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**Preliminary Information from Task Memo**

- **Client:** Joseph and Ellen Nash
- **Task:** Legal argument portion of a post-hearing brief to the Franklin Tax Court
- **Claim:** Mr. Nash’s testimony establishes the right under Franklin law, which uses the federal Internal Revenue Code and regulations to calculate Franklin tax liability, to the full deductions that the Nashes claimed
- **Posture:** Persuasive

<b>General Rule:</b> <u>Stone</u> (Franklin Tax Court 2008)	
Holding	The Franklin Department of Revenue’s decision denying deductions to taxpayers was affirmed because the taxpayers could not establish a profit motive for their horse farm
Rules	<ul style="list-style-type: none"> <li>• 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</li> <li>• Orders of the Department of Revenue are presumed correct and valid; the burden is on the taxpayer to demonstrate that the challenged order is incorrect</li> </ul>
<b>A. Full deductions for farm expenses from 2011 to 2015</b>	
Rules	<ul style="list-style-type: none"> <li>• Under IRC § 162, deduction of “expenses paid or incurred during the taxable year in carrying on any trade or business”</li> <li>• Under IRC § 182, “activity not engaged in for profit” limits deductions to the amount of income earned from the activity</li> <li>• Under 26 C.F.R. § 1.183-2(a), “activity not engaged in for profit” focuses on whether “the taxpayer entered into the activity, or continued the activity, with the objective of making a profit;” the taxpayer’s statement of intent receives less weight than objective factors</li> <li>• Under 26 C.F.R. § 1.183-2(b), there are nine factors to assess whether activity is engaged in for profit; no one factor is determinative, nor is a counting of a majority of those factors</li> </ul>
<b>(1) Manner of carrying out activity</b>	
Rule ( <u>Stone</u> ; 26 C.F.R. § 1.183-2(b))	The following may indicate a profit motive: carrying on the activity in a businesslike manner, maintaining complete and accurate books and records, changing operating methods, adopting new techniques, or abandoning unprofitable methods to improve profitability

Rule Explanation ( <u>Stone</u> )	No business plan, did not insure assets, no advertising, did not pay themselves, and no employees
File (Joseph Nash testimony)	<ul style="list-style-type: none"> <li>• Began operating as a tree farm in 2011</li> <li>• Kept records of activities and books of accounts of sales and expenses</li> <li>• Took advice from nearby Christmas tree farmer about managing larger operation</li> <li>• Changed business approach in 2011 to increase farm’s profitability</li> <li>• Insured farming equipment, maintained good connections with commercial buyers of their trees, and hired harvest helpers</li> </ul>
<b>(2) Taxpayer expertise</b>	
Rule	Preparation by consultation with experts or extensive study of accepted business, economic, and scientific practices may indicate profit motive where the taxpayer carries on the activity in accordance with such practices
Rule Explanation ( <u>Stone</u> )	No expertise because lacked formal education in horse breeding, and no evidence they sought or received advice on making business more profitable
File (Joseph Nash testimony)	<ul style="list-style-type: none"> <li>• Lived on 13-acre property for many years</li> <li>• Read extensively on tree farming and took courses on forest management</li> <li>• Apprenticed with nearby farmer; consulted with him about increasing production to increase profits</li> </ul>
<b>(3) Time and effort invested</b>	
Rules	<ul style="list-style-type: none"> <li>• Devoting much personal time and effort to carrying on an activity may indicate a profit motive</li> <li>• Withdrawing from another occupation to devote energies to an activity may indicate a profit motive</li> </ul>
Rule Explanation ( <u>Stone</u> )	Taxpayers had other full-time jobs; neutral factor at best
File (Joseph Nash testimony)	<ul style="list-style-type: none"> <li>• Ellen retired from county job in 2011 and runs Christmas tree farm full-time</li> <li>• Joseph has full-time job as associate principal to cover living and business expenses</li> <li>• Joseph devotes summers, weekends, and additional time during harvest season to work on the farm</li> </ul>

(4) Appreciation of assets	
Rule	Profit encompasses appreciation in the value of assets, such as land, used in the activity
Rule Explanation (Stone)	None of the business assets (e.g., horse farm) appreciated
File (Joseph Nash testimony)	<ul style="list-style-type: none"> <li>• Added improved tree-farming techniques to increase inventory</li> <li>• No appreciation in value of principal assets</li> <li>• Added new equipment, cleared additional acreage, and adopted practice of planting in rows and providing space for rotation of new seedlings</li> </ul>
(5) Success in similar activities	
Rule	Converting past similar activities from unprofitable to profitable may indicate a profit motive, even if the activity is presently unprofitable
Rule Explanation (Stone)	No previously run similar business; horse breeding farm was first attempt at operating horse-breeding operation
File (Joseph Nash testimony)	Never ran tree-farming business before
(6) History of income and losses	
Rule	If losses continue beyond the period customarily necessary to make the operation profitable and are not due to customary business risks or reverses, it may indicate that the activity is not being engaged in for profit; a series of years in which net income is realized is strong evidence of a profit motive
Rule Explanation (Stone)	History of losses over entire existence of horse farm; no profitability or potential for income to match losses
File (Joseph Nash testimony)	<ul style="list-style-type: none"> <li>• Loss in first year was due to heavy start-up investment</li> <li>• 2014 and 2015: hired workers to handle increased volume of sales</li> <li>• Depressed economy was unforeseen</li> <li>• Still sold trees every year from 2011 to 2015</li> </ul>

(7) Amount of profits	
Rule	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 evidence of the taxpayer’s intent
Rule Explanation (Stone)	Horse farm made no profit in years taxpayers were claiming full deductions; there was no profit in any two consecutive years over the entire 20-year history
File (Joseph Nash testimony)	<ul style="list-style-type: none"> <li>• No profit from 2011 to 2015, but sold trees in each of those years</li> <li>• Margin between losses and income has narrowed (loss of \$33,500 in 2011 and loss of \$7,500 in 2015)</li> <li>• Steady increase in yearly income (\$1,500 yearly increase from 2013 to 2015)</li> </ul>
(8) Financial status of taxpayer	
Rule	Lack of substantial income or capital from other sources may indicate a profit motive; substantial income from other sources may indicate that the activity is not engaged in for profit, especially if there are personal or recreational elements involved
Rule Explanation (Stone)	No salary or income from the horse farm; one taxpayer worked for a bank, and the other worked for an insurance agency
File (Joseph Nash testimony)	<ul style="list-style-type: none"> <li>• Ellen works full-time on the farm</li> <li>• Money from Ellen’s pension and Joseph’s job support them and their business</li> </ul>
(9) Recreational nature of activity	
Rule	Personal motives in carrying on an activity may indicate that the activity is not engaged in for profit, especially where there are recreational or personal elements involved, but 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
Rule Explanation (Stone)	One of the taxpayers participated in rodeo events, had ridden horses since he was a child, rode horses in games and trail rides, and took pleasure in riding and caring for horses, despite the time and difficult work required to maintain the farm

File (Joseph Nash testimony)	<ul style="list-style-type: none"> <li>• Christmas tree farm initially was a recreational activity, making \$1,000 per season</li> <li>• Specific expansion efforts, a home office, and education show it's no longer run as a recreational activity</li> <li>• Ellen and Joseph enjoy the activity but aim to make a profit</li> </ul>
<b>Conclusion on A:</b> Franklin Department of Revenue erred in denying full deduction of cost of operating the farm	
<b>B. Full deductions for home office</b>	
Rule	<ul style="list-style-type: none"> <li>• Under IRC § 280A, no taxpayer may take a deduction if the dwelling unit is used during the taxable year as a residence</li> <li>• Under § 280A(c)(1)(A), a deduction is permitted if the dwelling is exclusively used on a regular basis as a principal place of business for the taxpayer</li> </ul>
<u>Lynn</u> (Franklin Tax Court 2013)	
Holding	Lawyer may deduct as an expense the portion of his house used exclusively for practice, but not the room in his apartment because he could not prove that it was used exclusively for practice
Rule	Exclusive use is an “all or nothing” standard; the taxpayer’s dwelling must be used specifically for trade or business, and a physical separation from the other living areas is required
Rule Explanation	<ul style="list-style-type: none"> <li>• Home: office in house was separated from living areas, there was a physical conversion from a residential “mother-in-law” suite to an office, and there was a separate entrance</li> <li>• Apartment: little evidence of the room’s actual purpose; stored computer and law books there but also babysat his child, who watched TV in the room</li> </ul>
File (Joseph Nash testimony)	<ul style="list-style-type: none"> <li>• TV in Nash home office, but it is turned to the weather channel, which is vital to running the farm</li> <li>• Recliner and dogs in the office</li> <li>• The room stores books and accounts for the business, and Joseph never used the room for any other purpose than the business</li> </ul>
<b>Conclusion on B:</b> Franklin Department of Revenue erred in denying the full home-office deduction	
<b>Overall Conclusion:</b> Franklin Department of Revenue erred in denying full deductions for farm expenses and the home office	