

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.)

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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 four parts (A-D). I have estimated the time and allocated points as follows:

Part A (short answer) :	50 minutes-	30 points
Parts B & C (short essays):	40 minutes each-	25 points each
Part D (essay):	30 minutes-	20 points

The total estimated time is 160 minutes, leaving 20 minutes to review your answers or finish up unanswered sections. This is only an estimate; some sections may take longer, and some may be shorter. I have included this only to aid you in gauging your time on the exam.

5. Except for Part A, 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. In Part A, you need only provide an 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.

PART A

(30 points, 50 minutes)

This is a short-answer section; please limit your answers to three sentences or less. Each answer is worth 3 points.

1. What gives Congress the broad power to tax income?
2. In 2005, you purchase an antique desk for \$3,000 and it turns out to be worth \$600. However, in 2006, while cleaning the desk, you discover old coins worth \$2,400. What, if anything, do you report as income (gain or loss) and when?
3. You work in City A and your commute is 20 miles. You get a new job in City B which is 73 miles from your home. If you move to City B, can you deduct your moving expenses?
4. Clumsy falls in Super Market and wins a personal injury lawsuit. He is awarded \$25,000 for medical expenses, \$5,000 for pain and suffering, and \$10,000 as punitive damages. What does he report as income?
5. MD distributes free samples of prescription drugs to patients. Pharmaceutical Company (PC) illegally provides MD with 10% kickback (money back) from any prescriptions she writes for those drugs. MD would never have accepted the money if she had known it was illegal. Does MD have income?
6. Can MD take a business deduction for her attorney's fees for the criminal investigation into the kickback scheme or for the defense of her medical license?
7. PC gives MD a 20% discount on prescriptions for MD and her family. Does this qualify as a fringe benefit and does MD have income? Briefly explain why.
8. W and H divorce. To help get H on his feet, W agrees to pay H \$100,000 the first year, \$80,000 the second, then \$60,000, \$40,000, \$20,000 in subsequent years. After that, H is on his own. Can W treat the full amount in each year as alimony? Please explain.
9. A purchases stock for \$500 in 2000. A gives the stock to B in 2005 when it has decreased in value to \$300. The value of the stock continues to decline and in 2006, B trades the stock to C for a stock worth \$350. What, if anything, does B report on the exchange with C?
10. Mother buys a \$100,000 life insurance policy on Daughter and makes \$20,000 in payments. Daughter acquires policy from Mother for \$10,000 when it has a fair market value of \$40,000. Daughter names her new husband as beneficiary of the policy and he collects \$100,000 when she dies. Who is taxed and how much?

PART B

(25 points, 40 minutes)

Please explain your answers and cite authority when appropriate.

1. BW (business woman) comes to you (tax attorney) for tax advice regarding her business. She owns a very successful greeting card business in Andover, MA and is considering opening one in Newburyport, MA. She would like to include a small café in the Newburyport location as well. She realizes that it takes a few years to get established and turn a profit. She is wondering whether the new store can be part of the Andover business for tax purposes? What are the tax advantages and disadvantages of grouping the two ventures together?
2. BW elected to have her greeting card business treated as an accrual method taxpayer. Was that election proper? Now, she wants to hire some greeting card designers and start her own design company. Her plan is to sell the designs to established greeting card companies such as Hallmark. If that doesn't work, she will produce and distribute them herself. What method of accounting do you recommend for her new business and why?
3. BW has appreciated the advice you have given her so far. She started Design Co. on January 1, 2007. She soon realized that it is a tough business and she wants out. One of her staff writers has offered to buy out Design Co. for \$235,000. If BW has the option of selling all of her stock in Design Co. or liquidating the company by selling off the company's assets, which should she do? What are the tax consequences for both options (gains vs. losses, capital vs. ordinary, long-term vs. short-term)? How would each asset be treated? Assume there has been no depreciation taken yet. Which assets can be depreciated? If she was an accrual method taxpayer, would it matter if she waited until January 2, 2008 to make the sale?

If liquidated, the breakdown of Design Co.'s assets are as follows:

<u>Item:</u>	<u>Basis:</u>	<u>Fair Market Value:</u>
Inventory of demo cards	\$1,000	\$5,000
Land	\$100,000	\$115,000
Building	\$100,000	\$95,000
Accounts receivable	0	\$5,000
Equipment (computers)	\$10,000	\$5,000
Goodwill	0	\$10,000

4. BW owes \$300,000 to M on a piece of commercial property she purchased many years ago. She purchased the property for \$500,000 and has taken \$150,000 in depreciation. After 2 years on the market, the property hasn't sold because of a chemical spill nearby. Her mortgage is a non-recourse loan. The current fair market value of the property is estimated at \$200,000 but even that is unclear. How much would she realize if she let the bank foreclose on the loan and how would it be characterized? What would the results be if she had purchased the property for \$400,000 instead (and the other figures remained the same)?

Part C

(25 points, 40 minutes)

Please explain your answers and cite authority when appropriate.

1. OW (Oliver Wendell Douglas) is a lawyer in New York City. He decides to “get away from it all” and moves his family to rural New York. He purchases a run-down farm (Green Acres), paying \$100,000 for 50 acres with a farmhouse. He uses \$60,000 of his savings and gets a non-recourse loan to pay for the rest of the farm. He hires a farmhand to teach him the ropes and his wife begrudgingly helps out. It turns out that farming is much more difficult than he realizes. In each of the first three years, he has \$5,000 income and \$35,000 in expenses (\$5,000 property tax, \$5,000 mortgage insurance, \$10,000 employee expenses, \$15,000 equipment and seed). His only income is \$40,000 per year capital gains from long-term investments which he continues to receive every year. To what extent can OW take the losses? How are they characterized in each year?
2. Finally, OW realizes that organic farming can save his investment. As he transitions the farm to organic, he has a \$15,000 loss in year four, a \$15,000 gain in year five, and a \$40,000 gain in year six. How would he recognize these on his tax return?
3. After 5 years total, the farm is organic and consistently turning a profit. OW is enjoying the rural life, but his family is miserable. They want to return to the city. OW doesn't know what to do until he is approached by a developer who wants to turn the land into housing. OW discovers that a financial/business complex is going to be built nearby and his land will be worth millions if he subdivides and sells the lots for housing. OW decides that this is the perfect opportunity to achieve a balance between his family's desires and his own. The businesses will bring an element of the city to their rural town, they will have much more cash if he sells some of the land, and his family's quality of life would go up, up, up. Plus, he could keep the farm and continue to enjoy his new profession.
His plan is to keep a substantial lot for his home and farm and sell the remaining property by himself, controlling development. OW keeps a total of 10 acres, including the farm. OW partitions 20 acres and sells them himself over two years. Would the sale of the lots constitute ordinary income or capital gain? How would the legal fees associated with the partition and sale be allocated between the parcels and the farm? How would you determine basis? If OW had taken depreciation, how would that impact his sales?
4. OW arranged to lease the final 20 acres to the developer for 50 years at a substantial profit. He realizes he doesn't need all of that income, so he gifts 15 acres to his three children (5 each). Two agree to maintain the lease agreement and one child saves his land for use as a farm. As long as the developer has 10 acres, he is happy to continue their original lease agreement. Who realizes the income on the leased land for tax purposes?

Part D

(20 points, 30 minutes)

This is a policy question. Please explain your answer, cite specific code sections, and include any other relevant authority.

You are hired by Congress as a Tax Expert. Your job is to recommend how to improve the U.S. Federal Income Tax Code. Which code sections do you recommend changing first? How would you alter them and why?