Name: KEY

Accounting 385/685: Introduction to Taxation, Fall 2018
Exam 2
Version B

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 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. (7) Gain on sale of land can be taxed at ordinary income tax rates for several reasons. Describe three ways this can happen.

farmland held < 10 yrs.
→ soil & water conservation

subdivision 6th 5% dSP

2 ① short term capital gain

2 ② Inventory

7 if all correct → 3 correct

2 ③ §1231 operating asset: land under a building or a parking lot & §1231 look back

– Be open to other possibilities, if correct

2. (16) This year, Joyce Jacobson's books and records reflected the following:

Taxable income	$35,000
Short-term capital gain	500
Short-term capital loss	(2,400)
28% long-term capital gain	1,500
15% long-term capital loss	~~(3,600)~~ → ⟨3800⟩
25% long-term capital gain	1,000

Y

What is (are) the amount(s) and basket(s) of Joyce's capital loss carryover(s), if any?

Total loss = ⟨3200⟩

Short term:

Cap. gn		500
Cap. loss		⟨2400⟩ 3
net		⟨1900⟩

1st → ⟨1900⟩ → ord. loss

5

Long term:

gn	1500+1000	2500 3
loss		⟨3800⟩
		⟨1300⟩

2nd → ⟨1100⟩ → ord. loss

⟨3,000⟩ total max. allowed

Carryover: LTCL
1300 − 1100 = 200 LTCL → 28% Next year

5

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3. (10) This year Ernest Earner licensed his patent (basis of $0) to a company for manufacture and sale of the product in California. He receives $15 for each machine manufactured and a "signing bonus" of $150,000. This year, 10,000 machines were manufactured. What amount(s) must Ernest report on his tax return, and of what kinds (15%, 28%, etc. capital, or ordinary)?

6 License in just one state → ordinary income (must be entire Country for LTCG)

Bonus 150,000

Sales: 15X10,000 150,000 4

Total 300,000 ordinary income

4. (15) On October 1, 2016, Rita Racksaw purchased a warehouse for $200,000 which she leased to a manufacturing corporation. On January 5, this year, she sold the warehouse for $250,000. Assuming that the depreciation rules in 2001 are the same as today, how much and what type of gain will Rita have on the sale?

4 Warehouse → 39 year Life, straight line, ½ month 1st & last months

	Months
Oct. 2016	½
Nov & Dec	2
2017	12
Jan 2018	½
	15

5

Dep/month $= \frac{200{,}000}{39 \times 12} = 427$ (or 427.35)

S.P.		250,000
Cost	200000	
dep. 427X15	<6405> or 6410	
Basis	193595	<193595> <193,590>
Gain		56,405 56,410

6

25% LTCG 6405

§1231 50,000

5. (10) This year, Norman Newhouse sold equipment used in his business for $14,000. The equipment cost $10,000 and he had deducted $6,000 of depreciation on it. What is the amount of gain or loss that should be reported under Sections 1231 and 1245?

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S.P.		14,000
Cost	10,000	
dep.	<6,000>	
Adj.Basis	4,000	<4000>
GN		10,000

§1245 = ord inc = dep. taken 6,000

5

§1231 = Balance of gain 4,000

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6. (10) A taxpayer purchased land on which she grew Christmas trees, which were sold each December. If the land was purchased two years ago for ~~$60,000~~ and is sold today for ~~$85,000~~, what is (are) the amount(s) and character of the recognized gain(s); capital gain, 1231 gain, 1245 gain, and/or 1250 gain?

Land is a Bus. operating asset → §1231 5

S, P.	85,000
Basis	<60,000> 5
gN	25,000 §1231 gN

7. (16) A client in Syracuse has asked you a question about a tax matter related to a past tax return. You are researching their question and have found conflicting decisions from several different Courts. The tax court supports your client's position, but a federal district court for New York City and the Appellate Court for Washington D.C. takes the opposite position. What should be the outcome of a lawsuit if your client is forced to litigate this question? Why?

8 ① Client can go to tax court. None of the other courts are in its chain of appeal Therefore, you expect the tax court to do what it did before under stare decisis.
→ client can win in tax court.

5 ② However, if other, more recent cases have ruled otherwise, the tax court could change its mind and overrule its prior decision.

3 ③ Given different court decisions IRS likely will appeal and Appellate court may go with other, higher courts, and reverse the tax court

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8. (15) Jane, an Olympic runner, has signed a contract with Converse shoes to serve as a firm-representative and spokesperson for them. She is to receive a signing bonus of $2 million and an annual salary of $100,000 for the next five years. After speaking with you, she and Converse tore up the old contract and wrote a new one under which she will be paid her $100,000 per-year salary, as before, but the signing bonus will be paid to her at the rate of $200,000 per year, plus interest on the unpaid balance, for the next 10 years. How much income per year wil Jane recognize? Explain your answer.

Under the doctrine of constructive receipt, once the Contract was signed, Jane was entitled to the $2 mill. If the contract was changed only for tax reasons, then the change is ineffective – she is taxed this year on the $2 mill. Also, she is and will be taxed on the $200,000 this year and in later years

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10. (20) John, a CPA, is moving to a new apartment. 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 live in. In addition, he plans to devote 10 hours of his own time to working on the improvements (value of his time is $1,000). He has negotiated with the landlord to reduce his rent by $11,000 in return for dong this work. How will John and his landlord treat this arrangement for tax purposes? Explain fully.

6 ① John rendered service in lieu of rent.
② the value which is most definite is the rent reduction = $11,000.

John

gross receipts	11,000
Cost of materials	⟨7,000⟩
(services = ∅, as no basis without inc. recognition) 3	
Taxable Compensation inc.	4,000

No deduction for rent Paid, as it is personal. 3

Landlord

4 ① Rent income = 11,000
② Payment was a Capital improvement Not repair 4
→ depreciate 11,000 over 27½ years,
4 ½ month in the month the work is completed.

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9. (20) Assume the date is January 1, 2018. 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 10% and a municipal bond paying 8%. She has the following questions.

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

the implied tax rate makes after-tax returns equal.

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$$\underbrace{8\%(1-0)}_{\text{muni}} = \underbrace{10\%(1-tx)}_{\text{tax. bond}} \rightarrow tx = 20\%$$

muni tx rate

implicit tx rate

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

Client's tx rate, 22%, is greater than implicit tx rate, 20%. Therefore she should invest in munis.

8

Proof: RoR muni = 8% ← Better

RoR tx bond = 10%(1-.22) = 7.8%

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Accel. dep

11. (25) Jennifer is dying. She has two assets of substantial value. One is a warehouse she has been renting out. She acquired the warehouse in 1985 for $200,000 and has been renting it out since then. It is fully depreciated and its current fmv is $350,000. She also has Amazon stock that she bought for $250,000 8 months ago, which is also worth $350,000 today. Jennifer's nephew recently was married and he and his wife are having a baby soon. They are looking to buy a house at this time and Jennifer wants to help them out with the proceeds from one of these properties. Jennifer's ordinary income tax rate is 32% and her nephew's tax rate is 24%. They both have a long-term capital gains tax rate of 15%. Jennifer is considering selling one of her assets now and giving the proceeds to her nephew (he will inherit the other, later, as he is her only relative). Or, she is considering giving one to him, for him to sell. In any case, he will need the money in the next 30 days. The estate tax consequences of keeping either asset are the same for Jennifer's estate.

5 she should keep asset with the highest tax cost, when she dies, the income and the tax → ∅. Her nephew inherits prop. with basis = fmv.

(A) warehouse tax cost

① Non-residential, in-service between 1981-1986, accel depreciation → §1245.

3

S.P.		350,000
cost	200,000	
dep	<200,000>	<0>
gain		350,000

5 §1245 = ord. inc. = total dep. 200,000

§1231 = balance of gain, LTCG 150,000

Tax: ① Jennifer sells; gives $ → nephew: ord. inc. 200,000 x 32% = 64000
§1231, LTCG, 15%: 150,000 x .15 = 22500 } 86500 4

② gift → nephew, he sells: ord. inc. 200,000 x .24 = 48,000 4
§1231 : 150000 x .15 = 22500 } 70500

(B) Amazon Stock tx cost

① gain on sale: S.P. 350000 − Cost 250,000 = recog'dgn 100,000 → STCG, 8 months, Not > 12 months. → ord. inc. tx rate

tax: ① Jennifer sells gives nephew $: 100,000 x .32 = 32,000 4

② gift, nephew sells. 100,000 x .24 = 24,000 4

least tax cost. give this to nephew, he sells. ~~choice~~

MAX: 25 points