***Manocchio v. Commissioner, 78 T. C. 989 (1982)***

Expenses reimbursed by tax-exempt income are not deductible under Section 265(1) of the Internal Revenue Code.

**Summary**

John Manocchio, an airline pilot and Air Force veteran, sought to deduct flight-training expenses from his 1977 federal income tax return, which were partially reimbursed by the Veterans' Administration (VA). The VA payments were tax-exempt under 38 U. S. C. sec. 3101(a). The Tax Court held that the reimbursed portion of the expenses was not deductible under Section 265(1) of the IRC, which disallows deductions allocable to tax-exempt income. The court rejected Manocchio's estoppel argument against the IRS's retroactive application of a revenue ruling clarifying the non-deductibility of such expenses.

**Facts**

John Manocchio, a veteran and airline pilot, attended flight-training courses in 1977 to maintain and improve his professional skills. The courses cost $4,162, and Manocchio received $3,742. 88 from the VA, which was 90% of the cost, as a direct reimbursement. The VA payments were exempt from taxation under 38 U. S. C. sec. 3101(a). Manocchio claimed a deduction for the full cost of the training on his 1977 tax return, excluding the VA payments from his income.

**Procedural History**

The IRS issued a notice of deficiency to Manocchio for $924, disallowing the deduction for the flight-training expenses. Manocchio petitioned the U. S. Tax Court, which heard the case and ruled that the portion of the expenses reimbursed by the VA was not deductible.

**Issue(s)**

1. Whether the portion of Manocchio's flight-training expenses reimbursed by the VA is deductible under Section 162 of the IRC.
2. Whether the IRS is estopped from disallowing the deduction due to its previous positions on the matter.

**Holding**

1. No, because the reimbursed expenses are allocable to a class of tax-exempt income under Section 265(1) of the IRC, making them nondeductible.
2. No, because the IRS's retroactive application of Rev. Rul. 80-173 was not an abuse of discretion, and thus, estoppel does not apply.

**Court's Reasoning**

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The court applied Section 265(1) of the IRC, which disallows deductions for expenses allocable to tax-exempt income. The court found that the flight-training expenses were directly allocable to the VA reimbursement, which was tax-exempt, and thus, nondeductible. The court rejected Manocchio's argument that the expenses were allocable to his taxable employment income, emphasizing the one-for-one relationship between the expenses and the reimbursement. The court also considered the legislative history of Section 265(1), which aimed to prevent a double tax benefit. The court cited Banks v. Commissioner and Christian v. United States as precedents where deductions were disallowed for expenses paid by tax-exempt funds. On the estoppel issue, the court noted that the IRS has broad discretion to correct mistakes of law retroactively, and Manocchio's reliance on Rev. Rul. 62-213 and IRS Publication 17 was not sufficient to justify estoppel. The court distinguished between different types of VA benefits and found no abuse of discretion in the IRS's retroactive application of Rev. Rul. 80-173.

**Practical Implications**

This decision clarifies that expenses reimbursed by tax-exempt income, such as VA benefits, are not deductible. Taxpayers and their advisors must carefully consider the source of reimbursements when claiming deductions. The ruling reinforces the IRS's authority to retroactively correct its positions, even when taxpayers have relied on previous guidance. This case may affect veterans and others receiving tax-exempt benefits who seek to deduct related expenses. Subsequent cases, like Wolfers v. Commissioner, have followed this principle, further solidifying the non-deductibility of reimbursed expenses.

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