FEDERAL PERSONAL INCOME TAXATION

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Section M Fall 1989

FINAL EXAMINATION

This examination consists of three questions. It lasts for three hours. Including this cover sheet, it is four pages long.

Each question counts for one-third of the grade on the examination. Allocate your time as you wish. I do not necessarily mean to present the same proportionate degree of difficulty in each question.

The examination is "open-book, open-notes." You may consult any written materials you have carried into the room.

Assume for each question that there applies the Internal Revenue Code of 1986, as amended by the Technical and Miscellaneous Revenue Act of 1988 (TAMRA), Pub. L. No. 100-647, 100th Cong., 2nd Sess., approved Nov. 10, 1988. You may disregard subsequent legislation (such as the Omnibus Budget Reconciliation Act of 1989, H. R. 3299, which awaits signature at this writing).

Always be sure to apply the law to the facts. Identify any assumptions of fact, or alternative assumptions, you might wish to make. This course concerns federal law, and therefore pretty much a single jurisprudence, so I especially encourage you to cite to authority.

You may keep this examination for your files.

Good luck.

I. I represent Patricia L. F. Massey and John R. Massey, a married couple, with respect to their taxable year 1989. They use the cash method of accounting on the calendar year, and will file a joint return. Patricia is a lieutenant colonel in the United States Marine Corps. Earlier this year, she took a transfer from Florida to California, indeed to assume command of a Marine Corps base there. John is self-employed as a poet.

Among other matters, the Masseys paid a trucking company \$1796 to move a 36-foot sailboat, the "Hereford," from their old residence in Florida to their new residence in California. As one would expect, both Patricia and John love sailing, and spend most of their free time at it. They regretted that they had no time to sail the Hereford to California themselves. Patricia and John have owned the Hereford since 1978, and never have used the boat in a trade or business or for investment purposes. They lived on the Hereford for two weeks after closing the sale of their house in Florida, and for nine weeks before renting an apartment in California. John is pursuing an epic work with some commercial potential, and Patricia and he intend to use his earnings to replace the Hereford with a 45-foot boat in 1991 or 1992.

Patricia has paid certain expenses with respect to her assumption of command at her new station in California. Specifically, she paid expenses with respect to a party preceding the change-of-command ceremony and a reception following it. change-of-command ceremony, the preceding party, and the following reception all represent customs and traditions of the The actual change of command consists of a formal ceremony in which the outgoing commander conveys the unit's flag to the incoming commander. The troops pass in formation and the band plays, and attendance is mandatory. The party the night before the change of command is held in the incoming commander's Patricia paid \$444.37 for the party. The reception following the change of command is held at the officers' club. It reflects strict Marine Corps protocol regarding its time and place, the composition of the list of guests, and the entertainment provided. Patricia paid \$2064.63 for the reception.

The Marine Corps has spoken officially to the change of command, most recently in a 1988 memorandum to commanders from K. A. Smith, the Commanding General, as follows:

1. As a function of Command, all Commanding Officers...are required from time to time to participate and engage in official entertaining in the performance of their duties. Although no governmental funds are available to reimburse officers for personal funds expended in completing these duties, these duties must nevertheless be carried out in a professional and appropriate manner.

2. Whether the entertainment is official must be determined on a case-by-case basis; however, as a function of the Command several types of entertainment expenses are deemed necessary and clearly qualify as official. They are: Changes of Command, entertainment of visiting dignitaries whether military or civilian, representing the Command within the civilian community, and representing the Command at official functions.

John's attendance at the change of command required morning clothes (swallow coat, striped trousers, top hat, spats, Chesterton, etc.). Rental was unavailable, so he bought such clothing for \$1250. His attendance at the preceding party and following reception required evening clothes (black tie). He could have rented for \$100, but was told by the outgoing commander's wife that all the other civilian men or women who would attend owned their own evening clothes or formal gowns and that "one could tell the difference." He therefore bought such clothing for \$500.

Please advise me fully on the Masseys' federal income tax consequences from these facts.

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II. I teach a little in the area of corporate mergers and acquisitions, and I took some courses in American and European practices of investment banking for ten weeks this summer at the London School of Economics, of course in London, England. Perhaps unfortunately, I had to study the entire time (which did tend to defeat the purpose of being in London). My transportation cost \$500, and the courses cost \$5000 and room and board cost \$2000 at the then current rate of exchange.

I had no \$7500 to spend on that, and so have not had a very pleasant fall. But, last week I mentioned to my uncle how much I had enjoyed my studies, and he said that he would reimburse me for my expenses. Thus, I promptly presented him with my bills, and he paid me the full \$7500.

How should I analyze all of this, my visit to England and my dealings with my uncle, for purposes of my 1988 federal income taxes? No doubt like you, I use the cash method of accounting on the calendar year. Please explain in full.

III. TP, an individual, leased office space in a building he purchased in 1977. In 1988, the building had an adjusted basis of \$20,000 and land on which it sat had an adjusted basis of \$7000. Mounting losses on the building's operation, and declining property values, led TP to decide to burn down the building to collect the proceeds of fire insurance. TP paid a third party \$5000 to set a fire. The fire destroyed the building, leaving zero salvage value. TP collected \$100,000 under his insurance policy. All of this occurred in 1988.

On his 1988 return, TP deducted the \$5000 paid to the third party, calling it a fee for managing the building. TP's income from rents on the building equalled his other expenses and depreciation deductions attributable to renting the building.

In 1989, investigators discovered the arson. Committing arson, paying another to commit arson, and making fraudulent insurance claims constitute felonies under the applicable state law. These laws are generally enforced. TP was charged, and struck a plea bargain whereby he returned to his insurer the \$100,000 in policy proceeds.

TP later sold the land and building to his opportunistic brother for \$2500.

TP now has retained me to advise him with respect to his taxes. I have taken a cash retainer of \$2500, which I expect to account for the entire eventual bill.

What federal income tax consequences arise for TP from all of this? Please analyze in full.