

BEFORE THE TAX COMMISSION OF THE STATE OF IDAHO

In the Matter of the Protest of)	
)	DOCKET NO. 0-869-409-792
)	
)	
Petitioners.)	DECISION
)	

(Petitioner-husband) (jointly, Petitioners) protested the Notice of Deficiency Determination (Notice) dated February 24, 2023. The Tax Commission has reviewed the matter and hereby issues its final decision to uphold the Notice.

Background

Petitioners filed federal and Idaho income tax returns jointly for tax years 2019, 2020, and 2021. On each year’s federal return, they claimed a net loss on a Schedule C for competitive activity. The Tax Commission’s Audit Division (Audit) selected these returns for review.

Audit sent Petitioners two letters (dated December 1, 2022, and January 6, 2023) requesting information about the competitive activity reported on Schedule C for 2019, 2020, and 2021. Specifically, Audit asked for a completed Business Activity Analysis questionnaire, documentation of expenses and supplies, and depreciation schedules. Petitioners did not respond to either letter.

Audit issued the Notice on February 24, 2023, denying all claimed business expenses for the competitive activity. Petitioners subsequently completed the previously requested Business Activity Analysis questionnaire, which was then submitted to Audit along with a letter of protest and a form naming a representative. No documentation of their expenses was provided.

Audit sent copies of a letter to Petitioners and their representative on May 5, 2023, acknowledging receipt of the protest. Audit’s letter concluded that Petitioners’ activity was

not engaged in for profit and that Petitioners were not eligible to claim deductions for expenses related to the activity. It also reiterated the fact that Petitioners had not provided any documentation to support the expenses they claimed on Schedule C. The letter informed Petitioners that their file would be forwarded to the Tax Commission's Tax Appeals unit (Appeals) if they did not withdraw their protest by May 19, 2023. Petitioners did not withdraw their protest by the deadline given, so the file was transferred to Appeals.

Appeals sent Petitioners and their representative each two letters dated August 18, 2023, and December 7, 2023, outlining the available options for redetermining a protested Notice. These letters garnered no response. Therefore, the Tax Commission bases its decision on the information currently available.

Law & Analysis

Substantiation of Expenses

Petitioners claimed expenses on Schedule C for tax years 2019-2021 (under Petitioner-husband's name) related to competitive Expenses claimed included car and truck expenses for 2019 and 2020, depreciation and supplies for all three years, and tournament entry fees for 2020 and 2021. Expenses claimed over the three years in the audit period totaled \$23,106.

Internal Revenue Code (IRC) section 162 allows taxpayers to claim a deduction for ordinary and necessary expenses paid or incurred in carrying on a trade or business. An expense is "ordinary" if it is normal or customary within a particular trade, business, or industry.¹ An expense is "necessary" if it is appropriate and helpful for the development of the business. Expenses of a personal nature are not deductible under IRC section 162.² It is the taxpayer's

¹ *Hart v. Comm'r, T.C. Memo. 2013-289*

² *Marcello v. C.I.R., 380 F.2d 499, 504 (5th Cir. 1967)*

responsibility, and the burden rests upon him, to disclose his receipts and claim his proper deductions.³ If the taxpayer is unable to provide adequate proof of any material fact upon which a deduction depends, no deduction is allowed, and the taxpayer must bear his misfortune.⁴

Idaho Code section 63-3042(a) gives the Tax Commission authority to examine any records that may be relevant to verify the accuracy of a return. Tax Commission Administration and Enforcement Rule 200 states, “A taxpayer shall maintain all records that are necessary to a determination of the correct tax liability. Required records must be made available on request by the Tax Commission or its authorized representatives.” Failure to produce such records when asked may result in the disallowance of deductions, credits, or exemptions related to the requested information.

Audit requested documentation to substantiate the expenses claimed on Schedule C related to competitive activities. None was ever received. Due to the lack of substantiating documents, the Tax Commission agrees with the determination that Petitioners are not entitled to claim deductions for expenses on Schedule C.

Profit Motive

The protest letter Audit received focused on explaining that Petitioner-husband’s competitive activities were engaged in for profit. Audit did not raise this issue in the Notice but did address it in response to the protest letter. After reviewing Petitioners’ questionnaire responses, Audit analyzed the nine factors established by *Treasury Regulation section 1.183-2(b)* and used to distinguish between activities engaged in for profit and those not engaged in for profit.

Those factors are:

³ *United States v. Ballard*, 535 F.2d 400 (1976)

⁴ *Burnet v. Houston*, 283 U.S. 223, 51 S.Ct. 413 (1931)

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
9. Elements of personal pleasure or recreation

If the gross income derived from the activity exceeds the deductions for expenses (i.e., if the activity results in a profit) in any three of five consecutive years, then the activity is presumed to be engaged in for profit⁵. In this case, Petitioners do not meet the criteria for such a safe harbor presumption. According to the protest, the activity ceased after four years.

Each of the nine factors from *Treas. Reg. section 1.138-2(b)* are discussed in turn below.

(1) The manner in which the taxpayer carries on the activity

If a taxpayer carries on an activity in a business-like manner, it may indicate that he is engaged in it for profit. Operating in a business-like manner can include maintaining complete and accurate books and records, carrying on in a manner similar to profitable activities that are comparable in nature, or changing operating methods, adopting new techniques, or abandoning unprofitable methods in a way that is consistent with an intent to improve profitability.

Petitioners did not provide any records or books to indicate the way they were kept, but they did state that there was not a separate bank account established for the activity. In *Montage*⁶, not keeping separate accounts for business and personal funds was one factor that led to the conclusion that the activity was not conducted in a business-like manner. Petitioners did not create any type of business plan, make any financial projections, or conduct any profitability

⁵ *IRC section 183(d)*

⁶ *Brad Montage, et ux. v. Commissioner, TC Memo 2004-252*

analysis. According to their questionnaire response, “Receipts and deposits are accumulated and quantified for tax reporting.” It appears that Petitioners used receipts and other records for purposes of substantiating expenses, but not to use as “analytic or diagnostic tools” in trying to make their activity profitable. In *Nissley*⁷, this was one factor that led the court to conclude the activity in question was not carried out in a business-like manner.

Another factor to consider in determining if a person is carrying out an activity in a business-like manner is how a series of losses or other adverse business conditions is handled. Does the person change tactics or adjust their business model to try to become profitable? Petitioners’ protest states, “The taxpayer stopped competitively after 2021, mainly due to the cancellation of tournaments where they would normally compete. As a result, the taxpayer is no longer reporting their competitive business.” Abandoning an unprofitable enterprise could be viewed as a decision made by a shrewd businessperson. However, this view is somewhat clouded by the fact that Petitioners’ 2022 Idaho tax return was not filed until April 18, 2023, nearly two months after the Notice was issued and 10 days before the allotted period for protesting the Notice expired. It is unclear whether Petitioners would have filed a Schedule C for tax year 2022 showing a net loss if Audit had not issued the Notice denying expenses. A shrewd businessperson with a genuine profit motive could also have tried to change certain aspects of their business model rather than fully abandon it.

This factor weighs against a profit motive.

(2) The expertise of the taxpayer or his or her advisers

⁷ *Kenneth J. Nissley, et ux., v. Commissioner, TC Memo 2000-178*

Preparing for an activity by studying accepted business, economic, and scientific practices (or consulting with experts therein) and carrying on the activity in accordance with those practices may indicate a profit motive. When a person has studied accepted practices or consulted with experts but does not conduct an activity following such guidelines, it may indicate lack of a profit motive.

Petitioner-husband's responses to the questionnaire indicate over 20 years of tournament membership in multiple related organizations ([redacted]) and association with others who have made significant income from [redacted] competitively. Responses also indicate Petitioner-husband consulted with other tournament [redacted] prior to reporting the activity, but the nature of that consultation is unknown. There is no indication of speaking with any expert strictly on the business aspects of conducting this activity. Knowledge of an activity outside its economics is not enough to demonstrate that an activity is engaged in for profit.⁸

This factor doesn't weigh for or against a profit motive.

(3) The time and effort expended by the taxpayer in carrying on the activity

A person spending much of his or her personal time and effort carrying on an activity, especially one without significant personal or recreational aspects, may indicate that the activity is engaged in for profit. Likewise, if a person leaves another job to devote more time and effort to the activity, it may indicate the same. Spending limited time and effort on an activity does not necessarily show a lack of profit motive when the taxpayer employs qualified, competent people to carry on the activity in his or her absence.

⁸ *Henry J. Metz, et ux., v. Commissioner, TC Memo 2015-54*

Petitioner-husband does not indicate who is involved in the day-to-day operations but does state he has no employees. He states he participated in weekend club tournaments from March through September prior to 2020. In 2020, clubs cancelled tournaments and ended operations due to COVID-19. He does not indicate how much time he dedicated to the activity during 2020 or 2021.

This factor weighs against a profit motive.

(4) The expectation that the assets used in the activity may appreciate

The term “profit” can include appreciation in the value of assets, such as land, that are used in an activity. So, even though a person may not show periodic profits from the activity, there may be an expectation of an overall profit when the appreciated assets are sold.

The only asset mentioned in the protest letter and questionnaire is a purchased in 2018 for \$57,980. Its value was allocated 50% to personal use and 50% to use in the activity reported on Schedule C. The business portion of the value was then depreciated according to IRS regulations, and the expense claimed on Schedule C. This information is consistent with vehicle registration data and tax returns filed for tax years 2018 through 2021. The is not an asset that will increase in value over time.

This factor weighs against a profit motive.

(5) The success of the taxpayer in carrying on other similar or dissimilar activities

If a person has engaged in other activities and turned them from unprofitable to profitable in the past, this may indicate that he or she is engaged in the current activity for profit, even if it is not profitable at the moment.

Petitioner-husband reported he has not engaged in and converted from unprofitable to profitable any prior activities like or unlike the one reported on Schedule C for tax years 2018 through 2021.

This factor weighs against a profit motive.

(6) The taxpayer's history of income or losses with respect to the activity

If a person incurs a series of losses during what would normally be considered a start-up period, it would not necessarily be indicative of an activity not engaged in for profit. If, however, the losses continue beyond the initial timeframe typically needed to bring the activity to a profitable status, and those continuing losses are not explainable by normal business risks, it may indicate a lack of profit motive. Losses incurred because of unforeseen circumstances – such as disease, fire, theft, weather, etc. – are not indications that an activity is not engaged in for profit. A series of years where an activity results in net income would be strong evidence that it is engaged in for profit.

In filing Schedule C for the competitive activity, Petitioners reported losses of \$13,892, \$13,188, \$6,541, and \$3,577 for tax years 2018, 2019, 2020, and 2021 respectively. They have not reported any net profits from this activity.

This factor weighs against a profit motive.

(7) The amount of occasional profits, if any, which are earned

Periodic large profits – despite consistent, small losses – may be an indication that an activity is engaged in for profit. Even if the activity generates only losses or small profits, the opportunity for a large ultimate profit could indicate the same. Conversely, an occasional small profit interspersed with consistent losses may indicate that an activity is not engaged in for profit, especially if the person conducting the activity made substantial investments in capital or assets.

As stated previously, Petitioners' activity has never resulted in a profit. Accrued losses average just over \$9,000 per year. Since the activity has now been abandoned, there is no way to recoup those losses.

This factor weighs against a profit motive.

(8) The financial status of the taxpayer

If a person does not have another source of significant income or capital, it may be a sign that an activity is engaged in for profit. However, substantial income from other sources – especially if faced with losses from the activity that provides sizable tax benefits – may indicate that an activity is not engaged in for profit. This is particularly true if the activity involves personal or recreational elements.

Petitioners are both employed outside the competitive activity. They reported wages of \$150,720, \$151,865, \$154,728, and \$181,624 for 2018, 2019, 2020, and 2021 respectively, along with income from other sources that was not as significant. Clearly, Petitioners received enough income from other sources to offset the losses incurred from this Schedule C activity.

This factor weighs against a profit motive.

(9) Elements of personal pleasure or recreation

The presence of motives other than earning profit may indicate that an activity is not engaged in for profit, especially when the activity includes personal or recreational elements. Just because an activity has elements of personal satisfaction or recreation does not mean that it is not engaged in for profit. The lack of any personal motives beyond making a profit may indicate that an activity is engaged in for profit, but it is not necessary for an activity to be engaged in solely to earn a profit to rise to the level of “business” over “hobby.” There can be a mix of personal

satisfaction or pleasure and profit motive. If other factors indicate profit motive, the elements of personal satisfaction may be downplayed.

is typically viewed in one of two ways: as a means of providing food; or as a recreational activity. For many people, is simply a fun outdoor activity to enjoy with friends and family. Petitioner-husband has been in tournaments since 1999. Tournaments typically require an entry fee to participate. There must be a considerable element of recreation if Petitioner-husband has been taking part in tournaments for this long without considering it a business.

This factor weighs against a profit motive.

Summary

Petitioner-husband stated he bought a in 2018, “as it is required” for his competitive activity. This implies that he did not have a prior to 2018, but Petitioner-husband said he has his whole life, beginning in tournaments around 1999. If the primary source of revenue from competitive is from tournaments, and a is required to participate in tournaments, how did Petitioner-husband participate in tournaments since 1999 without a Available information shows that he purchased one in 2014 for \$29,826, which he then appears to have traded in for \$21,000 against the purchase of the new in 2018. The retention of market value from 2014 to 2018 indicates that the still had significant useful life left, so it appears that the purchase of a new for nearly double the price of the existing one was not a requirement.

Based on a review of the limited information provided, the Tax Commission agrees with Audit’s determination that the competitive activity was not engaged in with a genuine profit motive. IRC section 183(b)(2) allows an individual conducting an activity deemed “not engaged in for profit” to claim deductions for expenses that would otherwise be allowable only if the

activity were deemed “engaged in for profit” up to the amount of gross income generated by the activity. In short, an activity not engaged in for profit cannot generate a loss; one can claim expenses up to the amount of gross income, but not more.

Expenses deductible under IRC section 183 are considered miscellaneous itemized deductions subject to the two-percent-of-adjusted-gross-income floor⁹. These deductions are typically claimed on federal Schedule A, so would only be allowed if the taxpayer itemized deductions instead of claiming the standard deduction amount. However, under the Tax Cuts and Jobs Act of 2017, miscellaneous itemized deductions are not allowed for any tax year starting after December 31, 2017, and before January 1, 2026¹⁰. This includes all three tax years in the audit period.

Because the competitive activity was not engaged in for profit and miscellaneous itemized deductions are not allowed for the tax years included in the audit period, the Tax Commission determined that Petitioners are not entitled to any expenses claimed on Schedule C for 2019, 2020, and 2021.

Penalty and Interest

The Bureau added interest and penalty to Petitioners’ tax deficiency. The Tax Commission reviewed those additions and finds them to be appropriate and in accordance with Idaho Code sections 63-3045 and 63-3046, respectively.

Conclusion

Petitioners failed to substantiate their competitive expenses with appropriate documentation. Additionally, the Tax Commission finds that Petitioners’ competitive

⁹ *Treasury Regulation 1.67-1T(a)(1)(iv)*; see also *Carl L. Gregory, et ux. v. Commissioner, TC Memo 2021-115*

¹⁰ *IRC section 67(g)*

activity was not engaged in for profit. Therefore, Petitioners are not allowed to claim expenses more than their gross income from the activity. The allowable expenses are not deductible for tax years 2019, 2020, and 2021.

THEREFORE, the Notice dated February 24, 2023, and directed to

is hereby UPHeld and MADE FINAL.

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

<u>YEAR</u>	<u>TAX</u>	<u>PENALTY</u>	<u>INTEREST</u>	<u>TOTAL</u>
2019	\$860	\$43	\$125	\$1,028
2020	476	24	55	555
2021	252	13	30	<u>295</u>
				<u>\$1,878</u>

The Tax Commission DEMANDS immediate payment of this amount. Interest is calculated through May 20, 2024.

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

DATED this _____ day of _____ 2024.

IDAHO STATE TAX COMMISSION

CERTIFICATE OF SERVICE

I hereby certify that on this _____ day of _____ 2024,
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.

COPY MAILED TO: