

Chapter 2

The Tax Practice Environment

Solutions to Develop Research Skills

Note to Instructor: Many of the research problems can be solved using sources that are available on the Internet at no charge. URLs for these free sources are shown in Figure 2.2 of Chapter 2 in the text. The solution for each problem indicates if it can be solved using free Internet sources or if it requires access to *Checkpoint®* or a similar service. The research process for solving a sample problem is illustrated in Appendix A through screen captures for *Checkpoint®*.

56. *Deducting Cosmetic Surgery (can be solved using free Internet sources)*

Your client, Ms. I.M. Gorgeous, is an aspiring actress. She has managed to earn a living doing television commercials but was unable to get the acting parts she really wanted. She decided to have botox injections in her forehead and collagen enhancements to her lips. After these procedures, her career improved dramatically and she received several movie offers. Ms. Gorgeous is sure that she should be able to deduct the cost of the cosmetic enhancements because she read about another actress having a face-lift in 1988 and deducting the cost on her tax return as a medical expense. Can Ms. Gorgeous deduct the cost of these procedures?

Research Aids: Section 213(d)(9).

Issue: Can Ms. Gorgeous deduction the cost of the botox injections and collagen enhancements as medical expenses?

Conclusion: Ms. Gorgeous will not be allowed to deduct the cost of botox injections and collagen enhancements.

Discussion of Reasoning and Authorities: Code Section 213 allows a deduction for expenses paid for medical care of the taxpayer. Section 213(d)(1)(A) defines medical care as amounts paid “for the diagnosis, cure, mitigation, treatment, or prevention of disease or for the purpose of affecting any structure or function of the body.”

Rev. Rul. 76-332, 1976-2 C.B. 81 allowed a deduction for cosmetic surgery for a face-lift under Section 213. However, the Code was subsequently amended by the Revenue Reconciliation Act of 1990.

Under §213(d)(9)(A), no deduction is allowed for cosmetic surgery or other similar procedures, unless the surgery or procedure is necessary to ameliorate a deformity arising from, or directly related to, a congenital abnormality, a personal injury resulting from an accident or trauma, or disfiguring disease. Section 213(d)(9)(B) defines cosmetic surgery as any procedure which is directed at improving personal appearance and does not meaningfully promote the proper function of the body or prevent or treat illness or disease. Thus, no deduction will be allowed.

57. *Deducting Bad Debt Loss (can be solved using free Internet sources)*

Last year your client, Barney Bumluck, worked part-time for Timely Tax Return Preparation Service. Barney was promised an hourly wage plus a commission. He worked under this arrangement from early February until April 15. His accrued pay amounted to \$900 plus \$120 of commissions. When he went to collect his pay, however, he found only a vacant office with a sign on the door reading “Nothing is sure but death and taxes.” Can Barney take a bad debt deduction for the wages and commission he was unable to collect?

Research Aids: Reg. Section 1.166-1(e)

2 Taxation for Decision Makers Research Solutions

Issue: Can Barney take a bad debt deduction for the wages and commission he was unable to collect?

Conclusion: Barney will not be permitted a deduction since the wages and commission were not previously included in his return as income.

Discussion of Reasoning and Authorities: Under Reg. §1.166-1(e), worthless debts arising from unpaid wages, salaries, fees, rents, and similar items of taxable income shall not be allowed as a deduction unless the income has been included in the return of income for the year for which the deduction as bad debt is claimed or for a prior taxable year. Because Barney did not previously include the wages or commission in income, he is not entitled to a deduction for his inability to collect these items.

58. *Deducting Charitable Contributions (can be solved using Checkpoint® or a similar service)*

Your clients, Sonny and his wife Honey, believe in worshipping Ta-Ra, the Sun God. To practice their religious beliefs, they take a weeklong trip to Hawaii to worship Ta-Ra. The cost of this pilgrimage (including airfare, hotel, and meals) is \$2,800. Sonny wants to know if he can deduct the cost of this trip as a charitable contribution.

Research Aids: *Kessler*, 87 T.C. 1285 (1986)

Issue: Can Sonny and Honey deduct their trip to Hawaii as a charitable contribution made in the practice of their religion?

Conclusion: No deduction will be allowed because no donation was made directly to a qualified charitable organization.

Discussion of Reasoning and Authorities: In *Kessler*, 87 T.C. 1285 (1986), the Tax Court disallowed a charitable deduction for the expenses incurred for a trip to Puerto Rico. The Court denied the deduction because there was no donation made to a religious organization as defined by Code §170(c)(2)(B). The Court based its decision on precedent and Congressional intent stating that the purpose of the charitable contribution can only be furthered if the government can be assured that the funds are appropriately expended. This can be done only if contributions are made to a qualified organization that can be audited and examined. Since Sonny and Honey's expenses were not contributions or gifts to an organized entity, the expenses do not qualify under §170 as a charitable contribution.

59. *Trade or Business versus Hobby (can be solved using Checkpoint® or a similar service)*

Fred Fisher is a licensed scuba diver who lives in Key Largo. He is employed full-time as an engineer. Five years ago he had been employed as a professional diver for a salvage company. While working for the salvage company he became interested in marine archaeology and treasure hunting. Until last year he gave diving lessons on weekends and trained individuals in the sport of treasure hunting under the name of "Fred's Diving School." Three of the diving students he taught subsequently found shipwrecks. Fred generally did not engage in recreational diving.

Last year, Fred began a treasure hunting business named "Treasure Seekers Company." He bought a boat specifically designed for treasure hunting and did extensive research on potential locations of shipwrecks. Fred located several shipwrecks, but none were of substantial value. He did retrieve several artifacts but has not sold any yet. Although these artifacts may have some historical significance, they have a limited marketability. Thus, Fred has not yet had any gross income from his treasure hunting activities.

Other than retaining check stubs and receipts for his expenses and an encoded log, Fred did not maintain formal records for Treasure Seekers Company. Fred maintains as few written records as possible because he fears for his safety. He took steps to keep his boat and equipment from public view and took precautionary measures to maintain the secrecy of his search areas. Fred incurred \$5,000 of expenses relating to his treasure-hunting activities last year. Can Fred deduct the expenses of his treasure hunting business or will the IRS claim it is a hobby and disallow the expenses?

Research Aids: *Randy R. Reed, III*, T.C. Memo 1988-470, 56 TCM. 363, PH T.C. Memo ¶88470

Issue: Can Fred deduct the expenses of his treasure hunting as business expenses?

Conclusion: Yes, Fred should be able to deduct his expenses as trade or business expenses.

Discussion of Reasoning and Authorities: Section 162 allows a deduction for business expenses that are ordinary, necessary, and reasonable in amount. Reg. §1.183-2(b)(1)-(9) lists a number of factors that should be considered in determining whether an activity is a trade or business, or should be classified as a hobby. These include:

- (1) Manner in which the taxpayer carries on the activity.
- (2) The expertise of the taxpayer or his advisors.
- (3) The time and effort expended by the taxpayer in carrying on the activity.
- (4) Expectation that assets used in the activity may appreciate in value.
- (5) The success of the taxpayer in carrying on other similar or dissimilar activities.
- (6) The taxpayer's history of income or losses with respect to the activity.
- (7) The amount of occasional profits, if any, which are earned.
- (8) The financial status of the taxpayer.
- (9) Elements of personal pleasure or recreation.

The Tax Court's decision in *Randy Reed III*, 56 CCH T.C.M. 363, PH T.C. Memo ¶88,470 (1988) examines a situation very similar to that of Fred Fisher. In this case, a treasure hunter was an experienced diver and had personally trained other divers in the field of treasure hunting. His diving did not appear motivated by recreational intentions. He kept a checkbook separate from his personal account, maintained receipts and check stubs for his expenditures and kept a partial log book of his activities until his maps were stolen. Reed said that he kept limited records for security reasons. While not extensive, these records were held to be adequate for a sole practitioner in this type of business with a low volume of transactions, and Reed was allowed to deduct his expenses as those of a trade or business. In that the facts pertaining to Fisher's situation are nearly identical to Reed's, Fisher should be able to deduct the expenses of his treasure hunting business as valid business expenses.

60. *Locate and Read Court Cases (can be solved using free Internet sources)*

Locate and read *Greg McIntosh*, TC Memo 2001-144, 81 TCM 1772, RIA TC Memo ¶2001-144 (6/19/2001). Answer the following questions.

- a. What requirements must be met for a taxpayer to recover litigation costs from the IRS?
- b. Was the taxpayer in this case able to recover his attorney fees from the IRS? Why or why not?

Solution:

- a. Under Code Section 7430(a), a judgment for litigation costs incurred in connection with a court proceeding may be awarded only if a taxpayer: (1) is the "prevailing party"; (2) has exhausted his or her administrative remedies within the IRS; and (3) did not unreasonably protract the court proceeding. To be a prevailing party, the taxpayer must substantially prevail with respect to either the amount in controversy or the most significant issue or set of issues presented and satisfy the applicable net worth requirement.
- b. The taxpayer was not able to recover his attorney fees from the IRS because he was not found to be the "prevailing" party. In this case, the court found that the IRS's positions on the disputed issues were reasonable positions sufficiently supported by the facts and circumstances in the taxpayer's case and the existing legal precedent. Since the IRS's positions were found to have been reasonable, the court could not find the taxpayer to be the "prevailing" party.

This decision was affirmed in 91 AFTR 2d 2003-1275, 2003-1 USTC ¶50,334 (CA9, 3/7/2003)

4 Taxation for Decision Makers Research Solutions

61. *Locate and Analyze Court Cases (can be solved using free Internet sources)*

Locate and read the following two cases:

J.B.S. Enterprises, Inc., T.C. Memo 1991-254, 61 TCM. 2829, 1991 PH T.C. Memo ¶91,254

Summit Publishing Company, Inc., T.C. Memo 1990-288, 59 TCM. 833, 1990 PH T.C. Memo ¶90,288

List those facts that you feel most influenced the judges to reach different conclusions in these two cases.

Solution:

Facts

Person who received salary

J.B.S. Enterprises

Former spouse of sole shareholder

Summit Publishing

Spouse of sole shareholder

Services performed for salary

None

Extensive valuable services

Dividend history

Not mentioned

Substantial dividends paid

The court allowed a deduction for expenses in Summit Publishing for a portion of the payments that the IRS argued were unreasonable compensation. The Court noted how valuable the shareholder's spouse's services were to the firm and that dividends had been paid to the shareholder. In *J.B.S. Enterprises*, the sole shareholder seemed to be attempting to disguise support payments made to his former wife as salary expense. However, she performed no services for which compensation would normally be paid.