

# Chapter 12 – Personal, Living & Family Expenses

**Deductions for expenses incurred in activities generating income are permitted when:**

- 1 ) §162 – “ordinary and necessary” business expenses; and,**
- 2) §212 – expenses incurred in investments (i.e., non-business activities but activities are engaged in for profit).**

**Cf., §262 – no deduction is permitted for personal, living or family expenses.**

# Child-Care Expenses

Smith v. Commr. P.677

Could a married couple deduct child care expenses since “but for” these expenses the wife (in addition to the husband) could not be employed outside the home?

Held: This is a personal expense (i.e., a personal consumption item) and is not deductible. This is not an “ordinary and necessary expense” in carrying on a trade or business.

The “but for” causation argument is rejected.

# Tax Legislation & Child Care Benefits p.680-681

1) §21 household care credit – possible 35% tax credit for lower income taxpayers, phased out.

Maximum credit: \$3,000 when one child and \$6,000 for more than one child. Credit can also involve the care of an elderly parent living with the taxpayer.

2) §129(a) exclusion is available for benefit of an employer dependent care assistance program.

\$5,000 maximum exclusion. Non-discrimination requirement is imposed. §129(d)(2).

# Clothing Expenses

Pevsner

P.681

Employee of an upscale clothing store was required to buy and wear high fashion (YSL) clothing at work to “project the image.”

She did not wear this clothing after business.

§162 business expense or §262 personal cost?

Apply (1) a subjective (personal preference & the taxpayer’s lifestyle) or (2) an objective test (general acceptability of this clothing)?

Held: Objective test is applicable (5<sup>th</sup> Cir., reversing Tax Court decision). Why?

# Other clothing situations & §162 deductibility?

**Police uniform? Cf., Ms. Pevsner's "uniform"?**

**Formal concert attire for a classical musician?**

**Golf attire for the professional golfer (with branding & identification)?**

**Army fatigue uniform?**

**What about a "loan" of clothing from the employer – constituting gross income (§61)?**

**Should all clothing be assumed to be inherently personal whatever the style and format?**

# Correll case Page 684

## Travelling Expense

Issue re deductibility of “traveling expenses,”  
i.e., meals and lodging expense.

§162(a)(2) permits this deduction when “away  
from home.” Jury verdict for the taxpayer.

On appeal: Is the IRS “sleep or rest rule” a  
valid regulation (6<sup>th</sup> Cir. says no)?

What is the purpose of the “sleep or rest” rule?  
Are significant additional costs incurred then?

Relevance of this rule in the tax administration  
context? Held: This regulation is valid.

Flowers case

P.688

## Commuting Expense

Transportation expenses are deductible when traveling for business purposes. §162(a)(2).

Cf., commuting is a nondeductible expense.

*Flowers* – Lived in Jackson, MS & worked in Mobile, AL. He paid his travelling expenses to commute to & his hotel cost in Mobile, AL.

Was he “away from home” for business?

When travelling was he “in pursuit of business”?

**Holding:** No business relationship for costs to get to job; no decision re definition of “home”?

What if taxpayer has two business locations?

What if Flowers also conducted business in Jackson? And, then he travelled to his other office in Mobile? How create an “office” in Jackson to enable a deduction opportunity?

Are the travel expenses then deductible?

What if the residence location is also a location for a “home office”? Cf., people working from home, e.g., insurance agents.



# Hantzis

P.693

Law student living (with spouse) in Boston and has summer clerkship in NYC. She deducted (under §162(a)(2)) both her (1) transportation, (2) apartment cost, and (3) meals in NYC.

Were these expenses incurred while “away from home”? Was her “tax home” really NYC?

Tax Court permits deductibility.

Reversed: taxpayer was not “away from home.”

Choice of two residences was hers & personal.  
No business connection with Boston location.

# Temporary vs. Indefinite Employment p.697

If holding a temporary job away from home - then deductibility for travel & living costs at the destination location.

Not, however, if an indefinite stay occurs at the new location – treated as if a permanent job.

E.g., North Dakota oil workers in the Bakken field. What if a contract is made for a specified period of service at the destination location?

See §162(a) (flush language) that “temporary” can not exceed one year duration.

# Moving Expenses

## p.698

**§217 re deduction for moving expenses:**

**Deduction if paid for commencement of work as employee or self-employed at new principal place of work.**

**§82 – inclusion of reimbursement; but  
§132(a)(6) re possible exclusion.**

**No §217 deduction for meals. §217(b)(flush).**

**No house hunting or temporary living expenses as deductible.**

# Employer's House Purchase

p.699

**What income tax treatment when employer purchases employee's house at employee's cost and above market value (to facilitate the employee's move)?**

**Treatment to employee re sale?**

**Treatment to employer –**

- cost basis for residence?**
- Deduction for compensation paid?**

# Rudolph case

T&E

p.699

*Writ of certiorari* dismissed as “improvidently granted.” Why? Reference to **Duberstein case**.

Fact finding is subject to the clearly erroneous rule & no deemed importance of this litigation.

Separate opinion: Insurance co. provided trip for agents (and spouses) as a bonus reward.

Douglas dissent: Business sessions were conducted in NYC and on the train. Wife’s expenses are also deductible. She is part of the “community property” team!

# Sanitary Farms (acq.)

## P. 703

**Expenses for African hunting trip paid by Sanitary Dairy as the corporate employer.**

**Dairy claimed deductible amounts paid as advertising expenses for the corporate employer.**

**IRS asserts: (1) no deduction to corp. (dividend?), but (2) income to individuals.**

**Held: (1) valid current advertising expense as deductible, and (2) no individual income – but expense incurred by employees for corporation (i.e., no preponderant “personal element”).**

# Business Lunches – Moss case p.707

Moss as a partner in a defense litigation law firm. Partners (and associates) met for lunch daily at Café Angelo and discussed their cases.

Deduction for these lunches? Consider:

- 1) §262 – no deduction for personal expenses.
- 2) §119 – exclusion for meals provided in kind on “business premises” (to employees only).
- 3) §162(a) – ordinary and necessary business expenses as deductible. No.

**Other relevant considerations?**

# Cohan decision

## p. 711

**Result of this decision:** Some business expenses were incurred and some §162 deduction should be available (even if inadequate records).

**Case remanded to determine an appropriate tax deductible amount.**

**Lack of substantiation did not limit the availability of at least some expense deduction.**

**Does this reward lack of recordkeeping?**

**The response? Code §274 is enacted.**



# IRC §274 – Rules Limiting the T&E Deduction p.712

§274(a)(1)(A) – deduction for entertainment expense only if “directly related” to business.

No “goodwill” entertainment; but, deduction when expenses are in conjunction with a prior or later business discussion. E.g., expenses for Houston Texans/Rockets/Astros tickets.

§274(a)(1)(B) – no deduction for the cost of a facility. E.g., a hunting or fishing lodge.

See §274(a)(2) & (3) – limit also for dues to social and athletic clubs.

# §274(d) Substantiation Requirements

p.714

**No deduction for T&E unless substantiation:**

**(1) time, (2) place, (3) business purpose, (4) amount of the expense, and (5) the relationship to the recipients of the entertainment.**

**Contemporaneous records are required.**

**Per diem reimbursement may be acceptable if the time, place and business purpose are properly substantiated.**

# IRC §274 – Rules Limiting the T&E Deduction

**§274(m)(3) – no travel expense deduction or exclusion for expenses incurred by the spouse - unless the spouse is also on business.**

**See p. 702 (Rudolph case).**

**How facilitate the business status for the spouse?**

# Foreign travel deduction limitation p.714

§274(c) – possible expense limitation if combining business and pleasure and more than a one week trip. How avoid this rule?

Foreign convention limitation – see §274(h).

What is “foreign”? See §274(h)(6) re defining North America.

But, seminars & conventions on cruise ships?  
See §274(h)(2) re U.S. port limitation.

“Luxury water transportation” - §274(m)(1).

Travel as “education”? §274(m)(2). (p.762)

# Reduction for Meals and Entertainment p.715

**§274(n) – only 50 percent of any meal and entertainment expenses allowed as a deduction.**

**Purpose of this limitation?**

**Possible alternative approach: disallow the excess cost over actual cost which would be incurred if no entertainment /business meal?**

**Allocations to deduction/disallowance required when “all-inclusive” price for hotel, meals, etc.**

**Some statutory exceptions - §274(n)(2).**

# Hobby Losses - Bessenyei case

P.719

Was profit the primary goal in her horse breeding activities (&, therefore, conducting a business so losses could offset other income)?

Tax Court held: she did not have an intent to conduct her activities for a profit.

Ct. App.: Tax Court determination was not clearly erroneous. Duberstein case.

See §183 re limitations on deductions for activities not engaged in with a profit motive.

See determinative factors in Reg. §1.183-2(b).

# What income tax effect of “hobby loss” treatment?

Business loss is deductible against other income (e.g., compensation & investment income).

Otherwise, see the limitations in §183(b) re limitations on loss utilization.

How long a period should be allowed for the deduction of “start-up costs”? See §183(b).

Require capitalization of start-up costs? But, then a tax basis for future offset in determining gain realized upon asset dispositions.

How deal with the personal/pleasure element?

# Hobby Losses - P.719

## Reg. §1.183-2(b) Factors

- 1) **Manner in which activity conducted.**
- 2) **Expertise of taxpayer (or advisor).**
- 3) **Time and effort expended.**
- 4) **Expectation that assets will appreciate.**
- 5) **Other business successes of taxpayer.**
- 6) **Taxpayer's history of income/losses.**
- 7) **Amounts of occasional profits**
- 8) **Financial status of the taxpayer.**
- 9) **Elements of persona pleasure.**



# Housing – Loss on Stock Sale & Weir case P.726

Sale of preferred stock in a corporation which owned the building where the taxpayer had an apartment. One objective of the taxpayer's stock ownership was to influence the corporation's management of the building.

Held: Stock was purchased with a profit motive (e.g., to get dividends). Therefore, a (capital) loss deduction (under §165(c)(2)) was allowed when this stock was sold for a loss.

**Later repurchase – no “wash loss.”**

# Personal Residence Purchase & Sale P.729

- 1) Residence held primarily for personal purposes and, therefore, not primarily for investment. Loss on a sale would not be deductible, but (capital) gain is included in gross income. Possible gain exclusion - Code §121.
- 2) What happens when switching from home residence to rental property? Reg. §1.165-9. Possible reduced basis for loss determination.
- 3) What about rental income/deductions during the pendency of a sale of the personal residence?

# Vacation Home & Rental Losses- §280A P.730

**How allocate deductions attributable to rental of a vacation home against both (1) income derived from the rental and (2) other income?**

**Deductions are allowable only to the extent allocable to the rental period.**

**First: allocate the (entire?) statutory deductions (real estate tax and mortgage interest)?**

**§280A(e) - re allocation of maintenance expense.**

**Note rule re less than 15 days rental - §280A(g).**

# Home Offices §280A(a) Drucker (1983) p.733

**Taxpayer as a musician employed by the Metropolitan Opera. Required to practice at his home since no available facilities at the employer's location. Tax Court held primary place of taxpayer's business was at the Opera.**

**Reversed on appeal: Taxpayer needed to maintain a residential space for practice and his home was the principal place of business.**

**Deduction permitted (by 2<sup>nd</sup> Cir) for expenses attributable to that portion of the dwelling unit.**

# Office in the Home

## §280A(a)

Disallows all §§162, 165, 167, 168 and 212 deductions for a home office or work area in a personal residence. Why? Cf., §262.

What if office is “principal office” for trade or business of the taxpayer? §280A(c)(1)(A).

See §280A(c)(1) permitting a home office deduction if used for meeting customers.

Deduction is limited to offsetting the gross income from that activity (not other income).

§280A(c)(5) & allocation (§280A(c)(4)(C)).

# Limit on §280A deduction re Home Office Expense

**§280A(c)(5) provides for a limit on the office in the home deductions:**

- 1) First deductions are those allocable to the statutory deductions (e.g., taxes and interest).**
- 2) Additional deductions are proportionately allocated to the business use portion.**
- 3) Possible carryover of unused deductions to succeeding tax year..**

# Soliman case Sup. Ct. 1993

P.736

Anesthesiologist spent predominant amount of time in hospital but used “office in the home” for handling administrative details of his medical practice. Claimed expenses relating to use of home space for these business purposes.

Tax Court says home office is principal place of business. Aff’d by Ct. of Appeals.

Code §280A refers to “principal place of business” and Sup. Ct. reverses – based on hospital being the principal place of business.

# Rev. Proc. 2013-13

## Home Office Safe Harbor

Safe harbor permitted of \$5 per square foot up to a maximum of 300 square feet.

This is an alternative to the calculation of actual home office expenses.

Still must be exclusive use on a regular basis of this office in the home.

Deduction can not exceed the gross income derived from activities in that office in home (& no carryover of the excess to a later year).



# Possible Rental to the Employer?

P.745

**§280A(c)(6) precludes circumventing §280A limitation on housing cost deduction by:**

- 1) Renting home office space to the employer, and, then,**
- 2) Taking an income tax deduction for the costs of rental component of the residence (when including rental income from employer).**

# Litigation Expenses

## “Origin of Claim” Doctrine

U.S. v. Gilmore (p. 745) & Code §212(2).

What is §212(2) deductibility of the husband's expenses for attorney's fees for his successful resistance to ex-wife's community property claims in divorce proceeding? No deduction.

The husband's property consisted of interests in three corps. holding auto dealerships.

The “origin of the claim” doctrine (a personal divorce matter involved here) applies to deny an income tax deduction for his attorney's fees.

Patrick case

P.751

## Fees for Wife's Expenses

Divorce proceeding and amounts paid for (1) rearranging stock ownership in a privately held corporation, and (2) concluding the lease of real property to assure long term rental income stream into a trust.

Held: These costs were also incurred incidental to divorce litigation and this divorce origin controlled the tax characterization of these costs as deductible or nondeductible.

Difference here – as compared to Gilmore?

# Hunter case

## P.753

**No deduction (under § 212) for the costs of obtaining a reduction of alimony (i.e., a reduction of his alimony income tax deduction and, thereby, increasing the taxpayer's income stream).**

**Held: For §212 the deduction for the cost of the production of income means the creation of gross income and not the reduction of liabilities.**

**Is this the correct result?**

# Wild Case Acq. Divorce Proceeding P.753

Wife reported alimony payments as gross income. Also, she claimed a deduction for attorney fees for services in negotiating alimony payments to be received.

Taxpayer asserts legal fees were incurred to produce the alimony income & §212 deduction.

See Reg. §1.262-1(b)(7), p. 754, re deductible attorneys fees for collection of income (alimony).

Regs. (p.754) not changed after Gilmore case.

**Dissent: Gilmore controls & no deduction.**

# Gilmore case revisited

## P.758

**Should Gilmore's (non-deductible) costs in the divorce proceeding (because of "origin of the claim") be additions to tax basis for the property that was being protected from transfer to other spouse in the divorce proceeding?**

**Court says yes, p. 758? Correct result?**

# Education and Training

## P.759

Jorgensen case – p. 759

Courses taken in Greece and Southeast Asia by English teacher to enhance her skills.

Held: 1) Deduction not barred by §274(m)(2).

2) §162 expenses to improve her skills as a teacher. These are fact questions. Satisfying both the ordinary and the necessary standards.

3) Also, reasonable in amount (fact question).

An educational purpose was documented for these expenses under Reg. §1.162-5.

# Expenses of Education as Deductible

Query re these expenses: Incurred to improve specific skills required in employment and, therefore, deductible under Reg. §1.162-5?

Courses merely to improve general competence are not deductible.

What about law school tuition? Capitalize? (*next slide*).

What about LLM (tax) degree tuition costs?

What about CLE program costs to an attorney?



# Capital Cost Recovery

## P.770

If capitalization is required (permitted?) then enable amortization over some specific period?

Or, should these costs be “frozen” (similar to, previously, goodwill) subject to abandonment loss at time of retirement (e.g., giving up one’s bar license)? Or, on one’s final income tax return?

E.g., law school tuition and bar admission fees to be spread over the working career of the attorney (or deductible at retirement)?

# Tax Benefits for Education

p.772

- 1) §127 – educational assistance programs – up to \$5,250 per year.
- 2) Scholarships – if qualified, excluded from gross income under §117. Previously noted at p. 189. To be used to pay for tuition and fees and books, etc., but not for room and board.
- 3) No COD income for cancellation of certain student debt (e.g., community service provided). §108(f). P. 774.

# Direct Payment of Tuition and Fees

p.774-5

- 1) **Hope Scholarship credit –nonrefundable credit of 100 percent for first \$2,000 of qualified tuition, etc., and 25% of next \$2,000. §25A(b) & (f). Four 1<sup>st</sup> four years of post-secondary education.**
- 2) **Lifetime Learning Credit - 20% credit for up to \$10,000 of qualified tuition and related expenses.**

**Both credits are subject to income phase-outs.**

# §222 deduction for qualified tuition p.776

**Limited deduction for higher education expenses: \$4,000 for taxpayer with AGI below \$65,000 (\$130,000 for joint return) and \$2,000 with AGI below \$80,000 (but above \$65,000; \$160,000 for joint return).**

**Not a phase-out, but a “notch” and “cliff” provision.**

**§222 extended thru 2016 in PATH 2015.**

**No §222 deduction if a §25A credit is claimed.**

# Educational Savings Programs

p.777

**1) §135 – gross income exclusion for U.S. savings bond proceeds used to pay higher education expenses.**

**Limitation (with inflation adjustment) based on adjusted gross income, subject to an income phase-out.**

**2) Coverdell education savings accounts - §530. Account exempt from tax; \$2,000 annual contribution limit; used for qualified educational expense (including below college).**

# §529 Qualified Tuition Program

## p.778

How established? “Texas Tomorrow Fund,” and others (non-governmental funds)?

- Income realized in the account accrues exempt from §61 gross income inclusion.
- Distributions are tax-free if made for qualified educational expenses.
- Donor controls investment policy & can change beneficiaries for the 529 account (within the family).
- Gift tax and estate tax considerations.

# Chapter 12