1961

Adjective Tax Law: Final Examination (June 1961)

William & Mary Law School

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T is a lumberman in the business of cutting and selling timber. In 1955 he purchased Pineland, a tract of timber land for $30,000. In 1956 he cut and sold the timber on the land for $25,000. In his timely filed Federal income tax return for that year he reported sales of timber in the amount of $50,000, no part of which, however, included the $25,000 received for the Pineland timber, T believing in good faith that the proceeds should be treated merely as a reduction of his basis for the property.

In 1957 T sold the cleared Pineland to a realty development company for $25,000 and in his tax return for that year, filed timely, he reported gain of $20,000, computed upon the $5,000 adjusted basis.

In May, 1961, T received a statutory "90 day letter" determining a deficiency for the year 1956, based upon the sale of the Pineland timber, asserting that $15,000 of the $30,000 cost should have been allocated to the timber with a resulting $10,000 gain on its sale.

You have determined that the 1956 timber sale should have been treated by T in the manner in which the Government contends. In that case, however, cleared Pineland would have had a remaining basis of $15,000 with only a $10,000 gain on its sale in 1957. Therefore the primary consideration is to avoid, if possible, a $10,000 gain in 1956 as well as a $20,000 gain in 1957, when the over-all gain was only $20,000.

It is now June 3, 1961. Discuss the success potential of each of the following possible courses of action (a) through (d):

(a) Pay the 1956 deficiency and immediately file claim for refund for 1957.

(b) Assert the statute of limitations as a defense to the 1956 deficiency.

(c) Seek equitable recoupment of the 1957 overpayment to offset the 1956 liability.

(d) Take steps necessary to apply IRC Sec. 1312, paragraphs (7), (4), or (1) towards recovery of the 1957 overpayment.

(e) If you should elect the (c) course of action, what procedural steps would you take to effect a judicial determination of the issue?

(f) If you should elect the (d) course of action, what procedural steps would you take to make available the method of adjustment with the least possible delay?
II.

In his Federal income tax return for 1956, filed on Apr. 15, 1957, T reported net gain from the sale of capital assets, $10,000; loss in his retail furniture business, $6,000; deduction for personal exemptions, $1,800; and itemized deductions totaling $2,200. He attached to his return a statement that his home was burglarized of $5,000 worth of jewelry, but as he was uncertain at that time whether his insurance covered burglary loss, and as in any event his other itemized and personal exemptions deductions exceeded his adjusted gross income, leaving no taxable income, he had not included it in his itemized deductions.

In Feb. 1959 the Commissioner determined a $2,500 deficiency against him for the taxable year 1956 based upon T's treatment of $20,000 gain on the sale of lots as long term capital gain, the Com. asserting that it was ordinary income as T had made substantial improvements to the lots and was otherwise engaged in sales of realty throughout the years and therefore the sale of the lots was in the ordinary course of his business of selling realty.

T paid the $2,500 in March, 1959. In October, 1959, he filed claim for refund of that amount, setting forth in his claim that his improvements to the lots were "necessary improvements" (237(b)(3) and not the "substantial improvements" (237(a)(2) as contended by the Com. in the deficiency notice.

(a) If the Com. were to deny T's refund claim in June, 1960, would a new claim for refund of $1,000 alleged overpayment of his 1956 liability based upon the burglary loss be timely if filed immediately thereafter?

(b) If the Com. had taken no action on the original claim made in Oct. 1959, would amendment of the claim in June, 1961, be timely made so as to set forth the burglary loss in order that T may still get refund of $1,000 even if he should lose the capital gain issue?

(c) No new claim or amendment having been made and timely action being commenced June 1961 by T on the original claim, may T set up in his pleadings and prove that the improvements to the lots were made by the selling agent for increased commissions and therefore were not "substantial improvements made by the taxpayer" (237(a)(2)?

(d) May the Government set up in its pleadings and proof in the (c) action that by reason of faulty, but not fraudulent, inventories T's loss in his retail furniture business was not as much as the $6,000 which he claimed, and, if so, for what purpose?

(e) May T introduce in the (c) action the deductibility of the $5,000 burglary loss, and if so, for what purpose?
III.

In 1950 Grantor, G, established two, independent, irrevocable trusts, each with a corpus of $100,000, one primarily for his daughter, D, and the other for his son, S. The two trust instruments were identical with the exception of the designated beneficiaries. The income was to be accumulated and added to principal and upon the death of G, the principal to be distributed outright to the primary beneficiary if living, otherwise remainders over. However, G retained the power to distribute income or corpus to the primary beneficiary as might be necessary for his or her comfort and welfare.

G paid no gift tax, contending that by reason of his retained power, the gifts were incomplete, incurring no tax liability. The Commissioner determined a 1950 gift tax deficiency for the transfers, asserting that the power was subject to a sufficient external standard and therefore the transfers in trust constituted completed gifts. G took the controversy to the Tax Court and won his case in 1952, the Court holding that the gifts were incomplete by reason of G's retained power to shift the ultimate enjoyment of the property.

In 1955 D married against G's wishes. She and her husband became impoverished and she appealed to G for support from the trust. Upon G's refusal, she brought action in a State court of equity to compel distribution of trust funds to her, and succeeded, the Court holding that the power was not a discretionary one and that its exercise could be compelled when the standard of distributions being necessary for comfort and welfare was met.

G died in 1960. The Executor included the corpus of the two trusts in the gross estate for estate tax purposes, paid the tax thereon, and then filed claim for refund, grounded upon completed gifts having been made upon establishment of the trusts in 1950 with no reserved discretionary powers in Grantor. The refund claim was denied and in the litigation which followed, the Government contends that the Tax Court's 1952 decision is res judicata of the nature of the power retained by G, which is the only issue before the Court. The Government also asks for equitable recoupment of the 1950 gift tax which should have been payable if the Court were now to hold that res judicata does not apply and that the retained power was not a discretionary one. Discuss the merits of the Government's contentions.