Introduction

On December 1, 2012, Jude Jones and his wife, Jackie, were on their way to their new attorney’s office. They were very upset after receiving an unfavorable Internal Revenue Service (hereinafter IRS) notice of assessment (See Table 1) claiming back taxes, interest, and penalties related to their insurance business for the years of 2006 and 2007. The total IRS claim amounted to over $50,000. The deficiencies and penalties resulted from the IRS disallowing deductions relating to two different recreational vehicles the couple used in conjunction with business activities while traveling during those respective years. The largest items disallowed by the IRS were depreciation expenses for the older vehicle in 2006 and the new one in 2007.

For Jude and Jackie, the ordeal with the IRS was long, exhausting, and very frustrating. They were initially surprised that they were audited by the service at all because they never encountered any challenges to their returns before this incident. Chase Morgan, a CPA and personal friend of Jude’s since high school, always prepared their returns from the information they gave him. Chase never raised any concerns about their deductions. During the initial audit, the auditors seemed to display a hostile attitude and stated early in the meetings that they were not going to allow the couple to deduct the costs of these recreational vehicles against their overall business income. Jude and Jackie tried to explain to the auditors that these vehicles were necessary for them to develop the lines and territories of business where they were used and they had a clear business purpose in using these vehicles, but the auditors seemed determined to treat these vehicles solely as personal use property. After the initial audit resulted in significant claims for back taxes and penalties, the couple went through the IRS appeal procedure. Although that was somewhat less stressful than the audit experience, the end result was the same.

The final notice from the IRS stated their legal options. One option was to file a petition in the US Tax Court to litigate the IRS claim and that’s what they decided to do in contacting Max Blake, an attorney with significant experience handling tax matters. Jude and Jackie were experienced insurance professionals but they were not sufficiently versed in tax law (or court procedures) and needed an experienced tax professional to represent them in court.

Background: Cloudy Insurance Services and the Recreational Vehicle Insurance Business
Jude and Jackie walked into Max Blake’s office and exchanged greetings. After some initial pleasantries, Max asked them to describe their business background and how that led to the current dispute with the IRS.

Jude Jones was the owner operator of Cloudy Insurance Services, a sole proprietorship, and he had been in the insurance business for about 30 years. Jude’s spouse, Jackie Jones, worked for the company as a manager and insurance agent. Their insurance brokerage sold insurance policies for multiple insurance companies. The company offered many different lines of insurance including auto insurance, homeowners’, rental property insurance, commercial insurance, life insurance, disability insurance, health insurance, and the new line of insurance on higher end recreational vehicles. The insurance business was Jude and Jackie’s full-time job and they spent more than 40 hours weekly at their main office in the Dallas-Fort Worth area about three miles from their residence. Jude retired in 2011 when he sold his insurance business.

RV-related insurance was started in 2004 as an expansion of their insurance offerings because the Joneses saw the need for RV-specific insurance coverage from their relationships with RV owners. Jude realized that traditional auto insurance policies were not appropriate for some RVs, especially the high-end ones. Expensive RVs would need more protections that could not be provided by regular automobile insurance policies and higher-worth individuals would prefer better coverage to protect their investments. Jude began to explore and develop RV-specific policies and realized that there was a potentially favorable market for this specific insurance and that they could market these policies to RV owners. Most of their efforts to develop insurance customers for their RV insurance lines were expended at RV rallies. Shortly after exploring this line of business, they purchased a custom made banner advertising their insurance business and displayed this banner on their recreational vehicles during attendance at the rallies. Although RV insurance was a minor source of income in their overall insurance business, these contacts resulted in repeated premiums for that type of insurance and also resulted in new customers for the insurance company’s other products. Contacts made and the customers acquired through these rallies created a recurring cash flow for multiple years and helped to increase the sales value of Jude’s insurance brokerage when he decided to retire.

The Challenged Expenses

Max: “In our phone conversation, you told me that the dispute with the IRS concerned their disallowance of deductions taken for business use of two recreational vehicles. Tell me more about how you arrived at these expense amounts?”

Jude: “I kept a calendar and a mileage log of business trips we took with the RV during the two years at issue. All other mileage would have come from strictly recreational trips. So, if the RV was driven for total 5,000 miles in a specific year, and 4,000 miles were for business and 1,000 miles were for personal use, my accountant would deduct only 80% of the expenses as business-related. During 2006, the older vehicle was mostly used on these business trips and the new vehicle purchased in 2007 was 100% used on these business trips because we didn’t take any purely personal trips that year. In other years where we owned a recreational vehicle (2004,
2005, 2008, 2009, and 2010), we took more personal trips and the business use portion of the recreational vehicles was much lower.

Max: “What types of expenses were used for the deductions pertaining to these recreational vehicles?”

Jude: “We would have included mileage, maintenance, insurance, a property tax portion of registration, interest on the loan taken out to purchase the newer vehicle, and depreciation. The depreciation was the largest single expense and the one the IRS seemed to object to the most. Based on the nearly 100% business use of those vehicles during the years challenged, the depreciation expense on the older vehicle was calculated at $47,461 for 2006 and depreciation on the 2007 Winnebago RV purchased at the beginning of 2007 was $60,424. We took out a loan to help finance the purchase of the 2007 Winnebago and deducted $10,115 of business interest on the loan on our 2007 return. Although they disallowed all business deductions related to the RVs, the IRS did allow us to deduct the loan interest in 2007 as an itemized personal deduction for mortgage interest on a second home.”

Max: “So you did stay overnight in these vehicles for more than 14 days in each of 2006 and 2007?”

Jude: “Yes. In fact, that was the crux of the IRS claim. They said these vehicles were vacation homes to be treated as a second residence rather than business properties.”

Jackie: “In 2006, we took two or three very short local trips with the 2004 RV to spend some time camping with friends. During 2007, we took 15 trips and every single one was for business or business related.”

Jude: “Sometimes we just used the RV to get away to a local RV park with some friends or just to socialize with people met there. During the normal work week, we kept the RVs in storage.”

Max: “I’m just curious. How come you took no personal trips in 2007?”

Jackie: “That was because of my health issues at the time. In August 2007, I had a heart attack and four-way bypass surgery. We did not take any personal trips and even cancelled our planned attendance at some RV rallies for the remainder of the year.”

The Recreational Vehicles

Max: “Can you tell me a little more about these recreational vehicles?”

Jude: “Sure. The 2004 model was a nice RV. It had the standard equipment and area, a TV, refrigerator, bed, kitchen area, and living room. We sold it in January of 2007 because we felt a newer and nicer one was more appropriate to have while approaching high net worth clients. One thing we’ve learned in the insurance business over the years was that you needed to demonstrate some level of achievement to earn the trust of high-level people. We asked for
recommendations from some of our commercial clients and the 2007 Winnebago we purchased was the result of these suggestions. The new one was equipped with a 37-inch television, satellite dish, theater style lounge seating, washer and dryer, ceramic tile floors, Corian kitchen and bathroom countertops, a ceiling fan, a sleeper sofa, and a queen sized Sleep Number bed. It was definitely more on the line of a luxury motor home. After the options and sales taxes, the total price was about $302,000.”

Max: “You’ve mentioned a number of times now that you viewed the RV rallies as primarily places for business activities. Please tell me a little more about these rallies.”

The RV Rallies

A critical behavior of insurance professionals was to establish a rapport with potential clients so those people would feel comfortable discussing their assets and what was needed to protect them. Establishing this level of rapport sometimes took months or even a couple of years before the clients became comfortable and trusted them. Getting repeated contacts was essential in the insurance business. Jude and Jackie believed that they needed approximately 12 contacts to establish a good rapport, which was consistent with suggestions of the U.S. Chamber of Commerce that 11 or 12 discussions with potential clients on average was required to establish a sufficient level of trust for them. By attending the monthly rallies, Jude and Jackie could meet with the same people every month. That repetition was the best way for them to establish rapport. They tried to make repeated contacts as much as possible at each rally.

The potential clients that attended the RV rallies were business people. They were executives in various industries like aerospace, telecommunication, automotive, etc. There were also some higher-ranking current and former military officers. From years of training and experience, Jude and Jackie believed that they also needed to show an appropriate level of success to appear credible to higher net worth individuals. After decades in the business they had finally arrived at the point where they felt the confidence to interact with higher-level professionals. Acquiring a higher model recreational vehicle was a strategy to fit in more with these prospective clients.

RV rallies were mainly social events hosted by an RV club. Each club held an RV rally about once a month. Only club members could attend RV rallies. To sell the RV insurance policies, Jude and Jackie decided that they needed to join multiple RV clubs and attend numerous RV rallies. They joined three RV associations. Their first membership began in 1995 and they selectively joined two others.

In those rallies they could meet with many RV owners who might have been interested in buying RV-related insurance policies. Moreover, they could also sell non RV-specific insurance policies. These rallies allowed them to meet with the same people again and again because the club members tended to go to most of the rallies throughout the year. Many of their potential clients met at the rallies lived far from the Jones’ primary area of residence and business (quite a few lived more than 100 miles away). The RV rallies allowed them to meet with those clients.
Each club normally had one rally per month and, because they were members of multiple RV clubs, they would attend multiple rallies per month. A rally usually started on Friday afternoon when members started to arrive at the park. During the Friday potluck dinner, people started to have conversations with other RV owners. That first day of the rally was very informal and provided more unstructured opportunities for the attendees to chat with others. On Saturday morning, more structured and scheduled events began with breakfast hosted by the club leader followed by informational programs. During these programs, RV owners discussed a range of RV-related issues such as maintenance, ways to avoid or fix common problems, and other informational seminars promoting the RV lifestyle. RV related vendors and exhibitors also often attended these rallies. Saturday usually ended with a club wide meal. Sunday morning began with a leader led breakfast after which the attendees began to leave.

The weekend RV rallies usually lasted from 3:00 PM to 9:00 PM on Fridays, 8:00 AM to 9:00 PM on Saturdays, and 9:00 AM to noon on Sundays. Only RV owners were allowed to attend the rallies. Moreover, certain RV parks also required RV ownership.

Jude and Jackie usually left the rallies on Sunday morning. They would do business talking with potential clients on Friday night, Saturdays, and sometimes, on Sunday morning before leaving the rallies. Jude and Jackie estimate that they spent about 20 hours at each rally on activities designed to market their insurance business and some of that time would include traveling.

When they were not with potential clients, Jude and Jackie would spend time together inside their RV talking or watching television. Jackie would also cook in the RV to prepare meals for them when meals were not provided at RV rallies. They did not have a portion of the RV that was designated as an exclusive place for doing business.

Max: “So, it is fair to say that you would not have sold policies to these people without being at the RV rallies?”

Jude: “Absolutely, many of those clients lived more than 100 miles away from us. We would not have had any business with them had we not attended the RV rallies.”

Max: “Did you purchase these recreational vehicles with the primary intention of using them to further your business?”

Jude: “Yes. Without having an RV of our own and being able to join the three chapters, we would never have met the potential clients and would never have been able to establish rapport and sell them insurance.”

Jackie: “We went to the rallies to build the rapport from the people at the rallies. We needed to see the same people all the time to gain their trust. We needed to talk about their insurance portfolios and what we had to offer.”

Max: “Would it be accurate that to do business at an RV park you must own an RV?”
Jude: “That’s true, yes, and some RV parks had more limiting rules and regulations. For example, some parks required a motor home (i.e., a motorized self-contained vehicle) that had to be less than 15 years old. Some did not allow automobiles inside the park unless you were visiting.”

To be fair, Jude and Jackie explained that they also enjoyed the recreational aspects of the rallies. Jude and Jackie had always enjoyed recreational camping in natural settings and had been to national parks all over the country. Since 2006 they had attended more than 30 RV parks and always brought their dog with them. Since Jude sold the insurance business in 2011, they broadened their recreational travel even further by traveling throughout the country.

Methods of Doing Business at RV Rallies

Jude related the methods of doing business during the rallies. Once they got to the RV park, they put a banner on their RV advertising Cloudy Insurance Services. They usually set up a table by a clubhouse, if there was a clubhouse, or in another common area or outside of their RV. Their banner was always on display either at a table or on their RV. If they set up a table in a common area, they would staff it for about two hours at the rally. They also provided brochures for interested RV owners and both Jude and Jackie were available to answer questions.

Jude and Jackie’s RV was always open for potential clients during the rallies. When a potential client came, they would offer the clients a glass of water or soft drinks and hold discussions. They would invite potential customers to their RV and would sit together either outside or inside the RV to discuss the customer’s insurance needs. Selling RV insurance was not easy. Selling requires excellent rapport and building good relationships with potential clients. Sometimes, months or even years were required to build relationships with potential clients until the clients achieved enough of a level of comfort to approach them about insurance matters. Typical questions posed during these discussions were:

1. Did the client’s current RV policy have guaranteed replacement cost for the first five years?
2. Did the client’s current RV policy have additional campsite liability?
3. Did the client’s current RV policy have diminishing deductibles?
4. Did the client’s current RV policy have coverage for transportation of you and your family and guest over long distances (including interstate transportation) if the vehicle suffered a breakdown and did that coverage also repair or replace the RV and transport it to your home location?

After discussing RV insurance, Jude and Jackie would often move on to discussing coverage on the clients’ homes, commercial office buildings, rental properties, and other properties to find out whether the clients had the right kind of coverage to meet their needs. Sometimes the discussion resembled a round-table forum.

The couple had business forms readily available in their RV. The documents included application forms and questionnaires. Potential clients could provide information about the
insurance coverage they had or thought they had and this information allowed Jude and Jackie to provide meaningful comparisons to coverage they could offer.

Max: “So, if you had some research to do on a potential client’s insurance coverage, you would bring information and contracts back and forth from the rallies to your home office when you visited that same prospective client at another rally?”

Jude: “Yes.”

Jude and Jackie would spend their time at the rallies cultivating business contacts and closing sales. Some of their friends even said that Jude had a bit of a reputation as a “pest about insurance.” After the weekend RV rallies ended, Jude and Jackie went back to their office to do analysis and research. They took the data back to their office using the RV. To some extent, their RV served as a mobile office for them.

Using the data from the potential clients, they generated rate quotes. They evaluated the client’s needs and which insurance company could provide the best coverage for the most reasonable cost. The quotes would be presented to the potential clients at the next rally. Clients would review and sign the policies in Jude and Jackie’s RV or sometimes in the clients’ own RV.

Their efforts had been successful. From attending the rallies, they were able to generate revenues that resulted in recurring premiums. The revenues steadily increased each year and tripled in the fourth year of doing business at the RV rallies. During the years 2006, 2007, and 2008, for just new clients only, they provided more than $60 million more in protection. They also saved their clients more than $300,000 in premiums.

Max: “What other documentation do you have to support the business activities at the rallies?”

Jude: “Here’s a list of eight couples during February of 2007 alone with whom we had extensive insurance discussions at that time. We sold policies to all but two of them and most of those were for coverage on multiple properties. We also have signed contracts from them and pictures of us with them at the rallies. Funny thing. The IRS wouldn’t allow us to take business deductions for using our RVs, but they calculated that we earned $14,882 of premiums in 2006 and $19,446 of premiums in 2007 as a result of these meetings. Makes no sense to me. Even those calculated amounts understate the true value of those commissions over time because they were recurring and added to the market value of our insurance business.”

Max: “What were the totals of all your insurance sales in 2006 and 2007?”

Jude showed Max their tax returns for those years. The gross receipts from the insurance business were $240,972 and $258,700 for 2006 and 2007 respectively.

Max: “All right. I think you gave me a pretty solid understanding of the background to this case and the dispute between you and the IRS. I’ll be pleased to represent you in this matter. I will require some time to research the issues and I’ll begin drafting the US Tax Court petition to
challenge this IRS decision. I’ll contact you in a couple of weeks to discuss how we will proceed.”

At that point, Jude and Jackie bid their farewells to Max.

### Key Challenges

Max thought about his new clients’ dilemma. He sympathized with their case and believed from experience that IRS agents often refused to see the perspective of the taxpayer when the subject involved deductions of closely held businesses. He hoped that he could help them to obtain a favorable result. This was an unusual case and he had never encountered one quite like it. He knew from experience that the US government attorney was likely to be a prepared and formidable opponent. After filing the taxpayers’ petition to the US Tax Court, he needed to review the determinations of the IRS, extensively research the applicable tax law, and prepare his arguments to support the taxpayers’ positions. He also needed to become well aware of the possible arguments that the government’s attorney would use to uphold the IRS’s determination and tax assessment.

<table>
<thead>
<tr>
<th>Year</th>
<th>Deficiency</th>
<th>Additional Penalties</th>
<th>Total Claims</th>
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<tbody>
<tr>
<td>2006</td>
<td>$13,984</td>
<td>$2,796.80</td>
<td>$16,780.80</td>
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<tr>
<td>2007</td>
<td>$28,244</td>
<td>$5,648.80</td>
<td>$33,892.80</td>
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<tr>
<td>Total</td>
<td>$42,228</td>
<td>$8,445.60</td>
<td>$50,673.60</td>
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Appendix to the Case
A Primer on the Controlling Tax Law

I) Background on the Tax Law

This case involved issues cutting across multiple areas of tax law. The primary issue of contention between the taxpayers and the IRS concerned significant business deductions pertaining to expensive recreational vehicles owned by the taxpayers. These vehicles were used in part for recreation and in part for business, but the IRS refused to allow the full extent of the taxpayers’ claimed deductions on the grounds that those vehicles were mostly intended for personal use and weren’t exclusively used for business.

Initially one may wonder whether there were hobby loss limitation rules in play because the nature of the taxpayers’ activity involved both commercial and recreational aspects. Whether an activity was a business or a hobby (an activity without a true profit motive) was governed by the classification rules under Treasury Regulation § 1.183-2. The classification of an activity as a business or a hobby had significant federal income tax implications when the taxpayer’s activity was unprofitable. The effect of the hobby loss limitations was to prevent net tax losses from activities without a true profit motive from being used to lower taxpayers’ income from other sources. The taxpayers of this case probably were immune from the hobby loss limitations because the commercial activity here was not separate and unrelated to the taxpayer’s profitable insurance business. Furthermore, Internal Revenue Code (hereinafter IRC) Section 280A (see below) provides that if IRC Section 280A applied to a dwelling unit, the hobby loss rules did not apply (26 USC § 280A(f)(3)).

The primary areas of the tax law suggested by this case were IRC Sections 162, 163(a), 167(a), 262(a), 274, 275, and 280A. Section 162 was the general statutory allowance for business related deductions. Section 163 was the allowance for deduction of interest for indebtedness related to business property and activities. Section 167 allowed depreciation deductions on business property and on tangible property used in business or for production of income. Section 262(a) disallowed deductions for expenditures related to personal, living, and family matters unless those were allowed specifically by other Code sections (26 USC § 262(a)). Section 274 provided an extensive list of disallowances or special deduction rules for certain types of activities and certain types of property connected to business or investment and also required certain evidence of business use (26 USC § 274). Section 280A provided special rules for business or investment deductions when the property generating the deductions was used for both personal living and income producing purposes (26 USC § 280A).

IRC Section 162(a) allowed a deduction for all ordinary, necessary, and reasonable expenses incurred while carrying on a trade or business (26 USC § 162(a)). “Ordinary” meant the type of deduction that a business might be expected to encounter. “Necessary” meant appropriate and helpful to the taxpayer’s business. “Reasonable” meant a fair deduction amount for the value of goods and services used while carrying on the business. That paragraph also allowed reasonable expenses for travelling while away from home (regular commuting expenses to a fixed business
location are not deductible) in the pursuit of a trade or business (26 USC § 162(a)). Examples of traveling expenses were transportation to and from a temporary business location, lodging, and meals. If the purpose of the trip was predominately business (meaning the majority of days were business days with traveling days counted as business days), all transportation expenses were deductible. Lodging and meals were allowed only for business days and only 50% of those costs in most cases. There were no set number of required business hours under either the Internal Revenue Code or the Regulations thereunder for a taxpayer to qualify as traveling away from home in carrying on a business.

The “away from home” requirement generally indicated that the temporary business location was sufficiently removed from the taxpayer’s place of residence so that a rest period was required before returning to the place of residence. The taxpayer’s “tax home” was generally considered the location of the taxpayer’s normal place of business but there were exceptions to this rule and the tax home could be considered the place of residence in certain circumstances. To be “away from home,” the taxpayer must have maintained a stationary home so that the expenses of lodging while traveling on business were duplicative.

Included among the disallowances and special deduction rules of Sections 274 and 275 were disallowances of expenses related to entertainment, amusement, and recreation activities unless the taxpayer could establish that the activity was directly related to the conduct of a trade or business or the entertainment, amusement, or recreational activity preceded or followed a substantial and bona fide business discussion (26 USC § 275(a)(1)(A)). The same requirement was made for expenses related to a facility used for an entertainment, amusement, or recreational activity (26 USC § 275(a)(1)(B)). IRC Section 274(d) also required a greater substantiation threshold for traveling expenses, facilities as described in IRC Sec. 275(a)(1)(A) mentioned above, and “listed property” as described in IRC Section 280F(d)(4) (26 USC § 274(d)). Listed property was certain designated types of property that could easily switch back and forth from business and personal use. Listed property included passenger automobiles and other types of property that can be used as a means of transportation; entertainment; recreation, or amusement property; and computer and peripheral equipment. Properties fitting within those categories that were employed in a dedicated commercial enterprise were typically exempted. IRC Section 274(d) required that the taxpayer kept sufficient records and other evidence to corroborate 1) the amount of the expense or item, 2) the time and place of the activity or item and the business purpose for it, and 3) the business relationship to the taxpayer of any persons being entertained or using the property or facility described above (26 USC § 274(d)).

IRC Section 280A provided for special rules and limitations upon deductions for business and rental use of a dwelling unit that may also have been used by the taxpayer as a residence. The limitations under IRC Section 280A were imposed on individual taxpayers and individual shareholders of S Corporations (26 USC § 280A(a)). The major types of properties covered by this section were home offices and other work spaces within the taxpayer’s principal residence, vacation homes of the taxpayer that were also rented, and other dwelling units of the taxpayer that may have supported a business purpose. A “dwelling unit” was defined to include a house, apartment, condominium, mobile home, boat, or similar property, and any structures that go with
these properties but the term excludes portions of the unit that are used exclusively as a hotel, motel, inn, or similar establishment (26 USC § 280A(f)(1)(A) & (B)).

IRC Section 280A and the rules thereunder generally contemplated two types of situations where taxpayers used a dwelling unit for mixed personal and commercial purposes. In the first type of situation, the taxpayer used a portion of the dwelling unit *exclusively* for business purposes (licensed day care providers were exempt from the exclusivity requirement and could apportion dwelling expenses between business and personal based on hours of use). The dedicated space must have functioned as either 1) the taxpayer’s principal place of business; or 2) a place used by patients, clients, or customers in meeting or dealing with the taxpayer in the normal course of business; or 3) in the case of a separate structure, used in connection with the taxpayer’s trade or business. The section further provided that a space used solely as an administrative office may qualify is there is no other fixed location for performing those administrative duties (26 USC § 280A(c)(1)). The other type of situation envisioned by Section 280A occurred when a taxpayer owned a secondary dwelling unit that was used for personal purposes part of the year and rented at other times during the year.

The two general types of situations described above had some commonalities and differences with respect to how allowable business or rental related expenses of the dwelling unit were computed. A common rule was that the business or rental related expenses allocable to the dwelling unit could not exceed the income from the activity. In other words, these expenses couldn’t create an overall loss. This requirement was triggered for the rental situation where the taxpayer used the property for both personal and rental purposes and the taxpayer used the property for personal purposes more than the greater of 14 days or 10% of the days rented. Under both types of situations, expenses related to the dwelling unit (for example, mortgage interest, property taxes, maintenance, insurance, condominium association fees, and depreciation) were required to be allocated between the commercial and personal uses. Mortgage interest (provided the dwelling unit qualifies as a second home for the taxpayer because the taxpayer used it for more than 14 days) and property taxes were deductible as itemized deductions even if the property was used only for personal purposes so the allocated personal portions of those were deductible by the taxpayer. For the other types of expenses related to the dwelling unit, only the allocable business/rental portions of those were deductible.

IRC Section 280A also provided that nothing in that section should be construed to disallow an otherwise allowable deduction under IRC Section 162(a)(2) incurred by reason of the taxpayer being away from home in the pursuit of a trade or business (26 USC § 280A(f)(4)). The Circuit Court of Appeals noted that the legislative history of the enactment of IRC Section 280A envisioned that, in appropriate circumstances, ownership of a dwelling unit could qualify as a deductible business lodging expense (Andrews v. Commissioner, 931 F.2d 132 (1st Circuit, 1991)).

II) **Computational Methods under Section 280A**

IRC Section 280A stated that when a dwelling unit was used both substantially for business/rental and personal purposes, the expenses of the dwelling unit could not exceed the
income from the business or rental activity. The Code section did not require a particular method for dividing dwelling expenses between the personal and business/rental portions.

Computational methods had been described in IRS publications and in some court cases. The methods under these illustrations for allocating the expenses between the purposes depended upon how the property was used for commercial purposes. When a dedicated portion of the dwelling unit was used for business or rental purposes, square feet was the normal basis for allocating the expenses (U.S. Department of the Treasury. Internal Revenue Service. (2014). Publication 587). When the dwelling unit was a second home that was rented part of the year and used by the taxpayer for personal purposes part of the year, days of use was the common basis for allocation (U.S. Department of the Treasury. Internal Revenue Service. (2014). Publication 527). Courts had differed from the IRS’s preferred methodology of allocation based on days of use for the types of dwelling expenses that were deductible regardless of use (mortgage interest and property taxes). Courts had allocated these based on days of the year on the rationale that these expenses were attributable more to ownership than to use (Bolton v. Comm., 694 F.2d 556 (9th Circuit, 1982)). Two examples of the different types of situations were illustrated below.

Example 1 (Part of personal residence used as a business space)

Amy Smith owned a personal residence that served as both a dwelling unit and as the sole business location for her part-time business. Her business involved serving as an independent sales representative of consumer merchandise and she was paid on commission. She used a dedicated 400 square foot space of her 2,000 square foot residence as both the sole office of the business and as a storage area for customer samples provided by the manufacturers. She purchased the home for $200,000 but it was worth $240,000 at the time of converting part of the space to business use.

Amy received commissions of $25,000 during the year. She incurred miscellaneous office and other expenses related to her sales efforts of $10,000. The mortgage interest on her residence for the year was $8,000 and the property taxes were $3,200. She used the lower of the adjusted basis ($200,000) or fair market value on the date of conversion ($240,000) to computed depreciation and computed preliminary depreciation as if the entire residence were used for business purposes. If the entire residence were used for business purposes, she obtained a preliminary depreciation figure of $7,200. Other maintenance expenses of the home (including insurance and household wide utilities) totaled $6,400. Her computation of net taxable business income (including the proportionate amount of dwelling expenses) was shown in the table below.

Table 2: Illustrative Computation of Deductions When Part of Personal Residence Used as a Business Space

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
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</thead>
<tbody>
<tr>
<td>Commissions earned</td>
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<tr>
<td>Less:</td>
<td></td>
</tr>
<tr>
<td>Direct miscellaneous and sales expenses</td>
<td>10,000</td>
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</table>
Less Household Expenses (in total)

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
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<tbody>
<tr>
<td>Mortgage interest</td>
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<tr>
<td>Property taxes</td>
<td>3,200</td>
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<tr>
<td>Household expenses (w/o depreciation)</td>
<td>6,400</td>
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<tr>
<td>Depreciation</td>
<td>7,200</td>
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<tr>
<td><strong>Total</strong></td>
<td><strong>24,800</strong></td>
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<tr>
<td>Allocable business portion - 20%</td>
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</tr>
<tr>
<td>(400/2,000)</td>
<td>4,960</td>
</tr>
</tbody>
</table>

Net Taxable Income from Activity 10,040

The remaining 80% (personal use portion) of the mortgage interest and property taxes were deductible as itemized deductions for the taxpayer but the remaining portions of the other household expenses were not deductible. If the allocable business portions of the household expenses were more than the $15,000 of income from the activity remaining after the deduction for the direct office and miscellaneous sales expenses, only $15,000 of the allocable household expenses could have been deducted. For the type of situation described above, the IRS had also provided a simplified method of computing and deducting home office expenses (Revenue Procedure 2013-13) where a taxpayer may have taken a flat deduction up to $1,500 (or $5 per square foot if less than $1,500) in lieu of computing and allocating actual expenses.

**Example 2 (Vacation home rented and used for personal purposes)**

Andy Smith owned a 1,000 square foot cottage located in a vacation area. The cottage was rented for 30 days during the year and used 50 days for personal purposes during the year. The depreciable cost of the cottage was $160,000. Andy received $4,500 from tenants for the 30 days of rental use. The mortgage interest on the cottage for the year was $8,000 and the property taxes were $1,600. Other maintenance expenses of the home (including insurance and utilities) totaled $1,600. Depreciation computed as if the cottage were used 100% for rental purposes was $5,800.

The cottage was considered used significantly for personal purposes (the cottage also qualified as a secondary residence for deducting mortgage interest as an itemized deduction) because Andy used the cottage for more than 14 days. The cottage also was used significantly for rental purposes because it was rented for more than 14 days. The balance in days between rental and personal classified this usage as mixed and rental deductions could be taken only up to rental income.

Using the Tax Court method of allocation noted above, the first tier expenses (the otherwise deductible mortgage interest and property taxes) were allocated to the rental activity based on days in the year. The second and third tier expenses (normal rental expenses other than depreciation and depreciation) were allocated based on days of use. If the rental income was not sufficient to absorb all of the rental deductions, the deductions in excess of rental income must
have been carried forward to future tax years for possible deduction but could not be deducted in the current tax year. The allocations were illustrated in Table 3 below.

### Table 3: Illustrative Computation of Allocation of Vacation Home Expenses

<table>
<thead>
<tr>
<th></th>
<th>Total</th>
<th>Rental</th>
<th>Personal</th>
</tr>
</thead>
<tbody>
<tr>
<td>Rents Received</td>
<td>4,500</td>
<td>4,500</td>
<td></td>
</tr>
<tr>
<td>Deductions</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Mortgage Interest (allocated 30/365 to rental)</td>
<td>8,000</td>
<td>658</td>
<td>7,342</td>
</tr>
<tr>
<td>Property Taxes (allocated 30/365 to rental)</td>
<td>1,600</td>
<td>132</td>
<td>1,468</td>
</tr>
<tr>
<td>Other rental expenses (allocated 30/80 to rental)</td>
<td>1,600</td>
<td>600</td>
<td>Not deductible</td>
</tr>
<tr>
<td>Depreciation (allocated 30/80 to rental)</td>
<td>5,800</td>
<td>2,175</td>
<td>936</td>
</tr>
</tbody>
</table>

None of the references listed above had prescribed a particular allocation method fitting the circumstances of this case where a dwelling unit had been used or available for personal purposes at any time during the year but also had been claimed as used for mixed business and personal purposes during certain days of the year.
References

26 CFR § 1.183-2 (Activity not engaged for profit defined).

26 USC § 162 (Trade or business expenses).

26 USC § 163 (Interest).

26 USC § 167 (Depreciation).

26 USC § 262 (Personal, living, and family expenses).

26 USC § 274 (Disallowance of certain entertainment, etc., expenses).

26 USC § 275 (Certain taxes).

26 USC § 280A (Disallowance of certain expenses in connection with business use of home, rental of vacation homes, etc.).

26 USC § 280F.


Bolton v. Comm., 694 F.2d 556 (9th Circuit, 1982).

