Taxation Exam, Fall 2010

Prof. McIntyre's Notes on the Answers

1. The original transfer of the ring from Major Nelson (MN) to Jeanie (J) looks like a garden variety gift. MN has no gain or loss, as his basis in the ring equals its fair market value (FMV). J is exempt from tax on receipt of the gift under IRC § 102(a) and has a carryover basis in the ring of $10,000 under IRC § 1015.

We might consider reevaluating the initial transaction about the pair splits up and MN demands a return of the ring. Now it looks like he intended a conditional gift. That is, there was a quid pro quo (QPQ) expected — namely the promise to marry, which J now intends to breach. We might consider here the case of *Farid Es Sultaneh* (FES) (Casebook, p. 102), where the court held that an ostensible gift of stock by Mr. Kresge to FES was a payment, as part of a later ante-nuptial agreement, for her promise to marry and to renounce any property claims otherwise acquired by marriage. I think FES was wrongly decided, but, in any event, distinguishable, because I do not see any evidence of a serious QPQ coming from J and certainly no ante-nuptial agreement.

The later offer to settle for $2,000 and the ultimate settlement for $1,000 should not result in taxation to either party. We might view J as making a part gift, part sale of the ring. The gift part would produce no tax results for either party under IRC § 102(a). The sale part also would produce no gain or loss because J would have a basis in the property transferred equal to its FMV.

The fact that there may have been a ot of animosity between the parties does not prevent the set of transactions constituting gifts. The question illustrates the limitations of the gift analysis provided in the *Duberstein* case (Casebook, p. 80).

If one wanted to argue for tax to J, the argument would be that she actually had no claim to the ring — that the deal was a conditional transfer subject to return of the ring if the marriage did not occur. Under that view, MN paid J $1,000 not for the ring (of which he was the true owner) but to settle a frivolous law suit in which J had no basis. I do not think this argument is convincing because I think a gift of an engagement ring in anticipation of marriage in current American culture is a true gift.

2. There are at least three problems with the application of IRC § 1031.

(1) The exchange is not an exchange of "property of like kind" because the GRANOLA is a modern weapon, useful for defense and other operational purposes, whereas the Colt Navy is an antique, valuable primarily for its relative rarity.

(2) Oliver Brown (OB) did not make an exchange of property “which is to be held either for productive use in a trade or business or for investment” for like kind property “which is to be held either for productive use in a trade or business or for investment”. The traded property, the Colt Navy, probably was not held either for investment or use in the business. In any event, the GRANOLA clearly was acquired for personal use — to make a gift to his father, who will use the gun for personal purposes.

(3) The traded property (Colt Navy) probably should be viewed as inventory property (property primarily held for sale to customers) within the meaning of IRC § 1031(a)(2)(A). as such, it is not eligible for the benefits of IRC § 1031(a)(1).

Even if IRC § 1031 were to apply (if would not), the non-qualifying property (boot) of $200 would be taxable.

3. OB cannot claim a capital gain on the transfer of the Colt Navy because the gun was held for sale to customers within the meaning of IRC § 1221(a)(1). Any gain is ordinary income.

OB has a basis equal to the purchase price of the Navy Colt, which is $500 plus the $50 “deposit” that OB already included in income, plus the cost of improvements, which is $900 for parts. OB does not get any basis for the value of his repair work, which has not been included in income. Thus the total basis is $1,450 ($550 + $900).

The gain is the amount received (the fair market value of the GRANOLA plus the boot of $200) minus basis. Under the facts given, the GRANOLA has a FMV of $2,800. So the amount received is $3,000 ($2,800 + $200). The gain is $1,550 ($3,000 – $1,450).

4. BQ can anticipate little current income benefit from the installation of the Smart Grid technology for study purposes. The goal is to see whether the Smart Grid will provide the study group and the company with the future benefits that it is predicting. It would seem, therefore, that capitalizing the costs would be the proper tax result. That result is supported by the *INDOPCO* case (Casebook, p. 211), which held that an expenditure incurred to provide a future benefit should be capitalized. It is also supported by *Fall River Gas* (Casebook, p. 201), which held that the installation costs incurred by a company installing devices to allow the customers to use gas instead of oil for their furnace was a capital cost, even though the customer could ask for the devices to be removed at any time and at the company’s expense.

The argument for an expense is that BQ did not end up with any physical assets. The assets were all owned by the customers. Under *INDOPCO*, that fact would be irrelevant, but there has been some erosion of *INDOPCO*, by case law and regulations. Still, there is a physical assets, which would take the case outside of the holding of *Wells Fargo* (Casebook, p. 216). I believe *Wells Fargo* was wrongly decided, and it obviously cannot overturn a Supreme Court case. Still, it is some legal authority for the proposition that if the taxpayer does not get a physical asset, then the result depends on the facts and circumstances of the particular case.

In defending a current deduction, BQ might argue, under a facts and circumstances test, that the transfer of the assets to its customers was like a rebate of its normal fees for electricity. Surely BQ would not have to capitalize a "free gift" of advertising trinkets, like a pen or tote bag, even if those items were expected to last longer than a year. the counter to that argument is that BQ will continue to reap the benefits of the "free gifts" to its customers for some period of time longer than a year because the customer, in effect, is required to use those gofts to advance both its own interests and the interests of BQ.

By analogy, we can ask whether the result in *Fall River Gas* would have been different if the company had made an outright gift of the gas converters to its customers. I think the result should be the same — the installation costs are still a coat of earning future income. But in the post-*INDOPCO* world, I could see a court going the other way, especially with respect to the equipment owned by the customers. There is something odd about treating property owned by someone else as a capital asset of the taxpayer. I imagine BQ could not take depreciation on the equipment, given its lack of an ownership interest. Thus, I think BQ is probably well advised to make full disclosure but to claim the deduction and see how the IRS responds.

The issue presented in the question can be sidestepped in part if the expenditures qualify for a deduction as a research expenditure within the meaning of IRC § 174.