Hobby Loss Rules Regarding Complete and Accurate Records

Cross References

- *Foster,* T.C. Memo. 2012-207, July 23, 2012
- IRC §183

A recent hobby loss ruling illustrates that the requirement to maintain complete and accurate books and records involves more than preparing income and expense statements for purposes of filling out an income tax return. The taxpayer was a lawyer who had a profitable law practice. Since 1984, he also operated a horse racing, training, and breeding activity. He purchased approximately 12 acres of land and a barn for $375,000 to accommodate the horse activity. A number of improvements to the property were made, including stalls in the barn, adding fences, building an exercise track and a round pen for breaking and training horses, and installing a horse walker. A 2010 appraisal, which included the residential portion of the property, indicated that it had appreciated in value to $550,000.

The taxpayer spent more than 20 hours during the week and on weekends working with and caring for the horses. Through the years, the taxpayer continued to buy and race horses and consult with professional trainers and veterinarians regarding the horses. The taxpayer also bred horses, both for racing and to sell.

The taxpayer maintained a separate checking account for the horse activity and used QuickBooks software to track income and expenses. The IRS audited the taxpayer's returns and contended that the taxpayer was not engaged in the activity for profit. One of the factors to be weighed when considering whether a taxpayer is engaged in an activity for profit is the manner in which the taxpayer carries on the activity. Carrying on the activity in a businesslike manner, such as by maintaining complete and accurate books and records is one factor that may indicate a profit objective [Reg. §1.183-2(b)(1)].

The taxpayer contended that he maintained complete and accurate books and records. However, other than income and expense statements prepared with QuickBooks software and a business plan that included only generalized goals for the operation and a year-by-year narrative account of notable events occurring in the horse activity, the taxpayer produced virtually no business records. The business plan did not include budgets, economic forecasts, or other analyses demonstrating financial management or planning of the activity. The records appear to be intended only to comply with regulations under section 183 in anticipation of tax benefits.

The absence of accurate books and records does not conclusively establish the lack of a profit objective. However, there was scant evidence that the taxpayer used the few records that he did maintain for the important purpose of cutting expenses, increasing profits, and evaluating the overall performance of the operation. The records appear to have maintained income and expense statements in order to memorialize transactions for tax reporting purposes, rather than to analyze expenses or determine profitability.

The taxpayer did not produce separate records for each of his horses to demonstrate that he tracked breeding results and racing performance. He also did not produce any records that showed that he reviewed each of his specific horse-related activities of quarter horse racing, thoroughbred racing, breeding, and pinhooking to assess which were more profitable.

The Court said perhaps the most important indication of whether an activity is being performed in a businesslike manner is whether the taxpayer implements methods for controlling losses, including efforts to reduce expenses and generate income. The taxpayer argued that he worked to reduce expenses, including at times feeding the horses mule feed instead of horse feed, doing some of his own veterinary work, and having his son shoe the horses rather than a farrier. However, the taxpayer provided no evidence via business records regarding how much he reduced his expenses, if any, by implementing these measures.

In light of this evidence, along with other relevant factors, the Court concluded the taxpayer did not engage in his horse activity with a profit objective. The losses sustained in each of the years were not allowed under section 183.