Income Tax I
Fall 2017
Practice Problems

A. Gain, Loss, and Basis

1. Jay owns 1,000 shares of Acme Corp. common stock. His basis in the shares is 50 cents per share, for a total basis of $500. The stock has a fair market value of $1.20 per share. Acme declares a stock dividend, whereby Jay receives 1,000 additional shares of Acme common stock, with a fair market value of 60 cents a share. How much gain or loss does Jay realize on his receipt of the 1,000 new shares? What is his basis in the 1,000 new shares? What is his basis in his original 1,000 shares following the stock dividend?

2. Terri buys an antique sofa for $500. A few months later, she sells the sofa to Sarah for $600. How much gain or loss does Terri realize on the sale of the sofa? What is Sarah's basis in the sofa?

3. Same facts and questions as Question 2, except that Terri sells the sofa to Sarah for $425.

4. Dan buys Blackacre, a parcel of real estate, in year 1 for $30,000. In year 9, when the real estate has a fair market value of $40,000, Dan gives the land to his brother, Curtis, as a gift. How much gain or loss do Dan and Curtis realize at the time of the gift? In year 10, Curtis sells Blackacre for $55,000. How much gain or loss does Curtis realize as a result of the sale?

5. Same facts and questions as Question 4, except that at the time of the gift in year 9, Blackacre is worth (i.e., has a fair market value of) $20,000. (As in Question 4, Curtis sells it in year 10 for $55,000.)

6. Same facts and questions as Question 4, except that at the time of the gift in year 9, Blackacre is worth $20,000, and Curtis sells it in year 10 for $15,000.

7. Same facts and questions as Question 4, except that at the time of the gift in year 9, Blackacre is worth $20,000, and Curtis sells it in year 10 for $25,000.

8. Janice buys 1,000 shares of Nike stock in year 1 for $20 per share. In year 5, she dies, leaving the stock to her niece, Kay. At the time of her death, and for purposes of the estate tax on Janice's estate, the fair market value of the Nike stock is $80 per share. How much gain or loss do Janice and Kay realize as the result of Janice's death? In year 9, Kay sells all of the 1,000 shares for $85 a share. How much gain or loss does Kay realize on the sale of the stock?

9. Doris, a doctor reporting income on the cash method, performs services for a patient in October of year 1 and sends the patient a bill for $200 that same month. In November of year 1, Doris dies. For purposes of the estate tax, the account receivable from the patient has a fair market value of $200. In March of year 2, the patient pays the bill and Doris's estate receives the $200 cash. How much gain or loss do Doris and her estate have when Doris dies? When the patient pays the bill?

10. Eddie owns Greenacre, a 20-acre tract of real estate, with a basis of $100,000 and a fair market value of $200,000. He sells an easement across Greenacre to a neighbor for $25,000. How much gain or loss does Eddie realize on the sale of the easement? What is Eddie's basis in Greenacre immediately after the easement transaction?

11. Same as Question 11, except that, instead of selling an easement to the neighbor, Eddie sells her a fee simple absolute interest in two acres for $20,000. How much gain or loss does Eddie realize on the sale of the acreage? What is Eddie's basis in Greenacre immediately after the sale?

B. Debt

1. Ben borrows $5,000 from a bank to pay medical school tuition. How much income does Ben have when he borrows the $5,000?

2. Wally borrows $18,000 from a bank and uses it to buy a new car. How much income does Wally have when he borrows the $18,000? Assuming Wally does not use any of his own funds to buy the car — that is, the total price is $18,000 — what is Wally's basis in the new car? What if Wally chips in $4,000 of his own funds, along with the $18,000 borrowed from the bank, to buy a car?

3. Stuart borrows $3,500 from his father, Frank. The following year, on Stuart's birthday, Frank forgives the entire loan, which at that point had an outstanding balance of $3,000. What are the income tax consequences to Stuart of the making of the loan, its partial repayment, and its cancellation?

4. Connie buys a piece of computer equipment from a dealer. She agrees to pay the dealer a total of $5,000 for the equipment over a two-year period, along with interest on the unpaid balance at 11 percent a year. A few weeks after she gets the equipment home, Connie discovers that it does not work as well as the dealer had promised. When she complains, the dealer reduces Connie's debt from $5,000 to $4,200. What are the income tax consequences of these transactions to Connie?

5. Leonora borrows $500,000 from a bank to start a business. The loan is a long-term loan at a fixed interest rate. A few years later, when Leonora owes the bank $450,000 of principal, interest rates rise sharply, and she offers the bank $420,000 in exchange for her entire obligation. The bank accepts the $420,000 and cancels the other $30,000 of her debt. Leonora is solvent both before and after these transactions. What are the income tax consequences of these transactions to Leonora?

6. Same facts and question as in Question 5, except that the cancellation of the debt takes place in Leonora's Chapter 7 bankruptcy proceeding in the U.S. Bankruptcy Court.

7. Same facts and question as in Question 5 (with no bankruptcy), except that immediately before the cancellation takes place, Leonora has assets with an aggregate fair market value of $455,000, and total debts (including the debt to the bank) of $465,000.

8. Edna owes her housekeeper, Hank, $100. Edna satisfies this obligation by transferring to Hank a widget worth $100. Edna's adjusted basis in the widget

immediately before the transfer is $55. What are the income tax consequences of these transactions to Edna? By way of review of another topic, what are the tax consequences to Hank (including Hank's basis in the widget)?

9. Randy borrows $200,000 and uses it to buy a duplex for use as a rental property. Randy grants a first mortgage to the lender to secure the $200,000 loan, which is a recourse loan (i.e., Randy is personally liable for the entire amount). The total price of the duplex is $200,000.

Three years later, having taken $15,000 of depreciation on the property, Randy's adjusted basis in it is $185,000. The outstanding principal balance of the loan at this point is $195,000. Randy sells the duplex to Whitney, who pays Randy $15,000 and agrees to assume the mortgage. What are the tax consequences to Randy of these transactions? What is Whitney's basis in the duplex?

10. What difference (if any) would it have made in Question 9 if the mortgage had been nonrecourse rather than recourse?

11. What difference (if any) would it have made in Question 9 if Randy had been in bankruptcy at the time of the sale?

12. Teresa borrows $580,000 and uses it buy commercial real estate. Teresa grants a first mortgage to the lender to secure the $580,000 loan, which is a nonrecourse loan (i.e., Teresa is not personally liable for the unpaid balance). Teresa adds $20,000 of her own funds to make up the rest of the purchase price for the property, which totals $600,000.

Four years later, having taken $60,000 of depreciation on the property, Teresa's adjusted basis in it is $540,000. The outstanding principal balance of the loan at this point is $570,000. The value of the property is only $545,000. Teresa abandons the property, surrendering it to the lender in full satisfaction of the mortgage. What are the tax consequences to Teresa of these transactions?

13. What difference (if any) would it have made in Question 12 if the mortgage had been recourse rather than nonrecourse?

14. What difference (if any) would it have made in Questions 12 and 13 if Teresa had been in bankruptcy at the time of the abandonment?

15. Howard owns a rental house. His adjusted basis in the house is $70,000, and its fair market value is $115,000. Howard owns the property free and clear of any mortgages or other liens.

Howard takes out an equity loan, borrowing $25,000. He uses the money to add a bedroom to the rental house. The permanent improvement to the house increases Howard's adjusted basis to $95,000. Howard grants the bank making the equity loan a mortgage on the rental house.

A short time later, Howard sells the house to a buyer, Barb. Barb agrees to pay Howard $115,000 cash, and to assume the $25,000 mortgage. What are the tax consequences to Howard of these transactions? What is Barb's basis in the house?

16. How would the results in Question 15 have been different if Howard had used the proceeds of the equity loan to buy his son a car?

C. Nonrecognition Provisions

1. A, a dealer in real estate, swaps Blackacre, with an adjusted basis of $20 and a fair market value of $100, for Whiteacre, also with a value of $100. How much gain must A recognize in the year of the exchange? What is A's basis in Whiteacre immediately following the exchange?

2. B, a lawyer and investor, trades stock in one company for stock in a similar company. B's basis in the old stock was $40; its fair market value (and that of the like stock B acquires) is $70. How much gain must B recognize in the year of the exchange? What is B's basis in the new stock?

3. C has a truck she uses for productive use in her business. The truck has an adjusted basis of $30 and a fair market value of $80. C trades the truck for a different used truck, also to be used in her business, with a fair market value of $80. How much gain must C recognize in the year of the exchange? What is C's basis in the new truck?

4. Same as Question 3, except that C receives a different truck with a value of $60 and $20 cash.

5. Same as Question 3, except that C receives a different truck with a value of $20 and $60 cash.

6. D holds Greenacre for investment. Greenacre has an adjusted basis of $15 and a fair market value of $85. D trades Greenacre for Redacre, also to be held for investment, with a fair market value of $65, plus a truck worth $20. How much gain does D recognize in the year of the exchange? What is D's basis in Redacre? In the truck?

7. Same as Question 6, except that Greenacre is transferred subject to a mortgage of $20. Because D's "equity" in the property (fair market value minus mortgage) is only $65, D receives Redacre and no other consideration in the exchange.

8. Y has a computer that he uses in his trade or business. It has an adjusted basis of $45 and a fair market value of $35. Y trades the computer in at a local dealership. For the old computer and $40 cash, Y gets a new computer worth $75. The new computer is to be held by Y for use in Y's trade or business. How much gain or loss does Y recognize in the year of the trade-in? What is Y's basis in the new computer?

9. Z owns investment real estate with a fair market value of $200 and an adjusted basis of $80. Z trades it for other real property worth $350, taking the new property subject to a mortgage of $150. The new property is to be held for productive use in Z's trade or business. How much gain or loss does Z recognize on the exchange? What is Z's basis in the new property?

10. E has investment real property with a basis of $60 and a value of $100. The property is encumbered by a $30 bank debt, so that E's "equity" is $70. The property is condemned (or destroyed) ,and the condemning authority (or insurance company) pays E $100. E takes $30 of the $100 and pays off the bank; within 2 years later, he reinvests

$70 in other property similar in use to the property lost. What results (gain/loss and basis) to E? What if E is a real estate dealer?

11. In 2017, F sells Oldacre, his principal residence for the previous 15 years (basis $50,000, mortgage $10,000), for $70,000 cash plus assumption of his $10,000 debt. How much gain is recognized on the sale?

D. Installment Sales

In each problem, assume that the buyer's installment note bears interest at a market rate, and that such interest is payable, and actually paid, by the buyer monthly or quarterly.

1. Stan, a real estate dealer, sells Betty a parcel of real estate on which Betty intends to build an office building. Stan's adjusted basis in the parcel immediately before the sale is $60. Betty agrees to pay Stan a total of $100 for the property: $40 down and $10 of principal each year for six years. At the time of the closing, the fair market value of Betty's promissory note for the six deferred payments is $58. How much gain does Stan have when the sale closes and Betty delivers her check for the $40 down payment and her promissory note? How much gain does Stan have when the note is paid off?

2. Susan, an attorney, sells 750 shares of Fiat Chrysler Corp. stock to Bob. Bob agrees to pay Susan a total of $1,000 for the stock: $800 down and $200 on January 5 of the following year. Susan's adjusted basis in the stock immediately prior to the sale is $250. How much gain does Susan have when the transaction closes and she receives Bob's $800 check and $200 promissory note? How much gain does Susan have when Bob makes the $200 deferred payment the next year?

3. Steve, a physician, sells a piece of investment real estate to Barbara. Steve's adjusted basis in the parcel immediately prior to the transaction is $10,000. The total selling price of the parcel is $100,000. Barbara agrees to pay $20,000 down and $20,000 a year for four years. Barbara's obligation to make the deferred payments to Steve is guaranteed by Barbara's wealthy mother and additionally secured by a first mortgage on the property. How much gain does Steve have when the transaction closes and he receives Barbara's $20,000 check and $80,000 promissory note? How much gain does Steve have when Barbara makes each of the four deferred $20,000 payments of principal on the note?

4. Same facts and questions as in Question 3, but Steve makes an election under section 453(d) of the Code. Assume the fair market value of Barbara's note at the time of the closing is $75,000.

5. Same facts as in Question 3, but promptly after the closing, Steve gives Barbara's note to his son, Manny, as a birthday gift. (For this Question 5, assume that no election under section 453(d) is made.) How much gain does Steve have upon receipt of Barbara's check and note at the closing? Is the gift of the installment note a taxable event to Steve? To Manny? If so, how much gain does Steve or Manny recognize at the time of the gift? Can you think of a better way to structure this transaction?

6. Same facts as in Question 3 (with no election and no gift), but after collecting the $20,000 down payment and two of the four $20,000 payments due on the note, Steve sells the note (now with a face amount of $40,000) to a bank for $37,500. How much gain does Steve have at the closing of the original sale? When he collects the two $20,000 payments? When he sells the note to the bank?