EXAM NO. ___________

Wayne State University
Law School

Fall 2005

Prof. Michael J. McIntyre

Taxation

LEX 7816
Maximum Time: 4 hours
Maximum Points: 100
Tuesday, December 13, 2005
6:15 p.m. – 10:15 p.m., Room 1535

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 2004 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 2005 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 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-sized 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, 20; maximum lines, 28).** Boris is a sports equipment salesman in Livonia. He has dreamed of starting his own restaurant for many years. A restaurant specializing in Belgian and French cuisine has recently closed in Northville. The restaurant, called *Goos*, had a good reputation, but the owner has had health problems which led to severe business problems. In addition, the owner of the building where the restaurant was located would not renew the lease because he had decided to convert the building to condominiums. Boris has had discussions with the former owner of *Goos*, who is willing for Boris to take over the business at a new location. The plan is to open a new restaurant on September 1 under the same name. Prior to the grand opening, Boris does the following:

A. On June 1, he leases space in a building formerly used as a Mexican restaurant. The lease is for three years, with payments on the lease of **$4,000 per month**, beginning on June 1. He paid a real estate agent a fee of **$2,000** to locate the premises and arrange the lease.

B. He hires three former employees of *Goos* to help get the restaurant ready to open. From June 1 to the grand opening on September 1, he pays the employees a total of **$10,000**, from which he withheld all applicable taxes.

C. He pays a contractor **$6,000** to redo the restaurant in an appropriate style.

D. He pays **$7,000** to the former owner of *Goos* for use of the name *Goos* and the associated goodwill.

Boris has financed the above expenditures with his own savings and a loan (at commercial interest rates) from his mother. The restaurant opens on time and is successful during the opening year and thereafter.

Question 1. In filling out his tax return for the year, how should Boris treat the expenditures A through D listed above? In particular, what items, if any are deductible in the current year. If any items are not deductible, can he take amortization or depreciation deductions with respect to them? Over what time period? Explain, with references to the Code.

2. (Maximum Points, 10; maximum lines, 14). The following story by the Associated Press recently appeared in several newspapers:

Cabbie Strikes Gold for Returning Lost Diamonds

Los Angeles Taxi Driver Gets a Fat Check — and a Bracelet for His Wife

LOS ANGELES — A Southern California cab driver's simple act of honesty has turned to gold.

Two weeks ago, the driver, Haider Sediqi, tracked down a jeweler and returned to him the $350,000-worth of diamonds he left in the back seat of the taxi.

As a way of saying "thank you," the jeweler sent the cabbie a $10,000 check and a diamond bracelet.

But the honest cabbie was just as impressed with the man's thank-you note. The jeweler wrote that the cab driver had "changed his life."

The driver is putting the money in a bank account to help pay for his children's schooling. And he's giving the bracelet to his wife, who assured him he did the right thing in returning the diamonds.

Question 2a. Cabbie goes to you for tax advice. Since the story appeared in the press, he has been told by several friends that he is taxable on receipt of the $10,000 and the diamond bracelet. "It ain't a gift," one friend said, "because the guy didn't even know who you were before you showed up with his diamonds." What argument(s) can you make for Cabbie that the payment is a gift? Give appropriate references to the Code and case(s) discussed in the course.

Question 2b. Now assume that you are asked to give advice to the Diamond Guy (the jeweler who lost the diamonds that Cabbie returned). Diamond Guy wants to know if he can deduct the $10,000 in cash and the value of the diamond bracelet, which he correctly claims is worth $3,000. What advice do you give him? Give appropriate references to the Code and case(s) discussed in the course.

3. (Maximum Points, 10; maximum lines, 14). Section. 304 of H.R.4297, Tax Relief Extension Reconciliation Act of 2005, now before Congress, provides as follows:

> CAPITAL GAINS TREATMENT FOR CERTAIN SELF-CREATED MUSICAL WORKS.
>
> (a) IN GENERAL.– Subsection (b) of section 1221 (relating to capital asset defined) is amended by redesignating paragraph (3) as paragraph (4) and by inserting after paragraph (2) the following new paragraph:
>
> > (3) SALE OR EXCHANGE OF SELF-CREATED MUSICAL WORKS.– At the election of the taxpayer, paragraphs (1) and (3) of subsection (a) shall not apply with respect to any sale or exchange before January 1, 2011, of musical compositions or copyrights in musical works by a taxpayer described in subsection (a)(3).
>
> (b) LIMITATION ON CHARITABLE CONTRIBUTIONS.– Subparagraph (A) of section 170(e)(1) is amended by inserting "(determined without regard to section 1221(b)(3))" after "long-term capital gain".
>
> (c) EFFECTIVE DATE.– The amendments made by this section shall apply to sales and exchanges in taxable years beginning after the date of the enactment of this Act.

Question 3. The above language is included in the House version of the tax bill but not in the Senate version. You are an aide to a senator on the Conference Committee that is reconciling the House and Senate versions of the Tax Relief Extension Reconciliation Act of 2005. Your senator opposes the amendment. What argument(s) can you give him for rejecting the bill on fairness grounds? In particular, suggest categories of taxpayers who arguably are similarly situated to song writers who would not benefit from the bill.

4. (Maximum Points, 10; maximum lines, 14). AutoSupply, Inc. (AS) is a company that owns five auto-parts stores in Michigan. In 2004, it decided that it needed $1 million for expansion of its business and renovation of its stores. It explored the possibility of a bank loan, but the terms offered were not to its liking. It then contacted its main supplier, PartsMaker, Inc. (PM). PM offered to provide AS with the $1 million if AS agreed to sign a 5-year supply contract with PM and to sign a promissory note for the $1 million. The amount due on the note would be reduced by $200,000 for each year that AS met the terms of the supply contract. AS accepted the arrangement and received $1 million from PM in 2004.

The supply contract between AS and PM provides that AS will purchase $16 million of parts each year from PM at the prevailing market prices. That is, PM guaranteed that it would not charge more for the parts than its competitors. An excess in one year over the $16 million guaranteed would carry forward to the next year. For example, if AS purchased $18 million in 2005, it would need to purchase only $14 million in 2006. In each of the past three years, AS has purchased $20 million in parts from PM. Both PM and AS have assumed that AS would have no difficulty meeting the terms of the supply contract.

During 2005, AS purchases $22 million in auto parts from PM. The increase from prior years was due to the expansion that was facilitated by receiving the $1 million from PM. As a result of exceeding the $16 million target, the amount due on the $1 million note was reduced by $200,000.

Question 4. What are the tax consequences in 2004 and 2005 as a result of the arrangement made by AS with PM? In particular, what is the proper treatment of the payment to AS by PM of $1 million in 2004 and the $200,000 reduction in the principal amount of the promissory note in 2005? Explain how you anticipate the Internal Revenue Service will view the arrangements, how the taxpayer would like to treat the arrangements, and then give your assessment of the proper treatment. You are not required to give citations to authority but may do so as a shorthand in explaining your answer.

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 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.*