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INCOME TAXATION I
FALL 2022
BOGDANSKI

<u>FINAL EXAMINATION</u>
(Three and a half hours)

INSTRUCTIONS

This examination is in two parts. Part One consists of 36 multiple-choice questions (Questions 1 through 36). Part Two consists of two essay questions (Questions 37 and 38). An hour and a half (90 minutes) is recommended for the multiple-choice questions, and two hours is recommended for the essay questions (one hour per essay question).

At the end of the three and a half hours, you must return this set of questions to the Registrar's Office in the original envelope in which it came. You must submit all your answers using Examplify.

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In determining grades, each multiple choice question will count for 1 point, and each essay question will count for 24 points. Therefore, you should budget your time according to the allocation noted for each part of the exam. Experience has shown that failure to budget one's time appropriately can result in a drastic lowering of one's overall grade on this examination.

For the multiple-choice questions, choose the best answer to each question posed. Choose one, and only one, answer to each question. Although an incorrect answer earns no credit, there is no penalty for an incorrect answer on the multiple-choice questions, so it is in your interest to answer every question, guessing if necessary.

In the essay questions, pay close attention to the final portion, or "call," of each question. Failure to respond to the matters called for will result in a low score for the question. On the other hand, discussion of matters outside the scope of the call of the question will not receive credit.

In your essays, be sure to explain as thoroughly as possible your answers to the questions posed. Your reasoning, discussion, and analysis are often as important as any particular conclusion you reach.

Unless otherwise specified, assume that all of the transactions and events described in the questions take place in 2022, all taxpayers described in the questions are individuals, and all taxpayers described in the questions report their income on the cash method and the calendar year for federal income tax purposes. Any references to the "Code" mean the Internal Revenue Code of 1986, as amended.

PART TWO – ESSAY QUESTIONS
(Two hours)

QUESTION 37
(One hour)

Avery accepts a position as the chief financial officer of Corp, a corporation with stock publicly traded on a national stock exchange. As an employee of Corp, Avery is eligible for several valuable fringe benefits. For example, Corp pays the monthly premiums on health insurance for Avery.

In addition, Corp informs Avery that he can choose to designate part of his salary to be used to pay for medical insurance for his spouse, Shawn, and dependent children. Avery makes the election, and accordingly, money that would otherwise be paid to Avery monthly as salary is used by Corp to pay premiums for Shawn's and the children's health insurance. Avery, Shawn, and the children incur numerous health care costs during the year, most of which are paid for by the insurance company. Avery pays the rest of the family's medical bills out of Avery's personal checking account, without reimbursement.

As a benefit available only to its executives, Corp pays annual dues for Avery to be a member of a local athletic and social club. Avery agrees to use the club membership in part to entertain Corp's clients, customers, bankers, and accountants at the club's facilities. True to his word, Avery uses the club mostly for that purpose.

In 2022, Avery receives a large cash bonus from Corp in exchange for work Avery performed during that year. The bonus is calculated based on a formula related to Corp's revenues and tax liabilities. In 2024, it is discovered that due to a clerical error, Avery's 2022 bonus was improperly calculated. To correct the error, Avery is required to, and does, repay part of the 2022 bonus to Corp in 2024.

The next year, Corp terminates Avery's employment without cause. Avery sues Corp, claiming that the dismissal was wrongful and seeking damages for lost wages and emotional distress. Eventually, the parties settle the case. In the settlement, Corp pays Avery a lump sum of $300,000. Avery uses $100,000 of the settlement to pay Avery's attorney's fees and court costs. Corp pays its own attorney's fees and court costs.

What are the federal income tax consequences to Avery and Corp 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)

Mona is a highly successful real estate professional. Mona owns Rentacre, a parcel of urban real property consisting of land and an apartment building. Mona rents apartments in the building to individuals and families. The ground floor is occupied by commercial tenants. Property values in the neighborhood are increasing rapidly. Mona lives in the suburbs.

Mona dies, leaving Rentacre to her daughter, Dina. Immediately before Mona's death, Mona's adjusted basis in Rentacre is $500,000. (The adjusted basis is properly allocable entirely to the land; Mona fully depreciated the building in earlier years.) The fair market value of Rentacre when Mona dies is $5,000,000. Mona owned it free and clear of any mortgages or other liens, and Dina receives it in that unencumbered state.

Shortly after receiving Rentacre from Mona's estate, before taking any depreciation deductions with respect to the building, Dina, who has never set foot on the property, decides to place Rentacre on the market for sale. An unrelated party, Brenda, comes forward, eagerly offering to buy it for $5,100,000 cash. Meanwhile, Dina locates a parcel of undeveloped rural real estate, Viewacre, that Dina would like to own. Dina wants to hold Viewacre as a passive investment; it is being offered for sale by Stan, who is not related to either Dina or Brenda. Stan insists that the sale price be paid in cash.

Pursuant to contracts entered into by Dina, Stan, and Brenda, the following take place:

- At a closing on June 1, Dina transfers Rentacre to Brenda.
- At a closing on July 10, Brenda buys Viewacre from Stan for $5,700,000 cash.
- At a closing on July 11, Brenda transfers Viewacre to Dina, and Dina pays Brenda $600,000 cash.

At the last of the three closings, Dina also pays Mona and Dina's longtime family real estate broker, Brook, a fee of $398,000 for Brook's services in connection with these transfers. Two weeks later, Dina pays a handyman, Hank, $2,000 to tear down and remove some broken-down fencing on Viewacre.

Viewacre consists of 1,000 acres of land, all of which are vacant. Two years after Dina acquires Viewacre, she sells 500 of the acres to an unrelated neighbor, Nassir. Nassir pays Dina $3,200,000 cash for the 500 acres.

Dina rents some of the remaining portion of Viewacre to a winemaker, Vin. Dina tells Vin to pay the first three years' rent to Dina's son, Gabe, who needs the money for his medical school tuition. Vin follows this direction. After the three years, Vin pays the rent to Dina.

What are the federal income tax consequences to Mona, Dina, and Gabe 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)

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