HENRY & ALICE P. GAINES P.O. BOX 206 CALVERT, AL 36513,	§ §	STATE OF ALABAMA DEPARTMENT OF REVENUE ADMINISTRATIVE LAW DIVISION
Taxpayers,	§	DOCKET NO. INC. 07-988
v.	§	
STATE OF ALABAMA DEPARTMENT OF REVENUE.	§	

OPINION AND PRELIMINARY ORDER

The Revenue Department assessed Henry and Alice P. Gaines (jointly "Taxpayers") for 2004 and 2005 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 26, 2009. The Taxpayers and their representative, Steven Waddell, attended the hearing. Assistant Counsel David Avery represented the Department.

This case initially involved two issues – a disputed IRA distribution and disputed deductions relating to an alleged barter transaction. The Department now concedes that the IRA was correctly reported by the Taxpayers, and that its adjustment relating to the IRA should be reversed. The barter issue is discussed below.

Henry Gaines (individually "Taxpayer") worked to rebuild a private school building in Mobile in the subject years that had been destroyed in a hurricane. He did not charge the school for his work, and thus received nothing in return for his services.

The Taxpayer deducted on his 2004 and 2005 Alabama returns various expenses relating to his work on the school building. The primary expense was his travel from his home to the school and back. The Department disallowed the expenses as non-deductible personal expenses.

The Taxpayer argues that his work on the school was part of a barter transaction. He cites an IRS publication, "Topic 420 – Bartering Income," for the proposition that a taxpayer "may deduct any costs you incurred to perform the work that was bartered." The Taxpayer's representative explained the Taxpayers' position in part, as follows:

> Since the tax rule in Topic 420 provides for **deducting any costs you incurred to perform the work that was bartered** then the next issue is whether the matching principle in accounting that expenses matched against revenues in the same accounting period is being violated. The answer is no. The Department expressed this in there (sic) response by stating that the taxpayer's representative's explanation that the "bartering transaction" regarding the claim of a tax deduction (without recognition of revenue) for providing of personal services of the taxpayer for the reconstruction of facility (Emmanuel Junior Academy) operated by a non-profit is frivolous. However, there is nothing frivolous in bartering transaction where the cost incurred in performing the work that was bartered is related back to the Revenue Principle in Accounting. The Revenue principle (1), establishes when to record revenue, usually when earned, (2) Revenue is earned when the business has completed rendering services to the customer and (3) Amount to record is equal to cash value of services or goods. So in cash basis accounting (which is the accounting method chosen by the taxpayer on their Schedule C) the impact of events not recognized until cash is paid or received where decreases in retained earnings resulting from operations are called expenses and increases in retained earnings resulting from operations are called revenues and the distribution of assets to shareholders decreases retained earnings in the accounting equation. The concept of cost principle allows that services acquired are recorded at actual, historical cost. What this means in terms of accounting is that accounts receivables is decreased which is an asset account by crediting it and accounts payable a liability account is debited which decreases that account and this action results in income to the receiver on their Schedule C. It also reduces retained earnings on the balance sheet of the giver because the taxpayer deducted the expenses **incurred to perform the work that was bartered which is deducted under expense on form Schedule C.** Therefore, the Department's claim that the taxpayer claim is frivolous is without merit in light of a clear understanding of reporting transaction in the accounting process. Further, the Department's response as to this issue that the taxpayer's representative is sufficient to subject him to penalty as a preparer under 26. U.S.C. §§ 6694, 6700 and 6701, which are adopted by Alabama law through Ala. Code § 40-2A-11.1(a) is also without merit. (emphasis in original)
>
> The Department failed to consider the taxonomy of facts in the accounting process that constitutes the financial information transferred from the income

> statement to form Schedule C. Had the Department considered the entire accounting process that relates the balance sheet with the income statement and the cash flow statement then the consideration of the bartered transaction would have been easily recognized because of the cost of incurred in performing the work in bartering. The Department assumed that the labor and bartering did not have deductions to be considered. The Department failed to consider that as a business owner the taxonomy of facts involved the legal terminology of bartering as well and that accounting definition that permits the deductions involved in the reconstruction of the school by the taxpayer which is what is reported from the financial statements onto form Scheduled C. The cash accounting method impact events not recognized until cash is paid or received. The election to use the Standard Mileage deduction rather than the actual cost recognizes that cash was paid and therefore deductible for the bartering represented on both of their 2004 and 2005 Schedule C expenses for the tax years 2004 and 2005 for Gaines Construction Company.

Taxpayers' Response at 2 – 4.

A barter transaction occurs when two parties contract or agree to jointly trade or barter goods or services. Bartering does have tax consequences. The parties must report as income the fair market value of the goods or services exchanged. If one or both of the parties are in a trade or business, they may also deduct any ordinary and necessary expenses incurred in the transaction.

To begin, the Taxpayer's work in rebuilding the school was not a barter transaction. He performed services for the school, but he received nothing in return. Consequently, he volunteered or gifted his services to the school.[1]

Second, while the Taxpayer claims he was doing business as Gaines Construction, there is no evidence that he was actually engaged in a trade or business. Consequently, even if the Taxpayer and the school had entered into a barter transaction, the Taxpayer's

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[1] If the Taxpayer had bartered his services for something (non-cash) in return, he would have been required to report the fair market value of that something as income. He did not, however, report income from the transaction because, as discussed, he received nothing in return.

related expenses still could not be deducted.

The Department argues that the frivolous appeal penalty at Code of Ala. 1975, §40-2A-11(f) should apply because the Taxpayer's claim that he can deduct the fair market value of his labor in rebuilding the school is frivolous. "The arguments as made by these Taxpayers that a deduction can be allowed for the fair market value of their labor are routinely held to be frivolous." Department's Response at 2, 3.

It appears, however, that the Taxpayer did not deduct the value of the Taxpayer's labor on their Alabama returns. Rather, they deducted the transportation, supplies, and other costs associated with the Taxpayer's work.[2] Consequently, while the Taxpayers' arguments concerning the "barter" expenses are incorrect, they are not based on the frivolous claim that the value of the Taxpayer's labor can be deducted. Rather, the Taxpayers' representative merely misunderstood what constitutes a barter transaction. The frivolous appeal penalty thus does not apply.

The Department is directed to recompute the Taxpayers' liabilities by removing the IRA income from its calculations. It should notify the Administrative Law Division of the adjusted amounts due. A Final Order will then be entered.

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).

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[2] The Taxpayers' returns for the subject years were not submitted into evidence. However, the Taxpayers' Response lists the various items and amounts that were deducted, which apparently were claimed as "commission and fees" expenses on the returns.

Entered May 8, 2009.

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BILL THOMPSON
Chief Administrative Law Judge

bt:dr
cc: David E. Avery, III, Esq.
Steven Waddell
Kim Peterson