SUBSTANTIVE TAX LAW
(96 minutes)

# ANSWER THE QUESTIONS IN THIS PART OF THE EXAMINATION IN ANSWER BOOK/S SEPARATE FROM THE ANSWER BOOK/S CONTAINING ANSWERS TO OTHER PARTS OF THE EXAMINATION

Unless directed to the contrary, answer each question independent of the facts of other questions. In your answers state only the federal tax consequences of the facts presented.

Question S-1. (2 minute/s) Define the cash method of accounting for federal income tax purposes.

Question S-2. (2 minute/s) Define the accrual method of accounting for federal income tax purposes.

Question S-3. (2 minute/s) TP, who operates a dry cleaner, has elected the cash method of accounting for federal income tax purposes. On December 31, 2000, a customer comes to TP's place of business and gets out a checkbook in order to satisfy the customer's account with TP for cleaning services rendered. TP asks that the customer wait until after the first of the following year to mail the check, and the customer complies with TP's suggestion by mailing TP a check during January of 2001. For what year should the customer's check be included in TP's gross income and why?

Question 5-4. (2 minute/s) TP operates a trucking business and uses the accrual method of accounting for federal income tax purposes. Under state and local laws, trucking businesses are required to pay for various licenses, permits, and fees. In 1999, TP expended $4.3 million for licenses, some of which had an effective period extending into 2000. Also in 1999, TP paid $1 million for liability and property insurance, the coverage of which extended into 2000. A greater percentage of the license and insurance costs is allocable to 1999 than to 2000. For purposes of book accounting and financial reporting, TP allocated the license and insurance expenses ratably over 1999-2000. Discuss whether TP may deduct the entire amounts of the license and insurance expenses on TP's 1999 federal income tax return.

Question S-5. (2 minute/s) TP works for a company that manufactures widgets. TP's employer has an employee discount program available to all employees. The employee discount is thirty per cent (30%) of the retail sales price of any widget. During 2000, TP purchases, under the employee discount plan, a widget with a retail price of $500 by paying *$350.* During 1999, the employer's sales were $800,000 and its cost of goods sold was $600;000. For all of 2000, the employer's sales were $1,000,000 and its cost of goods sold was $800,000. State the amount of gross income to TP as to the purchase under the employee discount plan.

Question S-6. (2 minute/s) In January 2000, TP attended a silent auction benefitting a charitable organization and purchased a very old wooden chair for $10. While stripping the old paint off of the chair, TP discovered a plate identifying the maker of the chair. Suspecting that the chair was valuable, TP took (in February 2000) the chair to an appraiser, who advised TP that the chair was a valuable antique (worth $20,000). TI) retained the chair and used it in TP's residence for all of 2000. State the amount of gross income to TP in 2000 with respect to the desk.

Question S-7. (10 minute/s) State the amount (without any further explanation), if any, of the following items that constitutes gross income to TP:

(a) $700 cost to TP's employer of $40,000 of life insurance on TP's life, which is provided under a group term policy of the employer.

(b) $10,000 extorted from business acquaintance.

(c) $500 value of a chair won at the grand opening of a new furniture store.

(d) $1,000 of interest received on U.S. Treasury Bill.

(e) $4,000 of interest received on a State of Washington bond used to finance the construction of new public schools.

(f) $32,000 paid to TP at maturity of loan TP made to a business associate ($30,000 principal repayment and $2,000 of interest).

(g) $2,500 as a partial payment of the proceeds of a life insurance policy in the face amount of $30,000 on TP's spouse who died during the year. TP elected pursuant to the terms of the policy to receive a $2,500 payment in each year for life. TP's life expectancy is 15 years when the payments commence.

(h) $3,000 cash found on sidewalk in front of TP's house that TP spent on a vacation in New Zealand.

(i) $1,000,000 cash prize for winning the Nobel Prize in physics; TP accepted the award and used all of the money for research activities.

(j) $20,000 received on December 31, 2000, from a testamentary trust created according to the terms of the will of TP's spouse who died during the year. The spouse's will provided that all income of the trust was to be distributed to TP for TP's life and that, after the death of TP, the trust was to terminate by distribution to the spouse's then living lineal descendants. The distribution to TP was equal to the income of the trust for 2000 (and was equal to the distributable net income of the trust for 2000).

Question S-8. (5 minute/s) In 1995, TP buys industrial equipment for use in TP's trade or business from Seller for $400,000; TP paid $100,000 in cash and executed a promissory note to Bank for $300,000 with interest payable on the unpaid balance of the loan at the rate of 9% compounded annually. TP experiences economic difficulties and is unable to make total payments on the debts incurred in the business. On December 31, 2000, prior to the debt discharge described below, the fair market value of all of TP's trade or business assets (the only property owned by TP) is $275,000, TP's adjusted basis in those assets is $265,000, and the total amount of TP's debts is $300,000. On December 31, 2000, Bank forgives $40,000 of the amount owed by TP to Bank under the terms of the promissory note. As of December 31, 2000, TP has (1) no net operating loss carryover amounts, (2) no §38 tax credit carryover amounts, (3) no §53(b) credit amounts, and (4) no capital loss carryover amounts. Discuss the tax consequences to TP that are associated with the forgiveness by Bank of $40,000 of the amount owed by TP under the terms of the promissory note.

Question S-9. (4 minute/s) Describe the significant features of the Roth IRA.

Question S-10. (2 minute/s) TP creates a trust on January 1, 2000. Under the terms of the trust, TI) is to receive all of the income of the trust until TP's death, and upon TP's death the remainder is to go as appointed under TP's will. The trust is to distribute its income to TP on December 31 of each year. On December 15, 2000, TI) directs the trustee to distribute the current year's income to TP's children (all of the age of majority). Discuss whether the income should be taxed to TP or to TP's children.

Question S-11. (1 minute/s) While skiing in Colorado, TP was injured on February 2, 2000, by skiing off a cliff TP suffered physical injury to Xm's body and also emotional distress associated with the physical injuries. To cope with the emotional distress, TI) visited a psychiatrist during 2000 and incurred costs of $5,000. TP takes a court judgment against the ski area operator, and the judgment is paid by the operator on December 30, 2000. The damages awarded were as follows: (1) $400,000 compensatory damages for physical injury to the body of TP, (2) $50,000 punitive damages for physical injury to the body of TP, and (3) $100,000 compensatory damages for the emotional distress. State the amount of gross income with respect to the $400,000 compensatory damages for the physical injury to the body.

Question S-12. (1 minute/s) Same facts as Question 11. State the amount of gross income with respect to the $50,000 punitive damages for physical injury to the body.

Question S-13. (1 minute/s) Same facts as Question 11. State the amount of gross income with respect to the $100,000 compensatory damages for the emotional distress.

Question S-14. (1 minute/s) Same facts as Question 11. For taxable year 2000, may TP deduct under § 213 the $5,000 of psychiatric care?

Question S-15. (3 minute/s) TP retains counsel pursuant to a contingent fee agreement and initiates a lawsuit seeking money damages based on alleged wrongful termination of employment by TP's former employer. The court awards TP damages for (1) lost past earnings, (2) lost future earnings, and (3) lost fringes and lost pension benefits. The judgment was paid. by the former employer to TP during 2000. Also during 2000, TP paid legal fees to the counsel that represented TP in the litigation. Briefly explain whether TP must report (1) all of the damages received or (2) the damages received net of the fees paid to the attorney.

Question S-16. (4 minute/s) Discuss the rules applicable in determining whether expenses associated with a "home office" are deductible.

Question S-17. (3 minute/s) Describe the rules as to the deductibility of unreimbursed business travel expenses incurred by an employee posted, on a nonpermanent basis, to a work location several hundred miles away from the employee's permanent place of work.

Question S-18. (4 minute/s) Under what circumstances are daily transportation expenses incurred by a taxpayer in going between the taxpayer's residence and a work location deductible under §162(a) of the Internal Revenue Code?

Question S-19. (4 minute/s) TP and Spouse were married and owned all of the stock of X Corporation (X). TP and Spouse divorced, and the final judgment dissolving their marriage ordered (1) that Spouse sell and convey to TP, or at TP's election to X, all of Spouse's X stock, (2) that TP, or at TP's election X, pay a stated amount of cash to Spouse simultaneously with the sale and conveyance of such stock, and (3) that as additional consideration TP, or at TP's election X, deliver to Spouse an interest-bearing promissory note for the balance of the purchase price of that stock. Pursuant to the divorce judgment, TP elected that the sale and conveyance of all of Spouse's X stock be made to X (instead of to TP), (2) that X (instead of TP) pay the stated amount of cash to Spouse simultaneously with that sale and conveyance, and (3) that X (instead of TP) issue the required promissory note to Spouse for the balance of the purchase price. Pursuant to TP's election under the divorce judgment, Spouse sold and transferred to X, instead of to TP, all of the X stock that she owned. Discuss whether §1041 applies to this transaction.

Question S-20. A joint federal income tax return generally involves joint and several liability. The Internal Revenue Code now provides limitations to a spouse's (or former spouse's) liability:

(a) (3 minute/s) Describe and discuss these limitations.

(b) (2 minute/s) Discuss the extent to which the Tax Court has jurisdiction with respect to these limitations.

Question S-21. (6 minute/s) In 1994, Taxpayer acquired unimproved real property. To acquire the property, TP (1) paid $100,000 cash, (2) took subject to a preexisting first mortgage debt secured by the property in the amount of $75,000 (for which TP was not personally liable), and (3) executed a $40,000 second mortgage indebtedness (for which TI) was personally liable) to the seller. In 1996, TP borrowed $30,000 from a bank, in return for which TP executed a nonrecourse note (no personal liability to TP)

$30,000 debt. The $30,000 proceeds of the loan were used to purchase a speedboat. In 2000, TP received and a third mortgage on the real property to secure the an offer to buy the real property, which TP accepted. Buyer (1) paid $200,000 cash, (2) took subject to the first mortgage debt of $60,000 (it had been paid down from $75,000 to $60,000), (3) assumed the $40,000 second mortgage debt, and (4) took subject to the third mortgage debt of $20,000 (it had been paid down from $30,000 to $20,000).

(a) What was TP's basis in the property at the time of acquisition in 1994?

(b) Describe the federal income tax consequences of the 1996 borrowing and third mortgage transaction.

(c) Quantify TP's amount realized and any gain or loss realized upon the sale of the property to Buyer in 2000.

Question 5-22. (3 minute/s) On January 1, 2000, TP transfers several properties to a corporation in exchange for all of the issued and outstanding stock of the corporation. Two of the transferred properties are real property interests (Property #1 and Property #2), and each is encumbered by a mortgage securing a loan to TP. TP is personally liable on the debt encumbering Property #1. The debt encumbering Property #2 is nonrecourse. The corporation assumes the debt encumbering Property #1, and the corporation takes Property #2 subject to the encumbering debt and does not assume the debt encumbering Property #2. Discuss the federal income tax consequences to TP (only) associated with the transfers by TP to the corporation.

Question S-23. (3 minute/s) TP owned all the shares of an insolvent S corporation. The corporation owed money, in 2000 was forgiven the debt, and then liquidated during 2000. Pursuant to § 108(a), the corporation excluded the debt forgiveness amount from its 2000 gross income. Discuss whether the debt forgiveness amount flows through to TP and increases TP's basis in the S corporation stock.

Question S-24. (3 minute/s) In 2000, a partner contributes appreciated property (its fair market value exceeds its adjusted basis at the time of the contribution) to a partnership, and the partnership thereafter (and within 6 years of the contribution) distributes the property to another partner. Describe the federal tax consequences that apply to the contributing partner.

Question S-25. (3 minute/s) TP and Spouse owned as community property 5 million shares of the common stock of Corporation. The shares were held in a revocable inter vivos family trust that had been created by TP and Spouse. Spouse died and left Spouse's community property interest of *2.5* million shares of stock to an irrevocable marital trust (a qualified terminable interest property trust under §2056 (b)(7)) (the "marital trust") for the benefit of TP during the life of TP. Upon the death of TI), the property in the marital trust was to pass to others. Spouse's estate claimed a federal estate tax marital deduction in connection with that property. After Spouse died, TP removed TP's 2.5 million shares from the family trust and contributed them to another revocable trust (the “TP trust"), the income of which was payable to TP for TP's life. TP then died. Describe the following federal estate tax consequences with respect to the stock of Corporation:

(a) (2 minute/s) Identify which shares, if any, are to be included in the gross estate of TP.

(b) (1 minute/s) Discuss the valuation principles that apply to any such included shares of stock.

Question S-26. (3 minute/s) TP's father was in declining health and appointed TP as his agent under a durable power of attorney. For many years, TP's father had made gifts to his children during December. Pursuant to the power of attorney, TP prepared gift checks drawn against the father's checking account. TP prepared one check for TP and for each of TP's siblings; each of the checks was in the same dollar amount. The checks were prepared on December 15, 2000, and were delivered on December 20, 2000. All of the checks were deposited in the respective donee's checking account by the end of 2000, but one of the checks had not cleared against the father's checking account until January 2, 2001. The father died on January 31, 2001. The father's checking account had sufficient fluids to honor each of the checks. Explain whether TP's father has made a completed gift in 2000 as to the check that did not clear against his account until 200l.

Question S-27. (4 minute/s) (a) Discuss briefly the major requirements of the statutory provision that permits a transferee to refuse property for purposes of the federal estate and gift taxes. (b) Discuss whether such a refusal is effective with respect to a preexisting federal tax lien against all of the property of the disclaiming heir of a decedent.

Question S-28. (2 minute/s) Interest and penalties (a penalty, addition to tax, or additional amount with respect to any failure relating to the return that is computed by reference to the period of time the failure continues to exist) generally accrue with respect to due but unpaid federal income tax. Under what circumstances will the accrual of interest and penalties be suspended?

Question S-29. (5 minute/s) Describe the essential elements of the substantial understatement of income tax penalty as to an individual taxpayer.

Question S-30. (4 minute/s) Describe the alternative minimum tax as it applies to an individual taxpayer.