LESA M. TOUGER 3212 MIDLAND DRIVE BIRMINGHAM, AL 35223,	§	STATE OF ALABAMA DEPARTMENT OF REVENUE ADMINISTRATIVE LAW DIVISION
Taxpayer,	§	DOCKET NO. INC. 12-1133
v.	§	
STATE OF ALABAMA DEPARTMENT OF REVENUE.	§	

OPINION AND PRELIMINARY ORDER

The Revenue Department assessed Lesa M. Touger ("Taxpayer") for 2008, 2009, and 2010 income tax. The Taxpayer appealed to the Administrative Law Division pursuant to Code of Ala. 1975, §40-2A-7(b)(5)a. A hearing was conducted on May 23, 2013. The Taxpayer attended the hearing. Assistant Counsel David Avery represented the Department.

The Taxpayer was employed as a bookkeeper/accountant at three businesses in Birmingham, Alabama during all or a portion of the years in issue. She received W-2 compensation from those employers.

The Taxpayer was also involved in two other activities in the subject years – a film production company, Passions Heart Productions, and an accounting business, EMT Bookkeeping. She filed separate Schedule Cs for those activities on her Alabama returns for the subject years.

The 2008 Schedule Cs showed that the Taxpayer received $0 income from both activities in that year. The Schedule C for EMT Bookkeeping showed expenses for a vehicle, depreciation, legal services, supplies, meals, utilities, and other expenses that totaled $4,790. The Schedule C for Passions Heart Productions included expenses for

advertising, a vehicle, depreciation, interest, legal services, supplies, taxes/licenses, travel, meals/entertainment, utilities, and other expenses that totaled $10,565 for the year.

The 2009 Schedule Cs also showed $0 income from both activities during that year. The expenses on the EMT Bookkeeping Schedule C totaled $8,906, and on the Passions Heart Productions Schedule C expenses totaled $3,952.

The 2010 Schedule C for EMT Bookkeeping showed income of $13,788 and expenses of $9,365, for a net gain of $4,423. The Schedule C for Passions Heart Productions showed $0 income and total expenses of $5,089.

The Department audited the Taxpayer's returns for the above years and made various adjustments. Specifically, the Department disallowed the Schedule C expenses relating to Passions Heart Productions because it determined that the activity was not entered into for profit. That finding was based on the fact that the Taxpayer did not maintain a separate business bank account or credit card, did not prove that she had previously managed a musical group or produced a movie, failed to show that she was actively involved in producing a full-length movie, "Gillery's Little Secret", failed to prove that she had spent time attempting to obtain financing for the above movie, and failed to document the travel to meet with potential investors, among other reasons.

The Department allowed the travel expenses incurred when the Taxpayer traveled between her primary job and a second job, and also to a third place of employment. It disallowed as nondeductible commuting expenses the Taxpayer's travel to her two EMT Bookkeeping clients, First Choice Security in Murfreesboro, Tennessee, and Preferred Surgical Products in Birmingham, Alabama because (1) she did not prove that she

maintained a primary place of business at her home, and (2) she traveled to her clients' businesses at regular intervals.

The Department also disallowed the Taxpayer's other expenses concerning her work for First Choice Security and Preferred Surgical Products because her contracts with those customers provided that the customers would reimburse the Taxpayer for "all reasonable and approved out-of-pocket expenses" incurred by the Taxpayer. It also disallowed supplies deducted by the Taxpayer because she failed to document that her employers required her to provide her own supplies.

The Department moved the Taxpayer's medical/dental expense deductions from Schedule C to Schedule A. It also disallowed a $264 deduction for meals on a business-related trip the Taxpayer took to the United Kingdom. The Department disallowed those expenses because the Taxpayer "did not avail herself of dining options" provided free by her employer.

The Taxpayer adamantly objects to the Department's finding that her activities relating to Passions Heart Productions were not entered into for profit. She explained that she had a business plan for making "Gillery's Little Secret", and a contract to do the film. Actors and set location sites had already been arranged for. She pointed out that she was executive producer in 2006 on a 16 minute film entitled "Still"; she worked for American Idol in 2006; and that she did work for a musical group in 2008 for which she was paid $200.

As indicated, the Department disallowed the expenses relating to Passions Heart Productions because it determined that the activity was not entered into for profit.

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.

Some of the evidence in this case supports the Taxpayer's claim that Passions Heart Productions was an activity entered into for profit. The Taxpayer was clearly determined and sincere in her efforts to produce "Gillery's Little Secret." She also maintained detailed and accurate records of her travel and other expenses relating to that project. I also agree with the Taxpayer that a separate bank account and credit card in the name of Passions Heart Productions was not necessary. All that is required is a clear record of the expenses incurred, that the expenses were ordinary and necessary, and that said expenses were related to the business. The Taxpayer also expended considerable time and effort toward the activity.

Conversely, other factors show that the activity was not for profit. For example, there is no evidence that the Taxpayer ever successfully earned any substantial income from producing a film or managing a musical group or act in prior years. Importantly, the Taxpayer reported $0 income relating to Passions Heart Productions in the years in issue. While that factor is not conclusive, it is evidence that the activity was not for profit.

The "entered into for profit" issue need not be decided, however, because the Taxpayer never started producing or making the film, and thus was only preparing to go into business in the subject years. Her Passions Heart Productions expenses thus could not be deducted in the years incurred. *Goldman v. Comm. of Internal Revenue*, T.C. Memo 1990-8, is directly on point.

In *Goldman*, the taxpayer began making short films at the age of 15. He made a 7½ minute film in that year, and an 11 minute film in 1975. He was paid for and also won professional awards concerning the latter short film. After studying film at NYU, the taxpayer was hired in 1978 to make, produce, and edit a 20 minute film by a scientific institute. The institute paid the taxpayer a salary and also an additional amount for producing the film.

The taxpayer began working on a 60 minute documentary about the Maine coastline in 1981. His goal was to complete and make a profit on the film. During the year in issue, 1984, the taxpayer worked from 15 to 20 hours a week on the documentary, in addition to working full-time as a stagehand.

The taxpayer deducted the documentary-related expenses on his 1984 return. The IRS disallowed those expenses, and the case was appealed to the U.S. Tax Court. That Court stated the issue and the positions of the parties as follows:

> The principal issue before us is whether petitioner was engaged in the trade or business of film making during the taxable year at issue. Petitioner contends that he was so engaged in that his activities in connection with the production of the 60-minute documentary were simply part of his continuing efforts to make and distribute films reflected by (his prior films). Respondent asserts that, during 1984, petitioner was not engaged in his film-making activities for profit within the meaning of section 183, and alternatively, if

> petitioner was so engaged, such activity was merely by way of preparing to go into the trade or business of making and distributing films.

Goldman at 2.

The Court next generally discussed the factors for and against the taxpayer's claim that the activity was for profit. It declined to rule on that issue, however, holding that the expenses could not be currently deducted because the taxpayer "was merely preparing to enter the trade or business of producing and making films." *Goldman* at 3.

> In short, after reviewing the record as a whole, we are unable to satisfy ourselves as to how the profit objective issue under section 183 should be resolved. Fortunately, resolution of that issue is not necessary for the disposition of this case because we have concluded that, even if the petitioner were found to have had the requisite profit objective in 1984, we would sustain respondent's alternative contention, namely, that petitioner was, during 1984, merely preparing to enter the trade or business of producing and marketing films.
>
> Petitioner seeks to avoid the impact of respondent's alternative contention by asserting that he has already established himself in the film-making business through his prior films and that his endeavors in respect of the 60-minute documentary are simply an extension of an existing activity. But the facts of the matter are that the prior films were of a different character, that petitioner made the films during and as part of his educational development, that his efforts to turn them into profit-making activities after their initial production have been totally ineffective, and that there was a considerable lapse of time between the making of these films and the initiation of the 60-minute documentary project. In short, we conclude that petitioner has failed to carry his burden of proof that his activities during 1984 constitute anything more than preparation to go into the film-producing business. Under these circumstances, he is not entitled to a deduction under section 162 for his expenditures in respect of the film during that year. *Richmond Television Corp. v. United States, 345 F.2d 901, 907 (4th Cir. 1965)*, vacated per curiam on other grounds *382 U.S. 68 (1965)*; *Jackson v. Commissioner, supra.* Cf. *Commissioner v. Idaho Power Co., 418 U.S. 1, 12 (1974).*

Goldman at 3.

The Taxpayer established Passions Heart Productions in 2006. She subsequently produced a short 16 minute film in that year. She also performed services for at least one musical group or act. She did not report income from either activity.

In *Goldman*, the taxpayer had considerable experience in filmmaking, and had made at least three films before beginning work on the proposed 60 minute documentary. The Tax Court nonetheless rejected the taxpayer's claim that he had already established himself in the filmmaking business through his prior films, and that his work on the 60 minute documentary was merely an extension of that existing activity. Likewise, it is clear in this case that the Taxpayer had not established herself as a film producer before trying to produce "Gillery's Little Secret." The one short film she did produce was done two years earlier, and was also of a different nature than the full-length film she was attempting to finance and produce. And importantly, the Taxpayer never actually began making or producing the film because she was unable to obtain financing. Consequently, even if the Taxpayer intended to eventually profit from the proposed film, the start-up expenses relating to the film were not currently deductible. They were thus correctly disallowed by the Department.

The Department disallowed the travel expenses the Taxpayer claimed relating to her accounting business because it concluded that she did not have a primary place of business at her house. Consequently, the Department determined that the travel to and from her clients' offices were nondeductible commuting expenses.

The Taxpayer presented evidence that she does maintain an office in her house that she uses exclusively for business.[1] One of the Taxpayer's clients testified that she occasionally traveled to the Taxpayer's home to conduct necessary business. The Taxpayer also submitted detailed records of her travels to First Choice Security's office in Murfreesboro, Tennessee. The owner of that business testified that the Taxpayer began keeping her businesses' books and records in 2009, and that since that time the Taxpayer has traveled to her office in Tennessee twice a month to do her payroll. The travel-related expenses relating to the Taxpayer's accounting business were ordinary and necessary, and thus should be allowed.[2]

The Taxpayer also presented records concerning her supplies she used in her accounting business during the years in issue. Those expenses should be allowed as ordinary and necessary business expenses. Likewise, although the Taxpayer's accounting contracts provided that her clients would reimburse her for her expenses, the Taxpayer never asked them to do so. Consequently, those ordinary and necessary expenses should also be allowed.

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[1] The Taxpayer contends that she did not deduct the expenses relating to her home office. However, the Schedule Cs include deductions for utilities, which I assume could only relate to the utilities at her home.

[2] The Department suggested in a post-hearing submission that the primary reason the Taxpayer traveled to Murfreesboro twice a month was because she and the owner of First Choice Security were "involved in a non-business and loving relationship." There is no evidence in the record supporting that assertion. Rather, the owner of First Choice Security testified that the Taxpayer's work in keeping her company's books and records was invaluable, and that she intended to pay the Taxpayer when her business improved. The owner's testimony was sincere and believable.

Concerning the meal expenses incurred by the Taxpayer on her trip to the United Kingdom, the Department disallowed the expenses based on its understanding that the Taxpayer's employer offered her meals during the trip free-of-charge. The Taxpayer testified, however, that her employer intended to pay for her meals with a credit card, but that for some reason the card could not be used. Consequently, the Taxpayer paid for her own meals, and was never reimbursed by her employer. Those expenses thus should be allowed. The remaining adjustments made by the Department are affirmed.

The Taxpayer reported $0 income from her accounting business in 2008 and 2009, although she testified that she had two clients in those years. The owner of First Choice Security adequately explained that although the Taxpayer billed her in 2009, she was unable to pay at that time, but intended to do so in the future when business picked up. The Taxpayer failed to explain, however, why she failed to report the income she received from the other client she had in 2009 and the two she had in 2008. The Taxpayer should inform the Administrative Law Division by September 27, 2013 concerning the amount of income she received from her accounting clients in 2008 and 2009. Those amounts will then be added to her income in those years.

After the Taxpayer provides the above income information, the Department will be directed to recompute the Taxpayer's liabilities and notify the Administrative Law Division of the adjusted amounts due, if any. An appropriate Final Order will then be entered.

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 September 4, 2013.

BILL THOMPSON
Chief Administrative Law Judge

bt:dr
cc: Warren W. Young, Esq.
Lesa M. Touger
Brenda Lausane