

JOHN C. & ALICE H. CUTRIGHT
307 WHITING COURT
DAPHNE, AL 36526,

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§

STATE OF ALABAMA
DEPARTMENT OF REVENUE
ADMINISTRATIVE LAW DIVISION

Taxpayers,

§

DOCKET NO. INC. 09-561

v.

§

STATE OF ALABAMA
DEPARTMENT OF REVENUE.

§

OPINION AND PRELIMINARY ORDER

The Revenue Department assessed John C. and Alice H. Cutright (jointly “Taxpayers”) for 2006 and 2007 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 5, 2010. John Cutright (individually “Taxpayer”) attended the hearing. Assistant Counsel Duncan Crow represented the Department.

The Taxpayer is employed full-time with the State of Alabama, Department of Human Resources. He purchased a dilapidated 1967 Ford Mustang in 2003 with the intent of refurbishing and selling it. He paid \$1,700 for the vehicle.

The Taxpayer personally worked on the Mustang, and also subcontracted out some of the repair work he could not perform. He began showing the vehicle at auto shows after it was fully restored. He sold the vehicle in 2005 for \$35,000. He reported the gain on his 2005 Alabama return.

The Taxpayer purchased a 1968 Shelby in 2005 for \$34,000.¹ He subsequently restored that vehicle, again with the help of a trained mechanic. He shows the restored vehicle at auto shows, where he offers it for sale for \$90,000.

¹ The Taxpayer testified that the 1968 Shelby is a rare vehicle because only 89 such vehicles were built in 1968.

The Taxpayers claimed depreciation and deducted the expenses relating to the restoration of the 1968 Shelby on Schedule C of their 2006 and 2007 Alabama returns. They also claimed various itemized deductions on Schedule A. The Department audited the returns and requested records verifying the expenses and deductions.

The Taxpayers failed to submit any records concerning the Schedule A deductions. The Department consequently disallowed the unsubstantiated deductions, except for the FICA deduction.

Concerning the Schedule C deductions, the Department examiner determined that the Taxpayer's vehicle restoration activity was not a profit-motivated trade or business. He thus disallowed the Schedule C expenses in full.

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).

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). Whether the taxpayer had an intent to make a profit must be determined on a case-by-case basis from all facts and circumstances. *Patterson v. U.S.*, 459 F.2d 487 (1972).

As indicated, the Taxpayer purchased a used vehicle in 2003, restored it, and sold it for a profit in 2005. He purchased another vehicle, a 1968 Shelby, in 2005. He has restored that vehicle, and intends to sell it for a profit. The Taxpayer maintained records relating to the restorations, and otherwise operated the activity in a businesslike manner. The activity thus constituted a profit-motivated business, even though he has restored only two vehicles.

The Taxpayer is not, however, entitled to all of the Schedule C deductions he claimed relating to the activity. The 1968 Shelby restored by the Taxpayer in the subject years constituted his inventory of goods to be sold. A business cannot depreciate goods held for sale in the regular course of business. The depreciation claimed by the Taxpayer thus cannot be allowed.

The cost of the parts used to restore the Shelby, and the contract labor associated with the restoration, also cannot be deducted in the year incurred. Rather, those costs must be added to the Taxpayer’s cost of goods sold, and thus increase his basis in the

vehicle.

The Taxpayer may currently deduct all consumable supplies he used in restoring the vehicle. He could also deduct business miles traveled, but only if he satisfied the recordkeeping requirements of 26 U.S.C. §274.² That section requires that a taxpayer must keep a contemporaneous log or other sufficient records showing the amount, time, place, and business purpose for each travel expenditure. The Taxpayer in this case presented only a monthly recap of his business miles traveled, which clearly does not satisfy the strict requirements of 26 U.S.C. §274. Consequently, the business miles claimed on the returns cannot be allowed.

Concerning the Taxpayers' Schedule A expenses, the Taxpayers submitted mortgage interest statements for 2006 and 2007 after the February 5 hearing. Copies of the statements are attached to this Preliminary Order. Those amounts, \$11,805.42 in 2006 and \$10,344.64 in 2007, should be allowed. All other unverified expenses were correctly disallowed.

The Department should recompute the Taxpayers' 2006 and 2007 liabilities as indicated above. 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).

² Alabama has specifically adopted IRC §274 as it relates to the recordkeeping requirements for business-related travel, entertainment, and similar expenses. See, Code of Ala. 1975, §40-18-15(a)(20).

Entered March 11, 2010.

BILL THOMPSON
Chief Administrative Law Judge

bt:dr

cc: Duncan R. Crow, Esq.
John & Alice Cutright
Tony Griggs