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ORDINARY AND NECESSARY BUSINESS EXPENSE

PRIMER

Introduction

Determining the deductibility of a trade or business expense has consistently remained one of the top ten most litigated issues before the U.S. Tax Courts and is important to businesses of all sizes. Under § 162 of the Internal Revenue Code (IRC),[1] an expense is deductible if it is an ordinary and necessary one incurred in the carrying on of a trade or business. Much litigation arises from these key elements, namely the expense's ordinariness and necessity, and also whether the taxpayer is engaged in a trade or business. This primer focuses on the first two elements, ordinary and necessary, and explains how an expense may be deducted with regard to the applicable legal tests.

Relevant Law

§ 162(a) of the IRC allows the deduction of all *ordinary and necessary* business expenses incurred in the relevant tax year in the carrying on of a trade or business. Sections 1.162-1 to 1.162(l)-1 of the Regulations[2] provide further direction on how this is applied practically and help describe the various types of deductible expenses including salaries, travel expenses, repairs, materials and supplies, automobile operating expenses, advertising costs, and insurance premiums among many others.

Notwithstanding this guidance, the Internal Revenue Service (IRS) and taxpayers frequently disagree on whether an expense is presently deductible, whether it is one better made on account of capital, or

whether it is one the taxpayer is entitled to make. If an expense is both ordinary and necessary, it may be deducted from the taxpayer's income in the year it was incurred. Such a right has been called a "matter of legislative grace," meaning that it subsists in the wording of the IRC's text as proscribed by Congress and the burden resides with the taxpayer to prove they are entitled to it.

Despite the extensive text available under the IRC and the Treasury Regulations, a precise definition of both ordinary and necessary is unavailable. Courts, therefore, look to case law for guidance, including the foundational case, *Welch v. Helvering.*[3] It describes an ordinary expense as one that is "common and accepted" in the taxpayer's business and a necessary expense as one that is merely "appropriate and helpful." More recently, *Indopco*[4] restated the law but with a particular focus on the difference between capital expenses and those that are ordinary and necessary, a distinction that remains important in Tax Court litigation.

Necessary Expenses

The necessary test is, generally, easier to satisfy than the ordinary test. To determine necessity, the court asks whether the expense was appropriate and helpful to the taxpayer's business, which is usually a low threshold to meet. Such expenses have included the costs of defending allegations of fraud in litigation,[5] the cost of operating a private plane to attend meetings,[6] and payments to reduce royalty fees,[7] all considered necessary under the attendant circumstances.

One line of argument goes that an expense is necessary if it maintains or improves the business. Such necessary costs include those like advertising and marketing, entertaining suppliers or clients, or educating employees, however, the distinction between when such an expense is capital in nature may not always be clear.

In circumstances where the expense is not necessarily part of the usual costs of doing business, it may be considered necessary because it prevents a temporary or permanent disruption to the business. One unique case allowed the deduction of termination fees paid following a failed white knight bid because the expense was incurred on the genuine belief that it was necessary to defend the business from a hostile takeover.[8]

Importantly, such expenses must be made primarily for the business' benefit and not some other party. Courts are understandably hesitant to tell owners how to run their business, however, if an expense directly benefits the business' owner, the court may consider the expense unnecessary. For example, excessive salaries will attract an analysis of the difference between a reasonable salary and that deducted by the taxpayer to determine whether the full amount is necessary. An individual or group of individuals may also profit personally from a business expense in more subtle ways. In one case before the Second Circuit Court of Appeals,[9] benefits from life insurance accrued only to shareholders of certain closely held corporations, but not their employees. The court held the expenses were not deductible because they were not necessary to the business overall.

Ordinary Expenses

An expense is ordinary if it is normal, usual or customary in the taxpayer's business, or in the taxpayer's industry.[10] There are two main considerations: whether the expense is incurred by the taxpayer's competitors, and whether the expense is capital in nature. If the expense is a capital, it is not ordinary.

Generally, courts determine ordinariness by asking if the expense was customary in the taxpayer's industry through recurring or frequent incurrence; regularity is a sufficient but not necessary condition. For example, an expense may be incurred only once in a business' lifetime but if it is incurred commonly in the industry as a whole, it is likely customary. In a case regarding the deductibility of kickbacks in the construction industry, the Sixth Circuit held that because legal kickbacks were customary in the construction industry, they were ordinary expenses.[11] While such cases are rare, they show that courts can find a questionably incurred expense ordinary.

Capital expenditures, on the other hand, are not ordinary because they represent an investment in the business. In *Indopco*, the court laid out the law on differentiating between ordinary expenses, and capital expenses. If a taxpayer's expense creates or enhances an asset, this asset is capital. If an expense gives the taxpayer a future benefit, this is also capital. Such expenses must be amortized and deducted over the lifetime of the asset, which, for many taxpayers is less desirable than immediately deducting the full value of the expense from the immediate year's income. Note, however, that in circumstances of repair or maintenance, if the expense does not increase the overall value of the relevant asset, then it is better classed as an immediately deductible ordinary and necessary expense. For example, repairing windows damaged in an accident with identical panes would likely be considered a deductible ordinary and necessary expense. If, however, the taxpayer opts to install higher quality panes that reduce noise and heat loss, then they have more likely made a capital addition, which must be accounted for as capital.

Due consideration must also be given to whether the expense materially prolongs the life of the relevant asset or whether it allows it to be put to new use. The restoration of a vehicle, for example, can attract an argument as to capital investment. If an old company vehicle is repaired and painted a new color that makes it drivable for a new purpose, such as transporting passengers, when it was previously used to transport only goods, is likely to be a capital investment.

Blue J Legal Products

IRS Publication 535[12] provides U.S. taxpayers with practical guidance on deducting ordinary and necessary business incurred in the carrying of a trade or business but does not navigate the finer legal arguments involved. Blue J Legal's Deductibility of Trade or Business Expenses Classifier does. It identifies the factors important to a court's analysis and then asks the user a series of questions based on these factors and the specific fact pattern at hand. By then running that data through a machine learning algorithm trained on hundreds of U.S. Tax Court and Circuit Court opinions, it can predict the likelihood the relevant expense would be deductible under the given circumstances. It will also identify, and provide access to, those cases with a most similar fact pattern for further research.

Endnotes

1 26 U.S.C.
2 26 C.F.R.
3 *Welch v. Helvering*, 290 U.S. 111 (1933) (Welch v. Helvering).
4 *Indopco, Inc v. Commissioner of Internal Revenue*, 503 U.S. 79 (1992) (Indopco).
5 *Commissioner of Internal Revenue v. Tellier*, 383 U.S. 687 (1966).
6 *Noyce v. Commissioner of Internal Revenue*, 97 T.C. 670 (T.C., 1991).
7 *T.J. Enters Inc., v. Commissioner of Internal Revenue*, 101 T.C. 581 (T.C., 1993).
8 *Santa Fe Pacific Gold Co. v. Commissioner of Internal Revenue*, 132 T.C. 240 (T.C., 2009).
9 *Curcio v. Commissioner of Internal Revenue*, 689 F.3d 217 (2nd Cir., 2012).
10 *Deputy v. Du Pont*, 308 U.S. 488 (1940). This definition has supplanted that enunciated in Welch v. Helvering and is much more frequently invoked.
11 *Raymond Bertolini Trucking Co. v. Commissioner of Internal Revenue*, 736 F.2d 1120 (6th Cir., 1984).
12 Department of the Treasury, IRS Publication 535: For use in preparing 2017 Returns, available here: https://www.irs.gov/pub/irs-pdf/p535.pdf.