Contents

July 2016
MPT-2 File:
Nash v. Franklin Department of Revenue

The Carter Law Firm LLC
1891 Virginia Way
Bristol, Franklin 33800

MEMORANDUM

TO: Examinee
FROM: Sara Carter
DATE: July 26, 2016
RE: Tax Appeal of Joseph and Ellen Nash

Our clients Joseph and Ellen Nash own property in Knox Hollow, on which they raise Christmas trees for sale. For many years, they sold only to friends and neighbors. Five years ago, they started a commercial tree-farming operation and put a lot more money into the farm.

Starting that same year, they began to claim tax deductions for expenses from a trade or business. They had a huge start-up loss to report in the first year. Since then, their income from the farm has gone up, but their expenses have varied. For each of the past five years, they reported a loss on their joint tax return.

Since the Nashes' last tax filing, as the law allows, the Franklin Department of Revenue (FDR) reviewed the Nashes' returns for the years 2011–2015 and denied their claim of full deductions for the farm expenses for those years. The FDR said that the Nashes could only take deductions to offset income they earned from the farm in each of those five years. The Nashes want the full deductions so that they can offset the business losses against their other income.

The FDR also denied the Nashes' claim for a home office deduction.

The FDR assessed the Nashes with additional tax for all five years. To avoid interest and penalties, the Nashes paid the additional tax. Representing themselves, they filed an internal administrative review with the FDR, which was unsuccessful. (See attached Notice of Decision.)

The Nashes then retained us and we filed an appeal to the Franklin Tax Court, which went to hearing last week. We stipulated to the dollar amounts in question, and Mr. Nash testified. I have attached a transcript. The Tax Court has requested post-hearing briefing.

Please draft the legal argument portion of our brief to the Tax Court, following the attached guidelines for drafting persuasive briefs. You should argue that Mr. Nash's testimony establishes the Nashes' right under Franklin law to the full deductions that they claimed. Franklin law uses the federal Internal Revenue Code and regulations to calculate Franklin tax liability.

The Carter Law Firm LLC
1891 Virginia Way
Bristol, Franklin 33800

OFFICE MEMORANDUM

TO: Attorneys
FROM: Sara Carter
DATE: August 18, 2014
RE: Format for Persuasive Briefs

The following guidelines apply to persuasive briefs filed in the Franklin Tax Court.

[Other sections omitted]

. . .

III. Legal Argument

Your legal argument should be brief and to the point. Make your points clearly and succinctly, citing relevant authority for each legal proposition.

Do not restate the facts as a whole at the beginning of your legal argument. Instead, integrate the facts into your legal argument in a way that makes the strongest case for our client.

Use headings to separate the sections of your argument, and follow the same rule as your argument: do not state abstract conclusions, but integrate factual detail into legal propositions to make them more persuasive. An ineffective heading states only: "The deduction should be allowed." An effective heading states: "Under the Internal Revenue Code, the appellant may deduct the amount by which the value of the gift exceeds the value of the concert ticket he received."

The body of your argument should analyze applicable legal authority and persuasively argue how both the facts and the law support our client's position. Supporting authority should be emphasized, but contrary authority should also be cited, addressed in the argument, and explained or distinguished.

Finally, anticipate and accommodate any weaknesses in your case in the body of your argument. If possible, structure your argument in such a way as to highlight your argument's strengths and minimize its weaknesses. If necessary, make concessions, but only on points that do not concede essential elements of your claim or defense.

FRANKLIN DEPARTMENT OF REVENUE
NOTICE OF DECISION — ADMINISTRATIVE REVIEW

Taxpayers: Joseph Nash and Ellen Nash
Tax Years: 2011–2015
Type: Joint Filing
Date Issued: May 16, 2016

The taxpayers claim that the Franklin Department of Revenue incorrectly denied their claims for (1) deductions for expenses paid or incurred during the taxable year in carrying on a trade or business and (2) deductions related to the business use of their home.

(1) The taxpayers claim certain deductions related to the carrying on of a "Christmas tree farming" business as follows:

	2011	***2012***	***2013***	***2014***	***2015***
Income	$1,500	$2,000	$2,000	$3,500	$5,000
Deductions	$35,000	$9,500	$7,000	$9,000	$12,500
Gain/(Loss)	($33,500)	($7,500)	($5,000)	($5,500)	($7,500)

The Department determines that the taxpayers are not engaged in the tree-farming business for profit, due to the lack of a profit motive. Therefore, the taxpayers cannot take full deductions in each year. Instead, they may only deduct annual expenses up to the amount of income earned from the tree-farming activity: $1,500 in 2011; $2,000 in 2012; $2,000 in 2013; $3,500 in 2014; $5,000 in 2015. Of the nine factors identified in federal regulation 26 C.F.R. § 1.183–2(b)(1–9), which is controlling in Franklin tax cases, these factors support our conclusion: no profit in the tax years in question; a regular history of losses; no plan to recoup those losses; a history of similar activity without any deductions; and no evidence of operations in a businesslike manner.

(2) The taxpayers may take no deduction attributable to the use of a room in their home because the room was not used exclusively for business purposes. Internal Revenue Code § 280A(c)(1).

The assessment of tax for the years in question is affirmed. The taxpayers have exhausted their internal administrative remedies. They have the right to appeal to the Franklin Tax Court.

Ann Miller

Ann Miller, Commissioner of Franklin Department of Revenue

FRANKLIN TAX COURT, SIXTH DISTRICT
Transcript of Testimony of Joseph Nash
July 21, 2016

DIRECT EXAMINATION BY ATTORNEY CARTER

Att'y Carter: State your name for the record.

Joseph Nash: Joseph Nash.

Carter: Where do you live?

Nash: 3150 Old Sawmill Road in Knox Hollow, Franklin.

Carter: How long have you lived there?

Nash: Since we bought it in 1997.

Carter: Describe the land, please.

Nash: It's 13 acres: an acre for the house and sheds, and another two acres of fields. The rest is forested.

Carter: You started claiming tax deductions in 2011. Please tell the court how you used the land before then.

Nash: Originally, about two acres of the land had Leland cypress, spruce, and pine on it, good for Christmas trees. Soon after we bought it, our daughter and her friends would cut down trees for their own use. After a while, we put up a sign on the road each November and put out a garbage can with saws and twine in it. We charged $15 for the cypress, $20 for the pine, and $25 for the spruce.

Carter: What happened next?

Nash: At some point, we realized that most of the good trees would be gone in a few years. So I researched how to raise Christmas trees in a more orderly way.

Carter: What did you do?

Nash: I read a lot of books on raising trees, Christmas trees in particular. I took a whole series of classes on forest management. Finally, I met a nearby Christmas tree farmer and spent a whole vacation on that farm. I got really interested in it.

Carter: What did you do next?

Nash: First we set apart some of the acreage, cut everything down, and replanted in organized rows, leaving space to plant new seedlings in rotation. When the new trees came in, we'd sell them off, same as before.

Carter: How much did you make?

Nash: Up until five years ago, never more than $1,000 in any one year.

Carter: Did you report this as income on your tax returns during this period?

Nash: Yes. And up until that point, we claimed no deductions.

Carter: What happened then?

Nash: About five years ago, in 2011, the tree farmer I'd worked with let me know that he was planning to go out of business. And my wife retired from her job with the county. So we had to decide whether to step it up or not. We both liked working in the fields and selling the trees, so we said, "Why not?"

Carter: Then what happened?

Nash: That same year we contacted the farmer's commercial customers, as a target for expansion. Then we invited the farmer over to walk us through what a bigger operation would look like. He showed us how to keep records about the trees and to keep good books. We did exactly what he told us . . . still do.

Carter: You couldn't have sold that many more trees right away.

Nash: No, we didn't. 2011 was a hard year, because we cut down several acres of forest for additional fields and bought new equipment to deal with the additional planting. We couldn't do it by hand, the way we had before. So we bought specialized equipment to trim and shape the trees.

Carter: How do you manage things?

Nash: Starting in 2011, we set aside a room in the house just for this business. We keep the records there, and catalogues and books that we consult. We have a computer that we use just for the business and nothing else. The room has a desk and two chairs, and that's it. Nothing happens there but the business.

Carter: How did things go from then on?

Nash: Well, that first year, we made only $1,500, including sales to some retailers in the city. We made more each year after that, up until last year when we made $5,000.

Carter: How much of that was profit?

Nash: None of it. We had a huge loss in 2011. After that, we had to maintain the equipment, and we had to increase the size of each year's planting to

increase our sales five to six years later. For the past two years, we have had to hire people to help us during the harvest; it was just too much for us. And of course, the economy has been bad, and sales haven't been what we thought they would be. It's coming back, though.

Carter: How much time have you and your wife put into this?

Nash: Since 2011, my wife has spent pretty much full time year-round on this. I spend summers and weekends, when I can . . . a lot more time during the harvest. We love it; it's hard work, but it's outdoors and it's satisfying.

Carter: Just to be clear, you've never made a profit?

Nash: That's right.

Carter: Do you plan to make a profit?

Nash: Yes, we will make a profit, once the trees we started planting five years ago are big enough for harvesting. We have reliable customers who want our trees, and we've learned a lot in the past few years about how to keep costs down.

Carter: No further questions.

CROSS-EXAMINATION BY Franklin Dep't of Revenue ATTORNEY SHEPARD

Att'y Shepard: Mr. Nash, you work full-time at Knox County High School as an associate principal, correct?

Joseph Nash: Yes, that's right.

Shepard: Since your wife retired, hasn't she received a pension from the county?

Nash: Yes.

Shepard: You've lived off your salary and her pension the last five years, correct?

Nash: Yes.

Shepard: You've never run a business of your own, have you?

Att'y Carter: Objection. Argumentative.

Shepard: I'll rephrase. Other than this activity on your land, you and your wife have never run a business of your own, have you?

Nash: No.

Shepard: You've never taken a salary for either of you from this activity, have you?

Nash: No.

Shepard: You don't insure your trees, do you?

Nash: No. We do insure the farm equipment.

Shepard: You don't advertise, do you?

Nash: No, not commercially. Our local business is by word of mouth, and we have good connections with our commercial customers.

Shepard: You testified that you set a room aside only for this activity.

Nash: Yes.

Shepard: How did you use the room before?

Nash: We used it as a spare bedroom.

Shepard: You said that there is nothing in that room but a desk and two chairs?

Nash: Yes—we took out the bed.

Shepard: One of those two chairs is a recliner, isn't it? And you have a radio and TV there too, correct?

Nash: Yes. I keep the TV on the Weather Channel, for business reasons.

Shepard: The computer is connected to the Internet.

Nash: By wireless, yes.

Shepard: Your dogs will lie in that room with you while you're there?

Nash: Yes, they will.

Shepard: There's a fireplace in that room too, isn't there?

Nash: Yes.

Shepard: You testified that you love tree farming and are fascinated by it?

Nash: Yes.

Shepard: You enjoy working on the land and making things grow.

Nash: I do.

Shepard: It doesn't really matter to you if this activity makes a profit, does it?

Nash: Maybe not; but we mean to make one anyway. That's part of the fun.

Shepard: No further questions.

July 2016
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.