INSTRUCTIONS:

You may have with you any written materials you would like, as well as a hand-held calculator if you want. The examination consists of four (4) questions, equally weighted. You should plan to spend forty-five (45) minutes on each. Each question has sub-parts which will be variously weighted. Be sure to read the directions carefully, and to answer what (and only what) you are being asked to answer.

Where necessary, please make and clearly state any relevant assumptions. Please attempt to write neatly, and be as concise as possible. Please put only your examination number, and not your name, on any submitted materials.

YOU MUST STOP WRITING WHEN INSTRUCTED TO DO SO BY THE PROCTOR. FAILURE TO DO SO WILL BE CONSIDERED A BREACH OF ACADEMIC DUTY AND WILL BE REPORTED TO THE DEAN'S OFFICE BY THE PROCTOR.

DO NOT LIFT THIS COVER SHEET UNTIL INSTRUCTED TO DO SO BY THE PROCTOR.

THANK YOU AND GOOD LUCK!
Once upon a time three frat boys, George, John and Ralph lived together in a secret house, subject to the rules of the current federal income tax. A mysterious masked Wizard appeared one day to the boys. “You guys are all losers,” the Wizard said, “but I will give you each something to help.” “What will we owe you in return?,” the boys asked. “You’ll see,” said the Wizard.

Turning to John, the Wizard said: “You obviously lack courage.” He handed the young man a set of three valuable gold medals. John’s medals brought him widespread popularity. One Princess Teresa became especially enamored of him. During one romantic evening, John gave Teresa one of his medals, and, in exchange, she promised to marry him, and to bankroll his career in politics with her vast personal fortune, acquired just a few years before from her late husband Heinz. “Cool,” thought John, “I accept.” As John’s fame rose, his remaining medals became even more valuable. He donated a second medal to the Smithsonian Museum, which later decided to sell it to raise cash for other items for its collection. One day, years later, the Wizard reappeared to John. “I have come to close out the bargain,” the Wizard said, “You must throw away your remaining medal and then run for President.” “O.K.,” said John, though he thought the matter a little odd. He threw away his third medal, and soon thereafter declared himself a candidate for President.

Turning to Ralph on the initial fateful day, the Wizard said: “You obviously lack a brain.” With that, he handed Ralph a certificate and some strange pills, that had the effect of making Ralph know some things, half-way at least. Ralph proceeded to write a series of progressive books, donating all of the proceeds therefrom to a Consumer Advocacy Center he had set up. One day, years later, the Wizard reappeared to Ralph. “I have come to close out the bargain,” the Wizard said, “You must run for President.” “O.K.,” said Ralph, though he thought the matter a little odd, and soon thereafter declared himself a candidate for President.
Finally on the fateful first day, the Wizard turned to George and said: “You obviously lack a heart.” With that, he handed the young man a book, *Compassionate Conservativism*, full of special secrets on how to succeed in life. George took the lessons of the book to heart. Lesson #1 instructed George to place a call to a certain Dick in Texas, who proceeded to give George all of his stock in BigOilCo, his solely owned company, in exchange for George’s promise to be his lifelong friend. At the time, BigOilCo had yet to collect any money but had potentially lucrative contracts in place with several Middle Eastern countries. “O.K.,” said George, thinking this sounded compassionate. Lesson #2 was to do nothing while he owned BigOilCo, allowing the company to collect on the contracts and retain earnings while never paying him a salary. Lesson #3 was to place the relatives of his army commanders on BigOilCo’s payroll, in exchange for a deferment of his own military obligations. Lesson #4 was to go to a prestigious business school to burnish his credentials as CEO of BigOilCo. Lesson #5 was to run for Congress and lose, building character while BigOilCo continued to appreciate. Lesson #6 was to buy some military clothing. After doing all this, the Wizard reappeared to George. “Now it is time to collect on my bargain,” the Wizard said to George, “you must put on the military clothing and run for President.” “What’s in it for me?,” George asked. “Just do it, son,” answered the Wizard, removing his mask to reveal himself as Rich Dad. Sensing his inheritance might be at issue, George decided to follow Rich Dad’s advice, and he declared himself a candidate for President.

**Discuss the federal income tax consequences of the various events and transactions to John, Ralph, George, Princess Teresa, Dick and Rich Dad (aka the Wizard).**
Soon after declaring himself a candidate for President, George sat down with Rich Dad and asked how he had become so rich in the first place.

“Well, son,” Rich Dad explained, “behind every great fortune is a great crime.” The two shared a hearty laugh. Continuing, Rich Dad explained: “Your Grandfather made a pretty good penny in politics; let’s just leave it at that. When he passed away, he left a small fortune worth about $10,000,000 at the time, a life estate to me, a so-called remainder to you. I was getting $500,000 a year—5% of the principal—under the life estate, but my accountant told me I had to pay tax on that. That didn’t quite strike me as right. So I transferred Grandpa’s fortune to a little company some friends of ours formed, Texas Mutual Life (“TML”). I was young and healthy, and my accountants said that your remainder was worth $2,000,000. So TML set aside that much money to buy an insurance policy on my life, with you as the beneficiary. They held onto the rest, and gave me back some real estate worth $10,000,000, all financed with an interest-only mortgage at 5% interest. TML agreed to pay the interest every year while I was alive, $500,000 a year. Meanwhile, I could collect the rents, and offset them with depreciation deductions. So that got me started, and things went from there.”

“Cool enough,” said little George, “But what about me?”

“No worry,” said Rich Dad. “That $2,000,000 insurance policy was a cash value deal. You could borrow against any amount above $2,000,000. Each year when the policy appreciated by 5%, or $100,000, we just borrowed. You got $100,000 a year, tax-free, which held you over pretty well until that Compassionate Conservatism stuff kicked in.”

Please discuss Rich Dad’s description of these transactions. Explain the tax advice and doctrines behind them. What arguments against the transactions might the IRS raise? How might a court rule in any challenge?
George, John and Ralph are each now running for President. Their platforms include the following specific provisions:

**George:** a doubling of the rate brackets for married couples, and a plan for greatly expanded savings accounts on the “Roth IRA” model (that is, no deduction, tax-free build up inside the account, and no subsequent tax on withdrawal).

**John:** an expanded child-care credit, and a plan for expanded savings accounts on the “traditional IRA” model (that is, deduction, tax-free build up, but full taxation on subsequent withdrawal).

**Ralph:** separate filing, and a postpaid progressive consumption tax (that is, include debt as income but allow an unlimited deduction for savings.)

Choose two (2) of the following types of taxpayers, and discuss both how the plans might affect them compared to the status quo, and what planning advice you would give them under each alternative:

A. Two-earner couples

B. Wealthy one-earner couples

C. Law students (i.e., you)
In their presidential campaign, George, John and Ralph each have an idea for comprehensive tax reform.

George proposes a prepaid consumption or (equivalently) wage tax, flattening the rate structure so that there is a single rate of 25% after an initial zero bracket or exemption level.

John proposes to increase the progressivity of the rate structure under the income tax, restoring a top marginal rate bracket of 50% while lowering rates at the low end, raising the tax on capital gains to 25%.

Ralph proposes replacing the income tax with a steeply progressive postpaid consumption tax, with rates ranging up to 70%.

Write a draft of a newspaper story comparing and contrasting the plans you have chosen. Be sure to (1) clearly explain each plan (fleshing out any details you think essential to the ordinary reader); (2) note likely “winners” and “losers” under each; and (3) identify the best arguments for and against each.