

SWEETNESS AND SPICE

Tax Issues for Foodies

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Sweetness and Spice

- Case study for first tax course which develops the following skills:
 - Issue identification
 - Tax research
 - Written communication
 - Critical thinking
 - Tax planning
 - Technical knowledge

Summary of Facts

- Two sisters, Kate and Didi, decide to write a food blog.
- Kate owns a catering business, Katering LLC.
- Didi is a stay-at-home mother of two.
- Both sisters have degrees from culinary schools.



Katering LLC

- Operates out of Kate's home.
- Kate has separate commercial kitchen in her home.
 - She uses it for all Katering jobs.
 - Sometimes uses it for personal purposes.
- Uses an extra bedroom solely as a home office.
- She is a cash-basis taxpayer, filing Head of Household.

Sweetness and Spice

- Is the name of the food blog.
- Kate and Didi began posting at the first of the year.
- Purposes of blog:
 - To make a profit.
 - To attract clients for Katering.



Blog Activities

- Recipes
- Menu ideas
- Restaurant reviews
- Entertaining tips
- Product reviews
- Travel tips



Blog Revenue Sources

- Advertising
- Click-through sales
- Receipt of products for reviews



Typical Expenses for Bloggers

- Web hosting
- Search engine optimization
- Domain name registration
- Computer
- Camera



Facts

- Kate receives \$5,000 a month in cash from Katering.
- Didi contributes \$10,000 to start the blog.
 - Her husband earns \$216,000 a year.
- Kate works 10-15 hours a week on the blog.
- Didi works no more than 5 hours a week on the blog.

Recipe Development for Blog

- Kate develops recipes through trial and error.
- Kate, Didi, and Kate's daughter, Kelsey, eat the different versions of prepared recipes.



Final Recipes

- Kate takes photographs of the various steps in preparing a recipe.
- She also photographs the final product.
- The sisters have purchased dinnerware and serving pieces for the photographs.
 - They occasionally use these items for family gatherings.



Ingredients

- Kate and Didi purchase ingredients during regular grocery shopping trips.
- The items purchased for Katering and the blog are paid for separately.



Comps

- Kate and Didi receive complementary cookbooks, kitchen appliances, and ingredients.
- They sometime use these comps for blog contests and promotions.
- The sisters received complementary meals and lodging at a blogging conference in New Orleans.
 - Kate paid for airfare to the conference.
 - Didi used frequent flier miles to purchase her airplane ticket.

Tax Issues in Case

1. Is the determination of whether the blog is engaged in for profit made at the partner or partnership level?
2. Is the blog a hobby or trade or business?
3. How do the passive activity limitations impact Didi and Kate?
4. Is the blog a separate activity from the catering business for Kate?
5. Is Didi's payment of \$10,000 for the blog expenses considered a gift?
6. Does the extra bedroom qualify as a home office?

Tax Issues in Case

7. Are any of the commercial kitchen's expenses deductible as home office expenses?
8. What is the tax treatment of the commercial kitchen appliances?
9. Are expenses paid with Kate's personal credit card deductible?
10. Can Kate deduct the expenses for recipes under development which her family eats?
11. Are expenditures for cookware, dishes and flatware which are used for both the blog and personal purposes deductible?

Tax Issues in Case

12. Do Kate and Didi have income due to the receipt of complementary lodging and meals?
13. Are the travel expenses to New Orleans deductible?
14. What is the tax treatment of the items which *Sweetness and Spice* received and the blog giveaways?
15. Is Didi able to deduct any of the costs of her vacations when she makes blog posts?
16. How much can *Sweetness and Spice* deduct for the cost of the camera and related equipment?

Tax Issues in Case

17. Are the sisters' expenses for photography and wine-tasting classes deductible?
18. What are the tax benefits of Didi's volunteering at the farm-to-table kitchen?
19. What are the self-employment tax implications for Didi and Kate?
20. Are Didi and Kate permitted to deduct local mileage for trips to buy food to prepare recipes for the blog and to promote the blog?

Tax Issues in Case

21. When is Didi taxed on the \$7,500 advance for her book?
22. What is the tax treatment of Didi's prize for the Dandiest Donut contest?
23. What is the tax treatment of the costs for the web design consultant and search engine optimization?
24. What is the tax treatment of the costs of the computer software purchased?
25. What are the characteristics of a limited liability company (LLC) and how is it taxed?

Issue 1

- Is the determination of whether an activity is engaged in for profit made at the partner or partnership level?

Issue 1

- Per *Madison Gas and Electric* (72 TC 521 (1974) aff'd 633 F.2d 512 (7th Cir., 1980)) the determination of whether expenses are incurred in carrying on a trade or business is made at the partnership level.
 - In *Brannen* (722 F.2d 695 (1984), aff'g 78 TC 471 (1984, CA-11)) and *Goodwin* (75 TC 424 (1980)) the courts examined whether the hobby loss rules applied to a partnership.

Issue 2

- Is the blog a hobby or trade or business?
 - If a hobby, deductible expenses are limited to hobby income (IRC Sec. 183(b)(2)).
 - If a business, expenses in excess of hobby income are deductible.

Hobby or Trade or Business?

1. Whether the activity is conducted in a businesslike manner (Reg. 1.183-2(b)(1)).
2. Whether the taxpayer has expertise in the area or has consulted experts (Reg 1.183-2(b)(2)).
3. The amount of time and effort which the taxpayer expends in the activity (Reg 1.183-2(b)(3)).
4. Appreciation in value of the assets used in the business (Reg 1.183-2(b)(4)).
5. Prior success (Reg 1.183-2(b)(5)).

Hobby or Trade or Business?

6. The taxpayer's history of income or loss in the activity (Reg 1.183-2(b)(6)).
7. Amount of any profits earned (Reg 1.183-2(b)(7)).
8. Taxpayer's financial status (Reg 1.183-2(b)(8)).
9. Recreational aspects of the activity (Reg 1.183-2(b)(9)).

Hobby or Trade or Business?

- Is the activity primarily motivated by an intent to earn profit?
 - Only one case involving a blog (*Lee and William Storey TC Memo 2012-115*).
 - Filmmaker wrote a blog to promote film and was found to have a profit motive.

Hobby or Trade or Business?

- Factors 2 and 5 support classification as a business, whereas factor 9 indicates that the activity as a hobby.
- Sisters should carefully document the time spent on the blog and conduct the activity in a businesslike manner with the intention to earn a profit.

Issue 3

- How do the passive activity limitations impact Didi and Kate?
 - Kate meets a test for material participation since she works on the blog for more than 500 hours during the year.
 - Didi is likely to be considered passive.

Issue 4

- Is the blog a separate activity from the catering business for Kate?
 - Kate may treat the blog and catering business as a single activity for purposes of the passive activity provisions (Reg. 1.469-4(c)).

Issue 5

- Is Didi's payment of \$10,000 for the blog expenses considered a gift?
 - Didi is considered to make gift of \$5,000, the value of the initial 50% capital interest in their partnership (*J.C. Shepherd 115 TC 376 (2000) aff'd 283 F.3rd 1258 (CA-11, 2002)*).
 - The gift will not be taxed since it is less than the amount of the gift tax exclusion of \$14,000.

Issue 6

- Does the extra bedroom qualify as a home office?
 - IRC Sec. 280A(c)(1) permits the deduction of office in home expenses if the office is used as the principal place of business for any trade or business of the taxpayer, or a place of business that is used by patients, clients, or customers in meeting or dealing with a taxpayer's trade or business (IRC Sec. 280A(c)).
 - The office in Kate's home qualifies for a home office deduction.

Issue 6

- Kate will need to allocate her home office expenses between the blog and the catering business based on the ratio of the hours spent in each activity to the total home office hours in both activities.
- The total deduction for home office expenses (for both the blog and Katering) is limited to the income from the activities, reduced by the allocable portion of otherwise deductible interest and taxes, then by expenses not related to the use of the home, such as advertising, supplies and incidentals, and finally by depreciation (IRC Sec. 280A(c)(5)).

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Issue 6

- Revenue Procedure 2013-13 which allows taxpayers to deduct \$5 per square foot for home office expenses up to a maximum of 300 square feet.
 - This amount represents all expenses pertaining to the home office, except for otherwise deductible interest and taxes.
 - Depreciation on the home office is not deductible in the years in which the safe harbor is elected.
- The safe harbor election is made annually, but once it is chosen for a particular year, it is irrevocable.
- The home office expenses are deducted on Kate's individual tax return.

Issue 7

- Are any of the commercial kitchen's expenses deductible as home office expenses?
 - Since Kate sometimes uses the commercial kitchen to prepare family meals, it will not meet the exclusive use test of IRC Sec. 280A(c)(1) and none of the utilities and depreciation allocable to the commercial kitchen will be deductible.
 - In *Baie* (74 TC 105 (1980)), the taxpayer ran a hot dog stand but did much of her cooking preparation in her personal kitchen. The costs associated with the business use of her personal kitchen were not deductible as home office expenses.
 - *Anderson* (TC Memo 2006-33) and PLR 8732002 involve the determination of the business use of the home by bed and breakfasts. When part of the residence was used for both personal and business purposes, no deduction for home office expenses was allowed.

Issue 8

- What is the tax treatment of the commercial kitchen appliances?
 - Since Kate uses the appliances for family meals, they could be considered “listed property,” which is described as including property of a type generally used for entertainment, recreation, or amusement (Reg. 1.280F-6(b)(3)(i)).
 - If the appliances are used solely in a trade or business, they are not considered listed property (Reg. 1.280F-6(b)(3)(ii)).
 - Assets used more than 50% in a trade or business are eligible for Sec. 179 expensing.
 - Kate must determine the percentage of business use and multiply that amount by the \$3,800 cost to calculate the potential Sec. 179 deduction.
 - If depreciated, the appliances are seven-year MACRS property (Rev. Proc. 87-56).

Issue 9

- Are expenses paid with Kate's personal credit card deductible?
 - If the expenses were incurred to pay for the blog's ordinary and necessary business expenses, the expenses will be deductible.
 - In the future, the blog's expenses should be paid from a separate bank account or with a credit card used exclusively for blog-related purchases.

Issue 10

- Can Kate and Didi deduct the expenses for recipes under development which their families eat?
 - Kate incurs recipe development costs for the blog and her catering business, while Didi develops recipes for the cooking contest, cookbook and cooking classes.
 - Currently there is no tax authority directly addressing this issue.
 - FSA 002342 addressed whether expenditures for research to develop new food products qualified for the credit for increasing research activities. The expenditures were not eligible for the credit but were deductible as ordinary and necessary business expenses. These recipes were developed and tested in a large business establishment.

Issue 10

- The position taken on the tax return should meet the “reasonable basis” standard of Reg. 1.6662-3(b)(3).
- It is possible that the IRS could argue that there is no reasonable basis for a deduction for the food costs to develop recipes.
- If the food costs are deducted, they should be reduced by 50% in accordance with IRC Sec. 274(n)(1).
- Kate should maintain appropriate documentation if she chooses to deduct these expenses.

Issue 11

- Are expenditures for cookware, dishes and flatware which are used for both the blog and personal purposes deductible?
 - The cookware, dishes and flatware used in the catering business are smallwares according to Rev. Proc. 2002-12.
 - Smallwares purchased before the catering business opened are startup expenditures under Sec. 195.
 - Smallwares purchased during the operation of the business are considered consumed in the tax year in which they are available for use at the business establishment and therefore fully deductible under Reg. 1.162-3. (Rev. Proc. 2002-12).
 - However, this treatment does not apply to “collectibles, or other items of significant artistic or intrinsic value, items that are accounted for separately for tax or financial purposes, or items that generally are listed as scheduled property for insurance purposes.”

Issue 12

- Do Kate and Didi have income due to the receipt of complementary lodging, meals, cookbooks and other swag during their trip to New Orleans? Do Didi and Dave have income for their complementary restaurant meals?
 - The fair value of these items is includible in income (Reg. 1.61-1(a)). They may receive a Form 1099 with the fair market value of the items and services received.
 - Nonemployee compensation does not have to be reported on a 1099 if it is less than \$600 (IRC Sec. 6041(a)), so restaurants and providers of small amounts may not file a Form 1099.

Issue 13

- Are the travel expenses, including Didi's personal payment of incidental expenses, to New Orleans deductible?
 - Transportation costs are deductible if the majority of the time on the trip is related to the blogging activity (Reg. 1.162-2(b)(1)).
 - If any of the incidental expenses are for food and drink, then only 50% of the cost is potentially deductible (IRC Sec.274(n)(1)).
 - Any food and drink must be incurred for business purposes.
 - In order to claim a deduction, Kate and Didi must retain adequate substantiation for the meals and entertainment expenses.

Issue 14

- What is the tax treatment of the items which *Sweetness and Spice* received (e.g. cookbooks, knives, recipe software, combination gas grill and smoker) and the blog giveaways?
 - Any complementary items which the partnership receives are included in the partnership's income (Reg. 1.61-1(a)).
 - The partnership can deduct the fair market value of the items awarded as prizes under IRC Sec. 162.
 - *Sweetness and Spice* will have a \$450 increase in partnership income from the donations.

Issue 15

- Is Didi able to deduct any of the costs of her vacations when she writes blogposts about her experiences?
 - Since the primary purpose of the vacations is personal, Didi is not able to deduct any of her travel costs (Reg. 1.162-2(b)(1)).
 - Although the transportation costs are not deductible, the cost of Didi's meals which become the subject of blog posts are deductible subject to the 50% reduction (Reg. 1.162-2(b)(1) and Sec. 274(n)(1)).

Issue 16

- How much can *Sweetness and Spice* deduct for the cost of the camera and related equipment?
 - If the blog is classified as a trade or business, the partnership can elect to expense the equipment under IRC Sec. 179. For 2014, the maximum deduction is \$25,000.
 - Most bloggers will be subject to the provision limiting the deduction to the blog's taxable income (IRC Sec. 179(b)(3)(A)).
 - The IRC Sec. 179 deduction is not available for hobbies. In this instance, the assets must be depreciated over their class lives.
 - Cameras and related equipment have a class life of seven years (IRC Sec. 168(e)(3)(C)(v)(II)).

Issue 17

- Are the sisters' expenses for photography and wine-tasting classes deductible?
 - Education expenses are deductible if the education maintains or improves skills required by the individual in his employment or other trade or business (Reg. 1.162-5(a)(1)).
 - If the blog is a trade or business, Kate's cost of the photography classes will likely qualify as an ordinary, necessary business expense under IRC Sec. 162.
 - For Didi, it is less likely that she will be able to deduct the cost of the wine-tasting class since she is a passive participant in the blog.

Issue 18

- What are the tax benefits of Didi's volunteering at the farm-to-table kitchen?
 - Didi can deduct her automobile mileage to drive from home to the farm-to-table kitchen.
 - The standard mileage rate for charitable activities is \$.14 for 2015.
 - She cannot deduct the value of her services.

Issue 19

- What are the self-employment tax implications of the blog for Didi and Kate?
 - Both Kate and Didi are subject to self-employment tax on guaranteed payments for services and distributive shares of ordinary income (IRC Sec. 1402(a) and 1402(a)(13)).

Issue 20

- Are Kate and Didi permitted to deduct local mileage for trips to buy food to prepare recipes for the blog and the catering business?
 - They cannot deduct their mileage unless the trips are made solely to purchase food and supplies which will be used for the blog.
 - If the trips meet this requirement, mileage is deductible at the rate of \$.575 a mile for 2015 according to IRS Notice 2014-79.
 - Deduction is subject to the limitations which may be imposed under the hobby provisions.

Issue 21

- When is Didi taxed on the \$7,500 advance for her book?
 - Didi's advance is taxed in the year of receipt (Reg. 1.446-1(c)(1)(i)).

Issue 22

- What is the tax treatment of Didi's prize and recipe development expenditures for the Dandiest Donut contest?
 - Didi must include the prize in income under Sec. 74(a), but she can deduct the \$160 (50% of \$55 for costs of developing the donut recipe plus \$265 in ingredients for entries to other contests) as a For AGI deduction since her cooking activities are considered a trade or business (Rev. Rul. 83-180).

Issue 23

- What is the tax treatment of the costs for the web design consultant and search engine optimization consultant?
- The domain registration, web design and search engine optimization costs are startup expenditures according to IRC Sec. 195(c)(1)(A).
- The first \$5,000 of startup costs are deductible in the year in which the business begins (IRC Sec. 195(b)(1)(A)(ii)).

Issue 24

- What is the tax treatment of the cost of the computer software purchased?
 - The cost of computer software is amortized on a straight-line basis over 36 months (IRC Sec. 197(e)(3)(A)(i) and IRC Sec. 167(f)(1)(A) and (B)).

Issue 25

- Katering is a limited liability company (LLC).
What are the characteristics of a LLC and how is it taxed?
 - Limited liability companies combine the characteristics of a partnership with limited liability protection for the owners.
 - In general, a limited liability company is taxed as a partnership, meaning that income is taxed to owners when it is earned and not again upon distribution.
 - LLCs may make special allocations of income, gain, loss, deduction and credit among the owners.

Planning Ideas

1. Kate should stop using the commercial kitchen for personal purposes so that she can deduct its expenses.
2. Kate should keep logs of the percentage of blog and Katering use for the commercial kitchen, cameras and photography equipment, and computer and printer.
3. Kate could pay her daughter for work that she does for the blog and Katering.
4. Kate and Didi should consider getting a separate credit card to pay for blog expenses.
5. Kate can deduct interest on the home equity line-of-credit on her personal income tax return.

Planning Ideas

6. Kate, and perhaps Didi, should make estimated tax payments.
7. Kate and Didi should consider establishing Individual Retirement Accounts or another type of retirement savings plan.
8. Didi and Dave should consider investing in an activity which generates passive income if the blog generates passive losses.
9. Kate and Didi should each keep a log of recipe attempts and outcomes.
10. Kate should make separate trips to buy food for the blog and Katering rather than making combined shopping trips for business and personal purposes.
11. Kate and Didi should keep logs to document business use of their personal automobiles.

Planning Ideas

12. Kate and Didi should consider forming *Sweetness and Spice* as a limited liability company rather than a partnership to address potential liability issues.
13. Kate and Didi should promote the blog through the use of advertising and other means to help it be classified as a trade or business rather than a hobby.
14. Kate and Didi should prepare a written, formal business plan.

Student Feedback

	Mean Response	Percent Agree & Strongly Agree
I found the case interesting.	2.33	72%
This case was helpful in improving my ability to locate appropriate guidance using a tax research service.	2.00	78.67%
This case provided an excellent illustration of gray areas in the tax law where guidance does not exist or is unclear.	1.88	73.33%
The case improved my ability to identify tax issues for individuals and small home-based businesses.	1.95	81.34%

Student Feedback

	Mean Response	Percent Agree & Strongly Agree
My ability to identify tax issues from a complex set of facts improved as a result of completing the case.	1.92	82.67%
This case was helpful in improving my ability to understand and summarize relevant information from a complex set of facts.	1.97	85.34%
This case provided an opportunity for increasing my tax planning proficiency.	1.99	74.67%
I feel that this case was a valuable educational experience.	1.97	81.34%