PHILLIP AND RHODA LAMB 3996 COTTONVILLE ROAD GRANT, AL 35747,	§ §	STATE OF ALABAMA DEPARTMENT OF REVENUE ADMINISTRATIVE LAW DIVISION
Taxpayers,	§	DOCKET NO. INC. 10-1190
v.	§	
STATE OF ALABAMA DEPARTMENT OF REVENUE.	§	

FINAL ORDER

The Revenue Department assessed Phillip and Rhoda Lamb (together "Taxpayers") for 2009 Alabama 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 December 1, 2011. Rhoda Lamb and Enrolled Agent Paul Williams represented the Taxpayers. Assistant Counsel Keith Maddox represented the Department.

The Taxpayers live in rural Marshall County, Alabama. Rhoda Lamb retired from GE in 2006 because of health problems. She consequently received only disability income in the subject year. Phillip Lamb was employed full-time and earned approximately $45,000 in the year.

The Taxpayers purchased a young mare and a young stallion in the early 2000's. The horses matured and had their first foal in 2004, a second in 2008, and a third in 2010 or 2011. Rhoda Lamb testified at the December 1 hearing that she and her husband purchased and bred the horses for the purpose of profiting from the sale of the offspring. They have advertised the horses, but to date have only sold one of the horses due to the depressed market for horses in the Southeast.

The Taxpayers owned four Chow Chows when Rhoda retired in 2006. They purchased several English Bulldog puppies in 2006 because they liked the breed and

thought they could make money selling Bulldogs. The Bulldogs they purchased in 2006 began having puppies shortly thereafter. The Taxpayers began selling the puppies in 2008. They sold more puppies in 2009, and also a horse in that year. They also sold more puppies in 2010.

The Taxpayers reported the income and expenses relating to their dog and horse activities on Schedule F of their 2009 Alabama return. The total reported income was $12,558. They claimed costs of goods sold of $4,500, depreciation and §179 expenses of $9,214, feed of $4,983, freight and trucking of $404, fuel of $365, veterinary expenses of $3,404, and advertising of $1,054, for total expenses of $19,424. The net Schedule F loss was thus $11,366 for the year.

The Department reviewed the Schedule F and disallowed the expenses in full because, according to the Department's Answer, the expenses were not substantiated. The Taxpayers had, however, submitted records with their notice of appeal that verified most, if not all, of the expenses.

The Department requested in its Answer that the Taxpayers should explain the claimed depreciation (and §179 expense), and how it related to dog breeding, and also how the claimed hay expense related to dog breeding. The Department also asserted that the burden was on the Taxpayers to prove that their horse and dog breeding activities were entered into for profit, as required for the related expenses to be deductible.

The Taxpayers responded that the depreciation and §179 expense related to a barn on their property and a truck. They used the barn to house the horses and also the Bulldogs. Rhoda explained that the dogs had to stay in the barn to shelter them from the elements. She also testified that she and her husband used the truck exclusively relating to

the animals, and that they had two or three other vehicles that they used for personal travel. They needed hay to feed the horses, and also as a bed in the barn for the dogs.

Concerning the "entered into for profit" issue, Rhoda explained that after she was forced to retire in 2006, she and her husband needed to earn from $5,000 to $10,000 a year in extra income. They thought they could do so by breeding and selling the English Bulldogs and the foals produced from their two horses.

The Taxpayers advertised the dogs for sale on their own website, and also on al-com and puppyfind.com. As indicated, they received income of $12,558 from the sale of the dogs and a horse in 2009. They also had some income from the sale of the dogs in 2008, although the amount is not in evidence. The Taxpayers' representative submitted the Taxpayers' 2010 Schedule F after the December 1 hearing, which shows that the Taxpayers' receipts from the sale of the dogs in that year totaled $13,100.

Rhoda testified that she spends at least 50 hours a week feeding, cleaning, and otherwise tending to the dogs. Her husband helps when not working at his day job, and does all of the tasks that require heavy lifting. The Taxpayers have been unable to vacation together for the last few years because one of them must stay at home and tend to the dogs at all times. The Taxpayers also maintain a separate checking account through which they handle all financial transactions relating to their horse and dog activities. Additional relevant facts are set out in the Taxpayers' response to the Second Preliminary Order, a copy of which is attached to and made a part of this Final Order.

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). 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).

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.

Applying the above factors to this case, it is clear that the Taxpayers' dog and horse breeding activities were entered into for profit.

The Taxpayers operated the businesses in a business-like manner. They kept detailed records, advertised the dogs and horses for sale, and maintained a separate checking account relating to the activities.

The Taxpayers had some knowledge concerning dogs and horses, and Rhoda spent long hours each week tending to the dogs. The fact that one of the Taxpayers stayed at home and tended to the animals at all times shows that they were dedicated and determined to make the activities financially viable.

The Taxpayers have regularly received income from the activities since 2008. They earned more in 2010 ($13,100), than they did in 2009 ($12,558), which shows that their profits are improving with time.

The Taxpayers live off of Rhoda's disability income and Phillip's relatively meager wages. They started raising and selling dogs and horses because they needed to supplement their income by $5,000 to $10,000 a year. This confirms that the Taxpayers were not financially able to raise the horses and dogs as a mere hobby or diversion.

The Taxpayers also did not raise the dogs and horses for personal pleasure or recreation. They never ride the horses, and while they enjoy having dogs, they certainly cannot enjoy cleaning up after, feeding, and otherwise tending to the animals on average 50 hours a week. Likewise, they cannot enjoy the fact that because of the need to

constantly tend to the animals, they are never able to vacation together.

The above facts, viewed together, establish that the Taxpayers were engaged in their horse and dog breeding activities primarily for profit. That finding is supported by the additional facts set out in the Taxpayer's attached response to the Second Preliminary Order. The Taxpayers' dog and horse related expenses in the subject year were properly deducted. The final assessment in issue is voided.

This Final Order may be appealed to circuit court within 30 days pursuant to Code of Ala. 1975, §40-2A-9(g).

Entered January 12, 2012.

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BILL THOMPSON
Chief Administrative Law Judge

bt:dr
attachment
cc: Warren W. Young, Esq.
Paul Williams, EA
Kim Peterson