TAX UPDATE

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Sad Story of the Superintendent and Section 62
January 28, 2006

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I often tell clients that Congress really doesn't like employees—and that there's lots of support for this position in the Internal Revenue Code, though I know my Congressman and both Senators from Arizona would likely disagree with that characterization of their position. These problems have been made worse as more taxpayers skate close to (or actually become subject to) the alternative minimum tax (and may become significantly worse if Congress doesn't actually get around to extending the AMT relief that expired on December 31, 2005, though it seems very likely they will fix this unless they have a total meltdown in hammering out the reconciliation bill).

In the case we'll look at this week, a field superintendent who believed he had found a way around these problems was corrected by the Tax Court. The case is *Alley v. Commissioner*, (TC Summary Opinion 2006-4).[1] I suspect Mr. Alley would agree with

1 Obviously the opinion does not constitute precedent. But it does provide an interesting analysis of real world set of facts with the actual decision that was arrived at. This week, at the Arizona Society's Arizona Department of Revenue's Liaison meeting, Frank Migray of the Department of Revenue made the point that he thought all such material, even if not precendential, from his perspective was potentially useful because it gave information on applying facts to the law. Obviously, he was talking from a state law view, but the same concept would apply at the federal level.

my characterization of Congress's feelings for employees.

Business Deductions and the Employee Under the IRC

Business deductions generally are governed by Internal Revenue Code §162. The good news is that, if you study §162, you'll find the general rule under §162(a):

> **162(a)** IN GENERAL. --
>
> There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including --
>
> **162(a)(1)** a reasonable allowance for salaries or other compensation for personal services actually rendered;
>
> **162(a)(2)** traveling expenses (including amounts expended for meals and lodging other than amounts which are lavish or extravagant under the circumstances) while away from home in the pursuit of a trade or business; and
>
> **162(a)(3)** rentals or other payments required to be made as a condition to the continued use or possession, for purposes of the trade or business, of property to which the taxpayer has not taken or is not taking title or in which he has no equity.
>
> For purposes of the preceding sentence, the place of residence of a Member of Congress (including any Delegate and Resident Commissioner) within the State, congressional district, or possession which he represents in Congress shall be considered his home, but amounts expended by such Members within each taxable year for living expenses shall not be deductible for income tax purposes in excess of $3,000. For purposes of paragraph (2), the taxpayer shall not be treated as being temporarily away from home during any period of employment if such period exceeds 1 year. The preceding sentence shall not apply to any Federal employee during any period for which such employee is certified by the Attorney General (or the designee thereof) as traveling on behalf of the United States in temporary duty status to investigate or prosecute, or provide support services for the investigation or prosecution of, a Federal crime.

However, the problem becomes where you can deduct the expenses if you are an employee.

Above or Below the Line?

As we are all aware, deductions for individuals go either "above the line" (in computing adjusted gross income) or "below the line" (as an itemized deduction listed on Schedule A). So just how is it determined which deductions end up above or below that line? If

you go looking for the answer in the individual code provisions that provide for various deductions, you'll find the answer is not there—nothing in the text of §162 tells us if that deduction ends up above or below the line.

Rather, the answer for where a deduction ends up is found at §62 of the Internal Revenue Code. That section provides a list of items that are allowed in computing adjusted gross income for an individual. For individuals, *the default is that any deduction allowed under the Internal Revenue Code is an itemized deduction unless listed on that schedule*.

So what's the answer for Section 162 expenses? Well, it turns out that answer is a split one. We find in §62(a)(1) which provides the following are deductible in computing adjusted gross income:

> 62(a)(1) TRADE AND BUSINESS DEDUCTIONS. --
>
> The deductions allowed by this chapter (other than by part VII of this subchapter) which are attributable to a trade or business carried on by the taxpayer, *if such trade or business does not consist of the performance of services by the taxpayer as an employee*.

As I noted—Congress does not like employees, and they demonstrate that clearly here. Itemized deductions are inherently less valuable than above the line deductions for a number of reasons—first, many tax benefits are tied to the level of adjusted gross income an individual reports. So by moving a deduction below the line, a taxpayer may find they can no longer made a Roth IRA contribution, can no longer deduct losses from active rental real estate, obtain the benefit of various education credits, etc.

Second, some itemized deductions are limited based on having to exceed a percentage of adjusted gross income, meaning they get a double hit by moving below the line—not only do they potentially cause the taxpayer the loss of benefits noted above, they themselves may be eliminated or reduced by the fact that adjusted gross income just went up.

Third, taxpayers are automatically granted a standard deduction by §63(c), so unless they have enough overall itemized deductions to exceed the standard deduction amount, they may receive no benefit for those deductions—or the benefit may be effectively reduced since they only get a real benefit for the excess of the itemized deductions over the standard deduction.

Fourth, itemized deductions are further limited for taxpayers with income above specified levels by the "phase out" of itemized deductions found at §68.[2] The itemized deductions affected are generally those not already limited based on a percentage of adjusted gross income with one major exception (and, remember, Congress does not like employees).

2 Note this provision is scheduled to be phased out over the next few years, eliminated in 2010, and then, like the estate, return full force in 2011.

Miscellaneous Itemized Deductions

But it gets worse for an employee. While itemized deductions are disadvantaged by the Internal Revenue Code in general, some are more disadvantaged than others. Particularly disadvantaged are the class of deductions known as "miscellaneous itemized deductions" which have two major problems.

First, they are only deductible to the extent they, as a whole, exceed 2% of adjusted gross income (see §67(a)). Unlike most limited deduction, these are also not removed from the §68 phase out of the benefit of itemized deductions—so they get hammered twice by an increase in adjusted gross income.

Second, and becoming increasingly important, they are not deductible in computing the alternative minimum tax, per §56(b)(1)(A)(i). The alternative minimum tax has become an increasing problem in recent years, with more taxpayers being subject to the AMT and a large number of taxpayers sitting on precipice of being subject to the tax.

So what is a miscellaneous itemized deduction? Well that is defined in §67(b), using that favorite technique of Congress of first telling you *everything* fits the definition, then listing a group of items that will be specifically *excluded* from the definition.

That list of "blessed" items is found at §67(b):

> **67(b) MISCELLANEOUS ITEMIZED DEDUCTIONS.** --For purposes of this section, the term "miscellaneous itemized deductions" means the itemized deductions other than --
>
> **67(b)(1)** the deduction under section 163 (relating to interest),
>
> **67(b)(2)** the deduction under section 164 (relating to taxes),
>
> **67(b)(3)** the deduction under section 165(a) for casualty or theft losses described in paragraph (2) or (3) of section 165(c) or for losses described in section 165(d),
>
> **67(b)(4)** the deductions under section 170 (relating to charitable, etc., contributions and gifts) and section 642(c) (relating to deduction for amounts paid or permanently set aside for a charitable purpose),
>
> **67(b)(5)** the deduction under section 213 (relating to medical, dental, etc., expenses),
>
> **67(b)(6)** any deduction allowable for impairment-related work expenses,
>
> **67(b)(7)** the deduction under section 691(c) (relating to deduction for estate tax in case of income in respect of the decedent),
>
> **67(b)(8)** any deduction allowable in connection with personal property used in a short sale,
>
> **67(b)(9)** the deduction under section 1341 (relating to computation of tax where

taxpayer restores substantial amount held under claim of right),

67(b)(10) the deduction under section 72(b)(3) (relating to deduction where annuity payments cease before investment recovered),

67(b)(11) the deduction under section 171 (relating to deduction for amortizable bond premium), and

67(b)(12) the deduction under section 216 (relating to deductions in connection with cooperative housing corporations).

As you can see, employees business expenses generally don't make this list, with the sole exception of §67(b)(6)'s limited provision. Congress truly does hate employees, at least if you look at the results we obtain from the laws they have passed.

A Fix?

Back in July, I did a podcast on one potential solution for this problem—that is the accountable plan under §62(c). Rather than repeat that information, you can go to the podcast website and review the materials and audio there. That website is:

http://ezollars.libsyn.com/index.php?post_id=13485#

The Superintendent's Other Solution

Mr. Alley came up with another solution—at least the way he viewed it. Mr. Alley was a field superintendent responsible for on-site job management. His employer did not have a formal written reimbursement plan. However, there was a verbal agreement that the employer would pay its employees $25 a day for personal use of their vehicles while driving on company business.

The IRS and Mr. Alley agreed prior to trial that Mr. Alley had incurred over $25,000 of truck expenses for the two years, which is initially interesting since it would suggest that either a) Mr. Alley had fully complied with the documentation requirements of §274(d) for the use of listed property or b) the IRS just decided not to raise the issue (and the latter would seem unlikely, given other cases on automotive expense in front of the Tax Court).

Mr. Alley argued that he was in the business of leasing his vehicle to his employer—after all, they were paying $25 per day for the use of his vehicle. If that was true, then he would be in a trade or business other than that of an employee for these purposes, thus escaping the wrath of §62(a)(1)'s exclusion for employees and getting the §162 deductions above the line.

Unfortunately for Mr. Alley, the Tax Court didn't accept his view of the nature of this transaction. The judge looked at two key criteria—did he lease his vehicle to his employer and, if he did, did he have a profit motive in doing so?

The profit motive criteria the court explained as follows:

> This Court in Kurkjian v. Commissioner, 65 T.C. 862, 868 (1976) (quoting *Hirsch v. Commissioner*, 315 F.2d 731, 736 (9th Cir. 1963), affg. T.C. Memo. 1961-256), stated:
>
> From the very import of Section 23 [referring to sec. 23(a)(1)(A), the 1939 Code predecessor of sec. 162(a)], which presupposes that the taxpayer has received taxable income before deductions can be taken therefrom, it is clear that Congress intended that the profit or income motive must first be present in and dominate any taxpayer's "trade or business" before deductions may be taken. While the expectation of the taxpayer need not be reasonable, and immediate profit from the business is not necessary, nevertheless, the basic and dominant intent behind the taxpayer's activities, out of which the claimed expenses or debts were incurred, must be ultimately to make a profit or income from those very same activities. * * * Absent that basic and dominant motive, the taxpayer's activities, no matter how intensive, extensive or expensive, have not been construed by the Courts as carrying on a trade or business within the purview of Section 23. * * *

The court then analyzed Mr. Alley's actions:

> During taxable years 2000 and 2001, petitioner did not lease any other vehicles. Petitioner testified: (1) He did not try to lease his truck to any other individual; and (2) there was no formal written lease between himself and his employer. Furthermore, petitioner did not negotiate leasing terms with his employer; instead, he was paid a flat rate of $25 per day for the use of his personal vehicle in furtherance of Pacific's business. The flat rate of $25 per day could be received by any employee of Pacific who used his or her personal vehicle in furtherance of Pacific's business.
>
> Based upon on the record in this case, we conclude that petitioner did not possess the required profit or income motive when he used his personal vehicle in furtherance of Pacific's trade or business. In fact, we find that petitioner did not enter into any lease with his employer. Further, we conclude that petitioner's use of his personal vehicle in furtherance of Pacific's trade or business was within the scope of his activities as an employee of Pacific and that petitioner was not individually and independently in the business of leasing his truck to his employer.

Planning Points

A couple of points are important to note for planning purposes.

- Just labeling something as what you'd like it to be most likely won't work. While a written lease likely wouldn't have saved Mr. Alley due to the profit motive

analysis, the lack of one was a significant reason why the court decided that there simply wasn't a lease. It's always best if the other party to the transaction agrees with the form the client is arguing.

- Accountable plans, if structured right, are an important way around this problem if the employer is fully reimbursing the expense in question. That doesn't solve the problem if the reimbursement is less than the expense, but employees could attempt to negotiate a full reimbursement as part of their compensation package.
- Be careful with clients that have their own controlled business—often they want to take deductions personally due to a belief that somehow this is a "benefit" to them. Be sure that all business deductions are paid by the company and/or directly reimbursed back to the owner.