PIT ALABAMA LLM
PROFESSOR KAHN

PROBLEM SET # 1

1. Peter is an officer of Joy Unlimited, Inc., a toy manufacturing company. In December, 2000, Joy Unlimited and Peter came to an agreement concerning his salary for that year and for future years. Joy agreed that Peter was to receive his salary free and clear of any federal income taxes. To accomplish that, Joy agreed to pay to the Internal Revenue Service any federal income tax that Peter incurred because of his salary. Peter's salary for the calendar year 2000 was $350,000. Peter had almost $70,000 of other income in addition to his salary. The federal income tax on the salary he received from Joy was determined to be $95,000. Peter filed his tax return for the year 2000 on April 14, 2001, and he enclosed a check drawn by his employer, Joy, in the amount of $95,000 plus Peter's own check for the additional amount of federal income tax that he owed. What was the tax consequence of this transaction to Peter?

2. Jessica is an associate with a large law firm in Chicago. Generally, Jessica's work period ends at 5:00 PM on weekdays. However, when an assignment needs to be completed within a specified time, and if the assignment cannot be completed within that time if the normal working hours are followed, the firm requires its employees to work as late into the night as is necessary. When that occurs, the law firm purchases dinners from a nearby restaurant and has the meals delivered to the employees at their desks in the firm's office. Does Jessica have income from the receipt of a meal on the days she works late at the firm? Would it matter to the determination of the tax question whether the law firm ordered the same meal for everyone who was working late or whether the employees were permitted to select their meal from a menu provided by the restaurant?

3. Same facts as Question 2 except that the firm will reimburse an employee for the amount the employee expended to purchase supper in one of several nearby restaurants. Is the reimbursement that Jessica received for the cost of having supper income to Jessica?

4. The same facts as those stated in Question 3 except that Jessica is not required to work late, but she does so "voluntarily." The firm reimburses its employees for supper costs incurred on days when they work late on projects that are subject to time constraints. Are the reimbursements income to Jessica?

5. Sarah Thomas hired a domestic maid to clean her house, cook meals, wash, iron, etc. In addition to a regular salary, Sarah provides meals for the maid during the period that she is working at Sarah's home. Are these meals income to the maid? Would the maid realize taxable income if Sarah provided breakfast for her when she arrived in the morning, before she commenced work?

6. John Hill is a student at the University of North Carolina. He is employed at the school cafeteria. John receives no cash compensation for his work but receives his meals free. He is required to eat his meals in the cafeteria immediately before mealtime. The average price of a meal is $5.75. What tax consequence to John?

7. An historical society owns a house in Philadelphia that was once owned and occupied by a former president of the United States. During the day, the house is open to the public. The Society is concerned that if the house is left unoccupied at night, it will be burglarized or vandalized. To prevent that from occurring, the Society employs Ralph to live in the house at night. The Society permits Ralph to live in the house with his wife, but he is required to be there only outside of the visiting hours. Outside of visiting hours, Ralph and his wife can occupy any part of the house they wish, including the kitchen; but during visiting hours, they are limited to a part of the house that is not open to the public. Ralph receives no compensation for his services other than the use of the house. What are the tax consequences to Ralph? To Ralph's wife?

8. George is hired to be the manager of the Ocean View Apartments in Daytona Beach, Florida. The employer requires George to live on the premises of the apartment complex. George informs the employer that he is married, and that he has two young children (ages 2 and 4) who live with him and his wife. In addition, George's mother-in-law also lives with him, and so does his cat. The employer then offers to rent George a three-bedroom apartment in the complex for a monthly rental of $300. Comparable apartments in the building rent for $2,200 a month. The employer requires George to rent the apartment as a condition of holding his job. George accepts, and he, his wife, two children, mother-in-law, and cat all move into the apartment. George is paid a salary of $5,000 per month. In addition, the employer pays George a cash allowance of $150 a month to pay for meals for George and his family. What amount of gross income does George have because of these transactions?

9. The same facts as those stated in Question 8 except that the employer does not provide George a cash allowance for meals. Instead, the employer permits George and his family to take their meals at a dining room that is on the first floor of the apartment building and is operated by George's employer for the occupants of the apartments. Although other occupants of the apartments pay a fee for the meals they receive in the Dining Room, George and his family receive their meals without any charge. What is the tax consequence to George and his family?

10. Steve is an employee at Corporation Inc.'s San Francisco office. Corporation Inc. offers Steve a choice of benefits: (a) a monthly parking spot in downtown San Francisco (normally the parking garage charges $150 a month for a monthly spot) or (b) $150 cash per month. What are the tax consequences to Steve if he picks option (a) or option (b)? If Steve chooses option (a), what are the tax consequences if Steve personally pays for the parking spot and Corporation Inc. reimburses Steve for the payment?

11. Peter is a flight attendant with High Sky Airlines. He received a free ticket for a reserved (i.e., not standby) round trip flight on High Sky. The fair market value of the ticket was $400. Both flights were full and High Sky could have sold the seat to a paying customer. What are the tax consequences to Peter for receiving the ticket?

12. Same facts as Question 11 except that the flights were not full. In fact, there were a dozen or so empty seats on each flight that Peter was on. What are the tax consequences to Peter for receiving the ticket?

13. Huge Corporation owns both High Sky Airlines and Skyline Hotels. Peter, the flight attendant with High Sky Airlines, receives a free "standby" room at a Skyline Hotel as a fringe benefit of his employment. Can Peter exclude the value of the room from income?

14. The University of Michigan is the largest employer in the city of Ann Arbor, Michigan. Without consulting the university, Go Blue Sports Store decides to offer all university employees a 10 percent discount for all purchases at the store. Will the university employees who take advantage of the discount be able to exclude the value of the discount under § 132?

PIT ALABAMA LLM
PROFESSOR KAHN

PROBLEM SET #1.5

1. Al Slone owns a house worth $42,000. He is in need of cash and, after a series of sessions with hard driving realtor Joe Babcock, he sells out to Joe for $34,000. What gain does Joe recognize on his bargain purchase?

2. In 1992, Boswell purchased a home in the suburbs on 6 acres of choice land. He paid $250,000 for the land and the home. The home itself was worth $150,000. In 2001, Boswell sold off 3 acres to Carter for $100,000. Any gain to Boswell on his sale to Carter?

3. Helen is a lawyer who specializes in divorce. Malcolm is a real estate agent. Ralph and Helen have been friends since childhood. In Year One, Helen decided to sell her home, and she contacted Malcolm to represent her. The home was sold, and Helen offered to pay Malcolm for his services. Malcolm refused payment, saying that they had been friends for so long that he did not wish to charge her. Malcolm's normal fee for selling a comparable house would have been $14,000. Three months later, Malcolm and his wife had a terrible argument and decided to divorce. Malcolm asked Helen to represent him in the divorce, and she did so. The divorce became final in Year Two. Malcolm offered to pay Helen for her services. Helen would have liked to charge Malcolm, but she felt constrained not to charge him because of his refusal to charge her the previous year. Her normal fee for the services involved in Malcolm's divorce would be $20,000. Helen told Malcolm that there was no charge for her services. What were the tax consequences of these transactions to Malcolm and to Helen?

4. Robert and Susan have a 16 year-old son, Wyatt. They employ Wyatt to mow the lawn, take out the garbage, and clean his bedroom. They pay Wyatt a weekly salary of $20 for these services. In Year One, Wyatt earned $20 from his parents for each week of the year, and he also earned $4,000 for part-time work he did at a local grocery store. What amount of gross income did Wyatt have in Year One?

5. During the period 1961 through 1975 Allen purchased corporate stock. Allen's office was destroyed in a fire in 1999. Also lost in the fire were all of his records containing the dates of purchase and cost of all of his corporate stocks, and these dates and costs cannot be determined. In 2002, Allen sells all of the stocks. Does Allen realize any gain on this sale?

6. Buyer purchased an office building from Seller. Buyer paid Seller One Million Dollars ($1,000,000) for the building, but the terms of the sale permit Seller to occupy the building, rent free, for four years. The fair rental value of the building is $150,000 per year. What are the tax consequences of this transaction to Buyer and to Seller?

7. Susan attends a Detroit Tigers baseball game and sits in the seats near the left outfield. Detroit's third baseman, Martin May, hits a home run which Susan manages to catch. Luckily for Susan, the home run was number 74 for Martin May for the season, breaking the major league baseball single season home run record. In 1999, Mark McGwire's 70th home run baseball (which broke the previous home run record) was sold at auction for $3,005,000. What are the tax consequences to Susan for catching the ball?

PIT ALABAMA LLM
PROFESSOR KAHN

PROBLEM SET #2

1. *R* owned an antique vase which had a value of $15,000. *R*'s basis in the vase was $4,000. *T* negligently caused the destruction of the vase when it was being transported to a museum to be displayed on a temporary loan. *T*'s insurer paid *R* $15,000 cash to compensate for the loss of the vase. What amount of that payment is income to *R*?

2. *X* negligently operated his automobile which resulted in *Y*'s suffering physical injuries. *Y* sued *X* for damages. In a decision by the trial judge (sitting without a jury), *Y* obtained a judgment for $1,650,000, which was the total of the specific amounts listed below. *X* paid *Y* the amount of the judgment. What amount of the payment to *Y* is included in *Y*'s gross income?

$525,000	-	for wages that *Y* did not earn prior to the judgment because of her injuries
$1,000,000	-	for future wages that the court determined *Y* will not earn because of her injuries
<u>$125,000</u>	-	reimbursement of *Y*'s medical expenses
$1,650,000	-	Total amount of award

3. *M* sued *Q* for employment discrimination. *M* obtained a judgment for $300,000 compensatory damages and $600,000 punitive damages. The compensatory damages were for lost income and for emotional harm and mental stress. What amount of that award is included in *M*'s gross income when paid?

4. *Z* sued *K* for personal defamation because of statements that *K* had made about *Z*'s moral character. Z claimed that on account of such statements and the stress caused by them, *Z* suffered headaches, back pain, stomach problems, etc…*Z* obtained a judgment for $50,000 compensatory damages and $500,000 punitive damages. What amount of that award is included in *Z*'s gross income when paid?

5. *D* was sued by *P* for physical damages caused by *D*'s negligent operation of an automobile. In a decision, *P* obtained a judgment for $1,000,000, which was the total of the specific amounts listed below. *D* paid *P* the amount of the judgment. What amount of the payment to *P* is included in *P*'s gross income?

$500,000	- for pain and suffering
$200,000	- for emotional harm that P suffered
<u>$300,000</u>	- punitive damages
$1,000,000	- total damages

6. *D* was sued by *P* for physical damages caused by *D*'s negligent operation of an automobile. The case was tried to a jury, and *D* requested the judge to give the following two instructions to the jury. How should the judge rule?

(1) The judge should inform the jury that *P* will not have to pay any federal income tax on any of the damages they award to *P*.

(2) In determining the amount of income *P* lost because of his injuries, the jury should take into account the amount of income taxes that *P* would have paid on that income, and only the net amount remaining after payment of taxes should be awarded to *P*.

7. Larry was physically injured by David's negligent operation of an automobile. Larry sued David for damages in tort, and Larry's complaint listed the following request for damages:

$200,000	-	Loss of income due to the injuries
$300,000	-	Emotional harm and pain and suffering
$100,000	-	Medical expenses incurred
$400,000	-	Punitive damages
$1,000,000	-	Total damages requested

Larry and David settled the law suit by David's paying Larry $400,000. The settlement did not state how much was paid for the several items for which Larry had requested damages. How much of that $400,000 settlement is included in Larry's gross income?

8. Wilma was seriously physically injured by George's negligence. Wilma obtained a settlement from George for the damages she suffered. Wilma's husband, Harold, sued George for the damages Harold incurred as a consequence of the injuries that Wilma had suffered. Harold obtained a judgment against George for $250,000 for loss of consortium, and another $100,000 for the emotional harm that Harold suffered because of Wilma's injuries. George paid the judgment. How much of the payment to Harold is included in Harold's gross income. If any part of the payment is income, should it be included in Harold's gross income or in Wilma's?

9. *F* obtained a judgment for compensatory damages against *Z* for physical injuries *F* suffered as a consequence of *Z*'s negligence. The award included $15,000 for interest on the amount of the judgment computed as interest from the time that the complaint was filed until the judgment was entered. An award of that type is sometimes called "pre-judgment interest." Is the pre-judgment interest excluded from *F*'s gross income? Would interest payable on the judgment for the period between the entry of the judgment and the time when *Z* makes payment be excluded from *F*'s gross income?

10. Your client has a tort claim against *X* Corporation for a physical injury she suffered from the negligence of an employee of *X*. The parties have agreed that *X* is liable and that the amount of your client's actual damages total $500,000. This figure includes $65,000 in medical expenses, none of which has been deducted by your client. Your client's other income places her in the 35% marginal tax bracket (the top tax bracket for an individual), and so any income she recognizes from payments she receives from X or from the investment of such payments will be taxed at a 35% rate.

    X has offered your client a choice of: (1) receiving a lump sum of $500,000 cash, or (2) receiving annual payments of $66,000 for the next ten years. Your client is satisfied that $500,000 is a good figure for settlement. Your client has told you that if she accepts the $500,000 lump sum settlement, she will invest that amount with an insurance company to purchase an annuity for a ten-year period. The annuity provided by the insurance company will earn income at a 7% rate, and so your client would receive approximately $71,250 each year for 10 years. Your client has complete confidence that *X* can and will make the annual payments of $66,000 if she should choose that option, and so risk of nonpayment is not a factor in making her choice.

    Which of the alternatives that *X* has offered your client would you advise your client to take?

11. Martha was employed by the Ellsworth Corporation. Martha's supervisor frequently made lewd comments in her presence and made proposals to her of a sexual nature. Martha filed numerous complaints with her employer about the behavior of her supervisor, but the company took no action. One day, the supervisor pinched Martha's buttocks. The pinch caused a minor bruise that remained for a few days. Martha sued Ellsworth for permitting the sexual harassment to have continued to take place. The court awarded Martha: $1,000 for the bruise she suffered, $600,000 for the emotional distress that the incident caused, and $2,000,000 punitive damages. Ellsworth paid the award to Martha. Is all or any part of Martha's award taxable to her? If the pinch had not caused a visible bruise, what part of the award would be taxable to Martha?

12. The same facts as those stated in Question 11 except that Martha and Ellsworth settled her suit. Assume again that Martha had suffered a visible bruise from the pinch. The settlement agreement provided that Ellsworth was to pay Martha $2,500,000 as compensatory damages for her physical injury and emotional harm. The settlement agreement expressly states that no amount is to be paid to Martha as punitive damages. Ellsworth paid Martha the amount that the settlement required. Is any part of the amount that Martha received from Ellsworth taxable to her?

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PROFESSOR KAHN

PROBLEM SET # 3

A "net operating loss" is a term of art and refers to something other than a net loss. See IRC § 172. In answering the questions in Problem # 3, assume that *no* net operating loss carryover is available.

1. *D* owed a business debt of $20,000 to *M*. In Year One, *M* determined that the debt was not collectible, and *M* claimed and was allowed a bad debt deduction of $20,000 on his tax return for Year One. The marginal rate at which the $20,000 that was reduced by that deduction would have been taxed was a 25% rate. In Year Ten, *D* sold the rights to an invention he had created that year for several million dollars. Being then able to repay the debt to *M*, *D* repaid the debt of $20,000. If the $20,000 that *M* received from *D* in Year Ten is included in *M's* income, it will be taxed at a marginal rate of 35%. How should the $20,000 payment to *M* in Year Ten be treated for income tax purposes? If the statute of limitations on *D*'s debt expired before Year Ten, but *D* voluntarily repaid the debt anyway, how should the repayment be treated for tax purposes?

2. In the year 2002, Rick and his spouse, Marie, filed a joint income tax return in which they correctly reported adjusted gross income of $22,000. Rick and Marie were not entitled to any tax credits for that year. On their joint return for that year, Rick and Marie claimed and were allowed three exemptions for which they properly took a deduction of $9,150. In addition, Rick and Marie claimed and were allowed an itemized deduction of $15,000 for a real estate tax payment they made that year. The basic standard deduction for the year 2002 for married taxpayers was $7,950. Since their itemized deductions were greater than the basic standard deduction, Rick and Marie elected to itemize their deductions rather than to use the standard deduction.

   Rick and Marie had objected to the local taxing authority that the $15,000 real estate tax levied against them in 2002 was excessive. They had paid that tax under protest and appealed. In 2004, the appeals board agreed that the 2002 real estate tax that was paid by Rick and Marie was excessive and ordered that a refund of $5,000 be paid to them. The refund was duly paid in 2004. Rick and Marie filed a joint income tax return for the year 2004. How much of that $5,000 refund is included in Rick and Marie's joint income for 2004?

3. The same facts as those stated in Question 2 except that the amount ordered by the appeals board to be refunded to Rick and Marie in the year 2004 was $10,000, and that amount was refunded to them. How much of that $10,000 refund is included in the joint income of Rick and Marie?

4. In Year One, Penny made a gift of unimproved land to the Beth El temple. At the time of the gift, the land had a value of $120,000, and Penny was allowed a charitable deduction of that amount from which she obtained a tax benefit. Penny had a basis of $30,000 in the land, and she had held the land for more than 15 years. Penny gave the land to the temple to permit the temple to construct a building thereon to be used for the religious education of children. In Year Three, the temple abandoned its plan to build a new school building. The temple than returned the land to Penny. The land had a value of $100,000 when it was returned to Penny. Seven months later, Penny sold the land to an unrelated party for $105,000. What were the tax consequences of the return of the land to Penny and of Penny's sale of the land to the unrelated party?

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PROBLEM SET # 4

1. Assume *A* purchases stock for $2,000 and gives the stock to his daughter, *D*, at a time when the fair market value of the stock is $4,000. How much gain or loss (if any) is recognized by *D* on a sale to an unrelated person for the following amounts?
   (a) $10,000
   (b) $3,000
   (c) $1,000

2. Assume *B* purchased stock for $5,000 and gave the stock to her son, *S*, at a time when the fair market value of the stock was $2,000. How much gain or loss (if any) is recognized by *S* on a sale to an unrelated person for the following amounts?
   (a) $10,000
   (b) $1,000
   (c) $3,000

3. In Year One, *A* paid $100,000 to purchase 1000 shares of *X* stock. In Year Ten, *A* made a gift of the 1000 shares of *X* stock to *B*. At the date of that gift, the fair market value of the 1000 shares of stock was $35,000. In Year Twenty, *B* made a gift of the 1000 shares of *X* stock to *C*. At the date of that gift to *C*, the fair market value of the 1000 shares of stock was $50,000. In Year Twenty-Four, *C* sold the 1000 shares of *X* stock to an unrelated person for $30,000, which was the fair market value of the stock at that time. What is the amount of loss that *C* recognized on that sale?

4. The same facts as those stated in Question 3 except that the person to whom *C* sold the stocks in Year Twenty-Four was the sister of *C*. What amount of loss that *C* recognized on that sale is deductible?

5. Fred owned 500 shares of stock of the Widget corporation. Fred has a basis in those 500 shares of $80,000. Fred wished to dispose of those shares to his niece, Mary, but he was unwilling to make a gift of the entire value of the stocks. Fred solved that problem by selling the stocks to Mary at a bargain price (i.e., a price that was lower than the value of the stocks). The difference between the value of the stocks and the amount paid by Mary constitutes a gift from Fred. Determine the tax consequences to Fred and to Mary in each of the following alternative circumstances.

   (a) Fred sold the 500 shares to Mary for $40,000. The fair market value of the shares at that time was $100,000. Four years later, Mary sold the 500 shares to an unrelated party for $60,000, which was its value at that time.

   (b) Fred sold the 500 shares to Mary for $40,000. The fair market value of the shares at that time was $120,000. Four years later, Mary sold the 500 shares to an unrelated party for $100,000, which was its value at that time.

   (c) Fred sold the 500 shares to Mary for $100,000. The fair market value of the shares at that time was $180,000. Four years later, Mary sold the 500 shares to an unrelated party for $160,000, which was its value at that time.

   (d) Fred sold the 500 shares to Mary for $10,000. The fair market value of the shares at that time was $60,000. Four years later, Mary sold the 500 shares to an unrelated party for $50,000, which was its value at that time.

6. *A* gave *B* stocks in 1976. *A* died in 1980. In 1981, *B* sold the stocks for $10,000. There is no record or evidence of what A's basis was in the stocks, but it is shown that he purchased them sometime between 1940 and 1951. How is *B*'s gain or loss determined?

7. Your client, an elderly widower, desires to make a present of $20,000 to his son. Your client has three different stocks, any one of which he is willing to use as the corpus of the gift. The stocks have the following basis and fair market value:

	Basis	*FMV*
A Stock	$30,000	$20,000
B Stock	$15,000	$20,000
C Stock	$20,000	$20,000

Which of the three stocks (A, B or C) should your client give to his son?

8. In Year One, Helen made a gift of Blackacre (unimproved land) to her husband, Ralph. Helen had a basis of $100,000 in Blackacre, but its fair market value at the time of the gift was only $75,000. In Year Four, Ralph sold Blackacre to an unrelated party for its then value of $80,000. What was the tax consequence to Ralph of that sale?

9. In Year One, Susan sold Whiteacre (unimproved land) to her husband, Paul. The fair market value of Whiteacre was $190,000, and Paul paid that amount to Susan. In other words, Paul paid Susan an amount equal to the fair market value of the property. Susan's basis in Whiteacre was $125,000. In Year Six, Paul sold Whiteacre to an unrelated party for $300,000. What was the tax consequence to Susan of her sale of Whiteacre to Paul, and what was the tax consequence to Paul of his sale of Whiteacre in Year Six?

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PROBLEM SET # 5

1. On five days a week, Franklin stands on a corner and begs for money. Franklin is successful at this venture and collects over $40,000 per year. Are the amounts Franklin receives treated as gross income to him?

2. Henry's nephew, Dennis, told his family that he planned to drop out of college. To induce Dennis to remain in college, Henry promised that he would give Dennis $40,000 if Dennis would graduate from college. Dennis remained in college and did graduate. Henry fulfilled his promise and gave Dennis $40,000. Is any of that payment included in Dennis's gross income?

3. The same facts as those stated in Question 2 except that when Dennis graduated, Henry reneged on his promise and refused to pay. Dennis sued Henry and obtained a judgment for the $40,000 which had been promised to him. Henry paid the judgment. Is any of the payment included in Dennis's gross income?

4. Paula received welfare payments from the State of Utopia to support her and her three minor children. Are those payments included in Paula's gross income? Would it affect your answer if Paula received the payments under a welfare program in which the recipients of payments are required to provide services?

5. Hillary is a candidate for election to a federal office. A testimonial dinner is held to raise money for her campaign. The dinner raises $450,000 which amount is turned over to Hillary to assist in financing her campaign. What are the tax consequences to Hillary?

6. Randolph has worked for five years as an employee of his father in his father's real estate business. This year, Randolph married, and his father gave him a wedding gift of $150,000. Is any of that amount included in Randolph's gross income?

7. Patricia worked as a domestic servant for the Hawthorne family for over 30 years. On the death of Frances Hawthorne, she made a bequest of $50,000 to Patricia in appreciation of the loyal service that Patricia had provided. At the time of Frances's death, Patricia was still in her employ. Is any of that bequest included in Patricia's gross income? Would it affect your answer if Patricia had retired two years before Frances died?

8. In 2004, Oprah Winfrey gave her audience free Pontiac automobiles. As reported by Fortune Magazine:

> Oprah Winfrey, one of the world's richest entertainers, surprised her fans Monday by giving each of her 276 audience members a new car to celebrate the premiere of her show's 19th season.
>
> The billionaire talk show host told the audience that everybody will get a new Pontiac G-6 midsize 2005 sports sedan. Winfrey screamed and jumped up and down on the stage, shouting: "Everybody gets a car! Everybody gets a car!"

Assume Oprah told the winners that not only do they get the cars, but they are tax-free since they are gifts. As an IRS representative, briefly respond to Oprah's statement.

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PROBLEM SET # 7

1. Fred borrowed $5,000 from the Friendly National Bank. The terms of the loan provided for adequate interest payments. Fred is not an employee or otherwise related to the bank. Is any of the loan included in Fred's gross income?

    (a) Two years after the loan was made, the bank agreed to accept a payment of $3,000 in satisfaction of the loan, even though Fred was solvent. The bank determined that it was not worth the cost and difficulty it would incur in seeking to collect the full $5,000 owed to it. What was the tax consequence to Fred?

    (b) The same facts as those stated in Question 1(a) except that the lender was Fred's father instead of a bank. What was the tax consequence to Fred in that case?

    (c) The same facts as those stated in Question 1(a) except that the bank did not offer to accept a lesser amount and no part of the loan was ever repaid. The statute of limitations for a suit to collect the loan expired in June of Year Five. Did Fred recognize any income, and, if so, in what year?

2. Martha purchased an oil painting from Rhoda, an art dealer. The price for the painting was $40,000. Martha paid Rhoda $10,000 cash plus Martha's promissory note in the amount of $30,000, bearing adequate interest. Martha subsequently complained that Rhoda had made false and misleading statements about the painting. Rhoda denied those claims. After some negotiation and threats of litigation, Rhoda agreed to accept a new promissory note from Martha in the amount of $15,000 in exchange for the original note on which $30,000 was still owing. The terms of the new note were identical to those of the original note except that the face amount of the new note was a lesser figure. What was the tax consequence to Martha?

3. The Zion Baptist church of Willsboro initiated a fund raising campaign to obtain the funds to build a new church. Rupert Walters made a written pledge of $35,000 to the church. Subsequently, Rupert went to the officers of the church and asked them to reduce his pledge to $10,000 because he had suffered significant business losses in the interim, although he was solvent. Under local state law, a promise to make a contribution to a charitable organization is enforceable by the charity regardless of whether the obligor received consideration for the promise. Nevertheless, the officers of the church accepted $10,000 from Rupert and cancelled the remaining $25,000 of his obligation. What was the tax consequence to Rupert? Would it affect your answer to that question if the church officers had agreed to cancel $25,000 of Rupert's pledge because they were under the mistaken belief that they had no right to enforce Rupert's promise since no consideration was given for his promise?

4. Rachel owns and operates a boutique retail dress shop in Columbus, Ohio. In Year One, she bought a line of dresses from a French manufacturer for 4,000 Euros. She bought the dresses on credit, and so she made no cash payment and owed the manufacturer the Euros. At the time she purchased the dresses, 4,000 Euros were worth $6,000 in U.S. dollars. By March of Year Two, the Euro had fallen in value as compared to U.S. dollars, and so Rachel was able to purchase 4,000 Euros for only $3,000 in U.S. currency. Rachel then paid the 4,000 Euros she had purchased for $3,000 to the French manufacturer in satisfaction of her debt. What was the tax consequence to Rachel of this transaction?

5. In Year One, Paul opened a gourmet restaurant in Grand Rapids, Michigan. Paul hired a prominent chef for the restaurant and contracted to pay the chef a salary of $20,000 per month. The term of the contract was 5 years. In its first two years of operation, the restaurant did not produce the amount of income that Paul had anticipated. Consequently, Paul was unable to pay the chef the entire amount of salary that was owing to him under the contract. By the end of Year Two, Paul owed the chef $25,000 for wages that had not been paid. Despite these disappointments, the chef was convinced that the restaurant would prosper in the immediate future. In Year Three, Paul asked the chef to forgive the $25,000 of unpaid salary, and Paul promised to meet the payroll thereafter. The chef agreed, and the $25,000 debt was cancelled in July of Year Three. Paul reports his income from the restaurant on the accrual method of accounting, and the chef reports his income on the cash receipts and disbursement method of accounting. What are the tax consequences to Paul of the cancellation of the $25,000 debt in each of the following alternative circumstances?

   (a) On his tax returns for Years One and Two, Paul had accrued and deducted the $25,000 of unpaid salary, and Paul obtained a tax benefit from those deductions.

   (b) In his tax returns for Years One and Two, Paul had erroneously failed to claim a deduction for the unpaid salary.

   (c) In his tax returns for Years One and Two, Paul had taken deductions for the unpaid salary, but Paul had obtained no tax benefit from those deductions.

6. In Year One, Sylvia borrowed money from the Friendly National Bank. The debt was not secured, but Sylvia was personally obligated to repay it. At the beginning of Year Four, the unpaid balance of Sylvia's debt to the bank was $60,000. Sylvia had no other debts. The only assets that Sylvia had were $23,000 cash and an acre of unimproved land with a fair market value of $12,000. Sylvia's basis in the land was $28,000. Sylvia had no net operating losses or capital losses in Year Four, and she had no loss carryovers to that year. In March of Year Four, the bank cancelled $50,000 of Sylvia's debt in exchange for Sylvia's payment of $20,000 cash to the bank. Thus, the bank forgave $30,000 of the debt. After that payment, Sylvia had $3,000 cash, and the unimproved land; and the outstanding balance of her debt to the bank was $10,000. What was the tax consequence to Sylvia of the cancellation of $30,000 of her debt? As of January 1 Year Five, what basis does Sylvia have in the land that she owns?

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PROBLEM SET # 8

1. In Year One, George had taxable income of $80,000. George's marginal rate of federal income tax for that year was 30%, and $25,000 of George's taxable income was taxed at that 30% marginal rate. George's total federal income tax for Year One was $18,000. Consequently, the average rate of George's tax for Year One was 22.5%. Part of George's $80,000 taxable income was a commission of $25,000 that George received that year from his employer for sales that George initiated.

   In Year Four, George's employer discovered that George had received commissions for sales that should have been credited to another employee. After some negotiations, George and his employer agreed that George should have received a commission of only $10,000 in Year One, and George returned the excess $15,000 to his employer. The overpayment to George created a debt that he owed to the employer, and the statute of limitations for repayment of that debt had not expired when George repaid the amount to the employer. In Year Four, without taking the repayment of the commission into account, George had taxable income of $40,000. $30,000 of that income was taxable at a federal income tax rate of 15%, and the remaining $10,000 was taxable at a 20% federal income tax rate. What was the tax consequence to George of the repayment of $15,000 of the Year One commission? Would it effect your answer if the statute of limitations on George's obligation to repay the $15,000 had expired before the employer discovered the error, but George had nevertheless repaid that amount?

2. The same facts as those stated in Question 1. George's employer was in a marginal federal income tax bracket of 30% in Year One, and she was in a marginal federal income tax bracket of 50% in Year Four. The employer did not pay the other employee the $15,000 of commission owing to her until Year Five, and since the employer used the cash receipts and disbursements accounting method, she got no deduction for that payment until Year Five. What was the tax consequence to the employer from receiving the return of the $15,000 of George's commission in Year Four?

3. The same facts as those stated in Question 1 except that in Year One, George's deductions were so large that he had a net loss of ($20,000) for that year, and his tax return showed a net loss of ($20,000). George's loss did not constitute a net operating loss or a capital loss, and so George could not carry the loss forward or back to other taxable years. Consequently, if George had not received the $15,000 of commissions that were erroneously paid to him, he would have reported a loss of ($35,000) on his tax return for that year, but there would have been no effect on his tax liability. What was the tax consequence to George of repaying the $15,000 to his employer in Year Four?

4. The same facts as those stated in Question 1 except that the amount of commission that was erroneously paid to George in year one was only $2,000. In Year Four, George repaid to the employer the $2,000 of commissions he had erroneously received in Year One. What was the federal income tax consequence to George of making that $2,000 repayment?

5. Mary Walters is the sole proprietor of a wholesale business that is engaged in selling appliances. In Year Two, one of Mary's customers was overbilled by $6,000 because of a clerical error of an employee of Mary's, and the customer paid that bill. In Year Four, the customer discovered the error, requested Mary to return the $6,000 overpayment, and Mary did so. Mary was in a marginal federal income tax bracket of 50% in Year Two, but she was in a marginal federal income tax bracket of 30% in Year Four. What was the tax consequence to Mary of returning the overpayment?

6. Franklin Jones was the president and sole shareholder of Win All, Inc. In Year One, Franklin received a salary of $250,000. Upon auditing the corporation's Year One tax return, the IRS determined that the maximum reasonable salary for Fred was only $180,000, and consequently the excess $70,000 paid to him in Year One was a nondeductible dividend. (See Treas. Reg. § 1.162-8). The denial of the deduction would increase the corporation's tax liability for Year One. The corporation litigated that issue with the IRS, but in Year Five, the Tax Court held that the Service was correct and that $70,000 of the "salary" paid to Franklin was excessive. The corporation did not appeal that decision, and Franklin promptly paid $70,000 to the corporation as a return of the excessive compensation. What was the tax consequence to Franklin of making that repayment in the following alternative circumstances?

   (a) In Year One, Franklin and the Win All corporation executed a contract that required Franklin to return any part of his salary that was determined by the IRS or by a court to be excessive compensation.

   (b) There was no contractual agreement between Frederick and the corporation for Frederick to return the excessive element of any salary paid to him.

   (c) The contract between Franklin and the Win All corporation that is described in paragraph (a) above was executed in Year Three, which was prior to the audit of the corporation's tax return. The contract covered salary paid to Franklin by the corporation prior to and subsequent to its execution.

7. Margaret was employed as the manager of a retail clothing store. In June of Year One, Margaret discovered a very attractive investment opportunity that promised to turn over a substantial profit in a short period of time. To take advantage of that opportunity, Margaret needed to invest $40,000, but she had no funds available, and she could not borrow that amount. In order to make the investment, Margaret took $40,000 from the retail store and hid her action by altering the store's books. Margaret was confident that the investment would turn over with a profit within a year, and she fully intended to repay the $40,000 to the store as soon as she had the funds to do so. In Year One, Margaret was in a 30% marginal federal income tax bracket. On January 5, Year Two, Margaret sold her interest in the investment for $46,000. The profit of $6,000 that she earned thereby was less than she had anticipated, but she was satisfied. On January 8, Year Two, Margaret returned the $40,000 to the store, and altered the books to explain how that $40,000 suddenly appeared in the store's accounts. Unfortunately for Margaret, her actions were discovered by her employer on January 26, Year Two, and she was fired on that date. Margaret was charged and convicted of a crime. She was sentenced to two years in prison. Without taking the repayment of $40,000 into account, Margaret had taxable income of $4,000 in Year Two.

(a) What were the tax consequences to Margaret of taking the $40,000 from the store in year One, and of the return of the $40,000 to the store in Year Two? What effect would it have on your answer if Margaret had repaid the $40,000 to the store in December of Year One instead of in January of Year Two?

(b) What were the tax consequences to the retail clothing store (an incorporated organization) of Margaret's actions? In answering this question, see IRC § 165(c)(3), (e).

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PROBLEM SET # 9

In answering these questions, if a nonrecognition election is available, assume that it was or will be made.

1. Hilton purchased unimproved land. Hilton paid $40,000 cash for the land and took it subject to a $100,000 mortgage. Hilton did not assume personal liability to pay the mortgage. What is Hilton's basis in the land?

2. Smith owned Blackacre (unimproved land) which he held for investment. Smith had a basis of $200,000 in Blackacre. In each of the exchanges described below, determine the amount of gain or loss that was *realized* by Smith, and the amount of gain or loss that Smith *recognized*. Also, determine Smith's basis in the properties he received in the exchanges. All of the exchanges were at arms' length, and so it is presumed that properties of equal value were exchanged. Smith is not related to the persons with whom he exchanged properties. There were no encumbrances on Blackacre or on any of the properties Smith received in the exchanges.

   (a) Smith exchanged Blackacre for a warehouse that he then used in his business. The fair market value of the warehouse was $600,000.

   (b) Smith exchanged Blackacre for a commercial franchise (the right to use a trade name like McDonalds or Dominos) that had a value of $400,000. Smith used the franchise to conduct a business.

   (c) Smith exchanged Blackacre for an office building having a value of $500,000 plus $100,000 in cash. Smith used the office building in his business.

   (d) Smith exchanged Blackacre for an office building having a fair market value of $450,000 plus 1000 shares of stock of the *X* corporation having a value of $150,000. Smith used the office building in his business.

   (e) Smith exchanged Blackacre for Greenacre (unimproved land) having a value of $80,000 plus 100 shares of *Y* stock having a value of $50,000. Smith held Greenacre and the *Y* stock as investments.

   (f) Smith exchanged Blackacre for Greenacre (unimproved land) having a value of $180,000. In addition, Smith received in the exchange $40,000 in cash and 100 shares of *Z* stock having a value of $60,000. Smith held Greenacre and the *Z* stock as investments.

3. Mark had a basis of $250,000 in Redacre (unimproved land) which he held as an investment. Mark had a basis of $20,000 in 100 shares of stock of the *X* corporation. The fair market value of Redacre was $395,000, and the fair market value of the 100 shares of *X* stock was $5,000. Mark transferred Redacre and the 100 shares of *X* stock to Joan in exchange for which Joan transferred Greenacre (unimproved land) to Mark. The fair market value of Greenacre was $400,000 and Joan had a basis of $230,000 in Greenacre. Mark held Greenacre as an investment. Mark and Joan are not related. What basis does Mark have in Greenacre? What basis does Joan have in Redacre? Did Mark or Joan recognize any gain or loss on that exchange?

4. Lane had a basis of $800,000 in an apartment building he owned. The apartment building had a fair market value of $1,210,000 and was subject to a mortgage of $250,000. Scott had a basis of $650,000 in an office building he owned. The office building had a fair market value of $1,260,000 and was subject to a mortgage of $370,000. Neither Lane nor Scott had any personal liability to repay the mortgage debt on their respective properties, and so those mortgages were nonrecourse debts. Lane and Scott each held his building in connection with his real estate rental business. Lane and Scott are not relateed.

   Lane transferred the apartment building to Scott in exchange for which Scott transferred to Lane $70,000 cash and the office building. Lane took the office building subject to the $370,000 mortgage debt thereon, and Scott accepted the apartment building from Lane subject to the $250,000 mortgage debt on that property. Land and Scott held the buildings they received in the exchange for business use.

   (a) What amount of gain or loss did Lane and Scott *realize* and what amount of gain or loss did they *recognize* from the exchange?

   (b) What basis does Lane have in the office building he acquired in the exchange, and what basis does Scott have in the apartment building?

5. Paula owns a dress shop. Through an error in buying, Paula discovers that she has an oversupply of maternity dresses, and a shortage of cocktail dresses. Paula mentions her problem to John, who is the owner of another dress shop. John offers to swap 20 cocktail dresses with a value of $10,000 for 50 maternity dresses of equal value. Paula agrees, and the exchange takes place. Paula had a basis of $6,000 in the maternity dresses that she exchanged. Paula and John are not related. Did Paula *recognize* a gain on that exchange?

6. Renee collects paintings for a hobby. Renee does not hold the paintings as investments. One of the paintings that she acquired is titled the “Blue Girl,” and Renee had purchased that painting in Year One for $3,000. At all times in the following questions, the fair market value of the painting was $5,800.

   (a) Renee transferred the Blue Girl painting to an unrelated art collector in exchange for a painting by a different artist having a value of $6,000. How much gain (if any) did Renee recognize on that exchange?

   (b) The Blue Girl painting was destroyed by a fire caused by the negligence of Peter. To compensate Renee for the loss, Peter offered her a painting from his collection, and Renee accepted the offer. The value of the painting that Renee received from Peter was $6,000. Renee and Peter are not related parties. How much gain (if any) did Renee recognize?

   (c) The same facts as those stated in Question 6(b) except that Peter gave Renee $5,800 cash to compensate her for her loss. A month later, Renee purchased another painting for $5,500. Renee made no other purchases of paintings for the next four years. How much gain (if any) did Renee recognize?

   (d) The same facts as those stated in Question 6(b) except that the painting that Peter gave Renee to compensate her for the loss had a value of only $2,000. Nevertheless, Renee accepted that painting as full compensation. Did Renee recognize a gain or loss?

7. Melvin owned a building in a run down area of Detroit, and he held that property as an investment. Melvin had a basis of $50,000 in the building. Melvin read an article in a local newspaper that the city planned to condemn an area that included his building. Melvin telephoned the mayor who confirmed the newspaper report. Melvin then purchased unimproved land in Ann Arbor at a cost of $65,000, which he held as an investment. Eight months later, the city of Detroit did condemn Melvin’s building and paid him $70,000 as compensation for the condemnation. Is Melvin entitled to nonrecognition of the gain he realized on the condemnation? What is Melvin’s basis in the land he purchased in Ann Arbor?

8. Hicks wished to acquire Blackacre (an apartment house) from Leslie. Hicks and Leslie are not related. Leslie had a basis of $85,000 in Blackacre which had a fair market value of $212,000. Leslie refused to sell the property to Hicks, but she offered to exchange Blackacre for a lot in another part of town if Hicks would purchase that lot and construct an office building on it in accordance with specifications that Leslie would provide. Hicks agreed. Hicks purchased the lot at a cost of $40,000, and he had the building constructed according to Leslie's plans at a cost of $165,000. Hicks then deeded the lot and building to Leslie in exchange for her deeding Blackacre to Hicks. What were the tax consequences of those transactions to Hicks and to Leslie?

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PROBLEM SET # 10

1. In Year One, Mona, a single mother and 35 years old, had adjusted gross income of $30,000. Compute the amount of medical deduction allowable to Mona in each of following circumstances. in answering these questions, assume that Mona itemizes her deductions, and that all of the payments described below were made in one taxable year.

   (a) Mona paid premiums for medical insurance covering her and her 4-year old daughter whom she supports. The premiums she paid for that year amounted to $2,800. In that same year, Mona paid $125 to a dentist for dental work she incurred.

   (b) In addition to the payments noted in (a), Mona paid $300 to purchase medicines that were prescribed by Dr. Jones for Mona's daughter. Mona also paid $20 for pills providing pain relief, which pills were neither prescribed nor required to be prescribed by a physician. Mona also spent $20 for an electric toothbrush, and $5 for toothpaste.

2. Phil has an asthmatic condition that adversely affects his heart. Phil's doctor advised him to purchase an air conditioning system for his home. Phil pays $400 for an air conditioning unit and pays another $30 to have it installed in a window in his bedroom. Without regard to the floor on deducting medical expenses, are any of the payments that Phil made deductible? If instead of a window unit, Phil had paid $2,600 to purchase a central air conditioning unit and have it installed in his house, would that cost be deductible?

3. Mike has an ulcer. His doctor requires him to go on a diet of bland foods that must be specially prepared. As a result of his special diet, Mike's weekly food bill is $20 greater than it was before he went on that diet. Can Mike deduct the extra cost he incurs?

4. Ted is advised by his doctor to join Alcohol Anonymous. Ted joins and spends $15 per week on transportation to and from the AA meetings. Are those costs deductible? Would those costs be deductible if Ted had not been advised by a doctor to join AA, but instead Ted had joined on his own initiative?

5. To alleviate a heart condition, Kelly's doctor advises her to leave Virginia and live temporarily in Arizona until her condition improves. Kelly goes to Tucson, rents an apartment there, and lives there for four months at which time her condition is much improved.

   (a) Are Kelly's transportation expenses of moving from her residence in Virginia to Tucson and return deductible?

   (b) Are Kelly's expenses for meals and lodging in Tucson deductible?

   (c) If Kelly traveled by car to Tucson and return, could she deduct the cost of her meals and lodging incurred en route?

6. Donald is admitted to a hospital for an operation. He spends two weeks in the hospital and pays a bill to the hospital of $40,000, which includes the cost of his food and room. Is all of that $40,000 amount deductible?

7. William has an illness the symptoms of which are relieved by marijuana. Pursuant to a physician's prescription, William purchased marijuana at a pharmacy. The purchase and use of marijuana for medicinal purposes is permitted by the laws of the state in which William resides, but is prohibited by the federal Controlled Substance Act. Does William's cost of purchasing the marijuana qualify as a deductible medical expense? See Rev. Rul. 97-9.

8. Matilda is a devout Christian Scientist. Matilda becomes ill, and she seeks the services of a Christian Science practitioner to remove her symptoms. The practitioner talks with Matilda and prays with her to remove the spiritual blight that they believe to be the source of her symptoms. Is the cost that Matilda incurred in obtaining the services of the Christian Science practitioner deductible as a medical expense?

9. Henry has been working long hours for some time, and he becomes lethargic. At Henry's annual medical check-up, his doctor becomes concerned that Henry's run-down condition will lead to a serious medical problem for him. The doctor tells Henry that he needs to take time off from work and go on an extended vacation. The doctor recommends that Henry take a cruise. Henry does so, and his condition improves greatly. Is the cost of the cruise deductible as a medical expense?

10. Peter smoked a pack of cigarettes a day. Peter became concerned that his continuing to smoke would be harmful to his health. In order to end his craving for cigarettes, Peter joined a program, conducted by a psychologist, designed to break the habit of smoking. The program was successful, and Peter no longer smokes. Peter chose to enter the program on his own initiative and was not advised to do so by a doctor. Is the cost that Peter incurred to participate in the program deductible as a medical expense? See Rev. Rul. 99-28.

11. Do the premiums for the following insurance policies qualify for medical expense deductions?

    (a) The insurer will pay the policyholder $400 per week during a period in which the policyholder is disabled.

    (b) The insurer will reimburse the policyholder for medical expenses incurred by the policyholder or his spouse. In addition, in the event of the poicyholder's death, or loss of sight, the insurer will pay a specified amount to the policyholder or his estate.

12. Gladys is covered by a medical reimbursement insurance plan provided by Blue Cross. Gladys paid the premiums for the policy herself. In Year One, Gladys incurred and paid medical expenses totaling $5,600. Blue Cross paid Gladys $5,000 to reimburse her for most of those expenses. Gladys had adjusted gross income of $48,000 in Year One.

    (a) Is any part of the $5,000 reimbursement included in Gladys's gross income?

    (b) The same facts as those stated above except that the premiums for the Blue Cross insurance policy were paid jointly by Gladys and her employer (each paid half of the premiums). The employer paid part of the premiums as a fringe benefit to Gladys. Was the employer's payment of one-half of the premiums included in Gladys's gross income? Was any part of the insurer's reimbursement of $5,000 included in Gladys's gross income?

    (c) The same facts as those stated in Question 12(b) except that Gladys did not receive a reimbursement from the insurer in Year One. In her tax return for Year One, Gladys claimed and was allowed a medical expense deduction of $800. Gladys could not deduct $4,800 of the $5,600 of medical expenses she paid in that year because of the 10% floor on the deduction of medical expenses. In Year Two, Gladys received $5,000 from Blue Cross as reimbursement for part of the medical expenses she incurred and paid in Year One. What amount (if any) of that reimbursement is included in Gladys's gross income in Year Two?