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MPT-2 Library:
Nash v. Franklin Department of Revenue

Excerpts from Internal Revenue Code

Internal Revenue Code § 162. Trade or business expenses

(a) In general. There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business . . .

Internal Revenue Code § 183. Activities not engaged in for profit

(a) General rule. In the case of an activity engaged in by an individual . . . , if such activity is not engaged in for profit, no deduction attributable to such activity shall be allowed under this chapter except as provided in this section.

(b) [deductions for activity not engaged in for profit limited to the amount of income earned by that activity] [text omitted]

(c) Activity not engaged in for profit defined. For purposes of this section, the term "activity not engaged in for profit" means any activity other than one with respect to which deductions are allowable for the taxable year under section 162. . . .

Internal Revenue Code § 280A. Disallowance of certain expenses in connection with business use of home, rental of vacation homes, etc.

(a) General rule. Except as otherwise provided in this section, in the case of a taxpayer who is an individual . . . , no deduction otherwise allowable under this chapter shall be allowed with respect to the use of a dwelling unit which is used by the taxpayer during the taxable year as a residence.

. . .

(c) Exceptions for certain business or rental use . . .

(1) Certain business use. Subsection (a) shall not apply to any item to the extent such item is allocable to a portion of the dwelling unit which is exclusively used on a regular basis—

(A) as the principal place of business for any trade or business of the taxpayer.

Excerpts from Code of Federal Regulations
Title 26. Internal Revenue

26 C.F.R. § 1.183–2. Activity not engaged in for profit defined.

(a) In general. [Except as otherwise provided . . . ,] no deductions are allowable for expenses incurred in connection with activities which are not engaged in for profit. . . . The determination whether an activity is engaged in for profit is to be made by reference to objective standards, taking into account all of the facts and circumstances of each case. Although a reasonable expectation of profit is not required, the facts and circumstances must indicate that the taxpayer entered into the activity, or continued the activity, with the objective of making a profit. . . . In determining whether an activity is engaged in for profit, greater weight is given to objective facts than to the taxpayer's mere statement of his intent.

(b) Relevant factors. In determining whether an activity is engaged in for profit, all facts and circumstances with respect to the activity are to be taken into account. No one factor is determinative in making this determination. In addition, it is not intended that only the factors described in this paragraph are to be taken into account in making the determination, or that a determination is to be made on the basis that the number of factors (whether or not listed in this paragraph) indicating a lack of profit objective exceeds the number of factors indicating a profit objective, or vice versa. Among the factors which should normally be taken into account are the following:

(1) Manner in which the taxpayer carries on the activity. The fact that the taxpayer carries on the activity in a businesslike manner and maintains complete and accurate books and records may indicate that the activity is engaged in for profit. Similarly, where an activity is carried on in a manner substantially similar to other activities of the same nature which are profitable, a profit motive may be indicated. A change of operating methods, adoption of new techniques or abandonment of unprofitable methods in a manner consistent with an intent to improve profitability may also indicate a profit motive.

(2) The expertise of the taxpayer or his advisors. Preparation for the activity by extensive study of its accepted business, economic, and scientific practices, or consultation with those who are expert therein, may indicate that the taxpayer has a profit motive where the taxpayer carries on the activity in accordance with such practices. . . .

(3) The time and effort expended by the taxpayer in carrying on the activity. The fact that the taxpayer devotes much of his personal time and effort to carrying on an activity, particularly if the activity does not have substantial personal or recreational aspects, may indicate an intention to derive a profit. A taxpayer's withdrawal from another occupation to devote most of his energies to the activity may also be evidence that the activity is engaged in for profit. . . .

(4) Expectation that assets used in activity may appreciate in value. The term profit encompasses appreciation in the value of assets, such as land, used in the activity. . . .

(5) The success of the taxpayer in carrying on other similar or dissimilar activities. The fact that the taxpayer has engaged in similar activities in the past and converted them from unprofitable to profitable enterprises may indicate that he is engaged in the present activity for profit, even though the activity is presently unprofitable.

(6) The taxpayer's history of income or losses with respect to the activity. A series of losses during the initial or start-up stage of an activity may not necessarily be an indication that the activity is not engaged in for profit. However, where losses continue to be sustained beyond the period which customarily is necessary to bring the operation to profitable status, such continued losses, if not explainable as due to customary business risks or reverses, may be indicative that the activity is not being engaged in for profit. If losses are sustained because of unforeseen or fortuitous circumstances which are beyond the control of the taxpayer, such as drought, disease, fire, theft, weather damages, other involuntary conversions, or depressed market conditions, such losses would not be an indication that the activity is not engaged in for profit. A series of years in which net income was realized would of course be strong evidence that the activity is engaged in for profit.

(7) The amount of occasional profits, if any, which are earned. The amount of profits in relation to the amount of losses incurred, and in relation to the amount of the taxpayer's investment and the value of the assets used in the activity, may provide useful criteria in determining the taxpayer's intent. An occasional small profit from an activity generating large losses, or from an activity in which the taxpayer has made a large investment, would not generally be determinative that the activity is engaged in for profit. However, substantial profit, though only occasional, would generally be indicative that an activity is engaged in for profit, where the investment or losses are comparatively small.

. . .

(8) The financial status of the taxpayer. The fact that the taxpayer does not have substantial income or capital from sources other than the activity may indicate that an activity is engaged in for profit. Substantial income from sources other than the activity (particularly if the losses from the activity generate substantial tax benefits) may indicate that the activity is not engaged in for profit especially if there are personal or recreational elements involved.

(9) Elements of personal pleasure or recreation. The presence of personal motives in carrying on of an activity may indicate that the activity is not engaged in for profit, especially where there are recreational or personal elements involved. On the other hand, a profit motivation may be indicated where an activity lacks any appeal other than profit. It is not, however, necessary that an activity be engaged in with the exclusive intention of deriving a profit or with the intention of maximizing profits. . . . An activity will not be treated as not engaged in for profit merely because the taxpayer has purposes or motivations other than solely to make a profit. Also, the fact that the taxpayer derives personal pleasure from engaging in the activity is not sufficient to cause the activity to be classified as not engaged in for profit if the activity is in fact engaged in for profit as evidenced by other factors whether or not listed in this paragraph.

Stone v. Franklin Department of Revenue

Franklin Tax Court (2008)

In this appeal, we review and affirm a decision of the Franklin Department of Revenue denying deductions to taxpayers Jim and Maxine Stone related to the operation of a horse- breeding business. Orders of the Department of Revenue are presumed correct and valid; the taxpayer bears the burden of demonstrating that the challenged order is incorrect. *Nelson v. Franklin Dep't of Revenue* (Franklin Tax Ct. 1998). The Franklin legislature intended to incorporate the federal Internal Revenue Code (IRC) and the Code of Federal Regulations (CFR) for the purpose of determining Franklin taxable income.

The Stones claimed deductions for expenses relating to the operations of an alleged trade or business: a horse-breeding business operated under the name "Irontree." The FDR limited their deductions to the amount of income that they earned from horse breeding in each of the last seven tax years, because the Stones lacked a profit motive. The Stones appeal, seeking full deductions.

26 C.F.R. § 1.183–2 outlines the activities that may be considered "for profit" in order to allow income tax deductions. The regulation requires an objective standard and delineates nine factors used to assess whether the taxpayer "entered into the activity, or continued the activity, with the objective of making a profit." 26 C.F.R. § 1.183–2(a) & (b). These factors are not exclusive, nor is one factor or combination of factors determinative on the issue of profit motive. *Morton v. Franklin Dep't of Revenue* (Franklin Sup. Ct. 1984).

1) *Manner of Carrying Out Activity:* The Stones operated Irontree for nearly 20 years, and began to claim deductions for the last seven. The Stones offered slight evidence of businesslike operations. They produced no records of business activities. Mr. Stone knew little about when horses were purchased or sold, the prices paid, or what training occurred. They lacked a business plan and had no plan to recoup their losses. Such plans can suggest a motive to earn a profit. *Jennings v. Franklin Dep't of Revenue* (Franklin Tax Ct. 2001).

The Stones bought horse semen from a national champion. The Stones contend that this purchase reflected an effort to stem their losses, an effort that failed. The Stones never paid or received a salary from Irontree. Only for a hobby does one work for nothing for 20 years. The Stones advertised only by attending horse shows, an insufficient effort to advertise a horse breeding business. The Stones did not insure the assets of Irontree. Thus, when a horse slipped on some ice and eventually died, Irontree received nothing for its loss.

2) ***Taxpayer Expertise:*** The Stones have no formal education in breeding horses or the business of horse breeding. They have only recreational experience. They contend that they consulted with others on issues such as crossbreeding, animal care, and fence construction. But nothing shows that the Stones got or took advice on how to make Irontree profitable.

3) ***Time and Effort Invested:*** Mr. Stone claimed that he and his wife worked 30 to 40 hours per week on the farm, but did not show how he spent this time. The Stones kept full-time jobs. At best, we find this factor to be neutral.

4) ***Appreciation of Assets:*** Irontree consists of 20 acres, including the Stones' residence; barns for storage of hay, equipment, and tack; horse stalls; and wash stalls. Mr. Stone conceded that none of these assets appreciated.

5) ***Success in Similar Activities:*** Irontree was the Stones' first attempt at operating a horse-breeding operation or any business.

6) ***History of Income and Losses:*** The Stones own six horses. A seventh, Shiloh, was born and sold in 2005. During the years in question, Irontree accumulated losses of $132,751, compared to income of $4,000 from the sale of Shiloh. That $4,000 compared to losses of $33,901 in the same year. This history of losses over the entire existence of Irontree shows neither a history of profitability nor the potential for income to match losses.

7) ***Amount of Profits:*** Irontree made no profit in any of the years in question, or in any two consecutive years of its entire history. It seems unlikely that Irontree ever had the opportunity to generate a profit, let alone a profit substantial enough to justify the significant losses incurred.

8) ***Financial Status of Taxpayer:*** Mr. Stone worked for a bank during all the years in question, and Ms. Stone worked for an insurance agency. The Stones' income averaged $163,000. The Stones never received a salary or relied upon income from Irontree.

9) ***Recreational Nature of Activity:*** Mr. Stone engaged in rodeo events as part of his work with Irontree. He has been riding horses since he was a child, and rode horses in games and trail rides. Despite the hours and difficult work required to maintain the farm, the Stones' activities, including the pleasure in riding and caring for horses, indicate recreation, rather than operation of a business for profit.

Conclusion

For all of the foregoing reasons, we find that the factors outlined in 26 C.F.R. § 1.183–2(b)(1–9), except perhaps for factor three, weigh in favor of the Department. Therefore, we find that the Stones did not enter into the activity, or continue the activity, with the objective of making a profit. 26 C.F.R. § 1.183–2(a). The Department's assessment is affirmed.

Lynn v. Franklin Department of Revenue

Franklin Tax Court (2013)

Lorenzo Lynn claimed deductions for $2,307 in expenses attributable to the business use of his homes. The Franklin Department of Revenue denied those deductions and assessed additional tax due. Lynn paid the tax and then filed a claim for a refund. After an administrative review affirmed the Department's decision, Lynn timely appealed to this court. We affirm in part and reverse in part.

Lynn claimed that he operated his law practice first out of his house in Chatsworth, Franklin, and then out of his apartment in Athens, Franklin (to which he moved in May 2006). He claimed that the first floor of the Chatsworth house (25% of the total area of the house) and one of the eight rooms of the Athens apartment (the "computer office room") were used exclusively for his law practice. The Department argues that Lynn did not use any portion of either his house or his apartment exclusively as a principal place of business and that he is not entitled to any deduction for the business use of either residence.

We note that the Franklin legislature intended to make Franklin personal income tax law identical to the Internal Revenue Code (IRC) for purposes of determining Franklin taxable income, subject to adjustments and modifications specified by Franklin law. IRC § 280A provides that, generally, no deduction is allowed with respect to the personal residence of a taxpayer. However, under § 280A(c)(1)(A), this prohibition does not apply to expenses allocable to a portion of the taxpayer's residence that is used exclusively and on a regular basis as the principal place of business for any trade or business of the taxpayer. The exclusive use requirement is an "all-or-nothing" standard. *McBride v. Franklin Dep't of Revenue* (Franklin Tax Ct. 1990). The legislative history explains:

> Exclusive use of a portion of a taxpayer's dwelling unit means that the taxpayer must use a specific part of a dwelling unit solely for the purpose of carrying on his trade or business. The use of a portion of a dwelling unit for both personal purposes and for the carrying on of a trade or business does not meet the exclusive use test.

S. Rept. No. 94–938, at 48 (1976).

We first consider the Chatsworth house. We find that Lynn used the first floor of the premises—25% of the total area of the home—exclusively and on a regular basis as the principal place of business of his law practice. The area's physical separation from the living areas of the home, its physical conversion from a residential-type "mother-in-law suite" to an office, and the fact that it had a separate entrance with an awning all inform our finding.

We next consider the "computer office room" of the Athens apartment. We find that Lynn did not prove that he used the "computer office room" exclusively as the principal place of business of his law practice. Lynn testified cursorily that he used the room exclusively for his law practice and that he stored files and law books there. But he offered almost no details about what was in the room and how the room was used. His reference to the room as the "computer office room" suggests that his computer was in the room, but we believe that he used his computer for both personal and business tasks. Moreover, he testified that he would occasionally watch his infant daughter in that room, while his wife attended to personal business, and that he would do so by having his daughter watch television at a low volume. The presence of a television in the room, coupled with his cursory testimony about business use, leads us to conclude that Lynn has not met his burden of proving that he used the "computer office room" exclusively as his principal place of business.

Accordingly, we reverse the determination of the Department as it relates to the business use of the Chatsworth home and affirm its determination as it relates to the Athens apartment.