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Trade or Business?

-by Robert P. Achenbach, Jr., J.D.

In general, a taxpayer is entitled to deduct all ordinary and necessary expenses paid or incurred during the taxable year in carrying on a trade or business[1] or for the production or collection of income.[2] Ordinary expenses are ones that arise by virtue of common or frequent occurrences in the taxpayer's business, and necessary expenses are ones that are appropriate and helpful for the development of the business.[3]

Wegener v. Commissioner[4]

In this recent case, the taxpayer was employed full time as a financial officer for a national food corporation. The taxpayer established a business entitled "Kent's Cocoa llc," although the business was not organized as a limited liability company. The taxpayer reported the main business activity of the LLC as merchant wholesaler of raw farm products.

The taxpayer learned about Ghanaian cocoa farming through the taxpayer's employer's procurement of cocoa for the corporation's food products. The taxpayer entered into eight written limited partnership agreements with Ghanaian farmers under which the farmers agreed to transfer their assets to the partnerships including land, improvements, unharvested crops, and inventories of salable farm products, and the taxpayer agreed to make capital contributions to the partnerships. The taxpayer also agreed to make loans to the farmers which were to be paid first if the farms produced a profit.

The farms were managed by the farm owners or hired managers who were required to maintain records, but the farmers and managers only produced summaries of activities and expenses.

The taxpayer claimed the amounts provided to the partnerships as Schedule C expenses, labeled "monies invested in partnerships" but the IRS disallowed the deductions for lack of a trade or business.

Trade or Business

Although the Code provides no definition for a trade or business, the U.S. Supreme Court has stated: "[T]o be engaged in a trade or business, the taxpayer must be involved in the activity with continuity and regularity and . . . the taxpayer's primary purpose for engaging in the activity must be for income or profit."[5] A taxpayer's management of the taxpayer's own investments is generally not a trade or business.[6]

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A court looks at three requirements to determine whether an activity is a trade or business: (1) the taxpayer undertook the activity intending to earn profit; (2) the taxpayer is regularly and actively involved in the activity; and (3) the activity has actually commenced.[7] Failing to meet any one of these three requirements is dispositive that the taxpayer was not engaged in a trade or business.

For regular and active involvement to give rise to a trade or business, (item (2) above) the taxpayer must show extensive business activity over a substantial period. Sporadic activities, hobbies, and amusement diversions are not enough to establish a trade or business. When determining whether a taxpayer's involvement is regular and active, the courts consider whether the taxpayer devoted time to another job.[8]

In *Wegener*,[9] the court found that the taxpayer did not regularly and actively participate in the cocoa farming operations but merely invested in the farms in exchange for a portion of the farmers' assets and profits. Thus, the court found that the taxpayer's involvement was limited to providing funding for the farms.

In addition, the court noted that the taxpayer claimed that most of the funding was provided as loans to the farmers. The court held that loans are not a deductible business expense, even if the taxpayer had established that the taxpayer regularly and actively participated in the farming operations.[10]

Production of Income

Under I.R.C. § 212(1), a deduction is allowed for ordinary and necessary expenses incurred in the production of income. The cases agree that a taxpayer must establish that the activity is engaged in with the intent to make a profit. The determination of intent to make a profit is made under I.R.C. § 183 and the nine elements provided in the regulations:[11] (1) the manner in which the taxpayer carried on the activity, (2) the taxpayer's expertise, (3) the time and effort that the taxpayer expended in carrying on the activity, (4) the expectation that assets used in the activity may appreciate in value, (5) the taxpayer's success in carrying on other similar or dissimilar activities, (6) the activity's history of income or loss, (7) the amount of profit, if any, (8) the taxpayer's financial status, and (9) any elements of personal pleasure or recreation involved.

In *Wegener*,[12] the court held that the taxpayer's involvement in the cocoa farms was not for the purpose of making a profit because (1) the activity was carried on primarily through e-mails and online chats and the taxpayer did not provide any written substantiation for the expenses; (2) the taxpayer had no expertise in cocoa farming; (3) the taxpayer spent a limited amount of time on the activity, given the taxpayer's full time employment; (4) the taxpayer provided no evidence that the property of the farms would appreciate in value; (5) the activity did not produce any profits; (6) the activity produced only losses; (7) the losses from the activity offset the taxpayer's income from other sources; and (8) the taxpayer received personal pleasure from working with the Ghanaian farmers.

Conclusion

Although the *Wegener* case involved participation with farmers in another country, the same rules apply to similar participation in farms in this country in that mere investors in farms will find it difficult to deduct the costs of such investments without active and regular participation in the farming operation.

ENDNOTES

[1] I.R.C. § 162(a).

[2] I.R.C. § 212(1).

[3] Commissioner v. Tellier, 383 U.S. 687 (1996); Deputy v. du Pont, 308 U.S. 488 (1940).

[4] T.C. Memo. 2019-98.

[5] Commissioner v. Groetzinger, 480 U.S. 23 (1987).

[6] See Whipple v. Comm'r, 373 U.S. 193 (1963); Hatcher v. Comm'r, T.C. Memo. 2016-188.

[7] Jafarpour v. Comm'r, T.C. Memo. 2012-165.

[8] Jafarpour v. Comm'r, T.C. Memo. 2012-165.

[9] T.C. Memo. 2019-98.

[10] *See, e.g.*, Herrick v. Comm'r, 63 T.C. 562 (1975); Canelo v. Comm'r, 53 T.C. 217 (1969), *aff'd per curiam*, 447 F.2d 484 (9th Cir. 1971).

[11] Treas. Reg. § 1.183(a). See Harl and Achenbach, *Agricultural Law*, § 30.06 (2019).

[12] T.C. Memo. 2019-98.

CASES, RULINGS, REGULATIONS AND STATUTES

BANKRUPTCY

GENERAL

EXEMPTIONS

IRA. The debtor filed for Chapter 7 and one of the unsecured claims was for an unpaid loan. The debtor's estate included three IRAs, a I.R.C. § 401(k) pension and a distribution from an IRA. The debtor claimed an exemption under O.C.G.A. § 44-13-100(a)(2)(E) for the first three IRAs, a contributory IRA, a Roth conversion IRA and a contributory Roth IRA. The debtor claimed an exemption under O.C.G.A. § 44-13-100(a)(2.1) for the pension plan and IRA distribution. O.C.G.A. § 44-13-100(a)(2.1) allows a debtor to exempt the aggregate interest in any funds or property held on behalf of the debtor, but not yet distributed to the debtor, under an "individual retirement account within the meaning of Title 26 U.S.C. [§] 408." The court held that the contributory IRA and the pension plan were eligible for the