Tax I

Professor Davis

Fall 2016

Instructions:

1. This is a three hour examination. The recommended time for each question is indicated. The grading of the questions will be weighted accordingly. You may use your Code book and your calculator. No other materials are allowed.

2. Answer the questions in the order presented. Write legibly and in complete sentences. Do not abbreviate except for abbreviations that we have commonly used in class, such as FMV, AR, and AB

3. Your answers should be concise and to the point. Answers should include the analysis that leads to your conclusions. A clear and logical explanation of the issues, and the reasons for your answer, is more important than a simple conclusive answer. Some, but not all, of the questions have a single clearly correct answer. Where numerical answers are called for, it is imperative that you explain your statutory analysis as well as give the numerical answer. Do not "throw in the kitchen sink." Do not describe the tax consequences to parties to a transaction other than those you have been asked to describe.

4. Make certain that you apply the law to the facts. Do not merely recite rules of law.

5. Assume that all taxpayers use the cash method and the calendar year unless otherwise noted.

6. Return this examination booklet at the end of the exam period.

Question I
40 Minutes

Bobby negotiated with Amoco to open and operate an Amoco gas station and convenience store. Amoco agreed to provide Bobby with certain equipment and improvements as well as a cash payment of $175,000 that they characterized as a loan. The payment was made in January of 2010. They also entered a dealer supply agreement that provided for Bobby's purchase and sale of Amoco products at the gas station for 10 years.

Bobby executed a promissory note evidencing his obligation to repay the $175,000 in annual installments of $17,500 plus interest for ten years. The first payment was due in January of 2011. The note also provided the annual installment was to be deemed paid (i.e. the installment was forgiven) provided the dealer supply agreement remained in full force and effect on the due date of the installment.

The promissory note was secured by the gas station property. If the location of the station was sold or the business discontinued, the note became fully due at that time. Amoco's business practice was to enforce the terms of the note if the deal/borrower defaulted on the note.

In 2011, when the first installment was due, the dealer supply agreement was in force, and Amoco forgave the $17,500 payment that was due.

What position will the I.R.S. take about the tax consequences of the transfer of the $175,000 and the forgiveness of the first installment? What is the theory/logic of its argument?

What position will Bobby take about the transfer of the $175,000 and the forgiveness of the first installment? What is the theory/logic of his argument? (Assume Bobby is insolvent at the time the installment is forgiven.)

Assuming Bobby is right about the initial $175,000 transfer, what will the Service argue about the forgiveness of the first installment?

If he loses on his preferred argument, what would Bobby's second argument be?

Question II
10 Minutes

Years 2012, 2013, 2014 all go by with the dealer supply agreement in force, so those year's installments were also forgiven. But in 2015, when the balance due on the loan is $105,000, Bobby cancels the dealer supply agreement and negotiates with Texaco to operate a Texaco station. Amoco demands payment. Bobby borrows the $105,000 from Last National Bank and pays the $105,000.

Assuming the Service was correct about the character of the initial transfer, how should the $105,000 repayment be characterized?

Assuming Bobby was correct about the initial transfer, how should the repayment be characterized?

Question III
20 Minutes

M agreed to build a power plant for P for a price of $250 million. After P had paid $230,000 to M, disputes arose about M's obligations under the contract. In settlement of the dispute, P agreed to pay the remaining $20 million on the contract. M agreed to pay P $40 million to cover the remaining cost to complete the power plant. P then hired another contractor to finish the plant at a cost of $50 million.

What are the tax consequences to P?

Question IV
15 Minutes

Joe, a Mercedes Benz sales representative, purchased a new Mercedes from the dealer for whom he worked. Although the typical sales price for the car was

$30,000, Joe only paid $22,500 because he received a customary 25-percent employee discount. Assume the dealer profit ratio is 30 percent.

How much gross income does Joe have as a result of the purchase?

What result if Joe immediately sold the car for $28,000?

Question V
20 Minutes

Larry broke his leg at Beth's bar due to slipping in beer on the floor from the spilled drinks of excessively drunk customers. Larry tried to get her to pay for his medical expenses, but she refused to do so. Instead she told everyone in the bar on the next busy night that Larry broke his leg because he can't handle his liquor. This is per se slander in their state. Because Beth would not be reasonable, Larry sued. The jury returned a special verdict in Larry's favor for:

Damage to reputation--$100,000;
Past medical expenses--$10,000
Future medical expenses--$20,000
Pain and suffering--$50,000
Loss of earnings--$20,000
Attorney's fees--$10,000

Larry deducted the $10,000 of past medical expenses on his prior year's return.

How much gross income must Larry report?

Question VI
15 Minutes

Professor Smith, while reading an article in the Harvard Law Review with which he very much agreed, suddenly realized why the argument sounded so familiar. It was the same one she had published in another Law Review the year before. She sued Professor Jones, the author of the Harvard piece, for plagiarism. She won a sizeable damage award, which Professor Jones promptly paid.

What are the tax consequences to Professor Jones?

Question VII
20 Minutes

Married couple Izzy and Ike live in Oxford where Izzy is a law student. Ike graduated a year ago and is employed by an Oxford law firm. Izzy has worked as a law clerk for several Oxford law firms, but has another year before she graduates. She has accepted a job from a firm on the coast for the summer. Ike will stay in Oxford, while Izzy will rent an apartment for the summer and return to Oxford for the beginning of the fall semester.

Izzy has asked you if she can deduct any of her summer expenses. What do you tell her?

How would your answer change if she were already a lawyer for a firm in Oxford, and the firm sent her to their branch on the coast for the summer?

Question VIII
40 Minutes

Gerald has always had a fascination with cars. While he works as a nerdy computer programmer during the week, his weekends are spent with his beloved collection of antique cars. He inherited a lovely old 1950 Chevy from his Dad—who initially bought it for $15,000 and spent another $20,000 fixing it up. Its fair market value when Dad died was $50,000. Once Gerald inherited it, he swore he would never sell it. He has kept it in the garage for years, only taking it out for short trips when the weather is nice. He also has a 1960 Ford pickup truck that he bought for $60,000 two years ago that he uses as his personal vehicle to commute to work. And last, his Mom gave him her 2016 Cadillac that she bought this year for $50,000 but never really liked. Its fair market value when she gave it to him was $45,000. To support the upkeep on his special cars, he buys and sells nondescript cars from the early 2000s (a few per month) that he buys at auction, fixes up and resells. He currently has two on hand. One he paid $15,000 for and spend $5,000 doing body work, replacing interior carpets and repainting. The other he paid $10,000, but has not done any work on yet.

Recently the car of his dreams has become available. If he sells all his current cars and buys a $5,000 beater to drive around, he just might be able to buy it.

Assuming his programming salary puts him in the 39.6 percent ordinary income bracket, how much would he make, net of tax, if he sold the Chevy for $90,000, the pickup for $70,000, the Caddy for $40,000, and the two nondescript cars for $30,000 and $10,000 respectively?