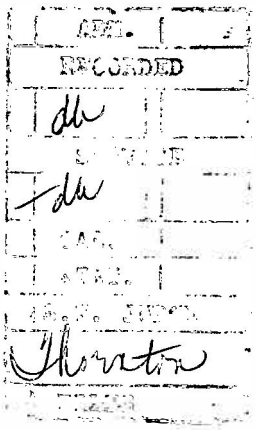

117 T.C. No. 24

UNITED STATES TAX COURT

SAMUEL T. SEAWRIGHT AND CAROL A. SEAWRIGHT, Petitioners v.
COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket No. 1796-00. Filed December 18, 2001.

R's examination of Ps' tax liability commenced no later than July 16, 1998. After Ps petitioned this Court to redetermine the deficiency, R's trial counsel informally contacted potential third-party witnesses without providing advance notice to Ps.

1. Held: Sec. 7602(c), I.R.C., which requires that R give the taxpayer advance notice of third-party contacts regarding R's examination or collection activities, is inapplicable with respect to R's examination activities here, which all occurred before the Jan. 19, 1999, effective date of sec. 7602(c).

2. Held, further, sec. 7602(c), I.R.C., is inapplicable with respect to R's trial preparation activities.

3. Held, further, sec. 7602(e), I.R.C., which restricts R's use of financial status or economic reality examination techniques, is inapplicable with respect to R's examination techniques which were employed before the July 22, 1998, effective date of sec. 7602(e), I.R.C..

4. Held, further, Ps bear the burden of proof.

FINDINGS OF FACT

The parties have stipulated some of the facts, which we incorporate herein by this reference.

Petitioners

Petitioners are married. When they filed their petition, they resided in Columbia, South Carolina.

Columbia North East Used Parts

Petitioner Samuel T. Seawright (Samuel) owned and operated a family business known as Columbia North East Used Parts (Columbia), located on Hardscrabble Road in Columbia, South Carolina. Samuel was the primary laborer for Columbia, petitioner Carol Seawright (Carol) was the record-keeper, and petitioners' son, Monty Seawright (Monty), worked with Samuel at Columbia on weekends.

Columbia began operations in 1977, when Samuel paid about $2,000 for five junked cars. Petitioners owned a 1978 Ford truck with a wrecker boom in the bed. Samuel used the truck to pick up and haul away items such as appliances, scrap metal, and junked vehicles. Samuel did not charge for the hauling service.

Petitioners stored the junked vehicles and other hauled-away items at their scrap yard on Hardscrabble Road. Samuel rebuilt some of the junked vehicles to sell. Petitioners salvaged and sold used parts from some of the junked vehicles.

Revenue and Taxation, Division of Motor Vehicles (DMV) an "Owner's/Rebuilder's Affidavit", certifying, among other things, the fair market value of each rebuilt vehicle, as estimated in the National Automobile Dealers Association (NADA) Official Used Car Guide (blue book).[3] Four of these affidavits were filed in 1995. On these affidavits, Samuel certified NADA estimated fair market values for four of the rebuilt vehicles in amounts totaling $32,100.[4]

Petitioners' Federal Income Tax Returns

Carol prepared petitioners' 1994 and 1995 joint Federal income tax returns. On the Schedule C, Profit or Loss From Business (Sole Proprietorship) (Schedule C), attached to their 1994 return, petitioners reported that Columbia had $500 gross receipts and zero cost of goods, showing no opening inventory, no purchases, and no ending inventory. For 1994, petitioners reported that Columbia had a net loss of $3,486.

On the Schedule C attached to their 1995 return, petitioners reported that Columbia had $20,852 in gross receipts, cost of

---

[3] Petitioners did not have a car dealer's license. In order to sell the six rebuilt vehicles, Columbia North East Used Parts (Columbia) first transferred title to petitioners' son, Monty Seawright (Monty), for no consideration. Monty then made application for certificates of title/registration with the South Carolina Department of Revenue and Taxation, Division of Motor Vehicles (DMV).

[4] The two remaining affidavits were filed in March and April 1996. On these affidavits, Samuel certified fair market values of the other two rebuilt vehicles totaling $9,925.

Expense item	Amount claimed on return	Amount allowed	Adjustment
Car & truck	--	$467	$(467)
Depreciation	--	856	(856)
Employee benefit program	$1,106	--	1,106
Insurance	844	--	844
Office expenses	514	154	361
Other rent	2,781	--	2,781
Supplies	2,450	--	2,450
Taxes & licenses	1,776	1,024	751
Mortgage	879	879	-
Utilities	646	404	242
Totals	$10,996	$3,784	$7,212

Respondent also disallowed petitioners' claimed cost of goods sold in its entirety on the grounds that petitioners had failed to substantiate the amount of purchases and had failed to establish the value of Columbia's opening and closing inventories for taxable year 1995. Respondent made no adjustment to the amount of Columbia's 1995 gross receipts as reported by petitioners.

On February 15, 2000, petitioners filed their petition with this Court. On March 27, 2000, respondent filed his answer, requesting that his determination as set forth in the notice of deficiency be in all respects approved. On October 2, 2000, the trial was held in Columbia, South Carolina.

Section 7602(c) is effective for contacts made after the 180th day after the July 22, 1998, enactment of RRA 1998 (i.e., after January 18, 1999). See RRA 1998 sec. 3417(b), 112 Stat. 758.

Alleged Third-Party Contacts During the Examination

On brief, petitioners allege that during the initial July 16, 1998, meeting, Leary told Carol that she had previously contacted petitioners' bank and that Leary subsequently asked Carol why petitioners changed banks so often. Petitioners allege that this line of inquiry "shows that she [Leary] had extensive third party contacts". Petitioners allege that they told Leary that they wanted to be notified whenever a third party was contacted, but they never received any third-party contact information from the Internal Revenue Service (IRS).

Section 7602(c) has no application to any third-party contacts that might have been made by respondent's agents before the January 19, 1999, effective date. The evidence does not show that Leary or any other of respondent's agents made any third-party contacts after January 18, 1999, in the course of the examination that culminated in the January 6, 2000, issuance of the notice of deficiency.

Alleged Third-Party Contacts During Trial Preparation

On brief, petitioners allege that shortly before the October 2000 trial date, respondent's agents contacted various third

The pertinent legislative history states that the purpose of section 7602(c) is to require "the IRS to notify the taxpayer before contacting third parties regarding examination or collection activities (including summonses) with respect to the taxpayer." S. Rept. 105-174, at 77 (1998), 1998-3 C.B. 537, 613 (emphasis added). Accordingly, we conclude that Congress did not intend section 7602(c) to apply to third-party contacts made by the IRS in the course of trial preparation activities, where those contacts are not with respect to examination or collection activities.[5]

This interpretation is consistent with the general statutory scheme, which distinguishes between the litigation of tax liabilities, see chapter 76 (captioned "Judicial Proceedings"),

---

[5] We are mindful that under sec. 6212(c), the Internal Revenue Service (IRS), may, in certain circumstances, determine an additional deficiency after the taxpayer files a timely petition with the Tax Court, and that in the course of making such further determination, the IRS is not barred from exercising its examination authority under sec. 7602(a). See United States v. Gimbel, 782 F.2d 89, 93 (7th Cir. 1986) (pending Tax Court proceedings did not bar IRS from invoking summons authority, rather than using Tax Court discovery procedures, in seeking the taxpayers' financial records, where the taxpayers' liability was still subject to redetermination pursuant to sec. 6212(c)); Bolich v. Rubel, 67 F.2d 894, 895 (2d Cir. 1933)("Since the Commissioner may apply to the Board [of Tax Appeals] to increase the assessment [in the notice of deficiency], he may need to prepare his case in advance by a further examination, which is quite another matter from producing evidence in support of it."). The instant case does not present, and we do not reach, the issue of the extent to which the restrictions of sec. 7602(c) might apply with respect to examinations conducted by the IRS to determine an additional deficiency pursuant to sec. 6212(c) during the pendency of a Tax Court proceeding.

does not restrict that authority.

As far as the record reveals, respondent's examination activities ceased no later than January 6, 2000, when respondent issued the notice of deficiency. Respondent has not sought to use the section 7602(a) examination power to determine any additional deficiency, pursuant to section 6212(c). There is no evidence that respondent used the section 7602(a) examination power to summon prospective third-party witnesses and take testimony under oath. Cf. Westreco, Inc. v. Commissioner, T.C. Memo. 1990-501, modified in Ash v. Commissioner, 96 T.C. 459 (1991). There is no evidence to suggest that respondent's agents made any third-party contacts in connection with any collection activity.[7]

We conclude that the informal contacts of potential witnesses by respondent's trial counsel in preparation for trial were not made in the course of respondent's examination or collection activities and therefore are not subject to the restrictions of section 7602(c).

---

[6](...continued)
be submitted to the Court and to petitioners at least 15 days before the trial session. Respondent complied with these requirements of the standing pretrial order.

[7] As a general matter, if the taxpayer has filed a petition with this Court for a redetermination of the deficiency, the IRS may not commence collection activities until this Court's decision has become final. Sec. 6213(a).

Under Rule 142, the burden of proof is upon the petitioner, except as otherwise provided by statute. In certain circumstances, if the taxpayer introduces credible evidence with respect to any factual issue relevant to ascertaining the proper tax liability, section 7491 places the burden of proof on respondent. Sec. 7491(a); Rule 142(a)(2). Section 7491 is effective with respect to court proceedings arising in connection with examinations commencing after July 22, 1998. RRA 1998 sec. 3001(c)(2), 112 Stat. 726.

The undisputed facts indicate that respondent's examination of petitioners' 1995 Federal income tax return commenced before July 23, 1998. Accordingly, section 7491 has no application to this case. Petitioners bear the burden of proof. Rule 142(a).

Petitioners' Trade or Business Expenses

The parties disagree about petitioners' entitlement to deduct, pursuant to section 162, various trade or business expenses.

Vehicle Expenses

On their 1995 return, petitioners claimed no deduction for vehicle expenses. In the notice of deficiency, respondent allowed petitioners a deduction of $467. Petitioners have not established that they are entitled to a vehicle expense deduction greater than respondent has allowed.

Petitioners have not established that they are entitled to any deduction for "Other rent".

Supplies

On their 1995 return, petitioners claimed a $2,450 deduction for supplies, all of which respondent disallowed in the notice of deficiency. On brief, respondent concedes that petitioners incurred $2,450 in expenses for materials used to rebuild vehicles but contends that this amount should be added to purchases in computing petitioners' cost of goods sold, rather than deducted as a current expense. We agree with respondent.

The evidence in the record indicates that the claimed supplies expenses relate to petitioners' rebuilding junked automobiles for sale and that these expenses represented either raw materials or supplies entering into the rebuilt automobiles or direct labor relating thereto. These amounts are includable in the cost of petitioners' rebuilt automobiles, see sec. 1.471-3(c), Income Tax Regs., and thus are not deductible as trade or business expenses pursuant to section 162(a) but rather enter into the calculation of petitioners' cost of goods sold in determining their gross income, see Beatty v. Commissioner, 106 T.C. 268, 273 (1996).

Small Tools

Petitioners contend that they are entitled to a $281 deduction for small tools. While small tools with a useful life

Columbia's ending inventory for 1995 consisted of whatever no-cost items remained from its 1995 opening inventory, plus the items purchased for $18,742 (including 14 junked vehicles) plus the $2,450 expended on supplies (as previously discussed). Thus, Columbia's ending inventory had a cost of $21,192.

Petitioners contend that the market value of Columbia's 1995 ending inventory was only $1,500, which they argue was the scrap value of the 1995 ending inventory. Petitioners have failed to substantiate their claimed market value "by providing evidence of actual offerings, actual sales, or actual contract cancellations." Thor Power Tool Co. v. Commissioner, 439 U.S. 522, 535 (1979). In any event, petitioners' contention is contradicted by Samuel's admissions in the Owner's/Rebuilder's Affidavits filed with the DMV in 1995, certifying that the NADA estimated fair market values of just four of the rebuilt automobiles in Columbia's inventory totaled $32,100.[10] Petitioners' contention is further undermined by evidence showing that these four rebuilt automobiles, along with another vehicle

---

[10] Although Columbia transferred title to the rebuilt vehicles to Monty for no consideration before the vehicles were sold to third parties, Samuel testified that the transfers to Monty were not gifts, stating: "The fact is that these vehicles were put in his [Monty's] name in order to sell it [sic]. All of them were reported as income through our business." Consequently, we ignore petitioners' transfers of the rebuilt automobiles to Monty.