

Trade or Business Expenses Under IRC § 162

TAXPAYER RIGHTS IMPACTED¹

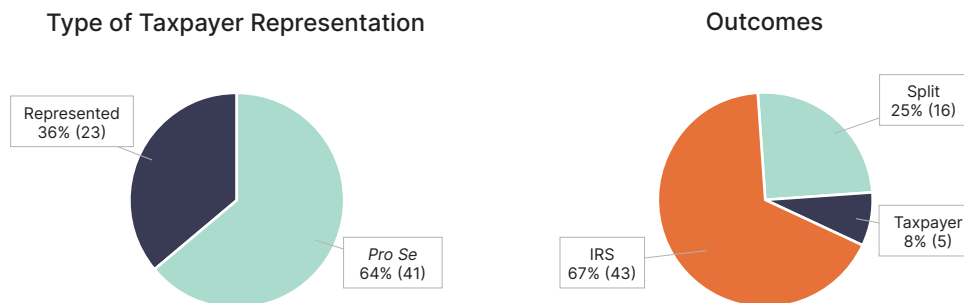
- *The Right to Pay No More Than the Correct Amount of Tax*
- *The Right to Challenge the IRS's Position and Be Heard*
- *The Right to Appeal an IRS Decision in an Independent Forum*
- *The Right to a Fair and Just Tax System*

OVERVIEW

Trade or business deductions have been among the most litigated issues ever since TAS started tracking such activity. This litigation typically focuses on the application of well-settled legal principles and exhaustively articulated statutes and regulations to taxpayers' particular facts and circumstances. In most years, very few cases break new ground or add to the legal landscape regarding deductibility of trade or business expenses under IRC § 162. Such was the case again this year.²

By and large, the 64 opinions we reviewed involved unrepresented taxpayers (*pro se*) and the IRS prevailed in the overwhelming number of cases. During this same period, taxpayers petitioned Tax Court in 6,956 cases where trade or business expenses were an issue during the examination.³

FIGURE 2.4.1⁴



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

2 TAS analyzed cases decided during the period beginning on June 1, 2019, and ending on May 31, 2020.

3 IRS Appeals response to TAS information request (Dec. 3, 2020) showing cases petitioned to Tax Court between June 1, 2019 and May 31, 2020. TAS matched this data to the cases identified by examination where an adjustment to trade or business expenses was recommended as recorded in the Examination Operational Automation Database on the IRS Compliance Data Warehouse (Dec. 2020).

4 Of the cases analyzed by TAS, 41 involved unrepresented taxpayers, while 23 involved taxpayers with representation. The IRS fully prevailed in 43 cases, while taxpayers fully prevailed in five. The remaining 16 opinions were split between the two litigants based upon their specific facts.

ANALYSIS OF LITIGATED CASES

IRC § 162 and related Code sections give rise to litigation in a variety of areas. This year, the cases present the following issues.

FIGURE 2.4.2, Trade or Business Expense Issues⁵

Issue	Type of Taxpayer	
	Individual	Business
Substantiation of Expenses Under IRC § 162, Including Application of the <i>Cohan</i> Rule	3	27
Deductibility of IRC § 162 Expenses	1	7
Substantiation of Expenses Under IRC § 274(d)	1	20
Schedule A Unreimbursed Employee Expenses Requiring Proof Employer Did Not Reimburse Taxpayer Under IRC § 162	4	6
Hobby Losses, Nondeductible Under Either IRC §§ 183 or 162	0	7
Home Office Under IRC § 280A	0	4
Net Operating Losses Under IRC § 172	1	5
Personal Expenditures Disallowed Under IRC § 262	0	4
Capitalization and Cost Recovery Under IRC §§ 263, 263A, 195, 179, and 167	2	8
Illegal Activities Under IRC §§ 280E, 162(c), 162(f), and 162(g)	0	1
Economic Substance Doctrine	0	2
Business Bad Debt Deduction Under IRC § 166	0	7
Not Engaged in a Trade or Business Under IRC § 162	0	4
Interest Deduction Under IRC § 163	0	0

Generally, the case law in this area is based upon the taxpayer’s specific facts and supporting evidence. Although this is a well-settled area of the law, cases are litigated on a reoccurring basis and span many different fact patterns. Key opinions providing new insights or revised precedents rarely are handed down. This year is no exception. However, controversy and confusion continue to arise regarding the deductibility of expenses incurred by medical marijuana dispensaries. Such dispensaries are prohibited by federal law, but legal under the laws of many states. Moreover, IRC § 280E specifies that no trade or business deductions are allowed for any business engaged in trafficking in substances that are illegal under federal law.⁶

In *N. Cal. Small Bus. Assistants, Inc. v. Commissioner*,⁷ the Taxpayer contended that, even if IRC § 280E bars IRC § 162 deductions, that prohibition does not extend to other deductions from related Code sections,

⁵ Multiple issues may appear within one case; therefore, these figures exceed the total case count.

⁶ IRC § 280E states: “No deduction or credit shall be allowed for any amount paid or incurred during the taxable year in carrying on any trade or business if such trade or business (or the activities which comprise such trade or business) consists of trafficking in controlled substances (within the meaning of schedule I and II of the Controlled Substances Act) which is prohibited by Federal law or the law of any State in which such trade or business is conducted.”

⁷ *N. Cal. Small Bus. Assistants, Inc. v. Comm’r*, 153 T.C. 65 (2019).

such as IRC § 167 depreciation.⁸ The Tax Court, however, consistent with other recent opinions, held that the IRC § 280E language was extremely broad and operated to deny deductions attributable to all marijuana dispensary operations.⁹

CONCLUSION

As witnessed by the IRS's success in litigating controversies regarding IRC § 162 trade or business deductions, most opinions in this area resulted either from taxpayer confusion regarding the applicable legal requirements or from taxpayers' occasional attempts to push the envelope. The case law, however, is well established and the statutory and regulatory guidance is exhaustive, if occasionally unduly complex.

As long as marijuana falls within schedules I or II of the Controlled Substances Act,¹⁰ while being legal within many states, the deductibility of dispensary expenses will continue to generate controversy. Congress could consider minimizing future litigation by removing marijuana from schedule I so that businesses legally selling marijuana would not face the challenges and complexities that currently lead to most of the federal income tax litigation in this area.¹¹

8 The taxpayer also raised constitutional and statutory arguments that the Tax Court found unpersuasive.

9 See, e.g., *Patients Mut. Assistance Collective Corp. v. Comm'r*, 151 T.C. 176 (2018).

10 See 21 U.S.C. Chapter 13. The schedules of controlled substances are located at 21 U.S.C. § 812(b).

11 Specifically, marijuana would need to be listed on neither schedule I nor schedule II for deductions in this area to be permissible.