INSTRUCTIONS

I. CONSULT ANY WRITTEN MATERIALS YOU CONSIDER HELPFUL.

2. UNLESS OTHERWISE INDICATED, ALL PARTIES USE THE CASH METHOD OF ACCOUNTING, USE THE CALENDAR YEAR, ARE UNRELATED, ARE SINGLE, AND ARE NOT HEADS OF HOUSEHOLDS.

3. ANSWER IN THE SPACE PROVIDED, IF POSSIBLE. IF YOU MUST ADD SPACE, CLEARLY LABEL THE QUESTION TO WHICH IT RELATES.

4. 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.

5. THIS EXAM IS DUE IN MY OFFICE BY 6:15 PM.

6. PLACE YOUR EXAM NUMBER OR OTHER FORM OF IDENTIFICATION AT THE TOP OF THIS PAGE.


8. ONCE THE EXAM BEGINS, I WILL ANSWER NO QUESTIONS PRIOR TO THE TIME YOU TURN IN YOUR PAPER. IF YOU FIND SOMETHING UNANSWERABLE DUE TO VAGUENESS OR INCOMPLETE OR CONTRADICTORY INFORMATION, PLEASE EXPLAIN WHAT INFORMATION OR CLARIFICATION YOU NEED AND WHY YOU NEED IT. THEN, ASSUME ALTERNATIVE INFORMATION AND THEN ILLUSTRATE THE DIFFERENCES IN YOUR ANSWER RESULTING FROM THE ALTERNATIVES.
ON MAY 1, 1997, XEROX LOANED ANN $42,000 TO PURCHASE A LARGE NEW COPIER FROM A XEROX DEALER, WHICH IS A SEPARATE LEGAL ENTITY FROM XEROX. SHE IS NOT EMPLOYED BY XEROX OR ANY RELATED ENTITY. SHE PAID $5,000 IDOWN AND, BEGINNING JUNE 1, 1997, ANN WILL PAY $736.17 PER MONTH TO XEROX FOR 60 MONTHS TO PAY OFF THE LOAN. XEROX TOOK A SECURITY INTEREST IN THE COPIER. XEROX IS AN ACCRUAL METHOD, CALENDAR YEAR C CORPORATE TAXPAYER.

IF XEROX REPORTS, FOR ITS FEDERAL INCOME TAX PURPOSES THE CONSEQUENCES OF THIS LOAN, WITHOUT ANY RECOMPUTATION FOR IMPUTED INTEREST, WHAT WILL BE ITS INTEREST INCOME, FROM THIS LOAN, FOR 1998?

$ 671.71

This is the interest for months 8 through 19 in an amortization.

PV is $42,000, i/yr is 2, N is 60, P/YR is 12, pmt is 736.17.

IF YOU REPRESENT XEROX, HOW MUCH INTEREST DO YOU ADVISE IT TO REPORT, FROM THIS LOAN, FOR 1998?

$ 1,740.65

This is the interest for months 8 through 19 in an amortization.

PV is 38,484.76, i/yr is 5.56, N is 60, P/YR is 12, pmt is 736.17.

WHAT IS ANN’S ORIGINAL COST BASIS IN THE COPIER?

$ 43,484.76

This is 38,484.76 plus 5,000 down payment.

WHAT IS THE XEROX DEALER’S AMOUNT REALIZED FROM THE SALE OF THE COPIER?

$ 47,000.00

The dealer got 47,000. The rebate came from a separate entity.

EXPLAIN:

Per 7872(b), Xerox paid a rebate to Ann of $3,515.24. This is the difference between the amount loaned of $42,000 and the Present Value at 5.56 nominal annual interest (using the April 1998 rates for mid-term loans) of the 60 payments of $736.17 ($38,484.76). Although the problems facts did not expressly denominate this as a rebate, no other reasonable explanation for the imputed initial payment exists.

Ann would reduce her purchase price - and hence her basis - by the amount of the rebate. If she mistakenly used $47,000 as her basis for depreciation, section 1016 would cause a basis reduction in the amount allowed, but not below zero. If she took excessive depreciation in a closed year, a later sale of the machine, which would require the determination of her basis could not trigger a section 1312 circumstance of adjustment.

If Ann failed to deduct the proper amount of interest, she could amend open years, but closed years would stay closed. Even if the government successfully challenged depreciation on the machine, no circumstance of adjustment would re-open any closed years for insufficient interest deductions.

If Xerox failed to include the proper amount of interest, the government could issue a notice of deficiency for any open years. Closed years would remain closed.

Xerox could probably deduct the rebate in the year of payment - 1997. Arguably, however, it may have shipped the machine - and sold it - to the dealer in a prior year. If at that time it knew of the planned rebate/low interest rate program, it could have accrued the deduction (or its present value) subject to section 461(h). This would appear to be an “other item” per section 461(h)(2)(D). As such, economic performance as to the rebate would not seem to occur until 1997 (when payment was imputedly made to Ann); hence, deduction for the rebate would be appropriate in 1997. Since Xerox did not sell the machine to Ann, this would not involve a reduction in amount realized. If Xerox failed to take the deduction, it runs some significant risk of the deduction year closing, while the corresponding inclusion years (for the interest imputed by 7872(b)) remaining open, at
least in part. No error correction device will permit correction of this inconsistency if ultimately the government forces Xerox to include the imputed interest, even if it failed to deduct the rebate.

WHAT WILL BE THE TAX CONSEQUENCES TO ANN AS A RESULT OF THIS TRANSACTION?

see above

QUESTION TWO

ON MAY 1, 1992, SCOTT LEASED HIS BUILDING TO GENE FOR FIVE YEARS FOR $1,000,000 DUE ON APRIL 30, 1997. IN 1992, SCOTT’S ACCOUNTANT RECOMMENDED HE NOT REPORT ANY INCOME FROM THIS TRANSACTION UNTIL 1997. GENE’S ACCOUNTANT RECOMMENDED THAT GENE NOT REPORT ANY DEDUCTION FOR 1992. SCOTT AND GENE EACH FOLLOWED THAT ADVICE. YESTERDAY, GENE PAID THE $1,000,000. SCOTT AND GENE ARE IN YOUR OFFICE TODAY, SEEKING ADVICE REGARDING THE TAX CONSEQUENCES OF THE PAYMENT.

YOU LOCATED PROP, TREAS. REG. § 1.467, PROPOSED ON JUNE 3, 1996. YOU DISCOVER THAT WHILE THE REGULATIONS ARE PROPOSED TO BE EFFECTIVE FOR RENTAL AGREEMENTS ENTERED INTO AFTER THE DATE FINAL REGS ARE PUBLISHED, THE SERVICE CAUTIONS THAT NO INFERENCE SHOULD BE DRAWN FROM THE PROPOSED EFFECTIVE DATE CONCERNING THE TREATMENT OF RENTAL AGREEMENTS ENTERED INTO BEFORE THE REGULATIONS ARE APPLICABLE. MOREOVER, THE IRS SAYS IT WILL, IN APPROPRIATE CIRCUMSTANCES, APPLY THE PROVISIONS OF SECTION 467 REQUIRING CONSTANT RENTAL ACCRUAL TO RENTAL AGREEMENTS ENTERED INTO ON OR BEFORE JUNE 3, 1996.

THEY HAVE ASKED YOU TO ANSWER THE FOLLOWING QUESTIONS, IN LIGHT OF THE REGULATION:


   $19,002.10 INTEREST INCOME TO BE REPORTED BY SCOTT OR GENE [CIRCLE ONE]

   $19,002.10 INTEREST DEDUCTION TO BE REPORTED BY SCOTT OR GENE [CIRCLE ONE]

2. IF THE SERVICE WERE TO DETERMINE THAT THIS SITUATION IS AN "APPROPRIATE CIRCUMSTANCE" IN WHICH TO APPLY 467 PRIOR TO THE PROPOSED DATE FOR THE REGULATIONS, HOW SHOULD EACH HAVE REPORTED THE TRANSACTION FROM 1992 THROUGH 1997?

3. BECAUSE YOUR ANSWER TO THE PRIOR QUESTION UNDOUBTEDLY RESULTS IN SCOTT’S HAVING HAD INCOME AND GENE HAVING HAD A DEDUCTION FOR 1992, HOW DO YOU RECONCILE THAT WITH THEIR ACTUAL 1992 TREATMENTS? CAN ANYTHING BE DONE TO REMEDY ANY “MISTAKES”? WHAT CAN BE DONE AND UNDER WHAT CIRCUMSTANCES?
AS A BONUS QUESTION: HOW WOULD ANY OF YOUR ABOVE ANSWERS HAVE CHANGED IF THE $1,000,000 WERE PAID ON MAY 1, 1992 - AT THE BEGINNING OF THE LEASE - RATHER THAN AT THE END?

PLEASE ANSWER ON YOUR OWN PAPER.

QUESTION THREE