1956

Basic Federal Taxation: Final Examination (February 1, 1956)

William & Mary Law School

Repository Citation
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I. (Suggested time: 1 hour)

That are H's and W's (a) CROSS INCOME; (b) ADJUSTED CROSS INCOME; (c) TAXABLE INCOME, and (d) TAX LIABILITY in the following circumstances, filing a joint return for 1955?

H is 60 years of age, married to W, 55 years old. W's niece, N, 12 years old, lives with H and W. H's father died in early 1955 and an insurance policy in his life in the face amount of $10,000 is payable to N at $800 a year for a period of 20 years. The $800 paid to N in 1955 is used for her support. In addition, H gave N board and lodging of the value of $500 and also paid $600 for H's medical expenses described below under disbursements.

Their receipts for the year include:

$600 in cash dividends on X Corporation stock owned jointly by H and W,
15,000 in cash commissions earned by H in his employment as traveling salesman for the X Corporation,
4,250 upon the sale of 6%, 10 year, municipal bonds of the City of Richmond, matured in 1950, face amount $6,000, for which H and W had paid $4,200 in 1950,
2% interest upon the bonds prior to their sale,
500 for entertainment of X Corp. customers while H is traveling in the pursuit of his selling activities.

Their disbursements for the year include:

$550 entertainment of customers of the X Corporation,
100 commissions paid to another who assisted H in the making of a sale of X Corp. products,
1,000 resulting from an automobile accident caused by H's negligence while pleasure driving, of which $300 was for the repair of H's pleasure car, $600 was in settlement for the damages caused to the other person's car, and $100 was for H's attorney who negotiated the settlement,
100 for the purchase of aluminum mining stock in February. The seller did not reveal to H at the time of the sale that a suit was then pending against the corporation challenging the corporation's title to the property which it intended to develop and mine, and which resulted in H's obtaining in a final judgment being entered against the corporation. The corporation had been formed with its only asset consisting of this property transferred to it by its founders, all of whom, including H's seller, sold their stock to others, such as H, and absconded,
2,852 in taxes consisting of the following: 300 Federal social security tax withheld on his $15,000 commissions; 2,000 Federal income tax; 250 State income tax; 3 State capital gains tax on himself and W; 200 County property taxes, realty and personal; and 100 in annual license taxes imposed by some of the States in which H carried on his selling activities,
600 medical expense incurred on behalf of N, of which 100 was for medicines and 500 for hospital and doctor's fees,
300 interest, of which 200 is upon a mortgage on H's and W's residence, and 100 is upon a personal note given by H to raise the cash necessary to purchase the X stock.

II. (Suggested time: 1 hour)

In 1951, H's father, F, acquired some land at a cost of $750. He constructed a house on the land, completing it in January 1952. When completed the house had an habitable usefulness of 25 years and was worth $12,000, although, due to the fact that F did considerable work on it himself, he was able to build it for $10,000 during the whole of 1952 and 1953 F rented the premises to a tenant.

In early January 1954 F deeded the property to S as a wedding present. Its value was then $8,000 for the land and $15,000 for the house. The increase in value being attributable to the development of the surrounding neighborhood.

S continued the tenant's lease for 1954. He attended college and the only income that he and his wife, W, had for that year was the $3,000 rental received from the tenant. He filed a tax return for that year jointly with W, setting forth on their return the $3,000 rental income, deducting the real property tax paid of $100, depreciation of $500, and personal exemptions of $2,000, to arrive at a taxable income of zero. He elected 500 as his depreciation, believing that that was approximately correct and that in any event he would owe no tax, and intentionally to arrive at the zero taxable income to save himself the trouble of any further calculations on the return.
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The lease terminated and S occupied the house as his residence from January to July 1955. He became dissatisfied with the house in May and decided to sell S. Preparatory to selling it, he redecorated and fixed it up with various repairs, at a total cost of $300, the bill for which he paid immediately. On July 1, 1955, S sold the property for $16,000, receiving $6,000 in cash and balance of $10,000 by 6% note payable in installments over 12 years, secured by deed of trust. In August he purchased a new house for $12,500, which he thereafter lived in as his residence. On December 1, he received one semi-annual installment payment on the note in the amount of $500 on the principal and $300 interest.

He has asked you to determine the amount and nature of his 1955 income resulting from the transaction, using all proper means to minimize it. (a) What is the basis for the new house?

III. (Suggested time, 25 minutes)

T consults you in December, 1955, seeking advice on a transaction which he has pending: one is the sale to the tenant of some rental properties which he has owned for several years and which will result in a profit of about $5,000; the other is the sale of some corporate ten stock which he purchased on July 1, 1955, and which will result in a loss of about $3,000. T has decided that he will make the sales and he is confident that he can conclude them either now (December 1955) or in January on the very same terms. The advice which he seeks is whether to sell either or both now or in January, and he gives you the following information for your consideration. His ordinary net earnings from his lumber business is fairly stable from year to year and will be about $20,000 for 1955, on the calendar year and cash basis. He does substantial buying and selling of picks and shovels, such transactions to date in 1955 resulting in a net long term gain of $3,000 and a net short term gain of $2,000. He anticipates substantial long term gains in 1956. Years ago he had purchased some diamonds at a bargain for $2,500 and had these made up into a diamond bracelet for his wife at an additional cost of $500. In May 1955 the diamond bracelet was stolen, uninsured and then worth $5,000. He can think of no other transactions in 1955 which may have tax consequences. He is not particularly concerned about deferring or not deferring his certain profits and losses as long as other factors would be given greater weight. That would you advise and why?

IV. (Suggested time, 15 minutes)

In 1952 T purchased for $500 an interest in a claim under which he was entitled to receive $2,500 a year. This interest was in the amount of $500 and pending was successfully. Following final judgment for the plaintiff, but before any payment, T in 1954 transferred his interest in the claim to his children. The judgment was paid in December, 1955, and the children received $25,000 in satisfaction of their interest. Discuss the taxability of the proceeds as to who has how much income and of what nature.

V. (Suggested time, 20 minutes)

A is the sole owner of a small retail store, having an adjusted basis for the business assets considerably less than their actual value. He proposes to expand his business and, looking for additional capital for the purpose, will take B into the business with him. B to contribute cash equal to the value of A's business for an equal interest and actively participate in the conduct of the business. They are undecided whether to operate as a partnership or as a corporation. Briefly mention in what tax respects the following facts considered separately are material, if at all, to the choice of the business form. For example: Fact - the expanded business is likely to produce a taxable income well in excess of $25,000. Good answer - The tax on the corporation will be 17% instead of only 25% of such excess and if the partners would not be in any high tax bracket individually, this fact would favor the partnership form. Excellent answer - all of the above plus - however, as the profits increase so would the tax brackets of the partners and eventually might reach a point where the corporate tax of 17% would be lower.

(e) B has substantial income from other sources.

(b) A substantial percentage of the net profits from the business will be attributable to the services to be rendered by A and B.

(c) The consequences on the formation of the business in that the value of the business assets exceeds their adjusted basis.

(d) The intention to retain in the business a substantial part of the net profits for expansion purposes.

(e) Following expansion, the business will invest its profits and build up a substantial capital reserve.