EXAM NUMBER__________

Introduction to Federal Income Taxation

Professor Feld

December 16, 2005

9:30 – 12:30

3 hours

You should have with you a copy of the Internal Revenue Code and the Regulations. In addition, you may have with you the casebook, supplementary readings, materials distributed during the semester and any notes or other materials that you yourself have prepared.

This examination consists of four questions. Each question requires a specific and well-organized answer. Include any alternative analyses and explain why you reject them. The answers will be weighted approximately in proportion to the time allocations.

Assume that all individuals are on the cash basis of accounting and that all corporations are on an accrual method. The taxable year for each taxpayer is the calendar year. In advising as to the consequences of a proposal, you may offer suggestions to improve it. Write legibly, on one side of the paper only.

If insufficient facts are supplied, state what additional facts you would need to answer the question, make some reasonable assumptions about them, and answer the question accordingly.

DO NOT BREAK THE SEAL ON THIS EXAMINATION UNTIL INSTRUCTED TO DO SO BY PROCTOR.

PLEASE STOP WRITING AND TURN THIS EXAMINATION IN PROMPTLY WHEN TIME IS CALLED BY THE PROCTOR. FAILURE TO DO SO MAY RESULT IN DISCIPLINARY ACTION. THIS EXAMINATION CONSISTS OF 3 PAGES, INCLUDING THIS COVER PAGE.

I

Sandra, unmarried, has one child, Dolly, age 6. Sandra was diagnosed in December 2004 with a serious illness that required months of treatment, fortunately covered by medical insurance. Sandra's sister and brother in law, Wilma and Henry, offered to take care of Dolly during Sandra's treatment and recuperation. Wilma and Henry have a child of their own, Brent, age 4.

Dolly moved in with Wilma, Henry and Brent in January 2005. Although Sandra did not personally contribute financially, she did transfer to Wilma $1,000 earned in an investment account belonging to Dolly that Dolly's grandfather had given Dolly at birth. Henry and Wilma have paid for Dolly's food and clothes. Wilma and Henry employ a part-time housekeeper to supervise the children and perform household chores and will have paid her $4,200 in 2005. Both Wilma and Henry have salaried jobs and each makes about $30,000 annually. Sandra, who supported herself for the year chiefly out of savings, will have a salary of $1,500 for 2005

Advise Wilma as to how the parties should report these matters on their Federal income tax returns for 2005.

II

In December 1999 Brad received from his employer, Platoon Industries, Inc. 1,000 shares of its publicly traded stock worth $100,000. Platoon retained the right to repurchase the stock for $1 per share ($1,000 total) if Brad left Platoon before December 31, 2002.

In November 2000 Brad divorced his wife Jen and transferred the Platoon stock to Jen in settlement of all marital rights. The stock (ignoring Platoon's repurchase right) had a market value of $90,000 at the time of transfer. Brad promised Jen to substitute other property if he left Platoon's employment and if the company then repurchased the stock. Brad, however, continued in Platoon's employ. At the end of 2002 the stock had a market value of $85,000.

Jen subsequently sold the stock to Jen's brother Matt in October 2003 for $70,000. Matt in turn sold the stock to his daughter Angela in January 2004 for $67,000. In May 2004 Angela sold the stock on the market for $71,000.

You are an auditing agent of the IRS, reviewing these transactions. Here is how the parties have reported them. On his 2000 tax return Brad reported a short term capital loss of $10,000 and a deduction for an alimony payment of $90,000. For 2003 Jen reported a long term capital loss of $20,000. Matt reported a short term capital loss of $3,000 in 2004. Angela reported a short term capital gain of $4,000 in 2004.

All of the tax years are open. What adjustments if any will you recommend?

III

The President's Advisory Panel on Federal Tax Reform has proposed that the home mortgage interest deduction be converted to a credit equal to 15% of the mortgage interest paid. The credit would be available to all taxpayers. In addition, the eligible acquisition mortgage debt would equal the average regional price of housing, a maximum of about $400,000. Revenue raised by the proposal would finance other proposed reforms such as repeal of the alternative minimum tax.

You are an attorney in the tax policy division of the Treasury, which has been asked to review and evaluate the Advisory Panel proposals. Your senior has asked you to evaluate the mortgage interest proposal. Prepare an outline of your response, stating how the proposal would change current law, whether the Treasury should recommend the proposal or some version of it and your reasons in support of the recommendation.

IV

M engages in the business of morale building onsite for corporate clients. She has used a room in her home exclusively as an office, from which she communicates with clients and potential clients, maintains records and keeps up with her field. The office constituted 20% of the home.

M purchased her home in 2001 for $500,000. M borrowed the funds to make the purchase from a major corporate client, Poolside, Inc. The loan, payable on demand with 90 days notice, bore no interest.

Fire completely destroyed M's home in September 2005. M sold the lot for $400,000 and received $800,000 from the insurance company.

M plans to purchase a new home for $1 million. M again will use 20% of the home as an office. M will use the remaining $200,000 to pay back part of the loan from Poolside.

How should M report these matters for Federal income tax purposes?