

BEFORE THE TAX COMMISSION OF THE STATE OF IDAHO

In the Matter of the Protest of)	
)	DOCKET NO. 0-215-603-200
)	
Petitioners.)	DECISION
<hr style="width: 45%; margin-left: 0;"/>)	

The Idaho State Tax Commission (“Commission”) reviewed your case, and this is our final decision. We uphold the Notice of Deficiency Determination (“Notice”) dated May 21, 2021, for taxable years 2017, 2018, and 2019. This means you **need to pay \$16,402** of tax, penalty, and interest for tax years 2017 through 2019. The Commission now DEMANDS immediate payment of this amount.

BACKGROUND

For each year under review, (“Petitioners”) reported a Schedule C activity and two Schedule F activities with significant losses and no income. Upon review, the Audit Division (Audit) determined that the activities were not engaged in for profit and issued the Notice denying the losses on all tax periods at issue. Petitioners filed a timely protest on July 23, 2021. Petitioners were informed of their appeal rights and requested a hearing through their authorized representative, which was held on May 18, 2022. Petitioners provided additional information for review on June 16, 2022, and on August 29, 2022. Having reviewed the file, the Commission hereby issues its final decision.

ISSUE

Have Petitioners met their burden of showing they were engaged in a trade or business for profit during the tax years at issue allowing them to deduct the ordinary and necessary business expenses they claimed on Schedule C and Schedules F pursuant to Internal Revenue Code (IRC)

section 162?

LEGAL BACKGROUND

Deductions for Activities Engaged in For Profit Under IRC section 162.

A taxpayer is allowed a deduction for all ordinary and necessary expenses paid or incurred in carrying on a trade or business pursuant to IRC section 162(a). To qualify for a Section 162 deduction, an item must be:

- (a) paid or incurred during the taxable year,
- (b) for carrying on any trade or business,
- (c) an expense,
- (d) a necessary expense, and
- (e) an ordinary expense.

Ellis Banking Corp. v. Comm'r, 688 F.2d 1376, 1378 (11th Cir. 1982).

A trade or business expense is “ordinary” if it is normal or customary within a particular trade, business, or industry. *Hart v. Comm'r*, T.C. Memo. 2013-289, 2013 WL 6800281 at *2. An expense is “necessary” if it is appropriate and helpful for the development of the taxpayer’s business. *Id.* An expense may only be deducted under Section 162 if it is made primarily in a furtherance of a bona fide profit motive activity, independent of tax consequences. *Green v. Commissioner*, 507 F.3d 857, 871 (5th Cir. 2007). Expenses of a personal nature are not deductible under Section 162. *Marcello v. C.I.R.*, 380 F.2d 499, 504 (5th Cir. 1967).

The taxpayer must be able to demonstrate that she is carrying on a trade or business for profit to be allowed expenses under Section 162. *Fischer v. United States*, 336 F. Supp. 428, 431 (E.D. Wis. 1971), *aff’d*, 490 F.2d 218 (7th Cir. 1973). Whether a taxpayer is carrying on a trade or business within Section 162 is a question of fact to be inferred from examination of the facts and circumstances of the case. *Id.*

Deductions for Activities Not Engaged in For Profit Under IRC section 183

IRC section 183 establishes that if an activity is found to be “not engaged in for profit,” then losses are only deductible to the extent of the income earned by the hobby and cannot be used to offset other income. IRC § 183(a)–(b). Section 183 generally applies to high-earning taxpayers attempting to reduce their tax liability by reporting losses from extravagant “side jobs” without a bona fide profit motive. *Losantiville Country Club v. C.I.R.*, 906 F.3d 468, 473 (6th Cir. 2018).

The taxpayer bears the burden of persuasion to show that the activity is for profit, with the taxpayer’s statement of intent given less weight than objective facts of case. *Burger v. C.I.A.*, 809 F.2d 355 (7th Cir. 1987). The following nine factors established by Treasury Regulation section 1.183-2(b) are used to distinguish between for-profit activities eligible for Section 162 deductions, and not-for-profit hobbies limited to deductions under Section 183, with no one factor being determinative.

1. The manner in which the taxpayer carries 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;
5. The success of the taxpayer in carrying on other similar or dissimilar activities;
6. The taxpayer’s history of income or losses with respect to the activity;
7. The amount of occasional profits, if any, which are earned;
8. The financial status of the taxpayer; and
9. Elements of personal pleasure or recreation.

Treas. Reg. § 1.183-2(b).

Taxpayers Must Produce Sufficient Records to Support Their Deductions Upon Review

Taxpayers are required to keep permanent books of accounts or records that are sufficient to allow the Tax Commission to determine the taxpayer’s correct amount of income, credits, and deductions, and other matters reported on tax returns. I.R.C. § 6001; Treas. Reg. § 1.6001-1(a). If

a taxpayer fails to produce adequate records supporting information shown on a tax return, the deduction or credit is not allowed. *Burnet v. Houston*, 283 US. 223, 51 S.Ct. 413 (1931).

DISCUSSION

Petitioners Have Not Shown They Engaged in Activities For Profit.

Petitioners moved to Idaho in 2016 and filed resident income tax returns for the years under review. The returns reported W-2 wages for each year. Mr. [REDACTED] is a mortgage broker who has worked for [REDACTED] and [REDACTED] while Mrs. [REDACTED] worked for [REDACTED] and [REDACTED].

A. Schedule C Activity -

Petitioners' Schedule C activity is a " [REDACTED] and [REDACTED] business called [REDACTED].

The business reported the following income and losses:

Tax Year	Income	Expenses	Net Gain/Loss
2017	-	\$80,567	(80,567)
2018	-	\$28,166	(28,166)
2019	-	\$35,799	(35,799)
TOTAL	(\$0)	\$144,532	(144,532)

As shown above, the business generated no income and reported losses totaling \$144,532 over three years. A record of substantial losses with no income whatsoever is persuasive evidence that Petitioners did not expect to make a profit from the activity. Mr. [REDACTED] incorporated " [REDACTED] Industries, Inc." with the Idaho Secretary of State (SOS) on October 26, 2016. However, other than the SOS filing, the Petitioners did not provide any evidence to show that they were operating the business in Idaho. The business was operated out of the home in the countryside. There was no known website.

Mr. [REDACTED] explained that he had had a similar business in California since 1999 servicing

and repairing He stated that he thought his customers would ship to him to Idaho to repair. Petitioner acknowledged on appeal that he did not advertise, did not receive any business and is no longer operating the business. Petitioners submitted proposed amended returns to remove the Schedule C business and move some of its expenses instead to the Schedule F businesses. However, the Commission did not agree to accept the amended returns to resolve the appeal.

B. Schedule F Activities: Livestock and Trees

In 2017 and 2018, Petitioners reported two Schedule F farming activities for livestock and trees. In 2019, they reported one Schedule F activity together as “Trees/Livestock.” The activities reported losses and no income in each year, as demonstrated by the following tables.¹

Livestock

Tax Year	Income	Expenses	Net Gain/Loss
2017	-	\$6,322	(6,322)
2018	-	\$4,178	(4,178)
2019	-	\$9,158	(9,158)
TOTAL	(\$0)	\$19,658	(19,658)

Trees

Tax Year	Income	Expenses	Net Gain/Loss
2017	-	\$34,866	(34,866)
2018	-	\$17,187	(17,187)
2019	-	\$9,159	(9,159)
TOTAL	(\$0)	\$61,212	(\$61,212)

Audit requested a “Business Activity/Hobby Loss Analysis” questionnaire to help them determine whether Petitioners had a bona fide profit motive for the reported activities following the nine standards of Treasury Regulation section 1.183-2(b). Petitioners did not return the questionnaire to Audit, but they did provide it on appeal. Petitioners instead provided a general explanation of their businesses to Audit. Despite request and follow-up by Audit, Petitioners failed to submit any written plans for their businesses, explanations of what they purchased, proof of

¹ For purposes of explanation, the \$18,317 in losses reported jointly for 2019 have been split for each activity.

payments, or a vehicle logbook to substantiate their business expenses. Based on its independent research and the information provided, Audit determined that Petitioners did not have a bona fide profit motive regarding the Schedule C and F businesses.

The Commission has reviewed the questionnaire but does not find it persuasive in showing Petitioners engaged in their businesses with the primary motive of making a profit. For example, Petitioners did not explain what efforts they made in attracting customers and securing suppliers or products for the business, other than “not finished” and “still building;” nor did they explain the specific activities they engaged in with their business. They responded on their questionnaire that they spent only “5 to 10 hrs ?” per week on their businesses. On the other hand, Petitioners held wage earning jobs in each tax year that presumably required significant time. In 2017, 2018 and 2019, they reported \$297,560; \$88,465; and \$135,561 for wages, respectively, and no income from the businesses.

Petitioners explained on appeal that they were building up their farming activities in 2017 through 2019 with the hope that the farm would supplement their income during retirement. Mrs. [redacted] retired in 2021 and Mr. [redacted] stated he is retiring in 2022. Petitioners provided photos of their farm from April 2022 and May 2022 showing they had many farm animals and had planted a garden by 2022. However, the photos are not from the years under review. Petitioners first received a seller’s permit for the farmer’s market on May 3, 2022. While Petitioners may have intended in tax years 2017 through 2019 to eventually engage in farming, they failed to show that they were actively engaged in farming activities during the years under review.

The Commission finds this matter analogous to *McGuire v. C.I.R.*, 77 T.C. 765 (1981), where taxpayers began, but never finished, renovating the second floor of their house which they had anticipated renting. The Court found that the taxpayers were not entitled to deduct expenses

allocable to the second story because they were not engaged in the activity for profit within the meaning of Section 162, considering they had never rented the second floor or held it out for rent. *Id.* at 778. The Court concluded that the failure to rent or hold the unit for rent indicated the property was not held for the production or collection of income. *Id.* Similarly, here Petitioners intended to eventually grow vegetables, fruit, and have animals for purchase, and began some initial efforts towards their farm during the taxable years at issue, but failed to show they grew or held anything out for sale. They merely purchased some necessary initial implements and cleared space to start a garden. Petitioners planted trees and requested an agriculture exemption from property tax, but they did not show they were using their land for the purpose of growing and harvesting trees, nor did they submit any business plans for their tree business. Petitioners acknowledged in their explanation of the businesses that due to unexpected family obligations and COVID, their plans “just came to a halt.”

Taking into consideration the relevant factors as analyzed by Audit and reviewing the file and information on appeal, the Commission concludes that Petitioners did not engage in the Schedule C or Schedule F activities with a bona fide profit objective within the meaning of IRC section 183.

Even if Petitioners Had a Profit Motive, They Did Not Produce Sufficient Records to Substantiate Their Deductions

The Commission agrees with Audit’s alternative position that even if the Schedule C and Schedule F activities had been engaged in for profit, the expenses were properly disallowed because Petitioners failed to submit sufficient documentation to confirm the amounts deducted. Petitioners’ business records consisted of a typewritten list of expenses and various excel spreadsheets listing expenses, but no information was provided as to what was purchased or the business purpose. For most of the expenses, Petitioners did not provide any invoices or receipts.

Some expenses were marked “personal” or “home.” Further, the information submitted did not match the totals on the return.

A Notice of Deficiency Determination issued by the Commission is presumed to be accurate. *Parsons v. Idaho State Tax Commission*, 110 Idaho 572, 574-575 n.2, 716 P.2d 1344, 1346-1347 n.2 (Ct. App. 1986). The burden is on Petitioner to show the deficiency is erroneous. *Albertson’s, Inc. v. State, Dept. of Revenue*, 106 Idaho 810, 814, 683 P.2d 846, 850 (1984). Deductions and credits are a matter of legislative grace. *New Colonial Ice Co. v. Helvering*, 292 U.S. 435, 54 S.Ct. 788 (1934). As with all claimed tax credits, the taxpayer bears the burden of showing that he is entitled to the credit. *United Stationers, Inc. v. United States*, 163 F.3d 440, 443 (7th Cir. 1998) (citing *Interstate Transit Lines v. Commissioner of Internal Revenue*, 319 U.S. 590, 593, 63 S.Ct. 1279 (1943)). The burden to show that claimed deductions come clearly within the scope of the statute rests upon taxpayer. *Int’l Trading Co. v. Comm’r*, 275 F.2d 578, 584 (7th Cir. 1960).

The Commission finds that Petitioners did not meet their burden of proving error in the Commission’s Notice.

CONCLUSION

Based on an analysis and application of the factors established by the courts, Audit determined that the losses claimed by Petitioners on Schedule C and Schedule F of their 2017 through 2019 tax returns are not losses from activities for profit, and therefore not allowable. The Commission agrees. The Commission also upholds the other adjustments shown in the Notice.

THEREFORE, the Notice dated May 21, 2021, and directed to Petitioners is hereby AFFIRMED and MADE FINAL.

IT IS ORDERED that Petitioners pay the following tax, penalty, and interest computed to

March 1, 2023:

<u>YEAR</u>	<u>TAX</u>	<u>PENALTY</u>	<u>INTEREST</u>	<u>TOTAL</u>
2017	\$5,573	\$279	\$985	\$6,837
2018	4,060	203	544	4,807
2019	4,415	221	383	<u>5,019</u>
			TOTAL DUE	\$16,663

DEMAND for immediate payment of the foregoing amount is hereby made and given.

An explanation of Petitioner's right to appeal this decision is enclosed.

DATED this _____ day of _____ 2022.

IDAHO STATE TAX COMMISSION

CERTIFICATE OF SERVICE

I hereby certify that on this _____ day of _____ 2022,
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:

Receipt No.
