EXAM NO. ___________

Wayne State University
Law School

Winter 2008
Prof. Michael J. McIntyre

Taxation

LEX 7816
Maximum Time: 4 hours
Maximum Points: 100
Tuesday, April 29, 2008
6:15 p.m. to 10:15 p.m., Room 1535

Instructions (Taxation)

1. Your copy of this examination *must be returned to the proctor* before you may leave the examination room. Laptop computers are permitted in accordance with Law School rules. 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 (if it is not already there) 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. If you are using a laptop computer, put you exam number and the name of the course and instructor on the front page of your answer sheets.

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 2007 or later edition of the Internal Revenue Code ("Code"), and an edited version of 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 (Essay) go in your bluebook or, if you are typing your exam on a laptop computer, on your answer sheets. *There are four (4) questions in Part I.* Question 1 and question 2 each has two (2) subquestions. Answers to Part II (Multiple Choice) go on your copy of the exam *for all students* taking the exam, including laptop users. 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 2007 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. If you are writing your answers using a **laptop computer**, follow the space limits below for those typing an exam.

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, 8; maximum lines, 14**).

Question 1a. Martha owns and operates a plum orchard. Her trees need water during the hot summer months for the fruit to develop properly. To provide water, Martha contracted to have a 150 foot well dug, at a cost of $20,000. The well-digging company drilled a deep hole, into which it inserted a PCV pipe, 12 inches in diameter. Sand was inserted in the hole outside the PCV pipe to hold it in place for the first 100 feet. Cement was used to encase the rest of the PCV pipe. Is Martha entitled to a deduction for depreciation with respect to her well? Discuss.

Question 1b. Ernie, at age 30, bought an annuity for $30,000. Under the contract, he is to be paid $5,000 a year for the rest of his life, beginning in the year in which he turns 65. He has now turned 65 and receives the first payment of $5,000. At that time, he has a life expectancy, according to the controlling IRS regulations, of 20 years. How much of the $5,000 payment is taxable to him?

2. (**Maximum Points, 14; maximum lines, 28**). Ted is a fan of the Detroit Tigers, a professional baseball team. He likes to go to Cleveland to watch his favorite team play the Indians at their home park (Progressive Field, formerly Jacobs Field). When he goes to Progressive Park for a game, he takes with him three business associates who live in Cleveland. Last year, so many

Tigers fans showed up at Progressive Field that the Tigers fans outnumbered the Indians fans, to the embarrassment of the Cleveland Indians owners. In an attempt to prevent a recurrence, the Indians adjusted their ticket policies. Instead of allowing fans to buy individual tickets to Indians-Tigers games, management insisted that such tickets be purchased as a package (a 5-pack) that included at least 4 other games. For example, a fan wanting 4 tickets to an Indians-Tigers game at Progressive Park also had to buy 4 tickets to 4 other Indians games against other teams. The idea was that most Tigers fans would not be willing to buy tickets to games other than Indians-Tigers games.

In response to the new rule, Ted purchased four (4) tickets to the Indians-Tigers game scheduled for July 28. To be allowed to buy those tickets, Ted also bought four tickets to the Indians-Twins games on July 25 and 26 and to the Indians-Blue Jays games on May 9 and 10. In total, he bought 20 tickets. Each ticket cost him \$25 (Upper Box Seats), for a total for all the tickets of \$500 (\$25 × 20 tickets). Because Ted only cared to attend the Indians-Tigers game, he sold the remaining 16 tickets on EBay for \$320 (\$20 each × 16). He plans to attend the Indians-Tigers game with his Cleveland business associates.

Question 2a. Ted wants to take a business expense deduction for the cost of the Indians-Tigers tickets. Can he do so? What additional information, if any, do you need to decide on the answer? Discuss, with appropriate references to the Code.

Question 2b. Ted also wants to deduct a loss of \$100 on the sale of the Twins and Blue Jays tickets. Can he do so? Discuss. In particular, discuss whether a loss is allowable and what Ted's basis should be in computing the amount of the loss.

3. (**Maximum Points, 14; maximum lines, 28**).

Joe and Edith have been having an affair for the past six months, unbeknownst to Andy, Edith's husband. Andy is a carpenter, earning \$50,000 a year. He and Edith have two small children. Edith does not work outside the home and relies on Andy for her support and the support of her children. Joe has urged Edith to leave Andy and move in with him. Joe is very rich and owns a fine home. Edith tells Joe that she would be happy to move in with him and leave Andy, but she is worried about financing the college education of their children. Joe promises Edith that if she moves in with him, he will support her and the children and will give Edith stock worth \$200,000, which she can put in trust for the education of the children. Joe has a basis in the stock of \$20,000. The expectation is that the children also will come to live in Joe's house. Joe expects that Andy will end up divorcing Edith, but he has no real interest in how they work out their legal relationship.

Question 3. Joe comes to you for tax advice. He wants to know, first of all, what the tax consequences will be on his transfer of the stock to Edith. He also wants to know whether he will be able to file as a head of household if Edith and her children move in with him and he provides for their support. What do you tell him? Explain, with reference to authorities.

4. (Maximum Points, 14; maximum lines, 28).

Thomas Brewer (Thomas) is a fireman for the city of St. Paul, Minnesota. He began work on January 1, 1965. During 1969, he fell from a ladder while he was attempting to extinguish the flames from a burning building. As a result of the fall, he injured his back seriously and was no longer able to work. He was awarded disability benefits by the St. Paul Fire Department equal to 40 percent of his salary, adjusted annually for inflation. He excluded the disability payments under Code Section 104(a)(2). He was audited by the Internal Revenue Service (IRS) in 1967, but no adjustment was made. He has continued to receive the payments until the present time.

On March 17, 2007, Thomas reached his 60th birthday, which is the retirement age for firemen in St. Paul. At that age, persons who retire after at least 20 years of service or after at least 2 years of service and disability status for at least 18 years are entitled to a pension. For disabled workers, the amount of the pension is the amount they were entitled to as disability payments. Until Thomas reached retirement age, the Fire Department had not withhold any Federal income taxes on the payments made to him. After Thomas reached retirement age, the Fire Department treated the payments as pension benefits and began withholding taxes. In January of 2008, Thomas received from the Fire Department a copy of a Form 1099-R, Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc. The form indicated that Thomas had received $30,000 in taxable income for 2007. The form also was submitted to the IRS.

The relevant provision of Minnesota law provides as follows:

> *Subdivision 1. Termination of disability benefit*. The disability benefit of any disabled member of a local police or firefighters department, whichever is applicable, shall terminate when the disabled member attains the minimum age for the receipt of a service pension in an amount equal to or greater than the amount of the disability benefit.

Thomas views the withholding tax as a cut in his disability benefit and is very upset. He goes to his union representative and is told that everyone who reaches retirement is treated this way and that there is nothing the union can do about it. Thomas is hoping that he can get the IRS to continue to treat the payments as disability payments under Code section 104(a)(2) so that he can get a refund of the taxes withheld.

Question 4. Do you think Thomas has a good chance of getting a refund of the withholding taxes? Explain. Your explanation should include a discussion of the tax policy justification for or against treating the payments as taxable pension benefits after retirement age has been reached.

Exam No. _________

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.** Those using laptop computers MUST answer these questions here and not on the computer.

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]