Lofstrom v. Commissioner of Internal Revenue, 125 T. C. 271 (U. S. Tax Court 2005)

In Lofstrom v. Comm’r, the U. S. Tax Court ruled that transferring a contract for deed does not qualify as alimony for tax deduction purposes. The court also disallowed deductions for bed and breakfast and writing activity expenses due to personal use and lack of profit motive. This decision clarifies the requirements for alimony deductions and the substantiation needed for business expense claims, impacting how taxpayers can claim such deductions.

Parties

Dennis E. and Paula W. Lofstrom, Petitioners (plaintiffs at the trial level), and the Commissioner of Internal Revenue, Respondent (defendant at the trial level).

Facts

Dennis Lofstrom, a retired doctor, was obligated to pay alimony to his former wife, Dorothy Lofstrom. In 1997, he transferred his $29,000 interest in a contract for deed to Dorothy, along with $4,000 in cash, to satisfy his alimony obligations. Dennis and his current wife, Paula, claimed the value of the contract for deed as an alimony deduction on their 1997 tax return. Additionally, they operated a bed and breakfast (B&B) on the first floor of their residence and claimed related expenses, including $19,158 for 1997. Dennis also claimed to be engaged in writing for profit and deducted expenses related to his writing activities, amounting to $1,664 in 1997 and $8,413 in 1998. The Internal Revenue Service disallowed these deductions.

Procedural History

The Commissioner of Internal Revenue issued a notice of deficiency to the Lofstroms for the tax years 1997 and 1998, disallowing their claimed deductions. The Lofstroms timely filed a petition with the U. S. Tax Court challenging the deficiency. The case was fully stipulated under Tax Court Rule 122, and trial was scheduled but continued due to the petitioners’ absence. The Tax Court proceeded to hear the case based on the stipulated facts and exhibits, ruling against the Lofstroms.

Issue(s)

1. Whether the transfer of a contract for deed can be deducted as alimony under sections 61(a)(8), 71(a), and 215(a) and (b) of the Internal Revenue Code?
2. Whether the Lofstroms may deduct expenses for operating a bed and breakfast under section 280A of the Internal Revenue Code?
3. Whether the Lofstroms may deduct expenses related to Dennis Lofstrom’s writing activities under sections 162 and 183 of the Internal Revenue Code?

Rule(s) of Law

1. Alimony payments must be made in cash or a cash equivalent to be deductible under sections 71(b)(1) and 215(a) of the Internal Revenue Code. A contract for deed is considered a third-party debt instrument and does not qualify as a cash payment. *Sec. 1. 71-1T(b), Q&A-5, Temporary Income Tax Regs. , 49 Fed. Reg. 34455 (Aug. 31, 1984)*.
2. Expenses related to a dwelling unit used as a personal residence are generally not deductible unless specific exceptions apply, such as exclusive business use and limitations on personal use. *Sec. 280A(c)(1), (d)(1), (f)(1)(B), and (g) of the Internal Revenue Code*.
3. To deduct expenses for an activity, taxpayers must demonstrate that they engaged in the activity with a bona fide profit objective. *Secs. 162 and 183 of the Internal Revenue Code; Sec. 1. 183-2(a), Income Tax Regs.*

Holding

1. The Tax Court held that the Lofstroms may not deduct the value of the contract for deed as alimony because it does not constitute a cash payment.
2. The Lofstroms may not deduct expenses for the bed and breakfast because they used it for personal purposes and failed to substantiate the expenses.
3. The Lofstroms may not deduct expenses related to Dennis Lofstrom's writing activities because they failed to show that he engaged in the activity for profit.

Reasoning

The court's reasoning focused on the statutory requirements and the facts presented. For the alimony deduction, the court applied the rule that payments must be in cash or a cash equivalent, concluding that a contract for deed, being a third-party debt instrument, does not meet this requirement. The court also considered policy considerations, noting that allowing such deductions could lead to tax avoidance by transferring non-cash assets.

For the bed and breakfast expenses, the court analyzed the limitations under section 280A, finding that personal use by the Lofstroms' daughter and family disqualified the deductions. The court also emphasized the lack of substantiation, requiring taxpayers to provide detailed records of business use and expenses.

Regarding the writing activity, the court applied the profit motive test under section 183, assessing factors such as the time and effort expended, history of income or loss, and the taxpayer's financial status. The court found that the Lofstroms did not provide sufficient evidence to demonstrate a bona fide profit objective, particularly given the lack of published works and consistent losses over several years.

The court's decision reflects a strict adherence to statutory requirements and the burden of proof on taxpayers to substantiate deductions. It also considered the broader implications of allowing such deductions on tax policy and fairness.

Disposition

The Tax Court sustained the Commissioner's determinations in the deficiency notice for 1997 and 1998, denying the Lofstroms' claimed deductions.

Significance/Impact

The Lofstrom case reinforces the strict requirements for alimony deductions, clarifying that non-cash transfers like contracts for deed do not qualify. It also underscores the importance of substantiation for business expense deductions, particularly those related to personal residences. The decision's treatment of the profit motive test provides guidance for taxpayers engaged in activities with potential tax benefits, emphasizing the need for objective evidence of profit intent. This ruling has practical implications for legal practitioners advising clients on tax deductions and planning, as well as for future court interpretations of similar issues under the Internal Revenue Code.