Taxation, Fall 2001, Prof. McIntyre
Notes on the Answers

Question 1.

The issue in all three parts was whether the payments involved needed to be capitalized or could be deducted currently as a business expense under IRC § 162(a). The law is not entirely clear, so a range of answers was acceptable

(a) The payment of $100 to Walton for services in locating a place to put the cooking cart provides a benefit to the business and is deductible under IRC § 162(a) unless it must be capitalized. The argument for capitalization is that it may provide a benefit into the future because Eddy hopes to use the new location for many seasons. I favor a current deduction, nevertheless, because the amount is relatively small, there is no clear asset created, and there was no reasonable expectation of a future benefit when the expenditure was made.

(b) The $1,000 payment to Grover seems to me to be a capital expense. There is no clear asset created in that Eddy gets no property right in the use of the parking lot, which Grover apparently does not own. But under INDOPCO, an asset is not necessary for capitalization. At the time of payment and thereafter, there is a reasonable expectation of a benefit extending beyond the taxable year, and the amount is large enough to require capitalization under Eddy's accounting system. I believe the capitalized amount may be recovered over 15 years under IRC § 197. thus the current deduction would be $1/15 \times \$1,000 = \$66.67$.

(c) The cost of the sausage given to the workers is deductible under the rules for inventory accounting. He would get a deduction of $\$2 \times 100 = \$200$ for his cost of goods sold. The question is whether this cost of goods sold must be capitalized and recovered over some longer period. I believe it is deductible currently because the gift of the sausages provided a benefit for the current year only. My take on the facts is that the free sausages are intended to keep the employees from upsetting the deal, perhaps by telling the owner of the parking lot about the arrangement.

Question 2.

If the taxpayer makes personal use of a home for more than 14 days, he/she typically can only deduct allocable expenses up to the amount of the income generated by the use of the home for business. There is an exception, however, in IRC § 280A(d)(4)(B) if the owner rents out the place for 12 consecutive months. In that event, the use before the 12-month period does not prevent the deduction during the 12-month period. Under the facts, the taxpayer has not yet rented for 12 months, but he has a 24-month lease and will satisfy the rule in the following year. Under these facts, the proper interpretation of the statute is that he can take advantage of the rule of IRC 280A(d)(4)(B). Otherwise the rule would be meaningless — no one who made use of the property for even a day in the year could satisfy the 12-month requirement.

Note: IRC § 183 has an analogous timing problem; it allows a presumption that the activity is business if there are profits in 3 or more of a 5-year period. When a business is just starting, there is no way to be sure if the presumption will be met. In that situation, the taxpayer is allowed to assume it will be met and is required to file an amended return if the presumption is not met. Presumably our taxpayer would have to file an amended return if he cancelled the lease and did not satisfy the 12-month rule in the following year.