeds become ordinary income with no loss allowed. Unadjusted basis less depreciation allowed measures the result.

**57. C** — The all-events test is not satisfied for a genuinely disputed amount, so only the undisputed portion accrues. Where the taxpayer has already received the disputed amount, the claim of right doctrine requires inclusion despite the dispute over entitlement to keep it. The claim of right doctrine reaches amounts already received.

**58. B** — Where an amount was included under a claim of right and later repaid, the taxpayer takes a deduction or, if more favourable, a credit for the tax attributable to the earlier inclusion. The relief matters where rates or circumstances differ materially between the two years. Rates differing between the two years make the relief valuable.

**59. A** — A taxpayer elects annually whether to deduct foreign taxes or claim a credit, and the election applies to all foreign taxes for that year. The credit is usually more valuable, but a deduction can be preferable where the credit limitation would strand most of the amount. The election covers all foreign taxes for that taxable year.

**60. D** — Foreign taxes are separately stated because each partner elects independently between the credit and the deduction, an election that cannot be made at partnership level. The partnership also reports foreign source income by category so the partner can compute the limitation. Foreign source income is reported by category for the limitation.

**61. B** — A United States person meeting the control or ownership thresholds in a foreign partnership must file the relevant information return reporting income, balance sheet, and transactions. Penalties for failure are substantial and the limitations period remains open until the filing is made. The limitations period remains open until the filing is made.

**62. C** — A domestic corporation owning at least ten percent of a specified foreign corporation may deduct the foreign source portion of dividends received, subject to a holding period requirement. The deduction eliminates residual tax on those earnings rather than deferring it further. A holding period requirement applies to the shares themselves.

**63. A** — A United States person with a financial interest in or signature authority over foreign accounts whose aggregate value exceeds the threshold at any point must file the report. It is filed separately from the tax return and carries its own substantial penalty regime. It is filed separately from the ordinary income tax return.

**64. D** — The statement covers foreign financial accounts and other specified foreign financial assets including certain interests in foreign entities, above thresholds varying with filing status and residence. It is filed with the return and its obligations overlap with but differ from the separate account report. Its obligations overlap with but differ from the account report.

**65. C** — The right to control how the work is performed remains the central question whatever contracting structure is used. An intermediary arrangement does not defeat employee status where the recipient business in substance directs the work, and joint employment consequences can follow. Joint employment consequences can follow from that finding. Contracting structure never displaces the control analysis.

**66. A** — A third-party settlement organization reports payments settled through its network above the applicable threshold. Recipients must reconcile the form to their own records, since gross amounts reported include sums later refunded and amounts belonging to others. Refunded sums and amounts belonging to others are included. Recipients must reconcile the form against their own records.

**67. B** — The correct approach is to request a corrected form from the payer while reporting the accurate figure with adequate explanation. Simply reporting the lower correct amount without explanation invites a matching notice, and reporting the incorrect figure overstates income unnecessarily. Reporting the incorrect figure overstates income unnecessarily. A corrected form should be requested from the payer directly.

**68. D** — The program matches amounts reported by payers on information returns against amounts the recipient reported. A discrepancy generates an automated notice proposing additional tax, which is not an examination and is resolved by responding with an explanation and supporting records. A notice is not an examination and is answered with records.

**69. C** — The account holds tax-exempt income and the expenses relating to it, which affect stock basis but never enter the accumulated adjustments account. It becomes relevant in the distribution ordering only after the first two tiers have been fully exhausted. It matters only after the first two tiers are fully exhausted.

**70. D** — Stock basis reflects tax-exempt income and related expenses while the accumulated adjustments account does not, which is why the two figures diverge. Basis also cannot fall below zero, whereas the adjustments account may be driven negative by allocated losses. Basis cannot fall below zero while the account may go negative.

**71. A** — Losses exceeding stock and debt basis are suspended indefinitely and carried forward. They become deductible when basis is restored through additional contributions, further loans, or allocated income, and any remaining suspended losses are generally lost on disposing of the stock. Remaining suspended losses are generally lost on disposition. Contributions, loans, or allocated income restore that basis.

**72. B** — A shareholder may elect to reduce basis by deductible losses before nondeductible noncapital expenses, carrying the latter forward instead. The election is binding for later years and helps where nondeductible items would otherwise absorb basis needed for genuine loss deductions. The election binds later years once it has been made.

**73. A** — A taxpayer meeting the gross receipts test may use the cash method and treat inventory as non-incidental materials and supplies or follow its own book treatment. The relief removed a longstanding trap for small businesses that carried modest quantities of goods. The relief removed a longstanding trap for small businesses.

**74. C** — The taxpayer may treat inventory as non-incidental materials and supplies, deductible when used or consumed, or may follow the treatment in its own applicable financial statement or books. Either route avoids full inventory accounting while still deferring cost until sale. Either route defers cost until the goods are actually sold.

**75. D** — The same average annual gross receipts test governs exemption from the uniform capitalization rules, the inventory requirement, and the accrual method mandate. A business crossing that threshold therefore becomes subject to all three regimes in the same taxable year. All three regimes therefore engage in the same taxable year. Inventory and accrual requirements engage at the same moment.

**76. B** — The test averages gross receipts for the three taxable years preceding the current one, annualizing any short year. Because the test looks backward, a business can predict with certainty at the start of a year whether the threshold applies to it. Looking backward gives certainty at the start of the year.

**77. C** — Where an allocation lacks substantial economic effect it is reallocated according to the partner's interest, determined from all facts and circumstances including contributions, rights to distributions, and interests in cash flow. The stated percentage is evidence but is not conclusive. The stated percentage is evidence but never conclusive. Contributions and rights to distributions are both weighed.

**78. D** — Substantiality asks whether the allocation has a real economic effect apart from tax consequences, examining whether partners' after-tax positions improve while their pre-tax economic positions remain effectively unchanged. Shifting and transitory allocations are the two patterns most commonly attacked. Shifting and transitory allocations are attacked most often. Pre-tax positions must genuinely change for it to be substantial.

**79. B** — Where a partner has no deficit restoration obligation, the alternate test permits economic effect provided the agreement contains a qualified income offset requiring income allocations to eliminate any unexpected deficit as quickly as possible. Allocations are limited to amounts not creating such a deficit. Allocations may not create a deficit beyond the permitted limits.

**80. A** — Contributing property subject to a liability produces a deemed distribution equal to the liability shifted to other partners. Where that exceeds the contributor's basis in the interest, gain is recognized, which is a genuine trap in contributing heavily mortgaged real property. Heavily mortgaged real property is the classic trap here.

**81. B** — Recourse liabilities are allocated by a constructive liquidation, assuming all assets become worthless and are disposed of for nothing, then determining which partner would bear the economic burden. That partner is allocated the liability regardless of the profit sharing arrangement. Profit sharing arrangements do not govern that allocation. Constructive liquidation assumes assets become entirely worthless.

**82. D** — The threshold applies to the aggregate net loss from all trades or businesses rather than activity by activity, after the basis, at-risk, and passive limitations have each been applied. Wages are excluded from business income for this particular computation. Wages are excluded from business income for this computation. Basis, at-risk, and passive limits all apply before it.

**83. A** — A joint return applies a single threshold to the couple's combined business losses rather than allowing each spouse a separate amount. The figure is indexed annually and the disallowed excess becomes a net operating loss carryforward to the following taxable year. The figure is indexed annually for inflation each year.

**84. C** — The disallowed excess becomes a net operating loss carryforward, subject in the following year to the eighty percent of taxable income limitation applying to post-2017 losses. It is therefore deferred rather than lost, though the deferral can extend across several years. Deferral can extend across several taxable years in practice.

**85. B** — An estate adopts its taxable year simply by filing its first return on that basis, and may choose any month end. The flexibility permits deferring beneficiary income and is unavailable to most trusts, which are confined to a calendar year. Most trusts are confined to a calendar year by contrast.

**86. C** — The fiduciary may elect to treat distributions made within the first sixty-five days of a year as made on the last day of the preceding year. It permits shifting income to beneficiaries after the year's results are known, which matters given compressed fiduciary brackets. Compressed fiduciary brackets make the shift worthwhile.

**87. D** — A complex trust may distribute corpus and deducts second-tier distributions within distributable net income, while a simple trust distributes only income currently. Both deduct administration expenses and depreciation, and the exemption differs in amount rather than availability between them. The exemption differs in amount rather than in availability. Second-tier distributions fall within distributable net income.

**88. A** — First-tier distributions of income required to be distributed currently absorb distributable net income before any second-tier discretionary amount is taxed. Where distributable net income is insufficient, second-tier beneficiaries report proportionately less than they actually received during the year. Insufficient income means second-tier amounts are reduced. Distributable net income caps what the tiers can carry out overall.

**89. B** — Excessive rent to a disqualified person is an excess benefit transaction attracting excise taxes on the recipient and on managers who knowingly approved it, with a further tax if not corrected. Revocation remains available for egregious cases but is not the ordinary remedy. Revocation remains available for genuinely egregious cases.

**90. D** — A grant to an individual for travel, study, or similar purposes is a taxable expenditure unless the procedures were approved in advance. Expenditure responsibility requirements apply separately to grants made to organizations that are not themselves public charities. Expenditure responsibility applies to organizational grants. Advance approval of the procedures is the operative condition.

**91. C** — Expenditure responsibility requires a reasonable pre-grant inquiry, a written agreement restricting use, reports from the grantee on how funds were spent, and reporting by the foundation. The obligation continues until the grant funds are fully expended by the recipient organization. The obligation continues until the funds are fully expended. Reporting by the foundation itself completes the obligation.

**92. A** — A supporting organization avoids private foundation classification and its excise taxes by maintaining one of three defined relationships with specified public charities. It remains subject to annual filing, unrelated business income tax, and the absolute prohibition on campaign intervention. Annual filing and the campaign prohibition still apply to it. One of three defined relationships must be maintained.

**93. D** — A patronage dividend paid in cash and qualified written notices of allocation is included in full when received, with the notices included at their stated dollar amount even though no cash accompanies them. Nonqualified notices are instead included only when redeemed. Nonqualified notices are instead included only on redemption. Stated dollar amounts apply even without accompanying cash.

**94. A** — A nonqualified written notice of allocation carries no current inclusion and no election, entering income only when redeemed. That deferral is why cooperatives use qualified notices where they want a current deduction, since deduction and inclusion are matched between the parties. Deduction and inclusion are matched between the two parties.

**95. B** — The loss deduction is limited to adjusted basis, which for raised livestock is generally zero because the costs of raising were already deducted. Purchased livestock retain basis and produce a genuine deduction, and insurance proceeds may create gain instead. Insurance proceeds may produce a gain rather than a loss. Raised livestock generally carry a basis of zero entirely.

**96. C** — Raised breeding livestock held for the required period produce Section 1231 gain equal to the full proceeds, because basis is zero. Depreciation recapture applies only to purchased animals that were actually depreciated during the period they were held. Recapture reaches only purchased and depreciated animals. Basis is zero because raising costs were already deducted.

**97. D** — The twenty-four month holding period for cattle and horses runs from birth for raised animals. The purpose of holding, being draft, breeding, dairy, or sport, must exist at disposition, and animals held primarily for sale never qualify whatever the period. Animals held primarily for sale never qualify whatever the period.

**98. C** — Averaging is computed on its own schedule, applying elected farm income against unused bracket capacity in the three base years. Those earlier returns are unaffected and need not be amended, and the election may itself be made on an amended return later. The election may itself be made on an amended return later.

**99. B** — Gain from selling land is excluded from elected farm income, though gain on other property regularly used in farming may be included. The distinction matters because a land sale often produces the largest gain a farming operation ever reports. A land sale often produces the largest gain a farm reports.

**100. A** — Farm income averaging is available only to individuals, including partners and S corporation shareholders reporting farm income, and never to a C corporation. Cash method availability, capitalization elections, and Section 1231 treatment all remain open to farming corporations meeting the conditions. Cash method availability remains open to farming corporations. Section 1231 treatment of breeding stock likewise remains available.