Income Taxation I
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Practice exam answers

MULTIPLE-CHOICE QUESTIONS

1. D. This is a tough question under section 125 of the Code, relating to cafeteria plans. Because the employees have the right to choose cash in lieu of other benefits, K is in constructive receipt of $600 cash, and thus has $600 of gross income, unless section 125(a) excludes the income. Section 125(a) excludes benefits received under a "cafeteria plan" from gross income, but "cafeteria plan" is defined in section 125(d)(2) to include only plans which are limited to cash and "qualified benefits," as defined in section 125(f). Section 125(f) states that "qualified benefits" are those excluded by the Code, but not those excluded by section 106(b), 117, 127, or 132. Here the plan offers tuition reimbursement, which is excludible, if at all, only under section 127. Therefore, the tuition reimbursement is not a "qualified benefit." Therefore, the plan is not a "cafeteria plan." Therefore, K has constructive receipt of $600 cash, and it is all includible in gross income.

2. D. To answer this question, you must know both sections 1014 and 1015 well. S's gain or loss depends upon his basis; that basis is determined under section 1015. His basis for determining gain is $3,000, his mother's basis. But since the fair market value at the time of the gift ($2,000) was less than M's basis, S's basis for determining loss is $2,000. When he sells for $2,500, he has no gain or loss. This is because his carryover basis of $3,000 results in a loss, and as just explained, his basis for determining loss is $2,000; since $2,000 basis results in a $500 gain, and $2,000 is only the basis for determining loss, no gain or loss is realized.

Knowing the correct treatment of S narrows the possibilities for the correct answer down to choices B and D. B is wrong because D's gain is only $200, not $5,900. D received the heirloom upon the death of M; thus, D's basis is the fair market value for estate tax purposes, or $5,800. When D sells for $6,000, her gain is only $200.

3. D again. Under section 102(c)(1), transfers from employers to employees cannot be gifts, no matter what the motivation of the employer; thus, A is wrong. As the car wasn't transferred to charity, there is no hope for an exclusion under section 74; therefore, choice B is incorrect. Since there appears to be no exclusion for the expensive automobile under any other Code provision, D is the best answer.

4. The correct answer is C. A is incorrect since, under cases such as *Smith*, child care expenses are nondeductible personal, family or living expenses, disallowed under section 262. D is incorrect since school age has nothing to do with the child care credit; the age limitation is 13 years old under section 21(b)(1)(A). This narrows the choices down to B and C. C is correct because under section 21(c), the cap on employment-related expenses eligible to be taken into account is $3,000 for a household with one "qualifying individual" (here, the child). Applying the applicable percentage, 20 percent, to the maximum $3,000 of expenses, the limit on the credit here is $600. Thus, B, which allows too much credit, is incorrect.

5. D is the correct answer. This is a casualty loss under section 165(c)(3), deductible subject to the 10 percent annual A.G.I. floor and the $100-per-occurrence "deductible" amount. Although the taxpayer's economic loss is $20,000, his basis is only $150. A casualty loss is the lesser of the two, $150. The amount of any loss under I.R.C. § 1001 is dependent on the taxpayer's basis. With only $150 of basis, after application of the 10 percent floor and the $100 *de minimis* amount, H is not entitled to any deduction. Answers A and B are incorrect because they allow deductions. C is also incorrect, in that a taxpayer can establish that a theft occurred without identifying the perpetrator.

6. C is the best answer. This is the problem presented by *Tufts*, the tax treatment of dispositions of nonrecourse-mortgaged property where the fair market value of the property is less than the outstanding balance of the mortgage loan. B is wrong because it reflects the suggestion of the obsolete *Crane* footnote that was rejected by *Tufts*. D is wrong because it taxes I as if all $100,000 of the mortgage were discharged in the abandonment, whereas I paid off $15,000 of the mortgage with his own after-tax dollars, leaving only $85,000 for an amount realized. A is a somewhat appealing answer, since I is bankrupt and section 108 allows exclusion of income that results from the discharge of indebtedness in such situations – but as the discussion (and rejection) of Professor Barnett's theory makes clear, gain from a disposition of property subject to a nonrecourse mortgage, even in the *Tufts* situation, does not qualify for section 108 treatment. Thus, C is correct – an $85,000 amount realized less an adjusted basis of $80,000, with no opportunity for exclusion under section 108.

7. C is the best answer. A is incorrect because it ignores section 172. B is incorrect because T is permitted to carry the net operating loss back to past years as well as forward to future years. D is incorrect because it allows a five-year carryback, whereas under current law, the carryback period is only two years.

8. D. All of these statements are true. A is true because the couple's taxable income is above the "breakpoint" between the 25 percent bracket and the 28 percent bracket. That dividing line is $151,900 for 2016. B is also true. The couple's marginal rate is 28 percent; this is higher than 10 percent, and their overall effective rate of tax is clearly lower than 28 percent. C is also true, since the child care credit under section 21 is available to all taxpayers, even those with high incomes. The credit is phased down, but not phased out.

ESSAY QUESTION

"Model" answers to essay questions are often unfairly intimidating; no one can write them under true exam conditions. Moreover, a question writer never knows all of the issues lurking in his or her handiwork. Surprises virtually always crop up in the course of grading! Therefore, I used for purposes of this practice exam an adaptation of an actual one-hour question from my summer 1987 examination (changing the dates as appropriate). Rather than tell how I would approach the problem, here are slightly adapted versions of two satisfactory answers I received on that actual exam (again, with the dates changed). They are not elegant, to be sure, but they covered the salient points to the extent necessary for a good grade in that class:

First sample answer

.A. Under the installment method, Sid would apply the gross profit ratio to his payments received.

50K × [100K-20K (basis) / 100K] = 40K taxable gain for 2016

Barbara's original escrow account of $200,000 could be construed as constructive receipt or as evidence that Sid is using the installment method only to save taxes. Since the deal was not finalized until later, Sid will probably get away with it. The $50,000 could also be constructive receipt, but Sid's contract does not give him the right to go and get the $50,000 and the $50,000 is subject to B's other creditors, so the deal is probably good. The accounts are for sale of property, not personal services, so they are not covered by Rev. Ruling 60-31, and securing the transaction with the mortgage is not constructive receipt.

B. Barbara's basis in Redacre is $100,000 – the purchase price. Barbara is, in effect, borrowing $50,000 from Sid and securing it with the mortgage. Borrowed money can buy basis.

C. The parties appear to have screwed up the 3-way exchange. Sid received money from Barbara, and then used the money to purchase O's property. If Barbara had given the money to O, it would have worked. Sid's receipt of the $100,000 is a recognized gain of $80,000 on Whiteacre. His basis in the leasehold is his cost – $100,000. Sid should have given Whiteacre to O in return for the leasehold. Then Barbara can buy the Whiteacre property from O for $. The lawyer may owe Sid some tax $. O was not trading his inventory, so the deal would work.[1]

[1] Note: This last sentence in the first sample answer is incorrect. Oscar's status as a dealer of inventory would not affect Sid.

Second sample answer

1. The Initial Discussion and Offer

Sid did not constructively receive the $200,000 that Barbara put in the escrow account. Although the check was payable to Sid, he had no legal right to the money and he did not "turn his back" on it. Barbara's clear willingness to sell [*sic*] does not create income for Sid.

Redacre

Redacre was sold by Sid to Barbara under an installment sale contract since at least one payment will be received after the close of the current taxable year. § 453(b)(1). Sid may make an election under 453(d) to decline to use the installment method for allocating basis to each payment, and instead use § 1001 and try to use the *Burnet v. Logan* approach of getting all your basis out first. This will probably not be successful. Thus, under § 453 Sid may allocate a portion of his basis to each payment he receives, including the down payment. The portion is:

gross profit realized / total contract price

Sid's 2016 down payment is taxable to the following extent:

$50,000 × [$100,000 - $20,000 / $100,000] = $40,000

Subsequent payments (of principal) will use the same fraction. Interest is always ordinary income.

The mortgage secured Barbara's promise to Sid to pay $50,000 & interest. So long as the payments are made it is insignificant to Sid.

Barbara's bank account to pay the interest will provide her with interest income. It has no tax significance to Sid.

Barbara's basis in Redacre immediately after the purchase is $100,000, her cost. The mortgage & note are equivalent to a loan, the proceeds are not income and they are included in her basis.

Whiteacre

The three way transaction is unnecessarily complex and results in a higher taxable income for Sid. In sum, Sid received $100,000 from Barbara, paid $100,000 to Oscar, transferred Whiteacre to Oscar and received the lease in return.

To get the lease Sid transferred Whiteacre. Since the lease had a FMV of $100,000, Sid is taxed on $80,000 because he can subtract his basis. The $100,000 of cash because it is subtracted from the $100,000 Sid paid results in no tax implications on the deal. Sid's basis equals his cost or $100,000 in the lease.

The proper, and certainly clearer, way to handle this problem is with a three way, like kind exchange under § 1031. Barbara would pay Oscar the $100,000. Oscar, a dealer in real estate, does not qualify for non-recognition. Neither would Barbara as she's paying cash. Sid would as he's receiving property to be used in a trade or business in exchange for investment property,

Whiteacre. The leasehold due to its length should be treated as a fee. Sid would transfer Whiteacre to Barbara through an exchange for the lease with Oscar. Oscar would transfer Whiteacre to Barbara. Sid would have no recognized income, although he would have realized income. Sid's basis would remain at $20,000. This differs from the previous result and is accomplished basically by keeping the cash out of Sid's hands.