

TAXATION

LEX 7816

Maximum Time: 4 hours

Maximum Points: 100

Friday, May 1, 2009

9:30 a.m. to 1:30 p.m., Room 1515 (A-L), 1545(M-Z)

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** (or follow Laptop instructions). 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 2008 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 (non-programmable) 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 five (5) questions in Part I.* 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 2008 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 five (5) 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).

Mr. Greg Anderson is a personal trainer, living and working in Southfield, Michigan. Greg drives his 2007 Ford Fusion to the homes of his clients, assisting them with their workouts. He spends around six hours per day in those activities. Then he spends two or three hours each day at his own home maintaining his records, preparing bills to his clients, and reading the latest periodicals on physical fitness. Between clients, Greg stops each day for lunch at the Green Pepper Deli, a vegetarian restaurant that serves low-cost meals.

Question 1. Can Greg deduct the cost of his transportation (Federal per diem mileage amount) in traveling to the homes of his clients as a business expense? What about deducting all or part of the cost of his meals at the Green Pepper Deli? Discuss, with appropriate references to the Code.

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

Merry Motors (MM), located in Michigan, builds speciality trucks, all using internal combustion engines. It is planning to use electric motors for its small-truck line, beginning in year 2. To achieve that goal, it has been working overtime in year 1 to complete the construction of an electric-

motor plant, located in Northville, Michigan. Top management, out of a concern that the electric-motor plant will not be completed in time, has entered into a contract with a Chinese company, Beijing Motor Works (BMW) to supply it with 40,000 electric motors for year 2, at a price of \$4,000 per motor. Under the terms of the supply contract, MM can cancel the contract at any time before February 1 of year 2. If it exercises its right to cancel the contract, it is required to pay BMW \$400,000 (\$10 per canceled motor) as liquidated damages.

In January of year 2, MM completes construction of the Northville electric-motor plant. As a result, it cancels its contract with BMW and pays BMW the agreed amount of \$400,000.

Question 2. How should MM treat the payment of \$400,000 to BMW in year 2? In particular, can MM take a deduction for the payment? Is some other treatment more appropriate? Discuss reasonable alternatives and explain which one you think is proper.

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

Art Truck Furniture Company (ATF) sells furniture at various locations in Michigan. During the 2008 football season, it made a special offer to anyone who purchased furniture from the company between September 1, 2008, and November 1, 2008, and accepted delivery before December 31, 2008. The offer was to give a 100% refund of the purchase price of the furniture if the Detroit Lions set a National Football League record by losing all 16 of their regular season games. The Detroit Lions did what was required of them, and Art Truck paid out \$1 million to 2,000 lucky purchasers in February of 2009.

Question 3. What are the tax consequences to the lucky furniture purchasers in 2009 as a result of the refunds they received from ATF? Discuss.

4. (Maximum Points, 8; maximum lines, 14).

Kavi is an employee (a computer technician) at Johnson's Real Estate, Inc. (JRE), which develops and sells personal residences. JRE offers a 10% discount on purchases of real estate from its inventory to all its employees. Under this program, Kavi was able to purchase a new home in January of Year 1 for \$360,000 that was listed for \$400,000. He financed the purchase by paying \$40,000 in cash and borrowing \$320,000 from National Bank, using the home as security for the loan. In Year 1, Kavi paid \$18,000 in interest on the loan, \$9,000 in real estate property taxes, and \$8,000 in utilities (gas, electric, and telephone) for his home.

Question 4. What deductions can Kavi take in Year 1? Explain, with references to the Code.

5. (Maximum Points, 6; maximum lines, 14).

The Obama Administration has favored a reform of the American health care system. The details of proposed reforms have not yet been released and apparently are underdevelopment. One result of the reform might be that virtually all Americans would be covered by some form of health insurance.

Question 5. If universal health care should become a reality in America, should the rules governing the medical expense deduction change? For example, should the current deduction for medical expenses be repealed? Should the 7.5% floor be modified? Are there currently any kinds of medical expenses now eligible for the deduction that are unlikely to be covered under a universal health care system? Should such medical expenses receive a government tax benefit?

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]