EXAM NO. ___________

Wayne State University
Law School

Fall 2010
Prof. Michael J. McIntyre

Taxation

LEX 7816 (Laptops Permitted)
Maximum Time: 4 hours
Maximum Points: 100
Tuesday, December 14, 2010
9:30 a.m. to 1:30 p.m., Room 1550

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 your 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 2009 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 three (3) 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 four (4) 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. Answers to Part III (True/False) also go on your copy of the exam. 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, II, and III 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 2010 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 (1) not to be governed by the installment method or (2) 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 four (4) 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.
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> *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.

A.

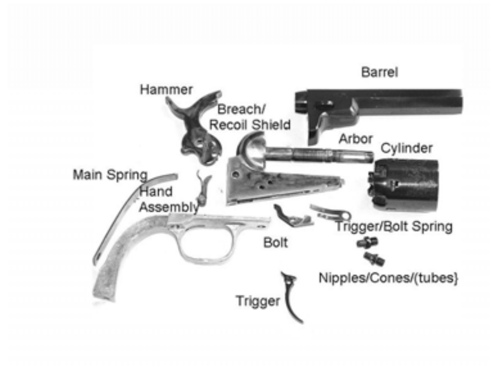
Major Nelson (MN) and Jeanie have been dating for two years. MN asks Jeanie to marry him, and she agrees. MN gives her a ring that he bought for $10,000; the ring, for all relevant purposes, continues to have a fair market value of $10,000. Two months later, Jeanie has an affair with Major Healy and breaks off her engagement with MN. MN asks for the ring back, and Jeanie refuses, saying "a gift is a gift". MN brings an action *pro se* in family court to get the ring back. During pre-trial mediation, Jeanie offers to give back the ring if MN will give her $2,000. MN counters with an offer of $1,000, and Jeanie accepts. Jeanie gets her $1,000 and MN gets back the ring.

Question 1. Maximum Points, 15; Maximum Lines, 28 OR Maximum Words, 308.

What are the tax consequences to Major Nelson and Jeanie as a result of the transactions described above?

B.

Oliver Brown (OB) runs a gun shop. He sells new and old guns and repairs old guns. The sale of new guns accounts for 80 percent of his profits. He rarely sells old guns, but he does so on occasion. He regularly repairs old guns and occasionally repairs new guns. One day, in 2008, a customer came into OB's shop with a Colt Navy Revolver. The .36 caliber hand gun is a percussion revolver; it is more commonly called a "Cap N Ball" gun because it uses ball shot, percussion caps, and black powder as its ammunition source. OB was very familiar with the gun. The Colt Navy had been used by Wild Bill Hickok and General Robert E. Lee, among many luminaries. The customer's gun was not in operating order but had an excellent finish for a gun over 150 years old.



Colt Navy, Parts

The customer left the gun with OB for a repair estimate, for which OB regularly charges $50, creditable against the repair bill. Two days later, after disassembling the gun and checking the market for replacement parts, OB gave the customer an estimate of $1,200 for repairs ($800 for parts and $400 for labor). The customer indicated he was not willing to invest that much in the gun and offered to sell it, as is, to OB for $500 and a waiver of the $50 fee due for the estimate. OB bought the gun for the suggested price. He reported $50 in income on his 2008 tax return because he treated the forgiveness of the $50 due for the repair estimate as part of the purchase price for the gun.

OB did an especially nice job at restoring the gun to working order, a task which he completed in 2008. In making the repairs, he spent $900 on replacement parts — $100 over his prior estimate. Two years later, in 2010, OB traded the Navy Colt with Bill Watson (BW), a gun enthusiast, for a new, in-the-box GRANOLA 584 Tactical shotgun plus $200 in cash (total of $3,000). The GRANOLA is a modern gun, manufactured in 2009, and is commonly sold to gun enthusiasts for home defense. The GRANOLA sells at reputable gun shops and gun fairs for $2,800. OB plans to give the GRANOLA to his father, who lives alone and is worried about intruders.

Question 2. Maximum Points, 10; Maximum Lines, 14 OR Maximum Words, 154.

On his tax return for 2010, OB expects to claim that the exchange with Bill Watson constituted a tax-free exchange within the meaning of Code section 1031(b). Please explain to OB the argument(s) that Internal Revenue Service could make against the application of that section under the facts of this case, with suitable references to the Code.

Question 3. Maximum Points, 10; Maximum Lines, 14 OR Maximum Words, 154.

Assume that OB is not able to claim the benefits of Code section 1031. In that event, how should he report the gain on the exchange? What is OB's basis in the Navy Colt, and how much gain has he realized on the exchange? Can OB claim a capital gain for some or all of the gain realized on the exchange transaction? Explain, with appropriate references to the Code.

C.

BQ is a publicly traded utility company, distributing electricity and gas over a multistate area. It distributes electricity to over 5 million customers in Michigan and Ohio. BQ plans to install "Smart Grid" technology in a sampling of its customer's homes, as a test of how effective such technology is as an energy conservation measure. Customers will not be charged for the Smart Grid technology.

The Smart Grid, when implemented, will be a modernization of the current electrical generation and distribution system. The Smart Grid will be an automated network, with a two-way flow of electricity and information. According to its promoters, the extensive monitoring of electrical usage will result in a much more efficient system. Utility companies will be better equipped to reduce generation and transmission costs, and consumers will be better prepared to make informed decisions affecting their use of electricity and control cost. Another characteristic of the Smart Grid is its ability to accept power from solar and wind systems. This ability can be important to customers who have their own solar or wind systems.

BQ plans to provide solar panels capable of generating electricity and certain monitoring devices to a sampling of its customers. The monitoring system will give hourly electricity pricing and will provide web-based electricity consumption and pricing information. The panels will allow a home to produce energy and to store it for use at other times. All of the equipment provided to customers will be owned by the customers and may increase the value of their home. The Internal Revenue Service has ruled (LTR 201046013) that the provision of this equipment to customers will not be taxable to the customers under Code section 136. That section provides that "Gross income shall not include the value of any subsidy provided (directly or indirectly) by a public utility to a customer for the purchase or installation of any energy conservation measure."

Question 4. Maximum Points, 15; Maximum Lines, 28 OR Maximum Words, 308.

How should BQ treat the amounts it pays to purchase and install the Smart Grid technology (monitoring devices and solar panels) in the homes of selected customers? Can it deduct the costs, or must they be capitalized? Discuss, with references to appropriate authorities. For purposes of this question, assume that Code section 197 is inapplicable.

[**Multiple Choice and True/False Questions Omitted**.]