The 'Good Faith and Reasonable Cause' Defense to Penalties

Lessons from Hobby Loss Cases

By Henry Stow Lovejoy

The gold standard for a "good faith and reasonable cause" defense to a tax penalty is reliance on advice from a professional tax advisor who is informed of all the relevant facts. But recent cases that have disallowed "hobby loss" deductions for operating a horse farm demonstrate that professional tax advice is not the only way to establish good faith and reasonable cause. These cases suggest that if taxpayers are serious about an activity, they can avoid an accuracy-related penalty.

The Accuracy-Related Penalty and the Good-Faith and Reasonable Cause Defense

If the IRS determines on audit that a taxpayer has underpaid the tax due, the taxpayer may not only have to pay the additional tax and interest on the tax but also an "accuracy-related penalty." IRC section 6662 imposes a penalty equal to 20% of an underpayment of tax, if the underpayment is attributable to 1) negligence or disregard of rules or regulations, 2) a "substantial understatement of income tax," or 3) a "substantial valuation misstatement," among other items.

A taxpayer may contest the penalty by arguing that he or she was not negligent, or that there was "substantial authority" for the position that resulted in a substantial understatement of income tax, or other definitional matters set forth in the tax code and regulations. IRC section 6664 provides the more general defense to an asserted penalty. No accuracy-related penalty applies to an underpayment if it is shown that there is "reasonable cause" for the underpayment and the taxpayer acted "in good faith" with respect to the underpayment.

Treasury Regulations section 1.6664-4 puts meat on the bones of "reasonable cause and good faith." Whether a taxpayer had reasonable cause and acted in good faith is determined based on all the facts and circumstances. A familiar set of circumstances used to establish reasonable cause and good faith is reliance on professional advice. Courts have stated the requirements for good faith reasonable reliance on professional advice as follows: 1) the advisor is a competent adviser who has 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 advisor's judgment [*Neonatology Associates, P.A. et al. v. Comm'r*, 155 T.C. 43, 99 (2000), aff'd. 299 F.3d 221 (3d Cir. 2002)].

Good faith reliance on a professional, however, is just a specific example of the regulations' more general rule for reasonable cause and good faith: "The most important factor is the extent of the taxpayer's effort to assess his or her proper tax liability." One circumstance that may indicate reasonable cause and good faith is an honest misunderstanding of fact or law that is reasonable in light of the circumstances, including the experience, knowledge, and education of the taxpayer. It appears that an honest misunderstanding of the law is what relieved taxpayers of accuracy-related penalties in three recent hobby loss cases.

The Hobby Loss Rule and Determining Profit Intent

IRC section 162 allows a taxpayer to deduct all reasonable and necessary expenses in carrying on any trade or business, and IRC section 212 allows an individual taxpayer to deduct all ordinary and necessary expenses for the production or collection of income. If an individual or S corporation does not engage in an activity for profit, however, IRC section 183 limits the taxpayer's deductions from that activity to 1) deductions that would be allowable without regard to whether the activity was engaged in for profit (such as property taxes and certain interest deductions) and 2) additional deductions to the extent that the gross income from the activity exceeds the deductions allowable under the previous point. As a result, a taxpayer must show that she has engaged in an activity for profit. Because the activities for which deductions are claimed are often personal recreational pastimes, this is referred to as the *hobby loss rule*.

Whether a taxpayer has engaged in an activity for profit is a subjective determination: What was the taxpayer's intent in engaging in the activity? Taxpayers will of course say that they intended to make a profit, if it means getting the benefit of tax deductions; for this reason, the regulations instruct one to determine the intent to profit by reference to objective standards (Treasury Regulations section 1.183-2). All facts and circumstances are to be considered, but the regulations elaborate on the following nine factors that should be taken into account in determining whether a taxpayer has engaged in an activity for profit:

■ *The manner in which the taxpayer carries on the activity.* If the taxpayer carries on the activity in a businesslike manner and keeps complete and accurate books and records, it indicates the activity is engaged in for profit. A businesslike approach may be indicated by preparing a business plan and by responding to adverse results by changing in a manner consistent with an intent to improve profitability.

■ *The expertise of the taxpayer and advisors.* If the taxpayer studies and follows the accepted business, economic, or scientific practices of an activity, or consults with experts in those practices and follows their advice, a profit motive might be indicated.

■ *The time and effort expended by the taxpayer.* If a 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, a profit motive might be indicated.

■ *The expectation that assets used in the activity may appreciate.* Profit could include appreciation of assets, such as land, used in the activity; the key question is whether the asset is part of the activity.

■ *The taxpayer's success in carrying on other similar or dissimilar activities.* If the taxpayer has successfully converted other unprofitable activities to profitable ones, a profit motive might be indicated.

■ *The taxpayer's history of income or losses with respect to the activity.* Initial losses might be expected, but if losses continue beyond a reasonable startup period, there needs to be an explanation.

■ *The amount of any occasional profits earned.* The amount of profits, in comparison to the size of losses in other years and the size of the investment, could also indicate the taxpayer's intent.

■ *The taxpayer's financial status.* If a taxpayer does not have substantial income or capital from other sources, a profit motive might be indicated; on the other hand, if the taxpayer has other substantial sources of income or capital, it might not.

■ *Elements of personal pleasure or recreation.* If a taxpayer gets personal pleasure from the activity, this might indicate that the taxpayer is not engaging in the activity for profit. On the other hand, if the activity lacks any appeal other than its profit potential, it's a good indication of a profit motive.

When the IRS questions whether a taxpayer is engaged in an activity for profit, all of these factors are examined. The inquiry is very detailed and requires marshaling of much evidence. When all the facts and circumstances are considered, a taxpayer will often be found not to have a profit motive for the activity. Generally, the amount of the disallowed deductions is great enough to give rise to a substantial understatement accuracy-related penalty. But, as three recent cases show, the process of investigating the factors itself provides the facts and circumstances that support a reasonable cause and good-faith defense.

Three Horse Farm Cases

All three cases discussed below involve horse breeding or training. Raising and training horses is a quintessential hobby loss activity: it is very expensive, providing an incentive to recoup some of the cost through tax deductions, and for many it is a pleasurable and regular recreation. As a result, there are many cases on the issue.

In Rodriguez v. Comm'r (T.C. Memo 2013-221), the taxpayers were a mother and daughter who ran a horse- breeding farm in California for Swedish warmblood horses. The farm had lost money every year from 1993 through 2009, reporting more than $1.8 million of losses. Of the nine factors outlined in the regulations, the court found that eight of the factors indicated that the activity was not engaged in for profit, while one factor (success in carrying on similar or dissimilar activities) was considered neutral. Not surprisingly, the court found that the taxpayers did not carry on the activity for profit.

Having dealt at length with the deduction of losses, the court dealt quickly with the accuracy-related penalty. The IRS carried its burden of production in showing that the disallowed losses resulted in a substantial understatement of tax, but the court decided that the taxpayers established a reasonable cause and good faith defense. It found that the taxpayers "made some good-faith efforts to comply with the law, but those efforts nonetheless fell short." On the basis of the specific facts of the case, the totality of the circumstances, and the evidence presented, the court held the taxpayers not liable for a penalty. The court did not explain what specific facts and circumstances convinced it.

Mathis v. Comm'r (T.C. Memo 2013-294) concerned a cutting horse farm in Texas. A wealthy couple purchased the farm in 1995 and used it at first to train cutting horses, but in 2000 their focus shifted to breeding rather than training. The farm did not earn a profit in any year from 1996 through 2011, with the largest losses being in the years before the court, 2006 to 2008. The court found that six of the factors in the regulations weighed against the activity being carried on for profit, two (the manner in which the taxpayer carried on the activity and the time and effort expended) weighed in favor, and one factor (the taxpayer's success in other activities) of no weight. The conclusion was that the taxpayers did not engage in the activity with the requisite profit objective.

In considering the penalty, the court found that the IRS had carried its burden in demonstrating a substantial understatement of income tax. In the taxpayers' defense, the court noted that they had retained a CPA to prepare their returns, and that the accountant was familiar with the farm's history, having worked for the taxpayers since 1999. However, the court did not find that the taxpayers had a reliance on professional advice defense. Instead, it acknowledged that the taxpayers "operated the farm in a professional manner and took their activity seriously." The combination of these facts showed the taxpayers had reasonable cause and acted in good faith. *Citing Rodriguez*, the court held that no penalty was due.

In *Price v Comm'r* (T.C. Memo 2014-253), a Pennsylvania automobile dealer purchased 150 acres to use as a farm where he and his wife could breed, board, train, haul, and show half-Arabian horses. The husband also hoped to "cross-market" automobiles to horse enthusiasts. The IRS had audited the taxpayers twice before, and had concluded that the horse farm was conducted with a profit objective. On the third audit, the IRS determined that the farm was not an activity engaged in for profit, and disallowed the deduction of losses in excess of income from the farm.

The court in *Price* had to first determine whether the horse farm and the automobile dealerships were a single activity because, if so, the activity was profitable for all the years at issue. The court found that they were separate activities, and then went on to decide whether the horse farm activity was conducted for profit. It analyzed the nine factors in the regulations, finding that eight weighed against the activity being engaged in for profit, and the ninth (time and effort expended) was neutral. As a result, the court held that the horse farm was not an activity engaged in for profit.

The IRS had asserted the accuracy-related penalty for all three years in dispute. The court found that the IRS had produced sufficient evidence to show a substantial understatement for two of the three years. For the two years in which there was a substantial understatement, the court found that the taxpayers had reasonable cause and acted in good faith. Although they did not seek the advice of their accountant in taking the deductions, they "made good-faith efforts to assess their tax liability" and discussed the efforts with their accountant. The court said that the taxpayers took the horse farm "seriously." Citing *Mathis*, the court held the taxpayers not liable for the accuracy-related penalty.

Lessons

In each of these three cases, the Tax Court found that the taxpayers' horse farming was not an activity entered into for profit. The analysis of each situation was fairly clear: the taxpayers failed on at least two-thirds of the factors in the Treasury Regulations. Yet in all three cases, the Tax Court did not sustain the accuracy-related penalty. None of the taxpayers had relied on professional advice. But despite absence of professional advice, or perhaps because of the absence, each taxpayer was serious about how he or she went about the horse-farming business. That seriousness was sufficient to convince the court that the taxpayer had reasonable cause and acted in good faith. These cases teach three lessons about defending against an accuracy-related penalty.

First, the in-depth and factual nature of the inquiry into the profit objective helped the taxpayers avoid penalties. The court spent much time considering evidence regarding most of the nine factors, and in many cases it had to weigh evidence that supported a profit motive with evidence that argued against it. As a result, the court needed little or no additional information in order to determine that the taxpayer had reasonable cause and acted in good faith. The court tried to understand the taxpayers' subjective intent for purposes of IRC section 183; once it found the taxpayers' intent, it was easier to make the subjective determination that the taxpayers possessed an honest misunderstanding of the law that was reasonable in light of the circumstances.

Second, the taxpayers did not rely upon, or seek, professional advice in filing their returns. Accountants reviewed their records, understood the activities, and prepared the returns, but they did not advise the taxpayers that they could take the deduction. Indeed, if the taxpayers had sought professional advice, they may well have been advised not to take the deductions. Such advice would likely have prevented the taxpayers from claiming good faith and reasonable cause.

Finally, the cases are a reminder that there are many ways to establish a defense of reasonable cause and good faith. In these three cases, the taxpayers demonstrated that they were serious about the horse-farming business. That seriousness showed that they had made sufficient effort to determine their correct tax liability. ❑

Henry Stow Lovejoy, JD, *is of counsel to Kostelanetz & Fink, LLP, New York, N.Y.*