



Tax Reduction Letter

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Action on Decision 1988-004

Re: Charles A. Scott and Jan F. Scott v. Commissioner

Venue: 5th Circuit

Dkt. No. 18916-82

Decision: April 15, 1985

Opinion: 84 T.C. 683

Issue:

Whether the term "gross income derived from such use" as used in the "Limitation on Deductions" provision of *I.R.C. § 280A(c)(5) (1954 Code)*, concerning certain business or rental uses of taxpayers' homes, may reasonably be interpreted to mean "gross income from the business activity in the unit reduced by expenditures required for the activity but not allocable to the use of the unit itself".

Discussion:

For taxable year 1980, Petitioners maintained on their property, within the same fenced area as their dwelling unit, a separate structure used by Mr. Scott as an office building for his chemical and rental businesses. Mr. Scott had several business expenditures that were not allocable to the use of the office building itself, such as those for his office supplies.

In response to the respondent's disallowance of expenses associated with the office, Petitioners argued that *section 280A* was inapplicable because the office building was not appurtenant to their dwelling unit. Alternatively, they argued the building constituted [*2] a separate structure under the exception of *section 280A(c)(1)(C)*.

Contrary to petitioners' principal argument, the Tax Court determined that the office building was appurtenant to their dwelling unit. On the other hand, although respondent agreed that the building, as a separate structure, came within the *section 280A(c)(1)(C)* exception, he contended that *section 280A(c)(5)* prohibits such deductions. *Section 280A(c)(5)* limits business or rental use of the home deductions to the amount by which gross income from such use exceeds the deductions allocable to such use that would have been allowable regardless of such use.

Respondent's view was elaborated in Proposed Treasury Regulations interpreting "gross income derived from such use" to mean gross income from the business conducted in the unit reduced by expenditures associated with the business but not allocable to use of the unit (such as expenditures for supplies and compensation paid to others). Under this interpretation, Petitioners would have been allowed no deductions in connection with the office because the expenses otherwise attributable to Mr. Scott's businesses exceeded his gross income from those businesses.

The court disagreed, [*3] finding the Proposed Treasury Regulations inconsistent with the statute. The court reasoned that the term "gross income" is a term of art, clearly defined, and in contrast to adjusted gross income, does not take business expenses into account. The court explained that "gross income derived from such use" was intended to identify the source of the income, distinguishing income derived from the business use of the office in the home from income derived from other sources. The court cited the portion of *section 280A*'s legislative history which notes that where gross income is derived from both the business use of the home and from other business facilities a reasonable allocation should be made. The court found this sufficient to explain why the statute was drafted in terms of income "derived from such use" in regard to business use of the home. Accordingly, the court determined that Mr. Scott's gross income from the businesses he conducted in the office should not have been reduced by related business expenses not allocable to use of the office.

Although we do not agree that the Proposed Treasury Regulations were inconsistent with the statute, it is unlikely that we could successfully [*4] argue that the court's strict construction of the term "gross income," even as limited by the statute to income "derived from such [business] use" of the office in the home, was unreasonable. Moreover, section 143 of the Tax Reform Act of 1986 has modified 280A so that office in the home deductions are now expressly limited to the taxpayer's net income from the business conducted in the office (gross income minus deductions attributable to the business), for years beginning on or after January 1, 1987.

Recommendation: Acquiescence.

Reviewers:

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