

Searcy

INDIVIDUAL INCOME TAX

Fall 1990

PROBLEM 1

Cherry farmer C owns several orchards and has been engaged in the active Trade or Business (T/B) of growing and selling cherries for many years. On January 1, 1987, C purchased Blackacre (BA) consisting of 10 acres of land with identical physical characteristics and FMV per acre, together with 200 identical FMV cherry trees on each acre. These trees had been producing cherries for five years. The values at the time of purchase were:

	<u>FMV Each</u>	Total FMV
10 acres Land	\$1,000	\$10,000
2,000 Trees	10	20,000
Aggregate FMV		\$30,000

C was a very good businesswoman, and negotiated in an arms' length transaction an aggregate BA purchase price of \$24,000, which she paid in cash in 1987. Assume \$24,000 was her aggregate sec. 1012 Cost Basis for BA, and assume she knows she has made a bargain purchase. Cherry trees are depreciable, but you are to disregard the method for computing depreciation.

Tax Expert TE advised C that income may be realized in the form of property; and that the fact that she has not yet sold the property will not preclude her from having income; and that her \$6,000 bargain is an increase in net worth, clearly realized, and over which she has complete dominion and control, which constitutes \$6,000 of 1987 GI. C prepared

her 1987 tax return by including this \$6,000 in GI.

1a. C consults you in 1989. Analyze C's correct 1987 GI as a result of her bargain purchase, together with the policy reasoning in support of your conclusion.

1b. Assume that C's correct 1987 GI does not include anything as a result of the \$6,000 bargain purchase, and that in 1989 you convince TE of this. TE explains to you that the correct procedure is for C to file an amended 1987 income tax return, excluding the \$6,000, and thus obtain a refund of the 1987 tax increase resulting from the \$6,000 erroneous inclusion. Assume that the Statute of Limitations (S/L) has not expired, so an amended 1987 return would still be timely.

- Analyze the correct procedure for C to follow regarding this 1987 mistake.

1c. Assume that in 1989 C properly corrected her 1987 tax return error. Analyze C's aggregate Cost Basis for the cherry trees on 1-1-87.

1d. Assume that after proper basis adjustments for depreciation and all other items, C's correct AB for the cherry trees was \$11,000 as of 1-1-90, and assume that no 1990 depreciation deduction is allowable. On January 1, 1990, her entire orchard suddenly became infested with cherry beetles which eat cherry trees at the same pace that termites eat wood. No cherries grew in 1990, and by December, 1990, all of her cherry trees had been completely destroyed and become worthless as a result of the beetles. Had it not been for the beetles, her trees would have remained productive for 10 more years before dying of natural aging. C had no insurance.

- State what the first requirement is which must be met

in order for a property transaction to affect the current year's tax liability, and analyze whether that requirement is present in 1990 by reason of the beetle damage to the trees.

1e. Assume that the first requirement as raised in part d above has been met in 1990; and assume that all of the subhotchpot sec. 1231(a)(4)(C) requirements are met except perhaps the "involuntary conversion" requirement; and assume that the words in sec. 1231(a)(4)(C) "arising from fire, storm, shipwreck, or other casualty" are in pari materia with the identical words in sec. 165(c)(3).

- Analyze whether the tree occurrence is a 1990 sec.1231(a)(4)(C) "other casualty." (Do not repeat your bluebook answer to part d, and feel free to refer back to your part d answer.)

1f. The FMV of the trees on 1-1-90 was \$9,000, and because they were completely destroyed in 1990 by the beetles their FMV on 12-31-90 was zero. Assume that the first requirement as raised in part d above has been met in 1990, and that C's loss deduction is fully allowable in 1990. Disregard the tax character of C's deduction.

- Analyze the dollar amount of C's deduction, citing both Code and Reg. authority, and explaining the rationale.

1g. In two sentences or less, without citing any authority but do state your rationale, explain the extent to which land used in a T/B is depreciable.

1h. In two sentences or less, explain whether this land used in C's T/B is a Capital Asset (CA), including Code authority and critical Code language.

1i. Assume C's 12-31-91 AB for the land portion of BA is

\$14,000. On 12-31-91 C voluntarily sold the entire 10-acres of BA land in an arm's length transaction for \$40,000 cash. (The cherry trees had been completely destroyed by beetles and were therefore no longer in existence.) Assume that this sale produced a sec. 1001(a) Gain Realized (GR) of \$26,000, all of which is fully recognized and none of which is subject to Depreciation Recapture (DR). C's only other 1991 Gain or Loss transaction consisted of a voluntary sale of a mechanical cherry tree insect spray machine giving rise to a \$35,000 Loss Realized (LR), all of which was fully recognized and is deductible under secs. 165(a) and 165(c) (1). Assume that the spray machine was depreciable tangible personal property used at all times exclusively in C's T/B, and assume that because the sale produced a LR there will be no DR. Assume that C's land is nondepreciable property held at all times up to the moment of disposition for use in her T/B. Assume that neither the land nor the machine was a CA.

- Analyze the Tax Character (CG or OG; CL or OL) of C's \$26,000 GR from sale of the land, and of C's \$35,000 LR from sale of the machine.

PROBLEM 2

Baseball Team (Team) is one of the men's professional teams associated in the World Baseball League (League). League has a policy that all teams must provide every sports reporter with equal access to the locker room immediately after each game regardless of the sex of the reporter. Coach C of Team is a male and believes that female reporters should not be permitted access to the locker room until after all players, who are male, have had time to shower and dress. C's reasons for his belief include his desire to promote orderliness in the locker room, uphold the team members' morale and team spirit, and maintain each team member's concentration on his good and bad performances in the time immediately following the game. In 1990, C

prevented Female Reporter FR from entering the locker room for the first 20 minutes after a game, but permitted male reporters to enter immediately after the game. C knew of the League policy. League investigated the incident, assessed a \$100,000 fine against C personally, and decided that Team had not authorized C's conduct and that Team was therefore not responsible and should not be punished at all. The fine was within the disciplinary authority of League, and was reasonable in amount under all the circumstances. C was an employee of Team, and C receives by contract \$150,000 annual salary from Team. Assume that being an employee constitutes being in a T/B.

2a. Assume that during 1990 C paid the \$100,000 fine in cash from his individual savings account. Assume the fine is not considered a payment to any government. Throughout all parts of this Problem 2, disregard Sec. 62. Assume C itemizes his deductions, and disregard the 2% floor on certain itemized deductions. C is interested in the deductibility of his \$100,000 payment, and has been advised by his Tax Adviser (TA) that the highly extraordinary nature of this payment and the fact that most sports coaches never incur a league fine are among the factors which make the payment nondeductible.

- Analyze separately the deductibility of C's payment under:

i. Sec. 165(a);

and ii. Sec. 212(1);

and iii. Sec. 162(a) first 3 lines.

2b. Assume that in part 2a, C was properly entitled to deduct the full \$100,000 in 1990, and that after allowing this \$100,000 fine and all other deductions, C's 1990

Taxable Income (TI) was \$20,000. In July, 1991, League on its own initiative reconsidered its fine against C, decided that \$25,000 was the proper amount for the fine, and repaid to C \$75,000 in cash.

- Analyze the tax consequences to C, including the taxable year(s) affected. Also, explain any sec. 1341 or sec. 1341-like alternative choice which is available to C, but do not try to compute any dollar amounts.

2c. The facts and assumptions are as in 2a except that instead of C paying the \$100,000 to League, the \$100,000 was paid by Team to League, with instructions to apply the payment to C's fine. Disregard 2b altogether. Team paid C in 1990 his contract salary of \$150,000 in cash, and informed C that Team would not seek reimbursement from him for any of the \$100,000 Team paid to League. Assume in this part 2c that if C had paid the fine himself, he would have been entitled to deduct the full \$100,000.

- i. Analyze C's 1990 Gross Income (GI).
- ii. Then analyze C's 1990 deduction by reason of Team's \$100,000 payment to League.

2d. In 1991, Team sold C one season ticket to all baseball games Team plays on Team's home field for \$200 cash. The usual selling price of this season ticket is \$600. Tickets in the "choice" seating location sold to C are always 100% sold out in advance before the season begins, but Team has cheaper \$500 per season unsold tickets at every game during the season. Assume that Team is engaged in rendering a service (as opposed to selling a product), and that similar discounts on season tickets are available to all team employees on a nondiscriminatory basis. Team's operations cost 75% of Team's GI, so Team has a 25% gross profit. Assume that the service (the ticket) is in the same line of business in which C works. Assume airline tickets

and hotel rooms are the type of fringes which may be excluded under sec. 132(b) as a no-additional-cost service.

- o Concisely analyze the dollar amount of C's \$400 discount which he may exclude from GI under:

- i. sec. 132(b) as a N-A-C service;

- and ii. sec. 132(c) as a Qualified Employee Discount (QED).

Problem 3

3a. Donor D purchased Unimproved Land (UL) in 1984 for \$100,000 cash. The FMV gradually increased to \$500,000 in 1990, when D gave UL outright to his son S without expecting or receiving any return consideration of any kind. Assume that the gift qualifies for sec. 102(a) exclusion from S's GI under Duberstein and other authorities.

- o Analyze whether this transfer by D to S is an income Taxable Event (TE) to D which causes D to realize gain on the transfer as if D sold UL for its \$500,000 FMV.

3b. In 1985, D purchased unimproved Greenacre (GA) for its 1985 FMV of \$90,000, paying cash and thereby obtaining a sec.1012 cost basis of \$90,000. By 1987 the FMV of GA had increased to \$300,000. D desired to raise money to purchase an airplane for use in D's Trade or Business (T/B). On 1-1-87 D borrowed \$200,000 cash from Lender L, and in return D signed and delivered to L his (D's) personal liability promissory note for \$200,000. The note required annual payment of 10% interest for 10 years on December 31 of each year (which is a sufficient rate to avoid any imputed interest or other tax oddities), and calls for payment of principal in one lump sum of \$200,000 on December 31, 1996.

The 1-1-87 FMV of D's note was \$200,000. D also delivered to L in 1987 a first mortgage on GA to secure the payment of the promissory note. This was not a nonrecourse debt or note. D was fully personally liable to pay all interest and principal on the note. D used the \$200,000 to purchase outright a business-use airplane.

- Analyze the amount of GI which D has in 1987 by reason of receiving \$200,000 from L.

3c. The facts and assumptions are all as in part 3b. Assume that D's 1987 grant to L of a first mortgage on GA was not an income Taxable Event (TE) to D and thus is not treated as a disposition by D of his ownership interest in GA. Assume also that D's AB for GA was not affected by the loan or mortgage, and therefore D's AB remained \$90,000. D made cash payment of all interest each year through 1988 when due.

In 1982, D purchased as an investment a famous jewel known as the Hope Sapphire for \$10,000 cash. Assume D had a sec. 1012 cost basis for the Sapphire of \$10,000, and because the Sapphire is not depreciable, D's AB was at all times \$10,000. In 1989, the FMV of the Sapphire had increased to \$60,000. D had only limited cash available to him in 1989, so he proposed to L that D transfer all rights in the Sapphire outright to L and in return L should regard D as having discharged \$20,000 of interest obligation which was due in 1989 ($10\% \times \$200,000 \text{ debt} = \$20,000 \text{ interest}$) plus as having discharged \$40,000 of principal (thus reducing the amount of unpaid principal from \$200,000 to \$160,000). L agreed, accepted the Sapphire, and marked the note: "1989 interest of \$20,000 discharged in full and \$40,000 of principal discharged, reducing the balance hereof to \$160,000. December 31, 1989. signed, L."

- Analyze the extent to which D's disposition of the

Sapphire is a 1989 TE with respect to the Sapphire.

3d. Assume that D's part 3c disposition is a 1989 TE with respect to the Sapphire; and that D's Amount Realized (AR) from this disposition is \$60,000; and that the Sapphire was a CA.

- o Analyze whether D's 1989 disposition of the Sapphire is a sec. 1222 Sale or Exchange (S/E). (Neither sec. 1222 nor any other Code section defines S/E.)

3e. Continuing with part 3d, assume that all interest which D paid to L in 1989 is fully deductible by D under sec. 163(a) because the loan is considered made to purchase T/B property (the airplane). D's Tax Counselor (TC) has advised D that cash method taxpayers may deduct interest only in the year actually paid, that D has not actually paid L any interest in 1989, and that D therefore has no 1989 interest deduction.

- o Analyze the dollar amount of D's 1989 interest deduction, including response to the points made by TC.

3f. Assume from part 3e that D is entitled to a deduction in 1989 as interest; and disregard the dollar amount deductible; and assume that in his 1989 income tax return D itemizes his deductions rather than taking the Standard Deduction. In not more than two sentences, analyze whether D's interest deduction is allowable from GI in computing AGI or is a deduction which D must itemize. Include precise citation to Code authority.

3g. At the beginning of January 1, 1990, D still owns GA, which then has a \$240,000 FMV, disregarding the mortgage. The 1-1-90 unpaid balance of principal on the note, which is secured by the mortgage, is \$160,000, and

disregard accrued interest because D's transfer of the Sapphire to L on 12-31-89 extinguished all interest obligation through 12-31-89. D proposed to his Niece N that he would transfer GA outright to N if she would agree to pay all future interest and principal payments directly to L with respect to D's promissory note. Of course, after L has been paid all interest and principal L will release the mortgage and N will thereafter own GA in fee simple absolute, free of any lien or encumbrance. N agreed and on 1-1-90 the D to N transfer was completed. Assume that it is correct to treat this transaction for D's tax purposes as a disposition of GA which is a gift to N of the excess of the 1-1-90 \$240,000 FMV of GA (if unencumbered) over the \$160,000 mortgage lien, or \$80,000 as a gift, and also as a disposition of BA which is a TE to D (because of the note and mortgage) and which gives rise to a sec. 1001(b) AR of \$160,000. Your task is to determine the AB which D will utilize for purposes of computing D's G/LR. Assume that D's aggregate AB for GA at the beginning of 1-1-90 was \$90,000 (his cash cost mentioned in part 3b). Of course D would like to use this full \$90,000 AB.

D's Tax consultant TC has advised D that this transaction is treated as a part sale/part gift, and that D's \$90,000 basis must be apportioned between the portion of GA deemed gifted to N (one-third) and the portion deemed sold to N (two thirds), and that D may use only the two-thirds of his basis which is properly allocable to the portion sold in computing D's GR on the "sale" of GA to N.

- o Analyze D's AB for purposes of computing his GR on the "sale" of GA to N.

3h. After N acquired GA, N paid to L in cash all interest as it came due ($10\% \times \$160,000 = \$16,000$ interest per year) on December 31 of 1990 through 1995. During the last year of the loan, 1996, another \$16,000 of interest

became due on December 31, and the \$160,000 principal also became due and payable on December 31, 1996. Unfortunately for L, N became financially ruined and during 1996 was discharged by a bankruptcy court decree from all liability under the note. Disregard the mortgage for purposes of this part 3h--that is, it is as if L never had any mortgage or other security interest in GA whatever. L has not been entitled to and has not deducted any Bad Debt (BD) with respect to the note in any year prior to 1996. Assume that L meets all the requirements for a 1996 sec. 166(a)(1) business BD deduction for a wholly worthless debt, and that the amount due which became worthless was \$176,000, consisting of \$16,000 of interest plus \$160,000 of principal. Assume that the nonbusiness BD rules have no application, and that an "ordinary" deduction will be available to L.

- Analyze the dollar amount of L's BD deduction with respect to the 1996 total worth less of his \$176,000 claim.

PROBLEM 4

4a. Husband H and Wife W live in Ohio, a separate (not community) property state, and each spouse has more than \$100,000 of separate assets. H purchased to hold for investment purposes an extremely rare Coin in 1982 for \$10,000 cash, its 1982 FMV. H's sec. 1012 Cost Basis was \$10,000; Coin was nondepreciable, and H's AB was at all times was \$10,000. In 1990 H sold the coin to W for its 1990 FMV of \$40,000 cash, which W paid from her separate funds. Assume that H's sale is a 1990 TE to H, who is still married to W.

- Analyze whether H's sale to W is a sec. 1041(a) nonrecognition transaction. Quote the critical sec. 1041

(a) word(s), and explain its (their) meaning as it relates to this part 4a.

4b. H has never been in the mousetrap manufacturing business or any related business before. During 1990 H expended \$3,000 for a general and preliminary investigation of this type of business, and \$5,000 for investigating MTC, which was one particular mousetrap company, for possible purchase by H. In 1991, H purchased the MTC, commenced operations, and properly elected sec. 195 amortization of start-up expenditures. Assume that if H had been in the mousetrap manufacturing business in 1990, the \$3,000 and \$5,000 would both have been fully deductible under sec. 162 (a) as costs of investigating the expansion of an existing T/B.

- o Analyze the dollar amount of H's sec. 195(c) (1) "start-up expenditures," including the relevance of the difference between H's \$3,000 preliminary investigation costs and H's \$5,000 transactional stage investigation costs.

END OF EXAM