HORSE SENSE: THE SEVENTH CIRCUIT LOOKS AT THE HOBBY LOSS RULES

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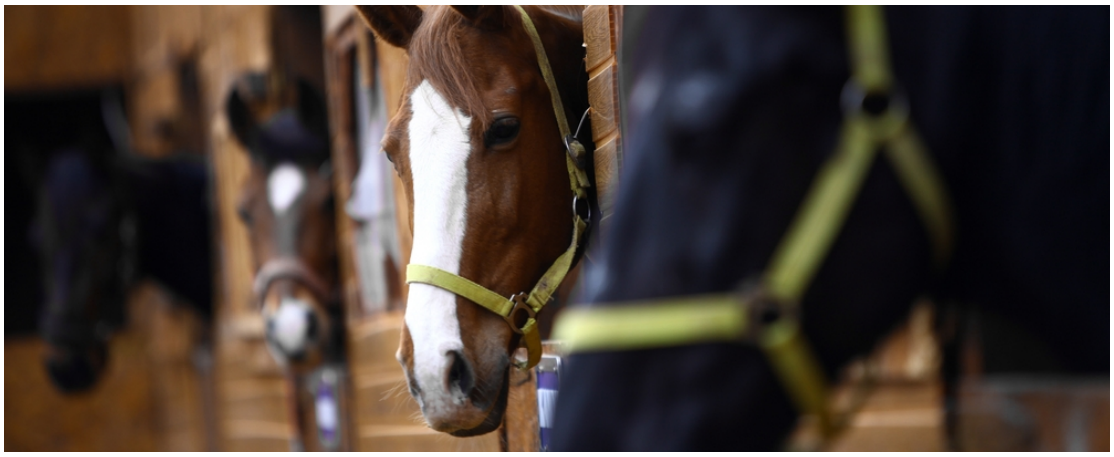

Ordinary and necessary business expenses are generally deductible under Section 162 of the Internal Revenue Code. But business expenses that involve fun are treated with suspicion. For example, Section 274 of the Code imposes special limitations on travel and entertainment expenses. And business activity that is not profitable can run afoul of the "hobby loss rules," which permit a taxpayer to deduct expenses associated with a hobby, but only to the extent that the hobby generated income. *See* I.R.C. § 183(b).

The horse is a recurring figure in hobby loss cases, which frequently feature breeders, owners and trainers. The Code even contains special rules for "the breeding, training, showing, or racing of horses" that provide a longer period of time for taxpayers to establish a profit that will create a presumption that the activity is a profit-seeking venture and not a hobby. *See* I.R.C. § 183(d). On April 15th, the Seventh Circuit issued an opinion addressing the hobby loss rules in the case of an individual who bred and trained racehorses. *Roberts v. Comm'r*, No. 15-3396, 2016 U.S. App. LEXIS 6865 (7th Cir. Apr. 15, 2016). The opinion stands out because it is lucid, because it is sensible, and because the government lost.

The taxpayer, Merrill G. Roberts, shifted from the restaurant business to the horse-racing business in the late 1990s; he shortly acquired a stable of ten horses and passed a state license test to become a trainer. *Roberts*, 2016 U.S. App. LEXIS 6865 at *3-*4. The tax court had sustained deficiencies for 2005 and 2006 under the hobby loss rules but held that Mr. Roberts had a legitimate business in 2007. *Id.* at *3.

In the relevant tax years, Mr. Roberts had been involved in developing a bigger and better training facility, expending between $500,000 and $600,000. *Id.* at *4. Roberts worked full-time, training the

horses himself, and he became involved in lobbying on behalf of the horse-racing industry for legislation that would permit slot machines at race tracks, which would increase the purses he was competing to win. *Id.* at *4-*5.

The Seventh Circuit immediately expressed skepticism over the Tax Court's decision that Mr. Roberts' activity shifted suddenly from a hobby to a business, which it characterized as "untenable." *Id.* at *6. In the court's view, the Tax Court's decision meant that "every business starts out as hobby and becomes a business only when it achieves a certain level of profitability." *Id*. Instead, the taxpayer's business that was in existence as of 2007 "evolved from his decision in 2005 to build a larger training facility," along with his subsequent purchases of land and the improvements he made to the property. *Id.* at *6. The Court of Appeals observed that "[t]he Tax Court's finding that his land purchase and improvements were irrelevant to the issue of profit motive until he began using the new facilities is unsupported and an offense to common sense." *Id.*

After noting a variety of internal inconsistencies in the Tax Court's reasoning, the Seventh Circuit then turned to "a goofy regulation" that the court "set forth in its full tedious length." *Roberts*, 2016 U.S. App. LEXIS 6865 at *9-*15 (quoting Treas. Reg. § 1.183-2). Initially, the court observed that the regulation explicitly indicated that the factors it listed were neither exclusive nor determinative. *Id.* at *15.

Next, the Seventh Circuit examined the nine factors set forth in the regulation and concluded that most favored the taxpayer's position that he was involved in a business, not a hobby, including the following:Roberts had operated in a business-like manner;

- Roberts had undertaken extensive study to obtain a training license;
- Roberts had withdrawn from his prior work in the restaurant industry to pursue his new career;
- Roberts had expected to earn profits, including from appreciation of business assets;
- Roberts had prior successful business experience;
- Roberts had losses in a start-up phase that were not inconsistent with a profit motive;
- Roberts had the opportunity to earn a substantial profit.

Id. at *15-*17.

While Roberts did have other income, the Court of Appeals discounted the relevance of this in view of the other factors indicating a profit motive. *Id.* at *17.

On the ninth factor, the pleasure motive, the Seventh Circuit observed that "[i]t may have been a fun business, but fun doesn't covert a business to a hobby. If it did, Facebook would be a hobby, Microsoft and Apple would be hobbies, Amazon would be a hobby, etc. ad infinitum." *Id.* at *18.

Accordingly, the Seventh Circuit reversed the Tax Court and directed that the relevant tax assessments be voided, observing that "suffering has never been made a prerequisite to deductibility." *Id.* at *20 (quoting *Comm'r v. Jackson*, 59 T.C. 312, 317 (1972)). So at least in the Seventh Circuit, it is okay to have fun at work.

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