Armstrong v. Commissioner, 113 T. C. 168 (1999)

The cost of nonpracticing malpractice insurance can be fully deducted in the year a business ceases operation, regardless of whether the insurance is considered a capital asset.

Summary

In Armstrong v. Commissioner, the Tax Court ruled that a retired attorney could fully deduct the cost of nonpracticing malpractice insurance purchased in the year he ceased practicing law. The IRS argued the insurance was a capital asset with an indefinite useful life, only allowing a partial deduction. However, the court held that since the attorney's business terminated in the same year, the entire cost was deductible as either a closing expense or a capital expenditure upon business dissolution. This case clarifies the deductibility of certain expenses when a business ends, impacting how similar costs are treated for tax purposes.

Facts

Petitioner, a self-employed attorney, retired from the practice of law in 1993. In December of that year, he purchased a nonpracticing malpractice insurance policy for $3,168, which covered him indefinitely for acts committed prior to retirement. On their 1993 tax return, petitioners claimed a full deduction for this cost on Schedule C. The IRS determined the policy was a capital asset and allowed only a 10% deduction for the year.

Procedural History

The case was assigned to a Special Trial Judge in the U. S. Tax Court. The court adopted the Special Trial Judge's opinion, which held that the full cost of the insurance was deductible in 1993. The decision was entered under Rule 155, reflecting the court's disposition and the petitioners' concessions on unrelated issues.

Issue(s)

1. Whether petitioners can deduct the entire cost of nonpracticing malpractice insurance purchased in the year the attorney ceased practicing law.

Holding

1. Yes, because the attorney's business terminated in the same year the insurance was purchased, the full cost is deductible as either a closing expense or a capital expenditure upon business dissolution.

Court's Reasoning

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The court analyzed the deductibility of the insurance cost under Section 162(a) of the Internal Revenue Code, which allows deductions for ordinary and necessary business expenses. The IRS argued the policy was a capital asset due to its indefinite useful life, requiring amortization. However, the court noted that even if classified as a capital asset, the cost was fully deductible in the year the business ceased operation, as per INDOPCO, Inc. v. Commissioner. The court cited Malta Temple Association v. Commissioner and Section 336, which allow deductions for business assets upon dissolution. Alternatively, if not a capital asset, the cost was deductible as an ordinary and necessary expense of closing the business, referencing Pacific Coast Biscuit Co. v. Commissioner and Welch v. Helvering. The court emphasized the policy's direct connection to the attorney's business and its necessity and ordinariness in the context of ceasing practice.

Practical Implications

This decision impacts how professionals, especially those in high-liability fields like law and medicine, should handle the tax treatment of nonpracticing insurance upon retirement or business termination. It clarifies that such costs can be fully deducted in the year of business cessation, simplifying tax planning for professionals winding down their practices. The ruling may influence how the IRS and taxpayers approach similar expenses in the future, potentially affecting tax strategies for business closure. Subsequent cases, such as Black Hills Corp. v. Commissioner, have distinguished this ruling by emphasizing the difference between prepayments for future benefits and costs associated with business termination.

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