PRACTICE EXAM 22: SEE PART 2 — BUSINESSES (100 QUESTIONS)

This full-length simulation exam contains 100 multiple-choice questions covering SEE Part 2: Businesses, built to mirror the domain weighting of the official IRS Special Enrollment Examination. The official Part 2 exam, administered by PSI Services LLC, consists of 85 scored questions (plus unscored pretest questions) with a 3.5-hour time limit; this practice exam is expanded to 100 questions per the book's practical question-count override so that the total practice question bank across all Part 2 exams reaches a useful study volume, while domain weighting percentages are scaled proportionally from the official 85-question breakdown. For the most realistic practice, allow yourself 3.5 hours to complete this exam without interruption, using only scratch paper and a basic calculator as permitted at the PSI test center. The IRS-published passing score is a scaled score of 500 or higher on a 200-800 scale. Mark your answer for each question, then check your work against the Answer Key and Explanations section that follows. For an interactive, timed practice experience, use the Online Exam Simulator included with this book.

1. Partner Foster begins the tax year with an outside basis of $8,000 in Maple Partners, a general partnership. During the year, the partnership allocates Foster $3,000 of ordinary income, makes a $5,000 cash distribution to Foster, and allocates Foster a $9,000 ordinary loss. Applying the required basis-adjustment ordering rules, what is the maximum loss Foster may deduct this year?

A. $9,000, because the full allocated loss is always deductible in the year it is allocated
B. $3,000, because losses are limited to the partnership's current-year income allocation alone
C. $5,000, because losses are limited to the amount of the current-year cash distribution received
D. $6,000, because basis is increased for income and decreased for distributions before the loss is applied

2. Foster retired from Ridge & Associates, a general partnership, three years ago. Under a written partnership retirement plan adopted before his retirement, Ridge & Associates pays Foster $30,000 annually for life. Foster performs no services for the partnership after retirement, and his successor partners' interest in partnership capital was fully paid to him before retirement began. How are these retirement payments treated for self-employment tax purposes?

A. Fully subject to SE tax because all partnership distributions to any former partner remain SE income indefinitely

B. Excluded from SE income under Section 1402(a)(10) as retirement payments under a written plan, with no continuing services and full payment for his interest

C. Subject to SE tax only for the first five years following his retirement date, then permanently excluded

D. Treated as investment income reportable on Schedule B, rather than as self-employment or retirement plan income

3. Priya begins operating a consulting practice as a sole proprietor and incurs $52,000 of qualified start-up expenditures before the business opens. In the year the business begins, how much of these costs may Priya immediately deduct before amortizing the remainder over 180 months under Section 195?

A. $3,000, because the $5,000 immediate deduction is reduced dollar-for-dollar by the $2,000 excess over $50,000

B. $5,000, the full standard immediate deduction with no reduction for costs exceeding $50,000

C. $0, because start-up costs exceeding $50,000 forfeit the entire immediate deduction

D. $52,000, because all start-up costs are fully deductible in the year the business begins

4. Priya owns a 60% interest in Ridgeline Partnership. She sells investment land with a $40,000 basis to the partnership for its $30,000 fair market value, a $10,000 loss. Two years later, the partnership sells the land to an unrelated buyer for $46,000. How are these transactions reported?

A. Priya deducts the $10,000 loss immediately in the year of the original sale to the partnership

B. The partnership recognizes the full $16,000 gain on the later sale with no offset

C. Priya's $10,000 loss is disallowed, and the partnership recognizes only $6,000 of gain on resale

D. Neither Priya nor the partnership ever recognizes any gain or loss on either transaction

5. At year-end, Partner Alvarez has only $4,000 of remaining outside basis. The partnership allocates Alvarez a $6,000 ordinary loss and a $3,000 Section 1231 loss, totaling $9,000. Under the Section 704(d) ordering rules for multiple loss items, how is the $4,000 of allowable basis allocated between the two losses?

A. $2,667 of ordinary loss and $1,333 of Section 1231 loss, allocated proportionately between the items

B. $4,000 entirely to the ordinary loss, with the Section 1231 loss fully suspended

C. $4,000 entirely to the Section 1231 loss, with the ordinary loss fully suspended

D. Alvarez may choose freely which loss item to deduct up to the $4,000 basis limit

6. Marcus purchases a 25% interest in Talon Partners for $90,000; the partnership has no Section 754 election in effect. Fourteen months later, Talon distributes equipment with a $20,000 inside basis to Marcus in a nonliquidating distribution. If Marcus makes the election under Section 732(d), how is his basis in the distributed equipment determined?

A. $20,000, the partnership's unadjusted inside basis in the equipment, with no further adjustment

B. Partnership basis plus a special basis adjustment computed as if a Section 754 election had been in effect when Marcus purchased his interest

C. Marcus's full outside basis immediately before the distribution, regardless of the equipment's inside basis

D. The equipment's fair market value on the date of the distribution, without regard to basis

7. A partnership contributed property with built-in gain uses the curative allocation method rather than the traditional method to address a ceiling rule distortion caused by limited tax depreciation. Which statement correctly describes how the curative allocation method operates?

A. It caps total tax allocations at the amount of book items, exactly as the traditional method does

B. It allocates all Section 704(c) built-in gain to the contributing partner immediately, regardless of disposition

C. It creates offsetting distortions by allocating items entirely unrelated in character to the contributed property

D. It offsets the ceiling rule distortion through reasonable, limited allocations of other partnership items of the same character to the noncontributing partners

8. Harlan gifts a 20% limited partnership capital interest in Redwood Farms LP, where capital is a material income-producing factor, to his 16-year-old son. However, Harlan retains sole check-writing authority over the son's capital account, uses distributions attributable to the interest to pay his own personal bills, and never gives the son access to partnership records. What is the tax result?

A. The gift is respected for tax purposes as long as the transfer is documented in writing

B. The gift is automatically respected because capital is a material income-producing factor in the business

C. The IRS may disregard the purported gift and continue taxing Harlan, because retained dominion and control defeats recognition of a bona fide transfer under the family partnership rules

D. The transfer is respected, but only half of the related income is reportable by the son

9. Dana operates a sole proprietorship as a full-time real estate developer, spending 1,900 hours a year materially participating in that trade. She also owns several rental properties in which she materially participates in management decisions. Her only other income is $8,000 from an unrelated part-time consulting job. How are losses from Dana's rental real estate activities treated?

A. As passive losses limited to the $25,000 special allowance regardless of her participation level

B. As passive losses that are fully suspended because rental activities are always per se passive

C. As subject only to the at-risk rules, since the passive activity rules never apply to real property

D. As nonpassive, because Dana qualifies as a real estate professional under Section 469(c)(7) and materially participates in the rental activities

10. Two individuals co-own an unimproved parcel held strictly for investment, sharing income and deductions in proportion to their ownership interests, and wish to file an annual election excluding the arrangement from partnership tax treatment. What condition must be satisfied for a valid election under Section 761(a)?

A. The venture must be used only for investment or mineral extraction under a joint operating agreement, must not conduct an active trade or business, and each co-owner must be able to compute income separately

B. The venture must have fewer than 100 total participants and must also elect out of the centralized BBA audit regime

C. The venture must first be organized as a state-law limited liability company before the election becomes available

D. The election is available to any persons carrying on a trade or business together, provided they timely file Form 1065 in the first year

11. Which of the following partnerships is eligible to elect out of the centralized BBA partnership audit regime for the tax year under Section 6221(b)?

A. A partnership with 150 total partners, all of whom happen to be individuals

B. A partnership with 60 partners, one of which is a disregarded single-member LLC entity

C. A partnership with 90 partners consisting only of individuals, C corporations, eligible S corporations, and eligible estates, issuing no more than 100 K-1s

D. A partnership with 40 partners, one of which is itself another partnership

12. A partnership sells fully depreciated equipment, originally costing $50,000 with an adjusted basis of $0, for $18,000. How is this gain characterized and reported to the partners?

A. $18,000 of Section 1231 gain, eligible for long-term capital gain treatment for all partners

B. $18,000 of ordinary income under Section 1245 depreciation recapture, reported separately to each partner

C. $18,000 of unrecaptured Section 1250 gain, taxed at a maximum 25% rate for all partners

D. No gain is recognized because the equipment's adjusted basis was already reduced to zero

13. A partnership makes a nonliquidating cash distribution to Partner Reyes that disproportionately reduces Reyes's share of the partnership's unrealized receivables relative to Reyes's overall interest, with no inventory involved in the transaction. What is the tax consequence of this distribution?

A. No consequence results, because Section 751(b) applies only to substantially appreciated inventory, never to unrealized receivables

B. The distribution is automatically treated as a complete liquidation of Reyes's entire partnership interest

C. Reyes is treated as exchanging a proportionate share of unrealized receivables for the cash received, triggering ordinary income under Section 751(b)

D. The distribution is entirely tax-free because unrealized receivables always carry a zero basis to the partnership

14. A partnership with 6 partners files its Form 1065 four months late, with no extension filed and no reasonable cause established. Using a per-partner, per-month penalty rate of $220, what is the total Section 6698 penalty?

A. $220 total, a flat fee applied regardless of the number of partners or months late
B. $220, applying the monthly rate only once without multiplying by the number of partners
C. $880, applying the monthly rate for four months but without multiplying by the partner count
D. $5,280, applying the monthly rate to each partner for each month the return was late

15. Meridian Partners has a $60,000 debt forgiven by a creditor during the year, resulting in cancellation of debt (COD) income. One of Meridian's partners, Reyes, is personally insolvent immediately before the discharge and wants to exclude her allocable share of this COD income from taxable income. At what level is the Section 108 insolvency exclusion applied to determine whether Reyes may exclude her share?

A. The COD income and its character are determined at the partnership level, but each partner separately applies the Section 108 insolvency exclusion based on that partner's own individual financial condition
B. At the partnership level; if the partnership itself is insolvent, all partners automatically exclude their entire allocable share of the COD income
C. Partnerships and their partners are categorically ineligible for the Section 108 insolvency exclusion under any circumstances
D. The exclusion is available only if every partner in the partnership is simultaneously insolvent immediately before the discharge

16. A married couple operates a bakery together as the only two owners, both materially participate, and they file a joint return. The business is held in the name of a state-law limited liability company with both spouses as members. Can the couple use the qualified joint venture election for this business?

A. Yes, because both spouses materially participate and file jointly, so the entity's legal form is irrelevant
B. No, because the qualified joint venture election is unavailable when the business is held through a registered state-law limited liability entity such as an LLC
C. Yes, but only if they additionally file Form 8832 to affirmatively elect qualified joint venture treatment
D. No, because the qualified joint venture election is available only to businesses operated in the agricultural sector

17. A partnership fails to designate a partnership representative on its timely filed Form 1065 for the year under a BBA audit. What happens under the centralized partnership audit regime?

A. The IRS may select any eligible person, including a partner or a qualifying non-partner, to serve as the partnership representative for that year

B. The audit cannot proceed until the partnership designates a representative, indefinitely suspending the statute of limitations

C. Each partner is automatically deemed the partnership representative with respect to that partner's own share of any adjustment

D. The partnership is automatically treated as having elected out of the BBA regime for that year

18. Maya operates a tax preparation practice, a specified service trade or business, as a sole proprietor. Her 2025 taxable income before the Section 199A deduction is well above the SSTB phase-out range for her filing status. Which statement correctly describes her qualified business income deduction for this business?

A. She may still claim the full 20% deduction, because sole proprietors are exempt from the SSTB limitation

B. Because her taxable income exceeds the SSTB phase-out range, her deduction for this business is completely eliminated, regardless of W-2 wages paid or UBIA of qualified property

C. Her deduction is limited only to 50% of W-2 wages paid, since the SSTB restriction does not apply to sole proprietorships

D. She may claim half of the normal 20% deduction because her income falls within the phase-in range

19. Four individuals form Zenith Corp. Three transfer equipment and cash in exchange for stock. The fourth performs only organizational and legal services for the corporation and receives stock worth $20,000 in return, transferring no property. Immediately after the exchange, the four hold 100% of Zenith's stock. What is the correct tax treatment, and does the group satisfy the Section 351 control requirement?

A. The services shareholder recognizes no income, and all four are treated as members of the control group for Section 351 purposes.

B. The services shareholder recognizes capital gain equal to the stock's value, but she is still counted toward the control group.

C. Section 351 boot rules apply, deferring recognition of her income until she later sells the Zenith stock she received.

D. The services shareholder recognizes ordinary compensation income and is excluded from the control group test unless she also transfers property of more than nominal value.

20. Harbor Corp is a valid S corporation. The current shareholders want to admit a new investor who is a nonresident alien individual living abroad, offering him a 15% stock interest. What is the tax consequence of admitting this shareholder?

A. Permitted without issue, provided the nonresident alien owns less than 20% of Harbor's outstanding shares at all times.
B. Permitted only if a US citizen shareholder co-signs a domestic agent agreement filed with the IRS on the nonresident alien's behalf.
C. Not permitted; a nonresident alien is an ineligible shareholder, and admitting him terminates the S election immediately as of that date.
D. Permitted only if his share of income is subject to mandatory 30% withholding under the FDAP income rules.

21. The shareholders of Ferry Corp, an S corporation, sell 100% of their stock to Nolan, an unrelated individual buyer, in a single qualifying disposition. Because Nolan is an individual rather than a corporation, a Section 338(h)(10) election is unavailable. The parties still want the transaction treated, for tax purposes, as if Ferry had sold its assets rather than its stock. Which mechanism accomplishes this?

A. A unilateral Section 338(g) election made by Nolan as the purchasing party after closing.
B. A joint Section 338(h)(10) election filed by both Ferry's selling shareholders and Nolan as purchaser.
C. A Section 336(e) election made by Ferry's selling shareholders, permitting deemed asset sale treatment even though the purchaser is not a corporation.
D. No such election exists; the transaction must remain a stock sale for federal tax purposes.

22. Alpha Corp owns 90% of the single class of stock of Beta Corp, a straightforward parent-subsidiary relationship. Separately, the same two individuals own 60% of Alpha and 60% of Gamma Corp in identical proportions to each other, satisfying the brother-sister ownership test. Are Alpha, Beta, and Gamma treated as a single controlled group for tax bracket apportionment purposes?

A. Yes — a combined group exists under Section 1563(a)(3) because Alpha is common parent of a parent-subsidiary group and also a member of a brother-sister group with Gamma.

B. No — a corporation cannot simultaneously belong to a parent-subsidiary group and a brother-sister group under the controlled group rules.

C. No — combined groups under Section 1563 require at least four separate corporations to exist.

D. Yes, but only Alpha and Gamma combine; Beta is excluded because individuals do not directly own its stock.

23. Calendar-year Trove Corp begins the year with $10,000 of accumulated E&P and generates $40,000 of current E&P for the year. It distributes $30,000 to shareholders in March and another $30,000 in October, with no other distributions. How should E&P be allocated between the two distributions to determine dividend treatment?

A. All current E&P applies first to the March distribution, and accumulated E&P applies only to the October distribution.

B. Current E&P ($40,000) is allocated pro rata between the two distributions ($20,000 each) regardless of timing; accumulated E&P ($10,000) is then applied first to the earliest distribution.

C. Accumulated E&P is allocated pro rata first between both distributions, and current E&P is used only if accumulated E&P proves insufficient.

D. Both distributions are entirely nontaxable returns of capital, since total E&P is less than total distributions made.

24. An individual owns all 100 shares of Liquid Corp, with a stock basis of $50,000. In a complete liquidation, she receives $20,000 cash plus a parcel of land with a fair market value of $90,000 (Liquid's adjusted basis in the land was $60,000). What gain does she recognize, and what is her basis in the land received?

A. Liquid Corp recognizes a $110,000 loss on the distribution, and her land basis carries over from the corporation at $60,000.

B. She recognizes no gain because complete liquidations automatically qualify as tax-free reorganizations, and her land basis carries over at $60,000.

C. She recognizes $40,000 of ordinary compensation income, and her basis in the land is its $90,000 fair market value.

D. She recognizes a $60,000 capital gain ($110,000 total value received minus her $50,000 stock basis), and her land basis is its $90,000 fair market value.

25. An acquiring corporation wants to use a merger subsidiary to acquire an unrelated target company. Which statement correctly distinguishes a forward triangular merger from a reverse triangular merger, both structured to qualify under Section 368(a)(2)(D) or (E)?

A. In a forward triangular merger the target survives as the operating entity; in a reverse triangular merger the acquiring subsidiary survives instead.

B. In a forward triangular merger the target merges into the acquirer's subsidiary, which survives holding substantially all target assets; in a reverse triangular merger the subsidiary merges into target, which survives as the acquirer's subsidiary.

C. Forward triangular mergers always require boot to be distributed; reverse triangular mergers must always be structured solely for voting stock.

D. Forward triangular mergers are available only to S corporation targets; reverse triangular mergers are available only to C corporation targets.

26. Anchor Corp has two classes of common shareholders. This year, Anchor distributes additional shares of common stock to Class A shareholders while distributing cash to Class B shareholders, both classes receiving amounts proportionate to their existing holdings within their own class. As a result, Class A shareholders' proportionate interest in Anchor's assets and earnings increases relative to Class B shareholders. How is the stock distribution to Class A shareholders treated?

A. Entirely tax-free under the general rule that stock dividends are excluded from gross income

B. Taxable only to the extent the stock's fair market value exceeds the cash paid to Class B shareholders

C. Tax-free because both classes received distributions proportionate to their own holdings within each class

D. Taxable under Section 305(b)(2) as a disproportionate distribution, because it results in some shareholders receiving cash while others receive an increased proportionate interest in the corporation

27. Coastal Corp converted from C to S status and is still within its Section 1374 recognition period. In year three, it sells an asset held at conversion, recognizing a $50,000 built-in gain, its only built-in gain item for the year. Coastal's taxable income computed as if it remained a C corporation for the year is $200,000. What is the built-in gains tax owed?

A. $10,500 — 21% of the $50,000 recognized built-in gain, since it does not exceed the $200,000 taxable income limitation.

B. $50,000, taxed entirely at the individual shareholders' ordinary rates, since the built-in gains tax was repealed for conversions after 2017.

C. $42,000 — 21% applied to the full $200,000 taxable income limitation rather than the actual recognized gain.

D. No tax is owed at all, because shareholders, not the corporation, are directly liable for any built-in gains tax.

28. Meridian LLC, a two-member domestic LLC, filed Form 8832 electing to be classified as a corporation, effective January 1 of Year 1. In Year 2, its members decide they would rather revert to the default partnership classification. What limitation governs this change?

A. None; entity classification elections under the check-the-box regulations may be freely changed every year without restriction.

B. The election may change only if all members unanimously consent in writing filed with the IRS within 30 days of the request.

C. Generally, the entity cannot elect a new classification again for 60 months from the prior election's effective date, absent a greater-than-50% ownership change or IRS consent.

D. The corporate election is permanent once made, and the LLC can never again be classified as a partnership.

29. A shareholder owns 400 of 1,000 outstanding shares of Bracken Corp (40%) before a redemption. Bracken redeems 250 of her shares in a single transaction, leaving 750 shares outstanding, of which she now holds 150 (20%). No family attribution issues apply. Does this redemption qualify as substantially disproportionate under Section 302(b)(2)?

A. No, because her post-redemption ownership percentage still exceeds 50% of her original pre-redemption percentage.

B. Yes — her post-redemption percentage (20%) is below both 50% and 80% of her pre-redemption percentage (32%), satisfying the mechanical safe harbor.

C. No, because Section 302(b)(2) applies only where the shareholder's entire interest is completely terminated.

D. Yes, but only if she also files a family attribution waiver agreement under Section 302(c)(2) with her return.

30. Newco is formed and becomes a member of an existing controlled group on November 1 of the group's calendar tax year. For purposes of apportioning the controlled group's graduated tax brackets among its members for that year, how is Newco treated?

A. Newco is included as a full component member and shares completely in the group's apportioned tax brackets for the entire year.
B. Newco must file a separate short-period return and is permanently excluded from controlled group status in every future year.
C. Newco is automatically treated as a parent-subsidiary member for the year regardless of actual ownership percentages held.
D. Newco is excluded as a component member for that year because it was a member for less than one-half the days in the group's tax year.

31. Ridge Corp, a calendar-year S corporation, makes a $10,000 cash charitable contribution during the year to a qualified public charity. How is this contribution reported to shareholders, and how are any deduction limitations applied?

A. The contribution is deducted at the corporate level in computing ordinary business income, and income is then passed through net of that deduction.
B. The contribution has no tax effect because S corporations are statutorily barred from making deductible charitable contributions of any kind.
C. The contribution is a separately stated item passed through pro rata to shareholders, who each apply their own individual AGI-based percentage limitations.
D. The contribution is treated as a nondeductible distribution that reduces each shareholder's stock basis dollar for dollar, with no deduction allowed.

32. An existing shareholder of Vault Corp contributes a parcel of land, fair market value $80,000 and his adjusted basis $30,000, directly to the corporation without receiving any additional stock or other consideration in return, simply to strengthen the corporation's balance sheet. What are the tax consequences of this contribution?

A. Vault Corp recognizes no income under Section 118, and its basis in the land equals the shareholder's carryover basis of $30,000.

B. Vault Corp recognizes $50,000 of taxable income because no stock was issued to the shareholder in exchange for the property.

C. The shareholder recognizes a $50,000 gain, since contributions made without receiving stock are treated as taxable sales to the corporation.

D. Vault Corp's basis in the land becomes its $80,000 fair market value, since capital contributions are treated as purchases at value.

33. Which of the following statements correctly describes the scope of tax attribute carryover, such as net operating loss carryovers, under Section 381?

A. Every reorganization qualifying under Section 368 results in complete carryover of the target's tax attributes to the acquiring corporation.

B. Carryover applies to Type A, C, acquisitive D, F, and nondivisive G reorganizations, but a Type B reorganization triggers no carryover because the target survives as a subsidiary retaining its own attributes.

C. Type E recapitalizations always result in the complete forfeiture of the corporation's existing net operating loss carryovers.

D. Section 381 carryover applies exclusively to capital loss carryovers and never extends to net operating loss carryovers.

34. An LLC member taxed as a partner has an outside basis of $60,000, which includes $35,000 attributable to her share of the LLC's nonrecourse debt that does not qualify as qualified nonrecourse real property financing. Her distributive share of the LLC's loss for the year is $50,000. Under the Section 465 at-risk rules, how much of the loss may she currently deduct?

A. Only $25,000 — the deduction is limited to her at-risk amount, which excludes the $35,000 of non-qualifying nonrecourse debt.

B. The full $50,000, because outside basis under Section 704 is the sole limitation applicable to partnership and LLC losses.

C. Only $35,000, because her at-risk amount is considered equal to her share of the nonrecourse debt itself.

D. None of the loss, because any nonrecourse financing automatically eliminates all current-year loss deductions for LLC members.

35. An LLC member holds a 10% capital interest, contributed only cash, has no management rights or authority under the operating agreement, performs no services for the LLC, and receives no guaranteed payments of any kind. Is her distributive share of the LLC's ordinary business income subject to self-employment tax?

A. Yes, because every member of an LLC is automatically treated as a general partner for self-employment tax purposes regardless of role.

B. Yes, because any income earned through an active trade or business conducted via an LLC is per se subject to self-employment tax.

C. No, but only if she formally and affirmatively elects out of partnership tax treatment under Section 761(a) for the year.

D. Generally no — under the functional Section 1402(a)(13) analysis, a member with no management authority and no services performed is treated like a limited partner, excluding her share from SE tax.

36. Meridian Fabricators, an accrual-method C corporation, voluntarily changes its method of accounting for inventory costs, resulting in a positive Section 481(a) adjustment that increases taxable income by $80,000 in the year of change. Under the general rule for accounting method changes, how must Meridian report this adjustment?

A. The entire $80,000 must be included in income in the year of change, with no spread allowed.

B. Meridian may elect to spread the adjustment over any period up to ten years.

C. The $80,000 must be spread evenly over four tax years, beginning with the year of change.

D. The adjustment is spread over four years only if Meridian first obtains IRS advance consent.

37. Bramwell Properties, an accrual-method commercial landlord, receives a $36,000 check in December for rent covering the following 12-month lease period. Bramwell also receives a separate $3,000 refundable security deposit from the same tenant. For the year of receipt, how must Bramwell treat these amounts?

A. Both amounts are deferred under the advance payment rules until the related lease period occurs.

B. The rent is deferred one year under Rev. Proc. 2004-34, and the deposit is excluded from income.

C. Both amounts must be included in gross income immediately upon receipt, with no exclusion for either.

D. The full $36,000 rent is included in income upon receipt; the $3,000 deposit is excluded as a liability.

38. Coastal Hardware Supply, an accrual-method sole proprietorship, extended $18,000 of trade credit to a struggling customer. By year-end, based on the customer's bankruptcy filing, Coastal reasonably determines that only 40% of the debt will ever be collected. The debt arose from the sale of merchandise in the ordinary course of business. What is Coastal's proper tax treatment this year?

A. No deduction is allowed until the debt becomes completely worthless in a later year.

B. Coastal may deduct $10,800 as a partial worthlessness deduction using the specific charge-off method.

C. Coastal must treat the loss as a short-term capital loss subject to the $3,000 annual limit.

D. Coastal must establish a bad debt reserve and deduct an estimated percentage each year.

39. Yusuf owns 70% of Hartline Manufacturing, an accrual-method C corporation. In November, Hartline accrues $14,000 of interest expense on a loan from Yusuf, a cash-method individual. The interest remains unpaid as of December 31. Hartline wants to deduct the accrued interest this year. What rule governs?

A. Hartline cannot deduct the interest until it is actually paid, when Yusuf also includes it in income.

B. Hartline may deduct the interest this year because the all-events test and economic performance are both satisfied.

C. Hartline may deduct the interest this year as long as it pays Yusuf within 2.5 months.

D. Hartline may deduct half the interest this year and the remainder when paid to Yusuf.

40. Granite Peak Builders enters a three-year long-term construction contract that does not qualify for any small-contractor exception. By the end of Year 1, Granite Peak has incurred costs equal to only 6% of the total estimated contract costs. Under the percentage-of-completion method's 10% method election, how should Granite Peak report income from this contract for Year 1?

A. Granite Peak must still report income based on the 6% completion percentage under regular PCM rules.

B. Granite Peak must switch to the completed contract method for the entire contract term.

C. Granite Peak may elect to defer contract income until a year in which at least 10% of costs are incurred.

D. Granite Peak must report the full contract price as income in Year 1 regardless of completion percentage.

41. Priya sells business real property for a contingent payment based on the buyer's future rental income, with no stated maximum selling price and no reliable way to determine the fair market value of the contingent payment right at the time of sale. Under the installment sale contingent payment regulations, how should Priya report this sale?

A. Priya may use the rare open transaction method, recovering basis first and recognizing gain only once basis is fully recovered.
B. Priya must use the standard installment method with a fixed 15-year default payment period.
C. Priya must report the entire estimated gain in the year of sale under the closed transaction method.
D. Priya must treat the sale as a like-kind exchange to defer all gain recognition.

42. Fenwick Distributors uses the LIFO inventory method and stocks thousands of similar interchangeable parts. To reduce the risk of an unfavorable LIFO layer liquidation caused by shifts in product mix within similar item categories, which technique should Fenwick's tax advisor recommend?

A. Switching entirely to the specific identification method for valuing all items.
B. Adopting the lower of cost or market method in place of LIFO.
C. Valuing each individual inventory item separately using its own distinct LIFO layer.
D. Grouping similar items into dollar-value LIFO pools measured by total dollar value.

43. Ridgeline Retail wants to adopt a 52-53 week tax year that always ends on the Saturday nearest to January 31, for better alignment with its retail sales cycle. Which statement correctly describes this election?

A. A 52-53 week year must always end on the last calendar day of the elected month.
B. A 52-53 week year is not permitted for any C corporation, only for individuals.
C. The year runs 52 or 53 weeks and is treated as ending on the last day of the chosen month.
D. A 52-53 week year requires new IRS advance consent every single year it is used.

44. Danville Appliance Co., an accrual-method retailer, sells appliances and receives full payment in December for merchandise it will ship to the customer in January of the following year. Danville reports this sale as revenue for financial statement purposes in the year of shipment. Under the advance payment deferral method for the sale of goods, how should Danville report the payment for tax purposes?

A. Danville must include the entire payment in income in the year of receipt, with no deferral available for goods.

B. Danville may defer including the payment in income until the following year, matching its financial statement treatment.

C. Danville must defer the payment for exactly three years regardless of when the goods are shipped.

D. Danville may exclude the payment from income permanently since delivery occurs in a different tax year.

45. Palisade Electronics, an accrual-method manufacturer, sells products with a two-year warranty. At year-end, Palisade estimates $95,000 of future warranty repair costs based on historical claim rates and wants to deduct that estimate currently. No repairs have yet been performed and no payments have been made to claimants. May Palisade deduct the $95,000 estimate this year?

A. Yes, because the all-events test is fully satisfied once the obligation is reasonably estimable.

B. No, because economic performance occurs only when repairs are actually performed or payments are made.

C. Yes, but only up to 50% of the estimated future warranty costs.

D. No, because warranty repair costs are never deductible under any circumstances.

46. A fire destroys business equipment owned by Castellan Metalworks with an adjusted basis of $40,000. Castellan receives $65,000 in insurance proceeds and, within the replacement period, purchases similar equipment for $70,000. Which statement correctly describes the tax treatment of the $25,000 realized gain?

A. Castellan must recognize the entire $25,000 gain in the year the insurance proceeds are received.

B. Castellan must recognize $25,000 of loss because the replacement cost exceeded the insurance proceeds.

C. Castellan cannot elect deferral because Section 1033 applies only to real property, not equipment.

D. Castellan may elect under Section 1033 to defer the full gain since replacement cost meets or exceeds proceeds.

47. Thistle & Vine, a qualifying small business taxpayer under Section 448(c) with average annual gross receipts well under the applicable threshold, wants to simplify its inventory accounting. Under Section 471(c), which of the following correctly describes an available option?

A. Thistle & Vine must continue using full absorption costing under Section 263A regardless of its status.

B. Thistle & Vine must switch to the LIFO method to qualify for any inventory simplification.

C. Thistle & Vine may treat inventory as non-incidental materials and supplies, or conform to its financial statements.

D. Thistle & Vine may deduct the full cost of all inventory immediately upon purchase, regardless of when sold.

48. Hollow Creek Ranch raises cattle for sale and wants a simplified way to value its raised-livestock inventory without tracking the exact cost of feeding and raising each individual animal. Which inventory valuation method is designed for this purpose?

A. The unit-livestock-price method, which groups animals by class and age and applies a standard per-unit value.

B. The dollar-value LIFO method, which pools livestock by total dollar value across all classes.

C. The retail inventory method, which applies a cost-to-retail ratio used by retail merchandisers.

D. The lower of cost or market method, applied item-by-item to each individual animal.

49. Verity Consulting Group, currently on a calendar tax year, wants to change to a fiscal year ending June 30 but does not meet any automatic approval criteria under the applicable revenue procedure. What must Verity do to make this change?

A. Simply begin filing returns on the new fiscal year with no IRS notification required.

B. File Form 1128 and obtain IRS approval, showing a substantial business purpose, plus a short-period transition return.

C. Wait five years after formation before any change of tax year is permitted.

D. Change is automatically effective once a majority of partners or shareholders agree in writing.

50. Oakhurst Industries wants to change its accounting method for a specific item that is not included on the IRS's published list of automatic changes. What procedural consequence follows from this?

A. Oakhurst may still self-effectuate the change simply by filing Form 3115 with its timely filed return.

B. Oakhurst cannot change this accounting method at all under any circumstances.

C. Oakhurst must request advance non-automatic consent from the IRS national office, generally paying a user fee, before changing.

D. Oakhurst may make the change only if it first amends the two preceding tax years' returns.

51. Vantage Manufacturing sold a stamping press for $200,000. The press had an original cost of $180,000 and accumulated MACRS depreciation of $150,000 at the time of sale, resulting in an adjusted basis of $30,000. Vantage held the press for six years as Section 1245 property used in its trade or business. How should Vantage report the gain on this sale?

A. The entire $170,000 gain is ordinary income under Section 1245, since all depreciation recapture rules require full ordinary treatment on personal property dispositions.

B. The entire $170,000 gain is Section 1231 gain, because depreciation recapture never applies once the adjusted basis has been reduced below the original cost.

C. $30,000 of the gain is ordinary income under Section 1245, and the remaining $140,000 is Section 1231 gain eligible for long-term capital gain treatment.

D. $150,000 of the gain is ordinary income under Section 1245 (recapturing all depreciation claimed), and the remaining $20,000 is Section 1231 gain.

52. An EA is advising a client who sold an apartment building held for eight years, generating a $90,000 gain attributable entirely to MACRS depreciation deductions, all of which were computed using the straight-line method as required for residential rental property. Which statement correctly describes the depreciation recapture treatment?

A. Because MACRS requires straight-line depreciation for real property, there is no Section 1250 ordinary income recapture; the $90,000 is unrecaptured Section 1250 gain taxed at a 25% maximum rate.

B. Section 1250 recapture requires reporting all depreciation taken on real property as ordinary income regardless of the depreciation method used.

C. Real property is exempt from any depreciation recapture provisions because Section 1245 governs personal property exclusively.

D. Section 1250 recapture applies only when real property is sold at a loss, converting the loss into an ordinary deduction.

53. Dana is the sole shareholder and an active employee of Redwood Consulting, an S corporation engaged in a qualifying (non-SSTB) trade or business. The corporation pays Dana reasonable compensation of $110,000 as a W-2 wage and passes through $85,000 of ordinary business income to her on Schedule K-1. For purposes of computing Dana's qualified business income (QBI) deduction, how should these amounts be treated?

A. Both the $110,000 wage and the $85,000 pass-through income are included in QBI, since both derive from Dana's active participation in the S corporation.

B. Neither amount is included in QBI, because S corporation shareholder-employees are treated as self-employed individuals for QBI purposes.

C. Only the wage is included in QBI, and the pass-through income is instead treated as investment income excluded from the deduction.

D. The $110,000 wage is excluded from QBI as reasonable compensation, while the $85,000 pass-through income is included in QBI.

54. An architecture firm designs a new commercial office building that incorporates energy-efficient interior lighting, HVAC, and building envelope systems, achieving certified energy cost savings that qualify under Section 179D. Because the building is owned by a government entity that cannot use tax deductions, the designer of the system is permitted to claim the deduction instead. Which statement correctly describes this benefit?

A. Section 179D is a tax credit computed as a fixed percentage of total construction cost, not a per-square-foot deduction

B. The deduction may only be claimed by the building's owner and can never be allocated to a designer under any circumstances

C. Section 179D allows a deduction computed on a per-square-foot basis for qualifying energy-efficient commercial building property, and for government-owned buildings the designer primarily responsible for the system may be allocated the deduction

D. The deduction is permanently unavailable for any building owned by a tax-exempt or governmental entity

55. During the year, Vantage Machining continues paying its employee, a Reserve service member called to active duty, a portion of his regular civilian salary representing the difference between his military pay and his usual wages. Vantage is a small employer with fewer than 50 employees. What credit may Vantage claim for these differential wage payments?

A. The Section 45P differential wage payment credit, equal to 20% of up to $20,000 of differential wage payments made to each qualified employee

B. The Work Opportunity Tax Credit, computed as 40% of the first $6,000 of differential wage payments made

C. No credit is available; differential wage payments are simply deductible as ordinary compensation expense with no special credit

D. A dollar-for-dollar credit equal to 100% of all differential wage payments made during the year, with no dollar cap

56. As part of purchasing a competitor's dental practice, Dr. Ellison pays $40,000 specifically allocated to a three-year covenant not to compete signed by the selling dentist. Over what period must Dr. Ellison amortize this intangible asset for tax purposes?

A. Over the three-year contractual term of the covenant, matching the period during which the covenant restricts the seller's competition.

B. Ratably over 15 years, because covenants not to compete entered into in connection with acquiring a business are Section 197 intangibles.

C. Immediately as a current deduction in the year paid, since covenants not to compete are not treated as capital expenditures.

D. Over the remaining useful life of the dental practice's other tangible assets acquired in the same transaction.

57. A retail chain completes $500,000 of interior nonstructural improvements to leased nonresidential building space already in service, placing the improvements in service in the current year. The improvements meet the definition of qualified improvement property (QIP). Which statement correctly describes the property's eligibility for bonus depreciation under current law?

A. QIP is assigned a 15-year MACRS recovery period and is eligible for bonus depreciation, following the technical correction that fixed the original TCJA drafting error.
B. QIP is assigned a 39-year MACRS recovery period and is permanently ineligible for bonus depreciation under any circumstances.
C. QIP is eligible for bonus depreciation only if the taxpayer also elects Section 179 expensing on the same improvements in the same year.
D. QIP must be depreciated using the alternative depreciation system over 40 years, making it categorically ineligible for bonus depreciation.

58. Renata purchases a pickup truck for $55,000 and uses it 70% for her landscaping business and 30% for personal errands, properly substantiated by a mileage log. The truck qualifies as listed property. Because business use exceeds the 50% predominant-use threshold, which depreciation treatment is available to Renata?

A. None; listed property used partly for personal purposes is always required to use the straight-line method regardless of the business-use percentage.
B. Renata may claim 100% of MACRS depreciation and Section 179 expensing without any reduction for the 30% personal-use portion.
C. Renata may use accelerated MACRS (such as 200% declining balance) and elect Section 179 expensing, both limited to the 70% business-use percentage.
D. Renata must use ADS straight-line depreciation over the property's class life, applied to the full unadjusted basis before any business-use reduction.

59. A shopping center owner installs a new paved parking lot, drainage system, and outdoor lighting fixtures adjacent to an existing building, at a total cost of $240,000. These land improvements are depreciable and separate from the land itself. What MACRS recovery period and method generally apply?

A. A 39-year recovery period using the straight-line method, identical to the nonresidential building the improvements serve.
B. A 5-year recovery period using the 200% declining balance method, identical to most general business equipment.
C. A 7-year recovery period using the 200% declining balance method, identical to office furniture and fixtures.

D. A 15-year recovery period using the 150% declining balance method, the standard MACRS class for land improvements.

60. A parent corporation leases a warehouse to its wholly owned subsidiary under a 10-year lease with total rent of $1,200,000, structured so that rent is minimal in the early years and substantially higher in the later years, meeting the definition of a Section 467 rental agreement with increasing rent. Which method must generally be used to report the rental income and expense?

A. Both parties may use their regular overall cash or accrual method with no special adjustment required

B. Both parties must use the constant rental accrual method, reporting a level amount of rental income and expense each year regardless of the actual cash payment schedule

C. The lessor must report all $1,200,000 in the first year under the recurring item exception

D. The lease is automatically recharacterized as an installment sale of the warehouse rather than a lease

61. An employer hires a qualified veteran with a service-connected disability who was unemployed for a period exceeding six months in the year before hire, and the veteran works 500 hours during the first year of employment at qualifying wages. What is the maximum Work Opportunity Tax Credit the employer may claim for this hire?

A. $2,400, computed as 40% of the first $6,000 of qualified first-year wages, the standard WOTC target-group cap.

B. $9,600, computed as 40% of the first $24,000 of qualified first-year wages, the enhanced cap for this veteran category.

C. $4,800, computed as 25% of the first $19,200 of qualified first-year wages under the reduced-hours veteran formula.

D. $1,200, computed as a flat credit amount regardless of wages paid, applicable to all veteran hires under WOTC.

62. Nova Biotech, a qualified small business with average annual gross receipts of $2 million and no gross receipts for any year before the current five-year period, generates $30,000 of research credit under Section 41 in its current tax year but has no income tax liability against which to use it. What election is available to Nova to obtain benefit from this credit?

A. Nova may elect under Section 41(h) to apply up to $500,000 of the research credit against its employer portion of payroll taxes instead of income tax liability.

B. Nova must carry the entire $30,000 credit forward 20 years, since no payroll tax offset election exists for the research credit.

C. Nova may convert the research credit into a fully refundable credit against income tax by filing an accelerated refund claim with the IRS.

D. Nova may only use the credit against alternative minimum tax liability, since qualified small businesses are barred from the general business credit ordering rules.

63. A gravel pit has an adjusted basis of $450,000, with an estimated 900,000 tons of recoverable gravel remaining at the start of the year. During the year, 120,000 tons are extracted and sold. Using the cost depletion method, what is the depletion deduction for the year?

A. $450,000, because cost depletion allows the entire remaining basis to be deducted once extraction begins during the tax year.

B. $67,500, computed by applying a flat 15% statutory rate to the $450,000 adjusted basis.

C. $60,000, computed as ($450,000 ÷ 900,000 tons) × 120,000 tons extracted and sold during the year.

D. $120,000, computed by treating each ton extracted as worth $1 of depletion regardless of the property's basis.

64. In March of the current year, Priya sells publicly traded stock for a $200,000 long-term capital gain. Within 150 days of the sale, she invests the full $200,000 gain in a Qualified Opportunity Fund (QOF). What is the federal income tax effect of this investment on the current-year gain?

A. The gain is permanently excluded from income immediately upon investment in the QOF, with no future recognition event.

B. The gain must still be recognized in full in the current year; QOF investments only affect the character of future gains, not deferral of the original gain.

C. Only 50% of the gain may be deferred through a QOF investment, with the remaining 50% taxable in the current year.

D. Recognition of the $200,000 gain is deferred, generally until the earlier of the QOF investment's disposition or a statutorily specified date, because the investment was made within the required 180-day window.

65. A city condemns a warehouse used in Sam's business, paying him a $350,000 condemnation award. Sam's adjusted basis in the warehouse was $210,000, producing a $140,000 realized gain. Within the replacement period, Sam purchases a similar warehouse for $330,000. How should Sam treat the gain from this involuntary conversion?

A. Sam must recognize the entire $140,000 gain currently, since involuntary conversions of real property no longer qualify for nonrecognition treatment after the TCJA.

B. Sam recognizes gain only to the extent the condemnation award exceeds the cost of replacement property, or $20,000 ($350,000 − $330,000), electing to defer the remaining $120,000 under Section 1033.

C. Sam must recognize the full $140,000 gain as Section 1245 ordinary income, since condemnation awards are treated identically to voluntary sales for recapture purposes.

D. Sam may defer the entire $140,000 gain only if he reinvests in a Qualified Opportunity Fund within 180 days of receiving the condemnation award.

66. A sole proprietor pays an independent contractor $2,400 during the year for consulting services. The contractor never returns a completed Form W-9, and the sole proprietor has no way to obtain the contractor's taxpayer identification number. Under Section 3406, what is the sole proprietor's obligation regarding this payment?

A. Withhold and deposit 24% backup withholding from the payment because a valid TIN was not furnished.

B. Withhold and deposit 22% flat supplemental wage withholding until a TIN is provided.

C. Report the full payment on Form 1099-NEC and withhold no tax, since backup withholding applies only to interest and dividends.

D. Refuse to make any further payments until the contractor supplies a Social Security card as identification.

67. The IRS is computing the trust fund recovery penalty against a responsible person at a corporation that failed to remit payroll taxes for three quarters. Which amounts are included in the trust fund portion subject to the 100% penalty under Section 6672?

A. The employer's share of FICA tax plus FUTA tax owed for the delinquent quarters.

B. Total federal income tax, Social Security, and Medicare tax owed by both the employer and employee.

C. FUTA tax and federal income tax withheld from employee wages during the delinquent quarters.

D. Federal income tax withheld from employees plus the employee's share of Social Security and Medicare tax.

68. An employer paid FUTA-taxable wages to employees working in two states during the year, one of which is a credit reduction state for that year. Which form must the employer complete and attach to Form 940 to properly calculate the additional FUTA tax owed?

A. Schedule B (Form 941), Report of Tax Liability for Semiweekly Schedule Depositors.

B. Form 8027, Employer's Annual Information Return of Tip Income and Allocated Tips.

C. Schedule A (Form 940), Multi-State Employer and Credit Reduction Information.

D. Schedule H (Form 1040), Household Employment Taxes.

69. A self-employed consultant uses the actual expense method to compute her home office deduction. She repaints only her home office, at a cost of $400, and pays $6,000 in total home mortgage interest and utilities for the year. Her home office occupies 15% of the home's square footage. How should these two costs be treated?

A. The $400 repainting cost is fully deductible as a direct expense; the $6,000 in mortgage interest and utilities is allocated 15% as an indirect expense.

B. Both costs are indirect expenses and must be allocated using the 15% business-use percentage before any deduction is allowed.

C. Both costs are direct expenses and are fully deductible in the year paid without any allocation.

D. The $400 repainting cost must be allocated at 15%, while the $6,000 in mortgage interest and utilities is fully deductible as a direct expense.

70. An employer provides a company car to an employee who uses it for both business and personal errands. The vehicle's fair market value was $16,200 when first made available for personal use, and it is driven at least 10,000 miles annually and used primarily by employees. Which special valuation method may the employer use to value the employee's personal use for fringe benefit purposes?

A. The unadjusted basis depreciation method under Section 168(k).

B. The commuting valuation rule, regardless of the vehicle's value.

C. The cents-per-mile method, multiplying personal miles by the standard mileage rate.

D. The per diem lodging method used for travel away from home.

71. An employer awards a plaque and a $300 gift card to an employee for 20 years of service, given under a written, nondiscriminatory qualified plan award program. How much of this achievement award may be excluded from the employee's taxable wages?

A. The full award is excludable, because length-of-service awards are always tax-free regardless of form.

B. None of the award is excludable, since a gift card is a cash equivalent and cash equivalents never qualify for the exclusion.

C. Only the plaque is excludable; the $300 gift card is fully taxable regardless of the plan's terms.

D. The plaque is excludable up to fair market value, and the gift card is excludable if later exchanged for tangible property.

72. A restaurant owner terminates an employee who had worked there for eight months. Under federal recordkeeping rules for the employment eligibility verification process, how long must the employer retain that employee's Form I-9?

A. Three years from the employee's hire date only, regardless of when employment ends.

B. Four years from the date employment ends, matching the general employment tax retention period.

C. One year from the employee's hire date, since termination occurred within the first year.

D. Three years from the hire date or one year from termination, whichever date is later.

73. An employee's wages from a single employer reach $215,000 by November of the calendar year. Under the Additional Medicare Tax withholding rules, at what point must the employer begin withholding the additional 0.9% Medicare tax, and does the employer consider the employee's spouse's wages from a different employer in making this determination?

A. The employer withholds the additional tax from the first dollar of wages and must combine the withholding with the spouse's separate employer's withholding

B. The employer is never required to withhold Additional Medicare Tax; it is collected only through the employee's individual estimated tax payments

C. The employer must begin withholding the additional 0.9% once wages paid by that employer alone exceed $200,000 in the calendar year, without regard to the employee's filing status or a spouse's separate wages

D. The employer withholds only if the employee affirmatively requests it in writing on Form W-4

74. An employer's Section 125 cafeteria plan document allows employees to carry over up to $660 of unused health FSA funds into the next plan year. The employer also wants to add a 2.5-month grace period, allowing additional time to incur expenses using prior-year funds. Is this combination permitted?

A. Yes, because the carryover and grace period apply to different types of FSA funds and never overlap.

B. Yes, both features may operate together without limitation as long as the plan document allows it.

C. No, cafeteria plans are prohibited from offering either a carryover or a grace period under current guidance.

D. No, a health FSA may offer a carryover or a grace period, but not both, for the same plan year.

75. A business enters into a service agreement with a Certified Professional Employer Organization (CPEO) under Section 3511 to handle its workforce. For federal employment tax purposes, how is the CPEO treated with respect to wages it pays to the business's worksite employees?

A. The CPEO is treated as the employer of the worksite employees and is solely liable for applicable federal employment taxes on those wages.

B. The CPEO acts only as a reporting agent, while the client business remains solely liable for all employment taxes.

C. Liability for federal employment taxes is always split equally between the CPEO and the client business.

D. The CPEO has no employment tax responsibility unless the client business defaults on payment.

76. A business withheld backup withholding from several vendor payments during the year and also withheld federal income tax from a retiree's pension distribution. On which form does the business report and reconcile these nonpayroll withheld amounts?

A. Form 941, Employer's Quarterly Federal Tax Return.
B. Form 945, Annual Return of Withheld Federal Income Tax.
C. Form 944, Employer's Annual Federal Tax Return.
D. Form 940, Employer's Annual Federal Unemployment Tax Return.

77. A civilian employee, not a member of the Armed Forces, relocates for a new job, and the employer reimburses $4,000 of moving expenses under a written company policy. How must the employer treat this reimbursement for federal employment tax purposes?

A. Include the full $4,000 in taxable wages, subject to federal income tax withholding, FICA, and FUTA.
B. Exclude the full $4,000 from wages as a qualified moving expense reimbursement under Section 132.
C. Include $4,000 in wages for income tax purposes only, but exclude it from the FICA and FUTA wage bases.
D. Exclude the reimbursement from wages up to the IRS standard moving expense limit, taxing only the excess.

78. A self-employed contractor's home is not a qualifying home office under Section 280A. On a given day, she drives from home to her first job site, then to a second job site, and finally back home. Which portion of this daily travel is nondeductible commuting mileage?

A. All of the mileage for the day, since travel between multiple job sites is always considered commuting.
B. None of the mileage, because visiting more than one job site in a day converts all travel into business mileage.
C. Only the mileage between the first and second job sites is nondeductible commuting.
D. The mileage from home to the first job site and from the last job site back home; travel between the two job sites is deductible.

79. An employee claimed exempt status from federal income tax withholding on Form W-4 for the prior calendar year and still qualifies for exempt status this year. By what date must the employee furnish a new Form W-4 to continue claiming exempt status, and what happens if the deadline is missed?

A. April 15; if missed, the employer must withhold as if the employee were married filing jointly with no adjustments.

B. February 15; if missed, the employer must begin withholding as if the employee had not claimed exempt status.

C. January 31; if missed, the employer must suspend the employee's pay until a new form is received.

D. March 31; if missed, the prior year's exempt Form W-4 automatically remains valid for the entire new year.

80. At his death, a decedent had earned but uncollected sales commissions of $60,000 owed to him by his former employer. The employer paid this amount to the decedent's estate three months after death. How must this $60,000 be treated for federal income tax purposes?

A. It is not taxable to anyone because it was fully earned by the decedent before his death occurred

B. It must instead be reported on the decedent's own final Form 1040 for the year of death

C. It is income in respect of a decedent, taxed to the estate with the same character it had to the decedent, and a Section 691(c) deduction may offset related estate tax

D. It is treated as a distribution of principal and is therefore not taxable income to anyone at all

81. A decedent bought a $500,000 policy on his own life fifteen years before he died and, at purchase, immediately transferred all ownership rights to his daughter, who was the applicant, owner, and beneficiary from day one. The decedent never held any rights in the policy but continued voluntarily paying the annual premiums until his death. Is the death benefit included in his gross estate?

A. No, the proceeds are excluded because the decedent held no incidents of ownership in the policy, and merely paying premiums does not itself create an incident of ownership

B. Yes, the proceeds are fully included under Section 2042 solely because the decedent paid the premiums each year

C. Yes, because the 3-year rule pulls the proceeds back in whenever the insured paid any premium within 3 years of death

D. Only 50% is included because ownership and premium payment were split between two people

82. A tax-exempt organization has average annual gross receipts of $180,000 and total assets of $450,000 at year end. It is not a private foundation. Which annual information return may this organization use to satisfy its IRS filing requirement?

A. Form 990-N e-Postcard only, since receipts are below $200,000
B. Form 990-PF, since all exempt organizations under $500,000 in assets use this form
C. Form 990 (full version) only; no shorter alternative exists for organizations of this size
D. Form 990-EZ, because gross receipts are under $200,000 and total assets are under $500,000

83. An employee participates in her employer's profit-sharing (defined contribution) plan. This year, employer contributions plus her own elective deferrals allocated to her account total $75,000, and her compensation is $200,000. Which rule governs the maximum annual additions permitted to her account under Section 415(c)?

A. The limit is a flat 25% of compensation with no dollar ceiling, so up to $50,000 is allowed and the plan has exceeded it
B. The limit is the lesser of the annually indexed dollar cap or 100% of the participant's compensation for the year
C. There is no statutory limit on annual additions to a defined contribution plan account
D. The limit applies only to the employee's own elective deferrals, never to employer contributions

84. A rancher purchased breeding heifers two years ago for $1,200 each and has held them continuously for breeding purposes. This year she sells 20 of these purchased heifers for $1,800 each. Because these were purchased (not raised) and held for the required holding period, how is the gain on sale generally treated?

A. As Section 1231 gain eligible for capital treatment, subject first to recapture, since purchased breeding livestock held 24 months qualifies as Section 1231 property
B. As fully ordinary income because all livestock sold by any farmer is always treated as inventory
C. As a nondeductible personal capital loss because breeding stock is treated as personal-use property
D. As nontaxable because purchased livestock automatically qualifies for a tax-free like-kind exchange treatment

85. A taxpayer owns an interest in a publicly traded partnership (PTP) that produces a passive loss this year. The taxpayer also has passive income from an unrelated non-PTP rental real estate activity. Under the special PTP rules, how may the PTP's passive loss be used?

A. It may offset the taxpayer's passive income from the unrelated rental real estate activity

B. It may offset up to $25,000 of the taxpayer's active trade or business income for the year

C. It may only offset income from that same PTP; it cannot offset other passive income and instead carries forward until the PTP produces income or is disposed of

D. It is fully deductible against any income because PTPs are statutorily exempt from passive loss rules

86. A charitable remainder trust earns $5,000 of unrelated business taxable income (UBTI) this year from an investment in an operating partnership. Under Section 664(c), what is the consequence to the CRT?

A. The UBTI is simply folded into DNI and taxed to the income beneficiary like any other trust income

B. The CRT permanently loses its exempt status the first time it earns any amount of UBTI

C. There is no consequence, since charitable remainder trusts are never subject to the UBTI rules

D. The trust is subject to a 100% excise tax on the UBTI amount, effectively taxing away the unrelated business income earned

87. A wealthy individual wants to use a significant portion of her lifetime gift and estate tax applicable exclusion amount before it potentially decreases, while still preserving indirect access to the transferred funds through her spouse if needed. She creates an irrevocable trust for the benefit of her spouse and descendants, naming her spouse as a permissible discretionary beneficiary, and funds it with cash and securities. What estate planning technique does this describe?

A. A qualified terminable interest property (QTIP) trust, which requires all trust income be paid at least annually to the spouse

B. A Spousal Lifetime Access Trust (SLAT), which removes the gifted assets and future appreciation from both spouses' estates while allowing indirect access to trust funds through discretionary distributions to the beneficiary spouse

C. A grantor retained annuity trust (GRAT), which pays a fixed annuity back to the grantor for a term of years

D. A charitable remainder trust, which pays income to the spouse for life with the remainder passing to charity

88. An employer maintains a cash balance plan. Which statement correctly distinguishes a cash balance plan from a traditional defined benefit plan expressed as a monthly annuity formula?

A. A cash balance plan is actually a defined contribution plan governed by the Section 415(c) annual additions limit

B. Cash balance plan benefits must always be paid out as a lifetime annuity, never as a lump sum

C. A cash balance plan is a defined benefit plan expressing the promised benefit as a hypothetical account balance built from pay and interest credits, still subject to DB funding and PBGC rules

D. Cash balance plans are exempt from minimum funding standards because benefits resemble individual retirement accounts

89. A charitable lead trust, a type of split-interest trust, has both a charitable and a noncharitable beneficiary interest. Which annual return must this trust file with the IRS to report its financial activity, separate from any income tax filing that may also be required?

A. Form 990, the standard exempt organization return

B. Form 1041 only; no additional information return applies to split-interest trusts

C. Form 5227, Split-Interest Trust Information Return

D. Form 990-PF, the private foundation return

90. State veterinary authorities order a farmer to destroy his entire dairy herd because of a contagious disease outbreak, and he receives state indemnity payments. He uses the proceeds to purchase replacement dairy cattle within the applicable statutory replacement period. Which Code section allows him to defer recognizing gain on this forced destruction?

A. Section 1031, the ordinary like-kind exchange rules governing business property

B. Section 451(e), the one-year weather-related forced sale deferral election

C. Section 1231, the ordinary loss and gain recapture characterization provision

D. Section 1033, the involuntary conversion rules, deferring gain if qualifying replacement property is timely acquired

91. A taxpayer sells his entire interest in a passive rental activity, which carries $30,000 of suspended passive losses, to his adult son in a fully taxable arm's-length sale for fair market value. Under Section 469(g), what happens to the suspended losses?

A. The suspended losses are NOT freed up on this sale because the buyer is a related party; they remain suspended until the son disposes of the activity to an unrelated party

B. The suspended losses become fully deductible against any income in the year of sale because it is a complete disposition

C. The suspended losses automatically transfer to the son and become his own suspended losses to carry forward

D. The suspended losses are permanently forfeited and can never be used by either party

92. A complex trust has $20,000 of taxable interest income and $10,000 of tax-exempt municipal bond interest, for total fiduciary accounting income of $30,000. The trustee distributes $15,000 to the sole beneficiary during the year. Which statement correctly describes the character of income the beneficiary must report?

A. The entire $15,000 is deemed to come from taxable interest first, since tax-exempt income carries out last under the tier rules

B. The distribution carries out a proportionate share of both income types based on their relative shares of DNI, so the beneficiary reports $10,000 taxable and $5,000 tax-exempt

C. Tax-exempt income can never be carried out to a beneficiary and is always taxed at the trust level instead

D. The entire $15,000 distribution is treated as tax-exempt because trusts distribute tax-exempt income before taxable income

93. An estate elects special use valuation under Section 2032A for qualified farmland, reducing the reported value by $800,000. Beyond meeting the qualified use test, which additional requirement concerning participation in the farming operation must generally be satisfied?

A. Only the decedent personally, and never any family member, may have materially participated before death

B. The decedent or a family member must have materially participated in the farming operation for at least 5 of the 8 years preceding death, disability, or retirement

C. Material participation is unnecessary whenever the farmland is cash-rented out to any unrelated third party

D. Material participation need only be demonstrated for the single calendar year of the decedent's actual death

94. A small business maintains a SEP-IRA using the standard eligibility provisions permitted by law. Under these baseline SEP eligibility rules, which employee must be included in the plan for the current year?

A. An employee age 22 who worked for the employer in at least 3 of the immediately preceding 5 years, earning $850 this year

B. A 19-year-old employee who just started working for the employer this year and earned $10,000

C. An employee who earned only $500 this year, regardless of any years of prior service with the employer

D. A leased employee, who is always statutorily barred from participating in any qualified employer retirement plan

95. A tax-exempt hospital pays its chief executive officer, a covered employee, total compensation of $1.3 million for the year. No portion of this compensation is treated as an excess parachute payment. Under Section 4960, what is the tax consequence of paying compensation exceeding $1 million to this covered employee?

A. The excess compensation is simply added to the organization's unrelated business taxable income and taxed at corporate rates

B. No consequence applies to exempt organizations; the excise tax under Section 4960 applies only to for-profit corporations

C. The covered employee personally owes a 21% excise tax on the compensation exceeding $1 million

D. The exempt organization itself owes a 21% excise tax on the amount of compensation paid to the covered employee exceeding $1 million

96. A farmer receives a cost-share payment from a qualifying federal conservation program funding part of an approved conservation practice on her land. Under Section 126, if she elects to exclude the government's share of this payment from income, what is the required consequence?

A. The payment is always fully taxable, with no exclusion option ever available under any circumstances

B. The payment must be included in gross income but automatically qualifies for long-term capital gain rates

C. She may exclude the government's share attributable to a qualifying improvement that does not substantially increase the farm's annual income, but must reduce the property's basis by the excluded amount

D. The payment may be excluded only if the recipient farmer is over age 65 at the time of receipt

97. A taxpayer materially participates in Acme Partnership and separately loans Acme $50,000, receiving $4,000 of interest income during the year. The taxpayer also owns an unrelated rental activity generating passive losses. Under the self-charged interest rules of Reg. Section 1.469-7, how may the $4,000 of interest income be treated?

A. As portfolio income only, permanently ineligible for any offset against passive activity losses

B. As active trade or business income, taxed identically to the taxpayer's regular wages

C. As passive activity income to the extent Acme's matching interest deduction is treated as passive, allowing an offset against other passive losses

D. As excluded entirely from gross income under a reciprocal self-charged-loan disregard rule

98. A 401(k) plan permits in-service distributions. An active employee who has reached age 59½ but has not separated from service wants to withdraw a portion of her vested account balance while still employed. Which statement correctly describes this withdrawal?

A. In-service withdrawals are never permitted from any 401(k) plan under any circumstances or plan design

B. The withdrawal is automatically subject to the 10% penalty regardless of the employee's actual age

C. In-service withdrawals remain prohibited until the plan's stated normal retirement age is reached, even past 59½

D. If the plan document permits it, she may withdraw without the 10% penalty, though ordinary income tax still applies while employed

99. A grantor establishes a trust for her children's benefit but retains the unrestricted power, exercisable at any time, to revoke the trust and reclaim all trust assets for herself. How is this trust treated for federal income tax purposes?

A. The trust is a grantor trust under Section 676 because the grantor retains power to revest assets in herself, so all items are reported on her own Form 1040

B. The trust is a complex trust that must file its own Form 1041 and pay tax at compressed trust rates

C. The trust is automatically classified as simple because all of its income must be distributed currently each year

D. The revocation power affects only estate tax treatment and has no bearing on income tax treatment at all

100. A decedent's estate made a QTIP election on property passing into a trust for his surviving spouse's lifetime benefit, which qualified the property for the marital deduction on his estate tax return. When the surviving spouse later dies, how is this QTIP trust property treated for her estate tax purposes?

A. It is excluded from the surviving spouse's gross estate because the marital deduction already applied when the first spouse died

B. It is included in the surviving spouse's gross estate under Section 2044 at its date-of-death value, because the QTIP election deferred, rather than eliminated, estate taxation until the surviving spouse's death

C. It is included in her estate only if she remarried before her own death

D. It is treated as a taxable gift made by the surviving spouse rather than as property in her estate

Answer Key and Explanations — Practice Exam 22, Part 2: Businesses

1. D — Basis Ordering Rule: Under Section 705(a) and Reg. 1.704-1(d)(2), outside basis is increased for allocated income ($8,000+$3,000=$11,000) and decreased for distributions ($11,000-$5,000=$6,000) before the loss limitation of Section 704(d) is tested. Foster may therefore deduct only $6,000 of the $9,000 allocated loss this year; the remaining $3,000 is suspended and carried forward indefinitely until basis is restored.

2. B — Retired Partner Exclusion. Section 1402(a)(10) excludes payments to a retired partner from self-employment income when made under a written retirement plan providing periodic payments, the partner renders no post-retirement services, and no obligation remains for his share of capital. All conditions are met, so Foster's payments escape SE tax entirely, unlike an ordinary distributive share.

3. A — Section 195 Start-Up Deduction: The $5,000 immediate deduction phases out dollar-for-dollar once cumulative start-up costs exceed $50,000. Priya's costs exceed that threshold by $2,000, reducing her immediate deduction to $3,000. The remaining $49,000 of costs is then amortized ratably over 180 months, beginning with the month in which the active trade or business actually commences operations.

4. C — Related-Party Loss Disallowance: Under Section 707(b)(1), a loss on a sale between a partner owning more than 50% and the partnership is disallowed. When the partnership later sells at a gain, Section 707(b) reduces the recognized gain by the previously disallowed loss, so only $6,000 ($16,000-$10,000) of gain is taxable.

5. A — Pro Rata Loss Allocation: Reg. 1.704-1(d)(2) requires that when basis is insufficient to absorb all allocated losses, the deductible amount is allocated proportionately among the loss items based on their relative size, not by partner election or a first-in ordering. Here, $4,000 is split 6,000/9,000 and 3,000/9,000 between the items.

6. B — Section 732(d) Special Election: A partner who purchased an interest and receives a distribution within two years may elect to compute the basis of distributed property as if the partnership had a Section 754 election in effect at the time of purchase, effectively giving the transferee the benefit of a hypothetical basis adjustment even absent an entity-level election.

7. D — Curative Allocation Method: Under Reg. 1.704-3(c), curative allocations correct ceiling rule distortions by allocating other partnership tax items of the same character — such as additional depreciation or ordinary income — to the noncontributing partners, up to the amount of the distortion. Unlike the traditional method, it is not capped by the ceiling rule.

8. C — Bona Fide Gift Requirement: Section 704(e) and its regulations require that a family member's capital interest be a genuine transfer of ownership. Retaining control over the account, diverting distributions, and denying access to records show the son never truly owned the interest, so the IRS may disregard the gift and tax Harlan on the income.

9. D — Real Estate Professional Exception: Section 469(c)(7) removes rental real estate from the per se passive category for a taxpayer who performs more than 750 hours and more than half of total personal service time in real property trades in which they materially participate. Because Dana also materially participates in the rentals, the losses are nonpassive and fully deductible.

10. A — Section 761(a) Election Out: Unincorporated organizations used for investment purposes (or joint operation, ownership, or leasing of mineral property) may elect out of Subchapter K if the participants can compute their own income without needing partnership-level computations and the venture is not actively conducting a trade or business. Active operating businesses do not qualify.

11. C — BBA Opt-Out Eligibility: Section 6221(b) allows an opt-out only for partnerships issuing 100 or fewer Schedules K-1 (counting each S corporation shareholder) to eligible partners — individuals, C corporations, eligible S corporations, and estates of deceased partners. Partnerships, trusts, and disregarded entities as partners disqualify the election, and exceeding 100 K-1s or partners also disqualifies it.

12. B — Section 1245 Recapture: Gain on disposition of depreciable personal property is ordinary income to the extent of depreciation previously allowed or allowable, up to the amount realized. Since the entire $50,000 cost was recovered, the full $18,000 gain is Section 1245 ordinary income recapture, separately stated and passed through to the partners on Schedule K-1.

13. C — Section 751(b) Hot Assets: Section 751(b) applies to a disproportionate distribution shifting a partner's share of either substantially appreciated inventory or unrealized receivables, not inventory alone. Reyes is treated as receiving a deemed exchange of receivables for cash, generating ordinary income to the extent the distribution shifts Reyes's proportionate share to the remaining partners.

14. D — Section 6698 Late-Filing Penalty: The penalty equals the monthly rate multiplied by both the number of partners and the number of months (or fraction) the return is late, up to twelve months. Here, $220 × 6 partners × 4 months equals $5,280, unless the partnership establishes reasonable cause or qualifies for a small-partnership abatement.

15. A — Partner-Level Insolvency Determination. A partnership's COD income and character are determined at the entity level, but the Section 108 insolvency exclusion is applied separately by each partner based on that partner's own individual financial condition, not the partnership's. Reyes may exclude her share only if she personally was insolvent immediately before the discharge, regardless of the partnership's status.

16. B — Qualified Joint Venture Limitation: The QJV election under Section 761(f) is available only for an unincorporated business co-owned directly by spouses; it cannot be used when the business is held in the name of a state-law entity providing limited liability, such as an LLC, because that arrangement is treated as a partnership or disregarded entity instead.

17. A — IRS Selection of Representative: If a partnership does not designate a partnership representative meeting the eligibility requirements (including a substantial U.S. presence), Section 6223 authorizes the IRS to select any eligible person, whether or not a partner, to act as the partnership representative for purposes of that year's audit and any resulting proceedings.

18. B — SSTB Phase-Out: Under Section 199A, once taxable income exceeds the applicable SSTB phase-out range, the qualified business income deduction for a specified service trade or business — including tax preparation — is reduced to zero entirely, regardless of W-2 wages paid or the unadjusted basis of qualified property, unlike non-SSTB businesses subject to the wage/UBIA limits.

19. D — Stock-for-services exclusion: under Reg. 1.351-1, stock received solely for services does not count toward the 80% control requirement, and the recipient recognizes ordinary compensation income under Section 83 rather than deferred gain. The remaining transferors must independently satisfy the control test using only stock issued for property, since services never qualify as property.

20. C — Ineligible shareholder rule: Section 1361(b)(1)(C) limits S corp shareholders to individuals other than nonresident aliens, certain estates, and qualifying trusts. A nonresident alien can never be an eligible shareholder regardless of ownership percentage, withholding arrangements, or co-signing agreements, so admitting one automatically and immediately terminates Harbor's S election on that date.

21. C — Section 336(e) deemed sale: unlike Section 338(h)(10), which requires a corporate purchaser completing a qualified stock purchase, Section 336(e) lets the selling shareholders unilaterally elect deemed asset sale treatment even when the buyer is an individual, partnership, or otherwise ineligible under Section 338, provided at least 80% of the stock is disposed of within a 12-month period.

22. A — Combined controlled group: Section 1563(a)(3) recognizes a combined group when a corporation is common parent of a parent-subsidiary group and simultaneously a member of a brother-sister group with another corporation. Alpha's dual role links Beta and Gamma into one controlled group, so all three share the group's apportioned tax brackets rather than each claiming a full bracket.

23. B — E&P allocation to multiple distributions: current E&P is allocated pro rata among all distributions made during the year regardless of timing, per Reg. 1.316-2. Accumulated E&P, by contrast, is applied chronologically, absorbed by the earliest distribution first until exhausted, so the March distribution draws on it before the October distribution does.

24. D — Shareholder gain on liquidation: under Section 331, a shareholder recognizes capital gain or loss equal to the FMV of everything received minus stock basis, treated as full payment in exchange for the stock. Here $20,000 plus $90,000 minus $50,000 equals a $60,000 gain, and her basis in distributed property becomes its FMV under Section 334(a), not a carryover basis.

25. B — Forward versus reverse triangular merger: in a forward triangular merger under Section 368(a)(2)(D), target merges into the acquirer's subsidiary, which survives holding target's assets. In a reverse triangular merger under Section 368(a)(2)(E), the subsidiary merges into target, which survives as the acquirer's subsidiary. Both require control and continuity of interest, but the surviving entity differs structurally.

26. D — Disproportionate Stock Dividend. Section 305(b)(2) taxes an otherwise tax-free stock dividend when the distribution results in some shareholders receiving cash or property while other shareholders' proportionate interests in corporate assets or earnings increase. The comparison is made across the entire shareholder group, not merely within each class separately, so Class A's stock dividend is taxable.

27. A — Built-in gains tax computation: Section 1374 taxes recognized built-in gain during the recognition period at the highest corporate rate, currently 21%, limited to taxable income computed as if the corporation remained a C corporation. Since the $50,000 recognized gain is below the $200,000 income ceiling, the full amount is taxed at the corporate level: 21% times $50,000 equals $10,500.

28. C — Sixty-month classification lock: once an eligible entity affirmatively elects its classification on Form 8832, Reg. 301.7701-3(c)(1)(iv) generally bars a further election changing that classification for 60 months, absent a greater-than-50% change in ownership or IRS consent to an earlier change. The default classification does not automatically resume without a new valid election after that period.

29. B — Substantially disproportionate redemption: Section 302(b)(2) is met when, after redemption, the shareholder owns less than 50% of voting stock and her percentage is less than 80% of her pre-redemption percentage. Here 20% is below both 50% and the 32% threshold (80% times 40%), so the mechanical safe harbor applies, producing automatic sale or exchange capital gain treatment.

30. D — Short-year component member exclusion: Section 1563(b)(2) excludes a corporation from component member status for bracket-apportionment purposes if it belonged to the controlled group for less than one-half the days in its own taxable year. Newco, joining November 1, was a member for fewer than half the year's days, so it is excluded solely for that first year.

31. C — Separately stated pass-through: under Section 1366(a), charitable contributions retain their separate character and pass through pro rata to each S corp shareholder rather than being deducted at the entity level. Each shareholder then applies the contribution against their own individual AGI-based percentage limitations under Section 170, consistent with the S corporation's conduit taxation structure.

32. A — Contribution to capital: Section 118 excludes from a corporation's gross income property contributed to capital by an existing shareholder, even without issuing additional stock. Under Section 362(c), the corporation's basis in the contributed property equals the contributing shareholder's own basis, here $30,000, not fair market value, and neither party recognizes any gain on the transfer.

33. B — Section 381 attribute carryover scope: NOL and other tax attributes carry over to the acquiring corporation in Section 332 liquidations and in reorganizations types A, C, acquisitive D, F, and nondivisive G. A Type B reorganization triggers no carryover because the target continues to exist as a subsidiary, retaining its own separate attributes rather than merging them into the acquirer.

34. A — At-risk limitation beyond basis: Section 465 caps deductible losses at the taxpayer's amount at risk, which excludes nonrecourse financing unless it qualifies as qualified nonrecourse real property financing. Even though her $60,000 outside basis would support the full $50,000 loss, only $25,000 ($60,000 minus $35,000 non-qualifying nonrecourse debt) is at risk, limiting her current deduction to that lower amount.

35. D — Limited partner SE tax exception: Section 1402(a)(13) excludes a limited partner's distributive share, other than guaranteed payments for services, from self-employment tax. Courts and the functional test extend this treatment to LLC members lacking management authority who perform no services, treating them like limited partners in substance, so this passive member's distributive share is generally excluded from SE tax.

36. C — Four-year spread rule. A positive (income-increasing) Section 481(a) adjustment from a voluntary accounting method change is generally spread ratably over four tax years beginning with the year of change. A negative adjustment, by contrast, is taken entirely in the year of change. Option A misapplies the negative-adjustment rule; B and D misstate the spread period and approval requirement.

37. D — Advance rent versus deposits. Advance rental payments are includible in gross income in the year received regardless of accounting method or the lease period covered; the deferral method for advance payments applies only to goods and services, not rent. A refundable security deposit is not income because it remains subject to repayment. Options A through C misapply these distinct rules.

38. B — Partial worthlessness for business debts. A business bad debt may be partially deducted in the year partial worthlessness is established, using the specific charge-off method — here 60% of $18,000. Nonbusiness debts instead require total worthlessness, as options A and C suggest under capital-loss treatment, and reserve methods have not been permitted for tax purposes since 1986, ruling out D.

39. A — Related-party matching rule. Under Section 267(a)(2), an accrual-method payor may not deduct an expense owed to a related cash-method payee (a more-than-50% shareholder) until the amount is actually paid and includible in the payee's income, overriding normal accrual timing. The 2.5-month rule (C) governs unrelated-party deferred compensation, not this related-party matching provision; B and D misstate the rule.

40. C — 10% method election. A taxpayer using percentage-of-completion may elect the 10% method, deferring recognition of contract income and costs until the tax year in which at least 10% of total estimated contract costs have been incurred, easing the burden of tracking early-stage costs. Option A describes standard PCM without the election; B and D describe unavailable or incorrect alternatives.

41. A — Open transaction doctrine. When a maximum selling price cannot be determined and the value of a contingent payment right is not reasonably ascertainable, the taxpayer may use the rare open transaction method, recovering basis before recognizing gain. This exception applies only in unusual cases; ordinarily contingent-payment sales use prescribed basis-recovery formulas, not the treatments described in B, C, or D.

42. D — Dollar-value LIFO pooling. Grouping substantially similar inventory items into dollar-value pools measures layers by aggregate dollar value rather than tracking each item separately, smoothing out mix shifts within a pool and reducing distortive liquidations. Specific identification (A) and lower of cost or market (B) are entirely different valuation methods; item-by-item LIFO (C) increases, rather than decreases, liquidation risk.

43. C — 52-53 week tax year. A properly elected 52-53 week year ends on a specified day of the week nearest to, or last occurring in, a chosen month, so its length varies between 52 and 53 weeks. For effective-date purposes, it is treated as ending on the last day of that month. Options A, B, and D misstate these mechanics.

44. B — Advance payment deferral for goods. The deferral method lets an accrual-method taxpayer receiving advance payments for goods defer recognition until the year after receipt, if the income is also recognized for financial statement purposes that later year. Full inclusion under A ignores deferral entirely; C misstates the one-year limit; D wrongly claims deferral is permanent.

45. B — Economic performance for warranty liabilities. Even though the liability may be fixed and reasonably estimable under the all-events test's first prong, economic performance for a service-type liability like warranty repairs occurs only as repairs are actually performed, or paid — no reserve or estimate deduction is allowed in advance. Options A, C, and D each misstate this timing rule.

46. D — Involuntary conversion deferral. Under Section 1033, gain on an involuntary conversion, such as fire destruction of equipment, may be deferred if replacement property is acquired within the replacement period for an amount equal to or exceeding proceeds received; here $70,000 exceeds $65,000, allowing full deferral. A misstates recognition; B confuses gain with loss; C wrongly limits 1033 to real property.

47. C — Section 471(c) small business inventory relief. A qualifying small business taxpayer may treat inventory either as non-incidental materials and supplies deductible when used or consumed, or by conforming to its applicable financial statements or books and records if none exist, without applying UNICAP. Option A wrongly requires Section 263A; B is unrelated to LIFO; D ignores the used-or-consumed timing rule.

48. A — Unit-livestock-price method. This farm-specific method groups raised livestock into classes by type and age, applying a standard full unit price per class instead of tracking each animal's actual raising cost, greatly simplifying farm inventory accounting. B, C, and D are legitimate inventory methods generally, but none is the livestock-specific simplification designed for this purpose.

49. B — Non-automatic change of tax year. A taxpayer not qualifying for automatic approval must file Form 1128 and demonstrate a substantial business purpose to obtain IRS consent under Section 442, plus file a short-period return covering the transition stub period. Options A and D ignore this approval requirement; C invents a waiting period not found in the actual rules.

50. C — Automatic versus non-automatic consent. Method changes not on the automatic change list require advance consent through a ruling request filed with the IRS national office, typically accompanied by a user fee, and the change generally cannot be implemented until consent is granted. Option A describes the automatic procedure, which does not apply here; B and D misstate the actual requirement.

51. D — Section 1245 recapture: Ordinary income recapture is limited to the lesser of realized gain or total depreciation claimed, so $150,000 of the $170,000 gain is ordinary. The remaining $20,000, representing appreciation above original cost, is Section 1231 gain. Options A, B, and C misstate the recapture ceiling or ignore it entirely.

52. A — Section 1250 recapture: Because post-1986 MACRS real property must use straight-line depreciation throughout, there is no excess accelerated-over-straight-line depreciation to recapture as ordinary income under Section 1250. Instead, the entire $90,000 gain is unrecaptured Section 1250 gain, taxed at a maximum 25% rate for individuals. Options B, C, and D each misstate this recapture rule for real property.

53. D — QBI wage exclusion: Reasonable compensation paid to an S corporation shareholder-employee is excluded from qualified business income under Section 199A, similar to how guaranteed payments are excluded for partners, because it is wage income rather than QBI itself. The $85,000 flow-through ordinary income, by contrast, remains QBI eligible. Options A, B, and C each misapply this wage-exclusion rule.

54. C — 179D Designer Allocation. Section 179D provides a per-square-foot deduction for qualifying energy-efficient commercial building property. Because government entities pay no tax and cannot use deductions, the primary designer responsible for the technical specifications may instead be allocated the deduction, an exception unique to government-owned buildings that does not extend to ordinary privately owned commercial structures.

55. A — Differential Wage Payment Credit. Section 45P allows eligible small employers to claim a credit equal to 20% of differential wage payments made to employees on active duty, up to $20,000 of payments per qualified employee annually. This differs from WOTC, which targets new hires from specific target groups rather than continuing employees called into active military service.

56. B — Section 197 amortization: A covenant not to compete entered into in connection with acquiring a trade or business is a Section 197 intangible and must be amortized ratably over 15 years, regardless of its stated contractual term. A, C, and D incorrectly tie amortization to the covenant's own term or ignore capitalization.

57. A — QIP recovery period: A drafting error in the original TCJA left qualified improvement property without any assigned recovery period, making it 39-year, non-bonus-eligible property by default. The CARES Act's technical correction retroactively assigned QIP a 15-year MACRS recovery period, qualifying it for bonus depreciation going forward. Options B, C, and D each misstate this corrected treatment.

58. C — Listed property threshold: Meeting the more-than-50% predominant business-use test allows accelerated MACRS methods and Section 179 expensing, but both remain limited to the business-use percentage (70% here), not the full cost. Falling below 50% would instead force straight-line depreciation. A, B, and D misstate the consequence of clearing the threshold.

59. D — Land improvements class: Depreciable land improvements such as paving, drainage, and outdoor lighting fixtures fall into MACRS's 15-year recovery class, recovered using the 150% declining balance method while switching to straight-line when advantageous, distinct from the building itself. Options A, B, and C each assign an incorrect recovery period or method to this asset class.

60. B — Section 467 Constant Rental Accrual. A Section 467 rental agreement providing increasing or decreasing rent between related parties generally requires both lessor and lessee to use the constant rental accrual method, spreading a level amount of rent over the lease term rather than following the actual payment schedule, preventing artificial income-shifting or deduction-timing distortions between related entities.

61. B — WOTC veteran enhancement: Qualified veterans with a service-connected disability unemployed at least six months before hire carry an enhanced $24,000 qualified first-year wage cap, producing a maximum credit of $9,600, computed as 40% of $24,000, once the 400-hour full-credit threshold is met. Options A, C, and D each apply an incorrect wage cap or credit rate.

62. A — Payroll tax offset election: Section 41(h) lets a qualified small business (under $5 million in gross receipts, none before the prior five years) elect to apply up to $500,000 of research credit against employer Social Security payroll tax liability when income tax liability is insufficient. B, C, and D describe unavailable or inapplicable options.

63. C — Cost depletion formula: The per-unit depletion rate equals adjusted basis divided by estimated recoverable units, here $450,000 divided by 900,000 tons equals $0.50 per ton, multiplied by the

120,000 tons extracted and sold, yielding $60,000. Cost depletion reduces remaining basis and can never exceed it. Options A, B, and D each misapply this formula or an unrelated method.

64. D — QOZ deferral mechanics: Section 1400Z-2 allows a taxpayer to defer recognition of eligible capital gain by investing the gain amount in a Qualified Opportunity Fund within 180 days of the sale. Deferral continues until the earlier of the QOF interest's sale or the statutory recognition date. A, B, and C misstate the deferral rule.

65. B — Involuntary conversion deferral: Under Section 1033, gain on a condemned business property is recognized only to the extent proceeds exceed the cost of qualifying replacement property; here $20,000 is recognized and $120,000 deferred by reducing the replacement property's basis. A, C, and D misstate the recognition or defer mechanism, which is unrelated to Section 1400Z-2.

66. A — Backup withholding: Section 3406 requires payers to withhold 24% from reportable payments, including nonemployee compensation, when a payee fails to furnish a valid TIN. The withheld amount must be deposited and reported. Option B confuses this with supplemental wage withholding; C wrongly limits backup withholding to investment income; D is not a legal withholding mechanism.

67. D — Trust fund composition: Section 6672's 100% penalty applies only to funds actually withheld from employees — federal income tax withholding and the employee share of FICA — money held in trust for the government. The employer's matching FICA share and FUTA are separate employer liabilities, not trust fund amounts, so A and C are wrong; B overstates the base.

68. C — Credit reduction states: Schedule A (Form 940) is required whenever an employer paid wages in a credit reduction state or in more than one state, allocating wages by state and computing the additional FUTA tax from the reduced 5.4% credit. Schedule B relates to Form 941 deposits, Form 8027 to tip reporting, and Schedule H to household employees.

69. A — Direct vs. indirect expenses: under the actual expense method, costs benefiting only the office, like painting solely that room, are direct expenses, fully deductible; costs benefiting the whole home, like mortgage interest and utilities, are indirect and allocated by business-use percentage. B and D misclassify the expenses, and C ignores required allocation entirely.

70. C — Cents-per-mile method: for a qualifying vehicle regularly used in the employer's business and driven at least 10,000 miles a year with fair market value under the applicable ceiling, personal-use value equals personal miles times the annual IRS standard mileage rate. The commuting rule requires a separate written policy limiting use to commuting; A and D value unrelated benefits.

71. B — Achievement award limits: Section 274(j) excludes only tangible personal property awarded under a qualified plan, up to $1,600. Cash, gift cards, and other cash equivalents are specifically carved out of the exclusion and remain fully taxable no matter the plan's terms. A overstates the rule; C and D mischaracterize how a gift card is treated.

72. D — Form I-9 retention: employers must retain each employee's Form I-9 for three years after the date of hire or one year after employment ends, whichever date is later. Here, three years from hire falls later than one year from an eight-month termination. A, B, and C each misstate this later-of standard.

73. C — Additional Medicare Tax Withholding. Section 3101(b)(2) requires an employer to withhold an additional 0.9% Medicare tax once an employee's wages from that employer alone exceed $200,000 in the calendar year, regardless of filing status or a spouse's wages from another job. Any true-up for combined household wages occurs on the employee's own return, not through employer coordination.

74. D — Carryover vs. grace period: IRS guidance permits a health FSA to adopt either a limited carryover, indexed annually, or a 2.5-month grace period, but not both for the same plan year, since combining them would defeat the use-it-or-lose-it structure. A and B wrongly allow combination; C wrongly claims both features are barred entirely.

75. A — CPEO status: a properly certified professional employer organization under Section 3511 is treated as the employer of the covered worksite employees for federal employment tax purposes and bears sole liability for the associated FICA and FUTA taxes. This differs from an ordinary reporting agent under B, which has no such liability shift; C and D misstate the framework.

76. B — Form 945 purpose: nonpayroll withholding, including backup withholding on vendor payments and withholding on pensions, annuities, and certain gambling winnings, is reported annually on Form 945, kept entirely separate from wage withholding. Forms 941 and 944 report wage-related payroll taxes, and Form 940 reports FUTA — none of which cover nonpayroll amounts.

77. A — Moving expense suspension: the TCJA suspended the exclusion for qualified moving expense reimbursements for civilian employees, so employer-paid moving costs are fully taxable wages subject to withholding, FICA, and FUTA. Only Armed Forces members under permanent-change-of-station orders retain the exclusion. B, C, and D each misapply an outdated or partial version of the rule.

78. D — Commuting mileage rule: without a qualifying home office, trips between home and the first or last business stop of the day are nondeductible commuting under Section 262, while travel between two business locations during the day is deductible business mileage. A and B overstate the commuting rule in opposite directions; C misidentifies which leg is nondeductible.

79. B — Exempt status renewal: a Form W-4 claiming exemption from withholding expires each year and must be renewed by February 15; if a new form is not furnished by that date, the employer must withhold as though the employee had not claimed exempt status. A, C, and D each state an incorrect deadline or consequence.

80. C — Income in respect of a decedent. Under Section 691, income earned but not received before death is taxed to whoever receives it (here, the estate), retaining its original character. Section 691(c) allows a deduction for estate tax attributable to the IRD. It cannot go on the final 1040 since it was uncollected at death, and it is not tax-free principal.

81. A — Incidents of ownership. Section 2042 includes life insurance proceeds in a gross estate only if the decedent held incidents of ownership, such as the right to change beneficiary, borrow, or cancel, at death. Paying premiums alone does not constitute ownership, so proceeds stay outside the estate. The 3-year rule applies to transfers of ownership, not premiums on policies never owned.

82. D — Form 990-EZ threshold. Organizations with gross receipts under $200,000 and total assets under $500,000 may file Form 990-EZ instead of the full Form 990. Form 990-N is limited to organizations with gross receipts normally $50,000 or less, and Form 990-PF applies only to private foundations, so those thresholds are not met here.

83. B — Section 415(c) annual additions. The 415(c) limit caps total annual additions (employer contributions, employee deferrals, and forfeitures) to a DC plan account at the lesser of an indexed dollar amount or 100% of compensation, not a flat 25% figure. Whether $75,000 is permissible depends on comparing it to that dollar cap for the year, not compensation alone.

84. A — Purchased breeding livestock. Livestock held for breeding and used in the business qualifies as Section 1231 property once the required holding period (24 months for cattle) is met, allowing potential capital gain treatment on sale, subject to any depreciation recapture on the purchased basis. This differs from raised livestock, which has zero basis since raising costs were expensed.

85. C — PTP special rule. Publicly traded partnerships are carved out of the general passive activity grouping rules; losses from a PTP may only offset income from that identical PTP, never income from other passive activities. Excess losses simply carry forward to future years of that same PTP, rather than being released against unrelated passive income or a $25,000 allowance.

86. D — CRT and UBTI excise tax. Since 2007, a CRT that earns any UBTI is not automatically disqualified from exemption; instead, Section 664(c)(2) imposes a 100% excise tax on the UBTI amount, taxing it away entirely rather than voiding the trust's exempt status or simply passing it through to beneficiaries untaxed.

87. B — SLAT Technique. A Spousal Lifetime Access Trust is an irrevocable trust one spouse creates for the benefit of the other spouse and often descendants, using the grantor's applicable exclusion amount to remove assets and future growth from both spouses' estates, while the beneficiary spouse's discretionary access provides indirect economic benefit if funds are later needed by the family.

88. C — Cash balance plans. A cash balance plan is legally a defined benefit plan, subject to Section 412 minimum funding and PBGC insurance, but it communicates the accrued benefit as a hypothetical account balance rather than a final monthly annuity formula. It is not a DC plan, and lump-sum payouts are commonly permitted, unlike option B suggests.

89. C — Split-interest trust reporting. Charitable lead trusts, along with charitable remainder trusts and pooled income funds, must annually file Form 5227 to report financial activities, distributions, and beneficiary information, in addition to filing Form 1041 if the trust has taxable income. Form 990 and 990-PF apply to exempt organizations, not split-interest trusts.

90. D — Involuntary conversion by disease. Livestock destroyed by disease under governmental order is an involuntary conversion under Section 1033, allowing gain deferral if the indemnity proceeds are reinvested in replacement livestock within the replacement period (which can extend beyond the usual 2 years for disease or weather conditions). This differs from 451(e), which applies to voluntary weather-forced sales.

91. A — Related-party disposition exception. A complete disposition normally releases suspended passive losses in full, but Section 469(g)(1)(B) denies release when the transferee is a related party. The losses remain suspended with the seller until the activity is later disposed of to an unrelated third party in a fully taxable transaction, not transferred to the son.

92. B — Proportionate DNI character. Absent specific allocation language in the governing instrument, a trust distribution carries out each class of DNI income proportionately based on its share of total DNI. Here, tax-exempt interest is one-third of DNI, so one-third of the $15,000 distribution ($5,000) is tax-exempt and two-thirds ($10,000) is taxable to the beneficiary.

93. B — 2032A material participation test. Section 2032A requires that the decedent or a family member materially participated in the farming or business operation for at least 5 of the 8 years ending with the decedent's death (or earlier disability/retirement), in addition to the separate qualified-use and ownership requirements, before special use valuation is available.

94. A — SEP eligibility rules. Standard SEP eligibility requires an employee to be at least age 21, have worked for the employer in at least 3 of the immediately preceding 5 years, and earned at least the annually indexed minimum compensation. A newer employee or one under the compensation floor need not be covered, so only option A satisfies all three tests.

95. D — Section 4960 Excess Compensation Excise Tax. An applicable tax-exempt organization is liable for a 21% excise tax on compensation exceeding $1 million paid to any of its five highest-compensated covered employees for the year, and on certain excess parachute payments. The tax is imposed on the organization itself, not the employee, and applies regardless of the organization's UBTI status.

96. C — Section 126 cost-share exclusion. Certain government cost-share payments for approved conservation improvements can be excluded from income if the improvement does not substantially increase the farm's annual income, but the excluded amount must reduce the basis of the improved property, preventing a permanent double tax benefit. There is no age-65 requirement for this election.

97. C — Self-charged interest rule. Ordinarily, interest income is portfolio income even when the lender materially participates in the borrowing entity. The self-charged interest regulations create an exception, recharacterizing a portion of that interest income as passive to the extent the corresponding interest expense is allocated to the taxpayer's passive activities, allowing the income to offset passive losses.

98. D — In-service withdrawal at 59½. A 401(k) plan may, if its document allows, permit in-service withdrawals once a participant reaches age 59½, and such withdrawals are exempt from the 10% early distribution penalty because the age-59½ exception applies, though ordinary income tax still applies. Employment status and reaching normal retirement age are not required for this exception.

99. A — Revocable trust grantor status. Section 676 makes a trust a grantor trust whenever the grantor, or a nonadverse party, holds power to revoke the trust and revest its corpus in the grantor. Trust income, deductions, and credits flow through to the grantor's return rather than being taxed to the trust, and this power also causes estate inclusion under Section 2038.

100. B — QTIP second-death inclusion. Because the QTIP election allowed the first spouse's estate to claim a marital deduction, Section 2044 requires the property to be included in the surviving spouse's gross estate at its value on her date of death, ensuring the property is taxed once at the second death rather than escaping estate tax entirely.