# PRACTICE EXAM 27: 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.** Rosalind Whitlock, a sole proprietor graphic designer, agrees to design a website for a local dentist in exchange for $2,400 of dental work for herself, with no cash changing hands. How must Rosalind report this exchange on Schedule C?

A. Report $2,400 of gross income from the bartered services, measured at the fair market value of the dental work received, in the year the exchange occurs
B. Report no income from the exchange, because bartering of services for services is not a taxable event unless a Form 1099-B is issued
C. Report $2,400 of income only when she later pays for comparable dental services in cash, deferring recognition until an actual outlay occurs
D. Report the transaction as a like-kind exchange under Section 1031, deferring any gain until she disposes of the dental services received

**2.** Nnamdi Emeka operates two separate sole proprietorships reported on two Schedule C forms: a landscaping business with a $35,000 net profit and a freelance photography business with a $12,000 net loss. How does Nnamdi compute his net earnings from self-employment for Schedule SE purposes?

A. Compute self-employment tax separately on each Schedule C, applying the 92.35% factor to each business's profit without regard to the other business's loss

B. Combine the net profit and net loss from both Schedule C activities into a single net earnings from self-employment figure before applying the 92.35% factor

C. Disregard the photography loss entirely for self-employment tax purposes, since only profitable Schedule C activities are included in net earnings from self-employment

D. Report self-employment tax only on the landscaping business, since a taxpayer may elect to exclude any activity that produced a net loss for the year

**3.** Callum Ashdown contributes inventory held in his sole proprietorship, with a basis of $40,000 and a fair market value of $55,000, to Brightwater Supply Partners in exchange for a partnership interest. Brightwater sells the inventory as a capital asset four years later at a gain. How is the $15,000 built-in gain characterized?

A. The entire gain is capital gain to the partnership, because inventory converts to a capital asset once contributed to a partnership under Section 721

B. The entire gain is capital gain, because more than one year has elapsed between the contribution date and the partnership's sale of the property

C. Half of the gain is ordinary and half is capital, reflecting a proportional blend of the property's character before and after the contribution date

D. The built-in gain retains its ordinary income character to the partnership because the property was inventory in Callum's hands, regardless of the partnership's holding period

**4.** Renata Kowalczyk, a limited partner in Marrowdell Logistics Partners, guarantees repayment of the partnership's nonrecourse debt, but only for amounts remaining after the partnership's other assets and the general partner's guarantee are exhausted. No other partner is obligated to reimburse Renata. How does this bottom-dollar guarantee affect her outside basis?

A. It fully converts her allocable share of the nonrecourse debt to recourse debt, increasing her outside basis by that entire guaranteed amount

B. It increases her outside basis only to the extent the guaranteed debt is later actually collected from her under the terms of the guarantee

C. It is disregarded for basis purposes because it is a bottom-dollar payment obligation, so her outside basis is unaffected by the guarantee

D. It proportionately reduces the general partner's outside basis by the same dollar amount that Renata's guarantee would otherwise have added to her own basis

**5.** Oakhurst Crest Partners' agreement entitles Partner Anselm Vasseur to a guaranteed minimum annual payment of $70,000 for services, regardless of partnership income. His distributive share of partnership ordinary income, computed before the guarantee, is $50,000. How should the $70,000 total payment to Anselm be characterized?

A. The entire $70,000 is a guaranteed payment under Section 707(c), and none of it is treated as a distributive share of partnership income
B. The entire $70,000 is treated as Anselm's distributive share of ordinary income, since a guaranteed minimum is simply a floor on that share
C. The $70,000 must be split evenly, with $35,000 treated as a guaranteed payment and $35,000 treated as a distributive share of income
D. $50,000 is Anselm's distributive share of income, and the $20,000 excess needed to reach the guaranteed minimum is a Section 707(c) guaranteed payment

**6.** Fairbrook Mercantile Partners distributes $18,000 cash to Partner Bianca Odusanya in a nonliquidating distribution. In the same transaction, a reallocation of partnership recourse debt reduces Bianca's share of partnership liabilities by $14,000. Bianca's outside basis immediately before the distribution is $25,000. How is her Section 731(a) gain, if any, determined?

A. Only the $18,000 actual cash distribution counts toward her basis test, because liability relief is never treated as a cash distribution under Section 752
B. The $14,000 liability relief is treated as an additional deemed cash distribution under Section 752(b), combined with the actual cash for the gain test
C. The $14,000 liability relief permanently increases her outside basis dollar for dollar, fully offsetting the actual cash distribution so no gain results
D. Gain can never result from a nonliquidating distribution no matter how large the combined cash and deemed cash amounts become under Section 731(a)

**7.** Percival Rathbone sells his entire interest in Corrigan Steelworks Partners, which holds raw-materials inventory with a $200,000 partnership basis and a $260,000 fair market value. For Section 751(b) purposes, at what point does this inventory become 'substantially appreciated' so that its value must be tested against unrealized receivables in a hot-asset analysis?

A. When the inventory's fair market value exceeds its adjusted basis to the partnership by any amount greater than zero, however small the excess may be
B. When the inventory's fair market value exceeds 200% of the partnership's adjusted basis in the inventory, regardless of the inventory's share of total partnership assets
C. When the inventory's fair market value exceeds 120% of the partnership's adjusted basis in the inventory, which the $260,000 value here does satisfy
D. When the inventory has been held by the partnership for more than one year, since holding period alone determines whether appreciation is substantial

**8.** Hallowmere Partners has a valid Section 754 election in effect. In a liquidating distribution, Partner Paloma Barbosa receives only cash of $90,000, exceeding her $70,000 outside basis, so she recognizes a $20,000 gain under Section 731(a). What is the effect of the Section 754 election on the partnership's remaining assets?

A. The partnership increases the basis of its remaining assets by $20,000 under Section 734(b), matching the gain Paloma recognized on the distribution
B. The partnership decreases the basis of its remaining assets by $20,000 under Section 734(b), offsetting the gain Paloma recognized on the distribution
C. The Section 754 election has no effect here, because Section 734(b) adjustments apply only to distributions of property, never to cash distributions
D. The partnership must reduce each remaining partner's outside basis by an equal share of the $20,000 gain Paloma recognized on her liquidation

**9.** Sablecrest Partners' agreement specially allocates all income to Partner Magnus Thorvaldsen in Year 1 and, under a provision negotiated at the same time, allocates an equal offsetting amount of income away from Magnus back to the other partners in Year 2, with little change in any partner's net economic position over the two years. What does this arrangement most likely fail?

A. The capital account maintenance requirement, because the agreement does not credit special allocations to a partner's capital account in the year they are made
B. The economic effect requirement, because a liquidation-based capital account test cannot apply to allocations that shift between different partners across two tax years
C. The substantiality requirement, because the allocation is a transitory shift that does not substantially affect the partners' shares of partnership economic income

D. The qualified income offset requirement, because only allocations reducing a partner's capital account below zero are subject to any substantiality analysis at all

**10.** A single buyer purchases a 60% interest in Windmere Trading Partners in one transaction, and Partner Dorothea Villanueva sells her share as part of that sale. Windmere continues its trade or business without interruption after the sale. Under current law, what is the effect of this sale on the partnership's existence for tax purposes?

A. Windmere terminates under Section 708(b)(1) because more than 50% of total partnership capital and profits interests changed hands within a twelve-month period

B. Windmere does not terminate, because the technical termination rule for sales of 50% or more of partnership interests was repealed and no longer applies

C. Windmere terminates automatically any time a single buyer acquires a majority interest, even if the underlying trade or business activities continue uninterrupted

D. Windmere terminates only if the Section 754 election is revoked as a direct result of the sale, which is presumed whenever ownership changes this significantly

**11.** Fenwick Holloway contributes $200,000 cash to Ashgrove Timber Partners. Fourteen months later, the partnership distributes $180,000 cash to Fenwick, and no other partner receives a disproportionate distribution during this period. There was no formal agreement linking the two transfers, but the amounts and timing are close enough that the IRS is examining whether Section 707(a)(2)(B) recharacterizes the transaction. Under the disguised sale rules, what is the significance of the two-year presumption period?

A. The two-year period is a safe harbor; transfers within it are automatically respected as contributions and distributions, never risk of being disguised sale treatment

B. Only transfers occurring simultaneously, on the very same day, trigger any disguised sale scrutiny under Section 707(a)(2)(B) at all

C. The presumption applies only if the partnership has fewer than five partners, exempting large partnerships from disguised sale scrutiny entirely

D. Transfers within the two-year period are presumed to be a disguised sale absent facts and circumstances clearly establishing the transfers are not related

**12.** Rosamund Marchwood is a limited partner in Cobalt Ridge Realty Partners, which holds only commercial rental real property. The property is financed with nonrecourse debt borrowed from an unrelated bank that is in the business of commercial lending. No partner bears personal liability for the debt. How does this debt affect Rosamund's amount at risk?

A. The debt qualifies as qualified nonrecourse financing under Section 465(b)(6), so Rosamund's amount at risk includes her share of the debt despite its nonrecourse nature

B. The debt can never increase Rosamund's amount at risk, because only recourse debt for which a partner bears personal liability counts under Section 465

C. The debt increases her outside basis under Section 752 but has no effect on her amount at risk, since the two calculations are always identical

D. The debt increases her amount at risk only if she also personally guarantees repayment, since a bank loan alone never satisfies Section 465(b)(6)

**13.** Otis Brannigan has $45,000 of suspended passive activity losses from his limited partner interest in Fernbridge Holdings Partners, disallowed in prior years because he had no other passive income. This year, Otis sells his entire interest to an unrelated buyer in a fully taxable transaction. What happens to the suspended losses?

A. The suspended losses are permanently disallowed and cannot be used, because a sale of the passive activity itself does not release prior-year suspended losses

B. The suspended losses can only offset passive income from Otis's other unrelated passive activities in future years, never his nonpassive income in the year of sale

C. The suspended losses become fully deductible against Otis's nonpassive income in the year of sale, since a complete disposition releases the suspended losses under Section 469(g)

D. The suspended losses transfer to the buyer along with the partnership interest, since suspended losses attach to the activity rather than to the selling partner

**14.** Fenella Ashworth used the regular method for her home office deduction last year, and $1,800 of expenses were disallowed under the gross-income limitation and carried forward. This year, Fenella elects the simplified method for her home office deduction. What happens to the $1,800 carryover from the regular method?

A. The $1,800 carryover is suspended, not forfeited, and becomes deductible in the first later year Fenella returns to the regular method

B. Fenella may deduct the $1,800 carryover in addition to the simplified method's flat-rate deduction, since carryovers survive a change in method

C. Fenella must amend last year's return to reclassify the $1,800 as a current-year loss before she may elect the simplified method this year

D. The $1,800 carryover is permanently disallowed and forfeited entirely, with no future deduction available under either method for any later tax year

**15.** Adaeze Osayande, a sole proprietor consultant, gives each of ten business clients a $60 holiday gift basket. She has no employment relationship with any of the clients and gives no other gifts to them during the year. What is the maximum amount Adaeze may deduct on Schedule C for these gifts?

A. $600, the full cost of all ten gift baskets, since business gifts are fully deductible without any per-recipient dollar limitation under current law

B. $60 total, since the deduction is limited to a single gift basket per year regardless of how many separate clients receive gifts

C. $300, because only half of the cost of a business gift is deductible, similar to the 50% limitation that applies to business meals

D. $250, because the deduction for business gifts is limited to $25 per recipient per year, capping each of the ten gifts at that amount

**16.** Alistair Quintrell gifts his 30% interest in Quintrell Hardware Partners to his son Corbin. Alistair's outside basis in the interest was $80,000, and Alistair pays $6,000 of federal gift tax attributable to the appreciation in the interest at the time of the gift. What is Corbin's basis in the gifted partnership interest?

A. $80,000, equal to Alistair's basis alone, since gift tax paid by the donor never carries over to increase the donee's basis in a gifted asset

B. $86,000, equal to Alistair's $80,000 basis plus the $6,000 of gift tax attributable to the appreciation in the interest at the time of the gift

C. The fair market value of the interest on the date of the gift, since gifted partnership interests always take a stepped-up basis like inherited property

D. Zero, because a donee's basis in any gifted partnership interest must be reconstructed entirely from the partnership's books rather than carried over from the donor

**17.** Adelina Castellano uses the regular method to compute her home office deduction. Her Schedule C net income before any home office deduction is $6,000, and her total allocable home office expenses, including mortgage interest, property taxes, utilities, and depreciation, total $7,500. In what order must these expense tiers be applied against her income limitation?

A. All categories are combined into one pool and deducted proportionately, so each category is reduced by the identical percentage regardless of its tier
B. Utilities and depreciation are deducted first, and only the remaining income limitation, if any, is available for mortgage interest and property taxes
C. Otherwise-deductible mortgage interest and property taxes are applied first, then operating expenses, then depreciation last, each limited by the remaining income
D. Depreciation is always deducted first because it is a noncash expense, followed by operating expenses, with mortgage interest and taxes applied last

**18.** Alaric Fenmore, a sole proprietor, took a deduction on Schedule C based on written advice from his CPA, to whom he provided complete and accurate information about the transaction. The IRS later disallows the deduction and proposes an accuracy-related penalty under Section 6662. Alaric has never before had an accuracy-related penalty assessed. Does the reasonable cause and good faith exception apply?

A. Yes, because reasonable reliance in good faith on a competent tax advisor's written advice, given complete and accurate facts, establishes reasonable cause
B. No, because the reasonable cause exception applies only to negligence penalties, never to accuracy-related penalties for a substantial understatement
C. Yes, but only if the CPA also personally signs Alaric's return as the paid preparer, not merely providing advice
D. No, because relying on a tax advisor's written advice can never establish reasonable cause once the IRS ultimately disallows the position taken

**19.** Nadine Calder, Simon Pratt, Yusuf Okonkwo, and Elise Marchand transfer business property to newly formed Kettering Precision Corp solely in exchange for voting common stock proportionate to the value each contributed, except that Okonkwo also receives a corporate promissory note with a face amount of $15,000. The four transferors together satisfy the control requirement immediately after the exchange. For federal income tax purposes, how is the note treated?

A. The note qualifies as a security under Section 351, so its receipt triggers no recognized gain to Okonkwo this year.

B. The note disqualifies the entire Section 351 exchange from nonrecognition treatment for all four transferors this year.

C. The note is treated as additional voting stock because it was issued directly by the corporation itself.

D. The note is boot, so Okonkwo recognizes gain up to the lesser of realized gain or the note's value.

**20.** The shareholders of Wintergreen Textiles Inc. advance funds to the corporation in direct proportion to their existing stock ownership percentages. The advances carry no fixed maturity date, are unsecured, and are expressly subordinated to the claims of the corporation's trade creditors and bank lender. The corporation deducts the related payments as interest expense. On examination, which factor most strongly supports recharacterizing the advances as equity rather than bona fide debt?

A. The advances were documented internally as loans rather than as additional paid-in capital contributions.

B. The corporation continued to pay its trade creditors and bank lender on a timely basis throughout the year.

C. The shareholders were also employed by the corporation and received reasonable compensation for services performed.

D. The advances were made proportionately to stockholdings, lack a fixed maturity, and are subordinated to outside creditors.

**21.** Harrow Distribution Corp. has accumulated earnings and profits of $60,000 as of the beginning of the year. For the current year, the corporation has a current-year earnings and profits deficit of $40,000, computed without regard to any distribution. On July 1, the corporation distributes $50,000 cash to its sole shareholder. For purposes of characterizing the distribution under Section 301, how are the current deficit and accumulated balance combined?

A. The full current-year deficit is disregarded entirely, so the distribution is a dividend to the extent of the $60,000 accumulated balance alone.

B. The current deficit is prorated to the distribution date and netted against the accumulated balance to measure available earnings and profits.

C. Current and accumulated earnings and profits are tested completely separately, so the distribution is automatically split evenly between the two pools.

D. A current-year deficit permanently eliminates all accumulated earnings and profits, making the entire distribution a nontaxable return of capital.

**22.** Glasswell Corp. adopts a plan of complete liquidation. As part of a single liquidating distribution, the corporation distributes a commercial building with a fair market value of $300,000 and an adjusted basis of $170,000 to its sole shareholder, Petra Lindholm, who assumes the $80,000 mortgage encumbering the building. How does this liability assumption affect the tax treatment of the liquidating distribution?

A. The liability assumption is disregarded entirely because liabilities never affect either party's gain calculation in a complete liquidation.
B. The corporation's recognized gain is reduced dollar for dollar by the amount of the mortgage that Lindholm assumes.
C. The corporation's gain is measured using the building's full fair market value, and Lindholm's amount realized is reduced by the assumed mortgage.
D. Lindholm may not assume the mortgage at all without disqualifying the distribution from liquidation treatment under Section 331.

**23.** Draymoor Corp. has operated both a wholesale hardware division and a landscaping equipment rental division for over ten years. The board genuinely contracts the corporate business by permanently terminating the landscaping rental division and distributing the net proceeds from selling its assets to shareholder Marguerite Wexley, a noncorporate shareholder, in redemption of a portion of her shares. Wexley's percentage ownership is only marginally reduced. How is this redemption treated?

A. It fails to qualify as an exchange because Wexley's proportionate ownership interest was not meaningfully reduced by the redemption.
B. It qualifies automatically as an exchange under the partial liquidation rules without regard to Wexley's proportionate reduction in ownership.
C. It qualifies as an exchange only if Wexley also completely terminates her entire remaining interest in the corporation.
D. It is treated as a dividend because partial liquidation treatment is available solely to corporate distributee shareholders.

**24.** Underhill Systems Inc. is an S corporation whose stock is held by twenty-two members of the Fairweather family, spanning four generations, along with a common ancestor still living. All family members elected to be treated together for shareholder-counting purposes. Twelve unrelated individuals also hold stock. For purposes of the 100-shareholder eligibility limit, how are the twenty-two Fairweather family members counted?

A. All members of the Fairweather family, across the qualifying generations, are counted together as a single shareholder.
B. Each of the twenty-two Fairweather family members must be counted separately, regardless of any family relationship.
C. Only the living common ancestor is counted, and all descendants are excluded entirely from the shareholder count.
D. The family members are counted separately unless they also file a single joint federal income tax return.

**25.** In Year 1, Miriam Talbridge's stock basis and debt basis in Rowanmere Corp., an S corporation, were both reduced to zero by passed-through losses, including $6,000 that reduced her loan basis. In Year 2, the corporation reports $9,000 of ordinary income and also repays $4,000 of the outstanding loan to Talbridge. In what order are these Year 2 items applied to her loan basis?

A. The loan repayment is tested for gain before any part of the Year 2 income restores her debt basis.
B. Debt basis is never restored by pass-through income, so the entire $4,000 repayment is taxable to Talbridge.
C. The Year 2 income first restores debt basis up to $6,000 before the loan repayment is tested for gain.
D. Stock basis must be fully restored to its original amount before any income can restore her debt basis.

**26.** Brookhaven Corp. terminated its S election on April 1 of Year 1 and became a C corporation. During the post-termination transition period, the corporation distributes cash to Silas Corven, who was a shareholder throughout the former S corporation's final tax year and held a positive accumulated adjustments account balance carried over from the S years. How is this post-termination transition period cash distribution generally treated?

A. It is fully taxable as an ordinary dividend because the corporation is now operating strictly as a C corporation.
B. It is automatically treated as a nontaxable loan repayment regardless of Corven's remaining stock basis.

C. It is treated first as long-term capital gain distribution under the built-in gains recognition period rules.
D. It is treated as a tax-free reduction of Corven's stock basis to the extent of the remaining accumulated adjustments account.

**27.** Chandler Alloys Inc. converted from C corporation to S corporation status three years ago and remains within its recognition period. This year, the corporation sells an appreciated parcel that was on hand at conversion, recognizing $90,000 of built-in gain. However, the corporation's taxable income for the year, computed as though it were still a C corporation, is only $65,000. How is the built-in gains tax for this year limited?

A. The tax applies only to $65,000 of recognized gain, with the remaining $25,000 carried forward to later years in the recognition period.
B. The tax under Section 1374 applies to the full $90,000 of recognized built-in gain regardless of the corporation's taxable income for the year.
C. No built-in gains tax applies this year because the corporation's taxable income is lower than the recognized built-in gain amount.
D. The built-in gains tax is permanently eliminated for any recognized gain amount that exceeds the current-year taxable income limitation.

**28.** Pinnacle Realty Trust, seeking to qualify as a REIT, must satisfy two annual gross income tests under Section 856(c). At least what percentage of Pinnacle's gross income must consist of real property rents, mortgage interest, and other qualifying real estate-related income under the more restrictive of these two tests?

A. 50%, the threshold under the less restrictive of the two annual gross income tests
B. 75%, the threshold under the more restrictive of the two annual gross income tests, which is limited to real estate-related sources
C. 90%, a threshold that applies only to the REIT's taxable income distribution requirement, not its gross income composition
D. 100%, since REITs may not earn any income from sources outside real estate under any circumstances

**29.** Stonebridge Holdings LLC, taxed as a partnership, converts into a corporation under a state law statutory conversion statute. The conversion statute is silent on the specific form the transaction takes for federal tax purposes, and the LLC does not otherwise indicate a different intended structure. Absent a contrary showing, how does the IRS treat this conversion for federal income tax purposes?

A. As an interests-over transaction in which the members are treated as contributing their LLC interests directly to the new corporation.
B. As a fully taxable sale of all partnership assets to an unrelated third-party corporation for cash consideration.
C. As an assets-over transaction in which the partnership contributes its assets to the corporation for stock, then liquidates.
D. As a tax-free reorganization automatically qualifying under the statutory merger provisions regardless of the state conversion statute's terms.

**30.** Fieldstone Partners LLC is taxed as a partnership and has three equal members. Member Rosalind Pemberton personally guarantees the LLC's $90,000 bank loan, while the other two members provide no guarantee and bear no personal liability for it. Neither the underlying property nor any member is at risk beyond that guarantee. How is the $90,000 liability allocated among the members for outside basis purposes?

A. The liability is allocated equally among all three members according to their equal profit-sharing percentages under the operating agreement.
B. The liability is allocated entirely to Pemberton, since she alone bears the economic risk of loss on that debt.
C. The liability is treated as nonrecourse to all members because the LLC itself, not any individual member, is the borrower.
D. The liability is excluded from every member's outside basis because LLC debt never increases a member's basis in the interest.

**31.** The Estate of Harlan Boswell holds stock in Blackwell Corp. representing 42% of the corporation's total value, and that stock value exceeds 35% of the estate's adjusted gross estate. Blackwell Corp. redeems a portion of the estate's shares in an amount equal to the federal estate tax, state death taxes, and funeral and administration expenses the estate must pay. How is this redemption treated?

A. It is treated entirely as a dividend because the redemption was funded by the corporation rather than by the estate's own assets.

B. It fails to qualify for exchange treatment unless the estate's proportionate stock interest is also substantially reduced.

C. It qualifies for exchange treatment only if the estate simultaneously terminates its entire remaining interest in Blackwell Corp.

D. It qualifies as a sale or exchange under Section 303 up to the sum of the death taxes and administration expenses.

**32.** Copperfield Corp. makes a $200,000 interest-free demand loan to its sole shareholder, Coraline Fenshaw, who is also a corporate officer, and the loan is never repaid during the year. No interest is charged, and the corporation does not treat any amount as compensation. Under the below-market loan rules, how is this arrangement generally treated for federal income tax purposes?

A. Imputed interest is treated as a constructive dividend to Fenshaw, with a corresponding deemed interest payment back to the corporation.

B. The loan is disregarded entirely because interest-free loans between a corporation and its shareholder are exempt from taxation.

C. The entire $200,000 principal amount is treated as a taxable dividend the moment the loan proceeds are disbursed.

D. No income is imputed to either party until the loan is either formally repaid or forgiven in a later year.

**33.** Oakmont Corp. is a validly electing S corporation. Walter Grimsby wishes to have his traditional individual retirement account acquire and hold shares of Oakmont Corp. stock directly, in place of holding the shares in his own name. Aside from a narrow grandfathered exception for certain bank stock held by an ESOP-owned IRA, how does a traditional IRA generally qualify as an S corporation shareholder?

A. A traditional IRA qualifies as an eligible shareholder as long as Grimsby is the sole beneficiary of the account.

B. A traditional IRA qualifies as an eligible shareholder only if it also elects to be treated as a grantor trust.

C. A traditional IRA does not qualify as an eligible shareholder, and its stock ownership would terminate the S election.

D. A traditional IRA qualifies automatically because retirement accounts are treated the same as individuals under Section 1361.

**34.** Winterbourne Corp. distributed Section 306 stock (preferred stock received tax-free as a stock dividend) to shareholder Perpetua Vantree several years ago, when the corporation had ample earnings and profits. This year, Winterbourne Corp. redeems all of Perpetua's Section 306 stock for cash. How is the redemption proceeds generally treated for Perpetua?

A. Treated as ordinary dividend income to the extent of the corporation's earnings and profits, without regard to the exchange-versus-dividend redemption tests that apply to other stock

B. Treated entirely as capital gain, since a redemption is always treated as an exchange rather than a dividend under Section 306

C. Treated as a tax-free return of capital in full, since Section 306 stock was originally received without any income recognition

D. Treated the same as a sale to an unrelated third party, qualifying automatically for capital gain treatment under Section 306(b)

**35.** Eleanor Gantry owns Gantry Family Holdings LLC, taxed as a partnership, whose primary asset is a capital-intensive equipment rental operation where capital is a material income-producing factor. Gantry gifts LLC interests to her two adult children, who receive genuine ownership rights, including the ability to sell or pledge their interests. For their allocated share of income to be respected for tax purposes, what must be true?

A. The children must also actively perform substantial personal services for the LLC before any income allocation to them is respected.

B. The children must be recognized as genuine owners of their capital interests, consistent with the family partnership rules of Section 704(e).

C. The gifted interests must first be held in a formal trust before any income can be allocated to the children at all.

D. The children's allocated income must be capped at the same dollar amount Gantry herself reports from her retained interest.

**36.** Bellcourt Hardware Corp receives a $150,000 settlement from a supplier for breach of a long-term supply contract. Of the total, $110,000 compensates Bellcourt for profits it would have earned reselling the goods, and $40,000 compensates for lasting damage to Bellcourt's goodwill and customer relationships caused by the breach. How should Bellcourt characterize the settlement?

A. The entire amount is a nontaxable return of capital, since it arises from a single breach-of-contract claim against one supplier

B. The entire amount is capital gain, since settlement proceeds always take on the character of the plaintiff's underlying legal claim

C. The entire amount is ordinary income, since litigation and settlement proceeds are always taxed as ordinary trade or business income

D. The $110,000 is ordinary income replacing lost profits, and the $40,000 is capital gain replacing destroyed goodwill, under the origin-of-the-claim test

**37.** Anders Fabrication Inc. has used the LIFO method to value its inventory for tax purposes for several years. Its controller proposes also writing certain slow-moving items down to market value whenever market value falls below LIFO cost, to more conservatively state inventory on the tax return. Is this write-down permissible?

A. Yes, because the lower of cost or market method may be freely combined with LIFO once the LIFO election has been made

B. Yes, but only for items expected to remain unsold for more than one full tax year following the write-down date

C. No, because a taxpayer using LIFO for tax purposes may not value any LIFO inventory below cost using market value

D. No, unless the taxpayer first obtains a private letter ruling approving the combined use of LIFO and market valuation

**38.** Thornfield Textiles Group is a general partnership with average annual gross receipts well under the small business threshold, and more than 35% of its losses in the current year are allocable to limited partners who do not materially participate in the business. May Thornfield use the cash method of accounting?

A. Yes, because any partnership below the gross receipts threshold automatically qualifies for the cash method regardless of ownership structure

B. Yes, because the cash method eligibility test looks only at gross receipts and never considers how losses are allocated

C. No, because partnerships are always treated as tax shelters barred from the cash method regardless of loss allocations

D. No, because Thornfield meets the definition of a syndicate, a tax shelter barred from the cash method regardless of gross receipts

**39.** Marisol Kade's catering business qualifies as a small business taxpayer under Section 448(c) and is not required to keep tax inventories under Section 471. Marisol wants to use the cash method for her service income while still accounting sensibly for the food and supplies she purchases for events. What is the correct treatment of these purchased goods under Section 471(c)?

A. The goods must still be tracked under full accrual inventory accounting, since any business holding goods for resale must maintain formal inventories

B. The goods may be treated as non-incidental materials and supplies, deductible in the year used and consumed, or in the year paid if that is later

C. The goods must be capitalized under Section 263A uniform capitalization rules regardless of the business's qualifying small business taxpayer status

D. The goods must be expensed entirely in the year purchased, even if a substantial portion remains unused at the close of the tax year

**40.** Silverline Appliance Retailers, a calendar-year corporation, wants to adopt a fiscal year ending January 31 to better match its natural business cycle, which peaks around the holiday season. To qualify for automatic approval of this change without a facts-and-circumstances ruling, what must Silverline demonstrate?

A. Gross receipts for the two months ending on the requested year-end totaled at least 25% of annual gross receipts for three consecutive years

B. Gross receipts for the requested new fiscal year are projected to exceed gross receipts for the prior calendar year by 25%

C. At least 25% of Silverline's shareholders have personally requested the change in a signed petition submitted with the ruling request

D. Silverline's inventory levels at the requested year-end are at least 25% lower than inventory levels at any other month-end

**41.** Dario Ashworth sells a piece of unimproved land held for investment to his daughter, Renata, for its fair market value, reporting the gain on the installment method. Eight months later, before Dario has collected most of the installment payments, Renata resells the land to an unrelated buyer for cash. What is the general tax consequence to Dario?

A. Dario reports no additional gain until he actually collects each remaining installment payment from Renata under the original contract terms

B. Dario's installment sale is automatically disqualified retroactively, requiring him to amend the original year's return to report the entire gain

C. Dario must treat the amount realized by Renata on her resale as received by him, accelerating recognition of his deferred gain

D. Dario faces no consequence because the related-party resale rule applies only to sales of inventory, not to investment real property

**42.** Cobalt Ridge Manufacturing trades a fully depreciated stamping machine used in its production line for a newer, similar stamping machine of equal value, with no cash changing hands. Cobalt wants to defer recognition of any gain under Section 1031 as a like-kind exchange of business property. Is this treatment available?

A. Yes, because exchanges of similar depreciable business equipment for equipment used in the identical line of business always qualify for Section 1031

B. No, because Section 1031 like-kind exchange treatment currently applies only to exchanges of real property, not to personal property such as machinery

C. Yes, because equipment exchanges qualify for Section 1031 whenever both machines fall within the same General Asset Class under the depreciation regulations

D. No, because Section 1031 was fully repealed and no exchange of business or investment property may ever defer gain recognition today

**43.** The city condemns a warehouse that Northbrook Grain Co. has held for several years and used in its trade or business, paying Northbrook a condemnation award exceeding its adjusted basis in the property. Northbrook wants to identify replacement property that will satisfy the Section 1033 test and avoid recognizing gain. Which standard applies to this condemned property?

A. Northbrook must acquire property that is functionally identical to the warehouse, performing the exact same physical function within its operations

B. Northbrook must acquire property used in a similar or related service or use, the narrower test applied to most involuntary conversions

C. Northbrook has no replacement option available, since condemnation awards for real property are always taxable in full in the year received

D. Northbrook may acquire any real property of like kind held for productive use in trade or business or for investment

**44.** Pinehollow Plastics Inc. voluntarily changes its method of accounting for a recurring expense item by filing Form 3115, and the change produces a negative Section 481(a) adjustment of $80,000, decreasing Pinehollow's taxable income. How must Pinehollow account for this negative adjustment?

A. Pinehollow takes the entire $80,000 negative adjustment into account in the year of change, rather than spreading it over future years
B. Pinehollow spreads the $80,000 negative adjustment ratably over the four tax years beginning with the year of change, the same as a positive adjustment
C. Pinehollow spreads the $80,000 negative adjustment ratably over the ten tax years following the year of change under the general averaging rule
D. Pinehollow may not claim any part of the negative adjustment until it files a separate refund claim for each prior affected tax year

**45.** Palisade Ventures Series LLC establishes three internally segregated series under its state's series LLC statute, each with separate business purposes, separate books and records, and separate ownership. Under the proposed federal tax regulations addressing series LLCs, how is each series generally treated for federal tax classification purposes?

A. All series are automatically combined and treated as a single entity, filing one consolidated federal return regardless of separate books
B. Each series is automatically taxed as a corporation, regardless of the number of owners or elections independently made by that series
C. Each series is generally treated as a separate entity for federal tax purposes, independently classified under the check-the-box regulations
D. Only the parent series LLC is recognized federally; the individual series have no independent tax significance whatsoever

**46.** Priscilla Adeyemi, a self-employed marketing consultant, included a $9,000 commission in gross income two years ago under the claim-of-right doctrine after her client paid it without dispute. This year, a billing error is discovered and Priscilla repays the client $2,400 of that amount. May Priscilla use the special Section 1341 claim-of-right computation for this repayment?

A. Yes, because Section 1341 relief applies automatically to any repayment of income that was previously included under a claim of right

B. No, because Section 1341 relief is unavailable when the repayment is $3,000 or less; Priscilla simply deducts the repayment in the current year

C. No, because Section 1341 relief applies only to repayments made by corporations, never to repayments made by self-employed individuals

D. Yes, but only if Priscilla first amends the original year's return to remove the $9,000 commission from that year's gross income

**47.** Windmere Distributors Inc. is unable to meet the terms of an outstanding business loan and negotiates with its lender to exchange the original note for a new note with a reduced principal balance and different interest terms. The exchange is treated as a significant modification of the debt instrument. How does Windmere determine any cancellation-of-debt income from this exchange?

A. Windmere compares the issue price of the new debt instrument to the adjusted issue price of the old debt instrument it replaces

B. Windmere recognizes no cancellation-of-debt income unless the lender formally forgives a portion of the principal in a signed written release

C. Windmere compares the face amount of the new note to the original face amount of the old note issued at the loan's inception

D. Windmere recognizes cancellation-of-debt income only if the interest rate on the new note is lower than the rate on the old note

**48.** Emmett Solano sells business real property in exchange for a series of payments to be made over a fixed ten-year period, with no maximum selling price stated anywhere in the sale agreement. Because the total selling price cannot yet be determined, how must Emmett recover his basis in the property under the installment sale regulations?

A. Emmett recovers his entire basis in the first year payments are received, then reports all later payments entirely as gain

B. Emmett applies the standard gross profit percentage used for stated-maximum-price contracts to each payment received throughout the ten-year term

C. Emmett may not use the installment method at all, since a contract lacking any stated maximum selling price fails to qualify

D. Emmett recovers his basis ratably over the fixed ten-year payment period, treating an equal portion of basis as recovered with each payment

**49.** Cascade Ridge Builders Inc. uses the completed-contract method for a long-term construction contract that qualifies for the method, deferring recognition of all contract income and most contract costs until the contract is complete. Cascade's controller believes that because CCM defers income recognition, direct and allocable indirect costs never need to be capitalized to the contract in the meantime. Is this belief correct?

A. Yes, because the completed-contract method entirely exempts a contract from any cost capitalization requirements until the contract is finished
B. No, direct costs and allocable indirect costs must still be capitalized to the contract as incurred, even though income recognition is deferred
C. Yes, because only businesses using the percentage-of-completion method are subject to any cost capitalization requirements under the Code
D. No, but only administrative costs, not direct labor or materials, must be capitalized to the contract under the completed-contract method

**50.** Amberleigh Industrial Corp. is currently under IRS examination for an open tax year when its controller identifies an impermissible method of accounting the company has been using and wants to file Form 3115 to correct it going forward. Under the general audit protection rules for accounting method changes, what consequence does filing during an active examination typically carry?

A. Amberleigh generally loses audit protection for the changed item, since a method change requested for an issue already under examination is not protected
B. Amberleigh automatically receives full audit protection for all open years regardless of when during the examination the Form 3115 is filed
C. Amberleigh may not file Form 3115 at all while under examination and must wait until the examination closes to request any change
D. Amberleigh receives audit protection only if the examining agent personally consents in writing to the specific method change being requested

**51.** Ridgeway Turbine Components LLC placed several items of 7-year MACRS equipment in service using the mid-quarter convention because more than 40% of that year's qualifying purchases occurred in the fourth quarter. This year, Ridgeway sells one of those items on August 10, within the third quarter. How much depreciation may Ridgeway claim for this asset in the year of disposition?

A. The full annual depreciation amount for the asset's recovery year, since mid-quarter convention rules apply only in the placed-in-service year, never later

B. One-half of the annual depreciation amount, using the same fixed 50% rule that applies whenever a half-year convention asset is disposed of

C. No depreciation at all for the disposition year, because mid-quarter convention property forfeits any deduction once sold before the recovery period ends

D. Depreciation prorated through the midpoint of the third quarter, since mid-quarter convention treats the disposition as occurring halfway through that quarter

**52.** Lakeside Family Apartments LLC sold a residential rental building, depreciated under MACRS using the mid-month convention, on November 10 of the current year. How much depreciation may Lakeside claim for the building in the year of sale?

A. A full month of depreciation for November plus all preceding months, since mid-month convention rounds up to the month of sale entirely

B. Depreciation through the end of October only, since the month of disposition itself is always excluded entirely from the calculation

C. One-half month of depreciation for November, in addition to a full month of depreciation for each preceding month of the year

D. No depreciation for November, but a full month for each of the ten preceding months, consistent with the mid-quarter convention's method

**53.** Ferrous Peak Manufacturing operates as a Qualified Opportunity Zone Business (QOZB) held by a Qualified Opportunity Fund. To satisfy the QOZB requirement, what percentage of Ferrous Peak's tangible business property must generally constitute qualified opportunity zone business property?

A. At least 50%, matching the general active-trade-or-business gross income sourcing test used elsewhere in the Code

B. At least 70%, the threshold that must be met for substantially all of a QOZB's tangible property to qualify

C. At least 90%, the same percentage threshold that applies directly to the Qualified Opportunity Fund itself, not its subsidiaries

D. 100%, since a QOZB may not hold any tangible property that fails to qualify as opportunity zone business property

**54.** Meridian Battery Components Inc. wants to claim the Section 48C qualifying advanced energy project credit for a new manufacturing facility that will produce components for renewable energy systems. Unlike most other energy credits, what unique feature governs whether Meridian may claim this credit?

A. The credit is claimed automatically on Meridian's return without any application process, based solely on self-certification of eligibility

B. The credit rate adjusts automatically each year based on Meridian's total qualifying expenditures, with no cap on the amount available

C. The credit is awarded only through a competitive application and certification process administered by the Department of Energy and the IRS, subject to a limited allocation

D. The credit applies only to projects located within a federally designated Opportunity Zone, regardless of the project's energy technology

**55.** Comet Courier Service purchases a new passenger automobile for $48,000, used 100% for business, and places it in service this year. The vehicle qualifies for 100% bonus depreciation. How much first-year depreciation may Comet actually claim?

A. The full $48,000 purchase price, since 100% bonus depreciation removes any dollar limitation for qualifying passenger automobiles

B. $24,000, exactly half of the purchase price, reflecting the mid-year convention applied to passenger automobile depreciation

C. Zero, since passenger automobiles used for courier delivery services are entirely excluded from any depreciation deduction

D. Only the amount permitted under the Section 280F luxury automobile first-year dollar limitation, despite 100% bonus eligibility

**56.** Kline & Ostrander Foods Inc. purchases a customer list intangible from a related party who owned and used the intangible before the effective date of Section 197's enactment. Under the anti-churning rules, how is this acquired intangible treated?

A. It is excluded from Section 197 amortization, since anti-churning rules bar amortizing intangibles acquired from related parties who held them pre-enactment

B. It is fully amortizable over 15 years, since any purchased intangible automatically qualifies once formally acquired for valuable consideration

C. It is amortizable, but only over the shorter of 15 years or the intangible's remaining useful life to Kline

D. It is immediately deductible in full, since related-party acquisitions of intangibles receive accelerated first-year expensing treatment under current law

**57.** Roth Industrial Supply Corp has a general business credit carryforward from a prior year in addition to a current-year general business credit it has just generated. Both cannot be fully used because of the tax liability limitation. In what order does Section 38(d) require these credit components to be absorbed?

A. The current-year credit is used first, followed by the carryforward credit, with any remaining unused carryforward simply expiring immediately

B. Both components are absorbed simultaneously on a pro rata basis, in proportion to their respective dollar amounts for the year

C. Carryforwards are absorbed first, on a first-in first-out basis, before any of the current-year general business credit is applied

D. The taxpayer may freely choose which component to absorb first each year, selecting whichever produces the more favorable result

**58.** Harvest Moon Bakery hires Renata Cho, who was unemployed and received unemployment compensation under state law for a period of at least 27 consecutive weeks immediately before being hired. Under which Work Opportunity Tax Credit targeted group does Renata's hiring qualify?

A. The vocational rehabilitation referral targeted group, available for individuals referred after completing rehabilitative services

B. The summer youth employee targeted group, limited to older teenagers hired during the summer months

C. The supplemental security income recipient targeted group, available only to disability benefit recipients

D. The long-term unemployment recipient targeted group, available to individuals unemployed at least 27 consecutive weeks

**59.** Nucleus Polymer Sciences Inc. conducts research activities at a laboratory located entirely outside the United States, testing a new polymer formulation that otherwise satisfies all four requirements of the Section 41 research credit test. How are these foreign research expenses treated for research credit purposes?

A. They fully qualify as qualified research expenses, since Section 41 imposes no geographic limitation on where research activities occur

B. They are excluded entirely from qualified research expenses, since Section 41 requires research to be conducted within the United States

C. They qualify at a reduced credit rate reflecting the additional currency conversion and cross-border compliance costs involved

D. They qualify only if Nucleus also maintains a domestic research facility performing comparable research during the same tax year

**60.** Boyd Family Hardware, an eligible small business, incurs $6,000 of qualifying access expenditures and claims a Disabled Access Credit under Section 44. How must Boyd treat the portion of these expenditures used to compute the credit for purposes of any related depreciation or expense deduction?

A. Boyd must reduce the otherwise allowable deduction or depreciable basis by the amount of credit claimed, preventing a double tax benefit

B. Boyd may fully deduct or depreciate the entire expenditure with no reduction, since the credit and deduction apply independently of each other

C. Boyd must forgo the credit entirely if any portion of the expenditure is also depreciated or currently deducted in the same year

D. Boyd must amortize the entire expenditure over five years instead of claiming any current deduction, once the credit has been claimed

**61.** Silverton Employer Group LLC, a qualifying small employer, has claimed the small employer health insurance credit under Section 45R for two consecutive tax years using SHOP Marketplace coverage. May Silverton claim the credit again for a third consecutive year?

A. Yes, the credit may be claimed indefinitely each year the employer continues purchasing coverage through the SHOP Marketplace

B. Yes, but only at a reduced 25% rate instead of the standard percentage used during the first two years
C. No, because SHOP Marketplace coverage may only be purchased for a single tax year under federal law
D. No, the credit is generally available only for a two-consecutive-tax-year credit period beginning with the employer's first claimed year

**62.** Hensley Manufacturing Inc. claimed a Section 45F employer-provided childcare credit for constructing a qualified childcare facility three years ago. This year, Hensley ceases operating the facility as a qualified childcare facility. What is the consequence of this early cessation?

A. Hensley must recapture a portion of the credit previously claimed, on a declining scale based on how many years since the facility opened
B. Hensley faces no recapture consequence, since Section 45F imposes no ongoing operational requirement once the credit has been properly claimed
C. Hensley must repay the entire original credit amount in full, regardless of how many years the facility was operated
D. Hensley must convert the credit into a current-year deduction instead, offsetting the recapture with an equivalent expense write-off

**63.** Fairwind Biofuels LLC produces biodiesel that it sells to an unrelated distributor for use in blending with petroleum diesel. Under Section 40A, what is the general character of the biodiesel fuel credit available to a producer of qualifying biodiesel?

A. A refundable credit against self-employment tax only, claimed exclusively on Schedule SE by the producer
B. A nonrefundable income tax credit, or in certain cases an excise tax credit, based on gallons of qualifying biodiesel produced or sold for a qualifying use
C. A flat annual credit of $10,000 per producer, regardless of the actual gallons of biodiesel produced during the year
D. A payroll tax credit claimed against the producer's quarterly Form 941 liability, unrelated to the volume of fuel produced

**64.** Fennimore Custom Cabinetry and Fennimore Installation Services are both wholly owned by the same individual, share centralized accounting and purchasing functions, and are operated as interdependent parts of a single overall business. The owner wants to aggregate the two businesses for purposes of the Section 199A qualified business income deduction. What must generally be true for this aggregation to be permitted?

A. Aggregation is never permitted between two separately organized businesses, even under common ownership, unless they file a combined tax return

B. Aggregation is automatic whenever two businesses share the same owner, without regard to any operational relationship between them

C. The businesses must satisfy the common ownership, same-taxable-year, and operational interdependence requirements of the Section 199A aggregation regulations

D. Aggregation is available only if at least one of the two businesses independently satisfies the W-2 wage or UBIA limitation on its own

**65.** Elliot Marsh operates Marsh Capital Trading LLC, a business that buys and sells securities and commodities for its own account, generating income principally from market timing and price movements rather than from fees charged to outside clients. How is this trading business classified for Section 199A purposes?

A. It is not an SSTB, since trading for the taxpayer's own account never involves providing services to clients

B. It is an SSTB only if Elliot also manages investment accounts for compensation on behalf of unrelated third parties

C. It is a specified service trade or business in the field of trading, subject to the SSTB income-based phase-out

D. It qualifies for the full QBI deduction regardless of income level, since trading activity is treated as a non-SSTB investment business

**66.** Redgate Trucking LLC is a calendar-year employer with no FUTA deposits made yet this year. Its cumulative undeposited FUTA tax liability was $340 through the end of the second quarter and reaches $560 by the end of the third quarter. Based on this cumulative liability, what must Redgate Trucking LLC do?

A. Wait until year-end and pay the entire FUTA liability with the annual Form 940 filing in January

B. Deposit the FUTA tax by the last day of the month following the third quarter, since cumulative undeposited liability now exceeds $500

C. Deposit the FUTA tax within three banking days, since any liability increase during a quarter triggers an accelerated deadline

D. Continue accumulating the liability without depositing, since FUTA deposits are never required before the fourth quarter ends

**67.** Solborne Landscaping hires Priya Nakamura to perform grounds maintenance work. Priya supplies and maintains her own specialized mowing and trimming equipment, actively advertises her services to several other landscaping clients in the area, and can realize a profit or suffer a loss depending on how efficiently she manages each job. Which category of common-law evidence do these facts primarily illustrate?

A. Financial control, since investment in equipment, market availability, and profit-or-loss opportunity are hallmarks of this factor

B. Behavioral control, since these facts describe how much instruction and training the worker receives from the business

C. Type of relationship, since these facts focus on written contracts and the permanency of the working arrangement

D. Statutory employee status, since certain occupations are treated as employees by law regardless of common-law factors

**68.** Featherstone Apparel Inc. discovers that it overreported both the employee and employer shares of FICA tax on a previously filed Form 941 for an earlier quarter. Before Featherstone may use the interest-free adjustment process on Form 941-X to correct the employee share of this overpayment, what must first occur?

A. Featherstone must file an amended Form 1120 reflecting the corrected federal tax deduction for the affected quarter

B. The IRS must issue prior written pre-approval authorizing Featherstone to use the interest-free adjustment process

C. Featherstone must wait until the following calendar year before filing any correction for the affected quarter

D. Featherstone must repay or reimburse the affected employees, or secure their written consent, before filing the adjustment

**69.** Rosalind Chatterjee employs a part-time household housekeeper and pays total cash wages of $2,800 during the year, but no single calendar quarter's wages to this worker reach $1,000. Which household employment tax must Rosalind nonetheless pay for this worker, and why?

A. Social Security and Medicare tax, because the year's total cash wages exceeded the annual FICA threshold for household employees

B. FUTA tax, because the year's total cash wages exceeded the $1,000 threshold that applies to household employers

C. Both FICA and FUTA tax, because combined wages for the year exceeded $2,000 in total

D. Neither tax applies, because no single calendar quarter's wages reached the $1,000 threshold amount

**70.** Dominic Alvear, an employee at The Blue Heron Bistro, received $34 in cash tips during June from this single employer. By what date must Dominic report these tips to his employer, and using what method?

A. He need not report any tips to his employer, since amounts under $50 per month are exempt from reporting

B. By the 10th day of the following month, using Form 4070 or an equivalent written statement

C. By the last day of June, the same month the tips were received, using Form W-2

D. Only at year-end, when Dominic prepares his individual income tax return reporting total annual tip income

**71.** Miriam Oyelaran, a self-employed consultant, qualifies for the home office deduction under the actual expense method. After deducting the mortgage interest and property taxes allocable to her office, her gross income from business use of the home is $1,800, while her remaining allocable expenses, including utilities, insurance, and depreciation, total $2,600. How must Miriam treat the $800 of expenses that exceed her gross income limitation?

A. Deduct the full $2,600 in the current year, since the gross income limitation applies only to the simplified method

B. Amend the prior year's return so the excess $800 is absorbed against that year's business income instead

C. Carry the disallowed $800 forward to future years, subject to the same gross income limitation each year

D. Permanently forfeit the $800, since the home office deduction allows no carryover of disallowed expenses whatsoever

**72.** Hazelbourne Retailers fails to file accurate Forms 1099-NEC for several contractors by the January 31 due date, and corrects the failure more than 30 days after the due date but before August 1 of the same year. Under Section 6721, which penalty tier applies to this correction?

A. No penalty applies as long as the correction occurs at any point before the original tax return for the year is filed
B. The maximum penalty tier applies automatically, regardless of how quickly Hazelbourne corrects the failure once discovered
C. The penalty is waived entirely because a good-faith attempt to file was made by the original January 31 due date
D. An intermediate penalty tier applies, higher than the rate for corrections within 30 days but lower than the rate for failures corrected after August 1

**73.** Marisol Quintana, a self-employed sales representative, uses the standard mileage rate to deduct her business vehicle expenses for the year. In addition to the standard mileage amount, which vehicle-related cost may she separately deduct?

A. Vehicle depreciation, since it is not already factored into the standard mileage rate calculation
B. Fuel and oil costs, since these expenses are excluded from the standard mileage rate entirely
C. Vehicle insurance premiums, treated as a separate itemized deduction apart from the mileage rate
D. Business-related parking fees and tolls, since these are not included in the standard mileage rate

**74.** Cassandra Wrenfield rents out her personal residence for 10 days during the year for a local festival, receiving $6,000 in rental income. She uses the home as her personal residence the rest of the year and does not rent it out again. How must Cassandra report this rental activity under Section 280A(g)?

A. She reports the full $6,000 as rental income on Schedule E and may deduct a proportional share of mortgage interest, taxes, and depreciation
B. She excludes the $6,000 from gross income entirely and may not deduct any rental-related expenses, since the home was rented fewer than 15 days

C. She reports the $6,000 as miscellaneous income on Schedule 1 but may not offset it with any expenses under any circumstances

D. She must allocate the rental income and her itemized mortgage interest and property tax deductions using the Tax Court method

**75.** Thornleigh Manufacturing maintains a self-insured medical reimbursement plan under Section 105(h) that reimburses its president, a highly compensated individual, for 100% of medical expenses, while reimbursing rank-and-file employees for only 70% of medical expenses under the same plan. What is the consequence of this disparity for the highly compensated president?

A. The president must include in gross income the portion of reimbursements that constitute a discriminatory benefit under the plan's nondiscrimination rules

B. No consequence occurs, since self-insured medical reimbursement plans are never subject to nondiscrimination testing, unlike insured group health plans

C. The plan automatically loses its entire tax-favored status for all employees, including the rank-and-file employees, once any disparity is found

D. The employer, not the president, must pay an excise tax equal to the discriminatory benefit amount, with no income inclusion to the president

**76.** Business owner Callista Faulkner trades in her business-use pickup truck, which has an adjusted basis of $9,000, for a new truck, receiving a $14,000 trade-in allowance toward the purchase price. How must Callista treat this trade-in for federal tax purposes?

A. As a tax-free like-kind exchange, since Section 1031 still applies to trades of similar business vehicles

B. As a nontaxable exchange, but only if she elects to defer the gain by filing Form 8824

C. As a taxable disposition, recognizing $5,000 of gain, since like-kind exchange treatment no longer applies to personal property

D. As a taxable disposition, but reportable only if the trade-in allowance exceeds the truck's original cost

**77.** Isadora Blackthorn wants to claim exemption from federal income tax withholding on Form W-4 for the current year. Which condition must she satisfy to properly claim this exemption?

A. She must have had no federal income tax liability last year and reasonably expect to have no tax liability for the current year

B. She must earn less than the standard deduction amount for the current year, regardless of her prior-year tax liability

C. She must be claimed as a dependent on another taxpayer's return, since dependents are automatically exempt from withholding

D. She must file a written request with the IRS and receive prior written approval before claiming any withholding exemption

**78.** Coldwater Manufacturing Co. fails to deposit federal payroll taxes when due and remains delinquent even after receiving an IRS notice and demand for immediate payment, ultimately making the deposit more than ten days after that notice was issued. Under Section 6656's tiered failure-to-deposit penalty structure, what penalty rate applies to this deposit?

A. 2 percent, the rate applicable to deposits made only 1 to 5 calendar days late

B. 5 percent, the rate applicable to deposits made 6 to 15 calendar days late

C. 10 percent, the rate applicable to deposits made more than 15 days late but before any IRS notice

D. 15 percent, the maximum rate, applicable once the IRS issues notice and demand and 10 days pass unpaid

**79.** Wendeline Fairholt, a self-employed hairstylist, had net earnings from self-employment of only $1,200 this year due to a slow season, and her net nonfarm profit exceeded $400 in two of the prior three years. She wants to use the nonfarm optional method to compute her self-employment tax for the year. Which limitation applies to this method?

A. It may be used only in a year when net earnings from self-employment are actually negative

B. It reports no more than two-thirds of gross nonfarm income and may be used in no more than five tax years total

C. It may be used an unlimited number of times, provided earnings stay below $1,600 in each qualifying year

D. It requires advance IRS approval through a written ruling request before it may be used in any tax year

**80.** The trustee of the Hargrove Wildlife Trust, a trust described in Section 4947(a)(1) as a wholly charitable trust, wants to elect a June 30 fiscal year for income tax reporting purposes instead of the calendar year normally required of trusts. Is this permitted?

A. No, every trust, without exception, must adopt a calendar tax year under Section 644's general mandatory rule

B. Yes, but only after the trustee formally reorganizes the trust as a nonprofit corporation under state law

C. Yes, because trusts exempt from tax under Section 501(a) and wholly charitable trusts are excepted from that rule

D. No, only estates, not trusts of any kind, may ever select a fiscal year for reporting

**81.** The Alderman Family Trust, a complex trust, is required by its governing instrument to distribute $30,000 of income annually to the grantor's widow, and separately makes a $20,000 discretionary distribution to the grantor's adult son during the same year. The trust's distributable net income for the year totals only $35,000. Under the tier system of Sections 661 and 662, how is this $35,000 of DNI allocated between the two beneficiaries?

A. The $35,000 is split proportionally between the widow and the son, based on the $30,000 and $20,000 each received

B. The $35,000 is allocated entirely to the son, because discretionary tier-two distributions receive priority over mandatory tier-one income

C. The widow's $30,000 mandatory distribution is satisfied first as a tier-one item, leaving $5,000 of DNI for the son

D. The $35,000 is allocated equally between the two beneficiaries, regardless of the amount each actually received this year

**82.** Meridian Heritage Society, a tax-exempt organization, licenses its trademarked logo to a for-profit company in exchange for a percentage of the licensee's sales, providing no additional services beyond the mere grant of the license. How is this royalty income treated for UBIT purposes?

A. Fully taxable as unrelated business income, because sales-based payments are inherently treated as service income

B. Taxable only if the licensee is a for-profit corporation rather than another tax-exempt entity

C. Excluded from UBTI only if the license agreement expires within twelve months of signing

D. Excluded from unrelated business taxable income as passive royalty income under Section 512(b)(2)

**83.** Kettering Precision Fasteners maintains a qualified retirement plan requiring the employer to contribute a fixed percentage of each eligible employee's compensation every year, regardless of whether the company earns a profit, with contributions allocated to individual employee accounts. Which type of qualified plan does Kettering maintain?

A. A traditional defined benefit pension plan promising employees a stated monthly retirement benefit
B. A money purchase pension plan, which requires fixed, mandatory annual employer contributions
C. A discretionary profit-sharing plan, since employer contributions vary each year based on profits
D. A cash balance plan, which credits each employee's hypothetical account with a pay credit

**84.** Which of the following taxpayers engaged in a farming business is eligible to elect farm income averaging under Schedule J?

A. An individual, including one who receives farm income through a partnership or an S corporation
B. A C corporation that is exclusively engaged in operating a farming business
C. A farming partnership itself, filing the election directly on its own partnership return
D. Any farming trust or estate, regardless of whether farming income passes through to beneficiaries

**85.** Priya Fenmore rents her lake cottage for 90 days during the year and uses it personally for 20 days, exceeding both the 14-day and 10%-of-rental-days thresholds so that the cottage is treated as a dwelling unit used as a residence under Section 280A. Her rental deductions are limited to rental income. In what order must Priya deduct her expenses against that rental income?

A. Depreciation is deducted first, followed by operating expenses, and finally mortgage interest and property taxes
B. All expense categories are deducted simultaneously, in proportion to their relative dollar amounts
C. Operating expenses are deducted first, followed by depreciation, and finally mortgage interest and property taxes
D. Mortgage interest and property taxes allocable to rental use are deducted first, followed by operating expenses, then depreciation

**86.** Millbrook Community Foundation, a public charity, pays its executive director compensation the IRS later determines is unreasonably excessive, resulting in an excess benefit transaction under Section 4958. What is the primary consequence to the executive director, a disqualified person, as a result?

A. The executive director is subject to an excise tax on the excess benefit received, and a separate excise tax if the excess benefit is not corrected

B. The foundation's tax-exempt status is automatically and immediately revoked the moment any excess benefit transaction is discovered

C. The executive director must return only the excess amount, with no additional excise tax or penalty imposed under any circumstances

D. The foundation is barred permanently from ever again employing the executive director in any capacity, paid or unpaid

**87.** Camborne Steel Fabricators' 401(k) plan is determined to be top-heavy for the plan year because key employees hold more than 60% of total plan assets. Under Section 416, what minimum benefit must the plan generally provide to non-key employees for that year?

A. No minimum contribution is required for non-key employees as long as the plan otherwise passes the ADP test

B. A minimum employer contribution of 3% of compensation, or the highest rate provided to any key employee if lower

C. A minimum employer contribution equal to 10% of compensation for every eligible non-key employee in the plan

D. A minimum benefit is required only for non-key employees who are also highly compensated employees

**88.** Foundation manager Cormac Whitlock knowingly approves an act of self-dealing between Ironwood Charitable Foundation, a private foundation, and a substantial contributor, without reasonable cause. Under Section 4941, what initial-tier excise tax may the IRS impose directly on Whitlock as the participating foundation manager?

A. A tax equal to 10% of the amount involved, assessed against the foundation itself rather than the manager

B. No tax may ever be assessed against a foundation manager personally under the self-dealing rules

C. A tax equal to 5% of the amount involved in the self-dealing act, up to $20,000 per act

D. A tax equal to 200% of the amount involved, identical to the correction-tax level imposed on self-dealers

**89.** Meadowvale Neighborhood Alliance is newly organized and intends to operate as a Section 501(c)(4) social welfare organization without seeking an IRS determination letter. Within how many days of its formation must it submit the required electronic notification to the IRS under Section 506?

A. Ninety days from the date the organization's founding document is executed, matching the deadline for Form 1024-A

B. There is no deadline, since Section 506 notification is entirely optional for social welfare organizations

C. One year from the date the organization begins operating, aligned with its first Form 990 due date

D. Sixty days from the date the organization is organized, using Form 8976, Notice of Intent to Operate

**90.** Fernvale Conservation Trust, a tax-exempt organization, owns a building acquired with mortgage debt. Ninety percent of the building's square footage is used directly for the trust's exempt conservation-education programs, while the remaining ten percent is rented to an unrelated tenant. Does the mortgage debt make this property unrelated debt-financed property subject to UBIT?

A. Yes, because any portion of debt-financed property rented to an unrelated party automatically taxes the entire property

B. No, because churches and conservation organizations are categorically excluded from the debt-financed property rules entirely

C. No, because the property escapes debt-financed treatment once 85% or more of its use serves the organization's exempt purpose

D. Yes, but only the rented ten percent is taxed, while the mortgage debt on the remaining ninety percent is disregarded

**91.** Following the death of the grantor, the trustee of the Hawthorne Revocable Trust and the executor of the grantor's estate jointly make a timely Section 645 election. What is the effect of this election?

A. The trust is treated as part of the decedent's estate for income tax reporting purposes for the applicable election period

B. The trust is permanently converted into an irrevocable complex trust, filing its own separate Form 1041 indefinitely

C. The election accelerates estate tax liability, requiring immediate payment of estate tax before the normal nine-month due date

D. The election terminates the trust entirely, requiring immediate distribution of all trust assets to the named beneficiaries

**92.** Trustee Ophelia Danforth manages the Cavendish Trust, invested for total return, which produces only modest traditional accounting income even though the portfolio's overall value has appreciated substantially. The trust instrument authorizes total-return investing, and state law has adopted the Uniform Principal and Income Act. What tool may Ophelia use to fairly balance the income and remainder beneficiaries' interests without violating the trust's terms?

A. She may not act; total-return trusts require a formal court reformation before any principal and income adjustment is possible

B. The statutory power to adjust between principal and income, reallocating a reasonable amount of appreciation to accounting income

C. A mandatory annual distribution of all trust corpus to the income beneficiary, converting the trust into a simple trust

D. An automatic conversion of the entire trust into a unitrust, without any need for beneficiary notice or consent

**93.** Draymoor Fixtures Corp maintains a traditional defined benefit pension plan for its owner, whose average compensation for his highest three consecutive years is $310,000. Under Section 415(b), how is the maximum annual retirement benefit payable to him from the plan generally limited?

A. To a flat 50% of his highest single year's compensation, regardless of any dollar cap

B. To the full $310,000, since defined benefit plans impose no ceiling on highly paid owners

C. To 100% of his final year's compensation only, without regard to any three-year average

D. To the lesser of the annually indexed dollar limit or his highest three-year average compensation

**94.** Decedent Edmund Colby died owning stock for which a dividend had been declared with a record date before his death but was not paid until after he died. The dividend, treated as income in respect of a decedent, was included at its date-of-death value in Edmund's gross estate, which was subject to federal estate tax. When his estate collects the dividend, what may it deduct under Section 691(c)?

A. Nothing; IRD is reported gross with no deduction, no matter how much estate tax was paid

B. The portion of the estate's federal estate tax attributable to including the IRD item in the gross estate

C. A full exclusion of the dividend, since it was already taxed once at the estate tax level

D. A deduction equal to the entire dividend amount, effectively eliminating any income tax on IRD items

**95.** Cash-method farmer Wendeline Corrigan's soybean crop suffers no physical damage, but she receives an $18,000 payment under a revenue protection crop insurance policy solely because the fall harvest price fell below the price used to set her coverage guarantee. She wants to defer this payment to next year under Section 451(d), as she would with proceeds from hail-damaged crops. May she do so?

A. Yes, all crop insurance proceeds, regardless of the triggering cause, qualify for the one-year deferral election

B. No, because farmers may never defer any crop insurance proceeds under any circumstances whatsoever

C. No, because Section 451(d) deferral applies only to physical crop damage, not price-only revenue coverage

D. Yes, but only if she also elects farm income averaging for the same year on Schedule J

**96.** Trustee Percival Langdon receives a 5% stock dividend on shares held in a trust portfolio, in addition to the portfolio's regular quarterly cash dividends. Under the Uniform Principal and Income Act's default rules, how are these two receipts classified for fiduciary accounting purposes?

A. The stock dividend is allocated to principal, while the regular cash dividends are allocated to accounting income

B. Both the stock dividend and the cash dividends are allocated entirely to principal, protecting the remainder beneficiary

C. Both the stock dividend and the cash dividends are allocated entirely to accounting income for the current beneficiary

D. The stock dividend is allocated to accounting income, while the cash dividends are allocated to principal instead

**97.** Full-time licensed real estate broker Owainn Brightwater logs 2,000 hours annually in real estate brokerage and construction consulting, easily satisfying the 750-hour and more-than-half-of-working-time tests for real property trades or businesses. Midway through the year, he purchases his first rental property but participates in that specific rental activity for only 40 hours before year-end. Does he qualify to treat that rental activity's losses as nonpassive under Section 469(c)(7)?

A. Yes, automatically; meeting the hour thresholds alone converts every rental activity's losses to nonpassive

B. No, because real estate professional status alone is not enough; he must also separately materially participate in that specific rental activity

C. Yes, but only if he formally converts his brokerage license into a property management license first

D. No, because rental real estate losses can never be treated as nonpassive under any circumstances

**98.** Instead of matching each employee's elective deferrals dollar-for-dollar up to 3% of compensation, Falkirk Manufacturing, a small employer sponsoring a SIMPLE IRA plan, wants to make a nonelective contribution for every eligible employee instead, regardless of whether that employee defers any salary. What is this alternative nonelective contribution generally set at?

A. 1% of compensation for every eligible employee, capped at $5,000 annually per employee

B. 4% of compensation for every eligible employee, matching the standard 401(k) safe harbor formula

C. 10% of compensation for every eligible employee, well above the standard matching contribution level

D. 2% of compensation for every eligible employee, applied up to the annual compensation limit, regardless of deferrals

**99.** Under the terms of its governing instrument, the Galebridge Trust, a simple trust, must currently distribute all accounting income to its sole beneficiary every year. An administrative delay causes the trustee to hold the distribution until January of the following year, even though the income was earned and available for distribution during the current year. In which year must the beneficiary include this income?

A. The current year, because a simple trust beneficiary is taxed on income required to be distributed, whether paid or not

B. The following year, because income is taxable to a trust beneficiary only in the year it is physically received

C. Neither year, because administrative delays in distribution permanently exclude the income from the beneficiary's gross income

D. The trust itself is taxed on the delayed income, since it was not actually distributed within the proper tax year

**100.** The Pemberton Bridge Trust earns $60,000 of taxable interest and $40,000 of tax-exempt municipal bond interest during the year, and the trustee pays $10,000 of indirect administration expenses, such as general trustee fees, that do not relate to any specific class of income. How must the trustee allocate these indirect expenses for fiduciary income tax purposes?

A. The entire $10,000 is deductible against taxable interest, since tax-exempt income requires no offsetting expense allocation

B. The entire $10,000 must be allocated to the tax-exempt income, permanently disallowing any income tax deduction

C. The $10,000 must be allocated proportionally between taxable and tax-exempt income, so only $6,000 remains deductible

D. The trustee may deduct the full $10,000 against taxable income now and again against tax-exempt income later

## Answer Key and Explanations — Practice Exam 27, Part 2: Businesses

**1. A** — Bartering income is taxable when received under IRC Section 61 and Reg. Section 1.61-2; a cash-method taxpayer reports the fair market value of goods or services received as gross income in the year the exchange occurs. No cash needs to change hands, and the absence of a Form 1099-B does not exempt the transaction from income recognition.

**2. B** — Section 1402(a) requires net earnings from self-employment to be computed by combining the net profit and net loss from all of a taxpayer's trades or businesses reported on separate Schedule C forms before applying the 92.35% factor on Schedule SE. A loss from one Schedule C activity offsets profit from another; it is not disregarded or excluded.

**3. D** — Under Section 724(b), property that was inventory in the contributing partner's hands retains its ordinary income character in the partnership's hands for five years after the contribution, regardless of how long the partnership later holds it before disposition. The full $15,000 built-in gain is therefore ordinary income to the partnership, not capital gain.

**4. C** — Under Reg. Section 1.752-2, a bottom-dollar payment obligation, one under which the guarantor's exposure begins only after other resources are exhausted, is disregarded entirely for purposes of allocating partnership recourse liabilities. Because Renata bears no genuine first-dollar economic risk of loss, her guarantee does not increase her share of the debt or her outside basis.

**5. D** — Under Section 707(c), when a guaranteed minimum exceeds a partner's distributive share computed without regard to the guarantee, only the excess is treated as a guaranteed payment; the remainder retains its character as a distributive share of partnership income. Anselm's $50,000 distributive share stands, and the $20,000 shortfall needed to reach $70,000 is the guaranteed payment.

**6. B** — Under Section 752(b), a decrease in a partner's share of partnership liabilities is treated as a deemed cash distribution. This $14,000 deemed distribution is aggregated with the $18,000 actual cash distribution, for $32,000 total, and tested against Bianca's $25,000 outside basis under Section 731(a), producing a $7,000 taxable gain to her.

**7. C** — Under Section 751(d), inventory items are 'substantially appreciated' when their aggregate fair market value exceeds 120% of the partnership's adjusted basis in that inventory. Corrigan's inventory, valued at $260,000 against a $200,000 basis, a 130% ratio, exceeds the 120% threshold, so the inventory qualifies as a hot asset under Section 751(b).

**8. A** — Because Hallowmere has a valid Section 754 election, Section 734(b) requires the partnership to increase the basis of its remaining assets by $20,000, matching the gain Paloma recognized under Section 731(a) on the liquidating cash distribution. This basis step-up prevents the same appreciation from being taxed again to the remaining partners.

**9. C** — An allocation with formal economic effect can still fail the substantiality test under Reg. Section 1.704-1(b)(2)(iii) if it is a transitory allocation, a prearranged offsetting shift between tax years that leaves the partners' economic shares substantially unchanged. Because the Year 2 reversal cancels the Year 1 allocation's economic effect, Sablecrest's allocation lacks substantiality and will be reallocated.

**10. B** — The Tax Cuts and Jobs Act repealed the former Section 708(b)(1)(B) technical termination rule for sales or exchanges of 50% or more of partnership interests within twelve months, effective for tax years beginning after 2017. A partnership now terminates under Section 708(b)(1) only when it ceases operating as a business, so Windmere continues without interruption despite the sale.

**11. D** — Under Reg. Section 1.707-3(c), a contribution and a distribution occurring within two years of each other are presumed to be a disguised sale under Section 707(a)(2)(B). This presumption shifts the burden to the taxpayer, requiring facts and circumstances clearly establishing the transfers are unrelated to overcome it; outside the two-year window, the opposite presumption applies.

**12. A** — Section 465(b)(6) provides that qualified nonrecourse financing, debt secured by real property and borrowed from a qualified unrelated lender such as a commercial bank, counts toward a partner's amount at risk even though no partner bears personal liability for repayment. This exception applies only to real property activities, so Rosamund's amount at risk includes her allocable share.

**13. C** — Section 469(g) provides that when a taxpayer disposes of his entire interest in a passive activity in a fully taxable transaction to an unrelated party, all suspended losses from that activity become fully deductible against nonpassive income in the year of disposition. Otis's complete, taxable sale of his Fernbridge interest releases the $45,000 of suspended losses.

**14. A** — Under Rev. Proc. 2013-13, home office expense carryovers disallowed under the regular method's income limitation are suspended, not permanently forfeited, if the taxpayer switches to the simplified method for a later year. The carryover becomes deductible again only in a subsequent year the taxpayer reverts to the regular method, subject to that year's income limitation.

**15. D** — Section 274(b) limits the deduction for business gifts to $25 per recipient per year, regardless of how many gifts are given or the gift's actual cost. Adaeze may deduct only $25 of each $60 gift basket, for a total deduction of $250 across her ten clients; the excess cost above each per-recipient limit remains permanently nondeductible.

**16. B** — Under Section 1015, a donee's basis in gifted property generally equals the donor's adjusted basis, increased by any gift tax paid that is attributable to the property's net appreciation in value. Corbin's basis is therefore Alistair's $80,000 basis plus the $6,000 of gift tax attributable to appreciation, for a total basis of $86,000.

**17. C** — Section 280A(c)(5) and its regulations impose a three-tier ordering rule for the regular home office method: otherwise-deductible expenses like mortgage interest and property taxes are applied first, then operating expenses, then depreciation last, each tier limited by remaining gross income from the business, with any excess carried forward to later years.

**18. A** — Section 6664(c) provides a reasonable cause and good faith exception to the Section 6662 accuracy-related penalty. Reasonable, good-faith reliance on a competent tax advisor's written advice, when the taxpayer supplied complete and accurate information, satisfies this exception even though the IRS ultimately disallows the position taken. The advisor need not sign the return as preparer.

**19. D** — Under Section 351(b), property or money received in addition to stock is boot. A short-term corporate note is debt, not a qualifying security, so it does not share in nonrecognition. Okonkwo recognizes gain equal to the lesser of his realized gain or the note's fair market value; the other transferors remain unaffected.

**20. D** — Courts weigh multiple factors when distinguishing debt from equity, including proportionality to stock ownership, absence of a fixed maturity date, and subordination to outside creditors. Advances sharing all three traits closely resemble a capital contribution, supporting reclassification as equity and disallowance of the corporation's related interest deductions under general debt-equity case law principles.

**21. B** — When current earnings and profits show a deficit but accumulated earnings and profits are positive, the deficit is generally prorated to the distribution date and netted against the accumulated balance to determine how much is available for dividend treatment under Section 301 and Section 316, rather than testing either pool in isolation.

**22. C** — Under Section 336(b), the corporation's fair market value for computing gain is not treated as less than the liability assumed by the distributee, so gain is measured on the full $300,000 value. Under Section 331, Lindholm's amount realized on her stock is reduced by the mortgage she assumes when computing her own gain or loss.

**23. B** — A distribution in partial liquidation under Section 302(b)(4) is tested at the corporate level under Section 302(e) for a genuine contraction of business, such as terminating an active line of business. For a noncorporate shareholder, qualifying redemptions receive exchange treatment automatically, without needing to separately satisfy the shareholder-level tests of Section 302(b).

**24. A** — Section 1361(c)(1) permits members of a family, defined broadly across generations from a common ancestor, to be treated as a single shareholder for purposes of the 100-shareholder eligibility limit. This family aggregation rule lets large, multi-generational family-owned businesses maintain a valid S election even while many individual family members hold stock directly in their own names.

**25. C** — Under Section 1367 and its regulations, pass-through income for the year restores previously reduced debt basis before a loan repayment during that same year is tested for gain. Talbridge's $9,000 of income restores her $6,000 debt basis reduction first, so the $4,000 repayment occurs against restored basis and is not currently taxable.

**26. D** — Section 1371(e) allows cash distributions made during the post-termination transition period to be applied against the corporation's accumulated adjustments account carried over from its S corporation years, reducing the shareholder's stock basis tax-free up to that remaining balance, similar to how distributions were treated while the S election was still in effect.

**27. A** — Section 1374(d)(2) caps the net recognized built-in gain subject to tax at the corporation's taxable income for the year, computed as if it remained a C corporation. Chandler is taxed on $65,000 this year, and the excess $25,000 carries forward and is treated as recognized built-in gain in a succeeding year within the recognition period.

**28. B** — Section 856(c) imposes two annual gross income tests on a REIT. The more restrictive 75% test requires at least 75% of gross income to come from real estate-related sources such as rents from real property, mortgage interest, and gains from real property sales. The broader 95% test permits additional passive sources like dividends and securities interest.

**29. C** — Under Revenue Ruling 84-111, when a state law conversion statute does not clearly establish the form of the transaction, the IRS treats the conversion as an assets-over transaction: the partnership is deemed to contribute its assets and liabilities to the new corporation in exchange for stock, followed by a liquidating distribution of that stock to the members.

**30. B** — A liability is allocated to the member who bears the economic risk of loss for repayment. Because Pemberton alone guarantees the loan and would bear the ultimate obligation if the LLC defaulted, the entire $90,000 recourse liability is allocated to increase only her outside basis, while the other members receive no basis increase from it.

**31. D** — Section 303 allows a corporation to redeem stock included in a decedent's gross estate to pay death taxes and funeral and administration expenses as a sale or exchange, without regard to the dividend-equivalence tests, when the stock's value exceeds 35% of the adjusted gross estate. The redemption here is limited to those specified expense amounts.

**32. A** — Under Section 7872, a below-market corporation-shareholder demand loan is recharacterized as if the corporation paid a dividend equal to the forgone interest, and Fenshaw is treated as paying that same amount back to the corporation as interest. The dividend is includible income to Fenshaw, while the deemed interest may be deductible or investment interest to her.

**33. C** — Section 1361(b)(1)(B) limits eligible S corporation shareholders to individuals and certain qualifying trusts and estates; a traditional IRA is neither. Outside the narrow grandfathered exception for specific bank stock held by an ESOP-owned IRA, an IRA holding S corporation stock is an ineligible shareholder, and the acquisition would terminate Oakmont Corp.'s S election.

**34. A** — Section 306(a)(2) treats a redemption of Section 306 stock as a distribution taxed as an ordinary dividend to the extent of the corporation's earnings and profits, regardless of the exchange-qualification tests under Section 302 that would otherwise apply to a stock redemption. This ordinary income characterization applies even though the stock itself was originally received tax-free.

**35. B** — Under Section 704(e), where capital is a material income-producing factor, a family member who is a genuine owner of a capital interest, including one acquired by gift, is recognized as a partner for tax purposes, and reasonable allocations of income attributable to that capital interest are respected, separate from any requirement to perform services.

**36. D** — Under the origin-of-the-claim doctrine, settlement proceeds are characterized by what they replace, not by the fact of litigation itself. Amounts compensating lost profits are ordinary income, while amounts compensating permanent injury to a capital asset such as goodwill are treated as proceeds from disposition of that asset, generally producing capital gain.

**37. C** — IRC Section 472 prohibits combining LIFO with the lower of cost or market method; once LIFO is adopted, inventory must be valued strictly at LIFO cost, never written down to a lower market value. This rule exists because LIFO already assumes the most recent, typically higher, costs are sold first, making a market write-down inconsistent with the method.

**38. D** — A partnership with more than 35% of losses allocated to limited partners or limited entrepreneurs who do not actively manage the business is a syndicate under Section 1256(e)(3)(B), a category of tax shelter under Section 448(a)(3). Syndicates are barred from the cash method automatically, regardless of how low their gross receipts are.

**39. B** — Under Section 471(c), a qualifying small business taxpayer that is not required to keep inventories may treat inventoriable goods as non-incidental materials and supplies. Under Section 1.162-3, such items are deducted in the year used or consumed, or, if the taxpayer's applicable financial statement so conforms, in the year paid, permitting a hybrid cash-and-simplified-inventory approach.

**40. A** — A natural business year exists when gross receipts for the last two months of the requested annual accounting period equal at least 25% of total annual gross receipts, for the current year and the two preceding years. Meeting this test permits an automatic accounting period change under the applicable revenue procedure, without a private letter ruling.

**41. C** — Under the related-party second disposition rule of Section 453(e), when a related first purchaser resells installment-sale property within two years of the original sale, the original seller must treat the resale proceeds as received, accelerating recognition of the deferred installment gain, subject to limited exceptions such as involuntary conversions or the purchaser's death.

**42. B** — The Tax Cuts and Jobs Act amended Section 1031, effective for exchanges completed after December 31, 2017, to limit like-kind exchange nonrecognition to real property held for productive use in a trade or business or for investment. Exchanges of personal property, including machinery and equipment, no longer qualify, so Cobalt must recognize any realized gain on the trade.

**43. D** — Section 1033(g) provides a special, broader replacement standard for real property condemned or seized in connection with a trade or business or investment: the taxpayer need only acquire property of a like kind, the same broad standard used for Section 1031 exchanges, rather than the narrower similar-or-related-service-or-use test applied to most other involuntary conversions.

**44. A** — Unlike a positive Section 481(a) adjustment, which is generally spread ratably over four tax years beginning with the year of change, a negative adjustment that decreases income is taken into account entirely in the year of change. This favorable treatment lets the taxpayer claim the full benefit immediately rather than deferring it across multiple years.

**45. C** — Proposed Treasury regulations under Section 7701 generally treat each series of a series LLC organized under a state series statute as a separate entity for federal tax purposes, independently classified under the check-the-box regulations based on its own number of owners and elections. Separate books, ownership, and business purposes support respecting each series individually rather than combining them.

**46. B** — Section 1341 provides special relief, deducting the repayment or recomputing the earlier year's tax, whichever produces the greater tax benefit, but only applies when the repayment exceeds $3,000. Because Priscilla's repayment is $2,400, she falls below that threshold and simply claims an ordinary deduction for the repayment in the current year, with no special recomputation available.

**47. A** — A significant modification of a debt instrument is a deemed exchange of the old debt for a new instrument under Section 1.1001-3. Cancellation-of-debt income equals the excess of the adjusted issue price of the old debt over the issue price of the new debt, generally its fair market value, not simply a comparison of stated face amounts.

**48. D** — When a contingent-payment sale has a fixed period but no stated maximum selling price, Treas. Reg. Section 15A.453-1(c)(3) requires basis to be recovered ratably over the fixed payment period. Each payment is allocated a pro-rata share of basis over that term, with the remainder taxed as gain, rather than using a single gross profit ratio applied throughout.

**49. B** — Deferring income recognition under the completed-contract method does not exempt a contract from cost capitalization. Direct costs and the allocable share of indirect costs under Section 263A must still be identified and capitalized to the contract as they are incurred; they are simply matched against the deferred contract income and recognized together only when the contract is complete.

**50. A** — Audit protection generally shields a taxpayer from IRS-imposed adjustments for a prior use of an impermissible method once a method change is properly filed. However, that protection is typically unavailable when the method for the same item is already an issue under consideration in an ongoing examination, subject to limited exceptions such as certain early-in-exam filing windows.

**51. D** — Under the mid-quarter convention, property is treated as disposed of at the midpoint of the quarter of actual disposition, not at the midpoint of the year. Because Ridgeway sold the equipment in the third quarter, depreciation for the disposition year is limited to the applicable mid-quarter percentage reflecting property held through the middle of that third quarter, per Section 168(d)(4)(A).

**52. C** — The mid-month convention treats residential rental and nonresidential real property as disposed of at the midpoint of the month of sale. Lakeside therefore claims a full month's depreciation for January through October and one-half month for November, the month of sale, under Section 168(d)(4)(B), rather than a full or zero deduction for that month.

**53. B** — To qualify as a Qualified Opportunity Zone Business, substantially all of the entity's tangible property must be qualified opportunity zone business property, defined under Section 1400Z-2(d)(3) as at least 70% of the entity's tangible business property. This 70% entity-level test is more lenient than the 90% asset test applied directly to the Opportunity Fund itself.

**54. C** — Unlike credits claimed automatically based on qualifying expenditures, the Section 48C qualifying advanced energy project credit is awarded only through a competitive application process. The Department of Energy reviews and recommends projects, and the IRS certifies allocations, up to a statutorily limited nationwide credit pool, meaning not every technically eligible project receives an allocation.

**55. D** — Passenger automobiles remain subject to the Section 280F annual dollar limitations even when 100% bonus depreciation applies; the statute caps the combined regular and bonus first-year deduction at the indexed luxury-auto ceiling. Comet may not deduct the full $48,000 cost in the first year, only the capped amount, with any excess basis recovered in later years.

**56. A** — The anti-churning rules of Section 197(f)(9) prevent taxpayers from converting a non-amortizable, pre-existing intangible into an amortizable Section 197 intangible simply by transferring it between related parties after the section's enactment. Because Kline acquired the customer list from a related party who already owned and used it pre-enactment, the intangible remains outside Section 197 amortization.

**57. C** — Section 38(d) requires that carryforward credits be used before the current-year general business credit, applied in the order earned, oldest first, on a first-in first-out basis. Only after older carryforwards are absorbed does the current year's credit apply, ensuring older carryforwards do not expire unnecessarily while newer credit amounts remain available for future years.

**58. D —** The Work Opportunity Tax Credit includes a long-term unemployment recipient targeted group under Section 51(d)(1)(J), covering individuals who received state or federal unemployment compensation for a period of not less than 27 consecutive weeks ending on the hire date. Because Renata satisfies this 27-week requirement, Harvest Moon Bakery's wages paid to her qualify under this specific targeted group category.

**59. B —** Section 41(d)(4)(F) excludes research conducted outside the United States, Puerto Rico, or any U.S. possession from the definition of qualified research, regardless of whether the activity otherwise satisfies the four-part test. Nucleus's foreign laboratory expenses generate no research credit benefit, even though the underlying polymer research would qualify if performed domestically instead.

**60. A —** Section 44(d)(7) requires that any deduction or depreciable basis otherwise allowable for the same expenditures be reduced by the amount of Disabled Access Credit claimed, so the taxpayer does not receive both a full credit and a full deduction for the identical costs. Boyd's basis or deduction is reduced dollar-for-dollar by the credit amount claimed.

**61. D —** Section 45R(e) limits the small employer health insurance credit to a credit period of two consecutive taxable years, beginning with the first year the employer or a predecessor claims it. Once Silverton has claimed the credit for two consecutive years, it is no longer eligible for the credit in a third consecutive year, even if it continues purchasing SHOP coverage.

**62. A —** Section 45F(d) imposes recapture if a taxpayer ceases operating a facility as a qualified childcare facility within ten years of the credit being claimed. The recapture percentage declines on a sliding scale, reaching 100% within the first few years and phasing down to zero after ten years, so Hensley recaptures only a declining portion, not the full credit.

**63. B —** Section 40A provides an incentive for biodiesel and renewable diesel, generally structured as a nonrefundable income tax credit computed per gallon of qualifying fuel produced or sold for a qualifying use, though in certain circumstances the incentive may instead be claimed as an excise tax credit against fuel excise tax liability. The amount depends on gallons, not a flat fee.

**64. C —** Treas. Reg. Section 1.199A-4 permits an individual to aggregate multiple trades or businesses for QBI purposes only if they satisfy common ownership requirements, use the same taxable year, and are not specified service trades, and satisfy at least two of three factors showing operational interdependence, such as shared facilities or centralized business elements like accounting and purchasing.

**65. C —** Section 199A(d)(2) and the regulations define trading as an SSTB when the business consists of trading in securities, commodities, or partnership interests, including trading for the taxpayer's own account. Marsh Capital Trading falls within this category, so Elliot's QBI deduction from the business is subject to the SSTB wage/UBIA phase-out once his taxable income exceeds the threshold.

**66. B —** Employers must deposit FUTA tax by the last day of the month following any calendar quarter in which cumulative undeposited liability exceeds $500. Redgate's liability reached $560 by the third quarter's end, so a deposit is required then, not held until year-end; liabilities of $500 or less may instead be carried forward to the next quarter.

**67. A —** The IRS common-law test groups evidence into behavioral control, financial control, and type of relationship. Financial control examines whether the worker has a significant investment in equipment, makes services available to the relevant market, and can realize a profit or incur a loss. Priya's equipment investment, outside advertising, and profit-or-loss exposure all point to financial control, favoring independent contractor status.

**68. D —** Under Section 6205 and its regulations, an employer correcting an overreported employee FICA share through the interest-free adjustment process must first repay or reimburse the affected employees for their overwithheld amount, or obtain their written consent to file the claim on their behalf. Without repayment, reimbursement, or consent, Featherstone must instead file a claim for refund.

**69. A —** A household employer owes FICA once a single employee's annual cash wages meet the indexed threshold, regardless of quarterly amounts. FUTA, however, applies only once cash wages to household employees reach $1,000 in any calendar quarter of the current or preceding year. Because Rosalind's annual total exceeds the FICA threshold but no quarter reached $1,000, only FICA applies here.

**70. B —** An employee who receives $20 or more in cash tips during a calendar month from a single employer must report the tips to that employer in writing by the 10th day of the following month, using Form 4070 or a similar statement. Because Dominic's June tips exceeded $20, he must report them to The Blue Heron Bistro by July 10.

**71. C —** Under Section 280A(c)(5), home office deductions using the actual expense method cannot exceed gross income from the business use of the home, after subtracting otherwise allowable expenses like mortgage interest and property taxes. Any excess is not lost; it carries forward indefinitely and remains subject to the same gross income limitation in future years, so Miriam carries forward $800.

**72. D —** Section 6721 imposes tiered per-return penalties for failing to timely file correct information returns. A lower rate applies if corrected within 30 days of the due date; a higher intermediate rate applies if corrected after 30 days but before August 1; the maximum rate applies to failures corrected on or after August 1 or never corrected at all.

**73. D —** The standard mileage rate already bundles depreciation, fuel, oil, insurance, maintenance, and repairs into a single per-mile figure, so none of those costs may be separately deducted alongside it. Business-related parking fees and tolls, however, are not built into the rate and remain separately deductible in addition to the standard mileage amount Marisol claims for her business driving.

**74. B —** Section 280A(g) excludes rental income from gross income entirely when a personal residence is rented for fewer than 15 days during the year. Because the rental period is so brief, none of the rental-related expenses, such as depreciation or a portion of utilities, may be deducted; mortgage interest and property taxes remain deductible only as ordinary itemized deductions.

**75. A** — Section 105(h) imposes nondiscrimination rules on self-insured medical reimbursement plans. If a plan favors highly compensated individuals by reimbursing a greater percentage of medical expenses than it reimburses rank-and-file employees, the discriminatory portion of the highly compensated individual's reimbursements is includible in that individual's gross income; the plan itself does not lose its tax-favored status entirely.

**76. C** — The Tax Cuts and Jobs Act repealed Section 1031 like-kind exchange treatment for personal property, including business vehicles, leaving it available only for real property. Trading in a business vehicle is therefore treated as a taxable sale, with gain or loss measured by comparing the trade-in allowance to adjusted basis. Callista recognizes $5,000 of gain: $14,000 allowance minus $9,000 basis.

**77. A** — To claim exemption from federal income tax withholding on Form W-4, an employee must have had no federal income tax liability for the prior year and must reasonably expect to have no tax liability for the current year. An exemption claim expires each February 15 and must be renewed annually if the employee still qualifies for it.

**78. D** — Section 6656 imposes graduated failure-to-deposit penalties: 2 percent for deposits 1 to 5 days late, 5 percent for 6 to 15 days late, 10 percent for more than 15 days late, and 15 percent once the IRS issues notice and demand for payment and the deposit remains unpaid more than 10 days later. Coldwater's facts trigger the maximum rate.

**79. B** — The nonfarm optional method allows a taxpayer with low net earnings to report self-employment income equal to two-thirds of gross nonfarm income, up to a specified maximum, provided net nonfarm profit was at least $400 in two of the prior three years. This method has a lifetime limit and may be used in no more than five tax years total.

**80. C** — Section 644(a) generally requires trusts to adopt a calendar tax year, but it excepts trusts exempt from tax under Section 501(a) and charitable trusts described in Section 4947(a)(1) treated as private foundations. Because the Hargrove Wildlife Trust falls within this exception, it may elect a fiscal year rather than the calendar year normally required.

**81. C** — Under the tier system of Sections 661 and 662, tier-one distributions, amounts required to be distributed currently, carry out distributable net income before tier-two distributions, which include discretionary or additional amounts. The widow's mandatory $30,000 is fully satisfied first, leaving only $5,000 of the trust's $35,000 DNI to carry out to the son's tier-two distribution.

**82. D** — Section 512(b)(2) excludes royalties from unrelated business taxable income, provided the exempt organization merely licenses its name or trademark without performing substantial services for the licensee. Because Meridian Heritage Society does nothing beyond granting the license, the sales-based royalty payments remain passive income excluded from UBIT, regardless of the licensee's for-profit status.

**83. B —** A money purchase pension plan is a defined contribution plan requiring the employer to make a fixed, mandatory contribution each year, stated as a percentage of compensation, regardless of profitability, with amounts allocated to individual accounts. This differs from a profit-sharing plan, where contributions remain discretionary, and from defined benefit or cash balance plans, which instead promise a stated benefit.

**84. A —** Farm income averaging under Section 1301 is available only to individuals engaged in a farming business, including individuals who receive farm income indirectly as a partner in a partnership or as an S corporation shareholder. C corporations, partnerships themselves, trusts, and estates may not make the Schedule J election; only the individual taxpayer computes and elects the averaging benefit.

**85. D —** Under the Section 280A vacation-home ordering rules, expenses deductible regardless of rental use, mortgage interest and property taxes allocated to rental days, are deducted first, followed by operating expenses such as utilities and insurance, with depreciation deducted last. Each tier is limited so total rental deductions cannot exceed the rental income reported for the year.

**86. A —** Section 4958 imposes intermediate sanctions on a disqualified person who receives an excess benefit from an applicable tax-exempt organization: an initial 25% excise tax on the excess benefit, and an additional 200% excise tax if the excess benefit is not timely corrected. These sanctions target the individual recipient rather than automatically revoking the organization's exempt status.

**87. B —** A top-heavy defined contribution plan under Section 416 must generally provide non-key employees a minimum employer contribution equal to 3% of compensation, or, if lower, the highest contribution rate percentage actually provided to any key employee for that year. This minimum applies regardless of whether the plan otherwise satisfies the ADP nondiscrimination test.

**88. C —** Section 4941 imposes a first-tier tax of 10% of the amount involved on the disqualified person who self-deals, and a separate 5% tax, capped at $20,000 per act, on any foundation manager who knowingly and without reasonable cause participates in the transaction. The manager's tax applies personally, apart from the foundation's own excise tax liability.

**89. D —** Section 506, enacted by the PATH Act, requires an organization intending to operate under Section 501(c)(4) to electronically notify the IRS on Form 8976 within 60 days of formation, regardless of whether it also seeks a determination letter using the optional Form 1024-A. Failing to file can result in penalties under Section 6652(c).

**90. C —** Section 514(b)(1)(A) excepts property from unrelated debt-financed property treatment when 85% or more of its use is substantially related to the organization's exempt purposes. Because 90% of Fernvale's building serves its conservation-education mission, the entire property escapes debt-financed property classification, and the small unrelated rental portion is instead evaluated under ordinary UBIT rules.

**91. A —** A Section 645 election, jointly made by the trustee of a qualified revocable trust and the executor of the related estate, treats the trust as part of the decedent's estate for income tax reporting purposes during the applicable election period, allowing the combined entity to file a single Form 1041 and access certain estate-only tax benefits.

**92. B —** Under the Uniform Principal and Income Act's power to adjust, a trustee investing under a total-return strategy may reallocate a reasonable amount of the portfolio's appreciation from principal to accounting income, fairly balancing the income beneficiary's and remainder beneficiary's interests without needing to convert the trust to a unitrust or seek court reformation first.

**93. D —** Section 415(b) caps the annual benefit a defined benefit plan may pay at the lesser of an annually adjusted dollar limit or 100% of the participant's average compensation for his highest three consecutive years of service. Because his three-year average compensation exceeds the indexed dollar limit in most years, that dollar cap typically controls his maximum allowable annual benefit.

**94. B —** Section 691(c) allows the recipient of income in respect of a decedent to deduct the portion of federal estate tax attributable to including that IRD item in the decedent's gross estate, preventing full double taxation. The dividend remains taxable income when collected, but the Section 691(c) deduction offsets part of the resulting income tax burden on the estate.

**95. C —** Section 451(d) allows a cash-method farmer to defer crop insurance or disaster payments received on account of destruction or damage to crops caused by drought, flood, or other natural disaster. Proceeds paid solely because of a decline in commodity price, with no physical crop damage, do not qualify for this deferral election and must be reported in the year received.

**96. A —** Under the Uniform Principal and Income Act's default rules, a stock dividend or stock split represents a change in the form of the underlying investment and is allocated entirely to principal, while ordinary cash dividends are treated as accounting income currently payable to the income beneficiary. This distinction preserves trust corpus for the benefit of remainder beneficiaries.

**97. B —** Qualifying as a real estate professional under Section 469(c)(7) only removes the automatic passive presumption for rental activities; the taxpayer must still separately satisfy a material participation test for each specific rental activity, or a valid grouping election, before its losses become nonpassive. His 40 hours alone likely fail to establish material participation in that particular activity.

**98. D —** As an alternative to the standard 3% matching formula, a SIMPLE IRA employer may instead elect to make a nonelective contribution equal to 2% of each eligible employee's compensation, up to the annual compensation limit, regardless of whether that employee defers any salary. This nonelective option must be offered uniformly to every eligible employee in the plan.

**99. A —** Section 652(a) taxes a simple trust's income beneficiary on the amount of accounting income required to be distributed currently, regardless of whether the trustee actually makes the distribution during the year or delays it for administrative reasons. Because distribution was required and the income was available, the beneficiary must report it in the current year, not when actually received.

**100. C —** Indirect expenses that cannot be directly attributed to a specific class of income, such as general trustee fees, must be allocated ratably between taxable and tax-exempt income based on their relative share of total trust income. Here, 60% of the $10,000, or $6,000, is allocable to taxable interest and deductible, while the remaining $4,000 allocable to tax-exempt income is nondeductible.