1973

Federal Income Tax: Examination (January 1973)

William & Mary Law School

FEDERAL INCOME TAX EXAMINATION

January, 1973 | Professor Donaldson

I.
In two sentences or less, identify or explain:

(A) The federal court or courts in which, in a tax controversy, the taxpayer may have a jury trial.

(B) Example of "conduit" or "pass-through" method of taxation.

(C) Step transaction doctrine.

(D) Elective provision pertaining to allowance of "ordinary loss" treatment with respect to sale of stock of certain corporations.

(E) Provision limiting the "Cohan" rule.

II.

As Assistant Secretary of Treasury for Tax Policy, you are asked to recommend income tax legislation that would effect the following. As to each, what would you recommend.

(A) Discourage purchase of capital equipment by industry, thereby cooling down the economy.

(B) Reduce the amount of "personal expenditures" across the nation, thereby reducing "consumer demand" and inflationary pressures.

(C) Encourage an increase in the pool of funds available for mortgage loans, thereby enabling expanded home ownership by more Americans at reduced interest rates on mortgage loans.

III.

Hiram Walker had an unusual year in 1972. In January a parcel of land which Walker had purchased in 1968 for $10,000 was condemned by the Highway Department and Walker received $25,000 as compensation for the taking, which he promptly used to purchase Whiteacre, which cost him $24,000. In February, Walker purchased a $1.00 ticket in a raffle and won a color television worth $400.00. In March, Walker was informed by the Company which employed him as a foreman that thereafter the Company was going to provide free Blue Cross coverage to all employees, at a cost to the Company of $8.00 per month per employee. In April, Walker was informed by his life insurance agent that the cash surrender value of his mutual insurance policy was increasing at a rate of $300.00 per year, although Walker was paying only $275.00 per year in premiums. In May, Walker, who had loaned $300.00 to a friend interest free the preceding year, was paid in full, although he did not expect to be repaid until 1973. In June, Walker, learning that Whiteacre had doubled in value because of a new industry nearby, borrowed $35,000 from a bank, giving a deed of trust on Whiteacre as security, and with the $35,000 purchased $1,000 shares of Amalgamated Industries common stock. In July Amalgamated Industries declared and paid a dividend of one-to-one in common stock, so that each common stock holder received one share of common stock for each share owned. After the dividend, Walker's 2000 shares of common stock were worth $36,000 and at the end of the year were worth $38,000. In August, Walker had a bad day at the race track and lost $250.00. In September Walker sold Whiteacre for $17,000 in cash and the buyer assumed the deed of trust on the property. In October Walker's wife died unexpectedly and Walker received $10,000 as a life insurance benefit under a policy purchased on her life by Walker and on which he had paid premiums of $3,000. In November Walker was robbed of $500.00 by a burglar and two days later was fired by his employer for alleged improper advances to female employees, which allegations were unfounded. Walker paid his attorney a $100.00 retainer to represent him and after a letter was written by the attorney, Walker was reinstated by his employer. On returning to work, Walker found that the employer had mentioned the reasons for Walker's discharge to other persons, including Walker's pastor and Walker's current girl friend. Walker was incensed, and in a stormy meeting with the employer, Walker demanded $10,000 as damages for slander or else he would bring suit. The employer presented Walker with a check for $8,000 in full settlement and Walker cashed it.

In December, Walker, meeting his attorney at a cocktail party, informed him of how he had successfully represented himself on the slander claim. Walker despaired when his attorney told him the slander claim was worth at least $35,000, that "a man who represents himself has a fool for a client," and that Walker had lost a substantial sum by failing to get legal advice. Just before Christmas, Walker was presented with a check for $15.000 and a turkey worth $7.00 as a gift or bonus from his employer. Each employee received a similar gift.

Note the effect of the preceding transactions on Walker's tax liability for 1972, and indicate whether the income or deduction is "ordinary" or otherwise.

<u>January</u>

<u>February</u>

<u>March</u>

<u>April</u>

<u>May</u>

<u>June</u>

July

August

September

October

November

December

IV.

Sam Jones, who is exceedingly wealthy and who has a lucrative income from his solely-owned unincorporated real estate agency, does the following during the year:

(A) He establishes a trust and transfers 10,000 shares of IBM stock to it, under terms where the trustee is to pay the income to William Jones, his minor son, for 7 years after which time the trust is to terminate and the principal to revert to Sam Jones.

(B) He gives $5,000 shares of AT&T stock to his aged, invalid father outright, believing that his father's will leaves everything to him. He had, prior to that, been giving his father $500.00 per month, which he now discontinues doing.

(C) He compels his 25 year old indolent, lazy daughter, Susan, whom he is tired of supporting, to accept a clerical job at his real estate agency at a salary of $5,000 a year, upon pain of disinheritance if she refused.

(D) He sells to his wife, who is independently wealth, 5,000 shares of stock for which he had paid $50,000, for a purchase price of $30,000 its fair market value. He is convinced that the stock is "sound" and should be kept in the family.

(E) To his elder sister, whom he has been supporting, he gives a life estate in Blackacre, a tenant farm which produces and annual income of $5,000, and ceases to support his sister.

Assuming that the properties involved in the above transactions produce substantial income, and assuming that Sam Jones' relatives are each in lower "tax brackets" than he, how, if at all, do the above transactions tend to reduce total taxes for Jones and his relatives.

V.

On January 1, 1972 William Smith purchased 10 acres of timberland for $5,000, believing that it would be valuable for residential development in a few years. He also bought a used desk and cabinet for use in his business, for which he paid $300.00 and a new duplicating machine for which he paid $1,000. He estimates that he will hold the timberland 10 years before selling it, that the desk and cabinet have a useful life of ten years and that the duplicating machine has a useful life of 10 years. As to each of his purchases, what is the maximum amount of depreciation he can elect to take for 1972.

VI.

X, who formed "X, Incorporated" in 1955 with a capital contribution of $20,000, in approaching retirement age and wishes to sell out. An independent appraiser has concluded that the net fair market value of all the corporation's assets is $300,000. X's accountant advises him that recapturable depreciation amounts to $60,000. Y Corporation is interested in acquiring the X, Incorporated assets and agrees that $300,000 is a fair estimate of the net value of its assets. Retained earnings in "X, Inc." are substantial. What are the various methods by which X can "get his money out", and note the advantages and disadvantages of each to the seller and buyer. §331

VII.

X owns land worth $100,000 that is subject to a mortgage of $50,000 and has a basis of $20,000. Y owns a restaurant on an adjoining parcel which has a basis of $35,000 and a fair market value of $40,000. Z has $40,000 in cash. X,Y and Z each join together to form the XYZ Corporation. X transfers his land subject to the mortgage, Y transfers his parcel with the restaurant and Z contributes $40,000 in cash. Each receives 100 shares of XYZ no-par common stock and X, in addition receives $10,000 in cash. Discuss the tax significance of the above transactions as they relate to X,Y and Z and to the corporation, noting any income that must be recognized and the basis of the assets and stock after the transfers.

VIII.

X's net taxable income, computed without regard to the following transactions and events, in 1972 was $10,000, after all deductions and exemptions. Taking into account the following, what is his net taxable income for 1972:

Sale of shares of G. M. stock held 4 months for $10,000, acquired by gift from father at time when value was $9,000. Father had paid $12,000 for the stock two years ago.

Sale of personal color television set that cost $350.00, for $100.00, and which had been held for 3 years.

Death without assets of a friend to whom X had loaned $1,000 three years ago, and who had not repaid the loan.

Exchange of an antique, which cost $4,000 eight years ago, for a summer cottage worth $6,000.

Sale of shares of Ford stock which cost $18,000 and held 5 months, for $17,500.

Sale of a depreciable asset used in business which cost $10,000, had been depreciated by $2,000, for $6,000, after having used the machine 4 years.

Death of X on December 15, 1972 at age 59, where he had purchased an annuity for $10,000 in 1950 which was to pay him $2,500 a year beginning at age 65.

IX.

X, a wealthy man with a huge stock and securities portfolio, and interested in locating a tax haven, formed a new corporation, "X Investments, Inc." and transferred to it stocks and securities which normally produced $20,000 of dividend and interest income yearly. The company's sole activity was managing its investment portfolio. X then had a will drawn which bequeathed the stock to his son. X did not intend to withdraw dividends from the new corporation. Has X, from a tax standpoint, acted wisely? Explain.

X.

Blue Corporation, which manufactures widgets, sells them exclusively to "AB" partnership, of which A is a 70% partner and also sole owner of Blue Corporation. Blue Corporation owns the land and buildings used by the AB partnership and has been charging $8,000 annual rent to the AB partnership. In 1971 Blue Corporation had net earnings of $38,000 and the AB partnership had net earnings of $12,000. Early in 1972 Blue Corporation agreed to reduce the rent charged the AB partnership by $3,000 and agreed to reduce the price of the widgets sold to the AB partnership by 20%, which was expected to reduce by $10,000 the cost of the goods to be sold by the AB partnership in 1972. Do the above pricing agreements reflect sound tax decisions. Explain.