POST HEARING BRIEF

III. Legal Argument

The Franklin legislature intended to incorporate the federal Internal Revenue Code (IRC) and the Code of the Federal Regulations (CFR) for the purpose of determining Franklin taxable income. Stone v. Franklin Dept. of Revenue (Stone). Orders of the Department of Revenue are presumed correct and valid, the taxpayers bears the burden of demonstrating that the challenged order is incorrect. Id.

The Franklin Department of Revenue (FDR) denied the Nashes full deductions for operating their Christmas Tree Farm after coming to a determination that it was not an activity for profit. Additionally, the FDR denied the Nashes their home-office deduction. However, as demonstrated below, the Christmas Tree Farm is a for profit enterprise meeting the burden as set forth in 26 C.F.R. § 1.183–2(b). Additionally, the home office is used exclusively for business and entitles the Nashes to a home office tax deduction.

Therefore, the FDR erred in denying the Nashes full deductions of operating the farm as demonstrated below.

A. The Nashes have a right to a full tax deduction under the IRC because their Christmas tree farm business is a for-profit enterprise meeting the requirement stated in the CFR.

IRC § 162 allows a deduction for "expenses paid or incurred during the taxable year in carrying on any trade or business." Additionally, IRC § 183 states that, for an "activity not engaged in for profit," a taxpayer's deductions are limited to the amount of the income earned from the activity. The term "activity not engaged in for profit" requires a focus on 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).

The regulation articulates a non-exclusive list of nine factors to be used in assessing whether an activity is engaged in for profit, which includes: (1) manner of carrying out activity, (2) taxpayer expertise, (3) time and effort invested, (4) appreciation of assets, (5) success in similar activities, (6) history of income and losses, (7) amount of profits, (8) financial status of taxpayer and (9) recreational nature of activity. 26 C.F.R. § 1.183–2(b). No one factor is determinative in deciding whether an activity is engaged in for profit, nor does the counting of a majority of factors control; other factors, in addition to the listed ones, may prove relevant. Id. This inquiry focuses on objective factors; the taxpayer's statement of intent receives less weight than these objective factors. None of the factors are exclusive or conclusive.

1. The Nashes run the Christmas tree farm in a business-like manner because they have a business plan, insure assets, advertise and pay salaries to employees.

"The fact that the taxpayer carries on the activity in a business-like manner and maintains complete and accurate books and records may indicate that the activity is engaged in for profit…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." 26 C.F.R. § 1.183–2(b)(1).

In Stone, the court found that the taxpayers did not conduct their activity in a businesslike manner, and therefore not engaged in for profit, because the taxpayer owners did not: (1) have a business plan, (2) insure their assets, (3) undertake advertising for their horses or (4) pay themselves. They also had no employees.

Here, although the Nashes did not operate their tree farm as a business until 2011, they have operated in a businesslike manner for the past five years because they kept records of their activities and kept books of accounts concerning their sales and expenses. They also tried to improve their operating methods because they received advice from a nearby Christmas tree farmer about managing a larger operation and followed that advice. Additionally, they changed their approach to the business in 2011 to increase the farm's profitability. In sharp contrast to Stone, the Nashes have a business plan involving the rotation of crops and the reduction of expenses. Finally, the Nashes conduct their operation in a businesslike matter because they insure their farming equipment, promote the Christmas Tree Farm by maintaining good connections with commercial buyers of their trees, and paid wages to the people they hired to help them during the harvest.

Therefore, contrary to the FDR's conclusion, there is ample evidence that the Nashes operate their tree farm in a businesslike manner.

2. The Nashes acquired the necessary expertise in commercial Christmas tree farming from reading, courses, and 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. . . ." 26 C.F.R. § 1.183–2(b)(2).

In Stone, the court found that the taxpayers had no expertise in their supposed business because they lacked formal education in horse breeding, and there was no evidence that they had sought or received advice on how to make their horse-breeding business more profitable, thereby making their business not engaged in for profit.

Here, the Nashes have expertise about the land itself because they have lived on their extensive property of over 13 acres for many years. Unlike Stone, Mr. Nash has expertise in tree farming because he read extensively on tree farming and took courses on forest management. Also, he went to great lengths to proactively acquire even more expertise because he apprenticed with a nearby farmer and consulted with that farmer about increasing production on his land in 2011 to increase his profits.

Therefore, Mr. Nash has the requisite expertise to run the Christmas Tree Farm as a business.

3. By Mrs. Nash working full-time in the company and Mr. Nash spending most of his personal time working on the farm, the Nashes have invested significant time and effort in the business.

"The fact that the taxpayer devotes much of his personal time and effort to carrying on an activity… 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. . . ." 26 C.F.R. § 1.183–2(b)(3).

In Stone, both taxpayers had little time and effort invested in their business because both the husband and wife taxpayer owners had full-time jobs in addition to their horse-breeding business. They both could not demonstrate how their time was spent on the business and the court found this factor neutral, at best, in determining that their business was not engaged in for profit.

Unlike Stone, Mrs. Nash retired from her job with the county in 2011 and since then has been running the Christmas Tree Farm as her full-time job. Furthermore, although Mr. Nash maintained a full-time job as an associate principal during the relevant period in order to cover living and business expenses, he

testified that he devoted much of his personal time and effort during summers, weekends, and additional time during harvest working on the tree farm.

Therefore, the Nashes have invested a significant amount of time and effort in the Christmas Tree Farm, further evidencing that they intend to run it for profit.

4. While the Nashes do not have profit for the periods they were denied deductions, they have made investments in long-term assets which will appreciate as the business grows.

"The term profit encompasses appreciation in the value of assets, such as land, used in the activity . . . ." 26 C.F.R. § 1.183–2(b)(4).

In Stone, the court found this factor weighed against finding the business was engaged in for profit because the taxpayer conceded that none of the business assets, including the horse farm itself, appreciated.

Unlike Stone, improved tree-farming techniques will likely produce an increase in inventory value (namely, the land from which the Christmas trees are harvested and the "inventory" of growing Christmas trees) and in the farm. Although the Nashes concede that there is no evidence in the record about the appreciation in value of the principal assets, the value of the business has increased because of the addition of the new equipment, the clearing of additional acreage, the practice of planting in rows and providing space for rotation of new seedlings, and other improvements. Furthermore, it is fair to take into consideration that the business is a start-up and it takes years for the trees to be mature enough for harvesting.

Therefore, although the appreciation in value is not obvious, the Nashes have taken steps to prepare the farm and the business to realize an appreciation of assets in the near future.

5. The Nashes have experience raising trees on the farm recreationally, despite not having run another similar business before.

"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." 26 C.F.R. § 1.183–2(b)(5).

In Stone, the taxpayer owners did not previously run a similar business since their horse breeding farm was the taxpayer's first attempt at operating a horse-breeding operation or any business, thereby confirming that the business was not engaged in for profit.

Here, although the Nashes have never run a large tree-farming business before, they have informally sold Christmas trees for several years before scaling up their operation in 2011. This is unlike the taxpayers in Stone who never had any similar horse-breeding business prior to their current endeavor. Given their history of informal Christmas tree sales, the Nashes are familiar with tree farming and have a history of managing their tree farm as a hobby that, while not profitable, produced some income every year. Additionally, it should be noted that heavily weighing the lack of prior business experience would eliminate full deductions for almost every first-time business owner and suppress entrepreneurial development of businesses.

Therefore, based on the Nashes' particular facts, and also for the good of business development, the court should consider this factor as neutral.

6. The Nashes' initial losses can be explained by their business expansion which later resulted in increased profit.

"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…A series of years in which net income was realized would of course be strong evidence that the activity is engaged in for profit." 26 C.F.R. § 1.183–2(b)(6).

In Stone, the court found that the history of losses over the entire existence of the horse farm showed neither a history of profitability nor the potential for income to match losses. The taxpayers owned six horses, with a seventh born and sold in 2005. During the years in question, the horse farm accumulated losses of $132,751, compared to income of $4,000 from the sale of the seventh horse. That $4,000 income compared to losses of $33,901 in the same year.

Here, this factor appears to have been given the most weight in the FDR's decision to deny the Nashes' claimed deductions. FDR Notice of Decision — Administrative Review. It is undisputed that the Nashes have incurred large losses in the last five years. However, unlike Stone, these losses should not be considered an indication that the business is not engaged in for profit because the losses can be attributed to either expansion of the business or general economic downturn. For example, the loss in the first year was attributable to the heavy start-up investment required. In 2014 and 2015 the losses were related to the need to hire workers to cope with an increased volume of sales. Additionally, according to Mr. Nash's testimony, the unforeseen circumstance of a depressed economy as a whole has further contributed to the losses. Finally, unlike Stone, where the taxpayers only sold one horse over the taxable period in question, the Nashes did sell trees in every year from 2011-2015.

Therefore, though the Christmas Tree Farm did post losses for all the years in question, this should not be a dispositive factor as there are legitimate reasons for these losses each year.

7. The margin between losses and profits has either decreased or can be explained by the nature of the business, despite the Nashes having not yet seen a profit.

"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…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. . . ." 26 C.F.R. § 1.183–2(b)(7).

In Stone, the court found the business was not engaged in for profit because the horse farm did not make a profit in years the taxpayers were claiming full deductions, nor did it make a profit in any two consecutive years of its entire 20-year history.

Unlike in the horse farm in Stone, the Nashes have only been running the farm for 5 years as a commercial enterprise. Although the Nashes did not earn a profit for the years in question (2011-2015), the margin between losses and income has narrowed, from a loss of $33,500 in 2011 to a loss of a mere $7,500 in 2015. Furthermore, the Nashes' yearly income has steadily increased, including a $1,500 yearly increase from 2013 to 2015. Overall, income is increasing while deductions/expenses appear to be holding steady or have specific causes for increasing.

Therefore, though the Nashes have never had a profit, the deductions and losses are easily explainable in the context of their specific start-up business and show their concerted efforts to make a profit.

8. The Nashes receive income from outside the business in order to dedicate more funds towards growing the business and making it profitable, and should not preclude them from receiving a full tax deduction.

"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." 26 C.F.R. § 1.183–2(b)(8). However, no one factor is determinative.

In Stone, the taxpayers never received a salary or relied upon income from the horse farm, supporting the court's holding that the business was not engaged in for profit. Mr. Stone worked for a bank during all the years in question, and Ms. Stone worked for an insurance agency.

Here, in contrast to Stone, Mrs. Nash worked full-time on the farm for the years in question after retiring from her full-time job in 2011. Since the Christmas tree farm business does not yet generate enough income, the Nashes support themselves and the business from Mrs. Nash's pension and Mr. Nash's full-time job as a high school principal. So far, they do realize a significant tax benefit from regular yearly losses. However, these facts need to be considered collectively with the other factors. Their income from outside sources, in addition to paying their living expenses, also helps pay their business expenses, allowing the business to become established. Although the Nashes have not been able to draw an income from the Christmas Tree Farm operation, the business is in its start-up phase. As a start-up family business, it takes time to establish a reputation in the industry. This, paired with the Nashes' "word of mouth" advertising, supports the notion that building a profitable brand takes time.

Therefore, while the Nashes do rely on income from outside the business, having those resources to support oneself is not incompatible with engaging in an activity with the intent to make a profit, especially for a start-up company.

9. The Nashes intend the business to be a commercial enterprise and not just a recreational hobby given the major capital investments they have made to date.

"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…It is not… necessary that an activity be engaged in with the exclusive intention of deriving a profit or with the intention of maximizing profits. . . .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…." 26 C.F.R. § 1.183–2(b)(9).

In Stone, the taxpayers' activities indicated recreation rather than operation of a business for profit because Mr. Stone engaged in rodeo events as part of his work with his horse farm. Also, since he had been riding horses since he was a child and rode horses in games and trail rides, this showed that he took pleasure in riding and caring for horses, despite the hours and difficult work required to maintain the farm.

Here, initially, the Nashes began Christmas tree farming as a recreational activity, making approximately $1,000 for the season. However, since then the Nashes have spent considerable amounts of money expanding their operation to make the business profitable. The Nashes' expansion efforts, home office, and additional education show that the Nashes no longer run their operation in a recreational capacity, unlike the taxpayers in Stone who focused on the recreational aspect of the horse farm rather than operating it as a business. Additionally, while Mr. Nash testified frequently about how much he and his wife enjoyed

the activity of running the tree farm, the fact that they enjoyed the work does not automatically make it recreational, nor is disliking the work in a business a prerequisite to granting the deduction.

Therefore, the Nashes' work on the tree farm is not recreational in nature, as they have been consistently aiming to make a profit. The fact that they enjoy their work makes it much more likely that it will continue and become profitable in the future.

In conclusion, the Nashes have a business they are engaging in for profit, as they have met the burden through the criteria above. As such, they should be allowed full deductions for their losses from the Christmas Tree Farm.

B. The Nashes should be allowed a home office tax deduction for the use of a room in their residence since it is the principal place of business for the Christmas tree farm, is used solely for that purpose, and was specifically converted from a residential room to a home office to run the business.

Under IRC § 280A, the general rule is that no taxpayer may take a deduction if the dwelling unit is used during the taxable year as a residence. An exception to the general rule under subpart (c) states that a deduction will not be prohibited if the dwelling is exclusively used on a regular basis as a principal place of business for a business of the taxpayer. The exclusive use requirement is an "all or nothing" standard. Lynn v. Franklin Department of Revenue (Lynn). The exclusive use requirement means the taxpayer's dwelling must be used specifically for trade or business use, and a physical separation from the other living areas is required. The mere presence of a television in a room without any other mitigating factors, will not weigh against the exclusive use requirement. Id.

In Lynn, the taxpayer claimed a home-office deduction in two residences, one in a house and another in a second room in an apartment where he subsequently moved. The room in the house was found to be a home-office because it was used exclusively and on a regular basis as a principal place of business. Facts that supported this conclusion were the area's 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. However, the second room in the apartment was not deemed a home office because it was not used exclusively for the business and the taxpayer offered little evidence as to the actual purpose of the room other than for storing a computer and some law books. Additionally, he babysat his child and allowed the child to watch television in the room.

Here, similar to the first room in Lynn, in 2011the Nashes transformed a spare bedroom into an office used exclusively to run the business and handle day-to-day matters for the Christmas Tree Farm. Unlike Lynn, Mr. Nash's testimony specifically indicates that this room stores the books and accounts for the business and that he never used the room for any other purpose than the business. Although Mr. Nash testified that a television is present in the office, he also stated that he uses it for business purposes to monitor the weather which is vital to running the farm. Although there is a recliner and the Nashes' dogs were often in the office, the mere presence of a chair and family pet does not invalidate the fact that the office is used exclusively for business purposes.

Therefore, the Nashes have met their burden by establishing that their office is used for exclusive use. As such, they are entitled to the full home-office deduction.

Conclusion

For the reasons mentioned above, the FDR erred in denying the Nashes full deductions of operating the farm and the full home-office deduction.