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Equine Law - Hobby Losses Aren't Horseplay: Recent Case Examines the Deductibility of Equestrian-Related Expenses

'Tis true that successful people love their work but truly successful people work at what they love. The tax law recognizes that people can mix profit and pleasure. Even where the prospect of profit may be deferred for years and ultimately never arrive, the intervening losses are deductible so long as the taxpayer is genuinely trying to reap an overall profit. Yes, the stodgy old tax law recognizes that people can still be profit motivated in activities they enjoy even though they may be incurring losses on the front-end of a start-up business and even when there may only be a small chance at a great profit. Of course, the IRS and the courts expect every taxpayer deducting losses from something he or she enjoys to say they were profit motivated. The courts in particular separate the genuine from the feigned by looking to nine objective factors.

Proof of that genuine profit motive in the face of an IRS attack can best be demonstrated by the recent story of one woman with courage in *Topping v. Commissioner*. Since childhood, Tracey Topping had competed in the hunter-jumper world. When life seemed to be crashing around her with a divorce at age 46, no alimony, and no work experience for the past 25 years, she turned to the three things she knew: horses, horse people, and an artistic gift for interior design. Buffeted by necessity and armed with this knowledge, Tracey launched her own interior design business focused upon those involved in the equestrian circuit. She brought the same level of attention to detail to her extraordinary artistic talent of drawing design perspectives freehand that those around her observed in her horse competition.

More important than any other one thing, Tracey was able to demonstrate the startling statistical correlation between her design customers and the horse circuit, and she was able to do so while protecting the identities of the clients. That was no mean feat given the number of IRS victories in attacking horse-based hobbies. To be sure, Tracey, as the IRS later stressed, was no MBA. She had no formal business plan, prepared no cash-flow projections, conducted no formal market study, and sought no additional formal training in design. Fortunately, the existence of a practical plan to build a design practice from the horse circuit could be proven from contemporaneous discussions with her accountant and a close friend who had built her own successful business. With hard work and talent, Tracey pressed her informal plan with dedication, talent, and raw determination.

In 1999, Tracey formed a limited liability company in Florida. Like many entrepreneurs, Tracey initially used her home office to handle all the financial aspects of her design business, and she hired an employee to take care of the general administrative work. Tracey used her few assets ---including horses, a truck, a trailer,

Equine Law - Hobby Losses Aren't Horseplay: Recent Case Examines the Deductibility of Equestrian-Related Expenses, Continued

and a car--- in both her equestrian and design activities. Tracey's business method consisted largely of attending horse shows, entering various competitions, and making contacts with existing and potential clients. Tracey developed many of her contacts while competing on the Winter circuit in Wellington, Florida. In addition to riding, Tracey rented a table for the season at the Jockey Club. Each time Tracey competed her name was announced over the loudspeaker, first as the horse's owner and then as its rider. If she finished in the ribbons, her name was again announced. It was also displayed on the leaderboard. Regardless of whether Tracey won or lost, she always returned to the Jockey Club, where she interacted with fellow competitors and horse enthusiasts.

Based on her belief that advertising would be offensive and counterproductive, Tracey did not advertise her design business in traditional media, such as equestrian-related magazines, websites or newspapers, and she did not display banners or sponsor events through her company. She recognized that those on the circuit would view publicity as desperate, tacky, and gauche. Tracey first used her equestrian background and her knowledge of each horse's particular circumstances to design high-end barns. For example, she introduced special features tailored to the horse's unique injury or temperament. Likewise, Tracey took into account the special needs of "horse people" when designing the interior of their homes. She often incorporated mudrooms, expanded storage for boots, saddles and other equipment, and selected durable fabrics that could be easily cleaned.

Tracey kept records of her equestrian and design activities, and she had her accountant produce profit and loss statements that traced the expenses. However, she did not maintain records of training costs or costs associated exclusively with horses in order to project a budget. Moreover, neither Tracey nor her accountant prepared monthly budgets.

From 1999 through 2001, Tracey's accountant included two separate Schedules C (Profit or Loss from Business) in her individual tax return, one for the horse activity and the other for the design activity. By 2002, however, the accountant filed just one Schedule C, where he combined the activities. The horse activity suffered significant losses, whereas the design activity produced sizable profits. Together though, Tracey enjoyed an overall net profit in six of the first seven years of her start-up business. In short, one fueled the other.

In August 2004, the IRS sent Tracey a notice of deficiency, disallowing all of the horse-related deductions that she had claimed. The IRS essentially argued that such expenses could not be deducted on Schedule C because they were linked to a "hobby," not a business. After some administrative wrangling, Tracey's case wound up in the United States Tax Court.

Tax Court Decision

Section 162 of the Internal Revenue Code allows a person to deduct ordinary and necessary business expenses from a trade or business. Importantly, the amounts deducted may offset a person's income from other sources, including those completely unrelated to the trade or business. By contrast, the "hobby loss" rules of Section 183 disallows losses associated with activities that lack a profit motive. Section 183 only allows a person to deduct expenses from a non-profit-motivated activity to the extent that she has income from that activity during the same year. Since most hobbies generate little (if any) income, the practical effect of Section 183 is to prohibit a person from writing off any deductions related to a hobby.

Because of the collision between Section 162 and Section 183, two key determinations must be made. First, do two particular undertakings constitute separate activities or just one single activity? In making this decision, the court examines the degree of organizational and economic interrelationship between the two undertakings, the business purpose served by carrying on the two

Equine Law - Hobby Losses Aren't Horseplay: Recent Case Examines the Deductibility of Equestrian-Related Expenses, Continued

undertakings separately or together, and the similarity of the two undertakings. Second, is a particular undertaking profit motivated? As noted, the court focuses on nine objective factors:

- Manner in which a person carries on the activity
- The expertise of the person or his advisors
- The time and effort expended by the person in carrying on the activity
- An expectation that assets used in the activity may appreciate in value
- The success of a person in carrying on other similar or dissimilar activities
- The person's history of income or losses from the activity
- The amount of occasional profits, if any, earned from the activity
- The financial status of the person
- Elements of personal pleasure or recreation derived from the activity

In Tracey's case, the Tax Court effectively killed two birds with one stone when it held that Tracey's horse and design undertakings represented one single activity. In coming to this conclusion, the Tax Court looked at the fact that (i) the two undertakings have a close organizational and economic relationship, (ii) Tracey's success as an equestrian competitor creates goodwill that benefits her design business, (iii) Tracey formed the two undertakings as a single integrated business and had an (unwritten) plan for such business, (iv) Tracey used the same books, records and assets for both undertakings, (v) the decision not to advertise the design aspect through traditional methods was a strategic one based on Tracey's deep understanding of her clients' attitudes toward direct marketing, and (vi) more than 90 percent of Tracey's clients came directly from her equestrian contacts. The court acknowledged that Tracey's accountant placed the horse activities and design activities on two separate Schedules C for several years and recognized that positions taken on tax returns constitute admissions against the taxpayer. Nevertheless, based on the "plethora of evidence" that the two undertakings actually represented just one activity, the court found that Tracey overcame what would likely have been that fatal segregation of the two endeavors.

As a result, the court also answered the second issue. Since the two undertakings constituted just one activity, and since that activity as a whole generated a net profit during the years in question, the issue of whether the activity was profit motivated was moot.

Lessons Learned

The IRS often prevails when it accuses a taxpayer of deducting hobby losses, but a healthy dose of foresight, an almost obsessive focus on the detailed facts, and persistence can lead you and your tax advisor to the winner's circle.