

Searcy

INDIVIDUAL INCOME TAX

Fall 1989

Problem 1

Law Clerk LC in a bona fide loan borrowed \$15,000 cash from his Uncle U in 1987, and in return, LC delivered to U LC's personal liability promissory note for \$15,000. Assume that an appropriate rate of interest is specified in the note and disregard all tax aspects of interest throughout this problem. Because LC does not have a good reputation for paying his debts, the 1987 Fair Market Value (FMV) of LC's note is \$12,000. Assume that no aspect of any subpart of this problem involves a gift, and that Secs. 102 and 1015 are altogether inapplicable. Disregard Sec. 83 and Sec. 1031 and all other nonrecognition rules throughout all parts of this problem.

1a. Analyze the dollar amount of LC's 1987 GI resulting from the \$15,000 loan proceeds which LC received from U. You must address the \$12,000 FMV of the note.

1b. During 1988, LC performed legal research work for Attorney A for an agreed compensation of \$9,000. In 1983, A paid \$20,000 for a new nondepreciable Corvette car, which A used exclusively for personal purposes; A's Adjusted Basis (AB) for the car was \$20,000 at all times until A disposed of the car. In late 1988, when the car had a FMV of \$9,000, A offered to transfer the car to LC if LC would accept the car in full payment of the \$9,000 compensation which A owed LC. LC refused the offer, saying that he had no use or desire for a car. Assume that applicable law provides that compensation for services shall be paid in cash, and that LC was for that reason legally justified in refusing to accept the Car. Assume that any compensation that LC receives from A is includible in LC's Sec. 61(a)(1) GI. Analyze the dollar

amount of LC's 1988 GI; you must include constructive receipt in your answer, and explain the significance of A's \$20,000 cost and AB for the car.

1c. Assume that any compensation that A pays to LC is fully deductible by A under Sec. 162(a)(1). Analyze the dollar amount of A's 1988 Sec. 162(a) (1) compensation deduction; you must include constructive payment in your answer, and explain the significance of A's \$20,000 cost and AB for the car. Remember that this is a Sec. 162(a) (1) only question; Sec. 165 consequences are not in issue.

1d. Assume that in part b the constructive receipt doctrine did apply to require LC to include \$9,000 in 1988 GI. In early 1989, LC changed his mind and agreed to accept the car from A and in return to cancel his \$9,000 claim against A. A transferred the Corvette to LC in 1989, when its FMV was still \$9,000. Analyze the amount of LC's 1989 Sec. 61(a)(1) compensation GI by reason of receiving the car.

1e. In 1990, the Corvette became a collector's item and rose in FMV to \$12,000. LC at all times drove the car for personal purposes only. Third party X offered LC \$12,000 cash for the car in 1990, but LC refused the offer. Analyze whether LC has a 1990 Taxable Event (TE) giving rise to Realized Gain or Loss. Do not analyze the dollar amount of any G/LR; confine your answer to the TE issue. You must include constructive receipt analysis in your answer.

1f. Assume that there was no TE to LC in part e in 1990. In 1991, the FMV of LC's car rose to \$15,000. LC had been paying interest but not principal to U each year, so the outstanding balance on LC's debt to U was \$15,000 in 1991. LC agreed with U that LC would transfer his car (FMV \$15,000) to U in return for U cancelling LC's \$15,000 debt; LC transferred the car, and U cancelled the debt in 1991.

Repeat the part e question, except that constructive receipt is not an issue.

1g. Assume that in part f LC does have a 1991 TE giving rise to realized G/L. Analyze LC's 1991 AB for the Corvette car. Assume the car was at all times nondepreciable and that there have been no basis adjustments after its 1989 acquisition from A. Include in your answer the significance of A's \$20,000 AB.

1h. The facts and assumptions are as in part g. Analyze the dollar amount of LC's 1991 Amount Realized (AR) from his transfer of the car.

1i. The facts and assumptions are as in part h. Analyze the dollar amount of LC's Sec. 61(a) (12) Discharge of Indebtedness (DOD) GI in 1991 from U's cancellation of the \$15,000 debt which LC owed to U. Remember to disregard Sec. 102.

Problem 2

Taxpayer T has been engaged in the sole proprietorship Trade or Business (T/B) of manufacturing shoes for 20 years. Seven years ago T purchased from Seller (S) Blackacre (BA) consisting of unimproved nondepreciable land adjacent to her factory. T at all times used the land as a parking lot for employees and customers of her T/B.

At the time of T's purchase of BA from Seller S in 1982, its unencumbered FMV was \$100,000. The last three zeros for all figures throughout the remainder of the Problem will be omitted, and you may do the same in your bluebook; thus this FMV will be shown as \$100. BA was subject to a nonrecourse mortgage of \$80 which bears interest at 10% per annum (which is a fair and sufficient interest rate for all tax purposes). The mortgagee (creditor) was Bank B, and S had no

personal liability on the mortgage debt. S's equity of redemption was worth \$20, and T paid S \$20 in cash. S deeded BA to T subject to the \$80 nonrecourse mortgage, and T did not assume any personal liability on the \$80 mortgage. Each year from 1983 through 1989 T paid B the full amount of interest on the BA mortgage plus \$3 on the principal on the mortgage. Thus by late 1989 the balance of principal due on the mortgage was \$80 minus \$21 ($\$3$ per yr. \times 7 yrs), or \$59 balance.

In late 1989 the unencumbered FMV of BA was \$30, which was far below the \$59 nonrecourse mortgage. T advised Bank B in writing that T had no further use for BA, T would not be making any further interest or principal payments on BA, and T irrevocably abandons BA. Since the mortgage was in default, B was entitled to and did foreclose upon BA in 1989. At a sheriff's foreclosure sale in 1989, purchaser X paid \$25 cash to the sheriff. The sheriff delivered all \$25 to B and delivered fee simple absolute ownership of BA, free of the mortgage, and possession of BA to X. Because B has no personal claim against anyone on the debt, B will never receive anything more from anyone.

Disregard T's right of redemption (i.e., T's right to pay something to X and thereby reacquire an interest in BA) and assume that T will never have any further interest in BA. All things done by all parties were entirely legal and proper.

2a. Remember that it was given that BA, unimproved land, was at all times nondepreciable; thus whatever basis T has will result in no depreciation deductions. The first occasion that T has had to be concerned about her basis for BA or any other tax consequences of BA is 1989. Analyze whether B's foreclosure sheriff's forced sale is an income Taxable Event (TE) to T. Do not mention any other issue. Read all other subparts before beginning to answer this or

any other subpart.

2b. Assume that the foreclosure is a TE to T, and that therefore T does have a realized Gain or Loss (G/L) in 1989. Analyze the dollar amount of T's realized G/L. T contends that there were no depreciation deductions and that T could therefore not have any 1989 economic benefit from transferring BA by reason of the \$59 nonrecourse mortgage. She notes that both Crane and Tufts received the tax benefit of depreciation deductions computed in part by reference to a basis which included nonrecourse mortgages, but that since she could not depreciate land those cases are distinguishable from her 1989 case. T's position is that she acquired in 1982 an equity of redemption in BA, i.e., that she paid \$20 cash for the right to pay off the \$80 mortgage and thereby obtain clear title to BA. She contends that she did not receive anything at all from the foreclosure upon BA, noting that all \$25 of proceeds were paid to Bank B. She urges that if she is to be treated for tax purposes as having received anything then it is either \$25 (the amount X paid at the sheriff's foreclosure sale) or \$30 (the FMV at the time T's interest in BA was extinguished by the 1989 foreclosure.) Begin your answer by stating the factors which enter into the computation of the dollar amount of T's realized G/L, together with Code authority and a concise summary of the code provisions. Then proceed to analyze the application of the law, including, of course, more than the Code as authority, and explain how the law applied to the facts of T's case. You must address but should not limit your analysis to each of T's contentions. Your answer must include the effect of T's seven \$3 annual principal payments (\$21 total) to Bank B upon T's Adjusted Basis (AB) for BA.

2c. Assume that T's 1989 transaction produced a Realized gain or loss. Since BA was not depreciable, Depreciation Recapture could not apply. Disregard Sec. 1231. Analyze whether the 1989 disposition of BA is a Sec. 1222(4) Sale or

Exchange (S/E). T contends that she abandoned BA and that there is no S/E. Address her contention, but do not limit your analysis to abandonment. Since S/E is nowhere defined in the Code or Regs, your answer must concentrate on other authority and upon techniques of tax analysis.

2d. Assume the foreclosure is a S/E by T in 1989, and disregard Sec. 1231, and assume BA is not inventory. Analyze whether BA is a Capital Asset (CA) by reference to Code language only (i.e., without Reg, Ruling, Case or other authority whatever). Your answer will be very brief.

2e. Assume that all requirements of Sec. 1231(a)(4)(C) are present provided the TE (the foreclosure sheriff's forced sale) is a Sec. 1231(a)(4)(C) subhotchpot Involuntary Conversion (IC). Analyze whether T's TE is a Sec. 1231(a)(4)(C) IC. Your answer will address only the IC aspect of the subhotchpot.

Problem 3

Taxpayer T is employed full time as president of Bank Corporation BC. T does not own any stock in BC. T studied sculpture as a hobby, but has never made or purchased any sculpture prior to 1989. In early 1989, while T was vacationing in Europe, an art dealer offered to sell T a statue of a fighting bull for \$10,000 cash. T believed that the bull was made by a Famous Sculptor, FS, and knew that statues made by FS were valuable collectors' items. T was convinced that the bull was worth at least \$25,000. T paid \$10,000 to the dealer and received absolute title to and possession of the statue. T's only purpose for purchasing or retaining the statue was to make money by selling it for more than his costs; T never used the statue for any personal purpose. T immediately ascertained that he was right--the FMV of the bull was \$25,000, and it was sculptured by FS. Assume the statue was at all times

nondepreciable.

3a. Analyze T's 1989 GI resulting from his purchase for \$10,000 of a bull statue with a FMV of \$25,000.

3b. The statue was made of stone which was painted with a shiny black laquer. Art Expert AE advised T that sculptures made by FS are much more valuable in their natural granite than when painted. AE cautioned T that it may be impossible to remove all traces of the laquer paint, and if any visible trace remains then the statue might just as well be repainted. However, if all visible traces of the paint are successfully removed, the FMV of the bull will be increased by \$15,000 to \$40,000. The paint removal must be done by a master craftsman in order to maximize the chance that all traces will be removed and minimize the chance that the statue's surface will be damaged in the process. T paid Master Craftsman MC \$8,000 cash in 1989 to remove the paint, with the understanding that MC would do his best but MC does not guarantee that he will succeed in removing all traces of the paint, and that MC retains the \$8,000 whether or not the paint removal is complete. MC worked diligently in 1989 and succeeded in completely removing all visible traces of the paint. The statue immediately rose in MV to \$40,000. Analyze the 1989 deductibility of the 1989 \$8,000 payment under Sec. 162(a) and Sec. 212(1) and Sec. 212(2), and the proper tax treatment of the \$8,000.

3c. T anticipated that the bull would rise in value in future years, and planned to keep it until he can make a larger profit from it. On January 1, 1990, T paid \$4,000 cash for a four year insurance policy; in the event that the statue is stolen, vandalized, or accidentally broken the insurance company will reimburse T. Assume that expenses for this type of insurance are deductible under Sec, 212(2) for taxpayers in T's position. Analyze the dollar amount of insurance premium which cash method taxpayer T may deduct in

1990.

3d. T decided to learn more about making money by investing in sculpture. Assume that T, having only purchased one sculpture in his life (the bull) and never even having sold any sculpture, is not in the T/B of dealing in sculpture, and that T never intended to enter sculpture as a T/B. Assume T's sculpture activities are bona fide for the production of income as that term is used in Sec. 212(1). Disregard Sec. 183. T pays tuition to take a course in sculpture investing at the local college. Assume that had T been in the T/B of buying and selling sculpture the tuition would have been fully deductible under Reg. 1.162-5 as an expense which "improves skills...in his...T/B," per Reg. 1.162-5(a)(1). Do not bother looking at any of the 1.162-5 regulations. Assume that the only reason T cannot deduct the tuition cost under Reg. 1.162-5 is that T's sculpture activities do not amount to a T/B.

T wishes to deduct his tuition under Sec, 212(1). T observes that Reg. 1.212-1(f) provides flatly that "expenses of taking special courses or training" are not deductible under Sec. 212. Assume that T comes squarely within this Reg. prohibition, and assume that the only possibility T has of winning a Sec. 212(1) deduction is to persuade a court that the quoted Reg. language is invalid. Assume that this Reg. is interpretative (Issued pursuant to Code Sec. 7805 (a)) and is not a "legislative" Reg. Explain the manner in which T would need to proceed to succeed in his court challenge of an interpretative regulation. Include *Bingler v. Johnson* in your answer but do not confine your answer to that case. Do NOT analyze the validity of Reg. 1.212-1(f). This fact situation is provided to afford a concrete hypothetical to orient you toward the issue, which is the vulnerability of a regulation to attack upon its validity. Your answer will discuss the several factors which a court will consider in deciding whether any interpretative

regulation should be held invalid.

3e. Museum M offered to pay T \$200 per calendar month (\$2,400 per year) to rent the statue from T. M and T signed a 5-year rental contract on January 1, 1991, which provided that each year's rent will be due and paid in full on the last business day of the calendar year. On December 29, 1991, M paid \$2,400 to T. On October 1, 1992, (after 9 months of 1992 elapsed), T irrevocably gave all of his rights in the statue outright to his adult Daughter D. On December 31, 1992, M paid \$2,400 cash to D. Disregard the Gift Tax altogether. Analyze the 1992 GI consequences to T and D resulting from M's \$2,400 payment to D. Assume that all of the Duberstein standards for gift are met.

3f. Very concisely analyze Daughter D's basis for the statue on October 1, 1992, the moment after she received all of her father T's interests in the statue, at which time the FMV of the statue was \$42,000. Disregard accrued rent altogether in this part, and disregard the gift tax.

Problem 4.

4a. Taxpayer T sustained a realized and fully recognized unreimbursed fire loss to a computer used in her sole proprietorship T/B of practicing law. Analyze whether the \$100 limitation of Sec. 165(h)(1) applies by reference only to Code language (utilize the key Code words).

4b. T's T/B is not performed as an employee--she is the sole owner of the unincorporated practice. Assume that her fire loss resulted in a deduction of \$4,000 after all applicable factors have been considered, and that Sec. 1231 characterized this loss as an ordinary (not capital) loss. Analyze by reference only to Code language whether T's loss is deducted from GI in arriving at Adjusted Gross Income (AGI) or is in the alternative an "itemized deduction."

4c. Taxpayer X is engaged in the T/B of manufacturing shoes. He investigated the profit potential of entering the window washing T/B in the same city as his shoe business. He paid in 1989 \$3,000 for a financial analysis of Williams & McGowan Window Washing Company, which he was considering purchasing for a \$200,000 lump sum cost. In 1990, X purchased that Company and began operating it as a sole proprietorship active T/B. Assume that the only unresolved issue which X must establish in order to take a Sec. 195 deduction is the Sec. 195(c)(1)(B) requirement, Concisely explain whether X meets this requirement.