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Supreme Court Limits Home-Office Deduction

Ruling to Hit Contractors Hard

In a decision likely to affect tens of thousands of contractors, the U.S. Supreme Court ruled this January that self-employed taxpayers cannot write off home office expenses if they spend more time and do more important parts of their business elsewhere. The decision will almost surely prevent the many small contractors who use their home offices only part-time from deducting the cost of keeping those offices. "Most small volume builders will be affected," said a National Association of Home Builders spokesperson.

All tax and court decisions are open to interpretation. But in this case, the specifics of the case ruled upon — the attempt of an anesthesiologist to write off the use of his home office — so closely resembles those of many small contractors that it seems almost certain that small contractors in similar situations will also have such deductions disallowed by the Internal Revenue Service.

The anesthesiologist, Nader Soliman, spent about 15 hours a week in his home office doing paperwork — billing, phone calls, correspondence, continuing education, and other desk work related to his medical practice. The office space met the "exclusive use" test that is part of home-office deductions, meaning that Soliman used the space exclusively for business matters. It was also essential to his business and was unduplicated, in that he had to do the paperwork somewhere, and none of the hospitals at which he practiced provided him with office space. The U.S. Tax Court found that these conditions qualified the office space as his "principal place of business" and allowed the deduction.

But the Supreme Court ruled that because the "essence of the professional service" — the actual patient treatment — was given elsewhere, the office did not qualify as his principal place of business, so Soliman could not write it off. Justice Anthony Kennedy, writing the majority opinion, argued that it wasn't enough that a home office be essential to a taxpayer's business; it had to be "the most important or significant place for the business," as determined by where the taxpayer spent the most time and did the most important work.

This is bad news to the many small contractors who spend most of the week in the field and do paperwork for 10 or 20 hours in a home office.

Unless you spend the majority of your time there, you probably can't write off that home office space anymore, according to a recent U.S. Supreme Court decision.

These people will likely find their home-office deductions disallowed. Only contractors who spend most of the work week in their home offices will be able to write them off.

The one exception, say observers, may be the part-time office that is kept for the purpose of meeting clients. But again, if the contractor meets most clients at other sites (as is usually the case), such a deduction might be disallowed.

Perhaps the most discouraging thing about the decision was its apparent finality. With its 8-1 vote on this decision, the Supreme Court's word is final, and can only be overturned by Congressional legislation, a change in IRS policy (highly unlikely), or a later Supreme Court decision reversing this one. Until then, those deducting home offices in which they don't spend at least half their time and perform their profession's most crucial tasks will likely face a fight with the IRS and potential penalties and interest charges. □

Scald Suits May Become Hot Issue

In the wake of the largest settlement on record in a tap-water scald lawsuit, it appears that the number of such lawsuits will mushroom — mostly at the expense of plumbers and contractors.

"We're the ones getting burned," said Dean Stevens, a Washington, D.C.-area plumbing contractor.

Stevens should know, having just settled out of court a scalding-injury lawsuit against his firm for $15 million. In the suit, the parents of four-year-old India Gomez sought damages for injuries stemming from an accident in which the girl was burned. When the girl was an infant, her mother left her unattended in a bathroom sink, and her three-year-old brother came in and turned on the hot water.

Stevens was included in the suit because he had installed the water heater in the apartment 13 years before. Also named were the water heater manufacturer, the gas valve manufacturer, the local gas utility, and the property manager. Despite that Stevens installed the heater according to code and all standard practices at the time, his insurance company decided against defending the case in court.

"They just didn't think we had a chance in front of a jury," said Stevens. "We're talking about a seriously injured little girl who will be scarred the rest of her life."

Stevens was sued not for improper installation, but for "failure to warrant," meaning, he says, "we didn't warn each and every customer we've ever installed a water heater for that hot water comes from a water heater and it can burn you. But nobody talked about scalding back then. I don't want to sound cold, but it sounds like we're paying for parents' negligence. How can we be held responsible?"

Nicholas Ballanco, a plumbing engineer and writer who is often called in as an expert on tap water scald lawsuits, says that these suits will only become more common as the issue of scalding gets more attention, and as preventative measures — pressure or temperature-regulating valves — become more widely known. Such valves are already required on all new shower and bath fixtures in at least three states (Massachusetts, Rhode Island, and Connecticut), and are recommended in the Kitchen and Bath Association's new design standards. These changes have been pushed by a National Safe Kids Campaign (NSKC), a lobbying campaign aimed at national, state, and local code bodies.

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STATE BY STATE

Massachusetts: New rules regarding water and septic systems may introduce larger minimum lot sizes and other restrictions for new houses. The Department of Environmental Protection has proposed regulations including: setting minimum house lot sizes through a daily gallon-per-acre formula, which would require lots for new homes not connected to sewers to be at least one acre; doubling setbacks between new septic systems and wetlands or bordering septic systems, from 50 to 100 feet; and requiring home septic systems to be inspected every three years.

Vermont: Fannie Mae may use Vermont for a pilot program that makes Energy Efficient Mortgages (EEMs) easier to apply for. The new EEM program would allow lenders to add $5,000 for energy improvements to a borrower's maximum qualifying loan, without any additional underwriting or appraisals. Current underwriting guidelines make it unwieldy for banks to include energy improvements as part of an EEM mortgage, because they must complete separate appraisals, paperwork, and inspection for the purchase and remodeling segments of the loan. The new procedure combines those and streamlines the process.

Arizona: In a decision that may help protect contractors, the Arizona Court of Appeals ruled that "potential knowledge" of unsafe conditions was not enough to prove a contractor willfully violated state safety regulations. The court still found that a serious violation had occurred when a rebar wall on a road bypass structure collapsed, injuring four workers, and fined the contractor $5,000. A finding that the violation was willful, however, would have doubled the fine. □

Contractor Wrestles Lawyer, Wins

This is a story in which a lawyer makes a mountain out of a molehill only to find himself beneath it. If you love lawyers and hate underdogs, stop here. Otherwise, read on.

He swings… Late in 1991, contractor and home inspector Jim Harangody inspected the roof of a $265,000 house for Michael Bendell, a personal injury lawyer who was considering purchasing the house. Harongody's 12-page inspection report noted that "lead flashing on tops of three plumbing vent pipes is not properly sealed and will allow some water intrusion to occur during moderate rainfall."

Despite this warning, lawyer Bendell failed to repair the roof. When a month later it leaked and required repair, he sent Harangody a letter demanding the $450 it cost to repair it. "You represented that there were no water leaks in my roof," Bendell's letter reportedly said. When Harongody refused, citing the report's notation of the potential leak site, Bendell sued.

He falls… Harongody, representing himself against the lawyer in small claims court, won the case.

Harongody wasn't rid of Bendell yet, though. He soon got another letter from the lawyer demanding $450 plus $290 in trial costs. The letter said that if Harongody didn't pay up, Bendell would file an appeal with a circuit court, forcing Harongody to hire a lawyer (as is necessary to take a case to circuit court), thus incurring lawyer's fees, court costs, and other legal expenses to settle the case.

"Basically," Harongody says, "he was telling me that it would cost me more to defend myself successfully than it would just to pay him the cost of the repair. I went to my lawyer and asked him what I should do. He said the guy was right, and advised me to pay it. I said 'No way.' "

It started as a fight over $450. Now the lawyer's out of $13,000.

Instead, Harongody wrote the court arguing that the appeal was taken only to intimidate him into paying. He also wrote columnist Frank Cerabino of the *Palm Beach Post*, who then published a column about the case. The column prompted calls to Harongody from several lawyers offering their services free of charge.

The lawyer Harongody chose, Richard Kupfer, went to court and countersued for attorney's fees. The court ruled for Harongody, awarding him $5,000 to cover Kupfer's legal fees.

He swings and falls again. After that, Bendell, having already made $5,000 of trouble for himself to save $450, appealed the case again. The judge in the appellate court, citing a law that allows it to double a penalty in frivolous appeal cases, did so. With the $1,500 in legal fees incurred for the appeal on top of the previous $5,000, the charge to be doubled came to $6,500. So the judge slapped Bendell with a judgment for $13,000.

"It was amazing," says Harongody. "The whole thing started as a way to get me to pay the $450, because Bendell said that would be cheaper than defending myself in court successfully. Now he's out of $13,000. I won't see any of that, but I don't really care. All I was trying to do was vindicate my rights.

"The man wouldn't let up. My lawyer told me he'd seen other lawyers shoot themselves in the foot before. But never one toe at a time." □

From What We Gather

About 200,000 people are seriously injured in glass-related accidents in the home each year, according to the Glass Tempering Association. Many of these injuries result from the inappropriate use of untempered glass, such as for doors, shower doors, table tops, or fronts for book cases or china closets. The Glass Tempering Association offers a "Glass Safety Checker" — a double layer of polarizing glass — through which you can look at existing glass to see if it is tempered (as shown by a wavy pattern). To order, send a $3 check and a stamped, self-addressed business-size envelope to the Glass Tempering Association, 3310 S.W. Harrison St., Topeka, KS 66611.

Frost-protected shallow foundations were honored with a "Best of What's New" award from *Popular Science* magazine recently. Contractor Bill Eich, a leading exponent of the shallow foundations, joined representatives of the National Association of Home Builders in accepting the award.

Many consumers don't like compact fluorescent light bulbs despite the energy savings they offer, according to a recent survey conducted by the Electric Power Research Institute. In the survey, 40% of users of compact fluorescent lights said they wouldn't buy more of them. And only 5% of nonusers said they would be likely to buy them in the future. The reason most often cited was price — prices over $10 were considered "outrageous," one respondent wrote. Other complaints concerned a lack of brightness (most compact fluorescents don't produce adequate reading light) and trouble fitting the bulbs in existing lamps and fixtures. □

TAX TALK

Deducting the Cost of Deductions (And Other Good News From the IRS)

by Milton Zall

For many years, taxpayers who itemized the deductions on their personal income tax returns could, in theory, itemize the cost of paying someone to prepare or help prepare their tax returns as a miscellaneous itemized deduction. But because such deductions are deductible only to the extent that they exceed 2% of your adjusted gross income, many taxpayers couldn't — and can't — deduct the cost of tax return preparation. Self-employed businesspeople find this 2% floor particularly irksome, because they often need paid assistance primarily to handle the complexities of properly preparing a Schedule C.

This policy seemed confirmed last year when the IRS, in a private letter ruling, held that even though a tax preparer's charges may in part relate to the preparation of a self-employed individual's Schedule C (business income) or Schedule E (rental income), the preparer's fee can only be claimed as a miscellaneous itemized deduction, subject to the 2% floor.

Fortunately for the self-employed, the IRS has since reconsidered. It now allows the portion of the tax preparer's fee that is attributable to the preparation of a Schedule C (or a Schedule E, for rental income) as a directly and fully deductible business expense, not subject to the 2% limitation. In addition, the cost of preparing the schedule relating to income or loss from rentals or royalties (part 1 of Schedule E) is also deductible.

The IRS also put a few other items on the list of items fully deductible. One is any costs incurred in "resolved asserted tax deficiencies" — that is, IRS audits — relating to a business, rental or royalty income, or farm. Thus if an audit pertains only to your business return (Schedule C), all of the fees associated with defending yourself in that audit, such as attorneys' or accountants' fees, can be written off.

This new IRS position is retroactive. Those who failed to claim deductions for such expenses in prior years can do so now, subject to the statute of limitations. For most contractors, this means 1990 and 1991. □

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Scald Suits, *continued*

NSKC wants regulators installed on sink faucets as well as on showers and baths.

"I'm actually all for what Safe Kids is doing," Stevens said. "How can you argue with protecting children? But the publicity surrounding their campaign has caught the attention of a lot of lawyers."

"What's happened in the last ten years," says consultant Ballanco, "is that the legal profession has gotten the message to people that if they have suffered and it's not their fault, somebody should pay. I've been telling plumbers for six or seven years now to throw their two-handle shower valves into the recycling bin. Plumbers carry a lot of liability insurance, and the lawyers know it."

Ballanco conjectures that the wider use of low-flow valves, which are more sensitive to drops or rises in pressure from one of the supply lines, may have led to more injuries. Specific numbers for injuries caused by scalding are sketchy, but one estimate holds that about 70,000 people were scalded last year.

The stakes are high in this issue, largely because of the scarring nature of the injury. Stevens, for instance, says that most scalding cases never make it to trial because the defense lawyers and insurers don't want to take their chances in front of a jury with such an emotion-laden case. So the insurers settle out of court, and the issue of who is actually responsible for the injury often goes unaddressed.

If the suits increase in number, general contractors will likely be pulled into them, much as the property manager was pulled into the Stevens suit. The ideal protection is to install one-handle controls and pressure or temperature regulators in every faucet, and most definitely in shower and bath faucets. And, as the Stevens case makes clear, contractors and plumbers should never "fail to warrant," that is, warn their clients about the dangers of hot water coming from the tap. □

— *Adapted from* Contractor *magazine.*