Income Tax I
Fall 2019
Final Exam
Samples of Good Essay Answers

QUESTION 37

No. 6722

1. Option

Assume the option is not an ISO. Further assume the option does not have a readily ascertainable value, then § 83 does not apply on grant, but it applies on exercise of the option.

Thus, when Clincorp granted the option to Reba, she does not receive income from such grant. But when she exercises her option, she will have a compensation income of $30 per share, i.e., the spread between the value of stock purchased ($80) and the amount paid for the stock ($50), or $30,000 total. Such gain is regular income for Reba. The basis per share is the purchase price of the stock, i.e., $80 per share, or $80,000 total. When Reba exercises her option in 2021, Clincorp can deduct an amount equal to the amount of compensation included in Reba's income, i.e., $30,000.

When Reba sells those stocks in 2023, Reba will have capital gain of $40,000 ($120,000 realized minus $80,000 basis). Clincorp cannot take any further deduction in 2023.

If, however, the option is an ISO, then Reba receives no income at grant or exercise. Her basis will be $50,000 based on the option price. At the sale of the stock, she will have a capital gain of $70,000 ($120,000 realized minus $50,000 basis). Clincorp, however, will not be able to receive any deduction.

2. Land exchange

Reba may deduct expenses on her vacant land (e.g., taxes, and other maintenance cost) because she held it for money making purpose. But since Reba is a working physician, any losses she incurred from operating her vacant land will be passive activity losses under § 469, and thus can only be used to offset passive activities income. Also note the Reba cannot adjust the basis of the land because the land is nondepreciable.

She engaged in a 3-way exchange of her real estate asset with Bertha and Sam. The exchange qualifies for the like kind exchange under § 1031. This is because Reba, who is not a real estate dealer, gave up real property she held for investment, and received real property to hold for use in trade/business (i.e., rental). The exchanged properties are of "like kind" based on their "nature and character" instead of "grade or quality."

By such exchange, Reba realized a capital gain of $1,000,000 (FMV $1,500,000 minus basis $500,000). However, some of the gain is not recognized under § 1031. The recognized gain is the smaller of realized gain and the boot she received. Here, in exchange of her vacant land, she received the apartment building which is the like-kind property as well as $300,000 cash, which is characterized as a boot. Thus, Reba must recognize $300,000 capital gain, i.e., $700,000 of the gain is not recognized. Reba's basis in the acquired apartment building will be her old basis $500,000, decreased by the boot $300,000 and increased by the recognized gain $300,000, i.e.,

$500,000.

When Reba rents out the units of the apartment building, she again engages in passive activities because rental is per se passive activity under § 469. Although she may deduct property tax (and interests if any, not applicable here) of the rental property above the line, her other expenses that result in operating loss associated with her rental activity will only be used to offset passive activities income (if any), and the extra losses can be carried over.

3. Donation

Reba's art collection is also a hobby, thus, any income/loss she incurred from that is also subject to the rule § 469.

Her donation to the local museum is subject to § 170. The museum likely qualifies a permissible recipient under § 170(c). Thus, Reba can claim itemized deduction of her charitable donation of the art, if she elects to use itemized deduction instead of using standard deduction under § 63.

In general, the amount of the deduction for gifts of property is equal to the FMV of the property, according to Reg. § 1-170A-1(c)(1). If that is the case, Reba can deduct the whole FMV of $10,000. However, that general rule is subject to an exception under § 170(e), which provides that the deduction must use the lower of the FMV or basis for tangible personal property that charity does not use in exempt function. Thus, if the museum keeps the art (e.g., use it in its exhibit), then Reba can deduct $10,000. But if the museum sells the art, then she can only deduct the basis of the art, which is $500.

Charitable donation is also subject to a ceiling which is a defined percentage of taxpayer's AGI. Since Reba is a physician and likely have a high AGI, and the max deduction she can take is $10,000, she probably can include the full deduction amount below the line.

4. State and local taxes

In general, taxes incurred on personal life can be deducted below the line under § 164, if the taxpayer elects the itemize her deduction. Thus, Reba can deduct her state and local property taxes ($22,000). She can also deduct her state and local income taxes ($15,000+$3,000=$18,000). As an alternative, she can elect to deduct her local general sales taxes ($5,000) instead of the state and local income taxes.

However, there is a $10,000 limit for the aggregate amount of taxes (the aggregate of state and local income taxes, real property taxes, and personal property taxes) taken in a taxable year, which is $10,000, or $5,000 for a married individual filing a separate return. If Reba is not the latter, her upper limit for tax deduction is $10,000. Thus, if she selects to deduct state income tax, the aggregate amount will be $40,000, which exceeds the $10,000 limit by $30,000. If she elects the deduct her local sales taxes, her aggregate amount is $27,000, which still exceeds the $10,000 limit. Thus, either way, Reba can only deduct $10,000 for her taxes.

No. 6895

1. Reba

R = Reba. C = Clincorp. B = Bertha. S = Sam.

The stock

The stock option is probably a qualified (or "incentive") stock option under §422. There was no disposition of the stock within 2 years of the grant of the option, nor within 2 year of the exercise of the option. §422(a)(1). The option was not "in the money" at the time of the grant; the exercise price was equal to the fair market value of the stock at the time of the grant (though it later became "in the money" by the time of the exercise). §422(b)(4). The option by its terms could not be outstanding for more than 10 years after the grant, as it was limited to a two-year period. §422(d)(3). The value of the stock covered by the option was less than $100,000. §422(d)(1). One thing that could make it into a nonqualified stock option is if Reba already owned more than 10% of the company's stock at the time of the grant. §422(d)(6). There is nothing in the problem that says that she does.

If she doesn't have more than 10% of the company, then it is a qualified stock option. At the time of the grant in 2019, there are no tax consequences for Reba. The exercise of the option in 2021 is not a taxable event for Reba. Her basis in the stock purchased is the option price of the 1,000 shares: $50,000. When she sells the stock in 2023, she will realize and recognize a gain equal to the excess of the sale price over the option price: $120,000 - $50,000 = $70,000. Under §1221, stock is a capital asset (unless R is a stock broker). The sale of the stock would be a sale or disposition of a capital asset, so under §1222, the gain will be capital. R will have $70,000 of capital gain in 2023 from the sale of the stock.

If she owns more than 10% of the stock in the company, it will be a nonqualified employee stock option under §83. The grant of the stock option will have no tax consequences, unless the option has a readily ascertainable FMV. In 2021, when she exercises the option, she will have ordinary income equal to the "spread" of the market value of the stock over her purchase price: $80,000 - $50,000 = $30,000 of ordinary income in 2021. Her basis in the stock will be the market value of the stock at the time of purchase: $80,000. Reg. §1.61-2(d)(2). When she sells the stock in 2023, she will have capital gain equal to the sale price minus the market value at the time of purchase: $120,000 - $80,000 = $40,000 capital income.

So if it is a nonqualified employee stock option (because she already owns more than 10% of the stock in the company), she will end up with $30,000 ordinary income and $40,000 capital income, in 2021 and 2023 respectively. Otherwise, she will have $70,000 of capital income in 2023.

The land

The exchange of the land for the apartment building is a like-kind exchange under §1031. Real property is generally "of like kind" with other real property, and both of the pieces of land involved are used either in a trade or business or for investment, so those requirements for a like-kind exchange are met. If the exchange happens simultaneously, there is no problem with the deadlines for a deferred exchange under §1031(a)(3).

When the exchange is made, R will realize a gain equal to her total amount realized over her adjusted basis in the land, but only part of that gain will be recognized. Her §1001 realized gain will thus be the excess of the sum of the value of the property received ($1,200,000) and the boot received ($300,000) over her adjusted basis in the vacant land ($500,000). ($1,200,000 + $300,000) - $500,000 = $1,000,000 realized gain. But under §1031(b), only the gain represented by the boot will be recognized, so only $300,000 of the gain will be recognized in the year of the transfer. That gain will be capital under §1222 because land held for investment is a capital asset under §1221, and there has been a sale or disposition of that asset. R's basis in the apartment

building, under §1031(d), will be equal to her basis in the old property minus the cash received plus the gain that was recognized: $500,000 - $300,000 + $300,000 = $500,000. Her old basis will essentially carry over to the new property.

If she were to sell the new property at its current fair market value, the rest of her gain from the appreciation of the old land would be recognized: $1,200,000 - $500,000 = $700,000, for an ultimate total of $1,000,000 of gain from the appreciation of her old land.

Any rental income received from the tenants of her new property will be ordinary income.

The sculpture

She might be eligible for a §170(a) charitable contribution deduction for her transfer of the sculpture to the museum. The museum is probably eligible under §170(c), provided that it is operated exclusively for educational purposes (although the IRS might not strictly enforce this requirement), the museum is in the USA, and the museum is not engaged in lobbying or politics (again, the IRS might not really press them on this). The problem tells us that it is a nonprofit, so that requirement is met. Under §170(b), R's contribution deduction will be limited to a percentage of her AGI, probably 30%. §170(b)(2)(B).

The amount of R's deduction will equal the net benefit that she is transferring to the museum. Here, she seems to be getting nothing in return, so it will be simply the value of the sculpture. Under Reg. §1.170A-1(c)(1), usually the amount of the deduction will equal the fair market value of the property. In this case the FMV is $10,000. Because the claimed value is more than $5,000, R will need to have the sculpture appraised. §170(f)(11)(C). She will also need a receipt or substantiation of some kind from the museum in order to be able to take the deduction. If the museum does not actually use the sculpture in its business (such as by adding it to its collection), and instead, for example, sells the sculpture immediately, then under §170(e) Reba might only be able to deduct her basis in the property, which is $500. Otherwise, the deduction will be $10,000. Either way the deduction will be capital (I think?) because the sculpture is a capital asset. I think. The deduction would be below the line.

Taxes

R may take federal deductions for state/local income tax under §164. §164(a)(1) allows for deductions for real property taxes. Here, those are $22,000. §164(a)(3) and (b)(3) allow Reba to deduct either her income or sales taxes, which would be either $18,000 or $5,000. But for Reba it doesn't matter which she chooses, because §164(b)(6)(B) limits such deductions to $10,000 a year, and her local property tax alone would hit this limit. Reba can take a $10,000 deduction, deductible against ordinary income. The deduction would be below the line.

No. 6050

Stock Option Tax Consequence

Reba first must determine whether the stock option grant was a qualified or nonqualified stock option plan because this will affect her final tax consequences. Neither plan has tax consequences when the option is granted since the grant is "in the money". If it was not in the money then Reba may have immediate ordinary income under 409A.

If Reba falls under a **non-qualified plan** (usually where the employer does not offer the plan to

other employees) then Reba will have a taxable event when she exercises her option to purchase. She will have to pay taxes on the increased value (30 dollars) and this will be taxed as ordinary income. Her basis will become the 80 dollars rather than the 50 dollars in the option. When she finally sells the stock in 2023, she will pay long-term capital gains tax on the increase from her purchase till her sale (120 each minus 80 dollars = 40 dollars per share).

If Reba works for an employer who issues the stock under a **qualified plan** (IRS 421 and 422/Incentive Stock Option), she will have a better tax result. Both the grant of the stock option AND the exercise will result in no tax consequence. She will have a basis of 50 dollars a share when she purchases them. Provided she keeps them past the specified period which it appears she does, she will pay long term (since it was over a year) capital gains tax on the increase in value when she sells them (rather than ordinary income rate) which will be $70 dollars per share (120 per share sell price minus 50 dollar basis).

She may have had an AMT issue prior to the 2018 (or if she sells after 2025). However, this is unlikely given the changes in AMT that results in it affecting very few people.

Land Sale

For Reba, the question is whether she can utilize IRS 1031 when she trades her vacant land for cash and another property. If she does not use 1031 then her exchange would be treated as a sale and anything in excess of basis would be taxed as a capital gain. This would result in her paying tax on 1 million dollars (1.5 million that she received in property and case minus her 500k basis). If she used this property for personal use, held it out for sale or was a real estate dealer, she will not be able to take advantage of 1031.

If she is able to use 1031 (and I hope for her sake she is), Reba must ensure that the exchange is for a "like kind" of property. Thankfully the IRS has defined it very broadly under Reg 1.103(a-b) and this exchange is allowed. Triangular exchanges are also allowed provided Reba finishes the exchange within 180 days. Since it appears she does meet these qualifications, she can probably take advantage of 1031 to avoid paying tax on all her gain and retain her original basis in the new property. Reba will have to pay tax on the boot (the 300k in cash she received) as any items besides the property received is taxed. She will not be able to utilize any of her basis to reduce her taxes on the 300k. However, she will get a basis of her original 500k in the property that has the 1.2 million dollar value. This is calculated by taking her old basis (500k) minus the cash received (lesser of boot or gain realized) (300k) and plus the gain recognized (300k) which gives her a new basis of 500k. Reba will not have to pay tax on the increased value of the property (700k) she got until she sells it since it was a non-recognizing event under 1031.

Art Donation

Because Reba collects art as a hobby, she would be unable to utilize any business deductions for her donation. Instead she must deduct it as a charitable gift. As the value is over the 5k, under 170(f)(11)(c), Reba would need to have an appraisal of the value. Assuming she got an appraisal that showed the property was worth 10k, Reba could deduct that appreciated amount since it would be a capital gain. How much she could deduct will depend on whether the educational institution is a private foundation or a not and whether the art is related to the charity's purpose. Reba would be limited to a deduction of half the value of the contribution base (usually AGI) if it was to a non-private nonprofit (see 170(c)). If it is a private foundation she would be limited to only 30 percent deduction of the value. Since it is appreciated property, this decreases even further to 20 percent.

Depending on how much Reba makes, she may be better off simply taking the standard deduction. Charitable deductions are a below the line itemized deduction. She can deduct nothing if she does not itemize.

Local and State Taxes

Since the 2017 Jobs and Tax Act raised the standard deduction substantially, Reba can only deduct her state and local taxes if she is one of the few who still itemizes. IRS 164 deals with state and local taxes and these deductions are below the line. Reba must itemize to get any deduction for them. Unfortunately for Reba, the maximum is only 10k. The remaining 35k that she spent would be lost (and there's no carry forward). She also must choose between income or sales tax. She will most likely choose state income since it is over the 10k anyways. Her property tax could be deductible under 164 provided that it was not used to upgrade the property in some way. If it was a special assessment or was used for improved roads, utilities, that portion would also not qualify for a deduction. (See 164(c)(1).

Reba is probably better off taking a standard deduction. The other thing she could do is move to a income/sales tax free state like Alaska. Reba may be disappointed in her tax burden, but she did make a lot of money.

QUESTION 38

No. 6041

Rent and other costs associated with writing business

Javier may be able to deduct the rent of room (pro rated) as an ordinary and necessary business expense above-the-line. Rent is an example of an ordinary and necessary business expense.

To deduct costs associated the his home office, the home office must be his principal place of business (PPOB), and Javier may ONLY do business in that room, which is often a difficult requirement to meet. (No kitties allowed!). Here, it seems like his home office is the PPOB because it is where he does all his writing. Assuming that Javier only does writing in the office, then he may deduct, pro rated, costs of the home office.

He may also have a qualified business income deduction under IRC § 199A.

Loan

The loan from the bank is not income because there is a presumption that he will pay the loan back.

Purchase Willowacre (WA)

Javier bought WA for $50k from his stock market account plus the $300k loan, $350k total. (Even though the $300k is loaned, it is added to the amount realized. *See* Crane). His basis in WA is the total amount of the price paid, $350k.

Repairs

The repairs that Javier made are deductible and he does not need to capitalize them so long as the repairs are not improvements. Improvements include substantial renovations and additions to property. Because he did not make substantial renovations or additions to the property, Javier

does not need to capitalize these expenses. He may instead deduct these costs as part of his business. However, there are doubts as to whether or not he has a legitimate business.

Net operating losses (NOL)

As a farmer, Javier can have his NOL carry backwards and forwards. However, seeing as he has no gains to offset, this may do him little use.

Cannabis cultivation

During Javier's taxable year as a cannabis farmer, IRC § 280E imposes restrictions that Javier may not claim a deduction or take a credit for amounts paid or incurred while carrying on his trade or business if the activities consist of trafficking in controlled substance and prohibited by federal law. If Javier sells the cannabis, he is likely "trafficking," and therefore cannot take a deduction or credit for his costs associated with his cannabis farming operation. As far as his cultivation in violation of federal law goes, illegal income is still income, and he will be taxed on any income from the operation. He does not have a second related business that he can "shelter" the business' activities.

Under IRC§162, expenses used in carrying out illegal activities *are* deductible. However, if he is trafficking drugs, as suggested above, then he does not enjoy a deduction.

Javier could, theoretically, use his cannabis business to treat expenses as part of his basis in the property because IRC § 280E does not mention basis.

Potential hobby

It is possible that Javier's farming falls under the purview of a hobby.

Even if an activity is not engaged in for profit, § 183 allows deductions without regard for whether it is engaged in for profit, but the TP can only deduct expenses against gains in the hobby. However, hobby expenses are miscellaneous and under the tax cuts and jobs Act (TCJA), Javier cannot deduct (below-the-line) hobby costs. However, the facts suggest that the farming is not a hobby for Javier. There is not a presumption that he is engaged in the activity for profit because he can not show profit for the preceding 3-5 years, only losses. Reg. § 1.183-2(b) provides objective factors to determine whether an activity is a hobby or a business including: manner in which TP carries on activity; time and effort spent on activity; expectation assets will appreciate; success carry on similar or dissimilar activities; history of income or losses; amount profit, if any; financial status of TP; and elements of personal pleasure. First, Javier does not spend much time on his farming, which weighs towards assuming a hobby. Second, there is a history of losses rather than income, which weighs towards assuming a hobby. Third, Javier derives personal pleasure from the hobby and enjoys the great outdoors, which weighs towards assuming a hobby. On the other hand, he did have an objective intention to make a profit. It seems like the farming is a hobby which means that he cannot take deductions for the farming-related expenses.

Passive activity

It is possible that because Javier is not heavily involved in the farming operation that his activities are passive. He only works there during the weekends and neighbors help the majority of the time. If the farming is passive, his losses can only count against gains from a passive activity, not income from his active writing business.

Depreciation deductions

Javier can take depreciation deductions for reasonable allowance of exhaustion, wear, and tear of the property if the property is used in business or to produce income and the property is subject to wear and tear. Assuming that he is depreciating real property, without an election, the method will be double-declining balance and mid-month. Assuming that the $10k is pursuant to the convention, $10k a year is acceptable; however, it is not acceptable if he is not using the buildings for a business or to produce income. If the farming is a hobby, then his only hope is to argue that the property is used to produce income (a potentially tough argument to make). Assuming he took the deduction appropriately, his adjusted basis (A/B) in his property is now $340k ($350k - $10k depreciation deduction).

Sale WA

Assuming he has not taken any other depreciation deductions, the A/B of WA at the time of sale is $340k. (If he needed to add any improvements to his basis, then the calculations would be slightly different). Any time a TP sells property and the buyer agrees to assume debt, the amount of debt assumed is added to the amount realized (A/R). Here, the A/R includes the cash received ($160k) as well as the assumption of debt on the entire loan ($240k) which equals $400k. Calculating a potential gain or loss on the transaction under IRC § 1031, the A/R ($400k) minus the A/R ($340k) equals a $60k gain.

The gain initially seems capital because there is a sale of property (WA), held for more than a year (several years); however, there is arguably the sale of an asset used in a business (the buildings), which triggers special rules. However, if the farming is not a business, then the gain is capital rather than ordinary income. If the farming is a business, there are special rules regarding depreciation recapture.

- Real estate commission

The commission Javier paid Mimi makes it seem like Javier only realized $380k ($140k cash plus $240 assumption of debt) from the sale; however, he effectively used the $20k cash to pay Rita. If the property was part of a legitimate business in the eyes of the IRS, then he could potentially deduct the real estate costs as an ordinary and necessary business expense when winding down the business.

Sale equipment

The sale of depreciated equipment requires depreciation recapture under IRC § 1245. Gains are ordinary to the extent that they represent depreciation previously taken. Because he deducted the entire cost of the machinery and depleted the equipment's basis, the gain is $5000 ordinary income ($5000 A/R - $0 A/B).

No. 6895

J = Javier. WA = Willowacre. M = Mimi.

The home

J might be able to deduct a part of his rental payments for his home under §280A(c) because if he does all of his writing in one room, it might count as his principal place of business. But the room must be used exclusively for business purposes. Otherwise, no part of Javier's rental payments for his home is deductible because they are likely to be considered personal, living, or

family expenses under §262.

The farm

When J takes out a loan to buy the farm, that is not a taxable event. But using his stock to pay part of the purchase price will realize any gain or loss from appreciation or depreciation of the stock. His amount realized from the stock will equal $50,000, and his gain from the transaction will be the excess of $50,000 over his basis in the stock. His basis in the farm will be the value of the cash plus the stock: $350,000.

Under Reg. §1.162-4, costs of repairs may be deductible, but costs of improvements are not. Under Reg. §1.263, property is "improved" if amounts paid are for a betterment to the unit of property (such as the money spent to get property up and running to begin with, to add a material addition ot the property, or to materially increase the productivity, efficiency, strength, quality, or output of the property), amounts paid to restore the unit of property if it is in a state of disrepair, or amounts paid to adapt the property to a new or different use. Incidental repairs to the buildings are probably deductible repairs, so J might be able to deduct the costs. But §183 generally prohibits deductions for costs spent on activities not engaged in for profit (so-called "hobby losses"). Here, the berry farming might be "engaged in for profit" if J expects to make a profit on it eventually, even if that belief is unreasonable. Under Reg. §1.183-2(b), we would look at, among other things, the time and effort spent by J in carrying on the activity, and J's history of income or loss with respect to the activity, and whether elements of personal pleasure or recreation are involved. Here, it tells us that J works there "most weekends," but it is unclear how much time he actually spends. He has made no profit. It does not tell us whether J expects to make a profit on the berries (though it does about the weed, later on). We also know that farming involves a significant element of personal enjoyment for J. The IRS would probably conclude that J is engaged in the farming for primarily recreational purposes, so J probably can't deduct his losses from the berry farming, but it is hard to say with so few facts available.

The farm activity is probably not a passive activity under §469(c) because it is not rental activity and J seems to materially participate in the farm. Reg. §1.469-5T suggests that around 500 hours in a year is enough to count as material participation. If he works "most weekends," for example, if he goes 48 out of 52 weekends a year, then 500/48 = 10.41 hours a weekend for material participation.

The weed

§280E prohibits trade/business deductions related to the business of selling schedule I or II controlled substances, which include marijuana, so J will not be able to take trade/business deductions for his weed-farming activities. If there is another significant business purpose involved with his farm, then he might (maybe) be permitted to take deductions related to those aspects of the business. §280E would also mean that he cannot deduct his interest payments on the loan for the farm.

The farm sale

J's amount realized on the sale of the farm would equal the cash received plus the amount of debt assumed by the buyer: $160,000 + $240,000 = $400,000. J's adjusted basis in the property, after taking $10,000 of depreciation deductions, is $340,000. §1016(a)(2). So his §1001 gain on the property would be $400,000 - $340,000 = $60,000 of gain. This is a disposition of depreciable real property, so under §1250, the gain from the sale will be capital, but the top rate will be 25%.

The machine sale

Because J has already deducted the entire cost of the machinery under §168(k), J's basis in the machinery is 0. His amount realized from the sale is $5,000. His §1001 gain is $5,000 - 0 = $5,000. He will be taxed on all of the cash received in the transaction, and the gain will be ordinary income in the year of the transaction. §1245.

No. 6244

1. Potential home office deduction

Section 280A governs the deductions for the use of part of a personal residence as a business facility. If it is a home office, he can deduct part of the utility, business expenses related and rents paid for that portion. 280A (c) requires the home office be used exclusively and on regular basis as principal place of business, place of business where patients, clients, customers meet with taxpayer, or separate structure used in connection with business. Principal place of business is read as the place the most important thing in the business were carried out, for example, for musicians, it is the place they do rehearsals. Here Javier is a writer, if he does all his writing in that room and exclusively for writing, I think it will meet the standards. If it is a home office, he gets to deduct some of the expenses related to that portion of the home.

2. The farm: business or hobby.

For Javier, farm could be either business or hobby. If it is a hobby, the loss can only be deducted against hobby gain, which is minimal. If it is a business, he could deduct the net operating loss against his ordinary income (Section 162) for the early years he grows berries. But federal law prohibit him from deducting anything for the years he grows cannabis, under section 280E. Javier then may want to claim the farming as a business and capitalize all his expenses in his basis and claim a much higher basis when he sells it. Information given is not clear on this.

When deciding whether this activity is a hobby or a business according to Keanini, court looks at the intent of the taxpayer whether is to make profit or mere hobby. Financial outcome is not the sole basis for the determination.According to Reg. 1.183-2, Court also looks at the following 9 factors in deciding between hobby and business: 1) manner, formality, 2) expertise of the person, 3) amount of time spent on the venture, 4) expectations of appreciation, 5) previous success, 6) history of income, 7) amount of profits, 8) financial status, and elements of personal pleasure.

In this senario, arguments for this is a business are as follows.1) Javier borrowed $300,000 from a bank to purchase the farm. It is not a small amount of loan, and it would be too a large investment to believe for just starting a hobby. In this sense, it is more like gathering funding to start a business. 4) INTENT: He expects to gain profits in this because when he found out growing berries did not render any meaningful gain, so he changed crops. This alone shows that he expects gain rather than merely enjoying the planting activity as a hobby. 9) he derives no specific pleasure from farming, although he likes the fresh air of the countryside, it is not a pleasure directly related to farming, planting berries or cannabis.

Arguments for this is a hobby would be as follows: 1) and 3), there is no proper manner for a business, he spent only "most weekends" at the farm and did not make any renovation nor additions. His input is not a lot. This is just a hobby rather than some business he is dedicated to. When he is not there, he did not hire any employees to look after the place, but asks a neighbor

to keep an eye. 8) Although he took out a large loan to start this farm, he is in good financial status, evidencing by his timely payment on the principal and interest, despite his non-success in the farm. He also believes, even if he is unsuccessful, he drives a great deal of enjoyment.

I think the argument for this is a business is stronger, because his intent to make it profitable and because how tried different crops. As I mentioned above, if it is a business, then he can deduct expenses for the years he grows berries. He can depreciate properties and machines he used in the business.

4. Sale of buildings on the farm.

According to IRC section 1001 (a), the gain realized from the sale is the difference between the sale price or amount realized and his adjusted basis. The amount realized according to 1001 (b) is the sum of money received plus the fair market value of property received, in this situation, it is the cash he received $ $160,000 plus the amount of debt assumed $ 240,000. His adjusted basis is the amount he paid for it including $300,000 bank loan and $50,000 self-financed = $350,000- $100,000 depreciation= $250,000. The gain realized is thus $150,000. $150,000- $100,000 = $50,000 of it is capital gain pursuant to section 1231, which allows depreciable real property used in a business to get capital gain. The amount up to the depreciation deduction of $100,000 is ordinary income. There is no recognition problem here because no statutory exclusion applies here. 1) there is no like-kind exchange pursuant to 1031, no real estate property is received. 2) the buildings are not his principal residence. Section 121 requires a taxpayer to live in the house for 2 or the last 5 years. Here Javier didn't live in the building. Thus, there is no recognition problem. All gain is both realized and recognized. This should be capital gain according to 1211 (b) because it is gain from 1) sale of 2) capital asset. Section 1221 (a) defines capital asset and this does not fit in the exceptions.

The $20,000 commission is deductible as business expense if the farming is a business because it is an ordinary and necessary expense in conducting the farming business. But if it is not a business, no deduction for hobby because there is no income generated from the hobby. The linkage between selling the farm and his day job as a children's book writer is very attenuated and I see the argument of business expense as related to that business hard to succeed.

5. Recapture problem on the machinery governed by section 1245

Section 1245 applies to appreciable property other than real estate, taxpayer's gain on the sale is taxed as ordinary income to the full extent of his prior depreciation deductions. If the gain exceeds that, the rest of the gain is still capital gain. Here the fact didn't provide the amount he deducted, thus, assume it is more than $5000, the $5000 he receives minus $0 (adjusted basis) is $5000 gain as ordinary income.

No. 6722

1. Home office

Javier's main job is a writer (assuming he is self-employed), and he can deduct many expenses above the line associated with his writing business.

Javier uses a room in his rental home for his writing work. Thus, he may make some deductions relating to that room that is used exclusively and regularly for business, if it meets one of 3 conditions described in § 280A(c)(1): (1) it is used as the principal place of business for any

trade or business of the taxpayer; (2) it is a place of business routinely used by patients, clients, or customers; (3) it is located in a separate structure, such as a garage, which is not attached to the dwelling unit. Here, giving the facts, Javier may satisfy condition (1) above. Thus, if he used the room exclusively and regularly for his writing, then he can deduct some of the expenses associated with home office. Even if the home is a rental home from an unrelated party, it is his principle place of residence and thus it satisfies § 280A. Otherwise, if he uses the room for some other purposes such as personal joy or if he used the room not regularly, then he cannot deduct any such expenses.

If he can deduct the expense, then he must allocate his expenses on the room from his aggregate expense (e.g., utility bills, maintenance expense, but not property tax and insurance since he is not the homeowner) on the home. In addition, his expenses will be capped, i.e., the deductions allowed shall not exceed the excess of the gross income (e.g., royalties of books) derived from the use of his home office, over the available deductions. The deduction can be above the line since he can claim the expenses is ordinary and necessary paid or incurred in carrying on his writing business.

2. Purchase of the land and farm operation

The purchased real estate has a basis of $350,000, which is the sum his borrowed money and his own stock market account (the nonrecourse loan must goes to the basis according to *Crane*). The land itself is not depreciable, but the small buildings on the property can be depreciated using the straight line method over 39 years (because it is a nonresidental real property).

Repair expenses, if used for business purpose or producing income, may be deductible under § 162 or § 212 (but as discussed later, such deduction is likely limited by the hobby loss rule under § 183). Reg. § 1.162-4 allows a deduction for the cost of incidental repairs that neither materially add to the value of the property nor appreciably prolong its useful life, but keep it in an ordinarily efficient operating condition. Reg. § 1.263(a)-3(d) provide that amounts paid to improve property must be capitalized. Here, because Javier merely made incidental repairs without making significant improvement, his expense can be deducted, not capitalized.

However, although Javier likely had a profit-seeking purpose, his farming operation is likely a hobby, not an activity engaged in for profit. Since he never turns profit on the farm operation, he cannot claim a presumption of engaging for profit under § 183(d). This is evidenced by the fact that he works there mostly in weekends and asked a neighbor to take care of the farm in weekdays. His main job is still writing books. He also derived a great deal of enjoyment of being in the farm. His farm also never made a profit. Thus, under § 183(b)(2), his expenses may be deducted, but only to the extent that they do not exceed the income from the farming activity. Also, his farming operation can also be considered as a passive activity under § 469. Thus, any loss he incurred in farming operation can only offset his passive income, in any.

If he deducts his hobby expense, he may deduct his interests on the loan under § 212 because he borrowed the money for the production or collection of income, but the deduction will be below the line deduction. He can also deduct his operation cost (e.g., property tax on the land, utility cost, maintenance cost, etc.) against any income he generated from the farm operation such as the berry sales.

After he changed his crop to cannabis, however, he cannot deduct his operating expenses associated with cultivation of cannabis, because § 280E prohibits any deduction associated with

selling or making of illegal drug under the federal statute. Here, cannabis is prohibited under the federal law, even if it is legal under the state law.

3. Sale of the land

Javier deducted depreciation of $10,000 for the buildings. That makes his basis on the land (including the building) to $350,000 - $10,000 = $340,000. By selling to the buyer who paid $160,000 cash and assumed the bank debt $240,000, he realized the amount of $400,000. Note that the amount of the debt assumed by the buyer must be included in calculating the amount realized on disposition of the real property (*Tufts*). Thus, he realized a long-term capital gain of $60,000 since the land and the buildings are capital asset that he had held for over one year. Such long term capital gain enjoys a more favorable tax rate 20% than regular income. Note the buildings are arguably not depreciable real property which otherwise would have a top rate of 25% because as described above, Javier was not using the buildings in a business, instead it was a hobby.

Javier's payment of $20,000 commission to Mimi is an expense incurred for production of income under § 212. Thus, such expenses can be deducted below the line. Mimi must report ordinary income $20,000 in her tax return.

4. Sale of the machinery

The farm machinery is arguably not a capital asset under § 1221 because it is a depreciable property used in farm business, thus it is a depreciable equipment under § 1245. Because Javier deducted the entire cost under § 168(k), the basis of the machine was zero. Thus, Javier's sale of the farm machinery yielded $5,000 gain. According to the depreciation recapture rule under § 1245, such gain is ordinary income. But if the farm machine is deemed a capital asset (e.g., based on the argument that the machine is not used in business, just a personal hobby), then the $5,000 gain could be capital gain, which would enjoy 20% tax rate.