

STATE OF ALABAMA  
DEPARTMENT OF REVENUE,

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DEPARTMENT OF REVENUE  
ADMINISTRATIVE LAW DIVISION

§

v.

§

DOCKET NO. INC. 87-245

LANNY E. & ELFRIEDE HELUS  
Route 4, Box 489-CC  
Prattville, AL 36067,

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§

Taxpayers.

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ORDER

The Revenue Department assessed income tax against Lanny E. and Elfriede J. L. Helus ("Taxpayers") for the calendar years 1984, 1985 and 1986. The Taxpayers appealed to the Administrative Law Division and a hearing was conducted on March 7, 1989. Robert E. L. Gilpin, Esq. and Lester Sanders appeared for the Taxpayers. Assistant counsel Mark Griffin represented the Department. Based on the evidence presented by the parties, the following findings of fact and conclusions of law are hereby entered.

FINDINGS OF FACT

The Taxpayers operate a dog kennel adjacent to their residence in rural Autauga County and deducted various expenses relating thereto on their Alabama income tax returns filed for 1984, 1985 and 1986. The Department disallowed the deductions, arguing that the kennel was not entered into for profit as required under Code of Ala. 1975, §40-18-15. The Taxpayers appealed the resulting deficiency assessments to the Administrative Law Division.

The relevant facts are largely undisputed.

The Taxpayers attended their first dog show in 1972 while the husband was serving in the military. The Taxpayers attended numerous other shows and studied various kennel operations over the next decade as their interest in operating a kennel steadily increased.

The husband retired from the military in 1981 and the couple moved to the Prattville area. The husband obtained a full-time job as a mechanic, and the wife worked as a full-time secretary/bookkeeper at a local business.

The Taxpayers also decided to open a kennel on the property adjacent to their residence in Prattville. The Taxpayers intended to begin with a nucleus of good stock, gradually add to the quality and quantity of animals through purchase and breeding, and thereby eventually build a reputation for quality breeding and show dogs.

The Taxpayers also decided to board other dogs at the facility to help defray expenses.

The property was cleared in 1981 and 1982 to make room for a kennel house, a grooming house, kennel runs and an exercise area.

The wife investigated the licensing requirements for a kennel and also obtained tax advice as to which kennel expenses should be capitalized versus currently deducted, what records should be maintained, and what tax returns should be filed.

A kennel house was constructed in 1983, and in that same year the Taxpayers acquired their first three female puppies. Two of the puppies were too young to breed, but the third was bred and

produced a litter in 1984. The number and quality of animals in the kennel steadily increased during 1984, 1985 and 1986 as the Taxpayers purchased outstanding stock and kept the best of their own litters. Several average dogs were removed from the kennel in 1984, 1985 and 1986 and either sold as pets or euthanized. The kennel produced its first outstanding female used for breeding purposes in 1985, and two show quality puppies were produced from the 1986 litter. Other quality dogs were produced from the 1987 and 1988 litters. The size of the kennel increased as follows:

Year	Placed in Breeding Kennel		On Hand In Breeding Kennel	Removed From Breeding Kennel	
	Purchased	Raised		Females	Males
1983	3		0	3	0
1984	4	3	2	7	1
1985	3	3	0	10	4
1986	2	5	3	11	7
1987	1	3	1	14	7
1988	2	2	3	14	8

The kennel facilities were enlarged and generally improved during the subject years. Six dog runs were added in 1984 and twelve more in 1985, all with water, electricity, half roofs, and dog houses. The kennel building was enlarged and improved in 1984 and a grooming house was built in 1986. A van was purchased in 1985 for transporting the dogs and equipment to shows and to the veterinarian.

The Taxpayers maintained a business office in their residence where the wife kept detailed breeding and litter records and records of income and expenses . relating to the kennel. Records

were kept on the performance and pedigree of each animal. The Taxpayers also purchased a computer for use in the kennel operation.

The husband maintained his full-time job as a mechanic during the subject years, but devoted approximately 50 hours a week to cleaning the kennel areas and caring for the animals. The wife quit her job as a secretary in 1986 and has since devoted full-time to the kennel business. The Taxpayers performed all of the work at the kennel, except for occasional volunteer workers, and also learned to administer routine drugs to the animals to reduce veterinary costs.

The Taxpayers attended numerous dog shows during the subject years and showed a number of their dogs to gain exposure and respectability for the kennel. The Taxpayers intend to apply for membership in the American Kennel Club as soon as the kennel has operated for the required minimum of five years. The Taxpayers also advertise in several kennel magazines and have a long list of repeat customers that use the facilities to keep their dogs.

During the years 1983 through 1988, the Taxpayers reported the following income, expenses and net losses on their Alabama income tax returns:

TAX				
<u>YEAR</u>	<u>INCOME</u>	<u>EXPENSES</u>	<u>DEPRECIATION</u>	<u>PROFIT OR (LOSS)</u>
1983	0.00	\$ 1,795	\$300.00	( \$2,095)

1984	723.00	15,290	2,661.00	( \$17,228)
1985	2,921.00	29,335	8,857.00	( \$35,271)
1986	3,033.00	26,717	12,355.00	( \$36,039)
1987	5,103.00	28,273	12,391.00	( \$35,561)
1988	15,370.00	13,633	5,563.00	( \$3,826)
	27,150.00	\$115,043	\$42,127.00	(\$130,020)

The Department audited the Taxpayers, determined that the kennel was not entered into for profit, and thereby disallowed the excess of claimed expenses over income. The factors considered by the Department were (1) the consistent reported losses in each year, (2) the inadequate records maintained by the Taxpayers, and (3) the fact that both Taxpayers maintained full-time jobs during the subject years.

#### CONCLUSIONS OF LAW

Code of Ala. 1975, §§40-18-15(1) and (5) and corresponding IRC provisions 26 U.S.C. §§162 and 212 provide a deduction for ordinary and necessary expenses incurred in a trade or business or in an activity entered into for profit. Conversely, if an activity is not engaged in for profit, then the expenses relating thereto can only be deducted up to the amount of the income reported from the activity, see 26 U.S.C. §183 and Department Reg. 810-3-15-.09.

The issue in the present case is whether the kennel operation was entered into for profit. The Taxpayers must establish that the activity was primarily profit motivated. Nickerson v. Commissioner, 700 F.2d 402; Faulconer v. C.I.R., 748 F.2d 890. Each case must be

decided on an objective analysis of the particular facts of the case. Faulconer v. C.I.R., supra.

IRS regulations list nine factors which should be used as a guideline in determining whether an for profit, see Treas. Reg. §1.183-2(b). follows:

- (1) The manner in which carries on the activity;
- (2) The expertise of the taxpayer or his advisor;
- (3) The time and effort expended by the taxpayer in carrying on the activities;
- (4) Expectation that assets used in the activity may appreciate in value;
- (5) The success of the taxpayer in carrying on other similar activities;
- (6) The taxpayer's history of income or losses with respect to the activity;
- (7) The amount of occasional profits earned, if any;
- (8) The financial status of the taxpayer; and
- (9) The elements of personal pleasure or recreation.

Applying the above factors to the present case, it must be decided that the Taxpayers entered into the kennel business with the primary goal of making a profit. To begin, the Taxpayers did extensive and detailed research concerning how kennels operated.

The Taxpayers also tracked the success and pedigree of each dog in the kennel through the use of detailed records, and otherwise operated the kennel in a business-like and professional manner.

The Taxpayers clearly enjoy caring for and handling animals, and naturally enjoy the recognition drawn to the kennel and themselves by the success of their dogs at shows and the growing reputation of the kennel. However, enjoyment and pride in one's work does not disqualify the activity as a profit seeking endeavor. Faulconer, supra, at page 901. Further, a good portion of the Taxpayers' time and energy is spent in mundane, nonrecreational activities such as record keeping, feeding and caring for the physical needs of the animals, and cleaning the ground and facilities. All facts considered, the kennel was started and is operated to turn a profit, and not primarily for personal enjoyment.

The kennel sustained consistent losses in its first years of operation. However, losses are oftentimes common and expected in the first years of any business, and especially in a growing kennel business where several years are needed to develop the stock of animals and gain a reputation for the kennel. The income of the kennel has increased steadily, as has the value of the stock and facilities and the potential for profits in the near future.

The Department cites Burger v. C.I.R., 809 F.2d 355, as authority in support of its position. In Burger the court determined that a dog breeding operation was not entered into for profit based on (1) the lack of detailed records on each dog; (2) the taxpayer's failure to seek expert business advice; (3) the personal satisfaction derived by the taxpayers; and (4) the consistent history of losses.

However, the present case is distinguishable from Burger in that (1) the Taxpayers kept detailed records of each dog and pedigree and otherwise operated the kennel in a business-like manner; (2) the Taxpayers investigated and studied other kennels before opening their own, and also sought tax advice and expertise on how to treat expenses and what returns to file. The wife is also an experienced bookkeeper with knowledge as to how to operate a business; (3) the kennel provided the Taxpayers with some personal pleasure, but as discussed above, the kennel was operated to make a profit; and (4) the consistent losses in the subject years were not unreasonable, especially given the Taxpayers' plan to start with a few animals, gradually complete the facilities, and eventually build a successful business. The kennel's assets have increased markedly in value over the beginning years and are expected to grow further as the animals mature and the kennel's reputation increases.

The above considered, the expenses relating to the kennel operation should be allowed in full. Consequently, the Department is hereby directed to reduce and make final the assessments in issue showing no additional tax due.

Entered this 24th day of May, 1989.

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BILL THOMPSON  
Chief Administrative Law Judge