

IN THE OREGON TAX COURT  
MAGISTRATE DIVISION  
Income Tax

|                        |   |                 |
|------------------------|---|-----------------|
| ORMOND H. ORMSBY       | ) |                 |
| and BARBARA J. ORMSBY, | ) |                 |
|                        | ) |                 |
| Plaintiffs,            | ) | TC-MD 031082C   |
|                        | ) |                 |
| v.                     | ) |                 |
|                        | ) |                 |
| DEPARTMENT OF REVENUE, | ) |                 |
| State of Oregon,       | ) |                 |
|                        | ) |                 |
| Defendant.             | ) | <b>DECISION</b> |

This matter is before the court for decision following a trial in which Plaintiffs (taxpayers) appealed the audit of their 1998 Oregon personal income tax return by Defendant Department of Revenue (the department).

I. STATEMENT OF FACTS

Taxpayers are married and, in 1998, filed a joint Oregon personal income tax return. In late 2003, the department audited that return. On November 17, 2003, taxpayers filed a complaint in this court, in which taxpayers challenged the department's audit in general. On December 1, 2003, Ronald E. Jackson (Jackson) became the auditor of record for taxpayers' appeal. Three days later, the department filed its Answer, in which it conceded that taxpayers' gross income should be reduced by \$381 and that taxpayers could claim their daughter Brianna as a dependent.

On July 21, 2004, Jackson prepared a final audit report related to taxpayers' 1998 personal income tax return. In that audit, Jackson made adjustments to the original 2003 audit. Most, if not all, of those adjustments were in taxpayers' favor. That audit formed the basis for  
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the department's position at trial, and it is on the basis of that audit that the parties organized their trial presentations.

In 1998, Ormond Ormsby (Ormond) was the CEO and president of United Recycling. Ormond received a salary in the amount of \$1,200 every two weeks from United Recycling. Those payments were paid to Ormond in the form of payroll checks generated by a payroll company. Ormond testified that he received, but did not negotiate, seven of those payroll checks because, as CEO and president of the company, he did not believe that United Recycling could honor those checks on the day that they were issued by the payroll company. Ormond also believed that, because he never negotiated those checks, he was permitted to exclude the net amount of those payroll checks (after withholdings and other deductions) from his 1998 gross income.

On their 1998 Federal Schedule C related to Ormond's financial consulting business, taxpayers claimed a business loss of \$50,972. That loss is based on reported income from the consulting business of \$7,492 and Schedule C expenses of \$58,464. In calculating that loss, taxpayers included expenses that were actually attributable to United Recycling. In addition, taxpayers deducted certain expenses related to lease arrangements between an equipment seller or sellers, Ormond as lessor, and United Recycling as lessee.

Of the \$58,464 in alleged Schedule C expenses, taxpayers only submitted evidence that taxpayers' claim substantiates approximately \$3,100 related to interest and depreciation attributable to those lease arrangements. Despite that lack of substantiation, Jackson conceded that the department would allow taxpayers a \$9,857 Schedule C deduction.

In early 1998, Ormond was injured in a car accident. His physician prescribed physical therapy and a work-hardening regimen. His physician apparently approved of Ormond

continuing his work-hardening regimen at the Multnomah Athletic Club, where taxpayers were members, in lieu of a physical therapist's office in Lake Oswego. On the basis of that approval, taxpayers deducted \$1,543 worth of payments to Multnomah Athletic Club on their 1998 Schedule C. The rationale, at least in part, was that those payments were attributable to medical expenses of Ormond.

In 1998, Barbara Ormsby (Barbara) was a flight attendant for Delta Airlines. Taxpayers claimed that Barbara incurred expenses of \$8,176.60 related to overseas trips she made while working for Delta.

## II. ISSUES

- A. May taxpayers make adjustments to their 1998 personal income for income attributable to non-negotiated payroll checks?
- B. May taxpayers take Schedule C deductions on their 1998 individual income tax returns?
- C. For the 1998 personal income tax year, may taxpayers make a deduction for medical care expenses?
- D. What is the amount of taxpayers' 1998 net Oregon itemized deductions?

## III. ANALYSIS

The Oregon legislature intended to make Oregon personal income tax law identical to the Internal Revenue Code (IRC) for purposes of determining taxable income, subject only to modifications specified in Oregon law. ORS 316.007.<sup>1</sup> As a result, the legislature adopted by reference the federal definitions and code sections relevant to the various personal income tax issues in this case. Unless otherwise noted, the parties agree on the code sections applicable to this dispute. Taxpayers, as the appealing party, bear the burden of proof. ORS 305.427.

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<sup>1</sup> All references to the Oregon Revised Statutes (ORS) are to 1997.

Although taxpayers initially filed their Complaint with respect to the department's original audit, Jackson subsequently updated that audit (final audit). To the extent that taxpayers benefit from the final audit, the court concludes that taxpayers may claim those benefits; therefore, the court will base its findings and conclusions on the court's resolution of taxpayers' disputes vis-à-vis the final audit. The court also concludes that taxpayers may benefit from the concessions made by the department in their answer.

Taxpayers did not dispute Jackson's conclusions that taxpayers should increase their 1998 Schedule D capital gains by \$124 or their taxable pension distributions by \$1,193. On those items, the court concludes that taxpayers have not met their burden of proof necessary to reverse the auditor's conclusions; therefore, taxpayers must include \$124 capital gains on their 1998 Schedule D and include taxable pension distributions in the amount of \$1,193.

At trial, the parties focused their dispute on four issues: (1) whether taxpayers may make adjustments to their 1998 gross income for non-negotiated United Recycling payroll checks; (2) the amount of taxpayers' Schedule C expenses; (3) the deductibility of taxpayer's medical expenses; and (4) the amount of taxpayers' net Oregon itemized deductions. Those issues are taken in turn.

A. *1998 Gross Income*

On their 1998 Form 1040, taxpayers indicated total wage income of \$64,804. Jackson asserted that taxpayers' wage income should total \$70,531. Thus, the parties are apart by \$5,727. The parties attribute that difference to seven payroll checks issued to Ormond by United Recycling during 1998 that taxpayers claim to have never negotiated. The gross amount of each check was \$1200, for a total of \$8,400. (Ptf's Exs 4-10.) The net amount of those checks totals \$6,750.45. (*Id.*)

Taxpayers assert that they were permitted to deduct the net amount of those checks from their income. There was also a claim by Ormond in a letter to the department, dated October 26, 2000, that he took at least some portion of the amount represented by the uncashed checks as an unreimbursed employee expense. (Ptf's Ex 3). That assertion is troubling because, even if the "income" represented by the checks was not legally part of taxpayers' gross income, taxpayers cannot both reduce their income and take a deduction. However, after reviewing the evidence, which is admittedly not without some problems, it appears to the court that although taxpayers did reduce their income by the amount of the non-negotiated payroll checks, they did not also take a deduction for unreimbursed employee expenses.

On the question of whether taxpayers are required to include the gross amount of the non-negotiated checks in their 1998 gross income, the court agrees with the department that taxpayers were in constructive receipt of the income when the checks were placed in their hands. This Tax Court adheres to the position of the Eighth Circuit Court of Appeals, which has stated:

"A check in the hands of a taxpayer ordinarily means that funds are immediately available. Therefore, the general rule is that a check constitutes taxable income to a cash-basis taxpayer *when received*. See *Avery v. Comm'r*, 292 US 210, 215 (1934); *Kahler v. Comm'r*, 18 TC 31 (1952). There are some common sense exceptions to this rule, such as when the payor may be insolvent, see *Lavery v. Comm'r*, 158 F2d 859, 860 (7<sup>th</sup> Cir 1946), or has imposed substantial restrictions or conditions that prevent the taxpayer from receiving funds, see *Bright v. United States*, 926 F2 383, 386-87 (5<sup>th</sup> Cir 1991)."

*Walter v. United States*, 148 F3d 1027, 1029, 98-2 US Tax Cas (CCH) ¶ 50,546 (8<sup>th</sup> Cir 1998) (Citations omitted; emphasis in original).

See also *Ormsby v. Dept. of Rev.*, \_\_\_ OTR \_\_\_ (Nov 24, 2004) (slip op at 7-8).

Taxpayers assert that their situation falls into an exception, arguing that United Recycling's alleged precarious financial position throughout 1998 "imposed substantial

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[hardships] or conditions that prevented taxpayer[s] from receiving funds.” *Walter*, 148 F3d at 1029. The evidence submitted by taxpayers, however, indicates otherwise. Ormond testified that he was a salaried employee of United Recycling and that he received a regular payroll check. The record indicates that those checks were issued every two weeks. Although Ormond claimed that he was unable to negotiate seven of those checks, the last non-negotiated payroll checks in the record is dated November 27, 1998. Implicit in the record, therefore, is the fact that taxpayers were able to negotiate at least two checks in December 1998. That fact, coupled with a lack of any evidence related to the financial condition of United Recycling, leads this court to conclude that taxpayers were in constructive receipt of the amount represented on the non-negotiated payroll checks.

In summary, the court concludes that the gross amount of the non-negotiated payroll checks must be included in taxpayers’ 1998 gross income. The court is unable to discern from this record, however, the actual amount of taxpayers’ gross income. On this record, the court finds that taxpayers have not met their burden necessary to prove that their 1998 gross income should total \$64,804. Although the department submitted evidence that suggests taxpayers’ wage income was in excess of \$72,000, Jackson conceded that taxpayers’ gross income should total \$70,531. On the basis of that concession, therefore, the court concludes that taxpayers’ 1998 gross income was \$70,531.

B. *Schedule C Expenses*

Taxpayers report gross income of \$7,492 on their federal Schedule C. The department does not dispute that claim. However, taxpayers deduct expenses in the amount of \$58,464, for a net loss of \$50,972. The department contends that taxpayers may deduct only \$9,857 in Schedule C expenses.

At trial, Ormond made a number of arguments regarding the deductibility of interest and depreciation related to lease arrangements that he claimed he brokered between an equipment seller, or sellers, and United Recycling. Taxpayers asserted that they made a total of \$6,160 in payments related to those leases. Of that total, Ormond conceded that taxpayers may only claim \$126 for interest and \$2,950 for depreciation. Taxpayers did not provide substantiation for the approximately \$55,500 in remaining Schedule C expenses.

Although the parties presented arguments as to the deductibility of the expenses related to the lease arrangements, the court is not required to address those arguments in this case because taxpayers have not submitted into evidence any substantiation for the vast majority of their claimed deductions. On this record, therefore, the court finds that taxpayers have not met their burden necessary to prove they incurred expenses in the amount of \$58,464 related to Ormond's financial consulting business.

Despite taxpayer's failure to substantiate their Schedule C deductions, Jackson conceded that taxpayers may deduct \$9,857 as valid Schedule C expenses. (Def's Ex P.) Jackson appears, however, to have made a computational error in his final audit report. In that report, Jackson permitted taxpayers to take a Schedule C *loss* – and not merely total expenses – of \$9,857. The result of that miscalculation has the effect of negating taxpayers' stated Schedule C income of \$7,492. The court concludes, therefore, that taxpayers may only claim Schedule C expenses of \$9,857, for a net Schedule C loss of \$2,365.<sup>2</sup>

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<sup>2</sup> \$7,492 (income) - \$9,857 (expenses) = -\$2,365 = net loss of \$2,365.

C. *Medical Expenses*

Taxpayers claimed \$1,543 in payments to the Multnomah Athletic Club as medical expenses. Under 26 USC § 213,

*“There shall be allowed as a deduction the expenses paid during the taxable year, not compensated for by insurance or otherwise, for medical care of the taxpayer, his spouse, or a dependent (as defined in section 152), to the extent that such expenses exceed 7.5 percent of adjusted gross income.”* (Emphasis added.)

Notwithstanding the fact that medical expenses of the nature asserted by taxpayers may not be claimed on Schedule C, taxpayers’ claims for a deduction for medical expenses fail for at least three reasons.

First, the incurred expenses must be for “medical care.” 26 USC § 213. Here, Ormond testified that taxpayers were members of the Multnomah Athletic Club before he used the facility to rehabilitate from injuries sustained in a car accident. Moreover, Ormond testified that he used the facility to entertain clients and for other personal reasons. Taxpayers did not submit any evidence from which the court could conclude that Ormond paid \$1,543 to the Multnomah Athletic Club for medical care.

Second, a taxpayer may only deduct expenses for medical care “not compensated by insurance or otherwise.” *Id.* Ormond testified that he may have received some amount of reimbursement from his insurance carrier. Taxpayers are required to substantiate the amount of their claimed medical care expenses that were not reimbursed by insurance. They did not.

Finally, even if taxpayers were permitted to claim a deduction for the \$1,543 in alleged medical expenses, that amount of expenses does not “exceed 7.5 percent of [taxpayers’] adjusted gross income.” *Id.* In conclusion, therefore, taxpayers may not take a deduction for medical care expenses.

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D. *Job Related Expenses*

Closely related to the above discussion of taxpayers' medical care expenses deduction is the amount of taxpayers' Schedule A deduction. On their 1998 Oregon Form 40, taxpayers claimed a net Oregon itemized deduction of \$30,667. Jackson contended that that amount should be reduced by \$9,184, for a net Oregon itemized deduction of \$21,483. (Def's Ex J.)

The parties focused their arguments in their written submissions and at trial on the deductibility of Barbara's job related expenses. The court is not required to reach that issue, however, because taxpayers did not submit evidence to support any of their federal Schedule A expenses. In particular, although Ormond testified at length as to the nature and general types of trips that Barbara would take for her employer, taxpayers did not substantiate which trips, if any, actually occurred in 1998. Moreover, there are no receipts to prove any expenses were incurred for travel or uniforms.

On this record, the court finds that taxpayers have not met their burden necessary to prove they incurred any of the expenses underlying their calculation of their federal Schedule A deduction. The department has, nonetheless, conceded that taxpayers may claim a net Oregon itemized deduction in the amount of \$21,483. On the basis of that concession, the court concludes that taxpayers may claim a net Oregon itemized deduction in the amount of \$21,483.

### III. CONCLUSION

Based on the foregoing, the court concludes that taxpayers' 1998 Oregon personal income tax return shall be adjusted in accordance with the findings and conclusions of this Decision.

Now, therefore,

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IT IS THE DECISION OF THE COURT that taxpayers' 1998 Oregon personal income tax liability and the amount of their surplus refund, if any, shall be calculated in accordance with the findings and conclusions stated herein; and

IT IS FURTHER DECIDED that taxpayers shall pay interest and penalties, if any, in accordance with the findings and conclusions stated herein.

Dated this \_\_\_\_\_ day of April 2005.

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DAN ROBINSON  
MAGISTRATE

***If you want to appeal this Decision, file a Complaint in the Regular Division of the Oregon Tax Court, by mailing to: 1163 State Street, Salem, OR 97301-2563; or by hand delivery to: Fourth Floor, 1241 State Street, Salem, OR.***

***Your Complaint must be submitted within 60 days after the date of the Decision or this Decision becomes final and cannot be changed.***

***This document was signed by Magistrate Dan Robinson April 29, 2005. The Court filed and entered this document April 29, 2005.***