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534 Federal Income Tax
Final Examination
Three Credits

Professor Alfred Mathewson
Thursday, December 7, 2000
9:00 a.m. to 12 Noon

INSTRUCTIONS

You may not collaborate with each other. The written product you turn in should be solely your work. Your answers may be handwritten or typed.

Answer each question. If you use bluebooks, please use a separate bluebook for each question. If you type, start each question at the top of a page.

Be sure that your Examination Number (NOT your name) is on each bluebook or typewritten page, as well as the course name and number and the professor's name. Number your bluebooks or typed pages.

You may use your casebook, statutory supplement, handouts from the professor, course notes, and any course outline that you have prepared for this course. You may not use any other materials.

Once you open the examination, you may not use any materials other than those permitted above. Moreover, once you open the examination, any time spent reading the permitted materials, reviewing the subject matter or working on the subject or issues in the examination count toward the six hours. If information is ambiguous, note it on your answer and resolve it.

All taxpayers use the cash disbursements and receipts method unless the problem indicates otherwise.

[END OF INSTRUCTIONS]

QUESTION ONE
(Recommended Time: 20 Minutes)

Austin Powers was a very successful insurance salesman. He expects to earn commissions of $150,000 in 2000. He also fashioned himself a rather successful trader and was writing a book about his investments. His strategy was relatively simple. The Treasury would periodically auction large quantities of bonds and notes, which would be underwritten by a relative handful of primary dealers. Powers would buy in huge quantities from these dealers and resell in smaller batches, often to the same dealers, a few weeks later.

Powers operated on the theory that the Treasury auctions were so large that each one would create a temporary glut of Treasury securities, driving price down. He would buy at the depressed price and hold the securities off the market until the glut disappeared because he was hoarding the securities, the price rose, and he would sell. In fact, because he skipped auctions that did not seem likely to produce the glut that was the basis of his speculative profits, there were months on end in which he had no Treasury securities. In some of the tax years in question, he participated in as few as 6 percent of the auctions, and never participated in more than 15 percent. As a result, he was out of the market for as much as 250 days a year.

Unfortunately, 2000 has not been a very good year. He expects to incur $150,000 in losses as prices have fallen more often than they have risen. Always able to find a silver lining in a cloud, he intends to use the losses to offset his income from his insurance business. At a recent party, he was boasting about his plans and a CPA buddy told him the losses were not deductible. Was the CPA correct? Why?

QUESTION TWO
(Recommended Time: 40 Minutes)

In 1998, Dorothy Dye delivered 1,000 shares of Blue Chip Corp stock to her stockbroker Slim Shady. She instructed Shady to hold the shares and bonds in an account for her benefit. Shady took the liberty of opening a margin account for her and made frequent trades on her behalf, for commissions of course.

From 1998 to 1999, Shady executed securities transactions on her account that resulted in $300,000 in trading losses for Dye. Because the transactions involved a margin account, she owed $200,000 to meet margin calls when the value of the securities in the account fell below the amounts borrowed to purchase the securities. Because of the "churning"—frequent unauthorized trading in her account to generate commissions—in Dye's account, Dye incurred $15,000 in commissions and transfer fees. Finally, Dye lost an additional $50,000 plus interest when Shady borrowed that amount from Dye's account and failed to repay it.

On her 1998 return, Dye reported capital losses totaling her $100,000 in trading loss and $7,500 in miscellaneous deductions for commissions, and on her 1999 return, she reported $200,000 in capital losses and $7,500 in miscellaneous deductions for commissions. However,

because I.R.C. § 1211(b) allows capital losses in a given tax year to be set off against gross income only to the extent of that tax year's realized capital gains, plus $3,000, Dye was able to set off against gross income a total of only $15,000 in capital losses on her 1997 return and $3,000 on her 1988 federal income tax returns. As a result, at the end of 1988, Dye had a "net long-term capital loss carryover" of $282,000, as permitted by I.R.C. § 1212(b).

On July 1, 2000, Dye sued Shady and his former employers under state and federal securities laws alleging securities fraud and mismanagement of her investment accounts, and for breach of fiduciary duty, negligence, common law fraud, and breach of contract regarding the unpaid $50,000 loan. In her complaint, she asked for damages of $300,000 in trading losses, $15,000 in unauthorized commissions, the forgiveness of the margin account loans and punitive damages of $500,000.

Dye is currently in the midst of settlement negotiations with Shady. Her attorney has contacted you for advice in structuring the settlement. Shady has offered the following in exchange for a release of all claims: $300,000 in cash, and forgiveness of her margin account debit balance of $200,000. Dye's attorney is recommending acceptance. The settlement offer did not provide a specific allocation of the settlement agreements to any category of claimed damages. Dye's attorney has consulted you about the tax consequences of the settlement and has asked for your advice on minimizing the tax consequences to Dye. She also informs you that her retainer agreement was orally made but she intends to bill Dye $200,000 for attorneys' fees and legal expenses. The state has an attorneys' fee lien statute under which an attorney has an equal to the proceeds of any judgment or settlement.

Please prepare a memo with your analysis of the tax consequences, and your advice and recommendations.

QUESTION THREE
(Recommended Time: 70 Minutes)

Stanley and Anne Jones (the "Jones'") received a notice of deficiency from the IRS for the tax years 1997, 1998 and 1999. Mr. Jones' earned $1 million a year from a consulting business. In January 1998, the Jones' purchased (1) real property in Tahiti, and (2) a Lear jet. The notice of deficiency indicated the Jones were deficient in their tax payments because they claimed impermissible tax deductions in connection with travel from their California home to a timber farm they owned in Oregon and to the Tahiti property. First, the IRS determined that the travel expenses including those attributable to the use of the Jones' Lear jet were not deductible pursuant to I.R.C. § 162. Second, the IRS determined that expenditures made to maintain the Tahiti property were not deductible under I.R.C. § 212 because it was a recreational or personal use property rather than an investment.

The Jones' provided the following information to their accountant who prepared their tax returns for the years in question.

The Timber Farm

The Jones' purchased the timber farm in 1990. It included 454 acres of forest land covered primarily with Douglas fir and spruce trees, 152 acres of bottom land, a number of barns, sheds, and three small houses. The Jones' paid $600,000 for the property. As of May of 1996, the assets on Jones' timber farm had a fair market value of approximately $3,000,000.

The Jones hired two employees to live and work on the timber farm. These employees were experienced farmers, timber men, and carpenters. The Jones and their employees had to constantly watch for and keep off of the timber farm individuals who would attempt to trespass on the property to strip cedar trees, to pick mushrooms, and to grow marijuana.

Douglas fir and spruce trees are typically cut or harvested by commercial foresters once every 35 to 60 years. Typically, timber farmers make the decision when to cut and harvest timber based on the price of timber and their individual financial needs. In 1995, the Douglas fir, spruce, and other trees located on the timber farm were of an average age of 40 to 50 years.

In 1990, soon after the Jones' purchased the timber farm, timber prices fell dramatically in the United States and, until at least 1999, remained below the estimated costs the Jones' would incur to harvest the timber. Accordingly, on advice of others in which he concurred, the Jones' postponed the cutting, harvesting, and sale of any of the standing timber on the timber farm. After 1999, even though prices for cut timber increased, the Jones' have continued to postpone the cutting and sale of timber on the timber farm in part because the trees on the timber farm were approaching 60 years of age--at which point in time trees move into a separate commercial class for trees over 60 years of age and increase in value by approximately 30 percent.

The Jones' initiated many projects to improve the timber farm during the tax years in question. The small houses and barns were repaired and improved. Poisonous plants in the pastures were eradicated and a water reservoir was constructed. Junk cars and junk farm machinery located on the timber farm were removed and hauled to the dump. They also incurred many expenses to repair and improve the existing roads and to construct new roads so as to be in a position, in subsequent years, to cut and harvest timber on the timber farm on short notice and thereby take advantage of favorable prices for cut timber.

The Jones' primary residence was in Orange, California. The Jones' dedicated two or three rooms in their 24 room mansion to business activities, including Mr. Jones' consulting business. They performed paperwork and computer tasks, performed their bookkeeping, maintained reference manuals and industry publications, and paid numerous bills relating to their many activities" in these rooms. They kept a computer and a copy machine, filing cabinets used exclusively for these activities at home.

The Jones' traveled to their Oregon timber farm approximately 4 or 5 times a year, and on each trip Jones typically would spend a number of weeks on the timber farm. In 1997, 1998,

and 1999, the Jones spent 127, 139, and 80 days, respectively, on the timber farm. On the days on which Jones were at the timber farm, the Jones' worked constantly on the timber farm -- designing and planning repairs and improvements, personally operating heavy equipment such as graders, and working to improve and maintain roads and buildings, to clear brush, to build new roads for fire protection and for use in eventual harvesting of the timber. When at the timber farm, Mrs. Jones worked on the records and other chores relating to maintenance of the timber farm, and the Jones generally worked from sunrise until sunset on various projects relating to the timber farm.

The Jones' used a modest mobile unit for use as an office and on-site sleeping accommodation for the days they were at the timber farm. Two of the rooms in the mobile unit were used as a computer room and workroom in connection with the timber farm. One room was used as a bedroom for Jones. The kitchenette and dining area were used frequently for paperwork, recordkeeping, meetings, and an office for the timber farm.

The farm had several recreational amenities including a tennis court, a nine-hole golf course, swimming pool, lake, and boating facilities.

Tahiti Property

In 1996, the Jones' purchased 5.5 acres of oceanfront property on the main island of Tahiti for $1.1 million (Tahiti Property). On the Tahiti Property during the years in issue, the Jones' or others paid by Jones' remodeled and renovated a house, installed a solar water heating system, a spa, a culinary water system, and underground utilities, dredged a boat channel, added a satellite TV system, converted the electrical power system to 110 volts, installed a diesel power generator as an alternate source of electricity, and made many other significant improvements. The Jones' maintain that from 1997 through 1999 their cumulative cash expenditures relating to purchase and improvements undertaken on the Tahiti Property totaled $250,000.

Generally, twice a year, the Jones' traveled from California to the Tahiti Property. Typically, on each trip, the Jones' would stay at the Tahiti Property for a number of weeks.

Lear Jet

In 1996, because of anticipated frequent travel, the Jones purchased a Lear jet airplane for $2 million. The Jones' paid $500,000 and the seller agreed to finance the balance on a nonrecourse basis. The loan bore interest at rate two percent below market and was payable in full upon demand. The Lear jet was used by the Jones' for personal travel and to travel to the Jones' timber farm in Oregon, to Jones' Tahiti Property, to pick up equipment and parts needed in Jones' various activities. They estimate that the jet was used for personal matters 10 percent of the time.

The Jones' had made 74 trips to Oregon between them during the three-year period in question, with Mr. Jones making 14 trips in 1997, 11 trips in 1998, and 14 trips in 1999, and his wife making 14 trips in 1997, 9 trips in 1998, and 12 trips in 1999.

During 1997 through 1999, the first-class air fare between Orange, California and North Bend, Oregon, the airport closest to the Jones' timber farm, was approximately $1,600 per person. A commercial airplane trip between these two cities would take approximately 9 hours and would involve two stops and at least one change of planes. The average time for one-way commercial air travel between Orange, California and North Bend, Oregon was nine hours and involved two stops and at least one change of planes. The trip took less than three hours one way when using the Lear jet. Saving twelve-hour per trip, the Jones saved approximately 888 hours of travel time when making the 74 trips to Oregon.

During the years in issue, the Jones' reported the following deductions. In 1997, they spent (i) $80,000 in transportation expenses including a salary for a full-time pilot to fly the Lear jet, jet fuel, maintenance, and airport fees; (ii) $20,000 for meals in Oregon and Tahiti. In 1998, they spent $60,000 in transportation expenses and $20,000 for meals. In 1999, they claimed $80,000 in transportation expenses and $10,000 in meals. They told the accountant not to take any depreciation deductions because they did not want to appear greedy. The jet has a class life of 6 years.

Please prepare a memo discussing the grounds upon which you will challenge the deficiency notice in Tax Court.

QUESTION FOUR
(Recommended Time: 50 Minutes)

After nine years of marriage, Juan and Alicia Vargas divorced July 31, 1997. As a part of the proceedings, the parties entered into an agreement entitled "Marital Property Settlement Agreement" ("the Agreement"). Article II of the Agreement, entitled "Property Settlement" provided, among other things, that a 100 unit apartment complex be awarded to Juan separate and that Alicia should receive a cash payment of $50,000 on or before July 31, 2001. Their basis in the property at the time was $250,000.

In Article III entitled "Maintenance (Spousal Support)," Juan agreed to pay Alicia each month" as and for maintenance, forty percent of the gross rental income from the apartment complex, reduced by an equal percentage of operating expenses, as alimony and support for 121 months or until Alicia's death or the sale of the property. The section further provided that in the event Juan should sell the property within 121 months from the filing of the effective date of the Agreement, the net sale proceeds shall be divided between them with Juan receiving sixty percent and Alicia receiving forty percent. Article III further provided that the maintenance payments are for the support of Alicia and are not in lieu of or partially in lieu of property division and that the parties have herein agreed to a fair and equitable division of marital property as provided in Article II of the Agreement.

Alicia requested during the negotiations that Juan sell the apartment complex and divide the proceeds equally. She specifically requested that the division be designated as an award of property and not an award of alimony. An appraisal she had done showed the value of the apartment complex to be $700,000. It is undisputed that at the time of the divorce, Alicia was a full-time homemaker with no independent income, an arthritic condition which hindered

her employment, no job skills or training although she had worked as Juan's secretary prior to their marriage, and monthly living expenses of $4,000. It is also undisputed that, at the time of the divorce, Juan was a mortgage banker with a monthly income of approximately $15,000 and monthly living expenses of $5,000.

Pursuant to the Agreement, Juan paid Alicia $90,000 in 1996, $100,000 in 1997, and $110,000 in 1998. He took deductions for the maintenance payments each year.

In November 2000, Juan had a severe cash flow problem. He pleaded with Alicia to write off the $50,000 payment due in 2001. She agreed to forgive the debt in exchange for an increase in her share of the apartment complex. He agreed to pay her 50% of the monthly proceeds beginning in January, 2001. During the negotiations for the debt forgiveness, Juan learned that Alicia had not included the maintenance payments in her gross income. He comes to you and asks you to advise him on the tax consequences of these transactions and what if anything he should do to minimize or avoid any increase in tax liability.