EXAM NO. ___________

Wayne State University
Law School

Fall 2006
Prof. Michael J. McIntyre

Taxation

LEX 7816
Maximum Time: 4 hours
Maximum Points: 100
Tuesday, December 19, 2006
9:30 a.m. – 1:30 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 2005 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 2006 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, 12; maximum lines, 28). The Acme Box Company has 100 employees. The annual salaries of the employees range from $25,000 to $300,000. In December, the company distributes to each of its employees a gift certificate of $100 to K-Mart (total face amount of $10,000). The employees are encouraged to "buy something nice for themselves or their family for the holidays." Acme Box has no commercial relationship with K-Mart. It negotiates with K-Mart to obtain the gift certificates for $90 each (total payment to K-Mart of $9,000). Acme Box deducts the $9,000 it pays to K-Mart as a business expense. It does not treat the distribution of the gift certificates as compensation to its employees and does not withhold taxes. It does provide the employees and the IRS with a 1099 information return, showing a payment to each employee of $90. Some of the employees use their gift certificates during the current taxable year, and the remaining employees use them the following January.

Question 1. From a tax policy perspective, given the general tax principles implicit in the Code that are applicable to gifts and employee fringe benefits, what is the proper treatment of the *employees* on their receipt and use of the gift certificates? Discuss. Citations to cases and provisions of the Treasury regulations are not necessary, but you should discuss the Code sections that should be applicable in taxing or not taxing the receipt and use of the gift certificates..

2. (Maximum Points, 15; maximum lines, 24).

Question 2a. Taxpayer purchased a factory, used in his business, for $100,000. Of that amount, $30,000 came from his savings and $70,000 came from a bank loan, on which he is personally liable. Taxpayer spent $30,000 improving the building. He properly deducted $20,000 in depreciation. What is Taxpayer's basis in the factory? No references to authorities are required.

Question 2b. Taxpayer purchased a machine on December 1, 2005, for use in her business. The cost was $50,000. The machine was put in service on January 1, 2006. It has a salvage value of $10,000. Its class life, within the meaning of IRC § 168(e)(1), is 7 years. How much depreciation can Taxpayer take on that machine in 2005? In 2006? No references to authorities are required.

Question 2c. Taxpayer works as a copy editor at the Ann Arbor News. She has one child, Billy, age 8. Taxpayer's husband works as a fireman, also in Ann Arbor. Taxpayer and her husband file a joint return. Billy attends public school in Ann Arbor. Because of their work, Taxpayer and her husband need to arrange for supervision of Billy during the three summer months when school is not in session. They find that it is impossible to arrange for quality day care at less than $1,000 per month when the child is going only part time. After considering their options, they send Billy to day camp for 2 months at a total cost of $1,000 ($500 per month) and to overnight camp for 1 month at a total cost of $1,000. Billy does not like day camp but likes overnight camp a lot. Can Taxpayer and her husband qualify for a child-care credit for the amounts spent for day camp and overnight camp, assuming that they meet all of the income requirements? Explain, with appropriate references to the Code.

3. (Maximum Points, 12; maximum lines, 28). ACo is a publicly traded corporation. In July of 2005, ACo acquired all of the assets of BCo in exchange for its stock. The ACo stock was distributed to the BCo shareholders in redemption of their BCo stock. ACo spent $2 million in legal fees associated with the acquisition of BCo. Under the terms of the acquisition agreement, the former shareholders of BCo were prohibited from selling their stock in ACo for one year.

In May of 2006, ACo announced that an audit of its books disclosed that it had misstated its income in Year 1 and for several prior years. It claimed that the misstatements were unintentional. As a result of this announcement, the price of ACo stock dropped sharply on the New York Stock Exchange. The former shareholders of BCo, now holding ACo stock, sued ACo, alleging that ACo had artificially inflated the value of its stock in violation of Federal securities laws. Before the suit went to trial, ACo settled with the former shareholders of BCo, paying them a total of $5 million.

Taxpayer incurred significant legal and administrative fees in connection with the litigation. These fees include amounts paid for attorneys, expert witnesses, court reporters, document management support, reporter transcripts, document copying, accounting advisors, investigative expenses, trial graphic support, jury focus groups, general trial support, and audit committee investigative expenses. The total of these expenses came to $3 million.

Question 3a. Can ACo deduct in 2005 the $2 million of legal fees paid in connection with the acquisition of the assets of BCo? Discuss, with appropriate references to the Code and to cases studied in the course.

Question 3b. Can ACo deduct in 2006 the settlement payment of $5 million paid to the former shareholders of BCo? What about the associated legal and administrative fees of $3 million? Discuss, with appropriate references to the Code and to cases studied in the course.

4. (Maximum Points, 11; maximum lines, 14). Great Lakes Operation Recover Yesteryear (GLORY) is a Michigan corporation that qualifies as an IRC § 501(c)(3) charity. That is, it can accept gifts without being taxable on them, and the donor generally can claim a charitable contribution with respect to such gifts under IRC § 170. The purpose of GLORY is to reduce pollution of the Great Lakes by promoting conservation projects and doing research on the effects of pollution on the Great Lakes. A major project has been to educate public officials about the need to improve local waste treatment facilities and to separate polluted waste products from city and town storm drains.

GLORY owns a boat, called "Peeking Judith," with a transparent observation bottom that allows passengers to view the effects of pollution on the lakes. It has invited state and local officials involved in making decisions affecting waste disposal to tour a portion of the lakes on Peeking Judith. The boat cruises have been very popular with public officials and, in the view of the management of GLORY, they have help considerably in educating these officials on the need for additional pollution-control efforts.

Like many charitable organizations, GLORY depends for much of its operating budget on contributions from the public. Ms. Apple, who works for GLORY, has come up with a plan for increasing public support for GLORY. Under her plan, donors making a contribution of $100 or more would be entitled to a free cruise on Peeking Judith.

Question 4. Ms. Beta, the managing director of GLORY, is concerned that gifts made under the Apple plan would not qualify for a tax deduction under IRC § 170. She comes to you for advice. What do you tell her?

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.*

[Multiple Choice Questions Omitted]