F. LaRUE McWATERS 110 FIRST AVENUE ASHFORD, AL 36312,	§ §	STATE OF ALABAMA DEPARTMENT OF REVENUE ADMINISTRATIVE LAW DIVISION
Taxpayer,	§	DOCKET NO. INC. 13-1193
v.	§	
STATE OF ALABAMA DEPARTMENT OF REVENUE.	§	

FINAL ORDER

The Revenue Department assessed LaRue McWaters ("Taxpayer") for 2009, 2010, and 2011 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 8, 2014. The Taxpayer and his attorney, David Johnston, attended the hearing. Assistant Counsel Margaret McNeill represented the Department.

FACTS

The Taxpayer is in his early 70's and has lived in Ashford, Alabama all of his adult life. After graduating from high school in the early 1960's, the Taxpayer worked as a butcher and then a meat salesman for almost 15 years. He subsequently owned and operated a grocery store in Ashford for ten years. He later worked eight years for a nuclear laundry business that laundered clothing, uniforms, etc. used at nuclear power plants. He thereafter started his own highly successful nuclear laundry business in 1987. The Taxpayer worked full-time at the business until 2004, when the business merged with another company and he started working part-time. He sold his interest in the business for over $6,000,000 in 2012.

The Taxpayer has been actively involved with Tennessee Walking horses since he was a teenager. He formed Triple M Farms as a horse breeding/showing activity in 1995.

He had purchased a Tennessee Walking horse stallion for $50,000 in the early 1990's. He purchases several mares and started breeding them with the stallion in 1995. The stallion subsequently won four Tennessee Walking horse world championships and also a world grand championship at the annual walking horse championships in Shelbyville, Tennessee in 1996. The Taxpayer sold the stallion for $75,000 in the late 1990's, and purchased another stallion in Kentucky. Two other horses owned by the Taxpayer also won world championships after 1996.

The Taxpayer spent approximately 80 percent of his time tending to his horses after he began working part-time with his nuclear laundry business in 2004. He regularly hauled some of his horses to Shelbyville for two week stays every Summer. During those stays, he showed his horses at various charitable and other events in the area. When in Shelbyville, he resided in a house that he had purchased there in the late 1990's. He also owns a trailer on the property where his stableman lived while they were in Shelbyville.

Triple M Farms is located on approximately 14 acres near the Taxpayer's house in Ashford. He has a barn with 26 stalls on the property, and also a 5 stall breeding barn. He has always used two trucks in conjunction with his horse farm, one to haul the horses to Shelbyville and back and another for use around the property. He also has tractors, bush hogs, and other equipment typically needed to operate a farm. He employed a full-time trainer during the years in issue, and also a stableman that helped him exercise his horses and do chores around the farm.

The Taxpayer had a single checking account during the subject years that he used for both personal and farm-related expenses. He testified, however, that the farm-related checks he writes to his veterinarian, for seed, to pay his farm help, etc. can be easily

identified and distinguished from his personal expenses. The Taxpayer also used a single credit card exclusively for farm-related expenses during the subject year.

The Taxpayer is a lifetime member of the Tennessee Walking Horse Breeders and Exhibitors Association, and has advertised as a breeder, trainer, and seller of horses in the *Walking Horse Report* magazine for over 20 years. He also maintains a chart in his barn showing when his mares were or would be bred.

In 2009, the Department audited the Taxpayer for the 2006, 2007, and 2008 tax years. The Department examiner initially determined that the Taxpayer's horse farm was a hobby and not an activity entered into for profit, i.e., not a trade or business. He thus initially disallowed the Taxpayer's farm-related deductions over and above the farm-related income reported by the Taxpayer.

After review, the examiner changed his mind and concluded that the Taxpayer's farm was a trade or business. He thus allowed the Schedule F expenses that were properly documented. The examiner explained his decision at the May 8 hearing, as follows:

> Q. What made you change your mind about the Triple M Farms not being a hobby and being a business?
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> A. I looked at income for the last two years. I talked to –
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> ALJ Thompson. That's two years or ten years?
>
> A. I looked at the income for '06 – 2006 and 2007. It had gross income of '06 for 70,000 roughly and '07, 40,000. After I sent the report to the taxpayer, I met again with the taxpayer and the – Jason and Tim and discussed what the value of the horses were and how many years they had losses.
> If they had a grand champion or world champion, they could sell it for a lot more. So I gave them the benefit of the doubt. So I gave them -- Since there was other adjustments on the return (due to lack of substantiation), I

> was willing to take that and give them a little bit longer to see if they made a profit.

(T. 77 – 78).

The same examiner audited the Taxpayer again for the years in issue, 2009, 2010, and 2011. Because the Taxpayer incurred larger Schedule F farm losses in those years than in the prior audit years, the examiner determined that the activity was, in fact, a nonbusiness hobby. He accordingly allowed the farm-expenses to offset the farm income, but disallowed the remaining expenses in full. The Taxpayer appealed the resulting final assessments to the Administrative Law Division.

Other relevant facts are included in the below Analysis.

ANALYSIS

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.

As with most disputed "hobby loss" cases, some of the above factors favor the Taxpayer, and some the Department. No one factor is determinative.

Factor (1). The Taxpayer operated his horse farm in a somewhat casual manner, but that is not unusual or unexpected because he had no investors or co-owners to answer to. And while the Taxpayer may not have kept exact or adequate records for all of his farm-related expenses, the examiner testified that "[h]e generally had the records to report the expenses." (T. 90).

The fact that the Taxpayer has advertised Triple M Farm as a breeder, trainer, and

seller of horses in the *Walking Horse Report*, a reputable national publication, also shows that the Taxpayer operated the farm in a somewhat businesslike manner. This factor slightly favors the Taxpayer.

Factor (2). This factor also favors the Taxpayer. He has worked with Tennessee Walking horses for over 50 years, and has expert knowledge concerning how to train a horse to be a national champion.

Factor (3). During the years in issue, the Taxpayer spent most of his time working with his horses and related activities. The Taxpayer testified that on a typical day, he leaves his house around 6:30 a.m. and picks up his trainer and stableman. They feed, train, and otherwise tend to the horses during the day, and the Taxpayer returns home anywhere from 6:00 p.m. to 9:00 p.m. He has mostly maintained that schedule since 2004, in addition to regularly hauling horses to Shelbyville for two week stays in the Summer. The Taxpayer clearly spends considerable time and energy around and working with his horses.

Factor (4) is not applicable because any increase in the value of the Taxpayer's farm property cannot be considered because the farm-related income did not exceed the related expenses in the subject years, see generally, IRC Reg. § 1-183-1.

Factor (5). Likewise, this factor also does not apply because the Taxpayer has never engaged in a similar or related business.

Factors (6) and (7). These factors support the Department's position. The Taxpayer suffered significant farm-related losses in the subject years. He reported farm income of $604 in 2009 and total expenses in that year of $211,852, for a loss of

$211,248. His 2010 farm income was $13,122 and his expenses were $267,547, for a loss of $254,425. His 2011 farm income was $9,282 and his expenses were $265,983, which resulted in a $256,701 farm loss.

The Taxpayer testified that he came close to making a profit in the early 2000's. The evidence shows, however, that the Taxpayer's horse farm has reported a substantial loss every year since at least 2001. Specifically, from 2001 through 2008, the horse farm incurred losses of $116,581, $50,548, $163,122, $73,389, $181,950, $74,474, $153,572, and $309,258, respectively, see, Taxpayer Ex. 7. Combined with the reported losses of $211,248, $254,425, and $256,701 in the subject years 2009 through 2011, respectively, the Taxpayer's horse farm has lost over $1,845,000 since 2001 without ever coming close to making a profit in a given year.

The start-up phase for a horse breeding operation is five to ten years. See, *Engdehl v. C.I.R.*, 72 T.C. 659 (U.S. Tax Ct. 1980). The Taxpayer started Triple M Farms in 1995. The years in issue were thus well after the start-up phase, and yet the Taxpayer still consistently incurred large losses. The substantial annual losses incurred by the Taxpayer in the activity strongly suggests that the activity was not entered into primarily for profit.

Factor (8). This factor also strongly supports the Department's position. The Taxpayer earned substantial income from his nuclear laundry business in the subject years. Specifically, the Taxpayer reported adjusted gross income of $601,736, $497,533, and $255,077 on his 2009, 2010, and 2011 returns, respectively. He also had adjusted gross income of $247,129, $513,958, and $398,845 in the prior audit years of 2006, 2007, and 2008, respectively, and similar large income amounts in the years going back to 2001, see again, Taxpayer Ex. 7. The Taxpayer consequently did not depend on his horse farm

to make a profit. To the contrary, because he had substantial income from his nuclear laundry business and other investments, he could afford to sustain the large farm losses he has incurred since at least 2001.

Factor (9). The Taxpayer obviously enjoys owning and showing Tennessee Walking horses. According to the audit report issued for 2006 through 2008, the Taxpayer entered his horses in 20 to 30 charity shows each year, and he and his son would go to and "spend quality time together" at the shows, see again, Taxpayer Ex. 7. While enjoying one's work does not by itself indicate that the activity is a hobby, the fact that the Taxpayer greatly enjoys raising and showing his horses supports the Department's claim that the activity was primarily for pleasure.

The Taxpayer has been around Tennessee Walking horses since he was a teenager. He started working straight out of high school, and apparently could not afford to buy and raise Tennessee Walking horses for a number of years. That changed after he started his highly successful nuclear laundry business in the late 1980's. Presumably using the large profits from that business, the Taxpayer purchased his first Tennessee Walking stallion for $50,000 in 1992. The horse turned into a world champion. From that time through the years in issue, the Taxpayer used his considerable income from his laundry business to fund Triple M Farms.

The Taxpayer, or any person that has an enjoyable hobby, would also like to make money from the hobby, if possible. The Taxpayer's 2012 and 2013 returns did report a small profit in each year, but only because the Taxpayer drastically cut expenses and also failed to deduct certain expenses to which he was entitled. But again, from the late 1990's through the years in issue, the Taxpayer operated in essentially the same manner and

consistently suffered horse-related losses that averaged almost $170,000 a year from 2001 through 2011. There is no evidence that he changed his method of operating during that period. To the contrary, he continued traveling to Shelbyville and showing his horses at charitable events and local shows during the summer months. There is also no evidence indicating that his trips to Shelbyville were necessary or helpful in selling his horses. He also continued entering his best horses in the annual world championships in Shelbyville in each year. Consequently, I can only presume that the Taxpayer regularly traveled to and stayed in Shelbyville because Shelbyville is the “Mecca” of Tennessee Walking horse activity, and the Taxpayer simply enjoyed showing his horses in the area, and trying to win championships.

The Taxpayer’s representative did an excellent job presenting the Taxpayer’s case, and my initial reaction was that the Taxpayer’s primary motive for operating Triple M Farms was to make a profit. After carefully studying and fairly weighing the evidence, however, I must conclude that the Taxpayer operated his horse farm primarily for enjoyment, and not for profit. The Department thus correctly disallowed the Schedule F expenses claimed in each year that exceeded the reported Schedule F income. Under the circumstances, the penalties are waived for cause.

The final assessments, less the penalties, are affirmed. Judgment is entered against the Taxpayer for 2009, 2010, and 2011 tax and interest of $11,588.88, $13,956.79, and $13,107.09, respectively. Additional interest is also due from the date the final assessments were entered, October 4, 2013.

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

Entered September 24, 2014.

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BILL THOMPSON
Chief Administrative Law Judge

bt:dr
cc: Margaret Johnson McNeill, Esq.
G. David Johnston, Esq.