

GAXATION

LEX 7816

Maximum Time: 4 hours

Maximum Points: 100

Thursday, December 17, 2009

6:15 p.m. to 10:15 p.m., Room 1515

Instructions (Taxation)

1. Your copy of this examination *must be returned to the proctor* before you may leave the examination room. Laptop computers are permitted in accordance with Law School rules. Do **not** remove staples from your copy of the examination and do **not** put your name or information about your personal status (i.e., graduating senior, graduate student) anywhere on the exam.
2. **Write your examination number (if it is not already there) in the upper right hand corner of this cover sheet in the space provided.** Also put your examination number, the name of this course (Taxation), and the name of the instructor (McIntyre) in the appropriate spaces on your **bluebook** (or follow Laptop instructions). Please do this now. If you are using a laptop computer, put you exam number and the name of the course and instructor on the front page of your answer sheets.
3. *Thank you for putting your exam number and other information in the appropriate spaces.* This is an **open book** examination. You are expected to have with you your copy of the casebook, supplemental materials, a 2008 or later edition of the Internal Revenue Code ("Code"), and an edited version of the Income Tax Regulations. You are permitted to have any books, notes, commercial outlines, or other materials you have used during the course. You may use a pocket calculator.
4. This examination has two (2) parts. The answers to Part I (Essay) go in your bluebook or, if you are typing your exam on a laptop computer, on your answer sheets. *There are three (3) questions in Part I.* Answers to Part II (Multiple Choice) go on your copy of the exam *for all students* taking the exam, including laptop users. Read the instructions for each part carefully and follow those instructions.
5. Certain assumptions are stated below which are applicable to all questions in Parts I and II unless a question explicitly asks you to make some other assumptions.

Note To Proctor:

All copies of the Examination **MUST** be returned to you by the end of the examination period. Please check carefully to be sure you can account for all copies. Persons allowed to leave the examination room **for any reason** must leave their copy of the examination with you to hold until they return.

Assumptions Applicable to Parts I and II

Unless a question specifies otherwise, make the following assumptions in answering the questions in Parts I and II of this examination:

1. Taxpayers are using the cash method of accounting and are not eligible to use any of the special accounting rules, such as those provided for farmers.
2. Taxpayers are using the calendar year as their taxable year.
3. Except for the transactions described in the questions, no transactions relevant to the answers have occurred during the relevant taxable years.
4. Technical terms and words of art are used in their exact tax sense.
5. The tax acts of 1986 through 2009 are fully effective.
6. All taxpayers are solvent.
7. Taxpayers have properly taken the amount of depreciation indicated.
8. All taxpayers are single.
9. All expenditures can be substantiated.
10. All taxpayers are itemizing their personal deductions rather than claiming the standard deduction.
11. The possible effects on tax liability of any floors, ceilings, or phase-outs that might apply to specific itemized deductions are to be ignored.
12. The taxpayers have not made an election not to be governed by the installment method or to deduct capital expenditures under Code section 179. They have made elections, when appropriate, for availing themselves of the benefits of Code section 195.
13. All transactions occur at arm's length.
14. All capital assets have been held for more than 12 months.

I. Essay
(maximum points: 50)

Instructions. Answer the three (3) questions below in your bluebook or on your laptop computer. Observe the maximum space limitations (lines for handwritten exams, words for laptop users). *You will suffer a grade penalty, proportionate to the offense, for exceeding the space limitations.* A penalty is not imposed for exceeding the limits by two lines or less (bluebook users) or by 22 words or less (laptop users).

Note to Those Writing in a Bluebook. If you are writing the exam, write in ink on every other line (**double space**). Do not write on the back side of any page, and **do not write in the margins**. One page of a bluebook, double-spaced, is 14 lines. A person with normal-sized handwriting typically gets about 10 to 12 words per line. Make an appropriate adjustment if your handwriting is unusually large or small. Please, do not count your words.

Note to Laptop Users. The space limits for laptop users are stated in words. I estimate that one line of writing is equal to 10-12 words, so I have set the word limit at 11 times the lines allowed to those writing in a bluebook. So, if the maximum lines is 14, the maximum words is 154.

1. (Maximum Points, 15; maximum lines, 28; maximum words, 308).

Margaret Poteet (MP) collects non-precious gem stones. She goes to Mr. Andrew Jackson, who runs a lapidary shop in Petoskey, Michigan, to get some items in her collection polished. Her collection includes hematite, turquoise, amethyst, lapis lazuli, and pyrite. Mr. Jackson agrees to do the work for \$500. Returning home after picking up the polished stones and paying Mr. Jackson, MP notices that one of the pyrite stones looks a little different. She compares it with a picture of her collection, which she had taken before the polishing, and realizes that Mr. Jackson has made a switch. MP hurries back to the lapidary shop and confronts Mr. Jackson. He admits the switch and exchanges the stolen gem for the replacement. Concerned that MP might give him a bad reputation or might even contact the police, Mr. Jackson gives her back the \$500 polishing fee plus an additional \$100. Just as MP is about to leave, Mr. Jackson calls after her: "And take good care of your stone. It's almost pure gold, worth \$10,000."

Question 1. What are the tax consequences for MP from the events described above? Please set forth the issue(s) raised by the question, your suggested resolution of the issue(s), and your reasons for the position(s) you have taken, with appropriate reference to the Internal Revenue Code.

2. (Maximum Points, 20; maximum lines, 28; maximum words, 308).

Teddy purchased a double lot in a housing development in year 1 for \$100,000 (\$50,000 per lot). The double lot is located in Saline, Michigan. His plan was to build a house on one of the lots for his family to live in and to use the other lot as a play area for his two young children. His longer term plan was to sell the second lot when his children were grown and he is preparing for retirement. True to his plan, he built a house on the first lot, at a cost of \$200,000, and grassed over the second lot. His children used the lot as a play area for many years. When the children reached adulthood and left home, Teddy hired a landscape architect to design a garden along the back and sides of the second lot, at a cost of \$10,000. Teddy became an avid gardener, implementing the architect's design. The center of the lot was left with grass, in the expectation that the lot would be sold at some point to someone who would want to build a home on it.

In year 30, Teddy traded the second lot for a condominium located in the Florida Keys plus \$20,000 in cash. Teddy expected to use the condo as a summer home when he retired, but, until then, he rented out the property to a tenant for \$4,000 per month. At the time of the trade, the back lot had a value of \$320,000, and the Florida condo had a value of \$300,000.

In year 36, the company that Teddy worked for went bankrupt, and Teddy not only lost his job but also most of his expected pension. His plan to retire to Florida had to be abandoned. Teddy decided to utilize his gardening skills to open a commercial plant nursery in Saline. He located a plant nursery that was having financial difficulties and arranged a trade with the owner. The nursery was valued at \$220,000. Teddy gave the nursery owner the Florida condo, then valued at \$260,000. To make the deal fair, the owner of the nursery agreed to spend \$40,000, prior to the trade, to fix up the buildings at the nursery and to install an automatic irrigation system.

Question 2a. What are the tax consequences to Teddy in year 30 on the trade of his second lot for the condominium in the Florida Keys? Explain, with appropriate references to the Internal Revenue Code.

Question 2b. What tax advice would you have given Teddy if he had engaged you as his tax advisor a few weeks prior to the trade of the Florida condo? In giving your answer, start by explaining, with appropriate references to the Internal Revenue Code, the tax consequences to Teddy in year 36 on the trade of his Florida condo for the Saline nursery, as improved at Teddy's request.

3. (Maximum Points, 15; maximum lines, 28; maximum words, 308).

Filbert Johansson (FJ) is a social worker case co-ordinator, employed by the Wayne County Foster Care Department. He earns \$44,000 per year. His job is to manage the case load of 10 social workers providing child protective services to over 350 foster children in the county. FJ was hired as a foster care social worker in 2002. He was promoted as a case co-ordinator in 2005. Wayne County has no special requirements for case co-ordinators other than the requirements for being a social worker. As a practical matter, however, no one is promoted to that position without having at least three years of experience as a social worker. Some case co-ordinators have a Master's Degree in Social Work (MSW).

Here is the job description published by the county for a foster-care social worker:

FOSTER CARE SOCIAL WORKER Position # 00231 (Wayne County) Salary: \$38,000

Duties and Responsibilities: Candidate will support and assist clients, individually and in groups, utilizing available resources to meet their personal, social, health and economic needs and help them develop their own capabilities. Provides guidance to clients seeking alternative solutions to specific problems such as child care, management of finances, housing, health needs, education, vocational training and employment. Applicant must be willing to work outside of normal working hours, which may include being on-call for emergencies 24 hours a day, including weekends. The applicant must have a Bachelor's degree in social work, health, behavioral science or equivalent or hold a Bachelor's degree in any field combined with two years of social services related experience. Bi-lingual skills helpful.

FJ felt that he lacked some of the management skills necessary to be really successful as a case co-ordinator. After some research, he has discovered that the Tucson School of Social Work has an on-line program that trains social workers for management positions. The program takes two-years for full-time students and four years for students, such as FJ, who enroll as part-time students. Completion of the program leads to a Master's Degree in Social Work (MSW). FJ enrolled in the program in 2005 and received his MSW degree in July of 2008. FJ has continued in his position as case coordinator. He received a raise of \$5,000 on receipt of the degree.

Before enrolling in the on-line program, FJ had a talk with his immediate supervisor, which led to talks with the director of the foster-care department. The department head was sympathetic to FJ's concerns and agreed that additional training would be extremely helpful to FJ in doing his job and could lead to a promotion at some future date. The department head agreed that the department would pay up to \$8,000 per year for FJ's education, provided that FJ sign an agreement committing him to work for the department for at least two years after receiving the degree or be obligated to repay the amounts received from the department. FJ

readily agreed. The annual tuition for part-time students at the Tucson School of Social Work is \$12,000 per year. Thus, FJ was required to pay \$4,000 in tuition, with the department paying \$8,000.

From 2005 to 2008, FJ did not report any income as a result of the amount paid by his department to the Tucson School of Social Work. He claimed a business expense deduction each year of \$4,000 for the amount he paid. He was audited, and the Internal Revenue Service (IRS) denied the deduction for his payments of \$4,000 per year and increased his income by \$8,000 for the amounts paid to the Tucson School of Social Work on his behalf by his employer.

Question 3. FJ has challenged the IRS assessment in the Tax Court, appearing *pro se*. You are clerk to Judge Mason, special trial judge in the Tax Court. He has asked you to prepare a brief legal memorandum, suggesting how he should rule on the issues in this case. Please prepare that memorandum. You are expected to make appropriate references to the Internal Revenue Code and Treasury Regulations and to any relevant cases included in the Casebook.

Exam No. _____

II. Multiple Choice (maximum points: 50)

Instructions. Mark your choice of alternative answers to each question by circling the **letter** of the correct answer on this exam. **Do NOT mark more than one alternative answer, or your answer will be scored as incorrect.** Those using laptop computers **MUST** answer these questions here and not on the computer.

Each question is worth 2.5 points. No points are taken off for wrong answers. Thus, you should guess at the answer if you do not know the answer.

In answering each question, make the assumptions stated on page two (2) of this exam unless a contrary assumption is stated in the question.

If you believe that unstated facts are crucial to your answer, or if you believe that a question is ambiguous, go ahead and answer the question as best you can. Then circle the **number** of the **question** on this exam, and, *in the space provided on the last page of the exam*, identify the unstated facts or the ambiguities and explain their relevance to the question. If your grounds for challenging a question are well-founded and you have properly shown the relevance of an alleged omission of fact or ambiguity to the answer, you will receive full credit for your answer. There are **no intentional ambiguities** or omissions of necessary facts.

WARNING: *If you decide to explain your answer, you do so at your own risk. Your answer to a question will be treated as incorrect if you have challenged that question and your grounds for doing so are unfounded or incorrectly stated even if you have selected the correct answer.*

[Multiple Choice Omitted]