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. We identified 99 cases involving a trade or business expense issue that were litigated in federal courts between June 1, 2016, and May 31, 2017. The courts affirmed the IRS position in 65 of these cases, or about 66 percent, while taxpayers fully prevailed in only two cases, or about two percent of the cases. The remaining 32 cases, or about 32 percent, resulted in split decisions.

TAXPAYER RIGHTS IMPACTED:
- 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. 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.

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.

The interaction of IRC § 162 with other code sections that explicitly limit or disallow deductions can be very complex. For example, the year in which the deduction for trade or business expenses can be taken depends on whether the taxpayer uses the cash or accrual method of accounting, IRC § 446.
depends on when the cost was paid or incurred, the useful life of an asset on the date of acquisition, or when the business operation is terminated.  

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 both the ongoing nature of this process and the necessary 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. The definition of a “trade or business” comes from common law, where the concepts have been developed and refined by the courts. 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.

**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. The Supreme Court describes an “ordinary” expense as customary or usual and of common or frequent occurrence in the taxpayer’s trade or business. The Court describes a “necessary” expense as one that is appropriate and helpful for the development of the business.

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

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6 See, e.g., IRC § 165 (deductibility of losses), IRC § 167 (deductibility of depreciation), and 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). “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. Neither has a broadly applicable authoritative judicial definition emerged.”


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

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) (internal citations omitted).

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.”

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

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.

**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. 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*. 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.” 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.”

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14 IRC § 162(a).
16 IRC § 167.
18 IRC § 6001. See also Treas. Reg. §§ 1.6001-1 and 1.446-1(a)(4).
19 See *Cohan v. Comm’r*, 39 F.2d 540 (2d Cir. 1930).
20 *id.* 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.
21 39 F.2d 540 (2d Cir. 1930) at 544, aff’g and remanding 11 B.T.A. 743 (1928).
22 767 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.”

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

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. 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. This year, we reviewed 99 cases involving trade or business expenses that were litigated in federal courts from June 1, 2016, through May 31, 2017. The Table 2 listed in Appendix 3 contains a list of the respective issues in these cases. The figure below categorizes the main issues raised by taxpayers. Cases involving more than one issue are included in more than one category.

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23 “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).

24 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).

25 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”).


28 See National Taxpayer Advocate 1998-2016 Annual Reports to Congress.
TABLE 3.2.1, Trade or Business Expense Issues—Cases Reviewed

<table>
<thead>
<tr>
<th>Issue</th>
<th>Individual</th>
<th>Business</th>
</tr>
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<tr>
<td>Substantiation of Expenses under IRC § 162, Including Application of the Cohan Rule</td>
<td>12</td>
<td>49</td>
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<tr>
<td>Substantiation of Expenses under IRC § 274(d)</td>
<td>5</td>
<td>34</td>
</tr>
<tr>
<td>Schedule A Unreimbursed Employee Expenses</td>
<td>15</td>
<td>11</td>
</tr>
<tr>
<td>Hobby losses, nondeductible under the provisions of either IRC §§ 183 or 162</td>
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<td>14</td>
</tr>
<tr>
<td>Home Office under IRC § 280A</td>
<td>3</td>
<td>8</td>
</tr>
<tr>
<td>Net Operating Losses under IRC § 172</td>
<td>0</td>
<td>8</td>
</tr>
<tr>
<td>Personal Expenditures Disallowed under IRC § 262</td>
<td>7</td>
<td>18</td>
</tr>
<tr>
<td>Capitalization and cost recovery under IRC §§ 263, 263A, and 167</td>
<td>1</td>
<td>10</td>
</tr>
<tr>
<td>Illegal activities under IRC §§ 280E, 162(c), 162(f), and 162(g)</td>
<td>1</td>
<td>2</td>
</tr>
<tr>
<td>Economic Substance Doctrine</td>
<td>0</td>
<td>4</td>
</tr>
</tbody>
</table>

Taxpayers represented themselves (*pro se*) in 62 of the 99 cases (about 63 percent). Taxpayers were represented by counsel in 37 out of the 99 cases (about 37 percent). Of the 99 cases, the taxpayers prevailed in two cases in full, and in 32 cases in part. The IRS won in the remaining 65 cases. None of the *pro se* individual taxpayers prevailed in full.

As in previous years, individual taxpayers routinely 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. Taxpayers also claimed travel, meals and entertainment expenses without understanding, or knowledge of, the substantiation requirements under IRC § 274(d). Many *pro se* litigants were unable to meet substantiation requirements.

### Individual Taxpayers

While the majority of cases involving individual taxpayers (the term “individual” excludes sole proprietorships) were issued as either summary opinions or tax court memorandum decisions, two noteworthy cases this reporting cycle are *Liljeberg v. Commissioner* from the Tax Court and

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29 Multiple issues can appear within one case; therefore, these figures will not match the total case count.
31 See *Windam v. Comm’r*, T.C. Memo. 2017-68.
33 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.
O’Connor v. Commissioner from the Tenth Circuit Court of Appeals.\textsuperscript{34} Liljeberg was the only regular opinion of the Tax Court among the individual trade or business cases.\textsuperscript{35}

In Liljeberg, three related cases were consolidated to determine whether nonresident foreign students enrolled in the State Department’s Exchange Visitor Program (EVP) were permitted to take Schedule A unreimbursed employee expenses for travel, meal and entertainment costs.\textsuperscript{36} The three students were from Finland, Russia, and Ireland and entered the United States (U.S.) on nonimmigrant “J visas” permitting 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 a taxpayer to deduct business expenses incurred while a taxpayer is “away from home” for business reasons.\textsuperscript{37}

The Tax Court, however, ruled that the students were not away from home within the meaning of the statute. Such was the case because the students failed to show adequate ongoing business links to their respective home countries during their time in the U.S. Moreover, the Tax Court rejected the students’ claims that their program contracts, visas, or other applicable laws contained any mandate that a home be maintained in the country of origin. As a result, the unreimbursed employee expenses at issue were disallowed.

In O’Connor, married taxpayers claimed Schedule A unreimbursed employee business expenses for travel, meals and entertainment, and other costs pertaining to the pursuit of the husband’s U.S. law degree.\textsuperscript{38} The taxpayers, appearing pro se, argued that the husband qualified under Treas. Reg. § 1.162-5 to deduct his legal education expenses because he had obtained his German law degree prior to his U.S. law degree. The husband argued that the German law degree satisfied the minimum educational requirements test of the Treasury Regulation because it qualified him to sit for the New York State Bar Exam in lieu of obtaining a U.S. legal education.\textsuperscript{39} However, the Court of Appeals for the Tenth Circuit disagreed, holding that the husband instead had become qualified in a new trade or business by earning the U.S. law degree. The Tenth Circuit reiterated that the husband’s German law degree did not automatically qualify him to practice law in the U.S. and further rejected the taxpayers’ secondary argument that he was engaged in the legal profession through his project management work and a qui tam legal action.\textsuperscript{40}

\textsuperscript{34} See, e.g., Liljeberg v. Comm’r, 148 T.C. No. 6 (2017), appeal docketed, No. 17-1204 (D.C. Cir. Sept. 12, 2017); O’Connor v. Comm’r, 653 F. App’x 633 (10th Cir. 2016), aff’g T.C. Memo. 2015-155.
\textsuperscript{35} Id.
\textsuperscript{36} Id.
\textsuperscript{37} 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.
\textsuperscript{38} O’Connor, 653 F. App’x at 633 (10th Cir. 2016), aff’g T.C. Memo. 2015-155.
\textsuperscript{39} See Treas. Reg. § 1.162-5(b)(2)(i), “The first category of nondeductible educational expenses within the scope of subparagraph (1) of this paragraph are expenditures made by an individual for education which is required of him in order to meet the minimum educational requirements for qualification in his employment or other trade or business.”
\textsuperscript{40} 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 “[h]e who sues in this matter for the king as well as for himself.” Black’s Law Dictionary (10th ed. 2014) (www.westlaw.com).
O’Connor is of particular significance because higher education degrees are frequently challenged by the IRS when taxpayers attempt to deduct these educational expenses as itemized deductions on Schedule A.41 The courts use a facts and circumstances test to make these determinations. While taxpayers have had some success in deducting other higher education degrees, they have had difficulties proving that law degrees improve skills in a taxpayer’s current profession, rather than qualifying them for a new profession.

Beyond substantiation, the business justification of claimed unreimbursed employee business deductions is consistently among the most common issues arising with respect to individual taxpayers.42 In Tanzi v. Commissioner, married taxpayers were employed by Seminole State College. The husband worked as a college professor while his wife worked as the campus librarian. On the taxpayers’ 2011 joint return, they deducted Schedule A unreimbursed employee expenses such as home internet, cellular phone, computer equipment, books, and satellite television. The taxpayers argued that their respective jobs required them to continually pursue knowledge. The taxpayers were able to produce receipts for the majority of the items claimed, but the Tax Court disallowed all the expenses as personal expenditures under IRC § 262(a) for lack of business purpose. The Tax Court rejected the taxpayers’ general assertion that the expenses deducted were ordinary and necessary under IRC § 162, because the expenses were not a condition of employment, not ordinary for a college professor, and appeared purely personal in nature.

**Business Taxpayers**

TAS reviewed 81 cases involving business taxpayers. In this context, business taxpayers fully prevailed in one case (approximately one percent), partially prevailed in 26 cases (approximately 32 percent), and the IRS was completely successful in the remaining cases (approximately 67 percent).

Of cases in which business taxpayers fully or partially prevailed, approximately 41 percent (11 of 27) involved taxpayers represented by counsel, while approximately 59 percent (16 of 27) involved pro se taxpayers. Of cases in which the IRS fully prevailed, approximately 39 percent (21 of 54) involved business taxpayers represented by counsel, while approximately 61 percent (33 of 54) involved pro se taxpayers. To the extent that pro se taxpayers were successful in court, these favorable outcomes stemmed mostly from their ability to provide records, testimony, and other credible evidence substantiating deductions in cases where such substantiation was in controversy.

As was the case for the individual taxpayers, substantiation of expenses was by far the most prevalent issue. In most such cases, courts denied business taxpayers’ deductions for failure to substantiate.44 However, courts did allow deductions for some expenses when business taxpayers were able to provide sufficient evidence in the form of records, receipts, or logs.45 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.46 As previously mentioned, however, IRC § 274(d) makes the Cohan rule unavailable in certain circumstances in which taxpayers are subject to heightened documentation requirements.

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41 O’Connor, 653 F. App’x at 633 (10th Cir. 2016), aff’g T.C. Memo. 2015-155.
45 See Alexander v. Comm’r, T.C. Memo. 2016-214 (rent expense partially substantiated through invoices and checking account statements).
Probandt v. Commissioner, however, explored a narrow exception to this general rule. In Probandt, the taxpayer successfully invoked the exceptional circumstances rule, which allows a reasonable reconstruction of records lost beyond the taxpayer’s control. The taxpayer was engaged in the business of securing exclusive rights to distribute Chinese products and deducted a number of Schedule C business expenses. Insofar as relevant to this discussion, the IRS disallowed deductions for travel, meals and entertainment expenses under IRC § 274(d). The taxpayer claimed that he maintained handwritten contemporaneous documentation in the form of spiral notebooks and day planners, which were lost in a Portland, Oregon storage unit subject to eminent domain while he was in China. As a result, the taxpayer argued that he was entitled to a reasonable reconstruction of these lost records under the exceptional circumstances rule. The Tax Court agreed and, applying the Cohan rule, permitted the taxpayer to deduct 40 percent of the travel, meals and entertainment expenses at issue.

In another substantiation case, Kilpatrick v. Commissioner, the Tax Court addressed deductibility issues for a number of items, ranging from automobiles to office furnishings. In Kilpatrick, the taxpayer was a certified public accountant who worked from home and sought to deduct various Schedule C business expenses. In particular, the taxpayer claimed automobile expenses, which are covered by IRC § 274(d). Nevertheless, he failed to maintain a contemporaneous log; instead, the taxpayer relied on reconstructed calendars and online map services produced for his IRS audit to prove his business mileage. Although the taxpayer also provided credible testimony that he used his car to distribute advertising materials, the Tax Court rejected the audit-related materials and found that there was insufficient evidence to corroborate the taxpayer’s own statements.

The taxpayer also sought to deduct room furnishings located in his home office. Based on the taxpayer’s credible testimony, the Tax Court agreed that the furnishings were used for business purposes. Nevertheless, the Court made an independent determination that the office furnishings were antiques and had to be capitalized. Because these assets did not have a diminishing useful life, however, and appreciated in value, no deductions were allowed.

The taxpayer’s attempts to deduct a laptop computer were likewise unsuccessful. The Tax Court disallowed a capital expense deduction for the computer because the taxpayer failed to make the

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48 Id.
49 The exceptional circumstances rule applies where, because of an unusual situation, taxpayers are unable to obtain evidence generally required to support their claimed deduction. In this case, they can be allowed to present the best secondary evidence available to establish the expenditures and their deductibility. See Treas. Reg. § 1.274-5T(c)(4), “Substantiation in exceptional circumstances.” Treas. Reg. § 1.274-5T(c)(5), “Loss of records due to circumstances beyond control of the taxpayer.”
50 Kilpatrick v. Comm’r, T.C. Memo. 2016-166.
51 Id.
52 See Treas. Reg. § 1.274-5T(c)(2)(ii).
53 IRC § 274(d) substantiation elements include 1) the amount of each expense related to the business use of the automobile; 2) the amount of business mileage for each business use of the automobile; 3) the total mileage (business and nonbusiness) of the automobile during the taxable year; 4) the date of each business use of the automobile; and 5) the business purpose of each business use of the automobile. Section 274(d) further states the taxpayer may substantiate these elements by 1) “adequate records” or 2) “sufficient evidence corroborating the taxpayer’s own statement” (flush language).
54 “Prior versions of the Internal Revenue Code had been interpreted to preclude a depreciation deduction for an asset the value of which is not reduced by the passage of time or by use.” Kilpatrick, T.C. Memo. 2016-166 (citing Hawkins v. Comm’r, 713 F.2d 347 (8th Cir. 1983), aff’d T.C. Memo. 1982-451).
required election on his return under IRC § 179(c).

Additionally, the Tax Court noted that the taxpayer admitted to personal use of the computer and was unable to substantiate the percentage of business use as specified by the IRC § 274(d) strict substantiation requirements.

Courts generally sustained IRS determinations that business expense deductions were not permissible (beyond the income reported) when an activity was not engaged in for-profit within the meaning of IRC § 183. A unique example of this “hobby loss” analysis arose in the case of Vest v. Commissioner.

The taxpayer, a successful businessman, used his various partnerships to deduct more than six million dollars to investigate the mysterious events surrounding his father’s unresolved 1946 homicide. When the IRS disallowed these deductions, the taxpayer argued that the expenses were incurred in his efforts to gather enough information to publish a profitable book or film script based on his father’s homicide. The Tax Court examined the taxpayer’s deductions using the nine-factor test of Treas. Reg. § 1.183-2(b). The Tax Court determined that the taxpayer’s losses were perpetual and substantial; that the taxpayer had no prior experience in professional writing; that the direction of the investigation was never altered in light of the losses incurred; that there was no business plan or budget for the ongoing activity; and that the taxpayer’s personal motives were readily apparent. As a result, the taxpayer was unable to deduct any expenses in excess of income attributable to the activity, based on the limits articulated under IRC § 183 with respect to hobby losses.

Taxpayers likewise experienced challenges in establishing the business use of their home offices, a prerequisite to the deductibility of claimed expenses. For example, in Jackson v. Commissioner, married taxpayers sold insurance products out of their recreational vehicle (RV) while attending RV rallies. Affirming the Tax Court, the Ninth Circuit disallowed the taxpayers’ Schedule C depreciation and interest deductions claimed with respect to the RV on the grounds that personal use of the RV had exceeded 14 days in both tax years. On the other hand, one judge dissented, arguing that, in at least one year, the business use of the RV outweighed its personal use, and that a deduction should have been allowed because the RV was a prerequisite for the taxpayers to enter the rallies to conduct their business.

CONCLUSION

The existence and amount of allowable business expenses are highly fact-specific and are often open to interpretation. 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 and creates some interpretative challenges.

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57 Vest v. Comm’r, T.C. Memo. 2016-187, aff’d, 690 F. App’x 210 (5th Cir. 2017).

58 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.


60 Jackson v. Comm’r, 672 F. App’x 760 (9th Cir. 2017), aff’d T.C. Memo. 2014-160.

61 IRC § 280A(d)(1)(A) precludes the deduction of a dwelling used as a personal residence, which is established by fact finding as to whether the taxpayer’s personal use exceeds 14 days.
issues. As in prior years, a number of cases arose regarding the merits of claimed deductions for home office expenses, hobby losses, and business expenses that were held to be personal in nature.

Taxpayers continued to demonstrate confusion in a range of trade or business expense issues. For example, in a number of cases this year, taxpayers attempting to substantiate unreimbursed employee business expenses failed to produce the requisite employer reimbursement plans or to demonstrate knowledge of reimbursements allowed under those plans. Likewise, a number of taxpayers failed to meet general substantiation requirements or to comply with the heightened substantiation rules of IRC § 274(d).

Some taxpayers were successful in asserting the Cohan rule to obtain partial deductions. 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.62 The Examination process that often leads to Appeals, however, does not generally employ the Cohan rule and has adopted a more stringent document request policy to close cases and bypass Appeals in several instances.63 If the IRS actively employed the Cohan rule during the Examination process, this interaction with taxpayers likely would bring about earlier resolution of many cases that currently are litigated. Further, it would serve as a mechanism for better educating taxpayers regarding the parameters of appropriate trade or business expenses and the manner in which they must be substantiated.

The IRS should continue to seek all possible means of communicating with taxpayers about these trade or business expense issues. Proactive education and outreach regarding trade or business expenses will also promote taxpayers’ rights to be informed and to challenge the IRS’s position and be heard. Nevertheless, the National Taxpayer Advocate has previously expressed concern that there are only 98 Small Business/Self-Employed (SB/SE) Outreach and Education employees for the roughly 62 million SB/SE taxpayers, and 14 states without any SB/SE Outreach and Education employees within their respective borders.64 By addressing this concern and 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.

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62 See National Taxpayer Advocate 2015 Annual Report to Congress 82-90.
63 Id.
64 See Hearing on IRS Reform: Perspectives from the National Taxpayer Advocate: Hearing on Tax Reform Before the Subcomm. on Oversight of the H. Comm. on Ways and Means, 115th Cong. 11 (2017) (statement of Nina E. Olson, National Taxpayer Advocate). See also 2016 National Taxpayer Advocate Annual Report to Congress 6-11 (Special Focus: IRS Budget and Oversight: To fairly, effectively, and efficiently administer the tax system, the IRS must receive increased funding, but such funding should be tied to additional congressional oversight of IRS strategic and operational plans).