

Individual Taxation

Massachusetts School of Law- Spring 2008
Professor McLellan

FINAL EXAM

PLEASE READ THE INSTRUCTIONS CAREFULLY BEFORE BEGINNING THE EXAM.

Instructions:

1. You have 3 hours to complete this exam. This is an open book exam. You may use your text book, the income tax code, and any written materials that you prepared. You may also use a calculator.
2. Write your social security number, rather than your name, for identification on your blue book.
3. Write all of your answers in the blue book. Please write only on one side of the page in the blue book and remember to write legibly. It is helpful to plan your answers before writing them. You may answer the questions in any order you wish, as long as you number your answers clearly.
4. There are ten questions. Each question is worth 8 points, for a total of 80 points. You can earn up to 5 extra credit points on the last question for a particularly thoughtful answer. Your score on the final exam will be added to your midterm grade to produce a final grade for the semester.

Most of the questions should take between 10 to 15 minutes to answer. The last question is a policy question and may require more time. If you average 15 minutes per question, you will have 30 minutes left at the end to review your answers. This is only an estimate; some questions may take longer, and some may be shorter. I have included this only to aid you in gauging your time on the exam.

5. Whenever asked, you should provide rationale for your answers and support your answers with legal authority, such as Internal Revenue Code sections, Treasury regulations, and cases. However, if you know an answer, but can't find the authority, you should still put down your answer.
6. If you feel that it is necessary, you may indicate or suggest the need for additional facts to answer a question, but briefly explain why you believe additional facts are necessary and the result of assuming them. Do not answer questions that were not asked.
7. Except as otherwise indicated, you may assume that all taxpayers use the cash receipts and disbursements method of accounting and use the calendar year as their taxable year. Any mention of the tax consequences refers to the U.S. federal income tax consequences.

Barbara (hereinafter "B") has loved to cook since she was a little girl. B decides to attend cooking school and works in a bakery for several years. Now a seasoned baker, B decides it is time to realize her dream of owning a bakery.

1. B's mom is fully supportive of this idea. She decides to loan B \$50,000 to start her new business. B agrees to pay mom back the \$50,000 as soon as she is able to or if her mom needs it. B had \$2,000 of investment income this year. The Applicable Federal Rate is 5% which is approximately \$2,500 per year when compounded semi-annually on \$50,000. Discuss the tax consequences to B and her mother.
2. B knows it takes a while for new businesses to become profitable. B has saved up \$25,000 to invest in her business in addition to her mom's contribution. B rents a trendy store space and her first big purchase is for commercial ovens. The ovens cost about \$20,000. Is there a way she can take a full deduction for the expense this year? Does she have to depreciate? Suppose the ovens are 7 year ACRES property. What are B's options for a depreciation schedule? Why would she choose one depreciation schedule over another?
3. It was a good thing that B had the \$50,000 from her mother and had set aside \$25,000 of her own money because she had a rough first couple of years in the business. Tough economic times combined with some marketing mishaps resulted in some unexpected losses. B had a \$20,000 loss in year 1 and a \$15,000 loss in year 2 despite working around the clock in the business. In year 3, the bakery turns a small profit of \$5,000 and a \$20,000 profit in year 4. How will B report her profits and losses on her income tax return in years 1 through 4?
4. B has an employee, Ginger, who is an avid organic farming activist. B allows Ginger to sell organic herbs and a small amount of produce in her store. Every year, Ginger spends about \$2,500 of her own money growing organic herbs and produce in her small garden. She only makes about \$1,500 per year, but she loves doing it. How much of Ginger's loss can she report on her income tax return and briefly state why?
5. B's cookie business has become very profitable. She decides it is time to spruce up her store. She plans to make some repairs and paint the walls. She is also thinking about reupholstering her couches and comfy chairs and fixing the stools. The stools seem to require replacement every year or two anyways due to normal wear and tear. B is also considering hiring a professional decorator and getting rid of everything and giving the place a brand new look and feel. Can she take an immediate deduction for any of these expenses? Please explain your answer and cite the related code section that allows or disallows the deduction.

6. Ginger's organic growing business attracts some media attention and becomes profitable overnight. Ginger decides to look into growing organic wheat for flour. B is considering offering an organic product and wonders about investing in Ginger's farming venture. B is contemplating becoming some type of partner (perhaps a limited partner) with Ginger mostly to help finance the project. Briefly explain how this would work for B in terms of reporting losses and gains.
7. B's cookware business uses an accrual method of accounting. B caters an event for A's business. A's business uses a cash method of accounting. A mails B a deposit of \$500 on December 30, 2007 and then pays the remaining \$1,000 on the date of the event-January 1, 2008. Discuss the tax consequences to A and B and the year it applies.
8. B purchases 100 shares of GE stock for \$100 per share on January 1, 2006. She purchases 100 more shares of GE stock on March 15, 2006 for \$150 per share. In 2007, she needs some cash and so she sells 120 unspecified shares of GE stock on March 1st for \$120 per share. Suppose B has \$50,000 of ordinary income and \$5,000 of long-term capital loss from the sale of other stocks in 2007. What are the tax consequences to B as the result of the sale and how is it characterized?
9. B's business has become extremely profitable. She decides to buy out the lease of the tenant next door and expand into that space. At first, she pays the tenant \$2,000 per month to sublease the space for 6 months. The tenant's rent is \$1,500 per month. After the 6 months is up, she buys out the remainder of the tenant's 5 year lease by giving the tenant \$6,000 and the landlord \$4,000. In exchange, the landlord/owner grants B a 10 year lease for \$2,000 per month. What are the tax consequences to the landlord and the tenant and how are these payments characterized?
10. This is a policy question. Would you advocate taxing capital gains at ordinary income tax rates or at preferential rates? What do you think of the current system? Please explain your position. (A particularly thoughtful answer will earn you up to 5 extra credit points.)