

PART II – ESSAY QUESTION

(75 points total – Suggested time: 1 hour, 15 Minutes)

Arnie is a senior partner at a prominent law firm ("Firm") located in a large city. In order to encourage participation in community activities and local society, the Firm pays its partners' membership fees for various local clubs and organizations. Taking advantage of this policy, Arnie, a great golfer, joined a prestigious country club and the Firm paid the \$30,000 membership fee as well as the monthly dues totaling \$5,000 this year. Arnie uses the country club on a regular basis for personal purposes, but he also occasionally entertains potential clients by inviting them for a round of golf. Arnie wanted to land one significant client, Ms. Big, and so invited her to play golf with him at the club several times this year. They usually had drinks and dinner following the games, and sometimes Ms. Big's husband joined them. Ms. Big never had any intention of doing business with Arnie or the Firm, but, hey, she wasn't about to turn down a free golf excursion or dinner at the club's 5-star restaurant. She casually discussed her company's business with Arnie during the games, but also discussed politics, sports, and her charitable endeavors. Arnie has receipts documenting that he spent \$1,000 this year on these golf games and meals with Ms. Big and her husband, which the Firm did not reimburse.

Arnie owns a rental house. He received the house in 2005 as an inter-vivos gift from his mother when the house had a fair market value of \$700,000. His mother's adjusted basis in the house at the time of the gift was \$750,000. Arnie has rented the house to a tenant for four years. With respect to the rental house this year, Arnie received \$24,000 rent and incurred expenses as follows: taxes \$7,000, new kitchen appliances \$3,000, gardening \$1,200, replacing the wood flooring \$3,000, and interior painting \$800. He was entitled to take depreciation deductions each of the four years he has owned the house of (roughly) \$2,500, but he never did. This year, Arnie sold the house (including the appliances) for \$500,000.

Arnie has a 16 year-old son, Ryan, who lives with his mother; the mother divorced Arnie several years ago and she has sole legal custody of Ryan. Arnie pays monthly child support as mandated by the divorce decree and consequently provides more than one-half of Ryan's annual support. Fortunately, Arnie remains very involved in his son's life, and generally spends one weekend a month and several weeks during the summer promoting and managing Ryan's amateur skateboarding activities. Ryan is a phenomenal skateboarder and is poised to break into the sport as a professional. But although Ryan has been competing for three years now, he has not yet won any prize money (and he doesn't otherwise earn any income). A proud father, Arnie remains completely optimistic that Ryan will emerge as a top professional skateboarder. In fact, for the first time Ryan will participate in a professional invitational skateboarding tournament early next year. Arnie hopes and expects that Ryan will earn substantial prize money and endorsement contracts before he turns 18. That is a good thing – Arnie figures that with all of the travel expenses and entrance fees he has spent close to \$10,000 this year on Ryan's skateboarding activities.

Question: Based on these facts, advise Arnie about the tax ramifications of his activities this year. Explain the basis for any items of income he must report and any deductions he may be eligible to take.

END OF THE EXAM