ANSWER KEY

University of Florida College of Law
Final Examination
Income Tax
Fall Semester, 1997
Professor Willis
Question One

TP has the following assets. Determine the basis and holding period for each.

1. Vacant land he purchased in 1970 for $10,000. It is now worth $150,000.

2. Vacant land he purchased in 1997 for $10,000. It is now worth $2,000.

3. Vacant land his father purchased in 1997 for $10,000. His father died in August and TP inherited the land. It was then worth $15,000. The estate's personal representative did not elect an alternate valuation date.

4. Vacant land he purchased in 1990 for $10,000 cash and a purchase money promissory note for $25,000. He has paid all interest due on the note and $17,000 of principal.

5. Vacant land he purchased in 1990 for $10,000. It is now worth $20,000. Yesterday, he borrowed $15,000 from a bank, giving a mortgage on the land as security for the loan. He deposited the loan proceeds in a savings account.

6. Vacant land his wife purchased in 1997 for $10,000. It is now worth $2,000. Yesterday, she gave it to him pursuant to their divorce.

7. Vacant land his employer transferred to him on December 20, 1996, as a year-end bonus. The land cost the employer $10,000 and was worth $15,000 at the time of the transfer. It is now worth $17,000.

8. A gold watch he found in the street yesterday. He had it appraised for $12,000 and has decided to keep it.

9. A gold watch he stole from a jeweler yesterday. It had a price tag of $15,000 on it.

10. An apartment building he bought in 1990 for $500,000 [of which $100,000 was allocated to the land]. During 1994 he made improvements of $200,000 to the building. It has been fully leased to tenants since the purchase.

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<thead>
<tr>
<th>Item</th>
<th>Basis</th>
<th>Holding period</th>
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<tbody>
<tr>
<td>1.</td>
<td>$10,000</td>
<td>long term: 27 years</td>
</tr>
<tr>
<td>2.</td>
<td>$10,000</td>
<td>short term: less than one year</td>
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<tr>
<td>3.</td>
<td>$15,000</td>
<td>effectively long term per § 1223(11)</td>
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</tbody>
</table>
4. $35,000 long term: 7 years
5. $10,000 long term: 7 years
6. $10,000 short term: 1 day
7. $15,000 short term: 355 days
8. $12,000 short term: 1 day
9. $15,000 short term: 1 day
10. Between $555,454.57 and 576,363.66 long term

To answer regarding number 10, I would need to know three pieces of information:

1. During which month of 1990 was the property acquired?
2. During which month of 1994 were the improvements completed?
3. Why do you want to know basis today?

1. Whichever month it was acquired, I would take ½ month depreciation plus all the remaining months of that year. Hence, I would take a minimum of ½ month for 1990 and a maximum of 11 ½ months.

2. Whichever month the improvements were completed, I would take ½ month depreciation plus all the remaining months of that year for the $200,000 of improvements, which would be depreciated separately. Hence, I would take a minimum of ½ month for 1994 and a maximum of 11 ½ months.

3. If you want to know the basis as of the end of 1997, I would take a full 12 months depreciation for 1997. However, if you need to know the basis today - perhaps for purposes of a proposed sale this month - I would merely take 11 ½ months depreciation for 1997.

Combining these possibilities, for the $400,000 original cost, to be depreciated straight-line over 27.5 years, I would take a minimum of 7 years depreciation (6 years for 1991 through 1996 plus ½ month for 1990 plus 11 ½ months for 1997). Or, I would take a maximum of 7 years, 11 ½ months depreciation (7 years for 1991 through 1997 plus 11 ½ months for 1990). For the $200,000 of improvements, also to be depreciated straight-line over 27.5 years, I would take a minimum of 3 years depreciation (2 years for 1995 through 1996 plus ½ month for 1994 plus 11 ½ months for 1997). Or, I would take a maximum of 3 years, 11 ½ months depreciation (3 years for 1995 through 1997 plus 11 ½ months for 1994).
$400,000 divided by 27.5 equals $14,545.45 per year and $1,212.12 per month.

$200,000 divided by 27.5 equals $7,272.73 per year and $606.06 per month.

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<thead>
<tr>
<th></th>
<th>Maximum Depr.</th>
<th>Minimum Depr.</th>
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<tbody>
<tr>
<td>Original cost</td>
<td>$500,000</td>
<td>$500,000</td>
</tr>
<tr>
<td>improvements</td>
<td>200,000</td>
<td>200,000</td>
</tr>
<tr>
<td>depreciation on original cost</td>
<td>115,757.54</td>
<td>101,818.15</td>
</tr>
<tr>
<td>depreciation on improvements</td>
<td>28,787.89</td>
<td>21,818.19</td>
</tr>
<tr>
<td>Adjusted Basis</td>
<td>$555,454.57</td>
<td>$576,363.66</td>
</tr>
</tbody>
</table>

**Question Two**

Joe, a lawyer, wrote a will for Ann. Prior to writing the will, they discussed his fee, which was $300. Ann offered to pay for the document up front; however, Joe refused, suggesting that he always billed clients after the work was finished. He finished the will today and sent Ann a bill.

If Ann mails Joe a check on December 27, 1997, and he receives it on January 2, 1998, when must he report the income?

**Question Three**

Client - who is 45 and in good health - has adjusted gross income of $450,000. She anticipates that level of income indefinitely into the future. She has no charitable contribution carryovers. During 1997, she gave $25,000 in cash to a public charity. She also gave 1000 shares of stock worth $300,000 to the public charity. She inherited the stock from her grandfather earlier this year. It was valued, for the estate tax return, at $225,000. Her grandfather originally paid $10,000 for the shares. She also gave $40,000 in cash to a private foundation not described in section 170(b)(1)(E). What is the amount of charitable contribution deduction you advise her to take for 1997 and what is the amount of her carryover, if any? Even if you offer alternatives, you must make a choice for her (or else she will not pay your fee).

A deduction of $160,000 with a carryover of $205,000 of which $165,000 would be to a public charity [composed of intangible capital gain property with a basis of $123,750] and $40,000 would be to a
private foundation [composed of cash].

An election per section 170(b)(1)(C) would be ill-advised because, while it would increase the deduction to $225,000, it would reduce the carryover to $65,000 [composed of intangible capital gain property with a value of $25,000 and a basis of $25,000 given to a public charity and $40,000 cash given to a private foundation]. Hence the total deduction over time - $290,000 - would be $75,000 less than with my recommended approach. Considering the client’s age, health, income and carryover status, I believe the delayed but increased deduction significantly outweighs the “election” result.

Question Four

H and W were divorced today. You represent H. Pursuant to the marital settlement agreement, they will each get two pieces of property. The items cannot be divided - they must be taken whole. One person will pick first, then the other will pick second and third. Then the first person will take the remaining piece of property. They had no debts. You should ignore sentimental value and liquidity. For these purposes, the fair market values given are correct, without question, and buyers are ready if either H or W decides to sell. Both are in a 40% tax bracket. Both parties are represented by competent counsel.

The four items are:

A. Shares of stock held for investment with a fair market value of $100,000, a basis of $20,000, and a holding period of two years.

B. Shares of stock held for investment with a fair market value of $75,000, a basis of $300,000, and a holding period of three years.

C. Machinery used in a business with a fair market value of $160,000, an original cost of $300,000, and a holding period of ten years.

D. Personal use items - such as cars, jewelry, clothing, furniture (none of which was held for investment or for use in a business) - with a fair market value of $50,000 and a basis of $500,000.

Do you want to pick first or second?

FIRST

SECOND

In what order do you anticipate the items to be chosen pursuant to the agreement? (Place the letter corresponding to the item on the line corresponding to your anticipated order. For example, if you believe they will be chosen in the order listed, place the letter “A” above the number “1” and the letter “B” above the number “2” and so forth.)
item likely after tax value
A $84,000
B 120,000 (this is a soft number. The actual value may be higher, but is likely lower).
C 96,000
D 50,000

Bonus One

Your client is getting a divorce today. He is in a 40% tax bracket. His ex-spouse will likely be in a 15% bracket. They have three children. He must pay $20,000 per year per child as child support. They would like to characterize these payments as alimony for tax purposes; however, they do not want the payments to continue indefinitely: they want them to end as soon as possible after the children each reach the age of 18, which is the local age of majority.

Two children were twins. The first was born on April 15, 1986, just before midnight. The second was born on April 16, 1986, just after midnight. The third child was born this morning.

Write the paragraph for the marital settlement agreement that will accomplish your client's desired purpose.

Husband shall pay in cash to ex-wife, as permanent periodic alimony, $5,000 (or the reduced amount, if applicable) per month, beginning with the signing of this agreement, and ending on the earlier of her death or June 12, 2020. Such obligation to pay alimony shall be reduced to $3,333.33 per month on October 16, 2004, and shall be further reduced to $1,666.67 per month on October 17, 2007.

Bonus Two

Your client, aged 50 and in good health, has an adjusted gross income of $600,000 with no net operating loss carryovers. He expects similar income in the future. During 1997, he has made contribution to two charities, both of which are described in section 501(c)(3) of the code. One is PC, which is also described in section 509(a)(3). The other is a private foundation not described in section 170(b)(1)(E).

To PC he gave $50,000 cash, shares of stock in a publicly traded corporation with a fair market value of $200,000 and a basis of $100,000, and a boat used in his business with a fair market value of $600,000, a basis of $150,000, and an original cost of $900,000.

To PF, he gave a tract of land with a fair market value of $300,000 and a basis of $310,000.
In addition, he has a charitable contribution carryover of $10,000 cash he gave to PF during 1992.

How much do you recommend he deduct under section 170 for 1997?

$300,000 [or $525,000 if my proposal works]

If he has a carryover to 1998, what is the amount and character of the carryover?

$410,000 with a character of $100,000 in intangible capital gain property to a PC with a basis of $50,000 plus $10,000 in cash to a PF, plus $300,000 in capital gain property to a PF.

[or $635,000, including $125,000 cash to a PC, $200,000 in capital gain property with a basis of $100,000 to a PC, plus $10,000 cash and $300,000 in capital gain property to a PF if my proposal works].

In answering this Question - if you have not already done so - consider alternatives to what the client has already done, to the extent possible. Remember, 1997 is not yet over and some things can still be undone and restructured (subject, of course, to various substance over form doctrines, such as that arising in the Court Holding Company decision). You cannot leave the client in a significantly worse position that he would otherwise be in if things were left as they are. Do you recommend any additional transactions? If so, describe them and show how they would be beneficial to your client or would better fulfill your client's apparent desires.

Do you recommend that he make any elections in relation to the above?

YES  NO

I would take the position that the boat is unrelated. As such, it is subject to 170(e)(1)(B)(i) without cost (because the amount of the contribution already dropped to basis per 170(e)(1)(A). As a result, section 170(b)(1)(C) would apply only to the stock, of which only $100,000 was described in (b)(1)(A); hence, (b)(1)(C) would cause no further reduction.

If, instead, the boat is related, then (b)(1)(C) will apply both to the boat and the stock, limiting the total of $250,000 described in (b)(1)(A) to $180,000 and causing an additional carryover of $70,000. [total deduction of $230,000 with a carryover of $480,000]. A (b)(1)(C) election would alleviate this; however, it would come at a cost of reducing the stock gift from $200,000 to $100,000. [total deduction of $300,000 with a carryover of $310,000]. Given the choice between these two options, I’d probably recommend not taking the election: the larger carryover is worth the $70,000 deferral, considering the age, health, and income status of the client.

However, my argument that the boat is unrelated is so unusual, it - I suspect - would have a substantial likelihood of success, particularly if I can convince the charity to sell the boat soon. Treas. Reg. § 1.170A-4(b)(3)(i) suggests that a quick sale is indicative of an unrelated use.
For an even better result, perhaps I can convince the charity to return the boat so that my client can sell it. This could significantly benefit the charity. Assume, for this illustration, that my client has a marginal rate of 40% and the charity a rate of 34%.

If the charity sells the boat, it will have 1245 gain of $450,000 and tax due of $153,000, leaving $447,000. My client will have - at most - benefitted $60,000 from the contribution. The government will benefit $93,000 [$153,000 minus $60,000].

If, instead, the charity returns the boat [ideally this year and thus obviating any tax benefit rule problems], my client can sell it, producing 1245 gain of $450,000 and tax due of $180,000. My client can then donate the remaining $420,000 plus an additional $180,000 of cash to the charity, thus eventually saving $240,000 in taxes [because his contribution base will have increased this year, he will be able to deduct $525,000 this year and to carryover $635,000, including $125,000 cash to a PC, $200,000 in capital gain property with a basis of $100,000 to a PC, plus $10,000 cash and $300,000 in capital gain property to a PF]. This will leave him the same $60,000 ahead [$180,000 tax due minus $240,000 tax savings] that he would be with the simple donation of the property [although it would be deferred at least one year]. The charity would then have $600,000 [rather than $447,000]. The government would be behind $60,000 [rather than ahead $93,000].