

# Taxation

Maximum Time: 4 hours  
Maximum Points: 100  
May 6, 1997

## 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 and name of this course (Taxation) in the appropriate spaces on your bluebook . 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, supplemental materials, a 1996 or later edition of the Internal Revenue Code, and 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 go in your bluebook. Answer the multiple choice questions in Part II 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.

### **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.

**I. Essay**  
(maximum points: 50)

*Instructions.* Answer the following two (2) questions 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 25 lines.

*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 size 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.

**A.**  
(Maximum points: 25; maximum lines: 50)

Albert and Betty Holly were retired in 1994 when they decided to buy and sell antique glassware. Betty had obtained a high school degree and attended 2 years of college, where she studied political science. She had worked as an administrative assistant from time to time and for about ten years was a full-time homemaker for her two children. Albert served in the United States military for many years and, after his military retirement, worked in the aerospace industry. During his military service, he obtained a bachelor's degree in business and a master's degree in urban affairs.

The Hollys decided to buy and sell glassware after Betty read a book entitled "How to Make Money in Antiques." Albert spoke with an accountant about bookkeeping and tax matters. They began buying glassware in April of 1994, focusing primarily on glass produced by Westmoreland Glass, a famous Victorian glass manufacturer founded in 1875. The Hollys did not prepare any financial statements or income projections for their enterprise. At the end of each taxable year, their accountant prepared their tax return based on information that they provided to him.

During the years 1994-96, the Hollys traveled to antique conventions and shops around the central United States. Both Albert and Betty obtained personal pleasure from these activities. They believed they could purchase glassware for 40-50 percent of its resale value. The couple stored the glassware in their home; some of the pieces were displayed in the living areas of the home. They kept detailed inventory

records and a mileage log. They maintained a separate bank account for the activity in 1994 and part of 1995, but closed the account in 1996 to eliminate the bank fees. They insured their glassware inventory.

Over the three-year period from 1994 to 1996, Betty spent about 40 hours per week on the activity; Albert spent 20-30 hours. They sold items through advertisements in newsletters, at antique conventions, and by renting a showcase at an antique gallery. During these three years, the Hollys had sales totalling \$4,100, and they reported losses totaling nearly \$64,000.

On an audit of the 1994-96 tax years, the Internal Revenue Service has disallowed the loss deductions, asserting that the activity was not for profit. The Hollys have been asked by the IRS to pay additional tax of \$25,000 plus interest as a result of the disallowance.

**Question 1 (two bluebook pages, double spaced).** You have been hired by the Hollys to represent them in their dispute with the Service. After some discussions with the IRS, you get the clear impression that you could settle the matter if the Hollys agree to pay additional tax of \$20,000 plus interest. Otherwise the matter will be pressed by the IRS and the Hollys will need to go to court. You have arranged for a meeting with the Hollys to discuss a possible settlement. Please prepare for the Hollys a memo that sets forth the strengths and weaknesses of their case. In that memo, indicate whether you recommend for or against settlement and the reasons for your recommendation.

**B.**

**(Maximum points: 25; maximum lines: 50)**

Allsafe Bank has a branch office on Michigan Avenue in Dearborn, Michigan. That office is in poor condition, and the company has decided to remodel it. At Allsafe's request, its insurance company, Mutual of Michigan, conducted several tests on the Michigan Avenue building, finding asbestos present in the building but in amounts not exceeding federal guidelines. Allsafe has decided to remove the asbestos in coordination with its remodeling project. The total estimated cost to renovate the building is \$7 million, \$2 million of which relates to removing the asbestos.

The Michigan Avenue building was constructed with asbestos-containing materials as its main fire-retardant material. At that time, the local fire code required that buildings contain fireproofing material. Asbestos-containing materials were sprayed on all columns, steel I-beams, and decking between floors. The health dangers of asbestos were not widely known when the building was constructed in 1969, and asbestos-containing materials were generally used in building construction in Michigan.

On March 29, 1971, the Environmental Protection Agency (EPA) designated asbestos a hazardous substance. Federal, State, and local laws and regulations, however, do not require asbestos-containing materials to be removed from commercial office buildings if they could be controlled in place. Building owners are required, however, to take reasonable precautions against the release of asbestos fibers in that the danger from asbestos arises when asbestos-containing materials are damaged or disturbed, thereby releasing asbestos fibers into the air.

Asbestos removal must be performed by specially trained professionals wearing protective clothing and respirators. The work area must be properly contained to prevent release of fibers into other

areas. Containment typically requires barriers of polyethylene plastic sheets with folded seams, complete with air locks and negative air pressure systems. Asbestos-containing materials that are removed must be wetted to reduce fiber release. Once removed, the materials must be disposed of in leak-tight containers in special landfills.

After the asbestos was detected at the Michigan Avenue building in the study conducted by Mutual of Omaha, Allsafe hired experts to conduct extensive additional testing for airborne asbestos-fiber concentrations. The results of those tests indicated that the airborne asbestos fiber concentrations present during normal occupancy of the building did not exceed federal guidelines. There was some the expectation, however, that the airborne asbestos-fiber concentrations would increase in future years under normal usage. Moreover, the asbestos-containing fireproofing at the building had characteristics that the EPA has identified as warranting (but not requiring) removal of the material, such as evidence of delamination, presence of debris, proximity to an air plenum, and necessity of access for maintenance. This prospect of future problems with the asbestos was a factor in the decision of Allsafe to remove it.

The dominant reason for deciding to remove the asbestos was the determination by Allsafe's experts that the planned remodeling would dislodge the asbestos and create a serious health risk during the remodeling period and thereafter. Allsafe was told that "managing the asbestos in place" was not a viable option, given the extent of remodeling that would disturb the asbestos. In addition, the experts concluded that removing the asbestos-containing materials from the building at the same time as, and in connection with, the remodeling was more cost efficient than conducting the removal and renovations as two separate projects at different times. That approach also would minimize the amount of inconvenience to building employees and customers.

Removing all the asbestos-containing materials from the Michigan Avenue building is expected to be a large project, entailing an enormous amount of work. Nearly every suspended ceiling and light fixture on all four levels of the building must be to be taken down. The asbestos fireproofing in the building is to be replaced with a mineral wool material. The removal of the asbestos-containing materials from the building is not expected to extend the building's useful life.

**Question 2 (two bluebook pages, double spaced).** Allsafe comes to you for tax advice. Its accountant has indicated that the \$5 million in renovation costs unrelated to asbestos removal must be capitalized but that the \$2 million relating to removal of the asbestos might be deducted currently as a business expense. What advice do you give to Allsafe? Explain the basis for your advice, with appropriate references to legal authorities.

## 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.**

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.*

### Note

The multiple choice questions have been omitted  
at request of the instructor.