Taxation Exam, Winter 2009

Prof. McIntyre's Notes on the Answers

1. Three issues are presented.

(1) Can GA deduct the expenses of traveling between the homes of his clients under IRC § 162(a)? The answer is "yes". Travel between job locations is permitted under Rev. Rul. 99-7 (CB, p. 347).

(2) Can GA deduct meals under IRC § 162(a)(3) as meals for travel away from home? The answer is "no". GA is blocked by the Service's overnight rule, affirmed by the Supreme Court in the *Correll* case (CB, p. 351).

(3) Can GA deduct the "commuting" expenses of traveling from home to the home of his first customer and from the home of his last customer to his home? The answer is not entirely clear, but probably "yes". The issue is whether GA's home is a principle place of business. If not, the expense is not deductible under Rev. Rul. 99-7. The facts suggest it might qualify as the place where the business is managed. See IRC § 280A(c) (flush language) (stating that a principle place of business includes a place used for administration and management, etc.).

2. The payment for canceling the contract for electric motors seems to me to be a capital cost, relating to the production of motors for the current year. I would treat the cost as an inventory cost, recoverable when the motors produced in year 2 are sold.

One might argue that the cost is really a cost for setting up the motor plant and should be allocated over the life of the plant, on the theory that it was incurred to prevent the loss of good will resulting from not having motors available in timely fashion. I do not think this argument has much merit because the cost really related to the motors to be produced in year 2.

A better argument is that the $400,000 is a current expense, paid to get out of a bad contract. The argument is that the payment provides no benefit to the company (aside from cancelling the claim against it by BMW).

3. The central issue is whether the refund of the price of the furniture is best characterized as a discount on the furniture, and not taxable, or as a prize or gambling winning, taxable to the buyer as income.

(1) *Discount*. It obviously is at best a very special discount. By analogy, I think a promotion that allows the first 5 customers on Black Friday to buy a chair for a dollar is a discount, not taxable to the buyer. This case is different because of the element of chance. Still, the "discount" is available to all prospective buyers and clearly is intended as a promotion.

(2) *Gambling winnings*. I come down on the side of it being income as gambling winnings. It clearly is a promotion, but giving out lottery tickets as a promotion would not prevent the

winnings on the lottery tickets from being income. With a real discount, the buyer is told of the discount at the time of purchase and decides whether to buy at that price. The people in line on Black Friday probably would not buy the hypothetical chair at its listed price. Here, few buyers would buy furniture unless they were willing to pay the "regular" price, since the chances of "winning" the chair for free were rather small.

Note: The question is based on a promotion in the Boston area, where a furniture store offered free furniture in 2007 if the Red Sox won the World Series, which they did. The store had taken out insurance to cover the potential loss.

4. The question, unfortunately, only asked about *deductions*.

(1) *Interest*. The interest of $18,000 is deductible as interest on "acquisition indebtedness with respect to any qualified residence" under IRC § 163(h)(3)(A)(i). The residence is "qualified" because it is his principal residence and the loan is secured by the home.

(2) *Property Taxes*. The property taxes of $9,000 are deductible under IRC § 164(a)(1).

(3) Utilities. The $8,000 in utilities is a non-deductible personal expense under IRC § 262(a).

Note: When I wrote the question, I meant to ask about the 10% discount provided by the taxpayer's employer on the purchase of the home. That issue is addressed in IRC § 132 (fringe benefits). Unless some exception applies, the discount to the employee of $40,000 is taxable. IRC § 61(a)(1). The only plausible exception is IRC § 132(c) (qualified employee discount). That provision does not permit an exclusion because IRC § 132(c)(4) defines "qualified property or services" to exclude, inter alia*, "real property".*

5. This question has no clear answer. It is an open-ended question allowing the answer writers to discuss tax policy in a real context. The following are useful points that might be made:

(1) If the new health coverage program is defining health care that the government feels should be covered, it might make good sense to eliminate a government benefit for health costs that are not covered. In effect, the government would have one definition of allowable health care, treating all other health costs as essentially personal. For example, building a swimming pool would be viewed as personal — those needing the use of a pool for health reasons could go to the YMCA or some other low-cost location. (*Note: This is my personal view, depending, however, on what health plan gets adopted.*)

(2) The 7.5% floor will now exclude most middle and upper-middle class taxpayers from claiming a medical expense deduction, assuming that most of the medical expenses will be

covered by the government plan. So, one the one hand, it would make sense to consider lowering the floor if we decide that taxpayers should be allowed to deduct non-covered expenses. On the other hand, the current floor might still be fine at establishing what is an "extraordinary" medical expense. Clearly some medical expenses are mostly personal and need not be deductible to provide a fair distribution of tax burdens.

(3) Current law prevents a deduction for various discretionary medical expenses, such as cosmetic surgery. I doubt that cosmetic surgery will be covered by a government plan. Current law also disallows a deduction for various artificial methods of reproduction, which can be very expensive in some cases. The gay community objects, claiming that "artificial" methods are their only avenue for reproduction. I doubt that such expensive procedures will be covered by a national plan, and I do not see the tax issue changing as a result of the adoption of a government insurance plan of some kind.