

LINDA EVANS
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GULF SHORES, AL 36547,

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STATE OF ALABAMA
DEPARTMENT OF REVENUE
ADMINISTRATIVE LAW DIVISION

Taxpayer,

§

DOCKET NO. INC. 07-1044

v.

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STATE OF ALABAMA
DEPARTMENT OF REVENUE.

§

OPINION AND PRELIMINARY ORDER

The Revenue Department assessed Linda Evans (“Taxpayer”) for 2003 income tax. It also denied a 2004 refund claimed by the Taxpayer. The Taxpayer appealed to the Administrative Law Division pursuant to Code of Ala. 1975, §§40-2A-7(b)(5)a. and 40-2A-7(c)(5)A. A hearing was conducted on June 10, 2008. The Taxpayer attended the hearing. Assistant Counsel Duncan Crow represented the Department.

The Taxpayer claimed Schedule A and Schedule C deductions on her 2003 and 2004 Alabama income tax returns. The Department audited the returns and requested records substantiating the deductions. The Taxpayer provided records relating to both Schedules.

The Department examiner allowed the Schedule A deductions for which the Taxpayer provided records. He disallowed the unverified deductions. He testified at the June 10 hearing that the Schedule C records were sufficient, but that he disallowed the Schedule C deductions because he determined that the Taxpayer had not operated a for-profit business in the subject years. He reached that conclusion based on statements by the Taxpayer’s CPA. He testified as follows at the June 10 hearing – “Based on the accountant saying that the only time that she could have made a profit she chose not to charge the people for their services, that I concluded that she wasn’t in business to make a

profit.” T. at 20 – 21.

The Taxpayer testified at the June 10 hearing that she worked as an information technology expert with the U.S. Air Force for 30-plus years. She retired in 2000. She formed a corporation, Karatech Enterprises, Inc., and started her own information technology consulting business at that time. She explained that she primarily worked with two corporations, CMS Information Services and Northrup Grumman, to prepare and submit proposals to the Department of Defense. The Taxpayer assisted in drafting from 24 to 30 proposals during the two years in issue.

The Taxpayer did not receive any income from her activities in the subject years. She testified, however, that contrary to what her accountant told the examiner, she never refused to receive pay for her services. Rather, she explained that she was trying to establish her information technology business, and that she knew it would take years to become profitable. She testified as follows:

A. It was a consulting business primarily for information technology for financial systems. That was my expertise. I was involved in the comptroller career field for thirty-two years working for the government. And I retired from there in 2000 and then went into business for myself.

And at the same time I worked for two major corporations, CMS Information Services and Northrop Grumman. And they in turn acted as a mentor to help me establish a small business. And they get like \$250,000 a year from the Federal government to assist me in getting established.

Q. Did they pay you some money or just pay your expenses?

A. They paid me to open doors for them. When you work for the Federal government you have certain contacts. So my benefit to them was to be able to make those contacts for them, set up meetings and open doors.

Q. Okay.

A. Most of the meetings I took personally were to try to establish my business by attending a lot of industry days, which is when the government provides all the information on a certain contract competition to people who are in the business to win work - -

Q. Okay.

A. - - from them.

Q. According to the Department, you didn't report any income relating to this business?

A. That's right. I had none.

Q. Well, I thought you just said the government paid you?

A. No, the government paid these large businesses to assist me in establishing a business. I didn't get any of that money.

Q. Okay. How would they assist you?

A. Well, they put me together with different teams to try to establish my business to do proposals to submit to the government. Which in that period of time I think we did - - we, these companies and I, did probably about twenty-four to thirty proposals during that two year period.

Q. And what did you intend to accomplish by doing that?

A. Well, I hoped to win work for the government for this small business so that I could get it kicked off the ground and develop an IT company that was the experts in financial systems. That was my idea.

Q. I have no idea what kind of expenses you claimed on your returns, Schedule C expenses. What did you have expenses for?

A. Travel to various bases throughout the United States, travel to various companies when we were doing proposals, visiting places like Robbins Air Force Base, Keesler, Venev Air, just various Department of Defense agencies across the United States.

Q. So you had travel and maybe overnight expenses?

A. Overnight expenses, a lot of driving to various bases. Like I would drive from Montgomery to Eglin Air Force Base and back and Robbins, as I said, and different - - just different bases.

Q. Did you keep a record of all of that?

A. Yes, sir. And that I turned in. It's all typed and everything and the expenses logged in there.

T. at 13 – 16.

Code of Ala. 1975, §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 nonbusiness 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).

In *Engdahl v. Commissioner of Internal Revenue*, 72 T.C. 659, 1979 WL 3705 (U.S. Tax Ct. 1980), the U.S. Tax Court addressed the issue of whether the taxpayer's horse breeding activities constituted a trade of business. The Tax Court opined as follows:

Breeding and raising horses for sale may constitute a trade or business for purposes of section 162. *Commissioner v. Widener*, 33 F.2d 833 (3d Cir. 1929). Whether it does or not, depends on whether petitioners engaged in the venture with the predominant purpose and intention of making a profit. *Allen v. Commissioner*, 72 T.C. 28 (1979); *Dunn v. Commissioner*, 70 T.C. 715, 720 (1978); *Churchman v. Commissioner*, 68 T.C. 696, 701 (1977); *Jasionowski v. Commissioner*, 66 T.C. 312, 319 (1976); *Benz v. Commissioner*, 63 T.C. 375, 383 (1974). Petitioners' expectation of profit need not be reasonable, but petitioners must establish that they continued their activities with a bona fide intention and good-faith expectation of making a profit. Sec. 1.183-2(a), *Allen v. Commissioner, supra* at 33; *Jasionowski v. Commissioner, supra* at 321; *Benz v. Commissioner, supra* at 383; *Besseney v. Commissioner*, 45 T.C. 261 (1965), aff'd. 379 F.2d 252 (2d Cir. 1967). Section 1.183-2(b), Income Tax Regs., lists some of the relevant factors to be considered in determining whether an activity is engaged in for profit. These factors include: (1) The manner in which the taxpayer carried on the activity; (2) the expertise of the taxpayer or his advisers; (3) the time

and effort expended by the taxpayer in carrying on the activity; (4) the expectation that assets used in the activity may appreciate in value; (5) the success of the taxpayer in carrying on other similar or dissimilar activities; (6) the taxpayer's history of income or loss with respect to the activity; (7) the amount of occasional profit, if any, which is earned; (8) the financial status of the taxpayer; and (9) whether elements of personal pleasure or recreation are involved.

The issue is one of fact to be resolved not on the basis of any one factor but on the basis of all the facts and circumstances. Sec. 1.183-2(b), Income Tax Regs.; *Allen v. Commissioner, supra* at 34. See *Boyer v. Commissioner*, 69 T.C. 521 (1977), on appeal (7th Cir., July 7, 1978). Greater weight is to be given to objective facts than to petitioners' mere statement of their intent. Sect. 1.183-2(a), Income Tax Regs.; *Churchman v. Commissioner, supra* at 701.

Engdahl 72 T.C. at 665, 666.

Applying the nine factors listed in Reg. 1.183-2(b), the Tax Court concluded in *Engdahl* that the taxpayers intended to derive a profit from their horse-related activities. The related expenses were thus allowed.

In this case, the fact that the Taxpayer received no income from the activity suggests that the activity was not for profit. But other factors indicate that the Taxpayer operated in a businesslike manner. She had 30-plus years of experience in the information technology business, so she had expertise in the field. She expended much time and effort pursuing the activity. She also maintained good records. Importantly, unlike the horse breeding activity in *Engdahl* and various other pleasurable "hobbies" engaged in by taxpayers, the Taxpayer's business involved traveling to military bases, meeting with government employees, and putting together proposals. Certainly, those activities cannot be viewed as a hobby engaged in for pleasure. Weighing all the factors, I find that the Taxpayer was engaged in business with the intent to eventually make a profit. She testified that she ran out of money and stopped pursuing the activity in 2005, but that does not make her

activities in the subject years any less of a profit-motivated business activity. Her Schedule C expenses in the subject years should be allowed.

The Department is directed to recompute the Taxpayer's liabilities in accordance with the above. An appropriate Final Order will be entered after the Department responds.

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 September 4, 2008.

BILL THOMPSON
Chief Administrative Law Judge

bt:dr

cc: Duncan R. Crow, Esq.
Linda H. Evans
Tony Griggs