PRACTICE EXAM 28: 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. An S corporation earns 365,000 dollars evenly across a 365-day year. A forty percent shareholder sells out after 146 days. What is allocated to that shareholder?

A. One hundred forty-six thousand dollars regardless of ownership share
B. One hundred forty-six thousand dollars under the closing of the books
C. Fifty-eight thousand four hundred dollars under the daily method
D. One hundred forty-six thousand dollars for the days actually held

2. A shareholder with a 45,000 dollar stock basis receives a 70,000 dollar distribution from an S corporation with no accumulated earnings and profits. What follows?

A. Tax-free recovery of basis with a twenty-five thousand capital gain
B. Ordinary dividend income of twenty-five thousand dollars
C. The entire distribution is tax free as a return of capital
D. The excess is carried forward against future stock basis

3. A corporation distributes property worth 180,000 dollars with a 140,000 dollar basis, subject to a 220,000 dollar liability. What gain does it recognize?

A. No gain, because the liability exceeds the property's value

B. Eighty thousand dollars, treating the liability as the value
C. Forty thousand dollars, the excess of value over adjusted basis
D. Two hundred twenty thousand dollars, the full liability amount

4. Which reduced rate applies to income tax withholding on reclassified workers where information returns were filed?

A. One and one half percent of the wages paid to those workers
B. Three percent of the wages paid to the reclassified workers
C. Twenty percent of the employee share of the payroll taxes
D. The full graduated rate that should originally have applied

5. Which business may elect to apply the research credit against payroll taxes?

A. A qualified small business within its first five years of receipts
B. Any business whose research expenses exceed its taxable income
C. Any corporation with fewer than fifty employees during the year
D. Any business operating in a designated research and development zone

6. Which additional tax applies to a distribution within two years of joining a savings incentive match plan?

A. No additional tax where the participant has separated from service
B. Fifteen percent applied to the taxable portion distributed
C. Twenty-five percent rather than the ordinary ten percent
D. Ten percent, matching the ordinary early distribution penalty

7. Which item passes to beneficiaries in the final year of an estate or trust?

A. Excess deductions together with unused loss carryovers
B. Only capital loss carryovers, with other deductions being lost

C. Nothing, since all attributes expire on the entity's termination
D. Only net operating loss carryovers arising from business activity

8. Which rate applies to unrecaptured Section 1250 gain?

A. The zero percent rate applying to qualified dividend income
B. A maximum of twenty-five percent on that portion of the gain
C. The ordinary income rate applying to the taxpayer's bracket
D. The fifteen percent rate applying to long-term capital gain

9. Which entity is a per se corporation that cannot elect its classification?

A. A foreign entity organized under a civil law jurisdiction
B. A business incorporated under a federal or state statute
C. A domestic limited liability company with several members
D. A joint venture operating under a written participation agreement

10. Which item is a single-member limited liability company treated as separate for?

A. Income tax reporting of the owner's business operations
B. The owner's self-employment tax computation for the year
C. Employment tax and certain excise tax obligations it incurs
D. Nothing, since the entity is disregarded for every purpose

11. Which condition applies where a partnership converts into a limited liability company?

A. The partnership generally continues with no taxable event
B. The conversion is a taxable liquidation of the partnership
C. The entity must obtain a new employer identification number
D. The partners recognize gain equal to their capital accounts

12. Which item does a redemption to pay death taxes permit?

A. Exchange treatment despite failing the ordinary redemption tests
B. A deduction to the corporation for amounts paid to the estate
C. Exclusion of the redemption proceeds from the estate entirely
D. Deferral of the estate tax attributable to the redeemed shares

13. Which condition must a partial liquidation satisfy?

A. The shareholder's interest must be entirely terminated
B. A genuine contraction of the corporation's business activity
C. The distribution must be pro rata among all shareholders
D. Approval of the distribution by a majority of shareholders

14. Which item applies where a corporation distributes its own debt obligation?

A. The obligation is treated as property at its fair market value
B. No distribution occurs until the obligation is actually paid
C. The corporation deducts the face amount as interest expense
D. The shareholder recognizes no income until redemption occurs

15. Which method allocates earnings and profits across multiple distributions in a year?

A. Current earnings prorated across all distributions during the year
B. Accumulated earnings applied to the earliest distribution first
C. Each distribution matched to the earnings of its own quarter
D. The shareholder electing which distribution absorbs the earnings

16. Which item does the varying interest rule address for a partnership?

A. Valuation of partnership property when a partner is admitted
B. The method used to depreciate partnership operating assets
C. Allocation where a partner's interest changes during the year
D. Allocation of partnership liabilities among the several partners

17. Which item does a partnership merger determine under the continuation rules?

A. Which partnership is treated as continuing after the merger
B. Which partnership must obtain a new identification number
C. Whether the merger produces a taxable event for the partners
D. How the surviving partnership must allocate its future income

18. Which item does a partnership division determine similarly?

A. Which resulting partnership continues the prior partnership
B. Whether the division triggers gain to the divided partnership
C. How liabilities are allocated between the resulting entities
D. Which partners must consent to the division taking place

19. Which trust may hold S corporation stock without a special election?

A. A charitable remainder unitrust holding the shares for a term
B. A foreign trust with a United States resident beneficiary
C. A voting trust created for a legitimate corporate purpose
D. A complex trust accumulating income at the trustee's discretion

20. Which period may a testamentary trust hold S corporation stock?

A. Until the administration of the estate is formally concluded
B. Two years beginning on the day the stock is transferred to it
C. Indefinitely, so long as the beneficiaries all remain eligible persons

D. Five years measured from the date of the decedent's own death

21. Which item does a leased employee arrangement raise for the recipient business?

A. A requirement to treat the workers as independent contractors
B. An obligation to file information returns for each worker
C. Possible inclusion of the workers in retirement plan testing
D. Complete exemption from any employment tax obligation

22. Which item does an employer report on the transmittal accompanying wage statements?

A. Totals of the wage and tax amounts across all statements
B. Each employee's individual withholding allowances claimed
C. The employer's own deposit schedule for the calendar year
D. The number of employees terminated during the year

23. Which item does an employer use to correct an over-reported employment tax amount?

A. A written request to abate the amount previously reported
B. The adjusted return using either the adjustment or claim process
C. An amended income tax return for the affected taxable year
D. A reduction applied to the following quarter's deposit amounts

24. Which item does a business include in wages for a household worker in a business setting?

A. Amounts paid where the work relates to the business premises
B. Nothing, because household employment is always personal
C. Only amounts exceeding the annual domestic wage threshold
D. Only amounts paid to workers who also perform business duties

25. Which item does the small business inventory relief permit a producer to do?

A. Follow the treatment used in its own books and records
B. Deduct all production costs currently regardless of sales
C. Ignore inventory entirely for both book and tax purposes
D. Value inventory at the lower of cost or market only

26. Which costing approach must a producer subject to capitalization use?

A. Full absorption, capitalizing direct and allocable indirect costs
B. Direct costing, capitalizing only materials and direct labour
C. Variable costing, excluding all fixed overhead from inventory
D. Prime costing, capturing only the prime cost of production

27. Which change is a change in overall method of accounting?

A. A correction of an error in a single prior year's return
B. A change from the cash method to the accrual method
C. A change in the useful life assigned to newly acquired assets
D. A change in the estimated allowance for doubtful accounts

28. Which convention applies to depreciation in a short taxable year?

A. The mid-month convention applied to personal as well as real property
B. No convention, because short years use actual months of service
C. The applicable convention with the deduction proportionately reduced
D. The full-year convention applied to all property placed in service

29. Which item carries over to a donee receiving depreciable business property by gift?

A. No depreciation history, since the gift resets the property
B. Only the donor's basis without any recapture exposure
C. The donor's basis together with depreciation recapture potential
D. A fresh recovery period beginning on the date of the gift

30. Which property is Section 1250 property rather than Section 1245 property?

A. A commercial building depreciated over thirty-nine years
B. Machinery permanently affixed to the floor of a factory
C. Office furniture used throughout the business premises
D. A single-purpose agricultural structure on a working farm

31. Which condition triggers the related party installment sale acceleration?

A. The related purchaser reselling the property within two years
B. The seller and buyer being members of the same family
C. The property being depreciable in the purchaser's hands
D. The sale price exceeding the property's fair market value

32. Which item does an installment sale of a partnership interest require?

A. Immediate recognition of gain attributable to hot assets
B. Allocation of the entire gain to the year of the sale
C. Deferral of the entire gain until the final payment is received
D. Election out of the installment method in every circumstance

33. Which item must a taxpayer do to report a sale other than by installment?

A. Elect out on a timely filed return for the year of the sale
B. Obtain the consent of the Service before the sale takes place
C. Report the entire gain on an amended return within three years

D. Notify the purchaser in writing of the reporting method chosen

34. Which item does a taxpayer report where an installment obligation is disposed of?

A. Ordinary income equal to the full face amount received
B. A deduction for the unrecovered basis in the obligation
C. Gain measured by the difference between value and basis
D. Nothing until the transferee actually collects the payments

35. Which item does the estate include for an installment obligation held at death?

A. The full face amount as ordinary income immediately
B. The obligation as income in respect of a decedent
C. Nothing, since the obligation ceases on the holder's death
D. Only payments actually received before the date of death

36. Which item does a trust allocate to tax-exempt income for deduction purposes?

A. A proportionate share of indirect expenses of administration
B. No expenses, since exempt income bears its own costs
C. Only expenses directly traceable to the exempt securities
D. All administration expenses regardless of the income source

37. Which item does distributable net income exclude where a trust holds municipal bonds?

A. The related expenses, which are added back to the total
B. Nothing, since exempt interest net of expenses is included
C. The exempt interest, which never enters the computation at all
D. The entire investment return from the municipal portfolio

38. Which item does an exempt organization use the streamlined application for?

A. A smaller organization meeting the eligibility conditions
B. Any organization regardless of its projected size or assets
C. Only organizations previously granted and then revoked
D. Only organizations operating in more than one state

39. Which arrangement permits several affiliated organizations to share one exemption?

A. A group exemption covering subordinates under a central organization
B. A consolidated return filed by the affiliated exempt group
C. A single application listing every affiliate as a co-applicant
D. A partnership among the affiliated exempt organizations

40. Which item does a farming business include in its at-risk amount?

A. The value of the farmer's own unpaid labour contributed
B. Government payments expected but not yet actually received
C. Cash contributed and recourse borrowing for the operation
D. Nonrecourse financing secured by growing crops in the field

41. Which item does a farmer use where crops are sold under a deferred payment contract?

A. Inclusion spread evenly across the contract's payment schedule
B. Inclusion in the year payment is received under the contract
C. Mandatory inclusion in the year the crop is actually harvested
D. Inclusion at the earlier of harvest or the contract's signing

42. Which item does a farmer report on the sale of a growing crop with the land?

A. The crop with the land where both are sold to the same buyer
B. The entire proceeds as ordinary income from farming operations
C. The crop separately as inventory at its market value
D. Nothing for the crop, since it merges into the land basis

43. Which item does an exempt organization report as a program service accomplishment?

A. Compensation paid to the organization's own officers
B. The organization's fundraising costs and their results
C. The activities carried out to further its exempt purposes
D. The organization's total investment return for the year

44. Which item does the functional expense classification separate?

A. Program services, management and general, and fundraising
B. Restricted and unrestricted contributions received
C. Cash and non-cash expenditures made during the year
D. Domestic and foreign expenditures made by the organization

45. Which item does a private foundation compute for the minimum distribution requirement?

A. A percentage of the fair market value of investment assets
B. The value of the foundation's total assets at the year end
C. The total contributions the foundation received that year
D. The foundation's net income from all sources for the year

46. Which item counts toward satisfying that distribution requirement?

A. Amounts set aside without any commitment to spend them
B. The foundation's own excise tax on net investment income
C. Qualifying distributions including grants and direct expenditures

D. Investment management fees paid on the endowment portfolio

47. Which item does a plan sponsor correct through the voluntary correction program?

A. An operational or document failure identified before examination
B. A failure discovered by the Service during an examination
C. A prohibited transaction with a disqualified person
D. An excess contribution returned within the correction window

48. Which item does self-correction permit a plan sponsor to do?

A. Correct failures only after obtaining a compliance statement
B. Correct eligible failures without a submission or user fee
C. Correct any failure regardless of significance without notice
D. Correct failures only where the plan has fewer participants

49. Which item does an employer do with an excess deferral discovered after year end?

A. Forfeit the amount to the plan's general trust fund
B. Distribute the excess with earnings by the applicable deadline
C. Retain the amount and report it in the following year
D. Recharacterize the amount as an employer contribution

50. Which item does a plan use to correct a failed deferral percentage test?

A. Corrective distributions to highly compensated participants
B. Forfeiture of the entire year's employer contributions
C. Immediate termination of the plan for that plan year
D. Retroactive amendment excluding the affected participants

51. Which item does an employer contribute to correct a coverage failure?

A. A refund of deferrals made by the highly compensated group
B. An additional matching contribution for every participant
C. A one-time payment to the plan's administrative trustee
D. A qualified nonelective contribution for excluded employees

52. Which item does an employer withhold on a distribution eligible for rollover?

A. Twenty percent unless the amount is transferred directly
B. Ten percent unless the participant elects otherwise in writing
C. The participant's marginal rate applied to the full amount
D. Nothing, because rollover eligible amounts escape withholding

53. Which item does the required minimum distribution calculation use?

A. The prior year end balance and a published life expectancy factor
B. The account balance at the close of the distribution year
C. The participant's average balance across the distribution year
D. The original contribution amounts adjusted for inflation

54. Which item does a business consider in selecting a plan for an uneven income stream?

A. A plan mandating the same percentage every single year
B. A defined benefit plan with actuarially determined funding
C. A plan permitting the employer to vary or skip contributions
D. A plan requiring a fixed annual employer contribution amount

55. Which item does a beneficiary receive where a trust distributes appreciated property?

A. A stepped-up basis determined at the date of the grantor's death
B. The trust's own carryover basis absent a contrary election
C. A fair market value basis with gain recognized by the trust
D. A basis equal to the distributable net income carried out

56. Which item does that election affect for the trust's distribution deduction?

A. The deduction is measured by fair market value rather than basis
B. The deduction is eliminated entirely for that particular distribution
C. The deduction is limited to the beneficiary's own tax liability
D. The deduction is deferred until the beneficiary sells the property

57. Which item does a charitable lead trust pay first?

A. An annuity or unitrust amount to the charitable beneficiary
B. A fixed sum to the individual remainder beneficiaries
C. The trustee's fees and administration expenses in full
D. A discretionary amount determined annually by the trustee

58. Which item does a charitable remainder trust require?

A. Distribution of the entire corpus within twenty taxable years
B. A payout of at least five percent and no more than fifty percent
C. A single individual beneficiary rather than several persons
D. Annual approval of the payout amount by the remainder charity

59. Which item does an exempt organization report about a substantial contributor?

A. Nothing, because contributor identity is always confidential
B. The contributor's relationship to any officer or director
C. The contributor's name and amount on the contributions schedule

D. The contributor's occupation and employer relationship

60. Which item does an organization risk by failing to provide a required disclosure?

A. A requirement to return the contribution to the donor
B. A penalty assessed for each contribution lacking the disclosure
C. Immediate revocation of the organization's exempt status
D. Disallowance of the organization's own deductions for that year

61. Which item is a quid pro quo contribution requiring that disclosure?

A. A membership subscription conferring no meaningful privileges
B. A payment made entirely without any benefit to the donor
C. A payment exceeding seventy-five dollars partly for goods received
D. Any contribution made by a corporation rather than an individual

62. Which item does an exempt organization exclude from unrelated business income as a royalty?

A. Payments received under a licence for use of its own name
B. Payments received for services performed by its own staff
C. Payments for the organization's active management of a venture
D. Payments measured by the licensee's own net operating profit

63. Which item does the volunteer labour exception require?

A. Substantially all the work performed without compensation
B. At least half the workers being unpaid volunteer members
C. The activity being conducted only once during the year
D. The organization being a church or religious organization

64. Which item does the convenience exception cover?

A. Any activity conducted on the organization's own premises
B. Sales at below market prices to any member of the public
C. A business carried on for the convenience of members or students
D. Any activity generating funds for the exempt purpose

65. Which item does a farmer include in gross income from a hedging transaction?

A. Nothing until the underlying physical commodity is finally sold
B. The entire contract value at the date the position is opened
C. Ordinary income or loss where the hedge is properly identified
D. Capital gain or loss from the futures contracts entered into

66. Which item must a farmer do to obtain that ordinary treatment?

A. Identify the transaction as a hedge on the day it is entered
B. Obtain advance approval from the Service before hedging
C. Close the position before the end of the taxable year
D. Limit hedging to no more than the expected physical production

67. Which item does the farm optional method of computing self-employment earnings permit?

A. Reporting a minimum earnings figure despite a low actual profit
B. Exclusion of all farm income from self-employment tax entirely
C. Deferral of self-employment tax to a later profitable year
D. Election of a reduced rate on the farming portion of earnings

68. Which item does a farmer use where an operation shows losses across several years?

A. An election permitting indefinite carryforward of the losses
B. The presumption test postponing the profit motive determination
C. Automatic classification as a hobby after three loss years
D. Mandatory conversion of the activity into passive treatment

69. Which item is a qualified conservation contribution by a farming business?

A. A perpetual easement donated for conservation purposes
B. A sale of development rights to a governmental authority
C. A lease of farmland to a conservation organization
D. A temporary restriction on use lasting thirty years

70. Which item does a business consider before donating a conservation easement?

A. The requirement that the easement be revocable by the donor
B. The substantiation, appraisal, and perpetuity requirements
C. The prohibition on retaining any use of the property afterward
D. The complete elimination of property tax on the encumbered land

71. Which item does a syndicated conservation easement arrangement attract?

A. Listed transaction treatment with disclosure obligations
B. A safe harbor where the deduction is under a stated multiple
C. Automatic approval where an independent appraisal is obtained
D. Exemption from the ordinary substantiation requirements

72. Which item does a business include in a reportable transaction disclosure?

A. A description of the transaction and the expected tax benefit
B. The identity of every other participant in the transaction
C. The business's complete financial statements for the year

D. A legal opinion supporting the position taken on the return

73. Which item is a reportable transaction category?

A. Any transaction involving more than two related entities
B. A transaction with contractual protection or confidentiality
C. Any transaction generating a deduction above a stated amount
D. Any transaction reported on an information return by a payer

74. Which item does a material advisor file regarding a reportable transaction?

A. A disclosure statement and a list of advisees maintained
B. A copy of the client's own return claiming the tax benefit
C. An annual certification that no such transactions occurred
D. A request for a private letter ruling on the transaction

75. Which item does the accuracy-related penalty apply to?

A. Only understatements the Service proves were intentional
B. Substantial understatement or negligence in the position taken
C. Only understatements arising from mathematical errors
D. Any understatement of tax regardless of its size or cause

76. Which item establishes a defence to the accuracy-related penalty?

A. Reasonable cause together with good faith in the position
B. Payment of the disputed tax before the assessment is made
C. Retention of a preparer to complete the return in question
D. The absence of any prior penalty history for the taxpayer

77. Which item does adequate disclosure require to protect a position?

A. The position must have at least a reasonable basis
B. A written opinion from counsel attached to the return
C. Advance notification to the Service before filing
D. Consent from the Service to the position being taken

78. Which item does a business face for failing to file a partnership return?

A. A penalty computed per partner for each month of delay
B. A penalty equal to the tax the partners should have paid
C. No penalty, since the partnership itself owes no tax
D. A penalty equal to a percentage of partnership receipts

79. Which item does the S corporation return failure penalty follow?

A. A flat amount regardless of the number of shareholders
B. A monthly amount per shareholder during the delinquency
C. The same computation as the individual failure to file penalty
D. A percentage of the corporation's gross receipts for the year

80. Which item does a business consider in requesting reasonable cause relief?

A. The number of employees the business currently maintains
B. The business's compliance history and the cause of the failure
C. Whether the business used a professional return preparer
D. The amount of tax ultimately determined to be owing

81. Which item does first time abatement relief cover?

A. Only penalties arising from mathematical computation errors
B. Only the accuracy-related penalty on substantial understatement
C. Any penalty regardless of the taxpayer's compliance history
D. Failure to file, failure to pay, and failure to deposit penalties

82. Which item does interest on an underpayment differ from a penalty in?

A. Interest cannot be abated for reasonable cause in the ordinary case
B. Interest is capped at a percentage of the underlying tax
C. Interest stops accruing once a notice of deficiency issues
D. Interest applies only where the underpayment exceeds a threshold

83. Which item does a business use to request a change in accounting period?

A. A written notification to the Service within ninety days
B. Automatic adoption of any period the business chooses
C. The application for change in accounting period where required
D. An election attached to the return for the short period

84. Which item may an entity establish to support a fiscal year request?

A. A natural business year or another substantial business purpose
B. The preference of the entity's owners for administrative reasons
C. The fiscal year used by the entity's principal customers
D. The desire to defer income into a later taxable year

85. Which item does a Section 444 election require of a partnership?

A. A required payment functioning as a deposit against deferral
B. A minimum distribution to each partner during the year
C. Consent of every partner holding a profits interest

D. Annual renewal of the election on each return filed

86. Which item terminates a Section 444 election?

A. Any change in the entity's ownership during the year
B. A change in the entity's principal business activity
C. The entity changing to its required taxable year
D. The passage of five taxable years from the election date

87. Which item does a business include in the required payment computation?

A. The number of owners benefiting from the deferral period
B. Net income for the deferral period at the highest rate plus one
C. The entity's total assets at the close of the deferral period
D. The entity's average tax liability across the preceding years

88. Which item does a personal service corporation face instead of that payment?

A. A minimum distribution requirement to its owner-employees
B. A prohibition on making any distribution during the deferral period
C. An additional tax computed on the deferral period income
D. A requirement to obtain annual approval of the fiscal year

89. Which item does a business report where it changes its entity classification?

A. An amended return for each of the affected prior years
B. Nothing, since classification changes are purely administrative
C. Deemed transactions arising from the change in classification
D. Only the new classification on the following year's return

90. Which item does a corporation electing partnership treatment experience?

A. A carryover of all attributes into the new classification
B. Continuation of the corporation with a new tax character
C. A tax-free reorganization into the new entity form
D. A deemed liquidation distributing assets to its owners

91. Which item restricts a subsequent classification election?

A. A requirement that all owners consent to any later change
B. Approval of the Service required for any subsequent change
C. A sixty-month limitation before another election may be made
D. A prohibition on ever changing classification a second time

92. Which item does a late classification election require for relief?

A. Reasonable cause together with filing within a defined period
B. Payment of a penalty computed on the entity's gross receipts
C. Consent from every person who held an interest at any time
D. A private letter ruling issued before the election is effective

93. Which item does an entity report on making a retroactive classification election?

A. Amended returns for every year the classification was wrong
B. Returns consistent with the intended classification from the outset
C. The classification change only from the date relief is granted
D. A reconciliation between the two classifications for each year

94. Which item does a business evaluate in choosing between an S election and a partnership?

A. Whether the business will employ more than ten workers
B. Whether the entity expects to hold appreciating real property
C. Whether the owners need flexible allocations of income items
D. Whether the entity intends to operate outside the United States

95. Which item favours an S corporation over a partnership for an operating business?

A. The ability to include entity debt in the owners' basis
B. The exclusion of distributive share income from self-employment tax
C. The ability to allocate losses disproportionately among owners
D. The ability to admit corporate and partnership owners freely

96. Which item limits the appeal of an S corporation for real property holdings?

A. The prohibition on an S corporation holding any real property
B. The inability to include entity debt in shareholder stock basis
C. The requirement to depreciate real property over shorter periods
D. The mandatory recognition of appreciation on the annual return

97. Which item does a business weigh in retaining C corporation status?

A. The flat corporate rate against the double tax on distributions
B. The complete absence of any tax at the entity level
C. The ability to allocate income disproportionately to owners
D. The exclusion of all fringe benefits from taxable income

98. Which item does a business consider on converting from C to S status?

A. The permanent loss of all existing corporate attributes
B. The built-in gains tax and any accumulated earnings carried over
C. A requirement to distribute all retained earnings first

D. The immediate recognition of all appreciation on conversion

99. Which item does a business face on converting from S to C status?

A. Recapture of all previously passed-through losses to shareholders
B. The post-termination transition period for distributing prior income
C. Immediate taxation of the accumulated adjustments account
D. A prohibition on paying dividends for five taxable years

100. Which item does an owner weigh in deciding to operate as a sole proprietorship?

A. The unavailability of any retirement plan to the owner
B. The prohibition on hiring employees in that business form
C. The complete exclusion of business income from taxation
D. Simplicity against unlimited liability and self-employment tax

Practice Exam 28: Answer Key and Explanations

1. D — The default per-share per-day method allocates one thousand dollars daily, of which the shareholder's forty percent for one hundred forty-six days gives fifty-eight thousand four hundred dollars. An election with the consent of affected shareholders may instead close the books on the transfer date. An election may instead close the books on the transfer date.

2. B — Where no accumulated earnings and profits exist, distributions are tax free to the extent of stock basis and produce capital gain beyond it. Forty-five thousand recovers basis and the remaining twenty-five thousand is capital gain from a deemed sale of the stock. Accumulated earnings would insert a dividend tier before that.

3. C — Where a distributed property's liability exceeds its fair market value, the value is deemed to be not less than the liability. Gain is therefore two hundred twenty thousand less the one hundred forty thousand basis, giving eighty thousand rather than the forty thousand a naive computation produces. A naive computation using fair market value understates it.

4. A — Section 3509 reduces the employer's liability to one and a half percent of wages for income tax withholding, doubling to three percent where required information returns were not filed. The employee share of Social Security and Medicare is similarly reduced to twenty percent. The employee share of payroll tax is similarly reduced.

5. A — A qualified small business with gross receipts below the threshold and no gross receipts more than five years before the current year may elect to apply the credit against employer payroll taxes up to an annual cap. The election helps pre-profit companies that cannot use an income tax credit. Pre-profit companies benefit most from that election.

6. D — The additional tax rises to twenty-five percent for distributions within two years of first participating. During that period a rollover is permitted only to another such plan, which makes an early move to a different arrangement unexpectedly expensive for the participant. Rollovers during that period reach only another such plan.

7. B — In the final year excess deductions, capital loss carryovers, and net operating loss carryovers all pass to the beneficiaries succeeding to the property. Excess deductions retain their character, so some are claimed above the line and others as itemized deductions. Character is preserved as the deductions pass through. Some are claimed above the line and others as itemized.

8. C — Straight line depreciation on real property is not recaptured as ordinary income, but the portion of gain attributable to it is taxed at a maximum rate of twenty-five percent. The balance of the gain receives ordinary long-term capital gain rates instead. The balance receives ordinary long-term capital gain rates. Only the straight line portion attracts that capped rate.

9. C — An entity incorporated under a federal or state statute, an insurance company, a state-chartered bank, and certain listed foreign entities are per se corporations with no classification election available. Other eligible entities may elect their treatment or accept the applicable default. Insurance companies and state-chartered banks are also listed. Other eligible entities may elect or accept the default.

10. D — A disregarded entity is nonetheless treated as a separate entity for employment tax and certain excise tax purposes, so it obtains its own identification number and files its own employment tax returns. Income tax reporting still flows onto the owner's own return. It obtains its own identification number for those purposes.

11. B — A conversion from a general or limited partnership into a limited liability company treated as a partnership is generally not a taxable event, and the partnership continues. Liability shifts may nonetheless produce deemed distributions where partners' shares of liabilities change materially. Liability shifts may still produce deemed distributions. The partnership itself continues without interruption.

12. A — Where closely held stock exceeds a stated share of the adjusted gross estate, a redemption up to death taxes and funeral and administration expenses receives exchange treatment. This avoids dividend treatment on a redemption that would otherwise fail the attribution-driven tests. Attribution-driven tests would otherwise force dividend treatment. Closely held stock must exceed a share of the gross estate.

13. C — The partial liquidation test is applied at the corporate level and generally requires a genuine contraction of the business, often established by terminating one of two qualified businesses conducted for five years. The distribution need not be pro rata among the shareholders. The distribution need not be pro rata among shareholders.

14. A — A corporation's own obligation distributed to shareholders is property valued at fair market value for the distribution rules. The corporation recognizes no gain on issuing its own obligation, but the shareholder includes the value received as a distribution immediately. The corporation recognizes no gain on issuing its own obligation. The shareholder includes the value received immediately.

15. B — Current earnings and profits are allocated proportionately across all distributions made during the year, while accumulated earnings are applied chronologically to distributions in the order made. The two pools therefore follow entirely different allocation conventions. The two pools follow entirely different allocation conventions. Accumulated earnings apply chronologically to distributions made.

16. D — Where a partner's interest varies during the year, items must be allocated to account for that variation using either an interim closing of the books or a proration method. Certain extraordinary items must be allocated on the date they occur regardless of the method chosen. Extraordinary items are allocated on the date they occur.

17. B — The resulting partnership is considered a continuation of the merging partnership whose members own more than half of the resulting capital and profits. The other partnership terminates, which affects elections, accounting methods, and the taxable year going forward. Elections, methods, and the taxable year all follow from it. More than half the resulting capital and profits is the test.

18. A — Any resulting partnership whose members owned more than half the capital and profits of the prior partnership is a continuation of it. A resulting partnership not meeting that test is a new partnership, with its own elections, methods, and identification number. A resulting partnership failing the test is entirely new.

19. D — A voting trust, a grantor trust, and a testamentary trust for a limited period may hold S corporation stock without a special election. An electing small business trust and a qualified subchapter S trust each require their own affirmative election to be made. Grantor trusts may likewise hold the shares without electing.

20. C — A trust receiving S corporation stock under a will may hold it for two years beginning on the transfer date without a special election. Beyond that period it must qualify as an electing small business trust or a qualified subchapter S trust or the election terminates. Beyond that period a qualifying election becomes necessary.

21. D — Leased employees meeting the statutory conditions may have to be counted in the recipient's retirement plan coverage and nondiscrimination testing, even though the leasing organization pays them. A safe harbor excludes them where the leasing organization maintains a qualifying plan. A safe harbor applies where the leasing organization has a plan.

22. B — The transmittal reports aggregate totals of wages, tips, withholding, and other amounts across all the wage statements filed. Those totals must reconcile to the employment tax returns filed during the year, and mismatches generate automated correspondence. Mismatches with the quarterly returns generate correspondence. Totals must reconcile to the employment tax returns filed.

23. C — The employer files the adjusted return and chooses between the adjustment process, which reduces a current liability, and the claim process, which seeks a refund. Employee consent or repayment is generally required before the employee share can be recovered. Employee consent is generally needed to recover their share. The adjustment and claim processes serve different purposes.

24. A — Where a worker's duties relate to the business rather than the owner's home, the amounts are ordinary business wages reported on the employment tax returns. Genuinely domestic employment is reported separately on the household employment schedule instead. Genuinely domestic work uses the household schedule instead. Business-related duties place the wages on the business return.

25. B — A taxpayer meeting the gross receipts test may treat inventory as non-incidental materials and supplies or follow the treatment in its applicable financial statement or books. It cannot simply deduct everything currently, since cost still defers until the goods are used or sold. Cost still defers until the goods are used or actually sold.

26. A — Full absorption requires capitalizing direct material, direct labour, and allocable indirect costs including fixed and variable overhead. Direct, variable, and prime costing all exclude amounts the rules require to be inventoried and are unacceptable for tax purposes. Fixed and variable overhead must both be inventoried. Direct and variable costing are unacceptable for tax purposes.

27. C — Moving between the cash, accrual, and hybrid methods is a change in overall method requiring consent. Changing the treatment of a single material item is also a method change, while corrections of errors and revisions to estimates are neither and require no application. Corrections of errors and estimate revisions are neither.

28. D — The ordinary convention still applies but the deduction is prorated for the shortened year. Determining the mid-quarter threshold in a short year requires care, since the quarters are themselves shortened and placements can shift the calculation unexpectedly. Mid-quarter testing in a short year requires particular care. The deduction is prorated for the shortened taxable year.

29. D — A donee takes the donor's basis and succeeds to the recapture potential, so selling the property later produces ordinary income to the extent of depreciation the donor claimed. Property received from a decedent by contrast generally sheds recapture along with the basis step-up. Property from a decedent generally sheds recapture instead.

30. B — Section 1250 property is depreciable real property that is not Section 1245 property, principally buildings and their structural components. Machinery, furniture, and single-purpose agricultural structures are Section 1245 property subject to full depreciation recapture on disposal. Structural components follow the building's own treatment. Machinery and furniture remain Section 1245 property throughout.

31. A — Where a related purchaser resells within two years, the original seller must accelerate the remaining deferred gain to the extent of the second disposition's proceeds. Marketable securities carry no two-year limit, so the rule applies to any subsequent resale at all. Marketable securities carry no two-year limit at all. The seller accelerates gain to the extent of those proceeds.

32. C — The ordinary income portion attributable to unrealized receivables and inventory is recognized in the year of sale rather than spread across the payments. Only the residual capital gain qualifies for installment reporting, mirroring the treatment of depreciation recapture on other property. It mirrors depreciation recapture on other property sold. Only the residual capital gain qualifies for installment reporting.

33. B — The installment method applies automatically, so a seller wanting full recognition in the sale year must elect out on a timely filed return including extensions. Revoking the election later requires consent and is granted only in limited circumstances. Revoking the election later requires consent from the Service. The installment method otherwise applies entirely automatically.

34. D — Disposing of an installment obligation accelerates the remaining gain, measured against the obligation's basis, which is the unrecovered cost portion. A transfer at death does not accelerate; the obligation instead becomes income in respect of a decedent in the recipient's hands. A transfer at death does not accelerate the remaining gain.

35. C — An installment obligation held at death is income in respect of a decedent, with no basis step-up. Payments received afterward carry the same gross profit percentage, and a deduction is available for the estate tax attributable to the item included. The same gross profit percentage applies to later payments. A deduction covers estate tax attributable to the item.

36. A — Expenses directly attributable to tax-exempt income are wholly disallowed, and a proportionate share of indirect expenses must also be allocated to it and disallowed. That allocation reduces the deductions available against the trust's taxable income each year. Indirect expenses must be allocated proportionately too. Directly attributable expenses are wholly disallowed first.

37. C — Tax-exempt interest net of allocable expenses is included in distributable net income, which affects how much a distribution carries out and in what proportions. The beneficiary then receives a proportionate share of exempt interest that remains exempt in their hands. The beneficiary's share remains exempt in their own hands. Distributions carry it out proportionately across the classes.

38. B — The streamlined application is available to smaller organizations meeting eligibility conditions on projected receipts, assets, and organizational form, completed through an eligibility worksheet. Larger organizations, foreign organizations, and certain types must file the full application instead. An eligibility worksheet governs whether it may be used. Foreign organizations must use the full application instead.

39. A — A central organization may obtain a group exemption covering subordinate organizations under its general supervision or control, which spares each from applying separately. The central organization must maintain and annually update the list of subordinates it covers. The central organization updates the subordinate list annually. Each subordinate is spared applying separately for exemption.

40. D — Amounts at risk include cash contributed, the adjusted basis of contributed property, and borrowed amounts for which the farmer is personally liable. Nonrecourse crop financing, unpaid labour, and anticipated government payments contribute nothing to the at-risk figure. Anticipated government payments contribute nothing at all. Recourse borrowing and contributed basis both count fully.

41. C — A cash method farmer contracting for payment in a later year includes the proceeds when received, provided the contract genuinely defers the right to payment. Where the farmer may demand payment at any time, constructive receipt places the income in the earlier year. Constructive receipt reaches amounts demandable at any time.

42. B — Where unharvested crops are sold together with land held for the required period to the same buyer, the crop is treated as part of the land and receives Section 1231 treatment. Selling the crop separately instead produces ordinary income from farming. Selling the crop separately produces ordinary farming income. The land must have been held for the required period.

43. D — The annual return requires narrative description of the organization's program service accomplishments together with the expenses and revenue attributable to each. Because the return is publicly inspectable, this section functions as the organization's principal public account of its work. Expenses and revenue attributable to each must be shown. It functions as the organization's principal public account.

44. A — The statement of functional expenses allocates each category of expense across program services, management and general, and fundraising. The resulting ratios are widely used by donors and rating agencies, which gives the allocation methodology real practical consequence. Donors and rating agencies rely heavily on those ratios. The allocation methodology therefore carries real consequence.

45. B — The distributable amount is based on a percentage of the average fair market value of assets not used directly in carrying out exempt purposes. Failure to distribute that amount by the end of the following year attracts an excise tax on the shortfall. Assets used directly in exempt purposes are excluded.

46. D — Qualifying distributions include grants, reasonable administrative expenses of carrying out exempt purposes, and amounts paid to acquire assets used directly in those purposes. Investment expenses and the excise tax itself do not count toward satisfying the requirement. Investment expenses do not count toward the requirement. Direct exempt purpose expenditures also count toward it.

47. A — The voluntary correction program addresses operational, document, and other qualification failures identified by the sponsor before examination, on payment of a fee and with a compliance statement issued. Self-correction handles insignificant failures without any submission at all. Self-correction handles insignificant failures without filing. A fee is payable and a compliance statement is issued.

48. C — Self-correction permits fixing eligible operational failures without submission or fee, subject to conditions on significance and timing and the existence of established practices and procedures. Significant failures must generally be corrected within a defined period to remain eligible. Established practices and procedures must already exist. Significant failures must be corrected within a defined period.

49. C — An excess deferral must be distributed with allocable earnings by the applicable deadline following the year of deferral. Failing to correct causes the amount to be taxed in the year deferred and again on eventual distribution, producing genuine double taxation. Failure to correct produces genuine double taxation. The deadline follows the year in which the deferral was made.

50. A — A failed test is corrected by distributing excess contributions to highly compensated employees or by making qualified nonelective or matching contributions for other participants. Correction after the deadline attracts an excise tax on the employer in addition to the required correction. Late correction attracts an excise tax on the employer.

51. D — A qualified nonelective contribution made for improperly excluded employees restores them to the position they would have occupied. The contribution is fully vested immediately and generally must include an earnings adjustment measured from the date the contribution should have been made. It is fully vested immediately and carries an earnings adjustment measured from the date it should have been made.

52. B — Twenty percent mandatory withholding applies to an eligible rollover distribution paid to the participant. A direct trustee-to-trustee transfer avoids it entirely, which is why the direct route is almost always preferable where a rollover is genuinely intended. A direct trustee-to-trustee transfer avoids it entirely, which is why the direct route is preferable where a rollover is intended.

53. B — The distribution is the prior year end account balance divided by the applicable life expectancy factor from the published tables. A separate table applies where the sole beneficiary is a spouse more than ten years younger than the account holder. A separate table applies where the sole beneficiary is a spouse more than ten years younger than the account holder.

54. D — A profit sharing plan or a simplified employee pension permits the employer to vary the contribution or skip a year entirely, which suits volatile income. A savings incentive match plan and a defined benefit plan both impose mandatory annual funding obligations. A savings incentive match plan and a defined benefit plan both impose mandatory annual funding obligations instead.

55. C — Absent an election to recognize gain, the beneficiary takes the trust's carryover basis and the trust recognizes nothing. Electing to treat the distribution as a sale at fair market value gives the beneficiary a higher basis at the cost of gain recognized at entity level. The trust itself recognizes nothing where the election is not made.

56. A — Where the election is made the distribution deduction and the amount the beneficiary includes are both measured by fair market value. Absent the election both are limited to the lesser of basis or value, which changes how much distributable net income is carried out. Absent the election both figures are limited to the lesser of basis or value received.

57. A — A charitable lead trust pays the charity first for a term, with the remainder passing to individuals. A charitable remainder trust reverses that order. The lead form is used principally to transfer appreciating assets while capturing a present charitable deduction. The lead form transfers appreciating assets while capturing a present charitable deduction for the donor.

58. B — The annual payout must be at least five percent and no more than fifty percent of the initial value for an annuity trust or the annually revalued assets for a unitrust. The charitable remainder must also be at least ten percent of the initial value. An annuity trust fixes the amount while a unitrust revalues annually.

59. D — Contributors meeting the threshold are reported on the contributions schedule with name and amount. Organizations other than private foundations may withhold contributor names and addresses from the publicly inspectable copy, while foundations must disclose them. Organizations other than private foundations may withhold those details from the publicly inspectable copy of the return.

60. C — An organization receiving a quid pro quo contribution above the threshold must inform the donor of the deductible amount, and a penalty applies for each contribution where it fails to do so. The obligation rests on the organization rather than on the donor. The obligation rests on the organization rather than on the donor who made the payment.

61. B — A quid pro quo contribution is a payment above seventy-five dollars made partly as a contribution and partly for goods or services. The organization must state the deductible amount and provide a good faith estimate of the value the donor received. A good faith estimate of the value the donor received must also be provided.

62. C — A genuine royalty for the passive use of intangible property such as a name or logo is excluded. Where the organization performs substantial services in connection with the arrangement, or the payment turns on net profits, the exclusion is lost entirely. Substantial services by the organization, or payments turning on net profits, defeat the exclusion.

63. A — The exception applies where substantially all the work in carrying on the trade or business is performed without compensation. Nominal benefits provided to volunteers generally do not defeat it, though genuine wages to a meaningful portion of workers will. Nominal benefits to volunteers generally do not defeat it, though genuine wages will.

64. D — The exception covers a trade or business carried on primarily for the convenience of members, students, patients, officers, or employees, such as a campus bookstore or hospital cafeteria. Serving the general public rather than that defined group defeats the exception. Serving the general public rather than that defined group defeats the exception entirely.

65. D — A properly identified business hedge produces ordinary rather than capital treatment, which matches the character of the underlying commodity transaction. Failure to identify the hedge on the day it is entered can force capital treatment and create an unwanted character mismatch. Failure to identify the hedge can force capital treatment and create a character mismatch.

66. B — The taxpayer must identify the transaction as a hedging transaction on the day it is entered into, and identify the item being hedged within a defined period. The identification requirement is strict, and inadvertent failure has produced adverse results repeatedly. The item being hedged must be identified within a defined further period as well.

67. A — The optional method permits a farmer with low or negative net earnings to report a minimum amount, which preserves social security coverage and may support certain credits. It increases current tax, so the choice weighs immediate cost against longer term benefit. It increases current tax, so the choice weighs immediate cost against longer term benefit.

68. C — A farmer may file to postpone the profit motive determination until the presumption period has run, which extends the limitations period for the activity's items. The presumption requires three profitable years out of five, or two out of seven for horses. Filing extends the limitations period for the activity's items across those years.

69. B — A qualified conservation contribution requires a qualified real property interest, donated to a qualified organization, exclusively for conservation purposes, and protected in perpetuity. Temporary restrictions and sales for consideration do not qualify, though a bargain sale may produce a partial deduction. Temporary restrictions and sales for consideration do not qualify, though a bargain sale may.

70. D — Qualified appraisal, contemporaneous acknowledgment, baseline documentation, and perpetual protection are all required, and the area has attracted intense enforcement attention. Retained agricultural use is generally permitted where consistent with the stated conservation purposes. Qualified appraisal, contemporaneous acknowledgment, baseline documentation, and perpetual protection are all required. The area has attracted intense enforcement attention in recent years.

71. C — Certain syndicated conservation easement arrangements are listed transactions requiring disclosure by participants and material advisors, with substantial penalties for failure. A statutory rule now disallows deductions exceeding a multiple of the investors' basis in the passthrough entity. A statutory rule now disallows deductions exceeding a multiple of the investors' basis.

72. A — The disclosure statement describes the transaction, identifies the category of reportable transaction, and states the expected tax treatment and benefit. Failing to disclose attracts its own penalty independent of whether the underlying tax position is ultimately sustained. Failing to disclose attracts its own penalty independent of the underlying position. The category of reportable transaction must also be identified.

73. C — The categories are listed transactions, confidential transactions, transactions with contractual protection, loss transactions, and transactions of interest. Each carries its own threshold and definition, and a transaction may fall within more than one category simultaneously. Each carries its own threshold, and a transaction may fall within more than one. Listed transactions and transactions of interest are the two named categories.

74. B — A material advisor must file a disclosure statement and maintain a list of persons advised, furnishing it on request. The thresholds for material advisor status turn on the fees received and differ for listed and other reportable transactions. Thresholds for material advisor status turn on fees and differ by transaction category.

75. D — The penalty reaches negligence, substantial understatement of income tax, substantial valuation misstatement, and certain other conduct. Reasonable cause and good faith provide a defence, and adequate disclosure can protect a position with a reasonable basis. Reasonable cause and good faith provide a defence, and disclosure can protect some positions. Substantial valuation misstatement is a further covered ground.

76. A — Reasonable cause and good faith is the general defence, assessed on all the facts including the taxpayer's experience and efforts to determine the correct liability. Reliance on professional advice can support it where the advice was informed and the reliance reasonable. Reliance on professional advice can support it where the advice was informed and reliance reasonable.

77. B — Disclosure protects against the substantial understatement penalty only where the position has a reasonable basis, which is a higher standard than not frivolous. Disclosure provides no protection at all for a position lacking that minimum level of support. Disclosure provides no protection at all for a position lacking that minimum support.

78. A — The penalty accrues monthly for each partner during the delinquency, capped at twelve months, and applies even though the partnership itself owes no tax. Reasonable cause relief is available, and a longstanding procedure assists small partnerships meeting defined conditions. Reasonable cause relief is available, and a procedure assists small partnerships meeting conditions.

79. C — The penalty accrues monthly for each shareholder during the delinquency, capped at twelve months, mirroring the partnership provision. Failing to furnish the shareholder statements attracts a separate penalty computed under the information return provisions instead. Failing to furnish shareholder statements attracts a separate information return penalty. The penalty is capped at twelve months of delinquency overall.

80. D — Reasonable cause turns on the facts, including the reason for the failure, the taxpayer's compliance history, the length of the delay, and the steps taken once the problem was discovered. Ordinary business care and prudence is the governing standard. Ordinary business care and prudence is the governing standard throughout the analysis.

81. C — Administrative first time abatement covers the failure to file, failure to pay, and failure to deposit penalties where the taxpayer has a clean compliance history for the preceding three years and has filed or arranged all currently required returns. A clean compliance history for the preceding three years is required to qualify.

82. A — Interest compensates for the use of money and is generally not abatable for reasonable cause, unlike penalties. It may be abated where attributable to unreasonable error or delay by the Service in performing a ministerial or managerial act. It may be abated where attributable to unreasonable Service error or delay.

83. D — A change in accounting period generally requires filing the application, with automatic approval available in defined circumstances. A newly formed entity instead adopts its period simply by filing its first return on that basis without any application at all. A newly formed entity adopts its period by filing its first return on that basis.

84. B — A business purpose must be shown, most readily through the natural business year test measuring receipt concentration. Deferral of income to owners is expressly not a business purpose, and administrative convenience alone has consistently been held insufficient. Deferral of income to owners is expressly not a business purpose at all.

85. A — A partnership or S corporation making the election must compute and pay a required payment, which functions as a deposit offsetting the benefit of deferral. A personal service corporation instead faces a minimum distribution requirement to its owner-employees. A personal service corporation faces a minimum distribution requirement instead. The payment offsets the benefit the deferral period confers.

86. D — The election ends where the entity changes to its required year, becomes a member of certain tiered structures, or fails to make the required payment. Once terminated it cannot be made again, so the decision to abandon it is effectively permanent. Once terminated the election cannot be made again, so abandonment is permanent.

87. C — The required payment applies the highest individual rate plus one percentage point to the deferral period income, reduced by the prior year's payment. Where the computed amount falls below a small threshold no payment is due for that year. Where the computed amount falls below a small threshold no payment is due.

88. B — A personal service corporation making the election must distribute a minimum amount to owner-employees during the deferral period, or its deduction for amounts paid to them is limited. The mechanism removes the benefit of deferring their compensation income. The mechanism removes the benefit of deferring the owner-employees' compensation income. Otherwise the deduction for amounts paid to them is limited.

89. B — An elective change produces deemed transactions with real tax consequences, such as a deemed liquidation where a corporation becomes a partnership. Those deemed transactions can trigger substantial gain, so modelling the consequences before electing is essential. Those deemed transactions can trigger substantial gain, so modelling beforehand is essential. A deemed liquidation is the most consequential such transaction.

90. C — The corporation is deemed to distribute all assets and liabilities in complete liquidation, recognizing gain at both corporate and shareholder level, with the owners then contributing them to a partnership. Appreciated assets make that election extremely expensive in practice. Appreciated assets make that election extremely expensive in practice for the owners.

91. D — An entity generally may not change its classification again within sixty months of a prior election. The Service may permit an earlier change where more than half the ownership interests are held by persons who did not hold them at the earlier election date. The Service may permit an earlier change where ownership has substantially changed.

92. A — Relief for a late election requires that the entity intended the classification, failed to obtain it solely because of the late filing, has reasonable cause, and acts within the prescribed period. All affected persons must have reported consistently with the intended classification. All affected persons must have reported consistently with the intended classification.

93. A — Where relief is granted the entity and its owners file or have filed returns consistent with the intended classification from the effective date. Consistency of reporting throughout the interim period is itself one of the conditions for obtaining the relief. Consistency of reporting throughout the interim is itself a condition of relief.

94. D — A partnership permits special allocations with substantial economic effect and allows entity debt to support owner basis, while an S corporation requires strictly proportionate allocations and gives basis only for direct shareholder loans. Those two differences drive most of the choice. Those two differences drive most of the practical choice between the forms.

95. C — An S corporation shareholder's distributive share escapes self-employment tax provided reasonable compensation is paid as wages, whereas a general partner's share is generally subject to it. That difference is the principal reason operating businesses choose the S corporation form. Reasonable compensation must nonetheless be paid as wages to the shareholder.

96. B — An S corporation shareholder gets no basis for entity level debt, so a leveraged property produces losses the shareholder often cannot deduct. Distributing appreciated property also triggers corporate gain, which a partnership generally avoids entirely. Distributing appreciated property also triggers corporate gain a partnership avoids. Leveraged property therefore produces losses often not deductible.

97. B — The flat corporate rate can be attractive where earnings are retained and reinvested, but distributions bear a second layer of tax. Fringe benefit treatment is also more favourable for shareholder-employees than in a passthrough, which matters for closely held service businesses. Fringe benefit treatment is more favourable for shareholder-employees than in a passthrough.

98. D — Conversion itself is not a taxable event, but appreciation existing at conversion carries built-in gains exposure for five years and accumulated earnings and profits bring passive investment income exposure. Both need modelling before the election is made. Both exposures need modelling before the election is actually made. Conversion itself is not a taxable event for the corporation.

99. A — The transition period permits distributing previously taxed income tax free to the extent of the adjustments account and stock basis. After that period ordinary C corporation distribution rules apply, so the timing of withdrawals following termination matters considerably. After that period ordinary distribution rules apply, so withdrawal timing matters. Previously taxed income may be withdrawn within those limits.

100. C — A sole proprietorship offers the simplest administration and requires no separate return, but the owner bears unlimited liability and pays self-employment tax on the entire net profit. Retirement plans remain fully available and employees may be hired in the ordinary way. Retirement plans remain fully available and employees may be hired normally.