STATE OF ALABAMA DEPARTMENT OF REVENUE,	§	STATE OF ALABAMA DEPARTMENT OF REVENUE ADMINISTRATIVE LAW DIVISION
v.	§	DOCKET NO. INC. 86-111
JACK E. & GRACE P. PROPST P. O. Box 117 Kennedy, AL 35574,	§	
Taxpayers.	§	

ORDER

This matter involves three preliminary assessments of income tax entered by the Revenue Department against Jack E. & Grace P. Propst (hereinafter "Taxpayers") for the calendar years 1981, 1982 and 1983. At the hearing, the Taxpayers were represented by the Hon. Samuel R. McCord. Assistant Counsel Mark Griffin represented the Revenue Department. Based on the evidence presented at the hearing, and in consideration of the arguments and post-hearing briefs filed by both parties, the following findings of fact and conclusions of law are hereby made and entered.

FINDINGS OF FACT

As the result of an audit concerning the years in dispute, the Revenue Department adjusted the Taxpayers' joint returns as follows: Itemized deductions on Schedule A were increased for 1981 and 1983 because the Taxpayers had failed to claim all allowable deductions as indicated by their records. Itemized deductions for 1982 were decreased due to lack of substantiation. Schedule C expenses relating to Mrs. Propst's occupation as a naturopath were disallowed based on the Department' determination that Mrs. Propst

was engaged in an illegal activity, and also was not engaged in the business to make a profit. The Department further determined that Mrs. Propst had failed to substantiate all of her claimed expenses relating to naturopathy. Schedule C expenses relating to Mr. Propst's employment as an attorney were denied in large part due to lack of substantiation. Schedule D profits from the sale of timber and minerals were increased due to the Department's disallowance of the cost basis claimed by the Taxpayers. Schedule F farm losses were disallowed due to lack of substantiation. However, those farm losses for which records were subsequently provided were allowed by the Income Tax Division hearing officer in Montgomery and are not presently in dispute. Finally, the Department added a 50% fraud penalty to each year's liability because the examiner determined that certain farm expense records, as well as the cost basis claimed in the timer and minerals, had been falsified.

Relative to the first item, during the years in question Mrs. Propst held herself out as a naturopath. Mrs. Propst received her training and education as a naturopath from various sources, and participated in continuing education courses during the audit years. Mrs. Propst does not claim to be a medical doctor, and in fact, provides her patients (customers) with a form indicating that she is not a medical doctor. Mrs. Propst does maintain daily office hours and has an Alabama business occupation license. The Taxpayer reported a net loss from Mrs. Propst's naturopathy

activities for each of the years in question. The majority of claimed deductions were for continuing education expenses.

In addition to arguing that naturopathy is illegal in Alabama and that any expenses relating thereto are therefore are not deductible, the Department also contends that Mrs. Propst was not in business to make a profit. Mrs. Propst testified that she had losses during the years in question because she had just moved to the area and had not established sufficient clientele to make a profit.

On the issue of substantiation, the Taxpayers agree that the Department's determination of substantiated expenses, as set out by the Department examiner at the hearing, are acceptable if it is found that Mrs. Propst's expenses should be allowed.

Concerning Mr. Propst's expenses as an attorney, only a general appointment calendar was produced in support of the claimed deductions, along with several individual receipts that were not related to any deductible expense. The Taxpayers admit that Mr. Propst kept no formal log or other record of travel and entertainment expenditures, but do argue that Mr. Propst did travel at least 400 miles per week in the course of his employment. The examiner allowed mileage and some expenses by estimating the distance between appointment locations as indicated in the appointment book.

The main portion of the additional tax set up by the examiner

resulted from the disallowance of the cost basis in timber and minerals sold by the Taxpayers. The Taxpayers received the land on which the timber and minerals were located from Mr. Propst's cousin in 1970 and 1972. On their returns for the years in question, the Taxpayers reported the timber and mineral sales and claimed either an 80% (1981) or 50% (1982 and 1983) cost basis. The Department disallowed the entire amounts claimed because the Taxpayers failed to provide verifying documentation.

The Taxpayers argue that the land on which the timber and minerals were located was gift from the cousin, and consequently, that the basis should be the fair market value of the property at the time of the gift, citing Code of Alabama 1975, §40-18-6. The Taxpayers further claim that the basis amounts claimed on their returns were derived from information contained on the cousin's income tax returns for the years 1970 and 1972, and should be accepted as the proper basis in the property.

At the hearing, two deeds were introduced, both of which conveyed portions of the property in question from the cousin to Mr. Propst for $10.00 and other good and valuable consideration. Mrs. Propst testified that the property had been conveyed in separate parcels and that the Taxpayers had in fact paid the cousin some money for the land. Mr. Propst testified that he had been given the land in return for taking care of and providing various services for the cousin over a fifteen year period. No gift tax

returns were filed by the cousin relative to the property.

The final issue in dispute concerns the fraud penalties. According to the Department examiner, the penalties were added because the Taxpayers had intentionally inflated the cost basis for the timber and minerals, and also had submitted fraudulent or altered records relating to their farming operation.

The allegedly falsified records were a group of invoices relating to purchases made by the Taxpayers at an auto parts/gas station. The invoices, some of which had been altered, were originally submitted to the Department as originals, but were later discovered to be copies. The invoice forms were numbered. However, the dates on the invoices did not correspond chronologically with the invoice numbers. That is, number 11783 was dated January 8, 1981, while an earlier number 11770 had a later date of March 23, 1981, and so forth. The business owner testified at the hearing that he had completed the invoices based on information from his ledger book. The owner testified that he had altered the records, not the Taxpayers, and further explained the non-numerical order of the invoices by the fact that the blank invoices had been kept in non particular sequence, and were used randomly in no particular order.

CONCLUSIONS OF LAW

The expenses claimed relative to Mrs. Propst's occupation as a naturopath were rejected by the Department on the dual grounds

that naturopathy is illegal in Alabama and that the activity was not entered into with the prime motive of making a profit.

On the first point, Alabama Income Tax Reg. 810-3-17-.01(a)(10) provides that losses sustained in an illegal activity are not deductible. The Department cites Williams v. State ex rel. Med. Licensure, 453 So.2d 1051, in support of its position that naturopathy is illegal in Alabama. In that case, a woman holding herself out as a naturopath was determined to be illegally practicing medicine without a license. However, the case does not hold that all naturopaths are engaged in the illegal practice of medicine or that naturopathy is an illegal activity. As in Williams, that determination must be made on a case by case basis.

In the present case, there is no substantial evidence indicating that Mrs. Propst was engaged in the illegal practice of medicine. To the contrary, Mrs. Propst as a matter of practice informed each customer prior to consultation that she was not qualified as a doctor and was not engaged in the practice of medicine.

Naturopathy is in itself not an illegal activity. Rather, it is recognized in Alabama and subject to licensing under Code of Alabama 1975, §40-12-155. Accordingly, without deciding the question of whether an expense incurred in an illegal activity is deductible, it is clear that Mrs. Propst's activities as a naturopath were not illegal and that any deductions relating

thereto should not be denied for that reason.

The Department also contends that Mrs. Propst did not practice naturopathy with the dominant intent of making a profit. The Department's case is hinged on Mrs. Propst's failure to make a profit for each of the three years in question. However, an actual profit is not necessary. All that is required is that the taxpayer have a good faith intention of making a profit. Du Pont v. U.S., 234 F. Supp. 681; Lamont v. C.I.R., 339 F.2d 377. Further, a continuing string of loss years is not fatal if the requisite profit motive is present. Morton v. C.I.R., 174 F.2d 302; Du Pont v. U.S., supra.

Mrs. Propst explained that her losses for the years in dispute were due to the fact that she was new in the area and had not had sufficient time to establish a regular clientele. She did keep regular business hours and sought to upgrade her skill and knowledge through continuing education courses. All considered, it does appear that Mrs. Propst intended to make a profit, however unreasonable that expectation. Accordingly, all expenses incurred by Mrs. Propst relating to her occupation as a naturopath, and for which the Taxpayers provided sufficient verifying records, should be allowed.

Concerning the deductions claimed by Mr. Propst relative to his activity as an attorney, the Department was correct in denying

all such deductions for which no verifying records were produced. The taxpayer has the ultimate burden of proving by competent records his right to claim a deduction. Interstate Transit Lines v. C.I.R., 63 S.Ct. 1279; Showell v. C.I.R., 238 F.2d 148. The Department did allow some deductions based on estimated distances between destinations set out in Mr. Propst's appointment book. However, additional evidence, other than Mr. Propst's unsupported oral testimony, was not provided from which any other deductions should be allowed. The unsubstantiated assertions of a taxpayer are insufficient to allow a deduction. State v. T. R. Miller Mill Co., 130 So.2d 185; State v. Levy, 29 So.2d 129.

The Department examiner also acted properly in disallowing the Taxpayers' claimed cost basis in the timber and minerals that were sold during the audit years. A taxpayer has the burden of establishing a cost basis in property, and in the absence of such proof a zero basis must be allowed. G. M. Leasing Corporation v. U.S., 514 F.2d 935; Factor v. C.I.R., 281 F.2d 100.

The Taxpayers argue that the property was a gift and therefore should have a basis equal to its fair market value at the time of the gift, citing Code of Alabama 1975, §40-18-6. However, Mrs. Propst testified that she and her husband had paid an undetermined sum of money for the property, and even if the property was given only in return for Mr. Propst's services as an attorney/caretaker, the cost basis would be the fair market value of those services.

Consequently, while the sale may not have been an arms-length transaction, clearly the Taxpayers did purchase the property in question. Thus, the cost basis would be the amount paid and/or the fair market value of the services provided by the Taxpayers. Accordingly, in light of the Taxpayers' failure to verify or establish a cost basis, a zero basis must be taken.

The final issue concerns the fraud penalties levied by the Department. The circumstances surrounding the farm operation records provided by the Taxpayers are questionable. However, given the explanatory testimony of the owner of the business relating to the records and the fact that the farm loss deductions claimed by the Taxpayers were ultimately allowed by the Department, the questionable records alone would be insufficient to support a fraud penalty. Certainly, if a taxpayer intended to falsify records, he would not do so by dating various invoices in non-numerical order, which would obviously draw attention to their authenticity.

However, given the obviously incorrect and unsubstantiated cost basis amounts claimed by the Taxpayers relative to the timber and minerals, in addition to the questionable records, it must be determined that the fraud penalties levied by the Department are justified.

For each of the three years, the Taxpayers claimed a cost basis in the timber and minerals of either 50% or 80%. The Taxpayers argue that those amounts were taken from the tax returns

of the donor. If the Taxpayers had in good faith, but erroneously, considered the property to have been a gift, and based thereon determined the basis from the donor's returns, then a fraud penalty would not be due. A good faith dispute, honestly entertained, will not support a claim of fraud. State v. Pollack, 38 So.2d 870; Best v. State, Department of Revenue, 423 So.2d 859. However, it is unbelievable that the basis amounts taken from the donor's 1970 and 1972 income tax returns would equal exactly 50% and 80% of the sales price of the property in 1981, 1982 and 1983. Further, there is no evidence, other than the unsupported assertions of the Taxpayers, that the claimed basis amounts were actually taken from the donor's returns. Accordingly, it is clear that the Taxpayers' "manufactured", without substantiation, the 50% and 80% basis figures, which directly resulted in a reduction in their tax liability. Based thereon, in addition to the questionable farm expense records that were provided to the Department, the fraud penalties levied by the Department should be upheld.

The Revenue Department is hereby directed to readjust the Taxpayers' liability for the years in question in accordance with the above findings and conclusions. The assessments should then be made final as adjusted.

Done this 29th day of October 1986.

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BILL THOMPSON

Chief Administrative Law Judge