1970

Federal Income Tax Law: Final Examination (January 14, 1970)

William & Mary Law School

MARSHALL-WYTHE SCHOOL OF LAW
COLLEGE OF WILLIAM AND MARY

Federal Income Tax Law (039) — Mr. Davies
January 14, 1970
9 a.m.--12 noon

FINAL EXAMINATION

Instructions:

This is an open-book examination to the extent that you may refer to (1) the Internal Revenue Code of 1954, (2) the Income Tax Regulations, (3) problems and other materials distributed during the course, and (4) anything else that you have prepared entirely by yourself. The total time limit for this examination is 3 hours. The suggested times listed below total 2-1/2 hours and are indicative of the relative importance of each question for grading purposes.

All taxpayers are on a cash basis and have adopted a calendar year for tax purposes. Assume, unless otherwise indicated, that the relevant year is 1968. You may disregard all of the provisions of the Tax Reform Act of 1969.

Be sure to include with each answer a detailed explanation of your analysis. You may include specific references to Code sections if you wish although such references are not required.

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Question I (suggested time:45 minutes)

During 1968, A was married with two minor children and was involved in the following transactions which he brings to your attention as possibly bearing upon his Federal income tax liability for the year. Compute A's Gross Income, Adjusted Gross Income and Taxable Income. Give reasons for your treatment of each item.

(1) A sold four blocks of shares during 1968 as follows:

Basis	Sales Price	Holding Period
$1,100	$1,500	3 months
1,300	1,100	3 months
1,200	1,800	9 months
1,200	400	27 months

(2) In 1967, A was in an automobile accident on account of which he collected, in 1968, $5,000 in settlement of his claim against the other driver for personal injuries and property damage. This amount was to cover $2,000 of doctor bills which were deducted as a medical expense in 1967, $800 for damage to A's automobile, and $2,200 for lost wages.

(3) A owned a farm which he had purchased as an investment in 1958 for $30,000. During the year, he was contacted by a developer and, after negotiations, the developer acquired the farm to use as a residential subdivision. In exchange, A received another farm property further out from the city worth $35,000 plus $10,000 in cash.

(4) On January 1, 196~~2~~4, A was given a summer home then worth $40,000 and subject to a $30,000 mortgage which his parents had purchased for their personal use on July 1, 1960 for $20,000. A did not use the property himself but converted it into rental property. The annual rent received has amounted to $1,500 per year. During the 5 years when he owned the property, A deducted depreciation on a straight-line basis of $1,000 per year. During the same period, he made mortgage payments of $1,200 per year and interest payments on the mortgage of $1,500 per year. On December 31, 1968, A sold the property, subject to the mortgage, for $20,000.

(5) During 1968, A received net wages of $10,500 after deductions for Federal income tax withholding of $1,800 and premiums for medical insurance of $300. In addition, A paid $250 as a contribution to his church, $1,800 as interest on the mortgage on his own home, and $3,000 for the purchase of a new automobile.

Question II (suggested time: 30 minutes)

Henry and Wilma were divorced on September 1, 1968, and Wilma was awarded the custody of their two children. Their separate attorneys prepared a Property Settlement Agreement which Henry and Wilma signed and which took effect, by order of the court, with the granting of the divorce. In the Agreement, Wilma released "all dower, statutory and other marital rights" in consideration for Henry's promises, as follows:

(1) Wilma will retain:
(a) the 12 place-settings of antique sterling silver flatware which her grandmother had given her before the marriage. (Original cost to grandmother: $200. Value on Sept. 1, 1968: $1,000.)

(b) the 1964 station wagon which Henry had purchased in his name for use by the family. (Original cost: $3,000. Value on Sept. 1, 1968: $1,800.)

(c) their bi-level colonial home purchased by Henry in 1953 for $28,000 and placed in joint tenancy with Wilma. The mortgage balance, which Wilma will assume, is $8,000 payable $1,600 per year over the next 5 years. (Value of home on Sept. 1, 1968: $32,000.)

(2) Henry will pay to Wilma $200 per month for her support, payable over the next 8 years or until Wilma dies or re-marries, and $250 per month for 15 years for support of the children.

(3) Henry will place his 200 shares of GM common (value on Sept. 1, 1968: $225/share) in trust for 5 years "to aid in the payment of the mortgage balance" on their home. The trustee is directed to pay all of the income each year to Wilma and, at the end of 5 years, to re-convey the shares to Henry. The annual trust income will consist of GM dividends of $1,600 per year.

(4) Henry will pay for the services of Wilma's attorney as well as for those of his own. Each has charged $300 for the Property Settlement Agreement and $200 for the divorce itself. Henry will pay the entire $1,000 during 1968.

Discuss the correct Federal income tax treatment of each of the above items for 1968 and future years (a) to Henry and (b) to Wilma. Each item may be considered separately; a computation of the overall effect of these items is not required.

Question III (suggested time: 30 minutes)

Two brothers are considering the disposition of an attic full of old furniture that they inherited from their father upon his death 16 years earlier. The collection is a motley lot; there are some items which, with considerable work put into them, might be sold as antiques. Many other items, while expensive when purchased thirty or forty years ago, are out of current fashion and hence hard to dispose of. Just as one of the brothers (a policeman with an income of $7,000 per year) is impatiently about to sell the whole lot to a second-hand furniture dealer in a bulk sale for $1,100 cash (of which each brother would receive one-half, or $550), the second brother (a wealthy doctor) suggests the following alternative. He will give the entire lot to a qualified charity. An antique dealer will give him a tax letter valuing the items at what he (the dealer) regards as their highest defensible value, conceivably totalling as much as $25,000. The deduction of this amount will be worth $12,500 to him since he is in the 50% bracket. He will then give one-half of the resulting tax savings, or $6,250, to the policeman, and thus each brother will be $5,700 better off.

Comment on the doctor's proposal, and advise the brothers how they should handle the transaction. What additional facts would you like to have?

Question IV (suggested time: 45 minutes)

Colonial Marysville, Inc. operates for profit a tourist attraction consisting of a Museum of Early American History and a restaurant featuring dining in the colonial manner. Last September, Don, a local high school student who had been working part-time for C-M, became intrigued with their loose security procedures and total lack of insurance protection.

By December, 1967, he had successfully stolen $10,000 from the receipts at the information desk plus two volumes out of a matched set of rare books which had been on display in the Museum. As a completed set, the five books were worth $15,000 although each separately was worth only $2,000. The books had been purchased in 1955 for a total of $5,000.

The missing cash was discovered in December, 1967, and early in 1968 the fact that the books were missing was discovered, but no clues were found as to the perpetrator, and Don remained happily on the job. C-M offered a reward of $1,000 to anyone for information leading to an arrest and conviction.

In June, Paul, a serious full-time student of history at a nearby college who was angered over the loss of the books, decided, primarily for that reason, although he knew of the reward money, to devote his summer to trying to solve the crime. He took a job at the Museum and, by building a confidential relation with Don, was able to gather information which led to Don's conviction. Of the cash and books taken, however, only $5,000 and one book were returned in 1968. The remainder was never recovered.

C-M, dispairing of ever getting the books back had already sold the remaining three volumes in 1968 for $6,000. After the conviction, the reward was paid to Paul in 1968 and C-M, recognizing the potential advertising value, also paid Paul's college tuition for 1968. The fact that C-M had paid this tuition was included in the December, 1968 news-letter that C-M sent to its regular patrons.

Discuss the correct Federal income tax treatment of these various items for 1967 and 1968 to (a) C-M, (b) Paul, and (c) Don.

END OF EXAMINATION