

ROBERT M. & SUE E. SMITH
232 BEAVERS ROAD
SOMERVILLE, AL 35670-6286,

§
§

STATE OF ALABAMA
DEPARTMENT OF REVENUE
ADMINISTRATIVE LAW DIVISION

Taxpayers,

§

DOCKET NO. INC. 09-543

v.

§

STATE OF ALABAMA
DEPARTMENT OF REVENUE.

§

FINAL ORDER

The Revenue Department assessed Robert M. and Sue E. Smith (jointly “Taxpayers”) for 2005, 2006, and 2007 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 September 15, 2009. The Taxpayers attended the hearing. Assistant Counsel Lionel Williams represented the Department.

ISSUE

The Taxpayers raised cattle on their farm in Morgan County, Alabama during the years in issue. The issue in this case is whether the Taxpayers properly deducted various expenses relating to the cattle-raising operation as ordinary and necessary business expenses during the subject years. That issue turns on whether the Taxpayers’ primary purpose in pursuing the activity was to make a profit.

FACTS

Robert Smith (individually “Taxpayer”) purchased a 284 acre farm in Morgan County, Alabama in 1982. He Taxpayer began buying and raising Santa Gertrudis cattle on the farm in 1985. He also built a house on the farm in that year, and has resided on the farm since that time.

The Taxpayer has constructed extensive fencing and several ponds on the farm. He has also built a barn and other buildings, and made various other improvements to the farm.

It is unclear how many animals the Taxpayer maintained at any one time because he did not maintain records showing when he purchased or sold an animal, when a calf was born, or when an animal died. The Taxpayer testified at the September 15 hearing that he currently has 35 to 40 animals on the farm, but the evidence indicates that he had approximately one-half that number during the years in issue.

The Taxpayer has never made a profit from his cattle operation. From 1996 through 2007, he claimed farm losses on his Alabama income tax returns totaling \$458,079. He claimed farm losses of \$42,268, \$51,209, and \$44,586 for the years in issue, 2005, 2006, and 2007, respectively. He reported income from the sale of livestock of \$1,510 in 2005, \$1,499 in 2006, and \$0 in 2007. He has reported total income of \$9,440 from the sale of livestock since 1998.

The Department audited the Taxpayers for the subject years and disallowed the Schedule F farming losses because it determined that the activity was not a trade or business, i.e., it was not entered into primarily for profit. The Department consequently entered the final assessments in issue.

The Department examiners determined that the activity was not for profit for several reasons. First, the Taxpayer did not operate in a businesslike manner because he failed to maintain complete records of his cattle activities. Specifically, he did not maintain profit and loss statements, cash flow statements, balance sheets, or a complete inventory of cattle showing when an animal was purchased or sold, when a calf was born, or when an animal

died. He also failed to maintain an annual depreciation schedule, and he paid his farm-related expenses out of his personal checking account.

Second, the examiners concluded that the Taxpayer could never realistically build his herd up to a profitable level of 100 animals, which was his goal, according to his business plan.¹

Third, the examiners relied heavily on the fact that the Taxpayer has never turned a profit from his cattle operation since 1985. They also concluded that given the Taxpayer's method of operation, he will never make a profit raising cattle.

Fourth, the Taxpayer earns substantial annual income (\$150,000 plus) working full time for Boeing in Huntsville, Alabama, and also has investment income, which allows him to continue losing money raising the cattle.

Fifth, and finally, the examiners concluded that the Taxpayer enjoys raising the cattle, thus indicating that he did so primarily for personal pleasure. A letter from one of the examiners to the Taxpayers reads in part:

It is obvious from meeting with Mr. Smith that he enjoys being a cattle farmer and takes pride in owning a small herd of Santa Gertrudis cattle. Mr. Smith grew up on a farm, has always worked (at least part-time) on a farm, and will probably continue to enjoy owning a farm as long as his health permits.

When asked if Mr. Smith would continue to raise cattle, even if the activity did not generate a profit or continued to show losses, he stated that he would – indicating there is a significant personal or recreational aspect or enjoyment to living on a farm and raising cattle.

Department Examiner's letter dated August 4, 2008 at 7.

¹ The Taxpayer formed a written business plan in 2005, after being audited by the Department for several prior years.

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). Whether the taxpayer had an intent to make a profit must be determined on a case-by-case basis from all facts and 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.

With most all cases involving the issue of whether an activity was entered into for profit, some facts in this case support the Taxpayer's claim that his farming activity was profit-motivated, and vice versa.

A fact supporting the Taxpayer's claim that his cattle farming activity is for profit is the fact that he is knowledgeable about cattle, and in particular the Santa Gertrudis and Brangus breeds. Unfortunately for the Taxpayer, a number of other facts support the Department's claim that the activity was not for profit.

The Taxpayer did not conduct the activity in a businesslike manner because he admittedly failed to keep adequate records concerning the activity. He also did not keep a separate "farm" checking account, nor did he maintain a depreciation schedule showing his depreciable assets, his cost basis in those assets, and the amount that each asset was depreciated in each year.

The Taxpayer is a successful businessman, but has had no success in activities similar to his cattle farming. He also earned over \$150,000 working for Boeing during the subject years, which shows that he was not depending on his cattle sales to make a living. It is also clear from the Taxpayer's testimony at the September 15 hearing that he enjoys

and takes personal pride and pleasure from raising the cattle. That is, he would continue the activity even if he never made a profit.

The biggest strike against the Taxpayer's position, however, is that he has never made a profit from the activity in any year since 1985. And more importantly, the Taxpayer sold only a few, if any, animals in any given year, and thus has earned little if any income from the activity. He sold only one animal in 2005 for \$1,500, only three animals in 2006 for \$1,499, and zero animals in 2007. From 1998 through the years in issue, he realized only \$9,440 in total cattle sales from the activity. The very small income from his farming activities strongly supports the Department's claim that the Taxpayer is not primarily in the activity for a profit.

The Taxpayer argues that the activity is profit-motivated because the land and building on the farm have greatly appreciated in value. But a farming activity must be considered as a separate activity from the ownership of the farm property if the income derived from farming is less than the farm-related deductions not attributable to owning the land.

Where land is purchased or held primarily with the intent to profit from increase in its value, and the taxpayer also engages in farming on such land, the farming and the holding of the land will ordinarily be considered a single activity only if the farming activity reduces the net cost of carrying the land for its appreciation in value. Thus, the farming and holding of the land will be considered a single activity only if the income derived from farming exceeds the deductions attributable to the farming activity which are not directly attributable to the holding of the land (that is, deductions other than those directly attributable to the holding of the land such as interest on the mortgage secured by the land, annual property taxes attributable to the land and improvements, and depreciation of improvements to the land.)

The Taxpayers' farming income in the subject years clearly did not exceed the amount of the non-land related farming deductions they claimed in the subject years. Consequently, the land appreciation cannot be considered in determining if the Taxpayer's cattle activity was for profit.

The Taxpayer is a forthright, determined individual. But an objective analysis of the evidence shows that his primary reason for continuing in the activity was not to make a profit. Consequently, his farm-related expenses cannot be deducted over the amount of his farm-related income.

The final assessments are affirmed. Judgment is entered against the Taxpayers for 2005, 2006, and 2007 tax and interest of \$1,787.17, \$2,174.82, and \$1,906.56, respectively. Additional interest is also due from the date the final assessments were entered, May 20, 2009.

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

Entered February 16, 2010.

BILL THOMPSON
Chief Administrative Law Judge

bt:dr

cc: Lionel C. Williams, Esq.
Dr. Robert M. Smith
Tony Griggs