Fishing Charter Was a Hobby, Not a Business

Cross References

- *Swanson,* T.C. Memo. 2023-81

Taxpayers are generally allowed deductions for business and investment expenses under IRC sections 162 and 212, even if the deductions exceed gross income from the activity. However, under IRC section 183, if the activity is not engaged in for profit, deductions are allowed only to the extent of gross income derived from the activity.

Hobby income and deductions are not reported on Schedule C (Form 1040). Instead, gross hobby income (less cost of goods sold) is reported on Schedule 1 of Form 1040. Expenses (up to the amount of gross income) are deductible as miscellaneous itemized deductions on Schedule A, subject to the 2% AGI limitation. For tax years 2018 through 2025, miscellaneous itemized deductions subject to the 2% AGI limitation are not deductible. Thus, for tax years 2018 through 2025, (or for any other year when the standard deduction exceeds itemized deductions), the taxpayer receives no benefit for hobby expenses, even though gross hobby income is taxable.

To be a for profit business, the expectation of a profit need not be reasonable. However, the taxpayer must conduct the activity with the actual and honest objective of making a profit.

The regulations provide a non-exhaustive list of nine factors to consider when determining whether an activity is a for-profit business.
1) The manner in which the taxpayer carries on the activity,
2) The expertise of the taxpayer or the taxpayer's 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 success of the taxpayer in carrying on other similar activities,
6) The taxpayer's history of income or loss 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) Whether elements of personal pleasure or recreation are involved.

Neither a single factor, nor the existence of even a majority of the factors is controlling. Rather, all the facts and circumstances should be evaluated.

The taxpayer in this case was an avid fisherman and has been fishing in Alaska for more than 30 years. After retiring in 2010 from two jobs (loading cargo and driving a city bus), he decided to establish a fishing charter business. He acquired a boat designed to fish for halibut.

During the years in issue, the taxpayer lived in Anchorage, Alaska, but his fishing charter activity was located in Homer, Alaska. He had relatives in Homer who allowed him to store his boat, camper, truck and other things on their property, which helped to reduce expenses. His plan was to eventually buy a cabin in Homer.

In 2015, to shorten his travel time between Anchorage and Homer, he acquired a plane. Although he wanted to use the plane to transport customers from Anchorage to Homer, he was not allowed to do that during the years in issue because he had only a student license.

The taxpayer did not own a commercial fishing permit for halibut fishing but rented one in 2015 and 2016. Because he did not have a permit for 2014, he had no fishing charter trips for that year. For 2015 and 2016, he had a combined total of 11 charter trips (with paying customers). During this time, he also took his boat out for personal fishing trips. On his personal trips, he sometimes took photographs of people catching fish for advertisements to promote his own fishing charter business.

In 2013, the taxpayer was diagnosed with cancer. In 2015, he suffered a knee injury in an automobile accident. In 2016, a boat fire took his boat out of service for a week or two. All of these unforeseen events hindered his ability to earn money from his fishing charter activity.

The taxpayer did not rely on his fishing charter activity for income. His main sources of income for the years in issue were Social Security, a pension, and rental income from two real estate properties. He did not use a separate bank account for his fishing charter activity.

During the years in issue, the taxpayer traveled to several trade shows hoping to attract customers. However, he was not able to land any customers from these shows.

The IRS audited his 2014, 2015, and 2016 tax returns and disallowed all deductions from his fishing charter activity that exceeded gross income. The taxpayer took the case to the Tax Court claiming that he should be allowed to deduct his losses. The court considered the above nine factors in determining whether or not the fishing charter activity was a for-profit business.

1) The manner in which the taxpayer carries on the activity. Carrying on an activity in a businesslike manner includes maintaining complete and accurate books and records, conducting the activity in a manner similar to other activities of the same nature that are profitable, and making changes in operations to adopt new techniques or abandon unprofitable methods. An important indication of whether an activity is being performed in a businesslike manner is whether the taxpayer implements methods for controlling losses, including efforts to reduce expenses and generate income.

For IRC section 183 purposes, the key question is not whether the taxpayer keeps records, but whether the taxpayer uses his or her records to improve profitability and take steps to control expenses and increase income.

The taxpayer kept various receipts for tax purposes that he would give to his accountant at the end of the year to prepare his tax return. He did not have a separate bank account for the fishing charter activity. Instead, he used Square, an application used to track business income and expenses. He did not explain to the court how he used the data about his income and expenses to make his activity profitable. Neither did he keep complete records. The court stated his maintenance of receipts of various expenses is insufficient.

The court also stated it was skeptical about the accuracy of his income tracking using the Square app. The IRS performed a bank deposits analysis on the taxpayer and demonstrated to the court significant discrepancies between his reported income and his deposits into his bank account.

The taxpayer did not have a business plan and made no significant changes to reduce expenses and generate income the entire time he operated his fishing charter activity.

The taxpayer argued that he did make changes by obtaining a fishing license and commercial insurance, he started using Square, and he engaged in advertising with the Chamber of Commerce. He also attended trade shows hoping eventually to land new clients.

The court stated some of these changes had nothing to do with increasing profitability or reducing expenses but instead were necessary to comply with applicable laws and regulations. And during the three years in issue when the taxpayer only had 11 fishing charter trips, he purchased an airplane and incurred significant expenses related to storing, maintaining, and operating it. Over the seven years of operating the fishing charter activity, the taxpayer never made changes that enhanced his prospect for making a profit.

The court stated this factor weighs against the taxpayer.

2) The expertise of the taxpayer or the taxpayer's advisers. The court stated it does not doubt that the taxpayer is an expert fisherman. But he did not demonstrate that he had any expertise in running a business, much less a fishing charter business.

When he first started, he did not have a commercial fishing license or commercial insurance. He did not demonstrate to the court how he prepared for running a fishing charter business, whether he did any research or study, or whether he consulted with experts or received any other advice about operating a fishing charter business.

He joined the Chamber of Commerce, but did not explain whether or how it better equipped him to run a profitable fishing charter business. He testified only that he viewed it as another avenue for advertising.

The court stated this factor weighs against the taxpayer.

3) The time and effort expended by the taxpayer in carrying on the activity. The taxpayer did not have any charter fishing trips in 2014. He had only five trips in 2015 and six trips in 2016. He testified that health issues restricted his physical activities in 2013 but did not indicate how his health problems affected his activities in the years in issue. Rather, the main reason he did not take any fishing trips in 2014 was that he did not have a commercial fishing license or commercial insurance. And he did not explain why he had only 11 trips in 2015 and 2016.

The court stated the limited time he spent on fishing charter trips in the years in issue is a factor that weighs against the taxpayer.

4) The expectation that assets used in the activity may appreciate in value. This factor was not addressed during the trial and so it is neutral.

5) The success of the taxpayer in carrying on other similar activities. The IRS testified that the taxpayer was engaged in the management of rental properties which also generated losses for all years in issue. The court stated this factor weighs against the taxpayer.

6) The taxpayer's history of income or loss with respect to the activity. While a series of losses during the startup stage of an activity may not necessarily indicate a lack of a profit motive, a record of large losses over many years is persuasive evidence that a taxpayer does not have a profit motive.

The taxpayer started his fishing charter activity in 2010 and experienced a loss for every year through 2016. Over the course of these seven years, he reported more than $130,000 in losses. The taxpayer contended that unforeseen circumstances caused him to experience losses.

The court stated it sympathizes with the taxpayer's setbacks, but does not think that those issues were the main reason his fishing charter activity was unprofitable.

The taxpayer testified that despite his health problems he was able to perform the duties of a boat captain and that he did not have to travel for medical treatments during the years in issue. The 2015 automobile accident also did not keep him from performing his fishing charter activity. Despite the accident, he was able to work that season.

The boat fire in 2016 interrupted his fishing charter activity for only a week or two, the time it took to make the necessary repairs.

The court stated continuous and significant losses indicates a lack of a profit motive, and this factor weighs against the taxpayer.

7) The amount of occasional profits, if any, which are earned. The fishing charter activity experienced losses for the seven years from its launch through the years in issue. This factor weighs against the taxpayer.

8) The financial status of the taxpayer. The taxpayer did not rely on income from the fishing charter activity as his main source of income, although he hoped that one day he would. He received income from a retirement pension, Social Security retirement, and rental properties. He used his purported losses from the fishing charter activity to reduce his income from other sources.

The court stated this factor weighs against the taxpayer.

9) Whether elements of personal pleasure or recreation are involved. The presence of personal motives for conducting an activity may indicate lack of profit objective, especially if the activity involves personal or recreational aspects. An activity is not classified as a hobby simply because the taxpayer finds it pleasurable. The analysis of this factor does not require that the activity be engaged in with the exclusive intent of deriving a profit or even maximizing profit. That said, where the possibility for profit is small, and the possibility for gratification is substantial, it is clear that the latter possibility constitutes the primary motivation for the activity.

The court stated it has no doubt that the taxpayer finds fishing pleasurable. The taxpayer used his boat for personal fishing trips. He could not adequately explain the number of times that he had to refuel the boat that had no corresponding charter booking. In addition, the taxpayer testified that his retirement plan has been to retire to Homer and fish.

The court stated the taxpayer's personal motives and the recreational or personal aspects of his fishing charter activity outweighed his desire for profit. This factor weighs against the taxpayer.

Conclusion. The court stated that while the taxpayer credibly testified about the time he spent on his fishing charter activity and the obstacles he faced, he did not demonstrate that it was more than just a retirement hobby. Considering the evidence as a whole, the court stated that although the taxpayer wanted his fishing charter activity to succeed and he devoted time to it, he was not operating it as a for-profit business. Consequently, he is entitled to deductions attributable to that activity only to the extent allowed by IRC section 183.