

Taxation

LEX 7816-001
MAXIMUM TIME: 4 HOURS
MAXIMUM POINTS: 100
DECEMBER 20, 2000 AT 1:30 P.M.

Instructions

1. Your copy of this examination *must be returned to the proctor* before you may leave the examination room. Do **not** remove staples from your copy of the examination and do **not** put your name or information on your personal status (i.e., graduating senior, graduate student) anywhere on the exam.
2. **Write your examination number 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**. Please do this now.
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 1999 or later edition of the Internal Revenue Code ("Code"), and 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, questions 1 and 2, go in your bluebook. Answer question 3 of Part I and the multiple choice questions in Part II on your copy of the exam.
5. Read the instructions for each part carefully and follow those instructions.
6. 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 1999 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.
7. All taxpayers are itemizing their personal deductions rather than claiming the standard deduction.
8. The possible effects on tax liability of any floors, ceilings, or phase-outs that might apply to specific itemized deductions are to be ignored.
9. The taxpayers have not made any special elections, such as, for example, an election not to be governed by the installment method, but they have complied with all necessary reporting and filing requirements.
11. All transactions occur at arm's length.
12. All capital assets have been held for more than 18 months.

I. Essay
(maximum points: 40)

Instructions. Answer the first two (2) questions below in your bluebook and answer the third question on your copy of the exam in the space provided. 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**. Observe the maximum space limitations. *You will suffer a grade penalty, proportionate to the offense, for exceeding the space limitations.* (As a practical matter, a penalty is not imposed for exceeding the limits by two lines or less.) One page of a bluebook, double spaced, is 14 lines.

Note on Handwriting: 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 typists: Put your exam number in the upper right hand corner of each page of your answer sheets. Number your answers clearly and observe the space limits. One handwritten line of normal size writing is equivalent to 1 line of a typed page (8½" × 11") with 1½ inch margins (pica) or 2 inch margins (elite). This notice is typed with a pica font (Courier 12 point) and has 1½ inch margins.

A. Short Answer
(Maximum points: 9; maximum lines: 15)

Question 1. Elmore, age 50, is in the construction business. His son, Guy, age 25, has never worked a day in his life. Guy likes to ski and drive fast cars. To encourage his son to become self sufficient, Elmore decided to nudge his son into a business enterprise that combined the son's affection for snow and motor vehicles. To this end, Elmore bought a used pickup truck for \$12,000 from Clancy, a business association. It turned out that the truck was not in great condition. Elmore paid \$10,000 for major repairs and an additional \$8,000 to outfit the truck with a snow plow. He hopes that Guy will start a business of plowing people's walks and driveways during the winter season. Acting on this hope, Elmore gave the truck to Guy. At the time of the gift, the truck had a fair market value of \$22,000. Guy thanks his Dad and promises to consider taking up the snow plow business.

1a. If Guy receives the truck from his father on February 1 of year 1 and uses it to plow driveways for profit for the rest of the winter, how much of a deduction for depreciation can Guy take in year 1? Assume that the truck is used exclusively for business in that year and that it constitutes 5-year property within the meaning of Code Section 168(e)(3). Explain your answer, showing your calculations. In support of your answer, give appropriate references to the Code.

1b. Assume that Guy plows his own driveway, finds the going tough, and decides not to get into the plowing business. He sells the truck for \$21,000. How much gain or loss should he realize? Explain, with appropriate references to the Code.

1c. From a policy perspective, what basis should a taxpayer have in property that is received as a gift for purposes of computing depreciation deductions and for purposes of computing gain or loss on a sale of that property? Should the basis be the same for both purposes? Discuss.

B. Medium-Length Essay

(Maximum points: 16; maximum lines: 2 blue book pages, double spaced)

Oilcan Calhoun is a famous baseball pitcher for the Toledo Mudhens. The Mudhens advanced to the World Series last November. Just before the Series, Oilcan had a severe toothache. His regular dentist, Dr. Roosevelt, told him that he had an impacted wisdom tooth that had to come out. Dr. Roosevelt does not do extractions. He sent Oilcan to a specialist, Dr. Fear. Oilcan had never met the good doctor and was very nervous about the procedure. To calm him down, Dr. Roosevelt told him: "The only thing you have to fear is Fear himself."

Dr. Fear successfully pulled the wisdom tooth. When Oilcan asked how much the charge was, Dr. Fear said that his usual fee was \$500 but he would waive the fee if Oilcan would autograph two Mudhens baseball caps for him. Oilcan readily agreed. Dr. Fear had bought the caps for \$20 each at a Mudhen's game. After Oilcan had signed the caps, they had a fair market value of \$620 each. Dr. Fear gave one of the caps to his 12 year old son, Bobby, who is a big fan of Oilcan. He gave the other cap to Eastern University, Oilcan's alma mater. Eastern put the hat on display in its alumni hall of fame. Eastern had offered to pay Dr. Fear \$1,000 for the cap before Dr. Fear decided to make a gift of it.

Question 2. What are the tax consequences of these events to Dr. Fear and Oilcan? Discuss the options and give support for your final positions.

C. True/False with Explanation

(Maximum points: 15; maximum lines: space provided)

Question 3. Answer this question on your copy of the examination in the space provided below. Do NOT answer this question in your bluebook. For each subquestion below, indicated whether it is True (T) or False (F) by circling the appropriate letter. If you circle "F," give the **correct** answer and support your position by giving appropriate citation to authority. If you circle "T," support your claim by giving appropriate citation to authority. Limit your explanation to the space provided below each subquestion.

3a. T F The taxpayer, who keeps his books on the accrual method, operates a diner in Eastpointe, Michigan. In January, he receives \$1,200 from a regular customer to pay for breakfast for the next three years. The customer is being sued by his former spouse for failure to make alimony payments. The customer tells taxpayer that he wants to be sure of getting his regular

breakfast at the diner no matter what happens with his former spouse. The entire \$1,200 is taxable to the taxpayer in the current year under the claim of right doctrine.

3b. T F After the construction of a dam on the Santa Fe River at High Springs and the impoundment of Lake Alachua, Ted obtained a permit from the U.S. Corp of Engineers to construct a floating marina on the lake. The marina cost \$250,000. Several years later, when the marina had a fair market value of \$700,000 and an adjusted basis of \$200,000, it was partially destroyed by a tornado. After the damage, the fair market value of the marina was \$400,000. Fortunately for Ted, the marina was insured. Ted received casualty insurance proceeds of \$200,000. Under these circumstances, Ted may properly claim a \$100,000 casualty loss, deductible against his business income.

3c. T F In 1996, Stanley purchased from Seller a small office building for \$600,000. Stanley financed the purchase by borrowing \$600,000 from the First Regional Bank. The bank took a security interest in the office building, and Stanley was not personally liable on the loan. Over the years, Stanley made interest payments to the bank but made no principal payments. He also properly took deductions for depreciation of \$200,000. In 2000, Stanley became unable to continue making any payments to the bank. The bank immediately foreclosed on the office building. At the time of the foreclosure, the fair market value of the office building was \$250,000 and its adjusted basis was \$400,000. Stanley does not recognize any gain or loss as a result of the foreclosure.

3d. T F In year 1, John borrowed \$50,000 from National Bank, which he used to purchase tax-exempt bonds issued by the State of Michigan. At the time, John held stock in the XYZ company that pays annual dividends of \$8,000. In year 2, John received interest of \$3,000 on the Michigan bonds and dividends of \$8,000 on the XYZ stock. He also paid interest of \$5,000 on the loan from National Bank in year 2. Under these conditions, John is allowed to deduct only \$2,000 of the \$5,000 in interest paid to the National Bank in year 2.

3e. T F Percy works as a computer specialists at a Detroit bank, earning an annual salary of \$130,000. He learns that the All Star game is scheduled to be played the following year at Comerica Park in Detroit. He decides that he should be able to make some extra money by selling customized T shirts with the pictures of the star players to people attending the All Star game and the related programs. He plans to rent the necessary scanning and other equipment in the following year. In anticipation of this business opportunity, he hires an employee and trains her in the use of the scanning equipment during the current year. For the current year, he pays her \$10,000 in salary. None of the \$10,000 is deductible in the current or following year because Percy was not engaged in business when the expense was incurred.

II. Multiple Choice (maximum points: 60)

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.**

Each question is worth 3 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 Questions Not Released}