Taxation Exam, Fall 2000
Prof. McIntyre's Notes on the Answers

1a. Elmore's (father's) basis in truck is cost: $12,000 (purchase price) + $18,000 (repairs made as part of acquisition plus snow plow) = $30,000. IRC § 1012. Guy (son) gets carry over basis, except for purpose of computing loss. IRC § 1015(a). Son uses basis of $30,000 to compute depreciation. Under Double declining method with half-year convention, he gets a deduction of $6,000 for depreciation in the first year ($30,000 40% = $6,000). IRC §§ 167 and 168.

1b. For purposes of computing a loss, Guy has a basis in the truck of $22,000 – the lower of fair market value and carryover basis at the time of the gift. IRC § 1015(a). Thus he has a realized loss of $1,000 ($21,000 sales proceeds minus $22,000 basis). Note: The loss may be personal and thus not allowable, but the question did not ask about allowable losses, only realized losses.

1c. Basis is limited under IRC § 1015(a) to lower of f.m.v or donor's basis to limit opportunities to traffic in losses. The risk of manipulating losses is probably small in the case of property transferred for use in a business, so the current rule is defensible. Depreciation, however, is really an estimate of an unrealized loss, so consistent treatment of losses and depreciation would be appropriate. Thus the better rule is to limit basis for depreciation to the lower of f.m.v. or donor's basis.

2. *Taxation of Oil Can*. Dr. Fear and Oil Can have an exchange of services (dental care) for services (signing caps) and both have income from the exchange. Oil Can received services worth $500 for signing the caps, and that amount is properly treated as income from sale of his autograph. Oil Can has no basis in his signature, so he cannot deduct anything for giving it up. Thus he has gross income of $500.

Oil Can may deduct the $500 as a medical expense under IRC § 213, subject to the floor of 7.5%. Assumption (8) (see page 2 of Exam) says to ignore floors etc. Nothing in § 213 says that the expenses must be paid in cash. What is important is that Oil Can has, in effect, a basis of $500 in services paid as a result of including the $500 in his gross income. Note: Oil Can's income is **not** cancellation of indebtedness income – it is in-kind income from sale of autographs. To be cancellation of indebtedness income, there must have been a loan that was not taxed because of a promise to repay and then a failure to pay. Here Oil Can did not borrow anything; he contracted for services and paid the bill by providing signing services of his own.

Taxation of Dr. Fear. Dr. Fear received an increase in the value of his property of $1,200 (($620 2 value) – ($20 2 basis)) from performing the dental services on Oil Can and getting Oil Can to sign the caps. That represents his gain, and, because it was received as payment for services, it is realized. (Note: it is possible to argue that only $500 – the value of the services – should be realized, on the ground that this amount was the amount received for the services, the remainder being a gift or an unexpected windfall.) Dr. Fear has no basis in his dental services so cannot deduct their value in computing his gain.

The gift from Dr. Fear to his son, Bobby, is not a taxable event. The son gets a carryover basis in the cap equal to $620 ($20 + $600 gain realized by father).

The gift of the cap to Eastern qualifies as a charitable donation under IRC § 170. The question is how much of a deduction Dr. Fear can get. At a minimum, he gets a deduction for his basis in the cap of $620. In general, a taxpayer can deduct the fair market value of property donated to a charity. The question suggests that the f.m.v. of the cap may have gone up to $1,000 at the time of the gift. Under IRC § 170(e), however, the f.m.v. of a gift of tangible personal property must be reduced by the sum of (1) the amount that **would NOT have** been a capital gain if sold at the time of the gift and (2) the amount that **would have been** a capital gain, unless the property is used in furtherance of the charity's exempt function. The question does not say how long the cap was held before the gift was made to Eastern, but Assumption (12) (see page 2 of Exam) says to assume 18 months. I think that displaying the cap is in furtherance of Eastern's exempt function. I conclude, therefore, that if the f.m.v. is $1,000, then Dr. Fear can deduct $1,000.

3. True/False with explanation

a F Claim of right applies to embezzlement and related situations, not to payments for future services. Here the issue is whether the income has accrued, due to liability for performing future services. It does accrue under Rev. Proc. 71-21 (Popkin Casebook, p. 583) because the services will not be fully performed in the current or subsequent taxable year. Note: The statement is true with respect to how the $1,200 is treated (taxable in current year) but incorrect in stating that the reason is Claim of Right. Thus the statement is false.

b F The insurance proceeds of $200,000 can be received tax free, to the extent of Ted's basis in the marina, but Ted must reduce his adjusted basis by that amount, from $200,000 to zero. (Note: In effect, the basis of $200,000 is allocated to the money received.) The additional loss of $100,000 cannot be deducted because the loss allowable under IRC § 165(c)(1) cannot exceed the adjusted basis. Note: The assumptions on page 2 of Exam said to ignore caps, floors, etc., such as $100 and 10% floors on personal casualty losses. In addition, these limits do NOT apply to business casualty losses, which are deductible under IRC § 165(c)(1).

c F Stanley is treated as having sold the building for $600,000 – the amount of the nonrecourse debt – under *Crane* and *Tufts*. His basis is $400,000, so he has a capital gain of $200,000.

d F John cannot deduct any of the interest under IRC § 265(a)(2) because the interest was paid on a loan used to finance the purchase of bonds producing tax-exempt income.

e F None of payment by Percy is deductible in the current year under *Richmond T.V.* case.. In the following year, however, Percy may deduct a portion of the expenses under IRC 195 (allowing amortization over 60 months beginning when trade or business begins). Note: An amortization deduction under IRC § 195 is a deduction!!