

**FINAL EXAMINATION
FEDERAL INCOME TAX (LAW 838B)
PROFESSOR STANLEY
SUMMER 2009**

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 Parts I and II, 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 five points, with the total of all multiple-choice questions worth 125 points or roughly 60% of the examination.** Part I should consume approximately 1 hour, 45 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 one essay question worth 75 points or roughly 40% of the examination.** You should allocate approximately 1 hour, 15 minutes to the essay question. Make sure you answer the questions that are asked, and include your reasoning and analysis as well as your conclusion. 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 an 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, 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 or any commercially prepared outlines. 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, 2008.
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 QUESTION

(1 question – 75 points)

Suggested time: 1 hour, 15 minutes

Pete holds a part-time appointment as a professor of State University, where he serves on the chemistry faculty. He is also employed as chief research scientist by Hydroponic, Inc., a firm that attempts to develop exotic hybrid plants.

PART A (40 points)

On January 1 this year, Pete purchased a computer for use in his home office from Compusell for \$10,000. Pete gave Compusell \$1,000 cash and a nonrecourse note for \$9,000. Pete properly claimed a \$1,000 depreciation deduction for the computer this year. In 2010, P received an offer from Smith to purchase the computer for \$15,000, its fair market value at the time. On December 30, 2010, Pete borrowed \$4,000 from Bank, securing the loan by giving Bank a second nonrecourse mortgage on the computer. For the taxable year ending December 31, 2010, P properly claimed a \$1,000 depreciation deduction. On January 2, 2011, P used the \$4,000 loan proceeds from the second mortgage to reduce the balance of the principal amount of his Compusell loan from \$9,000 to \$5,000. In 2011, the value of Pete's computer decreased from \$15,000 to \$5,000. For the taxable year ending December 31, 2011, Pete properly claimed \$1,000 of depreciation. Pete, realizing that the computer was subject to more debt than its current fair market value, returned the computer back to Compusell on January 1, 2012.

- a. What is P's adjusted basis in the compute on January 1, 2009? Explain your answer.
- b. What is P's adjusted basis in the computer on January 1, 2010? Explain your answer.
- c. What was the tax effect of the agreement executed between Bank and P on December 30, 2010? Explain your answer.
- d. What was the tax effect of Pete's repayment, on January 2, 2011, of \$4,000 of the \$9,000 loan from Compusell? Explain your answer.
- e. What was the tax effect of Pete's abandonment of the computer on January 1, 2012? Explain your answer.

PART B (35 points)

Pete is divorced but has sole legal custody of his 15-year old son. He accepted a visiting professorship at a City College in another state for the fall semester. During the four-month semester, Pete rented a two-bedroom apartment for himself and his son for \$1,600 per month; other monthly expenses included \$800 for groceries, \$300 for food eaten in restaurants, \$225 for gas used to commute from his apartment to the university, and \$100 for wine. Pete planned to return to State University when the semester was over at the end of this year, and had maintained his residence there, but City College offered him a permanent, tenured appointment, which he accepted on December 1, 2009, to begin with the Fall 2010 semester. Pete (and his son) then returned to State University to teach for the spring 2010 semester because he was contractually obligated to do so.

Because some of Pete's work at Hydroponic exposes him to hazardous chemicals, Pete must wear protective clothing in the Hydroponic lab. He spent \$6,000 on such clothing during the current year. Pete also does a great deal of research for Hydroponic out of his home office, which is exclusively and regularly used for that purpose.

Pete pays alimony to his former wife, Wanda, in the amount of \$50,000 a year for the duration of Wanda's life. In addition, if Wanda survives Pete, the payments to Wanda continue and must be made from Pete's estate. The divorce decree also requires that Pete pay the property taxes on the home in which Wanda resides (the former marital home of Pete and Wanda, which is now solely owned by Wanda). Pete paid \$5,000 of such taxes in the current year.

Discuss the income-tax results to Pete of the preceding transactions this year.

END OF EXAM