JAMES E. & ANN S. HUBBARD 1568 HAYSOP CHURCH ROAD CENTREVILLE, AL 35042,	§	STATE OF ALABAMA DEPARTMENT OF REVENUE ADMINISTRATIVE LAW DIVISION
Taxpayers,	§	DOCKET NO. INC. 12-175
v.	§	
STATE OF ALABAMA DEPARTMENT OF REVENUE.	§	

FINAL ORDER

The Revenue Department assessed James E. and Ann S. Hubbard (together "Taxpayers") for 2007 and 2008 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 October 25, 2012. The Taxpayers and their attorney, Mike Hobson, attended the hearing. Assistant Counsel Christy Edwards represented the Department.

The issue in this case is whether the Taxpayers' vegetable and tree farming activities during the subject years constituted a trade or business. That issue turns on whether the activities were entered into primarily for profit.

James Hubbard (individually "Taxpayer") was in his early 60's during the years in issue. He was born on and has lived all his life on a 300 – 350 acre farm in Bibb County, Alabama. He inherited the property when his father died in 1974. The Taxpayer's father farmed the property. The Taxpayer helped his father, and thus learned the basics of farming while growing up on the property.

The Taxpayer obtained an industrial engineering degree from Auburn University in the late 1960's. He was employed with Alabama Power Company until he retired in May 2008.

The Taxpayer maintained a small garden on his property before 2008. The Taxpayers consumed some of the vegetables grown in their garden, and also sold some by word of mouth to folks in the area. The remainder of the Taxpayer's property became overgrown. Beavers also dammed two ditches on the property, which turned the surrounding property into a useless wetland.

The Taxpayer testified that he began acquiring equipment in the early 2000's that he expected to use in clearing and reclaiming some of the property. A listing of the equipment, the dates acquired, and the Taxpayer's cost basis in the equipment is set out and discussed below.

The Taxpayer decided in 2007 to get into farming crops full-time after he retired in May 2008. He explained that he had known people that had died soon after they retired, and that he wanted to stay active. He accordingly purchased more equipment in 2007, and started clearing/restoring some of the land that had been inundated by the beaver dams.

The Taxpayer still maintained his small garden, but did not plant additional crops on the property in 2007 because the reclamation project was still ongoing. He also did not have a crop on the reclaimed land in 2008 because it was too late to plant when he retired in May of that year. The record does not show how many acres were available for planting in 2008. The Taxpayer explained, however, that he continued reclaiming the property, and that he can now grow crops on 3.25 acres.

The Taxpayer submitted various documents at the October 25 hearing supporting his claim that he actively farmed during the subject years. Specifically, he submitted (1) a May 24, 2012 letter from the Bibb County Extension Office showing that he has obtained a

State of Alabama Grower's Permit annually since 2009, and that he sells his produce "out of his vehicle at various locations in the Brent-Centreville area" (Taxpayer Ex. 18); (2) a May 15, 2012 letter showing that he paid $25 for a 2012 Bibb County Farmers Market membership fee (Taxpayer Ex. 19); and (3) an October 22, 2012 letter from the owner of Bibb Supply verifying that he has purchased farm supplies, seed, fertilizer, and plants from Bibb Supply for years, and that he sells his crops in the Brent-Centreville area in the Spring or Summer farming season (Taxpayer Ex. 20).

The Taxpayer testified that during the years in issue, he sold his crops to various individuals in the community through word of mouth. The Taxpayer reported income of $1,500, $2,200, $2,500, $3,500, $4,000, and $2,500 from the sale of vegetables in 2006 through 2011, respectively. He also reported Schedule F farming-related expenses of $50,362 and $42,125 in 2007 and 2008, respectively, and total farming losses of $324,836 from 2006 through 2011. The Schedule F expenses also included unspecified amounts spent by the Taxpayer relating to his timber.

The Taxpayers reported a loss on the sale of timber on their 2007 return. The Taxpayer had acquired the timber in October 2006 for $4,500. He sold it on January 5, 2007 for $487. He had also acquired timber in March 2003 for $15,000 that he sold in December 2006 for $12,421. He also inherited timber with a cost basis of $65,000, which he sold in December 2010 for $26,936. Finally, he planted 80 acres of pine trees on the property in 2009.

The Department audited the Taxpayers' Alabama returns for the subject years. It allowed the farm-related Schedule F expenses to offset the Schedule F income reported in

both years. It disallowed the remainder, however, because it determined that the Taxpayer's garden and timber activities were not for profit, and thus did not constitute a trade or business.

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).
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> Treas. Reg. §1.183-2 specifies nine factors that should be considered in determining if an activity was entered into for profit.
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> Factor (1). The manner in which the taxpayer conducted the activity.
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> Factor (2). The expertise of the taxpayer in carrying on the activity.
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> 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.
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> Factor (5). The taxpayer's success in similar or related activities.
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> Factors (6) and (7). The taxpayer's history of profits and losses, and the amounts of any occasional profits.
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> 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 Taxpayer's activities in question were for profit, while others indicate that they were not.

It is undisputed that the Taxpayer maintained a small garden and grew and sold some crops before and during the years in issue. The Taxpayer's testimony also showed that he is an intelligent individual with an obvious knowledge of farming and how to grow crops on his land. The balance of the evidence, however, supports the Department's position that the Taxpayer's farming activity was not a trade or business.

To begin, the Taxpayer failed to maintain a complete set of books and records concerning his farming, other than some receipts for the equipment he purchased before, during, and after the years in issue. He kept very few receipts for supplies and other expenses allegedly incurred in the activity. The failure to maintain records shows that the activity was not conducted in a businesslike manner.

The Taxpayers also received substantial amounts of other income during the subject years. Treas. Reg. §1.183-2(b)(8) specifies that substantial income from a source other than the activity in question may indicate that the activity was not entered into for profit,

especially if losses from the activity provided a substantial tax benefit, as in this case.

The Taxpayer also worked full-time as an engineer until May 2008. He thus spent little time on the activity. He testified that after he retired in May 2008, he spent 10 to 15 hours a week in the garden, which also is not much time devoted to the activity.

The Taxpayer cleared and drained some of his property, which has certainly increased the property's value. But the Department is correct that farming and the increase in the value of the land on which the farming is conducted will be considered together only if the farming income exceeds the related expenses. Treas. Reg. §1.183-1(d)(1). The farming-related expenses claimed by the Taxpayer in the subject years tremendously exceeded the small income reported from the activity. The presumed increase in the value of the Taxpayer's property thus cannot be considered in determining if the activity was for profit.

The biggest factor against the Taxpayer's position is his consistent history of large losses concerning the activities. The Taxpayer claimed farming losses of $48,062 in 2007, $39,525 in 2008, and a total of $324,836 in losses for 2005 through 2011. The average annual income from the activity over that period was just over $2,100. The Taxpayer's history of large losses and minimum income relating to the activity strongly suggests that the activity was not for profit.

I understand that a large percentage of the Taxpayer's farm losses involved depreciation. But the number of items depreciated and the amounts claimed raise a separate question. Below is a chart prepared by the Taxpayer and given to the Department examiner showing the items depreciated by the Taxpayer, the dates the items

were placed in service or purchased, and the amounts paid for the items.

Asset	Date in Service		Basis
Compressor	1/1/1995	$	377.00
Tractor		$	13,500.00
Winch		$	706.00
Bush hog mower		$	1,420.00
Herbicide sprayer		$	730.00
Pressure washer		$	956.00
Tow sprayer		$	221.00
Bush hog mower		$	1,450.00
Welder		$	740.00
Farm Trailer		$	850.00
7-ft tiller		$	750.00
Winch		$	450.00
4728 winch		$	275.00
Shed and works		$	10,149.00
4-wheeler		$	3,949.00
CJ5 – Jeep		$	4,900.00
Farm Trailer	6/1/2002	$	250.00
	Total	$	41,673.00
Mule – utility	3/15/2003	$	7,500.00
Honda foreman	7/15/2004	$	4,446.00
Back hoe	1/22/2005	$	26,000.00
Welder	7/19/2007	$	2,076.00
Truck lift	7/3/2007	$	3,693.00
Air compressor	6/17/2007	$	820.00
6x6 cargo cart	3/15/2007	$	1,500.00
Maintenance shed	7/1/2007	$	58,843.00
	Total	$	66,932.00
Farm RTV	5/21/2008	$	7,500.00
Farm RTV Rhino	5/5/2008	$	11,140.00
Farm Trailer	6/2/2008	$	821.00
	Total	$	19,461.00
Bulldozer	6/1/2009	$	35,500.00
F250 Truck	12/24/2009	$	60,606.00
Heavy Duty Bush	8/1/2009	$	2,573.00

Hog			
	Total	$	98,679.00

The Taxpayer testified that he used a backhoe and a tractor to clear a couple of acres for planting crops before and during the years in issue. But the Taxpayer also used that equipment for other purposes on the farm. Consequently, even if the backhoe and tractor could be depreciated, only a small portion or percentage could be allowed. There is also no evidence that the Taxpayer used any of the other depreciated items, i.e., the air compressor, truck lift, 4-wheeler, etc., in his farming activities. Consequently, even if the Taxpayer's farming activity was for profit, a great majority of the depreciation expenses claimed by the Taxpayer would not be allowable.

Even if the Taxpayer intended to eventually make a profit from his crop-related activities, the evidence shows that he had not yet begun planting crops on the reclaimed property in the subject years. Expenses incurred in preparing to conduct a trade or business cannot be deducted until the Taxpayer actually begins conducting the business. See generally, *Goldman v. Comm. of Internal Revenue*, T.C. Memo 1990-8; *Touger v. State of Alabama*, Docket Inc. 12-1133 (O.P.O. 9/4/2013). In 2007, the Taxpayer was still reclaiming the land where he intended to grow his vegetables. He thus did not plant a crop in that year. He also testified that he also did not grow crops on the land in 2008 because it was too late to plant when he retired in May of that year.

The Taxpayer did receive a small amount of income from the sale of vegetables in the subject years. But those crops apparently came from the Taxpayer's small personal garden that he had maintained while he worked for the Power Company. The letters

submitted as Taxpayer Exhibits 18, 19, and 20 also do not help the Taxpayer's case because the activities described in the letters occurred after the years in issue.

The Taxpayer also testified that he planted 80 acres of pine trees on his property, and that he has used the tractor to clear the land around the new trees. Those trees were, however, planted in 2009, after the years in issue. The Taxpayer also sold timber on only one occasion in the subject years, and on that occasion only received $487. He had purchased the timber only a few months before for $4,500. That one sale of timber for a large loss certainly does not establish that the Taxpayer bought and sold timber for profit. Under the circumstances, the Department's disallowance of the Taxpayers' farm-related expenses is affirmed.

The 2007 and 2008 final assessments are affirmed. Judgment is entered against the Taxpayers for $3,582.74 and $2,711.36, respectively. Additional interest is also due from the date the final assessments were entered, December 27, 2011.

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

Entered February 3, 2014.

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BILL THOMPSON
Chief Administrative Law Judge

bt:dr
cc: Warren W. Young, Esq.
Thomas M. Hobson, Sr.
Brenda Lausane