

THOMAS D. & JOAN T. McMURTREY §  
17582 PARKER ROAD  
ATHENS, AL 35611-8596, §

STATE OF ALABAMA  
DEPARTMENT OF REVENUE  
ADMINISTRATIVE LAW DIVISION

Taxpayers, §

DOCKET NO. INC. 11-857

v. §

STATE OF ALABAMA §  
DEPARTMENT OF REVENUE.

### FINAL ORDER

The Revenue Department assessed Thomas D. and Joan T. McMurtrey (together “Taxpayers”) for 2008 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 February 9, 2012. The Taxpayers attended the hearing. Assistant Counsel Mark Griffin represented the Department.

The Department audited the Taxpayers’ 2008 Alabama income tax return and disallowed the Schedule F farming expenses because, according to the Department, the Taxpayers’ farming activities were not entered into for profit. This appeal followed.

Thomas McMurtrey (individually “Taxpayer”) has worked full-time for the federal government as a livestock inspector for over 30 years. He and his wife purchased a ranch outside of Athens, Alabama in the late 1980’s.

The Taxpayer, who is 65 years old, explained that he has owned and worked with horses all his life. After he purchased the ranch in the late 1980’s, he started breeding outside mares with a stallion he owned. He purchased more stallions, and during the 1990’s his stallions annually bred with 25 to 30 mares owned by others. He also began purchasing and breeding mares and raising/selling the colts.

The Taxpayer testified that he wanted to grow his horse breeding business in the late 1990's. He consequently borrowed money to build two more barns on his property, and leased and purchased more pasture land over the next few years. He regularly bought and sold horses in the 1990's and into the 2000's, and currently has two stallions and approximately 40 mares or other horses on his farm.

The Taxpayers reported a substantial loss from the horse breeding activity on their 2008 Alabama return. As illustrated below, they had also reported losses from the activity since at least 2003.

The Taxpayer explained at the February 9 hearing that he incurred losses on his horse business over the last few years because he was borrowing and spending large sums of money expanding his facilities. He also testified that the horse business has been depressed for the last five or six years because the government closed down the horse slaughter market in 2005 or 2006. He has consequently been unable to sell his horses at a decent price since that time.

Other relevant facts are stated as necessary in the below 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.

The Department examiner, in a thorough and well-written audit report, addressed the above nine factors, as follows:

(1) Manner in which the Taxpayer Carries on the Activity.

Mr. McMurtrey, the taxpayer, presented a well-organized set of records in regards to his Schedule A and F income tax returns for the years 2008, 2009, and 2010. The taxpayer maintained only one bank account for the farm purchases and personal living expenses; however, he provided a detailed journal of day to day expenses kept on a per monthly basis. This journal consisted of five prior years of expenses kept in the same manner. It proved to be true and accurate for every sample taken by the examiners. The information contained within the journal provided documentation of purchases of feed and other supplies, purchases and sale of horses by name and amount, purchase and sale of cows; also included, were the out of pocket medical expenses for the taxpayers that proved to be true and accurate to the Schedule A for all years in question. The journal contained no documentation in regards the cash contribution made by the taxpayer. The Taxpayer failed to substantiate cash contributions for all years in question. He stated that he always gave cash and didn't get a receipt.

(2) The Expertise of the Taxpayer and His or Her Advisors.

The taxpayer stated he engages in the horse business because he loves it and wants to make a profit raising and selling Pedigrees. He stated that he loves to watch the foals being born and finding the colts good homes. He has been on a ranch all of his life. He state that he had acquired and maintained this ranch for 25 years, always putting all proceeds earned from the activity back into the maintenance of upkeep and equipment.

The taxpayer stated during the examination appointment that over the past few years he had cut out a day laborer employee, cut back on breeding and waited out the recession to try to eliminate losses. In 2010 he changed his strategy and moved toward a different breeding process, which included breeding a Paint Mare to produce a Pedigree foal. The taxpayer stated he expected this change in business plan to produce a profit in approximately three years.

(3) The time and effort expended by the Taxpayer in Carrying on activity.

The taxpayer works for the US Department of Agriculture of New Orleans, but lives on the ranch and devotes most of his spare time to the animals and up keep. The taxpayer claimed a day laborer for 2008 and 2009 on an as needed basis. He does not employ a laborer on a regular basis. He solely maintains the upkeep of the ranch with the help of his family occasionally.

(4) Expectation that assets used in the activity may appreciate in value.

The taxpayer has great expectations that the decision to breed a Paint Mare will yield great profits. The taxpayer is hoping for a turnaround in profits over the next three years with his change of business plan to breed the Paint Mare. The taxpayer discussed in detail the improvements he made over the past eight years to the ranch and his intentions for those improvements. He has added a barn in 2003 and an addition to it the following year. He has also added an indoor arena to the property to increase its value. The taxpayer made a purchase of an additional four acres of attached land to increase the size and value of his ranch. He financed this additional land with a bank loan.

(5) Success of the taxpayer in carrying on other similar or dissimilar activities.

The taxpayer made a purchase of a herd of cows in December 2008 for resale. The cows were sold in 2009 at a gain of \$358; however, the 2010 depreciation schedule produced by the taxpayer, shows these cows continuing to be depreciated. The taxpayers attempt to purchase and resale cattle seem to be a non-profitable endeavor on behalf of increasing profits for the ranch.

(6) The taxpayer's history of income or losses with respect to the activity.

The Examiners analyzed the income v. the losses for the years 2003 through 2010; over these eight years the taxpayer has reported a total loss of \$368,652 due to his horse ranching activities. The losses are as follows:

Year	Income	Expenses	Loss
2003			(\$35,471)
2004			(\$37,832)
2005			(\$48,057)
2006			(\$48,699)
2007	\$1,267	\$47,361	(\$48,628)
2008	\$1,895	\$56,224	(\$54,329)
2009	\$3,658	\$52,442	(\$48,784)
2010	\$2,768	\$49,621	<u>(\$46,853)</u>
			(\$368,652)

(7) The amount of Occasional profits, if any, which are earned.

The M-M Ranch has failed to show a profit over the years available to Examiners and continues to show a steady increase in loss over the eight consecutive years. In respect to the last eight years, the Ranch has continued to report losses at a 1.4 percent increase per year on average. For the years examined the largest loss was reported in 2008 with a 1.1%

increase for the prior year; however, the losses reported for 2009 and 2010 have decreased at a .99% rate per year on average. Even with the decrease in losses for 2009 & 2010 the reported loss are still greater than the least reported loss over the years listed.

(8) The financial status of the taxpayer.

Mr. McMurtrey is employed as a Livestock inspector for the US Department of Agriculture New Orleans and receives a regular salary. Mrs. McMurtrey is disabled and receives US Social Security Benefits, along with a Retirement Pension. The Taxpayers' ranch has proven un-profitable for many years. It is the opinion of the examiner that the taxpayer would not be able to maintain upkeep of an un-profitable ranch without the aid of his wages from an outside source. The taxpayer's willingness to continually support these kind of losses indicates this activity is not engaged in for profit.

(9) Elements of personal pleasure or recreation.

The taxpayer expressed his personal pleasure in the process of breeding and raising horses on his ranch. He seemed to take great pride in the quality of breed in which he raises. He also expressed his concerns with his health and the effect it has taken on his ability to maintain the ranch in the manner in which he has done in the past. He enjoys spending time with his grandchildren on the ranch. He stated that he had a foal born on Easter Sunday and his Granddaughter named it "Easter Bunny." The taxpayer stated that "riding" is a way of life for him, and that is what he knows.

The examiner concluded based on her nine factor analysis that the Taxpayer's horse-related activities were not for profit. She primarily relied on the fact that the Taxpayer had a history of losses, and that he took personal pleasure in being around horses. I agree that those two factors suggest that the activity was not entered into for profit. But "[t]he 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." Sect. 1.183-2(b), Income Tax Regs. Viewing the nine factors in total, I believe that the Taxpayer's horse farming activities were for profit.

To begin, the fact that a taxpayer consistently loses money on an activity is not conclusive evidence that the activity is not for profit. In *Enghdahl v. Comm. of Int.*

*Revenue*, 72 T.C. 657; 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 or business. The taxpayer had consistently reported large annual losses and, as in this case, had never turned a profit. The Court addressed those facts 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 Taxpayer's losses in 2008 and prior years can at least partially be explained by the fact that he borrowed and spent large sums of money in the late 1990's and early 2000's adding to and expanding the facilities on his farm. He built two new barns and purchased/leased additional pastureland in the hope of growing his business. Unfortunately, the horse market tanked, and he and his wife have struggled in the last few years to make ends meet.

Numerous other factors show that the Taxpayer's horse business was for profit. To begin, the Department concedes that the Taxpayer maintained a well-organized set of records showing his horse-related expenses. The Taxpayer thus operated in a businesslike manner. The Taxpayer is also an expert horseman, and has bought and sold horses all his life. He has applied that expertise in an effort to make his horse farm profitable. He changed his business plans and moved to a different breeding procedure in an attempt to eventually make a profit. He also usually does all of the tedious chores relating to the horses. He explained that "I just told (the examiner) it's not a hobby when

you're out there in the ice and snow, breaking ice and hauling feed to horses.” (T. 22). The Taxpayer also expected his capital improvements on the farm to appreciate in value, in addition to eventually helping him make a profit from the activity.

The Taxpayer has worked full-time for the government for over 30 years. His wife is on disability. He has used his government wages and borrowed money from family and friends to keep his horse farm operating over the last few years. I agree with the examiner's conclusion “that the taxpayer would not be able to maintain upkeep of an unprofitable ranch without the aid of his wages from an outside source.” I disagree, however, that the above fact indicates that the activity was not for profit. Rather, it shows just the opposite.

A taxpayer cannot engage in an enjoyable hobby primarily for personal pleasure, and also be allowed to deduct the resulting expenses/losses as a business expense. But the usual taxpayer that engages in a “hobby loss” activity is someone that can afford to incur an overall loss, not someone that must struggle to pay the expenses incurred in the activity. “Substantial income from (other sources) . . . may indicate that the activity is not engaged in for profit. . . .” Treas. Reg. §1.183-2(b)(8). The opposite is also true. If a taxpayer does not have substantial income from other activities or other sources of wealth, the taxpayer probably cannot afford an expensive hobby, and thus is most probably engaged in the activity for profit.

In *Duthie v. State of Alabama*, Docket Inc. 08-484 (Admin. Law Div. 10/20/2008), the taxpayers claimed expenses relating to a specialty gift basket business. The Department disallowed the expenses because it determined that the activity was not for profit. The Administrative Law Division held otherwise. A major factor in the decision was that, like the



Taxpayers in this case, the taxpayers in *Duthie* struggled financially to keep the business open. “Importantly, the Taxpayers are not wealthy, and it is improbable that they would have lost tens of thousands of dollars, and taken out a second mortgage on their home, to engage in a ‘hobby’ without a profit motive.” *Duthie* at 5.

The above rationale also applies in this case. The Taxpayers are on a limited, fixed income, and have cut back on their expenses to try and keep the business going. With the horse market depressed over the last few years, they have had no choice but to keep the horses alive and healthy and hope that the market eventually improves. As testified to by the Taxpayer:

Right now I’m stuck with about 30-something head of horses. I cut back on my feeding. I’ve always fed my broodmares and colts. I’ve always grained heavy during the winter months. This year I put them on round rolls of hay, and I said horses, I’m suffering, y’all got to suffer, too. I hate it, but I try to make ends meet. I sold my truck to cut back to a vehicle that I can buy gas for. I’ve done everything to try to stay in the business.

(T. 22).

The Taxpayer admittedly loves being around horses, but an individual can love his work and still be in business to make a profit. “Finally, while the Taxpayer obviously enjoys being around horses, that fact alone does not negate his intent to make a profit. As stated in *Engdahl*, ‘There is no ‘benefit’ in losing money.’ *Engdahl*, 72 T.C. at 670.” *Gremmels v. State of Alabama*, Docket Inc. 05-112 (Admin. Law Div. 7/18/2005).

Because the Taxpayer’s horse breeding business was for profit, and because he properly verified his expenses with excellent records, the Schedule F expenses in issue should be allowed. The final assessment in issue is accordingly voided. Judgment is entered accordingly.

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

Entered June 5, 2012.

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BILL THOMPSON  
Chief Administrative Law Judge

bt:dr

cc: Mark Griffin, Esq.  
Thomas & Joan McMurtrey  
Stoney Trammell