RODNEY & MIARIAM WELDON 303 JOYE LANE MONTEVALLO, AL 35115,	§	STATE OF ALABAMA DEPARTMENT OF REVENUE ADMINISTRATIVE LAW DIVISION
Taxpayers,	§	DOCKET NO. INC. 07-559
v.	§	
STATE OF ALABAMA DEPARTMENT OF REVENUE.	§	

OPINION AND PRELIMINARY ORDER

The Revenue Department assessed Rodney and Miariam Weldon ("Taxpayers") for 2000, 2002, and 2003 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 April 4, 2008. Doug Redd represented the Taxpayers. Assistant Counsel David Avery represented the Department.

This case involves two issues:

(1) Are the Taxpayers liable for Alabama income tax on all or a part of the land condemnation proceeds they received from the State in 2000; and,

(2) Were the Taxpayers in the business of renting their house in Florida in 2002 and 2003, and thus entitled to deduct the expenses relating to the house in those years.

The Taxpayers live in Montevallo, Alabama. They owned and operated a gift shop/tanning bed business on State Highway 119 just south of Birmingham, Alabama until 2000. The State condemned a portion of the property on which the business was located in 2000 so that the road could be widened. The Taxpayers received $190,000 from the State at that time, $23,974 of which was for damages to the Taxpayers' business.

The Taxpayers subsequently used $40,000 of the proceeds to buy a parcel of land at a development in Panama City, Florida. They used the remaining proceeds, and more,

to build a house on the property. Miariam Weldon (individually "Taxpayer") explained that she and her husband wanted to defer the gain on the condemnation proceeds pursuant to Code of Ala. 1975, §40-18-8(d) by reinvesting the proceeds in rental property in Florida. The above Alabama statute adopts by reference the federal non-recognition of gain provision at 26 U.S.C. §1033 relating to involuntary conversions.

The Taxpayers had problems with the Florida house from the beginning. The air conditioner was constantly malfunctioning, and the house leaked when it rained. The Taxpayers began renting the house in 2002, but continued having problems with the house. They filed a complaint against the contractor with the Panama City Building and Planning Department, but problems persisted.

The Taxpayers did not report the condemnation proceeds on their 2000 Alabama return because they intended to reinvest the proceeds in the Florida rental house. They reported rental income of $3,675 and $4,514 relating to the house in 2002 and 2003, respectively. They also claimed deductions for depreciation, travel, utilities, etc. relating to the house in those years of $27,672 and $31,174, respectively.

The Department audited the Taxpayers' 2000 through 2003 Alabama returns and determined that the Taxpayers' rental house in Florida was not a "for profit business." Department's Answer at 2. It consequently concluded that §1033 did not apply, and that the condemnation proceeds constituted taxable income in 2000. It also allowed the expenses concerning the Florida house in 2002 and 2003 up to the rental income reported by the Taxpayers in those years, but disallowed the balance.

The Taxpayer testified that their primary purpose in building the Florida house was to use it as rental property. Her husband never stayed at the house during the first three years after it was built, which included the years in issue. She stayed at the house in the subject years only when she traveled down from her home in Shelby County either to clean up after it had been rented or to pursue her complaint against the builder. None of the Taxpayers' relatives or friends stayed at the house during the subject years without paying rent.

The Taxpayers maintained complete records concerning when they rented the house, who they rented it to, and for how much. They also kept records of their expenses, including their travel miles to and from the house, maintenance supplies, furniture, etc. The Taxpayer prepared a CD that she gave to prospective renters showing the house and the various restaurants and other amenities in the area. The Taxpayers initially had trouble renting the house because of the leaks and the faulty air conditioning. They have, however, steadily increased their rental income from the house since 2003.

Both issues in this case turn on whether the Taxpayers' house in Florida was business property. That is, for §1033 to apply and also for the expenses relating to the house to be deductible as ordinary and necessary business expenses, the Taxpayers' primary purpose in building and then renting the house must have been to make a profit. This issue was addressed by the Administrative Law Division in *Blankenship v. State of Alabama*, Inc. 06-1215 (Admin. Law Div. O.P.O. 10/16/2007).

> 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 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 2 – 4.

The Taxpayers advertised the house for rent and maintained good records of their income and expenses relating to the house, which shows that they conducted the activity in a business-like manner. They also never used the house for personal pleasure or recreation during the subject years, which again shows a profit motive. Finally, there is no indication that the Taxpayers are wealthy and can afford to keep the Florida house without renting it.

The primary fact against the Taxpayers is that their expenses greatly exceeded their rental income in the subject years. The Taxpayer explained, however, that she had unexpected problems with the house after it was built, which made it unavailable and/or difficult to rent. The house was also revalued for property tax purposes, which caused the property taxes to be much greater than expected. It also is not unusual for expenses to be greater than income in the first years that rental property is put into use because of the initial start-up expenses and the lack of an established clientele, i.e., repeat renters, that know about the property. In any case, an actual profit is not required. Rather, "a taxpayer must only have a good faith expectation of realizing an eventual profit." *Blankenship* at 3, citing *Allen v. Commissioner*, 72 T.C. 28, 33 (1979).

On balance, I find that the Taxpayers built the house to use as business-related rental property, and that their primary purpose in doing so was for profit. Consequently, the condemnation proceeds from the property were tax-deferred pursuant to §1033.[1] The

[1] Taxpayers must elect on their return to defer a gain pursuant to §1033. If a taxpayer fails to include the gain as gross income on a return, the taxpayer is deemed to have elected to

(continued)

$23,974 received due to damages to the Taxpayers' business would, however, constituted income from the business. The Taxpayers also should be allowed to deduct the expenses relating to the Florida rental house.

The Taxpayers apparently claimed a basis in the house equal to what they paid for the house. Section 1033 requires, however, that the basis in any acquired property "shall be the same as in the case of the property so converted. . .", plus any additional amount spent on the acquired property over the amount received.[2] Section 1033(b)(1). It also appears that the Taxpayers may have expensed some capital items that should have been depreciated over time. Finally, the Department examiner explained at the April 4 hearing that while the Taxpayers had records, they were jumbled together and not sorted by type of expense.

The Taxpayers are directed to prepare amended returns for the subject years that reflect their correct basis in the rental house. They should also depreciate and not expense all of the capital expenditures relating to the house. Finally, they should organize their records by type of deduction. The amended returns and sorted records should be submitted to the Department examiner at the Birmingham/Shelby Taxpayer Service Center

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defer the recognition pursuant to §1033. See, 26 C.F.R. §1.1033(a)-2(c)(2). The Taxpayers thus elected to defer the gain when they elected not to report the income on their 2000 Alabama return.

[2] For example, if the Taxpayers had a $50,000 basis in the portion of their property that was condemned, and they spent $250,000 on the Florida house, their basis in the house would be the $50,000 basis in the old property plus the $83,974 they spent in addition to the condemnation proceeds ($250,000 less $166,026 ($190,000 less $23,974 for damage to business) equals $83,974), for a new basis of $133,974.

by August 22, 2008. The Department should thereafter notify the Administrative Law Division of its position after the returns and records have been reviewed. 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 June 30, 2008.

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BILL THOMPSON
Chief Administrative Law Judge

bt:dr
cc: Warren W. Young, Esq.
H. Doug Redd, Esq.
Tony Griggs