Income Tax I Bogdanski Fall 2007 Exam No 6215

Question 1

The Chipco stock options are incentive stock options (ISOs) under IRC 422. The facts suggest that the treatment of these options including a bar of sale two years from grant and one year after transfer and a requirement that there be no "spread" at grant have been observed. Assuming Betty has no other Chipco stock options, these options are also under the $100k cap described in IRC 422(d). These options merit ISO treatment.

The receipt of ISOs is not taxable as gross income. The spread at exercise of ISOs is also not taxable as gross income. However, the "spread" of $3.50 a share at exercise constitutes an AMT preference under IRC 56(b)(3) of $35k that may cause Betty to be subject to the AMT. At the time of purchase, Betty gets a cost basis of her price paid, $30k.

While Betty did not cash the check until 2008, this income is properly recognized in 2007 for tax purposes. Despite being a cash method taxpayer, this check was made available to Betty without restriction, such that Betty could have deposited it in 2007. The "constructive receipt" rule governs when income is received. Under Reg. 1.451-2, this income, although not actually deposited, was set aside for Betty and made available for Betty upon request. Her receipt of the check in December constituted constructive receipt of the dividends for tax purposes. The $9k must be included as 2007 income. Under IRC 1(h), this income is taxed at the capital gains rate rather than as ordinary income. While not properly a capital gain, favorable tax treatment applies. Therefore, Betty can claim $9k of dividend income taxed at capital gain rates in 2007.

The transfer of the house subject to the pre-nuptial agreement is a nullity for tax purposes. Under IRC 1041(a), no gain or loss is recognized on a transfer to a spouse. Although the Farid-es-Sultaneh case makes clear that this applies only to spouses not fiancees, this transfer happened after Betty and Jason were married. As a pre-nuptial agreement, Betty had no legal right to the transfer prior to marriage. Accordingly, Betty recognized no income from the transfer for tax purposes. Betty gets the property with the exact same basis as Jason had under IRC 1041(b), $275k.

The payment of $12k for legal fees is an expense associated with the acquisition of property. Accordingly, this is a capital expense that adds to Betty's basis in the property. Betty's total basis at this point is $275k + $12k = $287k. Betty will, of course, not be able to deduct this as a current expense.

The fact that Betty's salary is based on income from patents is immaterial for tax purposes. While income from patents may receive special depreciation treatment, Betty's income is not itself a royalty, but simple income from wages. Betty's wages are ordinary income.

The mistake in Betty's paycheck falls under IRC 1341. It appeared in the prior year that Betty had an unrestricted right to the income, so this income was properly included in her gross income in the prior year under the "claim of right" doctrine. However, the return of the money falls under IRC 1341. Because the amount is more than $3k, Betty may elect to take either a deduction of $4k in the current year under IRC 1341(a)(4) or a credit for the amount of tax on the $4k improperly paid in the prior year under IRC 1341(a)(5), her choice. This deduction may be taken against her ordinary income in this year.