

The Contemporary Tax Journal

Volume 11
Issue 2 *The Contemporary Tax Journal Volume
11, No. 2 – Summer 2022*

Article 4

8-18-2022

When Does a Trade or Business Begin?

Jakub Hench
San Jose State University

Follow this and additional works at: <https://scholarworks.sjsu.edu/sjsumstjournal>



Part of the [Taxation-Federal Commons](#)

Recommended Citation

Hench, Jakub (2022) "When Does a Trade or Business Begin?," *The Contemporary Tax Journal*: Vol. 11 :
Iss. 2 , Article 4.
<https://doi.org/10.31979/2381-3679.2022.110204> [https://scholarworks.sjsu.edu/sjsumstjournal/vol11/
iss2/4](https://scholarworks.sjsu.edu/sjsumstjournal/vol11/iss2/4)

This Tax Enlightenment is brought to you for free and open access by the Lucas Graduate School of Business at SJSU ScholarWorks. It has been accepted for inclusion in The Contemporary Tax Journal by an authorized editor of SJSU ScholarWorks. For more information, please contact scholarworks@sjsu.edu.

When Does a Trade or Business Begin?

By: Jakub Hench, MST Student

Estate of Charles P. Morgan, et ux. v. Commissioner, TC Memo 2021 – 104

Estate of Charles P. Morgan, et ux. v. Commissioner, TC Memo 2021-104, affirmed the position of the IRS that a former real estate developer and his wife were not entitled to Schedule C deductions of \$819,956, Schedule E deductions of \$648,118, and a Net Operating Loss (NOL) deduction of \$966,121 for the 2012 tax year because the taxpayers were not engaged in an active trade or business.

Who are these mysterious taxpayers?

The taxpayers involved in claiming and deducting these Schedule C, Schedule E, and NOL deductions were Charles P. Morgan and his wife, Roxanna L. Morgan. However, it was Charles P. Morgan who engaged in the particular activities leading to the claimed deductions. Roxanna L. Morgan was appointed to be the personal representative of Charles P. Morgan's estate after his death in April 2019.

Mr. Morgan was a successful, well-educated, and experienced real estate developer who earned an MBA in 1969 and worked at different real estate firms until 1983, when he founded his own home building company. This company came to consist of various firms, referred to here as the Morgan Entities, that he owned directly or indirectly while being involved in their operations and management. Mr. Morgan ran the Morgan Entities until 2009, when he was ordered by the Indiana Superior Court to relinquish control, owing to default and unpaid debts of \$75 million due to the decline of the real estate and financial markets. LS Associates, LLC was appointed as the receiver for the Morgan Entities to manage and liquidate the assets of the Morgan Entities, which was completed in 2013.

After handing over control of the Morgan Entities to the receivership of LS Associates, LLC, in 2009, Mr. Morgan spent six months relaxing with his family. However, being determined to stay busy, Mr. Morgan personally expressed interest in “acquiring a company . . . or starting another company probably in the real estate building field, but approaching it differently than I did in my first career.”¹ Mr. Morgan thus conducted research for trades or businesses to acquire between 2010 and 2012 in various real estate fields, using two firms that he had previously created, named Legacy and Falcon. In the end, despite employing 100 percent of his research time at Legacy as “business search/forward looking” and at Falcon engaging in “consulting” services², Mr. Morgan was unable to find or acquire a new trade or business.

What are Legacy and Falcon?

¹ *Estate of Charles P. Morgan, et ux. v. Commissioner*, TC Memo 2021-104

² *Estate of Charles P. Morgan, et ux. v. Commissioner*, TC Memo 2021-104

Legacy was a single-member LLC founded by Mr. Morgan in December 2008 and used by him in his trade/business search between 2010 and 2012. It employed many former employees from the Morgan Entities, along with outside consultants to assist Mr. Morgan in his business search. While Mr. Morgan investigated a variety of industries, he did not find a trade or business by 2012. The firm was taxed as a disregarded entity, defined as any domestic entity “disregarded as an entity separate from its owner if it has a single owner,”³ between 2010 and 2012.

Falcon was an aircraft management and maintenance firm founded by Mr. Morgan in 1996, and used by him between 1996 and 2009 when managing the Morgan Entities, and between 2010 and 2012 while doing his business search. Falcon was first taxed as a partnership in 2010 and 2011, but later taxed as a disregarded entity in 2012 when Mr. Morgan became the firm’s sole owner. Falcon did not provide any services or lease any aircraft to any unrelated third parties; it only provided aircraft and services to Mr. Morgan and any related parties in his business search.

Did Mr. Morgan have any other industry involvement?

Mr. Morgan also maintained indirect contact with the real estate development industry. However, his only actual involvement in the industry since the receivership of the Morgan Entities occurred when he provided a \$180,000 loan in 2009 to Pyatt Builders for help in acquiring property for home development. Mr. Pyatt, the owner of Pyatt Builders, was a former employee of the Morgan Entities and a close friend of Mr. Morgan. The loan was repaid to Mr. Morgan timely and with interest in 2010.

How did Mr. Morgan file his tax return?

Mr. Morgan filed a joint Form 1040 tax return in 2012, which was prepared by his certified public accountant of over three decades, Roy Rice, and the Somerset CPAs accounting firm. Mr. Morgan filed a Schedule C with a loss of \$303,302 for Falcon, incurred from gross income of \$516,654 and expenses of \$819,956, and he filed a Schedule E with a loss of \$648,118 for Legacy, reporting \$0 of gross receipts and \$648,118 of expenses. Mr. Morgan also claimed a NOL deduction of \$966,121, accrued from NOL carryforwards of aircraft and business-search expenses from the 2010 and 2011 tax years.

Why did the IRS believe that Mr. Morgan was not entitled to deduct the Schedule E and Schedule C deductions or the NOL deduction?

The IRS disallowed the \$819,956 Schedule C deduction for Falcon, the \$648,118 Schedule E deduction for Legacy, and the \$966,121 NOL deduction on the grounds that Mr. Morgan was not engaged in a trade or business. They claimed that Mr. Morgan’s business had ended in 2009 when he handed control of the Morgan Entities to LS Associates, LLC, for receivership, and that

³ Reg. 301.7701-3(b)(1)(ii)

the expenses were either non-deductible personal expenses⁴ or startup expenses, which are not deductible until the taxpayer begins engaging in a trade or business.⁵

What was Mr. Morgan's position in the case?

In response, Mr. Morgan went to the Tax Court and laid out his case that his original business with the Morgan Entities had not ended due to his continued engagement with the homebuilding industry. These engagements include his collaboration with Legacy and Falcon in his trade/business search and his \$180,000 loan to Pyatt Builders. Mr. Morgan also argued that his search for a new trade or business was itself a trade or business as it involved using Legacy and Falcon to explore various business opportunities, with Legacy hiring former Morgan Entities' employees and outside consultants to help Mr. Morgan with his endeavor.

What was the opinion of the Tax Court?

The Tax Court recognized that to determine Mr. Morgan's eligibility for the deductions on Legacy's Schedule E, Falcon's Schedule C, and the NOL deduction, it must first determine whether Mr. Morgan was actually engaged in a trade or business between 2010 and 2012 per IRC Sec. 162 through "an examination of the facts in each case."⁶

IRC Sec. 162 allows a "deduction [of] all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business" by identifying if (1) the taxpayer had engaged in a business or activity for profit motives, (2) there was any regular and active involvement in the business by the taxpayer, and (3) the trade or business was actually launched.

Any taxpayer to whom IRC Sec. 162 does not apply must comply with IRC Sec. 195, which defines that "no deduction shall be allowed for start-up expenditures." Start-up expenditures are any expenses "(A) paid or incurred in connection with - (i) investigating the creation or acquisition of an active trade or business, or (ii) creating an active trade or business, or (iii) any activity engaged in for profit and for the production of income before the day on which the active trade or business begins, in anticipation of such activity becoming an active trade or business, and (B) which, if paid or incurred in connection with the operation of an existing active trade or business."⁷ Start-up expenditures can only be deducted once a taxpayer declares an intention of whether they will engage in a trade or business, which specific trade or business they will enter, and if they are engaging in any relevant activities to that trade or business.

⁴ Section 262(a)

⁵ Section 195.

⁶ *Commissioner v. Groetzinger*, 480 US 23 (1987).

⁷ Section 195(c)(1).

What was the final judgment on Mr. Morgan’s claim of continuous involvement in the homebuilding industry being a qualified trade or business?

The Tax Court concluded that Mr. Morgan’s original trade or business ceased to exist in 2009 upon the Morgan Entities being given up for receivership to LS Associates, LLC, when he laid off employees of the Morgan Entities, and no longer engaged in any homebuilding activities. If Mr. Morgan had continuously and regularly operated with the Morgan Entities, then the entities would have been classified as an ongoing trade or business. In contrast, Mr. Morgan spent six months relaxing while assessing, in his own words, his interest in engaging in another trade or business after the Morgan Entities went into receivership. Even then, Mr. Morgan was uncertain about which type of trade or business he wanted to enter and often expressed a lack of interest in continuing in the same type of business as the Morgan Entities. He wanted to look into other angles of the homebuilding industry. Hence, as Mr. Morgan did not answer the “whether” or “what” question required under IRC Sec. 195, the Tax Court determined that Mr. Morgan was not continuously engaged in his original trade or business with the Morgan Entities.

The Tax Court also identified the \$180,000 loan made by Mr. Morgan to Mr. Pyatt as a one-time loan to a friend or trusted individual, and not part of a regular and continuous trade or business.

What was the final judgment on Mr. Morgan’s claim of general search for a new trade or business itself being a qualified trade or business?

The Tax Court concluded that Mr. Morgan’s general trade/business search does not qualify as a trade or business itself per IRC Sec. 162. Mr. Morgan had only incurred expenses for Legacy in researching various firms in different industries with the expectation of finding a trade or business, as is shown on the Legacy time sheets that he filed which were marked “100 percent Business Investigation/Looking Forward”. These expenses are more like startup expenditures per IRC Sec. 195, which include expenses “(A) paid or incurred in connection with - (i) investigating the creation or acquisition of an active trade or business.”⁸ As Mr. Morgan did not answer “whether” and “which” type of business he was going to enter by the end of 2012 and he did not have a profit motive with his trade/business search, Mr. Morgan did not engage in a trade or business.

The Tax Court also concluded that Falcon was not engaged in a separate trade or business in consulting, since it provided the same transportation services to Mr. Morgan and any related individuals during the new trade/business search as when Mr. Morgan operated the Morgan Entities. Falcon did not lease any of its airplanes to any unrelated third parties. Hence, Falcon

⁸ Section 195(c)(1)(A)(i).

was not independent of Mr. Morgan or Legacy as it only incurred gross receipts and expenses from them and not in a separate trade or business during the trade/business search.

Conclusion

A trade or business exists after a taxpayer declares “whether” and “which” trade or business they intend to establish, they engage in relevant and regular activities for the trade or business, establish a profit motive for their trade or business, and the trade or business itself is continuous and regular. A trade or business does not legally exist when a taxpayer is simply conducting research into different trades or businesses. A trade or business only exists when taxpayers meet the necessary requirements to show that they are starting or continuing a trade or business. Hence, it is important for taxpayers to pay attention to all the facts surrounding their situation when filing tax returns in order to determine whether are actually engaging in a trade or business and can deduct any business-related expenses.