The Tax Lawyer

When Taxpayers Go Fishing For Deductions

Robert W. Wood, 06.24.10, 5:00 PM ET

A Norman Rockwell-esque "Gone Fishin'" sign on a business may provoke nostalgia of halcyon middle America. It probably means something altogether different to Steve and Janice Lowe, taxpayers who recently went to U.S. Tax Court but came home with an empty creel. To put it in fishing nomenclature, they got skunked. The case is a good summer read, plus a roadmap of how taxpayers fare in hobby loss cases and which mistakes can prove fatal. (For more advice on hobby losses, click here.)

The legal question was whether Steve Lowe engaged in bass fishing for profit or as a hobby. See *Lowe vs. Commissioner*, T.C. Memo 2010-129 (June 14, 2010). Mrs. Lowe was the primary breadwinner, working full time as controller for a steel company, for 38 years. Steve was a house husband, working solely on improving the Lowe family home from 1986 to 1999. Aside from that, Steve fished. He had fished for as long as he could remember, he told the Tax Court. But his fishing was only recreational before 1999.

But in that year, he attended a fishing tournament that carried a first-place prize of $6,000, spawning his interest in tournament fishing. Believing it would be like shooting fish in a barrel, Steve took to tournaments like a fish to water. In 2005 Steve fished in 26 tournaments and eked out gross income of $4,241. In 2006 it was 15 tournaments, and his gross income swelled to $10,932.

Those receipts from fishing may sound pretty decent until you look at Steve's expense column. Racking up nearly $100,000 of expenses between 2005 and 2006, Steve lost almost $50,000 in 2005 and almost $40,000 in 2006. But was he *trying* to land a profit?

Hobby-loss cases are about a mix of factors, and in this case (as in many others) the Tax Court conscientiously wades through them, concluding each factor with references to whether the scale tipped toward Steve or the IRS. Did Steve carry on the activity in a business-like manner? The Tax Court devotes many paragraphs to this subject, finding that Steve did some things in a business-like way and some things not. Ultimately, the court found this factor to be neutral.

The expertise of the taxpayer or his advisors is also relevant, and the court found Steve to be a knowledgeable and accomplished fisherman. He studied and read books, magazines and newspapers about fishing. Steve was no bottom-feeder; he even consulted professional fishermen seeking to improve profitability, so the Tax Court gave Steve the benefit of the doubt on this factor.

The time and effort expended by the taxpayer is also relevant, and Steve hooked this factor well. An expectation that assets used in the activity may appreciate in value can be relevant, suggesting that one can achieve a profit in more than one way. Unfortunately, Steve admitted that none of his equipment appreciated--it depreciated instead. The IRS therefore had better evidence on this factor. The taxpayer's success in carrying on similar or dissimilar activities is also relevant, and that too was of no help to Steve.

As you would expect, the taxpayer's history of income and losses in the activity is relevant, but Steve had *never* made a profit. However, considering his fishing business still in start-up phase, the court found this factor to be neutral. Even occasional profits can be relevant, but the Tax Court could not resist saying that "the fishing activity has yet to reel in any profits."

Steve's fishing track record spoke for itself. While Steve may have had the best of intentions, his winnings were never close to covering his entry fees, let alone his travel costs or depreciation on his equipment. Steve's financial status, especially considering his wife's substantial income from other sources, suggested that his fishing activities were more recreational than business.

Nevertheless, as to personal pleasure or recreation, this was no fish tale. Steve testified that his fishing activities started out as recreational but by 2005-2009 were no fun! Professional fishing, it seems, is a different kettle of fish. Believing Steve's testimony, the Tax Court found this factor to be neutral.

Despite all the points in Steve's favor, the Tax Court found Steve's competitive strategy was not "fully consistent" with an intent to make a profit. Steve hit a major snag, a veritable underwater redwood: He consistently entered his spouse as his tournament partner, but Steve fished the tournaments alone. Steve's wife went along and he deducted her entry fees, but she didn't fish. This gave him a built-in handicap in his tournaments. Steve registered the couple as a team, but with only Steve fishing, to beat competing teams of two Steve had to catch twice as many fish all by himself. It was like running a race car with only two wheels! The Tax Court found that this conduct was inconsistent with intending to make a profit.

After considering all the factors, the Tax Court concluded Steve's fishing activity was not engaged in for profit so he could not deduct his expenses in excess of his gross income from fishing. Nevertheless, finding the case to be close enough that Steve had behaved reasonably and in good faith, the court shot down the accuracy-related penalties the Internal Revenue Service wanted to impose on him.

This is no fish story. If you want to claim tax deductions, see Ten Tips For Deducting Your Hobby.

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