TRADE OR BUSINESS

4

Learning Objectives

After completing this session, participants will be able to perform the following job-related actions:

- ✔ Understand the differences in the definition of trade or business among various provisions in the Internal Revenue Code
- ✔ Apply the proper definition of trade or business to the tax provisions that use that term
- ✔ Apply the not-for-profit rules of I.R.C. § 183
- ✔ Calculate a taxpayer's self-employment income
- ✔ Explain the effect of a tax home on a taxpayer's deduction of travel expenses
- ✔ Claim start-up expenses on a taxpayer's income tax return
- ✔ Apply the tax rules for trades or businesses to new business models such as selling goods or services on the Internet

Introduction

This chapter updates the *2004*, *2006*, and *2014 National Income Tax Workbooks* chapters on "Trade or Business."

This chapter is motivated by new business models in the online and "sharing" economy. Independent sellers using eBay, Amazon, and other online platforms; the popularity of flea markets and antique and peddler malls; and services such as Uber, Lyft, and Airbnb raise issues including

- the consequences of there being no trade or business,
- SE tax issues under I.R.C. §§ 1402 and 162,
- deducting trade or business travel expenses, and
- acceptance of cryptocurrencies such as Bitcoin.

The "Trade or Business References" section at the end of this chapter lists the many sections of the Internal Revenue Code that provide benefits

for or impose limitations on a trade or business activity, but there is no one all-encompassing statutory explanation of the term *trade or business.* Common law developed by the courts provides the definition in a piecemeal fashion.

DEFINITION OF A TRADE OR BUSINESS No one definition of the term *trade or business* applies to all tax law provisions.

Neither the Internal Revenue Code nor the regulations attempt a general definition of *trade or business.* Many Internal Revenue Code and Treasury regulations sections state that "for the purpose of this section, trade or business has the same meaning as described in section 162, trade or business expenses." This would be convenient if I.R.C. § 162 contained a definition of trade or business, but it does not.

As a result, practitioners must look to IRS rulings and to case law. Determinations of whether business expenses are deductible have often begun with determining whether a trade or business even exists. Although the determination is essentially a facts and circumstances test (which gives rise to inconsistent results), some factors apply across the board. A trade or business exists only if the taxpayer has a profit motive and, for some provisions, a degree of involvement in the activity. Individuals who have a trade or business generally report income and expenses on Schedule C (Form 1040), Profit or Loss From Business (Sole Proprietorship), or Schedule F (Form 1040), Profit or Loss From Farming, for individual taxpayers.

Factors Indicating There Is a Trade or Business

Because facts and circumstances determine whether or not there is a trade or business, this section reviews cases that illustrate how the courts determine whether or not a trade or business exists. It also explains the rules under I.R.C. § 183 that limit the deduction of expenses for an activity that is not engaged in for profit.

Court Decisions

In *Flint v. Stone Tracy Co.*, 220 U.S. 107 (1911), the Supreme Court affirmed that a management corporation was engaged in business for purposes of a federal excise tax imposed on the profits of business corporations. The opinion states, "We think it is clear that corporations organized for the purpose of doing business, and actually engaged in such activities as leasing property, collecting rents, managing office buildings, making investments of profits, or leasing ore lands and collecting royalties, managing wharves, dividing profits, and in some cases investing the surplus, are engaged in business within the meaning of this statute."

In a more recent case, the Supreme Court held that a full-time gambler was engaged in a trade or business for purposes of deducting business expenses from AGI. In reaching this decision, the Court held that offering goods or services to the public is not an absolute prerequisite to qualifying an activity as a trade or business. It noted that when a taxpayer "devotes his full-time activity to gambling, and it is his intended livelihood source . . . basic concepts of fairness . . . demand that his activity be regarded as a trade or business" [*Commissioner v. Groetzinger*, 480 U.S. 23 (1987)].

In *Groetzinger* the Supreme Court also distinguished a trade or business from investment activities:

> Of course, not every income-producing and profit-making endeavor constitutes a trade or business. The income tax law, almost from the beginning, has distinguished between a business or trade, on the one hand, and "transactions entered into for profit but not connected with . . . business or trade," on the other. See Revenue Act of 1916 . . . We accept the fact that to be engaged in a trade or business,

the taxpayer must be involved in the activity with continuity and regularity and that the taxpayer's primary purpose for engaging in the activity must be for income or profit. A sporadic activity, a hobby, or an amusement diversion does not qualify.

Investment Activity Distinguished

Continuity of an activity is only one factor that distinguishes trade or business activities from investment activities. The type of economic activity or involvement of the taxpayer in the enterprise was the focus of two earlier US Supreme Court cases that drew a line between business activity and production of income.

In *Higgins v. Commissioner*, 312 U.S. 212 (1941), the court concluded that even when extensive time is devoted to oversight of a personal investment portfolio, the activity is not carrying on a trade or business. Although an activity may be disqualified as a business because it is conducted sporadically, the "extent, continuity, variety and regularity" of an activity is not by itself a sufficient reason for treating the activity as a business. "No amount of personal investment management would turn those activities into a business," the court held. The taxpayer could not deduct as business expenses the portion of his employees' salaries and other expenses related to management of his stocks and bonds.

The court followed its own *Higgins* decision a few months later in a case dealing with deduction of trustee fees, *City Bank Farmers Trust Co. v. Helvering (Commissioner)*, 313 U.S. 121 (1941). The trustee of two testamentary trusts was held not to be carrying on a business when "the trustee [was] limited in its investments and cautioned in effect to be a safe investor rather than a participant in trade or business." The court also noted that the trust incurred "no expenses of conducting business other than the collection of coupons and mailing bonds" and a "negligible amount for transfer stamps or notary fees."

Temporary Hiatus

When an activity has been established as a business, expenses incurred during a temporary hiatus may still be deductible in the year they are paid or incurred. Facts and circumstances were considered in the three Tax Court cases discussed next.

When expenses are incurred during a tax year in preparation for the resumption of a trade or business at some indefinite future date, they *are not* attributable to a trade or business currently carried on by the taxpayer and therefore are not deductible. A lawyer who maintained an inactive private law office in another state while performing services only as a federal government employee could not deduct the law office expenses. The Tax Court held that he was "attempting to maintain an asset from which his future income would be derived" and that maintaining "a foundation for the future" does not constitute carrying on a trade or business [*Owen v. Commissioner*, 23 T.C. 377 (1954)].

But the temporary cessation of a trade or business does not preclude a finding that a taxpayer was carrying on a trade or business during that hiatus. In *Haft v. Commissioner*, 40 T.C. 2 (1963), a long-time costume jewelry salesman continued to contact and entertain buyers during a period when he didn't have a relationship with a manufacturer. However, he was actively seeking another position that would allow him to continue to service the same customers. The Tax Court distinguished Haft's position from *Owen* and held that he didn't cease to be in a trade or business merely because he temporarily had no merchandise to sell during a reasonable period of transition. It compared him to a worker who is temporarily unemployed and continues to pay union dues while looking for another job.

Whether the absence from the trade or business is temporary or indefinite is significant, the Tax Court held in *Schnelton v. Commissioner*, T.C. Memo. 1993-264. Before rejecting a home office deduction on more specific grounds, the court noted that "a taxpayer may be entitled to claim business deductions for carrying on a trade or business even though unemployed at the time the expenditures are incurred. An important factor in determining whether a taxpayer is still in a trade or business during a period of unemployment is whether the taxpayer's absence from the trade or business is temporary or indefinite."

Practitioner Note Previously Incurred Expenses

When a cash basis sole proprietor goes out of business, previously incurred expenses are still deductible in the year they are paid. "Ordinary and necessary expenses, incurred in a trade or business in prior years and paid in the current taxable year, by an individual taxpayer, using the cash receipts and disbursements method of accounting, are deductible under I.R.C. § 162, even though the business has been discontinued" [Rev. Rul. 67-12, 1967-1 C.B. 29]. Taxpayers should file a Schedule C (Form 1040), Profit or Loss From Business (Sole Proprietorship), to deduct the expenses, even without income.

Example 4.1 Part-Time Enterprise

Joe Bob Handy lives with his wife, Mary Ellen, in Oklahoma City and worked for an oil field service company until he was laid off in 2013. He has worked part-time repair and construction jobs in the past. Mary Ellen teaches at the local school.

In 2014 Joe Bob paid $25,000 for a house at a sheriff's sale. Because he has experience and skills in construction, he believed he could rehabilitate the house and sell it at a profit. He spent $14,500 on supplies and materials, completed the work, and sold the rehabilitated home in November for $45,000. In December Joe Bob accepted a full-time job at a company that builds gas and oil pipelines, and he does not intend to rehabilitate any more houses.

Question 1.
In 2014 did Joe Bob's activity constitute a trade or business of rehabilitating houses for purposes of the SE tax?

Answer 1.
Determination of a trade or business is based on all the facts and circumstances. Because Joe Bob rehabilitated only one house and does not intend to rehabilitate any more, it is likely that the IRS would not consider this activity a trade or business. In *Batok v. Commissioner*, T.C. Memo. 1992-727, a retiree's income earned from installing windows for 1 month was not subject to self-employment tax because the activity was not continuous and regular, and thus did not constitute a trade or business.

Question 2.
Where should Joe Bob report the income and expenses on the sale of his rehabilitated house?

Answer 2.
Income and expenses should be reported on Form 8949, Sales and Other Dispositions of Capital Assets, Part I, Short-Term, line 1. The $45,000 sale price should be reported on line 1 in column (d), Proceeds. The $14,500 of expenses should be included with the $25,000 purchase cost and reported on line 1 in column (e), Cost or Other Basis. Box (C) above line 1 should be checked.

Sole or Principal Business

Numerous cases establish that it is not necessary that activities constitute the taxpayer's sole or principal trade or business to qualify as a trade or business. "The fact that petitioner had other full time employment does not prevent him from being in the real estate business," the court stated in *Achong v. Commissioner*, 246 F.2d 445 (9th Cir. 1957).

"Any trade or business" means that a taxpayer may carry on more than one trade or business at the same time. "It is not material that the petitioner had other or larger business interests in which he was engaged. The statute is not so restricted as to confine deductions to a single business or principal business of the taxpayer," the BTA explained in *Alverson v. Commissioner*, 35 B.T.A. 482 (1937), acq. 1937-1 C.B. 1.

Even a full-time government employee may have another trade or business, the Tax Court held in *Schott v. Commissioner*, T.C. Memo. 1964-272. In determining that the taxpayer was engaged in the trade or business of being a real estate broker within the meaning of I.R.C. § 162 (in a year when he had no income from real estate sales), the court noted that he held a real estate license, produced at the trial a "listing book" of properties he was attempting to sell, and had given the federal agency employing him a statement that he intended to practice as a real estate broker.

Practitioner Note Separate Business Reporting

A taxpayer with more than one business must report income and expenses separately for each trade or business. Sole proprietors file a Schedule C or F (Form 1040) for each separate business.

Not-for-Profit Activities

A taxpayer must engage in an activity primarily for profit to deduct expenses under I.R.C. § 162 or 212.

Background

For tax years before 1970, taxpayers could deduct claimed business losses of up to $50,000 a year under the "hobby loss" rules of I.R.C. § 270. Losses were disallowed only to the extent they exceeded $50,000 per year in 5 consecutive years, and some deductions (including interest and taxes) weren't even considered in determining whether a loss exceeded $50,000.

The Tax Reform Act of 1969 repealed that provision and replaced it with I.R.C. § 183, which generally denies business deductions for expenses attributable to an activity that "is not engaged in for profit." The 1969 legislation established a presumption (as an objective standard) that an activity is engaged in with a profit motive if the gross income exceeds the related deductions for 2 years in a 5-year period. (This standard was changed to 3 of 5 years by the Tax Reform Act of 1986.) Horse activities (breeding, training, showing, or racing) meet the presumption if they show a profit in 2 of 7 years.

Congress enacted I.R.C. § 183 to distinguish trade or business activities from personal activities, such as hobbies, and prevent taxpayers from deducting expenses incurred for their hobbies from other income.

Cross-Reference Rulings and Cases

See the "Rulings and Cases" chapter in this book for cases that apply the I.R.C. § 183 limitations.

Determining that an activity is not conducted primarily for profit has three important consequences:

1. The gross income from the activity (without any reduction for expenses) is reported on line 21 of Form 1040, U.S. Individual Income Tax Return, as other income, but it is not self-employment (SE) income for SE tax purposes.
2. If the expenses associated with the activity exceed the income from the activity, the loss is not deductible. There is no carryover of unused expenses.
3. The allowable expenses (those limited to the amount of income) are deductible only on Schedule A (Form 1040), Itemized Deductions, and many of the expenses are miscellaneous itemized deductions subject to the 2%-of-AGI floor. The allowable expenses cannot be deducted for purposes of the alternative minimum tax.

Profit Motive Factors

Treas. Reg. § 1.183-2(b) lists nine nonexclusive factors that determine whether an activity is engaged in for profit. All facts and circumstances must be taken into account and no one factor is determinative. Other information can be considered and the factors are not necessarily equally weighted, so that the determination is not based on whether the number of factors (whether or not the factors are included in the list) indicating that a lack of profit objective exceeds the number of factors indicating a profit objective, or vice versa. Treas. Reg. § 1.183-2(a) states in part that "Greater weight is given to objective facts than to the taxpayer's mere statement of his intent." In other words, actions speak louder than words. The factors are as follows:

1. The manner in which the taxpayer carries on the activity
2. The expertise of the taxpayer or his or her advisers
3. The time and effort the taxpayer spent in carrying on the activity
4. The expectation that assets used in the activity may appreciate in value
5. The success of the taxpayer in carrying on other similar or dissimilar activities

6. The taxpayer's history of income or losses with respect to the activity
7. The amount of occasional profits, if any, that are earned
8. The financial status of the taxpayer (i.e., dependence on income from the activity)
9. Elements of personal pleasure or recreation

Practitioner Note Profit Objective Must Be Bona Fide

A taxpayer must demonstrate an actual and honest objective of making a profit. The expectation does not have to be reasonable, but the profit motive must be bona fide. It may be sufficient that there is a small chance of making a large profit [Treas. Reg. § 1.183-2(a)].The term *profit* means an economic profit independent of tax savings [*Beck v. Commissioner*, 85 T.C. 557 (1985)].

Presumption of Profit

I.R.C. § 183(d) provides a presumption that an activity is being conducted with a profit motive for a tax year if the taxpayer realizes a profit in 3 or more years of the 5 consecutive years ending with the current tax year. If the activity is primarily breeding, showing, training, or racing horses, it must be profitable in at least 2 of the 7 years ending with the current tax year.

If the taxpayer meets the presumption conditions, the IRS has the burden of proof if it challenges whether the activity is truly being conducted with a profit motive. (The presumption can be overcome using the factors in Treas. Reg. § 1.183-2.)

Example 4.2 Hobby Activity Determination

As a child Lois Weatherbee always wanted a horse. She is now a successful businesswoman who owns her own marketing company. Six years ago she bought a ranch in Texas and began buying horses to train for hippotherapy (therapeutic riding for the disabled). She employs people to care for and train the horses, and she goes to the ranch and rides the horses every chance she gets.

Practitioner Note For-Profit Presumption Applies Both Ways

When a taxpayer regularly makes a profit from an activity that the taxpayer considers to be a hobby or avocation, the IRS may determine that the activity is actually self-employment. To be engaged in a trade or business, an individual taxpayer must be involved in the activity with continuity, regularity, and the primary purpose of deriving a profit.

In *Lederer v. Cadwalader*, 274 F.753 (3d Cir. 1921), the court cited article 8 of Treas. Reg. 41, which stated, "In the case of an individual, the terms 'trade,' 'business,' and 'trade or business' comprehend all his activities for gain, profit, or livelihood, entered into with sufficient frequency, or occupying such portion of his time or attention as to constitute a vocation, including occupations and professions. When such activities constitute a vocation they shall be construed to be a trade or business whether continuously carried on during the taxable year or not."

The area surrounding the ranch is sparsely populated, so she plans to earn money by selling the horses after they are trained, rather than offering the therapy at her ranch. She did not sell any horses during the prior 6 years, and she has had a major economic loss in each of those years. Lois says part of the problem is the learning curve in figuring out what constitutes a good horse for this endeavor.

Lois does not satisfy the I.R.C. § 183(d) presumption-of-profit test for the 7-year period ending with the current tax year. She bears the burden to prove that she has deductible business losses rather than hobby expenses. Does Lois have a for-profit activity? Consider the following factors.

Time and effort: Lois visits the ranch frequently, but what effort is she actually making to try to sell the horses? With her marketing background there is an expectation that she would be successful at selling. Lois devotes her time to her marketing company and to riding her horses.

Dependence on income: Lois is making megabucks with her marketing business. She does not need income from the horse operation for her living expenses.

Losses: Lois has moved beyond the start-up period and still has not earned any gross income from the horses. Is there any reason to think that the circumstances are beyond her control? Is the learning curve a sufficient explanation for the lack of sales?

Changing methods of operation: Lois has not changed her business plan, and there is no indication that she has sought advice from successful horse trainers or traders.

Knowledge: We know that Lois never owned horses before she decided to buy the ranch, but we do not know if she researched the field to determine its needs. We know that she blames the learning curve. How hard is she working to change the results?

Success in other activities: There is no doubt that Lois knows how to create a successful business; she has done so with her marketing company. The question is whether she knows how to create a successful horse training business.

Profit history: She has not realized any income or profit in 6 years.

Asset appreciation: Lois bought a ranch house and the accompanying acreage, all of which can be expected to appreciate. The horses may or may not increase in value.

Personal pleasure: There is no question that Lois enjoys riding the horses.

Which of these factors weigh in Lois's favor? What advice would you give her as her new tax preparer?

Election to Postpone Determination

If the IRS waits until the 5- or 7-year period in I.R.C. § 183(d) ends, some of the earlier years are likely to be closed for tax assessments when the IRS challenges the loss deductions. [I.R.C. § 6501(a) generally requires tax assessments to be made within a 3-year period after a return is filed.] Because of the assessment time limit, the IRS may challenge loss deductions for an activity before the presumption period ends.

Taxpayers with losses in the initial years can file Form 5213, Election To Postpone Determination as To Whether the Presumption Applies That an Activity Is Engaged in for Profit, to postpone an IRS determination of whether the activity is operating as a for-profit business until the close of the fourth tax year after the year the taxpayer began the activity (the sixth tax year for an activity that consists mainly of breeding, training, showing, or racing horses).

Deadline for Filing

A taxpayer must file Form 5213 within 3 years after the unextended due date of the return for the first tax year that the taxpayer engaged in the activity. If the IRS issues a written notice proposing to disallow deductions because of the I.R.C. § 183 provisions, a taxpayer who wants to postpone the determination must file Form 5213 within 60 days after receiving the IRS notice. This rule does not extend the 3-year period.

Statute of Limitations Extension

Filing Form 5213 extends the statute of limitations for assessment until 2 years after the unextended due date for filing the return for the last year in the presumption period. The extension applies only to the tax years for which the assessment period would otherwise expire earlier. The extension generally applies only to the deductions for the activity, but it also extends to deductions that are affected by changes to AGI, such as medical expenses. It does not waive any rights to appeal an auditor's decision.

If a married couple files a MFJ return, both spouses must sign the election even if only one spouse is involved in the activity.

Example 4.3 Effect of Form 5213 on Assessments

Brandon Barnett is a high-caliber bowler who decided to compete professionally. However, the expenses he incurred for entry fees and travel expenses far exceeded his prizes during his first 2 years of competition, and he had no sponsors. Brandon deducted large losses for 2012, 2013, and 2014. Brandon has not received a notice from the IRS about the losses, but he knows about the potential problem, and he is thinking about filing Form 5213 to give himself time to turn things around.

Question 1.
What is Brandon's deadline for filing Form 5213?

Answer 1.
His 3-year period for filing Form 5213 will end April 15, 2016, 3 years after the April 15, 2013, due date for the 2012 return. If the IRS proposes to disallow his expense deductions before he makes the election, he must file Form 5213 within 60 days after receiving the IRS notice but no later than April 15, 2016.

Question 2.
If Brandon files Form 5213 timely, how long does the IRS have to assess additional taxes if Brandon's bowling activity is ultimately determined to be not-for-profit?

Answer 2.
Brandon's profit presumption period is 2012–2016 because 2012 was his first year of competition. His return for 2016 will be due April 15, 2017, so 2 years later is April 15, 2019. Because the 3-year assessment periods for his 2012, 2013, and 2014 returns would end before April 15, 2019, the assessment periods for those returns would be extended to April 15, 2019.

Question 3.
If Brandon files Form 5213, isn't he just asking for an audit?

Answer 3.
An audit could result, so many practitioners recommend not filing Form 5213 unless the taxpayer receives an IRS notice challenging the loss deductions. On the other hand, if an IRS notice is not received within the 3-year period, the opportunity to file Form 5213 and postpone the determination of a profit motive is lost. This could be a problem for a horse activity that has a 7-year presumption period.

Question 4.
What happens if Brandon files file Form 5213 and the IRS audits his 2012 return in 2018 and finds a large income adjustment that is not related to the bowling activity?

Answer 4.
The Form 5213 extension would not allow the IRS to pursue the income adjustment. However, if Brandon's omitted income was substantial (exceeding 25% of the amount of gross income he included on the return), the IRS has 6 years from the time the return was filed to assess the additional tax [I.R.C. § 6501(e)].

Practitioner Note — Permanent Disallowance

Expenses disallowed under I.R.C. § 183 cannot be carried to any other year. They are nondeductible personal expenses.

Reporting Income and Expenses

Individual taxpayers must report their gross income from not-for-profit activities as other income on line 21 of Form 1040. If the taxpayer has no income from the activity, no expenses are deductible.

Practitioner Note — Effect on State Income Tax

If the taxpayer has hobby income, the related expenses are deductible only as itemized deductions on the taxpayer's federal income tax return. If the taxpayer lives in a state that uses federal AGI as the starting point for state income tax but does not provide for itemized deductions at the state level, the taxpayer will owe state income tax on the gross income.

Restrictions on Deductions

Except for casualty losses, I.R.C. § 165 restricts individuals' loss deductions to losses incurred in a trade or business or losses incurred in transactions entered into for profit. Deductions are not allowable under I.R.C. §§ 162 or 212 for activities that are carried on primarily as a sport or hobby, or for recreation.

The I.R.C. § 183 rules for activities not engaged in for profit specifically apply to individuals and at the corporate level to S corporations. Because I.R.C. § 703(a) provides that a partner's taxable income is computed in the same manner as an individual's taxable income, the rules also apply at the entity level for partnerships and are reflected in the partners' distributive shares [Rev. Rul. 77-320, 1977-2 C.B. 78]. In addition, they apply to trusts and estates because the taxable income of an estate or trust is computed in the same manner as that of an individual.

Practitioner Note C Corporations

Treas. Reg. § 1.183-1(a) provides that "no inference is to be drawn [from I.R.C. § 183] that any activity of a corporation [other than an S corporation] is or is not a business or engaged in for profit." However, the IRS can still challenge deductions at the corporate level as not being allowable under I.R.C. § 162.

Three Tiers for Expenses

Deductible expenses are generally limited to the amount of income from the not-for-profit activity. For individuals the expenses are deductible only as itemized deductions on Schedule A (Form 1040). The allowable amount of expenses is deductible in three tiers:

- Category 1 includes expenses such as home mortgage interest, property taxes, and casualty losses that a taxpayer can deduct for personal as well as business activities. The full amount of these items is still deducted on the specified lines of Schedule A (Form 1040), but the portion allocable to the hobby activity reduces the hobby income before other deductions are considered.
- Category 2 includes business-type deductions that do not result in an adjustment to the basis of property, such as advertising, insurance premiums, interest, utilities, and wages. These amounts are deductible only up to remaining income from the activity after category 1 deductions. They are allowable only as miscellaneous itemized deductions, subject to the 2%-of-AGI reduction on line 23 of Schedule A (Form 1040).
- Category 3 includes business-type deductions that decrease the basis of property, such as depreciation, amortization, and the activity's portion of casualty losses that are not deductible in category 1 because of the $100 and 10%-of-AGI reductions of personal casualty losses. The allowable portion of these expenses is also entered on line 23 of Schedule A (Form 1040).

Example 4.4 Hobby Loss Tax Treatment

As the tax practitioner for Lois Weatherbee from Example 4.2, you analyzed the factors in Treas. Reg. § 1.183-2 and decided that she is engaging in a hobby rather than a for-profit activity.

Question 1.
Can she wait another year to treat the activity as a hobby because she has not had the full 7 years that the presumption-of-profit motive provision allows for horse activities?

Answer 1.
To meet the presumption conditions, she needs a profit in 2 out of 7 years. She has already had 6 years with no income, so she cannot meet the requirement in 1 more year. Even if she could show a small profit in 2 of 7 years, your analysis determined that she is not operating the horse ranch with a profit motive.

Question 2.
Lois tells you that she did sell some horses in 2014 and grossed $27,000 on those sales. Her real estate taxes for the ranch are $24,000, she paid $48,000 in wages, and she needs to gather her records for feed and other expenses. She has no mortgage on the ranch. How do you report this activity on her tax return?

Answer 2.
The $27,000 is reported as hobby income on line 21 of her Form 1040. The $24,000 in real estate taxes is deducted on line 6 of Schedule A. After calculating the portion of the real estate tax that is allocable to the ranch house (which Lois uses as a personal residence), the remainder is a category 1 deduction that reduces the income available for category 2 deductions. If the portion of the property taxes allocable to the horse activity is $20,000, Lois's deduction for all of the other expenses is limited to $7,000 ($27,000 – $20,000) before it is reduced by 2% of her AGI.

Question 3.
What should you do about the prior years' returns?

Answer 3.
You must advise Lois about the probable outcome if the IRS audits any of those returns. You can offer to file amended returns for the open years, but you cannot file them unless Lois agrees.

Question 4.
What if Lois incorporated the ranch 6 years ago and did not make an S corporation election?

Answer 4.
If the ranch operated as a C corporation, the IRS could not challenge its losses by applying I.R.C. § 183. Because a C corporation does not pass through its losses to its shareholders, Lois could not use the losses to reduce her income from the marketing business. If the corporation continues to generate losses, the only tax benefit would come in the year Lois sells the ranch, if she sells it for a profit.

Question 5.
What will happen in future years if Lois starts showing a profit from her horse activity? Does she always have to treat it as a hobby?

Answer 5.
No, Lois is not forever doomed to be operating a hobby activity. Her 7-year presumption-of-profit period shifts each year. In fact, it is likely that the IRS will not question her hobby classification in future years if the business consistently shows a profit.

SELECTED PROVISIONS FOR TRADES OR BUSINESSES

This section illustrates the use of the term *trade or business* in selected tax provisions.

This section illustrates the importance of the term *trade or business* in the following tax provisions:

1. Self-employment tax
2. Travel expenses away from home
3. Start-up expenses

Self-Employment Tax

Self-employment (SE) tax generally applies to all individuals who have income from a trade or business carried on as a sole proprietorship or by a partnership of which the individual is a member. The tax is imposed by I.R.C. § 1401 on SE income, which is explained in I.R.C. § 1402 as generally including profit or loss "derived by an individual from any trade or business carried on" by the individual. But I.R.C. § 1402 again defines trade or business with reference to I.R.C. § 162.

I.R.C. § 1402(c) Trade or Business

The term *trade or business*, when used with reference to SE income or net earnings from self-employment, shall have the same meaning as when used in I.R.C. § 162 (relating to trade or business expenses).

Thus, the cases discussed earlier in this chapter come back into play in determining whether the activity rises to the level of a trade or business for the SE tax.

For income to be "derived from" a trade or business, there must be a nexus between the income and a trade or business that is (or was) actually carried on. It is not necessary that the income be produced directly by the trade or business. The required nexus generally exists if it is clear that the payment would not have been made except for the individual's conduct of a trade or business, for example, payments that replace lost profits [Rev. Rul. 91-19, 1991-1 C.B. 186].

Practitioner Note SE Tax Limited to US Persons

The SE tax does not apply to self-employed nonresident aliens, even when they are working in the United States, unless an international social security agreement provides for coverage under the US social security system. Conversely, the tax does apply to self-employed US citizens and permanent residents, even when they are working outside the United States. A self-employed US citizen who can exclude foreign earned income under I.R.C. § 911 nevertheless is subject to SE tax on that income (unless an international social security agreement provides otherwise).

Practitioner Note Income Earned in US Possessions

US social security taxes generally apply for work performed in a US possession (including Guam, Puerto Rico, the US Virgin Islands, American Samoa, and the Northern Marianas). Self-employed residents of the listed possessions who file their income tax returns with the possession's tax agency (rather than with the IRS) must file Form 1040-SS, U.S. Self-Employment Tax Return (Including the Additional Child Tax Credit for Bona Fide Residents of Puerto Rico), with the IRS center in Charlotte, North Carolina, to pay the SE tax. If no check or money order is enclosed, the form is filed with the IRS center in Austin, Texas.

In community property states, each spouse is considered to have half the community income for income tax purposes, even if it was earned by only one spouse. But in the absence of a partnership, only the spouse actually carrying on the trade or business includes the income when calculating SE tax. The question of which spouse carries on the trade or business is a question of fact to be determined on a case-by-case basis [Rev. Rul. 82-39, 1982-1 C.B. 119; *Jones v. Commissioner*, T.C. Memo. 1994-230].

Practitioner Note Activities Carried On through Agents or Employees

The owner of a trade or business may be subject to SE tax even when the business is not carried on personally. Treas. Reg. § 1.1402(a)-2(b) provides that an owner who hires agents or employees to conduct a trade or business is nevertheless liable for SE tax on the profits. In *Berger v. Commissioner*, T.C. Memo. 1996-76, a taxpayer who "accepted the benefits and burdens of ownership" was held liable for SE tax on income from a cemetery business operated by employees.

Income Items Excluded from SE Tax

I.R.C. § 1402 specifically excludes some types of income from the definition of net earnings from self-employment. Some examples are

- most income that is not taken into account when calculating gross income for income tax purposes;
- rents from real estate and from personal property leased with the real estate, unless
  - the rents are received in the course of a trade or business as a real estate dealer; or
  - the real estate is land used in agricultural production, and certain conditions (discussed later in this section) are met;
- dividends and interest, unless they are received in the course of a trade or business as a dealer in stocks or securities;

Observation Day Traders

Because gains and losses on securities and other investment property are excluded from the definition of SE income (unless the securities are held for sale to customers), a day trader (defined as one engaged in frequent trades) does not realize SE income from the trading activity. Traders may deduct expenses such as investment interest on Schedule C (Form 1040), usually without any income reported there. The sales are reported on Schedule D (Form 1040), Capital Gains and Losses, unless the trader made a timely mark-to-market election under I.R.C. § 475(f). If the election is made, the trades are reported on Form 4797, Sales of Business Property. The distinction between traders and investors is explained later in this chapter.

This may be particularly problematic for online businesses that accept cryptocurrencies such as Bitcoin. The IRS treats Bitcoin as property, not as currency. Those who mine Bitcoin are in the trade or business of producing Bitcoin and must pay SE taxes [Notice 2014-21, 2014-16 I.R.B. 938]. For all transactions conducted in Bitcoin, information filing, usually a Form 1099, must be made. For those that neither mine Bitcoin nor are in the business of buying and selling Bitcoin, gains or losses on Bitcoin must be reported as short-term or long-term capital gains or losses.

- capital gains and losses and certain other gains and losses (such as those reportable on Form 4797, Sales of Business Property);
- net operating loss deductions;

- qualified termination payments received by former insurance salesmen;
- retirement payments made to a partner;
- a limited partner's distributive share (except guaranteed payments for services) of partnership income;

Practitioner Note Law Practice

In *Renkemeyer v. Commissioner*, 136 T.C. 137 (2011), the court held that distributive shares of income from a law firm organized as a limited liability partnership to its three partners were subject to SE tax because the income was from legal services they performed in their capacity as partners in the law firm.

- income from Indian tribal fishing rights; and
- wages earned as an employee, with limited exceptions.

Other Internal Revenue Code sections and IRS rulings exclude some specific items of income from the SE tax. Examples include

- qualified disaster relief payments [I.R.C. § 139(d)];
- payments under the Smallpox Vaccination Injury Compensation Program to individuals injured by administration of the smallpox vaccine [Notice 2004-17, 2004-11 I.R.B. 605];
- peanut quota buyout payments under § 1309 of the Farm Security and Rural Investment Act of 2002 [Notice 2002-67, Q&A-6, 2002-42 I.R.B. 715]; and
- supplemental payments made by a union to its members to equalize the hourly wage rate in the union's collective bargaining agreement and lesser amounts the workers received as wages from a contractor for targeted services [P.L.R. 1996-24-011 (March 14, 1996)].

Some cases involving whether an activity was subject to SE tax are summarized at the end of this section.

Practitioner Note Embezzlement

SE tax does not apply to income that is not derived from a trade or business. Some activities are seldom or never deemed to amount to a trade or business. Examples include embezzlement and serving as a juror. However, the tax does apply to SE income received from an illegal business [*Levine v. Commissioner*, T.C. Memo. 1998-383] and from panhandling [*Basada v. Commissioner*, T.C. Memo. 1998-144].

Income Items Included for SE Tax

Examples of trade or business items specifically included in SE income are the following:

- Directors' fees
- Amounts included in gross income under the recapture provisions of I.R.C. § 179 or 280F, when the business use of property drops to 50% or less
- Amounts that would be included in gross income if earned in the United States, including SE amounts excluded from gross income as foreign earned income or possession source income
- Gains and losses derived by options and commodities dealers from I.R.C. § 1256 contracts or from property related to those contracts
- An individual's distributive share of partnership income or loss, whether or not it is distributed
- Amounts received or accrued from a trade or business during a tax year, even when the services were performed in an earlier year
- Compensation (including wages and housing allowances) of members of the clergy who have not elected out by filing Form 4361, Application for Exemption From Self-Employment Tax for Use by Ministers, Members of Religious Orders and Christian Science Practitioners
- Church employee wages, if the church elected out of withholding the employee share and paying the employer share of social security tax

- Wages paid to a US citizen by an international organization or a foreign government for work performed in the United States

SE Income from Farming

Individuals deriving income from carrying on an agricultural or horticultural trade or business generally are subject to SE tax under the same rules that apply to nonfarm activity meeting the active conduct of a trade or business requirement of I.R.C. § 1402(c).

Specific items of farm income that are included in net earnings for self-employment include the following:

- Taxable patronage dividends from farm cooperatives, even if the taxpayer was not farming when the dividends were paid [*Shumaker v. Commissioner*, 648 F.2d 1198 (CA-9, 1981)]
- Value-added payments from a cooperative, even though the farmer bought (rather than grew) the grain he or she was required to deliver to the co-op each processing year [*Bot v. Commissioner*, 353 F.3d 595 (8th Cir. 2003), *aff'g* 118 T.C. 138 (2002)]. (The taxpayers had retired from daily farming but kept their membership in the co-op, the payments were received in consideration for delivering a specified amount of corn to the co-op, and the co-op acted as the taxpayers' agent in processing and selling the corn)
- Conservation reserve program (CRP) payments [C.C.A. 2003-25-002]

Law Change — Nonfarmers

The Eighth Circuit held that CRP payments to nonfarmers are rental income, not SE income [*Morehouse v. Commissioner*, 769 F.3d 616 (CA-8, 2014)].

- Storage fees paid by the Commodity Credit Corporation under a "reseal" agreement that are paid to a farmer for storing his or her own grain. However, grain storage fees paid to a farm landlord for the storage of a crop in respect of which he or she did not materially participate are to be excluded from net earnings from self-employment as rental income the same as the income realized from the actual sale of his or her share of the crop [Rev. Rul. 65-149, 1965-1 C.B. 434]
- The canceled portion of an emergency loan by the Farmers Home Administration, because the cancellation was intended to provide compensation for lost profits due to drought [Rev. Rul. 76-500, 1976-2 C.B. 254]
- Soil Bank Act payments if the recipient operates his or her farm personally or through agents or employees, or if it is operated by others and the recipient materially participates [Rev. Rul. 60-32, 1960-1 C.B. 23]
- Payments to a milk producer under the Dairy Termination Program that represent compensation for lost receipts from milk production, if the producer operated the milk production unit personally or through agents or employees, or if he or she participated materially in the production or management of production if someone else operated the unit [Notice 87-26, 1987-1 C.B. 470]
- National Tobacco Settlement Trust payments received by a taxpayer who raises and sells a tobacco crop [IR-News Rel. 2002-28 (March 6, 2002); and IR-News Rel. 2003-7 (January 21, 2003)]
- Payments for pasturing, feeding, and caring for another's cattle on the farmer's land [Rev. Rul. 56-677, 1956-2 C.B. 564]

Observation — SE Tax General Rules

The majority of activities (both farm and nonfarm) that are engaged in on a regular and continuous basis with a profit motive are subject to SE tax.

Income from Rental Property

I.R.C. § 1402(a) excludes rentals from real estate and from personal property leased with the real estate from the definition of net earnings from self-employment.

If the taxpayer provides significant services in conjunction with use of the real property, the activity is not a rental activity. Enterprises such as hotels, motels, bed and breakfasts, boarding houses, parking lots, and storage facilities are not treated as rental real estate activities [Treas. Reg. § 1.1402(a)-4(c)(2)].

Renting Personal Property

Rental of personal property (such as machinery or equipment) is not excluded from SE tax if the personal property is not leased with real estate. Therefore, if the rental activity amounts to a trade or business, it is subject to SE tax.

The IRS views a taxpayer as being in the business of renting personal property if the primary purpose for renting the property is income or profit and the individual is involved in the rental activity with continuity and regularity. The income and expenses from a business of renting personal property are reported on Schedule C (Form 1040).

If the activity is sporadic and does not qualify as a trade or business, but it is conducted with a profit motive, the income is reported on line 21 of Form 1040 as other income, and the related expenses are deducted on line 36 of Form 1040 as a write-in entry, notated as PPR (personal property rent). As noted earlier in this chapter, I.R.C. § 62(a)(4) permits these expenses to be deducted in calculating AGI.

Real Estate Dealers

The exclusion for rentals from real estate does not apply to rents received in the course of a trade or business as a real estate dealer. Treas. Reg. § 1.1402(a)-4 states that a dealer is an individual "engaged in the business of selling real estate to customers with a view to the gains and profits that may be derived from such sales." On the other hand, an individual who merely holds real estate for investment or speculation and receives rentals from it is not considered a real estate dealer.

It is possible for a dealer to hold some property for investment or speculation in addition to real estate held for sale to customers in the ordinary course of his or her trade or business. When this occurs only the rentals from the real estate held for sale to customers are included in determining net earnings from self-employment. The rentals from the real estate held for investment or speculation are still excluded.

Practitioner Note Use of Schedule E (Form 1040)

Rentals of real estate and personal property leased with real estate that are not subject to SE tax should be reported on Schedule E (Form 1040), Supplemental Income and Loss. Rents from real estate should be reported on Schedule C (Form 1040) if the taxpayer provides significant services, or the rents are received from property held for sale by a real estate dealer.

Example 4.5 Nonfarm Rental of Personal Property

Marty Morris ceased doing business as a caterer 2 years ago, but she has not disposed of most of the crystal and silver she used in that business because she hopes to resume that occupation after her release from home detention. A former competitor contacted her to ask about borrowing some items for a wedding with 5,000 guests. Marty agreed to let her use the crystal and silver (for a price) but insisted this was a one-time event and that the competitor should not expect Marty to help her in the future. Marty reports the rental income on line 21 of Form 1040 rather than on Schedule C (Form 1040) because she is not in a trade or business of renting personal property.

Rent from Land Used in Agricultural Production

In general, the rental of farm real estate and personal property leased with it (including rentals paid in crop shares) is not subject to SE tax. However, I.R.C. § 1402(a)(1) provides an exception to this exception for certain land used in agricultural production. Rents paid are included in SE income if

1. the income is derived under an arrangement between the lessor and another individual that provides that
   a. the other individual will produce agricultural or horticultural commodities on the land, and
   b. the lessor will materially participate in the production, or management of the production; and
2. there is material participation by the lessor with respect to the commodity.

Agricultural and horticultural commodities include livestock, bees, poultry, and fur-bearing animals and wildlife. The lessor may be either the landowner or a tenant who subleases the land. The lessor's material participation is determined without regard to any activities of an agent of the lessor.

Practitioner Note Material Participation under Other Provisions

The definition of material participation for I.R.C. § 1402 is not the same as its definition for passive activity losses and credits under I.R.C. § 469. The I.R.C. § 469 material participation rules are discussed later in this chapter.

For purposes of the estate tax special valuation rules, I.R.C. § 2032A(e)(6) states, "Material participation shall be determined in a manner similar to the manner used for purposes of paragraph (1) of section 1402(a) (relating to net earnings from self-employment)." Consequently, the meaning of material participation does not have to be exactly the same for the two provisions. Treas. Reg. § 20.2032A-3(e)(1) requires all of the I.R.C. § 1402 requirements to be met and imposes some additional requirements for material participation under the special valuation rules.

Material Participation

Treas. Reg. § 1.1402(a)-4 provides general guidance on material participation by a lessor for SE tax. In its *Farmer's Tax Guide* (Publication 225), the IRS offers four tests for whether a lessor is materially participating in either production or management of production. Two of the tests are objective, and two are not. A lessor is considered to materially participate if any one of the following tests is met.

Test No. 1

A lessor is considered to materially participate by doing any three of the following:

- Pay, using cash or credit, at least half the direct costs of producing the crop or livestock
- Furnish at least half the tools, equipment, and livestock used in the production activities
- Advise or consult with the tenant
- Inspect production activities periodically

Test No. 2

If a lessor regularly and frequently makes, or takes an important part in making, management decisions substantially contributing to or affecting the success of the enterprise, that individual is considered to materially participate.

Test No. 3

A lessor who works 100 hours or more spread over a period of 5 weeks or more in activities connected with agricultural production meets the requirements for material participation.

Test No. 4

Doing things that, considered in their totality, show material and significant involvement in the production of the farm commodities qualifies a lessor for material participation.

Practitioner Note Services Performed by Agents

Because services of an employee or agent aren't considered services of the lessor, a landowner who completely turns over management of the land to an agent, such as a professional farm management company, and doesn't materially participate in the farming operation does not have SE income from renting land for agricultural use [Treas. Reg. § 1.1402(a)-4(b)(5)]. The income and expenses should be reported on Form 4835, Farm Rental Income and Expenses.

Observation Farm Income

SE tax applies to both farmers and nonfarmers engaged in a trade or business of renting personal property (machinery and equipment). A farmer reports custom hire income (for both services and use of machines) on line 7 of Schedule F (Form 1040). But a taxpayer may have more than one trade or business. If a farmer has a separate trade or business of leasing equipment that is not leased with real estate, that income is not farm income and should be reported on Schedule C (Form 1040). This can affect estimated tax requirements [Rev. Rul. 77-105, 1977-1 C.B. 374, dealing with custom harvesters].

Summary of Rulings and Cases

The following synopses illustrate IRS and judicial efforts to refine the criteria of "regular and continuous activity" and "profit motive" for determining whether an activity is a trade or business subject to SE tax.

Accountant

A licensed public accountant was an employee of his closely held accounting firm (an S corporation) even though an Idaho state agency had treated him as an independent contractor [*Spicer Accounting Inc. v. United States*, 918 F.2d 90 (9th Cir. 1990)].

Citrus Grove Owners

Grove owners who turned over complete management of production, care, and raising of the fruit to a management company, but personally signed a picking and marketing agreement with a cooperative, were held to be in a trade or business and were subject to SE tax. The management company was an employee and the co-op acted as the owners' agent, the Tax Court held [*McAllister v. Commissioner*, 42 T.C. 948 (1964)].

Contractors

A handyman who advertised home repair services in newspapers, hired helpers, provided his own tools and equipment, and occasionally subcontracted jobs was not an employee of the homeowners but was in the trade or business of providing home repair services [*Adams v. Commissioner*, T.C. Memo. 1982-223 and T.C. Memo. 1985-297]. The activities of an individual who installed refrigeration equipment on approximately 30 occasions during a 6-month period were regular, continuous, and extensive enough to qualify as the conduct of a trade or business, and he engaged in them for the purpose of deriving a profit and his source of livelihood [*Church v. Commissioner*, T.C. Memo. 1970-146].

Drug Dealers

The illegal activity of buying and selling controlled substances is treated as a trade or business for SE tax purposes [*Hesse v. Commissioner*, T.C. Memo. 1989-515]. However, a taxpayer who did not take part in his father's marijuana activity, but apparently misappropriated some of his father's cash hoard, was liable for income tax but not SE tax [*Boone v. Commissioner*, T.C. Memo. 1997-471, *aff'd* on other issue 208 F.3d 212 (6th Cir. 2000)].

Honoraria

An individual who accepts an occasional invitation to make a speech for which he or she receives an honorarium is not engaged in a trade or business. But if that individual indicates his or her availability for speaking engagements for which he or she receives compensation and fills such engagements with reasonable regularity during the year, the activity would constitute a trade or business with income includable in computing net earnings from self-employment [Rev. Rul. 55-431, 1955-2 C.B. 312, amplified by Rev. Rul. 77-356, 1977-2 C.B. 317].

Hospital Owner

A medical doctor who owned a hospital that was managed by a professional hospital administrator was liable for SE tax. Although he didn't perform any management functions personally, "the operation of the hospital clearly was a trade or business, and is not analogous to the rentals received from the passive ownership of real estate . . . Petitioner delegated the responsibility of managing his trade or business to his employees and is therefore subject to self-employment tax on the net profits received" [*Price v. Commissioner*, T.C. Memo. 1993-265].

Incompetent Person

Income from an incompetent person's trade or business carried on by a guardian is SE income for the incompetent person, because no separate estate is created for a person of unsound mind [Rev. Rul. 58-267, 1958-1 C.B. 327, modifying Rev. Rul. 56-22, 1956-1 C.B. 558].

Inventor

Payments in settlement of a lawsuit for infringement of a patent and royalties were not SE income when the inventor was found not to be engaged in a trade or business because he did not develop or design inventions on a continuous or regular basis [*Levinson v. Commissioner*, T.C. Memo. 1999-212].

Investor

An investor in a cattle-feeding operation whose involvement was limited to instructing a feed yard to buy cattle and to paying expenses twice a month when he received a bill wasn't in a trade or business for purposes of the SE tax [Ltr. Rul. 1980-24-176 (March 24, 1980)].

Law Practice

A person may be engaged in a part-time activity in addition to his or her regular job as an employee, but facts and circumstances determine whether that activity is a trade or business. A computer analyst for the federal government who began a part-time law practice was not engaged in a trade or business when his interest was in gaining legal experience rather than earning a profit, his fees were very low, and he kept no business-like records. Business deductions were not allowed [*Sloan v. Commissioner*, T.C. Memo. 1988-294].

Leasing

A nonfisherman who leases crab pots and nets to commercial fishermen is engaged in the trade or business of leasing when the rental activity had been in place for several years and was expected to continue. The leasing of the pots and the leasing of the nets could be separate activities or could be sufficiently related to be one business activity. If they are combined into a leasing activity as a trade or business, it doesn't matter if either one separately does not amount to a trade or business [C.C.A. 2003-21-018].

Oil and Gas Working Interests

A working interest in an oil or gas property is a trade or business for SE tax purposes [Rev. Rul. 58-166, 1958-1 C.B. 324; *Methvin v. Commissioner*, T.C. Memo. 2015-81].

Real Estate Agents

Licensed real estate agents and direct sellers are statutory nonemployees under I.R.C. § 3508 and are subject to SE tax [Rev. Rul. 85-63, 1985-1 C.B. 292].

Seminar Speaker

A professor who gave seminars on a contractual basis for a sponsor related to his employer (a university) was self-employed for those seminars. He prepared the syllabus and all course materials for the seminars and other programs he designed and conducted. The university treated the seminars as an outside activity, even though the payment was processed through its payroll system. A Keogh plan contribution was allowed [*Reece v. Commissioner*, T.C. Memo. 1992-335].

Tree Cutter

A tree cutter was self-employed because he was free to run tree-cutting jobs as he saw fit. Although he was paid on an hourly basis by a timber mill, he was a skilled craftsman who was engaged to achieve an end result (to cut timber in certain geographic locations and within certain time frames designated by the timber mill), without specific direction from the timber mill as to how to accomplish the work. Although 60% of his payment was designated as equipment rental, it was all found to be Schedule C (Form 1040) income, subject to SE tax [*Walker v. Commissioner*, 101 T.C. 537 (1993)].

Window Installer

A retiree's income earned from installing windows for 1 month was not subject to SE tax because the activity was not continuous and regular, and thus did not constitute a trade or business [*Batok v. Commissioner*, T.C. Memo. 1992-727].

Employee or Independent Contractor

The Department of Labor's Wage and Hour Division issued Administrator's Interpretation No. 2015-1 on July 15, 2015. It states, "In order to make the determination whether a worker is an employee or an independent contractor under the FLSA, courts use the multi-factorial 'economic realities' test, which focuses on whether the worker is economically dependent on the employer or in business for him or herself." The Administrator's Interpretation addresses each of the economic realities factors and concludes that, "ultimately, the goal is not simply to tally which factors are met, but to determine whether the worker is economically dependent on the employer (and thus its employee) or is really in business for him or herself (and thus its independent contractor)."

Example 4.6 Regular and Continuous Involvement

In 2015 Joe Bob Handy from Example 4.1 decided to rehabilitate more houses, and multiple individuals offered to buy the first house even before it was finished. Joe Bob now has a waiting list of buyers and decided to buy more houses. Joe Bob quit his full-time job at the company that builds gas and oil pipelines and is planning to make this his full-time business. At the end of 2015, his records show sales, purchases, rehabilitation expenses, and projects in process.

Because Joe Bob rehabilitated a house in 2014, he has been involved in the activity for 2 years, and he intends to continue in the future. Likely, the IRS will consider his activity regular, continuous, and for a profit motive.

Question 1.
Should Joe Bob allocate expenses to the cost of each house?

Answer 1.
Because Joe Bob is in the trade or business of rehabilitating and selling houses, the expenses are subject to the I.R.C. § 263A capitalization rules. Joe Bob must accumulate each house's *direct expenses* and add them to the basis of the house, which will reduce the gain he must report when he sells the house. Because Joe Bob's *indirect expenses* are less than $200,000 per year, he does not have to allocate those expenses and can deduct them on his Schedule C (Form 1040) [Treas. Reg. § 1.263A-2(b)(3)(iv)].

Question 2.
Are Joe Bob's house sales eligible for capital gain treatment?

Answer 2.
No. Because Joe Bob is rehabilitating houses and holding them for sale in the ordinary course of his trade or business, the sales proceeds are ordinary income not eligible for capital gain.

Question 3.
Does it make a difference whether this is Joe Bob's full-time occupation or whether Joe Bob has another full-time job and is rehabilitating houses on a part-time basis?

Answer 3.
No. Meeting the requirement that the activity be regular and continuous with a profit motive does not require that the activity be full-time or the sole activity of the taxpayer. See "Sole or Principal Business" after Example 4.1 earlier in this chapter.

Travel Expenses

I.R.C. § 162(a)(2) allows taxpayers to deduct travel expenses, including those for meals and lodging, as ordinary and necessary expenses of carrying on a trade or business. Two separate but related rules allow taxpayers to treat travel expenses as necessary expenses of carrying on a trade or business.

1. Treas. Reg. § 1.262-1(b)(5) allows expenses incurred in traveling away from home to be deducted if they are incurred in the course of a trade or business. Neither I.R.C. § 162 nor the regulations define a tax home for a self-employed individual; however, by inference there must be a tax home for there to be deductions for travel expenses incurred while away from home. (See the "Temporary Distant Worksite Exception" later in this section.)
2. Although the cost of commuting between the taxpayer's residence and regular place of employment is a nondeductible personal expense [Treas. Reg. § 1.162(e); *Commissioner v. Flowers*, 326 U.S. 465 (1946)], transportation expenses incurred on trips between places of business may be deductible [*Steinhort v. Commissioner*, 335 F.2d 496, 503-504 (5th Cir. 1964), *aff'g* and *rem'g* T.C. Memo. 1962-233; *Heuer v. Commissioner*, 32 T.C. 947, 953 (1959), *aff'd* per curiam 283 F.2d 865 (5th Cir. 1960)]. If the taxpayer's residence is a place of business, transportation expenses between the residence and a worksite may be deductible.

Practitioner Note Tax Home vs. Residence

The terms *tax home* and *residence* are not synonymous. *Tax home* is the metropolitan area where the taxpayer lives and normally works. *Residence* is the dwelling unit where the taxpayer lives and may or may not be the taxpayer's tax home, principal place of business, or regular place of business as discussed later.

IRS Position

The IRS summarized its position on deducting travel expenses incurred in going between a taxpayer's residence and a work location in Rev. Rul. 99-7, 1999-1 C.B. 361, as follows:

> In general, daily transportation expenses incurred in going between a taxpayer's residence and a work location are nondeductible commuting expenses. However, such expenses are deductible under the circumstances described in paragraph (1), (2), or (3) below.
>
> (1) A taxpayer may deduct daily transportation expenses incurred in going between the taxpayer's residence and a TEMPORARY work location OUTSIDE the metropolitan area where the taxpayer lives and normally works. However, unless paragraph (2) or (3) below applies, daily transportation expenses incurred in going between the taxpayer's residence and a TEMPORARY work location WITHIN that metropolitan area are nondeductible commuting expenses.

Observation Away from Tax Home

Note that although paragraph (1) addresses transportation expenses from and to the taxpayer's *residence*, it is applying the travel *away-from-home* rule. (See the "Temporary Distant Worksite Exception" later in this section.)

> (2) If a taxpayer has one or more regular work locations away from the taxpayer's residence, the taxpayer may deduct daily transportation expenses incurred in going between the taxpayer's residence and a TEMPORARY work location in the same trade or business, regardless of the distance. (The Service will continue not to follow the Walker decision.)

Observation IRS vs. Tax Court

Note that the IRS does not agree with the tax court's holding in *Walker v. Commissioner,* supra. See the discussion of "Regular Place of Business" later.

> (3) If a taxpayer's residence is the taxpayer's principal place of business within the meaning of section 280A(c)(1)(A), the taxpayer may deduct daily transportation expenses incurred in going between the residence and another work location in the same trade or business, regardless of whether the other work location is REGULAR or TEMPORARY and regardless of the distance.
>
> For purposes of paragraphs (1), (2), and (3), the following rules apply in determining whether a work location is temporary. If employment at a work location is realistically expected to last (and does in fact last) for 1 year or less, the employment is temporary in the absence of facts and circumstances indicating otherwise. If employment at a work location is realistically expected to last for more than 1 year or there is no realistic expectation that the employment will last for 1 year or less, the employment is not temporary, regardless of whether it actually exceeds 1 year. If employment at a work location initially is realistically expected to last for 1 year or less, but at some later date the employment is realistically expected to exceed 1 year, that employment will be treated as temporary (in the absence of facts and circumstances indicating otherwise) until the date that the taxpayer's realistic expectation changes, and will be treated as not temporary after that date.
>
> The determination that a taxpayer's residence is the taxpayer's principal place of business within the meaning of section 280A(c)(1)(A) is not necessarily determinative of whether the residence is the taxpayer's tax home for other purposes, including the travel-away-from-home deduction under section 162(a)(2).

Principal Place of Business

The IRS and the Tax Court agree that if the taxpayer's residence is the principal place of business for the taxpayer's trade or business, then the taxpayer may deduct daily transportation expenses incurred in going between the residence and another work location in the same trade or business, regardless of whether the other work location is regular or temporary and regardless of the distance [Rev. Rul. 99-7; *Wisconsin Psychiatric Services, Inc. v. Commissioner*, 76 T.C. 839, 849 (1981); *Curphey v. Commissioner*, 73 T.C. 766, 777-778 (1980)].

The IRS and the Tax Court both refer to the business use of home rules under I.R.C. § 280A to define "principal place of business" for purposes of deducting daily transportation expenses from and to the taxpayer's residence. Neither of them require the taxpayer to meet the "exclusive use" requirement of I.R.C. § 280A(c)(1).

In Rev. Rul. 99-7, the IRS requires the taxpayer's residence to be the "principal place of business within the meaning of I.R.C. § 280A(c)(1)(A)." I.R.C. § 280A(c)(1)(A) lists "the principal place of business for any trade or business of the taxpayer" as one of three uses of a taxpayer's home for which expenses can be deducted [the other two are: (1) "used by patients, clients, or customers in meeting or dealing with the taxpayer in the normal course of his trade or business," and (2) "a separate structure which is not attached to the dwelling unit"]. I.R.C. § 280A(c)(1) imposes an additional requirement that the locations be used exclusively and regularly for business. Therefore, while exclusive use is a requirement for deducting business use of home expenses, it is not a requirement for deducting daily transportation expenses incurred in going between the taxpayer's residence and a place of business.

Similarly, in *Curphey v. Commissioner*, the Tax Court required only that the residence be a principal place of business to allow the taxpayer's deduction of automobile expenses for driving to his rental properties. Although the taxpayer did use the office in his home exclusively for business the court did not impose that requirement on deducting the automobile expenses.

Principal Place of Business

In response to the US Supreme Court decision in *Commissioner v. Soliman,* 506 U.S. 168 (1993), Congress added flush language following I.R.C. § 280A(c)(1)(C) that says, "For purposes of subparagraph (A), the term 'principal place of business' includes a place of business which is used by the taxpayer for the administrative or management activities of any trade or business of the taxpayer if there is no other fixed location of such trade or business where the taxpayer conducts substantial administrative or management activities of such trade or business" [section 932 of the Taxpayer Relief Act of 1997, Pub. L. No. 105-34, 111 Stat. 881, effective for tax years beginning after December 31, 1998].

Regular Place of Business

If the taxpayer's residence is not a principal place of business, the IRS and the Tax Court agree that expenses for traveling between the taxpayer's residence and a *regular* place of business cannot be deducted. They also agree that if the taxpayer has one or more regular work locations *away from his or her residence*, the taxpayer may deduct daily transportation expenses incurred in going between the residence and a *temporary* work location in the same trade or business, regardless of the distance.

The Tax Court also allows the taxpayer to deduct daily transportation expenses incurred in going between the residence and a temporary work location in the same trade or business, regardless of the distance, if the taxpayer's residence is a regular place of business [*Walker v. Commissioner,* supra]. The IRS requires the regular place of business to be away from the taxpayer's residence [Rev. Rul. 94-47, 1994-2 C.B. 18].

Temporary Distant Worksite Exception

Courts have carved out an exception to the rule that commuting expenses are nondeductible to cover instances in which workers commute long distances to their workplaces for business, rather than personal reasons. If taxpayers work at temporary worksites that are outside the metropolitan area in which they live, they can deduct

the cost of traveling to the temporary worksite without showing the travel is away from their tax home. In *Dahood v. United States*, 747 F.2d 46, 48 (1st Cir. 1984), the court explained the reasoning underlying the temporary distant worksite exception as follows:

> This exception permits taxpayers to deduct commuting expenses to a job that is temporary, as opposed to indefinite, in duration. The exception has been deemed necessary because "it is not reasonable to expect people to move to a distant location when a job is foreseeably of limited duration." Implicit in this exception is the requirement that the taxpayer commute to a worksite distant from his residence. Without such a requirement, the absurd result would obtain of permitting a taxpayer, who commuted to a succession of temporary jobs, to deduct commuting expenses, no matter how close these jobs were to his residence. [Citations omitted.]

However, taxpayers must have a fixed residence to invoke the temporary distant worksite exception. In *In re Bechtelheimer*, 239 B.R. 616 (Bankr. M. D. Fla. 1999), the taxpayers were self-employed artists or crafters who lived in a motor home. Because their home traveled with them, they were not away from home when they traveled and had no deductible travel expenses.

In *McClellan v. Commissioner*, T.C. Memo. 2014-257, the taxpayers had a house in Gulfport, Mississippi, and lived in an apartment in New York rented to them by a company that hired them as consultants to work in New York, Massachusetts, New Jersey, and Pennsylvania. They were required to share the New York apartment with other independent contractors, and it was not the only location in the Northeast from which they conducted work. The taxpayers performed consulting services for at least one other party during one or more of the years at issue. Because the taxpayers maintained a permanent residence in Gulfport and had no principal place of employment during the years at issue, the court held that Gulfport was their tax home during those years.

Example 4.7 Tax Home

Joe Bob Handy from Example 4.6 keeps all of his tools in the truck that he drives from his residence to the various locations where he is rehabilitating houses. He pays Sally Mae Smith, an independent contractor, to do all of the administrative work for his business from her office. He does no office work and no remodeling work at his residence.

Because Joe Bob has no regular place of business, he cannot deduct the cost of traveling in the metropolitan area from his residence to the first job site each day or the cost of driving from the last job site to his residence. However, he can deduct the cost of driving between job sites and the cost of driving from a job site to and from a retail store to purchase supplies for his remodeling work.

Question 1.
Joe Bob got a good deal on a run-down house in Tulsa, which is not in the Oklahoma metropolitan area, and bought it for rehabilitation. He drove the 107 miles to Tulsa every Monday morning for 6 weeks to work on the house. He worked 10 hours per day for 4 days each week and then returned to his residence in Oklahoma for a 3-day weekend. Can Joe Bob deduct the cost of his transportation, lodging, and meals for those trips?

Answer 1.
Because Joe Bob's tax home is in Oklahoma City, the Tulsa job site is a temporary worksite outside the metropolitan area in which Joe Bob lives. Therefore, his trips to Tulsa are away from home, and he can deduct his travel expenses.

Question 2.
Joe Bob set up a workshop in the garage of his residence so that he could build cabinets, windows, and other items that he can transport to the houses he is rehabilitating. He works about 10 hours each week in the workshop. Does this change the deductibility of his trips to job sites in the Oklahoma City metropolitan area?

Answer 2.
The IRS will still not allow Joe Bob to deduct his trips in the metropolitan area to the first job site and from the last job site each day because he does not have a regular place of business away from his residence [Rev. Rul. 99-7, supra]. The Tax Court will allow him to deduct the cost of those trips because his home is now a regular place of business [*Walker v. Commissioner*, supra].

Question 3.
Joe Bob set up an office in his residence to do the administrative work for his business, but he does not use the office exclusively for business

purposes and therefore cannot deduct the cost of maintaining an office in his home [I.R.C. § 280A(c)(1)]. Does this change the deductibility of his trips to job sites in Oklahoma City?

Answer 3.
As discussed under "Principal Place of Business" earlier, neither the IRS nor the Tax Court requires exclusive use of the office in the home to deduct transportation expenses to regular or temporary places of business regardless of the distance. Therefore, Joe Bob can deduct expense for all of his trips between his home and his job sites.

Start-Up Expenditures

Start-up expenditures are amounts paid or incurred to investigate the creation or acquisition of an active trade or business that would be currently deductible expenses if they were incurred to operate an existing active trade or business. Investigatory costs include expenses incurred to analyze or survey potential markets, products, labor supply, transportation facilities, and similar outlays for a prospective business. Preopening expenses that are included in start-up costs are amounts incurred after deciding to establish a business but prior to its actual operation. These costs include expenses for advertising; employee training; setting up books; and lining up distributors, suppliers, and potential customers. Travel costs for these purposes are part of these expenses, but interest, taxes, and research and experimental expenditures are specifically excluded.

When a taxpayer wants to acquire an existing business, general investigatory expenses to locate a target are I.R.C. § 195 costs. After a specific business has been identified for acquisition, subsequent costs are capital expenditures. IRS guidance uses three fact situations to illustrate qualifying investigatory costs when a taxpayer acquires the assets of an existing active trade or business [Rev. Rul. 99-23, 1999-20 I.R.B. 3, as clarified by Announcement 99-89, 1999-36 I.R.B. 408]. Costs to conduct industry research, to evaluate publicly available financial information, and to evaluate several potential businesses are qualified investigatory expenditures for I.R.C. § 195 purposes. On the other hand, costs of appraising a target corporation's assets, of conducting an in-depth review of its books and records to establish a purchase price, of drafting regulatory approval documents, and of conducting due diligence reviews of its internal documents are capital acquisition expenditures that are not eligible for I.R.C. § 195 treatment.

I.R.C. § 195 costs are those that would be immediately deductible if they were incurred in an ongoing trade or business. Any expense that must be capitalized if incurred in an ongoing business is not an I.R.C. § 195 cost.

I.R.C. § 195 permits a taxpayer to elect to deduct up to $5,000 of qualifying start-up expenditures in the month the business begins. The deduction is phased out on a dollar-for-dollar basis for start-up expenses exceeding $50,000. Start-up costs that are not deducted in the year the business begins are amortized over 180 months.

Practitioner Note — Different Rule for 2010

The Small Business Jobs Act of 2010, Pub. L. No. 111-240, § 2031, increased the amount of start-up expenses that may be deducted from $5,000 to $10,000, and increased the phaseout threshold from $50,000 to $60,000. However, that provision was in effect for only 1 year—tax years that began in 2010 [I.R.C. § 195(b)(3)].

Example 4.8 Website Development Costs—Existing Business

Ernie Gomez owned an antique store. Over the past several years, business dropped precipitously as the antique business moved to the web. He hired a contractor to develop a website through which he could sell antiques. The cost of developing the website, to the extent that those costs are not capital costs, are deductible costs of maintaining his existence business. Ernie may deduct these costs as an ordinary and necessary expense of his existing business.

Cross-Reference — Repair Regulations

See the "Repair Regulations" chapter in this book for an explanation of costs that must be capitalized and the election to capitalize costs that could be deducted.

Example 4.9 Website Development Costs—New Business

Ernie from Example 4.8 was not satisfied with what he was making in his antique store. He decided to close the store and sell art produced by various local artists over the Internet. He hired a contractor to develop a website through which he could sell art. This business is sufficiently different that he must treat it as a start-up. Expenses of developing the website may not be deducted, except to the extent allowed by I.R.C. § 195. Ernie had $53,000 of qualifying start-up expenses in his first year. The phaseout reduces his deduction by $3,000, to $2,000. He must amortize the remaining $51,000 of start-up expenses over 180 months.

Beginning of Active Trade or Business

The beginning point of a trade or business under I.R.C. § 195 has two consequences. First, if an activity never reached the point the trade or business begins, start-up costs incurred in the activity cannot be amortized under I.R.C. § 195. Second, the 60-month amortization period cannot commence until the trade or business begins [I.R.C. § 195(b)(1)(A); *Richmond Television v. United States*, 345 F.2d 901 (1965)]. Expenditures incurred after this time cannot be amortized under I.R.C. § 195 and may be currently deducted under I.R.C. § 162(a).

A manufacturing business begins when all the necessary operating assets have been acquired and put to use producing items intended to be offered for sale to the public [P.L.R. 1990-47-032 (August 27, 1990)]. An acquired active trade or business is treated as beginning on the date of acquisition [I.R.C. § 195(c)(2)(B)].

Whether the active business had begun was the focus of the following court cases.

Airplane Dealership/Aerial Photography

The taxpayer had not satisfied the franchisor's requirements to manufacture light sport aircraft by the close of the tax year for which he sought to deduct expenses. The Tax Court held that none of his activities constituted a trade or business, and, at best, were nondeductible start-up expenses. Because the amortization period did not commence, the taxpayer could not amortize those costs [*Bramlett v. Commissioner*, T.C. Summary Opinion 2012-73].

Automobile Production

A taxpayer whose ideas included designing one-of-a-kind vehicles for celebrities, producing reduced-emission vehicles for commercial applications, developing a motorcycle-powered sports car, and developing a unique sports car to sell in China provided evidence of an intent to construct automobiles but failed to prove that a commercial product existed or that the activity had advanced beyond the exploration stage. The taxpayer was still searching for a manufacturer to fabricate, test, and produce the concept vehicles it wanted to market [*Weaver v. Commissioner*, T.C. Memo. 2004-108].

Cellular Phone Company

Expenses of a cellular phone company may not be deducted where it has not commenced to provide service. The mere possession of an FCC license is insufficient evidence of the existence of a trade or business. In applying the test for whether an entity is a trade or business, the Tax Court held that activities of the entity must stand on their own without reference to the activities of affiliated entities. The use of the entity's licenses by another entity to operate a cellular network was insufficient to prove that the entity in question was engaged in a trade or business [*Broz v. Commissioner*, 137 T.C. 46 (2011)].

Restaurant and Nightclub

A couple purchased and began renovating a building because they intended to open a restaurant and nightclub. The owners arranged for some charitable fundraising events to be held at the property while the renovations continued, but they charged no rent for the use of the property and did not retain any of the proceeds. The Tax Court concluded that the taxpayers did not actually operate the facility as a going concern during the years in question [*Wilson v. Commissioner*, T.C. Memo. 2002-61].

The trade or business of a restaurant does not begin until the restaurant opens to the public [*Contreras v. Commissioner*, T.C. Memo. 2007-63].

Rental Cabins

A couple who purchased and began renovating lakeside rental cabins deducted expenses for supplies, taxes, travel, utilities, legal and professional services, and car and truck expenses related to the cabins. Renovation was completed in the year at issue, but the cabins were not offered for rent until 4 years later. Thus, the court concluded that the costs were preoperational start-up expenses that were not currently deductible [*Charlton v. Commissioner,* 114 T.C. 333 (2000)].

Software Development

A software development company that continued to revise its prototype product had progressed beyond start-up or preoperating activities, even though it had only one sale and wasn't soliciting orders, the US Court of Federal Claims held in *Lamont v. United States*, 80 A.F.T.R. 2d 97-7320 [Ct. Fed. Cl. 1997]. Three computer programmers actively worked for the company on a part-time basis throughout the year to develop the software.

Tree Farm

A taxpayer who was investigating the feasibility of creating a tree farm on his property was not engaged in an active trade or business. He conducted a "pre-purchase economic and market feasibility study," hired an expert to prepare a forestry management plan, and conducted an unsuccessful pilot planting to determine if the land could support a particular species of pine trees, but he had neither harvested any trees nor decided which species to plant [*McKelvey v. Commissioner*, T.C. Memo. 2002-63, *aff'd* (unpublished opinion) 76 Fed. Appx. 806 (9th Cir. 2003)].

NEW BUSINESS MODELS AND NONTRADITIONAL OCCUPATIONS

As the Internet has opened many new opportunities both for business and recreation, additional challenges have arisen to a correct determination of whether an activity constitutes a trade or business.

Defining the term *trade or business* may be an issue not only for taxpayers engaged in moonlighting activities, investing, or pursuing hobbies but also for individuals engaged in uncommon occupations.

Gambling

In *Commissioner v. Groetzinger*, 480 U.S. 23 (1987), a gambler who spent 60 to 80 hours each week at the dog races was held to be engaged in the trade or business of gambling. In reaching its conclusion, the Supreme Court relied on four factors:

1. The activity was engaged in on a regular and continuous basis.
2. The taxpayer spent substantial time studying racing forms, programs, and other materials to develop expertise and increase his income.
3. Gambling was his sole occupation.
4. He intended to earn a living from his gambling activities.

Because gambling is often conducted under informal conditions with cash and poor records, the IRS may use the bank deposit method to reconstruct the taxpayer's income from gambling. Where the taxpayer presented credible testimony to support her contention that all of the money deposited in her account was not income, the IRS could not rely solely on the bank deposit method for determining income [*Caglia v. Commissioner*, T.C. Memo. 1989-143].

Observation Gambling Losses

Losses from wagering transactions can be deducted only to the extent of gains from such transactions whether or not the taxpayer is in the business of gambling. The effect of being in the business of gambling is that other gambling expenses such as the cost of travel, meals and entertainment, telephone and Internet, admission fees, and subscriptions can be deducted without limit under I.R.C. § 162(a) [*Mayo v. Commissioner*, 136 T.C. 81 (2011)].

Fiduciaries

A fiduciary may have SE income under I.R.C. § 1402. Rev. Rul. 58-5, 1958-1 C.B. 322, distinguishes between professional and nonprofessional fiduciaries. A professional fiduciary is always engaged in a trade or business and is subject to SE tax unless he or she is acting as an employee. Nonprofessional fiduciaries, on the other hand, are not considered to be engaged in a trade or business unless three criteria are met:

- A trade or business is included in the entity (estate or trust).
- The fiduciary is directly involved in that trade or business.
- The fiduciary's fees are related to the operation of the trade or business.

Creative Occupations

The absence of an actual profit does not necessarily negate a profit motive. Because profits are seldom quickly realized in creative ventures, activities such as creating works of art can still be activities engaged in for profit even if they sustain consistent losses for a period of time.

In *Churchman v. Commissioner*, 68 T.C. 696 (1977), the Tax Court found that a taxpayer pursued her painting and writing activities for 20 years with a bona fide intent to make a profit, even though she never realized a profit. Her history of losses as a not-for-profit factor "is less persuasive in the art field than it might be in other fields because the archetypal 'struggling artist' must first achieve public acclaim before her serious work will command a price sufficient to provide her with a profit," the court explained.

Selling Personal Property

There are many people who engage in selling goods either through Internet services such as eBay, Craigslist, and Amazon or through flea markets, antique malls, and peddler malls. While some of these means of selling are new, the rules applicable for determining whether a trade or business exists are the same. Many taxpayers that engage in such selling activities have poor or nonexistent records and have used personal bank accounts for their business.

Andrea F. Orellana was an IRS revenue officer who moonlighted from her day job by selling items on eBay [*Orellana v. Commissioner*, T.C. Summary Opinion 2010-51]. She was originally the subject of a criminal investigation that was dropped due to insufficient evidence. The taxpayer argued that she did not consider herself to be in business and so did not believe that she had an obligation to keep records. The Tax Court rejected her contention that she was not in business and held that it was reasonable for the IRS to reconstruct her income from subpoenaed bank, eBay, and PayPal records. Although the taxpayer could not prove the exact amount of her expenses, she could prove that she had expenses and was therefore allowed to estimate those expenses. Nonetheless, accuracy-related penalties were upheld.

Services

The Internet has facilitated the development of many e-commerce startups that allow individuals to sell their services in their individual capacity as independent contractors. Uber and Lyft are competing companies that provide driving or essential taxi services. All drivers work as self-employed independent contractors. These new companies face a host of issues that include adequacy of their drivers' insurance coverage and the lack of taxi licenses and driver training. The most serious tax issue facing Uber is whether their drivers are self-employed independent contractors or employees. The California Labor Commission ruled that an Uber driver was misclassified as an independent contractor and should have been classified as an employee [Thad Moore, "Uber Driver Is an Employee, Not a Contractor, California Regulators Say," *Washington Post,* June 17, 2015, last accessed July 6, 2015, `www.washingtonpost.com/blogs/the-switch/wp/2015/06/17/uber-driver-is-an-employee-not-a-contractor-california-regulators-say/`]. Uber has filed an appeal [Notice of Appeal, *Berwick v. Uber Technologies, Inc.,* Sup. Ct. Calif., County of San Francisco, June 16, 2015]. Uber argues that it is merely a technology platform that facilitates transactions between riders and drivers. The plaintiff driver

argues that Uber is much more and that it exercised sufficient control over her activities to render her an employee. Holding that the plaintiff was improperly classified as an independent contractor and should have been classified as an employee, the California Labor Commission's fact-finding included all the following factors:

1. Uber controlled the plaintiff's tools used (cars had to be registered with Uber and could not be more than 10 years old).
2. Uber monitored the plaintiff's approval ratings and would terminate her if her rating fell below 4.6 stars.
3. The plaintiff was allowed to hire employees, but only Uber-approved and -registered drivers may use Uber's intellectual property (for which it does not charge a fee).
4. Passengers paid a set price for each trip, and Uber paid the plaintiff a non-negotiable service fee.
5. The plaintiff was not guaranteed a cancellation fee for no-shows or cancellations after she accepts passengers (Uber has the sole right to negotiate cancellation fees with passengers).
6. Uber prohibits accepting tips because it interferes with its advertising and marketing strategy.
7. The plaintiff's sole investments in the business were her labor, car, and iPhone.
8. Uber provided the iPhone app that contains Uber's intellectual property that was essential to the plaintiff's work.
9. The plaintiff's work entailed the use of no managerial skills that could affect profit or loss.

These factors are very similar to the factors that the IRS uses to determine whether a person has been properly classified as an employee or an independent contractor [IRS Publication 15-A, *Employer's Supplemental Tax Guide* (2015), pp. 7–10]. Most of these factors relate in one way or another to the amount of control exercised over an individual and the extent of that individual's investment in the enterprise.

The Department of Labor has launched a Misclassification Initiative [Wage and Hour Division (WHD), "Misclassification of Employees as Independent Contractors," US Department of Labor (USDOL), last accessed July 6, 2015, `www.dol.gov/whd/workers/misclassification/`]. It signed a memorandum of understanding with the IRS in September 2011. The WHD of USDOL is expected to issue detailed guidance on proper classification of employees in the near future [Lauren Weber, "Some Bosses Reclassify Employees to Cut Costs," *Wall Street Journal*, July 1, 2015].

TRADE OR BUSINESS REFERENCES

This section provides a listing of numerous Internal Revenue Code sections that refer to a *trade or business*.

Internal Revenue Code sections that refer to a *trade or business* include the following sections. The title following each number is the section's actual title in the Internal Revenue Code.

I.R.C. § 32 Earned Income

The definition of disqualified income for the earned income credit (EIC) includes "rents and royalties not derived in the ordinary course of a trade or business" [I.R.C. § 32(i)(2)(C)(i)].

I.R.C. § 41 Credit for Increasing Research Activities

Any trade or business that increases research activities is entitled to a 20% credit for excess expenses over its base. The test is applied separately to each business component. I.R.C. § 41(b)(4) waives the trade or business requirement for in-house research expenses of certain start-up ventures.

I.R.C. § 45O Agricultural Chemicals Security Credit

For purposes of the agricultural chemicals security credit, "'eligible agricultural business' means any person in the trade or business of–(1) selling agricultural products, including specified agricultural chemicals, at retail predominantly to farmers and ranchers, or (2) manufacturing, formulating, distributing, or aerially applying specified agricultural chemicals."

I.R.C. § 61 Gross Income Defined

"Gross income derived from business" is specifically included in gross income.

I.R.C. § 62 Adjusted Gross Income Defined

Deductions attributable to a trade or business carried on by the taxpayer are allowed to compute AGI "if such trade or business does not consist of the performance of services by the taxpayer as an employee."

I.R.C. § 108 Income from Discharge of Indebtedness

Provisions for qualified real property business indebtedness and qualified farm indebtedness refer to use in "a trade of business."

I.R.C. § 141 Private Activity Bond; Qualified Bond

This section defines private activity bonds used to support a private trade or business.

I.R.C. § 162 Trade or Business Expenses

A deduction is allowed for "all the ordinary and necessary expenses paid or incurred . . . in carrying on any trade or business."

I.R.C. § 163 Interest

"Interest paid or accrued on indebtedness properly allocable to a trade or business (other than the trade or business of performing services as an employee)" is excluded from the definition of nondeductible personal interest.

I.R.C. § 164 Taxes

State and local taxes paid or accrued "in carrying on a trade or business" generally are deductible, even if they are not income or property taxes.

I.R.C. § 165 Losses

Deductions for individuals are limited to specified losses, including those "incurred in trade or business."

I.R.C. § 166 Bad Debts

Nonbusiness bad debts are debts other than those created or acquired "in connection with a trade or business of the taxpayer." Thus, business bad debts are deductible when partially worthless and are reported as ordinary deductions rather than as short-term capital losses.

I.R.C. § 167 Depreciation

"A reasonable allowance for the exhaustion, wear and tear" is allowed for "property used in a trade or business."

I.R.C. § 172 Net Operating Loss Deduction

Deductions "not attributable to a taxpayer's trade or business" are "allowed only to the extent of the gross income not derived for such trade or business."

I.R.C. § 179 Election to Expense Certain Depreciable Business Assets

Qualifying property is I.R.C. § 1245 property "acquired by purchase for use in the active conduct of a trade or business."

I.R.C. § 195 Start-Up Expenditures

A taxpayer may elect to expense up to $10,000 of qualifying start-up expenditures paid or incurred in connection with the creation or purchase of an active trade or business, with the remainder amortized over 180 months.

I.R.C. § 199 Income Attributable to Domestic Production Activities

The deduction allowable from domestic production activities income "shall be applied by only taking into account items which are attributable to the actual conduct of a trade or business."

I.R.C. § 263A Capitalization and Inclusion in Inventory Costs of Certain Expenses

The requirement to capitalize certain direct and indirect costs does not apply to "property produced by the taxpayer for use by the taxpayer other than in a trade or business or an activity conducted for profit." Special rules apply to "the trade or business of farming," and to an "individual in the trade or business . . . (other than as an employee) of being a writer, photographer, or artist."

I.R.C. § 274 Disallowance of Certain Entertainment, Etc., Expenses

Entertainment, amusement, or recreation expenses cannot be deducted unless they are directly related to the active conduct of the taxpayer's trade or business.

I.R.C. § 280A Disallowance of Certain Expenses in Connection with Business Use of Home, Rental of Vacation Homes, Etc.

Expenses associated with the business use of a home can be deducted only if the use is in a trade or business.

I.R.C. § 280E Expenditures in Connection with the Illegal Sale of Drugs

Expenses cannot be deducted if they are derived from a trade or business that "consists of trafficking in controlled substances (within the meaning of Schedule I and II of the Controlled Substances Act) that are prohibited by Federal law or the law of any State in which such trade or business is conducted."

Practitioner Note Marijuana Dispensaries

Marijuana sellers whose operations are legal under state law may be barred from deducting their ordinary and necessary business expenses because marijuana remains a Schedule I controlled substance under federal law.

I.R.C. § 280F Limitation on Depreciation for Luxury Automobiles; Limitation Where Certain Property Used for Personal Purposes

Deductions for depreciation expenses for luxury automobiles used in a trade or business are subject to limitations. Depreciation expenses for property whose use is predominately personal (business use not greater than 50%) are denied.

I.R.C. § 461 General Rule for Taxable Year of Deduction

I.R.C. § 461(i)(4) provides special rules for determining whether a trade or business of farming is a tax shelter. I.R.C. § 461(j) includes any trade or business of processing commodities produced by a taxpayer in the trade or business of farming for purposes of limits on excess farm losses.

I.R.C. § 465 Deductions Limited to Amount at Risk

Deduction of losses arising from operation of a trade or business are generally limited to losses attributable to amounts that the taxpayer had at risk.

I.R.C. § 469 Passive Activity Losses and Credits Limited

A passive activity is defined as any activity that "involves the conduct of any trade of business" in which the taxpayer does not materially participate.

I.R.C. § 482 Allocation of Income and Deductions among Taxpayers

This section allows the IRS to allocate income among trades or businesses that directly or indirectly have common ownership to avoid the evasion of taxes.

I.R.C. § 502 Feeder Organizations

"An organization operated for the primary purpose of carrying on a trade or business for profit shall not be exempt from taxation" on grounds that the profits are payable to a tax-exempt organization.

I.R.C. § 513 Unrelated Trade or Business

With exceptions, "any trade or business" that is not substantially related to the performance of an organization's tax-exempt purposes or function is an unrelated trade or business. I.R.C. § 511 imposes a tax on income from unrelated trades or businesses.

I.R.C. § 864 Definitions and Special Rules

For purposes of determining the source of income and withholding tax on nonresident aliens and foreign corporations, the term *trade or business within the United States* includes the performance of personal services within the United States at any time within the tax year.

I.R.C. § 871 Tax on Nonresident Alien Individuals

This section imposes tax on income of a nonresident alien derived from a trade or business conducted in the United States.

I.R.C. § 875 Partnerships; Beneficiaries of Estates and Trusts

A nonresident alien individual or foreign corporation is engaged in a trade or business within the United States if the partnership in which such an individual or corporation is a member is engaged in a trade or business in the United States. The same rule applies to nonresident aliens that are beneficiaries of trusts or estates engaged in a trade or business in the United States.

I.R.C. § 882 Tax on income of Foreign Corporations Connected with United States Business

A foreign corporation engaged in trade or business within the United States during the taxable year must include its income connected with the conduct of a trade or business within the United States in taxable income.

I.R.C. § 936 Puerto Rico and Possession Tax Credit

Taxpayers can claim a credit for trade or business activities conducted in Puerto Rico or other US possessions.

I.R.C. § 989 Other Definitions and Special Rules

For purposes of foreign currency transactions, the term *qualified business unit* means any separate and clearly identified unit of a trade or business of a taxpayer that maintains separate books and records.

I.R.C. § 954 Foreign Base Company Income

I.R.C. § 951 includes a pro rata share of a controlled foreign corporation's "foreign personal holding company income" in the gross income of its US shareholders. I.R.C. § 954(2)(A) excludes rents and royalties that are derived in the active conduct of a trade or business and that are received from a person other than a related person from foreign personal holding company income.

I.R.C. § 1031 Exchange of Property Held for Productive Use or Investment

Gain or loss is not recognized if property "held for productive use in a trade or business" is exchanged for like-kind property.

I.R.C. § 1033 Involuntary Conversions

The replacement period for reinvestment to postpone recognition of gain from involuntarily converted property is 3 years (rather than 2 years) after the year of gain if "real property held for productive use in a trade or business" is condemned.

I.R.C. § 1202 Partial Exclusion for Gain from Certain Small Business Stock

Taxpayers can exclude 50% of the gain from the sale of qualified small business stock held for more than 5 years. One of the requirements to be qualified small business stock is that 80% (by value) of the assets of the corporation must be used in the active conduct of one or more qualified trades or businesses.

I.R.C. § 1221 Capital Asset Defined

A capital asset is property held by the taxpayer that is not (1) held for sale in the ordinary course of the trade or business or (2) depreciable property or real property used in a trade or business.

I.R.C. § 1231 Property Used in the Trade or Business and Involuntary Conversions

When depreciable property and real property used in a trade or business and capital assets that are held in connection with a trade or business for more than 1 year are sold, net gains are taxable as capital gains, and net losses are deductible as ordinary losses.

I.R.C. § 1301 Averaging of Farm Income

Taxpayers engaged in a farming business [defined by reference to I.R.C. § 263A(e)(4) as the trade or business of farming] or fishing business may average income to account for the large annual fluctuations of income typical of those businesses.

I.R.C. § 1402 Definitions

Net earnings from self-employment for purposes of the self-employment tax means income from "any trade or business carried on by such individual." In community property states, income and losses are considered attributable to the spouse who actually engaged in the trade or business.

I.R.C. § 1411 Imposition of Tax

The net investment income tax applies to gross income from a "trade or business" (other than a trade or business that is a passive activity within the meaning of I.R.C. § 469 or a trade or business of trading financial instruments or commodities), reduced by deductions allocable to such gross income.

I.R.C. § 2032A Valuation of Certain Farm or Other Real Property

Special use valuation for estate taxes applies to qualified real property "used in a trade or business."

I.R.C. § 4943 Taxes on Excess Business Holdings

This section imposes a 10% tax on excess business holdings of a private foundation in a business enterprise. An additional 200% tax is imposed on the value of such excess business holdings on private foundations that fail to dispose of such holdings prior to the close of the applicable taxable year. A business enterprise does not include a trade or business in which at least 95% of the gross income is derived from passive sources.

I.R.C. § 5180 Signs

Businesses engaged in distilled spirits operations must display required signage or face penalties under I.R.C. § 5681.

I.R.C. § 5551 General Provisions Relating to Bonds

All businesses of a distiller, warehouseman, processor, brewer, or winemaker may not commence or continue such a business until all required bonds have been approved by the secretary of the Treasury or the officer designated by him or her.

I.R.C. § 5602 Penalty for Tax Fraud by Distiller

This antimoonshining provision applies penalties, including imprisonment, to those who engage in the trade or business of distilling with the intent to defraud the United States.

I.R.C. § 5721 Inventories

"Every export warehouse proprietor, shall make a true and accurate inventory at the time of commencing business, at the time of concluding business, and at such other times, . . . as the Secretary shall by regulation prescribe."

I.R.C. § 6038 Information Reporting with Respect to Certain Foreign Corporations and Partnerships

All US persons are required to report interests in foreign business entities, defined as a foreign corporation and a foreign partnership.

I.R.C. § 6166 Extension of Time for Payment of Estate Tax for Closely Held Business

A portion of the estate tax liability may be deferred for up to 5 years and paid in up to 10 installments if more than 35% of the estate value is an interest in a closely held business. An interest in a closely held business is (1) an interest as a proprietor in a trade or business carried on as a proprietorship, (2) an interest as a partner in a partnership carrying on a trade or business, or (3) certain stock in a corporation carrying on a trade or business.

I.R.C. § 6334 Property Exempt from Levy

A limited amount of books and tools necessary for the taxpayer's trade, business, or profession is exempt from levy.

I.R.C. § 7011 Registration—Persons Paying a Special Tax

Persons engaged in any trade or business required to pay a special tax are required to register with the secretary of the Treasury.