

**STATE OF WISCONSIN
TAX APPEALS COMMISSION**

WALTER J. AND JUDY A. BACKLUND,

**DOCKET NOS. 06-I-67
06-I-68**

Petitioners,

vs.

DECISION AND ORDER

WISCONSIN DEPARTMENT OF REVENUE,

Respondent.

DIANE E. NORMAN, ACTING CHAIRPERSON:

These matters came before the Commission for a hearing on May 17, 2007. Petitioners, Walter J. Backlund and Judy A. Backlund (“petitioners”), appeared in person and were represented by Richard Zdanowski, CPA. Respondent, Wisconsin Department of Revenue (“Department”), was represented by Attorney Mark S. Zimmer. The parties presented testimony and evidence at the hearing.

Having considered the entire record before it, the Commission finds, concludes, and orders as follows:

JURISDICTIONAL FACTS

1. On June 14, 2004, the Department sent a Notice of Amount Due to petitioners for an assessment of income tax plus interest in the amount of \$2,410.19 for the year 1999 (Exhibit 1). On June 21, 2004, the Department sent a Notice of Amount Due to petitioners for an assessment (together with the 1999 assessment, the “assessments”) of income tax plus interest in the amount of \$6,027.45 for the tax years 2000 and 2001 (together with 1999, the “period under review”) (Exhibit 2).

2. By letters dated July 30, 2004, petitioners filed requests for redetermination of the assessments (Exhibits 3 and 4).

3. Under the date of January 16, 2006, the Department sent Notices of Action to petitioners denying their petitions for redetermination (Exhibits 5 and 6).

4. On February 25, 2006, petitioners filed timely petitions for review of the assessments with the Commission by certified mail.

OTHER FACTS

5. Petitioners purchased a 10-bedroom Queen Anne style home in Milwaukee in 1998 which they intended to use as their personal residence and operate as a bed and breakfast (the "House"). After extensive renovations, petitioners opened the Acanthus Inn Bed and Breakfast as a business (the "B & B") at the House on October 1, 1999.

6. The Department based the assessments on dimensions found in blueprints of the House that were provided by petitioners. Petitioner Walter Backlund agreed that these measurements were correct in a deposition prior to the hearing (Exhibit D), but at the hearing he testified that the measurements were different when he personally measured the rooms of the House. These measurements were slightly different from the blueprint measurements and not substantiated with any other evidence.

7. In addition to running the B & B, both petitioners are also employed full-time as nurses.¹ Petitioners operate the B & B by staggering their work schedules so that one of them is physically present in the House most of the time.

8. B & B rooms are not rented to guests every night.

9. Petitioners also run a side business selling antique lighting fixtures over the internet.

10. During the period under review, petitioners also expended money for seminars, literature and sample products from a company called Market America. Petitioners provided no substantiation of these expenses or any evidence to show that these expenses were related to the B & B.

11. Petitioners and the Department agreed that a small portion of the House basement was dedicated to personal use by the petitioners, that the second floor was exclusively used as a bed and breakfast and/or apartment with no personal use, and that the third floor's only personal use was the space used for petitioners' bedroom.

12. Petitioners testified that on the first floor of the House, the only rooms that were used both for the B & B and for personal uses included the kitchen, back hallway, back entryway, bathroom, pantry and staircase. They testified that all other portions of the first floor were used exclusively for the B & B with no personal use.

13. The Department's assessments are based in part on its determination that all of the first floor of the House was used for both personal and business purposes. At the hearing, the Department conceded that the third parlor located on the first floor was used exclusively for the B & B and had no personal use by petitioners.

¹ During a portion of the period under review, petitioner Walter Backlund was a full-time student until he graduated and obtained full-time employment as a nurse.

14. The disputed portions of the first floor of the House that petitioners claim are used exclusively for B & B purposes include the enclosed front porch, the front entryway, the front/Ladies' parlor, the dining room, the Music room/second parlor, the Iris room/office and storage closets. Petitioners both testified that the only rooms in the House that they ever used for their own personal use were the third-story bedroom, the back entry and hallway, the kitchen and pantry, the first-floor bathroom, the basement staircase and a small portion of the basement.

15. Petitioner Walter Backlund testified that he did use the Iris room/office on occasion for personal internet searches and computer work. He also stated that he watched television in the front/Ladies' parlor on rare occasions and that his personal guitar was in the Music room/second parlor.

16. Petitioners both testified that while friends and relatives sometimes stayed at the House, they always paid as if they were regular paying guests of the B & B.

17. Petitioners testified that they did entertain in the House on occasion, but that all entertaining was done to advertise the B & B and never for personal entertaining.

18. Petitioners provided gourmet breakfasts to the guests of the B & B that were prepared to order. Petitioners testified that their grocery receipts showed that the average breakfast cost \$28 per guest/per breakfast in 1999 and \$21 per guest/per breakfast in 2000 and 2001.

19. At the hearing, petitioners provided samples of grocery receipts for the period under review to show the grocery expenses of the B & B. Any items on the

grocery receipts that were breakfast items were marked as B & B expenses. Petitioners testified that they rarely ate at the House and never ate leftovers from the breakfasts provided to the B & B guests.

20. The Department allowed petitioners to deduct \$10 for groceries for each B & B guest per day of stay for the period under review.

21. During 2000 and 2001, petitioners landscaped exterior areas of the House to provide curb appeal and garden walkways for guests of the B & B. Petitioners testified that the House required landscaping to have the necessary curb appeal to attract customers of the B & B.

ISSUES

1. What portion of the House is used exclusively for business purposes?
2. Are the landscaping expenses for the House deductible as expenses of the B & B?
3. What grocery expenses are B & B expenses for the period under review?
4. Are the expenses for Market America deductible as expenses of the B & B?

CONCLUSION OF LAW AND OPINION

Assessments made by the Department are presumed to be correct, and the burden is upon the petitioner to prove by clear and satisfactory evidence in what respects the Department erred in its determination. *Edwin J. Puissant, Jr. v. Dep't of Revenue*, Wis. Tax Rptr. (CCH) ¶ 202-401 (WTAC 1984); Wis. Stat. § 77.59(1). Tax

exemptions, deductions, and privileges are matters of legislative grace and will be strictly construed against the taxpayer. *Fall River Canning Co. v. Dep't of Taxation*, 3 Wis. 2d 632, 637, 89 N.W.2d 203 (1958).

Exclusive Use as Bed and Breakfast

In general, Wisconsin follows federal law with respect to income tax. Section 162(a) of the Internal Revenue Code provides that there shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business.

Normally, deductions of expenses for maintaining a home or dwelling are not allowed under Section 262 of the Code. However, if a taxpayer uses part of the house as his place of business, such expenses as are properly attributable to such place of business are generally deductible as business expenses. Section 280A(c)(1)(B) of the Code provides that even if a dwelling is used as a residence by the taxpayer, expenses are deductible if they are applicable to a portion of the dwelling unit which is exclusively used on a regular basis as a place of business which is used by patients, clients, or customers in meeting or dealing with the taxpayer in the normal course of his trade or business.

According to IRS Letter Ruling 8732002 (1987), "exclusive use" of a portion of a taxpayer's dwelling unit means that the taxpayer must use a specific part of the dwelling unit **solely** for the purpose of carrying on his trade or business. (Emphasis added.) The use of a portion of a dwelling unit for both personal and business purposes does not meet the exclusive use test. Thus, a taxpayer who uses a den in his dwelling

unit for writing legal briefs, preparing tax returns, or engaging in similar activities, as well as for personal purposes, will be denied a deduction for expenses allocable to the business use of that portion of his residence.

Petitioners have not proven by clear and satisfactory evidence that the Department erred in finding that most of the first floor of the House (all but the third parlor) was used for both personal and business purposes. Petitioners testified that they only used their third-story bedroom, the kitchen, back hallway, back entryway, bathroom, pantry and staircase. However, petitioner Walter Backlund admitted in his testimony that petitioners sometimes watched television in the front parlor, sometimes did personal work in the office/Iris room and that he played his guitar on occasion in the music room. The House is petitioners' home, and B & B rooms were not rented out to customers every night of the period under review. Even though petitioners both work full-time as nurses and also work at running the B & B, it was reasonable for the Department to determine that petitioners used the common areas of the first floor of the House for some personal purposes along with the business purposes of the B & B.

Gardening and Landscaping Expenses

Petitioners argue that landscaping expenses for the exterior of the House should be deductible as B & B business expenses because an attractive exterior attracts customers to the B & B. However, the exterior of a home is considered a common area that is not exclusively used for business purposes. Letter Ruling 8732002 (1987). Therefore, petitioners' landscaping expenses for the House are not deductible under Section 162 of the Code. Also, expenses incurred in maintaining common exterior areas,

such as expenses for yard work or gardening, also would not be deductible under section 162.

Grocery Expenses

Petitioners maintain that they spent, on average, \$28 per guest/per breakfast for 1999 and \$21 per guest/per breakfast for 2000 and 2001 for their B & B guests. To substantiate these amounts, petitioners presented a sampling of grocery store receipts and testimony as to how the breakfasts were made to order for guests (Exhibit G). This evidence is not a complete nor an adequate substantiation of the money actually spent on groceries for the B & B and therefore is insufficient to rebut the Department's assessments.

Moreover, petitioners' testimony that they never purchased breakfast items for themselves and that all breakfast items were either eaten by guests of the B & B or thrown away is not credible. According to their own testimony, petitioners did eat some of their meals in the House and shared the kitchen with the B & B.

The Department allowed petitioners to deduct \$10 for groceries per guest of the B & B per breakfast. Under the rule of "indulgence" established by the U.S. Court of Appeals for the Second Circuit in *G. M. Cohan*, 2 USTC ¶489 (known as the *Cohan* rule), when a taxpayer is unquestionably entitled to a deduction, but the amount is not adequately substantiated, the court will make an allowance based upon an estimate. In this case, the Department made an estimate for the grocery expenses that has not been shown to be unreasonable by petitioners in any specific way.

Market America Expenses

Petitioners testified that they spent money in a business venture with a company called Market America that should be a business deduction of the B & B. They earned no income from this venture and failed to show how this venture was an expense of the B & B. Moreover, petitioners had no substantiation of their expenses for this venture. Therefore, petitioners failed to show by any evidence that the Department erred in not allowing petitioners to deduct any expenses of the Market America business venture.

ORDER

The Department's actions on petitioners' petitions for redetermination (as amended with the concession that the third parlor on the first floor of the House is used exclusively for the B & B) is affirmed.

Dated at Madison, Wisconsin, this 9th day of August, 2007.

WISCONSIN TAX APPEALS COMMISSION

Diane E. Norman, Acting Chairperson

David C. Swanson, Commissioner

ATTACHMENT: "NOTICE OF APPEAL INFORMATION"