THE LAW OF THE "HOBBY-LOSS" ISSUE AFTER FAULCONER AND ESTATE OF POWER: The Importance of Findings of Fact.

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The "Hobby loss" issue in federal income tax terms determines whether or not a taxpayer will be permitted to use expense and depreciation deductions incurred in a horse business, to the extent that they exceed horse business income (i.e., the horse business is reporting taxable losses) to offset the taxpayer's income from other sources. Internal Revenue Code Section 183 prohibits deduction of losses incurred in any activity which is not engaged in primarily for a profit. A "not primarily for profit activity" is also known as a "hobby". In other words, you can't deduct the cost of owning horses unless you are engaged in an activity which is primarily profit motivated. The test is what your intention is in engaging in the activity. This is a subjective test. However, due to the obvious motivation for a horse owner to say that he is in the horse business for a profit whether it is true or not, the Treasury promulgated regulations which are used to attempt to ascertain, as objectively as possible, a horse owning taxpayer's actual intention in engaging in the equine activity. These regulations are applied daily by the Internal Revenue Service (hereinafter, the "IRS" or the "Service") Auditors, Administrative Hearing Officers, taxpayers' attorneys and other representatives in the course of audits and hearings.

In 1983, the United States Tax Court twice decided "Hobby-loss" cases against horseowners: one a racehorse owner; one a showhorse owner. These cases were Faulconer v. Commissioner (T.C. Memo 1983-165;

CCH 45 TCM Dec. 39, 994(M)) decided in March, and Estate of Power v. Commissioner (T.C. Memo 1983-552; CCH 46 TCM Dec. 40, 438 (M)) decided in September. Power was appealed to the First Circuit Court of Appeals. In a highly important opinion in this field, the First Circuit affirmed the Tax Court's decision against the estate of the late owner of a highly successful Morgan horse show stable.

Both Power and Faulconer shed light on courts' treatment of the "Hobby loss" Regulations under Internal Revenue Code ("IRC") Section 183 and also the "2 in 7" presumption. We will review the significant aspects of the First Circuit's opinion in Power, then compare, looking for patterns in the Tax Courts' findings and reasoning in Power and Faulconer, then finally note the treatment of the "2 in 7" rule in each case.

LESSON FROM THE FIRST CIRCUIT: The Importance of the Facts

In a Tax Court, the judge will act as both a "finder of fact" and decider of issues of law. The judge will hear and/or read evidence concerning the facts of a case, and if there is controversy as to the facts, make a decision what to believe and thus what will be considered true for purposes of the trial.

By contrast, an appellate court, such as the Federal Circuit Court of Appeals is not a finder of fact, but rather is only a "trier of law". An appellate court will not set aside a factual conclusion of a trial court (a Tax Court is a trial court) unless it is "clearly erroneous," which basically means: (1) that there is no support for finding in the record; (2) that it is, in fact, wrong; (3) that it is material to the outcome of the case; and (4) that it has been raised by the appellant. It is _very rare_ to see a factual finding reversed on appeal, even if it is wrong.

In the _Power_ case, perhaps the most significant aspect of the Court's opinion was:

> The [Tax] Court's conclusion concerning profit objective, however, is a finding of fact which will be reversed only if clearly erroneous. [Citations omitted.] Having determined that the court properly considered the facts under the objective standards set out in Treasury Regulations Section 1.183-2(b) and that the conclusions are _adequately supported in the record_, we decline to reweigh the evidence. (emphasis added). (The Tax Court disbelieved the testimony to the contrary and agreed with the IRS that the taxpayer did _not_ have a profit motivation.)

Note, Judge Bownes, writing for the First Circuit, did not say that the Tax Court's conclusion was _correct_, but rather that it was "adequately supported in the record". This is unquestionably the correct standard of appellate jurisprudence. Adequate support in the record means that enough evidence appears so that someone might reasonably believe a "fact" to be so. Of course, "adequate support in the record" can at times be found for errors.

The paramount importance of assuring that the "facts" found by a trial court are the true and accurate facts, is highlighted by the First Circuit opinion. The "fact" that was fatal to the horse owning taxpayer's case was the Tax Court found that Mrs. Power did not have profit as her primary objective in her horse activity. There was evidence in the record that Mrs. Power did intend to make a profit. However, there was also evidence of over 20 years non-profitability, which the Tax Court viewed as strong evidence that there was a lack of profit motivation. The Tax Court Judge therefore disbelieved the favorable testimony that the activity was profit-motivated and found as fact that the taxpayer lacked profit motivation.

The lesson to be gleaned is that the determination of whether a horse business owner is motivated by profit or not, and thus whether or not he/she can deduct losses in the horse business against other income is an issue of fact, not one of law. Therefore, unless a finding is clearly erroneous, the Tax Court is the real arena of last resort as far as an IRS challenge to a horse owner's horse business as a hobby is concerned. Tax Courts can and do make errors sometimes, especially in fields new and unknown to judges, although certainly judges always attempt to render fair decisions based on the truth. It is, therefore, extremely important to present the facts fully and effectively in Tax Court. If factual errors are made by the trial court, it is very doubtful that they will be corrected at the appellate level.

FAULCONER AND POWER: What patterns develop?

In both cases, the Tax Court was presented with wealthy taxpayers, each of whom lived on inherited land, each of whom had suffered over 20 years of consecutive losses prior to the tax years in front of the court. Both taxpayers had large amounts of passive investment income which was sheltered in part by deduction of sizeable annual losses in horse activities. Both taxpayers presented evidence of profit motivation which was disbelieved by the Tax Court. Both taxpayers kept good records, but neither was found to have used the records kept to effect changes in operations to increase profit. Both taxpayers had experience with other animal breeding activities: cattle in the case of Mr. Faulconer, dogs in the case of Mrs. Power. Both used professional trainers. Both tried to invoke the presumption that their businesses were engaged in for profit by achieving a profit in 2 years out of 7. With respect to the "battle of the presumption", Faulconer won; Power lost, but <u>both</u> lost their cases and were required to pay large deficiencies assessed by the Service.

Judge Bowne's appellate opinion in the <u>Power</u> case pointed out four factors which were relied upon by the Tax Court in its holding that seemed to be common to both cases. They are:

(1) unbroken string of substantial losses stretching over decades;

(2) disbelief by the court of testimony given by or for the taxpayers;

(3) the taxpayers took personal pleasure in their respective horse activities; and

(4) trust and other passive investment income substantial enough to permit the consistent losses experienced without any lowering of the taxpayer's standard of living.

Of these four, item (2) is the most critical criterion, since if the horse business in question is actually operated in good faith by the taxpayer with the primary motivation of making a profit, then the horse business owner is entitled to deduct any losses incurrred, even if the taxpayer's expectation of a profit is <u>not</u> reasonable. (See Treas. Reg. Section 1.183-2(b)). The testimony of a taxpayer concerning his own intent is competent evidence of his intent, and if believed is sufficient to support a finding of fact for the taxpayer on the issue of profit motivation.

However, it seems clear that item (1) above, the over 20-year string of consecutive losses in each case, appeared to influence the Tax Court to disbelieve the testimony presented for both taxpayers that each activity was engaged in for profit.

The factors of large passive trust and investment income received by each taxpayer and personal pleasure enjoyed by each with horses also influenced the court. The court concluded in each case that rewards other than monetary were the chief reasons for the operation of the racing (Faulconer) and show (Power) stables. However, in practice, the elements of personal pleasure in the activity and other substantial income are generally considered of lesser importance unless the two damaging aspects, the long string of losses and disbelief in the taxpayer's testimony to a profit motive are also present.

The bottom line, it would seem at this time, is that where a horse owner receives large amounts of passive income and has a long string of unbroken losses in his horse activity, testimony to a profit motive is apt to be disbelieved by the trier of fact. If the finding of fact is made that the taxpayer's primary motivation is <u>not</u> to make a profit, losses in a horse activity will not be deductible, except to the extent of income in the horse business (in other words, you can use horse business deductions to offset horse business income but net losses cannot be used to offset other income).

What price presumption?

In both Faulconer and Power the taxpayer sought to gain the presumption of profit motive by achieving profit in 2 years out of 7. In Faulconer, the taxpayer succeeded in establishing the presumption, but the IRS overcame the presumption and won the case anyway. In Power, the Tax Court denied the presumption to the taxpayer, despite the taxpayer's reported profits. The Tax Court denied the presumption due to an unexplained shift in accounting method from the accrual method to the cash method, which the Tax Court indicated was made only for the purpose of showing a "false" profit. The taxpayer lost the entire "hobby loss" issue in Power as well as the lesser "included battle of the presumption".

In order to place the importance of the presumption in perspective, let's first address the question:

What is a presumption?

Basically, a presumption is a rule of evidence which can operate to shift the burden of proof. The burden of proof generally rests with the taxpayer in an income tax case. That is, the taxpayer must produce evidence to prove his case. If the taxpayer does not prove his case, he loses. If neither IRS nor the taxpayer prove anything, the taxpayer loses. If the proof on each side is considered of equal strength and merit, whoever has the burden of proof (usually the taxpayer) loses, since that party has failed to carry its burden of proof. But if a party which would normally bear the burden of proof is entitled to a _presumption_ in its favor, the burden of proof is shifted to the other side. For example, in a horse business case where the IRS has asserted a lack of a profit motivation, generally the burden of proof is on the horse business owner to prove that he _is_ engaging in the activity primarily for a profit. However, if the horse business owner had a profit in his horse business in each of the 2 years preceding the years audited, he is entitled to a _presumption_ that his business is engaged in for a profit. Thus, the burden of proof is shifted to the IRS, which now must _prove_ that the horse owner _did not_ have the requisite profit motivation.

The tactical advantage of the presumption in tax litigation was once thought to be so significant that the government would avoid taking cases to court in which it had the burden of proof. After all, the Service has some discretion in which cases it chooses to try, and why should it shoulder a burden of proof when its attorneys could always saddle the taxpayer with the burden of proof by simply choosing cases where this presumption did not apply?

After _Faulconer_, it is clear that the IRS will and has taken cases in which it has the burden of proof if the case appears to IRS to be one which should be prosecuted. Mr. Faulconer achieved 2 years of profit in 7, but the Tax Court found that the profit years were _not_ indicative of overall profit motivation. Obviously, therefore, the mere existence of a presumption is not a magical talisman against a horse activity's losses being held non-deductible on grounds that the activity is a hobby rather than a business.

In _Power_, we see that the taxpayer not only did not receive the benefit of the presumption, but the taxpayer's case may actually have been harmed by the taxpayer's attempts to gain the presumption. The Tax Court stated:

> "[U]nexplained changes in accounting methods. . . were used to enable Waseeka [the taxpayer's stable name] to report gains for the fiscal years 1975 through 1977, when losses would have resulted if the old accounting methods had been consistently employed. These attempts to employ inconsistent accounting practices to show a small profit do not reflect well on the credibility of petitioner and her advisors in claiming that profit was their objective."

The Taxpayer's returns did show certain profits in 2 years out of 7 in _Power_. However, as quoted above, the court not only disregarded the reported profit but seemed more suspicious of the taxpayer's profit motive as a result of the change in accounting methods which was used to produce a "paper profit". Treasury Regulations require business to seek the approval of the Service before _changing_ accounting methods. No approval for the change in accounting methods was sought or obtained in the _Power_ case. The cash method _is_ a _proper_ accounting method for farmers. It was not the use of the cash method, but the unexplained _change_ of methods which seemed to offend the Tax Court.

Actually, there are two distinct "presumptions" available to business owners. One is the "general presumption" and the other is referred to as the "special presumption". Under the general presumption, if a business makes a profit in 2 years out of 5 (the 5-year period is applicable to all businesses generally, but in the case of horse businesses, in recognition of the fact that horse businesses require more "start up" time than most business, the 5 year period is extended to 7 years) then the taxpayer is entitled to a presumption that the activity is engaged in for a profit in each year beginning with the second profit year in a 7-year period and continuing until the seventh year following the first profit year (e.g., if profit is earned in 1981 and 1984, in a horse business, the owner will be entitled to the presumption in 1984, 1985, 1986 and 1987, but not in 1981, 1982 or 1983.

If the second profit year were 1986 instead of 1984, the presumption would be available only for 1986 and 1987. If the second profit year were 1986 and in 1987 profit is earned again, the 1986 can serve, simultaneously, as the second profit year for the 7-year period beginning in 1981 and the first profit year for the 7-year period beginning in 1986. Thus, 1987 is the second profit year for the period 1986-1992 and the presumption would apply in 1987, 1988, 1989, 1990, 1991 and 1992.

The "special" presumption is available only to horse business people who are new to the business. If it is to be available at all, it must be claimed by the filing of an "election to defer determination" of whether or not the activity is engaged in for a profit. The election must be filed in writing with the IRS and is due no later than the due date of the first tax return which reflects the activity as a business. The effect of the election is that the taxpayer will not be audited on the issue of whether or not the activity is a business (deductions for losses allowed) or a hobby (deduction for losses not allowed) until the end of the first 7 years of the activity. If any 2 of the first 7 years are profit years, then the taxpayer is entitled to the presumption of profit motivation for all of the first 7 years.

This election can be beneficial in that it means only one audit for the first 7 years, while without the election, a taxpayer might be audited more than once during the first 7 years. Thus, the election may operate to save the waste of time and money due to multiple audits.

However, there are some negative aspects to the election. One is that it "raises a red flag" to IRS. Assuredly, you will be audited at the end of 7 years and all loss deductions from the entire period will be respected or denied in that audit. The second is that as Faulconer teaches, the special presumption is not a guarantee and can at times be overcome by the Service in Court.

In conclusion, it is always preferable to have a presumption of profit motivation than not to have it. However, the lesson of Faulconer and Power on presumptions is that the Service can overcome them, and unjustifiable "book juggling" to achieve paper profits will not support the presumption.

On balance, experienced tax litigators prefer that their horse owning clients simply run their businesses like businesses and make their decisions based on truly making their horse business profitable in an overall sense and ignore the presumptions. If a taxpayer is really in business, a good representative should be able to sustain the burden of proof.

CONCLUSION

The Faulconer and Estate of Power cases have established important points in the development of the law of IRC Section 183. The importance of findings of fact and treatment of "2 in 7" presumptions are perhaps the highlights. The horse business owner can benefit from planning with these cases in mind to avoid any mistakes being made by a finder of fact against him.