Notes on the Answers
Taxation, Fall 2006

Question 1.

The employees cannot claim a gift exclusion even if (doubtful) they could fairly claim that Acme was acting out of disinterested generosity because the general rule of IRC § 102(a), excluding gifts, is overridden by IRC § 102(c), explicitly including gifts from employers to employees in income. To avoid tax, the employees must argue that the gift certificates constitute a *de minimis* fringe benefit under IRC § 132(e). If so, then IRC § 102(c) is not applicable by its own terms. None of the other fringe benefit exclusions are even arguably relevant to this case.

Occasional gifts of goods or services at holidays are typically treated by the IRS as *de minimis* fringe benefits. The regulations provide, for example, for such treatment of a Christmas turkey. If the gift certificate is treated as a normal good, therefore, then the employees would have a good chance of avoiding tax. This treatment is probably inappropriate because under the facts there is no problem at all for the employer to account for the value of the benefit received, which is the asserted goal of the *de minimis* rule. In fact, however, Congress apparently wanted to take out of the system stuff that has traditionally not been taxed and would provoke taxpayer resistance if it were taxed.

Unfortunately for the employees, the *de minimis* exception does not apply to cash or to a cash equivalent. The issue, therefore, is whether a gift certificate is a cash equivalent. From a policy perspective, I think it should be so treated because the taxpayer has a range of choices of what to buy, similar to what he or she would get with cash. Otherwise, employer could avoid the tax on thrir employees without significantly affecting their economic condition by paying them in gift certificates rather than in cash. A major point of Section 132 is to prevent the extension of fringe benefits into new areas; the allowance of an exclusion for cash or a cash equivalent is inconsistent with that policy goal.

The employees are taxable in the year of receipt of the gift certificate under the cash method because the gift certificate is a cash equivalent. I think the amount included should be $90, not the $100 that the gift certificate can buy. I treat that extra $10 as a store discount to a class of customers, which is not taxable.

Notes.

(1) I explicitly did not ask about the treatment of Acme, the employer. As some students noted, under IRC § 274(b), Acme cannot deduct a gift to an employee in excess of $25 (annual limit) unless it treats the gift as compensation, which it did not do. I gave no credit for discussion of the tax treatment of Acme but did not take off for discussing it.

(2) The Treasury Regulations not included in the edited version of the regulations used in the course actually address the issue of gift certificates. Under those regulations, a gift certificate that is not restricted to the purchase of only a few products is treated as a cash equivalent. I obviously did not require any reference to these regulations for full credit.

Question 2.

(a) The original basis is the purchase price of $100,000 (equity plus loan proceeds). It is increased by $30,000 for the amount spent for improvements and reduced by $20,000 for depreciation allowed. The result is that the basis is $110,000.

(b) No depreciation is allowed in the first year because the machine was not put into service until year 2. For year 2, depreciation under the double-declining method is allowed. Since the property has a class life of 7 years, it is treated as 5-year property under IRC § 168(e)(1). That means that it is written off over 5 years. Under the straight line method, the recovery percentage is 20%. Under the double-declining method, it is twice that, or 40%. However, in the first year, the first-year convention applies, limiting the deduction to one half the normal amount. Applying these rules yields the following result:

$50,000 (original basis) x 40% x 1/2 = $10,000.

(c) The child-care credit for day camp is allowed. See IRC § 21(b)(2)(A)(ii) and *Zoltan v. Comm'r* (allowing a credit for camp expenses, p. 416 of casebook). The credit for overnight camp is not allowed. See IRC § 21(b) (flush language), overruling *Zoltan* for overnight camp but not for day camp.

Question 3.

(a) The legal fees paid by ACo in connection with the acquisition of BCo cannot be deducted currently. They are a cost of acquiring a capital asset, and, under IRC § 263 and INDOPCO, they must be capitalized. In *Wells Fargo*, a lower court (8th Circuit) has sought to limit the holding of the Supreme Court's decision in INDOPCO, and Treasury Regulations also have limited the holding. They have not undercut the rule, however, that capitalization is required for the costs of acquiring a capital asset.

(b) The tax treatment of the legal fees and settlement payment for incorrect accounting practices should be the same, since their origins are the same under *Gilmore*. Their proper treatment is not entirely clear. I would argue for capitalization, on the ground that the purpose of the bad accounting was to inflate the value of the taxpayer's stock in order to facilitate the purchase of BCo (or to acquire it for less ACo stock). The taxpayer would argue that it did not intentionally misstate its income, so the origin of the expense is its normal business activities. Under a pure INDOPCO analysis, my position probably would prevail, depending on how clear it was that the accounting violations were intentional. If they were not intentional, then the amounts should be deductible even under a pure INDOPCO analysis. The fact that ACo settled for a large sum strongly suggests to me that the claim of the plaintiffs had a lot of merit.

The question was inspired by a recent private letter ruling by the IRS (200649011, 12/8/2006). The facts of the ruling were far more complex. In that ruling, the IRS allowed a current deduction, suggesting that capitalization would be required only if inflating the stock was the sole motive for the accounting errors. Obviously, I did not expect anyone to be familiar with that letter ruling, and no one was.

Question 4.

Ms. Beta should understand that there is some significant risk that the plan may not provide deductions to donors under IRC § 170 because of the apparent *quid pro quo* – the provision of rides on *Peeking Judith* in exchange for contributors. If the holding of *Hernandez* (casebook, p. 523) is applied in full force, the deduction of $100 would be lost unless GLORY could show that the value of the ride was insignificant. In Rev. Rul. 86-63 (dealing with contributions to a university in return for favorable treatment in obtaining football tickets), the Service held that contributions over the minimum required for favorable treatment were deductible, notwithstanding the presence of a substantial *quid pro quo*. Thus, the amount of any deductions over $100 are not at risk. In my view, the risk of a loss of the deduction is sufficiently great for gifts of $100 that I'd want to explore alternative arrangements. Still, there is some argument, depending on the facts, that the boat rides have little value. It seems hard to see them as being a significant incentive for giving if they do not have significant value.

You should also inform Ms. Beta that the substantiation requirements of IRC § 170(f)(8) are not applicable to donations under $250. You would not be encouraging her or the prospective donors to act illegally; you are merely informing her of the extent of her reporting obligations. You also should tell her that if the IRS treats the boat rides as a *quid pro quo*, the burden would be on the donors to show that their value is less than the donation. She could assist the donors by assigning a reasonable value (say, $25) to the boat rides.

I think the stark *quid pro quo* of the proposed arrangement is not a very good plan because it is likely to appear to most people that GLORY is, in effect, selling boat rides. A better approach from a tax perspective would be to establish a Friends of GLORY society of some kind, with dues of some amount, such as $100. One of the perks of membership would be the opportunity to participate in educational programs, including rides on the Great Lakes on *Peeking Judith*. Again, I'm not suggesting some subversion of the charitable contribution rules. Such a society has to be legitimate to have merit. But it may be that such a society would be attractive to prospective donors and helpful to GLORY in advancing its educational mission. From a tax perspective, the goal would be to eliminate a direct link between the contribution and the benefit, as existed in *Hernandez* and seems to exist under the plan proposed by Ms. Apple.