Exam Number: _____

Federal Income Taxation

Professor Walker

May 1, 2007

9:30 – 1:00

Part II

This is an open book examination. You may use any written material that you have brought with you. The examination will last three and a half hours. The examination consists of two equally-weighted parts.

Part II – Essay. Part II consists of two equally-weighted essay questions (i.e., each essay represents 25% of your total grade for the exam) which will be distributed at the conclusion of the multiple choice portion of the exam. You may not begin writing your answers to the essay questions until 30 minutes have elapsed. Therefore, you will have 30 minutes, at a minimum, in which to think carefully about the questions and organize and outline your responses before writing. Following this initial 30 minute period, you will have 90 minutes to write your answers. I highly recommend that you take additional time thinking, outlining, and organizing. Clear, concise, well-organized responses will be rewarded. Please write your answers to the essay questions on one side of the page only. If you have large or difficult to read handwriting, please write on every other line.

Unless you are told otherwise, you may assume that the law in effect for all years is the law currently in effect and that all individual taxpayers use the calendar year and cash accounting. Unless otherwise stated, you may ignore the alternative minimum tax. If you find it necessary to make additional assumptions in order to answer the essay questions properly, make reasonable assumptions and state them.

Part II of this examination consists of 3 pages including this cover page.

Part II - Essays

A. (50% of Essay Points)

Oscar winning actor Kenan Spacely was on campus recently filming "BlackJack!", billed as "the true story of a group of MIT whiz kids who took the Vegas casinos for millions." Having heard of your tax expertise, Kenan asks you to explain to him the tax consequences of the *real* story he's learned during the shooting:

> Mitt was a B average math student at MIT. In 1999, Mitt developed a sure-fire card counting technique and borrowed $100,000 from relatives to take to Las Vegas and play blackjack. Mitt promised his relatives a 50% return on their investment.
>
> Mitt's card-counting technique didn't pan out, and he lost the entire $100,000 stake. Ashamed to return home empty handed, Mitt spent his last $10 on lottery tickets. Almost unbelievably, he won a $1 million jackpot! Under the rules of the lottery, the jackpot was payable as $50,000/year for 20 years.
>
> Mitt used the first three $50,000 payments (received in 1999, 2000, and 2001) to repay his relatives as promised. The next three payments (2002 through 2004) were used to repay student loans.
>
> In 2005, after several years spent looking for just the right job, Mitt landed a high-paying position on Wall Street. That same year, Mitt irrevocably assigned a 50% interest in the 14 remaining lottery payments to his sister, as permitted by the lottery rules. As a result, in 2005 and 2006, Mitt and his sister each received a $25,000 payment from the lottery authority. Mitt's sister paid nothing for the rights assigned to her. However, her holiday gift to Mitt in both 2005 and 2006 was a check for $10,000.

Kenan was so impressed with your explanation of the tax consequences of these events that he gave you the leather bomber jacket he was wearing. Each of the cast members had received a jacket with BlackJack! and the actor's name emblazoned on the back. You felt bad about it, but facing student loans yourself, you immediately sold the jacket on eBay for $5000.

Please recount the federal income tax consequences of the foregoing events for Mitt, his sister, the unnamed relatives, and yourself.

B. (50% of Essay Points)

In 2000 Joe Breaux, a successful businessman from Thibodaux (Louisiana) purchased a vacant lot in New Orleans for $3 million. He obtained a $12 million non-recourse loan from a bank and constructed a commercial office building. Over the next several years he collected rental income, paid interest on the loan, and repaid $2 million of the loan principal. He took depreciation deductions totaling $5 million.

In July, 2005, Joe acquired an apartment building in New Orleans through an exchange in which Joe contributed a ranch outside Thibodaux and $300,000 cash. Joe had owned the ranch for about five years, and at the time of the swap it had an adjusted basis in Joe's hands of $200,000. The apartment building had an appraised value of $2.5 million. The other party to the exchange assumed the obligation to pay outstanding real estate taxes owed on the ranch of $10,000.

In August, 2005, both buildings were completely destroyed by Hurricane Katrina. Joe and the bank have finally settled with the insurers. The bank will collect $5 million from the insurance policy on the office building. However, in accordance with his loan agreement with the bank, Joe retains title to the land on which the office building formerly stood. That land is now worth about $2 million.

Joe will collect $2.5 million from the policy on the apartment building. Joe is considering using the $2.5 million from the insurer to buy another apartment building, buy a new ranch, or perhaps buy something safe and secure, like technology stocks.

Please advise Joe as to the federal income tax consequences of the foregoing events and the options he is currently considering.

END OF EXAM.

Good luck with the rest of your exams and have a great summer!