Income Tax I
Fall 2017
Suggested Solutions to Practice Problems

A. Gain, Loss, and Basis

1. Although Jay receives new stock with a total fair market value of $600 (1,000 shares times $0.60), he realizes no gain under *Eisner v. Macomber*. His original basis in the first 1,000 shares (50 cents per share, or $500 total) must be apportioned among the old and new shares. Following the stock dividend, each share, old or new, has a basis of 25 cents ($500 total basis / 2,000 total shares). Treas. Reg. § 1.307-1.

2. Terri's realized gain is $100 — the difference between her amount realized on the sale ($600 cash) and her adjusted basis ($500). I.R.C. §§ 1001, 1012. Sarah's basis is her cost, $600. I.R.C. § 1012.

3. Terri's realized loss is $75 — the difference between her amount realized on the sale ($425 cash) and her adjusted basis ($500). I.R.C. §§ 1001, 1012. Note that the loss may or may not be deductible for Terri, under I.R.C. § 165(c), and if deductible, the loss may be a capital loss with limited deductibility under I.R.C. § 1211(b). Sarah's basis is her cost, $425. I.R.C. § 1012.

4. Gifts are not usually realizing events; thus, neither Dan nor Curtis realizes any gain or loss at the time of the gift. Assuming that no gift tax was paid at the time of the gift, Curtis's basis is a carryover basis from Dan, $30,000. I.R.C. § 1015. Thus, when Curtis sells Blackacre, his gain is $25,000 ($55,000 amount realized minus $30,000 adjusted basis).

5. Once again, no gain or loss is realized at the time of the gift. Since the fair market value of the property at the time of the gift is less than Dan's basis, Curtis gets a different basis for gain purposes than for loss purposes under I.R.C. § 1015. The basis for purposes of determining gain is the usual carryover basis from Dan, or $30,000; however, for purposes of determining loss, Curtis's basis is the fair market value of Blackacre at the time of the gift, or $20,000. When Curtis sells for $55,000, he has a gain; thus, he gets to use $30,000 (not $20,000) as his basis. As a result, he realizes a gain of $25,000 ($55,000 amount realized minus $30,000 adjusted basis).

6. Once again, no gain or loss is realized at the time of the gift. Since the fair market value of the property at the time of the gift is less than Dan's basis, Curtis gets a different basis for gain purposes than for loss purposes under I.R.C. § 1015. The basis for purposes of determining gain is a carryover basis from Dan, or $30,000; however, for purposes of determining loss, Curtis's basis is the fair market value of Blackacre at the time of the gift, or $20,000. When Curtis sells for $15,000, he sustains a loss; thus, he must use $20,000 (not $30,000) as his basis. As a result, he realizes a loss of $5,000 ($15,000 amount realized minus $20,000 adjusted basis). Note that the loss may or may not be deductible for Curtis, under I.R.C. § 165(c), and if deductible, the loss may be a capital loss with limited deductibility under I.R.C. § 1211(b).

7. Once again, no gain or loss is realized at the time of the gift. Since the fair market value of the property at the time of the gift is less than Dan's basis, Curtis gets a different basis for gain purposes than for loss purposes under I.R.C. § 1015. The basis for purposes of determining gain is a carryover basis from Dan, or $30,000; for purposes of determining loss, Curtis's basis is the fair market value of Blackacre at the time of the gift, or $20,000. When Curtis sells for $25,000, it is not initially clear whether he realizes a gain or a loss. Using the basis for determining gain — $30,000 carryover from Dan — he realizes a loss. Using the basis for determining loss — $20,000 fair market value at the time of the gift -- he realizes a gain. In this situation, Curtis realizes no gain or loss. Reg. § 1.1015-1(a)(2). In effect, he is assigned a basis of $25,000 — exactly the same as his amount realized.

8. Death and the passing of property at death are not realizing events; thus, neither Janice nor Kay realizes any gain or loss when Janice dies. When Kay sells the shares for $85 each, her amount realized is $85,000. Her basis in the shares is equal to their fair market value on the date of Janice's death, or $80,000. Thus, Kay's realized gain is $5,000. (If Janice's estate had properly elected to use an alternate valuation date for estate tax purposes, Kay's basis would be the fair market value on the alternate date.) On these facts, Janice's basis ($20,000) is not relevant.

9. Neither Doris nor her estate has income when Doris dies. Doris, a cash method taxpayer, neither actually nor constructively received the fee; the estate, presumably also on the cash method, similarly has no realizing event when Doris dies. Although the account receivable is in Doris's estate, and thus its fair market value is subject to the estate tax, it does not receive a step-up in basis under I.R.C. § 1014, because it is an item of income in respect of a decedent (IRD). I.R.C. §§ 1014(c), 691(a). The basis of the receivable is thus zero in the hands of the estate. When the patient pays the bill, the estate has $200 of gross income.

10. Eddie realizes no gain or loss. Assuming that the easement affects the entire parcel, he treats the $25,000 received on the sale of the easement as a partial return of his $100,000 basis in Greenacre. Eddie's basis in Greenacre is thus reduced from $100,000 to $75,000.

11. Eddie's outright sale of part of Greenacre requires him to allocate his basis in the parcel under Treas. Reg. § 1.61-6(a) and realize gain or loss. One way to "equitably apportion" the $100,000 overall basis among the 20 acres might be to assign an equal amount of basis to each acre. Assuming that such an allocation is "equitable," each acre's basis would be $5,000 ($100,000/20); the basis in the two acres that Eddie sold would be $10,000 ($5,000 × 2). Subtracting this amount from Eddie's amount realized of $20,000, his realized gain on the sale would be $10,000. His basis in Greenacre after the sale (the remaining 18 acres, that is) would be $90,000 – the original basis of $100,000, adjusted downward by the $10,000 of basis that Eddie "used up" on the sale of the two acres. Again, that would work out to $5,000 an acre ($5,000 × 18 = $90,000).

B. Debt

1. Zero. Borrowed funds are not income to the borrower. Ben has no increase in his wealth, since he incurs an obligation to repay the $5,000.

2. Wally has zero income when he borrows the money. If he spends just the $18,000 he borrows on the new car, his cost basis in the car immediately after he buys it is $18,000. I.R.C. § 1012. If he adds $4,000 of his own funds to the borrowed funds — for a total purchase price of $22,000 — his basis in the car is $22,000, its cost.

3. (a) The making of the loan produces no tax consequences for Stuart.

(b) Later, Stuart came up with $500 to repay part of the loan. Presumably, those were dollars on which Stuart had already paid income tax. (If he borrowed the $500 from someone else, he eventually would still have to find after-tax funds to repay that $500 debt.)

(c) The cancellation of the indebtedness is not income to Stuart, since it is a gift from Frank. I.R.C. § 102(a).

4. When Connie first buys the equipment, its basis to her is $5,000 — the principal amount she agrees to pay the dealer. This is her cost under I.R.C. § 1012. The reduction of the purchase price to $4,200, although arguably a discharge of indebtedness, is excluded from gross income as a renegotiation of the purchase price of the computer. See I.R.C. § 108(e)(5). Connie's basis is adjusted downward, from $5,000 to $4,200, as a result of the renegotiation of the price.

5. Leonora is able to obtain a release from her debt, which has an outstanding balance of $450,000, by paying only $420,000. The $30,000 difference is discharge of indebtedness income (also known as cancellation of indebtedness income); it must be included in Leonora's gross income for the year of the discharge, under *Kirby Lumber*.

6. Because Leonora's discharge of debt takes place in a federal bankruptcy proceeding, it is excluded from her gross income, under I.R.C. § 108(a)(1)(A). As a result, however, Leonora will lose certain future tax benefits (such as net operating loss carryforwards and even basis), under I.R.C. § 108(b).

7. Immediately before the discharge of the debt, Leonora is insolvent by $10,000; that is, the fair market values of all of her assets total $10,000 less than the amount of her total liabilities (including the debt to the bank). See I.R.C. § 108(d)(3), defining the term "insolvent." Since she is insolvent by only $10,000, only $10,000 of her discharge of indebtedness income is excluded from her gross income under I.R.C. § 108(a)(1)(B); the other $20,000 must be included in her gross income for the year in which the debt is cancelled.

8. The transfer of the widget in satisfaction of her debt is a realizing event for Edna under I.R.C. § 1001. Her amount realized is the $100 debt that she satisfies by transferring the property; subtracting her basis of $55, she has $45 of gain on the transfer of the widget to Hank. She gets no deduction, since housekeeping expenses are nondeductible personal expenses under I.R.C. § 262.

Hank has bartered his services for property. Under I.R.C. § 83, he has gross income of $100 (the fair market value of the widget) on the receipt of the widget. His basis in the widget immediately thereafter is his "tax cost," also $100.

9. Whitney pays Randy $15,000 cash and assumes a mortgage with an outstanding balance of $195,000. Under *Crane*, Randy's amount realized is both the $15,000 and the $195,000 mortgage assumption, for a total amount realized of $210,000. Subtracting Randy's adjusted basis of $185,000, Randy recognizes a $25,000 gain.

Whitney's basis in the duplex immediately after purchasing it is its total cost to Whitney, or $210,000. I.R.C. § 1012. Both the $15,000 cash payment and the assumed mortgage of $195,000 are included in this cost basis, pursuant to *Crane*.

10. On these facts, the result is the same regardless of whether the mortgage is recourse or nonrecourse. *Crane* applies in either case.

11. Randy's bankruptcy would have no effect, as none of the debt is being discharged (cancelled). Whitney is agreeing to pay it in full. Therefore, I.R.C. § 108 is inapplicable.

12. Under *Tufts*, Teresa's amount realized is the full balance of the mortgage, or $570,000. Subtracting her adjusted basis of $540,000, Teresa's gain on the abandonment of the property to the lender is $30,000. This makes sense because, while Teresa invested $20,000 of her own funds in the property originally and has paid another $10,000 in after-tax funds to the lender as repayments of principal, she deducted a total of $60,000 of depreciation. The difference between her $30,000 total after-tax investment and the $60,000 of depreciation deductions she took should be (and is) treated as gain when she "walks away from" the real estate.

While the realization of this $30,000 of gain definitely occurs, however, there is no discharge of indebtedness income here since the loan was nonrecourse. The lender received exactly what it originally bargained for — the possibility that Teresa could abandon the property to the lender with no personal liability. (In other words, on these facts, the Wayne Barnett theory from *Tufts* does not prevail.) See generally Treas. Reg. § 1.1001-2(e) Example (7). So there is simply a $30,000 gain, and no discharge of indebtedness income.

13. If the loan had been recourse, and somehow Teresa was able to satisfy $570,000 of recourse indebtedness by transferring property worth only $545,000 to the lender, the analysis would be somewhat different than in Question 12. Teresa's amount realized on the sale would be only $545,000 -- the fair market value of the property at the time of the abandonment. Subtracting her basis of $540,000, she would have only $5,000 of gain.

However, the lender now has an actual or potential judgment against her for the $25,000 difference between the value of the property as abandoned and the amount Teresa owed. That $25,000 deficiency is Teresa's personal liability. And if for some reason the lender does not collect anything on that personal liability, Teresa has discharge of indebtedness income equal to that $25,000, in addition to her $5,000 gain. See Treas. Reg. §§ 1.1001-2(a)(2), 1.1001-2(c) Example (8).

Here, the lender did not receive what it bargained for, which was complete repayment "come hell or high water." Thus, in this situation, we follow an approach similar to the one Wayne Barnett advocated in *Tufts*. Teresa has $5,000 of gain, and $25,000 of discharge of indebtedness income.

14. If Teresa had been in bankruptcy, she would get a strikingly different tax result in Question 13 from the tax result in Question 12. In Question 12, with a nonrecourse loan, since none of the income is discharge of indebtedness income, the bankruptcy is irrelevant; all $30,000 of gain under *Tufts* would be included in gross income. In Question 13, however, since $25,000 of debt was discharge of indebtedness income, it would be excluded under I.R.C. § 108(a)(1)(A); only the $5,000 of gain would be included in gross income.

In addition, gain on the sale of property may qualify as capital gain. In contrast, income from discharge of indebtedness is never capital gain — it is always ordinary income.

15. Howard realizes a gain of $45,000. His amount realized from Barb is $140,000 — $115,000 cash plus the $25,000 assumed liability. His adjusted basis is $95,000. The difference between the two ($140,000 minus $95,000) is his gain, $45,000. Barb's basis is $140,000 — the $115,000 cash she paid plus the liability she assumed, $25,000. *Crane*.

16. If Howard had used the loan proceeds to buy his son a car, the loan would not have increased Howard's basis in the rental house. His adjusted basis in the house would remain $70,000. (He would get a cost basis of $25,000 in the car, which would carry over to his son upon the gift under I.R.C. § 1015.) His amount realized from Barb is $140,000; therefore, his gain is $70,000. Once again, Barb's basis is $140,000.

C. Nonrecognition Provisions

1. A tricky question! Since A is a dealer in real estate, section 1031(a)(1) of the Code probably does not apply at all. Section 1031(a)(2)(A) renders it inapplicable to "property held primarily for sale." Assuming A held Blackacre primarily for sale, the entire $80 of realized gain ($100 amount realized minus $20 basis) must be recognized; A's basis in Whiteacre is $100.

2. Here, section 1031(a)(1) definitely does not apply. See I.R.C. § 1031(a)(2)(B). B must recognize the entire $30 of gain realized ($70 amount realized minus $40 basis) on the exchange. B's basis in the new stock is $70.

3. Section 1031(a)(1) applies, as each truck is used in a business. Although $50 of gain is realized ($80 amount realized minus $30 basis), none of it is recognized. C's basis in the new truck is the same as that of the old, $30. I.R.C. § 1031(d).

4. To compute the recognized gain, first compute the realized gain under I.R.C. § 1001: the amount realized is $80 ($20 cash plus $60 fair market value of property received), C's basis in the old truck was $30, and thus the gain realized is $50. Next, under section 1031(b), compute the "boot," i.e., the sum of money and fair market value

of non-like-kind property received — here, the $20 cash. The gain recognized is the lesser of the gain realized or the amount of the "boot" — here, $20.

C's basis in the new truck is that of the old, $30, decreased by the $20 in cash received and increased in the amount of gain recognized ($20) — in other words, a $30 basis in the new truck. I.R.C. § 1031(d).

5. Here, the gain realized is $50. The amount of "boot" (here, cash) is $60. The gain recognized is the lesser of the two, i.e., $50.

C's basis in the new truck is that of the old, $30, decreased by the $60 in cash received and increased in the amount of gain recognized ($50) — in other words, a $20 basis in the new truck. I.R.C. § 1031(d).

6. To compute the recognized gain, first compute the realized gain under I.R.C. § 1001: the amount realized is $85 (zero cash and $85 fair market value of property received), D's basis in Greenacre was $15, and thus the gain realized is $70. Next, under section 1031(b), compute the "boot," i.e., the sum of money and fair market value of non-like-kind property received. A truck is not of a like kind with real estate. Thus, the fair market value of non-like-kind property received is $20. The gain recognized is the lesser of the gain realized or the amount of the "boot" – here, $20.

D's basis in Redacre and the truck is $35, computed as follows: the basis in Greenacre, $15, decreased by any cash received (zero) and increased in the amount of gain recognized ($20), for a total new basis of $35. I.R.C. § 1031(d) (first sentence). This total must be allocated between Redacre and the new truck; the prevailing rule, under the second sentence of I.R.C. § 1031(d), is that the non-like-kind property is assigned all the basis up to its fair market value. Here, this means that the truck gets a basis of $20, its fair market value; the other $15 is allocated to Redacre.

7. The gain realized is still $70. D's amount realized is $85 ($65 fair market value of Redacre, plus $20 realized under *Crane* and *Tufts* on account of the $5 mortgage to which Greenacre is subject). As D's adjusted basis in Greenacre was $15, the gain realized is $70. Next, under section 1031(b), compute the "boot": the $20 mortgage on Greenacre, which is treated as cash received by D. See I.R.C. § 1031(d) (last sentence). The gain recognized is the lesser of the gain realized or the amount of the "boot" — here, $20.

D's basis in Redacre is computed as follows: the basis in Greenacre, $15, decreased by the cash received (the $20 mortgage on Greenacre) and increased in the amount of gain recognized ($20), for a new basis of $15.

8. Y realizes a loss, but is not permitted to recognize it because of section 1031(a). The loss on the exchange of the old computer is $10 — the amount realized ($35 of trade-in value) less the old computer's basis ($45). The loss is not recognized, however — nonrecognition under section 1031 is mandatory.

Y's basis in the new computer is $85, computed as follows: $45 basis in the old computer (I.R.C. § 1031(d)), plus $40 cash contributed (I.R.C. § 1012).

9. This is a like-kind exchange, even though the parcel surrendered by Z was held for investment and the property to be received was to be held for productive use in a trade

or business. See Treas. Reg. § 1.1031(a)-1(a). The gain realized is $120: the amount realized, $200 ($350 fair market value of the new property less $150 mortgage to which it is subject), minus the basis of the property surrendered, $80. There is no gain recognized, and the basis of the new property is $230 – that is, $80 basis in the old property (I.R.C. § 1031(d)) plus $150 mortgage assumed (*Crane*).

10. This is an involuntary conversion as described in section 1033(a)(2). E realizes $40 gain — the $100 cash received from the condemning authority (or insurance company) less his $60 basis. If E wishes, he may recognize the entire $40 of gain. Alternatively, E may elect nonrecognition under I.R.C. § 1033(a)(2)(A), in which case his gain is recognized only to the extent the amount realized ($100) exceeds the cost of the similar property purchased ($70). Thus, under a proper section 1033 election, E recognizes $30 of gain.

If section 1033 is not elected, E's basis in the new property is its cost, $70. I.R.C. § 1012. If section 1033 is elected, basis is governed by section 1033(b). The basis of the new property is its cost ($70), decreased by the gain not recognized on the transaction ($10), for a new basis of $60. See I.R.C. § 1033(b) (last sentence).

Unlike section 1031, section 1033 applies to property held primarily for sale; thus, on these facts, E's being a real estate dealer would have no bearing on the outcome.

11. The gain realized is $30,000. The amount realized is $80,000 — $70,000 cash plus $10,000 debt assumed (per *Crane*); the basis is $50,000. However, the gain is not recognized under I.R.C. § 121.

D. Installment Sales

In all of the problems, the interest component of the deferred payments is taxable to the seller as interest income (ordinary income).

1. Since Stan is a real estate dealer, it is highly likely that the parcel of real estate sold to Betty was held by Stan for sale to customers in the ordinary course of his trade or business; if so, the sale is not an "installment sale" within the meaning of section 453(b) of the Code, and the installment method of reporting is unavailable. See I.R.C. §§ 453(b)(2)(A), 453(l)(1)(B). Thus, Stan computes his gain in the year of the sale by computing his amount realized -- assuming Stan is a cash method taxpayer, his amount realized is the $40 cash and $58 fair market value of the note, for a total amount realized on the sale of $98 – and subtracting his basis of $60. His gain in the year of sale is therefore $38.

Having taken into account $58 amount realized on receipt of the note, Stan gets a basis in the note of $58. As the $60 of principal is paid on the note over the next six years, Stan has additional income – ordinary, interest income – totaling $2 (the precise timing of which is beyond the scope of this course).

2. Assuming that Fiat Chrysler stock is traded on an established securities market, section 453(k)(2)(A) applies. Under that provision, the installment method is unavailable and "all payments to be received shall be treated as received in the year of disposition." Therefore, Susan's gain in the year of the sale is $750 – the $1,000 of total payments to

be received minus her $250 basis. The fair market value of Bob's note is irrelevant. Susan's basis in the note after the gain is realized on the sale is its full face amount, $200. Thus, when Bob pays the $200 the following year, no further gain is realized.

3. This is an installment sale within the meaning of section 453(b). The guarantee by Barbara's wealthy mother does not cause receipt of the note by Steve to be treated as payment in the year of sale. I.R.C. § 453(f)(3). Nor does the mortgage taken by Steve to secure Barbara's obligation.

Since the installment method applies, the gain in any year is the payment received, multiplied by the "gross profit ratio." I.R.C. § 453(c); Temp. Treas. Reg. § 15a.453-1(b)(2). This ratio is the gross profit to be derived from the transaction, divided by the total contract price. Id. Here, the gross profit is $90,000 – the total contract price of $100,000 minus Steve's $10,000 adjusted basis. The total contract price is $100,000. Thus, the gross profit ratio is $90,000/$100,000, or 9/10 (90% or 0.9). Hence, under the installment method, when Steve receives the $20,000 cash down payment, he realizes $18,000 of gain (9/10 of $20,000). As Steve receives each of the four additional $20,000 payments, he has $18,000 additional gain, for a total gain on the transaction of $90,000.

4. If Steve makes an election under section 453(d), he elects out of the installment method. In such a case, the normal realization rules of section 1001 apply. Assuming that Steve is a cash method taxpayer, his gain in the year of sale would be $85,000. His amount realized is $95,000 – $20,000 cash down payment and $75,000 fair market value of Barbara's note – and his basis in the property sold is $10,000.

After taking into account a $75,000 amount realized on receipt of Barbara's note, Steve gets a basis in that note of $75,000. Thus, as Barbara makes the $80,000 of additional payments over the following four years, Steve has an additional $5,000 of income – interest income, and therefore ordinary income (the precise timing of which is beyond the scope of this course).

5. We are back to the installment method here. As noted earlier, on the closing of the sale to Barbara, Steve has an immediate gain of $18,000. If immediately thereafter, Steve gives the note to Manny, he has disposed of an installment note, triggering gain under section 453B. Since the transaction is a gift rather than a sale or exchange, section 453B(a)(2) applies. Steve must take into account as additional gain immediately upon the gift the difference between the fair market value of the installment obligation at the time of the gift and Steve's basis in the obligation at that time.

The fair market value of the note at the time of the gift is $75,000. To compute the gain accelerated by the gift, one needs to subtract Steve's basis in the note from that figure. Steve's basis in the note is, roughly speaking, the basis he had in the sold property that he did not get to "use" at the closing. Steve's original basis in the property was $10,000. At the closing, he received a $20,000 cash down payment but was taxed on only $18,000 of gain, so he "used up" $2,000 of his basis at that time. Therefore, his basis in the note at the time of the gift must be $8,000, and his gain on the gift must be $67,000 ($75,000 fair market value minus $8,000 basis in the note).

To follow the Code language more closely, section 453B(b) describes Steve's basis in the installment obligation as the excess of the face value of the obligation

($80,000) over "an amount equal to the income which would be returnable [i.e., reportable] were the obligation satisfied in full." If the obligation were satisfied in full – that is, if Barbara paid it off at the time at which Steve is disposing of it – Steve's gain would be $72,000 – a payment of the full $80,000 due, multiplied by the "gross profit ratio" of 9/10. Subtracting that hypothetical gain of $72,000 from the $80,000 face value of the installment obligation, section 453B(b) gets to the same result we did applying pure logic – an $8,000 basis in the note.

To sum up, Steve's gain on the gift of the note to Manny would be $67,000. Manny's basis in the note would carry over from Steve under section 1015, but it would include not only Steve's $8,000 basis in the note, but also the $67,000 of gain recognized at the time of the gift, for a basis to Manny of $75,000.

Steve would have had better timing consequences had he kept the note and given the proceeds to Manny as they came in every year.

6. When Steve collects each of the $20,000 down payment and first two deferred payments, he realizes $18,000 of gain. Thereafter, the face amount of the note is reduced to $40,000. When Steve sells the note to the bank for $37,500, section 453B comes into play. Because the obligation is being sold, under section 453B(a)(1), one simply subtracts from the amount realized, $37,500, Steve's basis in the installment obligation.

Since on these facts, the note has a face amount of $40,000 at the time it is sold, Steve's basis in the obligation is $4,000, computed under section 453B(b) as follows: $40,000 face amount less the amount that would have been income if the $40,000 were paid off ($40,000 × 9/10 = $36,000). Thus, the basis in the installment obligation at the time the obligation is sold (i.e., "factored") is $4,000.

Since the amount realized on the sale of the note is $37,500, and Steve's basis in the note is $4,000, his gain on the sale is $33,500. This makes sense because Steve's original basis in the property was $10,000, and he ultimately got $97,500 for it – $60,000 from Barbara and $37,500 from the bank. He paid tax on $54,000 of gain on receipt of the payments from Barbara, and $33,500 on the sale of the note to the bank, for a total gain of $87,500 – the correct result.