1. Three issues are presented:

(1) Is the $100 given to MP by AJ taxable income? In my view, yes, the $100 is taxable income. It is not a gift, as it was not motivated by disinterested generosity, and there was an expected *quid quo pro* of MP not making a public fuss about AJ’s bad behavior. See *Peebles* case, casebook, p. 88.

(2) Is the return of the $500 polishing fee taxable income? Yes. Basically the same answer as in (1). MP might want to argue that the return of the fee was a renegotiation of the polishing charge, but the facts do not support that claim.

(3) Is MP taxable on return of the stone taken by AJ, which she now realizes is a gold nugget worth $10,000? I do not believe MP has income. The mere fact that an asset appreciates in value is not enough to cause the taxpayer to have income. A realization event is needed. One might argue that the unwitting “trade” of the gold stone for the pyrite stone and then the return of the gold stone is enough to create a realization event. In my view, there is no realization event because AJ took the stone as custodian and had no ownership rights. What really happened was that stolen property was returned, and that should not be a realization event.

2a. The trade of the house lot for the condominium, in my view, is a taxable event, and Teddy is taxable on the difference between his basis in the lot and the value of the property received. The value of the property received is $320,000 (cash of $20,000 + condo worth $300,000). Teddy’s basis in the lot is $50,000 plus $10,000 of improvements = $60,000. So, his gain is $260,000 ($320,000 – $60,000), all of which is capital gain. His basis in the condo is $300,000 (purchase price), and his basis in the cash is $20,000.

Section 1031 does not apply because the lot was used for personal purposes (part of his personal residence), even if Teddy did have some hope of it appreciating in value. To qualify for section 1031, the property traded must be property held for investment or property used in a business. Personal property does not become investment property merely because the taxpayer has some hope that the property would appreciate. If that were the rule, the restriction in section 1031 would be rendered almost meaningless. Teddy can argue he has a changed purpose, but that argument is extremely weak in that the lot continued to be used as an extension of his personal residence.

If section 1031 did apply, Teddy would have recognized gain of $20,000 (the boot) and would have a basis in the condo of $60,000 (carryover basis of $60,000 plus gain recognized of $20,000 minus boot of $20,000).

2b. Assuming I am correct that the exchange of the lot for the condo is a taxable event, then Teddy has a basis in the condo, as noted above, of $300,000. So an outright sale of the condo for $260,000 (original value of the nursery of $220,000 plus $40,000 improvements) would produce a long-term capital loss of
$40,000. The facts do not make clear whether the taxpayer has a use for the loss, but presumably the loss has some value or will have some value in the near future.

Unfortunately for Teddy, he cannot take the loss on the disposition of the condo as the transaction is structured because the transaction qualifies as a tax-free exchange under section 1031. Under that section, no gain or loss is allowed if the transaction qualifies as a tax-free exchange. Section 1031 does not give the taxpayer a formal election; if the facts are such that the section applies, it applies. Teddy could have avoided the application of section 1031 by avoiding an “exchange”. That is, he could have sold the condo in the market place and used the proceeds to purchase the nursery. In that way, he could recognize the loss. I would have recommended that he make a sale and avoid a section 1031 exchange.

In addition, having the seller of the nursery pay for improvements and then increase the price of the nursery by the cost of the improvements is a bad tax plan. If Teddy pays $40,000 less for the property and does the improvements himself, it is quite likely that he will be able to take a current deduction for some or all of the costs (up to $50,000) as startup costs under section 195. Buying the property with the improvements already made would mean that Teddy would have to recover the cost of the improvements through a depreciation deduction over the assigned asset life of the improvements.

If Teddy had acquired the nursery in a tax-free exchange under section 1031, his basis in the nursery would be his basis in the condo ($300,000 under my analysis and $60,000 if the acquisition of the condo was a tax-free exchange). In either event, the money paid by the seller to improve the nursery property would not affect Teddy’s basis. By avoiding the section 1031 exchange, Teddy gets to add the $40,000 to his basis in the nursery (whether he makes the improvements or the buyer does so).

Extra Credit. Much of the property of the nursery is likely to be land, which is not depreciable. As a result, adding to the basis in the nursery generally would not be very helpful until Teddy sells the nursery. However, in the unlikely event that most of the value of the nursery property is property subject to depreciation, then Teddy may have done well to have the section 1031 exchange. The reason is that he now can take depreciation deductions with the carryover basis of $300,000 rather than the cost basis of $260,000 (at a cost of losing the deduction for a long-term capital loss of $40,000, which may have little current value to Teddy). The depreciation deductions cannot be taken immediately, so we would have to determine whether Teddy is better off taking extra depreciation deductions over the assigned life of the depreciable assets or taking currently a long-term capital loss. We cannot tell which is better under the facts provided. I did not expect students to discuss this issue in writing their answer to the question, and none did so.
3. There are two main issues:

   (1) Is the amount spent by FJ on tuition at the Tucson School of Social Work deductible as a business expense?

   (2) Is the amount of the tuition paid by FJ’s employer a tax-free fringe under section 132 or is it taxable income?

In answer to issue (2), above, the tuition paid by the employer is a taxable fringe benefit under IRC § 61(a)(1) (“Compensation for services, including fees, commissions, fringe benefits, and similar items”) unless it constitutes a “working condition fringe” within the meaning of IRC § 132(a)(3) and (d). The payment is a working condition fringe if the amount would have been deductible to the employee (FJ) if paid directly by the employee. Thus, the answer to (2) depends on the answer to (1).

The answer to (1) turns on the proper interpretation of Treas. Reg. § 1.162-5 (Expenses for Education). Reg. § 1.162-5(a) provides, in relevant part, that educational expenses are “deductible as ordinary and necessary business expenses (even though the education may lead to a degree) if the education— (1) Maintains or improves skills required by the individual in his employment or other trade or business. . . .” Whether that regulation is satisfied is primarily a fact question, and the facts are not entirely clear.

In my view, the facts justify the deduction, so I would allow FJ the deduction and would also allow an exclusion for the payments made by his employer under IRC § 132(d). Highly relevant is the fact that the MSW degree obtained is not necessary for the position he holds. Also relevant is that the employer agrees that the study plan would improve FJ’s skills for his current job. I find this case more like Coughlin, casebook, p. 383, and distinguishable from Hudgens, casebook, p. 385.

I also gave credit for the opposing position if well argued. The basic argument against the deduction is that the MSW degree qualifies FJ for promotion and that FJ was thinking about promotion in seeking the degree. I’m not convinced, however, because the facts do not establish that FJ qualified for a new position. Under Reg. § 1.162-5(b)(3), “a change of duties does not constitute a new trade or business if the new duties involve the same general type of work as is involved in the individual’s present employment.” I read the facts as indicating that FJ, after receiving the degree, was engaging in activities similar to those he engaged in prior to receiving the degree. His “new duties involve the same general type of work as is involved in the individual’s present employment.” Reg. § 1.162-5(b)(3).

This question was inspired by a Tax Court case recently decided. See Lori A. Singleton-Clarke, Petitioner v. Comm’r (December 2, 2009) (involving a nurse who received an advanced degree in nursing and was allowed the deduction).