Income Tax I Exam – Professor Bodanski
Spring 2002
Exam # 7216

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Essay 1:

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Rich earns in excess of $100,000 a year. That is ordinary income that will be part of his gross income for the year. The $250 gig he gets in November 2001 is ordinary income in 20001 (although that is not asked).

Rich invested much more into his music career than he has received from it (financially) in 2002. Bottom line: he has lost $6700. Rich will want to deduct all $8000 of expenditures for his career as a business expense. The IRS will claim that this is only a hobby for him; that he is actually a lawyer and that this is for his entertainment. If the IRS were correct in that argument, Rich would only be able to deduct losses on the hobby up to the amount he gained on the hobby. However, if he can show that he actually intended the activity to be for profit, then he may deduct the losses against gross income (above the line as a business expense – cost of making $).

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Just like in Nickerson, the facts here point to an intention to make profit. Rich's comment that he intends to quit law and become a rock star, coupled with the fact that he has spent $ to print business cards identifying himself as a musician, and that he is starting to get regular gigs, should be sufficient evidence of intent to make a profit. The amount of time he spends, his business like manner of conducting himself as a musician, and his gaining success of attaining gigs, should all show this. The fact that he only has one bank account might disprove his intent to start a business and might be evidence that this is only a hobby. His expertise in the industry might be contrary proof as well. However, he is just starting in the biz, and just like Nickerson, his expertise will grow as he learns about the business. I believe this will not be a hobby under § 183.

3

I also believe this is not passive income under § 469. If he spends "every evening after work, and several hours each weekend," that will surely be over 500 hours a year (assuming

conservative #'s of 1 hour each weekday and a total of 5 hours a weekend = 520). Thus, reg 1.469-5T(a) will say this is not a passive activity. Many other possible satisfactions under this reg would also conclude that his activity as a musician is not passive. (i.e., 100 hrs/yr, and no one else has greater participation, and many more).

The guitars will be a capital expenditure, since they will surely last more than a year. When one has current outlays of money with long term benefits, he will be required to depreciate the cost of the purchased asset over the useful life of the asset so as to accurately reflect his true income for each year by matching an expense with the income to which it relates. Section 168 says specifically what the deduction life is for tangible property. It is no longer based on the actual depreciation or life of the asset. The facts presented say a guitar has a class life of 3 yrs. 168(e)(1) says that property with a class life of 4 yrs or less shall be treated as three yr property. Thus, under the straight-line method, Rich would divide the $7000 cost of the guitars over the life of three years in order to depreciate them to a $0 value. That would give him a deduction of approx: $2333.34/yr. However, he will want to use the Accelerated Cost Recovery System to depreciate the asset quicker. That means he can take a deduction of 200% of what he can under the straight-line method, totaling 66.66% instead of 33.33%. In the first year, due to the half-year convention, he will only get half that deduction. SO, in 2002, his depreciation deduction for the guitars will be ½ of 66.66% of $7000, equaling: $2333.34.

The strings will be considered a current expense and the costs of them will not be depreciated. The business cards: I suppose it depends how long those cards are in use. I would say at the rate he is going to be trying to get his name out in Manhattan, he will go through them quickly and they will be a current expense as well.

The vocal lessons are a tough question. The vocal instructor could be considered an employee of his, in which case the employee / instructor, will have to include the lesson amounts as income (which (s)he will have to do anyway), and Rich can deduct the whole cost as compensation cost. If it is not compensation to an employee it could be an expense to a contractor and the value of the services received could be considered a capital expense because the benefit could last a very long time (like the Encyclopedia Britannica information or the workforce building the damn in Idaho power). However, I believe that lessons are something he will take continuously, and he may learn new lessons that negate the old lessons very soon. So the lessons will be most likely a current expense.

Transportation to work is not deductible unless it fits under § 162. This will not meet any type of business deduction for him and the $120 will have to come out of the business expenses for the year.

All of the expenses mentioned above can be taken above the line as the deductions were business deductions – costs of making income. The guitars will be capital expenses and will have to be depreciated over time. The remainder are current expenses and the deductions should be taken immediately. He will not be able to deduct the costs of the mileage. The money he made playing is ordinary income and will be added to his lawyer income in determining his AGI, taxable income and tax liability. He has no gains as he sold nothing.

Side notes: Rich is divorced. Chances are a NY atty at the age of 37 is paying alimony. Alimony is deductible to him and income to his Ex. Any property settlement he gave her will be a non-taxable event as 1041 says that any transfers b/w spouses or incident to divorce shall be non-recognized transactions. The Ex will get Rich's carry over basis. Also, the tutor had a home office. Since the home office is most likely the place of business used by the tutor's

patients/customers/clients in meeting and doing business, and also most likely his/her principle place of trade/business, under § 280, the tutor will get a deduction for expenses related to the home office. This is similar to an opera singer who is allowed a practice room.

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ESSAY 2:

A. Three Corner Like Kind Exchange

Bertha bought Oliver's building for 175K. Oliver is now out of the picture and sitting pretty, no longer dealing with tenants. Oliver is taxed on this income (to the amt of his capital gains). Now Sally and Bertha are going to enter into an exchange. Bertha's basis in the apt building is 175. She now wants to trade the building and some boot (the mortgage assumption of 25K) for Sally's place. Because she is a real estate dealer, she will not qualify for any tax deferral under §1031 or any other non-recognition statute. Sally however, will get a good deal out of this.

3 Sally will be giving up her investment property with a FMV of 200K, in which she has a 100K basis. She will be able to make this exchange without having to recognize the 100K gain 1 she gets in the deal. She will have to recognize the 25K boot she receives as income. The break 2 down will be thus:

Sally's amount realized will =
[FMV of Like-Kind Property Received +Boot Received (cash, property, net debt relief)] –
[Basis in Like-Kind Property Given Up + Boot Paid (cash, property, net debt assumed)]

[175K + 25K] – [100K + 0] = 100K.

Sally's gain recognized will =
Amount realized up to the value of boot received (including net debt relief), which in this case is 25K.

Sally's basis in the like-kind property received will =
[Adj. Basis in Like-Kind Property Given Up + Boot Paid Out (cash, property and net debt assumed)] –
Cash received (including debt relief) +
2 Gain Recognized

100K + 0
- 25K
+ 25K
= 100K

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So although Sally now has to recognize 25K of income (which is capital income b/c it is capital gains from sale of investment property), she was able to defer taxes on the majority of the exchange and now has revenue generating property with the same basis as her old property (which did not generate income – other than capital gains). Any income she generates as a landlord now from the building in the future will be ordinary income.

B. Damages Suit

Sally has rec'd 25K in damages. The first question in determining if damages are taxable income is to ask what the damages replace. If it is income, then it is income. If a gift, then it is a gift. Etc, etc. One exception to this is the §104 Personal Injury Recovery. Under this statute, even lost wages, which would normally be income and otherwise taxable are not taxable if due to a physical injury. The part of the damages that represents her physical personal injury, according to this statute will not be taxable income. As for the damages on her windsurfing gear, 1033, is another non-recognition statute, which allows one to defer gains received in an involuntary conversion of property, such as in Sally's case. Since she used the money to replace the gear immediately, she has not expired the section 1033 deferral. Under 1033, she must reinvest the entire amount received as damages for the property in like-kind property, or the amount she does not invest will be taxed as income up to the amount of gain on the destroyed windsurfer. It does not matter that we do not know how much damages went towards the damaged gear, since she put all the money into new gear. Sally's basis in the new property is:

the basis in the destroyed property +
additional cash or debt invested into the new property +
any gain recognized on the involuntary transaction –
proceeds not invested in similar use property.

As far as we know, she did not experience a loss on this property. If she did, she could get a deduction for a casualty loss. The calculation for her deduction would be:

FMV before casualty –
FMV after casualty =
Economic loss (or basis - lower of two) –
insurance or settlement proceeds –
$100 -
10% AGI floor =
Casualty deduction.

Her lawyer fees will not be deductible. This is a purely personal legal expense. If the legal expenses were related to the production of income, the expenses would be deductible (and subject to a 2% floor). However, these costs were purely personal and not eligible for a deduction.