FEDERAL INCOME TAXATION

Professor McCaffery

May 8, 2006

Three (3) hours, open book.

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 three (3) questions, weighted according to the time allocated to each. You should plan to spend ninety (90) minutes on Question I and forty-five (45) minutes each on Questions II and III. 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!
Question I
Ninety (90) Minutes

The events below took place in a strange land strangely subject to the U.S. federal income tax laws as they now exist.

One morning, as the Seven Dwarves were off to work in the mine, Doc, the eldest, turned to Snow White and said: “Snow, you’ve been great — your cooking, cleaning, and more have made our lives better. We’re going to give you our take from the mine today.” “Don’t worry, little men; I’m happy just to live here rent-free,” Snow replied.

The Dwarves went off, whistling as they went. They worked in a mine the use of which the Evil Queen had given them, on the condition that they give her any precious minerals they found, keeping “anything else.” Usually, the “anything else” meant coal. On this day, however, Dopey struck a vein with his pick-axe and a black liquid poured forth. Dopey had no idea what it was, but he agreed to share it, as per custom, with the six other Dwarves. Doc pointed out that the substance was high grade oil (“black gold”) and quickly calculated that the underlying well was worth $1 million at that day’s prices. Doc also told the other Dwarves that the oil belonged to Snow White, because of the pledge he had made that morning. The Dwarves patched up the opening and headed home.

The Dwarves hustled back to their cottage, whistling again as they went, to present Snow with the good news, only to find her sound asleep when they arrived.

Meanwhile, the Evil Queen found out about the oil find, and sued to claim ownership. A corrupt judge of the realm held that oil was indeed a “precious mineral” and thus within the terms of the Queen’s contract. The Dwarves appealed on behalf of Snow White. The oil well, now being pumped extensively by the Queen’s minions, was put into receivership pending the outcome of the appeal. The Queen’s Receiver held onto all the money being collected, running about $10,000 per month. The price of oil had spiked up, and the well was now valued at $2 million. All the Dwarves had to show for their efforts was $100,000 in legal fees to Goofy, their lawyer. Figuring that their chances of success on appeal were only one in ten (10%), they transferred contingent rights to one-half (50%) of the oil, should they win the appeal, to Goofy, in discharge of their debt.
Sad and penniless, the Dwarves borrowed $25,000 from friends and built a beautiful bed to rest Snow White on, and a magical looking glass structure to house it. People from all over the kingdom started to come to visit the “priceless” wonder, and many strangely wanted to kiss Snow White’s sleeping lips. To help pay off their debt, the Dwarves asked for voluntary contributions for the privilege of kissing Snow. Over the course of a year, the Dwarves collected enough money to pay down the loan principal.

One fine day a bit later, the Prince arrived. “You Dwarves are great little fellows, but you sure are not tax-savvy. I’ll tell you what I’ll do. I will buy this wonderful bed and structure from you for a $1; help you set up a Snow White Museum as a 501(c)(3) not-for-profit; and then immediately donate the bed and structure back to you all to display in the Museum.” “Huh,” said Dopey. “O.K.,” said Doc. And so it was done. Money continued to pour in from visitors far and wide.

Soon thereafter, the Prince himself kissed Snow White who, miraculously, awoke (who knew?). The Dwarves excitedly told her everything, including the fact of the oil well and its current placement in receivership. Snow said that she could not accept the well, but that she was grateful for all the Dwarves had done.

The Prince then ascended to the throne, discharged the corrupt judge, and appointed honest judges who found for the Dwarves. By this time the well was worth $3 million, on account of the continuing rise in world prices. The Dwarves said they didn’t want anything but Snow’s happiness. The Prince said he would take the well, net of Goofy’s one-half share, for the benefit of all, but would give each Dwarf an annuity, paying $10,000 a year (worth approximately $200,000 at 5% interest rates – Dwarves live a long time), and would also allow them to live rent-free in a newly constructed wing of the palace built with their special needs in mind. Crest-fallen, the Evil Queen died, with the Prince, her only natural heir, inheriting her remaining stash of precious minerals, which the Prince sold off to raise money for a big wedding party. Snow White and the Prince were married, had a bunch of kids, and (of course) lived happily ever after.

Discuss the federal tax consequences to the Seven Dwarves (collectively), Snow White, Dopey, the Evil Queen, Goofy, and the Prince.
The Prince is appalled at the nature of the tax laws of the land, once he has taken the time to study them. He appoints a Prince’s Advisory Panel on Tax Reform. The Panel came back some time later and recommended the following Proposal:

- Repeal the “alternative minimum tax,”
- Repeal the deduction for state and local taxes under IRC § 164,
- Replace all “personal deductions,” as for charitable contributions, extraordinary medical expenses, and home mortgage interest, with “personal credits” set at 15% of the amounts expended,
- Eliminate the “marriage penalty” by doubling all of the rate brackets,
- Repeal the special tax rate on “capital gains,”
- Change to a rate structure with four brackets of 0, 15, 22.5 and 30%, and
- Replace the variety of tax-favored savings vehicles (traditional and Roth IRAs, educational and health savings accounts, etc.), with a single “All Purpose Savings Account,” set up along a “prepaid” (or, equivalently, Roth-style) model, with a maximum contribution of $10,000 per taxpayer per year.

Consider the households of two of the Dwarves. Sneezy has gone off to live in a high-tax jurisdiction/state on the Left Coast; he is earning a fairly high salary as an entertainment lawyer, and has married an equally well-paid fashion model; he lives with his beau in a large newly acquired mansion. Happy, meanwhile, has stayed closer to home, in a low tax jurisdiction/state, earning a modest salary as a law professor, living in small cottage. He is married, too, and his wife stays home and takes care of their seven little children (all daughters).

Write a short memo to Sneezy and Happy explaining (a) how the Panel’s Proposal might affect each household, (b) whether they should support it, and (c) what if any changes to their tax and financial planning they might make to minimize taxes under the Proposal, were it to be adopted as law.
Grumpy proposes, in lieu of all the complex stuff that the Prince’s Panel was discussing, a simple FairyTax™ to cure the kingdom’s woes. The FairyTax™ would be a national retail sales tax that would apply to all consumption in the kingdom at a flat, 25%, tax-exclusive rate. To lend progressivity to the system, every man, woman, and child would get a $2500 check from the government each year.

Write a short memo to the Prince discussing how the FairyTax™ would differ from the current income tax. Be sure to include a discussion of what categories of taxpayers might win, and who might lose, from the proposal. Do you think it is a good idea? Why or why not? What else might you suggest to improve the tax system, either in addition to or in lieu of the FairyTax™?