

TAXATION

Maximum Time: 4 hours
Maximum Points: 100
6:15 p.m. to 10:15 p.m.

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 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 on the front cover of your bluebook and on the space provided in the lower left ("Identification Number") of **the multiple choice answer sheet**. Do not fill in any of the other identifying information on that answer sheet. The last digit of your examination number should be in column "J" of the multiple choice answer sheet. (See next page for example.) Please do this now.
3. *Thank you for putting your exam number in the appropriate spaces.* This is an **open book** examination. You are expected to have with you your copy of the casebook and supplemental materials, and a 1991 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. You may use a pocket calculator.
4. This examination has two (2) parts. Part I has two subparts. The answers to Subpart IA go in your bluebook. Answer the questions in Subpart IB directly on your copy of the examination in the space provided. Answer the multiple choice questions in part II **on the answer sheet, using a number 2 pencil.**
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 I, and II 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 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 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, 1988, 1989 and 1990 are 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 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, but they have complied with all necessary reporting and filing requirements.

**Example of How to Fill in Exam Number on Multiple Choice Answer Sheet,
(assuming your exam number is 009672)**

IA. Short Essay
(maximum points: 45)

Instructions. Answer the following two questions in your bluebook. Write in ink and do not write in the margins. Your answer to each question may not exceed twenty (20) 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 25 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 notice is typed with a pica font and has 1½ inch margins.

1. Betty, age 8, receives a metal detector for Christmas from Santa Claus. In the late spring of the following year (year 1), she goes to the beach with the metal detector, hoping to find coins that had fallen out of the pockets of beach goers during the prior summer. To her astonishment, she discovers a buried oaken bucket containing 10 gold coins. Betty hides two of the coins in her sock drawer without telling anyone. She shows the remaining eight to her step-father, Malcolm. Malcolm has an expert evaluate the coins and is told that the coins were left by the Vikings and are worth a lot of money. Malcolm contacts a Viking artifacts dealer, who arranges for Malcolm to sell the eight coins to the Boston Museum of Fine Arts for \$1 million each. The sale is made at the start of year 2.

Malcolm lies to Betty, telling her that he received a total of \$2 million for the eight coins. During year 2, Malcolm puts \$1 million in a stock fund, with Betty's mother, Alice, as the trustee and Betty as the beneficiary. The fund is to be used to finance Betty's education; any amounts remaining in the trust fund are to go over to Betty upon her reaching the age of twenty-one. With Betty's permission, another million is used to purchase a new house for the family. The new house has an attached barn, which the family plans to use as a riding stable for the horses they intend to purchase. The purchase is made in year 2, and title to the house is put in the name of Malcolm and Alice.

What are the tax consequences to Betty and Malcolm from the activities described above? Your answer should describe the amounts included in their incomes for years 1 and 2. It should also discuss their basis in the assets on hand at the end of year 2. Support your answer with appropriate references to the Code, Treasury regulations, or other authorities.

2. Ted and Shifty are friends. Shifty comes to Ted with a plan to purchase for \$10,000 a high-quality color copying machine manufactured by Canon ®. The machine was to be used to make copies of bank travellers checks. Ted was dubious, suggesting that they could get into trouble for counterfeiting. Shifting told Ted that what they were doing technically was not illegal in that bank checks are not "currency" under the counterfeiting laws. Ted and Shifty each put up \$5,000 toward purchase of the machine, which they acquired from a reputable dealer. At the time of purchase, Ted asked for a demonstration. The dealer made an almost perfect copy of a blue and gold stock certificate that Ted had brought along. Ted was very impressed.

When Ted and Shifty got the machine home to Ted's house, they immediately tried to made copies of some Citybank travellers checks. To their astonishment and horror, the checks came out black on white instead of the expected purple on light blue. Ted then tried to copy a \$1 bill, and that also came out black on white. All upset, Ted called the dealer, telling him that he had tried to copy a dollar bill as a joke and had gotten a black and white image. He accused the dealer of selling him a defective machine. The dealer said that Canon, at the insistence of the government of the United States and Japan, had installed a special computer chip in the copier that causes the machine to shift into black and white mode when it detects a bank note or a currency note. The purpose of the chip

was to discourage counterfeiting. Ted thanked the dealer for the information, concealing his disappointment to avoid detection as a potential counterfeiter.

After getting off the phone, Ted explains the situation to Shifty in angry tones. Ted tells Shifty that it is all his fault and that he wants his \$5,000 back. Shifty calls the dealer and asks him to take back the copier. The dealer agrees to do so, but only if Ted and Shifty pay a restocking fee of \$1,000. Shifty agrees, paying \$600 of the restocking fee himself and getting the remaining \$400 from Ted. Ted plans to deduct \$500 as a loss, treating the extra \$100 received from Shifty as a gift. In the alternative, Ted is thinking of claiming a depreciation deduction of \$500 on the machine. Can Ted claim the loss or take the deduction for depreciation? Explain.

3. You are working as a legislative assistant to Senator P, a member of the Senate Finance Committee. Senator P has read about a tax case in which the taxpayer had run up large gambling debts at a gambling casino. In year 1, the taxpayer had lost over \$1 million at the gambling tables of his own money and had lost another \$3 million worth of chips obtained on credit from the casino. In year 2, the casino cancelled \$2.5 million of the \$3 million debt, and the taxpayer paid the balance of \$500,000 to the casino. The Internal Revenue Service claimed that the taxpayer had cancellation of indebtedness income of \$2.5 million in year 2 and assessed tax on that amount. The taxpayer contested the assessment and ultimately lost in the courts. Senator P wants to propose a narrow amendment to the Code that would allow taxpayers to avoid having to pay tax in such circumstances. Explain to Senator P how he might design his reform proposal without undermining the generally applicable rules relating to cancellation of indebtedness. Explain the policy reasons for your advice to Senator P.

IB. Short Answer
(maximum points: 15)

Instructions. Answer the following questions directly on your copy of the exam in the space provided.

4. Ace owns a piece of land which he purchased for \$30,000. He agrees to sell the land to Banjo for a total of \$50,000. At the time of sale, Banjo is to pay Ace \$10,000 in cash and to give Ace a note for the balance of \$40,000. Interest is payable on the unpaid balance of the note at the fair market rate of eight percent per year. In year two, Banjo is to make a cash payment to Ace of \$20,000. In year 3, Banjo is to purchase an annuity from the XYZ Life Insurance Company payable over the life of Ace. The cost of the annuity is to be \$20,000, with the terms of the annuity set by the market conditions at the time of its purchase. Banjo is required to transfer the annuity to Ace as the final payment on the note.

- (a) Assume that Banjo lives up to the terms of the agreement. How much income will Ace be taxable on in year 3?

- (b) Assume that Ace has a life expectancy in year 4 of 15 years under the applicable Treasury regulations. Assume also that the annuity contract is to pay Ace \$1,000 per year for the rest of his life. How is Ace taxed on receipt of the first annuity payment of \$1,000 in year 4?

5. In the current year, Taxpayer pays the items of interest set forth below. Unless otherwise stated, the loans with respect to which the interest is paid are unsecured. In addition to the items of income mentioned in (a) – (h) below, Taxpayer has business income of \$80,000, dividend income from investments of \$20,000, and income of \$300 from a passive activity. How much, if any, of the following items of interest are deductible in the current year? Mark the amount in the space provided. Also give a reference to the Code in support of your answer.

- (a) \$1,000 of interest incurred on a \$100,000 loan used to pay a printer for handbills distributed by Taxpayer in her trade or business.
\$ IRC §
- (b) \$1,000 of interest on a \$100,000 loan used to finance the construction of a building to be used exclusively as the headquarters for Taxpayer's trade or business. At the end of the year, the building is still under construction and has not yet been placed in service. The loan is secured by the building under construction.
\$ IRC §
- (c) \$1,000 of interest on a \$100,000 loan used to purchase tax-exempt bonds issued by the State of Michigan. Interest of \$800 has been received in the taxable year on these bonds. The loan is secured by the bonds.
\$ IRC §
- (d) \$1,000 of interest on a \$100,000 loan used to purchase IBM stock. Dividends totalling \$400 were paid on the stock during the current year.
\$ IRC §
- (e) \$100 of interest on a \$10,000 loan that the taxpayer took out to finance a business trip. Unfortunately, Taxpayer was mugged just after taking out the loan and the loan proceeds were stolen.
\$ IRC §
- (f) \$300 of interest on a \$20,000 loan used to purchase a car used entirely for personal purposes.
\$ IRC §
- (g) \$100 of interest on a \$5,000 loan used to pay Taxpayer's medical expenses.
\$ IRC §
- (h) \$1,000 of interest on a \$100,000 loan used by Taxpayer to purchase her only vacation home.
\$ IRC §

II. Multiple Choice (maximum points: 40)

Instructions. Mark your choice of alternative answers to each question by filling in the appropriate circle on the **answer sheet** with a number 2 pencil. To protect yourself against a computer failure, you should also circle 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.**

Your score will be computed by deducting one fourth of the allowable points per question for each incorrect answer. Thus you should guess at the answer if you know that one or more of the alternative answers is wrong.

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.