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THE MEDICAL EXPENSE DEDUCTION FOR SRS
SURGERY: A PERSONAL DEDUCTION WITH BUSINESS
EFFECTS

by
David S. Kistler*

INTRODUCTION

This paper briefly explores the parameters for a medical deduction for a specific surgery. The issue presented is whether sexual reassignment surgery (SRS) is a nondeductible cosmetic surgery procedure or a deductible medical expense, in that it represents a necessarily prescribed treatment for a medical disease. This issue has been raised in a recent tax court case filed by *Rhiannon O'Donnabhain against the Commissioner*.¹

Although a personal deduction is not a business expense, many personal deductions affect businesses and are of great concern to specific industries. Examples include interest expense on home mortgages and medical expenses. The former is a deduction favored by the home builders and banking industries. The later is a deduction of concern to the insurance and medical industries. All deductions are of interest to tax preparation businesses.

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One specific type of medical deduction is the SRS procedure. This procedure is used to treat Gender Identity Disorder (GID) and involves both physicians and psychotherapists. Additional surgical procedures may also be undertaken by individuals diagnosed with SRS. This includes breast implant surgery, trachea shaving, nose realignment, lip augmentation, cheek implants, chin shrinkage, and scalp forwarding procedures. It is estimated that "1,000 to 2,000 Americans a year . . . undergo sex-change operations."² This paper will explore the arguments for and against allowing this expense as a tax deduction.

INTERNAL REVENUE CODE & TREASURY
REGULATIONS

Several parts of the Internal Revenue Code (IRC) § 213 apply to the question of deductibility regarding a surgical operation. The first subsection of this general rule of law allows a deduction for medical expenses and reads "There shall be allowed as a deduction the expenses paid during the taxable year . . . for medical care of the taxpayer."³ The second subsection defines *medical care* as the "amount paid for the diagnosis, cure, mitigation, treatment, or prevention of disease, or for the purpose of affecting any structure or function of the body."⁴ The third subsection that is applicable is a limitation restricting the term *medical care* by excluding "cosmetic surgery or other similar procedures."⁵ Finally, there is the subsection where *cosmetic surgery* is defined as "any procedure which is directed at improving the patient's appearance and does not meaningfully promote the proper function of the body or prevent or treat illness or disease."⁶

The Internal Revenue Regulations add insight to the Internal Revenue Code. In Treas. Reg. § 1.213-1(e)(1)(ii) it is stated that "[I.R.C.] § 213 will be confined strictly to expenses

incurred primarily for the prevention or alleviation of a physical or mental defect or illness.” The Regulations also state that the question of a medical expense is “a question of fact which depends upon the condition of the individual and the nature of the services he receives.”⁷

SETTING THE STAGE

The issue of whether or not to take an I.R.C. § 213 deduction for a medical surgery has several court created guidelines. These general rules attempt to clarify the question of what is deductible. Decisions made generally rest upon a question of fact.

In *Thoene v. Comm*’⁸ the plaintiff took dance lessons to help correct emotional and physical problems with he had been diagnosed. Upon the advice of his doctor and psychiatrist, petitioner took dance lessons to become engaged with people while in a social environment for these problems. Tax Court applied a rule that stated expenses which are normally considered personal items are not deductible. The dance lessons were deemed to be a normal personal item by the court. It was found that no physical or psychiatric therapy resulted from the dance lessons. Tax Court also stated that there would be “rare situations when such expenses would lose their identity as ordinary personal expenses and become properly classified as medical care expenses.”⁹ The tax court also was stated that “not every expenditure prescribed by a physician is . . . a medical expense.”¹⁰ Neither would the characterization of the treatment as beneficial be sufficient to allow a deduction as a medical expense.

Other cases support this reasoning. In *Mizl*¹¹ the petitioner took a cruise to help lessen the physical problems of hypertension, latent diabetes, and arteriosclerotic heart disease.

Petitioner’s physician never recommended the cruise. The Tax Court found that the cruise was similarly related to a vacation because it was not essential to the health of the petitioner. The rule established was that expenses for a person’s general health are not deductible even if recommended by a doctor.

In Revenue Ruling 97-9 the taxpayer, based upon a doctor’s recommendation, obtained a controlled substance for medical reasons. This was a violation of federal law (Controlled Substances Act). The Revenue Ruling stated that expenses for a drug are not deductible if such a purchase violates federal law notwithstanding the fact that a physician recommended the purchase or that state law allows the purchase.

In *Levine*,¹² the Tax Court held that legal expenses for the supervision of a mentally deficient person were not deductible as a medical expense. Legal expenses are deductible only if they are incurred in the pursuit of medical care. The rule established for a medical deduction was the “but for” test. The petitioner is required “to prove both that the expenditures were an essential element of the treatment and that they would not have otherwise been incurred for nonmedical reasons.”¹³

A reverse situation occurred in *Al-Murshidi*, where the opinion of a physician that an expenditure was cosmetic was deemed to be incorrect based on the facts. The petitioner had severe obesity. The Tax Court found that the excess skin caused “skin breakdowns, sores, infections, pain, and irritation.”¹⁴ The physician, a plastic surgeon, referred to the corrective surgery as “cosmetic.” The Tax Court stated that obesity is a well recognized disease and that the excess skin caused several medical problems. It was held that the surgery to remove the excess skin was a deductible expense. A special

note regarding this case is that under I.R.C. § 7463 “this opinion should not be cited as authority”¹⁵ because it is only a memorandum decision.

The personal expenditure for medical reasons rule is a presumption and can be overcome by sufficient evidence. A satisfactory nonmedical reason would be an expense for business purposes. Such a situation took place in a case regarding a breast enlargement. In *Hess*,¹⁶ the petitioner underwent surgery multiple times to enlarge her breasts to a size 56N. Each silicone breast implant weighed approximately 10 pounds. Normally, a breast enlargement surgery would be considered a personal expenditure. However, the court found that an enlargement of this proportion “made her [petitioner] appear ‘freakish.’”¹⁷ Petitioner claimed that the implants were only for her business as a professional exotic dancer and the court found that her fees almost doubled after the surgery. A similarity was drawn between the implants and a stage prop or clothing that is useful only in a business setting. The Tax court ruled in this situation that the “implants were so extraordinarily large . . . that they were useful only in her business.”¹⁸ Tax court relied upon the ordinary and necessary standard for business expenses.

Acceptable medical treatment expenses which are deductible also include items that affect the body in structure or function. In Revenue Ruling 2003-57 this concept included breast reconstruction surgery due to cancer in that it “ameliorates a deformity directly related to a disease”¹⁹ and laser eye surgery because it “is a procedure that meaningfully promotes the proper function of the body.”²⁰ Revenue Ruling 1973-201 included expenses for prevention “of conception and childbirth or to terminate pregnancy.”²¹ This ruling also covered vasectomies on the grounds that “purpose of the operation is to affect both a structure and a function of the

body”²² and therefore, deductible. Such operations do not need the recommendation of a physician. Revenue Ruling 73-603 allowed a deduction for an abortion where the petitioner sought the operation without advice of a physician.

In 2004, Katherine T. Pratt indicated in a Cornell Law Review article that “several courts have also held that sexual reassignment surgery for treatment of a transsexual with Gender Identity Disorder is a medical necessity.”²³ The article, however, cites only one case, *Pinneke v. Preisser*.²⁴ The Eight Circuit Court of Appeals in *Pinneke* stated that “from this record, it appears that radical sex conversion surgery is the only medical treatment available to relieve or solve the problems of a true transsexual.”²⁵

THE PROBLEM

In the current case of Rhiannon O’Donnabhain, the petitioner took a deduction for SRS and other surgical operations (breast implant surgery, trachea shaving, nose realignment, lip augmentation, cheek implants, chin shrinkage, scalp forward procedures). Petitioner desired to completely change his body function from male to female. The Internal Revenue Service (IRS) initially allowed the deductions, but then denied the deductions as cosmetic surgery and sent her a deficiency notice. O’Donnabhain filed suit in Tax Court in 2007 rather than pay the deficiency notice.

On behalf of the Petitioner, there were two psychotherapists that examined the taxpayer and both concluded that the taxpayer had GID. It was also found that the “the strict pre-surgery criteria of the Harry Benjamin Standards”²⁶ had been met. These criteria included 12 months of receiving hormone therapy to begin a change from a male body to a female body, living as a female for 12 months before

a SRS operation (referred to as “real-life experience”), and receiving ongoing psychotherapy to adjust for the change. The taxpayer showed that GID is a recognized disease as stated in the American Psychological Association’s handbook on mental disorders, *The Diagnostic and Statistical Manual of Mental Disorders, 4th Edition* (DSM-IV) (hereafter referred to as the APA handbook). SRS is the recommended medically necessary treatment for this mental disorder (GID).

The deduction is attacked by the IRS from a number of different positions. First, two expert witnesses are utilized to discredit SRS treatment. Dr. Park Dietz’s testimony attempts to support the position that GID is not a pathology problem and thus not a disease. Pathology is defined as something abnormal, either an anatomic or physiologic disease.²⁷ The testimony of Dr. Chester Schmidt, Jr. is intended to support the position that SRS is not able to meaningfully treat GID and that GID is not a universally accepted diagnosis. Second, the IRS uses the APA handbook against Petitioner because it has limiting statements. Some disorders stated in the APA handbook are clearly identified as being merely social or behavior problems. Examples are caffeine intoxication, sleep disorder, and jet lag. In addition, a cautionary statement is made in the APA handbook that a specific category may not meet legal criteria for a disease. The final argument by the IRS is that surgery and hormone treatment to bring about an appearance change is cosmetic in nature.

ANALYSIS

The pathology argument by Dr. Dietz is simply not substantiated. No Internal Revenue Code section, Treasury Regulation, court case, Revenue Ruling, or Revenue Memorandum supports the position that deductibility is denied if a disease, either anatomic or physiologic, is not of an

abnormal nature. Abnormality or normality is not the standard to determine deductibility. There are many physical diseases that are rare in occurrence or nature, but have treatments acceptable as medical deductions.

The APA Handbook itself contradicts Dr. Schmidt’s belief that SRS is not a meaningful treatment for GID. This “bible” of The American Psychological Association states the generally recognized standards of treatment for its listed mental and psychological diseases. Although Dr. Schmidt is correct in stating that GID is not accepted by all medical practitioners as the accepted diagnosis, GID is widely held to be the standard diagnosis for this mental condition.

Statements in the APA handbook are not decisive in and of themselves. Although some disorders in the APA handbook are categorized as merely social or behavior problems, GID is not one of them. Therefore, the terminology of behavioral problem does not apply to SRS. In addition, the cautionary statement in the APA handbook regarding the legal criteria is a general disclaimer that the psychological viewpoint of a disease may not meet the legal definition. Each specific disorder mentioned in the APA handbook, then, has to be examined. The real question is, what is the legal standard? The problem here is one of a mental disorder, which is not easily accepted as a medical problem due to the failure to see a need for a physical correction.

Finally, it is the IRS position on SRS “that sex-change surgery is a choice, like cosmetic surgery, rather than a deductible medical expense like psychiatric care.”²⁸ However, the question of choice is not the standard set by the Internal Revenue Code, the Treasury Regulations, or the courts for the deductibility of a surgical operation. The IRS argument is that this surgery is merely an improvement on one’s appearance

and that it is for personal satisfaction. The IRS could also argue that the surgery does not promote a proper body function in that the body the petitioners have already functions properly. The petitioner simply desires a different function. There is no restoration of the body to normal functioning and there is no avoidance of immediate danger of physical harm. Many of the individual procedures obtained by petitioner could be construed as personal expenditures. The Senate Finance Committee report in the Omnibus Budget Reconciliation Act of 1990, for example, stated that "procedures such as hair removal electrolysis, hair transplants, liposuction, and face lift operations generally are not deductible."²⁹ The IRS could take the position that SRS is a choice for psychological distress only in that the petitioner is seeking a correction in perception of him or her self. However, the APA handbook states that GID is "a profound disturbance of the individual's sense of identity with regards to"³⁰ their sex.

In examining the question of choice, SRS "is not treated by physicians as a purely elective surgery like cosmetic surgery."³¹ The general viewpoint of psychotherapists is that SRS "allows a person to function better and be more comfortable in society."³² GID is considered a mental disease and SRS is a corrective measure or treatment. What must be kept in mind is that the opinion of physicians has not been always a standard employed to determine deductibility. For example, in *Thoene* the physician recommended the treatment of dance lessons for which the petitioner was denied a deductible medical expense. Tax Court denied the deduction. The court stated that the opinion of a physician is not a standard to examine the question of deductibility. In a reverse situation, the physician in *Al-Murshidi* referred to the treatment as cosmetic, but the Tax Court held that the expenditure was a deductible medical expense.

Petitioner claims that having GID causes "severe emotional pain"³³ and that SRS is required for a normal life.³⁴ Life in the current state for petitioner was very unsatisfying³⁵ and there could have been psychological or physical damage to his or her well-being.³⁶ These statements are supported by the doctors who examined petitioner and required pre-determined criteria (Harry Benjamin Standards)³⁷ to be completed before SRS was approved. GID was considered a congenital abnormality (defect at birth) for petitioner.³⁸

CONCLUSION

Relying upon the Internal Revenue Code and the Treasury Regulations the correct standard for surgery is defined as a "diagnosis, cure, mitigation, treatment or prevention of disease."³⁹ A limitation for a nonallowable deduction exists in I.R.C. § 213 for cosmetic surgery. There is a two-pronged requirement under this limitation in that the cosmetic type of surgery is for improving the petitioner's appearance and not treating a disease. The Internal Revenue Code and the Treasury Regulations both recognize mental and physical illnesses or diseases. Both state that a medical expense is deductible for the alleviation of a mental illness. GID is defined by psychotherapists as a mental disorder in the APA handbook. SRS is used to treat the recognized disease of GID. Using these standards, SRS is a medical deductible expense.

Several rules have been established from Tax Court cases. First, there is the "rare situation" standard. The *Thoene* case established that an expense usually deemed as a personal item can be a medical expense deduction except for "rare situations." SRS is certainly not a rare procedure if 1,000 to 2,000 such operations are performed each year.

Next, the question is what is personal? SRS has never been clearly defined as a personal item. The Tax Court in *Hess* stated that neither the Internal Revenue Code nor the Treasury Regulations “contain a definition of ‘personal.’”⁴⁰ Normally, breast implants have been treated as personal expenditures because the surgery is done to enhance the appearance of the taxpayer. However, in *Hess* the breast implants were held to be deductible. It can also be argued that SRS changes the function of the body and is not merely a physical improvement. Even the Internal Revenue Code classifies a change in the function of the body as a deductible medical expense.

In *Levine* the petitioner was required to defeat the “but for” test. Petitioner was required to prove two elements for deductibility. First is that the treatment is an essential element for the cure of the disease. Second is that the expenditure would not have occurred except for medical reasons. In regards to the first element, a question could be raised what other type of treatment could be administered to correct for GID? To date, there are no other generally accepted treatments. Another question is whether there must be only one clear treatment or whether several treatments could coexist? In regards to the second element the question could be raised why would one want to have a surgical operation that changes the function of the body other than for medical reasons? This is not merely an improvement to one’s body, but a radical change.

From an examination of the statutes and court cases, SRS should fall within the purview of I.R.C. § 213 as a deductible medical expense. This is based upon: 1) the fact that GID is a well-recognized mental disorder and SRS is the only generally accepted treatment for that disorder (based upon the American Psychological Association’s psychiatric handbook on mental disorders), 2) the Internal Revenue Code

allows for the treatment of a mental disorder to be a deductible medical expense, 3) in *Al-Murshidi* the Tax Court found that expenditures for a well-recognized disease are deductible, and 4) the petitioner met all the pre-determined rigorous criteria for the surgery.

ENDNOTES

¹ *O'Donnabhain v. Comm'r*, No.640206, (Tax Court filed March 31, 2006).

² Anthony Faiola, *Woman Suing IRS Over Sex-Change Tax Claims*, Wash. Post, October 1, 2007, Suburban Edition at A03,

³ I.R.C. § 213(a).

⁴ I.R.C. § 213(d)(1)(A).

⁵ I.R.C. § 213(d)(9)(A).

⁶ I.R.C. § 213(d)(9)(B).

⁷ Treas. Reg. § 1.213-1(e)(1)(v).

⁸ *Thoene v. Comm'r*, 33 T.C. 62 (1959).

⁹ *Id.* at 3.

¹⁰ *Id.*

¹¹ *Mizl v. Comm'r*, 40 T.C. M. (CCH) 552 (1980).

¹² *Levine v. Comm'r*, 42 T.C.M. (CCH) 763 (1981).

¹³ *Id.* at 4.

¹⁴ *Al-Murshidi v. Comm'r*, T.C. Summary Opinion 2001-185.

¹⁵ *Id.* at 1.

¹⁶ *Hess v. Comm'r*, T.C. Summary Opinion 1994-79.

¹⁷ *Id.* at 3.

¹⁸ *Id.* at 4.

¹⁹ Rev. Rul. 2003-57, 2003-1 C.B. 959 at 2.

²⁰ *Id.*

²¹ Rev. Rul. 73-201, 1973-1 C.B. 140.

²² *Id.* at 2.

²³ Katherine T. Pratt, *Inconceivable? Deducting the Costs of Fertility Treatment*, 89 Cornell L. Rev. 1121, 1141 (2004) (discussing sexual reassignment surgery).

²⁴ *Pinneke v. Preisser*, 623 F.2d 546 (8th Cir. June 27, 1980).

²⁵ *Id.* at 4.

²⁶ *O'Donnabhain v. Comm'r*, No. 006402-06, (Tax Court filed March 31, 2006).

²⁷ Webster's Seventh New Collegiate Dictionary 618 (1969).

²⁸ Ataxingmatter.blogs.com, *Gender-Change Surgery: Medical Care or Cosmetic Surgery?* 8 (2007), http://ataxingmatter.blogs.com/tax/court_cases_of_interest/index.html

²⁹ *Al-Murshidi v. Comm'r*, T.C. Summary Opinion 2001-185, 5, quoting 136 Cong. Red. S15629, S15711 (1990).

³⁰ American Psychiatric Association, *Diagnostic and Statistical Manual of Mental Disorders* 536 (4th ed. 1994).

³¹ Ataxingmatter.blogs.com at 9.

³² *Id.* at 8 quoting Kenneth Vacovec, AP story.

³³ *O'Donnabhain v. Comm'r*, No.640206, (Tax Court filed March 31, 2006), at 4.

³⁴ *Id.* at 6.

³⁵ *Id.* at 7.

³⁶ *Id.*

³⁷ *Id.* at 5.

³⁸ *Id.* at 3.

³⁹ I.R.C. § 213(d)(1)(A).

⁴⁰ *Hess v. Comm'r*, T.C. Summary Opinion 1994-79 at 3.

POSSESSION, PERFECTION AND PRIORITY IN A FRAUDULENT ENVIRONMENT

by
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I. INTRODUCTION

Are fraudulent mortgage banking transactions on the rise? Today banks operate in an environment of increased competition, tightening credit restrictions due to the sub-prime mortgage lending fiasco, and a decreased volume of loans processed and sold. Their financial survival is in jeopardy. The purpose of this article is to examine the rights of innocent parties who are the victims of a scheme to defraud in transactions involving mortgage assignments.

A secured real property transaction consists of two documents: the mortgage document which creates a security interest in the real property, and the note which represents the debt that is secured by the mortgage.

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