EXAM NUMBER: __________

DATE: May 9, 2001
TIME: 9:00 A.M.
TIME LIMIT: FOUR HOURS, THIRTY MINUTES

Instructions

1. You may consult any written or electronic materials you consider helpful.

2. Unless otherwise indicated, all parties are on the cash method of accounting and use the calendar year. All parties are unrelated unless otherwise indicated. All parties are single and not heads of households, unless otherwise indicated.

3. Some questions have space provided for a short answer, such as a dollar amount or a single word (e.g., correct or incorrect). You must write an appropriate answer in such spaces. For example, if a question calls for a dollar amount, anything other than arabic numerals stated in terms of U.S. dollars will be incorrect.

4. This exam is due in my office by 1:30 p.m.

5. Place your exam number or other form of identification at the top of this page.

6. For all periods and all terms – short, mid, or long, the AFR is 10.25% nominal annual interest compounded annually, 10% compounded semi-annually, 9.878 compounded quarterly, and 9.798 compounded monthly. This is also the underpayment rate per section 6621.

7. I will answer no questions prior to the time you turn in your paper.

8. This exam contains SIX questions. You must answer each of them.
QUESTION ONE

Your client received $500,000 on December 31, 1994 as a bonus from his employer, who computed the amount by relying on records unavailable to your client. For the year 1994, he included, other than the bonus, other taxable income of $500,000. [For purposes of this question, ignore all deductions other than net operating loss deductions]. In 1995, the employer determined that your client improperly received the entire amount. After negotiations with his employer, your client agreed to repay the amount in 2001; however, in 2001 your client's employer awarded your client a $500,000 bonus. Rather than actually pay the new bonus, the employer has proposed that he simply cancel the obligation to repay. In the alternative, your client and employer would exchange payments of $500,000 simultaneously.

Your client had taxable income in 1990, 1991, 1992, 1993, 1995, 1996, and 1997 of $200,000 each year, ignoring the deduction of the $500,000 obligation. For the years 1990 through 2000, assume your client was in a flat tax bracket of 40%. For all years after 2000, your client was and will be in a flat tax bracket of 20%.

Do you recommend that your client accept the “cancellation option,” the “simultaneous exchange,” or some other option (which you must propose)? For purposes of this question, assume your client reported the bonus in 1994.

Cancellation  Simultaneous Exchange  Other

[Circle your choice].

To answer the above question, did you need to know whether your client reported the bonus in 1994?

YES  NO

[circle one of the above]

Explain, on other paper, any part of your answer if you care to do so.

I recommend client accept the bonus, deposit the money, and later, using other funds if possible, repay the debt. He will have income of $500,000 taxed at 20%, but he will get a credit of $200,000 per section 1341. Both the cancellation option and simultaneous exchange option should give the same result; however, I am concerned that the form in each of them is less clear, risking litigation. Section 1341 requires that a deduction be allowable for the current year. I fear the government might not view the cancellation as a substantive repayment for purposes of a section 162 deduction by a cash method taxpayer. Similarly, I fear the government might confuse the simultaneous exchange with a Burgess/Battlestein problem and thus attempt to deny the deduction. My third option should assure the proper result.

I don't need to know whether client reported the amount in the prior year for purposes of making the above choice. If he did not report the amount, the deduction would be for the current year at the 20%
rate, as section 1341 requires the amount have been included. But, I would still have the prior concerns about whether the first two options constitute a “payment.” Although I am certain they would, I am not confident the government or court would agree; hence, I choose the third option to be certain.

Note: nearly all students said they would need to know whether the prior amount was included. Although this is true for purposes of section 1341 application, it is not true for purposes of answering the first question regarding the form of the transaction. Also, most papers spent too much time demonstrating the mechanics of section 1341, which is not what was asked. This was a very simple section 1341 issue, which should not have consumed so much time – the simple answer that a credit of $200,000 would result would be sufficient (showing the work would be fine, but not essential). Showing all the steps of achieving this result and all the factors is superfluous and has little to do with the question asked.

QUESTION TWO

Taxpayer owns and operates a jewelry store as a sole, unincorporated proprietorship. In 1993, he correctly reported the gross receipts from sales of jewelry as $10,000,000. He correctly reported his costs of goods sold as $5,000,000 with the exception of one item: included in cost of goods sold was the $100,000 cost of a large diamond allegedly purchased and sold during the year. In fact no such diamond was ever purchased by his store and was never sold. His long trusted store manager, Bertha Louise, forged the purchase order and related inventory records. She stole the $100,000 by writing a check for the “purchase” to her alias, Bernice Boarhound.

Taxpayer discovered the theft in 2000. Bertha, aka “Bernice” was arrested. She plead guilty and filed for bankruptcy. She is insolvent within the meaning of section 108 and taxpayer discharged the obligation that she repay the $100,000 and the related interest of $94,871.71 (10% nominal annual interest compounded annually, imposed by state law on obligations resulting from theft). Taxpayer has no insurance coverage for the theft. In 2000, Taxpayer deducted $100,000 for the theft loss. He did not deduct $94,871.71 for the discharge of the interest owed by Bertha. He never reported the $94,871.71 interest income.

You are the auditor for the IRS. Do you accept or reject taxpayer’s return? The taxpayer has told you that if you send him a notice of deficiency, he will immediately file a petition with the Tax Court. [Assume that you have found no mistakes or omissions on the return other than any related to the above facts].

ACCEPT  REJECT

[Circle One]

Explain your answer if you care to, on other paper.

Two issues:

a. **interest**: arguably the interest should be included, but surely not before 2000 when the item was discovered. At that point, collection was already severely doubtful. Per the Clifton Manufacturing case, this probably should not be accrued. Although taxpayer uses the cash
method, for discount interest (which this effectively is) the accrual method is effectively required by section 1272; hence, accrual doctrines – such as Clifton – are also relevant.

b. **Theft loss:** Per regulations under section 165, 1.165-1(d)(3), theft losses are deductible when discovered. Hence, the $100,000 loss is deductible in 2000. The prior effect on cost of goods sold was a reduction from gross income rather than a deduction. This is upsetting; however, it is probably uncorrectable; hence, rejecting the return would not likely be productive. It is not a circumstance of adjustment under 1312 because it does not involve a double deduction (cost of goods sold is not a deduction). See the B.C. Cook case. I would, however, want to argue for application of equitable recoupment, as the taxpayer has twice benefited from the same item reducing taxable income: once as cost of goods sold and once as a deduction. No court I know of has discussed the application of recoupment to this scenario. I do not see how I could successfully argue this in the Tax Court, considering the Mueller case. If the Tax Court has no equitable jurisdiction, I would lose. If it does, even the Tax Court insists that there be a true deficiency, which there would not be; hence, I would lose. My only chance would be for the taxpayer to pay the deficiency and then seek a refund, which I might successfully oppose in the District Court using the recoupment argument. Taxpayer, however, has already told me this is not going to happen.

Note: this question reflects the B.C. Cook case found in the assignments. Most students did not recognize this, essentially telling me that they did not read the assigned material carefully. Even though we did not cover the case in class, it was indeed assigned. Also, many students viewed this as a tax benefit rule problem: perhaps, but I doubt it – I know of no authority applying the tax benefit rule to such a case involving a current deduction. The tax benefit rule either applies to recoveries or to other income/exclusion items – it does not traditionally apply to deductions.

**QUESTION THREE**

You represent the victim of a tort. He suffered personal physical injuries in an accident for which the tortfeasor was clearly negligent. You have agreed with the tortfeasor that the amount of damages – all for personal physical injuries – total $5,000,000.

He has three options:

a. receive $5,000,000 today

b. receive $689,951.34 annually, beginning today, for ten years

c. agree that the tortfeasor will pay $5,000,000 to a section 468B fund bday and receive regular payments from the fund for ten years.

Rank the options, one, two, and three, with number one being the one you recommend and number three being the one you your least recommend. If you are indifferent as to two options, rank them the same, indicating a tie.

One _________b___________

Two _________a___________

Three _________c___________
(Place the letter a, b, or c on each line, or place two letters and the word “tie”).

Explain, on other paper, any part of your answer if you care to do so.

Option b uses an 8% discount rate, which effectively is an after-tax rate because section 104 will exclude the entire amount of the payments.

Option a would result in a section 104 exclusion; however, client would have to report investment income from the $5,000,000. Unless he could confidently generate more than 8% income after tax, this option would not be advisable. I doubt he could consistently generate such income over the next ten years.

Option c would result in the Fund paying tax at the highest possible rate, which is more than the client would pay in most cases. Unless the Fund has consistent income after such tax of greater than 8%, this would be worse than option b. Typically, I would rather the client have control over the money than the Fund. If we need to tie up the money because client might waste it, I would rather create the trust myself. I would, however, need to consider non-tax consequences of a 468B Fund versus a fund or trust I would create for the client. For example, if client were anticipating a dissolution of marriage, the 468B Fund might be easier to keep as separate property, at least in part, as compared to a fund created with the proceeds of a tort settlement. Such considerations are beyond this course.

Using some numbers for an example, consider a 10% return on investment for all three options and a 40% flat tax bracket, thus a 6% after tax return. Option a will generate $8,954,238.48 in ten years, option b will generate $9,639,753.56, and option c will generate $8,954,238.48. These do not account for money spent, but there is no reason to assume the options would be affected differently by this factor.

Note: Most students missed this question completely even though I referred to it in class and distributed essentially the same question and answer in class. This tells me they did not read what I distributed. Most felt the PV of the $5,000,000 was the relevant factor; however, what is relevant is the after-tax return on the money.

**QUESTION FOUR**

On January 1, 2001, your client sold Whiteacre to John. John agreed to pay $10,000,000 on January 1, 2005. The agreement provides for no other payments. Whiteacre is an office building with a basis of $4,000,000. Client has owned it for three years. He acquired it by purchase. He has no other section 1231 transactions during the year.

Assuming your client reports the sale as an installment sale under section 453, how much tax does your client owe during 2001? For purposes of this computation, assume he is in a 25% flat bracket for ordinary income and 20% for net capital gains. Do not make this assumption for any other purpose. In your research, you have come across section 453A.

$__________244,924.79________________________

Do you recommend that your client seriously consider electing out of section 453?
[CIRCLE ONE].

To answer this question, do you need to know whether John’s promise is a cash equivalent?

YES  NO

Explain any of your answer, on other paper, if you care to.

Gain of $2,768,393.62 (($6,768,393.62 amount realized per section 1274: 10% i/yr, 8 N, 0 pmt, 10,000,000 FV, 2 p/yr and $4,000,000 basis).

$691,786.24 interest income per section 1272 ($6,768,393.62 present value, 5% periodic interest, $338,419.68 for period one, and $355,340.67 for period two, minus $1,974.11 for the day January 1, 2002). Taxed at 25%, this would be $172,946.56.

$71,978.23 additional tax per section 453A(c) on the deferred tax liability of $553,678.72 (20% of $2,768,393.62 § 1231 gain). The 453A(c) tax is 13%, using the 6621(a)(2) rate of 3% plus the short-term AFR, rounded to the nearest percent. This ignores the “applicable percentage” amount of section 453(A)(c)(4) because the facts are insufficient to determine the amount. Under this provision, the additional tax will be lower than the amount computed; however, I cannot determine the amount. If this is the only installment sale, the “applicable percentage” would be approximately 26%: 1,768,393.62 divided by 6,768,393.62 (the face of the obligation in excess of $5,000,000 divided by the amount of the obligation.) I used the PV as the face, consistent with section 1274.

The additional section 453A(c) tax results in the taxpayer effectively borrowing the section 453 tax deferral benefit from the government at the underpayment rate of section 6621. Even though this “tax” is deductible as interest, it removes much of the benefit of section 453. If this cost of borrowing is preferable to other sources of capital, client should consider it, particularly if he anticipates tax rate reductions for the relevant future year. But, he should make these comparisons; hence, he should seriously consider electing out of section 453: if he can borrow money at less than the underpayment rate and if he anticipates no tax rate reductions. This analysis is also a function of the “applicable percentage” in the above paragraph: the lower this number, the lower the section 453A(c) cost and thus the more favorable is 453 treatment. Hence, to make this decision I would need to know the total of installment sales – the higher they are, the more likely we would not receive any significant benefit from section 453.

Note: most students did not apply section 1274, which is a serious error, as we worked such problems in class.

QUESTION FIVE
On January 1, 2001, Client received an interest-free loan of $10,000,000 from his family’s closely held C corporation. The loan is to be re-paid on January 1, 2005. Taxpayer is not an employee of the corporation.

What are the year 2001 tax consequences from this loan to Client?

Explain on other paper.

Taxpayer has a section 7872(b) initial payment of $3,231,606.38, which is a corporate distribution. Whether it is taxable depends on information not available, such as whether the corporation has earnings and profits.

Taxpayer has interest income per section 1272 of $691,786.24 ($6,768,393.62 present value, 5% periodic interest, $338,419.68 for period one, and $355,340.67 for period two, minus $1,974.11 for the day January 1, 2002).

Note: most students handled this ok, although a surprising number applied section 7872(a). This would be correct if Client were not a substantial shareholder; however, those papers that applied 7872(a) did not tend to discuss the relevance of this factor.

QUESTION SIX

On January 1, 2001, Client received $10,000,000 from John as payment for the four year use of Blackacre, an office building Client purchased in 1990. John will thus vacate the building on December 31, 2004 (unless the lease is extended).

How much taxable income (gross minus deductions) does Client have in 2001 from this transaction? [ignore depreciation and maintenance costs].

$ 2,114,708.74

Explain on other paper, if you care to.

Per section 467(f), this is a 467 rental agreement. The constant rental amount is $2,913,690.17 (PV = 10,000,000, n = 4, l = 11.275 [110% of AFR], FV = 0, mode = begin, PMT = 2,913,690.17). This is rental income to client, regardless of his method of accounting.

The remaining “prepayment” is treated as a loan. 11.275% of $7,086,309.83 is $798,981.43. This amount is deductible interest to client per 467 and 163(e). The net is given above.

The absence of regulations implementing section 467(f) is troubling and was worth discussion. If 467 does not apply, income would be $10,000,000. Because the taxpayer appears to benefit from the application of section 467, I would want to explore whether the taxpayer can apply the statute as written without implementing regulations, which are arguably superfluous as application of the statute is not ambiguous or in need of explanatory regulation. Thus, the government ought not have the power to delay application of a statute (since at least 1986) by delaying regulations, the substance of which should be obvious and non-controversial.
Note: most students did not apply section 467, although I referred to it in class and in assigned material. This told me they did not read the assignments and prepared solely the problems worked in class.