More IRS Scrutiny of Hobby Losses

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In the past year, the Internal Revenue Service ("IRS") has increased its scrutiny of “Hobby Losses.” Technically, a Hobby Loss is a loss that the taxpayer incurs from an investment made in an “Activity *Not* Engaged in for Profit.” Unlike other investments, a taxpayer generally experiences a Hobby Loss when he engages in a trade or business for which the taxpayer has a *special* passion. Typical Hobby Loss cases include various horse activities, music, film, yachts, a book on searching for the perfect steak, cattle ranching (before searching for the perfect steak), donkey breading, and racing cars. Usually, the taxpayer who engages in a purported hobby type trade or business is successful in another pursuit, such as medicine, law, engineering, or hedge fund investments. For federal income tax purposes, a taxpayer who is held to have a Hobby Loss can only take expense deductions not in excess of the income from the activity. Further, those expenses are generally itemized deductions, which are further limited under current tax law. In one of the more colorful cases, the United States Tax Court summarized the issue as follows:

"In 1946, when petitioner was two years old, his father was found hanging by the neck in the bathroom of his shop in Gainesville, Texas. The death was originally ruled a suicide. In 2003 petitioner received an anonymous letter asserting that unidentified residents of Gainesville had murdered his father and staged it to look like a suicide. Having realized a large gain on the sale of his business, the petitioner had the means to devote significant time and resources to investigating the circumstances of his father's death."

The taxpayer attempted to deduct the cost of expenses associated with investigating his father's death, including the hiring of private investigators, forensic experts, morticians, and writers. The taxpayer hoped that his investigation would lead to a book or movie contract. The taxpayer deducted the costs ($6.4 million) incurred in his pursuit of the truth of his father's death. The taxpayer never received a dollar of revenue. The United State Tax Court ruled:

"By January 2008 petitioner had been investigating his father's death for five

years. As of that time, his investigative activities had not generated a single dollar of revenue. Those activities generated no income during 2008, 2009, or 2010, and petitioner had no reasonable prospect of generating future income. Petitioner never developed a business plan for commercializing his father's story. He has no professional background in writing, book publishing, or media. He did not modify the scale or scope of his investigative activities during 2008-2010 in an effort to minimize the substantial losses he was incurring."

The income tax regulations enumerate a non-exclusive list of factors in determining if a taxpayer engages in an activity for profit. The factors enumerated are:

1. The manner in which the taxpayer conducts the activity;
2. The expertise of the taxpayer or his advisers;
3. The time and effort spent 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 loss with respect to the activity;
7. The amount of occasional profits, if any;
8. The financial status of the taxpayer;
9. The presence of personal pleasure or recreation.

In applying the above factors to a particular activity, no one factor is determinative. A rebuttable presumption exists that an activity is engaged in for profit if the taxpayer can establish that in three of the five consecutive taxable years, including the tax year in question, income exceeds the deductions for those three years. If the taxpayer is engaged in an activity of breeding, training, showing, or racing horses, the presumption is applied by substituting two years for three years and seven years for five years. Thus, for purposes of applying the rebuttable presumption, horse-related activities receive more lenient treatment. The income tax regulations fine-tune how this rebuttable presumption is applied.

A recent case illustrates how a facts and circumstances analysis resulted in a taxpayer win. The taxpayers, **who had no prior ranching experience,** acquired a 1,100-acre cattle ranch for $2 million**.** Originally, the taxpayers expected that they would earn a profit from cattle sales and guided hunting expeditions. The taxpayers hired an experienced ranch manager. The taxpayers soon learned that cattle ranching was an uneconomical business, and the liability insurance premiums on guided hunting tours was exorbitant. As a result, the taxpayers changed their focus from cattle ranching to making improvements to the ranch for the purpose of profiting from the appreciation of the underlying real estate. While conceding that this was a “close case,” the United States Tax Court Judge held that the presence of a professional manager and the maintaining of “complete and accurate books” was evidence of a profit motive.

What is the bottom line? If a taxpayer intends to engage in a high-profile activity with elements of personal pleasure, the taxpayer should confer with a tax professional as soon as possible before commencing business operations. Hire competent advisors and keep accurate books.