PART TWO
SUBSTANTIVE TAX LAW
(96 minutes)

Question S-1. (4 minutes)
Describe briefly how the economic performance standard of the tax accounting rules applies to an accrual method taxpayer.

Question S-2. (3 minutes)
Explain the doctrine of cash equivalence.

Question S-3. (1 minute)
TP rents X a truck for a three month period. The terms of the agreement prescribe a $2,000 cash rental payment to TP and requires that X rebuild the engine of the truck at the end of the lease term. As required, X rebuilds the engine (fair market value $1,000) at an out-of-pocket cost to X for parts of $400. State the amount of gross income to TP.

Question S-4. (3 minutes)
TP receives two awards for service to TP's employer. TP receives a $4,000 check and a watch with a value (and cost to the employer) of $2,000. The $4,000 check was pursuant to a written plan of the employer to recognize outstanding contributions of senior-level executives ("Plan 1 "). The watch was awarded pursuant to a written plan of the employer to recognize the length of service contributions of all employees who complete 20 years of service ("Plan 2"). Plan 2 did not discriminate in favor of highly compensated employees. For 1998, the average cost of all employee awards under Plan 2 was $350. State the amount of gross income to TP as to the $4,000 check under Plan 1.

Question S-5. (3 minutes)
Same facts as Question 4. State the amount of gross income to TP as to the watch under Plan 2.

Question S-6. (2 minutes)
TP was awarded a scholarship by Famous University to pursue an undergraduate degree. The scholarship eliminated the tuition and fees of $12,000 and also eliminated the $6,000 charge for room and board at the undergraduate student dormitory. State the amount of gross income to TP.

Question S-7. (2 minutes)
TP was injured in January 1998 in an automobile collision. TP suffers physical injury to TP's body and also emotional distress associated with the collision. To cope with the emotional distress, TP incurred during 1998 costs of $10,000 for psychotherapy. TP takes a judgment against Defendant, and the judgment is paid by defendant on December 30, 1998. The damages awarded were as follows: (1) $80,000 compensatory damages for physical injury to the body of TP, (2) $150,000 punitive damages for physical injury to the body of TP, and (3) $50,000 compensatory damages for the emotional distress. State the amount of gross income with respect to the $80,000 compensatory damages for the physical injury to the body.

Question S-8. (1 minute)
Same facts as Question 7. State the amount of gross income with respect to the $150,000 punitive damages for physical injury to the body.

Question S-9. (2 minutes)
Same facts as Question 7. State the amount of gross income with respect to the $50,000 compensatory damages for the emotional distress.

Question S-10. (4 minutes)
In 1996, TP borrows $150,000 from Bank (on an unsecured basis) to purchase unimproved real property for a total purchase price of $175,000 (TP had $25,000 of cash with which to pay the rest of the purchase price). On June 1, 1998, prior to the debt discharge described below, TP's total debts are $220,000 (including the $150,000 debt to Bank), and the fair market value of TP's unimproved real property (the only property owned by TP) is $210,000 (its adjusted basis remains at $175,000). On June 1, 1998, Bank discharges $50,000 of the $150,000 debt. TP has no tax attribute amounts prescribed in IRC §108(b)(2)(A)-(D). State the amount of gross income to TP resulting from the $50,000 discharge of indebtedness.

Question S-11. (2 minutes)
Same facts as Question 10. State the amount of reduction in the basis of TP's property resulting from the $50,000 discharge of indebtedness.

Question S-12. (1 minute)
TP manufactures widgets. Periodically, TP incurs expenses for the graphic design of new packages for the widgets. State whether such expenses are deductible in the year incurred or must be capitalized.

Question S-13. (2 minutes)
TP is a sole proprietor and reports the revenues and expenses related to the proprietorship on a Schedule C to TP's federal income tax return. TP's return is examined by the IRS, and the IRS proposes a tax deficiency and appropriate underpayment interest with respect to unreported business income that should have been reported on the Schedule C. TP pays such underpayment interest to the IRS. Discuss briefly whether such interest is deductible under IRC §163.

Question S-14. (2 minutes)
TP is an unmarried minor who receives all support from A and B. TP's parents (who properly claim TP as a dependent federal income tax purposes). TP owns various investment properties and receives $2,000 of dividends and interest from the investment properties during 1998. In addition, TP earns $2,250 during 1998 working as a waiter at a local soda fountain. State the amount of standard deduction to which TP is entitled for 1998 (ignoring any inflation adjustment to the standard deduction amount).

Question S-15. (1 minute)
TP operated a document delivery business in downtown Metropolis. During 1998, TP incurred the following costs associated with operation of the proprietorship:

a. Daily commuting costs from TP's residence to the place of business, $600

b. Purchase of business apparel; TP and all of TP's employees wore monogrammed shirts ("We Deliver On Time" on the front of the shirt) and khaki slacks:
Cost of TP's monogrammed shirts, $300
Cost of TP's khaki slacks, $200

c. Operating costs for TP's automobile for visits from TP's office to the offices of prospective clients, $225

State the amount deductible under IRC §162 as to the daily commuting costs.

Question S-16. (2 minutes)
Same facts as Question 15. State the amount deductible under IRC §162 as to the business apparel acquisition costs.

Question S-17. (1 minute)
Same facts as Question 15. State the amount deductible under IRC §162 as to the costs for TP's automobile for visits from TP's office to the offices of prospective clients.

Question S-18. (2 minutes)
TP (engaged in business as a sole proprietor) travels from Homecity, Iowa, to Metropolis, California, to meet with a customer. TP meets with the customer at the customer's office to discuss the customer's order for TP's goods. After the office meeting, TP takes the customer out to dinner during which they discuss current events and personal matters. TP pays $160 for the meal. After dinner, TP takes the customer to a very-hard-to-get-into theatrical play. TP and the customer attend the play and do not discuss any business during the play. TP buys from the hotel concierge the two play tickets for $150 each, even though the price printed on the ticket is $75 each. Taxi costs for the evening were $20. State the amount that is deductible by TP as to the meal expense.

Question S-19. (2 minutes)
Same facts as Question 18. State the amount that is deductible by TP as to the tickets for the play.

Question S-20. (2 minutes)
On January 1, 1998, TP purchases for $10,000 cash new equipment exclusively for use in TP's business activity. The equipment has a class life of a six years. TP expects to use the equipment for four years and estimates that the equipment will have a salvage value of $2,000 at the end of the four-year period of use. State the amount of IRC §168 ACRS depreciation allowable in 1998 (ignoring IRC §179 for purposes of this Question),

Question S-21. (2 minutes)
Same facts as Question 20. State the amount of IRC §168 ACRS depreciation allowable in 1999 (ignoring IRC §179 for purposes of this Question).

Question S-22. (4 minutes)
TP is a traveling salesperson (a sole proprietor) who maintains an office in TP's residence. The office is a room that is used exclusively for business purposes. TP's business activities at the home office, which occur on a regular basis and only at the home office, include (1) contacting customers by telephone, (2) accounting functions (paying business bills, preparing bills to business customers, and accounts receivable management), and (3) reading of business literature to maintain current knowledge in TP's field. Discuss whether any expenses related to the home office are deductible.

Question S-23. (2 minutes)
TP and Spouse are divorced in 1998. Pursuant to the terms of the divorce settlement agreement, which the divorce court approved and adopted as its order in 1998, TP is required to make the following transfers to Spouse:

a. Property settlement payments in 1998: (1) $70,000 in cash and (2) all of TP's separate property stock of Nichtwest Corporation, which has a value of $60,000 and an adjusted basis to TP of $150,000.

b. Spousal support in cash: (1) $90,000 in 1998, (2) $60,000 in 1090, (3) $30,000 in 2000, and (4) $25,000 per year after 2000 until the death or remarriage of Spouse.

The divorce settlement agreement and the court order are silent as to the tax consequences of the various payments. TP makes all required payments.

State the amount of gross income to Spouse as to the 1998 transfer of the stock of Nichtwest Corporation as part of the property settlement.

Question S-24. (2 minutes)
Same facts as Question 23. State the amount of Spouse's adjusted basis in the stock of Nichtwest Corporation on the date of receipt.

Question S-25. (2 minutes)
In 1996, TP acquired a transferable option to purchase Blackacre, real property, at a price of $60,000. The option had a 3-year duration. TP paid $2,000 to the owner of Blackacre for the option and paid a $1,000 fee to a real estate agent for representing TP in the acquisition of the option. TP did not exercise the option. Instead, TP sold the option in 1998 for $10,000, and TP paid a $1,000 fee to a real estate agent for representing TP in the sale of the option. State the amount of gain or loss realized to TP upon sale of the option.

Question S-26. (2 minutes)
In 1980, TP acquired Blackacre, unimproved real property. TP paid cash of $200,000 and took the property subject to (without personal recourse to TP) a first mortgage lien in the amount of $60,000. In 1994, TP borrowed at the local bank $100,000 pursuant to a nonrecourse loan and, as security for the $100,000 loan, TP executed a second mortgage on Blackacre. TP used the $100,000 proceeds of the 1994 loan to purchase an airplane. In 1998, Buyer offered to buy Blackacre from TP, and TP accepted the offer. Buyer paid $300,000 cash, assumed the first mortgage indebtedness, which at the time of closing in 1998 was $20,000, and took Blackacre subject to the second mortgage, which at the time of closing was $50,000. State the amount of TP's adjusted basis in Blackacre at the time of acquisition in 1980.

Question S-27. (1 minute)
Same facts as Question 26. State the amount of gross income to TP due to the 1994 borrowing.

Question S-28. (1 minute)
Same facts as Question 26. State the amount of TP's adjusted basis in Blackacre at the end of 1994.

Question S-29. (2 minutes)
Same facts as Question 26. State TP's amount realized upon disposition of Blackacre in 1998.

Question S-30. (3 minutes)
To purchase depreciable property, TP incurs nonrecourse debt payable to the seller of the property. The amount of the nonrecourse debt exceeds a reasonable approximation of the fair market value of the property. Discuss the federal income tax implications of the nonrecourse debt.

Question S-31. (1 minute)
TP acquires stock of Worldsoft on February 15, 1997. TP sells those shares on February 15, 1998. Is the holding period more than a year for purposes of the capital gain and loss rules? State YES or NO.

Question S-32. (3 minute/s)
Describe the tax consequences associated with a sale of the taxpayer's principal residence in 1998.

Question S-33. (12 minutes; see allocation below)
On January 1, 1998, X and Y organize Microhard Corporation. The following transfers were made to the corporation:

Transferor	Property	Fair Market Value	Adjusted Basis to Transferor
X	Cash	$ 40,000	$ 40,000
X	Unimproved real property	50,000	40,000
Y	Equipment	100,000	60,000

The unimproved real property had been held by X as an investment. The equipment had been purchased in 1996 for use in Y's trade or business at a cost of $120,000, and because of depreciation, the adjusted basis had been reduced to $60,000 on January 1, 1998.

In exchange for the contributions of X and Y, the corporation issues its common stock, 200 shares to X and 200 shares to Y. The fair market value of the stock is $500 per share; the common stock is the only class stock authorized and outstanding. In addition to the 200 shares of stock, Y receives $5,000 of cash, a 1-year note of Microhard Corporation in the amount of $2,000 at 10% interest, and a 5-year note of Microhard Corporation in the amount of $3,000 at 9% interest. Each note has a fair market value equal to the face mount of the note.

(a) (3 minutes) Determine Y's gain realized, Y's gain recognized, and the character of any gain recognized by Y.
(b) (3 minutes) Determine Y's adjusted basis in the Microhard stock received.
(c) (2 minutes) Determine the mount of gain recognized by Microhard corporation.
(d) (2 minutes) Determine the adjusted basis of Microhard Corporation in the properties received from X and Y.
(e) (2 minutes) What would be the effect on the foregoing answers if, at the time of the incorporation transfer on January 1, 1998, X were obligated to sell 100 of X's 200 shares to Z.

Question S-34. (3 minute/s) A cash method partner owns zero-basis accounts receivable and inventory property [within the meaning of IRC §1221(1)]. The fair market value of the inventory is in excess of the partnership's adjusted basis in the inventory. Discuss the income tax consequences of these properties to a partner if the partner sells its partnership interest in 1998.

Question S-35. (4 minutes)
Briefly describe the federal tax entity classification rules that apply to an unincorporated business entity created under the laws of the United States in 1998.

Question S-36. (4 minutes)
TP makes a gift transfer in 1998, and TP files a gift tax return for 1998 reporting the gift transfer. Explain the statute of limitations rules that apply, for gift tax purposes and estate tax purposes, to the value reported on the 1998 gift tax return.

Question S-37. (1 minute)
X's cost to acquire land in 1993 was $200,000. On September 29, 1998, the fair market value of the property was $150,000, and X transferred the property by gift to TP. No gift tax was paid by X (or TP). State the amount of gross income to TP upon receipt of the property.

Question S-38. (1 minute)
Same facts as Question 37. State the amount of TP's gain or loss realized if TP sells the property on December 30, 1998, for $140,000.

Question S-39. (1 minute)
Same facts as Question 37. State the amount of TP's gain or loss realized if TP sells the property on December 30, 1998, for $175,000.

Question S-40. (3 minutes)
Describe the interest that is imposed on unpaid assessable penalties, additional amounts, or additions to tax.