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Sebastian has a number of issues as a taxpayer (TP) to deal with in what should have been his golden years.

Appraisal Activity

The first issue is whether his appraisal activity is a trade or business or a hobby. The difference is significant because if it is a hobby then only the expenses up to the \$40,000 he earned are deductible. If it is a business, then all expenses associated with the business are deductible and any loss may offset other income. It sounds like he did it on the side for free for friends, but is now trying to make it a business. Under sec 183 and the corresponding reg 1.183-2, it is presumptively a business if it makes profits in 3 of the last 5 years. There are no facts to support this presumption. The other factors which must be examined as outlined in the reg. are:

- 1) Manner in which TP carries on the activity;
- 2) Expertise of TP;
- 3) Time and effort expended by TP;
- 4) Expectation that assets used may appreciate;
- 5) Success of TP in similar or other activities;
- 6) TP's history of income with respect to the activity;
- 7) Amount of occasional profits;
- 8) Financial status of TP; and
- 9) Element of personal pleasure or recreation.

On balance, it seems Sebastian's appraisal activity is a business. It earned him 25% of his income for the year, he set up an office for the activity, it fits in with his prior teaching in art history and he owns a substantial art collection.

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§183 vs
§162
make?

Since it is a business, all necessary and ordinary expenses incurred in carrying on the business are deductible under sec. 162. The only expenses that seems to qualify would be his expenses in attending the national conference of art historians in Honolulu. Sec. 162 allows a deduction for all traveling expenses including meal and lodging while away from home in the pursuit of a trade or business as long as the expenses are not lavish in the circumstances. The expenses:

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are most likely in the pursuit of his appraisal business. Even though it is an event he has attended for 30 years, it is important for him to continue with old contacts and make new ones if he want to continue drumming up new appraisal customers. The issue is if the expenses were too lavish. It seems to me that \$500 per night for an art professor in Hawaii is extravagant. On the other hand, only wealthy people need art appraised and there may some image involved in staying there. On balance, I would say it is deductible.

Standards for deducting educational expenses?

Even if it is deductible under sec 162, the expenses may need to be capitalized as a startup cost of his new business. *what about the T/B of teaching?* Since he is new to the business, any expenses in the pursuit of a new business need to be capitalized and then amortized. It is unclear from the facts where in the process this conference was. If the business was already running, then it is deductible. If not, then it must be capitalized and amortized. However, it may be fully deductible since startup costs up to \$5,000 are deductible in the year the business starts. Since the business had \$40,000 of income this year, it has clearly started and the amount would be deductible since it is under \$5,000 and it does not appear from the facts there are any other startup costs which would limit the deduction.

Since it is a business, Sebastian may be entitled to a home office deduction under sec 280A. It can not be a home office for his teaching because it must be for the convenience of his employer. His employer has provided him an office at school which he does not personally like. Therefore, his teaching use of the home office is for his convenience, not theirs. The next way it may qualify is that it must be exclusively used as the principal place of the appraisal business or as the place for the administration or management of the appraisal business if there is no other location. Here, there is no other place to use for his appraisal business. However, it still fails as a home office as it is also used for his teaching activities and is therefore not exclusive to his

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appraisal business. *Can be used for 2 businesses.*

The computer which is used for both his teaching and appraisal business may be a capital expenditure that may yield a deduction. From the facts it seems that he uses it exclusively for either teaching or the appraisal business. If he does, then he would be entitled to take ACRS depreciations on the computer as a deduction. However, sec. 179 allows for up to \$100,000 of tangible personal property to be deducted in year 1. It seems this qualifies for Sebastian and he should be entitled to the \$3,000 deduction. *furniture, too?*

Living Expenses

The next issue is whether or not he may deduct his expenses while in HSFA. Sec. 162 allows a deduction for all traveling expenses including meal and lodging while away from home in the pursuit of a trade or business as long as the expenses are not lavish in the circumstances. The test (*Groetzinger*) for whether it is a trade or business is if it is the TP full time activity, is the TP involved on a regular and continual basis and is the activity intended as a source of the TP livelihood? His teaching assignment at HSFA is more than likely trade or business because, even though it fails the full time test, he has been involved on a regular basis for 30 years and it is intended as source of his livelihood since it provided 75% of his income for the year. Even though he was retired for 2 years, that seems like too short a break as compared to 30 years to be considered a break in his pursuit of teaching art history.

The real issue he has is whether or not he is away from home. A TP is considered away from home if he accepts a temporary work assignment which is one that will last less than one year. Although we do not have exact dates, it does appear that the teaching assignment is less than one year and it would qualify as a temporary assignment. However, he is involved in a divorce

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with his wife over the family home. It appears he has given up any right to live in the house as it is for sale and when he returned to Leland for the summer, he had to rent a hotel room because his wife had possession of the house. In *Rosenspan*, the court held that the language of the statute is plain and the taxpayer must have a home to be "away from". The rationale is that the statute provides some relief for duplicated living expenses. There may be some months where he and his wife were haggling over the house, but it seems he has no house to be away from and therefore, there is no deduction for his living expenses in HSFA. The IRS view is that home is where the business is, but even that fails here because the business is at HSFA and he is not "away from" HSFA.

Sebastian may then argue that his hotel and living expenses incurred for the summer in Leland should be deductible. Since the idea of the statute is to provide relief for duplicated expenses, he has the expenses of his apartment at HSFA plus his hotel in Leland for the summer. This argument would fail because his travel to Leland is not for the benefit of his trade or business. It seems like it is purely personal to either handle his divorce or to visit friends or family. Since there is no business purpose, there is no deduction. As far as the apartment for the summer, it is either for his convenience (so he does not need to find another in the fall) or it may in fact be his current home. The bottom line is no deduction for either the hotel or the apartment for the summer.

Very good analysis - short and to the point!

Since he is not "away from" home, in order to be deductible, there would need to be some business purpose for the car rental. If it is strictly for his commute, it is not a deduction as commute costs are non-deductible. It is irrelevant that it is cheaper than cab fare. Without more, the car is not deductible because commute costs are not deductible.

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Art Work

If all the pieces of art have the same chance of appreciation in the future, then my advice to Sebastian is to transfer to his wife the art work he purchased for \$500 years ago. The \$500 basis will transfer to his wife since it is a property settlement under the divorce decree. If it is sold, she will pay taxes on the \$99,500 gain albeit at the long term capital gain rates for collectibles of 28%. This way he still keeps the same value of art work with the same chance of appreciation, but he is not responsible for the \$99,500 "built in" gain.

Sale of Leland home?

Discount Travel

Sebastian is flying for free under a family pass provided by his nephew who works for the airline. This may be a free fringe benefit to his nephew under sec 132(a)(1) as a no additional cost service. However, Sebastian is an uncle and is not a qualified employee as defined by reg. 1.132-1(b). Since he is not qualified, it not a tax free fringe to his nephew. The tickets are probably taxable to Sebastian for the value of the travel. It appears the value is \$300 each way or \$6,000 total to Sebastian. It is unclear from the facts if Sebastian flew for free or if he paid \$100.

gift from Nephew is excludable §102

Hope you have a nice summer off.

Thanks!

END OF EXAM

Income

Salary	}	$\frac{19}{25}$
Airfare		
Art transfer		
Sale of mansion		

Expenses

HSFA	$\frac{30}{30}$
Home office	$\frac{20}{20}$
Conference	$\frac{8}{10}$
Other	$\frac{15}{15}$

$$\frac{92}{100}$$

Good work!