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4 Tax Questions

for *SJSU MST Contemporary Tax Journal*

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1. In Year 1, Gardner used funds earmarked for use in Gardner’s business to make a personal loan to Carson. In Year 3, Carson declared bankruptcy, having paid off only \$500 of the loan at that time. In Year 1, Gardner purchased equipment for use in Gardner’s business. In Year 3, Gardner sold the equipment at a \$5,000 loss. In January of Year 3, Gardner received shares of stock as a gift from Smith; the shares had been purchased by Smith in Year 1. In November of Year 3, Gardner sold the property for a \$5,000 gain.

Which of the above transactions will Gardner report as a long-term capital gain or loss for Year 3?

- I. The bad debt write-off
 - II. The sale of equipment
 - III. The sale of shares
- a) II and III only.
 - b) None of the above.
 - c) I only.
 - d) III only.

d) Correct! The uncollectibility of a personal loan represents a nonbusiness bad debt, which is treated as a short-term capital loss, regardless of the holding period. Depreciable business property held longer than one year is Section 1231 property and losses on sale are treated as ordinary, not capital losses. Shares received by gift will retain donor’s holding period and basis. Since the shares had been purchased by the donor more than 1 year before their sale, the result would be a long-term capital loss.

2. Betty, a salesperson, is an employee with \$52,000 AGI who maintains a home office for the convenience of her employer, Smart Systems. The office takes up 5% of Betty’s home and is used exclusively for her job. Smart Systems reimburses all of Betty’s direct costs of maintaining the home office. Betty also has the following expenses associated with her home:

Expense	Amount
Real property taxes on residence	\$3,500
Interest expense on residence	\$5,000
Operating expenses on residence	\$1,800
Depreciation on residence (based on 5% home office use)	\$ 150

Considering these facts, how much may Betty deduct *from* AGI on her tax return, assuming she elects to itemize deductions?

- a) \$0
- b) \$665
- c) \$9,410
- d) \$10,450

a) Correct! When a home office is maintained for the convenience of the employer, the expenses related to that portion of the home are deductible as miscellaneous expenses. This would include 5% of the real property taxes, interest expense, and operating expenses and all of the depreciation on the 5% used as a home office. As a result, total expenses will be 5% x (\$3,500 + \$5,000 + \$1,800) +

\$150 or \$665. A deduction is allowed to the extent that the amount exceeds 2% of AGI. Since the total of \$665 does not exceed 2% of \$52,000 or \$1,040, there is no deduction.

3. In Year 7 Standard Corp., a C corporation, sold Section 1250 property for \$600,000 that had an adjusted basis of \$550,000, resulting in a \$50,000 gain. The property had cost Standard \$720,000 when purchased in Year 1, and \$170,000 of accelerated depreciation had been taken. Had straight-line depreciation been used, depreciation would have been \$100,000. How should Standard report the gain on its Year 7 tax return?

- a) \$20,588 ordinary gain and \$29,417 long-term capital gain
- b) \$28,824 ordinary gain and \$41,176 long-term capital gain
- c) \$70,000 ordinary gain
- d) \$50,000 ordinary gain

d) Correct! When section 1250 property that has been held for more than 1 year is sold at a gain, excess depreciation is recaptured, resulting in an ordinary gain with the remainder, if any, recognized as long-term capital gain. Excess depreciation for a C corporation consists of the difference between the amount taken using an accelerated method and the amount that would have been allowed under straight-line, \$170,000 - \$100,000 or \$70,000, plus 20% of the amount allowed under straight-line, \$100,000 x 20% or \$20,000 for a total of \$90,000. Since this exceeds the amount of the gain, the entire \$50,000 gain would be ordinary.

4. Preakness Partnership makes a current distribution to Prasad consisting of \$30,000 in cash, land with a fair market value of \$50,000 (partnership basis \$55,000), and inventory with a fair market value of \$8,000 (\$3,000 partnership basis). Immediately prior to the distribution Prasad's outside basis in the partnership was \$35,000. What amount of gain will Prasad recognize on the distribution, and what is Prasad's resulting basis in the land?

	Recognized Gain	Basis in Land
a)	\$3,000	\$5,000
b)	\$0	\$0
c)	\$0	\$2,000
d)	\$3,000	\$0

c) Correct! In accounting for the distribution, Prasad will account for the cash of \$30,000, reducing Prasad's basis from \$35,000 to \$5,000. The inventory will be recognized at the partnership's basis of \$3,000, leaving Prasad a basis of 2,000, which will be the basis in the land. Gain would only be recognized if the amount of cash distributed exceeded Prasad's basis in the partnership.

The Contemporary Tax Journal's Interview of Mr. Gary Sprague

By: Xuan Hong, MST Student

Mr. Gary Sprague, a tax partner based in international law firm Baker & McKenzie's Palo Alto office, is a recognized leader in the international law and e-commerce law field. With decades of international taxation experience, Mr. Sprague was appointed by the OECD to serve as the business co-chair of the OECD Technical Advisory Groups ("TAG") on business profits and treaty characterization issues. Mr. Sprague also serves on the International Fiscal Association's Executive Leadership Committee, as well as Tax Management's U.S. International Advisory Board. As a top U.S. West Coast Tax Advisor, Mr. Sprague devotes time to the development of U.S. and international tax policy matters on behalf of clients. Mr. Sprague shares his research and perspectives via numerous publications and conferences. He regularly contributes to Tax Management International Journal's Leading Practitioner Commentary, as well as to the annual TEI-SJSU High Tech Tax Institute conference in Silicon Valley.

Despite such amazing achievements in the tax field, Mr. Sprague, however, said taxation was not his first choice of law fields at the beginning of his career. What led Mr. Sprague to step into the tax law area and take on significant roles in serving clients on complex tax matters and help many countries shape international tax policies? In this interview with Mr. Sprague, he shared his career path in the tax field and his views of taxation as a profession.

Following are questions asked by CTJ and a summary of Mr. Sprague's answers.

1. [CTJ] How did you get involved in the tax field and with a focus on international taxation?

[Sprague] In part, it was by design. In other parts, it was by luck - both good and bad, or at least it seemed bad at the time. By the time I entered law school, I knew that I was aiming for a career dealing with international matters. I had taken the first set of tests leading to a possible position in the U.S. Foreign Service, but withdrew from the process in order to focus on law school. There, I took several courses that addressed legal issues arising from cross-border transactions. International tax was one of the more interesting classes I took. Apparently, I wasn't very good at it; it was one of my lowest grades in law school.

By graduation, I had decided that I wanted a career in international banking. So, I joined a firm in San Francisco that boasted a large practice advising mostly non-US banks. The firm also was well known for its admiralty work. Pictures of the subjects of its most famous admiralty cases lined the walls. That created something of an ominous sense in the halls, as the most famous cases for an admiralty firm are generally ships running into things like bridges or islands, or sinking in heavy seas. The firm also had a very small tax practice that supported its international shipping clientele.

The bad luck (at the time) partly arose because among the four entering first year associates, I took the longest break between the bar exam and beginning work. When I finally showed up for the first day of work, to my dismay I learned that the firm allocated department assignments for the four first years on a first come, first served basis. The position in the high profile banking group was long gone, snagged by a much more punctual candidate. All that was left was the one position that none of the others wanted - tax.

Not having any better options, I agreed. At least the firm promised that after a year, they would reconsider whether I could transfer to a more interesting department.

Just before my first-year anniversary, the sole tax partner disappeared. It was never clear to me whether he was fired or resigned. A lateral partner recruit showed up to take his place. Firm management implored me