Income Tax I
Fall 2024
Exam Essay Questions
Issue Outline

QUESTION 37

When Mack buys the office building, his initial basis is his cost, \$5,000,000. The loan is not gross income. The depreciation deductions reduce this basis, so that at the start of 2027, Mack's adjusted basis is \$4,400,000.

Interest payments in connection with a business or rental activity are deductible above the line, IRC §§ 62(a)(1), 62(a)(4), but may be subject to the limitations in section 163(j). Principal repayments are not deductible.

Rent received is gross income, and it is ordinary income. The operating losses from the office building rental are likely deductible against Mack's other gross income, including income from activities other than real restate. Mack likely qualifies for the exception to the passive activity loss rules for real estate professionals. IRC § 469(c)(7).

The foreclosure by Banco is a realizing event for Mack. His amount realized is the outstanding balance on the debt, \$4,600,000. Subtracting his adjusted basis, Mack has a realized, recognized gain of \$200,000. It is a capital gain. It is not income from the discharge of indebtedness.

On the destruction of Country Place, Mack realizes a \$7,000,000 gain. It is a capital gain. However, if he makes an election under section 1033, the gain is recognized only to the extent that the amount realized on the conversion of Country Place (\$10,000,000) exceeds the cost of Shopspot (\$8,000,000), or \$2,000,000. Under the election, the basis of Shopspot is equal to its cost (\$8,000,000) minus the gain not recognized (\$5,000,000), or \$3,000,000. Absent the election, the basis of Shopspot is its cost, \$8,000,000. The loan is not gross income, with or without the election.

Under the election, the \$2,000,000 recognized gain is reduced to the extent that any of the improvements made by Mack to his other properties are made to replace Country Plaza.

The cost of repairs made to Mack's other rental properties are deductible above the line. Expenditures for improvements must be capitalized, i.e., added to basis.

Mack's recognized gains are subject to the depreciation recapture rules of section 1250. These impose tax rates on some capital gains that are less favorable than those applicable to other capital gains. They apply to Mack's recognized gains to the extent that the gains are attributable to depreciation deductions previously taken on the real estate.

All of Mack's property taxes and sales taxes paid in connection with his rental activities are deductible "above the line" (i.e., in computing adjusted gross income) under section 62(a)(4). If Mack itemizes his deductions, he may deduct up to \$10,000 of the other state and local taxes under section 164.

QUESTION 38

If the tickets and backstage passes are a gift, they do not constitute gross income to Lyn, under section 102(a). If, however, they are not a gift, they are gross income to Lyn under section 61. The proper treatment depends on the primary motivation of Tami in making the transfer. If it is "detached and disinterested generosity," it is a gift. If it is in recognition of services rendered, it is not a gift.

If the tickets and passes are gross income, they are taxed to Lyn at their fair market values. IRC § 83. This would be the $20,000 price at which they could be sold. It would be ordinary income.

The expenses of Lyn's home office are not deductible because they are miscellaneous itemized deductions, not deductible in 2024. IRC § 67.

The meals are gross income to Lyn unless excludible under section 119. If the meals are furnished for the convenience of Firmco, they qualify for the exclusion. If they are furnished for a noncompensatory business reason of Firmco, they are treated as being furnished for the convenience of Firmco. If, however, Firmco furnishes the meals only for a compensatory business reason, the meals are not excludible. If includible in gross income, the meals are taxed to Lyn at their fair market values. IRC § 83.

Receipt of the bequest of the paintings is not gross income. IRC § 102(a). Lyn's basis in the set of paintings is its fair market value at the time of Agnes's death, $100,000. IRC § 1014. When Agnes sells one of the three paintings in the set, the $100,000 basis must be allocated equitably between the painting sold and the paintings retained. One way of allocating the basis might be to determine what percentage of the fair market value of the set was attributable to the painting that was sold, either when Agnes died or at the time of the sale. Agnes's gain on the sale is the difference between the $40,000 sale price and the basis properly allocated to the painting sold. This is capital gain assuming that Lyn is not an art dealer. Whatever basis is subtracted on the sale of the painting reduces the $100,000 basis of the set, and the reduced amount is the basis of the two retained paintings.