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Tax Treatment of Business Expenses

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Introduction

This article discusses a 2020 Tax Court case involving the issue of when an expense should be treated as a start-up expense, trade or business expense, or as an income producing activity expense. This classification is crucial because the tax treatment of deductions is different for each category and therefore, affects taxpayer's calculation of taxable income and tax liability. It is important to observe whether the expenses incurred by a company were before the commencement of business or once it started carrying on business. The purpose of this paper is to discuss these types of expenses by analyzing a 2020 court case and Internal Revenue Code (IRC) sections 162 (trade or business expenses), section 195 (start-up expenditures) and section 212 (income producing activity expenses).

James Gordon Primus v. Commissioner, TC Summary Opinion 2020-2

James G. Primus, a New York accountant, bought a property consisting of 200 acres of maple trees in Quebec, Canada in September 2011. A significant number of the trees were mature and ready to produce maple syrup. Before collecting sap and producing syrup, James G. Primus thinned the maple bush and subsequently installed a pipeline to produce syrup from sap. The production and sale of maple syrup began in 2017.

At the time of acquisition of property in 2011, Primus also decided to produce blueberries. He ordered 2,000 blueberry bushes in 2014 and planted them in 2015. He cleared the area to plant blueberry bushes in 2012 and 2013.

In addition, the property also contained other species of trees, overgrown pastures, hay fields, and had twelve acres suitable for growing crops. There were also various other improvements on the property such as main house, two apartments, a garage, a barn, and a building with a pool and a gymnasium.

Primus reported a substantial amount of farming related expenses in 2012 and 2013, with most of the expenses attributable to the cost of repairs to various improvements on the property. He argued that these expenses incurred to produce and sell maple syrup and blueberries fell under IRC section 162 as expenses of a trade or business, or section 212 as expenses of an income producing activity. The IRS argued though that these expenses fell under section 195 as start-up expenditures denied the deductions, asserting that they were non-deductible start-up expenses because Primus had not yet commenced his business. Primus had not yet collected any sap, installed any infrastructure needed to convert sap into syrup, or bought any blueberry bushes. Subsequently, the U.S. Tax Court upheld the IRS's position. The court held that the expenses were not deductible as trade or business expenses until the business started functioning, at which time Primus could start amortizing them as allowed by section 195.

Section 162 Trade or Business Expenses

Deductible expenditures generally originate from a profit motivated activity. Section 162 provides all taxpayers with a deduction for their business expenses.[1] The IRC and the Treasury Regulations do not provide a precise definition of what constitutes a trade or business. Case law, however, does provide some guidelines. It states that those expenses incurred after a business had progressed beyond the start-up phase can be considered as trade or business expenses and are deductible. In *James C. Powell. v. Commissioner,*[2] the expenses in 2008 and 2009 related to starting a new brewery under Schedule C of Form 1040 were denied because the taxpayer failed to show that he actually began the business operating activities in 2008 and 2009. Section 162 permits a taxpayer to deduct ordinary and necessary expenses paid or incurred during the taxable year in carrying on a trade or business. A taxpayer is not carrying on a trade or business under section 162(a) until the business is functioning as a going concern and performing the activities for which it was organized. Going back to the *Primus* case, since the business had not begun operating in 2012 or 2013, the expenses claimed were rightfully not treated as trade or business expenses and therefore, were not deductible.

Section 212 Expenses for Production of Income

Section 212 provides for individuals to deduct expenses they incur for the production, or collection of income, or for the maintenance and conservation of income producing property (an investment activity). Thus, the requirement of an activity being profit motivated has two aspects: (1) a determination of whether an expenditure originates from an activity engaged in for profit (section 162), and (2) for individuals, a distinction between a trade or business and an investment activity (section 212). A tax advisor must examine all the facts and circumstances surrounding the activity in which the taxpayer incurs expenses in order to make this distinction.

It can sometimes be difficult to classify expenses as falling under section 162 or section 212 . For example, consider an individual who owns and rents out a home to a long-term tenant who handles the care and maintenance. Is this a trade or business activity with deductions allowed under section 162 and perhaps also section 199A that allows a deduction for qualified business income? Or is it an investment activity with deductions allowed under section 212 and no section 199A deduction?

Another distinction between section 162 and section 212 activities is where an individual realizes a loss on the sale of an asset. If the individual used that asset in a business, the individual likely has an ordinary loss under section 1231.[3] In contrast, if the taxpayer realizes a loss on the sale of an investment asset, the loss is treated as capital loss which receives less favorable tax treatment.

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[1] IRC section 162 provides, “There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business.”

[2] *James C. Powell. v. Commissioner,* T.C. Summary Opinion 2014-235. The *Powell* case was not addressed in *Primus* case.

[3] Under section 1231, the exact treatment depends on the total gains and losses from such property for the year.

In order to deduct a business or investment expense, it must also be considered "ordinary". Although neither section 162 nor 212 provide a definition or application of this requirement, the Treasury Regulations under section 212 [4] indicate that for an expense to be ordinary, it must be reasonable in amount and it must bear a reasonable and close relationship to the income-producing activity or property. Also, case law has held that for an expense to be ordinary, it must be customary or usual in the context of the industry or business community.[5] In addition to being ordinary, a deductible investment or business expense must also be "necessary". The Supreme Court has indicated that an expense is considered necessary if it is "-appropriate and helpful-" in the taxpayer's business.[6] Clearly in the *Primus* case, it is not immediately obvious that the expenses for property improvement, for example, can be considered either ordinary or necessary and thereby might not be deductible, but might instead be capitalizable.

Section 195 Start-up Expenditures

According to section 195, start-up expenditures are ordinary and necessary business expenses paid or incurred by an individual or corporate taxpayer for the creation or acquisition of an active trade or business, or to conduct an activity engaged in for profit or the production of income before the time the activity becomes an active trade or business. Under this section, a taxpayer may elect to deduct the first $5,000 of such qualified start-up expenditures. However, this amount is reduced (but not below zero) by the amount by which the cumulative start-up expenditures exceed $50,000. The taxpayer can amortize the remaining start-up expenditures over a 180-month period beginning in the month business begins.[7] In the *Primus* case, the court concluded that the expenditures were start-up expenditures under section 195, but it is not deductible until the year the business activity begins.

Conclusion

The *Primus* case serves as a reminder of the importance of properly classifying various types of expenses that are related to business or investment activities for tax purposes. A taxpayer can claim business expenses as deductions only after the business has commenced. Prior to that point, the taxpayer should track its start-up expenditures per section 195 so that it can start amortizing them once the business begins.

It is also crucial for a taxpayer to maintain books and records that substantiate income, expenses, and credits to claim in measuring income tax liability. The taxpayer should ensure that expenses are ordinary and necessary in carrying a trade or business under sections 162. To

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[4] Per Reg. 1.212-1(d), to be deductible under section 212, an expense must be "ordinary and necessary" meaning that such expense "must be reasonable in amount and must 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."

[5] *Cavanaugh, Jr. v. Commissioner,* 123 AFTR 2d 1279 (2019), Code Sec(s) 162.

[6] *Welch v. Helvering, 290 U.S. 111 (1933)*, *Haas & Associates Accountancy Corp. v. Commissioner*, 117 T.C. 48 (2001), Affd. 55 Fed. Appx. 476 (9th Cir. 2003).

[7] Reg. 1.195-1(a).

qualify as a start-up expenditure under section 195, the taxpayer must prove that expenses of creating an active business are incurred after a particular business is acquired or established but before the business actually begins operations. In summary, for individuals with for profit business entities, it is important for the taxpayers to understand when business related expenses are deductible to accurately file the tax returns and avoid claiming deductions in the wrong year or overlooking deductions.