Federal Income Taxation
Massachusetts School of Law- Spring 2012
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 8 questions. Each question is weighted equally. The final exam will comprise 70% 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 20 minutes per question. If you use the entire 20 minutes on every question, you will have 20 minutes remaining to review your answers. However, some questions may require less than 20 minutes and others may require more than 20 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. Do not answer questions that were not asked.

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

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 alternative 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:


   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.
Federal Income Taxation  
Massachusetts School of Law- Fall 2011  
Professor McLellan

MIDTERM EXAM

PLEASE READ THE INSTRUCTIONS CAREFULLY BEFORE BEGINNING THE EXAM.

Instructions:

1. This exam makes up 40% of your class grade for the semester.

2. Write your id number for identification on the top of this page of the exam.

3. You have 1 hour and 20 minutes to complete this exam. As a guideline, you may spend 5 minutes per short answer question and 15 minutes per essay question, and then you will have 20 minutes left to review your answers.

4. This is an open-book exam. You may use your text book, the income tax code, and your notes. You may not use commercial outlines. You may use a calculator.

5. This exam is a combination of short-answer and essay questions. You may need more time to organize your answers for the essay questions (numbers 7 & 8). Please keep your answers brief (no longer than 3 sentences) for the remaining questions (numbers 1-6).

6. Each short answer question is worth 4 points and each essay is worth 8 points.

7. You do not need to provide rationale for your answers or support your answers with legal authority, such as Internal Revenue Code sections, Treasury regulations, and cases, unless specifically asked.

8. 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.

9. 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.

10. Please make sure your handwriting is legible. The back pages of the exam are blank for you to organize your answers, or in case you require more space.
THE FOLLOWING QUESTIONS ARE WORTH 4 POINTS EACH:

1. Norm’s grandmother gives Norm her prize cuckoo clock. She purchased it in 1920 for $20. It was worth $2,500 when she gave it to Norm. That evening, Norm shows it to Cliff who falls in love with the clock and has to have it. He offers Norm $4,000 in exchange for the cuckoo clock. Norm agrees to the exchange.

   a) What, if anything, does Norm realize?

   b) What is Cliff’s basis in the clock?

2. Instead of giving Norm the clock, his grandmother leaves Norm the cuckoo clock in her will. Even though she only paid $20 for the clock, at the time of her death, it was worth $3,000. How much would Norm realize when he sells the clock to Cliff for $4,000?

3. Sam bought his condo for $225,000 in 2001. He immediately spends $10,000 to put in beautiful hardwood floors. He lived there until 2005, when he sold the condo for $500,000. He used the money to purchase a business. What, if anything, does Sam recognize on his tax return?
4. Sam and Diane divorce in 2010. They have no children. In 2010, in accordance with the divorce decree, Sam gives Diane the following:
   - $350,000 cash payment reflecting half of the value of Sam’s business, which Diane was awarded in the divorce. (Sam is giving her cash instead of a share in his business.)
   - A painting that Sam purchased for $35,000, but is now worth $50,000. Diane immediately sells it for $50,000.
   - $2,000 per month in alimony. Sam missed one alimony payment. As a result, $22,000 was paid to Diane in money orders in 2010.

Diane is unemployed for the entire year and has no other income. How much income and/or gain will Diane report in 2010?

5. Carla gets hit by her daughter’s school bus. She sues the bus company and the driver. She successfully recovers $100,000 as compensation for her injuries and $20,000 in lost wages, and the judge also awards her $300,000 in punitive damages. What, if anything, does Carla report as income?

6. Diane dies in a tragic accident. She had an insurance policy on her life for $600,000 and Sam was the beneficiary. Sam has a life expectancy of 40 years. He will receive $20,000 per year for life. Is his annual insurance payment taxable? If so, how much of it is taxable?
THE FOLLOWING QUESTIONS ARE WORTH 8 POINTS EACH:

7. Cliff buys Woody a lottery ticket for his birthday, and Woody wins the lottery. The prize is $200,000 (two hundred thousand) per year for life. Woody is so grateful that he decides to share his winnings with Cliff. Woody has an attorney draw up a contract which permanently assigns half of the earnings to Cliff. Who is taxed on the lottery winnings? Please explain your answer and cite any relevant cases and/or code sections.
8. Woody uses his share of lottery winnings to purchase Sam’s bar and the building that houses it. Woody also forgives a $20,000 loan that he made to Sam to cover the expenses of his divorce. Sam agrees to stay on as the general manager of the bar for two years. As part of this agreement, Sam is allowed to live rent-free in an apartment in the building. The rent would normally be $1,500 per month. There is also a restaurant in the building that rents space from Woody. Sam’s contract allows him to get free beverages from the bar, and the restaurant upstairs gives him a discount on meals, since he eats there every day. What is taxable to Sam? Please explain your answer. If you have time, cite any relevant cases and/or code sections.
Federal Income Taxation
Massachusetts School of Law- Fall 2010
Professor McLellan

MIDTERM EXAM

PLEASE READ THE INSTRUCTIONS CAREFULLY BEFORE BEGINNING THE EXAM.

Instructions:

1. This exam makes up 35% of your class grade for the semester.

2. Write your id number for identification on the top of this page of the exam.

3. You have 1 hour and 20 minutes to complete this exam. As a guideline, you may spend 15 minutes per question, and then you will have 5 minutes left to review your answers.

4. This is an open-book exam. You may use your text book, the income tax code, and your notes. You may not use commercial outlines. You may use a calculator.

5. This exam is a combination of short-answer and essay questions. You may need more time to organize your answers for the essay questions (numbers 2 & 3). Please keep your answers brief (no longer than 3 sentences) for the remaining questions (numbers 1, 4, 5).

6. Each answer is worth 7 points. Question 1 contains an extra credit component worth 2 points.

7. You do not need to provide rationale for your answers or support your answers with legal authority, such as Internal Revenue Code sections, Treasury regulations, and cases, unless specifically asked.

8. 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.

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10. Please make sure your handwriting is legible. The last page of the exam is blank for you to organize your answers or if you require more space.
1. Owner purchases a house for $200,000, which is paid for by cash and a $160,000 mortgage.

   A) What is Owner’s basis in the property?

   B) When the property increases in value to $250,000, Owner takes out a second mortgage for $50,000 and uses the money to pay off credit cards. What is Owner’s basis?

   C) Under the facts presented above, Owner has a first mortgage of $160,000 and a second mortgage of $50,000. Unfortunately, we have entered into a recession and the property is now worth $200,000. Owner cannot afford the mortgage and lets the bank foreclose on the property. Does Owner have any income? If so, how much?

Extra Credit (2 points):
   Does it matter if Owner’s mortgages are recourse or non-recourse? Briefly explain your answer.
2. Congress decides that only earned income (salaries and wages) should be taxed. The new law taxes income at a very high rate. Gains and losses from dealings in property or assets (unearned income) are not taxed at all. Does the Constitution (just the sections that we have looked at) allow this type of discrepancy? Is this treatment of income regressive? Why or why not?
3. Graduate student receives free housing plus a $6,000 annual stipend in exchange for serving as a residence hall director. The University requires that she live in the dormitory while school is in session, in order to perform her duties which include being accessible to the students living there and resolving conflicts as they arise. Ordinarily, the graduate suite would cost $1,000 per month. Does the graduate student have income? If so, how much? Please explain your answer, and cite relevant cases and code sections.
4. Lawyer and Farmer are in a barter club. Lawyer provides Farmer with $1,000 worth of legal advice. Farmer supplies Lawyer with $800 worth of fresh produce and meat. Does either party have income? If so, how much?

5. Husband and Wife divorce. As part of the written divorce agreement, Husband purchases a life insurance policy on his life with a death benefit of $500,000. He names the ex-wife as the owner of the policy and the irrevocable primary beneficiary. He makes annual payments to the insurance company.

a) Can he deduct his payments as alimony?

b) If Husband dies after paying $50,000 in premiums and Wife receives the $500,000 as a lump sum payment, is it taxable as income? If so, how much?

c) Wife has the option to receive the insurance benefit over a period of 5 years. If she chooses this option, she would receive $110,000 per year for 5 years. Does she have taxable income? If so, how much?
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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 8 questions and one longer “essay” question. Each question is worth 5 points, except Question 2 which is worth 10 points for those choosing not to write a final paper. The essay is only for those not writing the final paper and is worth 15 points. The final exam and paper 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 60 minutes to review your answers and write your essay. 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.

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FINAL EXAM

Since playing a role in the film series *Toy Story,* Ken has been an out of work actor, looking for a job. Ken loves to sail. He decides to try to make some money doing what he loves. He finds a terrific deal on a boat and puts all of his savings ($10,000) into purchasing a beautiful sail boat. He decides to teach sailing locally and take passengers on longer excursions. He places ads in several local papers, creates a website, joins some local organizations to help with marketing and meeting potential clients, and buys liability insurance. Most of these business start-up expenses were paid for using his personal credit cards.

1. In his first year of business, Ken earns $15,000 and has $25,000 of “ordinary and necessary” expenses. In his second year, he earns $20,000 and has $25,000 worth of expenses. Will Ken be able to take the losses that his company generates in Year One and Year Two? Briefly explain why or why not.

2. (THIS QUESTION IS WORTH 5 POINTS IF YOU ARE WRITING THE OPTIONAL PAPER AND 10 POINTS IF YOU ARE DOING ONLY THE EXAM. PLEASE INVEST EXTRA TIME AND ATTENTION IN YOUR ANSWER AND CITE RELEVANT CODE SECTIONS AND/OR CASES IF YOU ARE TAKING THE EXAM IN LIEU OF A PAPER.)

In his third year, Ken earns $50,000 because his business is expanding and he has an increasing interest in longer excursions. However, he had $60,000 in ordinary and necessary expenses, because he had underestimated the expense of taking customers on extended excursions. He is certain he can turn a profit in Year 4, but he is concerned about the rising costs of maintaining his boat. Barbie, Ken’s girlfriend, believes that the business will ultimately be a success. She lends him $15,000 in Year 3 to help him stay in business. Please explain whether he can take a loss for Year 3. Why or why not? If not, what happens? If Ken does take the loss, how much can he take? Is there any other information you would need to know in order to advise him?
3. Ken was ultimately able to make his sailing business profitable. He currently has the following expenses and is wondering if they are currently deductible (expensed), subject to depreciation, and/or capitalized. If the answer is unclear, please explain.

   a) Staining the deck and painting the boat, which happens once every year or two.
   b) Repairing a ripped sail.
   c) Replacing a sail that has completely torn apart.
   d) Purchasing a new motor to use in emergencies. The motor should last about 10 years.
   e) Finance classes used towards his college degree in order to help him manage the financial side of his business.

4. A financial planner took some of his clients on an evening sailing excursion and paid for dinner and wine from the galley (on the boat). Can he take a deduction for any of this expense? Briefly explain your answer.

5. Ken uses the boat 60% of the time for business purposes and 40% for his own personal use. Can he take depreciation deductions on the boat? If he sells the boat at a loss, is that a personal loss or a business loss. Briefly explain your answer.

6. In December 2003, Barbie, tired of waiting for Ken to settle down, buys a townhouse for $200,000. She takes out a mortgage for $150,000 and pays for the rest out of her savings. She pays $3,000 in points in order to get a lower interest rate. Her mortgage payments are $1,500 per month which includes $300 in interest payments. The bank, an accrual method taxpayer, requires Barbie to pay her first year's worth of interest in advance. So, Barbie makes $2,600 in interest payments to the Bank in 2003 ($200 for December 2003 and $2,400 for 2004). Assuming Barbie is a cash method taxpayer and that she itemizes her deductions, for what year can Barbie take the interest deduction, can she deduct the points paid, and when does the Bank report the income? If this was a business purchase and Barbie was an accrual method taxpayer, would that change when she reports the expense?
7. Barbie sells the townhouse in 2006 for $500,000 and purchases a condo for $300,000 that same year. After taking advantage of section 121, Barbie decides this is a great way to earn some cash. Every year or so, Barbie buys a luxury townhouse and fixes it up. She then she sells the property for a profit. In 2008, she made $200,000 on the sale of a property she held for 14 months and in 2009, she earned $150,000 on the sale of a townhouse that she had owned for 11 months. Assuming section 121 does not apply, what are the tax consequences of the sale of the townhouses, and what is the character of the income? Briefly explain your answer and cite relevant cases or code sections.

8. While Ken is away on his long sailing excursions, Barbie likes to research and invest in the stock market. Ken finally decides to settle down and make a commitment. He proposes during a sunset sailing excursion. Barbie cashes in the following stocks on October 21, 2011 to help pay for the wedding:

- General Electric purchased in 1994 for $2,000, sold for $5,000
- Whole Foods, Inc. purchased in 2005 for $3,000, sold for $6,000
- Caterpillar, Inc. purchased for $7,000 on 10/21/2010, sold for $5,000
- Verizon purchased 4 months ago for $10,000, sold for $5,000

What is the tax effect of these transactions on Barbie’s 2011 tax return? What is the character of gain or loss reported and/or carried forward? How would the tax consequences be different if she had purchased the Verizon stock for $5,000 and sold it for $10,000?

**ESSAY (15 points):**

During the second half of our course, we have looked at many different types of deductions and credits and the limitations imposed on taking certain losses and reporting expenses. Many of the complications inherent in the US tax code arise out of these rules. Taking the Ken and Barbie scenarios, how would you change the tax code as it applies to them to create a simpler and fairer system of taxation? Or, would you defend our current system as it exists? Do the rules that apply to their situations make sense? Do you think we need a major reworking of the internal revenue code, just some tweaking, or no change? Please cite and analyze relevant code sections and cases in your discussion.
Individual Taxation  
Massachusetts School of Law- Spring 2010  
Professor McLellan

FINAL EXAMINATION

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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 7 questions and one extra credit question. Each question is weighted equally, except for the extra credit question which is worth 3 points. The final exam will comprise 60% of your class grade. Your score on the final exam will be added to your midterm grade to produce a final grade for the semester.

5. You have an average of 20 minutes per question. If you use the entire 20 minutes on every question, you will have 40 minutes to review your answers at the end. However, some questions may require less than 20 minutes and others may require more than 20 minutes to answer. I have included this estimate only to aid you in gauging your time on the exam.

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1. Grandfather gives Grandson all of the dividends from his Pepsi stock in year one. In year two, Grandfather signs a document assigning all dividends from the stock to Grandson for as long as Grandfather owns the stock. Who reports the dividend income in Year One, and who reports the dividend income in Year Two?

2. MSL Dean Velvel attended law school and has experience in the field of Constitutional Law. He decides that he wants to get an advanced degree. He is trying to choose between a Masters Degree (MA) in school administration and an LLM in intellectual property law. Can Dean Velvel take a tax deduction for either degree? Please explain your answer.

3. Our donut shop purchased a stove for $34,000 when it began. The owner took a Section 179 deduction for $20,000. The stove is 7 year property under MACRS.
   a) Which depreciation method should she choose if she wants the fastest deduction?
   b) How much gain or loss will the owner report if she sells the stove for $15,000 after taking $9,000 in MACRS depreciation deductions?

4. JJ got married on December 31, 2009. His new wife has a dependant child.
   (Please provide very brief explanations to your answers.)
   a) Should he file his 2009 tax return as married or single?
   b) His new wife wants to file as married filing separately, because she thinks they will get extra deductions. Is that true?
   c) What status would you advise them to use when filing their 2009 IRS form 1040?
5. X Corp., an accrual method taxpayer, sells goods to two unrelated businesses - A and C. A is an accrual method taxpayer and C is a cash method taxpayer. A and C both sign contracts in December of 2009, agreeing to purchase 100 units each from X Corp for $10,000. The units will be delivered in 2010. In order to get a discount, all payments must be received up front and by the end of the year. Both A and C sign their respective contracts and pay X Corp. in full ($10,000 each) in December 2009. (Briefly explain your answers.)

   a) For what year(s) does X Corp. report income and how much?
   b) In what year does A report the expense?
   c) In what year does C report the expense?

6. Etrader buys 300 shares of Metlife stock and 500 shares of GE on December 31, 2008. He then buys 300 shares of WaMu stock on January 4, 2009. He sells all of his stock on January 4, 2010. He ends up with an $8,000 gain from Metlife, a $10,000 loss from GE, and a $5,000 loss from WaMu. How much loss can he take against his ordinary income in 2010? What is the amount and the character of the loss that he carries forward into next year?

7. Sally sells her primary residence, which she owned for 10 years, for a $300,000 gain (after taking into account her section 121 deduction). Is the reportable gain capital gain or ordinary income?

   Her boyfriend, an out-of-work carpenter, convinces Sally to purchase two homes at auction. It takes two years to renovate and sell the homes for a $250,000 profit, which they divide equally. Does Sally report this gain as a capital gain or ordinary income? How does her boyfriend report his share of the profit? Briefly explain your answer.

EXTRA CREDIT- 3 points:
How do I know that gross income includes income “in the form of services, meals, accommodations, stock, or other property, as well as in cash”? (Do not cite the case book.)
Individual Taxation
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2. Write your school ID 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 6 questions. The first two questions are worth 19 points each. The remaining questions are worth 8 points each, for a total of 70 points. There is one extra credit question worth 3 points on the last page. Your score on the final exam will be added to your midterm grade to produce a final grade for the semester.

   I suggest allotting 40 minutes for each of the first two questions. You can then spend 20 minutes each on the remaining questions. You will then have at least 20 minutes to review your answers. This is only an estimate. 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.

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These two questions are worth NINETEEN POINTS EACH (19):

1. President Obama has asked that you drop everything in order to advise him on his new tax policy. He is trying to raise tax revenue through progressive measures. He is looking for you to come up with some ideas based on what you have learned during this course. Are there deductions he should modify or do away with? Is there a fair way for him to raise the income tax? Where should he look for other sources of revenue? Would you suggest that the entire tax system be drastically overhauled? Do you recommend moving to a flat tax or some type of sales tax? Please explain your answer.

2. Hal, a collector of fine Japanese paintings, has decided to sell his collection which is the largest outside of Japan. He is seeking your advice, as his tax attorney. Hal is an executive for Ex Corp. and has substantial income. He doesn’t want to pay unnecessary taxes when he sells his collection. He can sell it as a whole, in sets, or piece by piece. He has the option to sell it himself, via an art dealer, or at auction. Obviously, museums would be interested in the collection as a whole or in a set and private investors would be more willing to purchase the artwork piece by piece. Some paintings are worth considerably more than what he paid for them. However, some are worth much less, so there could be an overall loss in any given year. He is wondering if it is better to sell over several years or all in one year. Please advise him on the tax consequences of each of his options. He is particularly interested in issues of capital gain/loss, how does that work, does he qualify for capital gain treatment? He is also wondering what deductions he would be allowed to take. Will the passive activity rules affect his reporting of gain or loss? What about section 465? If so, how?
The remaining questions are worth EIGHT POINTS EACH (8):

3. Hal has a son named Junior who is in college. Junior’s Art History professor is interested in purchasing one of Hal’s paintings, but his income is very small. Junior and Hal offer to sell him a painting for $100 per year to be paid over ten years. The professor will make the payments to Junior rather than Hal because Hal doesn’t need the income. Who is taxed on the income?

4. Jess owns a farm. There is a leak in the roof of the silo and if she doesn’t repair it, her grain will be ruined. Will Jess be allowed a current deduction under section 162 in the following circumstances:
   a) If she just does what is necessary to make the repair?
   b) What if she replaces the entire roof?
   c) What if the leak is so small, she doesn’t have to fix it (her grain won’t spoil), but she decides to fix it anyway?
   d) She builds a new silo?

5. Jess buys an antique tractor which she intends to use to plow her vegetable fields. It is so old, it will actually appreciate in value despite being used. Can she deduct the expense of her purchase? If so, what are her options?

6. Grocer, a cash method taxpayer, agrees to buy grain from Jess who is on the accrual method of accounting. According to their agreement, Grocer will receive three shipments- December 2009, February 2010, and May 2010. Grocer will pay Jess $600 right away before anything has shipped in 2009. Once all shipments have been made, Grocer will pay another $600 in 2010. How much income does Jess have in 2009 and how much in 2010? How much can Grocer deduct in 2009 and 2010? What would Grocer’s deductions be in each year if Grocer was an accrual method taxpayer?

EXTRA CREDIT- 3 points:

How do I know that amounts paid for personal, living expenses, specifically rent, water, and utilities, are not deductible from income? (Do not cite the case book.)
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.


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.)
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 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:

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

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?