

MLI #5 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 (MLIs) since the first edition of the National Taxpayer Advocate's Annual Report to Congress in 1998.¹ We identified 73 cases involving a trade or business expense issue that were litigated in federal courts between June 1, 2015 and May 31, 2016. The courts affirmed the IRS position in 50 of these cases, or about 68 percent, while taxpayers fully prevailed in only five cases, or about seven percent of the cases. The remaining 18 cases, or about 25 percent, resulted in split decisions.

TAXPAYER RIGHTS IMPACTED²

- *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*

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:

- 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 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 become very complex. For example, the year in which the deduction for trade or business expenses can be taken depends on when the cost was paid or incurred, the useful life of an asset on the date when it is sold, or when the business operation is terminated.⁶

¹ See National Taxpayer Advocate 1998-2015 Annual Reports to Congress.

² See Taxpayer Bill of Rights (TBOR), www.TaxpayerAdvocate.irs.gov/taxpayer-rights. The rights contained in the TBOR are now listed in the Internal Revenue Code (IRC). See Consolidated Appropriations Act, 2016, Pub. L. No. 114-113, Division Q, Title IV, § 401(a), 129 Stat. 2242, 3117 (2015) (codified at 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, illegal bribes, kickbacks, fines, and penalties are nondeductible payments.

⁶ See, e.g., IRC § 165 (deductibility of losses), IRC § 167 (deductibility of depreciation), and IRC § 183 (activities not engaged in for profit).

Rules regarding the practical application of IRC § 162 have evolved largely from case law and administrative guidance over the years. The IRS, the Department of Treasury, Congress and the courts continue to pose questions and provide legal guidance about whether a taxpayer is entitled to certain trade or business deductions. The litigated cases analyzed for this report illustrate that this process is ongoing and involves the analysis of facts and circumstances unique 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 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. 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.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

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.”¹³

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.¹⁴ No current deductions are allowed for the cost of

7 *Comm’r v. Groetzinger*, 480 U.S. 23, 35 (1987). “The phrase ‘trade or business’ has been in section 162(a) and that section’s predecessors for many years. Indeed, the phrase is common in the Code, for it appears in over 50 sections and 800 subsections and in hundreds of places in proposed and final income tax regulations... The concept thus has a well-known and almost constant presence on our tax-law terrain. Despite this, the Code has never contained a definition of the words “trade or business” for general application, and no regulation has been issued expounding its meaning for all purposes. Nether has a broadly applicable authoritative judicial definition emerged.”

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

10 290 U.S. 111, 115 (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).

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

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

13 176 F.2d 815, 817 (6th Cir. 1949), *cert. denied*, 338 U.S. 949 (1950).

14 IRC § 162(a).

acquisition, construction, improvement, or restoration of an asset expected to last more than one year.¹⁵ 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.¹⁶

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.¹⁷

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.¹⁸ 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.

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*.¹⁹ 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.”²⁰ In *Estate of Elkins v. Commissioner*, the Fifth Circuit recently 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.”²¹

15 IRC § 263. See also *INDOPCO, Inc. v. Comm’r*, 503 U.S. 79 (1992).

16 IRC § 167.

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

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

19 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.

20 39 F.2d 540 (2d Cir. 1930) at 544, *aff’g and remanding* 11 B.T.A. 743 (1928).

21 767 F.3d 443, 449 n. 7 (5th Cir. 2014) (citing *Cohan*, 39 F.2d at 543-44), *rev’g* 140 T.C. 86 (2013).

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;
- Entertainment, amusement, or recreation expenses;
- Gifts; and
- Certain “listed property.”²²

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.²³ 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.”²⁴ In addition, entertainment expenses require proof of a business relationship to the taxpayer.²⁵

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.²⁶ 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 MLIs since the first edition of the National Taxpayer Advocate’s Annual Report to Congress in 1998.²⁷ This year, we reviewed 73 cases involving trade or business expenses that were litigated in federal courts from June 1, 2015 through May 31, 2016. Table 5 listed in Appendix 3 contains a list of the main issues in these cases. Figure 3.5.1 categorizes the main issues raised by taxpayers. Cases involving more than one issue are included in more than one category.

22 “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).

23 Treas. Reg. § 1.274-5T(b).

24 Treas. Reg. § 1.274-5T(c)(1); *Reynolds v. Comm’r*, 296 F.3d 607, 615-16 (7th Cir. 2002) (noting that keeping written records is not the only method to substantiate IRC § 274 expenses but “alternative methods are disfavored”).

25 Treas. Reg. § 1.274-5T(b)(3)(v).

26 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).

27 See National Taxpayer Advocate 1998-2015 Annual Reports to Congress.

FIGURE 3.5.1, Trade or Business Expense Issues Cases Reviewed²⁸

Issue	Type of Taxpayer	
	Individual	Business
Substantiation of Expenses, Including Application of the <i>Cohan</i> Rule	5	31
Substantiation of Expenses Under IRC § 274(d)	3	22
Ordinary and Necessary Trade or Business Expenses	0	13
Not a Qualifying Trade or Business Carried on for Profit	1	16
Home Office	0	10

Taxpayers represented themselves (*pro se*) in 45 of the 73 cases (about 62 percent). Taxpayers were represented by counsel in 28 out of the 73 cases (about 38 percent). Of the 73 cases, the taxpayers prevailed in five cases in full, and in 18 cases in part. The IRS won in the remaining 50 cases, none of the *pro se* individual taxpayers prevailed.

As in previous years, individual taxpayers routinely claimed deductions for vehicle and transportation expenses without understanding, or knowledge of, the substantiation requirements under IRC § 274(d). Many *pro se* litigants were unable to meet the strict substantiation requirements.²⁹

Individual Taxpayers

None of the decisions involving individual taxpayers (where the term “individual” excludes a sole proprietorship) were issued as a regular opinion of the Tax Court.³⁰ All of the individual taxpayers appeared *pro se*. The court fully upheld the IRS in all of the cases.

The most common issue before the court was the substantiation of claimed business deductions.³¹ For example, in *Garcia v. Commissioner*, the husband was a truck driver who incurred expenses for meals and lodging while on the road for work.³² The married couple claimed deductions for token gifts he had given to workers who helped him to unload his truck, clothing and boots used for his job, and cell phone expenditures.³³ The taxpayer produced cancelled checks, credit card bills, and bank account statements to substantiate these expenses. However, the taxpayer did not maintain a contemporaneous record of the amount, timing, or business nature of the alleged unreimbursed employee business expenses as required under IRC § 274(d). The Tax Court disallowed these deductions because the taxpayer failed to

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

29 See *Avery v. Comm’r*, T.C. Memo. 2016-50 (denying deductions for vehicle and travel expenses).

30 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 IRC § 7463(b). See also U.S. Tax Court Rules of Practice and Procedure, Rules 170-175.

31 See, e.g., *Akey v. Comm’r*, T.C. Memo. 2015-227; *Garcia v. Comm’r*, T.C. Memo. 2016-21.

32 T.C. Memo. 2016-21.

33 The taxpayer stated that the cell phone was required by the employer and that he used it solely for business purposes which the court did not find credible.

maintain adequate records and because the costs of clothing the husband purchased was not specific to his employment.³⁴

Business Taxpayers

We reviewed 63 cases involving business taxpayers. Business taxpayers had a much better success rate compared to individual taxpayers. As stated above, individual taxpayers did not prevail in any cases. Meanwhile, business taxpayers received full or partial relief in 37 percent of cases (23 out of 63 cases).

Business taxpayers were represented by counsel in 35 percent (8 of 23) of favorably decided cases, including four cases where the taxpayer received full relief. Business taxpayers were represented by counsel in 40 percent (20 of 50) of the cases that the IRS won. To the extent that *pro se* taxpayers were successful in court, these favorable outcomes stemmed mostly from their ability to provide records substantiating deductions in cases where such substantiation was in controversy. Courts did, however, allow some of these deductions where the taxpayer produced sufficient evidence.³⁵

As was the case 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.³⁶ The courts allowed deductions for some expenses when business taxpayers were able to provide sufficient evidence in the form of records, receipts, or logs.³⁷ 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.³⁸ As previously mentioned, however, IRC § 274(d) makes the *Cohan* rule unavailable in certain circumstances in which the taxpayer must substantiate the deductions.

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. In *Jijun Chen v. Commissioner*, the taxpayer was the owner of a biotechnology company.³⁹ The taxpayer provided a self-created spreadsheet to substantiate several Schedule C expenses. This spreadsheet contained dates, names of vendors/ items, and amounts paid. The vendors listed were department stores, salons, music stores, and other common stores. The taxpayer failed to establish how the expenses incurred at these stores were done so by the biotechnology company in carrying on its trade or business. In fact, most of these business expense deductions were indeed personal in nature and were for the benefit of the taxpayer's children. The taxpayer's expenses related to an employee benefits program that consisted entirely for sending his children to daycare. The travel and entertainment expenses and depreciation of musical instruments were also related to the education of the taxpayer's children. The court could not find any relationship between these deductions and the ordinary and necessary needs of a biotechnology company. These expenses were personal in nature and thus disallowed.

34 Clothing costs may be deductible if the clothing is a type specifically required as a condition of employment, it is not suitable for wear as ordinary clothing, and it is not worn as ordinary clothing. *Pevsner v. Comm'r*, 628 F.2d 467, 469 (5th Cir. 1980) (citation omitted).

35 See, e.g., *Charley v. Comm'r*, T.C. Memo. 2015-232.

36 See *Philbrick v. Comm'r*, T.C. Memo. 2016-64; *Porter v. Comm'r*, T.C. Memo. 2015-122.

37 See *Charley v. Comm'r*, T.C. Memo. 2015-232 (business mileage expenses substantiated through index cards and credible testimony).

38 See *Arizaga v. Comm'r*, T.C. Memo. 2016-57.

39 T.C. Memo. 2015-167.

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 § 183.⁴⁰ However, in *Roberts v. Commissioner*, the taxpayer successfully established that he was engaged in the business of horse-racing.⁴¹ To arrive at this conclusion, the Tax Court proceeded to examine the taxpayer's deductions using the nine-factor test of Treas. Reg. § 1.183-2(b).⁴² Not a single one of the nine factors is determinative nor are they the only factors that can be taken into account when making a determination of whether a taxpayer's activities are engaged in for profit. The Tax Court decided that Mr. Roberts's horse-racing business was run as a hobby rather than a business and thus disallowed the expenses above the hobby profits. Upon appeal, the Court of Appeals for the Seventh Circuit reversed the Tax Court due to evidence that supported that business nature of the horse-racing conducted by Mr. Roberts. The evidence in support of the business nature of the horse-racing included the fact that the taxpayer purchased land specifically for expanding his ability to breed, race, and train horses. He became certified as a licensed trainer by the state and obtained his horse-racing license. He worked long hours with the horses and ceased his involvement with his previous businesses. One of the horses in his care was nominated to run in the Triple Crown Races which had the potential to greatly increase the profits to his horse-racing business. In fact, the Seventh Circuit was able to find support for all nine factors that Mr. Roberts conducted the horse-racing activity with the hopes of turning a profit. The fact that the activity had a social aspect and the lack of profit for the years in question were not enough to nullify the business nature of his activities.

Conversely, in *Estate of Stuller v. U.S.*, the Court of Appeals for the Seventh Circuit found that the manner in which the taxpayer conducted the activity of horse-breeding was not engaged in a manner consistent with a profit motive.⁴³ The court applied the nine factor test and found that only one, the expectation of asset appreciation, supported the taxpayer's assertion that the horse-breeding was carried on for profit. The evidence showed that the taxpayer kept minimal business records and did not retain any records of expenses related to the activities of horse-breeding. The lack of records kept essentially made it impossible for the taxpayer to make sound business decisions. The taxpayer did not change the operation methods or try new techniques to improve profitability. Nor did the taxpayer consult with any experts in the industry to determine better methods for running a horse-breeding endeavor. The taxpayer was able to rely upon the earnings from other businesses rather than relying upon horse-breeding which is also indicative that the activity was not carried out with a profit motive. The taxpayer derived great pleasure from the horse-breeding operation so the significant amount of time spent engaged in the activity is not necessarily a factor weighing in the taxpayer's favor. Unlike in *Roberts v. Commissioner*, the court was unable to determine that the horse-breeding activities conducted by Mr. Stuller were for profit and thus disallowed the deductions.

Another frequently litigated area was related to deductions taken in support of home offices. Taxpayers also had difficulty validating their home office deductions, losing in cases where business use of a home

40 See, e.g., *Stuller, Estate of, v. U.S.*, 811 F.3d 890 (7th Cir. 2016) (corporation was not an activity run for profit, had poor recordkeeping, lacked business practices directed at making a profit); *Pouemi v. Comm'r*, T.C. Memo. 2015-161, *aff'd*, 633 F. App'x 186 (4th Cir. 2016) (real estate activity not conducted in a businesslike manner, lacked a business plan, did not maintain a business bank account, and did not keep business books or records).

41 820 F.3d 247 (7th Cir. 2016), *rev'g* T.C. Memo. 2014-74.

42 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.

43 811 F.3d 890 (7th Cir. 2016).

residence was in question.⁴⁴ For instance, in *Grossnickle v. Commissioner*, the taxpayer, a real estate agent, sought to claim a home office expense for a room she rented from a family member.⁴⁵ The taxpayer failed to show any rents paid or other substantiation that she used the space exclusively as her principal place of business. Thus, the Tax Court denied the home office expenses.

CONCLUSION

The existence and amount of allowable business expenses are highly fact-specific and are often open to interpretation. This circumstance continues to generate substantial controversy between the IRS and taxpayers regarding the scope and extent 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 administratively resolved within the IRS. The courts generally favored the IRS's denial of business expense deductions, but specific facts and circumstances yielded some victories for taxpayers.

The *Cohan* rule was also a factor in several decisions this year. This common law doctrine allows taxpayers to deduct estimated expenses in cases where the expenses clearly existed but documentation showing the exact amount of the expenses is not readily available. The National Taxpayer Advocate believes the IRS Office of Appeals should expand the use of the *Cohan* rule in assessing hazards of litigation and in seeking to reach settlements with taxpayers.⁴⁶ The Examination process that often leads to Appeals, however, does not employ the *Cohan* rule and has adopted a more stringent document request policy to close cases and bypass Appeals in several instances.⁴⁷

Through education, outreach, and partnering with stakeholders, the IRS can help taxpayers understand what trade or business deductions are allowable and how they must substantiate those expenses. The IRS should continue to reach out proactively to taxpayers about these issues.

Proactive education and outreach to taxpayers regarding trade or business expenses will likewise promote taxpayers' *rights to be informed* and *to challenge the IRS's position and be heard*. By helping taxpayers understand not only the legal requirements but also their rights, the IRS will encourage taxpayers to comply with their tax obligations and minimize the risk of litigation.

44 See *Hawk v. Comm'r*, T.C. Memo. 2015-139 (denying expenses related to the home office). See also *Jijun Chen v. Comm'r*, T.C. Memo. 2015-167.

45 T.C. Memo. 2015-127.

46 See National Taxpayer Advocate 2015 Annual Report to Congress (Most Serious Problem: Appeals: *The Appeals Judicial Approach and Culture Project is Reducing the Quality and Extent of Substantive Administrative Appeals Available to Taxpayers*).

47 *Id.*