ROBERT & DELLA ROSEBERRY 9465 HIGHWAY 53 ARDMORE, AL 35739,	§	STATE OF ALABAMA DEPARTMENT OF REVENUE ADMINISTRATIVE LAW DIVISION
Taxpayers,	§	DOCKET NO. INC. 05-681
v.	§	
STATE OF ALABAMA DEPARTMENT OF REVENUE.	§	

FINAL ORDER

The Revenue Department assessed Robert and Della Roseberry ("Taxpayers") for 2001 income tax. The Taxpayers appealed to the Administrative Law Division pursuant to Code of Ala. 1975, §40-2A-7(b)(5)a. A hearing was conducted on February 2, 2006. Will Sellers and Walter McKay represented the Taxpayers. Assistant Counsel J.R. Gaines represented the Department.

ISSUE

The Taxpayers deducted various hauling and excavation related expenses on Schedule C of their 2001 Alabama income tax return. The issue is whether the expenses could be deducted as "ordinary and necessary" expenses incurred by the Taxpayers in a "trade or business." Code of Ala. 1975, §40-18-15(a)(1).

FACTS

Robert Roseberry (individually "Taxpayer") has been a long haul truck driver for over 25 years. He failed a required Department of Transportation ("DOT") physical in the early 1990's because of high blood sugar. The failed physical prevented him from long-haul driving. Consequently, he obtained a used backhoe and started doing backhoe work to earn money. He had grown up on a farm in Pennsylvania, and was familiar with and knew how to use backhoes, tractors, and other heavy equipment.

The Taxpayer resumed truck driving after he passed the DOT physical in 1995. He and his wife have been driving in tandem since that time. They are on the road four or five weeks at a time, off for seven to ten days, and then back on the road. They currently earn approximately $120,000 a year from truck driving, and are on-road an average of 265 to 275 days a year.

The Taxpayer claims he continued doing excavation and hauling work after he resumed driving in the mid-1990's. He has never advertised his excavating business. Rather, he testified that local contractors know that he does excavation work, and they call when they have work for him to do. The Taxpayer explained that he does not advertise because if someone asked him to do a job, he probably could not do the work in a timely manner because of his long-haul trucking activities.

In addition to the used backhoe, the Taxpayer also purchased a used dump truck and a lowboy trailer on which he hauls the backhoe. He later purchased a crawler-loader in 2002 or 2003. He keeps the equipment in a barn behind his house.

The Taxpayers have incurred losses relating to their excavation/hauling activities every year since 1993. They claimed net losses of $26,346, $24,804, $34,281, $38,999, and $34,527 on their 1996, 1997, 1998, 1999, and 2000 Alabama returns, respectively. In 2001, they claimed income of $1,350 and expenses of $32,731, for a net loss of $31,381. In 2002, 2003, and 2004, they reported income of $992, $527, and $0, respectively, and expenses of $43,605, $47,708, and $46,467, respectively, which resulted in net losses of $42,613, $47,181, and $46,467 in those years.

The Department audited the Taxpayers' 2001, 2002, and 2003 Alabama returns. It made various adjustments to the 2001 return that are not contested by the Taxpayers. It also disallowed the Schedule C expenses claimed on the 2001 return because it determined that the Taxpayers' excavation/hauling activities were not entered into for profit, and consequently, that the related expenses could not be deducted as ordinary and necessary business expenses.[1]

ANALYSIS

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

[1] The Department also adjusted the Taxpayers' 2002 and 2003 returns. However, final assessments had not been entered for those years as of the February 2 hearing date.

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 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 conducts the activity.

The Taxpayers claim they carried on their excavation activities in a business-like manner. However, they never advertised or otherwise actively solicited work, as businesses usually do. Also, although the Taxpayers incurred substantial losses concerning their excavation activity in each year, they never adopted a new business strategy or otherwise changed their method of operating in an effort to make a profit.

Factor (2). The expertise of the taxpayer.

This factor is favorable to the Taxpayers because the Taxpayer had experience using a backhoe and other heavy equipment.

Factor (3). The time and effort exerted by the taxpayer in conducting the activity.

The Taxpayers contend that they expended "substantial time and effort in carrying on their excavating business." Taxpayers' Pretrial Brief at 4. The evidence indicates otherwise. The Taxpayers claim they did the excavation work when they were not driving their truck. There is no evidence, however, that they were actively engaged in their excavation activities during those periods. To the contrary, the relatively insignificant

income the Taxpayers reported from the activity indicates that they spent very little time and effort on the activity. They reported income of only $1,350, $992, $527, and $0 from the activity in 2001 through 2004, respectively. Assuming that they charged the minimum $45 per hour for their backhoe work (they charged $75 per hour for the crawler loader), they spent a total of only 30 hours doing excavation work in 2001, and less than 64 hours total from 2001 through 2004. The miniscule number of hours spent on the activity strongly suggests that the Taxpayers could not have reasonably expected to profit from the activity.

Factor (4). The expectation that the assets used in the activity will appreciate.

The Taxpayers started with a used backhoe, a used dump truck, and a trailer in the early 1990's. They purchased a used crawler-loader in 2002 or 2003. There is no evidence that the above used equipment has or will appreciate in value. To the contrary, such equipment depreciates in value over time.

Factor (5). The taxpayer's success in similar or related activities.

The Taxpayers are full-time truck drivers. There is no evidence that they have ever operated any other business ventures, successfully or otherwise.

Factors (6) and (7). The taxpayer's history of profits and losses, and the amounts of any occasional profits.

A taxpayer's history of profits and losses, while not in itself determinative, is crucial in determining if an activity is entered into for profit. As indicated, the Taxpayers reported substantial losses from their excavation activities from 1996 through 2000. They reported income of only $1,350 from the activity in 2001, and a total of only $2,869 from 2001 through 2004. They claimed a loss of almost $32,000 in 2001, and losses of from $43,000

to $48,000 in each of the subsequent years. The Taxpayers' long and consistent history of very little income and substantial losses from their excavating activities since a least 1996 clearly shows a lack of a profit motive. And as indicated, despite the consistent losses, the Taxpayers never changed their method of operating in an attempt to become profitable.

Factor (8). The taxpayer's financial status.

The Taxpayers argue that they "rely on their excavation business to assist them in making ends meet." Taxpayers' Pretrial Brief at 6. That claim is contradicted by the small amount of gross income they reported from the activity in each year. Also, the Taxpayers earn over $120,000 a year from truck driving. They could thus easily sustain tax "losses" from their excavation/hauling activities, especially where the losses consisted in large part of depreciation.

Factor (9). The activity was for the taxpayer's personal pleasure and recreation.

The Taxpayer claims that the excavation work is difficult. However, he grew up operating heavy machinery, and to some extent enjoys the work. "I've been a farmer all my life, and we had backhoes and dozers and stuff. And I like that kind of business. I like working with soil so I kind of got into it, I guess. It's like a kid growing up. You like to do something, you try to get going on it." (R. 19)

The above factors, when applied to the facts in this case, strongly indicate that the Taxpayers' excavation activities were not entered into with the reasonable expectation of making a profit.

The Taxpayers' representative presented an affidavit from the Taxpayers' accountant after the February 2 hearing. The affidavit states that the IRS audited the

Taxpayers for 1994 and 1995 and did not challenge the Schedule C expenses relating to the Taxpayers' excavating activities. The Taxpayers contend that the fact that the IRS allowed or at least did not challenge the Schedule C expenses supports their claim that the expenses were deductible, citing *Dawson*.

To begin, the affidavit is technically inadmissible, and thus cannot be relied on in deciding the case. But even assuming that the facts in the affidavit are correct, those facts can be distinguished from the facts in *Dawson*. In *Dawson*, the IRS audited the taxpayer for one of the two years in issue in the case. In this case, the IRS audit was for 1994 and 1995, well before the year in issue. Also, as pointed out by the Department in its Post-Hearing Brief at 11, the IRS audit involved years when the Taxpayers had just started their excavation activities. Consequently, it would have been reasonable to expect "start up" losses in those years. In this case, however, the losses incurred in 2001 cannot be attributed to start-up expenses.

Dawson can otherwise be distinguished from this case. In *Dawson*, the Court of Civil Appeals held that the taxpayer's drag racing activities were entered into for profit because (1) drag racing was the taxpayer's only money-making activity during the subject years; (2) the taxpayer spent considerable time and energy on the activity; and (3) the losses were start-up losses. The Court also pointed out that the taxpayer reported a profit from his racing activities in the year after the years in issue.

None of the factors relied on by the Court in *Dawson* are present in this case. As discussed, the IRS audit of the Taxpayers for 1994 and 1995 is too remote in time to be relevant. Unlike the taxpayer in *Dawson*, the Taxpayers otherwise earned substantial

money and did not rely on their excavation income to live. They also spent relatively little time and energy on the activity. Finally, as discussed, while the losses in *Dawson* were start-up losses, the Taxpayers in this case have reported losses from the activity for at least twelve consecutive years.

Under the circumstances, I cannot objectively find that the Taxpayers' excavation activities were engaged in with the reasonable expectation of making a profit. The expenses were thus correctly disallowed. The final assessment is affirmed. Judgment is entered against the Taxpayers for 2001 tax, penalty, and interest of $1,185.03. Additional interest is also due from the date the final assessment was entered, May 24, 2005.

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

Entered June 7, 2006.

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BILL THOMPSON
Chief Administrative Law Judge