IN THE MAGISTRATE DIVISION

OF THE OREGON TAX COURT

Small Claims

Income Tax

MIKE R. HUNTER, CPA, PC, MIKE R. HUNTER, and MARSHA J. HUNTER,	)	
Plaintiffs,	)	No. 991451C
v.	)	
DEPARTMENT OF REVENUE, STATE OF OREGON,	)	
Defendant.	)	**DECISION AND JUDGMENT**

Plaintiffs have appealed certain adjustments made by defendant to Mr. Hunter's S Corporation (S corp.) return for 1995 and the resulting adjustments to their personal income tax return for that year. At the trial, held on May 4, 2000, Mr. Hunter testified for the plaintiffs and Nancy Green for the defendant.

STATEMENT OF FACTS

Mr. Hunter has been a self employed accountant in Hermiston, Oregon, for at least 20 years. Mr. Hunter had a 2,000 square foot office building built for him in Hermiston in 1978. He operates his CPA practice out of that building.

In 1982 Mr. Hunter incorporated as Mike R. Hunter, CPA, PC, an Oregon corporation. That entity became an S corp. on January 1, 1989. Plaintiff was and is the sole shareholder.

From 1982 to 1986, the corporation was the operating entity for Mike Hunter's CPA practice. In 1986, Mr. Hunter began operating the CPA practice as a sole proprietorship. The corporation became inactive, having no assets, liabilities, or business activities.

In 1988, Mr. Hunter purchased a 25 foot, two-bedroom travel trailer. Mr. Hunter testified that the cost of the trailer was $7,500. There were no documents to support the purchase. The trailer was used for personal use for roughly two years, for family camping trips and the like. Use of the trailer began to decline because Mr. Hunter's children were growing up.

In 1991, title to the trailer was transferred to the S corp. and the trailer was moved to property owned by Mr. Hunter and located about 10 miles from his office building and personal residence. Mr. Hunter had electric service to the trailer at that site, but no telephone. It is the expenses associated with the use of the trailer, and the subsequent sale, reported as a loss to the corporation, that generated the adjustments prompting the appeal.

After the trailer was moved in 1991, Mr. Hunter testified that he began using it to listen to continuing education tapes and meet with some of his clients. Mr. Hunter testified that he used the trailer in that fashion roughly 30 days per year. Mr. Hunter acknowledges that there was also a personal use of trailer, although he states that use was minimal. Mr. Hunter testified that at one time he had planned to use the trailer to operate as a mobile CPA practice. That plan was never executed.

Mr. Hunter did not keep records of the use of the trailer in terms of what clients he met with or how long those meetings lasted. The corporation did not charge rent for the use of the trailer and none was paid by Mr. Hunter. Nor did the corporation depreciate the asset. Mr. Hunter viewed the use of the trailer as a passive activity. He characterizes the activity as personal property rental from an S corporation by its sole shareholder and as such, Mr. Hunter considered any losses would be suspended.

The trailer was sold in 1995 for $2,300 cash, although Mr. Hunter has no evidence of the sale (receipt, bill of sale, etc.). He reported the sale as a loss on his timely filed S corp. tax return for 1995. Basis was reported as $7,500, which was the 1988 purchase price, and the amount reported on the S corp.'s books when title was transferred in 1991. A loss of $5,200 was reported by the S corp. ($7,500 - $2,300). The $2,300 in actual sale proceeds went to Mr. Hunter, but were not reported as income to him.

The sale was shown on the S corp.'s books as $144 for expenses for the trailer for the year, $341 as final payoff of a $1,000 loan to shareholder, and the balance was recorded as a loan from the corporation to its shareholder in the amount of $1,815. No interest or other contractual terms were attached to the loan.

At the time of the transfer of the trailer to the S corp. in 1991, the only assets on the S corp.'s books were the trailer and a loan to the shareholder (Mr. Hunter). The corporation had no liabilities. It had no bank account from which to pay any expenses. Capital stock was $500.

At all times Mike Hunter paid the expenses associated with the trailer (electricity, license fees, maintenance and repair costs, etc.). The corporation reduced the loan to its shareholder (Mr. Hunter) by the amounts paid by Mr. Hunter for the trailer expenses. In 1994, these payments exceeded the amount of the loan to Mr. Hunter, as carried on the corporation's books, and the corporation began treating the trailer expenses paid by Mr. Hunter as a loan from the shareholder to the corporation. The items were claimed as ordinary business expenses on the corporation's return.

Mr. Hunter views all business assets as a part of his CPA practice, including the travel trailer which was owned by the corporation. Mr. Hunter argues that the trailer was an ordinary and necessary business expense because it was purchased for little money and involved minimal annual operating costs. The trailer offered Mr. Hunter a relaxed setting away from the telephone to meet with clients and discuss sensitive issues and plan long term tax strategies.

COURT'S ANALYSIS

There are two main issues to resolve:1) Are expenses associated with the use of the trailer deductible as ordinary and necessary business expenses? 2) Is there a deductible loss on the sale of the trailer?

Defendant insists, and the court agrees, that the various entities involved must be considered separately for purposes of analyzing the tax consequences of the transactions involved. The department's auditor argues that the corporation operated in name only after 1986 and that it therefore had no expenses to deduct thereafter. Since the corporation was not carrying on a trade or business, no expenses are deductible and any loss stemming from the sale of the trailer does not qualify as a loss from the sale or exchange of business property. It is, therefore, a nondeductible event. Finally, the expenses paid by Mr. Hunter are properly characterized as personal expenses.

Expenses

The Internal Revenue Code (IRC) provides some basic rules governing deductible expenses. The code allows deductions for expenses incurred in a trade or business (IRC section 162) or expenses incurred for the production of income (IRC section 212). Personal expenses are nondeductible. IRC § 262(a). Only section 162 is applicable in this case, since the deductions were taken by the corporation.

Deductions are a matter of legislative grace. *DeArmond v. Dept. of Rev*., 14 OTR 112, 118 (1997); *In Re McKinnon's Estate*, 212 Or 213, 223, 319 P2d 579, 584 (1957). As such, they are to be strictly construed against the taxpayer. *In Re McKinnon*, 212 Or at 223 (citations omitted); *Keller v. Dept. of Rev*., 12 OTR 381, 385 (1993). Taxpayers have the burden of demonstrating that they come within the exemption. *Id*.

The expenses at issue are electricity, licensing fees and taxes. They were paid by Mr. Hunter but treated as a repayment of a loan to the corporation until 1994, when the payments exceeded the amount of the loan. This generated annual losses that flowed through to Mr. Hunter. In 1995, the payments, again made by Mr. Hunter, were deemed by him to be a loan to the shareholder from the corporation and deducted by the S corp. as ordinary (versus capital) business expenses.

For an expense to be deductible under section 162 of the code it must be "ordinary and necessary", and "incurred in carrying on a trade or business". Defendant argues that the S corp. was not engaged in a trade or business. (Def's Ex A-2). The court agrees.

Generally any demonstrable losses incurred by a corporation are deductible. *Mertens*, Law of Federal Income Taxation § 28.47, at 114. However, where the court finds that the entity claiming the loss is not engaged in a trade or business, any loss resulting from the disposition of property is nondeductible.

An important consideration in determining whether a taxpayer is engaged in a trade or business is whether the activity is engaged in for profit. *Gula v. Commissioner*, TC Memo 1989-486, 1989 WL 101453 (US Tax Court Sept 6, 1989); *Fuchs v.*

Commissioner, 83 TC 79 (1984); *Mertens*, Law of Federal Income Taxation § 25.06 at 27-28 (1998). There is no evidence of a profit motive in this case. Title to the trailer was transferred by Mr. Hunter to the S corp. in 1991. No rent was ever charged by the corporation for Mr. Hunter's use of the trailer. The trailer was the corporation's only asset. The corporation's only "activity" was ownership of the trailer.

Also relevant in the determination that the corporation was not engaged in a trade or business was the manner in which it operated. Not only is there no evidence of a profit motive, but the trailer was not depreciated by the corporation and the corporation had no bank account. Thus, the corporation made no money on the ownership of the trailer and did not operate like a business in the oversight of its assets. Rent could have been charged. The corporation had no other assets and it engaged in no business activities. (Mr. Hunter operated his CPA practice as a sole proprietorship.) It earned no income. As the Supreme Court said not too many years ago, "to be engaged in a trade or business, the taxpayer must be involved in the activity with continuity and regularity and * * * the taxpayer's primary purpose for engaging in the activity must be for income or profit." *Commissioner v. Groetzinger*, 480 US 23, 35, 107 S Ct 980 (1987); *see also Portland Golf Club v. Commissioner*, 497 US 154, 164, 110 S Ct 2780 (1990). The court does not find that to be true in this case.

Another problem with allowing the deductions here is that the S corp. did not pay the expenses; Mr. Hunter paid them. The corporation essentially credited its shareholder for the payments, though they were treated on its books as a loan. It is not clear that the expenses would ordinarily be paid by the corporation. Utilities made up the majority of the claimed expense and they are typically paid by the tenant. In that regard, it is questionable whether the expenses were "ordinary and necessary". Implicit in that phrase is a reasonableness standard under which courts sometimes ask whether a hardheaded businessman in like circumstances would have incurred the expense. *Textile Mills Securities Corp. v. Commissioner*, 314 US 326 (1941); *see also Mertens*, § 25.14 at 46 (1998).

In conclusion, the court is not persuaded that the expenses claimed were "ordinary and necessary expenses" or that the corporation was carrying on any "trade or business", as required by section 162(a). Accordingly, the expenses are not deductible.

The court finds defendant's hypothesis insightful. The apparent primary motivation for putting the trailer in the corporation was to reduce the loan to shareholder with the expenses associated with the trailer, thereby providing a method of avoiding any recognition of gain from forgiveness of the debt when the corporation liquidates.

Loss on Sale of Trailer

The Code allows as a deduction for "any loss sustained during the taxable year and not compensated for by insurance or otherwise." IRC § 165(a). The corporation in this case took an ordinary loss of $5,200 on the sale of the trailer. The court has already determined that the corporation was not engaged in carrying on any trade or business. Accordingly, the loss reported from the sale of the trailer is not deductible.

Since the consequences flow through to the shareholder under IRC section 1366, the activities cannot be allowed at that level either. As a consequence, neither the $144 in reported expenses nor the $5,200 reported loss are deductible by the corporation or its shareholder. Both are therefore disallowed.

Finally, the proceeds from the sale of the trailer, which went to Mr. Hunter, were treated as a repayment of a loan to the shareholder, Mike Hunter, rather than income. Since the court agrees with defendant that the absence of a debtor-creditor relationship negates the loan theory, the proceeds are to be treated as a distribution taxable to the shareholder under IRC section 1368 to the extent it exceeds basis. The result is a long term capital gain of $1,939. (Def's Ex A-6).

CONCLUSION

The expenses of $144 stemming from the use of the trailer and loss of $5,200 stemming from the sale of the trailer are both denied. Additionally, the proceeds from the sale of the trailer constitute a distribution from the S corp. and as such are taxable as a capital gain in the amount of $1,939 (allowing a $20 basis). The return is adjusted in accordance with defendant's Exhibit B-1, with a net change in taxable income of $7,283.

IT IS HEREBY ADJUDGED AND DECREED that plaintiffs' appeal is denied and relief granted in defendant's favor as set out immediately above.

Dated this ____ day of October, 2000.

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DAN ROBINSON
MAGISTRATE

THIS DOCUMENT WAS SIGNED BY MAGISTRATE DAN ROBINSON ON OCTOBER 27, 2000. THE COURT FILED THIS DOCUMENT ON OCTOBER 27, 2000.