S. KENT & LISA D. GREMMELS 5800 Meadow View Drive Trussville, AL 35173,	§ §	STATE OF ALABAMA DEPARTMENT OF REVENUE ADMINISTRATIVE LAW DIVISION
Taxpayers,	§	DOCKET NO. INC. 05-112
v.	§	
STATE OF ALABAMA DEPARTMENT OF REVENUE.	§	

FINAL ORDER

The Revenue Department assessed S. Kent and Lisa D. Gremmels (together "Taxpayers") for 2001 and 2002 Alabama income tax. The Taxpayers appealed to the Administrative Law Division pursuant to Code of Ala. 1975, §40-2A-7(b)(5)a. A hearing was conducted on March 21, 2005. Kent Gremmels (individually "Taxpayer") and his accountant, Stephen Schniper, attended the hearing. Assistant Counsel David Avery represented the Department.

The Taxpayers bred and sold thoroughbred race horses during the years in question. The issue in this case is whether the Taxpayers' horse breeding expenses can be deducted as ordinary and necessary business expenses. That issue turns on whether the Taxpayers conducted their horse breeding activities for the primary purpose of making a profit.

The Taxpayer is a full-time chiropractor. He and his wife live on a 17 acre farm in Jefferson County, Alabama. The Taxpayer worked with and enjoyed race horses while growing up in Illinois. He testified that his long-term ambition was to develop a horse breeding and racing program.

The Taxpayers purchased a thoroughbred race horse in the early 1990's. They raced the horse in Alabama and at tracks along the East Coast. The horse was

moderately successful until it broke a leg and could no longer race. The Taxpayers subsequently bred the horse with a stud in Kentucky. Unfortunately, the horse died before giving birth.

The Taxpayers bought another race horse in 1995, but the horse was unsuccessful. They acquired another horse in 1996 and began breeding both animals. During the mid-1990's, the Taxpayers also converted their farm from a cattle farm to a horse farm to accommodate the horses they intended to breed.

Before 1999, the Taxpayers paid from $2,000 to $6,000 to have their horses bred with studs in Kentucky. To enhance the pedigree of their horses, the Taxpayers decided in 1999 to breed their horses with higher pedigree studs under foal share agreements. That is, instead of paying a large stud fee to breed a horse with a premier stud, which the Taxpayers could not afford, they agreed to give the stud owner a percentage of the offspring in lieu of the stud fee.

The Taxpayers bred one of their horses, Muted Rhythm, in late 1999 pursuant to a foal share agreement. Unfortunately, the horse died of brain cancer in December 2000, three weeks before giving birth. They later bred another mare, and gave the stud owner a 50 percent interest in the offspring in lieu of a $50,000 stud fee. The Taxpayers anticipated selling the offspring in September 2001 for $80,000 to $100,000. However, just before the scheduled sale, the World Trade Center was bombed, which sent shock waves throughout the thoroughbred race horse business. Consequently, the horse sold for only $19,000, all of which went to the stud owner.

In an effort to make their breeding activities more profitable, in 2003 the Taxpayers began breeding their horses in Illinois instead of Kentucky because the owner of an Illinois-bred horse gets a percentage of the winnings.

The Taxpayers began deducting their horse breeding-related expenses in 1997. From 2001 through 2004, they incurred net losses from the breeding activities of approximately $43,500, $35,000, $17,000, and $10,000, respectively.

The Taxpayer spends considerable time caring for his horses. He explained that he feeds his horses every morning before he goes to work and after he returns home in the afternoon. He also tends to his horses during lunch on Mondays, Wednesdays, and Fridays, on Tuesday afternoons, and on weekends.

Code of Ala. 1975, §40-18-15(a)(1) allows a deduction for all ordinary and necessary expenses incurred in a trade or business. Section 40-18-15(a)(5) also allows a deduction for nonbusiness losses incurred in a transaction entered into for profit. Both statutes are modeled after their federal counterparts, 26 U.S.C. §§162 and 212, respectively. Consequently, federal case law interpreting the federal statutes should be followed in interpreting the similar Alabama statutes. *Best v. Dept. of Revenue*, 417 So.2d 197 (Ala. Civ. App. 1981).

In *Engdahl v. Commissioner of Internal Revenue*, 72 T.C. 659, 1979 WL 3705 (U.S. Tax Ct. 1980), the U.S. Tax Court addressed the issue of whether the taxpayer's horse breeding activities constituted a trade of business. The Tax Court opined as follows:

> Breeding and raising horses for sale may constitute a trade or business for purposes of section 162. *Commissioner v. Widener*, 33 F.2d 833 (3d Cir. 1929). Whether it does or not, depends on whether petitioners engaged in the venture with the predominant purpose and intention of making a profit.

> *Allen v. Commissioner*, 72 T.C. 28 (1979); *Dunn v. Commissioner*, 70 T.C. 715, 720 (1978); *Churchman v. Commissioner*, 68 T.C. 696, 701 (1977); *Jasionowski v. Commissioner*, 66 T.C. 312, 319 (1976); *Benz v. Commissioner*, 63 T.C. 375, 383 (1974). Petitioners' expectation of profit need not be reasonable, but petitioners must establish that they continued their activities with a bona fide intention and good-faith expectation of making a profit. Sec. 1.183-2(a), *Allen v. Commissioner*, *supra* at 33; *Jasionowski v. Commissioner*, *supra* at 321; *Benz v. Commissioner*, *supra* at 383; *Bessenyey v. Commissioner*, 45 T.C. 261 (1965), aff'd. 379 F.2d 252 (2d Cir. 1967). Section 1.183-2(b), Income Tax Regs., lists some of the relevant factors to be considered in determining whether an activity is engaged in for profit. These factors include: (1) The manner in which the taxpayer carried on the activity; (2) the expertise of the taxpayer or his advisers; (3) the time and effort expended by the taxpayer in carrying on the activity; (4) the expectation that assets used in the activity may appreciate in value; (5) the success of the taxpayer in carrying on other similar or dissimilar activities; (6) the taxpayer's history of income or loss with respect to the activity; (7) the amount of occasional profit, if any, which is earned; (8) the financial status of the taxpayer; and (9) whether elements of personal pleasure or recreation are involved.
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> The issue is one of fact to be resolved not on the basis of any one factor but on the basis of all the facts and circumstances. Sec. 1.183-2(b), Income Tax Regs.; *Allen v. Commissioner*, *supra* at 34. See *Boyer v. Commissioner*, 69 T.C. 521 (1977), on appeal (7th Cir., July 7, 1978). Greater weight is to be given to objective facts than to petitioners' mere statement of their intent. Sect. 1.183-2(a), Income Tax Regs.; *Churchman v. Commissioner*, *supra* at 701.

Engdahl 72 T.C. at 665, 666.

Applying the nine factors listed in Reg. 1.183-2(b), the Tax Court concluded in *Engdahl* that the taxpayers intended to derive a profit from their horse-related activities. The related expenses were thus allowed. Likewise, the evidence in this case establishes that the Taxpayers intended to make a profit from their horse breeding activities.

The Taxpayers maintained separate books and records of their horse breeding activities, which allowed them to monitor how much they were spending on their horses. They also changed their method of operating in order to increase their likelihood of

making a profit. Specifically, they began breeding their horses using foal share agreements, which they hoped would improve the pedigree of their horses. The sale of a single well-bred horse could result in a substantial gain. The Taxpayers also started breeding their horses in Illinois instead of Kentucky, which again shows an intent to make the activity more profitable.

The Taxpayer is knowledgeable concerning horses, and he regularly consulted with top breeders and others concerning how to improve his stock. He also spent a great deal of time tending to his horses. Most of the work was mundane, which indicates that he was not in it purely for pleasure.

The fact that the Taxpayers have never realized a net profit from their breeding business also does not conclusively establish that the activity was not entered into for profit. The Tax Court in *Engdahl* addressed the issue, as follows:

> We note, however, that a series of losses during the initial state of an activity does not necessarily indicate that the activity was not engaged in for profit. Section 1.183-2(b)(6), Income Tax Regs. The start-up phase of an American saddle-bred breeding operation is 5 to 10 years. The years in issue fall within this start-up period. See *Farris v. Commissioner*, *supra*. In addition, petitioners' losses can be explained by a series of unfortunate events beyond their control.

Engdahl, 72 T.C. at 669.

The Taxpayers' business was in its five to ten year start-up period during the subject years, and the business has incurred declining losses in each year. The Taxpayer testified that he expected to make a profit in 2005. Also, as in *Engdahl*, the Taxpayers' losses were due in part to unfortunate and unforeseen events. Several of the Taxpayers' horses died unexpectedly, and the events of September 11 forced the Taxpayers to sell a valuable horse at a substantial discount. But for the unexpected

deaths and the September 11 terrorist attacks, the Taxpayers could have perhaps realized a profit in the subject years.

Finally, while the Taxpayer obviously enjoys being around horses, that fact alone does not negate his intent to profit from the activity. As stated in *Engdahl*, "there is no 'benefit' in losing money." *Engdahl*, 72 T.C. at 670. Viewing all of the facts together, the Taxpayers did not engage in their horse breeding activities primarily for pleasure or to create losses to shield other income.[1] Rather, they had a genuine hope and expectation that they would be successful and eventually realize a profit. Their related expenses are thus deductible.

The final assessments in issue are voided.[2]

This Final Order may be appealed to circuit court within 30 days from the date of this Order pursuant to Code of Ala. 1975, §40-2A-9(g).

Entered July 18, 2005.

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BILL THOMPSON
Chief Administrative Law Judge

[1] The Taxpayers' representative asserted at the March 21 hearing that the IRS had audited the Taxpayers for 1999 and 2000 and had allowed the horse breeding-related expenses claimed by the Taxpayers. That would further support the Taxpayers' position. See, *State, Dept. of Revenue v. Dawson*, 504 So.2d 312 (Ala. Civ. App. 1987). Unfortunately, the representative failed to submit proof that the IRS had reviewed and allowed the deductions.

[2] For a contrary finding, see *Sparks v. State of Alabama*, Inc. 04-888 (Admin. Law Div. 5/19/05); *Tondera v. State of Alabama*, Inc. 02-870 (Admin. Law Div. 6/26/03); and *Dudewicz v. State of Alabama*, Inc. 02-367 (Admin. Law Div. 1/6/03). For a similar finding, see *State of Alabama v. Lipscomb*, Inc. 92-288 (Admin. Law Div. 3/24/93); and *State of Alabama v. Dawson*, Inc. 85-130 (Admin. Law Div. 11/19/85), rev'd by the Court of Civil Appeals in *State, Department of Revenue v. Dawson*, *supra*.