Taxation, Fall 2005
Prof. McIntyre

Notes on the Answers

1. *Boris Opens a Restaurant.*

A. The payment of $2,000 to the real estate agent for locating the property is a capital expense, written off over the life of the lease (3 years). The lease payment of $4,000 per month for the first three months are startup expenses, treated under Code § 195. They are deductible ratably over a 15 year period, with a special rule in the first year allowing up to $5,000 to be deductible for persons with income under $50,000. The least payments for the remaining of the years are deducible as ordinary and necessary business expenses under Code § 162.

B. The $10,000 paid to employees for the startup period are treated under Code § 195. See above.

C. The costs of redoing the restaurant are capital expenses, added to basis and written off over their life. I think they should be written off over the 3-year lease period, but I gave credit for those who wanted to write them off over a longer period as leasehold improvements.

D. The cost of the "Goos" name and associated good will is deductible ratable over 15 years under Code § 197.

Notes. The answers to A and B depend on whether or not Boris is starting a new business. I think it is clear from the facts that he is, even though there was a similar business run by someone else. Thus the expenses otherwise deductible under Code § 162 are startup expenses deductible only under Code § 195. Code § 195 is elective, so an election would have to be made by Boris. That election can be made on an item by item basis. The payments to the real estate agent and to the contractor for the construction work are not startup expenses for purposes of Code § 195 because they would not have been deductible for an ongoing business. That is, both are classical capital expenses, and their treatment is unchanged by Code § 195.

2a. *Possible Gift to Cabbie.*

Under Duberstein, the general test of a gift is whether there was a quid pro quo or disinterested generosity on the part of the giver. Tax people are likely to disagree on this matter. I believe it is a gift. The argument for gift treatment is that there was no quid pro quo because the diamonds had already been restorer to Diamond Guy before the gift was made. No reward or anything was offered. The IRS may contend that Diamond Guy was not motivated by disinterested generosity but rather by the "service" received from Cabbie. The claim would be that the payment is like a taxable tip to a waitress. In my view, however, Cabbie is just doing what he thinks is right and is not in the business of returning diamonds. The payment was not a tip for giving good service as a cab driver but instead was a gift for being a nice person.

Note: Cabbie is not the employee of Diamond Guy, so the rule of Code § 102(c) (denying gift treatment to employees on payments form employers) is not applicable.

2b. *Deduction for Diamond Guy.*

I do not think Diamond Guy should get a deduction. As indicated above, I think the payment of the $10,000 and the diamond bracelet are gifts. Under Code § 274(b), a taxpayer cannot deduct a gift of over $25. For this purpose, a gift is an amount excluded from the income of the donee under Code § 102.

Even if my position is rejected and gift treatment is not permitted, I would not be inclined to allow a deduction. The argument for the deduction is that the payment was for recovery of lost property, which is an ordinary expense. The contrary argument, which I favor, is that the payment is for good will in the community, which is a capital expense. I think it is reasonable to believe that Diamond Guy would not have been well thought of in the community if people learned he had given nothing but a thank you and a hand shake to Cabbie.

3. *Capital Gains for Music Composers, Etc.*

The bill gives capital gains to a small class of taxpayers (creators of musical works) who produce assets through their personal service activities. It does not give the benefit to other taxpayers whose efforts produce a saleable asset, such as painters, drafters of architect plans, sculptors, etc. Nor does it give the exclusion to musical performers who are paid for their performance. The bill overrides section 1221(a)(3), which requires, generally, that taxpayers have ordinary income on income generated by personal services even if the personal services result in the creation of an asset. The point of section 1221(a)(3) is to provide equal treatment (ordinary income treatment) to all persons who earn income from personal services. Thus the special treatment of musicians is unfair not only to other artists but to all people who earn their income through the performance of personal services. In addition, by exempting musicians from inventory rule of section 1221(a)(1), the proposed bill is unfair to business earning income through the sale of inventory property.

Notes. The bill does NOT allow musicians to get a charitable deduction for the fair market value of gifts of musical compositions. The point of the proposed amendment to section 170(e)(1) is to preserve current law with respect to charitable donations. This bill is a real bill that did pass the House; it is not some hypothetical bill invented for purposes of the exam.

4. *"Loan" from Supplier to Customer*

The IRS will treat AS receiving $1 million as income in year 2004 under the claim of right doctrine. It would claim that no debt obligation actually arose because no one expected the $1 million to be paid back. Under claim of right, the $1 million would be taxable in full in year 2004. The IRS would not tax AS in 2005 on the apparent canceled debt of $200,000 because its position is that there is no debt (and thus no debt to cancel).

In contrast, AS will want to claim that the $1 million received in year 2004 is a loan, not taxable on receipt. It would have to concede, however, that it would have cancellation of indebtedness income of $200,000 in 2005 under its theory.

I believe the IRS will win. The issue is whether there was a legitimate debt obligation. I do not think there was any real debt because there was never a reasonable expectation that the $1 million would be repaid. In effect, the $1 million is a kickback or discount on products to be purchased in the future.

Note: This question is based in part on *Deihl v. Comm'r*, T.C. Memo. 2005-287 (taxpayer lost in that case, with the advance payment treated as income under the claim of right doctrine). I certainly did not expect anyone taking the exam to have seen this case.