

BEFORE THE TAX COMMISSION OF THE STATE OF IDAHO

In the Matter of the Protest of)
[Redacted],) DOCKET NO. 24033
)
)
Petitioners.) DECISION
)
_____)

PROCEDURAL BACKGROUND

On March 10, 2011, the Audit Division (Audit) of the Idaho State Tax Commission (Commission) issued a Notice of Deficiency Determination (NODD) to [Redacted] (Petitioners). On May 11, 2011, the Petitioners filed a timely request for redetermination.

ISSUES

1. Whether the Idaho capital gains deduction was appropriately denied in 2007 on the sale [Redacted] in 2009 on the sale of a [Redacted] trailer.
2. Whether the Petitioners [Redacted] activities constitute activities engaged in for profit, under Internal Revenue Code (IRC) § 183(a) and Treasury Regulation 1.183-2(a).
3. The application of both negligence and substantial understatement penalties.

FACTUAL BACKGROUND

The first issue, analyzed in detail in the next section, is less subjective and more a matter of law.

The second issue, the Petitioners describe their activities [Redacted] on each year's Schedule F, "Profit or Loss Farming" attached to Federal Form 1040 as a single activity.

The Petitioners own and live on [Redacted] acres of land. The Petitioners work full time in other jobs and live on their wages earned from those other activities. They currently own [Redacted] and use to compete in [Redacted] competitions. [Redacted]. [Redacted] had 10

years' experience working in the [Redacted] industry and one year of college education [Redacted]. [Redacted] has experience [Redacted] and serves on the [Redacted] Committee.

Audit calls into question the bona fide business nature of the [Redacted] activities and therefore offsetting taxable income from other sources by the amount of losses generated.

Audit used the standards of Reg. 1.183-2(b) to ask the Petitioners for their response to the questions in trying to determine the nature of the activity. Those answers along with the answers given during the telephonic hearing were considered by the Commission in making this decision.

LAW AND ANALYSIS

I. Idaho Capital Gains Deduction

Idaho Code section 63-3022H(3)(c) requires that more than 50 percent of an individual's gross income be from [Redacted] operations in Idaho in order to take the capital gains deduction [Redacted]. For the purpose of this statute, "gross income" is as defined by IRC Section 61(a).

During the three years in question, the Petitioners did not have any [Redacted] income. There was no sale [Redacted]. The Petitioners' 2007 and 2009 Idaho income tax returns showed they did not meet the 50 percent gross income [Redacted] requirement for those years. There was no revenue reported from either activity in either year.

The Petitioners' position is that this restriction amounts to "invidious discrimination." In support of their position, the Petitioners cite Moritz v Commissioner of Internal Revenue, 469 F.2d 466, 469 (10th Cir. 1972). Mortiz was an individual denied a deduction for costs incurred for the care of his elderly mother who lived with him. The [Redacted] denied the deduction solely based on Mortiz's gender and marital status. The court held against the IRS and stated "a man who has never married and its allowance to women and widowers, divorcés, and husbands under certain circumstances is an invidious discrimination and invalid under due process

principles.” Thus, tax statutes that discriminate against specific classifications of individuals will be void under due process principles.

The Petitioners believe the same should apply to business activities. The Petitioners were denied the Idaho capital gains deduction because they did not meet the 50 percent of gross revenue from [Redacted] activity requirement.

The Idaho legislature has often written tax laws that encourage various types of business activities. This is not a case of discrimination of an individual. The intent of Idaho Code section 63-3022H was to provide tax relief to the agriculture industry. The Commission must follow Idaho law as written. Therefore, the deduction for the Idaho capital gains is denied.

II. Specialty [Redacted]

If an activity is found to be not engaged in for profit (a hobby), losses are limited to the income from the activity. The Petitioners were not allowed to deduct losses in excess of their income from the [Redacted] activities for taxable years 2007 through 2009.

Regulation 1.183-2 defines an activity not engaged in for profit. Treasury Regulation 1.183-2(b) lists nine relevant factors to use in determining whether an activity is engaged in for profit:

1. The manner in which the taxpayer carried on the activity.
2. The expertise of the taxpayer or his or her advisers.
3. The time and effort expended by the taxpayer in carrying on the activity.
4. The expectation that the assets used in the activity may appreciated in value.
5. The success of the taxpayer in carrying on other similar or dissimilar activities.
6. The taxpayer’s history of income or loss with respect to the activity.
7. The amount of occasional profits, if any, which are earned.
8. The financial status of the taxpayer.
9. Elements of personal pleasure or recreation.

Relevant Factors:

1. Manner in which the taxpayer carries on the activity: There was no written operating or business plan. The Petitioners did not seek out or attempt to make any financial or profitability projections. The [Redacted] activities are not separated. There is no separate bank account for personal activities.

The Petitioners advertised in print and on the internet. They also produced a CD to showcase [Redacted] they currently own. They competed in [Redacted] events and relied on word-of-mouth [Redacted] to develop sales. Advertising could indicate either a business or a hobby activity.

The [Redacted] activities are conducted in the Petitioners' spare time; mornings, evenings, and weekends. The Petitioners kept records, however, the spreadsheets provided listed expenses that were not supported by receipts, and the total expenses did not match the tax returns. The Petitioners claimed that they reduced the activities to cut expenses and were not trying to sell [Redacted] in a down market; however, the losses ballooned in the last three years. The Petitioners continued attending [Redacted]. The justification [Redacted] is that winning events increases the value [Redacted].

The fact that they hired [Redacted], purchased [Redacted], read periodicals and manuals was as much evidence of a hobby as evidence of a business. It is not necessarily indicative of a good faith profit objective.

The Petitioners failed to formulate a credible business plan; they were unaware of revenue and risk and commingled both activities' funds together with personal funds. They did not separately track their daughters' [Redacted] expenses from the business expenses. In this regard, their activities are indistinguishable from a hobby.

During the informal hearing, the Petitioners said that there would be some point at which they would be willing to stop and give up the [Redacted] activities. They did not define at what point that would be.

The Petitioners cited several cases in support of their lack of a business plan; Phillips v. Commissioner, Helmick v. Commissioner, Dennis v. Commissioner, Dworshak v. Commissioner, Strickland v. Commissioner, Burrus v. Commissioner, Mullins v. Commissioner, Engdahl v. Commissioner, Stephens v. Commissioner, Keanini v. Commissioner, Routon v. Commissioner, Faulconer v. Commissioner, Schaefer v. Commissioner. These court cases do not provide credible support in favor of the Petitioners and are easily distinguished on the facts. At best, the cases cited, demonstrate that, in some instances, [Redacted] could be a viable business. It is hard to see that the Petitioners have been operating in a similar manner to these examples or that they are moving in the direction of becoming a business. The Commission finds this factor to be neutral toward the determination.

2. The expertise of the taxpayer or his advisors: [Redacted] does have some knowledge of [Redacted], but not the economics of it. [Redacted] worked in the [Redacted] industry for ten years prior to starting the [Redacted] program in 1993. He studied [Redacted] in college for one year. There is no evidence that [Redacted] has any knowledge of or has sought out knowledge on how to make money in the [Redacted] industry.

[Redacted] sits on the board [Redacted]. This is a volunteer position according to the tax returns. [Redacted] attends clinics and seminars, receives journals, and utilizes the internet for researching information. There is no evidence that [Redacted] has knowledge or has sought out knowledge of how to make a profit [Redacted]. There is no evidence that the Petitioners have

sought out, either on their own or from professionals, any advice on how to make either activity profitable. This factor is indicative of an activity not engaged in for a profit.

3. The time and effort expended by the taxpayer in carrying on the activity: The Petitioners claimed to spend 1-2 hours per day during the spring and summer and 4-6 hours per day during the winter if the [Redacted] are kept on their property. The time spent by the Petitioners was scheduled around their main employment. The time spent is indistinguishable from that of a hobby. This factor is indicative of an activity not engaged in for a profit.

4. Expectation that the assets used in activity may appreciate in value: The Petitioners expect [Redacted] to appreciate in value, especially after training and winning competitions. In regard to the [Redacted] activity, the main asset is their home. [Redacted] by itself is not worth enough to justify the losses they are creating each year.

During the informal hearing, the Petitioners said that they would be willing to sell [Redacted] for an amount that would not even re-coup the previous year's losses, let alone the prior several years. They offered examples of others that had made large amounts [Redacted]. There was no evidence or claims that they expect to experience such a large gain [Redacted] that they currently own or any plans to purchase or breed new ones. The Petitioners do not claim to have a true expectation to make a profit, only that it is theoretically possible.

When asked about the land, [Redacted] admitted that the land was worth more with the [Redacted] on it than without. The harvesting [Redacted] actually works against the appreciation of the largest asset. A total [Redacted] would provide a one-time influx of revenue. However, the cycle [Redacted] is so long that doing so would lower the property value [Redacted] for at least a couple of decades. Any harvesting would have to be done at such a pace as to not be a material detriment to the land appraisal. This creates an automatic limitation on the potential

revenue stream [Redacted]. Harvest too much and the land becomes void [Redacted], too little and there is not enough revenue to keep pace with the cost of maintaining the property. There is no evidence, given the small size of the property, that the Petitioners would ever be able to keep up with the pace of expenses that they have been reporting.

In correspondence with Audit, the Petitioners stated, “there has been no need for appraisals, market investigations or financial projections of asset appreciation in connection with their two businesses.” This factor is indicative of an activity not engaged in for a profit.

5. The success of the taxpayer in carrying on other similar or dissimilar activities: There is no indication that the Petitioners have had other business successes or any particular business experience. This factor is found to be negative toward a finding of operating for a profit.

6. The taxpayer’s history of income or losses with respect to the activity: There was no revenue reported during the audit years. In all the years known to the Tax Commission, the total of the losses reported was \$423,606. The total lost during the 3 years of the audit period was \$179,287. A record of such large losses over so many years is persuasive evidence that the Petitioners did not expect to make a profit. There were no operational changes in order to reduce the losses. This factor is indicative of an activity not engaged in for a profit.

7. The amount of occasional profits, if any, which are earned: There is no evidence that the Petitioners have ever made any profits. At best, they recoup a fraction of the expenses, but only pennies on the dollar. During the informal hearing, the Petitioners cited Temple Smith v. Commissioner, a Tax Court case in which the court held that the lack of any profitable years did not in itself determine that Mr. [Redacted] was not engaged in the business of breeding [Redacted] for profit. There are a number of factors that distinguish the present case from Temple Smith. For example, [Redacted] built his [Redacted] up to nearly [Redacted]. He had a

significant track record of business success and expertise. He kept meticulous breeding and separate financial records for the [Redacted] business. He had a specific business plan that determined the necessary size of the herd to provide a steady supply of both breeding and [Redacted]. There is nothing that is comparable to the Petitioners situation other than the fact that it involved [Redacted]. This factor is indicative of an activity not engaged in for a profit.

8. *The financial status of the taxpayer:* The Petitioners lived on their W-2 earnings of \$317,127 during the audit period. The \$179,287 of net losses reported during that period served to offset the wages and save income taxes. This factor is indicative of an activity not engaged in for a profit.

9. *Elements of personal pleasure or recreation:* The trips [Redacted] seem to be the primary purpose of the [Redacted] activity. The explanation is that the [Redacted] gain value by scoring well [Redacted]. There does not appear to be any thought given to how the cost of travel, [Redacted], entry fees, and other expenses involved with the competition relate to the expected benefits. There is no separation of the daughters' [Redacted] activities and the "business" portion. This factor is indicative of an activity not engaged in for a profit.

Viewing the record as whole, the Commission concludes that the Petitioners did not engage in their [Redacted] activities with a bona fide profit objective within the meaning of IRC § 183. The Petitioners' activities do not constitute an activity engaged in for profit. Rather, the facts show that the Petitioners' activities more closely resemble that of a hobby. The Commission upholds the conclusion of the audit. The Petitioners cannot deduct the losses the parties have stipulated for the years at issue.

Penalties:

The Commission declines to pursue penalties at this time.

Viewing the record as whole, the Commission concludes that the Petitioners did not engage in their [Redacted] activities with a bona fide profit objective within the meaning of IRC § 183. Therefore, the Petitioners cannot deduct the losses the parties have stipulated for the years at issue.

THEREFORE, the Notice of Deficiency Determination dated March 10, 2011, and directed to the Petitioners, other than the negligence penalty is hereby AFFIRMED by this decision.

<u>YEAR</u>	<u>TAX</u>	<u>PENALTY</u>	<u>INTEREST</u>	<u>TOTAL</u>
12/31/07	\$4,862	\$0	\$1,035	\$5,897
12/31/08	4,462	0	664	5,126
12/31/09	5,690	0	564	<u>6,254</u>
			TOTAL DUE	<u>\$ 17,277</u>

Interest is calculated through July 31, 2012, and will continue to accrue at the rate set forth in Idaho Code section 63-3045.

DEMAND for immediate payment of the foregoing amount is hereby made and given. As set forth in the enclosed explanation, the Petitioners must deposit with the Tax Commission 20 percent of the total amount due in order to appeal this decision.

DATED this _____ day of _____ 2012.

IDAHO STATE TAX COMMISSION

COMMISSIONER

CERTIFICATE OF SERVICE

I hereby certify that on this _____ day of _____ 2012, a copy of the within and foregoing DECISION was served by sending the same by United States mail, postage prepaid, in an envelope addressed to:

[Redacted]

Receipt No.
