Name: KEY

Accounting 385/685: Introduction to Taxation, Spring 2019
Exam 2

Instructions: **No cell phones or computers may be used during the exam, not even on the desk, and not at any time. You will need to remain in the room, in your seat until the exam is over, even if you finish early. Be certain to turn in your notes, with your name on them, along with the exam.**

Note that there are 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**.

any 3. but is > 1 year needed, must mention it.

1. (7) Give three examples of sales or exchanges that could be taxed at a long term capital gain tax rate of zero. Explain fully what is necessary for this to happen.

3 A in all cases the ordinary income tax rate that would apply to these gains, is taxed as ordinary, must be 15% or less

examples: ① held > 1 year personal assets, Investments, §1231 gain, net of 1231 lookback, any sale of a capital asset.

4 ② No matter how short the holding period: Qualified patent sales, sales of inherited property.

2. (10) Joyce Jacobson's capital transactions were as follows: ~~$5,000~~ loss on sales of Hummel dolls purchased as investments five years ago; ~~$3,000~~ gain on sales of yahoo stock held for 2 years; ~~$3,000~~ of unrecaptured section 1250 gains; and short term capital gains of $7,000. If Joyce's long term capital gain tax rate is 20% and her ordinary income tax rate is 40%, what amounts of net gains and/or losses will she report and at what rate will they be taxed?

28% 25% 15% ord income

28% loss	3 25% inc.	4 15% inc (20%)	STCG	
<5,000> →	3000	3000	7000	<5000>
net loss	<2000>	1000	3	3000
		15%	ord inc. 40%	3000
				7000
				8000 net gain

3. (10) This year, Norman Newhouse sold a patent (basis of $0) to a firm that is going to make his product. Norman was also hired by the company to consult on the manufacture and sale of the item. Norman is to receive an annual salary of $100,000 and $15 for each item sold. If 20,000 items were sold how much income must Norman report and how much is long-term capital gain and how much is ordinary income?

5 ord. inc. = Salary 100,000

LT cap. gn = patent proceed = 15 X 20000 = 300,000
5

amounts are ① ord. income, 25% income, and LTCG.

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4. (~~10~~ 15) On January 4, 1983 Rita Racksaw purchased an apartment building for ~~$200,000~~ with an estimated life of 40 years. Recently, she has been renting out the apartments for, in total, $10,000 per month and on March 31, this year, she sold her building for ~~$650,000.~~ Assume that this is the only sale of business property by Rita in ~~the last~~ ten years, and that she has no other sales of business property this year. If she had deducted ~~$200,000~~ of depreciation, but straight-line depreciation would have been $160,000 what amounts of income does she report, and what ~~are the tax rates applicable to those amounts?~~ Tax rates

SAle of Apt. Building: S.P. 650,000

② Basis
Cost 200000
dep <200000> <0>

real'd/recog'd gn 650,000

③ Rent income
Jan → march. 3X10000 30,000
680,000

Tax rates
① Excess dep
Actual 200,000 ③
"SL" <160,000>
ord. 40,000
② "SL" dep. 25% 160,000 ③
③ gn > dep.
S.P. 650,000
total dep <200,000> ③
§1231 gn, 450,000

15 max

	ord.	25%	net 1231
rent	30,000		
Excess dep	40,000	160,000	450,000
	70,000		

all LTCG ③ Why? No 1231 lookback.

5. (7) This year, Thomas Manning sold equipment used in his ~~business for~~ ~~$35,000~~. He paid ~~$42,000~~ for it, and had taken ~~$25,000~~ of depreciation. Straight-line depreciation would have been $15,000. What amounts of net Sections 1231 and 1245 gain should he report?

S.P. 35000

③
Cost 42000
dep. <25,000>
Basis 17000 <17000>

gn 18,000

§1245, ord 18,000 ③

§1231 0 ①

6. (10) Explain the difference between a court case being overruled versus it being reversed.

⑤ overruled: same issue, later different case, different decision, by same court, or higher in chain of appeal

⑤ Reversed: same case, on appeal, different decision

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7. (12) On December 23, 2018, Jill purchased land next door to her CPA office to use for additional parking for $100,000. Jill's tax rates are 15% for LTCG and 40% for ordinary income. However, her plans changed and she accepted a very, very nice offer to work for a national accounting firm. She sold her CPA practice to a friend on April 17, 2019 (she wanted to keep it long enough to collect all of her clients' tax return preparation fees) for $400,000, which included $150,000 for the land. What amount of gain or loss does she report from the land sale, and at what rate is it taxed?

Land sale

S.P.	150,000
Basis	<100,000>
gain	50,000

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↑ Ord. income

Tax rate

① holding period, 12/23/2018 – 4/17/2019 is less than 12 months

② Parking lot is not a cap. asset it is an operating, §1231 asset

But, held < 12 months → ord. income

10 for explanation & Concluding ord. inc.

9. (20) Assume the date is January 1, 2019. Your client, Martha, has $500,000 to invest. She plans to liquidate her investment at the end of 2027 to use as a down payment on a condominium, which she plans to buy at that time. Her ordinary income tax rate is 22%. She is considering the following equally risky ~~investments~~: A corporate bond paying 8% and a municipal bond paying 6%. She has the following questions.

a. What is the implied tax rate of investors in the market at this time? Show all work and explain fully.

Implicit tax: $ROR_{muni} = (1 - \text{implicit tax rate})\, ROR_{corp}$

8 $\Rightarrow 6\% = (1-X)8\% \rightarrow X = 25\%$

b. Which investment do you recommend and why? Show all work and explain fully.

Her best choice is taxable.

Explanation: (several ways to do this) any one way is fine

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① her tax rate, 22%, is less than implied tax rate, 25%, → select taxable

② Compute both

$ROR_{muni} = 6\%$

$(1-.22).08 = 6.24\%$ Best as $6.24\% > 6\%$

her tax rate

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10. (20) John, a CPA with his own practice, is moving to a New office. His lease is for 5 years, and is renewable. Unfortunately, the space is not in good shape; it needs to have new walls installed and some walls taken down. John has determined that it will cost him ~~$7,000~~ to improve it and make it ready to move into. In addition, he plans to devote 10 hours of his own time to working on the improvements (value of his time as a CPA is $200 per hour, a low-cost cheap CPA who is not very busy). He has negotiated with the landlord to reduce his rent by $15,000 in return for dong this work. How will John and his landlord treat this arrangement for tax purposes? Explain fully.

John $\xrightarrow{\text{services}}$ Landlord

John $\xleftarrow[\text{15,000 rent relief.}]{}$ Landlord

John.

income

Comp. for services 15,000

Cost <7,000>

net income $\boxed{8,000}$

8

Rent expense, tax ded. business expense: $\boxed{\langle 15,000 \rangle}$

Land lord

Rent income 15,000 3

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Property capital improvement = 15,000 4

deductions = dep on 15,000, 5 39 years, straight line.

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11. (25) John Major and Wilma Smith have come to you for some advice about how to deal with a new flexible spending plan their employer is offering (they work for the same company and will split your fee, which you will charge at $500 per hour - you are not a cheap CPA and you are very busy). John's tax rate is 25% and Wilma's is 36%.

The plan is all or nothing. If an employee accepts the plan, their salary is reduced by $10,000, and, in return, they can select various benefits up to an amount of $10,000 or less. The benefits they have available are: Life Insurance, $3,000; Medical Care, $5,000; Long Term Disability, $2,000, and, Dental Care, $2,000. The employer has arranged with the care providers that any of these benefits can be purchased by employees for the same price whether they buy them inside the plan or outside of it.

3000
5000
2,000
2,500

Wilma is very conservative. She wants everything. If she can't buy it within the plan, then she will buy it with her own money. Since the plan does not provide enough money to buy everything, (1) what items should she buy within the plan and what items outside of it? Explain why. Compute for Wilma (2) how much of her salary, before tax, she saves by using the plan, as opposed to buying these things outside of it.

John is very different. He is convinced that his teeth are going to last forever and that he will never become disabled. He is only interested in Medical Care and Life Insurance. He instinctively feels that as he only needs $7,000 of benefits ($5,000 Medical Care and $2,000 Life Insurance) that he should opt to keep the $10,000 of salary, pay his tax, and then purchase these two items without using the plan. (3) Is he correct? Be certain to show all relevant calculations and other work to support your analysis of the differences in his pre-tax salary. Whatever is best how much does he save compared to the other alternative

Long-term disability is Not inside plan

anything is ok inside plan that sums to $10,000 - except

(1) Wilma should not buy long-term disability inside the plan. Why - (a) She must spend $5,000 of her own money. (b) if Long-term disability is bought with plan money → all ord. inc. If she gets any benefits, Tax free is paid for outside the plan.

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Explanation is very important

(2) Salary plan saves Wilma:

Value of plan = # of salary

(4)

$X(1-.36) = 10{,}000 \rightarrow X = \boxed{15{,}625}$ (5)

Savings $= 15{,}625 - 10{,}000 = \boxed{5{,}625}$ (3)

(3) John's choice

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(a) Salary, X, need to buy benefits without the plan

$X(1-.25) = 7{,}000 \rightarrow X = 9{,}333$, but plan costs 10,000 of Salary

→ Reject the plan ← Analysis (4)

he saves: $10{,}000 - 9{,}333 = \boxed{667}$

(2)