

Taxation

LEX 7816-001

Maximum Time: 4 hours

Maximum Points: 100

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 2001 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 go in your bluebook. Answers to the multiple choice questions in Part II 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 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 2001 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 12 months.

I. Essay (maximum points: 50)

Instructions. Answer the four (4) questions below in your bluebook. 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" x 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.

1. (**Maximum Points, 10; maximum lines, 14**) In year 1, Dr. S purchased a new Lotus Esprit automobile for \$80,000. In year 4, he received a notice from the ABZ Insurance Co. saying that it would extend the manufacturer's warranty on the Esprit for three years for a flat fee, payable in advance, of \$30,000. While Dr. S was considering the purchase of the extended warranty, he looked up "maintenance" on an Esprit website and found the following passage:

Esprits, as with most supercars, are built mostly for performance, not reliability. It takes patience and very deep pockets to keep one of these machines running properly. Do not be fooled by the low price you can buy a used Esprit for. If you can't afford to maintain it, you can't afford to own it. The purchase price is only half the story. I won't lie to you: parts are very expensive.

Armed with this information, Dr. S bought the extended warranty. During year 5, while the new warranty was in effect, he had some very minor repair problems with the Esprit. He paid for the repairs in cash and was reimbursed in full by ABZ Insurance Co. In total, Dr. S received payments from ABZ of \$120,000 in year 5. How should Dr. S treat the payments in year 5 on his tax return? Explain, with a discussion of possible policy concerns and with references to any applicable authority.

2. (**Maximum Points, 10; maximum lines, 14**) Ted, a U.S. citizen and resident, works nights at Mickey D's and by day writes novels that so far have not been a commercial success. For a vacation, he visited the Barbados and went snorkeling. To his great surprise and delight, he found a small metal chest filled with gold coins that apparently had come from a Spanish galleon in the 16th century. Ted took the chest home with him and kept it in the attic of his house. He plans to sell the coins next year.

Alice, a U.S. citizen and resident, is a professional diver and the owner of a ship salvage business that employs twenty people. As part of her business, she searches for sunken treasures. Last year, she headed a diving team that located some important Greek statues in the Mediterranean Sea, which she sold for \$3 million dollars. This year, she found a small metal chest filled with gold coins in the waters surrounding the Barbados. The coins are very similar to those found by Ted and apparently came from the same sailing ship. Alice put the coins in the vault at her office in Miami. She plans to sell them next year, after she has fully searched the ocean site for other sunken treasures.

In the opinion of the instructor in this course, Ted is taxable on the fair market value of the coins in the current year. In contrast, Alice will not be taxable until she actually sells the coins. Assuming that the instructor is correct, please explain the policy justification for this difference in treatment. You should support your position by using analogies when appropriate to domestic and foreign cases found in the casebook.

3. (**Maximum Points, 15; maximum lines, 21**) Mabel is a website designer, working for the ABC Company. In September, the company president told Mabel that he wanted a whole new design for the website for the Christmas holiday season, which begins on October 15. Mabel told the president that the redesign will take many hours to accomplish and cannot be done by October 15 unless she works a lot of overtime, which she is not willing to do without substantial additional compensation. The president responded that his key employees often work overtime to deal with special issues and that he considered her to be a key employee. Mabel replied that if she had to work overtime like a key employee, she should get the perks of a key employee. In particular, she wanted the right to park for free in the company parking lot (value of \$800 per month), a right to eat for free in the company dining room (value of \$300 per month), free membership in the local sports club (value of \$800 per month), and access to the company's luxury suite at the Detroit Lions football games. (value of \$160 per year). The president reluctantly agreed. Mabel finished the website revision on time and received the promised perks. How is she taxable on the perks? In particular, what amounts, if any, can she exclude from her income? Whenever possible, please give specific references to the Code and/or Treasury Regulations in support of your answer but do not look for

support elsewhere. If additional information is needed, explain why it is needed and then answer the question by making reasonable assumptions about the facts.

4. (*Maximum Points, 15; maximum lines, 21*) Janet is an artist. In year 1, she sold a painting to a local gallery for \$1,000. Her cost in producing the painting – for frame, paint, and canvas – was \$50. She reported ordinary income of \$950 on her tax return for year 1. In year 2, Janet saw the painting at a different gallery and inquired about the price. She was told that it was painted by a gifted local artist named Janet and sells for \$4,000. Janet offered \$3,500 and the offer was accepted. Janet hung the painting in her own studio as a decoration, along with several of her other favorite paintings. These paintings are all available for sale to customers, although most of her sales are made through a gallery. In year 7, a visitor to the studio admired the painting and offered to buy it for \$10,000. Janet made the sale, recognizing a gain of \$6,500 (\$10,000 – \$3,500). The question is whether the gain is capital gain, subject to preferential treatment, or ordinary income.

Janet goes for advice to her friend, Walter, who is a partner at the law firm of Holmes & Black. Walter is deeply puzzled. He assigns his three law clerks, Able, Badu, and Chad, to give him their best assessment of the answer. Here are the answers that Walter received:

- Able:** Janet must report the gain as ordinary income because the painting was “of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year” within the meaning of IRC § 1221(a)(1).
- Badu:** Janet must report the gain as ordinary income because the asset was held by “a taxpayer whose personal efforts created such property” within the meaning of IRC § 1221(a)(3)(A).
- Chad:** Janet can get a capital gain because the gain qualifies as “section 1231 gain” within the meaning of IRC § 1231(a) because it represents gain “on the sale or exchange of property used in the trade or business” within the meaning of IRC § 1231(a)(3)(A) and 1231(b)(1).

Is any of the above answers correct? Explain. Discuss each answer in light of the language, structure, and policy of IRC § 1221 and the capital gains preference in general. Start your discussion of each answer by stating clearly whether you think the suggested answer is right or wrong. If you conclude that all three of the above answers are wrong or probably wrong, state what you think is the best answer to the question and give support for it based on the language, structure, and policy of IRC § 1221.

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.**

Each question is worth 2½ 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 Omitted]