

Daffodil Preparatory School

In 2001, Thomas and Elizabeth Daffodil purchased a house, with adjoining garage, for \$185,625. The garage was valued at that time for fire insurance purposes at \$9,000. Thomas teaches mathematics at the Peony Regional College and has a salary of \$55,000 per year. Elizabeth cares for their three (3) children, ages 9, 7 and 5. The town of Peony has no nursery schools. In the summer of 2005, Elizabeth and some of her neighbors got together to establish a school for children ages 3 to 6, which would meet in the Daffodil garage. The Daffodil's youngest daughter, Daisy, would attend the school.

The original plan called for each interested family (except the Daffodils) to donate \$200 to a general fund for purchasing school supplies and for fixing up the garage. The garage, which had electricity but was not suitable for use as a classroom, would be paneled, and a wooden floor and a gas heater would be installed. Participating parents were to donate labor for the renovations. In addition, the parents would be expected to assist in teaching the students according to a schedule to be prepared by Elizabeth.

Including the Daffodils, six (6) families participated in the school for academic year 2005-2006. The entire \$1,000 collected ($\200×5) was expended for necessary school expenses in the fall of 2005, but detailed records were not kept. The Daffodils do have receipts, however, for the following expenditures:

Books	\$ 30.00
Portable chalkboard	25.00
Paper, paint, glue, etc.	18.00
Rug	90.00
Gas Heater	200.00
Building supplies	365.00
Total	\$728.00

Elizabeth estimates that the remaining \$272.00 was spent in 2005 on incidental teaching supplies and building supplies. The Daffodils spent an additional \$200 in 2005 for building supplies from their own funds. The renovation work on the garage was done by the parents and some friendly neighbors. No one was paid for his labor. The Daffodils also paid for the heat and utilities for the garage. The exact amounts expended are unknown, since there is a common gas and electric meter for the house and garage. Based on comparisons with the gas and electricity bills in the prior year, Thomas estimates that the additional gas for the heater cost from \$200 to \$300 and the additional electricity cost another \$75 to \$100.

During academic year 2005-2006, Elizabeth taught at the school every day, and two other mothers taught on alternate days. Each child, with the exception of the Daffodil child and two other children whose mothers taught regularly in the school, paid tuition of \$80 per semester, for a total tuition of \$480 ($\$80 \times 2 \times 3$). Elizabeth kept \$240 of the fees for herself and divided

the remaining \$240 between the two other teachers.

Over the summer of 2006 it became apparent that Elizabeth would have to take over full responsibility for the school in order for it to continue. Two of the students from academic year 2005-2006 were entering kindergarten and one had moved to another city. Only one of the two assistant teachers was willing to continue, and then only on a substitute basis. Elizabeth, however, was anxious to keep the school going. She felt her own daughter had progressed extremely well in the school and would be keenly disappointed if it folded. She also enjoyed teaching young children and experimenting with new methods of instruction.

Elizabeth ran an advertisement in the local newspaper, announcing that she was accepting applications for academic year 2006-2007. Tuition was set at \$200 per semester. Twelve students (in addition to the Daffodil daughter) applied and all were accepted. During the fall of 2006, \$2,400 in tuition was received. An additional \$2,400 was collected for the second semester. Elizabeth has receipts for expenditures of \$110 for teaching supplies during the fall of 2006. She estimates that another \$75 was spent on incidentals. She also hired the mother of one of the new students as a teacher and paid her \$1,000 per semester. For the second semester, she has receipts for purchases of \$200 of incidental teaching supplies. She made no other expenditures in that year that she can remember.

The Daffodils did not include any amounts in income or take any deductions in respect of the school on their 2005 tax return. During January of 2007, however, Thomas purchased a book, *How to Save Money on Taxes Without Risking Jail*, which promised the reader a tax savings of at least \$100 or a refund of the \$12.00 purchase price. After reading the book, Thomas got the idea to treat the school operation as a business and to deduct the "business losses" from his income. He prepared a tentative profit and loss account for 2006 as follows:

Profit & Loss Account for 2006

<i>Income</i>		
1. Tuition Fees 2005-2006 earned by Elizabeth in 2006		\$ 240
2. Tuition Fees 2006-2007 earned by Elizabeth in 2006	2,400	
Total	\$2,640	
<i>Expenses</i>		
3. Building Supplies Paid by Daffodils		\$ 200
4. Gas	300	
5. Electricity	100	
6. Teaching Supplies (\$110 + \$75)	185	
7. Depreciation on School Building ($\$185,625 \times 1/5 \times 1/27.5$)	1,350	
8. Salary to Teacher	1,000	
Total	3,135	
<i>Net Profit or (Loss)</i>		

Total income	\$2,640
Total expense	-3,135
Net Loss	(\$ 465)

The Daffodils filed the appropriate tax forms for reporting profit and loss and attached them to their 2006 joint return. They also attached the following explanatory note:

Loss was realized on operation of preparatory school. Depreciation deduction of \$1,350 was computed under IRC §§ 167 & 168, using a useful life of 27.5 years and the straight-line method. Basis was determined by allocating 1/5 of cost of house and garage to garage, using total floor space as method of allocation. Some of the expense items necessarily were subject to estimation.

Elizabeth expanded the school for academic year 2007-2008, admitting 22 students. To cover her increased costs and to make a profit, she raised the tuition to \$1,200 per semester. Thus her gross tuition for the fall of 2007 is \$26,400, and her gross tuition for the spring of 2008 is also \$26,400. She found a more suitable location for the school at an old church, because the garage was not really large enough for 22 students. Her children, moreover, wanted to use the garage as a play area. Her rent for the church is \$100 per month. She added a second teacher and raised the salary for teachers to \$3,000 per semester. Over the summer of 2008, Thomas got a job in Washington, D.C. and the school is reluctantly abandoned.

Questions

1. For 2006, were the Daffodils engaged in business? If so, at what date? What are the arguments to be made on this issue by the taxpayer and by the IRS? What about 2007? 2005?
2. Which deductions taken for 2006 by the Daffodils were proper? \$200 building supplies? \$400 utilities? \$185 teaching supplies? \$1,584 depreciation? \$1,000 salary? Was Thomas correct to ignore the expenses for academic year 2005?
3. Has Thomas correctly calculated the income from the school for 2006? What is the proper treatment of the donated labor in 2005 and 2006? Of the tuition received by Elizabeth and paid to the volunteer teachers?
4. Does Section 183 apply to this set of transactions? How about Section 280A? If so, what result? Is the garage a "dwelling unit" within the meaning of Section 280A.
5. Can the parents who pay tuition in 2005 get a child care credit? In 2006? In 2007? What is the test? Can the Daffodils get the credit?
6. In 2007, what tax consequences when the garage was converted back to a playroom? What tax

consequences if the Daffodils sell their house in 2008 and use the proceeds to buy a new one in Washington, D.C.? Any difference in result if the sale is made before or after the conversion of the garage/school into a playroom?

7. If the Daffodils pay interest on their mortgage of \$10,000 for 2006, what effect? Is Section 163(d) applicable? Section 469? Section 163(h)? What about taxes on the home? Same questions for 2007. (Note: We have not gotten to the interest deduction yet.)

8. Assuming some loss is allowable for 2006, what arguments are there for considering the deduction to be a tax expenditure? Evaluate the arguments. Contrast the usefulness of this “nursery school” deduction with the credit for child care.

9. When the school is moved to a rented church for academic year 2007-2008, what tax consequences? Does the tax picture change because Elizabeth now has 22 students and her daughter is no longer in the school? Is it important whether or not the school is profitable? Does it matter that the school is closed for academic year 2008/2009?

10. Any income resulting from the free tuition to the daughter? How much, if any?

11. What advice would you have given to Thomas in preparing his tax return for 2006 if he had hired you as his tax attorney? Same question for 2007 and 2008.

Code Sections: 21, 61, 132, 162, 165, 167, 168, 183, 212, 262, 280A, 1245