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Examination No._______

FEDERAL INCOME TAX
Semester I, 2002-2003

UNM School of Law
Final Examination
Three Credits

Professor Robert J. Desiderio
Saturday, December 7, 2002
Tuesday, December 10, 2002
9:00 am to 12:00 Noon

INSTRUCTIONS

1. This examination consists of 10 questions. All questions must be answered.

2. Equal weight will be given to each question. Each subdivision of a question will be given equal weight.

3. You may have with you in this examination your casebook, Internal Revenue Code and Regulations, the Chirelestein book, any materials I have distributed, and any notes and outlines that you have prepared or helped in preparing. You may tab your Internal Revenue Code and Regulations and your Code and Regulations may contain notes you have prepared. You may not have a calculator, any other book, materials or other information with you.

4. Please explain your answers to each question, referring to the applicable Internal Revenue Code and/or Regulation sections. In grading your answers, I will give more weight to your explanation than to the correctness of the answer.

NOTE THAT YOU HAVE 3 HOURS TO COMPLETE THE EXAMINATION.

GOOD LUCK!

(EXAMINATION BEGINS ON PAGE 2)

1. What are the tax consequences to Melinda under each of the following two situations:

   a) Melinda is the sole shareholder of ABC, Inc. ("ABC"). Melinda is also the sole employee of ABC. Two years ago, ABC obtained a loan from a bank under the condition that some of Melinda's property be transferred to ABC as additional security for the loan. Pursuant to this condition, Melinda transferred ownership of her personal Ferrari automobile to ABC two years ago. ABC then gave the bank a security interest in the Ferrari as collateral for the loan. At all times subsequent to this transfer, Melinda has continued to use the Ferrari for her personal use – totally unrelated to any manner or activity involving ABC.

   b) ABC operates a motel business. ABC purchased residential property adjacent to the motel and, by contract, required Melinda to use the residence and also furnished her meals. Melinda worked at the motel and was on call 24 hours a day.

2. Paul, while attending his brother's funeral, was shocked when he discovered that the funeral director had purposefully disfigured his brother's body. Paul suffered severe emotional trauma, so much so that he ultimately became physically ill and required hospitalization. He sued the funeral director under the tort of intentional infliction of emotional distress and reached an out-of-court settlement, with Paul receiving a total of $200,000. Of this total, $10,000 was for Paul's mental and emotional pain; $50,000 was for Paul's physical pain and suffering; $15,000 was to cover Paul's hospital bills; $25,000 was to compensate Paul for lost wages as a result of missing work because of the incident; and $100,000 was for punitive damages. How much, if any, of the $200,000 is gross income to Paul?

3. Amy is a first-year law student at an accredited law school. Because of her prior achievements, the law school awarded her a $30,000 scholarship for her first year of study. The scholarship benefits are specifically identified as follows:

   - $20,000 to fully offset her tuition;
   - $500 for books required for first-year classes;
   - $5,000 for housing; and
   - 4,500 to use for food and other living costs.

   How much, if any, of the $30,000 is gross income to Amy?

(Examination continues on Page 3)

4. José, who is not married and who suffers from severe arthritis, earned $50,000 in salary last year. At the insistence of his physician, he installed an elevator in his three-storey house in an effort to help alleviate the discomforts caused by his condition. José installed the elevator last year at a cost of $20,000; the elevator increased the value of his home by $14,000. José paid $1,000 for maintenance of the elevator last year. In addition, last year José paid $200 in over-the-counter (non-prescription) medicines that his doctor had recommended. José was not reimbursed through insurance for any of the above costs. Assuming that José has no other business, investment, or itemized deductions, what is José's <u>taxable income</u> for the year?

5. Rose has friends in Denver, and after earning a few days off, she decided to fly up for a visit. Prior to leaving, Rose's boss asked her to handle a business matter with one of the firm's Denver clients while she was in Denver. Rose arrived in Denver early on Tuesday and returned to Albuquerque early on Sunday. She met with the firm's client for twelve hours on Friday. Rose spent the remainder of the trip visiting with friends. She originally had planned on returning to Albuquerque on Saturday, but decided to stay over Saturday night because she then qualified for a reduced airfare. By staying until Sunday morning, Rose saved more in airfare than it cost her for the extra lodging and meals. Rose spent $500 for her plane tickets; $100 a night for a hotel room; and $50 a day for food. Assuming that all these expenditures were reasonable, how much, if any, may Rose deduct?

6. Five years ago, Leo purchased his personal residence for $400,000, paying $200,000 down and borrowing $200,000. He secured the loan with a mortgage on the residence. Leo pays $10,000 a year in interest on this loan. The value of Leo's residence has risen substantially, and in the current year he decided to borrow against his equity. Accordingly, he borrowed an additional $160,000, securing this debt with a second mortgage on the residence. Leo used $80,000 of the funds to add an addition to his home, $70,000 to purchase some stocks for investments, and $10,000 to pay for a luxury cruise. He pays $8,000 interest a year in interest on this second mortgage. His investments have not earned him any income in the current year. Also, in the current year, Leo purchased a vacation cabin (used exclusively for personal purposes and not rented out), borrowing $100,000 in a separate mortgage loan, secured by the cabin. He pays $6,000 a year in interest on this loan. Leo owns no other real property. Leo's interest payments for the year total $24,000. How much, if any, of the $24,000 is deductible in the current year?

(Examination continues on Page 4)

7. Daniella sold her personal residence during the year. Her timing, however, could not have been worse. She had purchased the house five years ago at the peak of a real estate boom for $400,000, hoping that it would be a good investment. Her instincts and timing proved to be poor; she sold the house in June of this year for $370,000. After paying a real estate commission of $20,000, she received $350,000. The house was her first, and only, house she owned and she has not decided whether she will buy another home in the near future. She lived in the house during all the time she owned it. What are the tax consequences to Daniella on the sale of her house?

8. Exactly five years ago, Edna and Tom, husband and wife, purchased a house for $400,000, taking title as joint tenants. Shortly after buying it, they spent $110,000 on major additions and improvements to the house. They bought the house for investment purposes, but decided to use it as their personal residence until the remodeling was completed. After the work was completed, their marriage faltered and ended in divorce this year. Pursuant to the divorce decree, Tom received 100% of the house, which he sold for $600,000. What are the tax consequences to Tom with respect to receipt and sale of the home?

9. Kevin borrowed $50,000 from Lender to finance the purchase of inventory from Dealer for a new shoe store that he opened on Central Avenue. Because of a downturn in the economy, Kevin was forced to liquidate the business after operating it for less than a year. Under the circumstances, Lender agreed to accept a lump sum payment of $20,000 in satisfaction of the $50,000 loan.

   a) What result to Kevin? Assume he is solvent.

   b) What result if Kevin's uncle had lent Kevin the money when Kevin was underage and the debt was unenforceable?

   c) What result if Kevin had borrowed the $50,000 from his parents instead of Lender and Kevin paid his parents $20,000, who accepted the $20,000 in satisfaction of the debt?

(Examination continues on Page 5)

10. On November 19, 2002, Leslie opened a restaurant. She purchased equipment, paying $50,000. The equipment is classified under § 168 as 5-year property. The equipment has a salvage value of $5,000. Leslie purchased no other depreciable property during the year.

a) Leslie wants to know the maximum depreciation deduction (disregarding § 168(k) and § 179) she may claim with respect to the equipment for each year she uses the equipment, assuming that she uses it in her restaurant for at least six years.

b) Assuming that Leslie elects to use § 179 and § 168(k) in 2002, what is the maximum amount she could deduct with respect to the equipment in 2002?

(End of Examination)