| | | |
|---|---|---|
| CLAYTON P. & SHIRLEY R. MILES<br>3425 STROLLAWAY DRIVE<br>HOOVER, AL 35226-2630, | §<br><br>§ | STATE OF ALABAMA<br>DEPARTMENT OF REVENUE<br>ADMINISTRATIVE LAW DIVISION |
| Taxpayers, | § | DOCKET NO. INC. 12-1129 |
| v. | § | |
| STATE OF ALABAMA<br>DEPARTMENT OF REVENUE. | § | |

**OPINION AND PRELIMINARY ORDER**

The Revenue Department assessed Clayton P. and Shirley R. Miles (together "Taxpayers") for 2008, 2009, and 2010 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 August 22, 2013. The Taxpayers and their representative, Will Sellers, attended the hearing. Assistant Counsel Kelley Gillikin represented the Department.

**ISSUES**

(1) Should the Taxpayers be allowed Schedule C deductions in 2010 relating to a wholesale doughnut business;

(2) Should the Taxpayers be allowed Schedule C deductions in all of the years in issue relating to CM Body/Parts Shop; and

(3) Should the Taxpayers be allowed Schedule A business mileage expenses relating to Clayton Miles' (individually "Taxpayer") job with McAleer's, d/b/a Krispy Kreme, during the years in issue.

**FACTS**

The Taxpayer lives in Hoover, Alabama. He began working for McAleer's, d/b/a Krispy Kreme, as a teenager, and has worked there for over 20 years. As director of operations, he was involved in most all aspects of Krispy Kreme's business during the

years in issue. His primary duty, however, was to oversee 14 salesmen that traveled throughout Central Alabama.

The Taxpayer traveled extensively in his own vehicle checking on the salesmen and meeting with existing and potential customers, i.e., convenience stores, grocery stores, etc. He worked 60 to 65 hours a week and earned over $150,000 a year working for McAleer's during the subject years.

The Taxpayers deducted the Taxpayer's business-related mileage on their Alabama returns for the years in issue. They claimed 75,531, 53,450, and 68,274 miles on their 2008, 2009, and 2010 returns, respectively.

The Taxpayer explained that in a prior Department audit, the Department examiner told him that he could maintain his business mileage on his computer. He accordingly had a special mileage program or application put on his computer. The Taxpayer testified that after each daily trip relating to his job, he would enter the ending odometer reading into his computer. The computer then automatically determined the miles traveled during the day based on the prior day's ending odometer reading. As discussed below, the computer print-out showed where the Taxpayer traveled each day, the general business purpose for the trip, and the exact miles traveled.

The Taxpayer further explained that he lives only a mile or so from the McAleer office, and that to account for nondeductible commuting miles, he claimed less miles on his returns then he actually traveled per his mileage log. The Taxpayer's testimony is verified by Department Ex. G, which shows the miles traveled per the Taxpayer's mileage log and the lesser amounts actually claimed on the Taxpayers' returns.

The Taxpayer was also involved in rebuilding and selling wrecked motor vehicles during the subject years under the name CM Body/Parts Shop ("CM"). That activity was done at a building owned by the Taxpayer in New Market, Alabama, which is 125 miles from the Taxpayers' home in Hoover.

The Taxpayer grew up in New Market, and his automobile shop was located on land he inherited from his parents. He explained that he and his brothers grew up repairing and rebuilding cars. He began operating the body shop in 2005, and one of his brothers helped him during the years in issue. The brother actually drove a truck owned by the Taxpayer to various auctions in the Southeast. If the Taxpayer purchased a vehicle at the auction, the brother would transport it back to New Market in the truck.

The Taxpayer never drove to an auction because of the long hours he worked in his job with Krispy Kreme. He testified, however, that he sometimes flew to auctions in Georgia, South Carolina, and elsewhere in an airplane he purchased in 2005. The Taxpayers depreciated and otherwise deducted the expenses relating to the airplane on their returns in the subject years.

His auto shop was extensively damaged by wind during the subject years. He subsequently repaired the building, but has since stopped buying and repairing vehicles because he never made a profit and was otherwise too busy. The below chart (Dept. Ex. K) summarizes the income , expenses, and net losses claimed by the Taxpayer relating to the body shop from 2005 through 2010. The chart also shows 2010 expenses relating to a wholesale doughnut business, which is discussed below.

| Year | Activity | Gross Proceeds | Expenses Claimed | Net Loss Claimed |
|---|---|---|---|---|
| 2005 | Body/Parts Shop | $ 10.00 | $ 59,658.00 | ($59,648.00) |
| 2006 | Body/Parts Shop | $ 4,290.00 | $ 58,651.00 | ($54,361.00) |
| 2007 | Body/Parts Shop | $ 3,390.00 | $ 52,541.00 | ($49,151.00) |
| 2008 | Body/Parts Shop | $ 2,950.00 | $ 50,817.00 | ($47,867.00) |
| 2009 | Body/Parts Shop | $ 3,126.00 | $ 38,853.00 | ($35,727.00) |
| 2010 | Body/Parts Shop | $ 1,255.00 | $ 9,932.00 | ($8,677.00) |
| 2010 | Wholesale Doughnut Sales | $ - | $ 20,154.00 | ($20,154.00) |
| 2010 Totals | Body Shop & Wholesale Doughnut Sales, Combined | $ 1,255.00 | $ 30,086.00 | ($28,831.00) |
| Totals for 2005-2010 | Body Shop & Wholesale Doughnut Sales, Combined | $ 15,021.00 | $ 290,606.00 | ($275,585.00) |

As indicated in the above chart, the Taxpayer deducted $20,154 on a separate Schedule C in 2010 relating to a wholesale doughnut business. He began preparing a site in 2008 on which he intended to erect a building in which he would conduct the business. He began construction, but the building was not completed until December 2011. He never started making and selling doughnuts, however, and instead abandoned the project after the building was damaged by a tornado in 2012.

Other relevant facts are stated in the below analysis.

## ANALYSIS

**Issue (1). The expenses relating to the wholesale doughnut business.**

The Department argues that the 2010 expenses incurred by the Taxpayer in preparing to open the wholesale doughnut business cannot be deducted because they were not incurred in an active trade or business. I agree.

Code of Ala. 1975, §40-18-15(a)(1) adopts by reference 26 U.S.C. §162, which allows deductions for all ordinary and necessary business expenses. To be deductible, however, the expenses must be incurred in an on-going business. The Taxpayer had not opened his wholesale doughnut business in 2010, and subsequently abandoned the endeavor without ever engaging in business. As correctly argued by the Department, start-up expenses incurred in a year before a business begins operating cannot be deducted in that year.

> Start-up expenses must either be capitalized or, by election of the Taxpayer, deducted in accordance with the provisions of 26 U.S.C. 195. Ala. Code 1975 § 40-18-15(a)(22). Under this election, a taxpayer is allowed a deduction for start-up expenses in an amount not in excess of $10,000.00 "*for the taxable year in which the active trade or business begins….*" Section 195 (emphasis added). As this Court has held, "for expenses to be deducted under [section] 195, a taxpayer must actually begin a business." *W. E. and Nell Bailey v. State of Alabama Dep't of Revenue*, Dkt. No. Inc. 99-265 (Ala. Dep't of Rev. Admin. Law Div. Nov. 19, 1999).

Department's Post-Hearing Brief at 4.

The Schedule C expenses relating to the Taxpayer's intended doughnut business were correctly disallowed by the Department.

**Issue (2). The expenses relating to CM Body/Parts Shop.**

This issue turns on whether the Taxpayer operated the body shop as a trade or business. That depends on whether the Taxpayer entered into the activity for the primary purpose of making a profit.

The Administrative Law Division has decided numerous cases involving the issue of whether an activity was entered into for profit. In *Blankenship v. State of Alabama*, Docket Inc. 06-1215 (Admin. Law Div. O.P.O. 10/16/2007), the Division explained the criteria to be

applied in deciding the issue.

> 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.

*Blankenship* at 3 – 4.

Concerning factor (1), Treas. Reg. §1.183-2 states that "[t]he fact that the taxpayer carries on the activity in a businesslike manner and maintains complete and accurate records may indicate that the activity is engaged in for profit." The Department examiner indicated that the Taxpayer failed to document or substantiate many of the claimed expenses relating to the body shop. The Taxpayer also testified that he had no idea how many vehicles he had bought and sold during the subject years. The Taxpayer's failure to maintain businesslike records showing his expenses and the number of vehicles he bought and sold indicates that the activity was not entered into for profit.

The Taxpayer also had no employees, no business hours, and no business plan outlining how he intended to improve his profitability in the future, which further evidences a lack of a profit motive.

Concerning factor (2), the Taxpayer testified that he has repaired/rebuilt cars since he was a teenager. Consequently, he presumably knows how to rebuild vehicles. But there is otherwise no evidence that the Taxpayer has expertise in the area. This factor is neutral.

The Taxpayer lives 125 miles from his body shop, and worked 60 to 65 hours a week for Krispy Kreme during the subject years. He testified that he went to the shop when he could, "depending on what we had going on." (T. 90). The Taxpayer thus put little time into the activity.

The above fact would not necessarily show a lack of profit motive "where the taxpayer employs competent and qualified people to carry on such activity." Treas. Reg.

§1.183-2(b)(3). But that provision does not help the Taxpayer in this case because he had no paid employees, and there is no evidence the brother that helped him was a competent, qualified mechanic that knew how to run a business. Factor (3) favors the Department.

Factors (6) and (7) strongly favor the Department because the Taxpayer consistently incurred large losses from the activity. As illustrated by the above chart, the Taxpayer realized gross income of only $15,021 from the business from 2005 through 2010, yet he deducted over $270,000 relating to the business in those years.

The Taxpayer also had a well-paying job during the subject years. Treas. Reg. §1.183-2(b)(8) specifies that substantial income from a source other than the activity in question may indicate that the activity was not entered into for profit, especially if losses from the activity provided a substantial tax benefit, as in this case. Factor (8) thus also favors the Department's position.

As indicated, the Taxpayer and his brothers grew up repairing/rebuilding cars for fun. He thus clearly enjoyed the activity. I must agree with the Department that the Taxpayer's "weekend trips to New Market to work on cars and 'shoot the breeze' with his brothers (T. 94), were simply an excuse to enjoy this life-long ambition." Department's Post-Hearing Brief at 12. Factor (9) supports the Department.

The Department argues that even if the activity constituted a trade or business, the expenses relating to the Taxpayer's use of his airplane still cannot be deducted because they were not ordinary and necessary. See, Department's Post-Hearing Brief at 12 – 15. That issue need not be decided, however, because the above analysis of the nine factors shows that the activity was not entered into primarily for profit, and thus was not a trade or

business. The expenses relating to the Taxpayer's body shop activity were properly disallowed.

**Issue (3). The Taxpayer's business travel relating to Krispy Kreme.**

It is undisputed that the Taxpayer traveled extensively concerning his supervisory job with Krispy Kreme. The issue is whether the travel was sufficiently documented.

Because business-related travel expenses are particularly susceptible to abuse, such expenses must be strictly documented with records showing the amount of travel, the time, the place or places traveled to, and the business purpose. See generally, 26 U.S.C. §274. Alabama has specifically adopted the recordkeeping requirements of IRC §274, see Code of Ala. 1975, §40-18-15(a)(20). The criteria for claiming business-related travel expenses was explained in *Langer v. C.I.R.*, 980 F.2d 1198 (1992):

> A taxpayer cannot deduct travel expenses under 26 U.S.C. § 162 unless the taxpayer meets the substantiation requirements of § 274(d). The taxpayer must substantiate the amount, time, place, and business purpose of each travel expenditure "by adequate records or by sufficient evidence corroborating [the taxpayer's] own statement." Treas. Reg. § 1.274-5(c) (1983). To substantiate expenditures with "adequate records," a taxpayer must keep an account book or similar record along with supporting documentary evidence that together establish each element of the expenditure. *Id.* § 1.274-5(c)(2)(i). To show substantiation by other "sufficient evidence," the taxpayer must establish each element by the taxpayer's own detailed statement and by corroborating evidence. *Id*. § 1.274-5(c)(3).

*Langer*, 980 F.2d at 1199.

The Taxpayer in this case testified that in a prior income tax audit conducted by the Department, the examiner informed him that he could keep his business-related mileage information on his computer. He accordingly had an acquaintance develop a special app

that he put on his computer that showed the date of the travel, the destination or destinations, the business purpose, and the beginning and ending odometer readings. He submitted the monthly computer print-outs at the August 22 hearing. He also testified extensively concerning the nature and business purpose for his various business trips.

The Taxpayer's computer log is deficient in that the specific person or people he met with on each trip are not identified. Rather, the purpose for each trip is identified generally as a sales trip, a meeting, or for equipment installation/repair. The records are otherwise complete, however, as to the date, the destination, and the exact miles traveled. The records were also corroborated by the Taxpayer's detailed testimony. Under the particular circumstances of this case, the Taxpayer's business-related miles are sufficiently verified, and should be allowed.

The Department should recompute the Taxpayers' liabilities for the subject years by allowing the business-related miles claimed on the returns. 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 January 28, 2014.

_____
BILL THOMPSON
Chief Administrative Law Judge

bt:dr
cc: Kelley A. Gillikin, Esq.
William B. Sellers, Esq.
Brenda Lausane