IN CASE YOU MISSED IT – August 2022

By Ellen S. Brody, JD, CPA, Esq.

Almost every day, federal and state courts issue opinions that affect taxpayers. The IRS and state taxing authorities also publish guidance on myriad topics.

Each month, this column will review a selection of recent court cases or guidance that tax professionals should know about when advising their clients and preparing tax returns.

For more extensive detail on any of these items, please feel free to reach out to the author.

Demuth - Which assets must be included in an estate?

The issue before the court in this case was whether or not 10 checks that were written before the taxpayer died, but had not yet been honored by his bank, were properly includible in his gross estate.

The taxpayer was a Pennsylvania domiciliary. Eight years prior to his death he executed a power of attorney (POA) appointing his son as his agent. The POA specifically authorized his son to make gifts to the taxpayer's issue each year up to the federal gift tax annual exclusion amount. The son did this from 2007 through 2014.

The taxpayer had an investment account at Mighty Oak Strong America Investment Co. ("Mighty Oak") that included a checking feature allowing the taxpayer, or his POA, to write checks against the account. It was evident by September 2015 that the taxpayer was nearing the end of his life. His son wrote 11 checks from the Mighty Oak account on September 6 to various members of the family in an attempt to make the gifts before the taxpayer died. The total amount of the checks was $464,000. By the time the taxpayer died five days later on September 11, only one of the checks had been paid by Mighty Oak.

Three of the checks were allegedly deposited on the morning of September 11, before the taxpayer died, but Mighty Oak did not make payment on those checks until September 14.

When the son prepared the taxpayer's Form 706, United States Estate (and Generation-Skipping Transfer) Tax Return, he excluded the amount of all 11 of the September 6 checks from the value of the Mighty Oak account. After the estate tax return was audited, the Service determined that the estate's assets should have included the value of the 10 checks that had not been paid by Mighty Oak as of the date of the taxpayer's death.

IRC section 2033 provides: “The value of the gross estate shall include the value of all property to the extent of the interest therein of the decedent at the time of his death.” Treasury Regulations expand this definition to specifically include “amount of cash belonging to the decedent at the date of his death, whether in his possession or in the possession of another, or deposited with a bank." Treasury Regulation section 20.2031-5. Thus, the court had to determine if the checks that were written prior to the taxpayer's death represented completed gifts or if the funds that were still in his bank account at the date of death were considered to still be in his possession and control, and therefore should be included in his estate.

Treasury Regulation section 25.2511-2(b) states that a gift will not be treated as having been completed until the donor has “parted with dominion and control as to leave him no power to change its disposition.” Pennsylvania law governed the question in this case as to whether the taxpayer had given up dominion and control of the funds in the bank account when the checks were written and delivered to the payees.

The Pennsylvania Commercial Code allows the person who writes a check to “stop payment of any item drawn on [their] account or close the account by an order to the bank describing the item or account with reasonable certainty received at a time and in a manner that affords the bank a reasonable opportunity to act on it.” 13 Pa. Cons. Stat. § 4403(a) (2015). Under this rule, as long as the check writer can issue a stop-payment order, the delivery of the check is considered to be revocable and not a completed gift. The Pennsylvania code goes on to state that a stop payment order will valid only if the bank has not yet accepted, certified, or satisfied the check. In this case, none of the 10 checks at issue had been presented to Mighty Oak to accept, certify, or make final payment on prior to the taxpayer's death. Thus, the court concluded, a stop-payment order could have theoretically been placed on any of those checks before final payment was made; therefore, under Pennsylvania law, none of the 10 checks at issue represented gifts that were completed prior to the taxpayer's death.

As an interesting side issue in this case, the Service had conceded at trial to exclude from the estate the three checks that had been presented for deposit the morning before the taxpayer died. The court noted that this factor was irrelevant because Mighty Oak had not paid the money over to the depositors' banks by the date of the taxpayer's death. However, the Service did not attempt to withdraw its concession and the estate relied upon the Service's concession when it wrote its briefs. Thus, although the court felt that all 10 checks should have been includible in decedent's gross estate under a proper legal analysis, it upheld the Service's concession and found only the remaining seven checks to be includible in the gross estate.

Takeaway: When preparing estate tax returns, it is important to review balances in the account at the date of death, and careful thought has to be considered as to the proper treatment of additions and subtractions that happen in the days immediately after.

Gonzalez – Taxpayer successfully defends deductions for commuting expenses – when is substantiation substantial enough?

The taxpayer in this case moved from Los Angeles to Palo Alto, California in 2014. Her daughter attended high school in Palo Alto and the taxpayer obtained a full time job at Stanford University. Her job was financial in nature, but she claimed that she also wanted to become a designer of children's clothing. To fulfill that desire, she rented warehouse space in Los Angeles and worked with a patternmaker there to make patterns and samples of her designs. She was able to show her designs in a sample sale in 2015, earning $1,200 in gross receipts.

The taxpayer claimed that she had to go back and forth between Palo Alto and Los Angeles to meet with the patternmaker approximately every other weekend. She would drive 400 miles each way for this business. She would stay with friends and family when meeting with her patternmaker. Although the court seemed somewhat skeptical about her business purpose, the Service agreed that she had could take deductions on a Schedule C for her rental of a warehouse and for advertising and utilities. This concession by the Service colored the rest of the court's determinations.

Although her records seemed primitive, she was able to produce an Excel spreadsheet that purported to be a log of the days that she went to Los Angeles. She also provided logs estimating the miles she traveled and some receipts that related to servicing of her vehicles used in the commute. Code section 162 generally allows a deduction for "all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business." The burden is on the taxpayer to prove that those expenses were of a business nature, rather than personal, and that they were ordinary and necessary. The ability to deduct travel expenses requires even greater substantiation.

Code section 162(a)(2) allows taxpayers to deduct traveling expenses if they are: (1) ordinary and necessary, (2) incurred while away from home, and (3) incurred in the pursuit of a trade or business. A taxpayer's "home" is generally considered to be his or her regular or principal place of business. When a taxpayer engages in business in various locations, her tax home will be where she spends the most time, engages in the most business activity, and derives the most income.

The record was clear that Palo Alto was her tax home. She lived there full time with her daughter who was attending high school there. She had a full-time job in Palo Alto that generated the vast majority of her income (her gross income from the clothing business was only $1,200). She traveled roughly every two weeks from Palo Alto to Los Angeles to conduct business relating to the production of children's clothing. As the Service had allowed the rent and related expenses, the court found that taxpayer was in fact in the clothing design business; also, as the court agreed that Palo Alto was her tax home, they agreed that her time in Los Angeles was time spent "away from home" in pursuit of such business.

She had calculated and deducted car and truck expenses in the amount of $12,256 in connection with her commute. The Service disallowed these expenses in full. Code section 274(d) generally requires strict substantiation for vehicle and travel expenses. The regulations clarify that strict substantiation requires the taxpayer to maintain an account book, a diary, a log, a statement of expense, trip sheets, or a similar record prepared *contemporaneously* with the expenditure and to also provide documentary evidence (e.g., receipts or bills) of certain expenditures. Treas. Reg. section 1.274-5(c)(2)(iii); Temp. Treas. Reg. section 1.274-5T(c)(2).

The court found that her mileage log detailing the dates and distance traveled, coupled with an explanation of the purpose of each trip, accompanied by her vehicle service receipts corroborating the number of miles driven, and her credible testimony about the business nature of her trips, satisfied that the expenses qualified both under Code section 162 as ordinary and necessary business expenses, and that her documentation met the strict substantiation requirements of Code section 274(d). Thus she was entitled to deduct $12,256 in car and truck expenses for the year in issue.

She also deducted travel expenses totaling $1,800. Rev. Proc. 2011-47 provides that a self-employed individual can deduct meal and incidental expenses computed at the federal standard per diem rate that is in effect for each calendar day of travel away from home. This is dependent on where the travel is to. Similar to the car and truck expenses, in order to take this deduction, the taxpayer had to substantiate the time, place, and business purpose of her travel. She was able to provide a contemporaneous log estimating her claimed meals and incidental expenses using the Los Angeles per diem rate. As she was able to explain the time, place, and business purpose of her travel, she was entitled to the deductions. Note that she did not have to provide any additional receipts as Code section 274(d) does not require stricter substantiation for meal and incidental expenses if they are computed using the federal standard per diem rate.

Accordingly, petitioner was entitled to deduct $1,800 in travel expenses for the year in issue as well.

Takeaway: This case shows the importance of a contemporaneous log as that was her main source of evidence. Both of these cases were partially won by the taxpayer due to concessions by the Service that the court might not have otherwise upheld if the Service had changed their approach at trial or brief.

Ellen S. Brody, JD, CPA, Esq., is a partner at Roberts & Holland LLP. Ms. Brody can be reached at (212) 903-8712 or ebrody@rhtax.com.