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Topping v. Commissioner: An Example of How an Equestrian Taxpayer Can Utilize "Single Activity" to Preclude the IRS "Hobby Loss" Challenge

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TOPPING V. COMMISSIONER: AN EXAMPLE OF HOW AN EQUESTRIAN TAXPAYER CAN UTILIZE "SINGLE ACTIVITY" TO PRECLUDE THE IRS "HOBBY LOSS" CHALLENGE

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I. INTRODUCTION

As stated by Russian novelist, Maxim Gorky, "When work is a pleasure, life is a joy!"[1] For this precise reason many individuals try to mix business and pleasure. While there is nothing wrong with this attractive combination, the Internal Revenue Service ("IRS") can quickly turn joy into tears. The most frequent IRS challenge to a taxpayer's return is a claim under Internal Revenue Code ("IRC") § 183.[2] This section allows the IRS to claim that a taxpayer did not engage in a particular activity primarily for profit.[3] This commonly used tactic of the IRS is referred to as the hobby loss challenge. Professionals in the equine industry are especially prone to this attack by the IRS, since activities such as racing, showing, boarding, and breeding horses are often viewed as hobbies. Unfortunately, the IRS usually wins attacks on horse-based hobbies, resulting in non-deductible losses for the taxpayer.[4] On the contrary, if a taxpayer wins, then the result is deductible business expenses that will reduce the taxpayer's taxable income and income tax.

To gain the upper hand over the IRS, a taxpayer must claim that the activity is not really a hobby, but a business activity. The IRS, however, will not give up easily when money is involved. According to IRS estimates, the incorrect deductions of hobby expenses add up to thirty billion dollars per year in unpaid taxes.[5] There is, however, another option for the taxpayer: when the taxpayer's equestrian activities are closely connected to their main business, deductions and income from each activity

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[1] From a quote by Maxim Gorky, Russian novelist: "When work is a pleasure, life is a joy! When work is a duty, life is slavery."

[2] 26 U.S.C. § 1983 (2008).

[3] *See* 34 AM. JUR. 2D *Federal Taxation* § 17480 (2008).

[4] *See* Keating v. Comm'r, 94 T.C.M. (CCH) 383 (2007); Thomas v. Comm'r, 84 T.C.M. (CCH) 178 (2002); Taras v. Comm'r, 74 T.C.M. (CCH) 1388 (1997); Hendricks v. Comm'r, 32 F.3d 94 (4th Cir. 1994); Osteen v. Comm'r, 62 F.3d 356 (11th Cir. 1995).

[5] Business or Hobby? Answer Has Implications for Deductions, http://www.irs.gov/newsroom/article/0,,id=169490,00.html (last visited Oct. 20, 2008).

can be aggregated into a single for-profit activity.[6] This combination allows the taxpayer to bypass the hobby loss challenge and to claim victory against the IRS in the form of a deduction.

Tracey Topping of Wellington, Florida is a proud equestrian who effectively utilized the "single activity" principle in an IRS hobby loss challenge.[7] Topping successfully argued in the U.S. Tax Court that her equestrian activities were an integral part of her design business.[8] This Comment analyzes *Topping v. Commissioner* and delineates the implications of this decision for taxpayers in the equestrian industry.

II. SECTION 183 AND RELEVANT REGULATIONS

The tax code recognizes that individuals can combine business with pleasure. Every taxpayer, therefore, wants to deduct losses from pleasure activities by claiming they were profit-driven. Classic cases involve doctors, lawyers, bankers and other professionals claiming deductible business expenses on equestrian activities.[9] Section 183 of the Internal Revenue Code places a major limitation on tax deductions in the form of the hobby loss challenge. According to the hobby loss challenge, losses are deductible only if they are a result of an activity that is "engaged in for profit."[10] If the loss is a hobby loss, the taxpayer may only deduct losses up to the amount of money earned through participating in the hobby over the course of the taxable year.[11]

A. *Activity Engaged in for Profit*

An activity is "engaged in for profit" if the taxpayer had an actual and honest profit motive.[12] Since hobbies involve a pleasure motive, hobby losses and expenses are limited in their deductibility. The IRS often uses § 183 to separate genuine claims from those that are false. Courts draw the line between business and hobby based the individual facts and

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[6] In practical terms, this means filing a Schedule C for the business activities instead of documenting the hobby losses on Schedule A where the value of the loss cannot exceed the total income derived from the hobby.

[7] Topping v. Comm'r, 93 T.C.M. (CCH) 1120, *1 (2007).

[8] *Id.*

[9] *See, e.g.*, De Mendoza v. Comm'r, 68 T.C.M. (CCH) 42 (1994) (lawyer claiming that he operated polo activities with a profit objective); Thomas v. Comm'r, 84 T.C.M. (CCH) 178 (doctor claiming he was engaged in the business of breeding and racing thoroughbred horses).

[10] I.R.C. § 183(a). There is an additional limitation on tax deductions codified in I.R.C. § 162. Expenses are deductible only when they are "ordinary and necessary" for conducting a business.

[11] 26 U.S.C. § 183(b) (2000).

[12] *Topping*, 93 T.C.M. (CCH) 1120 at *5.

circumstances of the case.[13] Both courts and the IRS utilized nine objective factors in deciding whether an activity is "engaged in for profit."[14]

B. *Single Activity Requirement*

Sometimes instead of drawing a line between hobby and business activities, it is advantageous to group two undertakings into a single activity. Treasury Regulation § 1.183-1 specifically recognizes that if the taxpayer engages in several undertakings, these "undertakings may constitute one activity."[15] If the taxpayer successfully groups two undertakings into a single activity, deductions and income from each activity can be aggregated in determining the taxpayer's intent to make a profit under § 183. If the grouping results in a cumulative profit, the need for a detailed and challenging nine-factor "for profit" analysis is automatically eliminated. Thus, grouping hobby and business activities into "single activity" status allows the taxpayer to by-pass the IRS hobby loss challenge so long as the activities meet the "single activity" test.[16]

A taxpayer's several pursuits may be treated as a single activity only if the undertakings are sufficiently interconnected.[17] Similar to the analysis of a taxpayer's profit motive is the determination of whether multiple undertakings are sufficiently interconnected. This decision is made based on the facts and circumstances of the particular case.[18] The most significant factors involve (1) "the degree of organizational and economic interrelationship" of the undertakings, (2) "the business purpose . . . served by carrying on the various undertakings separately or together," and (3) "the similarity of [the] various undertakings."[19] The general rule is that the taxpayer's characterization of multiple undertakings as a single activity will be accepted as long as it is not artificial or unreasonable.[20]

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[13] Treas. Reg. § 1.183-2(a) (1972).

[14] Treas. Reg. § 1.183-2(b) (1972) (the nine factors are: (1) the 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) the expectation that the assets used in the 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 that are earned, (8) the financial status of the taxpayer, (9) the elements of personal pleasure or recreation involved in the activity.)

[15] Treas. Reg. § 1.183-1(d)(1) (1972).

[16] *See infra* Section IV.

[17] Treas. Reg. § 1.183-1(d)(1) (1972).

[18] *Id.*

[19] *Id.*

[20] *Id.*

Other nonexclusive factors that the courts consider when determining whether multiple undertaking constitute a single activity are:

(1) whether the undertakings are conducted at the same place;

(2) whether the undertakings were part of the taxpayer's efforts to find sources of revenue from his or her land;

(3) whether the undertakings were formed as separate activities;

(4) whether one undertaking benefited from the other;

(5) whether the taxpayer used one undertaking to advertise the other;

(6) the degree to which the undertakings shared management;

(7) the degree to which one caretaker oversaw the assets of both undertakings;

(8) whether the taxpayer used the same accountant for the undertakings;

(9) the degree to which the undertakings shared books and records.[21]

III. CASE HISTORY OF *TOPPING*

The taxpayer in *Topping* was a 46-year-old, recently divorced woman.[22] After the divorce, she was left with a 16-year-old horse, a debt-encumbered condominium in Wellington, Florida, and no other means of financial support.[23] Topping had no college degree and had not worked for 25 years.[24] After the divorce, Topping turned to the only thing she knew, horses. She was an experienced equestrian who had competed on an amateur level since she was a teenager.[25] Equipped with her knowledge of

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[21] Mitchell v. Comm'r, 92 T.C.M. (CCH) 17, 21 (2006).
[22] *Topping*, 93 T.C.M. (CCH) 1120, at *1.
[23] *Id.*
[24] *Id.*
[25] *Id.*

horses, Topping decided to start a business designing horse barns.[26] After limited business planning, she formed Topping White Design, L.L.C. [27] Topping's business approach consisted of attending horse shows, entering in horse competitions, and making contacts with prospective clients at the shows.[28]

Topping developed her equestrian contact list while competing at the Winter Equestrian Festival, which is held at the elite, private Jockey Club.[29] Most of the attendees were wealthy people who owned horses and enjoyed equestrian competitions.[30] In addition to riding, Topping rented a table for a season at the Jockey Club, which allowed her to interact with the fellow competitors and equine enthusiasts.[31] It was the expenses of these equestrian activities that Topping sought to offset against her design business income.[32]

Topping testified that she neither used traditional advertising media, such as magazines, websites, or newspapers, nor displayed banners at any equestrian event.[33] She intentionally rejected that kind of generic advertising, because those in the equestrian circuit would consider it "tacky or gauche."[34] Instead she adopted a more subtle approach to attracting new clients. First, Topping relied on her exposure[35] and reputation[36] as a rider. Second, she utilized her equestrian background and knowledge of her clients' particular situations.[37] Third, Topping made herself available at the Jockey Club during key times, so that prospective clients could easily find her.[38] Finally, she relied on word of mouth and referrals by trainers.[39]

Topping used the same assets, a truck, trailer, and automobile, for both her equestrian "hobby" and interior design "business" activities.[40] She also kept records of both activities and had her CPA produce profit or loss

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[26] *Id.*

[27] *Id.* (explaining that Topping had no formal business plan; her business planning essentially amount to a discussion with a CPA).

[28] *Topping*, 93 T.C.M. (CCH) 1120 at *2.

[29] *Id.*

[30] *Id.*

[31] *Id.*

[32] *Id.* at *4.

[33] *Id.* at *3.

[34] *Topping*, 93 T.C.M. (CCH) 1120 at *3.

[35] *Id.* at *2 (explaining that Topping received wide exposure during competitions because her name was announced over the loudspeaker and flashed on the leader boards).

[36] *Id.* (explaining that Topping "testified that she has to maintain the reputation she has cultivated as a skilled competitor in order to keep her existing relationships and to cultivate new ones.").

[37] *Id.* at *3 (explaining that Topping introduces special features, like mudrooms, redesigned stalls, expanded storage for boots, saddles and other equipment, tailored to the horse's injury or temperament and client's personal needs).

[38] *Id.*

[39] *Topping*, 93 T.C.M. (CCH) 1120 at *1 (explaining that every trainer that Topping has worked with has referred at least one design client to her).

[40] *Id.*

statements that tracked expenses.[41] Topping did not keep records of training costs or costs associated exclusively with horse shows.[42] In addition, neither she nor her CPA prepared monthly budgets or cash-flow projections.[43] During the years at issue in the Tax Court (1999 through 2001), her CPA filed separate Schedules C, one for equestrian activities and another for design activities.[44] Her equestrian activities suffered considerable losses, while her design activities showed a significant profit.[45] On a consolidated basis, Topping's aggregated business activities produced a net profit six out of the first seven years of business.[46]

In 2004, the IRS audited Topping.[47] She was denied all deductions for her equestrian activities, because the IRS classified them as hobby, not business, expenses.[48] As a result, Topping's taxable income and income tax were increased.[49] On appeal to the Tax Court, Topping argued that her equestrian undertakings and interior design business were a single activity, which, if combined, showed a net profit.[50]

IV. THE ANALYSIS

A. *Holding*

Topping won against the IRS hobby loss challenge.[51] She convinced the Tax Court that her equestrian and design activities constituted a single activity for purposes of § 183, even though she filed separate Schedule C forms.[52] These activities produced a cumulative profit and the court found that the activities were sufficiently interrelated to be considered a single activity.[53] Thus, all of Topping's horse-related expenses were fully deductible as a profit seeking activity.[54] Topping's total deductions amounted to over one million dollars in cash expenses during the three years at issue.[55]

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[41] *Id.* at *3 (explaining that Topping used QuickBooks to keep records for both activities on a consolidated basis).
[42] *Id.*
[43] *Id.*
[44] *Id.* at *4. (explaining that only on 2002's return were activities combined in one Schedule C).
[45] *Topping*, 93 T.C.M. (CCH) 1120 at *4.
[46] *Id.*
[47] *Id.*
[48] *Id.*
[49] *Id.* at *4-5.
[50] *Id.* at *5.
[51] *Topping*, 93 T.C.M. (CCH) 1120 at *9.
[52] *Id.*
[53] *Id.* at *6.
[54] *Id.* at *4.
[55] *Id* at *4.

B. *Issues*

The Tax Court identified the following three issues: (1) Whether Topping conducted her equestrian activities as part of her design business; (2) whether these activities were for profit under § 183; and (3) if the activities were for profit, whether the equestrian expenses were ordinary and necessary under § 162.[56]

i. *The Taxpayer's Undertakings Constituted a Single Activity*

a. *Non-Exclusive Factors*

The Tax Court considered the threshold issue of "single activity" under the factors enumerated in § 1.183-1(d)(1) and additional factors identified in *Mitchell v. Commissioner*.[57] The court found that a close organizational and economic relationship existed between equestrian and design activities.[58]

In support of its position, the court first decided whether one undertaking benefited from the other. The court reasoned that Ms. Topping's success as an equestrian created "goodwill" that benefited her design business.[59] In considering the issue of goodwill, the court referenced *Keanini v. Commissioner*.[60] *Keanini* involved a dog breeding operation and a dog grooming shop.[61] In finding the existence of a close organizational and economic relationship between the two businesses, the Tax Court in *Keanini* noted that the goodwill derived from winning national championship titles benefited both the dog breeding and the grooming shop.[62] The Tax Court's comparison of Topping's equestrian success to *Keanini* suggests that, in finding goodwill, the Court places a significant emphasis on the success derived from winning.

Second, the court determined that the facts supported a finding that Topping's equestrian and design undertakings were a single activity.[63] The court's decided that a "significant" business purpose joined two undertakings.[64] Topping's prominence as a competitor garnered respect

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[56] *Id.* at *1.

[57] *Topping*, 93 T.C.M. (CCH) 1120 at *6.

[58] *Id.*

[59] *Id.* (explaining that the taxpayer "had been a competitor for most of her adult life, and she transformed this sport experience into an avenue to establish goodwill as an interior designer of horse barns").

[60] Keanini v. Comm'r, 94 T.C. 41 (1990).

[61] *Id.*

[62] *Id.* at 46.

[63] *Topping*, 93 T.C.M. (CCH) 1120 at *4 (explaining that "she had a plan for an integrated equestrian-based design business").

[64] *Id.* at *6.

among her peers and caused them to seek her out when they needed a designer for their horse barns.[65] In addition, without any deliberation, the Tax Court simply acknowledged that Topping managed both the equestrian undertakings and interior design, used the same CPA for both activities, and kept the same books and records.[66]

The court faced a bigger challenge when deciding whether Topping used one undertaking to advertise the other. The IRS faulted Topping for not using conventional advertising, like magazines or banners at horse shows.[67] The IRS claimed that "failure to specifically advertise the name of Topping White through conventional media [was] indicative of the lack of an economic relationship between the two undertakings."[68] The court, however, disagreed.[69] Evidence proved that traditional types of advertising were not welcomed by Topping's wealthy clientele.[70] Topping convinced the court that rejection of conventional advertising was a deliberate business decision.[71] In addition, Topping proved that a strong statistical correlation existed between her subtle advertising through equestrian activities and her design business.[72] More than 90 percent of Ms. Topping's design clients came directly from her equestrian contacts.[73] Topping's equestrian undertakings also served as an advertisement for her design activities.[74] As a result, Topping survived the IRS' attack on her lack of formal advertising.

b. *Rejection of the Similar "Single Activity" Cases*

The IRS cited several cases where the Tax Court held that a taxpayer's activities could not be aggregated. In *DeMendoza v. Commissioner*, the court refused to aggregate the taxpayer's polo activity and his real estate law practice.[75] DeMendoza claimed that his law practice was closely associated with his polo activities because his clients consisted mainly of people he met at the polo games.[76] The court found that the taxpayer's polo activities and law practice were separate undertakings and that they were not formed as a single business.[77] Similarly, in *Wilkinson v. Commissioner*, the taxpayer unsuccessfully claimed the publicity he derived

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[65] *Id.* at *4.
[66] *Id.*
[67] *Id.* at *7.
[68] *Id.* at *8.
[69] *Topping*, 93 T.C.M. (CCH) 1120 at *7.
[70] *Id.*
[71] *Id.*
[72] *Id.* at *8.
[73] *Id.* at *7.
[74] *Id.* at *6.
[75] DeMendoza v. Comm'r, 68 T.C.M. (CCH) 42, *8 (1994).
[76] *Id.* at *9.
[77] *Id.*

from playing polo helped him get patients for his cosmetic surgery practice.[78] Another case that the IRS relied on was *Zdun v. Commissioner*.[79] In *Zdun* a dentist argued that the costs of operating his organic apple farm were connected to his dental practice because his patients were buying apples at the dental office.[80] The taxpayer lost.[81]

The Tax Court rejected the IRS's cases by claiming that they were not analogous to Topping's situation.[82] First, the court believed that none of the activities in the aforementioned cases had the same level of integration and interdependence of Ms. Topping's activities.[83] In fact, the court stated that Topping's "involvement in the equestrian world [was] the cornerstone of her cultivation of relationships with her clientele."[84] Second, the court distinguished *DeMendoza* and *Wilkinson* by finding that the benefits at issue in those cases were incidental, whereas those in *Topping* were "material" benefits.[85] Finally, the Tax Court placed considerable weight on the statistical correlation between the two activities. When compared to Topping's very high 90% correlation between the two activities, *Zdun's* 15% figure seemed insignificant.[86]

c. *Schedule C Challenge*

The Tax Court acknowledged that during the years at issue Topping's CPA filed two separate Schedules C, one for the equestrian business and one for the interior design.[87] The court noted that "positions taken by a taxpayer in a tax return are treated as admissions and cannot be overcome without cogent proof that they are erroneous."[88] Nevertheless, based on "the plethora of evidence" that the two undertakings constituted a single activity, the court found that Topping overcame that position.[89]

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[78] Wilkinson v. Comm'r, 71 T.C.M. (CCH) 1959, *1-2, 9-10 (1996).
[79] Zdun v. Comm'r, 76 T.C.M. (CCH) 278 (1998).
[80] *Id.* at *2.
[81] *Id.* at *5.
[82] *Topping*, 93 T.C.M. (CCH) 1120 at *8.
[83] *Id.*
[84] *Id.*
[85] *Id.*
[86] *Id.*
[87] *Id.* at *9.
[88] *Topping*, 93 T.C.M. (CCH) 1120 at *9 (citing Mendes v. Comm'r, 121 T.C. 308, 312 (2003); Estate of Hall v. Comm'r, 92 T.C. 312, 337-338 (1989)).
[89] *Id.*

ii. *The Taxpayer's Undertakings were Engaged in for Profit*

The Tax Court may have strategically arranged the issues. By addressing the "single activity" issue first, the Tax Court killed two birds with one stone. Since Topping's equestrian and design undertakings constituted one activity, and the combined activities were profitable each of the years in question, the second issue of profit motive was answered automatically. The actual profit of Topping White Design, L.L.C. clearly demonstrated the taxpayer's intent to make a profit under § 183.[90] Thus, the need for a detailed nine-factor "for profit" analysis was eliminated.[91] Finally, the Tax Court found that Topping's equestrian expenses were ordinary and necessary in conducting her design business.[92]

V. IMPLICATIONS

The main issue addressed in *Topping*, whether the taxpayer's undertakings may be treated as one activity, is an important concept. The case demonstrates a taxpayer's successful defense against an IRS hobby loss challenge. Even though Topping won, however, most taxpayers are not that lucky. It is hard to convince the IRS that multiple undertakings are "sufficiently interconnected." *Zdun* and *DeMendoza* demonstrate that the success of cases with fact patterns similar to Topping's will depend heavily on how closely the two activities are related. On top of that, both the IRS and the Tax Court will perform a very strict factual analysis before either decides to recognize the taxpayer's hobby activity as a business.[93] Nevertheless, there is hope for taxpayers. Preventive long-term planning can avoid the IRS hobby loss challenge.

To avoid a hobby loss challenge, a taxpayer can periodically group the activities in the most advantageous way for the hobby loss purpose. *Topping* provides some useful guidance. First, it demonstrates that creative usage of facts can lead the taxpayer to victory. Because the scope of activity is a factual issue, the taxpayer can structure the facts favorably to his or her position prior to the IRS challenge. Second, the case conveniently outlines the factors that the Tax Court considers in determining a "single activity." Careful study of these factors will help equestrians and other professionals gain the upper hand over the IRS.

The opinion teaches that in claiming a "single activity" the taxpayers should: (1) develop a written business plan integrating two activities; (2) keep and consolidate the records and books of multiple

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[90] *Id.*
[91] *Id.*
[92] *Id.* at *10.
[93] *See supra* note 13.

activities; (3) utilize services of the same manager and the same CPA for both activities; (4) use the same assets for both businesses; (5) file a single Schedule C form for sufficiently related business and hobby activities;[94] (6) employ conventional advertising, unless the industry custom creates an exception similar to that in *Topping;* and (7) create "goodwill" by participating in and actually winning public competitions relating to the hobby. In addition, the taxpayer should keep any records that demonstrate the undeniable value of the hobby to the business activity. These records must illustrate "material," rather than "incidental," benefits to the main business. For example, a client list indicating that 15% of the business clientele was derived from hobby activities will not meet the "materiality" test, while a 51% figure may sway the court in the taxpayer's favor. After all, the general rule is that the grouping will be accepted as long as it is not artificial or unreasonable.[95] The closer the organizational and economic relationship between the activities, the better chance the taxpayer has of winning.

The holding in *Topping* is not limited to professionals engaged in typical equestrian activities, like farming, breeding, or boarding. Certainly, a jockey might combine his occupation with the horse breeding. A livestock insurance agent might combine his business with farming. The teachings of *Topping* extend to industries outside the equine area. Preventative long-term planning and creativity with facts can lead any taxpayer, within or outside the equine industry, to a victory against the IRS.

VI. CONCLUSION

In *Topping*, the Tax Court determined that the taxpayer's interior design business was a "for profit" activity. But instead of traditional application of the nine-factor test under the hobby loss provision of the IRC, the court first engaged in analysis of Topping's multiple undertakings. The factual presentation of the taxpayer's case made all the difference in *Topping*. Topping achieved a rare victory, especially considering that she filed two separate Schedule C's. Topping convinced the court that her money-losing equestrian activities were an integral part of her profitable design business. As a result, her equestrian expenditures were fully deductible. The taxpayer, who is engaged in multiple activities, should try grouping his or her activities according to the factors discussed in *Topping*. By extracting and applying the teachings of this case, future

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[94] *See supra* Section IV(B)(1)(c) (explaining that despite the fact that Topping was able to defeat her Schedule C admissions, positions taken by a taxpayer in a tax return are extremely hard to overcome).

[95] *Topping*, 93 T.C.M. (CCH) 1120 at *6.

taxpayers will have a greater chance of winning an IRS hobby loss challenge.