Exam Number: _____

Federal Income Taxation

Professor Walker

April 24, 2006

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.

Although the essay questions are equally weighted, the second question is more difficult conceptually. Therefore, I recommend that you spend at least half of the initial 30 minute period considering the second question and ensure that you save sufficient time during the writing phase to analyze and answer this question.

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)

Each year celebrity presenters at the Academy Awards receive a "swag bag" containing an assortment of high-end goods and services that are provided by the purveyors of these goods and services in an effort to generate favorable publicity. The bag received by George Clooney and other presenters this year included a BlackBerry 8700c, a Kay Unger kimono, a cultured Tahitian Pearl necklace, and a two-night stay at the Carlyle Hotel in New York, among many other goodies. The retail value of the bag's contents has been estimated at $100,000. Please analyze and describe the tax consequences for Mr. Clooney under the assumptions that follow. You should discuss the issues conceptually. You need not perform any calculations.

1. Clooney refuses to accept the bag.
2. Clooney keeps the bag, using some items for his personal enjoyment and letting others gather dust on his shelves.
3. Clooney keeps the bag, using most of the items for his personal enjoyment. However, he uses the BlackBerry (retail value = $1000) to arrange meetings with his agent, publicist, and other business contacts; and the two-night stay at the Carlyle Hotel (retail value = $2500) is used by him on his next business trip to New York.
4. Clooney keeps the bag. In 2008, he donates the cultured Tahitian pearl necklace (2006 retail value = $10,000) to the United Way, a public charity. In on on-line auction, the "Clooney necklace" sells for $15,000.
5. Clooney immediately donates the entire swag bag to the United Way. In an on-line auction, the bag sells for $45,000. (This is what actually happened. Google "Clooney Oscar swag bag" after the exam.) In addition to analyzing and describing the tax consequences to Mr. Clooney in this scenario, please compare the overall tax consequences of this scenario to scenario #1.

B. (50% of Essay Points)

Lucky Eddie bought a very dark picture in an attractive old frame for $1000 at a garage sale. On "Antiques on the Road," Eddie learned that the picture was a small, but important old masters painting that could be worth $2 million after restoration. Eddie knew Steve Lynn, a Las Vegas developer, from school. Lynn wanted to display the painting in Bellissimo, his newest Las Vegas casino and art gallery. The two agreed to the following terms: Lynn would lease the painting for 10 years for $10,000 per year and Lynn would invest the $100,000 needed for restoration. The annual lease payments would be assignable. A contract was drawn up, and Eddie immediately and irrevocably assigned the first two lease payments to his son, Bobby, who was a college sophomore, and the final two lease payments to his daughter, Susie, who would be entering college in eight years. Lynn had the painting restored per agreement, and hung it in Bellissimo. Ten years later, when the lease expired, Eddie received the painting back from Lynn. Two years after that, he sold the painting to an art dealer for $2.5 million.

Unlucky Betty bought a very dark picture in an attractive old frame for $1000 at a garage sale. Her story is exactly the same as that of Lucky Eddie, to a point. When the restoration of Betty's picture was complete, it was discovered that the painting was, in fact, a very old and nearly worthless forgery. Lynn immediately returned the painting to Betty, cancelled the lease, and demanded that Betty reimburse him for the $100,000 he had spent on restoration, as he was entitled to do under their contract. Poor Betty had never read the contract, although she had signed it. After much discussion and threats of lawsuits, Betty paid him $40,000 and promised to pay the balance the following year. She failed to fulfill that promise. Lynn considered suing, but finally decided against it. After all, Betty was a friend from school and she had been very unlucky. Several years later, Betty sold the painting for $1000, the value of the frame.

Please determine the tax consequences of the foregoing events to Eddie, Bobby, and Susie. Please determine the tax consequences for Betty, but only to the extent that they differ from those of Eddie.