BEFORE THE STATE TAX APPEAL BOARD

OF THE STATE OF MONTANA

JK 3 STAR RANCH, LLC, KELLY W. and JODEEN R. DURYEA, Appellants, -vs- THE DEPARTMENT OF REVENUE OF THE STATE OF MONTANA, Respondent.	)))))))))))))	DOCKET NO. IT-2013-3 FINDINGS OF FACT, CONCLUSIONS OF LAW, ORDER and OPPORTUNITY FOR JUDICIAL REVIEW

This case comes to us through a direct appeal by Taxpayer JK 3 Star Ranch, LLC, and others, from an adverse decision of the Office of Dispute Resolution (ODR) of the Department of Revenue (DOR). This Board elected to hear this appeal on the record without objection by the parties. The ODR decision and transcript was considered by this Board.

Statement of the Case

A hearing was held on November 13, 2012 before ODR's hearing examiner. W. Scott Green, attorney, represented the Taxpayers JK 3 Star Ranch LLC, and Kelly W. and Jodeen R. Duryea. The Department of Revenue (DOR) was represented by Tax Counsel Teresa Whitney, Larry Sullivan, Unit Manager for the Withholding Tax Unit, and Justin Ahlers, Tax Auditor for the Pass-Through Unit, Business and Income Tax Division.

Issue

The issue presented is whether or not the Taxpayers' raising of Highlander Scottish cattle and related ranch activities during the audit prior were not-for-profit, as that term is defined under § 183, I.R.C, and ancillary regulations.

Facts Presented

1. Mr. and Mrs. Duryea were selected for audit by DOR as a result of a random review of Schedule E or Schedule F losses. (ODR Tr., p. 90, lines 3-10.)
2. On April 5, 2011, DOR requested and received additional supporting documentation of expenses, as well as a business plan from the Taxpayers.
3. On June 22, 2011, DOR mailed the Taxpayers an audit assessment letter in which DOR determined the activity reported on Schedule F of the Montana Partnership returns for tax years 2006, 2007, 2008, 2009, and 2010 was an activity not engaged in for profit pursuant to § 183, I.R.C. DOR stated in this letter that the nine-factor test set forth in Treasury Regulation § 183-2 (b), was applied and each factor was analyzed in relation to the Ranch's Schedule F Activity. (DOR Exhibit 8.)
4. As a result of the audit, DOR disallowed certain of the claimed deductions related to the operation of the ranch. The adjustments resulted in the assessment of additional taxes for each of the five years at issue.
5. In response to the audit adjustments, Taxpayers filed a Request for Informal Review with DOR on September 19, 2011.
6. On September 30, 2011, DOR notified Taxpayer that it had reviewed the adjustments and confirmed that the activities carried out on the ranch were not allowable as activities for profit under I.R.C. § 183, concluding that "[t]he most prominent fact in this case is that the Duryeas incurred

significant losses over the course of many years. Our review of the evidence does not lead us to believe that the farm activity has the ability, or the taxpayers have the intention, to recoup the substantial losses incurred." (DOR Exhibit 3.)

7. Taxpayers appealed to the DOR's Office of Dispute Resolution disputing the DOR's application of the nine factors contained in Treasury Regulation § 1.183-2 (b) to their ranching operation. (ODR Notice of Referral.)

8. An ODR hearing was held on November 13, 2012, including testimony on behalf of the Taxpayers from various experts and appraisers of the property, as well as from the DOR appraiser who examined the returns. Kelly Duryea testified on behalf of the Taxpayers.

9. Kelly W. and Jodeen R. Duryea are husband and wife and were full-year residents of Montana during the audit period. They timely filed Montana Individual Tax Returns for all such years, married filing jointly.

10. Kelly Duryea is the full-time general director of transportation for Burlington Northern Santa Fee (BNSF) Railway and has worked in some capacity for the company for 39 years. (ODR Tr., p. 3, lines 13-18.)

11. Jodeen Duryea currently assists her husband with caring for the ranch and also helps to market their Scottish Highlander beef. (ODR Tr., p. 78, lines 7-12.)

12. On January 8, 2005, Kelly W. Duryea and Jodeen R. Duryea, along with their daughter, Tiffanie Church, formed JK 3 Star Ranch, LLC, a Montana limited liability company. Kelly and Jodeen each hold 45 percent ownership, and Tiffany holds 10 percent ownership. (ODR Tr., p. 24, line 7.)

13. Mr. Duryea explained that, in 2005, they had purchased 242 acres with the

goal of raising Scottish Highlander cattle as a source of retirement income. (ODR Tr., pp. 4, 5.) Mr. Duryea continues to hold a management position with the BNSF Railroad and works weekends at the ranch.

14. In 2007, the Duryea's purchased Highlander cattle for the ranch. The Duryea's daughter, Tiffanie Church, lives on the ranch with her husband, Jody, and daughter. (ODR Tr., pp. 5, 10.) The Churches provide on-site care for the cattle on the ranch, estimating 20 to 40 hours per week of work required. Jody Church also works for the Signal Peak Mine, working six 12-hour days and then three days off, for an average 55-hour workweek at the mine. (ODR Tr., p. 24, lines 13-14.)

15. Mr. Duryea stated that his two other sons also helped out from time to time, even though both are employed full-time elsewhere (ODR Tr., p. 22.)

16. Mr. Duryea estimated the present value of the ranch to be about $670,000 and the farm equipment to be worth $150,000 to $200,000. (ODR Tr., p. 15, lines 10-14.)

17. Mr. Duryea stated that there were 45 head on the ranch at the time of the hearing. He testified that this was down from the approximately 125 head they had in earlier years. Mr. Duryea sold 43 cow/calf pairs to a Wyoming rancher in 2011, explaining "I needed to size down the number of cattle and concentrate on the feeding out of the beef." (ODR Tr., pp. 15-16, lines 16-23 and 1-2.)

18. Mr. Wally Congdon, a specialist in the raising of Highland cattle, was hired by the Duryeas in 2011 to advise them on the running of their ranch. (ODR Tr., p. 45.)

19. Mr. Congdon testified that Highland cattle are a hardy breed that matures slowly, compared to typical cattle raised in Montana. The cattle will feed only by grazing, will not eat grain, and take about twice as long to mature

for marketing, requiring 30 to 40 months, compared to 22 months for Hereford and Angus steers. ODR Tr., p. 46. The fact that they are not grain-fed makes their meat very popular with specialty restaurants and consumers seeking low-fat meat without grain, who are willing to pay premium prices for the beef. (ODR Tr., pp. 47-60.)

20. Mr. Congdon stated it would take four to five years to make a profit raising Highland cattle and that he raised Angus initially, as well as Highland, to produce income in the early years. (ODR Tr., p. 47.)

21. Jodeen Duryea handles the marketing responsibilities for the ranch. She testified that she markets the cattle "basically by word of mouth" to those who are interested. They have also advertised their beef in the Highlander Association newsletter. (ODR Tr., p. 80, 81.)

22. Mr. Jason Smith, of Billings Farmhand, a ranch supply store, testified that he sold the Duryeas the ranch equipment they now have and performed an appraisal of it in 2011, concluding that it was worth $150,000 to $200,000, as Mr. Duryea has testified. (ODR. Tr., pp. 73, 74.)

23. Mr. Ken Minnie, a livestock rancher and realtor, estimated the value of the ranch as "the middle 590's to a high of $670,000." Mr. Minnie is not an appraiser and did not prepare a formal appraisal. (ODR Tr., p. 108.)

24. Mr. Justin Ahlers, of the DOR, testified that he had conducted the audit of the ranch. He requested and received documentation from the Duryeas of their expenses and efforts to run the ranch in a businesslike manner. He examined their records and their business plan and concluded that the Duryeas did not satisfy the nine factors set out in Treasury Regulation § 1.183-2 (b). (ODR Tr., pp. 90-104.)

25. Mr. Ahlers found that the ranch books were well-maintained but that other aspects of the business were lacking. The business plan for the

ranch was vague, incomplete, and lacked a marketing strategy, which he considered a significant failing for a business producing a "niche product" like Highland beef. He also pointed out that the Duryeas had not consulted experts or professionals for assistance in the ranching activity during the first five years in question in this case, and the hours spent working on the ranch by the members of the Duryea family, all with full-time jobs outside the ranch, did not reflect a reasonable estimate of the time required to run a ranch. Mr. Ahlers also pointed out that the expenses generated by the ranch have steadily increased over the five-year period, from a net loss of $70,736 in 2006 to $159,052 in 2010, so they are not approaching profitability. (ODR Tr., pp. 90-104.)

26. Finally, Mr. Ahlers concluded in his adjustment letter to the Duryeas, "the evidence leads us to conclude that the operation could not produce a profit without additional acres, additional time and experts hired, or allocated to the activity." (DOR Exh. 8, p. 3.)

27. The ODR issued a decision upholding the DOR's adjustments on March 12, 2013. In denying the business deductions, the opinion stated: "[E]ven if the Ranch consistently sold the maximum number of cow/calf pairs and several bulls or steers, the income derived from these sales would not be remotely sufficient to offset the financial losses occurring every year." (DOR Exh. A, ODR decision.)

28. Taxpayers appealed that decision to this Board in a timely fashion stating that the Hearing Examiner had "failed to take subjective intent into account [and] failed to properly analyze the objective intent of earning a profit as set forth" in the nine-factor test defined in the Internal Revenue Code Regulations §1.183-2(b). Taxpayers also argued that the burden of proof in the case shifted to the DOR when the Taxpayers made a *prima*

facie case that they were running a business. (26 U.S. C. 7491.)

Applicable Statutes

1. The State of Montana calculates taxable income under the Federal Internal Revenue Code, which permits the deduction from gross income of the ordinary and necessary expenses of running an income-producing business. (26 U.S.C. 61; § 15-30-2101(10), MCA.)
2. In the case of activities not engaged in for profit, the deductions are limited to the income from that activity, and, therefore, cannot be used to offset other taxable income. (26 U.S.C. 183 (b).) If the activity produces net income in three of five years, it is presumed to be engaged in for for profit and the business deductions are allowed. (26. U.S.C. 183 (d).)
3. Activities not profitable three of five years can still be found to be engaged in for profit under a nine-factor test defined in the Regulations. Treasury Regulations §1.183-2(b). Those factors, in brief are:
    1. 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;
    9. Elements of personal pleasure or recreation.

4. 26. U.S.C. 7491 states the burden of proof "shifts where the taxpayer produces credible evidence" and "the Secretary shall have the burden or proof with respect to the issue."

Findings of Fact, Conclusions of Law and Discussion

The issue before us is whether or not the cattle-raising operation at the Duryea ranch was a business or a hobby. In treating it as a business, the Duryeas have deducted more than $615,000 against other income over the five years under audit and the annual losses from the ranch more than doubled in that time. The Internal Revenue code requires that the business produce a net income in three out of five years, or failing that, satisfy the nine-factor test proving that the activity is legitimate business activity, even though unprofitable. Taxpayers clearly do not meet the three-out-of-five test, so the issue is whether they satisfy the factors set out in the Regulations as set out in the Applicable Statutes above.

Responding to the first element in the nine-part test (manner of activity), the Taxpayers maintained their financial accounts in Quickbooks and testified that they did considerable work fixing up the rundown state of the fences and buildings on the ranch. However, we note many persons who are not running a business commonly use accounting software today. The Duryeas testified that the ranch is to be their retirement home, which offers a non-business explanation for the repairs and the improvements. Treating their future retirement home as a business allowed the deduction of the expenses of fixing up the property, which would not be otherwise deductible as they are personal expenses.

Mr. Ahlers, DOR auditor, requested their business plan and testified that he found it inadequate and lacking detail. The Duryeas made no plans to earn other ranch income during the early years while the herd matured and did not properly estimate the number of cattle their land would support. Further, they did not develop a marketing scheme, as expert Mr. Congdon has done for his own cattle, which would maximize the income earned by their unique product. Mr. Congdon sells to specialty organic beef processors in the region and also sells directly to upscale restaurants. Mrs. Duryea, in charge of marketing, stated that she did the marketing by word of mouth. Developing a specialty market is crucial to the Duryeas if they are to command the premium prices for their beef necessary to support their operation. There is, therefore, conflicting evidence on the manner in which the Taxpayers carried on the activity. We find that the bookkeeping and repairs, while significant, do not clearly establish this as a business activity.

The second element in the nine-part test is the Taxpayers' expertise or use of professional advisors in the business aspects of the enterprise. The Taxpayers' own testimony described their decision to raise Highlands as based on a few conversations and Mr. Duryea's conviction that the longhaired cattle are ideally suited to the cold climate of Montana. The Duryeas' only prior experience raising cattle consists of Mr. Duryea's summers as a teenager helping with the chores on a relative's ranch. In terms of management, they have no prior cattle-raising experience of any kind, and no special knowledge of Highland cattle aside from a subscription to a newsletter. The Duryea's son-in-law, who lives on the ranch, does have ranching experience but he works an average of 55 hours per week at a mine, leaving little time to manage the ranch. No consultants on raising Highland cattle were hired until 2011 when Mr. Congdon was brought in to advise the Duryeas on the ranch operation. The federal regulations look for "preparation for the activity by extensive study of its accepted business, economic, and scientific practices, or consultation with those who are experts therein. (26 C.F.R. 1.183.) We find that the Duryeas did not have the expertise or the advisors described by the Regulations as evidence of serious business intent.

The third factor in the regulations test looks at the time and effort expended in the running of the business. Mr. Duryea testified that he and his wife worked there on weekends, two of his sons have also contributed help on occasion and his daughter, son-in-law, and grandchild live on the ranch. All of the family members who work on the ranch do so in their spare time as all have full-time employment elsewhere. Mr. Ahlers concluded that the Duryeas did not put in the time and effort that a ranch requires and we find no evidence that contradicts this testimony. We do not find that the Taxpayers have satisfied the third element in the nine-part test.

The fourth factor in the IRS test is the expectation of gain in the value of the assets used. Taxpayers submitted evidence that their farm machinery had not declined in value since they purchased it and that the ranch itself has appreciated in value.[1] While the estimated ranch value was not presented in a formal appraisal, the DOR did not contradict it. We accept, therefore, that the ranch has increased in value and that the machinery has not decreased in value. We find that the Taxpayers have a reasonable expectation of appreciation in the value of their ranch.

The fifth factor in the IRS test is the success of the taxpayer in carrying on other similar or dissimilar activities. The Taxpayers submitted no evidence of any other for-profit businesses they have created or managed, so this factor does not support the Taxpayers' claims.

The sixth factor is the taxpayer's history of income or losses with respect to the activity. All five years here under audit, 2006 through 2010, resulted in net losses, and those losses steadily increased from $70,736 in 2006 to $159,052 in 2010. Mr. Congdon testified that the slow maturation of the Highland cattle makes it difficult to make a profit in the first five years, which suggests that this particular business requires a longer start-up period than others. However, Taxpayers did not seek other sources of income, such as raising Angus cattle, as

[1] The record does not indicate whether the Highland cattle are treated as assets of the business and whether they gained in value, so we do not address the cattle in this factor.

Mr. Congdon did, to provide income in the early phases of the business. Instead, their losses more than doubled over the five years but it was not until 2011 that Taxpayers sought advice from Mr. Congdon about their ranch. We find that the fact that Taxpayers, with losses mounting from year to year, made no effort to modify their business plans or seek outside advice, suggests a lack of focus on earning income from their venture.

The seventh factor looks at the amount of occasional profits from the business. Taxpayers reported profits for the two years following the audit years but the record contains little information on those years. The profit in 2011 resulted largely from the sale of two-thirds of their herd to another rancher, according to the Taxpayers' testimony, a unique stream of income unlikely to be repeated in future years. Profit was also shown in 2012 but no details on that year are available from the record. During the years under audit, however, there were no occasional profits.

The eighth factor looks at the financial status of the taxpayer. In this case, the Duryeas receive substantial annual income from Mr. Duryea's job with BNSF. The Duryeas are not dependent on the ranch for their livelihood and used the net losses from the ranch to shelter $615,204 of other income from taxation in the first five years. This factor clearly suggests that the Taxpayers invested in the ranch as a tax shelter rather than a profit-seeking enterprise.

The final element in the test is the degree of personal pleasure or recreation derived from the activity. Taxpayers testified that they did not enjoy raising cattle and did not regard the cattle as "pets." However, the purpose of the purchase of the ranch was to provide a retirement home for the Duryeas, which is a strong personal enjoyment element not present in most business investments.

In summary, Taxpayers produced evidence that their land and equipment has increased in value or maintained value since they purchased it, but other factors in the nine-part test do not support the Taxpayers. They did not have expert consultants during the formative years of the ranch, they have very limited experience raising cattle, they have substantial non-farm income to shelter with ranch expenses, family members who contribute to running the ranch have full-time jobs outside the ranch, and the ranch was purchased as a retirement home for the couple and not purely as a business they intended to rely upon for their income. Taxpayers submitted no contrary evidence on these issues. Taxpayers also submitted no evidence that their losses were temporary or that they made concerted efforts to study the problems, change their operations to make them profitable or hire experts to advise them on ways to achieve that. Instead, the net losses kept steadily increasing.

All of these facts undermine the claim that the Taxpayers are focused primarily on making a profit from the ranch. The Duryeas have claimed that the DOR has failed to meet its burden of proof, which they say shifted to the DOR when they submitted credible evidence of their ranching activities. This argument relies on §7491 of the Internal Revenue Code, summarized above. The evidence submitted by the Duryeas, though credible and uncontested by the DOR, does not address most of the elements of the test and is not sufficient to overcome the opposite inference from the large, steadily growing losses and the bleak prospects for making a profit from the ranch as it is now operated. These facts strongly support the ODR holding that this was not a profit-seeking venture.

The Taxpayers further claim that the DOR had failed to establish their subjective as well as their objective intent in managing the ranch. The test imposed by the Internal Revenue Code is objective: it first looks for profit in a majority of years and, as a secondary test, examines the taxpayer's actions in the running of the business. We find that the Taxpayers in this case have not presented convincing evidence that the ranch was run with profitability as the chief goal and have not, therefore, satisfied the nine-part test put forth in the Regulations establishing their business motive.

This Board finds that the Taxpayers have clearly not met the test described in the I.R.S. Regulations establishing the ranch as a profit-seeking business. We hold that the additional audit assessments by the DOR are valid.

Order

IT IS THEREFORE ORDERED by the State Tax Appeal Board of the State of Montana that the Taxpayers' appeal and complaint be denied and that the adjustments made to the subject Individual Income Tax returns for tax years 2006 through 2010 conformed to law. Tax, penalties, and interest accruing form such adjustments are properly due and owing.

DATED this 24th day of July, 2013.

BY ORDER OF THE
STATE TAX APPEAL BOARD

Karen E. Powell

KAREN E. POWELL, Chairwoman

(S E AL)

Samantha Sanchez

SAMANTHA SANCHEZ, Member

David L. McAlpin

DAVID L. McALPIN, Member

NOTICE: You are entitled to judicial review of this Order in accordance with Section 15-2-303(2), MCA. Judicial review may be obtained by filing a petition in district court within 60 days following the service of this Order.

CERTIFICATE OF SERVICE

I certify that on this 24th day of July, 2013, a true and correct copy of the foregoing Order was served by placing same in the United States Mail, postage prepaid, and addressed as follows:

W. Scott Green
PATTEN, PETERMAN, BEKKEDAHL
& GREEN, P.L.L.C.
Suite 300, The Fratt Building
2817 Second Avenue North
Billings, Montana 59101

Teresa Whitney
Tax Counsel
Montana Department of Revenue
Legal Services Office
PO Box 7701
Helena, MT 59604-7701

Donna Eubank by ja
DONNA EUBANK, paralegal assistant