Taxation Exam, Fall 1994 (Evening)
Notes on the Answers

1. The payment is, in effect, the proceeds from a sale of part of the tree to the power company. It is includable in income under Code § 61 and 1001 to the extent the proceeds exceed basis. Following *Inaja Land* (payment for easement case discussed in class), the taxpayers should be able to use their basis in the house, to the extent necessary, to offset the $2,000 because the value of the tree and the actual amount of basis properly allocable to the portion damaged is very difficult to determine. Basis in the house is reduced from $150,000 to $148,000.

Note #1: If gain had been realized, it would have been taxable as ordinary gain. It would not have been short-term capital gain (asset held for less than a year) because there was no sale or exchange.

Note #2: Code § 104 is **not** applicable because the damage is not a personal injury (injury to the person). Nor is Code § 1033 applicable.

2. All of the payments probably are not taxable under Code § 104(a)(2) (payment for personal injuries). The legal fees are not deductible as they were paid to obtain tax-exempt income. (They would otherwise be deductible.) The concluding sentence of § 104 provides that punitive damages are taxable except in the case of physical injury -- there is obviously physical injury in this case. There is some case law for the proposition that punitive damages generally are taxable, but I doubt the IRS would win an argument for taxability in this case. In any event, it would have to establish how much, if any, of the payments were for personal injury.

Note #1: The interest component of the second payment is not taxable as the interest rules (e.g. Code § 483) do not override Code § 104.

3. **Mary**. The $100,000 is ordinary income received as payments for services rendered and is not a gift. The house was also received as payment for services, taxable at its fair market value of $400,000 at time of transfer. The free use of the house near the end of Sally's lifetime is a tax free gift. The transfer of the gold broach is a gift. Her basis is $10,000 (carryover basis under IRC § 1016) and her gain on sale is $30,000 ($40,000 – $10,000). the gain is capital (Sally's holding period is tacked under IRC § 1223).

Sally. Sally has disposed of her house in payment for services. She (or her estate) is taxable on $180,000, the difference between her basis in the house and the fair market value of the services ($400,000 – $220,000). She probably can exclude $125,000 under IRC § 121.

Note #1: Sally would have been better off promising Mary the value of the house. Then the estate could have gotten the stepped-up basis under IRC § 1014 and recognized no gain.

Note #2: I do not know whether the estate can file an election under IRC § 121 on behalf of Sally; consequently, I am not certain whether the protection of that section is available. I did not take off anything for failure to mention IRC § 121 -- I had not thought of the point myself when I wrote the question.

4. Jonathan cannot take any deduction in year 1 under IRC § 469 because the partnership investment is passive and he does not materially participate. The denied loss can be carried forward. In year 2, J has passive income of $10,000. He can offset that passive gain with the carryover from year 1.

Note #1: The at-risk rules of IRC § 465 also apply. J has a basis in the partnership of $220,000 ($20,000 cash investment plus 1/10th of $2 million loan). The loan is non-recourse and does not put J at risk. Thus under IRC § 465, J can claim a loss not in excess of $20,000. As stated above, he gets no loss because of IRC § 469 -- IRC § 465 only takes away, it does not permit deductions otherwise disallowed. I gave a major portion of the credit for a correct IRC § 465 answer even if no mention was made of IRC § 469.

Note #2: There is a typo. In the last line of the first paragraph, "$100,00" should have been "$100,000". No one appears to have been led astray by the typo. For clarity, I should have provided for J to have some significant amount of nonpassive income.

5. The question is a variation on *Haverly* (p. 171 of Popkin). Just as the taxpayer in *Haverly* exercised dominion over the unsolicited books when he made a charitable deduction, so also did Dr. K when he made a gift of the book to his nephew. I would tax, although I gave credit for a range of answers. One argument for taxing is that Dr. K, by making the gift, demonstrated that the book had value to him. Another argument is based on a tax benefit theory. The original receipt was exempt perhaps because it would have been deductible in any event under IRC § 162. By giving away the book, thereby converting it to consumption, Dr. K has acted inconsistently with the assumptions justifying the deduction (that the book is for business) and should be required to "recapture" the implicit deduction. See *Hillsboro Nat'l Bank* (p. of Popkin).

6. The question represents the other side of the *Hort* case (p. 386 of Popkin). In *Hort*, the taxpayer was required to report the receipt of the cancellation of lease payment as ordinary income. Here BK wants an ordinary loss deduction under IRC § 165 or a deduction under IRC § 162. The better argument is under § 165, as the payment results from cancellation of BK's ownership interest in the leasehold. The loss is not capital because there is no sale or exchange.

A contrary result, more consistent with sound tax policy, would be to require BK to capitalize the payment and treat it as a cost of acquiring the new leasehold. That result is superior because the benefit BK obtains from cancelling the lease extends well beyond the taxable year. The Code has no provision directly in point; an argument might be made for the result, however, under the "good accounting" rule of IRC § 446. The *Indopco* case, holding that creation of an asset is not requiried for capitalization, is helpful to the Service. If capitalized, the $70,000 would be recoverable over the life of the new lease.

7a. *Explanation of Code section 1286*. Code section 1286 requires a person stripping a bond to recognize accrued gain (including accrued interest and accrued market discount) as of the time the bond is stripped. The recomputed basis is then allocated between the bond and the stripped coupon(s) in proportion to the fair market value of the bond and the coupon(s) at the time the bond is stripped. If a person has acquired a bond or coupon in a tax free transaction (typically a gift transaction), that person's basis is determined in the same manner.

Application to Molly and Polly. Polly received the coupon by gift, so she has the same basis in the coupon at the time it is stripped as Molly would have. The accrued gain and discount cannot be calculated separately from the given facts, but for whatever reason, there is no net accrued gain (the value of the bond and the note ($3,660 + $340 = $4,000) equals the purchase price of $4,000. (For this result to take place, the accrued interest of around $200 must have been offset by a decline in the value of the bond and

coupon, due presumably to a rise in interest rates.) Thus no gain is taxable to Molly or Polly on the stripping of the bond. Polly's basis in the bond is $4,000 × $340/$4,000, or $340. Thus she has no gain or loss on the sale of the coupon.

Note 1: This is the promised question dealing with a Code section we had not covered in the course. the intent of the question is to see how well you can read new Code sections.

Note 2: The numbers used in the question are somewhat unrealistic. I now regret using them. I picked them to make certain calculations easy, as you can see above. Unfortunately, I confused a few people (and should have confused more). I took the problem with the question into account in grading.

Note 3: The question does not illustrate the purpose of Code section 1286. To see that purpose, assume that Molly sold the stripped bond for $3,660. Under the traditional basis rules (all basis to bond and none to coupon), she arguably would have a recognized tax loss of $340 even though she had not suffered an economic loss.

7b. Under the doctrine of the *Horst* case, the holder of an unstripped bond who has transferred the interest by gift is taxable on the interest when it becomes payable. Thus if the bond had not been stripped, Molly would have been taxable on $400 when it became payable to Polly. Thus Polly would not be taxable under the traditional view. *Horst*, however, may not be good authority for stripped bonds (that is, for bonds having attached coupons that arguably have status as property in their own right). It should not govern a case like this. Under the carved out income cases (e.g. *P.G. Lake*), Molly would have a zero basis in the coupon at the time of transfer, so Polly would inherit that basis under Code section 1015. Thus the sale to the First National Bank of Chicago would produce a gain of $340, taxable either to Molly or Polly. I would tax Polly, but I know of no definitive authority. By analogy to *Horst*, the gain should be taxable to Molly (Molly holds the "tree".) It is unclear whether the old case law required allocation of basis between the stripped bond and the coupons. It should have, but if it did, much of Code section 1286 would be surplusage.

Note 1: I gave most of the available points on this question for an intelligent discussion of *Horst*.