

BEFORE THE TAX COMMISSION OF THE STATE OF IDAHO

In the Matter of the Protest of)	
)	DOCKET NO. 25718
[Redacted],)	
)	
Petitioners.)	DECISION
_____)	

On March 21, 2013, the Audit Division (Audit) of the Idaho State Tax Commission (Commission) issued a Notice of Deficiency Determination (NODD) to [Redacted] (Petitioners). On May 23, 2013, the Petitioners filed a timely request for redetermination.

BACKGROUND

The Petitioners are Idaho residents for the years under review. For taxable years 2006 through 2008, Petitioners filed resident income tax returns, which reported W-2 wages for [Redacted] each year, listing his occupation as manager. [Redacted] occupation was listed as homemaker. The returns for the aforementioned years included a Schedule C and a Schedule F, which claimed losses of \$1,615, \$2,752, \$2,574, and \$38,150, \$27,469, and \$38,279, respectively. No returns have been submitted for taxable years 2009 and 2010.

ISSUES

The Petitioners' 2006 through 2008 Idaho income tax returns were selected for review. Specifically, Audit examined the following issues:

1. Whether the Petitioners' Schedule F ([Redacted]), constitutes an activity engaged in for profit under Internal Revenue Code (IRC) § 183(a) and Treasury Regulation 1.183-2(a).
2. Schedule C expenses.
3. Business use of the home.
4. Form 4684 Loss.

In addition, Audit requested Petitioners file Idaho Individual income tax returns for taxable years 2009 and 2010. These requests went unanswered.

In regards to the first issue, the Petitioners describe their activity [Redacted]Schedule F, “Profit or Loss from Farming” attached to their [Redacted]Form 1040. The test for determining whether an individual is carrying on an activity for profit is whether the taxpayer’s actual and honest objective in engaging in the activity is to make a profit. Audit used the standards of Reg. 1.183-2(b) and asked the Petitioners for their response to the questions in trying to determine the nature of the activity. The Petitioners’ answers, along with the information available to the Commission, were considered by Audit in making this determination.

LAW AND ANALYSIS

If an activity is found to be not engaged in for profit (a hobby), losses are limited to the income from the activity. Treasury Regulation 1.183-2(a) states that the term “activity not engaged in for profit” means any activity other than one with respect to which deductions are allowable under section 162. Deductions are allowable under section 162 for expenses of carrying on activities which constitute a trade or business. 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 appreciate 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 formalized, written operating or business plan, which according to the Petitioners was because they did not leverage any debt when establishing this activity. The Petitioners stated they began the “[Redacted]” activity to address the ongoing need in the marketplace for [Redacted] [Redacted]. The Petitioners stated their intent was to begin a [Redacted] based on [Redacted] of top-of-the line [Redacted]. The intent was to acquire [Redacted] with [Redacted] of [Redacted] and [Redacted] to produce [Redacted] for future [Redacted]. The Petitioners stated that at [Redacted], or [Redacted] to be [Redacted] and sold. Petitioners would then continue [Redacted] [Redacted] products with one of the greatest [Redacted]. The Petitioners’ plan was to then promote and sell the [Redacted] and to sell the initial [Redacted] to professionals. The Petitioners have provided no documentation to show what stage of the [Redacted] plan they are in or if the plan is being followed. The tax returns show very little revenue for [Redacted] could indicate either a business or a hobby activity. The Petitioners stated that in an attempt to obtain business, the [Redacted] are shown on their website, [Redacted]. The website was accessed and it contained no photographs of [Redacted], no [Redacted] were listed for sale, nor was there any indication that [Redacted] could be purchased. The Petitioners also stated advertising would be done through networking and long-time contacts in the [Redacted] along with [Redacted] and online classified ads. The Petitioners have not provided copies of any advertising efforts for the years under review, nor have they provided names of those in the [Redacted] network from whom they solicited promotion of their [Redacted].

Based on the limited information provided by the Petitioners related to the manner in which they conducted their “[Redacted]” activity, the Commission is unable to clearly

distinguish this activity from a hobby. It is hard to see that the Petitioners have been operating in a manner consistent with the intent to make a profit.

2. *The expertise of the taxpayer or his advisors:* [Redacted] does have [Redacted] experience, competing in [Redacted] and [Redacted]. [Redacted] also studied in a [Redacted] curriculum at [Redacted], specializing in [Redacted]. In addition, [Redacted] spent time researching the need for another [Redacted] and becoming familiar with [Redacted]. She discussed [Redacted] and market potential with several [Redacted] owners, as well as other future [Redacted] to determine what kind of product was moving in the marketplace. Although [Redacted] does have experience with [Redacted], there is no evidence that she has any knowledge of, or has sought out, either on her own or from professionals, any advice on how to make the [Redacted] 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:* When asked this question, [Redacted] claimed the [Redacted] activity is a 24/7, 365 day activity, with no set hours. [Redacted] stated she has worked full time running the business since 2010 and has not recently held any long term wage-earning jobs, but has, from time to time, worked an outside job to raise more capital to continue to the next step of the business plan. The time spent, although undocumented, would be indicative of an activity engaged in for a profit.

4. *Expectation that the assets used in activity may appreciate in value:* The Petitioners stated, in response to this question, that there were no assets of the [Redacted] business used for personal use. Even though not specifically mentioned by the Petitioners, it is assumed that they consider their [Redacted] to be assets. However, in 2008, Petitioners plead guilty to committing [Redacted]. Upon review of court documents, it was discovered that [Redacted] on one of the [Redacted]. This behavior is not consistent with that of a business owner intending to generate a

profit from the future sale of ones assets. 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: The Petitioners have filed a Schedule F with their [Redacted] income tax returns from 1999 through 2008. Each year's Schedule F showed a loss and, in several of the years, no gross income was reported. Based on information reported in Petitioner's returns, one [Redacted] was sold between 1999 and 2008. The sales price of the [Redacted] was \$129. In all the years known to the Tax Commission, the total of the losses reported was \$194,869. The total lost during the 3 years of the audit period was \$103,898. 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. In fact, in ten years, the Petitioners have only sold one [Redacted], for \$129. Even if the Petitioners incurred no future expenses, at a pure profit of \$129, the Petitioners would need to sell 1,511 [Redacted] just to recoup their expenses. This factor is indicative of an activity not engaged in for a profit.

8. The financial status of the taxpayer: The Petitioners lived on interest income and [Redacted] W-2 earnings totaling \$156,672 during the audit period. The \$103,898 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:* [Redacted] stated while she does enjoy the study of [Redacted] as it relates to what she is building, and enjoys using her college education in [Redacted], “there is **no** personal pleasure so far in this endeavor.” “It is a freakin’ lot of work and the payoff is all in the future.” The Commission finds this factor to be neutral in its determination.

In the present case, the Petitioners reported a loss on their Schedule F for each taxable year 1999 through 2008. Taking into consideration the relevant factors and assessing the record as a whole, the Commission concludes that the Petitioners did not engage in their [Redacted] with a bona fide profit objective within the meaning of IRC § 183.

Internal Revenue Code Section 183(d) states:

If the gross income derived from an activity for 3 or more of the taxable years in the period of 5 consecutive taxable years which ends with the taxable year exceeds the deductions attributable to such activity (determined without regard to whether or not such activity is engaged in for profit), then, unless the Secretary establishes to the contrary, such activity shall be presumed for purposes of this chapter for such taxable year to be an activity engaged in for profit. In the case of an activity which consists in major part of the breeding, training, showing, or racing of horses, the preceding sentence shall be applied by substituting “2” for “3” and “7” for “5”.

Because the Petitioners have not shown a profit in two of the last seven years, their activity is not presumed to be engaged in for profit. Rather, the facts show that the Petitioners’ activities more closely resemble that of a hobby.

The second issue examined by Audit was the expenses claimed by the Petitioners on Schedule C. Petitioners were asked to provide receipts for all of the expenses claimed on Schedule C related to officiating, including a detailed mileage log. The Petitioners provided no documentation to substantiate the expenses claimed, only a statement, “I am at a loss of your Schedule C issue which is very straight forward...” However, the law is well established that the taxpayer has the burden of proof with regard to the allowance of deductions:

Whether and to what extent deductions shall be allowed depends upon legislative grace; and only as there is clear provision therefore can any particular deduction be allowed.

* * *
Obviously, therefore, a taxpayer seeking a deduction must be able to point to an applicable statute and show that he comes within its terms.

New Colonial Ice Co. Inc. v. Helvering, 292 U.S. 435, 440, 54 S.Ct. 788, 790 (1934).

With regard to the Schedule C expenses, the Petitioners may have been entitled to some benefit, had they presented documentation to support their deductions. However, the Petitioners have not met their burden of substantiation for the expenses claimed on their 2006 through 2008 Schedule C.

The remaining audit issues, business use of the home deduction for taxable years 2006 through 2008 and the casualty loss, [Redacted] [Redacted], in taxable year 2007, were also disallowed after numerous requests for substantiation went unanswered.

The issue surrounding the NODD for taxable years 2009 and 2010 was due to the nonexistence of an Idaho individual income tax return for the Petitioners. Information available to the Commission indicates that the Petitioners were Idaho residents with income in excess of the filing requirement. Audit searched Commission records, but could not locate the Petitioners' Idaho individual income tax returns for taxable years 2009 and 2010. Audit notified the Petitioners of the missing returns. When returns were not submitted, Audit prepared provisional returns on the Petitioners' behalf and sent them an NODD. The [Redacted].

Interest and penalty were added pursuant to Idaho Code §§ 63-3045 and 63-3046. The Commission reviewed those additions and found them proper and in accordance with Idaho Code.

CONCLUSION

Based on an analysis and application of the factors established by the courts, Audit determined that the losses claimed by the Petitioners on their 2006 through 2008 Schedule F's are not losses from an activity for profit, and therefore not allowable. The Commission agrees. The Commission also upholds the other adjustments shown in the Notice of Deficiency as it pertains to taxable years 2006 through 2008. For taxable years 2009 and 2010, the Petitioners have yet to file returns; the Commission is left with no choice but to accept the provisional returns prepared by Audit as shown in the Deficiency Determination for taxable years 2009 and 2010.

THEREFORE, the Notice of Deficiency Determination dated March 21, 2013, and directed to the Petitioners, is hereby AFFIRMED by this decision.

<u>YEAR</u>	<u>TAX</u>	<u>PENALTY</u>	<u>INTEREST</u>	<u>TOTAL</u>
2006	\$2,290	\$115	\$830	\$ 3,235
2007	2,061	103	607	2,771
2008	2,064	103	476	2,643
2009	1,108	277	197	1,582
2010	1,703	426	229	<u>2,358</u>
			TOTAL DUE	<u>\$12,589</u>

Interest is calculated through November 3, 2014, 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.

An explanation of the Petitioners' right to appeal this decision is enclosed.

DATED this _____ day of _____ 2014.

IDAHO STATE TAX COMMISSION

COMMISSIONER

CERTIFICATE OF SERVICE

I hereby certify that on this _____ day of _____ 2014, 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.
