INSTRUCTIONS

1. Any written materials you believe are helpful are allowed.

2. Write your exam number on the top of this page.

3. You should attempt to answer the questions in the space provided. You may use additional space; however, you should not need to.

4. Your answers may be written in ink or pencil or typed.

5. Unless otherwise indicated, all parties are on the cash method of accounting and use the calendar year. All parties are unrelated unless otherwise indicated.

6. If you feel you need further facts, indicate what sort of facts you would want to know and what difference they would make in your answer.
QUESTION ONE (20 points)

Taxpayer received a bonus of $50,000 from his employer in 1994. He was then subject to a tax rate of 40% and he properly paid $20,000 in federal income tax on the bonus, leaving him with $30,000. In 2003, he has been told by his employer that the bonus was incorrectly paid to him: it should have been paid to another employee with a similar name. The mistake was not one Taxpayer should or could have discovered in 1994, even with reasonable diligence. Taxpayer has re-paid the $50,000 this year to employer. Because Taxpayer has since retired, his income is lower than it was in 1994. Also, marginal tax rates have fallen. You determine that without the deduction, Taxpayer would be subject to a marginal tax rate of 27% and that the re-payment, if deductible, would have consequences at that bracket.

A. Is the repayment deductible by Taxpayer? Under what authority?

Yes. Section 162 as an ordinary and necessary business expense.

B. Assuming the amount is deductible (regardless of your answer to A), what would be the after-tax cost of the repayment? To answer this question, you may want to examine section 1341.

$30,000

Under section 1341(a)(5), the taxpayer would not deduct the repayment. Instead, he would receive a credit equal to the reduction in tax that would have occurred in 1994 had the amount never been included. The only open issue involves whether the obligation to repay was properly "established" in 2003: a voluntary re-payment will not suffice for section 1341. Litigation is not required, but I would want to see it clearly established that Taxpayer had not received the amount correctly.

C. What is the relevance of the North American Oil, 266 U.S.417 (1932), decision to this question?

It created the "claim of right" doctrine. That is essentially the same as the "unrestricted right" language from section 1341.
QUESTION TWO (20 points)

During 2002, D, a calendar-year individual taxpayer, made a charitable contribution to a high school (an automatic public charity under section 509(a)(1)) of $130,000, consisting of $30,000 in cash and $100,000 in used electronic games (now considered antiques) from his arcade business (a sole-proprietorship). The game equipment was purchased in 1975 for a cost of $10,000. D’s adjusted gross income for 2002 was 200,000. D had no carryovers of charitable contributions from prior years and made no other contributions during the year. You are asked to determine D’s charitable contribution deduction for 2002 and the amount and description of any carryovers, if any.

Charitable contribution deduction: $90,000

Carryover: YES NO (circle one)

Describe the carryover, if any:

$30,000 contribution of capital gain property to which section 170(b)(1)(e) did not apply, with a basis of zero.

Would you advise Taxpayer to make any elections?

YES NO (circle one)

QUESTION THREE (25 points: 5 each)

During 2002, taxpayer had the following transactions (and none other). Not considering them, his adjusted gross income (all from salary) was $100,000. What are the consequences of each. What is your authority for the consequences?

a. A hailstorm destroyed his pool screen, in which he had a basis of $15,000. He had no insurance.

Deduction under 165(c)(3) of $3,400.

AGI: 100,000 plus 15,000. 10% = 11,500. The loss is 14,900 under 165(h)(1). This exceeds 11,500 by $3,400 per 165(h)(2).
b. He sold a used pinball machine. He purchased it for use in his arcade business in 1965 for $2000 and used it in the business (a sole-proprietorship) even since. He sold it for $15,000.

Section 1245 income of $2,000 and section 1231 gain of $13,000, which would be treated as long-term capital gain.

c. He sold stock in AOL-TIME/WARNER for $20,000. He inherited it in January, 2003, when it was worth $15,000.

Long term capital gain of $5,000. Character per section 1223(11).

d. Black mold infested his swimming pool. It cost $4,000 to drain the pool, bleach, and sandblast the marcite to repair the damage. He had no insurance coverage.

This is not likely deductible because it does not satisfy the casualty loss provisions of 165(c)(3), particularly the suddenness factor of “casualty.”

e. He loaned his neighbor $5,000 in April. The neighbor lost his job yesterday and claims he cannot pay the amount back.

Short-term capital loss of $5000 per section 166(d). This appears sufficiently worthless.

QUESTION FOUR (15 points)

How would your answer to question Three (b) change (other than for the dollar amount of gain/loss) if he sold twelve used pinball machines through E-bay during 2002?

The number of sales would probably rise to the level of a trade or business under section 1221 such that the property would have been converted from property used in the trade or business to property held primarily for sale to customers in the ordinary course of a trade or business. As such, the property would no longer be 1231 property and the resulting $13,000 of non-1245 gain would be ordinary.
QUESTION FIVE (20 points)

Husband and Wife are negotiating a dissolution of their marriage. You represent Wife. The parties have the following marital assets:

1. An Account Receivable from Husband’s Law Practice with a basis of zero and a value of $200,000. It is due in one month from a well-known insurance company, contingent on approval of a settlement by the Court (a risk you properly evaluate as low).
2. Inventory from Husband’s tavern with a basis of $50,000 and a value of $250,000 and a buyer willing to purchase it for $250,000.
3. An unencumbered primary residence with a basis of $25,000 and a value of $150,000.
4. Publicly traded stocks with a basis of $300,000 and value of $150,000.

You get to pick two assets. Which ones would you pick?

Circle the number of the assets you pick:

1
2
3
4

Why did you pick those assets? Analyze the pros and cons of each from a tax standpoint.

The first is not property under Rev. Rul. 2002-22 as it is subject to a contingency. As such, it is worth $200,000 to Wife. Husband will be responsible for the taxes per Rev. Rul. 87-112 and the Kochansky case.

The second would be property under section 1041 and would result in gain of $200,000 upon the sale. But, using a 30% tax bracket, the after-tax value would be about $190,000. Even using a 40% bracket (which does not exist), the after-tax value would be $170,000.

The third item is worth $150,000. It is unlikely, per section 121, to have any gain potential.

The fourth item is worth $150,000 plus the potential tax saving from the long-term capital gain potential of $150,000. This tax savings is worth, using a rate of 20%, up to $30,000, but probably is worth far less considering the difficulty in deducting capital losses under section 1211.