

COLLEGE OF LAW

TAX I PROFESSOR DAVIS

Date: December 13, 2004

Time Allowed: 3 hours

Instructions:

1. This is an open book examination. You may use your code book and a calculator.
2. Please "sign" the following pledge by writing your examination number on the line after the pledge. Do NOT write your name on this examination or on any bluebook.

By the act of submitting my examination, I do pledge, on my honor, that I have neither given nor received any improper assistance and that I will report any improper assistance given or received by others of which I am made aware.

Exam No. _____

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. Although specific references to Code sections are helpful to me in understanding your answers, detailed citations are not required. An explanation of a concept or a reason for a particular answer will usually suffice.

Do not "throw in the kitchen sink" Do not describe the tax consequences to any party to a transaction other than the parties you have been asked to describe. If you irrelevant information or answer questions other than those that I have asked you will run out of time, and it will prevent you from doing well on the examination.

4. Make certain that you apply the law to the facts. Do not merely recite rules of law, i.e., if the taxpayer "takes a fair market value basis," state the dollar value of the fair market value or explain why the dollar value is unascertainable from the facts given.
5. Assume all taxpayers use a cash method of accounting and a calendar year.

Return your examination booklet with your bluebooks at the end of the examination.

Question I
30 Minutes

Harry Homeowner purchased a home for \$275,000 in 2000. He paid \$25,000 from his own funds and borrowed \$250,000. He has made principal payments of \$50,000. Because of a significant downturn in the economy of the town, and a long-term losing streak for the home-town football team, housing values had dramatically declined in Oxford. His house is now only worth \$150,000. In addition, Harry's business (retailing Ole Miss sports paraphernalia) is struggling. Although Harry still has significant assets, he is expecting hard times. He has approached the bank that loaned him the money for his home. The bank and Harry agree that he will transfer the home and \$25,000 to the bank. The bank agrees that it will not attempt to enforce or collect the remaining \$25,000 of the debt.

What are the tax consequences to Harry and to the Bank of the above transactions?

Question II
1 Hour

Adam has a construction business. He contracted with Zebidiah to remodel the building that Zebidiah uses for his law firm offices. Due to bad weather, labor difficulties, and constant changes to the plans that Zebidiah's girlfriend Dalia insisted on, Adam has fallen far behind schedule. In a fit of anger, Zebidiah commandeered Adam's bulldozer. He used it to push Adam's truck and trailer full of tools and supplies over an embankment—destroying them completely. In addition, Zebidiah told everyone at the Eland Fraternal Organization lodge that Adam was a terrible builder and that Adam had propositioned Dalia in a lewd and lascivious manner. When Adam, who was present at the lodge, insisted that Zebidiah "take it back," Zebidiah shoved him down a flight of stairs and stormed out of the lodge. Adam filed suit claiming damages of \$100,000 for the truck, trailer, and tools that went over the bank, \$5,000 in rental fees for the use of the bulldozer, and \$45,000 for breach of contract. He also claimed \$500,000 for lost profits because he could not complete other contracts without his equipment and because of his injuries from the confrontation at the lodge. Adam alleged damage to his

reputation of \$1 million based on Zebidiah's statements to other businessmen at the Eland's lodge and asked for \$1 million in punitive damages.

Zebidiah has offered Adam \$1 million in settlement of the suit. Advise Adam about his tax consequences if he accepts this offer. What additional information would you need to collect?

Question III 30 Minutes

Electric Low-cost Fuel Co. (ELF) operated a coal-fired electric generating power plant in Lafayette County from 1950 until early last year. It originally purchased the land for \$100,000 and constructed the power plant at a cost of \$1.5 million. Over the years of its operation, ELF spent \$2 million maintaining the plant, but it never engaged in significant reconstruction or improvements. As newer, more efficient plants came on line, ELF decided to close its Lafayette County plant. This year ELF decided to use the Lafayette County land for a new headquarters building. To do so, ELF had to pay the Wreck-of-Ages Demolition Co. \$1 million to tear down the old plant and carry the rubble away. In addition, ELF had to pay Toxins-R-Us \$4 million to clean up the toxic contamination in the soil caused by the old plant. ELF also paid the Overcash & Posey LLC law firm \$100,000 to obtain a zoning variance from industrial to commercial. Finally ELF paid the Walker construction company \$10 million to construct the new office building.

In addition to the relevant Code sections that we studied during the semester, read and apply section 280B to the above facts. Discuss how these expenditures should be treated on ELF's tax return.

Question IV
20 Minutes

Grandma purchased Greenacre (a parcel of undeveloped land) in 1985 for \$20,000. In 2000, when the entire parcel had a fair market value of \$200,000, Grandma gave an undivided one-half interest as a tenant in common to her grandchild Skippy. In 2002, when the entire parcel had a fair market value of \$500,000, Grandma died and bequeathed the remaining one-half interest in Greenacre to Skippy. In 2004, Skippy sold Greenacre (still undeveloped land) to Wally World for \$800,000. What are the tax consequences to Skippy?

Question V
40 Minutes

Rich makes a good living as a trial lawyer. Each year he earns a generous salary and a decent bonus. He, however, is not completely satisfied with his life as a lawyer. Rich has played the guitar since childhood. He and his friends had several amateur rock bands during high school and college. Once he started law school, he stopped playing regularly. A couple of years ago, however, he began to play more frequently, and he finds this relaxes him from the stresses of his job. He began to practice more—every evening and several hours each weekend. He has even hired for \$250 to play at a friends wedding. It was his first paying gig ever.

This year Rich began taking voice lessons from a private tutor. By mid-summer, Rich was being hired to play shows for bars and restaurants for \$50 or \$100 per evening. In May he bought a new guitar for \$5,000. He also bought a case of guitar strings for \$300 and spent \$100 for business cards that identify him as a “guitarist/vocalist extraordinaire.” In September Rich informed his law firm that he could no longer work late on Fridays or on the weekend because he has regular bookings. He tells his friends that he wants to quit the law and become a rock star. One of his friends who had a lot of experience in the music industry tells him that “You can’t make any money in this business. You’d better keep your day job.”

Rich's expenses from his performing this year are:

New guitar	\$5,000
Voice lessons	1,000
Business cards	100
Strings	300
Mileage	200

He earned \$1,500 from his bookings.

What are Rich's tax consequences from his performing activities?