EXAM NO. ___________

Wayne State University
Law School

Winter 1998
Prof. Michael J. McIntyre

# Taxation

**Maximum Time: 4 hours**
**Maximum Points: 100**
**May 14, 1998**

## 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 1997 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 1997 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.

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.

11. All transactions occur at arm's length.

12. All capital assets have been held for more than 18 months.

# I. Essay
(maximum points: 50)

*Instructions*. Answer the following four (4) 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 14 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: 16; maximum lines: 28)

Ed and Ramona McWashington are residents of Detroit. In April, Ramona gave birth to octuplets, four boys and four girls. The McWashington babies are the first surviving set of octuplets ever to be born in the United States. The parents can expect some large bills, in addition to the medical bills that are covered by their insurance. It is estimated that the babies will dirty over 36,000 diapers before they are toilet trained. In an average day, experts predict the children will go through 96 diapers, 285 ounces of formula and 40 changes of clothes.

Fortunately, the parents have been showered with donations and gift offers, including the following (dollar amounts are estimated fair market value):

a. ALLSTATE Insurance Company has offered free car seats ($300).

b. Gerber is contributing a lifetime supply of its baby food ($3,000).

c. Toys-Я-Us is donating two "quad" strollers and 100 pounds of Play Dough ($400).

d. Two local food stores are donating groceries for a year ($1,500).

e. The local energy company has agreed to cover heating and cooling bills for two years ($1,600).

f. Mayor Archer of Detroit is offering 10 free rides on the People Mover ($5).

g. Pampers will provide a lifetime supply of its diapers ($4,000).

h. A local communications company is providing seven free years of cable T.V. ($2,100).

i. Disney is offering two copies of the video, Snow White ($20).

j. Chevrolet is donating a 15 passenger Chevy Express van ($30,000).

k. Mazda Motor Co. has donated a three-year lease of a Miata sports coup, so that Ed can get away for a ride in the country when the going gets tough ($7,000).

l. The family's church is scheduling meal preparation, laundry, child care and transportation assistance, all at no cost to the McWashingtons ($5,000).

m. A local computer repair company is contributing a computer ($1,500).

n. A local architect is offering free home design services ($400).

o. Governor Engler of Michigan has called upon the legislature to pass a bill allowing the McWashingtons to cut down up to 100 trees in a State forest ($4,000). The Sierra Club claims, probably correctly, that the bill would violate the Michigan Constitution.

p. A local saw mill has offered to cut the trees up into lumber ($1,000).

q. Former President Jimmy Carter has promised to organize a group to use the lumber to build the McWashingtons a new home ($44,000).

r. A local law firm has offered to provide the McWashingtons with free advice with respect to the federal tax consequences of any donations they may receive ($2,000).

s. Mr. Illich, owner of the Tigers, has offered the McWashingtons 100 tickets for bleacher seats in the planned new baseball stadium ($25).

Assume that the McWashingtons receive all of the of the above mentioned economic benefits. You are working as a law clerk for the local law firm that has volunteered to give the McWashingtons free tax advice.

*Question 1*. What do you tell your clients? Indicate which of the benefits (if any) are clearly not taxable, which raise some questions, and which are clearly taxable. What additional information do you need to know before giving your clients a full answer? Explain the relevance of that information. In organizing your answer, group together those items that you believe raise the same tax issues – do not discuss each item individually.

B.
(Maximum points: 7; maximum lines: 8)

Nancy is an artist. In year one, she sold a painting to a local gallery for $1,000. Her cost in producing the painting – for frame, paint, and canvas – was $50. She reported ordinary income of $950 on her tax return for year 1. In year 2, Nancy saw the painting at a different galley and inquired about the price. She was told that it was painted by a gifted local artist named Nancy and sells for $3,000. Nancy offered $2,500 and the offer was accepted. Nancy hung the painting in her own studio. In year 7, a visitor to the studio admired the painting and offered to buy it for $10,000. Nancy made the sale.

*Question 2.* Is Nancy's income of $7,500 from the sale in year 7 ($10,000 minus $2,500) a capital gain or ordinary income? Discuss the policy in favor of capital gains treatment and give whatever statutory support you can find for your answer.

C.
(Maximum points: 7; maximum lines: 8)

George is an architect who lives and works in Southfield, Michigan. He received a call from Paula, a member of the Governor's staff. Paula told George that the Governor is considering a plan to build a luxury retirement home for former state legislators who have been forced to retire from office as a result of Michigan's term-limit legislation. Paula wanted George to talk to her about submitting a design for the proposed home. She explained that the State could not pay for the meeting, although it would pay George for his design if the plan went forward and George was selected as the architect. George agreed to meet Paula in Lansing at 8:00 a.m. the next day. He got up at 6:30 a.m. and drove to Lansing. On the way to Lansing, George stopped at a respectable diner and had a hearty breakfast, paying $10 for the food and leaving a $2 tip. George usually goes to work at 9:00 a.m. and skips breakfast, getting a cup of coffee and a piece of toast at the office. The meeting with Paula lasted until 1:00 p.m. After the meeting, George drove directly to his office in Southfield. Because he was behind schedule, he skipping lunch, although normally he went out to lunch with his colleagues at work.

*Question 3.* Can George deduct the $12 paid for the hearty breakfast? Explain.

D.
(Maximum points: 20; maximum lines: 35)

Paul N, a famous actor, is one of your clients. Paul has developed secret recipes for salad dressings, called "End Zone Dressings," which he licenses to NewCo, an unrelated corporation that manufactures many different types of food products. NewCo markets the End Zone dressings throughout the United States. Paul receives annual royalties of $1 million from NewCo, all of which he gives to the Paul N Kids Club, a Section 501(c)(3) charitable foundation that Paul has established.

On January 5 of year 1, Paul prepared a new Bar-B-Q sauce while cooking pork ribs for some friends at his luxury apartment in Grasslands, Connecticut, where he resides with his wife and dog. Over the next six months, Paul experimented with and refined his new sauce. Once he was fully satisfied with the sauce, he attempted to license the secret recipe to an unrelated company. His initial efforts were unsuccessful. In October of year 1, however, Kraft Foods, Inc. a major seller of processed food, indicated a strong interest. NewCo also expressed an interest. As of the end of year 1, Paul had not entered into a licensing agreement, but both Kraft and NewCo indicated that they would be submitting offers in the near future. At all times, Paul intended to donate the profits from the Bar-B-Q sauce to his favorite charity, the Paul N Kids Club.

In January of year 2, Paul entered into a licensing agreement with NewCo under which he disclosed to a NewCo employee his secret recipe in exchange for a royalty of 10 percent of the sales price of Bar-B-Q sauce made by NewCo from that recipe. Paul received $18,000 under the agreement in year 2, all of which he donated to his favorite charity. In preparing his tax return for year 1, Paul deducted $50,000 as the cost of creating his sauce. He arrived at the amount of $50,000 as follows:

(1) $10,000 for the value of his time working on the sauce. Paul devoted 500 hours to working on the sauce in year 1 and valued his time at $20 per hour. (*Note: You may assume that $20 per hour is an appropriate estimate of the value of a chef's time*.)

(2) $17,000 paid for ingredients used in the testing of the sauce.

(3) $13,000 paid to individuals as compensation for helping him test the sauce.

(4) $10,000 for the use of the large kitchen in his luxury apartment. Rent and other costs for his apartment (such as maintenance, insurance, and utilities) cost Paul $100,000 in 1996. The kitchen occupies 20 percent of the apartment, and one half of Paul's use of the kitchen in year 1 related to developing and testing the sauce. Under these circumstances, it seemed reasonable to Paul that 10 percent of the $100,000 cost of the apartment should be allocated to the development of the sauce. When not working on the Bar-B-Q sauce, Paul used the kitchen to prepare meals for himself and friends.

Paul has kept meticulous records. He can substantiate the time he spent working on the sauce, his out-of-pocket expenses for ingredients and for paying his assistants, the amount of time spend in the kitchen for various uses, and the expenses for his apartment. All relevant facts were properly disclosed on his tax return for year 1.

It is now year 3, and Paul has been audited by the Internal Revenue Service. The IRS agent has indicated that he intends to disallow all $50,000 of the deductions. Paul asks you to prepare for him a brief memorandum discussing the merits of the claimed deductions. He informs you that the Bar-B-Q sauce is now selling well and that he has already received royalties of $200,000 for year 3.

"I want to do what's right," he tells you. "If I messed up on any of these deductions, tell me and I will pay the additional tax without a fuss." He suggests, however, that any extra tax will reduce his gifts to the Paul N Kids Club. "So if you can do something for those disadvantaged kids, you should do it," he added.

*Question 4.* Please prepare a draft memorandum for Paul. Tell him which deductions, if any, he must give up on and which ones, if any, are worth fighting over. You should clearly state how you believe the listed expenses relating to the sauce should be treated for tax purposes, with appropriate references to the Code and any other 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.*

[Multiple Choice Questions Not Made Public]