EXAMINATION BOOK
Instructions

1. Use a pen with black or blue ink.

2. Do not write in margins under any circumstances.

3. Complete identification data at top right corner of this book. Do not put your name on or in this book. Use your examination number only.

4. Start answer to each question at top of a fresh page unless instructed otherwise by the individual professor.

5. Write only on the front side of the pages in this book unless instructed otherwise by the individual professor. If you need more space, use an additional book(s). If you use additional book(s), complete items in identification space (top right corner) and write Book 2 of 2, etc., in space provided. Insert additional book(s) in book one before turning them in.

6. If you type your examination, use unruled paper. Put your examination number, subject of examination and date of examination on each page and on a cover sheet to be provided. Assemble in page order, place cover on top and staple (or otherwise secure).

7. Do not tear any pages out of this book under any circumstances.

8. Ability to follow instructions will be taken into consideration in grading examinations.

9. Place complete examination book(s) in envelope before sealing.
Question 1

R has earned $1,300 of ordinary income for his shows in 2002. Because of annual accounting and R's likely use of the cash method all $1,300 will be included in R's 2002 annual return as gross income. The $1,300 is taxable to R because it is income realized from his services.

R's biggest question is whether his performances will be considered part of carrying on any trade or business or an activity not engaged in for profit (aka hobby). To be considered a business, R needs to show that his primary purpose was to make a profit. R's expectations need only be honest, need not be realistic or even reasonable. At first, R's performing was clearly a hobby, as he did it to relax at home after work or on the weekends. His motive began to change around Nov. 2001, when he got paid for the first time. Soon after in 2002 R began taking voice lessons, which is some circumstantial evidence of a profit purpose, but probably not enough.
to turn from a hobby without other evidence like his statements of intention. By mid-summer, R's hobby is looking more like a business as he begins to play more regularly, bringing in money, and buying the equipment. By Sept, R's purpose is more clearly strongly one of profit. He states his intentions to his co-workers, and lets them know his weekends will be filled with music. R realizes that he won't make a profit in 2002, but he need only seek a future profit; a present one is not required. His "expert" friend is correct in saying making money is tough. R had better keep his day job, but this just goes to R's reasonableness and does not change the fact he plans on becoming a rock star with huge future profits. All in all, it will be R's burden to show he is not engaged in a hobby to take full advantage of possible deductions and he will have no benefit of a presumption because he has not made a profit in 3 of the
last 5 years.

If the court finds this to be a hobby throughout 2002 (which is unlikely), R can only deduct expenses to the extent of his hobby gains and not against his other income; thus a max of $1,300. With $8,000 in expenses in connection with the hobby, he would easily be able to offset his $1,300 gain and thus keep he would not pay taxes on the $1,300 in 2002. The remaining losses would be non-deductible personal expenses in 2002.

Assuming R can prove he had a profit motive, his outlays become either deductible business expenses or capital expenditures.

The $600 for voice lessons may still only be deductible as against hobby income because the evidence is weak he was seeking profit at the time. If it is found to be a free part of his business, he will likely not get an immediate deduction because the lessons will produce a long-term benefit, one that will last throughout his career this.
He must capitalize it and depreciate it over 15 years as an intangible.

It is education and he does not fall within Reg. 1.162-5 because the lessons do not maintain or improve skills required by his legal job, nor are they required. So they would still be non-deductible as a personal expense.

The 2 guitars are a capital expenditure because they produce long-term benefit to R. He will use them for well more than a year and they will contribute to his income throughout their life. As capital expenditures that wear out, R can deduct their cost. With a class life of 12, they are treated as 7-year property. R could elect under §179 to deduct the full amount now (up to $25,000) or he could use the straight-line method, which would be an additional $500 deduction in 2002 of $1,000 for the following 6 years. Lastly he could deduct (under double declining method) $1,000 in 2002, $2,000–1,000 for 12-year convention.

**Note:** Business cards are clearly...
an ordinary and necessary business expense. Thus he may deduct the
as a business expense.

R has a basis in the guitars of $7,000 when he bought them. This
is reduced by the amount of depreciation he takes in 2002,
depending on the method. A capital loss.
The business cards are an
ordinary and necessary business expense. They don't produce long-term
benefit (because they are like advertising) so R gets an
immediate deduction in 2002 of
$60. R's basis is $60 - his cost.

The strings are also deductible.

The strings are also deductible as a business expense. They are merely
repairs to the guitars I do not add
to their production lives, so the
strings do not affect the basis
I need not capitalize the cards,
or strings because, as an artist, he
is not subject to UNICAP.

Commuting expenses are generally
not deductible and do not appear
to be here. Thus they are probably
a non-deductible personal expense
in 2002.
Steve B could deduct them however if he uses a room in his home exclusively for his business (i.e., for rehearsals). If he does so, his trips from the office to the shows and directly back would be deductible as an business expense. He could deduct his actual costs in 2002 or use the IRS mileage rate.
EXAMINATION BOOK

Instructions

1. Use a pen with black or blue ink.

2. Do not write in margins under any circumstances.

3. Complete identification data at top right corner of this book. Do not put your name on or in this book. Use your examination number only.

4. Start answer to each question at top of a fresh page unless instructed otherwise by the individual professor.

5. Write only on the front side of the pages in this book unless instructed otherwise by the individual professor. If you need more space, use an additional book(s). If you use additional book(s), complete items in identification space (top right corner) and write Book 2 of 2, etc., in space provided. Insert additional book(s) in book one before turning them in.

6. If you type your examination, use unruled paper. Put your examination number, subject of examination and date of examination on each page and on a cover sheet to be provided. Assemble in page order, place cover on top and staple (or otherwise secure).

7. Do not tear any pages out of this book under any circumstances.

8. Ability to follow instructions will be taken into consideration in grading examinations.

9. Place complete examination book(s) in envelope before sealing.
Question 2

S is engaged in a 3 way exchange to take advantage of the non-recognition benefits of § 1031. Because S is holding Blackacre for investment, she may exchange it for another "like-kind" property that she will use for either investment or in a trade or business. All real estate is considered like all other real estate, so it’s OK to exchange the undeveloped land for the apartment and Whitacres. S is not a real estate dealer (and the fact that B is does not destroy the 1031 benefit for S). Also, S never touches any money by receiving any cash. In effect, S is exchanging Blackacre for Whitacres. S’s amount received = the $175,000 FMV of Whitacres plus $25,000 because assumed liabilities of $200,000. Her basis was $100,000 so her realized gain is $100,000. She will only recognize $25,000, which is the gain to the extent of the debt (the $25,000 mortgage). Her basis in Whitacres is $100,000 - 25,000 + 25,000 = $100,000. Thus she has a capital gain in 2002 in the amount of $25,000.
which is taxable at preferential rates in £1 (h) - either 20% or 10%. The fact that S transferred Blackburne 2 weeks before she received Whitley does not alter the result because S has a 45-day period in which to select the property and has 6 months to close.

It appears that all of the £25,000 will be excluded from S's income in 2002. Under £104(a)(2), S benefits from £104(a)(2) because she recovered damages in a tort cause of action while suffering from physical injury. Thus, any portion attributable to the compensatory damages is excluded in 2002. If not for the physical injury, S would have had to report it as ordinary income in 2002. In this category case, it does not matter what she does with the money; it doesn't affect the result. The portion of damages going to the casualty loss (damaged equipment) is also excluded as part of the judgement.
The damages going toward the damage equipment is part of the overall judgment so they too are excluded. If they had been pairities they would have been taxed as ordinary income in 2002.

S can’t take a casualty loss because she has been reimbursed for her losses to the equipment. Even if S wasn’t reimbursed, she would have had to have shown losses in excess of 10% of her AGI in 2002.

The money she spent on the lawyers is a non-deductible personal expense in 2002. The claim did not arise out of her bankruptcy (no connection at all).

Because her damages were excludable, she does not get a deduction. If she could have deducted them, S would be subject to a 2½% floor, which she might reach since her fees were “sizeable.”