CHAD E. BENNETT MARY J. TUTZAUER 291 HAWRIDGE ROAD OZARK, AL 36360-7362,	§	STATE OF ALABAMA DEPARTMENT OF REVENUE ADMINISTRATIVE LAW DIVISION
Taxpayers,	§	DOCKET NO. INC. 13-675
v.	§	
STATE OF ALABAMA DEPARTMENT OF REVENUE.	§	

FINAL ORDER

The Revenue Department assessed Chad E. Bennett and Mary J. Tutzauer (together "Taxpayers") for 2009, 2010, and 2011 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 19, 2013. The Taxpayers and their CPA, Charles McQuaid, attended the hearing. Assistant Counsel Christy Edwards represented the Department.

Mary Tutzauer is from the Republic of Panama. She moved to Alabama in 2000. Chad Bennett is from Dale County, Alabama. The couple married in 2004.

Tutzauer earned a business degree from the University of Panama before moving to Alabama. She worked as a graphic designer and at various other jobs after moving to the State. She also worked as a horse trainer at a high-end horse farm in Florida in the mid-2000's. She was employed as a survival instructor for the U.S. Army and Bennett worked as an airplane mechanic during the years in issue.

The Taxpayers decided in 2007 to open their own horse farm in Alabama. They accordingly purchased a few acres and some breeding horses in that year. They later mortgaged their house so they could purchase additional acres adjacent to their property.

They subsequently built a fence and a barn on the property, and cleared some of the land to make a pasture where the horses could run and graze.

The horse market tanked in 2008. The Taxpayers consequently needed to supplement their income, so they decided to make and sell specialty soaps, lotions, and other products.

Tutzauer explained that she got the idea of making and selling soap from a woman selling soaps at an arts and crafts fair in South Alabama. She initially made soap out of olive oil, coconut oil, and other oils. She later decided to make soap out of goat's milk because she thought it was a novelty that would sell. She consequently purchased two or three goats in 2007 or 2008. The herd eventually grew to seven goats.

The Taxpayers partnered with another couple in late 2007 or early 2008 to operate a business selling goat milk soaps, lotions, and other specialty items out of a building the other couple had inherited. They also intended to operate a small café in the building. The Taxpayers spent over $5,000 buying soap making ingredients and equipment, furniture, and otherwise generally preparing the building for use as a café/retail business. Unfortunately, the other couple left town unexpectedly and sold the building in 2008, which caused the Taxpayers to lose everything they had invested in the building and materials.

The Taxpayers thereafter decided to expand the scope of their business to include the growing and selling of exotic fruit trees. They accordingly purchased the trees and related items needed for that business. They continued making different types of goat milk soaps, lotions, and other products. They also started growing peas for sale, and invested in some chickens so they could produce and sell organic eggs. They sold the eggs to

health food stores in the area. They also continued their horse-related activities during and after the years in issue.

Tutzauer testified at the December 19 hearing that she quit her job in 2012 so that she could devote full-time to her horses and her soap making and other activities.

The record is unclear, but apparently the Taxpayers reported their income and expenses from their horse-related and goat milk products-related activities on a single Schedule F on their Alabama returns in the subject years. The Department audited the returns and determined that the above activities were not a trade or business, i.e., were not entered into for profit. It consequently disallowed the expenses and entered preliminary assessments against the Taxpayers for the additional tax due.

The Taxpayers petitioned for a review of the preliminary assessments. The Department subsequently determined that the Taxpayers' horse-related activities were entered into for profit. It consequently allowed the expenses related to that activity, but affirmed the disallowance of the goat milk-related expenses.

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.

The Department's analysis of the nine factors cites the following reasons why the Taxpayers' activities making soap and lotions, raising animals, selling vegetables, growing exotic trees, etc., were not for profit.[1]

[1] The analysis is found in a document submitted into evidence by the Department at the

The Department first notes that Tutzauer quit her full-time job as a survival instructor with the U.S. Army in 2012 to become a full-time horse trainer, but that she made no mention of the soap business.

The Department points out that the Taxpayers earned other income of over $100,000 in each of the subject years, and that they have used the losses in issue to realize a tax savings of approximately $5,000 since 2007.

The Department next cites the fact that the Taxpayers had looked into opening a dairy farm on their property, but that they decided not to because it would be too costly to buy the needed equipment and comply with the U.S. Department of Agriculture's requirements and regulations. The Department thus claims that the Taxpayer failed to change their method of operating in an effort to make a profit.

The fact that the Taxpayer did not have a formal business plan or a separate business account for the activity is next cited by the Department as a factor showing that the activity was not for profit. The Department also found that the Taxpayers had no history of making a profit in a similar activity, and that the Taxpayers had never made a profit from the activity itself.

The Department concedes that the value of the Taxpayers' land may have increased due to the clearing of and improvements to the property. It argues, however, that the increase in value cannot be considered because the income from the activity did not exceed the related expenses, citing IRC Reg. §1.183-1.

December 19 hearing entitled "Hobby Explanations." Unfortunately, that document is not itself marked as an exhibit.

The Department next asserts that the Taxpayers failed to show how they intended to improve the profitability of the activity. It also claims that the Taxpayer did not change their method of operation, citing the above discussed fact that they considered but elected not to start a dairy farm on the property.

Finally, concerning the method or manner in which the Taxpayers conducted the activity, the Department claims that the "taxpayers had some records, they had few discrepancies."

As indicated above, whether an activity was entered into for profit must be determined on a case-by-case basis. A given fact in such cases is that the taxpayer incurred consistent losses from the activity during the years in issue. That is also true in this case.

A consistent history of losses is evidence that the activity was not for profit. But that is only one factor to consider, and may be offset by other evidence that the taxpayer had a good faith expectation of eventually making a profit. As explained below, the evidence in this case, when viewed together, shows that the Taxpayers entered into the activities in issue with the expectation of eventually making a profit.

Tutzauer started her soap making business in 2007, just one year before the years in issue. She was consequently in the start-up phase of the business during the subject years. The courts have held that losses in the early or start-up years of a business are not unusual and do not necessarily indicate that the business was not for profit. See generally, *Engdahl v. Commissioner of Internal Revenue*, 72 T.C. 659, 1979 WL 3705 (U.S. Tax Ct. 1980). The losses were also made worse by the fact that the Taxpayers lost all of their

soap making equipment, furniture, ingredients, etc., when their erstwhile business partners unexpectedly sold the building in 2008 in which the Taxpayers intend to operate their business. They consequently had to start over from scratch.

The Taxpayers also put considerable time into the activity. They both worked full-time, yet they both spent three or four hours a day before and after work tending to the animals, the garden, and the other activities in issue. They also tried new activities, i.e., exotic trees, raising chickens and rabbits, etc., in an effort to eventually earn a profit. The above shows a clear intent to profit from the activities.

The Department cites the fact that the Taxpayers considered and decided not to start a dairy farm as evidence that the Taxpayers did not change their method of operating in an attempt to turn a profit. I disagree. To the contrary, the fact that the Taxpayers even considered branching out into dairy farming in itself shows that they were attempting to find a new activity from which they could make a profit. The fact that they eventually rejected the idea as unfeasible is of little consequence.

Deciding a "hobby loss" case is usually difficult because various factors favor the Department's position and others favor the taxpayer. A taxpayer's interaction and communications with the Department examiner during the audit is consequently important in determining how the issue is initially decided.

Tutzauer testified that English is her second language, and that she sometimes has difficulty communicating. Consequently, she may not have adequately explained to the Department examiner concerning the history and specifics of her soap-making venture. The examiner thus may not have been given all of the facts concerning the activity, in

which case it is understandable that the activity was deemed a not for profit hobby. In any case, the examiner certainly was not given all of the facts submitted at the December 19 hearing.

The losses relating to the Taxpayers' soap making activities during the three years in issue totaled less than $40,000. I do not believe the Taxpayers would have spent the considerable time, effort, and money they did on the activity with the primary intent of saving less than $2,000 in Alabama income tax over the three year period. The facts, when viewed together, show that the activity was for profit.

The final assessments are voided. Judgment is entered accordingly.

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

Entered February 13, 2014.

_____
BILL THOMPSON
Chief Administrative Law Judge

bt:dr
cc: Christy O. Edwards, Esq.
Charles L. McQuaid, CPA
Brenda Lausane