

BEFORE THE TAX COMMISSION OF THE STATE OF IDAHO

In the Matter of the Protest of)	
)	DOCKET NO. 0-482-984-960
,)	0-528-598-016
)	
Petitioners.)	DECISION
<hr style="width: 45%; margin-left: 0;"/>)	

(Petitioner-wife) and (jointly, Petitioners) protested the Notice of Deficiency Determination (Notice) for tax years 2018 and 2019 dated March 16, 2022, and the Notice for tax years 2020 and 2021 dated December 2, 2022. The Tax Commission reviewed the matter and hereby issues its final decision to modify the Notice for tax years 2018 and 2019 as modified and re-issued March 16, 2023, and to uphold the Notice for tax years 2020 and 2021 as issued December 2, 2022.

Background

The Tax Commission’s Audit Division (Audit) initially reviewed Petitioners’ 2018 and 2019 Idaho returns. Audit determined that Petitioners did not qualify for investment tax credit (ITC) they claimed to have earned for the purchase of a trailer in 2018 and issued a Notice on March 16, 2022, to deny the credit. Petitioners protested the Notice and on May 17, 2022, submitted amended federal and Idaho returns for 2018, 2019, and 2020. They provided an additional response on June 16, 2022, explaining the changes they made to their 2018, 2019, and 2020 returns. Audit sent a letter acknowledging the protest on June 23, 2022.

On August 9, 2022, Audit sent Petitioners a letter announcing the decision to expand the inquiry to include tax years 2020 and 2021 and issues beyond ITC. In this letter, Audit requested information and documentation to support business expenses claimed on Schedule C for tax years

2018 through 2021, along with a description of the qualified property placed in service during 2021 for which they claimed ITC.

Petitioners submitted information regarding activities reported on Schedule C, which Audit reviewed. Audit determined that Petitioners were not engaged in the activities for profit and issued a modified Notice for tax years 2018 and 2019 and a first Notice for tax years 2020 and 2021 on December 2, 2022, denying the total losses claimed on Petitioners' Schedule C for all four years, maintaining denial of ITC claimed on their 2018 and 2019 Idaho returns, and denying ITC claimed on their 2021 Idaho return.

Petitioners' protest of the original Notice for 2018 and 2019 was carried forward to the updated version for the same years. Petitioners renewed their objection to this Notice and filed a protest to the Notice for tax years 2020 and 2021, as well. They provided some additional documentation to support their position, but Audit did not cancel either Notice.

Audit issued a second modified Notice for tax years 2018 and 2019 on March 16, 2023, to correct an administrative error in which the adjustment for ITC was inadvertently included twice for each year, thereby overstating the amount due. This Notice included a statement that Petitioners' file would be sent to the Tax Commission's Appeals unit (Appeals) if they still disagreed with the adjustments. Petitioner provided documentation in response to this Notice, some of which was new but most of which was duplicates of information they had already submitted.

After receiving this information, clearly intended to show continued disagreement with the Notice, Audit forwarded the case to Appeals to continue the redetermination process. Appeals sent Petitioners a letter informing them of their appeal rights. Petitioner-wife requested a hearing, which was held on October 6, 2023, via telephone. Petitioner-wife attended the hearing. In accordance

with Idaho Code section 63-3045B(3)(b), the Tax Commission must render its final decision before April 3, 2024.

Law & Analysis

Profit Motive

Internal Revenue Code (IRC) section 162 allows taxpayers to claim a deduction for ordinary and necessary expenses paid or incurred in carrying on a trade or business. An expense is “ordinary” if it is normal or customary within a particular trade, business, or industry and “necessary” if it is appropriate and helpful for the development of the taxpayer’s business.¹ Expenses of a personal nature are not deductible under IRC section 162.² The taxpayer must be able to demonstrate that she is carrying on a trade or business for profit to be allowed expenses under IRC section 162.³ Whether a taxpayer is carrying on a trade or business within the meaning of IRC Section 162 is a matter of degree to be inferred from an examination of the facts and circumstances of the case. The taxpayer bears the burden to show that the activity is engaged in for profit, with the taxpayer’s statement of intent given less weight than the objective facts of the case.⁴ An activity does not need to show a profit, but taxpayers must have an actual and honest objective of making one.⁵ IRC section 183 establishes that if an activity is found to be “not engaged in for profit,” then losses are deductible only to the extent of the income earned by the activity and cannot be used to offset other income.

The question in this case is whether the craft-related activity Petitioners reported on Schedule C for 2018, 2019, 2020, and 2021 was engaged in for profit. The following nine factors

¹ *Hart v. Comm’r, T.C. Memo. 2013-289*

² *Marcello v. C.I.R.*, 380 F.2d 499, 504 (5th Cir. 1967)

³ *Fischer v. United States*, 336 F. Supp. 428, 431 (E.D. Wis. 1971), *aff’d*, 490 F.2d 218 (7th Cir. 1973)

⁴ *Burger v. C.I.A.*, 809 F.2d 355 (7th Cir. 1987)

⁵ *Dreicer v. Commissioner*, 78 T.C. 642, 645 (1982)

established by *Treasury Regulation section 1.183-2(b)* are used to distinguish between for-profit trades or businesses eligible for IRC section 162 deductions and not-for-profit hobbies limited to deductions under IRC section 183 and have been referenced as authority in numerous court cases.

No single factor is determinative.

1. The manner in which the taxpayer carries on the activity
2. The expertise of the taxpayer or his or her advisers
3. The time and effort expended by the taxpayer in carrying on the activity
4. The expectation that the assets used in the activity may appreciate
5. The success of the taxpayer in carrying on other similar or dissimilar activities
6. The taxpayer's history of income or losses with respect to the activity
7. The amount of occasional profits, if any, which are earned
8. The financial status of the taxpayer
9. Elements of personal pleasure or recreation

Additionally, if the gross income derived from an activity exceeds the deductions for expenses (i.e., if the activity results in a profit) in any three of five consecutive years, then the activity is presumed to be engaged in for profit.⁶ In this case, Petitioners do not meet the criteria for such a safe harbor presumption. Each of the nine factors from *Treas. Reg. section 1.138-2(b)* are discussed in turn below.

(1) The manner in which the taxpayer carries on the activity

If a taxpayer carries on an activity in a business-like manner, it may indicate that he or she is engaged in it for profit. This can include maintaining complete and accurate books and records, carrying on in a manner similar to profitable activities that are comparable in nature, or changing operating methods, adopting new techniques, or abandoning unprofitable methods in a way that is consistent with an intent to improve profitability.

⁶ *IRC section 183(d)*

Petitioner-wife is a designer for a direct sales multi-level marketing company (MLM) selling various etc. “Designer” is the entry-level category. According to the company’s compensation plan document, there are three levels each of “designer,” “mentor,” and “couturier.” The progression through ranks is dependent on one’s own sales and how many additional people the individual has recruited “downline.” Commissions are based on the performance of the team a person sponsors in the business. The more people one recruits to the downline team and the more those team members buy and sell, the greater the commission for the sponsor.

Petitioner-wife stated that she began the activity in 2018 after attending a craft fair where another person was demonstrating products. Petitioner-wife made her first purchase online on December 21, 2018.

Returns filed for tax years 2018-2021 show losses each year. Over these years, Petitioners’ returns show no gross receipts. In a written response to Audit’s request for information letter, Petitioner-wife wrote that she had gross income in 2019, 2020, and 2021. During the hearing held with Appeals, Petitioner-wife stated she had sold two items at a craft fair during the period covered by the audit. Likewise, Petitioners’ returns show total expenses that don’t match the total expenses reported in Petitioner-wife’s written response. On Schedule C for tax year 2021, Petitioner-wife reported an ending inventory of \$0. For tax year 2022, beginning inventory was reported as \$6,442. The discrepancies in reported sales, expenses, and inventory amounts all demonstrate a lack of consistency in recordkeeping which would indicate that the activity is not conducted in a business-like manner.

To support expenses claimed, Petitioner-wife provided copies of one hundred twenty-nine individual receipts. Ninety-nine showed transaction dates sometime in 2019. One had a transaction

date in 2020. Seven showed a date that was not legible enough to verify that the transaction took place during the audited years. Twenty-two did not show the date of the transaction (it appears that the portion of the receipt that shows the date was not captured during the copying process). Twenty-six had some kind of annotation to specify a purpose for the purchase. Nine of those twenty-six contained enough detail to support a business purchase. Thirty-two of the receipts show a combination of purchases for personal use and for the crafting activity (Petitioner-wife had crossed out individual line items on these receipts). The total of the purchases for the craft activity on the receipts does not match the total expenses claimed on Petitioners' 2019 Schedule C. Petitioner-wife did not provide anything to document purchases for any of the other years under audit as requested. The receipts were provided to Audit in an organized manner.

It appears that Petitioner-wife maintained receipts and other records for purposes of substantiating expenses, but not to use as “analytic or diagnostic tools” in an attempt to make her activity profitable. In *Nissley*⁷, this was one factor that led the court to conclude the activity in question was not carried out in a business-like manner.

The funds for the crafting activities appear to be co-mingled with personal funds, as evidenced by the purchase of items for personal use and for use in the craft activity in the same transaction. In *Montage*⁸, not keeping separate accounts for business and personal funds was one factor that led to the conclusion that the activity was not conducted in a business-like manner.

The business plan Petitioner-wife provided is a simple outline showing the name of the business, hours of operation, locations for demonstrations and craft fairs during 2022 and 2023, a list of operating cost categories (electric, heat/AC, water/sewer, advertisement, setup/teardown

⁷ *Kenneth J. Nissley, et ux., v. Commissioner, TC Memo 2000-178*

⁸ *Brad Montage, et ux. v. Commissioner, TC Memo 2004-252*

crew, transfers/stencils, paste/ink, surfaces to make gifts on) but no amounts, license (the required website), menu items, a list of office space/equipment needs, and information about her 12x12 office area and her 10x10 craft booth. The only monetary information included on the business plan are \$7 per hour paid to her teenage daughter for setup and teardown at craft events and \$19.99 per month paid to [redacted] for her website. The business plan appears to be more of a checklist of items to consider than an organized course of action to create a profitable business. The lack of a business plan was another factor cited by the court in *Nissley* in its determination that the activity in question was not carried out in a business-like manner.

(2) The expertise of the taxpayer or his or her advisers

Preparing for an activity by studying accepted business, economic, and scientific practices (or consulting with experts therein) and carrying on the activity in accordance with those practices may indicate a profit motive. When a person has studied accepted practices or consulted with experts but does not conduct an activity following such guidelines, it may indicate lack of a profit motive.

Petitioner-wife stated that she has “been a crafter [her] whole life.” When asked about consulting with experts or other people who have been successful in the same or a similar industry, Petitioner-wife indicated she only spoke with her “upline” and did not consult with anyone else when starting her activity. She did not mention being involved with any clubs or organizations that involve crafting.

[redacted] makes available on its website information about starting with the company as an independent designer, how to sell products, and how to create the best potential for income, along with numerous other topics. One article discusses “3 Best Ways to Sell”

products.⁹ This article states, “the best rewards in the Compensation Plan come from earning Personal Volume (PV). You'll earn 40% instant commission on products that you sell from your inventory and 25% deferred commission from sales.” In its discussion of selling items created by the designer using products (e.g., displaying and selling finished goods at a craft fair or boutique), the article states that “it is typically a more challenging way to build a Team or to earn income from Based on responses Petitioner-wife provided, she does not purchase items to hold in inventory and then resell to customers. She has hosted events in which she provides the products for others to use to create a finished product of their own, which is another tactic mentioned in the article. However, most of her effort in selling seems to be focused on creating finished products to sell at craft fairs.

While she may be a life-long crafter and possess a creative mind, Petitioner-wife does not appear to possess the economic expertise needed to run a successful (i.e., profitable) business selling products and has not consulted with others who do.

In its *Burger*¹⁰ opinion, the court wrote that the petitioners in that case consulted an accountant and a lawyer (general business experts) but did not consult anyone with expertise in the economics specific to the activity in question. In the eyes of the court, this indicated a lack of profit motive. The court also wrote:

“We note that a formal market study is not necessarily required to make this determination. . . . However, taxpayers should develop a plan or establish specific goals, either on their own or after consulting with an expert, outlining the profits expected to be reaped or the anticipated growth of the business activity. If no profits are ever expected, then the activity is clearly a hobby.”

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¹⁰ *Burger v. Commissioner*, 809 F.2d 355 [59 AFTR 2d 87-431] (7th Cir. 1987)

In *Metz*¹¹, the court referred to *Burger*, writing: “We think this means that knowledge of the activity itself apart from its economics is not enough to clear the hurdle: A taxpayer must demonstrate expertise and attempts to improve results in a money-losing business.”

(3) The time and effort expended by the taxpayer in carrying on the activity

A person spending much of his or her personal time and effort carrying on an activity, especially one without significant personal or recreational aspects, may indicate that the activity is engaged in for profit. Likewise, if a person leaves another job to devote more time and effort to the activity, it may indicate the same. Spending limited time and effort on an activity does not necessarily show a lack of profit motive when the taxpayer employs qualified, competent people to carry on the activity in his or her absence.

In a response provided during the audit, Petitioner-wife indicated that she was the only one engaged in the day-to-day operations of the crafting activities, spending two hours per day reviewing company news, looking at new products, and trying to find craft events to attend. She wrote that she does not have any employees, but her daughter helps with set-up and take-down, for which she isn't paid (this is inconsistent with her business plan where she states her daughter is paid \$7 per hour). During the hearing with Appeals, Petitioner-wife stated that she couldn't put the time that she wanted into this activity because of time commitments with other things, including her full-time job and health issues.

(4) The expectation that the assets used in the activity may appreciate

¹¹ *Henry J. Metz, et ux., v. Commissioner, TC Memo 2015-54*

The term “profit” can include appreciation in the value of assets, such as land, that are used in an activity. So, even though a person may not show periodic profits from the activity, there may be an expectation of an overall profit when the appreciated assets are sold.

Petitioner-wife stated that she doesn’t have anything that appreciates in value.

(5) The success of the taxpayer in carrying on other similar or dissimilar activities

If a person has engaged in other activities and turned them from unprofitable to profitable in the past, this may indicate that he or she is engaged in the current activity for profit, even if it is not profitable at the moment.

Petitioner-wife indicated that she has not engaged in any prior activities like or unlike

(6) The taxpayer’s history of income or losses with respect to the activity

If a person incurs a series of losses during what would normally be considered a start-up period, it would not necessarily be indicative of an activity not engaged in for profit. If, however, the losses continue beyond the initial timeframe typically needed to bring the activity to a profitable status, and those continuing losses are not explainable by normal business risks, it may indicate a lack of profit motive. Losses incurred because of unforeseen circumstances – such as disease, fire, theft, weather, etc. – are not indications that an activity is not engaged in for profit. A series of years where an activity results in net income would be strong evidence that it is engaged in for profit.

Petitioner-wife indicated that she began her activity on December 21, 2018. This activity has never resulted in a profit. Instead, Petitioners have accrued \$15,170 in annual losses. Total reported gross income from the activity over the same period was \$0. Petitioner-wife said she intended to make a profit, but never could because of circumstances beyond her control. 2020 was

the beginning of the COVID-19 pandemic, which resulted in temporary lockdowns preventing groups of more than a few from gathering closely, and her husband was considered a higher risk individual for complications if he contracted the virus. The way Petitioner-wife conducted her activity was through hands-on demonstrations where multiple people would be handling the same items. This was another reason she was uncomfortable hosting events.

(7) The amount of occasional profits, if any, which are earned

Periodic large profits – despite consistent, small losses – may be an indication that an activity is engaged in for profit. Even if the activity generates only losses or small profits, the opportunity for a large ultimate profit could indicate the same. Conversely, an occasional small profit interspersed with consistent losses may indicate that an activity is not engaged in for profit, especially if the person conducting the activity made substantial investments in capital or assets.

As stated previously, Petitioners’ activity has never resulted in a profit. Accrued losses total over \$15,000. An occasional small profit would hardly make a dent in recouping those losses. The Tax Commission doesn’t see any potential for a large windfall to offset the losses sustained over the short period Petitioner-wife has been engaged with

(8) The financial status of the taxpayer

If a person does not have another source of significant income or capital, it may be a sign that an activity is engaged in for profit. However, substantial income from other sources – especially if faced with losses from the activity that provide sizable tax benefits – may indicate that an activity is not engaged in for profit. This is particularly true if the activity involves personal or recreational elements.

According to their federal tax returns, Petitioner-wife was employed as a
for tax years 2018, 2019, 2020, and 2021. Her husband was also employed as

a for tax years 2019, 2020, and 2021 but was otherwise employed for tax year 2018. Total wages reported for 2018, 2019, 2020, and 2021 were \$67,310, \$91,179, \$101,935, and \$104,530, respectively.

Petitioners clearly had significant income from sources outside the crafting activity to subsidize the losses they declared. In *Golanty*¹², the court found that the petitioner was not engaged in an activity for profit where he had other gross income over \$84,000 and \$95,000 in the two years where he showed losses of \$26,000 and \$28,000.

(9) Elements of personal pleasure or recreation

The presence of motives other than earning profit may indicate that an activity is not engaged in for profit, especially when the activity includes personal or recreational elements. Just because an activity has elements of personal satisfaction or recreation does not mean that it is not engaged in for profit. The lack of any personal motives beyond making a profit may indicate that an activity is engaged in for profit, but it is not necessary for an activity to be engaged in solely to earn a profit to rise to the level of “business” over “hobby.” There can be a mix of personal satisfaction or pleasure and profit motive. If other factors indicate profit motive, the elements of personal satisfaction may be downplayed.

Petitioner-wife stated during her hearing with Appeals that she works full-time and conducts this activity on the side “just to have fun and kind of give [her] stress relief from [her] job.” She also said this activity was more down the line of a hobby, which she was trying to make successful for when she retires.

¹² *Golanty v. Commissioner*, 72 TC 411

One of the benefits of being an active designer (one who maintains certain minimum purchases per quarter and pays a monthly fee for the company to maintain her webpage) is that she can purchase the products at a 40% discount from the regular retail price. Even if not profitable, Petitioner-wife said she would “still want to do it because they have some great products that [she] can use to sell at craft fairs.”

Conclusion

Based on an evaluation of the nine factors laid out above, tax returns, and all other information available at this time, the Tax Commission determined that Petitioners’ crafting activity reported on Schedule C for tax years 2018, 2019, 2020, and 2021 was not engaged in for profit. While there are some indications that the activity was conducted in a business-like manner – such as the retention of receipts and invoices to document expenses – there are others that indicate the opposite – inconsistency in reporting income and expenses, the lack of a formal business plan, no financial study to examine profitability, etc. Petitioner-wife did not appear to try to expand her expertise on the business aspects of direct selling with an MLM. She did not consult with anyone other than the person who recruited her to get useful information about the business. Petitioner-wife spends a significant amount of time at her full-time job. There is no expectation that the value of any assets used in the activity will increase over time. Petitioners have no experience in running a profitable business. Petitioners have never shown a profit from the activity but have accrued a string of losses. Given the nature of the activity, it is unlikely to result in a single large profit or a series of profits sizable enough to overcome the financial hole Petitioners are in with this activity. “The Consumer Awareness Institute, whose research has been posted on the website of the Federal Trade Commission (FTC), found that 99% of people who participate in

[MLMs] lose money.”¹³ Petitioners have not been in a situation where they have relied on income from the activity to supplement other income; rather, they have subsidized the yearly losses with income from other sources. Finally, there are more elements of personal satisfaction and pleasure gained from the activity than any apparent profit motive.

Schedule C Deductions

IRC section 183(b)(2) allows an individual conducting an activity deemed “not engaged in for profit” to claim deductions for expenses that would otherwise be allowable only if the activity were deemed “engaged in for profit” up to the amount of gross income generated by the activity. In short, an activity not engaged in for profit cannot generate a loss; one can claim expenses up to the amount of gross income, but not more. Because Petitioners did not report any gross income on Schedule C and the activity was not engaged in for profit, the Tax Commission determined that Petitioners are not entitled to any expenses claimed on Schedule C for tax years 2018, 2019, 2020, or 2021.

Investment Tax Credit

Idaho Code section 63-3029B allows individuals to claim a credit against Idaho income tax on certain purchases of depreciable property made during a tax year (3% of qualifying cost). Property must have a useful life of at least three years, be property for which a deduction for depreciation is allowable, and be used in Idaho in a trade or business. The qualifying cost of mobile property used both inside and outside Idaho requires a special calculation. The same cost of qualified property cannot be expensed under IRC section 179 or used in claiming a special

¹³ <https://time.com/5864712/multilevel-marketing-schemes-coronavirus/>. Retrieved December 12, 2023.

depreciation allowance under IRC section 168(k). The portion of the cost of property used for personal use also does not qualify for ITC.

The amount of ITC a taxpayer can use in any tax year is limited based on several factors including the amount of credit available, the amount of tax based on income, and other credits the taxpayer is claiming for the same year. Any unused credit can be carried forward for a limited time until it can be used.

On their 2018 Idaho income tax return, Petitioners reported earning \$1,463 of ITC on the purchase of a Weekend Warrior Toy Hauler – a fifth wheel trailer – at a cost of \$48,871. They used a portion of this credit for tax year 2018 and the remaining balance for tax year 2019. They reported earning and using the same amount of credit (\$1,463) on their 2021 Idaho income tax return. In response to Audit’s request for information, Petitioner-wife responded by stating that the qualifying property for the 2021 ITC was a 2019 Weekend Warrior Toy Hauler to pull behind their pickup truck. According to information provided by the Idaho Transportation Department, Petitioners purchased a model year 2019 Weekend Warrior on May 12, 2018. During the hearing held with Appeals, Petitioner-wife confirmed that they purchased only one trailer.

As stated earlier, a qualifying asset is one used in Idaho in a trade or business. Because the Tax Commission found that Petitioners’ craft-related activities were not engaged in for profit, the activities do not rise to the level of a trade or business. Therefore, the use of the trailer is 100% personal, and the property is nonqualifying for purposes of claiming ITC. As such, the Tax Commission agrees with Audit’s disallowance of ITC claimed for tax years 2018, 2019, and 2021.

Penalties

Audit added a penalty of 5% of the additional tax due for tax years 2018 and 2019 to Petitioners’ tax deficiency. Idaho Code section 63-3046(a) states that if any part of a deficiency is

due to negligence or disregard of rules, a penalty must be imposed. Simply, negligence means not taking proper care in performing an action. The Tax Commission does not find that Petitioners' actions rise to the level of negligence in this case. Also, Audit did not add a similar penalty for tax years 2020 or 2021, even though the same adjustments were included in the Notice for those years. The Tax Commission finds the inconsistent inclusion of a negligence penalty unfair to Petitioners. Therefore, the Tax Commission will remove the penalty from the Notice for tax years 2018 and 2019.

Interest

Audit added interest to Petitioners' tax deficiency. The Tax Commission reviewed this addition and finds it to be appropriate and in accordance with Idaho Code sections 63-3045.

Conclusion

The Tax Commission finds that Petitioners' craft-related activity was not engaged in for profit. Therefore, Petitioners are not allowed to claim any expenses related to the activity. Likewise, Petitioners are not allowed the investment tax credit.

THEREFORE, the Notice for tax years 2018 and 2019 dated March 16, 2022, as modified by Audit and re-issued March 16, 2023, and directed to _____ is hereby MODIFIED and MADE FINAL. The Notice for tax years 2020 and 2021 dated December 2, 2022, and directed to _____, is hereby UPHeld and MADE FINAL.

IT IS ORDERED that Petitioners pay the following tax, penalty, and interest:

<u>YEAR</u>	<u>TAX</u>	<u>PENALTY</u>	<u>INTEREST</u>	<u>TOTAL</u>
2018	\$1,447	\$0	\$283	\$1,730
2019	293	0	41	334
2020	224	0	25	249
2021	1,942	0	177	<u>2119</u>
				<u>\$4,432</u>

The Tax Commission DEMANDS immediate payment of this amount. Interest is calculated through April 29, 2024.

An explanation of Petitioners' right to appeal this decision is enclosed.

DATED this _____ day of _____ 2024.

IDAHO STATE TAX COMMISSION

CERTIFICATE OF SERVICE

I hereby certify that on this _____ day of _____ 2024,
a copy of the within and foregoing DECISION was served by sending the same by United States
mail, postage prepaid, in an envelope addressed to:

Receipt No.
