

Taxation

LEX 7816

Maximum Time: 4 hours

Maximum Points: 100

Tuesday, December 9, 2003

6:15 – 10:15 p.m., Room 1545

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 about 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 2002 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 2003 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 or to deduct capital expenditures under Code section 179, 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: 40)

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" × 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)** Taxpayer operates a construction business. She enters into a contract with the City of New Bristol to repair several roads. The contract amount is \$500,000. In year 1, she does some basic patching of the roads in preparation for resurfacing them in the following year. She expends \$100,000 to do that work. In accordance with the contract, she receives a progress payment from the city of \$200,000. Under the contract, that amount must be repaid to the city if she does not complete the work in accordance with the job specifications. In year 2, she has serious problems with her paving equipment and defaults on the contract, repaying the \$200,000 received in year 1. What income must Taxpayer report and what deductions may she claim in years 1 and 2?

2. **(Maximum Points, 10; maximum lines, 14)** Agnes works as a copy editor at *Cranes Free News*, a monthly magazine covering business events in southeastern Michigan. She loves her job, notwithstanding the fact that her boss is a bit of a jerk. She earns around \$60,000 per year. In July of this year, her boss, the Managing Editor of *Cranes*, invites her to join him at the *Cranes* luxury box at Comerica Park to watch the Detroit Tigers lose to the Boston Red Sox. She does not like baseball very much, but the invitation was one she felt she could not refuse. The boss also asked her to drive because his license had been suspended. Agnes accepted the invitation and drove her 1997 Chrysler Cirrus to the baseball game.

After the game, which the Tigers lost, there was some difficulty getting out of the parking lot. Agnes and the boss waited in line to get out for nearly 10 minutes, and the boss got more and more irritated. Just as they were about to get into the lane to get out, the driver of a new BMW Seven Series (valued at \$70,000) cut in front of them. Agnes hit the brakes, but the boss screamed at her:

“Ram him, ram him!!!” She looked in horror at her boss, whose eyes were suffused with red. “Ram him or you’re fired,” the boss said, in an even tone that was even more frightening than his initial scream. Agnes let up on the brake and smashed into the side of the BMW, making an unsightly dent. The owner of the BMW never even made eye contact with Agnes, apparently fearing for his life. He swerved neatly, drove down the fire lane for 30 yards, cut in front of a Lincoln Town Car that was moving majestically down the exit lane and bounded out of the parking lot.

The Cirrus was dented in front, and the right headlight was damaged. Agnes had planned to trade the car in for a Nissan 350Z. The dealer had offered her \$5,000 for the Cirrus, but when Agnes brought in the damaged car, the dealer lowered his trade-in offer to \$4,000, which Agnes accepted. She ended up paying the dealer \$26,000 in cash plus the damaged Cirrus for the 350Z. Always the optimist, Agnes expected that the boss would offer to pay the damages to the Cirrus, and she even mustered the courage to let him know that she had lost \$1,000 from the crash. The boss, however, changed the subject and gave no indication that he felt any obligation to bear the cost of the loss. Agnes reported the loss to her insurance company, but the agent, who was a good friend, said that deliberate damage is not covered by her policy and that she would be well advised not to file a formal claim because the insurance company would cancel her policy. Agnes took this good advice. In December, Agnes received from *Cranes* a bonus of \$5,000. She was astonished because she had never received a bonus before, and *Cranes* does not have a policy of paying Christmas bonuses or any other kind of bonuses.

What are the tax effects of the loss of \$1,000 that Agnes suffered from the damage to her car and of the receipt of the \$5,000 bonus?

3. (Maximum Points, 10; maximum lines, 14) THo is a company that manufactures model trains. It reports its income for tax purposes using the accrual method of taxation. The trains are marketed to adults and children over 12 years of age. Some of the trains, nevertheless, are purchased by parents and relatives for young children. The train sets have many small parts, which children are inclined to put in their mouth and occasionally swallow. THo has put conspicuous warning signs on the train-set boxes, but the accidental ingestion of train parts has not ceased. THo had an insurance policy, for which it was paying \$400,000 per year, to cover legal fees and damage settlements resulting from injuries to children and other users of its products. It properly deducted the cost of the insurance. Payments under the policy, however, declined by a small amount recently, perhaps due to the efforts of the company to publicize the importance of keeping the train sets away from small children. Yet the insurance company recently announced that it was doubling the cost of liability insurance.

In response to the threat of higher insurance costs, THo decides to cancel its insurance policy. Instead, it sets up an account on its books for \$300,000 (first account) to cover expected liability claims from train sets sold in prior years. It also sets up an account for \$50,000 (second account) to cover expected future liability claims for train sets sold in the current period. These accounts are in accordance with generally accepted accounting practices (GAAP). During the current year, THo paid claims of \$280,000, which it charged to the first account. In computing its income for financial accounting purposes, it deducted \$350,000 — the total amount put in the two accounts. It did not deduct the \$280,000 in actual claims for financial accounting purposes, but instead reduced the first account by that amount. These actions conform to GAAP.

Can THo deduct the amounts put into either the first or second account in computing its taxable income for federal income tax purposes? Can it deduct the payments made to settle claims? Discuss, with appropriate references to the Code and relevant case law.

4. (Maximum Points, 10; maximum lines, 14) Ronald is 60 years old. He has a pony tail and wears bell-bottom trousers. He also suffers from glaucoma, a serious eye disease. It causes pain and nausea, both of which are relieved, he believes, by smoking marijuana. The purchase and use of marijuana is illegal under federal law. Ronald, who lived in Ann Arbor Michigan, has moved to Colorado, where the purchase and use of marijuana for the treatment of a disease is legal under state law if the use is prescribed by a certified Colorado doctor. About a half-dozen other states have a similar rule. Ronald obtains a marijuana prescription from a certified Colorado doctor, and pays \$10,000 in marijuana expenses during the taxable year. His adjusted gross income for the year is \$40,000. During the year, he is busted by a federal agent and pays a fine of \$500 for marijuana possession. Can Ronald deduct the marijuana expenses under Code section 213? How about the federal fine? Discuss. Note: The proper treatment of marijuana is not addressed explicitly in Code section 213 or the applicable regulations, and you should assume that no case law is directly in point.

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 Omitted