EXAM NUMBER ____________

Introduction to Federal Income Taxation

Professor Feld

December 13, 2007

9:30 – 12:15

2 hours, 45 minutes

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 three 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. (Note: Five minutes are unassigned.)

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 (50 minutes)

Maureen, a wealthy executive, purchased a tract of land for investment in 1996, paying $100,000 cash. In 2004, when the value of the land had appreciated to $1 million, Maureen borrowed $600,000 from Happy Bancorp, without recourse, secured by the land. The loan, payable in 2014, provided for interest-only payments at a rate of 8%.

In December 2006 Maureen gave the property to Gerald, her son. Gerald, a poet, earns a modest salary as a manuscript editor and has no investments. Gerald agreed to reimburse Maureen for any federal income taxes Maureen would incur arising out of or in connection with the gift.

In May 2007 Gerald discovered that the value of the land had declined. Gerald sold the property in September for $750,000 and paid off the loan to Bancorp. In the interim, Gerald had paid Bancorp $36,000 in interest.

An IRS agent has begun an audit of Maureen's 2006 return. Maureen reported nothing on the return concerning the gift.

Gerald has asked you to advise him as to how to report the sale of the property, as to his exposure under the reimbursement arrangement with Maureen, and as to any other tax issues the land transaction presents.

Prepare a memorandum of advice to Gerald.

II (50 minutes)

Mavis works as a cashier. In 2006 she earned $17,000 and she expects to earn about the same in 2007. Mavis' only child, Charles, who lives with her, completed high school in June 2006. In October, just after his 19th birthday, Charles took on part-time work as an assistant clerk, earning $2,000 in 2006. On her 2006 income tax return Mavis claimed Charles as a dependent and claimed an earned income credit. Charles did not file a return.

Early in 2007 Charles discovered that his long-time girl friend, Sally, was pregnant. Mavis, Charles and Sally decided it would be best for Sally to move into Mavis' house. In July Charles enrolled in a community college, taking a course of study in computer science, at a cost of $1,500 tuition. Charles continued his part-time work and expects to earn a total of

$12,000 in 2007 and, with his new computer skills, more in 2008. Sally had no earnings in 2007.

Sally gave birth to Penny in October. Charles would like to formalize his family relationship by marrying Sally, either late in December or early in January 2008. Charles has asked you to explain any income tax consequences for him, Sally or Mavis connected with the events in 2007 and the forthcoming wedding. Advise him.

III (One hour)

In 2004 Tower Investments, Inc., a publicly held corporation, entered into a contract with K.C. Simon, a well-known collector of modern artworks, under which Simon would advise Tower on the purchase of up to $20 million worth of modern artworks to be held for investment. Tower issued a press release praising Simon and his art prowess. Simon immediately traveled to London and Rome to begin his research. He incurred $20,000 in travel and other expenses. Simon entered into a contract to purchase a work, by Hugh Dauber, a rising young British painter, for $100,000.

Early in 2005 the United States indicted K.C. Simmons on securities and mail fraud charges. Mistakenly believing the accused was Simon the art collector, Tower executives terminated the art contract and issued a press release that said Tower could not work with Simon, whom they described as a perpetrator of fraud. Simon nevertheless felt obligated to pay Dauber $100,000 for the painting. Simon placed it in storage.

Simon engaged attorney Victor Breen, who brought suit against Tower for breach of contract and defamation. After long negotiations, Tower has proposed the following settlement:

1. Tower will pay Simon $500,000. If Simon prefers, Tower would instead pay $125,000 a year in each of the next five years.
2. Tower will issue to Simon 10,000 options, each of which would give Simon the right to purchase a share of Tower stock at a price of $5 at any time until December 31, 2009. Tower stock currently sells for $6 per share. Simon might want to hold the options for a while and exercise them if the stock price rises further.
3. Tower will allow Simon to keep the Dauber painting. Simon estimates the work has risen in value and probably would opt to sell it.
4. Tower will pay Breen's legal fees of $200,000.

Simon has asked you to advise him as to the tax implications of the settlement proposal. Advise him.