

TAX MANAGEMENT PORTFOLIOS™

U.S. INCOME

Trade or Business Expenses and For-Profit Activity Deductions

by

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TAX MANAGEMENT PORTFOLIOS™

U.S. INCOME

Trade or Business Expenses and For-Profit Activity Deductions

PORTFOLIO DESCRIPTION

Tax Management Portfolio, *Trade or Business Expenses and For-Profit Activity Deductions*, No. 505-4th, analyzes the deductions allowable for taxpayers carrying on a trade or business or a for-profit activity. For specific deductions that are the subject of other Portfolios, the description provides an overview and an introduction to the terminology and substantive requirements of the statute or other provision that applies. For the other deductions, each provision is analyzed in depth.

The analysis of the deductions begins with an exploration of the definitional aspects of trade or business and for-profit activity deductions. Following that discussion, the analysis focuses on specific types of trade or business and for-profit activity deductions. Deductions for expenditures that otherwise must be capitalized and deductions arising for specific types of trades or businesses complete the detailed analysis.

This Portfolio may be cited as Maule, 505-4th T.M., *Trade or Business Expenses and For-Profit Activity Deductions*.

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DETAILED ANALYSIS

I. Introduction

Subject to the restrictions and limitations discussed in 503 T.M., *Principles of Income Tax Deductions*, expenditures made in pursuit of income generally are deductible, whether that pursuit consists of carrying on a trade or business or merely conducting an activity entered into for profit.¹ The statutory provisions allowing these deductions fall into two types.

Under §162, ordinary and necessary expenses paid or incurred during the tax year in carrying on a trade or business are allowed as deductions.² This general rule is subject not only to limitations, as described in 503 T.M., *Principles of Income Tax Deductions*, but also to extensive regulatory and judicial interpretation as applied to a variety of expenses that arise in the operation of a trade or business.³ The definitional aspects of §162, including the meanings of trade or business, ordinary and necessary, and carrying on, are discussed in II., below. The application of §162 to specific types of business expenses is discussed in IV., below.

Under §212, individuals are allowed to deduct ordinary and necessary expenses paid or incurred during the tax year for the production or collection of income, for the management, conservation, or maintenance of property held for the production of income, or in connection with the determination, collection, or refund of any tax.⁴ This general rule is subject not only to limitations, as described in 503 T.M., *Principles of Income Tax Deductions*, but also to some regulatory and judicial interpretation as applied to a variety of expenses.⁵ The definitional aspects of §212 are discussed in III., below. The application of §212 to specific types of for-profit activity expenses is discussed in IV., below.

In addition to §162 and §212, a variety of other statutory provisions allow deductions for specific types of expenditures paid or incurred in carrying on a trade or business or in con-

ducting a for-profit activity.⁶ These provisions are also discussed in IV., below.

Although deductions otherwise allowed under §162 or §212 are subject to the limitations described in 503 T.M., *Principles of Income Tax Deductions*, the capitalization limitation is specifically overridden by provisions that allow deductions for amounts paid or incurred in carrying on a trade or business or in conducting a for-profit activity, and by provisions that allow the deduction, over a particular period of years, of amounts that have been capitalized.⁷ These provisions are discussed in V., below.

There are three particular trades or businesses, those of being an employee, a farmer, and a timber and mineral extractor, for which statutory or regulatory provisions allow deductions for specific types of expenses.⁸ These provisions are discussed in VI., below.

The deductibility of expenses under §162 and §212 must be viewed in the context of the suspension of the deduction for unreimbursed employee business expenses, other than unreimbursed educator expenses,⁹ and expenses paid or incurred by individuals under §212 for tax years beginning after 2017.¹⁰

For tax years beginning before 2018, another specific statutory provision allowed a deduction against income, not for a particular expenditure, but for a percentage of the taxpayer's qualifying income that was taken into account.¹¹ This provision is discussed in VI., below.

¹ See §162, §212. All section references are to the Internal Revenue Code, as amended, and the regulations issued thereunder, unless otherwise specified.

² §162(a); Reg. §1.162-1(a).

³ See, e.g., Reg. §1.162-1 through Reg. §1.162-25T.

⁴ §212.

⁵ See, e.g., Reg. §1.212-1(a) through Reg. §1.212-1(p).

⁶ See, e.g., §83(h), §165, §172, §176, §178, §186, §192, §194A, §196, §404, §404A, §419.

⁷ See, e.g., §167, §168, §169, §173, §174, §179, §190, §195, §196, §197, §248, §709, §1253(d)(1).

⁸ See §175, §179B, §180, §193, §194, §402(e)(3), §611, §613, §613A, §616, §617, §631, §911(c)(3); Reg. §1.162-12, Reg. §1.162-17.

⁹ See §67(b)(13), §67(g), added and amended, respectively, by the One Big Beautiful Bill Act (OBBBA), Pub. L. No. 119-21, §70110(b).

¹⁰ See §67(h), which suspends miscellaneous itemized deductions subject to the 2% AGI floor in taxable years beginning after 2017.

¹¹ See former §199 (repealed by the Tax Cuts and Jobs Act (TCJA), Pub. L. No. 115-97, §13305(a), effective for taxable years beginning after 2017).

II. Trade or Business Deductions Generally

A. In General

Under §162, the taxpayer is allowed to deduct ordinary and necessary expenses paid or incurred during the tax year in carrying on any trade or business.¹² The meaning of trade or business is discussed in II.B., below. The ordinary and necessary expense requirement is discussed in II.C., below. The meaning of carrying on a business is discussed in II.D., below. The requirement that the expenses be paid or incurred during the tax year is discussed in II.E., below.

The full amount of the §162 trade or business expenses is deductible, even though the expenses exceed the gross income derived during the year from the trade or business, thus generating a net operating loss.¹³ Net operating loss deductions are described in IV.P., below, and discussed in 539 T.M., *Net Operating Losses — Concepts and Computations*.

An expense that otherwise meets the requirements of §162, but that is deducted under another provision or used as the basis for computing a credit, is not deductible under §162.¹⁴ An expense that would otherwise be deductible under §162, but that is includible in the cost of inventory, is not deductible under §162.¹⁵ Inventory costs are discussed in IV.B., below, and capitalization limitations are discussed in 509 T.M., *Principles of Capitalization*.

B. Trade or Business

1. In General

Because, with one exception, there is no statutory or regulatory definition of a trade or business, the task of establishing tests to determine the existence of a trade or business has fallen to the courts.¹⁶ The courts have developed two definitional elements, one in relation to profit motive and the other in relation to the scope of the activities.¹⁷

No matter which definitional element is scrutinized, the issue ultimately is one of fact.¹⁸ Special rules apply to foreign corporations, such as the annual redetermination of whether a trade or business exists.¹⁹ These are discussed in 6460 T.M., *U.S. Income Taxation of Foreign Corporations* (Foreign Income Series).

Under §7701(a)(26), the performance of the functions of a public office constitute a trade or business.²⁰ The Tax Court has held that a taxpayer providing services to a state judicial department as an independent contractor is not in the trade or business of performing the functions of a public office because the taxpayer is not a public officer.²¹

¹² §162(a).

¹³ Reg. §1.162-1(a).

¹⁴ Reg. §1.162-1(a).

¹⁵ Reg. §1.162-1(a).

¹⁶ See *Commissioner v. Groetzinger*, 480 U.S. 23 (1987); *Gajewski v. Commissioner*, 723 F.2d 1062 (2d Cir. 1983), cert. denied, 469 U.S. 818 (1984), rev'g 45 T.C.M. 967 (1983), on remand, 84 T.C. 980 (1985).

¹⁷ *Groetzinger*, 480 U.S. 23.

¹⁸ See, e.g., *Spermacet Whaling & Shipping Co. v. Commissioner*, 30 T.C. 618 (1958), aff'd, 281 F.2d 646 (6th Cir. 1960).

¹⁹ §864(b), §882(d); Reg. §1.864-2, Reg. §1.882-1.

²⁰ §7701(a)(26).

2. Profit Motive

There can be no trade or business unless the taxpayer enters into and carries on an activity with a good faith intention to make a profit or in the belief that a profit can be made from the activity.²² The reasonableness of the taxpayer's belief that the activity will generate a profit is not relevant.²³ However, a mere hope that an activity will generate profits, in the absence of any specific plans to achieve a profit, is inconsistent with an allegation that the purpose or belief is in good faith.²⁴ Thus, no deductions were allowed for the publicity costs paid by a taxpayer in attempting to convince others that he had discovered a miraculous fusion system and a nuclear research advance, because no income was generated nor was any income likely ever to be generated.²⁵ Similarly, no deductions were allowed for franchise fees associated with a tax shelter because there was insufficient business activity and no profit objective.²⁶

A trade or business can exist even if there are no profits in the initial years,²⁷ provided that there is profit potential.²⁸ The taxpayer need not expect that profits will be generated immediately or within a short time,²⁹ but the intent to make a profit must be motivated by good faith.³⁰ Thus, a trade or business was held to exist even though the taxpayer was 65 years old and it would take 15 years for profits to be generated, because the taxpayer's purpose in carrying on the activity was to make a profit.³¹

There is no requirement that before an activity can be considered a trade or business the taxpayer must have previously engaged in the activity.³² Similarly, the Second Circuit has held that a for-profit motive on the part of an amateur's personal manager may exist prior to the time that the managed person turns professional.³³

Generally, an activity that is entered into as a nonprofit activity cannot be a trade or business.³⁴ Thus, in *Laurel Hill Cemetery Ass'n v. United States*,³⁵ a district court held that

²¹ *Allen v. Commissioner*, T.C. Memo 2009-102.

²² *Doggett v. Burnet*, 65 F.2d 191 (D.C. Cir. 1933), rev'g 23 B.T.A. 744 (1931); see also *Estate of Morgan v. Commissioner*, T.C. Memo 2021-104 (citing *Weaver v. Commissioner*, T.C. Memo 2004-108, and *McManus v. Commissioner*, T.C. Memo 1987-457).

²³ *Doggett*, 65 F.2d 191; *Hillcone S.S. Co. v. Commissioner*, 22 T.C.M. 1096 (1963).

²⁴ See *Sutherland v. Commissioner*, 27 T.C.M. 103 (1968).

²⁵ *Outten v. Commissioner*, 47 T.C.M. 1120 (1984), aff'd in unpub. op., 752 F.2d 648 (11th Cir. 1985).

²⁶ *Pitts v. Commissioner*, 63 T.C.M. 1742 (1992).

²⁷ E.g., *Worrell v. United States*, 254 F. Supp. 992 (S.D. Tex. 1966).

²⁸ *Sabelis v. Commissioner*, 37 T.C. 1058 (1962), acq., 1962-2 C.B. 5. See *Meinhardt v. Commissioner*, 766 F.3d 917 (8th Cir. 2014) (lack of evidence of rental property business strategy, and evidence that relatives lived in house rent-free, support finding that property held for personal use and lacks profit motive).

²⁹ *Van Beuren v. Commissioner*, 22 T.C.M. 1428 (1963).

³⁰ *Hill v. Commissioner*, 30 T.C.M. 534 (1971), aff'd on other issues, 392 F. Supp. 65 (10th Cir. 1973).

³¹ *Ellsworth v. Commissioner*, 21 T.C.M. 145 (1962).

³² *Snyder v. United States*, 674 F.2d 1359 (10th Cir. 1982).

³³ *McCarthy v. Commissioner*, 164 F.3d 618 (2d Cir. 1998), vacating and rem'g 74 T.C.M. 711 (1997), on remand, 79 T.C.M. 1912 (2000).

³⁴ See *Iowa State Univ. of Sci. & Tech. v. United States*, 500 F.2d 508 (Ct. Cl. 1974).

³⁵ 427 F. Supp. 679 (E.D. Mo. 1977), aff'd, 566 F.2d 630 (8th Cir. 1977).

§162 deductions were not allowed to a perpetual care fund administered by a nonexempt cemetery association organized and operated under state law as a nonprofit organization.³⁶ Similarly, the IRS has revoked an earlier ruling in which it had treated a nonprofit corporation's state-mandated payment to a charity as a deductible ordinary and necessary business expense because it considered the former ruling to be inconsistent with its current views.³⁷ However, in *Trustees of the Graceland Cemetery Improvement Fund v. United States*,³⁸ the Court of Claims held that a perpetual care fund's payments to an associated cemetery corporation were deductible under §162 because its activity was a business, despite the lack of a profit motive, noting that the expenses were similar to those incurred by for-profit entities that were engaged in the cemetery upkeep business.³⁹

Observation: The *Graceland* rationale opens the door to the elimination of the profit motive requirement. Most activities that do not constitute a trade or business involve the payment of expenses that are similar to those paid in the operation of a trade or business. The contrast can be drawn between stamp dealers and stamp collectors, amateur musicians and professional musicians, volunteer tax return preparers and paid preparers, and a variety of other activities. Merely because the maintenance of cemeteries is a trade or business when engaged in by those seeking to make a profit does not mean that anyone who maintains cemeteries is therefore engaged in a trade or business.

For a further discussion of which activities are determined to be motivated for profit, see 548 T.M., *Hobby Losses*.

3. Scope of the Activity

In *Commissioner v. Groetzing*,⁴⁰ the Supreme Court held that an individual's profit-seeking gambling activities constituted a trade or business because of the extent of his activities.⁴¹ In so holding, the Supreme Court refused to confine trades or businesses to those activities through which taxpayers seek profits by holding themselves out to others as offering goods or services.⁴²

Example: Y is a full-time gambler, spending 60–80 hours per week at the race track and reviewing race forms, programs, and other materials. He never places bets on behalf of any other person and has never sold tips, collected commissions for placing bets, or functioned as a bookmaker. He gambles strictly for his own account. Y has no other

employment. For tax purposes, Y is considered engaged in the trade or business of gambling because he pursues his gambling activities full-time on a regular basis, and the activities are the source of his livelihood.⁴³

Note: As a practical matter, most activities that are determined to be trades or businesses are so treated because the taxpayer offers goods or services to the public. The *Groetzing* decision, however, expands the group of activities that are treated as trades or businesses by bringing within the ambit of the definition the activities of a taxpayer who does not offer goods or services to the public, but which are the source of the taxpayer's livelihood.

A person who purchases and sells securities may be a trader, a dealer, or an investor.⁴⁴ A dealer purchases and sells securities for the accounts of others. A trader engages in a trade or business for purposes of §162 (a) of selling securities for his own account, and the income is primarily derived from short-term fluctuations in price.⁴⁵ An investor trades on his own account but is not considered to be in a trade or business, and the income so derived is due to long-term price appreciation of the investments.⁴⁶ Whether trading activity is a trade or business is a question of fact.⁴⁷

In *Higgins v. Commissioner*,⁴⁸ the Supreme Court held that managing securities investments and collecting the income therefrom is not a trade or business.⁴⁹

Example: T has extensive investments in stocks and bonds and devotes a considerable amount of time to the oversight of her interests on a regular and continuous basis. Regardless of the size of her investments, the continuity of her efforts, or time devoted to the activity, the activities of managing her investments and collecting the income therefrom does not rise to the level of a trade or business.⁵⁰

³⁶ *Laurel Hill Cemetery Ass'n v. United States*, 427 F. Supp. at 690. See also *Simpson v. Commissioner*, T.C. Memo. 2020-100 (partnership did not engage in a trade or business because primary purpose was supporting a tax-exempt, non-profit school and for which it lacked an ownership interest).

³⁷ See PLR 200228016, *revoking* PLR 9853007.

³⁸ 515 F.2d 763 (Ct. Cl. 1975).

³⁹ *Trustees of the Graceland Cemetery Improvement Fund*, 515 F.2d at 778.

⁴⁰ 480 U.S. 23 (1987).

⁴¹ *Commissioner v. Groetzing*, 480 U.S. at 35–36.

⁴² *Commissioner v. Groetzing*, 480 U.S. at 34. *But see Gajewski v. Commissioner*, 723 F.2d 1062 (2d Cir. 1983), cert. denied, 469 U.S. 818 (1984), reh'g denied, 469 U.S. 1066 (1984), rev'g 45 T.C.M. 967 (1983), *on remand*, 84 T.C. 980 (1985) (case decided before Supreme Court decision in *Groetzing*).

⁴³ *Commissioner v. Groetzing*, 480 U.S. 23 (1987).

⁴⁴ *King v. Commissioner*, 89 T.C. 445 (1987).

⁴⁵ *Crissey v. Commissioner*, T.C. Summ. Op. 2017-44.

⁴⁶ *Crissey v. Commissioner*, T.C. Summ. Op. 2017-44 (taxpayer's trading pattern was designed to catch "the swings in the daily market movements" and profits were short term); *Kay v. Commissioner*, T.C. Memo. 2011-159.

⁴⁷ *Higgins v. Commissioner*, 312 U.S. 212 (1941). For a non-exclusive list of factors used to distinguish an investor from a trader, see *Kay v. Commissioner*, T.C. Memo 2011-159.

⁴⁸ 312 U.S. 212 (1941), aff'g 111 F.2d 795 (2d Cir. 1940), aff'g 39 B.T.A. 1005 (1939).

⁴⁹ *Higgins v. Commissioner*, 312 U.S. at 218. See also *Moller v. United States*, 721 F.2d 810 (Fed. Cir. 1983), rev'g 553 F. Supp. 1071 (Ct. Cl. 1982), cert. denied, 467 U.S. 1251 (1984); *Herrick v. Commissioner*, 85 T.C. 237 (1985); *Deely v. Commissioner*, 73 T.C. 1081 (1980), supp., 41 T.C.M. 1457 (1981); *DuPont v. Commissioner*, 38 B.T.A. 1317 (1938), aff'd, 110 F.2d 641 (3d Cir. 1940); *Steffler v. Commissioner*, 69 T.C.M. 2940 (1995); *Dougherty v. Commissioner*, 68 T.C.M. 1347 (1994); *Frick v. Commissioner*, 56 T.C.M. 1368 (1989); *Zambakian v. Commissioner*, 51 T.C.M. 1101 (1986), aff'd in unpub. op. (3d Cir. Feb. 17, 1987); *Dickman v. Commissioner*, 46 T.C.M. 1102 (1983); *Harris v. Commissioner*, 32 T.C.M. 718 (1973), aff'd in unpub. op. (5th Cir. Oct. 16, 1974); *Skoglund v. United States*, 230 Ct. Cl. 833 (1982); *Wilson v. United States*, 179 Ct. Cl. 725 (1967); *Spring v. United States*, 76-2 USTC ¶ 9576 (E.D. Tex. 1976); Rev. Rul. 75-525, 1975-2 C.B. 350.

⁵⁰ *Higgins v. Commissioner*, 312 U.S. 212 (1941).

Note that a taxpayer can be in the trade or business of trading in securities, even for the taxpayer's own account,⁵¹ but the taxpayer must engage in substantial trading for this to be the case.⁵²

In contrast to the Supreme Court's holding in *Higgins*, the Tax Court determined, in *YA Global Invs., LP v. Commissioner*,⁵³ that the securities investment and related activities of the taxpayer, a limited partnership, constituted a U.S. trade or business. The taxpayer provided funding to portfolio companies in the form of convertible debentures, standby equity distribution agreements (SEDAs), and other securities. In each SEDA, the taxpayer committed to purchasing up to a specified dollar value of a portfolio company's stock over a fixed period, typically two years. The taxpayer's general partner not only managed investments but also structured transactions and performed due diligence for investment transactions. Applying agency principles, the Tax Court attributed the activities of the general partner to the limited partnership, and framed its analysis in terms of three determinations. First, the Tax Court determined that the activities the general partner conducted on behalf of the limited partnership were continuous, regular, and engaged in for the primary purpose of income or profit. Second, the Tax Court found that these activities were not limited to the management of investments. Third, the Tax Court found that these activities were not covered by the §864(b)(2)(A) safe harbor for trading in stocks or securities. Thus, the taxpayer failed to meet its burden of proving that it was not engaged in a U.S. trade or business as defined by §864(b), *Groetzinger*, and *Higgins*, during the years in issue; accordingly, the Tax Court concluded that the taxpayer was engaged in a U.S. trade or business during the years in issue.

A taxpayer who owns several parcels of land, manages them through an agent, pays taxes, expenses, and mortgage payments on them, and purchases and sells the parcels as conditions dictate is engaged in a trade or business because the management is considerable, regular, and continuous.⁵⁴

Example: X, a nonresident alien, owns — either directly or through a trust — various rental real estate properties in the United States. X contracts with various real estate firms to collect rent from the properties, make repairs, and acquire tenants. X is considered engaged in business in the United States because the activities carried on by his agents are considerable, continuous, and regular, and are beyond the scope of mere ownership of property.⁵⁵

Note: The “considerable, regular, and continuous” terminology has become a test for the determination of whether there is a trade or business.⁵⁶

Comment: It is possible to reconcile the *Groetzinger* and *Higgins* decisions by comparing the volume of transactions with other persons in which the taxpayer engages. In *Groetzinger*, the taxpayer engaged in numerous dealings with others, though on his own account, whereas in *Higgins*, the taxpayer collected checks and engaged in relatively few purchase, sale, or trade dealings with others. In effect, there must be “business,” as suggested by the Fifth Circuit in *Snell v. Commissioner*.⁵⁷

In Rev. Rul. 69-355, the IRS ruled that the owner of a royalty interest in an oil and gas lease was not in the trade or business of selling oil and gas because there was no opportunity to exploit or develop the property, reflecting the owner's status as an investor. Likewise, mere ownership of a patent, without exploiting it, does not constitute a trade or business.⁵⁸ Mere ownership of real property that is rented under a net lease does not constitute a trade or business because mere collection of net rent does not involve sufficient management activity.⁵⁹

Observation: In most instances, even if there is no trade or business, a deduction for expenses of investment activities is allowable under §212.⁶⁰ Section 212 is discussed in III., below.

4. Number of Trades or Businesses

A taxpayer is not restricted to one trade or business, but is permitted to demonstrate that two or more trades or businesses are being carried on.⁶¹ Each of those trades or businesses can generate §162 deductions.⁶² The taxpayer, however, has the burden of proving that more than one trade or business is being carried on.⁶³ Mere allegations are insufficient,⁶⁴ and contradictory evidence almost always makes the taxpayer's position unpersuasive.⁶⁵

In *Morton v. United States*,⁶⁶ the court held that a group of business activities served a “unified business enterprise,” and thus, the taxpayer was permitted to deduct airplane use expenses despite that the activity itself was not considered a business. The court reasoned that the taxpayer's airplane activity furthered the business purpose of the unified business enterprise. Similarly, a taxpayer who was a full-time partner in a law firm

⁵¹ *Compare Beals v. Commissioner*, 53 T.C.M. 492 (1987), with *Wiles v. United States*, 312 F.2d 574 (10th Cir. 1962), aff'g 61-1 USTC ¶9429 (E.D. Kan. 1960) and *Mohr v. Commissioner*, 45 T.C. 600 (1966).

⁵² E.g., *Holsinger v. Commissioner*, T.C. Memo 2008-191 (289 transactions on 63 days in one year, and 372 transactions on 110 days in another, not substantial); *Ball & Northrup v. Commissioner*, 80 T.C.M. 184 (2000) (15 transactions in two years not substantial); *Dougherty v. Commissioner*, 68 T.C.M. 1347 (1994) (14 trades in first year and 46 in second year not substantial). Cf. *Crissey v. Commissioner*, T.C. Summ. Op. 2017-44 (taxpayer held to be a trader where reported over 500 transactions for the applicable tax year by day-trading on his own account).

⁵³ 161 T.C. No. 11 (Nov. 15, 2023).

⁵⁴ *Pinchot v. Commissioner*, 113 F.2d 718 (2d Cir. 1940).

⁵⁵ *DeAmodio v. Commissioner*, 34 T.C. 894 (1960), aff'd, 299 F.2d 623 (3d Cir. 1962).

⁵⁶ See, e.g., *Lewenhaupt v. Commissioner*, 20 T.C. 151 (1953), aff'd, 221 F.2d 227 (9th Cir. 1955); *DeAmodio v. Commissioner*, 34 T.C. 894 (1960), aff'd, 299 F.2d 623 (3d Cir. 1962); see also *Estate of Morgan v. Commissioner*, T.C. Memo 2021-104 (factor in determining existence of trade or business is “whether the taxpayer is regularly and actively involved in the activity”).

⁵⁷ 97 F.2d 891 (5th Cir. 1938).

⁵⁸ *Aurynger v. Commissioner*, 9 B.T.A.M. 40-1000 (1940).

⁵⁹ E.g., *Neill v. Commissioner*, 46 B.T.A. 197 (1942).

⁶⁰ See, e.g., *Thomason v. Commissioner*, T.C. Memo 1997-480.

⁶¹ See, e.g., *Storey v. Commissioner*, T.C. Memo 2012-115; *McCrackin v. Commissioner*, T.C. Memo 1984-293; *Curphey v. Commissioner*, 73 T.C. 766 (1980); *Schott v. Commissioner*, T.C. Memo 1964-272.

⁶² *Curphey v. Commissioner*, 73 T.C. 766 (1980).

⁶³ E.g., *Campbell v. Commissioner*, T.C. Memo 1992-66; *Groder v. Commissioner*, T.C. Memo 1960-208.

⁶⁴ *Schafer v. Commissioner*, T.C. Memo 1964-156.

⁶⁵ *Slear v. Commissioner*, T.C. Memo 1987-395.

⁶⁶ 98 Fed. Cl. 596 (2011).

successfully argued before the Tax Court that she was also in the film production business.⁶⁷

Example: Z is a full-time partner in AB law firm. In addition, Z has a strong interest in the arts and began educating herself about filmmaking. She rearranged her law firm schedule to work primarily evenings and weekends. She organized a film production company which maintained its own set of books with a separate bank account, hired a bookkeeper and accounting firm to manage tax matters for her and her company, and created a written business plan. Z complied with all extensive legal requirements of documentary film production, and she obtained commercial liability insurance for on location shoots. Z produced a documentary film and created a website and blog to promote her film, attended film conferences and festivals, and actively marketed her film. Z is actively carrying on a film production business that she is engaged in with continuity and regularity.⁶⁸

The IRS has indicated that it will not acquiesce in the holding of *Morton v. United States* as applied to wholly-owned or majority-owned S-corporations, rejecting the “unified business enterprise” theory, but will continue to assert that *Moline Prop., Inc. v. Commissioner* is applicable in those situations to avoid aggregation of deductions from related business entities.⁶⁹

Comment: As the number of activities in which the taxpayer engages increases, the chances that all of the taxpayer’s activities will be treated as a trade or business decreases. For example, the nongovernment law practice of a full-time government attorney was held not to be a trade or business because the taxpayer did not pursue the activity with sufficient continuity and regularity.⁷⁰ Also, in *Steinberger v. Commissioner*,⁷¹ the taxpayer’s airplane activity was not treated as a business, as opposed to his medical practice. The court rejected the taxpayer’s claim that the businesses operated together as a “unified business enterprise,” like in *Morton*. The court distinguished the cases by emphasizing that because the *Steinberger* taxpayer was not a majority shareholder in each applicable entity, he was unable to create a “unified business enterprise” between the two activities, and without such his airplane travel expenses were nondeductible business expenses.

Note: As a practical matter, the taxpayer can deduct the activity’s expenses under §212, which does not require the existence of a trade or business, but the taxpayer will not be permitted to treat the excess of deductions over gross income from the activity as a net operating loss carryback or carryforward. Section 212 is discussed in III., below.

Example: From Year 1 through Year 3, X spent 40–45 hours per week as a U.S. Department of Justice (DOJ) at-

torney. In addition, during those years, X claimed to be engaged in the practice of law as a sole practitioner. During this period, X worked only intermittently at his non-DOJ activity. He wrote two law review articles for publication, engaged in limited advertising by printing business cards, and did not maintain legal malpractice insurance. For Year 1 through Year 3, X reported \$400 or less of income and substantial expenses from his non-DOJ activity, which resulted in losses reported on Schedule C. X is not entitled to the claimed business loss deductions because he did not pursue his non-DOJ activity with continuity or regularity or with the good faith objective of making a profit.⁷²

5. Specific Trades or Businesses

Although the number of specific types of trades or businesses is virtually unlimited, constantly growing as a result of human creativity, the list of activities that have been held to be trades or businesses if the requisite profit motive and scope are present is illustrative of the wide reach of §162. These activities include:

- acting;⁷³
- air charter operations;⁷⁴
- airplane remanufacturing;⁷⁵
- animal herd breeding;⁷⁶
- artistic illustration;⁷⁷
- artistic painting;⁷⁸
- auto racing;⁷⁹
- bird-dog training;⁸⁰
- boat charter operations;⁸¹
- coin trading;⁸²
- commodities trading;⁸³
- consulting engineer;⁸⁴
- delivering goods;⁸⁵
- development of automatic door opening device;⁸⁶
- development of miles per gallon indicator;⁸⁷

⁷² *Beard v. Commissioner*, T.C. Memo 1995-41.

⁷³ *Regan v. Commissioner*, T.C. Memo 1979-340.

⁷⁴ *Louismet v. Commissioner*, T.C. Memo 1982-294.

⁷⁵ *Bailey v. Commissioner*, T.C. Memo 2012-96.

⁷⁶ *Leppen v. Commissioner*, 77 T.C. 1326 (1981); *Ellsworth v. Commissioner*, T.C. Memo 1962-32.

⁷⁷ *Whitman v. Commissioner*, T.C. Memo 1960-88.

⁷⁸ *Adams v. Commissioner*, T.C. Memo 1966-242.

⁷⁹ *Bolt v. Commissioner*, 50 T.C. 1007 (1968), acq., 1969-1 C.B. 20.

⁸⁰ *Harris v. Commissioner*, T.C. Memo 1986-105.

⁸¹ *Jackson v. Commissioner*, 59 T.C. 312 (1972), acq., 1973-1 C.B. 1.

⁸² *Feistman v. Commissioner*, T.C. Memo 1982-306, aff’d in unpub. op. (9th Cir. Sept. 22, 1983).

⁸³ *Louismet v. Commissioner*, T.C. Memo 1982-294.

⁸⁴ *Riddle v. United States*, 205 F. Supp. 357 (D. Col. 1962).

⁸⁵ *Lopkoff v. Commissioner*, T.C. Memo 1982-701.

⁸⁶ *Purdy v. Commissioner*, T.C. Memo 1967-82.

⁸⁷ *Maximoff v. Commissioner*, T.C. Memo 1987-155.

⁶⁷ *Storey v. Commissioner*, T.C. Memo 2012-115.

⁶⁸ *Storey v. Commissioner*, T.C. Memo 2012-115.

⁶⁹ See CCA 201747006 for a discussion of *Morton v. United States*, 98 Fed. Cl. 596 (2011) and *Moline Prop., Inc. v. Commissioner*, 319 U.S. 436 (1943) (leading income tax “nominee” case holding that a corporation created for a business purpose or carrying on a business activity will be respected as an entity separate from its owner for federal income tax purposes).

⁷⁰ *Beard v. Commissioner*, T.C. Memo 1995-41.

⁷¹ T.C. Memo 2016-104.

- electronics research and development;⁸⁸
- engineering;⁸⁹
- farming;⁹⁰
- gambling as one's livelihood;⁹¹
- giving riding lessons;⁹²
- golf caddying for professional golfers;⁹³
- gun sales;⁹⁴
- horse boarding,⁹⁵ breeding,⁹⁶ farming,⁹⁷ showing,⁹⁸ and training;⁹⁹
- inventing;¹⁰⁰
- landfill operations;¹⁰¹
- leasing solar water heating systems;¹⁰²
- leasing video games;¹⁰³
- litigating a lawsuit;¹⁰⁴
- livestock trading;¹⁰⁵
- market research;¹⁰⁶
- metal fabrication;¹⁰⁷
- motorcycle racing;¹⁰⁸
- movie ownership and distribution;¹⁰⁹

- operating business franchise,¹¹⁰ business school,¹¹¹ cattle feedlot,¹¹² dog kennel,¹¹³ horse ranch,¹¹⁴ and leasing franchise;¹¹⁵
- photography;¹¹⁶
- professional baseball operations;¹¹⁷
- professional blood donation;¹¹⁸
- professional golfing;¹¹⁹
- publishing books;¹²⁰
- real estate development¹²¹ and selling;¹²²
- rental of realty to public with provision of additional services to tenants;¹²³
- rental property management;¹²⁴
- sales of jewelry¹²⁵ and food and beverages;¹²⁶
- scientific research;¹²⁷
- selling books;¹²⁸
- serving in the National Guard;¹²⁹
- stamp trading;¹³⁰
- talent managing;¹³¹
- tavern ownership and operation;¹³²
- teaching tennis;¹³³

⁸⁸ *Shoholm v. Commissioner*, T.C. Memo 1971-247.

⁸⁹ *Beckwith v. Commissioner*, T.C. Memo 1964-254.

⁹⁰ *Steinmann v. Commissioner*, T.C. Memo 1971-295; *Metcalf v. Commissioner*, T.C. Memo 1963-277.

⁹¹ *Commissioner v. Groetzinger*, 480 U.S. 23 (1987), aff'g 771 F.2d 269 (7th Cir. 1985), aff'g 82 T.C. 793 (1984); *Bathalter v. Commissioner*, T.C. Memo 1987-530; *Regan v. Commissioner*, T.C. Memo 1987-512; *Rusnak v. Commissioner*, T.C. Memo 1987-249; *Nipper v. Commissioner*, T.C. Memo 1983-644, aff'd in unpub. op. (11th Cir. 1984); *Ditunno v. Commissioner*, 80 T.C. 362 (1983).

⁹² *Sabelis v. Commissioner*, 37 T.C. 1058 (1962), acq., 1962-2 C.B. 5.

⁹³ *Christy v. Commissioner*, 65 T.C.M. 2369 (1993).

⁹⁴ *Cox v. Commissioner*, 45 T.C.M. 138 (1982).

⁹⁵ *Sabelis v. Commissioner*, 37 T.C. 1058 (1962), acq., 1962-2 C.B. 5.

⁹⁶ *Sabelis*, 37 T.C. 1058; *Ellis v. Commissioner*, 47 T.C.M. 991 (1984); *Farris v. Commissioner*, 31 T.C.M. 821 (1972); *Thacker v. Commissioner*, 28 T.C.M. 1433 (1969); *Worrell v. United States*, 254 F. Supp. 992 (S.D. Tex. 1966).

⁹⁷ *Seebold v. Commissioner*, 55 T.C.M. 723 (1988).

⁹⁸ *Pirnia v. Commissioner*, 58 T.C.M. 740 (1989); *Worrell v. United States*, 254 F. Supp. 992 (S.D. Tex. 1966).

⁹⁹ *Sabelis v. Commissioner*, 37 T.C. 1058 (1962), acq., 1962-2 C.B. 5; *Worrell v. United States*, 254 F. Supp. 992 (S.D. Tex. 1966).

¹⁰⁰ *Bailey v. Commissioner*, 22 T.C.M. 1255 (1963).

¹⁰¹ *Syracuse v. Commissioner*, 42 T.C.M. 288 (1981).

¹⁰² *Cooper v. Commissioner*, 88 T.C. 84 (1987).

¹⁰³ *Pierce v. Commissioner*, 58 T.C.M. 685 (1989).

¹⁰⁴ *Bagley v. United States*, 963 F. Supp. 2d 982 (C.D. Cal.2013).

¹⁰⁵ *Seven Sixty Ranch Co. v. Director*, 66-1 USTC ¶ 9293 (D. Wyo. 1966).

¹⁰⁶ *Miller v. Commissioner*, 40 T.C.M. 243 (1980).

¹⁰⁷ *Christensen v. Commissioner*, 56 T.C.M. 425 (1988).

¹⁰⁸ *Mills v. United States*, 88-2 USTC ¶ 9494 (N.D. Ohio 1988).

¹⁰⁹ *Abramson v. Commissioner*, 86 T.C. 360 (1986); *Sheid v. Commissioner*, 50 T.C.M. 663 (1985).

¹¹⁰ *Parker v. Commissioner*, 30 T.C.M. 890 (1971).

¹¹¹ *Goldberg v. Commissioner*, 73 T.C.M. 1988 (1997).

¹¹² *Estate of Cohen v. Commissioner*, 29 T.C.M. 1221 (1970).

¹¹³ *Kilman v. United States*, 73-2 USTC ¶ 9548 (E.D. Tex. 1972).

¹¹⁴ *Engdahl v. Commissioner*, 72 T.C. 659 (1979); *Pennington v. Commissioner*, 26 T.C.M. 520 (1967).

¹¹⁵ *Waddell v. Commissioner*, 86 T.C. 848 (1986), aff'd on other issues, 841 F.2d 264 (9th Cir. 1988).

¹¹⁶ *Eggert v. Commissioner*, 16 T.C.M. 1010 (1957).

¹¹⁷ *Selig v. United States*, 740 F.2d 572 (7th Cir. 1984), aff'g 565 F. Supp. 524 (E.D. Wis. 1983).

¹¹⁸ *Green v. Commissioner*, 74 T.C. 1229 (1980).

¹¹⁹ *Kimbrough v. Commissioner*, 55 T.C.M. 730 (1988).

¹²⁰ *Doggett v. Burnet*, 65 F.2d 191 (D.C. Cir. 1933), rev'g 23 B.T.A. 744 (1931).

¹²¹ *Duffy v. United States*, 81-1 USTC ¶ 9467 (Ct. Cl. Tr. J. Op. 1981).

¹²² *Peck v. Commissioner*, 44 T.C.M. 1030 (1982).

¹²³ *Cecil v. Commissioner*, 100 F.2d 896 (4th Cir. 1939), rev'g 37 B.T.A. 904 (1938); *Gorod v. Commissioner*, 42 T.C.M. 1569 (1981); *Copeland v. Commissioner*, 41 T.C.M. 253 (1980); *Francis v. Commissioner*, 36 T.C.M. 704 (1977).

¹²⁴ *Slack v. Commissioner*, 35 B.T.A. 271 (1937).

¹²⁵ *Haft v. Commissioner*, 40 T.C. 2 (1963).

¹²⁶ *Inter-Com Club, Inc. v. United States*, 721 F. Supp. 1112 (D. Neb. 1989); *Detroit Athletic Club v. United States*, 717 F. Supp. 1224 (E.D. Mich. 1989), vac'd on other grounds (6th Cir. 1990).

¹²⁷ *Stahnke v. Commissioner*, 40 T.C.M. 1177 (1980).

¹²⁸ *Doggett v. Burnet*, 65 F.2d 191 (D.C. Cir. 1933), rev'g 23 B.T.A. 744 (1931).

¹²⁹ *Perfetti v. Commissioner*, 762 F.2d 638 (8th Cir. 1985), aff'g in part and rev'g in part 46 T.C.M. 1317 (1983), supp., 51 T.C.M. 70 (1985).

¹³⁰ *Feistman v. Commissioner*, 44 T.C.M. 30 (1982), aff'd in unpub. op. (9th Cir. Sept. 22, 1983).

¹³¹ *Carr v. Commissioner*, 72 T.C.M. 467 (1996).

¹³² *Tarutis v. Commissioner*, 44 T.C.M. 48 (1982).

¹³³ *Presby v. Commissioner*, 69 T.C.M. 2648 (1995).

- the atrical entertainment;¹³⁴
- ticket sales;¹³⁵
- treasure hunting;¹³⁶
- writing books,¹³⁷ stories, magazine articles, and screen-plays.¹³⁸

6. Employment as Trade or Business

a. In General

The performance of services as an employee constitutes a trade or business.¹³⁹ In order for an expenditure to be deductible, the employee must show the relationship between the expenditure and the employment.¹⁴⁰ However, the performance of services for which compensation is not sought nor received does not constitute a trade or business because of the lack of a profit motive.¹⁴¹

Example: A is an airline pilot married to B. In Year 1, A and B purchased travel agency X, a State Y corporation, and signed a contract to work for X as commissioned sales agents. A and B are also officers of X. Because of poor cash flow, A and B, by written agreement with X, agreed to give up any commissions they would have received from X and agreed to accept \$1 as full payment for their efforts. Because the activities of A and B did not constitute a separate and independent business of A and B, but rather the business of X, the expenses A and B incurred for travel, entertainment, and the use of an automobile were not ordinary and necessary business expenses of A and B's business, nor were they unreimbursed employee business expenses. A and B had no profit motive, as they drew no salaries or dividends from X and by written agreement precluded themselves from receiving any commissions for business they produced for X. Thus, A and B were not independent travel agents. The expenses A and B incurred were either business expenses of X, or A and B's own personal expenses.¹⁴²

Termination of employment with a particular employer does not terminate the taxpayer's trade or business of performing services in the employee's line of business.¹⁴³ However, terminating employment with a particular employer can convert what would have otherwise been §162 deductions into personal expenses.¹⁴⁴ Thus, payments made by the taxpayer after resigning as corporate chief executive officer to persuade share-

holders to vote in favor of his position were not expenses of the trade or business of being employed as a corporate officer.¹⁴⁵

b. Corporate Officers and Directors

Generally, being employed as a corporate officer constitutes a trade or business.¹⁴⁶ Though acting in a corporate capacity and on behalf of the corporation, an officer's activities in doing so constitute a separate trade or business.¹⁴⁷

Thus, deductions have been allowed for the following:

- costs of blazer and vest suits purchased for employee use at trade shows;¹⁴⁸
- costs of defending a shareholder's derivative suit;¹⁴⁹
- costs of defending against allegations of improper selection as officer;¹⁵⁰
- costs of defending an action alleging fraud in the sale of the corporation's stock;¹⁵¹
- costs of defending an action for mismanagement;¹⁵²
- costs of defending criminal charges for allegedly filing fraudulent corporate tax returns;¹⁵³
- payments by a corporate officer-shareholder to settle claims by corporate creditor based on conduct as officer and actions as shareholder;¹⁵⁴
- payments by a corporate president to settle a lawsuit brought on grounds of misrepresentations by the president in both officer and broker-dealer capacities with respect to the sale of limited partnership interests;¹⁵⁵
- payments in settlement of an action based on the illegal payment of dividends;¹⁵⁶
- payments to an assistant whose efforts increased the officer's compensation;¹⁵⁷
- payments to an individual to keep the officer informed of matters occurring while the officer was out of state;¹⁵⁸
- payments to retain an employee.¹⁵⁹

However, the expenses of an officer who does not devote time, attention, and effort to the position are not deductible un-

¹³⁴ *Rodgers v. Commissioner*, 38 T.C.M. 573 (1979).

¹³⁵ *Griggs v. Commissioner*, T.C. Memo 2008-234.

¹³⁶ *Harrison v. Commissioner*, 72 T.C.M. 1258 (1996); *Reed v. Commissioner*, 56 T.C.M. 363 (1988).

¹³⁷ *Gestrich v. Commissioner*, 74 T.C. 525 (1980), aff'd in unpub. op. (3d Cir. Apr. 29, 1982).

¹³⁸ *Stern v. United States*, 71-1 USTC ¶ 9375 (C.D. Cal. 1971).

¹³⁹ See Reg. §1.162-17(a).

¹⁴⁰ See *Evans v. Commissioner*, 33 T.C.M. 1192 (1974), supp., 34 T.C.M. 783 (1975), aff'd on other grounds, 557 F.2d 1095 (5th Cir. 1977).

¹⁴¹ *Leamy v. Commissioner*, 85 T.C. 798 (1985).

¹⁴² *Leamy v. Commissioner*, 85 T.C. 798 (1985).

¹⁴³ See Rev. Rul. 75-120, 1975-1 C.B. 55, clarified by Rev. Rul. 77-16, 1977-1 C.B. 37.

¹⁴⁴ *Blake v. Commissioner*, 20 T.C.M. 1606 (1961).

¹⁴⁵ *Holmes v. Commissioner*, 37 B.T.A. 865 (1938).

¹⁴⁶ *Heineman v. Commissioner*, 82 T.C. 538 (1984).

¹⁴⁷ *Commissioner v. People's-Pittsburgh Tr. Co.*, 60 F.2d 187 (3d Cir. 1932), aff'd 21 B.T.A. 588 (1930).

¹⁴⁸ *Jetty v. Commissioner*, 44 T.C.M. 373 (1982).

¹⁴⁹ *Hochschild v. Commissioner*, 161 F.2d 817 (2d Cir. 1947), rev'g 7 T.C. 81 (1946).

¹⁵⁰ *Ditmars v. Commissioner*, 302 F.2d 481 (2d Cir. 1962), rev'g 20 T.C.M. 495 (1961).

¹⁵¹ *Mitchell v. United States*, 408 F.2d 435 (Ct. Cl. 1969).

¹⁵² *Great Island Holding Corp. v. Commissioner*, 5 T.C. 150 (1945).

¹⁵³ *Commissioner v. People's-Pittsburgh Tr. Co.*, 60 F.2d 187 (3d Cir. 1932), aff'd 21 B.T.A. 588 (1930).

¹⁵⁴ *Scofield v. Commissioner*, 74 T.C.M. 1356 (1997).

¹⁵⁵ PLR 9612005.

¹⁵⁶ *Smith v. Commissioner*, 6 T.C.M. 548 (1947).

¹⁵⁷ *Thompson v. Commissioner*, 9 T.C.M. 694 (1950).

¹⁵⁸ *Goldsmith v. Commissioner*, 7 B.T.A. 151 (1927).

¹⁵⁹ *LeBlanc v. Commissioner*, 7 B.T.A. 256 (1927).

der §162.¹⁶⁰ Likewise, performing activities as an uncompensated officer does not constitute a trade or business.¹⁶¹

7. Activities of Corporations

a. In General

Generally, a for-profit corporation's activities constitute a trade or business because the corporation's existence is predicated solely on engaging in transactions intended to generate a profit.¹⁶² Thus, the operation of a farm acquired by a mineral development corporation in order to exploit underlying minerals is part of the mineral development trade or business.¹⁶³ The activities of the corporation's agents and employees are determinative,¹⁶⁴ whereas those of shareholders who are not employees are not.¹⁶⁵

In Rev. Rul. 78-195, the IRS ruled that the expenses of a corporation whose sole activity was investing in unimproved real property that generated no income were deductible under §162. In contrast, the Supreme Court has held that a trade or business was not being carried on by a corporation that owned a railroad, leased all the rail road property to another company and then did nothing more than maintain its corporate form and distribute dividends derived from the lease payments.¹⁶⁶

However, a corporation was found not to be in a trade or business where its only activity was the operation of a stable of racing and breeding horses pursued to satisfy the final wish of a shareholder's dying parent.¹⁶⁷ A corporation is not carrying on a trade or business merely by making expenditures for the principal shareholder's speed boat racing hobby.¹⁶⁸ A corporation is not carrying on a trade or business merely by acquiring a yacht for use in purported charter operation but allowing only its principal shareholder and family to use it for personal purposes;¹⁶⁹ amounts so expended are nondeductible constructive dividends.¹⁷⁰

In a case in which a corporation's activities constituted a trade or business, the deductibility of a voluntary "free financial aid" payment by the corporation to a subsidiary was challenged by the IRS.¹⁷¹ The Fifth Circuit held that the voluntary payment to strengthen the financial position of the subsidiary was a payment in the nature of a contribution to capital and did not qualify as a §162 deductible business expense.¹⁷²

¹⁶⁰ *Hirsch v. Commissioner*, 315 F.2d 731 (9th Cir. 1963), aff'g 20 T.C.M. 1341 (1961).

¹⁶¹ *Van Fossan v. Commissioner*, 47 T.C.M. 411 (1983); *Kliethermes v. United States*, 27 Fed. Cl. 111 (Fed. Cl. 1992).

¹⁶² See, e.g., *Mountain Lake Corp. v. United States*, 71-1 USTC ¶9308 (M.D. Fla. 1971).

¹⁶³ *Pittsburgh Indus. Eng'g Co. v. Commissioner*, 9 T.C.M. 1132 (1950).

¹⁶⁴ E.g., *Tipton & Kalmbach, Inc. v. United States*, 480 F.2d 1118 (10th Cir. 1973); *Commissioner v. Hawaiian Philippine Co.*, 100 F.2d 988 (9th Cir. 1939), cert. denied, 307 U.S. 635 (1939).

¹⁶⁵ E.g., *Linen Thread Co. v. Commissioner*, 4 T.C. 802 (1945).

¹⁶⁶ *McCoach v. Minehill & Schuylkill Haven Ry. Co.*, 228 U.S. 295 (1913).

¹⁶⁷ *Blake Constr. Co. v. United States*, 77-1 USTC ¶9317 (Ct. Cl. Tr. J. Op. 1977), aff'd per curiam, 572 F.2d 820 (Ct. Cl. 1978).

¹⁶⁸ *Am. Props., Inc. v. Commissioner*, 262 F.2d 150 (9th Cir. 1958), aff'g 28 T.C. 1100 (1957).

¹⁶⁹ *Cirelli v. Commissioner*, 82 T.C. 335 (1984).

¹⁷⁰ *Cirelli v. Commissioner*, 82 T.C. at 351 (1984).

¹⁷¹ *Baker Hughes Inc. v. United States*, 313 F. Supp. 3d 804 (S.D. Tex. 2018).

Comment: A corporation's expenses that are not deductible under §162 are also not deductible under §212 because §212 is limited to individuals.

b. Use by Shareholder

A corporation originally formed to own and operate property for the recreation and pleasure of its sole shareholder is in a trade or business after it changes its activities in order to operate the property in a manner that is intended to generate a profit.¹⁷³ Expenses paid or incurred by a corporation to maintain property used primarily by shareholders for personal purposes are not deductible under §162 because they are not expenses of the corporation's trade or business.¹⁷⁴ If the property is used in part for personal purposes by the shareholders, only a proportionate part of the expenses are treated as trade or business expenses.¹⁷⁵ Likewise, if the personal use of the asset is incidental, all of the expenses of maintaining the asset may be treated as trade or business expenses.¹⁷⁶

If the shareholder pays fair rental value for the use of the property, all of the corporation's expenses of owning the property are trade or business expenses.¹⁷⁷ However, if the corporation does not rent similar property to unrelated persons, does not advertise the availability of the property, permits only the shareholder to use the property, and does not charge the shareholder for standby time, the payment of hourly rent by the shareholder does not elevate the corporation's ownership and maintenance of the property to a trade or business and thus precludes deductions for the maintenance expenses.¹⁷⁸

c. For Shareholder's Benefit

A hospital corporation's trade or business expenses do not include expenses incurred for the benefit of a shareholder's private medical practice.¹⁷⁹ Likewise, a corporation's trade or business expenses do not include the cost of maintaining a yacht owned and used by the major shareholder.¹⁸⁰

¹⁷² *Baker Hughes Inc. v. United States*, No. 18-20585, 2019 BL 448909 (5th Cir. Nov. 21, 2019), aff'g 313 F. Supp. 3d 804 (S.D. Tex. 2018), and citing *Schleppy v. Commissioner*, 601 F.2d 196, 197 (5th Cir. 1979). More generally, a shareholder's voluntary contribution to the capital of a corporation is an investment, and does not have immediate tax consequences. *Baker Hughes Inc. v. United States*, No. 18-20585, 2019 BL 448909 (5th Cir. Nov. 21, 2019), citing *Commissioner v. Fink*, 483 U.S. 89, 94 (1987).

¹⁷³ *Black Dome Corp. v. Commissioner*, 5 T.C.M. 455 (1946).

¹⁷⁴ *Mel Dar Corp. v. Commissioner*, 309 F.2d 525 (9th Cir. 1962), cert. denied, 372 U.S. 941 (1963), aff'g 19 T.C.M. 290 (1960); *Int'l Trading Co. v. Commissioner*, 275 F.2d 578 (7th Cir. 1960), aff'g 17 T.C.M. 521 (1958); *C. Ray Culver, Inc. v. Commissioner*, 46 T.C.M. 1592 (1983), aff'd in unpub. op. (9th Cir. Jan. 22, 1985).

¹⁷⁵ *Int'l Artists, Ltd. v. Commissioner*, 55 T.C. 94 (1970); *Hal E. Roach Studios v. Commissioner*, 20 B.T.A. 917 (1930); *Eden v. Commissioner*, 53 T.C.M. 195 (1987); *C. Ray Culver, Inc. v. Commissioner*, 46 T.C.M. 1592 (1983), aff'd in unpub. op. (9th Cir. Jan. 22, 1985).

¹⁷⁶ See *Mann v. Commissioner*, 42 T.C.M. 1766 (1981).

¹⁷⁷ See *Cnty. Research & Dev. Corp. v. Commissioner*, 38 T.C.M. 1043 (1979).

¹⁷⁸ See *Clymer v. Commissioner*, 47 T.C.M. 1576 (1984).

¹⁷⁹ *Kenner v. Commissioner*, 33 T.C.M. 1239 (1974), on remand from 445 F.2d 19 (7th Cir. 1971), rev'g 27 T.C.M. 893 (1968).

¹⁸⁰ *Progressive Eng'g, Inc. v. Commissioner*, 34 T.C.M. 411 (1975). See also *Gerald D. Roberts Consultants Inc. v. Commissioner*, 62 T.C.M. 890 (1991), aff'd in unpub. order, 981 F.2d 1251 (4th Cir. Dec. 17, 1992).

d. *Disguised Dividends*

Whether a payment by a corporation to a shareholder qualifies as a business expense deduction rather than a nondeductible dividend depends on the facts and circumstances.¹⁸¹ A significant factor is whether the payment has independent and substantial importance to the corporation.¹⁸² Thus, payments made by a corporation to induce a shareholder to take a course of action that is favorable to the corporation's business have been held to be deductible.¹⁸³

In *Cleveland Shopping News Co. v. Routzahn*,¹⁸⁴ a corporation permitted its shareholders to purchase advertising at cost plus a percentage surcharge, and it deposited the surcharges into a special account used to redeem the stock of shareholders who ceased to advertise and to pay for certain extraordinary costs. Amounts remaining in the account were paid to shareholders who had purchased advertising. The court characterized those payments by the corporation as dividends and not as rebates, even though the payments to the shareholders were not in proportion to their stock ownership. In *Peoples Gin Co. v. Commissioner*,¹⁸⁵ the court held that a corporation's distribution to its shareholders of profits earned from ginning cotton for shareholders in amounts reflecting the quantity of cotton ginned for each shareholder were dividends and not deductible expenses, even though profits from ginning for third parties were distributed in proportion to shareholdings.¹⁸⁶

However, the IRS has ruled that rebates paid by a corporation to its shareholders based on the volume of use by the shareholders and the shareholder's customers of the corporation's banking services are deductible business expenses.¹⁸⁷ In contrast, whether a rebate to a third party is treated as a reduction of sales price in calculating gross receipts or as a deductible ordinary and necessary business expense, even though the general effect on taxable income is the same, is a question that the IRS is reconsidering, and the IRS has cautioned taxpayers not to rely on its previous conclusion that manufacturer rebates are deductible trade or business expenses.¹⁸⁸ The IRS also ruled that Medicaid rebates paid by pharmaceutical manufacturers to state Medicaid agencies under the Medicaid rebate program are price adjustments.¹⁸⁹

8. *Fiduciary Activities*

a. *Estates and Trusts*

Whether a trust's or an estate's activities constitute a trade or business depends on whether the trust or estate meets the

profit motive and scope tests described in II.B.2. and 3., above.¹⁹⁰ In *Helvering v. Highland*, the Fourth Circuit stated:

... [C]ertain factors remain of lasting evidentiary importance. For instance the profit motive and presence of business-like policies should be given great weight Similarly, the fact that a separate office is maintained is of evidentiary importance to suggest that the taxpayer is engaged in business Likewise, the length of time required for an executor's dealings is an important factor in distinguishing purely administrative expenditures from expenses incurred in carrying on the estate as a business¹⁹¹

Thus, an estate that continues to carry on a trade or business carried on by the decedent is carrying on a trade or business.¹⁹²

In contrast, a trust that reviews its investments, occasionally sells investments and reinvests proceeds, collects income, keeps accounts, and files tax returns is not engaged in a trade or business.¹⁹³ An estate that pays premiums on life insurance policies held as security for a loan is not engaged in a trade or business.¹⁹⁴

Note: The fact that a trust or estate is not carrying on a trade or business does not necessarily preclude deduction of its expenses, because §212 allows deductions for amounts paid or incurred by the fiduciary of an estate or trust on account of administration expenses, fiduciaries' fees, and litigation expenses that are ordinary and necessary in connection with the performance of the fiduciary's duties, except to the extent the expenses are allocable to tax-exempt income.¹⁹⁵ Deductions under §212 are described in III., below.

b. *Personal Representatives*

Whether an executor or trustee is considered to be engaged in the trade or business of being a fiduciary depends on the scope and duration of their fiduciary activities.¹⁹⁶ In *Abbott v. Commissioner*,¹⁹⁷ the court held that an attorney in general practice who served as administrator of between nine and 18 estates and trusts over a six-year period was in the trade or business of being a fiduciary,¹⁹⁸ but in *Solomon v. Commissioner*,¹⁹⁹ a certified public accountant failed to persuade the Tax Court that he was in the business of being a trustee.²⁰⁰ In *Estate of Wallace v. Commissioner*,²⁰¹ the Fourth Circuit, relying on a broader definition of trade or business set forth by the Supreme Court in *Flint v. Stone Tracy Co.*,²⁰² held that a decedent's spouse serving as nonresident co-executrix was in the trade or business of being

¹⁹⁰ *United States v. Pyne*, 313 U.S. 127 (1941), vac'g 35 F. Supp. 81 (Ct. Cl. 1940).

¹⁹¹ 124 F.2d 556 (4th Cir. 1942), aff'g 43 B.T.A. 598 (1941).

¹⁹² *Estate of Adair v. Commissioner*, 43 B.T.A. 384 (1941).

¹⁹³ *City Bank Farmers Trust Co. v. Helvering*, 313 U.S. 121 (1941), aff'g 112 F.2d 457 (2d Cir. 1940), aff'g 39 B.T.A. 29 (1939).

¹⁹⁴ *Estate of Hall v. Commissioner*, 17 T.C. 20 (1951).

¹⁹⁵ Reg. §1.212-1(i).

¹⁹⁶ *Estate of Barnhart v. Commissioner*, 18 T.C.M. 194 (1959).

¹⁹⁷ 38 B.T.A. 1290 (1938), acq., 1939-2 C.B. 1.

¹⁹⁸ *Abbott v. Commissioner*, 38 B.T.A. at 1292.

¹⁹⁹ 33 T.C.M. 588 (1974).

²⁰⁰ *Solomon v. Commissioner*, 33 T.C.M. at 589.

²⁰¹ 101 F.2d 604 (4th Cir. 1939), rev'g 7 B.T.A.M. 38-390 (1938).

²⁰² 220 U.S. 107 (1911).

¹⁸¹ E.g., *Rubber Assocs., Inc. v. Commissioner*, 335 F.2d 75 (6th Cir. 1964), rev'g 22 T.C.M. 567 (1963); *Lengsfeld v. Commissioner*, 241 F.2d 508 (5th Cir. 1957), aff'g 14 T.C.M. 1024 (1955).

¹⁸² E.g., *T.J. Enters., Inc. v. Commissioner*, 101 T.C. 581 (1993); *Maxwell v. Commissioner*, 95 T.C. 107 (1990).

¹⁸³ *Fairmount Homes, Inc. v. Commissioner*, 45 T.C.M. 1340 (1983).

¹⁸⁴ 89 F.2d 902 (6th Cir. 1937), aff'g 13 F. Supp. 362 (N.D. Ohio 1935).

¹⁸⁵ 118 F.2d 72 (5th Cir. 1941), aff'g 41 B.T.A. 343 (1940).

¹⁸⁶ See also Rev. Rul. 83-141, 1983-2 C.B. 65.

¹⁸⁷ TAM 9830003.

¹⁸⁸ Rev. Rul. 2008-26, 2008-21 I.R.B. 985, superseding Rev. Rul. 2005-28, 2005-19 I.R.B. 997, and suspending in part Rev. Rul. 76-96, 1976-1 C.B. 23.

¹⁸⁹ Rev. Rul. 2008-26.

a fiduciary even though she did not regularly and continuously engage in fiduciary activities.²⁰³ In *McDowell v. Ribicoff*,²⁰⁴ the Third Circuit, declining to follow, held that serving as a fiduciary on a casual basis in family situations was not a trade or business. The Third Circuit pointed out that the Supreme Court had, subsequent to the *Estate of Wallace* decision, modified its definition of a trade or business and that the Fourth Circuit, in *Helvering v. Highland*,²⁰⁵ recognized that the Supreme Court made this change after *Estate of Wallace* was decided.²⁰⁶ The Tax Court has held that serving as trustee or executor for only one estate does not constitute a trade or business.²⁰⁷ The IRS agrees.²⁰⁸

Acting as executor is considered a trade or business if the executor is responsible for operating and directing enterprises that the decedent had owned and operated.²⁰⁹

Example: C, D, and E are the executors of A's estate and trustees of three residuary trusts provided for in A's will. For approximately 12 years, C, D, and E, in their role as executors, continued to supervise A's investment in various enterprises that were engaged in financing, real estate operations, the publication of daily and weekly newspapers, and other activities. As a result of certain actions relating to the administration of the estate and the handling of the trusts, objections were filed on behalf of certain infants who were contingent beneficiaries. C, D, and E each made a significant payment to the trusts in settlement of the objections. Based on the duration and scope of their activities, C, D, and E's activities in the conduct and operation of A's various business operations constituted the conduct of business, and the amounts paid in settlement of the objections to their accountings constituted ordinary and necessary business expenses.²¹⁰

Likewise, if the executor is required to devote substantial amounts of time to the management of a large estate, the activities constitute a trade or business.²¹¹

In contrast, if the activities are casual and sporadic, there is no trade or business.²¹² Thus, serving as trustee for no compensation on one occasion does not constitute a trade or business.²¹³ Likewise, in *Stuart v. Commissioner*,²¹⁴ the First Circuit held that a trustee whose fees were paid to the law firm that represented the trustee and performed the clerical work was not carrying on a trade or business even though he had no other occupation.²¹⁵ A volunteer trustee for a nonprofit organization is

not in the trade or business of volunteering nor in the trade or business of being a trustee.²¹⁶

Serving as a trustee in bankruptcy of a trade or business constitutes a trade or business.²¹⁷

Note: Not only does the taxpayer need to show that the activity as a fiduciary is a trade or business, the taxpayer must also show that the expenses arise from the taxpayer's fiduciary activities and not from personal relationships with beneficiaries, putative heirs or other persons and that the expenses are paid or incurred to benefit the estate or trust.²¹⁸

c. Beneficiaries

The beneficiary of a trust is not carrying on a trade or business by merely being a beneficiary, even if the trust is carrying on a trade or business.²¹⁹ This result is not changed even if the beneficiary's spouse is a trustee and the beneficiary attends trustees' meetings, because the beneficiary is not being compensated for attending.²²⁰ However, if the beneficiary is required to assume trust administration duties and manage individual trust businesses because of the trustee's inability to do so, the beneficiary's activities in doing so are a trade or business.²²¹

d. Guardianships

In several cases, the courts held that fulfilling the obligations of a guardian constitutes a trade or business.²²² In a subsequent case, *Van Wart v. Commissioner*,²²³ that addressed whether the guardian or the ward was allowed to deduct attorney's fees paid for the collection of the ward's income, the Supreme Court stated *in dictum* that it appeared the guardian was not engaged in a business, pointing out that guardianship is not a taxable entity.²²⁴ It is settled that being a ward does not constitute a trade or business.²²⁵

Note: The issue generally is moot because under §212, deductions are allowed for reasonable amounts paid or incurred for the services of a guardian or committee for a ward or minor, and other ordinary and necessary expenses of guardians and committees paid or incurred in connection with the production or collection of income inuring to the ward or minor, or in connection with the management, conservation, or maintenance of

²¹⁶ *Kurkjian v. Commissioner*, 65 T.C. 862 (1976).

²¹⁷ *Butler v. Commissioner*, 17 T.C. 675 (1951).

²¹⁸ See *Stiebling v. Commissioner*, 67 T.C.M. 3006 (1994), aff'd, 113 F.3d 1242 (9th Cir. 1997).

²¹⁹ *Morse v. Helvering*, 85 F.2d 262 (D.C. Cir. 1936), aff'g 4 B.T.A.M. 35-207 (1935); *Kenan v. Bowers*, 50 F.2d 112 (2d Cir. 1931), aff'g 48 F.2d 263 (S.D.N.Y. 1930).

²²⁰ *Clementson v. Commissioner*, 27 T.C.M. 559 (1968).

²²¹ *Lloyd-Smith v. Commissioner*, 40 B.T.A. 214 (1939), aff'd on other issues, 116 F.2d 642 (2d Cir. 1941), cert. denied, 313 U.S. 588 (1941).

²²² *Commissioner v. Linderman*, 84 F.2d 727 (3d Cir. 1934), rev'g 28 B.T.A. 113 (1933), cert. denied, 299 U.S. 589 (1936); *Commissioner v. Wurts-Dundas*, 54 F.2d 515 (2d Cir. 1931), aff'g 17 B.T.A. 881 (1929), rev'd on other grounds, *Van Wart v. Commissioner*, 295 U.S. 112 (1935), aff'g 69 F.2d 299 (5th Cir. 1934), rev'g 1 B.T.A.M. 32-329 (1932); *Robertson v. Corwin*, 3 F. Supp. 762 (E.D.N.Y. 1933).

²²³ 295 U.S. 112 (1935).

²²⁴ *Van Wart v. Commissioner*, 295 U.S. at 116.

²²⁵ *Van Wart v. Commissioner*, 295 U.S. 112 (1935), aff'g 69 F.2d 299 (5th Cir. 1934), rev'g 1 B.T.A.M. 32-329 (1932); *Vanderbilt v. Commissioner*, 39 B.T.A. 43 (1939), aff'd, 107 F.2d 1023 (2d Cir. 1939), cert. denied, 309 U.S. 683 (1940).

²⁰³ 101 F.2d at 606-07.

²⁰⁴ 292 F.2d 174 (3d Cir. 1961), cert. denied, 368 U.S. 919 (1961).

²⁰⁵ 124 F.2d 556 (4th Cir. 1942).

²⁰⁶ 292 F.2d at 178.

²⁰⁷ *Uhlenbrock v. Commissioner*, 67 T.C. 818 (1977).

²⁰⁸ Rev. Rul. 55-447, 1955-2 C.B. 533.

²⁰⁹ *Macy v. Commissioner*, 19 T.C. 409 (1952), aff'd, 215 F.2d 875 (2d Cir. 1954).

²¹⁰ *Macy v. Commissioner*, 19 T.C. 409 (1952), aff'd, 215 F.2d 875 (2d Cir. 1954).

²¹¹ *Rice v. Commissioner*, 44 B.T.A. 749 (1941), acq., 1944 C.B. 23.

²¹² *Estate of Josephs v. Commissioner*, 12 T.C. 1069 (1949); *Stiebling v. Commissioner*, 67 T.C.M. 3006 (1994), aff'd, 113 F.3d 1242 (9th Cir. 1997).

²¹³ *Seidler v. Commissioner*, 18 T.C. 256 (1952).

²¹⁴ 84 F.2d 368 (1st Cir. 1936), aff'g 32 B.T.A. 574 (1935).

²¹⁵ *Stuart v. Commissioner*, 84 F.2d at 370.

property held for the production of income that belongs to the ward or minor.²²⁶ Deductions under §212 are described in III., below.

C. Ordinary and Necessary Expense

1. In General

To be deductible under §162, a trade or business expense must be ordinary and necessary.²²⁷ In *Welch v. Helvering*,²²⁸ the Supreme Court emphasized that an expense must be both ordinary and necessary to be deductible.²²⁹

The IRS has concluded that for purposes of §21(h) of the Alaska Native Claims Settlement Act,²³⁰ as amended by the Alaska National Interest Lands Conservation Act,²³¹ all expenses paid or incurred by Alaska native corporations in connection with land selection or conveyance under the Act are deemed to be, or to have been, deductible under §162 as ordinary and necessary expenses for purposes of any form of taxation.²³²

2. Ordinary

Whether an expense is ordinary is determined by time, place, and circumstance.²³³ In *Deputy v. DuPont*,²³⁴ the Supreme Court described the scope of ordinary in the following terms:

One of the extremely relevant circumstances is the nature and scope of the particular business out of which the expense in question accrued It is the kind of transaction out of which the obligation arose and its normalcy in the particular business which are crucial and controlling.²³⁵

If payments for an expense are made regularly and arise from transactions that commonly or frequently occur in the type of business involved, the expense is ordinary in the generally accepted meaning of that word.²³⁶

However, to be ordinary, an expense need not be habitual or normal in the sense that the same taxpayer will need to pay or incur the same type of expense often.²³⁷ In *United Title Ins. Co. v. Commissioner*,²³⁸ the Tax Court held that an expense can be ordinary even if no other company engaged in the same business in the taxpayer's state makes similar payments.²³⁹

Example: Z is a small new title insurance company operating in a highly competitive business in State Y. Z invites certain real estate attorneys, realtors, and lenders to attend its out-of-state directors' meetings and a corporate planning conference. By attending, the non-director attendees learn about Z, including Z's financial health and conservative philosophy regarding issuing title insurance policies. In addition, Z learns what issues most concern the real estate professionals attending that affect its business. It allows Z to maintain a close relationship with the attendees. Most attendees have previously referred some business to Z, but are not obligated by attending to refer additional business to Z. Most, if not all, other title insurance companies operating in State Y do not offer real estate attorneys, realtors, and lenders the opportunity to attend out-of-state meetings at their expense. Because the expenditures arise out of Z's business and serve a variety of business purposes, including marketing Z's business, the expenditures are ordinary for purposes of §162(a).²⁴⁰

Comment: A requirement that all, or most, companies engaged in a particular trade or business make similar payments would impose a disadvantage on companies that discover novel approaches to the conduct of the trade or business, and thus would stifle business growth through creativity and ingenuity.²⁴¹

Despite the result in *United Title*, a variety of innovative and productive expenses have been disallowed under §162 on the grounds that they are not ordinary. In *Reffett v. Commissioner*,²⁴² the Tax Court disallowed §162 deductions for payments to witnesses of additional compensation contingent on the success of the litigation because such payments were not a common and accepted means of pursuing an action for damages to a business.²⁴³ The expense of registering common stock as required by the Securities and Exchange Act²⁴⁴ was held not ordinary because it was a unique expense, not recurring, even though annual filing was also required by the Act and even though similar businesses were subject to the same registration requirement.²⁴⁵

The cost of hiring a minister to provide spiritual advice to, and hold prayer meetings for, the taxpayer's employees was disallowed as not business related.²⁴⁶ Likewise, payments made to further the religious and work ethic beliefs of the taxpayer were not ordinary expenses.²⁴⁷ Personal expenses paid on behalf of an employee who is related to the taxpayer but that are not paid on behalf of other unrelated employees are not ordinary expenses of the business.²⁴⁸

²²⁶ Reg. §1.212-1(j).

²²⁷ §162(a).

²²⁸ 290 U.S. 111 (1933), aff'g 63 F.2d 976 (8th Cir. 1933), aff'g 25 B.T.A. 117 (1932).

²²⁹ *Id.* at 113.

²³⁰ 43 U.S.C. §1620 *et seq.*

²³¹ Pub. L. No. 96-487 (1980).

²³² CCA 200949038.

²³³ *Welch v. Helvering*, 290 U.S. 111 (1933), aff'g 63 F.2d 976 (8th Cir. 1933), aff'g 25 B.T.A. 117 (1932).

²³⁴ 308 U.S. 488 (1940), rev'g 103 F.2d 257 (3d Cir. 1939), rem'g 22 F. Supp. 589 (D. Del. 1938).

²³⁵ *Id.*

²³⁶ *Lilly v. Commissioner*, 343 U.S. 90 (1952), rev'g 188 F.2d 269 (4th Cir. 1951), aff'g 14 T.C. 1066 (1950).

²³⁷ *Welch v. Helvering*, 290 U.S. 111 (1933), aff'g 63 F.2d 976 (8th Cir. 1933), aff'g 25 B.T.A. 117 (1932).

²³⁸ T.C. Memo 1988-38.

²³⁹ *Id.* at 45.

²⁴⁰ *United Title Ins. Co. v. Commissioner*, T.C. Memo 1988-38.

²⁴¹ *Id.*

²⁴² 39 T.C. 869 (1963).

²⁴³ *Id.* at 879.

²⁴⁴ 15 U.S.C. §78a-78kk (1982 and 1987 Supp.).

²⁴⁵ *Consumers Water Co. v. United States*, 369 F. Supp. 939 (D. Me. 1974).

²⁴⁶ *Trebilcock v. Commissioner*, 64 T.C. 852 (1975), aff'd, 557 F.2d 1226 (6th Cir. 1977). See *May v. Commissioner*, 71 T.C.M. 2498 (1996) (same for payments to religious organizations by owner of piano sales and service business).

²⁴⁷ See *Bender v. Commissioner*, 43 T.C.M. 808 (1982).

²⁴⁸ *Shackelford v. Commissioner*, 70 T.C.M. 945 (1995).

The cost of maintaining a chartered plane on 24-hour standby was ordinary, even though its actual use was limited.²⁴⁹ In contrast, the costs incurred by a land clearing company to build houses on land owned by its president and sole shareholder were not ordinary because land clearing companies do not customarily build houses as a way of advertising.²⁵⁰

No deduction under §162 was allowed for funds embezzled by employees because embezzlement is not an ordinary business expense.²⁵¹ However, a deduction has been allowed for an employer's repayment to a client of funds embezzled from the client by an employee even though the employer was not required to include the embezzled funds in gross income, because it was reasonable for the employer to conclude that were the client to sue the employer for reimbursement the employer would be held liable for its employee's acts.²⁵²

Note: A deduction under §165 may be allowed for embezzled amounts, as discussed in 527 T.M., *Loss Deductions*.

The IRS has ruled that a public utility's expenditures for implementation and operation of energy conservation and load management programs are currently deductible as ordinary business expenses under §162 because these expenses are appropriate and helpful in carrying on the utility's business and are commonly and frequently incurred by utilities.²⁵³ The IRS also has ruled that up front incentive payments made to incentivize customers to purchase, install and maintain renewable energy production systems were currently deductible as ordinary business expenses because the payments were made in order to comply with a mandate of a regulatory agency overseeing power utility operations in the state.²⁵⁴ Likewise, the IRS has ruled that energy conservation program expenses are ordinary business expenses, resulting in operating costs savings.²⁵⁵ However, even though a regulated public utility may deduct the costs of energy conservation programs related to reducing energy usage by existing customers, it must capitalize costs related to acquiring new customers.²⁵⁶ The capitalization requirement is discussed in 509 T.M., *Principles of Capitalization*.

Where a non-stock insurance company was created under state law in response to the need for additional medical malpractice insurance carriers in the state, the IRS has ruled that payments by the insurance company to a state fund providing financial support for graduate medical education in the state were ordinary business expenses made with an expectation of financial return, and were currently deductible under §162.²⁵⁷

3. Necessary

a. In General

The term "necessary," for purposes of §162, means that the expense is appropriate and helpful, rather than absolutely essential.²⁵⁸ An expense is more readily characterized as neces-

sary if it is essential,²⁵⁹ but in *United Title Ins. Co. v. Commissioner*,²⁶⁰ the Tax Court held that an expense could be necessary even though there are other ways of attaining the same result.²⁶¹

Thus, if a taxpayer needed to keep a plane on 24-hour standby because the timing of business trips was unpredictable and uncontrollable, the expense of doing so was necessary even if the actual use of the plane was limited.²⁶² The cost of a full set of tools required by a journeyman printer was necessary because the nature of the position required that the printer use English and metric presses.²⁶³ A utility's cost for conducting a prudency audit of a power plant is a necessary expense because it is needed for the state utility commission's approval of a rate increase for the cost of constructing the power plant.²⁶⁴ The cost of prizes awarded by a bingo parlor operator to its patrons is ordinary and necessary because the prizes encouraged patrons to stay and play more games.²⁶⁵

In contrast, voluntary subscriptions to a professional association endowment fund whose benefits inured to contributors, noncontributors, and the public were not necessary.²⁶⁶ Similarly, §162 deductions were not allowed for the operation of an airplane by a medical corporation whose patients were not scattered over a wide area, because there was no business need for the airplane.²⁶⁷ The cost of comic books purchased by a math teacher for a comic book club sponsored by the teacher were not necessary because the teacher's employer required only that the sponsor supervise the students. Although the comic books were helpful to the students, because the teacher collected comic books as a hobby and failed to show how comic book purchases maintained or improved math teaching skills, the deduction was denied.²⁶⁸

Along these same lines, a payment by the shareholder of a professional corporation to a former employee in settlement of a lawsuit against the corporation and the shareholder for breach of the employment agreement and tortious interference with the former employee's new business is not a necessary business expense if the shareholder has ceased to practice and makes the payment to enhance the value of the stock in the corporation.²⁶⁹ An insurance services company's expenses for golf course assessments, locker fees, and bar association dues were held not to be ordinary and necessary.²⁷⁰ Payment of a commission to a realtor on a lease-purchase agreement breached by the buyer is not a necessary expense of renting if the commission is payable

²⁵⁸ *Welch v. Helvering*, 290 U.S. 111 (1933), aff'g 63 F.2d 976 (8th Cir. 1933), aff'g 25 B.T.A. 117 (1932).

²⁵⁹ *Lilly v. Commissioner*, 343 U.S. 90 (1952), rev'g 188 F.2d 269 (4th Cir. 1951), aff'g 14 T.C. 1066 (1950).

²⁶⁰ T.C. Memo 1988-38.

²⁶¹ *Id.* at 46-47.

²⁶² *Palo Alto Town & Country Vill., Inc. v. Commissioner*, 565 F.2d 1388 (9th Cir. 1977), aff'g 32 T.C.M. 1048 (1973). See also *Richardson v. Commissioner*, 72 T.C.M. 348 (1996).

²⁶³ *McCullum v. Commissioner*, 37 T.C.M. 1817 (1978).

²⁶⁴ TAM 9535011.

²⁶⁵ *Brown v. Commissioner*, 63 T.C.M. 1866 (1992).

²⁶⁶ *Montgomery v. United States*, 63 Ct. Cl. 588 (1927).

²⁶⁷ *Harbor Med. Corp. v. Commissioner*, 38 T.C.M. 1144 (1979), aff'd in unpub. op. (9th Cir. Mar. 19, 1982).

²⁶⁸ *Tesar v. Commissioner*, 73 T.C.M. 2709 (1997).

²⁶⁹ *Dogali v. Commissioner*, 69 T.C.M. 1759 (1995).

²⁷⁰ See *Indep. Ins. & Fin. Serv. Co. v. United States*, 95-2 USTC ¶ 50,412 (W.D. La. 1995).

²⁴⁹ *Palo Alto Town & Country Vill., Inc. v. Commissioner*, 565 F.2d 1388 (9th Cir. 1977), aff'g 32 T.C.M. 1048 (1973).

²⁵⁰ *Jim Wood Land Clearing Co. v. Commissioner*, 77 T.C.M. 1588 (1999).

²⁵¹ *Wintner v. Commissioner*, 36 T.C.M. 611 (1977).

²⁵² *Musgrave v. Commissioner*, 73 T.C.M. 1721 (1997).

²⁵³ Rev. Rul. 95-32, 1995-1 C.B. 8.

²⁵⁴ PLR 201341029; PLR 201341031.

²⁵⁵ TAM 9513002.

²⁵⁶ TAM 9548004.

²⁵⁷ PLR 201724012.

for sale, not rental.²⁷¹ Guaranty fees paid in connection with the issuance of commercial paper aren't necessary if they are not required as part of the issuance and do not change the risks borne by the issuer and purchaser.²⁷² The Tax Court has held that consulting fees paid by an accountant were not necessary because the accountant was experienced and had good relationships with the clients.²⁷³ The costs incurred by a land clearing company to build houses on land owned by its president and sole shareholder were not necessary because it was not appropriate or helpful to the business of a land clearing company to build houses as a way of advertising.²⁷⁴

The IRS has ruled that payments by an insurance company created under state law in response to the need for additional medical malpractice insurance carriers in the state to a state fund providing financial support to graduate medical education in the state were appropriate and helpful to the insurance company's business, and thus were necessary expenses under §162.²⁷⁵

b. Reasonableness

In *Commissioner v. Heininger*,²⁷⁶ the Supreme Court intimated that, had the expense in question been unreasonable, it would not have met the ordinary and necessary requirement to the extent of its unreasonableness.²⁷⁷ The reasonableness gloss reflects the notion that although to be necessary an expense need not be absolutely essential nor be the only means to the result, the means chosen must nonetheless be reasonable.²⁷⁸

Example: X is a dentist who sells false teeth through a mail order catalogue. The U.S. Postmaster-General issued a fraud order preventing the cashing of any money orders drawn to X and returning any mail addressed to X marked fraudulent. X incurred \$36,000 in legal fees fighting the fraud order, which was ultimately sustained. For X to employ a lawyer to defend his business is normal or ordinary. The expenses are also appropriate or helpful and therefore meet the "necessary" test as set forth in *Welch v. Helvering*. If the amount of the expenses had been unreasonable, the amount in excess of a reasonable amount would not meet the "necessary" test.²⁷⁹

The Tax Court and the Tenth Circuit have held that in determining whether the expenses of operating and maintaining depreciable property are reasonable, the depreciation deductions with respect to the property are not taken into account.²⁸⁰

If there are other more economical and practical means of attaining the result, the expense is not reasonable.²⁸¹ Thus, if a taxpayer can achieve flight training goals by renting a plane,

the expenses of owning and operating a private plane are unreasonable, and the deduction is limited to the costs of rental.²⁸² Similarly, in determining whether the cost of flying a private plane to another place of business is deductible, the additional time required for commercial flights is a factor that should be considered.²⁸³ The costs of depreciating books and microfilm equipment are disallowed as §162 expenses if the books and microfilm are available at local libraries and the costs are excessive when compared to the income being generated.²⁸⁴ Although a taxpayer who operates a stable is allowed to deduct the expenses of the taxpayer's personal horse because customers are reluctant to board horses at stables run by persons who do not own horses, the expenses of maintaining two personal horses are unreasonable if the stable can accommodate only ten horses.²⁸⁵

The determination of whether an expense is unreasonable is based on the facts and circumstances.²⁸⁶ The issue is more likely to arise when payments are made to related parties,²⁸⁷ particularly if an amount is much more than what otherwise would be paid.²⁸⁸

Example: T owned the stock of C, which was in the business of designing and manufacturing stencils for quilts, arts and crafts, and clothing. T also enjoyed racing cars and had C's name prominently displayed on his two race cars in Year 1 and his race car in Year 2. In Year 1, C also agreed to sponsor W, an unrelated driver, in return for putting C's name on W's race car. C claimed race car sponsorship expenses of \$31,000 in Year 1, of which \$26,000 was for maintaining T's cars and \$3,000 was attributable to W's car. C claimed race car sponsorship expenses of \$44,000 in Year 2, of which \$3,000 was for sponsoring W and the balance was attributable to T's car. The amounts C spent in excess of \$3,000 per car, which was the arm's-length amount necessary to sponsor an unrelated driver's car, were disallowed as excessive and unreasonable. Therefore, C was allowed a race car sponsorship deduction of only \$9,000 in Year 1 (\$3,000 × 3 cars) and \$6,000 in Year 2 (\$3,000 × 2 cars).²⁸⁹

Similarly, if the expense benefits not only the taxpayer who pays the expense but also other entities owned by the same

²⁸² *Behm v. Commissioner*, 53 T.C.M. 427 (1987).

²⁸³ *Kurzet v. Commissioner*, 222 F.3d 830 (10th Cir. 2000), rev'g and rem'g 73 T.C.M. 1867 (1997).

²⁸⁴ *Mathes v. Commissioner*, 60 T.C.M. 704 (1990).

²⁸⁵ *Ottow v. Commissioner*, 68 T.C.M. 60 (1994).

²⁸⁶ See, e.g., *Kurzet v. Commissioner*, 222 F.3d 830 (10th Cir. 2000), rev'g and rem'g 73 T.C.M. 1867 (1997); *Palo Alto Town & Country Vill., Inc. v. Commissioner*, 565 F.2d 1388 (9th Cir. 1977), aff'g 32 T.C.M. 1048 (1973); *Hall v. Commissioner*, 294 F.2d 82 (5th Cir. 1961), aff'g 32 T.C. 390 (1959); *Boomershine v. Commissioner*, 54 T.C.M. 43 (1987).

²⁸⁷ See, e.g., *Theodore v. Commissioner*, 38 T.C. 1011 (1962); *Oil Base, Inc. v. Commissioner*, 23 T.C.M. 1838 (1964), aff'd on other issues, 362 F.2d 212 (9th Cir. 1966), cert. denied, 385 U.S. 928 (1966). See also *ASAT Inc. v. Commissioner*, 108 T.C. 147 (1997).

²⁸⁸ *Gill v. Commissioner*, 76 F.3d 378 (6th Cir. 1996), aff'g 67 T.C.M. 2311 (1994); *Johnsen v. Commissioner*, 83 T.C. 103 (1984), rev'd on other issues, 794 F.2d 1157 (6th Cir. 1986). See also *Dharma Enters. v. Commissioner*, 74 T.C.M. 807 (1997).

²⁸⁹ *Gill v. Commissioner*, T.C. Memo 1994-92 (1994), aff'd, 76 F.3d 378 (6th Cir. 1996).

²⁷¹ *Ruckman v. Commissioner*, 64 T.C.M. 1166 (1992).

²⁷² *Medieval Attractions N.V. v. Commissioner*, 72 T.C.M. 924 (1996).

²⁷³ *Haas & Assocs. Accountancy Corp. v. Commissioner*, T.C. Memo 2000-183 (2000), aff'd by unpub. op., 55 Fed. Appx. 476 (9th Cir. 2003).

²⁷⁴ *Jim Wood Land Clearing Co. v. Commissioner*, 77 T.C.M. 1588 (1999).

²⁷⁵ PLR 201724012.

²⁷⁶ 320 U.S. 467 (1943).

²⁷⁷ *Id.* at 471.

²⁷⁸ See *Sherman v. Commissioner*, 44 T.C.M. 1324 (1982).

²⁷⁹ *Commissioner v. Heininger*, 320 U.S. 467 (1943).

²⁸⁰ *Kurzet v. Commissioner*, 222 F.3d 830 (10th Cir. 2000), rev'g and rem'g 73 T.C.M. 1867 (1997); *Noyce v. Commissioner*, 97 T.C. 670 (1991).

²⁸¹ *A.S. Barber, Inc. v. United States*, 85-1 USTC ¶ 9183 (E.D. Mo. 1984).

person who owns the taxpayer, only a portion of the expense is reasonable with respect to the taxpayer.²⁹⁰

It is not reasonable for a taxpayer to incur high bank charges on account of habitual issuance of business checks exceeding the balance in the taxpayer's account.²⁹¹ Payments by a corporation to a voluntary employees' benefit association that far exceeded the amounts needed for its stated purpose and that were invested in a nonfiduciary manner at the direction of the corporation's sole shareholder were not reasonable.²⁹²

c. Voluntariness

(1) Lack of Legal Obligation

(a) In General

The fact that an expenditure is made voluntarily does not necessarily mean that it is not an ordinary and necessary expense of carrying on a trade or business,²⁹³ though there are judicial opinions that suggest that amounts voluntarily paid are automatically not ordinary and necessary.²⁹⁴ Lack of an underlying legal liability does not necessarily preclude the deduction.²⁹⁵

Example: R was an employee of X. Due to a significant amount of foreign travel, R was uninsurable and therefore did not qualify for company-paid life insurance that was provided to X's other employees. R became sick in Year 2, was diagnosed with an incurable disease, and could no longer work. In Year 2, X's board of directors agreed to pay R or R's widow his monthly salary over the next 30 months, which was approximately the amount of insurance the company would have taken out on R had R been insurable. X accrued and deducted that amount on X's Year 2 income tax return based on the law in effect at that time. Even though there was no legal obligation to make the payment, X made the payment for the business reason of good employee relations. Because the payment had a business connection, i.e., it related to the employer-employee relationship, the expenditure is ordinary and appropriate to the conduct of X's business and was properly deductible.²⁹⁶

In applying these principles to specific situations, the courts and the IRS have reached conflicting results.²⁹⁷ In one case the Tax Court held that a law firm was allowed to deduct its reimbursement of losses suffered by investors who had re-

lied on the firm's advice but who had been deceived by a client,²⁹⁸ but in another case, in which the attorney reimbursed a client for a loss on an investment recommended by the attorney, the Tax Court denied the deduction.²⁹⁹

Observation: The difficulty of predicting how a specific situation will be treated is illustrated by how the IRS dealt with an organization that, in the process of demutualizing, made payments to a state in order to prevent certain claims concerning its historical nonprofit, tax-exempt status. At first the IRS advised that the payments were deductible as an ordinary and necessary business expense even though there was no legal obligation to make the payment, because the state could have asserted claims concerning the organization's historical status that would have triggered liabilities for the organization.³⁰⁰ Several years later, the IRS revoked its advice, concluding that the organization's payments were similar to a charitable trust obligation and thus not deductible under §162.³⁰¹

Deductions have been allowed for voluntary \$25 transfers to employees' children,³⁰² rewards for finding lost or stolen business property,³⁰³ and a railroad's cost of installing labels on freight cars before the regulation requiring them went into effect.³⁰⁴ In *Levy v. Commissioner*,³⁰⁵ the Tax Court held that a \$162 deduction was allowed for an agent's payments to a singer in an unsuccessful attempt to make the singer a star, even though the agent was under no obligation to make the payments, because of the possibility that if the singer became a star, the agent's income would have increased substantially; thus, the payments were held to be proximately related to the agent's business.³⁰⁶

Deductions have been disallowed for payments made by an attorney to a bankrupt client's creditors after the attorney had assured the creditors that the client's insurance policy would provide funds,³⁰⁷ the voluntary refunding of interest,³⁰⁸ voluntary payments to settle litigation against the taxpayer based on transactions between the taxpayer's controlled corporations and another company,³⁰⁹ the costs of purchasing annuities for employees who did not qualify for retirement plan coverage,³¹⁰ an employer's payment of an employee's bail on charges unrelated to the business,³¹¹ credits allowed to purchasers who did not fulfill the obligations under the credit

²⁹⁸ *Pepper v. Commissioner*, 36 T.C. 886 (1961).

²⁹⁹ *Slater v. Commissioner*, 11 T.C.M. 241 (1952), rev'd on other issues, 222 F.2d 470 (2d Cir. 1955).

³⁰⁰ TAM 200126008, *revoked by* TAM 200405005.

³⁰¹ TAM 200405005, *revoking* TAM 200126008. See PLR 201437004 (taxpayer payments to charitable organizations were not voluntary and therefore were not deductible under §170).

³⁰² *Hopkins v. Commissioner*, 30 T.C. 1015 (1958), rev'd on other issues, 271 F.2d 166 (6th Cir. 1959).

³⁰³ Rev. Rul. 67-98, 1967-1 C.B. 29.

³⁰⁴ Rev. Rul. 69-60, 1969-1 C.B. 49.

³⁰⁵ 30 T.C. 1315 (1958).

³⁰⁶ *Id.* at 1329.

³⁰⁷ *Friedman v. Delaney*, 171 F.2d 269 (1st Cir. 1948), aff'g 75 F. Supp. 568 (D. Mass. 1948).

³⁰⁸ *Louden Mach. Co. v. United States*, 57 F.2d 911 (Ct. Cl. 1932).

³⁰⁹ *Wilcox v. Commissioner*, 3 T.C.M. 28 (1944).

³¹⁰ *Commissioner v. H. B. Ives Co.*, 297 F.2d 229 (2d Cir. 1961), cert. denied, 370 U.S. 904 (1962), rev'g 18 T.C.M. 845 (1959).

³¹¹ *Banks v. Commissioner*, 20 T.C.M. 1165 (1961), aff'd in part and rev'd in part on other issues, 322 F.2d 530 (8th Cir. 1963).

²⁹⁰ *E.g., Ciaravella v. Commissioner*, 75 T.C.M. 1635 (1998).

²⁹¹ *Bailey v. Commissioner*, 62 T.C.M. 437 (1991), aff'd, 968 F.2d 25 (11th Cir. 1992).

²⁹² *Sunrise Constr. Co. v. Commissioner*, 52 T.C.M. 1358 (1987), aff'd in unpub. op. (9th Cir. 1988). See *Conn. Mut. Life Ins. Co. v. Commissioner*, 106 T.C. 445 (1996).

²⁹³ *E.g., Waring Prods. Corp. v. Commissioner*, 27 T.C. 921 (1957).

²⁹⁴ See, e.g., *Bonaire Dev. Co. v. Commissioner*, 679 F.2d 159 (9th Cir. 1982), aff'g 76 T.C. 789 (1981).

²⁹⁵ *Champion Spark Plug Co. v. Commissioner*, 30 T.C. 295 (1958), aff'd per curiam, 266 F.2d 347 (6th Cir. 1959).

²⁹⁶ *Champion Spark Plug Co. v. Commissioner*, 30 T.C. 295 (1958), aff'd per curiam, 266 F.2d 347 (6th Cir. 1959).

²⁹⁷ Compare *Pepper v. Commissioner*, 36 T.C. 886 (1961), with *Slater v. Commissioner*, 11 T.C.M. 241 (1952), rev'd on other issues, 222 F.2d 470 (2d Cir. 1955).

plan,³¹² and payment of indebtedness with respect to which the taxpayer remained liable but which was primarily the obligation of the person who purchased from the taxpayer the property acquired with the debt proceeds.³¹³ In addition, a taxpayer's payment to an endowment fund established as a result of criminal charges against the taxpayer was nondeductible under §162(a) because the payment was actually a fine/penalty that is nondeductible under §162(f).³¹⁴ The deductibility of fines and penalties under §162(f) is discussed in 524 T.M., *Deductibility of Illegal Payments, Fines, and Penalties*.

(b) Reimbursements

In *Langer v. Commissioner*, the Tax Court held that a bank officer and its majority shareholders were not allowed to deduct under §162 voluntary reimbursements to depositors who had waived a portion of their deposits when the bank closed.³¹⁵ In *Friedman v. Commissioner*,³¹⁶ the Tax Court held that a surviving partner was not allowed to deduct amounts paid to the estate of the decedent partner that exceeded the fair market value of the decedent's partnership interest.³¹⁷

In *Ky. Util. Co. v. Glenn*,³¹⁸ the Sixth Circuit held that a utility company's voluntary assumption of repair costs of a generator, though expedient, was not an ordinary and necessary expense.³¹⁹

Note: In *Miller v. Commissioner*,³²⁰ the Sixth Circuit overruled its *Ky. Util. Co.* decision to the extent it would have denied a casualty loss deduction to an individual taxpayer.³²¹

Comment: The result in *Miller* situations is now governed by §165(h)(4)(E), which permits individuals to deduct casualty losses to the extent covered by insurance only if the individual files a timely claim with respect to the loss.³²² This restriction does not apply to corporations, and even if it did, the facts in the *Ky. Util. Co.* decision arguably would not trigger application of §165(h)(4)(E). Thus, the extent to which the Sixth Circuit has effectively overruled *Ky. Util. Co.* remains to be specifically articulated by that court. Casualty loss deductions are discussed in 527 T.M., *Loss Deductions*.

(c) Compensation Repayments

In *Blanton v. Commissioner*, the Tax Court held that an employee's repayment of compensation held to be unreasonable was not deductible under §162 because any obligation that the employee had to repay the compensation did not arise out of the contract under which it had been paid to the employee, but from a subsequent agreement.³²³ This rationale was applied by the Tax Court in *Pahl v. Commissioner*, where the court held that the employee could deduct repayments relating to periods

after entering into a contract to repay compensation characterized as unreasonable.³²⁴

Note: Thus, repayments are deductible only to the extent they relate to compensation paid for services rendered after the employer and employee have entered into a contract imposing repayment obligations, and not merely the contract imposing compensation obligations on the employer.

A college professor who forwarded a portion of his fellowship award to his employer was allowed to deduct the payment as a business expense because the payment was required as a condition of the employment with the college, but he was not permitted simply to reduce his college salary gross income by the amount of the payment.³²⁵

(2) Acknowledgment of Legal Obligation

A payment made because the taxpayer acknowledges the existence of a legal obligation to pay is not disallowed merely because the taxpayer made the payment without the compulsion of a lawsuit.³²⁶ Likewise, payments made by a public utility to a municipality in excess of tax obligations pursuant to an agreement by which the utility agreed to pay the additional amounts so long as it was the sole franchisee in the municipality are deductible under §162³²⁷ because the public utility acknowledged an obligation it was required to incur in order to continue in business without competition.

d. Reimbursement and Refunds

An employee cannot deduct unreimbursed employee business expenses if the reason for the lack of reimbursement is the employee's failure to seek reimbursement.³²⁸ Expenses for which reimbursement is available, but for which it is not sought are not necessary³²⁹ or reasonable.³³⁰ Failure to seek reimbursement does not become necessary or reasonable merely because the reimbursement would not be forthcoming until the following year.³³¹

Note: An expense paid by an employee who knows that reimbursement would not be approved on the grounds it is not within the scope of the employee's business activities is almost certain to be held not ordinary and necessary.³³²

The §162 deduction of an employee who does not seek reimbursement is not disallowed if the employer's reimbursement policy is unclear, there is doubt that there would be reimbursement, and the employee's relationship with the employ-

³²⁴ 67 T.C. 286 (1976).

³²⁵ *Ruggiero v. Commissioner*, 74 T.C.M. 662 (1997).

³²⁶ *Anderson v. Bowers*, 117 F. Supp. 884 (W.D.S.C. 1954).

³²⁷ Rev. Rul. 73-517, 1973-2 C.B. 37.

³²⁸ *Leamy v. Commissioner*, 85 T.C. 798 (1985). See also *Horwath v. Commissioner*, 88 T.C.M. 279 (2004), aff'd, 140 Fed. Appx. 466 (4th Cir. 2005); *Rhodes v. Commissioner*, 85 T.C.M. 1276 (2003); *Maher v. Commissioner*, 85 T.C.M. 1053 (2003); *Putnam v. Commissioner*, 76 T.C.M. 238 (1998); *Spielbauer v. Commissioner*, 75 T.C.M. 1865 (1998); *Cavalaris v. Commissioner*, 72 T.C.M. 46 (1996); *Crumpton v. Commissioner*, 63 T.C.M. 2200 (1992); *Mulne v. Commissioner*, 72 T.C.M. 111 (1996); *In re Williams*, 95-2 USTC ¶ 50,349 (Bankr. N.D. Ind. 1995); TAM 9316003.

³²⁹ *Kerr v. Commissioner*, 59 T.C.M. 193 (1990).

³³⁰ See *Campbell v. Commissioner*, 54 T.C.M. 632 (1987).

³³¹ *Davoli v. Commissioner*, 68 T.C.M. 104 (1994).

³³² See *Baker v. Commissioner*, 73 T.C.M. 1653 (1997), app. dismissed (9th Cir. Sept. 23, 1998).

³¹² *Miss. Chem. Corp. v. Commissioner*, 86 T.C. 627 (1986).

³¹³ *Dankos v. Commissioner*, 52 T.C.M. 722 (1986).

³¹⁴ *Allied-Signal, Inc. v. Commissioner*, 63 T.C.M. 2672 (1992), aff'd in unpub. op., 54 F.3d 767 (3d Cir. 1995).

³¹⁵ 11 B.T.A.M. 42-134 (1942).

³¹⁶ 2 T.C.M. 382 (1943).

³¹⁷ *Id.* at 384.

³¹⁸ 394 F.2d 631 (6th Cir. 1968), aff'g 250 F. Supp. 265 (W.D. Ky. 1965).

³¹⁹ *Id.* at 633.

³²⁰ 733 F.2d 399 (6th Cir. 1984), aff'g 42 T.C.M. 665 (1981).

³²¹ 733 F.2d at 403.

³²² §165(h)(4)(E).

³²³ 46 T.C. 527 (1966), aff'd per curiam, 379 F.2d 558 (5th Cir. 1967).

er is discordant.³³³ Expenses paid by an employee that benefit the employer, that exceed the employer's reimbursement limit, and that the employer expects the employee to pay are ordinary and necessary expenses of the trade or business of being so employed.³³⁴

Example: C, an executive of X Corp., purchased an airplane, which he often uses for business travel. Under X Corp.'s written travel reimbursement policy, it will reimburse employees for required air travel only up to the cost of a coach airfare on a commercial airline, and it expects its officers to incur certain expenses on X Corp.'s behalf that will not be reimbursed, e.g., the cost of first-class airfare over coach airfare. Because X Corp. expects its officers to incur and pay for travel expenses in excess of the amount reimbursable, C's use of the plane and attendant expenses do not constitute the voluntary assumption of corporate expenses. Because C's use of the airplane allows him to reduce his travel time and attend more meetings, the airplane expenses for flights on behalf of X Corp. are an ordinary and necessary expense of C's business as a corporate official.³³⁵

In situations not involving employment, similar principles apply to amounts for which refunds are available.³³⁶ However, if there is a compelling business reason not to seek insurance reimbursement for repairs to business property, the deduction is not necessarily denied.³³⁷

Observation: If the employee is reimbursed, the employee is not permitted to deduct the expenses without taking the reimbursement into account to reduce the deduction.³³⁸

4. Applicability to Particular Situations

a. Payments for Employees

A farming corporation's expenses for meals and lodging provided to shareholder-employees required to live on the farm were ordinary and necessary expenses of its trade or business, but the telephone expenses of the shareholder-employees were not, because the telephone was not needed to make the lodging habitable.³³⁹ Similarly, the cost of food and medical care provided to member-employees of farm operated by a Hutterite non-profit religious corporation is ordinary and necessary because the demands of maintaining dairy cattle are such that it is appropriate and helpful to have employees on the farm around the clock, and employees must be fed.³⁴⁰ Fees paid for advice with respect to housing minority group employees were ordi-

nary and necessary expenses of the employer's trade or business.³⁴¹

Expenses of conducting employee seminars at which the founder's personal philosophies were expounded, but which did not address specific job skills, were not ordinary and necessary expenses of the employer's trade or business.³⁴² The costs of an employee's installation as an officer of a trade or similar association organized to promote the line of business in which the employer operates were ordinary and necessary expenses.³⁴³ In PLR 200245042, the IRS ruled that payments made to educational assistance programs for employees are deductible as an ordinary and necessary business expense under §162(a).

Note: Whether all or part of the amounts received by the employee under an educational assistance program qualify for exclusion under §127 or as a scholarship or grant under §117, and whether the employee may deduct the tuition expenses if some or all of the amounts received must be included in gross income are determinations separate from the employer's deduction. These issues are discussed in 394 T.M., *Employee Fringe Benefits*.

b. Assistance of Clients and Customers

Though assisting clients in obtaining financing is not technically within the practice of law, attorneys who do so can deduct the expenses as expenses of their law practices, because it is not unusual for attorneys to assist clients in obtaining financing.³⁴⁴ The costs of a small loan corporation to provide clients with credit insurance to meet similar offerings of competitors and to reduce bad debt risks are ordinary and necessary expenses of the loan business.³⁴⁵

The expenses of creating limited partnerships to purchase a corporation's goods are not ordinary and necessary expenses of the trade or business of selling those goods, because it is not a routine practice for a corporation to create and organize its own customers.³⁴⁶

Sickness, accident, and death benefits paid by a mutual benefit society to its members are ordinary and necessary expenses of operating the society's business of providing member benefits.³⁴⁷

c. Corporate Officers and Directors

A loss incurred by a corporate officer from selling stock at less than fair market value to key employees is not an ordinary expense of being a corporate officer.³⁴⁸ Nor is the cost or value of stock paid to sales representatives for selling corporate stock to raise the capital of a financially troubled corporation.³⁴⁹ Nor

³³³ *Jetty v. Commissioner*, 44 T.C.M. 373 (1982).

³³⁴ See *Noyce v. Commissioner*, 97 T.C. 670 (1991); *Marshall v. Commissioner*, 63 T.C.M. 1976 (1992); TAM 9330004, TAM 9330001.

³³⁵ *Noyce v. Commissioner*, 97 T.C. 670 (1991).

³³⁶ See *Campbell v. Commissioner*, 54 T.C.M. 632 (1987).

³³⁷ See *Waxler Towing Co. v. United States*, 510 F. Supp. 297 (W.D. Tenn. 1980).

³³⁸ See *Cooper v. Commissioner*, 74 T.C.M. 1089 (1997).

³³⁹ *Harrison v. Commissioner*, 41 T.C.M. 1384 (1981). See *J. Grant Farms, Inc. v. Commissioner*, 49 T.C.M. 1197 (1985).

³⁴⁰ *Stahl v. United States*, 861 F. Supp.2d 1226 (E.D. Wash. 2012), on remand from 626 F.3d 520 (9th Cir. 2010), rev'g & remanding 673 F. Supp.2d 1233 (E.D. Wash. 2009).

³⁴¹ Rev. Rul. 68-2, 1968-1 C.B. 61.

³⁴² *Love Box Co. v. Commissioner*, 842 F.2d 1213 (10th Cir. 1988), cert. denied, 488 U.S. 820 (1988), aff'g 49 T.C.M. 479 (1985).

³⁴³ See *Leo A. Daly Co. v. Vinal*, 69-1 USTC ¶9228 (D. Neb. 1968).

³⁴⁴ *Pepper v. Commissioner*, 36 T.C. 886 (1961), acq., 1962-19 C.B. 7.

³⁴⁵ See *Nichols Loan Corp. of Terre Haute v. Commissioner*, 321 F.2d 905 (7th Cir. 1963), rev'g 21 T.C.M. 805 (1962).

³⁴⁶ *Hoffman v. Commissioner*, 57 T.C.M. 51 (1989).

³⁴⁷ *Dante Alighieri Soc'y v. Commissioner*, 23 T.C.M. 1509 (1964).

³⁴⁸ *Berner v. United States*, 282 F.2d 720 (Ct. Cl. 1960).

³⁴⁹ *Hewett v. Commissioner*, 47 T.C. 483 (1967).

is the cost of bringing an action to prevent majority shareholders from selling corporate assets.³⁵⁰

Consulting fees paid by corporate officers in connection with their personal stock investments in the corporation are not ordinary and necessary expenses of being a corporate officer.³⁵¹ Payment by a corporate officer of the corporation's expenses is not an ordinary and necessary expense of being a corporate officer if the payment is made to protect the officer's investment in the corporation.³⁵²

A corporate director's expenses in compromising shareholder derivative suits are not ordinary and necessary expenses of being a director.³⁵³ Likewise, a director's expenses for promoting the business are not ordinary and necessary expenses of generating the director's fee.³⁵⁴

Example: T is a director of, and a major shareholder in, several corporations. His director's fees from all the corporations were \$6,000 in Year 1 and \$4,000 in Year 2. During Year 1 and Year 2, meetings of the various corporations were held in his home, in which officers, directors, or members of committees of the various corporations attended and were entertained by T. In Year 1, T flew to Europe on his own to determine why the sales of one of the corporation's products were below expectations. T claimed a deduction of \$44,000 for "business promotional expenses" on his income tax returns for each of Year 1 and Year 2. Because his director's fees were an insignificant portion of his total income, the expenditures claimed related primarily to T protecting his large investment in each corporation and only incidentally to protecting his director's fees. Therefore, they did not qualify as ordinary and necessary trade or business expenses of T. To the extent a corporation benefited from any expenditure, a corporation may have been able to deduct the expenditure if the corporation reimbursed T for the expenditure.³⁵⁵

d. Shareholder and Employee Taxes

In *Va. Nat'l Bank v. United States*, the Fourth Circuit held that payments made by a bank to its tax-exempt shareholders in lieu of paying a state tax on shares were dividends and not deductible §162 expenses because they were not ordinary and necessary expenses of carrying on the banking business, even though they were compulsory, because they were made to put the burden of the state tax on the tax-exempt shareholders.³⁵⁶ The Tax Court has held that payments by an employer of federal income taxes and employment taxes it fails to withhold from employees are not ordinary and necessary trade or business ex-

penses because they are paid to satisfy withholding obligations and not to conduct the trade or business.³⁵⁷ Yet 13 years later the IRS advised that an employer who pays the employment and other taxes on meal allowances paid to its employees may deduct those taxes because by paying them the employer protected employee morale, and that despite the position argued and upheld in the earlier case, "the more correct view" is to allow the deduction.³⁵⁸

Comment: Though the critical part of the IRS analysis in its advice is redacted, it appears that it distinguished the Tax Court case on the basis that the employer had undertaken on its own the obligation to pay the taxes.

e. Personal Purposes

Expenses paid by a hunting and fishing club for recreational programs are not ordinary and necessary expenses of carrying on a business.³⁵⁹ Ordinary and necessary expenses do not include:

- a restaurant corporation's costs of providing meals to shareholders' children,³⁶⁰
- a corporation's cost of providing a nurse to accompany a shareholder-employee who was recovering from surgery,³⁶¹
- a corporation's payment of medical, wardrobe, travel, gift, and entertainment expenses incurred by a shareholder for purposes not connected with the corporation's business,³⁶²
- a corporation's cost of obtaining loans the proceeds of which are immediately loaned to the shareholders,³⁶³
- a corporation's payment of educational expenses of a shareholder's child,³⁶⁴
- a corporation's payment for improvements to the homes of officer-shareholders,³⁶⁵
- a corporation's payment of legal fees incurred by a corporate officer in connection with the officer's personal residence,³⁶⁶
- a corporation's payment of a shareholder's insurance premiums,³⁶⁷
- a corporation's expenses of a Super Bowl trip subsequently characterized as a sales seminar but for which no business agenda had been established,³⁶⁸

³⁵⁷ *L & L Marine Serv., Inc. v. Commissioner*, 54 T.C.M. 312 (1987).

³⁵⁸ FSA 200025022.

³⁵⁹ *Five Lakes Outing Club v. United States*, 468 F.2d 443 (8th Cir. 1972), rev'g 71-2 USTC ¶ 9735 (E.D. Ark. 1971).

³⁶⁰ *Calamaras v. Commissioner*, 19 T.C.M. 1045 (1960).

³⁶¹ *Cummins Diesel Sales of Or., Inc. v. United States*, 321 F.2d 503 (9th Cir. 1963), aff'g 207 F. Supp. 746 (D. Ore. 1962).

³⁶² *Erhard Seminars Training v. Commissioner*, 52 T.C.M. 890 (1986).

³⁶³ *Oxford Dev. Corp. v. Commissioner*, 23 T.C.M. 1085 (1964).

³⁶⁴ *Caledonian Record Publ'g Co. v. United States*, 579 F. Supp. 449 (D. Vt. 1983).

³⁶⁵ *Am. Insulation Corp. v. Commissioner*, 50 T.C.M. 850 (1985).

³⁶⁶ *Davis v. Commissioner*, 78 T.C.M. 178 (1999).

³⁶⁷ *Falsetti v. Commissioner*, 85 T.C. 332 (1985).

³⁶⁸ *Danville Plywood Corp. v. United States*, 899 F.2d 3 (Fed. Cir. 1990), aff'g 16 Ct. Cl. 584 (1989).

³⁵⁰ *Ransburg v. United States*, 440 F.2d 1140 (10th Cir. 1971), aff'g 69-2 USTC ¶ 9582 (D. Kan. 1969).

³⁵¹ *Brinson v. Commissioner*, 42 T.C.M. 1712 (1981).

³⁵² *Van Hassent v. Commissioner*, 60 T.C.M. 1244 (1990). Cf. *Mortenson v. Commissioner*, 3 B.T.A. 300 (1926) (deduction allowed for payment by 28% shareholder of premiums on insurance policy covering corporation's sole asset).

³⁵³ *Graham v. Commissioner*, 40 T.C. 14 (1963), rev'd on other issues, 326 F.2d 878 (4th Cir. 1964).

³⁵⁴ *Nichols v. Commissioner*, T.C. Memo 1963-148.

³⁵⁵ *Nichols v. Commissioner*, T.C. Memo 1963-148.

³⁵⁶ 450 F.2d 1155 (4th Cir. 1971), cert. denied, 405 U.S. 1065 (1972), rev'g 321 F. Supp. 316 (E.D. Va. 1970).

- the costs of cigars, diapers, and garden tools claimed as medical supply expenses by an ophthalmology corporation,³⁶⁹
- interest on a promissory note executed as part of a settlement to repay a medical school scholarship,³⁷⁰ and
- a taxpayer's expenses of hiring a servant to cook, clean, and provide guard services.³⁷¹

The limitation on the deduction of personal expenses is discussed in 503 T.M., *Principles of Income Tax Deductions*.

D. Carrying On

1. In General

Trade or business expenses are not deductible unless they are paid or incurred in carrying on a trade or business.³⁷² Until the taxpayer is carrying on a trade or business (i.e., until the taxpayer's activity has actually commenced), the expenses are preparatory, start-up, or pre-opening costs that must be capitalized and recovered, if at all, through depreciation deductions, amortization deductions, or an optional but limited deduction in the year the business commences.³⁷³ So long as the business is not carried on but remains a mere expectation, no deductions are allowed under §162.³⁷⁴ The Fourth Circuit has summarized this timing-based requirement as follows:³⁷⁵

[E]ven though a taxpayer has made a firm decision to enter into business and over a considerable period of time spent money in preparation for entering that business, he has still not "engaged in carrying on any trade or business" within the intendment of section 162(a) until such time as the business has begun to function as a going concern and performed those activities for which it was organized.

The submission of a proposal by a newly formed corporation does not put the corporation into operational status if there are no additional investors, no income, no plan, no facilities, and no contracts.³⁷⁶ The Tax Court has held that no trade or business was being carried on where no activities were underway, no services were performed, no sales were conducted, and no income was earned.³⁷⁷ A similar conclusion was

reached where the taxpayers did not have customers and did not sell items.³⁷⁸ The capitalization requirement is discussed in 509 T.M., *Principles of Capitalization*. The amortization of start-up expenses is discussed in V.B., below.

2. Start-up Expenses in General

The pre-opening expenses of a newly formed corporation were not deductible under §162 because the corporation was not yet carrying on a trade or business, even though it was formed to continue the operations of an unsuccessful predecessor corporation.³⁷⁹

Observation: If the newly formed corporation in the above case were a sham, the expenses would be the predecessor's or shareholders' expenses. The predecessor would be allowed to deduct otherwise deductible expenses, but the shareholders would not, unless they were already carrying on the trade or business in their individual capacities. This situation is one in which the taxpayer, and not the IRS, argues that a corporation is a sham. The determination of which taxpayer is allowed to deduct an otherwise deductible expense is discussed in 503 T.M., *Principles of Income Tax Deductions*.

In contrast, even though a newly formed subsidiary's expenditures to sell memberships would be pre-opening expenses of a business not yet being carried on, if the subsidiary files a consolidated return with its parent and other subsidiaries engaged in the same trade or business, the expenses are treated as expenses of the trade or business being carried on by the group.³⁸⁰

Expenditures for the acquisition of territorial sublicenses for the distribution of a product are preparatory to the commencement of product sales and must be capitalized.³⁸¹ In *Juda v. Commissioner*, the Tax Court held that a partnership was required to capitalize, rather than deduct under §162, the fees paid to find investors in the patents that it was in the business of selling.³⁸² Likewise, a shareholder's expenses of promoting, developing, and financing a corporation's activities are not trade or business expenses because the corporation is not yet carrying on the activities.³⁸³ The expenses of an investment management corporation in starting new regulated investment companies are nondeductible start-up expenses if the corporation's right to manage those companies is indefinite and the expenses are similar to syndication costs.³⁸⁴ Payments made by an accountant to a public accounting firm for the right to take clients to a new practice are start-up expenses and not deductible under

³⁶⁹ *Bloomberg v. Commissioner*, 38 T.C.M. 206 (1979).

³⁷⁰ *Keane v. Commissioner*, 75 T.C.M. 2046 (1998).

³⁷¹ *Springmann v. Commissioner*, 54 T.C.M. 592 (1987).

³⁷² §162(a).

³⁷³ *Frank v. Commissioner*, 20 T.C. 511 (1953). See §195. See also *Estate of Morgan v. Commissioner*, T.C. Memo 2021-104 (citing *Weaver v. Commissioner*, T.C. Memo 2004-108); *Provitola v. Commissioner*, 859 Fed. Appx. 474 (11th Cir. 2021) (unpub. op.), cert. denied, No. 21-409, 2021 BL 388563 (U.S. Oct. 12, 2021) (professional fees paid during years at issue for designing, sourcing of materials, researching potential patent issues, and product testing to bring it to manufacturable state were more like capital expenditures, instead of ordinary and necessary expenses under §162, and thus, such start-up expenses could be amortized under §195 after business commences).

³⁷⁴ *Ellis v. Commissioner*, 26 T.C.M. 450 (1967). See *Forrest v. Commissioner*, T.C. Memo 2011-4.

³⁷⁵ *Richmond Television Corp. v. United States*, 345 F.2d 901, 907 (4th Cir. 1965), vacated and remanded on other grounds, 382 U.S. 68 (1965). See (citing *Richmond Television Corp.*, taxpayer was not carrying on a manufacturing or marketing business during years at issue given that it neither attempted to manufacture nor sell anything for which it was intended, and therefore, expenses claimed were not ordinary for §162 purposes).

³⁷⁶ *Willits v. Commissioner*, 78 T.C.M. 74 (1999).

³⁷⁷ *Haney v. Commissioner*, T.C. Memo 2007-238.

³⁷⁸ *Vianello v. Commissioner*, T.C. Memo 2010-17. See also *Wolfgram v. Commissioner*, T.C. Memo 2010-69.

³⁷⁹ *Bennett Paper Corp. v. Commissioner*, 699 F.2d 450 (8th Cir. 1983), aff'd 78 T.C. 458 (1982). See *Selig v. Commissioner*, 70 T.C.M. 1125 (1995); *Zards v. Commissioner*, 70 T.C.M. 1023 (1995).

³⁸⁰ See *Playboy Clubs Int'l, Inc. v. United States*, 76-2 USTC ¶ 9560 (N.D. Ill. 1976), aff'd in part, vac'd, in part, and rem'd, in part in unpub. op., 559 F.2d 1224 (7th Cir. 1977).

³⁸¹ *Jackson v. Commissioner*, 864 F.2d 1521 (10th Cir. 1989), aff'd 86 T.C. 492 (1986). See *Prod. House LP C-23 v. Commissioner*, T.C. Memo 1992-304, appeal dismissed (D.C. Cir. 1994).

³⁸² 90 T.C. 1263 (1988), aff'd, 877 F.2d 1075 (1st Cir. 1989).

³⁸³ *Brown v. Commissioner*, T.C. Memo 1983-291.

³⁸⁴ See *FMR Corp. v. Commissioner*, 110 T.C. 402 (1998).

§162.³⁸⁵ Expenses incurred to research new businesses to acquire are not deductible under §162.³⁸⁶

Comment: Under certain circumstances the start-up expenses may be deductible under §195, to a limited extent, in the tax year in which the business commences, as described in V.B., below. However, this deduction does not change the §162 non-deduction analysis.

3. Relationship to Trade or Business

Even though a taxpayer is carrying on a trade or business, expenses that are paid or incurred in carrying on some other activity are not deductible under §162.³⁸⁷ Thus, expenses paid by a corporate officer in prosecuting an action for slander are not paid or incurred in carrying on the trade or business of being employed as a corporate officer.³⁸⁸ Likewise, a bar and restaurant owner who incurred travel, meals, and lodging expenses while visiting other restaurants was not allowed to deduct the expenses under §162 because they were not incurred in carrying on the restaurant business.³⁸⁹ A nominee for the office of Vice President of the United States was not carrying on the trade or business of any previous office position when incurring nomination hearing expenses because each prospective term of office was a different trade or business.³⁹⁰

In *Rafter v. Commissioner*, the court held that an attorney who incurred expenses litigating on his own behalf was not permitted to deduct them under §162 because he was not practicing as an attorney, he received no income as an attorney, and the litigation was not a cost of rehabilitating his practice.³⁹¹ A public municipal official was not carrying on the functions of office when making a trip to South America merely because it was made under municipal auspices.³⁹² In contrast, the IRS has ruled that amounts paid to settle a claim that a taxpayer violated a covenant not to compete executed in connection with the taxpayer's sale of a business were connected with the carrying on of the taxpayer's trade or business and not the sale.³⁹³

³⁸⁵ *Haas & Assocs. Accountancy Corp. v. Commissioner*, T.C. Memo 2000-183, aff'd by unpub. op., 55 Fed. Appx. 476 (9th Cir. 2003).

³⁸⁶ *Estate of Morgan v. Commissioner*, T.C. Memo 2021-104 (“[P]etitioners cannot squeeze into section 162 and avoid section 195 by claiming that [the taxpayer's] trade or business was searching for a trade or business.”).

³⁸⁷ *Mack v. Commissioner*, T.C. Memo 1976-359. Compare *Morton v. United States*, 98 Fed. Cl. 596 (Fed. Cl. 2011) (where “unified business enterprise” existed, taxpayer could deduct expenses of operating airplane if use of airplane furthered business purpose of taxpayer's other related entities) with *Steinberger v. Commissioner*, T.C. Memo 2016-104 (unlike in *Morton* where because taxpayer was at least majority shareholder of each related entity, thereby allowing him to create “unified business enterprise,” *Steinberger* taxpayer had no such control over both entities involved, and therefore, could not unite airplane and medical practice activities into serving same business purpose).

³⁸⁸ *Lloyd v. Commissioner*, 55 F.2d 842 (7th Cir. 1932), aff'd 22 B.T.A. 674 (1931).

³⁸⁹ *Mack v. Commissioner*, T.C. Memo 1976-359.

³⁹⁰ *Estate of Rockefeller v. Commissioner*, 762 F.2d 264 (2d Cir. 1985), cert. denied, 474 U.S. 1037 (1985), aff'd 83 T.C. 368 (1984).

³⁹¹ 60 T.C. 1 (1973), aff'd, 489 F.2d 752 (2d Cir. 1974), cert. denied, 419 U.S. 826 (1974).

³⁹² *Green v. Bookwalter*, 319 F.2d 631 (8th Cir. 1963), aff'd 207 F. Supp. 866 (W.D. Mo. 1962).

³⁹³ PLR 200127022.

4. Suspension of Operations

Suspension of operations does not mean business is terminated or that expenses paid or incurred during the suspension necessarily must be capitalized as pre-opening expenses.³⁹⁴ Thus, business expenses paid by a taxpayer engaged in selling jewelry were not disallowed merely because they were paid during a period for which the taxpayer had no inventory.³⁹⁵ The same principle applies if the business is suspended while the taxpayer arranges for the acquisition of new assets.³⁹⁶

In contrast, a taxpayer was not carrying on a trade or business where the taxpayer terminated active business operations in order to attend school in connection with a related field.³⁹⁷ Likewise, a taxpayer ceased carrying on a homebuilding trade or business when the homebuilding activity stopped and a receiver was appointed to liquidate the business's assets.³⁹⁸

E. Paid or Incurred During the Tax Year

Any otherwise deductible trade or business expense of a cash method taxpayer is not deductible in any tax year other than the year in which it is paid.³⁹⁹ A similar principle restricts accrual method taxpayers' trade or business deductions to the tax year in which they are incurred.⁴⁰⁰ The impact of the timing rules on deductions is discussed in 503 T.M., *Principles of Income Tax Deductions*. The timing rules are discussed in 570 T.M., *Accounting Methods — General Principles*.

The fact that otherwise deductible trade or business expenses paid during the tax year exceed gross income from the trade or business does not preclude the deduction.⁴⁰¹ This is so even if the trade or business generates no gross income.⁴⁰² The deductibility of any resulting net operating loss is discussed in IV.P., below.

Otherwise deductible trade or business expenses of a cash method taxpayer paid during a tax year but relating to previous years' activities are deductible in the year paid even though the business to which they relate no longer is being carried on.⁴⁰³

³⁹⁴ *Helis v. United States*, 74-1 USTC ¶9167 (E.D. La. 1973), aff'd, 496 F.2d 1319 (5th Cir. 1974), on remand from 464 F.2d 330 (5th Cir. 1972), rev'd 71-1 USTC ¶9365 (E.D. La. 1971).

³⁹⁵ *Haft v. Commissioner*, 40 T.C. 2 (1963).

³⁹⁶ *Ravano v. Commissioner*, T.C. Memo 1967-170.

³⁹⁷ *Canter v. United States*, 173 Ct. Cl. 723 (1965).

³⁹⁸ *Estate of Morgan v. Commissioner*, T.C. Memo 2021-104.

³⁹⁹ See *Carlisle v. Commissioner*, 37 T.C. 424 (1961) (legal fees); *Heyman v. Commissioner*, 70 T.C. 482 (1978), aff'd, 652 F.2d 598 (6th Cir. 1980); see also *Brown v. Commissioner*, T.C. Memo 2017-18 (no wage deduction for year in which business did not exist); *Slavin v. Commissioner*, T.C. Summ. Op. 2016-28 (2016) (no deduction for capitalized mortgage interest); *Bodine v. Commissioner*, 37 T.C.M. 1411 (1978) (educational expenses); *Jove v. Commissioner*, 34 T.C.M. 710 (1975) (advances); *Kenner v. Commissioner*, 33 T.C.M. 1239 (1974), on remand, 445 F.2d 19 (7th Cir. 1971), rev'd 27 T.C.M. 893 (1968) (loan fee).

⁴⁰⁰ *Anderson v. Commissioner*, 35 T.C.M. 101 (1976), aff'd in unpub. op. (9th Cir. Feb. 6, 1979).

⁴⁰¹ *Anderson v. Commissioner*, 11 T.C.M. 384 (1952).

⁴⁰² *Markovits v. Commissioner*, 11 T.C.M. 823 (1952).

⁴⁰³ Rev. Rul. 67-12.

III. For-Profit Activity Deductions Generally

A. In General

Under §212, individuals are allowed to deduct ordinary and necessary expenses paid or incurred during the tax year for the production or collection of income, for the management, conservation, or maintenance of property held for the production of income, or in connection with the determination, collection, or refund of any tax.⁴⁰⁴ This general rule is subject to the limitations that apply to deductions generally, as described in 503 T.M., *Principles of Income Tax Deductions*.⁴⁰⁵

Deductions under §212 are not allowed to partnerships,⁴⁰⁶ nor are they allowed to corporations.⁴⁰⁷

The foundational aspects of §212 are described in III.B. through III.G., below, and the application of §212 to legal and accounting fees is discussed in 523 T.M., *Deductibility of Legal and Other Professional Fees*. The application of §212 to specific types of for-profit activity expenses is discussed in IV., below.

B. Lack of Trade or Business

There is no requirement that a trade or business be carried on for a deduction to be allowed under §212.⁴⁰⁸ The §212 deduction is not subject to the §195 start-up expense limitations simply because the taxpayer anticipates that eventually the for-profit activity will become a trade or business.⁴⁰⁹

Comment: If, in fact, a trade or business is being carried on, the determination of whether any deduction is allowable is made under §162.

However, no deduction is allowed under §212 for personal expenditures.⁴¹⁰ Thus, life insurance premiums are not deductible under §212.⁴¹¹ The deductibility of life insurance premiums as trade or business expenses is described in IV.E.2.c., below, and is discussed in 386 T.M., *Insurance-Related Compensation*. No deduction is allowed for bank service charges on personal checking accounts, even if the account earns interest.⁴¹² The costs of defending RICO charges giving rise to

claims against the taxpayer's property are not deductible under §212.⁴¹³

The nondeductibility of personal expenditures is discussed in 503 T.M., *Principles of Income Tax Deductions*.

C. Pre-Opening Expenses

Although there is no explicit carrying on requirement in §212 as there is in §162, expenses are not deductible under §212 if they are paid or incurred in preparing for the activity that would justify a deduction.⁴¹⁴ Expenses are deductible under §212 only after the activity is underway.⁴¹⁵ Until the taxpayer is carrying on the activity that justifies the §212 deductions, the expenses are preparatory, start-up, or pre-opening costs that must be capitalized and recovered, if at all, through depreciation or amortization deductions.⁴¹⁶ The capitalization requirement is discussed in 509 T.M., *Principles of Capitalization*. The amortization of start-up expenses is discussed in V.B., below.

D. Production of Income

1. Income Motive

a. In General

Whether an activity involves the production of income and whether a taxpayer holds property for the production of income are questions of fact.⁴¹⁷ The determination is not unlike that made with respect to the profit motive that is a prerequisite to the existence of a trade or business,⁴¹⁸ as described in II.B.2., above. Section 183 provides statutory presumptions with respect to the question of whether an activity is engaged in by the taxpayer for profit.⁴¹⁹ Under §183, deductions are allowed to the extent the property actually produces income,⁴²⁰ regardless of whether it is held for the production of income.⁴²¹

The §183 presumptions and the §183 deduction limitation computations are discussed in 503 T.M., *Principles of Income Tax Deductions*, and in 548 T.M., *Hobby Losses*.

⁴⁰⁴ §212.

⁴⁰⁵ Reg. §1.212-1(e).

⁴⁰⁶ §703(a)(2)(E); *Seese v. Commissioner*, 7 T.C. 925 (1946); *Nitzberg v. Commissioner*, 34 T.C.M. 707 (1975), rev'd on other issues, 580 F.2d 357 (9th Cir. 1978).

⁴⁰⁷ *Richmond Television Corp. v. United States*, 345 F.2d 901 (4th Cir. 1965), rev'g 18 AFTR2d 5077 (E.D. Va. 1963), rem'd on other issues, 382 U.S. 68 (1965); *NCNB Corp. v. United States*, 684 F.2d 285 (4th Cir. 1982); *KWTX Broad. Co. v. Commissioner*, 31 T.C. 952, aff'd on other grounds, 272 F.2d 406 (5th Cir. 1959).

⁴⁰⁸ §212.

⁴⁰⁹ *Toth v. Commissioner*, 128 T.C. 1 (2007).

⁴¹⁰ Reg. §1.212-1(f).

⁴¹¹ See *Carbine v. Commissioner*, 777 F.2d 662 (11th Cir. 1985), aff'g 83 T.C. 356 (1984); *United States v. Mellinger*, 228 F.2d 688 (5th Cir. 1956), rev'g 54-1 USTC ¶9197 (S.D. Tex. 1953); *Meyer v. United States*, 175 F.2d 45 (2d Cir. 1949), aff'g 80 F. Supp. 933 (S.D.N.Y. 1948); *Whitaker v. Commissioner*, 34 T.C. 106 (1960); *O'Donohue v. Commissioner*, 33 T.C. 698 (1960); *Estate of Hall v. Commissioner*, 17 T.C. 20 (1951); *Leslie v. Commissioner*, 6 T.C. 488 (1946); *Ferguson v. Commissioner*, 46 T.C.M. 1598 (1983).

⁴¹² Rev. Rul. 82-59.

⁴¹³ *Accardo v. Commissioner*, 94 T.C. 96 (1990), aff'd, 942 F.2d 444 (7th Cir. 1991).

⁴¹⁴ *Sorrell v. Commissioner*, 882 F.2d 484 (11th Cir. 1989), rev'g 53 T.C.M. 1362 (1987); *Lewis v. Commissioner*, 861 F.2d 1232 (10th Cir. 1988), rev'g 51 T.C.M. 868 (1986); *Johnsen v. Commissioner*, 794 F.2d 1157 (6th Cir. 1986), rev'g 83 T.C. 103 (1984); *Hardy v. Commissioner*, 93 T.C. 684 (1989), aff'd on this issue and rem'd on other issues in unpub. opin. (10th Cir. 1990), on remand, 61 T.C.M. 2500 (1991).

⁴¹⁵ *Sorrell v. Commissioner*, 882 F.2d 484 (11th Cir. 1989), rev'g 53 T.C.M. 1362 (1987).

⁴¹⁶ *Sorrell v. Commissioner*, 882 F.2d 484 (11th Cir. 1989), rev'g 53 T.C.M. 1362 (1987); *Hardy v. Commissioner*, 93 T.C. 684 (1989), aff'd on this issue and rem'd on other issues in unpub. opin. (10th Cir. 1990), on remand, 61 T.C.M. 2500 (1991).

⁴¹⁷ E.g., *Nelson v. Commissioner*, 37 T.C.M. 1204 (1978).

⁴¹⁸ E.g., *Gorod v. Commissioner*, 42 T.C.M. 1569 (1981); *Markward v. Commissioner*, 37 T.C.M. 1306 (1978); *Daniel v. Commissioner*, 37 T.C.M. 1180 (1978); *Mayes v. United States*, 87-2 USTC ¶9478 (W.D. Mo. 1986).

⁴¹⁹ §183(d).

⁴²⁰ §183(b).

⁴²¹ E.g., *Eisenstein v. Commissioner*, 37 T.C.M. 441 (1978); Rev. Rul. 75-14.

b. Factual Nature of Determination

Certain factors tend to support the conclusion that an income motive exists. Other factors tend to support the conclusion that an income motive does not exist. The absence of one or more factors that indicate the existence of an income motive does not preclude a determination that an income motive exists if other such factors are present.⁴²² Similarly, the presence of factors indicating the lack of an income motive does not preclude a determination that an income motive exists if there also exist factors indicating the existence of an income motive that outweigh the contradictory factors.⁴²³

Occasionally, one factor can be the difference between a finding of an income motive and a contrary conclusion. In *Gorod v. Commissioner*, the court held that property was held for the production of income even though the taxpayer was unable to find a tenant for the property because the crime rate had increased significantly.⁴²⁴ Yet in a later case involving the same taxpayer for a subsequent tax year,⁴²⁵ the court held that the taxpayer ceased to hold the property for the production of income when the taxpayer boarded up the property.⁴²⁶

c. Factors Indicating Income Motive

The factors indicating an income motive exists include the following:

- carrying on activity in businesslike manner;⁴²⁷
- acquiring expertise through extensive study of accepted industry practices and by consulting with experts;⁴²⁸
- advertising property for rent;⁴²⁹
- consistent efforts to generate income;⁴³⁰
- devoting substantial time to activity;⁴³¹
- expenditures to maintain property in income-generating condition;⁴³²
- intention to operate the property in a manner that produces income;⁴³³
- intention to resell property at a profit (i.e., property that will appreciate in value);⁴³⁴

⁴²² See, e.g., *Calbom v. Commissioner*, 41 T.C.M. 1009 (1981).

⁴²³ E.g., *Mayes v. United States*, 87-2 USTC ¶ 9478 (W.D. Mo. 1986).

⁴²⁴ 42 T.C.M. 1569 (1981). See also *Subt v. Commissioner*, 64 T.C.M. 417 (1992).

⁴²⁵ *Gorod v. Commissioner*, 49 T.C.M. 526 (1985), aff'd, 787 F.2d 578 (1st Cir. 1986).

⁴²⁶ *Id.* at 528.

⁴²⁷ See Reg. §1.183-2(b)(1); e.g., *Dishal v. Commissioner*, 76 T.C.M. 793 (1998); *Westphal v. Commissioner*, 68 T.C.M. 1038 (1994); *Krebs v. Commissioner*, 63 T.C.M. 2413 (1992).

⁴²⁸ See Reg. §1.183-2(b)(2); e.g., *Westphal v. Commissioner*, 68 T.C.M. 1038 (1994).

⁴²⁹ E.g., *Gorod v. Commissioner*, 42 T.C.M. 1569 (1981).

⁴³⁰ See Reg. §1.183-2(b)(3); e.g., *Fitch v. Commissioner*, T.C. Memo 2012-358; *Dishal v. Commissioner*, 76 T.C.M. 793 (1998); *Foster v. Commissioner*, 60 T.C.M. 466 (1990); *Nelson v. Commissioner*, 37 T.C.M. 1204 (1978); *Sherlock v. Commissioner*, 31 T.C.M. 383 (1972).

⁴³¹ E.g., *Krebs v. Commissioner*, 63 T.C.M. 2413 (1992).

⁴³² E.g., *Gorod v. Commissioner*, 42 T.C.M. 1569 (1981).

⁴³³ E.g., *Kaonis v. Commissioner*, 37 T.C.M. 792 (1978), aff'd by unpub. op., 639 F.2d 788 (9th Cir. 1981).

- history of converting similar activities from unprofitable to profitable enterprises;⁴³⁵
- pattern of investing in same type of property;⁴³⁶
- series of years in which net income is realized;⁴³⁷
- potential meaningful and substantial amounts of profit (especially in highly speculative ventures);⁴³⁸
- substantial likelihood of future profits;⁴³⁹
- activity is sole or principal source of income for taxpayer;⁴⁴⁰
- lack of personal or recreational use or motive;⁴⁴¹ and
- minimal personal use of property.⁴⁴²

d. Factors Indicating Not Held for Production of Income

The factors indicating an income motive does not exist include the following:

- lack of substantial business records, a separate bank account, a business plan, a marketing strategy, or signed/enforced contractual obligations;⁴⁴³
- failure to obtain information about operations;⁴⁴⁴
- lack of control over operations;⁴⁴⁵
- failure to advertise;⁴⁴⁶
- lack of effort to rent property;⁴⁴⁷
- failure to inquire about potential profitability with seller;⁴⁴⁸
- purchasing property for prices vastly above the manufacturing costs without negotiation;⁴⁴⁹
- charging rent at rates substantially below fair market rates;⁴⁵⁰
- failure to charge rent;⁴⁵¹

⁴³⁴ See Reg. §1.183-2(b)(4); e.g., *Markward v. Commissioner*, 37 T.C.M. 1306 (1978).

⁴³⁵ See Reg. §1.183-2(b)(5)

⁴³⁶ E.g., *Nelson v. Commissioner*, 37 T.C.M. 1204 (1978).

⁴³⁷ See Reg. §1.183-2(b)(6)

⁴³⁸ See Reg. §1.183-2(b)(7).

⁴³⁹ E.g., *De Boer v. Commissioner*, 71 T.C.M. 2730 (1996).

⁴⁴⁰ See Reg. §1.183-2(b)(8).

⁴⁴¹ See Reg. §1.183-2(b)(9); e.g., *Gorod v. Commissioner*, 42 T.C.M. 1569 (1981).

⁴⁴² E.g., *Nelson v. Commissioner*, 37 T.C.M. 1204 (1978).

⁴⁴³ See Reg. §1.183-2(b)(1); e.g., *Olsen v. Commissioner*, T.C. Memo 2021-41, aff'd, 52 F.4th 889 (10th Cir. 2022).

⁴⁴⁴ E.g., *Collins v. Commissioner*, T.C. Memo 2011-37.

⁴⁴⁵ E.g., *Nickeson v. Commissioner*, 962 F.2d 973, 977 (10th Cir. 1992).

⁴⁴⁶ E.g., *Hawthorne v. Commissioner*, 77 T.C.M. 1330 (1999).

⁴⁴⁷ E.g., *Towles v. Commissioner*, 78 T.C.M. 40 (1999); *Jackson v. Commissioner*, 66 T.C.M. 1047 (1993); *Cobb v. Commissioner*, 62 T.C.M. 408 (1991); *Nicath Realty Co., Inc. v. Commissioner*, 25 T.C.M. 1260 (1966).

⁴⁴⁸ E.g., *Nickeson v. Commissioner*, 962 F.2d 973, 977 (10th Cir. 1992).

⁴⁴⁹ See Reg. §1.183-2(b)(4); e.g., *Olsen v. Commissioner*, T.C. Memo 2021-41, aff'd, 52 F.4th 889 (10th Cir. 2022); *Nickeson v. Commissioner*, 962 F.2d 973, 977 (10th Cir. 1992).

⁴⁵⁰ E.g., *Eisenstein v. Commissioner*, 37 T.C.M. 441 (1978); *Nicath Realty Co. v. Commissioner*, 25 T.C.M. 1260 (1966).

- charging rent solely to alleviate financial burden of maintaining property being offered for sale;⁴⁵²
- property not suitable for activities generating income;⁴⁵³
- property requires extensive effort, further investment, and new expert hires before being suitable for generating income;⁴⁵⁴
- history of unprofitable operation;⁴⁵⁵
- substantial income from other sources;⁴⁵⁶
- investor marketing materials focus on expected tax benefits;⁴⁵⁷
- use of nonrecourse debt;⁴⁵⁸
- personal use of property;⁴⁵⁹ and
- acquisition of property as personal favor.⁴⁶⁰

Section 183 is discussed in 503 T.M., *Principles of Income Tax Deductions*, and 548 T.M., *Hobby Losses*.

2. Income

Deductions under §212 are allowed for the ordinary and necessary expenses of producing or collecting income which, if and when realized, is required to be included in gross income,⁴⁶¹ and for the ordinary and necessary expenses of managing, conserving, or maintaining property held for the production of such income.⁴⁶² For purposes of §212, property is considered held for the production of income if income is realized during the tax year, or if income was realized in a previous tax year or may be realized in a subsequent tax year.⁴⁶³ Property is considered held for the production of income not only if it produces recurring income, but also if gain is produced from the disposition of the property.⁴⁶⁴ Gross income is discussed in 501 T.M., *Gross Income: Overview and Conceptual Aspects*.

Thus, ordinary and necessary expenses paid or incurred with respect to bonds held for anticipated gain on resale are deductible under §212 even if the bonds are defaulted and no interest is being paid.⁴⁶⁵ Likewise, ordinary and necessary expenses

paid or incurred to maintain property held for the production of rent are deductible under §212 even if the property is vacant and not producing rent.⁴⁶⁶

Expenses paid or incurred in managing, conserving, or maintaining property held for investment are deductible under §212 even though the property is not currently productive and there is no likelihood that the property will be sold at a profit or otherwise produce income and even though the property is held merely to minimize a loss with respect to it.⁴⁶⁷

However, expenses incurred to determine or contest a liability are not deductible merely because property held by the individual for the production of income may be used or sold to satisfy the liability.⁴⁶⁸ Thus, the costs of defending RICO charges giving rise to claims against the taxpayer's property were not deductible under §212.⁴⁶⁹

E. Ordinary and Necessary

Expenses are not deductible under §212 except to the extent they are reasonable in amount and bear a reasonable and proximate relation to the production or collection of taxable income or to the management, conservation, or maintenance of property held for the production of income.⁴⁷⁰ Thus, in *Strickland v. Commissioner*,⁴⁷¹ the Tax Court sustained the disallowance of deductions under §212 because the taxpayer failed to demonstrate why 80 trips to rental property at a cost of \$11,000 was necessary to generate \$1,653 of income.⁴⁷² Interest paid by an estate on deferred legacies was held not to be ordinary and necessary because it was incurred only because the executors, rather than complying with the directive to pay the legacies with trust assets, transferred those assets to a foundation.⁴⁷³ In contrast, a trust beneficiary who was required to compensate other beneficiaries and the trustee for bad faith objections to the trustee's accounting was permitted to deduct those payments as ordinary and necessary expenses of attempting to maximize the amount of income paid by the trust to the beneficiary.⁴⁷⁴

⁴⁵¹ *E.g., Olsen v. Commissioner*, T.C. Memo 2021-41, aff'd, 52 F.4th 889 (10th Cir. 2022) (charging rent only if and when the property begins producing revenue); *Hirschel v. Commissioner*, 41 T.C.M. 1298 (1981), aff'd in unpub. op., 685 F.2d 424 (2d Cir. 1982).

⁴⁵² *E.g., Saunders v. Commissioner*, 83 T.C.M. 1795 (2002), aff'd, 75 Fed. Appx. 494 (6th Cir. 2003).

⁴⁵³ *E.g., Houle v. Commissioner*, 50 T.C.M. 603 (1985).

⁴⁵⁴ *E.g., Olsen v. Commissioner*, T.C. Memo 2021-41, aff'd, 52 F.4th 889 (10th Cir. 2022).

⁴⁵⁵ Reg. §1.183-2(b)(6).

⁴⁵⁶ Reg. §1.183-2(b)(8).

⁴⁵⁷ *E.g., Nickeson v. Commissioner*, 962 F.2d 973, 977 (10th Cir. 1992).

⁴⁵⁸ *E.g., Nickeson v. Commissioner*, 962 F.2d 973, 977 (10th Cir. 1992).

⁴⁵⁹ Reg. §1.183-2(b)(9); *e.g., Jackson v. Commissioner*, 66 T.C.M. 1047 (1993); *Houle v. Commissioner*, 50 T.C.M. 603 (1985); *Marx v. Commissioner*, 8 T.C.M. 55 (1949), aff'd, 179 F.2d 938 (1st Cir. 1950), cert. denied, 339 U.S. 964 (1950).

⁴⁶⁰ *E.g., Jackson v. Commissioner*, 708 F.2d 1402 (9th Cir. 1983), aff'd in part and rev'd in part 42 T.C.M. 1413 (1981).

⁴⁶¹ Reg. §1.212-1(a)(1)(i). *E.g., Commissioner v. Doering*, 335 F.2d 738 (2d Cir. 1964), aff'd 39 T.C. 647 (19), *nonacq.*, 1969-1 C.B. 22.

⁴⁶² Reg. §1.212-1(a)(1)(ii).

⁴⁶³ Reg. §1.212-1(b).

⁴⁶⁴ *Id.*

⁴⁶⁵ *Id.*

⁴⁶⁶ *Id. E.g., Coors v. Commissioner*, 60 T.C. 368 (1973), *Adolph Coors Co. v. Commissioner*, 519 F.2d 1280 (10th Cir. 1975), cert. denied, 423 U.S. 1087 (1976); *Goddard v. Commissioner*, 21 T.C.M. 419 (1962); *Wachter v. United States*, 75-1 USTC ¶9172 (W.D. Wash. 1974); *Hartford v. United States*, 265 F. Supp. 86 (W.D. Wis. 1967); *Drown v. United States*, 203 F. Supp. 514 (S.D. Cal. 1962), rev'd on other grounds, 328 F.2d 314 (9th Cir. 1964). See *Meinhardt v. Commissioner*, 766 F.3d 917 (8th Cir. 2014) (taxpayer failed to prove property held for profit, rather than personal use, because they did nothing to generate revenue and had no credible plan for operating it profitably in the future).

⁴⁶⁷ Reg. §1.212-1(b).

⁴⁶⁸ Reg. §1.212-1(m).

⁴⁶⁹ *Accardo v. Commissioner*, 94 T.C. 96 (1990), aff'd, 942 F.2d 444 (7th Cir. 1991).

⁴⁷⁰ Reg. §1.212-1(d); see, *e.g.*, CCA 202053010 (premiums paid toward policy regarding conservation easement are not deductible under §212(1) or §212(2); policy — and thus its premium — is unrelated to any income-producing activity of taxpayer; neither the deduction itself, nor any insurance payout for its disallowance, arises as a result of any purported investment activity, or is correlated to the success or failure of such activity).

⁴⁷¹ 43 T.C.M. 1061 (1982).

⁴⁷² 43 T.C.M. 1061 at 1063.

⁴⁷³ *Schwan v. Commissioner*, 264 F. Supp.2d 887 (D. S.D. 2003).

⁴⁷⁴ *DiLeonardo v. Commissioner*, 79 T.C.M. 1820 (2000).

F. Particular Endeavors

1. Fiduciary Activities

a. Trusts and Estates

If a fiduciary is not carrying on a trade or business on behalf of a trust or estate, the fact that deductions are not allowable under §162 does not preclude §212 deductions.⁴⁷⁵ Deductions are allowed under §212 for reasonable amounts paid or incurred by the fiduciary of an estate or trust on account of administration expenses, fiduciaries' fees, and litigation expenses that are ordinary and necessary in connection with the performance of the fiduciary's duties,⁴⁷⁶ except to the extent the expenses are allocable to tax-exempt income.⁴⁷⁷

The costs of distributing the corpus of a trust to its beneficiaries is an expense of managing property held for the production of income and is deductible under §212.⁴⁷⁸ Amounts paid by the trust to resist beneficiaries' attempts to accelerate receipt of their interests are deductible.⁴⁷⁹ However, deductions are not allowed for personal expenses of the fiduciary.⁴⁸⁰

Deductions allowable to trusts and estates are discussed in 852 T.M., *Income Taxation of Trusts and Estates* (Estates, Gifts, and Trusts Series).

b. Guardianships

Deductions are allowed under §212 for reasonable amounts paid or incurred for the services of a guardian or committee for a ward or minor, and other ordinary and necessary expenses of guardians and committees paid or incurred in connection with the production or collection of income inuring to the ward or minor, or in connection with the management, conservation, or maintenance of property held for the production of income belonging to the ward or minor.⁴⁸¹ Commissions, legal fees, and court fees paid by a ward with respect to the approval of the guardian's final account upon attaining majority are deductible by the ward under §212.⁴⁸² Expenses of appointing a committee to care for an incompetent are deductible,⁴⁸³ as are expenses paid by the committee to seek state court instructions on the making of an election against a will.⁴⁸⁴

c. Beneficiaries

Amounts paid by a trust beneficiary for legal and investigative expenses in order to increase the beneficiary's share of

trust income are deductible under §212.⁴⁸⁵ Amounts paid by a beneficiary to recover income lost through a trustee's misconduct are also deductible.⁴⁸⁶ Amounts paid by a beneficiary to obtain a construction of a will or to reach a settlement of an estate that increases the beneficiary's share of trust or other income are deductible under §212.⁴⁸⁷ However, amounts paid to obtain life insurance proceeds are not deductible because the proceeds are excluded from gross income under §101.⁴⁸⁸ Likewise, legal expenses paid to protect or assert rights to property, in contrast to income, as an heir or legatee are not deductible under §212.⁴⁸⁹

d. Business Trustees

Expenses paid by the administrator of a partnership estate created under state law by the death of a partner are deductible under §212 to the extent they are reasonable and approved by a state court.⁴⁹⁰ So, too, are expenses paid by trustees appointed by a state insurance superintendent to administer the assets of an insolvent title and mortgage company.⁴⁹¹ Expenses paid by a trustee in bankruptcy for the management, conservation, or maintenance of property held for the production of income are deductible under §212.⁴⁹²

2. Publishing

Deductions have been allowed under §212 for payments by authors to attorneys to handle the author's literary affairs, even if no trade or business was being carried on by the author.⁴⁹³ Deductions also have been allowed for the cost of printing a booklet that the taxpayer attempted to sell at a profit.⁴⁹⁴

3. Electioneering and Other Political Activity

No deduction is allowed under §212 for the cost of being elected to a public office⁴⁹⁵ or to a union official position.⁴⁹⁶ The costs of obtaining signatures on a political petition are not deductible.⁴⁹⁷

In Rev. Rul. 60-366, the IRS ruled that the North Carolina primary filing fee is not deductible,⁴⁹⁸ but in *Nichols v. United*

⁴⁸⁵ *Mann v. Commissioner*, 24 T.C.M. 855 (1965).

⁴⁸⁶ *Geary v. Commissioner*, 9 T.C. 8 (1947), *acq.*, 1947-2 C.B. 2; *Barr v. Commissioner*, 57 T.C.M. 1261 (1989).

⁴⁸⁷ *Tyler v. Commissioner*, 6 T.C. 135 (1946), *acq.*, 1946-1 C.B. 4; *Sneed v. Commissioner*, 12 T.C.M. 711 (1953), *aff'd* on other issues, 220 F.2d 313 (5th Cir. 1955).

⁴⁸⁸ *Commissioner v. Burgwin*, 277 F.2d 395 (3d Cir. 1960), *rev'g* 31 T.C. 981 (1959), *nonacq.*, 1964-2 C.B. 8.

⁴⁸⁹ *E.g.*, *Grabien v. Commissioner*, 48 T.C. 750 (1967); *Looby v. Commissioner*, 71 T.C.M. 2924 (1996).

⁴⁹⁰ *See Farris v. Commissioner*, 22 T.C. 104 (1954), *rev'd* on other grounds, 222 F.2d 320 (10th Cir. 1955), *acq.*, 1954-2 C.B. 4.

⁴⁹¹ *Trustees of Series Q, Grp. Certificates of N.Y. Title & Mortg. Co. v. Commissioner*, 2 T.C. 990 (1943), *rem'd* pursuant to stipulation (2d Cir. Apr. 26, 1945), *acq.*, 1944 C.B. 21.

⁴⁹² Rev. Rul. 68-48.

⁴⁹³ *E.g.*, *Wodehouse v. Commissioner*, 8 T.C. 637 (1947), *rev'd* on other issues, 166 F.2d 986 (4th Cir. 1948), *rev'd* on other issues, 337 U.S. 369 (1949).

⁴⁹⁴ *Crymes v. Commissioner*, 31 T.C.M. 4 (1972).

⁴⁹⁵ *Hakim v. Commissioner*, 33 T.C.M. 223 (1974), *aff'd*, 512 F.2d 1379 (6th Cir. 1975); *Fearey v. Commissioner*, 43 T.C.M. 726 (1982); *Moreland v. Commissioner*, 19 T.C.M. 938 (1960).

⁴⁹⁶ *Vernon v. Commissioner*, 18 T.C.M. 851 (1959), *aff'd*, 286 F.2d 173 (9th Cir. 1961).

⁴⁹⁷ *Washburn v. Commissioner*, 283 F.2d 839 (8th Cir. 1960), *cert. denied*, 365 U.S. 844 (1961), *aff'g* 33 T.C. 1003 (1960).

⁴⁹⁸ 1960-2 C.B. 63-65, *revoking* Rev. Rul. 57-345, 1957-2 C.B. 132.

⁴⁷⁵ Reg. §1.212-1(i).

⁴⁷⁶ Reg. §1.212-1(i). *E.g.*, *Commissioner v. Burrow Trust*, 333 F.2d 66 (10th Cir. 1964), *aff'g* 39 T.C. 1080 (1963), *acq.*, 1965-2 C.B. 4.

⁴⁷⁷ Reg. §1.212-1(i). *E.g.*, *Whittemore v. United States*, 383 F.2d 824 (8th Cir. 1967), *rev'g* 257 F. Supp. 1008 (E.D. Mo. 1966); *Estate of O'Connor v. Commissioner*, 69 T.C. 165 (1977); *Di Borgo v. Commissioner*, 23 T.C. 76 (1954). *See Case v. United States*, 66-2 USTC ¶9764 (D. Wyo. 1966).

⁴⁷⁸ *Trust Under the Will of Bingham v. Commissioner*, 325 U.S. 365 (1945), *rev'g* 145 F.2d 568 (2d Cir. 1944), *rev'g* 2 T.C. 853 (1943), *acq.*, 1945 C.B. 2.

⁴⁷⁹ *Moore Trust v. Commissioner*, 49 T.C. 430 (1968), *acq.*, 1968-2 C.B. 2.

⁴⁸⁰ *Estate of Fuller v. Commissioner*, 9 T.C. 1069 (1947), *aff'd*, 171 F.2d 704 (3d Cir. 1948), *cert. denied*, 336 U.S. 961 (1949).

⁴⁸¹ Reg. §1.212-1(j).

⁴⁸² *Spears v. Gagne*, 49 F. Supp. 263 (D.N.H. 1943).

⁴⁸³ *Estate of Weil v. Commissioner*, 13 T.C.M. 653 (1954).

⁴⁸⁴ *Kohnstamm v. Pedrick*, 66 F. Supp. 410 (S.D.N.Y. 1946).

States,⁴⁹⁹ a district court reached the opposite result with respect to Georgia primary filing fees. Filing fees paid to political parties in connection with entering a primary election are not deductible under §212.⁵⁰⁰

G. Determination, Collection, or Refund of Any Tax

1. In General

For tax years beginning after 2017, miscellaneous itemized deductions under §212 for expenses for the production of income are disallowed unless they are deductible above the line, e.g., on Schedule C or Schedule E.⁵⁰¹

A deduction is allowed under §212(3) for an expense paid or incurred by an individual in connection with the determination, collection, or refund of any tax, provided that it is an ordinary and necessary expense for that purpose.⁵⁰² The deduction is available whether the taxing authority is the United States, a state, a municipality or other taxing entity.⁵⁰³ Expenses paid or incurred in connection with taxes imposed by foreign countries are also deductible.⁵⁰⁴ Expenses incurred in connection with income, estate, gift, property or any other tax are deductible.⁵⁰⁵

An expense paid or incurred by an individual in connection with any proceeding involved in determining or contesting a tax liability is deductible.⁵⁰⁶ Convenience fees charged by credit and debit card companies for the use of a credit or debit card to pay personal income taxes, including estimated taxes, may be deducted under §212(3) as an expense paid or incurred in connection with collection of a tax.⁵⁰⁷

2. Tax Advice

For tax years beginning after 2017, the suspension of miscellaneous itemized deductions means that expenses are not deductible under §212 unless they are deductible above the line, e.g., on Schedule C or Schedule E.⁵⁰⁸

Legal fees paid to ascertain the tax consequences of settling a lawsuit are deductible.⁵⁰⁹ The portion of an antenuptial agreement's legal fees allocable to tax advice is deductible under §212, but the portion allocable to the property settlement is not.⁵¹⁰ Deductions are allowed for legal advice and services with respect to the tax consequences of divorce and separation.⁵¹¹ The taxpayer has the burden of demonstrating the amount of fees allocable to tax advice.⁵¹²

Deductions are allowed under §212 for the cost of estate planning advice only to the extent that the advice relates to tax considerations.⁵¹³ The taxpayer has the burden of demonstrating the portion of the cost attributable to tax planning.⁵¹⁴

The costs of family trust kits and similar tax avoidance devices are not deductible under §212 if they do not contain genuine tax advice with respect to the taxpayer's property and activities.⁵¹⁵ Fees paid to establish family trusts that are not paid to providers of tax advice are not deductible.⁵¹⁶ The costs of instructions and forms used to transfer assets to trusts are not deductible if the transfers are made for reasons not connected with tax liabilities.⁵¹⁷ The same principles apply to grave site exchange programs,⁵¹⁸ especially if the fees are based on participation rather than the amount of advice received.⁵¹⁹ No §212 deduction is allowable for the cost of tax advice with respect to transactions that have a history of being characterized as tax shelters lacking economic substance and profit motives.⁵²⁰

3. Tax Return Preparation

For tax years beginning after 2017, the suspension of miscellaneous itemized deductions means that expenses are not de-

⁴⁹⁹ 223 F. Supp. 709 (N.D. Ga. 1963).

⁵⁰⁰ *Nichols v. Commissioner*, 60 T.C. 236 (1973), aff'd, 511 F.2d 618 (5th Cir. 1975), cert. denied, 423 U.S. 912 (1975).

⁵⁰¹ §67(h).

⁵⁰² §212(3); Reg. §1.212-1(a)(1). Section 212(3) does not encompass amounts representing federal income tax. See §275. See also CCA 202053010 (premium paid toward policy regarding conservation easement is not deductible under §212(3)).

⁵⁰³ Reg. §1.212-1(l).

⁵⁰⁴ *Sharples v. United States*, 533 F.2d 550 (Ct. Cl. 1976).

⁵⁰⁵ Reg. §1.212-1(l). E.g., *Farwell v. Commissioner*, 35 T.C. 454 (1960), acq., 1961-2 C.B. 4; *Coffey v. Commissioner*, 1 T.C. 579 (1943), aff'd on other issues, 141 F.2d 204 (5th Cir. 1944), acq., 1947 C.B. 45.

⁵⁰⁶ Reg. §1.212-1(l).

⁵⁰⁷ IRS News Release IR-2009-37 (Apr. 7, 2009); PMTA 2009-002. The Chief Counsel's office had previously advised that these convenience fees were not deductible, taking the position that although §212(3) allows a taxpayer to deduct all the ordinary and necessary expenses incurred in connection with determining the extent of the taxpayer's liability, a taxpayer may not deduct the expenses incurred in paying that liability after its extent has been determined. SCA 200115032. In PMTA 2009-002, the Chief Counsel's office explained that while SCA 200115032 concluded that credit and debit card convenience fees were not fees to "determine" a tax under §212(3), SCA 200115032 did not address whether such convenience fees might qualify under §212(3) as fees to "collect" a tax. PMTA 2009-002 concluded that such convenience fees are deductible as fees to "collect" a tax under §212(3), thus effectively overriding SCA 200115032.

⁵⁰⁸ §67(h).

⁵⁰⁹ *Marquart v. Commissioner*, 34 T.C.M. 572 (1975).

⁵¹⁰ *Davis v. United States*, 287 F.2d 168, 175 (Ct. Cl. 1961), aff'd in part and rev'd in part on other issues, 370 U.S. 65 (1962).

⁵¹¹ *Carpenter v. United States*, 338 F.2d 366 (Ct. Cl. 1964).

⁵¹² E.g., *Snyder v. Commissioner*, 47 T.C.M. 355 (1983), aff'd in unpub. opin. (4th Cir. 11/21/85); *Munn v. United States*, 455 F.2d 1028, 1035 (Ct. Cl. 1972).

⁵¹³ E.g., *Merians v. Commissioner*, 60 T.C. 187 (1973), acq., 1973-2 C.B. 2; *Wong v. Commissioner*, 58 T.C.M. 1073, 1074-75 (1989).

⁵¹⁴ See *Benningfield v. Commissioner*, 81 T.C. 408 (1983).

⁵¹⁵ E.g., *Neely v. United States*, 775 F.2d 1092 (9th Cir. 1985); *Zmuda v. Commissioner*, 731 F.2d 1417 (9th Cir. 1984), aff'g 79 T.C. 714 (1982); *Morrison v. Commissioner*, 81 T.C. 644 (1983); *Prof'l Servs. v. Commissioner*, 79 T.C. 888 (1982); *Epp v. Commissioner*, 78 T.C. 801 (1982); *Contini v. Commissioner*, 76 T.C. 447 (1981); *Patterson v. Commissioner*, 48 T.C.M. 418 (1984); *Marvin v. Commissioner*, 45 T.C.M. 944 (1983); *Hicks v. Commissioner*, 43 T.C.M. 1081 (1982); *Hoelzer v. Commissioner*, 43 T.C.M. 264 (1982); *Gran v. Commissioner*, 41 T.C.M. 564 (1980), aff'd, 664 F.2d 199 (8th Cir. 1981); *Morgan v. Commissioner*, 37 T.C.M. 1661 (1978); *Holman v. United States*, 83-1 USTC ¶9295 (D. Col. 1983), aff'd, 728 F.2d 462 (10th Cir. 1984); Rev. Rul. 79-324, 1979-2 C.B. 119. See *Morrison v. Commissioner*, 53 T.C.M. 251 (1987); *Crowder v. Commissioner*, 48 T.C.M. 1359 (1984), aff'd in unpub. opin. (9th Cir. 9/30/86); *Swayze v. Commissioner*, 45 T.C.M. 1104 (1983).

⁵¹⁶ *Kautzmann v. United States*, 648 F. Supp. 86 (D. Mont. 1986).

⁵¹⁷ *Birkenstock v. Commissioner*, 47 T.C.M. 491 (1983).

⁵¹⁸ E.g., *Weintrob v. Commissioner*, 60 T.C.M. 895 (1990), reconsidered on other issues, 61 T.C.M. 1947 (1991), aff'd in part and rev'd in part sub nom., *Wagner v. Commissioner*, 31 F.3d 1175 (3d Cir. 1994).

⁵¹⁹ E.g., *Wagner v. Commissioner*, 31 F.3d 1175 (3d Cir. 1994), aff'g in part and rev'g in part *Weintrob v. Commissioner*, 61 T.C.M. 1947 (1991) and modifying *Weintrob v. Commissioner*, 60 T.C.M. 895 (1990).

⁵²⁰ *Candyce Martin 1999 Irrevocable Trust v. United States*, 822 F. Supp.2d 968 (N.D. Cal. 2011).

ductible under §212 unless they are deductible above the line, e.g., on Schedule C or Schedule E.⁵²¹

Expenses paid or incurred by an individual in connection with the preparation of tax returns are deductible under §212.⁵²²

Deductible expenses include expenditures for:

- advice and assistance in the preparation of returns;⁵²³
- legal fees in connection with the preparation of the returns;⁵²⁴
- professional fees in preparing an IRS ruling request;⁵²⁵
- accountant's fees;⁵²⁶
- accounting services;⁵²⁷
- seeking an IRS private letter ruling;⁵²⁸
- long distance calls to the IRS for advice;⁵²⁹
- travel to a return preparer's office;⁵³⁰
- appraisals to determine the amount of an income tax casualty loss deduction⁵³¹ or an income tax charitable contribution deduction;⁵³² and

- an insurance agent's inspection of a damaged residence to assist in claiming a casualty loss deduction.⁵³³

The costs of books used by taxpayers for assistance in preparing their own tax returns are also deductible.⁵³⁴

The IRS has ruled that fees paid by a sole proprietor to a tax preparer are deductible under §212, but that the portion of the fees relating to the sole proprietor's business (i.e., profit or loss from business (Schedule C), income or loss from rent or royalties (Part I of Schedule E), and farm income and expenses (Schedule F)) are deductible as trade or business expenses under §162.⁵³⁵

The cost of obtaining a master's degree in taxation, though it was of assistance to the taxpayer in preparing his returns, was not deductible under §212 because it was unreasonable in amount and represented the cost of education that benefitted the taxpayer over an indeterminate but long useful life.⁵³⁶ The cost

of storing tax records is not deductible even if the law requires that they be kept.⁵³⁷ The cost of a personal checking account is not a deductible expense of maintaining tax records.⁵³⁸

The burden is on the taxpayer to prove the amount of expenses paid or incurred for tax return preparation advice or services.⁵³⁹

4. Tax Liability Proceedings

For tax years beginning after 2017, the suspension of miscellaneous itemized deductions means that expenses are not deductible under §212 unless they are deductible above the line, e.g., on Schedule C or Schedule E.⁵⁴⁰

Expenses paid or incurred by an individual in connection with proceedings to determine the extent of tax liability or in contesting tax liability are deductible under §212.⁵⁴¹ Deductible expenses include accounting fees in connection with audits of earlier tax years and for representation at IRS audits,⁵⁴² fees to title insurance companies to determine the validity of local property tax assessments,⁵⁴³ and expenses to remove tax liens.⁵⁴⁴ It does not matter whether the taxpayer is successful in contesting a tax liability.⁵⁴⁵ A taxpayer is permitted to use the standard mileage rate to compute the deductible cost of using a vehicle to travel to locations where the taxpayer can copy returns, meet with the IRS, and research legal and tax issues in a law library.⁵⁴⁶

The expenses of claiming a tax refund are deductible under §212.⁵⁴⁷ So, too, are the expenses of opposing the assessment of additional taxes.⁵⁴⁸ The expenses of contesting alleged transferor tax liability are also deductible.⁵⁴⁹

The expenses of contesting proposed penalties for civil tax fraud are deductible,⁵⁵⁰ as are the expenses of defending criminal tax fraud charges.⁵⁵¹ However, if the taxpayer pleads guilty,

⁵³⁶ See *Wassenaar v. Commissioner*, 72 T.C. 1195 (1979).

⁵³⁷ *Stuart v. Commissioner*, 54 T.C.M. 70 (1987); *Hill v. Commissioner*, 41 T.C.M. 700 (1981), aff'd in unpub. opin. (9th Cir. 1982).

⁵³⁸ *Callander v. Commissioner*, 75 T.C. 334 (1980).

⁵³⁹ E.g., *Robinson v. Commissioner*, T.C. Memo 2011-99; *Solomon v. Commissioner*, T.C. Memo 2011-91; *Ware v. Commissioner*, 52 T.C.M. 315 (1986); *Bennett v. Commissioner*, 27 T.C.M. 365 (1968).

⁵⁴⁰ §67(h).

⁵⁴¹ Reg. §1.212-1(l). See, e.g., *Stoddard v. Commissioner*, 152 F.2d 445 (2d Cir. 1945), rev'g 4 T.C.M. 218 (1945); *Connelly v. Commissioner*, 6 T.C. 744 (1946); *Page v. Commissioner*, 66 T.C.M. 571 (1993), aff'd, 58 F.3d 1342 (8th Cir. 1995).

⁵⁴² E.g., *Blair v. Commissioner*, 42 T.C.M. 1576 (1981).

⁵⁴³ *Farwell v. Commissioner*, 35 T.C. 454 (1960), acq., 1961-2 C.B. 4.

⁵⁴⁴ *Meersman v. Commissioner*, 65 T.C.M. 1878 (1993).

⁵⁴⁵ *Trust Under the Will of Bingham v. Commissioner*, 325 U.S. 365 (1945), rev'g 145 F.2d 568 (2d Cir. 1944), rev'g 2 T.C. 853 (1943), acq., 1945 C.B. 2.

⁵⁴⁶ *Stussy v. Commissioner*, 86 T.C.M. 220 (2003).

⁵⁴⁷ *Williams v. McGowan*, 152 F.2d 570 (2d Cir. 1945), rev'g 58 F. Supp. 692 (W.D.N.Y. 1944); *Cammack v. Commissioner*, 5 T.C. 467 (1945), acq., 1945 C.B. 2.

⁵⁴⁸ *Dunitz v. Commissioner*, 7 T.C. 672 (1946), aff'd on other issues, 167 F.2d 223 (6th Cir. 1948), acq., 1946-2 C.B. 2; *Heyman v. Commissioner*, 6 T.C. 799 (1946), acq., 1946-2 C.B. 3.

⁵⁴⁹ *N. Trust Co. v. Campbell*, 211 F.2d 251 (7th Cir. 1954).

⁵⁵⁰ *Goodman v. Commissioner*, 9 T.C.M. 789 (1950), aff'd, 200 F.2d 681 (2d Cir. 1953).

⁵⁵¹ *Commissioner v. Shapiro*, 278 F.2d 556 (7th Cir. 1960), aff'g *Int'l Trading Co. v. Commissioner*, 17 T.C.M. 521 (1958); Rev. Rul. 68-662, 1968-2 C.B. 69.

⁵²¹ §67(h).

⁵²² Reg. §1.212-1(l).

⁵²³ E.g., *Wodehouse v. Commissioner*, 8 T.C. 637 (1947), acq., 1947-2 C.B. 5, rev'd on other issues, 166 F.2d 986 (4th Cir. 1948), rev'd on other issues, 337 U.S. 369 (1949); *Loew v. Commissioner*, 7 T.C. 363 (1946), acq., 1946-2 C.B. 3; *Armour v. Commissioner*, 6 T.C. 359 (1946); *Frankland Racing Equip., Inc. v. Commissioner*, 53 T.C.M. 658 (1987).

⁵²⁴ *Bonkowski v. Commissioner*, 29 T.C.M. 1645 (1970), aff'd on other issues, 458 F.2d 709 (7th Cir. 1972), cert. denied, 409 U.S. 874 (1972).

⁵²⁵ Rev. Rul. 89-68 (user fee paid to the IRS was also deductible).

⁵²⁶ *Collins v. Commissioner*, 54 T.C. 1656 (1970), acq., 1971-1 C.B. 2.

⁵²⁷ *Van Dyke v. Commissioner*, 45 T.C.M. 1233 (1983). See *Burleson v. Commissioner*, 67 T.C.M. 2517 (1994).

⁵²⁸ *Kaufmann v. United States*, 227 F. Supp. 807 (W.D. Mo. 1963).

⁵²⁹ PLR 8321042.

⁵³⁰ *Gettings v. Commissioner*, 55 T.C.M. 1361 (1988).

⁵³¹ Rev. Rul. 67-461, 1967-2 C.B. 125.

⁵³² E.g., *Neely v. Commissioner*, 85 T.C. 934 (1985); *Biagiotti v. Commissioner*, 52 T.C.M. 588 (1986).

⁵³³ *Stein v. Commissioner*, 31 T.C.M. 663 (1972), aff'd by unpub. opin. (7th Cir. 1974).

⁵³⁴ *Contini v. Commissioner*, 76 T.C. 447 (1981), acq., 1981-2 C.B. 1; *Spielbauer v. Commissioner*, 75 T.C.M. 1865 (1998); *Bodine v. Commissioner*, 47 T.C.M. 1337 (1984).

⁵³⁵ Rev. Rul. 92-29.

no deduction is allowed for expenses paid or incurred to prevent the ensuing indictment.⁵⁵²

In order to be deductible, the expenses must relate directly to the proceedings through which the tax liability is being contested.⁵⁵³ Thus, the expenses of a law school education were not deductible as training to contest subsequent tax deficiencies asserted against the taxpayer.⁵⁵⁴ No deduction was allowed for vacation time used by the taxpayer to appear before the Tax Court,⁵⁵⁵ nor for lost wages caused by conviction on criminal tax fraud charges.⁵⁵⁶ The cost of litigating a trust revocation to maintain tax savings is deductible.⁵⁵⁷

5. Taxpayers Entitled to Deduct Tax Determination Expenses

a. Fiduciaries

Expenses paid by a trustee to unsuccessfully contest an income tax on the trust and fees for legal advice with respect to tax problems of the trust are deductible under §212.⁵⁵⁸ Similarly, expenses paid by a trustee in bankruptcy for professional ad-

vice with respect to the tax liability of the bankruptcy estate are deductible.⁵⁵⁹

b. Nonresident Aliens

In Rev. Rul. 62-9, the IRS ruled that a nonresident alien was permitted to deduct expenses paid or incurred in contesting foreign tax liabilities assessed against the alien's income from sources within the United States if the nonresident alien computes tax under §871(b) or §871(c), but only to the extent the income is not exempt under a treaty. In the same ruling, the IRS concluded that no deduction was allowable if the alien computes tax under §871(a) because that subsection imposes a tax on gross income for which no deductions are allowable.

c. Donees and Beneficiaries

A deduction is allowed under §212 for legal fees paid by a donee to contest gift tax liabilities that are liens on the gift property.⁵⁶⁰ Legal fees paid by a trust beneficiary to recover taxes imposed against the grantor's estate but paid by the beneficiary to avoid transferee liability are deductible.⁵⁶¹

⁵⁵² *Tracy v. United States*, 284 F.2d 379 (Ct. Cl. 1960).

⁵⁵³ *E.g.*, *Harris v. Commissioner*, 39 T.C.M. 1126 (1980), *aff'd and rem'd* in unpub. opin. (9th Cir. 1982).

⁵⁵⁴ *E.g.*, *Dinsmore v. Commissioner*, 36 T.C.M. 1008 (1977).

⁵⁵⁵ *Stuart v. Commissioner*, 54 T.C.M. 70 (1987).

⁵⁵⁶ *Tranquilli v. Commissioner*, 39 T.C.M. 874 (1980).

⁵⁵⁷ *Matthews v. United States*, 425 F.2d 738 (Ct. Cl. 1970).

⁵⁵⁸ *Trust Under the Will of Bingham v. Commissioner*, 325 U.S. 365 (1945), *rev'g* 145 F.2d 568 (2d Cir. 1944), *rev'g* 2 T.C. 853 (1943), *acq.*, 1945 C.B. 2.

⁵⁵⁹ Rev. Rul. 68-48.

⁵⁶⁰ *Bonnyman v. United States*, 156 F. Supp. 625 (E.D. Tenn. 1957), *aff'd*, 261 F.2d 835 (6th Cir. 1958).

⁵⁶¹ *Goldberg v. Commissioner*, 31 T.C. 258 (1958).

IV. Specific Types of Deductible Expenses

A. Compensation Related Expenses

1. Compensation Generally

a. Allowance in General

A deduction for reasonable compensation paid for personal services actually rendered in connection with carrying on a trade or business is specifically allowed by §162.⁵⁶² Compensation paid in connection with investments is deductible under §212 if it is paid or incurred for the production or collection of income or for the management, conservation, or maintenance of property held for the production of income.⁵⁶³ The deduction for compensation paid is discussed in 390 T.M., *Reasonable Compensation*, and is described below.

b. Services Actually Rendered

(1) In General

Payments in the form of compensation that are not in fact for services rendered are not deductible.⁵⁶⁴ Whether payments are compensation for services rendered or are instead dividends, loans, loan repayments, interest or part of some other transaction is a question of fact.⁵⁶⁵

For example, payments to shareholders, all or most of whom draw salaries, are recharacterized as nondeductible dividends to the extent they do not represent remuneration for services rendered.⁵⁶⁶ Thus, even though amounts paid to a retired employee under a covenant not to compete are generally deductible, they are not deductible if they are made to a shareholder who continues to have an interest in the employer, intends to retire, and does not pose a competitive threat.⁵⁶⁷

In *Thatcher v. Commissioner*,⁵⁶⁸ the Ninth Circuit held that payments to an absentee employee who was doing missionary work abroad were not payments for services rendered and, thus, were not deductible.⁵⁶⁹ An employer's payments of taxes it failed to withhold from employees, and for which it did not seek reimbursement from the employees, was not compensation because they were in addition to the amount of compensation already paid to the employees pursuant to the employment contract.⁵⁷⁰ However, the IRS has advised that an employer who pays the employment and other taxes on meal allowances paid

to its employees may deduct those taxes because by paying them the employer protected employee morale, and that despite the position argued and upheld in the case, "the more correct view" is to allow the deduction.⁵⁷¹

Comment: It is unclear from the IRS analysis if the deduction is one for compensation or a more general §162 deduction.

Donations or gifts to employees or others, that are not for services rendered, are not deductible.⁵⁷² Thus, deductions are not allowed for wedding gifts to employees,⁵⁷³ but are allowed, assuming all the other requirements are met, for holiday gifts made to all or most employees if given in accordance with common industry practice.⁵⁷⁴ Whether the payments are intended as gifts or as compensation is a question of fact.⁵⁷⁵ Thus, for example, no compensation deduction is allowed for an employee's personal purchases made on the employer's credit card in the absence of intent that those purchases be treated as compensation.⁵⁷⁶

(2) Requisite Service Providing Relationship

For a compensation deduction to be allowed under §162 or §212, there must be proof of a contract to render services, actual performance, and a reasonable probability that payment was intended when the contract was made.⁵⁷⁷ The employee must have a genuine legal obligation to render services and the employer must have a genuine legal obligation to pay.⁵⁷⁸

Deductions for compensation are allowable for payments to employees as well as to independent contractors, provided services are actually rendered.⁵⁷⁹ Employees include not only traditional employees, but also corporate directors,⁵⁸⁰ corporations hired by the taxpayer,⁵⁸¹ trust managers,⁵⁸² employee patrons of cooperatives,⁵⁸³ and minor children of the taxpayer who render services in a bona fide capacity.⁵⁸⁴

⁵⁷⁰ *L. & L. Marine Serv., Inc. & Subsidiaries v. Commissioner*, T.C. Memo 1987-428.

⁵⁷¹ FSA 200025002.

⁵⁷² Reg. §1.162-9. See, e.g., *Anaheim Paper Mill Supplies, Inc. v. Commissioner*, T.C. Memo 1978-86 (1978).

⁵⁷³ See, e.g., *Webster Tool & Die, Inc. v. Commissioner*, T.C. Memo 1985-604.

⁵⁷⁴ E.g., *Poletti v. Commissioner*, 330 F.2d 818 (8th Cir. 1964), rev'g 21 T.C.M. 1415 (1962). See Rev. Rul. 59-58, 1959-1 C.B. 17.

⁵⁷⁵ See, e.g., *Farrow v. Commissioner*, 50 T.C.M. 1235 (1985).

⁵⁷⁶ *Troutman v. Commissioner*, 87 T.C.M. 953 (2004).

⁵⁷⁷ E.g., *Card v. Commissioner*, 20 T.C. 620 (1953), aff'd on other issues, 216 F.2d 93 (8th Cir. 1954); *Dilworth v. Commissioner*, 4 T.C.M. 836 (1945).

⁵⁷⁸ See, e.g., *Wright v. Commissioner*, 14 B.T.A. 1337 (1929).

⁵⁷⁹ See *Bennett's Travel Bureau, Inc. v. Commissioner*, 29 T.C. 350 (1957); *Wiesler v. Commissioner*, 6 T.C. 1148 (1946), aff'd on other issues, 161 F.2d 997 (6th Cir. 1947), cert. denied, 332 U.S. 842 (1947), acq., 1948-1 C.B. 3.

⁵⁸⁰ E.g., *Express Pub. Co. v. Commissioner*, 143 F.2d 386 (5th Cir. 1944); *Waldheim & Co. v. Commissioner*, 25 T.C. 594 (1955).

⁵⁸¹ See *Shaw v. Commissioner*, 59 T.C. 375 (1972).

⁵⁸² E.g., *Trust No. 5522 v. Commissioner*, 83 F.2d 801 (9th Cir. 1936), rev'g 27 B.T.A. 1250 (1933); *Alfred C. Goethel Co. v. Commissioner*, 15 B.T.A. 199 (1929).

⁵⁸³ E.g., *Astoria Plywood Corp. v. United States*, 79-1 USTC ¶9197 (D. Ore. 1979).

⁵⁸⁴ Rev. Rul. 72-23, 1972-1 C.B. 43. See *Romine v. Commissioner*, 25 T.C. 859 (1956); *Moriarty v. Commissioner*, 48 T.C.M. 59 (1984); *Roundtree v. Commissioner*, 40 T.C.M. 151 (1980); *Terrell v. Commissioner*, 38 T.C.M. 892 (1979).

⁵⁶² §162(a)(1). See Reg. §1.162-7(a). The compensation must actually be paid. See *Vaney Assocs. v. Commissioner*, T.C. Memo 2014-184 (no deduction where insufficient funds to honor bonus check).

⁵⁶³ Reg. §1.212-1(g). See, e.g., *Mallinckrodt v. Commissioner*, 2 T.C. 1128 (1943), aff'd on other issues, 146 F.2d 1 (8th Cir. 1945), cert. denied, 324 U.S. 781 (1945), acq., 1944 C.B. 18; *Walsh v. Commissioner*, 20 T.C.M. 1468 (1961), aff'd on other issues, 313 F.2d 389 (4th Cir. 1963).

⁵⁶⁴ Reg. §1.162-7(b)(1).

⁵⁶⁵ See, e.g., *Delia v. Commissioner*, 362 F.2d 400 (6th Cir. 1966), aff'g 23 T.C.M. 2018 (1964); *Clements v. Commissioner*, 42 T.C.M. 1144 (1981).

⁵⁶⁶ Reg. §1.162-7(b)(1). See *King's Court Mobile Home Park, Inc. v. Commissioner*, 98 T.C. 511 (1992) (funds diverted from corporation by controlling shareholder are nondeductible dividends and not wages because evidence shows lack of intent to compensate shareholder).

⁵⁶⁷ *Kalamazoo Oil Co. v. Commissioner*, 42 T.C.M. 304 (1981), aff'd, 693 F.2d 618 (6th Cir. 1982).

⁵⁶⁸ 533 F.2d 1114 (9th Cir. 1976), aff'g 61 T.C. 28 (1973).

⁵⁶⁹ *Id.* at 1116.

In *Tibbetts v. Sec’y of the Treasury*,⁵⁸⁵ a district court held that a taxpayer who claimed he was a business was not allowed to deduct the amount he purportedly paid to himself.⁵⁸⁶ Payments to persons the taxpayer is legally required to support are not deductible to the extent of the support obligation, even if cast in the form of compensation.⁵⁸⁷ Likewise, compensation deductions do not include payments to spouses for personal housekeeping or gifts to spouses.⁵⁸⁸

(3) Payment or Accrual

No deduction is allowed for a cash method taxpayer who does not pay the compensation.⁵⁸⁹ Entry on the taxpayer’s books of account is not essential.⁵⁹⁰ Unaccrued compensation is not deductible by accrual method taxpayers.⁵⁹¹

In *Wells Fargo & Co. v. Commissioner*,⁵⁹² the Eighth Circuit held that compensation paid to company officers who worked on the company’s acquisition was deductible, even though the acquisition provided a long-term benefit, because the salary expenses originated in the employment relationship between the taxpayer and its officers, were only indirectly related to the acquisition itself, would have been paid whether or not the acquisition occurred and was not increased because of the acquisition.

Note: The subsequently adopted requirement in Reg. §1.263(a)-5(a), that amounts paid or incurred to facilitate an acquisition of a trade or business or to change the capital structure of a business entity must be capitalized, does not apply to employee compensation⁵⁹³ unless the employer elects capitalization.⁵⁹⁴

c. Form of Compensation

(1) In General

The compensation may be in the form of salary or in any other form,⁵⁹⁵ including per diem allowances even if not designated as personal service compensation in the union’s contract with the employer,⁵⁹⁶ and deposits into the taxpayer’s account of checks payable to the person performing the services.⁵⁹⁷ Compensation based on contingencies is generally not treated any

differently from that based on flat rates.⁵⁹⁸ Usually, contingent compensation is deductible if it results from a free bargain between the employer and the employee that is made before the services are rendered and is not influenced by any other consideration on the part of the employer other than obtaining the employee’s services on fair and advantageous terms.⁵⁹⁹ A contingent compensation payment is deductible even though it works out that the amount paid is greater than the amount that would ordinarily be paid.⁶⁰⁰

(2) Bonuses

A bonus paid to or accrued in respect of an employee is allowed as a deduction for compensation if made in good faith, as additional compensation for services actually rendered, and provided the payments, when added to other compensation, do not exceed reasonable compensation for the services rendered.⁶⁰¹ It does not matter whether the bonuses are paid in cash, in property, or partly in cash and partly in property.⁶⁰² The IRS advised that bonuses paid to holders of incentive stock options to make them “whole” for taxes they would be required to pay as a result of disqualifying dispositions related to a leveraged buyout were deductible under §162 because the bonuses were compensatory in nature and based on the employment relationship.⁶⁰³ The IRS also advised that a hiring bonus was deductible, even though the employee was required to repay it, with interest, in five annual installments, because the employer paid annual bonuses equal to the required annual installments, but that only one-fifth of the hiring bonus was deductible in each of the five years.⁶⁰⁴ The cost of golf clubs transferred to an employee as a sales incentive and in recognition of services rendered have been treated as deductible ordinary and necessary compensation expenses.⁶⁰⁵

(3) Other Benefits

Amounts paid or accrued by a taxpayer on account of employees’ injuries, even if in the form of lump sums, are deductible under §162, but only to the extent the amounts paid are not compensated for by insurance or otherwise.⁶⁰⁶ The IRS Office of Chief Counsel has explained that this limitation does not apply if the employer pays compensation to a disabled employee under the employment contract even if receiving an insurance payment under a policy that covers employee disability, because the insurance payments would have been received even if the employer did not continue making payments under the employment contract after the employee became disabled

⁵⁸⁵ 577 F. Supp. 911 (W.D.N.C. 1984).

⁵⁸⁶ *Id.* at 914.

⁵⁸⁷ See *J.B.S. Enters., Inc. v. Commissioner*, 61 T.C.M. 2829 (1991) (wife); *Frankland Racing Equip. Inc. v. Commissioner*, 53 T.C.M. 658 (1987) (wife); *Roundtree v. Commissioner*, 40 T.C.M. 151 (1980) (children); Rev. Rul. 73-393, 1973-2 C.B. 33 (children).

⁵⁸⁸ *Tinkoff v. Commissioner*, 120 F.2d 564 (7th Cir. 1941), cert. denied, 314 U.S. 581 (1941). See *Pfister v. United States*, 102 F. Supp. 640 (D.S.D. 1952), rev’d on other issues, 205 F.2d 538 (8th Cir. 1953).

⁵⁸⁹ See, e.g., *Crowther v. Commissioner*, 6 B.T.A.M. 485 (1937), aff’d per curiam, 112 F.2d 167 (2d Cir. 1940).

⁵⁹⁰ See, e.g., *Black Motor Co. v. Commissioner*, 41 B.T.A. 300 (1940), aff’d on other issues, 125 F.2d 977 (6th Cir. 1942) (accrual method taxpayer); *Kins v. Commissioner*, 3 B.T.A. 1348 (1926) (cash method taxpayer).

⁵⁹¹ See *Verndale Garage Inc. v. Commissioner*, 15 B.T.A. 57 (1929).

⁵⁹² 224 F.3d 874 (8th Cir. 2000), rev’g *Norwest Corp. v. Commissioner*, 112 T.C. 89 (1999).

⁵⁹³ Reg. §1.263(a)-5(d)(1). See Reg. §1.263(a)-5(d)(2) (defining employee compensation for purposes of capitalization rule).

⁵⁹⁴ Reg. §1.263(a)-5(d)(4).

⁵⁹⁵ §162(a)(1); Reg. §1.162-7(b)(2).

⁵⁹⁶ *UAL Corp. v. Commissioner*, 117 T.C. 7 (2001).

⁵⁹⁷ *Grace Foreign Exch. Corp. v. Commissioner*, 68 T.C.M. 1464 (1994).

⁵⁹⁸ Reg. §1.162-7(b)(2). See, e.g., *Lilly v. Commissioner*, 14 T.C. 1066 (1950), aff’d on other issues, 188 F.2d 269 (4th Cir. 1951), rev’d on other issues, 343 U.S. 90 (1952) (based on success of branch managed by employee).

⁵⁹⁹ Reg. §1.162-7(b)(2). See, e.g., *Mobile Drug Co. v. United States*, 39 F.2d 940 (S.D. Ala. 1930).

⁶⁰⁰ Reg. §1.162-7(b)(2).

⁶⁰¹ Reg. §1.162-9.

⁶⁰² *Id.*

⁶⁰³ TAM 9527005.

⁶⁰⁴ TAM 200040004.

⁶⁰⁵ See *Dobbe v. Commissioner*, 80 T.C.M. 577 (2000), aff’d on other issues, 61 Fed. Appx. 348 (9th Cir. 2003).

⁶⁰⁶ Reg. §1.162-10(a).

and the salary continuation payments would have been required whether or not an insurance payment was received.⁶⁰⁷

Likewise, §162 allows deductions for dismissal wages, un-employment benefits, guaranteed annual wages, vacations, and amounts paid under sickness, accident, hospitalization, medical expense, recreational, welfare, or similar benefit plans to the extent they are ordinary and necessary trade or business expenses,⁶⁰⁸ such as payments under a §127 employee educational assistance plan.⁶⁰⁹

Severance payments are deductible business expenses, even if the employer anticipates future benefits as a consequence of a reduction in the number of employees, because the payments principally relate to previously rendered services by the employees, and thus capitalization is not required.⁶¹⁰ Accordingly, the IRS National Office advised that an acquiring company was allowed to deduct the increased severance benefits paid to the employees of an acquired company even though the increased benefits were negotiated as part of the acquisition, because the severance payments originated in the company's post-employment relationship with the employees.⁶¹¹

Note: The subsequently adopted requirement in Reg. §1.263(a)-5(a), that amounts paid or incurred to facilitate an acquisition of a trade or business or to change the capital structure of a business entity must be capitalized, does not apply to integration expenses, which appear to include severance payments.⁶¹²

However, amounts that may be used to provide stock bonus, pension, annuity, profit-sharing, or other deferred compensation benefits are not deductible under §162 or §212. The deduction for such amounts is governed by §404.⁶¹³ Deductions allowed under §404 are described in IV.A.3., below, and discussed in 371 T.M., *Employee Plans — Deductions, Contributions and Funding*. Amounts paid to a funded welfare benefit plan are not deductible under §162 or §212 but are deductible, if at all, under §419.⁶¹⁴ Deductions allowed under §419 are described in IV.A.5., below, and are discussed in 395 T.M., *VE-BAs and Other Welfare Benefit Funding Arrangements*. The timing of deductions for vacation pay is governed by §404(a)(5).⁶¹⁵ The timing of vacation pay deductions is discussed in 371 T.M., *Employee Plans — Deductions, Contributions and Funding*.

d. Reasonableness

(1) In General

The deduction for compensation paid is limited to the amount of compensation that would be reasonable under all the circumstances.⁶¹⁶ Generally, reasonable compensation is the

amount that would ordinarily be paid for like services by like enterprises under like circumstances.⁶¹⁷ The circumstances taken into account are those existing when the contract for services is made and not those existing when the reasonableness is questioned.⁶¹⁸ The IRS has the authority and duty to determine whether compensation is reasonable⁶¹⁹ and the taxpayer has the burden of demonstrating that the IRS's determination is erroneous.⁶²⁰

In determining the amount of reasonable compensation under §162(a)(1), it is necessary to consider both the amount of deferred and nondeferred compensation.⁶²¹ The Tax Court and several Courts of Appeals have adopted five factors in determining the reasonableness of compensation:

- the employee's role in the company;
- a comparison of the employee's salary with similarly situated employees;
- the character and condition of the company;
- whether the relationship of the employee to the corporation creates a conflict of interest regarding the awarding of compensation, and if so, whether the level of compensation would provide a satisfactory level of return on equity for a hypothetical independent investor; and
- the internal consistency of salaries paid to all employees of the company.⁶²²

The Second and Ninth Circuits have held that the reasonableness of compensation must be assessed from the perspective of a hypothetical or independent investor, not as a separate autonomous factor but instead as "a lens through which the entire analysis should be viewed," and requiring the application of four factors:

- whether a hypothetical investor would accept the compensation paid to the shareholder-officer;
- whether the shareholder-officer was paid according to a long-standing and consistently applied contingent compensation formula, and if so, whether the salary was reasonable in light of this formula;
- whether the shareholder-officer's compensation compared favorably with compensation paid by similar companies for comparable services; and
- whether after consideration of these factors, the balance shifted in favor of the showing that the corporation had

⁶¹⁷ Reg. §1.162-7(b)(3). See, e.g., *Young v. Commissioner*, 650 F.2d 1083 (9th Cir. 1981), aff'g 37 T.C.M. 957 (1979); *Geiger & Peters Inc. v. Commissioner*, 27 T.C. 911 (1957).

⁶¹⁸ Reg. §1.162-7(b)(3). See *Walsh v. Commissioner*, 42 T.C.M. 267 (1981).

⁶¹⁹ See *Gustafson Mfg. Co. v. Commissioner*, 1 B.T.A. 508 (1925); *Seinheimer Paper Co. v. United States*, 63 Ct. Cl. 429 (1927).

⁶²⁰ E.g., *Botany Worsted Mills v. United States*, 278 U.S. 282 (1929), rev'g 63 Ct. Cl. 405 (1927).

⁶²¹ *M. & E. Shindler, Inc. v. Commissioner*, 63 T.C.M. 3039 (1992).

⁶²² *RAPCO, Inc. v. Commissioner*, 85 F.3d 950 (2d Cir. 1996), aff'g 69 T.C.M. 2238 (1995); *Elliotts, Inc. v. Commissioner*, 716 F.2d 1241 (9th Cir. 1983); *Multi-Pak Corp. v. Commissioner*, T.C. Memo 2010-139; *M. & E. Shindler, Inc. v. Commissioner*, 63 T.C.M. 3039 (1992).

⁶⁰⁷ CCA 200947035.

⁶⁰⁸ *Id.*

⁶⁰⁹ PLR 200245042.

⁶¹⁰ Rev. Rul. 94-77, 1994-2 C.B. 19 (analyzing impact of *INDOPCO, Inc. v. Commissioner*, 503 U.S. 79 (1992)).

⁶¹¹ TAM 9731001. See also TAM 9721002.

⁶¹² Reg. §1.263(a)-5(c)(6).

⁶¹³ §404; Reg. §1.162-10(a), Reg. §1.162-10T, Q & A-1.

⁶¹⁴ §419; Reg. §1.162-10T, Q & A-2.

⁶¹⁵ See §404(a)(5) (last sentence).

⁶¹⁶ §162(a)(1); Reg. §1.162-7(b)(3), Reg. §1.212-1(d). See, e.g., *Dixo Co. v. Commissioner*, 27 T.C.M. 644 (1968).

met its burden of proving the compensation to be reasonable.⁶²³

The extent to which compensation is reasonable is discussed in 390 T.M., *Reasonable Compensation*.

(2) Treatment of Disallowed Amounts

Any amount that is disallowed as a deduction for compensation on the ground that it is unreasonable is recharacterized depending on the circumstances of each case.⁶²⁴ For example, an excessive amount paid by a corporation might be treated as a dividend, thus reducing earnings and profits,⁶²⁵ or as consideration for the redemption of the employee shareholder's stock.⁶²⁶ Payments that represent the purchase of property from a person rendering services must be added to the payor's adjusted basis in the property.⁶²⁷ Amounts that an employer intends to recover can be treated as loans,⁶²⁸ and other payments might in fact be treated as loan repayments by the employer.⁶²⁹

Generally, even if a deduction is disallowed on the ground that the compensation is unreasonable, it is included in the recipient's gross income as compensation.⁶³⁰ Compensation gross income is discussed in 501 T.M., *Gross Income: Overview and Conceptual Aspects*, and 390 T.M., *Reasonable Compensation*.

e. Deduction Disallowed for Excessive Compensation Paid

Subject to certain exceptions, §162(m) limits a publicly held corporation's allowable deduction for compensation paid to a covered employee to \$1,000,000.⁶³¹ A publicly held corporation is any corporation issuing any class of common equity securities required to be registered under §12 of the Securities Exchange Act of 1934 (15 U.S.C. §78I), or any corporation that is required to file reports under §15(d) of the Securities Exchange Act of 1934 (15 U.S.C. §78o(d)).⁶³² A covered employee is any employee of the taxpayer who:

(i) was the principal executive officer or principal financial officer of the taxpayer at any time during the tax year, or was an individual acting in such capacity;⁶³³

(ii) the total compensation of such employee for the tax year is required to be reported to shareholders under the Securities Exchange Act of 1934 because of the employee's status as one of the three highest compensated officers for the tax year (other than the principal executive officer or principal financial officer),⁶³⁴

(iii) for tax years beginning after 2026, was among the five highest compensated employees for the tax year (other than individuals described in (i) or (ii) above),⁶³⁵ or

(iv) was a covered employee, described in (i) or (ii) above, of the taxpayer or a predecessor of the taxpayer for any preceding tax year beginning after 2016.⁶³⁶

Special rules apply to employers participating in the Troubled Assets Relief Program,⁶³⁷ and to certain health insurance providers.⁶³⁸

The rules applicable to the deduction of excessive employee compensation are discussed in 390 T.M., *Reasonable Compensation* and 385 T.M., *Deferred Compensation Arrangements*.

2. Social Security Payments Made with Respect to U.S. Citizens Employed by Foreign Subsidiary Corporations

Under §176, domestic corporations are allowed to deduct social security tax equivalents⁶³⁹ paid or incurred pursuant to a §3121(l) agreement with respect to services performed by U.S. citizens employed by foreign subsidiary corporations.⁶⁴⁰ However, no deduction is allowed for amounts for which the corporation is compensated.⁶⁴¹ Any reimbursement of amounts allowed as deductions under §176 for previous tax years must be included in gross income.⁶⁴²

Comment: Nothing in §176 suggests that the tax benefit rule applies to the receipt of the reimbursement, thus making the gross income inclusion mandatory in all instances. The tax benefit rule is discussed in 502 T.M., *Gross Income: Tax Benefit, Claim of Right and Assignment of Income*.

Section 3121(l) agreements are discussed in 392 T.M., *Withholding, Social Security and Unemployment Taxes on Compensation*.

3. Employer Contributions to Qualified Plans

a. In General

Under §404, employer contributions to qualified plans and payments or accruals of deferred compensation are deductible

the Securities Exchange Act of 1934 because of the employee's status as one of the four highest compensated officers for the tax year (other than the chief executive officer). Pre-2018 §162(m)(3).

⁶³⁴ §162(m)(3)(B).

⁶³⁵ §162(m)(3)(C), as amended by the American Rescue Plan Act of 2021, Pub. L. No. 117-2, §9708.

⁶³⁶ §162(m)(3)(D).

⁶³⁷ §162(m)(5).

⁶³⁸ §162(m)(6).

⁶³⁹ See §3121(l)(1)(A).

⁶⁴⁰ §176.

⁶⁴¹ §176.

⁶⁴² §176.

⁶²³ *Dexsil Corp. v. Commissioner*, 147 F.3d 96 (2d Cir. 1998), vacating and rem'g 69 T.C.M. 2267 (1995); *Labelgraphics, Inc. v. Commissioner*, T.C. Memo 1998-343, aff'd, 221 F.3d 1091 (9th Cir. 2000).

⁶²⁴ Reg. §1.162-8.

⁶²⁵ Reg. §1.162-8; see, e.g., *Maggio Bros., Inc. v. Commissioner*, 6 T.C. 999 (1946).

⁶²⁶ E.g., *Am. Int'l Coal Co. v. Commissioner*, 43 T.C.M. 1097 (1982), aff'd in unpub. opin. (3d Cir. 3/8/83).

⁶²⁷ Reg. §1.162-8; see, e.g., *Hatt v. Commissioner*, 28 T.C.M. 1194 (1969), aff'd, 457 F.2d 499 (7th Cir. 1972) (acquisition of stock); *Hickey v. Commissioner*, 21 T.C.M. 1258 (1962) (acquisition of partnership interest).

⁶²⁸ See, e.g., *Saia v. Commissioner*, 33 T.C.M. 1391 (1974), aff'd in unpub. opin., 536 F.2d 388 (5th Cir. 1976), cert. denied, 429 U.S. 979 (1976).

⁶²⁹ E.g., *Don v. Commissioner*, 30 T.C.M. 565 (1971), supp., 31 T.C.M. 122 (1972), aff'd in unpub. opin. (9th Cir. 1973).

⁶³⁰ Reg. §1.162-8.

⁶³¹ §162(m)(1).

⁶³² §162(m)(2). For tax years beginning before 2018, a publicly held corporation was any corporation issuing any class of common equity securities required to be registered under §12 of the Securities Exchange Act of 1934. Pre-2018 §162(m)(2).

⁶³³ §162(m)(3)(A). For tax years before 2018, a covered employee was any employee that, as of the close of the tax year, was the taxpayer's chief executive officer or an individual acting in that capacity, or any person whose total compensation for the tax year was required to be reported to shareholders under

subject to special rules and limitations provided by §404.⁶⁴³ No deduction is allowed under any other provision of the Code.⁶⁴⁴ A qualified plan is a stock bonus, pension, profit-sharing, or annuity plan.⁶⁴⁵

In addition, corporate employers are allowed to deduct certain dividends paid in cash with respect to certain employer securities.⁶⁴⁶ This deduction is not subject to the limitations that apply to contributions to qualified plans and payments or accruals of deferred compensation.⁶⁴⁷ For tax years beginning after December 31, 1997, S corporations are not allowed this deduction.⁶⁴⁸

Deductions for employer contributions to qualified plans and for deferred compensation are described below, and are discussed in 371 T.M., *Employee Plans — Deductions, Contributions and Funding*.

b. Prerequisites

(1) Payments

No deduction is allowed for employer contributions to qualified plans unless the contribution is actually paid.⁶⁴⁹ In the case of pension, stock bonus, and profit-sharing plans, payments made on account of a tax year that are made by the due date, including extensions, for filing the tax return for that tax year, are treated as having been paid on the last day of the tax year.⁶⁵⁰

Any amount paid by an employer to a stock bonus, pension, profit-sharing, or annuity plan under §4041(b), §4062, §4063, or §4064, or part 1 of subtitle E of title IV of the Employee Retirement Income Security Act of 1974,⁶⁵¹ as in effect on the date of enactment of the Single-Employer Pension Plan Amendments Act of 1986,⁶⁵² is treated as a contribution paid to the plan.⁶⁵³ Special rules apply to the timing of the deduction⁶⁵⁴ and to the application of this rule to members of controlled groups.⁶⁵⁵

(2) Deductibility Qualification

A deduction is not allowed for employer contributions to qualified plans or payments and accruals of deferred compensation unless the amount would be deductible under another provision of the Code but for the §404 denial of deductions under other provisions.⁶⁵⁶ In other words, to be deductible under §404(a), amounts must be expenses that would be deductible under §162 or §212 if it were not for the provision in §404 that they are deductible, if at all, only under §404(a). Therefore, amounts are deductible under §404(a) only to the extent that

they are ordinary and necessary expenses during the tax year in carrying on the trade or business or for the production of income, and are compensation for personal services actually rendered.

(3) Plan Qualification

A deduction is allowed only for payments to a pension trust, other than stock bonus and profit-sharing trusts, made in a tax year that ends within or with a tax year of the pension trust for which it is exempt under §501(a).⁶⁵⁷ Similarly, a deduction is allowed only for payments to a stock bonus or profit-sharing trust made in a tax year that ends within or with a tax year of the trust for which it is exempt under §501(a).⁶⁵⁸ If a stock bonus, pension, or profit-sharing trust would qualify for exemption under §501(a) except for the fact that it is a trust created or organized outside of the United States, contributions to the trust by an employer that is a resident, a corporation or other entity of the United States, shall nevertheless be deductible.⁶⁵⁹

Plan qualification is discussed in 350 T.M., *Plan Selection — Pension and Profit-Sharing Plans*, 351 T.M., *Plan Qualification — Pension and Profit-Sharing Plans*, and 352 T.M., *Specialized Qualified Plans — Cash Balance, Target, Age-Weighted and Hybrids*.

c. Plan-Based Computations and Limitations

(1) Payments to Pension Trusts

(a) Basic Computations

There are three alternative tests for determining the maximum deductible contribution to a pension plan, subject to the maximum limitations described in IV.A.3.c.(1)(b), below.⁶⁶⁰ In applying the three tests, the funding method and the actuarial assumptions used are those used for the tax year under §412.⁶⁶¹ Funding rules are discussed in 371 T.M., *Employee Plans — Deductions, Contributions and Funding*. Special rules apply in the case of collectively bargained plans.⁶⁶² These special rules are discussed in 359 T.M., *Multiemployer Plans — Special Rules*.

The first alternative test allows an employer to deduct the amount necessary to satisfy the §412(a) minimum funding standard for plan years ending within or with the employer's tax year or for any prior plan year, if this amount is greater than the amount determined under the second or third alternative tests, whichever applies to the plan.⁶⁶³ The second alternative test allows an employer to deduct the amount necessary to provide, with respect to all employees under the pension trust, the remaining unfunded cost of their past and current service credits distributed as a level amount, or a level percentage of compensation, over the remaining future service of each covered employee, as determined under regulations.⁶⁶⁴ However,

⁶⁴³ §404(a).

⁶⁴⁴ §404(a).

⁶⁴⁵ §404(a)(1)–§404(a)(3).

⁶⁴⁶ §404(k)(1).

⁶⁴⁷ §404(k)(1).

⁶⁴⁸ §404(k)(1).

⁶⁴⁹ §404(a).

⁶⁵⁰ §404(a)(6).

⁶⁵¹ ERISA, 29 U.S.C. §1001 *et seq.*

⁶⁵² Title XI of Pub. L. No. 99-272.

⁶⁵³ §404(g)(1), §404(g)(4).

⁶⁵⁴ §404(g)(3).

⁶⁵⁵ §404(g)(2).

⁶⁵⁶ §404(a).

⁶⁵⁷ §404(a)(1)(A).

⁶⁵⁸ §404(a)(3)(A)(i).

⁶⁵⁹ §404(a)(4).

⁶⁶⁰ §404(a)(1)(A).

⁶⁶¹ §404(a)(1)(A) (flush language).

⁶⁶² See §413(b)(7).

⁶⁶³ §404(a)(1)(A)(i).

⁶⁶⁴ §404(a)(1)(A)(ii).

if the remaining unfunded cost with respect to any three individuals is more than 50% of the remaining unfunded cost, then the amount of the unfunded cost attributable to those individuals must be distributed over a period of at least five tax years.⁶⁶⁵ The third alternative test allows an employer to deduct an amount equal to the normal cost of the plan, as determined under regulations, plus, if past service or other supplementary pension or annuity credits are provided by the plan, an amount necessary to amortize the unfunded costs attributable to those credits in equal annual payments, until fully amortized, over 10 years, as determined under regulations.⁶⁶⁶

(b) Maximum Limitations

In any case, for single-employer plans, the maximum amount deductible equals the greater of the determined amount with respect to each plan year ending with or within the tax year,⁶⁶⁷ or the sum of the minimum required contributions under §430 for the plan years ending with or within the tax year.⁶⁶⁸ The determined amount equals the excess of the specified amount over the value of the assets of the plan which are held by the plan as of the valuation date for the plan year.⁶⁶⁹ The specified amount is the sum of the funding target for the plan year,⁶⁷⁰ the target normal cost for the plan year,⁶⁷¹ and the cushion amount for the plan year.⁶⁷² Special rules apply to plans with 100 or fewer participants,⁶⁷³ terminating plans,⁶⁷⁴ and cooperative and small employer charity plans.⁶⁷⁵ These special rules and computation of the cushion amount are discussed in 371 T.M., *Employee Plans — Deductions, Contributions and Funding*.

In any case, for multi-employer plans, the maximum amount deductible equals the excess, if any, of 140% of the plan's current liability computed under §431(c)(6)(D), over the value of the plan's assets computed under §431(c)(2).⁶⁷⁶ The maximum limitation for multi-employer plans is discussed in 359 T.M., *Multiemployer Plans — Special Rules*.

(2) Purchases of Employees' Annuities

Contributions toward the purchase of retirement annuities, or retirement annuities and medical benefits as described in §401(h), are deductible in the year paid, in an amount determined in accordance with the computations and limitations applicable to pension trust contributions, if three conditions are satisfied.⁶⁷⁷ First, the plan must comply with the requirements of certain paragraphs⁶⁷⁸ of §401(a).⁶⁷⁹ Second, the plan must comply with the requirements of §401(a)(10) and §401(d), if applicable.⁶⁸⁰ Third, if there are any premium refunds, they must be

applied within the current tax year or next succeeding tax year towards the purchase of retirement annuities, or retirement annuities and medical benefits.⁶⁸¹ Deductions for purchases of employees' annuities are discussed in 371 T.M., *Employee Plans — Deductions, Contributions and Funding*.

(3) Payments to Stock Bonus and Profit-Sharing Trusts

The amount that is allowed as a deduction for deductible payments to a qualified stock bonus or profit-sharing trust is the amount paid, limited to the greater of 25% of the compensation otherwise paid or accrued during the tax year to the beneficiaries under the stock bonus or profit-sharing plan, or the amount the employer is required to contribute to the trust under §401(k)(11) for the year.⁶⁸² For purposes of computing the deduction, stock bonus or profit-sharing trusts do not include any trust designed to provide benefits upon retirement and covering a period of years, if under the plan the amounts to be contributed by the employer can be determined actuarially as provided in the computational rules for pension trusts, as described in IV.A.3.c.(1), above.⁶⁸³ If contributions are made to two or more stock bonus or profit-sharing trusts, those trusts are treated as one trust for purposes of applying the limits on deduction.⁶⁸⁴ Special rules apply in the case of affiliated groups.⁶⁸⁵ The limitation does not apply to elective deferrals.⁶⁸⁶

Any amount not deductible by reason of the 25% of compensation/required contribution limitation is deductible in succeeding tax years in order of time to the extent that amount and the amount paid and otherwise deductible for the succeeding year does not exceed the 25% of compensation/required contribution limitation for the succeeding year.⁶⁸⁷ Special rules apply to carryforwards from tax years beginning before January 1, 1987.⁶⁸⁸

Deductions for payments to stock bonus and profit-sharing trusts are discussed in 371 T.M., *Employee Plans — Deductions, Contributions and Funding*.

(4) Payments to Other Plans

For any plan not described in IV.A.3.c.(1) through IV.A.3.c.(3), above, the employer is allowed to deduct the amount of the contribution, to the extent and in the year the contribution is included in the employee's gross income.⁶⁸⁹ If more than one employee participates in the plan, no deduction is allowed unless separate accounts are maintained for each employee.⁶⁹⁰ Any vacation pay treated as deferred compensation is

⁶⁶⁵ §404(a)(1)(A)(ii).

⁶⁶⁶ §404(a)(1)(A)(iii).

⁶⁶⁷ §404(o)(1)(A).

⁶⁶⁸ §404(o)(1)(B).

⁶⁶⁹ §404(o)(2)(A)(ii).

⁶⁷⁰ §404(o)(2)(A)(i)(I).

⁶⁷¹ §404(o)(2)(A)(i)(II).

⁶⁷² §404(o)(2)(A)(i)(III).

⁶⁷³ §404(o)(4).

⁶⁷⁴ §404(o)(5).

⁶⁷⁵ §404(o)(8), added by Pub. L. No. 113-97, §202(c)(6).

⁶⁷⁶ §404(a)(1)(D)(i).

⁶⁷⁷ §404(a)(2).

⁶⁷⁸ §401(a)(3)—§401(a)(9), §401(a)(11)—§401(a)(20), §401(a)(22), §401(a)(26), §401(a)(27), §401(a)(31), and §401(a)(37).

⁶⁷⁹ §404(a)(2).

⁶⁸⁰ §404(a)(2).

⁶⁸¹ §404(a)(2).

⁶⁸² §404(a)(3)(A)(i). §401(k)(11) defines a SIMPLE cash or deferred arrangement (401(k) plan) available to employers with no more than 100 employees who earned \$5,000 or more in compensation during the preceding calendar year. §401(k)(11)(D). Deductions for SIMPLE 401(k) plans are discussed in 358 T.M., *Section 401(k) Cash or Deferred Arrangements*. For a comparison of SIMPLE plans to other §401(k) plans, see 368 T.M., *SEPs and SIMPLEs*.

⁶⁸³ §404(a)(3)(A)(iii).

⁶⁸⁴ §404(a)(3)(A)(iv).

⁶⁸⁵ §404(a)(3)(B).

⁶⁸⁶ §404(n) (reference to §402(g)(3)).

⁶⁸⁷ §404(a)(3)(A)(ii).

⁶⁸⁸ §404(a)(3)(A)(v).

⁶⁸⁹ §404(a)(5).

⁶⁹⁰ §404(a)(5).

deductible by the employer in the tax year in which it is paid to the employee.⁶⁹¹ Deductions for payments to other plans are discussed in 371 T.M., *Employee Plans — Deductions, Contributions and Funding*.

(5) Payments to Multiple Plans

Special rules apply if amounts are deductible in connection with one or more defined contribution plans and one or more defined benefit plans or in connection with trusts or plans subject to two or more of the computational and limitation provisions described in IV.A.3.c.(1) through IV.A.3.c.(3), above.⁶⁹² For these purposes, any plan described in §412(e)(3) is treated as a defined benefit plan.⁶⁹³

The first special rule limits the deduction to the greater of two amounts.⁶⁹⁴ The first amount equals 25% of the compensation otherwise paid or accrued during the tax year to the beneficiaries of the plans.⁶⁹⁵ The second amount equals the contributions made to, or under, the defined benefit plans to the extent they do not exceed the amount of employer contributions necessary to satisfy the §412 minimum funding standard with respect to any defined benefit plans for the plan year that ends with or within the employer's tax year or for any prior plan year.⁶⁹⁶ In the case of a defined benefit plan that is a single employer plan, except as provided in regulations,⁶⁹⁷ the second amount is computed by treating the amount necessary to satisfy the §412 minimum funding standard as an amount that is not less than the excess, if any, of the plan's §430(d)(1) funding target over the value of the plan's assets.⁶⁹⁸ The limitation does not apply to elective deferrals.⁶⁹⁹

The second special rule provides that a defined contribution plan that is a pension plan shall not be treated as failing to provide definitely determinable benefits merely because employer contributions are limited to amounts deductible under §404.⁷⁰⁰

Any amount not deductible by reason of the limitations in §404(a)(7)(A) is deductible in succeeding tax years in order of time, but the amount deductible in any succeeding year together with the amount allowable under §404(a)(7)(A) may not exceed 25% of the compensation otherwise paid or accrued during the succeeding tax year to beneficiaries of the plans.⁷⁰¹

Deductions for payments to multiple plans are discussed in 371 T.M., *Employee Plans — Deductions, Contributions and Funding*.

(6) Self-Employed Individuals

Special rules apply to self-employed individuals who are treated as employees under §401(c)(1) and for whom contributions are made pursuant to pension, stock bonus, profit-shar-

ing or annuity plans.⁷⁰² Contributions to the plan on behalf of a self-employed individual treated as an employee under §401(c)(1)⁷⁰³ are treated as satisfying the conditions of §162 or §212 to the extent that the contributions do not exceed the individual's earned income as defined in §401(c)(2)⁷⁰⁴ derived from the trade or business for which the plan is established, and to the extent the contributions are not allocable, as determined by regulations, to the purchase of life, accident, health, or other insurance.⁷⁰⁵ Any reference to compensation in the case of a self-employed individual who is treated as an employee under §401(c)(1) is treated as a reference to that individual's earned income derived from the trade or business for which the plan is established.⁷⁰⁶ The treatment of self-employed individuals and qualified plans is discussed in 353 T.M., *Employee Benefit Plans and Issues for Small Employers*.

(7) Employee Stock Ownership Plans

(a) Principal Payments

If contributions are paid to a trust that forms part of an employee stock ownership plan (ESOP)⁷⁰⁷ and are applied by the plan to the repayment of the principal of a loan incurred for the purpose of acquiring employer securities,⁷⁰⁸ the contributions are deductible notwithstanding any limitation applicable to stock bonus plans, as described in IV.A.3.c.(3), above, or multiple plans, as described in IV.A.3.c.(5), above.⁷⁰⁹ The amount deductible, however, may not exceed 25% of the compensation otherwise paid or accrued during the tax year to the employees under the ESOP.⁷¹⁰ The limitation does not apply to elective deferrals.⁷¹¹ Any amount not deductible by reason of the 25% limitation is deductible in succeeding tax years in order of time to the extent of the difference between the amount paid and deductible in the succeeding year and 25% of the compensation otherwise paid or accrued during the succeeding tax year to beneficiaries of the plans.⁷¹² The amount of the deduction is not affected by §664(g)(1) qualified gratuitous transfers to the ESOP.⁷¹³ ESOPs are discussed in 354 T.M., *ESOPs*.

(b) Interest Payments

If contributions are paid to a trust that forms part of an ESOP⁷¹⁴ and are applied by the plan to the repayment of interest on a loan incurred for the purpose of acquiring employer securities,⁷¹⁵ the contributions are deductible notwithstanding any limitation applicable to stock bonus plans, as described in IV.A.3.c.(3), above, or multiple plans, as described in

⁶⁹¹ §404(a)(5).

⁶⁹² §404(a)(7)(A).

⁶⁹³ §404(a)(7)(D).

⁶⁹⁴ §404(a)(7)(A).

⁶⁹⁵ §404(a)(7)(A)(i).

⁶⁹⁶ §404(a)(7)(A)(ii).

⁶⁹⁷ See §404(a)(1)(D).

⁶⁹⁸ §404(a)(7)(A) (flush language).

⁶⁹⁹ §404(n) (reference to §402(g)(3)).

⁷⁰⁰ §404(a)(7)(A) (flush language).

⁷⁰¹ §404(a)(7)(B).

⁷⁰² §404(a)(8).

⁷⁰³ See §404(a)(8)(A).

⁷⁰⁴ See §404(a)(8)(B).

⁷⁰⁵ §404(a)(8)(C).

⁷⁰⁶ §404(a)(8)(D).

⁷⁰⁷ See §4975(e)(7).

⁷⁰⁸ See §4975(e)(8).

⁷⁰⁹ §404(a)(9)(A).

⁷¹⁰ §404(a)(9)(A).

⁷¹¹ §404(n) (reference to §402(g)(3)).

⁷¹² §404(n) (reference to §402(g)(3)).

⁷¹³ §404(a)(9)(D).

⁷¹⁴ See §4975(e)(7).

⁷¹⁵ See §4975(e)(8).

IV.A.3.c.(5), above.⁷¹⁶ The amount of the deduction is not affected by §664(g)(1) qualified gratuitous transfers to the ESOP.⁷¹⁷ No deduction is allowed for contribution of S corporation stock to an ESOP for use by the plan in repaying interest on a loan incurred for the purpose of acquiring employer securities.⁷¹⁸

(8) Simplified Employee Pensions

The deductibility of employer contributions to a simplified employee pension (SEP) (as defined in §408(k)) is determined as if they are made to a plan subject to §404.⁷¹⁹ For purposes of the multiple plan contribution rules described in IV.A.3.c.(5), above, a SEP is treated as if it were a separate stock bonus or profit-sharing plan.⁷²⁰

The amount deductible in a tax year for contributions to a SEP may not exceed 25% of the compensation paid to the employees who are participants during the calendar year ending with or within the tax year, or during the tax year in the case of a SEP maintained on the basis of the employer's tax year.⁷²¹ For any tax year for which the employer is allowed a deduction for a contribution to a SEP, the otherwise applicable limitations for deduction of contributions to plans subject to §404(a)(3)(A) must be reduced by the amount of the deductions allowed for contributions to SEPs for participants in such plans.⁷²² The limitation does not apply to elective deferrals.⁷²³

Any amount not deductible by reason of the 25% limitation is deductible in succeeding tax years in order of time, subject to the 25% limitation.⁷²⁴ Special rules apply to the timing of the deduction to the SEP.⁷²⁵

The SECURE 2.0 Act of 2022⁷²⁶ added an exception to the tax on nondeductible contributions to qualified plans to allow an employer to make deductible contributions to a SEP for a domestic employee who is not the employer or a member of his or her family, which are not deductible when contributed solely because such contributions are not made in connection with the trade or business of the employer.⁷²⁷

The definition of a SEP and the deductibility of contributions to SEPs are discussed in 368 T.M., *SEPs and SIMPLEs*.

(9) Independent Contractor Deferred Compensation

Amounts contributed to a deferred compensation plan arranged with an independent contractor, or amounts paid or accrued as deferred compensation for an independent contractor, are deductible under §404 for the tax year in which the amount is includible in the gross income of the independent

contractor.⁷²⁸ No deduction is allowed under any other provision of the Code.⁷²⁹

A deduction is allowed for contributions to deferred compensation plans or payments and accruals of deferred compensation for independent contractors only if the deduction would be allowed under another provision of the Code but for the §404 denial of deductions under other provisions.⁷³⁰

(10) Absence of Plan

If there is no plan, but there is a method or arrangement of employer contributions or compensation that has the effect of a stock bonus, pension, profit-sharing annuity plan or other plan deferring the receipt of compensation, the computational and limitation rules described above apply as if there were a plan.⁷³¹

For these purposes, any plan providing for deferred benefits, other than compensation, for employees, their spouses or their dependents are treated as plans deferring the receipt of compensation.⁷³² However, benefits provided through welfare benefit funds⁷³³ are not included in this rule.⁷³⁴ This rule applies to arrangements with independent contractors, as described in IV.A.3.c.(9), above.⁷³⁵ To the extent the application of the rules in IV.A.3.c.(1) through (7), above, is dependent on when the employee reports gross income but the benefits are excluded from gross income, the determination of when an amount is includible in gross income is made as though there were no exclusion.⁷³⁶

d. Benefit Based Limitations

In computing the amount of the deduction with respect to a defined benefit plan, benefits for any year in excess of any limitation on benefits provided by §415 for that year are not taken into account.⁷³⁷ In computing the amount of the deduction with respect to a defined contribution plan, the amount of any contributions otherwise taken into account must be reduced by any annual additions in excess of the §415 limitation for that year.⁷³⁸ In computing the deduction with respect to a pension plan, and in computing the full funding limitation, cost of living adjustments under §415(d)(1) for any year before the year for which the adjustment first takes effect are not taken into account.⁷³⁹ The §415 funding and benefit limitation rules are discussed in 371 T.M., *Employee Plans — Deductions, Contributions and Funding*.

For the purpose of determining the amount deductible for contributions to pension, annuity, stock bonus, or profit-sharing plans on behalf of a self-employed individual treated as an employee under §401(c)(1), the portion of the contributions allocable, as determined under regulations, to the purchase of life, accident, health or other insurance are not taken into account

⁷¹⁶ §404(a)(9)(B).

⁷¹⁷ §404(a)(9)(D).

⁷¹⁸ §404(a)(9)(C).

⁷¹⁹ §404(h)(1).

⁷²⁰ §404(h)(3).

⁷²¹ §404(h)(1)(C).

⁷²² §404(h)(2).

⁷²³ §404(n) (reference to §402(g)(3)).

⁷²⁴ §404(h)(1)(C).

⁷²⁵ §404(h)(1)(A).

⁷²⁶ Pub. L. No. 117-328, Div. T.

⁷²⁷ §4972(c)(6)(B), as amended by the SECURE 2.0 Act of 2022, Pub. L. No. 117-328, Div. T, §118, effective for taxable years beginning after December 29, 2022. §4972(c)(6) flush language.

⁷²⁸ §404(d)(2).

⁷²⁹ §404(d)(1).

⁷³⁰ §404(d)(2).

⁷³¹ §404(b)(1).

⁷³² §404(b)(2)(A).

⁷³³ See §419(e).

⁷³⁴ §404(b)(2)(B).

⁷³⁵ §404(d).

⁷³⁶ §404(b)(2)(A).

⁷³⁷ §404(j)(1)(A).

⁷³⁸ §404(j)(1)(B).

⁷³⁹ §404(j)(2).

in making the computations or calculating the limitations that apply to the plans.⁷⁴⁰ The computations and limitations are described in IV.A.3.c.(1) through (3), above.

e. Participant Compensation Based Limitations

Generally, for benefits accruing in plan years beginning after December 31, 1993, in computing the amount of the deduction for employer contributions to qualified plans and payments or accruals of deferred compensation, the amount of annual compensation of each employee taken into account may not exceed a specified amount, as adjusted for inflation.⁷⁴¹ The amount is adjusted by the IRS at the same time and in the same manner as cost of living adjustments are made for purposes of the funding rules of §401(a)(17)(B).⁷⁴² The amounts are mapped out in the Working Papers to 371 T.M., *Employee Plans — Deductions, Contributions and Funding*.

In computing the deduction with respect to a pension plan, and in computing the full funding limitation, any cost of living adjustments under §401(a)(17)(B) for any year before the year for which the adjustment first takes effect is not taken into account.⁷⁴³ Special rules apply to the determination of an employee's compensation.⁷⁴⁴ The compensation limit and its effective dates are discussed in 371 T.M., *Employee Plans — Deductions, Contributions and Funding*.

f. Deductible Dividends on Employer Securities

(1) In General

In the case of a corporation, deductions are allowed under §404(k) for any applicable dividends paid in cash by the corporation with respect to applicable employer securities.⁷⁴⁵ The IRS may disallow the deduction, however, for any dividend if it determines that the dividend constitutes, in substance, an avoidance or evasion of taxation.⁷⁴⁶ For tax years beginning after December 31, 1997, S corporations are not allowed this deduction.⁷⁴⁷

(2) Applicable Dividends

Applicable dividends are those which, in accordance with plan provisions, satisfy any one of four conditions.⁷⁴⁸ First, the dividends must be paid in cash to the participants in the plan or their beneficiaries.⁷⁴⁹ Second, the dividends must be paid to the plan and must be distributed in cash to participants in the plan or their beneficiaries not later than 90 days after the close of the plan year in which paid.⁷⁵⁰ Third, the dividends must be, at the election of the plan participants or their beneficiaries, either payable as provided in either of the first two conditions or paid to the plan and reinvested in qualifying employer securities,⁷⁵¹

but if the dividend is reinvested at the participant's election, it must be nonforfeitable.⁷⁵² Fourth, the dividends must be used to make payments on a loan incurred for the purpose of acquiring employer securities,⁷⁵³ the proceeds of which were used to acquire employer securities, whether or not allocated to participants, on which the dividends are paid.⁷⁵⁴ The fourth condition is not satisfied with respect to any employer security allocated to a participant unless the plan provides that employer securities with fair market values of not less than the amount of the dividend are allocated to the participant for the year which the dividend would have been allocated to the participant.⁷⁵⁵

(3) Applicable Employer Securities

Applicable employer securities are employer securities⁷⁵⁶ held on the record date for the applicable dividend in question by an ESOP⁷⁵⁷ maintained by the corporation paying the dividend or any other corporation that is a member of a controlled group⁷⁵⁸ of which the corporation paying the dividend is a member.⁷⁵⁹

(4) Timing

The deduction is allowed in the corporation's tax year in which the dividend is paid or distributed to a participant or a beneficiary.⁷⁶⁰ The deduction for dividends that are reinvested in qualifying employer securities at the election of participants is allowable for the tax year in which the later of the reinvestment or the election occurs.⁷⁶¹ If the dividend is an applicable dividend because it meets the fourth condition described in IV.A.3.f.(2), above, the deduction is allowed in the corporation's tax year in which the dividend is used to repay the loan.⁷⁶²

4. Employer Contributions to Certain Foreign Deferred Compensation Plans

a. In General

Under §404A, employer payments and accruals with respect to qualified foreign plans are deductible subject to special rules and limitations provided by §404A.⁷⁶³ No deduction is allowed under any other provision of the Code.⁷⁶⁴

Deductions for employer contributions to qualified foreign plans are described below, and are discussed in 371 T.M., *Employee Plans — Deductions, Contributions and Funding*.

b. Qualified Foreign Plan

A written plan of an employer for deferring the receipt of compensation is a qualified foreign plan if three conditions

⁷⁴⁰ §404(e).

⁷⁴¹ §404(l).

⁷⁴² *Id.*

⁷⁴³ *Id.*

⁷⁴⁴ *Id.*

⁷⁴⁵ §404(k)(1).

⁷⁴⁶ §404(k)(5)(A).

⁷⁴⁷ §404(k)(1).

⁷⁴⁸ §404(k)(2)(A).

⁷⁴⁹ §404(k)(2)(A)(i).

⁷⁵⁰ §404(k)(2)(A)(ii).

⁷⁵¹ §404(k)(2)(A)(iii).

⁷⁵² §404(k)(7).

⁷⁵³ See §4975(e)(8).

⁷⁵⁴ §404(k)(2)(A)(iv).

⁷⁵⁵ §404(k)(2)(B).

⁷⁵⁶ §404(k)(6)(A) (reference to §409(l)).

⁷⁵⁷ §404(k)(6)(B) (reference to §4975(e)(7)).

⁷⁵⁸ See §409(l)(4).

⁷⁵⁹ §404(k)(3).

⁷⁶⁰ §404(k)(4)(A).

⁷⁶¹ §404(k)(4)(B).

⁷⁶² §404(k)(4)(C).

⁷⁶³ §404A(a).

⁷⁶⁴ §404A(a)(1).

are satisfied.⁷⁶⁵ First, the plan must be for the exclusive benefit of the employer's employees or their beneficiaries.⁷⁶⁶ Second, 90% or more of the amounts taken into account for the tax year under the plan must be attributable to services performed by nonresident aliens the compensation for which is not subject to income tax.⁷⁶⁷ Third, the employer must elect, pursuant to regulations, to have §404A apply to the plan.⁷⁶⁸

The rules for deducting payments and accruals are different for qualified foreign plans that are qualified reserve plans than are the rules for qualified foreign plans that are qualified funded plans.⁷⁶⁹ A qualified reserve plan is a qualified foreign plan with respect to which an election made by the taxpayer is in effect for the tax year.⁷⁷⁰ An election is made in such manner and form as the IRS prescribes and, once made, may be revoked only with the consent of the IRS.⁷⁷¹ A qualified funded plan is any qualified foreign plan that is not a qualified reserve plan.⁷⁷²

c. Prerequisites

(1) Payments

No deduction is allowed for employer contributions to qualified funded plans unless the contribution is actually paid.⁷⁷³ Payments made on account of a tax year and made by the due date, including extensions, for filing the tax return for that tax year, are treated as having been paid on the last day of the tax year.⁷⁷⁴

(2) Deductibility Qualification

No deduction is allowed for employer contributions to qualified plans or payments and accruals of deferred compensation unless the deduction would be deductible under another provision of the Code but for the §404 denial of deductions under other provisions.⁷⁷⁵

(3) Plan Qualification

In the case of a qualified funded plan, a contribution is not taken into account unless it is paid to a trust, or the equivalent of a trust, meeting the requirements of §401(a)(2),⁷⁷⁶ for a retirement annuity,⁷⁷⁷ or to a participant or beneficiary.⁷⁷⁸

No deduction is allowed for payments with respect to a pension type qualified funded plan made in a tax year that ends within or with a tax year of the plan for which it is not exempt under §501(a).⁷⁷⁹ No deduction is allowed for payments with respect to any other type of qualified funded plan made in a tax

year that ends within or with a tax year of the plan for which it is not exempt under §501(a).⁷⁸⁰

Plan qualification is discussed in 350 T.M., *Plan Selection — Pension and Profit-Sharing Plans*; 351 T.M., *Plan Qualification — Pension and Profit-Sharing Plans*; and 352 T.M., *Specialized Qualified Plans — Cash Balance, Target, Age-Weighted and Hybrids*.

d. Plan-Based Computations and Limitations

(1) Qualified Funded Plans

(a) Payments with Respect to Pension Type Plan

The amount that is allowed as a deduction for the tax year for payments with respect to a qualified funded plan under which the benefits are fixed or determinable is computed using basic computational rules and limitations similar to those that apply to contributions to qualified pension trusts, as described in IV.A.3.c.(1), above, except that the third basic computational rule and the §412 full funding rule do not apply.⁷⁸¹

(b) Payments with Respect to Other Type Plan

The amount that is allowed as a deduction for the tax year for payments with respect to a qualified funded plan other than a pension type plan is computed using limitations similar to those that apply to contributions to qualified stock bonus or profit-sharing trusts, as described in IV.A.3.c.(3), above.⁷⁸²

(c) Carryforwards

Any amount not deductible by reason of the limitations described in IV.A.4.d.(1)(a) and (b), above, is treated as an amount paid in the succeeding tax year.⁷⁸³

(d) Payments to Multiple Plans

If amounts are deductible in connection with one or more qualified funded plans that are pension type plans and qualified plans that are not that type, the deduction is subject to limitations based on the rules similar to those that apply when amounts are deductible with respect to contributions to one or more defined contribution plans and one or more defined benefit plans.⁷⁸⁴

(2) Qualified Reserve Plans

The amount deductible in a tax year with respect to a qualified reserve plan is the reasonable addition for the tax year to a reserve for the taxpayer's liability under the plan.⁷⁸⁵ Unless otherwise required or permitted in regulations, the reserve is determined under the unit credit method modified to reflect two adjustments.⁷⁸⁶ All benefits paid under the plan must be charged to the reserve.⁷⁸⁷

⁷⁶⁵ §404A(e).

⁷⁶⁶ §404A(e)(1).

⁷⁶⁷ §404A(e)(2).

⁷⁶⁸ §404A(e)(3).

⁷⁶⁹ See §404A(c).

⁷⁷⁰ §404A(f)(2).

⁷⁷¹ §404A(f)(2).

⁷⁷² §404A(f)(1).

⁷⁷³ §404A(b)(1).

⁷⁷⁴ §404A(b)(2).

⁷⁷⁵ §404A(a)(2).

⁷⁷⁶ §404A(b)(5)(A).

⁷⁷⁷ §404A(b)(5)(B).

⁷⁷⁸ §404A(b)(5)(C).

⁷⁷⁹ §404A(b)(3)(A)(i) (reference to §404(a)(1)(A)).

⁷⁸⁰ §404A(b)(3)(A)(ii) (reference to §404(a)(3)).

⁷⁸¹ §404A(b)(3)(A)(i).

⁷⁸² §404A(b)(3)(A)(ii).

⁷⁸³ §404A(b)(4).

⁷⁸⁴ §404A(b)(3)(B) (reference to §404(a)(7)).

⁷⁸⁵ §404A(c)(1).

⁷⁸⁶ *Id.*

⁷⁸⁷ *Id.*

The first modification that must be made to the reserve is to take into account for the tax year only those items for which there is no substantial risk that the rights of the employee will be forfeited,⁷⁸⁸ and that meet the additional requirements established by regulations to ensure that the liability will be satisfied.⁷⁸⁹ The second modification requires amortization over 10 years of any increase or decrease to the reserve on account of the adoption of the plan or a plan amendment,⁷⁹⁰ experience gains and losses,⁷⁹¹ any change in actuarial assumptions,⁷⁹² changes in the reserve plan interest rate⁷⁹³ and any other factors as prescribed by regulations.⁷⁹⁴

e. Foreign Law Based Limitations

For any tax year, the deduction allowed under §404A is equal to the lesser of the cumulative United States amount or the cumulative foreign amount, reduced by the aggregate amount determined under §404A for all prior tax years.⁷⁹⁵ The cumulative United States amount is the aggregate amount determined with respect to the plan under §404A for the tax year and all prior tax years to which §404A applies, disregarding the previous sentence.⁷⁹⁶ The cumulative foreign amount is the aggregate amount allowed as a deduction under the appropriate foreign tax laws for the tax year and all prior tax years to which §404A applies.⁷⁹⁷

f. Nature of Services Limitation

No deduction is allowed under §404A for any item attributable to services either performed by a United States citizen or resident who is a highly compensated employee,⁷⁹⁸ or performed in the United States the compensation for which is subject to income tax.⁷⁹⁹ However, the employer is allowed to deduct the amount attributable to the contribution to the extent it is included in the employee's gross income, in the tax year of inclusion.⁸⁰⁰ If more than one employee participates in the plan, no deduction is allowed unless separate accounts are maintained for each employee.⁸⁰¹ Any vacation pay treated as deferred compensation is deductible for the tax year of the employer in which it is paid to the employee.⁸⁰²

g. Information Limitation

No deduction is allowable under §404A with respect to any plan for any tax year unless the taxpayer furnishes the IRS with certain information at such time as the IRS by regulations requires.⁸⁰³

⁷⁸⁸ §404A(c)(3)(A).

⁷⁸⁹ §404A(c)(3)(B).

⁷⁹⁰ §404A(c)(4)(A).

⁷⁹¹ §404A(c)(4)(B).

⁷⁹² §404A(c)(4)(C).

⁷⁹³ §404A(c)(4)(D) (reference to §404A(g)(3)(B)).

⁷⁹⁴ §404A(c)(4)(E).

⁷⁹⁵ §404A(d)(1).

⁷⁹⁶ §404A(d)(2)(A).

⁷⁹⁷ §404A(d)(2)(B).

⁷⁹⁸ §404A(g)(1)(A) (reference to §414(q)).

⁷⁹⁹ §404A(g)(1)(B).

⁸⁰⁰ §404A(g)(1) (reference to §404(a)(5)).

⁸⁰¹ *Id.*

⁸⁰² *Id.*

⁸⁰³ §404A(g)(2).

5. Contributions to Funded Welfare Benefit Plans

a. In General

Under §419, contributions paid or accrued by an employer to a welfare benefit fund are deductible subject to special rules and limitations.⁸⁰⁴ No deduction is allowed under any other provision of the Code.⁸⁰⁵

Deductions for employer contributions to welfare benefit funds are described below, and are discussed in 395 T.M., *VEBAs and Other Welfare Benefit Funding Arrangements*.

b. Welfare Benefit Fund

(1) In General

A welfare benefit fund is any fund which is part of a plan of an employer and through which the employer provides welfare benefits to employees or their beneficiaries.⁸⁰⁶ A welfare benefit is any benefit other than a transfer of property for services subject to §83,⁸⁰⁷ a contribution to a qualified stock bonus, profit-sharing, pension or annuity plan to which §404 applies⁸⁰⁸ or a contribution to a qualified foreign plan to which §404A applies.⁸⁰⁹

(2) Fund

A fund is any organization described in §501(c)(7), §501(c)(9), §501(c)(17), or §501(c)(20),⁸¹⁰ any trust, corporation, or other organization not exempt from income tax,⁸¹¹ and, to the extent provided in regulations, any account held for an employer by any person.⁸¹² However, a fund does not include amounts held by an insurance company pursuant to an insurance contract if the contract is a life insurance contract described in §264(a)(1) or a qualified nonguaranteed contract.⁸¹³

A qualified nonguaranteed contract is any insurance contract, including a reasonable premium stabilization reserve held thereunder, if there is no guarantee of a renewal of the contract, and other than insurance protection, the only payments to which the employer or employees are entitled are experienced rated refunds or policy dividends which are not guaranteed and which are determined by factors other than the amount of welfare benefits paid to, or on behalf of, the employees or their beneficiaries.⁸¹⁴ However, qualified nonguaranteed contracts are not excluded from the definition of a fund unless the amount of any experience rated refund or policy dividend payable to the employer with respect to a policy is treated by the employer as received or accrued in the tax year in which the policy year ends.⁸¹⁵

⁸⁰⁴ §419(a).

⁸⁰⁵ §419(a)(1).

⁸⁰⁶ §419(e)(1).

⁸⁰⁷ §419(e)(2)(A).

⁸⁰⁸ §419(e)(2)(B).

⁸⁰⁹ §419(e)(2)(C).

⁸¹⁰ §419(e)(3)(A).

⁸¹¹ §419(e)(3)(B).

⁸¹² §419(e)(3)(C).

⁸¹³ §419(e)(4)(A).

⁸¹⁴ §419(e)(4)(B)(i).

⁸¹⁵ §419(e)(4)(B)(ii).

c. Deductibility Qualification

No deduction is allowed for employer contributions to qualified plans or payments and accruals of deferred compensation unless the deduction would be deductible under another provision of the Code but for the §404 denial of deductions under other provisions.⁸¹⁶

d. Limitations

(1) In General

The amount of the deduction allowed under §419 for any tax year is limited to the welfare benefit fund's qualified cost for the tax year.⁸¹⁷ The qualified cost, with respect to any tax year, is the sum of the qualified direct cost for the tax year⁸¹⁸ and any addition to a qualified asset account for the tax year⁸¹⁹ to the extent it does not cause the amount in the account to exceed the account limit under §419A(b).⁸²⁰ No item may be taken into account more than once in determining qualified cost.⁸²¹

(2) After-Tax Income Reduction

The qualified cost for any tax year must be reduced by the welfare benefit fund's after-tax income for the tax year.⁸²² With respect to any tax year, after-tax income is the gross income of the welfare benefit fund reduced by the sum of the deductions directly connected with the production of the gross income plus any income tax imposed on the fund for the tax year.⁸²³ In determining gross income, contributions and other amounts received from employees are taken into account, but contributions from the employer are not taken into account.⁸²⁴

(3) Qualified Direct Cost

With respect to any tax year, qualified direct cost is the aggregate amount, including administrative expenses, which would have been allowable as a deduction to the employer with respect to the benefits provided during the tax year, if the benefits had been provided directly by the employer and the employer had used the cash method of accounting.⁸²⁵ A benefit is treated as provided when the benefit would be includible in the employee's gross income if provided directly by the employer, or would be so includible but for any provision excluding the value of the benefit from gross income.⁸²⁶

In determining qualified direct costs with respect to any child care facility, in lieu of depreciation, the adjusted basis of the facility shall be amortized ratably over 60 months beginning with the month the facility is placed in service.⁸²⁷ A child care facility is any tangible property which qualifies under regulations as a child care center primarily for children of employ-

ees of the employer.⁸²⁸ Child care facilities do not include any property not of a character subject to depreciation⁸²⁹ or located outside the United States.⁸³⁰

(4) Qualified Asset Account

A qualified asset account is any account consisting of assets set aside to provide for the payment of disability benefits, medical benefits, SUB or severance pay benefits or life insurance benefits.⁸³¹ Generally, the account limit for a qualified asset account for any tax year is the amount reasonably and actuarially necessary to fund claims incurred but unpaid as of the close of the tax year for covered benefits and administrative costs with respect to those claims.⁸³² Special rules for reserves apply to the accounts,⁸³³ and various limitations apply to the account limit with respect to particular benefits.⁸³⁴ Qualified asset accounts are discussed in 395 T.M., *VEBAs and Other Welfare Benefit Funding Arrangements*.

(5) Carryforwards

Any amount not deductible by reason of the limitation described in IV.A.5.d.(1), above, is treated as an amount paid by the employer to the fund in the succeeding tax year.⁸³⁵

e. Independent Contractor Benefits

Amounts contributed for benefits for an independent contractor are deductible under §419, determined as though the person for whom the services are provided and the independent contractor have an employer-employee relationship.⁸³⁶

f. Absence of Plan

If there is no plan, but there is a method or arrangement of employer contributions or benefits which has the effect of a plan, §419 is applied as if there were a plan.⁸³⁷

6. Employer's Deduction for Property Transferred Subject to Substantial Restriction

In the case of a transfer of property in connection with the performance of services to which §83 applies, the person for whom the services are performed is allowed a deduction under §162.⁸³⁸ The deduction is allowed for the service recipient's tax year in which ends the service performer's applicable tax year.⁸³⁹ The applicable tax year is the tax year in which the service performer must include the appropriate amount in gross income as required by §83(a), §83(b), or §83(d)(2).⁸⁴⁰ The amount of the deduction equals the amount includible in the gross income of the person performing the services.⁸⁴¹

⁸¹⁶ §419(a)(2).

⁸¹⁷ §419(b).

⁸¹⁸ §419(c)(1)(A).

⁸¹⁹ §419(c)(1)(B).

⁸²⁰ *Id.* (reference to §419A(b)).

⁸²¹ §419(c)(5).

⁸²² §419(c)(2).

⁸²³ §419(c)(4)(A).

⁸²⁴ §419(c)(4)(B).

⁸²⁵ §419(c)(3)(A).

⁸²⁶ §419(c)(3)(B).

⁸²⁷ §419(c)(3)(C)(i).

⁸²⁸ §419(c)(3)(C)(ii).

⁸²⁹ §419(c)(3)(C)(ii)(I).

⁸³⁰ §419(c)(3)(C)(ii)(II).

⁸³¹ §419A(a).

⁸³² §419A(c)(1).

⁸³³ See §419A(c)(2), §419A(f)(7).

⁸³⁴ See §419A(c)(4), §419A(c)(5), §419A(d), §419A(e).

⁸³⁵ §419(d).

⁸³⁶ §419(g).

⁸³⁷ §419(f).

⁸³⁸ §83(h).

⁸³⁹ *Id.*

⁸⁴⁰ *Id.*

⁸⁴¹ *Id.*

Transfers of property to which §83 applies are discussed in 384 T.M., *Restricted Property* — §83.

7. Black Lung Benefit Trust Contributions

a. In General

Under §192, a deduction is allowed for amounts contributed by the taxpayer to black lung liability trusts.⁸⁴² Black lung liability trusts are trusts that are established to satisfy liabilities under the Part C of Title IV of the Federal Mine Safety and Health Act of 1977, and any state law providing for compensation for disability or death due to pneumoconiosis, for disability or death due to pneumoconiosis and that are exempt from taxation under §501(c)(21).⁸⁴³

No deduction under §162 is allowed with respect to any liability taken into account in determining the §192 deduction of the taxpayer or a predecessor taxpayer.⁸⁴⁴

The §192 deduction is described below, and is discussed in 514 T.M., *Tax Incentives to Hire, Retain, or Compensate Employees*.

b. Payment

No deduction is allowed under §192 with respect to any contribution to a black lung liability trust other than one made in cash,⁸⁴⁵ in public debt securities of the United States,⁸⁴⁶ in obligations of a state or local government which are not in default as to principal or interest⁸⁴⁷ or as time or demand deposits in a bank⁸⁴⁸ or insured credit union⁸⁴⁹ located in the United States.⁸⁵⁰ Payments made on account of a tax year and made by the due date, including extensions, for filing the tax return for that tax year, are treated as having been paid on the last day of the tax year.⁸⁵¹

c. Limitation

(1) In General

The amount deductible under §192 for any tax year is limited to the greater of two amounts.⁸⁵² The first amount is the amount necessary to fund, with level funding, the remaining unfunded liability of the taxpayer for black lung claims filed, or expected to be filed, by or with respect to past or present employees of the taxpayer.⁸⁵³ The second amount is the aggregate amount necessary to increase each black lung liability trust to the amount required to pay all amounts payable from the trust for the tax year.⁸⁵⁴

⁸⁴² §192(a).

⁸⁴³ See §501(c)(21).

⁸⁴⁴ §192(c)(5).

⁸⁴⁵ §192(c)(4).

⁸⁴⁶ §192(c)(4) (reference to §501(c)(21)(A)(ii)(II)).

⁸⁴⁷ §192(c)(4) (reference to §501(c)(21)(A)(ii)(II)).

⁸⁴⁸ See §581.

⁸⁴⁹ See 12 U.S.C. §1752(6).

⁸⁵⁰ §192(c)(4) (reference to §501(c)(21)(A)(ii)(III)).

⁸⁵¹ §192(c)(3).

⁸⁵² §192(b).

⁸⁵³ §192(b)(1).

⁸⁵⁴ §192(b)(2).

(2) Funding Determinations

In determining the amounts described in IV.A.7.c.(1), above, the taxpayer must use reasonable actuarial methods and assumptions which are not inconsistent with regulations.⁸⁵⁵

Note: Regulations under §192 have not yet been promulgated.

The funding period is the greater of 10 tax years or the average remaining working life of miners, as defined in §402(d) of the Black Lung Benefits Act,⁸⁵⁶ who are present employees of the taxpayer.⁸⁵⁷ A different funding period may be used if regulations provide or the IRS consents to the taxpayer's proposal for a different period.⁸⁵⁸

Only black lung benefit claims the payment of which is expected to be made from the black lung liability trust are taken into account.⁸⁵⁹ Black lung benefit claims are claims for compensation for disability or death due to pneumoconiosis under part C of title IV of the Federal Mine Safety and Health Act of 1977⁸⁶⁰ or under any state law providing for such compensation.⁸⁶¹

d. Carryforwards

Any amount not deductible by reason of the limitation described in IV.A.7.c., above, is treated as an amount paid by the taxpayer to the trust in the succeeding tax year.⁸⁶²

8. Employer Liability Trust Contributions

a. In General

Under §194A, a deduction is allowed for the tax year for amounts contributed by an employer to withdrawal liability payment fund trusts⁸⁶³ that are properly allocable to the tax year. Withdrawal liability payment fund trusts are trusts that are established to pay the employer's withdrawal liability with respect to plans subject to §4223 of the Employee Retirement Income Security Act of 1974 (ERISA), are exempt from taxation under §501(c)(22), and meet the requirements of §4223(h) of ERISA.⁸⁶⁴ No deduction is allowed under §194A for any contribution that does not relate to any specified period of time.⁸⁶⁵

The §194A deduction is described below, and is discussed in 514 T.M., *Tax Incentives to Hire, Retain, or Compensate Employees*.

b. Allocable to the Tax Year

The amount of a contribution to a withdrawal liability payment fund trust allocable to a tax year is determined by prorating any contribution that relates to any specified period of time

⁸⁵⁵ §192(c)(1)(A).

⁸⁵⁶ 30 U.S.C. §902(d).

⁸⁵⁷ §192(c)(1)(B).

⁸⁵⁸ §192(c)(1)(C).

⁸⁵⁹ §192(c)(2).

⁸⁶⁰ 30 U.S.C. §901 *et seq.*

⁸⁶¹ §192(e).

⁸⁶² §192(d).

⁸⁶³ See §501(c)(22).

⁸⁶⁴ See §194A(a), §501(c)(22).

⁸⁶⁵ §194A(c).

that includes more than one tax year among those tax years pursuant to regulations.⁸⁶⁶

Note: Regulations under §194A have not yet been promulgated.

B. Cost of Goods Sold

1. In General

Cost of goods sold includes the “costs of acquiring inventory, through either purchase or production.”⁸⁶⁷ Technically, the cost of goods sold is an exclusion from gross income and not a deduction.⁸⁶⁸ However, the regulations under §162 describe the cost of goods purchased for resale as a cost that is “deducted from gross sales in computing gross income.”⁸⁶⁹ There can be no recognition of cost of goods sold before there are any gross receipts from the sale of goods.⁸⁷⁰ The exclusion of cost of goods sold from gross income is discussed in 501 T.M., *Gross Income: Overview and Conceptual Aspects*.

No adjustment for cost of goods sold is allowed if the taxpayer fails to prove that any costs were incurred.⁸⁷¹ The taxpayer has the burden of proving the amount expended for purchases of goods acquired for resale.⁸⁷² No deduction for cost of goods sold is allowed if the taxpayer does not report any gross sales of the goods.⁸⁷³

2. Elements of Cost of Goods Sold

a. Purchase Price

The cost of items acquired for resale are not deductible under §162 as trade or business expenses.⁸⁷⁴ Likewise, the costs of producing items for resale are not deductible under §162.⁸⁷⁵ Instead, these costs are included in cost of goods sold.⁸⁷⁶

Cost of goods sold includes accrued liability for special assessment bonds imposed on the real property included in the taxpayer’s inventory.⁸⁷⁷ It also includes proceeds from inventory sales used to satisfy floor plan loans used to purchase the inventory.⁸⁷⁸

Discounts on the cost of the goods acquired for resale reduce the cost of goods sold and do not reduce the amount realized from the sale of stock in the supplier to a related party.⁸⁷⁹

b. Use of Related Assets

Depreciation, amortization and depletion with respect to property used in connection with the acquisition or production of goods acquired or produced for resale is included in cost of goods sold.⁸⁸⁰ Likewise, cost of goods sold includes the cost of supplies consumed by the taxpayer in producing the goods held for resale.⁸⁸¹

c. Costs of Acquisition and Protection

Cost of goods sold includes amounts paid for freight and drayage charges on incoming goods,⁸⁸² and the costs of crating, packing and handling that are imposed on the taxpayer.⁸⁸³ Likewise, it includes the cost of storing and moving inventory maintained in other locations, ownership of which is represented by warehouse certificates, together with taxes on the inventory.⁸⁸⁴ Cost of goods sold includes taxes imposed on the sale to the taxpayer of gas used in carrying on the trade or business, provided the tax is not imposed at the same rate as the general sales tax.⁸⁸⁵

Cost of goods sold also includes amounts paid to accountants for checking and identifying physical inventories, provided the accountants’ charges are separated from their charges for other services.⁸⁸⁶ It also includes sales-service fees charged by a franchisor to a franchisee that are based on a percentage of goods purchased by the franchisee from the franchisor.⁸⁸⁷ Cost of goods sold does not include amounts paid to the child of a corporate officer in the form of commissions, but that have no connection with the acquisition or disposition of the inventory.⁸⁸⁸

Cost of goods sold includes expenses of caring for and maintaining the goods that are held for resale.⁸⁸⁹ It includes assessments imposed on the property held for resale and paid by the taxpayer.⁸⁹⁰

d. Assurance of Supply

Cost of goods sold does not include loans made to suppliers to ensure supply and eventual delivery,⁸⁹¹ or the cost of con-

⁸⁶⁶ §194A(b).

⁸⁶⁷ *Patients Mut. Assistance Collective Corp. v. Commissioner*, 151 T.C. 176 (2018), aff’d, 995 F.3d 671 (9th Cir. 2021).

⁸⁶⁸ See Reg. §1.162-1(a).

⁸⁶⁹ Reg. §1.162-1(a).

⁸⁷⁰ See *Patients Mut. Assistance Collective Corp. v. Commissioner*, 151 T.C. 176 (2018) (when accounting for cost of goods sold, taxpayers must capitalize an item’s cost in the year of acquisition or production, and either amortize it or wait until the year the item is sold to make the corresponding adjustment to gross income), aff’d, 995 F.3d 671 (9th Cir. 2021); *BRC Operating Co. v. Commissioner*, T.C. Memo 2021-59 (estimated drilling costs for natural gas exploration are not cost of goods sold in years when taxpayer had no gross receipts related to the sale of natural gas).

⁸⁷¹ See *Gibbs v. Commissioner*, 56 T.C.M. 459 (1988).

⁸⁷² E.g., *Carthage Spoke Co. v. Commissioner*, 21 B.T.A. 1135 (1931); *G.F. Stother Lumber Co. v. Commissioner*, 10 B.T.A. 1174 (1928); *Connorized Music Co. v. Commissioner*, 7 B.T.A. 213 (1927); *Maroon v. Commissioner*, 31 T.C.M. 570 (1972); *H.H. Mink & Son Bag Co. v. Commissioner*, 29 T.C.M. 778 (1970).

⁸⁷³ *Colvin v. Commissioner*, T.C. Memo 2007-157, aff’d, 285 Fed. App. 157 (5th Cir. 2008).

⁸⁷⁴ Reg. §1.162-1(a). See *Tarter v. Commissioner*, T.C. Memo 2007-320.

⁸⁷⁵ See §263A.

⁸⁷⁶ Reg. §1.162-1(a).

⁸⁷⁷ *Merlo Builders, Inc. v. Commissioner*, 23 T.C.M. 185 (1964).

⁸⁷⁸ *Denman v. Commissioner*, 42 T.C.M. 249 (1981).

⁸⁷⁹ *Eaton Paper Corp. v. Commissioner*, 1 T.C. 1 (1942).

⁸⁸⁰ §263A. See Rev. Rul. 53-141, 1953-2 C.B. 101.

⁸⁸¹ Rev. Rul. 75-407, 1975-2 C.B. 196.

⁸⁸² *May, Stern & Co. v. Commissioner*, 20 B.T.A. 241 (1930), aff’d per curiam, 56 F.2d 1034 (3d Cir. 1932).

⁸⁸³ *Doornbosch Bros., Inc. v. Commissioner*, 46 T.C. 199 (1966).

⁸⁸⁴ Rev. Rul. 74-264, 1974-1 C.B. 40.

⁸⁸⁵ Rev. Rul. 74-335, 1974-2 C.B. 55.

⁸⁸⁶ See *United Carbon Co. v. Commissioner*, 32 B.T.A. 1000 (1935), rev’d on other issues, 90 F.2d 43 (4th Cir. 1937).

⁸⁸⁷ Rev. Rul. 80-141, 1980-1 C.B. 111.

⁸⁸⁸ *Am. Lithofold Corp. v. Commissioner*, 55 T.C. 904 (1971).

⁸⁸⁹ *Biscayne Trust Co. v. Commissioner*, 18 B.T.A. 1015 (1930).

⁸⁹⁰ *50 E. 75th St. Corp. v. Commissioner*, 78 F.2d 158 (2d Cir. 1935), modifying 29 B.T.A. 277 (1933).

⁸⁹¹ *Powers Mfg. Co. v. Commissioner*, 7 B.T.A. 786 (1927), aff’d, 34 F.2d 255 (8th Cir. 1929); *Flick, Inc. v. Commissioner*, 27 T.C.M. 776 (1968); *Freedman v. Commissioner*, 35 T.C.M. 1531 (1976).

trolling stock in a supplier corporation.⁸⁹² However, in *McMillan Mortg. Co. v. Commissioner*,⁸⁹³ the Tax Court held that expenditures for the acquisition of Federal National Mortgage Association stock were deductible.⁸⁹⁴

Cost of goods sold includes any loss incurred on the disposition of stock in a supplier corporation acquired to assure the availability of goods purchased for resale.⁸⁹⁵ In some cases, the loss has been allowed as a deduction rather than being included in cost of goods sold when it arose from worthlessness rather than from sale.⁸⁹⁶ In other cases, a business deduction, rather than an inclusion in cost of goods sold, has been allowed when the loss arose from a sale.⁸⁹⁷ If the stock is acquired as an investment, any allowable loss is a capital loss and is not included in cost of goods sold.⁸⁹⁸

e. Future Costs

Cost of goods sold does not include amounts representing losses expected to be incurred when goods that are sold are returned.⁸⁹⁹ Likewise, cost of goods sold does not include estimates of additional work that might need to be done to make inventory salable after quality testing is performed in the following year.⁹⁰⁰

f. Personal or Other Use

Cost of goods sold must be reduced by items withdrawn for personal use by the taxpayer and related persons.⁹⁰¹ It must be reduced by the cost of items withdrawn from inventory and distributed as free samples for promotional purposes.⁹⁰² Advertising expenses are discussed in IV.F., below.

Cost of goods sold must be reduced by the cost of items of inventory that are seized by authorities as contraband.⁹⁰³ It must be reduced by the cost of items never received by, and never available for sale by, the taxpayer.⁹⁰⁴

g. Consignments and Holdbacks

Cost of goods sold does not include the cost or value of items placed with the taxpayer on consignment, because the taxpayer does not own those items and cannot hold them for resale.⁹⁰⁵ It does not include holdback charges that a manufacturer includes in the invoice price to its dealers but that is not paid and is not expected to be paid.⁹⁰⁶

3. Inventory Adjustments

Cost of goods sold must be computed by taking into account opening and closing inventories.⁹⁰⁷ Permissible methods of computing inventories are discussed in 578 T.M., *Inventories: General Principles; LIFO Method*.

If the taxpayer does not have inventories because it resells goods as soon as it acquires them, a proportionate method of computing cost of goods sold is used,⁹⁰⁸ unless inventories can be computed.⁹⁰⁹ In *Am. Indus. Corp. v. Commissioner*,⁹¹⁰ the court upheld a method by which the taxpayer's sales for a three-year period were divided by the cost of the goods acquired for resale, and the resulting fraction was multiplied by each year's sales to determine each year's cost of goods sold.⁹¹¹ A similar method has been used when the taxpayer's receipts have been destroyed and there is a relatively constant ratio between gross receipts and cost.⁹¹²

4. Excise Taxes

A taxpayer may claim as part of its cost of goods sold (COGS) only that excise tax which it actually paid or incurred. Thus, the amount of fuel excise tax includible in the taxpayer's COGS is reduced by the amount of tax credits that the taxpayer claims and receives under §6426(b) and §6426(c).⁹¹³

5. Proof

Unless the taxpayer proves otherwise, the IRS' computation of initial opening inventory is used in determining cost of goods sold.⁹¹⁴ So, too, is the IRS' determination of cost of goods sold.⁹¹⁵

⁸⁹² *Chalmers Liquor Co. v. Commissioner*, 1 B.T.A. 49 (1924).

⁸⁹³ 36 T.C. 924 (1961).

⁸⁹⁴ *Id.* at 933.

⁸⁹⁵ *Clark v. Commissioner*, 19 T.C. 48 (1952); *W. Wine & Liquor Co. v. Commissioner*, 18 T.C. 1090 (1952); *Kalil v. Commissioner*, 17 T.C.M. 342 (1958), aff'd on other issues, 271 F.2d 550 (5th Cir. 1959); *Flom v. Hofferbert*, 56-1 USTC ¶ 9236 (D. Md. 1955); *Hogg v. Allen*, 105 F. Supp. 12, 21 (M.D. Ga. 1952), aff'd, 214 F.2d 640 (5th Cir. 1954).

⁸⁹⁶ *E.g., Tulane Hardwood Lumber Co. v. Commissioner*, 24 T.C. 1146 (1955); *Hagan v. United States*, 221 F. Supp. 248 (W.D. Ark. 1963); *Smith & Welton v. United States*, 164 F. Supp. 605 (E.D. Va. 1958); *Todd v. United States*, 57-1 USTC ¶ 9389 (N.D. Ga. 1957); *Planters Exch., Inc. v. United States*, 57-1 USTC ¶ 9565 (N.D. Fla. 1957).

⁸⁹⁷ *Weather-Seal, Inc. v. Commissioner*, 22 T.C.M. 471 (1963); *Journal Co. v. United States*, 195 F. Supp. 434 (E.D. Wis. 1961).

⁸⁹⁸ *Gulftex Drug. Co. v. Commissioner*, 261 F.2d 238 (5th Cir. 1958), aff'g per curiam 29 T.C. 118 (1957); *McGhee Upholstery Co. v. Commissioner*, 12 T.C.M. 1455 (1953). See Rev. Rul. 58-40, 1958-1 C.B. 275, *suspended*, Notice 87-68, 1987-2 C.B. 378.

⁸⁹⁹ *Miller v. Commissioner*, 8 B.T.A. 566 (1927), modified in part on other issues, 10 B.T.A. 383 (1928).

⁹⁰⁰ *Nat'l Fireworks, Inc. v. Commissioner*, 15 T.C.M. 1 (1956), aff'd on other issues, 243 F.2d 295 (1st Cir. 1957).

⁹⁰¹ *Tucker v. Commissioner*, 39 T.C.M. 463 (1979); *Calamaras v. Commissioner*, 19 T.C.M. 1045 (1960).

⁹⁰² *Durovic v. Commissioner*, 487 F.2d 36 (7th Cir. 1973), cert. denied, 417 U.S. 919 (1974), aff'g in part, rev'g in part and rem'g in part 54 T.C. 1364 (1970), on remand, 65 T.C. 480 (1975), aff'd, 542 F.2d 1328 (7th Cir. 1976).

⁹⁰³ *Fuller v. Commissioner*, 20 T.C. 308 (1953), aff'd on other issues, 213 F.2d 102 (10th Cir. 1954).

⁹⁰⁴ *Spenger v. United States*, 167 F. Supp. 641 (N.D. Cal. 1958).

⁹⁰⁵ *Stoller v. United States*, 320 F.2d 340 (Ct. Cl. 1963).

⁹⁰⁶ Rev. Rul. 72-326, 1972-2 C.B. 30.

⁹⁰⁷ Reg. §1.162-1(a).

⁹⁰⁸ *Am. Indus. Corp. v. Commissioner*, 20 B.T.A. 188 (1930).

⁹⁰⁹ See *McGinnis v. Commissioner*, 4 B.T.A. 209 (1926).

⁹¹⁰ 20 B.T.A. 188 (1930).

⁹¹¹ *Id.* at 199.

⁹¹² See *Banks v. Commissioner*, 42 T.C.M. 1016 (1981).

⁹¹³ *Growthmark, Inc. v. Commissioner*, 160 T.C. No. 11, 2023 BL 166729 (May 16, 2023).

⁹¹⁴ See *Zeropack Co. v. Commissioner*, 47 T.C.M. 181 (1983), aff'd in unpublished opinion (4th Cir. 1985).

⁹¹⁵ See *Winer v. Commissioner*, 371 F.2d 684 (1st Cir. 1967), aff'g *Winer Enters. v. Commissioner*, 25 T.C.M. 525 (1966); *Estate of Sperling v. Commissioner*, 341 F.2d 201 (2d Cir. 1965), cert. denied, 382 U.S. 827 (1965), aff'g 22 T.C.M. 1301 (1963); *Billwiller v. Commissioner*, 11 B.T.A. 841 (1928), aff'd per curiam, 31 F.2d 286 (2d Cir. 1929), cert. denied, 279 U.S. 866 (1929); *Mosko v. Commissioner*, 52 T.C.M. 520 (1986); *Woodbury v. Commissioner*, 14 T.C.M. 191 (1955), aff'd per curiam on other issues, 231 F.2d 121 (3d Cir. 1956).

C. Renting Expenses

1. In General

A deduction for rental expenses is specifically allowed by §162.⁹¹⁶ Thus, a professional musician is permitted to deduct recording studio rental fees.⁹¹⁷ Rent paid in connection with investments is deductible under §212 if it is paid or incurred to produce or collect income or for the management, conservation or maintenance of property held for the production of income.⁹¹⁸

Thus, rents paid for safe deposit boxes used to keep property that produces income or evidence of the ownership of such property are deductible under §212.⁹¹⁹ But rents paid for safe deposit boxes used to keep jewelry and other items of personal use are not deductible.⁹²⁰

Additionally, the COVID-related Tax Relief Act⁹²¹ provides that otherwise deductible rent payments will not be denied a deduction merely because they are paid using nontaxable proceeds of a forgiven Paycheck Protection Loan (PPP loan)⁹²² if, among other requirements,⁹²³ the rent payment is for a covered rent obligation, which is an obligation under a leasing agreement in force before February 15, 2020.⁹²⁴

Under §162, the rental or other payment must be made as a condition to the continued use or possession, for the purposes of the trade or business, of property to which the taxpayer has not taken or is not taking title or in which he has no equity.⁹²⁵ Thus, in *Med. Collection Corp. v. Commissioner*,⁹²⁶ the Tax Court held that no deduction was allowed for amounts paid by a corporation to its president that were denominated rent but that were based on the payee's mortgage payments and taxes because the corporation had no profit motive in making the payments.⁹²⁷ In *Khinda v. Commissioner*,⁹²⁸ the IRS disputed rent deductions as not being ordinary and necessary for an apartment it considered as too large for the taxpayer's consulting business and which it suspected was the taxpayer's residence. The court chose to accept the taxpayer's claim of an office, perhaps because the IRS had already denied a mortgage interest

deduction on the apartment because it claimed it was not the taxpayer's qualified residence. The court, however, found that the "rent" payments were in reality mortgage payments, and a portion of the payments was nondeductible loan principal. The court did allow deduction of the portion of the payments relating to interest as a trade or business expense.

2. Lease Acquisition Expenditures

Expenditures for the acquisition of a lease are deducted proportionately over the term of the lease.⁹²⁹ For this purpose, the term of the lease includes all renewal options, and any other period for which the parties reasonably expect the lease to be renewed, if less than 75% of the cost is attributable to the period of the term of the lease remaining on its acquisition.⁹³⁰ In determining the period of the term of the lease remaining on its acquisition, any period for which the lease may subsequently be renewed, extended, or continued pursuant to an option exercisable by the lessee is not taken into account.⁹³¹ Lease acquisition expenditures are discussed in 593 T.M., *Real Estate Leases*.

3. Nature of Payments

Deductible rental payments include not only direct rents, but rents paid in kind by paying for improvements that are made to the lessor's property and that are intended to be credited against rents otherwise due.⁹³² Rental payments include taxes paid to or for a lessor by the taxpayer with respect to rented trade or business property,⁹³³ provided the lessee is obligated under the lease to make the payments.⁹³⁴

Advance rents are deductible for the tax years to which they relate.⁹³⁵ If they relate to the entire lease, they are deducted ratably over the lease term.⁹³⁶ Lease bonuses paid to the lessor are deducted ratably over the lease term.⁹³⁷

Rentals, advance rents, and lease bonuses are discussed in 593 T.M., *Real Estate Leases*.

4. Reasonableness

Rents that exceed the amount that would be charged in an arm's-length transaction are not deductible under §162 or §212 because they are not ordinary and necessary.⁹³⁸ The question is one of fact.⁹³⁹ Excessive rentals are a significant factor in determining that the transaction is in substance a purchase, making

⁹¹⁶ §162(a)(3).

⁹¹⁷ *Genck v. Commissioner*, 75 T.C.M. 1984 (1998).

⁹¹⁸ Reg. §1.212-1(g). *E.g.*, *Wiesler v. Commissioner*, 6 T.C. 1148 (1946), aff'd on other issues, 161 F.2d 997 (6th Cir. 1947), cert. denied, 332 U.S. 842 (1947), *acq.*, 1948-1 C.B. 3.

⁹¹⁹ *Kelly v. Commissioner*, 23 T.C. 682 (1955), aff'd on other issues, 228 F.2d 512 (7th Cir. 1956), *acq.*, 1955-1 C.B. 15; *Fry v. Commissioner*, 5 T.C. 1058 (1945), *acq.*, 1954-1 C.B. 4; *Imhoff v. Commissioner*, 39 T.C.M. 978 (1980), aff'd in unpub. opin. (3d Cir. 1982), cert. denied, 459 U.S. 1203 (1983).

⁹²⁰ Reg. §1.212-1(f).

⁹²¹ Pub. L. No. 116-260, Div. N, Title II, Subtitle B, §276 (amending §7A(i) of the Small Business Act), applicable to tax years ending after March 27, 2020.

⁹²² An "original PPP loan" is a PPP loan made during the covered period beginning on February 15, 2020, and ending on December 31, 2020. See CARES Act, Pub. L. No. 116-136, §1102(a)(2) (Mar. 27, 2020); Paycheck Protection Program Flexibility Act of 2020, Pub. L. No. 116-142, §3 (June 5, 2020).

⁹²³ For a complete discussion of Rev. Proc. 2021-20, see 536 T.M., *Interest Expense Deductions*.

⁹²⁴ CARES Act, Pub. L. No. 116-136, §1102(a)(4) (Mar. 27, 2020).

⁹²⁵ §162(a)(3).

⁹²⁶ 36 T.C.M. 1074 (1977).

⁹²⁷ *Med. Collection Corp. v. Commissioner* at 1080.

⁹²⁸ T.C. Summ. Op. 2017-32.

⁹²⁹ Reg. §1.162-11(a). *See, e.g.*, *Renwick v. United States*, 87 F.2d 123 (7th Cir. 1936) (long-term lease); *550 Park Ave. Corp. v. Commissioner*, 20 B.T.A. 288 (1930) (short-term lease).

⁹³⁰ §178(a).

⁹³¹ §178(b).

⁹³² *Your Health Club, Inc. v. Commissioner*, 4 T.C. 385 (1944).

⁹³³ Reg. §1.162-11(a). *See Metro. Co. v. United States*, 176 F. Supp. 195 (W.D. Ohio 1959).

⁹³⁴ *See Robinson v. Commissioner*, 53 F.2d 810 (8th Cir. 1931), aff'g 18 B.T.A. 703 (1930).

⁹³⁵ *See, e.g.*, *McCull v. Commissioner*, 10 B.T.A.M. 126 (1941).

⁹³⁶ *See, e.g.*, *Sw. Hotel Co. v. United States*, 115 F.2d 686 (5th Cir. 1940), aff'g 40-1 USTC ¶9414 (W.D. Tex. 1940).

⁹³⁷ *E.g.*, *Saks & Co. v. Commissioner*, 20 B.T.A. 1151 (1930).

⁹³⁸ Reg. §1.212-1(d). *See, e.g.*, *Midland Ford Tractor Co. v. Commissioner*, 277 F.2d 111 (8th Cir. 1960), aff'g 17 T.C.M. 1060 (1958); *Utter McKinley Mortuaries v. Commissioner*, 225 F.2d 870 (9th Cir. 1955), aff'g 12 T.C.M. 814 (1953); *Stanwick's Inc. v. Commissioner*, 15 T.C. 556 (1950), aff'd per curiam, 190 F.2d 84 (4th Cir. 1951).

⁹³⁹ *E.g.*, *Consol. Apparel Co. v. Commissioner*, 207 F.2d 580 (7th Cir. 1953), aff'g in part and rev'g in part 17 T.C. 1570 (1952).

all of the payments nondeductible as §162 or §212 rental expenses.⁹⁴⁰ The reasonableness of rental payments is discussed in 593 T.M., *Real Estate Leases*.

5. Existence of Lease

Payments are not deductible as rental expenses if there is in substance no lease and the payments are in fact payments towards the purchase price of the property.⁹⁴¹ The question is one of fact,⁹⁴² but the intent of the parties is usually the controlling factor.⁹⁴³

Payments are not deductible as rental expenses if there is in substance a financing structured as a sale-leaseback and the payments are in fact repayments of the amount borrowed.⁹⁴⁴ The question is one of fact.⁹⁴⁵

The treatment of disguised purchases and disguised financing devices is discussed in 593 T.M., *Real Estate Leases*.

6. Leasehold Improvements

The cost of making improvements on the rented property, including the cost of constructing buildings, must be capitalized and is not deductible as a rental expense under §162 or §212.⁹⁴⁶ A leasehold improvement, whether owned by the lessor or the lessee, must be depreciated by applying the depreciation rules of §168, including any additional first-year depreciation (bonus depreciation) deductions,⁹⁴⁷ even if the lease term is substantially shorter than the recovery period over which the cost of the improvement is deducted.⁹⁴⁸ Upon termination of a lease, either the lessor, in the case of a lessor-owned improvement,⁹⁴⁹ or the lessee, in the case of a lessee-owned improvement⁹⁵⁰ can claim a loss deduction with respect to the remaining undepreciated basis of any improvement that is irrevocably disposed of or abandoned, but any compensation from the lessor to the lessee for the improvements reduces the lessee's loss.

Leasehold improvements are discussed in 593 T.M., *Real Estate Leases*. Depreciation of leasehold improvements is discussed in 531 T.M., *Depreciation: MACRS and ACRS*.

7. Lease Cancellation Payments

Amounts paid by a lessee to obtain the lessor's agreement to terminate the lease are deducted in the year paid or accrued.⁹⁵¹ In addition, the lessee is allowed to deduct any remain-

ing unamortized or undepreciated basis in improvements made by the lessee.⁹⁵² Likewise, any remaining un-amortized leasehold acquisition costs are deductible when the lease is canceled.⁹⁵³ If the lessee abandons the leased property but continues to make the rental payments, those payments are deductible.⁹⁵⁴

Note: A lessor must capitalize amounts paid to the lessee to terminate a lease of real or tangible personal property between the taxpayer and the lessee.⁹⁵⁵ Presumably this principle is not inconsistent with the principle permitting a lessee to deduct in the year of payment or accrual the payment to obtain the lessor's agreement to terminate a lease.

However, no deduction is allowed if the purpose of the cancellation is to acquire a lease on newer or better property from the same lessor under circumstances demonstrating that the cancelled lease was not unprofitable but simply less financially advantageous than the new lease,⁹⁵⁶ but under the capitalization regulations a \$5,000 de minimis exception applies in the case of amounts paid to create, originate, enter into, renew or renegotiate property rental rights.⁹⁵⁷ The same reasoning applies if the cancellation is conditioned on acquisition of new property.⁹⁵⁸ In both situations, the lease termination payment must be capitalized and can be amortized over the new lease.

In *Union Carbide Foreign Sales Corp. v. Commissioner*,⁹⁵⁹ the Tax Court held that a lessee that paid to acquire depreciable property that it had been leasing, pursuant to a purchase option provided in the lease agreement, had to allocate the acquisition price entirely to its basis in the acquired property, and could not deduct any portion thereof as a lease termination payment. The Supreme Court has held likewise, but declined to opine on whether the outcome would have been different if there had been proof of excessive purchase price and proof that the rent under the lease was excessive.⁹⁶⁰ The Sixth Circuit, on the other hand, disagrees with *Union Carbide* and has held repeatedly that where the rent payments under the lease are excessive, the excess of the amount paid by the lessee-purchaser to acquire the property over the fair market value of the property is attributable to buying out the onerous lease and, thus, may be deducted by the lessee-purchaser.⁹⁶¹ The capitalization requirement is discussed in 509 T.M., *Principles of Capitalization*.

No deduction for unamortized leasehold acquisition costs or for unamortized or undepreciated basis in improvements made by the lessee is allowable under §162 or §212 merely because the lessee has an option to cancel the lease that has not

⁹⁴⁰ *E.g., J. Strickland & Co. v. United States*, 352 F.2d 1016 (6th Cir. 1965), vac'g and rem'g 64-2 USTC ¶ 9545 (W.D. Tenn. 1964).

⁹⁴¹ §162(a)(3). *E.g., Foyt v. United States*, 561 F.2d 599 (5th Cir. 1977).

⁹⁴² *E.g., Daniel v. Commissioner*, 37 T.C.M. 1180 (1978).

⁹⁴³ *E.g., WBSR, Inc. v. Commissioner*, 30 T.C. 747 (1958); *Smith v. Commissioner*, 35 T.C.M. 512 (1976); Rev. Rul. 55-540, 1955-2 C.B. 39.

⁹⁴⁴ *E.g., Perry v. United States*, 520 F.2d 235 (4th Cir. 1975), cert. denied, 423 U.S. 1052 (1976), rev'g 376 F. Supp. 15 (E.D. N.C. 1974); *Wiles v. Commissioner*, 59 T.C. 289 (1972), aff'd, 491 F.2d 1406 (5th Cir. 1974); Rev. Rul. 72-543, 1972-2 C.B. 87.

⁹⁴⁵ *Frank Lyon Co. v. United States*, 435 U.S. 561 (1978).

⁹⁴⁶ §263. See Reg. §1.162-11(b). See also Reg. §1.212-1(n). See *e.g., Nelson v. Commissioner*, 184 F.2d 649 (8th Cir. 1950), aff'g 8 T.C.M. 942 (1949); *Brown v. Commissioner*, T.C. Memo 1979-434; *Nat'l City Bank of Seattle v. United States*, 64 Ct. Cl. 236 (1927).

⁹⁴⁷ See, *e.g.*, §168(k), §168(m), §168(n). For a detailed discussion of bonus depreciation, see 532 T.M., *First-Year Expensing and Additional Depreciation*.

⁹⁴⁸ §168(i)(8)(A).

⁹⁴⁹ See §168(i)(8)(B).

⁹⁵⁰ See *Glazer Steel Corp. v. United States*, 388 F.2d 990 (Ct. Cl. 1967).

⁹⁵¹ *E.g., Denholm & McKay v. Commissioner*, 2 B.T.A. 444 (1925); Rev. Rul. 69-511, 1969-2 C.B. 24.

⁹⁵² *E.g., Cassatt v. Commissioner*, 137 F.2d 745 (3d Cir. 1943), aff'g 47 B.T.A. 400 (1942); *Coffey v. Commissioner*, 21 B.T.A. 1242 (1931); *Strauss v. United States*, 199 F. Supp. 845 (W.D. La. 1961).

⁹⁵³ *Guelph Hotel Corp. v. Commissioner*, 7 B.T.A. 1043 (1927).

⁹⁵⁴ *Stern Bros. v. Commissioner*, 13 B.T.A. 1192 (1928).

⁹⁵⁵ Reg. §1.263(a)-4(d)(7)(i)(A).

⁹⁵⁶ *U.S. Bancorp v. Commissioner*, 111 T.C. 231 (1998).

⁹⁵⁷ See Reg. §1.263(a)-4(d)(6).

⁹⁵⁸ PLR 9607016.

⁹⁵⁹ 115 T.C. 423 (2000).

⁹⁶⁰ *Millinery Ctr. Bldg. Corp. v. Commissioner*, 350 U.S. 456 (1956), aff'g 221 F.2d 322 (2d Cir. 1955).

⁹⁶¹ *ABC Beverage Corp. v. United States*, No. 13-01701, 2014 BL 164462 (6th Cir. June 13, 2014); *Cleveland Allerton Hotel, Inc. v. Commissioner*, 166 F.2d 805 (6th Cir. 1948).

been exercised.⁹⁶² Nor does lease modification justify the deductions.⁹⁶³ Even if the lessee is not allowed to deduct the cost of acquiring leased land on which the lessee has constructed a building, it can amortize the portion of the purchase price allocable to the building.⁹⁶⁴

The tax consequences of transfers of lease interests are discussed in 593 T.M., *Real Estate Leases*.

D. Repairs

1. In General

a. Limitations

A taxpayer may deduct amounts paid for repairs and maintenance to tangible property if the amounts paid are not otherwise required to be capitalized as improvements.⁹⁶⁵ The same principle applies to repairs to property held for the production of income.⁹⁶⁶

Observation: The temporary regulation providing this principle is generally applicable to tax years beginning Jan. 1, 2014 through Dec. 23, 2014. However, taxpayers may elect to apply this temporary regulation beginning Jan. 1, 2012.⁹⁶⁷ The previous regulation provided that incidental repairs to property were deductible if their cost neither materially added to the value of the property nor appreciably prolonged its life.

The IRS has ruled that deduction is not foreclosed merely because there is some future benefit.⁹⁶⁸ The IRS advises its examiners that the cost of fire protection, air phone and ground proximity warning system equipment added to an aircraft should be capitalized rather than deducted as repairs.⁹⁶⁹

An expenditure is treated as an improvement, which generally must be capitalized, if it is paid for activities performed after the property is placed in service by the taxpayer and causes a betterment or restoration of the property, or adapts it to a new or different use, applying the framework provided in the regulations.⁹⁷⁰ The capitalization requirement is discussed in 509 T.M., *Principles of Capitalization*.

b. Effect of Depreciation and Amortization

It does not matter that the property being repaired has been fully depreciated through tax deductions claimed in previous years.⁹⁷¹ It does not matter that in a particular year the total repair expenditures exceed the annual average.⁹⁷² In Rev. Rul. 69-119,⁹⁷³ the IRS ruled that repairs to four times as many rail-

road cars as were usually repaired in a year were deductible under §162 because they did not increase the fair market value of the cars or extend the useful life of the cars.⁹⁷⁴ In a ruling that involved the impact of particular methods of cost recovery generally no longer in use, the IRS ruled that it did not matter whether the property was depreciated over its normal expected useful life or amortized as emergency facilities.⁹⁷⁵

Observation: Similar reasoning should lead to the conclusion that it does not matter whether the property is being depreciated under §167, pre-1986 TRA §168, or §168 as currently in effect. It also supports the conclusion that it does not matter if a straight-line or alternative depreciation system election is in effect.

c. Recently Acquired Property

A repair deduction is not precluded merely because the property has been recently acquired.⁹⁷⁶ Thus, in *Osage S.S. Co. v. Commissioner*,⁹⁷⁷ the court held that repairs made to a vessel shortly after its acquisition to keep it in good operating condition were deductible.⁹⁷⁸ However, the expenditures must be capitalized if they prepare the property for a new use,⁹⁷⁹ recondition the property,⁹⁸⁰ are made pursuant to an obligation under the purchase contract,⁹⁸¹ or if the property is not suitable for any use when it is acquired.⁹⁸²

2. Expenditure Required

No deduction is allowed for the estimated cost of repairs that have not been made.⁹⁸³ No deduction is allowed for the value of the taxpayer's own labor in making the repairs.⁹⁸⁴

3. Timing of Deduction

The cost of repair parts purchased in one year but not used until the following year is deductible in the year that the expense is paid or accrued.⁹⁸⁵ If, however, the taxpayer is not billed and does not know the price of the repairs or parts until a subsequent tax year, the deduction is allowable in the year the bill is paid or received, and the taxpayer is not precluded from claiming the deduction merely because the deduction was not claimed in the year the repairs were made.⁹⁸⁶

⁹⁶² *Frederick Fox & Co. v. Commissioner*, 19 B.T.A. 232 (1930).
⁹⁶³ *Spokane Office Supply Co. v. Commissioner*, 8 B.T.A.M. 337 (1939).
⁹⁶⁴ *Millinery Ctr. Bldg. Corp. v. Commissioner*, 350 U.S. 456 (1956), aff'd 221 F.2d 322 (2d Cir. 1955).
⁹⁶⁵ Reg. §1.162-4(a).
⁹⁶⁶ §212(2); Reg. §1.212-1(n).
⁹⁶⁷ Reg. §1.162-4(c); Announcement 2013-7, 2013-3 I.R.B. 308.
⁹⁶⁸ See Rev. Rul. 94-12, 1994-1 C.B. 36 (analyzing impact of *INDOPCO, Inc. v. Commissioner*, 503 U.S. 79 (1992)).
⁹⁶⁹ FSA 200202026.
⁹⁷⁰ Reg. §1.263(a)-3, T.D. 9636, 78 Fed. Reg. 57685 (9/19/13), applicable to tax years beginning on or after Jan. 1, 2014 (or, at the taxpayer's option, Jan. 1, 2012).
⁹⁷¹ *E.g., Clark v. Commissioner*, 25 T.C.M. 118 (1966).
⁹⁷² *Henderson Cotton Mills v. Commissioner*, 4 B.T.A. 1212 (1926).
⁹⁷³ 1969-1 C.B. 141.

⁹⁷⁴ *Id.*
⁹⁷⁵ Rev. Rul. 54-578, 1954-2 C.B. 84.
⁹⁷⁶ *E.g., Mills v. Commissioner*, 4 T.C.M. 863 (1945).
⁹⁷⁷ 3 B.T.A. 141 (1925).
⁹⁷⁸ *Id.* at 143.
⁹⁷⁹ *E.g., H.S. Crocker Co. v. Commissioner*, 15 B.T.A. 175 (1929); *Allen v. Commissioner*, 2 B.T.A. 1313 (1925).
⁹⁸⁰ *E.g., L.A. Wells Constr. Co. v. Commissioner*, 46 B.T.A. 302 (1942), aff'd, 134 F.2d 623 (6th Cir. 1943).
⁹⁸¹ *H. Wilensky & Sons Co. v. Commissioner*, 7 B.T.A. 693 (1927).
⁹⁸² *E.g., Coca-Cola Bottling Works of Pittsburgh v. Commissioner*, 19 B.T.A. 1055 (1930).
⁹⁸³ *Fed. Plate Glass Co. v. Commissioner*, 6 B.T.A. 351 (1927).
⁹⁸⁴ *Clark v. Commissioner*, 25 T.C.M. 118 (1966).
⁹⁸⁵ *Claussner Hosiery Co. v. Commissioner*, 9 T.C.M. 891 (1950).
⁹⁸⁶ *Estate of Bryan v. Commissioner*, 22 T.C.M. 864 (1963), aff'd in part and rev'd in part on other issues, 364 F.2d 751 (4th Cir. 1966).

4. *Obligation to Make Repair*

No deduction is allowed if the taxpayer is not obligated to make the repair.⁹⁸⁷ In *Estate of Walling v. Commissioner*,⁹⁸⁸ the Third Circuit, reversing the Tax Court, held that the taxpayer was allowed to deduct the cost of repairs to business property that the taxpayer had contracted to sell, because the contract required the delivery of the property in good condition.⁹⁸⁹

5. *Type of Expenditures*

For a list of expenditures for which the §162 repair deduction has been allowed, and capitalization was not required, see Worksheet 2.

Note: The distinction between repairs and capital expenditures with respect to environmental clean-up costs is discussed in V.O., below.

E. *Payments for Insurance Coverage*

1. *In General*

Generally, premiums on insurance policies providing protection from losses to trade or business property from fire, storm, theft, accident or similar calamities are deductible if paid or incurred in carrying on the trade or business.⁹⁹⁰ The same principle applies to premiums on insurance policies providing such protection for property held for the production of income.⁹⁹¹

No deduction is allowed if the taxpayer acquires an asset that is transferable or refundable⁹⁹² or if the insurance relates to a period of construction.⁹⁹³ Thus, in *Commissioner v. Lincoln Savings & Loan Ass'n*,⁹⁹⁴ the Supreme Court held that payment to the Federal Savings and Loan Insurance Corporation of an additional premium required by §404(d) of the National Housing Act⁹⁹⁵ created a separate and distinct asset that could be transferred or recovered on liquidation and, thus, was a capital expenditure that was not deductible.⁹⁹⁶ The same result applies to subordinated loan certificates purchased by a physician to fund a physician-owned medical malpractice insurance exchange, because the certificate is a refundable asset.⁹⁹⁷ The Eighth Circuit has held that insurance premiums paid for black lung disability coverage are not deductible in the year paid because they produced significant benefits extending beyond the tax year, even though no separate and distinct asset was created.⁹⁹⁸ The capitalization limitation is discussed in 509 T.M., *Principles of Capitalization*.

⁹⁸⁷ *Wood v. Commissioner*, 14 T.C.M. 1156 (1955), aff'd in part and rev'd in part on other issues, 245 F.2d 888 (5th Cir. 1957).

⁹⁸⁸ 373 F.2d 190 (3d Cir. 1967), rev'g 45 T.C. 111 (1965).

⁹⁸⁹ 373 F.2d at 193.

⁹⁹⁰ Reg. §1.162-1(a).

⁹⁹¹ §212(2); Reg. §1.212-1(g). *E.g.*, *Higgins v. United States*, 75 F. Supp. 252 (Ct. Cl. 1948); *Hartford v. United States*, 265 F. Supp. 86 (W.D. Wis. 1967).

⁹⁹² §263.

⁹⁹³ §263A; *Columbia Theatre Co. v. Commissioner*, 3 B.T.A. 622 (1926).

⁹⁹⁴ 403 U.S. 345 (1971), rev'g 422 F.2d 90 (9th Cir. 1970), rev'g 51 T.C. 82 (1968); Rev. Rul. 66-49, 1966-1 C.B. 36, amplified by Rev. Rul. 72-366, 1972-2 C.B. 91, amplified on another issue, Rev. Rul. 74-371, 1974-2 C.B. 44.

⁹⁹⁵ 12 U.S.C. §1701 through §1748 (1991).

⁹⁹⁶ 403 U.S. at 354.

⁹⁹⁷ *Herman v. Commissioner*, 84 T.C. 120 (1985).

Comment: In TAM 200517030, which involved a payment by an insurance company, in contrast to payments of insurance premiums to an insurance company, the IRS distinguished *Lincoln Savings* and concluded that an insurance company was allowed to deduct a nonrefundable initial assessment payment to a state catastrophic loss fund set up after a previous catastrophe. The insurance company was required either to make the payment or provide coverage for losses caused by a catastrophe. The IRS noted that the payment was not refundable, the insurance company did not obtain any transferable interest in the fund, no separate account for the insurance company was maintained by the fund, no interest was credited to the insurance company for the amount paid to the fund and the insurance company did not acquire an asset or create a significant future benefit by making the payment. It would not be unreasonable to consider the payment as equivalent to a business license fee.

2. *Connection with Trade or Business*

a. *In General*

Insurance premiums and payments in the nature of insurance premiums are not deductible under §162 unless there is a direct relationship between the payment and the trade or business and unless there is an expectation of benefit to the taxpayer in the event the contingency being insured occurs.⁹⁹⁹ No deduction under §162 is allowed for insurance with respect to property that is not used in a trade or business,¹⁰⁰⁰ such as a building no longer used in the trade or business that was held for sale.¹⁰⁰¹ No deduction is allowed for payment of unemployment insurance made by a corporation seven days after its dissolution resolution was adopted.¹⁰⁰² Premiums for workers' compensation insurance purchased by a self-employed taxpayer are connected with the taxpayer's business if potential customers have a policy requiring independent contractors with whom they deal to have such insurance coverage.¹⁰⁰³

b. *Health-Related Policies*

Premiums paid for health and accident insurance are not deductible under §162 because there is no direct connection to the carrying on of a trade or business.¹⁰⁰⁴ No deduction for professional overhead disability coverage is allowed if the policy

⁹⁹⁸ *Black Hills Corp. v. Commissioner*, 73 F.3d 799 (8th Cir. 1996), aff'g 102 T.C. 505 (1994), supplementing 101 T.C. 173 (1993).

⁹⁹⁹ *Kessler v. Commissioner*, 49 T.C.M. 1565 (1985); see, e.g., CCA 202053010 (premiums paid toward policy regarding conservation easement are not deductible under §162; the reimbursable claims under the policy are unrelated to any purported trade or business activities of taxpayer; taxpayer is entitled to payment for amounts calculated with reference to the disallowed conservation easement deduction, whether or not taxpayer incurs any expenses related to any trade or business). See also CCA 202050015 (cost of tax insurance premiums for insurance policy that would have reimbursed partners for reduction of claimed tax benefits was not sufficiently related to partnership's income-producing activities to support deduction under §162 or §212).

¹⁰⁰⁰ *Edgar v. Commissioner*, 39 T.C.M. 816 (1979).

¹⁰⁰¹ *Lenington v. Commissioner*, 25 T.C.M. 1350 (1966).

¹⁰⁰² *Gossman v. Glenn*, 91 F. Supp. 1005 (W.D. Ky. 1950), aff'd per curiam, 191 F.2d 856 (6th Cir. 1951).

¹⁰⁰³ See *Otten v. Commissioner*, 68 T.C.M. 1342 (1994).

¹⁰⁰⁴ *Egner v. Commissioner*, 48 T.C.M. 1041 (1984); *Smith v. Commissioner*, 41 T.C.M. 425 (1980); *Andrews v. Commissioner*, 29 T.C.M. 93 (1970).

provides coverage regardless of whether business expenses are incurred during the period of disability.¹⁰⁰⁵

Note: The premiums might be deductible under §213 as a medical expense. The medical expense deduction is discussed in 513 T.M., *Family and Household Transactions*.

No deduction is allowed for health insurance paid by a taxpayer who is in the trade or business of selling his own blood.¹⁰⁰⁶

c. Life Insurance

The IRS has ruled that a corporation may not deduct premiums on life insurance on its shareholders' lives to provide funds for acquiring the shareholders' stock when they die.¹⁰⁰⁷ Premiums on the life of a corporate officer who is a shareholder may, under appropriate circumstances, be treated as nondeductible constructive dividends,¹⁰⁰⁸ but the IRS has advised that if the insurance proceeds are obligated solely for reacquisition of corporate stock from the deceased shareholder, no constructive dividend is deemed to exist with respect to the shareholder or the other shareholders if their primary obligation to acquire the stock is not relieved by the insurance.¹⁰⁰⁹ The constructive dividend result can also apply where the insurance is on the life of a retired executive-shareholder,¹⁰¹⁰ and someone other than the corporation is beneficiary.¹⁰¹¹

In *Whitaker v. Commissioner*,¹⁰¹² the Tax Court held that §162 did not allow a deduction for life insurance premiums on the life of a vendor required by a conditional sales contract with the vendor.^{1013 1014} The Tax Court held that a cooperative was allowed to deduct payments made to its patrons' trust to support a life insurance plan because the payments promoted the cooperative's business.¹⁰¹⁵

The deductibility of life insurance premiums as trade or business expenses is discussed in 386 T.M., *Insurance-Related Compensation*. The limitations on the deductibility of life insurance premiums is discussed in 529 T.M., *Income Taxation of Life Insurance and Annuity Contracts*.

d. Casualty Insurance

Fire insurance premiums paid by a personal holding company on property transferred to it from a shareholder who reserves a life estate in the property are not deductible because the company is not carrying on any trade or business with respect to the property.¹⁰¹⁶ Automobile insurance premiums paid by a corporation are not deductible to the extent the vehicle is

used by an employee for personal purposes.¹⁰¹⁷ Homeowners insurance premiums are not deductible even if trade or business property is stored in the home and covered by the policy if the amount of the premium is the same as it would be if the trade or business property were not stored in the home.¹⁰¹⁸

3. Paid or Incurred

a. Self Insurance

No deduction is allowed for amounts that are merely set aside by the taxpayer as reserves against future losses.¹⁰¹⁹ This is so even if the funds are set aside to provide the taxpayer the means to satisfy any liability that might arise from the operation of the taxpayer's trade or business.¹⁰²⁰ This is so even if the reserve is mandated by state law.¹⁰²¹ A deduction is allowed when an amount is paid to unrelated parties to compensate them for losses caused by the taxpayer.¹⁰²²

b. Payments to Related Parties

In *Steer Tank Lines, Inc. v. United States*,¹⁰²³ the court held that payments made to a related insurance company under an insurance arrangement with that company were not deductible because they were tantamount to self-insurance and did not shift risk, even though the taxpayer did not have control of the funds.¹⁰²⁴ The same result applies to payments to a trust formed by the taxpayer to pay its obligations under state worker compensation statutes.¹⁰²⁵ In *Anesthesia Serv. Med. Group, Inc. v. Commissioner*,¹⁰²⁶ the Ninth Circuit reached the same result with respect to payments to a trust formed by the taxpayer because the taxpayer remained obligated on any liabilities in excess of the amounts in the trust, which prevented the shifting of the loss.¹⁰²⁷ The IRS has advised, though, that a deduction for premium payments to an insurance company in which the taxpayer held shares was not disallowed merely for that reason, because risk shifted and the premiums were not refundable.¹⁰²⁸

The IRS has ruled that self-insurance does not exist when an insurer, owned by the same person who owns the insured, participates in a reinsurance pool with independent insurers unrelated to the insurer and insured, receives premiums from the insured, pays a percentage of the premiums to the pool, assumes a quota share of premiums from the pool roughly equivalent in dollar terms to the amount paid to the pool, is adequate-

¹⁰¹⁷ *Blackwell v. Commissioner*, 15 T.C.M. 962 (1956).

¹⁰¹⁸ *Vesey v. Commissioner*, 33 T.C.M. 697 (1974).

¹⁰¹⁹ *L.A. Thompson Scenic R.R. Co. v. Commissioner*, 2 B.T.A. 664 (1925); *L.A. Thompson Scenic R.R. Co. v. Commissioner*, 9 B.T.A. 1203 (1928); S.R. 2586, 1925 C.B. 227. See, e.g., *F.W. Servs., Inc. v. Commissioner*, 459 Fed. Appx. 389 (5th Cir. 2012) (*unpub. opin.*), *aff'g* T.C. Memo 2010-128 (self-insurance not insurance contract, premium not deductible).

¹⁰²⁰ *Pan-American Hyde Co. v. Commissioner*, 1 B.T.A. 1249 (1925); Rev. Rul. 57-485.

¹⁰²¹ *Spring Canyon Coal Co. v. Commissioner*, 43 F.2d 78 (10th Cir. 1930), cert. denied, 284 U.S. 654 (1931), *aff'g* 13 B.T.A. 189 (1928).

¹⁰²² I.T. 1797, 1923 C.B. 100; O.D. 964, 1921 C.B. 118. See Rev. Rul. 82-95.

¹⁰²³ 76-2 USTC ¶ 9526 (N.D. Tex. 1976), *aff'd*, 577 F.2d 279 (5th Cir. 1978), cert. denied, 440 U.S. 946 (1979).

¹⁰²⁴ *Id.*

¹⁰²⁵ Rev. Rul. 82-95, 1982-1 C.B. 101.

¹⁰²⁶ 825 F.2d 241 (9th Cir. 1987), *aff'g* 85 T.C. 1031 (1985).

¹⁰²⁷ 825 F.2d at 242.

¹⁰²⁸ TAM 199924001.

¹⁰⁰⁵ *Blaess v. Commissioner*, 28 T.C. 710 (1957); *Ferris v. Commissioner*, 51 T.C.M. 335 (1986); *Masat v. Commissioner*, 48 T.C.M. 317 (1984); Rev. Rul. 70-394, 1970-2 C.B. 34; Rev. Rul. 58-480, 1958-2 C.B. 62.

¹⁰⁰⁶ *Green v. Commissioner*, 74 T.C. 1229 (1980).

¹⁰⁰⁷ Rev. Rul. 70-117, *modified on other issues*, Rev. Rul. 74-503. See FAA 20031501F (same).

¹⁰⁰⁸ *Whipple Chrysler-Plymouth v. Commissioner*, 31 T.C.M. 230 (1972).

¹⁰⁰⁹ FAA 20031501F.

¹⁰¹⁰ *Whitcomb v. Commissioner*, 81 T.C. 505 (1983), *aff'd*, 733 F.2d 191 (1st Cir. 1984).

¹⁰¹¹ *Champion Trophy Mfg. Corp. v. Commissioner*, 31 T.C.M. 1236 (1972).

¹⁰¹² 34 T.C. 106 (1960).

¹⁰¹³ 34 T.C. 106 at 110.

¹⁰¹⁴ 68 T.C. 729 (1977).

¹⁰¹⁵ 68 T.C. 729 at 742.

¹⁰¹⁶ *Lone Pine Lawn Corp. v. Commissioner*, 41 B.T.A. 638 (1940), *aff'd*, 121 F.2d 935 (2d Cir. 1941).

ly capitalized, and has no guarantees of its obligations by any related persons, thus causing the insurer to assume risks from multiple independent policyholders with no single one of them accounting for more than 15 percent of the total risks assumed by the insurer.¹⁰²⁹

No deduction is allowed for insurance premium payments that are returned to the taxpayer, related parties or lenders from whom the taxpayer borrowed to obtain funds with which to make the payments, even though the transaction is structured as reinsurance, if none of the provisions of the reinsurance agreement are followed by the parties.¹⁰³⁰

Note: The IRS has ruled that if premiums are paid to an unrelated entity that insures only the taxpayer, there is no shift in the risk of loss, nor is there a shift if the insurance is provided by limited liability companies disregarded for tax purposes, but there is the requisite shift if those limited liability companies are treated as associations.¹⁰³¹ In contrast, the IRS has also ruled that there is a shift in the risk of loss when a company, whose only business consists of indemnity reinsurance contracts, and whose main contract covered only risks of a single policyholder, assumed sufficient risks under agreements with other insurance companies causing the company to meet the requirement of risk distribution as to each policyholder.¹⁰³²

c. Payments to Captive Insurance Companies

(1) In General

Amounts paid to wholly owned subsidiaries or to a captive parent for insurance coverage on the taxpayer are not deductible where the risk has not shifted and the arrangement is, in effect, self-insurance or a guaranteed investment contract.¹⁰³³ It does not matter that the taxpayer cannot obtain insurance from any other carrier¹⁰³⁴ or that there is a business purpose in structuring the insurance in this manner.¹⁰³⁵

(2) Defective Subsidiary

In *F.R. Johnson Prods. Co. v. Commissioner*,¹⁰³⁶ the Tax Court held that payments made to a wholly owned insurance company were not deductible because they were in substance self-insurance, as reinforced by the fact that the insurance company was not properly organized under state law and the payments were deposited into personal savings accounts owned by the taxpayer and employees.¹⁰³⁷ Likewise, if the subsidiary is in-

adequately capitalized, the conclusion that the taxpayer's payments are tantamount to self-insurance is inescapable.¹⁰³⁸

(3) Risk of Loss Shift

If the risk of loss shifts to the captive insurance company and it has independent economic existence, the taxpayer is allowed to deduct the insurance premium.¹⁰³⁹ These factors are evident if the captive company shifts and redistributes risk by underwriting the risks of unrelated parties and engages in the insurance business in the commonly accepted sense.¹⁰⁴⁰ In *Kidde Indus. v. United States*,¹⁰⁴¹ the Court of Claims allowed a deduction for captive insurance for its subsidiaries but not for captive insurance for its divisions because there was no risk shifting with respect to the divisions. In CCA 200442031, the IRS Chief Counsel's Office advised that an arrangement between a disregarded single-member LLC and its captive insurance company did not shift the risk of loss because the parties were considered to be one entity.

Amounts paid for insurance by the taxpayer to the wholly owned subsidiary of its parent are deductible if the risk shifts to the insurance subsidiary and the taxpayer is a separate and distinct corporate entity.¹⁰⁴² The Sixth Circuit disallowed deductions for premiums paid by subsidiaries to affiliated captive insurance companies and charged back by the parent company, reasoning that the undercapitalized foreign insurance captive, propped up by guarantees of the parent corporation, was essentially a sham corporation.¹⁰⁴³ In FSA 200029010, the IRS Chief Counsel's Office advised that it would cease challenging deductions for insurance premiums paid to captive insurance subsidiaries by sibling subsidiaries, observing that several courts had held such premiums deductible *except* where the captive insurance subsidiary is a sham, as in *Malone & Hyde*. Factors to be considered in determining whether a captive insurance subsidiary is a sham include whether the parent company guarantees its performance, whether there are true hazards, whether the premiums are based on commercial rates, whether the captive insurance company is thinly capitalized, whether the captive insurance company is loosely regulated by local insurance authorities, such as might be the case in a foreign country,

¹⁰³⁸ *Beech Aircraft Corp. v. United States*, 797 F.2d 920 (10th Cir. 1986), aff'g 84-2 USTC ¶ 9803 (D. Kan. 1984).

¹⁰³⁹ *Ocean Drilling & Exp. Co. v. United States*, 24 Cl. Ct. 714 (1991), aff'd, 988 F.2d 1135 (Fed. Cir. 1993); *Crawford Fitting Co. v. United States*, 606 F. Supp. 136 (N.D. Ohio 1985). See also *Rent-A-Center, Inc. v. Commissioner*, 142 T.C. 1 (2014) (payments from parent company's wholly owned subsidiaries to an insurance company also wholly owned by parent deductible as insurance expenses); *Securitas Holdings, Inc. v. Commissioner*, T.C. Memo 2014-225 (insurance payments from brother-sister companies to wholly owned captive insurer are deductible business expenses because captive insurance arrangement shifted and distributed risks, and constituted insurance in the commonly accepted sense); CCA 201533011 (no risk of loss shifted to captive insurance company because loss amounts were certain to occur and, in fact, had already been partially incurred at time policy terms were finalized).

¹⁰⁴⁰ *Sears, Roebuck & Co. v. Commissioner*, 96 T.C. 61 (1991), aff'd, 972 F.2d 858 (7th Cir. 1992), modified on other issues, 96 T.C. 671 (1991); *Harper Grp. v. Commissioner*, 96 T.C. 45 (1991), aff'd, 979 F.2d 1341 (9th Cir. 1992).

¹⁰⁴¹ 40 Fed. Cl. 42 (1997).

¹⁰⁴² *Humana Inc. v. Commissioner*, 881 F.2d 247 (6th Cir. 1989), aff'g in part and rev'g in part 88 T.C. 197 (1987). See FSA 200043012; FSA 200043011; FSA 200043008.

¹⁰⁴³ *Malone & Hyde, Inc. v. Commissioner*, 62 F.3d 835 (6th Cir. 1995).

¹⁰²⁹ See PLR 201219009, PLR 201219010, PLR 201219011.

¹⁰³⁰ *Bail Bonds by Marvin Nelson, Inc. v. Commissioner*, 51 T.C.M. 294 (1986), aff'd on other issues, 820 F.2d 1543 (9th Cir. 1987).

¹⁰³¹ Rev. Rul. 2005-40. See TAM 200816029 (analysis of whether risk-shifting occurs in the partnership context and who in the partnership is the insured).

¹⁰³² Rev. Rul. 2009-26. See PLR 201428006 (transaction similar to that described in Rev. Rul. 2009-26).

¹⁰³³ *Humana Inc. v. Commissioner*, 881 F.2d 247 (6th Cir. 1989), aff'g in part and rev'g in part 88 T.C. 197 (1987); *Kurt Orban Co. v. Commissioner*, 54 T.C.M. 861 (1987); CCA 200130032, CCA 201533011 (policies actually designed as guaranteed investment contracts, thus no risk shifted to insurer).

¹⁰³⁴ *Stearns-Rogers Corp. v. United States*, 774 F.2d 414 (10th Cir. 1985), aff'g 577 F. Supp. 833 (D. Colo. 1984).

¹⁰³⁵ *Mobil Oil Corp. v. United States*, 8 Cl. Ct. 555 (1985).

¹⁰³⁶ 43 T.C.M. 705 (1982).

¹⁰³⁷ 43 T.C.M. 705, 718 (1982).

and whether the captive's business operations are kept separate from the parent's.

In March 2014, the Tax Court held, in *Rent-A-Center, Inc. v. Commissioner*,¹⁰⁴⁴ that premiums paid by a company's subsidiaries to its wholly owned insurance company were deductible as a business expense. The decision is contrary to the IRS's long-held position that brother-sister captive insurance arrangements in a corporate group do not result in sufficient risk-shifting or risk distribution to allow for deductions of premiums paid to an insurance entity with the same parent corporation.¹⁰⁴⁵ In October 2014, in *Securitas Holdings, Inc. v. Commissioner*,¹⁰⁴⁶ the Tax Court held that a brother-sister captive arrangement was insurance. In both cases, one entity had significantly more risk than its sibling entities. The IRS has not yet issued guidance to replace its earlier rulings that arrangements similar to the one in *Rent-A-Center* do not meet the definition of insurance for federal tax purposes.¹⁰⁴⁷

In Rev. Rul. 2002-89, the IRS ruled that a parent may deduct premiums paid to its subsidiary insurance company if the premiums earned by the subsidiary from the parent accounted for less than 50% of all premiums earned. However, the IRS concluded that no deduction is allowed to a parent for premiums paid to a captive subsidiary insurance company if the premiums paid by the parent accounted for 90% of the subsidiary's total premiums earned. In Rev. Rul. 2001-31, the IRS ruled that it would not disallow a deduction for insurance premiums paid to a wholly owned captive insurance company simply because the taxpayer and the captive insurance company are members of the same "economic family" on the ground that risk did not shift away from the taxpayer. The IRS noted, though, that it would continue to disallow the deduction if other circumstances, such as the taxpayer's guarantee of a thinly capitalized wholly owned captive insurance company, demonstrated insufficient or non-existent risk shifting.

Note: In issuing Rev. Rul. 2001-31, the IRS abandoned 24 years of challenging the deduction on the "economic family" grounds. The IRS acknowledged that its "economic family" analysis had been rejected by the courts.¹⁰⁴⁸

In Rev. Rul. 2002-90, the IRS ruled that premiums paid by subsidiaries to a single parent captive insurance company were deductible, concluding that the premiums are deductible if risk shifting and risk distribution are present such that the insured taxpayer is not "in significant part paying for its own risks." The IRS had taken a similar approach to premium payments to an assessable mutual insurance company by its owners, even though all of the owners were related RICs.¹⁰⁴⁹ The IRS also

reached this conclusion for foreign assessable mutual insurance companies.¹⁰⁵⁰

In Rev. Rul. 2008-8,¹⁰⁵¹ the IRS ruled that no §162 deduction is allowable for amounts paid by a corporation to a protected cell company's cell in which the corporation participates, because the cell does not enter into arrangements with any policyholders other than the corporation, making the situation analogous to the denial of payments made by a parent corporation to its subsidiary described in Rev. Rul. 2002-89. The IRS reached the opposite conclusion with respect to amounts paid by the subsidiaries of a corporation to a protected cell company's cell in which the corporate shareholder of the subsidiary participates, because the cell distributes the risk of each subsidiary among all the subsidiaries, making the situation analogous to the allowance of deductions paid by subsidiaries to a captive insurance company described in Rev. Rul. 2002-90.

If the insurance is provided only to the taxpayer's unrelated shareholders and its affiliates, none of whom own a controlling interest in the foreign subsidiary and among whom the risk of loss is shifted and redistributed, the premiums are deductible if reasonable and based on sound actuarial principles.¹⁰⁵² Similarly, the IRS has ruled that premiums paid to a captive insurer formed by a small group of unrelated businesses in a highly concentrated industry are not treated as nondeductible self-insurance, noting that the arrangement was one in which no member owned more than 15% of the captive company, and policy limits were set so that a member's covered losses would probably exceed the premiums it paid.¹⁰⁵³

If the risk of loss is shifted to the parent's employees, through a group-term contract purchased on the employees' behalf by the parent from the subsidiary, the premiums are deductible as compensation.¹⁰⁵⁴

The combination of captive insurance with the §831(b) tax advantaged election for small insurance companies (allowing the premium payments to avoid characterization as income) has been recognized as a potentially abusive tax transaction and is being considered by the IRS as a transaction of interest that must be disclosed by taxpayers and their material advisors. Such so-called "micro-captive" insurance structures are reviewed for whether the payments are actually for insurance, which requires risk-shifting, risk distribution, that the risks are insurable, and that the policies meet commonly accepted notions of insurance.¹⁰⁵⁵ If the purported insurance fails to meet the definition of insurance, and the insurance issuer is orga-

¹⁰⁵⁰ PLR 9624028.

¹⁰⁵¹ See Notice 2008-19 (proposed guidance on whether amounts paid under an arrangement between a participant and an individual cell of a protected cell company constitute deductible insurance premiums); see also PLR 201224018 (captive insurance company (C) pools substantial amount of its direct consideration received from insureds and associated risks with other unrelated insurance companies, resulting in large enough number of unrelated covered entities such that none is paying for significant portion of its own risk; accordingly, reinsurance arrangement achieves adequate risk shifting and distribution such that contracts issued by C to its insureds constitute insurance for income tax purposes; thus, premiums paid by insureds to C are insurance premiums for purposes of Reg. §1.162-1(a)).

¹⁰⁵² Rev. Rul. 78-338, as modified by Rev. Rul. 2001-31.

¹⁰⁵³ Rev. Rul. 2002-91. See PLR 201224018.

¹⁰⁵⁴ Rev. Rul. 92-93, modified by Rev. Rul. 2001-31.

¹⁰⁵⁵ *Helvering v. Le Gierse*, 312 U.S. 531 (1941); *Rent-a-Center, Inc. v. Commissioner*, 142 T.C. 1 (2014).

¹⁰⁴⁴ 142 T.C. 1 (2014).

¹⁰⁴⁵ See, e.g., Rev. Rul. 2005-40. Erin McManus, *IRS Gives In to Captive Insurance, But Keeps Close Eye on 'Micro' Arrangements*, 103 DTR J-1 (May 29, 2015).

¹⁰⁴⁶ T.C. Memo 2014-225.

¹⁰⁴⁷ See, e.g., Rev. Rul. 2005-40. Erin McManus, *IRS Gives In to Captive Insurance, But Keeps Close Eye on 'Micro' Arrangements*, 103 DTR J-1 (May 29, 2015).

¹⁰⁴⁸ See, e.g., *Kidde Indus., Inc. v. United States*, 40 Fed. Cl. 42 (1997), app. dismissed, 194 F.3d 1330 (Fed. Cir. 1999); *Humana, Inc. v. Commissioner*, 881 F.2d 247 (6th Cir. 1989), aff'g in part and rev'g in part 88 T.C. 197 (1987); *Clougherty Packing Co. v. Commissioner*, 811 F.2d 1297 (9th Cir. 1987), aff'g 84 T.C. 998 (1985).

¹⁰⁴⁹ PLR 200121019.

nized in a jurisdiction with very low reserve requirements and the surplus is channeled back to the insured, e.g., through loans, the deducted premium payments are arguably just being moved back to the insured while avoiding taxation in the process.¹⁰⁵⁶

In 2025, the IRS finalized rules that identify transactions that are the same as, or substantially similar to, certain captive insurance transactions (i.e., “micro-captive transactions”) as “listed transactions,”¹⁰⁵⁷ and certain other micro-captive transactions as “transactions of interest,”¹⁰⁵⁸ both of which are types of reportable transactions.¹⁰⁵⁹ Thus, material advisors and certain participants in these listed transactions or transactions of interest are required to file disclosures with the IRS.¹⁰⁶⁰

Micro-captive insurance companies are discussed in 201 T.M., *Taxation of Domestic Insurance Companies*. Listed transactions and transactions of interest are discussed in 648 T.M., *Reportable Transactions*.

(4) *Subsidiary’s Deductions*

The subsidiary that, in effect, insures its parent is allowed to deduct the expenses of providing the insurance if it carries insurance for unrelated companies and thus is in substance an insurance company.¹⁰⁶¹

d. *Reinsurance with Subsidiary*

No deduction is allowed for insurance premiums paid to an unrelated insurance company which are in turn reinsured by that company with the taxpayer’s subsidiary, foreign or otherwise.¹⁰⁶² Likewise, no deduction is allowed for insurance premiums paid to an unrelated insurance company which are in turn reinsured by that company with the captive insurance company owned by the taxpayer’s wholly owned subsidiary, because the risk of loss is not shifted from the taxpayer.¹⁰⁶³

In *Gulf Oil Corp. v. Commissioner*,¹⁰⁶⁴ the Third Circuit held that no deductions were allowed for insurance premium payments made to a wholly owned subsidiary reinsurer because the risk did not shift and because the taxpayer made guarantees to protect the primary insurer if the subsidiary failed to meet its obligations.¹⁰⁶⁵ Likewise, no deduction is allowed for premiums

paid to a third party to insure a corporation and its subsidiaries to the extent reinsured by the corporation’s wholly owned subsidiary because there is no risk shifting, as demonstrated by the taxpayer’s lack of difficulty in acquiring insurance from a third party, the operation of the insurance subsidiary on only the extremely thin minimum capitalization required under foreign law, with little or no regulatory oversight, and the provision of guarantees to protect the third party primary insurer.¹⁰⁶⁶

e. *Payments to Industry Associations*

In Rev. Rul. 60-275, the IRS ruled that nonrefundable premium payments to a reciprocal flood insurance exchange were deductible, but that the amounts that could be withdrawn by the taxpayer were not.¹⁰⁶⁷ In *United States v. Weber Paper Co.*,¹⁰⁶⁸ the Eighth Circuit held that deductions were allowable under a similar plan because there was risk sharing, the amounts paid passed from the taxpayer’s control, and no portion could be withdrawn.¹⁰⁶⁹ In Rev. Rul. 64-72, the IRS announced that it would not follow the *Weber Paper* decision and would adhere to its position in Rev. Rul. 60-275.

In Rev. Rul. 80-120,¹⁰⁷⁰ the IRS ruled that insurance premiums paid by a professional medical corporation to a mutual insurance company owned by physicians were deductible because the insurance company insured more than 5,000 physicians and several medical corporations whereas the taxpayer had only 25 employees.¹⁰⁷¹ Amounts paid by members of a shipowners’ protective association to an association reserve fund to cover the \$100,000 deductible provided by standard marine insurance policies are deductible.¹⁰⁷²

4. *Self-Employed Individuals’ Health Insurance*

a. *In General*

Section 162(l) allows self-employed individual taxpayers to deduct the amount paid during the tax year for insurance that constitutes medical care for the taxpayer,¹⁰⁷³ the taxpayer’s spouse,¹⁰⁷⁴ the taxpayer’s dependents¹⁰⁷⁵ and any child¹⁰⁷⁶ of the taxpayer who has not attained age 27 as of the end of the tax year.¹⁰⁷⁷ Eligible long-term care insurance premiums¹⁰⁷⁸ for qualified long-term care insurance contracts¹⁰⁷⁹ are taken into account.¹⁰⁸⁰

For these purposes, a self-employed individual is an individual who for any tax year has earned income,¹⁰⁸¹ an individual who for any tax year would have earned income but for the fact

¹⁰⁵⁶ *Avrahami v. Commissioner*, 149 T.C. 144 (2017) (in case of first impression, micro-captive insurance structure was analyzed and held not to be insurance because insurance contracts did not meet definition of insurance; penalties were partially upheld but partially denied because of good faith reliance on professional advice and lack of clear authoritative guidance by IRS). See also *Caylor Land & Dev., Inc. v. Commissioner*, T.C. Memo 2021-30.

¹⁰⁵⁷ Reg. §1.6011-10, T.D. 10029, 90 Fed. Reg. 3534 (Jan 14, 2025).

¹⁰⁵⁸ Reg. §1.6011-11, T.D. 10029, 90 Fed. Reg. 3534 (Jan 14, 2025).

¹⁰⁵⁹ Previously, the IRS had issued guidance that only considered certain micro-captive transactions as transactions of interest, and had announced settlement offers for participants in abusive micro-captive transactions; however, the guidance was vacated for having violated the Administrative Procedure Act and was subsequently obsolete. Notice 2016-66, *obsolete by* REG-109309-22, 88 Fed. Reg. 21,547 (Apr. 11, 2023). See *CIC Servs., LLC v. IRS*, No. 3:17-cv-110, 2022 BL 97539 (E.D. Tenn. Mar. 21, 2022).

¹⁰⁶⁰ Reg. §1.6011-10(g), §1.6011-11(g).

¹⁰⁶¹ *Amerco v. Commissioner*, 96 T.C. 18 (1991), aff’d, 979 F.2d 162 (9th Cir. 1992).

¹⁰⁶² *Carnation Co. v. Commissioner*, 640 F.2d 1010 (9th Cir. 1981), aff’d 71 T.C. 400 (1978).

¹⁰⁶³ *Clougherty Packing Co. v. Commissioner*, 811 F.2d 1297 (9th Cir. 1987), aff’d 84 T.C. 998 (1985).

¹⁰⁶⁴ 914 F.2d 396 (3d Cir. 1990), aff’d 89 T.C. 1010 (1987).

¹⁰⁶⁵ 914 F.2d at 1026.

¹⁰⁶⁶ *Malone & Hyde, Inc. v. Commissioner*, 62 F.3d 835 (6th Cir. 1995), rev’d 66 T.C.M. 1551 (1993).

¹⁰⁶⁷ Rev. Rul. 60-275.

¹⁰⁶⁸ 320 F.2d 199 (8th Cir. 1963), aff’d 204 F. Supp. 394 (W.D. Mo. 1962).

¹⁰⁶⁹ 320 F.2d 199, 204 (8th Cir. 1963).

¹⁰⁷⁰ Modified by Rev. Rul. 2001-31.

¹⁰⁷¹ Rev. Rul. 80-120, modified by Rev. Rul. 2001-31.

¹⁰⁷² Rev. Rul. 55-189.

¹⁰⁷³ §162(l)(1)(A).

¹⁰⁷⁴ §162(l)(1)(B).

¹⁰⁷⁵ §162(l)(1)(C).

¹⁰⁷⁶ See §152(f)(1).

¹⁰⁷⁷ §162(l)(1)(D).

¹⁰⁷⁸ See §213(d)(10).

¹⁰⁷⁹ See §7702B(b).

¹⁰⁸⁰ §162(l)(2)(C).

¹⁰⁸¹ §162(l)(1) (reference to §401(c)(1)(B)).

that the trade or business carried on by the individual did not have net profits for that year¹⁰⁸² and any individual who has had earned income for any preceding tax year.¹⁰⁸³ Self-employed individuals are discussed in 392 T.M., *Withholding, Social Security and Unemployment Taxes on Compensation*.

Any amount deducted under §162(l) does not qualify for the medical expense deduction under §213.¹⁰⁸⁴ The deduction allowable under §162(l) is not taken into account in computing the taxpayer's net earnings from self-employment for purposes of the tax on self-employment income, except that for tax years beginning in 2010, it is taken into account.¹⁰⁸⁵

b. Limitations

The §162(l) deduction cannot exceed the taxpayer's earned income derived from the trade or business with respect to which the plan providing the medical care coverage is established.¹⁰⁸⁶

Earned income for these purposes means net income from self-employment as determined for purposes of the tax on self-employment income¹⁰⁸⁷ as modified for purposes of the qualified plan qualification.¹⁰⁸⁸ The definition of earned income for purposes of the qualified plan qualification is discussed in 351 T.M., *Plan Qualification — Pension and Profit-Sharing Plans*.

c. Eligible Individuals

The §162(l) deduction does not apply to any taxpayer who is eligible to participate in any subsidized health plan maintained by any employer of the taxpayer or of the spouse of, or any dependent, or any child (as defined in §152(f)(1)) of the taxpayer who is less than 27 years old as of the end of the taxable year.¹⁰⁸⁹ The determination of whether a self-employed individual or his or her spouse are eligible for employer-paid health benefits is made on a monthly basis.¹⁰⁹⁰

The §162(l) deduction applies to S corporation shareholders who on any day during the tax year own or constructively own¹⁰⁹¹ more than 2% of the outstanding stock of the corporation or stock possessing more than 2% of the total combined voting power of all stock of the corporation.¹⁰⁹² However, the shareholder's wages¹⁰⁹³ from the S corporation are treated as the shareholder's earned income.¹⁰⁹⁴ The IRS is authorized to make adjustments in the application of this S corporation rule.¹⁰⁹⁵

5. Types of Insurance

a. In General

Under §162 or §212, a taxpayer carrying on a trade or business or holding property for the production of income is allowed to deduct premiums for the following types of insurance: fire, theft, flood, merchandise and inventory protection, credit, public liability, employer liability, employees' group hospitalization and medical, malpractice, automobile and other vehicle, employee performance bonds, use and occupancy, business interruption and overhead.¹⁰⁹⁶ So, too, are automobile insurance premiums to the extent the automobile is used in carrying on a trade or business,¹⁰⁹⁷ including fleet insurance on the vehicles of a sheriff's department.¹⁰⁹⁸

Premiums paid on policies covering liability arising from wrongful acts of officers and to reimburse officers for expenses arising from such acts are deductible.¹⁰⁹⁹ Reserve premiums paid under medical malpractice liability insurance policies subject to retrospective rate credits are deductible in the year paid.¹¹⁰⁰ Similarly, the IRS has ruled that participation payments paid to an insurer by the sponsor of a deferred compensation plan funded by participating insurance contracts, were deductible by the sponsor because the mere possibility that the sponsor would receive a refund from the insurer in future years did not create a separate and distinct asset requiring capitalization.¹¹⁰¹ Amounts paid by FBI agents into a legal defense fund established to aid agents charged with wrongful conduct are deductible because they bear a direct relationship to being employed as an FBI agent and there is an expectation of benefit.¹¹⁰²

Life insurance premiums paid by a corporation selling homesites for insurance on the lives of homesite purchasers are deductible under §162.¹¹⁰³ Premiums paid by an employee for indemnification against dismissal for nonmedical reasons other than poor performance are deductible.¹¹⁰⁴

Premiums for professional overhead disability coverage are deductible under §162 because the policies would reimburse the taxpayer for business overhead expenses incurred during any prolonged period of disability.¹¹⁰⁵ No deduction is allowed if the policy provides coverage regardless of whether business expenses are incurred during the period of disability.¹¹⁰⁶

The Chief Counsel's Office has determined that the cost of premiums for a "tax insurance" policy that would have reimbursed partners for a reduction of claimed tax benefits related

¹⁰⁸² §162(l)(1) (reference to §401(c)(1)(B)(i)).

¹⁰⁸³ §162(l)(1) (reference to §401(c)(1)(B)(ii)).

¹⁰⁸⁴ §162(l)(3).

¹⁰⁸⁵ §162(l)(4) (reference to §1401 and §1402).

¹⁰⁸⁶ §162(l)(2)(A). See Rev. Proc. 2014-41 for optional calculation methods for computing §162(l) deduction.

¹⁰⁸⁷ See §1402(a).

¹⁰⁸⁸ §162(l)(2)(A) (reference to §401(c)(2)).

¹⁰⁸⁹ §162(l)(2)(B).

¹⁰⁹⁰ See H.R. Rep. No. 103-213, at 568 (1990) (Conf. Rep.).

¹⁰⁹¹ See §318.

¹⁰⁹² §162(l)(5) (incorporating §1372(a)).

¹⁰⁹³ See §3121.

¹⁰⁹⁴ §162(l)(5)(A); Notice 2008-1.

¹⁰⁹⁵ §162(l)(5)(B).

¹⁰⁹⁶ See IRS Pub. 334, *Tax Guide for Small Business (For Individuals Who Use Schedule C)*.

¹⁰⁹⁷ *Stein v. Commissioner*, 31 T.C.M. 663 (1972), aff'd in unpub. opin. (7th Cir. 1974).

¹⁰⁹⁸ *Patton v. Commissioner*, 49 T.C.M. 1068 (1985), aff'd on other issues, 799 F.2d 166 (5th Cir. 1986).

¹⁰⁹⁹ Rev. Rul. 69-491.

¹¹⁰⁰ Rev. Rul. 83-66.

¹¹⁰¹ PLR 200035009.

¹¹⁰² *Kessler v. Commissioner*, 49 T.C.M. 1565 (1985).

¹¹⁰³ Rev. Rul. 70-254.

¹¹⁰⁴ PLR 8321074.

¹¹⁰⁵ Rev. Rul. 55-264.

¹¹⁰⁶ *Blaess v. Commissioner*, 28 T.C. 710 (1957); *Ferris v. Commissioner*, 51 T.C.M. 335 (1986); *Masat v. Commissioner*, 48 T.C.M. 317 (1984); Rev. Rul. 70-394, Rev. Rul. 58-480.

to a charitable contribution was not sufficiently related to the partnership's income-producing activities to support deduction under either §162 or §212.¹¹⁰⁷

b. Worker Compensation

Payments for worker compensation insurance are deductible under §162.¹¹⁰⁸ However, the portion of premiums paid by a partnership that covers the partners is not deductible.¹¹⁰⁹

A deduction is permitted for a lump sum payment made by the taxpayer to obtain permission to withdraw from the state worker compensation insurance fund and to become self-insured because the lump sum covers the taxpayer's past employment loss obligations and is, in effect, the purchase of insurance to cover those potential liabilities.¹¹¹⁰

c. Unemployment and Nonoccupational Disability Insurance

Amounts mandatorily paid to states for unemployment insurance are deductible under §164 as a §162 trade or business tax described in the flush language of §164(a).¹¹¹¹ Amounts voluntarily paid are deducted under §162.¹¹¹² The §164 deduction is discussed in 525 T.M., *State, Local, and Federal Taxes*.

Amounts mandatorily paid to states for nonoccupational disability benefit funding are deductible under §164 as a §162 trade or business tax described in the flush language of §164(a).¹¹¹³ Amounts voluntarily paid are also deductible under §162.¹¹¹⁴ Payments to private plans established to provide nonoccupational benefits in lieu of the state plan are deductible.¹¹¹⁵

d. Miscellaneous

Amounts transferred from an insured association's secondary reserve with the Federal Savings and Loan Insurance Corporation to pay an annual "primary" premium are deductible by the association as insurance premiums.¹¹¹⁶ Likewise, amounts paid into an FSLIC secondary reserve account are deductible.¹¹¹⁷ In contrast, funds used to pay "additional premiums" as prepayments for the "primary premium" required by the FSLIC are nondeductible capital expenditures.¹¹¹⁸ Similarly,

the IRS National Office has advised that a state-mandated insurance pool may not deduct payments of net equity made to a trust in lieu of being used to buy reinsurance.¹¹¹⁹

License taxes imposed by a municipality on insurance companies and passed through to its policy holders are deductible by the policy holders as an insurance expense under §162 to the extent the insurance covers the policy holder's trade or business activities.¹¹²⁰

F. Advertising

1. In General

Generally, advertising expenses to promote the taxpayer's trade or business are deductible under §162.¹¹²¹ Whether a particular activity or undertaking is an ordinary and necessary method of advertising a business is a question of fact.¹¹²² Advertising expenses paid or incurred in order to collect income or to produce income from property held for the production of income are deductible under §212.¹¹²³

However, amounts expended for advertising that are directly connected with the acquisition of publicity or business that will endure for more than one year must be capitalized.¹¹²⁴ Thus, for example, amounts paid to promote the generation of long-term contracts or leases must be capitalized and deducted over the term of the contract or lease.¹¹²⁵ Accordingly, the IRS has ruled that although the decision in *INDOPCO, Inc. v. Commissioner*,¹¹²⁶ does not affect the treatment of advertising expenses, under unusual circumstances the costs of advertising directed towards obtaining future benefits significantly beyond those traditionally associated with ordinary product advertising or with institutional or goodwill advertising must be capitalized.¹¹²⁷ Thus, design expenditures for cigarette packages that generate a long-term effect akin to the benefits associated with ordinary business advertising are deductible as advertising.¹¹²⁸ The capitalization limitation is discussed in 509 T.M., *Principles of Capitalization*.

The mere fact that engaging in an activity generates customers, clients, patients or other business contacts is in and of itself insufficient to justify deducting the cost of the activity as advertising.¹¹²⁹ A lack of increase in business, though, makes it less likely that the expenditure is deductible as advertising under §162 or §212.¹¹³⁰

¹¹⁰⁷ CCA 202050015.

¹¹⁰⁸ *Jefferson Gas Coal Co. v. Commissioner*, 52 F.2d 120 (3d Cir. 1931), rev'g 16 B.T.A. 1135 (1929); *Stein v. Commissioner*, 31 T.C.M. 663 (1972), aff'd in unpub. opin. (7th Cir. 1974). See also *Otten v. Commissioner*, 68 T.C.M. 1342 (1994) (workers compensation insurance premiums deductible because taxpayer was required to purchase the insurance).

¹¹⁰⁹ Rev. Rul. 72-596.

¹¹¹⁰ Rev. Rul. 74-139.

¹¹¹¹ *Bryan v. Commissioner*, 32 T.C. 104 (1959), aff'd in part and rev'd in part on other issues, 281 F.2d 238 (4th Cir. 1960), cert. denied, 364 U.S. 931 (1961); Rev. Rul. 81-194 (California), Rev. Rul. 81-193 (New Jersey), Rev. Rul. 75-156 (Alabama), Rev. Rul. 71-59 (Indiana).

¹¹¹² *Bryan v. Commissioner*, 32 T.C. 104 (1959), aff'd in part and rev'd in part on other issues, 281 F.2d 238 (4th Cir. 1960), cert. denied, 364 U.S. 931 (1961); Rev. Rul. 71-246 (Michigan), Rev. Rul. 71-59 (Indiana), Rev. Rul. 70-577 (Wisconsin).

¹¹¹³ Rev. Rul. 81-194 (California), Rev. Rul. 81-193 (New Jersey), Rev. Rul. 81-192 (New York), Rev. Rul. 81-191 (Rhode Island).

¹¹¹⁴ Rev. Rul. 81-194.

¹¹¹⁵ Rev. Rul. 71-209 (New Jersey), clarified by Rev. Rul. 82-95.

¹¹¹⁶ Rev. Rul. 72-366, 1972-2 C.B. 91, amplified by Rev. Rul. 74-371, 1974-2 C.B. 44.

¹¹¹⁷ TAM 9252002.

¹¹¹⁸ See *Commissioner v. Lincoln Sav. & Loan Ass'n*, 403 U.S. 345 (1971), rev'g 422 F.2d 90 (9th Cir. 1970), rev'g 51 T.C. 82 (1968).

¹¹¹⁹ TAM 9810001.

¹¹²⁰ Rev. Rul. 61-85, 1961-1 C.B. 45.

¹¹²¹ Reg. §1.162-1(a).

¹¹²² E.g., *Virgin v. United States*, 75-1 USTC ¶9288 (S.D. Fla. 1974).

¹¹²³ §212(2); Reg. §1.212-1(g). E.g., *Ree v. Commissioner*, 22 T.C.M. 588 (1963).

¹¹²⁴ Rev. Rul. 69-331, 1969-1 C.B. 87. See Rev. Rul. 92-80, 1992-2 C.B. 57.

¹¹²⁵ Rev. Rul. 69-331, 1969-1 C.B. 87.

¹¹²⁶ 503 U.S. 79 (1992).

¹¹²⁷ Rev. Rul. 92-80, 1992-2 C.B. 57.

¹¹²⁸ *RJR Nabisco Inc. v. Commissioner*, T.C. Memo 1998-252, nonacq., 1999-40 I.R.B. 438. *Contra* FSA 200147035 (package and design costs are capital expenditures, citing Rev. Rul. 89-23, 1989-1 C.B. 85).

¹¹²⁹ E.g., *Boomershine v. Commissioner*, 54 T.C.M. 43 (1987); *Hahn v. Commissioner*, 39 T.C.M. 372 (1979).

¹¹³⁰ E.g., *Kenerly v. Commissioner*, 47 T.C.M. 1244 (1984).

2. Relationship to Trade or Business

For the expenses of an activity to be deductible under §212, the activity must be engaged in primarily to generate business.¹¹³¹ An expenditure that benefits employees in a private setting does not promote or advertise the taxpayer's business to the world of customers.¹¹³² The likelihood of persuading the IRS or the courts that an activity constitutes advertising is greater when the taxpayer does not have a personal interest in the activity¹¹³³ than when the taxpayer gains significant personal satisfaction.¹¹³⁴ Thus, the costs of inviting business associates to a child's wedding are not deductible.¹¹³⁵ In *Henry v. Commissioner*,¹¹³⁶ the Tax Court held that the expenses of maintaining a yacht were not deductible under §162 as advertising expenses merely because the taxpayer, a tax expert, flew a pennant with the numerals "1040" on it from the yacht.¹¹³⁷

An activity involving the display or frequent announcement of the taxpayer's trade or business name in an environment known or reasonably expected to attract potential business contacts strongly supports the conclusion that the expenses of that activity are deductible.¹¹³⁸ A contribution to a fund raising organization is deductible as advertising,¹¹³⁹ as are a life insurance company's payments under a charitable giving program that it organized and under which it pays a specified amount to a charitable or civic organization designated by the policy owner because the company expects to receive additional sales and increased renewals from the program.¹¹⁴⁰

The advertising must be directed toward those constituting the taxpayer's market or business environment.¹¹⁴¹ The lack of exposure to groups from whom the taxpayer's business contacts are likely to emerge precludes deduction of the expenses.¹¹⁴²

Expenses during wartime incurred by a taxpayer whose operations were converted to war production in order to maintain visibility until peacetime marketing resumes were deductible.¹¹⁴³ The cost of promoting the sale of war bonds was deductible.¹¹⁴⁴

3. Reasonableness

No deduction is allowed under §162 or §212 for the costs of advertising that are unreasonable or excessive in relation to the purposes served.¹¹⁴⁵ Thus, expenses by a franchise operation

for sponsoring an event were disallowed as advertising deductions to the extent they exceeded the franchiser's recommended national advertising contributions.¹¹⁴⁶

4. Specific Types of Advertising

a. Conventional Advertising

The cost of advertising the trade name of the taxpayer's trade or business is deductible under §162.¹¹⁴⁷ The cost of promoting use of the taxpayer's product, through advertising and allowances, is deductible.¹¹⁴⁸ The cost of an advertisement in a college yearbook is deductible,¹¹⁴⁹ as is the cost of advertisements in trade association journals.¹¹⁵⁰ Membership fees in trade associations are deductible.¹¹⁵¹

Advertising expenses can include salaries¹¹⁵² and commissions.¹¹⁵³ The costs of home demonstrations of the taxpayer's product are deductible under §162 as advertising expenses.¹¹⁵⁴ The cost of sending postcards to customers, clients, patients, professional colleagues and business contacts while on vacation is deductible provided they relate to the taxpayer's trade or business.¹¹⁵⁵ A professional musician is allowed to deduct the cost of promotional glossy photographs.¹¹⁵⁶

The cost of finding retailers to carry the taxpayer's products is deductible, even though some of the resulting agreements applied to periods of more than one year.¹¹⁵⁷ In contrast, the cost of purchasing retail outlets must be capitalized.¹¹⁵⁸

b. Business Gifts

The cost of gifts made to customers and prospective customers are not deductible unless the gift is reasonably connected to the taxpayer's opportunities to generate business income.¹¹⁵⁹ Thus, in *Brown v. Commissioner*,¹¹⁶⁰ the Tax Court held that a resident physician not in private practice was not allowed to deduct the cost of pens and other gifts distributed by him because the making of the gifts had no bearing on his income.¹¹⁶¹

In addition, deductions for gifts are specifically limited by §274.¹¹⁶² The §274 limitations are discussed in 519 T.M., *Travel, Transportation, Entertainment, Meal, and Gift Expenses*.

¹¹⁴⁶ *Brallier v. Commissioner*, 51 T.C.M. 382 (1986).

¹¹⁴⁷ *Ebner v. Commissioner*, 17 T.C.M. 550 (1958).

¹¹⁴⁸ Rev. Rul. 68-561, 1968-2 C.B. 117, distinguished by Rev. Rul. 69-331, 1969-1 C.B. 87.

¹¹⁴⁹ *Leonhart v. Commissioner*, 27 T.C.M. 443 (1968), aff'd on other issues, 414 F.2d 749 (4th Cir. 1969).

¹¹⁵⁰ *Nat'l Farmers Union Serv. Corp. v. United States*, 67-1 USTC ¶9234 (D. Col. 1967), aff'd on other issues, 400 F.2d 483 (10th Cir. 1968).

¹¹⁵¹ See *Veeneman v. United States*, 65-1 USTC ¶9334 (W.D. Ky. 1965).

¹¹⁵² Rev. Rul. 68-561, 1968-2 C.B. 117, distinguished by Rev. Rul. 69-331, 1969-1 C.B. 87.

¹¹⁵³ *Aptos Land & Water Co. v. Commissioner*, 46 B.T.A. 1232 (1942).

¹¹⁵⁴ Rev. Rul. 56-181, 1956-1 C.B. 96.

¹¹⁵⁵ See *Duncan v. Commissioner*, 30 T.C. 386 (1958).

¹¹⁵⁶ *Genck v. Commissioner*, 75 T.C.M. 1984 (1998).

¹¹⁵⁷ *Briarcliff Candy Corp. v. Commissioner*, 475 F.2d 775 (2d Cir. 1973), rev'g and rem'g 31 T.C.M. 171 (1972).

¹¹⁵⁸ *Holden Fuel Oil Co. v. Commissioner*, 31 T.C.M. 184 (1972), aff'd on other issues, 479 F.2d 613 (6th Cir. 1973).

¹¹⁵⁹ See, e.g., *Eder v. Commissioner*, 9 T.C.M. 98 (1950).

¹¹⁶⁰ 47 T.C.M. 1255 (1984).

¹¹⁶¹ *Id.* at 1258.

¹¹⁶² §274(b).

¹¹³¹ *Transamerica Corp. v. United States*, 65 F. Supp. 470 (Ct. Cl. 1946).

¹¹³² *Quarrier Diner Inc. v. Commissioner*, 22 T.C.M. 276 (1963).

¹¹³³ E.g., *U.S. Equip. Co. v. Commissioner*, 22 T.C.M. 1309 (1963).

¹¹³⁴ E.g., *Brallier v. Commissioner*, 51 T.C.M. 382 (1986).

¹¹³⁵ *Haverhill Shoe Novelty Co. v. Commissioner*, 15 T.C. 517 (1950).

¹¹³⁶ 36 T.C. 879 (1961).

¹¹³⁷ *Id.* at 884. Cf. *Roy v. Commissioner*, 74 T.C.M. 1428 (1997) (physician use of Rolls Royce allegedly to obtain patient referrals).

¹¹³⁸ See *Hestnes v. Commissioner*, 47 T.C.M. 528 (1983), aff'd in unpub. opin. (7th Cir. 1985), cert. denied, 474 U.S. 904 (1985).

¹¹³⁹ PLR 9828031.

¹¹⁴⁰ PLR 200236027.

¹¹⁴¹ *U.S. Equip. Co. v. Commissioner*, 22 T.C.M. 1309 (1963).

¹¹⁴² *W.D. Gale, Inc. v. Commissioner*, 297 F.2d 270 (6th Cir. 1961), aff'd 19 T.C.M. 998 (1960).

¹¹⁴³ *B.F. Boyer & Co. v. Commissioner*, 4 B.T.A. 180 (1926).

¹¹⁴⁴ *Id.*

¹¹⁴⁵ Reg. §1.212-1(d); *Brallier v. Commissioner*, 51 T.C.M. 382 (1986). See *Frank Guerrini Vending Mach., Inc. v. Commissioner*, 28 T.C.M. 1369 (1969).

Subject to the §274 limitations, the cost of novelties bearing the name of the taxpayer's trade or business, including pens, pencils, keychains, bookmarks, calendars, balloons and similar items, are deductible advertising expenses.¹¹⁶³ Likewise, the cost of complimentary tickets distributed to customers and prospects are advertising expenses.¹¹⁶⁴

The deductibility of business gifts is discussed in 519 T.M., *Travel, Transportation, Entertainment, Meal, and Gift Expenses*.

c. Samples

The cost of free samples given to potential customers and purchasers is deductible under §162.¹¹⁶⁵ However, if the intended benefit of the samples is to establish long-term goodwill with new customers, the expenses are nondeductible capital expenditures for goodwill.¹¹⁶⁶ The IRS has explained that the deduction for the cost of the samples is not allowed until the tax year in which the samples are distributed to customers and potential customers.¹¹⁶⁷

d. Prizes Awarded to Customers

The cost of prizes periodically awarded to one paying customer selected at random from all persons patronizing the establishment during the period in question is deductible under §162 as an advertising expense because the prizes are intended to attract customers to the business premises.¹¹⁶⁸ So, too, are prizes awarded at bingo games conducted by the taxpayer to attract customers to shows presented by the taxpayer.¹¹⁶⁹

e. Travel

Generally, the cost of travel is not deductible as an advertising expense unless the publicity is proven to be more than could be attained through conventional advertising methods.¹¹⁷⁰ Thus, in *Brown v. Commissioner*,¹¹⁷¹ the Eighth Circuit upheld the Tax Court's decision that no deduction was allowable for a safari taken by the president of a coffee company whose reputation as a coffee authority was enhanced by the trip.¹¹⁷² Yet in *Sanitary Farms Dairy, Inc. v. Commissioner*,¹¹⁷³ the Tax Court allowed a deduction for the cost of sending the corporation's officers on a publicity trip to Africa.¹¹⁷⁴ The IRS follows *Sanitary Farms* only to the extent the facts are substantially identical.¹¹⁷⁵

¹¹⁶³ *E.g., Ohio Novelty Co. v. Commissioner*, 6 T.C.M. 1128 (1947).

¹¹⁶⁴ *Canaveral Int'l Corp. v. Commissioner*, 61 T.C. 520 (1974).

¹¹⁶⁵ *Newman v. Commissioner*, 11 T.C.M. 908.

¹¹⁶⁶ *Durovic v. Commissioner*, 542 F.2d 1328 (7th Cir. 1976), cert. denied, 417 U.S. 919 (1974), aff'g 65 T.C. 480 (1975), on remand from 487 F.2d 36 (7th Cir. 1973), aff'g in part and rev'g in part 54 T.C. 1364 (1970).

¹¹⁶⁷ FSA 199925009.

¹¹⁶⁸ Rev. Rul. 69-510, 1969-2 C.B. 23.

¹¹⁶⁹ *572 So. Salina Corp. v. Commissioner*, 12 T.C.M. 470 (1953).

¹¹⁷⁰ See *Sanitary Farms Dairy, Inc. v. Commissioner*, 25 T.C. 463 (1955); Rev. Rul. 56-583, 1956-2 C.B. 117.

¹¹⁷¹ 446 F.2d 926 (8th Cir. 1971), aff'g 29 T.C.M. 1126 (1970).

¹¹⁷² *Id.* at 929.

¹¹⁷³ 25 T.C. 463 (1955).

¹¹⁷⁴ *Id.* at 467-68.

¹¹⁷⁵ Rev. Rul. 56-583, 1956-2 C.B. 117.

f. Racing and Other Event Sponsorship

If the sponsorship of a racing event, or an entry therein, generates publicity for the taxpayer's trade or business that is beneficial, the cost of the sponsorship is deductible under §162.¹¹⁷⁶ Thus, absence of any reference to the taxpayer's trade or business at the sponsored event precludes the deduction.¹¹⁷⁷

Deductions have been allowed for the sponsorship of race cars by automobile dealers¹¹⁷⁸ and by a slaughterhouse owner.¹¹⁷⁹ However, mere display of a business name on a racing boat does not justify deducting the expenses of maintaining the boat if the boat is raced under conditions that do not expose it to people among whom business contacts are likely to be found.¹¹⁸⁰

Generally, the expenses of sponsoring sports teams that represent the taxpayer's trade or business are allowable §162 deductions.¹¹⁸¹ In Rev. Rul. 66-277,¹¹⁸² the IRS ruled that costs incurred by a professional sports team to finance a local hall of fame are business deductions.¹¹⁸³ In *Hoffman v. Commissioner*,¹¹⁸⁴ the Tax Court held that costs incurred by a manufacturer of weight lifting equipment and publisher of health magazines for taking himself, employees, and sponsored athletes to the Olympics were deductible as advertising expenses because sales were made at the games and magazine material was obtained.¹¹⁸⁵

g. Animals

Whether the cost of maintaining and showing animals used for promotional purposes is deductible under §162 is a factual question.¹¹⁸⁶ There must be a connection with the trade or business, and the failure of the display to draw attention to the taxpayer's trade or business precludes the deduction.¹¹⁸⁷

¹¹⁷⁶ *Lang Chevrolet Co. v. Commissioner*, T.C. Memo 1967-212. See *Evans v. Commissioner*, T.C. Memo 2014-237 (motocross expenditures and taxpayer's construction company are proximately related and are therefore deductible).

¹¹⁷⁷ *E.g., Larrabee v. United States*, 68-2 USTC ¶9442 (C.D. Cal. 1968). See *Berry v. Commissioner*, T.C. Memo 2021-42 (car racing expenses were not ordinary or necessary advertising expenses for taxpayer's construction business because nowhere on race car was business's logo, taxpayer's racing activity was conducted under his name and not his business's name, and although taxpayer supposedly met with business contacts at racetracks, no credible evidence was provided to show any new deals resulted from those meetings).

¹¹⁷⁸ *Lang Chevrolet Co. v. Commissioner*, T.C. Memo 1967-212 (1967).

¹¹⁷⁹ See *Hestnes v. Commissioner*, T.C. Memo 1983-727, aff'd in unpub. op. (7th Cir. Apr. 11, 1985), cert. denied, 474 U.S. 904 (1985).

¹¹⁸⁰ *W.D. Gale, Inc. v. Commissioner*, 297 F.2d 270 (6th Cir. 1961), aff'g T.C. Memo 1960-191. See *Virgin v. United States*, 75-1 USTC ¶9288 (S.D. Fla. 1974).

¹¹⁸¹ *Dahl v. Commissioner*, 24 B.T.A. 1167 (baseball); *Bower v. Commissioner*, 58 T.C.M. 1162 (1990) (basketball); Rev. Rul. 70-393, 1970-2 C.B. 34 (baseball).

¹¹⁸² 1966-2 C.B. 42.

¹¹⁸³ *Id.*

¹¹⁸⁴ 19 T.C.M. 836 (1960), aff'd on other issues, 298 F.2d 784 (3d Cir. 1962).

¹¹⁸⁵ *Id.* at 849.

¹¹⁸⁶ *Compare Schulz v. Commissioner*, 16 T.C. 401 (1951) (horse show entrance fee allowable) with *Hahn v. Commissioner*, 39 T.C.M. 372 (1979) (deducted).

¹¹⁸⁷ *Rolland v. Commissioner*, 18 T.C.M. 702 (1959), aff'd, 285 F.2d 760 (5th Cir. 1961).

Thus, in one case the Board of Tax Appeals allowed a taxpayer to deduct horse show costs incurred to allow the taxpayer's horses to pull wagons carrying advertisements for the taxpayer's business.¹¹⁸⁸ In another case, the Tax Court held that the cost of maintaining show horses and dogs acquired and used to promote a restaurant chain was deductible.¹¹⁸⁹ However, the Tax Court has also held that the cost of maintaining a horse used by a physician as a member of a posse and drill team did not have the requisite connection with the medical practice merely because several team members were patients.¹¹⁹⁰ Similarly, the expenses of boarding and training a show horse paid by an enrolled agent practicing in the area of tax preparation, accounting and audit representation are not deductible simply because ownership and showing of horses provides a forum in which to meet potential clients.¹¹⁹¹

h. Miscellaneous

In *Kenerly v. Commissioner*,¹¹⁹² the Tax Court disallowed a §162 advertising expense deduction for the cost of maintaining a castle used by the taxpayer as a residence, because there was no connection between the taxpayer's living in the castle and proven benefits to the taxpayer's real estate business.¹¹⁹³ In *Fihe v. Commissioner*,¹¹⁹⁴ the Ninth Circuit rejected the attempt of a patent attorney to deduct new suits as an advertising expense based on the notion that patent business would not be obtained without looking prosperous.¹¹⁹⁵

In contrast, a taxpayer who operates a stable is allowed to deduct the expenses of the taxpayer's personal horse because doing so served a public relations purpose considering that customers are reluctant to board horses at stables run by persons who do not own horses.¹¹⁹⁶

G. Business Protection

1. In General

The Tax Court has held, and the Third Circuit has affirmed, that a deduction is allowed under §162 for ordinary and necessary expenses paid or incurred to protect the income of a trade or business.¹¹⁹⁷ However, in the same case, no deduction was allowed for expenses paid or incurred to protect the goodwill reputation of a trade or business.¹¹⁹⁸

In *General Pencil Co. v. Commissioner*,¹¹⁹⁹ the Tax Court held that a corporation was allowed to deduct the legal fees incurred in purchasing stock from one of its shareholders, because the corporation's primary purpose was to protect its business and income and not to acquire stock.¹²⁰⁰ In contrast, the

cost of additional stock acquired by a minority shareholder in a failing corporation is not deductible because the taxpayer acquired an asset for its payment, even though it purportedly did so in order to protect its reputation.¹²⁰¹

2. Connection to Trade or Business

Payments to protect a trade or business must be proximately related to the trade or business.¹²⁰² No deduction is allowed for payments that protect income that is personal rather than derived from the carrying on of a trade or business.¹²⁰³ Thus, in *McDonald v. Commissioner*,¹²⁰⁴ the Second Circuit held that an attorney was not allowed to deduct the cost of settling actions contesting a will he had drafted that contained bequests to him, because under the origin of the claim test enunciated in *United States v. Gilmore*,¹²⁰⁵ the attorney was defending a personal claim to bequests and not his future professional income.¹²⁰⁶ In one case, the Board of Tax Appeals held that no deduction was allowed to a corporation for payments to induce an officer's relative to cease behavior that was adversely affecting the officer's personal financial situation and incidentally was threatening the corporation's business.¹²⁰⁷ Similarly, no deduction was allowed to a savings and loan officer for a restitution payment made to the savings and loan for the tax benefits it lost when the officer illegally purchased stock in the savings and loan because the reason for the payment was grounded in the officer's personal decision to acquire the stock.¹²⁰⁸

No deduction is allowed for a company's transfer of assets to charitable foundations to settle lawsuits asserting that the company, before engaging in mergers, held certain assets subject to a charitable trust, because the transfers were made in response to the imposition of a constructive trust on those assets and not as a consequence of the company's corporate status nor to protect its business by avoiding litigation and business interruption.¹²⁰⁹ A similar conclusion applies even if the transfer is made to the state.¹²¹⁰

3. Ordinary and Necessary

Payments made to protect the taxpayer's business are not deductible if they are not ordinary and necessary.¹²¹¹ Thus, payments to allegedly dissatisfied customers are not deductible if the taxpayer fails to demonstrate that the customers would not have continued to do business with the taxpayer in the absence of the payments.¹²¹² Payments to acquire a decedent partner's interest in a partnership in order to keep the surviving relatives out of the business were found to be not essential to the survival

¹¹⁸⁸ *Brandenburg v. Commissioner*, 4 B.T.A. 108 (1926).

¹¹⁸⁹ *Rodgers Dairy Co. v. Commissioner*, 14 T.C. 66 (1950).

¹¹⁹⁰ *Hahn v. Commissioner*, 39 T.C.M. 372 (1979).

¹¹⁹¹ *Shapiro v. Commissioner*, 67 T.C.M. 2389 (1994).

¹¹⁹² 47 T.C.M. 1244 (1984).

¹¹⁹³ *Id.* at 1248.

¹¹⁹⁴ 265 F.2d 511 (9th Cir. 1958), aff'd 15 T.C.M. 696 (1956).

¹¹⁹⁵ 265 F.2d at 512.

¹¹⁹⁶ *Ottow v. Commissioner*, 68 T.C.M. 60 (1994).

¹¹⁹⁷ *Mathiasen v. Commissioner*, 20 T.C.M. 1681 (1961), aff'd per curiam, 310 F.2d 738 (3d Cir. 1962).

¹¹⁹⁸ *Id.*

¹¹⁹⁹ 3 T.C.M. 603 (1944).

¹²⁰⁰ *Id.* at 604.

¹²⁰¹ *First Chicago Corp. v. Commissioner*, 69 T.C.M. 2089 (1995).

¹²⁰² See *Estate of Skouras v. Commissioner*, 21 T.C.M. 152 (1962).

¹²⁰³ *McDonald v. Commissioner*, 592 F.2d 635 (2d Cir. 1978), rev'g 36 T.C.M. 852 (1977). See *Harden v. Commissioner*, 62 T.C.M. 756 (1991).

¹²⁰⁴ 592 F.2d 635 (2d Cir. 1978), rev'g 36 T.C.M. 852 (1977).

¹²⁰⁵ *Id.* at 638.

¹²⁰⁶ *Id.*

¹²⁰⁷ *Forty-Four Cigar Co. v. Commissioner*, 2 B.T.A. 1156 (1925).

¹²⁰⁸ *Mitchell v. Commissioner*, 67 T.C.M. 3015 (1994), aff'd, 73 F.3d 628 (6th Cir. 1996).

¹²⁰⁹ TAM 200439042.

¹²¹⁰ TAM 200405005, revoking TAM 200126008.

¹²¹¹ *John J. Wells, Inc. v. Commissioner*, 47 T.C.M. 1114 (1984).

¹²¹² *Donovan v. Commissioner*, 60 T.C.M. 184 (1990).

of the partnership, and thus were not deductible.¹²¹³ However, the Tax Court has held that a lessee's payment of the operating loss of its lessor were ordinary and necessary expenses because the lessor referred patients to the taxpayer and allowed the taxpayer to use medical equipment on the premises.¹²¹⁴

Note: The subsequently adopted requirement in Reg. §1.263(a)-4(d), that amounts paid or incurred to create an intangible do not apply to amounts paid to another party with the mere hope or expectation of developing or maintaining a business relationship with that party, provided they are not contingent on the origination, renewal or renegotiation of an agreement with that party.¹²¹⁵

4. Protection of Goodwill

Payments for goodwill must be capitalized.¹²¹⁶ The courts have expressed differing opinions on whether payments for the protection of goodwill are deductible.¹²¹⁷ For example, in *Alsobrook v. United States*,¹²¹⁸ the court held that payments made by a bank president to the bank to permit its continued operations were not deductible even though the bank's difficulties had been caused by the fraudulent making of loans, because the payments were made to protect business reputation and goodwill.¹²¹⁹ Yet, in *Conti v. Commissioner*,¹²²⁰ the Tax Court allowed a deduction for a bank officer's payments to the bank following his mismanagement of its loans because the payments were made to protect business reputation and earning capacity.¹²²¹ The IRS has advised that payments by a financial institution to bail out its structured securities mutual funds are deductible in the year of transfer.¹²²² The capitalization limitation on deductions is discussed in 509 T.M., *Principles of Capitalization*.

5. Competition Related Payments

a. Elimination of Competition

No deduction is allowed for payments to competitors to cease manufacturing imitations of the taxpayer's product because the benefits of the payments extend indefinitely into the future.¹²²³ Likewise, no deduction is allowed for the cost of acquiring a competitor because the primary purpose of such an

acquisition is the suppression of competition, which generates an intangible asset.¹²²⁴ The cost of acquiring evidence to be used by the appropriate authorities to terminate the operations of an illegal, though competitive, enterprise is deductible.¹²²⁵

b. Matching Competition

The cost of providing transportation for patrons to and from the taxpayer's business establishment was deductible because it increased business and permitted the taxpayer to compete with similar businesses that were doing similar things to encourage business.¹²²⁶ Commission rate adjustments, paid by a day-trader to his customers, were deductible because such payments were customary in the day-trading business, and often necessary to retain clients.¹²²⁷

c. Avoiding Disadvantageous Contracts

A payment for release from a contract is deductible if it is made to avoid the negative impact that the contract has on the taxpayer's income.¹²²⁸ Payments for the cancellation of onerous employment contracts are deductible,¹²²⁹ particularly if the payor obtains a benefit to the generation of income, such as a promise of noncompetition.¹²³⁰

Payment for release from a contract requiring the taxpayer to purchase all of its inventory from the other party has been held to be deductible.¹²³¹ Similarly, in a 1959 case, the Court of Claims held that a payment for release from a contract requiring the taxpayer to supply the other contracting party with all of a particular kind of supply was deductible.¹²³² The IRS has ruled that payments to suppliers to settle the suppliers' claims for damages resulting from the taxpayer's rejection of its supply contracts in a bankruptcy proceeding are deductible.¹²³³

The fact that the cancellation of the contract is procured through acquisition of the other party to the contract does not necessarily preclude the deduction.¹²³⁴ Thus, if the most reasonable method of obtaining cancellation is to purchase a controlling block of stock in the corporation with which the contract was made and to then terminate the contract, making the acquired corporation worthless, the expense has been held to be deductible under §162.¹²³⁵

¹²¹³ *Payte v. United States*, 492 F. Supp. 518 (N.D. Tex. 1979), aff'd, 626 F.2d 400 (5th Cir. 1980), cert. denied, 450 U.S. 995 (1981).

¹²¹⁴ *Cepeda v. Commissioner*, 66 T.C.M. 1032 (1993), *supp.*, 67 T.C.M. 2181 (1994), aff'd, 56 F.3d 1384 (5th Cir. 1995).

¹²¹⁵ Reg. §1.263(a)-4(d)(6)(ii). For example, in PLR 201736002, the IRS ruled that a support payment paid to shareholders to incentivize them to approve a merger was a deductible expense under §162(a). The taxpayer — a third party LLC under contract with the acquiring company — stood to see a large increase in its fees if the merger was successful, and thus the IRS found the expense to be a necessary one under §162(a). *Id.*

¹²¹⁶ *Alsobrook v. United States*, 431 F. Supp. 1122 (E.D. Ark. 1977), aff'd per curiam on other issues, 566 F.2d 628 (8th Cir. 1977).

¹²¹⁷ *Compare Alsobrook v. United States*, 431 F. Supp. at 1126 with *Allen v. Commissioner*, 283 F.2d 785 (7th Cir. 1960), rev'g and rem'g 18 T.C.M. 1101 (1959), and *Lutz v. Commissioner*, 282 F.2d 614 (5th Cir. 1960), rev'g and rem'g 18 T.C.M. 152 (1959).

¹²¹⁸ 431 F. Supp. 1122 (E.D. Ark. 1977), aff'd per curiam on other issues, 566 F.2d 628 (8th Cir. 1977).

¹²¹⁹ 431 F. Supp. at 1126.

¹²²⁰ 31 T.C.M. 348 (1972).

¹²²¹ *Id.* at 356–57. See TAM 9522003.

¹²²² TAM 200247004.

¹²²³ *Am. Dispenser Co. v. Commissioner*, 396 F.2d 137 (2d Cir. 1968), aff'g 26 T.C.M. 717 (1967).

¹²²⁴ *Fla. Publ'g Co. v. Commissioner*, 64 T.C. 269 (1975), aff'd in unpub. op. (5th Cir. Apr. 25, 1977). See Reg. §1.263(a)-5 (capitalization of amounts paid or incurred to facilitate an acquisition of a trade or business).

¹²²⁵ *Pierce v. Commissioner*, 18 B.T.A. 447 (1929).

¹²²⁶ *Ebner v. Commissioner*, 17 T.C.M. 550 (1958).

¹²²⁷ *Manning v. Commissioner*, T.C. Memo 2009-157.

¹²²⁸ *E.g., Capital Indem. Ins. Co. v. Commissioner*, 237 F.2d 901 (7th Cir. 1956), rev'g 25 T.C. 147 (1955); PLR 199913032 (public utility's payments to buy out and terminate burdensome energy contracts deductible); PLR 9842006 (same); PLR 9615028 (same); PLR 9240005 (same as to coal supply contract).

¹²²⁹ *Boulevard Frocks, Inc. v. Commissioner*, 1 T.C.M. 358 (1943). See *Chief Indus., Inc. v. Commissioner*, 87 T.C.M. 1002 (2004).

¹²³⁰ *Metro. Corp. v. United States*, 176 F. Supp. 195 (S.D. Ohio 1959).

¹²³¹ *Stuart Co. v. Commissioner*, 9 T.C.M. 585 (1950), aff'd, 195 F.2d 176 (9th Cir. 1952).

¹²³² *Montana Power Co. v. United States*, 171 F. Supp. 943 (Ct. Cl. 1959).

¹²³³ PLR 9552014.

¹²³⁴ See *Pressed Steel Car Co. v. Commissioner*, 20 T.C. 198 (1953).

¹²³⁵ *Helvering v. Cmty. Bond & Mortg. Corp.*, 74 F.2d 727 (2d Cir. 1935), aff'g 27 B.T.A. 480 (1932).

However, if the intent of the payment is to acquire stock or other property of the payee rather than to terminate a contract, the Second Circuit has held that no deduction is allowed, and the payment therefore has to be capitalized as part of the cost of the acquired property.¹²³⁶ The question is one of fact.¹²³⁷ If the agreement allocates all of the payment to the purchase of stock and provides for mutual releases from the contract, the taxpayer's reallocation of a portion of the amount paid to the release from the contract is ignored, and the entire payment must be capitalized.¹²³⁸ Likewise, if the payment is made principally to obtain a new contract with substantially improved benefits, no deduction is allowed.¹²³⁹

In *Harder Servs. v. Commissioner*,¹²⁴⁰ the Tax Court held that payments made to an employee for repurchase of his stock and to terminate his employment contract were in fact a refinancing of the employee's purchase obligation because there was no intent to terminate employment.¹²⁴¹ In *Philad Co. of Del. v. Commissioner*,¹²⁴² the court held that cancellation by the taxpayer of the other contracting party's debt to the taxpayer in exchange for release of the taxpayer from a restrictive covenant with its patent licensee was a capital expenditure for the restoration to the taxpayer of valuable rights in its patents that the release caused.¹²⁴³ In *Darlington-Hartsville Coca-Cola Bottling Co. v. United States*,¹²⁴⁴ the Fourth Circuit held that payments to a franchiser were not for relief from a contract but for the acquisition of a new franchise, and thus were not deductible.¹²⁴⁵ Relying on *Darlington-Hartsville Coca-Cola Bottling Co.*, the IRS has advised that a bank holding company must capitalize the statutory fees it paid to exit one insurance fund and enter another.¹²⁴⁶ The IRS also has advised that amounts paid for cancellation of a capital acquisition contract are not deductible except to the extent specifically allocable to the termination of the agreement.¹²⁴⁷

d. Lease Cancellations

The cost of obtaining the cancellation of a lease so that the taxpayer can use the property in the trade or business to generate income must be capitalized and amortized over the unexpired term of the canceled lease.¹²⁴⁸ The cost of obtaining the cancellation so that the taxpayer can lease the property to another party at a higher rental must be capitalized and amortized

¹²³⁶ *S. Bleckman & Sons, Inc. v. Commissioner*, 13 T.C.M. 870 (1954), aff'd per curiam, 299 F.2d 925 (2d Cir. 1956).

¹²³⁷ *Coca-Cola Co. v. Commissioner*, 369 F.2d 913 (8th Cir. 1966), aff'g *Butter-Nut Foods Co. v. Commissioner*, 24 T.C.M. 1588 (1965).

¹²³⁸ *Salzer Grain & Milling Co. v. Commissioner*, 51 T.C.M. 919 (1986), aff'd on other issues, 815 F.2d 1265 (9th Cir. 1987).

¹²³⁹ TAM 9334005.

¹²⁴⁰ 67 T.C. 585 (1976), aff'd in unpub. opin. (2d Cir. 11/10/77).

¹²⁴¹ *Id.* at 597-98.

¹²⁴² 47 B.T.A. 565 (1942).

¹²⁴³ *Id.* at 570.

¹²⁴⁴ 393 F.2d 494 (4th Cir. 1968), cert. denied, 393 U.S. 962 (1968), aff'g 273 F. Supp. 229 (D.S.C. 1967).

¹²⁴⁵ 393 F.2d at 495.

¹²⁴⁶ FSA 200008005.

¹²⁴⁷ FSA 199918022.

¹²⁴⁸ *E.g.*, *Peerless Weighing & Vending Mach. Corp. v. Commissioner*, 52 T.C. 850 (1969); *Trust Corp. v. Commissioner*, 42 T.C. 482 (1964); *Berger v. Commissioner*, 7 T.C. 1339 (1946); Rev. Rul. 71-283, 1971-2 C.B. 168. See Reg. §1.263(a)-4(d)(7) (capitalization of amounts paid to terminate certain contracts).

over the term of the new lease.¹²⁴⁹ The cost of obtaining the cancellation of a lease to allow the construction of a new building must be capitalized and included in basis of building.¹²⁵⁰

Lease cancellation payments are discussed in 593 T.M., *Real Estate Leases*.

e. Patent Infringement

The costs of defending patent infringement suits by a taxpayer engaged in the business of developing and exploiting patents are deductible.¹²⁵¹ However, although deductions are allowed for amounts paid to protect the property against infringement and to recover profits and damages as a result of the infringement, capitalization is required for amounts paid to another party to defend or perfect title to intangible property if the other party challenges the taxpayer's title to the intangible property.¹²⁵²

6. Asset Related Payments

a. Prevention of Physical and Similar Harm

An expenditure to prevent physical harm to the assets of a trade or business is not deductible under §162 if the threatened harm is not imminent.¹²⁵³ Thus, in *York Water Co. v. Commissioner*,¹²⁵⁴ the Tax Court held that a payment to the state for the cost of rerouting a road around a tract of land owned by the taxpayer was not deductible merely because the taxpayer might need the land for additional water storage at some time in the future.¹²⁵⁵ In contrast, a payment to the state to relocate a road so that immediate damage to the taxpayer's property can be prevented is deductible.¹²⁵⁶

The cost of constructing and removing temporary dikes designed to prevent flooding of business premises is deductible.¹²⁵⁷ The cost of security guards to prevent damage by disgruntled former employees is deductible.¹²⁵⁸

The cost of investigating employees and applicants to minimize the threat of theft and embezzlement is deductible.¹²⁵⁹

¹²⁴⁹ *E.g.*, *Montgomery Co. v. Commissioner*, 54 T.C. 986 (1970); *Latter v. Commissioner*, 20 T.C.M. 336 (1961).

¹²⁵⁰ *E.g.*, *Houston Chronicle Publ'g Co. v. United States*, 481 F.2d 1240 (5th Cir. 1973), cert. denied, 414 U.S. 1129 (1974), aff'g 339 F. Supp. 1314 (S.D. Tex. 1972); *Keiler v. United States*, 395 F.2d 991 (6th Cir. 1968), aff'g 285 F. Supp. 520 (W.D. Ky. 1966); *Cosmopolitan Corp. v. Commissioner*, 18 T.C.M. 542 (1959).

¹²⁵¹ *Urquhart v. Commissioner*, 215 F.2d 17 (3d Cir. 1954), rev'g 20 T.C. 944 (1953); *Addressograph-Multigraph Corp. v. Commissioner*, 4 T.C.M. 147 (1945). See also AM 2014-006 (costs paid to initiate infringement suit in response to Abbreviated New Drug Application with ¶IV certification deductible).

¹²⁵² See Reg. §1.263(a)-4(d)(9); Reg. §1.263(a)-4(e)(5) *Ex. 3*; FAA 20154502F (legal fees incurred to defend patent infringement suit facilitate process of obtaining FDA-approved Abbreviated New Drug Application with ¶IV certification, thus creating intangible, and must be capitalized); AM 2014-006 (same).

¹²⁵³ *York Water Co. v. Commissioner*, 36 T.C. 1111 (1961).

¹²⁵⁴ 3 T.C. 1111 (1961).

¹²⁵⁵ *Id.* at 1117.

¹²⁵⁶ *Seufert Bros. Co. v. Lucas*, 44 F.2d 528 (9th Cir. 1930), rev'g 14 B.T.A. 1023 (1929).

¹²⁵⁷ Rev. Rul. 70-90, 1970-1 C.B. 37.

¹²⁵⁸ *Munson v. Commissioner*, 18 B.T.A. 232 (1929).

¹²⁵⁹ *Desmonds, Inc. v. Commissioner*, 15 B.T.A. 738 (1929), *nonacq.*, 1929 C.B. 62.

Note: Amounts paid to produce or improve real property owned by another person must be capitalized if the real property can reasonably be expected to produce significant economic benefits for the taxpayer.¹²⁶⁰

b. Protection of Contract Rights

In *Helis v. United States*,¹²⁶¹ the court held that an oil drilling partnership's cost of negotiating the status of expiring concessions with a foreign government was deductible as expenses of protecting its contract rights and other assets.¹²⁶²

In Rev. Rul. 79-283,¹²⁶³ the IRS ruled that a financial institution was allowed to deduct payments to a fund administered by a league of financial institutions that made distributions to natural disaster victims who owned properties on which the financial institution held mortgages.¹²⁶⁴

Payments for the expense of opposing attempts by other parties to prevent the renewal of the taxpayer's franchise are deductible.¹²⁶⁵ The costs of cancellation of tenants' rents to induce them to continue occupancy of the taxpayer's building amounts to a deductible expense for the preservation of the lease.¹²⁶⁶

In *John J. Wells, Inc. v. Commissioner*,¹²⁶⁷ the Tax Court held that a corporation in a business requiring access to customers' homes was not allowed to deduct blackmail payments made to an employee for the employee's promise not to give the customers information about the sole shareholder that would almost certainly cause them to deny the corporation's employees access to their homes, because blackmail payments are not customary in the corporation's business, even though the payments were made to preserve the corporation's ability to retain and obtain contracts.¹²⁶⁸

c. Maintaining or Improving Liquidity

Payments made to settle litigation involving the termination of contracts are deductible to the extent they guarantee the collection by the taxpayer of accounts receivable, because the collection of accounts receivable is not the acquisition of an asset but an improvement in the taxpayer's liquidity.¹²⁶⁹

A medical provider's legal expenses of pursuing, with a patient, an action against the patient's medical insurer for reimbursement of the provider's charges are deductible, even if the provider is dismissed as an uninterested party, because the insurer's payment of the claim has a direct impact on the provider's income.¹²⁷⁰

7. Avoiding Interruptions and Disruption

a. Prevention of Disruptive Litigation

In *Kopp's Co. v. United States*,¹²⁷¹ the Fourth Circuit allowed a corporation to deduct the cost of settling litigation against it for damages arising from the personal use of a corporate vehicle by its president's child.¹²⁷² Similarly, a deduction was allowed for the legal fees and settlement amounts paid by a corporation to a former employee who brought a tort claim against the corporation that, if entirely successful, could have seriously damaged the corporation's business.¹²⁷³ A physician was allowed to deduct an amount paid to settle a lawsuit brought by a patient who alleged harmful treatment by the physician.¹²⁷⁴ The IRS has ruled that an employer was allowed a deduction for a settlement payment to a defined contribution plan with respect to which the employer had allegedly violated prohibited transaction rules under ERISA.¹²⁷⁵

In contrast, payments by a corporation to the trustees of a shareholders' trust in settlement of an action by the shareholders against the trustees were not deductible merely because an adverse decision would have resulted in distribution of all its net earnings, exhausting working capital.¹²⁷⁶

b. Prevention of Labor Difficulties

Deductions have been allowed for payments by employers to open shop associations,¹²⁷⁷ and to strike funds.¹²⁷⁸ Payments to associations for protection against labor demands have been allowed,¹²⁷⁹ as have payments to organizations that provide advice on legislation that would adversely affect labor relations¹²⁸⁰ and organizations that establish trade practices with respect to labor unions and labor issues.¹²⁸¹ However, in *Christodoulou v. Commissioner*,¹²⁸² the Tax Court held that payments to union officials to guarantee workers and uninterrupted performance were not deductible because they were not proven to be ordinary and necessary.¹²⁸³

An employer's payment of employee union dues is deductible if the payment enables the employer to obtain or retain qualified employees needed in the trade or business.¹²⁸⁴ Deductions have been allowed for payments to joint apprenticeship and training trust funds established by agreement with a union.¹²⁸⁵

¹²⁷¹ 636 F.2d 59 (4th Cir. 1980), rev'g 79-2 USTC ¶ 9430 (D. Md. 1979).

¹²⁷² 636 F.2d at 61.

¹²⁷³ *Naporano Iron & Metal Co. v. United States*, 6 Cl. Ct. 422 (1984).

¹²⁷⁴ *Oliver v. Commissioner*, 73 T.C.M. 2035 (1997).

¹²⁷⁵ PLR 199913047.

¹²⁷⁶ *E.W. Edwards & Sons v. United States*, 162 F. Supp. 97 (N.D.N.Y. 1957), aff'd per curiam, 255 F.2d 407 (2d Cir. 1958).

¹²⁷⁷ *Allen v. Commissioner*, 7 B.T.A. 1256 (1927).

¹²⁷⁸ *Harris v. Commissioner*, 11 B.T.A. 871 (1928); *Cohan v. Commissioner*, 11 B.T.A. 743 (1928), aff'd on other issues, 39 F.2d 540 (2d Cir. 1930).

¹²⁷⁹ *Campan v. Commissioner*, 16 B.T.A. 543 (1929).

¹²⁸⁰ *Richmond Hosiery Mills v. Commissioner*, 6 B.T.A. 1247 (1927), aff'd on other issues, 29 F.2d 262 (5th Cir. 1928), cert. denied, 279 U.S. 844 (1929).

¹²⁸¹ *Calif. Brewing Ass'n v. Commissioner*, 5 B.T.A. 347 (1926).

¹²⁸² 21 T.C.M. 10 (1962).

¹²⁸³ *Id.* at 16.

¹²⁸⁴ *Boyd Constr. Co. v. United States*, 339 F.2d 620 (Ct. Cl. 1964).

¹²⁸⁵ Rev. Rul. 58-238, 1958-1 C.B. 90.

¹²⁶⁰ Reg. § 1.263(a)-4(d)(8)(i).

¹²⁶¹ 74-1 USTC ¶ 9167 (E.D. La. 1973), aff'd, 496 F.2d 1319 (5th Cir. 1974), on remand from 464 F.2d 330 (5th Cir. 1972), rev'g 71-1 USTC ¶ 9365 (E.D. La. 1971).

¹²⁶² 74-1 USTC ¶ 9167.

¹²⁶³ 1979-2 C.B. 80.

¹²⁶⁴ *Id.*

¹²⁶⁵ *All State Freight, Inc. v. United States*, 72 F. Supp. 673 (N.D. Ohio 1947).

¹²⁶⁶ *Lab Estates, Inc. v. Commissioner*, 13 T.C. 811 (1949).

¹²⁶⁷ 47 T.C.M. 1114 (1984).

¹²⁶⁸ *Id.* at 1117.

¹²⁶⁹ *Lieb v. Commissioner*, 33 T.C.M. 1231 (1974), aff'd in unpub. opin. (3d Cir. 4/16/76).

¹²⁷⁰ *Pfluger v. Commissioner*, 51 T.C.M. 503 (1986), aff'd, 840 F.2d 1379 (7th Cir. 1988), cert. denied, 487 U.S. 1237 (1988).

In *Slaymaker Lock Co. v. Commissioner*,¹²⁸⁶ the Tax Court held that an employer's cost of purchasing a building for transfer to, and use by, a supervisory employees' association was deductible because the employer had no use for the building in its trade or business and it was some distance from the employer's premises.¹²⁸⁷ In contrast, in *Athenia Steel Co. v. Commissioner*,¹²⁸⁸ the court held that the cost of constructing a club on the employer's premises was a capital expenditure,¹²⁸⁹ a result it followed in *Oswego Falls Corp. v. Commissioner*,¹²⁹⁰ with respect to improvements to a club used by employees.¹²⁹¹

c. Material Supplies Procurement

A deduction is allowed for payments under an agreement that permits the taxpayer to purchase necessary materials for the operation of its business.¹²⁹²

8. Ownership and Management Controversies

a. Stock Ownership

In *Feagans v. Commissioner*,¹²⁹³ the Tax Court held that a corporation's payment to its manager to settle his stock ownership controversy with a shareholder was deductible.¹²⁹⁴ The same result was reached with respect to a corporation's payment to stop a lawsuit brought by an officer-shareholder with respect to an agreement on the control of the corporation.¹²⁹⁵

In *General Pencil Co. v. Commissioner*,¹²⁹⁶ the Tax Court held that a corporation was allowed to deduct the legal fees incurred in purchasing stock from one of its shareholders, because the corporation's primary purpose was to protect its business and income and not to acquire stock.¹²⁹⁷ However, in *Commerce PhotoPrint Corp. v. Commissioner*,¹²⁹⁸ the Tax Court disallowed a deduction by a corporation for legal fees incurred in settling a dispute among its shareholders, by which it acquired part of its own stock by transferring stock in its subsidiary, cash, and equipment.¹²⁹⁹ The taxpayer has the burden of proving that its primary purpose is not the acquisition of its own stock.¹³⁰⁰

Payments by a corporation to induce the surviving spouse of a decedent shareholder who owns a controlling interest in the corporation to sell the stock to another person are deductible if the stock sale is essential to permit the corporation to continue its business.¹³⁰¹ Payments to liquidate the interest of a share-

holder whose removal was necessary to insure the survival of the business were deductible.¹³⁰²

Observation: The deductibility results obtained in the General Pencil and Five Star Manufacturing cases were legislatively overruled. §162(k) now provides that a corporation will not be allowed any deduction otherwise allowable for any amount paid or incurred in connection with the corporation's reacquisition of its stock or of the stock of a related corporation. Exceptions to the disallowance rule in §162(k) are provided for interest deductible under §163, loan-related amounts amortized over the term of the loan and the §561 dividends-paid deduction.

b. Voting Trusts

Payments by a corporation to shareholders to establish a voting trust designed to permit continuation of the business by an employee were not deductible because they did not primarily benefit the corporation.¹³⁰³ Likewise, in *Warren Steam Pump Co. v. Commissioner*,¹³⁰⁴ the court disallowed deductions for payments by a corporation to a shareholder officer and his estate arising from an agreement to place his stock in trust in order to keep it intact as a block.¹³⁰⁵

c. Proxy Fights

A corporation's proxy fight expenses are deductible to the extent they are incurred primarily for the benefit of the corporation.¹³⁰⁶ The IRS takes the position that no deduction is allowed if the expenses are incurred primarily for the benefit of individuals rather than in connection with the defense of corporate policies.¹³⁰⁷ In *Cent. Foundry Co. v. Commissioner*,¹³⁰⁸ the Tax Court allowed a deduction for the corporation's reimbursement of expenses incurred by dissident shareholders who obtained a majority of seats on the board of directors in connection with prevailing in a proxy fight.¹³⁰⁹

Note: Proxy costs paid in the process of investigating or otherwise pursuing stock and asset acquisitions constituting a trade or business, reorganizations and similar enumerated transactions¹³¹⁰ must be capitalized.¹³¹¹

9. Payments Related to Sexual Harassment and Sexual Abuse

Under §162(q), no deduction is allowed for any settlement or payment related to sexual harassment or sexual abuse if such settlement or payment is subject to a nondisclosure agreement,¹³¹² and no deduction is allowed for attorney's fees related to such a settlement or payment.¹³¹³

¹²⁸⁶ 18 T.C. 1001 (1952), rev'd on other issues, 208 F.2d 313 (3d Cir. 1953).

¹²⁸⁷ 18 T.C. at 1009.

¹²⁸⁸ 1 B.T.A. 559 (1925).

¹²⁸⁹ *Id.* at 560.

¹²⁹⁰ 46 B.T.A. 801 (1942), rev'd on other issues, 137 F.2d 173 (2d Cir. 1943).

¹²⁹¹ 46 B.T.A. at 809.

¹²⁹² *Van Iderstine Co. v. Commissioner*, 261 F.2d 211 (2d Cir. 1958), rev'g 16 T.C.M. 790 (1957).

¹²⁹³ 23 T.C. 208 (1954).

¹²⁹⁴ *Id.* at 217.

¹²⁹⁵ *Brooks Packing Co. v. Commissioner*, 6 T.C.M. 583 (1947).

¹²⁹⁶ 3 T.C.M. 603 (1944).

¹²⁹⁷ *Id.* at 604.

¹²⁹⁸ 6 T.C.M. 386 (1947).

¹²⁹⁹ *Id.* at 393.

¹³⁰⁰ See *Erie Bronze Co. v. Commissioner*, 10 T.C.M. 205 (1951).

¹³⁰¹ *Williams & Waddell, Inc. v. Pitts*, 148 F. Supp. 778 (E.D.S.C. 1957).

¹³⁰² *Five Star Mfg. Co. v. Commissioner*, 355 F.2d 724 (5th Cir. 1966), rev'g 40 T.C. 379 (1963).

¹³⁰³ *D.A. Fisher, Inc. v. Henslee*, 54-1 USTC ¶9231 (M.D. Tenn. 1953).

¹³⁰⁴ 23 B.T.A. 585 (1931).

¹³⁰⁵ *Id.* at 588.

¹³⁰⁶ *Locke Mfg. Co. v. United States*, 237 F. Supp. 80 (D. Conn. 1964); Rev. Rul. 67-1, 1967-1 C.B. 28.

¹³⁰⁷ Rev. Rul. 67-1, 1967-1 C.B. 28.

¹³⁰⁸ 49 T.C. 234 (1967).

¹³⁰⁹ *Id.* at 250.

¹³¹⁰ See Reg. §1.263(a)-5(e)(3).

¹³¹¹ Reg. §1.263(a)-5(e)(2).

¹³¹² §162(q)(1), added by Pub. L. No. 115-97, §13307(a), effective December 23, 2017.

¹³¹³ §162(q)(2), added by Pub. L. No. 115-97, §13307(a), effective December 23, 2017.

H. Entertainment

Business entertainment expenses are generally not deductible for amounts paid or incurred after December 31, 2017, unless an exception applies.¹³¹⁴ For more information, see 519 T.M., *Travel, Transportation, Entertainment, Meal, and Gift Expenses*.

For amounts paid or incurred before January 1, 2018, subject to certain percentage limitations in §274, the cost of entertainment that was related to carrying on a trade or business was deductible under §162.¹³¹⁵ The tests located in pre-2018 §274(a) (1), however, were so stringent that any expense that met the tests of pre-2018 §274(a)(1) was virtually certain to also met the broader tests of §162.¹³¹⁶

I. Transportation, Travel, and Relocation Expenses

1. Transportation

Expenses paid or incurred in transporting people, goods, and equipment in carrying on a trade or business generally are deductible under §162. Transportation expense deductions are described below, and are discussed further in 519 T.M., *Travel, Transportation, Entertainment, Meal, and Gift Expenses*.

2. Ordinary and Necessary

Transportation expenses are deductible only if they are ordinary and necessary.¹³¹⁷ Transportation expenses are not ordinary and necessary if the taxpayer can use free transportation provided by an employer or client.¹³¹⁸

3. Trips Between Places of Business or Investment Properties

The cost of trips between different places of business is deductible if the trip is undertaken in the carrying on of the trade or business.¹³¹⁹ For these purposes, a union hall is not

a place of business.¹³²⁰ If the taxpayer's home is also a place of business, the IRS allows a deduction for the costs of daily transportation between the home and another business location only if the home is a principal place of business within the meaning of §280A(c)(1)(A) and the business conducted in the other location is the same trade or business as that conducted at the home.¹³²¹ In contrast, the Tax Court allows the deduction provided the home is a regular place of business.¹³²²

Comment: The law in this area is characterized by continual IRS attempts to limit the scope of judicial decisions in which its restrictive approach to the deduction of transportation expenses involving travel to or from the taxpayer's residence is at issue. Originally, the IRS found support for the proposition that the cost of trips between home and a place of business is not deductible even if the taxpayer carries on a trade or business at home that is not related to the places of business to which the trips are made,¹³²³ particularly if the taxpayer would have made the trip in any event.¹³²⁴ However, the courts crafted an exception applicable to trips from a place of business at home to other places of the same business.¹³²⁵ In response, the IRS relented but only to the extent indicated. The extent of the maneuvering is apparent from the events surrounding *Burleson v. Commissioner*,¹³²⁶ in which the IRS released its latest interpretation five days before it filed its brief in the case, citing that interpretation, even though the case had been submitted as fully stipulated 78 days before the IRS issued its interpretation. In deciding that it would be fundamentally unfair to the taxpayers to follow the IRS position, the Tax Court noted that the IRS issued its interpretation after the court had issued a decision on indistinguishable facts in which it treated the IRS position on the deduction as equivalent to a concession by the IRS on the issue.

Under §212, deductions are allowed for the expenses of transportation between properties that are held for the production of income.¹³²⁷

¹³¹⁴ §274(a).

¹³¹⁵ *E.g., Detko v. Commissioner*, 53 T.C.M. 186 (1987); *Williams v. Commissioner*, 14 T.C.M. 373 (1955).

¹³¹⁶ *See, e.g., McReavy v. Commissioner*, 57 T.C.M. 133 (1989).

¹³¹⁷ *E.g., Commissioner v. Motch*, 180 F.2d 859 (6th Cir. 1950), rev'g 11 T.C. 777 (1948).

¹³¹⁸ *E.g., Hall v. Commissioner*, 10 B.T.A. 847 (1928); *Kelly v. Commissioner*, 23 T.C.M. 472 (1964); *Cox v. United States*, 78-2 USTC ¶9572 (D. Nev. 1978), aff'd sub nom., *Coombs v. Commissioner*, 608 F.2d 1269 (9th Cir. 1979).

¹³¹⁹ *E.g., Chandler v. Commissioner*, 226 F.2d 467 (1st Cir. 1955), rev'g 23 T.C. 653 (1955); *Puckett v. Commissioner*, 56 T.C. 1092 (1971); *Fausner v. Commissioner*, 55 T.C. 620 (1971); *Musser v. Commissioner*, 3 B.T.A. 498 (1926); *Christman v. Commissioner*, 57 T.C.M. 538 (1989); *Hamby v. Commissioner*, 56 T.C.M. 783 (1988); *Whitaker v. Commissioner*, 56 T.C.M. 47 (1988); *Muhl v. Commissioner*, 51 T.C.M. 1538 (1986); *Hezel v. Commissioner*, 49 T.C.M. 458 (1985); *Kahl v. Commissioner*, 41 T.C.M. 1433 (1981); *Bass v. Commissioner*, 41 T.C.M. 1176 (1981); *Terry v. Commissioner*, 38 T.C.M. 1105 (1979); *Burke v. Commissioner*, 38 T.C.M. 815 (1979); *Scott v. Commissioner*, 33 T.C.M. 1299 (1974); *Phillips v. Commissioner*, 32 T.C.M. 255 (1973); *Newi v. Commissioner*, 28 T.C.M. 686 (1969), aff'd on other issues, 432 F.2d 998 (2d Cir. 1970); *Rountree v. Commissioner*, 27 T.C.M. 810 (1968); *Kutchinski v. Commissioner*, 27 T.C.M. 216 (1968); *Moylan v. Commissioner*, 27 T.C.M. 84 (1968); *Steele v. Commissioner*, 19 T.C.M. 966 (1960); *Ciro v. Commissioner*, 17 T.C.M. 76 (1958); *Driscoll v. Commissioner*, 11 T.C.M. 1217 (1952); *McWilliams v. Commissioner*, 9 T.C.M. 866 (1950); Rev. Rul. 55-637, Rev. Rul. 55-109, modified on other issues by, Rev. Rul. 90-23.

¹³²⁰ *E.g., Anderson v. Commissioner*, 60 T.C. 834 (1973); *Thompson v. Commissioner*, 15 T.C. 609 (1950), rev'd on other issues, 193 F.2d 586 (10th Cir. 1951); *Stanclift v. Commissioner*, 37 T.C.M. 1690 (1978); *Hess v. United States*, 329 F. Supp. 1353 (D. Kan. 1971).

¹³²¹ Rev. Rul. 99-7, modifying and superseding Rev. Rul. 94-47, and Rev. Rul. 90-23.

¹³²² *Walker v. Commissioner*, 101 T.C. 537 (1993). *See also Merritt v. Commissioner*, 69 T.C.M. 1779 (1995); *Stalcup v. Commissioner*, 69 T.C.M. 1777 (1995); *Burleson v. Commissioner*, 68 T.C.M. 288 (1994); *Burleson v. Commissioner*, 67 T.C.M. 2517 (1994); *Nikkila v. Commissioner*, 66 T.C.M. 1796 (1993); *Boice v. Commissioner*, 66 T.C.M. 1794 (1993); *Callison v. Commissioner*, 66 T.C.M. 1792 (1993); *Burleson v. Commissioner*, 66 T.C.M. 1791 (1993).

¹³²³ *Dougherty v. Commissioner*, 51 T.C.M. 986 (1986), aff'd in unpub. opin. (8th Cir. 1987); *Fisher v. Commissioner*, 38 T.C.M. 807 (1979); *Matteson v. Commissioner*, 33 T.C.M. 479 (1974), aff'd, 514 F.2d 43 (8th Cir. 1975).

¹³²⁴ *E.g., Mazzotta v. Commissioner*, 57 T.C. 427 (1971), aff'd, 465 F.2d 1399 (2d Cir. 1972); *Bloomberg v. Commissioner*, 38 T.C.M. 206 (1979); *Cherubini v. Commissioner*, 37 T.C.M. 1853 (1978).

¹³²⁵ *E.g., Curphey v. Commissioner*, 73 T.C. 766 (1980); *Downs v. Commissioner*, 49 T.C. 533 (1968); *Leitch v. Commissioner*, 58 T.C.M. 341 (1989), aff'd in unpub. opin. (9th Cir. Mar. 25, 1991); *Muhl v. Commissioner*, 51 T.C.M. 1538 (1986); *McKinsey v. Commissioner*, 48 T.C.M. 225 (1984).

¹³²⁶ 68 T.C.M. 288 (1994).

¹³²⁷ *E.g., Horowitz v. Commissioner*, 38 T.C.M. 108 (1979).

4. Commuting

a. In General

Generally, no deduction is allowed for the cost of commuting between the taxpayer's home and a place of business because the cost of commuting is a personal expense,¹³²⁸ regardless of the length of the trip.¹³²⁹ The costs disallowed include the costs of operating a commuting vehicle,¹³³⁰ parking fees,¹³³¹ tolls,¹³³² car pool payments¹³³³ and public transportation.¹³³⁴ The IRS has ruled that the costs of daily transportation between a place of business and a taxpayer's residence not used as a place of business are deductible if the place of business is a temporary work location outside of the metropolitan area in which the taxpayer normally lives and works or if the place of business is temporary and the taxpayer has one or more regular work locations away from the residence.¹³³⁵ The disallowance of deductions for personal expenses is discussed in 503 T.M., *Principles of Income Tax Deductions*.

b. Tools Exception

One exception to the nondeductibility of commuting expenses allows the taxpayer to deduct the excess costs paid or incurred in transporting tools or equipment used in the trade or business between home and a place of business,¹³³⁶ such as the extra costs of using a truck rather than an automobile to carry heavy equipment.¹³³⁷ This exception does not apply if the taxpayer would have used the same mode of transportation and would have incurred the same costs even if there were no need

to transport tools or equipment.¹³³⁸ Nor does it apply if the taxpayer could use available transportation that was free.¹³³⁹ Nor does it apply to expenses paid or incurred by the taxpayer that the taxpayer did not need to pay or incur in order to transport the tools or equipment.¹³⁴⁰

c. On-Duty Exception

In *Pollei v. Commissioner*, the Tenth Circuit recognized an exception to the prohibition against deduction of commuting expenses for police officers on duty during the time they travelled between their homes and their headquarters.¹³⁴¹ The Tax Court, however, disagrees.¹³⁴²

d. Transportation of Goods Exception

In *Green v. Commissioner*, the Tax Court held that a taxpayer in the business of selling her blood was allowed to deduct the cost of travelling to the clinic because the nature of her business required that she accompany the goods that she was selling to the market in which she sold them.¹³⁴³

5. Travel

a. In General

Subject to the §274 limitations, §162 specifically allows deductions for the travel expenses paid or incurred while away from home in the pursuit of a trade or business.¹³⁴⁴ Travel expenses include expenditures for food and lodging except to the extent lavish or extravagant under the circumstances.¹³⁴⁵ For tax years beginning before 2018, travel expenses paid or incurred in connection with the collection or production of income or with property held for the production of income are deductible under §212.¹³⁴⁶ For tax years beginning after 2017, §67(h) eliminates the deductibility of §212 expenses, with certain exceptions. Substantiation of business purpose and adequate contemporaneous recordkeeping of expenditures are critical issues un-

¹³²⁸ Reg. §1.162-2(e), §1.212-1(f). *E.g.*, *Mitchell v. Commissioner*, 42 T.C. 953 (1964); *Casey v. Commissioner*, 55 T.C.M. 664 (1988), aff'd, 876 F.2d 899 (11th Cir. 1989); *Dickson v. Commissioner*, 51 T.C.M. 970 (1986); *Brill v. Commissioner*, 43 T.C.M. 1542 (1982); *Solon v. Commissioner*, 39 T.C.M. 1245 (1980), aff'd in unpub. opin. (5th Cir. 1981); *Bothke v. Commissioner*, 39 T.C.M. 826 (1980), aff'd in unpub. opin. (9th Cir. 11/23/81); *Barton v. Commissioner*, 28 T.C.M. 261 (1969), aff'd, 424 F.2d 1295 (7th Cir. 1970); *Riscalla v. Commissioner*, 22 T.C.M. 541 (1963), aff'd, 337 F.2d 859 (5th Cir. 1964); *Smith v. Warren*, 67-1 USTC ¶9353 (W.D. Wash. 1967), aff'd, 388 F.2d 671 (9th Cir. 1968).

¹³²⁹ *E.g.*, *Coombs v. Commissioner*, 608 F.2d 1269 (9th Cir. 1979); *United States v. Tauferner*, 407 F.2d 243 (10th Cir. 1969), cert. denied, 396 U.S. 824 (1969), rev'g 68-1 USTC ¶9212 (D. Utah 1968); *Mann v. Commissioner*, 36 T.C.M. 130 (1977); *Smith v. Commissioner*, 31 T.C.M. 739 (1972); *Pemberton v. Commissioner*, 29 T.C.M. 875 (1970); *Tietjen v. Commissioner*, 29 T.C.M. 281 (1970); *Sue v. United States*, 78-1 USTC ¶9373 (D. Nev. 1978); *Slegers v. United States*, 77-1 USTC ¶9448 (D. Ore. 1977), aff'd in unpub. opin. (9th Cir. 8/13/79).

¹³³⁰ *E.g.*, *White v. Commissioner*, 31 T.C.M. 357 (1972).

¹³³¹ *E.g.*, *Meiers v. Commissioner*, 43 T.C.M. 454 (1982); *Greenway v. Commissioner*, 40 T.C.M. 24 (1980).

¹³³² *E.g.*, *Towne v. Commissioner*, 36 T.C.M. 1422 (1977).

¹³³³ *E.g.*, Rev. Rul. 55-555.

¹³³⁴ *Clark v. Commissioner*, 37 T.C.M. 1178 (1978).

¹³³⁵ Rev. Rul. 94-47, amplifying Rev. Rul. 90-23.

¹³³⁶ *E.g.*, *Crowther v. Commissioner*, 269 F.2d 292 (9th Cir. 1959), aff'g in part and rev'g in part 28 T.C. 1293 (1957); *Anderson v. Commissioner*, 55 T.C. 756 (1979); *Fausner v. Commissioner*, 55 T.C. 620 (1971); *Grayson v. Commissioner*, 36 T.C.M. 1201 (1977); *Tyne v. Commissioner*, 29 T.C.M. 1398 (1970), aff'd, 468 F.2d 913 (7th Cir. 1972), on remand from 409 F.2d 485 (7th Cir. 1969), cert. denied, 396 U.S. 833 (1969), on remand from 385 F.2d 40 (7th Cir. 1967), rev'g and rem'g 25 T.C.M. 1112 (1966); *Allenby v. Commissioner*, 16 T.C.M. 937 (1957); *Rice v. Riddell*, 179 F. Supp. 576 (S.D. Cal. 1959); Rev. Rul. 75-380.

¹³³⁷ *E.g.*, *Pool v. Commissioner*, 36 T.C.M. 93 (1977); *Eaton v. Commissioner*, 17 T.C.M. 60 (1958).

¹³³⁸ *E.g.*, *Sheehan v. Commissioner*, 497 F.2d 919 (2d Cir. 1974) (without opinion), rev'g 32 T.C.M. 512 (1973); *Coker v. Commissioner*, 487 F.2d 593 (2d Cir. 1973), cert. denied, 414 U.S. 1130 (1974), aff'g in part and rev'g in part 31 T.C.M. 317 (1972), on remand from 480 F.2d 146 (2d Cir. 1973); *Hitt v. Commissioner*, 55 T.C. 628 (1971); *McLaughlin v. Commissioner*, 45 T.C.M. 5 (1982); *Chapman v. Commissioner*, 43 T.C.M. 511 (1982); *Lopa v. Commissioner*, 43 T.C.M. 443 (1982); *Merighi v. Commissioner*, 43 T.C.M. 130 (1981); *Krambo v. Commissioner*, 41 T.C.M. 42 (1980); *Dolce v. Commissioner*, 39 T.C.M. 1008 (1980); *Fausner v. Commissioner*, 38 T.C.M. 1365 (1979), dism'd (9th Cir. 1980); *Regan v. Commissioner*, 37 T.C.M. 479 (1978); *Randazzo v. Commissioner*, 36 T.C.M. 1199 (1977); *McGraw v. Commissioner*, 35 T.C.M. 1016 (1976); *Reese v. Commissioner*, 35 T.C.M. 857 (1976); *Bradley v. Commissioner*, 32 T.C.M. 793 (1973); *Woolsey v. Commissioner*, 31 T.C.M. 138 (1972); *Fausner v. Commissioner*, 30 T.C.M. 1187 (1971), aff'd, 472 F.2d 561 (5th Cir. 1973), aff'd, 413 U.S. 838 (1973); *Castillo v. Commissioner*, 30 T.C.M. 354 (1971); *Kallander v. United States*, 75-1 USTC ¶9323 (Ct. Cl. Tr. J. Op. 1975), aff'd, 526 F.2d 1131 (Ct. Cl. 1975); *Jefferson v. United States*, 74-1 USTC ¶9205 (W.D. Ga. 1973).

¹³³⁹ *Marzano v. Commissioner*, 29 T.C.M. 694 (1970).

¹³⁴⁰ *E.g.*, *Gilberg v. Commissioner*, 55 T.C. 611 (1971); *Drake v. Commissioner*, 32 T.C.M. 553 (1973).

¹³⁴¹ 877 F.2d 838, 842 (10th Cir. 1989), rev'g 87 T.C. 869 (1986).

¹³⁴² *Pollei v. Commissioner*, 87 T.C. 869 (1986), rev'd, 877 F.2d 838 (10th Cir. 1989).

¹³⁴³ 74 T.C. 1229, 1238 (1980).

¹³⁴⁴ §162(a)(2); Reg. §1.162-1(a).

¹³⁴⁵ Reg. §1.162-2(a).

¹³⁴⁶ *E.g.*, *Gustin v. Commissioner*, 46 T.C.M. 1505 (1983); *Harris v. Commissioner*, 37 T.C.M. 1370 (1978).

der the §274 limitations.¹³⁴⁷ For tax years beginning after 2017, the disallowance of miscellaneous itemized deductions means that job-related travel expenses incurred by an employee that are not reimbursed by the employer are not deductible by the employee.¹³⁴⁸

Travel expense deductions and the §274 limitations are discussed in 519 T.M., *Travel, Transportation, Entertainment, Meal, and Gift Expenses*.

b. Ordinary and Necessary

Traveling expenses are not deductible unless they are ordinary and necessary,¹³⁴⁹ as well as reasonable and necessary in the conduct of the taxpayer's trade or business¹³⁵⁰ or for-profit activity.¹³⁵¹ The travel expenses of long-distance commuting are not deductible because living in an area distant from the taxpayer's place of business is not an ordinary and necessary business decision.¹³⁵² The travel expenses of attending shareholder meetings of companies in which the taxpayer owns stock are not deductible if they are not sufficiently related to the taxpayer's investment activities.¹³⁵³ The deduction for amounts paid to a wholly owned air charter company for air travel is limited to the cost of first-class commercial travel, rather than the cost of private charter, if the payments are found to be unreasonable.¹³⁵⁴

c. Away from Home

(1) In General

Travel expenses, in contrast to transportation expenses, are not deductible unless paid or incurred by the taxpayer while away from the taxpayer's tax home.¹³⁵⁵ Generally, the tax home is the territory or metropolitan area within which the taxpayer regularly conducts a trade or business.¹³⁵⁶ For employees, it

is the area in which is located the taxpayer's post of employment¹³⁵⁷ or principal place of employment.¹³⁵⁸ Generally, a taxpayer does not have a tax home if the taxpayer's trade or business activities are conducted over such a wide area that the taxpayer does not have any established base of operations¹³⁵⁹ or if the taxpayer has no home from which to be away.¹³⁶⁰ The First Circuit has held that a taxpayer who conducts business at one location for part of the year and at a geographically distant location for the other part of the year has only one tax home, contrary to the Tax Court's position, and stated that the determination of which location is the tax home requires a factual analysis of the taxpayer's major post of duty.¹³⁶¹

Determining the area in which the most trade or business activities are regularly carried on and the principal place of employment are questions of fact.¹³⁶² A significant factor is the time spent at each location,¹³⁶³ though it is not necessarily determinative.¹³⁶⁴ Other factors include office location,¹³⁶⁵ job site location,¹³⁶⁶ place salaries drawn,¹³⁶⁷ significance of work performed,¹³⁶⁸ and location of records and meetings, and performance of job duties.¹³⁶⁹

(1950). *But see* *Six v. United States*, 450 F.2d 66 (2d Cir. 1971), rem'g 322 F. Supp. 547 (S.D.N.Y. 1971); *Boyer v. Commissioner*, 36 T.C.M. 1329 (1977).

¹³⁵⁷ *E.g.*, *Mitchell v. Commissioner*, 74 T.C. 578 (1980); *Paolini v. Commissioner*, 43 T.C.M. 513 (1982), aff'd in unpub. opin. (3d Cir. 1/17/83); *Masline v. Commissioner*, 30 T.C.M. 850 (1971), aff'd, 462 F.2d 1328 (5th Cir. 1972).

¹³⁵⁸ *E.g.*, *Mosure v. Commissioner*, 42 T.C.M. 1279 (1981). *See* *Griffin v. Commissioner*, 63 T.C.M. 2582 (1992) (tax home of naval personnel of dry docked submarine is not the submarine itself, but is the area or vicinity of the person's principal place of business).

¹³⁵⁹ *E.g.*, *Barone v. Commissioner*, 85 T.C. 462 (1985), aff'd in unpub. opin. (9th Cir. 12/12/86); *Stokes v. Commissioner*, 63 T.C.M. 2886 (1992), aff'd, 22 F.3d 1098 (11th Cir. 1994) (tax home was entire state); *Holdreith v. Commissioner*, 57 T.C.M. 1383 (1989); *Edwards v. Commissioner*, 54 T.C.M. 115 (1987); *Dickie v. Commissioner*, 52 T.C.M. 493 (1986). *But see* *Dean v. Commissioner*, 54 T.C. 663 (1970); Rev. Rul. 71-247.

¹³⁶⁰ *E.g.*, *Brandl v. Commissioner*, 513 F.2d 697 (6th Cir. 1975), aff'g 33 T.C.M. 688 (1974); *Rosenspan v. United States*, 438 F.2d 905 (2d Cir. 1971), cert. denied, 404 U.S. 864 (1971), aff'g 316 F. Supp. 194 (E.D.N.Y. 1970); *Fisher v. Commissioner*, 23 T.C. 218 (1954), aff'd, 230 F.2d 79 (7th Cir. 1956); *Hamby v. Commissioner*, 60 T.C.M. 909 (1990); *Crossland v. Commissioner*, 33 T.C.M. 1278 (1974), aff'd, 535 F.2d 1240 (2d Cir. 1975), cert. denied, 429 U.S. 863 (1976); Rev. Rul. 73-529.

¹³⁶¹ *Andrews v. Commissioner*, 931 F.2d 132 (1st Cir. 1991), rev'g and rem'g 60 T.C.M. 277 (1990).

¹³⁶² *E.g.*, *Markey v. Commissioner*, 490 F.2d 1249 (6th Cir. 1974), rev'g 31 T.C.M. 766 (1972); *Ney v. United States*, 171 F.2d 449 (8th Cir. 1948), cert. denied, 336 U.S. 967 (1949), aff'g 77 F. Supp. 1005 (W.D. Ark. 1948); *Milam v. Commissioner*, 51 T.C.M. 1099 (1986); *Bernard v. United States*, 11 Cl. Ct. 437 (1986). *See also* *Hoepfner v. Commissioner*, 64 T.C.M. 1493 (1992) (taxpayer with two places of business was held to have a tax home at the place of full-time employment because he spent more time and derived more income there.).

¹³⁶³ *E.g.*, *Plante v. Commissioner*, 53 T.C.M. 1390 (1987); *Gorod v. Commissioner*, 42 T.C.M. 1569 (1981); *McAvoy v. Commissioner*, 24 T.C.M. 1617 (1965); *Schwartz v. Commissioner*, 24 T.C.M. 223 (1965); *Hogan v. Commissioner*, 22 T.C.M. 1500 (1963); *McKenzie v. United States*, 431 F. Supp. 993 (E.D. Tenn. 1976).

¹³⁶⁴ *E.g.*, *Johnson v. Commissioner*, 17 T.C. 1261 (1952).

¹³⁶⁵ *E.g.*, *Hogan v. Commissioner*, 22 T.C.M. 1500 (1963).

¹³⁶⁶ *E.g.*, *Massey v. Commissioner*, 27 T.C.M. 1452 (1968).

¹³⁶⁷ *E.g.*, *Dews v. Commissioner*, 53 T.C.M. 1378 (1987); *Davis v. Commissioner*, 48 T.C.M. 282 (1984).

¹³⁶⁸ *E.g.*, *Lary v. United States*, 608 F. Supp. 258 (N.D. Ala. 1985), aff'd on other issues, 787 F.2d 1538 (11th Cir. 1986).

¹³⁶⁹ *E.g.*, *Bernard v. United States*, 11 Cl. Ct. 437 (1986).

¹³⁴⁷ *See, e.g.*, *Khinda v. Commissioner*, T.C. Summ. Op. 2017-32.

¹³⁴⁸ §62(a)(2)(A), §67(h).

¹³⁴⁹ *E.g.*, *Ballantine v. Commissioner*, 46 T.C. 272 (1966); *Frick v. Commissioner*, 47 T.C.M. 564 (1983), aff'd, 774 F.2d 1168 (7th Cir. 1985).

¹³⁵⁰ Reg. §1.162-2(a), Reg. §1.212-1(d). *E.g.*, *Buckner v. Commissioner*, 41 T.C.M. 1230 (1981); Rev. Rul. 64-9.

¹³⁵¹ *E.g.*, *Kinney v. Commissioner*, 66 T.C. 122 (1976).

¹³⁵² *Commissioner v. Flowers*, 326 U.S. 465 (1946), rev'g 148 F.2d 163 (5th Cir. 1945), rev'g 3 T.C.M. 803 (1944); *Thompson v. Commissioner*, 6 T.C. 285 (1946), aff'd, 161 F.2d 185 (2d Cir. 1947); *Plante v. Commissioner*, 53 T.C.M. 1390 (1987); *Owens v. Thomas*, 45-2 USTC ¶9416 (N.D. Tex. 1945), aff'd, 157 F.2d 681 (5th Cir. 1946).

¹³⁵³ Rev. Rul. 56-511.

¹³⁵⁴ FSA 200137002.

¹³⁵⁵ §162; *Commissioner v. Flowers*, 326 U.S. 465 (1946), rev'g 148 F.2d 163 (5th Cir. 1945), rev'g 3 T.C.M. 803 (1944); *Cf.* Reg. §1.162-32, §1.262-1(b)(5) (away from home requirement not necessary for certain local lodging expenses if facts and circumstances indicate expenses incurred in carrying on the taxpayer's trade or business, though not necessarily if paid or incurred in for-profit activity transaction).

¹³⁵⁶ *Bunevith v. Commissioner*, 70-1 USTC ¶9414 (1st Cir. 1970), aff'g 52 T.C. 837 (1969); *Marshall v. Commissioner*, 14 T.C.M. 955 (1955), aff'd, 240 F.2d 185 (5th Cir. 1957); *Liljeberg v. Commissioner*, 148 T.C. 83 (2017), aff'd, 907 F.3d 623 (D.C. Cir. 2018) (tax home is typically the vicinity of taxpayer's principal place of employment and not where personal residence is located; foreign post-secondary students working temporary or seasonal jobs in United States under U.S. State Department program that required them to return to their home countries after four months had their tax homes at their job sites in United States, thus no deduction for living and foreign travel expenses); *Feese v. Commissioner*, T.C. Memo. 1984-46 (1984); *Egner v. Commissioner*, T.C. Memo. 1984-473; *McDougal v. Commissioner*, T.C. Memo. 1980-289; *Tucker v. Commissioner*, 55 T.C. 783 (1971); *Hicks v. Commissioner*, 9 T.C.M. 1088

Husbands and wives do not necessarily have the same tax homes.¹³⁷⁰ It does not matter that a joint return is filed or if there are duplicate living expenses.¹³⁷¹

(2) Temporary Assignments

Generally, if the location of the taxpayer's principal place of employment or area in which the most trade or business activities are regularly carried on changes, the taxpayer's tax home changes, making the traveling expenses paid or incurred at the new location nondeductible because the taxpayer is not away from the tax home while at the new location.¹³⁷² However, if the change is temporary, the tax home does not change, making the traveling expenses deductible.¹³⁷³

A job assignment is not temporary if the period of employment exceeds one year, but this limitation does not apply to federal employees during any period for which the employee is certified by the Attorney General or a designee as traveling on behalf of the United States in temporary duty status to investigate a federal crime or to provide support services for the investigation of a federal crime.¹³⁷⁴

Whether a job assignment of less than one year is temporary, rather than permanent or indefinite, is a question of fact.¹³⁷⁵ The taxpayer has the burden of demonstrating that there is a reasonable expectation that the change in principal place of employment will terminate within a short period of time.¹³⁷⁶ The employer's classification of the taxpayer's assignment or employment as temporary is not determinative.¹³⁷⁷

The assignment must be temporary from the outset.¹³⁷⁸ Traditionally, if a temporary assignment of less than one year became permanent or indefinite during the first year, no deduction was allowed,¹³⁷⁹ but since 1993 the IRS has allowed a deduction for expenses for the period beginning with the outset of the assignment and ending on the date the assignment becomes one realistically expected to last more than one year, un-

less there are facts and circumstances indicating otherwise.¹³⁸⁰ However, a deduction is allowed for the first year of the assignment if the assignment originally was for a temporary period of less than one year and throughout the year retains its initial temporary character, even if thereafter it becomes permanent or indefinite.¹³⁸¹ A temporary return to the original tax home does not make the assignment away from the original tax home temporary.¹³⁸²

The IRS considers assignments and positions to be temporary if both the realistically anticipated and actual duration of the change in principal place of employment is less than one year, unless there are facts and circumstances indicating to the contrary, but if the assignment is realistically expected to last more than one year or there is no realistic expectation that it will last for one year or less, then the assignment is treated as indefinite even if it turns out to last for one year or less.¹³⁸³ Courts have generally reached results consistent with the one-year test,¹³⁸⁴ though before the enactment of the one-year limitation exceptions had been made in particular cases.¹³⁸⁵ Other factors include:

- the employer's announced expectations of the length of the assignment;¹³⁸⁶
- the lack of any promises by the employer concerning continuation;¹³⁸⁷
- previous experience with the employer and the employer's past policies;¹³⁸⁸
- the impact of weather;¹³⁸⁹

¹³⁸⁰ Rev. Rul. 93-86, superseding Rev. Rul. 83-82.

¹³⁸¹ *Kaster v. Commissioner*, 50 T.C.M. 1506 (1985).

¹³⁸² *Drum v. Commissioner*, 68 T.C.M. 595, aff'd in unpub. opin., 61 F.3d 910 (9th Cir. 1995).

¹³⁸³ Rev. Rul. 93-86, superseding Rev. Rul. 83-82; Rev. Rul. 74-242; Rev. Rul. 60-189, amplified by, Rev. Rul. 83-82.

¹³⁸⁴ See, e.g., *Babeaux v. Commissioner*, 601 F.2d 730 (4th Cir. 1979) (*per curiam*), cert. denied, 444 U.S. 993 (1979), 445 U.S. 943 (1980), rev'g 36 T.C.M. 657 (1977), rev'g *Patrick v. Commissioner*, 36 T.C.M. 655 (1977), and rev'g *Waldrop v. Commissioner*, 36 T.C.M. 780 (1977) (19 to 32 months not temporary); *Boone v. United States*, 482 F.2d 417 (5th Cir. 1973) (15 months or more not temporary); *Horton v. Commissioner*, 86 T.C. 589 (1986) (6 months temporary); *Mitchell v. Commissioner*, 74 T.C. 578 (1980) (2.5 years not temporary); *Waters v. Commissioner*, 53 T.C.M. 1300 (1987) (7 years not temporary); *Case v. Commissioner*, 50 T.C.M. 1291 (1985) (3 to 7 months temporary); *White v. Commissioner*, 47 T.C.M. 1278 (1984) (4 years not temporary); *Tefft v. Commissioner*, 47 T.C.M. 1276 (1984) (5 years not temporary); *Davis v. Commissioner*, 38 T.C.M. 189 (1979) (3 to 7 months temporary); *Crouch v. Commissioner*, 36 T.C.M. 263 (1977) (15 months or more not temporary); *Kasey v. Commissioner*, 35 T.C.M. 1160 (1976) (2 years not temporary); *Kresge v. United States*, 82-1 USTC ¶9180 (M.D. Pa. 1982) (2 years not temporary); *Sue v. United States*, 78-1 USTC ¶9373 (D. Nev. 1978) (15 months or more not temporary).

¹³⁸⁵ See, e.g., *Commissioner v. Peurifoy*, 358 U.S. 59 (1958) (*per curiam*), aff'g 254 F.2d 483 (4th Cir. 1957), rev'g 27 T.C. 149 (1956) (8.7 months not temporary); *Cox v. Commissioner*, 38 T.C.M. 136 (1979) (16 months temporary); *Cowger v. Commissioner*, 25 T.C.M. 513 (1966) (more than 1 year temporary).

¹³⁸⁶ E.g., *Massey v. Commissioner*, 47 T.C.M. 1648 (1984); *Barkley v. Commissioner*, 35 T.C.M. 707 (1976).

¹³⁸⁷ E.g., *Blankenship v. Commissioner*, 39 T.C.M. 91 (1979); *Neff v. Commissioner*, 33 T.C.M. 1380 (1974).

¹³⁸⁸ E.g., *Myhrman v. Commissioner*, 50 T.C.M. 354 (1985); *Stout v. Commissioner*, 17 T.C.M. 518 (1958); *Cockrell v. Commissioner*, 321 F.2d 504 (8th Cir. 1963), aff'g 38 T.C. 470 (1962); *Goodman v. Commissioner*, 30 T.C.M. 1369 (1971).

¹³⁷⁰ E.g., *Foote v. Commissioner*, 67 T.C. 1 (1976); *Coerver v. Commissioner*, 36 T.C. 252 (1961), aff'd, 297 F.2d 837 (3d Cir. 1962).

¹³⁷¹ E.g., *Griffith v. Commissioner*, 37 T.C.M. 1651 (1978).

¹³⁷² E.g., *Tyler v. Commissioner*, 13 T.C. 186 (1949); *Lyman v. Commissioner*, 47 T.C.M. 1236 (1984); *Stelmaszek v. Commissioner*, 37 T.C.M. 811 (1978); *Kiah v. Commissioner*, 30 T.C.M. 1165 (1971); *Riscalla v. Commissioner*, 22 T.C.M. 541 (1963), aff'd, 337 F.2d 859 (5th Cir. 1964); *Lipps v. Commissioner*, 21 T.C.M. 358 (1962); *Raffone v. Commissioner*, 20 T.C.M. 1698 (1961); *Neff v. Campbell*, 63-1 USTC ¶9143 (N.D. Tex. 1962); Rev. Rul. 60-314.

¹³⁷³ See, e.g., *Holland v. Commissioner*, 55 T.C.M. 93 (1988).

¹³⁷⁴ §162(a) (flush language); see PMTA 2007-00309 (application of rule to IRS special agent on undercover assignment).

¹³⁷⁵ E.g., *Ellwein v. United States*, 778 F.2d 506 (8th Cir. 1985), aff'g in part, rev'g in part, and rem'g in part 577 F. Supp. 1368 (D.N.D. 1983); *Dahood v. United States*, 747 F.2d 46 (1st Cir. 1984), aff'g 585 F. Supp. 93 (D.N.H. 1984); *Garlock v. Commissioner*, 34 T.C. 611 (1960); *Garcia v. Commissioner*, 50 T.C.M. 1480 (1985), aff'd in unpub. opin. (9th Cir. 10/1/87); *Kohr v. United States*, 655 F. Supp. 306 (M.D. Pa. 1987).

¹³⁷⁶ See, e.g., *Broome v. Commissioner*, 50 T.C.M. 291 (1985); *Baughner v. Commissioner*, 47 T.C.M. 1523 (1984).

¹³⁷⁷ E.g., *Courtney v. Commissioner*, 32 T.C. 334 (1959); *Allison v. Commissioner*, 52 T.C.M. 42 (1986).

¹³⁷⁸ See *Commissioner v. Peurifoy*, 358 U.S. 59 (1958), aff'g per curiam 254 F.2d 483 (4th Cir. 1957), rev'g 27 T.C. 149 (1956), nonacq., 1957-2 C.B. 8.

¹³⁷⁹ See, e.g., *Doyle v. Commissioner*, 354 F.2d 480 (9th Cir. 1966), aff'g 23 T.C.M. 638 (1964); *Chimento v. Commissioner*, 52 T.C. 1067 (1969), aff'd, 438 F.2d 643 (3d Cir. 1971); *Moxey v. Commissioner*, 55 T.C.M. 607 (1988).

- the risk of layoff;¹³⁹⁰
- the effect of ongoing litigation;¹³⁹¹
- the possibility of being traded or transferred;¹³⁹²
- the taxpayer's intentions to continue or resign;¹³⁹³
- illness;¹³⁹⁴
- the possibilities of renewal;¹³⁹⁵
- changes in the taxpayer's duties; and¹³⁹⁶
- the length of leases into which the taxpayer enters.¹³⁹⁷

Comment: Presumably, for federal employees exempted from the one year limitation, the principles established in cases holding employment or assignment periods of more than one year to be temporary and the factors given weight in those decisions should continue to be relevant.

(3) Members of Congress

The place of residence of a Member of Congress, Delegate or Resident Commissioner within the state, congressional district or possession which the Member, Delegate or Commissioner represents is considered to be the individual's tax home. However, amounts expended for living expenses for travel away from home in pursuit of the trade or business of representing the district or possession are not deductible.¹³⁹⁸

(4) State Legislators

If an individual who is a state legislator at any time during the tax year so elects, the individual's residence within the represented legislative district is treated as the individual's tax home.¹³⁹⁹ The election does not apply to any legislator whose residence within the represented legislative district is 50 or fewer miles from the state capitol building.¹⁴⁰⁰ A taxpayer becomes a state legislator on the day the individual is sworn into office and ceases to be a state legislator on the day after the day on which the legislator's term ends.¹⁴⁰¹

If this election is made, the state legislator is deemed to be away from home in pursuit of the trade or business on each legislative day.¹⁴⁰² A legislative day is any day on which the

electing taxpayer is a state legislator, and that meets one of four alternative tests.¹⁴⁰³ First, it is a day on which the legislature is in session.¹⁴⁰⁴ Second, it is a day on which the legislature is not in session for a period not longer than four consecutive days, without extension for Saturdays, Sundays or holidays.¹⁴⁰⁵ Third, it is a day on which the state legislator's attendance at a meeting of a committee of the legislature is formally recorded.¹⁴⁰⁶ Fourth, the state legislator's attendance at any session of the legislature that only a limited number of members are expected to attend, such as a pro forma session, is formally recorded on any day other than a day when the legislature is in session or a day during a period of four consecutive days or less when the legislature is not in session.¹⁴⁰⁷ The legislature is in session when the members of the legislature are expected to attend and participate as an assembled body of the legislature, whether or not the electing legislator actually attends.¹⁴⁰⁸ A committee of the legislature is any group consisting solely of legislators charged with conducting business of the legislature, including but not limited to committees to which the legislature refers bills for consideration, committees that the legislature has authorized to conduct inquiries into matters of public concern, and committees charged with the internal administration of the legislature. Groups that are not considered committees of the legislature include, but are not limited to, groups that promote particular issues, raise campaign funds or are caucuses of members of a political party.¹⁴⁰⁹

In addition, if this election is made, the individual is treated as having expended, for living expenses in connection with the taxpayer's trade or business as a legislator, which include lodging, meals, and incidental expenses, an amount equal to the sum of the amounts determined by multiplying each legislative day of the taxpayer during the tax year by the greater of two amounts.¹⁴¹⁰ The first amount is the maximum amount allowable to federal government executive branch employees for living expenses while away from home in pursuit of a trade or business in the legislator's state capital for that day.¹⁴¹¹ The second amount is the amount generally allowable for that day to employees of the legislator's state for per diem while away from home, to the extent it does not exceed 110% of the first amount.¹⁴¹² For any legislative day for which the election is in effect, the amount of the electing legislator's living expenses while away from home is the greater of the deemed amount¹⁴¹³ or the living expenses otherwise allowable under §162(a)(2) in the pursuit of any trade or business of the legislator.¹⁴¹⁴ For any legislative day for which the election is in effect, the amount of the electing legislator's expenses other than living expenses for travel away from home is the sum of the substantiated expenses

¹³⁸⁹ *E.g., Frederick v. United States*, 603 F.2d 1292 (8th Cir. 1979), aff'd 457 F. Supp. 1274 (D.N.D. 1978); *Blatnick v. Commissioner*, 56 T.C. 1344 (1971); *Jennings v. United States*, 57-2 USTC ¶ 10,056 (D. Ore. 1957).

¹³⁹⁰ *E.g., Merighi v. Commissioner*, 43 T.C.M. 130 (1981); *Holter v. Commissioner*, 37 T.C.M. 1707 (1978).

¹³⁹¹ *E.g., Lees v. Commissioner*, 24 T.C.M. 1823 (1965).

¹³⁹² *E.g., Claunch v. Commissioner*, 29 T.C. 1047 (1958), aff'd, 264 F.2d 309 (5th Cir. 1959); *Horton v. Commissioner*, 86 T.C. 589 (1986); *Owens v. Commissioner*, 50 T.C. 577 (1968).

¹³⁹³ *E.g., Chwalow v. Commissioner*, 30 T.C.M. 770 (1971), aff'd, 470 F.2d 475 (3d Cir. 1972); *Weiberg v. Commissioner*, 639 F.2d 434 (8th Cir. 1981), aff'd 40 T.C.M. 272 (1980).

¹³⁹⁴ *E.g., Friedman v. Commissioner*, 58 T.C.M. 491 (1989).

¹³⁹⁵ *E.g., Stricker v. Commissioner*, 54 T.C. 355 (1970), aff'd, 438 F.2d 1216 (6th Cir. 1971); *Marth v. Commissioner*, 23 T.C.M. 660 (1964), aff'd, 342 F.2d 417 (9th Cir. 1965), cert. denied, 382 U.S. 844 (1965).

¹³⁹⁶ *E.g., Verner v. Commissioner*, 39 T.C. 749 (1963).

¹³⁹⁷ See *Linetsky v. Commissioner*, 68 T.C.M. 8 (1994).

¹³⁹⁸ §162(a) (flush language).

¹³⁹⁹ §162(h)(1)(A); Reg. §1.162-24(a)(1).

¹⁴⁰⁰ §162(h)(4); Reg. §1.162-24(c).

¹⁴⁰¹ Reg. §1.162-24(d)(1).

¹⁴⁰² Reg. §1.162-24(a)(3).

¹⁴⁰³ Reg. §1.162-24(b).

¹⁴⁰⁴ §162(h)(2)(A); Reg. §1.162-24(b)(1).

¹⁴⁰⁵ §162(h)(2)(A); Reg. §1.162-24(b)(2).

¹⁴⁰⁶ §162(h)(2)(B); Reg. §1.162-24(b)(3).

¹⁴⁰⁷ Reg. §1.162-24(b)(4).

¹⁴⁰⁸ Reg. §1.162-24(d)(3)(i).

¹⁴⁰⁹ Reg. §1.162-24(d)(4).

¹⁴¹⁰ §162(h)(1)(B); Reg. §1.162-24(a)(2).

¹⁴¹¹ §162(h)(1)(B)(ii); Reg. §1.162-24(a)(2)(ii), §1.162-24(d)(5) (reference to 5 U.S.C. §5702 and the regulations thereunder).

¹⁴¹² §162(h)(1)(B)(i); Reg. §1.162-24(a)(2)(i).

¹⁴¹³ Reg. §1.162-24(f)(1)(i)(A).

¹⁴¹⁴ Reg. §1.162-24(f)(1)(i)(B).

es, such as expenses for travel fares, telephone calls, and local transportation, otherwise deductible under §162(a)(2) in the pursuit of any trade or business of the legislator.¹⁴¹⁵ For any day that is not a legislative day, the amount of an electing taxpayer's expenses, including amounts for living expenses, for travel away from home is the sum of the substantiated expenses that are otherwise deductible under §162(a)(2) in the pursuit of any trade or business of the legislator.¹⁴¹⁶

The election must be made for each tax year for which the election is to be in effect.¹⁴¹⁷ The election must be made no later than the due date, including extensions, of the taxpayer's federal income tax return.¹⁴¹⁸ The election is made by attaching to the taxpayer's return a statement that includes the taxpayer's name, address, taxpayer identification number,¹⁴¹⁹ a declaration that the election is being made¹⁴²⁰ and information establishing that the taxpayer is a state legislator entitled to make the election, such as a statement identifying the taxpayer's state and legislative district and representing that the taxpayer's place of residence in the legislative district is not 50 or fewer miles from the state capitol building.¹⁴²¹ The election may be revoked only with IRS consent.¹⁴²² An application for consent to revoke an election must be signed by the taxpayer and filed with the submission processing center with which the election was filed, and must include the taxpayer's name, address, taxpayer identification number,¹⁴²³ a statement that the taxpayer is revoking the election for a specified year¹⁴²⁴ and a statement explaining why the taxpayer seeks to revoke the election.¹⁴²⁵

If the election is not made or is not available, the tax home of a state legislator is determined under the general principles.¹⁴²⁶ If the represented legislative district is the principal place of business, as determined by the time spent there for business purposes, the costs of traveling to the state capital on overnight trips in pursuit of business are deductible.¹⁴²⁷ If the state capital is the principal place of business, the costs of traveling to the represented legislative district on overnight trips in pursuit of business are deductible,¹⁴²⁸ and the costs of staying in the capital are not.¹⁴²⁹

(5) Members of the Armed Forces Reserve of the United States

An individual who performs services as a member of the U.S. Armed Services reserve at any time during the tax year is deemed to be away from home in the pursuit of a trade or busi-

ness for any period during which the individual is away from home in connection with that service.¹⁴³⁰ The deduction allowed by §162 for members of the Armed Forces reserve is an employee trade or business deduction for purposes of determining adjusted gross income which applies to expenses paid or incurred in connection with the performance of services for any period in which such reserve member is more than 100 miles away from home. The deduction amount is limited to the per diem rate.¹⁴³¹

d. Overnight

Expenses are not deductible as traveling expenses under §162 if the taxpayer is not away from home overnight.¹⁴³² A taxpayer is away from home overnight if the trip is of a character to require that the taxpayer sleep or rest while on the trip.¹⁴³³ Whether the trip requires that the taxpayer sleep or rest is a question of fact.¹⁴³⁴ The sleep or rest period must be substantial in time and not a mere pause.¹⁴³⁵

e. In Pursuit of a Trade or Business

(1) In General

Traveling expenses are not deductible under §162 or §212 if they are not directly attributable to the taxpayer's trade or business¹⁴³⁶ or for-profit activity.¹⁴³⁷ Thus, traveling expenses are not deductible under §162 or §212 if the trip is undertaken for other than business purposes.¹⁴³⁸ If the trip is undertaken for both business and other purposes, the travelling expenses to and from the destination are deductible only if the travel is primarily related to the taxpayer's trade or business.¹⁴³⁹

If the trip is primarily personal in nature, the traveling expenses to and from the destination are not deductible even if the taxpayer engages in some business activities while at the destination.¹⁴⁴⁰ However, expenses paid or incurred at the destination that are properly allocable to the taxpayer's trade or business are deductible even if the traveling expenses to and from the destination are not deductible.¹⁴⁴¹

¹⁴¹⁵ Reg. §1.162-24(f)(1)(ii).

¹⁴¹⁶ Reg. §1.162-24(f)(2).

¹⁴¹⁷ Reg. §1.162-24(e)(1).

¹⁴¹⁸ Reg. §1.162-24(e)(1).

¹⁴¹⁹ Reg. §1.162-24(e)(2)(i).

¹⁴²⁰ Reg. §1.162-24(e)(2)(ii).

¹⁴²¹ Reg. §1.162-24(e)(2)(iii).

¹⁴²² Reg. §1.162-24(e)(3).

¹⁴²³ Reg. §1.162-24(e)(3)(i).

¹⁴²⁴ Reg. §1.162-24(e)(3)(ii).

¹⁴²⁵ Reg. §1.162-24(e)(3)(iii).

¹⁴²⁶ See Joint Comm. on Tax'n, "General Explanation of the Economic Recovery Tax Act of 1981," JCS-71-81, at 63-64 (1981).

¹⁴²⁷ Rev. Rul. 61-67, modified by Rev. Rul. 76-453.

¹⁴²⁸ *Chappie v. Commissioner*, 73 T.C. 823 (1980); Rev. Rul. 61-67, modified by Rev. Rul. 76-453.

¹⁴²⁹ See *Montgomery v. Commissioner*, 532 F.2d 1088 (6th Cir. 1976), aff'g 64 T.C. 175 (1975).

¹⁴³⁰ §162(p).

¹⁴³¹ §62(a)(2)(E).

¹⁴³² *United States v. Correll*, 389 U.S. 299 (1967), rev'g 369 F.2d 87 (6th Cir. 1966); Rev. Rul. 74-291.

¹⁴³³ *United States v. Correll*, 389 U.S. 299 (1967), rev'g 369 F.2d 87 (6th Cir. 1966); *Unger v. Commissioner*, 51 T.C.M. 455 (1986); Rev. Rul. 75-170, Rev. Rul. 74-291.

¹⁴³⁴ See, e.g., *Williams v. Patterson*, 286 F.2d 333 (5th Cir. 1961); *Anderson v. Commissioner*, 18 T.C. 649 (1952).

¹⁴³⁵ E.g., *Siragusa v. Commissioner*, 39 T.C.M. 1196 (1980), aff'd in unpub. opinion (2d Cir. May 13, 1981); Rev. Rul. 75-170.

¹⁴³⁶ Reg. §1.162-2(a). E.g., *Simay v. United States*, 87-1 USTC ¶9365 (S.D. Cal. 1987), aff'd in unpub. op. No. 87-6188 (9th Cir. 1988).

¹⁴³⁷ Rev. Rul. 84-113.

¹⁴³⁸ Reg. §1.162-2(a). See *Johnson v. Commissioner*, 48 T.C.M. 289 (1984).

¹⁴³⁹ Reg. §1.162-2(b)(1); Rev. Rul. 84-113.

¹⁴⁴⁰ Reg. §1.162-2(b)(1). E.g., *McIntyre v. Commissioner*, 55 T.C.M. 320 (1988); *Levine v. Commissioner*, 54 T.C.M. 209 (1987); *Kadivar v. Commissioner*, 32 T.C.M. 427 (1973); *Eisenberg v. Commissioner*, 26 T.C.M. 174 (1967); *Bickel v. Commissioner*, 25 T.C.M. 1037 (1966); Rev. Rul. 74-292.

¹⁴⁴¹ Reg. §1.162-2(b)(1). E.g., *Levine v. Commissioner*, 54 T.C.M. 209 (1987); *Hosbein v. Commissioner*, 50 T.C.M. 530 (1985); *Bickel v. Commissioner*, 25 T.C.M. 1037 (1966).

Whether a trip is related primarily to the taxpayer's trade or business or is primarily personal in nature depends on the facts and circumstances.¹⁴⁴² One important factor is a comparison of the amount of time during the trip spent on personal activities and the amount of time spent on activities directly related to the taxpayer's trade or business.¹⁴⁴³ Trips undertaken solely to visit business sites are related primarily to the business,¹⁴⁴⁴ as are trips to receive awards earned in the conduct of the trade or business.¹⁴⁴⁵

The difficulty of determining whether travel is related primarily to the taxpayer's trade or business or to personal pursuits is illustrated by the treatment of mandatory home leaves for foreign service officers. The Fourth, Ninth and District of Columbia Circuits treat mandatory home leaves as related primarily to the taxpayer's trade or business,¹⁴⁴⁶ whereas the Tax Court and Claims Court treat them as primarily personal undertakings.¹⁴⁴⁷

(2) Spouses and Family Members

Deductions for travel expenses paid or incurred with respect to a spouse, dependent, or other individual accompanying the taxpayer, accompanying an employee of the taxpayer, or accompanying an officer of a corporate taxpayer on business travel are deductible only if three conditions are satisfied.¹⁴⁴⁸ First, the taxpayer's travelling companion must be the taxpayer's employee.¹⁴⁴⁹ Second, the travelling companion's travel must be for a bona fide business purpose.¹⁴⁵⁰ Third, the expenses must be expenses that would otherwise be deductible by the travelling companion.¹⁴⁵¹

Note: The second condition is a codification of judicial principles that had been applied for many years in cases involving travel by spouses and other family members.¹⁴⁵² These cases established that the performance of incidental services does not constitute a bona fide business purpose.¹⁴⁵³ Incidental services include social functions¹⁴⁵⁴ and minor secretarial duties.¹⁴⁵⁵

¹⁴⁴² Reg. §1.162-2(b)(2). *E.g.*, *George R. Holswade, M.D., P.C. v. Commissioner*, 82 T.C. 686 (1984).

¹⁴⁴³ Reg. §1.162-2(b)(2).

¹⁴⁴⁴ *E.g.*, *Joseph Elias & Co. v. Commissioner*, 17 B.T.A. 628 (1929), aff'd, 46 F.2d 1015 (2d Cir. 1931).

¹⁴⁴⁵ Rev. Rul. 74-208.

¹⁴⁴⁶ *Brewin v. Commissioner*, 639 F.2d 805 (D.C. Cir. 1981), rev'g 72 T.C. 1055, rev'g *Teil v. Commissioner*, 72 T.C. 841 (1979); *Hitchcock v. Commissioner*, 578 F.2d 972 (4th Cir. 1978), rev'g and rem'g 66 T.C. 950 (1976); *Stratton v. Commissioner*, 448 F.2d 1030 (9th Cir. 1971), rev'g 52 T.C. 378 (1969).

¹⁴⁴⁷ *Brewin v. Commissioner*, 72 T.C. 1055 (1979), rev'd, 639 F.2d 805 (D.C. Cir. 1981); *Teil v. Commissioner*, 72 T.C. 841 (1979), rev'd sub nom., *Brewin v. Commissioner*, 639 F.2d 805 (D.C. Cir. 1981); *Hitchcock v. Commissioner*, 66 T.C. 950 (1976), rev'd and rem'd, 578 F.2d 972 (4th Cir. 1978); *Stratton v. Commissioner*, 52 T.C. 378 (1969), rev'd, 448 F.2d 1030 (9th Cir. 1971); *Schwartz v. Commissioner*, 41 T.C.M. 431 (1980), aff'd in unpub. opin. (8th Cir. Dec. 9, 1981); *Richardson v. Commissioner*, 39 T.C.M. 53 (1979); *Bell v. United States*, 591 F.2d 647 (Ct. Cl. 1979).

¹⁴⁴⁸ §274(m)(3).

¹⁴⁴⁹ §274(m)(3)(A).

¹⁴⁵⁰ §274(m)(3)(B).

¹⁴⁵¹ §274(m)(3)(C).

¹⁴⁵² Reg. §1.162-2(c). *E.g.*, Rev. Rul. 56-168, Rev. Rul. 55-57.

¹⁴⁵³ Reg. §1.162-2(c). *E.g.*, Rev. Rul. 56-168.

¹⁴⁵⁴ *E.g.*, *United States v. Gotcher*, 401 F.2d 118 (5th Cir. 1968), rev'g 259 F. Supp. 340 (E.D. Tex. 1966); *Sheldon v. Commissioner*, 299 F.2d 48 (7th Cir. 1962), aff'g 20 T.C.M. 241 (1961); *Challenge Mfg. Co. v. Commis-*

A bona fide business purpose exists if the spouse is actively involved in the business.¹⁴⁵⁶ This conclusion is easily reached if the spouse works full-time in the business,¹⁴⁵⁷ or provides full-time business services on the trip.¹⁴⁵⁸

The difficulty of determining whether a spouse's presence on a business trip has a bona fide business purpose is illustrated by the treatment of spouses who accompany taxpayers in need of their medical care and attention. Although several district courts treat the spouse's presence for these purposes as bona fide business purposes,¹⁴⁵⁹ the Tax Court does not.¹⁴⁶⁰

Comment: Unless that first and third conditions also are satisfied, there no longer is a need to resolve the existence of a bona fide business purpose in these types of cases.

The transportation and lodging portion of travelling expenses attributable to the taxpayer's travelling companion is the excess of the expenses over the taxpayer's cost of transportation and lodging at single rates.¹⁴⁶¹ The other portion of traveling expenses attributable to the travelling companion is the cost of meals, tours and other activities allocable to the travelling companion.¹⁴⁶²

(3) Conventions and Meetings

Whether expenses in traveling to conventions or meetings are ordinary and necessary trade or business expenses depends on the facts and circumstances.¹⁴⁶³ For the expenses to be deductible, there must be a sufficient relationship between the taxpayer's trade or business and the attendance at the convention or meeting so that the interests of the trade or business are benefitted by the attendance.¹⁴⁶⁴ The costs of attending conventions for political, social or other nonbusiness purposes are not deductible,¹⁴⁶⁵ nor are the costs of traveling to conventions

sioner, 37 T.C. 650 (1962); *Alabama-Georgia Syrup Co. v. Commissioner*, 36 T.C. 747 (1961), rev'd on other issues sub nom., *Whitfield v. Commissioner*, 311 F.2d 640 (5th Cir. 1962); *Moorman v. Commissioner*, 26 T.C. 666 (1956); *Leonhart v. Commissioner*, 27 T.C.M. 443 (1968), aff'd on other issues, 414 F.2d 749 (4th Cir. 1969); *Schmaus Co. v. Commissioner*, 26 T.C.M. 959 (1967), rev'd on other issues, 406 F.2d 1044 (7th Cir. 1969). *But see Merritt v. Commissioner*, 21 T.C.M. 1011 (1962).

¹⁴⁵⁵ *E.g.*, *Johnson v. Commissioner*, 25 T.C.M. 858 (1966).

¹⁴⁵⁶ *E.g.*, *Dennet v. Commissioner*, 7 B.T.A. 1173 (1927); *Fairmont Homes, Inc. v. Commissioner*, 45 T.C.M. 1340 (1983).

¹⁴⁵⁷ *E.g.*, *Luetzow v. Commissioner*, 32 T.C.M. 272 (1973), aff'd in unpub. opin. (7th Cir. Feb. 4, 1974); *Duncan v. Bookwalter*, 216 F. Supp. 301 (W.D. Mo. 1963).

¹⁴⁵⁸ *Poletti v. Commissioner*, 330 F.2d 818 (8th Cir. 1964), rev'g 21 T.C.M. 1415 (1962).

¹⁴⁵⁹ *Quinn v. United States*, 77-1 USTC ¶9369 (D. Md. 1976); *Allenberg Cotton Co. v. United States*, 61-1 USTC ¶9131 (W.D. Tenn. 1960).

¹⁴⁶⁰ *Reisner v. Commissioner*, 34 T.C. 1122 (1960); *Zubrod v. Commissioner*, 26 T.C.M. 1010 (1967).

¹⁴⁶¹ Rev. Rul. 56-168. *See Schmidt v. Commissioner*, 11 B.T.A. 1199 (1928); *Webb v. Commissioner*, 1 B.T.A. 759 (1925).

¹⁴⁶² *E.g.*, *Giordano v. Commissioner*, 36 T.C.M. 430 (1977).

¹⁴⁶³ Reg. §1.162-2(d). *E.g.*, *Koh-I-Noor Rapidograph, Inc. v. Commissioner*, 51 T.C.M. 799 (1986); *Smith v. Commissioner*, 50 T.C.M. 904 (1985).

¹⁴⁶⁴ Reg. §1.162-2(d). *Cf.* Reg. §1.162-32(b) (safe harbor for local lodging at business meetings and conferences). *See, e.g.*, *A. Finkenberg's Sons, Inc. v. Commissioner*, 17 T.C. 973 (1951); *Ellis v. Commissioner*, 15 B.T.A. 1075 (1929), aff'd, 50 F.2d 343 (D.C. Cir. 1931); *Silverman v. Commissioner*, 6 B.T.A. 1328 (1927); Rev. Rul. 63-266.

¹⁴⁶⁵ *E.g.*, *Diggs v. Commissioner*, 715 F.2d 245 (6th Cir. 1983), aff'g in part and rev'g in part 76 T.C. 888 (1981); *Reed v. Commissioner*, 35 T.C. 199 (1960); Rev. Rul. 63-266.

at which recreational activities are the major feature.¹⁴⁶⁶ The costs directly attributable to business seminars at the convention, such as registration fees, are deductible.¹⁴⁶⁷ No deduction is allowable under §212 for travel and related expenses paid or incurred to attend a convention, seminar or similar meeting.¹⁴⁶⁸

In determining whether expenses of traveling to a convention or meeting are trade or business expenses, self-employed individuals and employees are treated alike. An employee's deduction is not precluded merely because vacation or leave time is used for the travel or because the attendance is voluntary.¹⁴⁶⁹

The deductibility of attending foreign conventions is specifically limited by §274.¹⁴⁷⁰ The foreign convention limitation is described in 519 T.M., *Travel, Transportation, Entertainment, Meal, and Gift Expenses*.

f. Types of Traveling Expenses

Traveling expenses include travel fares, meals, lodging, the costs of rooms for demonstrating samples, telephone and telegraph charges and public stenographers' fees.¹⁴⁷¹ They also include laundry costs while away from home,¹⁴⁷² costs of using a private plane¹⁴⁷³ and aides for disabled taxpayers who are traveling on business.¹⁴⁷⁴

6. Relocation and Moving Expenses

a. In General

The cost of moving business machinery and equipment from one place of business to another place of business is deductible as a trade or business expense under §162.¹⁴⁷⁵ The same principle applies to the cost of moving business equipment into storage.¹⁴⁷⁶ The cost of moving personnel from one place of business to another is deductible.¹⁴⁷⁷ The cost of freighting inventory items received as payment for a debt is deductible.¹⁴⁷⁸

The cost of moving property acquired for use in a trade or business from the place of purchase to the place the property is to be used is deductible.¹⁴⁷⁹ This principle applies even if the property needs to be repaired before its use in business operations commences.¹⁴⁸⁰

The cost of moving the contents of an office maintained to produce and collect income from investments is deductible under §212.¹⁴⁸¹

b. Capitalization Limitation

The cost of moving buildings must be capitalized.¹⁴⁸² The cost of new equipment acquired in connection with the moving is not deductible but must be capitalized.¹⁴⁸³ The capitalization limitation is discussed in 509 T.M., *Principles of Capitalization*.

c. Types of Moving Expenses

The cost of moving includes labor, freight, cartage, carfare and other expenses of the employees doing the moving.¹⁴⁸⁴ It includes the cost of setting up the equipment or machinery in the new location,¹⁴⁸⁵ and the cost of renting moving trucks.¹⁴⁸⁶ The taxpayer has the burden of proving the amount of the business moving expenses.¹⁴⁸⁷

The cost of cleaning damaged equipment, dismantling it and moving it to a new location is deductible,¹⁴⁸⁸ as is the cost of dismantling and removing obsolete equipment.¹⁴⁸⁹ But the cost of dismantling, moving and rebuilding equipment for purposes of improving its capacity must be capitalized.¹⁴⁹⁰

d. Reimbursement

If the taxpayer is guaranteed or approved for reimbursement of the moving costs, the deduction is disallowed to the extent of the reimbursement.¹⁴⁹¹ The same result is reached if the right to reimbursement is fixed.¹⁴⁹² However, a business moving expense deduction is not disallowed merely because a reimbursement is possible.¹⁴⁹³ Likewise, the deduction is not disallowed merely because estimated moving costs are part of the computation of the condemnation award made to the taxpayer for the property from which the taxpayer must relocate.¹⁴⁹⁴ The taxpayer is not required to prove that moving costs have not been reimbursed as part of the award.¹⁴⁹⁵ The concept of reimbursement is discussed in 503 T.M., *Principles of Income Tax Deductions*.

¹⁴⁶⁶ Rev. Rul. 79-425.

¹⁴⁶⁷ Rev. Rul. 84-55.

¹⁴⁶⁸ §274(h)(7).

¹⁴⁶⁹ Reg. §1.162-2(d).

¹⁴⁷⁰ See §274(h).

¹⁴⁷¹ Reg. §1.162-2(a).

¹⁴⁷² E.g., Rev. Rul. 63-145.

¹⁴⁷³ Rev. Rul. 70-558.

¹⁴⁷⁴ Rev. Rul. 75-317.

¹⁴⁷⁵ *Alexander Sprunt & Son, Inc. v. Commissioner*, 24 B.T.A. 599 (1931), aff'd in part and rev'd in part on other issues, 64 F.2d 424 (4th Cir. 1933); *MacAdam & Foster, Inc. v. Commissioner*, 8 B.T.A. 967 (1927); Rev. Rul. 70-392.

¹⁴⁷⁶ *Dahl v. Commissioner*, 24 B.T.A. 1167 (1931).

¹⁴⁷⁷ *Addressograph-Multigraph Corp. v. Commissioner*, 4 T.C.M. 147 (1945).

¹⁴⁷⁸ *Virtue Bros. Mfg. Co. v. Commissioner*, 19 T.C.M. 1448 (1960).

¹⁴⁷⁹ *Booras v. Commissioner*, 13 T.C.M. 179 (1954).

¹⁴⁸⁰ *N. Michigan Transp. Co. v. Commissioner*, 3 B.T.A. 255 (1925).

¹⁴⁸¹ *Abrams v. Commissioner*, 23 T.C.M. 1546 (1964).

¹⁴⁸² *Bullock v. Commissioner*, 27 B.T.A. 440 (1932), aff'd sub nom *Winnette v. Helvering*, 68 F.2d 614 (9th Cir. 1934); *Rush v. United States*, 59-2 USTC ¶9752 (N.D. Ala. 1959); Rev. Rul. 76-134.

¹⁴⁸³ *MacAdam & Foster, Inc. v. Commissioner*, 8 B.T.A. 967 (1927); *Addressograph-Multigraph Corp. v. Commissioner*, 4 T.C.M. 147 (1945).

¹⁴⁸⁴ *Fowler and Union Horse Nail Co. v. Commissioner*, 16 B.T.A. 1071 (1929); *Terminal Equip. Corp. v. Commissioner*, 14 T.C.M. 493 (1955).

¹⁴⁸⁵ *E. Shoe Mfg. Co. v. Commissioner*, 8 B.T.A. 1169 (1927).

¹⁴⁸⁶ *Flagg v. United States*, 84-1 USTC ¶9310 (S.D. Iowa 1984).

¹⁴⁸⁷ *Karp v. Commissioner*, 35 T.C.M. 390 (1976).

¹⁴⁸⁸ *Parkersburg Iron & Steel Co. v. Commissioner*, 17 B.T.A. 74 (1929), aff'd on other issues, 48 F.2d 163 (4th Cir. 1931).

¹⁴⁸⁹ *L.A. Thompson Scenic Ry. Co. v. Commissioner*, 9 B.T.A. 1203 (1928).

¹⁴⁹⁰ *Wooten v. Commissioner*, 12 T.C. 659 (1949), aff'd, 181 F.2d 502 (6th Cir. 1950).

¹⁴⁹¹ *Wolfers v. Commissioner*, 69 T.C. 975 (1978); Rev. Rul. 78-388.

¹⁴⁹² *Charles Baloian Co. v. Commissioner*, 68 T.C. 620 (1977), nonacq., 1978-2 C.B. 3, aff'd in unpub. op. (9th Cir. 1982). See also PLR 201617002.

¹⁴⁹³ *Elec. Tachometer Corp. v. Commissioner*, 37 T.C. 158 (1961).

¹⁴⁹⁴ *Buffalo Wire Works Co. v. Commissioner*, 74 T.C. 925 (1980), nonacq., 1982-1 C.B. 1, aff'd in unpub. op. (2d Cir. 1981).

¹⁴⁹⁵ *Best Universal Lock Co. v. Commissioner*, 45 T.C. 1 (1965).

J. Supplies

The costs of materials and supplies actually consumed or used during the tax year in carrying on a trade or business are deductible under §162 in that tax year.¹⁴⁹⁶

Note: Expenses of up to \$250 paid by an eligible educator in connection with books, supplies, computer equipment, personal protective equipment, disinfectant and other supplies used for the prevention of COVID-19,¹⁴⁹⁷ as well as other equipment and supplementary materials used by the eligible educator in the classroom are deductible as an above-the-line deduction in determining adjusted gross income on Form 1040.¹⁴⁹⁸

“Materials and supplies” means tangible property used or consumed in the taxpayer’s operations that is not inventory and that satisfies one of five conditions:¹⁴⁹⁹

- (1) It is a component acquired to maintain, repair, or improve a unit of tangible property¹⁵⁰⁰ owned, leased, or serviced by the taxpayer and that is not acquired as part of any single unit of tangible property;¹⁵⁰¹
- (2) It consists of fuel, lubricants, water, and similar items, that are reasonably expected to be consumed in 12 months or less, beginning when used in the taxpayer’s operations;¹⁵⁰²
- (3) It is a unit of property that has an economic useful life of 12 months or less,¹⁵⁰³ beginning when the property is used or consumed in the taxpayer’s operations,¹⁵⁰⁴
- (4) It is a unit of property that has an acquisition cost or production cost of \$100 or less;¹⁵⁰⁵ or
- (5) It is identified in published guidance as materials and supplies for which treatment is permitted under Reg. §1.162-3(c)(1).¹⁵⁰⁶

If the materials and supplies are incidental and no physical record of consumption or use is kept or for which no inventory record is maintained, the taxpayer is permitted to deduct their cost in the tax year in which they are purchased, provided the deduction does not distort taxable income.¹⁵⁰⁷

Rotable and temporary spare parts¹⁵⁰⁸ are deductible in the year disposed of.¹⁵⁰⁹ Airlines’ spare parts that are purchased, but

¹⁴⁹⁶ Reg. §1.162-3(a).

¹⁴⁹⁷ COVID-related Tax Relief Act of 2020, Pub. L. No. 116-260, Div. N., Title II, Subtitle B, §275, applicable to expenses paid or incurred after March 12, 2020. Such supplies include (among others) face masks, paint or chalk used to guide social distancing, hand soap, hand sanitizer, disposable gloves, physical barriers (e.g., clear plexiglass), and air purifiers. See Rev. Proc. 2021-15, §3.

¹⁴⁹⁸ See §62(a)(2)(D).

¹⁴⁹⁹ Reg. §1.162-3(c)(1).

¹⁵⁰⁰ See Reg. §1.263(a)-3(e).

¹⁵⁰¹ Reg. §1.162-3(c)(1)(i).

¹⁵⁰² Reg. §1.162-3(c)(1)(ii).

¹⁵⁰³ See Reg. §1.162-3(c)(3).

¹⁵⁰⁴ Reg. §1.162-3(c)(1)(iii).

¹⁵⁰⁵ Reg. §1.162-3(c)(1)(iv).

¹⁵⁰⁶ Reg. §1.162-3(c)(1)(v).

¹⁵⁰⁷ Reg. §1.162-3(a)(2).

¹⁵⁰⁸ See Reg. §1.162-3(c)(2).

¹⁵⁰⁹ Reg. §1.162-3(a)(3). See also Rev. Rul. 69-200, modified, T.D. 9564, 76 Fed. Reg. 81,060 (12/27/11), amended, 77 Fed. Reg. 74,583 (irreparable spare parts deductible in year used).

not used, by the end of the year, must be capitalized, their cost deducted in the year used, because the spare parts are not incidental.¹⁵¹⁰ The cost of smallwares paid by taxpayers operating restaurants or taverns is deductible in the year they are used.¹⁵¹¹ According to the IRS, this principle applies to small appliance costs paid by taxpayers providing coffee, related food and refreshment products and small appliances to customers, but not to taxpayers who only occasionally prepare beverages.¹⁵¹²

The determination of the tax year in which materials and supplies are deductible and changes in accounting methods relating to this determination are discussed in 570 T.M., *Accounting Methods — General Principles*; 572 T.M., *Accounting Methods — Adoption and Changes*; and 576 T.M., *Uniform Capitalization Rules: Inventory; Self-Constructed Assets; Real Estate*.

K. Education Expenses

1. In General

Expenditures by an individual for education in connection with a trade or business are deductible as ordinary and necessary business expenses under §162 if one of two allowance tests is met and neither of two disallowance tests is met,¹⁵¹³ even if the education leads to a degree.¹⁵¹⁴ Education expenditures are not deductible under §212.¹⁵¹⁵

For tax years beginning after 2017, the disallowance of miscellaneous itemized deductions means that job-related education expenses incurred by an employee that are not reimbursed by the employer are not deductible by the employee.¹⁵¹⁶ The disallowance does not apply to the above-the-line deduction for expenses incurred, up to \$250 (adjusted for inflation), paid by an eligible educator by reason of the participation of the educator in professional development courses related to the curriculum in which the educator provides instruction or to the students for which the educator provides instruction.¹⁵¹⁷ In addition, in taxable years beginning after 2025, the disallowance does not apply to the itemized deduction for expenses paid by an eligible educator, including an interscholastic sports administrator or coach, without regard to the dollar limitation and the requirement that supplies for courses of instruction in health or physical education not include nonathletic supplies, provided the expenses are in connection with books, supplies, equipment, and other materials used by the educator as part of instructional activity.¹⁵¹⁸

¹⁵¹⁰ Reg. §1.162-3(a)(3); see FSA 199925009; see also Rev. Rul. 69-200, modified, T.D. 9564, 76 Fed. Reg. 81,060 (12/27/11), amended, 77 Fed. Reg. 74,583 (irreparable spare parts deductible in year used).

¹⁵¹¹ Rev. Proc. 2002-12.

¹⁵¹² PLR 200351009.

¹⁵¹³ Reg. §1.162-5(a).

¹⁵¹⁴ Reg. §1.162-5(a); e.g., *Picknally v. Commissioner*, 36 T.C.M. 1292 (1977).

¹⁵¹⁵ Reg. §1.212-1(f). E.g., *Dreher v. Commissioner*, 46 T.C.M. 1144 (1983), aff’d in unpub. opin. (3d Cir. 1984); *Dinsmore v. Commissioner*, 36 T.C.M. 1008 (1977); *Wright v. Commissioner*, 32 T.C.M. 31 (1973).

¹⁵¹⁶ §62(a)(2)(A), §67(h).

¹⁵¹⁷ §62(a)(2)(D)(i), §62(d).

¹⁵¹⁸ §67(b)(13), §67(g), added by the One Big Beautiful Bill Act (OBBBA), Pub. L. No. 119-21, §70110(b).

2. Allowance Tests

a. In General

Education expenses are deductible only if the education meets one of the two allowance tests.¹⁵¹⁹ Even if one of the allowance tests is met, the expenses are not deductible if either of the disallowance tests, described below, are met.¹⁵²⁰ Education that does not meet one of the allowance tests is not precluded from meeting the other.¹⁵²¹ If the taxpayer does not carry on, or does not intend to carry on, the trade or business after completing the education, no deduction is allowed.¹⁵²² Likewise, if the taxpayer is not engaged in a trade or business at the time the education is commenced, no deduction is allowed.¹⁵²³

b. Maintaining or Improving Skills

The first allowance test is met if the education maintains or improves skills required by the individual in the individual's employment or other trade or business.¹⁵²⁴ Determining whether the education meets this test is a question of fact.¹⁵²⁵ A proximate and direct relationship between the education and the trade or business must be demonstrated.¹⁵²⁶ Refresher courses, current development courses, and academic or vocational courses meet the first allowance test.¹⁵²⁷

c. Expressly Required

The second allowance test is met if the education meets the express requirements of the individual's employer, or the requirements of applicable law or regulations, imposed as a condition to the retention by the individual of an established employment relationship, status or rate of compensation,¹⁵²⁸ but only if the requirements are imposed for bona fide business pur-

¹⁵¹⁹ Reg. §1.162-5(a). *E.g.*, *Duffey v. Commissioner*, 36 T.C.M. 609 (1977); *Kates v. Commissioner*, 21 T.C.M. 1396 (1962).

¹⁵²⁰ Reg. §1.162-5(a), Reg. §1.162-5(b)(2), Reg. §1.162-5(b)(3).

¹⁵²¹ Reg. §1.162-5(c)(2). *E.g.*, *Stoddard v. Commissioner*, 45 T.C.M. 323 (1982).

¹⁵²² *E.g.*, *Carter v. Commissioner*, 645 F.2d 784 (9th Cir. 1981), *aff'd* 37 T.C.M. 859 (1978); *Corbett v. Commissioner*, 55 T.C. 884 (1971); *Lenihan v. Commissioner*, 36 T.C.M. 1540 (1977).

¹⁵²³ *Link v. Commissioner*, 90 T.C. 460 (1988), *aff'd* in unpub. opin. (6th Cir., 1989); *Reisinger v. Commissioner*, 71 T.C. 568 (1979); *Mulherin v. Commissioner*, 42 T.C.M. 834 (1981); *Cannon v. Commissioner*, 40 T.C.M. 541 (1980), *aff'd* in unpub. opin. (7th Cir. 1981); *Cornish v. Commissioner*, 29 T.C.M. 235 (1970); PLR 9431024.

¹⁵²⁴ Reg. §1.162-5(a)(1). *E.g.*, *Brewer v. Commissioner*, 37 T.C.M. 1495 (1978).

¹⁵²⁵ *E.g.*, *Torre v. Commissioner*, 47 T.C.M. 1500 (1984); *Raines v. Commissioner*, 45 T.C.M. 940 (1983); *Kendrick v. Commissioner*, 26 T.C.M. 339 (1967). See *Stricker v. Commissioner*, 70 T.C.M. 1192 (1995) (20-day course with minimal assignments and pro forma exams held away from tax home and conducted by church).

¹⁵²⁶ See *Schwartz v. Commissioner*, 69 T.C. 877 (1978); *Wagner v. Commissioner*, 48 T.C.M. 43 (1984); *McKirahan v. Commissioner*, 45 T.C.M. 787 (1983); *Korth v. Commissioner*, 42 T.C.M. 866 (1981).

¹⁵²⁷ Reg. §1.162-5(c)(1). *E.g.*, *Coughlin v. Commissioner*, 203 F.2d 307 (2d Cir. 1953), *rev'd* 18 T.C. 528 (1952); *Nagraba v. Commissioner*, 68 T.C.M. 670 (1994); *Blair v. Commissioner*, 41 T.C.M. 289 (1980); *Petersen v. Commissioner*, 40 T.C.M. 1067 (1980); *Granger v. Commissioner*, 39 T.C.M. 1158 (1980); *Haseltine v. Commissioner*, 38 T.C.M. 1259 (1979). See *Takahashi v. Commissioner*, 87 T.C. 126 (1986).

¹⁵²⁸ Reg. §1.162-5(a)(2). *E.g.*, *Boser v. Commissioner*, 77 T.C. 1124 (1981), *acq.*, 1984-2 C.B. 1, *aff'd* in unpub. opin. (9th Cir. 1983).

poses of the employer.¹⁵²⁹ Determining whether the education meets this test is a question of fact.¹⁵³⁰

3. Disallowance Tests

a. In General

If either of the two disallowance tests is met, the taxpayer's education expenses are not deductible.¹⁵³¹ This is so even if the education meets one of the two allowance tests described above.¹⁵³² If either of the two disallowance tests is met, the education expenses are considered either personal expenditures or an inseparable aggregate of personal and capital expenses.¹⁵³³

b. Minimum Educational Requirements

(1) In General

The first disallowance test is met if the education is required of the individual in order to meet the minimum educational requirements for qualification in the individual's employment or other trade or business.¹⁵³⁴ The minimum education necessary to qualify for a position or other trade or business must be determined from a consideration of such factors as the requirements of the employer, the applicable law and regulations and the standards of the profession, trade or business involved.¹⁵³⁵ The fact that an individual is already performing service in an employment status does not establish that the minimum educational requirements have been met.¹⁵³⁶

Once an individual has met the minimum educational requirements for qualification in the individual's employment or other trade or business, as in effect when entering the employment or trade or business, the individual is treated as continuing to meet the minimum educational requirements even if they are changed.¹⁵³⁷

(2) Educational Institution Positions

The minimum educational requirements for qualification of an individual in a position in an educational institution is the minimum level of education, in terms of aggregate college hours or degree, which, under the applicable laws and regulations in effect when the individual is first employed in the position, is normally required of an individual initially being employed in the position.¹⁵³⁸

If there are no such normal requirements, then the individual is considered to have met the minimum educational re-

¹⁵²⁹ Reg. §1.162-5(c)(2).

¹⁵³⁰ *E.g.*, *Katz v. Commissioner*, 27 T.C.M. 87 (1968).

¹⁵³¹ Reg. §1.162-5(b)(1).

¹⁵³² *E.g.*, *Hinton v. Commissioner*, 44 T.C.M. 1160 (1982); *Drummond v. Commissioner*, 40 T.C.M. 1336 (1980).

¹⁵³³ Reg. §1.162-5(b)(1).

¹⁵³⁴ Reg. §1.162-5(b)(2)(i). *E.g.*, *Davis v. Commissioner*, 65 T.C. 1014 (1976); *Jungreis v. Commissioner*, 55 T.C. 581 (1970); *Woodward v. Commissioner*, 29 T.C.M. 1691 (1970); *Holstein v. Commissioner*, 29 T.C.M. 1687 (1970).

¹⁵³⁵ Reg. §1.162-5(b)(2)(i). *E.g.*, *Josephs v. Commissioner*, 39 T.C.M. 138 (1979).

¹⁵³⁶ Reg. §1.162-5(b)(2)(i). *E.g.*, *Davidson v. Commissioner*, 43 T.C.M. 743 (1982); *Antuna v. Commissioner*, 36 T.C.M. 1778 (1977).

¹⁵³⁷ Reg. §1.162-5(b)(2)(i).

¹⁵³⁸ Reg. §1.162-5(b)(2)(ii). See *Hering v. Commissioner*, 33 T.C.M. 1329 (1974).

quirements for qualification in the position when the individual becomes a member of the institution's faculty. Whether an individual is a member of an institution's faculty is determined on the basis of the particular institution's practices. However, an individual is considered to be a member of an institution's faculty if one of three tests is met.¹⁵³⁹ First, the individual has tenure or his years of service are being counted toward obtaining tenure.¹⁵⁴⁰ Second, the institution is making contributions to a retirement plan, other than Social Security or a similar program, on behalf of the individual's employment.¹⁵⁴¹ Third, the individual has a vote in faculty affairs.¹⁵⁴²

c. Qualification for New Trade or Business

(1) In General

The second disallowance test is met if the education is part of a program of study being pursued by the individual which will lead to the individual's qualification in a new trade or business.¹⁵⁴³ It does not matter that the taxpayer does not intend to conduct the trade or business for which the taxpayer is newly qualified.¹⁵⁴⁴

(2) Changes in Employee's Duties

For an employee, a change of duties does not constitute a new trade or business if the new duties involve the same general type of work as is involved in the individual's employment before the change.¹⁵⁴⁵

Education that qualifies individuals for the following changes in duties does not constitute preparation for a new trade or business:

- classroom teacher in one subject to classroom teacher in another subject;¹⁵⁴⁶
- classroom teacher to guidance counselor;¹⁵⁴⁷
- classroom teacher to principal;¹⁵⁴⁸
- elementary school classroom teacher to secondary school classroom teacher;¹⁵⁴⁹
- teacher in one state to teacher in another state;¹⁵⁵⁰
- teacher in one country to teacher in another country,¹⁵⁵¹ and
- teacher in private school to teacher in public school.¹⁵⁵²

¹⁵³⁹ Reg. § 1.162-5(b)(2)(ii).

¹⁵⁴⁰ Reg. § 1.162-5(b)(2)(ii)(a).

¹⁵⁴¹ Reg. § 1.162-5(b)(2)(ii)(b).

¹⁵⁴² Reg. § 1.162-5(b)(2)(ii)(c).

¹⁵⁴³ Reg. § 1.162-5(b)(3)(i). *E.g.*, *Gallery v. Commissioner*, 57 T.C. 257 (1971).

¹⁵⁴⁴ *E.g.*, *Zeidler v. Commissioner*, 71 T.C.M. 2603 (1996), aff'd, 132 F.3d 37 (7th Cir. 1997).

¹⁵⁴⁵ Reg. § 1.162-5(b)(3)(i); *Gilliam v. Commissioner*, 51 T.C.M. 567 (1986).

¹⁵⁴⁶ Reg. § 1.162-5(b)(3)(i)(B).

¹⁵⁴⁷ Reg. § 1.162-5(b)(3)(i)(C).

¹⁵⁴⁸ Reg. § 1.162-5(b)(3)(i)(D).

¹⁵⁴⁹ Reg. § 1.162-5(b)(3)(i)(A).

¹⁵⁵⁰ Rev. Rul. 71-58.

¹⁵⁵¹ *Laurano v. Commissioner*, 69 T.C. 723 (1978).

¹⁵⁵² See *Toner v. Commissioner*, 623 F.2d 315 (3d Cir. 1980), rev'g 71 T.C. 772 (1979).

(3) Examples of New Trade or Business

For a list of situations that are examples of education that qualify the individual for a new trade or business, see 517 T.M., *Educational Expenses and Credits*, at Worksheet 3.

(4) Not New Trades or Businesses

For a list of situations that are examples of education that do not qualify the individual for a new trade or business, see 517 T.M., *Educational Expenses and Credits*, at Worksheet 3.

4. Types of Education Expenses

a. In General

If the education qualifies for deductibility under §162, the deductible expenses include tuition,¹⁵⁵³ books,¹⁵⁵⁴ educational materials,¹⁵⁵⁵ typing and similar fees in connection with papers, theses, and dissertations,¹⁵⁵⁶ tutors,¹⁵⁵⁷ transportation between a place of business and the place at which the courses are taken,¹⁵⁵⁸ and other incidental expenses.¹⁵⁵⁹ Deductible expenses also include the cost of research undertaken as part of the educational program.¹⁵⁶⁰ However, deductible expenses do not include the cost of computer equipment on which a computer programmer operated self-teaching software.¹⁵⁶¹

b. Travel, Meals and Lodging

If the education qualifies for deductibility under §162, the deductible expenses include the costs of transportation, meals and lodging while away from home primarily to obtain education the expenses of which are deductible under §162.¹⁵⁶² No deduction is allowable for travel, meals and lodging in connection with education the expenses of which are deductible under §162 but that does not occur away from home.¹⁵⁶³ Expenses for travel as a form of education are not deductible.¹⁵⁶⁴

However, any portion of the travel, meals and lodging cost allocable to personal activities, such as sightseeing, social visiting or entertaining, is not deductible because it is a personal expenditure. If the transportation, meals and lodging are undertaken as part of travel away from home primarily in pursuit of personal purposes, the only deductible costs are those directly attributable to participating in educational activities the expenses of which are deductible under §162.¹⁵⁶⁵

Whether a particular trip is primarily personal or primarily to obtain education the expenses of which are deductible under §162 depends on all the facts and circumstances of each case.

¹⁵⁵³ *E.g.*, *Bird v. Commissioner*, 40 T.C.M. 289 (1980).

¹⁵⁵⁴ *Id.* at 293.

¹⁵⁵⁵ *Gudmundsson v. Commissioner*, 37 T.C.M. 1249 (1978).

¹⁵⁵⁶ *E.g.*, *Hester v. Commissioner*, 22 T.C.M. 501 (1963); Rev. Rul. 67-421.

¹⁵⁵⁷ *E.g.*, *Lage v. Commissioner*, 52 T.C. 130 (1969).

¹⁵⁵⁸ *E.g.*, *Carlucci v. Commissioner*, 37 T.C. 695 (1962); *Gudmundsson v. Commissioner*, 37 T.C.M. 1249 (1978).

¹⁵⁵⁹ See Rev. Rul. 76-65.

¹⁵⁶⁰ Reg. § 1.162-5(a); Rev. Rul. 67-421.

¹⁵⁶¹ *Nagraba v. Commissioner*, 68 T.C.M. 670 (1994).

¹⁵⁶² Reg. § 1.162-5(e)(1). *E.g.*, *Ford v. Commissioner*, 56 T.C. 1300 (1971), aff'd, 487 F.2d 1025 (9th Cir. 1973); *Johnson v. Commissioner*, 55 T.C.M. 700 (1988).

¹⁵⁶³ *E.g.*, *Adamson v. Commissioner*, 32 T.C.M. 484 (1973).

¹⁵⁶⁴ § 274(m)(2).

¹⁵⁶⁵ Reg. § 1.162-5(e)(1).

One important factor is a comparison of the amount of time during the trip spent on personal activities and the amount of time spent on activities directly related to the education.¹⁵⁶⁶

Decisions and rulings with respect to the deductibility of travel expenses under §162, described in IV.I.5., above, as well as the limitations applicable, described in 503 T.M., *Principles of Income Tax Deductions*, are applicable in determining the deductibility of travel expenses paid or incurred in pursuit of education the expenses that are deductible under §162.¹⁵⁶⁷ The deductibility of travel expenses is discussed in 519 T.M., *Travel, Transportation, Entertainment, Meal, and Gift Expenses*.

c. Training Costs

Amounts paid or incurred by an employer for employee training, including the costs of trainers and routine updates of training materials, that otherwise qualify are generally deductible as business expenses even though they may have some future benefit.¹⁵⁶⁸ Training costs must be capitalized, however, in the unusual circumstance where the training is intended primarily to obtain future benefits significantly beyond those traditionally associated with training provided in the ordinary course of a taxpayer's business.¹⁵⁶⁹

L. Professional Expenses

1. Preparation for and Acquisition of Profession

Deductible professional expenses do not include the costs of preparing to enter a profession.¹⁵⁷⁰ Thus, the expenses of review courses for being licensed as a C.P.A. are not deductible.¹⁵⁷¹ Likewise, the cost of admission to the bar is not deductible.¹⁵⁷²

The cost of readmission to the bar is not deductible.¹⁵⁷³ Nor is the cost of a stenographer's initial licensing.¹⁵⁷⁴

The deductibility of education expenses is described in IV.K., above, and discussed in 517 T.M., *Educational Expenses and Credits*.

The cost of acquiring an ongoing profession is not deductible under §162, but must be capitalized as part of the taxpayer's cost basis in the business.¹⁵⁷⁵ The costs of goodwill, office records, and client or patient names and addresses must be capitalized.¹⁵⁷⁶ The cost of a membership in Lloyd's of London

is not deductible.¹⁵⁷⁷ The capitalization limitation is discussed in 509 T.M., *Principles of Capitalization*.

2. Status as Professional

A professional person who is employed is treated as an employee and not as a professional for purposes of §162.¹⁵⁷⁸ This principle has been applied to salaried physicians employed as pathologists,¹⁵⁷⁹ attorneys employed by corporations,¹⁵⁸⁰ school teachers employed by public school systems¹⁵⁸¹ and geologists.¹⁵⁸²

The classification of taxpayers as employees is discussed in 392 T.M., *Withholding, Social Security and Unemployment Taxes on Compensation*.

Note: Employees are in the trade or business of being employed, as discussed in II.B.6., above, and, thus, are allowed to deduct the ordinary and necessary expenses of carrying on the employment. However, even though §162 applies to both professionals and employees, there are several distinctions. For example, application of the ordinary and necessary test in the case of employees produces different results from its application to professionals who are self-employed. The §162 deductions of employees generally are not allowed in computing adjusted gross income, whereas those of self-employed professionals generally are, as discussed in 503 T.M., *Principles of Income Tax Deductions*. There are minor differences in the tax treatment of employees and self-employed individuals with respect to qualified plans. The treatment of employees and self-employed individuals with respect to qualified plans is discussed in 350 T.M., *Plan Selection — Pension and Profit-Sharing Plans*, 351 T.M., *Qualification — Pension and Profit-Sharing Plans*, and 353 T.M., *Employee Benefit Plans and Issues for Small Employers*.

A retired professional is not in the trade or business of being a professional.¹⁵⁸³ Neither is a professional who stops practice in order to pursue personal activities.¹⁵⁸⁴ Professional expense deductions are not allowed for expenses paid or incurred by a professional who suspends the practice because of high malpractice insurance rates.¹⁵⁸⁵

3. Types of Professional Expenses

Deductible professional expenses include the cost of supplies used in the practice of the profession,¹⁵⁸⁶ operating and repair costs of vehicles used in making professional calls,¹⁵⁸⁷ advertising,¹⁵⁸⁸ rent paid or accrued for office space,¹⁵⁸⁹ exhibi-

¹⁵⁶⁶ Reg. §1.162-5(e)(1).

¹⁵⁶⁷ Reg. §1.162-5(e)(1).

¹⁵⁶⁸ See Rev. Rul. 96-62 (analyzing *INDOPCO v. Commissioner*, 503 U.S. 79 (1992)).

¹⁵⁶⁹ See *Cleveland Elec. Illumination Co. v. United States*, 7 Cl. Ct. 220 (1985).

¹⁵⁷⁰ Reg. §1.212-1(f). See, e.g., *Bodley v. Commissioner*, 56 T.C. 1357 (1971); *Spitaleri v. Commissioner*, 32 T.C. 988 (1959); *Condit v. Commissioner*, 21 T.C.M. 1306 (1962), aff'd, 329 F.2d 153 (6th Cir. 1964).

¹⁵⁷¹ E.g., *Glenn v. Commissioner*, 62 T.C. 270 (1974); *Cooper v. Commissioner*, 38 T.C.M. 955 (1979); *Archie v. Commissioner*, 37 T.C.M. 1759 (1978); *Cooper v. Commissioner*, 37 T.C.M. 529 (1978); Rev. Rul. 69-292, 1969-1 C.B. 84.

¹⁵⁷² E.g., *Avery v. United States*, 419 F. Supp. 105 (N.D. Iowa 1976).

¹⁵⁷³ *Kaufman v. United States*, 233 F. Supp. 123 (E.D. Pa. 1964).

¹⁵⁷⁴ *McCabe v. Commissioner*, 49 T.C.M. 1336 (1985).

¹⁵⁷⁵ E.g., *Smith v. Commissioner*, 36 T.C.M. 932 (1977).

¹⁵⁷⁶ E.g., *Meurlin v. Commissioner*, 25 T.C. 118 (1955).

¹⁵⁷⁷ *Snell v. Commissioner*, 38 T.C.M. 635 (1979).

¹⁵⁷⁸ See *James v. Commissioner*, 25 T.C. 1296 (1956).

¹⁵⁷⁹ *Id.* at 1300-01.

¹⁵⁸⁰ *Rogers v. Commissioner*, 20 T.C.M. 1515 (1961).

¹⁵⁸¹ *Hand v. Commissioner*, 16 T.C. 1410 (1951).

¹⁵⁸² See *Fees v. Commissioner*, 14 T.C.M. 601 (1955).

¹⁵⁸³ See, e.g., *Estate of Sussman v. Commissioner*, 37 T.C.M. 1430 (1978).

¹⁵⁸⁴ *Goldstein v. Commissioner*, 41 T.C.M. 1016 (1981).

¹⁵⁸⁵ Rev. Rul. 77-32, 1977-1 C.B. 38.

¹⁵⁸⁶ *Delaney v. Commissioner*, 45 T.C.M. 134 (1982), aff'd on other issues, 743 F.2d 670 (9th Cir. 1984); *Elsa v. Commissioner*, 5 T.C.M. 1116 (1946).

¹⁵⁸⁷ Former Reg. §1.162-6.

¹⁵⁸⁸ *Thomas v. Commissioner*, 8 B.T.A.M. 39-186 (1939).

¹⁵⁸⁹ *Bennett v. Commissioner*, 1 T.C.M. 31 (1942), aff'd, 139 F.2d 961 (8th Cir. 1944); *Thomas v. Commissioner*, 8 B.T.A.M. 39-186 (1939).

tion space¹⁵⁹⁰ and equipment,¹⁵⁹¹ the cost of fuel, light, water, telephone, telegraph, cable and other utilities used in the office,¹⁵⁹² postage,¹⁵⁹³ shipping,¹⁵⁹⁴ business taxes,¹⁵⁹⁵ office expenses¹⁵⁹⁶ and the expense of office assistants.¹⁵⁹⁷ Additionally, the COVID-related Tax Relief Act¹⁵⁹⁸ provides that a deduction for otherwise deductible utility expenses will not be denied merely because the expenses were paid using the nontaxable proceeds of a forgiven Paycheck Protection Loan (PPP loan)¹⁵⁹⁹ if, among other requirements,¹⁶⁰⁰ the utility payments are for covered utility services, which means services for the distribution of electricity, gas, water, transportation, telephone, or internet access which began before February 15, 2020.¹⁶⁰¹ Deductions for compensation paid or accrued by the taxpayer are described in IV.A., above, and discussed in 390 T.M., *Reasonable Compensation*.

Amounts currently paid or accrued for books, furniture and professional instruments and equipment, the useful life of which is short,¹⁶⁰² also are deductible.¹⁶⁰³ Costs of investigations paid or incurred in connection with the taxpayer's profession are deductible.¹⁶⁰⁴

Education that improves the skills of the professional, without qualifying the professional for a new trade or business, also are deductible.¹⁶⁰⁵ The deductibility of education expenses is described in IV.K., above, and is discussed in 517 T.M., *Educational Expenses and Credits*.

Deductible professional expenses include the cost of reimbursing clients for negligent practice,¹⁶⁰⁶ but not if there is insurance coverage against which the professional fails to make a claim.¹⁶⁰⁷ They also include the cost of prosecuting actions to protect the professional's reputation.¹⁶⁰⁸ Malpractice insurance

premiums are deductible.¹⁶⁰⁹ The deductibility of insurance premiums is described in detail in IV.E., above.

Deductible professional expenses include dues to professional societies¹⁶¹⁰ and subscriptions to professional journals.¹⁶¹¹ Deductible dues include bar association dues,¹⁶¹² law library dues¹⁶¹³ and architectural association dues.¹⁶¹⁴ Deductible subscriptions include a securities seller's subscription to a marketing service publication,¹⁶¹⁵ a mining engineer's subscriptions to trade and professional magazines¹⁶¹⁶ and a professional hockey player's subscription to "Hockey News,"¹⁶¹⁷ but only if the taxpayer establishes business use of the journal.¹⁶¹⁸

The costs of wardrobe, costumes, wigs, cosmetics and similar items paid or incurred by a professional actor or actress are deductible.¹⁶¹⁹ The same principle applies to costumes and supplies used in performing stunts,¹⁶²⁰ and professional outfits and laundering costs paid or incurred by professional musicians and singers.¹⁶²¹ Photography fees with respect to headshots and creating actor portfolios, talent agency fees, and acting class costs incurred by actors are considered inherently connected to acting and thus deductible.¹⁶²² Deductions have been allowed for the cost of physical fitness training by professional athletes,¹⁶²³ professional stunt players¹⁶²⁴ and actors portraying athletes.¹⁶²⁵

Attempts to deduct medical expenses as professional expenses generally have failed.¹⁶²⁶ However in *Denny v. Commis-*

¹⁶⁰⁸ E.g., *Dyer v. Commissioner*, 36 T.C. 456 (1961); *Draper v. Commissioner*, 26 T.C. 201 (1956).

¹⁶⁰⁹ Rev. Rul. 60-365, 1960-2 C.B. 49.

¹⁶¹⁰ Former Reg. §1.162-6.

¹⁶¹¹ Former Reg. §1.162-6. *But see Peyser v. Commissioner*, 1 T.C.M. 807 (1943).

¹⁶¹² E.g., *Keith v. Commissioner*, 11 B.T.A.M. 1629 (1942), aff'd on other issues, 139 F.2d 596 (2d Cir. 1944).

¹⁶¹³ E.g., *Bennett v. Commissioner*, 11 B.T.A.M. 1481 (1942), aff'd, 139 F.2d 961 (8th Cir. 1944).

¹⁶¹⁴ E.g., *Lee v. Commissioner*, 5 T.C.M. 240 (1946).

¹⁶¹⁵ E.g., *Shein v. Commissioner*, 11 T.C.M. 191 (1952).

¹⁶¹⁶ *Kasey v. Commissioner*, 54 T.C. 1642 (1970), aff'd, 457 F.2d 369 (9th Cir. 1972).

¹⁶¹⁷ *Stemkowski v. Commissioner*, 690 F.2d 40 (2d Cir. 1982), aff'd in part, rev'g in part and rem'g 76 T.C. 252 (1981), on remand 82 T.C. 854 (1984), appeal dismissed (2d Cir. 9/3/87).

¹⁶¹⁸ *Hanna v. Commissioner*, 63 T.C.M. 3178 (1992).

¹⁶¹⁹ See *Denny v. Commissioner*, 33 B.T.A. 738 (1935); *Cabot v. Commissioner*, 8 B.T.A.M. 213 (1939); *Six v. United States*, 300 F. Supp. 277 (S.D.N.Y. 1969).

¹⁶²⁰ *Hutchison v. Commissioner*, 13 B.T.A. 1187 (1928).

¹⁶²¹ *Fisher v. Commissioner*, 23 T.C. 218 (1954), aff'd on other issues, 230 F.2d 79 (7th Cir. 1956); *Loinaz v. Commissioner*, 34 T.C.M. 71 (1975).

¹⁶²² *Gaston v. Commissioner*, T.C. Memo 2021-107.

¹⁶²³ *Hanna v. Commissioner*, 763 F.2d 171 (4th Cir. 1985) (*per curiam*), aff'd on this issue and rem'g on other issues 76 T.C. 252 (1981); *Stemkowski v. Commissioner*, 690 F.2d 40 (2d Cir. 1982), rev'g and rem'g 76 T.C. 252 (1981).

¹⁶²⁴ *Hutchison v. Commissioner*, 13 B.T.A. 1187 (1928), *nonacq.*, 1929 C.B. 55.

¹⁶²⁵ *Denny v. Commissioner*, 33 B.T.A. 738 (1935), *nonacq.*, 1936 C.B. 30.

¹⁶²⁶ E.g., *Masat v. Commissioner*, 784 F.2d 573 (5th Cir. 1986), aff'd 48 T.C.M. 317 (1984); *Bourne v. Commissioner*, 23 B.T.A. 1288 (1931), aff'd, 62 F.2d 648 (4th Cir. 1933), cert. denied, 290 U.S. 650 (1933); *Bakewell v. Commissioner*, 23 T.C. 803 (1955); *Sparks v. Commissioner*, 8 B.T.A.M. 180 (1939), aff'd sub nom., *Sparkman v. Commissioner*, 112 F.2d 774 (9th Cir. 1940); *Evans v. Commissioner*, 8 B.T.A.M. 164 (1939); Rev. Rul. 71-45, 1971-1 C.B. 51; Rev. Rul. 57-461, 1957-2 C.B. 116. *But see* Rev. Rul. 75-316, 1975-2 C.B. 54.

¹⁵⁹⁰ *Elsea v. Commissioner*, 5 T.C.M. 1116 (1946).

¹⁵⁹¹ *Elsea v. Commissioner*, 5 T.C.M. 1116 (1946).

¹⁵⁹² *May v. Commissioner*, 39 B.T.A. 946 (1939); *Evans v. Commissioner*, 8 B.T.A.M. 39-164 (1939).

¹⁵⁹³ *Elsea v. Commissioner*, 5 T.C.M. 1116 (1946).

¹⁵⁹⁴ *Elsea v. Commissioner*, 5 T.C.M. 1116 (1946).

¹⁵⁹⁵ *Elsea v. Commissioner*, 5 T.C.M. 1116 (1946).

¹⁵⁹⁶ *Elsea v. Commissioner*, 5 T.C.M. 1116 (1946); *Thomas v. Commissioner*, 8 B.T.A.M. 186 (1939).

¹⁵⁹⁷ E.g., *Marcelle v. Commissioner*, 15 T.C.M. 1174 (1956); *Bennett v. Commissioner*, 11 B.T.A.M. 1481 (1942), aff'd, 139 F.2d 961 (8th Cir. 1944).

¹⁵⁹⁸ Pub. L. No. 116-260, Div. N, Title II, Subtitle B, §276 (amending §7A(i) of the Small Business Act), applicable to tax years ending after March 27, 2020.

¹⁵⁹⁹ An "original PPP loan" is a PPP loan made during the covered period beginning on February 15, 2020, and ending on December 31, 2020. See CARES Act, Pub. L. No. 116-136, §1102(a)(2) (Mar. 27, 2020); Paycheck Protection Program Flexibility Act of 2020, Pub. L. No. 116-142, §3 (June 5, 2020).

¹⁶⁰⁰ For a complete discussion of Rev. Proc. 2021-20, see 536 T.M., *Interest Expense Deductions*.

¹⁶⁰¹ CARES Act, Pub. L. No. 116-136, §1102(a)(5) (Mar. 27, 2020).

¹⁶⁰² See *King v. Commissioner*, 9 B.T.A. 502 (1927); *Kosmal v. Commissioner*, 39 T.C.M. 651 (1979), aff'd on other issues, 670 F.2d 842 (9th Cir. 1982).

¹⁶⁰³ E.g., *Meeks v. Commissioner*, 75 T.C.M. 1997 (1998) (dance teacher's jazz dance records); *Genck v. Commissioner*, 75 T.C.M. 1984 (1998) (musician's musical equipment).

¹⁶⁰⁴ See *Heller v. Commissioner*, 40 T.C.M. 1338 (1980), aff'd in unpub. opin., No. 81-4086 (2d Cir. 11/24/81).

¹⁶⁰⁵ See, e.g., *Cooper v. Commissioner*, 38 T.C.M. 955 (1979).

¹⁶⁰⁶ *Cochrane v. Commissioner*, 23 B.T.A. 202 (1931).

¹⁶⁰⁷ Rev. Rul. 78-141, 1978-1 C.B. 58. *Compare* §165(a).

sioner,¹⁶²⁷ the court allowed a §162 deduction for the cost of replacing the teeth of an actor who lost them in filming a boxing movie.¹⁶²⁸ In Rev. Rul. 75-316,¹⁶²⁹ the IRS, although it disagrees with the *Denny* decision,¹⁶³⁰ ruled that the expense of readers used by blind persons in practicing their professions is deductible under §162.¹⁶³¹

Note: Medical expenses disallowed as §162 expenses generally qualify for deduction as §213 medical expenses, subject to a limitation based on adjusted gross income. The §213 medical expense deduction and the limitation are discussed in 513 T.M., *Family and Household Transactions*.

M. Dues, Memberships, and Certifications

1. In General

Dues and other payments to an organization, such as a labor union or trade association, that meet the requirements of §162, are deductible.¹⁶³² Deductible dues include membership fees paid to a chamber of commerce¹⁶³³ or board of trade,¹⁶³⁴ trade association dues paid by brewers¹⁶³⁵ and liquor dealers,¹⁶³⁶ realtors' multiple listing association dues,¹⁶³⁷ stock exchange dues,¹⁶³⁸ and stock exchange assessments paid by stock exchange specialists.¹⁶³⁹

For tax years beginning after 2017, the disallowance of miscellaneous itemized deductions means that job-related trade and business expenses incurred by an employee that are not reimbursed by the employer (such as bar dues and other professional organization dues) are not deductible by an employee.¹⁶⁴⁰

No deduction is allowed for membership fees in clubs organized for business, pleasure, recreation, or other social purpose.¹⁶⁴¹ These types of clubs include country clubs, golf and athletic clubs, business luncheon clubs and airline and hotel clubs, but generally they do not include professional organizations such as bar and medical associations or civic or public service organizations such as Kiwanis, Lions, Rotary, or similar organizations.¹⁶⁴² If a principal purpose of the organization to which dues are paid is to conduct entertainment activities for

members or their guests or to provide members or their guests with access to entertainment facilities, then the organization is classified as organized for business, pleasure, recreation, or other social purposes.¹⁶⁴³

Even though amounts paid to an organization to obtain, renew, renegotiate, or upgrade a membership or privilege from that organization must be capitalized, the taxpayer is not required to capitalize amounts paid to obtain, renew, renegotiate, or upgrade certification of the taxpayer's products, services or business processes, such as an amount paid by an automobile manufacturer to a national quality ratings association to obtain a safety and quality rating for its automobiles.¹⁶⁴⁴ The IRS has ruled that costs incurred to obtain, maintain, or renew certification from the International Organization for Standardization are deductible under §162 because the benefits derived from certification are similar to benefits derived from advertising, training, and similar deductible expenditures.¹⁶⁴⁵ The capitalization limitation is discussed in 509 T.M., *Principles of Capitalization*.

2. Capital Expenditures

No deduction is allowed for dues paid to stock exchanges that are used for capital expenditures.¹⁶⁴⁶ Initiation fees, paid only once and paid in addition to annual dues, must be capitalized as part of the cost of acquiring the membership.¹⁶⁴⁷

Thus, payment of a stock exchange initiation fee to acquire a beneficial interest in a seat in which the taxpayer had a nominal interest was not deductible because it was for the acquisition of an asset providing benefits for more than one year.¹⁶⁴⁸ The same result has been reached with respect to admission fees paid by banks to clearing house associations.¹⁶⁴⁹ However, a deduction has been allowed for a stock exchange fee paid for the privilege of transferring a partnership's exchange seats from the name of a deceased partner to the name of a living partner.¹⁶⁵⁰

The capitalization limitation is discussed in 509 T.M., *Principles of Capitalization*.

3. Investments

No deduction is allowed under §162 for dues paid to stock and commodity exchanges in which seats are held as investments.¹⁶⁵¹ However, a deduction is allowed under §212 if the expense is ordinary and necessary and the investment is held for the production of income.¹⁶⁵²

¹⁶²⁷ 33 B.T.A. 738 (1935), *nonacq.*, 1936 C.B. 30.

¹⁶²⁸ *Id.* at 743.

¹⁶²⁹ 1975-2 C.B. 54.

¹⁶³⁰ 1936 C.B. 30.

¹⁶³¹ Rev. Rul. 75-316. See also Rev. Rul. 75-317, 1975-2 C.B. 57.

¹⁶³² Reg. §1.162-15(c).

¹⁶³³ *Smith-Bridgman & Co. v. Commissioner*, 16 T.C. 287 (1951).

¹⁶³⁴ *Emery, Bird, Thayer Dry Goods Co. v. Commissioner*, 20 B.T.A. 796 (1930).

¹⁶³⁵ *Best Brewery Co. v. Commissioner*, 16 B.T.A. 1354 (1929); *Indep. Brewing Co. of Pittsburgh v. Commissioner*, 4 B.T.A. 870 (1926).

¹⁶³⁶ *LeSage v. Commissioner*, 6 T.C.M. 1263 (1947), *rev'd* on other issues, 173 F.2d 826 (5th Cir. 1949).

¹⁶³⁷ *Haseltine v. Commissioner*, 38 T.C.M. 1259 (1979).

¹⁶³⁸ *Whitney v. Commissioner*, 73 F.2d 589 (3d Cir. 1934); *Robertson v. Commissioner*, 1 B.T.A. 501 (1925).

¹⁶³⁹ *Lowell v. Commissioner*, 30 B.T.A. 1297 (1934).

¹⁶⁴⁰ See §67(h).

¹⁶⁴¹ §274(a)(3).

¹⁶⁴² Reg. §1.274-2(a)(2)(iii)(a).

¹⁶⁴³ Reg. §1.274-2(a)(2)(iii)(b).

¹⁶⁴⁴ Reg. §1.263(a)-4(d).

¹⁶⁴⁵ Rev. Rul. 2000-4.

¹⁶⁴⁶ *Whitney v. Commissioner*, 73 F.2d 589 (3d Cir. 1934).

¹⁶⁴⁷ Rev. Rul. 77-354. See *Bradley v. Commissioner*, 41 B.T.A. 153 (1940).

¹⁶⁴⁸ *Harman v. Commissioner*, 72 T.C. 362 (1979).

¹⁶⁴⁹ *Grace Nat'l Bank of N.Y. v. Commissioner*, 15 T.C. 563 (1950), *aff'd*, 189 F.2d 966 (2d Cir. 1951).

¹⁶⁵⁰ *Lehman v. Commissioner*, 11 B.T.A.M. 1380 (1942).

¹⁶⁵¹ *Hyman v. Commissioner*, 44 B.T.A. 1122 (1941).

¹⁶⁵² §212(2); Reg. §1.212-1(g).

4. Insurance

In a 1986 ruling, the IRS ruled that a commodities trader is not allowed to deduct amounts required to be paid to the commodities exchange to fund death benefits payable to the trader's beneficiaries.¹⁶⁵³ Prior to this ruling, the IRS and one court had held that such payments were deductible.¹⁶⁵⁴

Comment: The rationale for the IRS's reversal of its pre-1986 position was that the death benefits constituted life insurance, which provides a personal, rather than business-related, benefit to the trader's beneficiaries, and that the amounts paid for the insurance therefore are nondeductible personal expenditures.

In contrast, in TAM 200517030, the IRS concluded that an insurance company was allowed to deduct a nonrefundable initial assessment payment to a state catastrophic loss fund set up after a previous catastrophe. The insurance company was required either to make the payment or provide coverage for losses caused by catastrophe. The IRS noted that the payment was not refundable, the insurance company did not obtain any transferable interest in the fund, no separate account for the insurance company was maintained by the fund, no interest was credited to the insurance company for the amount paid to the fund and the insurance company did not acquire an asset or create a significant future benefit by making the payment.

N. Payments for Professional Services

1. Accounting Fees

Deductions under §162 are allowed for fees paid to accountants for services in connection with the carrying on of a trade or business.¹⁶⁵⁵ They are allowed under §212 for fees paid to accountants for services in connection with the production or collection of income or the holding of property for the production of income.¹⁶⁵⁶

The accountants' services for which the deduction is allowed include fees paid for the audit of the taxpayer's business books,¹⁶⁵⁷ for tax consultation in connection with the trade or business¹⁶⁵⁸ and for preparation of tax returns for the trade or business.¹⁶⁵⁹ They also include cost accounting analyses relating to the preparation of government contract bids,¹⁶⁶⁰ accounting analyses used in making a bankruptcy claim¹⁶⁶¹ or seeking

¹⁶⁵³ Rev. Rul. 86-80, *revoking* Rev. Rul. 70-342.

¹⁶⁵⁴ Rev. Rul. 70-342; *Whitney v. Commissioner*, 73 F.2d 589 (3d Cir. 1934).

¹⁶⁵⁵ *E.g., Malone & Hyde, Inc. v. United States*, 568 F.2d 474 (6th Cir. 1978).

¹⁶⁵⁶ §212(1) and §212(2); Reg. §1.212-1(g). *E.g., Goodman v. Commissioner*, 5 T.C.M. 1126 (1946), *aff'd* on other issues *sub nom., Heyman v. Commissioner*, 176 F.2d 389 (2d Cir. 1949), *cert. denied*, 338 U.S. 904 (1949); *Estate of Milner v. Commissioner*, 1 T.C.M. 513 (1943).

¹⁶⁵⁷ *Hightower v. Commissioner*, 8 T.C.M. 1003 (1949), *aff'd* on other issues, 187 F.2d 535 (5th Cir. 1951); *Wolkowitz v. Commissioner*, 8 T.C.M. 754 (1949); *Richardson v. Commissioner*, 1 T.C.M. 440 (1943).

¹⁶⁵⁸ *Byerlein v. Commissioner*, 13 T.C. 1085 (1949); *Hightower v. Commissioner*, 8 T.C.M. 1003 (1949), *aff'd* on other issues, 187 F.2d 535 (5th Cir. 1951).

¹⁶⁵⁹ *Frankland Racing Equip., Inc. v. Commissioner*, 53 T.C.M. 658 (1987); *Hightower v. Commissioner*, 8 T.C.M. 1003 (1949), *aff'd* on other issues, 187 F.2d 535 (5th Cir. 1951).

¹⁶⁶⁰ *Kamen Soap Prods. Co. v. Commissioner*, 15 T.C.M. 777 (1956); *Wolkowitz v. Commissioner*, 8 T.C.M. 754 (1949).

return of a performance bond¹⁶⁶² and preparation of statements of account.¹⁶⁶³ Deductions are allowed for fees paid to accountants to install an accounting system¹⁶⁶⁴ or to open a new set of books,¹⁶⁶⁵ but the taxpayer has the burden of proving the portion of the fee allocable to those services.¹⁶⁶⁶

2. Business Advice

Deductions under §162 are allowed for fees paid to professionals for their services with respect to a trade or business being carried on by the taxpayer.¹⁶⁶⁷ The services for which the deduction is allowed include advice with respect to changing accounting periods,¹⁶⁶⁸ changing the form in which business is conducted,¹⁶⁶⁹ adding new members to a partnership,¹⁶⁷⁰ incorporating a partnership,¹⁶⁷¹ tax consequences of trade or business transactions,¹⁶⁷² the feasibility and wisdom of making loans to specific customers¹⁶⁷³ and operating and management decisions in connection with the trade or business.¹⁶⁷⁴

In *Evens & Howard Fire Brick Co. v. Commissioner*,¹⁶⁷⁵ the court held that fees paid to efficiency engineers to increase the taxpayer's production while decreasing costs was deductible, even though the taxpayer, because of the interplay of the fees with other tax attributes, contended that they were capital expenditures.¹⁶⁷⁶ However, in another case involving the same taxpayer for a different tax year,¹⁶⁷⁷ the Eighth Circuit held that the fees were not deductible but were capital expenditures.¹⁶⁷⁸

3. Investment Advice

A business may deduct fees paid to professionals for investment advice under §162.

For tax years beginning before 2018, deductions are allowed under §212 for fees paid to professionals for their services in connection with the production or collection of income or the holding of property for the production of income.¹⁶⁷⁹ The services for which the deduction is allowed include providing

¹⁶⁶¹ *Miles Prod. Co. v. Commissioner*, 28 T.C.M. 1387 (1969), *aff'd* on other issues, 457 F.2d 1150 (5th Cir. 1972).

¹⁶⁶² *Smith v. Commissioner*, 68 T.C.M. 1538 (1994).

¹⁶⁶³ *Arc Realty Co. v. Commissioner*, 34 T.C. 484 (1960), *aff'd* in part and *rev'd* in part on other issues, 295 F.2d 98 (8th Cir. 1961).

¹⁶⁶⁴ *Schlosser Bros., Inc. v. Commissioner*, 2 B.T.A. 137 (1925).

¹⁶⁶⁵ *N. Star Granite Corp. v. Commissioner*, 21 B.T.A. 222 (1930).

¹⁶⁶⁶ *See United Carbon Co. v. Commissioner*, 32 B.T.A. 1000 (1935), *rev'd* on other issues, 90 F.2d 43 (4th Cir. 1937).

¹⁶⁶⁷ *E.g., Fumigators, Inc. v. Commissioner*, 31 T.C.M. 29 (1972).

¹⁶⁶⁸ *Meldrum & Fewsmith, Inc. v. Commissioner*, 20 T.C. 790 (1953), *aff'd* on other issues, 230 F.2d 283 (6th Cir. 1956).

¹⁶⁶⁹ *Id.*

¹⁶⁷⁰ *Parker v. Commissioner*, 6 T.C. 974 (1946).

¹⁶⁷¹ *Id.*

¹⁶⁷² *Byerlein v. Commissioner*, 13 T.C. 1085 (1949).

¹⁶⁷³ *PNC Bancorp v. Commissioner*, 212 F.3d 822 (3d Cir. 2000), *rev'g* 110 T.C. 349 (1998) (credit screening, property reports, and appraisals).

¹⁶⁷⁴ *Anderson v. Commissioner*, 8 T.C.M. 740 (1949).

¹⁶⁷⁵ 8 B.T.A. 867 (1927).

¹⁶⁷⁶ *Id.* at 877.

¹⁶⁷⁷ *Becker v. Evens & Howard Sewer Pipe Co.*, 70 F.2d 596 (8th Cir. 1934).

¹⁶⁷⁸ *Id.* at 598-99.

¹⁶⁷⁹ §212; Reg. §1.212-1(g). For tax years beginning after 2017, §67(h) eliminates the deductibility of §212 expenses, with the exception of expenses to manage real estate and certain trust and estate expenses, which are deductible above the line.

information on recommended purchases, retentions, and sales of investments,¹⁶⁸⁰ custodian and income collection charges,¹⁶⁸¹ financial counseling,¹⁶⁸² estate planning with respect to the re-arrangement of the taxpayer's investments,¹⁶⁸³ guidance on entering into transactions to protect investments¹⁶⁸⁴ and advice regarding potential hostile takeovers.¹⁶⁸⁵

Note: The subsequently adopted requirement in Reg. §1.263(a)-5(a), that amounts paid or incurred to facilitate an acquisition of a trade or business or to change the capital structure of a business entity must be capitalized, does not apply to amounts paid or incurred to defend against a hostile takeover until and unless the target agrees to the takeover.¹⁶⁸⁶

The deduction is allowed even if the taxpayer does not follow the advice.¹⁶⁸⁷

For tax years beginning after 2017, the disallowance of miscellaneous itemized deductions means that expenses for investment advice generally are not deductible as a miscellaneous itemized deduction (but may be deductible in connection with an activity reported on Schedule E or business income reported on Schedule C).¹⁶⁸⁸

4. Corporation Services

Deductions under §162 are allowed for fees paid by corporations to corporation representation agencies to comply with state law requirements that a corporate office be maintained in the state of incorporation.¹⁶⁸⁹

Fees paid to stock exchanges for maintaining a corporation's listing with the exchange are deductible.¹⁶⁹⁰ However, the initial cost of listing the stock on the exchange is not deductible and must be capitalized.¹⁶⁹¹ Fees paid to stock transfer agents and stock registrars for maintenance of capital stock records are deductible provided they are not related to an original issue of stock, a merger, a consolidation or a stock dividend.¹⁶⁹²

Note: The subsequently adopted requirement in Reg. §1.263(a)-5(a), that amounts paid or incurred to facilitate an acquisition of a trade or business or to change the capital structure of a business entity must be capitalized, does not apply to registrar and transfer agent fees for the maintenance of capital

¹⁶⁸⁰ *E.g., Williams v. Commissioner*, 3 T.C. 200 (1944), *acq.*, 1944 C.B. 30; *Mallinckrodt v. Commissioner*, 2 T.C. 1128 (1943), *aff'd*, 146 F.2d 1 (8th Cir. 1945), *cert. denied*, 324 U.S. 781 (1945), *acq.*, 1944 C.B. 18; *Dolin v. Commissioner*, 54 T.C.M. 1448 (1988).

¹⁶⁸¹ *Herbst v. Commissioner*, 2 T.C.M. 361 (1943).

¹⁶⁸² Rev. Rul. 73-13.

¹⁶⁸³ *Bagley v. Commissioner*, 8 T.C. 130 (1947), *acq.*, 1947-1 C.B. 5.

¹⁶⁸⁴ *E.g., Bagley v. Commissioner*, 8 T.C. 130 (1947), *acq.*, 1947-1 C.B. 5; *Straub v. Granger*, 143 F. Supp. 250 (W.D. Pa. 1956).

¹⁶⁸⁵ *Pope & Talbot Inc. v. Commissioner*, 73 T.C.M. 2229 (1997), *supp.*, 74 T.C.M. 471 (1997), *aff'd*, 172 F.3d 874 (9th Cir. 1999). See *A.E. Staley Mfg. Co. & Subs. v. Commissioner*, 119 F.3d 482 (7th Cir. 1997), *rev'g* and *rem'g* 105 T.C. 166 (1995) (advice and printing services in response to hostile takeover bid).

¹⁶⁸⁶ Reg. §1.263(a)-5(l) Ex. 11.

¹⁶⁸⁷ *Picker v. United States*, 371 F.2d 486 (Ct. Cl. 1967) (*per curiam*).

¹⁶⁸⁸ See §67(h).

¹⁶⁸⁹ *Stires Corp. v. Commissioner*, 28 B.T.A. 1 (1933).

¹⁶⁹⁰ *Chesapeake Corp. of Va. v. Commissioner*, 17 T.C. 668 (1951).

¹⁶⁹¹ *Gulf, Mobile & N. R.R. Co. v. Commissioner*, 22 B.T.A. 233 (1931), *aff'd* on other issues, 71 F.2d 953 (D.C. Cir. 1934); *Dome Mines, Ltd. v. Commissioner*, 20 B.T.A. 377 (1930).

¹⁶⁹² Rev. Rul. 69-615, 1969-2 C.B. 26.

stock records unless the amount is paid with respect to a stock issuance or similar transaction.¹⁶⁹³

The cost of filing employee stock option semiannual reports with the SEC is deductible under §162.¹⁶⁹⁴ However, expenses of preparing and filing post-effective amendments to SEC registration statements are a cost of raising capital and are nondeductible capital expenditures.¹⁶⁹⁵

5. Appraisal Fees

Deductions under §162 are allowed for fees paid to appraisers for making valuations or estimates of business assets in connection with the carrying on of a trade or business.¹⁶⁹⁶ They are allowed under §212 for fees paid to appraisers for services in connection with the production or collection of income or the holding of property for the production of income.¹⁶⁹⁷

Appraisal fees are deductible whether needed for auditing, income tax or borrowing purposes.¹⁶⁹⁸ The cost of estimating the extent of oil and gas reserves is deductible if the uncertain useful life of the survey precludes amortization and if capitalization would distort income.¹⁶⁹⁹

However, the cost of appraising the value of the stock of shareholders objecting to a merger must be capitalized as part of the cost of acquiring that stock regardless of the corporation's purpose, the manner in which title passes, the method of determining price or the time title passes.¹⁷⁰⁰

6. Actuarial Fees

Deductions under §162 are allowed for actuarial fees paid by the taxpayer in connection with the carrying on of a trade or business.¹⁷⁰¹ They are allowed under §212 for fees paid to actuaries for services in connection with the production or collection of income or the holding of property for the production of income.¹⁷⁰²

7. Business Services

Fees paid for management services are deductible if reasonable and paid pursuant to a bona fide contract between the taxpayer and another, separate entity.¹⁷⁰³ Amounts paid to related parties in excess of reasonable arm's-length rates are not deductible.¹⁷⁰⁴ Management fees in connection with long-term agreements must be capitalized and amortized over the length of the agreement.¹⁷⁰⁵ The same principle applies to fees paid

¹⁶⁹³ Reg. §1.263(a)-5(c)(7).

¹⁶⁹⁴ Rev. Rul. 65-13, 1965-1 C.B. 87.

¹⁶⁹⁵ *Affiliated Capital Corp. & Subs. v. Commissioner*, 88 T.C. 1157 (1987).

¹⁶⁹⁶ *Compare Evans v. Commissioner*, 33 T.C.M. 1192 (1974), *supp.*, 34 T.C.M. 783 (1975), *aff'd* on other issues, 557 F.2d 1095 (5th Cir. 1977).

¹⁶⁹⁷ §212; Reg. §1.212-1(g).

¹⁶⁹⁸ *S. Eng'g & Metals Corp. v. Commissioner*, 9 T.C.M. 93 (1950).

¹⁶⁹⁹ *Southland Royalty Co. v. United States*, 582 F.2d 604 (Ct. Cl. 1978), *aff'g* 77-2 USTC ¶9680 (Ct. Cl. 1977), *cert. denied*, 441 U.S. 905 (1979).

¹⁷⁰⁰ *United States v. Hilton Hotels Corp.*, 397 U.S. 580 (1970), *aff'g* 410 F.2d 194 (7th Cir. 1969), *aff'g* 285 F. Supp. 617 (N.D. Ill. 1968).

¹⁷⁰¹ *The Cardinal Corp. v. Commissioner*, 52 T.C. 119 (1969).

¹⁷⁰² §212; Reg. §1.212-1(g).

¹⁷⁰³ Reg. §1.162-7(a); *Achiro v. Commissioner*, 77 T.C. 881 (1981).

¹⁷⁰⁴ *Latham Park Manor, Inc. v. Commissioner*, 69 T.C. 199 (1977), *aff'd* in unpub. opin., No. 79-1058 (4th Cir. 1/28/80).

¹⁷⁰⁵ *Gilmartin v. Commissioner*, 47 T.C.M. 1532 (1984).

for financing services,¹⁷⁰⁶ office services,¹⁷⁰⁷ telephone answering and filing services¹⁷⁰⁸ and franchisor's services rendered to the franchisee.¹⁷⁰⁹ Management fees paid by an upper-tier partnership not engaged in a trade or business are not deductible under §162 if the fees are not paid or incurred on behalf of any lower-tier partnership in connection with its trade or business, but are deductible under §212 in connection with the upper-tier partnership's investment activities.¹⁷¹⁰

Savings and loan associations that hold Federal Home Loan Mortgage Corporation (FHLMC) mortgage participation certificates may deduct, under §162, amounts paid to the FHLMC for guarantee and management fees.¹⁷¹¹ Taxpayers who hold Government National Mortgage Association (GNMA) mortgage backed certificates in connection with carrying on their trades or businesses may deduct servicing, custodian and guarantee fees paid to the GNMA.¹⁷¹² The same principle applies to fully modified pass-through mortgage backed certificates¹⁷¹³ and to fees covering monthly service charges, late payment charges, assumptions and prepayment penalties.¹⁷¹⁴

Fees paid to speakers to address employees with respect to trade or business matters are deductible.¹⁷¹⁵ The costs of management surveys are also deductible.¹⁷¹⁶ Fees paid by a professional musician to a recording engineer are deductible.¹⁷¹⁷

8. Legal Counseling

a. In General

Deductions under §162 are allowed for legal fees paid in obtaining legal advice with respect to the taxpayer's trade or business.¹⁷¹⁸ They are allowed under §212 for legal fees paid in connection with the production or collection of income, the holding of property for the production of income or the determination, collection or refund of any tax.¹⁷¹⁹

The deductibility of legal counselling fees is described in IV.N.8.b. and IV.N.8.c., below, and is discussed in 523 T.M., *Deductibility of Legal and Other Professional Fees*.

Legal services for which a deduction is allowed include giving advice with respect to government investigations of sales by the taxpayer,¹⁷²⁰ representation at SEC proceedings to enjoin the sale of the taxpayer's stock¹⁷²¹ and the creation of employee pension trusts.¹⁷²² They also include solving working capital and credit problems,¹⁷²³ handling a final liquidation,¹⁷²⁴ but not a mere divisional reorganization,¹⁷²⁵ giving advice to the taxpayer's clients on behalf of the taxpayer¹⁷²⁶ and managing the taxpayer's investments.¹⁷²⁷

In *Salt v. Commissioner*,¹⁷²⁸ the Tax Court allowed a deduction for fees paid by a movie script writer for legal advice in connection with his appearance as a witness before a Congressional committee investigating alleged communist infiltration into the movie industry. The deduction was allowed because the investigation affected the entire industry and the taxpayer's employment therein and could have resulted in the blacklisting of the taxpayer.¹⁷²⁹

b. Personal Matters

No deduction is allowed with respect to legal advice in connection with personal matters,¹⁷³⁰ even if related to the trade or business or the property held for the production of income.¹⁷³¹ If the legal fees cannot be allocated between business and personal services, no deduction is allowed.¹⁷³²

c. Acquisition of Property

No deduction is allowed with respect to legal fees incurred in obtaining advice regarding the purchase of property, because the fees must be capitalized as part of the cost of the property.¹⁷³³ Likewise, legal fees paid in connection with the renewal of licenses that are capital assets must be capitalized.¹⁷³⁴ No deduction is allowed for legal services in connection with organization of a business.¹⁷³⁵ The capitalization limitation is discussed in 509 T.M., *Principles of Capitalization*.

¹⁷⁰⁶ See *Foster v. Commissioner*, 25 T.C.M. 1390 (1966), aff'd in part and rev'd in part on other issues sub nom., *Likins-Foster Honolulu Corp. v. Commissioner*, 417 F.2d 285 (10th Cir. 1969), cert. denied, 397 U.S. 987 (1970); *Nielson v. United States*, 212 F. Supp. 801 (M.D. Tenn. 1962), aff'd in part and rev'd in part on other issues, 333 F.2d 615 (6th Cir. 1964).

¹⁷⁰⁷ *Wynnefield Heights, Inc. v. Commissioner*, 25 T.C.M. 953 (1966).

¹⁷⁰⁸ *Dollard v. Commissioner*, 53 T.C.M. 1335 (1987).

¹⁷⁰⁹ Rev. Rul. 80-141, 1980-1 C.B. 111.

¹⁷¹⁰ Rev. Rul. 2008-39.

¹⁷¹¹ Rev. Rul. 71-399, 1971-2 C.B. 433, amplified by, Rev. Rul. 72-376, 1972-2 C.B. 647. See generally Rev. Rul. 80-96, 1980-1 C.B. 317; Rev. Rul. 74-300, 1974-1 C.B. 169; Rev. Rul. 74-221, 1974-1 C.B. 365.

¹⁷¹² Rev. Rul. 70-544, 1970-2 C.B. 6, clarified, Rev. Rul. 84-10, 1984-1 C.B. 155, modified on another issue, Rev. Rul. 74-169, 1974-1 C.B. 147.

¹⁷¹³ Rev. Rul. 70-545, 1970-2 C.B. 7, clarified, Rev. Rul. 84-10, 1984-1 C.B. 155, modified on another issue, Rev. Rul. 74-169, 1974-1 C.B. 147.

¹⁷¹⁴ Rev. Rul. 84-10, 1984-1 C.B. 155.

¹⁷¹⁵ *Lewis-Hall Iron Works v. Commissioner*, 2 B.T.A. 788 (1925).

¹⁷¹⁶ *Goodwyn Crockery Co. v. Commissioner*, 37 T.C. 355 (1961), aff'd on other issues, 315 F.2d 110 (6th Cir. 1963).

¹⁷¹⁷ *Genck v. Commissioner*, 75 T.C.M. 1984 (1998).

¹⁷¹⁸ E.g., *Levenson and Klein, Inc. v. Commissioner*, 67 T.C. 694 (1977); *Alisobhani v. Commissioner*, 68 T.C.M. 1493 (1994); *Kennedy v. Commissioner*, 60 T.C.M. 456 (1990); *Miles Prod. Co. v. Commissioner*, 28 T.C.M. 1387 (1969), aff'd on other issues, 457 F.2d 1150 (5th Cir. 1972).

¹⁷¹⁹ §212; Reg. §1.212-1(g), Reg. §1.212-1(i); *Milner v. Commissioner*, 1 T.C.M. 513 (1943).

¹⁷²⁰ *Cardinal Corp. v. Commissioner*, 52 T.C. 119 (1969).

¹⁷²¹ *Rodman v. Commissioner*, 32 T.C.M. 1307 (1973), aff'd on other issues, 542 F.2d 845 (2d Cir. 1976). See *Peters, Gamm, W. & Vincent, Inc. v. Commissioner*, 71 T.C.M. 2789 (1996).

¹⁷²² *Meldrum & Fewsmith, Inc. v. Commissioner*, 20 T.C. 790 (1953), aff'd on other issues, 230 F.2d 283 (6th Cir. 1956).

¹⁷²³ *Id.*

¹⁷²⁴ *Claussen's Inc. v. United States*, 71-2 USTC ¶9632 (S.D. Ga. 1971), rev'd on other issues, 469 F.2d 340 (5th Cir. 1972).

¹⁷²⁵ *Bilar Tool & Die Corp. v. Commissioner*, 530 F.2d 708 (6th Cir. 1976), rev'g 62 T.C. 213 (1974). See also Reg. §1.263(a)-5.

¹⁷²⁶ *Levy v. Commissioner*, 30 T.C. 1315 (1958).

¹⁷²⁷ *Herbst v. Commissioner*, 2 T.C.M. 361 (1943).

¹⁷²⁸ 18 T.C. 182 (1952).

¹⁷²⁹ *Id.* at 185-86.

¹⁷³⁰ E.g., *Mathews v. Commissioner*, 61 T.C. 12 (1973), rev'd on other issues, 520 F.2d 323 (5th Cir. 1975), cert. denied, 424 U.S. 967 (1976).

¹⁷³¹ Reg. §1.212-1(f). See, e.g., *Jack's Maint. Contractors, Inc. v. Commissioner*, 703 F.2d 154 (5th Cir. 1983), rev'g 42 T.C.M. 330 (1981); *Johnson v. Commissioner*, 37 T.C.M. 1645 (1978).

¹⁷³² E.g., *Jordan v. Commissioner*, 12 B.T.A. 423 (1928); *Estate of Pennell v. Commissioner*, 4 B.T.A. 1039 (1926).

¹⁷³³ Reg. §1.212-1(n). See, e.g., *Atzingen-Whitehouse Dairy, Inc. v. Commissioner*, 36 T.C. 173 (1961), acq., 1976-2 C.B. 3; *Douglas Coal Co. v. United States*, 429 F. Supp. 322 (D. W. Va. 1977).

¹⁷³⁴ *Spain v. Commissioner*, 37 T.C.M. 1158 (1978).

¹⁷³⁵ *Durkin v. Commissioner*, 87 T.C. 1329 (1986), aff'd, 872 F.2d 1271 (7th Cir. 1989), cert. denied, 493 U.S. 824 (1989).

9. Litigation Fees and Expenses

a. In General

Litigation fees and expenses are deductible under §162 if they have their origin in the taxpayer's carrying on of a trade or business.¹⁷³⁶ They are deductible under §212 if paid or incurred in the collection of income¹⁷³⁷ or if they have their origin in management of property held for the production of income.¹⁷³⁸

Application of this "origin of the claim" test requires a factual analysis of the circumstances of the litigation.¹⁷³⁹ Generally, litigation fees and expenses paid or incurred in collecting business income are deductible,¹⁷⁴⁰ as are litigation fees and expenses paid or incurred in resolving the division of partnership profits.¹⁷⁴¹ In contrast, litigation fees and expenses paid or incurred in obtaining or defending ownership are not deductible.¹⁷⁴²

Legal fees related to a settlement or payment related to sexual harassment or sexual abuse are not deductible if such settlement or payment are subject to a nondisclosure agreement.¹⁷⁴³

The deductibility of litigation fees and expenses are described in IV.N.9.b. through IV.N.9.d., below, and are discussed in 523 T.M., *Deductibility of Legal and Other Professional Fees*.

b. Collection or Generation of Income

Amounts paid by an oil and gas company in connection with litigation over the proper computation of royalty income are deductible.¹⁷⁴⁴ So, too, are legal fees paid with respect to collections, judgments and suits unrelated to property acquisition.¹⁷⁴⁵ Litigation costs incurred in recovering punitive damages for the defendant's breach of a contract with the taxpayer's sole proprietorship are deductible.¹⁷⁴⁶ Legal fees paid in settling litigation regarding the termination of a security trading arrangement are deductible under §212.¹⁷⁴⁷ Legal fees paid to

secure production of income and distributions from a former spouse's §401(k) plan are deductible under §212.¹⁷⁴⁸

Legal fees paid to enjoin the enforcement of post office orders barring the taxpayer's advertising from the mails are deductible.¹⁷⁴⁹ Amounts paid by taxpayers to prosecute libel suits primarily for protection of their incomes derived from carrying on a trade or business are deductible under §162.¹⁷⁵⁰

Legal fees and expenses paid or incurred in contesting tax liabilities regarding trade or business property are deductible under §162.¹⁷⁵¹ Legal fees and expenses paid or incurred in contesting other tax liabilities are deductible under §212.¹⁷⁵²

c. Connected to Trade or Business

Litigation fees and expenses paid in connection with personal matters are not deductible under §162.¹⁷⁵³ Thus, legal fees arising from litigation with the condominium association for the development in which the taxpayer lived were held nondeductible because they involved alleged overcharges by the association and allegations of its property mismanagement.¹⁷⁵⁴ Similarly, legal fees and expenses paid by a sole proprietor to recover punitive damages for the defendant's breach of contract were deductible because the contract related solely to the proprietorship business.¹⁷⁵⁵ No deduction is allowed for lawsuits arising out of personal endeavors¹⁷⁵⁶ or from a taxpayer's activities as a volunteer.¹⁷⁵⁷ Bankruptcy fees have been held deductible to the extent that the bankruptcy was proximately caused by the failure of the taxpayer's business and the taxpayer's debts were almost entirely attributable to operation of the business.¹⁷⁵⁸

Legal fees paid in connection with the taxpayer's cost of defending allegations of breach of fiduciary duty are personal expenses and are not deductible,¹⁷⁵⁹ unless the breach clearly originates in a business context,¹⁷⁶⁰ such as administration of a pension plan.¹⁷⁶¹ Legal expenses of defending criminal charges are personal,¹⁷⁶² even if conviction would be detrimental to the

¹⁷³⁶ *United States v. Gilmore*, 372 U.S. 39 (1963); *Guill v. Commissioner*, 112 T.C. 325 (1999); PLR 200127022; PLR 9612005.

¹⁷³⁷ Reg. §1.212-1(k). E.g., *Goodman v. Commissioner*, 9 T.C.M. 789 (1950), aff'd on other issues, 200 F.2d 681 (2d Cir. 1953); *Goodman v. Commissioner*, 5 T.C.M. 1126 (1946), aff'd on other issues sub nom. *Heyman v. Commissioner*, 176 F.2d 389 (2d Cir. 1949), cert. denied, 338 U.S. 904 (1949).

¹⁷³⁸ E.g., *Waldheim v. Commissioner*, 25 T.C. 839 (1956), aff'd on other issues, 244 F.2d 1 (7th Cir. 1957), acq., 1956-2 C.B. 2; *Sergievsky v. McNamara*, 135 F. Supp. 233 (S.D.N.Y. 1955). See also *Alexander v. IRS*, 72 F.3d 938 (1st Cir. 1995) (legal fees for breach of employment contract suit against former employer only deductible as miscellaneous itemized deduction rather than trade or business expense); TAM 9728002 (legal and accounting fees of limited partner in suit against general partner are §212 expenses).

¹⁷³⁹ See, e.g., *McKeague v. United States*, 788 F.2d 755 (Fed. Cir. 1986), on remand, 11 Cl. Ct. 342 (1986), 12 Cl. Ct. 671 (1987).

¹⁷⁴⁰ E.g., *Crocker v. Commissioner*, 27 B.T.A. 588 (1933).

¹⁷⁴¹ E.g., *Kornhauser v. United States*, 276 U.S. 145 (1928), rev'g 62 Ct. Cl. 647 (1926); *Leidesdorf v. Commissioner*, 26 B.T.A. 881 (1932).

¹⁷⁴² Reg. §1.212-1(k); See, e.g., *Estate of Cole v. Commissioner*, 32 T.C.M. 313 (1973). See also *Dower v. United States*, 668 F.2d 264 (7th Cir. 1981), aff'g 80-2 USTC ¶9784 (N.D. Ill. 1980).

¹⁷⁴³ §162(q).

¹⁷⁴⁴ *Southland Royalty Co. v. United States*, 582 F.2d 604 (Ct. Cl. 1978), aff'g 77-2 USTC ¶9680 (Ct. Cl. 1977), cert. denied, 441 U.S. 905 (1979).

¹⁷⁴⁵ *Douglas Coal Co. v. United States*, 429 F. Supp. 322 (D. W. Va. 1977).

¹⁷⁴⁶ *Guill v. Commissioner*, 112 T.C. 325 (1999).

¹⁷⁴⁷ *58th St. Plaza Theatre, Inc. v. Commissioner*, 16 T.C. 469 (1951), aff'd on other issues, 195 F.2d 724 (2d Cir. 1952), cert. denied, 344 U.S. 820 (1952), acq., 1952-1 C.B. 4.

¹⁷⁴⁸ *Seidel v. Commissioner*, 89 T.C.M. 972 (2005).

¹⁷⁴⁹ *Commissioner v. Heininger*, 320 U.S. 467 (1943), aff'g 133 F.2d 567 (7th Cir. 1943), rev'g 47 B.T.A. 95 (1942).

¹⁷⁵⁰ *Dyer v. Commissioner*, 36 T.C. 456 (1961); *Draper v. Commissioner*, 26 T.C. 201 (1956).

¹⁷⁵¹ E.g., *Gloyd v. Commissioner*, 19 B.T.A. 966 (1930), aff'd on other issues, 63 F.2d 649 (8th Cir. 1933).

¹⁷⁵² §212(3); Reg. §1.212-1(l).

¹⁷⁵³ See *Karelas v. Commissioner*, 56 T.C.M. 832 (1988).

¹⁷⁵⁴ *Colvin v. Commissioner*, 87 T.C.M. 1094 (2004), aff'd, 122 Fed. Appx. 788 (5th Cir. 2005).

¹⁷⁵⁵ *Guill v. Commissioner*, 112 T.C. 325 (1999).

¹⁷⁵⁶ *Lewis v. Commissioner*, 253 F.2d 821 (2d Cir. 1958), aff'g 27 T.C. 158 (1956); *Kleinschmidt v. Commissioner*, 12 T.C. 921 (1949).

¹⁷⁵⁷ *Cook v. Commissioner*, 57 T.C.M. 681 (1989).

¹⁷⁵⁸ See *Catalano v. Commissioner*, 79 T.C.M. 1632 (2000), rev'd on other issues, 279 F.3d 682 (9th Cir. 2002).

¹⁷⁵⁹ *Kurkjian v. Commissioner*, 65 T.C. 862 (1976).

¹⁷⁶⁰ E.g., *B.T. Harris Corp. v. Commissioner*, 30 T.C. 635 (1958), acq., 1958-2 C.B. 5; *Butler v. Commissioner*, 17 T.C. 675 (1951).

¹⁷⁶¹ PLR 9807028, PLR 9746039, PLR 9507030 (business deduction allowed for payments in settlement of breach of fiduciary duty in pension plan administration); PLR 200241046 (restorative payments to pension plan).

¹⁷⁶² E.g., *Estate of Trott v. Commissioner*, 28 T.C.M. 74 (1969); *Capital Video Corp. v. Commissioner*, 311 F.3d 458 (1st Cir. 2002). See *Blodgett v.*

taxpayer's trade or business,¹⁷⁶³ unless the charges arise out of the taxpayer's legal trade or business.¹⁷⁶⁴ Legal fees paid in connection with any settlement or payment related to sexual harassment or sexual abuse, if such settlement or payment is subject to a nondisclosure agreement, are not deductible.¹⁷⁶⁵

d. Acquisition or Retention of Property

Litigation fees and expenses arising from disputes over the taxpayer's acquisition of property are not deductible as they constitute a part of the cost of the property.¹⁷⁶⁶ Likewise, those arising from disposition of property are not deductible under §162 or §212 but are capital expenditures.¹⁷⁶⁷ Legal expenses arising from attempts to collect loan principal, in contrast to interest, are not deductible under §212.¹⁷⁶⁸

Expenses incurred in resolving a boundary dispute must be capitalized because they relate to the retention of title to property.¹⁷⁶⁹ Legal expenses paid in connection with the partition of inherited property must also be capitalized.¹⁷⁷⁰

O. Trade or Business and For-Profit Activity Losses

1. In General

Losses sustained during the tax year in carrying on a trade or business or in any transaction entered into for profit are deductible under §165, unless they are compensated for by insurance or otherwise.¹⁷⁷¹

Comment: Taxpayers other than individuals are allowed to deduct all losses, even if not sustained in carrying on a trade or business or transaction entered into for profit, but it is extremely infrequent that a taxpayer other than an individual would sustain such a loss. The few situations in which a corporation

is treated as not carrying on a trade or business are discussed in II.B.7.a., above. Casualty loss deductions are described in 527 T.M., *Loss Deductions*.

Bad debts are deducted, if at all, under §166, and are not deductible under §165.¹⁷⁷² Bad debt deductions are discussed in 538 T.M., *Bad Debts*.

Losses are discussed in 527 T.M., *Loss Deductions*.

2. Measurement of the Loss

The basis for computing the amount of loss allowable as a deduction is the adjusted basis provided in §1011 for determining the loss from the sale or other disposition of property.¹⁷⁷³ In determining the amount of loss actually sustained, proper adjustment must be made for any insurance or other compensation received.¹⁷⁷⁴ The IRS takes the position that proceeds from a subsequent salvage of the damaged property reduces the amount of the loss,¹⁷⁷⁵ but the Court of Claims and two Courts of Appeals have held that subsequent salvaging is a separate event with respect to which gain or loss is computed with reference to the salvage proceeds.¹⁷⁷⁶

Any FSLIC assistance received by the taxpayer with respect to any loss of principal, capital, or similar amount upon the disposition of an asset is treated as compensation for the loss.¹⁷⁷⁷ FSLIC assistance is any assistance or right to assistance with respect to a domestic building and loan association¹⁷⁷⁸ under §406(f) of the National Housing Act,¹⁷⁷⁹ §21A of the Federal Home Loan Bank Act,¹⁷⁸⁰ or any similar provision of law.¹⁷⁸¹

3. Limitations

a. Capital Losses

Losses from sales or exchanges of capital assets are allowable as deductions only to the extent allowed in §1211 and §1212 even if those losses otherwise would be fully deductible under §165.¹⁷⁸² Corporations are allowed to deduct capital losses only to the extent of capital gains.¹⁷⁸³ Taxpayers other than corporations are allowed to deduct capital losses only to the extent of capital gains increased by the lesser of \$3,000 or the

Commissioner, 86 T.C.M. 90 (2003), aff'd, 394 F.3d 1030 (8th Cir. 2005); *Kelly v. Commissioner*, 77 T.C.M. 1501 (1999); *Silberman v. Commissioner*, 40 Fed. Cl. 895 (1998).

¹⁷⁶³ *E.g.*, *Jack's Maint. Contractors, Inc. v. Commissioner*, 703 F.2d 154 (5th Cir. 1983), rev'g 42 T.C.M. 330 (1981); *Zielezinski v. Commissioner*, 53 T.C.M. 1081 (1987); *Greenway v. Commissioner*, 40 T.C.M. 24 (1980); *Patch v. Commissioner*, 39 T.C.M. 880 (1980).

¹⁷⁶⁴ *Commissioner v. Tellier*, 383 U.S. 687 (1966), aff'g 342 F.2d 690 (2d Cir. 1965), rev'g 22 T.C.M. 1062 (1963); *Transp. Mfg. & Equip. Co. of Del. v. Commissioner*, 374 F.2d 173 (8th Cir. 1967), rev'g *Riss & Co. v. Commissioner*, 23 T.C.M. 1113 (1964); *Logan Lumber Co. v. Commissioner*, 365 F.2d 846 (5th Cir. 1966), aff'g in part and rem'g in part 23 T.C.M. 735 (1964); *Parker v. Commissioner*, 365 F.2d 792 (8th Cir. 1966), cert. denied, 385 U.S. 1026 (1967), aff'g in part, rev'g in part and rem'g in part *Found. for Divine Meditation, Inc. v. Commissioner*, 24 T.C.M. 411 (1965); *Carey v. Commissioner*, 56 T.C. 477 (1971), aff'd, 460 F.2d 1259 (4th Cir. 1972), cert. denied, 409 U.S. 990 (1972); *Murphy v. Commissioner*, 39 T.C.M. 958 (1980); *Manu-Mine Research and Develop. Co. v. Commissioner*, 26 T.C.M. 1259 (1967); *Cent. Coat, Apron & Linen Serv., Inc. v. United States*, 298 F. Supp. 1201 (S.D.N.Y. 1969); Rev. Rul. 68-662, 1968-2 C.B. 69. See also *Allied-Signal, Inc. v. Commissioner*, 63 T.C.M. 2672 (1992), aff'd in unpub. opin., 54 F.3d 767 (3d Cir. 1995).

¹⁷⁶⁵ §162(q).

¹⁷⁶⁶ Reg. §1.212-1(k). See, e.g., *Redwood Empire S & L Ass'n v. Commissioner*, 628 F.2d 516 (9th Cir. 1980), aff'g 68 T.C. 960 (1977).

¹⁷⁶⁷ Reg. §1.212-1(k). See, e.g., *Madden v. Commissioner*, 514 F.2d 1149 (9th Cir. 1975), cert. denied, 424 U.S. 912 (1976), rev'g and rem'g 57 T.C. 513 (1972), *nonacq.*, 1978-1 C.B. 2.

¹⁷⁶⁸ *Miller v. Commissioner*, 80 T.C.M. 152 (2000).

¹⁷⁶⁹ *E.g.*, *Heath v. Commissioner*, 46 T.C.M. 698 (1983).

¹⁷⁷⁰ Reg. §1.212-1(k). See *Smith v. Commissioner*, 55 T.C. 133 (1970).

¹⁷⁷¹ §165(a), §165(c)(1), §165(2); Reg. §1.165-1(a), Reg. §1.165-1(e)(1), Reg. §1.165-1(e)(2).

¹⁷⁷² *Spring City Foundry Co. v. Commissioner*, 292 U.S. 182 (1934); *Betts v. Commissioner*, 62 T.C. 536 (1974).

¹⁷⁷³ §165(b); Reg. §1.165-1(c)(1). See PLR 9534023 (automobile dealership can accrue deduction under §165 for loss incurred on sale of installment note).

¹⁷⁷⁴ §165(a); Reg. §1.165-1(c)(4).

¹⁷⁷⁵ See Reg. §1.165-1(c)(4).

¹⁷⁷⁶ *Weyerhaeuser Co. & Subs. v. United States*, 92 F.3d 1148 (Fed. Cir. 1996), cert. denied, 117 S. Ct. 766 (1997), aff'g in part and rev'g in part 32 Fed. Cl. 80 (1994), *on remand*, 39 Fed. Cl. 410 (1997); *Cox v. United States*, 537 F.2d 1066 (9th Cir. 1976), vacating 371 F. Supp. 1257 (N.D. Cal. 1973); *Forward Commc'ns Corp. v. United States*, 608 F.2d 485 (Ct. Cl. 1979), remanding 78-2 USTC ¶9542 (Ct. Cl. Tr. Div. 1978).

¹⁷⁷⁷ Revenue Reconciliation Act of 1993, Pub. L. No. 103-66, §13224(a)(1), 107 Stat. 312, 485.

¹⁷⁷⁸ See §7701(a)(19).

¹⁷⁷⁹ 12 U.S.C. §1729(f) (as in effect before its repeal by Pub. L. No. 101-73, §407, 103 Stat. 363 (1989)).

¹⁷⁸⁰ 12 U.S.C. §1441(a) (1994 and Supp. II 1996).

¹⁷⁸¹ Revenue Reconciliation Act of 1993, Pub. L. No. 103-66, §13224(b), 107 Stat. 312, 485.

¹⁷⁸² §165(f); Reg. §1.165-1(c)(3).

¹⁷⁸³ §1211(a).

excess of the losses over the gains.¹⁷⁸⁴ The \$3,000 amount is reduced to \$1,500 for married individuals filing separate returns.¹⁷⁸⁵

b. Wagering Losses

For taxable years beginning after December 31, 2017, losses from wagering transactions, including any deduction otherwise allowable incurred in carrying on a transaction, are allowed only to the extent of the gains from such transactions. However, for taxable years beginning after December 31, 2025, the deduction is further limited to 90% of losses from wagering transactions.¹⁷⁸⁶ For tax years beginning before January 1, 2018, losses from wagering transactions are allowed to the extent of gains from wagering transactions without regard to any deductions.¹⁷⁸⁷ Wagering losses are discussed in 527 T.M., *Loss Deductions*.

c. Registration-Required Obligations

No deduction is allowed, under §165(a) or any other provision, for any loss sustained on any registration-required obligation unless the obligation is in registered form or the issuance of the obligation was subject to tax under §4701.¹⁷⁸⁸ A registration-required obligation is any obligation, including any obligation issued by a governmental entity, other than an obligation which is issued by a natural person, is not of a type offered to the public, and has a maturity at issue of not more than one year.¹⁷⁸⁹ The latter two exceptions do not apply if the obligations in question are of a type specified in regulations.¹⁷⁹⁰

The registration-required obligation limitation does not apply to obligations held by any person satisfying any one of the following four conditions.¹⁷⁹¹ First, the person holds the obligations in connection with a trade or business outside the United States.¹⁷⁹² Second, the person holds the obligations as a broker dealer, registered under federal or state law, for sale to customers in the ordinary course of trade or business.¹⁷⁹³ Third, the person holding the obligations complies with reporting requirements with respect to ownership, transfers, and payments as the IRS requires.¹⁷⁹⁴ Fourth, the person promptly surrenders the obligation to the issuer for the issuance of a new obligation in registered form.¹⁷⁹⁵ This exception applies only if the obligations are held under arrangements designed to assure that they are not delivered to any United States person other than one satisfying one of the first three conditions.¹⁷⁹⁶

¹⁷⁸⁴ §1211(b).

¹⁷⁸⁵ §1211(b)(1).

¹⁷⁸⁶ §165(d), as amended by the One Big Beautiful Bill Act (OBBBA), Pub. L. No. 119-21, §70114.

¹⁷⁸⁷ See former §165(d) (2017). *E.g.*, *Estate of Todisco v. Commissioner*, 46 T.C.M. 35 (1983), aff'd, vac'd and rem'd on other issues, 757 F.2d 1 (1st Cir. 1985); *Kozma v. Commissioner*, 51 T.C.M. 956 (1986); *Offutt v. Commissioner*, 16 T.C. 1214 (1951).

¹⁷⁸⁸ §165(j)(1); Reg. §1.165-12(a); Prop. Reg. §1.165-12(a), REG-125374-16, 82 Fed. Reg. 43,720 (Sept. 19, 2017).

¹⁷⁸⁹ §165(j)(2)(A) (reference to §163(f)(2)(A)); Reg. §5f.163-1(b).

¹⁷⁹⁰ See §163(f)(2)(B).

¹⁷⁹¹ §165(j)(3); Reg. §1.165-12(c).

¹⁷⁹² §165(j)(3)(A); Reg. §1.165-12(c)(1).

¹⁷⁹³ §165(j)(3)(B); Reg. §1.165-12(c)(2).

¹⁷⁹⁴ §165(j)(3)(C); Reg. §1.165-12(c)(3).

¹⁷⁹⁵ §165(j)(3)(D); Reg. §1.165-12(c)(4).

¹⁷⁹⁶ §165(j)(3); Reg. §1.165-12(c).

The rules relating to deduction of losses sustained on registration-required obligations are discussed in 527 T.M., *Loss Deductions* and 538 T.M., *Bad Debts*.

4. Timing

a. In General

A loss is allowed as a deduction under §165 only for the tax year in which the loss is sustained.¹⁷⁹⁷ A loss is treated as sustained during the tax year in which the loss occurs if it is evidenced by closed and completed transactions, fixed by identifiable events, and, with the exception of disaster losses, as described in IV.O.4.e., below, is actually sustained during the tax year.¹⁷⁹⁸

b. Reimbursement

A loss is not sustained to the extent there exists a claim for reimbursement, if there is a reasonable prospect of recovery, until the tax year during which it can be ascertained with reasonable certainty that the claimed reimbursement will not be received.¹⁷⁹⁹ Whether there is a reasonable prospect of recovery is a question of fact to be determined upon an examination of all the facts and circumstances.¹⁸⁰⁰ To the extent there is no reasonable prospect of recovery of reimbursement, the loss is sustained during the tax year in which the event causing the loss occurs.¹⁸⁰¹

c. Decline in Value

A loss is not sustained solely because the value of stock owned by the taxpayer declines in value due to market fluctuations or other similar causes.¹⁸⁰² A mere shrinkage in value, even though extensive, does not justify a §165 deduction if the stock has any recognizable value on the date claimed to be the date of the loss.¹⁸⁰³ Similar principles apply to declines in value of other securities,¹⁸⁰⁴ patent rights¹⁸⁰⁵ and tangible property.¹⁸⁰⁶

d. Theft Losses

Any loss arising from theft is treated as sustained during the tax year in which the taxpayer discovers the loss.¹⁸⁰⁷ However, the loss is not sustained to the extent there exists a claim for reimbursement, if there is a reasonable prospect of recovery, until the tax year during which it can be ascertained with

¹⁷⁹⁷ Reg. §1.165-1(d)(1).

¹⁷⁹⁸ Reg. §1.165-1(b), Reg. §1.165-1(d)(1).

¹⁷⁹⁹ Reg. §1.165-1(d)(2)(i). *E.g.*, *Motter v. Wallace*, 72 F.2d 678 (10th Cir. 1934); *Holm v. Commissioner*, 13 B.T.A. 322 (1928); *Stephenson v. Commissioner*, 13 B.T.A. 311 (1928); *Kimball v. Commissioner*, 14 T.C.M. 1011 (1955); *Wagner v. United States*, 2003-1 USTC ¶50,238 (M.D. Fla. 2003).

¹⁸⁰⁰ Reg. §1.165-1(d)(2)(i). See, e.g., *Title Guarantee Co. of Rhode Island v. Commissioner*, 10 B.T.A. 871 (1928); *Lopo v. Commissioner*, 20 T.C.M. 620 (1961).

¹⁸⁰¹ Reg. §1.165-1(d)(2)(ii).

¹⁸⁰² Reg. §1.165-4(a). *E.g.*, *Sinsky v. Commissioner*, 30 T.C.M. 1286 (1971), aff'd in unpub. opin. (3d Cir. 1973).

¹⁸⁰³ Reg. §1.165-4(a).

¹⁸⁰⁴ See Reg. §1.165-5(f).

¹⁸⁰⁵ *Consol. Window Glass Co. v. Commissioner*, 1 B.T.A. 365 (1925).

¹⁸⁰⁶ *E.g.*, *Matter of Gude Bros., Kieffer Co. v. Commissioner*, 2 B.T.A. 1029 (1925).

¹⁸⁰⁷ §165(e); Reg. §1.165-1(d)(3), Reg. §1.165-8(a)(2). *E.g.*, *Gerstell v. Commissioner*, 46 T.C. 161 (1966).

reasonable certainty that the claimed reimbursement will not be received.¹⁸⁰⁸

A theft is any criminal appropriation of another's property to the use of the taker.¹⁸⁰⁹ Thefts include, but are not necessarily limited to, larceny, embezzlement and robbery.¹⁸¹⁰ They also include theft by swindle, false pretenses and any other form of guile.¹⁸¹¹

Theft losses are discussed in 527 T.M., *Loss Deductions*.

e. Federally Declared Disaster Losses

A taxpayer may elect to deduct a loss occurring in a disaster area and attributable to a federally-declared disaster in the tax year immediately preceding the disaster year (i.e., the year preceding the tax year in which the loss occurs).¹⁸¹² If a §165(i) election is made, the casualty causing the loss is treated as having occurred in the tax year preceding the disaster year.¹⁸¹³ The amount of the disaster loss claimed under the election cannot exceed the uncompensated loss determined as of the date the taxpayer claims the loss.¹⁸¹⁴

For a further discussion of disaster losses, see 527 T.M., *Loss Deductions*.

f. Worthless Securities

If any security that is a capital asset becomes worthless¹⁸¹⁵ during the tax year, the resulting loss is treated as a loss from the sale or exchange, on the last day of the tax year, of a capital asset.¹⁸¹⁶ A security is a share of stock in a corporation,¹⁸¹⁷ a right to subscribe for or to receive a share of stock in a corporation,¹⁸¹⁸ a bond, debenture, note, certificate or other evidence of indebtedness, issued with interest coupons in registered form by a corporation or by a government or a governmental political subdivision.¹⁸¹⁹

Any security in a corporation affiliated with a taxpayer that is a domestic corporation is not treated as a capital asset.¹⁸²⁰ Special rules apply in determining whether corporations are af-

filiated for this purpose.¹⁸²¹ Losses from securities in affiliated corporations are discussed in 527 T.M., *Loss Deductions*.

g. Obsolescence of Nondepreciable Property

A loss incurred in a trade or business, in a transaction entered into for profit and arising from the sudden termination of the usefulness in the trade or business or transaction of any nondepreciable property is allowed as a deduction under §165 if the trade or business or transaction is discontinued or the property is permanently discarded from use therein.¹⁸²² The deduction is allowed in the tax year the loss is sustained, but the tax year in which the overt act of abandonment of the property or loss of title to the property occurs is not necessarily the tax year in which the loss is sustained.¹⁸²³ These principles do not apply to losses sustained from the sale or exchange of property, losses sustained upon the obsolescence or worthlessness of depreciable property, casualty losses or certain inventory losses.¹⁸²⁴

P. Net Operating Loss Deduction

Taxpayers may take a net operating loss deduction under §172 (limited to 80% of taxable income for tax years after 2020).¹⁸²⁵ An NOL arising in tax years beginning in 2018, 2019, or 2020 may be carried back for a period of five years and may be carried forward indefinitely.¹⁸²⁶ An NOL arising in tax years beginning in 2021 and later generally may not be carried back but may be carried forward indefinitely.¹⁸²⁷ The amounts carried over to a later year are adjusted to take into account the limitation.

Net operating losses, including the rules applicable to NOLs arising before 2018, are discussed further in 539 T.M., *Net Operating Losses — Concepts and Computations*.

Q. Antitrust, Infringement, and Contractual Losses

1. In General

Under §186, a taxpayer is allowed to deduct antitrust, infringement and contractual losses for a tax year if the taxpayer includes in gross income for that tax year a compensatory amount received for compensable injury.¹⁸²⁸ The amount of the deduction is the lesser of the compensatory amount included in gross income or the amount of the unrecovered losses sustained as a result of the compensable injury.¹⁸²⁹

¹⁸²¹ See §165(g)(3); Reg. §1.165-5(d)(2), Reg. §1.165-5(e), Reg. §1.165-5(g), Reg. §1.165-5(h).

¹⁸²² Reg. §1.165-2(a).

¹⁸²³ Reg. §1.165-2(a).

¹⁸²⁴ Reg. §1.165-2(b).

¹⁸²⁵ See §172(a), as amended by the CARES Act, Pub. L. No. 116-136, §2303(a)(1), effective for NOLs arising in tax years ending after December 31, 2017 and taxable years beginning on or before such date to which net operating losses arising in taxable years beginning after such date are carried.

¹⁸²⁶ §172(b)(1)(D), as amended by the CARES Act, Pub. L. No. 116-136, §2303(b)(1), effective for NOLs arising in tax years ending after December 31, 2017 and taxable years beginning on or before such date to which net operating losses arising in taxable years beginning after such date are carried.

¹⁸²⁷ See §172(b). Farming NOLs and NOLs of property and casualty insurance companies may be carried back two tax years and carried-forward 20 years.

¹⁸²⁸ §186(a); Reg. §1.186-1(a).

¹⁸²⁹ §186(a); Reg. §1.186-1(a).

¹⁸⁰⁸ Reg. §1.165-1(d)(3). *E.g.*, *Florman v. Commissioner*, 38 T.C.M. 1018 (1979).

¹⁸⁰⁹ See *Edwards v. Bromberg*, 232 F.2d 107 (5th Cir. 1956), aff'g 64-2 USTC ¶ 9525 (M.D. Ga. 1955); *Meyer v. Patterson*, 64-2 USTC ¶ 9525 (N.D. Ala. 1964).

¹⁸¹⁰ Reg. §1.165-8(d).

¹⁸¹¹ See *Edwards v. Bromberg*, 232 F.2d 107 (5th Cir. 1956), aff'g 55-1 USTC ¶ 9404 (M.D. Ga. 1955).

¹⁸¹² §165(i); Reg. §1.165-11(a), §1.165-11(b)(4), T.D. 9789, 84 Fed. Reg. 55,245 (Oct. 16, 2019). See also Rev. Proc. 2016-53 for procedures for making a §165(i) election.

¹⁸¹³ §165(i)(2); Reg. §1.165-11(c).

¹⁸¹⁴ §165(i)(3). See also *Woodall v. Commissioner*, 964 F.2d 361 (5th Cir. 1992) (partnership's loss deduction for fire damage to its nightclub limited to the adjusted basis of partnership assets shown on the Schedule L attached to its tax return).

¹⁸¹⁵ See *Boehm v. Commissioner*, 326 U.S. 287 (1945), aff'g 146 F.2d 553 (2d Cir. 1945), aff'g 2 T.C.M. 954 (1943).

¹⁸¹⁶ §165(g)(1); Reg. §1.165-5(c).

¹⁸¹⁷ §165(g)(2)(A); Reg. §1.165-5(a)(1).

¹⁸¹⁸ §165(g)(2)(B); Reg. §1.165-5(a)(2). See, e.g., *Becher v. Commissioner*, 22 T.C.M. 1251 (1963).

¹⁸¹⁹ §165(g)(2)(C); Reg. §1.165-5(a)(3). See, e.g., *Atwood Grain & Supply Co. v. Commissioner*, 60 T.C. 412 (1973); *Funk v. Commissioner*, 35 T.C. 42 (1960); *Allied Chem. Corp. v. United States*, 305 F.2d 433 (Ct. Cl. 1962).

¹⁸²⁰ §165(g)(3); Reg. §1.165-5(d)(1). See generally *W. Pac. R.R. Corp. v. W. Pac. R.R. Co.*, 85 F. Supp. 868 (N.D. Cal. 1949), aff'd on other issues, 197 F.2d 994 (9th Cir. 1951), cert. denied, 346 U.S. 910 (1953).

The deduction for antitrust, infringement, and contractual losses is described in IV.Q.2. through 5., below, and is discussed in 522 T.M., *Tax Aspects of Settlements and Judgments*.

2. Compensable Injury

There are three types of compensable injuries.¹⁸³⁰ The first is an injury sustained as a result of an infringement of a patent issued by the United States.¹⁸³¹ The second is an injury sustained as a result of a breach of contract or a breach of fiduciary duty or relationship.¹⁸³² The third is an injury sustained in business, or to property, by reason of any conduct forbidden in the antitrust laws for which a civil action may be brought under §4 of the Clayton Act¹⁸³³ by the taxpayer.¹⁸³⁴

3. Compensatory Amount

a. In General

The compensatory amount is the amount received or accrued during the tax year as damages as a result of an award in, or in settlement of, a civil action for recovery for a compensable injury, reduced by any amounts paid or incurred in the tax year in securing the award or settlement.¹⁸³⁵ Compensatory amount includes only compensation for actual economic injury, and does not include punitive, exemplary or treble damages.¹⁸³⁶ The compensatory amount does not include interest on the damages.¹⁸³⁷

b. Settlement

The compensatory amount does not include amounts received or accrued in settlement of a claim for a compensable injury if the amount is received or accrued before any action is commenced.¹⁸³⁸ An action is commenced when service of process on all defendants that pay or incur an obligation to pay a compensatory amount has been completed in accordance with the laws and rules of the court in which the action has been commenced or to which it has been removed.¹⁸³⁹ If the action for a compensable injury is settled, the specifications of the parties generally control the determination of the compensatory amount, unless the specifications are not reasonably supported by the facts and circumstances of the case.¹⁸⁴⁰ If there are no specifications, the taxpayer's complaint may be considered in determining what portion of the amount of the settlement is the compensatory amount.¹⁸⁴¹

c. Amounts to Secure the Award or Settlement

Amounts paid or incurred in securing the award or settlement include legal expenses such as attorney's fees, witness

fees, accountant fees and court costs.¹⁸⁴² Expenses incurred in securing a recovery of both a compensatory amount and other amounts from the same action must be allocated among such amounts in the ratio each of such amounts bears to the total recovery.¹⁸⁴³

4. Unrecovered Losses

a. In General

Unrecovered losses sustained as a result of a compensable injury are computed by subtracting the sum of two amounts from the sum of the net operating losses for each tax year in whole or in part within the injury period, to the extent that the net operating losses are attributable to the compensable injury.¹⁸⁴⁴ The first of the two amounts added together is the amount of the net operating losses described in the preceding sentence which were allowed for any prior tax year as a §172 deduction as a net operating loss carryback or carryover to that year.¹⁸⁴⁵ The second of the two amounts added together is the amount allowed as a deduction under §186 for any proper tax year for prior recoveries of compensatory amounts for the compensable injury.¹⁸⁴⁶ A deduction is allowed under §186 even if the period for carryover under §172 has expired.¹⁸⁴⁷

Net operating losses are described in IV.P., above, and are discussed in 539 T.M., *Net Operating Losses — Concepts and Computations*.

b. Injury Period

The injury period for an injury arising from an infringement of a patent is the period in which the infringement occurred.¹⁸⁴⁸ The injury period for an injury arising from a breach of contract or breach of fiduciary duty or relationship is the period during which amounts would have been received or accrued but for the breach of contract or breach of fiduciary duty or relationship.¹⁸⁴⁹ The injury period for an injury arising from antitrust violations is the period in which the injury was sustained.¹⁸⁵⁰

The injury period is determined on the basis of the facts and circumstances of the taxpayer's situation.¹⁸⁵¹ It may include periods before and after the period covered by the civil action commenced by the taxpayer.¹⁸⁵²

c. Net Operating Loss Attributable to Compensable Injury

A net operating loss for any tax year is treated as attributable to a compensable injury to the extent of the compensable injury sustained during that year, even if it is not actually attributable to the compensable injury.¹⁸⁵³ A judgment for a compens-

¹⁸³⁰ §186(b); Reg. §1.186-1(b)(1).

¹⁸³¹ §186(b)(1); Reg. §1.186-1(b)(2).

¹⁸³² §186(b)(2); Reg. §1.186-1(b)(3).

¹⁸³³ 15 U.S.C. §15 (1982).

¹⁸³⁴ §186(b)(3); Reg. §1.186-1(b)(4).

¹⁸³⁵ §186(c); Reg. §1.186-1(c)(1).

¹⁸³⁶ Reg. §1.186-1(c)(1).

¹⁸³⁷ Reg. §1.186-1(c)(2).

¹⁸³⁸ Reg. §1.186-1(c)(3)(i).

¹⁸³⁹ Reg. §1.186-1(c)(3)(i).

¹⁸⁴⁰ Reg. §1.186-1(c)(3)(ii).

¹⁸⁴¹ Reg. §1.186-1(c)(3)(ii).

¹⁸⁴² Reg. §1.186-1(c)(4).

¹⁸⁴³ Reg. §1.186-1(c)(4).

¹⁸⁴⁴ §186(d)(1)(A); Reg. §1.186-1(d)(1). See §172.

¹⁸⁴⁵ §186(d)(1)(B)(i); Reg. §1.186-1(d)(1)(i).

¹⁸⁴⁶ §186(d)(1)(B)(ii); Reg. §1.186-1(d)(1)(ii).

¹⁸⁴⁷ Reg. §1.186-1(d)(1).

¹⁸⁴⁸ §186(d)(2)(A); Reg. §1.186-1(d)(2)(i).

¹⁸⁴⁹ §186(d)(2)(B); Reg. §1.186-1(d)(2)(ii).

¹⁸⁵⁰ §186(d)(2)(C); Reg. §1.186-1(d)(2)(iii).

¹⁸⁵¹ Reg. §1.186-1(d)(2).

¹⁸⁵² Reg. §1.186-1(d)(2).

¹⁸⁵³ §186(d)(3)(A); Reg. §1.186-1(d)(3).

able injury apportioning the amount of the recovery to specific tax years within the injury period is conclusive.¹⁸⁵⁴ If the judgment does not apportion the amount of the recovery, it is prorated among the tax years within the injury period in the proportion that the net operating losses sustained in each of those tax years bears to the total net operating losses sustained for all tax years in the injury period.¹⁸⁵⁵

If the action for a compensable injury is settled, the specifications of the parties generally control the determination of the apportionment of the amount of recovery, unless the specifications are not reasonably supported by the facts and circumstances of the case.¹⁸⁵⁶ If there are no specifications, the amount of the recovery is prorated among the tax years within the injury period in the proportion that the net operating losses sustained in each of those tax years bears to the total net operating losses sustained for all tax years in the injury period.¹⁸⁵⁷

If only a portion of a net operating loss for a tax year is attributable to a compensable injury, then in applying §172 for purposes of §186, that portion is treated as a separate net operating loss for that tax year to be applied after the other portion of the total net operating loss.¹⁸⁵⁸

Net operating losses are described in IV.P., above, and are discussed in 539 T.M., *Net Operating Losses — Concepts and Computations*.

5. Effect on Net Operating Loss Carryovers

If, for the tax year in which a compensatory amount is received or accrued, any portion of a net operating loss carryover to that tax year is attributable to the compensable injury for which the compensatory amount is received or accrued, the carryover must be reduced.¹⁸⁵⁹ It is reduced by the excess of the §186 deduction allowed with respect to the compensatory amount over any portion of the unrecovered losses sustained as a result of the compensable injury with respect to which the period for carryover under §172 has expired.¹⁸⁶⁰

Net operating losses are described in IV.P., above, and are discussed in 539 T.M., *Net Operating Losses — Concepts and Computations*.

R. Unused Business Credits

1. In General

Under §196, any unused qualified business credit of a taxpayer may be deducted in the appropriate tax year.¹⁸⁶¹ An unused qualified business credit is the portion of any qualified business credit that is not allowed as a credit under the limitation on credits based on taxable income and that is not allowed as a credit even after application of the business credit carryback and carryover provisions of §39.¹⁸⁶² The deduction

does not apply to credits that are disallowed because they are reduced by the provision allowing the credit in contrast to expiring because the end of the carryforward period has been reached.¹⁸⁶³

Only 50% of unused qualified business credits is allowed as a §196 deduction for the investment credit determined under §46, other than the rehabilitation credit.¹⁸⁶⁴

2. Appropriate Tax Year

The appropriate tax year for the §196 deduction is the first tax year after the last tax year for which the credit would have been permitted under the business credit carryover provisions.¹⁸⁶⁵ However, if the taxpayer dies or ceases to exist before that first tax year after the last tax year for which the credit would have been permitted, the unused qualified business credit is allowed, as prescribed by regulations, as a deduction in the tax year in which the taxpayer dies or ceases to exist.¹⁸⁶⁶

For credits that are subject to the direct pay election under §6417(b), the carryback period is applied separately from the general business credit and is the applicable credit is carried back to the three tax years preceding the unused credit year and is carried forward to the earliest of the next 23 years to which it can be carried considering the carryforward of the other business credits. For further discussion of credit carrybacks and carryforwards, see 506 T.M., *Principles of Income Tax Credits*.

3. Qualified Business Credit

A qualified business credit is any of the following:

- the investment credit as determined under §46, but only to the extent attributable to property the basis of which is reduced under §50(c);¹⁸⁶⁷
- the work opportunity credit determined under §51 (formerly the targeted jobs credit);¹⁸⁶⁸
- the alcohol fuels credit determined under §40(a);¹⁸⁶⁹
- the research credit determined under §41(a), other than the research credit determined under §280C(c)(3) for tax years beginning after December 31, 1988;¹⁸⁷⁰
- the enhanced oil recovery credit determined under §43(a);¹⁸⁷¹
- the empowerment zone employment credit determined under §1396(a);¹⁸⁷²
- the Indian employment credit determined under §45A(a);¹⁸⁷³

¹⁸⁶³ *MCI Commc'ns Corp. v. United States*, 26 F. Supp.2d 6 (D.D.C. 1998), aff'd sub nom. *Telecom*USA Inc. v. United States*, 192 F.3d 1068 (D.C. Cir. 1999), cert. denied, 529 U.S. 1123 (2000); *B.F. Goodrich Co. v. United States*, 94 F.3d 1545 (Fed. Cir. 1996), aff'g 32 Fed. Cl. 571 (1995).

¹⁸⁶⁴ §196(d).

¹⁸⁶⁵ §196(a). See §39.

¹⁸⁶⁶ §196(b).

¹⁸⁶⁷ §196(c)(1).

¹⁸⁶⁸ §196(c)(2) (reference to §51).

¹⁸⁶⁹ §196(c)(3).

¹⁸⁷⁰ §196(c)(4).

¹⁸⁷¹ §196(c)(5).

¹⁸⁷² §196(c)(6).

¹⁸⁷³ §196(c)(7).

¹⁸⁵⁴ Reg. §1.186-1(d)(3).

¹⁸⁵⁵ Reg. §1.186-1(d)(3).

¹⁸⁵⁶ Reg. §1.186-1(d)(3).

¹⁸⁵⁷ Reg. §1.186-1(d)(3).

¹⁸⁵⁸ §186(d)(3)(B); Reg. §1.186-1(d)(4).

¹⁸⁵⁹ §186(e); Reg. §1.186-1(e)(1).

¹⁸⁶⁰ §186(e); Reg. §1.186-1(e)(1), Reg. §1.186-1(e)(3). See Reg. §1.186-1(e)(2).

¹⁸⁶¹ §196(a).

¹⁸⁶² §196(a). See §38(c).

- the employer social security credit determined under §45B(a);¹⁸⁷⁴
- the new markets tax credit determined under §45D(a);¹⁸⁷⁵
- the small employer pension plan startup cost credit determined under §45E(a);¹⁸⁷⁶
- the biodiesel fuels credit determined under §40A(a);¹⁸⁷⁷
- the low sulfur diesel fuel production credit determined under §45H(a);¹⁸⁷⁸
- the energy efficient home credit determined under §45L(a);¹⁸⁷⁹ and
- the small employer health insurance credit determined under §45R(a).¹⁸⁸⁰

S. Special Provisions

1. Federal National Mortgage Association Contributions

Under §162(d), any excess of the amount of capital contributions evidenced by a share of stock issued under §303(c) of the Federal National Mortgage Association (FNMA) Charter Act¹⁸⁸¹ over the fair market value of the stock as of its issue date is treated by the initial holder of the stock as an ordinary and necessary expense of carrying on a trade or business. In *E. Serv. Corp. v. Commissioner*,¹⁸⁸² the Second Circuit held that the §162(d) deduction was not allowed if the cost of the stock was less than its fair market value, noting that the stock was a capital asset in the taxpayer's hands because the taxpayer was not carrying on the business of servicing FNMA mortgages.

2. Depositors' Guaranty Fund Set Asides

If three conditions are satisfied, banking corporations may deduct under §162 the amount set aside to a depositors' guaranty fund.¹⁸⁸³ First, the laws of the state in which the banking corporation does business must require it to set apart, keep and maintain in the bank the amount levied and assessed against it by state authorities as a depositors' guaranty fund.¹⁸⁸⁴ Second, the fund, when set aside and carried to the credit of the state banking board or duly authorized state officer, must cease to be an asset of the bank and may be withdrawn in whole or in part upon demand by the board or officer to meet the needs of these officers in reimbursing depositors in insolvent banks.¹⁸⁸⁵ Third, no portion of the amount set aside and credited may be returned under the laws of the state to the assets of the banking corporation.¹⁸⁸⁶ Thus, amounts paid to the federal deposit insurance

fund are deductible when actually paid either directly or by application of a prior credit.¹⁸⁸⁷

If the amount set aside to the depositors' guaranty fund is merely set up on the books of the bank as a reserve to meet a contingent liability and remains an asset of the bank, it is not deductible until and unless it is actually paid out as required by law and upon demand of the proper state officers.¹⁸⁸⁸ Thus, advance payments are not deductible until the fund is operative.¹⁸⁸⁹

Amounts paid to restore a state guaranty fund are deductible, but amounts paid to increase the size of the fund are not.¹⁸⁹⁰ Equalization payments by a savings and loan association to a deposit guaranty fund as a condition of membership that represent the acquisition of an equity in the fund are not deductible and are nonamortizable capital expenditures.¹⁸⁹¹

Although the IRS takes the position that a bank or bank holding company may not deduct fees paid to the FDIC for conversion of assets from Savings Association Insurance Fund coverage to Banking Insurance Fund coverage,¹⁸⁹² the Tax Court has held to the contrary, permitting deduction of these so-called "entrance" and "exit" fees, because it characterized the fees to the exited fund as compensation for lost future premiums and the fees to the entered fund as current annual premiums and because no identifiable asset was created.¹⁸⁹³

Note: The subsequently adopted requirement in Reg. §1.263(a)-4(d) that amounts paid to an organization to obtain, renew, renegotiate or upgrade a membership or privilege from that organization must be capitalized, does not require capitalization of amounts paid to obtain, renew, renegotiate or upgrade certification of the taxpayer's products, services or business processes.

3. Federal Deposit Insurance Corporation Premiums

No deduction is allowed for the applicable percentage of any Federal Deposit Insurance Corporation (FDIC) premiums paid or incurred by a taxpayer.¹⁸⁹⁴ The applicable percentage for any taxable year is the ratio which the excess of a taxpayer's total consolidated assets (determined as of the close of such taxable year) over \$10 billion, bears to \$40 billion. An exception applies for any taxpayer for any taxable year if the taxpayer's total consolidated assets do not exceed \$10 billion (determined as of the close of such taxable year).¹⁸⁹⁵ For purposes of this sub-

¹⁸⁸⁷ Rev. Rul. 55-478, 1955-2 C.B. 18.

¹⁸⁸⁸ Reg. §1.162-13.

¹⁸⁸⁹ *First Nat'l Bank of Braddock v. Commissioner*, 38 B.T.A. 1244 (1938); *State Nat'l Bank of El Paso, Texas v. United States*, 39-1 USTC ¶9471 (W.D. Tex. 1939).

¹⁸⁹⁰ *Wichita State Bank & Trust Co. v. Commissioner*, 69 F.2d 595 (5th Cir. 1934), rev'g 27 B.T.A. 822 (1933).

¹⁸⁹¹ Rev. Rul. 72-379, 1972-2 C.B. 92.

¹⁸⁹² FSA 200008005; TAM 9402006; TAM 9348003.

¹⁸⁹³ *Metrocorp, Inc. v. Commissioner*, 116 T.C. 211 (2001).

¹⁸⁹⁴ §162(r)(1). "FDIC Premium" means any assessment imposed under §(b) of the Federal Deposit Insurance Act, 12 U.S.C. § 1817(b). §162(r)(4); see AM 2024-003 (concluding that §162(r) does not apply to an FDIC special assessment imposed under §13(c)(4)(G) of the FDI Act).

¹⁸⁹⁵ §162(r)(2). "Total consolidated assets" has the meaning given such term under §165 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, 12 U.S.C. § 5365. §162(r)(5).

¹⁸⁷⁴ §196(c)(8).

¹⁸⁷⁵ §196(c)(9).

¹⁸⁷⁶ §196(c)(10).

¹⁸⁷⁷ §196(c)(11).

¹⁸⁷⁸ §196(c)(12).

¹⁸⁷⁹ §196(c)(13).

¹⁸⁸⁰ §196(c)(14).

¹⁸⁸¹ 12 U.S.C. §1718 (1982).

¹⁸⁸² 650 F.2d 379 (2d Cir. 1981), rev'g 73 T.C. 833 (1980).

¹⁸⁸³ Reg. §1.162-13.

¹⁸⁸⁴ Reg. §1.162-13.

¹⁸⁸⁵ Reg. §1.162-13.

¹⁸⁸⁶ Reg. §1.162-13.

section, members of an expanded affiliated group are treated as a single taxpayer.¹⁸⁹⁶

T. Prepaid Dues Income Doubly Included in Gross Income

Under §456(d)(2), a deduction is allowed to a taxpayer who makes an election under §456(d)(1) with respect to prepaid dues income and who includes in gross income for any tax year to which the election applies an amount under §456(d)(1).¹⁸⁹⁷ If the election is made, the taxpayer is required to include in gross income under §456(d)(1) not only prepaid dues income otherwise includible in gross income for the tax year for which the election is effective¹⁸⁹⁸ but also an additional amount equal to the amount of prepaid dues income received in the preceding three tax years which would have been included in gross income in the earlier tax years had the election been effective three years earlier.¹⁸⁹⁹

The additional amount that the taxpayer includes in gross income under §456(d)(1) is allowed as a deduction, but only to the extent that the additional amount included in gross income under §456(d)(1) was also included in gross income during any of the three tax years preceding the tax year for which the election is effective.¹⁹⁰⁰

One-fifth of the amount deductible under §456(d)(2) is allowed in the tax year to which the §456(d)(1) election applies and one-fifth is allowed in each of the four succeeding tax years.¹⁹⁰¹

Observation: The §456(d)(2) deduction is, in effect, a mechanism to adjust for the double inclusion in gross income of certain prepaid dues income.

U. Miscellaneous Trade or Business Deductions

1. Telephone Expense

Telephone expenses incurred in a trade or business or in pursuit of a for-profit activity are deductible under §162 or §212. Thus, for example, the Board of Tax Appeals has held that a taxpayer may deduct the expense of maintaining separate telephones in its employees' homes for use in making after hours calls concerning the taxpayer's business.¹⁹⁰² In addition, it has been held that if the employee is required by the employer to maintain a separate telephone, the expense is deductible as an employee business expense.¹⁹⁰³

Comment: The cost of a separate telephone maintained by the employee, but not required by the employer, is deductible if under the circumstances it is ordinary and necessary.

Clearly, the cost of telephone calls made for business purposes is deductible.¹⁹⁰⁴ The disallowance of expenditures for certain telephone service deemed to be personal in nature is discussed in 513 T.M., *Family and Household Transactions*.

2. Governmental Impositions

Governmental fees and taxes incurred in a trade or business or for-profit activity are deductible under §162. Thus, for example, the Tax Court has held that fishing license fees and local taxes for boats and automobiles used in carrying on a trade or business are deductible under §162.¹⁹⁰⁵ The IRS has ruled that parking meter fees are deductible under §162 to the extent they are paid in carrying on a trade or business.¹⁹⁰⁶ In addition, the IRS has ruled that monthly sewer service charges are deductible to the extent paid or incurred with respect to property used in a trade or business.¹⁹⁰⁷

Amounts paid to a foreign government as a fee for the privilege of doing business in its country, that are measured by the periodic volume of business, are deductible under §162.¹⁹⁰⁸ It does not matter that the foreign government has a beneficial interest in the taxpayer making the payment.¹⁹⁰⁹ However, amounts paid to obtain long-term concessions are not deductible and must be capitalized.¹⁹¹⁰

3. Financing Expenses

Trade or business or for-profit activity financing expenses are deductible. Thus, for example, the IRS has ruled that fees paid by taxpayers in the trade or business of selling items on the installment method, in order to sell the accounts receivable to a bank, are deductible under §162 as an ordinary and necessary expense of collecting income funds.¹⁹¹¹ The IRS has also ruled in a private letter ruling that the amount paid to a bank by a builder and seller of homes to induce the bank to issue loans to home buyers at interest rates that are less than the market rate is deductible as a cost of selling the homes.¹⁹¹²

The IRS has also ruled that amounts paid for the use of another person's property as collateral for debt incurred by the taxpayer in carrying on a trade or business are deductible.¹⁹¹³

Quarterly commitment fees paid on a revolving credit facility are deductible as an ordinary and necessary business expense under §162.¹⁹¹⁴

4. Safety Devices

Certain expenses relating to the operation of necessary safety devices are deductible under §162 if incurred in connection with a trade or business or for-profit activity. Thus, for example, the IRS has ruled that the cost of maintaining and op-

¹⁸⁹⁶ §162(r)(6). "Expanded affiliated group" means an affiliated group as defined in §1504(a), determined without regard to §1504(b)(2)–§1504(b)(3) and by using fifty percent as the threshold for meeting the ownership requirement. A partnership or other non-corporate entity is treated as a member of the expanded affiliated group if such entity is controlled, within the meaning of §954(d)(3), by members of such group. §162(r)(6)(B).

¹⁸⁹⁷ §456(d)(2); Reg. §1.456-7(b).

¹⁸⁹⁸ See §456(a).

¹⁸⁹⁹ §456(d)(1); Reg. §1.456-7(a).

¹⁹⁰⁰ §456(d)(2); Reg. §1.456-7(b).

¹⁹⁰¹ §456(d)(2); Reg. §1.456-7(b).

¹⁹⁰² *Moline Dispatch Publ'g Co. v. Commissioner*, 11 B.T.A. 934 (1928).

¹⁹⁰³ *Fausner v. Commissioner*, 30 T.C.M. 1187 (1971), aff'd on other issues, 472 F.2d 561 (5th Cir. 1973), aff'd, 413 U.S. 838 (1973).

¹⁹⁰⁴ *Cook v. Commissioner*, 37 T.C.M. 771 (1978).

¹⁹⁰⁵ *Haman v. Commissioner*, 31 T.C.M. 466 (1972), aff'd on other issues, 500 F.2d 401 (9th Cir. 1974).

¹⁹⁰⁶ Rev. Rul. 73-91.

¹⁹⁰⁷ *Noble v. Commissioner*, 70 T.C. 916 (1978), nonacq., 1979-2 C.B. 2.

¹⁹⁰⁸ *Allied Am. Corp. v. Commissioner*, 25 B.T.A. 1276 (1932).

¹⁹⁰⁹ See *Amtorg Trading Corp. v. Commissioner*, 65 F.2d 583 (2d Cir. 1933), rev'g 25 B.T.A. 327 (1932).

¹⁹¹⁰ See *All Am. Cables, Inc. v. Commissioner*, 10 B.T.A. 213 (1928).

¹⁹¹¹ Rev. Rul. 54-43.

¹⁹¹² PLR 8229120.

¹⁹¹³ Rev. Rul. 73-122.

¹⁹¹⁴ FAA 20182502F.

erating safety devices constructed on city property by a manufacturer of aircraft and missiles in order to comply with safety requirements are deductible under §162.¹⁹¹⁵

5. Public Officials' Expenses

The IRS has ruled that amounts paid by members of Congress to publish and distribute newsletters are deductible under §162 as employee business expenses.¹⁹¹⁶ The IRS has also ruled that amounts paid for reasonable salaries of additional staff also are deductible under §162,¹⁹¹⁷ as are amounts paid to Congressional interns.¹⁹¹⁸ The IRS has ruled that salaries, office rent and supplies paid or incurred by city council members are deductible under §162.¹⁹¹⁹ In TAM 9426001, the National Office advised that a person serving as an honorary consul of a foreign country performed functions of public office, and thus, in the absence of evidence suggesting appointment to the position as a stratagem to avoid taxes, was engaged in a trade or business.

6. Family Day Care Providers

The IRS allows family day care providers the option to use a standardized rate to claim a deduction for meals provided to children in their care, instead of keeping detailed records and receipts of food purchased for use in their business.¹⁹²⁰ Family day care is care provided to children in the home that is non-medical, does not involve a transfer of custody, and is generally less than 24 hours.¹⁹²¹ The standard rate option is available only with respect to meals provided to children in the provider's care who satisfy three conditions: (1) they must be minors under parental control and not self-supporting, (2) they must not be full-time or part-time residents of the home, and (3) they must not be children for whom care is provided solely for personal reasons.¹⁹²²

The IRS permits a standard rate for up to one breakfast, one lunch, one dinner and three snacks per day, per child, provided the meals and snacks are actually purchased and served,¹⁹²³ and lists these rates in Pub. 587, *Business Use of Your Home*. Providers must maintain adequate records to substantiate their computation of the total amount deductible and must include the name of each eligible child, the date and hours of the child's attendance at the family day care facility and the type and quantity of meals and snacks served.¹⁹²⁴ In an Appendix to its ruling, the IRS provides an example of an acceptable log.

The standard meal and snack rate for a particular tax year is the USDA Tier 1 reimbursement rate in effect on the December 31 that precedes the beginning of the family day care provider's tax year.¹⁹²⁵ The rate is adjusted annually.¹⁹²⁶

7. Charitable Contribution as Business Expense

A payment to, or a transfer of property to, or for the use of, an organization described in §170(c) that bears a direct relationship to the taxpayer's trade or business and that is made with a reasonable expectation of financial return commensurate with the amount of the transfer may constitute an allowable deduction as a trade or business expense under §162 rather than as a charitable contribution under §170.¹⁹²⁷

Following the enactment of the §164(b)(6) limitation, the IRS issued final regulations that provide that if a taxpayer makes a payment to, or transfers property to, or for the use of, a §170(c) organization and the taxpayer receives, or expects to receive, a state or local tax credit in return for such payment, the tax credit constitutes a return benefit, or quid pro quo, to the taxpayer, and reduces the taxpayer's charitable contribution deduction.¹⁹²⁸

However, questions arose as to whether a business entity could deduct such payments under §162 as ordinary and necessary business expenses incurred in carrying on a trade or business. The IRS published Rev. Proc. 2019-12, which provides safe harbors under §162 for certain payments made by a C corporation or a specified pass-through entity to, or for the use of, a §170(c) organization if the taxpayer receives, or expects to receive, a state or local tax credit in return for such payment.¹⁹²⁹ These safe harbors were subsequently incorporated into the regulations issued under T.D. 9907.

The safe harbor for C corporations provides that if a C corporation makes a payment to, or for the use of, a §170(c) organization and receives, or expects to receive, a tax credit that reduces a state or local tax imposed on the corporation in return for such payment, the corporation may treat such payment as meeting the requirements of an ordinary and necessary business expense for purposes of §162(a) to the extent of the credit received or expected to be received.¹⁹³⁰

The safe harbor for a specified pass-through entity provides that if such an entity makes a payment to or for the use of a §170(c) organization and receives or expects to receive a tax credit that the entity applies or expects to apply to offset a state

¹⁹²⁶ Rev. Proc. 2003-22, §5.04. For standard meal and snack rates for recent years, see Tables, Charts & Lists (Federal), Standard Meal and Snack Rates, *Standard Meal and Snack Rates*.

¹⁹²⁷ Reg. §1.162-15(a) and §1.170A-1(c)(5) (reference to Reg. §1.162-15(a) for payments or transfers to entity described in §170(c) by taxpayer carrying on trade or business). Reg. §1.162-15(a)(1) applies to payments or transfers made on or after December 17, 2019; in addition, taxpayers may choose to apply Reg. §1.162-15(a)(1) to payments and transfers made on or after January 1, 2018. Reg. §1.162-15(a)(4). See also T.D. 9907, 85 Fed. Reg. 48,467 (Aug. 11, 2020) (updating §162 regulations to reflect current law regarding application of §162 to taxpayers that make payments or transfers for business purposes to entities described in §170(c)).

¹⁹²⁸ See Reg. §1.170A-1(h)(3), T.D. 9864, 84 Fed. Reg. 27,513 (June 13, 2019), which is discussed in detail in 525 T.M., *State Local and Federal Taxes*. The preamble to the final regulations notes that the regulations are intended to apply to transfers pursuant to state and local credit programs regardless of whether the program was established in response to the §164(b)(6) limitation. Neither the intent of the §170(c) organization, nor the date of enactment of a state tax credit program, are relevant to the application of the quid pro quo principle. Preamble to T.D. 9864.

¹⁹²⁹ Rev. Proc. 2019-12.

¹⁹³⁰ Reg. §1.162-15(a)(3)(i), T.D. 9907, 85 Fed. Reg. 48,467 (Aug. 11, 2020); Rev. Proc. 2019-12, §3.

¹⁹¹⁵ Rev. Rul. 54-579.

¹⁹¹⁶ Rev. Rul. 73-356.

¹⁹¹⁷ Rev. Rul. 73-464, amplified by Rev. Rul. 84-110.

¹⁹¹⁸ Rev. Rul. 75-146.

¹⁹¹⁹ Rev. Rul. 84-110.

¹⁹²⁰ Rev. Proc. 2003-22, §3.

¹⁹²¹ Rev. Proc. 2003-22, §4.02.

¹⁹²² Rev. Proc. 2003-22, §4.03.

¹⁹²³ Rev. Proc. 2003-22, §5.01.

¹⁹²⁴ Rev. Proc. 2003-22, §5.03.

¹⁹²⁵ Rev. Proc. 2003-22, §6.

or local tax other than a state or local income tax, the specified pass-through entity may treat such payment as meeting the requirements of an ordinary and necessary business expense for purposes of §162(a) to the extent of the credit received or expected to be received. An entity is considered a specified pass-through entity only if:

- (1) The entity is a business entity other than a C corporation that is regarded for all federal income tax purposes as separate from its owners under Reg. §301.7701-3;
- (2) The entity operates a trade or business within the meaning of §162;
- (3) The entity is subject to a state or local tax incurred in carrying on its trade or business that is imposed directly on the entity; and
- (4) In return for a payment to a §170(c) organization, the entity receives or expects to receive a state or local tax credit that the entity applies or expects to apply to offset a state or local tax that is incurred in carrying on its trade or business other than a state or local income tax.¹⁹³¹

In the case of a pass-through entity, the payment must be determined at the level of the individual owners of the entity if the credit received or expected to be received will reduce a state or local income tax subject to the limitations in §164(b)(6).¹⁹³² The specified pass-through entity safe harbor does not apply if the credit received, or expected to be received, reduces a state or local income tax.¹⁹³³

The regulatory safe harbors for C corporations and specified pass-through entities making payments to §170(c) entities in exchange for state or local tax credits apply to payments made by these entities on or after December 17, 2019. However, taxpayers may choose to apply the safe harbors to payments

made on or after January 1, 2018.¹⁹³⁴ The safe harbors of Rev. Proc. 2019-12 apply to amounts that are paid on or after January 1, 2018.¹⁹³⁵

Example: X, a C corporation engaged in a trade or business, makes a payment of \$1,000 to an organization described in §170(c). In return for the payment, X receives or expects to receive a dollar-for-dollar state tax credit to be applied to X's state corporate income tax liability. Under the safe harbor, X may treat the \$1,000 payment as meeting the requirements of an ordinary and necessary business expense under §162.¹⁹³⁶

Example: P is a limited liability company (LLC) classified as a partnership for federal income tax purposes and is owned by individuals A and B. P is engaged in a trade or business within the meaning of §162 and makes a payment of \$1,000 to a §170(c) organization. In return for the payment, P receives or expects to receive a dollar-for-dollar state tax credit to be applied to P's state excise tax liability incurred in the course of its business. Under applicable state law, the state's excise tax is imposed at the entity level (not the owner level). P may treat the \$1,000 payment as meeting the requirements of an ordinary and necessary business expense under §162.¹⁹³⁷

The treatment of payments to, or for the use of, an organization described in §170(c) in excess of the amount deductible under §162(a) is discussed in detail in 521 T.M., *Charitable Contributions: Income Tax Aspects*. For a detailed discussion of the treatment of tax payments, see 525 T.M., *State Local and Federal Taxes*.

¹⁹³¹ Reg. §1.162-15(a)(3)(ii); Rev. Proc. 2019-12, §4.

¹⁹³² Rev. Proc. 2019-12, §4.

¹⁹³³ Reg. 1.162-15(a)(3)(ii)(C).

¹⁹³⁴ Reg. 1.162-15(a)(4).

¹⁹³⁵ Rev. Proc. 2019-12, §5.01.

¹⁹³⁶ Reg. §1.162-15(a)(3)(iv)(A), Ex. 1; Rev. Proc. 2019-12, §3.

¹⁹³⁷ Reg. §1.162-15(a)(3)(iv)(C), Ex. 3; Rev. Proc. 2019-12, §4.

V. Expenditures Otherwise Capitalized

A. In General

Although §263 and §263A specifically require that, with certain exceptions, taxpayers must capitalize expenditures that represent the acquisition of assets or rights with useful lives of more than one year,¹⁹³⁸ nonetheless, certain expenditures for these types of assets or rights are deductible, either in the tax year made or over a period of tax years.¹⁹³⁹ These deductible expenditures are described in V.B. through V.R., below, except that those related to the specific trades or businesses of farming and timber, and mineral extraction are described in VI.B., and VI.C., below. The capitalization requirement is discussed in 509 T.M., *Principles of Capitalization*.

B. Start-Up Expenditure Amortization

Generally, although no deduction is allowed for start-up expenditures,¹⁹⁴⁰ under §195 the taxpayer may elect to deduct start-up expenditures.¹⁹⁴¹ The deduction is divided between a start-up year portion and an amortization portion.¹⁹⁴² The start-up year portion is allowed for the tax year in which the taxpayer begins the active trade or business and equals the lesser of the start-up expenditures with respect to that trade or business¹⁹⁴³ or \$5,000 reduced by the amount by which the start-up expenditures exceed \$50,000.¹⁹⁴⁴ The amortization portion consists of the start-up expenditures not in the start-up year portion and is amortized ratably over the 180-month period beginning with the month in which the active trade or business begins.¹⁹⁴⁵

Comment: The specific statutory disallowance, aside from the current year deduction and amortization allowance, reflects the character of start-up expenditures as outlays made before the taxpayer begins carrying on the trade or business to which the expenses relate.¹⁹⁴⁶

The amortization of start-up expenditures is discussed in 534 T.M., *Start-Up Expenditures*.

C. Organizational Expenditures

Generally, although no deduction is allowed for the organizational expenditures of a corporation,¹⁹⁴⁷ a corporation may elect, under §248, to deduct its organizational expenditures.¹⁹⁴⁸

The deduction is divided between a start-up year portion and an amortization portion.¹⁹⁴⁹ The start-up year portion is allowed for the tax year in which the corporation begins business and equals the lesser of the organizational expenditures¹⁹⁵⁰ or \$5,000 reduced by the amount by which the organizational expenditures exceed \$50,000.¹⁹⁵¹ The amortization portion consists of the organizational expenditures not in the start-up year portion and is amortized ratably over the 180-month period beginning with the month in which the corporation begins business.¹⁹⁵²

Comment: The disallowance of deductions for organizational expenditures of corporations aside from the current year deduction and amortization allowance reflects the character of organizational expenditures as outlays made before the corporation is carrying on the trade or business to which the expenses relate.

The 180-month period over which organizational expenditures in excess of the amount deducted in the year of start-up are amortized begins with the month in which the corporation begins business.¹⁹⁵³

The amortization of the organizational expenditures of a corporation is discussed in 758 T.M., *Transfers to Controlled Corporations*.

Generally, although no deduction is allowed for the organizational expenditures of a partnership,¹⁹⁵⁴ the partnership may elect, under §709, to deduct its organizational expenditures.¹⁹⁵⁵ The deduction is divided between a start-up year portion and an amortization portion.¹⁹⁵⁶ The start-up year portion is allowed for the tax year in which the partnership begins business and equals the lesser of the organizational expenditures¹⁹⁵⁷ or \$5,000 reduced by the amount by which the organizational expenditures exceed \$50,000.¹⁹⁵⁸ The amortization portion consists of the organizational expenditures not in the start-up year portion and is amortized ratably over the 180-month period beginning with the month in which the partnership begins business.¹⁹⁵⁹

The 180-month period over which organizational expenditures in excess of the amount deducted in the year of start-up are amortized begins with the month in which the corporation begins business.¹⁹⁶⁰ The amortization period elected by the partnership is irrevocable and may not be changed.¹⁹⁶¹

The amortization of the organizational expenditures of a partnership is discussed in 711 T.M., *Partnerships — Formation and Contributions of Property or Services*.

¹⁹³⁸ See §263, §263A.

¹⁹³⁹ See §167, §168, §169, §173, §174, §174A, §175, §179, §179B, §179C, §179D, former §179E, §180, §190, §193, §194, §195, §196, §197, §198, §248, §611, §613, §613A, §616, §617, §631, §709, §1253(d)(1). See generally §263(a)(1)(A)–§263(a)(1)(L).

¹⁹⁴⁰ §195(a).

¹⁹⁴¹ §195(b)(1).

¹⁹⁴² §195(b)(1).

¹⁹⁴³ §195(b)(1)(A)(i).

¹⁹⁴⁴ §195(b)(1)(A)(ii), §195(b)(3).

¹⁹⁴⁵ §195(b)(1)(B).

¹⁹⁴⁶ See §162(a).

¹⁹⁴⁷ E.g., *Warner Mountains Lumber Co. v. Commissioner*, 9 T.C. 1171 (1947); *Commercial Inv. Trust Corp. v. Commissioner*, 28 B.T.A. 143 (1933), aff'd per curiam, 74 F.2d 1015 (2d Cir. 1935); *W.P. Brown & Sons Lumber Co. v. Commissioner*, 26 B.T.A. 1192 (1932), appeal dismissed, 68 F.2d 1022 (6th Cir. 1934); *Parker Gravel Co., Inc. v. Commissioner*, 21 B.T.A. 51 (1930); *Se. Express Co. v. Commissioner*, 19 B.T.A. 490 (1930), rev'd on other issues, 56 F.2d 600 (5th Cir. 1932); *Udolpho Wolfe Co. v. Commissioner*, 15 B.T.A. 485 (1929).

¹⁹⁴⁸ §248(a).

¹⁹⁴⁹ §248(a).

¹⁹⁵⁰ §248(a)(1)(A).

¹⁹⁵¹ §248(a)(1)(B).

¹⁹⁵² §248(a)(2).

¹⁹⁵³ §248(a)(2); Reg. §1.248-1(a)(1).

¹⁹⁵⁴ §709(a); Reg. §1.709-1(a).

¹⁹⁵⁵ §709(b)(1).

¹⁹⁵⁶ §709(b)(1).

¹⁹⁵⁷ §709(b)(1)(A)(i).

¹⁹⁵⁸ §709(b)(1)(A)(ii).

¹⁹⁵⁹ §248(a).

¹⁹⁶⁰ §709(b)(1); Reg. §1.709-1(b)(1).

¹⁹⁶¹ Reg. §1.709-1(b)(2).

D. Depreciation

1. In General

Under §167, a depreciation deduction is allowed with respect to property used in the trade or business or held for the production of income,¹⁹⁶² but not for personal use property.¹⁹⁶³ Depreciation is a reasonable allowance for exhaustion, wear and tear, and obsolescence.¹⁹⁶⁴

For a discussion of depreciation, which taxpayer is entitled to the depreciation deduction, what property is depreciable, depreciable basis, and accounting for depreciation, see 530 T.M., *Depreciation: General Concepts*.

Property that qualifies for accelerated cost recovery system (ACRS) deductions under §168 does not qualify for §167 depreciation deductions.¹⁹⁶⁵ ACRS deductions are discussed in 531 T.M., *Depreciation: MACRS and ACRS*.

Comment: Most of the provisions in §167 relating to the computation of depreciation have been repealed as deadwood,¹⁹⁶⁶ even though taxpayers continue to own and acquire property for which depreciation must be computed under §167.¹⁹⁶⁷ The repeal of most of the computational provisions of §167 does not apply to property that is excluded by anti-churning rules¹⁹⁶⁸ from §168 ACRS deductions,¹⁹⁶⁹ or to certain rehabilitation expenditures.¹⁹⁷⁰

Observation: Technically, no statutory computational provisions apply to property excluded from §168 ACRS deductions for reasons other than the anti-churning rules.¹⁹⁷¹

Depreciation deductions are described in V.D.2. through 4., below, and are discussed in 530 T.M., *Depreciation: General Concepts*.

2. Depreciable Property

a. Tangible Property

For tangible property for which depreciation deductions are computed under §167, only that part of the property that is subject to wear and tear, to decay or decline from natural causes, to exhaustion and to obsolescence may be depreciated.¹⁹⁷² Thus, no deduction under §167 is allowed for inventories or stock in trade,¹⁹⁷³ or to land apart from the improvements or physical development added to it.¹⁹⁷⁴

The deduction under §167 does not apply to natural resources for which the depletion deduction under §611 is allowable.¹⁹⁷⁵ Depletion deductions are described in VI.C.3., below,

and are discussed in 603 T.M., *Mineral Properties Other Than Gas and Oil — Operation*.

For a further discussion of what property is depreciable, see 530 T.M., *Depreciation: General Concepts*.

b. Intangibles

Certain intangible assets qualify for amortization under §197, as described in V.F., below. In regulations, the IRS permits amortization of certain created or enhanced intangibles lacking readily ascertainable useful lives over a 15-year period.¹⁹⁷⁶ Amortization of intangible assets is discussed in 533 T.M., *Amortization of Intangibles*.

Observation: Intangible property does not qualify for ACRS deductions under §168.¹⁹⁷⁷ The computational rules applicable to intangible property were repealed as deadwood,¹⁹⁷⁸ as described in V.D.1., above.

For a further discussion of what property is depreciable, see 530 T.M., *Depreciation: General Concepts*.

c. Term Interests

No deduction under §167, or any other provision, is allowed for any term interest in property for any period during which the remainder interest in the property is directly or indirectly held by a related person.¹⁹⁷⁹ This limitation does not apply to property to which the §273 limitation applies¹⁹⁸⁰ nor to the holder of the dividend rights which were separated from any stripped preferred stock to which §305(e)(1) applies.¹⁹⁸¹ The §273 limitation is discussed in 503 T.M., *Principles of Income Tax Deductions*.

If a deduction for depreciation under §167 is disallowed under the term interest rule, adjustments are made to the adjusted basis of the taxpayer holding the term interest and to the adjusted basis of the taxpayer holding the remainder.¹⁹⁸² The term interest limitation and the basis adjustments are discussed in 530 T.M., *Depreciation: General Concepts*.

3. Computational Structure

a. In General

Generally, to compute depreciation under §167, the depreciable basis of the property is, in effect, allocated over the tax years in its useful life, using an acceptable method.¹⁹⁸³ Special rules permit the taxpayer to compute depreciation deductions under §167 individually with respect to each item of property or to combine two or more properties into single accounts, group accounts, composite accounts and classified accounts.¹⁹⁸⁴ Other

¹⁹⁶² §167(a); Reg. §1.167(a)-1(a).

¹⁹⁶³ See Reg. §1.167(a)-2.

¹⁹⁶⁴ §167(a). See Reg. §1.167(a)-9.

¹⁹⁶⁵ See §167(b), §168.

¹⁹⁶⁶ Pub. L. No. 101-508, §11812(a).

¹⁹⁶⁷ See §168(f); Pub. L. No. 101-508, §11812(c).

¹⁹⁶⁸ See §168(f)(5).

¹⁹⁶⁹ Pub. L. No. 101-508, §11812(c)(2).

¹⁹⁷⁰ Pub. L. No. 101-508, §11812(c)(3) (reference to Pub. L. No. 99-514, §252(f)(5), as added by Pub. L. No. 100-647, §1002(l)(31) (1988)).

¹⁹⁷¹ See §168(f).

¹⁹⁷² Reg. §1.167(a)-2.

¹⁹⁷³ Reg. §1.167(a)-2.

¹⁹⁷⁴ Reg. §1.167(a)-2.

¹⁹⁷⁵ Reg. §1.167(a)-2.

¹⁹⁷⁶ Reg. §1.167(a)-3(b).

¹⁹⁷⁷ §168(a).

¹⁹⁷⁸ Pub. L. No. 101-508, §11812(a).

¹⁹⁷⁹ §167(e)(1).

¹⁹⁸⁰ §167(e)(2)(A).

¹⁹⁸¹ §167(e)(2)(B).

¹⁹⁸² §167(e)(3).

¹⁹⁸³ Reg. §1.167(a)-1(a), Reg. §1.167(b)-0. See §167 (as in effect before Nov. 5, 1990). See Pub. L. No. 101-508, §11812(c)(2).

¹⁹⁸⁴ See Reg. §1.167(a)-7. Reg. §1.167(a)-7 generally does not apply to MACRS property (generally property placed in service after 1986) or ACRS property (generally property placed in service after 1980 and before 1987) or property for which depreciation is determined under an additional first-

special rules apply to retirements of property for which depreciation deductions are computed under §167.¹⁹⁸⁵

b. Depreciable Basis

Depreciable basis is the basis in depreciable property reduced by salvage value.¹⁹⁸⁶ The basis in property for which depreciation is computed under §167 is the adjusted basis provided under §1011 for purposes of determining the gain on the sale or other disposition of the property.¹⁹⁸⁷ If property is acquired subject to a lease, no portion of the adjusted basis is allocated to the leasehold interest,¹⁹⁸⁸ and the entire adjusted basis is used in computing the depreciation deduction with respect to the property subject to the lease.¹⁹⁸⁹ If property is converted from personal use to use in a trade or business or for the production of income, the basis for depreciation is the lesser of the adjusted basis of the property or the fair market value of the property at the time of conversion.¹⁹⁹⁰

If the taxpayer acquires depreciable and nondepreciable tangible property, such as land and buildings, for a lump sum, the basis for depreciation cannot exceed an amount which bears the same proportion to the lump sum as the value of the depreciable property bears to the value of the entire property at the time of acquisition.¹⁹⁹¹ If the acquisition is an applicable asset acquisition subject to §1060, the depreciable basis cannot exceed the amount of consideration allocated to the property under §1060.¹⁹⁹² Applicable asset acquisitions subject to §1060 are discussed in 561 T.M., *Capital Assets*.

For further discussion of depreciable basis, see 530 T.M., *Depreciation: General Concepts*.

c. Acceptable Methods

(1) In General

For property for which depreciation deductions are computed under §167, acceptable methods of depreciation include the straight-line method,¹⁹⁹³ the declining balance method,¹⁹⁹⁴ the sum of the years-digits method,¹⁹⁹⁵ or any other consistent method productive of an annual allowance which, when added to all allowances for the period commencing with the taxpayer's use of the property and including the tax year, does not, during the first two-thirds of the useful life of the property, exceed the total of such allowances which would have been used

year depreciation deduction provision of the Internal Revenue Code. Reg. §1.167(a)-7(e).

¹⁹⁸⁵ See Reg. §1.167(a)-8. Reg. §1.167(a)-8 generally does not apply to MACRS property or ACRS property or property for which depreciation is determined under an additional first-year depreciation deduction provision of the Internal Revenue Code. Reg. §1.167(a)-8(g).

¹⁹⁸⁶ See Reg. §1.167(a)-1(c).

¹⁹⁸⁷ §167(c)(1); Reg. §1.167(g)-1.

¹⁹⁸⁸ §167(c)(2)(A).

¹⁹⁸⁹ §167(c)(2)(B).

¹⁹⁹⁰ Reg. §1.167(g)-1.

¹⁹⁹¹ Reg. §1.167(a)-5.

¹⁹⁹² Reg. §1.167(a)-5T.

¹⁹⁹³ Reg. §1.167(b)-1. See pre-1990 RRA §167(b)(1) (in effect before Nov. 5, 1990); Pub. L. No. 101-508, §11812(c)(2).

¹⁹⁹⁴ Reg. §1.167(b)-2. See pre-1990 RRA §167(b)(2) (in effect before Nov. 5, 1990); Pub. L. No. 101-508, §11812(c)(2).

¹⁹⁹⁵ Reg. §1.167(b)-3. See pre-1990 RRA §167(b)(3) (in effect before Nov. 5, 1990); Pub. L. No. 101-508, §11812(c)(2).

had the declining balance method been used.¹⁹⁹⁶ The rate used for the declining balance method may not exceed double the straight-line rate.¹⁹⁹⁷

Other acceptable methods include the income forecast method,¹⁹⁹⁸ the unit-of-production method,¹⁹⁹⁹ the retirement method,²⁰⁰⁰ the sinking fund method,²⁰⁰¹ the present value projected net income method,²⁰⁰² the operating day method,²⁰⁰³ the completed contract method²⁰⁰⁴ and the personal inspection method.²⁰⁰⁵ Methods that have not been accepted generally include the cost recovery method,²⁰⁰⁶ the sliding scale method,²⁰⁰⁷ the inventory method²⁰⁰⁸ and the hybrid method.²⁰⁰⁹

Observation: Taxpayers may elect to forgo computing depreciation deductions under §168 with respect to property properly depreciable under the unit of production method or any method of depreciation not expressed in a term of years, other than the retirement-replacement-betterment method.²⁰¹⁰ However, the computational rules applicable to these methods of depreciation, such as the determination of useful life and salvage value, were repealed as deadwood,²⁰¹¹ as described in V.D.1., above.

Depreciation methods are discussed in 530 T.M., *Depreciation: General Concepts; Non-ACRS Rules*.

(2) Limitations

(a) Straight-Line Method

Only the straight-line method may be used for motion picture films, video tapes and sound recordings placed in service generally before September 14, 1995.²⁰¹²

Observation: Motion picture films, video tapes and sound recordings cannot be depreciated under §168.²⁰¹³

¹⁹⁹⁶ Reg. §1.167(b)-4. See pre-1990 RRA §167(b)(4) (in effect before Nov. 5, 1990); Pub. L. No. 101-508, §11812(c)(2).

¹⁹⁹⁷ Reg. §1.167(b)-2. See pre-1990 RRA §167(b)(2) (in effect before Nov. 5, 1990); Pub. L. No. 101-508, §11812(c)(2).

¹⁹⁹⁸ §167(g).

¹⁹⁹⁹ See, e.g., *Cumberland Portland Cement Co. v. Commissioner*, 29 T.C. 1185 (1958); *Browning-Ferris Indus., Inc. v. Commissioner*, 53 T.C.M. 397 (1987).

²⁰⁰⁰ See, e.g., *St. Paul Union Depot Co. v. Commissioner*, 123 F.2d 235 (8th Cir. 1941), aff'd 9 B.T.A.M. 40-849 (1940); Rev. Rul. 62-59, 1962-1 C.B. 315.

²⁰⁰¹ See Reg. §1.167(b)-4.

²⁰⁰² See *Citizens and S. Corp. v. Commissioner*, 91 T.C. 463 (1988), aff'd per curiam, 919 F.2d 1492 (11th Cir. 1990).

²⁰⁰³ See Rev. Rul. 56-652, 1956-2 C.B. 125.

²⁰⁰⁴ See *Lane v. Commissioner*, 37 T.C. 188 (1961).

²⁰⁰⁵ See *Otis Steel Co. v. Commissioner*, 6 B.T.A. 358 (1927); *Cumberland Glass Mfg. Co. v. United States*, 44 F.2d 455 (Ct. Cl. 1930).

²⁰⁰⁶ See *Inter-City TV Film Corp. v. Commissioner*, 43 T.C. 270 (1964); Rev. Rul. 60-358, amplified, Rev. Rul. 64-273.

²⁰⁰⁷ See *Garner v. Commissioner*, 54 T.C.M. 824 (1987); Rev. Rul. 79-285.

²⁰⁰⁸ *Goldberg v. Commissioner*, 13 T.C.M. 1207 (1954), aff'd on other issues, 239 F.2d 316 (5th Cir. 1956); *Theodore Tiedemann Corp. v. Commissioner*, 1 B.T.A. 1080 (1925); *Theodore Tiedemann & Sons Inc. v. Commissioner*, 1 B.T.A. 1077 (1925).

²⁰⁰⁹ See Rev. Rul. 78-358, 1978-2 C.B. 119.

²⁰¹⁰ See §168(f)(1).

²⁰¹¹ Pub. L. No. 101-508, §11812(a).

²⁰¹² See pre-1990 RRA §167(c) (in effect before Nov. 5, 1990); Pub. L. No. 101-508, §11812(c)(2).

²⁰¹³ §168(f)(3), §168(f)(4).

Only the straight-line method is acceptable for property with a useful life of less than three years.²⁰¹⁴ Only the straight line method is acceptable for certain other new and constructed property,²⁰¹⁵ for certain rehabilitated property²⁰¹⁶ and for certain boilers.²⁰¹⁷ Only certain methods are acceptable for real property.²⁰¹⁸ Similar special rules apply to utility property for which depreciation deductions are computed under §167.²⁰¹⁹

Note: Public utility property with respect to which a normalization method of accounting is not used is not depreciable under §168.²⁰²⁰ However, the rules relating to utility property for which depreciation deductions are computed under §167 were repealed as “deadwood,”²⁰²¹ as described in V.D.1., above.

In general, only the straight-line method, and a useful life of 36 months, may be used for computer software that is otherwise depreciable.²⁰²² Computer software is any program designed to cause a computer to perform a desired function, but does not include a data base or similar item unless it is in the public domain and is incidental to the operation of otherwise qualifying computer software.²⁰²³ Nor does computer software subject to depreciation include computer software that qualifies as an amortizable §197 intangible, as discussed in V.F.2.a., below. If the computer software would be considered tax-exempt use property under §168(h) if §168 applied to computer software, then instead of 36 months, the useful life of the software cannot be less than 125% of the lease term.²⁰²⁴

Only the straight-line method, and a useful life of 108 months, may be used for otherwise depreciable rights to service indebtedness secured by residential real property, unless they are acquired in a transaction, or series of transactions, involving the acquisition of the assets of a trade or business, or a substantial portion of a trade or business, other than mortgage servicing rights.²⁰²⁵

(b) Special Rules

Special methods of depreciation are provided with respect to the following types of property for which depreciation deductions otherwise are allowable.²⁰²⁶

- Any right, other than a right acquired as part of a purchase of a trade or business, to receive tangible property or services under a contract or granted by a governmental unit or agency or instrumentality of a governmental unit or agency;²⁰²⁷

- Any interest, other than an interest acquired as part of a purchase of a trade or business, in a patent or copyright;²⁰²⁸ and

- To the extent provided in regulations, any right, other than a right acquired as part of a purchase of a trade or business, under a contract, or granted by a governmental unit or agency or instrumentality of a governmental unit or agency, if the right has a fixed duration of less than 15 years,²⁰²⁹ or is fixed as to amount and, without regard to §197, would be recoverable under a method similar to the unit-of-production method.²⁰³⁰

If any property in any of these three groups would be considered tax-exempt use property under §168(h) if §168 applied to that property, then the useful life provided by the regulations must not be less than 125% of the lease term.²⁰³¹

Generally, for the first group, the depreciation deduction equals the basis of the right multiplied by a fraction that represents the proportion of the total amount of property or services to be received under the contract or governmental grant that is received during the tax year.²⁰³² If the amount of property to be received is not specified, the depreciation deduction is computed by prorating the basis of the right over the period of the right.²⁰³³

Generally, the depreciation deduction for an interest in a patent or copyright equals the portion of the purchase price paid or incurred during the tax year if the purchase price is payable at least annually as a fixed amount per use or a fixed percentage of revenue derived from use of the patent or copyright.²⁰³⁴ Otherwise, it is depreciated either ratably over its useful life, or under the income forecast method.²⁰³⁵

Generally, for the third group, the depreciation deduction equals the basis of the right multiplied by a fraction that represents the proportion of the total amount to be received under the contract or grant that is received during the tax year.²⁰³⁶ If the amount to be received is not specified and the period of the right is less than 15 years, the depreciation deduction is computed by prorating the basis of the right ratably over the period of the right.²⁰³⁷

(c) Income Forecast Method

The income forecast method may be used only for motion picture films, television films and taped shows, books, patents,

²⁰¹⁴ Reg. §1.167(c)-1(a)(3). See §167(c) (as in effect before Nov. 5, 1990); Pub. L. No. 101-508, §11812(c)(2).

²⁰¹⁵ Reg. §1.167(c)-1. See §167(c) (as in effect before Nov. 5, 1990); Pub. L. No. 101-508, §11812(c)(2).

²⁰¹⁶ Reg. §1.167(k)-1 through §1.167-4 (as in effect before repeal of 167(k) on Nov. 5, 1990). See §167(n) (as in effect before Nov. 5, 1990); Pub. L. No. 101-508, §11812(c)(2).

²⁰¹⁷ See §167(p), §167(q) (as in effect before Nov. 5, 1990); Pub. L. No. 101-508, §11812(c)(2).

²⁰¹⁸ Reg. §1.167(j)-1 through §1.167-7 (as in effect before repeal of 167(j) on Nov. 5, 1990). See §167(j) (as in effect before Nov. 5, 1990); Pub. L. No. 101-508, §11812(c)(2).

²⁰¹⁹ Reg. §1.167(l)-1 through §1.167-4 (as in effect before repeal of 167(l) on Nov. 5, 1990). See §167(l) (as in effect before Nov. 5, 1990); Pub. L. No. 101-508, §11812(c)(2).

²⁰²⁰ See §168(f)(2).

²⁰²¹ Pub. L. No. 101-508 §11812(a).

²⁰²² §167(f)(1)(A). See Reg. §1.167(a)-14(b)(1). See also Reg. §1.168(k)-2 (for depreciable computer software that qualifies for bonus depreciation).

²⁰²³ §167(f)(1)(B) (reference to §197(e)(3)(B)).

²⁰²⁴ §167(f)(1)(C) (reference to §168(i)(3)).

²⁰²⁵ §167(f)(3) (reference to §197(e)(6)). See Reg. §1.167(a)-14(d).

²⁰²⁶ §167(f)(2). See Reg. §1.167(a)-14(c).

²⁰²⁷ §167(f)(2) (reference to §197(e)(4)(B)).

²⁰²⁸ §167(f)(2) (reference to §197(e)(4)(C)).

²⁰²⁹ §167(f)(2) (reference to §197(e)(4)(D)).

²⁰³⁰ §167(f)(2).

²⁰³¹ §167(f)(2) (reference to §168(i)(3)).

²⁰³² See Reg. §1.167(a)-14(c)(1)(i).

²⁰³³ See Reg. §1.167(a)-14(c)(1)(ii).

²⁰³⁴ See Reg. §1.167(a)-14(c)(4).

²⁰³⁵ See Reg. §1.167(a)-14(c)(4).

²⁰³⁶ See Reg. §1.167(a)-14(c)(2)(i).

²⁰³⁷ See Reg. §1.167(a)-14(c)(2)(ii).

master sound recordings, copyrights and other property designated in regulations.²⁰³⁸

Observation: Motion picture films, video tapes and sound recordings cannot be depreciated under §168.²⁰³⁹

For property depreciated using the income forecast method, four conditions apply.²⁰⁴⁰ First, in determining the amount of the depreciation deduction, the taxpayer must include all estimated income generated by the property within its first 10 years rather than within the asset's useful life,²⁰⁴¹ and for this purpose income means gross income.²⁰⁴² Second, the property's adjusted basis can include only amounts that satisfy the §461(h) economic performance standards.²⁰⁴³ Third, any costs that are not recovered by the end of the 10th tax year after the property was placed in service may be taken into account as depreciation in that year.²⁰⁴⁴ Fourth, other than for property costing less than \$100,000,²⁰⁴⁵ the taxpayer must pay or is entitled to receive interest calculated using a lookback method,²⁰⁴⁶ under which depreciation claimed by the taxpayer is compared to what would have been claimed had actual rather than estimated income been taken into account and the resulting increase or decrease in tax liability is used to compute the interest.²⁰⁴⁷

(3) Change in Method

The method of depreciation, for property for which depreciation deductions are computed under §167, may be changed from the declining balance method to the straight line method at any time the taxpayer so elects, unless the taxpayer has otherwise agreed.²⁰⁴⁸

(4) Useful Life

Useful life is the period over which the property may reasonably be expected to be useful to the taxpayer in the trade or business or in the production of income.²⁰⁴⁹ Its determination requires a factual analysis of the taxpayer's experience with similar property and can entail a variety of factors.²⁰⁵⁰ Salvage value is not a factor in determining useful life.²⁰⁵¹ Useful life may be redetermined at the end of a tax year if the change is significant and there is a clear and convincing basis for the change.²⁰⁵²

For property for which depreciation deductions are computed under §167, agreements can be entered into by the taxpayer and the IRS with respect to the useful life of the property.²⁰⁵³ Similarly, if the property is included in a class for which a class life is prescribed, the taxpayer can elect to use the class

life prescribed by the IRS which reasonably reflects the anticipated useful life of the class to the industry or other group.²⁰⁵⁴

Useful lives are discussed in 530 T.M., *Depreciation: General Concepts; Non-ACRS Rules*.

d. Salvage Value

Salvage value is the amount, determined at the time of acquisition, which is estimated will be realized upon sale or other disposition of the property when it is no longer useful in the taxpayer's trade or business or in the production of income and is to be retired from service by the taxpayer.²⁰⁵⁵ Once determined, salvage value is not changed, except that it may be changed if the useful life is redetermined.²⁰⁵⁶

For personalty, salvage value may be reduced by an amount that does not exceed 10% of the basis of the property.²⁰⁵⁷ For this purpose, personalty is any depreciable personal property, other than livestock, with a useful life of three or more years.²⁰⁵⁸

Salvage value is discussed in 530 T.M., *Depreciation: General Concepts; Non-ACRS Rules*.

4. Taxpayer Entitled to Computation

a. In General

Only the owner of property is allowed to deduct depreciation deductions computed under §167.²⁰⁵⁹ The owner of property for these purposes is not necessarily the owner under local law but the person who bears the economic loss from any decrease in value of the property.²⁰⁶⁰

b. Life Estates and Income Interests with Remainders

Special rules apply for property, for which depreciation is computed under §167, that is held by one person for life with remainder to another.²⁰⁶¹ The deduction is computed as if the life tenant were the absolute owner of the property and is allowed to the life tenant.²⁰⁶² If the property is held in trust, the allowable deduction is apportioned between the income beneficiary and the trustee in accordance with the pertinent provisions of the instrument creating the trust, or, in the absence of such provisions, on the basis of the trust income allocable to the income beneficiary and the trustee.²⁰⁶³ If the property is held by an estate, the allowable deduction is apportioned between the estate and the heirs, legatees and devisees on the basis of the income of the estate allocable to each.²⁰⁶⁴

²⁰³⁸ §167(g)(6), effective for property placed in service after Aug. 5, 1997.

²⁰³⁹ §168(f)(3), (4).

²⁰⁴⁰ §167(g)(1).

²⁰⁴¹ §167(g)(1)(A).

²⁰⁴² §167(g)(5)(E).

²⁰⁴³ §167(g)(1)(B).

²⁰⁴⁴ §167(g)(1)(C).

²⁰⁴⁵ §167(g)(3).

²⁰⁴⁶ §167(g)(1)(D).

²⁰⁴⁷ See §167(g)(2).

²⁰⁴⁸ Reg. §1.167(e)-1.

²⁰⁴⁹ Reg. §1.167(a)-1(b).

²⁰⁵⁰ See Reg. §1.167(a)-1(b).

²⁰⁵¹ See Reg. §1.167(a)-1(b).

²⁰⁵² See Reg. §1.167(a)-1(b).

²⁰⁵³ Reg. §1.167(d)-1.

²⁰⁵⁴ Reg. §1.167(a)-11.

²⁰⁵⁵ Reg. §1.167(a)-1(c)(1).

²⁰⁵⁶ Reg. §1.167(a)-1(c)(1).

²⁰⁵⁷ Reg. §1.167(f)-1.

²⁰⁵⁸ Reg. §1.167(f)-1(b)(1).

²⁰⁵⁹ *Weiss v. Weiner*, 279 U.S. 333 (1929), rev'g 27 F.2d 200 (6th Cir. 1928), rev'g 17 F.2d 650 (N.D. Ohio 1926).

²⁰⁶⁰ *Weiss v. Weiner*, 279 U.S. 333 (1929), rev'g 27 F.2d 200 (6th Cir. 1928), rev'g 17 F.2d 650 (N.D. Ohio 1926).

²⁰⁶¹ §167(d); Reg. §1.167(h)-1.

²⁰⁶² §167(d); Reg. §1.167(h)-1(a).

²⁰⁶³ §167(d); Reg. §1.167(h)-1(b).

²⁰⁶⁴ §167(d); Reg. §1.167(h)-1(c).

E. Accelerated Cost Recovery System Deductions

Under §168, the taxpayer is allowed to deduct depreciation on MACRS property under the modified accelerated cost recovery system (MACRS).²⁰⁶⁵ For ACRS property, the deduction is computed under the original accelerated cost recovery system (ACRS).²⁰⁶⁶

The ACRS and MACRS deductions are discussed in 531 T.M., *Depreciation: MACRS and ACRS*, and in 532 T.M., *First-Year Expensing and Additional Depreciation*.

F. Amortization of Certain Intangibles

Under §197, an amortization deduction is allowed for amortizable §197 intangibles.²⁰⁶⁷ The deduction is computed by amortizing the adjusted basis of the property, as computed for purposes of determining gain, ratably over the amortization period, beginning with the month in which the taxpayer acquires the intangible.²⁰⁶⁸ The amortization period is 15 years,²⁰⁶⁹ except that the period for any §197 intangible which would be tax-exempt use property as defined in §168(h) if §168 applied to the intangible must be no less than 125% of the lease term.²⁰⁷⁰

Any amortizable §197 intangible is treated as property of a character subject to the §167 depreciation deduction.²⁰⁷¹ No other depreciation or amortization deduction is allowable for an amortizable §197 intangible.²⁰⁷²

The amortization of intangibles under §197 is discussed in 533 T.M., *Amortization of Intangibles*.

G. Certain Asset Expensing

Under §179, a taxpayer may elect to deduct, rather than capitalize and recover through MACRS or ACRS, the cost of §179 property, up to specified dollar limits.²⁰⁷³ The deduction is allowable in the year the property is placed in service.²⁰⁷⁴

The §179 expensing deduction is discussed in 532 T.M., *First-Year Expensing and Additional Depreciation*.

H. Pollution Control Facility Amortization

Under §169, a taxpayer may elect to deduct the amortizable basis of any certified pollution control facility as amortization over a 60-month period.²⁰⁷⁵ No deduction under §167 or

§168²⁰⁷⁶ is allowed with respect to the pollution control facility for which the §169 election is in effect,²⁰⁷⁷ except for the portion of the adjusted basis that is not amortizable under §169.²⁰⁷⁸ The 60-month period is extended to an 84-month period for atmospheric pollution control facilities placed in service after April 11, 2005, that are used in connection with an electric generation plant or other property that is primarily coal fired.²⁰⁷⁹

Pollution control facility amortization is discussed in 530 T.M., *Depreciation: General Concepts*.

I. Research and Experimental Expenditures

Domestic R&E expenditures incurred after 2024 can be immediately deducted in the year incurred,²⁰⁸⁰ though foreign R&E expenditures must be still be amortized ratably over 15 years.²⁰⁸¹ For tax years beginning in 2022 and later, research and experimentation expenditures generally had to be charged to capital account and amortized.²⁰⁸²

Current expense and amortization deductions for research and experimental expenditure are discussed in 556 T.M., *Research and Development Expenditures*.

J. Architectural and Transportation Barrier Removal Expenditures

1. In General

Although expenditures for architectural and transportation barrier removal are in the nature of capital expenditures, §190 allows the taxpayer to elect to treat them as expenses not chargeable to capital account if they are qualified architectural and transportation barrier removal expenses.²⁰⁸³ Expenditures so treated are allowed as a deduction in the tax year in which they are paid or incurred.²⁰⁸⁴

2. Limitation

The amount deductible as an expense under §190 is limited to \$15,000 for each tax year.²⁰⁸⁵ Amounts expended in excess of the \$15,000 limitation are capital expenditures.²⁰⁸⁶

²⁰⁶⁵ §168.

²⁰⁶⁶ §168 (1954).

²⁰⁶⁷ §197(a).

²⁰⁶⁸ §197(a).

²⁰⁶⁹ *Id.*

²⁰⁷⁰ §197(f)(10). See §168(i)(3) (definition of lease term).

²⁰⁷¹ §197(f)(7).

²⁰⁷² §197(b).

²⁰⁷³ §179(a).

²⁰⁷⁴ §179(a).

²⁰⁷⁵ §169(a).

²⁰⁷⁶ See §167(b), §168.

²⁰⁷⁷ §169(a).

²⁰⁷⁸ §169(g).

²⁰⁷⁹ §169(d)(5)(B).

²⁰⁸⁰ §174A, added by the One Big Beautiful Bill Act (OBBBA), Pub. L. No. 119-21, §70302(a).

²⁰⁸¹ §174(a), as amended by the OBBBA, Pub. L. No. 119-21, §70302(b) (1).

²⁰⁸² Pre-OBBBA §174.

²⁰⁸³ §190(a)(1); Reg. §1.190-1(a).

²⁰⁸⁴ §190(a)(1).

²⁰⁸⁵ §190(c).

²⁰⁸⁶ Reg. §1.190-1(b).

In the case of partners in partnerships, the limitation applies to the partnership and to each partner.²⁰⁸⁷ For a partner, the limitation applies to the aggregation of the partner's share of deductible architectural and transportation barrier removal expenses from each partnership in which the partner is a partner and the partner's own deductible architectural and transportation barrier removal expenses.²⁰⁸⁸ The partner may allocate the portion of the expenditures disallowed on account of the limitation among the various partnerships and the partner's own expenditures in any manner.²⁰⁸⁹ A partnership must assume that each partner's share of the partnership's qualified architectural and transportation barrier removal expenses was deductible by the partner, unless the partner provides clear and convincing evidence to the partnership that the limitation caused some or all of the partner's share of the partnership's qualified architectural and transportation barrier removal expenses to be nondeductible.²⁰⁹⁰

Example: P is a 10% partner in ABC Partnership and a 20% partner in DEF Partnership. In 2013, ABC expended \$500,000 for qualified architectural and transportation barrier removal expenses, DEF expended \$300,000, and P expended \$13,000 individually. The \$15,000 limitation applies to ABC and DEF, making \$485,000 of ABC's expenditures and \$285,000 of DEF's expenditures capital expenditures. P's respective \$1,500 and \$3,000 shares of the qualified architectural and transportation barrier removal expenses of the two partnerships must be added to P's own \$13,000 of this type of expense. Of the \$17,500 total, only \$15,000 is deductible by P. P may elect to treat the \$2,500 that is not deductible in any of the following six ways:

- as consisting entirely of P's own expenditures;
- as consisting entirely of P's share of DEF's expenditures;
- as consisting of P's \$1,500 share of ABC's expenditures and \$1,000 of P's own expenditures;
- as consisting of P's \$1,500 share of ABC's expenditures and \$1,000 of P's share of DEF's expenditures;
- as ratably consisting of \$1,857.25 ($\$13,000/\$17,500 \times \$2,500$) of P's own expenditures, \$214.25 ($\$1,500/\$17,500 \times \$2,500$) of P's share of ABC's expenditures, and \$428.50 ($\$3,000/\$17,500 \times \$2,500$) of P's share of DEF's expenditures; or
- as consisting of any other combination P selects.²⁰⁹¹

3. Architectural and Transportation Barrier Removal Expenses

Architectural and transportation barrier removal expenses are expenditures for the purpose of making any facility or public transportation vehicle owned or leased by the taxpayer for

use in connection with a trade or business more accessible to, and usable by, handicapped and elderly individuals.²⁰⁹² A facility is all or any portion of a building, structure, equipment, road, walk, parking lot or similar real or personal property.²⁰⁹³ A public transportation vehicle is a vehicle, such as a bus, railroad car or other conveyance, that provides to the public general or special transportation service, including service to customers of a taxpayer not in the trade or business of rendering transportation services.²⁰⁹⁴

4. Qualified Architectural and Transportation Barrier Removal Expenses

a. In General

Qualified architectural and transportation barrier removal expenses are architectural or transportation barrier removal expenses with respect to which the taxpayer establishes, to the satisfaction of the IRS, that the resulting removal of the barrier meets the standards promulgated by the IRS with the concurrence of the Architectural and Transportation Barriers Compliance Board.²⁰⁹⁵ An expense is not qualified if it is not specifically attributable to the removal of an existing architectural or transportation barrier.²⁰⁹⁶ Qualified architectural and transportation barrier removal expenses do not include any expense paid or incurred in connection with the construction or comprehensive renovation of a facility or public transportation vehicle or the normal replacement of depreciable property.²⁰⁹⁷

b. Specific Standards

(1) In General

The IRS has set forth in regulations the standards that apply to a variety of facility or vehicle features with which the removal must comply in order for the expense to be a qualified architectural and transportation barrier removal expense.²⁰⁹⁸ They are adapted from the "American National Standard Specifications for Making Buildings and Facilities Accessible to, and Usable by, the Physically Handicapped" (1971), the copyright for which is held by the American National Standards Institute, 1430 Broadway, New York, New York 10018.²⁰⁹⁹ The standards are described below.

(2) Grading

The grading of ground, even contrary to existing topography, must maintain a level with a normal entrance to make a facility accessible to individuals with physical disabilities.²¹⁰⁰

²⁰⁸⁷ *Id.*

²⁰⁸⁸ *Id.*

²⁰⁸⁹ *Id.*

²⁰⁹⁰ *Id.*

²⁰⁹¹ *Id.*

²⁰⁹² §190(b)(1); Reg. §1.190-2(a).

²⁰⁹³ Reg. §1.190-2(a)(1).

²⁰⁹⁴ Reg. §1.190-2(a)(2).

²⁰⁹⁵ §190(b)(2); Reg. §1.190-2(b)(1).

²⁰⁹⁶ Reg. §1.190-2(b)(1).

²⁰⁹⁷ *Id.*

²⁰⁹⁸ See Reg. §1.190-2(b)(2) through §1.190-2(b)(22).

²⁰⁹⁹ See Reg. §1.190-2(b)(1).

²¹⁰⁰ Reg. §1.190-2(b)(2).

*(3) Walks**(a) Size, Grade, and Surface*

A public walk must be at least 48 inches wide and must have a gradient of no more than 5%.²¹⁰¹ A walk of maximum or near maximum grade and of considerable length must have level areas at regular intervals.²¹⁰² A walk or driveway must have a nonslip surface.²¹⁰³

(b) Intersections

A walk must be of a continuing common surface and must not be interrupted by steps or abrupt changes in level.²¹⁰⁴ Where a walk crosses another walk, a driveway, or a parking lot, they must blend to a common level.²¹⁰⁵ However, the elimination of curbs that are safety features for the handicapped, particularly the blind, need not be removed.²¹⁰⁶

(c) Platforms

An inclined walk must have a level platform at the top and at the bottom.²¹⁰⁷ If a door swings out onto the platform toward the walk, the platform must be at least five feet deep and five feet wide.²¹⁰⁸ If a door does not swing onto the platform or toward the walk, the platform must be three feet deep and five feet wide.²¹⁰⁹ A platform must extend at least one foot beyond the strike jamb side of any doorway.²¹¹⁰

*(4) Parking Lots**(a) Location and Size*

At least one parking space that is accessible and approximate to a facility must be set aside and identified for use by the handicapped.²¹¹¹ A parking space for the handicapped, when placed between two conventional diagonal or head-on parking spaces must be at least 12 feet wide.²¹¹²

(b) Layout

A parking space must be open on one side to allow room for individuals in wheelchairs and individuals using crutches or braces to get in and out of an automobile onto a level surface suitable for wheeling and walking.²¹¹³ A parking space must be positioned so that individuals in wheelchairs and individuals using crutches or braces need not wheel or walk behind parked cars.²¹¹⁴

*(5) Ramps**(a) Grade and Surface*

A ramp must not have a slope greater than a one inch rise in 12 inches.²¹¹⁵ A ramp must have level platforms at not more than 30-foot intervals and at any turn.²¹¹⁶ A ramp must have a nonslip surface.²¹¹⁷

(b) Handrails

A ramp must have at least one handrail that is 32 inches in height, measured from the surface of the ramp, that is smooth, and that extends one foot beyond the top and bottom of the ramp.²¹¹⁸ However, handrail extensions which themselves are hazards are not required.²¹¹⁹

(c) Platforms

A ramp must have a level platform at the top and at the bottom.²¹²⁰ If a door swings out onto the platform or toward the ramp, the platform must be at least five feet deep and five feet wide.²¹²¹ If a door does not swing onto the platform or toward the ramp, the platform must be at least three feet deep and five feet wide.²¹²² A platform must extend at least one foot beyond the strike jamb side of any doorway.²¹²³

(d) Curb Ramps

A curb ramp must be provided at an intersection.²¹²⁴ The curb ramp must not be less than four feet wide and must not have a slope greater than one inch rise in 12 inches.²¹²⁵ The transition between the surfaces must be smooth.²¹²⁶ A curb ramp must have a nonslip surface.²¹²⁷

(6) Entrances

A building must have at least one primary entrance which is usable by individuals in wheelchairs and which is on a level accessible to an elevator.²¹²⁸

*(7) Doors and Doorways**(a) Size and Characteristics*

A door must have a clear opening of no less than 32 inches and must be operable by a single effort.²¹²⁹ The door closer must be selected, placed and set so as not to impair the use of the door by the handicapped.²¹³⁰

²¹⁰¹ Reg. § 1.190-2(b)(3)(i).

²¹⁰² *Id.*

²¹⁰³ *Id.*

²¹⁰⁴ Reg. § 1.190-2(b)(3)(ii).

²¹⁰⁵ Reg. § 1.190-2(b)(3)(iii).

²¹⁰⁶ *Id.*

²¹⁰⁷ Reg. § 1.190-2(b)(3)(iv).

²¹⁰⁸ *Id.*

²¹⁰⁹ Reg. § 1.190-2(b)(3)(iv).

²¹¹⁰ Reg. § 1.190-2(b)(3)(iv).

²¹¹¹ Reg. § 1.190-2(b)(4)(i).

²¹¹² Reg. § 1.190-2(b)(4)(iii).

²¹¹³ Reg. § 1.190-2(b)(4)(ii).

²¹¹⁴ Reg. § 1.190-2(b)(4)(iv).

²¹¹⁵ Reg. § 1.190-2(b)(5)(i).

²¹¹⁶ Reg. § 1.190-2(b)(5)(v).

²¹¹⁷ Reg. § 1.190-2(b)(5)(iii).

²¹¹⁸ Reg. § 1.190-2(b)(5)(ii).

²¹¹⁹ *Id.*

²¹²⁰ Reg. § 1.190-2(b)(5)(iv).

²¹²¹ *Id.*

²¹²² *Id.*

²¹²³ *Id.*

²¹²⁴ Reg. § 1.190-2(b)(5)(vi).

²¹²⁵ *Id.*

²¹²⁶ *Id.*

²¹²⁷ *Id.*

²¹²⁸ Reg. § 1.190-2(b)(6).

²¹²⁹ Reg. § 1.190-2(b)(7)(i).

²¹³⁰ Reg. § 1.190-2(b)(7)(iii).

(b) Adjacent Floor

The floor on the inside and outside of a doorway must be level for a distance of at least five feet from the door in the direction the door swings and must extend at least one foot beyond the strike jamb side of the doorway.²¹³¹ There must be no sharp inclines or abrupt changes in level at a doorway.²¹³² The threshold must be flush with the floor.²¹³³

*(8) Stairs**(a) Nosing and Risers*

Stairsteps must have round nosing of between one and 1/2 inch radius.²¹³⁴ Steps must have risers that do not exceed seven inches.²¹³⁵

(b) Handrails

Stairs must have a handrail 32 inches high as measured from the tread at the face of the riser.²¹³⁶ Stairs must have at least one handrail that extends at least 18 inches beyond the top step and beyond the bottom step.²¹³⁷ However, handrail extensions which themselves are hazards are not required.²¹³⁸

(9) Floors

Floors must have a nonslip surface.²¹³⁹ Floors on a given story of a building must be of a common level or must be connected by a ramp that meets the standards described in V.J.4.b.(5), above.²¹⁴⁰

*(10) Toilet Rooms**(a) Space and Lavatories*

A toilet room must have sufficient space to allow traffic of individuals in wheelchairs.²¹⁴¹ A toilet room must have lavatories with narrow aprons.²¹⁴² Drain pipes and hot water pipes under a lavatory must be covered or insulated.²¹⁴³

(b) Stalls and Urinals

A toilet room must have at least one toilet stall that meets five specifications.²¹⁴⁴ The first specification requires that the stall be at least 36 inches wide.²¹⁴⁵ The second specification requires that the stall be at least 56 inches deep.²¹⁴⁶ The third specification requires that if the stall has a door it must be at least 32 inches wide and swing out.²¹⁴⁷ The fourth specification requires

that the stall have handrails on each side, 33 inches high and parallel to the floor, 1/2 inches in outside diameter, 1/2 inches clearance between rail and wall and fastened securely at ends and center.²¹⁴⁸ The fifth specification requires that the stall have a water closet with a seat 19 to 20 inches from the finished floor.²¹⁴⁹

A toilet room must have, in addition to, or instead of, the stall described in the preceding paragraph, at least one toilet stall that meets five specifications.²¹⁵⁰ The first specification requires that the stall be at least 66 inches wide.²¹⁵¹ The second specification requires that the stall be at least 60 inches deep.²¹⁵² The third specification requires that if the stall has a door it must be at least 32 inches wide and swing out.²¹⁵³ The fourth specification requires that the stall have a handrail on one side, 33 inches high and parallel to the floor, 1/2 inches in outside diameter, 1/2 inches clearance between rail and wall and fastened securely at ends and center.²¹⁵⁴ The fifth specification requires that the stall have a water closet with a seat 19 to 20 inches from the finished floor, centerline located 18 inches from the side wall on which the handrail is located.²¹⁵⁵

A toilet room for men must have wall-mounted urinals with the opening of the basin 15 to 19 inches from the finished floor or must have floor-mounted urinals that are level with the main floor of the toilet room.²¹⁵⁶

(c) Accessories

A mirror and a shelf above a lavatory must be no higher than 40 inches above the floor, measured from the top of the shelf and the bottom of the mirror.²¹⁵⁷ Towel racks, towel dispensers, other dispensers and disposal units must be mounted no higher than 40 inches from the floor.²¹⁵⁸

(11) Water Fountains

A water fountain and a cooler must have up-front spouts and controls.²¹⁵⁹ A water fountain and a cooler must be hand-operated or hand-and-foot-operated.²¹⁶⁰ A water fountain mounted on the side of a floor-mounted cooler must not be more than 30 inches above the floor.²¹⁶¹ A wall-mounted, hand-operated water cooler must be mounted with the basin 36 inches from the floor.²¹⁶² A water fountain must not be fully recessed and must not be set into an alcove unless the alcove is at least 36 inches wide.²¹⁶³

²¹³¹ Reg. §1.190-2(b)(7)(ii).²¹³² Reg. §1.190-2(b)(7)(iii).²¹³³ *Id.*²¹³⁴ Reg. §1.190-2(b)(8)(i).²¹³⁵ Reg. §1.190-2(b)(8)(ii).²¹³⁶ Reg. §1.190-2(b)(8)(iii).²¹³⁷ Reg. §1.190-2(b)(8)(iv).²¹³⁸ *Id.*²¹³⁹ Reg. §1.190-2(b)(9)(i).²¹⁴⁰ Reg. §1.190-2(b)(9)(ii).²¹⁴¹ Reg. §1.190-2(b)(10)(i).²¹⁴² Reg. §1.190-2(b)(10)(ii).²¹⁴³ *Id.*²¹⁴⁴ Reg. §1.190-2(b)(10)(iii).²¹⁴⁵ Reg. §1.190-2(b)(10)(iii)(A).²¹⁴⁶ Reg. §1.190-2(b)(10)(iii)(B).²¹⁴⁷ Reg. §1.190-2(b)(10)(iii)(C).²¹⁴⁸ Reg. §1.190-2(b)(10)(iv)(D).²¹⁴⁹ Reg. §1.190-2(b)(10)(iv)(E).²¹⁵⁰ Reg. §1.190-2(b)(10)(v).²¹⁵¹ Reg. §1.190-2(b)(10)(v)(A).²¹⁵² Reg. §1.190-2(b)(10)(v)(B).²¹⁵³ Reg. §1.190-2(b)(10)(v)(C).²¹⁵⁴ Reg. §1.190-2(b)(10)(v)(D).²¹⁵⁵ Reg. §1.190-2(b)(10)(v)(E).²¹⁵⁶ Reg. §1.190-2(b)(10)(vi).²¹⁵⁷ Reg. §1.190-2(b)(10)(vii).²¹⁵⁸ Reg. §1.190-2(b)(11)(i).²¹⁵⁹ Reg. §1.190-2(b)(11)(ii).²¹⁶⁰ Reg. §1.190-2(b)(11)(iii).²¹⁶¹ Reg. §1.190-2(b)(11)(iv).²¹⁶² Reg. §1.190-2(b)(11)(v).²¹⁶³ Reg. §1.190-2(b)(11)(vi).

(12) Public Telephones

A public telephone must be placed so that the dial and the headset can be reached by individuals in wheelchairs.²¹⁶⁴ A public telephone must be equipped for those with hearing disabilities and so identified with instructions for use.²¹⁶⁵ Coin slots of public telephones must not be more than 48 inches from the floor.²¹⁶⁶

(13) Elevators

An elevator must be accessible to, and usable by, the handicapped or the elderly on the levels they use to enter the building and all levels and areas normally used.²¹⁶⁷ Cab size must allow for the turning of a wheelchair.²¹⁶⁸ The cab must measure at least 54 by 68 inches.²¹⁶⁹ The door clear opening width must be at least 32 inches.²¹⁷⁰ All essential controls must be within 48 to 54 inches from the cab floor.²¹⁷¹ These controls must be usable by the blind and must be tactilely identifiable.²¹⁷²

(14) Controls

Switches and controls for light, heat, ventilation, windows, draperies, fire alarms and all similar controls of frequent or essential use, must be placed within the reach of individuals in wheelchairs.²¹⁷³ These switches and controls must be no higher than 48 inches from the floor.²¹⁷⁴

*(15) Identification**(a) Room Doors*

Raised letters or numbers must be used to identify a room or an office.²¹⁷⁵ This identification must be placed on the wall to the right or left of the door at a height of 54 inches to 66 inches, measured from the finished floor.²¹⁷⁶

(b) Dangerous Doors

A door that might prove dangerous if a blind person were to exit or enter by it must be tactilely identifiable.²¹⁷⁷ These doors include doors such as those leading to loading platforms, boiler rooms, stages or fire escapes.²¹⁷⁸

(16) Warning Signals

An audible warning signal must be accompanied by a simultaneous visual signal for the benefit of those with hearing

disabilities.²¹⁷⁹ A visual warning signal must be accompanied by a simultaneous audible signal for the benefit of the blind.²¹⁸⁰

(17) Hazards

Hanging signs, ceiling lights and similar objects and fixtures must be placed at a minimum height of seven feet, measured from the floor.²¹⁸¹

(18) International Accessibility Symbol

The international accessibility symbol must be displayed on routes to and at wheelchair-accessible entrances to facilities and public transportation vehicles.²¹⁸² The international accessibility symbol is the outline drawing of a person in a wheelchair, and is reproduced in the regulations.²¹⁸³

(19) Additional Standards for Rail Facilities

A rail facility must contain a fare control area with at least one entrance with a clear opening at least 36 inches wide.²¹⁸⁴ A boarding platform edge bordering a drop-off or other dangerous condition must be marked with a warning device consisting of a strip of floor material differing in color and texture from the remaining floor surface.²¹⁸⁵ The gap between the boarding platform and the vehicle doorway must be minimized.²¹⁸⁶

*(20) Standards for Buses**(a) Access Mechanism*

A bus must have a level change mechanism, such as a lift or ramp, to enter the bus and sufficient clearance to permit a wheelchair user to reach a secure location.²¹⁸⁷ A bus must have a wheelchair securement device.²¹⁸⁸ However, a wheelchair securement device that is itself a barrier or hazard is not required.²¹⁸⁹

(b) Steps

The vertical distance from a curb or from street level to the first front door step must not exceed eight inches.²¹⁹⁰ The riser height for each front doorstep after the first step up from the curb or street level must also not exceed eight inches.²¹⁹¹ The tread depth of steps at front and rear doors must be at least 12 inches.²¹⁹²

(c) Information

A bus must contain clearly legible signs that indicate that seats in the front of the bus are priority seats for handicapped or

²¹⁶⁴ Reg. § 1.190-2(b)(12)(i).

²¹⁶⁵ Reg. § 1.190-2(b)(12)(ii).

²¹⁶⁶ Reg. § 1.190-2(b)(12)(iii).

²¹⁶⁷ Reg. § 1.190-2(b)(13)(i).

²¹⁶⁸ Reg. § 1.190-2(b)(13)(ii).

²¹⁶⁹ *Id.*

²¹⁷⁰ Reg. § 1.190-2(b)(13)(iii).

²¹⁷¹ Reg. § 1.190-2(b)(13)(iv).

²¹⁷² *Id.*

²¹⁷³ Reg. § 1.190-2(b)(14).

²¹⁷⁴ Reg. § 1.190-2(b)(14).

²¹⁷⁵ Reg. § 1.190-2(b)(15)(i).

²¹⁷⁶ *Id.*

²¹⁷⁷ Reg. § 1.190-2(b)(15)(ii).

²¹⁷⁸ *Id.*

²¹⁷⁹ Reg. § 1.190-2(b)(16)(i).

²¹⁸⁰ Reg. § 1.190-2(b)(16)(ii).

²¹⁸¹ Reg. § 1.190-2(b)(17).

²¹⁸² Reg. § 1.190-2(b)(18).

²¹⁸³ See Reg. § 1.190-2(b)(18).

²¹⁸⁴ Reg. § 1.190-2(b)(19)(i).

²¹⁸⁵ Reg. § 1.190-2(b)(19)(ii).

²¹⁸⁶ *Id.*

²¹⁸⁷ Reg. § 1.190-2(b)(20)(i).

²¹⁸⁸ Reg. § 1.190-2(b)(20)(ii).

²¹⁸⁹ *Id.*

²¹⁹⁰ Reg. § 1.190-2(b)(20)(iii).

²¹⁹¹ Reg. § 1.190-2(b)(20)(iii).

²¹⁹² Reg. § 1.190-2(b)(20)(iii).

elderly persons.²¹⁹³ A bus must contain clearly legible signs that encourage other passengers to make the priority seats available to handicapped or elderly persons who wish to use them.²¹⁹⁴

(d) Handrails

Handrails and stanchions must be provided in the entranceway to the bus in a configuration that allows handicapped and elderly persons to grasp the assists from outside the bus while starting to board and to continue to use the assists throughout the boarding and fare collection processes.²¹⁹⁵ The configuration of the passenger assist system must include a rail across the front of the interior of the bus located to allow passengers to lean against it while paying fares.²¹⁹⁶ Overhead handrails must be continuous except for a gap at the rear doorway.²¹⁹⁷

(e) Surfaces

Floors and steps must have nonslip surfaces.²¹⁹⁸ Step edges must have a band of bright contrasting color running the full width of the step.²¹⁹⁹

(f) Illumination

A stepwell immediately adjacent to the driver must have, when the door is open, at least two foot-candles of illumination measured on the step tread.²²⁰⁰ Other stepwells must have, at all times, at least two foot-candles of illumination measured on the step tread.²²⁰¹

The doorways of the bus must have outside lighting that provides at least one foot-candle of illumination on the street surface for a distance of three feet from all points on the bottom step tread edge.²²⁰² This lighting must be located below window level and must be shielded to protect the eyes of entering and exiting passengers.²²⁰³

(g) Fare Box

The fare box must be located as far forward as practicable and must not obstruct traffic in the vestibule.²²⁰⁴

(21) Standards for Rapid and Light Rail Vehicles

(a) Doors and Doorways

Passenger doorways on the vehicle sides must have clear openings at least 32 inches wide.²²⁰⁵ Audible or visual warning signals must be provided to alert handicapped and elderly persons of closing doors.²²⁰⁶

(b) Handrails

Handrails and stanchions must be sufficient to permit safe boarding, onboard circulation, seating and standing assistance and unboarding by handicapped and elderly persons.²²⁰⁷ On a level entry vehicle, handrails, stanchions and seats must be located so as to allow a wheelchair user to enter the vehicle and position the wheelchair in a location that does not obstruct the movement of other passengers.²²⁰⁸ On a vehicle that requires the use of steps in the boarding process, handrails and stanchions must be provided in the entranceway to the vehicle in a configuration that allows handicapped and elderly persons to grasp the assists from outside the vehicle while starting to board and to continue using the assists throughout the boarding process.²²⁰⁹

(c) Surfaces

Floors and steps must have nonslip surfaces.²²¹⁰ Step edges on a light rail vehicle must have a band of bright contrasting color running the full width of the step.²²¹¹

(d) Illumination

A stepwell immediately adjacent to the driver must have, when the door is open, at least two foot-candles of illumination measured on the step tread.²²¹² Other stepwells must have, at all times, at least two foot-candles of illumination measured on the step tread.²²¹³

The doorways of a light rail vehicle must have outside lighting that provides at least one foot-candle of illumination on the street surface for a distance of three feet from all points on the bottom step tread edge.²²¹⁴ This lighting must be located below window level and must be shielded to protect the eyes of entering and exiting passengers.²²¹⁵

(22) Other Barrier Removals

Any barrier that would not be removed by compliance with the standards described in V.K.4.b.(2) through (21), above, must satisfy three conditions.²²¹⁶ First, a substantial barrier to the access to or use of a facility or public transportation vehicle by handicapped or elderly individuals must be removed.²²¹⁷ Second, the barrier which is removed must have been a barrier for one or more major classes of handicapped or elderly individuals, such as the blind, deaf or wheelchair users.²²¹⁸ Third, the removal of the barrier must be accomplished without creating any new barrier that significantly impairs access to or use of the facility or vehicle by the class or classes obstructed by the barrier.²²¹⁹

²¹⁹³ Reg. §1.190-2(b)(20)(iv).

²¹⁹⁴ *Id.*

²¹⁹⁵ Reg. §1.190-2(b)(20)(v).

²¹⁹⁶ *Id.*

²¹⁹⁷ *Id.*

²¹⁹⁸ Reg. §1.190-2(b)(20)(vi).

²¹⁹⁹ *Id.*

²²⁰⁰ Reg. §1.190-2(b)(20)(vii).

²²⁰¹ *Id.*

²²⁰² Reg. §1.190-2(b)(20)(viii).

²²⁰³ Reg. §1.190-2(b)(20)(viii).

²²⁰⁴ Reg. §1.190-2(b)(20)(ix).

²²⁰⁵ Reg. §1.190-2(b)(21)(i).

²²⁰⁶ Reg. §1.190-2(b)(21)(ii).

²²⁰⁷ Reg. §1.190-2(b)(21)(iii).

²²⁰⁸ Reg. §1.190-2(b)(21)(iii).

²²⁰⁹ Reg. §1.190-2(b)(21)(iii).

²²¹⁰ Reg. §1.190-2(b)(21)(iv).

²²¹¹ Reg. §1.190-2(b)(21)(iv).

²²¹² Reg. §1.190-2(b)(21)(v).

²²¹³ *Id.*

²²¹⁴ Reg. §1.190-2(b)(21)(vi).

²²¹⁵ *Id.*

²²¹⁶ Reg. §1.190-2(b)(22).

²²¹⁷ Reg. §1.190-2(b)(22)(i).

²²¹⁸ Reg. §1.190-2(b)(22)(ii).

²²¹⁹ Reg. §1.190-2(b)(22)(iii).

5. Handicapped Individual

A handicapped individual is any individual who satisfies one of two conditions.²²²⁰ First, the individual has a physical or mental disability which for the individual constitutes or results in a functional limitation to employment.²²²¹ Physical disability includes, but is not limited to, blindness and deafness.²²²² Second, the individual has any physical or mental impairment which substantially limits one or more major life activities of the individual,²²²³ such as performing manual tasks, walking, speaking, breathing, learning or working.²²²⁴ Physical disability includes, but is not limited to, blindness and deafness, and physical impairment includes, but is not limited to, sight or hearing impairment.²²²⁵

6. Elderly Individual

An elderly individual is an individual age 65 or over.²²²⁶

7. Election

a. Manner of Electing

The §190 election is made by claiming the expense deduction or amortization deduction as a separate item identified as such on the taxpayer's income tax return for the tax year for which the election is to apply.²²²⁷ In the case of expenditures by a partnership, the election is made by the partnership²²²⁸ by claiming the expense deduction or amortization deduction as a separate item identified as such on the partnership income tax return for the taxable for which the election is to apply.²²²⁹

b. Deadline for Election

The §190 election is not valid unless the return for the tax year for which it is to apply is filed no later than the due date, including extensions, for filing the return.²²³⁰ The election is irrevocable after the due date, including extensions, for filing the return.²²³¹

c. Scope of Election

The election applies to all qualified architectural and transportation barrier removal expenses paid or incurred during the tax year.²²³² If the \$15,000 limitation applies, the election applies to all expenses allocated by the taxpayer to the \$15,000 limitation, as described in V.J.4.b.(2) through V.J.4.b.(22), above.²²³³

d. Records to be Retained

If the §190 election is made, the taxpayer must have available records and documentation, including architectural plans and blueprints, contracts, and building permits, of all the facts necessary to determine the amount of any deduction to which the taxpayer is entitled on account of the election and the amount of any basis adjustment for expenditures exceeding the \$15,000 limitation.²²³⁴ These records must be retained so long as their contents may become material in the administration of any internal revenue law.²²³⁵

K. Circulation Expenditures

1. In General

Under §173, certain circulation expenditures that otherwise would be capitalized under §263 are deductible,²²³⁶ regardless of the taxpayer's method of accounting.²²³⁷ It does not matter that the taxpayer treats the expenditures as deferred costs for financial accounting purposes.²²³⁸ Only the publisher who makes the circulation expenditures that qualify for the §173 deduction is allowed to claim the deduction.²²³⁹

2. Tax Year of Amortization

The deduction is allowable only for the tax year in which the expenditures are paid or incurred.²²⁴⁰ Renewal commissions collected by news agents with respect to installment subscription sales, on behalf of an accrual method taxpayer, are deductible in the tax year in which the taxpayer collects the installment payment to which the commissions are connected.²²⁴¹

However, under §59(e), a taxpayer who is not a corporation may elect to amortize over three years the circulation expenditures that would otherwise be deductible under §173.²²⁴² If the §59(e) election is made, the amortization deductions are not treated as items of tax preference for purposes of the alternative minimum tax,²²⁴³ whereas the amounts deductible under §173 are so treated.²²⁴⁴ The alternative minimum tax is discussed in 587 T.M., *Noncorporate Alternative Minimum Tax* and 752 T.M., *Corporate Alternative Minimum Tax*.

3. Deductible Circulation Expenditures

a. Qualifying Expenditures

The circulation expenditures that are deductible under §173 are those made to establish, maintain, or increase the circulation of a newspaper, magazine or other periodical.²²⁴⁵ They include compensation paid to persons obtaining subscriptions, telephone costs for making sales calls, the cost of verifying or-

²²²⁰ §190(b)(3); Reg. §1.190-2(a)(3).

²²²¹ §190(b)(3); Reg. §1.190-2(a)(3)(i).

²²²² *Id.*

²²²³ §190(b)(3); Reg. §1.190-2(a)(3)(ii).

²²²⁴ Reg. §1.190-2(a)(3)(ii).

²²²⁵ §190(b)(3); Reg. §1.190-2(a)(3)(i) and §1.190-2(a)(3)(ii).

²²²⁶ Reg. §1.190-2(a)(4).

²²²⁷ §190(a)(2); Reg. §1.190-3(a).

²²²⁸ Reg. §1.190-1(a).

²²²⁹ Reg. §1.190-3(a).

²²³⁰ *Id.*

²²³¹ Reg. §1.190-3(b).

²²³² *Id.*

²²³³ *Id.*

²²³⁴ Reg. §1.190-3(c).

²²³⁵ Reg. §1.190-3(c) (reference to *id.* Reg. §1.6001-1(e)).

²²³⁶ §173(a); Reg. §1.173-1(a).

²²³⁷ Reg. §1.173-1(a).

²²³⁸ Rev. Rul. 57-526.

²²³⁹ Reg. §1.173-1(a)(2).

²²⁴⁰ Reg. §1.173-1(a)(3).

²²⁴¹ Rev. Rul. 73-125, 1973-1 C.B. 215.

²²⁴² §59(e)(1), §59(e)(2).

²²⁴³ §59(e)(6).

²²⁴⁴ *E.g.*, §56(b)(2).

²²⁴⁵ §173(a); Reg. §1.173-1(a).

ders, and overhead associated with subscription campaigns.²²⁴⁶ They also include the cost of obtaining new subscriptions to replace those lost during the year.²²⁴⁷

Circulation expenditures include sales commissions retained by subscription selling agents,²²⁴⁸ whether for new or renewal subscriptions.²²⁴⁹ Circulation expenditures include amounts accrued to a newspaper dealers' profit sharing plan because those amounts reflect the cost of obtaining the dealers' services in maintaining and increasing circulation.²²⁵⁰ They also include the portion of subscription prices received by a newspaper and donated to charity as part of the subscription plan.²²⁵¹

The IRS has ruled that a web-based publication that provides subscribers with information on a continuing basis and that is updated periodically constitutes an "other periodical" for purpose of §173.²²⁵² The IRS explained that, because the term is not defined in the statute or regulations, the definition used by the Supreme Court in a case antedating the income tax,²²⁵³ was appropriate guidance.²²⁵⁴ Under that definition, a periodical appears at stated intervals and consists of separate issues that contain multiple articles by different authors, are devoted to some special branch of learning or a special class of subjects, are incomplete in themselves and are numbered in a manner showing a relationship with previous or subsequent issues of the same series.²²⁵⁵

b. Production Expenditures

Circulation expenditures do not include the cost of binders, tab guides, looseleaf paper, envelopes, boxes and printing ink used in publishing, printing, and distributing periodicals.²²⁵⁶

c. Acquisition Expenditures

The §173 deduction is not allowed for expenditures for the purchase of land or depreciable property or for the acquisition of circulation through the purchase of any part of the business of another publisher of a newspaper, magazine or other periodical.²²⁵⁷ However, in *Triangle Publ'ns, Inc. v. Commissioner*,²²⁵⁸ the Tax Court allowed a deduction for the portion of the payment for a corporate franchise that exceeded the asset value, allocating it to subscriber lists that were obtained to insure an orderly transition on the transfer of the franchise.²²⁵⁹ In *Fla. Publ'g Co. v. Commissioner*,²²⁶⁰ the Tax Court held that premiums allegedly paid by a newspaper when it purchased its competitor were not deductible as circulation expenditures because

the primary purpose of the acquisition was to eliminate competition and not to increase circulation.²²⁶¹ In TAM 9448003, the IRS advised that a newspaper's expenditures to settle a lawsuit with independent contract carriers and for related legal fees are deductible circulation expenditures under §173 because the settlement payment helped to maintain and increase circulation.

4. Election to Forego §173 Amortization

a. In General

The §173 deduction is not allowed for any otherwise qualified circulation expenditures that are chargeable to capital account if the taxpayer elects to forego the deduction.²²⁶² The election to forego the deduction applies to the total amount of the expenditures that are chargeable to capital account.²²⁶³

b. Expenditures Properly Chargeable to Capital Account

Generally, expenditures normally made from year to year in an effort to maintain circulation are not properly chargeable to capital account.²²⁶⁴ Expenditures made in an effort to establish or increase circulation are properly chargeable to capital account.²²⁶⁵ The mere fact that subscriptions increase in a tax year for which a newspaper pays employees to solicit new and renewal subscriptions in order to maintain circulation at a saturation point does not make the expenditures properly chargeable to capital account.²²⁶⁶

Example: A newspaper pays five employees to obtain subscription renewals by telephone. The expenditures made in connection with their efforts are not properly chargeable to a capital account. The election to forego §173 amortization deductions does not apply to those expenditures.²²⁶⁷

Example: Assume that the newspaper hires 20 employees for a limited period in an effort to obtain new subscriptions through a telephone marketing plan. The expenditures made in connection with their efforts are properly chargeable to a capital account. They are deductible under §173, unless the newspaper makes the election to forego §173 amortization.²²⁶⁸

c. Election Procedure

The election to forego §173 amortization is made by attaching a statement to the income tax return for the first tax year for which the election is applicable.²²⁶⁹ The election is binding for all subsequent tax years unless the IRS approves the

²²⁴⁶ Rev. Rul. 54-3, 1954-1 C.B. 67.

²²⁴⁷ *Journal of Living Publ'g Corp. v. Commissioner*, 3 T.C. 1058 (1944).

²²⁴⁸ Rev. Rul. 64-127, 1964-1 C.B. (Part 1) 173. See PLR 200528003 (same).

²²⁴⁹ Rev. Rul. 67-201, 1967-1 C.B. 66.

²²⁵⁰ *Washington Post Co. v. United States*, 405 F.2d 1279 (Ct. Cl. 1969).

²²⁵¹ Rev. Rul. 54-3, 1954-1 C.B. 67.

²²⁵² PLR 200529005.

²²⁵³ *Houghton v. Payne*, 194 U.S. 88 (1904).

²²⁵⁴ PLR 200529005.

²²⁵⁵ *Id.*

²²⁵⁶ Rev. Rul. 67-201, 1967-1 C.B. (Part 1) 66.

²²⁵⁷ §173(a); Reg. §1.173-1(a)(1); Rev. Rul. 74-103, 1974-1 C.B. 62.

²²⁵⁸ 54 T.C. 138 (1970) *acq.*, 1972-2 C.B. 3.

²²⁵⁹ *Id.* at 152.

²²⁶⁰ 64 T.C. 269 (1975), *aff'd* without pub. opin. (5th Cir. 4/25/77).

²²⁶¹ 64 T.C. at 282.

²²⁶² §173(a); Reg. §1.173-1(c)(1).

²²⁶³ *Id.*

²²⁶⁴ Reg. §1.173-1(c)(1).

²²⁶⁵ *Id.*

²²⁶⁶ See *Perkins Bros. Co. v. Commissioner*, 78 F.2d 152 (8th Cir. 1935), *rev'g* 2 B.T.A.M. 33-885 (1933).

²²⁶⁷ See Reg. §1.173-1(c)(1).

²²⁶⁸ *Id.*

²²⁶⁹ Reg. §1.173-1(c)(2). For a sample election statement required under §173, see the Working Papers, below.

taxpayer's written application to revoke it.²²⁷⁰ The IRS has advised that the written application, defined in the regulations as an "application made to him in writing"²²⁷¹ means a letter ruling request.²²⁷² If revocation is allowed, the IRS may impose such conditions as it deems necessary.²²⁷³

L. Franchises, Trademarks, and Trade Names

1. Contingent Serial Payments

Under §1253(d)(1), the taxpayer is allowed to deduct, as §162 deductions, contingent serial payments paid or incurred during the tax year on account of a transfer, sale or other disposition of a franchise, trademark or trade name.²²⁷⁴ Contingent serial payments are amounts that satisfy three conditions.²²⁷⁵ First, the amount must be contingent on the productivity, use or disposition of the franchise, trademark or trade name.²²⁷⁶ Second, the amount must be paid as part of a series of payments that are payable not less frequently than annually throughout the entire term of the transfer agreement.²²⁷⁷ Third, the amount must be paid as part of a series of payments that are either substantially equal in amount or payable under a fixed formula.²²⁷⁸

2. Payments in Discharge of Principal Sums

Any amount, whether fixed or contingent, that is paid or incurred on account of the transfer of a franchise, trademark or trade name, other than amounts that are contingent on productivity, use or disposition of the property and which are currently deductible under §1253(d)(1), must be capitalized and amortized over the 15-year period allowable under §197.²²⁷⁹

M. Railroad Rolling Stock Rehabilitation Expenditures

1. In General

Though railroad rolling stock rehabilitation expenditures are capital in nature, the taxpayer can elect under §263(d) to treat qualified rehabilitation expenditures as deductible repairs under §162 or §212.²²⁸⁰ The §263(d) railroad rolling stock rehabilitation expenditure deduction is discussed below.

2. Qualified Rehabilitation Expenditures

a. In General

Qualified rehabilitation expenditures are expenditures for a tax year that satisfy two conditions.²²⁸¹ First, the expenditures must be made in connection with the rehabilitation of a unit

of railroad rolling stock used by a domestic common carrier by railroad which otherwise would be chargeable to capital account.²²⁸² Second, during any 12-month period these expenditures must not exceed 20% of the basis of the unit of rolling stock.²²⁸³ The 20% condition is not a limitation on amounts otherwise deductible as repairs without regard to the §263(d) railroad rolling stock rehabilitation expenditure deduction.²²⁸⁴

b. Railroad Rolling Stock

A unit of railroad rolling stock is a unit of transportation equipment the expenditures for which are of a type chargeable to the equipment investment accounts in the uniform system of accounts for railroad companies prescribed by the Interstate Commerce Commission.²²⁸⁵ If the property is leased to a domestic common carrier by railroad, a unit of railroad rolling stock is a unit of transportation equipment the expenditures for which would be of a type chargeable to those equipment investment accounts.²²⁸⁶ However, the unit is not railroad rolling stock unless it exclusively moves on, moves under or is guided by rail and is not a locomotive.²²⁸⁷ A locomotive is self-propelled equipment, the sole function of which is to push or pull railroad rolling stock.²²⁸⁸ A self-propelled passenger or freight car is not a locomotive.²²⁸⁹

Railroad rolling stock includes box cars, gondola cars, passenger cars, cars designed to carry truck trailers and containerized freight, wreck cranes and bunk cars.²²⁹⁰ It does not include barges, tugboats, containers used to carry containerized freight, truck trailers or automobiles.²²⁹¹

c. Used by a Domestic Common Carrier by Railroad

(1) Use

A unit of railroad rolling stock is not used by a domestic common carrier by railroad if the unit satisfies two conditions.²²⁹² First, the unit must be owned by a person other than a domestic common carrier by railroad.²²⁹³ Second, either of two tests must be met.²²⁹⁴ The first test is met if the unit is exclusively used for transportation by the owner.²²⁹⁵ The second test is met if the unit is exclusively used for transportation by another person that is not a domestic common carrier by railroad.²²⁹⁶

Example: A railroad leasing company that is not a domestic common carrier by railroad owns a boxcar and leases it to a manufacturing company. The boxcar is not a unit of

²²⁷⁰ §173(a); Reg. §1.173-1(c)(2).

²²⁷¹ Reg. §1.173-1(c)(2).

²²⁷² CCA 200214003.

²²⁷³ Reg. §1.173-1(c)(2).

²²⁷⁴ §1253(d)(1)(A). See *Jefferson-Pilot Corp. v. Commissioner*, 98 T.C. 435 (1992), aff'd, 995 F.2d 530 (4th Cir. 1993) (FCC broadcast license is franchise under §1253); *Tele-Communications, Inc. v. Commissioner*, 95 T.C. 495 (1990), aff'd, 12 F.3d 1005 (10th Cir. 1993), acq., 1996-2 C.B. 1 (public cable television franchise qualifies as franchise under §1253).

²²⁷⁵ §1253(d)(1)(B).

²²⁷⁶ §1253(d)(1)(B)(i).

²²⁷⁷ §1253(d)(1)(B)(ii)(I).

²²⁷⁸ §1253(d)(1)(B)(ii)(II).

²²⁷⁹ See H.R. Rept. No. 213, 103d. Cong., 1st Sess. 678 (1993).

²²⁸⁰ §263(d); Reg. §1.263(e)-1(a)(1).

²²⁸¹ §263(d); Reg. §1.263(e)-1(a).

²²⁸² §263(d); Reg. §1.263(e)-1(a)(1).

²²⁸³ §263(d); Reg. §1.263(e)-1(a)(2), §1.263(e)-1(d)(1).

²²⁸⁴ Reg. §1.263(e)-1(a)(2).

²²⁸⁵ Reg. §1.263(e)-1(b)(2).

²²⁸⁶ Reg. §1.263(e)-1(b)(2).

²²⁸⁷ §263(d); Reg. §1.263(e)-1(b)(2).

²²⁸⁸ Reg. §1.263(e)-1(b)(2).

²²⁸⁹ Reg. §1.263(e)-1(b)(2).

²²⁹⁰ Reg. §1.263(e)-1(b)(2).

²²⁹¹ Reg. §1.263(e)-1(b)(2).

²²⁹² Reg. §1.263(e)-1(b)(4).

²²⁹³ Reg. §1.263(e)-1(b)(4).

²²⁹⁴ Reg. §1.263(e)-1(b)(4).

²²⁹⁵ Reg. §1.263(e)-1(b)(4)(i).

²²⁹⁶ Reg. §1.263(e)-1(b)(4)(ii).

railroad rolling stock used by a domestic common carrier by railroad.²²⁹⁷

(2) Domestic Common Carrier by Railroad

A domestic common carrier by railroad is a railroad subject to regulation under Part I of the Interstate Commerce Act²²⁹⁸ or a railroad which would be so subject if it were engaged in interstate commerce.²²⁹⁹

d. Expenditures Made in Connection with Rehabilitation

An expenditure is made in connection with rehabilitation if it would otherwise be chargeable to capital account.²³⁰⁰ Expenditures for incidental repairs or maintenance are not made in connection with rehabilitation.²³⁰¹ The determination of whether an expenditure is a repair or a capital expenditure is made in accordance with the principles that apply in making that determination generally, as discussed in 509 T.M., *Principles of Capitalization*.²³⁰² The determination is made without regard to the classification of the expenditure under the uniform system of accounts prescribed by the Interstate Commerce Commission.²³⁰³

e. Twenty Percent Condition

(1) Time Made

For purposes of the 20% condition, an expenditure made in connection with the rehabilitation of a unit of railroad rolling stock is deemed to be made in the month in which the rehabilitation is completed.²³⁰⁴

(2) Twelve-Month Period

For purposes of the 20% condition, any period of 12 calendar months consists of any 12 consecutive calendar months other than those before January 1, 1970.²³⁰⁵ If the unit of railroad rolling stock is sold, exchanged or otherwise disposed of in a transaction in which its basis in the hands of the transferee is determined in whole or in part by reference to its basis in the hands of the transferor, calendar months during which the unit is in the hands of the transferor and in the hands of the transferee are included in the calendar months used by the transferor and by the transferee in determining any period of 12 calendar months.²³⁰⁶

(3) Basis

For purposes of the 20% condition, basis is the adjusted basis determined without regard to the basis adjustments provided by §1016(a)(1), (2), and (3) and by §1017.²³⁰⁷ If the basis

of a unit in the transferee's hands is determined in whole or in part by reference to its basis in the hands of the transferor, then the basis of the unit in the hands of the transferor is its basis in the hands of the transferee.²³⁰⁸ If the basis is determined in whole or in part by reference to the taxpayer's basis in another unit, then the basis of the latter unit is the basis of the former unit.²³⁰⁹ Whether a capital expenditure results in the retirement of a unit of railroad rolling stock and the creation of another unit is determined without regard to the rules under the uniform system of accounts prescribed by the Interstate Commerce Commission.²³¹⁰

(4) Inability to Apply 20% Condition

If, based on the information available when the income tax return for a tax year is filed, it is impossible to determine whether an expenditure satisfies the 20% condition, the expenditure must be claimed as a deduction.²³¹¹ If it is subsequently determined that the expenditure did not satisfy the 20% condition, an amended return must be filed on which the deduction is eliminated.²³¹² Additional tax for that tax year must be paid, and any adjustments applicable to tax liability for other tax years with respect to which the statute of limitations has not yet expired must be made.²³¹³

3. Election

An election under §263(d) is made by attaching a statement to that effect to the income tax return or amended income tax return for the tax year for which the election is made if the return is filed before the due date, including extensions, for filing the return.²³¹⁴ The election is an annual election that may be made with respect to one or more units of railroad rolling stock owned by the taxpayer.²³¹⁵ The statement must include the total number of units for which the election is being made,²³¹⁶ the aggregate basis of these units²³¹⁷ and the total deductions being claimed under §263(d).²³¹⁸

If the election is not made on time, no election is allowed on amended returns filed after the time for making the election.²³¹⁹ However, if the election is not made and it is subsequently determined that an expenditure was erroneously treated as an expenditure that was not a qualified rehabilitation expenditure, the election may be made on an amended return within the time for filing amended returns.²³²⁰

²²⁹⁷ See Reg. §1.263(e)-1(b)(4).

²²⁹⁸ 49 U.S.C. App. §1 through §27 (1988 and Supp. 1989).

²²⁹⁹ Reg. §1.263(e)-1(b)(3).

²³⁰⁰ Reg. §1.263(e)-1(c).

²³⁰¹ Reg. §1.263(e)-1(c).

²³⁰² Reg. §1.263(e)-1(c).

²³⁰³ Reg. §1.263(e)-1(c).

²³⁰⁴ Reg. §1.263(e)-1(d)(1).

²³⁰⁵ Reg. §1.263(e)-1(d)(2).

²³⁰⁶ Reg. §1.263(e)-1(d)(3).

²³⁰⁷ Reg. §1.263(e)-1(b)(1)(i).

²³⁰⁸ Reg. §1.263(e)-1(b)(1)(i) (references to §362, §374, §723).

²³⁰⁹ Reg. §1.263(e)-1(b)(1)(i) (reference to §1033(c)).

²³¹⁰ Reg. §1.263(e)-1(b)(1)(i).

²³¹¹ Reg. §1.263(e)-1(d)(4).

²³¹² Reg. §1.263(e)-1(d)(4).

²³¹³ Reg. §1.263(e)-1(d)(4).

²³¹⁴ Reg. §1.263(e)-1(a)(3)(i). For a sample election statement under §263(d), see the Working Papers, below.

²³¹⁵ Reg. §1.263(e)-1(a)(1), (3)(i).

²³¹⁶ Reg. §1.263(e)-1(a)(3)(iv)(a).

²³¹⁷ Reg. §1.263(e)-1(a)(3)(iv)(b).

²³¹⁸ Reg. §1.263(e)-1(a)(3)(iv)(c).

²³¹⁹ Reg. §1.263(e)-1(a)(3)(i).

²³²⁰ Reg. §1.263(e)-1(a)(3)(iii).

4. Recordkeeping Requirements

a. In General

The taxpayer must maintain whatever records are necessary for accurately determining whether an expenditure is a qualified rehabilitation expenditure.²³²¹ No deduction is allowable unless the taxpayer substantiates by adequate records that the expenditures are qualified rehabilitation expenditures.²³²²

b. Separate §263(d) Record

A separate §263(d) record must be maintained for each unit for which a §263(d) election is made.²³²³ The record must identify the unit,²³²⁴ state the basis of the unit,²³²⁵ state the date of acquisition of the unit,²³²⁶ enumerate for each unit the expenditures incurred in connection with the rehabilitation of the unit regardless of whether they are qualified rehabilitation expenditures and regardless of whether the taxpayer or another person undertakes the rehabilitation,²³²⁷ describe the nature of the work,²³²⁸ specify the calendar month in which the rehabilitation is completed²³²⁹ and specify the tax year in which each expenditure is paid or incurred.²³³⁰ The record must not include expenditures that are incidental repairs or maintenance, but the taxpayer must maintain records to reflect that those expenditures are deductible.²³³¹

The §263(d) record need only be prepared for a unit of railroad rolling stock for the period beginning on the first day of the eleventh calendar month immediately preceding the month in which the rehabilitation of the unit is completed, and ending on the last day of the eleventh month immediately succeeding the month in which the rehabilitation of the unit is completed.²³³²

c. Aggregated §263(d) Records

When a group of units of the same type are rehabilitated in a single project and the expenditure for each unit in the project will approximate the average expenditure per unit for the project, expenditures for the project may be aggregated without regard to the unit in the project with respect to which each expenditure is connected.²³³³ An amount equal to the aggregate expenditures for the project divided by the number of units in the project may be entered in the §263(d) account of each unit in the project.²³³⁴

²³²¹ Reg. § 1.263(e)-1(e)(1).

²³²² Reg. § 1.263(e)-1(e)(1).

²³²³ Reg. § 1.263(e)-1(e)(2).

²³²⁴ Reg. § 1.263(e)-1(e)(2)(i).

²³²⁵ Reg. § 1.263(e)-1(e)(2)(ii).

²³²⁶ Reg. § 1.263(e)-1(e)(2)(ii).

²³²⁷ Reg. § 1.263(e)-1(e)(2)(iii).

²³²⁸ Reg. § 1.263(e)-1(e)(2)(iv).

²³²⁹ Reg. § 1.263(e)-1(e)(2)(v).

²³³⁰ Reg. § 1.263(e)-1(e)(2)(v).

²³³¹ Reg. § 1.263(e)-1(e)(3).

²³³² Reg. § 1.263(e)-1(e)(2) (flush language).

²³³³ Reg. § 1.263(e)-1(e)(4).

²³³⁴ Reg. § 1.263(e)-1(e)(4).

N. Railroad Tie Expenditures

Though the replacement of a wood railroad tie with one made of any other material is capital in nature, any domestic common carrier by rail which used the retirement-replacement method of accounting for depreciation of railroad track is allowed under §263(f) to deduct expenditures for replacement railroad ties and fastenings related to the ties to the same extent they would be deducted if they were made of wood.²³³⁵ A domestic common carrier by rail is described in V.M.2.c.(2), above, but also includes a railroad switching or terminal company.²³³⁶

The cost of repairing wood ties with concrete ties is deductible.²³³⁷ However, the cost of welding rail joints is not deductible, but must be capitalized, because the welding improves the usefulness, capacity, and durability of the rails.²³³⁸

Note: Railroad ties are just one of many items the cost of which constitute track structure expenditures eligible for a safe harbor method of accounting provided by the IRS under its §446 authority to prescribe methods of accounting that clearly reflect income.²³³⁹ Whether this safe harbor method of accounting survives the promulgation of the §263 capitalization regulations²³⁴⁰ has been questioned.²³⁴¹ Methods of accounting are discussed in 570 T.M., *Accounting Methods — General Principles*, and 572 T.M., *Accounting Methods — Adoption and Changes*. Capitalization limitations are discussed in 509 T.M., *Principles of Capitalization*.

O. Energy Efficient Commercial Building Property

Under §179D, the costs of energy efficient commercial building property, the construction of which begins before July 1, 2026, are allowed as a deduction²³⁴² even though they otherwise would be capitalized.²³⁴³

If a §179D deduction is allowed with respect to any energy efficient commercial building property, the basis of that property must be reduced by the amount of the deduction.²³⁴⁴

Comment: The IRS must promulgate regulations providing for recapture of the deduction if the energy-savings plan required as a condition of the deduction is not fully implemented.²³⁴⁵

The energy efficient commercial building property deduction is discussed in 512 T.M., *Tax Incentives for Production and Conservation of Energy and Natural Resources*.

²³³⁵ §263(f).

²³³⁶ §263(f).

²³³⁷ Rev. Rul. 84-22.

²³³⁸ *S. Pac. Transp. Co. v. Commissioner*, 75 T.C. 497 (1980), supplemented on other issues, 82 T.C. 122 (1984); *Louisville & Nashville R.R. Co. v. Commissioner*, 66 T.C. 962 (1976), aff'd in part and rev'd in part on other issues, 641 F.2d 435 (6th Cir. 1981).

²³³⁹ See Rev. Proc. 2002-65; Rev. Proc. 2001-46.

²³⁴⁰ See Reg. § 1.263(a)-3.

²³⁴¹ See Ass'n of Am. Railroads comments to REG-168745-03 (May 29, 2008).

²³⁴² §179D(a).

²³⁴³ §263(a)(1)(K).

²³⁴⁴ §179D(e).

²³⁴⁵ §179D(h)(2).

P. Film or Television Production Costs, Live Theatrical Production Costs, and Sound Recording Costs

Under §181(a), subject to dollar limitations, the costs of any qualified film or television production,²³⁴⁶ the costs of any qualified live theatrical production,²³⁴⁷ and the costs of any qualified sound recording,²³⁴⁸ are allowed as a deduction (subject to the dollar limitation described below) if the taxpayer so elects,²³⁴⁹ even if it otherwise would have been capitalized.²³⁵⁰ If the §181 election is made, no other depreciation or amortization deduction is allowed.²³⁵¹ The §181 deduction is allowed for qualified film and television productions, qualified live theatrical productions, and qualified sound recording productions,

²³⁴⁶ Defined in §181(d).

²³⁴⁷ Defined in §181(e).

²³⁴⁸ Defined in §181(f).

²³⁴⁹ See §181(c).

²³⁵⁰ §181(a)(1).

²³⁵¹ §181(b).

commencing before January 1, 2026.²³⁵² The §181 deduction is discussed in 599 T.M., *The Taxation of Filmed Entertainment Content Production & Distribution*.

Note: As an alternative to the §181 deduction, which expires after December 31, 2025, taxpayers may deduct the same expenses, without the dollar limitation, under §168(k) (bonus depreciation). Bonus depreciation is available for qualified film productions, qualified television productions, qualified live theatrical productions, and qualified sound recording productions (as defined in §181(d), §181(e), and §181(f)) for which a deduction otherwise would be allowable under §181 (without regard to the dollar limitation or the termination date).²³⁵³ Bonus depreciation is deducted for the year in which the production is initially released, broadcast, or staged live, as applicable. The bonus depreciation deduction under §168(k) is discussed in 532 T.M., *First-Year Expensing and Additional Depreciation*.

²³⁵² §181(h).

²³⁵³ §168(k)(2)(A)(i)(IV), §168(k)(2)(A)(i)(V), §168(k)(2)(A)(i)(VI).

VI. Specific Situations

A. Employee Expenses

1. In General

The performance of services as an employee constitutes a trade or business.²³⁵⁴ The employee must show the relationship between the expenditures and the employment.²³⁵⁵ However, the performance of services for which compensation is not sought nor received does not constitute a trade or business because of the lack of a profit motive.²³⁵⁶ Employee business expenses are described in VI.A.2. through VI.A.4., below, and discussed in 519 T.M., *Travel and Transportation Expenses — Deduction and Recordkeeping Requirements*.

For tax years beginning after 2017, employees may not deduct unreimbursed employee business expenses.²³⁵⁷

2. Specific Expenses

a. Labor Union Dues

Dues paid to a labor union that are used to meet expenses of labor union activities are deductible employee business expenses.²³⁵⁸ Amounts allocated to a special loan fund for union members are deductible,²³⁵⁹ as are assessments to fund union unemployment benefits.²³⁶⁰ Service charges imposed on employees who are not union members and that are paid to a union are deductible.²³⁶¹ However, amounts paid to a strike fund used to satisfy individual obligations to employees under a settlement agreement that created a property interest in the fund for its members are not deductible.²³⁶²

For tax years beginning after 2017, the disallowance of miscellaneous itemized deductions means that expenses for job-related union dues incurred by an employee that are not reimbursed by the employer are not deductible by the employee.²³⁶³

Union dues that are allocated to the payment of death benefits are not deductible.²³⁶⁴ Also nondeductible are voluntary payments made by union members to separate unemployment compensation plans²³⁶⁵ and to union pension funds.²³⁶⁶ No deduction is allowed for the portion of union dues allocated to the operation of a recreation center.²³⁶⁷

²³⁵⁴ See Reg. §1.162-17(a).

²³⁵⁵ See *Evans v. Commissioner*, 33 T.C.M. 1192 (1974), supp. opin., 34 T.C.M. 783 (1975), aff'd on other issues, 557 F.2d 1095 (5th Cir. 1977).

²³⁵⁶ *Leamy v. Commissioner*, 85 T.C. 798 (1985).

²³⁵⁷ See §67(h).

²³⁵⁸ *E.g., Kaplan v. Commissioner*, 35 T.C.M. 84 (1976).

²³⁵⁹ *E.g.*, Rev. Rul. 82-15.

²³⁶⁰ *E.g.*, Rev. Rul. 72-463.

²³⁶¹ *E.g.*, Rev. Rul. 68-82.

²³⁶² TAM 200240001.

²³⁶³ See §67(h).

²³⁶⁴ Rev. Rul. 72-463.

²³⁶⁵ *E.g.*, Rev. Rul. 57-383, modified by Rev. Rul. 62-54.

²³⁶⁶ *E.g., Kaplan v. Commissioner*, 35 T.C.M. 84 (1976); *Simenstad v. United States*, 325 F. Supp. 1249, 1252 (N.D. Cal. 1971).

The deductibility of labor union dues is discussed in 519 T.M., *Travel and Transportation Expenses — Deduction and Recordkeeping Requirements*.

b. Unemployment and Nonoccupational Disability Insurance

Amounts mandatorily paid by employees to states for unemployment or nonoccupational disability insurance are deductible under §164 as a tax described in the flush language of §164(a).²³⁶⁸ Amounts voluntarily paid are not deductible.²³⁶⁹ The §164 deduction is discussed in 525 T.M., *State, Local, and Federal Taxes*.

Amounts paid by employees to fund private unemployment insurance policies are deductible.²³⁷⁰ In contrast, amounts paid to fund private disability benefit plans are not deductible because those plans provide coverage for loss of wages due to unemployment caused by nonoccupational hazards rather than business hazards.²³⁷¹

The deductibility of unemployment and nonoccupational disability insurance is discussed in 519 T.M., *Travel and Transportation Expenses — Deduction and Recordkeeping Requirements*.

c. Job Search Expenses

For tax years beginning after 2017, the disallowance of miscellaneous itemized deductions means that job-search expenses are not deductible by the taxpayer.²³⁷²

The expenses of searching for a new job are deductible if they are paid or incurred in seeking a new position within the same trade or business.²³⁷³ It does not matter whether the search is successful,²³⁷⁴ or even whether the taxpayer accepts a new position when it is obtained.²³⁷⁵ It does not matter that the taxpayer is temporarily unemployed while searching,²³⁷⁶ or that the taxpayer is temporarily engaged in a different trade or business while searching for a new position in the trade or business previously conducted by the taxpayer.²³⁷⁷

²³⁶⁷ *E.g., Briggs v. Commissioner*, 694 F.2d 614 (9th Cir. 1982), cert. denied, 461 U.S. 928 (1983), aff'g 75 T.C. 465 (1980); *Ridder v. Commissioner*, 76 T.C. 867 (1981).

²³⁶⁸ Rev. Rul. 81-194 (California), Rev. Rul. 81-193 (New Jersey), Rev. Rul. 81-192 (New York), Rev. Rul. 81-191 (Rhode Island), Rev. Rul. 75-156 (Alabama).

²³⁶⁹ Rev. Rul. 81-194 (California), Rev. Rul. 81-193 (New Jersey), Rev. Rul. 81-192 (New York).

²³⁷⁰ PLR 201152005.

²³⁷¹ Rev. Rul. 81-193.

²³⁷² §67(h).

²³⁷³ See, e.g., *Martin v. Commissioner*, 72 T.C.M. 1211 (1996), aff'd, 155 F.3d 559 (4th Cir. 1998).

²³⁷⁴ *E.g., Cremona v. Commissioner*, 58 T.C. 219 (1972); Rev. Rul. 75-120, clarified by Rev. Rul. 77-16.

²³⁷⁵ *E.g., Kenfield v. Commissioner*, 54 T.C. 1197 (1970), acq., 1978-2 C.B. 2.

²³⁷⁶ *E.g., Primuth v. Commissioner*, 54 T.C. 374 (1970), acq., 1972-2 C.B. 2 (in result only).

²³⁷⁷ *E.g., Charlton v. Commissioner*, 56 T.C.M. 573 (1988).

Job search expenses include employment agency fees,²³⁷⁸ employment counselling fees,²³⁷⁹ resume preparation expenses and postage,²³⁸⁰ travel and transportation expenses,²³⁸¹ and advertising.²³⁸² They do not include the forfeiture of a deposit on a residence in the area in which the taxpayer is searching,²³⁸³ or losses on the sale of a former employer's stock.²³⁸⁴

The expenses of searching for a new job in a new trade or business are not deductible.²³⁸⁵ A taxpayer who has been unemployed for more than a reasonably temporary period is not in the trade or business of being employed, and thus the expenses of searching for a job are not deductible.²³⁸⁶

The deductibility of job search expenses is discussed in 519 T.M., *Travel and Transportation Expenses — Deduction and Recordkeeping Requirements*.

d. Uniforms and Work Clothing

For tax years beginning after 2017, the disallowance of miscellaneous itemized deductions means that job-related business expenses incurred by an employee and not reimbursed by the employer — including expenses for uniforms and work clothes — are nondeductible by an employee.²³⁸⁷

Generally, the cost of acquiring and maintaining uniforms is not deductible unless the uniforms are specifically required as a condition of employment and are not adaptable to general or continued usage to the extent they replace regular clothing.²³⁸⁸ Thus, if the uniform replaces regular clothing or is suitable for ordinary wear, no deduction is allowed even if the uniform is required as a condition of employment.²³⁸⁹ The same principles apply to work clothing that is not a uniform.²³⁹⁰ For example, the cost of military uniforms and their maintenance are generally not deductible because they replace regular clothing,²³⁹¹ but deductions have been allowed for uniforms not authorized for off-duty use,²³⁹² insignias and shoulder boards,²³⁹³ and uniforms required for infrequent occasions by reservists.²³⁹⁴

The question of whether a uniform or work clothing is suitable for ordinary wear and the question of whether its use is specifically required as a condition of employment are questions of fact.²³⁹⁵ Work clothing is considered not suitable for or-

dinary wear when prohibiting such protects important governmental and public safety interests. In June 2015, the IRS issued a directive for federal, state, and local government employees (FSLG Directive), which discussed the deductibility of costs of casual, yet distinctively marked police and fire department work clothing. Those departments prohibit off-duty wear of such work clothing to minimize the confusion that can result from the difficulty in readily identifying on-duty police officers and firefighters, and to discourage the impersonation of such bona fide officers. Thus, prohibiting off-duty officers from wearing work clothing as casual wear protects important governmental and public safety interests. Accordingly, if those officers are prohibited from wearing their designated uniforms off-duty, then the clothing is not suitable for ordinary wear.

Uniform deductions have been allowed for such taxpayers as Amway distributors,²³⁹⁶ baseball players,²³⁹⁷ dairy workers,²³⁹⁸ nurses,²³⁹⁹ police officers,²⁴⁰⁰ professional musicians²⁴⁰¹ and railroad conductors.²⁴⁰² They have been disallowed for such taxpayers as attorneys,²⁴⁰³ automobile mechanics,²⁴⁰⁴ construction superintendents,²⁴⁰⁵ corporate executives,²⁴⁰⁶ driver license examiners,²⁴⁰⁷ flight attendants,²⁴⁰⁸ food servers,²⁴⁰⁹ librarians,²⁴¹⁰ machine operators,²⁴¹¹ musicians,²⁴¹² probation officers,²⁴¹³ teachers²⁴¹⁴ and truck drivers.²⁴¹⁵ Deductions have been allowed for helmets,²⁴¹⁶ special work gloves,²⁴¹⁷ special boots,²⁴¹⁸ special or-

²³⁹⁶ *Williams v. Commissioner*, 62 T.C.M. 110 (1991), aff'd, 996 F.2d 1230 (9th Cir. 1993).

²³⁹⁷ *E.g.*, Rev. Rul. 70-476.

²³⁹⁸ *Puente v. Commissioner*, 10 T.C.M. 735 (1951), aff'd on other issues, 199 F.2d 940 (9th Cir. 1952).

²³⁹⁹ *E.g.*, *Murphy v. Commissioner*, 52 T.C.M. 704 (1986).

²⁴⁰⁰ *E.g.*, *Commissioner v. Benson*, 146 F.2d 191 (9th Cir. 1944), aff'g 2 T.C. 12 (1943); *Scarborough v. Commissioner*, 30 T.C.M. 613 (1971); FSLG Directive (June 15, 2015) (costs of casual but distinctively marked clothing issued to state and local policemen and firemen are considered deductible expenses; excluded from wages under §132).

²⁴⁰¹ *Genck v. Commissioner*, 75 T.C.M. 1984 (1998).

²⁴⁰² *E.g.*, *Wildman v. Commissioner*, 5 T.C.M. 712 (1946).

²⁴⁰³ *E.g.*, *Strong v. Commissioner*, 68 T.C.M. 203 (1994), aff'd in part, 79 F.3d 1154 (9th Cir. 1996); *Kosmal v. Commissioner*, 39 T.C.M. 651 (1979), aff'd on other issues, 670 F.2d 842 (9th Cir. 1982).

²⁴⁰⁴ *E.g.*, *Sito v. Commissioner*, 8 T.C.M. 1105 (1949).

²⁴⁰⁵ *E.g.*, *Drill v. Commissioner*, 8 T.C. 902 (1947).

²⁴⁰⁶ *E.g.*, *Bothke v. Commissioner*, 39 T.C.M. 826 (1980), aff'd by unpub. order (9th Cir. Nov. 23, 1981).

²⁴⁰⁷ *E.g.*, *Sanner v. Commissioner*, 28 T.C.M. 476 (1969).

²⁴⁰⁸ *E.g.*, *Stiner v. United States*, 524 F.2d 640 (10th Cir. 1975).

²⁴⁰⁹ *E.g.*, *Scrobe v. Commissioner*, 24 T.C.M. 433 (1965); *Bassett v. Commissioner*, 22 T.C.M. 26 (1963), aff'd on other issues sub nom. *Anson v. Commissioner*, 328 F.2d 703 (10th Cir. 1964).

²⁴¹⁰ *E.g.*, *Johnson v. Commissioner*, 43 T.C.M. 248 (1982).

²⁴¹¹ *E.g.*, *Henry v. Commissioner*, 30 T.C.M. 224 (1971).

²⁴¹² *E.g.*, *Tilman v. Commissioner*, 644 F. Supp.2d 391 (S.D. N.Y. 2009).

²⁴¹³ *E.g.*, *Shepherd v. Commissioner*, 35 T.C.M. 219 (1976), aff'd by unpub. order (7th Cir. Apr. 22, 1997).

²⁴¹⁴ *E.g.*, *Cinnamon v. Commissioner*, 37 T.C.M. 533 (1978).

²⁴¹⁵ *E.g.*, *Hamilton v. Commissioner*, 38 T.C.M. 775 (1979); *Henson v. Commissioner*, 38 T.C.M. 510 (1979).

²⁴¹⁶ *E.g.*, *Kaonis v. Commissioner*, 37 T.C.M. 792 (1978), aff'd by unpub. order (9th Cir. Jan. 16, 1981).

²⁴¹⁷ *E.g.*, *Thompson v. Commissioner*, 15 T.C. 609 (1950), rev'd on other issues, 193 F.2d 586 (10th Cir. 1951); Rev. Rul. 55-235.

²⁴¹⁸ *E.g.*, *Thompson v. Commissioner*, 15 T.C. 609 (1950), rev'd on other issues, 193 F.2d 586 (10th Cir. 1951).

²³⁷⁸ *E.g.*, *Blewitt v. Commissioner*, 31 T.C.M. 1225 (1972).

²³⁷⁹ *E.g.*, Rev. Rul. 78-93.

²³⁸⁰ *E.g.*, Rev. Rul. 75-120, clarified by Rev. Rul. 77-16.

²³⁸¹ *E.g.*, *Murata v. Commissioner*, 72 T.C.M. 117 (1996); Rev. Rul. 77-16, clarifying Rev. Rul. 75-120.

²³⁸² *E.g.*, *Avery v. Commissioner*, 29 T.C.M. 1187 (1970).

²³⁸³ *E.g.*, *Krych v. Commissioner*, 20 T.C.M. 44 (1961).

²³⁸⁴ See *Slater v. Commissioner*, 64 T.C. 571 (1975).

²³⁸⁵ Reg. §1.212-1(f). *E.g.*, *Carter v. Commissioner*, 51 T.C. 932 (1969).

²³⁸⁶ *E.g.*, *Blewitt v. Commissioner*, 31 T.C.M. 1225 (1972); *Miller v. United States*, 362 F. Supp. 1242 (E.D. Tenn. 1973).

²³⁸⁷ §67(h).

²³⁸⁸ Rev. Rul. 70-474.

²³⁸⁹ *Id.*; *Barnes v. Commissioner*, T.C. Memo 2016-79.

²³⁹⁰ *E.g.*, *Dill v. Commissioner*, 8 T.C. 902 (1947).

²³⁹¹ *E.g.*, *Motch v. Commissioner*, 11 T.C. 777 (1948), rev'd, 180 F.2d 859 (6th Cir. 1950).

²³⁹² *E.g.*, Rev. Rul. 67-115.

²³⁹³ Rev. Rul. 62-122.

²³⁹⁴ *E.g.*, Rev. Rul. 55-109, modified by Rev. Rul. 76-453, and modified on other issues by Rev. Rul. 90-23.

²³⁹⁵ *E.g.*, *Gerres v. Commissioner*, 52 T.C.M. 1119 (1986); *Veizaga v. Commissioner*, 42 T.C.M. 1678 (1981); *Kennedy v. Commissioner*, 32 T.C.M. 52 (1973).

safety shoes,²⁴¹⁹ safety glasses²⁴²⁰ and clothing displaying employer logos,²⁴²¹ but disallowed for work clothing,²⁴²² fur coats,²⁴²³ cosmetics,²⁴²⁴ business suits²⁴²⁵ and fitness apparel.²⁴²⁶

The deductibility of clothing is discussed in 513 T.M., *Family and Household Transactions*.

e. Rural Mail Carrier Expenses

The amount allowable as a deduction for a qualified rural mail carrier equals the amount of qualified reimbursements received by the carrier.²⁴²⁷ A qualified rural mail carrier is an employee of the United States Postal Service (USPS) who performs services involving the collection and delivery of mail on a rural route and who receives qualified reimbursements for the expenses incurred by the employee for the use of a vehicle in performing those services.²⁴²⁸

If the reimbursements a rural letter carrier receives from the USPS fall short of the carrier's actual costs, the costs in excess of reimbursements qualify as a miscellaneous itemized deduction subject to the 2% floor of §67, but only for tax years beginning before 2018, because miscellaneous itemized deductions are disallowed for tax years beginning after 2017.²⁴²⁹

A qualified reimbursement is the amount paid by the USPS to employees as equipment maintenance allowances under the 1991 collective bargaining agreement between the USPS and the National Rural Letter Carrier's Association. Qualified reimbursements also include amounts paid as equipment maintenance allowances under later collective bargaining agreements that supersede the 1991 agreement if those amounts do not exceed the amounts that would have been paid under the 1991 agreement as adjusted for inflation.²⁴³⁰

f. Other Employee Business Expenses

For tax years beginning after 2017, the disallowance of miscellaneous itemized deductions means that job-related business expenses incurred by an employee that are not reimbursed by the employer are not deductible by the employee.²⁴³¹

Deductible employee business expenses can include, assuming the requirements of §162 are met, such items as telephone expense,²⁴³² small tools,²⁴³³ research expense,²⁴³⁴ subscriptions,²⁴³⁵ dues for memberships in organizations pursuant to em-

ployer requirements,²⁴³⁶ and liability insurance.²⁴³⁷ An executive employee who is contractually required to pay to the employer an amount equal to operating losses sustained by the employer while under the direction of the employee are deductible.²⁴³⁸ However, a teacher's unreimbursed expenses to incentivize student learning are not deductible unless the school requires the employee to incur such expenses.²⁴³⁹ They also can include the types of expenses described in IV., above.

The deductibility of employee business expenses is discussed in 519 T.M., *Travel and Transportation Expenses — Deduction and Recordkeeping Requirements*.

3. Reporting and Recordkeeping

a. In General

Regulations under §162 provide special reporting and recordkeeping rules that apply to employee business expense deductions. These rules do not apply to expenses paid or incurred for incidental items, such as office supplies for the employer or local transportation in connection with an errand for the employer.²⁴⁴⁰

The employee business expense reporting and recordkeeping rules are described in VI.A.3.b. through VI.A.3.e., below, and are discussed in 519 T.M., *Travel and Transportation Expenses — Deduction and Recordkeeping Requirements*.

b. Expenses for Which Accounting to Employer Required

An employee need not report employee business expenses paid or incurred solely for the benefit of the employer if three conditions are satisfied. First, the employee must be required to account to the employer for the expenses. Second, the employee must so account. Third, the expenses must be charged directly or indirectly to the employer or must be paid to the employee through advances, reimbursements or otherwise that equal the amount of the expenses. The employee is only required to state in the income tax return that these conditions have been satisfied.²⁴⁴¹

If the advances, reimbursements or other charges to the employer exceed the expenses, the employee must include the excess in gross income and state on the return that this has been done.²⁴⁴² If the expenses exceed the advances, reimbursements or other charges to the employer, the employee must supply certain information in order to claim the excess as a deduction. The requisite information includes the amounts re-

²⁴¹⁹ *E.g., Thompson v. Commissioner*, 15 T.C. 609 (1950), rev'd on other issues, 193 F.2d 586 (10th Cir. 1951); *Swiderski v. Commissioner*, 11 T.C.M. 904 (1952).

²⁴²⁰ *E.g., Bushey v. Commissioner*, 30 T.C.M. 651 (1971).

²⁴²¹ *E.g., Riscato v. Commissioner*, 48 T.C.M. 10 (1984).

²⁴²² *E.g., Roth v. Commissioner*, 17 T.C. 1450 (1952); *Thompson v. Commissioner*, 15 T.C. 609 (1950), rev'd on other issues, 193 F.2d 586 (10th Cir. 1951).

²⁴²³ *E.g., Jackson v. Commissioner*, 13 T.C.M. 1175 (1954).

²⁴²⁴ *E.g., Douglas v. Commissioner*, 38 T.C.M. 901 (1979).

²⁴²⁵ *E.g., Igberaese v. Commissioner*, T.C. Memo 2010-284.

²⁴²⁶ *E.g., Farias v. Commissioner*, T.C. Memo 2011-248.

²⁴²⁷ §162(o)(1)(A).

²⁴²⁸ §162(o)(1).

²⁴²⁹ §162(o)(2), §67(h).

²⁴³⁰ §162(o)(3).

²⁴³¹ §62(a)(2)(A); §67(h), §162(a).

²⁴³² *E.g., Banks v. Commissioner*, 42 T.C.M. 1016 (1981); *Drummond v. Commissioner*, 40 T.C.M. 1336 (1980); *Fausner v. Commissioner*, 30 T.C.M. 1187 (1971), aff'd on other issues, 472 F.2d 561 (5th Cir. 1973), aff'd, 413 U.S. 838 (1973); *Grossman v. Commissioner*, 30 T.C.M. 999 (1971).

²⁴³³ *E.g., Boback v. Commissioner*, 45 T.C.M. 1278 (1983); *Busking v. Commissioner*, 37 T.C.M. 1727 (1978); *Kaonis v. Commissioner*, 37 T.C.M. 792 (1978), aff'd by unpub. order (9th Cir. 1981).

²⁴³⁴ *E.g.*, Rev. Rul. 63-275.

²⁴³⁵ *E.g.*, Rev. Rul. 78-265.

²⁴³⁶ *E.g.*, Rev. Rul. 72-192, Rev. Rul. 66-261.

²⁴³⁷ *E.g.*, Rev. Rul. 76-277.

²⁴³⁸ See *DeLorean v. Commissioner*, 69 T.C.M. 3027 (1995).

²⁴³⁹ *Luczaj & Assocs. v. Commissioner*, T.C. Memo 2017-42; *Farias v. Commissioner*, T.C. Memo 2011-248 (teacher who bought candy and audio players for the classroom to motivate students could not deduct these expenses when the school did not require her to purchase them).

²⁴⁴⁰ Reg. §1.162-17(a).

²⁴⁴¹ Reg. §1.162-17(b)(1).

²⁴⁴² Reg. §1.162-17(b)(2). See, e.g., *Amos v. Commissioner*, 49 T.C.M. 1013 (1985).

ceived, amounts expended, categorization of the expenses, details about the expenses and their connection to the employment and other matters specified in the regulations.²⁴⁴³

c. Expenses for Which Accounting to Employer Not Required

If the employee is not required to account to the employer with respect to employee business expenses, the employee must supply certain information in order to claim any deduction.²⁴⁴⁴ The requisite information includes the amounts received, amounts expended, categorization of the expenses, details about the expenses and their connection to the employment and other matters specified in the regulations.²⁴⁴⁵

d. Substantiation

Although the IRS has the option of requiring any taxpayer to substantiate trade or business deductions, it ordinarily does not require substantiation of employee business expense account information except in four cases.²⁴⁴⁶ The first case is that of a taxpayer who is not required to account to the employer or who is so required but does not comply.²⁴⁴⁷ The second case is that of a taxpayer whose employee business expenses exceed advances, reimbursements and other charges to the employer and who claims a deduction for the excess.²⁴⁴⁸ The third case is that of a taxpayer who is related to the employer.²⁴⁴⁹ The fourth case is that of a taxpayer whose employer uses accounting procedures that are inadequate.²⁴⁵⁰

e. Recordkeeping

Employees must keep whatever records are needed to enable the IRS to correctly determine their income tax liabilities. One type of record is the daily diary in which expenditures and details with respect to them are recorded. In addition, supporting documents should be retained, particularly in the case of large or exceptional expenditures.²⁴⁵¹ If records are not complete or available, approximations are acceptable under certain conditions, except for those expenses within the §274(d) stringent substantiation rules.²⁴⁵²

4. Housing Cost Amount Not Attributable to Employer Provided Amounts

Under §911(c)(4), an employee who is a U.S. citizen working abroad may deduct the “housing cost amount” for the

tax year that is not attributable to employer provided amounts, subject to a limitation.²⁴⁵³ The housing cost amount is the excess of the taxpayer’s housing expenses over the product of 16% of the exclusion amount, multiplied by the number of days within the tax year that are within the period of foreign country residence or presence that qualifies the employee for the §911 exclusion.²⁴⁵⁴ The exclusion amount is \$80,000 per year, plus an annual adjustment for inflation.²⁴⁵⁵ Employer-provided amounts are amounts paid or incurred on behalf of the employee by the employer that constitute foreign earned income included in the employee’s gross income for the tax year, determined without regard to the §911 exclusion.²⁴⁵⁶

The deduction is limited to the product of 30% of the exclusion amount, computed on a daily basis, in effect for the calendar year in which the tax year begins,²⁴⁵⁷ multiplied by the number of days within the tax year that are within the period of foreign country residence or presence that qualifies the employee for the §911 exclusion.²⁴⁵⁸ The limitation percentage is 30%, adjusted in Treasury guidance as deemed necessary based on geographic differences in housing costs relative to U.S. housing costs.²⁴⁵⁹

The §911(c)(4) deduction and its computational components are discussed in 6080 T.M., *Section 911 and Other International Tax Rules Relating to U.S. Citizens and Residents* (Foreign Income Series).

B. Farming

1. Application of §162 to Specific Expenses

a. In General

Because the nature of the trade or business of farming is unique in many ways, special rules elaborate on the application of §162 to farmers.²⁴⁶⁰ Trade or business deductions for farmers are described in VI.B.1.b. through VI.B.1.f., below, and are discussed in 607 T.M., *Farm and Ranch Expenses and Credits*.

b. Operating Expenses

(1) In General

Farmers who operate farms for profit are allowed to deduct as necessary expenses all amounts actually expended in carrying on the business of farming.²⁴⁶¹ The cost of ordinary tools of short life or small cost, such as hand tools, including shovels and rakes, is deductible.²⁴⁶² The purchase of feed and other costs connected with raising livestock may be treated as expense deductions to the extent those costs represent actual outlays, but

²⁴⁴³ Reg. §1.162-17(b)(3).

²⁴⁴⁴ Reg. §1.162-17(c). See, e.g., *Burdett v. Commissioner*, 43 T.C.M. 229 (1981).

²⁴⁴⁵ Reg. §1.162-17(c).

²⁴⁴⁶ Reg. §1.162-17(d)(1).

²⁴⁴⁷ Reg. §1.162-17(d)(1)(i).

²⁴⁴⁸ Reg. §1.162-17(d)(1)(ii).

²⁴⁴⁹ Reg. §1.162-17(d)(1)(iii) (reference to §267(b)).

²⁴⁵⁰ Reg. §1.162-17(d)(1)(iv).

²⁴⁵¹ Reg. §1.162-17(d)(2).

²⁴⁵² See §274(d); Reg. §1.162-17(d)(3). In *Khinda v. Commissioner*, T.C. Summ. Op. 2017-32, the taxpayer’s noncontemporaneous reconstructed partial records were inadequate to support his unreimbursed employee business expense deductions for vehicle expenses, parking fees and tolls, and travel expenses while away from home. Similarly, the taxpayer’s records were inadequate or wholly lacking for utility, travel and meal deductions related to his consulting business, and the taxpayer was unable to establish that the expenses were ordinary and necessary to his consulting business.

²⁴⁵³ §911(c)(4)(A); Reg. §1.911-4(e)(1).

²⁴⁵⁴ §911(c)(1).

²⁴⁵⁵ §911(b)(2)(D). For the annual inflation-adjusted amounts, see Tables, Charts & Lists, *Foreign Earned Income Exclusion Tables by Year*.

²⁴⁵⁶ §911(c)(4)(D).

²⁴⁵⁷ §911(c)(2)(A)(i).

²⁴⁵⁸ §911(c)(2)(A)(ii).

²⁴⁵⁹ §911(c)(2)(A)(i), §911(c)(2)(B).

²⁴⁶⁰ E.g., Reg. §1.162-12.

²⁴⁶¹ Reg. §1.162-12(a).

²⁴⁶² *Id.*

no deduction is allowed for farm produce grown on the farm or for the farmer's labor.²⁴⁶³

(2) Crop Method

If the farmer is engaged in producing crops and the process of gathering and disposing of the crops is not completed within the tax year in which they were planted, the deduction for the expenses of raising the crop may be determined under the crop method, if the IRS consents.²⁴⁶⁴ Under the crop method, the deductions must be claimed in the tax year in which the gross income from the crop is realized.²⁴⁶⁵

(3) Seed, Feed, and Fertilizer

If the crop method is not used, the cost of seed and young plants purchased for further development and cultivation before sale in later years may be deducted as an expense in the year of purchase, provided the farmer follows a consistent practice of deducting these costs as an expense each year.²⁴⁶⁶ This rule does not apply to the planting of timber.²⁴⁶⁷ Deductions on account of raising timber are described in VI.C., below.

The cost of feed for livestock paid in the tax year but to be consumed in a subsequent tax year is deductible in the year of payment if the expenditure is not a deposit, the prepayment is made for business and not tax avoidance reasons, and the deduction does not materially distort income.²⁴⁶⁸ Assuring feed supplies at a guaranteed maximum price is a business reason,²⁴⁶⁹ but if the deduction materially distorts income it does not matter if the other requirements have been met.²⁴⁷⁰ Repeatedly buying feed at the end of a tax year and selling the feed back to the vendor at the beginning of the following year makes it impossible to demonstrate a business purpose.²⁴⁷¹

Under §464, limitations apply to farming syndicates, and to certain farmers that prohibit certain prepaid deductions for seed, feed, fertilizer and similar expenses.²⁴⁷² The §464 timing limitations are discussed in 607 T.M., *Farm and Ranch Expenses and Credits*, and 608 T.M., *Reporting Farm Income*.

c. Machinery and Buildings

The cost of farm machinery, equipment, automobiles and farm buildings are a capital investment and are not deductible other than through depreciation deductions.²⁴⁷³ The cost of fuel for farming equipment and repairs to the equipment is deductible.²⁴⁷⁴

d. Animals

Amounts expended in purchasing work, breeding, dairy or sport animals are capital expenditures.²⁴⁷⁵ These amounts are either recovered through depreciation or included in inventory, depending on the use of the animal.²⁴⁷⁶ The cost of raising livestock can be deducted or capitalized at the taxpayer's option.²⁴⁷⁷ Farming can involve the breeding and raising of animals that are hunted as well as animals that are slaughtered.²⁴⁷⁸

e. Preparatory Expenditures

Amounts expended during the preparatory period of the farm, before development or operations begin, must be capitalized.²⁴⁷⁹ Preparatory activities include land clearing if the §175 election does not apply, as described in VI.B.2., below,²⁴⁸⁰ irrigation equipment installation,²⁴⁸¹ cost of trees,²⁴⁸² and initial planting.²⁴⁸³ The capitalization limitation is discussed in 509 T.M., *Principles of Capitalization*.

f. Development Expenditures

Amounts expended in the development of farms, orchards and ranches before the time when the productive state is reached may be regarded as a capital investment, at the election of the taxpayer.²⁴⁸⁴ Development expenses are those paid or incurred during the growing stages.²⁴⁸⁵ However, the uniform capitalization rules generally restrict this election to plants with a preproductive period of two years or less.²⁴⁸⁶ The uniform capitalization rules are discussed in 577 T.M., *Uniform Capitalization Rules: Special Topics; Method Change Rules*.

2. Soil and Water Conservation and Endangered Species Recovery Expenditures

a. In General

Under §175, taxpayers engaged in the business of farming may treat soil or water conservation expenditures paid or incurred during the tax year as expenditures that are not chargeable to capital account.²⁴⁸⁷ The expenditures so treated are allowed as deductions.²⁴⁸⁸

²⁴⁷⁵ Reg. §1.162-12(a). *E.g.*, Rev. Rul. 72-113, 1972-1 C.B. 99.

²⁴⁷⁶ Reg. §1.167(a)-6(b). *E.g.*, *Wiener v. Commissioner*, 58 T.C. 81 (1972), aff'd on other issues, 494 F.2d 691 (9th Cir. 1974); *Herbert A. Nieman & Co. v. Commissioner*, 33 T.C. 451 (1959), acq., 1965-2 C.B. 6; *Tenney v. Commissioner*, 42 B.T.A. 1049 (1940); *Smith v. Commissioner*, 15 T.C.M. 139 (1956).

²⁴⁷⁷ Reg. §1.162-12(a), Reg. 1.471-6(a). *E.g.*, *Duggar v. Commissioner*, 71 T.C. 147 (1978); *Welder v. United States*, 329 F. Supp. 739 (S.D. Tex. 1971), aff'd, 461 F.2d 1269 (5th Cir. 1972).

²⁴⁷⁸ TAM 9615001.

²⁴⁷⁹ *E.g.*, *Gleis v. Commissioner*, 24 T.C. 941 (1955), aff'd, 245 F.2d 237 (6th Cir. 1957); *McBride v. Commissioner*, 23 T.C. 901 (1955), acq., 1955-2 C.B. 7.

²⁴⁸⁰ *E.g.*, *Harding v. Commissioner*, 29 T.C.M. 789 (1970).

²⁴⁸¹ *E.g.*, *Thompson & Folger Co. v. Commissioner*, 17 T.C. 722 (1951).

²⁴⁸² *E.g.*, *Gyro Eng'g Corp. v. Commissioner*, 33 T.C.M. 1343 (1974).

²⁴⁸³ *E.g.*, Rev. Rul. 83-28, 1983-1 C.B. 47.

²⁴⁸⁴ Reg. §1.162-12(a). *E.g.*, *Estate of Wilbur v. Commissioner*, 43 T.C. 322 (1964); *Whitman v. United States*, 248 F. Supp. 845 (W.D. La. 1965).

²⁴⁸⁵ See *Wagner Mills, Inc. v. Commissioner*, 33 T.C.M. 1267 (1974), aff'd, 530 F.2d 827 (8th Cir. 1976).

²⁴⁸⁶ §263A(a), §263A(d)(1)(A).

²⁴⁸⁷ §175(a).

²⁴⁸⁸ §175(a).

²⁴⁶³ *Id.*

²⁴⁶⁴ *Id.*

²⁴⁶⁵ Reg. §1.162-12(a). See, e.g., *Kahuku Plantation Co. v. Commissioner*, 43 B.T.A. 784 (1941), aff'd, 132 F.2d 671 (9th Cir. 1942).

²⁴⁶⁶ Reg. §1.162-12(a).

²⁴⁶⁷ *Id.*

²⁴⁶⁸ Rev. Rul. 79-229, 1979-2 C.B. 210.

²⁴⁶⁹ See *Mann v. Commissioner*, 483 F.2d 673 (8th Cir. 1973), rev'g 31 T.C.M. 808 (1972).

²⁴⁷⁰ See *Clement v. United States*, 580 F.2d 422 (Ct. Cl. 1978), cert. denied, 440 U.S. 907 (1979), adopting in part 77-2 USTC ¶9600 (Ct. Cl. 1977).

²⁴⁷¹ See *Gragg v. United States*, 26 F.3d 1118 (5th Cir. 1994).

²⁴⁷² §464.

²⁴⁷³ Reg. §1.162-12(a), Reg. §1.167(a)-6(b).

²⁴⁷⁴ Reg. §1.162-12(a).

The deductibility of soil and water conservation expenditures is described in VI.B.2.b. through VI.B.2.f., below, and is discussed in 607 T.M., *Farm and Ranch Expenses and Credits*.

b. Adoption of Method

A taxpayer may, without the consent of the IRS, adopt the current expense method for soil and water conservation expenditures for the first tax year for which §175(a) expenditures are paid or incurred.²⁴⁸⁹ With the consent of the IRS, a taxpayer may adopt the current expense method at any time.²⁴⁹⁰

c. Scope of Method

If the current expense method for soil and water conservation expenditures is adopted, it applies to all of the taxpayer's soil and water conservation expenditures.²⁴⁹¹ The method adopted must be followed in computing taxable income for the tax year of adoption and all subsequent tax years, unless the IRS approves a change to a different method with respect to some or all of the expenditures.²⁴⁹²

d. Percentage Limitation

The amount deductible under §175 for any tax year is limited to 25% of the gross income derived from farming during the tax year.²⁴⁹³ Gross income from farming does not include gains from the sale of assets or from the disposition of land.²⁴⁹⁴ If the soil and water conservation expenditures treated as an expense for the tax year exceed the 25% limitation, the excess is deductible in succeeding tax years in order of time, subject to the 25% limitation in each of those tax years.²⁴⁹⁵

e. Soil and Water Conservation Expenditures Defined

(1) In General

Soil and water conservation expenditures are expenditures paid or incurred by the taxpayer for the purpose of soil or water conservation with respect to land used in farming or for the prevention of erosion of land used in farming.²⁴⁹⁶ Expenditures that meet this definition are those for the treatment or moving of earth, including, but not limited to, leveling, grading and terracing, contour furrowing, the construction, control, protection of diversion channels, drainage ditches, earthen dams, watercourses, outlets, and ponds, the eradication of brush and the planting of windbreaks.²⁴⁹⁷ Soil and water conservation expenditures also include expenditures paid or incurred for the purpose of achieving site-specific management actions recommended in recovery plans approved pursuant to the Endangered Species Act of 1973.²⁴⁹⁸

(2) Exceptions

Soil and water conservation expenditures do not include amounts paid or incurred for the purchase, construction, installation or improvement of structures, appliances or facilities of a character subject to the allowance for depreciation deductions under §167.²⁴⁹⁹ Soil and water conservation expenditures do not include any amount paid or incurred which is allowable as a deduction without regard to §175.²⁵⁰⁰

(3) Conservation and Drainage District Assessments

(a) In General

Soil and water conservation expenditures also include any amount that satisfies two conditions.²⁵⁰¹ First, the amount must not be otherwise allowable as a deduction.²⁵⁰² Second, the amount must be paid or incurred to satisfy any part of an assessment levied by a soil or water conservation or drainage district to defray expenditures made by the district which meet one of two tests.²⁵⁰³ The first test is met if the district's expenditures would be soil and water conservation expenditures deductible under §175 if they were made by the taxpayer.²⁵⁰⁴ The second test is met if the expenditures are for property of a character subject to the allowance for depreciation deductions under §167 and used in the district's business as such, but only to the extent that the taxpayer's share of the assessments levied on members of the district does not exceed 10% of those assessments.²⁵⁰⁵

(b) Nine Year Amortization

If the amount of the assessment paid or incurred by the taxpayer during the tax year, for expenditures that meet the second test, exceeds 10% of all such assessments which have been and will be levied on the taxpayer's land, and if the excess is more than \$500, then the entire excess is treated as having been paid or incurred ratably over each of the nine succeeding tax years.²⁵⁰⁶ If the land with respect to which the assessment is levied is sold or otherwise disposed of during the nine-year period, any remaining excess not yet treated as having been paid or incurred for the tax year before the sale or disposition is added to the adjusted basis of the land and is not treated as having been paid or incurred in any subsequent tax year.²⁵⁰⁷ If the taxpayer dies during the nine-year period, any remaining excess not yet treated as having been paid or incurred for the tax year ending before the death is treated as having been paid in the tax year during which the taxpayer dies.²⁵⁰⁸

(4) Land Used in Farming

Land used in farming is land used before, or simultaneously with the soil and water conservation expenditures, by the

²⁴⁸⁹ §175(d)(1).

²⁴⁹⁰ §175(d)(2).

²⁴⁹¹ §175(e).

²⁴⁹² §175(e).

²⁴⁹³ §175(b).

²⁴⁹⁴ *Id.*

²⁴⁹⁵ §175(b).

²⁴⁹⁶ §175(a).

²⁴⁹⁷ §175(c)(1).

²⁴⁹⁸ §175(c)(1)(B).

²⁴⁹⁹ §175(c)(1)(A).

²⁵⁰⁰ §175(c)(1)(B).

²⁵⁰¹ §175(c)(1).

²⁵⁰² §175(c)(1) (flush language).

²⁵⁰³ *Id.*

²⁵⁰⁴ §175(c)(1) (flush language (i)).

²⁵⁰⁵ §175(c)(1) (flush language (ii)).

²⁵⁰⁶ §175(f)(1).

²⁵⁰⁷ §175(f)(2).

²⁵⁰⁸ §175(f)(3).

taxpayer or a tenant of the taxpayer for the production of crops, fruits or other agricultural products or for the sustenance of livestock.²⁵⁰⁹

f. Policy Limitations

(1) Conservation Plan Consistency

No deduction under §175 is allowed for an expenditure unless it is consistent with any plan approved by the Soil Conservation Service of the Department of Agriculture or the recovery plan approved pursuant to the Endangered Species Act of 1973 for the area in which the land is located, or if there is no such plan, with any soil conservation plan of a comparable state agency.²⁵¹⁰

(2) Wetlands

No deduction under §175 is allowed for an expenditure made in connection with the draining or filling of wetlands or land preparation for center pivot irrigation systems.²⁵¹¹

3. Land Conditioning Expenditures

a. In General

Under §180, a taxpayer engaged in the business of farming may elect to treat land conditioning expenditures paid or incurred during the tax year as expenditures that are not chargeable to capital account.²⁵¹² The expenditures so treated are allowed as deductions.²⁵¹³

The deductibility of land conditioning expenditures is described in VI.B.3.b. through c., below, and is discussed in 607 T.M., *Farm and Ranch Expenses and Credits*.

b. Land Conditioning Expenditures Defined

Land conditioning expenditures are those made for the purchase or acquisition of fertilizer, lime, ground limestone, marl or other materials to enrich, neutralize, condition land used in farming or for the application of those materials to the land.²⁵¹⁴ Land used in farming is land used, before or simultaneously with the soil and water conservation expenditures, by the taxpayer or a tenant of the taxpayer for the production of crops, fruits or other agricultural products or for the sustenance of livestock.²⁵¹⁵

c. Election

The §180 election for any tax year must be made by the due date, including extensions, for filing the tax return for that tax year.²⁵¹⁶ The election is made by claiming a deduction for land conditioning expenditures that are otherwise chargeable to capital account.²⁵¹⁷ Once made for a tax year, the election cannot be revoked without the consent of the IRS.²⁵¹⁸

²⁵⁰⁹ §175(c)(2).

²⁵¹⁰ §175(c)(3)(A).

²⁵¹¹ §175(c)(3)(B).

²⁵¹² §180(a).

²⁵¹³ *Id.*

²⁵¹⁴ §180(a).

²⁵¹⁵ §180(b).

²⁵¹⁶ §180(c).

²⁵¹⁷ §180(c).

²⁵¹⁸ §180(c).

C. Timber, Oil and Gas, and Minerals

1. In General

Because the nature of the trades or businesses of growing timber, producing oil and gas and extracting minerals are unique in many ways, special rules elaborate on the application of §162 to taxpayers engaged in those trades or businesses. Special deductions also are provided to taxpayers engaged in one or another of these trades or businesses.²⁵¹⁹ Deductions for taxpayers engaged in these trades or businesses are described in VI.C.2. through 10., below, and are discussed in 601 T.M., *Mineral Properties — Exploration, Acquisition, Development and Disposition*, 603 T.M., *Mineral Properties Other Than Gas and Oil — Operation*, 605 T.M., *Oil and Gas Transactions*, and 610 T.M., *Timber Transactions*.

2. Application of §162 to Specific Expenses

a. Lease Payments and Royalties

Minimum royalties paid under a mining lease are deductible,²⁵²⁰ but royalties based on production are not deductible until production occurs.²⁵²¹ Gas and oil overriding royalties are deductible under §162.²⁵²²

First year rental payments under competitive governmental or private nongovernmental oil and gas leases are deductible under §162 if the payments have the characteristics of a delay rental that are not lease bonuses, but may be capitalized at the lessee's option.²⁵²³ An operator of an oil or gas lease paying a percentage of profits to the assignor of the lease is allowed to deduct the amounts paid, and is not required to capitalize them.²⁵²⁴ Expenses paid or incurred to pay production payments and to extinguish the interest of the seller of the lease are not deductible because they are part of the purchase price of the lease.²⁵²⁵

b. Forest Management

The expenses of managing forests held for the production of timber are deductible under §162.²⁵²⁶

²⁵¹⁹ See, e.g., §179B, §193, §194, §611, §613, §613A, §616, §617, §631.

²⁵²⁰ E.g., *Helvering v. Russian Fin. & Constr. Corp.*, 77 F.2d 324 (2d Cir. 1935), aff'g 2 B.T.A.M. 716 (1933); *Commissioner v. Jamison Coal & Coke Co.*, 67 F.2d 342 (3d Cir. 1933), modifying in part 24 B.T.A. 554 (1931); *Burnet v. Hutchinson Coal Co.*, 64 F.2d 275 (4th Cir. 1933), cert. denied, 290 U.S. 652 (1933), aff'g 24 B.T.A. 973 (1931); *Merillat v. Commissioner*, 9 B.T.A. 813 (1927).

²⁵²¹ E.g., *Ward v. Commissioner*, 784 F.2d 1424 (9th Cir. 1986), aff'g 48 T.C.M. 1479 (1984); *Wiseman v. Commissioner*, 53 T.C.M. 1432 (1987); *Walls v. Commissioner*, 46 T.C.M. 1158 (1983).

²⁵²² E.g., *Carter Found. Prod. Co. v. Campbell*, 61-2 USTC ¶9630 (N.D. Tex. 1961), aff'd in part and rev'd in part on other issues, 322 F.2d 827 (5th Cir. 1963).

²⁵²³ Rev. Rul. 80-49, 1980-1 C.B. 127.

²⁵²⁴ *Burton-Sutton Oil Co., Inc. v. Commissioner*, 328 U.S. 25 (1946), rev'g 150 F.2d 621 (5th Cir. 1945), aff'g 3 T.C. 1187 (1944), on remand, 168 F.2d 903 (5th Cir. 1946); *Commissioner v. Gracey*, 159 F.2d 324 (5th Cir. 1947), rev'g in part and aff'g in part 5 T.C. 296 (1945).

²⁵²⁵ *Producers Chemical Co. v. Commissioner*, 50 T.C. 940 (1968).

²⁵²⁶ E.g., *Wilmington Trust Co. v. United States*, 610 F.2d 703 (Ct. Cl. 1979), aff'g *McMullan v. United States*, 78-2 USTC ¶9656 (Ct. Cl. 1978).

c. Timber Cruising

The costs of paying employees to cruise timber paid by a taxpayer in the business of trading timber and timber lands is deductible under §162.²⁵²⁷ Incidental expenses of the cruise also are deductible.²⁵²⁸

3. Depletion

a. In General

Under §611, a reasonable allowance for depletion and depreciation of improvements is allowed in the case of mines, oil and gas wells, other natural deposits and timber, depending on the peculiar conditions in each case.²⁵²⁹ For this purpose, mines include deposits of waste or residue, if the extraction of ores or minerals from the deposits is treated as mining under §613(c).²⁵³⁰ If percentage depletion under §613, allowable for deposits other than oil, gas and timber, described in VI.C.4., below, generates a greater allowance for depletion for a tax year, then the §613 deduction is allowable in lieu of §611 cost depletion deduction.²⁵³¹

Depletion is described in VI.C.3.b. through d., below, and is discussed in 603 T.M., *Mineral Properties Other Than Gas and Oil — Operation*.

b. Computation for Property Other than Timber

(1) In General

The depletion deduction for a tax year with respect to depletable property other than timber is computed by dividing the basis for depletion by the number of units of mineral remaining as of the tax year, and by multiplying that amount by the number of units of mineral sold during the tax year.²⁵³² The total aggregate depletion deductions with respect to a property is limited to the cost or other basis of that property, plus allowable capital additions, although percentage depletion under §613 is thereafter allowable.²⁵³³

The unit of mineral is the principal or customary unit paid for, and can be tons of ore, barrels of oil or thousands of cubic feet of gas.²⁵³⁴ If production from a natural gas well is not metered, the taxpayer may use rock pressure differential computations.²⁵³⁵

(2) Basis for Depletion

The basis on which depletion is computed with respect to any property is the adjusted basis of the property provided in §1011 for determining gain upon the disposition of the property.²⁵³⁶ Basis does not include amounts recoverable through de-

preciation or other deductions,²⁵³⁷ or the residual value of land and improvements.²⁵³⁸

Special rules apply to determining basis in the case of mines,²⁵³⁹ oil and gas wells²⁵⁴⁰ and geothermal wells.²⁵⁴¹ Basis, and the depletion deduction, is adjusted in the case of bonus payments,²⁵⁴² advanced royalties²⁵⁴³ and delay rental.²⁵⁴⁴

(3) Number of Units Remaining as of the Tax Year

The number of units of mineral remaining as of the tax year equals the number of units of mineral remaining to be recovered at the end of the tax year plus the number of units sold during the tax year.²⁵⁴⁵ Special rules apply to the determination of the number of recoverable units remaining.²⁵⁴⁶ If it is ascertained as a result of operations or of development work that recoverable units are greater or less than the prior estimate then the prior estimate must be revised and the allowance for depletion must be based on the revised estimate.²⁵⁴⁷

(4) Number of Units Sold During the Tax Year

The number of units sold during the tax year by a cash method taxpayer is the number of units for which payment is received during the tax year even though produced or sold before the tax year.²⁵⁴⁸ The number of units sold during the tax year by an accrual method taxpayer is determined from the taxpayer's inventories kept in physical quantities in a manner consistent with the taxpayer's method of inventory accounting.²⁵⁴⁹

c. Computation for Timber Property

(1) In General

The depletion deduction for a tax year with respect to timber equals the number of units of timber cut during that year multiplied by the depletion unit for the timber.²⁵⁵⁰ Depletion is separately computed for each timber account maintained by the taxpayer,²⁵⁵¹ though taxpayers have relatively broad latitude to form or divide blocks of timber.²⁵⁵² Taxpayers who maintain timber accounts on a monthly basis may compute depletion on a monthly basis.²⁵⁵³ The total aggregate depletion deductions with respect to a timber account is limited to the cost or other basis of the property in that account plus subsequent allowable capital additions.²⁵⁵⁴

²⁵³⁷ Reg. §1.612-1(b)(1)(i).

²⁵³⁸ Reg. §1.612-1(b)(1)(ii).

²⁵³⁹ See Reg. §1.612-2.

²⁵⁴⁰ See Reg. §1.612-4. See also Reg. §1.611-2(a).

²⁵⁴¹ See Reg. §1.612-5.

²⁵⁴² See Reg. §1.612-3(a).

²⁵⁴³ See Reg. §1.612-3(b).

²⁵⁴⁴ See Reg. §1.612-3(c).

²⁵⁴⁵ Reg. §1.611-2(a)(3).

²⁵⁴⁶ See Reg. §1.611-2(c).

²⁵⁴⁷ §611(a).

²⁵⁴⁸ Reg. §1.611-2(a)(2)(i).

²⁵⁴⁹ Reg. §1.611-2(a)(2)(ii).

²⁵⁵⁰ Reg. §1.611-3(b)(2).

²⁵⁵¹ *Id.*

²⁵⁵² See Reg. §1.611-3(d)(1).

²⁵⁵³ See Reg. §1.611-3(b)(2).

²⁵⁵⁴ Reg. §1.611-3(c)(1).

²⁵²⁷ *E.g., Alabama Mineral Land Co. v. Commissioner*, 28 B.T.A. 586 (1933); *Robinson Land & Lumber Co. of Alabama, Inc. v. United States*, 112 F. Supp. 33 (S.D. Ala. 1953).

²⁵²⁸ *E.g., Drey v. United States*, 61-1 USTC ¶ 9116 (E.D. Mo. 1960).

²⁵²⁹ §611(a); Reg. §1.611-1(a)(1).

²⁵³⁰ §611(a).

²⁵³¹ Reg. §1.611-1(a)(1).

²⁵³² Reg. §1.611-2(a)(1).

²⁵³³ Reg. §1.611-2(b)(2).

²⁵³⁴ Reg. §1.611-2(a)(1).

²⁵³⁵ See Reg. §1.611-2(a)(4).

²⁵³⁶ §612; Reg. §1.611-2(a)(1), Reg. §1.612-1(a).

(2) Number of Units Cut

The amount of depletion with respect to timber that has been cut may be computed when the quantity of cut timber is first accurately measured in the process of exploitation.²⁵⁵⁵ Depletion allowable with respect to units that are cut but the products of which are not sold during the tax year is added to the closing inventory of those products.²⁵⁵⁶

*(3) Depletion Unit**(a) In General*

The depletion unit is determined by dividing recomputed basis by adjusted units.²⁵⁵⁷

(b) Recomputed Basis

Recomputed basis equals the adjusted basis²⁵⁵⁸ of the timber on hand at the beginning of the tax year, increased by the cost of the number of units of timber acquired during the tax year and by proper additions to capital²⁵⁵⁹ with respect to the timber.²⁵⁶⁰ Recomputed basis must be reduced by the adjusted basis of any timber that the taxpayer elects under §631(a) to treat as a sale or exchange when it is cut during the tax year.²⁵⁶¹

Basis does not include amounts recoverable through depreciation or other deductions,²⁵⁶² or the residual value of land and improvements.²⁵⁶³ Basis, and the depletion deduction, is adjusted in the case of bonus payments,²⁵⁶⁴ advanced royalties²⁵⁶⁵ and delay rentals.²⁵⁶⁶

(c) Adjusted Units

Adjusted units equals the total number of units of timber on hand in the timber account at the beginning of the tax year, plus the number of units acquired during the tax year, plus any amount required to be added to correct the estimate of remaining units, minus any amount required to be subtracted to correct the estimate of remaining units.²⁵⁶⁷ Special rules apply to the determination of the number of remaining units.²⁵⁶⁸

*d. Taxpayers Entitled**(1) In General*

The depletion deduction is allowable only to the owner of an economic interest in mineral deposits or standing timber.²⁵⁶⁹ An economic interest is possessed if the taxpayer has acquired by investment any interest in mineral in place or standing tim-

ber, and secures, by any form of legal relationship, income derived from the extraction of the mineral or severance of the timber, to which the taxpayer must look for a return of the invested capital.²⁵⁷⁰ A person with no capital interest in the mineral deposit or standing timber does not possess an economic interest merely because a contractual right gives the person a mere economic or pecuniary advantage derived from production.²⁵⁷¹

No depletion deduction is allowed to an owner of timber, coal or domestic iron ore if the owner has disposed of the timber, coal or iron ore under any form of contract through which the owner retains an economic interest, if the disposition is treated as a sale under §631(b) or (c).²⁵⁷² Treatment of dispositions with retained interests as sales under §631(b) or (c) is discussed in 603 T.M., *Mineral Properties Other Than Gas and Oil — Operation*.

(2) Multiple Owners or Interests

The depletion deduction must be equitably apportioned between the lessor and the lessee.²⁵⁷³ If depletable property is held by one person for life with remainder to another person, the depletion deduction is computed as though the life tenant were the absolute owner and is allocated entirely to the life tenant.²⁵⁷⁴ If depletable property is held in trust, the depletion deduction is apportioned between the income beneficiaries and the trustee in accordance with the pertinent provisions of the instrument creating the trust, or, if there are no such provisions, on the basis of the trust income allocated to the income beneficiaries and the trustee.²⁵⁷⁵ If depletable property is held by an estate, the depletion deduction is apportioned between the estate and the heirs, legatees and devisees on the basis of the income of the estate allocable to each.²⁵⁷⁶ If depletable property is held by a corporation, the depletion deduction is allowed to the corporation and not its shareholders.²⁵⁷⁷

*4. Percentage Depletion**a. In General*

Under §613, the §611 depletion allowance is determined by multiplying the gross income from the property by the specified percentage,²⁵⁷⁸ but percentage depletion is not applicable for a tax year for which the allowance under §611 without regard to §613 is greater.²⁵⁷⁹

Percentage depletion is described in VI.C.4.b. through e., below, and is discussed in 603 T.M., *Mineral Properties Other Than Gas and Oil — Operation*, and 605 T.M., *Oil and Gas Transactions*.

²⁵⁵⁵ Reg. §1.611-3(b)(1).

²⁵⁵⁶ *Id.*

²⁵⁵⁷ See Reg. §1.611-3(b)(2).

²⁵⁵⁸ See §1012, §1016.

²⁵⁵⁹ See Reg. §1.611-3(b)(2).

²⁵⁶⁰ *Id.*

²⁵⁶¹ Reg. §1.611-3(b)(3); §1.612-1(b)(2).

²⁵⁶² Reg. §1.612-1(b)(1)(i).

²⁵⁶³ Reg. §1.612-1(b)(1)(ii).

²⁵⁶⁴ See Reg. §1.612-3(a).

²⁵⁶⁵ See Reg. §1.612-3(b).

²⁵⁶⁶ See Reg. §1.612-3(c).

²⁵⁶⁷ Reg. §1.611-3(b)(2).

²⁵⁶⁸ See Reg. §1.611-3(e).

²⁵⁶⁹ Reg. §1.611-1(b)(1).

²⁵⁷⁰ *Id.*

²⁵⁷¹ *Id.*

²⁵⁷² Reg. §1.611-1(b)(2).

²⁵⁷³ §611(b)(1); Reg. §1.611-1(c)(2).

²⁵⁷⁴ §611(b)(2); Reg. §1.611-1(c)(3).

²⁵⁷⁵ §611(b)(3); Reg. §1.611-1(c)(4).

²⁵⁷⁶ §611(b)(4); Reg. §1.611-1(c)(5).

²⁵⁷⁷ Reg. §1.611-1(b)(1).

²⁵⁷⁸ §613(a); Reg. §1.613-1.

²⁵⁷⁹ §613(a); Reg. §1.613-1.

b. Excluded Properties

(1) In General

Percentage depletion is allowable only with respect to the mines, wells and other properties for which specified percentages are provided.²⁵⁸⁰ Thus, percentage depletion is not allowable with respect to timber.²⁵⁸¹ Percentage depletion is not allowable with respect to the income from a disposal of coal or lignite or domestic iron ore with a retained economic interest to the extent the income is treated under §631(c) as from a sale of coal or iron ore.²⁵⁸² Treatment of dispositions with retained interests as sales under §631(b) or (c) is discussed in 603 T.M., *Mineral Properties Other Than Gas and Oil — Operation*.

Except as provided under §613A, percentage depletion is not allowable with respect to oil and gas wells.²⁵⁸³

(2) Natural Gas Exception

Regulated natural gas²⁵⁸⁴ and natural gas sold under a fixed contract²⁵⁸⁵ are not subject to the limitation applicable to oil and gas wells.²⁵⁸⁶ Qualified natural gas from geopressured brine²⁵⁸⁷ also is not subject to this limitation.²⁵⁸⁸

(3) Independent Producer Exception

Independent producers and royalty owners (which excludes retailers and certain refiners)²⁵⁸⁹ are entitled to a percentage depletion allowance of 15%.²⁵⁹⁰ The percentage depletion allowance applies to the gross income from so much of the taxpayer's average daily production²⁵⁹¹ of domestic crude oil as does not exceed the taxpayer's depletable oil quantity;²⁵⁹² and to the gross income from so much of the taxpayer's average daily production of natural gas²⁵⁹³ as does not exceed the taxpayer's depletable natural gas quantity.²⁵⁹⁴

If the taxpayer so elects,²⁵⁹⁵ the portion of the taxpayer's average daily marginal production²⁵⁹⁶ of domestic crude oil that does not exceed the taxpayer's depletable oil quantity determined without regard to §613A(c)(3)(A)(ii) is subject to percentage depletion.²⁵⁹⁷ If the taxpayer so elects,²⁵⁹⁸ the portion of the taxpayer's average daily marginal production²⁵⁹⁹ of domes-

tic natural gas that does not exceed the taxpayer's depletable natural gas quantity²⁶⁰⁰ also is subject to percentage depletion.²⁶⁰¹

The preceding exceptions do not apply to retailers,²⁶⁰² but this retailer preclusion does not apply if the combined gross receipts from the retail sales do not exceed \$5,000,000.²⁶⁰³ The preceding exceptions do not apply to taxpayers if they or related persons²⁶⁰⁴ engage in the refining of crude oil and on any day during the tax year the refinery runs of the taxpayer and any related person exceed 75,000 barrels, determined by dividing the aggregate refinery runs for the tax year by the number of days in the tax year.²⁶⁰⁵ The preceding exceptions are computed without including in gross income any lease bonus, advance royalty, or other amount payable without regard to production from the property.²⁶⁰⁶

Special rules apply to crude oil produced in excess of depletable oil quantity,²⁶⁰⁷ natural gas produced in excess of depletable natural gas quantity,²⁶⁰⁸ allocation of taxable income from the property,²⁶⁰⁹ partnerships,²⁶¹⁰ businesses under common control,²⁶¹¹ fiscal year taxpayers,²⁶¹² interrelationship with the natural gas exceptions²⁶¹³ and S corporations.²⁶¹⁴

c. Gross Income from the Property

(1) In General

(a) Measurement of Gross Income

In the case of property other than oil or gas wells and other than geothermal deposits, gross income from the property is the gross income from mining.²⁶¹⁵ In the case of oil and gas wells, gross income is the amount for which the taxpayer sells the oil or gas in the immediate vicinity of the well.²⁶¹⁶ If the taxpayer does not sell the oil or gas on the premises but, before sale, converts or manufactures it into a refined product or transports it from the premises, the gross income is presumed to be the representative market or field price of the oil or gas before conversion or transportation.²⁶¹⁷

(b) Exclusions

Gross income from the property is determined by excluding an amount equal to any rents or royalties paid by the taxpayer with respect to the property.²⁶¹⁸ Gross income does not include an amount equal to the amount of bonus payments paid

²⁵⁸⁰ See §613(a).

²⁵⁸¹ See §613(a), §613(b).

²⁵⁸² Reg. §1.613-2(c)(4).

²⁵⁸³ §613(d), §613A(a); Reg. §1.613A-1.

²⁵⁸⁴ See §613A(b)(3)(B).

²⁵⁸⁵ See §613A(b)(3)(A).

²⁵⁸⁶ §613A(b)(1).

²⁵⁸⁷ See §613A(b)(3)(C).

²⁵⁸⁸ §613A(b)(2).

²⁵⁸⁹ §613A(d)(2), §613A(d)(4).

²⁵⁹⁰ §613A(c)(1).

²⁵⁹¹ See §613A(c)(2).

²⁵⁹² See §613A(c)(3).

²⁵⁹³ See §613A(c)(2).

²⁵⁹⁴ See §613A(c)(4).

²⁵⁹⁵ See §613A(c)(6)(B); Reg. §1.613A-5.

²⁵⁹⁶ See §613A(c)(6)(D), §613A(c)(6)(E), §613A(c)(6)(F), §613A(c)(6)

(G).
²⁵⁹⁷ §613A(c)(6)(A)(i).

²⁵⁹⁸ See §613A(c)(6)(B); Reg. §1.613A-5.

²⁵⁹⁹ See §613A(c)(6)(D), §613A(c)(6)(E), §613A(c)(6)(F), §613A(c)(6)

(G).

²⁶⁰⁰ See §613A(c)(6)(A)(ii).

²⁶⁰¹ §613A(c)(6)(A)(ii).

²⁶⁰² See §613A(d)(2).

²⁶⁰³ §613A(d)(2) (flush language).

²⁶⁰⁴ See §613A(d)(3).

²⁶⁰⁵ §613A(d)(4).

²⁶⁰⁶ §613A(d)(5).

²⁶⁰⁷ See §613A(c)(7)(A).

²⁶⁰⁸ See §613A(c)(7)(B).

²⁶⁰⁹ See §613A(c)(7)(C).

²⁶¹⁰ See §613A(c)(7)(D).

²⁶¹¹ See §613A(c)(8).

²⁶¹² See §613A(c)(9).

²⁶¹³ See §613A(c)(10).

²⁶¹⁴ See §613A(c)(11).

²⁶¹⁵ §613(c)(1); Reg. §1.613-4(a).

²⁶¹⁶ Reg. §1.613-3.

²⁶¹⁷ *Id.*

²⁶¹⁸ §613(a); Reg. §1.613-2(c)(5)(i).

with respect to the property in any tax year that is allocable to the product that is sold.²⁶¹⁹ Gross income does not include an amount equal to any deduction claimed for the tax year on account of any advance royalties paid with respect to the property.²⁶²⁰

(2) Mining

(a) In General

Mining includes not merely the extraction of the ores or minerals from the ground but also other activities.²⁶²¹ Mining includes the treatment processes considered as mining and the treatment processes necessary or incidental²⁶²² to those processes.²⁶²³ Mining also includes so much of the transportation of ores or minerals, whether or not by common carrier, from the point of extraction from the ground to the plants or mills in which those treatment processes are applied as is not in excess of 50 miles,²⁶²⁴ unless the IRS determines that a greater distance is warranted from the physical or other requirements of the situation.²⁶²⁵ Mining also includes the extraction by mine owners or operators of ores or minerals from the waste or residue of prior mining, but this does not include extraction of the mineral or ore by a purchaser of the waste or residue or by a purchaser of the rights to extract ores or minerals from the waste or residue.²⁶²⁶

(b) Treatment Processes Considered as Mining

Treatment processes considered as mining include the following, to the extent they are applied by the mine owner or operator to the ore or mineral with respect to which the owner or operator is claiming depletion:

- Coal: cleaning, breaking, sizing, dust allaying, treating to prevent freezing and loading for shipment.²⁶²⁷
- Sulfur recovered by the Frasch process: cleaning, pumping to vats, cooling, breaking and loading for shipment.²⁶²⁸
- Iron ore, bauxite, ball and sagger clay, rock asphalt, and ores or minerals which are customarily sold in the form of a crude mineral product:²⁶²⁹ sorting,²⁶³⁰ concentrating,²⁶³¹ sintering,²⁶³² substantially equivalent processes to bring to shipping grade and form²⁶³³ and loading for shipment.²⁶³⁴
- Lead, zinc, copper, gold, silver, uranium, fluorspar ores, potash and ores or minerals which are not customarily sold in the form of the crude mineral product: crushing,

grinding, and beneficiation by gravity, flotation, amalgamation, electrostatic, or magnetic concentration, cyanidation,²⁶³⁵ leaching,²⁶³⁶ crystallization,²⁶³⁷ precipitation²⁶³⁸ other than electrolytic deposition, roasting, thermal or electric smelting or refining,²⁶³⁹ or by substantially equivalent processes or combination of processes used in the separation or extraction of the product or products from the ore or the mineral or minerals from other material from the mine or other natural deposit.²⁶⁴⁰

- Talc: pulverization.²⁶⁴¹
- Magnesite: burning.²⁶⁴²
- Phosphate rock: sintering²⁶⁴³ and nodulizing.²⁶⁴⁴
- Trona: decarbonization.²⁶⁴⁵
- Quicksilver ores: furnacing.²⁶⁴⁶
- Calcium carbonates and other minerals when used in making cement: all processes, other than preheating the kiln feed, applied before the introduction of the kiln feed into the kiln, but not including any subsequent process.²⁶⁴⁷
- Clay in the 5% or 7.5% specified percentage categories, as described in VI.C.4.d., below: crushing, grinding and separating the mineral from the waste, but not including any subsequent process.²⁶⁴⁸
- Oil shale: extraction from the ground, crushing, loading into the retort and retorting, but not hydrogenation, refining or any other process subsequent to retorting.²⁶⁴⁹

Treatment processes considered as mining also include any other treatment processes prescribed by the IRS which, with respect to the particular ore or mineral, is consistent with the preceding list.²⁶⁵⁰ Unless included in the preceding list, or as necessary or incidental²⁶⁵¹ to processes in that list, electrolytic deposition, roasting, calcining,²⁶⁵² thermal and electric smelting,²⁶⁵³ refining,²⁶⁵⁴ polishing,²⁶⁵⁵ fine pulverization,²⁶⁵⁶ blending with other materials,²⁶⁵⁷ treatment effecting a chemical

²⁶¹⁹ Reg. § 1.613-2(c)(5)(ii).

²⁶²⁰ Reg. § 1.613-2(c)(5)(iii).

²⁶²¹ § 613(c)(2); Reg. § 1.613-4(f)(1).

²⁶²² See Reg. § 1.613-4(f)(2)(iii).

²⁶²³ § 613(c)(2); Reg. § 1.613-4(f)(2).

²⁶²⁴ § 613(c)(2). See Reg. § 1.613-4(f)(1)(iii).

²⁶²⁵ § 613(c)(2); Reg. § 1.613-4(f), (h).

²⁶²⁶ § 613(c)(3). See Reg. § 1.613-4(f)(2)(iv).

²⁶²⁷ § 613(c)(4)(A); Reg. § 1.613-4(f)(2)(i)(a).

²⁶²⁸ § 613(c)(4)(B); Reg. § 1.613-4(f)(2)(i)(b).

²⁶²⁹ See Reg. § 1.613-4(f)(2)(i)(c).

²⁶³⁰ See Reg. § 1.613-4(f)(3)(i).

²⁶³¹ *Id.*

²⁶³² See Reg. § 1.613-4(f)(3)(ii).

²⁶³³ See Reg. § 1.613-4(f)(3)(iii).

²⁶³⁴ § 613(c)(4)(C); Reg. § 1.613-4(f)(2)(i)(c)(2).

²⁶³⁵ See Reg. § 1.613-4(f)(2)(i)(d).

²⁶³⁶ *Id.*

²⁶³⁷ *Id.*

²⁶³⁸ *Id.*

²⁶³⁹ See Reg. § 1.613-4(f)(4), § 1.613-4(g).

²⁶⁴⁰ § 613(c)(4)(D); Reg. § 1.613-4(f)(2)(i)(d), § 1.613-4(f)(4).

²⁶⁴¹ § 613(c)(4)(E); Reg. § 1.613-4(f)(2)(i)(e)(2).

²⁶⁴² § 613(c)(4)(E); Reg. § 1.613-4(f)(2)(i)(e)(3).

²⁶⁴³ See Reg. § 1.613-4(f)(3)(ii), Reg. § 1.613-4(f)(2)(i)(e)(4).

²⁶⁴⁴ § 613(c)(4)(E); Reg. § 1.613-4(f)(2)(i)(e)(4).

²⁶⁴⁵ § 613(c)(4)(E).

²⁶⁴⁶ § 613(c)(4)(E); Reg. § 1.613-4(f)(2)(i)(e)(1).

²⁶⁴⁷ § 613(c)(4)(F); Reg. § 1.613-4(f)(2)(ii)(a).

²⁶⁴⁸ § 613(c)(4)(G); Reg. § 1.613-4(f)(2)(ii)(b).

²⁶⁴⁹ § 613(c)(4)(H); Reg. § 1.613-4(f)(2)(ii)(d).

²⁶⁵⁰ § 613(c)(4)(I). See Reg. § 1.613-4(f)(2)(ii)(c), (5).

²⁶⁵¹ See Reg. § 1.613-4(f)(2)(iii).

²⁶⁵² See Reg. § 1.613-4(g)(6)(i).

²⁶⁵³ See Reg. § 1.613-4(g)(6)(ii).

²⁶⁵⁴ See Reg. § 1.613-4(g)(6)(iii).

²⁶⁵⁵ See Reg. § 1.613-4(g)(6)(iv).

²⁶⁵⁶ See Reg. § 1.613-4(g)(6)(v).

²⁶⁵⁷ See Reg. § 1.613-4(g)(6)(vi).

change,²⁶⁵⁸ thermal action,²⁶⁵⁹ molding and shaping are not treatment processes considered as mining.²⁶⁶⁰

d. Specified Percentage

Generally, the specified percentages are as follows:

- 22%: sulphur,²⁶⁶¹ uranium,²⁶⁶² extractions from deposits within the United States of anorthosite, clay, laterite and nephelite syenite, to the extent that alumina and aluminum compounds are extracted therefrom, asbestos, bauxite, celestite, chromite, corundum, fluorspar, graphite, ilmenite, kyanite, mica, olivine, radio grade quartz crystals, rutile, block steatite talc, zircon,²⁶⁶³ ores from deposits within the United States of antimony, beryllium, bismuth, cadmium, cobalt, columbium, lead, lithium, manganese, mercury, molybdenum, nickel, platinum, platinum group metals, tantalum, thorium, tin, titanium, tungsten, vanadium, zinc²⁶⁶⁴ and natural gas for which percentage depletion is allowed under §613A.²⁶⁶⁵
- 15%: extractions from deposits within the United States of gold, silver, copper, iron ore,²⁶⁶⁶ oil shale not within the 7.5% category,²⁶⁶⁷ geothermal deposits²⁶⁶⁸ located in the United States or a possession of the United States²⁶⁶⁹ and crude oil and natural gas within the independent producer exemption of §613A(c)(1),²⁶⁷⁰ except that the percentage is increased based on changes in the reference price²⁶⁷¹ of crude oil, to amounts not to exceed 25%.²⁶⁷²
- 14%: metal mines not within the 22% or 15% categories, rock asphalt, vermiculite,²⁶⁷³ ball clay, bentonite, china clay, sagger clay and clay used or sold for use for purposes dependent on its refractory properties, except for clays within the 22%, 7.5% or 5% categories,²⁶⁷⁴ aplite, barite, borax, calcium carbonates, diatomaceous earth, dolomite, feldspar, fullers earth, garnet, Gilsonite, granite, limestone, magnesite, magnesium carbonates, marble, mollusk shells, clam shells, oyster shells, phosphate rock, potash, quartzite, slate, soapstone, stone used or sold by the mine operator as dimension stone²⁶⁷⁵ or ornamental stone,²⁶⁷⁶ thenardite, tripoli, trona, and, unless within the 22% category, bauxite, flake graphite, fluorspar, lepidolite, mica, spodumene, talc, pyrophyllite²⁶⁷⁷ and all other minerals not

within any other category,²⁶⁷⁸ except minerals within the second 5% category, and except soil, sod, dirt, turf, water, mosses, minerals from sea water, the air, or similar inexhaustible sources and oil and gas wells,²⁶⁷⁹ but minerals, other than sodium chloride, from brines pumped from a saline perennial lake within the United States are not minerals from an inexhaustible source.²⁶⁸⁰

- 10%: asbestos not within the 22% category, brucite, coal, lignite, perlite, sodium chloride, wollastonite²⁶⁸¹ and natural gas from geopressed brine for which percentage depletion is allowed under §613A.²⁶⁸²
- 7.5%: clay and shale used or sold for use in the manufacture of sewer pipe or brick, and clay, shale or slate used or sold for use as sintered or burned lightweight aggregates.²⁶⁸³
- 5%: gravel, peat, pumice, sand, scoria, shale not within the 15% or 7.5% categories, stone not within the 14% category,²⁶⁸⁴ clay used or sold for use in the manufacture of drainage and roofing tile, flower pots, kindred products,²⁶⁸⁵ bromine, calcium chloride and magnesium chloride from brine wells.²⁶⁸⁶
- 5%: minerals that otherwise would be in the 14% category, other than slate that would then be within the 7.5% category, that are used or sold for use by the mine owner operator as rip rap, ballast, road material, rubble, concrete aggregates or for similar purposes, but not if the sale is made on bid in direct competition with a bona fide bid to sell a mineral in the 14% category.²⁶⁸⁷

Special rules apply if more than one mineral is derived from a mineral property and those minerals are within different specified percentage categories.²⁶⁸⁸

e. Taxable Income Limitations

Percentage depletion is limited to 50% of the taxpayer's taxable income²⁶⁸⁹ from the property.²⁶⁹⁰ In the case of oil and gas properties, the limitation percentage is 100%.²⁶⁹¹ For this purpose, taxable income is computed without any allowance for depletion and without the deduction for qualified domestic production activities.²⁶⁹² The 100% limitation does not apply to tax years beginning in 1998 through 2007 or tax years beginning in 2009, with respect to marginal production from oil and gas properties.²⁶⁹³ Marginal production is domestic crude oil or do-

²⁶⁵⁸ See Reg. §1.613-4(g)(6)(vii).

²⁶⁵⁹ See Reg. §1.613-4(g)(6)(viii).

²⁶⁶⁰ §613(c)(5); Reg. §1.613-4(g)(1), §1.613-4(g)(2), §1.613-4(g)(3), §1.613-4(g)(4), §1.613-4(g)(5).

²⁶⁶¹ §613(b)(1)(A).

²⁶⁶² *Id.*

²⁶⁶³ §613(b)(1)(B).

²⁶⁶⁴ *Id.*

²⁶⁶⁵ §613A(b)(1).

²⁶⁶⁶ §613(b)(2)(A).

²⁶⁶⁷ §613(b)(2)(B).

²⁶⁶⁸ See §613(e)(2), §613(e)(1)(B).

²⁶⁶⁹ §613(e)(1).

²⁶⁷⁰ §613A(c)(1).

²⁶⁷¹ See §613A(c)(6)(C) (reference to §45K(d)(2)(C)).

²⁶⁷² §613A(c)(6)(C).

²⁶⁷³ §613(b)(3)(A).

²⁶⁷⁴ §613(b)(3)(B).

²⁶⁷⁵ See Reg. §1.613-2(b)(3).

²⁶⁷⁶ *Id.*

²⁶⁷⁷ §613(b)(7).

²⁶⁷⁸ *Id.*

²⁶⁷⁹ §613(b)(7)(A), (B), (C); Reg. §1.613-2(b)(4).

²⁶⁸⁰ §613(b)(7).

²⁶⁸¹ §613(b)(4).

²⁶⁸² §613A(b)(2).

²⁶⁸³ §613(b)(5).

²⁶⁸⁴ §613(b)(6)(A).

²⁶⁸⁵ §613(b)(6)(B).

²⁶⁸⁶ §613(b)(6)(C).

²⁶⁸⁷ §613(b)(7).

²⁶⁸⁸ See Reg. §1.613-2(c)(2).

²⁶⁸⁹ See Reg. §1.613-5(a), §1.613-5(c).

²⁶⁹⁰ §613(a).

²⁶⁹¹ *Id.*

²⁶⁹² §613(a).

²⁶⁹³ §613A(c)(6)(H).

mestic natural gas produced from a property that is a stripper well property or a property from which substantially all of the production is heavy oil.²⁶⁹⁴

Mining expense deductions taken into account in determining taxable income for this purpose must be decreased by an amount equal to so much of any gain that is treated under §1245 as ordinary income and that is properly allocable to the property.²⁶⁹⁵

Percentage depletion with respect to oil and gas for which percentage depletion is allowed under the independent producer exception described in VI.C.4.b.(3), above, is limited to 65% of the taxpayer's taxable income for the tax year,²⁶⁹⁶ computed without regard to percentage depletion,²⁶⁹⁷ the qualified business income deduction,²⁶⁹⁸ net operating loss carrybacks,²⁶⁹⁹ capital loss carrybacks,²⁷⁰⁰ and certain other deductions.²⁷⁰¹ For tax years before 2018, this percentage depletion was also computed without regard to the U.S. domestic production activities deduction under former §199.²⁷⁰² Amounts disallowed under the 65% limitation are treated as a percentage depletion deduction for the succeeding tax year, subject to the 65% limitation applicable to the succeeding tax year.²⁷⁰³

5. Development Expenditures

a. In General

Under §616, development expenditures paid or incurred during the tax year are deductible in computing taxable income if they are paid or incurred after the existence of ores or minerals in commercially marketable quantities has been disclosed.²⁷⁰⁴ Development expenditures are those paid or incurred for the development of a mine or other natural deposit other than an oil or gas well.²⁷⁰⁵

The deductibility of development expenditures is described in VI.C.5.b. through c., below, and is discussed in 601 T.M., *Mineral Properties — Exploration, Acquisition, Development and Disposition*.

b. Exceptions

(1) Expenditures Otherwise Deductible

The §616 deduction does not apply to development expenditures that are deductible under any other provision of the Code.²⁷⁰⁶

²⁶⁹⁴ §613A(c)(6)(D).

²⁶⁹⁵ §613(a). See Reg. §1.613-5(b).

²⁶⁹⁶ §613A(d)(1).

²⁶⁹⁷ §613A(d)(1)(A).

²⁶⁹⁸ §613A(d)(1)(B), as amended by the TCJA, Pub. L. No. 115-97, §11011(d)(4), effective for taxable years beginning after December 31, 2017.

²⁶⁹⁹ §613A(d)(1)(C), as amended by the TCJA, Pub. L. No. 115-97, §11011(d)(4), effective for taxable years beginning after December 31, 2017.

²⁷⁰⁰ §613A(d)(1)(D), as amended by the TCJA, Pub. L. No. 115-97, §11011(d)(4), effective for taxable years beginning after December 31, 2017.

²⁷⁰¹ §613A(d)(1)(E), as amended by the TCJA, Pub. L. No. 115-97, §11011(d)(4), effective for taxable years beginning after December 31, 2017.

²⁷⁰² Pre-2018 §613A(d)(1)(B) (repealed by the TCJA, Pub. L. No. 115-97, §13305(b)(5)).

²⁷⁰³ §613A(d)(1).

²⁷⁰⁴ §616(a).

²⁷⁰⁵ §616(a).

²⁷⁰⁶ Reg. §1.616-1(b)(1).

(2) Depreciable Property

The §616 deduction does not apply to expenditures for the acquisition or improvement of property of a character subject to depreciation deductions under §167.²⁷⁰⁷ However, the depreciation deductions are treated as deductible expenditures for purposes of the §616 deduction.²⁷⁰⁸

(3) Election of Deduction Based on Production

The §616 deduction does not apply if the taxpayer elects to treat the development expenditures as deferred expenses deductible on a ratable basis reflecting the taxpayer's sales of units of produced ores or minerals benefitted by the expenditures.²⁷⁰⁹ In the case of development expenditures paid or incurred during the development stage of the mine or deposit, the election applies only to the excess of development expenditures during the tax year over net receipts during the tax year from the ores or minerals produced from the mine or deposit.²⁷¹⁰ The election applies to all development expenditures with respect to the mine or deposit, except to the extent the preceding sentence applies, and is binding for the tax year.²⁷¹¹

Development expenditures to which the election applies increase adjusted basis in the property when the election is made, and the ratable deductions based on production reduce adjusted basis, but the development expenditures are not included in the basis for computing the §611 depletion deduction.²⁷¹²

(4) Foreign Development Expenditures

The §616 deduction and the election to deduct development expenditures ratably based on production do not apply to development expenditures paid or incurred with respect to the development of a mine or other natural deposit, other than an oil, gas or geothermal well, located outside the United States.²⁷¹³ Instead, the development expenditures are allowed as a deduction ratably over the 10 taxable-year period beginning with the tax year in which the expenditures are paid or incurred.²⁷¹⁴ However, the taxpayer may elect to forego the 10-year amortization and instead include the development expenditures in the basis used for computing the §611 depletion deduction.²⁷¹⁵

c. Alternative Minimum Tax Election

Under §59(e), a taxpayer who is not a corporation may elect to amortize over 10 years the development expenditures that would otherwise be deductible under §616.²⁷¹⁶ If the §59(e) election is made, the amortization deductions are not treated as items of tax preference for purposes of the alternative minimum tax,²⁷¹⁷ whereas the amounts deductible under §616 are

²⁷⁰⁷ §616(a).

²⁷⁰⁸ *Id.*

²⁷⁰⁹ §616(b).

²⁷¹⁰ *Id.*

²⁷¹¹ *Id.*

²⁷¹² §616(c).

²⁷¹³ §616(d)(1).

²⁷¹⁴ §616(d)(2)(B).

²⁷¹⁵ §616(d)(2)(A).

²⁷¹⁶ §59(e)(1), §59(e)(2).

²⁷¹⁷ §59(e)(6).

so treated.²⁷¹⁸ The alternative minimum tax is discussed in 587 T.M., *Noncorporate Alternative Minimum Tax* and 752 T.M., *Corporate Alternative Minimum Tax*.

6. Mining Exploration Expenditures

a. In General

Under §617, the taxpayer may elect to treat mining exploration expenditures paid or incurred during the tax year as deductions.²⁷¹⁹ Mining exploration expenditures are expenditures paid or incurred for the purpose of ascertaining the existence, location, extent or quality of any deposit or ore or other mineral, if they are paid or incurred before the development stage of the mine.²⁷²⁰ The deduction is subject to recapture when the mine reaches producing stages and when the property is sold.²⁷²¹

The deductibility of mining exploration expenditures is described in VI.C.6.b. through c., below, and is discussed in 601 T.M., *Mineral Properties — Exploration, Acquisition, Development and Disposition*.

b. Exceptions

(1) Expenditures Otherwise Deductible

The §617 deduction does not apply to mining exploration expenditures that are deductible without regard to §617.²⁷²²

(2) Depreciable Property

The §617 deduction does not apply to expenditures for the acquisition or improvement of property of a character subject to depreciation deductions under §167.²⁷²³ However, the depreciation deductions are treated as deductible expenditures for purposes of the §617 deduction.²⁷²⁴

(3) Percentage Depletion Qualification

The §617 deduction does not apply to amounts paid or incurred for the purpose of ascertaining the existence, location, extent or quality of any deposit or oil or gas or of any mineral for which percentage depletion deductions are not allowed under §613,²⁷²⁵ as described in VI.C.4.b., above.

(4) Foreign Development Expenditures

The §617 deduction does not apply to mining exploration expenditures paid or incurred before the development stage for the purpose of ascertaining the existence, location, extent or quality of any deposit of ore or other mineral, other than an oil, gas or geothermal well, located outside the United States.²⁷²⁶ Instead, the mining exploration expenditures are allowed as a deduction ratably over the 10 taxable-year period beginning with the tax year in which the expenditures are paid or incurred.²⁷²⁷ However, the taxpayer may elect to forego the 10-year amorti-

zation and instead include the development expenditures in the basis used for computing the §611 depletion deduction.²⁷²⁸

c. Alternative Minimum Tax Election

Under §59(e), a taxpayer who is not a corporation may elect to amortize over 10 years the mining exploration expenditures that would otherwise be deductible under §617.²⁷²⁹ If the §59(e) election is made, the amortization deductions are not treated as items of tax preference for purposes of the alternative minimum tax,²⁷³⁰ whereas the amounts deductible under §617 are so treated.²⁷³¹ The alternative minimum tax is discussed in 587 T.M., *Noncorporate Alternative Minimum Tax* and 752 T.M., *Corporate Alternative Minimum Tax*.

d. Election

(1) Time and Manner

The §617 election is made by deducting mining exploration expenditures on the taxpayer's income tax return for the first tax year to which the election is to apply.²⁷³² The election must be made before the time for filing a claim for credit or refund of tax with respect to the first tax year for which the election is made.²⁷³³ The statutory period for the assessment of any deficiency attributable to the election or its revocation is extended until at least the last day of the two-year period beginning on the day after the date on which the election or revocation is made.²⁷³⁴ The deficiency may be assessed at any time before the expiration of the two-year period.²⁷³⁵

(2) Scope

The §617 election applies to all mining exploration expenditures paid or incurred by the taxpayer during the tax year or any subsequent tax year.²⁷³⁶ The election may not be revoked without the consent of the IRS.²⁷³⁷

7. Reforestation Expenditures

a. In General

Under §194, the taxpayer may elect to deduct the basis of qualified timber property.²⁷³⁸ If the taxpayer further elects, the deduction divided between a year-of-incurrence portion and an amortization portion.²⁷³⁹ The year-of-incurrence portion is allowed for the tax year in which the taxpayer pays or incurs the reforestation expenditures and is limited, with respect to each qualified timber property, to \$10,000, or \$5,000 for married taxpayers filing separate returns.²⁷⁴⁰ The amortization portion consists of the reforestation expenditures not in the year-of-in-

²⁷¹⁸ E.g., §56(b)(2).

²⁷¹⁹ §617(a)(1).

²⁷²⁰ §617(a)(1).

²⁷²¹ See §617(b), §617(c), §617(d).

²⁷²² §617(a)(1).

²⁷²³ §617(a)(1).

²⁷²⁴ *Id.*

²⁷²⁵ §617(a)(1).

²⁷²⁶ §617(h)(1).

²⁷²⁷ §617(h)(2)(B).

²⁷²⁸ §617(h)(2)(A).

²⁷²⁹ §59(e)(1), (2).

²⁷³⁰ §59(e)(6).

²⁷³¹ E.g., §56(b)(2).

²⁷³² §617(a)(2)(A); Reg. §1.617-1(c)(1)(i), §1.617-1(c)(1)(ii).

²⁷³³ §617(b)(2)(B); Reg. §1.617-1(c)(2).

²⁷³⁴ §617(a)(2)(C); Reg. §1.617-1(c)(4).

²⁷³⁵ *Id.*

²⁷³⁶ §617(a)(2)(B).

²⁷³⁷ §617(a)(2)(B).

²⁷³⁸ §194(a), §194(b).

²⁷³⁹ *Id.*

²⁷⁴⁰ §194(b)(1)(B).

currence portion²⁷⁴¹ and is amortized ratably over the 84-month period beginning with the first day of the first month in the second half of the year in which the expenditures are paid or incurred.²⁷⁴² If a deduction is allowed or allowable under §194, no deduction with respect to the expenditures is allowable under any other provision.²⁷⁴³

The deductibility of reforestation expenditures is described in VI.C.7.b. through e., below, and is discussed in 610 T.M., *Timber Transactions*.

b. Qualified Timber Property

Qualified timber property is a woodlot or other site located in the United States which will contain trees in significant commercial quantities and which is held by the taxpayer for planting, cultivating, caring for and cutting of trees for sale or use in the commercial production of timber products.²⁷⁴⁴

c. Reforestation Expenditures

Reforestation expenditures are direct costs incurred in connection with forestation or reforestation by planting or artificial or natural seeding.²⁷⁴⁵ It includes costs for the preparation of the site,²⁷⁴⁶ costs of seeds and seedlings²⁷⁴⁷ and costs for labor and tools, including depreciation of equipment used in planting or seeding, such as tractors, trucks, tree planters and similar machines.²⁷⁴⁸

Reforestation expenditures do not include any expenditures for which the taxpayer has been reimbursed under any governmental reforestation cost sharing program, unless the amounts reimbursed have been included in the taxpayer's gross income.²⁷⁴⁹

d. Limitations

(1) Maximum Dollar Limitation

(a) In General

For each qualified timber property, the amount that may be deducted in the year in which the expenditures are paid or incurred is limited to \$10,000, \$5,000 for married taxpayers filing separate returns²⁷⁵⁰ or \$0 in the case of a trust.²⁷⁵¹

(b) Related Taxpayers

In applying the maximum dollar limitation, all component members of a controlled group are treated as one taxpayer,²⁷⁵² and the dollar amount of the limitation is allocated among the component members of the group in a manner specified in regulations.²⁷⁵³ A controlled group has the meaning assigned to it

under §1563(a) except that the 80% test is replaced by a 50% test.²⁷⁵⁴ Controlled groups are discussed in 754 T.M., *Consolidated Returns — Elections and Filing*.

The maximum dollar limitation applies to partnerships and to each of their partners.²⁷⁵⁵ A similar rule applies to S corporations and their shareholders.²⁷⁵⁶

(2) Trusts and Estates

The \$10,000 deduction for reforestation expenses is allowed for estates but not for trusts.²⁷⁵⁷ For both trusts and estates, the aggregate amount of reforestation expenses must be apportioned between the income beneficiaries and the fiduciary under regulations to be prescribed and any amount apportioned to a beneficiary must be taken into account as an expenditure incurred by the beneficiary.²⁷⁵⁸

(3) Life Tenants and Remainders

If qualified timber property is held by one person for life with remainder to another person, the §194 deduction is computed as though the life tenant were the absolute owner.²⁷⁵⁹ The deduction is allowable to the life tenant.²⁷⁶⁰

e. Amortization Deduction Computation

The amortization portion of the §194(a) deduction is computed by determining the monthly amortization for each month of the 84-month amortization period that is within the tax year.²⁷⁶¹ Monthly amortization is computed by dividing the amortizable basis at the end of the month by the number of months remaining in the 84-month period.²⁷⁶² The amortization at the end of the month is determined without regard to the amortization deduction for that month.²⁷⁶³

8. Tertiary Injectant Expenses

a. In General

Under §193, a taxpayer is allowed to deduct an amount equal to the qualified tertiary injectant expenses of the taxpayer for tertiary injectants injected during the tax year.²⁷⁶⁴ The deductibility of tertiary injectant expenses is described in VI.C.8.c., below, and is discussed in 512 T.M., *Tax Incentives for Production and Conservation of Energy and Natural Resources*.

b. Exceptions

No deduction under §193 is allowed for any expenditure with respect to which the taxpayer has made an election under §263(c).²⁷⁶⁵ The §263(c) election is discussed in 605 T.M., *Oil and Gas Transactions*.

²⁷⁴¹ §194(c)(2).

²⁷⁴² §194(a).

²⁷⁴³ §194(c)(5).

²⁷⁴⁴ §194(c)(1).

²⁷⁴⁵ §194(c)(3)(A).

²⁷⁴⁶ §194(c)(3)(A)(i).

²⁷⁴⁷ §194(c)(3)(A)(ii).

²⁷⁴⁸ §194(c)(3)(A)(iii).

²⁷⁴⁹ §194(c)(3)(B).

²⁷⁵⁰ §194(b)(1)(B).

²⁷⁵¹ §194(b)(1)(B)(iii).

²⁷⁵² §194(b)(2)(A)(i).

²⁷⁵³ §194(b)(2)(A)(ii).

²⁷⁵⁴ See §194(b)(2)(A) (flush language).

²⁷⁵⁵ §194(b)(2)(B).

²⁷⁵⁶ *Id.*

²⁷⁵⁷ §194(b)(1)(B)(iii).

²⁷⁵⁸ §194(c)(4).

²⁷⁵⁹ §194(d).

²⁷⁶⁰ *Id.*

²⁷⁶¹ See §194(a).

²⁷⁶² §194(a).

²⁷⁶³ *Id.*

²⁷⁶⁴ §193(a).

²⁷⁶⁵ §193(c)(1).

No deduction under §193 is allowed for any expenditure for which a deduction is allowed or allowable under any other provision of Chapter 1 of the Code.²⁷⁶⁶

c. Qualified Tertiary Injectant Expenses

(1) In General

Qualified tertiary injectant expenses are any costs paid or incurred, whether or not chargeable to capital account, for any tertiary injectant that is used as part of a tertiary recovery method.²⁷⁶⁷ For a detailed discussion of what constitutes a qualified tertiary injectant expenses, see 605 T.M., *Oil and Gas Transactions*.

(2) Tertiary Recovery Method

A tertiary recovery method is any method described in §212.78(c)(1) through (9) of the June 1979 energy regulations, as defined in §4996(b)(8)(C) as in effect before its repeal,²⁷⁶⁸ and any method to provide tertiary enhanced recovery which is approved by the IRS.²⁷⁶⁹

(3) Recoverable Hydrocarbon Injectant

A qualified tertiary injectant does not include a recoverable hydrocarbon injectant.²⁷⁷⁰ A hydrocarbon injectant includes natural gas, crude oil and any other injectant comprised of more than an insignificant amount of natural gas or crude oil.²⁷⁷¹ A hydrocarbon tertiary injectant does not include any tertiary injectant which is hydrocarbon-based, or a hydrocarbon-derivative, and which is comprised of no more than an insignificant amount of natural gas or crude oil.²⁷⁷² The portion of a hydrocarbon injectant which is not a hydrocarbon is not treated as a hydrocarbon injectant.²⁷⁷³

9. Intangible Drilling and Development Costs

Although intangible drilling and development costs are in the nature of capital expenditures, they are allowed as a deduction to the extent the taxpayer makes an election to deduct them.²⁷⁷⁴ The election to deduct intangible drilling and development costs applies with respect to oil and gas wells and to wells drilled for any geothermal deposit.²⁷⁷⁵

The §263(c) election may not be made with respect to intangible drilling and development costs paid or incurred with respect to oil, gas or geothermal wells located outside the United States.²⁷⁷⁶ This restriction does not apply to costs paid or incurred with respect to nonproductive wells.²⁷⁷⁷

Intangible drilling costs to which the §263(c) election does not apply are allowed as a deduction ratably over the 10 tax year period beginning with the tax year in which the costs are

paid or incurred.²⁷⁷⁸ However, the taxpayer may elect to forego the amortization and to include the costs in adjusted basis for purposes of computing depletion deductions, but percentage depletion is not allowed with respect to these costs.²⁷⁷⁹

The deduction of intangible drilling and development costs is discussed in 605 T.M., *Oil and Gas Transactions*.

10. EPA Sulfur Regulation Compliance Costs

a. In General

Under §179B, taxpayers who are small business refiners are allowed to deduct qualified costs if they elect to do so.²⁷⁸⁰ The deduction equals the qualified capital costs paid or incurred by the taxpayer during the tax year multiplied by the applicable percentage.²⁷⁸¹

Observation: The §179B deduction is in lieu of the capitalization of these costs that otherwise would be applicable.²⁷⁸²

Note: The basis of any property with respect to which a §179B deduction is allowed is reduced by the amount of the deduction.²⁷⁸³ To the extent the deduction reflects costs that would be subject to a depreciation deduction if they were not deducted, the deduction is treated as depreciation for purposes of §1245.²⁷⁸⁴

The §179B deduction is described in VI.C.10.b. through e., below, and is discussed in 512 T.M., *Tax Incentives for Production and Conservation of Energy and Natural Resources*.

b. Small Business Refiners

A taxpayer is a small business refiner for a tax year if the taxpayer satisfies three conditions.²⁷⁸⁵ First, the taxpayer must be a refiner of crude oil.²⁷⁸⁶ Second, the taxpayer must have no more than 1,500 individuals engaged in its refinery operations on any day during the tax year.²⁷⁸⁷ Third, the taxpayer's average daily domestic refinery run or average retained production for all facilities for the one-year period ending on December 31, 2002, must not have exceeded 205,000 barrels.²⁷⁸⁸

c. Qualified Capital Costs

Qualified capital costs are capital costs that otherwise would be chargeable to capital account²⁷⁸⁹ and that are paid or incurred after Dec. 31, 2002, in tax years ending after that date.²⁷⁹⁰ Capital costs with respect to any facility consist of those costs paid or incurred during the applicable period for compliance with the applicable EPA regulations with respect to the facility.²⁷⁹¹ They include expenditures for the construction of new process operation units or the dismantling and recon-

²⁷⁶⁶ §193(c)(2).

²⁷⁶⁷ §193(b)(1).

²⁷⁶⁸ §193(b)(3)(A).

²⁷⁶⁹ §193(b)(3)(B).

²⁷⁷⁰ §193(b)(1).

²⁷⁷¹ §193(b)(2).

²⁷⁷² *Id.*

²⁷⁷³ *Id.*

²⁷⁷⁴ §263(c).

²⁷⁷⁵ §263(c) (reference to §613(e)(2)).

²⁷⁷⁶ §263(i)(1).

²⁷⁷⁷ §263(i) (flush language).

²⁷⁷⁸ §263(i)(2)(B).

²⁷⁷⁹ §263(i)(2)(A).

²⁷⁸⁰ §179B(a).

²⁷⁸¹ §179B(a).

²⁷⁸² §263(a)(1)(I).

²⁷⁸³ §179B(c)(1).

²⁷⁸⁴ §179B(c)(2).

²⁷⁸⁵ §179B(a) (reference to §45H(c)(1)).

²⁷⁸⁶ *Id.*

²⁷⁸⁷ §179B(a) (reference to §45H(c)(1)(A)).

²⁷⁸⁸ §179B(a) (reference to §45H(c)(1)(B)).

²⁷⁸⁹ §179B(a).

²⁷⁹⁰ Pub. L. No. 108-357, §338.

²⁷⁹¹ §179B(a) (reference to §45H(c)(2)).

struction of existing process units to be used in the production of low sulfur diesel fuel, associated adjacent or offsite equipment, including tankage, catalyst, power supply, engineering, construction period interest and site work.²⁷⁹² Low sulfur diesel fuel is diesel fuel with a sulfur content of 15 parts per million or less.²⁷⁹³ The applicable EPA regulations are the Highway Diesel Fuel Sulfur Control Requirements of the EPA.²⁷⁹⁴

Comment: To the extent these costs are incurred for demolition, §280B does not apply to any amounts deducted under 179B.²⁷⁹⁵

The applicable period for a facility is the period beginning January 1, 2003, and ending on the earlier of two dates.²⁷⁹⁶ The first date is the date which is one year after the date on which the taxpayer must comply with the applicable EPA regulations with respect to the facility.²⁷⁹⁷ The second date is December 31, 2009.²⁷⁹⁸

d. Applicable Percentage

Generally, the applicable percentage is 75%.²⁷⁹⁹ However, for small business refiners with average daily domestic refinery runs for the base year in excess of 155,000 barrels, the 75 percentage points are reduced, but not below zero, by the reduction amount.²⁸⁰⁰ The base year is the one-year period ending on December 31, 2002.²⁸⁰¹ The reduction amount equals the number of percentage points obtained by multiplying 75 percentage points by a fraction.²⁸⁰² The numerator of the fraction is the excess of the taxpayer's daily domestic refinery runs for base year over 155,000.²⁸⁰³ The denominator of the fraction is 50,000 barrels.²⁸⁰⁴

e. Cooperative Owners

If the §179B expensing deduction would otherwise be allowable to a §1381 cooperative²⁸⁰⁵ and one or more persons directly holding an ownership interest in that cooperative §1381 cooperatives,²⁸⁰⁶ the cooperative otherwise entitled to the deduction may elect to allocate all or a portion of the deduction to its members who are cooperatives.²⁸⁰⁷ The allocation equals the member cooperative's ratable share of the total amount allocated, determined on the basis of the member's ownership interest in the cooperative making the allocation.²⁸⁰⁸ The taxable income of the cooperative making the allocation is not reduced under §1382 by any amount allocated to a member.²⁸⁰⁹

If any portion of the deduction allocated to member cooperatives, the cooperative making the allocation must provide any member receiving an allocation with written notice of the amount of the allocation.²⁸¹⁰ The notice must be provided before the date on which the timely filed return is due.²⁸¹¹

The election to allocate the deduction to or among member cooperatives for any tax year must be made on a timely filed return for that year.²⁸¹² The election, once made, is irrevocable for that tax year.²⁸¹³

11. Qualified Refinery Property Costs

a. In General

Under §179C, the costs of refinery property are allowed as a deduction to the extent they are qualified refinery costs and the taxpayer makes an election to deduct them, even though otherwise they are generally in the nature of a capital expenditures.²⁸¹⁴ The deduction equals 50% of the cost of qualified refinery property placed in service during the tax year.²⁸¹⁵ The deduction applies to costs of property placed in service after August 8, 2005.²⁸¹⁶

Observation: The §179C deduction is in lieu of the capitalization of these costs that otherwise would be applicable.²⁸¹⁷

The §179C deduction is described in VI.C.11.b. through e., below, and is discussed in 512 T.M., *Tax Incentives for Production and Conservation of Energy and Natural Resources*.

b. Qualified Refinery Property

Qualified refinery property is any portion of a qualified refinery that satisfies six conditions.²⁸¹⁸ First, its original use must begin with the taxpayer.²⁸¹⁹ Second, it must be placed in service by the taxpayer after August 8, 2005, and before January 1, 2014.²⁸²⁰ Third, unless it is separate from an existing refinery, it must meet the production capacity requirements.²⁸²¹ Fourth, it must meet all applicable environmental laws in effect on the date it is placed in service.²⁸²² Fifth, it must not be the subject of a written binding contract for its construction that was in effect before June 15, 2005.²⁸²³ Sixth, it must meet one of three tests.²⁸²⁴ The first test is met if its construction is subject to a written binding construction contract entered into before January 1, 2010.²⁸²⁵ Seventh, it must not be ineligible refinery property.²⁸²⁶ The second test is met if it is placed in service before January 1, 2010.²⁸²⁷ The third test is met if it is self-construct-

²⁷⁹² *Id.*

²⁷⁹³ §179B(a) (reference to §45H(c)(5)).

²⁷⁹⁴ §179B(a) (reference to §45H(c)(3)).

²⁷⁹⁵ §179B(d).

²⁷⁹⁶ §179B(a) (reference to §45H(c)(4)).

²⁷⁹⁷ *Id.*

²⁷⁹⁸ *Id.*

²⁷⁹⁹ §179B(a).

²⁸⁰⁰ §179B(b).

²⁸⁰¹ *Id.*

²⁸⁰² *Id.*

²⁸⁰³ *Id.*

²⁸⁰⁴ *Id.*

²⁸⁰⁵ §179B(e)(1)(A).

²⁸⁰⁶ §179B(e)(1)(B).

²⁸⁰⁷ §179B(e)(1) (flush language).

²⁸⁰⁸ *Id.*

²⁸⁰⁹ §179B(e)(1) (flush language).

²⁸¹⁰ §179B(e)(3).

²⁸¹¹ *Id.*

²⁸¹² §179B(e)(2).

²⁸¹³ *Id.*

²⁸¹⁴ §179C(a).

²⁸¹⁵ *Id.*

²⁸¹⁶ Pub. L. No. 109-58, §1323(c).

²⁸¹⁷ §263(a)(1)(J).

²⁸¹⁸ §179C(c)(1).

²⁸¹⁹ §179C(c)(1)(A).

²⁸²⁰ §179C(c)(1)(B).

²⁸²¹ §179C(c)(1)(C).

²⁸²² §179C(c)(1)(D).

²⁸²³ §179C(c)(1)(E).

²⁸²⁴ §179C(c)(1)(F).

²⁸²⁵ §179C(c)(1)(F)(i).

²⁸²⁶ §179C(f).

²⁸²⁷ §179C(c)(1)(F)(ii).

ed property and its construction begins after June 14, 2005, and before January 1, 2010.²⁸²⁸ A qualified refinery is any refinery located in the United States and designed to serve the primary purpose of processing liquid fuel from crude oil or qualified fuels.²⁸²⁹ For property placed in service after October 3, 2008, a qualified refinery also includes any refinery located in the United States which is designed to serve the primary purpose of processing liquid fuel from directly from shale or tar sands.²⁸³⁰ In determining whether the fourth condition is satisfied, a waiver under the Clean Air Act is not be taken into account.²⁸³¹

For purposes of the first condition, a special rule applies to property originally placed in service after August 8, 2005, by a person,²⁸³² and then sold and leased back by that person within 3 months after the date the property was originally placed in service.²⁸³³ In this situation, the property is treated as originally placed in service no earlier than the date on which it is used under the leaseback.²⁸³⁴

The production capacity requirements are met if the portion of the qualified refinery enables the qualified refinery to achieve either of two production outputs.²⁸³⁵ The first is an increase in total volume output, determined without regard to asphalt or lube oil, by 5% percent or more on an average daily basis.²⁸³⁶ The second is processing of shale, tar sands or qualified fuels²⁸³⁷ at a rate equal to or greater than 25% of the total throughput of the qualified refinery on an average daily basis.²⁸³⁸

c. Deduction Prohibited

No deduction is allowed under §179C for ineligible refinery property.²⁸³⁹ There are two types of ineligible refinery property.²⁸⁴⁰ The first is any qualified refinery property the primary purpose of which is use as a topping plant, asphalt plant, lube oil facility, crude or product terminal or blending facility.²⁸⁴¹ The second is any qualified refinery property built solely to comply with consent decrees or projects mandated by federal, state or local governments.²⁸⁴²

No deduction under §179C is allowed unless the taxpayer files with the IRS a report containing whatever information with respect to the operation of the taxpayer's refineries that the IRS requires.²⁸⁴³

d. Cooperative Owners

If the §179C expensing deduction would otherwise be allowable to a §1381 cooperative²⁸⁴⁴ and one or more persons directly holding an ownership interest in that cooperative are also cooperatives,²⁸⁴⁵ the cooperative otherwise entitled to the deduction may elect to allocate all or a portion of the deduction to its members who are cooperatives.²⁸⁴⁶ The allocation equals the member cooperative's ratable share of the total amount allocated, determined on the basis of the member's ownership interest in the cooperative making the allocation.²⁸⁴⁷ The taxable income of the cooperative making the allocation is not reduced under §1382 by any amount allocated to a member.²⁸⁴⁸

The election to allocate the deduction to or among member cooperatives for any tax year must be made on a timely filed return for that year.²⁸⁴⁹ The election, once made, is irrevocable for that tax year.²⁸⁵⁰

If any portion of the deduction allocated to member cooperatives, the cooperative making the allocation must provide any member receiving an allocation with written notice of the amount of the allocation.²⁸⁵¹ The notice must be provided before the date on which the timely filed return is due.²⁸⁵²

e. Election

The §179C expensing election for any tax year must be made on the taxpayer's tax income return for that year.²⁸⁵³ The election must be made as directed by the IRS in regulations.²⁸⁵⁴ The election is irrevocable unless the IRS consents.²⁸⁵⁵

12. Geological and Geophysical Expenditure Amortization

Under §167(h), the taxpayer is allowed to deduct qualified geological and geophysical expenditures ratably over a 24-month period beginning on the date the expenditures are paid or incurred.²⁸⁵⁶ Qualified geological and geophysical expenditures are geological and geophysical expenses paid or incurred in connection with the exploration for, or development of, oil or gas within the United States,²⁸⁵⁷ and that are paid or incurred in tax years beginning after August 8, 2005.²⁸⁵⁸ No other depreciation or amortization deduction is allowable with respect to qualified geological and geophysical expenditures.²⁸⁵⁹

Any payment paid or incurred during a tax year is treated as having been paid or incurred on the mid-point of that tax

²⁸²⁸ §179C(c)(1)(F)(iii).

²⁸²⁹ §179C(d) (reference to §45K(c), before amendment by Pub. L. No. 110-343, Div. B, §209(b)).

²⁸³⁰ §179C(d).

²⁸³¹ §179C(c)(3).

²⁸³² §179C(c)(2)(A).

²⁸³³ §179C(c)(2)(B).

²⁸³⁴ §179C(c)(2) (flush language).

²⁸³⁵ §179C(e).

²⁸³⁶ §179C(e)(1).

²⁸³⁷ See §45K(c).

²⁸³⁸ §179C(e)(2).

²⁸³⁹ §179C(f).

²⁸⁴⁰ §179C(f).

²⁸⁴¹ §179C(f)(1).

²⁸⁴² §179C(f)(2).

²⁸⁴³ §179C(h).

²⁸⁴⁴ §179C(g)(1)(A).

²⁸⁴⁵ §179C(g)(1)(B).

²⁸⁴⁶ §179C(g)(1)(B).

²⁸⁴⁷ *Id.*

²⁸⁴⁸ *Id.*

²⁸⁴⁹ §179C(g)(2).

²⁸⁵⁰ *Id.*

²⁸⁵¹ §179C(g)(3).

²⁸⁵² *Id.*

²⁸⁵³ §179C(b)(1).

²⁸⁵⁴ *Id.*

²⁸⁵⁵ §179C(b)(2).

²⁸⁵⁶ §167(h)(1).

²⁸⁵⁷ *Id.* (reference to §638).

²⁸⁵⁸ Pub. L. No. 109-58, §1329(c).

²⁸⁵⁹ §167(h)(3).

year.²⁸⁶⁰ If any property with respect to which geological and geophysical expenses are paid or incurred is retired or abandoned during the 24-month period, no deduction is allowable on account of the retirement or abandonment and the amortization deduction continues with respect to the payment.²⁸⁶¹

The §167(h) deduction is discussed in 605 T.M., *Oil and Gas Transactions*.

D. U.S. Domestic Production Activities Deduction

Under former §199,²⁸⁶² taxpayers were permitted to deduct from taxable income (or, in the case of an individual, adjusted gross income) 9% of the lesser of the taxpayer's qualified production activities income for the tax year,²⁸⁶³ or the taxpayer's specified income amount.²⁸⁶⁴ For individuals, the specified income amount was adjusted gross income,²⁸⁶⁵ determined after application of §86, §135, §137, §219, §221, former §222 (expired after 2020) and §469,²⁸⁶⁶ and without regard to former §199.²⁸⁶⁷ For all other taxpayers, the specified income amount was taxable income for the tax year determined without regard to former §199.²⁸⁶⁸

In general, qualified production activities income was equal to domestic production gross receipts reduced by the sum of: (1) the costs of goods sold that were allocable to those receipts; and (2) other expenses, losses, or deductions which were properly allocable to those receipts.²⁸⁶⁹

Domestic production gross receipts consisted of the taxpayer's gross receipts derived from any of the following qualifying activities:²⁸⁷⁰

- Any lease, rental, license, sale, exchange or other disposition of qualifying production property (tangible personal

property, computer software, and sound recordings) which was manufactured, produced, grown or extracted by the taxpayer in whole or in significant part within the United States;²⁸⁷¹

- Any lease, rental, license, sale, exchange or other disposition of any qualified film produced by the taxpayer;²⁸⁷²
- Any lease, rental, license, sale, exchange or other disposition of electricity, natural gas or potable water produced by the taxpayer in the United States;²⁸⁷³
- Construction of real property performed in the United States by a taxpayer in the ordinary course of a construction trade or business;²⁸⁷⁴ and
- Engineering or architectural services performed in the United States by the taxpayer in the ordinary course of that trade or business with respect to the construction of real property in the United States.²⁸⁷⁵

However, domestic production gross receipts did *not* include the sale of food and beverages prepared by the taxpayer at a retail establishment, the transmission or distribution of electricity, natural gas, or potable water, or the lease, rental, license, sale, exchange, or other disposition of land.²⁸⁷⁶

The amount of the domestic production activities deduction for a tax year was limited to 50% of the W-2 wages paid by the taxpayer and properly allocable to domestic production gross receipts during the calendar year that ends in such tax year.²⁸⁷⁷

Special rules were provided with regard to the application to certain entities and the application to certain activities, including oil-related activities and activities in Puerto Rico.

The Former §199 deduction is discussed in detail in 510 T.M., *Section 199: Deductions Relating to Income Attributable to Domestic Production Activities*.

²⁸⁶⁰ §167(h)(2).

²⁸⁶¹ §167(h)(4).

²⁸⁶² Section 199 was repealed by the TCJA, Pub. L. No. 115-97, §13305(a), effective for taxable years beginning after December 31, 2017.

²⁸⁶³ Former §199(a)(1).

²⁸⁶⁴ Former §199(a)(2).

²⁸⁶⁵ Former §199(d)(2).

²⁸⁶⁶ Former §199(d)(2)(A).

²⁸⁶⁷ Former §199(d)(2)(B).

²⁸⁶⁸ Former §199(a)(2).

²⁸⁶⁹ Former §199(c).

²⁸⁷⁰ Former §199(c)(4)(A).

²⁸⁷¹ Former §199(c)(4)(A)(i)(I), Former §199(c)(5).

²⁸⁷² Former §199(c)(4)(A)(i)(II).

²⁸⁷³ Former §199(c)(4)(A)(i)(III).

²⁸⁷⁴ Former §199(c)(4)(A)(ii).

²⁸⁷⁵ Former §199(c)(4)(A)(iii).

²⁸⁷⁶ Former §199(c)(4)(B).

²⁸⁷⁷ Former §199(b)(1) (repealed by the TCJA, Pub. L. No. 115-97, §13305(a)).

TABLE OF WORKSHEETS

CHARTS

Worksheet 1 Table of Key Deductible Trade or Business Expenses.

Worksheet 2 List of §162 Repair Deductions.

ELECTIONS

Worksheet 3 Sample §173 Election to Capitalize Circulation Expenditures.

Worksheet 4 Sample §263(d) Election to Deduct Expenditures for Rehabilitation of Railroad Rolling Stock.

Working Papers for this Portfolio can be found at <https://bloombergtax.com>.

Additional Resources

- IRS Publication 334, *Tax Guide for Small Business*, at 8. Business Expenses.

