

Essay 1: Suggested time = 60 minutes

Homeowner purchases a house to use as Homeowner's personal residence. The sale price of the house is \$440,000. Homeowner borrows \$400,000 from a local bank on a fully recourse note. Homeowner uses the loan proceeds as well as Homeowner's own cash of \$100,000 to purchase the house and to add on a room at a cost of \$60,000. This loan is repayable with market interest of 8% over 30 years.

Ten years later when Homeowner has reduced the mortgage to \$300,000, Homeowner refinances the loan by borrowing \$420,000. Of that amount, \$300,00 is used to pay off the original loan and the remaining \$120,000 is used to purchase tax-exempt securities. At the time of the refinancing, the house is worth \$500,000, and Homeowner is required to pay 2 points (i.e., 2% of the loan amount, or \$8,400) to the refinancing lender to obtain the loan. This new loan is nonrecourse and is repayable with market interest of 7% over 15 years.

After the refinancing loan is paid off, Homeowner sells the house to T, an unrelated investor, subject to the right of Homeowner to continue to live in the house for the remainder of Homeowner's life. At the time of this transaction, Homeowner has a life expectancy of 10 years. T pays Homeowner \$350,000 for the house subject to the reserved life estate, while the fair market value of the house unencumbered by the life estate would be \$550,000. As part of the transaction, Homeowner agrees to spend \$25,000 to add a new garage to the house. However, only four years later, Homeowner dies and T takes the house free and clear. Prior to Homeowner's death, Homeowner spent \$25,000 constructing the garage as promised to T.

In answering the following questions, you are not expected to do any computations. Instead, you are expected to describe how any necessary computations would be done.

(1) What portion, if any, of the interest on the original loan can Homeowner deduct? (2) What portion, if any, of the interest on the refinancing loan can Homeowner deduct? (3) When and to what extent can Homeowner deduct the points paid on the refinancing loan? (4) What are the tax consequences to Homeowner of the sale to T? (5) What are the tax consequences to Homeowner and to T of Homeowner's construction of the garage and of Homeowner's death?

Essay 2: Suggested Time = 30 minutes

H is an insurance agent who receives renewal commissions whenever one of his customers renews an insurance policy. W is H's wife, and as incorporated into their divorce agreement, H and W agree that W will receive one-half of any renewal commissions payable to H. In the first taxable year subsequent to the divorce, renewal commissions of \$10,000 are paid to H, and in accordance with H's obligation to W, H gives half of that amount to W. What are the tax consequences to H and to W of the post-divorce renewal commissions? Be sure to consider the application of §§71 and 1041.

Essay 3: Suggested Time = 40 minutes

All the outstanding shares of X Corp. are owned by members of one family. An individual unrelated to that family, Z, becomes employed by X Corp., and in addition to an annual salary

of \$100,000, Z is given an option to purchase 1000 shares of X Corp. for \$1.00 per share. This option can be exercised by Z at any time during the next 3 years, but the shares so acquired will be forfeited by Z if Z gets divorced within two years of issuance of the shares. Z exercises the options after one year, paying \$1,000 for the 1000 shares. Z holds the shares for the next 5 years (without getting divorced) and then sells them for \$10 per share (\$10,000 total). At the time the option was issued, the shares were selling for \$2.00 per share. At the time the option was exercised, the shares were selling for \$5.00 per share. *Assume that section 422 does not apply to the shares of X Corp.*

Questions: (1) What are the tax consequences to Z of these events? (2) Should Z have filed an election under §83(b), and when could such an election have been filed?