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**NORTHWESTERN SCHOOL OF LAW**  
**LEWIS & CLARK COLLEGE**

Book	<u>1</u>	of	<u>2</u>	Books
Examination Number	<u>7872</u>			
Subject of Examination	<u>Income Tax</u>			
Date of Examination	<u>5-1-02</u>			

## **EXAMINATION BOOK**

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## Question 1

R has earned \$1,300<sup>00</sup> of ordinary income for his shows in 2002. ~~Because~~ Because of annual accounting and R's likely use of the cash method all \$1,300<sup>00</sup> will be included in R's 2002 annual return as gross income.

The \$1,300 is taxable to R because it is income realized from his services.

R's biggest question is whether his performances will be considered part of carrying on any trade or business or an activity not engaged in for profit (aka hobby). To be considered a business, R needs to show that his primary purpose was to make a profit. R's expectations need only be honest, + need not be realistic or even reasonable. At first, R's performing was clearly a hobby, as he did it to relax at home after work + on the weekends. ~~His~~ His motive began to change around Nov. 2001, when he got paid for the first time. ~~After~~ Soon after in 2002 R began taking voice lessons, which is some circumstantial evidence of a profit purpose, but probably not enough.

to turn from a hobby without other evidence like his statements of intention. ~~By mid-summer~~ or evidence when he started trying to book more shows. By mid-summer, R's hobby is looking more like a business as he begins to play more regularly, bringing in money, & buying the guitars. By Sept, R's purpose is now fairly strongly one of profit. He states his intentions to his co-workers & lets them know his weekends will be full with music. R realizes that he won't make a profit in 2002, but he need only seek a future profit; a present one is not required. His "expert" friend is correct in saying making money is tough & R had better keep his day job, but this just goes to R's reasonableness and ~~it~~ does not change the fact he plans on becoming a rock star with huge future profits.

~~As General~~ It will be R's burden to show he is not engaged in a hobby to take full ~~advantage~~ advantage of possible deductions and he will have no benefit of a presumption because he has not made a profit in 3 of the

last 5 years.

2 If the court finds this to be a hobby throughout 2002 (which is unlikely), R can only deduct expenses to the extent of his hobby gains and ~~not against his other income~~; thus a max of \$1,300. With \$8,000 in expenses in connection with the hobby, he would easily be able to offset his \$1,300 gain and thus ~~he~~ would not pay taxes on the \$1,300 in 2002. The remaining losses would be non-deductible personal expenses in 2002.

Assuming R can prove he had a profit motive, his outlays become either deductible business expenses or capital expenditures.

The \$600 for voice lessons may still only be deductible as against hobby income because the evidence is weak he was seeking profit at the time. If it is found to be a ~~part~~ part of his business, he will likely not get an immediate deduction because the lessons will produce a long-term benefit, one that will last throughout his career. Thus,

He must capitalize it and depreciate it over 15 years as an intangible

2 it is education and he does not fall within Reg. 1.162-5 because ~~he doesn't~~ the lessons do not maintain or improve skills required by his legal job nor are they required. So they would still be non-deductible as a personal expense.

2 The 2 guitars are a capital exp expenditure because they produce long-term benefit to R. He will use them for well more than a year and they will contribute to his income throughout their life. As capital exp expenditures that wear out, R can deduct their cost. With a class life of 12, they are treated as 7 year property. R could elect under §179 to deduct the full amount now (up to \$24,000) or he could use the straight-line method, which would be ~~\$500~~ deduction in 2002 + \$1,000 for the following 6 years. Lastly he could deduct (under double declining method) ~~\$1,000~~ in 2002.  $\frac{2,000 - 1,000}{2}$  for 1/2 year convention. The business cards are already

because of 1/2 year convention

#500

an ordinary & necessary business expense. Thus he may deduct the \$60 as a business expense.

R has a basis in the guitars of \$7,000 when he buys them. This is reduced by the amount of depreciation he takes in 2002, depending on the method. A capital loss.

\$60  
ordinary  
loss

2

→ The business cards are an ordinary & necessary business expense. They don't produce long term benefit (because they are like advertising) so R gets an immediate deduction in 2002 of \$60.00. R's basis is \$60 - his cost.

\$210  
ordinary  
loss

2

→ The strings are also deductible as a business expense in 2002. They are merely repairs to the guitars & do not add to their productive lives, so the strings do not affect the basis.

R need not capitalize the cards, or strings because, as an artist, he is not subject to UNICAP.

Commuting expenses are generally not deductible and do not appear to be here. Thus they are probably a non-deductible personal expense in 2002.

At Case R could deduct them however if he uses a room in his home exclusively for his business (i.e., for rehearsals). If he does so, his trips from the office to the shows and directly back would be deductible as a business expense. He could deduct his actual costs in 2002 or use the IRS mileage rates.

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## Question 2

S is engaged in a 3 way exchange to take advantage of the non-recognition benefits of § 1031. Because S is holding Blackacre for investment she may exchange it for another "like-kind" property that she will use for either investment or in a trade or business.

All real estate is considered like all other real estate, so it's OK to exchange the undeveloped land for the apartment and Whiteacre. S is not a real estate dealer (and the fact that B is does not destroy the 1031 benefit for S). Also, S never touches any money by receiving any cash.

In effect, S is exchanging Blackacre for Whiteacre. S's amount received = the \$175,000 FMV of Whiteacre plus \$25,000 for her release from the mortgage: a total of \$200,000. Her basis was \$100,000 so her realized gain is \$100,000. She will only recognize \$25,000, which is the gain to the extent of the boot (the \$25,000 mortgage). Her ~~new~~ basis in Whiteacre is  $100,000 - 25,000 + 25,000 =$  \$100,000. Thus she has a capital gain in 2002 in the amount of \$25,000

because assumed liabilities are treated like money received.

which she is doing by renting out the apartment

which is taxable at preferential rates in § 1(h) - either 20% or 10%. The fact that ~~the~~ S transferred Blackacre 2 weeks before she received Whiteacre does not alter the result because S has a 45-day period in which to select the property and has 6 months to close.

It appears that all of the \$25,000 will be excluded from S's income in 2002. ~~Under § 104(a)(2) S benefits from~~ § 104(a)(2) because she recovered damages ~~as a result of~~ ~~whiteacre~~ suffering physical injury in a tort cause of action while suffering from physical injury. Thus, ~~the money is excluded~~ any portion attributed to the compensatory damages is excluded in 2002. If not for the physical injury, S would have had to report it as ordinary income in 2002. ~~The portion of~~ In this ~~money~~ case, it does not matter what she does with the money, it doesn't affect the result. ~~The portion of damages going to the casualty loss (damaged equipment) is also excluded as part of the judgment.~~

~~Order 1033,~~

The damages going toward the damage equipment is part of the overall judgement so they too are excludable. If there had been punitive they would have been taxed as ordinary income in 2002.

S can't take a casualty loss because she has been reimbursed for her losses to the equipment. Even if S wasn't reimbursed, she ~~was~~ would have had to have shown losses in excess of 10% of her AGI in 2002.

The money she spent on the lawyer is a non-deductible personal expense in 2002. The claim did not arise out of her business (no connection at all).

Because her damages were excludable, she does not get a deduction. If she could have deducted them, S would be subject to a 2% floor, which she might reach since her fees were "sizeable."