

Classic Car Ownership and Taxes

ALBERT EINSTEIN, NO SLOUCH IN THE BRAINS DEPARTMENT, is said to have said: "The hardest thing in the world to understand is the income tax." (That quote actually appears on the IRS website.)

If Dr. Einstein scratched his magnificent head trying to fathom his taxes, what hope can there be for the rest of us? But try we must. So, as 2012 winds its way down, many will be thinking about the taxes they must pay next year. For classic car owners and restorers, one question may be whether losses (i.e., expenses exceeding income) from such activities may be deducted.

There have been a number of tax court cases over the years that have addressed the question in the context of particular classic car ownership or restoration situations. Additional guidance has been provided more generally in the Internal Revenue Code and regulations, as well as in publications and statements issued by the IRS. As these authorities reflect, the critical underlying question is often whether the classic car ownership or restoration work done constituted a business or a hobby.

Generally, taxpayers may deduct ordinary and necessary expenses for conducting a trade or business. An ordinary expense is an expense that is common and accepted in the taxpayer's trade or business. A necessary expense is one that is appropriate for the business. An activity generally qualifies as a business if it is carried on with the reasonable expectation of earning a profit.

For the most part, if business expenses exceed income for the tax year, the taxpayer can claim a loss for the year, up to the amount of taxable income they received from other activities. Remaining losses, if any, can usually be carried over into other years. However, if an activity is not done for profit, the ability to deduct expenses is generally limited to the amount of income generated from that activity. Thus, losses from that activity usually may not be used to offset other income.

For losses to be deductible as relating to a business or a "for profit" activity, the taxpayer generally must engage in or carry on the activity with an "actual and honest" objective of making a profit. The burden is on the taxpayer to prove that such an

objective exists, and that burden can be a heavy one.

The determination of whether or not an activity is operated with an actual and honest profit motive is based on analysis of the particular facts and circumstances of each case. Typically, the following nine non-exclusive factors are considered:

1. *The manner in which the taxpayer carried on the activity (is it businesslike, with complete and accurate books and records being kept?).*

2. *The expertise of the taxpayer or his or her advisers (including study of or consultation regarding accepted business practices related to the activity).*

3. *The time and effort expended by the taxpayer in carrying on the activity (generally, the more personal time and effort spent, the better).*

4. *The expectation that the assets used in the activity may appreciate in value.*

5. *The success of the taxpayer in carrying on other similar or dissimilar activities.*

6. *The taxpayer's history of income or loss with respect to the activity (a series of years in which income was generated would be helpful).*

7. *The amount of occasional profits, if any, which are earned (the bigger, the better).*

8. *The financial status of the taxpayer (including whether the taxpayer has substantial income from other sources).*

9. *Elements of personal pleasure or recreation (although profit need not be the sole purpose of the activity).*

No single factor controls the determination; other factors may also be considered, and the mere fact that there are more factors indicating the lack of a profit objective than the number indicating the presence of a profit objective (or vice versa) is not conclusive. Courts give more weight to objective facts than to the taxpayer's mere statement of his or her intent.

Thus, you should (as the IRS does) consider questions such as the following:

1. *Does the time and effort put into the activity indicate an intention to make a profit?*

2. *Does the taxpayer depend on*

income from the activity?

3. *If there are losses, are they due to circumstances beyond the taxpayer's control, or did they occur in the start-up phase of the business?*

4. *Has the taxpayer changed methods of operation to improve profitability?*

5. *Does the taxpayer or his/her advisers have the knowledge needed to carry on the activity as a successful business?*

6. *Has the taxpayer made a profit in similar activities in the past?*

7. *Does the activity make a profit in some years?*

8. *Can the taxpayer expect to make a profit in the future from the appreciation of assets used in the activity?*

If you intend to claim a profit motive, it's important to create and maintain sufficient contemporaneous documentation to support and evidence such a claim. The Internal Revenue Code allows a presumption that the taxpayer is engaged in the activity for profit if, in three of five consecutive years, the activity is profitable.

Benjamin Franklin wrote in 1789 that "in this world, nothing is certain but death and taxes," and, for many, the ability to deduct classic car ownership and restoration losses may be quite an uphill climb. But what is also pretty certain is that in dealing with these matters, your best bet is to seek tailored advice from a professional familiar with your specific circumstances. ☞

