BEFORE THE TAX APPEAL BOARD
OF THE STATE OF DELAWARE

JAY J. JAMES and PAMELA JAMES	)	
	)	
Petitioners,	)	
	)	
v.	)	Docket No. 1462
	)	
DIRECTOR OF REVENUE,	)	
	)	
Respondent.	)	

BEFORE: Todd C. Schiltz, Esq., Chairman, Steven R. Director, Esq., Vice Chairman and Regina Dudziec, Cynthia L. Hughes and Joan M. Winters, CPA, Members

Harold W.T. Purnell, II, Esq., for Petitioners

John S. McDaniel, Esq., Deputy Attorney General for Respondent

The issue in this case is whether a loss incurred by J&J Shop in 2005 may be used to offset income petitioners earned from other sources.

The Director of Revenue contends that petitioners should not be allowed to deduct expenses in excess of the income produced by J&J Shop because the entity's dirt track racing activity was not engaged in for profit, and, therefore, any expenses in excess of its income are not deductible under 26 U.S.C. § 183. Petitioners contend that the Director is mistaken and that they should be allowed to deduct all of the expenses generated by J&J Shops and that the resulting loss can be used to offset their other income because: (i) petitioners' activities in connection with J&J Shop should be aggregated with the activities of Planned Poultry Renovation and/or Bridgeport Speedway, LLC to constitute a single activity for purposes of determining whether petitioners had the requisite profit motive for purposes of 26 U.S.C. §

183(a); and (ii) even if not aggregated with the other entities, J&J Shop standing alone constitutes an activity engaged in for profit for purposes of 26 U.S.C. § 183(a).

For the reasons set forth below, the Board concludes that the activities of J&J Shop should not be aggregated with either Planned Poultry Renovation or Bridgeport Speedway, LLC and that, in 2005, petitioners' activities with respect to J&J Shop were not engaged in for profit for purposes of 26 U.S.C. § 183(a).

Statement of Facts

A. Background

Petitioner Jay J. James began operating J&J Shop ("Shop") as a general welding and metal fabrication business in the 1980s. Mr. James has always treated Shop as a sole proprietorship and maintained separate books and records for its operations. Two of the activities Mr. James engaged in through Shop were the repair of automobiles and the racing of trucks in sanctioned races.

By no later than 1993, Shop began operating dirt track race cars that it assembled from parts it purchased. Prior to engaging in the dirt car endeavor, Mr. James did not investigate or forecast the income and expenses that the operation would generate, he did not prepare a business plan and he did not consult others engaged in the racing industry about the potential for profit. The potential sources of income from dirt car racing include: (i) purse money won in individual races (at most approximately $6,300 per race), (ii) points money paid at the end of a racing season for points accumulated through the racing season, and (iii) sponsorship fees paid by persons or entities who advertise on the dirt car or otherwise associate themselves with the racing operations (at most approximately $20,000 per year per sponsor). In addition to the cost of maintaining the dirt cars, expenses include: (i) depreciation of the dirt cars, which often are

scrapped at the end of their short, useful life; (ii) entry fees that race teams must pay; and (iii) fuel and tires, which must be purchased from track operators.

B. The Poultry Business and PPR

In addition to metal fabrication work on automobiles, much of the work Mr. James performed through Shop related to the fabrication, installation, renovation and maintenance of poultry processing plant equipment. This aspect of the Shop business proved successful, and by the 1990s, much, if not most, of Shop's work was concentrated in this area.

As Shop's business with poultry processing plants grew, Mr. James determined that, in order to get larger jobs as the prime contractor, Shop needed to have its own engineer. In 1995, Mr. James and Brian Ramey, an engineer, formed Planned Poultry Renovation ("PPR") as a general partnership. Mr. James obtained a 51% ownership interest in PPR and Mr. Ramey owns the remaining 49% interest in PPR.

PPR was going to engage in the fabrication, installation, renovation and maintenance of poultry processing plant equipment, just as Shop had done, and consequently all but one of Shop's employees became PPR employees. While the employees were transferred to PPR, the fabrication equipment and other physical assets Shop utilized to perform this work were not transferred to PPR.[1] Instead, Shop retained ownership of this equipment and all of its other physical assets and allowed PPR employees to use the welding and fabrication equipment free of charge to complete jobs for poultry processing plants. Shop did not perform additional welding or metal fabrication work following the creation of PPR, except to the extent such work was

[1] Mr. James testified that "all of the equipment had been bought and paid for, and . . . I didn't want to just give up half of what I worked ten years for . . . ." and that Mr. Ramey was not interested in contributing funds to buy out those assets.

necessary for its dirt racing car activities. Shop continued to pursue its dirt racing activities after the formation of PPR.

PPR maintains its own books and records and these demonstrate that the partnership has been highly successful over the years. Although Mr. Ramey manages almost all of PPR's affairs, in all years for which there is evidence, PPR has provided Mr. James with income ranging from approximately $225,000 to almost $400,000, with the exception of 2005, a year in which Mr. James earned approximately $90,000 from PPR.

PPR has never had a dirt racing or other automobile racing operation and Mr. James testified that Mr. Ramey does not support "PPR putting money into race cars."

C. Bridgeport Raceway

In 2003, Mr. James and Mr. Ramey formed Bridgeport Speedway, LLC ("Bridgeport") in order to acquire and operate an existing dirt track raceway in New Jersey. Messrs. James and Ramey each own a 50% interest in Bridgeport.

At the hearing in this matter, Mr. James testified as follows about the acquisition of Bridgeport:

> Q: If you didn't have the race car business, would you have ever bought Bridgeport?
>
> A: I don't know. I would say, yes.
>
> Q: Why do you say that?
>
> A: Because I really think I can make a good strong business out of it. The two don't have anything to do with – one doesn't have anything to do with the other. I mean, it's separate businesses.
>
> Q: They are complimentary, though?
>
> A: Yes, very much so. I feel all of them are. I feel everything shares a valued piece. One company shares a value off each of the other ones; if I didn't, they wouldn't be – I wouldn't have them together. And they're not really together. I think I've explained al that.

In 2004 and 2005, Bridgeport made extensive improvements to its facilities. Part of this work was performed by PPR. Bridgeport did not pay PPR for the work it performed, although the work for Bridgeport limited PPR's ability to perform work for other customers. Bridgeport maintains its own separate books and records.

Although Mr. Ramey agreed to purchase a dirt race track with Mr. James, Mr. Ramey has refused to become involved in the ownership, operation or racing of dirt cars.

D. Shop's Losses

Following the formation of PPR, Shop continued to own a commercial building and PPR leased space in this building from Shop. In addition, Shop continued to own trucks and other equipment that PPR utilizes to fabricate metal. Finally, Shop continued to assemble, own and race dirt cars. The metal chassis for such cars are made of bent tubing; yet, Shop bought its chassis already fabricated instead of fabricating the chassis itself. The PPR logo was displayed on the dirt race cars operated by Shop; however, in 2005, the tax year at issue, Shop realized no income from racing sponsors, including from PPR.

The record reflects that Shop's operations have not been profitable since it contributed its poultry operations to PPR. In 2005, Shop received approximately $109,000 in gross income from its activities, the vast majority of which arise from payments from PPR for rent and other miscellaneous items, while its expenses exceeded $347,000. Most of the expenses relate to dirt race car activities and include the costs of employing a professional driver who drove the cars and a mechanic who built and maintained Shop's dirt race cars, served as pit crew and

maintained the metal fabricating equipment owned by Shop, but used by PPR.[2] Mr. James testified that he did not drive the dirt cars during the 2000-2007 time period.

As reflected in the following chart, Shop's losses in 2005 were consistent with the losses it has experienced over the years.

Year	Loss
2000	$133,433
2001	$231,914
2002	$222,411
2003	$119,655
2004	$148,798
2005	$237,693
2006	$256,067
2007	$140,625

In calculating its 2005 loss, Shop claimed depreciation expense on a "2003 Chevrolet" which, in fact, is a Corvette model sports car. Mr. James testified that (i) the Corvette was purchased to be used as a pace car at Bridgeport, not for Shop,[3] (ii) Shop purchased the car because Mr. Ramey "didn't want anything to do with the Corvette. He didn't want it at the racetrack," (iii) Mr. James decided not to use the Corvette as a pace car because a sponsor

[2] Neither Mr. James nor Mr. Ramey spent considerable time working for Shop in 2005. In that year, Mr. James spent most of his working time on Bridgeport activities while Mr. Ramey ran PPR's business.

[3] Although the car was purchased to be used as a pace car, the insurance binder Mr. James received from his insurance company indicates under the heading "Ordinary Use of Vehicle" that Mr. James' wife or father will use the Corvette for pleasure or for commuting to work, and not for activities related to the operation of Shop or Bridgeport. Mr. James testified that the binder reflects the car will be used for personal use because "I didn't want to tell them I was going to use it for a pace car. I don't think State Farm would have liked that too much" and because he "wanted to get the cheapest insurance rate possible."

provided him with another vehicle, and (iv) Shop now holds the car as an investment. Shop is not in the business of holding assets for purposes of appreciation.

When calculating its 2005 loss, Shop also deducted the costs of college textbooks purchased by one of petitioners' children. Mr. James recognizes this expense is not connected to Shop business and testified that the amount should be reclassified as owner draw.

Finally, Shop's books reflect an expense which was the homeowner's insurance paid on petitioners' personal residence. There is nothing in the record that indicates that this is an expense associated with Shop business, and Mr. James testified that the amount should be reclassified as owner draw.

The losses Shop has suffered through the years have been used to offset the income Mr. James has received from PPR.

E. The Loans

In 2004, PPR loaned Bridgeport $50,000 without entering into a written loan agreement or having Bridgeport execute a promissory note or pay interest on the loan. PPR continued to loan additional funds, and by 2007 the balance due was $147,126.

In 2005, PPR loaned Shop $90,000 without entering into a written loan agreement or having Shop execute a promissory note or pay interest on the loan. The loan was repaid in 2006.

In 2005, Bridgeport loaned Shop $10,000 without entering into a written loan agreement or having Shop execute a promissory note or pay interest on the loan. This loan was still outstanding at the end of 2007.

F. The Director's Assessment

Petitioners filed a joint tax return for the calendar year 2005. The return reflected wages, interest and other income of approximately $205,000, losses of $237,693 (arising from Shop's activities) for a total adjusted gross income of negative $32,693. Petitioner's return was audited

by the State of Delaware Division of Revenue. The auditor determined that Shop's dirt racing activities were more akin to pursuit of a hobby and did not constitute a trade or business engaged in for profit and, therefore, that the excess of Shop's expenses over its income was subject to the provisions of 26 U.S.C. § 183 and not deductible against petitioners' other income.[4]

The Director of Revenue sent petitioners a notice of proposed assessment dated September 3, 2007, assessing them with $10,816.00 in additional Delaware personal income tax, interest of $1,838.72, penalty of $919.36 for failure to pay amounts required to be paid on a return and penalty of $107.36 for failure to pay estimated tax. Petitioners protested the proposed assessment and the Director affirmed the auditor's findings in a July 1, 2008 Notice of Determination. Petitioners then appealed the Notice of Determination.

An evidentiary hearing was held before the Board on October 26, 2009, and the parties completed their post-hearing briefing on February 16, 2010.

Analysis

Section 183 of the Internal Revenue Code of 1986, as amended, provides that a taxpayer may not fully deduct losses incurred in connection with an activity unless that activity is "engaged in for profit." 26 U.S.C. § 183(a). In order to determine if losses may be deducted pursuant to Section 183, a threshold issue that must be resolved is determining the exact activity in which the taxpayer is engaged. See Treas. Reg. § 1.183-1(d)(1). Where the taxpayer is

[4] Internal Revenue Code section 183 applies to the question of whether petitioners' owe Delaware tax, interest and penalty because the computation of Delaware taxed income begins with federal adjusted gross income. Federal adjusted gross income is federal gross income minus trade or business deductions, among others. 26 U.S.C. § 62(a)(1). Trade or business deductions are ordinary and necessary expenses associated with carrying on a trade or business for profit. 26 U.S.C. § 162. If an activity is not engaged in for profit, section 183 limits the deduction of expenses related to such activity. More specifically, a taxpayer may deduct expenses only to the extent it has gross income from the section 183 activity during a particular tax year. 26 U.S.C. § 183(a) and (b).

engaged in several activities, if the activities are separate, the activities cannot be looked at collectively to determine whether the taxpayer is engaged in a for profit activity under § 183.

A. Whether Shop May Be Treated as One Activity with Petitioners' Other Undertakings

Multiple undertakings of a taxpayer may be treated as one activity if the undertakings are sufficiently interconnected. Treas. Reg. § 1.183-1(d)(1). The most important factors in making this determination are the degree of organizational and economic interrelationship of the undertakings, the business purpose served by carrying on the undertakings separately or together, and the similarity of the undertakings. *Id.* Taxing authorities generally accept the taxpayer's characterization of two or more undertakings as one activity unless the characterization is artificial or unreasonable. *Id.*

Based on the record presented, we find that petitioners' characterization of the Shop undertaking and the PPR and/or Bridgeport undertakings as a single activity for purposes of Section 183 is artificial and unreasonable. The facts do not demonstrate that a close organizational or economic relationship exists between these undertakings. To the contrary, Mr. James formed the three undertakings as separate distinct businesses – one of which is a sole proprietorship, one of which is a general partnership and one of which is a limited liability company – and his economic ownership interest is different in each. In 1995, Mr. James transferred the poultry processing business away from Shop and to PPR and he testified that he considers Shop and Bridgeport to be separate, although complimentary, businesses. Moreover, there is no evidence of a central unified plan to promote the success of the three undertakings, none of which engage in similar business activities. Rather, different managers are primarily responsible for managing distinct assets/businesses, each undertaking keeps its own set of books and records, Shop utilizes a recording keeping system that is separate and distinct from the

systems utilized by PPR and Bridgeport and Mr. Ramey refuses to participate in the dirt racing activities in which Shop engages (a very clear lack of unity with the other undertakings).

Further, we find that there is no economic interrelationship between the various undertakings, *i.e.*, the economic success of one undertaking is not related to or dependent upon the economic success of the other undertakings. Although Mr. James testified that he believes the activities of Shop benefit PPR and Bridgeport in the form of increased customer awareness, which results in enhanced business, he offered no objective evidence to support that conclusion. There is no evidence that PPR and Bridgeport's clients are Shop-related contacts who look to petitioners' knowledge of dirt racing, metal fabrication or welding as the reason why they elected to utilize PPR or Bridgeport's services. Likewise, there is no evidence that Shop's dirt car racing activities actually caused PPR or Bridgeport clients to seek out Mr. James or Mr. Ramey when they are in need of the services provided by PPR or Bridgeport.[5] Based on the record presented, including Mr. Ramey's refusal to participate in Shop's dirt racing activities, we are not convinced that (i) petitioners continue the dirt racing activities to generate business for PPR or Bridgeport, (ii) the dirt racing business materially benefits petitioners' other undertakings (PPR or Bridgeport) or (iii) petitioners' various undertakings are sufficiently interconnected to treat them as one activity.

B. Whether Shop's Dirt Racing Activities Were Engaged In For Profit

As the Board has determined that Shop's undertakings cannot be combined with PPR or Bridgeport, the issue becomes whether Shop's dirt racing activities in 2005 were "engaged in for profit" within the meaning of section 183. Treasury Regulations promulgated pursuant to section

[5] Mr. James' testimony suggests that the individuals who attend the dirt track races and/or are dirt racing fans are not the same individuals who are deciding whether or not to award business to PPR.

183 establish an objective test for determining whether a taxpayer is engaging in an activity for profit:

> The 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. Although a reasonable expectation of profit is not required, the facts and circumstances must indicate that the taxpayer entered into the activity, or continued the activity, with the objective of making a profit . . . . In determining whether an activity is engaged in for profit, greater weight is given to objective facts than to the taxpayer's mere statement of his intent.

Treas. Reg. § 1.183-2(a). Regulation 1.183-2(b)(1)-(9) lists nine nonexclusive factors that courts consider when determining whether a profit motives exist. These factors are:

> (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 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; and
> (9) whether elements of personal pleasure or recreation are involved.

No factor or set of factors is controlling, nor is the existence of a majority of factors favoring or disfavoring a profit objective necessarily controlling. The individual facts and circumstances of each case are the primary test.

1. The Manner in Which Petitioners Carried on the Activity

The fact that a taxpayer carries on an activity in a business-like manner may indicate a profit motive. In determining whether a taxpayer conducted an activity in a business-like manner, courts consider whether the taxpayer maintained complete and accurate books and records, whether the activity was conducted in a manner substantially similar to comparable businesses that are profitable, and whether changes were attempted to earn a profit. Treas. Reg. 1.183-2(b)(1).

We find that Shop did not carry on its dirt car racing activities in a business-like manner in 2005. Although Shop's maintains some books and records, its books and records are not complete or accurate. As to completeness, there is no evidence that Shop has a business plan, either written or oral, there is no evidence that Shop prepares forecasts for income or expenses so that it can track whether it is profitable, and there is no evidence the loans PPR and Bridgeport made to Shop were ever documented. As to accuracy, the inclusion of personal expenses as corporate expenses demonstrates that the books are not completely accurate.

Moreover, there is no evidence that Shop took steps to make its dirt car racing activities profitable. It did not obtain sponsors who could help defray the sizeable costs associated with operating dirt race cars (as do race teams that are profitable). It did not advertise its services as a fabricator of dirt cars. It made no attempt to generate other income (appearance fees, etc.) from its dirt car racing activities (as do race teams which are profitable). The essence of operating an activity in a business-like manner is making some effort to make it profitable. There is simply no evidence that Shops pursued such effort here. To the contrary, as Shop never made any changes to its operations in an effort to earn a profit, it appears that Shop is content with continuing to incur substantial losses on its dirt racing activities and that, in 2005, it had no objective of actually making a profit. *Dreicer v. Commissioner*, 78 T.C. 642, 645 (1982), *aff'd without opinion*, 702 F.2d 1205 (D.C. Cir. 1983) ("the facts and circumstances must indicate that the taxpayer . . .continued the activity . . . with the actual and honest objective of making a profit").

2. The Expertise of Taxpayers or Their Advisors

Although Mr. James had experience fabricating and repairing automobiles before he established Shop, there is no evidence he had any expertise owning, operating or managing a dirt car racing enterprise before Shop entered this endeavor. Likewise, Shop consulted no experts

about the potential for profit prior to engaging in its dirt racing activities. The absence of evidence of expertise draws into question whether Shop carried on its dirt car racing activities for profit.

3. Time and Effort Expended by the Taxpayer

Mr. James testified that he spent "very little" time working at Shop in 2005. He spent his time managing Bridgeport in 2005 and that Mr. Ramey spent his time that year managing PPR. Shop did hire a race car driver and did employ a mechanic who also served as pit crew, although the mechanic also was tasked with repairing the metal fabrication equipment that PPR used but Shop owned. The record does not reflect how much time these individuals spent on Shop's dirt car activities as opposed to other activities. Overall, this factor neither favors nor disfavors a finding of profit motive.

4. Expectation that Assets May Appreciate in Value

The record reflects that the principal asset used in dirt car racing, the race car, is a depreciating asset that often is scrapped at the end of its short life. Furthermore, petitioners also claimed depreciation on the 2003 Corvette, even though Mr. James testified that he kept the vehicle for appreciation. Given these facts, this factor does not support petitioners' contention that they operated the dirt racing activity for profit.

5. Taxpayer Success in Carrying on Other Similar or Dissimilar Activities

The record as to this factor is mixed. Petitioners do not carry on any similar business so this is not relevant. Mr. James' experience with PPR suggests that he has knowledge and skills necessary to run a business successfully; however, his experience with Bridgeport has not been a success. Overall, this factor neither favors nor disfavors a finding of profit motive.

6. The History of Income or Loss with Respect to the Activity

Shop has a history of large losses, which extend over several years. Nothing suggests these losses are attributable to the fact Shop is a start up company or that the losses arise from unforeseen circumstances that are beyond the petitioners' control. This factor weighs against finding that Shop was operated for profit.

7. The Amount of Occasional Profits, If Any, Which are Earned

Petitioners incurred losses from the dirt track racing activity from 2000 to 2007 and there is no evidence that Shop earned a profit on the dirt racing activities in any year. This factor does not support petitioners' contention that they engaged in the dirt racing activity for profit.

8. The Financial Status of the Taxpayer

If a taxpayer does not have substantial income or capital from sources other than the activity in question, it may indicate that the taxpayer engages in the activity for profit. Treas. Reg. 1.183-2(b)(8). Conversely, substantial income from sources other than the activity, especially if the losses generate large tax benefits, may indicate that the taxpayer is not conducting the activity for profit. *Id.* Taxpayers with substantial income from other sources have a much greater tax incentive to incur large expenditures in a hobby type of business.

Petitioners had substantial income from PPR that the dirt racing activities could and did offset. Petitioners reported considerable net income during each of the relevant years. This factor weighs against petitioners' contention that they engaged in the dirt racing activity for profit.

9. Whether Elements of Personal Pleasure or Recreation are Involved

Mr. James testified that he only experiences personal pleasure regarding dirt track racing when his car wins a race, an occurrence he testified occurs infrequently. There is no evidence that either petitioner drives the dirt race cars for pleasure; however, other facts in the case, including Mr. James' lifelong association with racing, his affinity for mechanical devices, and his testimony that all of his children are involved in racing in some capacity, lead us to believe that Mr. James may be an dirt car hobbyist. Overall, this factor neither favors nor disfavors a finding of profit motive.

In sum, the nine nonexclusive factors and the facts and circumstances of this case lead us to conclude that petitioners did not engage in dirt car racing with the primary purpose of realizing an economic profit independent of tax savings. Therefore, we find that petitioners have not met their burden of proving the requisite profit motive for their dirt racing activity.

CONCLUSION

For the reasons stated, we sustain the Director's determination in the Notice of Deficiency. The Director is instructed to circulate a proposed form of order to petitioners for review within fourteen (14) days of the date of this opinion. The proposed form of order shall detail the total tax, penalty and interest that petitioners owe as of the date of this opinion for the 2005 tax year, as well as a per diem calculation for each additional day the amounts due pursuant to the order remain unpaid. Tax Appeal Board Rules 19(e) and 20. The parties shall file a joint proposed order for signature by the Board, or, if necessary, separate proposed forms of order, within thirty (30) days of the date of this opinion. Tax Appeal Board Rule 20.

Agatha L. Hughes

Steven R. Prieto

Regina C. Rodriguez

Date: April 14, 2010

BEFORE THE TAX APPEAL BOARD
OF THE STATE OF DELAWARE

JAY J. JAMES and PAMELA J. JAMES Petitioners.	)	
v.	)	Docket No. 1462
DIRECTOR OF REVENUE, Respondent.	)	

FINAL ORDER

AND NOW this 12th day of May 2010, the Tax Appeal Board (the "TAB") having rendered its Opinion dated April 14, 2010 in the above captioned matter in which the TAB sustained the determination of the Director set forth in the Notice of Proposed Assessment dated September 3, 2007 with respect to the liability of Petitioners for Delaware personal income tax for their 2005 taxable year, penalty and interest, and the parties having submitted a computation of the Delaware personal income tax, penalty and interest due and owing through April 14, 2010 together with a "per diem" amount of the additional interest accruing each day thereafter until the date of payment, all in accordance with the Opinion of the TAB, it is hereby ORDERED that Petitioners are liable for and ordered to pay Delaware personal income tax for their 2005 taxable year, penalty and interest accrued through April 14, 2010 in the following amounts, together with the "per diem" amount set forth below until the date of payment:

Delaware personal income tax through April 14, 2010	$ 10,816.00
Penalty through April 14, 2010	$ 107.73
Interest accrued through April 14, 2010	$ 3,582.34
Total Tax, Penalty and Interest through April 14 2010	**$ 14,506.07**
"Per Diem" amount from April 14, 2010 until payment	$ 1.82

Todd C. Schiltz, Chairperson

Steven R. Director

Regina C. Dudziec

Cynthia L. Hughes

Joan M. Winters