STATE OF NEW YORK

TAX APPEALS TRIBUNAL

In the Matter of the Petition	:	
of	:	
WILLIAM AND DAWN TEMPLE	:	DECISION DTA NO. 818509
for Redetermination of a Deficiency or for Refund of Personal Income Tax under Article 22 of the Tax Law for the Years 1996 and 1997.	:	

Petitioners William and Dawn Temple, 5 Heidis Path, Ballston Lake, New York 12019-2210, filed an exception to the determination of the Administrative Law Judge issued on May 8, 2003. Petitioners appeared by Hiscock & Barclay, LLP (Philip J. Vecchio, Esq., of counsel). The Division of Taxation appeared by Mark F. Volk, Esq. (Kevin R. Law, Esq., of counsel).

Petitioners filed a brief in support of their exception and the Division of Taxation filed a brief in opposition. Petitioners filed a reply brief. Oral argument, at petitioners' request, was heard on January 14, 2004 in Troy, New York.

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

ISSUES

I. Whether it was proper for the Division of Taxation to disallow petitioners' losses from Tesco International because the business was not engaged in for profit within the meaning of Internal Revenue Code ("IRC") § 183.

II. Whether it was proper for the Division of Taxation to deny the casualty losses claimed by petitioners for the years 1996 and 1997.

III. Whether the expenses incurred by petitioners in seeking new employment were deductible.

IV. Whether it was proper for the Division of Taxation to deny certain deductions claimed by petitioners for unreimbursed employee business expenses.

V. Whether petitioners have established that the Division of Taxation improperly imposed penalties.

FINDINGS OF FACT

We find the facts as determined by the Administrative Law Judge. These facts are set forth below.

Background

1. In 1996 and 1997, petitioner William Temple was a senior project manager for Sempra Energy Services Company "Sempra".[1] In this position, he worked a 40-hour week assisting in developing, managing and constructing energy conservation projects. The design of the energy conservation projects was the responsibility of a combination of inside and outside consultants. Mr. Temple critiqued the designs as well as reviewed and approved them. He also visited job sites, prepared estimates of job costs and supervised other employees, subcontractors and outside engineering consultants. In 1996 and 1997, Mr. Temple's wages from Sempra were $66,750.00 and $73,912.38, respectively.

[1] During the years in issue, Sempra was known as CES-Way.

2. Sempra is a Fortune 500 company and engages in business throughout the United States, Europe and Asia. It is Mr. Temple's understanding that he is considered Sempra's best project manager. Sempra has received four national awards based on projects in which Mr. Temple was involved.

3. In practice, a client would invite Sempra to its facility in order to determine if it could save on the client's utility costs. After entering into certain contracts, Sempra performed an audit to determine where savings could be materialized and the anticipated payback. The recommendations consisted of a mix of energy conservation measures. Mr. Temple was involved in the financial aspects of the projects. He arranged the financial models and put together the budget transmittals and billings for each month. He also wrote the purchase orders, contracts and consultant agreements.

4. Petitioner Dawn Temple has been a registered nurse since 1994. During the years in issue, she worked at Saint Clare's Hospital in Schenectady, New York. In this position, she prepared people for surgery and took care of them after surgery. She also worked in the orthopedic and hospice units. During the years 1996 and 1997, Mrs. Temple's wages from Saint Clare's Hospital were $29,265.43 and $32,688.55, respectively.

Income Tax Returns

5. On their joint New York State Resident Income Tax Return for the year 1996, petitioners reported a business loss of $19,192.99 arising from a firm named Tesco International[2] ("Tesco"). Tesco was an energy service company which was owned and operated by Mr. Temple. Tesco reported that it had no receipts. The reported expenses were as follows:

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[2] TESCO stands for Temple Energy Service Company.

Expense	Amount
Advertising	$ 279.00
Car and truck expenses	3,195.92
Insurance	816.00
Legal and professional services	75.00
Office expense	8,623.87
Rent or lease of vehicle	6,203.00
Total	$19,192.99[3]

6. According to petitioners' return, Mr. Temple drove a leased vehicle 17,000 miles for business and 100 miles for commuting.

7. Petitioners reported that they had itemized deductions of $84,362.29. This amount included Mrs. Temple's unreimbursed employee expenses of $7,167.87[4] and job search expenses of $759.15. It also included Mr. Temple's unreimbursed employee expenses of $880.59 and job search expenses of $1,533.74.

8. Petitioners' return stated that they had a casualty loss of $63,908.02 arising from flood damage to their personal residence. According to the return, the property had a cost basis of $125,000.00 and, before the casualty, had a fair market value of $175,000.00. They also reported that, as a result of the casualty, the fair market value of the property declined from $175,000.00 to $102,651.00.

[3] It appears that petitioners' made a small arithmetic error in totaling the amount of the loss. The reported loss totals $19,172.79.

[4] This expense was claimed for the cost of the uniforms worn by Mrs. Temple, the cost of cleaning the uniforms and the related mileage.

9. On their New York State Resident Income Tax Return for 1997, petitioners reported a business loss from Tesco in the amount of $37,450.49. As was the case with the prior year's return, Tesco had no receipts. The reported expenses were as follows:

Expense	Amount
Advertising	$ 152.10
Car and truck expenses	4,532.43
Insurance	928.00
Interest - other	75.00
Office expense	21,216.44
Rent - vehicles	10,436.47
Taxes and licenses	110.00
Total	$37,450.49

10. According to the return, Mr. Temple drove a leased vehicle 21,800 miles on business and 150 miles commuting.

11. Petitioners claimed itemized deductions in the amount of $56,728.19. This amount included Mrs. Temple's unreimbursed employee expenses of $6,177.72, Mr. Temple's unreimbursed employee expenses of $1,416.68 and unknown expenses of $1,243.18.

12. Petitioners reported a casualty loss of $34,873.41 from a flood on November 17, 1997 which caused damage to their personal residence and to their furniture, equipment and materials. According to Federal form 4684, the residence had a cost or other basis of $125,000.00 and a fair market value before the casualty of $150,000.00. The schedule reported that, after the casualty, the residence had a fair market value of $125,185.63. Petitioners further reported that their furniture, equipment and materials had a cost or other basis of $17,224.86 and that this was also

the value before the casualty. According to the return, these items had no value after the casualty.

Commencement of the Audit

13. After reviewing the returns, the Division of Taxation ("Division") determined that an audit should be conducted. Initially, the Division experienced difficulty in scheduling an audit appointment because of repeated requests by petitioners for postponements and rescheduling. The difficulty in scheduling an appointment prompted the Division to issue an assessment disallowing petitioners' business expenses. Thereafter, petitioners scheduled an audit appointment.

14. An audit appointment took place on August 12, 1999. During the meeting, Mr. Temple explained that he, through Tesco International, was trying to devise a better flushing system that would conserve water. Mr. Temple stated that most of his evenings were consumed in his garage designing items that have to do with flushing. According to Mr. Temple, he leased a Lexus automobile for his business and deducted, on his schedule C, the cost of the lease payments, repairs and auto insurance. He further explained that he drove the Lexus to construction sites to pick up used water closets so that he could examine them.

Audit of 1996

15. The Division analyzed whether Tesco was being carried on in a businesslike manner. In the process, it found that although the business was started in 1994, there were no receipts in 1994, 1995, 1996 or 1997. As a result, it concluded that none of the business expenses for 1996 should be allowed because it did not consider the business to be carried on for profit. Even if it had determined that the business was operated for profit, certain expenses would have been

disallowed because they were not supported by documentation or receipts or they were deemed personal in nature.[5]

16. Upon reviewing the deduction for the casualty loss, the Division noted that an appraisal was not performed and that the amounts of $175,000.00 and $102,651.00 were estimates. Further, there was no record to show that the items of personal property existed in the house, to show that they were damaged, to show what their value was at the time of the loss or to show what petitioners paid for them. The Division disallowed the casualty loss in its entirety because (1) petitioners did not present a competent appraisal of the fair market value of the property before and after the casualty loss; (2) a letter from an insurance company indicated that the damage was to the basement only; (3) the loss must be based on fair market value and not cost; and, (4) no documentation was presented to prove that items existed or were destroyed.

17. In support of their claim for unreimbursed employee expenses for 1996, Mr. Temple offered the Division a list of expenses for clothing that Mrs. Temple purchased for her job, the mileage she traveled to obtain the clothing and the cost of the clothing. The cost of detergents to clean the clothing was also included on the list. Upon reviewing the list, the Division disallowed items that were purchased from stores such as Walmarts, J.C. Penney Co. Inc. ("J.C. Penney") and Barbara Moss because there were no detailed receipts showing what was purchased at the store which would have enabled the Division to identify the item as part of Mrs. Temple's

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[5] In essence, the Division would have allowed 25 percent of the car expenses, insurance and cost of the leased vehicle for a total of $10,327.61. Three-quarters of the car expenses, insurance expenses and rental expenses would have been disallowed because these items related to lease payments on the Lexus automobile and were regarded as nondeductible personal expenses. The Division believed that the automobile was used primarily for personal and not business reasons. The amount purporting to be advertising was a newspaper subscription that the Division concluded was a nondeductible personal expense. Legal and professional expenses and office expenses would have been disallowed because, among other things, they were regarded as nondeductible personal expenses.

uniform or something specific to the nursing uniform. The Division allowed deductions for purchases from Uniform Village and Sherons because these were shops which sell uniforms. The Division did not allow a deduction for the mileage claimed to purchase an article of clothing and return regardless of whether the cost of the item was deductible because the Division did not think that the cost of the mileage to buy a deductible item is deductible. Further, petitioners did not maintain a contemporaneous log of mileage.

18. The Division examined Mr. Temple's unreimbursed employee expenses of $880.59 and found that the expenses claimed were for safety equipment consisting of safety glasses and multiple pairs of safety boots, that is, those with steel toes and steel shanks. Mr. Temple also claimed a deduction for the mileage he incurred to purchase the items. The Division disallowed a deduction for these items because the items purchased were regarded as personal and because it did not see any receipts for the purchases. In reaching this conclusion, the Division noted that the safety boots were purchased from an establishment known as Norse House, which was a ski shop in Vermont. The Division also found that the expense for the safety glasses was incurred at Sunglass Hut. Even if it had seen the receipts and allowed the expense, the Division would not have allowed the mileage to purchase the items.

19. Mr. Temple's job search expenses were based upon the mileage he allegedly incurred looking for employment. These expenses were disallowed because the travel claimed was regarded as primarily for personal reasons and because there was a lack of adequate records to prove the expense. Further, no documentation was provided by petitioners to establish that Mr. Temple was actually searching for a job. Similarly, Mrs. Temple's job search expenses were

disallowed because there was no mileage log or documentation to show that she was actually seeking a job or interviewing on these trips.

20. The Division allowed a deduction for the cost of having Mrs. Temple's uniforms professionally cleaned. However, it disallowed a deduction for the mileage to bring an article of clothing to the cleaners to have the item cleaned. It also disallowed the deductions claimed for detergent, Clorox and whiteners under the assumption that if Mrs. Temple was bringing the items to the cleaners, she would not be washing them at home. In addition, it felt that personal use of the detergents might be involved.

21. Although the deduction for some of Mr. and Mrs. Temple's unreimbursed employee expenses were regarded as permissible, they were totally disallowed because of the two-percent limitation on miscellaneous itemized deductions.

Audit of 1997

22. For the year 1997, the Division concluded that Tesco was not carried on in a business-like manner and that it was not operated for profit. Therefore, it disallowed the entire loss as a hobby loss. Nevertheless, as it had done for the previous year, the Division reviewed petitioners' business expenses in the event it was concluded that Mr. Temple was operating Tesco for profit.[6]

23. Mr. Temple's unreimbursed job expenses of $1,416.68 for 1997 were allegedly incurred for the acquisition of safety glasses, safety boots and safety gloves. They were also incurred for the repair of safety gloves. The associated mileage was also deducted. The Division disallowed the entire expense because there was a lack of receipts to prove the

[6] If the Division had determined that Tesco was operated for profit, it would have allowed a loss of $15,395.57. This amount is based upon 25 percent of the car, insurance, rental, tax and license expenses. It also includes $11,868.76 of the office expense.

expenses. In addition, the purported business mileage was disallowed because the mileage was considered primarily personal. Mrs. Temple's unreimbursed employee expense of $6,177.72 was premised upon the cost of the nursing attire, the cost of cleaning the nursing uniforms and the associated mileage incurred to purchase and clean the uniforms. The Division allowed a deduction for the dry-cleaning costs and the expenses incurred at the uniform shops. The remaining expenses, including mileage, cost of detergents which were used at petitioners' home and expenses incurred at stores which did not specialize in uniforms such as Walmarts and J.C. Penney were disallowed. After totaling all of Mr. Temple's and Mrs. Temple's unreimbursed expenses, an additional amount of $1,243.18 remained. Petitioners did not provide any explanation of what this amount was or what it corresponded to. Since there were no receipts to support the deduction, it was labeled unknown and disallowed.

24. With respect to the casualty loss, Mr. Temple advised the Division that he determined the $150,000.00 value himself based on the value of properties in the area. Mr. Temple also explained that historical cost was used to value the items of personal property. The Division disallowed the casualty losses in full because there was no appraisal before or after the flood to determine the fair market value or petitioners' actual loss. In addition, no receipts or other documentation were presented to establish the amount of the loss. The Division did not question that there was water damage to the house.

25. On the basis of its audit, the Division issued a Notice of Deficiency to petitioners, dated November 26, 1999, which asserted a deficiency of personal income tax, interest and penalty for negligence as follows:

Period	Tax	Interest	Penalty	Balance Due
1996	$ 5,802.44	$1,214.60	$ 897.42	$ 7,914.46
1997	$ 5,128.94	$ 599.15	$ 556.02	$ 6,284.11
Total	$10,931.38	$1,813.75	$1,453.44	$14,198.57

26. In 1994, Mr. Temple decided to pursue a business which involved modifying the Sloan flush valve, which is standard equipment, in order to regulate how long a flushometer is open and closed. Mr. Temple anticipated that his product would save water each time a water closet or urinal was used which would, in turn, save money on water and sewer bills. Mr. Temple expected to not only acquire a patent but also to operate a business. According to Mr. Temple, he expected to profit from the sale of the modifications and from the installation of the components. Mr. Temple saw a potential for excellent savings and anticipated that the product would be purchased by State and Federal governments and institutions such as hospitals, schools and large office buildings. Mr. Temple ran some financial models with regard to the savings on institutions and it showed a payback period to the owner of roughly three and three-quarter years. Mr. Temple asserted that he would be in a position to guarantee his customers a certain level of savings and if these savings were not achieved, he would write them a check for the difference between what was guaranteed and what actually materialized in savings.

27. Mr. Temple visited construction sites in order to obtain the porcelain parts used in a toilet or urinal. For a particular piece of china and a relief valve, Mr. Temple would conduct tests using various pressures to find the least amount of water that could pass the flush test - 80 sheets of toilet paper. Mr. Temple performed all of the testing of his prototypes at his home at 5 Heidis Path in Ballston Lake.

28. Mr. Temple prepared a matrix which selected the type of china, flushometer, Sloan relief valve and modifications which would make it acceptable to pass the flush test. He would then modify the orifice so it would operate at the pressure he established. Thereafter, he would test with other pressures. Testing the various pressures has been an ongoing process.

29. Mr. Temple's matrix deals with 90 percent of the porcelain currently in use. For some porcelain, it is not possible to put in a low consumption device because it will not pass the flush test. For these customers, the porcelain has to be replaced.

30. If Mr. Temple were to make a proposal, he would survey the premises to determine what the water pressures are on each floor, each wing, or at the end of each floor and then determine what the savings would be in dollars and water. Thereafter, a financial model would be developed to determine what the cost would be to implement the water conservation measures. This would be developed into a detailed survey arrangement for the customer to accept or reject. Based on the information gathered throughout the years and the type of flushometer, Mr. Temple would select the appropriate relief valve and diaphragm.

31. There are a number of reasons why the product has not been placed on the market. One reason is product liability. It takes time to develop a reliable product. There is a risk that a water closet could overflow and damage items such as computer equipment, records and building materials. Another reason that the product has not been placed on the market is that there are a number of differences from building to building and from floor to floor. Each floor has a different water pressure and each section of the city may have a different water pressure. Mr. Temple also had to test a number of different scenarios. In a medium-sized hospital there may be 500 water closets in the facility. According to Mr. Temple, one has to go to each wing of

each floor and determine what the water pressure is over a 24-hour period for six months before one could refer back to the engineering matrix to determine what kit should go in what floor and wing of the building. Mr. Temple did not approach potential customers in 1996 or 1997 because he was still in the development stage.

32. There are other companies or individuals that are engaged in performance engineering pertaining to water savings with toilets. However, they are taking a standard approach like Sloan. The other companies do not modify the diaphragm.

33. At the hearing, Mr. Temple explained that he expected that Tesco would be profitable on the basis of a number of studies he had done in the past. He anticipated that eventually the profits would more than offset the losses and he could retire on the profits from the business. None of these studies were offered into evidence at the hearing.

34. As of the date of the hearing, Mr. Temple stated that he believed that he was ready to approach clients. However, he feels that he needs to find the right client.

35. Mr. Temple has brought other innovations to market and sold them. The expenses for developing the other products were written off on the tax return of a company that Mr. Temple owned. He recouped all of the expenses he incurred in this design.

36. Mr. Temple asserted that the expense for the lumber that was disallowed was used "for the most part" for mockups in connection with Tesco. According to Mr. Temple, it was not related to improving his house or in any way modifying his house or office. Mr. Temple does his design and testing at his residence.

37. At the hearing, Mr. Temple explained that he usually does not follow current events. Rather, he subscribed to a newspaper in order to find out what was going on in the community

regarding demolition and new construction. This enabled him to ascertain if porcelain would be available. Nevertheless, he subscribed to newspapers prior to 1994 when he started Tesco. At that time, the purpose was just to have a newspaper. Mrs. Temple explained that she read the Times Union largely to see the advertisements for nurses. However, prior to becoming a nurse, she read the newspaper.

38. In 1996, Mr. Temple leased a Lexus automobile. In 1997, the lease on the Lexus expired and he leased an Acura. During the years in issue, Mr. Temple drove a Honda Accord, which he owned, for personal use. He also drove a Nissan automobile which he owned. Mr. Temple also owned a 1970 Mustang but he did not drive it. At the hearing, Mr. Temple explained that he used his leased vehicle to drive to job sites to pick up china. He also anticipated using the vehicle to meet potential customers.

39. Mr. Temple drove the Lexus to Sempra and back if there was a reason. On one or two occasions, he may have driven the vehicle in order to have it serviced. The Lexus dealership was near where Mr. Temple's employer was located. Therefore, Mr. Temple would bring the vehicle to the dealership and the dealership would take Mr. Temple to work. At the hearing, Mr. Temple estimated that personal use of the automobile amounted to approximately 200 to 300 miles a year.

40. If Mr. Temple was wearing the correct safety gear such as a hard hat and safety glasses, he would be allowed to enter the demolition site and remove some of the porcelain and flushometers. Sometimes the porcelain would be piled up outside of the building and he would examine the material at the demolition site. Neither the china nor the flushometers had significant scrap value.

41. The only time Mr. Temple used items such as safety glasses, safety boots and safety gloves was in connection with his employment at Sempra Energy Services. Mr. Temple felt that he needed work clothing because he was required to visit construction sites to survey the progress of each project. Each of these projects came under the rules and regulations of OSHA[7] which required, among other things, safety glasses and safety boots. Mr. Temple had to ensure that subordinates were compliant with OSHA. During the years in issue, Mr. Temple visited construction sites once or twice a week. Mr. Temple asserts that the boots he purchased in 1996 were not ski apparel. Further, Sunglass Hut did not sell safety glasses. However, Mr. Temple had to buy the frame from Sunglass Hut for the safety lenses which were provided by Troy Eye Associates. Mr. Temple wore the glasses while he was driving and while he was on the job.

42. Petitioners' home is located adjacent to a farm field which slopes on two corners toward petitioners' property. Whenever the ground is frozen and there is a heavy rainfall the debris from the field will wash toward the back of petitioners' property and flood the street in front of petitioners' home. On January 19, 1996, the street was flooded to a level where the water was above the roofs of cars and petitioners had flooding in the basement and first floor of their home. As a result, petitioners had to cope with the mud and chemicals that were used on the farm such as insecticides and fertilizers. Although flooding has occurred on more than one occasion in the basement, this was the only time it occurred on the first floor. A number of homes in petitioners' housing development suffered water damage.

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[7] OSHA stands for the Occupational Health and Safety Administration.

43. Petitioners submitted a list of the items of personal property which were allegedly lost in the respective floods. Adjacent to each item they recorded the cost of the item. Petitioners did not provide evidence concerning the items' fair market value.

44. The flooding caused the insulation between the walls to become wet which, in turn, caused mold to grow between the walls. Further, the floors warped and the carpets became stained. According to the receipts offered by petitioners at the hearing, Mr. Temple purchased materials at a cost of $17,929.73 in order to restore his home because of the damage caused by the flood in 1996.

45. Petitioners submitted an appraisal, dated April 10, 2002, to substantiate a portion of the casualty losses which occurred on January 19, 1996 and November 7, 1997, when another flood occurred. The appraisal states that the market value of petitioners' residence prior to the flood on January 19, 1996 was $135,000.00 and after the flood was $61,250.00. The appraisal values the residence at $135,000.00 immediately prior to the November 7, 1997 flood and $76,250.00 following the flood. In his appraisal report, the appraiser viewed the flooding as one of external obsolescence because the cause of the problem was external to the subject property and petitioners did not have direct control of the problem. For each of the years in issue, the appraiser reduced the market value of the residence by a "cost to cure." For 1996, the cost to cure was $40,000.00 and for 1997 the cost to cure was $25,000.00. In each instance, the appraisal report states "[a] review of past and current costs to cure the flood/water damage to the lower finished basement area has a range from $18,000.00 to $40,000.00 per year." There is no data or information provided to support the particular amounts ascribed to the "cost to cure" in

either year.[8] Petitioners' appraiser viewed the flooding as "a recurring problem on an annual basis. . . . " In determining the valuation for 1996, the appraiser reduced the value of the property by 20 percent or $27,000.00 apparently on the basis of the anticipated market reaction to the flooding problem. The appraiser did not factor in the $27,000.00 reduction when estimating the value of the residence immediately before the flood of November 7, 1997. However, he reduced the market value of the residence by the same $27,000.00 after the flood of November 1997. The appraiser also reduced the value of the property by 5 percent, or $6,750.00, during each of the years in issue because of a stigma. The appraiser believed that this adjustment was warranted because, even if it were possible to remedy the flooding problem, a stigma would be attached to the property and the area affected by the flooding.

46. The figure of $175,000.00 for the value of his home on the casualty loss form for 1996 was based on an estimate from Mr. Temple's insurance agent who had come to his property. Mr. Temple prepared his own return and does not believe that the structure was restored to the $175,000.00 value because he did not replace paneling in a particular room and the tiles in the bathroom were replaced with a lower grade of tile.

47. Mr. Temple incurred job hunting expenses in 1996 because he was looking for work in the same profession with another firm. He did not write down the names of the employers that he visited because he was concerned that others might see it.

48. Mr. Temple converted his garage into his office. During the years in issue, Mr. Temple's office contained a desk, computer, drafting board, several bookcases containing engineering books, filing cabinets, records, files and electronic equipment that he used for

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[8] The appraisal report directs the reader's attention to the homeowner's records for the actual cost to cure.

testing. Personal records, such as insurance, were not kept in the office. Mr. Temple used a computer located in a second floor bedroom for preparing resumes and cover letters. When Mr. Temple was working at home on Sempra business, he usually worked on his dining room table. Other than the drafting board, the office did not have a table large enough to spread out his papers.

49. The hospital where Mrs. Temple was employed had a dress code which described what the uniform may consist of. If a nurse appeared for duty in attire that did not comply with the code, the nurse could be sent home to change. Having clothes become soiled while at work was common. Since the hospital wanted nurses to be neat and clean, it was anticipated that a nurse would have the uniforms cleaned in some fashion when he or she went home.

50. Mrs. Temple was employed in the "med-surg" unit of Saint Clare's Hospital. Her position caused her to come into contact with bodily fluids. Further, Mrs. Temple's unit also took care of patients who were HIV positive. In addition, the floor where Mrs. Temple worked also had isolation rooms for patients with tuberculosis.

51. Mrs. Temple worked the 11:00 P.M. to 7:00 A.M. shift. In the nighttime the hospital was cooler and Mrs. Temple looked for a sweater to wear. It started getting warmer about 6:00 A.M.

52. Mrs. Temple washed her nursing uniforms separately from her family's clothes because of what she is exposed to. She also washed them separately because she used a lot of Clorox and detergent. The excessive exposure to bleaches eventually wore away the clothes. Mrs. Temple maintained a separate supply of detergents for the clothes she wore for her job and the clothes she and Mr. Temple wore other than for work.

53. Mrs. Temple used several different vendors for uniforms because she liked to add variety and style to her uniform. She probably had more uniforms than other clothing because she worked a lot and changed her uniform every day. As far as Mrs. Temple was concerned, once clothing was worn on a nursing duty shift, it was not appropriate for personal use. She did not wear her work uniform after work hours. Similarly, she would not go to work on a shift with an outfit she had been wearing all day around town. The least expensive place Mrs. Temple could purchase a uniform, besides a uniform store, was a department store such as Walmart's, J. C. Penney or Sears. A nurse at Saint Clare's could buy white street clothes at Barbara Moss or J.C. Penney's and assemble them in such a way that they would meet the hospital's uniform code. However, the items which Mrs. Temple purchased from stores such as Walmarts, Bradlee's, Talbot's, Barbara Moss or J.C. Penney's could have been worn on the street as regular clothes.

54. When Mrs. Temple purchased clothing she was interested in functionality. It had to have a certain look about it. It also had to have a certain number of pockets so she could perform her job. Pockets were important because she carried a stethoscope, bandages, tape, scissors, pens, and other items. Saint Clare's did not provide an allowance for uniforms for the registered nurses.

55. Mrs. Temple's deduction for job search expenses was premised, in part, upon the expense she incurred in mileage looking for new employment. She also deducted the cost of a subscription to a newspaper as a job search expense. During the years in issue, Mrs. Temple interviewed with different hospitals in the area and at some job fairs. Mrs. Temple was interested in ascertaining if there was a position that she would be interested in as a nurse.

THE DETERMINATION OF THE ADMINISTRATIVE LAW JUDGE

The issue presented in this matter is whether petitioners have substantiated the deductibility of certain expenses. The Administrative Law Judge viewed this issue as raising two questions: whether petitioners are entitled to deduct the expense as a matter of law and, if so, the amount of the deduction to be allowed. He noted that, under the Tax Law, petitioners carry the burden of refuting the Division's disallowance of deductions and of establishing their entitlement to claimed expenses. The starting point for determining New York personal income tax liability is a taxpayer's Federal adjusted gross income (***see***, Tax Law §§ 612[a], 689[e]; 20 NYCRR 112.1). Since the New York State personal income tax law is patterned after the Federal income tax laws, Federal law is determinative of the substantive questions presented here.

The first issue addressed by the Administrative Law Judge was whether Tesco was engaged in for profit within the meaning of Internal Revenue Code § 183. The question here is whether, during 1996 and 1997, Mr. Temple's activities with Tesco were engaged in for profit, and resolution of that issue rests on whether Mr. Temple had an actual and honest objective of making a profit from his purported business activity (***see***, ***Dreicer v. Commissioner***, 78 T.C. 642, ***affd*** 702 F2d 1205). Such an objective, the Administrative Law Judge pointed out, is properly determined upon review of the surrounding facts and circumstances and in consideration of the nine factors set forth in Treasury Regulation § 1.183-2(b) (***see***, ***Hoag v. Commissioner***, T.C. Memo 1993-348, 66 TCM 326).

The Administrative Law Judge applied the nine factors to the facts in this case as follows:

(1) Manner of Carrying on the Activity

The question presented is whether Mr. Temple was operating Tesco in a manner which demonstrates a profit motive. The Administrative Law Judge found that the manner in which Mr. Temple operated Tesco casts doubt upon whether he had a true profit motive. Petitioners deducted all of the costs of leasing and maintaining a Lexus automobile in 1996 and an Acura automobile in 1997. If one were to accept Mr. Temple's explanation, he leased a Lexus automobile, an acknowledged luxury car, and an Acura automobile in order to pick up discarded toilet bowls and urinals at construction sites. According to the tax returns, he drove 38,800 miles over a two-year period in this endeavor and, during the same period of time, he reported that he only drove the Lexus and Acura a total of 250 miles for personal use.

Tesco also claimed an advertising expense based on acquiring a local newspaper, the Times Union. Both Mr. and Mrs. Temple stated that they read the newspaper prior to 1994. However, for some reason, after starting Tesco, Mr. Temple was only interested in the newspaper because it listed construction or demolition sites. The Administrative Law Judge found it noteworthy that although petitioner admitted that he was not ready to market his product during the years in issue, Mr. Temple stated, at one juncture, that he leased the automobiles to meet potential customers.

The Administrative Law Judge concluded that the very substantial mileage coupled with the use of luxury automobiles at a time when there was no revenue was not indicative of a profit motive. The Administrative Law Judge found that this factor did not support petitioners' position.

(2) Expertise of Taxpayer or His Advisors

The Administrative Law Judge found that Mr. Temple has substantial expertise in "performance engineering," and concluded that this factor inures to petitioners' benefit.

(3) Time and Effort Expended in Activity

The record shows that Mr. Temple was a senior project manager for Sempra and that he assisted in developing, managing and constructing energy conservation projects. In this capacity, he worked 40 hours a week. Although the record also shows that Mr. Temple made trips to pick up discarded toilets and urinals and tested these items at various pressures, the record does not reveal how much time Mr. Temple devoted to this project. The Administrative Law Judge concluded that since Mr. Temple bears the burden of proof, the lack of evidence lends support for the Division's position.

(4) Expectation that Assets May Appreciate

The Administrative Law Judge found that this factor did not appear to have any bearing on the matter.

(5) Taxpayer's Success in Carrying on Other Activities

At the hearing, Mr. Temple claimed that he had brought other products to the market and sold them. However, petitioners offered no evidence regarding what the previous products were or any detail regarding the prior history of income and expenses. The Administrative Law Judge concluded that the lack of evidence required that this factor be regarded as supporting the Division's position.

(6) Taxpayer's History of Income or Loss; (7) Amount of Occasional Profits

The Administrative Law Judge noted that a history of substantial losses may indicate that the activity was not engaged in for profit, however, a taxpayer may have a profit objective even

when the activity has a history of losses without any profit (***see***, ***Bessenyey v. Commissioner***, 45 T.C. 261, ***affd*** 379 F2d 252, 67-2 USTC ¶ 9488, ***cert denied*** 389 US 931, 19 L Ed 2d 283).

In this case, Tesco not only did not show a profit in any year, it did not have any revenues in any year. Mr. Temple testified about his expectations of a profit from Tesco, but the Administrative Law Judge did not find petitioners' evidence on this issue persuasive. The Administrative Law Judge noted that although Mr. Temple claimed that he ran financial models, no documentation on this point was placed in evidence. Further, while Mr. Temple explained that he needed to exercise care before bringing his product to the market and that he planned on eventually making a profit on his idea, no timetable was placed in evidence to show when this was anticipated to happen. The Administrative Law Judge concluded that petitioners failed to carry their burden of proof on both points.

(8) The Taxpayer's Financial Status

The Administrative Law Judge noted that the fact that the taxpayer does not have substantial income from sources other than the activity in question may suggest that the activity is engaged in for profit. In this case, petitioners have substantial income from their respective professions. Accordingly, the Administrative Law Judge found that this factor supports the Division's position.

(9) Aspects of Personal Pleasure

Petitioners contended that there is no aspect of personal pleasure in developing flush valves for toilets and that this case is distinguishable from typical hobby loss cases involving horse breeding or car racing. The Administrative Law Judge accepted this as a factor in petitioners' favor.

However, upon reviewing the expenses and all the surrounding circumstances, the Administrative Law Judge concluded that Mr. Temple did not have the objective of making a profit. The Administrative Law Judge found that the evidence supports the conclusion that Tesco was a mechanism for shifting nondeductible personal expenses (such as the cost of driving an automobile or subscribing to a newspaper) to deductible business expenses. In view of the foregoing conclusion, the Administrative Law Judge found that petitioners' argument that the expenditures made by Mr. Temple prior to bringing Tesco's product to market may be deducted each year is academic. The Administrative Law Judge also found moot petitioners' argument that the expenditures of Tesco were "ordinary and necessary."

The Administrative Law Judge next addressed petitioners' claimed casualty losses, noting that, in general, IRC § 165(a) and (c) permit a deduction for such losses. While petitioners' appraiser described the flooding as a recurring problem on an annual basis, the Administrative Law Judge noted there was no evidence of any flooding prior to 1996 or that there was any reason to anticipate that there would be a flood before 1996. The Administrative Law Judge found that the flooding of petitioners' home was in the nature of a casualty, and concluded that petitioners suffered a casualty loss within the meaning of the Internal Revenue Code.

The Administrative Law Judge next focused on the amount of the deduction attributable to the casualty. The amount of loss from a casualty is the lesser of the difference in fair market value immediately before and immediately after the casualty or the adjusted basis for determining the loss from the sale or other disposition of the property. Generally, the Administrative Law Judge pointed out, the fair market value of property before and after the casualty is determined by a competent appraisal.

In this case, petitioners submitted a list of the items of personal property which were allegedly lost or destroyed in the respective floods. Adjacent to each item they recorded the cost of the item. Petitioners did not provide evidence concerning the items' fair market value. Under the circumstances, the Administrative Law Judge found that the schedule did not provide a basis to determine the amount of a casualty loss for the items of personal property which were lost or destroyed. However, on the basis of the receipts submitted at the hearing, the Administrative Law Judge found that petitioners substantiated a deduction of $17,929.73 based upon what was damaged in the flood of January 19, 1996.

Next, addressing the real property, petitioners submitted an appraisal, dated April 10, 2002, to substantiate the casualty losses which were claimed on the income tax returns. The Administrative Law Judge found serious deficiencies in the appraisal report. The appraisal report states that the cost to cure ranges from $18,000.00 to $40,000.00 without showing any basis for the figures. In this vein, the appraiser used $40,000.00 as the cost to cure for 1996 and $25,000.00 for 1997 without any explanation for the particular amounts used. Without any supporting data, the Administrative Law Judge found this adjustment unacceptable.

The Administrative Law Judge noted that in his appraisal report, the appraiser characterized the flooding as one of external obsolescence, because the cause of the problem was external to the subject property and petitioners did not have direct control of the problem. Therefore, in determining the valuation for 1996, the appraiser reduced the value of the property by 20 percent or $27,000.00 apparently on the basis of the anticipated market reaction to this type of problem. The Administrative Law Judge pointed out that the appraiser did not factor in the $27,000.00 reduction when estimating the value of the residence immediately before the

flood of November 7, 1997. However, he reduced the market value of the residence by the same $27,000.00 after the flood of November 1997. Agreeing with the Division, the Administrative Law Judge noted that logic requires that the $27,000.00 reduction in market value after the 1996 flood would remain when determining the value of the property before the November 1997 flood.

The appraiser also reduced the value of the property by 5 percent, or $6,750.00, during each of the years in issue because of a stigma. The appraiser believed that this adjustment was warranted because, even if it were possible to remedy the flooding problem, a stigma would be attached to the property and the area affected by the flooding.

The Administrative Law Judge rejected the adjustments premised upon the anticipated market reaction to the flooding, that is, the $27,000.00 for market reaction and $6,700.00 because of the stigma. Noting that the amount of a casualty loss is limited to physical damage to property (***see***, ***Squirt Co. v. Commissioner***, 51 T.C. 543, ***affd*** 423 F2d 710, 70-1 USTC ¶ 9281; ***Pulvers v. Commissioner***, 48 T.C. 245, ***affd*** 407 F2d 838, 69-1 USTC ¶ 9222), the Administrative Law Judge found that the anticipated market reaction to be too speculative to support a deduction. Thus, the Administrative Law Judge found that the appraisal report was not sufficiently reliable to support a deduction for a casualty loss.

The Administrative Law Judge then focused his attention on section 162 of the Internal Revenue Code which permits an individual to deduct expenses incurred in seeking new employment in the same trade or business if the expenses are directly connected with such trade or business. Mrs. Temple claimed a deduction for the cost of a subscription to the Times Union as a job search expense. In view of Mrs. Temple's acknowledgment that she looked through the

newspaper before she became a nurse, the Administrative Law Judge found her claim that she read the newspaper mostly for the ads to see what employment opportunities were available for nurses, an attempt to improperly convert a nondeductible personal expense into a deductible expense.

The Administrative Law Judge also found that the mileage expenses claimed by Mr. and Mrs. Temple for job search expenses were not properly documented. A log reporting total mileage, business mileage and other personal mileage driven is required. Here, petitioners' documentation did not include the required log. Accordingly, the Administrative Law Judge found that petitioners had not carried their burden to establish entitlement to the deduction.

Upon audit, the Division disallowed a portion of the deduction claimed for Mrs. Temple's work clothing since it determined that Mrs. Temple failed to demonstrate that the clothing she bought at department stores was not suitable for general or ordinary wear. With respect to those items which were disallowed, the Division contended that the associated costs, such as mileage to purchase the items, were also properly disallowed. The Administrative Law Judge rejected petitioners' argument that the distinctive nature of nurses uniforms makes them *per se* deductible (***see***, ***Bradley v. Commissioner***, T.C. Memo 1996-461, 72 TCM 1001 [which held, among other things, that a nurse was not entitled to a deduction for the cost of uniforms because no evidence was offered as to whether the uniforms could be worn as ordinary clothing]). With respect to Mrs. Temple's purchases, the Administrative Law Judge found that the clothing she purchased was adaptable to general usage and, therefore, properly disallowed. The Administrative Law Judge found irrelevant the arguments petitioners proffered using official notice as their basis.

The Division also disallowed the deductions claimed by Mr. Temple for safety boots and safety glasses, arguing that the deductions were properly disallowed because Mr. Temple's explanation was not credible. The Administrative Law Judge agreed and found it dubious that a person residing in New York would travel to a ski shop in Vermont to purchase safety boots for work when there are many stores closer to petitioners' home. The Administrative Law Judge found that the same could be said of the decision to purchase frames from Sunglass Hut. The Administrative Law Judge pointed out that compounding the difficulty in accepting petitioners' explanation is the fact that there is a clear pattern of attempting to shift nondeductible personal expenses to deductible expenses (e.g., automobile expenses and newspaper subscriptions). Under the circumstances, the Administrative Law Judge concluded that petitioners had not sustained their burden of proof of establishing that the Division improperly disallowed the deductions for the safety boots and sunglasses.

The Administrative Law Judge also took a jaundiced view of petitioners' claim that detergents they purchased were used exclusively to clean work clothes. To accept petitioners' position, the Administrative Law Judge said, one would have to accept the proposition that there was no personal use of these items.

The Administrative Law Judge noted that petitioners failed to present any evidence supporting the abatement of the penalties. Accordingly, other than the limited adjustments made as discussed above, the Administrative Law Judge denied the petition.

ARGUMENTS ON EXCEPTION

Petitioners argue that they have shown they were engaged in a business for profit within the meaning of IRC § 183. Petitioners urge that the Administrative Law Judge failed to take into

account the long lead time in design and develepment of an innovated product. Further, petitioners state, IRC § 174 allows a taxpayer to elect to currently expense research and experimental expenditures. According to petitioners, the Administrative Law Judge failed to take into consideration the potential for enormous profits inherent in the type of technological innovation at issue with Tesco.

Petitioners also take exception to the Administrative Law Judge's finding that they failed to produce evidence sufficient to support their claimed casualty losses, expenses and deductions.

The Division urges that we affirm the determination of the Administrative Law Judge.

OPINION

Section 174(a)(1) of the IRC allows a taxpayer to deduct research and experimental expenses which are paid or incurred during the taxable year "in connection" with a trade or business not chargeable to a capital account. This section applies to research or experimental expenditures only to the extent that the amount thereof is "reasonable under the circumstances" (26 USC § 174[e]). Under early interpretations of IRC § 174(a)(1), research or experimental expenses were held to be not deductible unless they were incurred or paid after the actual commencement of business. The Supreme Court departed from this approach in its decision and opinion in ***Snow v. Commissioner*** (416 US 500, 40 L Ed 2d 336). Accordingly, since the decision in ***Snow,*** a taxpayer need not be engaged in a trade or business at the time of expenditure in order to qualify for a deduction under IRC § 174(a)(1), but ***Snow*** did not eliminate the trade-or-business requirement. The trade-or-business requirement continues to limit the scope of IRC § 174 to activities carried on with the goal of realizing a profit (***see***, ***Green v. Commissioner***, 83 T.C. 667). To paraphrase the Court in ***Diamond v. Commissioner*** (930

F2d 372, 91-1 USTC ¶ 50,186), the question is not whether it is possible in principle, or by further contract, to engage in a trade or business, but whether, in reality, petitioners possessed the capability and the objective intent during the subject years to enter into a new trade or business in connection with their proposed product. Put another way, to qualify for a deduction under § 174, petitioners' evidence must establish that they had a "realistic prospect" and intent *at the time of the expenditures* that they would enter a trade or business involving the technology being developed (***Lewin v. Commissioner***, 335 F3d 345**,** 2003-1 USTC ¶ 50,330***; Kantor v. Commissioner***, 998 F2d 1514, 93-2 USTC ¶ 50,433 [wherein it was held that a taxpayer demonstrates such a prospect by manifesting both the objective intent to enter such a business and the capability of doing so]; ***Diamond v. Commissioner***, ***supra***). Internal Revenue Code § 183 provides, generally, that where an activity is not engaged in for profit, deductions attributable to such activity are allowable only to the extent of income from such activity. Resolution of this issue, in turn, rests on whether the taxpayer had an actual and honest objective of making a profit from his purported business activity (***see***, ***Dreicer v. Commissioner***, ***supra***). The existence of a profit motive is an important factor because it distinguishes between an enterprise carried on in good faith as a trade or business and an enterprise merely carried on as a hobby (***see***, ***International Trading Co. v Commissioner,*** 275 F 2d 578, 60-1 USTC ¶ 9335).

Based on all of the evidence before us, we find that petitioners have failed to carry their burden of proving by clear and convincing evidence that *in 1996 and 1997 (the time of their expenditures)* that they had a realistic expectation (as opposed to a hope) of entering a trade or business involving the flush valve. While Mr. Temple may have had the capability of operating a trade or business, the record does not support a finding that he possessed the objective intent in

1996 and 1997 of doing so (***see***, ***Lewin v. Commissioner***, ***supra***). We note, in particular, that petitioners' evidence failed to demonstrate a clear business plan of how Mr. Temple could bring the flush valve to market (if it was ever successfully developed), a financial plan, business loans, or revenues or profits or the realistic expectation of profits.

Petitioners have the burden of refuting the Division's disallowance of their deductions and of establishing their entitlement to the claimed expenses (***see***, Tax Law § 689[e]). Petitioners' documentation of their claimed business expenses failed to show that said expenses were in fact business related, rather than personal. Even if petitioners' evidence had shown that Tesco was a business engaged in for profit for purposes of IRC § 183, petitioners would still not have prevailed based on this record, because their documentation fails to prove that the claimed expenditures were business related.

Petitioners have also failed to carry their burden of showing that during 1996 and 1997, Mr. Temple's activities with Tesco were engaged in with the objective of making a profit within the meaning of IRC § 183. Petitioners' evidence, and certainly Mr. Temple's testimony, does not rise to the level of clear and convincing evidence. The Administrative Law Judge found, and we agree, that Tesco was a mechanism for shifting petitioners' nondeductible personal expenses to deductible business expenses.

We affirm the remainder of the determination of the Administrative Law Judge for the reasons stated therein. After a thorough review of the record and the arguments made thereon, we find that the Administrative Law Judge has completely and correctly addressed each of the issues presented. Petitioners offered no evidence below and, have raised no arguments on exception, that would justify our modifying the determination in any respect.

Accordingly, it is ORDERED, ADJUDGED and DECREED that:

1. The exception of William and Dawn Temple is denied;

2. The determination of the Administrative Law Judge is affirmed;

3. The petition of William and Dawn Temple is granted to the extent indicated in conclusions of law "F" and "G" of the Administrative Law Judge's determination, but is otherwise denied; and

4. The Notice of Deficiency, dated November 26, 1999, as modified in accordance with paragraph "3" above, is sustained.

DATED: Troy, New York
July 8, 2004

/s/Donald C. DeWitt
Donald C. DeWitt
President

/s/Carroll R. Jenkins
Carroll R. Jenkins
Commissioner