Tax
Mr. Sims

SAMPLE EXAMINATION QUESTIONS

Sample Essay Questions
(With original time recommendations)

All sample essays are exact versions of questions that appeared on past examinations. Time recommendations were as specified, except that in most instances students were not actually permitted to begin writing for a period that varied from 15-30 minutes, depending on the length of the question itself.

QUESTION
(*Recommended Time*: 75 Minutes)

Outel Corporation is a manufacturer of microprocessors used in personal computers. After a slow start-up period, during which it incurred substantial losses, it started becoming profitable in the late 1980's, producing income on which, because of net operating loss carryforwards from its early years of operation, it was required to pay no federal income tax. Since the beginning of 1991, however, it has been both profitable and taxable, producing net income of $3.85 billion over the three-year period, on which it paid federal income taxes at the rate of 35 percent, and accumulating total earnings after taxes of $2.5 billion ($2,500,000,000). It has adopted the practice of not declaring or paying any dividends, but instead of reinvesting all of its retained earnings in its rapidly growing business. As of the end of 1993, Outel had 50,000,000 shares of common stock outstanding, each of which had a per/share "book value," including both paid-in capital and retained earnings, of approximately $58, but which were trading on the New York Stock Exchange at a price of approximately $100 per share. At the very end of 1993, Outel split its stock 2/1, so that each holder of the stock received one new share for each share they already owned, after which Outel stock was selling at about $50.

During the first three quarters of 1994, Outel earned about $500,000,000. Then, a flaw was discovered in Outel's most recent line of high-speed microprocessors, the *Zentium*, which caused all *Zentium* processors to be unable to perform certain kinds of division operations correctly. At first Outel stonewalled the public, maintaining that the *Zentium* would only perform one out of every 27 billion computations incorrectly. But the Zentium was a public relations disaster. Finally, Outel caved in to public pressure, and recalled and replaced *all* 15 million *Zentium* processors it had already sold.

The pre-tax cost to Outel of this recall was $3.5 billion ($3,500,000,000), which completely wiped out Outel's earnings to that point in 1994, and produced a $3 billion operating loss in 1994. Outel's stock plummeted in the market, dropping to $30 per share. In an effort to buoy its sagging stock, Outel, for the first time in its corporate history, decided to pay a dividend to its shareholders. At the very end of 1994, it declared and paid in cash an extraordinary distribution of $10 per share to the holders of its outstanding common stock.

Bob, Carol, Ted and Alice are each owners of Outel common stock. Bob is an astute investor who acquired 500 shares of Outel at the time of its initial public offering of 50,000,000 shares, and who originally paid $8/share. Carol received 500 shares of Outel common stock in early 1993 as a gift from her mother, who had originally purchased the stock in 1991 for $80/share. Ted received 1,000 shares of Outel common stock in 1994 from the estate of his father, who had originally acquired the Outel stock for $10/share, and who had died when Outel was selling for $50/share. However, at the suggestion of a friend, Ted had purchased another 1,000 shares of Outel on November 20, 1994, at which time Outel was then selling for $30/share, and had then sold his original 1,000 shares of Outel, also for $30/share, on December 10, 1994. Alice first acquired Outel stock in late November 1994, purchasing 1,000 Outel shares for $30 each.

Please describe what you think are the probable federal income tax consequences (including any basis consequences) of these events to Outel, Bob, Carol, Ted, and Alice, for the years appropriate to each. For Outel you may assume that it was at all relevant times taxed (when appropriate) at a marginal rate of 35 percent. You should be especially careful, and explicit about any assumptions that you adopt, in dealing with the consequences to Outel.

QUESTION

(*Recommended Time*: 120 Minutes)

Nancy is a lawyer by training who for ten years had taught at a law school in Chicago. She is one of two children, is unmarried, lives modestly, and saves carefully. A good part of her savings are in the form of her account with her employer's retirement plan. Under that plan the university has made contributions each year equal to 10 percent of Nancy's salary during that year. None of the university's contributions were included in Nancy's gross income when they were made. In addition, Nancy has made additional contributions to the plan through "salary reduction," under which a portion of Nancy's regular salary is paid to the retirement plan instead of to her, and for that reason is also excluded from her income.

Nancy's father died many years ago, and in recent years her mother's health had been failing. Four years ago she had given Nancy 100 shares of Microsoft common stock (which at the end of 1991 were worth $100 a share). Those shares were part of a block of 500 shares of Microsoft, for which her mother originally paid the equivalent of $50 each.

At the end of 1991, Nancy's mother died. In accordance with her will, Nancy received approximately one-half her mother's estate, that share consisting of the remaining 400 shares of Microsoft, valued at $100 each, and her mother's home in Evanston, Illinois, which was valued for estate tax purposes at $450,000, and which was not subject to any outstanding mortgage. These assets were distributed to Nancy at the beginning of 1992.

Not at all certain what to do with the house, or her life, Nancy rented the house to a professor visiting at Northwestern during the entire year. For tax purposes she reported the rental income she received, and deducted the expenses she incurred (including $15,000 of depreciation). During the year her Microsoft stock appreciated in value to $150, and at the end of the year it split 2 for 1.

Taking stock of both her life and her financial position at the end of the year, Nancy decided it was time for a change. At the beginning of 1993, she resigned her position as a teacher. She contracted to purchase a small Inn, located in Boothbay Harbor, Maine, where Nancy's family had vacationed when she was young. The price specified in the contract of sale was $750,000, but the purchaser agreed to accept in satisfaction of the purchase price a package of consideration consisting of (1) all 1,000 of Nancy's shares of Microsoft stock (which, at the date of closing on that purchase, were worth a total of $100,000); (2) the house in Evanston; and (3) $150,000 cash. Nancy raised the cash by taking out a conventional mortgage loan, secured by a security interest in the Inn, in that amount. This exchange occurred on February 1, 1993.

To help make ends meet while she started out a new life as an innkeeper, Nancy elected (as permitted by the University) to treat her resignation as the equivalent of "retirement", and to commence receiving periodic payments from the proceeds in her retirement account. She received monthly payments amounting in all to $15,000 during 1993. This proved to be wise since, as a business, the Inn just broke even during 1993, and made only a modest profit in 1994.

In December 1994, a severe winter storm struck mid-coastal Maine, completely destroying Nancy's Inn. Eventually, in the middle of 1995, she received compensation (through insurance) of $800,000 by reason of this calamity. Reconsidering her life again, Nancy decided to return to Chicago. She sold the land on which the Inn had been situated to a purchaser who, as consideration for the purchase, agreed to pay Nancy $50,000 in cash, and to assume the outstanding mortgage loan. This sale was completed in June of 1995, and Nancy moved back to Chicago, her prior job, and her prior life.

You may assume that the rental of the house in Evanston in 1992 was properly reported for Federal income tax purposes and you need not address that matter. That aside, please discuss briefly the Federal income tax consequences to Nancy of the events that occurred during 1992, 1993, 1994 and 1995.

QUESTION

(*Recommended Time*: 40 Minutes)

[*Tricky!* - High Reward to Thought, Little to Writing]

Sandy and Sunshine were twins. They had gone through life pretty much on the same track, attending the same grammar schools, the same prep school (Emma Willard), and the same college (Yale). At that point, however, they began to go their separate ways. Sandy majored in political science while Sunshine studied drama. After graduation, Sandy went off to law school, while Sunshine went to New York to pursue an acting career.

Several years later, during Sandy's final year in law school, their parents decided to give them each $20,000 cash. Sandy used most of what she received to pay tuition for her final year in law school, and used the balance to pay for living expenses for the year. To defray the balance of her expenses she took out a $5,000 student loan.

Sunshine, on the other hand, had developed a hankering to move to Los Angeles to get into movies. In keeping with the image she wished to cultivate, she applied the $20,000 towards the purchase of a BMW 325is (a modest vehicle by L.A. standards). She, too, took out a loan ($10,000) to pay the balance of the purchase price. It cost Sunshine another $1,500 to purchase insurance for the car.

Sandy completed law school, and found a job with a law firm in the same city in which she had attended school. She enrolled in a bar review course (paying the usual outrageous fee), passed the examination, and started work. During her first year (1996) she repaid her outstanding student loan. For Sunshine, matters developed in a somewhat more unexpected way. Shortly after arriving in L.A., she had (exuberantly) been driving down Rodeo Drive, the sunroof open and the stereo cranked up, at an excessive rate of speed. A pedestrian (name of Garcia) started to cross Rodeo in the middle of the block, and Sunshine had to stand on the anti-lock brakes to (barely) keep from hitting him. When Garcia saw Sunshine bearing down on him, he had instinctively turned back towards the curb. In the process, he stumbled against a parked car and fell to the pavement, severely scraping his elbow and both knees.

Garcia's injuries were remedied with soap, water, antiseptic, and some bandages. Nevertheless he threaten to sue Sunshine for the pain and distress that these events had caused. Sunshine's insurer decided to settle the matter quickly, and agreed to pay Garcia $15,000. He, in turn, having in the course of settlement discussions taken something of a fancy to Sunshine, used a (small) part of the $15,000 to take her to dinner at the fanciest restaurant in L.A. He enjoyed himself so much that, by the end of the dinner, he felt regretful about having threatened to sue her in the first place,. So he used a (larger) part of the $15,000 to pay off Sunshine's outstanding automobile loan.

Please discuss briefly the impact of these events on the taxable income of (a) Sandy, (b) Sunshine and (c) Garcia.

QUESTION
(*Recommended Time*: 75 Minutes)

Frances Fisher was a software engineer employed by Macrosoft Corporation, a well-known and very profitable writer of software that had become fabulously successful with the advent of the personal computer. Macrosoft's founder and Chairman, Bill Grits, had decided early on that the way to attract and keep key personnel like Frances was to give them a piece of the action via stock options. Between 1981 and 1988, Macrosoft had simply granted key employees options to purchase Macrosoft common stock at the prevailing market price when the options were granted, exercisable at any time more than 18 months after the options were granted, provided that the option holder was still employed by Macrosoft at that time. In 1988, however, Macrosoft, after consulting with its tax advisors, adopted the "Macrosoft Incentive Stock Option Plan" ("MAISOP") an arrangement that was structured to comply with the requirements of section 422 of the Internal Revenue Code of 1986, and that covered all stock options granted by Macrosoft to its employees in 1989 and thereafter. Neither the MAISOPs nor the pre-1989 options were transferable by the holders (that is, the grantees of the options).

Frances had first joined Macrosoft in 1987, and as a result of her position and performance had during 1988 been granted options to purchase 1,000 shares of Macrosoft common stock at the then prevailing price of $50 per share. In 1989, Frances was granted MAISOP options to purchase another 1,000 shares of Macrosoft stock, at the (by then) prevailing market price of $100 per share. Thus, Frances held options to purchase a total of 2,000 shares of Macrosoft common stock.

On January 20, 1991, Frances exercised all her outstanding options to purchase Macrosoft stock, which on that date was selling for $200 per share. Thus, Frances paid a total of $150,000 for 2,000 shares of stock. To finance this purchase, Frances borrowed $150,000 from a bank, pledging as security for the loan 1,000 shares of her newly-acquired stock. Frances kept meticulous records: the shares pledged as security consisted of those acquired on exercise of the options granted in 1988. Frances retained the 1,000 shares acquired on exercise of the MAISOPs. In January of 1992, Macrosoft split its stock 2 for 1, as the result of which the per share market value declined to about $100, and Frances received certificates for an additional 2,000 shares. Of these, she deposited with the bank the certificates for the 1,000 shares received in respect of the shares already pledged.

In the summer of 1992, Frances remodelled the kitchen in her condominium apartment, at an agreed-upon cost of $50,000, which she paid for by transferring to the contractor 500 shares of Macrosoft common stock. During that year she gave another 500 shares of Macrosoft common stock to her mother. At the beginning of 1993, at a time when Macrosoft stock had declined in value to $75 per share, Frances transferred to the lender, in satisfaction of the outstanding principal balance on her loan, the 2,000 shares of Macrosoft stock pledged as security for that loan.

Please describe the Federal income tax consequences of these events to Macrosoft and Frances, in 1988-1991; to Frances, her mother, and the contractor, in 1992; and to Frances and the bank in 1993. Please be specific about the basis at which the various parties hold their Macrosoft common stock.

QUESTION (*Very Tricky!*)
(*Recommended Time*: 75 Minutes)

Stanley Kaplan was a "hot property" in the software business. He was one of the original programmers to work for Microsoft Corporation, and had done financially very well. He lived near Microsoft's headquarters in the vicinity of Seattle, Washington, and had also built a house on Puget Sound. Being, like all high-tech instant millionaires, very tax conscious, Stanley has operated this house as an investment, intending eventually to live there full-time only after he retires (at age 40, or so). In the interim, however, he has rented the house year-round.

It originally cost Stanley $330,000 to build the house on Puget Sound, and the house was subject to a mortgage loan with an outstanding principal balance of $200,000. During three years of rental operation, Stanley had taken a total of $30,000 in deductions for depreciation. About two years ago, Stanley had been offered $800,000 for the house. More recently, however, real estate values had subsided in the Seattle area, and a real estate broker friend of Stanley's had surmised that the house would currently fetch no more than $600,000.

Stanley was recently approached by I.B.M., who wanted to hire someone with Stanley's experience to help it build up its own software division, which has been doing poorly by comparison with Microsoft. One of the sticking points in the negotiations was Stanley's concern that he would have to move to the New York area, where I.B.M is headquartered, and would have to unload his house on Puget Sound at a loss. I.B.M. therefore offered to exchange it for a house on the Connecticut shore on Long Island Sound. After thinking things over, Stanley agreed to leave Microsoft to work for I.B.M.. As part of the agreement, he transferred the house to I.B.M on the following terms.

First, Stanley borrowed $200,000, the repayment of which was secured by a second mortgage on the house. Then, Stanley transferred the Puget Sound house to I.B.M.. In exchange, I.B.M transferred to Stanley a house in Connecticut, selected by Stanley, which I.B.M had purchased for $400,000 cash. (As with the Puget Sound house, Stanley did not intend to occupy the Connecticut house until he retired.) As part of this exchange, I.B.M assumed the obligation to repay all of Stanley's outstanding debt on the Puget Sound house.

(1) Please describe what the probable Federal income tax consequences would be to Stanley from this exchange. (Before doing so you would be well-advised both to think, and to read the relevant provisions of the statute, *carefully*.) At what basis does Stanley hold the Connecticut house?

(2) Assuming I.B.M were to sell the Puget Sound house for $600,000 shortly after having acquired it from Stanley, how do you think I.B.M properly should be taxed? (Here, you are mostly advised to *think* before you write.)

QUESTION
(*Recommended Time*: 75 Minutes)

Howard Hotshot was born in 1973, just at the dawn of the personal computer era. He grew up spending all his time fiddling with computers, as the result of which he became an extremely creative software writer and otherwise a totally miserable student. He dropped out of high school in 1989 to go to work for a startup software firm in Cambridge, then moved to work for Lotus (which had become a division of IBM), and in 1993 moved to another start-up firm, Hickory Networks, which specialized in developing networking storage software for the (then) nascent World Wide Web. Howard quickly became a key player in Hickory's software engineering group, and was compensated accordingly. He was given free pizza and unlimited amounts of Mountain Dew during the nights he worked late (basically, all the time); and he was paid a salary of $40,000 annually, enough to cover his rent, transportation to work, food (when he ate) and laundry (when he did it). The balance of his compensation took the form of options on Hickory common stock. During each year between 1994 and 1999 Howard was granted options to purchase an average of about 8,500 shares of HN stock, each exercisable for 10 years following the date on which they were granted, at exercise prices that depended on the market value of the stock when the various options were granted. As a result of these grants, by the end of 1999 Howard held unexercised options to purchase 50,000 Hickory Network shares at an average exercise price of $50/share. All were non-qualified stock options.

By the beginning of 2000, however, Howard felt as though it were time for him to try something completely different. He figured, moveover, that he was financially in a secure position, given his theretofore modest lifestyle and the value of the options that he held. So, in February of 2000, Howard borrowed $2,500,000 from a bank and used the proceeds to exercise all 50,000 Hickory Network stock options, as the result of which he acquired 50,000 shares of HN stock which, at the time of exercise, had a fair market value of $200/share.

Howard immediately sold all 50,000 shares in the market. With the proceeds, as required by his agreement with the bank, he repaid the $2,500,000 loan (together with interest of $1,700 for the five days the loan had been outstanding). Out of what was left, Howard, after consulting a tax advisor, invested $1,500,000 in a single-premium deferred annuity contract, written by John Hancock Life Insurance company, which guaranteed Howard interest of 5 percent annually for at least five years, and allowed him (if he wished) to withdraw all (or any part of) the earnings on the contract each year. He then purchased an historic house, refurbished to function as a bed and breakfast inn, overlooking the water in the town of Nantucket, for which he agreed to pay $4 million. Of the purchase price, $1 million was financed by a conventional loan, made by a local Nantucket Bank, secured by a first mortgage lien on the Inn; the balance Howard paid from the proceeds of his sale of the Hickory stock. As a condition of making the loan the bank required Howard to have the property appraised, and required him to carry at least $1 million of hazard insurance. (The appraisal put the value of the property at $4.1 million, $500,000 of which it attributed to the underlying land.)

Howard closed on his purchase of the Inn in April 2000, and immediately moved to Nantucket to operate the Inn (which he renamed "Howard's Inn") as a sole proprietor. He heaved a sigh of relief at what he had done as he watched the stock market (and Hickory Networks stock) decline precipitously during 2000 and 2001. During the next two years Howard operated the Inn on a breakeven basis, earning no profit and sustaining no loss for tax purposes, after deducting all his expenses (including depreciation of the structure). Howard lived in and spent virtually all his time operating the Inn, so his living expenses were modest, and he was not obligated to withdraw any money from his deferred annuity.

In July, 2002, a Nor'easter descended on New England, striking Cape Cod and Nantucket Sound with special force. Howard's Inn was totally destroyed. Fortunately, however, advance warnings of the ferocity of the impending storm had led to Nantucket's being evacuated, as the result of which nobody was injured. A competent appraiser put the value of the Inn immediately before the damage at $5 million, and its value after the destruction at $1 million. Howard collected $1 million from the insurer and sat back to consider his options. For the balance of 2002 he continued to make payments on the mortgage, and spent $10,000 to have the wreckage cleaned up.

In early 2003, as real property values on Nantucket continued to rise, Howard was offered $2 million for his land, just as it then was. After reflecting on the matter Howard decided to accept. He transferred the land to the purchaser, subject to the existing $1 million bank loan, receiving $1 million cash in return.

Please discuss the Federal income tax consequences of these events to (a) Hickory Networks, and (b) Howard. (c) At what basis does the purchase hold Howard's (former) Inn?

Sample Multiple Choice Questions
(Typically 30-35 questions in Two Hours)

> *The following questions will familiarize you with the TYPE of question you can expect to encounter on any multiple choice portion of the final examination. In particular, they should highlight for you the need to think a bit before marking down an answer. Most have actually appeared on prior exams. As judged by past performance, they are* ***above average*** *in difficulty.*

Facts for Questions 1-4

During 1992 Eugene, a young practicing lawyer, received the following from his father: some stock, worth $25,000, which his father had owned for many years; a deferred annuity contract, also worth $25,000, which has father had owned for many years; and $25,000 cash.

1. For tax purposes, the transfer of these assets to Eugene from his father in 1992 will probably produce:

(a) No income for Eugene but income for his father.
(b) Income for Eugene but no income for his father.
(c) Income for both Eugene and his father.
(d) No income for Eugene or his father.
(e) None of the above.

Q2. Immediately after he received these assets from his father, Eugene decided to use \$10,000 of what he had received to purchase a new car. The way for Eugene to do this that would probably minimize the Federal income tax consequences to him would be to:

(a) Withdraw \$10,000 from the annuity contract.
(b) Use \$10,000 of the cash.
(c) Either withdraw \$10,000 from the annuity contract or use \$10,000 of the cash.
(d) Sell \$10,000 worth of stock.
(e) None of the above.

Q3. Eugene decides not to buy a car in 1992. Instead, he holds on to the stock and the annuity contract and puts all of the cash into a bank account. By the beginning of 1994, the stock and the annuity contract each is worth \$27,500, and the balance in the bank account has likewise grown to \$27,500. In 1994 Eugene decides to spend \$10,000 to buy the car. The way for Eugene to do this that would probably minimize the Federal income tax consequences to him would be to:

(a) Withdraw \$10,000 from the annuity contract.
(b) Withdraw \$10,000 from the bank account.
(c) Either withdraw \$10,000 from the annuity contract or withdraw \$10,000 from the bank account.
(d) Sell \$10,000 worth of stock.
(e) None of the above.

Q4. Eugene decides, instead of purchasing a car, to contribute \$5,000 to Boston University School of Law. The most advantageous way for Eugene to do so would probably be to

(a) Withdraw \$5,000 from the annuity contract and contribute it to BUSL.
(b) Withdraw \$5,000 from the bank account and contribute it to BUSL.
(c) Sell \$5,000 of the stock and contribute it to BUSL.
(d) Give \$5,000 worth of stock to BUSL.
(e) None of the above.

Answers

Q1. Under a 1986 amendment to I.R.C. § 72, the transfer of a deferred annuity contract by gift is taxed to the transferor, in an amount equal to the excess of the contract's "cash surrender value" over the transferor's "investment in the contract." By the same token, the donee's "investment in the contract" after the transfer is "stepped up" to its cash surrender value. Thus, the answer to *Q1* is "(a)".

Q2. Best answer here is "(c)". Since Eugene's "investment in the contract" is its current cash surrender value, there are no tax consequences from *either* withdrawing money from the bank *or* from the annuity contract. As to the stock, however, Eugene takes a "transferred" basis, and would probably be taxed on some gain, since his father's basis in the stock -- which his father had owned "for many years" -- was probably less than $25,000.

Q3. Best answer is now "(b)". Since time has passed since Eugene received the annuity contract, its cash value is now in excess of Eugene's $25,000 "investment in" the contract. Hence, under I.R.C. § 72(e), a withdrawal from the contract, like a sale of part of the stock, would produce taxable income or gain. In contrast, any interest credited to the bank account in which Eugene had deposited the $25,000 received by gift would already have been taxed to Eugene, so that a withdrawal from that account would have no further consequences.

Q4. (d). Since the stock if sold would probably produce long-term capital gain the amount of the deduction is not affected by § 170(e) and the most advantageous way to make the contribution would be in stock: fair market value deduction, no tax on the appreciation.

> I cannot now honestly recall if the questions below ever actually appeared on an examination. They may have simply been written as specimens. In any event, if you compare them with the last of the essay questions above, you will see that they to some extent deal with the same sorts of issues as it does.

Facts for Questions 5-9

A agreed to purchase from B, for $325,000, a house that B had acquired ten years earlier for $125,000. A promptly went to a local bank and secured its agreement to extend to A, in connection with this purchase, a $200,000 loan secured by a first mortgage on the house. That loan bore interest at the then prevailing market rate of 10 percent, and was repayable over thirty years in level monthly installments of principal and interest. When this sale was consummated, A thus paid $125,000 in cash and borrowed $200,000, while B received $325,000 for the house. Two months later, A took out a "Home Equity" line of credit of $25,000 to acquire new furniture for the house.

One year later, A's employer (E) decided to transfer A from Washington to New York. At that time, interest rates had risen to nearly 15 percent and housing prices in A's neighborhood had in general not significantly appreciated. Nevertheless, to facilitate the transfer, E offered to purchase the house from A, agreeing to pay A $175,000 cash and to take title subject to the both the existing first mortgage and the $25,000 outstanding home equity loan. A agreed, this sale was concluded, and A departed for New York. Six months later, after trying without success to get a better price, E sold the house for $325,000 and repaid approximately $225,000 in outstanding loans.

5. The sale of the house to A will produce for B:

   (a) A realized gain, none of which will probably be taxed.
   (b) A realized gain, all of which will be taxed.
   (c) A realized gain, half of which will be taxed.
   (d) No realized gain.
   (e) None of the above.

6. Payments by A of principal and interest on the home mortgage and home equity loans will probably be:

   (a) Deductible as to interest but not as to repayments of principal.
   (b) Deductible as to the home mortgage but not as to the home equity loan.
   (c) Deductible in their entirety.
   (d) Non-deductible in their entirety.
   (e) None of the above.

7. The transfer of the house by A to E would probably produce for A:

   (a) A $75,000 gain.
   (b) A $175,000 gain.
   (c) Compensation of $75,000 and no gain.
   (d) Compensation of $175,000.
   (e) None of the above.

8. E's purchase and sale of the house will probably produce for E:

   (a) A $175,000 deduction.
   (b) A $75,000 deduction.
   (c) No tax benefit.
   (d) A $400,000 deduction and gain of $325,000.
   (e) None of the above.

9. Ignoring interest payments, E's repayments of the outstanding indebtedness on the house will probably produce for E:

   (a) A $25,000 deduction.
   (b) A $200,000 deduction.
   (c) A $225,000 deduction.

(d) None of the above.
(e) I'm sorry I ever took this course.

Best answers would be:

5-(a): On sale of the house, B realized a $200,000 gain, so (d) is wrong and (c) doesn't make a lot of sense, but since most gains from the sale of a residence are now excluded (up to a limit, not binding here), (a) is a better answer than (b).

6-(a): All the interest is deductible under sections 163(a) and (h), and repayments of principal are not deductible.

7-(c): This would be a tricky part. A purchased for $325,000 and A's amount *apparently* realized on the sale of the house is the sum of (a) the cash ($175,000), and (b) the loans assumed by E ($225,000), or a total of $400,000, which would produce a realized gain of $75,000. But the facts are fishy. They suggest that A's house hasn't *really* appreciated, and E *is* A's employer, so it's more plausible to conclude that E is attempting to pay A compensation of $75,000 disguised as profit on the sale of the house. Best answer is therefore that the $75,000 "profit" *is* compensation, and that A sold the house to E at no gain.

8-(b): E either purchased the house for $400,000 and sold it for $325,000, or (better) purchased *and* sold the house for $325,000 and simultaneously paid A compensation of $75,000, in either event in the ordinary course of E's trade or business. The first produces a $75,000 deductible loss; the second produces a $75,000 deduction for compensation and no gain or loss on the house. In either event, E gets a $75,000 deduction.

9-(d): Repayments of principal are not deductible.