Chapter Three

Business Expenses and Losses

Proposed § 199 Regulations Abandon Benefits and Burdens Test for an Activity Performed Under a Contract.

Overview. On August 27, 2015, the IRS issued proposed regulations (REG-136459-09) that clarify several "problem areas" involving § 199, including the removal of the benefits and burdens test in contract manufacturing situations.

Business Expenses and Losses

The proposed regulations:

Provide guidance on amendments made to § 199 by the Energy Improvement and Extension Act of 2008 and the Tax Extenders and Alternative Minimum Tax Relief Act of 2008 (involving oil related qualified production activities income and qualified films);

Business Expenses and Losses

Provide guidance involving activities in Puerto Rico under the American Taxpayer Relief Act of 2012;

Provide guidance on determining domestic production gross receipts; and the terms manufactured, produced, grown, or extracted; contract manufacturing; hedging transactions, construction activities, allocating cost of goods sold, and agricultural and horticultural cooperatives.

Business Expenses and Losses

Section 199(a) allows a deduction equal to 9% of the lesser of (a) the qualified production activities income (QPAI) of the taxpayer for the taxable year; or (b) taxable income for the taxable year.

The amount of the deduction allowable shall not exceed 50% of the W-2 wages of the taxpayer for the taxable year.

The term QPAI is defined as an amount equal to the excess of the taxpayers domestic production gross receipts

properly allocable to such receipts.

Business Expenses and Losses

<u>IRS Examples of Non-MPGE Activities</u>. On March 16, 2015, the IRS issued LB&I-04-0315-001 to provide examiners with examples of retail activities that generally do not meet the definition of "manufactured, produced, grown, or extracted"

The examples of activities performed at a retail level:

a. Cutting blank keys to a customer's specification;
b. Mixing base paint and a paint coloring agent;
c. Applying garnishments to a cake that is not baked where sold;

Business Expenses and Losses

d. Applying gas to agricultural products to slow or expedite fruit ripening;

e. Storing agricultural products in a controlled environment to extend shelf life; and

f. Maintaining plants and seedlings.

Business Expenses and Losses

In ILM 201313020, the IRS concluded that a book publisher's activities did not constitute MPGE where its activities included developing the content of a book and providing layout and editing, after which it produced an electronic book that it provided to a contract printer. The IRS focused on the electronic version of the book that the taxpayer provided to the printer, noting that it was not tangible personal property. Under § 199(c)(5), qualifying production property includes only tangible personal property, computer software, and sound recordings.

Business Expenses and Losses

On July 16, 2013, the IRS issued field service advice, FSA 20133302F, in which it concluded that photography processing activities constitute MPGE, but merely putting a customer's intangible picture files onto a CD or DVD not manufactured by the taxpayer is not a MPGE activity.

On November 28, 2012, the IRS issued a legal memorandum, ILM 201302017, in which it concluded that billboards, other than mobile billboards, constitute an inherently permanent structure and therefore are not qualified production property for

Business Expenses and Losses

Nice Try Award: Professor and Librarian Cannot Deduct Computer and Other Costs to Keep Up on General Knowledge.

In Tanzi v. Comm'r, T.C. Memo. 2016-148, the Tax Court held that a college professor and his spouse, a college librarian, could not deduct as unreimbursed employee business expenses the cost of Internet, cell phone, and satellite television service or the cost of computer equipment, finding that the expenses were personal, nondeductible expenses.

Business Expenses and Losses

Dr. Tanzi taught math and other classes as an adjunct professor, and Mrs. Tanzi was a campus librarian. Dr. Tanzi is highy educated and holds a doctorate in communications. He testified that individuals holding such "terminal degrees bear a lifelong burden of developing knowledge, finding knowledge, exploring, and essentially self- educating." He claimed that all expenses paid in adding to his "general knowledge" should be deductible as unreimbursed employee business expenses.

Business Expenses and Losses

The Court held that none of the alleged unreimbursed employee business expenses were deductible, generally because an expense must be "ordinary and necessary" to the taxpayer's employment to be deductible under § 162, and here the Tanzis had not proven the expenses were ordinary and necessary to their employment.

Internet expenses, even if they increased the Tanzis' "general knowledge," are in the nature of a personal expense rather than a ordinary and necessary business expense for a college professor or a college

Business Expenses and Losses

- The Tanzis also did not show what portion of the cell phone expenses were related to work, and there was insufficient evidence to estimate such a portion.
- As to computer equipment expenses, the Tanzis were required to meed strict substantiation requirements under § 274(d) that apply to listed property.
- The Tanzis claimed $12,332 of depreciation expenses for property allegedly purchased between 2004 and 2008.
- Finally, a $2,028 deduction for maintaining a professional library of books, CDs, and DVDs was improper, as was a $1,825 deduction for DirecTV.

Business Expenses and Losses

No Deduction for Clothing.

In *Barnes v. Comm'r*, T.C. Memo. 2016-72, the Tax Court has held that a salesman for a major designer who was required to wear the designer's apparel while representing the company could not deduct the cost of such clothing as unreimbursed employee expenses.

Business Expenses and Losses

Under § 262, a taxpayer generally cannot deduct personal, living, or family expenses. Section 162(a), however, allows as a deduction all ordinary and necessary expenses.

Expenditures for the purchase and maintenance of clothing are generally nondeductible expenses under § 262, even though the clothing is worn by the taxpayer in connection with his trade or business, unless: (1) the clothing is required or essential in the taxpayer's employment, (2) the clothing is not suitable for general or personal wear, and (3) the

Business Expenses and Losses

MiSEA 2016

Although Mr. Barnes was required to wear Ralph Lauren clothing while representing the company, the Tax Court easily denied the deduction because Ralph Lauren clothing is suitable for general or personal wear.

The court also upheld the IRS's limited allowance of a $1,000 noncash charitable contribution for each year at issue. It noted that, while the donation receipts established that Barnes made noncash charitable contributions to the Salvation Army in both 2010 and 2011, they failed to provide the court with adequate

Deductions or Credits for Education Expenses.

In *Santos v. Comm'r*, T.C. Memo. 2016-100, the Tax Court has concluded that an accountant could not deduct his law school tuition and fees as ordinary business expenses, finding that those expenses qualified him for a new trade or business and thus were nondeductible under Reg. § 1.162-5(b). The Court also declined to consider the taxpayer's late-raised arguments challenging the validity of that regulation.

Business Expenses and Losses

Education expenses are deductible under § 162(a) if made by a taxpayer either to maintain or improve skills required in his business or employment or to meet the express requirements of his employer, or the requirements of law or regulations, if they are imposed as a condition to retaining his salary, status or employment (Reg. § 1.162-5).

The expense is deductible only if the taxpayer is established in the trade or business at the time he pays or incurs the expense (Jungreis, 55 TC 581 (1970)).

Business Expenses and Losses

Deductions are not allowed if the education:

a. Is needed to meet the minimum requirements for taxpayer's present or intended employment, trade, business or profession (Reg. § 1.162-5(b)(2)); or
b. Is undertaken to fulfill general education aspirations or for other personal reasons; or
c. Is part of a program of study that will lead to qualifying the individual in a new trade or business (Reg. § 1.162-5(b)(3)(i)).

Business Expenses and Losses

According to the facts, Emmanuel Santos began working as a return preparer in 1990. He became an "enrolled agent" authorized to represent taxes before IRS in 1995, and earned a master's degree in taxation in 1996. He began offering other services to his clients, including financial planning.

Santos attached a Schedule C (Profit or Loss From Business) to his 2010 Form 1040 for the "business or profession" of tax and financial planning. On his Schedule C, Santos deducted a variety of expenses, including $20,275 for law school tuition and fees.

In *Kopiagora v. Comm'r*, T.C. Summ. Op. 2016-35, the Court held that an individual who worked as an assistant controller at a hotel and who later obtained a similar position with another employer could deduct the costs he incurred in obtaining an executive master of business administration (EMBA) degree as unreimbursed employee business expenses under § 162.

Business Expenses and Losses

The taxpayer began working for Marriott International Corp. in 2002 as an accounting manager. In June 2006 he accepted a position as a senior assistant controller for a Marriott hotel in Los Angeles, and managed a team of employees performing accounting duties and preparing financial reports according to GAAP.

In July 2010 the taxpayer enrolled in the EMBA degree program at Brigham Young University (BYU) to improve his leadership skills in

Business Expenses and Losses

MiSEA 2016

In April 2011 the taxpayer’s employment with the Marriott was unjustifiably terminated.

The taxpayer received his EMBA degree in August 2012. On September 2, 2012, he was hired as vice president of finance of a small financing company.

The taxpayer claimed a $18,879 deduction on his 2011 return for EMBA degree expenses as

Business Expenses and Losses

MiSEA 2016

The Court noted that a taxpayer must be presently engaged in a trade or business in order for education expenses to be deductible. A taxpayer, however, may be engaged in a trade or business, although unemployed, if he or she was previously involved in and actively sought to continue in that trade of business.

The IRS argued that the taxpayer did not carry on his trade or business through 2011 because he was unemployed.

Business Expenses and Losses

When the taxpayer enrolled in the EMBA degree program, he was a well-established finance and accounting business manager for Marriott.

The Court also noted that the taxpayer's unemployment did not prevent him from continuing his trade or business as a finance and accounting business manager.

Business Expenses and Losses

Compare *O'Connor v Comm'r*, 2016-1 U.S.T.C. (CCH) ¶ 50,331 (10th Cir. 2016), where a U.S. citizen deducted U.S. law school expenses incurred in 2010 and 2011 at a time he was not an employee of any company, and he had never practiced law in the U.S. before although he was licensed to practice law in Germany.

The taxpayer's U.S. law school degree qualified him to enter a new trade or business, and the IRS properly disallowed the deductions.

Business Expenses and Losses

Individual Cannot Claim Credit for Tuition Paid in Prior Tax Year. In McCarville v. Comm'r, T.C. Summ. Op. 2016-14, the Court held that a taxpayer was not entitled to claim an American Opportunity Tax Credit in 2012 for spring 2012 tuition that he paid in December 2011.

Business Expenses and Losses

Lucas McCarville attended Arizona State University (ASU) from 2008 to 2012. The fall semester at ASU begins in August and ends in December, and the spring semester begins in January and ends in May. Lucas paid his tuition for the fall semester 2011 in August 2011, and paid his tuition for the spring semester 2012 in December 2011, even though ASU did not require payment for the spring semester 2012 until January 25, 2012.

Reg. § 1.25A-5(e)(1). Section 25A(g)(4), however, provides that if such expenses "are paid by the taxpayer during a taxable year for an academic period which begins during the first 3 months following such taxable year, such academic period shall be treated for purposes of this section as beginning during such taxable year." Under this provision, if tuition is paid in 2011 for a semester beginning in January 2012, the credit is allowed only for 2011.

Business Expenses and Losses

Compare *Terrell v. Comm'r*, T.C. Memo. 2016-85, where a student was entitled to the education credit for tuition and expenses paid in 2011 by loan disbursements, even though a portion of her spring 2011 tuition was billed to her account in 2010, and the university did not report such amount on Form 1098-T.

Business Expenses and Losses

Terrell claimed an AOTC of $2,500 for 2011. The IRS disallowed the credit.

The Court had no trouble ruling for Terrell. The tuition in question was for the spring

2011 semester and all of it was paid in January 2011 through a loan disbursement to the

university.

Note that under legislation passed by Congress in December 2015, educational institutions are now

actually paid, rather than just billed in any given year.

Business Expenses and Losses

MiSEA 2016

Doctor's Mobile Home Was Not Used 85% for Work.

In Cartwright v. Comm'r, T.C. Memo. 2015-12, the Court reduced business expense deductions claimed by a doctor for a mobile home he used while performing on-call duties. The Court found that the vehicle was primarily used for personal purposes, and the calculations by the IRS as to business use were reasonable and correct.

Business Expenses and Losses

Jefferson Cartwright is an orthopedic surgeon who resides in Arlington, Washington. In 2007-2010 he practiced in Arlington, and also worked as an on-call physician and staff surgeon at a hospital about 25 miles from his home. As an on-call physician and surgeon at the hospital, Cartwright was required to work a 24-hour shift three days a month from Friday through Sunday.

Business Expenses and Losses

In March 2008, Cartwright and his wife purchased a Navigator Rambler motor home (the “Navigator”), which he drove from his home to the hospital when he reported for on-call duty.

he believed the use of the Navigator would help him better serve his patients. He reviewed patient charts when he was in the Navigator and referred to his medical books. He did not treat patients in the vehicle. He maintained

of the Navigator in 2008 and 2009.

Business Expenses and Losses

MiSEA 2016

The Court recited rules on the deduction or ordinary and necessary business expenses, and then swiftly upheld the IRS determinations. Cartwright claimed that the IRS was incorrect in using a percentage of total mileage each year to determine business use because he used the vehicle as a “mobile office” for 85% of the time he was on-call in 2008, and 100% of the time he was on-call in 2009.

Business Expenses and Losses

The Court rejected that argument, noting that the documentary evidence showed only that Cartwright's business use of the Navigator was 27 days in 2008 and 36 days in 2009, and that both he and his wife used the Navigator for personal purposes for the remainder of those years. The percentages of 19% and 22% determined by the IRS were "fair, reasonable, and correct."

Daughter's Use of Rental Home Precluded Deductions.

Overview. In *Okonkwo v. Comm'r*, T.C. Memo. 2015-181, the Tax Court held that § 280A prevented parents who rented a home to their daughter for less than fair rent from deducting expenses related to the home.

Business Expenses and Losses

Facts. The taxpayers built a rental home and tried to sell it through 2001. They then rented it to an unrelated tenant from 2002 to 2006 for $6,000 per month. In 2007 to 2010 they rented the home to their daughter, who paid them $2,000 each month in rent. In 2008 through 2010 the taxpayers filed returns claiming net losses on the rental to their daughter in amounts ranging from $84,000 to $135,000. The IRS disallowed the losses under § 280A.

Applicable Rules. Section 280A(a), subject to exceptions, disallows deductions with respect to the

during the taxable year as a residence.

Business Expenses and Losses

Proposed Regulations on Information Returns Reporting Gambling Winnings from Bingo, Keno, and Slot Machine Play.

On March 3, 2015, the IRS issued proposed regulations (REG-132253-11) under § 6041 on the filing of information returns to report winnings from bingo, keno, and slot machine play. The regulations bring reporting into the 21st Century, and adopt reporting rules for slot machine play consistent with Notice 2015-21. The proposed regulations will not be effective until final regulations are published.

Business Expenses and Losses

MiSEA 2016

Highlights of the proposed regulations include the following.

A. a. Reporting requirements are updated to account for changes in technology.

B. b. The reporting regulations are moved from Reg. § 1.6041-1 to Reg. § 1.6041-10.

C. c. The IRS retains the use of Form W-2G and the threshold reporting amounts of $1,200 for bingo and slots, and $1,500 for keno. The IRS requests comments about reducing the thresholds to $600.

D. d. Payers must report for foreign payees under a different system that includes 30% withholding and Form 1042 rather than Form W-2G.

Business Expenses and Losses

MiSEA 2016

The proposed regulations provide new reporting options for electronically tracked slot machine play (ETSMP), based on the rules in Notice 2015-21 described above. Winnings for ETSMP must be reported when two criteria are met:

1) <u>The total amount of winnings earned during a single session netted against the total amount of wagers placed during the same session is $1,200 or more; and</u>
2) At least one single win during the session (without regard to the amount wagered) equals or exceeds $1,200.
3)

Notice 2015-21 for these purposes.

Business Expenses and Losses

If a payor makes more than one payment of reportable winnings to the same payee from the same type of game during the same session, the payor may report the aggregate amount of the winnings on one form W-2G.

Issues Concerning Marijuana Businesses.

Background. About 20 states have legalized medical marijuana, and Colorado, Washington, Alaska, and Oregon have legalized recreational marijuana, at least to some extent. Marijuana remains a controlled substance under Federal law, however, and under current policy of the Department of Justice, the Attorneys General throughout the country have discretion as to the extent they will enforce Federal law. Presently, marijuana businesses that are operating legally under State law face several

Business Expenses and Losses

First, § 280E provides that no deduction or credit shall be allowed for any amounts paid or incurred during the taxable year in carrying on any trade or business if it consists of trafficking in controlled substances prohibited by Federal law.

Some states, such as Colorado, have amended State income tax rules to allow deductions for trade or business expenses that would be deductible under Federal law but for § 280E. In addition, legislation is pending in Congress that would repeal or amend § 280E, and/or address issues such as access to banking

Business Expenses and Losses

Ethical issues exist for practitioners, who could be viewed as aiding and abetting a Federal crime by providing assistance to marijuana businesses that are legal under State law. Although some State bar associations (such as in Colorado) have indicated an attorney may assist such businesses if they inform the client of applicable Federal law, practitioners still face potential criminal charges.

Business Expenses and Losses

IRS Concedes Case Challenging Penalties for Failure to Deposit Employment Taxes Electronically. In April 2015, the IRS settled a case in which a Colorado marijuana company, Algreens LLC, challenged an IRS denial of its request to abate failure-to-deposit penalties on the grounds that it was unable to secure a bank account that would allow it to comply with electronic payment requirements.

Business Expenses and Losses

On June16, 2015, the IRS issued SBSE-04-0615-0045 to provide guidance on required electronic tax payments and marijuana businesses.

The guidance (dated June 9, 2015) does not apply to taxpayers that can get bank accounts but choose not to. The guidance is effective until June 9, 2016.

Business Expenses and Losses

IRS Weighs in on Inventory Accounting for Marijuana Businesses. On December 10, 2014, the IRS issued ILM 201504011, concluding that taxpayers involved in marijuana businesses must determine cost of goods sold using the § 471 inventory-costing regulations that existed when § 280E was enacted, and the IRS may require taxpayers to change their inventory method if they are not using the applicable inventory-costing regime.

Business Expenses and Losses

When § 280E was enacted in 1982, “inventoriable cost” meant a cost that was capitalized to inventories under § 471 and the regulations thereunder. A marijuana reseller using an inventory method would have capitalized the invoice price of the marijuana purchased, less trade or other discounts, plus transportation or other necessary charges incurred in acquiring possession of the marijuana.

Business Expenses and Losses

Therefore the IRS concluded that a taxpayer trafficking in controlled substances is entitled to determine inventoriable costs using the applicable inventory-costing regulations under § 471 as they existed when § 280E was enacted.

- Thus, for example, a producer of marijuana should be permitted to deduct wages, rents, and repair expenses attributable to its production activities, but should not be permitted to deduct wages, rents, or repair expenses attributable to its general business or

Business Expenses and Losses

Olive v. Comm'r. In Olive v. Comm'r, 139 T.C. No. 2 (2012), aff'd, 792 F.3d 1146 (9th Cir. 2015), the Ninth Circuit affirmed the Tax Court in holding that § 280A precluded a taxpayer from claiming deductions related to his operation of a medical marijuana dispensary.

Business Expenses and Losses

Affirmed: Real Estate Professional Not Automatically Entitled to Deduct Rental Loss.

In Gragg v. U.S., 2014-1 U.S.T.C. (CCH) § 50,245 (N.D. Ca. 2014), a taxpayer who materially participated in a real estate trade or business as a real estate agent was not automatically exempt from having her rental real estate losses categorized as passive losses; rather, the taxpayer had to demonstrate her material participation in the rental real estate activities separately from her material participation in her primary occupation as a real estate agent.

Business Expenses and Losses

MiSEA 2016

Taxpayers Must Keep Adequate Records. Most recent real estate professional cases involve IRS disallowance of deductions on the grounds that the taxpayer has failed to meet either the 750-hour test or the 50% test.

In Calvanico v. Comm'r, T.C. Summ. Op. 2015-64, the Court held that neither a husband nor a wife was a real estate professional because the husband's time working as a licensed real estate appraiser as an employee of two different firms did not count because he did not show that he was a 5% owner of

Business Expenses and Losses

MiSEA 2016

In Farris v. Comm'r, T.C. Summ. Op. 2015-53, the Court held that a wife failed to qualify as a real estate professional when initial logs created after an audit commenced showed 852 hours spent on two rental activities and 1,040 hours spent in part-time employment with a therapist company. Later, revised logs showing 1,254 hours of participation.

Business Expenses and Losses

In Cantor v. Comm'r, T.C. Summ. Op. 2014-103, the taxpayer failed to establish he was a real estate professional because he did not prove that he spent more hours working on real property trades or businesses than he did on activities that clearly were not real property.

Business Expenses and Losses

In *Lopez v. Comm'r*, T.C. Summ. Op. 2015-22, the Court rejected status as a real estate professional when a couple's testimony was "unreliable" and the husband's estimates of time spent on rental activities were "vague and improbable."