Taxation, Fall 2003, Prof. McIntyre
Notes on the Answers

Question 1: Warranty Repairs of Lotus Esprit.

The $120,000 received under the warranty on the Lotus Esprit are akin to lottery winnings or insurance proceeds. As a starting point, you can argue that the gross receipts from the warranty are taxable to the extent they exceed basis. IRC § 1001(a). The Code does exempt life insurance and occasionally has exempted certain other types of insurance proceeds, but it does not contain a general exemption for insurance proceeds or a special exemption that is applicable to these facts.

The amount deductible for basis in the warranty contract is unclear. The problem is that the cost of the warranty relates to the entire warranty period, some of which has not yet expired. By analogy to *Burnet v. Logan*, I would allow the deduction of the full cost of the warranty, due to the uncertainty of another claim. An alternative argument is that none of the cost is deductible because the warranty costs should be allocated to each minute or moment of the warranty period, so that the amount allocated to the moment of the event causing the need for repairs would round to zero. Another alternative argument is that the cost should be allocated on a yearly basis, much like the allocation of basis under an annuity contract.

If there is taxable gain, that gain is ordinary income because there was no sale or exchange of a capital asset but rather a payment on a warranty policy. The cost of the repairs is not deductible because it is a personal expense (nothing in the facts suggest that the taxpayer was using the Lotus Esprit for business).

From a policy perspective, I am unhappy with the above result. I would prefer that the taxpayer be allowed to exclude the reimbursed amount and get no deduction for the cost of the warranty. Such treatment is consistent with the general treatment of warranties from a car manufacturer, who fixes the car without charge during the warranty period. There does not appear to be statutory support, however, for the general treatment of warranties issued by the car manufacturer.

The proper treatment of warranty payments is controversial. Some commentators argue that the taxpayer purchased a service — repair of car over a period — and the warranty company simply provided that service. The taxpayer obtained what he paid for. The analogy is to a homeowner who hires a snow-removal company to plow his driveway for the winter at a flat fee. Apparently there is no income if the winter is particularly snowy, so that the contract turns out to have been a good deal; and there is no loss if there is little snow (the loss would not have been deductible anyway because it would be personal). Some commentators suggest that the taxpayer should be treated as having a basis in the warranty claim in the amount paid for the repairs, on the theory that making that payment of the repair costs was a condition for having the warranty claim. I gave credit for any reasonable discussion of any of the above points.

Question 2: Found Treasure by Amateur and Professional.

For Ted, the gold coins are a windfall, and windfalls are taxable when reduced to possession. For Alice, the gold coins are inventory and inventory gains are taxable when the inventory is sold.

The difference is treatment may be justified on several grounds. Taxing Ted and similar finders at the time of the finding is both fair and administratively advantageous. On administrative grounds, the time of finding is the best time to tax because the Service will have trouble determining when Ted has sold the coins unless he makes a special report of the sale. In addition, Ted has realized the gain under *Glenshaw Glass* because the coins are a cash equivalent and Ted has reduced them to his possession. Taxing Ted on receipt puts him in the same position as people who have found money.

For Alice, the found coins are part of the inventory of her business. The general rule is that inventory gains are realized when the inventory property is sold. There is no special administrative problem in postponing the realization because the taxpayer is keeping books of account in which the sale should be reported as a normal part of the business. Postponement is fair because the amount of income is not known until the expenses associated with the finding have been deducted, and the deduction of those expenses is done under inventory accounting.

By analogy, some support for the difference in treatment is provided from an analysis the two British cases in the casebook, *Sharkey v. Wernher* and *Mason v. Innes*. Although the cases themselves were not well argued, the basic distinction was that realization should turn on the nature of the taxpayer's business. Someone in the horse business should be taxable on the transfers of a horse for personal use because otherwise the expenses associated with that horse will get deducted, in effect, as a cost of the other horses remaining in inventory. For a cash-basis taxpayer transferring an item with its own identifiable basis, however, it is acceptable to let the basis go with the transfer and postpone realization until sale. The point of the analogy is that the choice of rules in what might appear to be very similar circumstances ought to depend on the practical effects under each taxpayer's accounting system.

Question 3: Various Fringe Benefits.

These issues in this question are all addressed in Code section 132 and associated regulations.

Parking. Qualified parking is a tax-free qualified transportation fringe benefit up to a cap. IRC § 132(f)(1)(C). This parking is "qualified," assuming, as seems likely, the company parking lot is located on or near the employer's place of business. The cap of $165 per month, adjusted upwards for inflation (for 2002, the adjusted amount is $185 — you did not have to know this). Ignoring the inflation adjustment, the cap is $165 per month, so $635 ($800 – $165) of the parking fringe is taxable. The fact that the fringe favors key employees is irrelevant, as the parking fringe can be discriminatory.

Dining Room. The free food at the company dining room is probably taxable in full. In general, the provision of an eating facility is a tax-exempt *de minimis* fringe under IRC § 132(e)(2) if the eating facility charges enough to cover its costs and does not discriminate in favor of high compensated employees. It appears that the eating facility gets no revenue from the employees — the facts suggest that employees eat there for free. Thus it flunks the first test. Facts are inadequate to know if the plan discriminates in favor of highly compensated employees, but it seems highly likely that it does because access is restricted to key employees, who tend to be highly paid.

The first test might be passed if everyone using the facility can quality under IRC § 119 for an exclusion. IRC § 132(e) (flush language, providing that the employee exempt under IRC § 119 is deemed to have paid an amount for each meal equal "to the direct operating costs of the facility attributable to such meal"). It seems very unlikely, however, that the eating facility is provided for the convenience of the employer with respect to all of the employees. Indeed, unless Mabel herself qualified for exemption under IRC § 119, the test cannot be met. If she does qualify, then she can exclude the value of the meals without reference to IRC § 132(e)(2). For purposes of IRC § 119, the meals must be provided "on the business premises." For purposes of IRC § 132, it is enough that the meals be furnished "on or near" the business premises. The facts do not make clear where the dining facility is located. It seems pretty clear from the facts that the meals are not being furnished to Mabel for the convenience of the employer. That is, the employer does not have a reason why Mabel must eat in the company dining room to do her job effectively. The employer apparently is giving her that perk as bargained-for compensation.

Sports Club. Membership in a sports club is not excluded as a working condition fringe because expenses for a sports club are not deductible under IRC § 274(a)(1)(B). If the sports club is located on the employer's business premises, however, it can be excluded under IRC § 132(j)(4). It seems unlikely under the facts that the "local sports club" is located on the employer's business premises and that all of the use of it is made by employees and related persons. It is not a *de minimis fringe*. Reg. § 1.132-6(e)(2).

Luxury Suite at Lion's Football Games. There is no provision in IRC § 132 explicitly dealing with free football tickets. None of the exclusions appears to be applicable. The tickets are not a no-cost benefit (the company's business does not selling space in luxury suites). Nor are they a working-condition fringe because the expense of the "tickets" would not be deductible (the facts do not suggest any business use of the luxury suite by Mabel). My understand9ng of the facts is that Mabel can use the luxury suite whenever she wants. As a result, it is like a season ticket, and a season ticket is not a *de minimis* fringe. See Reg. § 1.132-6(e)(2). The right to occasional use of the suite would be *de minimis* fringe. See Reg. § 1.132-6(e)(1). Actual use does not matter — it is the right that matters because that is what she received from her employer.

Question 4: Repurchase and Sale of Own Painting.

The advice of Able and Babu is sensible and probably correct, in that a court probably would decide in accordance with their views. The issue, however, is not free from doubt. Chad is clearly wrong.

Able. The painting, in and of itself, might be viewed as property held for personal reasons or for investment rather than an inventory property. The language of IRC § 1221(a)(1), however, seems to remove the issue of specific intent. It states that property will not be treated as a capital asset if it is “of a kind” which would be included in the taxpayer’s inventory. Janet’s inventory consists of paintings held for sale, and this particular painting seems to be “of a kind” with those other paintings, notwithstanding Janet’s intent to use the painting as a decoration.

From a policy perspective, it seems proper to treat the painting as inventory property without reference to the taxpayer’s particular intent. If the taxpayer is selling certain assets as part of its business, it should not be able to argue that some portion of its assets are really being held for investment purposes. Such a rule would invite abuse and be difficult to police.

Babu. The painting clearly falls within the categories of property excluded from capital gains treatment by IRC § 1221(a)(3) because it is an asset held by a taxpayer whose personal efforts created it. The Court in *Corn Products* overrode the literal language of IRC § 1221 to prevent a taxpayer from improperly getting capital gains on the gains from the sale of corn futures contracts. But overturning the language to expand the preference for capital gains seems inappropriate.

It can be argued, nevertheless, that Congress did not anticipate the situation arising in this case — it was concerned about preserving ordinary-income treatment on labor income. According to that argument, the labor income was taxed on the first transfer, and any subsequent appreciation in the value of the property should be considered as a classic capital gain. This policy argument, however, cannot be accepted without ignoring the clear language of the statute. In addition, it is not at all clear that Congress would have wanted to give capital gains treatment in this case if the issue had been presented to it. A decision for the taxpayer might encourage artists and other taxpayers to sell their self-produced products at low fee to a straw and then repurchase them from the straw for a small markup. Then the subsequent gain would all be capital gain. Policing possibly sham transactions would put an excessive burden on the US tax authorities.