EXAM NO. ________

Wayne State University
Law School

Fall 1994
Prof. Michael J. McIntyre

Taxation (JDC 881)

Maximum Time: 4 hours
Maximum Points: 100
6:15 p.m. to 10:15 p.m.
Room 101

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 first significant digit of your examination number should be in column ``A'' 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 1994/95 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. The answers to Part I go in your bluebook. Answer the multiple choice questions in Part II **on the answer sheet, using a number 2 pencil** and also on your copy of the exam.

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, 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 1993 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)

I. Short Essay
(maximum points: 64)

Instructions. Answer the following seven questions in your bluebook. Write in ink and do not write in the margins. **Number your answers clearly**. Please write on every other line (double space), and do not write on the back side of the bluebook pages. Observe the maximum space limitations shown for each question. Your answer to each of the first five questions (1-5) may not exceed seven (7) lines of normal-sized writing. You have up to fifteen (15) lines to answer question six (6) and ten (10) lines to answer each subquestion in question seven (7). *You will suffer a grade penalty, proportionate to the offense, for exceeding the space limitations.*

Note on Handwriting: A person with nornal-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. A double-spaced page of a bluebook has 25 lines.

> **Note to typists: 1 handwritten line of a bluebook (normal size writing) 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 (Courier 12 point) and has 1½ inch margins.**

1. Mr. and Mrs. T bought a personal residence in Clinton, Michigan, for $150,000. In their back yard was a 100 year-old oak tree of considerable value. Its exact value would be extremely difficult to determined, although an appraiser who looked at the house for the T's at the time of purchase suggested it was probably worth more than $5,000. Soon after buying the residence, the T's made arrangements to upgrade the electrical service to the house from 60 amps to 100 amps. As part of the upgrade process, they asked the local electric company, Consumption Power, to install a new power line from the company's utility pole located on their lot line to the house. The old power line ran within a few feet of the oak tree. Believing that the new line would be too close to the tree, the line installer called the Consumption Power tree crew to trim the giant oak. The crew behaved badly, cutting off about half of the tree, spoiling its shape, and endangering its life. Mr. and Mrs. T were upset and threatened to sue Consumption Power. In the eventual settlement of their claim, the T's received payment of $2,000 from Consumption Power.

Question (Max: 7 points, 7 lines). How is the payment taxed to the T's? You answer should indicate (a) how much, if any, of the payment is included in their gross income, (b) the effect, if any, of the transaction on their basis in their residence, and (c) the character of any gain as ordinary or capital. Cite available authority for your answer.

2. Joe is a roofer. He is hired by Ed to install a roof on the house Ed is building in Mortgage Hill, a new residential development in Pinkney, Michigan. The high-voltage power line of Consumption Power, the local electric company, runs within three feet of Ed's house footprint. When Ed was first planning the new house, he talked to Consumption Power about moving the line, but the company wanted him to pay over $2,000 to get it moved. Ed decided against it. When he hired Joe to do the roof, he warned him several times to be very careful to avoid contact with the power line. Unfortunately, when Joe was installing the aluminum weather stripping on the edge of the roof, he let the weather stripping float a little too close to the power line. Acting like an electric magnet, the power line attracted the weather stripping, causing Joe to receive a jolt of electricity that left him barely able to use his hands. Joe sued the power company. He claimed $300,000 for lost earnings, due to his inability to do roofing any more, $400,000 for permanent damage to his hands, $500,000 for pain and suffering, and $1,000,000 as punitive damages.

The case went to arbitration, and Joe was awarded $360,000 by the arbitrator, with $180,000 to be paid in year 1 and the balance of $180,000 to be paid in year 2. In accordance with Joe's agreement with his lawyer, Joe paid the lawyer $120,000 out of the $180,000 payment received in year 1.

Question (Max: 7 points, 7 lines). How is Joe taxed in year 1 and year 2? You may assume that the appropriate annual interest rate for all relevant purposes is 10 percent.

3. Bill was born and raised in Medina, Ohio. In 1943, he married Sally, just before he was shipped off to France to join General Patton's Third Army. He fought bravely in the Battle of the Bulge and came home from World War II with many military honors. His only son, Ted, was killed in combat in the Vietnam war. Bill and Sally moved to Ann Arbor, Michigan, in 1986. They bought a house, paying $220,000.

Bill was a big fan of the Cleveland Browns. One day in the winter of 1988, during a heavy sleet storm, Bill tried to pick up the signal on his television set from a Toledo T.V. station that was carrying the Browns-Oilers game. The signal was faint, so Bill climbed up onto the roof of his two-story house to adjust the antenna. He slipped and fell to his death, leaving Sally the beneficiary of a $1 million accidental-death life insurance policy. At the time of his death, Bill was 79 years old.

Sally has continued to live in their Ann Arbor home. She has many friends in that city, but she has no living relatives that she knows about. Quite naturally, she started to worry about how she would take care of the house and herself in her old age. Next door to her live the Rileys -- Tom, Alice and their ten children. The Rileys have always been very nice to Sally. She discussed with them her concerns for the future and offered to leave them her house and $100,000 if they would agree to take care of her until her death. That was in 1990. The Rileys agreed. With the help of a lawyer friend, Sally drew up a contract. Under the terms of the contract, the Rileys' youngest daughter, Mary, would take care of Sally's needs in exchange for the promise that she would receive title to Sally's house on Sally's death and $100,000. All went splendidly for the next several years. Sally developed great affection for Mary, and Mary fulfilled her agreed duties. In 1992, Mary got married and moved to an apartment in the neighborhood. She continued to look in on Sally every day.

In January of 1994, Sally took ill and had to go to the hospital. Her doctors informed her that the illness was terminal -- that she would never return again to her home. Wanting to do right by Mary, Sally called Mary to her hospital room and gave her a check for $100,000. Sally also told Mary that she and her husband could move into the house whenever they wanted. At that time and at all future relevant times, the house was valued at $400,000. Mary acknowledged in writing that the money was received in full satisfaction of the $100,000 owed under the contract. Sally also gave Mary a gold broach having a cost of $10,000 and a value of $40,000. Mary immediately sold the broach for $40,000. She and her husband moved into Mary's house soon thereafter.

In June of 1994, Sally passed away. As promised, she left Mary the house in her will. The remainder of her estate she left to the Red Cross.

Question (Max: 7 points, 7 lines). How are Mary and Sally (or her estate) taxed under the income tax in 1994 on the transactions described above? What amounts, if any, must they include in gross income? Do any of such amounts qualify as a capital gain? Do NOT discuss possible gift tax or estate tax issues.

4. Jonathan purchased a 1/10th interest in a limited partnership for $20,000. The partnership was formed to buy a diesel locomotive on credit and lease it to the B&O Railroad. The partnership gave a promissory note of $2 million for the locomotive. Under the terms of the note, payments of the purchase price and applicable interest were to come exclusively from the net rents received by the partnership or from the proceeds of a sale of the locomotive. The seller retained a security interest in the locomotive. During taxable year 1, rental income equalled $120,000. The partnership had an allowable depreciation deduction of $420,000 and an interest expense of $100,000. Thus deductions exceeded rents by $400,000 in year 1. In year 2, the partnership had a gain of $100,00, of which $10,000 was attributed to Jonathan.

Question (Max: 7 points, 7 lines). How much of his $40,000 share of the loss may Jonathan deduct in year 1? What happens in year 2? Explain, with citation to the Code.

5. Dr. K is a professor of American history at Harvard College. He occasionally reviews books for the *New York Times*. Because of his position, he receives dozens of free books from publishers. In early December of 1994, Dr. K received from Simon & Schuster a book titled *Cortez and the Conquest of Mexico*. He did not read the book. Instead, he wrapped it and gave it to his nephew, Michael, as a Christmas present.

Question (Max: 8 points, 7 lines). As a matter of tax policy, how should Dr. K be taxed with respect to the book that he gave to Michael? Discuss.

6. Mrs. BK runs a profitable publishing business in Detroit. For all relevant years, she has earned a profit in excess of $200,000. In 1985 she entered into a 30-year lease with the XYZ company for office space in the Renaissance Center. The agreed rent was $5,000 per month, to increase to $6,000 per month after 10 years and to $7,000 per month after 20 years. Part of the reason for renting the office space was that the printing company that she typically contracted with was also located in Detroit. In 1993, the printing company moved to Southfield, Michigan.

In 1994, Mrs. BK decided to move her operation to Southfield, partly to again be close to her printer and partly because the rents in Southfield were low, due to overbuilding in the mid-1980s. She found suitable premises in Southfield owned by the ABC Leasing Company. They made a tentative agreement for BK to enter into a 20-year lease, subject to her being able to cancel her lease with XYZ. The rent on the new lease would be $5,000 per month for quarters slightly larger than her quarters in the Renaissance Center. After some negotiations with XYZ, she agreed to pay $70,000 for the cancellation of the old lease. That amount was duly paid to XYZ, and BK entering into the new 20-year lease with ABC.

Question (Max: 14 points, 15 lines). How should BK treat the $70,000 paid to XYZ? Discuss first how BK would like to treat the payment, with appropriate references to authority in support of the taxpayer's position. Then discuss what would be the proper result under sound tax policy (either defending the taxpayer's position or defending some alternative position).

7. Molly holds a coupon bond -- that is, a bond that has detachable coupon(s) that represent the interest payable on the bond. She purchased the bond for $4,000. The face amount of the bond is $4,000, payable on the first day of year 2. There is one interest coupon attached to the bond, in the amount of $400. The coupon is also payable on the first day of year 2. On day 183 of year 1, Molly makes a gift of the coupon to Polly, her daughter. Polly immediately sells the coupon for $340 to the First National Bank of Chicago, an unrelated person. You may assume that the annual interest rate for all relevant purposes is 10 percent. You may also assume that the present value of the $400 coupon transferred was $340 at the time of the transfer and that the remaining portion of the bond had a value of $3,660 at that time.

Question 7a (Max: 7 points, 10 lines). How is Polly taxed in years 1 and 2 under the provisions of Code section 1286, assuming that section 1286 is applicable to this case? You do NOT need to do exact calculations.

Question 7b (Max: 7 points, 10 lines). How would Polly be taxed in years 1 and 2 under the applicable case law if Code section 1286 had not been enacted?

II. Multiple Choice
(maximum points: 36)

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.**

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.

Multiple Choice Questions Omitted