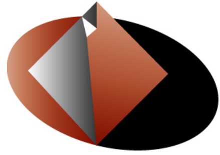
« Back to News 

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Bad Choices Issue: Three Tax Court Cautionary Tales

by David Herzog, Associate

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PLUS!! NOL Update. Individuals Still Have Until October 15

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1. Fooling With Mother Nature: Avoiding Discharge of Debt Income For Disputed Debts

When you have discharge-of-indebtedness income, you are required to recognize as taxable income the extent of the reduction in your obligation. So, if you owed $10,000, and you settled for $7,000, you may have to pay tax on the $3,000 you did not have to pay, like it was income to you. Simple enough.

But if your debt is disputed, you may not be required to pay the tax on the forgiven income. Under this exception, if you, in good faith, dispute the amount of a debt, then the excess of the original debt over the amount determined to have been due is disregarded for tax purposes. So, in my example above, when you pay the $7,000, you will have been deemed to have paid the full amount of the initially disputed debt (which was originally $10,000). There is no tax consequence to you. In other words, the $3,000 that you did not pay will not be considered income to you, and so won't be taxable.

In a recent tax court case (TC Memo 2009-199), Mr. and Mrs. Melvin argued that their entire credit card debt of $13,084 was disputed. They had

settled the debt for $4,579, with Chase forgiving the rest. Chase then turned around and issued a 1099-C for the balance, which caused the Melvins to recognize the forgiven amount as taxable income. The Melvins argued that the debt was disputed, and therefore was excepted from taxability. Disputed? Their argument wasn't complex: Because Chase settled the debt, it must have been in dispute. Not so fast, said the court: "The mere fact that Chase settled for less than the full amount of [the Melvins'] debt is insufficient to establish that the debt was disputed." And just so we're clear on whether taxing them on forgiven debt is fair, the court stated, "[The Melvins] received goods and services (and cash advances) on credit; when Chase relieved them of their corresponding obligation to pay, petitioners without question received an "accession to income".

Moral of the Story: First, if a debt, or part of a debt is cancelled, you may have taxable income. Second, if the debt is genuinely disputed, you may avoid that tax. Third, if you think you have a dispute, keep it documented, and any settlement paperwork should clearly state the debt is disputed, and that a 1099 will not be issued.

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2. Hobby Horses: More Pleasure Than Business

Like to ride horses? Like to buy them? Sell them occasionally? Lose some money on the deals? Stop right there, because your next question is: Can I deduct my losses? Can I deduct my losses against my other income? Against my spouse's income? The Rosses tried that, and on September 9, 2009, the tax court said (and I'm paraphrasing): Hay, we don't think so.

Denise Ross liked horses; she liked them ever since she was a girl. In 1999, with her husband's help, she began buying them at auction and selling them through friends. In fact, from 1999 through 2004, she had done such a bad job at trading them, her horse trading ended up netting her losses of over $500,000, which losses she spread out over those five years, writing off those losses against her husband's lucrative medical practice.

The question the tax court wrangled with (TC Memo 2009-201) was whether Ms. Ross was engaged in a business - in which case she could keep her losses - or whether this was just a hobby - in which case her deductions for the hobby's expenses are generally limited to its income, which would erase her $500,000 loss. Generally speaking, if you're looking to extend your expenses into a loss, your activity needs to be engaged in with the intent of making a profit. (Take a look at my previous email regarding hobby losses.) Here, the court noted that Ms. Ross lacked any records, she had no business plan, hired no experts or business professionals to advise her, made no marketing or sales efforts, and generally engaged in the

activity for mostly her own pleasure - she admitted as much. It was an activity, she said, she could share with her sons. Family fun does not a taxable loss make.

Ms. Ross's tax exposure did not end there: the court also determined that she and her husband were subject to a negligence penalty for not keeping accurate books and records. Neigh!!

Moral of the Story: If you plan on using the losses from your activity to write off against your other income, then do not put the cart before the horse by engaging in the activity and then, without any paperwork or evidence of a for-profit intention, attempt to call it a business.

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3. Happy Endings? Not So Much

What do you get when you cross a lawyer with a prostitute? Great tax court fodder!

Mr. Halby, a Brooklyn-based semi-retired tax attorney (yes, tax attorney), deducted medical expenses on his return in an amount exceeding $100,000. These weren't just any expenses: Mr. Halby wrote off $100,000 worth of services from prostitutes and another $7,000 worth for pornography.

And, like any other good taxpayer, kept a journal of his visits and expenses (see Morals above). Not only were his tax returns timely filed, but attached to his schedules were various documents supporting his expenses. (the less said here the better - but they included evidence of bank charges and interest on loans used to pay for his "claimed medical expenses.")

Just in case we aren't all clear on what a medical expense is, here's the definition under the Internal Revenue Code: "Medical care" means 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".

Mr. Halby, according to the tax court (TC Memo 2009-204), "points to book and magazine articles about the positive health effects of sex therapy and argues that we should allow him a deduction despite the illegality of his conduct or the fact that petitioner's doctor did not prescribe this treatment." Again, in case we're not clear: "A taxpayer is not entitled to a deduction for any illegal operation or treatment."

The court then said, oddly enough, that he didn't have a prescription from his doctor. You're telling me all I need is a scrip? The court tacked on a penalty as well, saying Mr. Halby, a tax attorney, should have known better.

Moral of the Story: Please contact your trusted legal and tax advisors before attempting to deduct certain questionable, albeit creative expenses.

NOL Update. Individuals Still Have Until October 15

In my April 27 2009 newsletter, I advised you on the new rules that went into effect to extend the amount of time you could go back to amend your returns for refunds based on losses you were experiencing now. For corporations, the time has passed (September 15). But for individuals, you still have until October 15 to carry back your losses 2, 3, 4, or even 5 years back, to what might have been more profitable years, thereby generating a refund. Stop waiting!

This article is intended as a general guideline. The rules are complex, and changing continually. Please consult your tax advisor.

If you have any questions or suggestions for article topics, please feel free to email David at dherzog@pinnaclelawgroup.com.

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