ALABAMA TAX TRIBUNAL

GERALD A., JR. & TERRI W. SPARKS,	§	
Taxpayers,	§	DOCKET NO. INC. 18-506-LP
v.	§	
STATE OF ALABAMA DEPARTMENT OF REVENUE.	§	

FINAL ORDER

The Revenue Department assessed Gerald A. and Terri W. Sparks (the "Taxpayers") for 2014 Alabama income tax. A hearing was conducted on November 7, 2018. Gerald A. Sparks (individually "Taxpayer") and the Taxpayers' attorney, Deven Moore, attended the hearing. Assistant Counsel David Folmar represented the Department.

The Revenue Department examined the Taxpayers' 2014 Alabama income tax return and disallowed expenses related to a car racing activity of the Taxpayers, determining that the activity was not entered into for profit. The Department adjusted the Taxpayers' return, denying a refund of approximately $3,000 and assessing tax due of $102, plus interest and penalties. The Taxpayers appealed to this Tribunal.

The Taxpayers began a car-racing venture in 2011. The Taxpayers' son drives the racecar, and the Taxpayer is the mechanic on the racecar. The son also performs mechanic work. The Taxpayers are not dependent on the racing activity for income. Gerald Sparks is a physician and Terri Sparks does not work outside the home. They rely on the income from Dr. Sparks' medical practice. From 2011 to 2016, the racing activity generated income of $148,125 and losses of $475,376, for an overall loss of $327,240. In 2017, the activity earned a profit of approximately $90,000.

The Department sent the Taxpayers an audit letter on February 1, 2017. While it is unclear whether the Taxpayers claim that they had begun the process of incorporating the business prior to the receipt of the audit letter, they did incorporate the business on February 23, 2017, obtain a separate identification number on February 29, 2017, and open a separate bank account for the business in May of 2017. The Taxpayers purchased real property for the purpose of building an office/garage in September 2017. In 2017, the business was incorporated in Florida, with the principal place of business located in Florida where the Taxpayers' son lives.

Ala. Code § 40-18-15(a)(1) allows a deduction for all ordinary and necessary expenses incurred in a trade or business. Section 40-18-15(a)(5) also allows a deduction for non-business losses incurred in a transaction entered into for profit. Both statutes are modeled after their federal counterparts, 26 U.S.C. §§162 and 212, respectively. Consequently, federal case law interpreting the federal statutes should be followed in interpreting the similar Alabama statutes. *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 in engaging in the activity is to make a profit. *Zell v. Commissioner of Revenue,* 763 F.2d 1139 (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. Whether the taxpayer had an intent to make a profit is a question of fact that must be determined from all the circumstances. *Patterson v. U.S.,* 459 F.2d 487 (1972).

Treasury Regulation § 1.183-2 sets forth nine factors to be considered when evaluating whether a Taxpayer conducted an activity for profit. No one factor is determinative, the list of

factors to be considered is not exhaustive, and the number of factors indicating for-profit or not is not determinative. The factors are set forth below and applied to the Taxpayer.

1. *Manner in which the taxpayer carries on the activity.* The Taxpayer testified that he kept business records for his racing business, including a ledger of checks written, receipts, income received, etc., and documentation of each racing series with a schedule of races and the Taxpayer's goal to win cash prizes at each event. The Taxpayer did not keep a separate bank account for the racing business. He stated that he was operating the business as a sole proprietorship. The incorporation and obtaining of a separate bank account and identification number did not occur until 2017, after the audit letter was sent. Nevertheless, the Taxpayer did keep records and carry on the activity as a sole proprietorship in 2014. This factor weighs in favor of the Taxpayer.

2. *The expertise of the taxpayer or his advisors.* The Taxpayer testified that he began working on cars as a teenager and has continued to do so since then. Most of his knowledge of cars is self-taught. Additionally, he is a trained engineer and worked in that field for 12 years. Testimony reflects that the Taxpayer does have expertise in auto mechanics. This factor weighs in favor of the Taxpayer.

3. *The time and effort expended by the taxpayer in carrying on the activity.* The Taxpayer works full-time as a physician. He testified that he spends six to eight hours each weekend day during the racing season working on the racing business. Racing season runs from March to October and consists of 14 races across the country. The Taxpayer attends each race and performs mechanic duties at the races. Out of season, he

consistently spends time on the business. As the Taxpayer contributes a significant amount of time to this venture, this factor weighs in favor of the Taxpayer.

4. *Expectation that assets used in activity may appreciate in value.* The Taxpayer testified that the values of the race cars he has owned have increased due to improvements made by him. But the vehicles depreciated as indicated on the Taxpayers' return. However, the successor corporation did purchase real property for an office/garage in 2017, which is assumed to appreciate in value. This factor weighs in favor of the Taxpayer.

5. *The success of the taxpayer in carrying on other similar or dissimilar activities.* The Taxpayer does not have experience with other activities as a business outside of his medical practice. This factor is neutral.

6. *The taxpayer's history of income or losses with respect to the activity.* The Taxpayer stated that the losses for 2014 were start-up losses. The Taxpayer testified that in nearly every year, the activity did earn some revenue, but the acquisition of tools, inventory, and a race car caused greater losses. The regulation states:

> A series of losses during the initial or start-up stage of an activity may not necessarily be an indication that the activity is not engaged in for profit. However, where losses continue to be sustained beyond the period which customarily is necessary to bring the operation to profitable status such continued losses, if not explainable, as due to customary business risks or reverses, may be indicative that the activity is not being engaged in for profit.

Treas. Reg. § 1.183-2(b)(6). The Taxpayer testified that the losses in years following start-up he attributes to business risk. The revenue in 2017 was $231,182, and the venture

made a profit of nearly $90,000, indicating that the possible income is substantial and attainable. This factor weighs in favor of the Taxpayer.

7. *The amount of occasional profits, if any, which are earned.* The racing activity did make a profit in 2017 of approximately $90,000. However, the Taxpayer does not expect it to make a profit in 2018. With only one of eight years profitable, this factor leans towards the Department.

8. *The financial status of the taxpayer*. The Taxpayer's main source of income is his occupation as a physician. This factor weighs in favor of the Department.

9. *Elements of personal pleasure or recreation.* The Taxpayer testified that he does enjoy working on cars and the racing activity. This factor weighs in favor of the Department.

Consideration of all facts and circumstances, including the nine factors, indicates that the Taxpayers did enter the racing activity with the intent to make a profit.

The final assessment is voided. The Taxpayers are due a refund of $3,183 plus interest. The Department is directed to issue the refund and interest in due course.

This Final Order may be appealed to circuit court within 30 days, pursuant to Ala. Code § 40-2B-2(m).

Entered January 18, 2019.

/s/ Leslie H. Pitman
LESLIE H. PITMAN
Associate Tax Tribunal Judge

lhp:dr
cc: T. Deven Moore, Esq.
David Folmar, Esq.