

REGINALD K. & RITA K. BLANKENSHIP§  
2786 COUNTY ROAD 460  
MOUNT HOPE, AL 35651, §

STATE OF ALABAMA  
DEPARTMENT OF REVENUE  
ADMINISTRATIVE LAW DIVISION

Taxpayers, §

DOCKET NO. INC. 06-1215

v. §

STATE OF ALABAMA §  
DEPARTMENT OF REVENUE.

### **OPINION AND PRELIMINARY ORDER**

The Revenue Department assessed Reginald K. and Rita K. Blankenship (together “Taxpayers”) for 2003 and 2004 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 April 20, 2007. Ross Cohen represented the Taxpayers. Assistant Counsel David Avery represented the Department.

Reginald Blankenship (individually “Taxpayer”) is in his mid-40’s. He was raised on a farm in Lawrence County, Alabama, where he learned how to raise horses and cows and perform other farm chores. He has worked full-time for Delphi, a General Motors parts supplier, for over 25 years. The Taxpayer’s wife also worked full-time for Delphi during the subject years, but has since retired for health reasons.

The Taxpayer purchased 18 acres of farmland in Lawrence County in 1981 or 1982. He raised a few cows and horses on the land during the 1980’s. He decided in the early 1990’s to grow his farm into a profit-making venture. Toward that end, he began acquiring additional parcels of land contiguous to the original 18 acres. He currently owns 150 acres, and leases 50 more, on which he has 100 cows and 50 horses. He and his wife live on the property in a house they built in 2003 or 2004.

The Taxpayer has always done the work necessary to maintain the farm property and care for the animals, including most of the needed veterinary work. His wife also helps with the bookkeeping and miscellaneous outside chores.

Delphi downsized in 2006, and the Taxpayer had the option of leaving the company or taking a job in Kentucky. He opted to work in Kentucky. He stays in Kentucky during the week, and returns to work on his farm every weekend. His retired father sometimes helps out on the farm. He also hires part-time labor to bale hay and do other chores around the farm, as needed.

The Taxpayer purchased 18 acres in Kentucky after he was transferred in 2006. He is currently maintaining and training horses on that property. He hopes to sell the horses for a profit in due course.

The Taxpayers claimed losses from their farming activities on their 2003 and 2004 Alabama returns. The Department audited the returns, determined that the Taxpayers' farming activities were not entered into for profit, and consequently disallowed the losses in excess of the farm-related income reported in each year. It assessed the Taxpayers accordingly.

### **ANALYSIS**

Code of Ala. 1975, §40-18-15(a)(1) allows a deduction for all ordinary and necessary expenses incurred in a trade or business. That deduction is modeled after its federal counterpart, 26 U.S.C. §162. Consequently, federal case law interpreting the federal statute should be followed in interpreting the similar Alabama statute. *Best v. Dept. of Revenue*, 417 So.2d 197 (Ala. Civ. App. 1981).

The general test for whether a taxpayer is engaged in a “trade or business,” and thus entitled to deduct all ordinary and necessary business expenses, is “whether the taxpayer’s primary purpose and intention in engaging in the activity is to make a profit.” *State of Alabama v. Dawson*, 504 So.2d 312, 313 (Ala. Civ. App. 1987), quoting *Zell v. Commissioner of Revenue*, 763 F.2d 1139, 1142 (10th Cir. 1985). To be deductible, the activity must be engaged in “with a good faith expectation of making a profit.” *Zell*, 763 F.2d at 1142. As stated by the U.S. Supreme Court – “We accept the fact that to be engaged in a trade or business, the taxpayer must be involved in the activity with continuity and regularity and that the taxpayer’s primary purpose for engaging in the activity must be for income or profit. A sporadic activity, a hobby, or an amusement diversion does not qualify.” *Commissioner v. Groetzinger*, 107 S.Ct. 980, 987 (1987). But a taxpayer’s expectation of a profit need not be reasonable. Rather, the taxpayer must only have a good faith expectation of realizing an eventual profit. *Allen v. Commissioner*, 72 T.C. 28, 33 (1979). Whether the taxpayer had an intent to make a profit must be determined on a case-by-case basis from all the circumstances. *Patterson v. U.S.*, 459 F.2d 487 (1972).

Treas. Reg. §1.183-2 specifies nine factors that should be considered in determining if an activity was entered into for profit.

Factor (1). The manner in which the taxpayer conducted the activity.

Factor (2). The expertise of the taxpayer in carrying on the activity.

Factor (3). The time and effort exerted by the taxpayer in conducting the activity.

Factor (4). The expectation that the assets used in the activity will appreciate.

Factor (5). The taxpayer’s success in similar or related activities.

Factors (6) and (7). The taxpayer’s history of profits and losses, and the amounts of

any occasional profits.

Factor (8). The taxpayer's financial status.

Factor (9). The activity was for the taxpayer's personal pleasure and recreation.

This is a close case because while some of the above factors indicate that the Taxpayers' farming activities were for profit, others do not. Factors supporting the Taxpayers are that they operated the farm in a business-like manner, and although their records were not perfect, they maintained satisfactory records of their farming activities. The Taxpayer has expertise concerning how to operate a farm, and he and his wife also devoted considerable time and effort to farming. Finally, the value of the Taxpayers' farm property has appreciated in value, although that factor may not be relevant under the circumstances, see 26 CFR 1.183-1(d)(1).

Various other factors indicate that the activity was not for profit. A profit from farming was not necessary for the Taxpayers to pay their monthly living expenses because the Taxpayer was otherwise employed. The Taxpayer also enjoys being outside tending to his farm, although he sometimes may not enjoy specific chores. But the primary factor relied on by the Department is that the Taxpayers have never realized a profit from farming. As indicated, however, realizing a profit is not required for an activity to be entered into for profit.

After listing the nine factors that should be considered in determining if an activity was profit-motivated, Reg. §1.183-2 gives several examples, two of which involve farming.

Example 1. The taxpayer inherited a farm from her husband in an area which was becoming largely residential, and is now nearly all so. The farm had never made a profit before the taxpayer inherited it, and the farm has since had substantial losses in each year. The decedent from whom the taxpayer inherited the farm was a stockbroker, and he also left the taxpayer substantial stock holdings which yield large income from dividends. The

taxpayer lives on an area of the farm which is set aside exclusively for living purposes. A farm manager is employed to operate the farm, but modern methods are not used in operating the farm. The taxpayer was born and raised on a farm, and expresses a strong preference for living on a farm. The taxpayer's activity of farming, based on all the facts and circumstances could be found not to be engaged in for profit.

Example 4. The taxpayer inherited a farm of 65 acres from his parents when they died 6 years ago. The taxpayer moved to the farm from his house in a small nearby town, and he operates it in the same manner as his parents operated the farm before they died. The taxpayer is employed as a skilled machine operator in a nearby factory, for which he is paid approximately \$8,500 per year. The farm has not been profitable for the past 15 years because of rising cost of operating farms in general, and because of the decline in the price of the produce of this farm in particular. The taxpayer consults the local agent of the State agricultural service from time to time, and the suggestions of the agent have generally been followed. The manner in which the farm is operated by the taxpayer is substantially similar to the manner in which farms of similar size, and which grow similar crops in the area, are operated. Many of these other farms do not make profits. The taxpayer does much of the required labor around the farm himself, such as fixing fences, planting crops, etc. The activity of farming could be found, based on all the facts and circumstances, to be engaged in by the taxpayer for profit.

In Example 1, the activity was not for profit because the taxpayer had substantial investment income, she was not involved in operating the farm, and modern farming methods were not used. She apparently simply liked living in the rural setting that the farm provided.

In Example 4, the taxpayer was employed full-time in a factory. He nonetheless performed much of the required labor on the farm, and operated the farm in substantially the same manner as other farms in the area, which also incurred losses. Those facts were sufficient to establish that the farming was entered into for profit, despite the fact that the farm had incurred losses for 15 straight years.

The facts in this case are very similar to the facts in Example 4. The Taxpayer is employed full-time away from the farm, just as the taxpayer in the example. The Taxpayer

operates the farm in the customary manner, and importantly, he performs most all of the work relating to the farm, again just as the taxpayer in the example. If the facts in Example 4 were sufficient to overcome 15 years of losses, they are sufficient in this case to overcome losses in the years before the years in issue.<sup>1</sup>

The Department contends that the Taxpayer farms because he takes pride in his work. I do not doubt that the Taxpayer and his wife take pride in their farm, the horses they train and sell, etc. But taking pride in one's work and the results of that work does not indicate that the work was not for profit. A person can obviously take pride in a profit-motivated venture.

The Department is directed to recompute the Taxpayers' liabilities for the subject years by allowing in full the farm-related expenses claimed by the Taxpayers. A Final Order will then be entered for the adjusted amounts due.

This Opinion and Preliminary Order is not an appealable Order. The Final Order, when entered, may be appealed to circuit court within 30 days pursuant to Code of Ala. 1975, §40-2A-9(g).

Entered October 16, 2007.

---

BILL THOMPSON  
Chief Administrative Law Judge

---

<sup>1</sup> The Department claims in its brief that the "Taxpayer has experienced deep losses for more than 20 consecutive years." Department Brief at 3. There is no evidence, however, supporting that claim. The Taxpayers' attorney submitted the Taxpayers' 1996 – 2002 Alabama returns after the April 20 hearing, all of which show a loss from farming (although the farming income generally increased from year to year). But there is no evidence concerning the years before 1996. In any case, the Taxpayer explained that he did not decide to turn his farm into a profit-making enterprise until the early 1990's.

bt:dr

cc: David E. Avery, III, Esq.  
Ross N. Cohen, Esq.  
Tony Griggs