SUBSTANTITVE TAX
(96 Minutes)

Question S-1 (2 minute/s) Compare and contrast the cash method of accounting and the accrual method of accounting.

Question S-2 (2 minute/s) Explain whether federal income tax accounting incorporates the concepts of (1) constructive receipt and (2) constructive payment.

Question S-3 (10 minute/s) State the amount (without any further explanation), if any, of the following items that constitutes gross income to Taxpayer

a) $80,000 gross wages from employment ($60,000 net of federal taxes).

b) $900 cost to Taxpayer's employer of $45,000 of life insurance on Taxpayer's life, which is provided under a group term policy of the employer.

c) $25,000 embezzled from employer.

d) $200,000 proceeds of a life insurance policy on Taxpayer's grandfather. The policy was purchased by the grandfather by payment of a single premium, and was owned by the grandfather until his death; taxpayer was the designated beneficiary of the proceeds.

e) $275,000 received as winner of the Nobel Prize in literature; Taxpayer accepted the prize and used the proceeds to buy a vacation home.

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

g) $5,000 gain realized upon sale of State of Montana bond (used to finance the construction of new public schools).

h) $50,000 paid to Taxpayer at maturity of loan Taxpayer made to a business association ($47,000 principal repayment and $3,000 of interest).

i) $7,000 as partial payment of the proceeds of a life insurance policy in the face amount of $50,000 on Taxpayer's spouse who died during the year. Pursuant to the terms of the policy, Taxpayer elected to receive a $7,000 payment in each year for life. Taxpayer's life expectancy is 10 years when the payments commence.

j) $3,000 fair market value of antique pocket knife Taxpayer found behind a sink on Taxpayer's house; Taxpayer retained and used the knife.

Question S-4 (2 minute/s) Taxpayer purchased a share of stock issued by a corporation. Taxpayer immediately thereafter assigned all future dividends from the shares to Donee, while retaining to Taxpayer all other rights as owner of the share. Discuss which party should be taxed on the periodic dividends from the share.

Question S-5 (3 minute/s) Briefly discuss the scope of §183.

Question S-6 (2 minute/s) Discuss briefly the substantiation requirements that a taxpayer must satisfy in order to obtain deductions for business travel expenses.

Question S-7 (3 minute/s) Taxpayer incurs tuition and book costs for attending law school. Taxpayer is a certified public accountant who specializes in the area of taxation. Taxpayer attends law school (at night while continuing full-time practice as a certified public accountant) to improve Taxpayer's skills in taxation. Discuss whether Taxpayer's tuition and book costs for attending law school will be deductible for federal income tax purposes.

Question S-8 (2 minute/s) On January 1, 2002 the amount of the first mortgage debt secured by Taxpayer's principal residence was $600,000 and the value of the residence was $900,000. Taxpayer obtained a loan in the amount of $200,000 that was secured by a second mortgage on the principal residence. The $200,000 proceeds of the second mortgage loan were used by Taxpayer to add a wing to the principal residence. Discuss and quantify the principal amount of debt on which interest is deductible in 2002.

Question S-9 (3 minute/s) Sections 167 and 168 provide differing capital cost/depreciation rules. Discuss in general terms the essential differences between the two deduction rules.

Question S-10 (3 minute/s) Taxpayer's personal use lake house was built in the 1940's. Because of gradual corrosion, one of the hot water pipes burst and caused substantial damage to Taxpayer's lake house because the hot water leaked into the walls, the floors, and the basement. The cost to fix the hot water pipe was $500, and the cost to repair the damage to the house was $5,000. Discuss narratively whether Taxpayer will be allowed a casualty deduction for these two losses (you need not quantify your answer).

Question S-11 (4 minute/s) Taxpayer is a charitable person who likes to support needy persons and needy organizations. During 2002, Taxpayer's adjusted gross income is $100,000 (and Taxpayer is not eligible for a net operating loss carryover to 2002 from another year). During 2002, Taxpayer is engaged in the following transactions:

1. Contribution of 5 hours of service as financial services consultant to the Boy Scouts of America. Taxpayer's trade or business is providing financial advisory services, and Taxpayer charges $200 per hour for Taxpayer's services.
2. Parking fees of $50 and transportation costs of $150 as out-of-pocket expenses incurred a volunteer for the American Red Cross blood drive.

3. Cash gift of $40,000 to Harvard University.
4. Cash gift of $6,000 to A, the grandchild of a deceased friend of the taxpayer, to enable A to attend college.

Assume that each of the Boy Scouts of America, the American Red Cross, and Harvard University (1) is a qualifying §170(c) organization and (2) is described within §170(b)(1)(A).

Determine:

a. Which of the foregoing transactions qualify for deduction according to §170 and
b. The combined total amount of the §170 deduction to which Taxpayer is entitled in 2002.

Question S-12 (4 minute/s) Taxpayer was driving an automobile on February 15, 2002 and was injured in a collision and was hospitalized. Taxpayer was hospitalized from February 15 to July 22, 2002, the date of Taxpayer's death. Substantial medical expenses were incurred in providing care to Taxpayer in 2002 before Taxpayer's death. Medical and hospital expenses of $40,000 had been paid by Taxpayer in 2002 before death, but medical and hospitalization insurance reimbursed Taxpayer during 2002 the amount of $29,000. Other medical expenses incurred during 2002 before Taxpayer's death were paid by the estate of Taxpayer during 2003 in the amount of $30,000. Taxpayer's adjusted gross income for the period of January 1, 2002 to the date of death was $100,000. Describe the tax consequences or options available with respect to the deduction of the medical expenses paid by Taxpayer and the estate of Taxpayer.

Question S-13 (5 minute/s) Will Taxpayer be entitled to a §151(c) dependent exemption-deduction in 2002 for the following persons? State YES or NO:

a. A, Taxpayer's 20 year old unmarried child, who resides with Taxpayer for July and August of 2002 but for all other months is away at college. A has 2002 gross income of $7,000 from summer employment. Taxpayer provides $20,000 to support A, and A expends $4,000 of A's own money for A's support.
b. B, Taxpayer's eighteen year old unmarried child, who resides with Taxpayer for the entire year. B works full time and has gross income of $20,000 in 2002, but all of B's support is provided by Taxpayer.
c. C, Taxpayer's twenty year old unmarried child, who resides with Taxpayer for the entire year. C works full time and has gross income of $30,000 in 2002, but all of C's support is provided by Taxpayer.
d. D, a foster child who spends the whole year in the house of Taxpayer and for whom Taxpayer provides all support. D has no gross income for 2002.
e. E, Taxpayer's dependent parent, who lives with Taxpayer and who has

2002 gross income of $8,000. Taxpayer provides all support.

Question S-14 (2 minute/s) Taxpayer is §151 dependent of Parent for 2002. Taxpayer has 2002 earned income of $4,000. State the amount of standard deduction to which Taxpayer is entitled.

Question S-15 (1 minute/s) Taxpayer is a married person filing a separate return, and Taxpayer's spouse itemizes deductions on the spouse's separate return. State the amount of standard deduction to which Taxpayer is entitled.

Question S-16 (2 minute/s) May a divorced parent not having custody of a child be entitled to a §151(c) dependency exemption-deduction for the child. State YES or NO and briefly explain.

Question S-17 (4 minute/s) Describe the transfers that qualify as alimony for purposes of §§71 and 215.

Question S-18 (4 minute/s) Taxpayer owns real property, and on March 15, 2002, the property has a fair market value of $100,000 and an adjusted basis to Taxpayer of $120,000. Taxpayer and Spouse are divorced of March 15, 2002 and pursuant to the divorce decree, Taxpayer transfers title to the real property to Spouse on March 15, 2002. On December 15, 2002 Spouse sells the real property to an unrelated third party for $90,000 cash. Briefly discuss the tax consequences to Spouse with respect to the March 15 transfer and the December 15 sale to the third party.

Question S-19 (6 minute/s) Taxpayer acquired unimproved real property in 1998. To acquire the property, Taxpayer (1) paid $60,000, (2) took subject to a preexisting first mortgage debt secured by the property in the amount of $40,000 (for which Taxpayer was not personally liable), and (3) executed a $30,000 second mortgage indebtedness (for which Taxpayer was personally liable) to the seller. In 2000, Taxpayer borrowed $50,000 from a bank, in return for which Taxpayer executed a nonrecourse note (no personal liability to Taxpayer) and a third mortgage on the real property to secure the $50,000 debt. The $50,000 proceeds of the loan were used to construct a storage building on the real property. In 2002 Taxpayer received an offer to buy the real property, which Taxpayer accepted. Buyer (1) paid $150,000 cash, (2) took subject to the first mortgage debt of $25,000 (it had been paid down from $40,000 to $25,000), (3) assumed the $30,000 second mortgage debt, and (4) took subject to the third mortgage debt of $10,000 (it had been paid down from $50,000 to $10,000).

a. What was the Taxpayer's basis in the property at the time of acquisition in 1998?

b. Describe the federal income tax consequences of the 2000 borrowing and third mortgage transaction.

c. Quantify Taxpayer's amount realized and any gain or loss realized upon the sale of the property to Buyer in 2002.

Question S-20 (8 minute/s) Taxpayer and B exchanged unimproved real properties that have been encumbered by mortgage debs. In the exchange transaction, Taxpayer's mortgage debts are assumed by B, and B's mortgage debts are assumed by Taxpayer.

The gross fair market value of B's property is $100,000, its adjusted basis is $60,000, and it is encumbered by a $20,000 mortgage leaving a net equity of $80,000, and B receives from Taxpayer $10,000 of cash. The gross fair market value of Taxpayer's property is $120,000 its adjusted basis is $40,000, and it is encumbered by a $50,000 mortgage leaving a net equity of $70,000. Discuss and quantify the §1031 consequences to Taxpayer (not B).

Question S-21 (3 minute/s) Taxpayer transferred encumbered real property to a corporation all of the stock of which was owned by Taxpayer (both before and after the transfer of the real property). The debt encumbering the real property was assumed by the corporation. The debt encumbering the real property was greater than Taxpayer's adjusted basis in the real property. Taxpayer also prepared, signed and contributed to the corporation a promissory note of the Taxpayer's payable to the corporation. Discuss the consequences under §357 (c) of Taxpayer's promissory note payable to the corporation.

Question S-22 (6 minute/s) Taxpayer and Y formed TY Corporation on January 1, 1993. On January 1, 1993 Taxpayer acquired 60% of the stock of TY and Y acquired 40% of the stock of TY and those ownership percentages have not changed. TY has been a qualifying S corporation since its inception in 1993. As of January 1, 1993, Taxpayer's adjusted basis in the shares of TY was $60,000 and Y's adjusted basis in the shares of TY was $40,000. TY realized the following amounts of net nonseparately computed income (as defined in §1366 (a)(1)(B)) and no items subject to §1366(a)(1)(A).

YEAR	**AMOUNT ($)**
1993	5,000
1994	10,000
1995	12,000
1996	18,000
1997	75,000
1998	80,000

TY makes no distribution to a shareholder until December 31, 1998, when TY made a cash distribution of $360,000; $216,000 to Taxpayer and $144,000 to Y. Describe and quantify the tax consequences of the distribution to both Taxpayer and Y.

Question S-23 (5 minute/s) discuss the "check the box" rules applicable in classifying a domestic entity as either a partnership or an association taxable as a corporation.

Question S-24 (4 minute/s) Taxpayer was in declining health and appointed A, Taxpayer's child, as Taxpayer's agent under a durable power of attorney for many years. Taxpayer had made cash gifts to Taxpayer's children during

December. Pursuant to the power of attorney, A prepared gift checks drawn against Taxpayer's checking account payable to A and to each of A's siblings. The checks were prepared on December 15, 2001 and were delivered on December 20, 2001. Taxpayer died on December 20, 2001. All of the checks were deposited in the respective donee's checking account by the end of 2001, but none was accepted or paid by the drawee bank until after Taxpayer's death. Discuss whether these checks represent completed gifts of funds in Taxpayer's checking account that are not includible in Taxpayer's gross estate.

Question S-25 (2 minute/s) Taxpayer pleaded guilty to the criminal offense of tax evasion under §7201, and was sentenced to two years in prison, fined $250,000, and required to pay restitution to the IRS. Following the §7201 conviction, the IRS determined and the Tax Court sustained deficiencies in tax and civil fraud penalties against Taxpayer. Taxpayer argues in a Tax Court Rule 155 proceeding that the $250,000 fine should be credited against the civil fraud penalty, and the IRS argues that no credit should be allowed. How should the Tax Court rule? Briefly explain.

Question S-26 (4 minute/s) Explain the substantial authority exception to the §6662(b)(2) penalty for substantial understatement of income tax.