

FINAL EXAMINATION
FEDERAL INCOME TAX (LAW 838B)
PROFESSOR STANLEY
SUMMER 2006

1. This examination is **three (3) hours** long.
2. There are two parts to this exam. There is, however, no formal restriction of time between the parts, and you may allocate the three hours as you deem best.
 - } **Part I consists of 25 Multiple Choice questions. Each question in this Part is worth six points, with the total of all multiple-choice questions worth 150 points or one-half of the examination.** Part I should consume approximately 90 minutes of the allotted time. The answers are to be marked on the ParScore answer sheet form provided using pen or pencil and following the instructions on that form. If you change your answer, place a clear X through the wrong answer and mark the correct answer. A machine will score the exam and any ambiguities will be counted as a wrong answer.
 - } **Part II consists of two essay questions, each worth 75 points, for a total of 150 points or one-half of the examination.** You should allocate 90 minutes to the essay questions. Make sure you answer the questions that are asked, and include your reasoning and analysis as well as your conclusion. If you use Examsoft, please use a 12-point font and double space. If writing, please answer the essay question in the blue books provided to you, writing only on the right side of the page. Please use a blue or black ink pen.
3. This is a **partial open book** examination, and you may use any of the following written materials (with or without your hand-written notations): the Internal Revenue Code, Treasury Regulations, your casebook, your class notes, the class power point slides, and any self-prepared outlines, either handwritten or printed. You may use a calculator. You may use scratch paper provided by the Proctor. You may **not** use any notes or outlines prepared by another member of the class or another student unless they are the joint work product of you and the other student. You may **not** use your computer other than in conjunction with ExamSoft. No other materials are permitted.

4. Read the essay question *carefully* and explain the reasons for your answers, showing each step in your analysis and any computation necessary to resolve the issue. Address all reasonable arguments supporting your position. Credit will be given based on your ability to identify and analyze the relevant issues. If you find it necessary or appropriate to assume facts not given, please state them. Ignore any non-income tax issues (*e.g.*, estate and gift taxes, state taxes). READ, THINK, and ORGANIZE before you write.
5. Unless otherwise indicated, all parties are unrelated individuals, are on the cash receipts and disbursements method of accounting, and use the calendar year.
6. All topics listed on the course syllabus may be tested on this examination.
7. Internal Revenue Code sections, Treasury regulations and case names may be cited where known. Citations may include the entire case name or an identifiable abbreviation. Unless otherwise indicated, all Section references are to the Internal Revenue Code of 1986, as in effect on December 31, 2005.
8. Write your exam number on your exam envelope. Put your student exam number at the top of this page, each page of questions, ParScore answer form and each blue book. **Do not** use your name, student ID number or Social Security Number on any exam materials.
9. At the conclusion of the exam, return all exam materials to the exam envelope and submit it to the Proctor. **Do not** seal the envelope. Students who do not return all exam materials at the end of the exam may not be graded.

Good Luck!

Thanks for being such a great class!

PART II ESSAY QUESTIONS

Essay Question #1

(75 points total Suggested time: 45 Minutes)

After a successful and highly paid career as a world-class cyclist, Lance Allström, decided to retire from professional racing and open a bicycle shop. Lance investigated four shops that were for sale in Northern California and Montana. He spent \$3,300 on transportation, meals, and lodging to travel to the locations of each potential business opportunity, or \$800 per shop with respect to each of the three shops he investigated but did not purchase, and \$900 with respect to the shop he purchased. Lance also spent \$600 in legal and accounting fees to investigate each of the four shops, for a total of \$2,400.

Lance decided to purchase the shop in Montana, where he could combine sales of racing bikes as well as mountain bikes. He spent \$1,500 in legal and accounting fees to negotiate acquisition of the business that he purchased. He also paid the seller \$5,000 to keep its original name, Big Sky Cycles. While the acquisition of the shop was still pending, Lance made two trips to the East Coast to consult with the manufacturers of bicycle lines that he was planning to sell in the shop. Each of these trips cost \$1,200. Following his acquisition of the shop, he closed the shop for two weeks to reorganize the inventory, install the new line of mountain bikes, and train the employees to deal with the customers. He paid employee salaries of \$2,000 during this two-week period. One week after he opened the doors to customers, Lance traveled to Vermont to meet with representatives of a line of cycling clothing and accessories, which he intended to sell in the shop. This trip cost \$1,500.

Not long after Lance opened Big Sky Cycles, a story appeared in a large regional newspaper that reported an allegation made by Lance's former cycling teammate that he, Lance, had used performance-enhancing drugs during his professional cycling career. Lance immediately called the newspaper denying the allegation and demanding a retraction, but the paper refused. Lance then hired a local attorney and brought a libel lawsuit against the newspaper alleging that the allegation was false and claiming that the newspaper's story had damaged both his personal and business reputation, specifically alleging damage to his new cycling shop. After a few months, Lance accepted the newspaper's offer to settle the case for \$30,000, out of which he paid his attorney a \$10,000 contingency fee.

Lance has hired you to advise him about the tax consequences of these activities, all of which occurred this year. Please draft a short legal memorandum to Lance describing the items of income and deduction available to him as a result of these activities.

Essay Question #2

(75 points total Suggested time: 45 Minutes)

Brad and Angie are the parents of two minor children, and they live together with their children but are not married. Angie has not worked for the last few years because she stays home with the kids and assists various charitable causes. Brad is an up-and-coming actor and is Angie's sole source of support.

Angie suffers from anorexia nervosa, an eating disorder. Angie, Brad, and the children flew from their home in New York to Malibu, California, where Angie was admitted to an in-patient treatment facility, New Horizons, that specializes in eating disorders. After several weeks, Angie was released but her doctor ordered her to attend daily sessions at the facility and to buy and consume a special high-calorie nutritional supplement that was available only by doctor's prescription. Brad and Angie rented a large home on the beach at Malibu (which had an elaborate security system to protect them in case of *paparazzi*) so that Angie could attend her daily sessions at the facility. In addition, Angie went to an acupuncturist who promised that the treatments would reduce her stress and better enable her to eat as a normal person. The treatment seemed to help.

Brad, increasingly concerned about his thinning hair, went to a hair replacement clinic in Los Angeles for a hair transplant. Brad believed that the hair transplant would make him look better and enhance his acting career. His dermatologist also advised that a hair transplant would reduce his chances of skin cancer on his scalp. His psychiatrist opined that the hair transplant would improve Brad's self-esteem and combat his frequent bouts of depression and self-doubt. After the transplant, Brad won a coveted role as the leading man in a new romantic comedy.

When Angie finished her treatment at the Malibu facility, Brad purchased a 38-foot motor home for \$90,000. The fair market value of the motor home was really \$100,000, but the dealer gave Brad a discount because Brad posed for an advertisement. Brad paid \$15,000 in cash and borrowed the remaining \$75,000 of the purchase price from a bank, with the loan secured by the motor home. This year, Brad paid \$4,000 interest on the motor home loan. Brad already had a mortgage of \$950,000 on his permanent residence in New York. Brad, Angie and the kids drove the motor home cross-country back to New York, where he began filming his new movie. The cost of this cross-country trip was \$5,000.

Given on these facts, please explain the legal basis for the tax deductions, exemptions, or credits to which Brad is entitled this year.

END OF THE EXAM

Thanks for being such a great class!!