PRACTICE EXAM 31: ENROLLED AGENT PART 2 BUSINESSES SIMULATION (100 QUESTIONS)

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

1. A taxpayer has 300,000 of qualified business income, 80,000 of W-2 wages, no qualified property, and sits forty percent through the phase-in range. What is the deduction?

A. Fifty-two thousand dollars after the phase-in reduction
B. Sixty thousand dollars, being twenty percent of the income
C. Forty thousand dollars, being the fully applied wage limit
D. Twenty-four thousand dollars, being forty percent of the tentative

2. A business has 40,000 of Section 1231 gains and 95,000 of Section 1231 losses. How is the net amount treated?

A. Fifty-five thousand of ordinary loss deductible in full
B. Fifty-five thousand of capital loss limited to three thousand
C. Forty thousand ordinary with fifteen thousand carried forward
D. Fifty-five thousand suspended until Section 1231 gains arise

3. A corporation holds both a pre-2018 and a post-2017 net operating loss carryforward. Which is used first?

A. Whichever produces the larger current year deduction available

B. They are used proportionately in the ratio of their amounts
C. The pre-2018 loss, which carries no percentage limitation
D. The post-2017 loss, being subject to the percentage limitation

4. A proprietor with net earnings above the Social Security wage base pays which rates?

A. Twelve point four percent on all earnings without any cap
B. Twelve point four percent to the base and two point nine above it
C. Fifteen point three percent on the entire net earnings figure
D. Two point nine percent on all earnings with no Social Security

5. A partner with 90,000 of outside basis receives 20,000 of cash and two parcels with 45,000 and 35,000 carryover bases in liquidation. What basis attaches to the first parcel?

A. Thirty-nine thousand three hundred seventy-five after reduction
B. Forty-five thousand dollars, its full carryover basis
C. Thirty-five thousand dollars, matching the second parcel
D. Twenty-two thousand five hundred, allocated equally between them

6. A business with 700,000 of taxable income before the deduction contributes 50,000 of cash and 30,000 of appreciated inventory to charity. What limits the deduction?

A. Ten percent of taxable income computed before the deduction
B. Twenty percent of taxable income for a corporate donor
C. Fifty percent of taxable income as for an individual donor
D. No limit applies where inventory is contributed to charity

7. A corporation redeems all of a shareholder's stock, but the shareholder's adult child retains shares. What is required for exchange treatment?

A. The corporation must have a business purpose for the redemption

B. The child must simultaneously dispose of the retained shares
C. A waiver of family attribution with the required agreement filed
D. Nothing further, since the shareholder's interest is fully terminated

8. A partnership with 250,000 of ordinary income allocates thirty percent to a partner who also receives a 40,000 guaranteed payment. What is that partner's self-employment income as a general partner?

A. One hundred fifteen thousand dollars, combining both amounts
B. Seventy-five thousand dollars, being the distributive share
C. Forty thousand dollars, being the guaranteed payment alone
D. Nothing, since a partner is never an employee of the firm

9. An S corporation shareholder has 60,000 of stock basis when the corporation allocates a 25,000 loss and makes a 50,000 distribution. What is the result?

A. The distribution is taxable to the extent of fifteen thousand
B. Loss reduces basis to thirty-five thousand and the distribution follows
C. Both are fully absorbed, leaving no basis at the year end
D. The distribution reduces basis first and the loss is then suspended

10. A corporation acquires equipment for 250,000 in a year when it has 180,000 of business taxable income and elects maximum Section 179. What follows?

A. One hundred eighty thousand deducted with the balance carried
B. Two hundred fifty thousand deducted, creating a business loss
C. One hundred eighty thousand deducted with the balance lost
D. No deduction, since the cost exceeds available taxable income

11. A trust distributes 30,000 to a beneficiary when distributable net income is 45,000 including 9,000 of tax-exempt interest. What does the beneficiary report as taxable?

A. Twenty-one thousand dollars, the taxable share of the income
B. Thirty-six thousand dollars, being the taxable portion of the income
C. Twenty-four thousand dollars after proportionate allocation
D. Thirty thousand dollars, being the entire amount received

12. An exempt organization has 90,000 of unrelated business gross income and 70,000 of directly connected expenses. What is taxable?

A. Twenty thousand, before any further statutory adjustment
B. Nineteen thousand after the specific deduction is applied
C. Ninety thousand, since expenses of exempt entities are disallowed
D. Nothing, because the net amount falls below the threshold

13. A business trades an office building worth 500,000 with a 200,000 basis for a warehouse worth 450,000 plus 50,000 of cash. What gain is recognized?

A. No gain, because both properties are real property held for use
B. Fifty thousand dollars, being the boot actually received
C. Three hundred thousand dollars, the entire realized gain
D. Two hundred fifty thousand, the gain net of the boot received

14. A corporation has 60,000 of current earnings, a 200,000 accumulated deficit, and makes a 90,000 distribution to a shareholder with 15,000 of stock basis. What capital gain arises?

A. Thirty thousand dollars after the dividend tier is applied
B. Seventy-five thousand dollars, the excess over stock basis
C. Fifteen thousand dollars after the dividend and basis tiers
D. Ninety thousand dollars, the entire distribution being gain

15. A business has 45,000 of business interest expense, no business interest income, and 100,000 of adjusted taxable income, with average receipts of 40,000,000. What is deductible?

A. Thirty thousand, with fifteen thousand carried forward
B. Forty-five thousand dollars, since the taxpayer is exempt
C. Fifteen thousand, being the excess over the applicable cap
D. Nothing, because no business interest income was earned

16. A farmer sells land held eight years for 400,000 with a 150,000 basis and elects farm income averaging. What may be averaged?

A. Nothing, because gain from selling land is excluded
B. Two hundred fifty thousand, being the entire gain realized
C. One hundred twenty-five thousand, being half the gain
D. The gain only where the land was used in the farming business

17. A business owner pays 22,000 of self-employed health insurance premiums with 18,000 of net self-employment earnings. What is deductible as an adjustment?

A. Eighteen thousand, limited by the net earnings from the business
B. Twenty-two thousand dollars, the full premiums actually paid
C. Eleven thousand dollars, being half the premiums paid
D. Nothing, since premiums are personal rather than business costs

18. A partnership has 500,000 of assets, 300,000 of recourse debt, and two equal general partners. What is each partner's share of the liability?

A. One hundred fifty thousand each under constructive liquidation
B. Two hundred fifty thousand each, following the asset values
C. Three hundred thousand to whichever partner signed the note
D. Nothing, since partnership debt belongs to the entity itself

19. A business is assessed a 60,000 environmental penalty and pays 25,000 identified in the order as remediation. What is deductible?

A. Nothing, because all payments to a government are disallowed
B. Twenty-five thousand identified as remediation in the order
C. Sixty thousand dollars, being the total amount paid out
D. Thirty-five thousand, being the balance after remediation

20. A corporation distributes property worth 120,000 with a 45,000 basis and a 30,000 attached liability. What does the shareholder report?

A. Forty-five thousand, being the corporation's own basis
B. One hundred fifty thousand, adding the liability to the value
C. Ninety thousand, being the value net of the liability assumed
D. One hundred twenty thousand as the gross distribution received

21. A business owner works 90 hours in an activity where a paid manager works 200 hours. What follows?

A. Material participation because the owner directs the manager
B. The activity is passive, since no participation test is met
C. Material participation under the hundred hour test applies
D. The activity is passive unless it is grouped with another

22. How would grouping that activity with another where the owner works 600 hours change the analysis?

A. Grouping requires the consent of the Service before filing
B. The activities remain separate for participation purposes
C. Participation is tested across the combined economic unit
D. Grouping is unavailable where a paid manager is involved

23. An employer pays 8,000 of employee educational assistance under a written non-discriminatory plan. What is excludable?

A. The amount within the annual statutory exclusion limit
B. Nothing, since educational assistance is always taxable wages
C. The entire eight thousand regardless of any annual limit
D. Half the amount, with the balance included in wages

24. A corporation sells a building for 900,000 with a 500,000 basis after 300,000 of straight line depreciation. How is the corporate gain treated?

A. Additional recapture applies to twenty percent of the straight line amount
B. Four hundred thousand entirely as ordinary income to the corporation
C. Four hundred thousand entirely as Section 1231 gain with no recapture
D. Three hundred thousand at the capped individual rate on the gain

25. A business with 300,000 of receipts operates at a 40,000 loss with 250,000 of wages from unrelated employment. What limitation may apply?

A. None, since the loss is well below the excess business loss threshold
B. The passive activity rules where the owner does not participate
C. The excess business loss cap on the aggregate business loss
D. The eighty percent limitation on the resulting operating loss

26. A partnership makes a 25,000 charitable contribution. How is it reported?

A. Not deductible at all, since partnerships are not taxpayers
B. Deducted only where every partner consents to the contribution
C. Separately stated so each partner applies their own limitation
D. Deducted on page one in computing ordinary business income

27. A shareholder-employee is provided group term life insurance of 200,000 by an S corporation in which they own five percent. What follows?

A. Only the cost of the first fifty thousand of coverage is excluded
B. The full cost is included in the shareholder's taxable wages
C. The entire cost is excludable as an employee fringe benefit
D. The cost is deducted by the corporation but excluded from wages

28. A business has a 100,000 general business credit, 60,000 of net regular tax, and no tentative minimum tax. What is claimed?

A. Fifty-one thousand two hundred fifty under the limitation
B. One hundred thousand with the excess refunded to the taxpayer
C. Sixty thousand with forty thousand carried back and forward
D. Twenty-five thousand under the twenty-five percent limitation

29. A trust in its final year has 18,000 of excess deductions and a 12,000 capital loss carryover. What follows?

A. Both pass to the beneficiaries succeeding to the trust property
B. Both are lost entirely when the trust terminates its existence
C. Only the capital loss carryover passes to the beneficiaries
D. Only the excess deductions pass with their character preserved

30. A business owner sells S corporation stock with a 200,000 basis for 350,000 when the corporation holds substantially appreciated inventory. What follows?

A. The hot asset rules apply exactly as they do to a partnership
B. The gain is allocated between ordinary and capital by asset
C. One hundred fifty thousand of capital gain on the stock sale
D. One hundred fifty thousand of ordinary income on the inventory

31. A partnership distributes 50,000 of cash to a partner with 30,000 of basis in a non-liquidating distribution. What follows?

A. Fifty thousand of ordinary income from the distribution
B. Twenty thousand of gain, generally capital in character
C. No gain, since only liquidating distributions produce gain
D. Twenty thousand suspended until the interest is sold

32. A corporation has 5,000,000 of receipts and pays 1,200,000 to its founder who works part-time. What analysis applies?

A. The independent investor test alongside the ordinary factors
B. A safe harbor permitting any amount below a stated ratio
C. No analysis, since compensation is a matter of corporate policy
D. Automatic disallowance of amounts above a statutory ceiling

33. A business elects to expense 900,000 under Section 179 having placed 4,300,000 in service. What reduction applies?

A. Three hundred thousand of reduction under the phase-out
B. No reduction, since the election is below the annual limit
C. Nine hundred thousand fully allowed against business income
D. Four hundred thousand of reduction against the annual limit

34. A farmer has 200,000 of gross farm income and pays 90,000 for prepaid feed with 100,000 of other farm expenses. What is deductible for the feed?

A. Fifty thousand dollars, being fifty percent of other expenses
B. Ninety thousand dollars, being the full amount actually paid
C. Forty thousand dollars, being the excess over the limitation
D. One hundred thousand, being fifty percent of gross income

35. A business receives a 30,000 payment settling a claim for lost profits. How is it taxed?

A. Excluded entirely as compensation for a business injury
B. Section 1231 gain netted with other business dispositions
C. Ordinary income, replacing the profits it was meant to replace
D. Capital gain, since a legal claim is a capital asset

36. A corporation with a June year end places property in service in May. Which taxable year claims the depreciation?

A. Both years proportionately across the placement date
B. The year ending in June, applying the appropriate convention
C. The following year, since the placement fell late in the period
D. Neither year until the property produces income for the business

37. A business has 700,000 of average receipts and holds inventory it wishes to expense as purchased. What is available?

A. Treatment as non-incidental materials and supplies deductible when used
B. Immediate deduction of all inventory purchases as incurred
C. No relief, since inventory always requires full accounting
D. Deduction only where the business uses the accrual method

38. An exempt organization receives a 60,000 bequest of an operating business. What follows?

A. The bequest is excluded and the business income is exempt
B. The bequest is excluded but the business income may be unrelated
C. Automatic loss of exemption for operating a commercial business
D. The bequest is taxable as unrelated business income when received

39. A shareholder contributes 100,000 to a corporation without receiving additional stock. What follows?

A. A deductible contribution by the shareholder to the entity
B. A taxable distribution reversed in the corporation's accounts
C. A contribution to capital increasing the shareholder's stock basis
D. Ordinary income to the corporation in the year received

40. A partnership has 300,000 of nonrecourse debt secured by property with a 220,000 basis. What is the partnership minimum gain?

A. Eighty thousand, the excess of the debt over the property basis
B. Three hundred thousand, being the entire nonrecourse liability
C. Two hundred twenty thousand, being the property's adjusted basis
D. Nothing, since minimum gain arises only on an actual disposition

41. A business incurs 500,000 of costs producing goods and 80,000 of selling expenses. Which enters inventory?

A. Eighty thousand only, being the selling costs incurred
B. Five hundred thousand of production costs alone
C. Both amounts, since all costs relate to the goods sold
D. Half of each amount under a proportionate allocation

42. A corporation pays 40,000 of premiums on a policy insuring its founder with the corporation as beneficiary. What follows?

A. No deduction and the eventual proceeds are excluded from income
B. The premiums are deductible as an ordinary business expense
C. The premiums are deductible and the proceeds taxable in full
D. The premiums are capitalized into the policy's cash surrender value

43. A partner sells a partnership interest at a 60,000 loss when the partnership holds substantial unrealized receivables. What follows?

A. The loss is capital, with the hot asset rules producing ordinary income
B. The entire loss is ordinary because of the receivables held
C. The loss is suspended until the receivables are actually collected
D. The loss is disallowed entirely where hot assets are present

44. A business claims 200,000 of bonus depreciation on property that was previously leased by that same taxpayer. What follows?

A. The deduction is allowed at a reduced applicable percentage
B. The deduction is allowed only where the lessor was unrelated
C. The deduction is denied because the taxpayer previously used it
D. The deduction is allowed because used property now qualifies

45. A trust has 80,000 of income, distributes 50,000, and the instrument permits accumulation. What is the trust's deduction?

A. Nothing, since a complex trust receives no distribution deduction
B. Twenty-five thousand, being half the distributed amount
C. Fifty thousand, limited by distributable net income available
D. Eighty thousand, being all the income earned for the year

46. A business owner sells equipment to their own S corporation at a 20,000 gain. What follows?

A. The gain is ordinary income because the buyer may depreciate it
B. The gain receives Section 1231 treatment in the ordinary way
C. The gain is deferred until the corporation resells the equipment
D. The gain is disallowed entirely under the related party rules

47. A partnership distributes property to a partner who contributed different property two years earlier. What may follow?

A. A disguised sale where the two transfers are related in substance
B. Termination of the partnership under the continuation rules
C. Gain to the contributing partner under the mixing bowl rules
D. No consequence, since property distributions are always tax free

48. A corporation has 400,000 of earnings and profits and redeems shares from an unrelated shareholder reducing their interest from 40 to 25 percent. What follows?

A. Exchange treatment, satisfying the substantially disproportionate test
B. Dividend treatment, since earnings and profits remain available
C. Partial liquidation treatment on the corporate level contraction
D. Dividend treatment unless the corporation elects otherwise

49. A business owner takes a 150,000 distribution from a partnership in which they have 40,000 of basis and 200,000 of suspended losses. What follows?

A. One hundred ten thousand of gain with the losses still suspended
B. The suspended losses offset the distribution gain entirely
C. No gain, because suspended losses exceed the distribution
D. One hundred ten thousand of ordinary income from the partnership

50. A business has 30,000 of qualified research expenses and elects the reduced credit. Why?

A. To increase the credit percentage applied to the expenses
B. To claim the credit against payroll rather than income tax
C. To carry the credit back more than one taxable year
D. To avoid reducing the deduction for the research expenses

51. A corporation acquires 100 percent of a target's stock and elects to treat it as an asset purchase. What follows?

A. No election of that kind is available for a stock acquisition
B. The target is treated as selling its assets and repurchasing them
C. The target's historic basis carries over to the acquiring corporation
D. The target's shareholders recognize no gain on the transaction

52. A partnership has 60,000 of ordinary income and 25,000 of Section 1231 gain. How is the gain reported?

A. Separately stated so each partner nets it with their own items
B. Aggregated into ordinary income on page one of the return
C. Allocated only to partners who materially participate
D. Deferred until the partnership itself is finally liquidated

53. A business owner dies owning a sole proprietorship with 400,000 of appreciated equipment. What basis passes?

A. Zero, since a proprietorship terminates on the owner's death
B. A stepped-up basis with depreciation recapture also eliminated
C. The decedent's own carryover basis in the equipment held
D. A stepped-up basis with recapture potential still attaching

54. A trust pays 15,000 of state income tax on business income it retains. What follows?

A. The deduction is limited by the cap applying to individuals
B. The tax is fully deductible against the trust's business income
C. No deduction, since state taxes are personal in character
D. Half the amount is deductible with the balance carried forward

55. A corporation issues stock to an employee subject to a three-year vesting condition. When does the employer deduct?

A. Rateably across the three-year vesting period involved
B. Never, since equity issuance produces no employer deduction
C. When the employee includes the value, on vesting or election
D. In the year the stock is granted regardless of the conditions

56. A business with 3,000,000 of receipts pays 200,000 of interest on a loan used to buy inventory. What applies?

A. Full deduction, since the gross receipts test exempts the business
B. Capitalization of the interest into the cost of the inventory
C. Disallowance of the interest as a non-business expenditure
D. Deduction limited to thirty percent of adjusted taxable income

57. A partnership makes a distribution reducing a partner's liability share by 40,000 when basis is 25,000. What follows?

A. Forty thousand of ordinary income to the affected partner
B. Fifteen thousand of gain from the deemed cash distribution
C. No consequence, since liability shifts are not distributions
D. Twenty-five thousand of gain measured against the full share

58. An exempt organization sells its headquarters at a 300,000 gain. What follows?

A. Taxable as debt-financed income where a mortgage was outstanding
B. Exempt in every case, since capital gains are always excluded
C. Taxable in full because real property sales are always unrelated
D. Unrelated business income, since the property was not exempt use

59. A business elects the de minimis safe harbor and purchases 40 items at 900 dollars each. What follows?

A. Deduction of the full amount where the per-item ceiling is met
B. Capitalization, since the aggregate exceeds the annual ceiling
C. Deduction of half the amount under a proportionate rule
D. Capitalization of all items acquired in a single transaction

60. A corporation makes a 90,000 contribution to a foreign charity. What follows?

A. Not deductible as a charitable contribution to a foreign entity
B. Deductible in full as an ordinary charitable contribution
C. Deductible up to five percent of taxable income for the year
D. Deductible only where a treaty specifically permits the deduction

61. A farmer receives 120,000 of government agricultural program payments. How are they treated?

A. Capital gain since they relate to the underlying farmland
B. Deferrable to the following year in every circumstance
C. Ordinary farm income subject to self-employment tax
D. Excluded entirely as government transfer payments received

62. A business has 80,000 of losses suspended under the at-risk rules and later contributes 50,000 of cash. What follows?

A. Fifty thousand of the suspended losses becomes deductible
B. The entire eighty thousand becomes deductible in that year
C. The suspended losses remain locked until disposition occurs
D. The contribution restores basis but not the at-risk figure

63. A corporation reports 500,000 of book income including 60,000 of accrued but unpaid related party expenses. What adjustment arises?

A. An addition of sixty thousand until the payee includes it

B. A subtraction of sixty thousand as already deducted for tax
C. No adjustment, since accrued expenses are deductible when fixed
D. An addition of thirty thousand under a proportionate rule

64. A partnership has two partners sharing profits 70 and 30 but losses equally. How is nonrecourse debt allocated?

A. Equally, following the arrangement for sharing losses
B. Entirely to the partner with the larger capital account
C. Seventy and thirty, following the profit sharing arrangement
D. In proportion to each partner's original capital contribution

65. A business sells a customer list it created internally for 200,000 with no basis. How is it taxed?

A. Capital gain where the required holding period is satisfied
B. Ordinary income, since self-created intangibles are excluded
C. Section 1231 gain netted with other business dispositions
D. Ordinary income to the extent of amortization never claimed

66. An S corporation has 200,000 of accumulated earnings from C years and makes a 150,000 distribution when its adjustments account is 250,000. What follows?

A. Seventy-five thousand from each of the first two tiers equally
B. One hundred fifty thousand tax free from the adjustments account
C. One hundred fifty thousand taxed as a dividend from earnings
D. The accumulated earnings must be distributed before the account

67. A business owner works 45 hours weekly in an S corporation and takes no salary, only distributions. What follows?

A. The distributions are automatically treated as return of capital

B. The S election terminates for failure to pay any compensation
C. Distributions will be recharacterized as wages with payroll tax
D. The arrangement is permitted where the corporation has losses

68. A corporation with a 300,000 net operating loss undergoes an ownership change when its value is 2,000,000. What limits the loss?

A. Value multiplied by the published long-term tax-exempt rate annually
B. The entire loss is forfeited on the change of ownership
C. Half the loss becomes available in each of the following years
D. The loss is limited to twenty percent of taxable income each year

69. A partnership incurs 12,000 of costs admitting a new partner. How are they treated?

A. Amortized over one hundred eighty months from admission
B. Deducted currently as an ordinary business expense
C. Capitalized permanently as a syndication cost with no recovery
D. Added to the new partner's own outside basis in the interest

70. A trust holds S corporation stock and makes the electing small business trust election. How is the S income taxed?

A. At the ordinary graduated fiduciary rates for the trust
B. Exempt at trust level and taxed only to beneficiaries
C. At the highest rate applicable to the S portion of the trust
D. At the beneficiary's own marginal rate on distribution

71. A business acquires a truck for 70,000 with a gross vehicle weight above the threshold, used entirely for business. What applies?

A. The full cost may be expensed with no limitation at all

B. A separate Section 179 ceiling applies to heavy vehicles
C. The passenger automobile caps limit the annual deduction
D. No deduction is available for vehicles above that weight

72. An exempt organization has 40,000 of unrelated business income and expects 8,000 of tax. What follows?

A. Estimated tax payments are required during the taxable year
B. The tax is payable only with the annual information return
C. No tax arises where the income funds the exempt purpose
D. The organization may elect to defer the tax for one year

73. A business owner claims a home office and later sells the residence at a gain. What follows?

A. Depreciation claimed on the office is recaptured on the sale
B. The entire gain qualifies for the residence exclusion
C. The office portion of the gain is entirely disqualified
D. No gain arises where the office was within the dwelling unit

74. A corporation makes a 200,000 distribution when earnings and profits are 200,000 but it has no cash, distributing a note instead. What follows?

A. The note is a distribution measured at its fair market value
B. The corporation deducts the note's face amount as interest
C. No distribution arises until the note is actually paid
D. The shareholder defers income until the note is redeemed

75. A partnership allocates 100 percent of income to one partner in a year and 100 percent of loss to another the next. What may follow?

A. Automatic reallocation according to capital contributions

B. Termination of the partnership for abusive allocations
C. Challenge as transitory allocations lacking substantiality
D. Respect for the allocations as the partners freely agreed them

76. A business claims 500,000 of research expenses and elects amortization. Over what period?

A. Five years for domestic and fifteen for foreign research
B. Sixty months beginning with the month benefits are first realized
C. Fifteen years for all research regardless of its location
D. Immediately, since research expenses remain currently deductible

77. A shareholder receives a 50,000 distribution from an S corporation with zero accumulated earnings, 60,000 of stock basis, and a 40,000 loss allocated. What is taxable?

A. Fifty thousand of ordinary income from the distribution
B. Forty thousand of loss with the distribution fully tax free
C. Nothing taxable, with basis reduced to ten thousand thereafter
D. Ten thousand of gain after the loss reduces the stock basis

78. A corporation has 700,000 of gross receipts from services performed by its owner-employees in law. What limitation may apply?

A. The reduced accumulated earnings credit for service corporations
B. The prohibition on service corporations electing S status
C. The disallowance of all compensation to owner-employees
D. The mandatory use of the accrual method regardless of receipts

79. A business converts inventory to a capital asset by holding it for investment. What follows?

A. Gain on later sale is capital where the holding period is met
B. The character is determined by the taxpayer's purpose at sale

C. The character changes immediately upon the change in purpose
D. Conversion is not permitted, since inventory is always ordinary

80. A partnership terminates and distributes only cash of 40,000 to a partner with 70,000 of basis. What follows?

A. Thirty thousand of ordinary loss on the liquidation received
B. No loss recognized on a liquidating distribution of any kind
C. Thirty thousand added to the basis of other assets held
D. Thirty thousand of capital loss recognized on liquidation

81. A business has 250,000 of qualified property and 40,000 of W-2 wages with 400,000 of qualified business income above the threshold. Which limb applies?

A. Twenty-six thousand two hundred fifty under the combined limb
B. Eighty thousand, being twenty percent of the business income
C. Nothing, since the wage figure is too small to support it
D. Twenty thousand under the wage-only limb of the limitation

82. A corporation has 40,000 of foreign taxes on 100,000 of foreign income with 400,000 of total taxable income. What limits the credit?

A. The United States tax attributable to the foreign source income
B. The full forty thousand paid, since no limitation applies
C. Fifty percent of the total tax liability for the taxable year
D. Twenty-five percent of the foreign source income received

83. A business owner sells a partnership interest for 400,000 with a 250,000 basis, receiving payments across four years. What follows?

A. The entire gain is deferred until the final payment is received

B. Ordinary income from hot assets is recognized in the sale year
C. The gain is reported entirely in the year of the sale
D. The installment method is unavailable for partnership interests

84. A trust has 100,000 of income and its instrument requires 40,000 distributed annually to a beneficiary who receives nothing this year. What follows?

A. The trust deducts and the beneficiary reports forty thousand
B. The amount is taxed to the trust and deferred to the beneficiary
C. Nothing is taxed to the beneficiary who received no payment
D. The beneficiary reports the amount only when it is actually paid

85. A business has 90,000 of gross receipts from an activity generating consistent losses across six years with substantial personal enjoyment. What risk arises?

A. Reclassification as an activity not engaged in for profit
B. Automatic classification as a passive activity for all years
C. Mandatory capitalization of all expenses into the assets
D. Disallowance of the losses only in the sixth taxable year

86. A corporation issues 100,000 of stock and incurs 8,000 of issuance costs. How are those costs treated?

A. Netted against the proceeds with no deduction or amortization
B. Deducted currently as an ordinary business expense
C. Amortized over one hundred eighty months from issuance
D. Added to the corporation's own basis in its treasury stock

87. A partnership uses the interim closing method when a partner's interest changes mid-year. What does that require?

A. Allocation of all items to whoever holds the interest at year end
B. Allocation of all items to whoever held the interest at the start
C. Closing the books as of the date the interest actually changed
D. Proration of annual items by the number of days each interest was held

88. An exempt organization spends 200,000 on lobbying having made the expenditure election. What follows?

A. Immediate revocation of the organization's exempt status
B. No consequence, since the election permits unlimited lobbying
C. An excise tax on amounts exceeding the sliding scale limit
D. Reclassification as a social welfare organization automatically

89. A business acquires equipment on an installment contract with title passing at the end of payments. How is it treated?

A. As a purchase, with depreciation and interest deductible
B. As a lease, with the payments deductible as rent when paid
C. As neither until title actually passes to the purchaser
D. As a purchase only where the taxpayer uses the accrual method

90. A corporation with 50,000 of earnings and profits distributes 200,000 of appreciated property worth 200,000 with a 60,000 basis. What is the dividend?

A. Two hundred thousand, being the property's full market value
B. One hundred ninety thousand after the gain increases earnings
C. Fifty thousand, being the earnings and profits available
D. Sixty thousand, being the corporation's basis in the property

91. A partnership has a partner who is also an employee of a partner-owned corporation. What follows for that partner?

A. The partner remains a partner and cannot be a partnership employee
B. The partnership must withhold payroll tax on the distributive share
C. The corporation's wages are treated as partnership guaranteed payments
D. The partner may receive wages from the partnership as an employee

92. A business claims 120,000 of Section 179 and 200,000 of bonus depreciation with 90,000 of business taxable income. What follows?

A. Neither deduction is available where income is insufficient
B. Both deductions are limited to the ninety thousand available
C. Section 179 is limited to ninety thousand and bonus is not
D. Bonus is limited to ninety thousand and Section 179 is not

93. A farmer sells 200 head of raised cattle held eighteen months for breeding. What follows?

A. Ordinary income because the holding period was not satisfied
B. Section 1231 gain on the full proceeds with a zero basis
C. Capital gain reduced by the accumulated costs of raising them
D. Deferral available under the involuntary conversion provisions

94. A corporation with 900,000 of accumulated earnings and no expansion plans retains all its income. What may apply?

A. A requirement to distribute the excess within twelve months
B. No consequence, since retention is a matter of business judgment
C. The personal holding company tax on the undistributed income
D. The accumulated earnings tax on amounts beyond reasonable needs

95. A partnership distributes unrealized receivables to a partner who collects them the following year. How is the collection taxed?

A. Deferred until the partnership itself is finally liquidated
B. Tax free, since the receivables carried no basis in the hands
C. Ordinary income, since unrealized receivables retain their character
D. Capital gain, since the receivables were distributed property

96. A business has 600,000 of average receipts and constructs its own warehouse. What applies?

A. Interest capitalization during the production period of the property
B. Full current deduction of all construction period interest
C. Amortization of the interest over sixty months from completion
D. No deduction for interest on self-constructed property at all

97. A trust distributes property with a 40,000 basis and 65,000 value without electing to recognize gain. What follows?

A. The beneficiary takes a sixty-five thousand fair market value basis
B. The distribution deduction is measured at sixty-five thousand
C. The beneficiary takes the trust's forty thousand carryover basis
D. The trust recognizes twenty-five thousand of gain on the distribution

98. A business owner with 500,000 of business income considers a defined benefit plan. What is the principal attraction?

A. Contribution levels far exceeding those of a defined contribution plan
B. The ability to skip contributions in any unprofitable year
C. The complete absence of any annual administrative obligation
D. Immediate vesting of all contributions for the owner alone

99. A corporation makes a 30,000 payment to a shareholder documented as a loan but never repaid over eight years. What is likely?

A. Recharacterization as a constructive dividend to the shareholder
B. Respect as a loan given the original documentation prepared
C. Treatment as a return of the shareholder's original capital
D. Treatment as deductible compensation for services rendered

100. A business owner completes the sale of their company and wishes to minimize total tax across both parties. Which allocation generally suits the seller?

A. Allocation toward equipment carrying depreciation recapture
B. Allocation toward goodwill producing capital gain treatment
C. Allocation toward inventory producing ordinary income
D. Allocation toward a covenant not to compete paid over time

Practice Exam 31: Answer Key and Explanations

1. B — The tentative deduction is sixty thousand and the fully applied wage limit is forty thousand, giving an excess amount of twenty thousand. Forty percent of that excess is eight thousand, which reduces the tentative figure to fifty-two thousand as the allowable deduction. The applicable percentage measures progress through the range.

2. A — A net Section 1231 loss is entirely ordinary and deductible without the capital loss limitations, which is the asymmetric benefit the provision confers. The loss also enters the five-year lookback pool, recharacterizing future net Section 1231 gains as ordinary. The asymmetry between net gains and net losses is deliberate. It is the asymmetric benefit the provision deliberately confers.

3. D — Pre-2018 losses are applied first and carry no eighty percent limitation, with post-2017 losses then applying subject to that cap. Using them in the reverse order would waste the unrestricted losses behind restricted ones and produce a worse result. Reverse ordering would waste the unrestricted losses entirely. Post-2017 losses then apply subject to the eighty percent cap.

4. C — Social Security applies at twelve point four percent up to the annual wage base while Medicare applies at two point nine percent without limit, with an additional Medicare levy above a further threshold. Half the resulting total is an adjustment to income. An additional Medicare levy applies above a further threshold.

5. B — Cash reduces outside basis first, leaving seventy thousand for the two parcels whose combined carryover basis is eighty thousand. The excess is reduced proportionately, so the first parcel takes forty-five thousand multiplied by seventy over eighty, or thirty-nine thousand three hundred seventy-five. Cash always reduces outside basis before property does.

6. A — The corporate limitation is ten percent of taxable income computed before the charitable and dividends received deductions, giving seventy thousand here. Excess amounts carry forward five years and are used after current year contributions in each later year. Excess amounts carry forward for five taxable years. Current year contributions are used before any carryforward.

7. D — Family attribution treats the departing shareholder as owning the child's shares, defeating complete termination. A waiver is available where the shareholder retains no interest other than as a creditor, acquires none for ten years, and files the required agreement. No interest other than as a creditor may be retained. A ten-year reacquisition bar and a filed agreement are required.

8. A — A general partner includes both the guaranteed payment for services and the distributive share of trade or business income, giving forty thousand plus seventy-five thousand. A limited partner would generally exclude the distributive share while still including the payment. A limited partner would exclude the distributive share instead. Both amounts flow from the same partnership for that partner.

9. C — Distributions reduce basis before losses do. Fifty thousand reduces basis to ten thousand, so only ten thousand of the loss is currently deductible and fifteen thousand is suspended. Reversing the order would wrongly suggest the distribution was partly taxable. Reversing the order suggests a wrongly taxable distribution. Only ten thousand of the allocated loss is currently deductible.

10. B — The deduction cannot exceed aggregate taxable income from the active conduct of any trade or business, so one hundred eighty thousand is allowed. Seventy thousand carries forward indefinitely, and bonus depreciation could instead have absorbed the remainder without an income limit. Bonus depreciation carries no comparable income limitation. Seventy thousand carries forward indefinitely to later years.

11. D — The distribution carries out income proportionately, and exempt interest is one fifth of distributable net income. One fifth of the thirty thousand distribution is exempt, leaving twenty-four thousand taxable and six thousand exempt in the beneficiary's hands. Exempt interest remains exempt in the beneficiary's hands. One fifth of the distribution is exempt in the same proportion.

12. C — Directly connected expenses reduce ninety thousand to twenty thousand, and the one thousand dollar specific deduction leaves nineteen thousand of unrelated business taxable income. The organization must also make estimated payments where the expected liability reaches the threshold. Estimated payments become due above the applicable threshold. The specific deduction reduces the taxable amount by one thousand.

13. C — Realized gain is three hundred thousand and boot is fifty thousand, so the lesser figure of fifty thousand is recognized. The warehouse takes a basis of two hundred thousand, plus the fifty thousand gain recognized, less the fifty thousand boot, giving two hundred thousand. Basis is relinquished basis plus gain less boot received.

14. D — Sixty thousand is a dividend from current earnings under the nimble dividend rule despite the deficit. Fifteen thousand then exhausts stock basis as a return of capital, leaving fifteen thousand of capital gain from a deemed sale of the shares. The accumulated deficit does not offset current earnings. Fifteen thousand then exhausts the shareholder's stock basis.

15. B — Receipts above the threshold mean the limitation applies, capping the deduction at thirty percent of one hundred thousand. Thirty thousand is deductible and the remaining fifteen thousand carries forward indefinitely to later taxable years. Floor plan financing interest would be added to the cap. The remaining fifteen thousand carries forward indefinitely.

16. A — Gain from the sale of land is expressly excluded from elected farm income even where the land was farmed. Gain on other property regularly used in the farming business may be included, which makes the character of the asset decisive here. Other property regularly used in farming may still be included.

17. A — The self-employed health insurance deduction is limited to net earnings from the trade or business under which the plan was established, giving eighteen thousand. The excess four thousand may be claimed as a medical itemized deduction subject to its own floor. The excess may be claimed as a medical itemized deduction.

18. B — A constructive liquidation assumes all assets become worthless and determines who bears the economic burden. Two equal general partners each bear one hundred fifty thousand, and that share increases each partner's outside basis correspondingly. That share increases each partner's outside basis correspondingly. Two equal general partners each bear one hundred fifty thousand.

19. C — Fines and similar penalties are nondeductible, but amounts constituting restitution, remediation, or coming into compliance may be deducted where identified as such in the order or agreement. The identification requirement makes the drafting genuinely consequential. Identification in the order or agreement is what matters. Coming into compliance is treated the same as remediation.

20. D — The distribution is measured by the property's fair market value reduced by any liability the shareholder assumes, giving ninety thousand. The shareholder nonetheless takes a full fair market value basis of one hundred twenty thousand in the property received. A full fair market value basis nonetheless passes to them. Liabilities assumed reduce the amount of the distribution.

21. C — Ninety hours fails the five hundred hour test and fails the hundred hour test both on hours and because another individual participated more. No other test is satisfied on these facts, so the activity is passive for that taxpayer. No other participation test is satisfied on those facts. Another individual participated more, defeating that test.

22. D — Where activities form an appropriate economic unit they may be grouped, and material participation is then tested across the combined group. Six hundred and ninety hours comfortably satisfies the five hundred hour test for the group as a whole. Six hundred ninety hours comfortably satisfies the test. Groupings must be disclosed and generally bind later years.

23. B — A qualified educational assistance programme permits exclusion up to an annual limit where the plan is written, non-discriminatory, and offers no choice between assistance and cash. No more than five percent of amounts may go to more-than-five-percent owners. The plan must be written and offer no cash alternative. Owners above five percent face a separate allocation cap.

24. A — A corporation faces Section 291, which recaptures as ordinary income twenty percent of the additional amount that would have been recaptured had the property been Section 1245 property. The unrecaptured Section 1250 rate is an individual provision only. Section 291 reaches corporations rather than individuals. Twenty percent of the additional amount becomes ordinary income.

25. A — The threshold applies to aggregate business losses and forty thousand falls far below it. Wages are not business income for that computation, so the loss offsets them in full provided basis, at-risk, and passive activity hurdles are all cleared. Wages are not business income for that particular computation. Basis, at-risk, and passive hurdles must all be cleared first.

26. D — Charitable contributions are separately stated because the percentage limitations operate on each partner's own return. Aggregating them into ordinary income would destroy the information partners need to apply their individual limitations correctly. Each partner applies their own percentage limitation separately. Aggregating them would destroy information partners require. The percentage limits operate at the partner level entirely.

27. C — A more-than-two-percent shareholder cannot exclude group term life insurance, so the entire cost is wages. An ordinary employee would exclude the cost of the first fifty thousand of coverage and include only the balance under the published table. An ordinary employee would exclude the first fifty thousand. The published table measures the cost of excess coverage.

28. B — With no tentative minimum tax the limit is net income tax less twenty-five percent of regular tax above twenty-five thousand dollars, giving fifty-one thousand two hundred fifty. The unused amount carries back one year and forward twenty. The unused amount carries back one and forward twenty years. Tentative minimum tax would otherwise set the binding limit.

29. 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 to beneficiaries. Some are claimed above the line and others as itemized.

30. D — Selling S corporation stock produces capital gain measured against stock basis without any hot asset lookthrough. That contrast with the partnership rules is a genuine structural difference and a frequent source of confusion between the two forms. That contrast with the partnership rules is a real difference. No hot asset lookthrough applies to S corporation stock.

31. C — Money distributed in excess of outside basis produces gain, generally capital, whether the distribution is liquidating or not. Twenty thousand is recognized here and outside basis falls to zero for the partner concerned. Outside basis falls to zero for the partner concerned. Liquidating and non-liquidating distributions follow the same rule.

32. A — The independent investor test asks whether a hypothetical investor would be satisfied with the return remaining after the compensation. That test operates alongside duties, hours, experience, and comparable pay, and part-time service weighs heavily against a large figure. Part-time service weighs heavily against a large figure. Duties, hours, experience, and comparable pay all feature.

33. A — The phase-out reduces the annual limit dollar for dollar by placements above the threshold, and here the excess is three hundred thousand. Because the reduced limit still exceeds the nine hundred thousand elected, the full election remains available. The reduced limit still exceeds the amount actually elected. Placements above the threshold reduce the limit dollar for dollar.

34. B — Prepaid farm supplies are limited to fifty percent of other deductible farm expenses, giving fifty thousand here. The excess forty thousand is deducted when the feed is actually consumed, unless the farmer meets the substantial-business exception. A substantial-business exception may lift the restriction. The excess is deducted when the feed is actually consumed.

35. D — Damages take the character of what they replace, so a recovery for lost profits is ordinary income. A recovery for damage to a capital asset instead reduces basis, with any excess above basis producing gain rather than ordinary income. Damages replacing a capital asset instead reduce its basis. Damages take the character of whatever they replace.

36. C — Depreciation belongs to the taxable year in which the property is placed in service, here the year ending June thirtieth, with the applicable convention determining how much. Fiscal year taxpayers apply the same conventions with quarters measured against their own year. Fiscal year taxpayers measure quarters against their own year.

37. A — A business meeting the gross receipts test may treat inventory as non-incidental materials and supplies, deductible when used or consumed, or follow its own book treatment. Neither route permits deducting purchases before the goods are actually used or sold. Neither route permits deducting before use or sale occurs. Book treatment may be followed as the alternative route.

38. C — The bequest itself is not income to the organization, but operating the business regularly and without substantial relation to the exempt purpose produces unrelated business taxable income. Excess business holdings rules would separately apply to a private foundation. Excess business holdings rules would reach a private foundation. The bequest itself is not income to the organization.

39. D — A shareholder contribution to capital is not income to the corporation and increases the shareholder's basis in existing stock. The corporation takes a carryover basis in any property contributed, and no deduction arises for the contributing shareholder. The corporation takes a carryover basis in contributed property. No deduction arises for the contributing shareholder at all.

40. B — Partnership minimum gain is the gain that would arise if the property were disposed of in satisfaction of the nonrecourse liability, being eighty thousand here. A decrease in that figure triggers a chargeback allocating income to the partners who took the deductions. A decrease triggers a chargeback to the partners who benefited.

41. C — Production costs including direct materials, direct labour, and allocable indirect costs are capitalized into inventory, while selling, distribution, and marketing costs are period expenses deducted currently. The dividing line turns on whether goods still await a buyer. Selling and distribution costs remain period expenses throughout. Direct materials and direct labour are both capitalized.

42. B — Premiums on a policy where the corporation is the beneficiary are nondeductible, and the eventual death benefit is excluded from taxable income. Both figures nonetheless affect earnings and profits, which measures genuine economic capacity to distribute. Both figures nonetheless affect the earnings and profits measure. The death benefit is excluded from taxable income entirely.

43. A — Section 751 can produce ordinary income even where the overall result is a loss, since the hot asset component is computed separately. The seller may therefore report ordinary income alongside a larger capital loss on the same transaction. Ordinary income and a capital loss can arise on one transaction. The hot asset component is computed entirely separately.

44. D — Used property qualifies only where the taxpayer did not previously use it. Property the taxpayer leased before acquiring fails that condition, so bonus depreciation is unavailable even though the property is used and acquired from an unrelated party. Prior use by the taxpayer defeats the used property extension. Related party acquisitions are excluded on the same basis.

45. D — A complex trust deducts distributions to the extent of distributable net income, giving fifty thousand here. The remaining thirty thousand is taxed to the trust at the compressed fiduciary rates, which reach the top bracket at very low income. Compressed rates reach the top bracket at very low income. Distributable net income caps the deduction available.

46. C — Gain on selling depreciable property to a related person who may depreciate it is ordinary rather than capital or Section 1231. The rule prevents converting future ordinary depreciation deductions into present capital gain within a controlled group. Present capital gain cannot replace future ordinary deductions. The rule reaches sales within a controlled group.

47. B — Where a partner contributes property and receives other property within seven years, the contributor recognizes gain to the extent of remaining precontribution appreciation. The companion rule reaches contributed property distributed to a different partner within the same period. Seven years is the operative period for both companion rules. Precontribution appreciation is what the rules preserve.

48. A — Twenty-five percent is below fifty percent and below eighty percent of the prior forty percent interest, which is thirty-two percent. Both prongs are satisfied, so the redemption is substantially disproportionate and receives exchange treatment. Thirty-two percent is eighty percent of the prior interest. Both prongs of the disproportionate test are satisfied.

49. A — Money exceeding outside basis produces gain regardless of suspended losses, which are released only as basis is restored. The one hundred ten thousand gain is generally capital, and the losses remain suspended until basis returns. Suspended losses release only as basis is later restored. The gain arising is generally capital in character.

50. D — A taxpayer must either reduce the research expense deduction by the credit claimed or elect a reduced credit instead. The election preserves the full deduction, and which route is preferable depends on the taxpayer's marginal rate and credit usability. Marginal rate and credit usability drive the choice made. The full research expense deduction is preserved by electing.

51. C — A qualified stock purchase election treats the target as having sold all its assets at fair market value and repurchased them, giving a stepped-up basis at the cost of gain recognized. The variant with a selling consolidated group shifts that gain to the seller. The variant used with a selling consolidated group shifts that gain to the seller instead.

52. B — Section 1231 gain is separately stated because each partner nets it against their own Section 1231 items and applies their own lookback history. Aggregating it would destroy the character information partners need for their individual computations. Each partner applies their own lookback history to the amount allocated to them. Character information would otherwise be destroyed entirely.

53. C — Property acquired from a decedent takes a stepped-up basis, and depreciation recapture potential is generally eliminated along with the appreciation. That contrasts sharply with a lifetime gift, where both basis and recapture exposure carry over to the donee. That contrasts sharply with a lifetime gift, where both basis and recapture carry over.

54. A — State and local taxes paid on income from a trade or business or from property held for the production of income remain fully deductible, since the cap reaches taxes not connected with such activity. Trusts face the cap on the same terms as individuals. Trusts face the same cap as individuals on taxes unconnected with such activity.

55. D — The employer deducts the amount the employee includes, in the employer's year in which or with which the employee's year ends. A Section 83(b) election accelerates both the inclusion and the deduction to the year of grant. A Section 83(b) election accelerates both the inclusion and the deduction to grant.

56. B — A business meeting the gross receipts test is exempt from the business interest limitation entirely, so the interest is fully deductible. Interest capitalization reaches the production period of self-constructed property rather than ordinary inventory purchases. Capitalization reaches self-constructed property rather than ordinary inventory purchases. Ordinary inventory purchases are outside that capitalization rule.

57. C — A decrease in liability share is a deemed distribution of money, so forty thousand against twenty-five thousand of basis produces fifteen thousand of gain. It belongs in the distribution step rather than the loss step of the ordering sequence. It belongs in the distribution step rather than the loss step of the ordering.

58. D — Capital gains from the disposition of property are generally excluded from unrelated business taxable income, but the exclusion is lost where the property was debt-financed. An outstanding acquisition mortgage therefore changes the outcome materially. An outstanding acquisition mortgage therefore changes the outcome materially. Capital gains are otherwise excluded from unrelated income.

59. A — The safe harbor applies per item or per invoice rather than in aggregate, so forty items each within the ceiling all qualify. A written accounting policy must be in place at the start of the year for a taxpayer without an applicable financial statement. A written accounting policy must be in place at the start of the taxable year.

60. B — A charitable deduction requires a domestic qualifying organization, so a direct gift to a foreign charity is not deductible. A domestic organization with foreign operations, or one operating under a treaty provision, can produce a different outcome. A domestic organization with foreign operations can produce a different outcome. Treaty provisions can also alter the ordinary domestic requirement.

61. D — Program payments are ordinary farm income and generally subject to self-employment tax. Conservation reserve payments are the notable exception for taxpayers receiving social security retirement or disability benefits, which escape the self-employment charge. Conservation reserve payments are the notable exception for social security recipients. Program payments are ordinary farm income in the usual way.

62. B — Increasing the amount at risk releases suspended losses to that extent, so fifty thousand becomes deductible subject to the passive activity rules. The remaining thirty thousand stays suspended until the at-risk figure rises further. The remaining thirty thousand stays suspended until the figure rises further. Passive activity rules still apply to the released amounts.

63. A — The matching rule defers the deduction until the related cash method payee includes the amount, so book income must be increased by the accrued but unpaid sixty thousand in reconciling to taxable income for the year. The payee's own method of accounting therefore controls the payer's timing. Book income must be increased by the accrued unpaid amount.

64. C — Nonrecourse liabilities are allocated by profit shares because no partner bears the economic risk of loss. Recourse liabilities instead follow the constructive liquidation analysis, which here would point to the equal loss sharing arrangement. Recourse liabilities instead follow the constructive liquidation analysis entirely. Profit shares govern nonrecourse allocation in every case.

65. A — Self-created customer lists, goodwill, and going concern value sold with a business produce capital gain where held long enough. Purchased intangibles that were amortized instead face Section 1245 recapture to the extent of the amortization claimed. Purchased intangibles that were amortized instead face Section 1245 recapture. Self-created goodwill and going concern value follow the same rule.

66. C — The adjustments account is the first tier, so the entire distribution comes tax free from it to the extent of stock basis. The accumulated earnings remain undistributed and continue to expose the corporation to the passive investment income provisions. The accumulated earnings continue to expose it to the passive income provisions.

67. D — A shareholder providing substantial services must receive reasonable compensation, and taking only distributions invites recharacterization with payroll tax, interest, and penalties. The absence of any salary is among the strongest indicators the Service looks for. The absence of any salary is among the strongest indicators examined. Payroll tax, interest, and penalties follow the recharacterization.

68. B — The annual limitation is the value of the loss corporation multiplied by the published long-term tax-exempt rate. Unused amounts carry forward subject to the same ceiling, so the loss is deferred across years rather than lost outright. Unused amounts carry forward subject to the same annual ceiling each year. Value multiplied by the published rate sets the annual ceiling.

69. B — Costs of admitting partners are syndication costs, capitalized permanently with neither deduction nor amortization available. Genuine organizational costs incurred in forming the partnership qualify for the immediate deduction and amortization treatment instead. Genuine organizational costs instead qualify for deduction and amortization. Syndication costs are capitalized permanently with no recovery. Neither deduction nor amortization is available for them.

70. D — The S portion of an electing small business trust is taxed at the highest rate applicable to trusts, with no deduction for distributions of that income. A qualified subchapter S trust instead taxes the single beneficiary directly on the S income. A qualified subchapter S trust taxes the single beneficiary directly instead.

71. C — Vehicles above the gross weight threshold escape the passenger automobile caps but face their own Section 179 ceiling, with the balance eligible for bonus depreciation. Business use must exceed fifty percent for Section 179 to be available at all. Business use must exceed fifty percent for Section 179 to be available.

72. A — An organization expecting tax of five hundred dollars or more must make quarterly estimated payments, following corporate rules. The unrelated business income tax is a genuine liability with the same payment and penalty regime as any other. The unrelated business income tax carries the same penalty regime as any other.

73. B — Depreciation claimed after a specified date is recaptured as unrecaptured Section 1250 gain and cannot be excluded. Where the office was within the dwelling unit the remaining gain generally qualifies for the residence exclusion in the ordinary way. The remaining gain generally qualifies for the residence exclusion normally. Depreciation after a specified date cannot be excluded at all.

74. C — A corporation's own obligation distributed to shareholders is property valued at fair market value. 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 at all. Fair market value measures the distribution to the shareholder.

75. D — Allocations that reverse over a short period so partners' after-tax positions improve without their pre-tax economic positions changing are transitory and lack substantiality. They are reallocated according to the partners' interests in the partnership. They are reallocated according to the partners' interests in the partnership. Pre-tax economic positions must genuinely change to be substantial.

76. A — Specified research and experimental expenditures must be capitalized and amortized over five years for domestic research and fifteen for foreign, with software development treated as research.

Immediate deduction is no longer available for these expenditures. Software development is treated as research for this particular purpose. Immediate deduction is no longer available for these amounts.

77. D — Distributions reduce basis before losses, so fifty thousand reduces basis to ten thousand tax free. Only ten thousand of the forty thousand loss is then currently deductible, with thirty thousand suspended until basis is restored. Thirty thousand is suspended until basis is restored in a later year. Distributions reduce basis before losses do in the ordering.

78. A — A corporation whose principal function is performing services in law, health, engineering, accounting, and similar fields receives the reduced accumulated earnings credit and is confined to a calendar year absent a business purpose for another. It is also confined to a calendar year absent a business purpose. Health, engineering, and accounting fall in the same category.

79. C — Character turns on the purpose for which the property is held at the time of sale, examined on all the facts. A genuine change in purpose supported by conduct can change the character, though the Service scrutinizes such claims closely. The Service scrutinizes such claims of changed purpose closely. Purpose at the time of sale determines the character.

80. B — Where a liquidating distribution consists only of money, unrealized receivables, and inventory, loss is recognized to the extent basis exceeds the amounts received. Cash alone satisfies that composition, so thirty thousand of capital loss arises. Cash alone satisfies the composition requirement for that treatment. Loss arises only where basis exceeds the amounts received.

81. D — The limitation is the greater of fifty percent of wages, being twenty thousand, or twenty-five percent of wages plus two and a half percent of qualified property, giving ten thousand plus six thousand two hundred fifty, or sixteen thousand two hundred fifty. The taxpayer claims whichever of the two limbs produces the larger figure.

82. B — The credit is limited to United States tax multiplied by the ratio of foreign source income to total taxable income. Excess amounts carry back one year and forward ten within the applicable income category rather than being lost. Excess amounts carry back one year and forward ten within the category.

83. A — The ordinary income portion attributable to unrealized receivables and inventory is recognized in the year of sale rather than deferred. Only the residual capital gain qualifies for installment reporting across the payment period. Only the residual capital gain qualifies for installment reporting. Unrealized receivables and inventory drive that recognition. Deferral applies only to the residual capital component.

84. C — First-tier distributions are amounts required to be distributed currently whether or not actually paid. The trust deducts forty thousand and the beneficiary reports it, so the trustee's failure to pay does not defer the beneficiary's tax at all. The trustee's failure to pay does not defer the beneficiary's tax. First-tier amounts are required to be distributed currently.

85. A — Persistent losses combined with personal pleasure elements invite a hobby determination, after which income is reported in full with no offsetting deduction. The nine regulatory factors are weighed together with no single factor being determinative. The nine regulatory factors are weighed with none being determinative. Income is then reported in full with no offsetting deduction.

86. B — Stock issuance costs reduce the proceeds of the issuance and are neither deductible nor amortizable, which distinguishes them from genuine organizational costs qualifying for the immediate deduction and one hundred eighty month amortization treatment. Genuine organizational costs qualify for entirely different treatment. They reduce the proceeds of the issuance rather than income.

87. D — The interim closing method closes the books on the date of the change and allocates the actual results of each segment. The proration method instead spreads annual items by days, and extraordinary items must be allocated on their actual date either way. Extraordinary items must be allocated on their actual date either way.

88. C — Exceeding the sliding scale limit produces an excise tax rather than immediate revocation. Revocation follows only where the limits are exceeded substantially measured across a four-year period, which is the principal advantage of making the election. Substantial excess across four years remains grounds for revocation. An excise tax rather than revocation follows the excess.

89. A — An arrangement transferring the benefits and burdens of ownership is a purchase whatever it is called, so the user depreciates the property and deducts the interest element. The payments themselves are not deductible as rent at all. The payments themselves are not deductible as rent in any amount. Benefits and burdens of ownership determine the treatment.

90. C — The corporation recognizes one hundred forty thousand of gain on the distribution, which increases earnings and profits to one hundred ninety thousand. The dividend is therefore one hundred ninety thousand with the remaining ten thousand a return of capital. The remaining ten thousand is a tax-free return of capital to them.

91. D — A partner cannot be an employee of the same partnership, so amounts for services are guaranteed payments rather than wages. Employment by a separate corporation is a distinct relationship producing ordinary wages in the usual way. Employment by a separate corporation is a distinct relationship. Guaranteed payments rather than wages arise for services.

92. B — Section 179 cannot exceed aggregate business taxable income, so it is capped at ninety thousand with the balance carried forward. Bonus depreciation carries no such limitation and may create or increase a net operating loss for the year. Bonus depreciation may create or increase a net operating loss. The Section 179 balance carries forward indefinitely instead.

93. B — Cattle held for breeding require twenty-four months, so eighteen months fails the test and the proceeds are ordinary income. Other livestock including hogs, sheep, and goats would have satisfied a twelve-month requirement instead. Hogs, sheep, and goats would satisfy a twelve-month requirement. Twenty-four months is required for cattle and horses.

94. C — The accumulated earnings tax reaches accumulations beyond the reasonable needs of the business made to avoid shareholder tax. The credit shelters a base amount, and specific plans for expansion or debt retirement would support the retention. Specific expansion or debt retirement plans would support retention. The credit shelters a base amount below which retention is safe.

95. D — Unrealized receivables retain their ordinary character permanently in the distributee partner's hands, unlike inventory whose character converts after five years. Collection therefore produces ordinary income however long the partner holds them. Inventory by contrast converts in character after five years. Ordinary character attaches permanently to the receivables. Collection produces ordinary income however long they are held.

96. A — Interest allocable to the production period of self-constructed property must be capitalized regardless of the gross receipts test, which exempts only the ordinary uniform capitalization rules. Direct and allocable indirect costs are capitalized on the same footing. The gross receipts test exempts only the ordinary capitalization rules. Direct and allocable indirect costs are capitalized alongside it.

97. D — Absent an election the beneficiary takes the trust's carryover basis and no gain is recognized. The distribution deduction and the amount the beneficiary includes are both limited to the lesser of basis or value, being forty thousand here. Both are limited to the lesser of basis or value distributed. No gain is recognized by the trust absent that election.

98. C — A defined benefit plan permits contributions far above the defined contribution limits, particularly for an older owner with a short funding horizon. The trade-off is mandatory annual funding, actuarial certification, and materially higher administrative cost. Mandatory funding and actuarial certification are the trade-off. An older owner with a short funding horizon benefits most.

99. B — Documentation alone does not establish a loan where the conduct of the parties shows no genuine expectation of repayment. Absence of repayment across eight years, no interest charged, and no enforcement point strongly toward a constructive dividend. No interest charged and no enforcement point the same way. Conduct rather than paperwork governs the characterization.

100. A — A seller prefers goodwill because it produces capital gain, while equipment recapture, inventory, and covenant payments all produce ordinary income. The buyer prefers the opposite, and the required consistency makes the allocation a genuine negotiating term. The buyer prefers the opposite, making it a negotiating term. Consistency between the parties is required on the statement.