PONTIS COMMUNITY SERVICES

PCS eLearn

US Tax Court Exam – 2023 - Session One

Federal Taxation

Question S-1 (1 point). On December 28, year 1, TP performed services for A. Immediately after TP performed the work, A offered to write a check to TP to compensate TP for the services. TP refused to accept the check and requested that A pay instead on January 3, year 2, which A did. In what year should TP report the income?

I – Issue

Should TP include the payment for services in **Year 1** (when the check was offered) or **Year 2** (when the check was accepted), given TP refused payment in Year 1 at their own request?

R – Rule

- **IRC §451(a)** – For cash-method taxpayers, income is reported in the year it is **actually or constructively received**.
- **Treas. Reg. §1.451-2(a)** – *Constructive receipt* occurs when income is **credited to the taxpayer's account, set apart, or otherwise made available** so they may draw upon it at any time, and there are no substantial restrictions or limitations.
- Taxpayers **cannot defer** income recognition by refusing payment when it is otherwise available without restriction.

A – Application

- On **Dec 28, Year 1**, TP had completed services, and A offered immediate payment via check.
- The funds were available to TP without restriction; the only reason TP did not receive them in Year 1 was a voluntary choice to delay.
- Under the **constructive receipt doctrine**, voluntary postponement does not change the tax year.
- Since the payment was offered and could have been accepted in Year 1, TP had **unrestricted access** to the income that year.

C – Conclusion

TP must report the income in **Year 1** because the payment was constructively received when it was offered without restriction, even though TP requested and received the check in Year 2.

Question S-2 (2 points). TP, a doctor, was offered a job by Medical, Inc. As a requirement to accept the job, TP must live in a home that Medical owns one street block away from the hospital building where TP will work. Medical required this arrangement so that TP could get to the hospital quickly for emergencies. TP is not expected to do any work in the provided home. TP accepted the position and moved into the home. State whether TP is required to report as income the value of the lodging. Explain why or why not?

I – Issue

Must TP include the value of employer-provided lodging in gross income when the lodging is required by the employer, located near the hospital, and no work is performed in the lodging?

R – Rule

- **IRC §119(a)** – The value of lodging furnished to an employee **by the employer** can be excluded from gross income if:
    1. Lodging is furnished on the **business premises** of the employer;
    2. Lodging is furnished for the **convenience of the employer**; and
    3. The employee is **required to accept** such lodging as a condition of employment.
- **Business premises** means the place of employment or where the employee performs significant duties. Lodging located off-site generally does not qualify.

A – Application

- **Condition of employment?** ✔ Yes — Medical, Inc. required TP to live in the home.
- **Convenience of employer?** ✔ Yes — The requirement was to ensure TP's quick arrival for emergencies.
- **On the business premises?** ✘ No — The home is one street block away from the hospital and TP is not expected to perform work there.
- Because the lodging is **not on the business premises**, the §119 exclusion does not apply.
- Therefore, the value of the lodging is taxable as additional compensation.

C – Conclusion

TP must **include the value of the lodging in gross income** because, although the arrangement was for the employer's convenience and required as a condition of employment, it fails the **on-the-business-premises** test under IRC §119.

Question S-3 (2 points). TP had several loans canceled for no consideration by her bank. TP is determining whether she meets the insolvency exception of § 108. TP is the signed guarantor of $900,000 in loans that her brother took out in 2021. What, if anything, will TP need to show in order to include the $900,000 guarantee as part of TP's insolvency calculation?

I – Issue

When calculating insolvency under **IRC §108**, can TP include the $900,000 debt from a loan she guaranteed for her brother — and what must she show to do so?

R – Rule

- **IRC §108(a)(1)(B)** – Discharge of indebtedness income may be excluded if the taxpayer was **insolvent** immediately before the discharge.
- **IRC §108(d)(3)** – Insolvency means the excess of liabilities over the fair market value of assets.
- **Debt Inclusion in Liabilities** – Contingent liabilities, such as guarantees, are **not automatically included** in the insolvency calculation.
- **Case law & IRS guidance** – A guaranteed debt is included **only if the taxpayer is legally obligated to pay** and the debt is more than a remote possibility of becoming a fixed liability. The taxpayer must show:
    1. The liability is enforceable against them; and
    2. It is likely they will have to pay (not just a theoretical risk).

A – Application

- TP is a **signed guarantor** for $900,000 of her brother's loans.
- A guarantee is a **contingent liability** — TP only owes money if her brother defaults and the bank enforces the guarantee.
- To count this amount toward insolvency, TP must prove:
    - **Enforceability**: That the bank can legally require TP to pay under the guarantee terms.
    - **Likelihood of payment**: That her brother is unable to pay and the bank is reasonably expected to demand payment from TP.
- If the brother is solvent and making payments, the $900,000 is **too remote** to include in the insolvency calculation.

C – Conclusion

TP can include the $900,000 guarantee in her **§108 insolvency calculation** only if she can show that:

1. She is legally obligated under the guarantee; and
2. It is probable that she will be required to pay the debt because her brother cannot and the bank will enforce the guarantee.

If those facts are not shown, the $900,000 is excluded from the insolvency calculation.

__Question S-4 (8 points).__ State the amount that constitutes gross income to TP (without any further explanation) of each of the following items received during 2022 (answer each part below separately).

a. $5,000 payment by TP's employer to the IRS to satisfy TP's federal income tax liability. The payment was in consideration of the importance of TP's services to the employer.

Gross Income: $5,000
Explanation: Under **Old Colony Trust Co. v. Commissioner**, 279 U.S. 716 (1929), an employer's payment of an employee's personal obligation is taxable compensation to the employee. The payment was made **in consideration of TP's services**, so it is additional taxable wages under **IRC §61(a)(1)**.

b. $2,000 of interest received on U.S. Treasury note purchased for $60,000.

Gross Income: $2,000
Explanation: Interest on U.S. Treasury obligations is taxable at the federal level under **IRC §61(a)(4)**, though it may be exempt from state and local tax. No federal exclusion applies.

c. $3,000 of interest received on a City of Sacramento (California) bond the proceeds of which were used by the city to finance the construction of a new airport.

Gross Income: $0
Explanation: Interest on state or local government obligations is excluded from gross income under **IRC §103(a)**. The exclusion applies regardless of the public project funded (airport construction qualifies).

d. $1,000 cash received for winning a contest for the article of the year about chemistry. TP had entered the article into the contest. Immediately upon receipt of the payment, TP transferred the amount to a tax-exempt qualified charity.

Gross Income: $1,000
Explanation: Prizes and awards are included in gross income under **IRC §74(a)** unless they meet narrow exceptions (e.g., certain religious, scientific, or charitable transfers made without TP accepting the prize — see §74(b)). Here, TP **accepted** the prize and then donated it, so it is includible in gross income, with a potential **charitable contribution deduction** under **IRC §170**.

e. Blackacre (unimproved land) received as a gift from TP's aunt. The aunt's adjusted basis in Blackacre as of the date of the gift was $300,000, and the fair market value of Blackacre as of the date of the gift was $200,000.

Gross Income: $0
Explanation: Property acquired by gift is excluded from gross income under **IRC §102(a)**. The aunt's basis and FMV do not create immediate taxable income; basis rules for gifts (§1015) matter only upon later sale or disposition.

f. Same facts as 4.e. Later in the year, TP sold Blackacre for $350,000.

Gross Income: $50,000
Explanation: Under **§1001**, gain = amount realized ($350,000) – adjusted basis ($300,000) = $50,000. The basis is the donor's adjusted basis since FMV was below basis at gift but sale was at a gain. This gain is taxable as capital gain.

g. On February 1, 2022, TP was injured when D carelessly crashed into TP while walking on the sidewalk. TP was awarded a court judgment against D, and the judgment was paid. The damages paid to TP pursuant to the judgment were as follows: (1) $75,000 pain and suffering damages for TP's physical injury, (2) $100,000 lost earnings damages to compensate TP for missing work while injured, (3) $40,000 in emotional harm damages incurred on account of the physical injury, and (4) $35,000 punitive damages for the physical injury to TP. State the amount of gross income with respect to the $75,000 received for pain and suffering damages for TP's physical injury.

Gross Income: $0
Explanation: Emotional distress damages are excluded under **§104(a)(2) if** they are attributable to a physical injury. Since they stem directly from the physical injury, they are excluded.

h. Same facts as 4.g. State the amount of gross income with respect to the $100,000 received for lost earnings damages to compensate TP for missing work.

Gross Income: $0
Explanation: Lost wages are excluded under **§104(a)(2)** if they are compensation for lost earnings **due to physical injury or physical sickness**. The key is the origin of the claim — here, it arises from the physical injury.

i. Same facts as 4.g. State the amount of gross income with respect to the $40,000 received for emotional harm damages incurred on account of TP's physical injury.

Gross Income: $0
Explanation: Emotional distress damages are excluded under **§104(a)(2) if** they are attributable to a physical injury. Since they stem directly from the physical injury, they are excluded.

j. Same facts as 4.g. State the amount of gross income with respect to the $35,000 received for punitive damages for the physical injury to TP.

Gross Income: $35,000
Explanation: §104(a)(2) does **not** exclude punitive damages, even when related to a physical injury (per *O'Gilvie v. United States*). They are always taxable.

k. $10,000 cash discovered in a used piano that TP had bought at a garage sale.

Gross Income: $10,000
Explanation: Found property is taxable under the **treasure trove rule** (Reg. §1.61-14(a)) in the year it is reduced to undisputed possession.

l. $5,000 winnings from playing roulette in a casino.

Gross Income: $5,000
Explanation: Gambling winnings are includible in gross income under **§61(a)** regardless of source or legality.

m. $1,000 alimony payments as set out in a divorce and separation agreement. TP's divorce was finalized in 2022.

Gross Income: $0
Explanation: For divorce/separation instruments executed **after Dec. 31, 2018**, the TCJA repealed the inclusion/deduction rules. Alimony is **not taxable** to the recipient (§11051 TCJA amending §61 and §215).

n. $1,500 in child support payments as set out in a divorce and separation agreement. TP's divorce was finalized in 2022.

Gross Income: $0
Explanation: Child support payments are excluded from gross income under **§71(c)** (pre-2019) and remain so under current law.

o. $20,000 lump-sum proceeds of life insurance policy on the life of TP's sister. TP purchased and owned the policy at all times. Under the policy, the proceeds were payable to TP.

Gross Income: $0
Explanation: IRC §101(a)(1) excludes life insurance death benefit proceeds from gross income when paid by reason of the insured's death, regardless of who owns the policy.

p. TP owns 100 shares of Corporation common voting stock. Corporation declares a 1 for 1 stock dividend for all common voting stock shareholders and therefore TP received another 100 shares of Corporation common voting stock. After the stock dividend, the gross fair market value of 100 shares of common voting stock was $9,000.

Gross Income: $0
Explanation: §305(a) excludes pro rata stock dividends from gross income if paid on common stock and no shareholder receives property or cash. No change in proportionate ownership occurs.

Summary Table

Item	Gross Income	Reason
a	$5,000	Employer paying personal tax is taxable compensation (§61, Old Colony)
b	$2,000	U.S. Treasury interest taxable federally (§61(a)(4))
c	$0	Municipal bond interest excluded (§103(a))
d	$1,000	Prize taxable under §74(a); donation is separate deduction
e	$0	Gifts excluded from gross income (§102(a))
f	$50,000	§1001 gain calc, §1015 basis rules
g	$0	§104(a)(2) physical injury exclusion
h	$0	§104(a)(2) lost wages due to injury
i	$0	§104(a)(2) emotional distress from injury
j	$35,000	§104(a)(2) punitive damages taxable
k	$10,000	Reg. §1.61-14(a) treasure trove
l	$5,000	§61 gambling winnings
m	$0	TCJA – alimony post-2018 not taxable
n	$0	§71(c) child support exclusion
o	$0	§101(a)(1) life insurance proceeds
p	$0	§305(a) stock dividend exclusion

<u>Question S-5 (2 points).</u> TP is a self-employed attorney. State the amount that is deductible by TP (without any further explanation) of each of the following putative business expenses during 2023 (answer each part below separately).

a. $1,000 in commuting expenses for driving from TP's home to her office.

Deductible Amount: $0
Explanation: Under **IRC §262** and Reg. §1.262-1(b)(5), commuting expenses between a taxpayer's home and regular place of business are nondeductible personal expenses, even if for business purposes.

b. $3,000 in meal expenses during lunches where TP was meeting with clients while away from home on a seven-day business trip.

Deductible Amount: $1,500
Explanation: IRC §162(a)(2) allows deductions for meals while away from home on business, but **§274(n)(1)** generally limits the deduction to **50%** of the cost (unless temporary special COVID-related 100% restaurant deduction applied in 2021–2022 only). For 2023, only 50% is deductible.

c. $5,000 in advertising expenses.

Deductible Amount: $5,000
Explanation: Ordinary and necessary advertising costs for a trade or business are deductible under **§162(a)**. No limitation applies here.

d. $1,000 in pro football tickets which TP used to entertain clients.

Deductible Amount: $0
Explanation: IRC §274(a) disallows deductions for entertainment expenses, including the cost of tickets to sporting events, even if directly related to business, except for certain very narrow exceptions (not applicable here).

Summary Table

Item	Deductible	Authority
a	$0	§262, Reg. §1.262-1(b)(5) – commuting nondeductible
b	$1,500	§162(a)(2), §274(n)(1) – 50% meal limit
c	$5,000	§162(a) – advertising
d	$0	§274(a) – entertainment nondeductible

Question S-6 (1 point). In 2020, TP purchased Blackacre (unimproved property). To acquire the property, TP (1) paid $400,000 cash at the closing and (2) assumed a preexisting first mortgage debt secured by Blackacre in the principal amount of $200,000 (for which TP became personally liable). In 2021, TP took out a second mortgage debt of $300,000. The debt was secured by Blackacre. TP used the loan proceeds to purchase inventory for her business.

a. Quantify the amount of TP's adjusted basis in Blackacre at the time of the acquisition in 2020.

I – Issue

When TP acquires property by paying cash and assuming a mortgage for which she is personally liable, what amount is included in her **initial basis** in the property?

R – Rule

- **IRC §1012** – The basis of property is generally the cost of the property.
- **Cost** includes the amount paid in cash and the amount of any liability assumed or taken subject to as part of the purchase price (**Reg. §1.1012-1(a)**).
- Assumption of a mortgage (recourse or nonrecourse) is included in cost basis.

A – Application

- Cash paid at closing: **$400,000**
- Assumed mortgage: **$200,000** (personal liability assumed)
- Total initial cost = $400,000 + $200,000 = **$600,000**
- This is TP's adjusted basis at acquisition.

C – Conclusion

TP's adjusted basis in Blackacre at the time of acquisition in 2020 = **$600,000**.

b. Explain the effect on TP's adjusted basis in Blackacre after TP took out the second mortgage debt in 2021.

I – Issue

Does borrowing additional funds secured by the property (second mortgage) increase TP's basis in the property?

R – Rule

- Basis increases when a taxpayer makes capital improvements or adds costs directly allocable to acquiring or improving the property (**§1016(a)**).
- Merely borrowing money secured by the property does **not** change basis unless the borrowed funds are used for capital improvements to the property.

- Using loan proceeds for unrelated business expenses or inventory does **not** affect the property's basis.

A – Application

- In 2021, TP borrowed $300,000 secured by Blackacre.
- The funds were used to buy **business inventory**, not to improve or acquire the property.
- Since the proceeds were not used for a capital improvement to Blackacre, the basis remains unchanged at $600,000.

C – Conclusion

The 2021 second mortgage does **not** change TP's adjusted basis in Blackacre. It remains **$600,000**.

Question S-7 (4 points). Without regard to the floor on deducting medical expenses, state Yes or No whether the following expenses qualify as deductible medical expenses. TP paid the expenses out of pocket and was not reimbursed for any of them.

a. $10,000 for an in-patient hospital bill for heart surgery.

Yes – Deductible medical expense under **IRC §213(d)(1)(A)** as amounts paid for the diagnosis, cure, mitigation, treatment, or prevention of disease.

b. $1,000 for prescription drugs.

Yes – Deductible under **§213(d)(3)**. Prescription drugs are qualified medical expenses.

c. $700 for over-the-counter painkilling medicine (such as aspirin or ibuprofen).

No – Under **§213(b)** and IRS Pub. 502, over-the-counter medicines are **not** deductible as medical expenses unless prescribed (and even after 2020's CARES Act change for HSAs/FSAs, §213 rules for itemized medical deductions remain unchanged).

d. $200 for transportation expenses to travel to medical appointments.

Yes – Deductible under **§213(d)(1)(B)** for transportation primarily for and essential to medical care.

e. $3,000 for a cruise vacation that was recommended by TP's doctor to help TP relax and lessen stress.

No – Travel for general health or well-being is **not** deductible (§213(d)(1)(A), Reg. §1.213-1(e)(1)(ii)) unless it is for a specific medical treatment provided by a licensed facility.

f. $1,500 for medicinal marijuana that is not illegal under TP's state law and that was prescribed by a doctor.

No – Even if legal under state law, it is illegal under federal law, and §213 does not allow deduction for federally illegal controlled substances (*Olive v. Comm'r*).

g. $1,300 in premiums paid for medical care insurance.

Yes – Health insurance premiums are deductible as medical expenses under **§213(d)(1)(D)**.

h. $1,200 in premiums paid for disability insurance which provides payments to the insured in the event that the insured becomes disabled.

No – Premiums for disability insurance that replace income are **not** deductible as medical expenses (§213(d)(1)(C)).

Summary Table

Item	Deductible?	Authority / Reason
a	Yes	§213(d)(1)(A) – surgery
b	Yes	§213(d)(3) – prescription drugs
c	No	§213(b) – OTC not deductible
d	Yes	§213(d)(1)(B) – transportation for care
e	No	Reg. §1.213-1(e)(1)(ii) – general health trip
f	No	Federal illegality (*Olive*)
g	Yes	§213(d)(1)(D) – medical insurance
h	No	§213(d)(1)(C) – disability income insurance

Question S-8 (3 points). In 2022, TP had Adjusted Gross Income (AGI) of $100,000. That year, a hurricane completely destroyed TP's boat and car. TP held both assets for personal use only. At the time of the destruction, the fair market value of the boat was $40,000, and TP's adjusted basis was $20,000. TP had insurance coverage for the boat, and the insurance company paid TP $40,000 compensation for the destruction of the boat. TP decided not to buy another boat to replace the one destroyed by the hurricane. At the time of the destruction, the fair market value of the car was $20,000, and TP's adjusted basis was $25,000. TP did not have any insurance coverage on the car. The hurricane was declared a federal disaster. Quantify the amount of loss that TP may deduct for 2022 for the destruction of the car.

I – Issue

How much of TP's personal-use car loss from a federally declared disaster can be deducted in 2022, considering the AGI limitation and the $100-per-event reduction?

R – Rule

- **IRC §165(a)** – Allows deductions for uncompensated losses sustained during the tax year.
- **§165(c)(3)** – For individuals, casualty losses of personal-use property are deductible only if arising from fire, storm, shipwreck, or other casualty, and only if in a federally declared disaster.
- **Loss Calculation** (per asset):
    1. Loss = **lesser of**:
        - Adjusted basis, **or**
        - Decline in FMV due to casualty (before insurance).
    2. Subtract any insurance or other reimbursement.
- **§165(h)(1)** – Subtract $100 per casualty event.
- **§165(h)(2)** – Reduce total casualty losses by **10% of AGI**.

A – Application

Step 1 – Determine loss before limits

- Car basis = $25,000; FMV before loss = $20,000
- Loss = lesser of basis ($25,000) or FMV before loss ($20,000) → $20,000
- No insurance recovery → loss remains $20,000

Step 2 – Apply $100 per-event reduction

- Loss after $100 reduction: $20,000 – $100 = **$19,900**

Step 3 – Apply 10% of AGI limitation

- 10% of AGI = 10% × $100,000 = **$10,000**
- Deductible loss = $19,900 – $10,000 = **$9,900**

C – Conclusion

TP may deduct **$9,900** for the car loss in 2022.

Question S-9 (1 point). TP is the president of Company, Inc. Company offers TP a choice of either (1) a parking spot in a garage across the street from TP's office or (2) $100 in cash. If TP chooses option (1), TP will pay the monthly garage parking fee and Company will reimburse TP for the expense. The monthly cost of a parking spot in the garage is $100. TP is the only employee offered this benefit. State whether TP has income in the following alternatives:

a. TP chooses option 1.

Gross Income: $100

Explanation:

- **IRC §61(a)** – Gross income includes compensation for services in any form, including fringe benefits, unless a specific exclusion applies.
- **Qualified transportation fringe benefits** under **§132(f)** can exclude employer-provided parking up to a monthly limit ($280 for 2022).
- **However**: This benefit fails §132(f) because it is offered only to TP (not to employees generally) and is given in lieu of cash (cash-or-benefits choice triggers **constructive receipt**).
- Result: Reimbursement is taxable as compensation.

b. TP chooses option 2.

Gross Income: $100

Explanation:

- Direct cash payment is always included in gross income under **§61(a)**.
- There is no exclusion for cash under §132 — cash in lieu of a benefit is fully taxable.

Question S-10 (2 points). TP agreed to purchase a painting from Seller. The agreement stated that TP would pay $10,000 cash and provide Seller a $40,000 debt note that is payable over five years. Before the first payment was due, TP notified Seller that TP believed Seller misrepresented something about the painting. After some negotiation, Seller agreed to reduce TP's debt note to $20,000. TP was not insolvent or in a bankruptcy case. State the tax consequences to TP on account of the debt reduction.

I – Issue

Does TP have taxable cancellation of debt (COD) income under **IRC §61(a)(12)** when a seller reduces the purchase-money debt for property already transferred, and what exception might apply?

R – Rule

- **IRC §61(a)(12)** – Gross income includes income from discharge of indebtedness unless an exclusion under **§108** applies.
- **Purchase Price Adjustment Exception – §108(e)(5)**: If the debt reduction is:
  1. Between the original buyer and original seller,
  2. For debt that arose from the purchase of property,
  3. The buyer is not insolvent or in bankruptcy, and
  4. The property is still held by the buyer,

     then the reduction is treated as a **purchase price adjustment**, **not** COD income.
- Result: Basis in the property is reduced by the amount of the debt reduction instead of recognizing income.

A – Application

- TP's debt arose directly from buying the painting from Seller.
- The debt reduction was negotiated with the original seller (Seller).
- TP is **not** insolvent and not in bankruptcy.
- TP still owns the painting when the debt is reduced.
- All requirements of **§108(e)(5)** are satisfied.
- Therefore, the $20,000 reduction is **not** COD income; instead, it reduces TP's basis in the painting by $20,000.

C – Conclusion

No taxable income arises from the $20,000 debt reduction. TP reduces their basis in the painting by $20,000 under the purchase price adjustment rule in **§108(e)(5)**.

Question S-11 (16 points). TP and B agree to exchange unimproved real properties that are encumbered by mortgage debts. Both properties were held for investment. In the exchange transaction, TP's mortgage debts are assumed by B, and B's mortgage debts are assumed by TP. B will also pay TP $10,000 cash as part of the exchange. The gross fair market value of B's property is $300,000. B's adjusted basis is $90,000. The property is encumbered by a $90,000 mortgage debt leaving net equity in the property of $210,000. The gross fair market value of TP's property is $240,000. TP's adjusted basis in the property is $140,000. The property is encumbered by a $20,000 mortgage debt leaving net equity in the property of $220,000. Provide the following tax consequences of the exchange: Gain or loss recognized by TP. TP's basis in TP's acquired property. Gain or loss recognized by B. B's basis in B's acquired property.

I – Issue

When TP and B exchange investment real property with mortgages assumed by the other party, plus some cash, what are:

1. The gains or losses recognized by each,
2. The bases of the properties each acquires, under **IRC §1031** like-kind exchange rules?

R – Rule

- **§1031(a)** – No gain or loss recognized on exchange of like-kind property held for investment or business use, except to the extent of **boot** (cash or other non-like-kind property) received.
- **Boot** includes:
    - Cash received, and
    - Net debt relief (if the other party assumes more of your debt than you assume of theirs).
- **Amount realized** = FMV of property received + boot received + debt relief.
- **Recognized gain** = lesser of realized gain or boot received. Losses are not recognized in like-kind exchanges.
- **Basis of property received** = Adjusted basis of property given up + gain recognized – boot received – debt relief given + debt assumed. (**§1031(d)** formula)

A – Application

Step 1 – Debt netting

- **TP**: Debt given up = $20,000; Debt assumed from B = $90,000 → **Net debt assumed = $70,000** (liability increase, not boot received).
- **B**: Debt given up = $90,000; Debt assumed from TP = $20,000 → **Net debt relief = $70,000** (this is treated as boot received by B).

Step 2 – TP's transaction

Amount realized by TP = FMV of B's property ($300,000) + cash received ($10,000) – debt assumed by TP ($90,000) + debt relief ($20,000)
= $300,000 + $10,000 – $90,000 + $20,000
= **$240,000**

Realized gain for TP = Amount realized ($240,000) – Adjusted basis ($140,000) = **$100,000**

Boot received by TP = $10,000 cash + net debt relief (negative here because TP took on more debt, so no boot from debt relief) = **$10,000**

Recognized gain for TP = lesser of realized gain ($100,000) or boot received ($10,000) → **$10,000 recognized gain**

Basis of property received by TP = Old basis ($140,000) + gain recognized ($10,000) – boot received ($10,000) – debt relief given ($20,000) + debt assumed ($90,000) = 140,000 + 10,000 – 10,000 – 20,000 + 90,000 = **$210,000**

Step 3 – B's transaction

Amount realized by B = FMV of TP's property ($240,000) + debt relief ($90,000 – $20,000 = $70,000) = $240,000 + $70,000 = **$310,000**

Realized gain for B = $310,000 – basis ($90,000) = **$220,000**

Boot received by B = net debt relief $70,000 (treated as boot) – no cash received.

Recognized gain for B = lesser of realized gain ($220,000) or boot received ($70,000) → **$70,000 recognized gain**

Basis of property received by B = Old basis ($90,000) + gain recognized ($70,000) – boot received ($70,000) – debt relief given ($90,000) + debt assumed ($20,000) = 90,000 + 70,000 – 70,000 – 90,000 + 20,000 = **$20,000**

C – Conclusion

TP:

- Gain recognized = **$10,000**
- Basis in new property = **$210,000**

B:

- Gain recognized = **$70,000**
- Basis in new property = **$20,000**

Question S-12 (2 points). TP owned unimproved land. TP's adjusted basis in the land was $100,000, and the land was subject to mortgage debt of $40,000. On February 1, year 1, TP donated the land to a qualified charitable organization. At the time of the donation, the gross fair market value of the land was $160,000. The charity accepted the land and assumed the mortgage debt of $40,000. The charity became personally liable for that debt. Quantify the amount of gain, if any, recognized by TP on account of the donation.

I – Issue

When TP donates mortgaged property to a qualified charity and the charity assumes the debt, does TP recognize gain, and if so, how much?

R – Rule

- **IRC §170** – Allows a deduction for charitable contributions of property to qualified organizations.
- **IRC §1011(b)** – If a charitable gift is partly a sale or exchange (e.g., because the donee assumes debt), the transaction is treated as part sale, part gift.
- **Reg. §1.1001-1(e)** – The "amount realized" from a transfer includes liabilities assumed by the transferee.
- **Gain calculation** for part sale:
    1. Amount realized = liabilities assumed by the charity + any other consideration received.
    2. Compare amount realized to the proportionate basis allocated to the "sale" portion.
- If the liability assumed exceeds the basis allocable to that portion, the excess is recognized as gain, even though the overall transfer is partly a gift.

A – Application

- FMV of land = $160,000
- Debt assumed by charity = $40,000 (this is **amount realized** for the "sale" portion).
- TP's basis = $100,000.
- **Proportionate basis for sale portion**: 40,000÷160,000=25%40,000 ÷ 160,000 = 25\%40,000÷160,000=25% of the property is treated as sold.
  25% × $100,000 basis = **$25,000** basis allocable to sale portion.
- **Gain** = Amount realized ($40,000) – Allocable basis ($25,000) = **$15,000** recognized gain.
- The remainder of the basis ($75,000) applies to the gift portion and is not recognized as gain.

C – Conclusion

TP recognizes **$15,000** gain in year 1 due to the charity's assumption of the mortgage debt. The transaction is treated as a part-sale (generating gain) and part-charitable contribution.

<u>Question S-13 (2 points).</u> TP owned unimproved land. TP's adjusted basis in the land was $80,000. On March 1, 2022, the gross fair market value of the land was $50,000. TP sold the land to her niece for $10,000. TP purposely sold the land for less than its fair market value because she wanted to make a partial gift to the niece. TP paid no federal gift tax.

1. Quantify the gain or loss recognized by TP for federal income tax purposes on account of the transaction with the niece.

I – Issue

When TP sells property to a related party (niece) for less than FMV as part-sale/part-gift, how is the gain or loss determined for federal income tax purposes?

R – Rule

- **IRC §1001(a)** – Gain/loss = amount realized – adjusted basis.
- **Part-sale/part-gift**: **Reg. §1.1001-1(e)** – If property is transferred for less than FMV to a related person, it is treated as a sale to the extent of the amount paid; the remainder is a gift.
- **IRC §267(a)(1)** – Disallows recognition of losses on sales or exchanges between related parties (includes family members per §267(c)(4); niece counts as "related" because she is a descendant of a sibling).
- If transaction produces a gain, gain is recognized; if it produces a loss to a related party, the loss is disallowed.

A – Application

- **Amount realized** = $10,000 (cash from niece)
- **Adjusted basis** = $80,000
- **Loss** = $10,000 – $80,000 = **($70,000)** loss
- Since niece is a related party, **§267(a)(1)** disallows the loss deduction. Recognized loss = **$0**.

C – Conclusion

TP recognizes **$0** gain or loss. The $70,000 realized loss is disallowed due to related-party rules.

2. On December 1, 2022, the niece sold the land to an unrelated party for $70,000. Quantify the gain or loss recognized by the niece on that sale.

I – Issue

What is the niece's basis and gain/loss on sale of property acquired from a related party in a loss-disallowed transaction?

R – Rule

- **§1015(a)** – Donee's basis in property acquired by gift is donor's basis if FMV ≥ basis at the time of gift. But in part-sale/part-gift to related person where a loss was disallowed:
  - Special dual-basis rule applies:
    - For **gain**: use the donor's adjusted basis.
    - For **loss**: use the FMV at the time of the gift.
    - If sale price falls between FMV and donor's basis, no gain/loss is recognized.
- In this case, niece acquired property for part purchase/part gift. The portion attributable to the sale price keeps its purchase basis; the gifted portion follows the gift rules.

A – Application

- Donor's adjusted basis: $80,000
- FMV at time of transfer: $50,000
- Sale price to niece: $10,000
- For niece's **gain calculation**: use donor's basis ($80,000).
  - Gain = $70,000 (sale to unrelated) – $80,000 = **loss** of $10,000 → but for **loss**, must use FMV at time of gift ($50,000).
  - Loss = $70,000 – $50,000 = **$20,000 gain** (because $70,000 > $50,000).
- Wait — careful: $70,000 > donor's basis? No — $70,000 is less than $80,000, so no gain using gain-basis, but more than FMV, so no loss using loss-basis.
- Result: **No gain or loss** because sale price is between FMV at gift date and donor's basis.

C – Conclusion

Niece recognizes **$0** gain or loss on sale to unrelated party because of the dual-basis rule in §1015 for property acquired in a loss-disallowed related-party transfer.

<u>Question S-14 (2 points).</u> List the three factors used by the Court to determine whether TP may deduct clothing expenses as business expenses.

Clothing expenses are deductible as ordinary and necessary business expenses under **IRC §162(a) only if** all three tests are met:

1. **Required or Essential for Employment**
    - The clothing is specifically required as a condition of employment.
2. **Not Suitable for Everyday Wear**
    - The clothing is not suitable for general or personal wear outside of work.
3. **Not Worn for Personal Use**
    - The taxpayer does not wear the clothing for personal or non-work purposes.

Explanation

The Tax Court and other courts have consistently applied these three factors in cases such as **Pevsner v. Commissioner**, 628 F.2d 467 (5th Cir. 1980).

- Ordinary suits, dresses, or shoes that could be worn outside work fail the "not suitable" test, even if the taxpayer *chooses* not to wear them personally.
- Uniforms, protective gear, or specialized costumes can meet the test if they are required, unsuitable for general wear, and not actually worn off the job.

Question S-15 (10 points). In 2022, Corporation was created with a capitalization of 200 shares of common voting stock and 50 shares of preferred non-voting stock. The preferred stock is not §306 stock. In the initial capitalization, A exchanged unimproved land for 120 shares of Corporation common voting stock. A's adjusted basis in the land was $30,000 and the gross fair market value of the land was $120,000. B exchanged $80,000 cash for 80 shares of Corporation common voting stock. C exchanged services for 50 shares of preferred non-voting stock. The fair market value of C's services was $20,000.

1. Does this capitalization qualify for nonrecognition under §351.

Answer: No

Explanation:

- **IRC §351(a)** – No gain or loss recognized if:
    1. Property is transferred to a corporation,
    2. Solely in exchange for stock, and
    3. Immediately after the exchange, the transferors of property are in **control** of the corporation (**§368(c)** – at least 80% of total voting stock and at least 80% of total shares of each other class).
- Here:
    - A and B transferred **property** (land and cash).
    - C transferred **services** — services are **not** "property" for §351 purposes (**§351(d)**).

- For control test, **only property transferors count**. A and B together own 200/200 = 100% of **common voting stock**, so they meet the control test **if we only consider the voting stock requirement**.
- However, the 80% test also applies **separately to each class of stock**. A and B transferred **no property** for the preferred stock class (only C got it for services), so they own **0% of that class** — failing the 80% rule for that class.

Conclusion: The transaction **fails §351** for all parties because the 80% control requirement is not satisfied for the preferred stock class.

2. Does A's tax result depend on whether the capitalization qualifies for nonrecognition under §351? Explain why or why not.

Answer: Yes

Explanation:

- If §351 applied, A would recognize **no gain**, and basis in the stock would be **carryover basis** from the land ($30,000).
- Because §351 does **not** apply, this is a **taxable exchange**:
  - Amount realized = FMV of stock received ($120,000).
  - Basis in land = $30,000.
  - **Gain recognized** = $120,000 – $30,000 = **$90,000** (capital gain).
- Therefore, the nonrecognition provision directly determines whether A's gain is deferred or immediately taxable.

3. Does B's tax result depend on whether the capitalization qualifies for nonrecognition under §351? Explain why or why not.

Answer: No

Explanation:

- B transferred **cash** for stock. Under §1001, exchanging cash for stock does not produce gain or loss (basis in stock = cash paid).
- Even without §351, B's basis in stock = $80,000 and no gain/loss is recognized.
- §351 status makes no difference to B's tax result.

4. Does C's tax result depend on whether the capitalization qualifies for nonrecognition under §351? Explain why or why not.

Answer: No

Explanation:

- C transferred **services**, not property, so §351 does **not** apply to C regardless of the rest of the transaction.
- Under **§61(a)** and **Reg. §1.61-2(d)(1)**, the FMV of stock received for services is taxable as **ordinary income** at the time received.
- Here, C recognizes **$20,000** ordinary income (FMV of preferred stock).
- §351 treatment of other parties does not affect C.

5. Does Corporation's tax result depend on whether the capitalization qualifies for nonrecognition under §351? Explain why or why not.

Answer: Yes (but only for certain items)

Explanation:

- **§1032** – Corporation generally recognizes no gain/loss on issuing its own stock in exchange for property, regardless of §351.
- **§351(b)** and **§362(a)** – If §351 applies, the corporation takes a **carryover basis** in the property received. If §351 does not apply, the corporation's basis is FMV at the time of the exchange (§1012).
- Here:
    - Land from A: With §351, corporation's basis = $30,000; without §351, basis = $120,000 FMV.
    - Cash from B: Basis unaffected (cash always basis = face amount).
    - Services from C: Corporation may deduct $20,000 as compensation expense under §162 if otherwise deductible (or capitalize if appropriate).
- So for the land, §351 status **does** change the corporation's basis.

Party	§351 Applies?	Effect on Tax Result
1. Overall Transaction	No – fails 80% control for preferred stock class	
A	Yes – changes result	Without §351 → $90k gain; With §351 → defer gain
B	No – no change	No gain/loss either way
C	No – no change	$20k ordinary income under §61
Corporation	Yes – changes land basis	§351 → carryover basis ($30k); No §351 → FMV basis ($120k)

Question S-16 (2 points). TP is a shareholder of Corporation, Inc. On June 1, year 1, Corporation distributed Blackacre (unimproved land) to TP. The distribution qualified as a dividend under § 316. The gross fair market value of Blackacre was $100,000 and Blackacre was subject to a mortgage debt of $10,000. TP accepted Blackacre subject to the $10,000 mortgage. At the time of the distribution, Corporation's adjusted basis in Blackacre was $40,000.

Facts Recap

- FMV of Blackacre: **$100,000**
- Mortgage debt: **$10,000** (TP takes subject to debt)
- Corporation's adjusted basis in Blackacre: **$40,000**
- Distribution qualifies as **dividend** under §316.

1. Quantify the amount of dividend income that TP has on account of the distribution.

TP's Dividend Income

Rule

- **§301(b)** – Property distributions are measured at the FMV of property received, reduced by any liabilities assumed.
- **§301(c)(1)** – To the extent of current and accumulated earnings and profits (E&P), the amount is a **dividend**.
- **§301(b)(2)** – If the liability assumed is less than the property's FMV, dividend amount = FMV of property **without** reducing for the liability assumed (liability is treated as cash received to pay it).

Application

- FMV of Blackacre = **$100,000**.
- Liability ($10,000) does **not** reduce the dividend amount — it simply affects TP's basis.
- Assuming sufficient E&P, **dividend income** = **$100,000**.

Answer: $100,000 dividend income.

2. Quantify TP's basis in Blackacre after the distribution.

TP's Basis in Blackacre

Rule

- **§301(d)** – Basis in property received = FMV at time of distribution, **reduced** by any liabilities to which the property is subject.

Application

- FMV = $100,000
- Less mortgage liability assumed = $10,000
- Basis = $90,000

Answer: $90,000 basis.

3. Quantify Corporation's gain or loss recognized on account of the distribution.

Corporation's Gain or Loss Recognized

Rule

- **§311(b)** – If a corporation distributes appreciated property, it must recognize gain as if the property were sold at FMV.
- Gain = FMV – Adjusted Basis.
- Loss is **not** recognized on distribution of property to a shareholder.

Application

- FMV = $100,000
- Adjusted basis = $40,000
- Gain = $100,000 – $40,000 = **$60,000** (character depends on asset type — here, likely capital gain if capital asset).

Answer: $60,000 gain recognized.

Final Answers Table

Item	**Amount**	**Explanation**
1. TP's Dividend Income	**$100,000**	FMV of property; liability doesn't reduce dividend amount under §301(b)(2)
2. TP's Basis in Blackacre	**$90,000**	FMV – liability assumed (§301(d))
3. Corporation's Gain	**$60,000**	FMV – adjusted basis (§311(b))

Question S-17 (2 points). Describe the “Substance over Form” doctrine.

Answer

The **“Substance over Form” doctrine** is a judicial principle in tax law that holds that the **true substance** of a transaction — not merely the formal structure or labels chosen by the parties — determines its tax consequences.

Explanation

Rule

- Originates from case law, notably **Gregory v. Helvering**, 293 U.S. 465 (1935).
- The IRS and courts look to the **economic reality** and **practical effect** of a transaction, not just how it is documented.
- If the form of a transaction disguises its real nature to obtain a tax benefit, the transaction can be **recharacterized** for tax purposes.

Purpose

- Prevents taxpayers from structuring transactions in a way that meets the literal wording of the tax code while defeating its intent.
- Ensures the tax system reflects actual economic events.

Examples

- A “loan” that, in substance, is a disguised dividend because there’s no real intent or ability to repay.
- A corporate reorganization with no legitimate business purpose, done solely to avoid taxes.

Bottom line: In tax law, **what actually happens** (substance) matters more than **what you call it** (form).

Question S-18 (8 points). In 2021, individuals TP1 and TP2 formed a general partnership (which would not have been treated as an investment company under §351 if incorporated). Under the partnership agreement, TP1 and TP2 share everything (interest in partner capital, profits, and losses) equally. To form the partnership, TP1 contributed unimproved land. The gross fair market value of the land was $200,000. The land was encumbered by a mortgage debt of $100,000. The partnership received the land subject to the $100,000 mortgage debt and the partnership became personally liable for the debt. TP1 purchased the land in 2012 as an investment. TP1's adjusted basis in the land was $30,000. TP2 contributed $100,000 cash.

Facts Recap

- **Partnership formation** (general partnership, equal shares)
- **TP1**: Contributed unimproved land (FMV $200,000), subject to $100,000 mortgage, adjusted basis $30,000. Debt taken over by partnership. Land was an investment asset.
- **TP2**: Contributed $100,000 cash.
- Debt is **recourse** (partnership personally liable).

1. Discuss, quantify, and characterize any gain or loss recognized by TP1 upon formation of the partnership.

TP1 – Gain or Loss on Formation

Rule

- **§721(a)** – No gain/loss recognized on contribution of property to partnership in exchange for a partnership interest.
- **Exception:** §721(b) applies only if partnership is an "investment company" (not the case here).
- **§752(b)** – A **decrease** in a partner's share of partnership liabilities is treated as a distribution of money to the partner.
- **§731(a)(1)** – Gain recognized if money deemed distributed exceeds the partner's adjusted basis in their partnership interest immediately before the distribution.

Application

- TP1's share of the $100,000 debt before contribution: 100% (sole owner of land).
- After contribution: partnership owes the $100,000, split equally among TP1 and TP2 because of equal profit/loss sharing (unless otherwise agreed). TP1's share is now 50% = $50,000.
- Debt relief = $100,000 – $50,000 = $50,000.
- **Deemed distribution** under §752(b) = $50,000.
- TP1's basis in land before contribution = $30,000.
- Deemed distribution ($50,000) **exceeds** basis ($30,000) by $20,000 → gain recognized.
- Gain character: capital gain (land held for investment = capital asset under §1221).

Answer: TP1 recognizes **$20,000 capital gain**.

2. Discuss, quantify, and characterize any gain or loss recognized by TP2 upon formation of the partnership.

TP2 – Gain or Loss on Formation

Rule

- §721(a) – No gain/loss on property (cash is property) contributed for a partnership interest.
- §752(a) – Increase in partner's share of partnership liabilities is treated as a **cash contribution** by the partner, increasing basis but not creating taxable income.

Application

- TP2 contributes $100,000 cash and takes on 50% share of $100,000 debt = $50,000 liability share.
- Liability share is treated as additional contribution to partnership; no gain recognized.

Answer: TP2 recognizes **no gain/loss**.

3. Discuss and quantify TP1's adjusted basis in TP1's partnership interest upon formation of the partnership.

TP1's Adjusted Basis in Partnership Interest

Rule

- Initial basis = Basis of property contributed (§722)
- Plus: share of partnership liabilities assumed by partner (§752(a))
- Minus: decrease in liabilities treated as distribution (§752(b))
- Plus: any gain recognized.

Application

- Start: $30,000 (basis of land)
- Plus: share of partnership debt after formation ($50,000)
- Minus: debt relief ($100,000 before – $50,000 after = $50,000 deemed distribution)
- Plus: gain recognized ($20,000)

Calculation:
$30,000 + $50,000 – $50,000 + $20,000 = **$50,000**

Answer: TP1's basis = **$50,000**.

4. Discuss and quantify TP2's adjusted basis in TP2's partnership interest upon formation of the partnership.

TP2's Adjusted Basis in Partnership Interest

Rule

- Basis = cash contributed (§722) + share of liabilities (§752(a)).

Application

- Start: $100,000 (cash contributed)
- Plus: $50,000 share of partnership liabilities

Basis = $100,000 + $50,000 = **$150,000**

Answer: TP2's basis = **$150,000**.

Final Answer Table

Item	Amount	Character
1. TP1 gain	$20,000	Capital gain
2. TP2 gain/loss	$0	N/A
3. TP1 basis	$50,000	Partnership interest basis
4. TP2 basis	$150,000	Partnership interest basis

Question S-19 (2 points). Explain whether it is possible for an S Corporation to have more than 100 shareholders.

Answer

Yes, but only in limited circumstances.
An S corporation generally may not have **more than 100 shareholders** under **IRC §1361(b)(1)(A)**. However, certain rules allow more than 100 individuals to be counted as **a single shareholder** for purposes of this limit.

Explanation

General Rule – 100 Shareholder Limit

- **IRC §1361(b)(1)(A)**: An S corporation cannot have more than 100 shareholders.
- The 100 limit is tested at all times during the tax year.

Exceptions – Counting Multiple People as One Shareholder

Under **IRC §1361(c)(1)**, certain family members are treated as **one shareholder** for the 100-shareholder test:

- A family is defined as a **common ancestor** and all lineal descendants of that ancestor (and their spouses/former spouses).
- Up to **six generations** can be counted as one.
- Also, certain trusts, estates, and entities eligible to hold S stock are counted as a single shareholder (e.g., a qualified subchapter S trust).

Example: If 30 cousins (all descendants of the same grandparent) own S corporation shares, they count as **one shareholder** toward the 100 limit.

Bottom line: An S corporation can have **more than 100 actual owners** if some of them qualify to be grouped under the **family aggregation** rule or other special counting provisions.

Question S-20 (4 points). TP is a C Corporation. In year 1, TP sells Blackacre (unimproved land) to Buyer, an unrelated party. The terms of the sale provide that Buyer will pay $100,000 cash at closing and Buyer will execute a promissory note payable to TP of $900,000 payable over a nine-year period beginning in the taxable year after the sale and bearing an adequate rate of interest. At the time of the sale, TP's adjusted basis in Blackacre was $500,000.

Facts Recap

- Seller: TP (C corporation)
- Sale price: $1,000,000 total (cash $100,000 + $900,000 note)
- Adjusted basis in land: $500,000
- Interest is adequate, payments over 9 years starting the year after sale.
- Asset: Blackacre (unimproved land — a capital asset for a C corp).
- Buyer is unrelated.

1. Quantify how much taxable gain TP recognizes in year 1 according to §453 on account of the sale of Blackacre.

Year 1 Taxable Gain under §453 (Installment Method)

Rule

- **IRC §453(a)** – Installment method available for non-dealer sales of property when at least one payment is received after the year of sale.
- **Gain recognized each year** = (Payments received in that year) × (Gross profit percentage).
- **Gross profit percentage** = (Gross profit ÷ Contract price).
- **Gross profit** = Selling price – Adjusted basis.

Application

- Selling price: $1,000,000
- Adjusted basis: $500,000
- **Gross profit** = $1,000,000 – $500,000 = **$500,000**.
- Contract price = $1,000,000 (no qualifying debt assumption that reduces it).
- Gross profit % = $500,000 ÷ $1,000,000 = **50%**.

Year 1 payment received = $100,000 cash at closing.

- Recognized gain = $100,000 × 50% = **$50,000**.

Answer: $50,000 gain recognized in year 1.

2. Quantify the effect on TP's earnings and profits in year 1 on account of the sale of Blackacre.

Effect on Earnings & Profits (E&P) in Year 1

Rule

- **§312(f)(2)** – For E&P purposes, **installment method is NOT used**.
- E&P is increased by the **entire gain** in the year of sale, regardless of when payments are received.
- That means we compute E&P effect as if all gain is recognized immediately.

Application

- Total gain on sale = $500,000.
- Entire $500,000 increases E&P in year 1 (subject to any other year adjustments not relevant here).

Answer: E&P increases by $500,000 in year 1.

Final Answer Table

Item	Amount	Explanation
1. Year 1 taxable gain	$50,000	Installment method under §453 (50% of $100,000 payment)
2. Year 1 E&P effect	$500,000	Full gain recognized for E&P purposes under §312(f)(2)

<u>Question S-21 (2 points).</u> The IRS issued a notice of deficiency to an estate, based on disallowance of the charitable contribution deduction claimed on the federal estate tax return filed by the estate. The notice of deficiency also determined a §6662 penalty based on the estate's alleged negligence in claiming the deduction. The estate's petition filed with the Court defended against the penalty by alleging that the estate had relied on the advice of its return preparer that the claimed deduction was appropriate. Identity the elements the estate must establish to succeed as to this defense.

I – Issue

What must the estate prove to successfully assert a **reasonable cause and good faith reliance** defense to a **§6662 accuracy-related penalty** based on negligence, when it claims reliance on advice from its return preparer?

R – Rule

- **§6662** – Imposes an accuracy-related penalty for negligence or disregard of rules/regulations.
- **§6664(c)(1)** – No penalty shall be imposed if the taxpayer shows there was **reasonable cause** and the taxpayer acted in **good faith**.
- **Treas. Reg. §1.6664-4(b)(1)** – The most important factor is the extent of the taxpayer's effort to assess the proper tax liability.
- **Reliance on professional advice** can constitute reasonable cause and good faith **if** the taxpayer establishes three elements (from cases such as *Neonatology Assocs., P.A. v. Comm'r*, 115 T.C. 43 (2000), aff'd 299 F.3d 221 (3d Cir. 2002)):
    1. **Competent Advisor** – The adviser was a competent professional with sufficient expertise to justify reliance.
    2. **Complete Disclosure** – The taxpayer provided the adviser with all necessary and accurate information to evaluate the matter.
    3. **Actual Good Faith Reliance** – The taxpayer actually relied in good faith on the adviser's judgment.

A – Application

- **Competent Advisor** – The estate must prove its return preparer was a qualified tax professional (e.g., attorney, CPA, enrolled agent) experienced in estate tax law.
- **Complete Disclosure** – The estate must show it gave the preparer all relevant facts about the charitable contribution — including documentation, the terms of the gift, and any conditions affecting deductibility.
- **Actual Good Faith Reliance** – The estate must show it reasonably trusted the preparer's judgment, and there were no obvious red flags that would make the reliance unreasonable (e.g., too-good-to-be-true deduction, contradictory IRS guidance).

If the estate fails to prove **any** of these elements, the reasonable cause defense fails.

C – Conclusion

To defeat the §6662 penalty, the estate must establish:

1. The return preparer was a competent, qualified professional.
2. The estate provided full and accurate information to the preparer.
3. The estate actually relied in good faith on the preparer's advice. If all three are proven, the penalty should be abated under §6664(c)(1).

Question S-22 (3 points). In each of the following situations, the IRS issued a notice to the TP, the notice determined a penalty (not a penalty automatically calculated through electronic means), TP filed a petition with the Court in which TP challenged the penalty, and the case was tried and briefed. In each of the situations, state whether the IRS would bear, as part of its initial burden of production, the burden to show that the immediate supervisor (or higher level official) of the IRS individual who made the initial penalty determination personally approved that determination in writing. State "yes" or "no" to each subpart.

Relevant Rule

- **IRC §6751(b)(1)** – No penalty may be assessed unless the initial determination of the assessment is **personally approved in writing by the immediate supervisor** of the IRS employee making that determination (or a higher official).
- **Burden of production**:
  - **§7491(c)** – In any court proceeding with respect to an individual's liability for any penalty, the IRS has the burden of **production** (must produce sufficient evidence that imposition of the penalty is appropriate).
  - *Graev v. Commissioner*, 149 T.C. 485 (2017) — IRS must show written supervisory approval before penalty is first communicated to taxpayer in a manner that makes them aware of it being proposed.

- **Exceptions (§6751(b)(2))** — No written approval required for:
1. Penalties automatically calculated through electronic means, and
2. Certain penalties for failure to file or pay (e.g., delinquency penalties under §6651).

1. TP was an individual, the notice issued by the IRS was a notice of deficiency, and the penalty determined by the notice was a delinquency penalty for late filing of a required tax return.

Individual – Notice of deficiency – Delinquency penalty (§6651)

- §6651 penalties are **excepted** from §6751(b)(1) approval requirement under **§6751(b)(2)(A)** because they are for failure to file/pay.
- IRS does **not** need to produce evidence of written supervisory approval.

  Answer: No.

2. TP was an individual, the notice issued by the IRS was a notice of deficiency, and the penalty determined by the notice was a § 6662 penalty.

Individual – Notice of deficiency – §6662 penalty

- §6662 is **not** excepted — it's an accuracy-related penalty.
- For an individual, under §7491(c), IRS bears initial burden of production, which includes showing **compliance with §6751(b)(1)** (supervisory written approval before first formal communication of penalty to taxpayer).

  Answer: Yes.

3. TP was a partnership, the noticed issued by the IRS was a notice of final partnership administrative adjustment, and the penalty determined by the notice was a § 6662 penalty.

Partnership – Notice of FPAA – §6662 penalty

- Even though §7491(c) applies only to individuals, courts (including *Graev* and later *Belair Woods, LLC v. Commissioner*, 154 T.C. 1 (2020)) have held that §6751(b)(1) applies to **all taxpayers**, including partnerships.
- The IRS bears the burden of production for §6751(b) approval in partnership cases as part of its case when the penalty is contested.

  Answer: Yes.

Question S-23 (1 point). The notice of deficiency issued to the TP (1) disallowed two deductions claimed on TP's return, (2) determined that TP had failed to report taxable income from TP's business, and (3) asserted the §6663 penalty as to the entire deficiency. TP's petition conceded that he had fraudulently underreported his business income but maintained that his overstatement of his deductions was negligent, not fraudulent. State which party –TP or the IRS –will bear the burden of proof as to applicability of the §6663 penalty to the portion of the deficiency attributable to the overstated deductions.

I – Issue

When a notice of deficiency asserts the **§6663 civil fraud penalty** for the *entire* deficiency, but the taxpayer concedes fraud only for part (underreported income) and contests the rest (overstated deductions) as negligent, which party bears the burden of proof for the fraud penalty on the deduction portion?

R – Rule

- **§6663(a)** – Imposes a penalty equal to **75% of the portion of the underpayment attributable to fraud**.
- **§6663(b)** – If any portion of the underpayment is attributable to fraud, the *entire* underpayment is treated as attributable to fraud **unless the taxpayer establishes** by a preponderance of the evidence that some portion is not.
- **Burden of Proof**:
  - IRS bears the burden to prove fraud **by clear and convincing evidence** (§7454(a); Tax Court Rule 142(b)).
  - Once IRS proves *any* portion is due to fraud, **the burden shifts to the taxpayer** to prove that the remainder is not due to fraud (§6663(b)).

A – Application

- Here, TP conceded fraud as to the unreported business income.
- Because fraud is conceded for part of the deficiency, **§6663(b)** applies.
- This creates a presumption that **the entire deficiency** is attributable to fraud unless TP can prove otherwise.
- Thus, for the overstated deductions portion, **TP** bears the burden of proof to show they were not fraudulent — e.g., by proving they were merely negligent.

C – Conclusion

TP bears the burden of proof to establish that the portion of the deficiency from overstated deductions is not attributable to fraud, once fraud has been established for part of the deficiency under §6663(b).

Question S-24 (2 points). TP established an irrevocable trust in favor of his grandson. She transferred to the trust corporate stock worth $13,000. Under the terms of the trust instrument, (1) the First National Bank was established as trustee and (2) the trustee had sole and absolute discretion either to distribute the corpus or income of the trust to the grandson or to withhold such distributions. State whether TP may claim the annual exclusion from federal gift tax on account of this transfer. Explain why or why not.

I – Issue

Can TP claim the **annual exclusion** from federal gift tax for a transfer of $13,000 in stock to an irrevocable trust for her grandson, when the trustee has **sole discretion** to distribute or withhold corpus or income?

R – Rule

- **IRC §2503(b)** – The annual exclusion applies only to gifts of a **present interest**.
- A **present interest** is an unrestricted right to the immediate use, possession, or enjoyment of property or income from property.
- A **future interest** is any interest that commences in use, possession, or enjoyment at a future date — including interests subject to discretion of a trustee to withhold distributions.
- Treasury Reg. §25.2503-3(b) — If the donee's enjoyment is postponed or conditioned, the interest is future and does not qualify for the annual exclusion.
- Case law (*Fondren v. Commissioner*, 324 U.S. 18 (1945)) — Gifts in trust without a present, enforceable right to income or corpus are future interests.

A – Application

- TP's grandson has **no immediate enforceable right** to receive either corpus or income.
- Distributions are entirely within the trustee's **sole and absolute discretion**.
- Therefore, the grandson's interest is a **future interest**, because he can only enjoy the property if and when the trustee decides to distribute it.
- Since the annual exclusion applies only to present interests, the $13,000 gift to the trust does **not** qualify for the exclusion.

C – Conclusion

No, TP may not claim the annual exclusion under §2503(b) because the gift is a **future interest** — the grandson does not have an immediate, unconditional right to use, possess, or enjoy the property or income.

Question S-25 (2 points). TP created an irrevocable trust in favor of his daughter. TP was the sole trustee up until the time of his death, at which time a bank became the successor trustee. Under the trust instrument, the trustee had the authority (1) to retain or invest the assets of the trust in property not permitted for investment under state law and (2) to determine what constituted income of the trust and what constituted principal. State whether the assets of the trust are includible in TP's gross estate for estate tax purposes. Explain why or why not.

I – Issue

Are the assets of the irrevocable trust includible in TP's **gross estate** for federal estate tax purposes when TP served as sole trustee with broad discretionary powers until death?

R – Rule

- **IRC §2036(a)(2)** – Includes in the gross estate any transferred property where the decedent retained the right, either alone or with others, to designate the persons who will enjoy the property or its income.
- **IRC §2038(a)(1)** – Includes property if, at death, the decedent retained the power to alter, amend, revoke, or terminate the enjoyment of the property, either alone or with others.
- Retaining certain **administrative powers** as trustee can cause inclusion if they effectively allow control over **beneficial enjoyment**.
- *United States v. Byrum*, 408 U.S. 125 (1972) and subsequent cases — Mere investment discretion without control over distributions may not trigger inclusion, but powers that can shift benefits between income and principal (and thereby affect who gets what and when) are powers over **beneficial enjoyment**.
- Treas. Reg. §20.2036-1(b)(3) — Power to allocate receipts between income and principal can be a power to designate enjoyment if it affects the economic benefits to beneficiaries.

A – Application

- TP, as trustee, had **two significant powers**:
    1. Power to retain or invest in assets not permitted under state law → broad investment discretion.

2. Power to determine what constitutes income vs. principal → affects who benefits (income beneficiary vs. remainder beneficiary).

- The second power is critical — the ability to allocate between income and principal can **shift the economic benefits** and thus is considered the power to designate who will enjoy the property (§2036(a)(2) / §2038(a)(1)).
- Because TP retained this power **until death**, the trust assets are includible in TP's gross estate at fair market value on the date of death.

C – Conclusion

Yes, the assets are includible in TP's gross estate under **§2036(a)(2)** and **§2038(a)(1)** because TP, as trustee, retained until death the power to determine beneficial enjoyment by allocating between income and principal.

<u>Question S-26 (4 points).</u> TP works full-time as an employee of Corporation, Inc. In 2021, TP worked 2000 hours in her employment position at Corporation. TP also owns four rental properties. In 2021, TP worked 1400 hours managing the rental properties. In 2021, TP had a net loss of $50,000 from the rental properties. Based on these facts, state whether the TP will be able to use the $50,000 loss to offset her income from her employment. Explain why or why not.

I – Issue

Can TP use her $50,000 rental real estate loss in 2021 to offset her wage income from employment, given her work hours in both employment and rental activities?

R – Rule

- **IRC §469(a)** – Disallows passive activity losses against non-passive income (such as wages).
- **§469(c)(2)** – Rental activity is generally treated as a **per se passive activity**, regardless of level of participation, unless the taxpayer qualifies for the **real estate professional exception** under §469(c)(7).
- **Real estate professional exception** (§469(c)(7)(B)) — A taxpayer qualifies if:
    1. **More than half** of personal services performed in trades or businesses during the tax year are performed in real property trades or businesses in which the taxpayer materially participates, **and**
    2. The taxpayer performs **more than 750 hours** of services during the year in real property trades or businesses in which the taxpayer materially participates.
- **Material participation** (§469(h), Treas. Reg. §1.469-5T) – Involves meeting certain tests, such as working more than 500 hours in the activity.

A – Application

- TP worked **2000 hours** as an employee of Corporation (non–real estate trade or business).
- TP worked **1400 hours** managing rental properties.
- While the 1400 hours exceed the **750-hour** requirement, she **fails the "more than half of personal services"** test:
  - Total hours worked in all trades/businesses = 2000 + 1400 = 3400 hours.
  - Hours in real property trades/businesses = 1400 hours.
  - 1400 ÷ 3400 ≈ 41% — not more than half.
- Because TP is **not** a real estate professional under §469(c)(7), the rental activity remains **per se passive**.
- Passive losses (here, $50,000) cannot be used to offset active income (wages) unless an exception applies, such as:
  - **$25,000 active participation allowance** (§469(i)), phased out starting at AGI $100,000. But even if available, it would only partially offset the loss, not the full $50,000.

C – Conclusion

No, TP may not use the full $50,000 rental loss to offset her wage income because she does not qualify as a real estate professional and the rental activity is passive under §469(c)(2). The loss is limited to passive income for the year, with any excess carried forward.

Question S-27 (2 points). In 2021, TP settled a criminal complaint with the Securities Exchange Commission (SEC) that involved TP's business selling securities to investors. As part of the settlement, TP disgorged $400,000 of profits that were attributable to TP's securities business. Based on these facts, can TP deduct that disgorgement payment as a valid business expense? Explain why or why not.

I – Issue

Can TP deduct the $400,000 disgorgement payment to the SEC as an ordinary and necessary business expense under **IRC §162(a)**, given it was part of a settlement for a securities law violation?

R – Rule

- **IRC §162(a)** – Allows deduction of ordinary and necessary expenses paid or incurred in carrying on a trade or business.

- **§162(f)(1)** – No deduction is allowed for any amount paid or incurred to, or at the direction of, a government in relation to the violation of any law or the investigation into a potential violation.
- **§162(f)(2)** – Exception if payment is restitution (including remediation) or to come into compliance with the law, **and** is identified as such in a court order or settlement agreement.
- The **2017 Tax Cuts and Jobs Act (TCJA)** amended §162(f) to make this limitation broader, applying to **all payments** to government entities related to legal violations, unless they fall under the restitution/compliance exceptions.
- *Liu v. SEC*, 140 S. Ct. 1936 (2020) — SEC disgorgement may qualify as equitable relief, but for tax purposes, it's still generally considered a penalty unless it meets the statutory exceptions.

A – Application

- TP's $400,000 payment was **disgorgement of profits** from unlawful securities activity.
- This payment is **to a government agency** (SEC) **in relation to a violation of law** — triggering §162(f)(1)'s prohibition.
- To be deductible, it would have to qualify under §162(f)(2) as restitution or remediation and be **identified as such** in the settlement agreement or court order.
- The problem: SEC disgorgement generally is **not** treated as restitution for tax purposes unless explicitly labeled as such and intended to restore victims.
- If the settlement agreement did **not** specifically identify the payment as restitution to harmed investors, the deduction is disallowed.

C – Conclusion

No, TP cannot deduct the $400,000 disgorgement payment as a business expense because it was paid to a government entity in relation to a law violation, and it does not meet the §162(f)(2) restitution/compliance exception unless expressly identified as such in the settlement — which is not indicated in the facts.

<u>Question S-28 (2 points).</u> Describe the test used to determine whether an expenditure is an expense or a capital expenditure.

Test for Expense vs. Capital Expenditure

Rule:

- Under **IRC §162(a)** – A business may deduct "ordinary and necessary" expenses paid or incurred in carrying on a trade or business (generally short-term benefits).

- Under **IRC §263(a)** – No deduction is allowed for capital expenditures; instead, these costs must be capitalized and recovered through depreciation, amortization, or upon sale/disposition (long-term benefits).
- **Key Test** (from *INDOPCO, Inc. v. Commissioner*, 503 U.S. 79 (1992) and related regs):
    1. **Does the expenditure provide a benefit that extends substantially beyond the current tax year?**
    2. **Does it create or enhance a separate and distinct asset?**
    3. **Is it for acquisition, improvement, or restoration of property, or to adapt property to a new or different use?**

If **yes** to these questions → generally a **capital expenditure** under §263.
If the expenditure is recurring and only maintains operations without producing a long-term benefit → generally a **current deductible expense** under §162.

Example:

- Paying $1,000 to repaint a store's interior each year = deductible expense (maintenance).
- Paying $50,000 to add a new wing to the store = capital expenditure (improves and extends useful life).

Summary Answer:
An expenditure is a **capital expenditure** if it results in the acquisition, improvement, restoration, or adaptation of a property, or produces a benefit substantially beyond the current year; otherwise, it is a deductible current expense.

Question S-29 (2 points). TP owns Blackacre (unimproved property). TP held Blackacre as an investment for over five years. On June 1, 2022, TP sold Blackacre to his sister, B, for $100,000. At the time of the sale, the gross fair market value of Blackacre was $100,000 and TP's adjusted basis in Blackacre was $120,000. Blackacre was not encumbered. On December 1, 2022, B sold Blackacre to an unrelated party for $150,000 which was its gross fair market value on the date of that sale.

Relevant Rule

Losses Between Related Parties – IRC §267(a)(1)

- Losses from the sale or exchange of property between related parties (including **siblings**) are **not deductible**.
- However, under **§267(d)**, if the related-party transferee later sells the property at a gain, the gain is reduced (but not below zero) by the amount of the disallowed loss from the earlier related-party sale.

Basis Rules for Related-Party Loss Transactions – Treas. Reg. §1.267(d)-1

- The transferee's basis is **not** adjusted to reflect the disallowed loss; they take basis as normally determined (generally purchase price).
- The disallowed loss may offset **only** future gain from the sale of the same property.

Step 1 – Facts

- **TP to B Sale** (June 1, 2022)
    - TP's adjusted basis: $120,000
    - Sale price: $100,000 → TP's loss = **$20,000**
    - Loss disallowed under §267(a)(1) (siblings are related).
- **B's Basis in Blackacre**
    - Purchase price = $100,000 (no adjustment for TP's disallowed loss).

1. Quantify the amount of gain or loss recognized by B on the December 1 sale.

B sells to unrelated party for $150,000

- Amount realized: $150,000
- Basis: $100,000
- Initial gain = $50,000
- **§267(d) adjustment**: Gain reduced by TP's previously disallowed loss (**$20,000**), but not below zero.
- Recognized gain = $50,000 – $20,000 = **$30,000**.

Answer: $30,000 gain

2. Same facts except that B sold Blackacre for $60,000 (which was its gross fair market value for purposes of this question). Quantify the gain or loss recognized by B on the December 1 sale.

B sells to unrelated party for $60,000

- Amount realized: $60,000
- Basis: $100,000
- Loss = $40,000
- §267(d) applies **only** to reduce gain; it does **not** allow recovery of the disallowed loss to increase a loss.
- Therefore, the full $40,000 loss is recognized.

Answer: $40,000 loss