Chapter 10: Small Business Issues

Corrections were made to this workbook through January of 2009. No subsequent modifications were made.

ISSUE 1: HOME OFFICE DEDUCTION

BACKGROUND INFORMATION

National Taxpayer Advocate Report.[1] In January 2008, Nina Olson, the National Taxpayer Advocate, released her annual report to Congress for 2007. It contained a 9-page legislative recommendation for the home office business deduction. Following is a synopsis of the most important issues discussed in that report (items in italics are verbatim from the report):

1. *The tax laws regarding the home office deduction are considered by many to be too complex and the recordkeeping responsibilities associated with the deduction to be too time-consuming. It is questionable whether most taxpayers who are eligible to take the deduction actually do so.*

2. Reporting the deduction is complicated. For example, depending on the taxpayer's status, the deduction is claimed on several different schedules:
   - A taxpayer who is an employee claims the deduction on Form 1040, Schedule A, line 21 (unreimbursed employee expenses), and must attach Form 2106, *Employee Business Expenses.*
   - A self-employed taxpayer with a nonfarm business claims the deduction on Form 1040, Schedule C, line 30 (expenses for business use of your home), and must attach Form 8829, *Expenses for Business Use of Your Home.*
   - A self-employed farmer claims the deduction on Form 1040, Schedule F, line 34 (other expenses), and must use a 41-line worksheet found in IRS Pub. 587, *Business Use of Your Home*. The worksheet is substantially the same as Form 8829.

3. It appears that the deduction is not claimed by many eligible taxpayers. According to data compiled by the U.S. Census Bureau, the number of homes containing a home office used **exclusively** for business increased by approximately 20% between 1999 and 2005. Still, of the approximately 20 million Schedule C returns filed for 2003, only 2.7 million claimed the deduction. This is in stark contrast to estimates that over half of small businesses are home-based.

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1. National Taxpayer Advocate's *2007 Annual Report to Congress*, Legislative Recommendations section, pp. 503–511, www.irs.gov/pub/irs-utl/arc_2007_vol_1_legislativerec.pdf

4. *To alleviate taxpayer burden associated with complexities in reporting the home office deduction, the National Taxpayer Advocate recommends that Congress amend §280A to provide an optional standard home office deduction… The applicable standard rate would be multiplied by the allowable square footage of the home office.*

   The optional standard home office deduction square-footage rate would factor in mortgage interest, real estate taxes, utilities, repairs, home insurance, and depreciation. In addition, the business-use square footage would be limited to an allowable maximum.

Observation. Computer tax-preparation software makes computing the home office deduction relatively simple, assuming the taxpayer keeps adequate records. The most time-consuming chore in computing the home office deduction usually involves the initial year the deduction is claimed.

Observation. Although her research indicates that the deduction is underutilized, the National Taxpayer Advocate does not address the **exclusive use** test.

Observation. One taxpayer whose home office deduction was challenged by the IRS was a former New York City police commissioner. According to information included in a federal tax fraud indictment, the taxpayer is alleged to have claimed home-office expenses for a New Jersey home even though he did not reside in it.[2] The taxpayer pled not guilty to the charges. If the allegation is true, the taxpayer might find it very difficult to meet the exclusive-and-regular-use test.

GENERAL RULES FOR THE HOME OFFICE DEDUCTION

Generally, a taxpayer is entitled to a home office deduction for part of his home if the following requirements are met:

1. The home office is used **exclusively** and **on a regular basis** for any trade or business of the taxpayer.[3]
2. The home office is used:
   - As the principal place of business;
   - As a place of business which is used by patients, clients, or customers in meeting or dealing with the taxpayer in the normal course of his trade or business; or
   - In the case of a separate structure which is not attached to the home, in connection with the taxpayer's trade or business.[4]

Deduction Limited by Net Income of Business

Even if these tests are met, the home office deduction may still be limited. If the taxpayer's gross income from the business use of his home equals or exceeds the total business expenses (including depreciation), there is no limitation applied to the home office deduction. Otherwise, it is limited.[5] The limitation is applied on various lines of Form 8829, *Expenses for Business Use of Your Home*.

2. See New York FBI press release at newyork.fbi.gov/dojpressrel/pressrel07/publiccorruption110907.htm
3. IRC §280A(c)(1)
4. IRC §§280A(c)(1)(A), (B), and (C)
5. IRC §§280A(c)(5)(A) and (B)

Carryover of Disallowed Expenses

If the net income limitation applies, any unused or disallowed home-office expenses for the current tax year are carried over to future tax years.[6] Disallowed losses of operating expenses may be carried forward to a new office unless the business operation from the original home office ceases. Disallowed depreciation cannot be carried forward. Only **allowed** depreciation reduces basis.[7]

PROBLEM AREAS FOR PREPARERS

Exclusive-and-Regular-Use Requirement

The exclusive-and-regular-use requirement, when strictly enforced by IRS examiners, is difficult to meet. Fortunately, this requirement is interpreted liberally by many IRS examiners.

Example 1. Felix is a self-employed plumber who employs three union plumbers. He normally uses his home office a minimum of 20 hours per week exclusively for administrative and management duties related to his business. His home office is his only office and contains the following:

- Business computer and printer
- Copier
- Four file cabinets for storing business records
- Shredder
- Three bookcases for storing business-related documents
- Business phone, which has a different number than his home phone

Tax Result for Example 1. Felix met these tests for claiming a home office deduction on Schedule C:

1. The exclusive-and-regular-use test,[8] and
2. The principal-place-of-business test (explained later).[9]

Therefore, he computes his home office deduction on Form 8829. Assuming that the gross income limitation does not apply, he is entitled to deduct all his allowable home office expenses on Schedule C.

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> **Note.** In **Example 1,** the principal-place-of-business test was met because Felix had no other business office.

Exceptions to the Exclusive-Use Test. The home office does not have to meet the exclusive-use test if either of the following applies:

- Part of the home is used for storage of inventory or product samples.
- The home is used as a daycare facility.

6. IRC §280A(c)(5)
7. IRS Pub. 523, *Selling Your Home*
8. IRC §280A(c)(1)
9. IRC §280A(c)(1)(A)

Example 2. Laura, an employed professional, sells wall decorations mainly at parties held in the homes of her friends, relatives, and business associates. She is self-employed in this part-time business and reports her income and expenses on Schedule C. She stores her purchased samples of the decorations in a 10' by 12' area in her basement laundry room.

Tax Result for Example 2. Laura is entitled to a home office deduction for the 120 square feet used for sample storage. Her home is the sole fixed location of her business.[10]

Example 3. Sally has a state-licensed daycare business in her home for up to five children. She began the daycare business in August 2007. Even though her home is not used exclusively for daycare, she is entitled to a home office deduction since she meets the regular-use test.

In **2008,** she used her home for daycare from 6:30 a.m. to 5:30 p.m. five days per week for 245 days. Following are the facts needed to complete her **2008** Form 8829, Part 1:

- 2,695 business-use hours (245 days × 11 hours)
- Total square footage in her home is 3,200
- Square footage used for daycare is 1,800 (basement and two rooms upstairs are off limits to the children)

Note. If the taxpayer started or stopped using her home for daycare during the tax year, the number of hours must be prorated based on the number of days the home was available for daycare.

Tax Result for Example 3. Sally is entitled to a $5,185 home office deduction on line 30 of her 2008 Schedule C. This is calculated by following the lines on Form 8829, as explained below:

1. Determine the percentage of the area of the home used as a business by dividing the area of the home used as a daycare facility by the total area of the home. (See lines 1–3 of the following Form 8829.)
2. Determine the percentage of time the home was used for business purposes by dividing the total hours the home was used as a daycare facility by the total number of hours in a year. (See lines 4–6 of Form 8829).
3. Multiply the percentage on line 3 of Form 8829 by the percentage on line 6. The result, the business percentage, is shown on line 7 of the form.
4. In 2008, Sally spent $4,870 on repairs and maintenance to the area of her home that she used as a daycare. However, because she did not use this area exclusively for the daycare business, she must multiply the $4,870 by the percentage of time this area was used as a daycare (30.7% on line 6 of Form 8829). She then enters $1,495 ($4,870 × 30.7%) on line 19, column (a).
5. She lists her indirect expenses (mortgage interest and real estate taxes) on lines 10–11, column (b) of the 8829. The total of these indirect expenses is multiplied by the business percentage on line 7 of the form because these expenses relate to the entire home. The resulting amount is subtracted from the tentative profit or loss of the daycare (shown on line 8 of the 8829) and entered on line 15. Sally's other indirect expenses for the daycare (insurance and utilities) are listed on lines 16–21, column (b), and the total is multiplied by the percentage on line 7. This result is entered on line 23.

10. IRC 280A(c)(2)

6. The total of the direct expenses from line 22, column (a) is added to the indirect expenses on line 23. This sum is compared to the amount on line 15 (the daycare portion of mortgage interest and real estate taxes subtracted from the tentative profit of the business). The smaller of the two totals represents the allowable operating expenses for the daycare and is entered on line 26 of the 8829. This number is then subtracted from line 15 and entered on line 27.

7. The depreciation allowance is calculated on Form 8829, Part III by multiplying the percentage on Line 7 of the form by the basis of the home (excluding land). The result is then multiplied by the applicable factor in the MACRS table for nonresidential real property, mid-month convention, which is summarized in the IRS instructions for Form 8829.

8. The allowable indirect expenses listed on line 14, the allowable operating expenses on line 26, and depreciation expense on line 29 are added together. However, the ordering rules may allow mortgage interest and real estate taxes even if there is a loss from the activity. This sum is entered on line 35 of Form 8829 and on Schedule C, line 30. In essence, Sally's daycare expenses for the business use of her home, to which the appropriate percentages have been applied, are deductible up to the amount of profit from the daycare business before deducting the expenses for business use of her home.

Note. If Sally used her home for a business other than a daycare facility, she would use only lines 1–3 of Form 8829, Part I to determine the business-use percentage of her home; she would not make any entries in lines 4–6 of Part I. Therefore, for a business other than a daycare, 100% of direct expenses for the business use of the home are deductible, as well as the total of indirect expenses to which the percentage on line 3 has been applied. As stated above, these expenses are limited to the amount of the profit of the business before deducting the expenses for business use of the home.

Note. If a daycare operator is **required** to be licensed under state law, but is not licensed, no home office deduction is allowed.

For Example 3

Form **8829** — Department of the Treasury, Internal Revenue Service (99)

Expenses for Business Use of Your Home

▶ File only with Schedule C (Form 1040). Use a separate Form 8829 for each home you used for business during the year.

▶ See separate instructions.

OMB No. 1545-0074 — **2008** — Attachment Sequence No. **66**

Name(s) of proprietor(s): **Sally**

Your social security number: **999 88 7777**

Part I Part of Your Home Used for Business

1	Area used regularly and exclusively for business, regularly for daycare, or for storage of inventory or product samples (see instructions) ①	1	1,800
2	Total area of home	2	3,200
3	Divide line 1 by line 2. Enter the result as a percentage	3	56.25 %
	For daycare facilities not used exclusively for business, go to line 4. All others go to line 7.		
4	Multiply days used for daycare during year by hours used per day	4	2695 hr.
5	Total hours available for use during the year (366 days × 24 hours) (see instructions) ②	5	8,784 hr.
6	Divide line 4 by line 5. Enter the result as a decimal amount	6	.307
7	Business percentage. For daycare facilities not used exclusively for business, multiply line 6 by line 3 (enter the result as a percentage). All others, enter the amount from line 3 ▶ ③	7	17.27 %

Part II Figure Your Allowable Deduction

		(a) Direct expenses	(b) Indirect expenses		
8	Enter the amount from Schedule C, line 29, **plus** any net gain or (loss) derived from the business use of your home and shown on Schedule D or Form 4797. If more than one place of business, see instructions			8	28,000
	See instructions for columns (a) and (b) before completing lines 9–21.				
9	Casualty losses (see instructions)				
10	Deductible mortgage interest (see instructions)		9,000		
11	Real estate taxes (see instructions) ⑤		4,000		
12	Add lines 9, 10, and 11		13,000		
13	Multiply line 12, column (b) by line 7		13: 2,245		
14	Add line 12, column (a) and line 13			14	2,245
15	Subtract line 14 from line 8. If zero or less, enter -0-			15	25,755
16	Excess mortgage interest (see instructions)				
17	Insurance		750		
18	Rent				
19	Repairs and maintenance	④ 1,495			
20	Utilities		3,000		
21	Other expenses (see instructions)				
22	Add lines 16 through 21	1,495	3,750		
23	Multiply line 22, column (b) by line 7		23: 648		
24	Carryover of operating expenses from 2007 Form 8829, line 42		24:		
25	Add line 22 in column (a), line 23, and line 24 ⑥			25	2,143
26	Allowable operating expenses. Enter the **smaller** of line 15 or line 25			26	2,143
27	Limit on excess casualty losses and depreciation. Subtract line 26 from line 15			27	23,612
28	Excess casualty losses (see instructions)		28:		
29	Depreciation of your home from Part III below		29: 797		
30	Carryover of excess casualty losses and depreciation from 2007 Form 8829, line 43		30:		
31	Add lines 28 through 30			31	797
32	Allowable excess casualty losses and depreciation. Enter the **smaller** of line 27 or line 31 ⑧			32	797
33	Add lines 14, 26, and 32			33	5,185
34	Casualty loss portion, if any, from lines 14 and 32. Carry amount to **Form 4684,** Section B			34	
35	Allowable expenses for business use of your home. Subtract line 34 from line 33. Enter here and on Schedule C, line 30. If your home was used for more than one business, see instructions ▶			35	5,185

Part III Depreciation of Your Home

36	Enter the **smaller** of your home's adjusted basis or its fair market value (see instructions)	36	225,000
37	Value of land included on line 36	37	45,000
38	Basis of building. Subtract line 37 from line 36	38	180,000
39	Business basis of building. Multiply line 38 by line 7	39	31,086
40	Depreciation percentage (see instructions) ⑦	40	2.564 %
41	Depreciation allowable (see instructions). Multiply line 39 by line 40. Enter here and on line 29 above	41	797

Part IV Carryover of Unallowed Expenses to 2009

42	Operating expenses. Subtract line 26 from line 25. If less than zero, enter -0-	42	
43	Excess casualty losses and depreciation. Subtract line 32 from line 31. If less than zero, enter -0-	43	

For Paperwork Reduction Act Notice, see page 4 of separate instructions. Cat. No. 13232M Form **8829** (2008)

Special Limitation for Employees. Employees who use part of their home exclusively and regularly for employer-related duties **are not entitled** to a home office deduction unless they are required to do so for the **convenience of the employer.**[11]

Example 4. Linda is employed as dean of admissions at Piniella State University. She is furnished with an adequate office at the university which is available to her during off-duty hours if needed.

Tax Result for Example 4. Even if Linda uses a home office exclusively and regularly for her duties at PSU rather than her employer-provided office, she cannot claim the home office deduction on Form 2106.

> **Note.** See the 1990 *Cadwallader* 7th Circuit Appeals Court case for a thorough analysis of the convenience-of-the-employer rule.[12]

Principal-Place-of-Business Requirement

A taxpayer may have more than one business location for a single trade or business. In order to deduct home-office expenses, the taxpayer's residence must be the principal place of business for that trade or business. To determine whether the home meets that test, consider the following:

- The relative **importance of the activities** performed at each place where business is conducted, and
- The amount of **time spent** at each place where business is conducted.

The home office will meet the principal-place-of-business test if the following two requirements are met:

1. It is used exclusively and regularly for **administrative or management activities** related to the trade or business.
2. There is no other fixed location where substantial administrative or management activities are performed.

Administrative or Management Activities. The following are examples of administrative or managerial activities:

- Billing customers, clients, or patients
- Keeping books and records
- Ordering supplies
- Scheduling appointments
- Forwarding orders or writing reports

Example 5. Brenda is a self-employed decorating consultant in Plano, Texas. Most of her time is spent at customers' homes and offices. She has a 20' x 12' den in her home, which she uses exclusively and regularly for administrative and management activities of her business.

Brenda spends an average of 15 hours per week working at her home office. There is no other location where she conducts administrative and management duties for her business.

Tax Result for Example 5. Brenda meets all of the requisite tests, including the principal-place-of-business test. Therefore, she can deduct her home office expenses on Form 8829.

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11. IRC §280A(c)(1)

12. *Cadwallader v. Comm'r*, No. 89-3429, 7th Cir., Dec. 11, 1990, *aff'g* TC Memo 1989-356, 57 TCM 1030, July 24, 1989

Sale of a Home with a Home Office

Depreciation after May 6, 1997. The regulations[13] provide that the only factor to consider when a home used partially for business or rental purposes is sold is any depreciation allowed or allowable after May 6, 1997. The sale is not treated as two separate sales (one sale for the personal-use portion and a separate sale for the partial business- or rental-use portion).

Caution. If the dwelling unit and the business-use portion of the building are separate units, the regulations specify that the gain attributable to the business-use portion is taxable.[14] For example, the sale of a duplex with a business in one half and a residence in the other — each of which has separate entrances — is treated as two separate sales.

Example 6. Geovony and Maria, a married couple, sold their jointly-owned principal residence for $280,000 on January 2, 2008. It was purchased in 2000, and the dual two-out-of-five years' ownership and use tests were met for the personal residential use portion of the home.

Maria deducted home-office expenses for her consulting business on her 2003–2007 Schedules C. The total depreciation she claimed for the home office portion of the home for those five years was $4,000. The gain on the 2008 sale of the home was $100,000 after the basis was adjusted for $4,000 of allowed depreciation.

Tax Result for Example 6. If the home had been used exclusively as a personal residence, the entire gain would be excludable on Geovony and Maria's 2008 joint return. However, $4,000 of the gain is taxable due to depreciation allowed after May 6, 1997.

The sale of the residence is reported initially on Geovony and Maria's 2008 Form 4797, *Sales of Business Property*. The $4,000 recognized portion of the $100,000 gain is treated as unrecaptured §1250 gain. It is taxed at a maximum 25% tax rate. The $4,000 recognized gain flows to their Schedule D. Following is the partially completed 2008 Schedule D for Geovony and Maria.

Note. See paged 8–16 in the 2003 *University of Illinois Federal Tax Workbook* for a similar example with completed forms and schedules.

13. Treas. Reg. §1.121-1(d)

14. Treas. Reg. §1.121-1(e)(4), Example 3

For Example 6

SCHEDULE D (Form 1040)
Department of the Treasury Internal Revenue Service (99)

Capital Gains and Losses

► Attach to Form 1040 or Form 1040NR. ► See Instructions for Schedule D (Form 1040).
► Use Schedule D-1 to list additional transactions for lines 1 and 8.

OMB No. 1545-0074
2008
Attachment Sequence No. 12

Name(s) shown on return: **Geovony and Maria**
Your social security number: **111 22 3344**

Part II **Long-Term Capital Gains and Losses—Assets Held More Than One Year**

(a) Description of property (Example: 100 sh. XYZ Co.)	(b) Date acquired (Mo., day, yr.)	(c) Date sold (Mo., day, yr.)	(d) Sales price (see page D-7 of the instructions)	(e) Cost or other basis (see page D-7 of the instructions)	(f) Gain or (loss) Subtract (e) from (d)
8					

9	Enter your long-term totals, if any, from Schedule D-1, line 9	9	
10	**Total long-term sales price amounts.** Add lines 8 and 9 in column (d)	10	
11	Gain from Form 4797, Part I; long-term gain from Forms 2439 and 6252; and long-term gain or (loss) from Forms 4684, 6781, and 8824	11	4,000
12	Net long-term gain or (loss) from partnerships, S corporations, estates, and trusts from Schedule(s) K-1	12	
13	Capital gain distributions. See page D-2 of the instructions	13	
14	Long-term capital loss carryover. Enter the amount, if any, from line 15 of your **Capital Loss Carryover Worksheet** on page D-7 of the instructions	14	( )
15	**Net long-term capital gain or (loss).** Combine lines 8 through 14 in column (f). Then go to Part III on the back	15	4,000

For Paperwork Reduction Act Notice, see Form 1040 or Form 1040NR instructions. Cat. No. 11338H **Schedule D (Form 1040) 2008**

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For Example 6

Schedule D (Form 1040) 2008 Page **2**

Part III **Summary**

16	Combine lines 7 and 15 and enter the result	**16**	**4,000**
	If line 16 is: ● A **gain**, enter the amount from line 16 on Form 1040, line 13, or Form 1040NR, line 14. Then go to line 17 below. ● A **loss**, skip lines 17 through 20 below. Then go to line 21. Also be sure to complete line 22. ● **Zero**, skip lines 17 through 21 below and enter -0- on Form 1040, line 13, or Form 1040NR, line 14. Then go to line 22.		
17	Are lines 15 and 16 **both** gains? ☑ **Yes.** Go to line 18. ☐ **No.** Skip lines 18 through 21, and go to line 22.		
18	Enter the amount, if any, from line 7 of the **28% Rate Gain Worksheet** on page D-8 of the instructions . . . . ▶	**18**	**0**
19	Enter the amount, if any, from line 18 of the **Unrecaptured Section 1250 Gain Worksheet** on page D-9 of the instructions . . . . ▶	**19**	**4,000**
20	Are lines 18 and 19 **both** zero or blank? ☐ **Yes.** Complete Form 1040 through line 43, or Form 1040NR through line 40. Then complete the **Qualified Dividends and Capital Gain Tax Worksheet** on page 35 of the Instructions for Form 1040 (or in the Instructions for Form 1040NR). **Do not** complete lines 21 and 22 below. ☑ **No.** Complete Form 1040 through line 43, or Form 1040NR through line 40. Then complete the **Schedule D Tax Worksheet** on page D-10 of the instructions. **Do not** complete lines 21 and 22 below.		
21	If line 16 is a loss, enter here and on Form 1040, line 13, or Form 1040NR, line 14, the **smaller** of: ● The loss on line 16 or ● ($3,000), or if married filing separately, ($1,500) }	**21**	( )
	Note. When figuring which amount is smaller, treat both amounts as positive numbers.		
22	Do you have qualified dividends on Form 1040, line 9b, or Form 1040NR, line 10b? ☐ **Yes.** Complete Form 1040 through line 43, or Form 1040NR through line 40. Then complete the **Qualified Dividends and Capital Gain Tax Worksheet** on page 35 of the Instructions for Form 1040 (or in the Instructions for Form 1040NR). ☐ **No.** Complete the rest of Form 1040 or Form 1040NR.		

Schedule D (Form 1040) 2008

Disallowance of Deductions When Employee Rents Home Office to Employer.[15] Another limitation is applied to home-office expenses of employees who rent their home office to their employer.

Caution. This strategy should be avoided. The tax result in this situation is Schedule E rental income with no allowable rental expenses.

Example 7. Kyle is the sole stockholder of his S corporation. He signed a lease with his corporation which provides that he is to receive $10,000 in 2008 for rent of his home office.

Tax Result for Example 7. Kyle reports the $10,000 rental income on his 2008 Schedule E. He is not entitled to any home office deductions to partially offset the rental income. Therefore, the entire $10,000 represents net rental income. However, Kyle could deduct 100% of his home's mortgage interest and real estate taxes on Schedule A.

Note. To avoid this situation, the lease could be converted to an arrangement in which the employer merely reimburses the employee for direct home-office expenses paid, such as the allocable share of utilities and insurance plus specific office repairs. Consequently, Schedule E will not be required. Under this arrangement, the only type of expense that is not reimbursable is home-office depreciation.

Favorable Rule for Deducting Local Transportation Expenses. If a taxpayer's home office qualifies as her principal place of business for purposes of the home office deduction, all local transportation expenses are deductible as ordinary and necessary business expenses.[16]

Example 8. Kathy is a salaried manufacturer's representative for a pharmaceutical company which is headquartered in Indianapolis. She lives in a residence she owns in Naperville, Illinois (a Chicago suburb). Her principal place of business is her home office, which she maintains for the convenience of her employer. She does all of her administrative work in her home office. During a typical day, she drives to the offices of four physicians. She is paid a very generous sales commission and receives no auto reimbursement from her employer.

Tax Result for Example 8. Kathy is entitled to deduct the cost of all her local transportation expenses, including the mileage for driving from her home to the first physician's office and from the last physician's office to her home.

15. IRC §280A(c)(6)

16. Rev. Rul. 99-7, 1999-1 CB 361

ISSUE 2: NOT-FOR-PROFIT ACTIVITIES

BACKGROUND INFORMATION

Report from the Treasury Department[17]

A 2007 critical report from the Treasury Department concludes that the enforcement of the hobby-loss rules[18] by the IRS is inefficient. Following are the most important portions of the report (italicized text is verbatim from the report):

1. *A number of taxpayers who have significant income from other sources reduce their taxable incomes by reporting losses…*

> **Note.** In addition to the issue of whether a Schedule C business loss has satisfied the for-profit activity requirements of IRC §183, the IRS is faced with another serious compliance problem: preparers and taxpayers creating sizeable Schedule C losses, many with overstated expenses, to lower earned income in order to qualify a taxpayer for the earned income credit.

2. In 2003, the IRS performed limited testing to determine if examinations of potential Schedule C hobby-loss cases could be accomplished through correspondence exams. This type of exam does not involve a full-fledged audit of a taxpayer's books and records. The testing included 148 returns that reported Schedule C losses. Following is an analysis of the results of this testing project:
   - The IRS disallowed the Schedule C losses of 103 of the 148 taxpayers in the testing sample, a disallowance rate of nearly 70%. Interestingly, the Treasury Department concluded that based on a summary review of the 45 allowed losses, 36 of those losses should also have been disallowed.
   - The IRS assessed taxes and interest of $372,089 for the 103 exams in which the Schedule C losses were disallowed. This is an average of $3,613 per return.
   - The IRS collected $345,600 from 95 (92%) of the 103 taxpayers. This is an average of $3,355 for each of the 103 exams.
   - Five of the 103 taxpayers appealed their assessments, and the Office of Appeals conceded the assessed tax in four cases.

> **Note.** Even though three taxpayers still owe the IRS, the unpaid assessments may be satisfied via seizure of future tax year overpayments and stimulus payments.

In a follow-up to the limited testing done by the IRS in 2003, the Treasury Department reviewed the accounts of the 95 taxpayers who had paid the assessments for disallowed Schedule C hobby losses. This analysis showed that 48 (51%) of the 95 taxpayers continued to claim the same Schedule C hobby losses in subsequent tax years.

> **Note.** In an effort to address this issue, the IRS posted a Fact Sheet on its website in April 2007 entitled "Business or Hobby?" The IRS posts monthly Fact Sheets on its website as part of a strategy to reduce the tax gap. See page 556 in the 2007 *University of Illinois Federal Tax Workbook* for details.

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17. *Significant Challenges Exist in Determining Whether Taxpayers With Schedule C Losses Are Engaged in Tax Abuse*, Reference #: 2007-30-173, Treasury Inspector General For Tax Administration, Sept. 7, 2007

18. IRC §183

3. *The Internal Revenue Code and Treasury Regulations make it difficult to determine when a Schedule C loss is related to a business or hobby.*

Following are some of the reasons for this conclusion:

- *The Code and Treasury Regulations do not require a taxpayer to have a reasonable expectation of profit; rather, the taxpayer just needs the 'objective' of making a profit. Therefore, all facts and circumstances need to be considered in each case.*
- *In determining whether a profit objective exists, courts have ruled it may be sufficient that there is a small chance of making a profit... Additionally, the IRS, bears the burden to rebut the presumption that an activity was a for-profit business.*
- The law also allows taxpayers to justify a substantial Schedule C loss by reporting an occasional minimal profit:

  For example, an activity could be considered a for-profit business if a taxpayer shows any profit during a 5-year period, even though much larger losses are claimed in the other taxable years. This allows taxpayers to break the cycle of having continuous years of losses and give the appearance of being a for-profit business.

4. Another analysis involved identifying Schedule C returns that showed only consecutive losses over tax years 2002–2005 (a 4-year period). Following are the conclusions reached in this analysis:

- Approximately 1.5 million taxpayers, many with significant income from other sources, were identified. Tax practitioners prepared 73% of these returns.
- Of the 1.5 million taxpayers, 332,615 reported total incomes of $100,000 or more on their 2005 returns. These high-income taxpayers avoided approximately $1.9 billion in taxes for 2005.
- About 70,000 of the high-income taxpayers claimed 2005 Schedule C expenses which were five times greater than reported Schedule C revenues.

GENERAL NOT-FOR-PROFIT ACTIVITY RULES (IRC §183)

Taxpayers Subject to the Disallowance Rules

The IRC §183 disallowance rules apply to individuals and S corporations. C corporations are exempt from these restrictions. Even though the §183 disallowance rules do not specifically apply to partnerships (including LLCs), they do apply to individual partners (or LLC members) with respect to the flow-through of their potential not-for-profit activities.

General Disallowance Rule

If an activity is not engaged in for profit, no deduction attributable to such activity is allowable.[19]

Objective Presumption Rule

A profit motive is presumed when the activity has shown a profit for at least three of the last five years. In the case of horse breeding, training, racing, or showing, there must be profits in two of the last seven years.[20] Otherwise, the burden of proof shifts to the taxpayer.

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19. IRC §183(a)

20. IRC §183(d)

Subjective Factors Used to Determine Whether a Bona Fide Profit Motive Exists

Taxpayers, preparers, and IRS examiners need to carefully analyze nine nonexclusive factors to make the profit-motive determination. Certain factors can be given greater weight than others, and some can be ignored if not applicable. The courts have thoroughly analyzed these nine factors in deciding disputed tax cases. They are:

1. The **manner** in which the taxpayer carries on the activity. This factor is usually detrimental to a taxpayer who does not keep adequate books or records, or does not engage in normal business practices.

2. The **expertise** of the taxpayer or his advisors. This factor is usually detrimental to a taxpayer with little background and training in the activity. Still, this problem can be overcome if the taxpayer consults with experts on how to make the activity profitable.

3. The **time and effort** expended by the taxpayer in carrying on the activity. The fact that the taxpayer devotes substantial time to the activity may indicate a bona fide profit motive, especially if the activity is not recreational.

4. Expectation that assets used in the activity may **appreciate in value.** A long-term, as opposed to current, profit expectation may indicate the requisite profit motive. However, if this is the only factor in the taxpayer's favor, it generally does not suffice if the objective presumption rule has not been met.

5. The **success** of the taxpayer in carrying on **other activities.** A taxpayer who has a history of turning losing enterprises into profitable ventures will benefit from this factor. This factor is often not applicable; consequently, it is ignored in making the profit-motive determination.

6. The taxpayer's **history** of income and losses for the activity. Even if the activity generated significant losses for several years, this factor can still be decided in favor of the taxpayer if the losses are due to unforeseen circumstances. However, if the taxpayer continually reported large losses on his tax returns for the activity, an IRS examiner is likely to heavily rely on this factor.

7. The amount of **occasional profits** earned. An occasional large reported profit from the activity is a positive factor for the taxpayer. On the other hand, negligible profits likely are a negative factor.

8. The **financial status** of the taxpayer. A profit motive may be indicated if the taxpayer's other sources of income are small. On the other hand, in many court cases, high-income taxpayers with substantial net worth often claim Schedule C losses for many consecutive years. They can offset these losses with significant income from other sources. In this situation, an honest profit motive is less likely.

9. Elements of **personal pleasure or recreation.** Activities that create doubt about profit motive include:
   - Collecting valuables;
   - Racing cars, boats, or motorcycles;
   - Raising animals; and
   - Participating in musical or artistic endeavors.

Note. See the "Not-for-Profit" section of Chapter 15, "Rulings and Cases," for court cases pertaining to the above nine factors.

An analysis of §183 court cases (as reported by Commerce Clearing House, a WoltersKluwer Company) since the inception of §183 through 2007 discloses the following:

Type of Activity	Decisions in Favor of IRS	Decisions in Favor of Taxpayer
Automobile and motorcycle racing	27	3
Restoring vintage automobiles	6	0
Cattle breeding and raising	17	11
Charter boats and yachts and boat racing	33	9
Coin and stamp collecting	2	2
Dance talent agency contract between parents and teenage daughter	1	0
Dog breeding, showing and operation of kennels	20	12
Fishing tournaments	4	0
Foot massaging	1	0
Golfing	4	1
Horse racing, breeding or showing	107	51
Lawn mower repair	1	0
Model railroading	1	0
Parasailing	0	1
Photography	4	2
Ranching and farming (including vineyards and breeding/raising chinchillas, llamas, and exotic animals)	47	47
Rental of dwelling units	32	9
Treasure hunting	1	2

COURT CASE ANALYSIS

The fact that there are numerous court cases involving the hobby-loss issue indicates that IRS examiners continue to raise the subject. IRC §183 was added to the Code in 1969 and became effective for tax years beginning in 1970.

The hobby-loss topic is one of the most highly litigated of all IRS examination issues. The ambiguity and subjective nature of how §183 was drafted by Congress has made its interpretation difficult.

An IRS Audit Techniques Guide (ATG) is specifically devoted to §183 losses from cattle operations and horse activities because those activities are of such a nature that they carry significant opportunities for taxpayer abuse. In fact, according to the ATG, many written publications exist that instruct taxpayers on how to use these activities as a means of tax avoidance.

Analysis of a Recent Court Case

Since activities involving horses are the most often litigated of all hobby-loss pursuits, the Wilson and Ryan consolidated case was chosen for analysis.

> **Note.** At the time of the Tax Court petition in December 2005, the taxpayers resided in Murphysboro, Illinois. They apparently operated the quarter-horse activity as an informal joint venture and split the income and expenses equally on their 2002 separate returns.

***Paula Wilson and Michael Ryan v. Comm'r*, TC Summary Opinion 2007-117 (July 11, 2007)**

Facts. Ms. Wilson and Mr. Ryan were full-time police officers. In 1995, they established Wilson Ryan Quarter Horses, a horse breeding and training operation. Paula Wilson had significant experience in training horses, which she began doing at age 9.

In 1997, the taxpayers sold five horses for a profit. In an effort to maximize their profit potential, they conducted careful research and concluded that the "Skipper W" quarter-horse line produced the best all-around performance horses. Consequently, they bought a champion-bred "Skipper W" mare in October 1996.

In 2000, the taxpayers sold their 10-acre farm and purchased a 75-acre farm. It had three small buildings, a barn with stalls, and a riding area to facilitate the training of horses.

Beginning in 2001, the taxpayers suffered a string of unforeseen incidents:

- Paula Wilson suffered an on-the-job injury in September 2001 that prevented her from training horses for approximately one year.
- In the fall of 2002, Ms. Wilson suffered a broken collarbone and was unable to train horses for another year.
- A purchased stallion, which had the potential to sire numerous offspring that could be sold for profit, died in 2002 from an undetected illness.

Despite these setbacks, the taxpayers' herd grew from five horses in 1997 to 41 horses in 2002. In its examination of the taxpayers' 2002 tax returns, the IRS determined that their horse breeding and training activity was not engaged in for profit. Expenses in excess of income were disallowed.

Holding. The Tax Court held that even though the taxpayers reported losses on their 1995 through 2002 tax returns, they actually and honestly intended to make a profit in the activity. The court carefully reviewed and evaluated the nine subjective factors. Following are the reasons for the decision reached:

1. Losses incurred during the initial phase of a business are not necessarily an indication that the activity was not engaged in for profit.[21]
2. The activity was **conducted in a businesslike manner.**[22] They advertised in trade magazines, attended seminars, and kept records. In addition, they sought to improve profitability by making a determination that the "Skipper W" bloodline would likely be more profitable. (Factor 1 discussed earlier.)
3. The taxpayers did not ride their horses for pleasure. This is an indication that **elements of personal pleasure or recreation** (Factor 9 discussed above) were not involved.[23]

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21. Treas. Reg. §1.183-2(b)(6)
22. Treas. Reg. §1.183-2(b)(1)
23. Treas. Reg. §1.183-2(b)(9)

4. The taxpayers **devoted considerable time and effort** to the activity by spending almost all of their free time caring for and training the horses. They handled all material aspects of the activity. Therefore, Factor 3 was favorable for the taxpayers.[24]

5. The taxpayers expected that their 75 acres and their quarter horses would **appreciate in value.**[25] Therefore, Factor 4 was favorable for the taxpayers.

6. The taxpayers **did not have substantial income or capital** from other sources.[26] Thus, Factor 8, financial status, was in the taxpayers' favor.

Observations on the Wilson & Ryan Decision.

- Although not stated in the Tax Court transcript, the IRS apparently prevailed on only two of the nine subjective factors. They were Factor 6, the history of income and losses for the activity,[27] and Factor 7, the amount of occasional profits earned.[28]

- Factor 5, the success of the taxpayer in carrying on other activities, was not applicable.[29]

CONCLUSION

From the sheer volume of §183 court cases, it is obvious that IRS examiners frequently raise the not-for-profit issue. Also, it is reasonable to assume that if this issue is contested, the taxpayer stands a better chance of prevailing at the Appeals Office of the IRS than if the case is heard in Tax Court.

Preparers should be aware of potential §183 issues in the preparation of Schedules C and F. The following common-sense recommendations for preparers seem prudent:

- Advise the client about the potential IRS-examination issue that can result in additional tax, interest, and penalties.

- Ensure that questionable expenses (personal versus business-related) are minimized or eliminated.

- In the case of certain activities in which personal pleasure or recreation is a major factor, the preparer may be wise to decline preparation of the return.

- Inquire as to whether the client has a business plan.

- Prepare a cash-flow projection to determine if a profit potential exists.

24. Treas. Reg. §1.183-2(b)(3)
25. Treas. Reg. §1.183-2(b)(4)
26. Treas. Reg. §1.183-2(b)(8)
27. Treas. Reg. §1.183-2(b)(6)
28. Treas. Reg. §1.183-2(b)(7)
29. Treas. Reg. §1.183-2(b)(5)

ISSUE 3: ECONOMIC SUBSTANCE DOCTRINE

BACKGROUND INFORMATION

Although not a part of the IRC, the economic substance doctrine has routinely been used by the IRS in examinations and has been sanctioned in numerous court decisions. Following is a concise definition, paraphrased from a court opinion:[30]

> If the underlying transaction has no meaningful economic purpose, except the tax benefits to the taxpayer, it must be ignored for tax purposes.

The economic substance doctrine has received significant coverage lately by the major tax reporting services. The reason for the increased attention is a series of recent litigation victories by the IRS. The IRS won five of the following six cases involving the economic substance doctrine. The taxpayer prevailed in only one, the *Countryside Limited Partnership* case.

1. *Coltec Industries, Inc., v. U.S.,* No. 05-5111, Federal Cir. Ct. of Appeals (July 12, 2006)
2. *Jade Trading, LLC et al. v. U.S.*, No. 03-2164T, Court of Federal Claims (Dec. 21, 2007)
3. *Countryside Limited Partnership et al. v. Comm'r,* TC Memo 2008-3 (Jan. 2, 2008)
4. *Cemco Investors, LLC, et al. v. U.S.,* No. 07-2220, 7th Cir. Ct. of Appeals (Feb. 7, 2008)
5. *Enbridge Energy Co., Inc., et al. v. U.S.*, Civil Action # H-06-657, Case No. 4:06-cv-00657, Southern District Tex. (Mar. 31, 2008)
6. *Kornman & Associates, Inc., v. U.S.*, No. 06-11422, 5th Cir. Ct. of Appeals (May 12, 2008)

ANTI-ABUSE RULE APPLICABLE TO PARTNERSHIPS[31]

Aside from the economic substance doctrine, the Treasury regulations contain a specific anti-abuse rule that applies to partnerships. Many tax shelter entities are partnerships.

The anti-abuse rule permits the IRS to disregard and recast the form of a partnership transaction if the transaction's principal purpose is to substantially reduce the partners' aggregate federal tax liability. This rule applies if such transactions are inconsistent with the intent of subchapter K, the part of the Internal Revenue Code dealing with partnerships. These adjustments are required to be made at the partnership level in accordance with the Tax Equity and Fiscal Responsibility Act (TEFRA).

Burden of Proof

If the economic substance doctrine is used by the IRS in an examination, the burden of proof is on the taxpayer to show that the doctrine was applied incorrectly. In the *Cemco Investors, LLC* case, the 7th Circuit opinion stated: "The Commissioner has a statutory power to disregard transactions that lack economic substance."

> **Note.** In the *Enbridge Energy Co. Inc*. district court case, the judge used the term "conduit theory" rather than "economic substance doctrine." According to the judge in that case, an entity can be disregarded "if it is a mere conduit for the real transaction at issue."

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30. *Coltec Industries, Inc. v. U.S.*, No. 05-5111, Federal Cir. Ct. of Appeals (July 12, 2006)

31. Treas. Reg. §1.701-2

CEMCO INVESTORS, LLC — 7TH CIRCUIT

The *Cemco Investors, LLC* case originated as a district court case in the Northern District of Illinois.[32] The taxpayers lost in district court and appealed to the 7th Circuit Court of Appeals. The 7th Circuit upheld the prior decision of the district court. The transactions, at first glance, appear complex, and the mechanics of how they evolved are confusing. The following four entities were involved in this tax shelter transaction:

- Cemco Investors, LLC, which, for tax purposes, was treated as a partnership (so that its profits and losses passed through to its owners);
- Cemco Investment Partners (the Partnership);
- Cemco Investors Trust (the Trust); and
- Deutsche Bank, a German-based international bank.

Quotes from the 7th Circuit Court of Appeals Opinion

(Bolded emphasis has been added.)

> *Paul M. Daugerdas, a tax lawyer whose opinion letters while at Jenkins & Gilchrist led to the firm's demise (it had to pay more than $75 million in penalties on account of his work), designed a tax shelter for himself, with one client owning a 37% share. Like many tax shelters, it was complex in detail but simple in principle, and to facilitate exposition we cover only its basics, rounding all figures…*
>
> *In December 2000, the Trust purchased from Deutsche Bank two options in euros, one long and one short. The long position had a premium of $3.6 million (nominally paid to Deutsche Bank) and entitled the Trust to $7.2 million if, two weeks in the future, the euro was trading at $.8652 or lower. (Back in 2000, the dollar was worth more than the euro.)*
>
> *The short position had roughly the same premium (nominally paid by Deutsche Bank to the Trust) and required the Trust to pay Deutsche Bank $7.2 million if, on the same date, the euro exchange rate was $.8650 or lower.* ***In other words, if on the exercise date the euro was worth $.8652 or more, or $.8650 or less, the long and short positions would cancel out; but if the euro was trading for $.8651 on December 19, 2000, then Deutsche Bank would pay $7.2 million to the Trust.***
>
> *Like the options, the premiums matched almost exactly. The only money that changed hands was $36,000, which the Trust paid Deutsche Bank as the difference between the long and short premiums. And Deutsche Bank promised to refund $30,000 of this $36,000 if the options offset on the exercise date.*
>
> *The Trust assigned its rights in these options to the Partnership, contributing some cash as well. The Partnership spent about $50,000 to buy euros at an exchange rate of .89 dollars per euro. The next day Deutsche Bank remitted $30,000, because the options had offset. Soon, the Partnership liquidated and distributed its assets (both dollars and euros) to the Trust. Next, the Trust transferred to Cemco the €56,000 it had received from the Partnership. Finally, on the year's last business day, Cemco sold the euros for $50,000.*
>
> *One would think from this description that the Trust (and the Partnership as its assignee) suffered a loss of $6,000—the net premium paid for options that cancelled each other out and hence lacked value on the exercise date—while Cemco had neither profit nor loss.* ***Yet Cemco filed a tax return for 2000 showing a loss of $3.6 million!***
>
> *Its theory was that the Partnership's euros (later contributed to Cemco) had the same $3.6 million basis as the long option, and that a loss could be recognized once the euros had been sold. Cemco passed the loss to Daugerdas and his client, who reported it on their tax returns.*

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32. *Cemco Investors, LLC, et al. v. U.S.*, No. 07-2220 (7th Cir. 2007)

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What of the $3.6 million that Deutsche Bank "paid" the Trust for the short option, which almost exactly offset the long option? Well, Cemco took the view that this stayed with the Trust—and would never be taxed to the Trust, which, after all, had a net loss of $6,000—or if assumed by Cemco may be ignored because the options offset in the end. ***The purchase and sale of euros was the device used to transfer the basis of one option to Cemco while consigning the other option to oblivion.***

A transaction with an out-of-pocket cost of $6,000 and no risk beyond that expense, while generating a tax loss of $3.6 million, is the sort of thing that the Internal Revenue Service frowns on. ***The deal as a whole seems to lack economic substance; if it has any substance (a few thousand dollars paid to purchase a slight chance of a big payoff) then the $3.6 million "gain" on one premium should be paired with the $3.6 million "loss" on the other; and at all events the deal's nature ($36,000 paid for a slim chance to receive $7.2 million) is not accurately reflected by treating €56,000 as having a basis of $3.6 million…***

The Commissioner has a statutory power to disregard transactions that lack economic substance... And the IRS has considerable latitude in issuing regulations that specify the kinds of transactions that may be looked through.

Observations Concerning the 7th Circuit's Opinion

1. There were other technical issues that were decided in favor of the IRS, including whether Notice 2000-44, *Tax Avoidance Using Artificially High Basis,* and Treas. Reg. §1.752-6, *Partnership assumption of partner's §358(h)(3) liability after October 18, 1999, and before June 24, 2003,* applied to the disregarded transactions.

2. The 7th Circuit also dismissed the argument that the Notice of Final Partnership Administrative Adjustment (FPAA) should have been issued to Cemco Investment Partners (the Partnership) rather than to Cemco Investors, LLC (treated as a partnership).

3. The facts in the *Coltec Industries, Inc.; Jade Trading, LLC;* and the *Kornman & Associates Inc.* cases have similar characteristics to the facts in the *Cemco Investors, LLC* case.

Note. Son-of-BOSS transactions evolved from BOSS (bond and options sales strategy) tax-shelter transactions. These tax-shelter strategies were heavily marketed to wealthy individuals by numerous prominent accounting and law firms. According to the IRS, son-of-BOSS strategies were used by thousands of taxpayers in their attempts to save about $6 billion in taxes.[33]

KORNMAN & ASSOCIATES INC. — 5TH CIRCUIT

The following are quotes from the Justice Department's Press Release dated May 13, 2008 (bolded emphasis added).

The United States Court of Appeals for the Fifth Circuit today agreed with a federal district court that tax shelter promoter Gary Kornman was not entitled to the tax benefits from a tax shelter that he attempted to use to reduce his own tax liability.

Gary Kornman was an attorney who marketed tax shelters to wealthy individuals through his wholly-owned corporation, the Heritage Organization. To reduce his own tax liability, he employed the short-sale variant of the notorious 'Son-of-BOSS' abusive tax shelter. His version, like other versions, is designed to manipulate the partnership provisions found in subchapter K of the Internal Revenue Code to generate for the taxpayer an artificially high cost basis in a partnership interest that, in turn, can be transformed into a huge artificial loss upon the disposition of such interest. In Kornman's case, he engineered a short sale of Treasury Securities that produced an economic loss of $200,000, but he claimed on his tax return for 1999 that he incurred a capital loss of $102.5 million.

33. Novack, J. (2005, Apr. 11). "Leaky shelters." *Forbes.*

The Internal Revenue Service disallowed the loss. Kornman challenged this determination before a federal district court. In 2006, the court ruled against him, and he appealed to the United States Court of Appeals for the Fifth Circuit. ***In rejecting Kornman's appeal, the court observed that to create a $102.5 million tax loss from transactions that involved the economic loss of only $200,000 is 'reminiscent of an alchemist's attempt to transmute lead into gold.'***

Observations Concerning the 5th Circuit's Opinion

- The court held that the partnership anti-abuse rule,[34] the economic substance doctrine, the step-transaction doctrine, Rev. Rul. 95-26, and Rev. Rul. 95-45 were properly applied by the IRS. The step-transaction doctrine is an extension of the substance-over-form doctrine. It treats a series of technically separate steps as a single transaction if such steps are in substance integrated, interdependent, and focused toward a particular result.[35] Both revenue rulings concern short sales.
- The court upheld the validity of Rev. Ruls. 95-26 and 95-45 which "reflect the Commissioner's desire to prevent taxpayers from deducting non-economic losses."

COUNTRYSIDE LIMITED PARTNERSHIP ET AL. — TAX COURT[36]

Caution. The *Countryside* decision was issued as a Tax Court Memorandum decision, which carries less weight than a decision published by the Tax Court. The decision was also a summary judgment on a narrow issue, which may not be applicable to other economic-substance cases.

The Tax Court judge held that the partnership transactions were bona fide and should not be disregarded simply because they were tax motivated. The judge noted that the IRS "erroneously focused on the tax-motivated means instead of the business-oriented end."

The IRS alleged that the entire series of transactions was a sham and should be disregarded for federal income tax purposes and recast in accordance with its substance. But the judge refused to accept that line of reasoning in holding that the economic substance doctrine did not apply.

Note. For a detailed analysis of the *Countryside* Tax Court decision, see critical commentary by Lee Sheppard, which appeared in the January 14, 2008, *Tax Notes Today* magazine (published by Tax Analysts). The headline for the analysis is "Erroneous Application of the Economic Substance Doctrine."[37]

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CODIFICATION OF THE ECONOMIC SUBSTANCE DOCTRINE

There have been recent Congressional attempts to codify the economic substance doctrine. The original Senate version of the comprehensive Food, Conservation, and Energy Act of 2008 (also called the 2008 Farm Bill) included codification of the economic substance doctrine. However, the final Farm Bill,[38] which became law in May 2008 after the president's veto was overridden, omits this codification provision.

Charles Rangel, the House Ways and Means Committee Chairman, is in favor of codifying the economic substance doctrine. It was included as part of his comprehensive tax reform proposals released in 2007.

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34. Treas. Reg. §1.701-2
35. www.irs.gov/pub/irs-utl/ii.b_-_judicial_doctrines_ii.pdf
36. *Countryside Limited Partnership, CLP Holdings. Inc., Tax Matters Partner v. Comm'r,* TC Memo 2008-3 (Jan. 2, 2008)
37. 2008 TNT 10-4 News Analysis, Jan. 14, 2008 (Doc. 2008-629)
38. Food, Conservation, and Energy Act of 2008

It is interesting to note that Donald Korb, IRS Chief Counsel, does not favor codification. He said, regarding the recently-decided *Jade Trading, LLC* case, "The holding should leave no doubt that the judicially developed economic substance doctrine does not need to be incorporated into the tax code. Even without an act of Congress, the court in *Jade Trading* had all of the tools it needed not only to decide the case in favor of the government but also to sustain a 40% penalty against the partnership."[39]

ISSUE 4: OIL PIPELINE EASEMENTS

BACKGROUND INFORMATION

There are over 2 million miles of crude oil and natural gas pipelines in the United States.[40] Increasing energy demands will result in construction of additional pipelines. Currently, one energy company is attempting to extend its crude oil pipeline system that originates in the oil sands of Alberta, Canada.[41] The expansion consists of:

- 454 miles of 42-inch pipeline from Superior, Wisconsin, to Pontiac, Illinois. This pipeline will run through Boone, DeKalb, LaSalle, and Livingston counties in Illinois.

> **Note.** This project has been approved and construction has begun with a budget of $2.1 billion.

- 170 miles of 36-inch pipeline from Pontiac, Illinois, to a downstate terminal in Patoka, Illinois. This pipeline would run through Livingston, McLean, DeWitt, Macon, Christian, Shelby, Fayette, and Marion counties in Illinois.

> **Note.** As of June 30, 2008, this proposed project is being considered by the Illinois Commerce Commission. Most observers believe approval will eventually be granted. The company wants to begin construction in 2008 and has a budget of $353 million.

- Continuation of the pipeline from Patoka, Illinois, to refineries in the Texas Gulf Coast area.

The company is currently negotiating with landowners in Illinois to acquire pipeline easements. Although they do not publicly disclose the terms of contracts, the company is reported as paying in excess of $6,000 per easement-covered acre to secure completed contracts. Many Illinois landowners have received approximately $10,000 to $25,000 for granting an easement to the company. An inspection of one of these contracts disclosed the following:

- The contract is labeled as "Right-Of-Way and Easement Grant." The easement granted is perpetual, not limited or temporary.

> **Note.** Most easement contracts are perpetual in nature. A few easement contracts are granted temporarily for a limited term of years. Only the tax treatment for the sale of perpetual easements is discussed in this section.

- The contract gives the company the right to "lay, construct, operate, maintain, inspect (including aerial patrol), remove, alter, abandon in place, replace, relocate, and reconstruct a pipeline..."
- The contract states that the company "shall, at the time of construction, bury said pipelines at a sufficient depth through cultivated lands so that they will not interfere with ordinary annual crop cultivation."

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39. Gray, P. and Coder, J. (2008, Jan. 18) "Claims court rules for gov't on economic substance." *Tax Practice*, p. 31

40. Enbridge brochure, *Know your neighbor. Know your pipeline.*

41. Farmers, energy interests clash over pipeline plan (2008, Jan. 6). *The Chicago Tribune*

- The company "shall pay for damage to annual crops, fences, trees and other improvements which may arise from the exercise of the rights herein granted."
- Although not specifically stated in the contract, title to the land for which the easement is granted remains with the grantor. Therefore, the grantor is responsible for real estate taxes on the land covered by the easement.

TAXATION OF EASEMENT PROCEEDS

Granting of a Perpetual Easement

The general rule is set out in Treas. Reg. §1.61-6(a) as follows:

> *When a part of a larger property is sold, the cost or other basis of the entire property shall be equitably apportioned among the several parts. The realized gain or sustained loss on the part of the entire property sold is the difference between the selling price and the cost or other basis allocated to such part. The sale of each part is treated as a separate transaction, and gain or loss shall be computed separately on each part. Therefore, gain or loss shall be determined at the time of sale of each part and shall not be deferred.*

FACTORS TO DETERMINE WHEN A PERPETUAL EASEMENT IS GRANTED

When a perpetual easement is granted, there are two issues involved in determining basis:

1. **Property affected.** Basis must be allocated to the portion of the property that is subject to the easement (as opposed to the basis of the rest of the property).
2. **Rights affected.** Basis must be further allocated between the rights created by the easement and the rest of the rights in property subject to the easement.

Determination of Property Affected

This issue has often been disputed in cases involving the granting of a perpetual easement. Taxpayers desire to use their entire basis on a tract of land on which a perpetual easement is granted in order to offset the easement proceeds.

Example 9. Brent, an operating farmer, granted a perpetual easement and right-of-way to Xavier, Inc., in 2008 for a crude oil pipeline that affects a small portion of an 80-acre tract of farmland. He purchased the farmland in 1984 for $2,000 per acre, and his total cost in the 80-acre tract is $160,000. He allocated $10,000 of the $160,000 purchase price to drainage tile, which he already depreciated. He received $15,000 from Xavier for granting the easement and right of way.

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Question 9A. Is Brent permitted to use his entire remaining $150,000 basis in the 80 acres to offset the $15,000 of easement proceeds he received in 2008?

Answer 9A. It appears the answer is **No.** The authority for this answer is:

- Rev. Rul. 59-121,[42] clarified by Rev. Rul. 68-291,[43] which states:

  Where a taxpayer grants an easement that affects only a specific portion of an entire tract of land, only the basis properly allocable to the affected portion is reduced by the consideration received in determining the amount of gain realized, if any.

- *Iske v. Comm'r* [44] (involving easements for electrical transmission lines)
- *Fasken v. Comm'r*[45] (involving pipeline easements)

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42. Rev. Rul. 59-121, 1959-1 CB 212

43. Rev. Rul. 68-291, 1968-1 CB 351

44. *Iske v. Comm'r*, TC Memo 1980-61 (Mar. 5, 1980), *aff'd* by 8th Cir. Ct. of Appeals (unpublished opinion) (Nov. 18, 1980)

45. *Fasken v. Comm'r*, 71 TC 650 (Jan. 25, 1979)

Question 9B. The easement contract specifies that the area covered by the easement on his 80 acres is 50 feet wide and 2,123 feet long. Xavier has no legal rights on Brent's 80-acre tract not included in that specific area.

Applying the authority shown above, how much of Brent's remaining $150,000 cost basis can be used to offset the $15,000 of easement proceeds he received in 2008?

Answer 9B. $4,575 can be used, computed as follows:

1. The specific area granted in the easement is 50 feet × 2,123 feet, or 106,150 square feet.
2. The specific area granted in the easement is 2.44 acres (one acre = 43,560 square feet).
3. $150,000 remaining cost in the 80 acres = $1,875 per acre.
4. 2.44 acres covered by the easement × $1,875 = $4,575

Question 9C. Brent paid $1,500 in legal fees in 2008 for services pertaining to the Xavier easement contract. What is his realized gain in 2008 on granting the permanent easement?

Answer 9C. $8,925, computed as follows:

Easement proceeds	$15,000
Less: legal fees (expense of sale)	(1,500)
Less: cost basis in the easement	(4,575)
Gain on sale of business property	$ 8,925

Question 9D. Where should Brent report this gain on his 2008 tax return?

Answer 9D. On Form 4797, Part I. The long-term gain is taxed at either the zero tax rate or 15% depending on the elements of Brent's 2008 taxable income. This assumes that Brent sold no other capital assets in 2008.

> **Note.** If Brent receives $7,000 in 2009 for damage to growing crops during construction of the pipeline, the $7,000 will be reported on his 2009 Schedule F as other income (line 10).[46]

Question 9E. Is there any authority for Brent to use the $15,000 easement proceeds to reduce his remaining $150,000 basis in his 80 acres to $135,000 and recognize no §1231 gain in 2008?

Answer 9E. Yes, but the selling price may only be credited against the basis for the entire property if an apportionment of the basis is impossible or impractical.[47] With the facts as given, Brent cannot meet this requirement because the Xavier easement contract is not ambiguous or silent regarding the square footage area covered by the easement and right of way.

> **Note.** See Chapter 14, "Agricultural Issues and Rural Investments," for information on wind turbine easements.

46. IRS Pub. 225, *Farmer's Tax Guide*

47. *Inaja Land Co., Ltd., v. Comm'r*, 9 TC 727 (1947) and *Fasken v. Comm'r*, 71 TC 650 (Jan. 25, 1979)

EMINENT DOMAIN (CONDEMNATION)

The energy company discussed above is seeking the power of eminent domain to force reluctant landowners to grant the easements.[48] Taxpayers who grant easements under the use or threat of eminent domain may treat the sales as involuntary conversions.[49] As such, taxpayers may postpone taxation of the gain if they purchase replacement property within three years of the close of the tax year in which the involuntary conversion took place.[50]

> **Note.** See Chapter 3, "Form 4797," Involuntary Conversions, for more information on condemnations.

ISSUE 5: TAX ASPECTS OF FRANCHISES

BACKGROUND INFORMATION

A franchise is a contract with a company (franchisor) that gives the purchaser (franchisee) the right to use that company's name and sell its product within a particular geographical area. It gives small business owners the name recognition of an established brand and experienced guidance to help succeed in its industry. The company may also provide such assistance as:

- Finding a location,
- Start-up training,
- Periodic workshops or seminars,
- Operating manuals,
- Business models,
- Ongoing support,
- Proprietary software,
- Advertising,
- Payroll services, and
- Credit card processing.

According to the IRS, new restaurants have an 80% failure rate in the first two to three years, but franchised and national chain restaurants have an 80–90% success rate.[51]

In exchange for all this help, the purchaser pays the franchising company an initial franchise fee and agrees to operate the business in accordance with the contract. Often the contract requires the purchaser to pay a percentage of its sales to the company, contribute to a cooperative advertising fund, and buy certain products from the company.

As more taxpayers are sold on the idea of franchising, practitioners must have an understanding of the tax consequences of these arrangements. The following material covers common aspects of franchises, from inception to end.

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48. www.pjstar.com/news/x889231516/Lawsuit-targets-eminent-domain-in-pipeline-project (accessed on June 3, 2008)

49. Rev. Rul. 72-549, 1972-2 CB 472

50. IRC §1033(g)(4), see also Ltr. Rul. 200219006 (January 17, 2002)

51. IRS *Retail Industry Audit Technique Guide*, August 2005

PURCHASING A FRANCHISE

A purchaser may contract directly with the franchising company or buy an existing contract from a third party. Typically, an initial purchase includes:

- Equipment and supplies,
- Lease or purchase of real estate,
- Franchise fee, and
- Goodwill (if the company is already operating in the area).

It is important to properly allocate the purchase price among the assets to establish the correct basis for depreciation and amortization.

Equipment is normally depreciated over five or seven years under MACRS. The actual life depends on the industry and the specific equipment.

> **Note.** See Chapter 7, "Depreciation," for a review of MACRS, class lives, and industries with requisite depreciation methods.

Supplies may be capitalized or expensed depending on the quantity and cost. Typically, they are expensed as consumables. However, supplies that are not incidental may be treated as prepaid expenses or as assets that should be capitalized and depreciated.[52]

The taxpayer can elect to deduct certain **start-up and organizational costs** — up to $5,000 each. The balance is capitalized and amortized over 180 months, starting with the month the taxpayer begins operating the business.[53] In 2008, the IRS amended the Treasury Regulations to provide that the taxpayer is **deemed** to elect these deductions. Taxpayers may forgo the election by clearly capitalizating the expenditures on a timely-filed income tax return (including extensions) for the taxable year in which the business begins. The election is irrevocable and applies to all start-up and organizational expenditures that relate to this business.[54]

> **Note.** See IRS Pub. 535, *Business Expenses*, for more information on deducting start-up and organizational costs.

A portion of the purchase price may be allocated to the **right to lease or sublease** real estate.[55] The cost of this right is capitalized and amortized over the life of the lease.[56] The life of the lease includes the current term plus any renewal periods if less than 75% of the cost is attributable to the original lease period.[57] Treasury regulations state that this determination is based on the facts and circumstances of each situation.[58] There are several methods to determine how much of the cost is attributable to the original lease period. These include:

- Contractually-stipulated price of the option to renew,
- Present value of annuity principals, and
- Estimated useful life of the leased asset.

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52. Prop. Treas. Reg. §1.162-3
53. IRS Pub. 535, *Business Expenses*, Chapter 9
54. TD 9411, 2008-34 IRB
55. Treas. Reg. §1.197-2(c)(8)(ii)
56. Treas. Reg. §1.162-11(a)
57. IRC §178(a)
58. Treas. Reg. §1.178-1(b)(5)

Caution. Purchases masquerading as leases should be treated as purchases. There are no bright-line laws or regulations that define whether or not a transaction is a lease for federal tax purposes. However, Rev. Proc. 2001-28 and the related revenue procedures referenced therein provide factors to consider when making this determination. One such factor is the residual cost of purchasing the asset versus its projected FMV at the time the purchase option is exercised.

Any costs allocable to an **option to purchase** should be capitalized. At the time the option is exercised, the cost of the option is added to the depreciable basis of the property. If the option expires without being exercised, the loss is deductible in the same manner that a loss on the sale of the underlying property would have been.

Example 10. Karen signed an option-to-purchase contract with Stregis on May 2, 2008. She paid $5,000 for the option. The contract gave her the right to buy a Stregis Supercuts franchise for $220,000 during the period from May 3, 2008, through May 2, 2009. Her payment for the option will be applied to the $220,000 purchase price if she decides to exercise the option. After carefully exploring all financial aspects, Karen decides not to exercise the option.

Tax Result for Example 10. Karen can deduct a $5,000 loss for abandonment of a business asset on her 2009 Form 4797, *Sales of Business Property,* in Part II (Ordinary Gains and Losses).

Note. See Abandonments in IRS Pub. 544, *Sales and Other Dispositions of Assets*, for more information.

The cost of real estate purchased should be allocated among the components of the property. The cost of the land must be identified, because it is not depreciable. The taxpayer may want to obtain a cost-segregation study to further allocate the price between personal property and real property.

Note. See Chapter 7, "Depreciation," for more information about cost segregation.

The **initial franchise fee** is an intangible asset which is amortizable ratably over 15 years, starting with the month the franchise was acquired.[59] The costs to renew must also be capitalized and amortized over 15 years.[60] Franchise fees based on productivity, which are discussed later, do not have to be capitalized.[61]

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Goodwill and most other intangibles acquired as part of a purchase are also amortizable ratably over 15 years, starting with the month purchased. Other amortizable intangibles include:[62]

- Going concern value;
- Trademark;
- Trade name;
- Noncompete agreements;
- Workforce in place;
- Customer lists and other information bases;
- Any patent, copyright, formula, process, design, pattern, know-how, format, and similar items;

59. IRC §197(a)
60. IRC §197(f)(4)(B)
61. IRC §1253
62. IRC §197(d)

- Customer-based intangibles;
- Supplier-based intangibles; and
- Telephone number.

OPERATING A FRANCHISE

A business operating under a franchise agreement may pay many different types of fees to the franchisor. Often these fees are also called franchise fees. Tax consequences are different for fees that **purchase a right** and fees **based on operations.** Franchise fees are currently deductible if the payments are:[63]

1. Contingent on productivity, use, or disposition of the franchised product;
2. Payable at least annually for the entire term of the franchise agreement; and
3. Substantially equal in amount or payable under a fixed formula.

Example 11. Jeff purchases a window-cleaning franchise on January 1, 2008, for $60,000. Under the agreement, he has the right to use the franchise name, Phish Cleaning, and has access to support from the franchisor. He is required to pay the franchisor the following fees monthly:

- 5% of revenues
- $250 cooperative advertising fee
- 2% of all credit card payments processed through the franchisor

Tax Result for Example 11. The $60,000 franchise fee must be **capitalized and amortized** over 15 years, starting in January 2008.

The fee equal to 5% of revenues is **currently deductible** because it is contingent upon productivity, payable at least annually, and based on a fixed formula.

The $250 per month advertising fee and the 2% credit card processing fee are both **deductible as current expenses.**

Most franchisors that charge cooperative advertising fees also reimburse the operator a percentage of the advertising costs incurred using the franchise name. If the reimbursement is received in the same year as the expense is deducted, the reimbursement should reduce the deductible expense. If the reimbursement is received in a subsequent year, the reimbursement should be reported as income.[64] Ordinarily, this distinction is not important; however, there are tax laws that are based on the gross income of the taxpayer, such as corporate AMT. If applicable, the reimbursements could cause the taxpayer to exceed the thresholds for the given law.

Example 12. Kelly, a calendar-year taxpayer, owns a bookstore that she is operating under a franchise agreement with a major national chain. As part of their agreement, the franchisor reimburses her 60% of all her advertising costs. The reimbursement is paid annually in February for expenses incurred the prior year.

In 2007, Kelly paid $200,000 for advertising. She is a cash-basis taxpayer, so she deducted the full $200,000 on her 2007 return. On February 22, 2008, she received $120,000 from the franchisor, which she recorded as other income. Also during 2008, she spent $10,000 for qualified disabled-access improvements.

Tax Result for Example 12. In 2008, her gross receipts are $900,000 before consideration of the reimbursement. By including the reimbursement as income, her gross receipts are $1,020,000. Since her gross receipts exceed $1 million, she cannot claim the credit for qualified disabled-access improvements that she placed in service during 2008.

63. IRS Pub. 535, *Business Expenses*

64. Ibid

SELLING THE FRANCHISE

Typically, a business owner ends the relationship with the franchisor by selling the franchise. The buyer may be a third party or the franchising company. Most franchise contracts require that any sale be approved by the company, which may complicate the sale process.

Noncorporate Taxpayers — Tax Rates

When a noncorporate owner of a franchise sells the various assets, these assets are subject to different tax treatments. For almost all depreciable assets held long-term, the portion of the capital gain that is attributable to prior depreciation is taxed as ordinary income. Real estate is an exception in that the depreciation recapture is taxed at a maximum rate of 25%.[65]

The sale of assets that produce ordinary income in the course of business is also taxed as ordinary income when sold with the business of the franchise. The proceeds related to these assets are reported on the schedule normally used to report the income and expenses of that business, such as Schedule C. Assets in this category include accounts receivable and inventory.[66]

Any long-term gain from the sale of depreciable assets above the original (prior to depreciation) basis is normally taxed at the lower capital-gains rates of 0% or 15%, depending on the marginal tax bracket of the taxpayer.

Caution. These capital-gains rates are scheduled to expire for tax years beginning after December 31, 2010.[67] See Chapter 9, "Individual Taxpayer Problems," for more information on the future of the zero tax rate.

The sale of goodwill and other intangibles are eligible for capital-gains tax rates on the portion of the gain in excess of any prior amortization.[68] When multiple intangibles are disposed of in a single transaction or a series of related transactions, all the intangibles are treated as if they were a single asset for purposes of determining the amount of gain that is ordinary income, except those whose value is less than the basis.[69]

Income from a noncompete agreement between the seller and the new owner is taxed as ordinary income on Form 4797, Part II.[70] The courts have consistently held that payments received for noncompete agreements are compensation for services, "albeit in the negative form of forbearance from future competitive conduct."[71] From the seller's perspective, this makes the noncompete distinct from other intangibles. The seller is not transferring an intangible that he already owned; instead, he is being paid in advance to refrain from working in a competitive manner. The buyer, however, is buying an intangible which may be amortized as a §197 intangible.

65. IRC §1(h)(1)(D)
66. IRC §1221(a)(4)
67. Tax Increase Prevention and Reconciliation Act of 2005 (TIPRA), Pub. Law 109-222, §102
68. Sales of amortizable property used in a trade or business are governed by §1231, which allows net gains to be taxed at capital-gains rates.
69. IRC §1245(b)(8) for sales after August 8, 2005
70. Rev. Rul. 74-29, 1974-1 CB 79; see also the *Muskat* case in the "Capital Gains and Losses" section of Chapter 15, Rulings and Cases.
71. *Davee v. U.S., Jordan and Lea Associates, Inc. v. U.S.*, U.S. Court of Claims, Nos. 242-66, 433-66, 195 Ct. Cls. 184 (June 11, 1971)

Example 13. Carla, a sole proprietor, owns a retail cosmetic store. The store has a franchise agreement with a national supplier. She purchased the franchise agreement directly from the supplier in July 1994 for $40,000. In July 2008, she sold the business. In the sales contract, the sales price allocated to intangibles includes:

Franchise agreement	$ 3,000
Goodwill	50,000
Covenant not to compete	2,000

Computation of adjusted basis:

Intangible	Cost	Prior Amortization	Adjusted Basis
Franchise agreement	$40,000	$37,339	$2,661
Goodwill	0	0	0
Covenant not to compete	0	0	0

Gain on intangibles:

Intangible	Sales Price	Basis	Gain
Franchise agreement	$ 3,000	$2,661	$ 339
Goodwill	50,000	0	50,000
Covenant not to compete	2,000	0	2,000

Tax Result for Example 13. Carla must report the $2,000 gain from the covenant not to compete as ordinary income on Form 4797, Part II.

She wants to report the gains on the franchise agreement and the goodwill separately. This is allowed since IRC §197(c)(2) excludes "self-created intangibles" (such as Carla's goodwill) from the definition of amortizable §197 intangibles. Thus, Carla has a $50,000 long-term capital gain on the goodwill and a $339 ordinary §1245 gain on the sale of the purchased franchise agreement.

If Carla's goodwill had been purchased rather than created, she would be required to report the franchise agreement and the goodwill as the sale of a single asset on Form 4797, Part III..

Note. Both the buyer and seller are required to file Form 8594, *Asset Aquisition Statement,* to make certain that assets are being classified in the same manner by both parties.

Corporate Taxpayers — Tax Rates

When a franchise is owned by a C corporation and it sells the business, the net capital gain realized by the C corporation is generally taxed at the same marginal rate as ordinary income, but the tax on the net capital gain is capped at the 35% rate.[72] However, the characterization of income as ordinary or capital gain is still important because a C corporation cannot deduct capital losses against ordinary income.[73]

Net capital gains realized by S corporations generally pass through to the shareholders and are taxed at the rates applicable to each shareholder.

ABANDONING THE FRANCHISE

Not all franchise agreements end happily. When a business operator wants to leave the business, she may not be able to find a buyer for her assets or for the franchise agreement. She may find that simply going out of business violates the franchise contract or subjugates her to damages under the contract.

What Constitutes Abandonment[74]

Determining that an asset has been abandoned is based on the facts and circumstances in each situation. Generally, a taxpayer must both show intent to abandon the asset and must overtly attempt to abandon it. This is usually easy to establish when physical assets are involved.

> **Caution.** When a business is abandoned, frequently there are assets that the former operator retains for personal use. Tax consequences to consider include:
>
> - Recapturing §179 deductions,
> - Recapturing bonus depreciation for vehicles, and
> - Taxable distributions from corporations and partnerships.

It is not always as easy to determine when intangible assets are abandoned. The courts have held that abandonment of intangible property should be accompanied by some "express manifestation" that makes it obvious to outsiders that an irrevocable separation has occurred. For example, dissolution of the business entity would be an express manifestation of abandonment. In that case, the operating intangibles (e.g., the franchise agreement and goodwill) and the organizational intangibles would be considered abandoned.

Deducting Losses from Abandonment

Taxpayers may claim a loss equal to the asset's adjusted basis at the time of abandonment.[75] The loss is reported on Form 4797, Part II, Ordinary Gains and Losses.

Contract Settlements Paid

The origin and character of the claim for damages determines if the settlement is deductible as an ordinary business expense. For example, the IRS determined that settlement of a legal claim based on monthly franchise fees is deductible in the year paid because the monthly franchise fees are currently deductible.[76] Legal fees defending a breach of contract suit are also currently deductible.[77]

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72. IRC §1201(a)
73. IRC §1211(a)
74. Rev. Rul. 2004-58, IRB 2004-24
75. Treas. Reg. §1.167(a)-8(a)(4)
76. Rev. Rul. 79-208, 1979-2 CB 79
77. Rev. Rul. 69-547, 1969-2 CB 24

ISSUE 6: TAX ASPECTS OF SIDELINE BUSINESSES

BACKGROUND

Many taxpayers have small businesses or sideline ventures in addition to their "paycheck" jobs. This trend is increasing with the ease of establishing a website or selling items via online auctions.

Sideline businesses of clients can be difficult and time consuming for tax practitioners. Many taxpayers never disclose the existence of profitable sideline ventures to their tax preparer, such as selling unused season tickets to sporting events at an online auction site. However, when the ventures are unprofitable, most clients willingly disclose this information to their preparer in an attempt to lower their tax liability. Unprofitable ventures often include such activities as multi-level marketing, horses, or automobile racing.

> **Note.** See "Issue 2: Not-for-Profit Activities," earlier in this chapter, for more information on activities that may be governed by the rule of §183.

In many cases, the records kept by clients who have sideline businesses are inadequate. The preparer must educate clients about what records to keep and how to keep them. If the records have to be reconstructed, the time spent by the preparer can be significant. Preparers should discuss the fees for additional time with the client prior to compiling the records.

Taxpayers turn to their tax advisors with numerous questions about these undertakings. The remainder of this section discusses some common questions and tax consequences of sideline enterprises.

Taxable Income

How many times have preparers heard "I made under $600, so I don't have to pay taxes on this income, right?" from clients?

Despite the popular belief that if income isn't reported to the IRS, it isn't taxable, "gross income means all income, from whatever source derived" except for certain income specifically excluded from gross income under the law.[78]

Conducting a Business

Is the taxpayer in business? It is important to first establish the nature of the activity in order to properly report its income and deductible expenses. Unfortunately, the Code does not define **business** except in a few specific circumstances.[79] The courts have concluded that the facts and circumstances of each situation determine if the taxpayer is in business or if the taxpayer is engaged in a hobby or other nonbusiness activity.[80]

In 1987, the U.S. Supreme Court identified a 2-prong test[81] to determine whether an activity is engaged in as a business. To meet this test, the taxpayer must:

- Be involved in the activity with continuity and regularity, and
- Intend to generate a profit.

The first prong of the test is subjective and should be determined based on the taxpayer's particular situation. A sporadic activity or hobby does not qualify as a business,[82] **even if it is profitable.**

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78. IRC §61(a)
79. *Comm'r v. Groetzinger,* 480 U.S. 23 (1987)
80. *Higgins v. Comm'r,* 312 U.S. 212 (1941)
81. *Comm'r v. Groetzinger,* 480 U.S. 23 (1987)
82. Ibid

The second prong was explained in detail earlier in "Issue 2: Not-for-Profit Activities."

Observation. There is a tendency among practitioners and the IRS to **first** establish if there is a profit and **then** base the categorization of the activity on the extent of the profit or loss and the tax consequences of each treatment. **This may not result in the most accurate treatment of the activity.**

Example 14. One weekend in the cold of winter, Annette was bored. She found an Internet site that invites the psychically gifted to register as psychic hotline advisors. Advisors receive 50% of all fees generated for their calls.

Over the weekend, Annette earned $2,000. Despite the lucrative pay, she decided not to continue working the hotline due to the strain on her voice and ears.

Tax Result for Example 14. Because the activity was a single event, it does not meet the continuity test to be considered a business.[83] The $2,000 is reported as "other income" on Form 1040, page 1, and is not subject to self-employment tax.

REPORTING BUSINESS ACTIVITIES

Assuming the activity is a sole proprietorship (or qualified husband-and-wife joint venture),[84] the business income and expenses are reported on either Schedule C or F. The taxpayer may be eligible to deduct home-office expenses as covered earlier in this chapter in "Issue 1: Home Office Deduction."

Any net business profit is subject to self-employment tax as well as income tax. However, this net profit may also make the taxpayer eligible for benefits such as:

- The earned income credit,
- The child tax credit,
- The child and dependent care credit,
- A higher personal exemption, if a dependent,
- Social security benefits, and
- IRA and pension contributions and deductions.

Caution. Practitioners should be careful to deduct only the business portion of expenses that are related to both personal and business use. Examples include vehicles, home computers, Internet access fees, and phone usage.

83. Ibid

84. IRC §761(f)(2)

REPORTING NONBUSINESS ACTIVITIES

The income and expenses of **nonbusiness** activities are reported in different places on the income tax return depending on the source of the income.

Selling Nonbusiness Services

Income from selling services is reported on Form 1040, line 21, other income. Expenses incurred to earn the income are deductible on Form 1040, Schedule A. Treasury regulations[85] specify the order in which these expenses are deducted by categorizing them into three tiers:

- **Tier 1** expenses are those **related to the nonbusiness activities that are also deductible under other provisions of the Code.** These include home mortgage interest, taxes, and casualty losses. These deductions are not limited to the income from the hobby. However, if Tier 1 expenses exceed the activity's income, no further deductions are allowed.
- **Tier 2** expenses are **those that do not result in an adjustment to the basis of property.** Examples include advertising, supplies, and travel. Deductions for Tier 2 expenses cannot exceed gross income minus Tier 1 expenses. These expenses are subject to the 2% AGI limitations.
- **Tier 3** expenses are **those that reduce the basis of property, such as depreciation.** Deductions for Tier 3 expenses cannot exceed gross income minus the Tier 1 and 2 expenses. These expenses are also subject to the 2% AGI limitations. Disallowed Tier 3 expenses do not reduce the asset's basis.

Expenses in excess of income do not carry forward.

Example 15. Gene loves to photograph wildlife. He spends his weekends hiking in the mountains near his home, capturing intriguing moments. When he has time, he travels to distant wildlife preserves to photo-document the inhabitants.

In February 2008, he decided to share his passion with the world by establishing a website dedicated to his collection. Visitors to the website are charged a nominal fee to download copies of their favorite pictures. During 2008, he collected $3,000 from the download fees. He paid the following expenses related to the activity:

Tier 1

- Interest paid on home equity line of credit (used to purchase new digital camera) — $720

Tier 2

- Website hosting fee — $250
- Internet subscription — $330 ($30 per month for 11 months)
- Mileage to remote locations — 2,000 (900 of which was incurred prior to July 1)

Tier 3

- Laptop computer purchased in 2007 — $800 (worth $500 when he started the website)
- Digital camera (5-year MACRS property) purchased in 2008 — $6,000

Gene kept a log documenting the amount of time he used the computer and the Internet for this hobby versus his other personal activities. He found his personal use of the computer to be exactly 20%. The digital camera was used solely for the website activity.

85. Treas. Reg. §1.183-1

Tax Result for Example 15. His preparer reports the $3,000 income on Form 1040, line 21 and divides the list of expenses into the appropriate tiers. His expenses are reduced by any personal portion unrelated to the photo venture.

Gene's allowable Schedule A deductions are:

Gross Income		$3,000
Tier 1: Mortgage interest paid on equity line of credit (Sch. A, line 10)		(720)
Net income after Tier 1 deductions		$2,280
Tier 2: Mileage (900 × $0.505)	$ 454	
Mileage (1,100 × $0.585)	644	
Website hosting	250	
Internet subscription	330	
Less: personal-use portion	(66)	
Total Tier 2 expenses (Sch. A, line 23)	$1,612	(1,612)
Net income after Tier 2 deductions		**$ 668**
Tier 3: Depreciation of camera ($6,000 × 20% MACRS)	$1,200	
Depreciation of laptop ($500 × 80% website use = $400 × 20% MACRS)	80	
Total Tier 3 expenses	$1,280	(1,280)
Tier 3 deductions limited to net income after Tier 2 (Sch. A, line 23)		**$ 668**

Gene allocates the $668 of depreciation pro rata between the camera and laptop.[86] His basis in the equipment is reduced only by the amount actually deductible.

Selling Nonbusiness Assets

Merchandise sold **outside** of the ordinary course of business is a capital asset, not inventory.[87] Capital assets qualify for the lower long-term capital-gains rates, while inventory is taxed as ordinary income.

Income from **selling nonbusiness assets** is reported on Form 1040, Schedule D less the direct costs of purchasing or creating the goods. Profits are taxed as long- or short-term capital gains depending on the length of time the assets were held. Losses from sales of personal-use assets and hobby merchandise are not deductible.[88]

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Example 16. In 2006, Kim purchased a remote-controlled bronze ceiling fan for $300 (regularly priced $600) at a going-out-of-business sale. Although she intended to install it in her home, the fan was still sitting in her garage two years later. In 2008, she sells it to Bob for $450.

Tax Result for Example 16. Kim reports this sale on Form 1040, Schedule D, *Capital Gains and Losses*, Part II. Because she held the fan for more than one year, the $150 profit is a long-term capital gain and qualifies for either the 0% or 15% capital gains tax rate depending on her other income.

Any expenses related to selling the items, other than the direct costs, are deducted on Schedule A using the tier system explained above.

Note. If the taxpayer's sideline venture does not meet the requirements to be considered a business, sales of merchandise in multi-level-marketing activities are reported on Schedule D.

86. Treas. Reg. §1.183-1(b)(2)

87. IRC §1221

88. Treas. Reg. §1.262-1(b)(4)

Selling Collectibles

The maximum long-term capital gains rate for collectibles is 28%, as opposed to 15% for other capital assets.[89] Collectibles are defined as any:[90]

- Work of art,
- Rug,
- Antique,
- Metal (such as gold, silver, platinum bullion),
- Gem,
- Stamp or coin, or
- Alcoholic beverage.

Example 17. Larry sells a gold coin for $600 in 2008. It was worth $200 when he inherited it. He pays the online auction site $30 in fees related to the sale.

Tax Result for Example 17. Larry reports the sale on Form 1040, Schedule D, Part II. He shows the sales price of $600 and the basis of $230 for a profit of $370. The $370 gain on the gold coin is taxed at a maximum rate of 28%.

Example 18. Larry also sells an autographed baseball for $300 in 2008; it was worth $140 when he inherited it. He pays the online auction site $15 in fees related to the sale.

Tax Result for Example 18. Larry reports this sale on Form 1040, Schedule D, Part II. He shows the sales price of $300 and the basis of $155 for a gain of $145. Since baseballs are not included in the list defining collectibles, his baseball is a capital asset that qualifies for long-term capital gains tax rates. The $145 gain on the baseball is taxed at a maximum rate of 15%.

Caution. The code section defining collectibles includes "any other tangible personal property specified by the Secretary for purposes of this subsection."[91] Currently, the regulations do not add any other collectibles to this list.

The only IRS guidance expanding on the list of collectibles subject to the maximum 28% tax rate is the instructions for the 2007 Form 1040, Schedule D. The instructions state that "Collectibles include... certain other tangible property."

Although IRS instructions do not constitute substantial authority, if the return is examined, the IRS may argue that the baseball is a collectible subject to the maximum 28% tax rate. On the other hand, the IRS examiner may be amazed that the sale is reported and not pursue the issue.

Only the excess of collectible gains over collectible losses for the year is subject to the maximum tax rate of 28%.[92]

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89. IRC §1(h)(4)

90. IRC §408(m)(2). Note: IRC §1(h)(5) states that collectibles for this purpose are defined by §408(m) without regard to paragraph 3 thereof.

91. IRC §408(m)(2)(F)

92. IRC §1(h)(4)

Example 19. Curly, who is single, owns two completely-restored vintage autos. He drives them occasionally for personal use and displays them at several auto shows every year. In 2008, he sells both autos after he loses his high-paying job. The sales are summarized in the chart below:

Automobile	Date Bought	Purchase Price	Date Sold	Sales Price	Gain or (Loss)
1950 Packard	03/02/1999	$40,000	07/06/2008	$35,000	($5,000)
1956 Corvette	09/04/2003	60,000	08/09/2008	70,000	10,000
Net gain on sale of antique autos in 2008					$ 5,000

Tax Result for Example 19. Before consideration of the collectible gain, Curly's 2008 taxable income is $170,000, which is in the 33% tax bracket. The $5,000 net gain from the sale of these two antiques is taxed at 28%.

Note. If Curly's 2008 taxable income before consideration of the collectible gain was only $10,000, his marginal tax rate would be 15%. As such, the $5,000 gain would only be taxed at 15%, which is the lesser of his marginal rate or the maximum capital gains rate on collectibles. If Curly sustained a net loss, the loss would not be deductible if the cars are considered personal-use assets.

Losses from listed collectibles may be deductible,[93] depending on the use of the asset.

Example 20. Laura purchased a painting by a local artist whom everyone believed would be the next Frida Kahlo. She paid $800 for the painting in 2001. She stored the painting carefully in anticipation of its appreciation. In 2008, she sold the painting on eBay for $200.

Tax Result for Example 20. Based on the given facts, the painting is not a personal-use asset. Taxpayers are allowed to deduct losses incurred in any transaction entered into for profit,[94] unless otherwise prohibited. Therefore, Laura can deduct the $600 loss on her 2008 Schedule D, Part II.

EMPLOYEES OR CONTRACTORS[95]

It is critical that businesses correctly determine the status of individuals who provide services to them. Individuals may be employees or independent contractors. Generally, businesses must withhold income taxes, withhold and pay social security and Medicare taxes, and pay unemployment tax on wages paid to an employee, in addition to any state-specific requirements. Businesses do not generally have to withhold or pay any taxes on payments to independent contractors.

Note. This topic is discussed in depth in Chapter 1, "Employment Taxation."

93. IRC §1(h)(5)(A)

94. IRC §165(c)(2)

95. www.irs.gov/businesses/small/article/0,,id=99921,00.html

GOOD BUSINESS PRACTICES

Records

Practitioners should encourage small businesses to keep proper records and adopt management techniques to help the businesses succeed. The University of Illinois Tax School has a free 8-page Adobe (PDF) handout suitable for clients available on its website. The handout is called "Recordkeeping in a Nutshell" and can be found at **www.TaxSchool.uiuc.edu/pdf/recordkeeping1.pdf.** In addition to providing answers to "What do I keep?" and "How long do I keep it?" the handout also explains IRS documentation requirements for vehicles, listed property, and other special expenses.

The IRS encourages businesses to have a separate bank account for each activity. Proper segregation of funds also helps the business owner keep better track of income and expenses.

Business Plans

Practitioners may provide value-added services to small businesses by helping them design business plans. Although business plans are most often thought of as financing tools, they can also be the roadmap that helps management understand key aspects of the business and stay on track.

There may also be local issues that practitioners should address with their clients. Potential topics include:

- State and local sales taxes,
- Zoning regulations, and
- "Doing business as" name registration.

Other Resources

IRS Website. The IRS website is a valuable resource for practitioners and small businesses. Under the business tab on **www.irs.gov,** there is a link to the small business resources page, which has references to many informative articles. The following are among the types of information available on the website:

A-Z Index for Business
Find it Fast! Know what you're looking for and want to find it fast? Select business topics using our A-Z listing, or by business type such as sole proprietor, corporation, etc. We also provide links to major business subjects, such as Business Expenses, which provides a gateway to all related information on that subject.

Business-related News
Keep abreast of the latest tax-related news that could affect your business.

Self-Employed Individuals
The basics on self-employment, filing requirements, and reporting responsibilities for independent contractors.

Business Expenses
Find out what qualifies as a deductible business expense, including depreciation.

Businesses with Employees
Guidance on tax-related responsibilities for an employer.

Small Business Forms and Publications
Download multiple small business and self-employed forms and publications.

- Online Learning and Educational Products
  Learn about business taxes on your own time, and at your own pace.
- Employer ID Numbers (EINs)
  Find out more on EINs or apply for one online.
- Industries/Professions
  Industry-specific information
- Starting, Operating, or Closing a Business
  Deductions, recordkeeping, accounting methods...
- Filing and Paying Your Business Taxes
  Information about how to pay your business taxes.

Electronic IRS: File, Pay.... and More
The IRS is making it easier than ever for you to conduct business with us electronically.

Filing Late and/or Paying Late
Before you decide not to file your tax return on time or not pay all of your taxes when they are due, consider this.

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Small Business Resources

Business.gov
Business.gov guides you through the maze of government rules and regulations and provides access to services and resources to help you start, grow, and succeed in business.

Court Rulings
This page provides links to various federal, state and private sites that provide legal information for the small business owner.

Department of Agriculture - Office of Small and Disadvantaged Business Utilization (OSDBU)
The mission of the OSDBU is to provide maximum opportunities for small businesses to participate in USDA contracting activities by establishing and attaining small disadvantaged business program goals.

Department of Commerce
The Commerce Department's mission is to create the conditions for economic growth and opportunity by promoting innovation, entrepreneurship, competitiveness and stewardship.

Department of Labor: Occupational Safety & Health Administration (OSHA)
OSHA's mission is to assure the safety and health of America's workers by setting and enforcing standards; providing training, outreach, and education; establishing partnerships; and encouraging continual improvement in workplace safety and health.

GobiernoUSA.gov
El portal oficial en español del Gobierno de los EE. UU (The U.S. government's official Spanish-language Web portal)

SBTV.com
SBTV.com is a television network on the Web devoted exclusively to providing engaging streaming video content to small businesses. It provides technical information on how to run your business, inspirational stories from entrepreneurs across the country, information about small business conferences and events, and resources to help solve day-to-day business challenges.

Small Business Administration
The mission of the SBA is to maintain and to strengthen the nation's economy by enabling the establishment and viability of small businesses and by assisting in the economic recovery of communities after disasters.

In addition, the IRS issues several publications each year to help small businesses comply with tax provisions. The following may be helpful:

- IRS Pub. 15, Circular E, *Employer's Tax Guide*
- IRS Pub. 334, *Tax Guide for Small Business (For Individuals who Use Schedule C or C-EZ)*
- IRS Pub. 535, *Business Expenses*
- IRS Pub. 538, *Accounting Periods and Methods*
- IRS Pub. 583, *Starting a Business and Keeping Records*

Internet. Besides the IRS website, there is a vast and ever-expanding amount of business information available on the Internet. Of course, the user must exercise caution in making judgments about the reliability of the various resources at hand. If one is unsure about the credibility of a certain source of information found by using an Internet search engine, for example, it is always prudent to verify the data in another manner. Still, aside from concerns about the trustworthiness of data, the Internet often proves to be an invaluable resource in generating ideas for the business owner to run the business in a more efficient, effective, and creative way.