BEFORE THE ARIZONA DEPARTMENT OF REVENUE

In the Matter of	)	**DECISION OF HEARING OFFICER**
[REDACTED]	)	
UTI # [REDACTED]	)	**Case No. 200700131-I**
	)	

A hearing was held on October 23, 2007 in the matter of the protest of [REDACTED] (Taxpayers), to assessments of income tax and interest by the Individual Income Tax Audit Section (Section) of the Arizona Department of Revenue (Department) for tax year 2003.

FINDINGS OF FACT

Based on information obtained from the Internal Revenue Service (IRS) through the Department's exchange of information agreement with the IRS (I.R.C. § 6103(d)(1)), the Section audited Taxpayers' 2003 Arizona income tax return and disallowed federal Schedule C losses claimed by Taxpayers. The Section also disallowed charitable deductions claimed by Taxpayers in the amount of $[REDACTED]. Accordingly, the Section issued a proposed assessment for 2003 that included tax and interest. Taxpayers timely protested the assessment. At issue is the propriety of the Section's proposed assessment of taxes for 2003.

In 2003, Taxpayers claimed a $41,520 loss on Schedule C of their federal tax return, stemming from [REDACTED] participation in barrel racing activities. Among the items included in Taxpayers' loss calculation are items such as: car/truck

expenses, depreciation, meals & entertainment, training, tack & feed for the horse(s), veterinarian fees, and race entry fees. Taxpayers maintain that they are engaged in barrel racing as a "for profit" business and that any losses are subject to deductions as a business loss. The Section argues that Taxpayers did not engage in barrel racing as a "for profit" business, and therefore the losses claimed should not be allowed.

At the hearing, Taxpayers testified that [REDACTED] has been involved with riding horses her entire life, and that she began barrel racing competitively in 2000. During the tax period at issue in this case, [REDACTED] was retired and [REDACTED] worked part time as a [REDACTED]. Taxpayers also spent considerable time, mostly on the weekends, traveling to rodeos at various locations in the southwestern United States in order for [REDACTED] to participate in barrel racing. Taxpayers reported gross receipts of $2,500 from barrel racing activities in 2003. Both Taxpayers also received income from sources other than barrel racing in 2003. [REDACTED] received a pension as a retired [REDACTED], and [REDACTED] received wages from her part-time employment with [REDACTED]. These other sources of income exceeded $115,000 in 2003.

While Taxpayers have reported some gross receipts from barrel racing activities since they began in 2000, their losses have far outweighed any income received. To date, Taxpayers have not yet made a profit in barrel racing. Since Taxpayers

began claiming losses of income in 2000, their income and losses from barrel racing activities have been reported as follows:

Year	Earnings from Barrel Racing	Losses Reported
2000	$ 600	$ 14,805
2001	$1,192	$ 53,650
2002	$3,035	$ 45,682
2003	$2,500	$ 41,520
2004	$3,900	$130,400
2005	$3,300	$ 92,047
2006	$3,000	$ 71,385

While Taxpayers have yet to make a profit, they provided copies of a professional rodeo magazine at the hearing indicating that the earnings of the top 20 barrel racers in the world was between $38,934 and $134,853 in 2007[1]. Taxpayers testified at the hearing that at the end of the season the top 15 barrel racers in the world are invited to the "NFR" (National Finals Rodeo) where significant additional money can be made. They also testified that it is their goal to take part in the NFR. Whether or not the losses can be deducted in full on Schedule C depends upon whether Taxpayers' barrel racing activities were engaged in as a "for profit" business.

CONCLUSIONS OF LAW

An assessment of additional income tax is presumed correct. *Arizona State Tax Commission v. Kieckhefer,* 67 Ariz. 102, 191 P.2d 729 (1948). Taxpayers have not provided sufficient evidence to prove that the Section's assessment is incorrect.

[1] No documentation was provided regarding potential for earnings in the year 2003.

The first issue is whether the Section properly disallowed the federal Schedule C losses. I.R.C. § 162(a) provides in pertinent part that "[t]here shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business..."

However, I.R.C. § 183(a) provides that where an individual participates in an activity that "is not engaged in for profit, no deduction attributable to such activity shall be allowed under this chapter except as provided in this section." I.R.C. § 183(d) provides a presumption that the activity is engaged in for profit where:

> **. . . 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)**
> **. . .**

I.R.C. § 183(d). In cases where the activity primarily deals with the "breeding, training, showing, or racing of horses," the activity may be presumed to be engaged in for profit if the activity produced a net income in 2 of the past 7 taxable years. *See id*. If the taxpayer meets this criterion, the taxing entity has the burden of proof to rebut this presumption.

In this case, Taxpayers have not yet made a profit in barrel racing since they began in 2000. Therefore, they are not entitled to a presumption that their activity is engaged in for profit under I.R.C. § 183(d). Thus, Taxpayers have the burden

of proving that the Section's determination is incorrect and that they are entitled to the claimed losses from their barrel racing activities.

Treas. Reg. § 1.183-2(a) states that "[t]he determination of whether an activity is engaged in for profit is to be made by reference to objective standards, taking into account all of the facts and circumstances of each case." The regulation further states that "the facts and circumstances must indicate that the taxpayer entered into the activity, or continued the activity, with the objective of making a profit," noting that "greater weight is given to objective facts than to the taxpayer's mere statement of his intent." Treas. Reg. § 1.183-2(a).

In determining whether an activity is engaged in for profit, Treas. Reg. § 1.183-2(b) states that among the factors that should normally be taken into account are: 1) the manner in which the taxpayer carries on the activity, 2) the expertise of the taxpayer or his advisors, 3) the time and effort expended by the taxpayer in carrying on the activity, 4) the expectation that 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 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) the elements of personal pleasure or recreation involved in the activity.

No single factor is determinative. Rather, whether a taxpayer possesses the relevant profit objective is a question

of fact to be determined in light of all the facts and circumstances. *See* Treas. Reg. § 1.183-2(b). With the above in mind, we consider the limited evidence presented to the Hearing Office pertaining to these factors.

Factor (1) *Manner in Which the Taxpayer Carried on the Activity*.

At the hearing, Taxpayers provided a list of the dates and locations of the rodeos they attended in 2003. Taxpayers also noted that they have kept records of their activities and expenses. However, extensive documentation was not presented into evidence. Taxpayers did not produce evidence demonstrating that they had developed a budget, profit plan, or any type of formal business plan before beginning their barrel racing activities, in order to determine whether the activity could be operated profitably. At the hearing, Taxpayers admitted that they had no written business plan. Taxpayers did, however, address the cost effectiveness of the rodeos in which they chose to participate. They testified that they participated only in the rodeos where prize money was available, and that in subsequent years they tried to plan a route that would be most cost effective.

Because very few business records were submitted at the hearing, there is little evidence to show whether or not "complete and accurate books" were maintained. *See* Treas. Reg. § 1.183-2(b)(1). Further, although Taxpayers attempted to curb costs in subsequent years by mapping out a more cost effective route, the Taxpayers' lack of a business plan or budget upon

starting the business causes this factor to weigh more in favor of the Section.

Factor (2) *The Expertise of the Taxpayer or Her Advisors*.

There was little evidence provided at the hearing regarding the extent of Taxpayers' expertise in barrel racing, or the extent to which they sought counsel from advisors. However, [REDACTED] testified that she has been around horses nearly all of her life. It was also apparent that they subscribe to and read rodeo magazines to further their knowledge, and seem to attend every rodeo event that they can. Therefore, this factor favors the Taxpayers.

Factor (3) *The Time and Effort Expended by the Taxpayer in Carrying on the Activity*.

There is no doubt that Taxpayers spent a great deal of time and energy in attending and participating in rodeos and barrel racing activities. Taxpayers' handwritten log shows that they attended rodeos most weekends in 2003. [REDACTED] was retired and [REDACTED] worked only part time for [REDACTED]. Thus, Taxpayers had time to devote to the activity. While this factor favors the Taxpayers, it is somewhat discounted because the activity has substantial recreational aspects, especially given Taxpayers' long-term interest in horses and rodeos.

Factor (4) *The Expectation That Assets Used in the Activity May Appreciate in Value*.

It is unclear from the testimony given as to how many horses Taxpayers owned in 2003. However, Taxpayers testified that they have bought and sold many horses during their barrel

racing years, and that they currently own three horses. While Taxpayers testified that they generally make money from the sale of horses due to training, they had only two specific examples of horse sales, one sale for a profit and one sale for a loss. Sale of barrel racing horses would be somewhat speculative, while they the horses may increase in value due to training, they also face significant risk of injury. In addition, other significant assets in their business (such as a truck and trailer) are depreciating in value. Indeed, Taxpayers reported $9,860 of depreciation on federal Form 4562 in 2003 stemming from assets in their barrel racing activities. Overall, this factor tends to favor the Section.

Factor (5) *The Success of the Taxpayer in Carrying On Similar or Dissimilar Activities*.

No evidence was presented at the hearing regarding whether Taxpayers had ever been successful in making other similar or dissimilar activities profitable. Therefore, this factor is not relevant.

Factors (6) and (7) *The Taxpayers History of Income or Losses With Respect to the Activity and the Amount of Occasional Profits, If Any, Which Were Earned*.

Treas. Reg. § 1.183-2(b)(6) provides that:

> Where losses continue to be sustained beyond the period which customarily is necessary to bring the operation to profitable status such continued losses, if not explainable as due to customary business risks or reverses, may be indicative that the activity is not being engaged in for profit.

Taxpayers testified at the hearing that there is a potential to make a great deal of money in barrel racing. To support their

testimony, Taxpayers submitted documents listing total purse and prize money available at various events in the Professional Rodeo Cowboys Association (PRCA) during 2006-2007. They also provided pro rodeo magazine articles showing that the earnings of the top 20 barrel racers in the world were between $38,934 and $134,853 in 2007 (no documentation was provided regarding the year 2003). Taxpayers testified at the hearing that the top 15 barrel racers in the world are invited to the "NFR" (National Finals Rodeo), where significantly more money can be made. They also testified that it is their goal to take part in the NFR.

However, in looking at the objective facts, Taxpayers have been in business for over seven years and have not yet broken even in any year. While Taxpayers contend (by citing to 2007 figures) that the potential to make a profit is possible, their annual losses reported have ranged from a low of $14,805 to a high of $130,400. The race entry fees alone claimed by Taxpayers on their 2003 Schedule C were $6,500. This amount was more than the gross profits claimed by Taxpayers in any single year from 2000 – 2006.

It is significant to note that according to the documents Taxpayers produced, the barrel racer ranked #20 in the world in 2007 only brought in $38,934 of earnings, and even at such a high ranking, she would not be eligible for the NFR. The $38,934 earned by that high-ranking racer is less than the losses reported by Taxpayers in every year except 2000. The goal of any profitable business must be to realize a profit on the entire operation. This presupposes that a business intends

not only to attain net earnings in future years, but also to obtain sufficient net earnings to recoup the losses which were sustained in the start up or intervening years. In the case at hand, even if Taxpayers made it to the NFR, the potential income would not likely cover the cumulative expenses and losses incurred by Taxpayers (which now total almost $450,000).

Losses in the early years of a business may be explainable, especially where there are start up costs for equipment. *See* Treas. Reg. § 1.183-2(b)(6). In addition, losses sustained due to unforeseeable events beyond the control of the Taxpayers may not indicate the lack of a profit motive. *See Id.* At the hearing, Taxpayers testified that the majority of the equipment and set up costs were front loaded. However, the Taxpayers losses do not seem to be dwindling down over the years. Taxpayers also indicated that [REDACTED] had sustained an injury at some point that caused a set back. The details were not specific as to the tax year and extent of the injury. However, in barrel racing, risk of injury to the horses or the rider, cannot be considered an unforeseen circumstance.

In addressing this issue, the Fourth Circuit Court of Appeals noted that "a taxpayer may have a profit motive despite a history of losses. Yet, a record of continued losses over an extended period of time is plainly relevant in discerning a taxpayer's true motivations." *Hendricks v. Commissioner*, 32 F.3d 94, 99 (4th Cir. 1994)(citations omitted). Given Taxpayers' history of significant and continuous losses, with no

periods of profit, the objective facts weigh in favor of the Section on Factors (6) and (7).

Factors (8) and (9) *The Financial Status of the Taxpayer and the Elements of Personal Pleasure or Recreation*.

Treas. Reg. § 1.183-2(b)(8) provides that:

> **Substantial income from sources other than the activity (particularly if the losses from the activity generate substantial tax benefits) may indicate that the activity is not being engaged in for profit especially if there are personal or recreational elements involved.**

Taxpayers reported over $115,000 of income from sources other than barrel racing during 2003. It appears that they were not relying on the barrel racing activities for their economic sustenance, and that the losses could generate substantial tax benefits. Coupled with Taxpayers' fondness of horses and the element of recreational enjoyment of rodeo barrel racing, these two factors favor the Section.

Having considered all of the objective factors above, it is evident that Taxpayers have spent a great deal of time and effort in their endeavors. However, given the Taxpayers' significant continued losses over a sustained period of time and the recreational nature of barrel racing, the evidence indicates that Taxpayers engaged in this activity primarily for recreation or personal pleasure, and not with the primary objective of making a profit. Therefore, the Hearing Office upholds the Section's disallowance of Taxpayers' Schedule C losses.

The next issue involves the Section's denial of Taxpayers' Schedule A deduction for $[REDACTED] in charitable

contributions. Taxpayers claimed a $[REDACTED] deduction for a gift of cash or check to a charity, and a $[REDACTED] deduction for charitable contributions of property other than money.

With regard to charitable contributions of cash, Treas. Reg. § 1.170A-13(a) provides that the taxpayer must retain a copy of a cancelled check, a receipt or letter from the charitable organization, or other reliable written records that verify the donation. Regarding charitable contributions of property other than money, Treas. Reg. § 1.170A-13(b) provides a taxpayer must maintain a receipt from the charitable donee that states: (i) the name of the donee, (ii) the date and location of the contribution, and (iii) a reasonably sufficient description of the property donated.

In addition, Arizona law requires taxpayers to keep and preserve "suitable records and other books and accounts necessary to determine the tax for which the person is liable for the period prescribed in § 42-1104." *See* A.R.S. § 42-1105.D. A.R.S. § 42-1104.A establishes a general four-year statute of limitations. The instructions to the 2003 Arizona Form 140 accordingly direct a taxpayer to keep all records that support income and deductions for a tax year until the period of limitations expires for the return for that tax year.

Taxpayers did not maintain or produce the required records to show that they are entitled to claim the itemized deductions disallowed by the Section. Therefore, the Section properly disallowed Taxpayers' deductions for charitable contributions claimed on Schedule A.

As to the interest portion of the assessment, A.R.S. § 42-1123.C provides that if the tax "or any portion of the tax is not paid" when due "the department shall collect, as a part of the tax, interest on the unpaid amount" until the tax has been paid. Therefore, interest is a part of the tax and generally may not be abated unless the tax to which it relates is found not to be due for whatever reason. The tax was due in this case and the associated interest cannot be abated.

Based on the foregoing, the Section's proposed assessment is affirmed.

DATED this 5th day of November, 2007.

ARIZONA DEPARTMENT OF REVENUE
APPEALS SECTION

[REDACTED]
Hearing Officer

Original of the foregoing sent by certified mail to:

[REDACTED]

Copy of the foregoing mailed to:

[REDACTED]

Copy of the foregoing delivered to:

Arizona Department of Revenue
Individual Income Tax Audit Section