

ENROLLED AGENT PRACTICE EXAMS

Part 2 - Businesses



ERRATA SHEET

2025/26
Testing Cycle



SKILLPREP BOOKS

Enrolled Agent Practice Exams PART 2 - ERRATA SHEET

This document contains corrections and clarifications for *Enrolled Agent Practice Exams PART 2 2025-2026* by *SkillPrep Books* for editions published **before April, 2025**.

Some questions have been corrected, while others have been revised to enhance clarity. Please use this information to update the content and ensure you have the most accurate version possible.

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PART 2 - PRACTICE EXAM #1

QUESTION 8

8. A corporation records a \$35,000 operational loss and receives \$120,000 in dividends from a corporation it owns 25% of. Its pre-dividend deduction taxable income is \$85,000. What is its taxable income?

- A. \$29,750
- B. \$55,250
- C. \$60,000
- D. \$85,000

ANSWER: A. \$29,750

The corporation's taxable income before considering the dividends-received deduction (DRD) is given as \$85,000. Because the corporation owns 25% of the distributing corporation, it is eligible for a 65% DRD. The tentative DRD is calculated as 65% of the dividends received: $\$120,000 * 0.65 = \$78,000$.

However, the DRD is limited to 65% of the corporation's taxable income *before* the DRD. This limitation is calculated as $\$85,000 * 0.65 = \$55,250$.

We must then determine if taking the full tentative DRD (\$78,000) would create a net operating loss (NOL). Since $\$85,000 - \$78,000 = \$7,000$, which is not an NOL, the DRD is limited to the lesser amount of \$55,250.

Therefore, the corporation's final taxable income is $\$85,000 - \$55,250 = \$29,750$.

Topic: Corporate Dividends-Received Deduction (DRD)

QUESTION 12

12. Charles pays \$15,000 on June 1, 2024, for a business insurance policy effective from that date for one year. How much of this expense is deductible in 2024?

- A. \$1,250
- B. \$7,500
- C. \$8,750
- D. \$15,000

ANSWER: D. \$15,000

Prepaid insurance premiums are typically deducted over the period they cover. However, a key exception is the 12-month rule. This rule allows a taxpayer to currently deduct a prepaid expense if the right or benefit created does not extend beyond the earlier of:

- 12 months after the first date the taxpayer realizes the right or benefit, OR
- The end of the tax year following the tax year in which the payment was made.

In this scenario, the policy covers exactly 12 months (June 1, 2024 / May 31, 2025). This falls squarely within the 12-month rule. Charlie is permitted to deduct the full \$15,000 in 2024.

Topic: Prepaid Expenses (12-Month Rule)

QUESTION 13

13. Henry owns a music school and uses the accrual accounting method. On September 1, 2024, he receives \$6,000 for a one-year contract covering 36 lessons starting that day. He delivers six lessons by year-end. What portion of the payment must Henry include in his 2024 income?

- A. \$0
- B. \$1,000
- C. \$5,000
- D. \$6,000

ANSWER: B. \$1,000

Under the accrual method of accounting, income is generally recognized when it is *earned*, regardless of when payment is received. Henry received \$6,000 for 36 lessons, meaning each lesson costs \$166.67. Since he performed 6 lessons in 2024, he should report the income from those 6 lessons: $6 \text{ lessons} * \$166.67/\text{lesson} = \$1,000$.

Topic: Accrual Method of Accounting

QUESTION 21

21. Marcia trades in her two-year-old business vehicle, with a \$3,800 adjusted basis and \$5,000 trade-in value, for a new \$22,000 model. Normally, she would trade in her old car and pay \$17,000. To increase her depreciation basis, she sells her old car to the dealer for \$5,000 cash and buys the new one outright for \$22,000. What is Marcia's depreciation basis for the new car?

- A. \$3,800
- B. \$5,000
- C. \$20,800
- D. \$22,000

ANSWER: C. \$20,800

The IRS does not allow taxpayers to circumvent the like-kind exchange rules by structuring a transaction as a separate sale and purchase when, in substance, it's a trade-in. This is known as the "step transaction doctrine" or the "substance over form" doctrine. Even though Marcia structured the transaction as a sale and a separate purchase, the IRS will likely treat it as a like-kind exchange because it occurred with the same dealer. Here's the correct calculation, treating it as a like-kind exchange:

- Adjusted Basis of Old Vehicle: \$3,800
- Boot Paid: \$17,000 (This is the difference between the new car's price and the trade-in value, not the full \$22,000, because the dealer gave her credit for the trade).

- Basis of New Vehicle: Adjusted Basis of Old Vehicle + Boot Paid = \$3,800 + \$17,000 = \$20,800
- Because the dealer gave her credit, her basis in the new vehicle is 20,800.

Topic: Like-Kind Exchanges (Substance Over Form)

QUESTION 33

33. Which statement about the built-in gains tax for S corporations that were previously C corporations is correct?

- A. The built-in gains tax is passed through to the shareholders and paid at the shareholder level.
- B. The built-in gains tax applies only to recognized built-in gains during the 5-year period beginning on the first day of the first tax year for which the corporation was an S corporation.
- C. The built-in gains tax applies only if the corporation was a sole proprietorship before electing S corporation status.
- D. The built-in gains tax is calculated at the individual income tax rates of the shareholders.

ANSWER: B. The built-in gains tax applies only to recognized built-in gains during the 5-year period beginning on the first day of the first tax year for which the corporation was an S corporation.

The built-in gains tax is a corporate-level tax imposed on S corporations that were previously C corporations. It applies to the "recognized built-in gain" on assets the corporation held at the time of its conversion from a C corporation to an S corporation. Crucially, this tax only applies if those assets are disposed of within a specific recognition period. The recognition period is 5 years, beginning on the first day of the first tax year for which the corporation is an S corporation.

A is incorrect: The tax is paid at the corporate level, not by the shareholders directly (although it reduces the income flowing through to them).

C is incorrect: The tax applies to former C corporations, not former sole proprietorships.

D is incorrect: The tax is calculated at the highest corporate tax rate (currently 21%), not individual rates.

Topic: S Corporation Built-In Gains Tax

QUESTION 39

39. John receives Income in Respect of a Decedent (IRD) in 2024. He also incurs other expenses during the year. Is John required to itemize his deductions in order to deduct the estate tax attributable to the IRD?

- A. Yes, the deduction is only available if he itemizes and his total itemized deductions exceed his standard deduction.
- B. No, the deduction for estate tax attributable to IRD can be claimed regardless of whether John itemizes his deductions.
- C. Yes, the deduction is only available if the IRD is related to a trade or business.
- D. No, the deduction is claimed directly on Form 1040 and reduces gross income, not AGI.

ANSWER: B. No, the deduction for estate tax attributable to IRD can be claimed regardless of whether John itemizes his deductions.

The deduction for federal estate tax attributable to Income in Respect of a Decedent (IRD) is a miscellaneous itemized deduction that is NOT subject to the 2%-of-AGI floor. Critically, the suspension of miscellaneous itemized deductions subject to the 2% floor by the Tax Cuts and Jobs Act (TCJA) does not affect the deductibility of the estate tax attributable to IRD. It remains deductible. Furthermore, although it is an itemized deduction, taxpayers can take the deduction even if they don't take other itemized deductions. It is deductible even if the taxpayer claims the standard deduction.

Topic: Deductions (IRD)

QUESTION 46

46. Retired at 75, Joseph, who stopped working at his family business, has an RMD of \$2,500 for 2024 but only takes out \$2,000. What excise tax might he face?

- A. \$75
- B. \$125
- C. \$150
- D. \$500

ANSWER: B. \$125

The SECURE Act 2.0 reduced the penalty for failure to take an RMD. It used to be 50%, it was reduced to 25%, and can be further reduced to 10% if corrected in a timely manner. The shortfall is $\$2,500 - \$2,000 = \$500$. The penalty is 25% of the shortfall, not 50%. Therefore the tax would be $500 \times .25 = \$125$

Topic: Required Minimum Distributions (RMDs)

QUESTION 49

49. XYZ Corporation made cash contributions totaling \$60,000 to qualified charitable organizations. XYZ received \$35,000 in dividends from a domestic corporation in which it holds a 26% ownership stake. XYZ's taxable income for the year was \$180,000 after the correct dividends-received deduction but before the deduction for charitable contributions. What is XYZ's charitable contribution deduction for the year?

- A. \$18,000
- B. \$20,275
- C. \$50,687.50
- D. \$60,000

ANSWER: B. \$20,275

A corporation's deduction for cash charitable contributions is generally limited to 10% of its taxable income, calculated *before* the charitable contribution deduction, the dividends-received deduction (DRD), NOL carrybacks, and capital loss carrybacks.

XYZ's taxable income *before* the charity deduction but *after* the DRD is \$180,000.

The DRD for 26% ownership is $65\% * \$35,000 = \$22,750$.

Taxable income *before* both charity and DRD = $\$180,000 + \$22,750 = \$202,750$.

The 10% limit is $10\% * \$202,750 = \$20,275$.

Since the actual contribution (\$60,000) exceeds the limit (\$20,275), the deduction is capped at \$20,275. The excess can be carried forward 5 years.

Topic: Corporate Taxation (Charitable Contribution Deduction Limit)

QUESTION 50

50. Corporations are allowed a dividends-received deduction (DRD) for dividends received from taxable domestic corporations, subject to certain requirements. Which of the following is a necessary condition for a corporation to claim the DRD on dividends received?

- A. The distributing corporation is a tax-exempt entity.
- B. The receiving corporation held the stock of the distributing corporation for more than 45 days during a specific period surrounding the ex-dividend date.
- C. The dividend is received from a Real Estate Investment Trust (REIT).
- D. The receiving corporation is *not* obligated to make related payments (e.g., short sale payments) with respect to substantially similar or related property.

ANSWER: B. The receiving corporation held the stock of the distributing corporation for more than 45 days during a specific period surrounding the ex-dividend date.

The dividends-received deduction (DRD) is intended to mitigate the multiple levels of taxation on corporate earnings. To prevent corporations from taking advantage of the DRD by briefly holding stock just to receive the dividend, there's a holding period requirement. Generally, the corporation must have held the stock for more than 45 days during the 91-day period that begins 45 days before the ex-dividend date¹ and ends 45 days after that date. This is a necessary condition (though not the only condition) for claiming the DRD.

Topic: Dividends-Received Deduction (DRD); Holding Period Requirement

QUESTION 51

ANSWER: B. Alice no gain and Mark \$8,000 gain

Mark's \$8,000 recognized gain is due to the cash 'boot' received; Alice's transaction involving cash for stock and receipt of land is treated as resulting in no gain for her under the Section 351 formation context.

Topic: Recognition of Gain on Property for Stock Exchange

QUESTION 55

55. In tax year 2019, MNO Corporation reported \$2,000 in long-term capital gains and \$5,000 in short-term capital gains. In tax year 2023, MNO Corporation incurred a \$15,000 long-term capital loss and a \$6,000 short-term capital gain. MNO Corporation reported no other capital gains or losses in any other tax year. How much net capital loss will be available for MNO Corporation to carry into tax year 2024?

- A. \$0
- B. \$1,000
- C. \$6,000
- D. \$9,000

ANSWER: D. \$9,000

Corporations can carry back a net capital loss to the three preceding tax years and carry it forward for up to five years. The loss is carried back first to the earliest year and then forward, offsetting any capital gains in those years. The carried loss is always treated as a short-term capital loss in the year to which it's carried.

2019: Net capital gain of \$7,000 (\$2,000 long-term + \$5,000 short-term).

2023: Net capital loss of \$9,000 (\$15,000 long-term loss - \$6,000 short-term gain).

Carryback: MNO Corporation must first carry back the \$9,000 loss to the three preceding years: 2020, 2021 and 2022. Since there were no capital gains in those years, the entire \$9,000 loss is carried forward.

The entire loss will not have been absorbed.

2024: The full \$9,000 net capital loss from 2023 is available as a carryforward to 2024.

Topic: Corporate Capital Loss Carrybacks and Carryforwards

QUESTION 56

56. As of December 31, 2024, Cooper, Inc. had incurred \$7,000 in potential market feasibility costs and \$3,000 in advertising costs for the business launch (totaling \$10,000 in §195 start-up costs), plus \$4,500 in legal fees for setting up the corporation (\$248 organizational costs) and \$22,000 for equipment purchases. Cooper, Inc. started business operations on January 1, 2024. Cooper elects to forgo the initial \$5,000 first-year deduction for its start-up costs and instead amortizes the entire \$10,000 of start-up costs over the standard 180-month period. What is the start-up cost amortization expense Cooper, Inc. can deduct in 2024?

- A. \$666.67
- B. \$4,500.00
- C. \$5,166.67
- D. \$10,000.00

ANSWER: A. 666.67

Under Section 195, taxpayers can elect to amortize qualified business start-up costs over a period of 180 months, beginning with the month the active trade or business begins. Taxpayers can also elect to deduct up to \$5,000 in the first year, but this question specifies that Cooper Inc. *elects to forgo* this initial deduction and amortizes the full amount. Cooper Inc. incurred \$10,000 in qualifying start-up costs and began business on January 1, 2024. The full \$10,000 is amortized over 180 months. Monthly amortization = \$10,000 / 180 months = \$55.556 (rounded). Since the business operated for all 12 months of 2024, the total amortization expense for start-up costs in 2024 is \$55.556 * 12 months = \$666.67 (rounded).

Topic: Business Expenses (Start-up Cost Amortization - §195)

QUESTION 62

ANSWER: D. When the liquidating distribution equals or exceeds \$600 in a calendar year

Form 1099-DIV is required for each person to whom the corporation has paid dividends and other distributions on stock when it amounts to \$600 or more in the case of a liquidating distribution.

Topic: Reporting Dividends and Other Distributions

QUESTION 65

65. Linda and Mark, a married couple, made gifts in 2024: Linda gave \$50,000 to her sister and Mark gave \$30,000 to his nephew. They agree to split the gifts. What is the taxable amount of gifts, after the annual exclusion, each must report on Form 709 - United States Gift (and Generation-Skipping Transfer) Tax Return?

- A. Linda and Mark each have taxable gifts of \$7,000
- B. Linda has a taxable gift of \$24,000 and Mark has a taxable gift of \$12,000
- C. Linda and Mark each have taxable gifts of \$8,000
- D. Linda has a taxable gift of \$24,000 and Mark has a taxable gift of zero

ANSWER: A. Linda and Mark each have taxable gifts of \$7,000

When a couple chooses to split their gifts, the total amount of each gift is divided equally between them, and each spouse takes responsibility for half. The annual exclusion is then applied individually to each half of the gift. In this scenario, a \$30,000 gift is split between George and Helen, resulting in each contributing \$15,000. Since this amount is below the annual exclusion limit, neither George nor Helen has any taxable amount from this gift.

Similarly, a \$50,000 gift is divided equally, giving George and Helen \$25,000 each. With the 2024 annual exclusion being \$18,000, both George and Helen find themselves with a taxable gift of \$8,000 each, calculated as \$25,000 minus the \$18,000 exclusion.

Topic: Gift Tax Return and Exclusions

QUESTION 66

66. In 2024, Eldon Family Trust, a simple trust, reported the following items of income and expenses during the year:

- **Ordinary income from rental properties (gross): \$8,000**
- **Taxable dividend income: \$2,000**
- **Interest income from corporate bonds: \$1,500**
- **Interest income from tax-exempt municipal bonds: \$800**
- **Rental expenses: \$3,000**
- **Trustee fees allocable to income: \$1,200**
- **Trustee fees allocable to corpus: \$600**

What is Eldon Family Trust's distributable net income (DNI) for 2024?

- A. \$4,300
- B. \$5,300
- C. \$7,500
- D. \$8,300

ANSWER: C. \$7,500

Distributable Net Income (DNI) for a simple trust is calculated to determine the maximum distribution deduction and amount taxable to beneficiaries. It generally starts with taxable income before the distribution deduction, adds back the exemption, adds net tax-exempt income, and subtracts capital gains allocated to corpus.

Gross Taxable Income = \$8k rent + \$2k div + \$1.5k corp int = \$11,500. Tax-Exempt = \$800. Total = \$12,300.

Total Fees = \$1.2k + \$0.6k = \$1,800. Fees allocable to tax-exempt = $(\$800/\$12,300)*\$1,800 \approx \117 .

Deductible fees = \$1,800 - \$117 = \$1,683. Total Deductions = \$3,000 (rent exp) + \$1,683 = \$4,683.

Taxable Income before dist ded/exemption = \$11,500 - \$4,683 = \$6,817.

Net Tax-Exempt Income = \$800 - \$117 = \$683.

DNI = \$6,817 + \$683 = \$7,500.

Topic: Trust and Estate Income Tax (Distributable Net Income - DNI)

QUESTION 67

67. Meadow Trust, a complex trust with a document that directs capital gains to the corpus, allocates \$3,000 for charitable uses from its gross income and mandates a yearly distribution of \$12,000. If Meadow Trust earned \$25,000 in gross income, including \$6,000 from capital gains, what is its income distribution deduction for 2024?

- A. \$6,000
- B. \$12,000
- C. \$13,000
- D. \$15,000

ANSWER: B. \$12,000

The income distribution deduction for a complex trust is the lesser of (1) the amount distributed (or required to be distributed) other than amounts qualifying for the charitable deduction, or (2) the Distributable Net Income (DNI), reduced by net tax-exempt income. Capital gains allocated to corpus are generally excluded from DNI. Calculate approximate DNI:

Gross Income for DNI \approx \$25k (total) - \$6k (cap gain alloc to corpus) = \$19k. Reduce by expenses/charity (assume \$3k charity deduction applies against this \$19k). DNI \approx \$19k - \$3k = \$16k (ignoring other expenses/exemption). Amount Distributed = \$12,000 (mandatory).

Deduction = Lesser of Amount Distributed (\$12k) or Adjusted DNI (approx \$16k) = \$12,000.

Topic: Trust and Estate Income Tax (Complex Trust - Income Distribution Deduction)

QUESTION 72

ANSWER: B \$1,000

Frank's basis was his \$9,000 cost. He realized a \$4,000 gain when selling for \$13,000. This \$4,000 gain is reduced by Judy's \$3,000 previously disallowed loss (from the related-party sale), resulting in Frank's recognized gain of \$1,000.

Topic: Capital Gains on Related-Party Transactions

QUESTION 80

80. Family members can be recognized as partners in a partnership where capital is NOT a material income-producing factor (e.g., a service partnership) if:

- A. The partnership agreement acknowledges their right to share in the partnership's profits.
- B. Capital is not crucial, they genuinely aim to run a business together, agree on profit shares, and each contributes either capital or effort.
- C. Capital is essential, they obtained their shares through genuine transactions, own their interests outright, and control them despite family ties.
- D. The partnership agreement specifies partner roles, contributions, and their shares in profits, losses, and other partnership aspects.

ANSWER: B. Capital is not crucial, they genuinely aim to run a business together, agree on profit shares, and each contributes either capital or effort.

The recognition of family members as partners for tax purposes depends on the specific facts and circumstances, particularly whether capital is a material income-producing factor in the partnership. When capital is *not* a material income-producing factor (e.g., in a partnership whose income relies primarily on the partners' services or skills), family members are recognized as partners if they genuinely formed the partnership with the intent to conduct business, agreed on how profits and losses would be shared, and each recognized partner contributes either capital *or* substantial or vital services or effort to the business operation. Option B accurately describes these conditions necessary for recognizing family partners in such a scenario where personal services or effort, rather than capital ownership, is the key factor. Option C describes the requirements applicable when capital is considered a material income-producing factor.

Topic: Partnership Taxation (Family Partnerships - Service Partnership)

QUESTION 81

81. Under which condition is no gain or loss recognized by a partnership or its partners when property is contributed to the partnership?

- A. During the partnership's formation.
- B. When the transfer would classify the partnership as an investment company if incorporated.
- C. While the partnership is operational.
- D. When depreciable property without encumbrances is contributed.

ANSWER: A. During the partnership's formation.

Internal Revenue Code Section 721 generally provides that no gain or loss is recognized by either the partnership or its partners when property is contributed to the partnership in exchange for an interest. This nonrecognition rule applies most fundamentally during the partnership's formation, but also generally applies to subsequent contributions of property. An exception exists under §721(b) which triggers gain recognition if the contribution is to a partnership that would be treated as an investment company if incorporated (involving diversification). Option A describes the primary context where §721 nonrecognition applies.

Topic: Partnership Taxation (Contribution of Property - §721 Nonrecognition)

PART 2 - PRACTICE EXAM #2

QUESTION 14

14. James operates a farm and also earns \$8,500 annually from non-farm activities. Which method or methods can James use to report the income from his non-farm activities?

- A. James can use both farm and nonfarm methods, choosing the most beneficial.
- B. James must use the farm-only method for all income earned.
- C. James must use the nonfarm method for all income earned.
- D. James must use the regular calculation method for his nonfarm earnings, as his income exceeds the threshold for the nonfarm optional method.

ANSWER: D. James must use the regular calculation method for his nonfarm earnings, as his income exceeds the threshold for the nonfarm optional method.

Farmers may sometimes use optional methods (farm or nonfarm) to calculate earnings for self-employment tax, primarily to gain Social Security credits. The nonfarm optional method has specific eligibility requirements, including limits on nonfarm net earnings (must be less than \$6,540 for 2024 and less than 72.189% of gross nonfarm income) and a lifetime use limit (5 times). James's nonfarm earnings of \$8,500 exceed the \$6,540 threshold, making him ineligible to use the nonfarm optional method. Therefore, he must use the regular calculation method for his \$8,500 nonfarm income for self-employment tax purposes.

Topic: Optional Methods for Self-Employment Tax (Farmers)

QUESTION 16

16. Thomas sold 60% of his business to his son, forming a partnership where capital is significant. The partnership had a \$75,000 profit. Thomas provided services reasonably valued at \$30,000, while his son provided none. After allocating the reasonable compensation for Thomas's services, what amount of the remaining profit is allocated to Thomas based on his capital interest?

- A. \$18,000
- B. \$27,000
- C. \$30,000
- D. \$45,000

ANSWER: A. \$18,000

In family partnerships where capital is a material income-producing factor, profits must first be allocated to reasonably compensate partners for services rendered. Thomas provided \$30,000 worth of services, which is allocated to him first. The remaining partnership profit is $\$75,000 - \$30,000 = \$45,000$. This remaining profit is then allocated based on partnership capital interests (Thomas retained 40%, his son holds 60%). The rephrased question specifically asks for the amount of this remaining profit allocated to Thomas based on his 40% capital interest, which is $40\% \text{ of } \$45,000 = \$18,000$.

Topic: Partnership Profit Allocation

QUESTION 24

ANSWER: C. \$600

As a 50% partner, Zara's share of 'book' depreciation (on the \$12,000 FMV asset) is \$600. The partnership's total tax depreciation (on its \$6,000 tax basis) is also \$600. Under IRC Section 704(c), to account for the pre-contribution gain, Zara (the non-contributing partner) is allocated tax depreciation equal to her book share, limited to the total tax depreciation available. Thus, Zara is allocated the entire \$600.

Topic: Partnership Depreciation Deductions

QUESTION 31

31. Carl owns a tennis academy, uses the accrual method of accounting, and has a calendar tax year. On October 1, 2024, he receives a \$10,200 payment for a two-year lesson contract starting immediately. For his financial reporting purposes, Carl includes the full \$10,200 advance payment in revenue in 2024. Under the general book conformity principle for advance payments for services (reflecting Treas. Reg. §1.451-8(c)), what amount of the payment must Carl include in gross income for tax purposes in 2024?

- A. \$0
- B. \$1,800
- C. \$9,000
- D. \$10,200

ANSWER: D. \$10,200

Under current tax regulations (reflecting IRC Sec 451(c) and Treas. Reg. §1.451-8) for accrual-method taxpayers receiving advance payments, the timing of income inclusion for tax purposes is often linked to when the income is included for financial reporting purposes. The question states that Carl includes the full \$10,200 payment in revenue for his financial reporting in 2024. Following the principle of book conformity embedded in the regulations, since the income is recognized in his financial statements in 2024, Carl must also include the full \$10,200 in his gross income for tax purposes in 2024.

Topic: Accounting Methods (Advance Payments & Book Conformity)

QUESTION 45

ANSWER: B. Thompson, Ltd. reports the expense in 2023 and Alice reports the income in 2024

Alice, using the cash basis, includes income when actually received (2024). Thompson, Ltd., using accrual accounting, typically reports an expense when it accrues (2023). If related-party rules (IRC Sec. 267) that could defer Thompson, Ltd.'s deduction are disregarded for this question's basic timing focus, then the interest is expensed by Thompson, Ltd. in 2023, and reported as income by Alice in 2024 when received.

Topic: Accounting Methods

QUESTION 48

48. Special rules apply to like-kind exchanges between related persons. Under these rules, related persons include:

- A. The taxpayer and a member of his or her family
- B. The taxpayer and a corporation in which the taxpayer directly or indirectly owns more than 50% of the stock (by value).
- C. The taxpayer and a partnership in which the taxpayer directly or indirectly owns more than 50% of the capital interest or the profits interest.
- D. All of the above

ANSWER: D. All of the above

For purposes of like-kind exchanges, related persons are defined broadly and include family members (siblings, spouses, ancestors, and lineal descendants), a corporation where the taxpayer owns more than 50% of the stock, and a partnership where the taxpayer owns, directly or indirectly, more than a 50% interest in the capital or profits.

Topic: Like-Kind Exchanges - Related Persons

QUESTION 58

58. On October 10, 2024, Partnership X incurred \$12,000 in accounting and legal fees to establish the partnership agreement. The partnership commenced business activities on November 1, 2024. Which of the following is a permissible election for the treatment of the \$12,000 payment?

- A. Deduct \$12,000
- B. Deduct \$6,000 and amortize the remaining \$6,000 over a 5-year period
- C. Deduct \$5,000 and amortize the remaining \$7,000 over 180 months
- D. Amortize \$12,000 over a 5-year period

ANSWER: C. Deduct \$5,000 and amortize the remaining \$7,000 over 180 months

Partnership organizational costs, such as the \$12,000 in legal and accounting fees incurred here, are capital expenditures. Under IRC Section 709, a partnership may elect a specific treatment for these costs. The election allows the partnership to deduct up to \$5,000 of organizational costs in the tax year in which the partnership begins business. This \$5,000 allowance applies fully here because the total costs (\$12,000) do not exceed the \$50,000 phase-out threshold. The amount of organizational costs that exceeds the \$5,000 deduction ($\$12,000 - \$5,000 = \$7,000$) must then be amortized ratably over a period of 180 months (15 years), beginning with the month the partnership begins business (November 2024 in this case). Option C accurately describes this elective treatment.

Topic: Partnership Organizational Costs (Section 709 Election)

QUESTION 63

63. Which of the following earnings is not subject to self-employment tax?

- A. Gains and losses, by an *investor* (not a dealer) in options or commodities, from trading in commodity futures contracts
- B. Fees earned by a professional executor who manages a deceased person's estate
- C. Fees received for services performed as a notary public
- D. All of the above

ANSWER C. Fees received for services performed as a notary public

Income earned from performing services as a notary public is exempt from self-employment tax.

Topic: Self-Employment Income Exemptions

QUESTION 65

65. John purchased a vacant lot in 2020 for \$30,000 and built his primary residence on it for an additional \$200,000. In 2024, John relocated to another city but kept the house he constructed in 2020, converting it into a rental property. On the date John made this conversion, the fair market value of the converted property was \$250,000. For depreciation purposes, what is John's basis in this rental property?

- A. \$180,000
- B. \$200,000
- C. \$230,000
- D. \$250,000

ANSWER: C. \$230,000

When property is converted from personal use to rental (business or investment) use, the basis for calculating depreciation is the *lower* of the property's adjusted basis or its fair market value (FMV) *at the time of conversion*. John's adjusted basis was the cost of the land plus the cost of the house (\$30,000 + \$200,000 = \$230,000). The FMV at conversion was \$250,000. The lower of these two figures is \$230,000, which becomes the basis for depreciation.

Topic: Basis of Property (Conversion to Business Use)

QUESTION 67

67. Patricia exchanged her old laptop used in her business for a new laptop valued at \$6,000 that she will also use in her business. In addition to her old laptop, Patricia paid \$4,500 cash for the new laptop. Her old laptop was worth \$1,500 and had an adjusted basis of \$600. What is Patricia's basis for depreciation in the new laptop?

- A. \$1,200
- B. \$2,100
- C. \$3,600
- D. \$6,000

ANSWER: D. \$6,000

Since the TCJA, like-kind exchange rules (Sec. 1031) don't apply to personal property like laptops. This is treated as a sale of the old laptop (recognizing a \$900 gain) and a purchase of the new one. Therefore, the new laptop's basis for depreciation is its \$6,000 cost.

Topic: Basis of Property Received in Exchange

QUESTION 72

72. Olivia sells her 50% interest in DEF partnership to Max for \$5,500 cash. Her outside basis in the partnership is \$4,000. The partnership consists only of inventory, with an adjusted basis of \$7,000 and a fair market value of \$8,000. The partnership has no capital assets or other investments. Under §751 (hot assets rule), how should Olivia recognize her gain from the sale?

- A. Ordinary income of \$2,500 and a capital loss of \$800
- B. Capital gain of \$1,500 on the sale of her partnership interest
- C. Ordinary income of \$1,500, the amount of cash she received
- D. Ordinary income of \$500 and a capital gain of \$1,000

ANSWER: D. Ordinary income of \$500 and a capital gain of \$1,000

Section 751 "hot assets" include unrealized receivables and substantially appreciated inventory. When a partner sells their interest, a portion of the gain attributable to these hot assets is treated as *ordinary income*, rather than capital gain.

Total Gain: \$5,500 (sale price) - \$4,000 (basis) = \$1,500

Olivia's Share of Inventory Appreciation: (\$8,000 FMV - \$7,000 Basis) / 2 = \$500

Ordinary Income: \$500 (share of inventory appreciation)

Capital Gain: \$1,500 (total gain) - \$500 (ordinary income) = \$1,000

Topic: Sale of Partnership Interest - Section 751 Hot Assets

QUESTION 73

73. Thomas and Richard established a partnership that commenced operations on June 1, 2024. They incurred \$4,500 in legal expenses for drafting and negotiating the partnership agreement and \$2,500 for accounting services to set up the partnership's financial systems, resulting in \$7,000 of qualifying organizational costs. Fees associated with securing assets (\$1,500) are treated separately. They elected under Section 709 to amortize all \$7,000 of organizational costs over the permissible 180-month period, forgoing the initial \$5,000 deduction. What is the correct amortization expense for these organizational costs for the 2024 tax year?

- A. \$816.69
- B. \$1,100
- C. \$272.23
- D. \$116.67

ANSWER: C. \$272.23

Legal, and accounting services directly related to the organization of the partnership. Fees associated with acquiring assets for the partnership are not organizational fees. Add up the qualifying organizational costs: \$4,500 (legal) + \$2,500 (accounting) = \$7,000.

A partnership may elect to deduct a portion of its organizational costs in the year of its operation. In this situation, they did not, so the full amount is amortized over a period of 180 months.

$\$7,000/180 = 38.89$

The partnership begins on June 1, 2024. June-December = 7 months. $\$38.89 * 7 = 272.23$

Topic: Organizational Expenses - Partnership

QUESTION 81

81. On May 20, 2023, Martin purchased a Section 1256 regulated futures contract for \$60,000. By the end of the year on December 31, 2023, the fair market value of the contract was \$68,000. Martin recognized an \$8,000 gain in 2023, treated as 60% long-term and 40% short-term capital gain. On March 4, 2024, he sold the contract for \$67,000. How should Martin treat the sale of this contract on his 2024 income tax return?

- A. \$1,000 long-term capital loss
 - B. \$1,000 short-term capital loss
 - C. \$1,000 60% long-term and 40% short-term capital loss
 - D. \$1,000 ordinary gain
-

QUESTION 83

83. In 2022, Mark purchased a new hybrid vehicle on June 1st for \$20,000 and claimed a \$2,500 deduction for clean fuel vehicles on his 2022 tax return. He used the vehicle only for personal purposes in 2022. Starting January 1, 2024, he began using it solely for business. The fair market value on that date was \$19,000. What is the depreciable basis of the vehicle as of January 1, 2024?

- A. \$16,500
 - B. \$17,500
 - C. \$19,000
 - D. \$20,000
-

QUESTION 89

89. Mr. Thompson, a self-employed fish merchant, hosted a business meeting with his top five clients. On their arrival evening, he and his wife entertained these clients and their spouses at home, spending \$450 on refreshments. Each client received a gift basket valued at \$45 upon departure. The business discussions took place the following day at his office. Assuming these were his only related expenses for the year, what is the deductible amount for these expenditures?

- A. \$0
- B. \$125
- C. \$150
- D. \$350

ANSWER: B. \$125

Entertainment expenses are generally not deductible after the Tax Cuts and Jobs Act (TCJA). Therefore, the \$450 spent on refreshments is not deductible. However, business gifts are deductible, up to \$25 per recipient per year. Mr. Thompson gave gift baskets to his five clients. Therefore, he can deduct $\$25 * 5 = \125 for the gifts. The fact that the clients' spouses were present is irrelevant; the refreshments are entertainment, and the gifts are limited to the clients.

Topic: Business Gifts and Entertainment Expenses

QUESTION 92

92. How is the cost of buildings or improvements made on leased land recovered in 2024?

- A. Over the duration of the lease.
- B. Through a 60-month amortization.
- C. The lesser of the lease's remaining term or the MACRS recovery period for the improvement type.
- D. As a MACRS deduction, aligning the recovery period with the nature of the improvement rather than the lease term.

ANSWER: D. As a MACRS deduction, aligning the recovery period with the nature of the improvement rather than the lease term.

The cost of buildings or improvements made by the lessee on leased property is recovered through depreciation using the Modified Accelerated Cost Recovery System (MACRS). The recovery period is determined by the type of property (e.g., residential rental property, nonresidential real property), not by the length of the lease. This rule applies regardless of the lease term.

Topic: Leasehold Improvements - Depreciation

QUESTION 99

99. Elaine, who is unmarried and not subject to the passive loss income phase-out rule for rental real estate, has \$80,000 in salary (non-passive income) and \$20,000 in income from a partnership where she does not materially participate (passive income). She also incurred a \$30,000 loss from a rental real estate activity in which she actively participates. What is the total amount of her \$30,000 rental real estate loss that she can deduct against her non-passive income (salary) in 2024?

- A. \$0
- B. \$5,000
- C. \$10,000
- D. \$20,000

ANSWER: C. \$10,000

When a taxpayer or their spouse is actively involved in a passive rental real estate activity, the restriction on passive activity losses is lessened, allowing them to deduct up to \$25,000 of those losses against their non-passive income. This special allowance serves as an exception to the usual rules that prohibit passive activity loss deductions. Furthermore, the taxpayer may also apply credits from the activity against their tax liability on up to \$25,000 of non-passive income, considering any losses already permitted under this exception.

For example, Elaine, who actively participates in her rental real estate activities, has a \$30,000 loss. She can offset \$20,000 of this loss against her \$20,000 in passive income from a partnership. The remaining \$10,000 of her rental real estate loss can then be used to offset \$10,000 of her nonpassive income, such as wages.

Topic: Rental Real Estate Tax Deductions
