Exam No._____

UNIVERSITY OF FLORIDA
COLLEGE OF LAW
FINAL EXAMINATION
INCOME TAX
FALL SEMESTER 2001
PROFESSOR WILLIS

DATE: DECEMBER 6, 2001
TIME: 9:00 a.m.
TIME LIMIT: 4-1/2 HOURS

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)

Father has an auto repair shop, which he operates as a sole proprietorship. Not including the following facts, his adjusted gross income from the business during 2001 is $150,000 and will be the same amount in 2002. Father consulted you about marital problems. He anticipates leaving his wife and kids sometime next year. He would like to minimize his obligation to pay alimony and child support (both of which you know to be a function of his income). You have learned, from experience, that “income” as determined for U.S. tax purposes is typically a reference point for the determination of alimony and child support.

Father is interested in purchasing a new machine that will cost $215,000. It has a class life of seven years. If he purchases the machine today, what will be his adjusted gross income for 2001 and 2002.

To minimize his 2001 income, he would elect section 179. This would be advisable because the alimony and child support issues will likely be a function of the income from both 2002 and 2001 (and perhaps even some earlier years). Per section 179(b) the limit would be 24,000 reduced by at least 15,000 (the amount by which the property cost exceeds 200,000). I would need to know whether he placed other section 179 property into service during 2001, as well. If he did, the cost would be added to the 215,000, resulting in a larger reduction: if he placed $9000 or more into service during 2001, he would have no section 179 eligibility. To the extent his section 179 amount would be lower, his depreciable basis for 2001 and 2001 would be greater in the following discussion. For example, if he could not use section 179, his section 168 amounts (using the mid-year convention) for 2001 and 2002 would be 43,000 and 68,800, causing his AGI to be correspondingly higher.

If he is able to use the mid-year convention under section 168 (purchase of the machine did not result in his having made over 40% of his purchases of section 168 property in the final quarter), he would also have 41,200 depreciation in 2001 and 65,920 in 2002. I calculated this with the depreciation calculator, using 209,000 as the depreciable basis (215,000 minus 9,000 per section 179) and five years as the recovery period (a class life of seven years results in a recovery period of five years). This results in adjusted gross income in 2001 of 99,800 and in 2002 of 84,080. If, as explained above, he was unable to use section 179, his 2001 AGI would be 107,000 and his 2002 AGI would be 81,200. Thus the loss of
section 179 (if he’d already used it for 2001) would not be serious; in fact, his 2002 income would be even lower. Perhaps this sharper relative drop would be even more influential to the court in reducing his obligation for alimony and child support! But, this answer may defy logic: if purchase of the machine constituted less than 40% of all the property placed into service during the year, then he must have had such other sufficient purchases so that he would not be able to use section 179. Hence, his likely AGI would be the alternate answer (highlighted).

If he must use the mid-quarter convention, he would be able to deduct 5% of the depreciable basis in 2001 and 38% in 2002. Using 215,000 as the depreciable basis (unreduced by section 179), his 2001 deduction would be 10,750 and his 2002 deduction would be 81,700. His 2001 AGI would be 139,250 and his 2002 AGI would be 68,300. 

Considering the large cost of the property and his income, I suspect the mid-quarter convention would be applicable. I also suspect he would have already placed at least 9000 of other section 179 property into service during 2001. Hence, this is the most likely correct answer. To be sure, however, I would clarify the facts with my client.

5 points for general 179 and 168
5 points for good computation (including 179 limits)
5 points for convention issues
5 points for correct

QUESTION TWO (15 points)

During 2000, D, a calendar-year individual taxpayer, made a charitable contribution to a school of $80,000, consisting of $20,000 in cash and $60,000 in vacant land. The land had an adjusted basis of $5000. For such year, D's contribution base was $150,000. D had no carryovers of charitable contributions from prior years and made no other contributions during the year. During 2001, D gave $10,000 in vacant land (with a basis of $12,000) to DPF (a private foundation). D had a year 2001 contribution base of $30,000. You are asked to determine D’s charitable deduction for 2001 and the amount and description of any carryovers, if any.

$9000 deduction with a carryover of $16,000,
consisting of:

$6000 in vacant land (with a basis of $500) to a public charity and contribution date of 2000 plus $10,000 in vacant land (with a basis of $12,000) to a private foundation and a contribution date of 2001.

5 points for general accurate
5 points for close
5 points for correct

QUESTION THREE (30 points: 5 each)

During 2001, taxpayer had the following transactions. Not considering them, his adjusted gross income was $100,000. What are the consequences of each.

a. A hailstorm destroyed his lawn furniture, in which he had a basis of $3,000. He had no insurance.

He would not likely be able to deduct anything for this. Section 165(c)(3) would allow the loss, even though it appears personal, because it resulted from a storm. Section 165(h) would then apply two limits: first it would reduce the amount by $100 and then it would allow the remaining $2,900 only to the extent net personal casualty losses exceeded 10% of his AGI ($10,000). Thus I would need to know whether he had any personal casualty gains during the year and the amounts thereof: these would reduce the allowed loss. Then I would need to know whether he had any other personal casualty losses during the year: I would combine them with this reduced loss to apply the $10,000 limit. Any excess would be an itemized deduction per section 63.

b. He sold Intel stock for $15,000. He had a basis of $2,000 and had held the stock since 1997.
$13,000 long term capital gain.

c. He owned stock in Pets.com, which became worthless during the year. He inherited it in 1999 from his brother when it was worth $100,000. He brother paid $1000 for it.

$100,000 long term capital loss per section 165(g). Sections 1211 and 1212 would limit deductibility to the extent of his net capital gains (at least 13,000) plus 3000. Because he also had a short term capital loss during the year (e), that would be deducted against ordinary income first, probably using up the 3000 limit. The remainder would be carried over as long-term capital loss.

d. He sold his old lawnmower for $100. He originally paid $1,500.

Unless this property was used in a trade or business or for the production of income (which would be considered a transaction for profit under section 165), this loss of $1,400 would not be allowed under section 165. Also section 262, which disallows personal losses and deductions, is relevant.

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

This likely results in a $5,000 short term capital loss per section 166. This appears to be a non-business bad debt and it also appears worthless. Taxpayer would have the duty to prove worthlessness, as well as legitimacy of the debt. I would like to see written documentation of both (note, as well as written evidence the neighbor lost the job). I would also be concerned with whether a family relationship existed between the two, which might cause the government to classify this as a gift. The loss, if allowed, would be deductible to the extent of capital gains per section 1211 and the remaining amount, if any, would be deductible against ordinary income (to the extent of $3000) and the rest carried over per section 1212.
f. He sold a machine used in his business for $90,000. The machine cost $80,000 on March 1, 1998, when he purchased it. He took the maximum deductions allowable on the machine.

In 1998, he may have taken as must as 18,500 in section 179 deductions for the machine. Also, he would have then taken substantial section 168 deductions for 1998, 1999, and 2000. For 2001, he would take one-half year of depreciation (if he used the mid-year convention). Without knowing the recovery period for the machine, I cannot compute the current adjusted basis; however, I know it would be substantially lower than $80,000. To compute the year 2001 consequences, I would subtract the adjusted basis from $80,000 (his section 1245 recomputed basis). The result would be ordinary income under section 1245. The remaining $10,000 of gain would be section 1231 gain, to be characterized by that section in conjunction with other section 1231 transactions.

QUESTION FOUR (20 points)

Pursuant to a marital settlement agreement (dated today) Taxpayer agreed to transfer to his ex-wife the following amounts.

1. $100,000 due upon signing of the agreement.

2. $2,000 per month for 110 months beginning today.

3. $1000 per month until their child (who is six - today is her birthday) reaches the age of nineteen, beginning today.

4. The mineral rights in 640 acres of land he inherited from his father in 1960. At the time of his father's death, the land (including the minerals) was worth $50,000. Today, the land is worth $1,000,000, of which 40% is attributable to the minerals.

Taxpayer's obligation to make the transfers listed in "2" ends on the death of his ex-wife or on her remarriage. His obligation to make the transfers listed in "3" ends on the death of his ex-wife, but not on her re-marriage.

The marital settlement agreement is silent as to the tax consequences of the payments.
Assuming taxpayer makes all payments when due, what are the tax consequences to Taxpayer and to his ex-wife?

Item 3 would be child support and have no tax consequences. Items 1 and 3 would be alimony (although the Webb case casts some doubt as to item 1). If item 1 is treated as alimony (which I fear is correct), taxpayer would deduct 102,000 in 2001 and ex-wife would include the same amount. Taxpayer would deduct 24,000 in 2002 and ex-wife would include the same amount. Taxpayer would deduct 24,000 in 2003 and ex-wife would include the same amount, but taxpayer would also include 63,000 in 2003 and ex-wife would deduct 63,000. The remaining payments of 2000 per month would be deductible by taxpayer and includible by ex-wife when paid.

The transfer of the mineral rights raises a difficult problem. It likely is not covered by section 1041, as it appears to be a carve-out of ordinary income; hence, the Davis case would apply. Taxpayer would likely have $400,000 income in 2001. Wife would have no income, but would have an effective basis of $400,000. This is not clear, but appears to follow from the Kochansky case, especially in light of the P.G. Lake decision. Ex-wife would like this result and taxpayer would not. The matter remains unsettled in the eleventh circuit. I would need to know more about the mineral rights, including state law rules. The issue involves whether they amount to “property” under section 1041. If these are already subject to a production contract, for example, I would expect them to be considered a “carve-out” (traditional assignment of income item). However, state law may permit such a division of property separate from the underlying fee and without any current production. If so, this may very well not be a Kochansky/Davis problem. Taxpayer should have had this clarified prior to signing the agreement. I would discuss with him the malpractice liability of his family law attorney.

This answer relies on Rev. Rul. 79-12. It did not apply 2002-22, which was issued after the date of this exam. Rev. Rul. 2002-22 would change the result contemplated by this paragraph. Under it, the mineral rights would be property and the assignment of income doctrine would not apply.

5 points for general with alimony and child support
5 points for recapture and accurate numbers
10 points for 1041 issue
QUESTION FIVE (15 points)

My mother-in-law owes $25,000 to her neighbor. She cannot pay it and the neighbor is threatening to sue her. I purchase the note from the neighbor for $15,000 and he assigns to me all his rights against my mother-in-law. I tell her to take her time in paying the note. I also drop the interest rate from 15% to 6%. What are the consequences to me and to my mother-in-law and to the neighbor from these facts?

Neighbor has a $10,000 loss. It is probably capital (unless he was in the trade or business of making loans). If he loaned it more than one-year ago, it would be long term.

No consequences result from the lowering of the interest rate, as it is prospective only, and within the current section 1274 AFR; hence, section 7872 would not apply.

Section 108 would treat this as a purchase by mother-in-law, as I am a member of her family per section 108(e)(4)(B). Thus she would have $10,000 discharge of indebtedness income, possibly excluded under section 108 if she is insolvent or files bankruptcy.

If my holding the debt if not a gift, I may ultimately have a non-business bad debt deduction under section 166 if the debt even becomes worthless.

5 points for neighbor
5 points for 108
5 points for no consequence on lower interest