Schirmer v. Commissioner, 89 T. C. 292 (1987)

The court must assess whether an activity is engaged in for profit by examining the taxpayer's bona fide objective of making a profit, considering multiple factors outlined in the regulations.

Summary

In Schirmer v. Commissioner, the Tax Court ruled that the taxpayers' farming activity was not engaged in for profit, disallowing their claimed losses. The Schirmers owned a farm but did not live there, showed no income from it, and took no significant steps to improve its profitability. The court applied nine factors from the IRS regulations to determine the absence of a profit motive, leading to the disallowance of deductions and upholding of additions to tax for substantial understatement and negligence. This case highlights the importance of demonstrating a genuine profit motive to claim tax deductions for activities that could be considered hobbies.

Facts

Dolphus E. Schirmer and Mary J. Schirmer owned 554 acres of farmland in Arkansas. They did not reside on the farm and had not done so for many years. The Schirmers did not keep separate financial records for the farm and reported no income from it for the years 1978 to 1983, claiming significant losses mainly from depreciation on farm houses. The farm's value decreased over time. Dolphus spent about 2-3 days a month on farm activities, which were minimal and included no crop planting or leasing. The Schirmers consulted a county agent and commissioned a Forest Management Plan but did not follow the advice given. Their primary income came from other sources, with adjusted gross income ranging from $235,003 to $328,681 during the relevant years.

Procedural History

The Commissioner of Internal Revenue determined deficiencies in the Schirmers' federal income tax and additions to tax for the years 1981 to 1983. The Schirmers filed a petition in the U. S. Tax Court, contesting the disallowance of their farm losses and the additions to tax. The Tax Court, after considering the facts and applying the relevant regulations, ruled against the Schirmers, sustaining the Commissioner's determinations.

Issue(s)

1. Whether the Schirmers' farming activity was engaged in for profit under section 183 of the Internal Revenue Code.
2. Whether Dolphus E. Schirmer is liable for the addition to tax under section 6661(a) for substantial understatement of income tax.
3. Whether the Schirmers are liable for additions to tax under sections 6653(a)(1)

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and 6653(a)(2) for negligence.

Holding

1. No, because the Schirmers failed to demonstrate a bona fide objective of making a profit from the farm.
2. Yes, because Dolphus E. Schirmer's treatment of the farm losses lacked substantial authority and adequate disclosure on the tax return.
3. Yes, because the Schirmers' underpayment was due to negligence or intentional disregard of rules and regulations.

Court's Reasoning

The court applied the nine factors from section 1. 183-2(b) of the Income Tax Regulations to assess the Schirmers' profit motive. They noted the absence of separate books or accounts for the farm, the minimal time spent on farm activities, and the failure to follow expert advice as indicators of a lack of profit motive. The court emphasized that the Schirmers' history of losses, the farm's declining value, and the use of farm losses to offset substantial income from other sources further supported the conclusion that the farming activity was not profit-driven. The court also rejected Dolphus E. Schirmer's arguments regarding substantial authority and adequate disclosure for the section 6661(a) addition to tax, finding that the mere filing of Schedule F and Form 4562 did not constitute adequate disclosure of the controversy. Finally, the court found the Schirmers negligent in claiming deductions for an activity not engaged in for profit, thus sustaining the additions to tax under sections 6653(a)(1) and 6653(a)(2).

Practical Implications

This decision reinforces the need for taxpayers to demonstrate a clear profit motive when claiming deductions for activities that could be classified as hobbies. Legal practitioners must advise clients to maintain detailed records and follow expert advice to support a profit motive. Businesses and individuals engaging in sideline activities should be cautious in claiming losses, as the IRS may challenge such deductions. Subsequent cases have cited Schirmer to assess profit motives, emphasizing the importance of objective evidence over mere statements of intent. This ruling has influenced the practice of tax law by highlighting the scrutiny applied to hobby losses and the potential consequences of negligence in tax reporting.

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