

**Haeder v. Commissioner [I.R.C. §§61,74,162,166,274,408,6651 and 6662]
(taxpayer failed to show that his wife provided services as an employee)**

Facts. Taxpayer, a sole-proprietor attorney, deducted **wages that he claimed were paid to his wife for services performed for his legal practice and amounts for a medical reimbursement plan on his Schedule C (Form 1040).** The amounts deducted as wages were transferred into wife's IRA account and deducted as IRA contributions on taxpayers' jointly filed tax returns. The IRS disallowed the wage deductions, IRA contributions, medical plan expenses, legal and professional fees, travel, entertainment, bad debt deduction, and repairs to an Oriental rug. The IRS also determined that the taxpayers failed to report prize income and additional business income, but the taxpayers overstated their dividend income. The IRS imposed penalties for failure to file and understatement of taxes.

Issue

Issue 1. Whether taxpayer wife was an employee of taxpayer husband's attorney practice, which would allow deductions for wages, medical plan expenses, and IRA contributions.

Issue 2. Whether taxpayers were allowed deductions for legal and professional fees, travel and entertainment expenses, bad debt, and repairs to Oriental rug.

Issue 3. Whether taxpayers were subject to the failure to timely file penalty under I.R.C. §6651 and the accuracy-related penalties for negligence and substantial understatement of taxes under I.R.C. §6662.

Analysis and Holding

Issue 1. According to Treas. Reg. 1.162-7(a), salaries are deductible only if reasonable in amount and paid or incurred for services actually rendered. The court pointed out that, where a family relationship is involved, close scrutiny is applied to determine whether a bona fide employer-employee relationship exists and whether the payments received were made on account of the employer-employee relationship or the family relationship [*Denman v. Commissioner*, 48 T.C. 439 (1967)]. The court concluded that taxpayers failed to show that wife provided services as an employee since they provided no documentary evidence of the work performed, Forms W-2 were not issued in four of the five years at issue, and the payments were transferred directly to the IRA account. The court found that the taxpayers determined the purported salary on the basis of the maximum IRA deduction and claimed the employee relationship to enable them to deduct personal medical and dental expenses as business expenses and make deductible IRA contributions. Therefore, the Tax Court held that **taxpayer wife was not an employee of taxpayer husband's attorney practice**, which

would not allow deductions for wages, medical plan expenses, and IRA contributions.

Issue 2. The court concluded that the taxpayers failed to substantiate the legal and professional fees for the law practice as required under I.R.C. §162 and failed to satisfy the substantiation requirements of I.R.C. §274(d) for travel, meal, and entertainment expenses. The court disallowed the bad debt deduction since the taxpayers failed to show that the debt arose from a true debtor-creditor relationship. The court found that the taxpayers failed to substantiate the rug repair cost or to show it was an ordinary and necessary business expense under I.R.C. §162. Therefore, the Tax Court held that **taxpayers were not allowed deductions for legal and professional fees, travel and entertainment expenses, bad debt, and repairs to Oriental rug.**

Issue 3. The Tax Court held that taxpayers were subject to the failure to timely file penalty under I.R.C. §6651 and the accuracy-related penalties for negligence and substantial understatement of taxes under I.R.C. §6662.

[*Haeder v. Commissioner*, 81 T.C.M. (CCH) 987 (2001)]

See also *James A. Poyda, et ux. v. Commissioner* (T.C. Summary Opinion 2001-91) for a similar result. In this case, medical insurance premiums were disallowed for a Schedule F farm activity because the compensation (including medical insurance) paid to the spouse was not commensurate with duties actually performed.