FOSTER S. & LOUISE F. WAMBLES P.O. BOX 66 BELLWOOD, AL 36313-6313,	§	STATE OF ALABAMA ALABAMA TAX TRIBUNAL
Taxpayers,	§	DOCKET NO. INC. 12-654
v.	§	
STATE OF ALABAMA DEPARTMENT OF REVENUE.	§	

OPINION & PRELIMINARY ORDER

The Alabama Department of Revenue assessed Foster S. and Louise F. Wambles (together "Taxpayers") for 2007, 2008, 2009, and 2010 Alabama income tax. The Taxpayers appealed to the Administrative Law Division, now the Tax Tribunal, pursuant to Code of Ala. 1975, §40-2A-7(b)(5)a. A hearing was conducted on November 4, 2014. The Taxpayers and their representatives, Charles McQuaid and Ulrike Steiner, attended the hearing. Assistant Counsel David Avery represented the Department.

Foster Wambles (individually "Taxpayer") is in his late 50's, and has lived in rural Geneva County, Alabama most of his life. He served in the U.S. military until 1990, and has worked at Fort Rucker as a mechanic since 1997.

In 2002, the Taxpayer began growing hay on leased property and selling it to the public. In 2004, he entered into an informal partnership or joint venture to grow and sell hay with an individual that owned property in Geneva County. The parties agreed that the Taxpayer's partner would provide the land and also pay for the operating supplies, i.e., seed, gasoline, etc. The Taxpayer agreed to provide the necessary labor. The income from the sale of the hay would be split evenly between the two. The Taxpayer also agreed to purchase and pay for the equipment needed to plant, tend to, and harvest the hay.

The Taxpayer and his partner began purchasing cattle in 2004 because they had excess hay that they could use to feed the cattle. They periodically sold some of the cattle, and eventually ended up with over 80 head in 2010. The Taxpayer's partner handled and received the money from the sales of the cattle and hay.

Despite the agreement that the Taxpayer's partner would pay for the daily operating expenses, the Taxpayer ended up buying the seed and the other needed supplies, and also paying the miscellaneous expenses incurred in growing the hay and tending to the cattle.

The Taxpayer testified at the November 4 hearing that at the end of each year, he gave his farm-related receipts to his partner, and his partner would thereafter write the Taxpayer a small $200 - $400 check for what the partner told him was his part of the annual net profit from the venture. The Taxpayer trusted the partner, and consequently did not request a verbal or written accounting or explanation from the partner that showed the total annual income and expenses of the operation.

In late 2009 or early 2010, the Taxpayer realized that he was spending considerably more on the activity than he expected to spend because his partner was not paying the operating costs, as he agreed to do. The Taxpayer consequently canceled the agreement with the partner and began operating the farm on his own.

The Taxpayers reported Schedule F losses from the hay/cattle activity on their 2004, 2005, and 2006 returns. The Department audited those returns and determined that the activity was not for profit, and thus not a business. It consequently disallowed the Schedule F losses. The Taxpayers' tax preparer at the time advised the Taxpayers not to challenge that finding.

The Taxpayer also claimed Schedule F losses from the activity during the years in issue. The losses averaged approximately $35,000 per year, which is approximately 40 percent of the Taxpayer's annual Fort Rucker salary of $83,000 - $88,000. The Department audited the Taxpayers for the years in issue and again determined that the Taxpayer's farming activity was not for profit, and thus not a trade or business. It consequently disallowed the claimed Schedule F deductions that exceeded the reported Schedule F income. The Taxpayers appealed the resulting final assessments to the Department's Administrative Law Division, now the Tax Tribunal.

Additional relevant facts are stated as needed in the below analysis.

The Administrative Law Division, now the Alabama Tax Tribunal, 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.
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> Factor (1). The manner in which the taxpayer conducted the activity.
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> Factor (2). The expertise of the taxpayer in carrying on the activity.
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> Factor (3). The time and effort exerted by the taxpayer in conducting the activity.
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> Factor (4). The expectation that the assets used in the activity will appreciate.
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> 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.
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> Factor (8). The taxpayer's financial status.
>
> Factor (9). The activity was for the taxpayer's personal pleasure and recreation.

Blankenship at 3 – 4.

I agree with the Department that a technical analysis of the nine factors tends to favor the Department's position. But for the reasons explained below, I find that the Taxpayer engaged in his hay and cattle farming activities during the years in issue with the primary and predominant purpose of making a profit.

The Taxpayer is not a sophisticated businessman, and with all due respect, is not a sophisticated individual. Other than serving in the military, he has lived in rural Geneva County all of his life. He learned how to farm and raise cattle while growing up, and after leaving the military in 1990, he helped his brother-in-law and perhaps others on their farms.

In the early 2000's, the Taxpayer thought he could make a profit growing and selling hay. He knew an individual, his future partner, that owned some farmland in Geneva

County. As discussed, he and the individual agreed that they would grow hay on the individual's property. The individual agreed to pay the operating expenses, and the Taxpayer agreed to provide the labor. As it turned out, however, the Taxpayer not only did all the labor, he also ended up paying most all of the ongoing operating expenses.

The Taxpayer's partner handled all of the venture's hay and cattle sales, and at the end of each year he gave the Taxpayer a small amount of money as his share of the net proceeds. The Taxpayer apparently trusted his partner, and did not ask for or receive an annual accounting of the venture's income and expenses. I agree with the Department that "it appears that his partner may have cheated him on the profits (if any) of this enterprise." Department's Brief at 5.

The Taxpayer was generally aware during the years in issue that he was not making money from the venture. He did know, however, that he was paying for the equipment he had purchased and was using in the activity, and that the equipment would be mostly if not fully paid for when he retired from his job at Fort Rucker. The Taxpayer explained that his primary motive for engaging in the farming activity was to establish a source of post-retirement income.

> Q. And you never did any sort of financial planning for yourself in any of these years?
>
> A. Yeah. I – I thought I was.
>
> Q. What did you do?
>
> A. And I was losing.
>
> Q. Okay.
>
> A. I was losing. Because I'm – I'm wanting to retire, and I've got to have something to make money on when I retire. And it's hard to get in the

business and go out and buy everything when you done retired to start all that stuff. And I was young enough. I thought that I could have it all paid for and I would be making money when I retire.

Q. Did you have any sort of a business plan other than some kind of loosely defined goals?

A. As far as business plan?

Q. Correct.

A. Yes. I – I planned on having everything paid for when I retired as far as my tractor and my baler ---

Q. Okay.

A. --- and my cutter and hay rakes and grain drills and – where I could run around 35 head of cows a year, sell 30, 35 yearlings a year, and sell 10 to $12,000 worth of hay a year.

Q. Okay. All right. Did you ever try to work the numbers to see if you could make a profit at doing that?

A. Well, everybody else does, and I figured I could too because I know – I know the haying business and I know the cow business.

T. 51 – 53.

In support of its position, the Department argues that the Taxpayer did not maintain detailed books and records concerning the activity, did not have a written business plan; did not seek expert advice about how to make the activity profitable; exaggerated his claim that he worked on the farm 40 to 45 hours a week; could not expect that his farm equipment would appreciate in value; never reported a profit from the activity on his tax returns; and had substantial income from working at Fort Rucker that he could afford to lose money farming. "A taxpayer with substantial income unrelated to the activity can more readily afford a hobby." Department's Brief at 12. Finally, the Department claims that the Taxpayer enjoys and has personal motives for farming.

I agree that the Taxpayer did not keep separate books and records, did not have a written business plan, and did not seek expert advice concerning the activity, but it is clear that he didn't think he needed to. As stated, the Taxpayer is an unsophisticated individual. He was generally aware that he was losing some money on the venture, but he also knew that once he had his equipment paid for, he would be able to make money from the activity.

The Taxpayer also spent considerable time and energy working at the activity. He testified that he does farm-related work on weekends and on weekdays from when gets off work at 2:30 p.m. until dark. As to whether the Taxpayer enjoyed and took personal pleasure in the farm work, the Taxpayer testified that he would not do the work but for the fact that he wants to pay for the equipment and thereafter supplement his retirement income.

> Q. Your goal is to use this business as a retirement in addition to your retirement from Fort Rucker?
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> A. That is correct.
>
> Q. There is no other reason. And nobody would spend this time in the summer out in the hot sun, pulling bales of hay for fun.
>
> A. That's correct. I would not.
>
> Q. You wouldn't do it for fun.
>
> A. I wouldn't think so.

T. 73.

The Department contends that the Taxpayer earns substantial income from his job at Fort Rucker that allowed him to operate his farm "hobby" at a loss. To begin, it is debatable that an annual gross income of $83,000 - $88,000 is substantial. In any case, a

$35,000 Schedule F loss would have saved the Taxpayers only $1,750 in Alabama income tax for the year. That tax savings is insignificant when compared to the tens of thousands of dollars the Taxpayer spent annually on the activity.[1] There is no benefit in losing a considerable amount of money on an activity to "gain" a small tax savings.

In *Burrow v. CIR*, TC Memo 1990-621, the U.S. Tax Court, citing *Engdahl v. Comm.*, 72 T.C. 659, 670 (1979), stated that "[a]s long as tax rates are less than 100 percent, there is no 'benefit' in losing money. . . ." I agree. The Taxpayer did not substantially benefit from his hay/cattle activity based on his meager tax savings, and would not have continued the farming but for his hope that he would profit from the activity after he paid off his equipment.

I also do not believe the Taxpayer would spend 40 percent of his annual gross income on a hobby. In *Danzey v. State of Alabama*, Docket Inc. 12-1003 (Admin. Law Div. O.P.O. 9/24/2014), the taxpayer, a lawyer, engaged in raising and selling cattle. As in this case, the taxpayer spent a large percentage of his other income, approximately one-half, on the cattle, and incurred large annual losses. I held in *Danzey* that the fact that the taxpayer spent so much money on his cattle business supported his claim that the activity was entered into for profit.

> Consequently, given the large Schedule F losses, the Taxpayer lost nearly half of his disposable income on his cattle farm during the years in issue.
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> If anything, however, the above facts indicate that the Taxpayer intended and expected to eventually make a profit on his cattle. The Taxpayer is relatively young and has a wife and a young child at home. It is unreasonable to believe that someone in that situation, and there is no evidence that the

[1] A substantial part of the loss in each year involved depreciation of the Taxpayer's equipment. The actual out-of-pocket loss in each year was thus less than the total tax loss claimed.

> Taxpayer has family wealth or other income besides wages, would spend (and lose) over one-half of their relatively limited disposable income on a nonprofit motivated hobby such as raising cattle. That is, no one would spend one-half of their disposable income on an activity unless they expected in good faith to eventually make a profit from the activity. It is thus reasonable to conclude that the Taxpayer intended and thought, and still thinks, that he can eventually turn a profit from his cattle farm. And while the Taxpayer's judgment and decision to continue operating the cattle farm year after year at a loss may be questioned, it is not required that the expectation of profit must be reasonable. *Allen v. Commissioner*, 72 T.C. 28, 33 (1979).

Danzey at 5 – 6.

The Department argues that farming is in the Taxpayer's blood, that he takes pride in his farming activities, and that his primary reason for farming is personal pleasure. According to the Department, the Taxpayer "seems to be dedicated to farming and that is a very positive aspect of his moral fiber. . . ." Department's Brief at 14. There is little evidence supporting that position. To the contrary, the Taxpayer repeatedly emphasized at the November 4 hearing that he would not do the tedious farm work but for his desire to make a profit.

> Q. All right. And I would assume that you would be involved in farming on a much smaller scale, but you would still continue to be – have some involvement in farming even if you did not make a profit.
>
> A. If I did not make a profit, I probably would not.
>
> Q. If you weren't losing money.
>
> A. I mean, that's my whole intent is to make money off of it, to have something to fall back on when I retire. So if I wasn't making any money, if I could not make any money off of it, I wouldn't get out there and do that hard work for nothing.

(T. 63 – 64).

And when asked if farming gave him some personal respect in the neighborhood, the Taxpayer twice answered "No." (T. 64). I see no reason to doubt the Taxpayer's

honest, straightforward testimony.

In summary, while the Taxpayer was a poor businessman and engaged in sloppy business practices during the years in issue, his primary motive for engaging in his hay and cattle business was to make a profit.[2] Consequently, the ordinary and necessary expenses incurred by the Taxpayer in carrying on that activity should be allowed.

The remaining issues are whether the claimed expenses were ordinary and necessary, and did the Taxpayer maintain records to sufficiently verify the claimed Schedule F expenses/deductions.

The Taxpayer testified that he took all of his farm-related receipts to his tax preparer. As revealed at the November 4 hearing, those records included, for example, receipts for dog food purchased for the Taxpayers' household pets, which clearly is not

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[2] This holding can be contrasted with the facts and holding in *McWaters v. State of Alabama*, Docket Inc. 13-1193 (Admin. Law Div. 9/24/2014). The taxpayer in *McWaters* started a highly successful and lucrative business in the late 1980's. He had been very involved with Tennessee Walking horses since he was a teenager, but for years never had the money to own the horses. That changed when his business became successful, and he bought his first Walking horse in the early 1990's. He thereafter built a large horse farm on his property in Southern Alabama. He also owned a house and stables in the Shelbyville, Tennessee that he regularly visited and showed his horses in the area. Shelbyville is known as the "Mecca" of Tennessee Walking horse activity.

The Administrative Law Division, now the Tax Tribunal, found in *McWaters* that the taxpayer greatly enjoyed owning and showing Tennessee Walking horses as a hobby, and that he could afford to incur large losses on the activity based on his net worth and large annual income (he sold his business in 2012 for $6 million). The taxpayer was thus engaged in a hobby, not a business.

In this case, however, the Taxpayer did not enjoy the hard work required in growing and harvesting hay and tending to his cattle. Rather, the evidence shows that he farmed to eventually make a profit. The activity was thus a business, not a hobby.

deductible. The Taxpayer also comingled his gas receipts for his vehicles used on the farm and his personal vehicles.

The burden is on the Taxpayers to prove that they are entitled to the Schedule F expenses/deductions claimed in the subject years. The Taxpayers' representative is directed to contact Department examiner Danny Hansen (or another examiner at the Department's direction) for the purpose of providing and explaining the records in support of the Taxpayers' Schedule F deductions. The Department should thereafter notify the Tribunal of the results of the meeting. Appropriate action will then be taken.

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 22, 2015.

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BILL THOMPSON
Chief Tax Tribunal Judge

bt:dr
cc: David E. Avery, III, Esq.
Charles L. McQuaid