The line isn't always clear as to what is considered a deductible investment expense. But IRS rulings and court decisions can help you decide which ones pass muster.

An Investor's Guide to Deducting Investment-Related Expenses

By Julian Block

The United States got along without an income tax for over a century and a quarter. Not until 1913 did we amend the Constitution to permit one. And not until World War II did the tax become democratized, when tax withholding was introduced and the term "take-home pay" entered the language.

Since then, harkening to the voice of the home folks, all American presidents have committed themselves to tax reform. I think you will enjoy what Russell Baker's New York Times column of September 4, 1976, had to say about how we have benefited from that commitment:

"The words "tax reform" send chills down the spine of every sentient American because each new reform deepens the nightmare of income-tax law. Just when you have got a purchase on this monster, Congress reforms it and everybody has to start all over again. It has become a complexity to confound a Dickens lawyer, a maze to make King Minos' labyrinth look like a playpen. The conscientious citizen would have to devote every waking hour to its study if he wanted to make a reasonably close guess at what he owes his government each April.

"Even then, he would probably be wrong. Tests of Internal Revenue workers—the people who help the desperate fill out their forms—have shown that the majority even of these experts didn't know what the law means. And it may all change again."

A decade after Mr. Baker's plaint appeared in print, President Ronald Reagan and a complaisant Congress cut a deal that spawned the Tax Reform Act of 1986. Tucked into that overhaul of the Internal Revenue Code was a provision that scaled back the write-offs allowed investors who itemize their deductions on Schedule A of Form 1040.

Although the rules have themselves been in effect for a decade, they remain a maze to most investors. As the end of the tax year looms, it is an opportune time to provide an investor's guide through this maze of tax rules as they relate to investment expenses.

The Rules Today

The rules that were tightened under the 1986 Tax Reform Act apply to miscellaneous itemized deductions for such investment-related expenses as subscriptions to publications that track the ups and downs of the stock market, rentals of safe-deposit boxes, and fees charged by financial planners and other advisers. Besides investor outlays, the miscellaneous category includes deductions such as dues payments to unions and professional associations.

Formerly, the law allowed itemizers to deduct 100% of their miscellaneous expenses. Now, however, most of these expenses are allowable only to the extent that their total in any one year exceeds 2% of adjusted gross income (AGI, in tax lingo). Anything below the 2%-of-AGI floor is no longer deductible. (Adjusted gross income is the amount you list on the last line of the front of Form 1040 after all reportable income is offset by certain deductions such as payments of alimony and funds placed in an IRA.)

For example: You declare an AGI of $30,000 and itemize. Your investment and other miscellaneous expenses aggregate $800. Previously, the amount deductible was the entire $800. Now the allowable amount is just $200 (what is left after the $800 is reduced by $600, which is 2% of $30,000). With an AGI above $40,000, the $800 ceases to be deductible at all under the revised rules.

Where can you run into trouble?

- If your adjusted gross income is above a specified amount, you suffer a partial disallowance of your allowable write-offs for most itemized deductibles, including miscellaneous deductions. The disallowance is 3% of

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This article is excerpted from "Julian Block's Tax Avoidance Secrets 1996," published by Boardroom Inc., available for $19.95 from the author, 3 Washington Square, Dept. AA Larchmont, N.Y. 10538-2032.

the amount by which your AGI surpasses the specified amount, which is adjusted annually for inflation. In 1996, the threshold amount is adjusted gross income of $117,950.

- If you are subject to the alternative minimum tax (AMT), no miscellaneous deductions are allowed when calculating AMT.
- If your portfolio includes both taxable and tax-exempt investments, you must determine the portion of the expenses allocable to tax-exempt income. Those outlays are not deductible as investment expenses.

What can you do to optimize your tax situation?

Assuming you incur sufficient miscellaneous deductions to surpass the 2%-of-AGI floor, you should familiarize yourself with the array of deductions available to investors. Allowable expenses include many more items than just those obvious outlays for investment counseling, subscriptions to advisory services, telephone calls, and postage. Often, though, it is difficult to know just where the Internal Revenue Service and the courts draw the line on what you can deduct.

For instance, your deductibles include the cost of a safe-deposit box that holds stocks, bonds or other investment assets, but not one that contains only personal papers or tax-exempt securities. Similarly, you can write off fees paid to a bank or broker for collections of dividends or interest, but not brokerage commissions that must be added to the cost of the securities purchased.

Gray areas abound because revenue agents and judges take their cues from guidelines set by Internal Revenue Code Section 212, a loosely worded statute that authorizes investors to write off their expenses "for the production or collection of income" or "for the management, conservation or maintenance" of income-producing property.

Here's a more detailed look at some IRS rulings and court decisions to help you decide whether your expenses pass muster.

Travel

One frequently overlooked deduction is for the cost of travel, though not all trips are deductible. For example, the Tax Court allowed Martha Henderson and other investors to deduct what they spent on trips to their brokers to discuss specific stock transactions. On the other hand, the court refused to approve travel deductions for someone like Stanley Walters who regularly spent his lunch hours in brokers' offices where he merely watched the ticker tape to "get a feel for the market."

When your investments require travel by bus, train, plane, or taxi, simply keep a record of your fares. Include them on Schedule A of Form 1040 with your other itemized deductions under "miscellaneous deductions," just the same as for payments to return preparers or for publications that help you with your tax planning.

As for travel by auto, you have the usual options in figuring deductions:

- Claim your allowable operating expenses (gas, repairs, depreciation) attributable to use of the car.
- Simplify the recordkeeping by using a standard mileage rate. Under the rules applicable to tax year 1996, the standard rate is $0.31 a mile.

Whether you claim operating expenses or a flat allowance, don't forget to deduct for parking fees and bridge or highway tolls. You should back up your deductions for investment travel with a glove-compartment diary in which you record why and how far you went, along with the cost of parking and tolls. A typical diary entry might read "7/8/96; travel expenses to Smith Barney, regarding purchase of common stocks; round trip of 20 miles at $0.31 per miles equals $6.20, plus $2.00 for bridge tolls, for a total of $8.20."

Shareholders' Meetings

Back in 1956, the IRS issued a ruling that spelled out its guidelines for persons who attend stockholders' meetings of companies in which they own stock, but have no other interest. The ruling bars any deduction for travel expenses when such stockholders attend merely to get information that would help in making further investments. It makes no difference that their major sources of income are dividends and profits on stock transactions (Rev. Rul 56-511).

Subsequently, however, the IRS yielded on a deduction for expenses incurred by the leader of a stockholders' revolt. It seems that John Hickey owned a substantial number of shares in Icarus Airlines. His shares had dropped in value because the company had issued new shares to the public at prices below book value. To stop such sales, an irate John hied himself to Icarus' annual meetings and persuaded the concern to poll its shareholders about joining an association. Assuming sufficient support for his proposal, there would be an organizational meeting at which John expected to be a mover and a shaker.

An obliging IRS linked the travel to protection of his investment. It ruled that John was entitled to deduct what he spent for travel, including lodging and 50% of meal expenses, to the annual and organizational meetings, provided two requirements were satisfied. First, he must be "one of the main organizers of the association, so that his presence at the meeting would be required." Second, the primary purpose of the trips must be to "form the association to prevent or reduce the dilution of his stock" (Ruling 8042071).

Protection of an investment also justified a deduction for Robert Montesi, who traveled to an annual shareholders' meeting of Procrustes Furniture. Robert introduced and maneuvered to pass a resolution requiring the company to halt its practice of issuing shares at below-book value through dividend reinvestment and stock-purchase plans. The IRS distinguished his case from its 1956 ruling, which disallowed deductions for shareholders who attend annual gatherings mainly to pick up information for future investment moves. Here, Robert's pilgrimage was prompted primarily by his desire to safeguard his sizable stake in Procrustes (Ruling 8220084).

Investment Seminars

Tax reform also abolished deductions for costs incurred by investors to attend conventions, seminars, or similar meetings at which they obtain information that helps them plot strategies. Disallowed expenses include travel to the meeting site, attendance fees, meals, lodging, and local travel while attending.

What prompted Congress to enact this absolute prohibition? A key factor was the unhappiness of the IRS with the pro-taxpayer position taken by the tax court in a dispute involving Lorraine Gustin of Brown Deer, Wisconsin, a serious student of the stock market.

Lorraine's pursuit of profits took her to investment-club conferences in Amsterdam, Cleveland, and San Diego during the year selected for audit by the IRS. She devoted a considerable amount of time to managing her portfolio and held posts in the National Association of Investment Clubs, an organization that holds conventions where members can discuss investment strategies with stock market analysts and other experts and listen to presentations from executives about their companies.

Lorraine took a write-off for her expenses of attending the three meetings, but not those of her husband or the cost of their post-convention side trips to places like the Greek islands and San Francisco. The IRS argued that her expenditures of $2,400 for air fares, meals and hotel rooms were non-deductible personal expenses because the main aim of conventioneering was not to collect investment information.

But Lorraine convinced the court that "her attendance at the convention was part of a rationally organized investigation into investment opportunities and strategies. It was reasonable to spend $2,400 to protect and enhance a portfolio worth $98,000. Any personal benefits of the trip were secondary to the investment benefits." Moreover, the information that she obtained at the conventions from analysts and company representatives directly influenced her later decisions on what stocks to add to or remove from her portfolio.

Predictably, the IRS persuaded an accommodating Congress that Lorraine's victory should not be repeated. That is why the long list of scaled-back or repealed deductions features a provision that wipes out any tax breaks for investment seminars, a move guaranteed to cause those gatherings to be less alluring to investors.

Office-at-Home, Computers & Software

You are unable to claim this kind of write-off when you use part of your residence to, say, read financial publications and clip bond coupons. The only exception, cautions the IRS, which has the consistent backing of the courts, is for someone whose investing activities qualify as a "trade or business"—a stipulation that few investors satisfy.

The IRS is not as unyielding when you use a computer to keep track of your portfolio, select stocks or help plan taxes and fill out returns. What the agency requires is that you use the "straight-line method" to figure depreciation.

For example, say you use a $3,000 home computer 40% of the time for investment and tax purposes and 60% for personal reasons, such as home budgeting or entertainment. The amount to depreciate: Just $1,200, and that has to be deducted in equal slices over the computer's "useful life" of five years.

Software generally is depreciated over 36 months. For a faster write-off, you must be able to show that the program has to be replaced each year—tax-preparation software, for instance. In that case, you get to deduct the entire cost immediately and, like the computer, count it as a miscellaneous deduction that helps you to surmount the 2% threshold.

Proxy Fights

Usually, the IRS goes along with a deduction for the cost of carrying on a proxy fight, except where a shareholder engages in the fight for personal reasons rather than to protect income. Moreover, the tax court has held that this rule applies to legal fees paid in anticipation of a proxy fight that never took place because the dispute was compromised. Here's a case in point:

Jean Nidetch was president and director of Weight Watchers International, as well as a major shareholder. A dispute arose among Weight Watchers shareholders, and a proxy battle was foreseen. Jean had earlier placed a substantial block of Weight Watchers stock in two trusts for the benefit of her children. The trusts were managed by trustees who were friendly with the opposing group in the upcoming proxy contest. To bolster her position, Jean brought legal proceedings to replace those trustees with individuals who were friendly to her. Ultimately, the dispute was settled without the necessity of a proxy contest.

The tax court held that the legal fees paid by Jean to replace the trustees did qualify as expenses incurred to protect her dividend income from the corporation and to safeguard her job. It made no difference that the proxy contest never came to pass.

"The preliminary steps taken in anticipation of a proxy fight preempted by settlement are incurred for the same purposes as those incurred in the initial stages of a dispute culminating in any actual proxy battle. To deny deductibility of the former, while according deductibility to the latter, would penalize those parties who are able to amicably settle their disputes," stated the court.