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Roberts Turns Your Hobby Loss Analysis Up to 11

by John Hackney

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In this article, Hackney asserts that *Roberts* provides several helpful hints for practitioners facing an IRS challenge in a hobby loss case. He analyzes the decision and breaks down those tips.

> "These go to 11." — Nigel Tufnel, *This Is Spinal Tap*

In the 1984 mockumentary *This Is Spinal Tap*, lead guitarist Nigel Tufnel explains that when he needs that extra little push to make him bigger and brasher than other bands, he simply turns his specially made amplifiers beyond their normal 10 up to 11. When the filmmaker asks why 11 and not 10 (the normal loudest setting), Nigel explains that his amplifiers are louder because they go to 11.

The Seventh Circuit discussed in *Roberts* the "goofy" nine-factor test found in reg. section 1.183-2(b).[1] In analyzing whether section 183 determinations should reference solely the nine-factor test, the Seventh Circuit confirmed that taxpayers, the IRS, and the courts could go to 11 and consider any relevant factors as long as they "explained why the factors that 'should normally be taken into account' were insufficient."[2]

The Seventh Circuit urged the Tax Court to presume as hobbies activities that attract hobbyists and incur large losses that taxpayers deduct against other conventional sources of income. Taxpayers facing section 183 adjustments should take the Seventh Circuit's advice and address any additional business facts that will get them to 11. Those taxpayers in presumptively hobby-like activities will want to ensure that they have dotted every "i" and crossed every "t" before continuing to deduct losses.

Section 183 Applies to Hobbies

The IRC allows taxpayers to deduct some expenses for profit-motivated activities. Section 162 allows taxpayers to deduct all ordinary and necessary business expenses, while section 212 allows taxpayers to deduct some profit-motivated expenses.

In contrast, section 183 disallows hobby loss deductions, with exceptions. If the code deems an activity a hobby (defined as an activity "not engaged in for profit"), a taxpayer may deduct expenses that would otherwise be deductible regardless of profit motive, such as interest or real estate taxes.[3] A taxpayer may deduct hobby loss expenses (less those allowed under section 183(b)(1)) to the extent that they do not exceed the gross income from the activity.[4]

The Commissioner Attempts to Clarify

Section 183 defines an activity not engaged in for profit as "any activity other than one with respect to which deductions are allowable for the taxable year under section 162 or under paragraph (1) or (2) of section 212." Because this definition

[1] *Roberts v. Commissioner*, 820 F.3d 247 (7th Cir. 2016), *rev'g* T.C. Memo. 2014-74.

[2] *Id.* at 252 (citing reg. section 1.183-2(b)).

[3] Section 183(b)(1).

[4] Section 183(b)(2).

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provides little practical help, the commissioner set forth a series of factors to be considered, including:

1. manner in which the taxpayer carries on the activity;

2. the expertise of the taxpayer or his advisers;

3. the time and effort expended by the taxpayer in carrying on the activity;

4. expectation that the assets used in 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.[5]

A hobby loss determination depends on all the facts and circumstances, with no one factor being determinative. However, taxpayers may argue that other factors confirm a profit motive. Finally, a taxpayer need not have a *reasonable* expectation of profit as long as he entered into the activity with the objective of making a profit.[6]

The Tax Court Splits the Baby

Merrill C. Roberts operated a horse breeding and racing operation between 2005 and 2008 and incurred losses in all years.[7] The IRS believed Roberts ran his horse breeding and racing operation as a hobby and issued a notice of deficiency. The taxpayer timely filed a petition contesting that determination. Following a three-day trial and extensive briefs, the Tax Court issued a 49-page opinion.

The Tax Court initially focused on Roberts's business history. Beginning in 1969 he opened a series of nightclubs, and through the years, he grew the business into six separate establishments and a staffing company. He participated in various trade organizations and took on leadership roles. Roberts expanded his operations through the real estate purchases. One of the parcels included an operational stable on 95 acres. In the mid-1990s Roberts sold his interest in the nightclubs to his adult children and briefly operated other profitable businesses before discontinuing those activities.

Roberts attended a meeting of horse owners and breeders that piqued his interest, and in 1999 he purchased two horses and earned $18,000 in profit from racing them. By 2001 Roberts owned 10 horses and a breeding stallion. Roberts expanded his horse business by earning his trainer's license, consulting with other professional trainers, and engaging a bloodstock agent to advise him on future purchases.

Around 2005 Roberts decided to expand his operations. He sold the 95-acre parcel and purchased a 180-acre parcel in Mooresville, Indiana. Roberts invested approximately $500,000 in new training facilities based on the design of his bloodstock agent. He hired an assistant trainer to help at the new property. The trainer attended races, while Roberts determined which horses to enter into races and performed manual labor at the stables. Like with the nightclub operations, Roberts participated in several trade organizations, through which he lobbied the Indiana state legislature for the passage of a bill increasing purses for horse racing. Roberts maintained a rudimentary set of books and records, tracking income using publicly available databases and expenses through canceled checks.

During these years, Roberts's business suffered a series of setbacks. First, several horses died after being spooked. Second, the state forced Roberts to quarantine several horses because of an infectious disease. Roberts lost money from his horse business from 2005 through 2008 and reported the losses both on Schedule C and on an S corporation return.

The Tax Court analyzed the nine-factor test to determine whether Roberts's activity qualified as a business or a hobby. In evaluating how the

[5] Reg. section 1.183-2(b).

[6] Reg. section 1.183-2(a).

[7] *Roberts*, T.C. Memo. 2014-74, at 16-17.

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taxpayer carried on the activity, the court noted that Roberts significantly changed his operations in 2006, when he purchased the Mooresville property. The new property allowed him to reduce costs. Roberts hired an assistant trainer, which allowed for more efficient operations. Finally, Roberts's rudimentary accounting system provided enough information to make informed business decisions. This factor favored Roberts after the move to Mooresville in 2007.

Regarding expertise, the court noted that Roberts immersed himself in horse training, sought out horse training experts, learned how to administer medication, and spent considerable amounts of time gaining expertise in how to race horses. Roberts participated in several professional organizations, which confirmed his profit motive for all years.

The court also held that Roberts's time and effort supported a profit motive in all years. Roberts worked full time on his horse racing activity beginning in 2002. He endured cold temperatures and performed unpleasant work.

The court split the asset appreciation factor between the original parcels and the Mooresville property. The taxpayer purchased the original parcel for appreciation purposes. Because Roberts did not earn a profit in 2005 and 2006, any real estate appreciation is considered a separate activity from the horse racing business.[8] However, the taxpayer purchased the Mooresville property primarily for use as a horse training facility. Therefore, the appreciation of the Mooresville property in 2007 and 2008 supported a profit motive.[9]

The court found that Roberts's prior success in operating nightclubs supported his profit objective in all years.[10] On the series of losses, the court noted that horse-related activities may have a five- to 10-year start-up period.[11] Moreover, Roberts's losses resulted from unforeseen events like a quarantine. As to the seventh factor, the court found that the taxpayer's business remained highly speculative but presented the opportunity for significant profits. The expectation of profit supported a profit motive in all years.

For the last two factors, the taxpayer's financial status and elements of personal pleasure, the court noted that Roberts was not an excessively wealthy individual. He participated in the less recreational aspects of horse racing, such as mucking stalls, baling hay, and building fences. When he moved to the Mooresville property in 2007, this work increased. Thus, the court split the final element, supporting the IRS for 2005 and 2006 and the taxpayer for 2007 and 2008.

Based on all the facts and circumstances, the Tax Court concluded that Roberts started his horse business without a profit motive. However, it held that the taxpayer first showed a profit motive when he opened the Mooresville property in 2007. Roberts appealed to the Seventh Circuit.

The Seventh Circuit Suggests a Simpler Approach

The Seventh Circuit reversed the Tax Court's decision for 2005 and 2006. The court viewed the Tax Court's holding for the early years as "untenable" and said that it "amounts to saying that a business's start-up costs are not deductible business expenses — that every business starts as a hobby and becomes a business only when it achieves a certain level of profitability."[12] The court analogized the Tax Court's approach to a landlord who takes two years to acquire and build a new building:

> No one would say that his rental business was a "hobby" for the first two years because no tenant could move in and as a result he could obtain no income thus no profit until year three. But that's what the Tax Court ruled in this case.[13]

The Tax Court remained "imprisoned by a goofy regulation."[14] The law does not require the Tax Court to apply the nine-factor test in every case, according to the Seventh Circuit. Instead, the Tax Court "could have devised its own test, with its own factors, as long as it explained why the

[8] Reg. section 1.183-1(d)(1).

[9] *Roberts*, T.C. Memo. 2014-74, at 34.

[10] Reg. section 1.183-2(b)(5).

[11] *Roberts*, T.C. Memo. 2014-74, at 36.

[12] *Roberts*, 820 F.3d at 249.

[13] *Id.* at 250.

[14] *Id.*

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factors that should normally be taken into account were insufficient."[15]

The Seventh Circuit completed a cursory analysis of the nine factors and concluded that they all either supported or remained consistent with Roberts operating a business in 2005 and 2006. Given the goofy regulation, the Seventh Circuit suggested a simpler analysis:

> A business that is in an industry known to attract hobbyists (and horse racing is that business par excellence), that loses large sums of money year after year that the owner of the business deducts from a very large income that he derives from other (and genuine) businesses or from trusts or from other conventional sources of income, is presumptively a hobby, though before deciding for sure the court must listen to the owner's protestations of business motive.[16]

Helpful Lessons From *Roberts*

Roberts provides several helpful hints for practitioners facing an IRS challenge. First, take the nine-factor test up to 11. As confirmed by the Seventh Circuit, not all nine factors must be applied in every case. Taxpayers can argue that specific factors do not apply or that other, unlisted factors should be considered. Because the taxpayer and her advisers have the best access to the facts, they need to be creative when arguing for a profit motive.

Second, taxpayers engaging in new ventures should focus on the start-up aspects of *Roberts*. Taxpayers in the early years of their operations should emphasize that losses result from normal start-up efforts. Taxpayers should also show how they have changed their operations from the start-up period to minimize future losses. Roberts's decision to move to a larger property and build a new stable indicated a profit motive.

Third, the Seventh Circuit makes an important point about profit and fun. In many hobby loss cases, the IRS disallows losses because the taxpayer enjoys the activity. The Tax Court split the years under review in part because Roberts's horse racing business included a social component. The Seventh Circuit confirmed that "fun doesn't convert a business to a hobby. If it did Facebook would be a hobby, Microsoft and Apple would be hobbies, Amazon would be a hobby."[17] *Roberts* provides an important safeguard against the IRS's argument that an enjoyable activity must be a hobby.

When faced with a hobby loss challenge, taxpayers and their advisers must get creative. They control the facts. Advisers shouldn't be afraid to turn the nine-factor test up to 11 in defense of their clients. ■

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[15] *Id.* at 250-252.

[16] *Id.* at 254.

[17] *Id.* at 253-254.

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