

Review Questions (Set No. 8)

The following facts apply to questions 1 through 5:

Emmet, an accrual method taxpayer, is an attorney who graduated from the University of Pittsburgh School of Law. Emmet is a solo practitioner who operates his law practice out of his home. Emmet owns a two-story house in the Beechview section of Pittsburgh, which he has filled with antiques. On the first floor of the house is Emmet's office, where he meets with clients, as well as a library with all of the law books that he uses in his practice and where he performs research. Also on the first floor are a kitchen and dining room. The second floor has three bedrooms. All of the rooms in the house are of approximately equal size. Aside from working as a lawyer, which takes up most of his time, Emmet enjoys entertaining friends. He often invites them over for dinner parties. He likes to have his friends join him in the kitchen while he cooks, then eat in the dining room, and finally retire to the library for after-dinner drinks and dessert.

1. Last year, Emmet had \$140,000 of gross income, \$60,000 of above-the-line deductions, \$5,000 of deductible home mortgage interest, and \$2,000 of deductible real estate taxes. Emmet also deducted as worthless a \$3,000 debt owed to him by a client. Last week, the client showed up in Emmet's office and told him that he wanted to repay the portion of his debt that he was able to, and gave Emmet his grandfather's pocket watch, which had been appraised by an antiques dealer at a value of \$1,000. What are the U.S. federal income tax consequences to Emmet of this course of events?
 - a. Emmet must include \$3,000 in his gross income under the tax benefit rule.
 - b. Emmet must include \$2,000 in his gross income under the tax benefit rule.
 - c. Emmet must include \$1,000 in his gross income under the tax benefit rule.
 - d. Emmet must include \$500 in his gross income under the tax benefit rule.
 - e. Emmet can exclude the value of the watch from his gross income.

2. To comply with recently-enacted state law requirements for maintaining his license to practice law, Emmet took 12 hours of continuing legal education courses this year. Emmet paid \$1,000 for these courses, which are provided by educational organizations that are approved by the Pennsylvania court system. Emmet also decided to enroll at the University of Pittsburgh to obtain a Master's degree in social work. He has found that being a lawyer involves a great deal of "people" skills, and he believes that social work education will help him better to deal with and advise his clients. He also plans to become a licensed social worker, which requires at least a Master's degree in social work and the passage of an examination administered by the state, so that he can add that credential to his resume and his business card. The tuition for Emmet's social work courses this year is \$10,000. What portion of these educational expenses may Emmet deduct for U.S. federal income tax purposes?
- a. None of the expenses.
 - b. The \$1,000 of continuing legal education expenses.
 - c. The \$1,000 of continuing legal education expenses and only the portion of the social work education expenses that Emmet can prove are directly related to his practice of law.
 - d. The \$10,000 of social work education expenses.
 - e. All of the expenses.

3. In calculating his tax liability, what portion of the expenses related to Emmet's home are deductible?
 - a. All of the expenses related to his home are deductible because he uses his home in his trade or business in order to produce income.
 - b. All of the home mortgage interest and real estate taxes and two-sevenths of the other general expenses related to Emmet's home are deductible.
 - c. All of the home mortgage interest and real estate taxes and one-seventh of the other general expenses related to Emmet's home are deductible.
 - d. Two-sevenths of the expenses related to Emmet's home, including the home mortgage interest and real estate taxes, are deductible.
 - e. One-seventh of the expenses related to Emmet's home, including the home mortgage interest and real estate taxes, are deductible.

4. Last Saturday night, Emmet held a dinner party for some of his friends and their spouses. A few of these friends are clients and Emmet hopes that a few others might send some business his way; however, Emmet has not worked on any matters for any of these friends recently and the discussion during the entire evening was about the group's planned summer vacation in Greece. To what extent may Emmet deduct the expenses of the dinner party for U.S. federal income tax purposes?
 - a. Emmet may fully deduct the expenses of the dinner party.
 - b. Emmet may deduct only one-half of the expenses of the dinner party.
 - c. Emmet may deduct all of the expenses attributable to the friends who are clients or may be clients, but not the expenses with respect to any of their spouses.
 - d. Emmet may deduct one-half of the expenses attributable to the friends who are clients or may be clients, but not the expenses with respect to any of their spouses.
 - e. None of the expenses for the dinner party are deductible.

5. A few months ago, Emmet renovated his kitchen. He had a contractor come in and completely gut the kitchen, install new cabinets, new appliances, and a new floor. The cost of the renovation was \$25,000. What portion of the renovation expenses are currently deductible by Emmet?
- a. All of the expenses are currently deductible under § 162.
 - b. All of the expenses are currently deductible, if Emmet makes a § 179 election.
 - c. One-seventh of the expenses are currently deductible.
 - d. Two-sevenths of the expenses are currently deductible.
 - e. None of the expenses are currently deductible.

The following facts apply to questions 6 and 7:

Buffy was a fifty-something sculptor who lived a reclusive life. She hated people—she did not like to talk to them, to hear them, or even to see them. To reduce her entanglements with society to an absolute minimum, Buffy rented a house on a large plot of land in a rural area. Buffy's closest neighbor was five miles away. Buffy paid a fair market rent for the house and the land under a long-term lease. She loved the house and the land so much that she expected to spend the rest of her days there. To facilitate her work, Buffy asked for permission from the landlord (and received his permission) to build a small studio behind the house where she could work. The studio was expected to have a useful life far beyond the time when Buffy's lease was set to expire and she would leave the land. The studio was completed within a few months after Buffy moved in to her new home, at a cost to Buffy of \$30,000. A few years later, Buffy passed away, the lease terminated, and the property was returned to the landlord. The landlord had the land appraised at that time, and it turned out that the studio had added \$40,000 to the value of the land.

6. What are the U.S. federal income tax consequences to the landlord of this course of events?
 - a. The landlord was required to include \$30,000 in his gross income at the time that the studio was completed.
 - b. Beginning in the year the studio was completed, the landlord was required to include the \$30,000 in his gross income ratably over the remainder of the lease term.
 - c. In the year the studio was completed, the landlord was required to include in his gross income the value that the studio was expected to have at the termination of the lease, discounted to present value.
 - d. The landlord was required to include \$40,000 in his gross income at the time that the lease terminated.
 - e. The landlord was not required to include anything in his gross income as a result of this course of events.

7. The landlord bought the house and property that Buffy rented in the early 1990s—several years before she rented it from him. The total price that he paid was \$25,000. Before Buffy moved in, the landlord used the property as his personal residence and made \$5,000 of improvements to the property. Buffy was his first renter, and, during the time that he rented the property to her, he took \$2,000 of depreciation deductions. If the landlord sells the property (i.e., the land, house, and studio) for \$100,000 shortly after Buffy’s death, what are his U.S. federal income tax consequences?
- a. The landlord will recognize a \$75,000 gain.
 - b. The landlord will recognize a \$72,000 gain.
 - c. The landlord will recognize a \$42,000 gain.
 - d. The landlord will recognize a \$32,000 gain.
 - e. The landlord will recognize neither a gain nor a loss.

8. Brian is the president of a corporation that has been doing very well under his direction. The board of directors of the corporation sets Brian's salary, which was \$500,000 for 2004. This salary was comparable to that of other company presidents who managed companies of similar size and that were engaged in similar businesses. Brian was doing so well that the board of directors decided to pay Brian a bonus to recognize his good work, to keep him happy, and to ensure that other companies would not be able to attract him away with offers of a higher salary. The board of directors authorized and paid Brian a \$50,000 bonus on December 24, 2004. In early January 2005, minority shareholders of the corporation learned of the bonus payment and protested. They argued that the board of directors had exceeded its authority in paying a \$50,000 bonus to Brian and demanded that Brian repay the bonus to the company. Brian refused to repay the bonus, maintaining that it was rightfully paid to him. What are the U.S. federal income tax consequences to Brian of this course of events?
- a. Brian is not required to include the \$50,000 bonus in his gross income in 2004, but will be required to include his \$500,000 of regular compensation.
 - b. Brian must include \$550,000 in gross income for his 2004 taxable year, but will be entitled to a \$50,000 deduction in his 2005 taxable year.
 - c. Brian must include \$550,000 in gross income for his 2004 taxable year, will be entitled to a \$50,000 deduction in his 2005 taxable year, and will benefit from the application of the rules of § 1341 in calculating his 2005 tax liability.
 - d. Brian must include \$550,000 in gross income for his 2004 taxable year.