ANSWER KEY

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

DATE: MAY 1, 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.

7. Count the pages of this booklet. There should be 7 remaining pages.

8. Assume that the Internal revenue code, as in existence on January 1, 2001 was in existence at all relevant times (i.e. without considering any amendments which were enacted after that date even if there are retroactive).

9. Plan your answer before you write in the space provided. Part of the test considers whether you can present an organized, logical, coherent answer. You need not use complete sentences; however, you should write clearly.

10. Write legibly!

11. Relax.
QUESTION ONE

Taxpayer purchased a computer, which he used in the design and construction of a building to be used for his own business use in an existing unincorporated trade or business. The computer cost $350,000 and was purchased on March 1, 2000. He expects to complete the construction of the building on December 31, 2002, at which point he will likely want to sell the computer to a design corporation owned by his nephew, although he will use it, in his business, for a year or more prior to the sale.

For this problem, you should assume that the computer has a class-life of seven years and a salvage value of $10,000, and is used exclusively for business purposes.

a. Assuming Taxpayer deducted the maximum permissible correct amount of depreciation attributable to the computer in 2001, how much would he have actually deducted on his tax return for that year for depreciation on the computer?

$ 0

On what code section(s) or case authority did you base your answer?

Comm’r v. Idaho Power, section 263

Explain, if you care to:
Depreciation of the computer is capitalized onto the cost of the building. As the computer basis depreciates, the basis of the building will increase. The Idaho Power case held this. General capitalization principles of section 263 also support it.

b. Assuming Taxpayer used the maximum permissible depreciation method for the computer for the years 2000 through 2003, what would be his basis in the computer (assuming he made no additions to it and it suffered no casualties) on December 31, 2003?

$ 60,480

Explain, if you care to:
2000: 70,000
2001: 112,000
2002: 67,200
2003: 40,320
Cost $350,000
Total Dep. $289,520
Basis: $60,480

c. Taxpayer wants to know the character of any gain or loss attributable to his anticipated sale of the computer on January 1, 2004. Naturally, your answer must be function of the possible sale price and expected adjusted basis of the computer (as you determined above). Explain (using numbers and words) how different possible sales prices will result in differing characters of gain or loss.

Assuming the TP took the depreciation calculated in (b), if he sold the computer on January 1, 2004, for more than $40,320, the first $309,680 of gain would be 1245 ordinary gain and the remaining gain would be 1231 hotchpot gain subject to what ever else he sells during the year. Since it is January we have to wait until the end of the year to find out what is the character of the 1231 gain. If he sold it for less than $40,320, the loss would be 1231 hotchpot loss. Since it is only January we have to wait until the end of the year to find out what is the character of his loss.

In any event, he would have $20,160 of 168 depreciation in 2004 because of the impute July 2004 sale date under the mid-year convention.

If he failed to take the prior depreciation on the prior years were closed, the basis would be $70,000 per 1016(a)(2). Any gain would be 1231 gain and any loss would be 1231 loss. 1245 would not apply if he could prove his failure to deduct depreciation. Or he could file an amended return to take the past three years of depreciation. Issues of amended returns, however, are beyond this course.

d. If taxpayer were to die on July 1, 2001, and his son were to inherit the unincorporated sole proprietorship described above at a time when the computer was worth $175,000, what would be son’s gain or loss if he were to immediately sell the computer for $175,000?

$ 0

Explain, if you care to:

Per section 1014, son would obtain a basis equal to the date of death fair market value of the property. Thus no gain or loss would be possible, as son would be selling immediately.

e. If son were instead to continue operation of the unincorporated business, what would be son’s depreciable basis in the computer on July 1, 2001?

$ 175,000
Explain, if you care to:

See section 1014 for basis of inherited property.

**QUESTION TWO**

Taxpayer's uncle inherited Whiteacre (a residential lot) in 1950 from his father, who had purchased it in 1930 for $2500. On the date of death (and six months thereafter) it had a fair market value of $15,000. The uncle (who is married) gave the lot to Taxpayer on July 1, 1990. On that date the lot had a fair market value of $20,000. On August 15, 1993, Taxpayer borrowed $75,000 from Bank Two, giving a mortgage on the property as security. He used $65,000 to add a rental house and $10,000 to pay off some personal credit card debts. Construction on the house was completed January 1, 1994. Taxpayer immediately rented the property to his brother for $500 rent per month, which was a fair rental amount. On December 12, 1998, taxpayer was married. Today, he was awarded a dissolution from his wife. In exchange for her release of all alimony rights, she received Whiteacre, subject to the remaining debt of $50,000 (which she became obligated to pay), plus the rights to the $4,000 rent which Taxpayer's brother had neglected to pay since September, 2000. Brother paid $2000 of the past due rent today plus the current rent of $500. Wife forgave the rest of the past due rent.

What are the 2001 tax consequences from these facts on Taxpayer?

**TP received a 15,000 basis from his uncle per section 1015.** He added 65,000 of additions which gives him a basis of $80,000 per section 1016. The property is subject to 75,000 debt; however, this is irrelevant as only the money spent on additions would affect his basis. He would be entitled to depreciation on the $65,000 house through May 15, 2001, under the section 168 mid-month convention. TP would have generated $887.00 of Depreciation on the house for year $65,000/27.5 X 4.5 months. TP could deduct any interest paid on the loan per section 163. [any discussion of section 7872 or 1272 issues would be beyond this course].

Since the property was immediately rented in 1994, no personal taint arose from personal use. Rental to brother would not appear to count as personal use by the taxpayer per section 280A(d)(3), which allows rental of residence to family members if the rental unit is a fair. Based on the facts it doesn’t seem that the brother has a interest in the unit under 280A(d)(3)(B). As a result, TP would be allowed a 165 loss on a sale (which does not occur because of section 1041), 167 Depreciation (per above), and section 212 up-keep and maintenance (no facts are provided to illustrate these, but some would likely exist, e.g., property taxes,
insurance, and costs of overseeing the property and collecting the rent or attempting to collect the rent).

Property is transferred during 2001 to an ex-wife in a 1041 exchange. Per 1041, because the transfer was incident to a to a divorce, the husband would recognize no gain or loss, even though he substantively “sold” the property for the amount of the debt to which the property was subject. The wife takes the property with the adjusted basis of the husband (Whatever he depreciated over the years using the straight line method divided by 27.5 years.)

The wife’s assumption of TP’s debt would likely have no consequences because of section 1014, as explained above. Ideally, the parties would label this as non-alimony such that no question would arise; however, since wife’s assumption probably would extend past her death, any payments she made on what began as TP’s debt would not be alimony under section 71.

The past due rent assigned to wife presents a difficult section 1041 problem. Per Rev. Rul. 87-112, this is likely not a transfer of “property”; hence, the historic rule of U.S. v. Davis would apply, as would both the assignment of income and acceleration of income doctrines. The amount of income to the Taxpayer would be a function of the value of the right transferred, less his basis (which would be zero on accrued rent). Because the amounts were past due, they would be difficult to value. However, when brother paid $2000, it would constitute income to TP, not wife. The discharge would have no impact on taxpayer or wife as the right to collect it would have a zero basis. The $500 current rent would be taxable to wife as she would now be the owner of the property.

**QUESTION THREE**

During the year 2000, taxpayer had long-term capital gains of $42,000, short-term capital gains of $17,000, long-term capital losses of $64,000, and short-term capital losses of $19,000. He also had a short-term loss carryover of $15,000 from 1999.

What is his capital loss carryover, and its nature, to 2001, if any?

$14,000 STKL and 22,000 LTKL

**QUESTION FOUR**

Taxpayer owes $14,000 in personal credit card debt, but is unable to pay it. As his counsel, you negotiated with the credit card company to reduce the debt to $10,000, which includes a discharge of $1000 principal and $3000 capitalized interest (unpaid interest which was added
Explain to your client the consequences of this discharge. (You may want to review section 163(h) for this question).

The $4,000 discharge results in discharge of indebtedness income per 61(a)(12) and Kirby Lumber. The TP cannot use 108 unless he is not insolvent. If TP is insolvent per 108 he would be able to exclude the $4000 to the extent that liabilities exceeds assets at the time of the discharge.

Section 108(e)(2) is irrelevant because payment of the interest would not give rise to a deduction: see section 163(h).

Counsel should also consider the implications of the Zarin case regarding whether the discharged interest was a legitimate debt. If it were not, per Zarin, the discharge would not give rise to income.

QUESTION FIVE

Does section 1231 apply to personal casualty losses (for example, a loss from the theft of an automobile used exclusively for personal purposes)?

YES (NO)

(CIRCLE ONE)

Explain if you care to:

Normally, a personal casualty loss would be a loss under 165(c)(3), subject to the 100 per casualty 165((h)(1) and allowed to the extent that the loss exceeds 10% of the AGI. It would not be affected by section 1231.

However, if this was an antique automobile held in a transaction entered for profit, it would qualify as a 1231 casualty loss and be thrown into the firepot. Calling such a set a facts “personal”, however, would not seem correct.