This is a comprehensive tax case. Almost all of the tax topics covered in this class are covered in this case, and maybe even some additional reading and research are needed. Please read the case carefully, then go to the assessment tool to access the multiple choice questions related to this case.

You can access the assessment tool as many times as you want. Note that once you submit the case, answers will be given to you, with explanations. You can go back and redo the case again. My main purpose of having you do this case is for you to get some experience with a complicated tax situation so I want to encourage you to go back to the assessment again and again until you get it 100% correct, with full understanding of the concepts underneath. Although I cannot prevent anybody from taking the easy way and look up the answers first, I don't think that is the best learning practice. So please try to answer the questions first before you look up the answers. Hopefully all of you will do it the right way and gain some good learning experience in this process.

CASE: STEVE AND MICHELLE WALKER

PERSONAL INFORMATION AND BACKGROUND

Steve and Michelle Walker were both 40 years old when they moved from northern Virginia to California on January 1st of this tax year, after Steve received a high-paying job offer as a marketing executive in San Francisco. Three months later, Steve was tragically killed in a car accident on his way to work. Michelle was left to care for their 2-year old daughter Jessica and their 10-year old cat Buster. She has hired a part-time nanny to provide assistance and will pay her $15,000 in the current year. Michelle also has a 21-year old daughter Kristin from a previous marriage. Kristin is currently studying abroad in Paris, through a program sponsored by her university.

Michelle's first husband Bill was a wealthy CEO who was convicted and sentenced to prison in one of the largest accounting scandals to hit the Washington, DC area. Michelle was so outraged by his dishonesty and his rumored numerous affairs, she filed for divorce immediately. She was awarded full custody of Kristin, their Virginia house, half of what was left from his cash estate (after his legal fees were paid), and $10,000 per month in alimony. When Kristin turned 18 three years ago, the payment dropped down to $5,000 per month, and when Michelle married Steve a few months later, the payments stopped altogether.

BUSINESS INFORMATION

Michelle is the sole shareholder of an S corporation, MW Designs. She is an artist who is well-known for decoration the walls of the homes of wealthy politicians in Washington, DC.

She opened a studio in San Francisco in January; however, she has only one client so far and does not anticipate any more for the current year. She plans to finish a piece of work for the client in November, when she will collect $33,000 for her services. Michelle also received a payment of $20,000 in January of this year for a piece of work she completed last December. Michelle has elected the calendar year as the tax year for MW Designs.

Michelle purchased $55,000 worth of lighting and furniture in February to outfit her new studio. She knows she will have to replace her old computer equipment before the end of the year. The existing equipment was purchased 3 years ago for $3,000. By the end of last year, she had taken $1,500 in depreciation deductions on the old equipment. The current fair market value of the old equipment is $2,000. She thinks the new equipment will cost $5,000, and she plans to purchase it in September of this year. The class life of computer equipment is 5 years.

Michelle also like to promote the use of works created by lesser-known local artists, so she carries an inventory of sculptures and paintings she purchases at trade shows. MW Designs was originally formed as a C corporation 7 years ago and cost Michelle $4,000 in legal fees. Then, 4 years ago, Michelle paid an attorney $2,000 to convert it to an S corporation. In the year of conversion, Michelle held several paintings in inventory that had appreciated in value. In that year she sold on e to a client for $7,000. She had purchased it 5 years prior for only $1,000! Michelle has always used the specific-identification method for her inventory.

CHARITABLE GIVING

Steve and Michelle had always been generous in donating money to good causes. After Steve's death this year, Michelle gave Steve's brother $5,000 to support his political campaign. He was running for the California state senate, and she hoped he would be able to lobby for reduced speed limits on the interstate where Steve was killed.

Steve was particularly fond of the Northern Virginia Animal Shelter for where he adopted Buster 7 years ago. Michelle is considering a gift to the shelter of $105,000 in his honor. She has not decided whether she will give it to the shelter this year or next year. She will either make a cash contribution of give securities from their joint brokerage account (the A fund and the D fund).

Michelle is also thinking about donating one of her own creations, a painting, to her church. The supplies to create the painting cost $1,000, and the church could probably sell the painting for $5,000.

REAL ESTATE INFORMATION

In December of last year, Steve and Michelle sold their colonial-style home in Virginia for $1,000,000 (net of selling expenses) and purchased a penthouse condominium in San Francisco for $1,250,000. Michelle had previously owned the Virginia home with her ex-husband Bill. They had purchased it 15 years earlier for only $300,000. Five years later, they built an addition onto it for $175,000 and replaced an expensive stained glass window for $25,000, after Bill shattered it while practicing golf in the backyard. Michelle was awarded the house in the divorce and retitled it jointly with Steve as soon as they were married.

Steve owned a townhouse in Washington, DC, which he purchased 10 years earlier for $150,000. The tax assessment in the year of purchase allotted $50,000 of the value to land and $100,000 of value to the structure. He had made no improvements since then, and the townhouse is currently valued at $300,000. Last year, on January 1st, he retitled the townhouse jointly with Michelle and started renting it out to local university students. The year, Michelle expects to collect $24,000 in rent and have expenses (including depreciation deductions) of $22,000. Michelle knows that she needs to complete repairs on the faulty plumbing system, but this will cost her $5,000, so she is considering deferring this expense until next year.

Michelle inherited a piece of land located in Nevada when her mother died 6 months age. Her mother had purchased it 15 years earlier as investment property for $5,000, and when she died, it was worth $20,000. Today, it is worth $30,000. Michelle wants either to sell the land outright or exchange this land for a piece of land in California. She has found a builder who is willing to five her a piece of land worth $45,000 in exchange for the Nevada land, plus Michelle will have to give the builder $10,000. She would also be required to assume her mortgage of $5,000. The builder had originally purchased the land in California for $25,000 five years ago. Michelle has another offer from someone who is willing to give her $15,000 in cash today and $5,000 each year for the next three years. They will also pay interest on the outstanding installment payments.

Steve and Michelle owned a small vacation home in Sedona, Arizona. Last year, they rented it out from March 1st through November 30th and claimed rental income (net of expenses) of $15,000. This year, Steve and Michelle wanted to avoid any recognition on income from this property, so they had not accepted any tenants for the entire year.

INCOME TAX INFORMATION

Steve and Michelle had an adjusted gross income of $250,000 last year and paid $35,000 in taxes to the federal government. Michelle's adjusted gross income this year is estimated to be $150,000, and her total tax is estimated to be $20,000. Michelle makes regular estimated payments to the IRS. These payments plus Steve's withholdings will equal $17,500 by the end of this year. She is in the 25% tax bracket for the current year.

Steve had always prepared his own tax returns because he was surrounded by plenty of experts who gave him advice. His neighbor in Washington, DC was an enrolled agent with the IRS, his brother is an attorney, his cousin is a CPA, and his sister has a Master of Science degree in taxation. Steve had finished last year's tax return before his death, and Michelle remembered to file it on time. However, she forgot to enclose a check for the $3,000 deficiency. She received a notice about the missing payment and paid it in full on July 15th.

Michelle consulted Steve's brother about the tax impacts of the exchange of the Nevada land. He was unsure of the proper treatment, so he helped Michelle draft an inquiry to the IRS regarding the treatment of this transaction.

EDUCATION INFORMATION

Kristin is in her fifth and final year at an expensive private university. Her tuition and fees total $35,000 per year; these are paid by Michelle and represent more than 50% of Kristin's support. Kristin affords her living expenses through an irrevocable trust set up several years ago by her father Bill. Kristin is the sole beneficiary of the trust, and National Bank is the trustee. The trust pays all income annually to Kristin and allows distribution of principal, as deemed necessary by the trustee. Bill retained no rights or powers associated with this trust.

Michelle also expects Jessica to attend a private university, so she and Steve had set up a custodial account when Jessica was born. They funded it immediately with 500 shares of stock from XYZ Corporation. Steve had acquired these shares on two separate occasions: 250 shares were purchased 5 years age for $10 per share, and the other 250 shares were purchased 2 years later for $25 per share. At the time of the gift to Jessica, the shares were worth $40 each. The stock has been rapidly appreciating ever since. Early last year, the corporation announced a 2:1 stock split. Jessica's account was worth $47,000 at the end of last year. Michelle expects the taxable dividends on these shares to be $3,750 in the current year.

Statement of Financial Position
Steve and Michelle Walker
As of December 31st last year

ASSETS

Cash and Cash Equivalents	
Checking account: JT	$25,000
Savings account: JT	$200,000
Total Cash and Cash Equivalents	$225,000
Invested Assets	
Rollover IRA: H	$275,000
Rollover IRA: W	$310,000
Brokerage account: W	$890,000
Brokerage account: JT	$455,000
Total Invested Assets	$1,930,000
Business Assets	
MW Designs: W	$96,000
Washington, DC rental townhouse: JT	$300,000
Nevada land: W	$30,000
Alaska Oil LP: H	$24,000
Total Business Assets	$450,000

Personal-Use Assets	
San Francisco condo: JT	$1,250,000
Sedona vacation home: JT	$400,000
Jewelry: W	$32,000
BMW: H	$35,000
Lexus: W	$44,000
Furniture and household items: JT	$75,000
Total Personal-Use Assets	$1,836,000
Total Assets	**$4,441,000**

LIABILITIES AND NET WORTH

Liabilities	
Mortgage: JT	$250,000
Total Liabilities	$250,000
Total Liabilities	**$250,000**
Net Worth	**$4,191,000**

Notes to Statement of Financial Position

H = Husband
W = Wife
JT = Joint tenancy

THE WALKERS' INVESTMENT INFORMATION

Joint Brokerage Account

Steve and Michelle opened a joint brokerage account shortly after their marriage and had been saving diligently ever since. The four mutual funds have performed quite well during the recent stock market boom.

Name	Shares	Adjusted Cost Basis	FMV (End of Last Year)
A Fund	250	$15,000	$55,000
B Fund	430	$185,000	$245,000
C Fund	240	$90,000	$105,000
D Fund	220	$16,000	$50,000
		$306,000	$455,000

The C fund invests in foreign securities and will pay $110 in taxes to foreign countries on Michelle's behalf in the current year.

Michelle's Rollover IRA

Michelle was awarded one-half of Bill's 401(k) assets in the divorce decree. She opened a rollover IRA at that time to receive these assets. She has made no subsequent contributions.

Personal-Use Assets – Automobiles

The BMW and Lexus were both purchased on January 1st of the previous year.

Alaskan Oil LP

Steve held an interest in Alaskan oil through a non-publicly traded limited partnership. Michelle expects the partnership to report $2,000 of income in the current year.

Incentive Stock Options

Steve was granted 1,000 incentive stock options during his first month on the new job. The exercise price is $50 per share. After his death, Michelle was told she has 90 days to exercise the options. The stock is currently trading at $55 per share.

Picasso Painting

In an old and festering dispute over esoteric tax issues related to a rare Picasso painting, Michelle had indicated a desire to pursue action in a court that involves a jury, where she hopes for a better result than she would get from a non-jury hearing.