

STATE OF NEW YORK

TAX APPEALS TRIBUNAL

In the Matter of the Petition :
of :
STEVE AND LINDA HORN :
for Redetermination of a Deficiency or for Refund of : **DECISION**
New York State Personal Income Tax under Article 22 of : **DTA NO. 825333**
the Tax Law for the Years 2004 through 2009. :

The Division of Taxation filed an exception to the determination of the Administrative Law Judge issued on July 2, 2015. Petitioners appeared by Roberts & Holland LLP (Joseph Lipari, Esq., of counsel). The Division of Taxation appeared by Amanda Hiller, Esq. (Marvis A. Warren, Esq., of counsel).

The Division of Taxation filed a brief in support of its exception. Petitioners filed a brief in opposition. The Division of Taxation filed a reply brief. Oral argument was heard in New York, New York, on October 20, 2016, which date began the six-month period for the issuance of this decision.

After reviewing the entire record in this matter, the Tax Appeals Tribunal renders the following decision.

ISSUE

Whether the Administrative Law Judge properly determined that the activities of Steve and Linda Horn, Inc., an S corporation, were separate activities engaged in for profit, thus entitling petitioners, as owners of the S corporation, to a deduction for the claimed losses for the years in issue.

FINDINGS OF FACT¹

We find the facts as determined by the Administrative Law Judge except for findings of fact 105, 144, and 162, which have been modified to more accurately reflect the record. We have not included the Administrative Law Judge's finding of fact 170, which discusses the disposition of proposed findings of fact submitted by petitioners below. The Administrative Law Judge's findings of fact and the modified findings of fact are set forth below.

1. Steve and Linda Horn (petitioners) are married individuals with an address in Ossining, New York.

2. During the years 2004 through 2009 (the tax years at issue), petitioners filed joint federal (forms 1040) and New York (forms IT-201) personal income tax returns.

3. During the tax years at issue, Steve and Linda Horn, Inc. (the Company) was an S corporation for both federal and New York State income tax purposes. All of the stock of the Company is owned by petitioner Linda Horn. All of the income and losses of the Company passed through for income tax purposes to petitioners and were reported on their joint personal income tax returns.

4. On September 16, 2011, the Division of Taxation (Division) issued a notice of deficiency, notice number L-036622577-5, to petitioners for the years at issue. The notice assessed tax as follows:

Year	Tax	Interest	Penalty	Current Balance Due
2004	\$134,337.00	\$86,348.16	\$13,433.00	\$234,118.16
2005	\$1,157,264.00	\$605,801.83	\$115,726.00	\$1,878,791.83

¹ The parties executed and submitted a stipulation of facts setting forth 13 numbered stipulated facts and including 27 agreed-upon exhibits. The stipulated facts are incorporated herein, with the exception of stipulated fact 13, which is merely a recitation of the agreed exhibits that have been accepted into the record. The stipulated facts are set forth herein as findings of fact numbered 1 through 12.

2006	\$374,685.00	\$148,102.34	\$37,468.00	\$560,255.34
2007	\$261,861.00	\$73,162.49	\$26,186.00	\$361,209.49
2008	\$365,914.00	\$72,786.49	\$36,591.00	\$475,291.49
2009	\$179,974.00	\$20,210.72	\$17,997.00	\$218,181.70

5. Petitioners timely protested the notice of deficiency by means of a request for a conciliation conference filed on November 18, 2011.

6. A conciliation conference was held before the Bureau of Conciliation and Mediation Services (BCMS) on April 18, 2012.

7. BCMS issued a conciliation order dated August 17, 2012, sustaining the notice of deficiency.

8. Petitioners timely filed a petition, which was received by the Division of Tax Appeals on November 5, 2012.

9. The Division filed an answer dated January 16, 2013.

10. The tax amount reflected in the notice of deficiency was calculated by disallowing all of the Company's losses for the years at issue and by disallowing net operating loss carryforwards and carrybacks.

11. The 2005 tax liability on the notice of deficiency also includes the disallowance of an Internal Revenue Code (IRC) (26 USCA) § 1031 like-kind exchange entered into by the Company in 2005. However, the section 1031 like-kind exchange issue is no longer being pursued by the Division due to the Company's sale of the property located at 930 Ocean Boulevard, Palm Beach, Florida (the Ocean Property) in 2011 and its reporting of the capital gain recognized on that sale in its tax return for that year.

12. The parties have agreed that following the issuance of a determination in this matter,

the liability for each tax year will be recalculated to reflect the resolution of the like-kind exchange issue and the resolution of the remaining issues as set forth in the determination.

Background

13. Steve Horn went to an art and music high school, after which he received a scholarship to the Pratt Institute, where he majored in advertising. He then studied at Columbia University, where he received a Bachelor of Arts degree in Fine Arts and worked towards a master's degree.

14. After school, Mr. Horn worked as a commercial photographer, eventually partnering with another photographer to form a firm, Horn/Griner.

15. Linda Horn initially worked as an assistant to a fashion photographer. A few years later, she worked at Avon Products (Avon). Mrs. Horn worked her way up the corporate ladder to become the beauty and fashion director at Avon. In this position, she would travel throughout the country to develop an understanding of Avon's mass market appeal, in order to determine the look of the Avon catalogues and what consumers wanted.

16. In 1970, while at Avon, Mrs. Horn was responsible for the first commercial that Avon produced, called "Field Flowers." During that production, Mrs. Horn first met Mr. Horn, who worked on the commercial shoot.

17. After Avon, Mrs. Horn was hired to become executive editor at Vogue Patterns (Vogue), and became editor-in-chief six months later. As editor-in-chief, she was responsible for the entire editorial production of the magazine.

18. In 1973, Mr. and Mrs. Horn married.

19. In 1974, Mr. Horn had a dispute with the other partners of Horn/Griner and left the firm. Mrs. Horn, with the knowledge and blessing of Vogue, continued to give Mr. Horn work as a photographer.

20. After the breakup of Horn/Griner, Mr. Horn was locked out of the partnership's building and had significant personal debt. Only two Horn/Griner employees, a cleaning man and a receptionist, left the partnership with Mr. Horn.

21. The Horns then went into business together. They created the Company, an S corporation. Under the original certificate of incorporation, filed on July 12, 1974, the S corporation's name was Steve Horn, Inc. On September 5, 1991, the name of the S corporation was changed to Steve & Linda Horn, Inc. The certificate of incorporation states, in part, the following purposes for which the corporation was formed:

“(a) To engage in the general business of still photography for advertising agencies, print media, and all other persons, firms or corporations, and on its own behalf, and of film production of every type, nature and description, including but not limited to the filming of commercials for TV viewing, and the production of motion picture films, and to engage in all business and activities in furtherance thereof, or incidental or related to said business, for others or on its own behalf.

(b) To lease, rent, purchase or otherwise acquire, outfit, develop and maintain studios, equipments, materials and supplies, and all the articles and things necessary or convenient in pursuing the business of the corporation.

(c) To purchase, sell, rent, lease, sub-let, hold and exchange real property, improved and unimproved, to build, re-build, construct, demolish, alter and improve buildings and stores thereon, fixtures and personal property including or incidental thereto and connected therewith, and real property generally.

(d) To purchase, acquire, hold, sell, exchange . . . or otherwise dispose of or deal in, the stocks, notes, bonds, debentures or other evidences of indebtedness and obligations of any private, public, quasi-public, or municipal corporation . . .

(e) To purchase, lease, or otherwise acquire . . . the business, goodwill, rights, franchises and property of every kind, and to undertake the whole or any part of the assets or liabilities of any person, firm, association, or corporation engaged in or authorized to conduct any business similar to any business authorized to be conducted by this corporation, or owning any property necessary, desirable or suitable for its purposes . . .

(f) To acquire . . . and to hold or dispose of stocks, bonds, and any other obligations of any corporation formed for or engaged in or pursuing any one or more of the kind or kinds of business, purposes, objects or operations above indicated . . .

(g) To borrow or raise money for the purposes of the corporation, to mortgage and charge all or part of the present or hereafter acquire property, rights and franchises of the corporation, and to issue and sell stocks, bonds, debentures and other evidence of indebtedness.

(h) To purchase, hold and re-issue shares of its capital stock . . .

(i) To do all, and everything necessary, suitable, proper, and/or convenient for the accomplishment of the purposes . . . herein set forth”

22. Due to Mr. Horn’s financial difficulties, the Company was formed with funds from Mrs. Horn, who owned, and continues to own, 100% of the stock of the Company. The Company initially operated out of petitioners’ apartment. The Company eventually engaged in the production of television commercials.

23. Mr. and Mrs. Horn both worked for the Company. Mrs. Horn worked as a producer, scouting locations, casting and clothing actors, and deciding where to shoot a commercial, whether in a studio or at a location. She also made bids on behalf of the Company to advertising agencies for particular jobs.

24. Mr. Horn directed the commercials, worked on storyboards and did camera and lighting work.

25. Petitioners worked long hours during the commercial production business, but took weekends off to spend time with their young children. As their children grew older, petitioners would do some work on weekends.

26. In addition to petitioners, the Company has always had some long-term employees, including Alayne Baxter, Thomas Drohan, Cheryl Baxter, Katherine Horn and Efleda Danao. Mrs. Horn felt that each of these employees could do the work of two or three people.

27. Cheryl Baxter has been with the Company since the year it was created. She began doing billing for the print photography business and answering telephones.

28. Later, Cheryl Baxter began to work as a coordinating producer, hiring crews, stylists,

and set decorators and designers, renting props, creating schedules and arranging logistics for the commercial shoots, including location scouting, travel arrangements and catering.

29. During the commercial production business, Cheryl Baxter's job required working 10-12 hours per day, five days a week, and would require working as many as 14 hours a day when they were shooting a commercial.

30. Alayne Baxter, Mrs. Horn's sister, worked after college as an editor at Mademoiselle Magazine.

31. Alayne Baxter started working for the Company in the 1970s, where she learned the entire film business. She eventually became the Company's "rep," acting as the salesperson who obtained new commercial production jobs for the Company.

32. Katherine Horn, petitioners' daughter, initially worked as an assistant buyer for a women's clothing store, Putumayo, eventually becoming a buyer and creative director there. In the 1990s, she began to work for the Company as a stylist, dealing with costumes and wardrobe.

33. Mr. Drohan had been involved in theatrical and film production since he finished school, working as a "grip" (i.e., a lighting, electrical and rigging technician). Through a recommendation, he was hired by the Company.

34. Mr. Drohan eventually became assistant director, booking equipment, contacting the crew, assisting on lighting and shoot decisions, and working on timesheets and production reports. He would typically work 12 to 14 hours per day when the Company was shooting commercials.

35. Ms. Danao started with the Company in 1994 as an assistant bookkeeper. Since 1997, she has served as the Company's bookkeeper. Ms. Danao has an accounting degree from the Philippines.

36. Over the years, the Company employed a number of full-time and freelance

employees for the television commercial production business who were independent contractors. At times, they would have multiple jobs in the house at the same time and would employ the independent contractors for three or four months.

37. In 1981, the Company purchased 435 East 83rd Street, New York, New York (the Studio), which it used and still uses as the headquarters for all of its activities.

38. The Horns felt that it was important for the success of their business to create a brand. The Horns' approach to commercials included creating "little mini movies and little stories." This approach carried over to their antique business, where they felt that it was important to create a brand under the Linda Horn name and would create vignettes for the store displays to tell a story about the items they were selling.

39. Petitioners' commercial production business became well known in the advertising world and received accolades such as Mr. Horn's induction into the Art Directors Club Hall of Fame. In 1981, Michael J. Arlen wrote a book, *Thirty Seconds*, about petitioners and the Company's commercial production business, in which Mr. Horn was described as one of "the top men in business." In 1985, *Advertising Age* named Mr. Horn "Television Commercial Director of the Year."

40. The Company created commercials for AT&T, G.E., McDonald's, Coke and Pepsi, as well as the "I Love New York" commercials. The Museum of Modern Art inducted into its collections a reel of the Company's commercials.

41. Petitioners have also had a long-standing antiques and decorative items business (the antiques business), which they began in the early 1980s.

42. The idea for an antiques business came to Mrs. Horn during her travels with the Company to shoot television commercials in Europe. For example, while in the Netherlands for a shoot for Pan American airlines, she decided to buy antiques for resale and ship them back to

the United States. Mrs. Horn felt that it was a good buying time because the prices were good and the dollar was strong. Furthermore, by buying pieces when the Company was otherwise working in Europe, petitioners could eliminate the middleman and avoid markups on the items.

43. Mr. Horn would accompany Mrs. Horn on trips to acquire antiques, act as a courier and note taker, make recommendations and take photographs of pieces. He prepared the shipping invoices to ship the items to New York. Mr. Horn would also take professional photographs of purchased antiques once they were added to the store's inventory.

44. Mrs. Horn described the antiques business's initial concept as "not a big money-making thing, but it was something that would pay for itself." She explained that when they began the antiques business, they intended to make it work for itself and break even with the potential to make more money. During the antiques business's start-up, petitioners had the strength and income from both the commercial production business and the real estate activity. As the commercial production business declined in 2004 and 2005, petitioners focused on the antiques business and intended to grow it into a mass market business by increasing their appeal to a wider audience.

45. Mrs. Horn made all purchase decisions with respect to the antiques business.

46. Mrs. Horn's knowledge of the fashion business was informed by influences such as Donna Karan, Ralph Lauren and Calvin Klein and their creation of branded lines such as DKNY, RL, Lauren and CK. Mrs. Horn had previously, about 15 years earlier, been offered a job with Donna Karan to run DKNY, and Mary Wells, the head of the advertising agency Wells Rich Greene, had offered her a job to run a division. However, Mrs. Horn preferred to stay with the Company.

47. The Company originally purchased a property in the early 1980s in Valhalla, New York, to serve as an antiques store. The store was initially run by Mrs. Horn's sister, Mary

Donahue. The Valhalla property was used for the antiques store up to about four or five years prior to the years at issue. Petitioners subsequently operated an antiques store on Madison Avenue in Manhattan. The Valhalla store was operated simultaneously with the Madison Avenue store for a period prior to the years at issue. Petitioners then tried to sell the Valhalla property, but were unable to sell it until 2013. From 2004 to 2009, the Valhalla property was vacant with a “for sale” sign posted. The property was sold in 2013, resulting in a capital gain.

48. In approximately 1984, the Company opened a store in Manhattan in a space leased by Murray Mondschein, professionally known as Fred Leighton. Mr. Leighton was an expert in the jewelry antiques world and supported Mrs. Horn in her development of the antiques store. Mr. Leighton provided the store for no rent, on the condition that the store be called “Linda Horn at Fred Leighton.” Mrs. Horn obtained advice from Mr. Leighton on running the antiques store.

49. After Mr. Leighton’s lease ran out, the store moved to its own space on 79th Street and Madison Avenue in Manhattan. The store operated at the 79th Street location until approximately 2005, when it moved to its current location on Madison Avenue and 93rd Street.

50. In addition to the television commercial business and the antiques business, the Company, as well as Mr. and Mrs. Horn, through other entities, has bought and sold real estate for investment purposes during, prior and subsequent to the years at issue.

51. In 1980, the Company purchased, for \$775,000.00, property located at 166 East 73rd Street, New York, New York (the Church). The Church was originally purchased to become the headquarters for the Company, but the neighborhood block association would not allow a television production company on the premises. The building was then used for storage for the commercial business and the antiques store.

52. In 2005, the Church was sold for \$12,000,000.00, resulting in a profit in excess of \$11,000,000.00.

53. In 1981, the Company purchased property located at 435 East 83rd Street, New York, New York (the Studio) for \$525,000.00. The Studio had five floors, with 2,500 square feet per floor, plus a full basement, a high ceiling and skylight. The Studio has a curb cut so that a car can be driven into a car elevator. Mrs. Horn testified that she has no idea what the property is worth, but believes it is worth more than the purchase price. The Studio was used as a photography studio during the operation of the commercial production business and had housed the wardrobe used for various television commercials petitioners filmed. During the years at issue, the Studio was used as the main office headquarters for the Company.

54. In 1999, Woodland Farms, LLC, of which petitioners were 100% owners, purchased and renovated property at 120 Woodside Avenue, Briarcliff Manor, New York (the Creamery). In 2001, Woodland Farms, LLC, purchased and renovated property at 104 Woodside Avenue, Briarcliff Manor, New York (the Warehouse). The Company stores inventory that is not at the antiques store at the Warehouse and the Creamery and used the properties for receiving merchandise. The Company pays rent to Woodland Farms, LLC, for use of the properties.

55. Mrs. Horn testified that in 1999, petitioners purchased property at 52-62 Cooper Square, New York, New York, for \$14,000,000.00 and sold it in 2000 for \$21,000,000.00. She could not remember whether they owned the property individually or through the Company.

56. In early 2004 to 2005, the Company's television commercial business declined and came to an end. The decline happened for a number of reasons, including a change in the commercial business from the use of film, which petitioners used, to digital, creating an increase in competitors who could produce commercials at a lower price.

57. After discontinuing the production of television commercials, petitioners decided to remain in business and continue working. Petitioners decided to devote their time to expanding the existing antiques business and real estate business.

58. Recognizing the change in the Company's business resulting from the winding down of the commercial business, petitioners realized they had to cut overhead. Petitioners gradually reduced the total number of Company employees, from 20 in 2005 to 14 in 2009, and ceased working with various independent contractors.

59. With respect to the antiques business, Mrs. Horn's business plan was to have a brand that is known by many people and to take the brand to a mass market level. Mrs. Horn's plan emulated what she saw from designers such as Calvin Klein, Donna Karan and Ralph Lauren, opining that "all the moneys that [these designers] made were not on the designer lines. They were all in [mass market brands such as] DKNY, RL, Lauren, CK."

60. Mrs. Horn felt that it was necessary to move from the smaller antiques store on 79th Street and Madison Avenue to a larger store in order to create a larger impact and have a better showcase so that her brand name would be more widespread.

61. After scouting locations all over New York City, the Company found a location at 1327 Madison Avenue, on 93rd Street and Madison Avenue (the 93rd Street Store), which the Company rented in December 2005, effective February 1, 2006.

62. The 93rd Street Store was previously a children's clothing store. The space required a complete renovation before it could be used as a store. Mrs. Horn designed the renovation, and the physical work was overseen by Thomas Drohan and Cheryl Baxter.

63. Mr. Drohan worked as a project manager/general contractor for the renovation, supervising the installation of lighting (including installation of a chandelier), electrical work, painting, and the installation of carpeting, sheet rock, and tile. The work required Mr. Drohan to work eight to ten hours a day and took approximately six to eight months to complete.

64. Cheryl Baxter was also involved in finding contractors to construct, and materials to

be used in, the renovations. Together with Mr. Drohan, she hired contractors, electricians and plumbers, and purchased lights and materials. Ms. Baxter testified that her work on the renovations was much like her work in the production business, bringing in similar scene workers and set designers to do the scene work, set builders to do the construction, and using prop people whom she knew to obtain materials.

65. The Creamery and the Warehouse also required significant renovation before they could be used by petitioners. The Creamery required new floors, walls, sprinkler system, doors and a roof. The Warehouse required walls, floors, a loading dock, heating and air conditioning and a new roof.

66. Mr. Drohan acted as general contractor on the renovations for the Creamery and the Warehouse, dealing with subcontractors and business inspectors. Mr. Drohan was also involved in moving the store inventory from the 79th Street location to the warehouses until the store relocated several months later to the 93rd Street location.

67. With respect to all of the renovations, petitioners' goal was to get the best price possible. Cheryl Baxter negotiated deals on items and used companies such as SceniX, that they knew from their work in the television commercial business.

68. Post-renovation, the 93rd Street Store has 50 feet of show windows facing Madison Avenue. The store is on two levels, with between 3,500 and 4,500 square feet of space.

69. The 93rd Street Store has significantly more space than the prior store, allowing for the display of more items. It also has double doors that allow for inventory such as furniture to be brought in for display.

70. The store is open to the public from 10:00 A.M. to 6:00 P.M., Monday through Saturday. However, the store would never turn customers away and is known for opening early,

closing late, and reopening after hours in order to accommodate customers.

71. The inventory is roughly 60% to 70% antiques, which are defined as items that are at least 100 years old. The rest of the inventory includes pieces from the 1950s through the 1970s, petitioners' famous photography, a small amount of jewelry, and new recreations (reproductions). During the tax years at issue, the inventory at cost ranged from \$8,199,654.00 at the end of 2004 to \$10,006,457.00 at the end of 2009.

72. Mrs. Horn expects the inventory items to appreciate in value. Although a formal appraisal of the inventory had been done previously, she could not recall when and testified that it was probably done ten years ago. During the market crash, petitioners' accountant suggested that they appraise the inventory and then offer work for sale at a lower price and take a loss. Mrs. Horn would not consider the suggestion of taking a possible write down for tax purposes.

73. Petitioners purchased some items of inventory to be sold as collections, such as Majolica collections.

74. For the tax years at issue, the Company's cost for purchases of new inventory items for the antiques business was as follows: \$638,417.00 in 2004; \$1,118,844.00 in 2005; \$1,396,156.00 in 2006; \$703,581.00 in 2007; \$199,431.00 in 2008; and \$165,888.00 in 2009.

75. Mr. and Mrs. Horn both do work for the antiques business. Mrs. Horn is responsible for the overall conception of the antiques business. She makes the final decision with respect to items purchased for the store's inventory and sets the prices. Mrs. Horn estimated that she would spend between two to four hours or more working between the antiques store, the Creamery, the Warehouse and the Studio. Mrs. Horn testified that when she is not physically present at the store, warehouses or Studio, she is "constantly" on the phone with Alayne Baxter regarding the store.

76. Utilizing his background in art and photography, Mr. Horn takes photographs of every item of inventory for the antiques business's website database and designs all of the advertisements for the business. During the audit period, petitioners placed advertisements for the antiques store in Architectural Digest, Rosewood Magazine, Veranda, Quest Magazine, Avenue Magazine, Palm Beach Cottage Gardens Magazine, NY Spaces, Elle Decor, and Platinum Publications, which publishes magazines for New York hotels. Petitioners also advertized through holiday mailers and emails to clients for special occasions and discounts.

77. With their launch of an expanded antiques business, petitioners relied on long-term employees Alayne Baxter, Thomas Drohan, Cheryl Baxter, Katherine Horn and Efleda Danao.

78. Mrs. Horn asked her sister, Alayne Baxter, to take over running the store because Mrs. Horn felt that Ms. Baxter, whose background was in sales, would be an excellent salesperson. Petitioners wanted Ms. Baxter to take her experience in sales from the film industry and use it to turn the store around. Ms. Baxter's primary job is to sell. Ms. Baxter works in the store five days a week, from at least 10:00 A.M. to 6:00 P.M., and takes calls from the person running the store on the days she is not on the premises. On Sundays, Ms. Baxter usually meets with Mrs. Horn to discuss the store.

79. Alayne Baxter changes the store's window displays every couple of months for holidays and changes of seasons, or to display a new collection, and updates the displays more frequently as needed to fill a hole when items in the display are sold. The store is locally famous for its Christmas windows, which feature Parisian animated polar bears.

80. Ms. Baxter is also responsible for changing the layout of the store displays, moving items in the store daily and rotating inventory from the warehouses in order to keep the store looking new for regular clients.

81. Mr. Drohan loads and moves the inventory as it rotates between the store and the Warehouse or Creamery.

82. Mrs. Horn and Ms. Baxter conceived of the store's display as a series of little vignettes, where multiple pieces come together to form a collection that tells a story. Mrs. Horn developed this same concept during her years in the film business. Katherine Horn dressed mannequins for her work in wardrobe, and would come up with a theme to create a collection.

83. The store uses sales diaries, which petitioners refer to as the Madison Diaries. The Madison Diaries allow Ms. Baxter and her salespeople to keep track of the contact information and sales history of every customer who has come into the store. The store's sales people write down the names of customers who come in, what items they are interested in, if the customer was given a special price, and customer contact information. They then use the diaries as a sales technique to follow-up with customers and contact customers when they find an item for which the customer was looking. Other antiques stores have copied the Company's sales diary technique.

84. Ms. Baxter, along with Katherine Horn and Ms. Danao, have implemented a "tear sheet" system. Ms. Baxter came up with the idea based on her background work in magazines. Katherine Horn created the information database to store information in a manner that could easily print out on the tear sheets.

85. The tear sheets have several functions. Ms. Baxter and her sales staff print out from the database "short" one-page tear sheets, which display, for an individual item, a photograph, measurements, and a description. Depending on the customer, the tear sheets may or may not show a price. The staff can quickly produce tear sheets to give to customers and decorators, so that potential customers remember their favorite items after they leave and can call back to

purchase the item. A decorator may walk out of the store with multiple tear sheets at a time to show a client.

86. There is also a “long” version of the tear sheets for Ms. Baxter’s use, which provides vendor information, financial reports, purchase price information, and customer information. Ms. Baxter can access the long form tear sheet in order to determine what price to offer for an item and to access information about past customer purchases. Using the tear sheets, Ms. Baxter knows when she can offer a discount of anywhere from 10% to 20% on an item. The staff can quickly toggle between “short” and “long” versions of the tear sheets on the computer screen to make sure that customers do not see internal store information.

87. Ms. Baxter can also access from her store computer the sales reports generated by Ms. Danao to see how much the store has sold for the day, and can check year-to-date sales for the current and prior years. Ms. Baxter uses the sales history garnered from the reports to set current sales goals.

88. Katherine Horn uses the product area and vendor section of the database to enter information from purchase orders and assign an SKU, similar to a bar code, to each item. The items are categorized by the SKU to identify antiques, recreations and limited edition items.

89. Mr. Horn takes the inventory photographs for the tear sheet database and website.

90. Around 2002 or 2003, Katherine Horn became in charge of the Company’s computers and database. She found that although the Company had a website, it did not have email or internet sales. She encouraged petitioners to increase their online presence and create a program that would combine the database, website and sales. The Company required a customized program containing pictures of different views and other information. Ms. Horn interviewed companies for the project, but they were too expensive and she worked to combine

the database and website herself. In approximately 2003 or 2004, the store had a working system with a combined customized point of sale, database and website. The Company's combined system has evolved and been upgraded over the years from its creation through today. For example, views on the system increased from one to four. Ms. Horn has also worked to increase the Company's use of social media, such as Facebook, Twitter, Instagram and Pinterest and maintains the Company's database.

91. As the database and website manager, Ms. Horn typically works from 8:30 or 9:00 A.M. until 6:00 P.M., but can stay up late at night updating the database as additional inventory is acquired, uploading pictures onto the website and database.

92. Petitioners redesigned labels for the antiques store's items and created stickers to place on store items that identified "Linda Horn Collection" items. They also created unique packaging designs to appeal to customers.

93. In February 2008, the Company entered into a sales arrangement with 1stdibs.com (1stdibs), which Alayne Baxter characterized as "the number one online site in the world for selling antiques." The Company updated its 1stdibs inventory monthly. The site is the Company's major online selling tool and Ms. Baxter testified that over half of the items listed get sold.

94. 1stdibs considers petitioners' store to be a major dealer, and the store is often featured in a place of prominence on the website and picked for feature stories. The antiques business posts new items on 1stdibs monthly. Both the former and current chairman of 1stdibs have come to the antiques store. Ms. Baxter has met with 1stdibs' current chairman, David Rosenblatt, two or three times and discussed ideas.

95. In order to appeal to the mass market, the antiques business started selling recreations or reproductions of antiques, wherein petitioners reproduce an antique so that it is more

affordable. Through reproductions, petitioners create high demand items at a lower price point, described by Mrs. Horn as somewhere between Pottery Barn and Ralph Lauren. Petitioners started to produce a small amount of reproductions during the audit years 2004 - 2009, and produced approximately a dozen seahorse lamps and 14 swans, all of which sold. Subsequent to the audit period, petitioners made connections with manufacturers to produce a larger quantity of reproductions and plan to increase sales through an increase in reproductions. Petitioners have tried to find sources within the country to produce the reproductions so that they can sell them to the mass market.

96. Mrs. Horn is in contact with manufacturers in North Carolina and South Carolina for the production of recreations.

97. The Company's gross receipts, as reported on the S corporation income tax returns, increased from 2005 to 2007 to wit: in 2005 the Company reported \$872,659.00 in gross receipts; in 2006 the Company reported \$1,026,583.00; and in 2007 the Company reported \$1,222,103.00. For 2008 and 2009, the Company reported gross receipts in the amount of \$805,738.00 and \$834,742.00, respectively.

A breakdown of the gross receipts pertaining to the antiques business only, as stated in the antiques business's trial balances and monthly accounting reports, are as follows: \$461,594.18 in 2004; \$473,800.51 in 2005; \$1,026,349.82 (\$492,257.68 in sales from Steve and Linda Horn, Inc., d/b/a Linda Horn Antiques and \$534,092.14 in sales from Linda Horn LLC) in 2006; \$1,177,806.30 in 2007; \$796,468.00 in 2008; and \$779,952.04 in 2009.²

² The following discrepancies are noted between the monthly accounting report and trial balances: November 2008, sales per monthly report are \$89,877.00 and sales per trial balance are \$88,900.00. For October 2008, sales per monthly report are \$65,444.10 and sales per trial balance are \$65,235.00. For April 2008, sales per monthly report are \$81,050.00 and sales per trial balance are \$80,700.00. For March 2008 sales per monthly report are \$50,675.00 and sales per trial balance are \$47,175.00. For 2009, the total gross receipts, including consignment sales as reported in the monthly accounting report is \$831,791.00. There was no explanation for these discrepancies.

98. The Company maintained detailed records of the purchase price and sales price for items in the antiques business inventory. An annual comparison of the Company's purchase price versus the amount for which the items were sold is as follows:

Year	Selling Price	Cost of Goods Sold
2004	\$461,595.00	\$202,683.00
2005	\$473,801.00	\$181,778.00
2006	\$1,026,350.00	\$379,198.00
2007	\$1,177,806.00	\$459,672.00
2008	\$796,468.00	\$298,766.00
2009	\$831,791.00	\$351,440.00

99. In conversations with another antiques dealer, Mrs. Horn was told to use her eye to find unique and interesting items.

100. The Company has provided items from the antiques store for use in store window displays of Bergdorf Goodman and Ralph Lauren. Every time an object is used from the antiques store in those stores' windows, the name of Linda Horn Antiques is written on the window, which provides publicity for the antiques store.

101. In 2008, the financial crisis hit, depressing the market for high-end items.

102. As a result of the decline in sales in 2008 and 2009, the store took steps to reduce costs, including getting rid of the store's security guard and replacing him with Alayne Baxter's dog.

103. The Company also adjusted salaries from 2004 to 2009 as follows:

	2004	2005	2006	2007	2008	2009
Commercial Business	\$681,194	\$665,108	\$475,527	\$445,442	\$317,062	\$271,204

Antiques Business	\$642,210	\$932,814	\$992,367	\$974,763	\$987,570	\$841,200
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104. Additionally, Ms. Baxter negotiated with the landlord of the antiques store, and the lease was amended in May 2014 to reduce the rent, forgive unpaid back rent, and renew the lease at a favorable rate.

105. Travel and entertainment expenses for the antiques business were also adjusted from 2004 to 2009 as follows:

2004	2005	2006	2007	2008	2009
\$66,104.00	\$89,880.00	\$62,430.00	\$58,169.00	\$32,806.00	\$23,599.00

106. The antiques business also reduced purchases of new inventory in 2008 and 2009 (*see* finding of fact 74).

107. Subsequent to the audit period, media executive Barry Diller and 1stdibs selected the antiques store to feature in a television show for Mr. Diller’s wife, Diane von Furstenberg.

108. After the audit period, the Company planned to increase the strength of the “Linda Horn” brand through the advertisement of its collection of Majolica, a type of pottery created in England in the mid-1800s. The collection has been acquired over 40 years and sold in the store.

109. After the audit period, Mr. and Mrs. Horn have been designing a book together featuring the Majolica collection. Mr. Horn is taking the photographs of the pieces and doing the layouts. Cheryl Baxter is helping petitioners with the research and photographs. Petitioners plan to publish the book and then conduct a large sale of the collection at an auction house such as Christie’s.

110. Petitioners have considered selling or franchising the Linda Horn brand subsequent to the audit period.

111. The Company's accountant, Michael Hecht, counseled petitioners on structuring real estate purchases. In regard to petitioners' real estate activities, Mr. Hecht stated that petitioners would "buy opportunistically." In 2004, Mr. Hecht recommended that the Company sell the Church in a like-kind exchange pursuant to IRC (26 USCA) § 1031. Petitioners were interested in expanding to the Palm Beach, Florida, area, and had advertised there for the antiques store during winters to gain exposure with visiting New Yorkers. In April 2004, the Company purchased property at 260 Via Bellaria, Palm Beach, Florida (the Lake House) for \$9,850,000.00 with money advanced to the Company by petitioners, individually, as part of an intended IRC (26 USCA) § 1031 like-kind exchange with the Church. However, petitioners did not complete a timely like-kind exchange and the Lake House was subsequently transferred out of the Company to petitioners' limited liability company, 260 Via Bellaria, LLC, to satisfy the debt of petitioners' loan for the property. The actual date of transfer of the property to 260 Via Bellaria, LLC, is unclear from the record.

112. Mrs. Horn testified that she planned to make a profit from the Lake House by renovating and then selling the property. Petitioners used recognized designers that designed buildings from the 1920s and 1930s and renovated the Lake House property to its original look. Petitioners renovated the property in an art deco style and gained press coverage for the renovation.

113. Cheryl Baxter helped Mrs. Horn with the design of the Lake House, researching the items that Mrs. Horn wanted, with the goal of finding the items at the best price possible.

114. Mr. Drohan acted as a project manager/general contractor to the work on the Lake House, and described the work as a "total gut job." Mr. Drohan supervised a contractor in Florida and reviewed pricing and payroll. When the Florida contractor left the project early, Mr.

Drohan personally went to Florida to supervise and perform work on the elevator, cabinetry, and small electrical items.

115. In August and September 2004, Hurricanes Charley, Frances, Ivan and Jeanne hit Florida, with Hurricanes Frances and Jeanne directly impacting the Palm Beach area.

116. In April 2005, the Company sold the Church, which it purchased for \$775,000.00, for approximately \$12,000,000.00. The Company reported the sale as an IRC (26 USCA) § 1031 like-kind exchange on its 2005 tax return, acquiring 930 South Ocean Boulevard, Palm Beach, Florida (the Ocean Property) in May 2005 and 353 Peruvian Avenue, Palm Beach, Florida (the Peruvian Ave. property) in June 2005. The Company reported a fair market value of the like-kind property received of \$15,443,000.00 on its 2005 return.

117. The Ocean Property was a residential property acquired for renovation and investment. Despite the Florida hurricanes, it was in relatively good condition at the time of purchase. The property did sustain some hurricane damage to roof tiles and a balustrade. Additionally, petitioners constructed a new terrace and patio, landscaping and lighting. Mr. Drohan dealt with the contractors involved in this renovation work, receiving estimates and discussing the scope of work.

118. The Peruvian Avenue property was a strip mall on Peruvian Avenue and Coconut Row, a block from the main street in Palm Beach. It was purchased with the idea of opening a Linda Horn Antiques store in Palm Beach. The Company also considered renting a portion of the Peruvian Avenue property.

119. Petitioners' son Christopher Horn, a real estate agent in Palm Beach, managed the Company's real estate holdings. He moved into a garage apartment at the Ocean Property after his apartment was damaged by a hurricane to allow him to supervise construction and show the real estate.

120. In October 2005, Hurricane Wilma hit Florida and caused significant property damage in the state. The widespread damage from multiple hurricanes within a short time span delayed renovations throughout the community. For example, the Palm Beach area was devoid of landscaping and nursery stock and the Company had to wait a long time to purchase replacement landscaping for the Florida properties.

121. At some point, Mrs. Horn was diagnosed with Lyme disease and Mr. Horn had a quadruple bypass. As a result, petitioners decided not to extend themselves further and the Company eventually abandoned plans to open an antiques store in Palm Beach. In February 2008, the Company entered into a sale listing agreement with a real estate broker, Linda A. Gary Real Estate, Inc. (the listing agent), to list the Peruvian Avenue property for sale. The property was advertised by the listing agent.

122. The Lake House and Ocean Property were also advertised for sale by the listing agent.

123. The 2008 financial crisis depressed the real estate and consumer market.

124. On December 11, 2008, Bernard Madoff was arrested for running a Ponzi scheme. Because many Palm Beach residents had invested money with Mr. Madoff, the resulting collapse of the Ponzi scheme had a significant negative effect on the local economy.

125. In 2011, the Company sold the Ocean Property for \$11,500,000.00, reporting a gain of \$7,388,713.00 on its 2011 federal income tax return for an S corporation.

126. In 2013, 260 Via Bellaria, LLC, sold the Lake House for \$15,000,000.00, more than its original cost but less than the \$25,000,000.00 for which it was valued before the financial crisis started.

127. The Peruvian Avenue property is still currently on the market.

128. Mrs. Horn enjoys the antiques business and finds it fascinating. Alayne Baxter,

who runs the antiques store, loves the work and wants to do it.

129. The Division's auditor, Summer Mann, testified at trial that she believes Mrs. Horn is an honest woman who works very hard. Ms. Mann also believes that Mrs. Horn derives personal pleasure from the antiques business rather than possessing an actual profit objective.

130. The Company's administrative and executive office for all of its businesses is at the Studio.

131. Ms. Danao, as the Company's bookkeeper, pays all of the Company's bills, keeps track of expenses, and generates sales reports. Ms. Danao uses the accounting software Sage, and formerly used the accounting software Peachtree, to maintain general ledgers and trial balances for the Company. Separate trial balances and general ledgers are maintained for the antiques store. Sales reports for the antiques store are generated from store invoices, which are entered into the system by store employees. Ms. Danao prints sales reports at the end of every month and reviews the reports against the invoices. James Moirano at Hecht and Company, P.C. (Hecht and Co.), petitioners' accountants, testified that Ms. Danao's records are adequate and professional. The records are used by Mr. Moirano to prepare the Company's and petitioners' tax returns, which are then reviewed by Fred Slomovic of Hecht and Co.

132. Ms. Danao reviews all expenditures and separates out personal expenditures of Mr. and Mrs. Horn. These expenses are not deducted but are offset against loans made by the Horns to the Company.

133. From 2004 to 2006, the antiques business was a division of the Company known as Steve and Linda Horn, Inc., d/b/a Linda Horn Antiques. In 2006, the antiques business was transferred to a limited liability company, Linda Horn, LLC, which was wholly owned by the Company.

134. Separate bank accounts are maintained for the Company, Linda Horn, LLC,

Woodland Farms LLC, and petitioners personally.

135. The Company did not provide a separate breakdown of income for the television commercial business, the antiques business, or the real estate business during the audit. The Company did not provide a separate breakdown of expenses for the three businesses during the audit. A schedule partially breaking down the expenses was prepared after the conciliation conference. During the hearing, separate trial balances and general ledgers for the Company, Steve and Linda Horn, Inc., d/b/a Linda Horn Antiques, and Linda Horn, LLC, were submitted into the record. Separate sales reports for Steve and Linda Horn, Inc., d/b/a Linda Horn Antiques, and Linda Horn, LLC, were submitted into the record.

136. The trial balances indicate if income or receipts are from the television commercial business or the antiques business. The trial balances do not include receipts or income from the Florida real estate. While certain expenses of the Company can be apportioned solely to the antiques business on its trial balances, some of the expenses listed on the general ledgers of the Company are allocable to all of the Company's business activities. For example, Ms. Danao is the bookkeeper for all of the Company's business lines, but her salary is listed only on the books of the Company. Professional fees and the costs of maintaining the Studio, which is used as the administrative office for the antiques store, are also on the books of the Company.

137. Over the years, petitioners have loaned money to the Company. Petitioners have lent over \$31,000,000.00 to the Company over the audit period. The Company pays interest to petitioners on the loans. Any personal expenses of petitioners incurred by the Company are charged against the loans.

138. The Company has employed the services of an outside accounting firm, Hecht and Co., since its creation. Hecht and Co. prepares the Company's tax returns, in consultation with ' Ms. Danao.

139. Michael Hecht, a principal at Hecht and Co. and a certified public accountant, has known and advised petitioners for 40 years. He described the Horns as tremendously optimistic and only seeing the possibilities and benefits with respect to their work.

140. Mr. Hecht testified that because petitioners were hard-working individuals, he could only meet with them after 6:00 or 6:30 P.M. and could not meet with them during the normal working day.

141. On March 11, 2008, the Company's and petitioners' cases were assigned for audit for the period 2004 through 2006 to the Rochester, New York, district office of the Division. On March 14, 2008, internal audit logs were created by the Division's auditor.

142. On March 17, 2008, the Division's auditor sent a letter to the Company advising that its New York State tax returns for the period 2004 to 2006 were selected for audit. The letter requested that the Company provide, in part, the following: details of the like-kind exchange; workpapers detailing the balances in the loans from shareholders account and copies of the loan agreement documents detailing the interest rate, payment terms and note holders; workpapers detailing the note receivable from HD Antiques & Collectables, LLC, and copies of the loan agreement documents; and copies of all insurance policies used for the business. The letter further stated that in addition to the aforementioned documents, the Division may require the following documents as the audit continues: federal unemployment reports; information regarding interests in a partnership, LLP, LLC or S corporation; a written description of the business activities or the taxpayer both within and without New York State, including a description of the places of business and activities performed at each location, the number of employees, and whether the location is owned or leased; all books, records, worksheets, schedules, and other documents pertinent to the preparation of the Company's tax returns, including general ledger, purchase disbursements, and sales/receipts journals, payroll ledger, and

year end adjusting entries; accountant's workpapers reconciling the books to the tax returns; names, addresses, and social security numbers of all officers/shareholders/partners, including duties and responsibilities; board of directors meeting minutes; chart of accounts; an organizational chart identifying parent, subsidiary, brother or sister entities as well as a detailed descriptions of their business activity inside and outside of New York; copies of the consolidated form 1120-S, U.S. income tax return, including schedules and attachments; copies of the filed Article 9-A corporation franchise tax returns, MTA surcharge returns, and forms NYS-45 and NYS-45-ATT, quarterly combined withholding, wage reporting and unemployment insurance return and attachment; copies of audited financial statements, annual reports, annual statements, and SEC 10-K reports; documentation and details to support New York State and federal net operating loss, rent expense deducted on federal returns, interest expense per the federal return, including principal amount, interest paid and purpose of each loan; bad debt deduction for federal, New York State and IBF purposes; workpapers used to compute the interest expense deduction for federal purposes and for the IBF; copies of federal personal income tax forms for the shareholders for the audit years; and W-2 wage statement for the audit period.

143. In an entry dated March 17, 2008, the Division's audit log pertaining to the Company described the audit issues as "analyzing the like kind exchange" and "analyze the loans from shareholders."

144. On April 11, 2008, the Division received a power of attorney from Ephraim Slomovic, a certified public accountant and tax manager at Hecht and Co., who has worked as petitioners' accountant for over 15 years. Mr. Slomovic notified the Division that he was the Company's representative for the audit.

145. An entry in the Division's field audit log dated June 17, 2008 notes that the auditor conducted research on IRC (26 USCA) § 1031.

146. Over the course of the audit from June 17, 2008 through September 29, 2008, the Division requested and the Company provided information in relation to the like-kind exchange issue.

147. On December 1, 2008, the Division's auditor sent the Company a letter requesting details regarding the use and occupancy of each of the two replacement properties in Florida and copies of leases in effect for the audit period if the properties were being held for investment purposes.

148. In response, the Company's representative sent a letter dated January 28, 2009, stating that the Company purchased the Ocean Property as an investment with the expectation of appreciation, but had been unsuccessful in selling the property, and that the Peruvian Avenue property was a commercial property purchased in part to extend the antiques store to Florida, and to rent out the remaining space. The letter further indicates that due to the difficult real estate market, the Company had been unable to launch the Florida store, rent the retail space or sell the property.

149. In response to additional inquiries from the Division, the Company's representative sent a letter stating that the real estate properties suffered significant hurricane damage, which made them uninhabitable, and referenced newspaper and real estate broker listings.

150. On May 1, 2009, the auditor requested additional information with respect to the like-kind exchange, including, in part, the date and name of the hurricane mentioned in the representative's prior correspondence, copies of invoices substantiating the dollar amounts spent in rehabilitating the properties, the name and address of the employee supervising the renovation, real estate tax bills, floor plans, leases and rent receipts.

151. On June 23, 2009, in response to the Division's request, the Company sent a letter and documents, including invoices detailing amounts spent on the Florida properties, real estate

tax bills, a list of employees who supervised property renovations, and a floor plan of the Peruvian Avenue property. Said documents referenced in the letter were not included in the record as attachments to the letter. The Company further noted in the letter that Hurricane Wilma was responsible for the damage to the properties.

152. An entry in the Division's field audit log dated September 11, 2009 notes, in part, the Division's question of whether the Company's business is a viable business and indicates that the auditor needs to conduct research regarding the activities not engaged in for profit.

153. On October 16, 2009, after transfer to a new auditor, the Division's auditor sent a letter to the Company's representative requesting additional information with respect to the like-kind exchange. The letter also requested a full description of the business activities of the Company, including the locations where all business is conducted and the number of employees at each location, substantiation of the Company's shareholder, stock and loan basis, copies of loan agreements, and substantiation as to where petitioners stay when they are in Florida, including details of their travel account and record for travel expenses. The letter did not reference IRC (26 USCA) § 183.

154. In response to the Division's request, the Company's representative sent correspondence dated December 14, 2009, stating, "[e]nclosed is the documentation requested in your letter of October 16th." The referenced enclosures are not included in the record.

155. On April 27, 2010, the Division's auditor sent a letter requesting a full description of the business activities for the Company, including the locations where all business is conducted and the number of employees at each location; income statements and trial balances for each business entity conducted under the Company; insurance policies for all the Florida property under the Company; substantiation as to where petitioners stay when they are in Florida; and the realtor listing for the Ocean Property. The auditor also questioned the validity of the

like-kind exchange. The auditor did not mention IRC (USCA) § 183.

156. On June 29, 2010, the Company's representative sent a letter in response to the Division's request, stating, in part, "I am enclosing copies of the following: 1. "Quiet Open Listing" dated December 5, 2008 listing the property for sale, or rental; 2. Realtor Listing Service Agreement between Steve and Linda Horn and Linda A. Gray real Estate Inc. dated December 17, 2009." Said enclosures were not attached to the letter in the record. The letter also noted that "due to significant hurricane damage the taxpayer was unable to list the property for either sale or rent immediately after its purchase."

157. An entry in the Division's field audit log dated October 4, 2010 notes, in part, that Mr. Slomovic spoke with the auditor and stated that the Company's businesses are commercials and antiques, and that the company had been phasing out the commercial business.

158. On October 27, 2010, the Company's representative sent another letter in response to the Division's April 27, 2010 letter, stating, in part, that the Company was engaged in the business of selling antiques and in the business of television commercial production. The letter also notes that the administrative and executive office of both businesses were located at the 435 E. 83rd Street (the Studio).

159. The Division's audit log notes that on November 24, 2010, November 26, 2010, December 23, 2010, December 24, 2010 and January 12, 2011, the Division's auditor conducted research regarding IRC (26 USCA) § 183.

160. An entry in the Division's field audit log dated January 13, 2011 notes, in part, that the Division's auditor contacted the Company's representative and requested the Company's articles of incorporation. The entry further notes that the auditor informed Mr. Slomovic that the Division was reviewing the section 1031 exchange and whether it qualified for nonrecognition of gain. The entry does not indicate that the auditor referenced IRC (26 USCA) § 183.

161. On February 10, 2011, the Division's auditor sent a letter to the Company's representative updating the audit period to include tax years 2007, 2008 and 2009. The letter further stated that the Division determined that the Ocean Property obtained during the tax year 2005 like-kind exchange does not qualify for deferred gain treatment. The letter also stated that after reviewing IRC (26 USCA) § 183, Activities Not Engaged in for Profit, the Division determined that the Company is not a business that is engaged in for profit, based on the following:

- “1. The shareholder does not depend on the income from the business.
2. The business has not made a profit in at least the last eight years of operation.
3. The losses were not due to circumstances beyond their control and they did not occur in the start-up phase of their business.
4. The business has not changed their methods of operation to improve profitability.”

162. On April 1, 2011, Roberts & Holland LLP (R&H) submitted a power of attorney and took over the representation of the Company and petitioners with respect to the audit. On May 10, 2011, R&H sent a letter in response to the Division's February 11, 2011 letter, arguing that the like-kind exchange was valid and that the Company's activity was engaged in for a profit, noting, among other things, that the Company earned substantial sums on the sale of the Church property in 2005.

163. An entry in the Division's field audit log dated May 20, 2011, notes, in part, with respect to the IRC (26 USCA) § 183 issue, “[t]he business made a profit when they sold the NY building, but the gain was deferred. They did not go into any details to defend or support how the business intends to make a profit.”

164. As noted in an entry in the Division's field audit log dated July 28, 2011, during a conversation with the Company's representative, the auditor requested a breakdown of income for each business segment. The representative informed the auditor that the business is one

entity and they do not separate the income and expenses.

165. On September 16, 2011, the Division issued a notice of deficiency to petitioners for the years 2004 through 2009 (*see* finding of fact 4). The tax amount for each year was calculated by disallowing all of the Company's losses for the year and by disallowing any net operating loss carryforwards and carrybacks from other tax years.

166. Prior to making its determination, the Division never asked to visit the Studio, the Warehouse, the Creamery, or the antiques store. During the audit, the Division did not know that the antiques store changed its location in 2005. The Division's auditor was also not aware that the antiques store had expanded its internet presence during the audit period.

167. On April 28, 2012, a conciliation conference was held before BCMS. On August 17, 2012, a conciliation order was issued sustaining the statutory notice.

168. The Division does not dispute that the Company's commercial production business was engaged in for profit.

169. The Division's audit report states, "Based on review of returns and discussion with taxpayers there are no indications of any tax shelter activity."

THE DETERMINATION OF THE ADMINISTRATIVE LAW JUDGE

The Administrative Law Judge first analyzed petitioners' several undertakings to determine whether they should be considered separate activities or a single activity for purposes of the hobby loss rule under IRC (26 USCA) § 183. The Administrative Law Judge reviewed the facts herein in light of various factors developed by courts in deciding whether a taxpayer's characterization of its activities was reasonable. Ultimately, the Administrative Law Judge concluded that petitioners' television commercial production business, the antiques business and the real estate investments were separate activities. Accordingly, the Administrative Law Judge found that each activity should be reviewed separately to determine whether it was engaged in

business for profit and hence whether the Division's disallowance of petitioners' claimed losses was proper.

With respect to petitioners' commercial production activity, the Administrative Law Judge noted that there was no dispute that this activity was engaged in for profit and that it had been profitable in years prior to the audit period. The Administrative Law Judge noted that this activity was winding down during the audit period and that the winding down period was reasonable in length. The Administrative Law Judge thus concluded that the expenses associated with this activity were properly deductible.

The Administrative Law Judge next turned to the antiques business and the real estate activities. She considered nine factors listed in the IRC regulations (*see* Treas Reg [26 CFR] § 1.183-2 [b]) to resolve the factual question of whether petitioners were engaged in these activities with the actual and honest objective of making a profit.

The Administrative Law Judge determined that both the antiques business and the real estate activities were conducted in a businesslike manner, noting that each maintained thorough and accurate records. The Administrative Law Judge also noted that an outside accounting firm prepared the Company's tax returns each year and that such accountants testified that the Company's books and records were kept in a professional manner. The Administrative Law Judge further observed that the antiques store maintained and used sales diaries as a means to track customer purchases and to follow-up when the store obtained an item that could be of interest to a particular customer. The Administrative Law Judge cited the antiques store's detailed inventory as further evidence of businesslike records.

While acknowledging the lack of a written business plan, the Administrative Law Judge found that petitioners had an unwritten business plan for the antiques store. Specifically, the Administrative Law Judge saw such a plan in petitioners' efforts to create the "Linda Horn"

brand and in the progression of the antiques store from the small store in Valhalla to the various Manhattan locations.

The Administrative Law Judge saw additional evidence of a businesslike approach in the operation of the antiques store in petitioners' use of advertising and promotion. On this point, the Administrative Law Judge disagreed with the Division's characterization of petitioners' advertising as inconsistent and intermittent, noting that petitioners geared their advertising to the appropriate audience and that they saved on advertising expenses because Mr. Horn was able to photograph and design all of the Company's ads.

The Administrative Law Judge also saw a profit motive in several changes to the Company's operations. Specifically, the Administrative Law Judge noted that the Company modernized its marketing techniques and also reduced expenses in an effort to improve profitability. While acknowledging the Division's criticism that such cost cutting measures were insufficient, the Administrative Law Judge found that petitioners' efforts to improve performance supported their claim of a profit motive.

The Administrative Law Judge also concluded that petitioners' real estate activities were conducted in a manner consistent with an activity engaged in for profit. The Administrative Law Judge noted that, in addition to maintaining accurate books and records, renovations on the Florida properties were conducted professionally. She also found that petitioners had an unwritten business plan for their real estate activities, as reflected by their actions. The Administrative Law Judge dismissed the Division's assertion that petitioners were not engaged in real estate activity because they bought only four properties and sold only one during the years at issue. To the contrary, the Administrative Law Judge noted that the IRC does not require that a specific number of properties be bought or sold, but only that the property be held for the production of income. The Administrative Law Judge concluded that, under this standard,

petitioners' pattern of purchasing properties for investment purposes strongly supports their position.

Additionally, the Administrative Law Judge determined that petitioners' consultations with experts indicated a profit motive. With respect to the antiques business, the Administrative Law Judge cited Mrs. Horn's consultation with antique jewelry expert Fred Leighton; the antiques store manager's consultation regarding online selling; and the Company's use of outside accountants. The Administrative Law Judge also noted that petitioners themselves were marketing experts. With respect to the real estate activities, the Administrative Law Judge noted that petitioners consulted with outside accountants, hired professional contractors, and hired a professional real estate agency.

The Administrative Law Judge found several other factors that supported a finding of a profit motive. Specifically, the Administrative Law Judge determined that petitioners and the Company, through its employees, expended substantial time and effort in both the antiques business and the real estate activities; that petitioners had an honest expectation that their assets in both their antiques business and their real estate activities would appreciate; and that petitioners' had a prior success in flipping real estate for profit.

The Administrative Law Judge also noted three factors that were neutral on the issue of profit motive. First, although the Company's history of losses would tend to weigh against petitioners' position, the Administrative Law Judge found that petitioners offered a reasonable explanation for the losses and showed that they tried to respond. Hence, the Administrative Law Judge deemed this factor neutral. Petitioners' wealth, which could weigh against them on this issue, was considered neutral by the Administrative Law Judge because petitioners suffered actual, out-of-pocket losses and, according to the Administrative Law Judge, had a genuine hope

of economic profit. Also, while elements of pleasure from an activity generally weigh against a finding of a profit motive, the Administrative Law Judge found that despite Mrs. Horn's enjoyment of the antiques business, it was run in a businesslike manner and thus this factor was neutral.

Finally, on the factor of occasional profit from the activities, the Administrative Law Judge determined that the absence of any such profit weighs against petitioners with respect to the antiques business. Given the profit on the sale of the Church, the Administrative Law Judge determined that this factor was neutral with respect to the real estate activities.

In summary, the Administrative Law Judge found that the evidence in the present matter supported petitioners' position that both the antiques business and the real estate activities were engaged in for profit and not as a hobby. The Administrative Law Judge thus granted the petition and canceled the subject notice of deficiency.

SUMMARY OF ARGUMENTS ON EXCEPTION

The Division attacks the deductions attributable to the commercial production business by noting that this part of the Company's operations ceased as of late 2004 or early 2005. At that point, the Division asserts, the commercial production operation was no longer engaged in business for profit. The Division also contends that the Administrative Law Judge erroneously found that the five-year wind down period for this business was reasonable.

Next, the Division reviews petitioners' antiques business and real estate activities in light of the nine factors considered by the Administrative Law Judge and concludes that the Administrative Law Judge erred in finding that such activities were engaged in for profit.

The Division asserts that these activities were not conducted in a businesslike manner. In support, the Division asserts that, although they maintained books and records, petitioners failed

to use such records to improve the Company's performance. The Division also notes that the Company did not have any written business plan and did not prepare any annual budgets. As it did below, the Division continues to assert that the Company's advertising of the antiques business was intermittent and thus inconsistent with a businesslike approach.

The Division takes issue with the Administrative Law Judge's conclusion that the Company maintained records that were thorough and accurate. As noted, the Division emphasizes that petitioners did not use the records to improve the Company's performance and also contends that the Administrative Law Judge erred in concluding that the records were used to set sales goals. The Division also asserts that the sales diaries were of little use in increasing antiques sales.

The Division further asserts that the Administrative Law Judge erroneously found that petitioners changed their operations to improve profitability. The Division contends, rather, that petitioners failed to show that they abandoned any unprofitable operating methods in response to the losses that the Company experienced.

The Division also objects to the Administrative Law Judge's conclusion that petitioners' consultations with experts indicate a profit motive. The Division specifically dismisses consultations with Mr. Leighton because his specialty was antique jewelry and the Company sold very little antique jewelry. The Division also argues that petitioners failed to seek advice regarding improved performance from their accountants. Further, the Division contends that petitioners did not establish that the Company's employees had any relevant expertise.

On the factor of the petitioners' time and effort in the activities, the Division contests the Administrative Law Judge's finding that Mrs. Horn devoted significant time to the antiques business and thus contends that this factor does not support petitioners' position.

The Division also argues that the Administrative Law Judge wrongly concluded that petitioners credibly expected the Company's assets to appreciate. The Division asserts that there is no basis in the record to conclude that such assets would appreciate sufficiently to cover the losses incurred during the audit period.

Additionally, the Division asserts that petitioners did not show prior success in turning around an unprofitable business. The Division contends that petitioners' prior success in the commercial production business is a nonfactor here because of the dissimilarity between that business and the purchase and sale of antiques and real estate.

The Division argues that the Company's sustained series of significant losses and the lack of any occasional profits strongly supports a finding that petitioners were not engaged in business for profit. The Division asserts that petitioners' personal wealth, which enabled the Company to sustain the many years of losses, also strongly supports a finding against petitioners. The Division further contends that petitioners derived significant personal pleasure from the antiques business. Specifically, the Division notes Mrs. Horn's unquestioned enjoyment of this business; the Company's employment of family members; and the Company's travel and entertainment deductions, which the Division asserts were personal expenditures. The Division argues that these factors indicate that petitioners were not engaged in business for profit during the years at issue.

Alternatively, assuming that the real estate activity existed and was engaged in for profit, the Division contends that the Administrative Law Judge erred by allowing losses that should be disallowed under passive activity loss rules. The Division raised this issue for the first time on exception.

In response to petitioners' contention raised before the Administrative Law Judge that,

assuming the activities are deemed not to be engaged in for profit, the Division asserts that petitioners' tax liability should not be reduced to account for interest and rental expense deductions of the Company that were included in petitioners' income.

Finally, the Division contends that no reasonable cause exists to abate penalties imposed herein.

Petitioners contend that the Administrative Law Judge correctly concluded that their various activities were engaged in for profit. Like the Division, petitioners review the nine factors considered by the Administrative Law Judge in the determination. Petitioners concur in the Administrative Law Judge's findings that petitioners conducted their activities in a businesslike manner; that they had expertise and sought out expert advisors; that they devoted significant time and effort to the antiques and real estate activities; that they reasonably expected their assets to appreciate; that their earlier success in commercial production and in real estate favors a finding that the subject activities were engaged in for profit; that their history of out-of-pocket losses was attributable to market conditions; that they sought to make changes to their operations to improve profitability; that they earned some profit in their real estate activities; that their personal wealth does not favor the Division's position, given their losses of real dollars; and that any personal pleasure derived by Mrs. Horn from the antiques business is offset by significant time spent on many unglamorous activities associated with the various businesses.

Alternatively, petitioners assert that the Administrative Law Judge improperly determined that petitioners' activities should be viewed as separate activities for purposes of determining whether such activities are engaged in for profit.

In response to the Division's contention that, assuming that the real estate activity existed and was engaged in for profit, then losses attributed to such activity should be disallowed under

passive activity loss rules, petitioners make two arguments. First, petitioners argue that this Tribunal should not consider this argument because it is a factual issue raised for the first time on exception. Second, if this issue is considered, petitioners assert that their real estate activity is not a passive activity under the IRC and thus the passive activity loss rules do not apply.

Also alternatively, petitioners reassert the argument raised below that, assuming their claimed losses are disallowed, the tax deficiency should be reduced to account for interest payments and rental payments of the Company that were included in petitioners' income.

Finally, and also alternatively, petitioners assert that they acted in good faith and had reasonable cause for the deductions taken on their income tax returns during the period at issue. Petitioners note further that they relied on their accountants in preparing their returns. Petitioners thus assert that reasonable cause exists for abatement of penalties imposed herein.

OPINION

As noted by the Administrative Law Judge, in order to determine whether a taxpayer's deductions stemming from losses generated by various business undertakings should be subject to the limitation under IRC (26 USCA) § 183 and the relevant regulations, the activity or activities of the taxpayer must be ascertained (Treas Reg [26 CFR] § 1.183-1 [d] [1]). Where a taxpayer is engaged in several undertakings, each undertaking may be a separate activity, or several undertakings may constitute one activity (*id.*). If the taxpayer engages in two or more separate activities, deductions and income from each separate activity are not aggregated either in determining whether a particular activity is engaged in for profit or in applying section 183 (*id.*). In ascertaining the taxpayer's activities, all facts and circumstances of the case must be taken into account. The most significant facts and circumstances in making this determination are the degree of organizational and economic interrelationship of various undertakings, the business

purpose that is (or might be) served by carrying on the various undertakings separately or together in a trade or business or in an investment setting, and the similarity of the various undertakings (*id.*). A taxpayer's characterization of two or more undertakings as one activity is generally accepted unless it is artificial or unreasonable in light of the facts and circumstances (*id.*).

Courts have applied various factors in deciding whether a taxpayer's characterization of several undertakings as one activity is unreasonable for purposes of IRC (26 USCA) § 183, including:

- “(1) whether the undertakings are conducted at the same place;
- (2) whether the undertakings were part of a taxpayer's efforts to find sources of revenue from his or her land;
- (3) whether the undertakings were formed as separate activities;
- (4) whether one undertaking benefitted from the other;
- (5) whether the taxpayer used one undertaking to advertise the other;
- (6) the degree to which the undertakings shared management;
- (7) the degree to which one caretaker oversaw the assets of both undertakings;
- (8) whether the taxpayer used the same accountant for the undertakings; and
- (9) the degree to which the undertakings shared books and records” (*Price v Commissioner*, TC Memo 2014-253 [2014], *affd* 633 Fed Appx 101 [2016], citing *Mitchell v Commissioner*, TC Memo 2006-145 [2006]).

We find that the Administrative Law Judge correctly applied the *Mitchell* factors in determining that petitioners' undertakings in commercial production, real estate and antiques constituted separate activities for purposes of IRC (26 USCA) § 183. While petitioners' various business activities were carried out at different locations, the Studio did serve as the administrative center of petitioners' business interests and is where bookkeeping was performed. However, we agree with the Administrative Law Judge that this administrative activity was

incidental to the different business lines carried out by petitioners during the years at issue. The antiques business was carried out in various storefronts over the years, while petitioners' real estate activities were conducted on site, whether in Florida or in New York. Similarly, petitioners' commercial production and antiques businesses do not qualify as efforts to derive revenue from their real estate holdings, as the real estate or other asset must exist before the start of the activity (*Price v Commissioner, citing Estate of Stangeland v Commissioner*, TC Memo 2010-185 [2010]). Petitioners' undertakings were clearly formed as separate activities at different points in time (commercial production in 1974, the antiques business in the early 1980s and real estate from the 1980s through the present). While the Company's certificate of incorporation also lists purchasing and selling real estate in addition to commercial production as a purpose of the Company, the real estate activities did not begin until years after the formation of the commercial business and were sometimes conducted by separate entities (e.g. Woodland Farms, LLC and 260 Via Bellaria, LLC). The antiques business was originally carried out by the Company "doing business as" Linda Horn Antiques, and subsequently as Linda Horn, LLC. There is no evidence that the Company's commercial production, antiques business and the real estate activities shared a client base or that the activities synergistically generated leads or sales for the other, thus it was properly concluded that the businesses did not benefit each other, even if the Company relied on its trusted employees in more than one activity. There is no evidence of cross-advertising between the undertakings; that is, there is no evidence that any advertisements covered the commercial business, antiques business and real estate business together. The advertisements presented into the record are limited to the antiques business and make no mention of the other activities. The real estate listings similarly did not mention Linda Horn Antiques or feature her brand in any way. We further agree with the Administrative Law Judge that the Company's employees do not qualify as caretakers in the sense of caring for property in

the owner's absence. Even though petitioners' bookkeeper, Ms. Danao, maintained the books for all of the undertakings, separate trial balances and general ledgers were maintained for the separate activities. Thus, the books and records of the various undertakings were not inextricably intertwined.

In contrast, two factors weigh in favor of aggregating petitioners' undertakings into a single activity. All the undertakings shared general management in the form of Linda Horn, who is also the sole owner of the stock of the Company. The Company also used the same accountants, Hecht & Company, P.C., for all of the undertakings.

Based on the foregoing factors and a review of the facts, we agree with the Administrative Law Judge's determination that the various undertakings were separate activities. As such, each activity must be reviewed separately for purposes of IRC (26 USCA) § 183, and deductions and income from each separate activity are not aggregated either in determining whether a particular activity is engaged in for profit or in applying IRC (26 USCA) § 183. Additionally, where the taxpayer is engaged in more than one activity, an item of deduction or income may be allocated between two or more of these activities. Where property is used in several activities, and one or more of such activities is determined not to be engaged in for profit, deductions relating to such property must be allocated between the various activities on a reasonable and consistently applied basis (Treas Reg [26 CFR] § 1.183-1 [d] [2]).

Profit Motivation with Regard to the Separate Activities

With regard to petitioners' commercial production activity, the Administrative Law Judge noted that the Division does not dispute that it was engaged in for profit. We agree that a taxpayer does not lack a profit motive merely because he or she takes a reasonable time to unwind an unprofitable business and minimize his or her losses (*Bailey v Commissioner*, TC Memo 2012-96 [2012], *affd Bailey v IRS*, 2014 WL 1422580 [1st Cir 2014]). Even though the

commercial production business was winding down by the mid-2000s, it was an historically profitable activity. As the profit motivation with regard to this activity is undisputed, expenses attributable to the Company's commercial production activities are deductible. As noted above in the discussion of whether the undertakings qualified as separate activities, the Treasury Regulations require allocation of deductions among the separate activities. However, here it is not necessary to attribute the expenses to the separate activities, as we agree with the Administrative Law Judge's conclusion that each separate activity was engaged in for profit.

IRC (26 USCA) § 162 (a) provides for a deduction from income for all the ordinary and necessary expenses paid or incurred during the taxable year in carrying out any trade or business. IRC (26 USCA) § 212 allows deductions for expenses incurred for the management, conservation, or maintenance of property held for the production of income. The test as to whether property is held for the "production of income" within the meaning of IRC (26 USCA) § 212 is whether the taxpayer's primary, good faith purpose and intention in engaging in the activity was to make a profit (*Zell v Commissioner*, 763 F2d 1139, 1142 n.3 [10th Cir 1985]; *Snyder v United States*, 674 F2d 1359, 1362 [10th Cir 1982]; *Lowry v United States*, 384 F Supp 257, 261 [1974]).

Thus, petitioners are entitled to a deduction for ordinary and necessary expenses of the antiques business and real estate activities if petitioners engaged in the activities with an actual and honest objective of making a profit (*see Annuzzi v Commissioner*, TC Memo 2014-233 [2014]). Deductions for activities not engaged in for profit are allowable only to the extent of income from such activities (IRC [26 USCA] § 183 [b] [2]; *Matter of Temple*, Tax Appeals Tribunal, July 8, 2004). Determining whether petitioners' activities were engaged in for profit is based on a review of all of the surrounding facts and circumstances while considering the nine

factors set forth in Treasury Regulation (26 CFR) § 1.183-2 [b] (*see Hoag v Commissioner*, TC Memo 1993-348 [1993]). In determining whether the taxpayer had an honest and actual profit motivation, greater weight is given to the objective facts than to the taxpayer's statements (*id.*).

Here, it is appropriate to note that we have held that the credibility of witnesses is a determination within the domain of the trier of the facts, the person who has the opportunity to view the witnesses first hand and evaluate the relevance and truthfulness of their testimony (*Matter of Moss*, Tax Appeals Tribunal, November 25, 1992; *Matter of Jericho Delicatessen, Inc.*, Tax Appeals Tribunal, July 23, 1992; *Matter of Spallina*, Tax Appeals Tribunal, February 27, 1992). While this Tribunal is not bound by an Administrative Law Judge's assessment of credibility and is free to differ with the Administrative Law Judge to make its own assessment, we will only make our own determination of credibility where contrary evidence in the record compels us to do so (*see Matter of Stevens v Axelrod*, 162 AD2d 1025 [1990]). Where, as here, the legal issue revolves about the subjective intent of a taxpayer, we will generally defer to the credibility determination of the Administrative Law Judge unless such determination is not substantially supported by the record (*cf. Matter of Wachsman*, Tax Appeals Tribunal, November 30, 1995).

The factors listed under Treasury Regulation (26 CFR) § 1.183-2 (b) for consideration in determining whether a taxpayer has engaged in an activity for profit are as follows: (1) the manner in which the taxpayer carries on the activity; (2) the expertise of the taxpayer or his advisors; (3) the time and effort expended by the taxpayer in carrying on the activity; (4) the expectation that 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 losses with respect to the activity; (7) the amount of occasional profits, if any, that are earned;

(8) the financial status of the taxpayer; and (9) elements of personal pleasure or recreation. No single factor or combination of factors is conclusive in indicating a profit objective and the factors themselves are nonexclusive (*see Ranciato v Commissioner*, 52 F3d 23 [1995]).

Although the nine factors are useful in determining the profit motivation of a taxpayer, the courts have cautioned against substitution of reasonableness for subjective intent to pursue profit in a business activity (*Metz v Commissioner*, TC Memo 2015-54 [2015], *citing Wolf v Commissioner*, 4 F3d 709 [1993]). It is the taxpayer's actual and honest intent to make a profit that renders the activity as having a profit motivation.

The Manner in Which the Taxpayer Carries on the Activity

The first factor considers whether the taxpayer engaged in the activity in a businesslike manner (Treas Reg [26 CFR] § 1.183-2 [b] [1]). Courts have considered several factors in considering whether the activity was pursued in a businesslike manner, including whether accurate books were kept, whether the activity was conducted in a manner similar to other comparable businesses and whether changes were attempted in order to make a profit (*Dodge v Commissioner*, TC Memo 1998-89 [1998], *affd* 188 F3d 507 [1999]). We agree with the Administrative Law Judge that the record overall shows that the Company engaged in the antiques business and real estate activities in a businesslike manner.

The Company kept detailed records of both the antiques business and the real estate activities, which were used by the Company's bookkeeper in maintaining trial balances and general ledgers reflecting the income and expenses of the activities of the Company. The antiques business relied on the data recorded by its sales staff and manager and the Company generated monthly sales reports, which it used in setting sales goals. Petitioners maintained separate accounts for their business undertakings and personal matters. Petitioners used a

professional outside accounting firm to prepare the Company's tax returns each year. The antiques business maintained a ledger of sales leads (the "Madison Diaries") that it used to follow up with potential customers. The maintenance and use of such records in the antiques business supports petitioners' contention that the business was run with a profit motive (*see Elliott v Commissioner*, 90 TC 960, 970 [1988], *affd* 899 F2d 18 [1990]; *Metz v Commissioner*).

While petitioners have loaned personal funds to the Company for both the antiques business and purchase of real estate investments, a loan account is maintained for the Company against which petitioners' personal expenses are charged. Petitioners charge interest on this loan account to the Company, which is reported on petitioners' personal income tax returns. This separation of personal and business expenses demonstrates that the real estate and antiques business activities were conducted in a businesslike manner.

We agree with the Administrative Law Judge that a written business plan is not required where the plan was evidenced by the taxpayers' actions (*see Annuzzi v Commissioner; Dishal v Commissioner*, TC Memo 1998-397 [1998]; *Estate of Brockenbrough v Commissioner*, TC Memo 1998-454 [1998]; *Phillips v Commissioner*, TC Memo 1997-128 [1997]). Petitioners had an unwritten business plan of creating the "Linda Horn" brand for the antiques business, based on their experience in creating advertisements for various brands. Petitioners' business plan was also based on Mrs. Horn's familiarity with fashion designer mass market brand lines. The Administrative Law Judge found that Mrs. Horn was credible in her testimony regarding development of her brand and her plan of eventually expanding into mass market decorative objects. Nothing in the record counters this finding.

We also agree that petitioners' advertising campaign, promotion of their store through

window displays at Bergdorf Goodman and Ralph Lauren, holiday mailings and online sales initiatives are indicative of their desire to promote the “Linda Horn” brand and demonstrate that they conducted the activity in a businesslike manner (*see Metz v Commissioner; Jackson v Commissioner*, 59 TC 312 [1972]). The record shows that petitioners also demonstrate a willingness to attempt new marketing strategies, new product lines and reduce costs (including salaries and rent), further indicating their businesslike manner in reacting to market conditions (*see Metz v Commissioner; Annuzzi v Commissioner*; Treas Reg [26 CFR] § 1.183-2 [b] [1]). We agree with the Administrative Law Judge that this factor weighs in petitioners’ favor with regard to the antiques business.

We also agree with the Administrative Law Judge that petitioners’ real estate investment activities were carried on in a businesslike manner. Petitioners hired skilled professionals to repair and renovate the properties (*see Vandeyacht v Commissioner*, TC Memo 1994-148 [1994]). Petitioners listed the Florida properties with a real estate professional and entered into a listing agreement with a real estate agency in an effort to sell the properties. Consistent with their antiques business, petitioners also had an unwritten business plan for their real estate activities, as reflected by their actions and strategy of buying low in desirable markets, renovating, and listing for sale at a profit. We concur with the Administrative Law Judge that the record evidences that petitioners exhibited a “common entrepreneurial pattern” with their real estate investments (*Holmes v Commissioner*, 184 F3d 536 [1999]). Petitioners consulted with their accountants regarding the real estate activities and created new holding entities as the business need arose. The facts and circumstances presented in the record indicates that petitioners conducted both the antiques business and the real estate activities in a businesslike manner, indicating that they had a profit objective.

Expertise of the Taxpayers or their Advisors

A taxpayer's "consultation with those who are expert" in a particular activity may indicate a profit motive (Treas Reg [26 CFR] § 1.183-2 [b] [2]). The record shows that Mrs. Horn consulted with people familiar with the industry and her store manager consulted with the owner and chairman of an online auction service about expanding the store's reach. As noted above, petitioners used a professional accounting firm during all of the years at issue and employed a bookkeeper with an accounting degree to maintain the Company's books and records. We also agree with the Administrative Law Judge's finding that petitioners' extensive professional experience in advertising and brand marketing indicates their professional expertise in brand development.

Petitioners consulted with their accountants before purchasing the Florida properties, hired professional contractors to complete the renovations, and hired a professional real estate agency to list and market the properties. We agree with the Administrative Law Judge that this factor supports petitioners' position for both activities.

Taxpayer's Time and Effort

Employing substantial time and effort to an activity may be indicative of a profit motive, although full time immersion in an activity is not required (Treas Reg [26 CFR] § 1.183-2 [b] [3]; *see Annuzzi v Commissioner, citing Givens v Commissioner*, TC Memo 1989-529 [1989]). Even if a taxpayer spends limited time on an activity purportedly for profit, employing competent and qualified people to help carry on the activity may suffice to show a profit motive (Treas Reg [26 CFR] § 1.183-2 [b] [3]). Here, petitioners have demonstrated a commitment to employing a number of employees on whom they depend for the smooth operation of their various business interests. Petitioners themselves are intimately involved with the antiques business with Mrs.

Horn estimating that she spends two to four hours in the antiques store in addition to spending time working for the antiques business in the Studio and the warehouses. Mrs. Horn also does all of the buying for the antiques business, including travel to purchase pieces for the store, and prices all of the items in the business' inventory. Mr. Horn accompanied Mrs. Horn on the business trips, photographing the items purchased and preparing shipping invoices to have the items shipped to the Company's warehouse, as well as producing the advertisements for the antiques business and designed mailers for special sales.

The Company also expended significant time and effort in the real estate activities. The Company hired professional contractors to perform work on the Florida real estate and hired a real estate broker to list the properties. The Company employed Mr. Drohan, who acted as the general contractor for the various Florida real property renovations in addition to his duties related to the antiques business. Similarly, Cheryl Baxter devoted time and effort to the real estate activities by finding items, materials and workers that Mrs. Horn needed for the real property restoration projects. We agree with the Administrative Law Judge that overall this factor favors petitioners' argument.

Expectation that Assets May Appreciate

An expectation that assets used in the activity may appreciate in value may indicate a profit motive (Treas Reg [26 CFR] § 1.183-2 [b] [4], *see also Annuzzi v Commissioner*). We agree with the Administrative Law Judge that petitioners credibly testified that they expected both the inventory of the antiques business and the real estate to appreciate. Documents submitted pursuant to the hearing also support their stated expectation of appreciation in the value of their assets. Petitioners' monthly sales reports and trial balances for the antiques business show that the price for which the items were sold was significantly greater than the

Company's purchase price for the items. We agree with the Administrative Law Judge's assessment that the gross profits over the costs of goods evidences a plausible expectation of appreciation.

The Administrative Law Judge found that petitioners likewise had credible expectation that the real properties would appreciate in value, as evidenced in the instance of the Company's sale of the Church. When petitioners decided to expand the Company's real estate investments, their accountant suggested selling the Church in an IRC (26 USCA) § 1031 like-kind exchange, and petitioners eventually sold the Church for a substantial profit. The Administrative Law Judge found petitioners credible when they testified that they purchased the Ocean Property with the intent to renovate it and sell it for a profit and purchased the Peruvian Avenue property to appreciate in value. Likewise, we agree with the Administrative Law Judge that given petitioners' largely profitable history of real estate investment, they had a reasonable expectation of appreciation in value of their assets, further indicating an actual expectation of appreciation in value (*see Holmes v Commissioner; Metz v Commissioner*). We agree that petitioners have credibly demonstrated that they expected the assets of both the antiques business and the real estate activities to appreciate in value and find that this factor favors petitioners' position.

Taxpayer's Success in Other Activities

This factor looks at the taxpayers success in carrying on other activities Treas Reg [26 CFR] § 1.183-2 (b) (5) and "the regulation unequivocally encompasses both 'other similar or dissimilar activities'" (*Holmes v Commissioner*). We tend to agree with the Administrative Law Judge that the profitability of the commercial production business in its early years, contrasted against the losses sustained during the audit period, rendered this factor neutral. But, as pointed out by the Administrative Law Judge, petitioners' success in other real estate ventures clearly

shows this factor as being in petitioners' favor.

The Taxpayer's History of Income or Loss

A series of losses extending beyond a business' startup period may display a lack of a profit motive (*Annuzzi v Commissioner*; Treas Reg [26 CFR] § 1.183-2 [b] [6]). However, an honest and actual profit motivation is not vitiated by unforeseen circumstances that are beyond the control of the taxpayer, such as drought, disease, fire, theft, weather damages, or other involuntary conversions, or depressed market conditions (Treas Reg [26 CFR] § 1.183-2 [b] [6]). We agree with the Administrative Law Judge that petitioners have established that the business losses were due to increased expenses from the store's expansion and circumstances beyond their control.

The Administrative Law Judge analogized the antiques business' expansion and move into a new storefront in 2005 to a startup period, during which losses are expected (*see Annuzzi v Commissioner*). The record shows that the antiques business' expenses and gross receipts grew in 2005, 2006 and 2007. According to petitioners, the store's gross receipts declined in 2008 due to the overall decline in the economy. As noted by the Administrative Law Judge, Treasury Regulation (26 CFR) § 1.183-2 (b) (6) specifically provides that depressed market conditions are an example of a condition beyond the taxpayer's control, and that losses sustained due to market conditions do not necessarily indicate that the activity is not engaged in for profit. Like the Administrative Law Judge, we find *Metz v Commissioner* illustrative of the effect of the market crash on the market for luxury goods: "[t]he bottom fell out of the economy that fall [of 2008], and the Great Recession depressed the demand for luxury goods worldwide."

Similarly, 2005 turned out to be a poor time to invest in the Florida real estate market with the expectation of a quick profit and petitioners' Florida real estate activity was met with a series of unfortunate events, resulting in construction delays and a reduced market for the

properties that petitioners were developing. Petitioners testified that despite their efforts, they were unable to sell the Ocean Property until 2011. Additionally, due to the downturn in the economy, they were unable to complete their plans of expanding the antiques business to the Peruvian Avenue property. While the Company's losses in the antiques business and real estate during the audit period do not weigh in their favor, petitioners have offered a reasonable explanation for circumstances beyond their control and showed that they tried to respond to the losses. We concur that, under the circumstances, this factor is neutral.

Amount of Occasional Profit

Treasury Regulation (26 CFR) § 1.183-2 (b) (7) provides that “an opportunity to earn a substantial ultimate profit in a highly speculative venture is ordinarily sufficient to indicate that the activity is engaged in for profit even though losses or only occasional small profits are actually generated.” We agree with the Administrative Law Judge that in real estate, the opportunity to earn a substantial ultimate profit certainly exists. This is clearly demonstrated by the gain the Company reported in 2011 as a result of the sale and like-kind exchange of the Church. We agree with the Administrative Law Judge that this factor favors petitioners with regard to their real estate business, but against them with regard to the antiques business, which has not shown a profit during the audit period.

The Financial Status of the Taxpayer

The Treasury Regulation provides that an indication of a profit motive may be discerned when a taxpayer does not have substantial income or capital from sources unrelated to the activity (Treas Reg [26 CFR] § 1.183-2 [b] [8]). Conversely, substantial income from sources other than the activity (particularly if the losses from the activity generate substantial tax benefits) may indicate that the activity is not engaged in for profit especially if there are personal

or recreational elements involved (*id.*).

Unquestioningly, petitioners had substantial wealth from successful years in the commercial business and investments. However, this is not necessarily detrimental to petitioners' position because mere existence of independent sources of wealth does not undermine an otherwise actual and honest profit motivation especially if the taxpayers suffered actual out of pocket monetary losses in that undertaking, rather than mere paper losses manufactured to shelter unrelated income (*Holmes v Commissioner, citing Ranciato v Commissioner*, 52 F3d 23 [1995]). The mere offsetting of losses against other income does not necessarily mean that the loss-generating activity is a tax shelter (*Engdahl v Commissioner*, 72 TC 659 [1979]). We agree with the Administrative Law Judge that the record as a whole indicates petitioners' genuine motivation to achieve profitability with respect to the antiques business and real estate activity.

Elements of Personal Pleasure or Recreation

The Treasury Regulation provides that the presence of recreational or personal pleasure may suggest that the activity may not be engaged in for profit (Treas Reg [26 CFR] § 1.183-2 [b] [9]). The Regulation further provides that an activity will not be treated as not engaged in for profit merely because the taxpayer has purposes or motivations other than solely to make a profit (*id.*). As noted by the Administrative Law Judge, Mrs. Horn admits that she enjoys the antiques business and finds it fascinating. Courts have held "gratification received from an activity is insufficient in itself to cause the activity to be considered not engaged in for profit" (*Faulconer v Commissioner*, 748 F2d 890, 901 [1984]); *see also Jackson v Commissioner* ["a business will not be turned into a hobby merely because the owner finds it pleasurable; suffering has never been made a prerequisite to deductibility"]. We agree with the Administrative Law Judge that

the enjoyment that Mrs. Horn has in her work does not outweigh the other factors that indicate overall that the business was engaged in with a profit motive. Although she enjoyed the activity, the business was run in a professional manner and is distinguishable from the stereotypical hobby cases (*Helmick v Commissioner*; *cf. Wilmot v Commissioner*, TC Memo 2011-293 [2011]; *Besseney v Commissioner*, 45 TC 261 [1965], *affd* 379 F2d 252 [1967], *cert denied* 389 US 931 [1967]). Regarding the real estate business, we think the Administrative Law Judge correctly determined that petitioners did not use the Florida properties for their personal enjoyment. The record shows that petitioners did not use the properties as a vacation home. Mrs. Horn testified that she found it difficult to deal with historical properties in a different state, in stark contrast with her enthusiasm for the antiques and decorative arts business. We agree that this factor is neutral with regard to both activities.

When considered in its entirety, the weight of the evidence supports petitioners' position that both the antiques business and the real estate activities were engaged in for profit and not as hobbies. As the Division clearly stated that it considered the commercial production business to be pursued with a profit motivation, we must conclude that all three activities were conducted with a profit motivation during the audit period. Thus, petitioners are entitled to deduct the losses they sustained in each of the business activities in which they were engaged during the audit period.

For the first time on exception, the Division argues that the IRC (26 USCA) § 469 rules regarding passive activity losses for persons who do not materially participate in an activity should prevent petitioners from utilizing the losses sustained in their real estate activities even if they were engaged in those activities for profit (*see* IRC [26 USCA] § 469 [c] [1]). "Material participation" is defined under the Code as involvement in the operations of the activity on a

regular, continuous and substantial basis (IRC [26 USCA] § 469 [h] [1]). We deem this to be essentially a factual determination with legal consequences that would have been addressed by the Administrative Law Judge had it been presented in the Division's argument at the hearing and thus is not preserved for our consideration on exception. This Tribunal has consistently held that new legal issues can be raised on exception (*see Matter of Howard Enterprises*, Tax Appeals Tribunal, August 4, 1994; *Matter of Chuckrow*, Tax Appeals Tribunal, July 1, 1993; *Matter of Standard Mfg. Co.*, Tax Appeals Tribunal, July 11, 1991). However, the raising of factual issues after the closing of the record has been distinguished from the raising of legal issues (*Matter of Sandrich, Inc.*, Tax Appeals Tribunal, April 15, 1993; *see also Matter of Clark*, Tax Appeals Tribunal, September 14, 1992, where we held that an amended answer would have put the taxpayers on notice of the alternative grounds for assessment). Thus we do not reach this alternative basis for assessment.

The remaining issues raised by the parties, in consideration of our ultimate conclusions regarding the application of IRC (26 USCA) § 183 to petitioners' business activities, are moot.

Accordingly, it is ORDERED, ADJUDGED and DECREED that:

1. The exception of the Division of Taxation is denied;
2. The determination of the Administrative Law Judge is affirmed;
3. The petition of Steve and Linda Horn is granted; and
4. The notice of deficiency dated September 16, 2011 is canceled.

DATED: Albany, New York
April 20, 2017

/s/ Roberta Moseley Nero
Roberta Moseley Nero
President

/s/ James H. Tully, Jr.
James H. Tully, Jr.
Commissioner

/s/ Dierdre K. Scozzafava
Dierdre K. Scozzafava
Commissioner