

Name: KEY

Accounting 385/685:
Introduction to Taxation, Spring 2019
Final Exam
Version A

Instructions: No cell phones or computers may be used during the exam, not even on the desk, and not at any time. Be certain to turn in your notes, with your name on them, along with the exam.

Note that there are two longer problems at the end of the test. (I know, it doesn't add to 100 - but it's ok - it will be scaled)

Partial credit is available on all problems and to receive full credit **SHOW ALL WORK NEEDED TO ARRIVE AT YOUR ANSWER AND PROVIDE AN EXPLANATION FOR YOUR ANSWER.**

1. (8) Leonard Lambert's commercial building, which had an adjusted basis of \$600,000, was totally destroyed by fire. The fair market value was \$300,000 just before the fire. Leonard received \$150,000 insurance proceeds. What is the amount of his loss deduction?

⑥ { Total Loss \rightarrow ded. loss = Basis - Insurance
 $= 600,000 - 150,000 = 450,000$

calculation: (2)

2. (6) Tom Thompson traded in a station wagon (used in his business) which had an adjusted basis of \$7,500 for a new one with a price of \$42,000. The auto dealer allowed a trade-in allowance of \$20,000 on the old station wagon and Tom paid \$20,000 in cash. What is Tom's recognized gain or loss (if any) and basis in the new station wagon?

④ New basis = FMV. Only real prop. qualifies for LK exchange.

Basis = 42,000, Gain = $42,000 - 7500 - 20,000 = 14,500$

② OR: Could assume FMV = 40,000 (not list-price)

Basis = 40,000, Gain = $40,000 - 7500 - 20,000 = 12,500$

3. (8) Bill Burns purchased used furniture from his employer for \$5,000 this year. The fair market value of the furniture was \$8,500 at the time of his purchase. What is Bill's basis in the furniture? Explain.

③ Basis = FMV = 8,500. a Bargain purchase and "discount" is actually compensation \rightarrow Bill. \rightarrow Bonus = \$3,500, income.

Explanation
⑤ Basis = 5,000 + 3,500 = 8,500
\$ Pd inc. recorded 1 FMV

Name: _____

4. (9) Margaret Mildred, whose annual salary is \$50,000, has a net long-term capital loss of \$1,000 and a net short-term capital loss of \$8,000. What is her capital loss deduction this year and what income, if any, does it offset? What amount(s) of capital loss carryover to next year and into what rate basket do they go, if there are any carryovers?

$$\begin{array}{l} STCL \quad <8,000> \\ LTCL \quad <1,000> \end{array} \left\{ \rightarrow \quad <3,000> \right. \quad \begin{array}{l} \text{ord. ded } \textcircled{3} \\ \text{All from STCL,} \\ \text{which is applied 1st} \end{array}$$

Cap. loss carryovers

$$STCL: \quad <8,000> \xrightarrow{\text{ord. ded}} <3,000> \xrightarrow{\text{carryover}} <5,000> \rightarrow \text{ST Basket}$$

$$LTCL: \quad <1,000> \rightarrow <1,000> \rightarrow 28\% \text{ basket}$$

5. (8) Tom Truman sells a business machine that he has owned for four years for \$27,000. Tom purchased the machine for \$45,000 and has taken \$35,000 in depreciation. How much and what type of income, ordinary, capital, Sec. 1231, effect will result from this sale?

S.P.	27,000
cost	45,000
dep.	<u><35,000></u>
adj. Basis	<u>10,000</u> <(10,000>
real'd \neq recog'dgn	17,000

all ord. inc

$\textcircled{3}$ (§1245 recap = lesser of real'dgn,
or total dep.)

6. (9) This year, Norman Newhouse sold real estate used in his business for \$110,000. It cost \$100,000 and Norman had properly claimed MACRS deductions totaling \$40,000. Straight-line depreciation, if it had been used, would have been \$25,000. What amount of gain should he report as Section 1231 and as ordinary income?

S.P.	110,000
cost	100,000
dep	<u><40,000></u>
adj. Basis	<u>60,000</u> <60,000>
real'd \neq recog'dgn	50,000
ord. = Accel. > SL	15,000
SL	25,000
1231	10,000

S.P.
cost
 \rightarrow SL dep. = 25,000
 \rightarrow Accel. dep. = 15,000
Adj. BASIS \rightarrow SL.

(6)

Name: _____

7. (8) On January 1, this year, Alex Burg, a CPA who accounts for his business on the cash basis, billed his client, Joe Schmoe, \$10,000 for tax work done last year. Unfortunately, Joe is not a nice person. He was convicted of murder and sentenced to life in prison this year, and Alex will never collect any money for his work. How much of a tax deduction can Joe claim for this loss, and is ordinary or capital?

(3) $\text{Loss} = \emptyset$

Explanation: Alex is a cash basis taxpayer.

(5) He recognizes gain only on receipt of actual payment, no accrual income. Thus, no inc. recog'd. \rightarrow No basis in the receivable. No basis \rightarrow No ded.

8. (10) Bill, whose tax rate is 28%, wants to invest in bonds. He can buy equal-risk taxable bonds paying 3.1% or muni bonds paying 2.1%. Which is best for him? What is the market rate of implicit tax? Show all needed work to support your answer. (imp. tx rate)

Muni-bond implicit tax rate:

$$ROR_{\text{muni}} = (1 - \frac{\text{imp. tx rate}}{\text{rate}}) ROR_{\text{taxable, corp. bond}}$$

(6) $\rightarrow 2.1\% = (1 - \frac{\text{imp. tx rate}}{\text{rate}}) 3.1\% \rightarrow (1 - \frac{\text{imp. tx rate}}{\text{rate}}) = \frac{2.1}{3.1} = 0.67742$

$\rightarrow \text{imp. tx rate} = 32.3\%$

Bill should buy taxable bonds, his tx rate, 28%, is less than imp. tx rate of 32.3%

(4) Proof: $3.1\%(1 - .28) = \overbrace{2.232\%}^{\text{ROR muni}} > 2.1\%$

$ROR_{\text{corp.}}$ after-tx
 taxable bond
 ROR for Bill

Name: _____

9. (30) John and Margaret are exchanging properties. John paid \$2,000,000 for an apartment building in 1985 and it is currently worth \$3,500,000. Under straight-line ACRS he has properly claimed \$1,000,000 of depreciation since 1985. His property is subject to a mortgage of \$500,000. Margaret has an office building which she bought 2 years ago for \$2,750,000 on which she has properly claimed \$200,000 of depreciation and other cost recovery. Straight-line depreciation would only have been \$180,000. Her property is currently worth \$3,800,000 and is subject to a mortgage of \$100,000. They are considering the following arrangement: They are to exchange properties and Margaret is to assume the mortgage on John's property and he is to assume the mortgage on hers. In addition John is to pay Margaret \$700,000.

30 MAX

Required:

1) Determine, under the proposed transaction, both parties' realized and recognized gains and/or losses and how they are taxed (1231, 25%, ordinary income) and their bases in properties received.

2) Suggest improvements to this plan. Be specific, and show all work as well as exactly what will result from your suggestions in terms of both parties' realized and recognized gains and/or losses and how they are taxed (1231, 25%, ordinary income) and their bases in properties received.

RE ~~5mv cost dep. debt~~ ~~\$1 Pd~~
~~J 3500K 200K 100K 500K, \$700K~~
~~M 3800K 2750K 200K 100K~~

~~3,800K 2,750K 200K 100K~~

② Eq. FMV? $3,500,000 + 700,000 - 500,000 =$
 $3,800,000 - 100,000$, both: $3,700,000$ ✓ yes

Real'dgn

	J	M
inv LK rec'd	3,800,000	3,500,000
lebt relief	500,000	100,000
" assumed	<100,000	<500,000
Pd ⑧	<700,000	—
rec'd	—	700,000
Basis given	<1,000,000	<2,550,000
cost - dep	2,500,000	1,250,000
real'dgn		
ecog'dgn		
C. debt relief ③	500,000	100,000
debt relief	<100,000	<500,000
lebt assumed	<700,000	—
↓ Pd	—	<0 → 0
↓ rec'd ⑤	0	700,000

Actual dep SL dep ord. Excess inc. dep
 W rates: $200,000 - 180,000 = 20,000$
 Balance of dep: $SL = 180,000 \times 25\% =$
~~1231 gN = balance = 700,000 - 200,000 =~~ ②

Basis	J	M
LK basis given	1,000,000	2,550,000
gn recog'd	0	700,000
debt relief	<500,000	<100,000
" assumed ⑧	100,000	500,000
\$ Pd	200,000	—
\$ rec'd	—	<700,000
	1,300,000	2,950,000
FMV LK rec'd	3,800,000	3,500,000
def'dgn = real'd - recog'd	—	4
gn - gn	—	—
J = 2,500,000 - 0 → <2500000	—	—
M = 1,250,000 - 700,000 → <550,000	—	—
	1,300,000	2,950,000

Planning: ① J pays $\$ \rightarrow$ Mortgage → $\$ 200,000$ cash remains. ⑧
 ② If $J \neq M$ do not agree to ③ below,
 J has $\frac{1}{2}$ no excess debt relief = $\$$.
 M's gn = 200,000 (from \$ rec'd)
 ③ If $J \neq M$ agree: ① M pays off
 mortgage of $\$ 100,000$. ② J puts
 $\$ 200,000$ into prop. improvement.
 \rightarrow Eq. FMV, No debt, No $\$ \rightarrow$ recognized gn

Name: _____

10. (20) Bud's business is very profitable and has been growing steadily. John put several new assets in service in his business this year. The first is a machine with a five-year life and a cost of \$12,500, which was put into service on February 10. The second is a warehouse, which cost \$1,250,000 and went into service on June 11. The third is operating equipment, three-year life, which went into service on August 12, and cost \$13,000. The final asset is another machine with a five-year life, costing \$20,000, which went into service on November 12.

Required: What is the maximum amount of cost recovery that Bud can get this year? Ignore bonus depreciation but be certain to consider the optimal section 179 deduction allocation. However, because of other property investments through his partnership, the maximum amount of section 179 deduction, for this problem, is \$25,000. Be certain to show all of your work clearly.

① Mid-Qtr or mid-year % yr?

Qtr	\$	if $\frac{\sum \text{4th Qtr}}{\text{2 years}} > 40\%$ → mid-Qtr, else mid-year
1	12,500	
2	0	
3	13,000	here:
4	$\frac{20,000}{45,500}$	$\frac{20,000}{45,500} = 44\% \rightarrow \text{mid-Qtr is required.}$

② Optimal § 179 ded. allocation

Ⓐ 1st yr. dep. rates

Qtr	\$	life	rate	Notes
1	12,500	5	$\frac{1}{5} \times 2 \times \frac{2}{8} = 0.35$	Could use tables from master tax guide
3	13,000	3	$\frac{1}{3} \times 2 \times \frac{3}{8} = 0.25$	Allocate balance, $25,000 - 20,000 = 5,000$ of § 179 here
4	20,000	5	$\frac{1}{5} \times 2 \times \frac{1}{8} = 0.05$	allocate max., 20,000, of § 179 here

③ Total 1st-year cost recovery

$$\text{Building: } \frac{1,250,000}{(39 \times 12)} \times 6\frac{1}{2} =$$

$$\text{dep. } 17,361 \quad \$179$$

$$\text{Qtr 1: } 12,500 \times 0.35 =$$

$$4,375$$

$$\text{Qtr 3: } (13,000 - 5,000) \times 0.25 =$$

$$2,000$$

$$\text{Qtr 4: } (20,000 - 20,000) =$$

$$0$$

Subtotals

23,736

5,000

20,000

25,000

TOTAL

48,736

§ 179 allocations
④

11. (12) It is now December 15 and your client, Cheryl Maxwell, has come to you for some tax advice. He started his business in January of last year and, now, at the end of this year finds, for the first time, that he wants to dispose of some operating assets. He is somewhat flexible about the timing of when he does this. The first asset is his business car. It cost him \$40,000 and he has properly taken \$5,000 of depreciation. Its current fair market value is \$30,000. The second asset is his office desk. It is an antique and was an excellent investment for Cheryl. He paid \$45,000 for the desk and he has properly taken \$12,000 of depreciation on it. It is now worth \$50,000.

Required: Advise Cheryl about how to structure these sales so that he pays the minimum income tax. For this purpose, assume that his tax rate on ordinary income is 40% and that his rate for capital gain is 20%.

Key to this problem: No §1231 look back at this time.
So, if gain this year and loss next year \rightarrow No later
§1231 look back, either.

Benefit: LTCG, @ 20%, this year and ord. loss,
@ 40%, next year

Sell desk	S.P.	50,000	
this year:	cost	45,000	
	dep	<u>(12,000)</u>	
	Basis	33,000	<u>(33,000)</u>
	gain		(7,000)
<hr/>			
Next year:			
Sell Business	S.P.	30,000	
car	cost	40,000	
	dep	<u>(5,000)</u>	
	Basis	35,000	<u>(35,000)</u>
	loss		<u>(5,000)</u> → §1231 loss
			→ ord @ 40% loss

Wrong answer: Worst sell car, loss, this year and desk, in,
next year. $\leftarrow \cancel{\text{O}}$

less bad. sell both this year

$$R_{\max} = 6$$