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#2**Trade or Business Expenses Under IRC § 162 and Related Sections****SUMMARY**

The deductibility of trade or business expenses has long been among the ten Most Litigated Issues since the first edition of the National Taxpayer Advocate's Annual Report to Congress in 1998.¹ We identified 115 cases involving a trade or business expense issue that were litigated between June 1, 2013, and May 31, 2014. The courts affirmed the IRS position in 87 of these cases (76 percent), while taxpayers fully prevailed in only three cases (three percent). The remaining 25 cases (22 percent) resulted in split decisions.

PRESENT LAW

Internal Revenue Code § 162 allows deductions for ordinary and necessary trade or business expenses paid or incurred during the course of a taxable year.² Rules regarding the practical application of IRC § 162 have evolved largely from case law and administrative guidance. The IRS, the Department of the Treasury, Congress, and the courts continue to provide guidance about whether a taxpayer is entitled to claim certain deductions. The cases analyzed for this report illustrate that this process is ongoing and involve the analysis of facts and circumstances particular to each case. 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 those discussed below.

What is a trade or business expense under IRC § 162?

Although "trade or business" is one of the most widely used terms in the IRC, neither the Code nor Treasury Regulations provide a definition.³ The definition of a "trade or business" comes from common law, where the concepts have been developed and refined by the courts.⁴ 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 profit.⁵

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 in order to be deductible. 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.⁶ The Supreme Court describes an "ordinary" expense

1 See National Taxpayer Advocate 1998-2013 Annual Reports to Congress.

2 Hereafter, the Internal Revenue Code will be referred to as the "IRC" or the "Code."

3 In 1986, the term "trade or business" appeared in at least 492 subsections of the Code and in over 664 Treasury Regulations. See F. Ladson Boyle, *What is a Trade or Business?*, 39 Tax Law. 737 (Summer 1986).

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

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

6 290 U.S. 111, 113 (1933) (suggesting an examination of "life in all its fullness" will provide an answer to the issue of whether an expense is ordinary and necessary).

as customary or usual and of common or frequent occurrence in the taxpayer's trade or business.⁷ The Court describes a "necessary" expense as one that is appropriate and helpful for development of the business.⁸

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. In *Commissioner 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."⁹

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.¹⁰ No current deductions are allowed for the cost of acquisition, construction, improvement, or restoration of an asset expected to last more than one year.¹¹ 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.¹²

Whether an expenditure is deductible under IRC § 162(a) or is a capital expenditure under IRC § 263 is a question of fact. Courts have adopted a case-by-case approach to applying principles of capitalization and deductibility.¹³

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" in order to be deductible. The Code also requires a taxpayer to maintain books and records that substantiate income, deductions, and credits, including adequate records to substantiate deductions claimed as trade or business expenses.¹⁴ If a taxpayer cannot substantiate the exact amounts of deductions by documentary evidence (e.g., invoice, 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.

The Cohan rule

The *Cohan* rule is one of "indulgence" established in 1930 by the Court of Appeals for the Second Circuit in *Cohan v. Commissioner*.¹⁵ The court held that the taxpayer's business expense deductions were not

7 *Deputy v. du Pont*, 308 U.S. 488, 495 (1940) (citation omitted).

8 *Comm'r v. Tellier*, 383 U.S. 687, 689 (1966) (citations omitted).

9 176 F.2d 815, 817 (6th Cir. 1949), cert. denied, 338 U.S. 949 (1950).

10 IRC § 162(a).

11 IRC § 263. See also *INDOPCO, Inc. v. Comm'r*, 503 U.S. 79 (1990).

12 IRC § 167.

13 See *PNC Bancorp, Inc. v. Comm'r*, 212 F.3d 822 (3d Cir. 2000); *Norwest Corp. v. Comm'r*, 108 T.C. 265 (1997).

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

15 39 F.2d 540 (2d Cir. 1930). George M. Cohan was an actor, playwright, and producer who spent large sums travelling and entertaining actors, employees, and critics. Although Cohan did not keep a record of his spending on travel and entertainment, he estimated that he incurred \$55,000 in expenses over several years. The Board of Tax Appeals, now the Tax Court, disallowed these deductions in full based on Cohan's lack of supporting documentation. Nevertheless, on appeal, the Second Circuit concluded that Cohan's testimony established that legitimate deductible expenses had been incurred. As a result, the Second Circuit remanded the case back to the Board of Tax Appeals with instructions to estimate the amount of deductible expenses.

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.”¹⁶

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

1. Travel expenses;
2. Entertainment, amusement, or recreation expenses;
3. Gifts; and
4. Certain “listed property.”¹⁷

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.¹⁸

Who has the burden of proof in a substantiation case?

Generally, the taxpayer bears the burden of proving that he or she is entitled to the business expense deductions and the IRS’s proposed determination of tax liability is incorrect.¹⁹ IRC § 7491(a) provides that the burden of proof shifts to the IRS when the taxpayer:

- Introduces credible evidence with respect to any factual issue relevant to ascertaining the taxpayer’s liability;
- Complies with the requirements to substantiate deductions;
- Maintains all records required under the Code; and
- Cooperates with reasonable requests by the IRS for witnesses, information, documents, meetings, and interviews.

ANALYSIS OF LITIGATED CASES

The deductibility of trade or business expenses has been one of the ten Most Litigated Issues since the first edition of the National Taxpayer Advocate’s Annual Report to Congress in 1998.²⁰ This year, we reviewed 115 cases involving trade or business expenses that were litigated in federal courts from June 1, 2013, through May 31, 2014. Table 2 in Appendix III contains a list of the main issues in those cases. Figure 3.2.1 (below) categorizes the main issues raised by taxpayers. Cases involving more than one issue are included in more than one category.

16 39 F.2d 544 (2d Cir. 1930), *aff’d and remanding* 11 B.T.A. 743 (1928).

17 “Listed property” means any passenger automobile; any 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).

18 Treas. Reg. § 1.274-5T(b).

19 See *Welch v. Helvering*, 290 U.S. 111, 115 (1933) (citations omitted) and U.S. Tax Court Rules of Practice and Procedure, Rule 142(a).

20 See National Taxpayer Advocate 1998–2013 Annual Reports to Congress.

FIGURE 3.2.1, Trade or Business Expense Issues in Cases Reviewed

Issue	Type of Taxpayer	
	Individual	Business (including sole proprietorships)
Substantiation of expenses, including application of the <i>Cohan</i> rule ^a	16	54
Profit objective ^b	0	12
Ordinary and necessary trade or business expenses ^c	2	9
Personal vs. business expenses ^d	9	17
Business expenses vs. capital expenditures ^e	1	2
Did the taxpayer establish the carrying on of a trade or business?	3	9
Gambling expenses ^f	0	4

a IRC § 6001 and Treas. Reg. § 1.6001-1 require a taxpayer to maintain books and records that substantiate income, deductions and credits. Treas. Reg. § 1.162-17 provides guidance regarding maintaining adequate records to substantiate deductions claimed as trade or business expenses in connection with the performance of services as an employee. The *Cohan* rule allows courts to estimate certain expenses not properly substantiated. See *Cohan*, 39 F.2d at 544.

b IRC § 183(a) provides the general rule that no deduction attributable to an activity engaged in by an individual or an S corporation shall be allowed if such activity is not engaged in for profit. Treas. Reg. § 1.183-2(b) provides the following nonexhaustive list of nine factors to consider in determining whether an activity is conducted for profit: (1) manner in which the taxpayer carries on the activity; (2) expertise of the taxpayer or his advisors; (3) time and effort expended by the taxpayer in carrying on the activity; (4) expectation that assets used in the activity may appreciate in value; (5) success of the taxpayer in carrying on similar or dissimilar activities; (6) taxpayer's history of income or losses with respect to the activity; (7) amount of occasional profits if any, which are earned; (8) financial status of the taxpayer; and (9) elements of personal pleasure or recreation.

c IRC § 162(a) allows deductions for ordinary and necessary trade or business expenses paid or incurred during the taxable year.

d IRC § 262(a) provides that personal, living, and family expenses are generally not deductible.

e Under IRC § 263(a), generally no deduction is allowed for capital expenditures, where capital expenditures include any amount paid for permanent improvements made to increase the value of any property. Under IRC § 195(a), start-up expenditures generally cannot be deducted unless a taxpayer makes an expense/amortization election according to IRC § 195(b). Taxpayers who make the election may generally deduct up to \$5,000 of start-up expenditures in the tax year in which an active trade or business begins and amortize any excess over 180 months. The \$5,000 deduction is reduced by a dollar for every dollar that total start-up expenditures exceed \$50,000. See IRC §§ 195(b)(1)(A) and (B). (These amounts are increased to \$10,000 and \$60,000 for taxable years beginning in 2010. See IRC § 195(b)(3).

f IRC § 165(d) provides that "losses from wagering transactions shall be allowed only to the extent of the gains from such transactions."

Approximately 64 percent of the cases (74 of 115) involved taxpayers representing themselves (*pro se*). The 36 percent (41 of 115) of cases with taxpayers represented by counsel fared slightly better than their *pro se* counterparts. Taxpayers with representation received full or partial relief in approximately 27 percent of cases (11 of 41). By contrast, *pro se* taxpayers received full or partial relief in 23 percent of cases (17 of 74).

Individual Taxpayers

None of the 23 decisions involving individual taxpayers (where the term "individual" excludes a sole proprietorship) was issued as a regular opinion of the Tax Court.²¹ Seventeen of the 23 individual taxpayers

21 Tax Court decisions fall into three categories: 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 significant. Finally, "S" case decisions (for disputes involving \$50,000 or less) are not appealable and, thus, have no precedential value. See IRC § 7463(b). See also U.S. Tax Court Rules of Practice and Procedure, Rules 170-175. More than half of the cases reviewed this year involving individual taxpayers (excluding sole proprietorships) were "S" cases.

appeared *pro se*. No individual taxpayers received full relief, while only seven earned split decisions. The court upheld the IRS position in 16 of 23 cases (70 percent).

The most prevalent issue was the substantiation of claimed trade or business expense deductions. For example, in *Humphrey v. Commissioner*, the Tax Court denied several claimed business expense deductions for failure to substantiate.²² The taxpayer, a Customs and Border Protection agent, was unable to substantiate travel and vehicle expenses for trips related to his work because he only gave the Court a rough estimate of his miles rather than a contemporaneous log. He similarly failed to provide any records for other travel expenses. Further, the Tax Court denied expense deductions for meals and entertainment because the taxpayer did not provide any substantiation. Deductions for gifts and cell phone expenses were also denied as there was no evidence proving a business purpose. Finally, the Court denied a deduction for legal fees for failure to provide adequate substantiation.²³

Business Taxpayers

We reviewed 92 cases involving business taxpayers. As it turned out, business taxpayers had a slightly lower success rate compared to individual taxpayers. Individual taxpayers did not win a single case in full; however, individuals received partial relief from split decisions in 30 percent of cases (seven of 23). Meanwhile, business taxpayers received full or partial relief in approximately 23 percent of cases (21 of 92).

Business taxpayers were represented by counsel in 38 percent (eight of 21) of favorably decided cases, including all three of the cases in which the taxpayer received full relief. Business taxpayers were represented by counsel in 37 percent (26 of 71) of the cases the IRS won. The success of *pro se* taxpayers in court stemmed mostly from their ability to provide records substantiating deductions in cases where such substantiation was in controversy.

As it was for the individual taxpayers, substantiation of expenses was by far the most prevalent issue, and in most instances, the courts denied the business taxpayers' deductions for failure to substantiate.²⁴ Courts did, however, allow some of these deductions when the taxpayer produced sufficient evidence.²⁵ Courts occasionally applied the *Cohan* rule where the taxpayer presented sufficient documentation to prove an expense was incurred, but had limited documentation of the precise amount. As previously mentioned, however, IRC § 274(d) makes the *Cohan* rule unavailable in certain circumstances in which the taxpayer must substantiate the deductions.

22 T.C. Memo. 2013-198.

23 The taxpayer provided carbon copies of checks without anything more, which is not adequate substantiation. *Id.* (citing *Miller v. Comm'r*, T.C. Memo. 1996-402). Another example is *Golit v. Comm'r*, T.C. Memo. 2013-191, where the Tax Court disallowed deductions for books and stethoscopes, among other items, due to the taxpayer's failure to substantiate claimed business expenses.

24 See *Alexander v. Comm'r*, T.C. Memo. 2013-203 (deduction denied for grain farming expenses for failure to substantiate; court did not reach question of profit motive); *Edem v. Comm'r*, T.C. Memo. 2013-238 (taxpayers introduced no evidence to substantiate business expenses; deductions were denied); *Gorokhovskiy v. Comm'r*, 549 F. App'x 527 (7th Cir. 2013), *aff'g* T.C. Memo. 2012-206 (deduction denied for business expenses for failure to substantiate; self-generated, handwritten notes were not credible evidence of deductions); *Van Velzor v. Comm'r*, T.C. Memo. 2014-71 (deduction for labor expenses for failure to substantiate when only evidence was self-serving testimony and unreliable hearsay).

25 See *Azimzadeh v. Comm'r*, T.C. Memo. 2013-169 (deductions for business expenses allowed to the extent substantiated; deduction denied for travel expenses for failure to meet IRC § 274 substantiation requirements); *Karch v. Comm'r*, T.C. Memo. 2013-237, *appeal docketed*, No. 14-3179 (3d Cir. July 3, 2014) (deduction for wage, mortgage, and contract service expenses allowed to the extent substantiated; deductions denied for other business expenses for failure to substantiate).

Taxpayers had particular difficulty validating their home office deductions, losing cases where business use of a personal residence was at issue.²⁶ One example of this issue was *Thunstedt v. Commissioner*, where the taxpayer, an art dealer, sought to deduct over 60 percent of his home as an office.²⁷ In his testimony, the taxpayer listed business activities he conducted out of his home, asserting, “everything I do is business.”²⁸ However, he failed to provide evidence that any part of the house was exclusively used for business and also attested that his children frequently stayed in the house. The Tax Court denied the deduction in full because the taxpayer did not give evidence that any specific part of the house was used exclusively for business, which meant the Court could not even make a rough estimate of the proper deduction using *Cohan*.

Another common theme was the difficulty in proving that expenses were ordinary and necessary to the taxpayer’s business.²⁹ The taxpayer in *Bagley v. Commissioner*, however, scored a victory after he sought to deduct litigation expenses from a *qui tam* lawsuit.³⁰ Laid off and failing to find other work, the taxpayer initiated a *qui tam* lawsuit against his old employer, a federal contractor, under the False Claims Act. The government eventually intervened in the suit, and at the case’s conclusion, the government paid the taxpayer over \$36 million as the combination of an award, plus statutory attorneys’ fees. The taxpayer in turn paid over \$18 million to the attorneys he had hired to assist with the suit. The IRS disputed the categorization of the \$18 million of legal fees as a business expense.

After determining the litigation activities did indeed constitute a trade or business, the court proceeded to examine whether the litigation expenses were ordinary and necessary. Because the trade or business in question was litigation, the court agreed with the taxpayer that legal fees constituted ordinary and necessary business expenses and allowed the claimed deduction.³¹

Taxpayers were also denied business expense deductions under IRC § 262(a) when the courts found the expenses were related to personal, rather than business activities.³² In *Dargie v. United States*, Dr. Dargie

26 IRC § 280(A)(c)(1) allows the deduction of “a portion of the dwelling unit which is exclusively used on a regular basis ... as the principal place of business for any trade or business of the taxpayer.” If the taxpayer is an employee, the home office deduction is only allowable if the exclusive use is for the convenience of the employer. *Id.* Examples of cases examined in which the court denied deductions for home office expenses are *Dupre v. Comm’r*, T.C. Memo. 2013-287 (home office deduction denied for failure to show exclusive use or convenience of employer) and *Scully v. Comm’r*, T.C. Memo. 2013-229 (deduction denied for failure to provide any evidence of exclusive use).

27 T.C. Memo. 2013-280.

28 *Id.*

29 See IRC § 162(a) (“There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including ... (3) rentals or other payments required to be made as a condition to the continued use or possession, for purposes of the trade or business, of property.”). For examples of cases examined in which the court denied deductions for failure to prove the expense was ordinary and necessary in business, see, e.g., *Chaganti v. Comm’r*, T.C. Memo. 2013-285 (deduction for court-ordered fines denied because they were not ordinary and necessary to the taxpayer’s business); *Elick v. Comm’r*, T.C. Memo. 2013-139, *appeal docketed*, No. 13-73837 (9th Cir. Oct. 31, 2013) (deduction denied for management fees for failure to prove ordinary and necessary in business).

30 963 F. Supp. 2d 982 (C.D. Cal. 2013). The False Claims Act (FCA) establishes liability for any person who knowingly presents, or causes to be presented, to an officer or employee of the United States Government a false or fraudulent claim for payment or approval. 31 U.S.C. § 3729(a). The FCA authorizes both the Attorney General and private persons to bring civil actions to enforce the Act. 31 U.S.C. § 3730. An action brought by a private person under § 3730(b) of the FCA is termed a *qui tam* suit. *Qui tam* is a writ whereby a private individual who assists a prosecution can receive all or part of any penalty imposed. Its name is an abbreviation of the Latin phrase *qui tam pro domino rege quam pro se ipso in hac parte sequitur*, meaning “[he] who sues in this matter for the king as well as for himself.”

31 963 F. Supp. 2d at 1002.

32 IRC § 262(a) provides that personal, living and family expenses are generally not deductible. See, e.g., *Bigdeli v. Comm’r*, T.C. Memo. 2013-148 (deduction denied for vehicle and travel expenses because expenses were of a personal nature); *Austin Otology Assocs. v. Comm’r*, T.C. Memo. 2013-293 (deduction denied for hunting trips and security expenses because expenses were of a personal nature).

signed a “conditional award agreement” with his medical school saying that he would either spend four years working in an underserved community in exchange for payment of his educational expenses or pay back his award—up to double the amount being awarded.³³ After graduating, he chose not to work in the specified location and instead repaid the amount of his initial award, plus interest.

The taxpayers (husband and wife) then sought to deduct that expense, claiming it was a payment of damages attributable to Dr. Dargie’s breach of the agreement and thus an ordinary and necessary expense of opening his medical practice in the chosen location. The Court of Appeals for the Sixth Circuit rejected that characterization, upholding the lower court’s determination that the payments were personal expenses incurred to enable Dr. Dargie to meet the minimum requirements for his occupation.³⁴

Courts likewise generally sustained IRS determinations that business expense deductions were not attributable to an activity engaged in for profit within the meaning of IRC § 183.³⁵ In *United States v. Hart*, the taxpayer sought to deduct expenses related to a book he had written.³⁶ The court proceeded to examine the taxpayer’s deductions using the nine-factor test of Treas. Reg. § 1.183-2(b).³⁷ The taxpayer self-published the book, entitled *Constitutional Income: Do You Have Any?*, but failed to realize any profit from the publication. Hart testified the first and second editions of the book sold out, but he also gave away hundreds of copies.

The court held that he did not engage in his book writing activity for profit, stating that “Mr. Hart’s testimony concerning how he managed his book-writing activity simply does not support a finding that the book writing was engaged in for purposes of generating a profit.”³⁸ The court noted that Hart had never written a book before, worked as an engineer during the writing process, never put together a business plan for his writing activities, and admitted that he had personal reasons for writing the book.

Similarly, the taxpayers in *Schlievert v. Commissioner* sought to deduct expenses related to their music label activity under IRC § 162(a), but the Tax Court denied the deduction because the activity was not engaged in for profit pursuant to IRC § 183.³⁹ In *Schlievert*, the taxpayers, a husband and wife, held themselves out as a record label and sought to deduct a variety of expenses related to band activities.

The taxpayers started their label at the behest of their daughter, who was trying to break into the music industry as a band manager. They financed a band their daughter had recruited by reimbursing her for expenses and claimed those reimbursements as deductions. Examining those expenses with the nine factors of Treas. Reg. § 1.183-2(b), the Tax Court denied the deductions because the activity was not engaged in for profit. It cited the lack of previous experience in the music industry, the lack of profits, the absence of a business plan, and a personal desire to help their daughter succeed as weighing against

33 742 F.3d 243 (6th Cir. 2014), *aff’g* 113 A.F.T.R.2d (RIA) 817 (W.D. Tenn. 2013).

34 *Id.*

35 See, e.g., *Hoelscher v. Comm’r*, T.C. Memo. 2013-236 (deduction denied for ranching activities because not engaged in for profit under IRC § 183).

36 111 A.F.T.R.2d (RIA) 2235 (D. Idaho 2013).

37 Those factors are (1) the manner in which the taxpayer carries on the activity; (2) the expertise of the taxpayer or his advisors; (3) the time and effort expended by the taxpayer in carrying on the activity; (4) the expectation that assets used in the activity may appreciate in value; (5) the success of the taxpayer in carrying on similar or dissimilar activities; (6) the taxpayer’s history of income or losses with respect to the activity; (7) the amount of occasional profits, if any, which are earned; (8) the financial status of the taxpayer; and (9) elements of personal pleasure or recreation.

38 111 A.F.T.R.2d 2235 (D. Idaho 2013).

39 T.C. Memo. 2013-239.

a profit motive. The Tax Court declared the record label expenses were investments in the career of the taxpayers' daughter, which, "though laudable," were not deductible.⁴⁰

Another issue addressed by the courts this year deals with the question of whether a transaction has economic substance, which is a prerequisite for deductibility.⁴¹ For example, in *John Hancock Life Insurance Company v. Commissioner*, the Tax Court denied rent, depreciation, interest, and transaction expense deductions because they were derived from transactions that lacked economic substance.⁴² The transactions in question were a series of lease-in-lease-out (LILO) and sales-in-lease-out (SILO) transactions whereby John Hancock would lease (LILO) or buy (SILO) from a tax-exempt entity, then lease the property back to the original entity, garnering favorable tax treatment. The Tax Court found that the transactions lacked economic substance because they were structured so that John Hancock never incurred any real risk and thus were similar in substance to a loan rather than a lease or sale.

CONCLUSION

The definition of an allowable business expense remains open to interpretation and is highly fact-specific. This circumstance continues to generate substantial controversy between the IRS and taxpayers regarding the scope of properly claimed business deductions. This year, as in prior years, the IRS actively scrutinized and challenged many such deductions, while taxpayers were often willing to resort to litigation where the disallowance could not be resolved administratively within the IRS. From June 1, 2013, through May 31, 2014, courts generally favored the IRS's denial of business expense deductions, but specific facts and circumstances yielded some victories for taxpayers.

Many taxpayers remain confused over the Code's requirements. This confusion is particularly apparent with respect to the IRC § 280(A) limitations on the home office deduction.⁴³ Taxpayers lost on this issue and routinely argued for deductions while admitting that the space was used for personal activities or that their employer did not ask them to work from home. The fact that taxpayers claim home office deductions, while then effectively conceding their inapplicability through their testimony, indicates a general lack of understanding about the requirements. This confusion regarding the rules surrounding IRC § 280(A) underscores the need for a home office standard deduction or similar safe harbor as previously recommended by the National Taxpayer Advocate.⁴⁴

Given the relative frequency of home office litigation, we recommend that the IRS highlight the available home office guidance on its website and improve the landing page taxpayers see when they access the home office section.⁴⁵ While the page provides an accurate overview of the deduction, it may not adequately emphasize or define the requirement of "exclusive use" or define the phrase "for the convenience

40 T.C. Memo. 2013-239.

41 Taxpayers lost all three cases litigated on the economic substance issue. See *John Hancock Life Ins. Co. v. Comm'r*, 141 T.C. 1 (2013); *UnionBanCal & Subsidiaries v. U.S.*, 113 Fed. Cl. 117 (Fed. Cl. 2013) (denying deduction for rent expenses because transactions did not have economic substance); *Humboldt Shelby Holding Corp. v. Comm'r*, T.C. Memo. 2014-47, appeal docketed, No. 14-3428 (2d Cir. Sept. 12, 2014) (denying deduction for legal expenses because the associated transactions did not have economic substance).

42 141 T.C. 1 (2013).

43 This longstanding confusion likely is why the IRS issued guidance to simplify calculation and reporting of this deduction in Revenue Procedure 2013-13. As part of a taxpayer burden reduction effort, the IRS concurrently began a marketing campaign to further educate taxpayers regarding this deduction.

44 National Taxpayer Advocate 2007 Annual Report to Congress 503-511 (Key Legislative Recommendation: *Home Office Business Deduction*).

45 See IRS, Home Office Deduction, available at <http://www.irs.gov/Businesses/Small-Businesses-&Self-Employed/Home-Office-Deduction> (last visited on Sept. 5, 2014).

of your employer.” Taxpayers may access more detailed explanations by following the link to Publication 587, *Business Use of Your Home*, but would be better served if the initial page elaborated on these two vital and frequently misunderstood requirements. Through education, outreach, and collaboration with stakeholders, the IRS can help taxpayers understand the requirements and limitations of the home office and other business expense deductions.