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**NORTHWESTERN SCHOOL OF LAW**

**LEWIS & CLARK COLLEGE**

Book <u>1</u> of _____ Books
Examination Number <u>7285</u>
Subject of Examination <u>Income Tax</u>
Date of Examination <u>5/1/02</u>

## **EXAMINATION BOOK**

### **Instructions**

1. Use a pen with black or blue ink.
2. Do not write in margins under any circumstances.
3. Complete identification data at top right corner of this book. Do not put your name on or in this book. Use your examination number only.
4. Start answer to each question at top of a fresh page unless instructed otherwise by the individual professor.
5. Write only on the front side of the pages in this book unless instructed otherwise by the individual professor. If you need more space, use an additional book(s). If you use additional book(s), complete items in identification space (top right corner) and write Book 2 of 2, etc., in space provided. Insert additional book(s) in book one before turning them in.
6. If you type your examination, use unruled paper. Put your examination number, subject of examination and date of examination on each page and on a cover sheet to be provided. Assemble in page order, place cover on top and staple (or otherwise secure).
7. Do not tear any pages out of this book under any circumstances.
8. Ability to follow instructions will be taken into consideration in grading examinations.
9. Place complete examination book(s) in envelope before sealing.

(1)

Rich has \$100,000 of ordinary income as an employee of his large corporate law firm. He will be taxed as single since he is divorced. His tax is \$14,625 plus 30% of the excess over \$67,750. Thus, his tax is \$24,315. He will get to take ~~with~~ a personal exemption of \$3,000, but will not get to take an exemption for his spouse (since he is divorced) or children (doesn't appear to have any). His personal exemption is not subject to phase out unless his income exceeds \$137,300 (he'll lose 2% of his exemption for every \$2,500 over that threshold amount). He may either take a standard deduction or itemize his ~~personal~~ deductions. His stock is income only if he sells it, and at which time the sale proceeds will either be a capital gain or a capital loss. <sup>Appreciation is not income.</sup> If he itemizes he will not be subject to the ~~overall limitations~~ <sup>reduction</sup> in deductions under §69 ~~unless~~ <sup>unless</sup> his income is over the applicable amount (\$137,300 for married filing jointly; not sure what it is for single). If it is over he will lose <sup>deduction equal to 3%</sup> of excess over adjusted gross income above the threshold amount. Rich doesn't appear to have any of the normal itemized deductions like home mortgage interest, so he would be stuck with the standard deduction, which is \$4,700 for single.

Rich appears, however, to have started a new career. ~~in~~

2001, he must report his ~~of~~ income from playing guitar at his neighbor's wedding. He is paid \$250, and under §60, he has gross income (ordinary income) — all gains, clearly ~~all~~ realized, regardless of source. He has a positive change in his wealth. When he is just playing for fun you could say he has imputed income — it relaxes him from the stress of his job and he doesn't have to pay for a massage — but the tax system doesn't recognize Rich's activity as income unless he gets paid for it (either by cash, property or return services).

During 2002, Rich's new "career" really takes off. He presumably wants to deduct all of his expenses, that he will call business expenses, against his income (total income — both from the law firm and from the activity). The tax system will let Rich deduct all ordinary and necessary expenses incurred in carrying on any trade or business, ~~but because he is~~ and if his music endeavor is a business he will get to get all actual expenses that fall into the definition as business expenses, above the line. Personal, family expenses are not deductible. As an individual, under 212, Rich can deduct all ordinary and necessary expenses paid for the production of income. To determine whether the money spent is in

or just a hobby,

the production of income, section 183 helps; but really, section 183 sends Rich either to 162 (ordinary business expenses) or 212 (expenses incurred for the production of income).

Rich hasn't ~~had~~ been playing music for very long, only 1 year so far, so the rebuttable presumption (make profit 3 out of 5 years) doesn't help. But, Rich may still get to deduct if he can show that he has a purpose of earning a profit. Congress created §183 to help combat utilizing loss to offset other income (like Rich's salary + bonuses). So, if Rich can show this is not just a hobby, and is for profit, he can deduct his losses from his gross income. If, however, it looks like just a hobby, he can only deduct his losses against his gains. (all of this income/loss is ordinary as there is no sale or exchange of a capital asset - just personal services). Reg. 1.183(2) has some factors that help figure out if this is a hobby or a for-profit activity. The amount of time he spends is minimal in the beginning of the year, and only weekends after September. He does, however, conduct himself in a business-like manner - has cards, keeps a log of expenses; keeps separate books. His expertise is debatable - he's

been playing since childhood, played w/ a band in college and high school, but his friend tells him to keep his day job. Plus, he gets a great deal of pleasure out of playing - it eases his stress. Finally, the last factor is whether his assets are likely to appreciate. Perhaps his guitars will appreciate, but nothing else. All-in-all it is a toss-up and will mainly depend on his intent. Nickerson was deemed to be doing farming for profit, and he was at the farm on weekends, only every few weeks.

Even if Rick can deduct his expenses against his gross income, he will not be entitled to take the deductions he has marked in his ~~log~~ log. Plus, those that he does get may be capital expenditures, in which case he wouldn't get to deduct them in 2002 anyway. First, the voice lessons are like an education expense, and the IRS considers education expenses to be ~~a~~ personal expenses generally. The voice lessons can be deductible if they either 1) help Rick maintain or improve skills required by an individual in his trade or business, or 2) are required by his present job in order to maintain it. Potentially the voice lessons would comply with 1) → maintain or improve skills required for

his business. However, he takes them before he really starts to play <sup>a lot</sup>, which makes them seem like he is trying to qualify for a new trade. Although what Rich is doing is not as dramatic as a cop taking philosophy, perhaps a <sup>(or IRS)</sup> court wouldn't buy Rich taking voice lessons as a business expense deduction (plus has to be ordinary/necessary → maybe more like capital expenditure, an improvement of his voice, or not something that most guitar players need). Second, the business cards are probably fine - certainly an ordinary and necessary expense.

Don't think can capitalize this expenditure - more like advertising which is considered a current expense. The mileage is not deductible as a business expense - just commuting to and from work. If he is traveling outside his regular commute (maybe from show to show), Rich could deduct it as a business expense. Home is defined as principal place of business so perhaps if Rich could show that he has a home office at his home maybe he could deduct the travel expense. But, Rich probably doesn't have a home office - has to be his principal

became not undergraduate graduate - out of voice teacher's house

place of business where he spends a lot of time; most important activity. For all intents and purposes, Rich is still an employee at his law firm, and his office is there. If ~~it~~ mileage did qualify, he is taking the right mileage rate (36.54 per mile) that the IRS publishes. Rich probably wouldn't have any credits - no children, doesn't qualify for Hope Credit or ~~that~~ Lifetime Learning Credit, or the Earned Income Tax Credit. The final question is whether Rich gets to deduct for his guitars as a business deduction, and the strings that go along with them. Rich is not subject to Unicap, so he doesn't have to show all of his business expenses into his basis in the guitars - not producing real or tangible personal property. But he is spending money on his guitars now ~~that~~ for a profit motive (allegedly) that will provide him with a long-term benefit. ~~The~~ § 263 wants the taxpayer to ~~set up~~ <sup>use</sup> depreciation over the life of the asset which will more accurately reflect the taxpayer's true income for each year. I don't know if ~~guitars are class~~ <sup>is</sup> Because guitars have a class life of 12 years, he ~~may~~ <sup>is</sup> be required

2 to depreciate the expense of the guitars over their lives. The strings may be included if they are improvements, rather than repairs. But repair strings are probably repairs - incidental things that don't materially increase the value or extend the life of the guitar.

2 Thus, Rich may deduct the \$210 spent in strings as ordinary business expenses. The guitars are assets held for production of income, so they are depreciable. Rich may use the ACRS or straight-line ~~depr~~ method - he will want ACRS.

His adjusted basis in the guitars is a cost basis of \$7,000, divided by the total number of years in the period - ~~6~~, multiplied by 2 (for the 200% declining balance) is \$2,333.

But, because we must use the half year convention (assume all property bought in middle of year) he will only get to depreciate (and deduct) \$1,166 in the first year of ownership. His main basis return will be in the second year. If in the end he gets all his business expense deductions (plus his depreciation of the guitars) he will have \$2,166 of loss and \$1,200 of gain. He may get to take the loss from his ordinary income if this is a profit activity, otherwise he just gets to take 1300 of losses against his gains.



②

This is a non-recognition event for Sally. Sally, Bertha and Oliver have entered into a 1031 three-way like-kind exchange, and have done it properly. Sally is transferring Blackacre to Bertha and in exchange is getting an apartment building. Both the property she is exchanging and the property she is getting and holding she has, or will, used exclusively for productive use in a trade or business or for investment. Like-kind is very broadly defined for real estate; she is getting undeveloped real estate for an apartment, and that is fine. It is immaterial for the purposes of 1031. It is important that Sally never touched any money — otherwise it would ruin the exchange. It doesn't matter that Bertha is a real estate dealer. ~~But~~ Sally's basis in the ~~new~~ <sup>old</sup> property would become her basis in the new, if there were no "boot" involved. Sally's "boot" is the FMV of the property + net liability assumed. Her amount realized is [FMV of like-kind property received + boot received] - [Basis in like-kind property given up + boot paid]. Her gain recognized is the amount realized up to the value of the boot received (including debt relief). So, her amount realized is \$100,000. Her boot is \$25,000. Her ~~gain in the like-kind~~ <sup>gain in the like-kind</sup> property received is gain recognized is the amount realized up to the value of the boot — \$25,000

The timing is fine - like-kind property must be identified w/in 45 days and received w/in 180 days - here just 2 weeks.

2 Thus, her basis in the like-kind property is \$100,000. If there were no boot, there would be no gain recognized, even though there is gain realized (under Cottage Savings → hair trigger realization, exchanging property that is different enough to be realizing event). Thus, Sally only has to pay tax on \$25,000 of gain recognized.

Capital gain because sale or exchange of capital asset - real estate held for investment. ~~Best of both worlds → Capital gain / Ordinary loss~~

Sally has no income ~~for~~ from the compensatory damages awarded to her as a result of her physical personal injury. Under §104, gross income does not include the amount of any damages received on account of a personal physical injury. The damages are for a tort claim. There appears to be no emotional distress attached, although Sally could collect for it if it were ~~attached~~ <sup>a by product</sup> of her physical injury, or if she needed to see a psychiatrist and needs to pay ~~for~~ <sup>that</sup> as medical expense (regardless of whether physical injury for the latter). Not sure what all the compensatory damages cover, but ok if for medical expenses, lost wages (although that makes Sally better off than other wage earners), lost of consortium. As for the damage to her windupping gear, the payment may be income because may see as return of her basis.

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~~But~~ plus more - The FMV of her property. But, under 1033, the payment for her property

is a non-recognition of gain as a result of destruction. She has 2 years w/in which to replace it. She must invest all of the money in like-kind use, which she did. If she hadn't she would be treated as having loot and taxed on the amount of gain. Called "rollover": If were income, w/s ordinary.

Finally, she pays her atty fees for bringing lawsuit - she probably wants to try to deduct the fees. Because she was the plaintiff, we need to look at the nature of the recovery to see if it is deductible. Will the recovery be gross income? NO → personal physical injury is excluded

from gross income, and the payment for her property is rolled over into new property and is not income. Even if she did get to deduct, it is a miscellaneous deduction - she only gets to deduct <sup>if the expense is over</sup> 2% of her AGI. If this were a contingency fee, she would be paying tax on her attorney's payment, and her attorney would be paying tax as income.