

Federal Income Taxation
Massachusetts School of Law- Fall 2013
Professor McLellan

FINAL EXAMINATION

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 MSL identification number, rather than your name, 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 10 questions. Each question is weighted equally. The final exam will comprise 60% of your class grade. Your score on the final exam will be combined with your midterm grade to produce a final grade for the semester.
5. You have an average of 15 minutes per question. If you use the entire 15 minutes on every question, you will have 30 minutes remaining to review your answers. However, some questions may require less than 15 minutes and others may require more than 15 minutes to answer. I have included this estimate only to aid you in gauging your time on the exam.
6. 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.
7. 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.
8. 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.

FINAL EXAM

For 2013, most long-term capital gains are taxed at a 20% rate and the section 179 annual limit is \$100,000. You are an attorney and have been asked by your firm's largest client, JJ, for some advice. JJ is a Producer for the largest record label east of the Mississippi. He rose from humble beginnings on the streets of New York to the most famous record producer of this decade. He has asked you for confidential tax advice regarding the following situations:

1. In 1992, after JJ got his first job, JJ bought a house in the neighborhood that he grew up in. He paid \$50,000 for the house and through the years made \$100,000 worth of improvements. He actually lived there until a year ago, when he married and bought a penthouse apartment so he could be closer to work. JJ sold his former residence for \$450,000. JJ's wife has never owned a home and did not live with JJ in his former residence. What is his taxable gain, if any, as a result of this sale? Is it long-term or short-term? Briefly explain your answer.
2. Several years ago, JJ decided to anonymously open up a recording studio in his old neighborhood. It is a place where anyone can come and record a demo of their music for a very reasonable price. It is his way of giving back to the community and also secretly searching for new, fresh talent. This year, the studio took in \$60,000 and had the following expenses:
 - a) Rent \$6,000
 - b) Recording Equipment \$120,000
 - c) Paint \$800
 - d) Advertising \$600
 - e) Salaries \$50,000
 - f) Office Supplies \$400
 - g) A Michael Jackson Gold Record to hang in the waiting room which he purchased for \$2 million at auction.
 - h) \$25,000 for a state of the art security and sprinkler system.

Which of these expenses can JJ deduct in this year? Which expenses are capitalized and which are depreciated? Please explain any choices that JJ has regarding these deductions.

3. JJ put \$150,000 cash into the recording studio business in year one. An old friend of his runs the business for JJ and contacts him only when he thinks there is a demo that JJ should listen to. The urban recording studio had a loss of \$90,000 in year one, a \$50,000 loss in year two, and a \$20,000 loss in year three. However, in year three, JJ discovered a very talented singing group and in year four the studio is now in high demand. In year four, the studio had \$100,000 income in excess of expenses. Can JJ deduct the losses in years one through three from his other sources of income (Producer salary and capital gains)? Please explain when and how JJ will report these losses. Also, discuss any issues you feel JJ should be aware of. Cite relevant code sections where applicable.

4. What if JJ had been married and his wife had run the studio? And, would it make a difference if the initial investment had been in the form of a non-recourse loan? How would these facts impact your answer in number 3 above? Briefly explain your answer.
5. JJ's record label is an accrual method taxpayer. He signed on the new talent, the Bee Bops, this year and agreed to pay them a \$20,000 advance for recording studio work to be performed some undetermined time between July 2013 and June 2014. They will receive an additional \$10,000 per month over the same time period as compensation for their scheduled performances (\$60,000 this year and \$60,000 next year for July to June). They will be performing roughly 20 times per month and the schedule is predetermined. The Bee Bops are a cash method taxpayer. How much of this income will the Bee Bops report this year and next? When will JJ's record label take a deduction for the salaries paid? (For the purposes of this question, treat the Bee Bops as if they are one entity.)
6. In order to finance the recording studio and purchase his penthouse apartment, JJ had to sell off some of his stock portfolio. This year he had the following transactions:
100 shares RCA stock: purchased 2/1/2000 for \$40,000 sold 1/31/2013 for \$80,000
500 shares Microsoft: purchased 2/3/2012 for \$30,000, sold on 2/2/2013 for \$40,000
100 shares GM: purchased 6/7/2007 for \$60,000, sold 1/2/2013 for \$30,000
200 shares YUM: purchased 12/4/2012 for \$25,000, sold 8/9/2013 for \$10,000

How much tax will he owe, if any, as the result of these transactions? Will he carry anything forward into next year? If so, how much and what is the character?

7. If JJ had an overall long-term capital loss of \$20,000 and no other capital transactions, how would he report that?
8. JJ would like to irrevocably grant his brother the right to collect all of the royalties from the first successful recording he produced. Each time a song is played from that album over the next 20 years, JJ is entitled to a payment. If he irrevocably grants the right to receive all of the royalties to his brother, who would report the royalty income on their tax return?
9. JJ's brother, BJ, is a widower with 2 children. BJ is planning on marrying his old high school sweetheart. His fiancé works as a teacher and has one minor child who has significant medical issues. They are planning on purchasing a home and will need to make it wheel chair accessible. Briefly discuss any aspects of the tax code you feel particularly benefit BJ and his family. Is there an improvement or amendment that you would make to the tax code which would further benefit BJ.
10. BJ has had a difficult time staying employed while raising 2 kids on his own. For the past two years, he has been selling his immense record collection to earn some extra money. Some of the albums are quite valuable. This year, he made \$30,000. He wants to know if this income is taxed as ordinary income or capital gain. Briefly explain how this determination is made and what factors would be considered.

FINAL EXAM

1. Barry owns 100 shares of GM stock. He inherited the shares from his grandmother on January 1, 2012 when it was worth \$25 per share. His grandmother bought the stock for \$2 per share in 1950. He sold the stock for \$50 per share on September 15, 2012. What is his capital gain and at what rate will he be taxed?
2. In 2008, Barry decided that he didn't need the dividends that the GM stock was paying. He signed a contract directing GM to give all of his future dividends to his Aunt Zeituni. Who pays income tax on the dividends?
3. GM usually distributes 2 dividends per year, one in February and one in October. In the year of the GM stock sale, does the seller (Barry) or the buyer report the October dividend on their 2012 income tax return? Briefly explain your answer.
4. President Obama and Congress are trying to decide whether to raise tax revenue either by getting rid of most itemized deductions (medical, home mortgage interest, charitable deduction, deduction for state and local property taxes, deduction for employer's portion of health insurance, etc.) or by increasing the top tax rates or by letting the Bush era tax rules expire (which would increase capital gain rates, decrease the amount excluded from the estate tax, decrease or eliminate Section 179, etc.). Leaving economics aside (if possible), what method of tax reform is the fairest and most progressive? Is there a better alternative that isn't being discussed? Please put some thought into your answer and cite any relevant cases or code sections.

5. Mitt purchases an office supply megastore. He immediately outfits the store with new electronics in order to better track the sales patterns and revenue. In total, he spent \$400,000 on computers and other devices. This equipment will probably last about 6 years and have a salvage value of \$100,000. Under MACRS, the equipment has a 3-year class life. Assume the Section 179 amount for the current year is \$250,000 and was not applied to any other purchases. How can Mitt maximize his deductions regarding this property in the first year? What method(s) of depreciation would he use?

6. Mitt decided to bring in a consultant in order to figure out how to maximize his profits. He is going to pay the consultant an annual salary of \$300,000, which is the industry standard. He also offered the consultant a \$1,000,000 bonus if he could double the store's profits by the end of his two-year contract. The consultant directed Mitt to remodel the store with a 1950's theme. The renovations cost \$150,000. They purchased shopping carts that looked like Ford model T's for \$50,000 and hired 20 new staff people, each with an annual salary of \$20,000. They also hired a DJ for \$25,000 per year to play 1950's Rock and Roll music and give out free burgers and shakes to anyone who spends \$100 or more. This strategy has been extremely successful, but the food cost is approaching \$500 per day. Finally, Mitt and the Consultant took 10 potential investors out for an expensive meal to pitch their new store concept to them. The meal cost \$500. Which of these expenses is deductible under IRC 162? Briefly explain why and cite relevant cases. If the treatment of an item is uncertain, please explain why.

7. Based on what you know, if Mitt had a \$650,000 loss in the first year, would he be able to take that loss? State at least two tax considerations that may be relevant in determining whether he is able to take the loss. Briefly explain your answer and cite relevant code sections.

8. Mitt's wife, Ann, collects rare jewelry. She is becoming famous for her expensive collection and she is contemplating selling a few pieces to some acquaintances who admire her taste. What would be the character of her gain and why? Briefly explain your answer and cite any relevant case(s).

FINAL EXAM

1. Mr. Monopoly owns a luxury office building at Park Place, a prime metropolitan location. Mr. Scottie has a 10 year rental agreement for the second floor office space. Mr. Scottie no longer needs the space, but has 7 years left on his lease. He is contemplating subleasing the space to a third party or selling the entire lease to a third party. What is the character of the income in the following alternate situations (ordinary income or capital gain)?
 - a) Mr. Scottie subleases the space to Mrs. Thimble for the remainder of the lease term for \$12,000 per month.
 - b) Mrs. Thimble pays Mr. Scottie \$100,000 to take over the entire lease. Mrs. Thimble now rents directly from Mr. Monopoly.
 - c) Mr. Scottie pays Mr. Monopoly \$100,000 to get out of the lease early.
2. Mrs. Thimble ends up taking over the lease and now rents directly from Mr. Monopoly. Mr. Monopoly is a cash method taxpayer and Mrs. Thimble is an accrual method taxpayer. Under the terms of their agreement, Mrs. Thimble pays the last month's rent in advance. (She pays Mr. Monopoly \$10,000 in January 2011 for rent attributable to December 2017.) When does Mr. Monopoly report the income and when can Mrs. Thimble take a deduction for the expense?
3. Mr. Monopoly, a real estate tycoon, is extremely wealthy. He decides that he would like to start making regular gifts to his nieces and nephews. His nephew, Jeremy Irons, is also interested in real estate. Mr. Monopoly decides to give all of his rental income from the Park Place property to Jeremy. He executes an irrevocable agreement effectuating his gift. Who is taxed on the income? Briefly explain why.

4. Mr. Monopoly also invests in a very busy restaurant on Atlantic Avenue. His niece, Hattie, started the business several years ago and it is a huge success. Mr. Monopoly usually makes about \$120,000 per year from this investment. He helps with some of the management decisions since Hattie is a terrific chef, but had never run a business before. Mr. Monopoly hired the accountant and takes care of all of the advertising. He also makes suggestions from time to time about the menu selections. This year, the restaurant lost money due to an unexpected downturn in the economy. Can Mr. Monopoly take his share of the losses (about \$200,000)? What limiting factors should he be concerned with when it comes to business or investment losses? Which of those factors could apply here and how would the loss rules impact Mr. Monopoly? Briefly explain your answer.
5. Hattie's restaurant had the following expenses. Are they deductible? If so, which are expensed and which are depreciated? Briefly explain your answer if you feel it is necessary.
- a) New China \$30,000
 - b) New Bar Stools \$8,000
 - c) Reupholstered dining room seats \$6,000 (mended chairs rather than new).
 - d) Entertainment for a group of potential new investors after dinner and a business discussion \$1,000
 - e) Class on how to "Dress for Success" \$500
 - f) Airfare, hotel, and meals while at a restaurant trade show \$2,500

6. The Community Chest Foundation provides free tax counseling. A man on horseback stops in and asks for some advice. He is recently widowed (just last year) and is wondering if he should file as head of household? Since the accident which left him widowed, his six year old daughter cannot walk and needs a special chair lift to be installed in his home so she can reach her bedroom on the second floor. The chair lift will cost \$20,000. It will increase the value of his home by \$9,000. Also, he paid the property taxes on his mother's home. He is wondering if these expenses are tax deductible. After the accident, his 18 year old niece moved in with him. She attends a local college. Since his niece has no income, he pays for all of her expenses including food, clothing, and personal care needs. Can he claim his niece as a dependant?
7. Mr. Monopoly owns stock in many railroads and several utility companies. He had the following stock transactions in 2011:
- a) Reading Railroad 200 shares purchased on January 1, 1950 for \$400. Sold January 1, 2011 for \$40,400.
 - b) Short Line Railroad 100 shares purchased on January 1, 2011 for \$35,000. Sold on December 31, 2011 for \$15,000.
 - c) Water Works 50 shares purchased on February 2, 2010 for \$5,000. Sold on February 2, 2011 for \$10,000.
 - d) Pennsylvania Railroad 1,000 shares purchased on June 20, 2005 for \$90,000. Sold December 31, 2011 for \$50,000.
 - e) He owns 3,000 shares of Electric Company. Blocks of 1,000 shares were purchased in 1960, 1970, and 1980. The total purchase price in 1960 was \$10,000; in 1970 it was \$20,000; and in 1980 it was \$30,000. He sold 2,000 shares for \$60,000 in 2011 and did not designate which shares he sold.

How much tax would Mr. Monopoly owe for the 2011 tax year as a result of these transactions?

8. Mrs. Monopoly is a huge supporter of a flat tax. As she understands it, a flat tax would involve the elimination of all tax credits and itemized deductions which are primarily reported on Form 1040 schedule A (a copy is attached). She believes that this would allow for a unified, reduced tax rate since more income would potentially be reported. Please discuss the advantages and disadvantages of eliminating deductions and credits. Should above-the-line deductions be eliminated as well? Do you believe this would be a regressive or progressive measure? Please explain your answer.