Income Tax I
Fall 2021
Bogdanski

<u>FINAL EXAMINATION – PART TWO</u>
(Two hours)

QUESTION 37
(One hour)

Hal and Ward are a married couple filing a joint federal income tax return. Hal owns a home, known as Woodacre, in the mountains. The couple's principal residence is in the city. Hal owns Woodacre free and clear of any mortgages.

In 2021, Hal rents Woodacre to unrelated parties at market rent for a total of 100 days. Also in 2021, Hal, Ward, and members of their family use Woodacre for recreational purposes for a total of 100 days. The property sits vacant for the other 165 days of the year. Hal incurs substantial maintenance, repair, and insurance expenses, as well as homeowners' association dues, in connection with Woodacre.

In 2022, Hal and Ward obtain a divorce in their home state, which is a separate property state. In the divorce, in satisfaction of Ward's rights to marital property, Ward receives Woodacre. Immediately before the transfer of the property in the divorce, Hal has an adjusted basis in Woodacre of $200,000. At the time of the transfer, Woodacre has a fair market value of $550,000. Also in the divorce, Hal receives $40,000 from Ward's bank account. Upon the divorce, Ward immediately stops renting Woodacre out to tenants.

In 2024, Ward dies. Under Ward's will, all of Ward's property, including Woodacre, passes to Ward's adult son, Sam. At the time of Ward's death, Woodacre has a fair market value of $625,000. Sam and other family members continue to use Woodacre for recreation.

Included in the property passing from Ward to Sam at Ward's death is the right Ward had to receive income from Chloe, a client in Ward's professional practice. Ward had performed services for Chloe before Ward died, but Chloe had not paid Ward for the services before Ward's death. A month after Ward dies, Chloe pays the fee for Ward's services to Sam.

Early in 2025, the state highway department condemns Woodacre, demolishes the house, and uses the property for a new road. The state pays Sam $700,000 cash for Woodacre. Late in 2027, for the purpose of replacing Woodacre, Sam buys a cabin that Sam uses as a vacation home. Sam pays $680,000 cash for the cabin.

What are the federal income tax consequences to Hal, Ward, and Sam of each of the transactions and events just discussed, with and without any available elections? Be sure to discuss the amount, timing, and character (ordinary or capital) of each item of income, gain, loss, deduction, or credit, and the basis of each item of property, at each stage of the transactions and events.

Discuss.

(End of Question 37)

QUESTION 38
(One hour)

Eva has a job as a sales associate at an art gallery operated by a corporation, Rtco. Rtco requires its employees to wear traditional business attire while on duty on the gallery floor. Recognizing the added expense this creates for its workers, Rtco reimburses each sales employee up to $2,000 a year for clothing expenses, in addition to salary. Eva takes advantage of this benefit and is reimbursed the full $2,000 each year.

In 2021, Rtco awards Eva a bonus in the form of 1,000 shares of Rtco stock, which have a fair market value of $10 per share at the time of the award. Under the terms of the award, Eva will forfeit the stock if she does not continuously work for Rtco through November 30, 2023. Eva remains steadily employed by Rtco long past that date, and so she does not forfeit the Rtco stock. On November 30, 2023, the Rtco stock has a fair market value of $14 per share, but Eva holds onto it until 2025, when she sells all 1,000 shares for $17 per share.

Recognizing Eva's management potential, Rtco encourages her to take graduate-level business management courses at a university near the gallery. In 2022, Rtco reimburses Eva $5,000 of her tuition expense. Some of the courses Eva takes that year are not related to business or art. Soon thereafter, Rtco's business takes an unexpected downturn, and Eva is never offered a management position.

Eva has various debts: an unsecured student loan from her undergraduate days, an auto loan secured by her auto, unsecured credit card debt, and a mortgage loan that she took out in order to remodel the kitchen and bathroom in the residence she inherited from her uncle. Eva pays principal and interest on each of these loans every month.

Eva finds time to do volunteer work for a local charity that provides help to people in need of food. The value of the services that she provides to the charity is approximately $8,000 per year.

Among other duties, Eva uses her own car to deliver food on behalf of the charity.

What are the federal income tax consequences to Eva of each of the transactions and events just discussed, with and without any available elections? Be sure to discuss the amount, timing, and character (ordinary or capital) of each item of income, gain, loss, deduction, or credit, and the basis of each item of property, at each stage of the transactions and events.

Explain.

(End of examination)