

CHARLES & REDONNA D. INGRAM §
4041 HICKORY GROVE ROAD §
COTTONWOOD, AL 36320-5427, §

STATE OF ALABAMA
DEPARTMENT OF REVENUE
ADMINISTRATIVE LAW DIVISION

Taxpayers, §

DOCKET NO. INC. 11-495

v. §

STATE OF ALABAMA §
DEPARTMENT OF REVENUE.

OPINION AND PRELIMINARY ORDER

The Revenue Department assessed Charles and Redonna Ingram (together “Taxpayers”) for 2007, 2008, and 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 June 21, 2012. The Taxpayers and their representative, Ben Armstrong, attended the hearing. Assistant Counsel Billy Young represented the Department.

ISSUE

The Department disallowed the Schedule F farming losses claimed by the Taxpayers on their 2007, 2008, and 2009 Alabama income tax returns. The issue is whether the Taxpayers conducted their farming activities during the years in issue with the primary purpose of making a profit. If so, the farm losses were incurred in a trade or business, and thus should be allowed pursuant to Code of Ala. 1975, §40-18-15(a)(1).

FACTS

The Taxpayers live on a farm in rural Houston County, Alabama. Charles Ingram (individually “Taxpayer”) worked as a federal corrections officer during the years in issue. He normally worked the midnight to noon shift three or four days a week. His wife, Redonna Ingram, worked as a teacher for the Houston County Board of Education.

The Taxpayer is a third generation farmer. His grandfather farmed on the property where the Taxpayers lived in the subject years. His father took over the farm from his grandfather, and the Taxpayer took over from his father in 1995.

The Taxpayer farms approximately 390 acres. His father owns 200 of the acres, he purchased 15 of the acres after taking over in 1995, and he leases the remaining 175 acres. He plants approximately 100 acres in beans, 50 to 80 acres in oats, 15 to 30 acres in melons, and some in corn. He sells the beans and melons primarily at farmers markets in the area. He feeds the oats and corn to his cattle.

The Taxpayer's father had 30 to 35 head of cattle on the farm when the Taxpayer took over in 1995. The Taxpayer now has approximately 120 brood cows and 6 bulls. He explained that he sells the 100 or so newborn calves each year and uses most of the proceeds to purchase more brood cows.

The Taxpayer does most of the work required to operate the farm. His wife, father, and teenage son also help. He also hires seasonal labor at harvest time. The Taxpayer explained that when not on duty as a corrections officer, he normally starts working on the farm at 6:00 – 6:30 a.m., and continues working until sundown or later. On days when he works at his corrections job, he is usually back on the farm by 1:00 p.m. and works until dark. He also testified that he likes to hunt and fish, but that he rarely gets to do so because he is always busy with farm work.

William Birdsong has been an Auburn University extension agronomy specialist based in Southeast Alabama for over 20 years. He testified at the June 21 hearing that he has known the Taxpayer since the early 1990's. He periodically visits the Taxpayer's farm and helps the Taxpayer with his melons and row crops. He advises the Taxpayer as to the

best farming techniques, what fungicides he should use, how he should irrigate his property, and otherwise “how to better his operation or improve his operation,” to make it more profitable. (T. 12). Birdsong explained that the Taxpayer operates his farm in generally the same manner as the full-time farmers in the area.

The Taxpayers have reported Schedule F farming losses on their Alabama income tax returns since at least 2001. In 2007, the Taxpayers reported farm income of \$74,445 and farm expenses of \$174,786, for a net loss of \$100,341; in 2008, the Taxpayers reported farm income of \$85,188 and farm expenses of \$175,718, for a net loss of \$90,530; and in 2009, the Taxpayer’s reported farm income of \$46,026 and farm losses of \$179,788, for a net loss of \$133,762. Because of the Schedule F losses, the Taxpayers reported negative taxable income in the three years in issue.

A Department examiner audited the Taxpayers for the subject years and disallowed the Schedule F expenses because he determined that the Taxpayers’ farming activity was not for profit. The various factors considered by the examiner are discussed in his audit report, which reads in part as follows:

1. The taxpayers failed to carry on this agricultural enterprise in a business-like manner. They failed to maintain records of the cattle and crop activities, and could not produce Profit and Loss Statements, Cash Flow Statement, Balance Sheets or any other type of standard business records. The only business records submitted consisted of Bank Statements and a number of folders and envelopes full of invoices and receipts, none of which was separated by type of expense or vendor. It was not possible to determine which of the receipts were business or personal. . . . The taxpayer’s Sch. “F” records were not maintained by any accountant or bookkeeper.
2. Based on the information obtained from the taxpayers representative, Mr. Ingram has been farming and raising cattle for over 20 years. Also during this time the taxpayer has been employed full time off the farm and has therefore only been able to devote a limited amount of time to this

endeavor. I have no knowledge of the taxpayer's level of training or education in this type of enterprise. It appears to be evident that the taxpayer has had no success in this endeavor as far as I can determine. . . . Also during the examination it was noted that the taxpayer has made no significant changes to the way he conducts this operation that might change the outcome from losses to profits.

3. As previously stated the taxpayer is employed full time as a prison guard supervisor at a correctional facility and as such can only devote whatever time he is not working to this activity.

4. Virtually all of the assets associated with this activity are the assets shown on the depreciation schedule and they will therefore lose value over time. No long term gain can be expected from any of these assets that would have any effect on the substantial losses shown.

* * *

6. As far at the taxpayer's history of income and losses for this Sch. "F" activity, As far as the period under examination is concerned, in 2007 the taxpayers had Sch. "F" income of \$74,445.00 and Sch. "F" expenses of \$174,786.00 for a Sch. "F" loss of \$101,341.00, in 2008 taxpayers had Sch. "F" income of \$85,188.00 and Sch. "F" expenses of \$175,718.00 for a Sch. "F" loss of \$90,530.00, in 2009 the taxpayers had Sch. "F" income of \$46,026.00 and Sch. "F" expenses of \$179,788.00 for a Sch. "F" loss of \$133,762.00.

7. As previously stated there is no record of any profits from farm related activities by these taxpayers. . . . It would seem that if an activity was entered into with a profit motive in mind that over some period of time the gap between expenses and income would begin to narrow, rather than grow wider as it tends to do in this case.

8. As far as the financial status of the taxpayer goes, Upon examination of the taxpayers bank records they have been able to send their child to private school, have traded vehicles on a regular basis, have had normal amounts of expenditures relating to individuals with comparable earnings from wages and salaries. The taxpayers have been able to pay down their home mortgage loan at an accelerated rate by making what appears to be two payments per month. It appears that many of the receipts and invoices included in the farm records could very well be for personal expenses not related to the Sch. "F" activities. Vehicles purchased and included on the farm depreciation schedule could very well be used for personal activities and commuting to and from work on a daily basis.

9. As far as what motivation the taxpayers have for engaging in this activity it would be impossible to imagine that the activity is being carried out with a for profit motive based on the fact that I can find no record of any profit ever being created from the Sch. "F" operation. It would have to be an activity engaged in for recreational or maybe even some type of personal pleasure or for a sense of satisfaction purpose. What it has allowed them to do is to charge many expenses which might otherwise be classified as personal to the Sch. "F" activities.

ANALYSIS

The Administrative Law Division has decided numerous cases involving the issue of whether an activity was entered into for profit. In *Blankenship v. State of Alabama*, Docket Inc. 06-1215 (Admin. Law Div. O.P.O. 10/16/2007), the Division explained the criteria to be applied in deciding the issue.

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 3 – 4.

As in most cases involving this issue, some of the above factors indicate that the Taxpayers' farming activity was for profit, while others indicate that it was not. The relevant factors are discussed below.

The Department claims that the Taxpayer did not conduct his farming activities in a business-like manner because he did not maintain profit and loss statements, cash flow statements, or balance sheets, and that his records were not maintained by an accountant or bookkeeper.

The Administrative Law Division has not reviewed the Taxpayers' records because they were not submitted into evidence at the June 21 hearing. The Taxpayer testified, however, that he had a separate farm checking account that he used to pay all of his farm-related expenses. He also indicated that he records all of his farm-related expenses in a notebook, and that he also keeps his receipts relating to the farm.

A. Well, I put all my receipts in a clothes bin. And when I get time, I write them in my notebook.

Q. Are you familiar with these Rubbermaid containers that are in the courtroom?

A. Oh, yes. Oh, yes.

Q. And those are? Can you tell me?

A. Those are my receipts.

Q. Those are your receipts from 2007, '08, and 09.

A. Yes, sir.

Q. So you keep your receipts in a clothes bin until you get time to reconcile your records. What do you do with those receipts then? Do you store them?

A. I store them.

Q. At the end of the year, how do you go about having a tax return prepared?

A. Well, I go through every one of the receipts, and I'll divide them up into fertilizer, seed, supplies, parts. And I divide them up, tally them up, and write that figure down. And then I take that figure to my tax preparer.

(T. 62 – 63).

Although not sophisticated, the Taxpayer's recordkeeping appears to be adequate. The Taxpayer testified that he maintained a separate farm checking account, and there is no evidence that he wrote checks on that account for anything other than his farm-related expenses. He also recorded the expenses in a notebook and retained the underlying receipts. Many self-employed individuals keep their own records, and also do not maintain balance sheets or other formal accounting books. Many also do not use a bookkeeper or accountant.

The Taxpayer belongs to various farm co-ops in the area, and he purchases crop insurance to protect himself against catastrophic loss. As discussed, William Birdsong also

testified that the Taxpayer operates his farm in the same manner as the other farmers in the area. The above shows that the Taxpayer operates the farm in a business-like manner.

The Department contends that because the Taxpayer is otherwise employed full-time, he only devotes a limited amount of time to his farming activities. The evidence shows, however, that the Taxpayer works on the farm from sunup to sundown on the three or four “off” days a week when he is not working at his corrections job. Even on the days that he goes to his corrections job, he works on the farm from when he gets home in the early afternoon until dark or later. Clearly, the Taxpayer spends a significant amount of time working on the farm, as does his father.

The Department also claims that the Taxpayer has not changed his method of operating to turn his losses into profits. But the Taxpayer explained that he quit growing peanuts because he kept losing money on peanuts.

A. Well, it got to where it was taking my produce money and my cow money to pay me out of the peanut business and to pay my bills. So I quit.

ALJ. So you tried peanuts at one time.

A. I’ve tried it. Yes, sir.

ALJ. And you lost so much money you had to quit?

A. And I lost so much. That’s one of the reasons I – it just got to – when the government cut the quote out, I just couldn’t make no money at \$300 a ton for peanuts. And I quit.

(T. 57 – 58).

The Department asserts that none of the Taxpayer’s assets have appreciated in value. The Taxpayer has, however, increased his cattle herd from 30 to 35 head of cattle

in the mid-1990's up to approximately 125 brood cows and bulls currently, not including the approximately 100 calves born each year. He also purchased 15 additional acres and has updated his farm equipment using his farm income. The value of the farm has clearly increased.

The Department also points to the fact that the farm losses increased during the years in issue. That is correct, but as explained by the extension agent, the larger losses were due to a drought and then a devastating flood that hurt all of the farmers in the area.

The primary factor supporting the Department's position is that the Taxpayers have consistently reported farming losses on their Alabama returns. But consistent losses are only one factor to be considered, and are not conclusive that the activity was not for profit. *Baker v. State of Alabama*, Docket Inc. 08-725 (Admin. Law Div. 3/9/2009).

Viewing the facts together, I find that the Taxpayer operated his farm during the subject years with the primary purpose of making a profit. The Taxpayer operated the farm in the same manner as other farmers in the area; he knows how to operate the farm; he seeks advice from the local extension agent to better grow his crops; and he works long hours on the farm. I agree with the Department examiner that the Taxpayer surely gets a sense of personal satisfaction in operating the farm, but that does not negate a profit motive. Many individuals enjoy and get satisfaction from their job or the business they are engaged in.

When asked why a farmer would stay in business and continue farming, even after 20 years of losing money, William Birdsong, the extension agent, testified as follows:

I'd say that farmers are not quitters. Okay? And they don't like to quit. And I feel like that, you know – I guess it goes back to something that my – with me being raised on a farm, okay, and my father being a retired farmer.

And I can remember making a statement years ago and my sister stating something to me – and I thought about it. And I said, you know, you're right. And I've said – I very remember saying, well, next year we're going to do such and such or maybe next year will be the year or next year, next year. Okay. And next year we're going to do it this way. Next year we're going to do it that way, and you know, maybe next year will be a good year.

And my younger sister said, you know, I don't think there's such a thing as a good next year, you know, or the perfect next year. It's like –

But my point is, it's always that hope and it's that drive. And then that's just that fire that's inside that farmer that keeps them going and it keeps them pursuing to try to – they're looking for that good year. They're looking for the satisfaction and the profitability of producing a good crop and making good financial returns.

And, unfortunately, sometimes when you get in the middle of the corps, you know, it's at harvest time and you realize it's a bad crop, you can't just say, well, this is a bad crop. I can't – I can't deal with this. I'm going to go home, you know, because, I mean, I'm going to be out here working like crazy and I'm going to lose money.

Well, you can't do that, because then that means you're going to lose even more money. You can't quit. You can't give up. You're in the middle of it. You're committed to it. You've got to finish it.

(T. 41 – 43).

I believe that the above aptly describes the Taxpayer's attitude toward farming. He works hard trying to make the farm profitable, and he takes pride in his efforts. He has so much time, money, and effort tied up in the farm that he cannot afford to quit.

But the fact that the Taxpayers operated the farm as a business does not mean that all of their claimed Schedule F losses should be allowed. Rather, the Taxpayers must provide adequate records verifying the Schedule F deductions.¹

¹ The Taxpayers claimed net farm losses of \$101,341, \$90,530, and \$133,762 on their 2007, 2008, and 2009 returns, respectively. Given those large losses, it would seem that the Taxpayers would have been required to use most if not all of their wage income to operate the farm. The Taxpayer testified, however, that he did not use any of his wage

The examiner stated in his audit report that the Taxpayers provided “a number of folders and envelopes full of invoices and receipts, none of which were separated by type of expense or vendor. It was not possible to determine which of the receipts were business or personal.” State Ex. 1, at 1. The examiner presumably did not ask the Taxpayers or their tax preparer to organize the Taxpayers’ invoices and receipts to match the claimed Schedule F deductions. Rather, he disallowed all of the Schedule F expenses because he concluded that they were personal or nonbusiness in nature.

As indicated, the burden is on the Taxpayers to present records verifying the deductions claimed on their Schedule F in each year. *Norgaard v. C.I.R.*, 939 F.2d 874 (1991). The Taxpayers or their tax preparer are directed to organize the Taxpayers’ records by the type of deduction claimed, and then provide the organized records to the Department examiner for review. The examiner should review the records and determine if and to what extent the records support the claimed Schedule F deductions. The examiner should discuss the various records with the Taxpayer and/or his tax preparer if he has any questions. The Taxpayers or their tax preparer should provide the records directly to the examiner at the Dothan Taxpayer Service Center by November 2, 2012. The Department should notify the Administrative Law Division in due course of the examiner’s findings. Appropriate action will then be taken.

income to operate the farm. The examiner also indicated that the Taxpayers regularly traded vehicles, paid down their house mortgage at an accelerated rate, and otherwise paid their normal living expenses during the subject years. The above facts led the examiner to conclude that some of the claimed Schedule F farm deductions may have been nondeductible personal expenditures.

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 10, 2012.

BILL THOMPSON
Chief Administrative Law Judge

bt:dr

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