Taxation Exam, Fall 1998
Notes on the Answers

1. Job hunting expenses may be either a capital expense or a personal expense. They can be capital in that the objective of the expenses is to earn income in the future. They can be personal in that the individual hinting for a job may also have personal reasons for the associated travel. they do not fit well under IRC § 162 because the job seeker is not engaged in a trade or business. He or she is *seeking* a trade or business. Similarly, the expenses are not the cost of obtaining profits within the meaning of IRC § 212. See Reg. § 212-1(f) (denying a deduction, inter alia, for "expenses such as those paid or incurred in seeking employment"). A taxpayer may be able to amortize the expenses over 60 months under IRC 195 by classifying them as "start-up expenses." The statutory language, however, is not a perfect fit – it speaks of "investigating the creation or acquisition of an active trade or business."

2. Items (1) and (2) are taxable; item (3) and item (4) are not taxable. The facts are insufficient to determine if item (5) is taxable, although it would appear that it is taxable.

Items (1) and (2) are simply wage compensation, explicitly included by IRC § 61(a)(1).

Item (3), free parking, is excluded by IRC § 132(a)(5) and (f)(1)(C), but only up to $155 per month under IRC § 132(f)(2)(B), adjusted for inflation since 1993. The adjusted amount for 1998 is $175. Here F receives parking valued at $170 per month, so F is not taxable on any of the parking. Note: Full credit was given if you identified the proper issue even if you did not know the exact inflation-adjusted amount.

Item (4) is traditionally viewed as a working condition fringe within the meaning of IRC § 132(a)(3). Office furnishings generally are a deductible business expense. See Reg. § 1.162-6.

Item (5) is not taxable if (1) the cafeteria generally takes in enough money to cover expenses and (2) assuming that F is a highly compensated individual, the cafeteria is available to other employees under substantially the same conditions and the group selected for the benefit does not result in discriminate in favor of highly compensated employees. From the facts, it would appear that the second condition is not met, as most employees must pay and F does not have to pay. Thus it appears that F is taxable on item (5).

3. Eddy is using the shed and the basement in his business, so the depreciation deduction under IRC § 167 is proper unless prohibited by IRC § 280A. Under § 280A, deductions for business use of a dwelling unit, including appurtenant structures, are denied unless one or more of the exceptions of IRC § 280A(c) applies. Depreciation for the shed qualifies under IRC § 280A(c)(3) because the shed is used "in connection with" Eddy's business and it is a "separate structure." the basement does not qualify because it is not a separate structure, is not Eddy's principal place of business, and is not a place where he has clients, etc. The storage rule of IRC § 280A(c)(2) does not apply because the lobster traps are not inventory held for sale to customers, and the recent amendment occasioned by the *Solomon* case does not apply because Eddy does not do his record keeping in the basement.

4. The alternations improve the building from its prior condition by making it comply with the current earthquake code. Thus they arguably constitute an “improvement” that must be capitalized under IRC § 263(a). The taxpayer can argue, however, that the costs were incurred not to improve the building but to comply with the building code; Consequently, they should be allowed as an ordinary business expense under IRC § 162. *Midland Empire* can be cited in support of the taxpayer’s position. *Midland Empire*, however, can be distinguished if the alternations increased the value of the building for the purpose for which it was being used by the taxpayer. If earthquakes are common in the area (they are) and the risk of severe damage and liability in the case of an earthquake was significant, then the alternation of the entablature would seem to enhance the property and constitute a capital expense. If the expenditures did not enhance the value of the building, then a deduction under IRC § 162 is appropriate. The *Norwest* case suggests that courts will look to the principal purpose of the alternations in deciding whether they are capital in nature. Here the apparent purpose was to comply with the earthquake code, not to improve the structure.

[Note: I would require capitalization if the alternations significantly increased the value of the hotel and would allow a business expense deduction if they did not.]