

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 in the Annual Report. We identified 134 cases involving a trade or business expense issue that were litigated between June 1, 2012, and May 31, 2013. The courts affirmed the IRS position in the vast majority (approximately 74 percent) of cases, while taxpayers fully prevailed only about two percent of the time.¹ The remaining cases resulted in split decisions.

PRESENT LAW

Internal Revenue Code (IRC or the “Code”) § 162 allows deductions for ordinary and necessary trade or business expenses paid or incurred during the course of a taxable year. Rules regarding the practical application of IRC § 162 have evolved largely from case law and administrative guidance. The IRS, the Department of the Treasury, Congress, and the courts continue to provide guidance about whether a taxpayer is entitled to claim certain deductions. The cases analyzed for this report illustrate that this process is ongoing and involves the analysis of facts and circumstances. When a taxpayer seeks judicial review of the IRS’s determination of a tax liability stemming from the deductibility of a particular expense, the courts must often address a series of questions, including those discussed below.

What is a trade or business expense under § 162?

Although “trade or business” is one of the most widely used terms in the IRC, neither the Code nor the Treasury Regulations provide a definition.² The definition of a “trade or business” comes from common law, where the concepts have been developed and refined by the courts.³ The Supreme Court has interpreted “trade or business” for purposes of IRC § 162 to mean an activity conducted with “continuity and regularity” and with the primary purpose of earning income or making profit.⁴

What is an ordinary and necessary expense?

IRC § 162(a) requires a trade or business expense to be both “ordinary” and “necessary” in relation to the taxpayer’s trade or business in order to be deductible. In *Welch v. Helvering*, the Supreme Court stated that the words “ordinary” and “necessary” have different meanings, both of which must be satisfied for the taxpayer to benefit from the deduction.⁵ The Supreme Court describes an “ordinary” expense

1 The IRS prevailed in full in 99 out of 134 cases, while taxpayers prevailed in full in only three cases.

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

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

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

5 290 U.S. 111, 113 (1933) (suggesting an examination of “life in all its fullness” will provide an answer to the issue of whether an expense is ordinary and necessary).

as customary or usual and of common or frequent occurrence in the taxpayer's trade or business.⁶ The Court describes a "necessary" expense as one that is appropriate and helpful for development of the business.⁷

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."⁸

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.⁹ No deductions are allowed for the cost of acquisition, construction, improvement, or restoration of an asset expected to last more than one year.¹⁰ Instead, capital expenditures may be subject to amortization, depletion, or depreciation over the useful life of the property.¹¹

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.¹²

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 Code also requires a taxpayer to maintain books and records that substantiate income, deductions, and credits — including adequate records to substantiate deductions claimed as trade or business expenses.¹³ If a taxpayer cannot substantiate the exact amounts of deductions by documentary evidence (*e.g.*, invoice, paid bill, or canceled check), but can establish that he or she had some business expenditures, the courts may employ the *Cohan* rule to grant the taxpayer a reasonable amount of deductions.

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

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

8 176 F.2d 815, 817 (6th Cir. 1949), *cert. denied*, 338 U.S. 949 (1950).

9 IRC § 162(a).

10 IRC § 263. See also *INDOPCO, Inc. v. Comm'r*, 503 U.S. 79 (1950).

11 IRC § 167.

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

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

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*.¹⁴ The court held that the taxpayer’s business expense deductions were not adequately substantiated, but stated that “the Board 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.”¹⁵

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

1. Travel expenses;
2. Entertainment, amusement, or recreation expenses;
3. Gifts; and
4. Certain “listed property.”¹⁶

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.¹⁷

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.¹⁸ 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.

14 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.

15 *Id.* at 544 (2d Cir. 1930), *aff’g and remanding* 11 B.T.A. 743 (1928).

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

17 Treas. Reg. § 1.274-5T(b).

18 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).

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 1998.¹⁹ This year, we reviewed 134 cases involving trade or business expenses issues that were litigated in federal courts from June 1, 2012, through May 31, 2013. Table 2 in Appendix III contains a list of the main issues in those cases. Table 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 in Cases Reviewed

Issue	Type of Taxpayer	
	Individual	Business (including sole proprietorships)
Substantiation of expenses, including application of the <i>Cohan</i> rule ¹	9	78
Profit objective ²	0	19
Ordinary and necessary trade or business expenses ³	0	34
Personal vs. business expenses ⁴	4	26
Business expenses vs. capital expenditures ⁵	0	1
Did the taxpayer establish the carrying on of a trade or business?	0	7
Gambling expenses ⁶	1	0

Approximately 64 percent of the taxpayers litigating trade or business deduction issues represented themselves (*pro se*). However, those represented by counsel fared better than their *pro se* counterparts. Taxpayers with representation received full or partial relief in approximately 33 percent of cases (16 of 48). By contrast, *pro se* taxpayers received full or partial relief in just 22 percent of cases (19 of 86).

19 See National Taxpayer Advocate 1998-2012 Annual Reports to Congress.

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

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

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

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

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

25 IRC § 165(d) provides that "[l]osses from wagering transactions shall be allowed only to the extent of the gains from such transactions."

Individual Taxpayers

None of the 11 decisions involving individual taxpayers (where the term “individual” excludes a sole proprietorship) was issued as a regular opinion of the Tax Court.²⁶ Nine of the 11 individual taxpayers appeared *pro se*. No individual taxpayers received full relief, while only one earned a split decision; the court upheld the IRS position in ten of 11 cases (91 percent).

The most prevalent issue was the substantiation of claimed trade or business expense deductions, which appeared in nine cases. For example, in *Noz v. Commissioner*,²⁷ the Tax Court denied several claimed business expense deductions for failure to substantiate. The claimed deductions included travel expenses, meals and entertainment, and computer-related equipment. The taxpayers, two university professors, were unable to substantiate travel expenses for trips around the United States to give lectures in connection with their appointments as professors. The taxpayers provided no evidence as to the price of their plane tickets or the dates of their travel. As there was no evidence establishing the business purpose of the travel aside from the taxpayer’s testimony, the court denied those deductions. It also denied expense deductions for meals and entertainment while traveling in the absence of evidence as to the cost, time and place of the meals, and the business purpose of the expenses. Deductions for computer equipment were also denied as there was no evidence indicating purchase price or purchase date.

The taxpayers, one of whom lived in Sweden while the other lived in New York, also sought to deduct travel expenses for trans-Atlantic travel. Because the court deemed this travel personal, rather than associated with a business purpose, it also denied those deductions. Because travel expenditures, meals and entertainment and listed property, such as computer equipment, are enumerated in IRC § 274(d), no deductions are allowed absent proper substantiation. As a result, the court could not invoke the *Cohan* rule.²⁸

Business Taxpayers

We reviewed 123 cases involving business taxpayers, who had a far greater success rate than individual taxpayers. While individual taxpayers did not win a single case in full, splitting one case and losing ten of 11 others, business taxpayers received full or partial relief in approximately 28 percent of cases (34 of 123). Business taxpayers were represented by counsel in nearly half of the favorably decided cases (16 of 34) and in 34 percent of the cases that the IRS won (30 of 89).

26 Tax Court decisions fall into three categories: regular decisions, memorandum decisions, and small tax case (“S”) decisions. The regular decisions of the Tax Court include cases which have some new or novel point of law, or in which there may not be general agreement, and therefore have the most legal significance. In contrast, memorandum decisions generally involve fact patterns within previously settled legal principles and therefore are not as significant. Finally, “S” case decisions (for disputes involving \$50,000 or less) are not appealable and, thus, have no precedential value. See IRC § 7463(b). See also U.S. Tax Court Rule of Practice and Procedure, Rules 170-175. With respect to the cases we reviewed this year, more than half the cases involving individual taxpayers (excluding sole proprietorships) were “S” cases.

27 T.C. Memo. 2012-272.

28 There were other examples of individual taxpayers who failed to substantiate claimed business expense deductions. See, e.g., *Harris v. Comm’r*, T.C. Memo. 2012-312 (holding deductions were improper for unreimbursed employee expenses related to lodging, meals and vehicle mileage for failure to substantiate).

As with the individual taxpayers, substantiation of expenses was by far the most prevalent issue,²⁹ and in most instances, the court denied the business taxpayers' deductions for failure to substantiate.³⁰ Courts did, however, allow some of these deductions when the taxpayer produced sufficient evidence.³¹ 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.³² IRC § 274(d), however, makes the *Cohan* rule unavailable in certain circumstances in which the taxpayer must substantiate the deductions.

Another common difficulty was the failure to prove that expenses were ordinary and necessary to the taxpayer's business. For example, in *Curcio v. Commissioner*,³³ the taxpayers sought to deduct contributions to life insurance plans for employees, but because they failed to prove this was an ordinary and necessary business expense, the court denied the deduction. The court discussed the possibility that employee incentive programs, such as those involving contributions to life insurance plans, could be made primarily in furtherance of a profit objective, and, therefore, may be eligible as an ordinary and necessary business expense. In *Curcio*, however, the life insurance plans covered only four principal owners and the owner's stepson, and the court consequently ruled the payments were not "normal, useful, or helpful for the development of the taxpayer's business, and were not made in furtherance of a profit objective or for any viable business purpose, but rather, were a mechanism by which taxpayers could divert company profits."³⁴ As the expense was not ordinary and necessary to the taxpayer's business, it was not deductible as a trade or business expense pursuant to IRC § 162(a).³⁵

In *Consolidated Edison Co. of NY, Inc. v. United States*,³⁶ the United States Court of Appeals for the Federal Circuit, reversing the Court of Federal Claims, disallowed certain business expense deductions that the taxpayer took in connection with a leasing arrangement. The taxpayer claimed on its tax return multiple deductions pertaining to a lease-in/lease-out ("LILLO") tax shelter transaction in which it leased property from a foreign company, not subject to U.S. taxation, and subleased the property immediately back to the foreign entity. The tax scheme is designed to accelerate losses to the taxpayer and defer gains, thereby taking advantage of the time value of money by delaying tax payments.

29 Substantiation of expenses was at issue in 78 out of 123 cases (63 percent) involving business taxpayers.

30 See *Schoppe v. Comm'r*, 711 F.3d 1190 (10th Cir. 2013), *aff'g* T.C. Memo 2012-153 (deduction denied for real estate practice expenses for failure to substantiate), *Christine v. Comm'r*, 475 F. App'x 259 (9th Cir. 2012), *aff'g* T.C. Memo 2010-144 (deduction denied for failure to substantiate), *MacGregor v. Comm'r*, 501 F. App'x 663 (9th Cir. 2012), *aff'g* T.C. Memo 2010-187 (deduction denied for marketing expenses for failure to substantiate expenses), *Natkunanathan v. Comm'r*, 479 F. App'x 775 (9th Cir. 2012), *aff'g* T.C. Memo 2010-15 (deduction for business expenses denied for failure to substantiate).

31 See *Striefel v. Comm'r*, T.C. Memo. 2013-102 (deduction allowed for lodging and meal expenses to the extent substantiated; deduction denied for failure to meet strict substantiation requirement for car and truck expenses), *Longino v. Comm'r*, T.C. Memo. 2013-80 (deduction allowed for utility and extermination expense in personal residence to extent substantiated as held exclusively for business purposes).

32 See *Bauer v. Comm'r*, T.C. Memo. 2012-156 (deduction allowed under *Cohan* for contract labor expenditures).

33 689 F.3d 217 (2d Cir. 2012), *aff'g* T.C. Memo. 2010-115.

34 *Id.* at 226.

35 See IRC § 162(a)(3) (There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including ... rentals or other payments required to be made as a condition to the continued use or possession, for purposes of the trade or business, of property ..."). For other examples of cases examined in which the court denied deductions for failure to prove the expense was ordinary and necessary in business, see *DiDonado v. Comm'r*, T.C. Memo. 2013-11 (deduction denied for firearm expense for failure to prove ordinary and necessary in business), *Abarca v. Comm'r*, T.C. Memo. 2012-245 (deduction denied for car and truck rental expenses for failure to prove ordinary and necessary in business).

36 703 F.3d 1367 (Fed. Cir. 2013), *rev'g* 90 Fed.Cl. 228 (2009).

Applying the substance-over-form doctrine,³⁷ the United States Court of Appeals for the Federal Circuit disallowed the deductions because “there was a reasonable likelihood that the tax-indifferent entity in the LILO Transaction (the lessor of the master lease) would exercise its purchase option at the conclusion of the ConEd sublease, thus rendering the master lease illusory.”³⁸ Accordingly the court ruled the deductions were not properly allowable under IRC § 162(a)(3).

Taxpayers were also denied business expense deductions when the courts found the expenses related to personal, rather than business, activities³⁹ pursuant to § 262(a).⁴⁰ To illustrate, the taxpayers in *Robinson v. Commissioner*⁴¹ sought to deduct expenses for vehicle use and travel, but the court held the expenses were personal and, therefore, not eligible for deduction under § 162. The taxpayers deducted expenditures for family trips to Disneyland and Disney World, hotel stays, airfare, and retail merchandise, claiming the family took trips and visited tourist sites for business purposes. The husband, a professor at Temple University, also claimed a deduction for the business use of his car in travel to and from the university. Although he taught for relatively few days at Temple, he deducted expenses corresponding to tens of thousands of miles traveled. The taxpayers also deducted expenses related to the personal use of their home office, including the use of a cellular phone and computer. As the taxpayers failed to present any evidence establishing the business use of any of these expenses, they were denied as business expense deductions. Additionally, the taxpayers failed to demonstrate that their expenses were related to a business purpose and were not primarily personal.

Courts generally upheld the IRS’s determination that the business expense deductions were not attributable to an activity that was engaged in for profit within the meaning of § 183.⁴² In *DKD Enterprises v. Commissioner*,⁴³ the taxpayers sought to deduct expenses related to a cat breeding activity. The taxpayers claimed that they intended to operate the activity for profit, and they entered their kittens in several national tournaments. The kittens were valued from \$1,000-\$5,000, and the owners won four national championships in two years. The taxpayers operated a website for marketing the kittens, and did earn some income from sales during the years in question. However, the Eighth Circuit Court of Appeals held the taxpayers had not engaged in cat breeding for profit. In doing so, the court noted that it “should find the trade or business venture lacked a genuine profit motive only if the court finds, as a factual matter, the taxpayer lacked a good-faith, subjective intention to make a profit and was engaged in the activity for wholly different reasons.”⁴⁴ The expenses related to the activity, therefore, were not deductible.

37 The Court of Appeals for the Federal Circuit followed the substance-over-form doctrine it articulated in *Wells Fargo & Co. v. U.S.*, 641 F.3d 1319 (Fed. Cir. 2011) (the tax consequences of a transaction are based on the substance of the transaction rather than its legal form).

38 *Consolidated Edison Co.*, 703 F.3d at 1369.

39 See, e.g., *Sernett v. Comm’r*, T.C. Memo. 2012-334 (deduction denied because expenses related to sprint car racing activity were personal), *Johnson v. Comm’r*, T.C. Memo. 2012-231 (deduction denied because expenses related to drag racing activity were personal).

40 See *supra*, note 23.

41 487 F. App’x 751 (3d Cir. 2012), *aff’g* T.C. Memo. 2011-99.

42 See, e.g., *Pederson v. Comm’r*, T.C. Memo. 2013-54 (deduction denied for horse breeding activity for failure to show engaged in for profit under § 183).

43 685 F.3d 730 (8th Cir. 2012), *aff’g* T.C. Memo. 2011-29.

44 *Id.*