

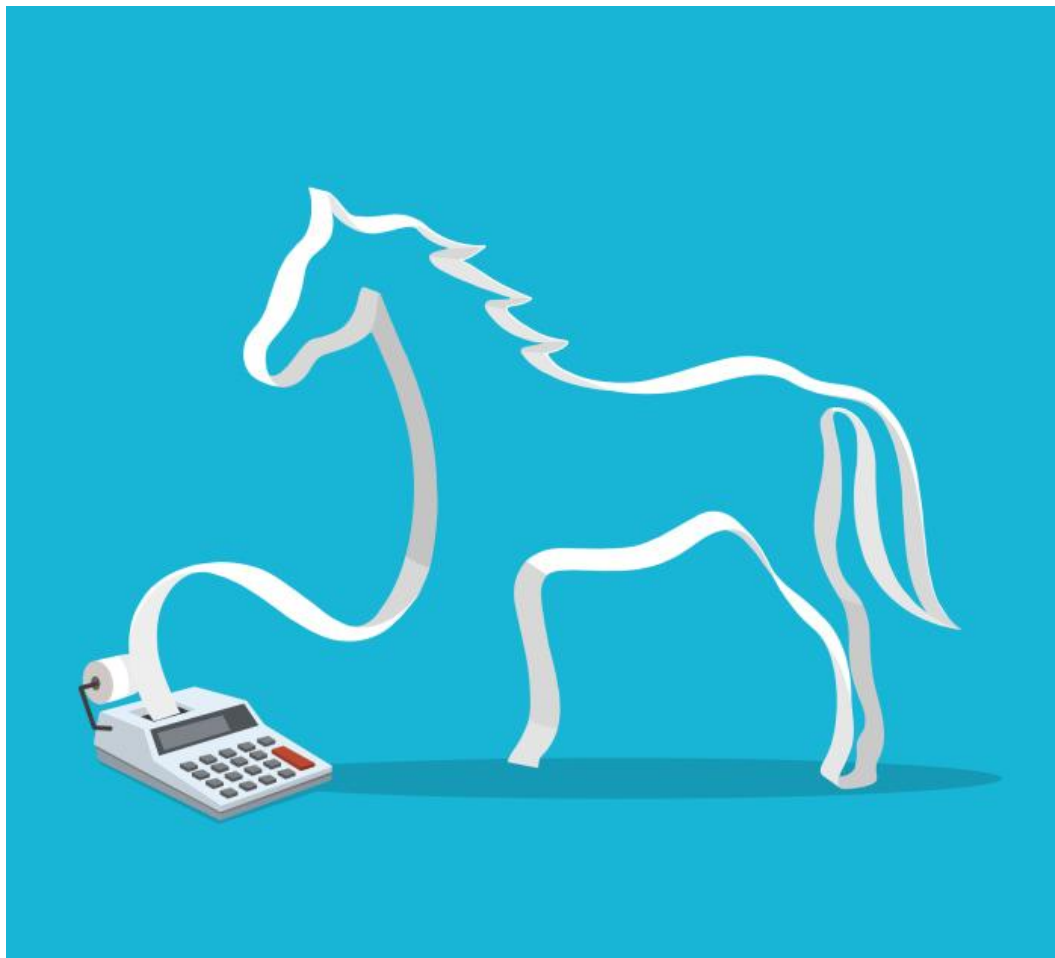
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Why a Couple Lost a \$200,000 Tax Battle Over Their Horses

The cost of your hobby can be tax deductible, but you have to do it right

By Laura Saunders

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KIERSTEN ESSENPREIS FOR WSJ

Lots of Americans lose battles with the Internal Revenue Service. But sometimes those fights provide insights the rest of us can use to win against the IRS on similar issues.

A recent Tax Court case about so-called hobby losses by a Nebraska couple, Keith and Rhonda Schumacher, is a good example.

The Schumachers loved breeding and training horses, and they did what many taxpayers with costly hobbies do, or would like to: They claimed their interest was a business, making net losses from it deductible against their other income.

When this strategy is successful, it can save taxpayers a lot of money. In the Schumachers' case, the horse-related losses were largely responsible for reducing their taxes by a total of nearly \$200,000 from 2017 through 2019, according to the court's opinion.

However, the Tax Court judge rejected the couple's horse-related deductions. The reason, she concluded, is that they didn't show they intended to make a profit from their horse business during the years in question.

Dr. Keith Schumacher, who remains active as a horse breeder and trainer, declined to comment.

The paradoxical result of the Schumachers' case is that it provides a fresh road map for taxpayers who want to turn their hobbies into businesses for tax purposes.

Many taxpayers try to go this route, for good reason. "People pay for 100% of their hobby costs. But if your hobby is a business, you can drop the cost by up to half," says Robert Wood, a tax attorney in San Francisco who has studied hobby-loss cases.

Here's a simplified example. John loves old cars, and he spends quite a bit to buy, refurbish and maintain a collection of them—about \$40,000 a year. But if John's hobby is a business because he sells some cars or rents them for weddings, a lot of his car expenses could be deductible. (He could owe Social Security and Medicare taxes, of course.)

Say the business has a \$30,000 loss for the year. Deducting those losses could reduce tax on John's wages from his day job or other income. If his top federal tax rate is 37%, the deduction could save about \$11,000, plus hefty state taxes in some areas.

Congress and the IRS are alert to this strategy, however. To prevent Uncle Sam from subsidizing hobbies, the law requires business owners who deduct losses to *want* to make a profit. As a result, the IRS has to look into the taxpayer's intent, and the law offers a nine-factor test to gauge this.

Some hobbyist/owners pass the test, according to Wood. The IRS isn't likely to litigate such cases, but he says he has seen successful outcomes. Such cases have involved race-car drivers, fishing consultants, sports agents, travel-book writers and stamp collectors.

The Schumachers didn't pass the test, although they did win on some factors. For example, the opinion acknowledges that they had expertise in the area of horse breeding and training, and they strove to learn more. They also spent a lot of their own time managing and caring for their horses, although both worked full time—Keith as a veterinarian and Rhonda in education.

In addition, the judge was impressed enough with the couple's efforts to comply with the law that she didn't impose nearly \$34,000 in accuracy penalties requested by the IRS. In part, this was because the Schumachers relied in good faith on their tax adviser.

That good faith didn't win them the case, though. The issues that tripped up the Schumachers show up often in hobby-loss disputes, so here are questions for taxpayers who want to deduct losses from their own hobbies.

Was the activity carried on in a businesslike manner?

The owner needs a business plan plus accurate books and records, which the opinion says the Schumachers didn't have. While they had a separate bank account for their horse business, they paid many of its expenses from their personal checking account. Their tax adviser had to rely on handwritten notes and statements to prepare their returns, instead of business-account bank statements.

Was there an expectation that business property would appreciate in value?

According to the opinion, the couple didn't formally track the value of their horses. This went against them.

What's the business's history of profit or loss?

Although profit isn't absolutely required to prove profitable intent, especially during the startup phase of a business, it helps. In general, the IRS presumes there's a profit motive if a business has profit in three of the past five years. With horse businesses, the standard is two out of the past seven years.

However, the Schumachers started their horse business in 2001 and never turned a profit, according to the opinion.

What is the taxpayer's overall financial status?

If the owner of a business that could be a hobby has enough income from other sources to absorb losses, that could mean he or she didn't intend to

profit from it. The opinion says the Schumachers had substantial other income that the losses could shelter, so that also counted against them.

Did the taxpayer derive substantial pleasure from the activity?

This one is tricky, but important. It's OK for a business owner to get pleasure as well as loss deductions from a money-losing activity—as long as other factors support a profit motive.

But if they don't, then deriving pleasure from the activity can be a negative. According to the opinion, both Schumachers loved horses from childhood and enjoyed breeding, raising, training and showing them. Because other factors went against them, this one did, too.

Moral: If you want to deduct losses from your hobby, don't enjoy it too much.