MLI #1 Trade or Business Expenses Under IRC § 162 and Related Sections

SUMMARY

The deductibility of trade or business expenses has perpetually been among the ten Most Litigated Issues (MLIs) since the first National Taxpayer Advocate's Annual Report to Congress in 1998.[1] We identified 82 cases involving a trade or business expense issue that were litigated in federal courts between June 1, 2018, and May 31, 2019. The courts affirmed the IRS position in 61 of these cases, or about 74 percent, while taxpayers fully prevailed in only two cases, or about two percent of the cases. The remaining 19 cases, or about 23 percent, resulted in split decisions.

TAXPAYER RIGHTS IMPACTED[2]

- *The Right to Be Informed*
- *The Right to Pay No More Than the Correct Amount of Tax*
- *The Right to Challenge the IRS's Position and Be Heard*
- *The Right to Appeal an IRS Decision in an Independent Forum*
- *The Right to a Fair and Just Tax System*

PRESENT LAW

Internal Revenue Code (IRC) § 162(a) permits a taxpayer to deduct ordinary and necessary trade or business expenses paid or incurred during the taxable year.[3] These expenses include:

- A reasonable allowance for salaries or other compensation for personal services actually rendered;
- Travel expenses while away from home in the pursuit of a trade or business; and
- Rentals or other payments for use of property in a trade or business.[4]

In addition to the general allowable expenses described above, IRC § 162 addresses deductible and nondeductible expenses incurred in carrying on a trade or business, and provides special rules for health insurance costs of self-employed individuals.[5]

The interaction of IRC § 162 with other Code sections that explicitly limit or disallow deductions can be complex. For example, the year in which the deduction for trade or business expenses can be taken and its amount depend on when the cost was paid or incurred, the useful life of an asset on the date of

1 *See* National Taxpayer Advocate 1998-2018 Annual Reports to Congress.

2 *See* Taxpayer Bill of Rights (TBOR), www.TaxpayerAdvocate.irs.gov/taxpayer-rights. The rights contained in the TBOR are also codified in the Internal Revenue Code (IRC). *See* IRC § 7803(a)(3).

3 The taxable year in which a business expense may be deducted depends on whether the taxpayer uses the cash or accrual method of accounting. IRC § 446.

4 IRC § 162(a)(1), (2), and (3).

5 *See*, *e.g.*, IRC § 162(c), (f), and (l). For example, nondeductible trade or business expenses include illegal bribes, kickbacks, fines, and penalties.

acquisition, and when it was sold or when the business operation is terminated.[6] Rules regarding the practical application of IRC § 162 have evolved largely from case law and administrative guidance over the years. When a taxpayer seeks judicial review of the IRS's determination of a tax liability relating to the deductibility of a particular expense, the courts must often address a series of questions, including, but not limited to, the ones discussed below.

What Is a Trade or Business Expense Under IRC § 162?

Although "trade or business" is a widely used term in the IRC, neither the Code nor the Treasury Regulations provide a definition.[7] The definition of a "trade or business" comes from common law, where the concepts have been developed and refined by the courts.[8] The Supreme Court has interpreted "trade or business" for purposes of IRC § 162 to mean an activity conducted with "continuity and regularity" and with the primary purpose of earning income or making a profit.[9]

What Is an Ordinary and Necessary Expense?

IRC § 162(a) requires a trade or business expense to be both "ordinary" and "necessary" in relation to the taxpayer's trade or business to be deductible.[10] The Supreme Court describes an "ordinary" expense as customary or usual and of common or frequent occurrence in the taxpayer's trade or business.[11] The Court describes a "necessary" expense as one that is appropriate and helpful for the development of the business.[12] Further, an employee business expense is not ordinary and necessary if the employee is entitled to reimbursement from the employer.[13] Common law also requires that in addition to being ordinary and necessary, the amount of the expense must be reasonable for the expense to be deductible.[14]

Is the Expense a Currently Deductible Expense or a Capital Expenditure?

A currently deductible expense is an ordinary and necessary expense paid or incurred during the taxable year in the course of carrying on a trade or business.[15]

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6 *See*, *e.g*., IRC § 165 (deductibility of losses), IRC § 167 (deductibility of depreciation), IRC § 183 (activities not engaged in for profit), and IRC § 1060 (special allocation rules for certain asset acquisitions, including the reporting of business asset sales when closing a business).

7 *Comm'r v. Groetzinger*, 480 U.S. 23, 35 (1987).

8 Carol Duane Olson, *Toward a Neutral Definition of "Trade or Business" in the Internal Revenue Code*, 54 U. Cin. L. Rev. 1199 (1986).

9 *Groetzinger*, 480 U.S. at 35.

10 In *Welch v. Helvering*, the Supreme Court stated that the words "ordinary" and "necessary" have different meanings, both of which must be satisfied for the taxpayer to benefit from the deduction.

11 *Deputy v. du Pont*, 308 U.S. 488, 495 (1940) (internal citations omitted).

12 *See Comm'r v. Heininger*, 320 U.S. 467, 471 (1943).

13 *Podems v. Comm'r*, 24 T.C. 21, 22-23 (1955). As unreimbursed employee business expenses are miscellaneous itemized deductions under IRC § 67, they will not be available to taxpayers for the 2018-2025 tax years under IRC § 67(g). The employee has the burden of establishing the amount of the expense and that the expense is not eligible for reimbursement.

14 In *Comm'r v. Lincoln Electric Co.*, the Court of Appeals for the Sixth Circuit held "the element of reasonableness is inherent in the phrase 'ordinary and necessary.' Clearly it was not the intention of Congress to automatically allow as deductions operating expenses incurred or paid by the taxpayer in an unlimited amount." 176 F.2d 815, 817 (6th Cir. 1949), *cert. denied*, 338 U.S. 949 (1950).

15 IRC § 162(a). IRC § 263. No current deduction is allowed for the cost of acquisition, construction, improvement, or restoration of an asset expected to last more than one year. *See also INDOPCO, Inc. v. Comm'r*, 503 U.S. 79 (1992). Instead, those types of expenses are generally considered capital expenditures, which may be subject to depreciation, amortization, or depletion over the useful life of the property. IRC § 167; IRC § 179. Note, the Tax Cuts and Jobs Act increased the maximum deduction under IRC § 179 from $500,000 to $1 million and increased the maximum asset-spending phaseout from $2 million to $2.5 million. IRC § 179(b)(1), (b)(2).

When Is an Expense Paid or Incurred During the Taxable Year, and What Proof Is There That the Expense Was Paid?

IRC § 162(a) requires an expense to be "paid or incurred during the taxable year" to be deductible. The IRC also requires taxpayers to maintain books and records that substantiate income, deductions, and credits, including adequate records to substantiate deductions claimed as trade or business expenses.[16] If a taxpayer cannot substantiate the exact amounts of deductions by documentary evidence (*e.g.*, invoice paid, paid bill, or canceled check) but can establish that he or she had some business expenditures, the courts may employ the *Cohan* rule to grant the taxpayer a reasonable amount of deductions.[17]

When Can an Approximation of Business Expenses Be Used?

The *Cohan* rule is one of "indulgence" established in 1930 by the Court of Appeals for the Second Circuit in *Cohan v. Commissioner*.[18] The court held that the taxpayer's business expense deductions were not adequately substantiated, but stated that "the [Tax Court] should make as close an approximation as it can, bearing heavily if it chooses upon the taxpayer whose inexactitude is of his own making. But to allow nothing at all appears to us inconsistent with saying that something was spent."[19] In *Estate of Elkins v. Commissioner*, the Fifth Circuit described "the venerable lesson of Judge Learned Hand's opinion in *Cohan*: In essence, make as close an approximation as you can, but never use a zero."[20]

The *Cohan* rule cannot be used in situations where IRC § 274(d) applies. IRC § 274(d) provides that unless a taxpayer complies with strict substantiation rules, no deductions are allowable for:

- Travel expenses (including meals and lodging while away from home);
- Gifts; and
- Certain "listed property."[21]

A taxpayer must substantiate a claimed IRC § 274(d) expense with adequate records or sufficient evidence to establish the amount, time, place, and business purpose.[22]

16 IRC § 6001. *See also* Treas. Reg. §§ 1.6001-1 and 1.446-1(a)(4).

17 *See Cohan v. Comm'r*, 39 F.2d 540 (2d Cir. 1930).

18 *Id.*

19 39 F.2d 540 (2d Cir. 1930) at 544, *aff'g and remanding* 11 B.T.A. 743 (1928).

20 767 F.3d 443, 449 n. 7 (5th Cir. 2014) (citing *Cohan*, 39 F.2d at 543-44), *rev'g* 140 T.C. 86 (2013).

21 "Listed property" means any passenger automobile; any other property used as a means of transportation; any property of a type generally used for purposes of entertainment, recreation, or amusement; any computer or peripheral equipment (except when used exclusively at a regular business establishment and owned or leased by the person operating such establishment); and any other property specified by regulations. IRC § 280F(d)(4)(A) and (B).

22 Treas. Reg. § 1.274-5T(b). Ironically, if George M. Cohan brought his case today before the Tax Court, he would be unable to benefit from application of that rule because of the strict substantiation required by IRC § 274(d). A contemporaneous log is not explicitly required, but a statement not made at or near the time of the expenditure has the same degree of credibility only if the corroborative evidence has "a high degree of probative value." Treas. Reg. § 1.274-5T(c)(1); *Reynolds v. Comm'r*, 296 F.3d 607, 615-616 (7th Cir. 2002) (noting that keeping written records is not the only method to substantiate IRC § 274 expenses but "alternative methods are disfavored").

ANALYSIS OF LITIGATED CASES

This year, we reviewed 82 cases involving trade or business expenses that were litigated in federal courts from June 1, 2018, through May 31, 2019. The table 1 listed in Appendix 5 contains a list of the respective issues in these cases. Figure 2.1.1 categorizes the main issues raised by taxpayers. Cases involving more than one issue are included in more than one category.

FIGURE 2.1.1, Trade or Business Expense Issues Cases Reviewed[23]

Issue	Type of Taxpayer	
	Individual	Business
Substantiation of Expenses Under IRC § 162, Including Application of the *Cohan* Rule	10	34
Substantiation of Expenses under IRC § 274(d)	8	18
Schedule A Unreimbursed Employee Expenses Requiring Proof Employer Did Not Reimburse Taxpayer Under IRC § 162	8	7
Hobby Losses, Nondeductible Under Either IRC §§ 183 or 162	0	9
Home Office Under IRC § 280A	4	5
Net Operating Losses Under IRC § 172	0	6
Personal Expenditures Disallowed Under IRC § 262	2	2
Capitalization and Cost Recovery Under IRC §§ 263, 263A, 195, 179, and 167	0	10
Illegal Activities Under IRC §§ 280E, 162(c), 162(f), and 162(g)	0	6
Economic Substance Doctrine	0	2
Business Bad Debt Deduction Under IRC § 166	0	4
Not Engaged In a Trade or Business Under IRC § 162	0	2
Interest Deduction Under IRC § 163	0	1

Taxpayers represented themselves (*pro se*) in 35 of the 82 cases (about 43 percent). Taxpayers were represented by counsel in 47 out of the 82 cases (about 57 percent). Of the 82 cases, the taxpayers prevailed in two cases in full, and in 19 cases in part. The IRS won in the remaining 61 cases. None of the *pro se* individual taxpayers prevailed in full.

As in previous years, a number of individual taxpayers claimed deductions for Schedule A unreimbursed employee expenses that were either related to personal rather than business activities or the taxpayer did not meet the burden of showing his or her employer would not reimburse these expenses.[24] Additionally, taxpayers claimed travel, meals, and entertainment expenses, but occasionally failed to meet the heightened substantiation requirements of IRC § 274(d).[25] Many *pro se* litigants were unable to meet substantiation requirements.[26]

23 Multiple issues can appear within one case; therefore these figures will not match the total case count.

24 *See, e.g.*, *Farolan v. Comm'r*, T.C. Summ. Op. 2018-28; *Cates v. Comm'r*, T.C. Memo. 2017-178, *appeal dismissed,* (11th Cir. Apr. 30, 2018); *Beckey v. Comm'r*, T.C. Summ. Op. 2017-80.

25 *See Lewis v. Comm'r*, T.C. Memo. 2017-117; *Fehr v. Comm'r*, T.C. Summ. Op. 2018-26.

26 *See Wooten v. Comm'r*, T.C. Summ. Op. 2017-58.

Individual Taxpayers

Unsurprisingly, relatively few of this year's IRC § 162 trade or business cases involve individual taxpayers (the term "individual" excludes sole proprietorships). All but one of these cases were issued as either Tax Court memorandum opinions or summary opinions.[27]

The sole individual case decided by a Court of Appeals was *Liljeberg v. Commissioner*, in which the Court of Appeals for the D.C. Circuit affirmed an earlier decision by the U.S. Tax Court.[28] *Liljeberg* involved the question of whether three nonresident foreign students enrolled in the State Department's Exchange Visitor Program could deduct Schedule A unreimbursed employee business expenses for travel, meal, and entertainment costs. The students, who were from Finland, Russia, and Ireland, entered the U.S. on nonimmigrant "J visas," which permitted them to work part-time jobs while studying as full-time students for up to four consecutive months. The students argued that they could deduct their travel, meal, and entertainment expenses under IRC § 162(a)(2), which allows taxpayers to deduct business expenses incurred while "away from home" for business reasons.[29]

The D.C. Circuit, however, ruled that the students were not away from home on business in the manner contemplated by IRC § 162(a)(2). Such was the case because the students came to work in the U.S. voluntarily and were not required by their employers to retain an abode in their home countries. The fact that this home country residency requirement was established by the visa process, as opposed to the employers themselves, was insufficient in the eyes of the D.C. Circuit. As a result, the Court of Appeals affirmed the Tax Court and denied deductions for unreimbursed employee business expenses not incurred in the pursuit of a trade or business.

Another case illustrating some of the most commonly arising issues in the individual trade or business context is *Sutherland v. Commissioner*.[30] There, a taxpayer sought to deduct a variety of job search expenses. The court allowed deductions related to the creation and mailing of a "value proposition deck," because it was used to seek employment. On the other hand, deductions incurred for meals, entertainment, and transportation costs during the job search were disallowed because Taxpayer did not meet the heightened contemporaneous documentation standards of IRC § 274(d). Likewise, Taxpayer could not establish that computer supplies had been used solely for business purposes.

Taxpayer's spouse, a manager for a furniture company, also attempted to deduct meals and entertainment expenditures as unreimbursed employee business expenses. He claimed deductions for meals purchased while out of town on business and for costs incurred in taking his employees out for meals and entertainment for team building and recognition. However, these deductions were disallowed because, among other reasons, he never requested reimbursement and because he did not seek authorization from his superiors for the recognition-related expenses.

27 Tax Court decisions are categorized into three types: regular decisions, memorandum decisions, and small tax case ("S") decisions. The regular decisions of the Tax Court include cases which have some new or novel point of law, or in which there may not be general agreement, and therefore have the most legal significance. In contrast, memorandum decisions generally involve fact patterns within previously settled legal principles and therefore are not as legally significant. Finally, "S" case decisions (for disputes involving $50,000 or less where the taxpayer has elected Small Case status) are not appealable and, thus have no precedential value. *See also* IRC § 7463(b); U.S. Tax Court Rules of Practice and Procedure, Rules 170-175.

28 *Liljeberg v. Comm'r*, 907 F.3d 623 (D.C. Cir. 2018), *aff'g* 148 T.C. 83 (2017).

29 *See Barone v. Comm'r*, 85 T.C. 462, 465 (1985) (citations omitted), which states that for an expense to qualify under section 162(a)(2) it must (1) be ordinary and necessary, (2) have been incurred while the taxpayer was "away from home", and (3) have been incurred in the pursuit of a trade or business. The second element of whether the taxpayers were "away from home" was in dispute in *Liljeberg*.

30 *Sutherland v. Comm'r*, T.C. Memo. 2018-186.

Business Taxpayers

TAS reviewed 69 cases involving business taxpayers. Business taxpayers prevailed fully in two cases (approximately three percent), partially prevailed in 16 cases (approximately 23 percent), and the IRS was completely successful in the remaining cases (approximately 74 percent). Of cases in which business taxpayers fully or partially prevailed, 67 percent (12 of 18) involved taxpayers represented by counsel. Alternatively, six *pro se* business taxpayers partially prevailed, but none fully prevailed. Of cases in which the IRS fully prevailed, approximately 61 percent (31 of 51) involved business taxpayers represented by counsel, while approximately 39 percent (20 of 51) involved *pro se* taxpayers.

One of the more commonly litigated issues from year to year is whether an activity is carried on as a business for profit or whether it simply represents a hobby. This distinction is significant because losses attributable to a hobby can only be deducted to the extent of income generated by the activity, while business losses have no such limitation.[31]

The analysis employed to distinguish between business and hobby activities is well illustrated by *Ford v. Commissioner*. The case focused on a music venue called Bell Cove that enjoyed substantial success when operated by Taxpayer, a former country music singer, and her husband, a producer and record label owner.[32] The venue closed upon the husband's death, but was reopened by Taxpayer several years later as she attempted to restore Bell Cove to its former glory. Among other things, Taxpayer engaged musicians to perform on weekends and hosted various events, including parties and weddings. Despite Taxpayers' efforts, however, Bell Cove was consistently unprofitable, losing approximately $420,000 between 2008 and 2014. She was able to continue operating the venue by drawing on trust funds at her disposal.

In affirming the prior Tax Court decision, the Sixth Circuit analyzed the nine-factor test for distinguishing for-profit activities from hobbies, set forth in the regulations under IRC § 183.[33] Based on these factors, the Sixth Circuit determined that Taxpayer did not have the requisite intent to make a profit in her operation of Bell Cove. Among other things, the Sixth Circuit noted that Bell Cove was not operated in the manner of a traditional business, as Taxpayer made no effort either to minimize expenses or to undertake improvements and innovations that would increase revenue. Further, the activity generated ongoing losses that showed no realistic likelihood of being offset by annual profits or appreciation in the property. These circumstances, when combined with the substantial personal pleasure derived by Taxpayer from running Bell Cove and her ability to defray losses with her personal income, caused the Sixth Circuit to conclude that Bell Cove and its operations represented a hobby, rather than a business. Accordingly, Taxpayer was unable to deduct Bell Cove's losses against her income from other sources.

On the other hand, in *Potter v. Commissioner*, Taxpayer found a way of circumventing the loss limitations of IRC § 183.[34] Taxpayer, an independent contractor who sold soil on commission, operated his business through a C corporation, of which he was the sole shareholder and only employee. When the third-party company for whom Taxpayer sold soil was purchased, Taxpayer, via his corporation, received substantial termination pay and discontinued all sales activities. Having significant leisure time, he took up cowboy mounted shooting, in which participants, wearing old western or military garb, engage in riding and shooting competitions for prize money.

31 IRC § 183(b)(2).

32 *Ford v. Comm'r*, 751 F. App'x. 843 (6th Cir. 2018) *aff'g* T.C. Memo. 2018-8.

33 Treas. Reg. § 1.183-2(b).

34 *Potter v. Comm'r*, T.C. Memo. 2018-153.

In furtherance of this activity, Taxpayer purchased a truck, trailer, and tractor for over $150,000. These expenditures were capitalized and depreciated by Taxpayer's corporation. At first, the deductions were disallowed by the IRS on the grounds that Taxpayer was involved in a hobby, rather than a for-profit activity. However, IRC § 183, by its very terms, does not apply to C corporations. Thus, when the Tax Court determined that Taxpayer was pursuing his cowboy mounted shooting through the corporation, rather than in his individual capacity, this ruling led to the presumptive conclusion that Taxpayer was involved in a trade or business, expenses from which could be deducted even if they exceeded income from the associated activity.

Where a trade or business is being carried on, compensation is one of the few deductible expenses specifically identified by IRC § 162.[35] Occasionally, controversy arises regarding whether payments made by the business are in fact deductible compensation, or instead represent some other sort of nondeductible transfer. Just such an issue was presented in the case of *Little Mountain Corp v. Commissioner*.[36]

Taxpayer (Little Mountain Corp) purchased a precious metals business from Franklin Sanders, who then set up a sole proprietorship, Always Frank Consulting, and purportedly began performing consulting services for Taxpayer.[37] According to Taxpayer, it paid him approximately $900,000 of consulting fees, which Taxpayer deducted on its 2011 return. However, Taxpayer did not issue Sanders a Form 1099, and he reported no compensation of any sort during that year. The IRS disallowed Taxpayer's deduction on the grounds that Taxpayer failed to prove that the payments in question were deductible compensation.

The Tax Court sustained this determination and, upon review, the Ninth Circuit affirmed the lower court's decision. In particular, the Ninth Circuit was concerned that the payments were provided in the form of checks made out to "cash," which ultimately were endorsed by individuals unassociated with Franklin Sanders or his consulting business. Likewise, an ill-kept ledger and generic invoices, when combined with the lack of any Forms 1099 and Sanders's nonreporting, failed to clarify the nature of the payments. As a result, the Ninth Circuit held that Taxpayer had fallen short of the level of proof necessary to establish that the cash transfers in question represented deductible compensation.

An increasing number of cases also present scenarios in which otherwise allowable expenses are barred from deductibility because of a specific statutory exclusion. The most common of these prohibitions arises with respect to illegal expenses under IRC § 280E in the context of marijuana dispensaries. *Patients Mut. Assistance Collective Corp. v. Commissioner* provides an excellent discussion of the legal issues surrounding the controversy.[38] The case involved a corporate taxpayer that operated a medical marijuana dispensary, legally organized under California law. Taxpayer incurred a variety of expenses, including employee compensation, that it sought to deduct. Despite conceding that these expenditures were directly related to Taxpayer's trade or business, the IRS disallowed these deductions under IRC § 280E, which specifies, "No deduction or credit shall be allowed for any amount paid or incurred during the taxable year in carrying on any trade or business if such trade or business (or the activities which comprise such trade or business) consists of trafficking in controlled substances." In upholding the IRS's disallowance of the deductions, the Tax Court explained that IRC § 280E had been passed by

35 IRC § 162(a)(1).

36 *Little Mtn. Corp. v. Comm'r*, 736 F. App'x 691 (9th Cir. 2018), *aff'g* T.C. Memo. 2016-147.

37 Taxpayer was owned by relatives of Franklin Sanders and, according to the Tax Court, "The record strongly suggests that the corporation is Mr. Sanders' alter ego." *Little Mtn. Corp. v. Comm'r, T.C. Memo*. 2016-147.

38 *Patients Mut. Assistance Collective Corp. v. Comm'r*, 151 T.C. No. 11 (2018).

Congress as a direct response to a prior decision that "allowed a cocaine dealer to deduct the ordinary and necessary expenses of his illicit trade."[39]

Taxpayer also provided a variety of other non-marijuana services and products, including yoga, tai chi, hypnotherapy, acupuncture, and t-shirts. The IRS disallowed all expenses related to these lines of business as well. In sustaining the IRS disallowances, the Tax Court premised its conclusion on a broad reading of IRC § 280E, holding that it prohibits deductions from all activities within a trade or business, even if only part of the trade or business actually involves the direct sale of marijuana.[40]

CONCLUSION

The existence and amount of allowable business expenses are highly fact-specific and are often open to interpretation. IRC § 162 deductions are based upon a complex interaction of multiple statutes and regulations, as well as case law. This circumstance perpetuates substantial controversy between the IRS and taxpayers regarding the scope and extent of properly claimed business deductions. As a result, courts rendered decisions in 82 cases involving IRC § 162 related issues between June 1, 2018, and May 31, 2019.

As in prior years, a variety of cases arose regarding the merits of claimed deductions for legal fees, costs associated with marijuana dispensaries, and business expenses that were held to be personal in nature. Many cases involved taxpayers' often-unsuccessful attempts to meet general substantiation requirements or to comply with the heightened substantiation rules of IRC § 274(d). Moreover, a number of taxpayers in this year's litigated cases evidenced difficulty distinguishing between nondeductible personal expenses or hobby losses on the one hand, and deductible business expenses on the other hand.

39 *Edmonson v. Comm'r*, T.C. Memo. 1981-623.

40 In a separate case dedicated to the consideration of whether Taxpayer should be liable for accuracy-related penalties under IRC § 6662(a), the Tax Court determined that these penalties were inapplicable because of the lack of clear authority in this area.