

Part I – 1986 Code

Section 262.---Personal, living, and family expenses

(Also: 280A)

Rev. Rul. 2004-32

PURPOSE

The Service is aware that some taxpayers are attempting to reduce their federal tax liability by claiming that otherwise nondeductible personal, living or family expenses are deductible because they relate to a purported home-based business of the taxpayer that, in fact, is not a bona fide home business. The purported business in these schemes is no more than an attempt to create the appearance of having a home-based business where none actually exists. The Service also is aware that promoters, including return preparers, are advising or recommending that taxpayers take frivolous positions based on this argument. Some promoters may be marketing a package, kit, or other materials, that claim to show taxpayers how they can avoid paying income taxes based on this and other meritless arguments. This home-based business scheme and the promotion of this scheme are described in more detail in this revenue ruling.

This revenue ruling emphasizes to taxpayers, and to promoters and return preparers who assist taxpayers with home-based business schemes, that they cannot avoid income tax by claiming otherwise nondeductible personal, living or family expenses as business deductions that supposedly relate to a purported home-based business that is not a bona fide trade or business. This argument has no merit and is frivolous.

The Service is committed to identifying taxpayers who attempt to avoid their tax obligations by taking frivolous positions. The Service will take vigorous enforcement action against these taxpayers and against promoters and return preparers who assist taxpayers in taking these frivolous positions. Frivolous returns and other similar documents submitted to the Service are processed through its Frivolous Return Program. As part of this program, the Service confirms whether taxpayers who take frivolous positions have filed all of their required tax returns, computes the correct amount of tax and interest due, and determines whether civil and criminal penalties should apply. The Service also determines whether civil or criminal penalties should apply to return preparers, promoters, and others who assist taxpayers in taking frivolous positions, and recommends whether a court injunction should be sought to halt such activities. Other information about frivolous tax positions is available on the Service website at www.irs.gov.

DISCUSSION OF HOME-BASED BUSINESS SCHEMES

Several promoters are selling packages of materials (sometimes referred to as a “Tax Toolbox” or a “Tax Toolkit”) containing video or audio tapes, workbooks, record-keeping aids, or other materials that the promoters claim will assist taxpayers in taking tax deductions for a taxpayer’s personal, living or family expenses under the guise of conducting a business, usually out of the taxpayer’s home. The promoters of these packages typically make one or more of the following claims: (1) taxpayers can legally reduce or eliminate their federal income taxes by establishing a business, regardless of whether the business is a bona fide business conducted for profit; (2) operating a business will permit the deduction of personal expenses (such as weddings, children’s allowances, and vacations) as legitimate business expenses; (3) placing a calendar, desk, file cabinet, telephone, or other office-type item in each room of a home will allow taxpayers to deduct all or most of the costs of operating their personal residences; or (4) by using the materials that the promoter sells, taxpayers are guaranteed to receive a large federal income tax refund or to reduce their federal income tax liability by a substantial amount.

Whether an individual is carrying on a bona fide trade or business depends on the facts and circumstances. Nevertheless, the actions taxpayers take as part of a home-based business scheme, such as the placing of a filing cabinet in a bedroom, invariably are taken for the purpose of claiming personal, living or family expenses as deductible business expenses, and not for the purpose of carrying on a bona fide trade or business. Home-based business schemes typically are used by taxpayers who perform all of their work at their employers’ place of business.

Section 262 disallows deductions for personal, living or family expenses, except as otherwise expressly provided by the Internal Revenue Code. Medical expenses, for example, are deductible only if the specific requirements of section 213 are satisfied. Similarly, the provisions of section 163(h) govern when an individual taxpayer may deduct interest on a mortgage or home equity loan. See I.R.C. §§ 163(h)(2) and (h)(3).

With respect to business expenses, only expenses paid or incurred during the taxable year in carrying on a trade or business may be deducted under section 162(a). A trade or business expense deduction under section 162, however, is not permitted with respect to a taxpayer’s residence unless specifically permitted in limited circumstances by section 280A. I.R.C. § 280A(a). For example, with respect to the business use of a taxpayer’s residence, section 280A provides that in order for allocable expenses to be deductible under that section, the portion of the taxpayer’s residence must be used exclusively by the taxpayer on a regular basis as a principal place of business for the taxpayer’s trade or business, or to meet or deal with patients, clients or customers in the normal course of the taxpayer’s trade or business. If the taxpayer is an employee, the exclusive and regular use of a portion of the taxpayer’s residence must be for the convenience of the taxpayer’s employer before any expenses relating to that part of the taxpayer’s residence may be deducted. I.R.C. § 280A(c).

Taxpayers participating in home-based business schemes invariably do not have a bona fide home-based business and are not using any portion of their residences exclusively and regularly for a work-related use. These schemes will not convert otherwise nondeductible personal, living or family expenses into legitimate deductions. Moreover, detailed recordkeeping cannot create a permissible deduction unless the expenses at issue are legitimate business expenses. Although deductions must be substantiated in order to be allowable, a taxpayer also must establish entitlement to the deduction, e.g., that the claimed expenses were ordinary and necessary for the production of income in a trade or business.

Courts routinely reject the types of arguments made by participants in home-based business schemes as frivolous and penalize taxpayers who make these types of arguments. Courts also have enjoined promoters who market frivolous tax avoidance schemes that utilize these frivolous arguments. See, e.g., United States v. Estate Preservation Services, 202 F.3d 1093 (9th Cir. 2000) (ordering an injunction against a promoter of a trust scheme who made fraudulent statements that expenses related to a personal residence could be deducted if the residence was transferred to a trust); United States v. Buttorff, 761 F.2d 1056, 1060 (5th Cir. 1985) (ordering an injunction against a promoter of a trust scheme who made fraudulent statements that personal consumption expenses could be deducted if personal property was transferred to a trust); Peete v. Commissioner, T.C. Memo. 2004-31 (imposing accuracy-related penalty against taxpayer who deducted personal and living expenses as purported business expenses related to recruiting participants in a tax avoidance pyramid scheme); Manley v. Commissioner, T.C. Memo. 1983-558 (disallowing deductions of claimed personal and living expenses and imposing both an accuracy-related penalty and a penalty under section 6673 for advancing frivolous arguments).

CIVIL AND CRIMINAL PENALTIES

In determining the correct amount of tax, the Service will disallow personal, living or family expenses that have been improperly claimed as business deductions. In addition to liability for tax due plus statutory interest, individuals who claim tax benefits on their returns based on home-business schemes and other frivolous arguments face substantial civil and criminal penalties. Potentially applicable civil penalties include: (1) the section 6662 accuracy-related penalty, which is equal to 20 percent of the amount of taxes the taxpayer should have paid; (2) the section 6663 penalty for civil fraud, which is equal to 75 percent of the amount of taxes the taxpayer should have paid; (3) a \$500 penalty under section 6702 for filing a frivolous return; and (4) a penalty of up to \$25,000 under section 6673 if the taxpayer makes frivolous arguments in the United States Tax Court.

Taxpayers relying on this scheme also may face criminal prosecution for: (1) attempting to evade or defeat tax under section 7201 for which the penalty is a fine of up to \$100,000 and imprisonment for up to 5 years; or (2) making false statements on

a return under section 7206 for which the penalty is a fine of up to \$100,000 and imprisonment for up to 3 years.

Persons who promote this scheme and those who assist taxpayers in claiming tax benefits based on this scheme also may face penalties. Potential penalties include: (1) a \$250 penalty for each return prepared by an income tax return preparer who knew or should have known that the taxpayer's argument was frivolous (or \$1,000 for each return where the return preparer's actions were willful, intentional or reckless); (2) a \$1,000 penalty under section 6701 for aiding and abetting the understatement of tax; and (3) criminal prosecution under section 7206 for which the penalty is a fine of up to \$100,000 and imprisonment for up to 3 years for assisting or advising about the preparation of a false return or other document under the internal revenue laws. Promoters and others who assist taxpayers in engaging in these schemes also may be enjoined from doing so under section 7408.

HOLDING

Taxpayers cannot use schemes designed to create the appearance of having a home-based business, where none actually exists, for the purpose of converting otherwise nondeductible personal, living or family expenses into purportedly legitimate deductions. Arguments that such schemes generate tax benefits are frivolous. A taxpayer who is not engaged in a bona fide home-based trade or business cannot deduct, as a trade or business expense under section 162, any expenses alleged to relate to a purported home-based business. Taxpayers attempting to reduce their federal income tax liability by taking frivolous positions will be liable for the actual tax due plus statutory interest. In addition, the Service will determine civil penalties against taxpayers where appropriate, and those taxpayers also may face criminal prosecution. The Service also will determine appropriate civil penalties against persons who prepare frivolous returns or promote frivolous positions, and those persons also may face criminal prosecution. Promoters and others who assist taxpayers in engaging in these schemes also may be enjoined from doing so under section 7408.

Even if a taxpayer is engaged in a bona fide trade or business or is conducting activities from his home for the convenience of his employer, the taxpayer must satisfy the specific requirements of the Internal Revenue Code, such as those contained in sections 162 and 280A, to be entitled to deduct expenses related to those activities. Personal, living or family expenses are not deductible except as otherwise expressly provided by the Internal Revenue Code. I.R.C. § 262(a).

DRAFTING INFORMATION

This revenue ruling was authored by the Office of Associate Chief Counsel (Procedure and Administration), Administrative Provisions and Judicial Practice Division. For further information regarding this revenue ruling, contact that office on (202) 622-4910 (not a toll-free call).