**Issue Outline**
**Income Tax I Essay Exam Questions**
**Fall 2018**

**Question 37**

Miles's payment of Bettina's fee is deductible as an ordinary and necessary business expense. *Heininger*.

Miles's transfer of the case of whiskey to Bettina may or may not be a gift. The proper characterization depends on Miles's primary motivation in making the transfer; if it is detached and disinterested generosity, then the transfer is a gift. Here, there has been commercial contact between the two, indicating that Miles may be saying thank you for services rendered by Bettina – in which case the transfer would not be a gift.

If the transfer is a gift, then any business deduction by Miles is limited to $25 under IRC § 274(b). The IRS could argue that the gift is not deductible at all because it is too personal. If the transfer is a gift, Miles may additionally have gross income under the tax benefit rule. When he previously deducted the cost of the whiskey, the rationale is likely to have been that he would serve it to customers at Now. His giving it away to Bettina is arguably inconsistent with the premise of the prior deduction. The gross income would be the amount of the previous deduction.

If the transfer is not a gift, Miles can deduct the full fair market value of the whiskey under IRC § 83(h), because that is the amount that Bettina would include in gross income under IRC § 83(a). But the use of the whiskey to pay compensation to Bettina would likely be considered a realizing event, similar to use of appreciated property to satisfy a debt. In this case, because the cost of the whiskey was previously deducted, its basis would be zero. The amount realized would be the fair market value of what he is receiving in exchange with Bettina. It could be as much as the fair market value of the whiskey, or $3,500.

Any income realized on the transfer of the whiskey to Bettina would be ordinary income, in that supplies are not capital assets. See IRC § 1221(a)(5).

Payment of the bribe is not deductible. IRC § 162(c).

Miles's receipt of the murals from Vivek is rental income equal to the fair market value of the murals, $12,000. Miles's subjective valuation of the murals is not relevant. *Rooney*. The income is ordinary income because there has been no sale or exchange of property, as is required for capital gain treatment. Miles's basis in the murals is their fair market value. Because he uses them in his business, Miles can take depreciation on the murals or elect to "expense" them, that is deduct their entire basis immediately.

The deductions just discussed are above the line, that is, taken into account in computing adjusted gross income. IRC § 62(a)(1). Miles may also be entitled to the 20 percent below-the-line deduction for qualified business income under IRC § 199A. All of the deductions may be taken against ordinary income as well as capital gain, because the deductions are not from capital losses.

**Question 38**

The trust is a grantor trust under IRC § 674, because Felicia retains the right to change the income beneficiary. Thus, Felicia is treated as the owner of the bonds. Felicia must report gross income from the interest on the bonds as soon as the interest is received by the trust. Bond interest is ordinary income because there is no sale or exchange.

Felicia has $80,000 of gain on the sale of the XYZ stock to Portia. Because it is an installment sale, the default treatment of the gain is to spread it out over the life of the contract. A portion of each payment, including the down payment, is treated as capital gain when Felicia receives it. The portion is determined by multiplying each payment by a fraction: gross profit divided by total contract price. The gross profit is $80,000. The total contract price is $200,000. Thus, the fraction is 2/5, or 40 percent.

Felicia can elect out of the installment method. If she does so, because she is a cash method taxpayer, her gain on the sale would be recognized in the year of sale. That gain would be calculated by subtracting her $120,000 basis in the stock from the sum of (a) the $80,000 down payment plus (b) the fair market value of the promissory note.

Felicia's gain on the sale would be capital gain, unless she is a dealer in closely held stocks. If she is a dealer, installment reporting is also unavailable. IRC § 453(b)(2)(A).

The interest on the note is gross income, ordinary income, to Felicia as she receives it.

The transaction with Darya is a bargain sale. Felicia is allowed to use all of her $30,000 basis to offset the $50,000 amount realized. Thus, her gain is $20,000. Felicia's gain on the sale would be capital gain, unless she is a dealer in real estate.

Damages received on account of personal physical injury are excluded from gross income under IRC § 104(a)(2). Assuming Felicia was physically injured, all of the damages are excluded from her gross income. The fact that she received a series of periodic payments does not affect this result, as the Code specifically excludes all of the payments.