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DEALER TAX WATCH

A Quarterly Update of Essential Tax Information

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DEALER TAX WATCH *OUT*

If you had called me personally to ask, "What's happening lately with IRS audits of dealers and dealerships that I need to know about?" ... Here's what I'd say:

#1. THIS MID-SUMMER CASE SHOULD WAKE UP A FEW DEALERS & THEIR CPAs. One case this summer shouldn't be quickly read and dismissed as simply an example of the IRS catching a big fish on a small line. Truth is stranger than fiction, and we think this case is so important that we've devoted this whole issue of the *Dealer Tax Watch* to it.

In *James R. & Myrtice L. Peacock v. Comm.* (T.C. Memo 2002-122), a dealer surreptitiously tried to run almost $1 million worth of fishing expenses through his personal tax return, indirectly as part of his wife's K-1 losses from her S corporation.

This case could be a wake-up call for some CPAs if they have blindly believed or relied on their dealer clients who insist that they should be able to "justify things to the IRS in case they should be questioned."

In other respects, some taxpayers may be gratified to see in this case some tangible evidence that the IRS ... and the Tax Court ... were able to work through the maze and ferret out personal and recreational expenditures that were being deducted under the guise of business expenses.

Nevertheless, through an S corporation owned solely by his wife and funded in part by consulting fees paid by other dealerships, the case of *James R. & Myrtice L. Peacock v. Comm.* shows how it is possible to try to do just about anything using the best tax shelter there ever was ... your own closely-held corporation. Within limits, that's a great lesson for every creative tax planner and advisor out there ... ***within limits***!

In the *Peacock* case, both husband and wife were avid deep sea tournament fishermen. However, in the context of the larger lessons that we're talking about here, that is an insignificant, almost throw-away, fact. In countless other scenarios, with minor variations on which family members' interests are being indulged, what those interests are, and what combination of entity structures are involved, you readers of this publication have undoubtedly seen in your own experiences that the possibilities are seemingly endless.

Dealers, like everybody else, have varied interests and hobbies, and some of them can grow to very expensive proportions. Let's see, there's hunting, fishing, collecting just about anything you can imagine, horse breeding and racing, cattle raising, farming, all kinds of car racing, show dogs, show cats, antiques ... you name it (the list goes on) ... and you've probably seen more of it than you wish. And, dealers are always quick to insist on just how impor-

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tant these activities are in helping them sell more cars. As Lou Rukeyser says: "You betcha."

As with many other cases covered in the *Dealer Tax Watch* over the years, the fact that the taxpayers involved were dealers, their dealerships and related entities by no means limits the application of the lessons from this case.

Often, our clients have strong and convincing reasons (at least they believe them)–not to mention the force of their own personalities–that lead them to believe that they're entitled to deduct losses from a wide variety of hobby-type activities. Many times, the CPA advising the dealer/client and preparing the tax returns may not look objectively at what's really going on - or the CPA may not want to "upset" the dealer by suggesting that maybe they are either being too greedy or at least pushing the limits of credibility and common sense ... not to mention the rules in Section 183 which are fairly straight-forward.

In *Peacock*, the taxpayers based their defense on their enthusiastic and interesting testimony before the Court. If you don't read anything else, read the stories about the "Big Ones" that got away on pages 6-7. Unfortunately, not only were their losses from their fishing activities disallowed, they were also stuck with additional accuracy-related penalties which exceeded $50,000.

Still other issues? For more thoughtful readers, there are also some issues that were not addressed in the Tax Court. For example, the wife's S corporation, through which the fishing activities were conducted, was named "Profitable Management Services, Inc." or PMSI. On its tax return, PMSI reported its principal business activity as providing consultation on automobile dealerships.

One could argue that neither the Corporation's name, nor the identification of its "principal business activity" in its tax returns was accurate or descriptive of what was really going on beneath the surface. Just look at the summary of income and expense for proof of that. Ms. Peacock, the active fisherman, merely answered the business phones when she wasn't fishing and Mr. Peacock received salary *as an employee* that was minimal in relation to the consulting fees collected from the dealerships. Since Ms. Peacock owned 100% of the S Corporation stock, could there have been other allocation issues here that the Service overlooked?

Really, The lesson is simple... It's that maybe CPAs shouldn't always swallow hook, line and sinker, everything that their dealer clients tell them. Or let's soften that a bit: when this case went to the Tax Court, the Peacocks failed totally and completely to convince the Court that their fishing activity had a for profit business motive. Judge Laro applied (common sense and) the factors listed in the Regulations to the facts at hand.

As part of our coverage, we've included for your consideration a checklist that goes beyond the specifics of the *Peacock* case for identifying possible exposure to the IRS' disallowance of losses incurred in activities not engaged in for profit. We hope it will be helpful in considering your roles as tax advisor and tax return preparer where these delicate *recreation* versus *business* issues are involved.

#2. CITATION FOR IRS RULING FOR OLDS DEALERS. In the March 2002 *DTW*, we analyzed the Private Letter Ruling that NADA obtained from the IRS for an Oldsmobile dealer in connection with the tax treatment of payments received from General Motors. The citation for this Ruling did not appear in the text of the article. It is LTR 200218034.

#3. AUTO DEALER HELD NOT RESPONSIBLE FOR UNPAID LUXURY VEHICLE EXCISE TAXES. Recently, the IRS attempted to collect unpaid Federal excise taxes from the owner of two dealerships out of the net proceeds that he had received when the dealerships were sold. At about the same time that the dealerships were being sold, the IRS began an investigation of a dealership employee who eventually pleaded guilty to aiding and assisting in the preparation of false income tax returns.

The dealer, who was President and controlling shareholder, received net proceeds of $134,000 after deducting a $110,000 commission that was paid for brokering the sale. At that time, the Corporation's unpaid debts to unrelated parties included $100,000 of unpaid rent, a potential liability of $100,000 for brokerage fees related to a previous attempt to sell the dealership and attorney's fees in excess of $50,000. In addition, the dealership owed the dealer approximately $700,000 for money that the dealer had lent the dealership when it was previously declared out of trust by its floorplan provider. The dealer, who was primarily liable for the debts to unrelated third parties, eventually settled some of the dealership's unpaid debts for reduced amounts.

At the time the dealerships were sold, the dealer was unaware that there were any unpaid Federal excise taxes. Furthermore, he had no reason to be aware of this liability to the IRS.

The U.S. District Court for the Middle District of Florida held that when the dealership transferred its

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SOMETHING FISHY ABOUT THOSE FISHING ACTIVITY LOSSES DEDUCTED IN THE DEALER'S TAX RETURN

In *James R. Peacock v. Comm.* (T.C. Memo 2002-122), Mr. Peacock, an auto dealer, went to the Tax Court to protest the IRS' disallowance of losses that had been claimed in his joint returns for the years 1995 through 1997. Most of these disallowed losses were, in effect, flow-through deductions from his wife's S Corporation, and they resulted in proposed income tax deficiencies totaling over $270,000. In addition, the IRS asserted another $54,000 - or 20% - resulting from its imposition of accuracy-related penalties under Section 6662 for claiming these deductions.

Mr. Peacock had worked in the automobile industry for approximately 20 years and had owned various automobile dealerships. In October 1993, Mr. Peacock sold 51% of his 100% ownership interest in one of the dealerships in order to spend more time with his wife in an activity, fishing, that they had both enjoyed since their childhood.

Shortly thereafter, Mr. and Ms. Peacock organized Profitable Management Services, Inc. (PMSI), an S Corporation, in December of 1993. PMSI's president and only shareholder was Ms. Peacock. However, both she and Mr. Peacock were treated as paid employees of PMSI.

On its S Corp. tax return, Form 1120S, PMSI reported its principal business activity as providing consultation on automobile dealerships, and, during the relevant years, it had consulting arrangements with a few automobile dealerships. The Corporate return reported net ordinary income of approximately $23,000 in 1994, a net loss of $305,000 in 1995, a net loss of approximately $250,000 in 1996 and net ordinary income of approximately $2,000 in 1997.

However, these "bottom line amounts" really gave no indication that for the 4 years involved, net losses from fishing activities aggregating almost $995,000 were being deducted in arriving at these final taxable income or loss amounts. In fact, for the years 1994 through 1997, the primary activity of the S Corporation owned by the dealer's wife involved their participation in numerous deep-sea fishing tournaments. For more on the specifics of their participation, see *Mixing Business with Pleasure on the Deep Sea Fishing Tournament Circuit* on pages 8-9.

Both Mr. and Ms. Peacock had fished recreationally since their childhood and began tournament fishing for pleasure sometime in 1988 or 1989. The Peacocks decided, after consulting with other members of their tournament team, that they and the team would participate in the tournaments through PMSI, Ms. Peacock's S Corporation. The only service that Ms. Peacock performed for PMSI, other than those connected with its fishing activities, was answering the telephones.

What is clear, is that Ms. Peacock was the principal fisherman/woman. Mr. Peacock was not a member of the 4-person fishing team. According to the record, it would not be accurate to say that Mr. Peacock only went along for the ride. It would be more accurate to say that "he accompanied the team aboard the yacht during the tournaments and handled the management and financial side of the fishing activity." For a summary of PMSI's income and expenses, including salaries paid to Mr. and Ms. Peacock and to the other PMSI employees, see page 5.

THE ISSUES

In auditing the tax returns for the dealership, the consulting/fishing S Corporation, and the joint returns filed by Mr. and Ms. Peacock, the IRS smelled something fishy. Eventually, the IRS denied some of the deductions claimed in PMSI's tax return (and that were passed through to the Peacocks' joint Form 1040 income tax return via Schedule K-1).

The Service took the position that PMSI's fishing activity was not engaged in for profit. It was up to the Tax Court to determine the extent of PMSI's deductions for its fishing activity that should be allowed in the computation of its income or loss.

Essentially, there were three major issues before the Tax Court:

1. Whether the Peacocks' deep-sea tournament fishing activity was an "activity not engaged in for profit" under Section 183,

2. Whether Mr. Peacock's dealership could deduct a certain bad debt, and

3. Whether the Peacocks were liable for the 20% accuracy-related penalties in connection with their claiming these deductions.

One other issue in the case involved a late-filing penalty in connection with one of the years' tax returns; that issue will not be discussed in this article.

WERE THE FISHING ACTIVITIES ENGAGED IN "FOR PROFIT?"

Section 183 contains the rules relating to the limitation and (non)deductibility of expenses incurred

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in connection with activities that are not engaged in for profit. This Section applies to activities engaged in by individuals or by them through their S corporations, and it generally limits the deductions for an "activity not engaged in for profit" to the amount of income received from the activity.

An activity is engaged in for profit if the taxpayer entertained an actual and honest, even though unreasonable or unrealistic, profit objective in engaging in the activity. The case law that has established this general rule includes *Osteen v. Commissioner*, 62 F.3d 356, 358 (11th Cir. 1995), affg. on this issue T.C. Memo 1993-519; and *Dreicer v. Commissioner*, 78 T.C. 642, 645 (1982), affd. without opinion 702 F.2d 1205 (D.C. Cir. 1983).

Section 183(d) includes the following presumption ... "If the gross income derived from an activity for three or more of the taxable years in a period of five consecutive taxable years ... exceeds the deductions attributable to such activity ..., then, unless the Secretary establishes to the contrary, such activity shall be presumed ... to be an activity engaged in for profit."

The Peacocks did not satisfy this presumption, and accordingly, they had to bear the burden of proving that PMSI entered into, and remained in, the fishing activity with the requisite profit objective.

Reg. Sec. 1.183-1(f) provides that Section 183 applies at the corporate level with respect to the activities of an S corporation. Therefore, Ms. Peacock's intent, once determined by the Court, is attributable to PMSI - her wholly-owned S corporation.

THE PEACOCKS' TESTIMONY

During the trial in the Tax Court, both Mr. and Ms. Peacock testified as to their fishing activities. They testified that "they aimed to earn money from that activity and that they could win millions of dollars in the activity." They further testified that Ms. Peacock's S Corporation would have reported a profit for each year under audit ... except that two fish got away and one other one rammed his head into the side of another boat. (Are we having fun yet?)

In prose rivaling anything put on paper by Melville, Hemmingway, or the author of *Jaws* in describing the first encounter of the *Orca* with Shaw's nemesis, the Peacocks' testimony leaves little doubt that they couldn't help but completely love every minute that they spent on board their yachts. Excerpts from their testimony, edited only because of space limitations are on pages 6-7.

The Peacocks should have realized that they were taking a huge risk when they relied solely on their testimony to establish all of their proposed findings of disputed facts. Putting all their eggs in one basket turned out badly for the Peacocks. Despite their animated recounting of their tales, Judge Laro seemed impassively unimpressed. He said, among other things, "We give petitioners' uncorroborated testimony little weight in determining whether PMSI had the requisite profit objective."

9 FACTORS TO BE CONSIDERED

Judge Laro said that in order to determine whether PMSI's participation in fishing activities was "permeated with the honest and actual profit objective," it would be necessary to "give greater weight to the nine objective factors set forth [in the Regulations] than ... to the petitioners' expressions of subjective intent."

The Regulations under Section 183 contain a nonexclusive list of factors to be considered in ascertaining whether or not an activity is engaged in for profit. All facts and circumstances must be taken into account, and no single factor or mathematical preponderance of factors is determinative. These factors are found in Reg. Sec. 1.183-2(b).

9 FACTORS

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 assets used in the activity may appreciate in value,
5. The taxpayer's success 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, if any, which are earned,
8. The financial status of the taxpayer, and
9. Elements of personal pleasure or recreation.

"IT'S A DIRTY JOB, BUT SOMEBODY'S GOT TO DO IT"

In the course of things, Judge Laro discussed the "work environment." He noted, "The tournaments had an atmosphere resembling that of a college spring break and took place in some of the world's most beautiful locations. During the tournaments,

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PROFITABLE MANAGEMENT SERVICES, INC. (PMSI)
SUMMARY OF INCOME & EXPENSE
FOR THE YEARS 1994 - 1997

	1994	1995	1996	1997
Income from fishing activities				
Tournament winnings	$ 0	$123,000	$109,270	$117,954
Other	116,135	-0-	-0-	-0-
Consulting fees from dealerships	-0-	242,997	249,200	-0-
Trailer park income	-0-	159,483	54,555	-0-
Loss on sale of condo	-0-	(9,896)	-0-	-0-
Loss on sale of land	-0-	-0-	(5,600)	-0-
Other receipts (details not provided)	221,227	-0-	-0-	332,613
Cost of goods sold (details not provided)	-0-	-0-	-0-	(198,809)
Total Income	337,412	515,584	407,425	332,613
Expenses related to fishing activity				
Tournament fees	$65,645	$49,375	$71,975	$59,350
Boat supplies	7,010	8,079	16,451	5,946
Tackle & bait	2,203	11,439	6,314	-0-
Marina fees	11,786	17,146	19,611	8,855
Fuel	14,489	14,300	32,109	16,011
Lodging & travel	12,623	27,407	26,359	29,380
Contract labor	7,650	6,555	725	10,236
Professional fees	54,711	24,394	-0-	-0-
Depreciation	66,277	119,298	98,139	84,616
Insurance	41,723	5,985	8,637	-0-
Interest expense	-0-	42,150	33,609	25,561
Meals/entertainment	-0-	3,022	-0-	-0-
Officer compensation	-0-	7,000	19,500	25,500
Permits	-0-	567	658	-0-
Salaries	-0-	9,800	39,100	66,531
Repairs & maintenance	-0-	21,746	22,727	25,030
Taxes	-0-	2,263	4,482	-0-
Charter fees	-0-	9,814	3,615	2,500
Miscellaneous	-0-	13,415	12,275	7,619
Subtotal: Fishing Activity Expenses	284,117	393,755	416,286	367,135
Other Expenses	29,992	426,804	239,686	(36,593)
Total Expenses	314,109	820,559	655,972	330,542
Ordinary Income (Loss) Per Tax Return	$ 23,303	$ (304,975)	$ (248,547)	$ 2,071

Loss From Fishing Activity	$ (167,982)	$ (270,755)	$ (307,016)	$ (249,181)

Salaries Paid				
Mr. Peacock	$ 0	$7,000	$26,000	$23,000
Ms. Peacock	-0-	7,000	19,500	25,500
Other Employees	-0-	30,098	72,439	Not Indicated
Total	$ 0	$ 44,098	$ 117,939	$48,500

YOU SHOULDA SEEN THE BIG ONES THAT GOT AWAY
"MISS PIGGY" & TWO OTHER (ALMOST HAD 'EM) FISH STORIES

1. HOW WE ALMOST WON $300,000 IN 1995 ... *(From Mr. Peacock's direct testimony at trial.)*

"It was in 1995 ... at Cabo San Lucas, Mexico.

So about two or three o'clock, we hook up with this fish and it just takes off running. And Myrtice gets in the chair and gets strapped down. We get the cockpit clear, meaning you have to take in all other lines, all the teasers, and all the time, this fish is running and taking line. You've got your drag backed all the way off.

The reel has built-in pressure. And that's why you can catch a big fish with 80-pound test is you have to back off and let the fish run and when you realize that he's not running, or whatever, you've got to reel like ... [crazy] to get that line in, until he starts running again.

This fish takes off and he's running and he jumps and we know it's a 400-pound fish. I mean, we've caught enough fish ... we're not going to say a one-pound bass is a five-pound bass. We know what the size is.

An(d) Myrtice works on the fish and works on the fish and works on the fish and we're backing down on the fish and he takes off for his last run and everything went slack. And we said, you know, 'What ... happened?' Well, when we reel it in, the dead line, the hook, the knot came untied."

2. AND, WE COULDA WON $350,000 IN 1996 ... IF "MISS PIGGY" HADN'T GOT AWAY

(From Ms. Peacock's direct testimony at trial.)

"We're fishing. It was a spring day, in 1996.

There was only a few boats that actually fished out in this area. It was kind of like a little secret type thing. You could catch large fish out there. You might not get a bunch of hits, but, you know, there were large fish.

This other boat radios over and said, 'You're not going to believe what we just saw.' They were cleaning out the refrigerator and threw a bucket of clam chowder over. Well, right in the mess of clam chowder, comes this humongous blue marlin. Everybody's kind of guessing at 1,200 pounds. I mean, they just worked and worked and never could get it to back up.

So they radio us to be on the lookout for it and said, you know, 'If you find her, you know, you -- if anybody can catch her, you all can.' Because we were kind of noted for catching large fish.

So we troll around out there for, I'm guessing, about an hour or so and just, out of the blue, she's right there at the back of the boat. I mean, she's huge. And everybody's just kind of standing there with their mouth wide open, looking at this fish that's right here. And she is as wide, I mean, as long as the boat's wide. And that boat had a 16.3 beam on it. I mean, this fish was huge.

So she kind of looks around in the spread. We've got a couple of teasers out, both short and long lures out there. And she just kind of has to look around. No big deal. And then she comes up and spots a bumper. ...

[A bumper] is normally used to hang off a boat, you know, on a dock or something. What we did with them was, they were painted up with dolphin-type colors. They were supposed to represent a fish.

And it's hanging probably ten, twelve feet off on I would say a thousand pound leader. Well, she just, you know, just casually eats this thing. So we're, you know, everybody's going bananas. And then she just comes back over and looks at this lure. And I guess it was dessert. That's why I got to calling her ***'Miss Piggy.'***

And you know, the reel's singing and we're just -- oh, you want me to stop. I'm sorry. I got into my fish story.

Q. Well, no. What happened to ***'Miss Piggy?'***

A. We stood there kind of awestruck, you know, not doing anything?

Q. Was she on your line?

A. Oh, yes, she was on the line.

Q. How did she get off your line?

A. We got in the chair, she's running, you know, we're reeling; we're backing up, and then she starts to jump. And it was so amazing to see this fish and I quit reeling.

Q. Did she snap the lines?

A. Yes, she came down, broke the line, angler error."

YOU SHOULDA SEEN THE BIG ONES THAT GOT AWAY
"MISS PIGGY" & TWO OTHER (ALMOST HAD 'EM) FISH STORIES

3. AND WE WOULDA WON THE TOURNEY IN 1997 ... EXCEPT THAT OTHER SUCKER RAN RIGHT INTO THE SIDE OF A CRUISE SHIP & KNOCKED ITSELF OUT.

(From Mr. Peacock's direct testimony at trial.)

A. "... We was in Grey Harbour, which is in the lower part of the Harbour Island, which is in the lower part of the Bahamas. And we were out, it was either the third or the fourth day of the tournament. I can't remember which one.

But we was sitting on a 683-pound fish that we knew was going to be a tournament winner. But the tournament winner is not only predicated on the largest fish, it's the total pound of fish. It's two separate categories. The winner is based on pounds of fish.

And there was a boat out of Fort Lauderdale that had caught a fish that morning. And it wasn't that big a fish. It was about 300 or so pounds. And so we're sitting on this 683-pound fish, that we had caught right in the middle of the day. And we just absolutely knew that we not only had the tournament won, we had the daily won.

So what happens is, there's about 20 minutes to go. And we hear on the radio that this boat is hooked up --

Q. Let me stop you, please. When you say, 'there's 20 minutes to go,' what significance does that have to you?

A. Well, you have a starting time and a finishing time. You can't put the lines in the water -- we're already on patrol by tournament headquarters. You can't put the lines in the water until they call you and say, 'Okay, lines in.' And so everybody, at one time, throughout the tournament area, puts their lines in the water. By the same token, at the end of the day, they call the end of the day. And if you show the tape, you will see what happens when we get to the end of the day. ...

But it was 20 minutes to go in the fishing day. We knew we had it won. If somebody caught a big fish, there was no way that they was going to be able to get it in time to get the lines out of the water, to get to the dock. And, all of a sudden, we hear that this boat, they called in a hook-up. And they said, you know, 'We got about a 300-, 350-pound fish.' And we said, 'Ah, no problem.'

Well, this fish takes off running, as we find out later, when we get to the dock, because ten minutes later, they call in and they say, 'We got the fish in the boat.' And we all say, 'How * * * did they get that fish in the boat in ten minutes?' I mean, that just don't happen with a killable fish.

You can back down on a little fish. I mean, you just run the boat backwards as fast as you got the backbone to run it backwards with the water pouring in on you, but you don't do that with a live fish, because that fish will just run away from you.

How'd they get the fish in that quick? Well, when we get back to the dock, we find out. This fish hooks up, while they're clearing all the lines, don't even start, he takes off running and he's skipping across the water and runs right into the side of a * * * cruise ship. Bam!

Takes his bill off, knocks himself out, and he's just kind of floating on top of the water, flopping. They backed down on him, just nice and easy, reach over and get him and put in the boat. $150,000. Boom!

Just that easy, because the fish knocked itself out. They would have never got him in. We had a 683-pound fish. That's a * * * fish. But because of what he had caught that morning and what he caught that afternoon, their combined weight was more than the weight of our fish.

They won the daily and the tournament. We came in second in the tournament, with a trophy fish, 683 pounds. All because this cruise ship just happened, * * * it just happened to come by as this fish, who is fearing for his life, is running just as fast as he can, runs into the side of the boat. ..."

Source: ***James R. & Myrtice L. Peacock v. Comm.*****, T.C. Memo 2002-122, May 15, 2002, Dkt. No. 6111-00**

Recreation or Business?	*MIXING BUSINESS WITH PLEASURE ON THE DEEP SEA FISHING TOURNAMENT CIRCUIT*
Fishing Proficiency	• Petitioners have fished recreationally since their childhood and began tournament fishing for pleasure sometime in 1988 or 1989. • Both petitioners are extremely knowledgeable about the techniques of fishing and are experts in catching a desired fish. Petitioners won the 1993 Bahamas Billfish Championship. • Ms. Peacock won the 1994 World Billfish Series and she placed second in the 1995 World Billfish Series. • During her lifetime, Ms. Peacock has caught approximately 75 billfish and has been featured approximately 50 times in various sport fishing magazines. • On one occasion in 1993, Ms. Peacock caught an 885-pound blue marlin which, at that time, was the second largest fish caught in the Bahamas and which, she claims, is displayed at Ripley's Believe It or Not in Niagara Falls, New York.
PMSI Corporate Activity	• For 1994 through 1997, PMSI's primary activity involved petitioners' participation in numerous deep-sea fishing tournaments. • Petitioners decided together after consulting with other members of their tournament team that they and the team would participate in the tournaments through PMSI.
Billfish Tournament Series	• The tournaments were mostly part of the Billfish (in this case, blue or black marlin) Series, a series of tournaments held throughout the world with contestants representing a wide range of countries. • The Billfish Series tournaments generally awarded trophies and cash prizes to the contestants who within an allotted time caught at the tournament one of the four largest billfish and/or the four contestants who within that time caught the most billfish. • The total purse of each of the Billfish Series tournaments generally ranged from $100,000 to $2.5 million, and the individual prizes awarded to the contestants generally ranged from $150,000 to $1.2 million.
PMSI Winnings & Net Losses	• PMSI did not win any cash prizes in 1994 but won two cash prizes in 1997. • PMSI won one or two cash prizes in each of 1995 and 1996. • PMSI's claimed losses from the fishing activity totaled almost $995,000 ... **Year** / **Net Loss** 1994 $168,042 1995 $270,755 1996 $307,016 1997 $249,181
Tournament Locations & Atmosphere	• The tournaments were hosted by marinas worldwide in exotic, resort-like places such as the Bahamas, Cabo San Lucas (Mexico), Tahiti, Mauritius, and St. Thomas and presented a social setting that included cocktail parties and dinners, with camaraderie among contestants. • Petitioners participated in the tournaments held in the Bahamas, Cabo San Lucas, and St. Thomas, mainly from April through July. • Between 25 and 80 teams participated in each tournament, and approximately 15 of those teams, including petitioners' team, participated in the same circuit of tournaments every year. • The tournaments had an atmosphere resembling that of a college spring break and took place in some of the world's most beautiful locations. • During the tournaments, the sunny, crystal-clear blue water vacation destinations were the backdrop to sunglassed, beach-attired men and women, five-star restaurants, free-flowing alcoholic beverages, and swarms of revelers consisting mainly of contestants and spectators. • The contestants generally fished during the day and danced and celebrated through the night. • The celebrations occurred at or near the expensive, posh accommodations where the contestants generally stayed during the tournaments.

Recreation or Business?	***MIXING BUSINESS WITH PLEASURE ON THE DEEP SEA FISHING TOURNAMENT CIRCUIT***
Team Composition	• Mr. Peacock was not a member of the four-person team, but he accompanied the team aboard the yacht during the tournaments and handled the management and financial side of the fishing activity. • Ms. Peacock generally fished at the tournaments from petitioners' luxurious yacht. At the tournaments held in Mexico, petitioners chartered a yacht because it was too expensive and hazardous for them to sail their yacht to Mexico through the Panama Canal. • Ms. Peacock was part of a four-person team working together on the yacht to catch and land the desired fish. • The team consisted of a captain, two mates, and an angler. The captain remained on the bridge of the yacht during the tournaments, and he was responsible for operating and maintaining the yacht. The angler and the mates worked in the yacht's cockpit. Ms. Peacock was her team's angler, and she was the team's most important member. She was responsible for single-handedly landing each billfish after it had been caught. • Each team member's compensation was based primarily on a portion of the team's tournament winnings; i.e., generally, the captain was paid 10% of the winnings, the mates were paid 10% of the winnings, and petitioners were entitled to keep the rest.
Work Environment	• The atmosphere on petitioners' yacht during the tournaments varied from that of a hardworking, dedicated, and skilled group of team members to that of a smiling, celebratory group of individuals who shared in the spirit of competition and the pursuit of the team's goal to catch the desired fish. • Sometimes, celebrations aboard the yacht included the consumption of alcohol. Other times, the captain's wife accompanied him aboard the yacht, and they and petitioners (and possibly other individuals) dined aboard the yacht on fish caught during the day. • Petitioners allowed friends and family members to accompany them aboard the yacht during the tournaments.
Career-Ending Injury	• In late 1997, PMSI stopped participating in the tournaments because Ms. Peacock suffered a knee injury that caused her to decide to discontinue her participation.
Documentation, Books & Records	• PMSI did not prepare a business plan for the fishing activity. • Petitioners kept and coded invoices, receipts, canceled checks, and a ledger which was given to their accountant to prepare their and PMSI's annual tax returns. • Neither petitioners nor PMSI had a balance sheet, income projection, or other financial statement for the fishing activity until the end of the taxable year. • They were not able to ascertain the fishing activity's financial status for a year until they received the tax returns reporting the activity for that year. • Petitioners studied the fishing activity from the point of view of ascertaining the best way that they could catch the desired fish. They did not study the fishing activity from the point of view of catching the fish at a cost that would be less than the anticipated revenues which would be connected therewith.
Citation	• **Citation:** ***James R. and Myrtice L. Peacock v. Commissioner*** **T.C. Memo 2002-122 (May 15, 2002) Docket No. 6111-00**

(Continued from page 4)

the sunny, crystal-clear blue water vacation destinations were the backdrop to sunglassed, beach-attired men and women, five-star restaurants, free-flowing alcoholic beverages, and swarms of revelers consisting mainly of contestants and spectators. The contestants generally fished during the day and danced and celebrated through the night. The celebrations occurred at or near the expensive, posh accommodations where the contestants generally stayed during the tournaments."

Wow! Talk about unsavory working conditions...

Along these lines, the Court commented, "The record reveals that contestants at the tournaments spent much of their time ***frolicking and reveling*** with family and friends, and we are unable to find in the record credible evidence that would indicate that such was not the case with petitioners." "Frolicking and reveling" ... Somehow this choice of words sounds a little ominous for the angling taxpayers.

Judge Laro conceded a little bit to the Peacocks in stating that "...it is true that petitioners aspired in the tournaments to win large cash prizes." He then qualified that tiny concession by pointing out that "...the mere fact that they so aspired and were qualified to win those prizes does not mean that PMSI entered into the fishing activity with the requisite profit objective."

He noted that the net worth of the taxpayers each year exceeded $1 million. Therefore, the fishing losses were obviously producing a tax benefit for them at the highest brackets. The Court observed that "...By participating in the fishing activity ... petitioners aim to reduce their income while, at the same time, participating jointly in an expensive activity that they both enjoy with a subsidy from the fisc."

The Court concluded that none of the nine factors specified in the Regulations favored the taxpayer. In fact, seven were found to favor the IRS, and the other two were determined to be "neutral." The neutral factors were #2 and #3 in the box on page 4.

The final blow should come as no surprise: The Court upheld the IRS' disallowance of the fishing losses. It held that PMSI did not engage in the fishing activity with an actual and honest objective of making a profit. Almost adding insult to injury, it said, "...The record reveals that petitioners conducted the fishing activity as a means to participate jointly in a recreational and social pursuit."

For a more complete analysis of the nine factors, see *What the Tax Court Said...* on pages 12-15. And, for the full text of the regulation list, see pages 18-19.

DISALLOWED DEDUCTION FOR DEALERSHIP'S BAD DEBT

A lesser issue in this case involved the IRS' disallowance to one of Mr. Peacock's dealerships of a deduction that had been claimed for a bad debt in the amount of $50,000. This amount had been loaned by the dealership to an acquaintance of Mr. Peacock as an inducement to get him to relocate in order to work for the dealership as its General Manager.

In 1993, Mr. Peacock had spoken to this acquaintance who was living on Florida's west coast about his coming to work for the dealership. However, this would mean that he would have to relocate from the west coast to the east coast of Florida. Mr. Peacock persuaded his acquaintance to accept the position by causing the dealership to lend him $50,000 to use as a down-payment on a condominium that was located near the dealership. Mr. Peacock believed that his acquaintance would repay the loan to the dealership when he had the money to do so.

At the time when Mr. Peacock sold his 51% interest in the dealership, the acquaintance left the dealership and moved back to Florida's west coast without having made any payments on the loan. At that time, the acquaintance transferred the condominium to Mr. Peacock subject to a mortgage. Mr. Peacock later sold the condominium, but he never transferred any of the net proceeds from the sale of the condominium to the dealership.

The dealership, an S corporation for income tax purposes, had claimed a $50,000 bad debt deduction for 1995 on account of the loan. The IRS disallowed that deduction. On May 18, 1998, the dealership's 51-percent shareholder agreed to the disallowance of the bad debt deduction. At that time, Mr. Peacock continued to own the remaining stock of the dealership.

Mr. Peacock claimed that the condominium was worth less than the balance on the loan when it was transferred to him. He also claimed that he had reported in his personal income tax return the proceeds which he received when he later sold the condominium.

Section 166(a)(1) allows a deduction for any debt that becomes worthless within the taxable year. A nonbusiness bad debt is deductible only in the year it becomes totally worthless. A deduction is not allowed for partial worthlessness. To qualify for a bad debt deduction, a taxpayer must show that "some event occurred during the year in which the deduction is sought that rendered the debt uncollectible."

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Without any real discussion, the Tax Court held that the law and the facts did not support Mr. Peacock's position. Among other things, Mr. Peacock had not proven: (1) that the amount of the loan was uncollectible from the acquaintance or (2) that the equity in the condominium which he had received did not exceed the loan balance.

TAX COURT SUSTAINS 20% ACCURACY-RELATED PENALTIES

The IRS had also determined that the Peacocks were liable for accuracy-related penalties under Section 6662(a) for, among other things, negligence and intentional disregard of rules or regulations. The Peacocks argued that they reasonably believed that the fishing activity was a business and that they reasonably relied upon their tax return as prepared by their accountant.

Section 6662(a) and (b)(1) imposes a 20% accuracy-related penalty on the portion of an underpayment that is due to negligence or intentional disregard of rules or regulations. Negligence includes a failure to attempt reasonably to comply with the Code. Sec. 6662(c). Disregard includes a careless, reckless, or intentional disregard. An underpayment is not attributable to negligence or disregard to the extent that the taxpayer shows that the underpayment is due to the taxpayer's having reasonable cause and acting in good faith.

Reasonable cause requires that the taxpayer have exercised ordinary business care and prudence as to the disputed item. The good faith reliance on the advice of an independent, competent professional as to the tax treatment of an item ***may*** meet this requirement. It is important here to observe that the word used is *"may."*

Whether a taxpayer relies on advice and whether such reliance is reasonable hinge on the facts and circumstances of the case and the applicable law.

Generally, to avoid the penalty, the taxpayer must prove that:

1. The adviser was a competent professional who had sufficient expertise to justify reliance,

2. The taxpayer provided necessary and accurate information to the adviser, and

3. The taxpayer actually relied in good faith on the adviser's judgment.

The Tax Court held that the Peacocks did not meet their burden of proof as to this issue.

The Court said,

"First, we are unable to find that petitioners reasonably believed that the fishing activity was actually a business. Mr. Peacock, a successful businessperson, knew, or at least should have known, that the manner in which he conducted the fishing activity was dramatically different from the manner in which he conducted his automobile ventures."

"Nor do we believe that petitioners can escape the reach of the accuracy-related penalties by asserting baldly that they relied reasonably upon their accountant. Petitioners (i.e., the Peacocks) never called their accountant to testify as to the preparation of any of the returns. Petitioners also never attempted to meet any of the requirements of the [3-prong test mentioned above]."

Accordingly, the Tax Court upheld the IRS' determination of the accuracy-related penalties under Section 6662(a).

CONCLUSION

It turns out that the Peacocks' large deductions for their fishing activities almost turned out to be the big ones got away from the IRS. But, not quite.

This case, for some, may be a real wake-up call if they have been blindly deducting recreational or hobby losses under the guise of their being conducted as "business activities." Many dealers–and other taxpayers–have strong and often convincing reasons (not to mention the force of their own personalities) that seem to overcome faint opposition to their deductions for losses from a wide variety of hobby-type activities.

Hunting, fishing, collecting, horse racing, cattle raising and farming, all kinds of car racing, show dogs, show cats, antiques ... you name it (the list seems endless) ... you've probably seen more of it than you wish.

In the *Peacock* case, out of the list of nine factors, seven were interpreted against the taxpayer and only two were found, not to favor the taxpayer, but to be merely "neutral." Is it any wonder that, in addition to sustaining the disallowance of the losses, the IRS successfully asserted the 20% accuracy-related penalties?

CPAs should be aware from this case, and others, that if their clients are going to try to avoid the underpayment penalties, it will be necessary for the CPAs to testify in court on a number of very uncomfortable matters. On pages 16-17, we have included a ***Practice Guide*** checklist for identifying possible exposure to the disallowance of losses for activities not engaged in for profit. This may be helpful in spotting and handling sensitive, but similar, client situations.

WHAT THE TAX COURT SAID IN APPLYING THE "FOR PROFIT" CRITERIA TO THE PEACOCKS' FISHING ACTIVITIES

What's the difference between pursuing a personal/recreational/ hobby activity or interest in a non-businesslike fashion ... and pursuing that same kind of activity with a business, "for profit" motive? The answer is that net losses resulting from a for profit activity are deductible. Net losses from an activity not engaged in for profit are not deductible.

When is an activity "not engaged in for profit?" The Regulations include a list of factors or criteria to be evaluated in making these determinations. No single factor or mathematical preponderance of factors is determinative. The Tax Court discussed each of these nine factors and concluded that the taxpayer did not engage in the fishing activity with an actual and honest objective of making a profit.

1. THE MANNER IN WHICH THE TAXPAYER CARRIES ON / CONDUCTS THE ACTIVITY

What the Regulations say about this test/factor. The fact that a taxpayer carries on an activity in a businesslike manner and maintains complete and accurate records on the activity may indicate that the activity is engaged in for profit. A change in operating methods and procedures, the adoption of new techniques or the abandonment of unprofitable methods in a manner consistent with an intent to improve profitability may also indicate a profit motive.

Application of this Test to the Peacock Case. PMSI neither carried on the fishing activity in a businesslike manner nor maintained complete and accurate records for the activity. PMSI never set forth a statement of corporate purpose as to the fishing activity in, for example, its articles of incorporation, by-laws, or board minutes. Nor did PMSI ever prepare a business plan, budget, balance sheet, income projection, or other financial statement. Petitioners did not keep a separate set of books and records on the fishing activity. They did keep invoices, receipts, canceled checks, and a ledger on and for the activity. Petitioners, however, never used those records or the data reflected therein to evaluate or improve the fishing activity's financial performance. The Peacocks were unable to state with any specificity the costs which they incurred in each tournament and the amount of money that could be won there.

Nor did petitioners ever undertake a meaningful effort to make the fishing activity more profitable. Mr. Peacock is an accomplished and successful businessperson who for many years has been directly involved with the requirements of business, including the need to keep complete and accurate records. As an individual who had the skills necessary to make his automobile dealerships profitable and successful, we believe that he was, or should have been, sufficiently familiar with business practices to allow him to conduct the fishing activity in a manner evidencing a profit objective had he had one. Instead, the manner in which he and Ms. Peacock fished at the tournaments suggests that they were participating in the tournaments recreationally.

Tax Court Finding: This factor favors the respondent (i.e., the IRS), and not the taxpayer.

2. THE EXPERTISE OF THE TAXPAYER OR HIS ADVISERS

What the Regulations say .... A taxpayer's expertise, research, and study of an activity, as well as his or her consultation with experts, may be indicative of a profit intent.

Application to the Peacock Case. Although petitioners studied tournament fishing and competitions from the point of view of a contestant, and were very good fishers at that, they never undertook a basic investigation of the factors that affected the profitability of the fishing activity. Petitioners were aware of the large cash prizes which could be won at the tournaments and believed that they could win many of those prizes because their skills were superior to those of other contestants.

Petitioners, however, never seriously studied tournament fishing from a businessperson's point of view; e.g., they never researched or solicited advice on the magnitude of expenses which they were likely to incur in attempting to win the prizes. In fact, we are unable to find in the record that petitioners ever performed any meaningful economic study on the profit potential of tournament fishing. By contrast, petitioners did solicit advice on the best way to catch the desired fish and hired a seasoned crew to help reach that goal.

(Continued)

The fact that they solicited such advice and hired the crew, but never requested advice on the economics of the fishing activity, reinforces our conclusion that petitioners' participation in the fishing activity was recreational.

Petitioners' expertise and experience in fishing is counterweighed by their lack of knowledge on the economics of tournament fishing.

Tax Court Finding: Petitioners argue that this factor weighs heavily in their favor. We disagree. This factor is neutral.

3. THE TIME & EFFORT EXPENDED BY THE TAXPAYER IN CARRYING ON THE ACTIVITY

What the Regulations say .... The fact that a taxpayer devotes much of his or her personal time and effort to an activity may indicate a profit intent, especially where the activity does not involve substantial personal or recreational aspects. Also, a taxpayer's withdrawal from another occupation to devote his or her time and effort to an activity may indicate a profit motive.

Application to the Peacock Case. Although petitioners devoted their time to the activity during the tournaments, they spent only approximately 3 months of the year on that activity. Moreover, not all of that time was devoted to the fishing activity. The record reveals that contestants at the tournaments spent much of their time frolicking and reveling with family and friends, and we are unable to find in the record credible evidence that would indicate that such was not the case with petitioners. We also note that Mr. Peacock's stated reason for leaving the automobile industry in 1993 was to spend more time with his wife rather than to devote his time to another business.

Tax Court Finding: Petitioners argue that this factor weighs in their favor. We disagree. This factor is neutral.

4. THE EXPECTATION THAT ASSETS USED IN THE ACTIVITY MAY APPRECIATE IN VALUE

What the Regulations say .... The term "profit" encompasses appreciation in the value of assets. Therefore, in evaluating a taxpayer's intent, we also look to the taxpayer's expectation that the assets used in an activity may appreciate in value. The potential for asset appreciation is usually associated with land and other tangible assets.

Application to the Peacock Case. Petitioners make no argument as to this factor. Nor have they offered any evidence that indicates that any assets used in the fishing activity would appreciate in value.

Tax Court Finding: This factor favors the respondent (i.e., the IRS), and not the taxpayer.

5. THE TAXPAYER'S SUCCESS IN CARRYING ON OTHER SIMILAR/DISSIMILAR ACTIVITIES

What the Regulations say .... Although an activity is unprofitable, the fact that a taxpayer has previously converted similar activities from unprofitable to profitable enterprises may show a profit intent with respect thereto.

Application to the Peacock Case. Although Mr. Peacock has been a successful entrepreneur in the automobile industry, the record does not reveal that his work in that industry had any bearing on petitioners' ability to conduct PMSI's fishing activity profitably. Moreover, the record reveals that petitioners conducted the fishing activity as a means to participate jointly in a recreational and social pursuit. In fact, PMSI terminated the activity when Ms. Peacock was no longer able to participate in it.

Tax Court Finding: This factor favors the respondent (i.e., the IRS), and not the taxpayer.

(Continued)

WHAT THE TAX COURT SAID IN APPLYING THE "FOR PROFIT" CRITERIA TO THE PEACOCKS' FISHING ACTIVITIES

6. THE TAXPAYER'S HISTORY OF INCOME OR LOSSES W/R/T THE ACTIVITY

What the Regulations say .... A series of losses beyond the startup stage may be indicative of the absence of a profit motive unless the losses can be blamed on unforeseen or fortuitous circumstances beyond the taxpayer's control.

Application to the Peacock Case. Notwithstanding that their tournament winnings totaled almost $500,000 in 1994 through 1997, PMSI reported losses from the fishing activity of $168,042 for 1994, $270,755 for 1995, $307,016 for 1996, and $249,181 for 1997. In total, PMSI incurred almost $1.5 million of expenses to win approximately $500,000, producing an approximate loss of $1 million.

The record, moreover, contains no credible evidence to suggest that PMSI ever expected to recoup any of these losses. The fact that the fishing activity suffered losses year after year and that petitioners took no meaningful action to reverse the tide supports a finding that they were indifferent as to whether the losing trend could be reversed.

Although it is true that petitioners aspired in the tournaments to win large cash prizes, the mere fact that they so aspired and were qualified to win those prizes does not mean that PMSI entered into the fishing activity with the requisite profit objective.

Tax Court Finding: This factor favors the respondent (i.e., the IRS), and not the taxpayer.

7. THE AMOUNT OF OCCASIONAL PROFITS, IF ANY, WHICH ARE EARNED

What the Regulations say .... Occasional profits may indicate a profit motive. The absence of profits, however, is not determinative of a lack of profit motive. Petitioners need only have an actual and honest profit objective. Absent actual profits generated from the activity, an opportunity to earn a substantial ultimate profit in a highly speculative venture may be sufficient to indicate that the activity is engaged in for profit even though losses or only occasional small profits are actually generated. The term "profit" means economic profit independent of tax consequences.

Application to the Peacock Case. The fishing activity has never earned a profit, and petitioners have not persuaded us that PMSI had a chance either to make a profit or to recoup their losses. Whereas petitioners testified that the nonoccurrence of three misfortunes would have resulted in PMSI's reporting a profit for each subject year, we are unpersuaded that such would have been the case. Among other things, we are unpersuaded that petitioners would have won the claimed amounts of money had the misfortunes not occurred. The record lacks any objective evidence to establish the specific prizes which petitioners would have won had those misfortunes not occurred, or the net amount of those prizes which would have ultimately been realized by PMSI.

The Court indicated in a note that it found as a fact that the Billfish Series tournaments awarded individual contestants prizes generally ranging from $150,000 to $2 million. The Court said that it was unable to find, however, the amount of the specific prizes which were paid by the tournaments in which petitioners participated. Nor was the Court able to find the specific prizes payable by the tournaments in which the misfortunes occurred.

Tax Court Finding: This factor favors the respondent (i.e., the IRS), and not the taxpayer.

(Continued)

WHAT THE TAX COURT SAID IN APPLYING THE "FOR PROFIT" CRITERIA TO THE PEACOCKS' FISHING ACTIVITIES

8. THE FINANCIAL STATUS OF THE TAXPAYER

What the Regulations say .... Substantial income from sources other than the activity (particularly if the losses from the activity generate substantial tax benefits) may indicate that the activity is not engaged in for profit. This is especially true where there are personal or recreational elements involved.

Application to the Peacock Case. Profitable Management Services, Inc. (PMSI) was an S Corporation, wholly owned by Ms. Peacock, the spouse of the dealer, Mr. Peacock. The net income or loss from the S Corporation's activities were reported in the individual income tax return filed jointly by the dealer and his spouse each year.

Petitioners had substantial income and cash receipts from activities other than PMSI, and their net worth exceeded $1 million in each of the years under examination. Petitioners' financial status allowed them to finance the fishing activity and to use the activity's losses to reduce significantly their income tax liability. To be sure, but for those losses, PMSI would have reported (and Ms. Peacock would have been required to recognize) large amounts of ordinary income in each subject year. By participating in the fishing activity, however, petitioners aim to reduce their income while, at the same time, participating jointly in an expensive activity that they both enjoy with a subsidy from the fisc.

Tax Court Finding: This factor favors the respondent (i.e., the IRS), and not the taxpayer.

9. ELEMENTS OF PERSONAL PLEASURE OR RECREATION

What the Regulations say .... Although the mere fact that a taxpayer derives personal pleasure from a particular activity does not mean that he or she lacks a profit intent with respect thereto, the presence of personal motives may indicate that the activity is not engaged in for profit. This is especially true where there are recreational elements involved. "[T]he fact that the taxpayer derives personal pleasure from engaging in the activity is not sufficient to cause the activity to be classified as not engaged in for profit if the activity is in fact engaged in for profit as evidenced by other factors."

Application to the Peacock Case. Petitioners began tournament fishing for pleasure sometime in the late 1980s and focused their participation in tournaments on ones held in exotic, resort-like locations. Although a taxpayer's participation in a tournament fishing activity may sometimes qualify as an activity engaged in for profit (e.g., *Busbee v. Commissioner*, T.C. Memo. 2000-182), such is not the case here. Petitioners' pursuit of competitive excellence was not motivated primarily by the pursuit of profit. On the basis of our evaluation of the record as a whole, including our viewing of an approximately 1-hour video on the 1994 World Billfish Series, a segment of which was devoted to petitioners and their team, we conclude that petitioners participated in the tournaments for pleasure and recreation rather than the pursuit of business.

Tax Court Finding: This factor favors the respondent (i.e., the IRS), and not the taxpayer.

10. *SUMMARY ... OVERALL CONCLUSION*

Seven factors favor the IRS and not the taxpayer. Two factors are "neutral." Accordingly,
the taxpayer did not engage in the fishing activity with an actual and honest objective of making a profit.

(Concluded)

Citation: ***James R. and Myrtice L. Peacock v. Commissioner***
T.C. Memo 2002-122 (May 15, 2002) Docket No. 6111-00

PRACTICE GUIDE

CHECKLIST FOR IDENTIFYING POSSIBLE EXPOSURE TO DISALLOWANCE OF LOSSES FOR ACTIVITIES NOT ENGAGED IN FOR PROFIT

Type of Activity or Activities	_____ (Car Racing; Hunting; Fishing; Golfing; Other Sports; Ranching; Farming; Cattle Breeding; Horse Racing, Breeding, Showing, etc.; Collecting/Fine Arts; Antiques; etc.)
Participant(s)	___Taxpayer ___Spouse ___Child or Children ___Other _____
Entity / Entities Involved	Corporation: ___C Corp. ___S Corp. ___Holding Company ___Other _____ Other: ___LLC ___Partnership ___LLP ___Other _____ Year of Formation: _____ Shareholders: _____ Officers: _____
Funding	If activity has been operating at a loss, how have the funds to cover the expenses been provided? _____
Documentation	Is there adequate documentation in the Minutes? ___Yes ___No Are the books & records adequate? ___Yes ___No. Is there a business plan? ___Yes ___No

ACTIVITY PROFITABILITY & FINANCIAL RESULTS

	Gross Receipts	*Total Expenses*	*Net Income (Loss)*
Fifth prior year			
Fourth prior year			
Third prior year			
Second prior year			
First prior year			
Current year (projected)			
Next year - projected			
Next two years - projected			
Average for three prior years			
Average for five prior years			

"For Profit" Presumption... Section 183(d) states that "If the gross income derived from an activity for *3* or more of the taxable years in the period of *5* consecutive taxable years (which ends with the taxable year) exceeds the deductions attributable to such activity ..., then, unless the Secretary establishes to the contrary, such activity shall be presumed ... to be an activity engaged in for profit."

Special Rule for Horse-Related Activities ... "In the case of an activity which consists in major part of the breeding, training, showing or racing of horses, the preceding shall be applied by substituting '2' for '3' and '7' for '5.'" In other words, these horse-related activities are afforded a longer period of time in which to produce a profit.

ADDITIONAL COMMENTS & EXPLANATIONS

_____

_____

_____

_____

_____ _____

Preparer's Signature & Date *Reviewer's Signature & Date*

PRACTICE GUIDE

CHECKLIST FOR IDENTIFYING POSSIBLE EXPOSURE TO DISALLOWANCE OF LOSSES FOR ACTIVITIES NOT ENGAGED IN FOR PROFIT

RECREATION, PLEASURE, HOBBY-LIKE ACTIVITY? VS. ACTIVITY CONDUCTED WITH FOR PROFIT MOTIVE & BUSINESS INTENT?

Nine Factors to Consider	***Does the Factor Support the Position that the Activity Is Engaged in For Profit?***		
	Yes	*No*	*Uncertain / Borderline*
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 assets used in the activity may appreciate in value.			
5. The taxpayer's success 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, if any, which are earned.			
8. The financial status of the taxpayer.			
9. Elements of personal pleasure or recreation.			

Note: In determining whether an activity is engaged in for profit, all facts and circumstances are to be taken into account. No one factor is determinative in making this determination. In addition, it is not intended that only the factors described above are to be taken into account in making the determination, or that a determination is to be made on the basis that the number of factors (whether or not listed above) indicating a lack of profit objective exceeds the number of factors indicating a profit objective, or vice versa. ... (Reg. Sec. 1.183-2(b))

ENGAGEMENT & RISK MANAGEMENT ISSUES

1. Are there any factors other than those listed above that should be considered in the overall evaluation? If so, describe & explain: _____
2. Based on your objective evaluation and weighting of all these factors, is there sufficient evidence and documentation to support the position that the activity for which deductions are being claimed is being engaged in for profit? ___Yes ___No
3. Have these factors and your conclusion(s) been discussed with the client? ___Yes ___No. If so, on what date?
4. If this is a potential issue, has this been discussed in a letter or memo to the client? ___Yes ___No. If we have any reservations as to the possible outcome of this issue, have these reservations been communicated to the client? ___Yes ___No. If so, how? Discuss & provide dates of meetings and discussions with client.
5. Has the client been advised that, if the IRS successfully challenges the deductions related to this activity, it is likely that accuracy-related penalties (20%) will also be assessed? ___Yes ___No
6. In the tax return(s) to be filed, are any special disclosures required or advisable in connection with these activities to try to limit the ability of the IRS to assess accuracy-related penalties? ___Yes ___No. What are they?_____ Have these additional disclosures been discussed with the client? ___Yes ___No
7. If we are called upon to testify in court, how adequate is our documentation? Who will have to testify?_____ Are we likely to be effective as witnesses on our client's behalf? ___Yes ___No

NINE FACTORS TO CONSIDER IN EVALUATING WHETHER OR NOT AN ACTIVITY IS ENGAGED IN FOR PROFIT TEXT OF REG. SEC. 1.183-2(b)

The Regulations list 9 relevant factors to be considered in determining whether an activity is engaged in for profit. All facts and circumstances with respect to the activity are to be taken into account. No one factor is determinative in making this determination. In addition, it is not intended that only the nine factors listed are to be taken into account in making the determination, or that a determination is to be made on the basis that the number of factors (whether or not listed) indicating a lack of profit objective exceeds the number of factors indicating a profit objective, or vice versa.

Note that in the *Peacock* case (*James R. & Myrtice L. Peacock v. Comm.*, T.C. Memo 2002-122, May 15, 2002), out of a possible score of 9 favorable factors, none were found favorable to Peacock ... seven were found favorable to the IRS and 2 were found to be neutral.

Below in its entirety is the text of Reg. Sec. 1.183-2(b) which describes nine factors to be taken into account.

Manner in which the Taxpayer Carries on the Activity ***(Factor #1)***	• The fact that the taxpayer carries on the activity in a businesslike manner and maintains complete and accurate books & records may indicate that the activity is engaged in for profit. • Similarly, where an activity is carried on in a manner substantially similar to other activities of the same nature which are profitable, a profit motive may be indicated. • A change of operating methods, adoption of new techniques or abandonment of unprofitable methods in a manner consistent with an intent to improve profitability may also indicate a profit motive.
The Expertise of the Taxpayer or his Advisors ***(Factor #2)***	• Preparation for the activity by extensive study of its accepted business, economic, and scientific practices, or consultation with those who are expert therein, may indicate that the taxpayer has a profit motive where the taxpayer carries on the activity in accordance with such practices. • Where a taxpayer has such preparation or procures such expert advice, but does not carry on the activity in accordance with such practices, a lack of intent to derive profit may be indicated unless it appears that the taxpayer is attempting to develop new or superior techniques which may result in profits from the activity.
The Time and Effort Expended by the Taxpayer in Carrying on the Activity ***(Factor #3)***	• The fact that the taxpayer devotes much of his personal time and effort to carrying on an activity, particularly if the activity does not have substantial personal or recreational aspects, may indicate an intention to derive a profit. • A taxpayer's withdrawal from another occupation to devote most of his energies to the activity may also be evidence that the activity is engaged in for profit. • The fact that the taxpayer devotes a limited amount of time to an activity does not necessarily indicate a lack of profit motive where the taxpayer employs competent and qualified persons to carry on such activity.
Expectation that Assets Used in the Activity May Appreciate in Value ***(Factor #4)***	• The term "profit" encompasses appreciation in the value of assets, such as land, used in the activity. • Thus, the taxpayer may intend to derive a profit from the operation of the activity, and may also intend that, even if no profit from current operations is derived, an overall profit will result when appreciation in the value of land used in the activity is realized since income from the activity together with the appreciation of land will exceed expenses of operation. • See, however, Reg. Sec. 1.183-1(d) for definition of an activity in this connection.
The Taxpayer's Success in Carrying on Other Similar or Dissimilar Activities ***(Factor #5)***	• The fact that the taxpayer has engaged in similar activities in the past and converted them from unprofitable to profitable enterprises may indicate that he is engaged in the present activity for profit, even though the activity is presently unprofitable.

NINE FACTORS TO CONSIDER IN EVALUATING WHETHER OR NOT AN ACTIVITY IS ENGAGED IN FOR PROFIT TEXT OF REG. SEC. 1.183-2(b)

The Taxpayer's History of Income or Losses With Respect to the Activity (Factor #6)	• A series of losses during the initial or start-up stage of an activity may not necessarily be an indication that the activity is not engaged in for profit. • However, where losses continue to be sustained beyond the period which customarily is necessary to bring the operation to profitable status, such continued losses (if not explainable as due to customary business risks or reverses), may be indicative that the activity is not being engaged in for profit. • If losses are sustained because of unforeseen or fortuitous circumstances which are beyond the control of the taxpayer, such as drought, disease, fire, theft, weather damages, other involuntary conversions, or depressed market conditions, such losses would not be an indication that the activity is not engaged in for profit. • A series of years in which net income was realized would, of course, be strong evidence that the activity is engaged in for profit.
The Amount of Occasional Profits, If Any, which Are Earned (Factor #7)	• The amount of profits in relation to the amount of losses incurred, and in relation to the amount of the taxpayer's investment and the value of the assets used in the activity, may provide useful criteria in determining the taxpayer's intent. • An occasional small profit from an activity generating large losses, or from an activity in which the taxpayer has made a large investment, would not generally be determinative that the activity is engaged in for profit. • However, substantial profit, though only occasional, would generally be indicative that an activity is engaged in for profit, where the investment or losses are comparatively small. • Moreover, an opportunity to earn a substantial ultimate profit in a highly speculative venture is ordinarily sufficient to indicate that the activity is engaged in for profit even though losses or only occasional small profits are actually generated.
The Financial Status of the Taxpayer (Factor #8)	• The fact that the taxpayer does not have substantial income or capital from sources other than the activity may indicate that an activity is engaged in for profit. • Substantial income from sources other than the activity (particularly if the losses from the activity generate substantial tax benefits) may indicate that the activity is not engaged in for profit, especially if there are personal or recreational elements involved.
Elements of Personal Pleasure or Recreation (Factor #9)	• The presence of personal motives in (the) carrying on of an activity may indicate that the activity is not engaged in for profit, especially where there are recreational or personal elements involved. • On the other hand, a profit motivation may be indicated where an activity lacks any appeal other than profit. • It is not, however, necessary that an activity be engaged in with the exclusive intention of deriving a profit or with the intention of maximizing profits. • For example, the availability of other investments which would yield a higher return, or which would be more likely to be profitable, is not evidence that an activity is not engaged in for profit. • An activity will not be treated as not engaged in for profit merely because the taxpayer has purposes or motivations other than solely to make a profit. • Also, the fact that the taxpayer derives personal pleasure from engaging in the activity is not sufficient to cause the activity to be classified as not engaged in for profit if the activity is in fact engaged in for profit as evidenced by other factors whether or not listed in this paragraph. [i.e., in Reg. Sec. 1.183-2(b)]

(Continued from page 2)

remaining assets to the dealer in exchange for his agreement to satisfy the unrelated third party creditors, the dealership became devoid of assets or liabilities. Other than the liability for the unpaid Federal excise taxes, which was not disclosed until more than a year later, all of the dealership's outstanding debts had been satisfied and the Corporation had insured that all of its debts would be paid as they became due by transferring the remainder of its assets to the dealer in a process that ensured that the dealership was solvent. Consequently, there had been no intentional fraud, and the dealership was not insolvent at the time when the dealer closed on the sale because the dealer had assumed all known debts.

The Court held that the dealer did not receive Corporate assets (i.e., the $134,000 of net sale proceeds) on the basis of his status of being a stockholder. Rather, he had received that amount in exchange for his satisfying the outstanding known debts of the dealership to unrelated parties in a transaction between himself and the dealership that did not render the dealership insolvent. As a result, the IRS was not able to use the "trust fund theory" of liability to recover the unpaid excise taxes from the dealer.

The citation for this case is *United States v. Executive Auto Haus, Inc. and Frank C. Holtham, Sr.* (6:00-cv-154-Orl-18KRS, June 2002). ✻

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