

## Review Questions (last class)

1. Ed and Ramona McWashington are residents of Detroit. In April, Ramona gave birth to octuplets, four boys and four girls. The McWashington babies are the first surviving set of octuplets ever to be born in the United States. The parents can expect some large bills, in addition to the medical bills that are covered by their insurance. In an average day, experts predict the children will go through 96 diapers, 285 ounces of formula and 40 changes of clothes. Fortunately, the parents have been showered with donations and gift offers, including the following (dollar amounts are estimated fair market value):

- a. ALLSTATE Insurance Company has offered free car seats (\$300).
- b. Gerber is contributing a lifetime supply of its baby food (\$3,000).
- c. Toys-Я-U's is donating two "quad" strollers (\$400).
- d. Two local food stores are donating groceries for a year (\$1,500).
- e. The local energy company has agreed to cover heating and cooling bills for two years (\$1,600).
- f. Pampers will provide a lifetime supply of its diapers (\$4,000).
- g. A local communications company is providing seven years of free cable T.V. (\$2,100).
- h. Chevrolet is donating a 15 passenger Chevy Express van (\$30,000).
- i. Mazda Motor Co. has donated a three-year lease of a Miata sports coup, so that Ed can get away for a ride in the country when the going gets tough (\$7,000).
- j. The family's church is scheduling meal preparation, laundry, child care and transportation assistance, all at no cost to the McWashingtons (\$5,000).
- k. A local architect is offering free home design services (\$400).

Assume that the McWashingtons receive all of the of the above mentioned economic benefits. You are working as a law clerk for the law firm that has volunteered to give the McWashingtons free tax advice. What do you tell your clients?

2. Mr. Jade runs a small, unincorporated printing business. He files his tax returns on a calendar year basis. On March 1 of year 1, he purchased a new cutting machine for \$2,500 and put it into service immediately. The useful life of the cutting machine, under normal conditions, is expected to be 9 years. He estimates the salvage value of the machine to be \$500. Compute his allowable depreciation deduction for the cutting machine for year 1 (the first year of use) and year 2 (the second year of use).

3. Miss Carpet owns an unincorporated construction firm that keeps its book on the calendar year. In year 2, she dug the foundation of a new office building in Pontiac for her own business. In doing the work, she used her bulldozer, which she had purchased for \$100,000 and put in service on January 1 of year 1. For the rest of year 2, the bulldozer was used for repairing some city roads. The bulldozer had an estimated useful life for all relevant purposes of 10 years when

put in service and no salvage value. The office building has an estimated useful life of 40 years, and the city roads have useful lives of indeterminate length. What depreciation deduction can she take on the bulldozer for year 2? Show how to compute in theory but you do not need to do the actual computations. Assume that Miss Carpet used the half-year convention in computing depreciation in year 1.

4. Mother, who is rich and doting, has always worried terribly about Junior. After Junior graduated from dental school, Mother presented him with a new, high speed drill, costing \$4,000, and a year's subscription to *Dentist's Quarterly*, a periodical containing articles of interest to the dental profession. The cost of the subscription was \$40. Junior has set up a dental practice. He used the drill and reads the journal. Can Junior deduct the cost of the subscription as a business expense? Can he take depreciation deductions on the drill?

5. Jones owns a warehouse and the land surrounding it, which he rents to tenants. What tax consequences in the following situations: (a) Jones exchanges the land and warehouse for land and a gasoline station which he rents to an oil company. Jones' land is worth \$10,000, with a basis of \$2,000. The warehouse is worth \$25,000 with a basis of \$28,000. The land received is worth \$20,000 and the gas station is worth \$15,000. (b) The state condemns the land and warehouse. Jones uses the condemnation proceeds to buy land and erects a gas station, which he rents to an oil company.

6. Professor A teaches political science at the University of Massachusetts. He publishes a review in the *Massachusetts Political Science Quarterly* of a book, *The Political Thoughts of Emmanuel Kant*, by Professor B. In the review, Professor A accuses Professor B of "unacknowledged reliance" on the work of several German political thinkers. He substantiated the charge by extensive quotations from their published works. Professor B sues Professor A for libel, alleging damages of \$100,000. The University of Massachusetts pays \$20,000 in legal fees for attorneys defending Professor A in the libel suit. A jury awards Professor B damages of \$1 which Professor A pays. What are the tax consequences to Professor A?

7. Jake was found innocent of killing his former wife and is wife's in a criminal trial but was later found liable for damages for wrongful death in a civil action. As a result of the civil action, he owes millions of dollars to the family of the deceased. To avoid paying, he has tried to conceal his assets. He now plans to write a book about the killing and has a promised advance from the book publisher for \$3.5 million. In an attempt to avoid paying any of the advance to the family of his alleged victims, he has entered into a contract with his publisher under which the advance is to be paid to a friend of his living in Spain. What are the tax consequences of this arrangement?

8. GMG Studio, a producer of movies and television programs, wishes to acquire the services of Errol Tracey, a famous actor, for production of a movie on the life of Billy Sol Estes. Mr. Tracey owns a huge mansion, which he inherited from his father in 1957. At that time, its fair

market value was \$600,000. It had cost his father \$30,000 in 1933. Mr. Tracey wants to dispose of the mansion, because of the high operating costs. He has listed the property for \$500,000, but the only offer he has received was for \$350,000. GMG Studio offers to pay Mr. Tracey \$100,000 for his services in making the movie. Mr. Tracey refuses the offer, but he finally agrees to work for \$20,000, with a right to 10% of gross receipts from the film in excess of \$60 million. GMG also agrees to purchase the mansion for \$450,000. What tax results?