

EXAM NO. _____

Wayne State University
Law School

December 21, 1988 (Wednesday)
Prof. Michael J. McIntyre

TAXATION

MAXIMUM TIME: 4 HOURS
MAXIMUM POINTS: 100
9:30 A.M. TO 1:30 P.M. IN ROOM 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.
2. **Write your examination number in the upper right hand corner of this cover sheet in the space provided.**
3. This is an **open book** examination. You are expected to have with you your copy of the casebook and supplemental materials, and a 1988 edition of the Internal Revenue Code and the Income Tax Regulations. You are permitted to have any books, notes or other materials you have used during the course. Do not bring any library materials or commercial tax services. You may use a pocket calculator.
4. This examination has three (3) parts. Answer the questions in parts I and II in your bluebook, and answer the questions in part III **directly on your copy of the examination.** Parts I and II contain essay questions and Part III contains a set of 16 multiple choice questions.
5. Read the instructions for each part carefully and follow those instructions.
6. Certain assumptions are stated below which are applicable to all questions in Parts II and III unless a question explicitly asks you to make some other assumptions. For easy reference, an extra, unstapled copy of the assumptions has been inserted into your copy of the examination.

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 II AND III

Unless a question specifies otherwise, make the following assumptions in answering the questions in Parts II and III of this examination:

1. Taxpayers are using the cash method of accounting.
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 Reform Act of 1986 is fully effective.
6. All taxpayers are solvent.
7. All taxpayers are itemizing their personal deductions rather than claiming the standard deduction.
8. The possible effects on tax liability of the phase-outs of the 15 percent tax bracket and the personal exemption 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.

GENERAL INSTRUCTIONS FOR PARTS I and II

Answer the following three questions in your bluebook. Write in ink and do not write in the margins. Your answer to each question may not exceed the specified number of lines of normal-sized writing. Make an appropriate adjustment if your handwriting is unusually large or small. *You will suffer a grade penalty for exceeding the space limitations.* Please write on every other line (double space), and do not write on the back side of the bluebook pages. A double-spaced page of a bluebook has 15 lines.

Note to typists: 1 line of a bluebook is equivalent to 1 line of a typed page (8½" x 11") with 1½ inch margins (pica) or 2 inch margins (elite). This exam is typed with an elite font.

I.
Essay Question
(maximum points: 28)

The Technical and Miscellaneous Revenue Act of 1988 amended the uniform capitalization rules of IRC § 263A by redesignating subsection (h) as subsection (j) and by inserting after subsection (g) the following new subsection:

(h) EXEMPTION FOR FREE LANCE AUTHORS, PHOTOGRAPHERS, AND ARTISTS.-

(1) IN GENERAL.- Nothing in this section shall require the capitalization of any qualified creative expense.

(2) QUALIFIED CREATIVE EXPENSE.- For purposes of this subsection, the term 'qualified creative expense' means any expense-

(A) which is paid or incurred by an individual in the trade or business of such individual (other than as an employee) of being a writer, photographer, or artist, and

(B) which, without regard to this section, would be allowable as a deduction for the taxable year.

Such term does not include any expense relating to printing, photographic plates, motion picture films, video tapes, or similar items.

(3) DEFINITIONS.- For purposes of this section-

(A) WRITER.- The term 'writer' means any individual if the personal efforts of such individual create (or may reasonably be expected to create) a literary manuscript, musical composition (including any accompanying words) or dance score.

(B) PHOTOGRAPHER.- The term 'photographer' means any individual if the personal efforts of such individual create (or may reasonably be expected to create) a photograph or photographic negative or transparency.

(C) ARTIST.-

(i) *IN GENERAL.*- The term `artist' means any individual if the personal efforts of such individual create (or may reasonably be expected to create) a picture, painting, sculpture, statue, etching, drawing, cartoon, graphic design, or original print edition.

(ii) *CRITERIA.*- In determining whether any expense is paid or incurred in the trade or business of being an artist, the following criteria shall be taken into account:

(I) The originality and uniqueness of the item created (or to be created).

(II) The predominance of aesthetic value over utilitarian value of the item created (or to be created).

(D) *TREATMENT OF CERTAIN PERSONAL SERVICE CORPORATIONS.*- [omitted]

Question 1 (3 double-spaced pages or 45 lines). Discuss the merits of this amendment to the Code. Your answer should discuss whether this measure is a tax expenditure, whether it is justified on tax policy grounds, and its likely administrative implications. Consider the implications of the amendment for expenses incurred by technical writers, such as, for example, the author of the casebook used in this course. Also consider the implications for designers of jewelry. Note and comment upon the following statement in the Conference Committee Report: "Thus, for example, any expense that is paid or incurred in producing jewelry, silverware, pottery, furniture, and other similar household items generally is not to be considered as being paid or incurred in the business of an individual being an artist." Your answer should follow the following outline.

- I. General Description of the Amendment**
- II. Arguments in Favor of Amendment**
- III. Arguments Against**
- IV. Discussion of Technical Writers**
- V. Discussion of Jewelry Designers**
- VI. Additional Comments and Conclusions**

II.

Short Essay Questions
(maximum points: 24)

Question 2 (20 lines). Under IRC § 21, certain qualifying individuals can claim a tax credit for certain household and dependent care services. The credit is a percentage of the "employment related expenses" of the individual. For married individuals, there is a cap on "employment related expenses" equal to the lesser of (1) that individual's earned income for the year and (2) the earned income of that individual's spouse. Under § 21(d)(2), however, a spouse who is a full-time student at an educational institution is deemed to have earned

income of up to \$400 per month. The policy goal of the § 21 credit is unclear, but a variety of arguments, some of them inconsistent with each other, have been offered in support of the credit. Which, if any, of the following arguments are consistent with the deemed-income rule of § 21(d)(2)? Explain for each argument.

(1) Dependent-care costs incurred by a married individual with a qualifying dependent are a legitimate business expense as long as the spouse of that individual is not available, because of work or study obligations, to provide those dependent-care services on a full-time basis.

(2) The credit is a technique for indirectly taxing some portion of the imputed income earned by parents who take care of their qualifying dependents as a full-time occupation.

(3) The credit reduces tax barriers that tend to discourage married women from fully participating in the work force.

(4) The credit encourages married women with qualifying dependents to continue their education.

Question 3 (15 lines). Q is a scientist working as an astronomer at a famous observatory and earning a salary of \$80,000 per year. On his way to work at the observatory, he is sideswiped by an overloaded truck owned and operated by Tank Truck Inc. Q is seriously hurt. He loses 20 percent of the vision in his right eye and suffers a broken leg and collar bone. As a result of the vision loss, P can no longer tell a super nova from Halley's comet. He is forced to take a lesser job at the observatory that pays \$50,000 per year. In settlement of Q's claim against it, Tank Truck agrees to make periodic payments to Q totalling \$3 million, without payment of interest. Q will receive \$600,000 (20% of total settlement) for lost wages and \$2.4 million (80% of total settlement) for the pain and suffering and loss of function resulting from his personal injuries. Payments of \$50,000 per year are to be made to Q over his life, with any balance due from the total of \$3 million being payable to Q's estate on his death. Q is a cash basis taxpayer and Tank Truck properly reports its income on the accrual basis. How should Q and Tank Truck be taxed as a result of their settlement agreement? In particular, what amounts, if any, can Q exclude from income, and when can Tank Truck claim a deduction for the amounts due under the settlement agreement? Discuss the proper answer and compare it with the answer under the Code.

III.
Multiple Choice
(maximum points: 48)

GENERAL INSTRUCTIONS FOR PART III

Mark your choice of alternative answers to each question by circling its identifying letter. **Do NOT circle more than one alternative answer.**

Your score will be computed by adding three (3) points for each correct answer. Nothing is subtracted for incorrect answers. Thus you should make guesses, even wild guesses.

In answering each question, make the assumptions stated on page two (2) of this examination 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 the question sheet and, on the space provided on the last page of the examination, 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.

MULTIPLE CHOICE QUESTIONS OMITTED

--- Space to Explain Multiple Choice Answers ---
Use ONLY if necessary

Question () _____

Question () _____

Question () _____
