BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeals of)
)
WILLIAM C. AND JANE J. KELLOGG)

Appearances:

For Appellants: Mark E. Zatt
Attorney at Law

For Respondent: Michael R. Kelly
Counsel

OPINION

These appeals are made pursuant to section 18593 of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protests of William C. and Jane J. Kellogg against proposed assessments of additional personal income tax in the amounts of $3,434.70, $2,722.15, $3,219.24, and $3,244 for the years 1977, 1978, 1979, and 1980, respectively; and pursuant to section 19057, subdivision (a), of the Revenue and Taxation Code from the action of the Franchise Tax Board in denying the claims for refund of personal income tax in the amounts of $1,288.70 and $380.71 for the years 1978 and 1979, respectively.

The issues presented here are the following: (1) whether respondent properly determined that certain aspects of appellants' horse stable operations and appellant-husband's geophysicist consulting activities were not engaged in for profit; (2) whether payments made by appellants to the previous owner of certain property were made either as gifts or as the cost of appellants' acquisition of such property so as to be added to the basis; and (3) whether expenses related to appellant-husband's travel between La Jolla and Altadena. were personal in nature.

During the years at issue, appellant-wife (hereinafter "Jane") was primarily involved in the operation of two horse stables in Altadena, California. Appellants had operated the Altadena Stables since 1974 and the Robinson Stables since 1976. Appeliants acquired the Robinson Stables in September of 1975 from Aloha Robinson. As part of the acquisition agreement, Mrs. Robinson signed an employment agreement with appellants providing that she would continue her activities at the stables as a horse trainer together with her other responsibilities in return for a monthly salary of $200. During this same period, appellant-husband (hereinafter "William") was primarily involved in operating his family's business in La Jolla. However, during this period he continued to incur-and to deduct expenses related to his previous full-time occupation of geophysicist. In addition, William deducted travel and meal expenses for hisregular weekend trips between La Jolla and his wife and family in Altade-na, concluding that he was engaged in different, trades or businesses in each location.

Upon audit, respondent initially disallowed most of the expenses involving the horse stables claimed for 1977 through 1979 on the basis that pursuant to Revenue and Taxation Code section 17233 the operation of the stables was not an activity entered into primarily for profit. However, after meeting with appellants' representative, respondent concluded that the operation of the stables itself was, in fact, an activity engaged in for profit, but that appellants' ownership of a string of between six and eight horses was not such an activity. Accordingly, respondent revised its determination disallowing 20 percent of the total of the claimed stable

expenses.[1] Respondent determined that William's geophysicist consulting activities during the years at issue were likewise not engaged in primarily for profit and, accordingly, disallowed the expenses related to that activity. In addition, respondent determined that the salary and other expenses paid by appellants to or for the benefit of Aloha Robinson after the acquisition of her property should not be allowed as deductions but should either be considered to be part of the cost of acquisition of such property and, therefore, added to basis or be treated as gifts to her. Lastly, respondent disallowed the expenses associated with William's travel between La Jolla and Altadena.

Based upon the adjustments noted above, respondent revised the proposed assessments for 1978 and 1979 to include additional assessments totaling $1,105.21 and also issued a proposed assessment for 1980. Appellants appealed the amounts originally assessed but failed to appeal the additional amounts assessed for 1978 and 1979, Appellants subsequently paid the additional assessments of $1,105.21, together with interest of $564.20, and filed claims for refund which were denied, Appellants appealed the denial of the claims for refund for 1978 and 1979, and the amount assessed for 1980. The instant proceeding is a consolidation of the appeals from the assessments of additional taxes for the years 1977 through 1980, together with the denial of the claims for refund for 1978 and 1979.

As indicated above, respondent concluded that appellants' activities with respect to the ownership of between six and eight horses (hereinafter sometimes referred to as "horse string") and with respect to William's geophysical interests were activities "not engaged in for profit" within the meaning of Revenue and Taxation Code section 17233. Section 17233 provides, in relevant part, that if an individual's activity is 'not engaged in for profit," only those deductions allowable regardless of a profit objective (e.g., taxes or interest) may be allowed. Accordingly, the disputed deductions with respect to the horse string and the activities as a geophysicist are allowable only if

1/ Respondent contends that appellants have agreed that if the expenses relating to the horses which they owned are disallowed, 20 percent of the total stable expenses should be disallowed. However, appellants contend that no such agreement was reached,

appellants had an actual and good faith profit objective for engaging in those activities. (Appeal of Paul J. and Rosemary Henneberry, Cal. St. Bd. of Equal,, May 21, 1980; Appeal of F. Seth and Lee J. Brown, Cal, St, Bd. of Equal,, Aug. 16, 1979,) The taxpayer's expectation of profit need not be a reasonable one, but there must be a good faith objective of making a profit, (Truett E. Allen, 72 T.C. 28 (1979).) Of course, whether the activities were engaged in primarily for such profit-seeking motives is a question of fact upon whisk the taxpayer has the burden of proof. (Appeal of Guy E. and Dorothy Hatfield, Cal. St. Bd. of Equal,, Aug. 1, 1980; Appeal of Clifford R. and Jean G. Barbee, Cal. St. Bd. of Equal., Dec. 15, 1976.) The regulations-2/ provide a list of factors relevant in determining whether a taxpayer has the requisite profit motive. While all facts and circumstances with respect to the activity are to be taken into account, no one factor is controlling in making this determination. (Treas. Reg. § 1.183-2(b).)

Among the factors which normally should be taken into consideration are the following: (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) 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) elements of personal pleasure or recreation. After carefully reviewing the facts and circumstances involved here, we are convinced that appellants possessed the requisite profit motive with respect to each of the subject activities so that the disputed deductions are allowable.

As indicated above, respondent now concedes, that the horse boarding, training, and equitation class activities at the stables were engaged in primarily for profit during the years at issue. However, respondent

2/ As section 17233 conforms to Internal Revenue Code section 183 and since there are now no regulations of the Frandhise Tax Board in this area, the regulations under section 183 of the Internal Revenue Code govern the interpretation of section 17233, (Cal. Admin. Code, tit. 18, reg. 19253.)

still contends that appellants" ownership of the string of horses was not integrated with the other activities at the stables and that such activity was not engaged in primarily for profit. (Theodore Sabelis, 37 T.C. 1058 (1962).) Respondent's segregation of the activities involving appellants' personally owned horses resulted in the disallowance of the following deductions:

Year	Income	Expense	Loss
1977	-0-	$12,617.07	$12,617.07
1978	$7,500	$11,472.17	$ 3,972.17
1979	-0-	$ 9,486.92	$ 9,486.92
1980	-0-	$ 6,589.55	$ 6,589.55

In Sabelis, the Tax Court found that the taxpayer's operations of breeding, training, and boarding horses were activities primarily engaged in for profit, but that the activities of taxpayer's daughter connected with a 4-H project involving horses were primarily engaged in for her education and were, therefore, primarily personal in nature. In essence then, respondent contends that the ownership of the subject horses was isolated from the other operations of the stables and engaged in primarily for Jane's personal recreation or pleasure, To support this contention, respondent states that none of these horses were used for equitation classes conducted at the stables or were leased out to patrons, Moreover, respondent doubts that these horses were in fact held for sale as part of the stable activities as appellants allege, Respondent contends that only one horse was sold by appellants during the period at issue.

However, documentation submitted by appellants subsequent to the oral hearing on this appeal disproves respondent's allegations. First, during the years at issue,, three of appellants' horses were leased out: "Suena," beginning in 1977 at $85 per month; "Cicero," beginning in 1978 at $105 per month; and "Emmy," beginning in 1978 at $50 per month, The reduced lease payment for "Emmy" was due to the fact that appellants reserved the right to use her for lessons during the period of the lease. Accordingly, we must infer that the subject horses were used, at least on occasion, in conjunction with appellants' other activities, Moreover, after the years at issue, five other horses which appellants. owned were leased for rates of between $150 to $200 per month, Based upon these facts, it appears that there was a pattern of integration between appellants' ownership of the subject horses and their other equestrian activities.

In addition, contrary to respondent's contention that only one horse was sold by appellants during the years at issue, appellants have compiled data which indicates that seven of their horses were sold during this period. The following chart details these sales:

HORSE SALES

Sale Date	Horse	Price	Purchaser
June 4, 1978	"Goody"	$1,200	Nadine McColluty
May 1, 1978	"Countess Orazona"	$1,000	Francis Wilcox
October 12, 1978	"Gonzales"	$7,500	Rubin Zisman
May 15, 1979	"Cicero"	$ 800	DuVaughn Banfield
December 13, 1979	"Catch"	$ 990	Edward Drenton
December 13, 1979	"Pony"	$ 350	Gary Ensign
April 30, 1980	"Hot Dog,"	$ 800	Susan Parillo

Moreover, appellants have submitted copies of classified advertisements placed in newspapers and in telephone directories during the years at issue which indicate that their stables were active in horse sales activities, Accordingly, we must conclude that contrary to respondent's contention, appellants' ownership of the subject horses was not isolated from their other equestrian activities but was fully integrated with them, Moreover, a review of the factors noted above clearly establishes that the ownership of the subject horses was primarily engaged in for profit as was the operation of the stables.

While conceding that the operation of the stables itself was conducted in a businesslike manner, respondent concluded that appellants' activities with respect to their own horses were not conducted in such a manner. Respondent's most stinging criticism appears to be that although appellants kept complete books and records with respect to their other equestrian operations, they were unable to present any specific records with respect to the expenses of their own horses. However, the reason for this apparent lack of segregated records may be explained by the fact that, as indicated above, their entire equestrian activities were integrated so that separate records for the horse string were unnecessary. In this instance, it appears to us that what is true of the whole must be true of the part. Thus, if the stables were operated in a businesslike manner, so too were the string of horses. Moreover, as

indicated above, contrary to respondent's allegations, appellants did advertise horses for sale in the classified section of the newspapers during the period at issue and they did, in fact, sell seven of the&r horses, Again, this would indicate a businesslike operation, In addition, contrary to respondent's allegation that Jane's participation in horse shows indicates that the horses were used for her recreation, such participation has been found to be an approved promotional activity and good advertisement indicative of a "for profit" operation. (Theodore N. Engdahl, 72 T.C. 659 (19'49); James S. Bishop, ¶ 72,167 P-H Memo. T.C. (1972); Charles B. Pennington, ¶ 67,111 P-H Memo, T.C. (1967).) Indeed, the abandonment of such endeavors has been found to be an indication that a taxpayer's horse-selling activities were not engaged in primarily for profit, (Stanley A. Golanty, 72 T.C. 411, 430 (1979).) Accordingly, contrary to respondent's allegation that Jane's involvement in horse shows was for her own recreational purposes indicative of a hobby, such involvement was actually indicative that her activities were conducted in a businesslike manner,

Even respondent notes that Jane had a lifelong involvement with horses, with her equestrian activities dating back to her teenage and college years in the early 1930's. Her first job after college was as a riding instructor at Bishop's School in La Jolla, In addition, she had trained extensively with experts over the years, Indeed, a California saddle horse publication acknowledged in print that she is a professional in her field. Certainly, that expertise must include proficiency in training her own horses for sale or lease. Clearly, Jane has greater expertise and a longer record of that expertise in this area than did many taxpayers who had been found to have acquired sufficient training to indicate they had a profit motive. (See Herbert C. Sanderson, ¶ 64,284 P-H Memo.T.C. (1964), involving a practicing surgeon and his wife; Charles B. Bennington, supra, involving the owner of a merchant patrol service and his wife; Lawrence A. Appley, ¶ 79,433 P-H Memo. T.C. (1979), involving a taxpayer described as one of the country's foremost experts in the field of management and organization.) Moreover, the record indicates that appellants have had several. paid employees during the years at issue, including a professional trainer. There is no reason to surmise that these people's duties did not include al% facets of appellants' integrated eguestrian operations, including their own string of horses, Retention of such employees is evidence that

appellants had a profit motive regarding the ownership of the horses, (Lawrence A. Appley, supra.) In addition, there is no question that Jane devoted much of her personal time and effort to carrying on her integrated equestrian activities.

Moreover, as indicated above, the losses generated from the ownership of the subject horses as segregated by respondent appear to be relatively minor, (Compare Appeal of Virginia R. Withington, Cal. St, Bd. of Equal., May 4, 1983.) While the record may be incomplete, when the income from the sales and leases of the subject horses noted above is added back to the figures segregated by respondent, those losses are even more insignificant. and, in fact, result in a small profit in 1978:

Year	Income	Expenses.	Profit (Loss)
$977	$ 1,020	$12,617.07	($11,597.07)
1978	$11,560	$11,472.17	$ 87.83
1979	$ 4,000	$ 9,486.92	($ 5,486.92)
1980	$ 1,400	$ 6,589.85	($ 5,189.85)

Remembering that appellants began the operations of the Altadena Stables in 1974 and the Robinson Stables in 1976 and that a series of losses during the start-up stage in such a venture is normal and not necessarily an indication that the activity was not engaged in for profit, we find that appellants' record is actually strong evidence that the activity is engaged in for profit, Indeed, appellants report that their integrated equestrian operations generated a profit in 1982,

In light of the preponderance of evidence cited above, we do not find that the fact that appellants have substantial income from other sources is determinative of the issue here,, Indeed, in this appeal, we have some sympathy with the sentiment that 'the concurrent existence of other income poses the ["for profit"] question, rather than answers it." (Theodore N. Engdahl, supra, 72 T.C. at 670.) Moreover, in light of that same evidence, the fact that Jane may have derived "personal pleasure from engaging in the activity is not sufficient to cause the activity to be classified as not engaged in for profit . . . ." (Treas. Reg. § 1.183-2(b)(9).) Accordingly, based upon the above discussion, we find that appellants engaged in the ownership of the subject horses primarily for profit so that all of the deductions involved are allowable.

In addition to its review of appellants' equestrian activities, respondent determined that William's geophysicist consulting activities during the years at issue were not engaged in primarily for profit. Respondent concluded that the following financial losses of William indicated this lack of a profit motive:

Year	Income	Expenses	(Loss)
1977	-0-	$3,479.18	($3,479.18)
1978	-0-	$4,632.08	($4,632.08)
1979	$1,801.83	$6,819.02	($5,017.19)
1980	-0-	$3,605.07	($3,605.07)

The record clearly establishes that William has had a long and illustrious career as a geophysicist. William graduated from the Colorado School of Mines with a degree in geological engineering in 1943. He is registered with the California Department of Consumer Affairs as a professional geologist and geophysicist and has been engaged in that profession since 1950. His resume reveals a record of increasingly more responsible positions in that profession, including service as Chief Geophysicist for Lockwood, Kessler and Bartlett from 1965 through 1973. Apparently, in 1973, he left that position and became involved in his family's business in La Jolla. Nevertheless, William continued his geological and geophysicist activities as a consultant, founding his own company, the Kellogg Exploration Company. His efforts proved successful and he was retained on at least two occasions in 1974 and 1975 by Alcoa, During the years at issue, he has continued to advertise and maintain his business connections,

In spite of this impressive background, respondent determined that William's ongoing geophysicist consulting activities during the period at issue lacked a profit motive pursuant to the terms of Revenue and Taxation Code section 17233, cited above, However, a brief review of the factors cited above supports our conclusion that William is engaged in the geophysicist activities for profit, William has devoted substantial time and expense in an effort to develop his geophysicist consulting activities,, Voluminous records exist indicating that William bid on significant projects during the years at issue, Documentation of one of the bids indicates that if William's group had been the successful bidder, he would have earned $50,000. Treasury regulation § 1,183-2(a) provides that if there is a small chance of making a large profit, a profit motive may exist. Clearly

the returns from such activity would have been so large that it induced William to continue the costs of his geophysicist work. Moreover, William is sufficiently qualified by his background so that there is a reasonable basis for his geophysicist activities. (See also, Treas. Reg. § 1.183-(c) Example (6) which found a for-profit motive to exist upon facts quite similar to those in the instant case.) Accordingly, we conclude that during the years at issue William engaged. in his geophysicist consulting activities primarily for profit.

Respondent has also disallowed various deductions claimed by appellants as ordinary and necessary business expenses for payments made to Aloha Robinson subsequent to the transfer of her stables to appellants. Specifically, respondent has disallowed the monthly salary paid to Mrs. Robinson, contending that such. payment and certain miscellaneous payments made on Mrs. Robinson's behalf, such as her personal utility, medical, food, and hair dressing bills, were made either as gifts or as costs of acquisition of such property which should be added to the basis of the property. Remembering that appellants have the burden of proving that they are entitled to such deductions, we must review the evidence which they have submitted. (Appeal of Ambrose L. and Alice M. Gordos, Cal. St. Bd. of Equal., March 31, 1982.

Appellants have submitted a document entitled, "A Petter of understanding," which outlines the provisions for the transfer of Mrs. Robinson's stables to appellants. That document clearly provides that as part of the terms of transfer, Mrs. Robinson was to be retained as an employee at $200 per month and that appellants were to pay her medical and utility bills. While Mrs. Robinson and Jane were close friends, we are impressed with the fact that such friends chose to reduce their understanding to writing and even retained the assistance of an attorney. Clearly, payment of the salary, medical, and utility bills by appellants was not primarily motivated by the disinterested generosity indicative of a gift, but was motivated by the acquisition of Robinson Stables. As such, we find unconvincing respondent's contention that these payments were gifts. Moreover, we find unconvincing respondent's contention that such payments may not be deductible but must be capitalized as costs of acquisition. The sale of a business by an owner or a controlling shareholder may be accompanied by a contract for employment or advisory services by the seller. The fact that the sales

agreement and the contract for services "are integral parts of a single transaction does not, as a matter of law, make the payments under the service contract other than 'compensation'," (Royal Arrow Co. Inc., ¶ 92,058 P-H Memo, T.C. (1972).) However, where assets are purchased for a nominal consideration plus a so-called "employment contract," it has been held that payments of "salary" are actually paid as consideration for such assets, (Nicholas Co., 38 T.C. 348 (1962).) Based upon the record before us, we are unable to determine whether appellants paid Aloha a fair price for her stables or only a nominal consideration indicative that the employment agreement was actually a disguised payment for the stables. Accordingly, we are forced to hold that appellants have not carried their burden of proving that they are entitled to deduct the subject payments made to Aloha and respondent must be sustained on this issue.

Lastly, we must address the question of whether William has properly deducted expenses related to his regular weekend trips between his business interests in La Jolla, his "tax home," and his wife and family in Altadena. Appellants argue that such trips were necessitated by his business responsibilities surrounding the stables and his geophysicist consulting activities. However, appellants have not been able to document that contention. Instead, it appears that the primary reason for such trips was for William to be with his family in Altadena. It is well settled that when a traveling taxpayer engages in both business and personal activities, expenses for transportation and meals are deductible only if the trip is related primarily to the taxpayer's trade or business and not engaged in primarily for personal reasons. (Stratton v. Commissioner, 448 F.2d 1030 (9th Cir. 1971).) Accordingly, William's expenses related to his traveling between La Jolla and Altadena were properly disallowed by respondent.

Based upon our discussion above, respondent's action on this matter must be modified.

O R D E R

Pursuant to the views expressed in the opinion of the board on file in this proceeding, and good cause appearing therefor,

IT IS HEREBY **ORDERED, ADJUDGED** AND DECREED, pursuant to section 18595 of the Revenue and Taxation Code, that the action of the Franchise Tax Board on the protests of William C. and Jane J. Kellogg against proposed assessments of additional personal income tax in the amounts of **$3,434.70, $2,722.15, $3,219.24,** and $3,244 for the years 1977, 1978, 1979, and 1980, respectively, and pursuant to section 19068 of the Revenue and Taxation Code, that the action of the Frandhise Tax Board in denying the claims for refund of personal income tax in the amounts of **$1,288.70** and $380.71 for the years 1978 and 1979, respectively, be and the same are hereby modified in accordance with this opinion. In all other respects, the action of the Franchise Tax Board is sustained.

Done at Sacramento, California, this 25th day of June , 1985, by the State Board of **Equalization,** with Board Members Mr. Dronenburg, Mr. Collis, Mr. Bennett and Mr. Nevins present.

_____, Chairman

Conway H. Collis, Member

William M. Bennett, Member

Richard Nevins, Member

_____, Member