# RESTORATION

## A TAXING EXPERIENCE

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When is a business not a business? When the IRS says that it isn't.

Joseph and Dennis Gruse were (1) father and son, and (2) partners in a venture known as "Gruse Enterprises." The principal business activity indicated on the partnership tax returns was "auto restoration." They deducted various expenses relating to that activity.

The IRS disagreed with those deductions. The Gruses appealed to the Tax Court.

In its decision of April 10, 1990, the Tax Court ruled in favor of the IRS.

The Court noted that the Internal Revenue Code distinguishes between activities that are "engaged in for profit" and those that are not. If an activity is not engaged in for profit, a taxpayer can generally only deduct expenses up to the level of income.

If the taxpayer proves that he or she engaged in the activity with an actual and honest objective of making a profit, then he or she may be able to deduct certain additional expenses. Such expenses must be (1) necessary to the conduct of the business or (2) incurred in managing, conserving, or maintaining property held to produce income.

Although a reasonable expectation of a profit is not required, the goal of making a profit must be bona fide. "Profit" here means economic profit, independent of tax savings. Mere statements of intent to make a profit may not be enough.

Tax regulations provide some factors to consider in determining the existence of a taxpayer's profit objective. These include the taxpayer's: (1) manner of carrying on the activity; (2) expertise (or that of advisors); (3) time and effort expended; (4) expectation that assets used may appreciate; (5) success in carrying on similar or dissimilar activities; (6) history of income or losses from the activity; (7) occasional profits, if any; (8) financial status; and (9) personal pleasure or recreation involved in the activity. Not every factor applies in every case; no one factor is conclusive.

Applying such considerations to the facts, the Court concluded that the Gruses had not engaged in their vintage automobile restoration activity with an actual and honest objective of making a profit. Accordingly, losses claimed from this activity were not deductible. The Court also upheld the IRS's denial of investment tax credits for property used in the activity.

In its analysis, the Court found that the Gruses had not conducted the automobile restoration in a business-like manner. Before entering the activity, they had not performed a profitability study, investigating or analyzing the costs, risks, and returns of operating or determining their financial break-even point. Nor had they consulted automobile restoration experts. This suggested a casual attitude toward the financial aspects of the activity.

They also had not kept records for cutting expenses, increasing profits, and evaluating the overall performance of the activity. In fact, expenses (besides depreciation) directly related to the restoration activity had substantially exceeded income. The Court suggested that if the Gruses had aimed to make a profit, they would have reevaluated or redirected their efforts and acted to minimize losses and increase profit potential. There was no evidence of such a plan or change. For example, they had made no effort to advertise. This suggested they had been content to deduct the losses and claim the tax credits, and had not been serious in operating the restoration activity for profit.

The Court noted that, although losses in the initial years of an activity are not necessarily determinative, the ultimate goal of an activity engaged in for profit must be a net profit to recoup losses. Gruse Enterprises had reported little or no income from restoration. Indeed, both Gruses had continued to work full-time at their respective jobs. The Court questioned spending so much time and effort on an activity resulting in minimal income over the years involved.

The Court also noted that the Gruses had never transferred ownership of the automobiles, tools, buildings, and equipment used to Gruse Enterprises. The Gruses had derived significant deductions from the restoration activity. Their economic status was such that they could afford to sustain the losses while benefitting from the resulting tax advantages.

Finally, the Court noted that the Gruses had received personal and recreational gratification from the restoration. This, coupled with the substantial tax benefits, further suggested to the Court that they had not engaged in the activity for profit.

While this article is not intended to provide specific tax advice, the lesson of the Gruse case is a valuable one. While automobile restoration can provide pleasure and challenge, it may not necessarily provide a tax deduction for expenses or losses incurred.

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