

MLI #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 (MLIs) since the first edition of the National Taxpayer Advocate's Annual Report to Congress in 1998.¹ We identified 106 cases involving a trade or business expense issue that were litigated in federal courts between June 1, 2017, and May 31, 2018. The courts affirmed the IRS position in 81 of these cases, or about 76 percent, while taxpayers fully prevailed in only six cases, or about six percent of the cases. The remaining 19 cases, or about 18 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*
- *The Right to a Fair and Just Tax System*

PRESENT LAW

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

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

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

The interaction of IRC § 162 with other Code sections that explicitly limit or disallow deductions can be very complex. For example, the year in which the deduction for trade or business expenses can be

1 See National Taxpayer Advocate 1998-2016 Annual Reports to Congress.

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

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

4 IRC § 162(a)(1), (2), and (3).

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

taken and its amount depend on when the cost was paid or incurred, the useful life of an asset on the date of acquisition, and when it was sold or when the business operation is terminated.⁶

Rules regarding the practical application of IRC § 162 have evolved largely from case law and administrative guidance over the years. 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.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

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

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

8 Carol Duane Olson, *Toward a Neutral Definition of “Trade or Business” in the Internal Revenue Code*, 54 U. CIN. L. REV. 1199 (1986).

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

10 290 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).

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

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

Further, an employee business expense is not ordinary and necessary if the employee is entitled to reimbursement from the employer.¹⁴ The employee has the burden of establishing the amount of the expense and that the expense is not eligible for reimbursement.

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

A currently deductible expense is an ordinary and necessary expense paid or incurred during the taxable year in the course of carrying on a trade or business.¹⁵ No current deductions are allowed for the cost of acquisition, construction, improvement, or restoration of an asset expected to last more than one year.¹⁶ 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.¹⁷

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.¹⁸

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.¹⁹ 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.²⁰

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*.²¹ 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

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

14 *Podems v. Comm’r*, 24 T.C. 21, 22-23 (1955).

15 IRC § 162(a).

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

17 IRC § 167; IRC § 179. Note, the Tax Cuts and Jobs Act increased the maximum deduction under IRC § 179 from \$500,000 to \$1 million and increased the maximum asset-spending phaseout from \$2 million to \$2.5 million. IRC § 179(b)(1), (b)(2).

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

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

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

21 *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.

to allow nothing at all appears to us inconsistent with saying that something was spent.”²² 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.”²³

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;
- Gifts; and
- Certain “listed property.”²⁴

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.²⁵ 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.”²⁶

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.²⁷ 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 1998.²⁸ This year, we reviewed 106 cases involving trade or business expenses that were litigated in federal courts from June 1, 2017, through May 31, 2018. Table 2 listed in Appendix 3. contains a list of the respective issues in these cases.

22 39 F.2d 540 (2d Cir. 1930) at 544, *aff’g and remanding* 11 B.T.A. 743 (1928).

23 767 F.3d 443, 449 n. 7 (5th Cir. 2014) (citing *Cohan*, 39 F.2d at 543-44), *rev’g* 140 T.C. 86 (2013).

24 “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).

25 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).

26 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”).

27 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).

28 See National Taxpayer Advocate 1998-2016 Annual Reports to Congress.

Figure 3.2.1 categorizes the main issues raised by taxpayers. Cases involving more than one issue are included in more than one category.

FIGURE 3.2.1, Trade or Business Expense Issues Cases Reviewed²⁹

Issue	Type of Taxpayer	
	Individual	Business
Substantiation of Expenses Under IRC § 162, Including Application of the <i>Cohan</i> Rule	3	44
Substantiation of Expenses Under IRC § 274(d)	9	23
Schedule A Unreimbursed Employee Expenses Requiring Proof Employer Did Not Reimburse Taxpayer Under IRC § 162	14	5
Hobby Losses, Nondeductible Under Either IRC §§ 183 or 162	1	12
Home Office Under IRC § 280A	0	3
Net Operating Losses Under IRC § 172	0	7
Personal Expenditures Disallowed Under IRC § 262	2	1
Capitalization and Cost Recovery Under IRC §§ 263, 263A, 195, 179, and 167	3	9
Illegal Activities Under IRC §§ 280E, 162(c), 162(f), and 162(g)	0	1
Economic Substance Doctrine	1	3
Business Bad Debt Deduction Under IRC § 166	0	10
Not Engaged In a Trade or Business Under IRC § 162	2	10
Interest Deduction Under IRC § 163	0	2

Taxpayers represented themselves (*pro se*) in 60 of the 106 cases (about 57 percent). Taxpayers were represented by counsel in 46 out of the 106 cases (about 43 percent). Of the 106 cases, the taxpayers prevailed in six cases in full, and in 19 cases in part. The IRS won in the remaining 81 cases. None of the *pro se* individual taxpayers prevailed in full.

As in previous years, a number of individual taxpayers claimed deductions for Schedule A unreimbursed employee expenses that were either related to personal rather than business activities or the taxpayer did not meet the burden of showing his or her employer would not reimburse these expenses.³⁰ Additionally, taxpayers claimed travel, meals, and entertainment expenses, but occasionally failed to meet the heightened substantiation requirements of IRC § 274(d).³¹ Many *pro se* litigants were unable to meet substantiation requirements.³²

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

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

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

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

Individual Taxpayers

Unsurprisingly, relatively few of this year's IRC § 162 trade or business cases involve individual taxpayers (the term "individual" excludes sole proprietorships). All of these cases were issued as either Tax Court memorandum opinions or summary opinions.³³ Two cases illustrating some of the most commonly arising issues in individual trade or business cases are *Baham v. Commissioner* and *Rademacher v. Commissioner*.³⁴

Although Tax Court summary opinions have no precedential value, the Tax Court's decision in *Baham v. Commissioner* provides an instructive scenario in which *pro se* Taxpayers (a husband and wife) sought to deduct, as unreimbursed employee business expenses, costs the wife incurred in relation to various animals she brought into the classroom as a teacher.³⁵ In order for a teacher to deduct expenses for teaching supplies, the supplies must be directly related to the job and a necessary expense of being a teacher, not just helpful to students and appropriate for use in the classroom.³⁶

At various points, Mrs. Baham acquired and cared for two bearded dragons, two African gray parrots, several red-eared sliders, two rabbits, koi, a tortoise, and a rainbow boa that she kept in the classroom during the school year. She then would take them home at the end of each school year to look after them over the summer. The Tax Court determined the related expenses generally were not personal expenditures, as testimony indicated that her children disliked having the animals at home because they were required to clean up after them, and the animals were not given names. Moreover, the animals did assist the teacher in her work, as they reduced tardiness and truancy and helped better engage the attention of students.

Nevertheless, the Tax Court denied Taxpayers' claimed deductions on the grounds that the expenses were not "ordinary and necessary," as required by IRC § 162. "We do not doubt that the classroom animals were pedagogically helpful to students and appropriate for classroom use, but this is not sufficient to cause these expenses to be deductible as ordinary and necessary business expenses." The court based its holding on the premise that, although teachers may, at times, provide equipment for classroom use out of their own funds, they do not do so ordinarily, even though the result might be to enhance their reputations as dedicated teachers or to increase the quality of the education they provide.

As discussed in the Present Law section above, taxpayers must substantiate their trade or business expenditures. Additionally, certain categories of expenses are subject to heightened substantiation requirements under IRC § 274(d). One case considering whether these more stringent standards were met is *Rademacher v. Commissioner*, which examined the expenses of a manager of a used car business.³⁷ Taxpayer, as part of his duties, incurred expenses for vehicle mileage, travel, meals, and entertainment, which he sought to deduct.

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.

34 *Baham v. Comm'r*, TC Summ. Op. 2017-85; *Rademacher v. Comm'r*, T.C. Memo 2018-43.

35 *Baham v. Comm'r*, T.C. Summ. Op. 2017-85.

36 *Farias v. Comm'r*, T.C. Memo. 2011-248 (citations omitted).

37 *Rademacher v. Comm'r*, T.C. Memo. 2018-43.

The Tax Court disallowed Taxpayer's meals and entertainment expenses attributable to snacks, coffee, and drinks for potential clients, which he estimated at approximately \$60 per day, but could not document.³⁸ On the other hand, as part of his duties, Taxpayer was required to attend the same four car auctions every week, to which he drove his personal vehicle. As he was not reimbursed for this mileage and could establish that he drove approximately 38,000 miles per year for the years in question, the Tax Court held that Taxpayer had met his substantiation burden, even under the heightened standards of IRC § 274(d). Accordingly, these deductions were sustained.

Business Taxpayers

TAS reviewed 86 cases involving business taxpayers. In this context, business taxpayers fully prevailed in six cases (approximately seven percent), partially prevailed in 13 cases (approximately 15 percent), and the IRS was completely successful in the remaining cases (approximately 78 percent).

Of cases in which business taxpayers fully or partially prevailed, 47 percent (9 of 19) involved taxpayers represented by counsel. Alternatively, ten *pro se* business taxpayers partially prevailed, but none fully prevailed. Of cases in which the IRS fully prevailed, approximately 49 percent (33 of 67) involved business taxpayers represented by counsel, while approximately 51 percent (34 of 67) involved *pro se* taxpayers.

As was the case for the individual taxpayers, substantiation of deductible expenses was by far the most prevalent issue. In most such cases, courts denied business taxpayers' deductions for failure to substantiate.³⁹ 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.⁴⁰ 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.⁴¹ As previously mentioned, however, IRC § 274(d) makes the *Cohan* rule unavailable in certain circumstances in which taxpayers are subject to heightened documentation requirements.

Nevertheless, even where IRC § 274(d) requirements are absent, the courts still demand the production of persuasive evidence before they will apply *Cohan*. For example, in *Brookes v. Commissioner*, a husband and wife carried on a business under the auspices of Brookes Financial, an S corporation.⁴² Taxpayer wife operated an art business, while Taxpayer husband conducted a financial services and tax return preparation business.

Among other expenditures, Taxpayers sought to deduct miscellaneous expenses through their S corporation, including legal and professional fees, maintenance costs, office expenses, and storage, telephone, and utility charges. The Tax Court determined Taxpayers provided poorly organized evidence but nonetheless looked at the merits of the case and applied the *Cohan* rule. As explained by

38 Under changes made by the Tax Cuts and Jobs Act, Pub. L. No. 115-97, 131 Stat. 2054, 2124 (2017), deductions for entertainment expenses are no longer allowable for amounts incurred or paid after December 31, 2017. IRC § 274(a)(1). Subject to various limitations, meals remain deductible to the extent that they do not constitute entertainment.

39 See, e.g., *RJ Channels, Inc. v. Comm'r*, T.C. Memo. 2018-27; *Justine v. Comm'r*, T.C. Memo. 2017-198.

40 See, e.g., *Cai v. Comm'r*, T.C. Memo. 2018-52.

41 See, e.g., *Pokawa v. Comm'r*, T.C. Memo. 2017-186.

42 *Brookes v. Comm'r*, T.C. Memo. 2017-146.

the Tax Court, however, Taxpayers' level of substantiation was insufficient even to support an estimate of any deductions:

The Court has sustained respondent's determination with regard to these deductions because petitioners have failed to offer any evidence that certain expenses were in fact paid and because petitioners' lack of receipts, confusing and inconsistent accounting techniques, and vague testimony leave the Court with no reasonable means of differentiating or estimating which of the reported expenses Brookes Financial paid as ordinary and necessary business expenses.

By contrast, the Tax Court was willing to apply *Cohan* to allow some deductions for art supply costs and rental expenditures. The Tax Court began its analysis by determining that Taxpayers did not meet their substantiation burden because of illegible or insufficient receipts for the art supplies and a lack of proof of payment for the rent. Nevertheless, the court applied *Cohan* to allow Taxpayers a portion of their claimed deductions, as the court was persuaded that such payments had been made and the minimum amount could be estimated with reasonable accuracy.

Another issue that is the subject of recurring litigation from year to year involves taxpayers' attempts to deduct losses from activities that may or may not be engaged in for profit. To the extent that an activity is carried on as a trade or business, such losses are fully deductible, but to the extent that the activity in question represents a hobby, expenses are only deductible against income generated by the activity. For example, in *Knowles v. Commissioner*, Taxpayer, in addition to other deductions, claimed losses attributable to Big Dog Farms, which was established for the purpose of breeding, selling, and showing horses.⁴³

The Tax Court examined Taxpayer's deductions using the nine factor test of Treas. Reg. § 1.183-2(b).⁴⁴ Among other things, the Tax Court determined that Big Dog Farm's losses were perpetual and substantial; that the activity was not carried on in a businesslike manner; that Taxpayer could not substantiate that she had ever hired professionals to assist in operating the horse farm; that Taxpayer demonstrated no reasonable expectation that the farm or its assets would appreciate in value; and that Taxpayer was a medical doctor who had significant income during the tax years at issue, and the losses from Big Dog Farms would generate substantial tax benefits. Based on these factual findings, the Tax Court concluded that Big Dog Farms was not a for-profit activity and generated hobby losses that, under IRC § 183, could only be deducted against income generated by the horse farm.⁴⁵

In cases where the existence of a business is not in controversy, the courts are sometimes called upon to determine whether a given transaction had economic substance and therefore produced an expense deductible under IRC § 162 or related Code sections. For example, in *Rutter v. Commissioner*, Taxpayer operated a medical technology company that did business as a C corporation.⁴⁶ Taxpayer, a reknowned

⁴³ *Knowles v. Comm'r*, T.C. Memo. 2017-152.

⁴⁴ 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.

⁴⁵ To illustrate the frequency with which this controversy arises with respect to horsebreeding operations, see *Hylton v. Comm'r*, 721 F. App'x 300 (4th Cir. 2018), *aff'g* T.C. Memo. 2016-234, *reh'g* and *reh'g en banc denied*, No. 17-1777 (4th Cir. Aug. 3, 2018), and *McMillan v. Comm'r*, 697 F. App'x 489 (9th Cir. 2017), *aff'g* T.C. Memo. 2013-40, *cert. denied*, 138 S.Ct. 1010 (2018).

⁴⁶ *Rutter v. Comm'r*, T.C. Memo. 2017-174, *appeal dismissed*, No. 17-73320 (9th Cir. Jan. 30, 2018).

biotechnologist, previously had played a role in sequencing the HIV genome; discovering the Hepatitis C virus; developing a diagnostic test to detect HIV and the Hepatitis B and C viruses; developing the first vaccine for the Hepatitis B virus using recombinant DNA technology; and co-developing a method to clone human insulin genes to produce vaccines that are used throughout the world. His new company, iMetrikus International (iMetrikus) developed technology systems to improve doctor-patient access to clinical data via a device and an application. Taxpayer was not a shareholder of common stock in iMetrikus; he was its driving force and funded the bulk of its operations through cash advances. Ultimately, the company was unable to form the corporate partnerships it had envisioned, incurred millions of dollars of losses, and eventually ceased business operations. As the company's financial situation became increasingly precarious, Taxpayer and the company entered into negotiations regarding the cash he had previously contributed, as part of which they collectively executed a debt forgiveness certificate for \$8.55 million.

Taxpayer sought to deduct this amount under IRC § 166 as a bad debt incurred in the course of a trade or business. The IRS, however, argued that the \$8.55 million was not debt, but instead represented equity that could not yet be deducted. In analyzing the issue, the Tax Court looked to the economic substance of the transfers in question. “The question of whether the advances...are debt or equity depends on the economic substance of the transactions between them and not upon the form of the advances.”⁴⁷

As a guide to analyzing the cash advances, the Tax Court considered a range of nonexclusive factors traditionally distinguishing debt from equity. For example, Taxpayer acted as a capital investor, rather than a creditor; exercised management control over the company; and provided funds under circumstances and terms that no regular creditor would have found acceptable. Based on these criteria, the Tax Court concluded that, in substance, the cash advances represented equity in the company. Accordingly, Taxpayer's IRC § 166 bad debt deduction was disallowed.

A separate element essential to an IRC § 162 deduction is the taxpayer's ability to prove that it was incurred in the year in which the deduction is claimed. This issue arises in another IRC § 166 case, *Hatcher v. Commissioner*.⁴⁸ Taxpayer loaned her boyfriend approximately \$400,000 over a period of years to develop a golf-themed cartoon strip entitled, “In the Rough.” Later, after the boyfriend became an ex-boyfriend, she sought repayment in 2010 and received an email saying, “I HAVE NO MONEY.” Shortly thereafter, Taxpayer and her husband sued the ex-boyfriend in an attempt to recover some or all of the amounts loaned. Ultimately, no money was ever recovered and Taxpayer sought to claim a bad debt deduction for the principal interest in 2010.

The Fifth Circuit, however, affirmed the Tax Court's decision that Taxpayer had failed her burden of proving that the debt actually became worthless in 2010. In particular, the Fifth Circuit noted that Taxpayer's attempts to collect the debt via legal proceedings in 2011 and related negotiations in 2012 were inconsistent with the position that the debt was worthless as of 2010. Consequently, even though the debt may have been worthless in a later year and properly deductible in that year, it could not be claimed as an IRC § 166 bad debt deduction related to the conduct of a trade or business in 2010.

Once expenses otherwise deductible under IRC § 162 are established, the question arises regarding whether those expenditures created assets with a useful life of more than one year, such that the

47 Rutter, T.C. Memo. 2017-174 (quoting *Davis v. Comm'r*, 69 T.C. 814, 835 (1978)).

48 *Hatcher v. Comm'r*, 726 F. App'x (5th Cir. 2018), *aff'g* T.C. Memo. 2016-188.

expenditures must be capitalized and depreciated over the useful life of the assets.⁴⁹ In *Wells v. Commissioner*, Taxpayer owned and operated a farm in Colorado, which produced grapes for wine and grape juice, and which also leased part of its land to third parties for the grazing of horses and cattle.⁵⁰ The farm experienced a number of nature-related setbacks, including drought, a wildfire, flooding, and bears that consumed much of the grape harvest and damaged vines. Taxpayer incurred a variety of resulting costs, including installation of an improved piping system carrying water throughout the farm, replacement of a road, construction of fencing, and rehabilitation of areas damaged by fire. Taxpayer sought to currently deduct under IRC § 162 the full amount of these expenses.

Although allowing some of the claimed deductions, the IRS contended that the bulk of the expenses should be capitalized and recovered over time. The Tax Court generally agreed with the IRS, ruling that these expenditures did not simply restore the property to its prior condition, but extended the useful life of the property for a period in excess of one year. Most of the expenditures were made as part of a long-term plan of improvement and could not be fully deducted in the year incurred. Accordingly, the Tax Court required that the expenditures be capitalized and recovered over time as depreciation deductions.

CONCLUSION

The existence and amount of allowable business expenses are highly fact-specific and are often open to interpretation. IRC § 162 deductions are based upon a complex interaction of multiple statutes and regulations, as well as case law. This circumstance perpetuates substantial controversy between the IRS and taxpayers regarding the scope and extent of properly claimed business deductions. As a result, courts rendered decisions in over 106 cases involving IRC § 162 related issues between June 1, 2017, and May 31, 2018.

As in prior years, a variety 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. Many of these cases involved taxpayers' often-unsuccessful attempts to meet general substantiation requirements or to comply with the heightened substantiation rules of IRC § 274(d). Moreover, a number of taxpayers in this year's litigated cases evidenced difficulty distinguishing between nondeductible personal expenses or hobby losses on the one hand, and deductible business expenses on the other hand.

As recommended by the National Taxpayer Advocate in the past, ongoing efforts to educate taxpayers and their representatives on these subjects are an essential element of tax compliance and would benefit both taxpayers and the IRS.⁵¹ Also, consistent with observed historical patterns, many *pro se* litigants were unable to meet substantiation requirements. This circumstance presents an opportunity for the IRS to conduct better outreach and education on substantiation issues. However, we note that there are only 105 employees dedicated to outreach for small business/self-employed taxpayers, and 17 states have no such employee within their borders.⁵²

49 The capitalization analysis occurs under IRC §§ 263 and 263A, while the period over which the capitalized costs will be recovered is generally determined by IRC § 167.

50 *Wells v. Comm'r*, T.C. Memo. 2018-11, *appeal docketed*, No. 18-9007 (10th Cir. Aug. 27, 2018).

51 National Taxpayer Advocate 2016 Annual Report to Congress 388-389.

52 National Taxpayer Advocate Fiscal Year (FY) 2019 Annual Report to Congress 2.

Additionally, many of the cases that are litigated in this area likely could be resolved at the administrative level if the IRS developed and implemented a more robust alternative dispute resolution program.⁵³ Such a program would facilitate a dialogue between taxpayers and the IRS that would clarify disputed facts and would help taxpayers better understand the applicable law. This process for clarification and education would enable taxpayers and the IRS to administratively resolve an increased number of cases and generally resort to litigation only where there are true disagreements regarding the facts or law essential to a case decision. It would also further taxpayers' rights *to be informed* and *to challenge the IRS's position and be heard*.

53 National Taxpayer Advocate 2016 Annual Report to Congress 211-219.