Exam Number:

Federal Income Taxation

Professor Walker

May 2, 2008

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)

Old McDonald had a farm. The farm consisted of a nice little farmhouse, a sizeable barn, and 100 acres of pastureland. McD had purchased the entire property for $200,000 a number of years ago and had lived in the house alone (except for his pets -- McD had never married) and worked the farm. His accountant had allocated $100,000 of his original cost basis to the barn, which was the only depreciable asset he had purchased.

In 2005, McD decided he was too old to continue farming and was ready to write his memoirs, which would reveal to all the true meaning of "E-I-E-I-O". He sold the farmhouse to a city slicker for $350,000 and moved into a rented apartment in the nearest town, which was 60 miles away. The cost of the move was $5,000. He leased the pastureland and barn to Mrs. O'Leary, a neighbor, for $10,000/year for three years.

In 2006, O'Leary's cow kicked over a lantern and started a fire that destroyed McD's barn, which, to his surprise, was uninsured. At the time of the incident, the barn was worth $250,000 and McD's adjusted basis in the barn was $30,000. O'Leary admitted that she was responsible for maintaining insurance on the barn under the terms of the lease, and she promised that she would compensate McD. She also continued to make the $10,000 annual rental payments.

In 2007, O'Leary had not yet compensated McD for the destruction of the barn, and McD hired an attorney and filed suit against her. In December of that year, partially as a result of the stress of the lawsuit, McD passed away. Wendy, McD's niece, inherited the property, subject to the lease, of course. She immediately had the property appraised. The value of the property, absent the destroyed barn, was $1,000,000.

In early 2008, when O'Leary's lease expired, Wendy sold the property as it was, i.e., without a barn, for $1.1 million. She also won the case against O'Leary, which she had inherited along with the farm, with the court awarding her compensatory damages of $250,000, punitive damages of $50,000, and interest. Unfortunately, Wendy was only able to collect $200,000 from O'Leary, who apparently had no liquid assets beyond this amount.

Please determine the federal income tax consequences of the foregoing events for McDonald, Wendy, and O'Leary, discussing both the amount and character of any items of income.

B. (50% of Essay Points)

Investment bank Bull, Friendlies & Co. has been a major victim of the credit crisis. Recently, it has come to light that BF&Co. made a number of large and, as it turns out, bad bets in the credit markets over the last several years. But everything looked rosy in 2007. That year, Cindy CEO was awarded a $10 million cash bonus. ($3 million of that bonus was guaranteed in her contract; the other $7 million was awarded based on the achievement of a number of financial performance goals.) Also, many employees exercised stock options for large gains. For example, Fred, a star financial analyst, held a non-qualified (i.e., non-ISO) option on 10,000 shares with an exercise price of $20/share. At a point in 2007 when BF&Co. stock was trading at $50/share, Fred decided to exercise the option. Being quite bullish himself, Fred didn't want to sell the stock, but he was also a little short of cash. (Every spare dollar Fred could put his hands on was invested in stocks and bonds.) BF&Co. came to his rescue by loaning him $150,000. The loan was secured by the stock Fred received on exercise of the option, but was non-recourse as to Fred. The loan was structured as a demand loan and bore an interest rate of 1%. Fred put up $50,000 of his own money, which combined with the loan from BF&Co., enabled him to pay the $200,000 exercise price.

In February 2008, when BF&Co's exposure to the credit crisis was revealed, its stock plummeted to $10/share. Being pilloried by the press, Cindy voluntarily returned to the company the $10 million bonus she had received in 2007. She also declined to accept a $5 million bonus ($3 million guaranteed; $2 million performance-based) that she had recently been awarded by the board of directors, and she asked the board to increase the bonus pool for non-executive employees by $15 million, the total amount she had refused and/or returned. The board complied (as it always did), and as a result, Fred, who had originally been awarded a bonus of $50,000, received $65,000 instead. That was good news for Fred. The bad news was that two months later BF&Co. demanded that Fred repay its $150,000 loan to him. Fred had paid the interest on the loan, but no principal, and thus the loan balance remained at $150,000. Having turned bearish, Fred decided to relinquish the 10,000 shares to BF&Co. and walk away from that transaction (as well as his job).

Please discuss the federal income tax consequences of the foregoing events for Cindy, Fred, and BF&Co. in 2007 and 2008. Also, please discuss whether/why the tax consequence for Fred resulting from his relinquishing the shares to BF&Co. is sensible.

END OF EXAM.

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