

GRAEME R. & SUSAN DUTHIE
2505 CLOVIS ROAD
HUNTSVILLE, AL 35803,

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STATE OF ALABAMA
DEPARTMENT OF REVENUE
ADMINISTRATIVE LAW DIVISION

Taxpayers,

§

DOCKET NO. INC. 08-484

v.

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STATE OF ALABAMA
DEPARTMENT OF REVENUE.

§

OPINION AND PRELIMINARY ORDER

The Revenue Department assessed Graeme R. and Susan Duthie (together “Taxpayers”) for 2004, 2005, and 2006 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 September 5, 2008. Susan Duthie (individually “Taxpayer”) and her attorney, Gene Bowman, attended the hearing. Assistant Counsel Lionel Williams represented the Department.

The Department audited the Taxpayers’ 2004, 2005, and 2006 Alabama returns. The Department examiner reduced the medical expenses claimed on Schedule A in each year because the Taxpayers failed to substantiate the entire amounts claimed. The remaining Schedule A expenses were verified, and thus allowed.

The examiner also reviewed the Schedule C expenses claimed on the returns, which related to the Taxpayer’s activity of selling specialty gift baskets. The Taxpayers provided records, albeit disorganized, relating to the activity. The Department examiner determined that the activity was not a for-profit business. She consequently allowed the expenses only up to the amount of income reported on the Schedule Cs. The remaining Schedule C expenses were disallowed, which resulted in additional tax due in each year. The Department assessed the Taxpayers accordingly.

The Taxpayer testified at the September 5 hearing that she started her business, Baskets Your Way, in early 2003. She explained that she had quit working in the late 1990's to stay home with her small children. Her husband made a modest salary, and she started the business to help pay the bills and perhaps buy a larger house.

She researched several ideas before finally deciding to sell special-order gift baskets. She could sell the baskets from home, which allowed her to be with her two youngest children, who were six and seven years old at the time. She ordered a gift basket starter package that included a shrink wrap machine, a hot glue gun, baskets, miscellaneous basket fillers, etc.

The Taxpayer initially advertised at the PX on Redstone Arsenal in Huntsville, and otherwise sold baskets by word of mouth. She subsequently created a website on which she advertised her business. Some customers ordered baskets on-line, but most ordered using the business's toll-free telephone number that was listed on the website.

The Taxpayer spent several hours each day making baskets, obtaining supplies, and constantly updating the website. She opened a business checking account in the name of the business. She testified that all of the receipts from the business were deposited into the account, and that all checks written on the account were business-related. She also used an American Express credit card to purchase all business-related items.

The Taxpayers reported Schedule C income of \$6,565, \$17,686, and \$20,497 from the business in 2004, 2005, and 2006, respectively. After expenses and other deductions, they claimed net losses from the business of \$16,310, \$25,875, and \$24,731, respectively, in those years.

The Taxpayer conceded that her husband did not want her to start the business because she had never stuck with a project, and he thought she would fail. He nonetheless supported and encouraged her once she started the business. That motivated her to continue operating, despite the losses in each year. She also testified that she enjoyed selling the baskets, although she did not like actually preparing the baskets.

The Taxpayers obtained a \$40,000 second mortgage on their home so that the Taxpayer could continue in business. They finally ran out of money, and the Taxpayer closed the business in early 2008. She is now employed outside of the home.

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 or business. While the activity in this case is not horse breeding, the rationale used by the Tax Court applies to any activity. 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.

The Department examiner concluded that the Taxpayer's activities did not constitute a for-profit business because: (1) the Taxpayer's records were "extremely disorganized," (T. 40); (2) the Taxpayer had no expertise in selling baskets; (3) the Taxpayer spent extensive time and effort in carrying on the activity; (4) the business had no substantial fixed assets that could increase in value; (5) the Taxpayer had never operated a successful business; (6) the Taxpayer incurred substantial losses in each year; (7) the Taxpayers were not wealthy, so, according to the examiner – "I'm not aware of how they can continue the activity after suffering the substantial losses." (T. 43); and (8) the Taxpayer stated that she enjoyed the business, which shows that the Taxpayer took personal pleasure in the activity.

As in most cases that involve the issue of whether an activity constitutes a for-profit business, various factors in this case indicate that the Taxpayer's business was not for profit, and others indicate that it was. The fact that the Taxpayer's records were disorganized, i.e., not maintained in a businesslike manner, hurts the Taxpayer's case. She also had no prior experience in operating a small business. But the most obvious fact against the Taxpayer's claim that she had a profit motive was that the business lost money every year.

Other factors tend to show, however, that the Taxpayer did have a good-faith profit motive. She advertised, had a separate bank account and a toll-free number for the business, and except for the sloppy bookkeeping, conducted the business in a businesslike manner. Importantly, the Taxpayers are not wealthy, and it is improbable that they would have lost tens of thousands of dollars, and taken out a second mortgage on their home, to engage in a "hobby" without a profit motive. The amount of sales also increased in each year. Finally, while the Taxpayer enjoyed selling the baskets, she did not enjoy actually preparing the baskets or the other tasks, i.e., updating the website, maintaining records, etc., she was required to do relating to the business.

The Department examiner conducted a professional and thorough audit. But based on all of the facts, I find that the Taxpayer intended to make a profit from her basket business during the years in issue. She thought she would eventually turn a profit, but she obviously underestimated how difficult it would be to do so. I gather from her testimony that she continued operating the business, even though it continued losing money, because she hoped and believed that it would eventually be profitable. As indicated above, "the expectation of profit need not be reasonable," Another understandable reason she

stayed in business was that she wanted to show her husband she could stick with something and make it work.

The records provided by the Taxpayer were disorganized and not sorted by type of deduction. The Taxpayer should organize her records and clearly indicate the deductions that the various records relate to. The Taxpayers' representative should then submit the records to examiner Alayne Blankenship in the Department's Jefferson/Shelby Taxpayer Service Center by November 7, 2008. The examiner should review the records and determine the amount of the claimed Schedule C expenses that should be allowed. 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 October 20, 2008.

BILL THOMPSON
Chief Administrative Law Judge

bt:dr

cc: Lionel C. Williams, Esq.
Gene Bowman, Esq.
Tony Griggs