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A Blend of Old Wines in a New Wineskin: Section 183 and Beyond

JOHN W. LEE *

Introduction

A TAX problem of long standing has been the practice of using losses from an operation to offset other income, primarily either to enjoy a "hobby," partially at the expense of the federal fisc, or for the tax shelter provided by the losses, but in either event not primarily to carry on the venture as a business at a before-tax profit. New section 183, enacted by the Tax Reform Act of 1969 to disallow certain tax deductions attributable to "an activity not engaged in for profit," is but the latest government remedy provided for this problem.

Section 270—which, wherever an individual's losses from a trade or business exceeded its gross income by \$50,000 for each of five consecutive years, disallowed the excess losses for all five years—was the largely ineffective statutory predecessor to section 183. Its inefficacy was due to (1) the frequent taxpayer ability to slightly rearrange income and deductions in order to break the five year string of losses and (2) the fact that specially treated deductions, often comprising the bulk of losses in the initial years of a farm venture, were excluded from the \$50,000 loss computation.¹ The government had scored more, but not spectacular, success with the judicially fashioned doctrine that a taxpayer must have an intention to make a profit from the operation in order to deduct his losses under either section 162 or 212. The rationale for the doctrine was that the definition of "trade or business" under section 162 is limited to "that which occupies

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¹ S. REP. NO. 91-552, 91st Cong., 1st Sess. 103 (1969). See *Sonnabend v. Comm'r*, 377 F.2d 42 (1st Cir. 1967); *Welder v. United States*, 329 F. Supp. 739 (S.D. Tex. 1971), *aff'd per curiam*, 72-2 U.S.T.C. ¶ 9628 (5th Cir. 1972).

the time, attention, and labor of men for the purpose of livelihood or *profit*”² and the section 212 standard of “production or collection of income” is similarly limited to an individual’s “profit-seeking activities.”³ An alternative, more recent, approach has been the contention that where profit lay far in the future the activities were merely preparatory to engaging in a trade or business and were akin to amassing capital assets to commence a business.

A similar tax problem, farmer utilization of special farm tax accounting rules to currently deduct from nonfarm income the developmental costs of raising a farm commodity to a productive state and then disposing of it at capital gain rates, initially caught the administrative and legislative attention that ultimately resulted in the enactment of section 183 as well as section 1251 and other provisions.⁴ A review of the legislative history resulting in section 183 is necessary to fully appreciate it and, particularly, to understand the course taken by the extensive section 183 regulations.

LEGISLATIVE HISTORY

The Treasury Department Tax Reform Studies and Proposals, released in February 1969, noted that section 270, which of course applied to all individual businesses, did not curb the farm tax problem and proposed that if a farmer did not elect to give up the favorable farm tax accounting rules in question, only \$15,000 of his farm losses could be deducted against nonfarm income, with a carryforward and carryback of the disallowed portions.⁵ The allowance of the first \$15,000 of loss was designed to exclude from the proposal bona fide farmers who supplemented their farm income with part-time or off-season employment. Thus, the two themes of these proposals were curbing the tax shelter abuse of farm tax accounting methods by farmers with substantial nonfarm income, while leaving the bona fide farmer as he was.

The Nixon tax reform proposals, delivered two months later,

² *Flint v. Stone Tracy Co.*, 220 U.S. 107, 171 (1911), quoting from 1 *BOUVIER'S LAW DICTIONARY* 273 (2d ed. 1897).

³ *United States v. Gilmore*, 372 U.S. 39 (1963).

⁴ U.S. TREASURY DEP'T TAX REFORM STUDIES AND PROPOSALS (PART I), 91ST CONG., 1ST SESS. (Comm. Print 1969).

⁵ *Id.* at 156-57.

turned the proposed disallowance provision into a quasi-recapture provision—"excess" farm losses were not disallowed but were instead "placed" in an excess deduction account (EDA) which converted any subsequent capital gain associated with the sale of the farm or of farm assets into ordinary income to the extent of the balance of the EDA. In addition, the administration proposed to strengthen section 270 by disallowing losses in excess of \$50,000 if they exceeded \$50,000 in any three out of five consecutive years.⁶ Only the latter proposal is the direct antecedent to section 183—the former became section 1251.

The House Committee on Ways and Means also recognized that section 270 had been ineffectual, but noted courts had fashioned another basis for disallowing hobby losses under sections 162 and 212 which allow deductions of ordinary and necessary expenses incurred in a trade or business or for the production of income: "[T]hat the activity carried on by the taxpayer from which the loss results is not a business but merely a hobby. Your committee believes that this basic principle provides a more effective and reasonable basis for distinguishing situations where taxpayers are not carrying on a business to realize a profit, *but rather are merely attempting to utilize the losses from the operation to offset their other income.*"⁷

The House Committee on Ways and Means therefore proposed, in August 1969, to replace old section 270 with a new section 270 which would have provided that if deductions from an activity exceeded its gross income by more than \$25,000 in any three out of five years, the activity would be rebuttably presumed to be not operated "with a reasonable expectation of profit," resulting in a disallowance of all business deduction losses attributable to the activity in excess of its gross income. Thus, the administration's section 270 test was amalgamated with the judicial profit motive test, probably effecting a synergism which would have been stronger than both considered separately. As under old section 270, the losses were to be determined separately as to each activity carried on by the taxpayer.

In September 1969 the Treasury recommended that the House provision be amended to clarify that the reasonably anticipated profit must be an economic profit, not a "tax savings" profit, and such profit need not be determined on an annual basis. Other

⁶ *Id.* at 52-54 (Message from the President of April 21, 1969, presented by Representatives of the Treasury Department).

⁷ H.R. REP. NO. 91-413 (Part I), 91st Cong., 1st Sess. 71 (1969) (emphasis added).

technical amendments, probably covered by the proposed statute or committee report, were suggested as well.⁸

The Senate Committee on Finance declared in late November 1969 that it was in basic agreement with the House approach, but was concerned that a "reasonable expectation" of profit standard—prior cases had split as to whether such an expectation must be present or whether merely a bona fide intent to make a profit was sufficient⁹—might cause losses of an activity actually engaged in for profit to be disallowed. Therefore, it modified the House provision, placing the focus on:

[w]hether the activity is engaged in for profit rather than whether it is carried on with a reasonable expectation of profit.

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In making the determination of whether an activity is not engaged in for profit, the committee intends that an objective rather than a subjective approach is to be employed. Thus, although a reasonable expectation of profit is not to be required, the facts and circumstances (without regard to the taxpayer's subjective intent) would have to indicate that the taxpayer entered the activity, or continued the activity, with the objective of making a profit.¹⁰

The most significant Senate Committee on Finance change, however, was the reversal of the presumption: A taxpayer is presumed to be engaged in an activity for profit for a taxable year, unless established otherwise by the government, if, in two or more years of the five year period ending with the tax year, the activity was carried on at a profit. With this, section 183 was reduced to a codification of the judicial test where the presumption was not applicable and a pro-taxpayer provision where it was applicable—a far cry from the administration and House proposals. The regulations specify that no inference that the activity is not engaged in for profit is to arise from failure to meet the presumption.¹¹

⁸ Deductions allowable under the Code without regard to whether incurred in a trade or business or for the production of income would be deductible even if incurred in an activity not engaged in for profit. Deductions (other than the above) would be allowable to a proper extent where income is realized from an activity not engaged in for profit. TAX REFORM ACT OF 1969, TECHNICAL MEMORANDUM OF TREASURY POSITION ON H.R. 13270, 91ST CONG., 1ST SESS. 35-36 (Comm. Print 1969). The bill provided: "[I]tems attributable to an activity shall be allowed only to the extent of the gross income from such activity unless such activity is carried on with a reasonable expectation of realizing a profit." H.R. 13270, 91st Cong., 1st Sess. § 213(a) (1969).

⁹ Compare *Blackmon v. United States*, 68-2 U.S.T.C. ¶ 9655 (N.D. Tex. 1968); with *Patterson v. United States*, 459 F.2d 487 (Ct. Cl. 1972).

¹⁰ S. REP. NO. 91-552, 91st Cong., 1st Sess. 103-04 (1969).

¹¹ Reg. § 1.183-1(a). Practitioners had been concerned that agents would create a negative inference à la the House approach in such circumstances.

In addition, the Senate Committee on Finance basically followed the Treasury's technical suggestions as to (1) continuing to permit deductions allowable without regard to whether they were incurred in a trade or business or for the production of income (the standards under sections 162, 167 and 212) such as interest, taxes and capital gain deductions, and (2) allowing deductions of business or production of income expenses in an activity not engaged in for profit to the extent of gross income from the activity, reduced by deductions under (1) above, but made no reference to the "economic" profit or nonannual basis of determining profit concepts.

The Senate Committee on Finance was concerned that new section 183 (section 270 was repealed for tax years beginning after December 31, 1969) might not be administered reasonably and recommended that the Treasury establish two advisory groups drawn from the cattle and horse industries to aid the Service in establishing standards for its application of section 183 in order to achieve reasonable results and to resolve policy questions in such application from time to time, which the Treasury indicated it was willing to do and, in fact, has done. A Senate Committee on Finance news release announced:

These advisory groups would be composed of industry experts and would examine and recommend action to the Service with respect to cases involving their industries. *This action would precede disallowance by the Internal Revenue Service of deductions of losses under this provision.* This would assure taxpayers of a high level review of their cases by responsible representatives of their industry. This intent will be repeated in the Committee reports and the tax reform bill.¹²

Such intent is apparently reflected in a considerably diluted version by the Senate Committee on Finance print statement of November 21, 1969 that the establishment of the advisory groups "Should help limit the disallowance by the Internal Revenue Service of the deduction of losses under this provision to cases where it is generally recognized that this is appropriate."¹³

The Service news releases announcing the formation of the two advisory committees indicate that in the eyes of the Commissioner the role of the committees was to be purely advisory and was to relate to (1) the early development of policies and (2) proposed administrative guidelines and proposed revenue

¹² Committee on Finance, United States Senate Press Release No. 31 (October 17, 1969) (emphasis added).

¹³ S. REP. NO. 91-552, 91st Cong., 1st Sess. 103-04 (1969).

rulings.¹⁴ The committees contributed to the drafting of the proposed section 183 regulations,¹⁵ but it does not appear that the Service contemplates review of specific cases before 90 day letters can be issued assessing a deficiency in taxes due to a disallowance by virtue of section 183 of deductions.

In essence, section 183 codifies the profit motivation case law approach, with legislative rejection of the reasonable expectation of profit and subjective approaches, in sections 183(a) and (c). Section 183(c) specifically adopts a netting approach (allowance of deductions up to the amount of gross income), followed by most decisions, with the significant addition of a tier system by which such gross income deduction is reduced first by deductions not within the purview of section 183. The positive presumption is set forth in section 183(d) and rules for its application are contained in section 183(e) (added by the Revenue Act of 1971).

Comprehensive proposed regulations were issued under section 183 in August 1971¹⁶ and moderately modified final regulations were promulgated in July 1972.¹⁷ While the drafters of the netting and positive presumption provisions of these regulations declined in the first instance to follow the Senate Committee on Finance report statements and in the second to follow the literal words of the statute on point,¹⁸ the regulations appear to reach the correct results here and are unlikely to be successfully challenged in litigation. The paragraphs dealing with the definition of activity and the manner in which the determination whether an activity is engaged in for profit is to be made (including nine nonexclusive objective factors), on the other hand, contain quite controversial elements and may generate considerable litigation. The activity paragraphs are largely patterned after developments under section 270 and appear shaped in some aspects by the

¹⁴ I.R. 1075 (Oct. 30, 1970), reprinted in MERTENS, *LAW OF FEDERAL INCOME TAXATION*, 1969-71 RULINGS, Miscellaneous Announcements 159.

¹⁵ See Thrower, *Recent Developments in Federal Income Taxation*, 21 *TUL. TAX INST.* 1, 23 (1972); Oshins, *Proposed Regulations Provide New Rules for the Hobby Loss Game*, 35 *J. TAXATION* 214, 215 n.9 (1971). The latter author was the attorney-advisor in the Office of Tax Legislative Counsel, United States Treasury Department, at the time the proposed regulations were issued and appears to have been responsible for drafting them. BITTKER & STONE, *FEDERAL INCOME, ESTATE AND GIFT TAXATION* 236 (4th ed. 1972).

¹⁶ Prop. Reg. § 1.183, 36 *Fed. Reg.* 16112 (Aug. 19, 1971).

¹⁷ Reg. § 1.183.

¹⁸ See Oshins, *Proposed Regulations Provide New Rules for the Hobby Loss Game*, 35 *J. TAXATION* 214, 217 (1971), for an excellent discussion justifying the positions taken by the regulations.

genesis of section 183 in the use of farm accounting rules to enjoy current ordinary deductions at a favorable tax cost of future capital gain appreciation in the farm product or farmland itself. The "objective factors" provisions are derived principally from the farm loss section 162 and section 212 profit motive decisions. Here again the origin of section 183 in attention on deduction by high bracket taxpayers of farm losses against non-farm income, together with concern for the lower bracket or marginal farmers, have strongly influenced the emphasis of this portion of the regulations, particularly in the examples illustrating the nine factors. Significant also are two topics the final regulations do not expressly consider: (1) the definition of profit and (2) the preparatory to engaging in a trade or business and similar arguments frequently applied in the alternative to the profit motive test to activities.

Applicability

The statute provides that section 183 is applicable to individuals and subchapter S corporations.¹⁹ The regulations add estates and trusts to the reach of section 183 under the express rationale that their taxable income is computed in the same manner as that of an individual with certain minor exceptions.²⁰ Both the regulations and the statute are silent as to partnerships and partners. Since section 270, by its terms, applies only to individuals and the partnership regulations provide that each partner must take into income his distributive share of partnership "hobby losses" under section 270, it appears clear that section 183 can affect a partner as well.²¹ The Senate Committee on Finance report states that no inference is to be drawn from the decision not to include regular corporations in the coverage under section 183 as to whether any activity of a corporation constitutes a business or is engaged in for profit. The articulated justification is that individuals primarily enter into an activity to obtain a loss in order to offset other income and that coverage of regular corporations would present a number of difficulties, such as its effect on shared facilities provided on a cost basis.²² The provision in the regulations that no inference is to be drawn from

¹⁹ I.R.C. § 183(a).

²⁰ Reg. § 1.183-1(a).

²¹ Reg. § 1.702-1(a)(8)(ii); BITTKER & EUSTICE, *FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS* 1-26 (3d ed. 1971).

²² S. REP. NO. 91-552, 91st Cong., 1st Sess. 104 (1969).

the provisions of section 183 and the regulations thereunder that any activity of a regular corporation is or is not a business or is engaged in for profit is probably intended to have no broader import than the committee report reference, but is capable of the construction that the nine factors for determining profit motive could not be used by analogy or as a codification of prior judicial factors in applying the section 162 profit motive test to a regular corporation.

Section 183 is to be applied at the corporate level in determining allowable deductions of a subchapter S corporation according to the regulations.²³ Presumably this means it is the corporate motive for engaging in the activity and not the shareholder's motive that is determinative. A similar question arises as to whether motive for engaging in the activity is to be determined at the partnership or partner level. Commentators generally agree that character of income is determined at the partnership level retaining such character, *e.g.*, capital gain or section 270 hobby loss, in the hands of the partner.²⁴ Arguably character encompasses motive. Indeed, the Service has ruled: "The purposes for which the partnership incurs any indebtedness shall be attributed to the general partners in applying section 265(2)." ²⁵ However, a limited partnership interest is considered by this revenue procedure to constitute a portfolio investment, which gives rise to an inference of a purpose by the limited partner to carry tax-exempt obligations, regardless of the actual purpose of the partnership in incurring the indebtedness.²⁶ Nevertheless, following the character of income rules, profit motive for section 183 should be determined at the partnership level with no distinction between limited and general partnerships.

Presumption

An activity is rebuttably presumed under section 183(d) to be engaged in for profit for a taxable year if its gross income for

²³ Reg. § 1.183-1(f).

²⁴ Reg. § 1.702-1(b). See, *e.g.*, Wolfman, *Level for Determining Character of Partnership Income—"Entity" v. "Conduit" Principle in Partnership Taxation*, 19 N.Y.U. INST. 287, 290-92 (1961). Lee, *Operating Expenses and Section 174: Will Snow Fall?*, 27 TAX LAWYER 381, 405-09 (1974).

²⁵ Rev. Proc. 72-18, 1972-1 C.B. 740, 742 § 4.05.

²⁶ *Id.* at § 4.04. Such distinction appears inconsistent with George A. Butler, 36 T.C. 1097, 1106 (1961) (partnership business imputed to limited partner). But see Young, *Income Tax Consequences of Investment Losses of Individuals*, 27 TAX L. REV. 1, 27-28 (1971).

two or more of the taxable years in the five consecutive year period ending with such year (seven year period in the case of an activity consisting in major part of horse breeding, training, showing or racing) exceeds the "deductions attributable to such activity (determined without regard to whether or not such activity is engaged in for profit)." The near identity of the parenthetical language to that of section 183(b)(1) where "deductions which would be allowable . . . without regard to whether or not such activity is engaged in for profit" means deductions that do not require a profit motive to be deductible (tier 1 deductions), such as interest or taxes, lends itself to the construction that gross income from the activity need only exceed the tier 1 deductions in two out of five consecutive years for the presumption to apply. Congress probably meant to say gross income exceeds the deductions attributable to the activity determined as if the activity were engaged in for profit.²⁷ The Senate Committee on Finance almost left the impression that gross income had only to exceed tier 2 and tier 3 deductions (deductions allowable only if the activity is engaged in for profit), but ended on the note that for the purposes of the presumption all deductions attributable to the activity other than the net operating loss deduction are to be taken into account.²⁸ Seizing upon the ambiguity created by the inconsistency between the statute and the committee print, the drafters of the regulations followed the latter. The choice is correct; otherwise the presumption would be of little worth and undoubtedly would easily be rebutted. The statutory construction offered in support of the drafters' choice is, however, quite intriguing.

The analysis is as follows: The language in Section 183(d) speaks of "deductions *attributable*" to the activity while the language in Section 183(b) (1) refers to "deductions which would be *allowable*." The term "deductions attributable" found in Section 183(d) is also found in Section 183(a). The reasoning continues that since Section 183(a) states that "no deduction attributable to such activity shall be allowed" the term "deduction attributable" includes both deductions allowed and disallowed and as such is broader and encompasses more than "deductions allowable" as used in Section 183(b). Accordingly, the draftsmen decided to adopt the same meaning of "deductions attributable" for both Sections 183(a) and 183(d).²⁹

²⁷ Comment, *Section 183: Work Horse or Hobby Loss*, 20 CATHOLIC U.L. REV. 716, 731 (1971).

²⁸ S. REP. NO. 91-552, 91st Cong., 1st Sess. 104-05 (1969).

²⁹ Oshins, *Proposed Regulations Provide New Rules for the Hobby Loss Game*, 35 J. TAXATION 214, 217 (1971).

The draftsmen did not follow the surface import of the committee print statement that all deductions attributable to the activity except the net operating loss deduction were to be taken into account in applying the presumption. They added that for the purposes of the presumption determination, the section 1202 deduction was not to be taken into account. Apparently the drafters followed the reasoning of an early commentator on section 183 who pointed out that (1) under section 270 the Service had ruled that the 50 per cent gain deduction under section 1202 did not constitute a deduction "attributable to a trade or business" carried on by an individual for the five year \$50,000 test and (2) activity under section 183 is to be determined by the scope of the term "trade or business" under section 270.³⁰

The regulations provide that the five or seven year presumption period begins with the first profit year and the positive presumption applies with respect to the second profit year and all years subsequent to the second profit year.³¹ Thus, if in the period from 1970 through 1975 the only profit years were 1971 and 1974, the presumption would apply to 1974 and 1975 only. This was probably not the original intent of Congress but is supported by the literal language of section 183(d) in another of the drafting infelicities in which section 183 abounds. For the legislative history to section 183(e) (enacted by the Revenue Act of 1971) reveals that it had come to the attention of the committee that if the period ending with the current tax year did not include a profit year, the taxpayer was not being allowed to use the presumption, even though at that time there were not five (or seven) consecutive years in which to measure the presumption. "The committee believes that this interpretation does not reflect the intent of Congress in originally adopting this provision."³² Of course, under the regulations years prior to the two profit years could never receive the benefit of the presumption even if there were at that time five years in which to measure the presumption.

³⁰ Comment, *Section 183: Work Horse or Hobby Loss*, 20 CATHOLIC U.L. REV. 716, 729 (1971). This excellent article highlights a number of problems created by section 183 and appears to have been frequently relied upon by the draftsmen of the regulations in addressing them.

³¹ Reg. § 1.183-1(c). Literally section 183(d) would limit the presumption to the fifth or seventh year. Consequently, its extension by the regulation to the second profit year (which may be earlier than the fifth year) may be viewed as a departure from the statute. Carey & Gallagher, *Requisite Grace: The Section 183 Regulations*, 19 LOYOLA L. REV. 41, 61-62 (1973).

³² S. REP. NO. 92-437, 92d Cong., 1st Sess. 74 (1969).

The regulation result appears required by section 183(d) since it provides for a presumption only as to a taxable year which ends a five or seven year period in which two years were profitable. Rather than amending section 183(d) to conform with what Congress originally intended (all years in the five or seven year period receive the benefit of the presumption), section 183(e) was enacted. It provides that a taxpayer may elect that the section 183(d) presumption not be made before the end of the fourth (or sixth) year following the year in which the taxpayer first engages in the activity. If such election is made and two years in the five (or seven) year period beginning with the first year in which the taxpayer engaged in the activity are profitable, the presumption provided by section 183(d) applies to *all* five or seven years. In reality, this constitutes a new section 183(e) presumption. Under section 183(e) the presumption in the above hypothetical would apply to 1970 through 1974. If the taxpayer is able to apply the presumption under section 183(d) to 1975 as well, he will have been able to use the same two profit years to create presumptions extending to six years.

The regulations provide that the section 183(d) presumption arises only if the activity is substantially the same activity during each of the relevant taxable years, including the tax year in question.³³ This requirement undoubtedly extends to section 183(e) as well. According to an example in the regulations an activity can continue to qualify as the same activity although conducted on a much reduced basis and in a different manner.³⁴ This test is probably more liberal than the substantially the same trade or business prerequisite of section 382(a) as explicated by the accompanying regulations.

The regulations also state that in applying the presumption under section 183(d) only tax years beginning after December 31, 1969, are to be taken into account. Thus, they conclude that section 183(d) does not apply prior to the second profitable year beginning after December 31, 1969. Most commentators would agree that the position taken in the regulations—pre-1970 profit years cannot be used for the presumption—is correct.³⁵ For the Senate Committee on Finance report, in discussing the effective

³³ Reg. § 1.183-1(c)(1)(ii).

³⁴ Reg. § 1.183-1(c)(2) Ex. (2)(ii).

³⁵ Comment, *Section 183: Work Horse or Hobby Loss*, 20 CATHOLIC U.L. REV. 716, 730-31 (1971); Oshins, *Proposed Regulations Provide New Rules for the Hobby Loss Game*, 35 J. TAXATION 214, 218 (1971); Rhodes, *Hobby Losses—A New Challenge*, 56 A.B.A.J. 893, 896 (1970).

date for section 183, stated that while the general effective date was to be December 31, 1969,³⁶ in applying the presumption section 183 would be applicable to prior taxable years, but the conference committee declared it was following all the Senate amendments to the House version of section 183 "except for the effective date relating to the presumption."³⁷ Against this clear legislative history several commentators have argued pre-1970 profit can be used for the presumption because the conference committee "deleted" the Senate Committee on Finance reference "probably because it was considered superfluous," accordingly, with no express reference in the statute the plain meaning permits reference to pre-1970 profit years.³⁸ This reasoning is in error because the conference committee did not delete the Senate reference, it rejected it.

The literal language of section 183(d) suggests—and is corroborated by the legislative history of section 183(e)—that the first year to which the section 183(d) presumption can apply is the fifth year of the activity, even if the first two years are profit years. Assume then that the first year which an activity was engaged in was 1967 and the first and second profit years were 1970 and 1971. The draftsman of the section 183 regulations has written that in drafting the regulations it was decided to avoid the result that pre-1970 years could not even be used for purposes of aggregating the five or seven year period.³⁹ Therefore, one must conclude that the regulation statement that only post-1969 years are to be taken into account in applying the section 183(d) presumption was intended to apply only to the two profitable years requirement and not to the five year requirement. The five year prerequisite itself is surely another drafting error; Congress could not have intended that if the first two years of an activity were profitable the presumption would only apply to the fifth year. In any event all of these problems are rendered academic if the section 183(e) election is made.

Indeed, both presumptions are rather superfluous. We are told by the regulations that if a taxpayer does not meet the requirements of section 183(d) "no inference that the activity

³⁶ S. REP. NO. 91-552, 91st Cong., 1st Sess. 105 (1969).

³⁷ CONF. REP. NO. 91-782, 91st Cong., 1st Sess. 299 (1969).

³⁸ Sharpe, *New "Hobby Loss" Rule Is Tougher But "Engaged in for Profit" Dilemma Remains*, 32 J. TAXATION 289, 290 (1970); DICKINSON, *FARM AND RANCH LOSSES*, BNA TAX MANAGEMENT PORTFOLIO NO. 241, A-21 n.151 (1970).

³⁹ Oshins, *Proposed Regulations Provide New Rules for the Hobby Loss Game*, 35 J. TAXATION 214, 218 (1971).

is not engaged in for profit shall arise by reason of the provisions of section 183.”⁴⁰ Presumably this means section 183 should be applied as if section 183(d) did not exist and does not mean no inference can be drawn (independently) from the nine regulation factors for determining profit motive. On the other hand, in most of the reported decisions in which there were some profit years present the taxpayer won even where section 183(d) would not have resulted in the favorable presumption. Likely the significance of this provision will lie in the Service not pursuing the controversies, probably few, to which the presumption will apply. Most cases will turn on the nine factors and tax planning should be of more avail there than in attempting to juggle income and deductions to meet the presumption.

Deductions Allowable: The Tier System

The regulations under section 162 treating farm deductions applicable to pre-1970 tax years provided that if a farm were operated primarily for recreation or pleasure and its expenses exceeded its receipts, the entire receipts were to be ignored in reporting income and the expenses incurred since personal would not be deductible.⁴¹ On the other hand, the regulations under section 212 were silent on this point. It has been suggested that by virtue of section 262 the Service could have disallowed the entire amount of the deductions while taxing all the gross receipts, but administratively allowed taxpayers to deduct expenses up to the income generated in the activity. Apparently the rationale was either that the taxpayer was engaged in the activity for profit to the extent income was earned or that the harshness of taxing gross income without permitting *pro tanto* deductions was unfair.⁴² Although in at least one reported decision the Commissioner did disallow all of the deductions of an activity not engaged in for profit while at the same time not taxing any of the gross receipts from the activity,⁴³ in most of the decisions in which “netting” takes place the Service merely disallowed the

⁴⁰ Reg. § 1.183-1(c)(1)(ii).

⁴¹ Reg. § 1.162-12(b).

⁴² Oshins, *Proposed Regulations Provide New Rules for the Hobby Loss Game*, 35 J. TAXATION 214, 215 (1971). But cf. *Adirondack League Club*, 55 T.C. 796, 819-20 (1971), *aff'd per curiam*, 458 F.2d 506 (2d Cir. 1972) (concurring opinion; question left open whether corporation that is not carrying on a trade or business as to recreational facilities is permitted to deduct expenses to extent of gross income or denied any deduction at all).

⁴³ *Bertha R. Conyngham*, 23 T.C.M. 1179 (1964).

net losses from the activity.⁴⁴ The majority of the netting cases holding for the government did not comment on this aspect. In *Ernst H. Martin*,⁴⁵ however, the Tax Court held in the context of a yacht chartering activity which it had determined was not profit motivated that where there is taxable income the taxpayer is entitled under section 212 to deduct expenses paid or incurred for the production of that income. While this rationale has surface appeal, it overlooks the basic principle that the expenses should first be allocated between the income producing and personal uses and only then would deduction of the amount attributable to the income producing use be permitted up the amount of gross income—in some instances the gross income might exceed the so allocated expenses. In another controversy the Tax Court held that a trade or business existed to the extent of the actual income from the activity.⁴⁶ In *T. Gardner Hill*, where the Commissioner had disallowed net losses only, the Tax Court in contrast turned this factor against the Service.

Our first observation is why, if respondent feels there was no separate business engagement, he did not disallow all of the claimed business expenses. Surely they should all be disallowed as personal expenses under section 262 if petitioner was not engaged in an independent business. Respondent's determination practically admits petitioner carried on a separate business yet his first argument on brief is that he did not.⁴⁷

Yet where the taxpayer in *Five Lakes Outing Club v. United States*⁴⁸ raised a similar argument (to find a profit motive essential to deductibility is to hold that the Service cannot allow deduction of a social club's expenses in operating its nonprofit recreational program even to the amount of club revenues), the Eighth Circuit's immediate reply was that one should not look a gift horse in the mouth, but then in a more serious vein it adopted the rationale that the income producing activities for tax purposes were to be considered as separate from the social activities.

⁴⁴ *E.g.*, *Mitchell v. United States*, 70-1 U.S.T.C. ¶ 9129 (W.D. Tenn. 1969); *V.H. Monette & Co.*, 45 T.C. 15, 41, 44 (1965), *aff'd per curiam*, 374 F.2d 116 (4th Cir. 1967); *Harold I. Snyder*, 25 T.C.M. 1326 (1966).

⁴⁵ 50 T.C. 341, 364-65 (1968), *acq.*

⁴⁶ *Richard L. Westerman*, 55 T.C. 478, 481 n.5 (1970).

⁴⁷ 22 T.C.M. 1056, 1060 (1963).

⁴⁸ 468 F.2d 443, 446 (8th Cir. 1972). Although there were income producing activities apart from the recreational activities, the recreational activities themselves produced considerable income (\$13,380.49) and the Service ruled that the recreational expenses (\$24,234.80) could be deducted to extent of such income.

It is not surprising in view of the uncertainties in this area that when the House proposal did not address netting the Treasury recommended clarifying amendments.

It should also be made clear that those deductions which are allowable under the Code without regard to whether they are incurred in a trade or business or for the production of income, such as interest and certain state and local taxes, will continue to be deductible even where incurred in an activity not engaged in for profit. Similarly, it should be made clear that deductions incurred in an activity not engaged in for profit (other than those described in the preceding sentence) shall be allowable to a proper extent where income is realized from that activity. *The amount allowed should be that proportion of the total of such deductions which the income realized bears to the total deductions attributable to the activity, including deductions described in the first sentence of this paragraph.* Thus, if the taxpayer with a hobby farm has interest and taxes of \$100,000, operating costs of \$120,000, and depreciation of \$80,000, and if the income from the farm is \$30,000, the taxpayer should be entitled to deduct the full \$100,000 amount of interest and taxes plus \$12,000 of operating costs and \$8,000 of depreciation.⁴⁹

The Senate Committee on Finance did provide a netting rule, albeit less liberal than Treasury's recommendation. Section 183(d) classifies deductions in two categories: (1) those not dependent upon profit motive for deductibility (tier 1 deductions, in the developing section 183 tax jargon), *i.e.*, "deductions which would be allowable . . . without regard to whether or not such activity is engaged in for profit," and (2) those allowable only if the activity is engaged in for profit (tier 2 and tier 3 deductions). Rather than following the proportionate approach proposed by the Treasury, the Code provides that deductions requiring a profit motive are deductible only to the extent gross income exceeds tier 1 deductions. Thus, rather than tier 1 deductions "eating up" only a proportionate amount of gross income from the activity, under the Senate Committee on Finance approach (section 183(b)), they eat it up dollar for dollar, with only the excess available as the measuring rod for deductibility of tier 2 and 3 deductions. Section 162 farm expense regulations in effect permitted the deduction of tier 2 and 3 expenses to the full extent of gross income not reduced by tier 1 deductions.⁵⁰

The three tier system comes about as the regulations further divide deductions requiring a profit motive into those not involv-

⁴⁹ TAX REFORM ACT OF 1969, TECHNICAL MEMORANDUM OF TREASURY POSITION ON H.R. 13270, 91ST CONG., 1ST SESS. 35-36 (Comm. Print 1969) (emphasis added).

⁵⁰ Reg. § 1.162-12.

ing basis adjustments (tier 2) and those resulting in basis adjustments (tier 3), such as depreciation and amortization, partial losses with respect to property and partially worthless debts.⁵¹ Tier 3 deductions in turn are allowable only to the extent gross income exceeds tier 2 deductions. The Senate Committee on Finance report similarly set a priority on the type of deductions to be first allowed after tier 1 deductions, but would have allowed first (tier 2) those deductions resulting in basis adjustments.⁵² The draftsmen of the regulations reversed the committee's order, reasoning that if basis adjustment deductions, particularly depreciation, were tier 2 rather than tier 3, then the application of the recapture rules upon the subsequent disposition of the property would result in section 183(b)(2) deductions not being allowed to the extent of gross income in excess of tier 1 deductions.⁵³ Where tier 3 deductions involve more than one asset, the deduction is allocated to each asset proportionately based upon the total amount which would have been deductible had the activity been engaged in for profit. The basis of such assets is then reduced only by the amount of the tier 3 deductions so allocated to them.⁵⁴

Most of the controversy in this area will undoubtedly arise as to tier 1 deductions since they will be deductible regardless of whether they are associated with the activity, but their amount directly affects the deductibility of tier 2 and 3 deductions in an activity not engaged in for profit. For instance, one commentator has suggested that contrary to the regulations where property is used partially for personal purposes and partially for rental use, but the entire activity is determined not to be engaged in for profit, the tier 1 deductions should be divided between personal and business use.⁵⁵ Thus, in the calculation under section 183(b) gross income would be reduced only by the tier 1 deductions attributable to the rental operation. This suggestion has the surface appeal of symmetry, particularly since the regulations allocate the tier 2 and 3 deductions to the rental activity

⁵¹ Reg. §§ 1.183-1(b)(1)(ii) and (iii).

⁵² S. REP. NO. 91-552, 91st Cong., 1st Sess. 104 (1969).

⁵³ Oshins, *Proposed Regulations Provide New Rules for the Hobby Loss Game*, 35 J. TAXATION 214 (1971); see Rhodes, *Hobby Losses—A New Challenge*, 56 A.B.A.J. 893, 894 (1970); Comment, *Section 183: Work Horse or Hobby Loss*, 20 CATHOLIC U.L. REV. 716, 726 (1971).

⁵⁴ Reg. § 1.183-1(b)(2)(ii).

⁵⁵ Thrower, *Recent Developments in Federal Income Taxation*, 21 TUL. TAX INST. 1, 23-24 (1972).

and to personal use (with the latter allocated deductions being independently disallowed under section 262).⁵⁶ It overlooks, however, the fact that the obvious function of section 183(b), as enacted, is to preclude the taxation of gross receipts while section 183(b)(2) deductions are disallowed, in order not to allow the taxpayer to use any amount of such deductions against other income as the Treasury proportionate proposal would have allowed.

Another commentator has suggested that in situations of dual use, rental and personal, the taxpayer should treat the operation as two activities. While his goal was to enable the rental portion to qualify separately as an activity engaged in for profit, the same approach would result in allowance of a greater amount of tier 2 or 3 deductions where both activities are not engaged in for profit, assuming that all the gross income is allocated to the rental activity but the tier 1, 2 and 3 deductions are allocated between the two activities.⁵⁷ Although characterization as two activities may prove difficult and is inadvisable if the entire operation can be shown to be a single activity engaged in for profit with secondary personal use, the taxpayer has nothing to lose with such a fragmentation approach if as a single activity the entire operation is not engaged in for profit.

Not surprisingly the first substantive revenue ruling under section 183 involved tier 1 deductions. In Revenue Ruling 73-219⁵⁸ the Service treated interest paid on an insurance policy loan, the proceeds of which had been used to purchase a beach house used in an activity not engaged in for profit, as a tier 1 deduction indirectly attributable to the activity. The rationale that the use of the borrowed money is determinative appears correct, but the ruling more likely signals the advent of a tracing concept like that applied in section 265. In its more extreme form this concept reaches some situations in which the taxpayer could sell tax-exempt obligations to meet economic needs, but instead incurs indebtedness to do so.⁵⁹ But there the reasoning is that such interest is incurred to carry the tax-exempts, whereas interest *attributable* to rental property arises from indebtedness that was in-

⁵⁶ Reg. § 1.183-1(d)(3) Ex. (ii).

⁵⁷ Gage, *Treasury's Tough New Final Regs on Partly-Rented Vacation Home Deductions: Analysis*, 37 J. TAXATION 312, 313 (1972) (advocates two activities); Carey & Gallagher, *Requisite Greed: Section 183 Regulations*, 19 LOYOLA L. REV. 41, 58 (1973) (two activities result in more allowable tier 2 and 3 deductions).

⁵⁸ 1973-20 I.R.B. 9; Note, 39 J. TAXATION 94 (1973).

⁵⁹ Fox, *The Leslie Case*, 26 TAX L. REV. 159 (1970).

curred, or the proceeds of the loan were used, in connection with the rental property or with the production of income therefrom.⁶⁰ The latter does not appear to encompass interest on indebtedness incurred to *carry* property used in an activity not engaged in for profit.

The most complicated portion of the tier 1 deduction regulations—section 1.183-1(b)(4)(ii)—deals with the section 1202 net long-term capital gain deduction. No section 1202 deduction is allowable with respect to an activity not engaged in for profit (section 183 activity), unless (1) without regard to section 183 there is an excess of net long-term capital gain over short-term capital loss and (2) that excess is allocable to such section 183 activity. The function of the first prerequisite is quite subtle, even nice. The regulations provide a constructive profit motive as to tier 2 and 3 deductions to the extent of gross income in order to achieve netting. With such a constructive profit motive a bad debt would qualify as a business bad debt giving rise to an ordinary loss under section 166(a). A nonbusiness bad debt, on the other hand, is treated as short-term capital loss. Accordingly, without the constructive profit motive of section 183(b)(2), a bad debt incurred in an activity not engaged in for profit is allowable only as a short-term capital loss. Thus, it could be said that a business bad debt ordinary loss is a section 183(b)(2) deduction because it is allowable as such only if the activity is engaged in for profit. By virtue of the above tier 1 section 1202 deduction rules such a loss, rather than being allowed as a tier 3 deduction, must reduce long-term capital gains, which then may give rise to a tier 1 deduction. In some instances such calculation of net long-term capital gains without regard to section 183 results in more taxable income.

An early commentator offered the following example, which may have brought the question to the eyes of the draftsmen of the regulations: A taxpayer carrying on an activity without a profit motive has a long-term capital gain of \$10,000 and a bad debt of \$6,000. If, as under the regulations, the bad debt is treated as a short-term capital loss, it reduces the net long-term capital gain in excess of short-term capital loss, to \$4,000. After deduction of the 50 per cent capital gains deduction (here \$2,000), the net gain from the activity would be \$2,000. If on the other hand, the \$6,000 bad debt were treated as a tier 3 deduction, there

⁶⁰ Reg. § 1.183-1(b)(4)(ii).

would be no taxable income from the activity, computed as follows: tier 1 deduction, \$5,000 section 1202 deduction, and tier 3 deduction, \$6,000 bad debt ordinary loss allowable to the extent of gross income in excess of the tier 1 deduction, *i.e.*, \$5,000.⁶¹ An argument in support of the regulation technique is that tier 1 deductions are to be allowed first, tier 1 contains no constructive profit motive, therefore, the bad debt would be nonbusiness and, as a short-term ordinary loss, must be netted with the long-term capital gain in order to first determine the amount of tier 1 deductions. A counter argument would be that a tier 3 deduction is being lifted up into tier 1 and, more significantly, that a taxpayer is being taxed on income from the activity without being able to offset this income with a deduction he would be entitled to were the activity deemed to be engaged in for profit up to the amount of gross income from the activity. The latter point, it is submitted, is more consonant with the purpose of section 183(b), but whether the regulation is an invalid interpretation of its literal words is more problematical.

If all activities, profit motivated and section 183 activities, have an excess of net long-term capital gain over short-term capital loss calculated without regard to section 183, the section 1202 capital gain deduction is allocated to each activity in proportion to its share of such excess. If any activity has a net capital loss, the section 1202 deduction is allocated only to net long-term activities, in the ratio that each activity bears to the total, not excess, net long-term capital gains of all activities. The total section 1202 deduction is reduced by the allocable deduction to section 183 activities and such reduction is then allowable as a tier 1 deduction attributable to capital gains.⁶² The purpose of these computational gymnastics is to force section 1202 deductions into section 183(b)(1) where the activity generating the activity is not engaged in for profit, thereby reducing tier 2 and 3 allowable deductions.

Activity

The term activity is not defined in section 183. Prior to promulgation of the regulations, commentators raised two main points: (1) lest the Service tend to seek a narrow definition of the term

⁶¹ Comment, *Section 183: Work Horse or Hobby Loss*, 20 CATHOLIC U.L. REV. 716, 724-25 (1971). See Carey & Gallagher, *Requisite Graced: Section 183 Regulations*, 19 LOYOLA L. REV. 41, 48-52 (1973).

⁶² Reg. § 1.183-1(b)(4)(iii).

so as to fragment an integrated activity and disallow expense attributable to an isolated slice of a single trade or business, they advocated that the term be defined broadly; and (2) it was argued that since the House Committee on Ways and Means stated that "as under present law, the loss would be determined separately with respect to each activity carried on by an individual" and earlier had referred to section 270 as the present law, the content of the term "activity" should be governed by the section 270 separate business rule.⁶³

The regulations under section 270 provided little guidance as to whether one or two businesses were involved. They did state that the mere use of different forms of carrying on the same business did not create separate businesses. Furthermore, where several business activities emanated from a single commodity, such as a tract of land, it did not necessarily follow that such activities were one business for the purpose of section 270. "However, in order to be treated separately, it must be established that such business activities are actually conducted separately and are not closely interrelated with each other."⁶⁴ Two cases developed the scope of the separate business rule considerably: *Arthur V. Davis*⁶⁵ and *Joseph M. Collins*.⁶⁶ The principal contention of the Service in the *Davis* case was that the "nature" test is controlling—activities which are the same or substantially the same in nature constitute a single trade or business even where conducted at more than one location. Its alternative position was that two or more business ventures, though differing in nature, would still constitute a single trade or business unless they were separately conducted for a bona fide business purpose. Application of these two tests may be illustrated by:

[A] man raising potatoes on a farm in Maine and also raising potatoes on a farm in Idaho would be carrying on only one business regardless of the fact that the operations on each farm were conducted separately, and also . . . a man raising cotton on a farm in Alabama and cattle on a ranch in Texas [would be] carrying on one business if there was a common management of the two farms.⁶⁷

⁶³ H.R. REP. NO. 91-413 (Part I), 91st Cong., 1st Sess. 71 (1969) (emphasis added). See Comment, *Section 183: Work Horse or Hobby Loss*, 20 CATHOLIC U.L. REV. 716, 721 (1971); DICKINSON, FARM AND RANCH LOSSES, BNA TAX MANAGEMENT PORTFOLIO NO. 241, A-21 (1970); Rhodes, *Hobby-Losses—A New Challenge*, 56 A.B.A.J. 893, 895 (1970); Diamond & Horne, *Hobby-Losses; Miscellaneous Individual and Corporate Problems*, 23 TAX LAWYER 609, 610-12 (1970).

⁶⁴ Reg. § 1.270-1(a)(4); Rev. Rul. 54-178, 1954-1 C.B. 128.

⁶⁵ 29 T.C. 878 (1958).

⁶⁶ 34 T.C. 592 (1960), *nonacq.*

⁶⁷ *Arthur V. Davis*, 29 T.C. 878, 889 (1958).

The taxpayer maintained that the proper test was whether the ventures were, in fact, separately and independently conducted and were not materially interrelated: the "economic interrelation" test. Under it, if one farm owned by a taxpayer were used for the running and pasturage of hogs and another farm also owned by him were used for the production of feed for those hogs, the operation of both farms would be considered a single business, even though they were physically separated and each farm had its own resident manager, for there would be sufficient economic interrelation in the operation of the two farms to justify the conclusion that as a practical matter there was but one business unit. Although in the *Davis* case the Tax Court concluded that it did not have to choose among the taxpayer's approach and the government's two tests, since the same result would obtain under all, it did state that the economic interrelationship test had much to commend it.

Subsequently, in *Joseph M. Collins*⁶⁸ the Tax Court was forced to make the choice. It rejected the nature test and held that the two businesses in question were separately and independently conducted by the taxpayer with no economic or other interrelation between them. Because in *Collins* the court found the activities were conducted separately and independently as well as having no economic relationship, the question whether common management alone without any economic relationship would result in a single business remained unanswered.

The regulations eclectically adopt all of the tests set forth in *Collins* and *Davis*, both those approved and discarded by the Tax Court. For the regulations provide that in ascertaining the activity or activities of the taxpayer all the facts and circumstances must be taken into account and generally the most significant facts and circumstances are (1) the degree of organizational and economic interrelationship, (2) the business purpose for carrying on the various undertakings separately or together and (3) the similarity of the various undertakings.⁶⁹ The similarity test was clearly overruled in *Collins*. Had the Tax Court had to make a choice in *Davis*, it probably would have rejected as well the organizational and business purpose tests which were presented as a single alternative test there. Only the economic interrelation test has the full support of the prior case law, although the organizational interrelationship test finds some valid-

⁶⁸ 34 T.C. 592 (1960), *nonacq.*

⁶⁹ Reg. § 1.183-1(d)(1).

ity in the fact that in *Collins* the court held that there was no economic or organizational interrelationship. In short, litigation may be expected as to these factors derived in part as they are from defeated litigating postures of the Service under section 270, which the legislative history provides as the pattern for the term "activity." Only the degree of organizational and economic interrelationship factor should be sustained.

Probably to forestall any temptation on the part of field agents to fragment a single integrated activity, the regulations provide that generally the Commissioner will accept the characterization by the taxpayer of several undertakings either as a single activity or as separate activities. However, this characterization will not be accepted if artificial and will not be reasonably supported under the facts and circumstances of the case.⁷⁰ This approach is apparently derived from the business purpose factor set out in the definition of activity. Again the taxpayer's characterization should be struck down only if it fails the organizational and economic interpretation test.

The section 183 activity provisions on this point can be said to be substantially broader than their section 270 predecessor only in that they adopt tests rejected under those cases. Indeed, the government argued for a broad single business rule under section 270 to maximize the losses for the five year \$50,000 rule.⁷¹ Contrary to the evident belief of the draftsmen of the regulations, it is submitted that they are narrower here than the section 270 rules, at least as to the question of whether farming and the holding of the land on which such farming is conducted constitutes a single activity.⁷² The significance of this question lies in the fact that the term "profit" encompasses, according to other provisions of the regulations, appreciation in the value of assets used in the activity, such as land. Thus, a taxpayer may satisfy the profit motivation standard because he intends to derive a profit from operating the activity, but also intends that even if no profit is derived from current operations, an overall profit will result when appreciation in the value of the land used in the activity is realized. This factor of unrealized appreciation has been an increasingly significant factor in the

⁷⁰ *Ibid.*

⁷¹ Diamond & Horne, *Hobby Losses: Miscellaneous Individual and Corporate Problems*, 23 TAX LAWYER 609, 610-11 (1970).

⁷² Oshins, *Proposed Regulations Provide New Rules for the Hobby Loss Game*, 35 J. TAXATION 214, 216 (1971).

farm loss cases under section 162.⁷³ The activity defining provisions of the regulations maintain, however, that the farming and the holding of land used for such farming, which was acquired or held primarily with the intent to profit from its appreciation, will ordinarily be considered a single activity "only if the farming activity reduces the net cost of carrying the land for its appreciation in value."⁷⁴

It may be noted that the proposed regulations couched this rule in terms of the taxpayer's intent—whether he expected or intended that the farming activity would reduce the net cost of carrying the land.⁷⁵ This earlier approach seems more consonant with the thrust of the profit motive factor—that the taxpayer may intend to make a profit from farming activities, but may also intend that in any event an overall profit will result considering land appreciation—with which it was clearly designed to mesh. Furthermore, for over four decades, such intent has won judicial approval. As early as 1931, the taxpayer in *Edwin S. George* argued, to the court's satisfaction, "that he planted the orchards for the purpose of increasing the value of his property and because he thought that the proceeds of the sale of the fruit would help him to carry his land until the proper time for the sale of the land arrived."⁷⁶

It might be inferred from this formulation of activity as applied to a farming venture and from the section 162 case law, that where the taxpayer shows he has not purchased or acquired the farm land primarily as an investment he can continue to rely upon any unrealized appreciation of the land as establishing profit motivation where his primary intention was to derive a profit from the farm operations.⁷⁷ On the other hand, the regulations illustrate the general statement that where the taxpayer's primary intent is to profit from appreciation in farm land, the holding and farming of the land will ordinarily be considered a single activity only if the farming activity reduces the net cost of carrying the land with the much broader, absolute example:

[T]he farming and holding of the land will be considered a single activity *only* if the income derived from farming exceeds the deductions

⁷³ See Comment, *The Effect of Unrealized Appreciation in Determining Profit Motive in Farming Enterprises*, 16 KAN. L. REV. 529 (1968); see Reg. § 1.183-2(b)(4).

⁷⁴ Reg. § 1.183-1(d)(1).

⁷⁵ Prop. Reg. § 1.183-1(d)(1), 36 Fed. Reg. 16112 (August 19, 1971).

⁷⁶ 22 B.T.A. 189, 195 (1931).

⁷⁷ See Crouch, *How Treasury's Final Regulations on the New Hobby Loss Rules Operate*, 38 J. TAXATION 184, 187 (1973).

attributable to the farming activity which are not directly attributable to the holding of the land (that is, deductions other than those directly attributable to the holding of the land such as interest on a mortgage secured by the land, annual property taxes attributable to the land and improvements, and depreciation of improvements to the land.⁷⁸

Thus, it is clear that the thrust of this portion of the regulations is to deny use of land appreciation in testing profit motivation in all unprofitable farming activities, thereby undercutting the factor of unrealized farm land appreciation provided elsewhere. This technique, designed to obviate the prior taxpayer success with land appreciation, may be expected to provoke litigation in two areas: (1) whether the "automatic" separate activity rule is limited to situations where the taxpayer's primary intention with respect to the land is to hold it for appreciation and (2) whether that rule is generally consistent with the (proper) meaning of the term "activity." The answers to these issues will turn on the resolution of several conflicting factors, *e.g.*, the prior separate business development under section 270, the context in which section 183 was enacted, the vast body of section 162 case law implicitly treating holding and farming of land as a single activity and the handful of recent decisions questioning whether farming expenses were necessary expenses in the maintenance of property for future sale or production of income.

Under the "common management" test for determining whether undertakings constituted a single business argued for by the Service in *Davis*⁷⁹ as an alternative test, and which is reincarnated in the criterion in section 1.183-1(d)(1) of the regulations of the degree of organizational interrelationship of the various undertakings, a farming venture and the holding of land used for it would be a single activity as long as they are under the same management. More significantly, the Tax Court illustrated in *Davis* a single business under the "practical economic interrelation" test, also reincarnated in the regulation's definition of activity in the factor of economic interrelationship, with the example of two farms, one used for running and pasturage of hogs and a second commonly owned farm, under a different resident manager, used for production of feed for the same hogs. A similar production link exists between raising livestock or crops and holding the land on which they are raised. Thus, from the point of view of the farming undertaking, the holding of

⁷⁸ Reg. § 1.183-1(d)(1) (emphasis added).

⁷⁹ *Arthur v. Davis*, 29 T.C. 878 (1958).

the land used in that activity bears a close economic and management interrelationship to the farming venture. Accordingly, under section 1.183(1)(d)(1) of the regulations holding and farming the same tract of land would appear to constitute a single activity.

Just as the incorporation by the legislative history of the section 270 single-separate business development into section 183 cuts toward treatment of the holding and farming land as a single activity, consideration of the context in which section 183 was enacted reveals that in many instances such treatment would produce results inconsistent with the general purpose of the farm provisions of the Tax Reform Act of 1969. The original impetus for farm tax reform arose from a perceived distortion of income from taxpayers enjoying ordinary income deductions incurred in the development of a farm product, such as a breeding herd, and then disposing of the mature product at more favorable capital gain rates. It was felt that the "existing 'hobby loss' provision of the Internal Revenue Code [*i.e.*, section 270 was] ineffectual in dealing with this problem."⁸⁰ In the final version of the Tax Reform Act legislation the spotlighted distortion abuses were handled principally by section 1251 and the direct legislative history of section 183 does not refer to such abuse. Nevertheless, the enjoyment of current ordinary income deductions from farm operations when it is expected that the ultimate profit will be capital gains from appreciation of the farmland falls into the pattern the farm tax reform provisions in general were designed to curb. Thus, the Treasury's attempt to preclude this result through using the word "activity" is not surprising. It could be argued, however, that since Congress essentially covered this problem through the carefully structured provisions of section 1251, the Treasury should not be permitted to fashion its own broader, overlapping tool, with a different remedy, in the section 183 regulations. In short, it is not likely this factor will be given overt weight in the resolution of the issues here but it may nevertheless influence the result.

Certainly, the large number of farm loss decisions turning at

⁸⁰ U.S. TREASURY DEPT TAX REFORM STUDIES AND PROPOSALS (PART 1), 91ST CONG. 1ST SESS. 153 (Comm. Print 1969). This legislative history supports the result of this portion of the regulations, which is to deny use of the unrealized appreciation in land which is used in a farming activity, but one commentator has raised the counter arguments that (1) since land is a necessary capital asset in farming, it is artificial to separate the land and farming and (2) such appreciation is not limited to hobby farms. Carey & Gallagher, *Requisite Greed: Section 183 Regulations*, 19 LOYOLA L. REV. 41, 57 (1973).

least in part on unrealized appreciation in land used in farming implicitly have considered the farming and land holding as a single business or venture. As a recent such decision held "The farm increased in value (no doubt at least in part as a result of his efforts) . . . considerably more than the aggregate net losses claimed, so that in fact there was a net ultimate profit from the venture."⁸¹

Invariably these cases have approached the issue of profit motivation in the context of whether the farm operations constituted a trade or business within the meaning of section 162. Focus on appreciation in farmland might suggest, however, that the analysis should be whether the expenses are ordinary and necessary in the maintenance or holding of the farm property for the production of income and, hence, be deductible under section 212. When the issue has been framed in that manner, the taxpayer has had to show that the farming undertaking helped financially carry or otherwise aided in the maintenance of the land, or that the farm activity itself was independently carried on with an expectation of profit. The leading, and virtually only, analysis on point is contained in *Richard R. Riss, Sr.*,⁸² involving the issue whether various farming expenses were ordinary and necessary in the management, conservation or maintenance of the taxpayer's greatly appreciated property which, the court had found, he held primarily for investment. It concluded that they were not:

To our knowledge, no connection existed between the raising of these animals and the maintenance of the . . . property for future sale, or for use as development property. Nor do we find grounds for concluding that the raising of these animals constituted a separate and independent income-producing endeavor, related to the . . . property only by reason of location. Accordingly, we hold that Richard's breeding activities amounted to little more than a hobby or pastime. . . .⁸³

The same reasoning, albeit inarticulated, apparently underlies the jury charge in *Cavender v. United States*⁸⁴ that the taxpayer must have a bona fide expectation of making a profit at farming before the farm expenses would be deductible: An intention to

⁸¹ Woodrow L. Wroblewski, 32 T.C.M. No. 37 at 172 (1973); See, e.g., *DuPont v. United States*, 234 F. Supp. 681, 688 (D. Del. 1964); *Israel O. Blake*, 38 B.T.A. 1457, 1460 (1938); *George Thacker*, 28 T.C.M. 1433 (1969); *Herbert C. Sanderson*, 23 T.C.M. 1723 (1964).

⁸² 56 T.C. 388 (1971).

⁸³ *Id.* at 422.

⁸⁴ 71-2 U.S.T.C. ¶ 9723 (S.D. W. Va. 1971).

merely hold the farm as a real estate investment would not be sufficient. The court went on to state that a long-range goal of profitable disposition for commercial purposes would not render farm expenses nondeductible, if during the interim the taxpayer decided, and had a bona fide intent, to operate the farm at a profit.

These two decisions, essentially the only authorities to consider the problem, suggest that where farm property is held primarily as an investment, any farm activities undertaken by the taxpayer in connection with the property either must be ordinary and necessary in such holding to be deductible under section 212 or must constitute "a separate and independent income-producing endeavor" with expenses deductible under section 162. Under this approach, operating a farm and ownership of land held primarily as an investment are separate activities if the operational expenses are not ordinary and necessary section 212 expenditures in the holding of the land. However, these cases do not directly answer whether the unrealized appreciation in the land can be considered in determining whether the farming activity is engaged in for profit, the implication is that it cannot. In any event, other authorities suggest that in some circumstances farming expenses are helpful in maintaining the property for future sale, although they are not helping financially to carry it. In *DuPont v. United States*,⁸⁵ the court accepted the taxpayer's argument that he carried on a cattle breeding operation on land held for appreciation in order to keep it from becoming overgrown with woods and underbrush and to prevent erosion. Therefore, the emphasis on the farming operations helping financially to carry the land should not result in an absolute bar of the deductibility under sections 162 and 183 of the expenses of farm operations in excess of gross receipts, as one reading of the regulations would clearly do.

The activity definition in the regulations, the appreciation factor in the profit motive portion of the regulations, *Riss*⁸⁶ and *Cavender*,⁸⁷ and the large body of farm loss decisions beginning with *Israel O. Blake*⁸⁸ finding profit motivation satisfied by appreciation in assets including, or sometimes only consisting of, farmland could all be reconciled by encompassing unrealized farmland appreciation within the term "profit" for determination of

⁸⁵ 234 F. Supp. 681, 689 (D. Del. 1964).

⁸⁶ Richard R. Riss, Sr., 56 T.C. 388 (1971).

⁸⁷ *Cavender v. United States*, 71-2 U.S.T.C. ¶ 9723 (S.D. W. Va. 1971).

⁸⁸ 38 B.T.A. 1457, 1460 (1938).

whether a farming operation constitutes a trade or business only when the taxpayer holds the land primarily for use in a farming operation, and not primarily for its appreciation. This would, of course, reintroduce the question of subjective intent. It is submitted, however, that *Riss* and the *Blake* progeny conflict in most instances. Where an asset is held primarily for appreciation rather than for use in an asserted trade or business, unrealized appreciation should only be a factor in determining whether the property is held for the production of income and not in ascertaining whether the activity for which it is used is profit motivated. While such appreciation is relevant to expectation of realizing a profit upon the disposition of the property, in which case it is held for the production of income, it is not relevant to an expectation of profit from day to day operations. Of course, appreciation in inventory-type assets, such as livestock, would be relevant to an expectation of profit in the business of raising such livestock for sale. Appreciation in noninventory assets becomes no more relevant to an expectation of profit from everyday operations when the property is held primarily for use in that activity. Furthermore, a man planning to make a profit from an activity usually does not plan to do so by liquidating it. Perhaps most significant is that the *Riss* approach forces the operations deductions to qualify as ordinary and necessary expenses of holding the asset for production of income where an overall profit is expected only from the sale of the asset.

Under this conclusion *Blake* was correctly decided as to the appreciation in the livestock but not as to the appreciation the land used in raising the livestock. Rather than facing the difficult task of overruling the old and well established rule that appreciation in noninventory assets may indicate an expectation of profit from the activity in which the assets were used, the drafters of the regulations endorsed it and then sought to undermine it through special activity rules, which arguably conflict with the general definition provided for the term "activity." Furthermore, by separating operational expenses from the production of income activity in all instances in which they exceed income from operations, the regulations would in some instances disallow operational deductions which are in fact ordinary and necessary section 212 expenses. Thus, both this portion of the activity provisions and the factor of expectation of appreciation in value of assets used in an activity should be reevaluated, administratively or judicially.

In addition to offering guidelines as to the ascertainment of activity, section 1.183-1(d)(2) of the regulations provides rules for allocation of expenses. Where property is used in several activities and at least one is not engaged in for profit, the deductions relating to such property must be allocated between the various activities on a reasonable and consistently applied basis.

A similar question of allocation has frequently arisen under sections 162 and 212, as well as other sections permitting deductions for business use. The rule there is that a deduction for maintenance and depreciation, for example, is permitted where acquisition of property is associated primarily with business motivated purposes and any personal use is distinctly secondary and incidental. On the other hand, if the acquisition and maintenance was motivated primarily by personal considerations, no deductions are allowed. This primary purpose criterion is applicable, however, only where the secondary purposes are incidental and relatively insignificant. "Where substantial business and personal motives exist, however, allocations become necessary."⁸⁹ The Service's usual posture, as set forth, for instance, in Revenue Ruling 62-180,⁹⁰ has been to make such allocation on a time-use formula utilizing in the time factor the ratio of business use time to total time regardless of whether such time was utilized for personal purposes. Thus, if during a 24 hour period, business use was two hours and personal use was two hours, the business use time would be one twelfth. Some early decision adopted this approach, while others sub silentio rejected it.⁹¹

The Tax Court in *International Artists, Ltd.*,⁹² made the allocation on the basis of business use to personal use, disregarding the time when the facility was not used at all. Moreover, in *George W. Gino*,⁹³ a recent decision following *International Artists*, the same court expressly refused to follow this aspect of Revenue Ruling 62-180, reasoning:

⁸⁹ *International Artists, Ltd.*, 55 T.C. 94, 105 (1970), *acq.*

⁹⁰ 1962-2 C.B. 52, 56 Ex. 5.

⁹¹ Compare *Hoggard v. United States*, 67-2 U.S.T.C. ¶ 9741 (E.D. Va. 1967) and *Martha E. Henderson*, 27 T.C.M. 109 (1968), with *International Artists, Ltd.*, 55 T.C. 94, 107 (1970); *Demor, Inc.*, 27 T.C.M. 1496 (1968); cf. *Harlan H. Hilliker*, 31 T.C.M. 896 (1972).

⁹² 55 T.C. 94, 107 (1970).

⁹³ 60 T.C. No. 37 (1973), *on appeal*. Section 1.274-2(e)(4)(i) of the regulations, in interpreting the "primarily for the furtherance of the taxpayer's trade or business" requirement of section 274(a)(1)(B) incorporates, in a manner similar to section 183(c) the ordinary and necessary tests of sections 162 and 212; and the actual use test is described as establishing deductibility under those provisions.

The obvious difficulty with an allocation of business use as a percentage of total hours of availability for use rather than total hours of use, is the erroneous and distorting assumption that a dual-use facility is not, when unused, just as much available for business as it is for nonbusiness use. The correct rule is to pro-rate in proportion to actual use, in the manner specified in regulations section 1.274-2(e)(4), without the thumb on the scales provided by the allocation to personal use of all hours of non-use.⁹⁴

The regulations under section 183 implicitly adopt this more reasonable approach of ratio of actual personal use to business use. While they do not provide an illustration of property used both in an activity engaged in for profit and in an activity not engaged in for profit, there is an example in which expenses, for application of the rule that deductions are allowed under section 183(b)(2) to the extent of income, are allocated to rental use and personal use of property used in a single activity. In Example 2 of section 1.183-1(d)(3) of the regulations, the beach house example, the property was used for three months out of the year, two months for rental use and one month for personal use. The expenses were allocated two thirds to rental use and one third to personal use. Thus, the Service has in this context rejected at least the broad implications of Revenue Ruling 62-180.

This beach house illustration, the sole example accompanying the activity paragraph of the regulations, does not provide any guidance for the application of the principles set forth for determining whether a single activity or several activities are present. It recites that a taxpayer owned a beach house in a resort community, which could be rented for only three months out of the year. Customarily, the taxpayer leased the beach house for two months of the three month recreational season to vacationers and reserved the house for his own use during the remaining month of the recreational season. The rental income was less than the expenses attributable to the house. The example concluded that "under these facts and circumstances, A is engaged in a single activity, holding the beach house primarily for personal purposes, which is 'an activity not engaged in for profit.'" A commentator has pointed out that this conclusion is presumed without any indication as to its rationale and maintains that there is nothing in the Code or the committee prints which support this conclusion.⁹⁵ The example appears to be derived from *John R. Carkhuff*.⁹⁶

⁹⁴ George W. Gino, 60 T.C. No. 37 (1973), on appeal.

⁹⁵ Gage, *Treasury's Tough New Final Regs on Partly-Rented Vacation Home Deductions: Analysis*, 37 J. TAXATION 312, 313 (1972).

⁹⁶ 28 T.C.M. 375 (1969), *aff'd*, 425 F.2d 1400 (6th Cir. 1970); see *Kanter v. United*

In the *Carkhuff* case, involving a beach house, the peak rental period was for four and one half months each year and the taxpayer reserved the house for two of those months: an action, in the words of the review court, not entirely consistent with profit making. The taxpayer did not argue strongly in the Tax Court that he was holding the beach property for rental as a trade or business so that the expenses would be deductible under sections 162 and 167. Rather, he maintained that he held the property for production of income within the meaning of section 212.

The taxpayer offered no evidence of any intention of making a profit from the rental of the beach property and did not present evidence as to his intent in listing the property for rent when it was not being occupied. The trial court drew the inference that the listing for rental was in hope of recouping some of the costs of maintaining a personal residence which he did not intend to occupy for the entire year. The taxpayer's answer was that since he acquired the house partially for personal use and partially for business use, he did not have to have a reasonable expectation of making a profit from the business use of the house. The Tax Court concluded, however, that there had to be a bona fide conversion of the property to an income producing use for section 212 to be applicable and, concerning that issue, the possibility of profit would be a factor, but only a factor, to be weighed with other objective factors. The court did not decide whether property may be converted to income production for part of the taxable year and then reconverted to personal use for the remainder of that taxable year, in a recurring pattern. For it found there was no sufficient conversion of the property to any use which could be said to have been primarily for the production of income.

From the Tax Court's decision in *Carkhuff*, one commentator has concluded that the rental portion and owner occupied portion of a beach house, for example, could be separate activities.⁹⁷ The Sixth Circuit, however, in affirming the Tax Court sidestepped the recurring partial conversion issue by reasoning that taxpayers can make a dual use of property and an allocation of the expenses and depreciation is permissible to that part of the use which

States, 73-1 U.S.T.C. ¶ 9311 (E.D. Va. 1973) (substantial personal use), *aff'd per curiam*, 74-1 U.S.T.C. ¶ 9182 (4th Cir. 1974). In *William K. Coors*, 60 T.C. No. 44 (1973), the court contrasted the substantial personal use in *Carkhuff* with the holding out of the property in question for rental about 95 per cent of the tax year.

⁹⁷ Gage, *Treasury's Tough New Final Regs on Partly-Rented Vacation Home Deductions: Analysis*, 37 J. TAXATION 312 (1972).

relates to earning income or making a profit. It found the taxpayer did not have any expectation that ownership of the beach property would be an income producing operation. In essence, the circuit court's analysis appears to support the basic approach of the regulation example, *i.e.*, the ownership and rental of the beach property would be a single activity. If the rental portion were engaged in for profit, then an allocation of expenses to the personal use and the rental use would be called for and those attributable to the rental use would be deductible.⁹⁸ The controversy would then arise as to whether the single activity was engaged in for profit.

It is unfortunate that the example does not give more factors as to why the single activity was not engaged in for profit. It omits completely any reference to possible appreciation in the property and, in terms of the nine factors provided elsewhere in the regulations as guidelines as to whether an activity is engaged in for profit, the example touches only upon personal use and the fact that losses are incurred. While the *Carkhuff* opinions do disclose that personal use during the peak rental period is a factor inconsistent with a profit making motive, there were many other negative factors in the case.⁹⁹ Nevertheless, with the skeletal example provided, it may be expected that revenue agents will tend to take a blanket approach in treating all second residences used partially for personal use as activities not engaged in for profit.

Ironically, based on the facts provided in the regulation example, and some conservative estimates as to the fair market value of the property and annual rate of appreciation, a strong argument can be made that the taxpayer actually could expect a profit from the ownership of the property if unrealized apprecia-

⁹⁸ But see William K. Coors, 60 T.C. No. 44 (1973) (no apparent allocation of depreciation to personal use; perhaps taxpayer used only deducted portion attributable to rental use).

⁹⁹ For example, the cottage was neither specifically mentioned nor advertised individually by the Sea Island Company which owned the local hotel and maintained a list of all the cottages on the island available for rent. Such rental activities, which were not a major concern of the company, were not sufficient to sustain the taxpayer's burden of proof. The taxpayer did not install air conditioning in the cottage although it was beginning to face more severe competition from air conditioned homes. The taxpayer in Joseph W. Johnson, Jr., 59 T.C. No. 78 (1973), did add air conditioning to his Sea Island cottage and offered it for rent during the entire peak rental period, but was found not to have held the property primarily for production of income on the following objective facts: (1) no prepurchase investigation as to rentability, (2) no allocation of expenses between personal and rental use, (3) no books and records and (4) over-expensive improvements.

tion were included. The total expenses attributable to the property in the example, including depreciation, were \$3,900. Allocating all of these expenses according to the ratio of the rental use to the personal use results in \$2,600 being attributable to the rental use. Rental income of \$2,000 was received in the example. However, due to the fact that the income derived from the rental exceeded the deductions attributable to the rental activity which were not directly attributable to the holding of the building, *i.e.*, deductions other than interest, annual property taxes and depreciation, the renting and the holding of the building would be considered a single activity based on the analogy of farming and holding of land used in the principles supplied in section 1.183-1 (d)(1) of the regulations.

The beach house illustration does not state the fair market value of the beach house, nor does it supply the annual rate of appreciation in local land values. However, based on the facts that the depreciation which would have been allowed had "the activity been engaged in for profit" was \$1,200 and that the guideline useful life for residences is 45 years,¹⁰⁰ the taxpayer's costs for the house would range from \$39,394 to \$54,545 depending upon whether the depreciation was taken under the 150 per cent declining balance or the straight-line methods, respectively—real property that does not qualify as residential rental property, as defined in section 167(k)(3)(C), cannot be depreciated at a rate in excess of 150 per cent declining balance if new, or straight-line if used.¹⁰¹ Whether new or used, the current rules of thumb as to annual rate of appreciation on new real estate is 10 per cent a year and on used improved real estate is between 3 and 5 per cent, the annual unrealized appreciation of the beach property would be far in excess of the \$600 gap between the rental income and the expenses attributable to the rental use of the property.

It is indeed unfortunate that the beach house example has such bare bones since it obviously has a chilling effect upon investors desiring to make dual use of similar property. For instance prospectuses for public offerings of dual use condominium units have expressly referred to this example in disclosing the

¹⁰⁰ Rev. Proc. 62-21, 1962-2 C.B. 418.

¹⁰¹ I.R.C. § 167(j)(1). Under straight-line depreciation $\$54,545 \times 2.2$ per cent = \$1,199. Useful life is 45 years; $1/45 = 2.2$ per cent. Under 150 per cent declining balance depreciation $\$39,394 \times 3.3$ per cent = \$1,199. Assuming that the beach house would be rented only on a transient basis, double declining balance depreciation would not be available. I.R.C. § 167(j)(2).

potential section 183 risks an investor faces.¹⁰² Moreover, it will undoubtedly encourage agents to attack such dual use of property. Accordingly, the beach house example should be clarified to indicate the reasons that the single activity was not engaged in for profit, with particular attention given to the factor of unrealized appreciation.

Profit

The term "profit" is not defined in the Code. The Treasury recommended that the House "provision be amended to make it clear that the reasonably anticipated profit [the House standard rejected by the Senate] must be an economic profit, not a 'tax savings' profit, and that such 'profit' need not be determined on an annual basis."¹⁰³ Although Congress did not heed this suggestion, the proposed regulations provided that (1) the fact that a taxpayer could not reasonably expect to produce an "economic profit" from an activity may indicate the taxpayer is not engaged in it for profit and (2) the term profit encompasses appreciation in the value of assets used in the activity.¹⁰⁴ The first element was deleted in the final regulations, no doubt due to the reasonable expectation of profit aspect. The Senate Committee on Finance report applied the term profit to the trigger in the section 183(d) presumption provision—income from the activity in excess of deductions attributable to the activity which would be allowed if it were engaged in for profit—but such definition, or better, description, should not be determinative as to the general definition of profit under section 183(c) defining an activity not engaged in for profit: (1) The Treasury did not follow such a definition as to section 183(c) since it stated in the regulations that profit includes unrealized appreciation which does not come within gross income until realized and (2) some cases under sections 162, 212(1) and 212(2) adopt a broader definition not necessarily coincident with taxable income, *i.e.*, gross income less deductions.¹⁰⁵

¹⁰² Prospectus, Montaneros Shareholders Recreation Programs, Inc. 43 (Oct. 13, 1972).

¹⁰³ TAX REFORM ACT OF 1969, TECHNICAL MEMORANDUM OF TREASURY POSITION ON H.R. 13270, 91ST CONG., 1ST SESS. 35 (Comm. Print 1969).

¹⁰⁴ Prop. Reg. §§ 1.183-2(b)(9) and 1.183-2(b)(10), 36 Fed. Reg. 16112 (August 19, 1971). The later factor is identical with Reg. § 1.183-2(b)(4).

¹⁰⁵ S. REP. NO. 91-552, 91ST CONG., 1ST SESS. 104-05 (1969). Section 183(d) does not base its presumption on the term "profit"; rather the presumption is triggered when "the gross income . . . exceeds the deductions attributable to such activity." The Senate Committee on Finance was describing an activity with such excess of gross income over deductions as being engaged in for profit, which indeed it is. There is, however, no indication

A model for exploring the perimeters of the concept of profit is a limited partnership interest in a syndicate operating non-owner occupied residential real estate. Typically, such a partnership generates large tax losses (often a limited partner's pro rata share exceeds, over a six to seven year period, his initial investment) through accelerated depreciation and mortgage interest deductions during the first six and one half years of operation and thereafter (the turn-around or cross-over) generates taxable income so that the limited partner ultimately recoups his tax losses and enjoys an overall profit.¹⁰⁶ Furthermore, tax-free distributions of cash flow are commonly made during this period to the limited partner, again often in an amount equal to his investment and, in addition, the partnership assets may be expected to appreciate considerably during this period.¹⁰⁷ Finally, if at the end of the seven year loss period the limited partner disposes of his partnership interest, he will recognize a taxable gain, in addition to any cash consideration received, equal to his prior tax losses and cash distributions, less his capital contribution to or investment in the partnership.¹⁰⁸ Such gain may be taxed in part as ordinary income

that profit (not the dispositive term in section 183(d)) as used in section 183(c) is limited to gross income in excess of deductions, attributable to the activity. In short, the committee report appears to have used profit as a description of gross income in excess of deductions, rather than gross income as a definition of profit. See Note, *Analysis of New Code Section 183 and Some Ramifications for the Resort Home*, 9 WILLAMETTE L.J. 117, 122 (1973) (profit not restricted to excess of income over expenses).

¹⁰⁶ Guido, *The Impact of the Tax Reform Act of 1969 on the Supply of Adequate Housing*, 25 VAND. L. REV. 289, 303 n.55 (1972); McKee, *The Real Estate Tax Shelter: A Computerized Exposé*, 57 VA. L. REV. 521, 529 (1971) (turnaround in tenth year); Rabinowitz, *Realty Syndication: An Income Tax Primer For Investor and Promoter*, 29 J. TAXATION 92-96 (1968); Pircher, *Tax Sheltered Investments: What, Who, When and Which?*, 28 BUS. LAWYER 897, 902 (1973).

¹⁰⁷ In computation of cash flow income, mortgage amortization but not depreciation is deducted. Rabinowitz, *Realty Syndication: An Income Tax Primer For Investor and Promoter*, 29 J. TAXATION 92, 95 (1968). Another way of expressing the concept, which does not differ in results, is "net profits after taxes plus non-cash charges, such as depreciation, depletion, and amortization." HERWITZ, *BUSINESS PLANNING* 6 (1966). While there are many alternative definitions of real estate investment return (see Roulac, *Truth in Real Estate Reporting*, 3 REAL ESTATE REV. 90, 91 (1973)), and methods for distributing cash flow (see Schwartz, *How to Find Tax Shelter as a Limited Partner*, 1 REAL ESTATE REV. 54, 57-58 (1971)), when used in text and footnotes the above definition of cash flow is meant. Cash flow as a return on investment frequently exceeds 10 per cent of investment on an annual basis. U.S. TREASURY DEP'T TAX REFORM STUDIES AND PROPOSALS (PART 1), 91ST CONG., 1ST SESS. 455 (Comm. Print 1969); Pircher, *Tax Sheltered Investments: What, Who, When, and Which?*, 28 BUS. LAWYER 897, 902 (1973).

¹⁰⁸ The amount realized upon the sale of a partnership interest includes the partner's share of partnership liabilities. Reg. § 1.752-1(d); *Crane v. Comm'r*, 331 U.S. 1 (1947); Frank A. Logan, 51 T.C. 482 (1968). This is computed on the basis of his share of profits or losses. Reg. § 1.752-1(e). Such share is included in his basis of his partnership interest. Reg.

by virtue of section 751 to the extent of potential recapture at the partnership level with respect to partnership property.

This model is particularly appropriate in view of the increasing, in the words of one commentator, booming, market in the sale of such limited partnership interests as tax shelters.¹⁰⁹ Indeed, the SEC has recently informally required that prospectuses for public offerings of units or participations in such syndicates explain the possible impact of section 183 on investors lacking a profit motive who invest in any tax shelter (limited partnership) which is expected to generate annual net losses for tax purposes for a period of years. Such requirement is the apparent source for the following statement in a recent prospectus for a public offering of units in a limited partnership investing in government assisted

§§ 1.752-1(a)(2) and 1.722-1. It serves as a ceiling on the deductibility of a partner's distributive share of partnership losses. I.R.C. § 704(d). This basis is reduced (but not below zero) by the partner's share of partnership losses and cash distributions. I.R.C. §§ 705(a)(2) and 733. To the extent such losses and cash flow distributions are in excess of the partner's equity investment, they reduce his share of the partnership liabilities included in his basis. Thus, the difference between the partner's share of the liabilities still in his basis and his share of the liabilities in the amount realized constitutes taxable income. In short, prior deductions and cash distributions in excess of a partner's cash investment increase his taxable gain on disposition. Rabinowitz, *Realty Syndication: An Income Tax Primer For Investor and Promoter*, 29 J. TAXATION 92, 96 (1968); Pircher, *Tax Sheltered Investments: What, Who, When and Which?*, 28 BUS. LAWYER 897, 902-03 (1973). Assuming there is no recapture depreciation (I.R.C. §§ 1245 and 1250) at the partnership level and no other unrealized receivable or substantially appreciated inventory, as defined in section 751, abandonment or gift of the partnership interest produces the same tax consequences since withdrawal from the partnership reduces the partner's share of partnership liabilities to zero, which is treated as a constructive cash distribution to him. Reg. § 1.752-1(b)(1); Rev. Rul. 74-4, 1974-4 I.R.B. 10. Such distributions to the extent in excess of the partner's basis are treated as gain from the sale or exchange of his partnership interest. See Bonovitz, *What is the Tax Cost of Getting Out of a Losing Partnership Venture?*, 25 J. TAXATION 106 (1966). I.R.C. § 731(a). If, however, section 751 property is present, the constructive cash distribution is apparently treated under the section 751 regulations as (1) a pro rata distribution of section 751 and non-751 property to the withdrawing partner with (2) a simultaneous sale by him of the section 751 property to the partnership in return for constructive cash. See Aronsohn, *Admission of a New Partner For Cash, Property or Services*, 23 TAX LAWYER 325, 337 (1970). Such constructive sale could result in a larger gain than what would result from a reduction in basis alone.

In a syndicated real estate tax shelter a limited partner's share of deductions is usually in excess of his equity investment since such leverage is one of the basic components of the shelter. See McDaniel, *Tax Reform and the Revenue Act of 1971: Lesions, Lagniappes and Lessons*, 14 B.C. IND. & COM. L. REV. 813, 823 (1973). In late 1973, the Service was considering requiring for advance ruling purposes a representation that the aggregate tax deduction for the first two operating years of a limited partnership would not exceed the equity investment. *Remarks of the Honorable Donald C. Alexander Before the Cleveland Tax Institute*, 27 TAX LAWYER 173, 176 (1974).

¹⁰⁹ Perry, *Limited Partnerships and Tax Shelters: The Crane Rule Goes Public*, 27 TAX L. REV. 525 (1972).

housing projects, which it declared were expected "to provide a return on investment primarily in the form of tax losses":

Counsel for the Partnership are aware of no situation in which the foregoing provisions [section 183] have been applied to activities similar to those of the Partnership. There can be no assurance, however, that the foregoing provisions may not be so applied in the future to disallow deductions attributable to operations of the Partnership.¹¹⁰

It appears well settled that an expenditure motivated by a desire to effect a tax reduction, *i.e.*, a tax shelter motive, does not arise in connection with the taxpayer's profit seeking activities which is the standard under section 212.¹¹¹ While some of the cases in this line equate profit with taxable income, usually in dicta, others reject any definition of income as used in section 212 limited to an excess of receipts over expenses and hold instead that the word should be taken to mean an inflow of money or gross receipts.¹¹²

The cases indicating that cash flow can satisfy the profit requirement manifest the profit is not limited to the excess of gross receipts over deductions. Cash flow may be defined as net profits after taxes less debt amortization plus noncash charges, such as depreciation.¹¹³ To the extent that cash flow arises from adding back depreciation, it may be viewed as income from the activity which is sheltered by the depreciation, indeed, the Treasury in another context has so viewed it.¹¹⁴ The Tax Court in *Norman C.*

¹¹⁰ Prospectus, U.S. Shelter Limited Partnership 30 (December 18, 1972). More recently and after this article was substantially completed, the SEC apparently began to require in such explanation a caveat that although the Service "has never indicated that Section 183 is applicable to Limited Partners, it is conceivable that it may take such a position, notwithstanding any 'profit objective' which the Partnership may be deemed to have." Prospectus, DLJ Properties/73 at 46 (October 18, 1973). The reference here, of course, is to the level at which motive is ascertained. In addition, the Commissioner recently stated that losses from syndicated tax sheltered investments may not be deducted if the only profit will result from tax savings. On audit, national staff economists are to assist in determining "whether participants can, absent unexpected problems, *reasonably* expect to earn a profit appropriate to the investment and the degree of risk involved." I.R. No. 1336, 749 CCH STAND. FED. TAX REP. ¶ 6257 (emphasis added).

¹¹¹ *Brown v. United States*, 396 F.2d 459, 466 (Ct. Cl. 1963); *Knetsch v. United States*, 348 F.2d 932, 937-38 (Ct. Cl. 1965); *cert. denied*, 383 U.S. 957 (1967); *Samuel Yanow*, 44 T.C. 444, 452-53 (1965), *aff'd per curiam*, 358 F.2d 996, 998 (3d Cir. 1966).

¹¹² Compare, *e.g.*, *Weir v. Comm'r*, 109 F.2d 996, 998 (3d Cir.), *cert. denied*, 310 U.S. 637 (1940) and *Justin A. McNamara*, 32 T.C.M. 11 (1973), with *Hartford v. United States*, 265 F. Supp. 86 (W.D. Wis. 1967); *cf. Goldsborough v. Burnet*, 46 F.2d 432, 433 (4th Cir. 1931).

¹¹³ HERWITZ, BUSINESS PLANNING 6 (1966).

¹¹⁴ TAX REFORM BILL OF 1973, ADMINISTRATION'S PROPOSALS FOR TAX CHANGE WITH TREASURY EXPLANATION, 93RD CONG., 1ST SESS. 15 (Comm. Print 1973); See Young, *The*

Demler,¹¹⁵ a prophetic decision in other respects, stated that it expressed "no opinion as to the extent to which depreciation (and particularly the method used for tax purposes) should be taken into account in determining 'expectation of profit'"—depreciation being the primary factor causing cash flow to be greater than taxable income.¹¹⁶ Moreover, in *Worrell v. United States*,¹¹⁷ the district court pointed out: "[V]iewed on a cash-flow basis, the cash loss was not nearly so great as the tax loss." The court went on to point out that in one year the taxpayer realized an actual cash profit from the farm operations on a cash flow or economic basis. In *John R. Carkhuff*,¹¹⁸ on the other hand, the Tax Court stated that if the taxpayer's beach residence were fully rented for the period and at the rental for which offered, in fact, in some years it was not rented at all, the property would not have returned an amount equal to depreciation, taxes and costs of operations, "although it would have returned an amount in excess of direct operating expenses."¹¹⁹ While this language could be construed as equating profit with taxable profit and not cash flow, in fact the decision clearly turned on other factors. Moreover, the Sixth Circuit in affirming the Tax Court did not address the question.

It is submitted that profit should not be limited to taxable income (gross income in excess of deductible expenditures) for purposes of section 183(c), but should encompass income or cash flow. Certainly cash flow comes within one definition of profit under section 165(c)(2): "the advantage or gain resulting from the investment of capital, or the acquisition of money beyond the amount expended; a pecuniary gain."¹²⁰ The section 165 and

Role of Motive in Evaluating Tax Sheltered Investments, 22 TAX LAWYER 275, 289-90 (1969).

¹¹⁵ 25 T.C.M. 620, 626 n.10 (1966). One commentator has suggested that the expectation of profit should be ascertained by calculating profits and losses in accordance with general accounting rules, rather than special rules which accelerate deductions, such as accelerated depreciation, since this is the approach ordinarily used by businessmen to determine their profits or losses. Allington, *Farming as a Tax Shelter*, 14 S.D.L. Rev. 181, 193-94 (1969).

¹¹⁶ U.S. TREASURY DEP'T TAX REFORM STUDIES AND PROPOSALS (PART 3), 91ST CONG., 1ST SESS. 455 (Comm. Print 1969).

¹¹⁷ 254 F. Supp. 992, 995 n.4 (S.D. Tex. 1966).

¹¹⁸ 28 T.C.M. 375, (1969), *aff'd*, 425 F.2d 1400 (6th Cir. 1970).

¹¹⁹ 28 T.C.M. at 379. It may be significant that Judge Scott, the trier of fact in *Carkhuff*, recently ruled in *Justin A. McNamara*, 32 T.C.M. 11, 18(1973), that "a motive to effect a tax reduction is not a 'profit' motive since it is not intended to produce taxable income."

¹²⁰ *Goldsborough v. Burnet*, 46 F.2d 432, 433 (4th Cir. 1931), quoting from *Brooks Bros. v. Cassebeen*, 157 App. Div. 683, 142 N.Y.S. 781, 782 (1913). A commentator on

section 212 cases defining profit as taxable income could have reached the same result by merely holding that reduction in taxes does not constitute profit for those provisions—the approach taken by the majority of decisions in the area. Cash flow qualifies as profit in the economic sense of the term, which should be the standard under section 183, and in the everyday meaning investors would ascribe to the term.

As previously discussed, profit motive should be determined at the partnership level, with such motive being transmitted to the partner. Thus, where a partnership is engaged in an activity for profit—as is the case in our model since it expects after the initial loss period to make a taxable profit once the cross-over point is reached and after a certain point earn net income from operations over all prior losses—the limited partner has incurred the loss in an activity engaged in profit. Nevertheless, the Service will probably be tempted to examine the partner's motive where he contemplates disposing of his partnership interest prior to the cross-over point.¹²¹ In such circumstances motive should be determined at the partner level as to expectation of profit from operations. Although, such a disposition will trigger a realized gain equal to prior losses, that would not constitute a before tax profit, only a wash, or if such gain is taxed in part as capital gains on after-tax profit, which is not sufficient.¹²² But, at the same time, the partner usually may expect a further gain from appreciation in the partnership assets, which he may indeed have already realized but not recognized through his partnership's refinancing its liabilities and distributing to the limited partners the proceeds from the new mortgage in excess of the outstanding principal

profit motive under sections 162, 212, et cetera, has concluded that a taxpayer's claim to be holding property for the production of income would seem to be improved by cash flow. Young, *The Role of Motive in Evaluating Tax Sheltered Investments*, 22 TAX LAWYER 275, 290 (1969); see Note, *Death and Taxes: An Analysis of 1014, 743, 236, and the Limited Partnership*, 59 VA. L. REV. 122, 149 n.144 (1973).

¹²¹ See Young, *The Role of Motive in Evaluating Tax Sheltered Investments*, 22 TAX LAWYER 275, 289 n.38 (1969). Where the taxpayer bases his profit motive on the unrealized appreciation in the residual value of the rental property and thus claims mixed motives, profit and tax reduction, "[e]vidence introduced by the Commissioner of an actual or planned premature disposition of the property in such a way that the taxpayer would not realize the residual value would cast doubt upon the taxpayer's assertion of mixed motives."

¹²² Hjorth, *Farm Losses and Related Provisions*, 25 TAX L. REV. 531, 607-09 (1970) (a wealthy taxpayer anticipating that his only profits will be capital gain attributable to recovery of the ordinary deductions (through basis adjustments) is not engaged in the activity for a before-tax profit, only an after-tax profit).

amount of the old mortgage.¹²³ Such appreciation in the regulations is recognized as profit:

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 income from the activity together with the appreciation of land will exceed expenses of operation.¹²⁴

The district court in *Kanter v. United States*¹²⁵ recently rejected, however, the taxpayer's contention that production of income under section 212 meant not only the production of rental income from a dual use beach cottage, but also the production of prospective income from its capital appreciation (about \$31,000 in appreciation versus approximately \$22,000 in net losses during the tax years).

The *Kanter* court reasoned that since capital appreciation and taxable income therefrom only become a fact when a sale of the asset occurs, it could not subscribe to such broad reading of section 212. Furthermore, it believed that the consequence of the taxpayer's contention would be "any maintenance and repair expense of any home, even of a permanent residence, whether rented or not or even available for rental, would be a deductible expense on the claim of the owner that he was holding the cottage or home for the ultimate production of income upon its sale at a hoped-for capital gain."¹²⁶ It is submitted that the court was in error on both grounds.

The section 212 regulations provide that the provision applies to the property held for investment even though it is not currently income productive, echoing legislative history which contemplated income which might be realized in the future.¹²⁷ Similarly, the

¹²³ Cowan, *Receipt of an Interest in Partnership Profits in Consideration for Services: The Diamond Case*, 27 TAX L. REV. 161, 200 n.118 (1972).

¹²⁴ Reg. § 1.183-2(b)(4).

¹²⁵ 73-1 U.S.T.C. ¶ 9311 (E.D. Va. 1973), *aff'd per curiam*, 74-1 U.S.T.C. ¶ 9182 (4th Cir. 1974). By the time of trial, three years later, the property had appreciated an additional \$45,000.

¹²⁶ *Kanter v. United States*, 73-1 U.S.T.C. ¶ 9311 (E.D. Va. 1973) (emphasis by court), *aff'd per curiam*, 74-1 U.S.T.C. ¶ 9182 (4th Cir. 1974).

¹²⁷ Reg. § 1.212-(b). Congress stated that the term "income" for the purposes of the predecessor to section 212 "comprehends not merely income of the taxable year but also income which the taxpayer has realized in a prior taxable year or may realize in subsequent taxable years, and is not confined to recurring income but applies as well to gain from the disposition of property." S. REP. NO. 1631, 77th Cong., 2d Sess. 87 (1942) (emphasis added). See also Rev. Rul. 74-28, 1974-3 I.R.B. 7.

regulations under section 183 recognize that profit encompasses appreciation in the value of assets used in the activity. Thus, they continue, the taxpayer may intend that even without a profit from current operations an overall profit will result when appreciation in the assets is realized. Furthermore, the Tax Court in several section 162 hobby loss decisions has provided a direct answer to the implicit limitation of income to realized income provided in *Kanter*: While profits and losses must be computed on an annual basis for recognition of gains or losses, this is not true in determining whether the taxpayer has a profit motive. For it is not necessary that the activity be profitable in the tax year, only that the taxpayer have a bona fide expectation of an overall net profit from income which he expects to realize in a subsequent year.¹²⁸

As to the second leg of the *Kanter* rationale, it acknowledged the principle that for section 212, if the taxpayer is holding the property for production of income from appreciation, such appreciation must have taken place while it was dedicated to profit purposes, rather than while it was used for personal purposes. Thus, the court's argument that reliance on unrealized capital appreciation would permit deductibility under section 212 of maintenance and repair expense of a permanent residence was a straw man. To the extent that the court meant the appreciation could not be considered because the cottage was being primarily used for personal purposes, it was indulging in a bootstrap argument. For proper application of this rule would mean that if the taxpayer were engaged in two activities with respect to the beach property—one personal and the other engaged in for profit—only the appreciation in the property during the latter activity can be considered in determining whether the taxpayer has conducted the latter activity primarily for profit. The Tax Court in *Carkhuff*¹²⁹ was bothered by the possibility of a recurring conversion of beach property from personal use to business use, then back to personal use and so forth. Because the requisite section 212 appreciation profit has been categorized as post-conversion appreciation, it might prove difficult to establish the amount of post-conversion appreciation, during all periods of business dedication or only during the most recent conversion to business

¹²⁸ See Margit Sigray Besseney, 45 T.C. 261 (1965), *aff'd*, 379 F.2d 252 (2d Cir. 1967); Herbert C. Sinderson, 23 T.C.M. 1723 (1964); *accord*, Lillian Solomon, 26 T.C.M. 919 (1967).

¹²⁹ John R. Carkhuff, 28 T.C.M. 375 (1969), *aff'd*, 425 F.2d 1400 (6th Cir. 1970).

use.¹³⁰ On the other hand, if only a single activity were involved, part business and part personal use, the proper approach would appear to be allocation of unrealized appreciation to business and personal uses to determine whether the former portion is in excess of losses attributable to business use.

The court in *Kanter*, due to its erroneous treatment of appreciation, never faced the difficult question of whether an activity is engaged in primarily for profit where unrealized appreciation attributable to a period dedicated to rental purposes is substantially in excess of losses attributable to such period, and the taxpayer's business acumen as to such property is undisputed, but substantial personal elements are present: personal use during the entire peak rental period, selection of the particular lot on the basis of personal factors and rental of cottages in the area for ten summers prior to construction of the property. *Carkhuff* contains the seeds of the proper approach to this question. There, in many years no rents were received at all and the gross receipts when received were substantially less than the total expenses including depreciation. As to appreciation, the court acknowledged the property had increased in value but found no evidence that the taxpayer ever intended to dispose of the property after future increase in value. Thus, the court concluded that the property could not at any time be said to have been held as an investment. Judge Scott, the trier of fact in *Carkhuff*,¹³¹ recently expanded in *Leonard F. Barcus*¹³² the thought she had presented in the earlier decision. The taxpayers in *Barcus* purchased and sold antiques which they also used as the furnishings in their home (95 per cent). Their testimony that many of the antiques had or would increase in value and that some day they might sell them at a large profit indicated to the court more of an interest in keeping valuable purchases than an interest in making a profit from a trade or

¹³⁰ Frank A. Newcombe, 54 T.C. 1298, 1302 (1970) (production of income limited to post-conversion appreciation).

¹³¹ John R. Carkhuff, 28 T.C.M. 375 (1969), *aff'd*, 425 F.2d 1400 (6th Cir. 1970). Allocation of unrealized appreciation to business and personal use finds support in *Sharp v. United States*, 199 F. Supp. 743 (D. Del. 1961), *aff'd per curiam*, 303 F.2d 783 (3d Cir. 1962) (allocation of basis of aircraft and proceeds of sale to business and personal use).

¹³² 32 T.C.M. 660, 664 (1973), *aff'd per curiam*, 74-1 U.S.T.C. ¶ 9288 (2d Cir. 1974). See Note, *Analysis of New Code Section 183 and Some Ramifications for the Resort Home*, 9 WILLAMETTE L.J. 117, 134 (1973) (appreciation factor may be outweighed by personal aspect). Significantly, the Fourth Circuit in its *per curiam* affirmation of *Kanter* reasoned that the district court had found that "the home was not purchased and maintained for purposes of financial gain, whether by way of capital appreciation or current income." 74-1 U.S.T.C. ¶ 9182 (4th Cir. 1974).

business of purchasing and selling antiques. Thus, unrealized appreciation alone is not sufficient, the taxpayer must show that his primary purpose is ultimately to realize such appreciation in order for the appreciated property to be held for the production of income or to be held as inventory in a trade or business of selling such items. Under such analysis *Kanter* might have reached the correct result, but there are no findings in the reported decision on the point.

Even more difficult is the question whether allocation and partial deductions are called for where the taxpayer does intend to ultimately realize the income from the appreciated property, but this motive is outweighed by personal motives for holding the property. Of course, this would only be a problem in areas in which the investment is of a type particularly subject to personal use—antiques, paintings or dual use beach houses.¹³³ The answer to whether such allocation is permitted is difficult to find. On the one hand, section 212 is commonly thought to adopt an all or nothing primary purpose test; but, on the other, most of the various areas of deductions under section 162 follow an allocation approach where the secondary purpose is more than merely incidental.¹³⁴ Although conceptually sound, an allocation rule where

¹³³ See, e.g., *Wrightsmen v. United States*, 428 F.2d 1316 (Ct. Cl. 1970) (paintings); *Kanter v. United States*, 73-1 U.S.T.C. ¶ 9311 (E.D. Va. 1973) (beach house); *Leonard F. Bareus*, 32 T.C.M. 660 (1973) (antiques).

¹³⁴ A judicial conflict has arisen under section 162 as to whether in a mixed motive situation profit motivation must be the dominant or primary intent or need it be only a purpose. See *Oshins, Proposed Regulations Provide New Rules for the Hobby Loss Game*, 35 J. TAXATION 214, 215 (1971); *DICKINSON, FARM AND RANCH LOSSES*, BNA TAX MANAGEMENT PORTFOLIO No. 241, A-26 (1970). The majority of the hobby loss decisions favor the dominant or primary purpose test. Moreover, the Supreme Court recently resolved, in *United States v. Generes*, 405 U.S. 93, 105 (1972), a similar conflict under section 166(d) as to the test for whether a bad debt was business motivated in favor of a dominant motivation standard over a significant motivation standard. The Court also concluded that the dominant motivation standard was consistent with that applied to losses incurred in a trade or business under section 165(c)(1) and that consistency is desirable in such related areas. It may be noted that some earlier hobby loss decisions had relied upon section 165(c) in opting for a primary purpose test, *Alice D. Worcester*, 21 T.C.M. 1138, 1143 n.3 (1962), and that *Generes* has already been read to dictate the use of a primary purpose standard under section 162 in areas other than hobby losses, *Leonard F. Cremona*, 58 T.C. 219, 223 (1972) (concurring opinion). Finally section 1.212-1(c) of the regulations (mirrored in regulation section 1.183-2(b)) follow a negative primary purpose test: "expenses of carrying on transactions . . . which are carried on primarily as a sport, hobby, or recreation are not allowable as nontrade or nonbusiness expenses." However, *Myron Edwin Cherry*, 26 T.C.M. 557 (1967), indicates that the primary purpose test under section 212 is not applicable to section 162. Nevertheless, it is most likely that the primary purpose test will be applied to section 183. The harder question is whether a partial deduction will be allowed under section 183 where the taxpayer's business purpose is not

profit motive is not the primary motive may offer the same insurmountable administrative problems that the travel and entertainment expenditures did prior to the enactment of section 274.

In conclusion, the limited partner in our model expects a profit from appreciation and cash flow in addition to tax shelter. Accordingly, he may be engaged in this activity for profit by virtue of the first two elements, but cannot consider the last element.¹³⁵

Definition of Activity Not Engaged in for Profit

Section 1.183-2(a) of the regulations, as well as the statute, ties the phrase, "activity not engaged in for profit" into sections 162 and 212(1) or (2):

[A]n activity other than one with respect to which deductions are allowable for the taxable year under section 162 or under paragraph (1)

primary but is more than merely incidental. One commentator states the apparent rule as being that if the taxpayer's use of the vacation home is not incidental to the rental activity, maintenance of the home will be treated as primarily personal, with expenses deductible only under the tier system. He further notes that H.R. 1040 would treat ownership of such a vacation home as an activity not engaged in for profit. Emory, *The Corman and Mills-Mansfield Bills: A Look at Some Major Tax Reform Issues*, 29 TAX L. REV. 1, 58 (1973).

In general under section 162 an all or nothing approach is followed only where the secondary use or motive is merely incidental. Where the secondary use or motive is more than incidental then allocation is called for. *International Artists, Ltd.*, 55 T.C. 94, 107 (1970). Thus, where business use of an airplane was 27 per cent, that percentage of depreciation was allowed. *Sharp v. United States*, 199 F. Supp. 743 (D. Del. 1961), *aff'd*, 303 F.2d 783 (3d Cir. 1962). In the area of travel expenses, however, if a trip is primarily personal, section 1.162-2(b)(1) of the regulations provides that the traveling expenses to and from the destination are not deductible, even though the taxpayer engages in business activity while at such destination. In effect an all or nothing approach, rather than allocation, was followed here. See Klein, *The Deductibility of Transportation Expenses of a Combination Business and Pleasure Trip—A Conceptual Analysis*, 18 STANFORD L. REV. 1099 (1966).

¹³⁵ Commentators have suggested on the basis of *George L. Schultz*, 50 T.C. 688 (1968), *aff'd per curiam*, 420 F.2d 490 (3d Cir. 1970), which held that the intention of a taxpayer purchasing raw whiskey to hold for the normal four year aging was to acquire four year old bourbon so that he had to capitalize insurance and storage costs as acquisition costs, that (1) the costs of acquiring the residual interest in the appreciation might have to be capitalized as acquisition costs of such interest (*Allington, Farming as a Tax Shelter* 14 S.D.L. REV. 181, 203 (1969)) and (2) the investor has not acquired new rental property, only the residual interest, and therefore would not be entitled to interest or depreciation deductions since he is not the present owner of the property securing the loan which is being depreciated. Young, *The Role of Motive in Evaluating Tax Sheltered Investments*, 22 TAX LAWYER 275, 290 (1969). But see *Daniel D. Kinley*, 51 T.C. 1000, 1004 (1969) *aff'd*, 70-2 U.S.T.C. ¶ 9462 (2d Cir. 1970) (Tax Court rejected Commissioner's argument that taxpayer grew scotch pine trees which he converted into marketable Christmas trees through annual shearings; rather he planted Christmas trees which through proper care during their growth matured into marketable trees).

or (2) of section 212. Deductions are allowable under section 162 for expenses of carrying on activities which constitute a trade or business of the taxpayer and under section 212 for expenses incurred in connection with activities engaged in for the production or collection of income or for the management, conservation, or maintenance of property held for the production of income. Except as provided in section 183 and § 1.183-1, no deductions are allowable for expenses incurred in connection with activities which are not engaged in for profit. Thus, for example, deductions are not allowable under section 162 or 212 for activities which are carried on primarily as a sport, hobby, or for recreation.

The basis of this close relationship of section 183 to sections 162 and 212 was the decision of the Tax Reform act Congress to adopt the judicially fashioned principle under the latter sections that losses or expenses are not deductible if the loss generating activity is not a business, but merely a hobby. From the articulation of this decision in the statute through cross reference to sections 162 and 212, commentators on section 183 prior to the issuance of the regulations, uniformly concluded that the provision was, in essence, a codification of prior hobby loss cases.¹³⁶

The section 162 and 212 case law contains, however, several areas in which splits of authority exist. Congress resolved two of these conflicts: (1) an objective rather than a subjective approach is to be employed in determining profit motive and (2) a reasonable expectation of profit is not required.¹³⁷ Accordingly, cases

¹³⁶ Diamond & Horne, *Hobby Losses; Miscellaneous Individual and Corporate Problems*, 23 TAX LAWYER 609, 610 (1970); Comment, *Section 183: Work Horse or Hobby Loss*, 20 CATHOLIC U.L. REV. 716, 732 (1971); Rhodes, *Hobby Losses—A New Challenge*, 56 A.B.A.J. 893, 894 (1970); O'Byrne, *New Law Greatly Limits Tax Shelter Formerly Provided by Farming Operations*, 32 J. TAXATION 298, 299 (1970); Oshins, *Proposed Regulations Provide New Rules for the Hobby Loss Game*, 35 TAXATION 214, 215 (1971).

¹³⁷ See S. REP. No. 91-552, 91st Cong., 1st Sess. 104 (1969). One commentator has suggested that the objective approach adopted by the Senate Committee on Finance militates against total repudiation of the reasonable expectation of profit test, the apparent reasoning being that limitation to objective manifestations of profit motive would result in the expectation also being reasonable. See DICKINSON, *FARM AND RANCH LOSSES*, BNA TAX MANAGEMENT PORTFOLIO No. 241, A-26 (1970). To the contrary, the committee's news release prior to the publication of the committee print stating that "testimony presented at the hearings indicated considerable difficulty could be expected from the subjective nature of the test (reasonable expectation of profit) applied by the House Bill, Committee on Finance, United States Senate Press Release #31 (October 17, 1969), cuts toward indentifying rejection of the subjective approach with repudiation of the *reasonable* expectation of profit, so that subjective evidence may be considered as to aspects other than the reasonableness of the expectation of profit." The language of the committee print is, of course, of much broader import. See Walter E. Edge, Jr., 32 T.C.M. 1291 (1973).

which followed the contrary positions on these questions are not applicable to section 183.

The regulations provide that the determination whether an activity is engaged in for profit shall be made on the basis of "objective standards," taking into account all the facts and circumstances of each case. Nine factors, purportedly objective, are provided. Yet, section 1.183-2(a) of the regulations further states that greater weight is to be given to objective facts than to the taxpayer's mere statement of his intent. In view of Congress's rejection of the subjective approach, it is somewhat surprising that the regulations accord any weight at all to the taxpayer's subjective intent as manifested through his statements. The drafters of the regulations meant that the taxpayer's actions speak louder than his words and that his mere unsupported statement should normally be accorded little or no evidentiary weight. Nevertheless, they believed that "[w]here the taxpayer's words can justify his actions and he is able to convince the trier of the facts of the veracity of his statements, the case should be determined in his favor."¹³⁸

Perhaps one should not look a gift horse in the mouth, but this writer has the strong suspicion that the Treasury's apparent liberality flowed from a refusal to accept the following corollary of the Senate Finance Committee's adoption of an objective standard: Where the objective factors, such as business like appearance and efficiency in operations are in the taxpayer's favor, he should be found to be engaged in the activity for profit regardless of the presence of such subjective factors as his love of the activity or desire to disseminate his philosophy. In this context, another commentator had reasoned prior to the issuance of any regulations under section 183 that while the outcome of the vast number of prior cases would not have been changed by the application of the objective standards of section 183, the result of cases like *Schley v. Commissioner*¹³⁹—the pattern for the first

¹³⁸ Oshins, *Proposed Regulations Provide New Rules for the Hobby Loss Game*, 35 J. TAXATION 214, 215 (1971). This statement regulation has now been incorporated into the sections 162 and 212 case law. Joseph W. Johnson, Jr., 59 T.C. No. 78 (1973) ("No single factor is controlling but greater weight is to be given to objective facts than to the taxpayer's mere expression of intent.").

¹³⁹ *Schley v. Comm'r*, 375 F.2d 747, 750 (2d Cir. 1967); Rhodes, *Hobby Losses—A New Challenge*, 56 A.B.A.J. 893, 895 (1970). Another commentator obviously views the mandated objective approach in the same light as Rhodes: "In other words, the taxpayer does not have to demonstrate that he had a subjective expectation of making a profit but merely that the way in which he carries on the activity should make a profit when con-

example in the regulations accompanying the objective factors—would. The Tax Court opinion in *Schley* summarized the subjective factors indicating a lack of profit motive, but also stated that the same picture was painted by the objective evidence: (1) a 28 year history of losses, (2) static gross profits with increasing expenses, (3) retention of an inefficient manager, (4) failure to consult with managers as to the extent of losses, and (5) a farm suffering from numerous deficiencies, inefficiency and obvious indifference to profit making in the overall operation and management. The circuit court favored the subjective factors of the taxpayer's background, her love of the farm and her substantial independent income, although also emphasizing the more objective factor of the magnitude of the losses incurred for more than 25 years. Despite (or perhaps because of) the belief of the above commentator that the love of the farm and the independent wealth would reflect more on the subjective side, consideration of which it will be recalled was prohibited by the Senate Finance Committee report, the first example, derived from *Schley*, mixes the objective and subjective facts relying both on total absence of profit and use of a farm manager, but not modern methods and on the subjective factors of large unrelated income, birth and rearing on a farm, and expression of a strong preference for living on a farm.

In *Lamont v. Commissioner*,¹⁴⁰ in contrast to *Schley*, the objective criteria of business-like manner of operations, continuity and efficiency were all in the taxpayer's favor, but the Tax Court and the appellate decision disregarded them in view of the taxpayer's subjective interest in the wide dissemination of his philosophical ideas and his independent financial status. The second example based upon *Lamont* omits those objective factors which were in the taxpayer's favor and, instead, focuses almost exclusively on the subjective factors of wealth and great interest in philosophy and dissemination of ideas.

Finally, the third example, patterned after *Imbesi v. Commissioner*,¹⁴¹ most clearly reveals the bias of the drafters of the regulations regarding subjective factors. The Tax Court appeared to rely equally on the subjective elements of a desire to maintain a fading breed of dogs and independent wealth and the objective

sidered objectively." Comment, *Analysis of New Code Section 183 and Some Ramifications for the Resort Home*, 9 WILLAMETTE L. J. 117, 122 (1973).

¹⁴⁰ 339 F.2d 377 (2d Cir. 1965).

¹⁴¹ 361 F.2d 640 (3d Cir. 1966), *rev'd on other grounds*, 23 T.C.M. 1678 (1964).

factors of extremely haphazard books and records in the taxpayer's activities of raising dogs and horses and the lack of any attempt to cut costs by culling the horses or dogs. The Third Circuit, while affirming the Tax Court as to the dogs, remanded it as to the horses, ostensibly on the ground that some horses were in fact culled. In reality its disagreement was with the objective approach:

The Tax Court, in seeking to determine motive, appears to have directed its inquiry to objective indications such as record-keeping, the general profit-potential of the activity and the actual results achieved by the taxpayer, and to have excluded his direct testimony regarding his motive. Objective factors are, of course, valuable evidence of a taxpayer's motive, although these are often burdened with the same infirmity as a taxpayer's testimony, since the meticulous observance of details which have been labeled as important objective signposts is of doubtful value once their observance becomes self-conscious.¹⁴²

In the statement of facts in the third example the unbusiness-like records and failure to cull of the actual case underlying the example are completely omitted while the large income and belief that the breed of dogs was declining are early on emphasized. This clear bias towards the subjective is, however, somewhat softened by (1) the addition in the example of the objective factors of a failure to advertise the dogs and showing of the horses only at prestige tracks and (2) the reliance in the conclusion to the example essentially on objective factors (although the independent income was noted).

We may conclude that the Treasury was unwilling to accept the implications of application of a purely objective approach to cases such as *Schley*, *Imbesi* and *Lamont* and, consequently, cracked the door slightly in the introduction to the nine factors for the taxpayer's use of the subjective intention as a shield while flinging it open for the government's use of subjective factors as a sword in the first three examples (surely not by happenstance, beginning with the *Schley* illustration). Due to the basic disagreement in this context of many courts, like the Third Circuit in *Imbesi* with the objective approach under section 162, it is not possible to determine at this time whether the subjective bias of the regulations, or at least of the first three examples in section 1.183-2(c) of the regulations, will be struck down as being inconsistent with the statute, which it clearly is.

The proposed regulations less subtly attempted to undo the other

¹⁴² 361 F.2d at 645.

legislative choice that there is no requirement that the expectation of profit be reasonable. While the proposed regulations, as do the final regulations, state that a reasonable expectation is not required, the former went on to provide in the "relevant factors" for ascertaining whether an activity is engaged in for profit that "The fact that a taxpayer is engaged in an activity which could not reasonably be expected to produce an economic profit may indicate that the taxpayer is not engaged in such activity for profit. The reasonableness of an expectation of profit is not conclusive but is merely some evidence of the intent of the taxpayer."¹⁴³

The drafters' apparent justification was that since a reasonable expectation of profit was not required, it was only to be one of the many factors to be considered, there was no conflict with the legislative history.¹⁴⁴ In fact, this general approach does appear in some of the cases which followed the bona fide profit intent, as contrasted with the reasonable expectation of profit approach, but in at least some instances appears to reflect a sub rosa adoption of the reasonable expectation of profit requirement.¹⁴⁵ In any event, this more obvious undermining of the legislative mandate under section 183 was totally abandoned in the final regulations. Although we may expect to see the Service attempt to resuscitate it as one of the factors not listed in the nine factors of the regulations, the fact that it appeared in the proposed regulations and was deleted from the final version will carry strong weight against its use by the Service.¹⁴⁶ Whether the subjective bias of the regulations will similarly be deleted on judicial review remains to be seen.

RELEVANT FACTORS PROVIDED BY REGULATIONS

The final regulations provide nine factors clearly distilled from the prior case law for ascertaining whether an activity is en-

¹⁴³ Prop. Reg. § 1.183-2(b)(9), 36 Fed. Reg. 16112 (Aug. 19, 1971).

¹⁴⁴ Oshins, *Proposed Regulations Provide New Rules for Hobby Loss Game*, 35 J. TAXATION 214, 216 (1971).

¹⁴⁵ Compare Henry L. Sutherland, 27 T.C.M. 103, (1968) (expectation need not be reasonable, but prospect of profit has bearing on intents; taxpayer had hoped to make a profit, but mere hope does not reach even unreasonable expectation), with *Brooks v. Comm'r*, 274 F.2d 96, 99 (9th Cir. 1959) (hope for profit qualifies as good faith purpose of making profit); *Hicks v. United States*, 72-1 U.S.T.C. ¶ 9383 (S.D. Miss. 1972); *Gross v. United States*, 71-2 U.S.T.C. ¶ 9715 (N.D. Fla. 1971); *Norman C. Demler*, 25 T.C.M. 620 (1966); *Henry L. Sutherland*, 25 T.C.M. 822, 824 n.1 (1966).

¹⁴⁶ Cf. *Hauptman v. Director*, 309 F.2d 62, 65 (2d Cir. 1962), *cert. denied*, 372 U.S. 909 (1963). See *Continental Ins. Co. v. United States*, 447 F.2d 661 (Ct. Cl. 1973).

gaged in for profit. The proposed regulations contained eleven factors, of which one was omitted as discussed above and two others were consolidated in the final version.

The proposed regulations provided that (1) no one factor was determinative, (2) the regulation factors were not the only factors to be taken into account and (3) that any one factor (whether or not set forth in the regulations) need not necessarily be given more weight than any other factors used in making the determination.¹⁴⁷ The drafter of the section 183 regulations has suggested that even if all the enumerated factors are against the taxpayer, he still may prevail if he can show his intention was to earn a profit. *Quaere*, whether this can be done without reliance upon a subjective approach. Apparently this position was presented to mollify some members of the Commissioner's Advisory Group on Cattle and Horses, who had expressed concern lest the factors be used as a weapon by the Service rather than serve merely as indicia of the taxpayer's intention. The intention of the drafters of the proposed regulations was that "the list be merely used as an aid in the ultimate determination of the intention of the taxpayer."¹⁴⁸

The final regulations deleted the ground rule that any one factor must not necessarily be given any more weight than any other factor and in section 1.183-2(b) of the regulations substituted in its stead the statement that a determination was not to be made on the basis of whether the number of factors, including those not listed, indicating a lack of profit objective exceeded the number indicating profit motivation, or vice versa. The case law clearly supports this approach—a controversy is not to be decided on a nose count of factors.¹⁴⁹ Similarly, in the overwhelming majority of decisions no one factor was determinative, and like black letter statements are frequently articulated in other "all facts and circumstances" areas.¹⁵⁰ The implication of the deleted statement that all factors are to be weighted equally, however, is clearly

¹⁴⁷ Prop. Reg. § 1.183-2(b), 36 Fed. Reg. 16112 (Aug. 19, 1971).

¹⁴⁸ Oshins, *Proposed Regulations Provide New Rules for Hobby Loss Game*, 35 J. TAXATION 214, 215 n.9 (1971). This writer fails to see how agents could avoid using at least some of the nine factors (or the taxpayer's alleged failure to meet them) as a sword, and, in fact, in his experience they have been so used.

¹⁴⁹ See, e.g., *Besseney v. Comm'r*, 379 F.2d 252, 256 (2d Cir.), cert. denied, 389 U.S. 931 (1967).

¹⁵⁰ See, e.g., *Albert Ravano*, 26 T.C.M. 793 (1967) (constructive dividend). See generally *Lee, Shareholder Withdrawal—Loan or Dividend: Repayments, Estoppel, and Other Anomalies*, 12 WM. & MARY L. REV. 512, 516 (1971).

not in accord with the existing case law. Indeed, one case has stated that the taxpayer's intent is best illustrated by his overt efforts to accomplish the goals of the activity; and to a lesser extent by the results actually attained.¹⁵¹ Similarly, factors such as absence of personal use are viewed as not bearing directly on the taxpayer's profit motive, but instead, as an indication that the activity is not primarily engaged in for pleasure or recreation,¹⁵² hence, are implicitly of less weight than the efforts to accomplish a profit. Applying these principles to the nine factors, it would appear that the first, second, third and fifth factors should be accorded more weight than the fourth, sixth, seventh, eighth and ninth factors.

The following discussion of these factors follows their order in the regulations. Since the impetus for tax reform in this area arose from farm losses, the overwhelming majority of hobby loss cases involved such losses and the legal principles were most developed there, it should not be surprising that these factors are clearly distilled from the sea of farm loss authorities. Accordingly, the discussion is primarily derived from farm loss cases and commentators, but evaluation of the factors in the other areas to which section 183 applies is made wherever possible.

Manner in Which Taxpayer Carries on the Activity

The fact that the taxpayer carries on the activity in a business-like manner and maintains complete and accurate books and 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.¹⁵³

In actuality this factor encompasses four criteria: (1) business-like manner of operations, (2) complete books and records, (3) similarity to profitable activities of the same nature and (4) changes in operating methods. It should be initially noted that the order of the factors set forth in the regulations does not

¹⁵¹ Harold I. Snyder, 25 T.C.M. 1326 (1966).

¹⁵² Rex B. Foster, Jr., 32 T.C.M. No. 14 (1973). Similarly, the financial status of the taxpayer and his standard of living appear of less weight than such factors as lack of investigation, segregation of expenses, absence of records, et cetera. Joseph W. Johnson, Jr., 59 T.C. No. 78 (1973).

¹⁵³ Reg. § 1.183-2(b)(i).

indicate their relative weight, for the proposed regulations contained a completely different order. For example, this factor was the eighth in the proposed regulations.

Business-Like Manner. In some cases, the criterion of business-like manner appears more a generic term overlapping several other criteria set forth in this factor, such as accurate books and records and adoption of new techniques, with perhaps a touch of the third regulation factor by covering supervision of employees.¹⁵⁴ Indeed, this item was not separately delineated by the corresponding factor in the proposed regulations and a commentator has described the application of this criterion in prior decisions as based on the overall operations of the activity rather than on individual factors.¹⁵⁵

Nevertheless, the term has various everyday meanings which the case law has emphasized, such as economy and constant attempts to cut costs and to improve income, as by switching from commercial cattle to a purebred breeding herd or seeking in every way to improve and upgrade the animals in a breeding herd.¹⁵⁶

Another connotation of business-like operations is thoroughness and a methodical approach. This aspect of business-like is also manifested in the case law.¹⁵⁷ Conversely, inattention to details or a lack of knowledge as to the extent of expenditures and receipts in the activity militate against profit motivation.¹⁵⁸

¹⁵⁴ *Whitney v. Comm'r*, 73 F.2d 589, 591 (3d Cir. 1934); *Israel O. Blako*, 38 B.T.A. 1457 (1938); *W. Jane Luce*, 29 T.C.M. 894 (1970); *Henry Potter Russel*, 1038 B.T.A.M. ¶ 38094.

¹⁵⁵ *DICKINSON, FARM AND RANCH LOSSES*, BNA TAX MANAGEMENT PORTFOLIO No. 241, A-34-35 (1970).

¹⁵⁶ *John S. Ellsworth*, 21 T.C.M. 145 (1962) (economy); *accord*, *Herbert O. Sanderson*, 23 T.C.M. 1723 (1964) (improve and upgrade livestock); *Rowe B. Metcalf*, 22 T.C.M. 1402 (1963) (switch breeds). A leading treatise acknowledges that a factor evidencing operation of a farm activity for a profit where the principal goal of the farm is growing a long-term crop which will not produce an immediate profit is the "fact that in the development period the taxpayer temporarily attempts to supplement income with short-time crops." 5 MERTENS, *FEDERAL INCOME TAXATION* § 28.73 n.20; see *Patterson v. United States*, 459 F.2d 487, 493 (Ct. Cl. 1972); *Margaret E. Amory*, 22 B.T.A. 1308, 1309 (1931); *Walter P. Temple*, 10 B.T.A. 1238, 1241 (1928). The converse of attempting to reduce net losses by supplementing income is attempting to reduce gross expenditures. *See, e.g., DuPont v. United States*, 28 F. Supp. 122, 125 (D. Del. 1939); *John S. Ellsworth*, 21 T.C.M. 145 (1962).

¹⁵⁷ *Samuel Riker, Jr.*, 6 B.T.A. 890, 893 (1927). *See also* *Thomas F. Sheridan*, 4 B.T.A. 1299, 1301 (1926).

¹⁵⁸ *Ewing v. Comm'r*, 213 F.2d 438 (2d Cir. 1954); *Margit Sigrey Bessenyoy*, 45 T.O. 261, 275 (1965), *aff'd*, 379 F.2d 252 (2d Cir.), *cert. denied*, 389 U.S. 931 (1967); *Edward J. Drew*, 31 T.C.M. 799 (1972); *Julian Panek*, 24 T.C.M. 658 (1965), *aff'd per curiam*, 66-2 U.S.T.C. ¶ 9722 (7th Cir. 1966). *But see* *Cornelius Vanderbilt, Jr.*, 16 T.C.M. 1081 (1957).

In addition, utilization of scientific techniques indicates a business-like operation, as does the element of self-education and efforts to market the results of the activity or advertising.¹⁵⁹ In the same vein, a failure to advertise and, more recently, a failure to establish a business name for a farm activity, may indicate that an activity is not engaged in for profit.¹⁶⁰

Books and Records. Professor Dickinson believes the theory supporting the conclusion that the maintenance of business-like records constitutes an important indication of profit intent is "a taxpayer would not go to the trouble of keeping good records—especially in a farming context—unless he were genuinely interested in using the records to help achieve a profitable operation."¹⁶¹ Cases that find significance in employment of a separate bookkeeper or auditing of records by certified public accountants support this theory.¹⁶² Moreover, judicial emphasis on adequate financial records as to the operation of a farming activity, which are maintained separately from the taxpayer's books on his other activities or which segregate the farm expenses from admittedly personal expenses, appears bottomed on this assumption.¹⁶³ A further rationale is that such records are necessary to control expenditures with an eye to reducing losses and eventually achieving a profit.¹⁶⁴

Adequate records need not necessarily be formal books and records, for in *Thomas W. Jackson*,¹⁶⁵ the taxpayer did not main-

¹⁵⁹ Rose P. Crane, 9 B.T.A. 437, 440-41 (1927) (scientific techniques); Rex B. Foster, 32 T.C.M. No. 13 (1973) (advertising); Johan A. Louw, 30 T.C.M. 1421 (1971) (attempts to market); Lillian Solomon, 26 T.C.M. 919 (1967) (self-education); *accord*, Herbert C. Sanderson, 23 T.C.M. 1723 (1964) (self-education).

¹⁶⁰ Edward J. Drew, 31 T.C.M. 799 (1972) (no business name); *accord*, W. Jane Luce, 29 T.C.M. 894 (1970); Robert E. Currie, 28 T.C.M. 12 (1969); *see* Harold I. Snyder, 25 T.C.M. 1326 (1966) (failure to advertise). Conversely, use of a trade name indicates a profit motive. Rex B. Foster, Jr., 32 T.C.M. No. 14 (1973).

¹⁶¹ DICKINSON, FARM AND RANCH LOSSES, BNA TAX MANAGEMENT PORTFOLIO No. 241, A-31 (1970). The Tax Court (then the Board of Tax Appeals) reasoned similarly in *Harold T. Avery*, 47 B.T.A. 538, 541-42 (1942): "If pleasure was the only incentive and recompense sought by the petitioner in developing his mechanical ideas, there was no necessity to go to the trouble and expense of procuring patents."

¹⁶² *Patterson v. United States*, 459 F.2d 487, 493-94 (Ct. Cl. 1972); *Worrell v. United States*, 254 F. Supp. 992, 993 (S.D. Tex. 1966); *Israel O. Blake*, 38 B.T.A. 1457, 1459 (1938); Rose P. Crane, 9 B.T.A. 437, 439 (1927); *Everell E. Fisher*, 27 T.C.M. 1048 (1968); *Leland E. Rosemond*, 10 T.C.M. 625 (1951).

¹⁶³ *See, e.g., Teitelbaum v. Comm'r*, 294 F.2d 541 (7th Cir. 1961), *cert. denied*, 363 U.S. 987 (1962); *John Randolph Hopkins*, 15 T.C. 160 (1950); *C.J. Anderson*, 14 T.C.M. 148 (1955); *Dan R. Hanna, Jr.*, 10 T.C.M. 566 (1951).

¹⁶⁴ *Glen H. Morton*, 30 T.C.M. 671 (1971).

¹⁶⁵ 59 T.C. 312 (1972). Similarly, in *Norma Mathews Lauer*, 20 T.C.M. 1038 (1961),

tain a formal set of records in his yacht chartering business, instead, he required his captains to account for expenditures and periodically turned over these records, together with cancelled checks and stubs, to his accountant for preparation of the yacht's financial records. The Tax Court observed that "[t]hough perhaps not the most efficient method of business accounting, it was adequate and does not indicate any lack of profit motive."¹⁶⁶

On a few occasions courts have leveled the counter argument that maintenance of books and records does not in and of itself demonstrate the object of an enterprise. The rationale is that objective factors in general, and record keeping in particular, "are often burdened with the same infirmity as a taxpayer's testimony, since the meticulous observance of details which have been labeled as important objective signposts is of doubtful value once their observance become self-conscious."¹⁶⁷ However, such cases generally have placed more weight on subjective than objective factors in determining whether the activities were profit motivated¹⁶⁸—an avenue now closed in application of section 183 since profit intent is to be established by objective facts and circumstances without regard to the taxpayer's subjective intent. Consequently, their continued value as precedents in construing these regulations must be severely discounted. Of continuing significance, however, is the assignment of minimal weight to adequate records where other counterbalancing factors point to a lack of concern for the economical operation of the activity.¹⁶⁹

Nonfinancial records can also be relevant. Indeed, keeping of

the taxpayer's records in conducting her horse breeding activities consisted of invoices, cancelled checks, copies of bills of sale of horses sold; her accountant had advised her that a regular set of books was not necessary. On the other hand, a growing number of recent decisions treat records limited to collections of cancelled checks and assorted bills as a negative factor. *W. Jane Luce*, 29 T.C.M. 894 (1970); *Robert E. Currio*, 28 T.C.M. 12 (1969). A commentator has suggested, however, that since (1) this first factor also states that carrying on an activity in a manner similar to other profitable activities of the same nature may be indicative of a profit motive and (2) it is common knowledge that many farmers maintain few records other than cancelled checks and deposit slips, "the taxpayer's lack of farm records for a particular activity is not indicative of a lack of profit intent in view of the record keeping practices of for-profit farmers." *RIDENOUR, FARM AND RANCH LOSSES*, BNA TAX MANAGEMENT PORTFOLIO No. 241-2d, A-25 (1973).

¹⁶⁶ *Thomas W. Jackson*, 59 T.C. 312, 316 (1972), *acq.*, 1973-21 I.R.B. 5.

¹⁶⁷ *Imbesi v. Comm'r*, 361 F.2d 640, 645 (3d Cir. 1966); *Harry C. Fisher*, 29 B.T.A. 1041, 1050 (1934).

¹⁶⁸ *Schley v. Comm'r*, 375 F.2d 747 (2d Cir. 1967); *Lamont v. Comm'r*, 339 F.2d 377 (2d Cir. 1964); *Louise Cheney*, 22 B.T.A. 672 (1931); *Everell E. Fisher*, 27 T.C.M. 1048 (1968); *Bertha R. Conyngham*, 23 T.C.M. 1179 (1964).

¹⁶⁹ *Celeste B. Smith*, 30 T.C.M. 516, 518 (1971).

detailed agricultural records may be even more indicative of a profit motive than maintenance of adequate financial records. Thus, the district court in *Wright v. United States*¹⁷⁰ highlighted the fact that the taxpayer regularly kept and maintained breeding records of his livestock, but made no reference to accounting books and records. Moreover, in *DuPont v. United States*,¹⁷¹ where the government conceded that a subchapter S corporation's records were adequate from an agricultural standpoint, the district court rebuffed the government's assertion that the corporation's failure to keep financial records accurately reflecting its profits and losses manifested an indifference to whether the operation was profitable.

Ascertaining the relative weight to be ascribed to this factor is difficult. At one end of the spectrum are the plethora of authorities holding that the activities were engaged in for profit where adequate business records were kept¹⁷² and not engaged in for profit where no records were maintained;¹⁷³ at the other, a more moderate number of cases in which a profit motive was proven in the absence of records or no profit motive was shown despite adequate records.¹⁷⁴ While in a handful of opinions records were a determinative factor¹⁷⁵ and in many the juxtaposition of business-like operations and careful records of expenses forms a leitmotiv,¹⁷⁶ the majority merely catalogues the presence of accurate books with a host of other factors.¹⁷⁷ Indeed, a few early reported

¹⁷⁰ 249 F. Supp. 508, 512 (D. Nev. 1965); cf. *Marshall Field*, 26 B.T.A. 116 (1932), *aff'd*, 67 F.2d 876 (2d Cir. 1933) (both agricultural and financial records); *James S. Bishop*, 31 T.C.M. 829 (1972). *But see* *W. Jane Luce*, 29 T.C.M. 894 (1970).

¹⁷¹ 234 F. Supp. 681 (D. Del. 1964).

¹⁷² *Rood v. United States*, 184 F. Supp. 791, 793 (D. Minn. 1960); *Israel O. Blake*, 38 B.T.A. 1457 (1938); *Lucien H. Tyng*, 36 B.T.A. 21 (1937), *rev'd on other grounds*, 106 F.2d 55 (2d Cir. 1939), *rev'd on other grounds*, 308 U.S. 527 (1940); *Lillian Solomon*, 26 T.C.M. 919 (1967).

¹⁷³ *E.g.*, *Teitelbaum v. Comm'r*, 294 F.2d 541 (7th Cir. 1961), *cert. denied*, 368 U.S. 987 (1962); *Imbesi v. Comm'r*, 361 F.2d 640 (3d Cir. 1966).

¹⁷⁴ *Theodore Sabelis*, 37 T.C. 1058 (1962); *Laura M. Curtis*, 28 B.T.A. 631 (1933); *James Clark*, 24 B.T.A. 1235 (1931); *Norma Mathews Lauer*, 20 T.C.M. 1038 (1961); *Vincent Treanor*, 10 T.C.M. 336 (1951).

¹⁷⁵ *Samuel Riker, Jr.*, 6 B.T.A. 890 (1927). In *Joseph W. Johnson, Jr.*, 59 T.C. No. 78 (1973), the court observed that the taxpayer did not keep books and records of maintenance expenses or rental income "such as would be normally expected of one engaged in a transaction for profit"

¹⁷⁶ *See, e.g.*, *Israel O. Blake*, 38 B.T.A. 1457 (1938); *James S. Bishop*, 31 T.C.M. 829 (1972); *Lillian Solomon*, 26 T.C.M. 919 (1967).

¹⁷⁷ *Helis v. Usry*, 71-1 U.S.T.C. ¶ 9365 (E.D. La. 1971), *rev'd on other grounds*, 464 F.2d 330 (5th Cir. 1972); *Bennet v. United States*, 65-2 U.S.T.C. 9701 (E.D. Va. 1965); *Margaret E. Amory*, 22 B.T.A. 1398 (1931); *Rose P. Crane*, 9 B.T.A. 437 (1927);

cases mentioned records in the facts only.¹⁷⁸ On the other hand, most of the decisions holding against the taxpayer in the face of adequate records employed a subjective rather than an objective approach. Conversely, the authorities sustaining a taxpayer without adequate farm books and records have rested on other objective manifestations of profit motivation, such as attention to expenses or abandonment of unprofitable operations.¹⁷⁹

Similarity to Profitable Activities of Same Nature. This factor's approval of a comparison of manner of operation to substantially similar profitable activities is too limited. For instance, the section 183 regulations themselves, in an example illustrating the objective factors, compare the operation of questioned activities with the operation of farms in the area, similar in size and production, many of which the example noted were unprofitable.¹⁸⁰ More significantly, the cases have drawn the comparison between overall operations or specific techniques of the questioned activity and similar activities in general without comment as to whether the latter were profitable.¹⁸¹ On one occasion, the Tax Court simply found that from the standpoint of economy and efficiency the taxpayer's method of operation compared favorably to other similar establishments.¹⁸² Other decisions have noted that specific techniques or equipment were those utilized in the industry.¹⁸³

More frequently, however, courts have compared specific aspects

Leonard M. Sasso, 20 T.C.M. 1068 (1961); George Thacker, 28 T.C.M. 1433 (1969); Charles B. Pennington, 26 T.C.M. 520 (1967); W. Clark Wise, 16 T.C.M. 361 (1957), *aff'd per curiam*, 260 F.2d 354 (6th Cir. 1958).

¹⁷⁸ *Whitney v. Comm'r*, 73 F.2d 589 (3d Cir. 1934); Lucien T. Tyng, 36 B.T.A. 21 (1937), *rev'd on other grounds*, 106 F.2d 55 (2d Cir. 1939), *rev'd on other grounds*, 308 U.S. 527 (1940); Marshall Field, 26 B.T.A. 116 (1932), *aff'd*, 67 F.2d 876 (2d Cir. 1933); Thomas F. Sheridan, 4 B.T.A. 1299 (1927).

¹⁷⁹ *DuPont v. United States*, 234 F. Supp. 681 (D. Del. 1964); Thomas W. Jackson, 59 T.C. 312 (1972), *acq.*, 1973-21 I.R.B. 5; Theodore Sabelis, 37 T.C. 1058 (1962); Laura M. Curtis, 28 B.T.A. 631 (1933); James Clark, 24 B.T.A. 1235 (1931); Norma Mathews Lauer, 20 T.C.M. 1038 (1961).

¹⁸⁰ Reg. § 1.183-2(c) Ex. 5.

¹⁸¹ Significantly the Tax Court refused in *W. Clark Wise*, 16 T.C.M. 361 (1957), *aff'd per curiam*, 260 F.2d 354 (6th Cir. 1958), to take judicial notice of the fact that farms below a certain size could not be profitably operated. Moreover, the Senate Committee on Finance believed that a marginal farmer could be engaged in his farming activity for profit, albeit without a reasonable expectation thereof. S. REP. NO. 91-552, 91st Cong., 1st Sess. 105 (1969).

¹⁸² *John S. Ellsworth*, 21 T.C.M. 145 (1962); *accord*, *Rose P. Crane*, 9 B.T.A. 437, 440-41 (1927).

¹⁸³ *Helis v. Usry*, 71-1 U.S.T.C. ¶ 9365 (E.D. La. 1971), *rev'd on other grounds*, 434 F.2d 330 (5th Cir. 1972); Samuel Riker, Jr., 6 B.T.A. 890 (1927); Charles D. Eggert, 16 T.C.M. 1010 (1957); *cf.* *Norman C. Demler*, 25 T.C.M. 620 (1966).

of the questioned activity to business operations in general rather than singling out similar operations.¹⁸⁴ Indeed, the observation, for example, that a farm has all the physical characteristics and appearance of an ordinary farm carried on for a business forms a refrain in the reported farm loss decisions.¹⁸⁵ Moreover, some cases have drawn an even more attenuated comparison emphasizing that similar activities are a common business enterprise in the taxpayer's locale, *e.g.*, *Thomas W. Jackson*¹⁸⁶ began its analysis with the fact that the chartering of boats, particularly in the taxpayer's geographic area of operation, was a common business enterprise.

Again, cases such as *Schley v. Commissioner*,¹⁸⁷ adopting the tack now prohibited under section 183 of a subjective rather than an objective approach, have dismissed evidence that the taxpayer's activities qualified as those usually performed by one in the taxpayer's alleged business with the observation, for instance, that "mere operation of a farm is not enough."¹⁸⁸

In addition to comparison to other similar activities or business appearance in general, authorities have considered the method of operation by other owners, both subsequent and prior, of the same property.¹⁸⁹ Indeed, the fourth example illustrating these factors in the regulations states that the taxpayer operates the farm activity in the same manner as the prior owners (his parents). Not surprisingly, operation by other owners of the property as a hobby or country estate militates against a profit motive on the part of the taxpayer, unless he takes care to eliminate show-place practices or facilities of prior owners.¹⁹⁰

In conclusion, the paucity of explicit comparisons of questioned activities with similar operations in the extant cases as well as the absence of such a factor in the commentators' lists of factors

¹⁸⁴ Margaret E. Amory, 22 B.T.A. 1398 (1931). See generally Sharpe, *What the Taxpayer Should Do to Have the Courts Recognize His Farm as a Business*, 28 J. TAXATION 48, 51 (1968).

¹⁸⁵ Samuel Riker, Jr., 6 B.T.A. 890, 893 (1927); Mary Ellis Turner, 23 T.C.M. 1186 (1964).

¹⁸⁶ 59 T.C. 312 (1972), *acq.*, 1973-21 I.R.B. 5; *accord*, James Otis, 7 B.T.A. 882, 884 (1927); Charles B. Pennington, 26 T.C.M. 520 (1967).

¹⁸⁷ 375 F.2d 747 (2d Cir. 1967).

¹⁸⁸ 375 F.2d 747 (2d Cir. 1967); *accord*, Alfred M. Cox, 24 T.C.M. 23 (1965), *aff'd per curiam*, 354 F.2d 659 (3d Cir. 1966).

¹⁸⁹ *Teitelbaum v. Comm'r*, 294 F.2d 541 (7th Cir. 1961), *cert. denied*, 386 U.S. 987 (1962) (prior); Rowe B. Metcalf, 28 T.C.M. 1402 (1963) (subsequent).

¹⁹⁰ Compare John Randolph Hopkins, 15 T.C. 160 (1950), with *Helis v. Usry*, 71-1 U.S.T.C. ¶ 9365 (E.D. La. 1971), *rev'd on other grounds*, 464 F.2d 330 (5th Cir. 1972).

used in determining profit motive portend that this factor may be of minor significance. Nevertheless, the natural inclination of taxpayers to develop their proof to meet the criteria set forth in the regulations will probably shift the focus from business-like appearance in general to direct comparisons with specific similar activities.

Change in Operating Methods. This factor occurs but once in the examples accompanying the regulation factors and then only in a negative sense: the first example states that modern methods were not used in operating the farm. Contrary to this lack of emphasis, however, changes in operating methods may well be the most frequently relied upon factor of significance in the vast sea of case law. Indeed, the factor of abandonment of unprofitable operating methods, and in particular unprofitable activities, historically has carried more weight than maintenance of books and records and comparability of operations to other similar activities, as well as the many other factors set forth in the regulations. This item has frequently been linked inextricably with reliance upon expert advice.¹⁹¹ On one occasion, however, such an abandonment was given negative import by characterization as "vacillation in the objectives" of the enterprise manifesting a lack of preliminary exploration as to the profit potential of the activity.¹⁹²

Although the regulations speak only of changes in methods or techniques, the cases almost invariably have dealt with changes in product lines or divisions.¹⁹³ A variety of patterns recur in these cases. In some of the farm loss decisions, the taxpayer began operations with a broad range of crops and livestock and gradually eliminated the unprofitable lines.¹⁹⁴ Similarly, taxpayers have constantly shifted from one farm activity to another in the search for the elusive profitable product.¹⁹⁵ Such approach has been

¹⁹¹ See RIDENOUR, FARM AND RANCH LOSSES, BNA TAX MANAGEMENT PORTFOLIO NO. 241-2d, A-25 (1973).

¹⁹² Celeste B. Smith, 30 T.C.M. 516, 518 (1971). From this, the court concluded the taxpayer's activities were merely preparatory to engaging in a trade or business. For a discussion of this concept, see notes 496 through 533 *infra* and the accompanying text.

¹⁹³ *E.g.*, Rood v. United States, 184 F. Supp. 791, 94 (D. Minn. 1960); Dean Babbitt, 23 T.C. 850 (1955); Norton L. Smith, 9 T.C. 1150 (1947); Rex B. Foster, 32 T.C.M. No. 13 at 47 (1973).

¹⁹⁴ Norton L. Smith, 9 T.C. 1150 (1947); Marshall Field, 26 B.T.A. 116 (1932), *aff'd*, 67 F.2d 876 (2d Cir. 1933); Rose P. Crane, 9 B.T.A. 437 (1927).

¹⁹⁵ Patterson v. United States, 459 F.2d 487 (Ct. Cl. 1972); Dean Babbitt, 23 T.C. 850, 857 (1955); Rowe B. Metcalf, 22 T.C.M. 1402 (1963). The Tax Court in Eugene J. Davis, 25 T.C.M. 616, 620 (1966), concluded: "Throughout the history of the farm, we find

frequently described as experimentation.¹⁹⁶ In other decisions, the changes were more modest: abandoning a minor activity while continuing the major activity,¹⁹⁷ undertaking new activities without terminating existing ones,¹⁹⁸ replacing the single farm activity being engaged with a new activity,¹⁹⁹ and replacing employees.²⁰⁰ This factor has not been limited to farm loss cases—in *Rood v. United States*²⁰¹ the court was favorably impressed by the fact that the taxpayer, a sculptor, changed media several times in order to realize a profit by meeting specialized markets.

The most frequent, and apparently most convincing, change in operations is abandonment of the activity in its entirety, either in the tax year or, as is more frequent, in a subsequent year.²⁰² Abandonment based on experience gained from operations that the activity cannot be made profitable, on realization the profit forecasts by advisors were over optimistic, or in accord with professional advice has impressed the courts.²⁰³ As the Tax Court stated in *Benjamin E. Adams*,²⁰⁴ its conclusion that the taxpayer had intended to make a profit from his painting was strengthened by the fact that when, after a few years, the taxpayer found that he could not make money from his art activities, he gave up the full-time pursuit of them and found other employment. Where such abandonment has occurred, the Commissioner has scant success in arguing that the venture should have been abandoned

petitioners trying to operate it so as to make a profit, changing from one type of operation to another in order to attain that end."

¹⁹⁶ *Whitney v. Comm'r*, 73 F.2d 589, 591 (3d Cir. 1934); *DuPont v. United States*, 28 F. Supp. 122 (D. Del. 1939); *George B. Lester*, 19 B.T.A. 549 (1930); *Mary Ellis Turner*, 23 T.M.M. 1186 (1964).

¹⁹⁷ *Theodore Sabelis*, 37 T.C. 1058 (1962); *Rose P. Craue*, 9 B.T.A. 437 (1927).

¹⁹⁸ *August Merckens*, 7 B.T.A. 32 (1927).

¹⁹⁹ *George B. Lester*, 19 B.T.A. 549 (1930); *Rex B. Foster*, 32 T.C.M. No. 13 (1973); *D. Joseph St. Germain*, 18 T.C.M. 1061 (1959); *Dan R. Hanna, Jr.*, 10 T.C.M. 566 (1951); *Vincent Treanor*, 10 T.C.M. 336 (1951).

²⁰⁰ *Dean Babbitt*, 23 T.C. 850, 867 (1955); *Norton L. Smith*, 9 T.C. 1150, 1151 (1947); *Lillie S. Wegeforth*, 42 B.T.A. 633 (1940).

²⁰¹ 184 F. Supp. 791, 794 (D. Minn. 1960).

²⁰² Tax year: *Benjamin E. Adams*, 25 T.C.M. 1239 (1966); *Alice D. Worcester*, 21 T.C.M. 1138 (1962); *Harvey S. Farrow*, 16 T.C.M. 836 (1957). Subsequent year: *Wright v. United States*, 249 F. Supp. 508 (D. Nev. 1965); *DuPont v. United States*, 28 F. Supp. 122 (D. Del. 1939); *Laura M. Curtis*, 28 B.T.A. 631 (1933); *Irving C. Ackerman*, 24 B.T.A. 512 (1931), *aff'd*, 71 F.2d 586 (9th Cir. 1934); *W. Brown Morton*, 16 T.C.M. 420 (1957).

²⁰³ *Alice D. Worcester*, 21 T.C.M. 1138 (1962) (overly optimistic forecasts); *Harvey S. Farrow*, 16 T.C.M. 836 (1957) (experience); *cf. Lazonby v. Tomlinson*, 272 F. Supp. 558 (N.D. Fla. 1967) (abandonment of planning of one activity before undertaking second).

²⁰⁴ 25 T.C.M. 123 (1966); *DICKINSON, FARM AND RANCH LOSSES*, BNA TAX MANAGEMENT PORTFOLIO No. 241, A-31 (1970).

earlier: "It is not for the Collector to second-guess the taxpayer by concluding that the operating losses in earlier years dictated an abandonment of the enterprise in 1957, 1958 or 1959 [rather than in 1960]." ²⁰⁵ On the other hand, the triers of fact often have ruled against taxpayers who fail to abandon a continually unprofitable line and especially have been critical of a failure to cull unprofitable animals.²⁰⁶ Conversely, culling unprofitable or unproductive livestock, a variant of abandoning unprofitable activities, evidences a profit motive.²⁰⁷

Furthermore, while abandonment of the entire activity in subsequent years has usually been a determinative factor in a taxpayer's favor, mere changes in operation in later years or in the tax year after prolonged use of less efficient methods have fared less well—"While in 1963 petitioner changed his cattle raising activities, this change does not alter his intent for prior years."²⁰⁸ Such authorities appear, however, by and large to be tainted by a subjective approach.²⁰⁹ Nevertheless, should abandonment occur only after audit and the Service has begun to question the taxpayer's losses, it may not serve as a factor in the taxpayer's favor and could even constitute a negative factor.²¹⁰ Furthermore, a recent trend has been to treat an abandonment of a purported business activity coupled with a continuation of the same activity as a hobby as practically tantamount to an admission that the activity was never engaged in for profit, but rather was primarily for personal satisfaction.²¹¹

Courts have expressly noted that once it becomes apparent to the taxpayer that the venture cannot be made profitable, the ac-

²⁰⁵ *Wright v. United States*, 249 F. Supp. 508, 513 (D. Nev. 1965).

²⁰⁶ Failure to abandon: *Broderick v. Derby*, 236 F.2d 35 (10th Cir. 1956); *Jack R. Mavis*, 14 T.C.M. 332 (1955). *But see* *Mary Ellis Turner*, 23 T.C.M. 1186 (1964). Failure to cull: *Anthony Imbesi*, 23 T.C.M. 1678 (1964), *rev'd on other grounds*, 361 F.2d 640 (3d Cir. 1966); *accord*, *Edward J. Drew*, 31 T.C.M. 799 (1972); *Celesto B. Smith*, 30 T.C.M. 516 (1971).

²⁰⁷ *Widener v. Comm'r*, 33 F.2d 833 (3d Cir. 1929); *Lucien H. Tyng*, 36 B.T.A. 21 (1937), *rev'd on other grounds*, 106 F.2d 55 (2d Cir. 1939), *rev'd on other grounds*, 308 U.S. 527 (1940); *James S. Bishop*, 31 T.C.M. 829 (1972); *Charles B. Pennington*, 26 T.C.M. 520 (1967).

²⁰⁸ *Alfred M. Cox*, 24 T.C.M. 23, 25 (1965), *aff'd per curiam*, 354 F.2d 659 (3d Cir. 1966).

²⁰⁹ *See, e.g., Schley v. Comm'r*, 375 F.2d 747 (2d Cir. 1967); *George T. McLean*, 19 T.C.M. 673 (1960), *aff'd per curiam*, 285 F.2d 756 (4th Cir. 1961).

²¹⁰ *See Billy V. Wann*, 27 T.C.M. 1301 (1968); *cf. Leonard F. Barcus*, 32 T.C.M. 660 (1973), *aff'd per curiam*, 74-1 U.S.T.C. ¶ 9288 (2d Cir. 1974); *Everett R. Taylor*, 28 T.C.M. 941 (1969).

²¹¹ *Robert E. Currie*, 28 T.C.M. 12 (1969).

tivity may be continued during a reasonable period of liquidation (during which deductions are allowable), which may last as long as a year.²¹² Moreover, in such liquidation, the taxpayer is apparently not required to dispose of all property if the only price obtainable is in his opinion too low.²¹³ However, the mere allegation by the taxpayer that he does not intend to remain in the business if he were able to dispose of livestock is entitled to little weight where he makes no actual efforts to sell his stock.²¹⁴

Expertise of Taxpayer or His Advisors

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.²¹⁵

The case law development manifests a variety of approved means by which a taxpayer may prepare for an activity to gain expertise as to its accepted business, economic and scientific practices.

In nonfarming activity areas, earlier experience has been an infrequent factor in the taxpayer's favor,²¹⁶ although occasionally the questioned activity has been the taxpayer's sole occupation, particularly in the field of writing²¹⁷ and inventing.²¹⁸ Farming has been proportionally less common as the taxpayer's sole occupation, but quite frequently expertise in a farming activity has been acquired by childhood experience on a farm.²¹⁹ On the other

²¹² *Lazonby v. Tomlinson*, 272 F. Supp. 558 (N.D. Fla. 1967); *Vincent Treanor*, 10 T.C.M. 336 (1951).

²¹³ *Eugene J. Davis*, 25 T.C.M. 616 (1966). *See generally* *Oshins, Proposed Regulations Provide New Rules for the Hobby Loss Game*, 35 J. TAXATION 214, 216 (1971) (minimization of losses); Rev. Rul. 74-28, 1974-3 I.R.B. 7.

²¹⁴ *Edward J. Drew*, 31 T.C.M. 799, 806 (1972).

²¹⁵ Reg. § 1.183-2(b)(2).

²¹⁶ *See, e.g.*, *Norman C. Demler*, 25 T.C.M. 620 (1966); *Thelma C. Whitman*, 19 T.C.M. 456 (1960).

²¹⁷ *Stern v. United States*, 71-1 U.S.T.C. ¶ 9375 (C.D. Cal. 1971); *Cornelius Vanderbilt, Jr.*, 16 T.C.M. 1081 (1957); *cf.* *Benjamin E. Adams*, 25 T.C.M. 1239 (1966); *Sebastian de Grazia*, 21 T.C.M. 1572 (1962). *But cf.* *Porter v. Comm'r*, 437 F.2d 39 (2d Cir. 1970).

²¹⁸ *Johan A. Louw*, 30 T.C.M. 1421 (1971); *Nicholas A. Dodich*, 30 T.C.M. 248 (1971). *Contra*, *White v. Comm'r*, 227 F.2d 779 (6th Cir. 1955), *cert. denied*, 351 U.S. 939 (1956).

²¹⁹ *Lucien H. Tyng*, 36 B.T.A. 21 (1937), *rev'd on other grounds*, 106 F.2d 55 (2d Cir.

hand, such early interest and experience has sometimes proven to be a slippery factor, with the Service utilizing it as ammunition for an attack that such personal interest was the motivation for the activity rather than profit.²²⁰ In fact, in *Mary Ellis Turner*²²¹ the Service even asserted (albeit to no avail) that the taxpayer's scientific interest in the breeding characteristics of her livestock, derived from experience in applied genetics and useful in the taxpayer's scientific breeding program, dominated her expenditures to the complete subservience of any profit motivation. Such posture has, however, usually been rebuffed: "While it is true that petitioner has been interested in and engaged in farming and breeding livestock practically all of his life, this fact is not fatal to a finding of a profit-making motive. In fact, it has been observed that '[s]uccess in business is largely obtained by pleasurable interest therein.'"²²² Moreover, the Commissioner has scored his greatest success with this tack in the subjective intent decisions.

*Robert E. Currie*²²³ presents perhaps an intermediate position. A lifelong interest in the activity, there raising horses and dogs, does not preclude profit motivation—the court noted that to the contrary, familiarity could be the motivating factor for embarking on a business venture—but a history of hobby enjoyment raises a presumption that the taxpayer is not engaging in the activity for profit, which he must overcome with a greater amount of proof than he would need had he not previously enjoyed the activity as a hobby. Clearly then, it is not the prior experience, but the prior engaging in the hobby that is a negative factor.

Where the taxpayer has had no prior experience in the activity, common means of acquiring expertise are self-education through study of books and periodicals in the area, attendance at seminars or trade meetings or shows, membership in trade organizations and association and consultation with those expert in the activ-

1939), *rev'd on other grounds*, 308 U.S. 527 (1940); Irving C. Ackerman, 24 B.T.A. 512 (1931), *aff'd*, 71 F.2d 586 (9th Cir. 1934); Hamilton F. Kean, 10 B.T.A. 97 (1928); George Thacker, 28 T.C.M. 1433 (1969); Eugene J. Davis, 25 T.C.M. 616 (1966).

²²⁰ See, e.g., *Imbesi v. Comm'r*, 361 F.2d 640 (3d Cir. 1966); Edward J. Drew, 31 T.C.M. 799 (1972). The following cases are representative of those which reject such a contention: James S. Bishop, 31 T.C.M. 829 (1972); Morris A. Stoltzfus, 29 T.C.M. 1610 (1970); William L. Brueck, Sr., 23 T.C.M. 1228 (1964); cf. Woodrow L. Wroblewski, 32 T.C.M. No. 37 (1973).

²²¹ 23 T.C.M. 1186 (1964).

²²² Morris A. Stoltzfus, 29 T.C.M. 1610, 1634 (1970) (footnote omitted).

²²³ 28 T.C.M. 12, 18 (1969). Judge Irwin decided both *Stoltzfus* and *Currie*.

ity.²²⁴ The fine arts cases offer more examples of full-time study.²²⁵ The agricultural activity cases, on the other hand, have proven an especially fertile field for consultation with experts—owing no doubt in part to the ready availability of federal, state and local farm agents—which if followed may be even more persuasive than subscription to technical publications.²²⁶ Indeed, subscription to trade publications has been described in one instance as a “bare essential” in the search for knowledge.²²⁷

Consultation with government soil conservation experts and following their recommendations forms a recurring factual pattern in farm loss authorities constituting strong evidence of a profit motive.²²⁸ Cases holding for the taxpayer are also legion. In these taxpayers consulted local farm agents or university agricultural extension services in efforts to conduct their farm activities along sound business-like lines.²²⁹ Such consultation, prior to beginning an activity, as to the possibility of operating at a profit is a favorable factor.²³⁰ Seeking advice is not limited to official sources, for courts frequently have noted taxpayer consultation with those engaged in similar activities including, for instance, in the agricultural activities category neighboring farmers.²³¹ Still only procuring advice from acquaintances would usually be at best a neutral factor. Accordingly, such advice seldom appears in the reported cases. However, in *Edward J. Drew*,²³² evidence was adduced that the taxpayer, although not knowledgeable about horse training, only consulted his friends and colleagues in medical

²²⁴ See, e.g., *Patterson v. United States*, 459 F.2d 487 (Ct. Cl. 1972); *Rex B. Foster, Jr.*, 32 T.C.M. No. 14 (1973); *Alden B. Starr*, 28 T.C.M. 167 (1969); *Lilian Solomon*, 26 T.C.M. 919 (1967). See generally *Sharpe, What the Taxpayer Should Do to Have the Courts Recognize His Farm as a Business*, 28 J. TAXATION 48, 51 (1968).

²²⁵ E.g., *Benjamin E. Adams*, 25 T.C.M. 1239 (1966); *Sebastian de Grazia*, 21 T.C.M. 1572 (1962).

²²⁶ *RIDENOUR, FARM AND RANCH LOSSES*, BNA TAX MANAGEMENT PORTFOLIO No. 241-2d, A-25 (1973).

²²⁷ *Rex B. Foster, Jr.*, 32 T.C.M. No. 14 at 52 (1973).

²²⁸ *Mary Ellis Turner*, 23 T.C.M. 1186 (1964); *George M. Zengler*, 17 T.C.M. 454 (1958); *Theron D. Stay*, 17 T.C.M. 861 (1958).

²²⁹ *Patterson v. United States*, 459 F.2d 487 (Ct. Cl. 1972); *Hamilton F. Kean*, 10 B.T.A. 97 (1928); *Harvey S. Farrow*, 16 T.C.M. 836 (1957); *Hedi Katz*, 13 T.C.M. 188 (1954).

²³⁰ *Marshall Field*, 26 B.T.A. 116 (1932), *aff'd*, 67 F.2d 876 (2d Cir. 1933); *Margaret E. Amory*, 22 B.T.A. 1398 (1931); *Rex B. Foster, Jr.*, 32 T.C.M. No. 14 at 52 (1973). See generally *Note, Breeding Farms and Racing Stables—Hobby or Business?* 54 KY. L.J. 92, 94 (1965).

²³¹ *Dean Babbitt*, 23 T.C. 850 (1955); *Jean A. Lowenthal*, 27 T.C.M. 387 (1968); *Lilian Solomon*, 26 T.C.M. 919 (1967); *Alice D. Worcester*, 21 T.C.M. 1138 (1962).

²³² 31 T.C.M. 799, 806 (1972).

practice and did not even follow the advice given—not surprisingly the court held that the taxpayer carried out the activity without a profit motive.

To date, the authorities have almost invariably analyzed experience and expertise in terms of study of the scientific practices or techniques used in the activity,²³³ rather than of its accepted business or economic practices—the regulations list all three in the conjunctive. *Glenn H. Morton*²³⁴ appears to be an unusual exception. The taxpayer brought exceptionally useful advanced education, experience, specialized study and self-education to the activity of horsebreeding. Yet the court discounted this factor, reasoning that while the taxpayer was informed as to the technicalities of breeding horses, he admitted to having no knowledge concerning the capital outlay needed to support such an operation and, further, had not seriously investigated the market for such horses in his locale. A conclusion that the taxpayer was not engaged in the activity for profit would have been amply supported by other objective criteria,²³⁵ but the court appears instead to have turned the taxpayer's extensive preparation against him, categorizing it as general investigation of the possibilities of breeding horses for profit, not going beyond the exploratory and investigative stage of any plan to establish a business—not an existing trade or business. Application of such preparatory to engaging in a trade or business concept (a frequent government argument used alternatively with lack of profit motive) to agricultural activities is discussed below; however, *Morton* serves as clear warning of the danger that the Service may attempt to use taxpayer preparation against him. Of course, considering this factor alone, *Morton* clearly represents a minority view both in emphasis on lack of study of economic aspects and on lack of investigation of the local market.

Failure to follow expert advice is quite rare in the reported cases, *Drew* being one of the few examples. The regulation's ex-

²³³ See, e.g., *Lilian Solomon*, 26 T.C.M. 919 (1967); *Charles B. Pennington*, 26 T.C.M. 520 (1967); *Hedi Katz*, 13 T.C.M. 188 (1954).

²³⁴ 30 T.C.M. 671 (1971). Taxpayers with equivalent or less preparation prevailed in *Rex B. Foster, Jr.*, 32 T.C.M. No. 14 (1973); *Alden B. Starr*, 28 T.C.M. 167 (1969); and *Lilian Solomon*, 26 T.C.M. 919 (1967).

²³⁵ For example, he did not maintain adequate books or records, devote much time to the activity, advertise, had no facilities and previously had engaged in the activity as a hobby. *Joseph W. Johnson, Jr.*, 59 T.C. No. 78 (1973), also relied heavily on the fact that the taxpayer "[h]ad no knowledge and apparently made no investigation prior to purchasing the property to determine whether the property had ever been rented by the former owner, or if so, for how much."

ception to lack of profit motive where such failure is the result of attempts to develop new or superior profitable techniques is perhaps even more rarely reflected in the case law. More common has been the recent trend to rely heavily on lack of experience and, particularly, on failure to take positive steps to remedy such a lack.²³⁶ Historically, taxpayers with this factor in their favor have had the smallest chance, particularly in the agricultural activity area, of losing. Yet its absence has been scarcely noted by the courts; however, the recent trend of emphasis on the absence of this factor will undoubtedly grow.

On the other hand, the Service's frequent attempts to turn the taxpayer's expertise against him as evidence of a subjective motive other than profits will either cease or enjoy even less success in view of the objective approach mandated by Congress. Nevertheless, taxpayer expertise can, in certain objective circumstances, cut against establishment of a profit motive. *Norman C. Demler*²³⁷ offers a succinct but cogent analysis of the pitfalls of reliance on expertise in the prophetic observation that the elements of experience and expertise "can be a sword as well as a shield in that, in some situations, they will clearly indicate that the taxpayer's asserted expectation of profit is hardly worthy of belief." Such a situation subsequently arose in *Carkhuff v. Commissioner*,²³⁸ where the Sixth Circuit dubbed the taxpayers' argument—that their prior consultation with their tax advisor as well as preparation of a depreciation schedule and a method of accounting manifested rental of their summer home in a business-like manner—a double edged sword in that it also revealed that they were not ignorant of the reasonable prospects of profit and loss. Consequently, the resulting losses did not reflect simply an unwise investment, but rather a lack of profit motivation.²³⁹ It may be significant that *Carkhuff* was an appellate decision and, under the clearly erroneous principle, an appellate court will upset a trial court's decision only if there was no evidence to support

²³⁶ Compare *Patterson v. United States*, 459 F.2d 487 (Ct. Cl. 1972), with *Edward J. Drew*, 31 T.C.M. 799 (1972) and *Harold J. Snyder*, 25 T.C.M. 1326 (1966).

²³⁷ 25 T.C.M. 620 (1966).

²³⁸ 425 F.2d 1400, 1404 (6th Cir. 1970).

²³⁹ *Donald A. McCormick*, 28 T.C.M. 1337, 1342 (1969), illustrates the same principle on a more general level. The Tax Court reasoned that because the taxpayer was an experienced and successful businessman, the unprofitability of his activity could not be justified or explained on the basis of a lack of business experience or on naivete. See *W. Jane Luce*, 29 T.C.M. 894 (1970).

that decision.²⁴⁰ Trial courts, if the reported decisions are any guide, may be expected to less frequently draw such negative inferences from the taxpayer's expertise.

Time and Effort Expended by Taxpayer in Carrying on the Activity

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.²⁴¹

The proposed regulations focused solely on the devotion of much personal time and effort by the taxpayer in carrying on the activity and his withdrawal from another occupation to devote most of his energies to the activity.²⁴² Both factors are widespread in the case law. Of course, the proposed regulations left the impression that application of only limited time by the taxpayer himself was a negative factor. The final regulations softened this inference considerably by providing that devotion of a limited amount of time to an activity by the taxpayer is not necessarily an indication of a lack of a profit motive where he employs competent and qualified persons to carry on the activity. The examples accompanying the regulations add little. In the second example, the taxpayer engaged in extensive lecturing activity, advocating and disseminating his ideas, but was nevertheless found not to have engaged in the activity for profit. Conversely, the fourth example, where the taxpayer could be found in the cautious language of the drafters to have engaged in the activity of farming for profit, noted that he did much of the required labor around the farm himself, such as fixing fences and planting crops. Similarly, the sixth example illustrating an investor engaged in his experimental activities for profit, provides that he conducted his research on a regular, systematic basis.

Contrary to the tenor of the regulations the cases have fre-

²⁴⁰ See *Duberstein v. Comm'r.*, 363 U.S. 278 (1960). Where evidence would support either of two permissible conclusions, the Tax Court's choice is not clearly erroneous. *United States v. Yellow Cab Co.*, 338 U.S. 338, 342 (1949).

²⁴¹ Reg. § 1.183-2(b)(3).

²⁴² Prop. Reg. § 1.183-2(b)(6), 36 Fed. Reg. 16112 (Aug. 19, 1971).

quently held for the taxpayer, particularly in the agricultural area, where he devoted substantially less than much of his personal time and effort to carrying on the activity. Thus, taxpayers have frequently prevailed where they spent only evenings and weekends in the activity, with only occasional or no hired help.²⁴³ On the other hand, in nonfarm cases, devotion of considerable, or even full time to the activity has frequently been of no avail.²⁴⁴ In fact, in nonagricultural activities, this criterion generally appears to be no more than a make weight factor, in that cases holding against the taxpayer usually do not mention the amount of time devoted, while those holding for the taxpayer usually mention it only in passing.²⁴⁵ A unifying thread may lie in the suggestion that devotion of personal effort evidences profit motive only where the activity could not be considered recreational in any sense.²⁴⁶ As discussed below, the farm loss cases appear to assume that hard physical labor is not recreational.

As might be expected, older cases adopting a subjective approach and downplaying objective criteria have discounted the devotion of effort by the taxpayer.²⁴⁷

The regulation's rather weak statement that devotion of a limited amount of time by the taxpayer does not necessarily indicate a lack of profit motive where he employs competent, qualified persons to carry on such activity is too mild in view of the prior case law. For very common factual patterns in early cases finding a profit motive involved (1) little or no personal effort by the taxpayer, but use of experienced personnel as managers,²⁴⁸ or (2) devotion of personal time through close supervision of such managers together with some part-time physical labor and use of experienced employees.²⁴⁹ These results fully comport with

²⁴³ See, e.g., Theodore Sabelis, 37 T.C. 1058 (1962); Rex B. Foster, Jr., 32 T.C.M. No. 14 (1973); Herbert C. Sanderson, 23 T.C.M. 1723 (1964).

²⁴⁴ E.g., Porter v. Comm'r, 437 F.2d 39 (2d Cir. 1970); White v. Comm'r, 227 F.2d 779 (6th Cir. 1955), cert. denied, 351 U.S. 939 (1956).

²⁴⁵ Compare, e.g., Lamont v. Comm'r, 339 F.2d 377 (2d Cir. 1964), with, e.g., Thelma C. Whitman, 19 T.C.M. 456 (1960) and Charles D. Eggert, 16 T.C.M. 1010 (1957).

²⁴⁶ RIDENOUR, FARM AND RANCH LOSSES, BNA TAX MANAGEMENT PORTFOLIO No. 241-2d, A-26 (1973).

²⁴⁷ Harry C. Fischer, 29 B.T.A. 1041 (1934), aff'd per curiam, 74 F.2d 1014 (2d Cir. 1935); accord, Alfred M. Cox, 24 T.C.M. 23 (1965), aff'd per curiam, 354 F.2d 659 (3d Cir. 1966).

²⁴⁸ E.g., Patterson v. United States, 459 F.2d 487 (Ct. Cl. 1972); Whitney v. Comm'r, 73 F.2d 589 (3d Cir. 1934); Wright v. United States, 249 F. Supp. 508 (D. Nev. 1965); Dean Babbitt, 23 T.C. 850 (1955); Walter P. Temple, 10 B.T.A. 1238 (1928); James Otis, 7 B.T.A. 882 (1927).

²⁴⁹ E.g., Irving C. Ackerman, 24 B.T.A. 512 (1931), aff'd, 71 F.2d 586 (9th Cir. 1934);

the general principle that one can carry on a trade or business through an agent.²⁵⁰ The rationale is that an agent's acts are imputed to his principal.²⁵¹ Nevertheless, the Service has, on occasion, asserted that minimal time devoted by the taxpayers indicated a lack of profit motive, despite the fact that experienced trainers were used.²⁵² The Tax Court disagreed, pointing to the great reliance on independent trainers because of the taxpayer's own inexperience and inability. Similarly, the Ninth Circuit, in *Mercer v. Commissioner*,²⁵³ answered the government's reliance on the fact that the taxpayer held a full-time job and spent only four months engaged in the farming activity during the two years in question as follows: "It is reasonable to conclude that work as a laborer was necessary to raise the funds required to support his cattle operation. In any event, it is not a necessary prerequisite that one devote himself completely to an enterprise to qualify it as a trade or business." Indeed, some cases have found the taxpayer's extensive use of professional employees a decisive factor and have not relied on the considerable time devoted by the taxpayer to promotional activities.²⁵⁴ Conversely, other cases have based a conclusion of lack of profit motive in part on the fact that the taxpayer had no expert manager or regular employees.²⁵⁵ In short, the fact that the taxpayer devotes a limited amount of time does not, rather than does not necessarily, indicate a lack of profit motive where he employs competent and qualified persons to carry on the activity.

The finding in the fourth example accompanying the regulations that the taxpayer did much of the required labor around the farm himself is abundantly reflected in the case law. The courts have been greatly impressed by physical labor by the taxpayer.

George B. Lester, 19 B.T.A. 549 (1930); Hamilton F. Kean, 10 B.T.A. 97 (1928); C.J. Anderson, 14 T.C.M. 148 (1955).

²⁵⁰ *Comm'r v. Maple*, 440 F.2d 1055, 1057 (9th Cir. 1971). But see Young, *The Role of Motive in Evaluating Tax Sheltered Investments*, 22 TAX LAWYER 275, 296 (1969).

²⁵¹ Lee, "Active Conduct" Distinguished from "Conduct" of a Rental Real Estate Business, 25 TAX LAWYER 317, 321 (1972).

²⁵² Charles B. Pennington, 26 T.C.M. 520 (1964).

²⁵³ 376 F.2d 708, 710 (9th Cir. 1967) (footnote omitted).

²⁵⁴ Lillie S. Wegeforth, 42 B.T.A. 633 (1940); Samuel Riker, Jr., 6 B.T.A. 890 (1927); Rowe B. Metcalf, 22 T.C.M. 1402 (1963). One commentator believes that use of professional employees is more significant than the taxpayer's own efforts. Sharpe, *What the Taxpayer Should Do to Have the Courts Recognize His Farm as a Business*, 28 J. TAXATION 48, 51 (1968).

²⁵⁵ Edward J. Drew, 31 T.C.M. 799 (1972); Harold I. Snyder, 26 T.C.M. 1326 (1966); Sterling Beckwith, 23 T.C.M. 1537 (1954).

In *Leland E. Rosemond*,²⁵⁶ the Tax Court stated that the taxpayer's physical labor by no means appeared to be recreation. The same thought is reflected in *Norma Mathews Lauer*²⁵⁷ where the court stated "[a] mere dilettante, or hobbyist, would not in our opinion, have applied himself so unstintingly, as did the petitioner to her horsebreeding activities." Indeed, analysis that it would be hard to believe that the taxpayer, with his relatively modest income, would make large expenditures and engage in the physical labor required in the particular activity without having the intention to make a profit, occurs with some regularity.²⁵⁸ It would appear that the courts have focused too much on whether the activity had aspects of a hobby, *i.e.*, recreation, and not enough on whether there was a bona fide expectation of profit.²⁵⁹ For it is quite conceivable that an activity with no aspects of recreation or hobby could be carried on without a profit motive.²⁶⁰ While there might be some question under the presection 183 case law whether the expenses of such an activity were deductible,²⁶¹ there can be no question under new section 183 as to the limitation on deductibility of the expenses in such circumstances.

The amount of time devoted to the enterprise, either by the taxpayer personally or through employees, is unquestionably a significant factor. Yet because of the possibility of personal interests which might be the source of extensive attention by the taxpayer, courts sometimes evaluate it differently.²⁶² As a commentator had earlier pointed out:

A taxpayer's devoting a considerable amount of time and energy to the daily management of his venture, *e.g.*, breeding race horses, may, in fact, be more indicative of a hobby than the boarding of his horses on a distant farm in the care of independent professional trainers. In the latter case, the chances for success would be more or less the same

²⁵⁶ 10 T.C.M. 625 (1951).

²⁵⁷ 20 T.C.M. 1038 (1961).

²⁵⁸ *Rex B. Foster, Jr.*, 32 T.C.M. No. 13 (1973); *James S. Bishop*, 31 T.C.M. 829 (1972); *Alden B. Starr*, 28 T.C.M. 167 (1969); *Lillian Solomon*, 26 T.C.M. 919 (1967).

²⁵⁹ See *Sharpe, What the Taxpayer Should Do to Have the Courts Recognize His Farm Business*, 28 J. TAXATION 48, 51 (1968).

²⁶⁰ See, *e.g.*, *Henry L. Sutherland*, 27 T.C.M. 103 (1968).

²⁶¹ See, *e.g.*, *Brydia v. Comm'r*, 450 F.2d 954, 955 (3d Cir. 1971) (concurring opinion); *Cecil v. Comm'r*, 100 F.2d 896, 899, 901 (4th Cir. 1939).

²⁶² Compare *W. Jane Luce*, 29 T.C.M. 894 (1970), with *Joan F.W. Farris*, 31 T.C.M. 821 (1972).

irrespective of whether the taxpayer entertained a primary motive of financial gain or was wholly indifferent to profit.²⁶³

In other respects as well, taxpayer effort can be a government sword: One tribunal found it inconceivable that a successful businessman could devote so much time to an activity and have so little to show for it if he were engaged in it for profit.²⁶⁴

Expectation That Assets Used in Activity May Appreciate in Value

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, paragraph (d) of § 1.183-1 for definition of an activity in this connection.²⁶⁵

*Israel O. Blake*²⁶⁶ appears to have been the first decision to discuss in any detail unrealized appreciation as a factor in profit motivation. There the Board of Tax Appeals accepted the taxpayer's contention that despite his long period of uninterrupted farm losses the venture was not unprofitable, for "he has a very valuable collection of horses to show for his investment as well as some real estate which has constantly increased in value during the period of his holding." *Blake* was foreshadowed by *Marshall Field*²⁶⁷ where the court found that the taxpayer's herd could be sold at a profit over all losses and by *Edwin S. George*²⁶⁸ where the taxpayer planted orchards to increase the value of his property and because he thought that the proceeds from the sale of fruit would help carry the land until it was sold. *Herbert C. Sanderson*²⁶⁹ sets forth the theory of unrealized appreciation.

²⁶³ Sharpe, *What the Taxpayer Should Do to Have the Courts Recognize His Farm as a Business*, 28 J. TAXATION 48, 51 (1968).

²⁶⁴ Donald A. McCormick, 28 T.C.M. 1337 (1969); accord, *Marshall Field*, 26 B.T.A. 116, 125 (1932), *aff'd*, 67 F.2d 876 (2d Cir. 1933) (dissenting opinion).

²⁶⁵ Reg. § 1.183-2(b)(4).

²⁶⁶ 38 B.T.A. 1457 (1938). See Comment, *The Effect of Unrealized Appreciation in Determining Profit Motive in Farming Enterprises*, 16 KAN. L. REV. 529, 533 (1968).

²⁶⁷ 26 B.T.A. 116, 124 (1932), *aff'd*, 67 F.2d 876 (2d Cir. 1933),

²⁶⁸ *Edwin S. George*, 22 B.T.A. 189 (1931).

²⁶⁹ 23 T.C.M. 1723 (1964) (footnote omitted); accord, *Lilian Solomon*, 26 T.C.M. 919 (1967).

Furthermore, all is not as black (or in the red) with respect to this venture as it may appear to be. The uncontradicted evidence indicates that the value of the real estate acquired by petitioners for this venture in 1957 has about tripled, and that the potential value of the horses petitioner has on hand at the time of this trial was considerable. It may well be that while petitioners have realized annual cash losses, they may have unrealized appreciations in value which would at least equal those realized losses. While profits and losses must be computed on an annual basis for tax purposes, this is not necessarily true in determining whether there was a bona fide profit motive and a reasonable expectation thereof in a business venture such as this.

Such increase in value, accordingly, indicates the profit potential present and bears on the taxpayer's professed intention to make a profit.²⁷⁰

Furthermore, the factor of unrealized appreciation has been considered significant even where it was not equal to the realized losses. For example, in *Joan F.N. Farris*,²⁷¹ the value of the herd in question at the time of trial was \$200,000; however, the aggregate net losses in the years 1959 through 1970 were \$412,326. The court was nevertheless impressed with the factor of unrealized appreciation in this herd or inventory.

While in the agricultural context appreciation in land alone may be sufficient, taxpayers usually rely upon appreciation in both land and inventory, *e.g.*, breeding herds or crops such as timber.²⁷² And under section 162 courts have proven increasingly willing to consider such unrealized appreciation in determining profitability.²⁷³ Outside this area, unrealized appreciation has seldom been available to taxpayers.²⁷⁴ Some small success has, however, been scored by artists under the theory that successful exhibits require large inventories of good paintings, and a lack of sales attributable to creation of such an inventory—which implicitly contains unrealized appreciation—is no indication of lack of bona fide profit expectation.²⁷⁵ Such contention is probably limited to situations in which the art is salable and the artist has an established reputation.²⁷⁶ As is the case with some of the other

²⁷⁰ 5 MERTENS, FEDERAL INCOME TAXATION § 28.74 n.41.1.

²⁷¹ 31 T.C.M. 821, 824 (1972).

²⁷² *DuPont v. United States*, 234 F. Supp. 681 (D. Del. 1964); *George Thacker*, 28 T.C.M. 1433 (1969).

²⁷³ See Comment, *The Effect of Unrealized Appreciation in Determining Profit Motive in Farming Enterprises*, 16 KAN. L. REV. 529, 538-39 (1968); RIDENOUR, FARM AND RANCH LOSSES, BNA TAX MANAGEMENT PORTFOLIO No. 241-2d, A-19, A-28 (1973).

²⁷⁴ See, *e.g.*, *Chaloner v. Helvering*, 69 F.2d 571, 572 (D.C. Cir. 1934).

²⁷⁵ *Sebastian de Grazia*, 21 T.C.M. 1572 (1962).

²⁷⁶ *Louis H. Porter*, 28 T.C.M. 1489, 1492 n.3 (1969), *aff'd per curiam*, 437 F.2d 39 (2d Cir. 1971).

factors, there has been a recent movement to apply this factor as a sword. The principal example is *Edward J. Drew*²⁷⁷ where the court noted unfavorably that the taxpayer's horses did not increase significantly in value as a result of the training received.

In summary, under prior law unrealized appreciation was becoming a significant factor in farm loss cases and seemed destined in the current era of inflationary land values to become even more so.²⁷⁸ Accordingly, prior to promulgation of the regulations one commentator on section 183 believed that this trend would continue under that provision so "that a taxpayer might obtain a deduction for losses incurred with respect to a farming operation that would necessarily produce losses until ultimate sale of the land at a gain."²⁷⁹ The drafters of the regulation were undoubtedly aware of this trend and commentary as well as the potential it afforded for enjoying current ordinary losses with future income being taxed as a capital gain. Consequently, while the regulations explicitly acknowledge in the profit motivation factors the effect of unrealized appreciation in farm land on determining whether a farm activity is engaged in for profit, they seek in the definition of the term "activity" to, in effect, preclude reliance upon such appreciation in determining whether a loss farm activity is engaged in for profit. As discussed above, the regulations instead should have limited use of unrealized appreciation in noninventory assets to determining whether such assets were held for the production of income.

Success of Taxpayer in Carrying on Other Similar or Dissimilar Activities

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.²⁸⁰

While the heading of this factor in the regulations refers to success in both similar and dissimilar activities, the discussion following it speaks only to conversion of similar activities from

²⁷⁷ 31 T.C.M. 799 (1972).

²⁷⁸ Comment, *The Effect of Unrealized Appreciation in Determining Profit Motive in a Farming Enterprise*, 16 KAN. L. REV. 529, 540 (1968); RIDENOUR, FARM AND RANCH LOSSES, BNA TAX MANAGEMENT PORTFOLIO No. 241-2d, A-19, A-20 (1973).

²⁷⁹ DICKINSON, FARM AND RANCH LOSSES, BNA TAX MANAGEMENT PORTFOLIO No. 241, A-23 (1970).

²⁸⁰ Reg. § 1.183-2(b)(5).

unprofitable to profitable status. The actual cases, on the other hand, have considered experience in both types of activities, but the aspect of conversion to profitable status has played no discernible role. Farm loss decisions resting in part on the taxpayer's previous operation of other similar activities, without indicating whether such activities were profitable, are illustrative.²⁸¹ Even where the decisions expressly relied upon the fact that prior farming activities were profitable, they have not considered whether they were initially unprofitable.²⁸² Similarly, several fine arts decisions have pointed out that the taxpayer's prior financial success in his creative endeavors gave him grounds for belief that he could again be successful in the field, but have not discussed whether such prior success was preceded by a period of losses.²⁸³

Courts have gone beyond the mere fact that the taxpayer enjoyed success in other activities, similar or dissimilar. They have considered whether similar risks and profit potential were involved and have compared the manner in which the activities were conducted. For instance, the district court in *Helis v. Usry*,²⁸⁴ stated that where the principal business of the taxpayer involves high risk and a large investment, with a commensurate promise of great profit, it is normal to expect him to engage in other businesses with similar risks and prospects of profit.

In comparing the manner in which the taxpayer conducted a profitable and a losing activity, courts have considered the type and character of the records maintained in the two undertakings.²⁸⁵ Where the records in the questioned activity are haphazard in comparison with the records maintained in clearly profit motivated and successful activities, the conclusion is almost inescapable that the purpose in carrying on the former is other than

²⁸¹ Walter P. Temple, 10 B.T.A. 1238 (1928); Hamilton F. Kean, 10 B.T.A. 97 (1928); John S. Ellsworth, 21 T.C.M. 145 (1962).

²⁸² Jean A. Lowenthal, 27 T.C.M. 387 (1968); Eugene J. Davis, 25 T.C.M. 616 (1966); William L. Brueck, Sr., 23 T.C.M. 1228 (1964).

²⁸³ Rood v. United States, 184 F. Supp. 791 (D. Minn. 1960); Thelma C. Whitman, 19 T.C.M. 456 (1960); Cornelius Vanderbilt, Jr., 16 T.C.M. 1081 (1957).

²⁸⁴ 71-1 U.S.T.C. ¶ 9365 (E.D. La. 1971), *rev'd on other grounds*, 464 F.2d 330 (5th Cir. 1972); *accord*, Farish v. Comm'r, 103 F.2d 63, 65 (5th Cir. 1939) ("But we think the Board was psychologically wrong in concluding that the Farishes, as men of sound business judgment, would not have engaged in the ventures with any expectation of profit. Both are actively engaged in the oil business. It is common for a man in the oil business, of sound judgment, to expend thousands of dollars in exploring the land and drilling for oil in 'wild cat' territory.")

²⁸⁵ Gross v. United States, 71-2 U.S.T.C. ¶ 9715 (N.D. Fla. 1971); Arthur H. Eppler, 58 T.C. 691 (1972).

the purpose with respect to the latter.²⁸⁶ Juries have also been permitted to compare the size and character of profitable activities and questioned activities as well as the time spent on both,²⁸⁷ but the significance and scope of such comparisons is unclear.

In addition to the negative application of this factor to the specific fact of haphazard records in a loss activity in contrast to adequate records in successful activities, courts have recently begun to draw similar negative comparisons as to operations in general. In *Donald A. McCormick*²⁸⁸ the court emphasized that the taxpayer was an experienced and successful businessman so that his boat chartering activities could not be justified or explained on the basis of lack of business experience or naivete—the activity was not pursued in the systematic and energetic method that the court would expect of such a person.

Taxpayer's History of Income or Losses With Respect to the Activity

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.²⁸⁹

In essence, the general rule that continued losses may indicate that an activity is not engaged in for profits forms the keystone of this factor, but in the same breath the provision recognizes two exceptions: (1) losses incurred in the initial or start-up stage of an activity and (2) losses sustained by unforeseen or fortuitous circumstances.

Continued Losses. The case law early established that a continuing lack of profits constituted an important factor bearing on

²⁸⁶ *Anthony Imbesi*, 23 T.C.M. 1678 (1964), *rev'd on other grounds*, 361 F.2d 640 (3d Cir. 1966).

²⁸⁷ *Hicks v. United States*, 72-1 U.S.T.C. ¶ 9383 (S.D. Miss. 1972); *Gross v. United States*, 71-2 U.S.T.C. ¶ 9715 (N.D. Fla. 1971).

²⁸⁸ 28 T.C.M. 1337 (1969); *accord*, *W. Jane Luce*, 29 T.C.M. 894 (1970).

²⁸⁹ Reg. § 1.183-2(b)(6).

the taxpayer's true intention.²⁹⁰ The rationale is that an ordinary businessman will abandon an undertaking if he encounters losses after the period customary to bring it to a profitable state.²⁹¹ Frequently linked with the continued loss factor are losses which were disproportionate to receipts.²⁹² Indeed, the corresponding factor in the proposed regulations contained the following statement: "Moreover, a high ratio of expenditures to receipts may also be indicative of a lack of profit intent. A declining loss ratio may, however, suggest that profitability is imminent."²⁹³ While ample authority is available for both statements,²⁹⁴ the disproportionate loss factor has been largely counterbalanced—at least in the agricultural context, which is both the mother lode from which these factors were mined and the principal activity to which they appear directed—or even nullified by the start-up stage concept.²⁹⁵

Moreover, a complete absence of gross receipts is more important than continued losses.²⁹⁶ One commentator surveying the section 162 authorities concluded that the great majority of courts have abandoned primary reliance on the expenditures-to-receipts ratio or the duration of the loss and now look to the ultimate profitability of the enterprise, "on the assumption that several loss years must necessarily accompany the building of a profitable operation."²⁹⁷ Indeed, in summarizing the House proposals in the Tax Reform Act of 1969, the staff of the Joint Committee pointed out that an objection to the House hobby loss provision, which contained a presumption that an activity was not carried on with a reasonable expectation of profit—the standard of

²⁹⁰ *Morton v. Comm'r*, 174 F.2d 302, 304 (2d Cir.), *cert. denied*, 338 U.S. 828 (1949). *Cecil v. Commissioner*, 100 F.2d 896 (4th Cir. 1939), would have made this an independent test.

²⁹¹ *Proebstle v. United States*, 1965-2 U.S.T.C. ¶ 9497 (S.D. Tex. 1965). *See generally* Sharpe, *What The Taxpayer Should Do to Have the Courts Recognize His Farm as a Business*, 28 J. TAXATION 48 (1968); Note, *Analysis of New Code Section 183 and Some Ramifications For the Resort Home*, 9 WILLAMETTE L.J. 117, 121 n.13 (1973).

²⁹² *Schley v. Comm'r*, 375 F.2d 747 (2d Cir. 1967); *Arthur E. Eppler*, 53 T.C. 691 (1972).

²⁹³ Prop. Reg. § 1.183-2(b)(1), 36 Fed. Reg. 16112 (Aug. 19, 1971).

²⁹⁴ Disproportionate loss: *Alfred M. Cox*, 24 T.C.M. 23, (1965), *aff'd per curiam*, 354 F.2d 659 (3d Cir. 1966). Declining loss ratio: *Henry Potter Russell*, 1938 B.T.A.M. ¶ 38,094. *See generally* DICKINSON, FARM AND RANCH LOSSES, BNA TAX MANAGEMENT PORTFOLIO No. 241, A-28 (1970).

²⁹⁵ *See, e.g., Cenac v. United States*, 67-2 U.S.T.C. ¶ 9576 (E.D. La. 1966); *James S. Bishop*, 32 T.C.M. 829 (1972); *Walter E. Edge, Jr.*, 32 T.C.M. 1291 (1973).

²⁹⁶ *Oliver B. Kilroy*, 32 T.C.M. No. 7 at 30 (1973).

²⁹⁷ DICKINSON, FARM AND RANCH LOSSES, BNA TAX MANAGEMENT PORTFOLIO No. 241, A-28 (1970).

deductibility—if its losses were greater than \$25,000 in three out of five years, was that the bill failed “to recognize that farming generally is a risky operation and that substantial losses are frequently incurred in early years.”²⁹⁸

Historically, the courts were early to realize that although the relation of receipts to expenditures might give rise to a negative inference in determining the taxpayer's intent, such inference could be overcome by other factors, such as personal attention and business-like operations.²⁹⁹ Moreover, some early cases questioned whether continued losses (in one instance where average losses were twice the amount of gross receipts) gave rise to an inference that an activity was not undertaken for profit.³⁰⁰ In any event, the courts began to adopt, almost as a counterweight to the above rubric of continued, disproportionate losses, the catch phrase that the mere fact that the taxpayer sustains losses from year to year does not prove that an activity was not operated as a business venture.³⁰¹ The careful balancing of these rules perhaps reached its apex in the oft-cited Tax Court decision in *Margit Sigray Bessenyei*:

[A] record of continued losses over a series of years or the unlikelihood of achieving a profitable operation may be an important factor bearing on the taxpayer's true intention. . . . On the other hand, the presence of losses in the formative years of a business, particularly one involving the breeding of horses, is not inconsistent with an intention to achieve a later profitable level of operation, bearing in mind, however, that the goal must be to realize a profit on the entire operation, which presupposes not only future net earnings but also sufficient net earnings to recoup the losses which have meanwhile been sustained in the intervening years.³⁰²

As the dominant trend in the farm loss cases manifests, the initial or start-up stage exception has, however, virtually swallowed the continued loss rule.

Start-Up Losses. From the earliest hobby loss opinions to the present, courts have been quite receptive to taxpayer contentions

²⁹⁸ STAFFS OF THE JOINT COMMITTEE ON INTERNAL REVENUE TAXATION AND THE COMMITTEE ON FINANCE, SUMMARY OF H. R. 13270, THE TAX REFORM ACT OF 1969 (AS PASSED BY THE HOUSE OF REPRESENTATIVES), 91ST CONG., 1ST SESS. 43 (Comm. Print 1969).

²⁹⁹ Thomas F. Sheridan, 4 B.T.A. 1299, 1301 (1926).

³⁰⁰ Rose P. Crane, 9 B.T.A. 437, 441 (1927); cf. Israel O. Blake, 38 B.T.A. 1457, 1460 (1938).

³⁰¹ Hamilton F. Kean, 10 B.T.A. 97, 102 (1928).

³⁰² 45 T.C. 261, 274 (1965), (footnote omitted), 379 F.2d 252 (2d Cir.), cert. denied, 389 U.S. 931 (1967).

that losses incurred in the initial stages of a farm operation were not inconsistent with a profit motive. The cases rapidly progressed from the simple justification that heavy initial expenses caused the lack of profits to the more sophisticated rationale that the taxpayer "had to build up his business and the reputation of his farm for producing desirable horses before a failure to realize profits could be taken as a reasonably clear indication of failure," in the face of which latter failure a bona fide profit motive would disappear if the venture were continued thereafter.³⁰³ Equally persuasive was the claim that the taxpayer had not been engaged in his breeding activities long enough to build up a herd of sufficient stock from which to realize sales profits.³⁰⁴ Indeed, many authorities categorically state that it takes from five to ten years or even longer to develop a profitable livestock herd.³⁰⁵ In *Alden B. Starr*,³⁰⁶ the government even acknowledged on brief to the Tax Court that the taxpayers could not have expected to realize a profit until they had horses of breeding age. The Commissioner further acknowledged there that additional losses may be incurred even after that event because it takes time to establish a reputation for breeding and raising quality horses. The *Starr* court concluded that there was no doubt that during the tax years, the fifth and sixth years of operations, the venture was still in its "formative stage, during which losses incurred are not inconsistent with a declared intention to make a profit."

One commentator, based upon information supplied by a state extension service county farm agent, has succinctly set forth the farm economics that dictate losses in the initial stage of a livestock breeding operation.

It usually takes a minimum of five years to begin the development of any cattle breed, and probably longer to become profitable. A farmer who wants to develop a herd will buy heifers at weaning age (above seven months). He must then wait two years to breed them and it will be nine months later before calves are born. Thus, for two years and nine months there will be no income, but expenses will be continuous. When the first calves are born, approximately fifty percent will

³⁰³ Lucien H. Tyng, 36 B.T.A. 21, 35 (1937), *rev'd on other grounds*, 106 F.2d 55 (2d Cir. 1939), *rev'd on other grounds*, 308 U.S. 527 (1940); *accord*, Irving C. Ackerman, 24 B.T.A. 512, 516 (1931), *aff'd*, 71 F.2d 586 (9th Cir. 1934).

³⁰⁴ Henry Potter Russell, 1938 B.T.A.M. ¶ 38,094 at 163 (1938).

³⁰⁵ *Farish v. Comm'r*, 103 F.2d 63, 64 (5th Cir. 1939); *DuPont v. United States*, 234 F. Supp. 681, 686 (D. Del. 1964); Joan F.W. Farris, 31 T.C.M. 821 (1972); Morris A. Stoltzfus, 29 T.C.M. 1610 (1970); Lillian Solomon, 26 T.C.M. 919 (1967); John S. Ellsworth, 21 T.C.M. 145 (1962).

³⁰⁶ 28 T.C.M. 167, 173 (1969).

be heifers. Because the farmer is developing a breeding herd, he will keep as many of these heifers as possible; in most instances, retaining eighty percent of the heifers is not unusual. The farmer may also keep the better bull calves in some cases. Thus, less than sixty percent of the calf crop will be sold, which will usually result in a net loss for the year. Following this procedure for another generation means it will be another three years before a whole crop of calves from the owner's herd can be sold. This is the earliest a breeder may begin to profit. However, it will probably take longer to develop a fine breeding herd, which requires more experimentation, since the traits the breeder wants in his herd may not appear for several generations. This is probably why it was stated in *DuPont* that it takes twenty-five years to develop Santa Gertrudis cattle.³⁰⁷

Substantially similar facts have been found by the courts, and used to support the conclusion that a developmental period during which expenses would inevitably exceed income was necessary in the venture.³⁰⁸ The two out of seven years test for determining whether the section 183(d) profit motive presumption applies to a horse breeding operation, added by a Senate floor amendment, may well have been prompted by the large number of horse breeding authorities indicating that a profit was not possible in the first five years of a horse breeding activity.

A taxpayer may extend the normal start-up period by gradual entry into the activity, as by breeding a herd up to minimum profitable number rather than initially purchasing that number.³⁰⁹ More significant are those authorities indicating that a taxpayer by abandoning unprofitable techniques or specific activities may have available a series of start-up periods in which losses are not significant.³¹⁰ Similarly, the factor of unforeseen circumstances may extend the start-up stage: *DuPont v. United States*³¹¹ noted that the dispersal of a breeding herd occasioned by disease prolonged the initial stage of the venture.

Development of a livestock herd is not the only acceptable explanation for an initial period of losses. For example, where consistent net losses are attributable to the repair and buildup of a badly rundown business facility, a nonprofit motive does not necessarily follow from such losses.³¹² Thus, farm loss authorities

³⁰⁷ Comment, *The Effect of Unrealized Appreciation in Determining Profit Motive in Farming Enterprises*, 16 KAN. L. REV. 529, 538-39 (1968) (footnote omitted).

³⁰⁸ See, e.g., Lillian Solomon, 26 T.C.M. 919 (1967); John S. Ellsworth, 21 T.C.M. 145 (1962).

³⁰⁹ Joan F.W. Farris, 31 T.C.M. 821, 825 (1972).

³¹⁰ Rex B. Foster, 32 T.C.M. No. 13 (1973); Rowe B. Metcalf, 22 T.C.M. 1402 (1963).

³¹¹ 234 F. Supp. 681 (D. Del. 1964).

³¹² Hicks v. United States, 72-1 U.S.T.C. ¶ 9383 (S.D. Miss. 1972); Cavender v. United

have strongly emphasized soil reclamation activities in determining profit motive.³¹³ On the other hand, in activities other than farming, taxpayers have found it more difficult to show acceptable explanations for initial losses. Indeed, the Tax Court in one farm loss decision distinguished one of the leading nonfarm authorities that had emphasized a long history of disproportionate losses, on the basis that no explanation was given there for the initial period of losses, whereas, in the case before it, the losses were incurred during "a necessary developmental period of several years during which expenses would inevitably exceed income."³¹⁴ Consequently, it may be significant that in *Arthur H. Eppler*,³¹⁵ where the Tax Court recently held that a long record of heavy expenditures without any real effort to curtail them or any offsetting revenues indicated the activity was not conducted for profit, it noted that cats being raised (as many as 450) were not for sale, did not produce any marketable product and "they could not be established as a breed."

*Sebastian de Grazia*³¹⁶ stands as one of the few examples of successful use of the initial stage concept outside the farm loss area. The Tax Court recognized that profits may not be immediately forthcoming in the fine arts. "Examples are legion of the increase in value of a painter's works after he receives public acclaim. Many artists have to struggle in their early years. This does not mean that serious artists do not intend to profit from their activities. It only means that their lot is a difficult one."³¹⁷ More frequently, however, the nonagricultural cases have turned on a continued history of loss disproportionate to gross receipts.³¹⁸ If the Service attempts to extend section 183 to ownership of nonowner occupied rental residential real estate, the start-up period concept may yet flower outside the farm loss area since a profit from operations is not possible prior to the turnaround.

States, 71-2 U.S.T.C. ¶ 9723 (S.D. W. Va. 1970); *W. Clark Wise*, 16 T.C.M. 361 (1957), *aff'd per curiam*, 260 F.2d 354 (6th Cir. 1958).

³¹³ *Mary Ellis Turner*, 23 T.C.M. 1186 (1964); *George M. Zengler*, 17 T.C.M. 454 (1958); *cf. Lazonby v. Tomlinson*, 272 F. Supp. 558 (N.D. Fla. 1967); *Norton L. Smith*, 9 T.C.M. 1150 (1947).

³¹⁴ Compare *John S. Ellsworth*, 21 T.C.M. 145 (1962), with *White v. Commissioner*, 227 F.2d 779 (6th Cir. 1955), *cert. denied*, 351 U.S. 939 (1956).

³¹⁵ 58 T.C. 691, 698 (1972).

³¹⁶ 21 T.C.M. 1572 (1962).

³¹⁷ *Id.* at 1577.

³¹⁸ See, e.g., *Porter v. Comm'r*, 437 F.2d 39 (2d Cir. 1970); *Lamont v. Comm'r*, 339 F.2d 377 (2d Cir. 1964); *White v. Comm'r*, 227 F.2d 779 (6th Cir. 1955), *cert. denied*, 351 U.S. 939 (1956).

At least one decision has sought to make the start-up stage subject to the disproportionate loss principle. In *Robert Y.H. Thomas*³¹⁹ the Tax Court acknowledged that the early years of a breeding enterprise may well show losses and it takes five to seven years before such an operation can be expected to make a profit, but it found no convincing evidence that the farm was headed for profitable operations in that period. The court thought it significant that losses were wholly disproportionate to receipts and the small receipts were not attributable to breeding operations. On the other hand, most other Tax Court decisions have recognized that during the formative stages revenues from sale of livestock are insubstantial, since sales of foundation stock prior to establishment of the herd would jeopardize or even sacrifice the goal of the entire undertaking.³²⁰ Hence, losses are frequently disproportionate. Perhaps, therefore, it should not be surprising that a district court found the taxpayer in *Thomas* had engaged in his breeding operations for profit in the tax year immediately prior to the years before the Tax Court.³²¹

The Treasury, too, has sought to play down the importance of the start-up stage. Apparently the drafters of the regulations subtly intended to place more weight on the casualty exception than on the initial stage exception in the general continued loss principle. For they provided that losses sustained because of unforeseen or fortuitous circumstances would not be an indication that the activity is not engaged in for profit, whereas, a series of losses during the initial or start-up stage may not necessarily be an indication the activity is not engaged in for profit. The reported cases, to the contrary, emphasize the start-up stage exception over that of unforeseen circumstances. As one commentator has stated:

[T]he most convincing evidence for the taxpayer in a case involving a long loss period is customary to the industry in the process of building a profitable enterprise. For instance, the taxpayer may be able to show that building a breeding herd through the natural increase method ordinarily requires seven to ten loss years, depending on the initial herd size. However, the duration of the loss experience will often prove decisive in indicating lack of profit intent if the losses continue to be

³¹⁹ 21 T.C.M. 382 (1962), *vacated and remanded*, 324 F.2d 798 (5th Cir. 1963).

³²⁰ John E. Ellsworth, 21 T.C.M. 145 (1962); *see* Lucien H. Tyng, 36 B.T.A. 21 (1937), *rev'd on other grounds*, 106 F.2d 55 (2d Cir. 1939, *rev'd on other grounds*, 308 U.S. 527 (1940); Rowe B. Metcalf, 22 T.C.M. 1402 (1963).

³²¹ *Robert Y.H. Thomas v. United States*, 62-1 U.S.T.C. ¶ 9274 (S.D. Fla. 1962). Indeed, the Fifth Circuit remanded the Tax Court decision because it had seemingly given no weight to this fact.

sustained after the period that would ordinarily be necessary to bring the operation to a profitable status.³²²

Unforeseen or Fortuitous Circumstances. This exception to the significance of continued losses, unlike the start-up stage exception, appears almost exclusively in the farm or kennel loss cases, where it has been termed one of the most helpful factors in establishing profit intent despite substantial losses.³²³ The recent Tax Court decision in *Thomas W. Jackson*³²⁴—resting in part on the conclusion that the vicissitudes of sea and weather conditions prevented profitability in the activity of chartering a yacht—constitutes a significant example outside that area.

In addition to the illustrations of fortuitous circumstances in the nature of involuntary conversions provided for in the regulations, the cases also supply such examples as sterility in breeding livestock and injuries to livestock, particularly horses.³²⁵ The regulations speak of circumstances beyond the taxpayer's control. This may well be a reflection of the argument presented by the Joint Committee against the House proposal that the provision "will result in farmers who experience losses (e.g., because of crop failures) being harassed by revenue agents seeking to apply this provision."³²⁶ While disease, weather, et cetera, fit this involuntary category and the authorities also demonstrate like situations such as forced dispersal of a herd at a loss because of incapacity of a key employee,³²⁷ many decisions also have accepted various adverse circumstances as causing the continued losses, rather than a lack of profit motive, which are attributable to

³²² DICKINSON, FARM AND RANCH LOSSES, BNA TAX MANAGEMENT PORTFOLIO No. 241, A-29 (1970) (footnote omitted).

³²³ *Id.* at A-30.

³²⁴ 59 T.C. 312, 317 (1972), *acq.*, 1973-21 I.R.B. 5.

³²⁵ *Patterson v. United States*, 459 F.2d 487 (Ct. Cl. 1972); *Worrell v. United States*, 254 F. Supp. 992 (S.D. Tex. 1966); *Wright v. United States*, 249 F. Supp. 508 (D. Nev. 1965); *Hamilton F. Kean*, 10 B.T.A. 97 (1928). A list of such factors is contained in RIDENOUR, FARM AND RANCH LOSSES, BNA TAX MANAGEMENT PORTFOLIO No. 241-2d A-24 (1973).

³²⁶ STAFFS OF THE JOINT COMMITTEE ON INTERNAL REVENUE TAXATION AND THE COMMITTEE ON FINANCE, SUMMARY OF H.R. 13270, THE TAX REFORM ACT OF 1969 (AS PASSED BY THE HOUSE OF REPRESENTATIVES), 91ST CONG., 1ST SESS. 43 (Comm. Print 1969). Section 270's treatment of "specially treated deductions" was based on a policy decision "to remove from the potential application of the 'hobby loss' provision those deductible items which might occur by reason of events beyond the taxpayer's control or which might occur in an unusually risky business." Comment, *Section 183, Work: Horse or Hobby Loss*, 20 CATHOLIC U.L. REV. 716, 720 (1971).

³²⁷ *Theron D. Stay*, 17 T.C.M. 861 (1958).

taxpayer's actions, thus, are arguably within his control.³²⁸ In short, to date the courts by and large have not distinguished between fortuitous circumstances on the basis of whether they were within the taxpayer's control as the regulations do. But to the extent that cases begin to accept such a distinction, *Robert E. Currie*³²⁹ may prove prophetic in treating injury to livestock, universally a favorable factor in other cases, as showing, in effect, a lack of profit motive origin for losses, *i.e.*, a negative factor. *Currie* included in factors indicating a lack of profit motive: "what seems to us to be petitioner's failure to exercise sufficient care to protect the first foal which was dead at birth, as well as the second foal which was killed by petitioner's rottweilers and the second mare which was killed by an automobile."³³⁰ Under this approach, some fortuitous circumstances accepted in the past by courts as explaining continued losses might, on second look, have been due to lack of taxpayer advance planning or attention, which other factors in the regulations and recent cases apply as negative factors.

In summary, the Treasury's formulation of this factor fairly restates the current case law. Unfortunately, revenue agents in applying it will undoubtedly focus on the continued losses with scant regard for the start-up stage and the unforeseen circumstances exceptions. The courts may be expected to rely heavily on these exceptions, particularly in the farm loss area. Although the formative period concept has appeared determinative in many recent decisions, the proper perspective is that results are secondary to objective steps taken to achieve profit in ascertaining motivation for an activity.³³¹ It is only because the government has overemphasized results, *i.e.*, losses, that the accepted explanations not inconsistent with profit motivation have played such a predominant role in the cases.

Amount of Occasional Profits, If Any, Which Are Earned

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 determin-

³²⁸ Woodrow L. Wroblewski, 32 T.C.M. No. 37 (1973); Jean A. Lowenthal, 27 T.C.M. 387 (1968); Harvey S. Farrow, 16 T.C.M. 836 (1957).

³²⁹ 28 T.C.M. 12 (1969).

³³⁰ *Id.* at 21.

³³¹ Harold I. Snyder, 25 T.C.M. 1326 (1966).

ing 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.³³²

The negative application of this factor is covered by the sixth factor of history of income or *losses*. The first question is the weight to be accorded actual profits. The Treasury has drawn a distinction between small and substantial, occasional profits in answering it—only substantial, occasional profits are generally indicative that the activity is engaged in for profit. This distinction is not supported by the majority of cases. For most authorities in which a net profit was earned prior, or occasionally subsequent, to the tax year have merely favorably noted that there was such a profit without indicating its size,³³³ or at most have stated the taxpayer was previously quite successful in the activity or earned at least enough to support his family.³³⁴ Moreover, in many decisions in which existence of a prior profit impressed the court, that profit was clearly small, particularly in relationship to the amount of losses incurred and the investments.³³⁵ Indeed, in *Norman C. Demler* the Tax Court recognized, but appears to have deprecated, the fact that the loss was small: "It is noteworthy that in fiscal 1965 the Corporation realized a profit—albeit small—from a fourth-place finish."³³⁶ There are, however, a few exceptions to this trend. For example, a recent decision concluded that where a small profit is realized only after audit has commenced and arises from a sharp reduction in claimed deductions, it is entitled to little weight.³³⁷ This conclusion may portend the likelihood of the Commissioner over-

³³² Reg. § 1.183-2(b)(7).

³³³ *Brooks v. Comm'r*, 274 F.2d 96 (9th Cir. 1959); *Rood v. United States*, 184 F. Supp. 791 (D. Minn. 1960); *James Clark*, 24 B.T.A. 1235 (1931).

³³⁴ *Thelma C. Whitman*, 19 T.C.M. 456 (1960) (quite successful); *Cornelius Vanderbilt, Jr.*, 16 T.C.M. 1081 (1957) (support family).

³³⁵ *Dean Babbitt*, 23 T.C. 850 (1955); *Marshall Field*, 26 B.T.A. 116 (1932, *aff'd*, 67 F.2d 876 (2d Cir. 1933).

³³⁶ 25 T.C.M. 620, 626 (1966).

³³⁷ *Leonard F. Barcus*, 32 T.C.M. No. 138 (1973), *aff'd per curiam*, 74-1 U.S.T.C. ¶ 9288 (2d Cir. 1974); see *R.C. Coffey*, 1 T.C. 579, 589-90 (1943), *aff'd*, 141 F.2d 204 (5th Cir. 1944); *Lamont v. Comm'r*, 339 F.2d 377, 379 (2d Cir. 1964).

coming the section 183(d) or (e) presumption where the two profit years are achieved after audit and by juggling deductions or income.

In addition to actual profit, this factor of the regulations considers the possibility of future profit—again with emphasis on a substantial profit. The regulation states that the possibility of earning a substantial profit in a highly speculative venture ordinarily suffices to show a profit motive, although losses or only occasional small profits are actually generated. The liberal proviso is actually dictated by legislative history mandating that the focus be on whether the activity was engaged in for profit, rather than whether the expectation of a profit was reasonable. For the Senate Committee on Finance illustrated this focus with the examples of a bona fide inventor and the investor in a wildcat oilwell, to whom section 183 was to apply, although it might be argued that neither had a reasonable expectation of profit.³³⁸ The committee also described these two situations as activities in which “there was a small chance of a large profit.”

The regulations touch on the subject of a large, speculative profit in three places: (1) in this factor, (2) in the introduction to the definition of an activity not engaged in for profit (“it may be sufficient that there is a small chance of making a large profit,” illustrated by an investor in a wildcat oilwell) and (3) in two of the examples accompanying the nine factors, involving an independent oil and gas operator and driller and a research chemist.³³⁹

Activities in which there is a small chance of a spectacular profit are not limited to oil investments and inventing. Indeed, livestock breeding has been explicitly compared to wildcat oil drilling.³⁴⁰ Furthermore, racing horses or automobiles are outstanding examples of such an activity.³⁴¹ Apparently, however, when the chance for a profit moves from speculative to a pure gamble, the profit motive test is not met.³⁴² In addition, some non-

³³⁸ S. REP. NO. 91-552, 91st Cong., 1st Sess. 103-04 (1969).

³³⁹ Reg. § 1.183-2(a) and 1.183-2(c) Exs. 5 and 6.

³⁴⁰ *Helis v. Usry*, 71-1 U.S.T.C. ¶ 9365 (E.D. La. 1971), *rev'd on other grounds*, 464 F.2d 330 (5th Cir. 1972).

³⁴¹ *Comm'r v. Widener*, 33 F.2d 833 (3d Cir. 1929); *Norman C. Demler*, 25 T.C.M. 620 (1966).

³⁴² See *Mitchell v. United States*, 70-1 U.S.T.C. ¶ 9129 (W.D. Tenn. 1969) (appears to rely on reasonable expectation of profit requirement); *James T. Shiosaki*, 30 T.C.M. 110 (1971), *aff'd*, 475 F.2d 770 (9th Cir. 1973). It is possible that *Shiosaki* could have reached the same result (disallowance of losses from gambling at craps) under the theory that section 165(d) was intended to restrict the deductibility of wagering transaction losses and

agricultural loss authorities indicate that the chance for a spectacular profit must have some foundation in fact, but this comes close to a reasonable expectation of profit requirement.³⁴³

Earlier authorities which had adopted the good faith intention test, just as does section 183, rather than the reasonableness of the taxpayer's belief that a profit will be realized, of course, were nevertheless favorably impressed by a reasonable expectation of profit.³⁴⁴ Consequently, this factor should also cover a reasonable chance of a more moderate profit. Yet revenue agents in application of this factor may be expected to tend to disregard chances for a moderate profit and actual small profits—contrary to case law. Furthermore, they may tend to apply it as a negative factor where no profit is present, despite the fact that the sixth factor covers this aspect and carefully sets out the exceptions to continued losses as a negative factor. For these reasons the seventh factor, as presently worded, would have been better omitted, leaving the small chance of a large profit aspect to the introduction and the accompanying examples. Hopefully courts will quickly place this factor in its proper bed of prior case law in order to retard these tendencies.

Financial Status of the Taxpayer

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.³⁴⁵

Modest Income. The thrust of the first prong of this factor is that a lack of substantial income or capital from sources other than the activity favors the taxpayer's case. Indeed, the fourth example accompanying these regulations, which involves a mar-

attendant expenses to the amount of wagering income. See GILJUM, LOSSES—THEFT, WAGERING, WAR, AND CONFISCATION, BNA TAX MANAGEMENT PORTFOLIO No. 278, A-21 (1973).

³⁴³ Charles A. Nemish, 29 T.C.M. 1249 (1970), *aff'd per curiam*, 452 F.2d 611 (9th Cir. 1972). The taxpayer's glowing terms of the profit potential of his novels—"if and when I finally sell this first novel, then I know that sooner or later I am going to make a killing—it will be tremendous, these days a novel will go for hardly less than one hundred thousand dollars"—did not indicate to the Tax Court a bona fide profit motive.

³⁴⁴ Worrell v. United States, 254 F. Supp. 992 (S.D. Tex. 1965); Joan F.W. Farris, 31 T.C.M. 821 (1972).

³⁴⁵ Reg. § 1.183-2(b)(8).

ginal farm operated by a taxpayer employed full-time as a skilled machine operator in a nearby factory at an annual wage of \$8,500 per year, concludes that he may be engaged in the activity for profit. This example appears to be the fleshing out of one of the Senate Committee on Finance's illustrations of an activity engaged in for profit, although arguably not carried on with a reasonable expectation of profit: "a poor person engaged in what appears to be an inefficient farming operation."³⁴⁶ The cases, too, have been favorably disposed towards taxpayers of modest means, reasoning that the taxpayer could not afford to indulge in an extravagant or full-time hobby.³⁴⁷ Use of savings or earnings of other family members is also indicative of a profit motive.³⁴⁸ While these cases frequently contrast the taxpayer's situation with that of "a high bracket taxpayer seeking to have the Federal fisc subsidize his hobby" or a wealthy man indulging his hobby,³⁴⁹ the decisions actually involving such high bracket taxpayers by and large do not find independent wealth a very significant factor.

Substantial Income. In the second prong of this factor, the Service attempts to apply the reverse of the modest income factor. The regulation asserts that substantial outside income, particularly if coupled with substantial deductible losses from the activity, may indicate that the activity is not engaged in for profit. Although the modest outside income as a positive factor does not appear to have been a part of the Service's presection 183 repertoire, it strongly pursued the substantial income principle under section 162, but to little avail. As one commentator has concluded:

Frequently, the Commissioner has argued that if the taxpayer has independent wealth or a substantial income unrelated to farming, this should be considered as some evidence that the farm is not operated for profit. Apparently the premise is that a wealthy man can more readily afford a "hobby farm." Most courts have not been receptive to this argument and have been willing to allow farm losses to persons with substantial nonfarm resources or income where profit intent is adequately established by other factors.³⁵⁰

³⁴⁶ S. REP. NO. 91-552, 91st Cong., 1st Sess. 103 (1969).

³⁴⁷ Harold M. Clark, 28 T.C.M. 1260 (1969); George Thacker, 28 T.C.M. 1433 (1969); Benjamin E. Adams, 25 T.C.M. 1239 (1966); Hedi Katz, 13 T.C.M. 188 (1954).

³⁴⁸ Woodrow L. Wroblewski, 32 T.C.M. No. 37 (1973).

³⁴⁹ Harold M. Clark, 28 T.C.M. 1260, 1262 (1969); accord, *Whitman v. United States*, 248 F. Supp. 845 (W.D. La. 1965).

³⁵⁰ DICKINSON, FARM AND RANCH LOSSES, BNA TAX MANAGEMENT PORTFOLIO No. 241, A-34 (1970) (footnote omitted).

In one of the best reasoned decisions in the area, the judge believed that substantial taxable income from sources other than the activity was relevant only as offering a possible alternative motivation for continuing to establish a profitable activity, but as such would not accord it much weight.³⁵¹ He could see no reason to accord business status to a marginal dirt farmer while reaching a contrary result merely because the taxpayer could afford, *i.e.*, pay from outside income or capital, the losses incurred while the farm was being developed.

A few of the early authorities relied upon the taxpayer's independent wealth, apparently influenced in part by the fact that he therefore was not dependent upon the activity for his livelihood, but courts soon accepted taxpayer contentions that although not dependent on the activity's success for a livelihood, the taxpayer could not afford to suffer losses indefinitely.³⁵² This is as it should be, since the Supreme Court source of the livelihood definition of a trade or business used this term and the term "profit" disjunctively.³⁵³ The other basis, as indicated, is that such a taxpayer could more readily afford a hobby. Significantly, cases finding that the activity was profit motivated have held that although the taxpayers were wealthy enough to afford activity with discouraging losses, they were not utterly indifferent to whether there was gain or loss.³⁵⁴ A recent decision, *Joan F.W. Farris*,³⁵⁵ joined these two themes reasoning that "Although the knowledge that she would not have to look to the operation for a livelihood may have been an inducement to petitioner for entering the industry, we cannot say on the facts of this case that her intentions were less business-like for that reason. We are disinclined therefore to draw the inference from the presence of losses in every year that petitioner was indifferent to making a profit."

Even more significant has been the growing judicial recognition that independent income or capital is a prerequisite for entry into a venture requiring a start-up stage in which losses may be

³⁵¹ *Wright v. United States*, 249 F. Supp. 508, 514 (D. Nev. 1965).

³⁵² Compare *Doggett v. Burnet*, 65 F.2d 191 (D.C. Cir. 1933), *Thacher v. Lowe*, 288 F. 994 (S.D.N.Y. 1922) and *Georges Simenon*, 44 T.C. 820, 847 (1965), with *Margaret E. Amory*, 22 B.T.A. 1398 (1931).

³⁵³ *Flint v. Stone Tracy Co.*, 220 U.S. 107, 171 (1911); accord, *Chaloner v. Helvering*, 69 F.2d 571 (D.C. Cir. 1934).

³⁵⁴ *Widener v. Comm'r*, 33 F.2d 833 (3d Cir. 1929); *John S. Ellsworth*, 21 T.C.M. 145 (1962).

³⁵⁵ 31 T.C.M. 821, 825 (1972).

expected or into a risky activity with heavy initial capital demands.³⁵⁶ For instance, the Tax Court rejected the Commissioner's reliance on the factor of independent income in *John S. Ellsworth*³⁵⁷ on the grounds that substantial nonfarm income or sources of capital were a necessary basis for embarking on a cattle breeding operation because of anticipated losses in the earlier years. The court countered a similar contention in *Norman C. Demler*³⁵⁸ with the conclusion that the taxpayer's proceeds from a sale of land (approximately \$465,000) provided him "with the necessary capital funds to make his entry into the auto racing business meaningful."

In addition to an overemphasis on independent wealth, the regulation's formulation of this factor is deficient in not (1) distinguishing between substantial income and substantial capital, (2) considering the effect of borrowed capital and (3) providing guidelines as to the meaning of substantial income. The distinction between using substantial income and using capital to carry on a venture currently generating losses is best drawn by the opinion in *Rowe B. Metcalf*.³⁵⁹ There the court counterbalanced the taxpayer's ability to absorb farm losses by offsetting them against his sizable taxable income to produce a tax savings, with the fact that in later years he was forced to invade his capital to a considerable extent to absorb the losses. The *Metcalf* court thought it more logical that a successful businessman would invade capital in hopes of recouping his losses over the long haul than that he would indulge in that manner a costly hobby with no intention of making it pay.³⁶⁰ Other decisions too have relied upon the taxpayer's sale of income-producing assets or the utilization of other means of dipping into capital to obtain operating funds for the activity.³⁶¹

The authorities are also favorably impressed by the taxpayer's borrowing of funds to carry on an activity.³⁶² Indeed, the Service

³⁵⁶ Sharpe, *What The Taxpayer Should Do to Have The Courts Recognize His Farm as a Business*, 28 J. TAXATION 48, 50 (1968).

³⁵⁷ 21 T.C.M. 145 (1962).

³⁵⁸ 25 T.C.M. 620, 627 (1966).

³⁵⁹ 22 T.C.M. 1402 (1963).

³⁶⁰ See *Rex B. Foster*, 32 T.C.M. No. 13 at 47 (1973) (in the short run it appeared doubtful that taxpayer would recoup amounts already invested but a successful conversion of horse herd would enable them "to adequately manage the then bleak situation in their investment with the chance for overall profit in the long run").

³⁶¹ *Mary Ellis Turner*, 23 T.C.M. 1186 (1964); *Benjamin E. Adams*, 25 T.C.M. 1239 (1966).

³⁶² *Thomas W. Jackson*, 59 T.C. No. 31 (1972), *acq.*, 1973-21 I.R.B. 5 (if primary in-

has on occasion argued that a failure to borrow in order to carry on activity on an expanded scale is inconsistent with a profit motive.³⁶³ Borrowing may also be significant as a concomitant of the extent of the taxpayer's investment in the activity in relation to the taxpayer's total resources: If he spends the great majority of his income from sources other than the activity, this is strong evidence the activity is engaged in for profit.³⁶⁴

The regulation speaks of substantial income from sources other than the activity and one may infer from the fourth example accompanying these factors that income of \$8,500 per year is not substantial.³⁶⁵ Beyond this the regulations do not go. Although the decisions really do not define substantial income,³⁶⁶ they do indicate that a taxpayer with dividend income of over \$35,000 is by no means a wealthy man who can afford to sit back and allow losses in the activity to continue.³⁶⁷ Indeed, income in this range has been termed by one farm loss case "relatively modest."³⁶⁸ The court pointed out that the taxpayer's annual income ranged from a low of approximately \$18,000 to a high of almost \$45,000, with considerable variation from year to year. In such circumstances, the court found it "difficult to imagine" that a person would make large expenditures and engage in the physical labor required to breed and show horses without an intention to make a profit.³⁶⁹ In still another recent decision the court was impressed by the taxpayer's relatively modest income of \$25,000.³⁷⁰

The importance the drafters of the section 183 regulations at-

terest is in tax benefits, no benefit from loans for working capital. This is to be distinguished from non-recourse mortgages which create leverage without economic loss—when operating funds are expended there is an economic loss); Harvey S. Farrow, 16 T.C.M. 836 (1957); Leland E. Rosemond 10 T.C.M. 625 (1951).

³⁶³ Charles B. Pennington, 26 T.C.M. 520 (1967). Conversely, if the taxpayer does make substantial investments in depreciable improvements, the government is wont to argue that the activity is unprofitable (including depreciation deductions) because it is over capitalized. *Patterson v. United States*, 459 F.2d 487 (Ct. Cl. 1972).

³⁶⁴ See Woodrow L. Wroblewski, 32 T.C.M. No. 37 (1973). See generally RIDENOUR, FARM AND RANCH LOSSES, BNA TAX MANAGEMENT PORTFOLIO No. 241-2d, A-27 (1973).

³⁶⁵ Comparison of the Treasury proposals, Nixon proposals and section 1251 reveals that the line for substantial nonfarm income is difficult to draw: \$15,000, \$5,000 and \$25,000 were the respective cutoff marks under the above proposals and final statute.

³⁶⁶ Compare *Wright v. United States*, 249 F. Supp. 508 (D. Nev. 1965), with *George Thacker*, 28 T.C.M. 1433 (1969).

³⁶⁷ Jean A. Lowenthal, 27 T.C.M. 387, 393 (1968).

³⁶⁸ James S. Bishop, 31 T.C.M. 829, 831 (1972).

³⁶⁹ Identical analysis is contained in *Rex B. Foster*, 32 T.C.M. No. 14 (1973); *Alden B. Starr*, 28 T.C.M. 167 (1969); *Lilian Solomon*, 26 T.C.M. 919 (1967); and *Herbert C. Sanderson*, 23 T.C.M. 1723 (1964).

³⁷⁰ *Thomas W. Jackson*, 59 T.C. No. 31 (1972), *acq.*, 1973-21 I.R.B. 5.

tached to significant income from sources other than the questioned activity is obvious. The first three examples accompanying the nine factors, which were derived from actual cases, all carefully state that the taxpayers have substantial, sizable or large income from such sources. Yet a careful reading of the three cases—*Ellen R. Schley*,³⁷¹ *Corliss Lamont*,³⁷² and *Anthony Imbesi*³⁷³—reveals that in none did the trier of fact rely upon this factor. While the review courts in *Schley* and *Lamont* did consider the taxpayer's financial status in affirming the Tax Court, both appellate opinions run counter to the weight of authority and clearly preferred the now prohibited subjective approach over reliance on objective factors.

In summary, the Service may be expected to emphasize heavily the factor of substantial nonactivity income wherever present: "[I]t is the taxpayer of independent means or who is otherwise profitably engaged who is likely to be challenged."³⁷⁴ Undoubtedly the legislative history of the farm tax reforms of the Tax Reform Act of 1969, which focused on the abuse of farm tax accounting rules by taxpayers with substantial nonfarm income plays no small part in such emphasis. Nevertheless, if the prior case law—the only source for factors which can validly be no more than an administrative codification of the existing sea of authorities, weighted by the legislative rejection of the reasonable expectation of profit and subjective approach—is properly presented in litigation, the courts will continue to accord a cold reception to this argument.

Elements of Personal Pleasure or Recreation

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

³⁷¹ 24 T.C.M. 588 (1965), *aff'd*, 375 F.2d 747 (2d Cir. 1967) (adjusted gross income from other sources of \$94,000).

³⁷² 23 T.C.M. 3 (1964), *aff'd*, 339 F.2d 377 (2d Cir. 1964) (income from other sources ranged from \$94,000 to \$289,000).

³⁷³ 23 T.C.M. 1678 (1964), *rev'd on other issue*, 361 F.2d 640 (3d Cir. 1966) (other source income from \$57,000 to \$97,000).

³⁷⁴ Oshins, *Proposed Regulations Provide New Rules For Hobby Loss Game*, 35 J. TAXATION 214, 216 (1971). It would appear, however, that this factor carries less weight. Joseph W. Johnson, Jr., 59 T.C. No. 78 (1973) ("Other factors to be considered, though not of themselves controlling, are the financial status of the petitioners and the standard of living to which they are accustomed.").

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.³⁷⁵

This factor first sets forth the two general principles that (1) personal motives, particularly where recreational or personal elements are involved, may indicate a lack of profit intent and (2) a limited converse, a lack of any appeal other than profit, may indicate that the activity is engaged in for profit. In addition, it in effect provides that a taxpayer may have mixed motives and derive personal pleasure from it and still be engaged in the activity for profit so long as other factors evidence such profit motivation.

Personal Motives. The authorities do hold that the objective factors of significant recreational facilities or substantial recreational use, for example, of a farm are strong evidence that an activity is not engaged in for profit.³⁷⁶ For instance, where a farm contained a private residence, barbecue shelter, swimming pool, boathouse, tennis court and deer shelter for deer purchased for the enjoyment of children of the taxpayer's dominant shareholder, the court easily concluded that the farm was operated as a hobby and not as a trade or business.³⁷⁷ Nevertheless, entertainment use or even maintenance of a personal residence on a farm is not fatal, particularly where the personal expenses and farm expenses are carefully segregated.³⁷⁸ As a leading commentator has stated:

In many cases in which the taxpayer has maintained his home on the premises, the Commissioner has argued that the farm was primarily personal rather than business in character. The Commissioner has generally had little success with this contention, except where substantial recreational facilities accompanied the home, or the farming activities

³⁷⁵ Reg. § 1.183-2(b)(9).

³⁷⁶ See generally RIDENOUR, FARM AND RANCH LOSSES, BNA TAX MANAGEMENT PORTFOLIO No. 241-2d, A-27 (1973); Sharpe, *What The Taxpayer Should Do to Have The Courts Recognize His Farm as a Business*, 28 J. TAXATION 48, 51 (1968).

³⁷⁷ V.H. Monette & Co., 45 T.C. 15 (1965), *aff'd per curiam*, 374 F.2d 116 (4th Cir. 1967).

³⁷⁸ See, e.g., John S. Ellsworth, 21 T.C.M. 145 (1962).

were clearly incidental to occupancy of the house. However, in cases in which the taxpayer has not segregated the farm expenses from the home expenses or has regarded his agricultural activities as merely an adjunct to his residence, losses have ordinarily been disallowed. Also, where the farm is viewed primarily as a restful place of retirement for the taxpayer, the Commissioner has been successful.³⁷⁹

If the courts follow this lead and consider the taxpayer's subjective intent and personal satisfaction, then we may expect to see the Service advocate with force for acceptance of the approach taken in *Robert E. Currie*.³⁸⁰ There the Tax Court found that the taxpayer had a lifelong interest in both dogs and horses and derived considerable pleasure from both. It reasoned that this factor alone did not preclude business status:

But we believe that the history of petitioner's enjoyment from these animals raises a presumption under the circumstance of this case that he was not in the trade or business of raising them. That is, a greater amount of proof is required than would be necessary if he had not previously enjoyed these animals as pets. . . .

.

While not inconsistent with a profit motive, the presence of personal satisfaction requires counterbalancing evidence that this satisfaction was not the primary motive for embarking on this venture.

District court opinions frequently raise a similar rebuttable inference of lack of profit motive if both elements of personal pleasure and continued losses are involved.³⁸¹

Just as prior pleasure may be an unfavorable factor, conversion of an activity from admitted hobby status to business status has often proven difficult, particularly if there are no changes of method of operation, but is not impossible.³⁸² In areas other than

³⁷⁹ DICKINSON, FARM AND RANCH LOSSES, BNA TAX MANAGEMENT PORTFOLIO No. 241, A-35 (1970) (footnotes omitted). Thus, the fact that the taxpayer in Example 1 of section 1.183-2(c) of the regulations (the *Schley* case) lived on an area of the farm set aside exclusively for living purposes should not be a negative factor. See, e.g., C.J. Anderson, 14 T.C.M. 148 (1955). The drafters, however, would appear to have (mistakenly) believed otherwise, since the third example emphasizes the presence of the taxpayer's residence on the property where his dog and horse raising activities were conducted. Yet the actual *Imbesi* decisions only briefly mentioned that during the tax years the taxpayer purchased a country residence, to which he moved his dog kennels and apparently his horse breeding activities as well. The residence itself and recreational activities were not described in these decisions in contrast to the regulation example based upon them.

³⁸⁰ 28 T.C.M. 12, 19, 21 (1969).

³⁸¹ See, e.g., *Hicks v. United States*, 72-1 U.S.T.C. ¶ 9383 (S.D. Miss. 1972); *Gross v. United States*, 71-2 U.S.T.C. ¶ 9715 (N.D. Fla. 1971).

³⁸² Compare *Robert E. Currie*, 28 T.C.M. 12 (1969) and *George T. McLenn*, 19 T.C.M. 673 (1960), *aff'd per curiam*, 285 F.2d 756 (4th Cir. 1961), with *Lillie S. Wegforth*, 42

farm losses, however, special rules have developed as to conversion of property held for personal use to property held for production of income. Courts early established that where property was previously dedicated to personal use, there must be some unmistakable subsequent conduct manifesting its appropriation to income producing purposes.³⁸³ For losses under section 165(c) abandonment of personal use of property, such as a residence or a yacht, followed by a listing of the property with a real estate agent is not a sufficient appropriation.³⁸⁴ The underlying policy was that the taxpayer could too easily put unrented property back in personal use.³⁸⁵ The actual rental requirement of a transaction entered into for profit of section 165(c) was not imported into section 212 or section 162 and, instead, a number of factors are considered in ascertaining whether the requisite conversion has occurred.³⁸⁶

Where the taxpayer has not originally held the property for personal purpose, however, he has a much easier task in establishing that the property is used in his trade or business or is held for the production of income.³⁸⁷ Furthermore, the Tax Court in *Marjorie M.P. May*³⁸⁸ indicated that conversion from a property use in a mere hobby to property held for production of income is more difficult to show than conversion from residential property. It may since have disavowed that stance.³⁸⁹

The implications of the *May* case as well as the Tax Court's apparent doubts in *Carkhuff* as to the possibility of a recurring pattern of conversion to business use and reconversion to personal use indicate that where property is used for business and personal uses the taxpayer should not attempt to argue that two activities are involved. Rather he should follow the *Carkhuff* example in the regulations to the effect that a single activity is involved,

B.T.A. 633 (1940), *Everell E. Fisher*, 27 T.C.M. 1048 (1968), and *Norman C. Demler*, 25 T.C.M. 620 (1966).

³⁸³ See generally *Swanson, Loss on the Sale of Residential Property*, 33 TAXES 589 (1955).

³⁸⁴ *Gevirtz v. Comm'r*, 123 F.2d 707 (2d Cir. 1941).

³⁸⁵ *Rumsey v. Comm'r*, 82 F.2d 158 (2d Cir.), *cert. denied*, 299 U.S. 552 (1936); *Morgan v. Comm'r*, 76 F.2d 390 (5th Cir.), *cert. denied*, 296 U.S. 601 (1935).

³⁸⁶ *William C. Horrmann*, 17 T.C. 903 (1951); *Mary Laughlin Robinson*, 2 T.C. 305, 307 (1943). These factors are set forth in *Frank A. Newcombe*, 54 T.C. 1298, 1300-01 (1970).

³⁸⁷ *Estelle G. Marx*, 5 T.C. 173 (1945) (section 162); *Herman Schaevitz*, 30 T.C.M. 823 (1971) (section 212).

³⁸⁸ 35 T.C. 865, 874-75 (1961), *aff'd*, 299 F.2d 725 (4th Cir. 1962).

³⁸⁹ Compare *Frank A. Newcombe*, 54 T.C. 1298, 1301 (1970), with *Walter E. Beckjord*, 32 T.C.M. No. 123 (1973).

but argue that it is engaged in for-profit. Carefully segregating and not deducting the personal portion of the expenses of the activity will strengthen his case.³⁹⁰

It may be noted that the Tax Court has traditionally found trade or business status more readily in the context of rental real estate where the property was acquired by inheritance, as contrasted with converted from prior personal use. The rationale is that the acquisition by inheritance is neutral and therefore does not require an affirmative change of intention as it does when the property is initially acquired for personal purposes.³⁹¹ This may also be the case in farm losses, but not where the inheritance is from a spouse.³⁹² Probably the unarticulated but practical cause is a covert recognition of husband and wife as a single economic unit.³⁹³ This development and exception appear reflected in the first and fourth examples accompanying this portion of the regulations.

Lack of Appeal Other Than Profit. The difficulty inherent in so elusive a test as motive has resulted in the search for objective guideposts.³⁹⁴ This search should be intensified by the congressional mandate that section 183 employ the objective approach. In the context of the factor of elements of personal pleasure or recreation, a significant and certainly the most frequently relied upon objective indicium has been whether the facilities used in the activity were equipped for or used as a place of entertainment or recreation. A recurring theme in the objective search for profit motive in this area has been the conclusion that a farm, for example, was never used as a place of entertainment and was in no sense a show place.³⁹⁵ Not infrequently, the courts in reaching this conclusion have focused on the following objective criteria: (1)

³⁹⁰ In *Joseph W. Johnson, Jr.*, 59 T.C. No. 78 (1973), where the activity was determined not to be engaged in for profit, the court noted that the taxpayer did not segregate or allocate expenses between personal and rental use.

³⁹¹ *Estelle G. Marx*, 5 T.C. 173, 174 (1945).

³⁹² Compare *Alice D. Worcester*, 21 T.C.M. 1138 (1962), with *Bertha R. Conyngham*, 23 T.C.M. 1179 (1964).

³⁹³ Cf. *Rudolph v. United States*, 370 U.S. 269, 278, 285 (1962) (Douglas J., dissenting to dismissal of certiorari as improvidently granted).

³⁹⁴ *Imbesi v. Comm'r*, 361 F.2d 640 (3d Cir. 1966).

³⁹⁵ Not used for recreation: *Dean Babbitt*, 23 T.C. 850 (1955); *Norton L. Smith*, 9 T.C. 1150 (1947); *Marshall Field*, 26 B.T.A. 116 (1932), *aff'd*, 67 F.2d 876 (2d Cir. 1933); *Thomas F. Sheridan*, 4 B.T.A. 1299 (1926). Not a showplace: *Herbert C. Sanderson*, 23 T.C.M. 1723 (1964); *Rowe B. Metcalf*, 22 T.C.M. 1402 (1963); *George M. Zeagler*, 17 T.M.M. 454 (1958); *Theron D. Stay*, 17 T.C.M. 861 (1958). See generally *Sharpe, What The Taxpayer Should Do to Have The Courts Recognize His Farm as a Business*, 28 J. TAXATION 48, 51 (1968).

utilitarian appearance; (2) lack of luxury items, such as golf courses, race tracks, greenhouses, tennis courts, or flower gardens; and (3) business-like operations in contrast to social or recreational use.³⁹⁶ Indeed, the last criterion has been expressed as an absolute rule: "Where the operation is conducted on a business-like basis and there is no evidence of its use for social, pleasure or show purposes, losses therefrom are deductible as business expenses."³⁹⁷ Of course, a showing of a lack of any recreational or aesthetic feature alone is not enough, the taxpayer must also prove the element of business-like operations.³⁹⁸ As the *Currie* court stated, it is not necessary to decide that the taxpayer's activities constitute a recreation or a hobby, rather, the burden of proof is on the taxpayer to show that his activities were conducted as a trade or business.³⁹⁹ However, such factors, by indicating a lack of hobby motive, may bear indirectly on profit motivation.⁴⁰⁰

The regulation's statement that a profit motivation may be indicated by a lack of any appeal other than profit in the activity is strongly reflected in two lines of cases: (1) authorities relying on hard work demanded by the activity coupled with the taxpayer's background,⁴⁰¹ and (2) decisions turning on the scale of operations.⁴⁰² In a number of farm loss controversies, where the taxpayer had modest income or was just beginning his main career after a long period of strained circumstances, typically a doctor, the Tax Court has reasoned that it is hard to believe that a taxpayer with such a background and at a stage of life with increasing responsibilities and expenditures would embark on a hobby entailing large costs and much physical labor.⁴⁰³ A dissent,

³⁹⁶ Utilitarian appearance: Lillian Solomon, 26 T.C.M. 919 (1967); Theron D. Stay, 17 T.C.M. 861 (1958). Lack of luxury items: Hamilton F. Kean, 10 B.T.A. 97 (1928); Rose P. Crane, 9 B.T.A. 437 (1927). Business-like operations: Lucien H. Tyng, 36 B.T.A. 21 (1937), *rev'd on other grounds*, 106 F.2d 55 (2d Cir. 1939), *rev'd on other grounds*, 308 U.S. 527 (1940).

³⁹⁷ *Helis v. Usry*, 71-1 U.S.T.C. ¶ 9365 (E.D. La. 1971) (footnote omitted), *rev'd on other grounds*, 464 F.2d 330 (5th Cir. 1972).

³⁹⁸ Frank M. Austin, 28 T.C.M. 27, 31 (1969); *see* Louise Cheney, 22 B.T.A. 672 (1931).

³⁹⁹ Robert E. Currie, 28 T.C.M. 12, 18 (1969).

⁴⁰⁰ Rex B. Foster, Jr., 32 T.C.M. No. 14 (1973).

⁴⁰¹ Lillian Solomon, 26 T.C.M. 919 (1967); Herbert C. Sanderson, 23 T.C.M. 1723 (1964); Leland E. Rosemond, 10 T.C.M. 625 (1951).

⁴⁰² Samuel Riker, Jr., 6 B.T.A. 890 (1927); Rex B. Foster, 32 T.C.M. No. 13 (1973); Joan F.W. Farris, 31 T.C.M. 821 (1972); Robert E. Currie, 28 T.C.M. 12 (1969). *See generally* DICKINSON, FARM AND RANCH LOSSES, BNA TAX MANAGEMENT PORTFOLIO No. 241, A-33 (1970).

⁴⁰³ Rex B. Foster, 32 T.C.M. No. 13 (1973); James S. Bishop, 31 T.C.M. 829 (1972).

however, to this generally followed approach may be seen in *Robert E. Currie*⁴⁰⁴ where the court focused on the fact that a breeding operation does not produce immediate income and is speculative and, indeed, becomes profitable if at all only when the young professional would be cashing in on his training. The court rather cogently reasoned that a prudent man in financial need—the taxpayer argued that he engaged in these activities since he believed that his income from his medical profession was insufficient—would not make expenditures on speculative ventures that could at best yield only a long-term profit unless he derived personal satisfaction from such expenditures. This rationale ignores however, the common profit motivated goal of offsetting current ordinary income with farm losses with the expectation of a long-range capital gain—a goal only moderately circumscribed by section 1251 of the Tax Reform Act of 1969.

Currie also illustrates the effect of the scale of operations on the question whether the activity lacks any appeal other than profit. In the presence of the taxpayer never owning more than two or three ponies and a like number of dogs, the court held that while a small scale operation is not necessarily indicative that an activity is not engaged in for profit, it is a factor to consider. The court exposed its underlying premise by contrasting the taxpayer's operation of a ten acre orchard with approximately 800 apple trees. "The very magnitude of this operation seems to suggest a business operation for . . . there is nothing aesthetic or pleasant about thousands of decaying apples on a 10-acre farm."⁴⁰⁵ *Rex B. Foster, Jr.*⁴⁰⁶ suggests that this factor only indicates the activity is not engaged in primarily for pleasure or recreation, hence, it does not bear directly on the taxpayer's business motives.

In contrast to the effect of large scale operations on the determination of profit motivation, there is considerable disagreement among the courts as to the effect of a smaller scale of operations. For instance, the Ninth Circuit in *Mercer v. Commissioner*⁴⁰⁷ expressed some reservation as to the weight to be given the size of the operation, but concluded that in any event this test is necessarily relative to and limited by the particular taxpayer's

⁴⁰⁴ 28 T.C.M. 12, 19 (1969); accord, *Joan F.W. Farris*, 31 T.C.M. 821, 825 (1972). See *Norton L. Smith*, 9 T.C. 1150 (1947).

⁴⁰⁵ *Robert E. Currie*, 28 T.C.M. 12, 21 (1969).

⁴⁰⁶ 32 T.C.M. No. 14 (1973).

⁴⁰⁷ 376 F.2d 708 (9th Cir. 1967).

resources. Where, however, the expenses of the activity are of a recurring type and the scale of activity is such that sales proceeds could not exceed such expenditures, yet the taxpayer is not in this position and does not intend to increase the size of operations, this constitutes evidence that he lacks the requisite intent to realize a profit even eventually.⁴⁰⁸

Mixed Motives. The conclusions of the regulations that an activity need not be exclusively engaged in for profit and that a mixture of profit and personal motives will not alone cause an activity to be treated as not engaged in for profit find abundant precedents in the case law.⁴⁰⁹ As the Tax Court recently stated in *Thomas W. Jackson*:⁴¹⁰ "[A] business will not be turned into a hobby merely because the owner finds it pleasurable; suffering has never been made a prerequisite to deductibility. 'Success in business is largely obtained by pleasurable interest therein.'"

The statement in the regulations that the availability of other investments with a greater rate of return or better prospects of profitability for profit is not evidence the activity is not engaged in for profit is probably directed more to the mixed motives of profit and tax reduction. For one presection 183 commentator analyzed this situation as follows:

The effect of tax avoidance as a motive becomes more complex if it is assumed that the operation would be, strictly speaking, economically profitable, but not reasonably so without adding on the tax benefits. Suppose the taxpayer could expect to make a small economic profit on his total investment, but not as much as he could make by investing his money elsewhere. Assume that this expected profit represents only a two or three percent return on his investment while a higher rate of return would be more reasonable when viewed strictly from an investment standpoint. The two or three percent return would be unacceptable, but the total return on the investment might approach a more reasonable level if tax savings resulting from the deduction of tax losses from other income are included in the calculation. Although allowing deduction of the tax losses in this situation will also encourage transactions which might not take place if the tax savings were not available, the reasoning of *Goldstein* would not prevent the deduction. The most that can be said is that the taxpayer has mixed motives for the investment, one of which is saving some taxes. But the tax avoidance motive cannot, by itself, preclude a finding that a business purpose exists so long as some economic profit, however small, can be expected. A fortiori,

⁴⁰⁸ *Billy V. Wann*, 27 T.C.M. 1301, 1306 (1968).

⁴⁰⁹ *DuPont v. United States*, 234 F. Supp. 681, 685 (D. Del. 1964); *Mary Ellis Turner*, 23 T.C.M. 1186 (1964); *William L. Brueck, Sr.*, 23 T.C.M. 1228 (1964); *John S. Ellsworth*, 21 T.C.M. 145 (1962).

⁴¹⁰ 59 T.C. No. 31 (1972) (footnote omitted).

the taxpayer who can expect to realize a reasonable return on his investment without tax savings could be engaged in a trade or business even though the tax benefits gained by deducting farm losses will give him an even greater total return.⁴¹¹

The regulations implicitly reach the same conclusion.

OTHER RELEVANT FACTORS

The regulations state "it is not intended that only the factors described in this paragraph [section 1.183-2(b)] are to be taken into account." The most significant factor not so described is that of advertising. Accordingly, it is considered first. In addition, there are a handful of other unlisted factors discussed in the succeeding section. The most important of these last is the presence of a specific plan for improving profitability.

Advertising

The third example accompanying the nine regulation factors stated that the taxpayer—who it concluded could be determined not to be engaged in the activity of raising and selling dogs for profit—did not advertise his dogs for sale and displayed them only infrequently. The sixth example, on the other hand, in reaching the opposite conclusion as to experimental activities, noted that the taxpayer made extensive efforts to market his developments.

In some early decisions, advertising was mentioned only in the facts, sometimes with the opinion merely stating that the activity was business-like in every way.⁴¹² Soon, more recognition was given to this factor, but since some forms of advertising may exhibit personal elements, the Service has on occasion attempted to utilize such advertising as a factor in its favor.⁴¹³ As in other areas, judicial support for the latter tack is, for the most part, to be found only in dicta.⁴¹⁴ Ironically, where prize winning products were raised, the courts typically have found that exhibiting the

⁴¹¹ Allington, *Farming as a Tax Shelter*, 14 S.D.L. REV. 181, 196-97 (1969).

⁴¹² Israel O. Blake, 38 B.T.A. 1457 (1938); Lillie S. Wegeforth, 42 B.T.A. 633 (1940); Lucien H. Tyng, 36 B.T.A. 21 (1937), *rev'd on other grounds*, 106 F.2d 55 (2d Cir. 1939), *rev'd on other grounds*, 308 U.S. 527 (1940); Leland E. Rosemond, 10 T.C.M. 625 (1951).

⁴¹³ Rowe B. Metcalf, 22 T.C.M. 1402 (1963); Norma Mathews Lauer, 20 T.C.M. 1038 (1961).

⁴¹⁴ Dean Babbitt, 23 T.C. 850 (1955); *see* Farish v. Comm'r, 103 F.2d 63 (5th Cir. 1939).

products at shows was an effective means of promotion.⁴¹⁵ Indeed, in *Charles B. Pennington*,⁴¹⁶ where the Commissioner placed great weight on the taxpayer's having entered some of his horses in shows and having spent relatively large sums for costumes used in them, the Tax Court concluded the taxpayer was not showing the horses as a hobby; instead, they constituted advertising both of the horse shows and of the taxpayer's trade name. On the other hand, if such advertising is continued without concrete results or in conjunction with objective manifestations of a lack of profit motive, it is not entitled to any positive weight in the taxpayer's favor. Furthermore, in these circumstances such advertising may actually be counted as a fact in the government's favor as indicating a personal motive for engaging in the activity.⁴¹⁷

Recent cases illustrate business-like methods with advertising in journals and enhancing the reputation of one's products through shows.⁴¹⁸ Conversely, although the overwhelming majority of decisions make no reference to advertising, a few cases have characterized an absence of advertising as a failure to follow the ordinary steps a business organization takes toward making a profit.⁴¹⁹ In the farm loss context, the absence of a stable or farm name has recently been considered as evidence of unbusiness-like operations.⁴²⁰ In summary, advertising has become increasingly important as an objective indicium of business-like operations.

Miscellaneous Factors

Plans. A number of district court farm loss decisions, in testing for profit motive, have considered whether the taxpayer had any specific plan or design for increasing the profitability of the activity and what action was taken pursuant to such plan.⁴²¹ The

⁴¹⁵ See, e.g., *Lillie S. Wegeforth*, 42 B.T.A. 633 (1940).

⁴¹⁶ 26 T.C.M. 520 (1967).

⁴¹⁷ *Donald A. McCormick*, 28 T.C.M. 1337 (1969).

⁴¹⁸ See, e.g., *Rex B. Foster, Jr.*, 32 T.C.M. No. 14 (1973); *James S. Bishop*, 31 T.C.M. 829 (1972).

⁴¹⁹ *American Properties, Inc.*, 28 T.C. 1100 (1957), *aff'd per curiam*, 262 F.2d 150 (9th Cir. 1958); *Robert E. Currie*, 28 T.C.M. 12 (1969); *Harold I. Snyder*, 25 T.C.M. 1326 (1966).

⁴²⁰ *W. Jane Luce*, 29 T.C.M. 894 (1970); *Robert E. Currie*, 28 T.C.M. 12 (1969).

⁴²¹ *Cavender v. United States*, 71-2 U.S.T.C. ¶ 9723 (S.D. W.Va. 1971); *Graves v. United States*, 67-1 U.S.T.C. ¶ 9192 (D. Col. 1967); *Cenac v. United States*, 67-2 U.S.T.C. ¶ 9576 (E.D. La. 1966); *Bennet v. United States*, 65-2 U.S.T.C. ¶ 9701 (E.D. Va. 1965); *O'Neill v. Patterson*, 65-1 U.S.T.C. ¶ 9436 (N.D. Ala. 1964). See also *Curtis C. Smith*, 26 T.C.M. 1219 (1967); *James E. Ashe*, 26 T.C.M. 791 (1967).

significance of this factor lies in part in its use to offset the factor of continued losses, since it indicates an intention to derive an ultimate net profit over all prior losses. Frequently this factor is inextricably bound with the formative or initial stage concept.⁴²² Indeed, in *Bertha R. Conyngham*,⁴²³ where no such plan existed, the Tax Court reasoned that despite the fact it takes a number of years to develop a breeding herd, the taxpayer did not formulate any long-range plans for such development. *Harold I. Snyder*⁴²⁴ carried this line of reasoning to its logical conclusion: Absence of well defined plans indicates an activity is more in the nature of preparing to enter a business than the conduct of a business. Furthermore, a lack of plans may result in the activity being engaged in so sporadically that it is not sufficiently continuous and regular to qualify as a business or, at best, indicates very unbusiness-like operations.⁴²⁵ In conclusion, this factor for the most part complements other factors or doctrines.

Third-Party Financial Stake. A number of the farm loss decisions have favorably noted that the manager participated in a profit sharing arrangement.⁴²⁶ The apparent rationale is that such an arrangement indicates third party expectation that the activity will be profitable which serves to corroborate the taxpayer's intention to make a profit.⁴²⁷ A closely related factor is the promotion of the taxpayer's products by a third party at his own expense in return for a sales commission, such as an art dealer who advertises the taxpayer's works of art.⁴²⁸ Although such a promoter earns his commission regardless of whether the taxpayer makes a profit, it is in the former's financial interest to obtain as high a sales price as possible, which increases the taxpayer's prospects of a net profit. Similarly in a highly speculative venture or in the formative period during which there can

⁴²² See *Wright v. United States*, 249 F. Supp. 508, 513 (D. Nev. 1965); *Joan F.W. Farris*, 31 T.C.M. 821 (1972).

⁴²³ 23 T.C.M. 1179 (1964).

⁴²⁴ 25 T.C.M. 1326 (1966).

⁴²⁵ *Donald A. McCormick*, 28 T.C.M. 1337, 1342 (1969).

⁴²⁶ *Marshall Field*, 26 B.T.A. 116, 118 (1932), *aff'd*, 67 F.2d 876 (2d Cir. 1933); *Rowe B. Metcalf*, 22 T.C.M. 1402 (1963); *George M. Zeagler*, 17 T.C.M. 454 (1958). But see *Morton v. Comm'r*, 174 F.2d 302, 303 (2d Cir.), *cert. denied*, 338 U.S. 828 (1949) (tenant farmer, still not profit motivated).

⁴²⁷ Cf. *John S. Ellsworth*, 21 T.C.M. 145 (1962). For an analogous instance in which benefit to the employer is considered in determining if an expenditure by an employee is "necessary" in the latter's business, see Lee, *Command Performance: The Tax Treatment of Employer Mandated Expenses*, 7 RICHMOND L. REV. 1, 90-91 (1972).

⁴²⁸ *Rood v. United States*, 184 F. Supp. 791 (D. Minn. 1960).

be no profits to be shared, sharing in gross receipts by a third party may constitute an objective indication that the activity is engaged in for profit.

Time at Which Profit Motive Is Determined. A few early farm loss authorities held that the determination of whether an activity was engaged in for profit was to be made as of the commencement of the activity.⁴²⁹ An early inroad into this doctrine can be found in the decisions finding that the taxpayer converted a hobby into a profit motivated activity.⁴³⁰ More recent cases have concluded that the purposes for which an activity is conducted can change from year to year.⁴³¹ To the extent that a conflict still existed among these authorities the Senate Committee on Finance appears to have resolved it as to section 183 with the following statement: "[A]lthough a reasonable expectation of profit is not to be required, the facts and circumstances (without regard to the taxpayer's subjective intent) would have to indicate that the taxpayer *entered the activity, or continued the activity*, with the objective of making a profit."⁴³²

Alternatives to Section 183

COMMON-LAW APPROACHES

As indicated in the introduction and particularly in the discussion of the term "profit," the government undoubtedly will attempt to apply section 183 to two distinct areas: (1) activities engaged in primarily for personal reasons rather than for a profit and (2) activities engaged in for tax shelter. Section 183 and the profit motive test clearly apply to and are suited for the former. The latter is a more complex problem. If the taxpayer's goal is no more than deferral of taxes—enjoyment of current ordinary losses with expectation of realization of future income in no greater amount, possibly taxed as capital gain—section 183

⁴²⁹ *Tatt v. Comm'r*, 166 F.2d 697 (5th Cir. 1948); *Farish v. Comm'r*, 103 F.2d 1011 (5th Cir. 1939).

⁴³⁰ See *Robert E. Currie*, 28 T.C.M. 12 (1969); *Everell E. Fisher*, 27 T.C.M. 1048 (1968); *Norman C. Demler*, 25 T.C.M. 620 (1966); *George T. McClean*, 19 T.C.M. 673 (1960), *aff'd per curiam*, 285 F.2d 756 (4th Cir. 1961); *Lillie S. Wegeforth*, 42 B.T.A. 633 (1940).

⁴³¹ See, e.g., *Abrams v. United States*, 449 F.2d 662 (2d Cir. 1971). See generally *Sharpe*, *New "Hobby Loss" Rule Is Tougher But "Engaged in for Profit" Dilemma Remains*, 32 J. TAXATION 289, 291 (1970).

⁴³² S. REP. NO. 91-552, 91st Cong., 1st Sess. 104 (1969) (emphasis added).

applies here as well. Mere reduction in taxes, the most that would occur in such a transaction, does not constitute a profit for section 183.⁴³³ If, however, the goal of the tax shelter consists of ultimate realization of taxable income and true economic gain in excess of the early losses in addition to tax deferral, section 183 and its judicially fashioned profit motive predecessor are inapplicable.

Matching the deductions with their corresponding income offers a simple solution. But because no statutory provision or common-law doctrine currently precludes the deduction of ordinary and necessary section 162 or 212 expenses simply because the activity is yielding no current income,⁴³⁴ or requires deferral of such deductions until related income is realized,⁴³⁵ the Service has attempted to rely on a number of other doctrines derived with varying degrees of judicial acceptance from the term "trade or business" in hopes of achieving roughly the same results. These doctrines are the trade or business glosses of (1) continuity, (2) holding one's self out to others as engaged in the selling of goods or services and (3) activity which must be an existing, operating business rather than preparatory to engaging in a trade or business. Where courts have applied these doctrines the expenditures are capitalized and deductible, if at all, through depreciation or amortization over a period of years.⁴³⁶

The continuity approach is usually considered an independent criterion, less frequently an element of the profit motive prerequisite to deductibility under section 162.⁴³⁷ In any event it plays a significant role only in the hobby loss area. The holding one's self out doctrine, while displaying this same duality, possesses precedents in both the hobby loss and tax shelter areas. The analysis of tax shelter abuse as a mismatching of expenses and

⁴³³ See the text accompanying note 111 *supra*.

⁴³⁴ See, e.g., *Mercer v. Comm'r*, 376 F.2d 708 (9th Cir. 1967); *Frank A. Newcombe*, 54 T.C. 1298, 1301 (1970) (property held only for sale and not for rent, i.e., current income, held for production of income).

⁴³⁵ *E.H. Sheldon & Co. v. Comm'r*, 214 F.2d 655, 658-59 (6th Cir. 1954); *accord*, *A. Finkenberg's Sons, Inc.*, 17 T.C. 973, 982-83 (1951).

⁴³⁶ In order for the cost of an intangible capital asset to be amortizable, its useful life must be capable of estimation with reasonable accuracy. Reg. § 1.176(u)-3. No deduction is allowable for goodwill. Often preopening expenses are added to the cost or basis of assets without a determinable life. See *Richmond Television Corp. v. United States*, 354 F.2d 410 (4th Cir. 1965).

⁴³⁷ Independent criterion: *Stanton v. Comm'r*, 399 F.2d 326 (5th Cir. 1968); *Kerns Wright*, 31 T.C. 1264 (1959), *aff'd per curiam*, 274 F.2d 883 (6th Cir. 1960); *Hamilton D. Hill*, 30 T.C.M. 534 (1971). Element of profit motive: *Percy S. Winfield*, 25 T.C.M. 305 (1966), *aff'd*, 67-1 U.S.T.C. ¶ 9268 (7th Cir.), *cert. denied*, 389 U.S. 851 (1967); *Martin C. McGowan*, 23 T.C.M. 1439 (1964), *aff'd*, 347 F.2d 728 (7th Cir. 1965).

deductions underlies the preparatory to engaging in a trade or business concept, which has been applied to hobby losses and tax deferral (*i.e.*, tax shelter), but primarily the latter.

Because the term "trade or business" is not designed to deal with the problem of mismatching of income and deductions, the Service has obtained only irregular, unpredictable and sometimes unfortunate results under these three doctrines. Furthermore, the courts' common application in the same case of one or another of these principles together with the profit motive requirement without overt consideration whether tax shelter or hobby loss motives or a mixture of both were involved has generated considerable confusion and blurring of the meaning of trade or business.⁴³⁸ Aberrational decisions under section 162 have resulted from the usually unarticulated desire to avoid mismatching of deductions and related income. Section 183 may suffer the same fate unless the courts isolate and analyze the elements the government attacks or the Service is satisfied with the other statutory remedies at hand or presently actively contemplated by Congress which deal with tax deferral. The current spate of activity under the presection 183 profit motive test as to dual use beach houses and condominium units, which display both personal or hobby loss and tax shelter aspects,⁴³⁹ suggests however that the Service is currently attempting to create precedents there for later use under section 183 against tax shelters without any personal elements. Indeed, failure of this development to critically analyze the questions involved has already resulted in questionable conclusions.⁴⁴⁰

Continuity

*Kerns Wright*⁴⁴¹ is the leading decision requiring continuous or repeated activity coupled with an expectation of making a profit to qualify an activity as a trade or business under section 162. A taxpayer can satisfy this requirement by demonstrating devotion of a substantial portion of his time to the activities at

⁴³⁸ John F. Koons, 35 T.C. 1092 (1961); Harold I. Snyder, 25 T.C.M. 1326 (1966); Edward R. Godfrey, 22 T.C.M. 1 (1963), *aff'd on other grounds*, 335 F.2d 82 (6th Cir. 1964), *cert. denied*, 379 U.S. 966 (1965) (affirmed on profit motive ground only).

⁴³⁹ *E.g.*, Kanter v. United States, 73-1 U.S.T.C. ¶ 9311 (E.D. Va. 1973), *aff'd per curiam*, 74-1 U.S.T.C. ¶ 9182 (4th Cir. 1974); William K. Coors, 60 T.C. No. 44 (1973); Joseph W. Johnson, Jr., 59 T.C. No. 78 (1973).

⁴⁴⁰ See text accompanying notes 125 through 130 *supra*.

⁴⁴¹ 31 T.C. 1264 (1959), *aff'd per curiam*, 274 F.2d 883 (6th Cir. 1960); Georges Simenon, 44 T.C. 820 (1965).

issue or that there has been extensive or repeated activity over substantial periods of time.⁴⁴²

The continuity approach offers the advantage that the objective fact of sporadic conduct is easier to establish than a lack of profit motive, which may necessitate examination of often conflicting objective as well as subjective factors. Moreover, the two approaches often overlap since sporadic activities commonly do not result in a profit.⁴⁴³ They are not, however, coextensive since many activities are regularly and extensively performed without a profit motive.

One limitation on the continuity doctrine has been its less than universal judicial acceptance. For instance, *Mercer v. Commissioner*⁴⁴⁴ reversed a Tax Court decision resting in part on this concept (as well as upon the reasonable expectation of profit and the preparatory to engaging in business doctrines), holding that it is not necessary to devote oneself extensively to an enterprise to qualify it as a trade or business: "The taxpayer expended his effort and capital to the limit of his available time and resources. There can be no conclusion other than that the taxpayer's venture, though small in results, was a trade or business."⁴⁴⁵

Clearly *Mercer* and *Kerns Wright* conflict. The proper resolution may lie in *Celeste B. Smith*⁴⁴⁶ which balanced the holding of *Mercer*, without directly citing it, that small scale and a limited amount of time do not preclude trade or business status, with a reading of *Kerns Wright* that the amount of time is a factor to be considered rather than determinative, as *Wright* actually held. It is submitted that *Smith* strikes the proper balance, for most of the *Wright* progeny and parallel decisions, as well as *Wright* itself, could have been decided on traditional profit motivation grounds, or on the ordinary and necessary requirements of section 162.⁴⁴⁷ Furthermore, many farm loss authorities

⁴⁴² *Stanton v. Comm'r*, 399 F.2d 326, 329 (5th Cir. 1968).

⁴⁴³ Cf. *Percy S. Winfield*, 25 T.C.M. 305 (1966), *aff'd*, 67-1 U.S.T.C. ¶ 9268 (7th Cir.), *cert. denied*, 389 U.S. 851 (1967).

⁴⁴⁴ 376 F.2d 708 (9th Cir. 1967).

⁴⁴⁵ *Mercer v. Comm'r*, 376 F.2d 708, 711 (9th Cir. 1967).

⁴⁴⁶ 30 T.C.M. 516 (1971). Judge Scott, the trier of fact in *Smith*, several years earlier distinguished the taxpayer's reliance on *Mercer* for the proposition that scale of operation was irrelevant to profit motive on the theory that *Mercer* was speaking to the preparatory to a trade or business issue (discussed in text accompanying notes 463 through 533 *infra*). *Mildred Van Cleve*, 27 T.C.M. 1213 (1968). It is submitted, however, that *Mercer* was speaking to both questions.

⁴⁴⁷ Profit Motive: See, e.g., *Industrial Research Products, Inc.*, 40 T.C. 578, 590 (1963); *Charles H. Schafer*, 23 T.C.M. 927 (1964). But see *Stanton v. Comm'r*, 399 F. 2d 326, 329 (5th Cir. 1968).

demonstrate that devotion of a limited amount of time does not preclude trade or business status.

In any event, even if continuity and regularity are properly prerequisites to trade or business status, they are not the sine qua non of profit motivation, although they are factors in some cases. Accordingly, the second limitation on the continuity doctrine is that noncontinuous but profit motivated activities which do not constitute carrying on a trade or business under section 162 may nevertheless be conducted for the production of income under section 212.⁴⁴⁸ Undoubtedly, this factor underlies a recent decision in which an unsuccessful writer with a bona fide profit motive, as in *Kerns Wright*, was denied a deduction under section 162 because she was not engaged in the business of being an author, but was permitted a deduction under section 212 because the writing and printing of her two books were related to a profit seeking purpose.⁴⁴⁹ Probably for these reasons the extensive activity tack has not been widely utilized in the farm loss area,⁴⁵⁰ although it has enjoyed some success in the fields of research and development ("R & D") expenditures under section 174 and rental real estate losses.⁴⁵¹ An unarticulated factor in the R & D cases may be that section 174 incorporates only the trade or business standard of section 162 and not the production of income standard of section 212. In addition, the capital gain precedents as to sales of real estate and patents had no little effect here.⁴⁵²

Kerns Wright was clearly concerned with abuse of the ordinary and necessary requirement—"we are not convinced that the trip would have been made for the sole objective of making a profit on the sale of the book. We think petitioners were also motivated by a desire to see their son, his new wife, and her family, and a desire to travel and see the many interesting places where they stopped, and that the trip actually served the joint purpose of satisfying these desires and gathering material for the book." 31 T.C. 1267. However, cases such as *Charles A. Nemish*, 29 T.C.M. 1249, 1251 (1970), *aff'd per curiam*, 452 F.2d 611 (9th Cir. 1971), indicate that the requirement that a business expense be necessary is sufficiently broad to curb most, if not all, potential abuses here.

⁴⁴⁸ Cf. *Ditmars v. Comm'r*, 302 F.2d 481, 486 (2nd Cir. 1963). But compare *Young, The Role of Motive in Evaluating Tax Sheltered Investments*, 22 TAX LAWYER 275, 297 (1969).

⁴⁴⁹ *Marian B.S. Crymes*, 31 T.C.M. 4 (1972).

⁴⁵⁰ *Hamilton D. Hill*, 30 T.C.M. 534 (1971), and *Celeste B. Smith*, 30 T.C.M. 516 (1971), are the principal exceptions.

⁴⁵¹ *Stanton v. Comm'r*, 399 F.2d 326 (5th Cir. 1968); *Industrial Research Prods., Inc.*, 40 T.C. 578 (1963); *Georges Simenon*, 44 T.C. 820 (1965); *James E. Austin*, 35 T.C. 221 (1960), *aff'd*, 298 F.2d 583 (2d Cir. 1962); *Kerns Wright*, 31 T.C. 1264 (1959), *aff'd per curiam*, 274 F.2d 883 (6th Cir. 1960); *Charles H. Schaffer*, 23 T.C.M. 927 (1964).

⁴⁵² Compare *Fahs v. Crawford*, 161 F.2d 315 (5th Cir. 1947); with *Loy D. Mercer*,

***Holding One's Self Out to Others as Selling
Goods or Services***

A concurring opinion by Justice Frankfurter in *Deputy v. DuPont*⁴⁵³ forms the genesis of the doctrine that carrying on a trade or business "involves holding one's self out to others as engaged in the selling of goods or services." Just as is the case with the element of continuity, this approach is also simpler to apply than the profit motive test, being limited to a single objective factor, but is narrower since, for example, a taxpayer can advertise without a profit motive. More importantly, it too appears limited to section 162. For in *Deputy v. DuPont* Justice Frankfurter preceded the above quotation with the observation that expenditures incurred in active concern over one's financial interest, *i.e.*, investments, did not suffice for deduction under the predecessor to section 162—the expenditures were of the type later made deductible by section 212. Accordingly, the holding one's self out doctrine would appear peculiar to the trade or business prerequisite of section 162 and other provisions and not extend to the production of income standard of section 212. Moreover, a subsequent oft-cited decision, *Trent v. Commissioner*, clearly so limits the concept.

Throughout the Internal Revenue Code there runs a distinction between those expenses and losses incident to the endeavor to earn a livelihood by "holding one's self out to others as engaged in the selling of goods or services," *Deputy v. DuPont* . . . , those incident to other activities that are pecuniarily motivated, *Higgins v. C.I.R.*, 1941, 312 U.S. 212 . . . , and those incident to activities that are not.⁴⁵⁴

Section 212 was enacted to permit deductibility of the second category of nonbusiness but pecuniarily motivated expenditures which *Higgins* had held did not come within the trade or business requirement of section 162, the first category.⁴⁵⁵ However, section 212 is not available to corporations, and section 174 limits the deduction to R & D expenditures paid in connection with the taxpayer's trade or business without a section 212 analogue. Therefore, in these two areas, the holding one's self out doctrine has the potentiality of being determinative. Section 183 as well

25 T.C.M. 467 (1966), *rev'd*, 376 F.2d 708 (9th Cir. 1967). Compare *Harold T. Avery*, (1940), 47 B.T.A. 538 (1942), with *Charles H. Schaffer*, 23 T.C.M. 927 (1964).

⁴⁵³ 308 U.S. 488, 499 (Frankfurter, J., concurring).

⁴⁵⁴ 291 F.2d 669, 670-71 (2d Cir. 1961).

⁴⁵⁵ See *McDonald v. Comm'r*, 323 U.S. 57, 61-62 (1944).

does not extend to regular corporations and its interrelationship with section 174 is very unclear.

With the significant exception of research and development cases, the doctrine has not enjoyed wide use in the hobby loss cases. Thus, while many of the district court farm loss cases illustrate the term "trade or business" by declaring that generally the person engaged in such activities holds himself out as selling either goods or services,⁴⁵⁶ such broad statements have not proved adequate in resolving the variety of factual situations presented to the courts.⁴⁵⁷ Consequently, courts have turned to a number of other objective criteria. In the Tax Court the doctrine has played only a minor role in farm loss and, surprisingly, rental property decisions, where failure to advertise or rent to the general public would usually be inconsistent with a profit motive.⁴⁵⁸ In these latter areas failure to hold one's self out has frequently been used merely as a factor in ascertaining whether profit motivation was present and not as independent criterion.⁴⁵⁹ Failure to hold one's self out has been the primary decisive factor in section 174 cases, but even there decisions concluding that the taxpayer did not hold himself out to others as an inventor or did not attempt to manufacture any invention or sell others patent rights⁴⁶⁰ by and large appear to meld the holding one's self out requirement into some other requirement: (1) profit motive, (2) regularity and continuity or (3) preliminary to engaging in a trade or business.⁴⁶¹ Moreover, most, but not all, of the R & D

⁴⁵⁶ *Hicks v. United States*, 72-1 U.S.T.C. ¶ 9383 (S.D. Miss. 1972); *Cavender v. United States*, 71-2 U.S.T.C. ¶ 9723 (S.D.W.Va. 1970); *Gross v. United States*, 71-2 U.S.T.C. ¶ 9715 (N.D. Fla. 1971).

⁴⁵⁷ *Martin C. McGowan*, 23 T.C.M. 1349 (1964), *aff'd*, 347 F.2d 728 (7th Cir. 1965).

⁴⁵⁸ Compare *James E. Austin*, 35 T.C. 221 (1960), *aff'd*, 298 F.2d 583 (2d Cir. 1962), with *C. Fink Fischer*, 50 T.C. 164 (1968) and *Hofmann Bros. Realty Corp.*, 22 T.C.M. 1678 (1963).

⁴⁵⁹ See, e.g., *Joseph V. Curran*, 29 T.C.M. 696 (1970).

⁴⁶⁰ *Edwin S. Snow*, 58 T.C. 585 (1972), *aff'd*, 73-2 U.S.T.C. ¶ 9559 (6th Cir. 1973), *cert. granted*, 42 U.S.L.W. 3382 (U.S. Jan. 7, 1974) (failure to hold one's self out); *William Tiffin Downs*, 49 T.C. 533 (1968) (failure to manufacture or sell); *Charles H. Schaffer*, 23 T.C.M. 927 (1964) (failure to hold one's self out).

⁴⁶¹ Profit Motive: *Charles H. Schaffer*, 23 T.C.M. 927 (1964). Regularity and Continuity: *Stanton v. Comm'r*, 399 F.2d 326 (5th Cir. 1968). But see *Myron Edwin Cherry*, 26 T.C.M. 557 (1967) (profit motive and engaged in as business separate requirements: latter evidenced by (1) devotion of substantial time, (2) repeated or extensive activity, (3) holding one's self out as engaged in activity and (4) business-like conduct of all aspects of activity related to profit). Preliminary to Engaging in a Trade or Business: *Edwin S. Snow*, 58 T.C. 585 (1972), *aff'd*, 73-2 U.S.T.C. ¶ 9559 (6th Cir. 1973), *cert. granted*, 42 U.S.L.W. 3382 (U.S. Jan. 7, 1974); *William Tiffin Downs*, 49 T.C. 533 (1968).

cases under section 174 could have been decided on continuity and regularity or profit motive criteria alone.⁴⁶²

PREPARATORY TO ENGAGING IN A TRADE OR BUSINESS:
NONAGRICULTURAL

Ironically, the primary significance of the holding one's self out doctrine lies not in the doctrine itself, but rather in its utilization as a conceptual underpinning for the preparatory to engaging in a trade or business approach, which appears to be more frequently applied to tax shelter (deferral) situations than to hobby losses. *Cleophus L. Kennedy* best illustrates this point:

Ordinarily, carrying on a trade or business "involves holding one's self out to others as engaged in the selling of goods or services." *Deputy v. DuPont* 308 U.S. 488, 499 (1940).

[E]ven though a taxpayer has made a firm decision to enter into business and over a considerable period of time spent money in preparation for entering that business, he still has not "engaged in carrying on any trade or business" within the intendment of section 162(a) until such time as the business has begun to function as a going concern and performed those activities for which it was organized. [Footnote omitted.]

Richmond Television Corp. v. United States, 345 F. 2d 901, 907 (C.A. 4, 1965), vacated and remanded on other grounds 382 U.S. 68 (1965) (see also the cases cited therein).

Riverside did not begin to function as a going concern until the date it first opened its doors to the public—September 12, 1969. Albeit Mr. Kennedy was legally capable of filling prescriptions at an earlier date because of having acquired the requisite licenses, the ability to transact business does not satisfy the "carrying on" requirement of the statute. Therefore, we hold that none of the pharmacy-related expenditures made prior to opening on September 12, 1969, is deductible by petitioners under section 162(a).

Mr. Kennedy's preopening expenditures were incurred in creating a business which would ultimately produce income taxable to Riverside after incorporation.⁴⁶³

⁴⁶² See, e.g., *Stanton v. Comm'r*, 399 F.2d 326 (5th Cir. 1968); *Oliver B. Kilroy*, 32 T.C.M. No. 7 at 29 (1973) ("It is clear that Kelroy's isolated research effort could not by itself constitute a trade or business. *Martin Mayrath*, 41 T.C. 582, 589 (1964), *aff'd*, 357 F.2d 209 (C.A. 5, 1966), *John F. Koons*, 35 T.C. 1092, 1100 (1961)"). But see *Edwin S. Snow*, 58 T.C. 585 (1972), *aff'd*, 73-2 U.S.T.C. ¶ 9559 (6th Cir. 1973).

⁴⁶³ 32 T.C.M. 52, 55 (1973); see *Snow v. Comm'r*, 73-2 U.S.T.C. ¶ 9559 (6th Cir. 1973), *cert. granted*, 42 U.S.L.W. 3382 (U.S. Jan. 7, 1974). The conclusion in *Kennedy* that ability to transact business does not satisfy the carrying on requirement should be contrasted with *Cecil Randolph Hundley, Jr.*, 48 T.C. 339, 348 (1967).

Early Development

Many of the preopening expense decisions do not clearly articulate any rationale to support the conclusion that preopening, preparatory or start-up costs are not incurred in carrying on a trade or business. The issue arose in reported decisions as early as 1929 when the majority of the then Board of Tax Appeals held in *Harrisburg Hospital, Inc.*, that “‘operation of a trade or business regularly carried on by the taxpayer’” for the purpose of the net operating loss provisions of the Revenue Act of 1925 was not satisfied where the taxpayer was not actually engaged in carrying on a trade or business, but was “merely making preparations to carry on its business and was in the process of erecting a hospital for that purpose.”⁴⁶⁴ No further explanation was offered, but the facts disclose that during the period in question the hospital was in the process of construction and arrangements were being perfected for its operation, no income was received until the construction was completed and operation of the hospital was begun in a subsequent year.

The Board subsequently followed *Harrisburg Hospital* in *379 Madison Avenue, Inc.*⁴⁶⁵ There, in 1922 the taxpayer leased land, commenced construction of an office building, secured tenants and incurred rental agent commissions. The taxpayer maintained its business was carried on from the moment it acquired the leasehold and commenced construction since it was authorized to do so by its charter, hence, such activities constituted part of its business. The Board of Tax Appeals disagreed, reasoning that a preliminary period of preparation—of getting ready to carry on a business—did not constitute operating a trade or business. In the eyes of the Board all of the taxpayer’s activities were prospective. The Second Circuit reversed the lower court.

Certainly the corporation was “carrying on business” within the ordinary meaning of that phrase, and within its meaning in section 1000 of the Revenue Act of 1921 imposing a special excise tax with respect to “carrying on or doing business.” 42 Stat. 294. See Reg. 64, arts. 11, 12; *Associated Furniture Corp’n v. United States* (Ct. Cl.) 44 F. 2d 78. Cf. *Flint v. Stone Tracy Co.*, 220 U. S. 108, 171, 31 S. Ct. 342, 55 L. Ed. 389, Ann. Cas. 1912B, 1312. We see no reason why

⁴⁶⁴ 15 B.T.A. 1014, 1018 (1929). It has been argued that such expenses should be treated as organizational expenditures amortizable under section 248. Carruthers, *How to Treat the Expenses of Organization, Reorganization and Liquidation*, 24 N.Y.U. INST. 1055, 1062 (1966). See generally Comment, *The Deductibility of Pre-Incorporation Expenses*, 20 CATHOLIC U.L. REV. 463, 473-76 (1970).

⁴⁶⁵ 23 B.T.A. 29 (1931), *rev’d*, 60 F.2d 68 (2d Cir. 1932).

in section 204 a similar meaning should not be ascribed to the phrase "business regularly carried on," provided the corporate activities have continuity and are of normal character. So much is implied by the word "regularly"; it excludes isolated or unusual transactions. See *Auburn & Alton Coal Co. v. United States*, 61 Ct. Cl. 438, 444; *Bedell v. Commissioner*, 30 F. (2d) 622, 625 (C.C.A.2). In the case at bar, the corporation was continuously engaged in 1922 in carrying on the business for which it was chartered. It not only acquired a leasehold and prosecuted the erection of its building, but it employed real estate brokers, made leases of space to prospective tenants, and collected nearly \$50,000 of rentals paid in advance. In improving its real estate, negotiating leases, and incurring the expenses which it seeks to deduct, it was prosecuting its normal activities and was regularly carrying on its business even though that business was not yet at full flower. We think the claimed net loss deductions should have been allowed.⁴⁶⁶

After this brief development the preliminary to carrying on a trade or business issue remained relatively dormant for a decade and a half until *George C. Westervelt*.⁴⁶⁷ There the Tax Court using preparatory language concluded that a trade or business did not exist at the stage (actually in advance of the start-up or preopening period) where the taxpayer incurred expense prior to and for the purpose of reaching a decision whether to establish a business. The decade of the fifties saw considerable litigation concerning such investigatory expenses, and it now appears well established that they must be capitalized under the theory that they are not incurred in an existing trade or business.

Overlooking the earlier *Harrisburg Hospital* and *379 Madison Avenue* development, in the early 1960's the Tax Court extended the investigatory cases to the start-up stage in two areas: R & D expenditures under section 174 and farm losses.⁴⁶⁸ The latter de-

⁴⁶⁶ *379 Madison Ave., Inc. v. Comm'r*, 60 F.2d 68, 69 (2d Cir 1932). The Supreme Court in *Higgins v. Comm'r*, 312 U.S. 212 (1941), held that the *Flint v. Stone Tracy* line of cases (the articulated basis for decision in *Madison Avenue*) was not precedent for what constituted a trade or business for purposes of section 162. However, the issue in *Higgins* was whether the activities in question constituted a trade or business in contrast to investment activities. Arguably, therefore, *Higgins* does render reliance upon *Madison Avenue* risky in determining when a trade or business commences. While equating business with corporate purposes, a premise of *Madison Avenue*, may be erroneous under more recent decisions such as *Adirondack League Club*, 55 T.C. 796, 817 (1971), *aff'd*, 458 F.2d 506 (2d Cir. 1972) (concurring opinion), the same concurring opinion read *Flint v. Stone Tracy* as enunciating a profit motive test. 55 T.C. at 816.

⁴⁶⁷ 8 T.C. 1248 (1947). See generally Fleischer, *The Tax Treatment of Expenses Incurred in Investigation for a Business or Capital Investment*, 14 TAX L. REV. 567 (1959).

⁴⁶⁸ In *T.R. Ewart*, 25 T.C.M. 96 (1966), apparently the only reported decision in this area in which the taxpayer chose to rely upon *Madison Avenue*, the Tax Court brushed such reliance aside without analysis under the unconvincing rubric that the facts before

velopment is considered separately because of its significance and the impact of different tax accounting rules applicable to farmer taxpayers. In *John F. Koons*⁴⁶⁹ the Tax Court reasoned that the reference in section 174 to trade or business by virtue of the committee report citation to section 162 dictated that the "concept was not intended to encompass all activities engaged in for profit, but was used in the realistic and practical sense of a going trade or business."⁴⁷⁰ The taxpayer had purchased an invention that was in a preliminary laboratory state and had entered into a development contract with a research laboratory to bring the invention to maturity as a practical device. The taxpayer sought to deduct the amounts paid for such development services under section 174. The *Koons* court concluded that the development activity was preliminary to the coming into existence of a business. "Expenditures made in investigating a potential new trade or business, or preparatory to entering into such business, do not, in our opinion, qualify for the application of section 174(a)(1)."⁴⁷¹ Neither *Koons* nor its progeny in the R & D area considered the distinction between investigatory and developmental or start-up expenses. Moreover, most if not all such decisions could have been decided under the existing profit motive, continuity or holding one's self out authorities under section 162.

Richmond Television Corp.

The leading preopening expenses decision, *Richmond Television Corp. v. United States*,⁴⁷² was neither a farm loss nor a R & D case, although influenced to some degree by the latter trend. At issue was the deductibility of preopening expenses incurred prior to receipt of a FCC license and initiation of commercial broadcasting in training a staff to operate a television broadcasting station. The Fourth Circuit viewed the question as the deductibility of preopening expenses incurred between the decision to establish a business and actual beginning of business operations, noting that investigatory expenses were indisputably capital expenditures. It acknowledged that prior decisions contained "little

it were quite different from those in *Madison Avenue* and found the expenses in question to be nondeductible investigatory expenses.

⁴⁶⁹ 35 T.C. 1092 (1961).

⁴⁷⁰ *John F. Koons*, 35 T.C. 1092, 1100 (1961).

⁴⁷¹ *Id.* at 1101.

⁴⁷² 345 F.2d 901, 905-07 (4th Cir.), *vacated and remanded per curiam on other grounds*, 382 U.S. 68 (1965).

discussion of the question of when, in point of time, a trade or business actually begins.”⁴⁷³

The government in fact had not argued this issue in its brief to the Fourth Circuit, rather, it had asserted that (1) the training of the staff created a capital asset in the form of a reservoir of skills with continuing benefits over a period of years and (2) charging against the first year's income of the business through net operating loss deductions the large outlays required to enter into it would produce a gross distortion of the taxable income for that year.⁴⁷⁴ The taxpayer responded in its brief that there was no legal requirement that expenses must produce income in the year that they are incurred and the expense of training employees was traditionally an ordinary and necessary expense. It further attempted to distinguish *Petersburg Television Corp.*, one of the decisions cited by the Department of Justice on appeal but not discussed in a preopening context, on the grounds that (1) the taxpayer there conceded it was not engaged in business prior to granting of the FCC license and (2) the pre-business authorities relied upon therein involved investigatory expenses.⁴⁷⁵

While the *Richmond Television* court accepted the government's acquisition of staff theory as an alternative holding, it first proceeded to survey several investigatory and preopening decisions concluding that:

The uniform teaching of these several cases is that, even though a taxpayer has made a firm decision to enter into business and over a considerable period of time spent money for preparation for entering that business, he still has not “engaged in carrying on any trade or business” within the intendment of section 162(a) until such time as the business has begun to function as a going concern and performed those activities for which it is organized.⁴⁷⁶

⁴⁷³ *Richmond Television Corp. v. United States*, 345 F.2d 901, 905 (4th Cir. 1965).

⁴⁷⁴ Brief for Appellant at 12-13, *Richmond Television Corp. v. United States*, 345 F.2d 901 (4th Cir.), *vacated and remanded per curiam on other grounds*, 382 U.S. 68 (1965). The government reiterated this argument before the Supreme Court, and *Snow v. Comm'r*, 73-2 U.S.T.C. ¶ 9559 (6th Cir. 1973), analyzed the preparatory to engaging in a trade or business concept (which it bottomed on the holding one's self out doctrine in the context of preventing the use of section 174 to effect “unintended tax shelters”).

⁴⁷⁵ Brief for Appellee at 9-12, *Richmond Television Corp. v. United States*, 345 F.2d 901 (4th Cir.), *vacated and remanded per curiam on other grounds*, 382 U.S. 68 (1965).

⁴⁷⁶ 345 F.2d at 907. With one exception these cases were either investigatory cases or the prebusiness holding was superfluous since the expenditures were clearly capital under traditional criteria (the television license decisions). That exception, *Cohn v.*

In requesting that the Supreme Court grant a writ of certiorari in *Richmond Television* the taxpayer asserted that the decision presented an important unsettled tax question: "When has a corporation's business commenced so that admittedly ordinary and necessary expenses paid or incurred in starting up are deductible as expenses and are not capital."⁴⁷⁷ The government, in opposition to the granting of the writ, primarily justified the Fourth Circuit's result on the alternative staff training ground, citing numerous cases and other authorities to support that rationale. It reiterated that permitting the (NOL) deduction would result in a gross distortion of income. As to the preopening concept of the Fourth Circuit, the Solicitor General stated:

Petitioner relies upon § 162 of the Code as authorizing the instant deductions. In line with the requirement that pre-operating expenditures must be capitalized, that provision allows a deduction for only those expenses "paid or incurred during the taxable year in *carrying on any trade or business*." The court of appeals correctly held that petitioner did not carry on any trade or business during the years 1953-1955 and that the costs here in question were thus nondeductible capital expenditures.⁴⁷⁸

Of course, the requirement for which no authority was cited by the government had been virtually resurrected by the Fourth Circuit in *Richmond Television*, so that the government was indulging in a bootstrap argument. Despite the government's rather passive role in the formulation of the preopening expense doctrine by the *Richmond Television* court, it immediately relied upon the decision in farm loss controversies (to little avail) and more recently has begun to rely upon it in the area of corporate preopening expenses.⁴⁷⁹

The Supreme Court did not address the preopening issue in *Richmond Television*, consequently, it remains unsettled.⁴⁸⁰ For

United States, 57-1 U.S.T.C. ¶ 9457 (W.D. Tenn. 1957) is partially flawed by heavy reliance on the erroneous definition of capital expenditures as nonrecurring expenditures.

⁴⁷⁷ Petitioner's Brief for Certiorari at 5, *Richmond Television Corp. v. United States*, 382 U.S. 68 (1965).

⁴⁷⁸ Respondent's Brief in Opposition to Certiorari at 3, *Richmond Television Corp. v. United States*, 382 U.S. 68 (1965) (emphasis added).

⁴⁷⁹ Compare *Worrell v. United States*, 254 F. Supp. 992 (S.D. Tex. 1966) and *Whitman v. United States*, 248 F. Supp. 845 (W.D. La. 1965), with *Cleophus L. Kennedy*, 32 T.C.M. No. 15 (1973).

⁴⁸⁰ The Supreme Court did not address the preopening expense issue but merely remanded for consideration of whether the taxpayer was entitled to amortization deductions for expenses not derived from the NOL carry forwards (which had been the focus of the lower court controversy). Interestingly on that remand the Fourth Cir-

despite the Fourth Circuit's opinion there is ample authority in various provisions in the regulations that a corporation commences business as soon as its activities have advanced to the extent necessary to establish the nature of its business operations. "For example, the acquisition of operating assets which are necessary to the type of business contemplated may constitute the beginning of business."⁴⁸¹ While it might be argued that beginning a business, here for purposes of section 248, as well as of section 1.1371-1(a)(2) of the regulations, is not the same as carrying on a trade or business, the same approach is used in determining when a corporation commences the active conduct of any trade or business under sections 955(e) and 1372(e)(5). Thus, the active conduct, for instance, of a restaurant business can commence in the taxable year in which construction of the restaurant facility is undertaken or real property is purchased or leased for such use.⁴⁸² Indeed, the Service has ruled that developmental planning, negotiating for financing and readying property for construction constitutes being engaged in the active conduct of a trade or business.⁴⁸³ Furthermore, the Administration Proposals for Tax Change (Tax Reform Bill of 1973) implicitly acknowledge that

cuit's restatement of its earlier holding omitted the preopening rationale and instead mentioned only its alternative capitalization holding. *Richmond Television Corp. v. United States*, 354 F.2d 410 (4th Cir. 1965).

⁴⁸¹ Reg. § 1.248-1(a)(3); accord, Reg. § 1.1371-1(c)(2)(ii). See, Mandell, *Deductibility of Pre-Operating Expense: Successful and Unsuccessful Ventures*, 25 N.Y.U. INST. 1235 (1967); Note, *Federal Income Tax Treatment of Business and Employment Investigatory Expenses*, 56 MINN. L. REV. 1157, 1164 n.28 (1972). The district court in *Richmond Television Corp. v. United States*, 66-2 U.S.T.C. ¶ 9589 (E.D. Va. 1963), clearly relied upon these regulations in giving the jury instructions as to when a business commences. Unfortunately, before the Fourth Circuit the taxpayer more fully relied upon the section 248 regulations for the somewhat attenuated argument that since start-up costs were not mentioned in such regulations as chargeable to capital account they were not required to be capitalized. Brief for Appellee at 15, *Richmond Television Corp. v. United States*, 345 F.2d 901 (4th Cir.), vacated and remanded per curiam on other grounds, 382 U.S. 68 (1965). Ironically, while many commentators have suggested that the section 248 strongly supports the argument that trade or business status can attach prior to full grown operations, its first explicit presentation to a court after *Richmond Television* was an individual hobby loss case, rather than a preoperating expense case. Justin A. McNamara, 32 T.C.M. 11, 16 (1973). Instead of pointing out that the section 248 regulations speak only to when a business commences and not to whether the requisite profit motive is present, the Tax Court broadly announced: "Our attention has not been called to, nor have we found any case which holds or even implies that the test set forth in section 1.248-1(a)(3) has any applicability to determining whether an enterprise in other than corporate form was actually entered into a trade or business for purposes of section 162(a)."

⁴⁸² Reg. § 1.1372-4(b)(5)(ii)(b); accord, Reg. § 1.955-5(a)(3).

⁴⁸³ Rev. Rul. 72-220, 1972-1 C.B. 365.

construction period or preopening expenses in the context of rental real estate are currently deductible.⁴⁸⁴

RATIONALES FOR START-UP COSTS

In addition to the state of hopeless confusion as to when a business begins, the various rationales for capitalization of start-up costs that can be gleaned from case law—(1) increase in earning power or providing benefits to future years, (2) integral part of constructed asset and (3) the requirement of holding one's self out—all carry with them their own contrary precedents and attendant confusion.

Increase in Earning Power

In *Mid-State Products Co.*⁴⁸⁵ the Tax Court concluded that expenses—which the taxpayer had originally capitalized on its books as “Deferred Development and Preoperating Expense” and had then offset against related income earned in future tax years, but at trial maintained in the alternative should have been deducted when incurred—were capital items although of a type ordinarily deductible currently as ordinary and necessary expenses. “Here the expenditures were designed and intended to increase the earning capacity of petitioner beyond that of the shell egg business, for which it was organized and in which it was engaged, by setting up and establishing a new and additional business, namely, that of producing and selling dried eggs in which operations actually began in the next succeeding year.”⁴⁸⁶

Nevertheless, otherwise deductible expenditures that expand the capacity of an existing business or a new business related to an existing business are currently deductible.⁴⁸⁷ For example, it has

⁴⁸⁴ TAX REFORM BILL OF 1973, ADMINISTRATION'S PROPOSALS FOR TAX CHANGE WITH TREASURY EXPLANATION, 93D CONG., 1ST SESS. 99 (Comm. Print 1973). The committee print speaks of “otherwise deductible construction period or ‘pre-opening’ costs which by their nature precede the income to which they relate,” including interest, taxes and costs deductible under section 162 or 212 such as “management, brokerage and legal fees, insurance, advertising, and transfer and recording fees.” While use of “otherwise deductible” indicates a surface neutrality as to whether preopening expenses are deductible, the enumerated deductible section 162 or 212 preopening expenses would not be deductible if *Richmond Television* were applicable to construction period expenses. See Hamovit, *Construction Period Expenses*, 29 N.Y.U. INST. 1075, 1079 (1971). Cf. Dean, *Tax Considerations and Problems of the Developer-BUILDER*, 26 N.Y.U. INST. 209, 210 (1968).

⁴⁸⁵ 21 T.C. 696 (1954).

⁴⁸⁶ *Mid-State Products Co.*, 21 T.C. 696, 714 (1954).

⁴⁸⁷ See, e.g., *York v. Comm'r*, 261 F.2d 421 (4th Cir. 1958); *Best Universal Lock Co.*, 45 T.C. 1 (1965); *Kenneth Reiner*, 24 T.C.M. 1005 (1965).

been held in a number of cases that advertising expenses, even though incurred heavily in a certain year with resulting benefits over future years, are currently deductible in the year in which expended.⁴⁸⁸ Thus, increase in earning power or benefit to future years is not alone sufficient, otherwise all ordinary and necessary business expenditures resulting in greater profit would have to be capitalized, which is not the law. It might be argued that deductibility should not obtain if the preopening trade or business is properly viewed as essentially a separate and distinct additional asset. An answer may be that as soon as the business commences, any further start-up expenditures are expanding the earning capacity of an existing business and do not create or enhance an additional asset—with a business commencing as soon as its activities establish the nature of operations. In any event in this area of intangible contributions (advertising, start-up costs) to an intangible asset (a company's position in the market or its earning capacity) "the rulings and decisions are in a state of hopeless confusion."⁴⁸⁹

Integral Part of Construction

Some decisions have allocated preopening expenses, such as cleaning up a construction site, to the basis of the taxpayer's newly constructed principal assets on the theory that such expenditures are an integral part of the total cost of such assets.⁴⁹⁰ A distinction is drawn, however, in this context between payments for services performed in carrying on the business of the taxpayer and for the acquisition of something of permanent use or value in that business.⁴⁹¹ In essence preopening or start-up costs consist of expenditures of the same nature as deductible expenses the taxpayer will incur in carrying on his trade or business after it comes into full flower, but which are made prior to that

⁴⁸⁸ See, e.g., *E.H. Sheldon & Co. v. Comm'r*, 214 F.2d 655, 658-59 (6th Cir. 1954). While the Tax Court recently concluded from the same precedents relied upon in *E.H. Sheldon* that advertising, albeit ordinarily deductible, is capital where made for the cultivation of business the benefits of which will be realized in future years, it was reversed by the Second Circuit. *Briareliff Candy Corp.*, 31 T.C.M. 171 (1972), *rev'd*, 73-1 U.S.T.C. ¶ 9288 (2d Cir. 1973).

⁴⁸⁹ *Briareliff Candy Corp. v. Comm'r*, 73-1 U.S.T.C. ¶ 9288 (2d Cir. 1973).

⁴⁹⁰ *Herbert Shainberg*, 33 T.C. 241 (1959); see *Ben Perlmuter*, 44 T.C. 382 (1956), *aff'd*, 373 F.2d 45 (10th Cir. 1967). Cf. *Acer Realty Co.*, 45 B.T.A. 333, 337 (1941), *aff'd*, 132 F.2d 512 (8th Cir. 1942).

⁴⁹¹ *Suckow Borax Mines Consol., Inc.*, 12 T.C.M. 786 (1953). See *Acer Realty v. Comm'r*, 132 F.2d 512, 514 (8th Cir. 1942).

time. Accordingly, preopening expenses should be viewed as more in the nature of expenses incurred in carrying on the business rather than for acquisition of a capital asset, particularly since the business has already commenced, and are therefore deductible.⁴⁹²

Holding One's Self Out

The holding one's self out doctrine was alluded to by the Fourth Circuit in *Richmond Television* and clearly relied upon in *Cleophus Kennedy* as supporting nondeductibility under section 162 of preopening expenses. There appears to be no direct precedent contrary to this doctrine. Rather, a number of hobby loss decisions hold for the taxpayer without discussion of this doctrine on facts disclosing no sales or advertising, so that the taxpayer could hardly have been holding himself out as selling goods or services. A more fundamental objection is that in *Deputy v. DuPont* this hallmark of trade or business was intended to exclude from that term investment activities, where the taxpayer never can provide goods or services to others. By contrast the taxpayer in the preopening business will ultimately provide goods or services to others. In short, the test was designed to distinguish between trade or business and investment activities and not to determine when a trade or business has commenced. Moreover, even if this doctrine is applicable to preopening enterprises, it does not extend to section 212 so that individuals (but not corporations, to which section 212 is unavailable) would be able to deduct their preopening expenses under that provision.⁴⁹³ Such potential dis-

⁴⁹² See *Colorado Springs National Bank v. United States*, 73-2 U.S.T.C. ¶ 9795 (D. Col. 1973); cf. *Dixie Frosted Foods Inc.*, 6 T.C.M. 586 (1947) (where services performed in carrying on regular business of employer and not extraordinary compensation, they are not to be capitalized). See Ellentuck, *Tax Aspects of Organizing and Operating Hotels and Motels*, 29 N.Y.U. INST. 887, 900 (1971) (preopening expenses of recurring nature should be considered section 162 expenses). The *Colorado Springs National Bank* court analyzed the deductibility of the "start-up costs" of a Master Charge card operation, a new type of business not just an extension of the lending field, cf. *York v. Comm'r*, 261 F.2d 421 (4th Cir. 1958), on the basis of the traditional ordinary versus capital factors. The court thought that it was faced with a case of first impression although it noted that several start-up costs cases were pending in the Tax Court.

⁴⁹³ It should be noted, however, that the Tax Court in perhaps the leading investigatory decision, *Morton Frank*, 20 T.C. 511, 514 (1953), held that the predecessor to section 212 was not applicable to preparatory expenses because that provision was limited to expenses of "producing or collecting income in which one has an existent interest or right." Investigatory expenses were viewed as expenses incurred in an attempt to obtain income by the creation of some new interest, which might in the future prove productive of income. This existing interest requirement has long and soundly been criticized by commentators.

crimination between similarly situated different classes of taxpayers has recently strongly influenced the Second Circuit to reverse a Tax Court decision which held that items such as advertising which would ordinarily be currently deductible may be capital in nature when they are made for the cultivation or development of business, the benefits of which will be realized in future years.⁴⁹⁴

MATCHING INCOME AND DEDUCTIONS

The government's arguments on brief to the Fourth Circuit and the Supreme Court in *Richmond Television* clearly expose that its goal in the preopening expense area is to match start-up deductions with the related income ultimately produced. This conclusion is corroborated by the Limitation on Artificial Accounting Losses (LAL) currently proposed by the administration. The LAL is designed to preclude tax shelters that arise from the deduction of artificial tax losses from an activity against unrelated income. The LAL's remedy is to defer deduction of such accelerated deductions, *i.e.*, deductions clearly related to some future expected profit, until such related profit or income is generated, at which time the deferred losses are deducted against such income. The Treasury views the LAL as a framework of a reasonable matching of income and expense.

Among other items artificial tax losses include otherwise deductible construction period preopening costs (which are illustrated by a number of expenses stated to be deductible under section 162 or section 212 as well as other provisions) that by their nature precede the income to which they relate⁴⁹⁵—obviously the Treasury places little faith in the *Richmond Television* preopening expense doctrine despite considerable speculation by commentators

See, *e.g.*, Wilberding, *An Individual's Business Investigation Expenses: An Argument Supporting Deductibility*, 26 TAX LAWYER 219, 230-32 (1973). Note, *Investigation Costs: An Analysis and a Proposal*, 41 TEMPLE L.Q. 81, 90-95 (1967). Regardless of the validity of investigatory authorities, a strong case can be made that they are not applicable to start-up costs. See Solomon, *Tax Treatment of Pre-Opening Expenses*, 46 TAXES 521 (1968); Erbacher, *Start-Up Costs: Are They Deductible by a Corporation for Federal Income Tax Purposes*, 48 TAXES 488 (1970). The preexisting interest rule would appear particularly subject to this argument since the taxpayer has the interest, it merely is not yet income producing. "Expenses paid or incurred in managing, conserving, or maintaining property held for investment may be deductible under section 212 even though the property is not currently productive . . ." Reg. § 1.212-(b).

⁴⁹⁴ *Briarcliff Candy Corp. v. Comm'r*, 73-1 U.S.T.C. ¶ 9288 (2d Cir. 1973).

⁴⁹⁵ See note 484 *supra*.

of its effect on the deductibility of start-up costs incurred in the construction of rental real estate.

PREPARATORY TO ENGAGING IN A TRADE OR
BUSINESS: FARM LOSSES

Another accelerated deduction in Treasury's eyes consists of expenses relative to crops or livestock which would not produce income until a future time and it believes would be capitalized or inventoried in a business other than farming.⁴⁹⁶ Indeed, the recapture provisions of section 1251 are inapplicable if a farmer elects to capitalize such expenditures.⁴⁹⁷ The legislative history to that provision describes the tax treatment of such expenses as follows:

In most businesses, the cost of constructing an asset (including maintenance of the asset prior to its being used in the business) is a capital expenditure which may not be deducted as incurred but may be recovered only by depreciation over the useful life of the asset. In this manner, the cost of the asset is matched with the income earned by the asset. Farmers, however, have been permitted to deduct some admittedly capital costs as they are incurred. For example, a citrus grove may not bear a commercial crop until 6 or 7 years after it has been planted. Yet, the farmer may elect to deduct as incurred all costs of raising the grove to a producing state even though such expenditures are capital in nature. Similarly, the capital nature of expenditures associated with the raising of livestock held for breeding may be ignored, and the expenditures may be deducted currently.⁴⁹⁸

⁴⁹⁶ See notes 549 through 550 *infra* and accompanying text.

⁴⁹⁷ I.R.C. § 1251(b)(4)(A).

⁴⁹⁸ S. REP. NO. 91-552, 91st Cong., 1st Sess. 153 (1969). The premise of this entire analysis is that farm development costs are capital expenditures which the government has given farmers the option to capitalize. This premise may, however, be seriously questioned. First, while the regulations have provided since 1922 that "[a]mounts expended in the development of farms, orchards, and ranches prior to the time when the productive state is reached may be regarded as investments of capital," article 110 of regulation 62 (1922) (which the Treasury interpreted in L.T. 1610, II-1 C.B. 85 (1923), as giving the taxpayer the option of treating such amounts as expenses or capitalizing them), in Mimeograph 6030, 1946-2 C.B. 45, *declared obsolete* in Revenue Ruling 67-123, 1967-1 C.B. 383, 386, the Service took the position that the correct interpretation of this provision of the regulations was that the taxpayer has the option only to capitalize otherwise ordinary and necessary current expenses during the development period, but cannot treat capital items as ordinary and necessary expenses. In short, it is submitted that the special farm tax accounting rules permit capitalization of ordinary and necessary expenses, not expensing of capital costs. *But see* *Welder v. United States*, 329 F. Supp. 739 (S.D. Tex. 1971), *aff'd per curiam*, 72-2 U.S.T.C. ¶ 9628 (5th Cir. 1972).

The validity of Mimeograph 6030 was accepted by the Tax Court in *Thompson & Folger Co.*, 17 T.C. 722, 728 (1951); and in *Richard R. Wilbur*, 43 T.C. 322 (1964), the court elaborated that unless the expenditure was clearly deductible or fell within the grey area

The parallelisms between this understanding of the nature of farm expenses and rationales used to support the preparatory to engaging in a trade or business doctrine are obvious and, not surprisingly, the first decision after *Mid-State Products* to extend the investigatory expense development to start-up costs was a farm loss decision, *Edwin H. Miner*.⁴⁹⁹ The taxpayer there clearly had gone beyond the investigatory stage presented in *Westervelt*. He had chosen to build up his herd to a profitable size—a process in his case lasting seven to eight years, which would not be completed until at least three years beyond the tax years at issue—by the natural increase method rather than initially purchasing the requisite number of cattle. The Tax Court held:

[T]he most that can be said of petitioner's beef-raising activities during the taxable years here involved (as well as before and after them) is, that he was endeavoring to build up a herd of animals which would enable him to engage in a cattle business, that *might* prove profitable at some future time. The expenses incident to such a herd build-up were, accordingly, of a capital nature, and hence not currently deductible. *They were analogous to the amassing of the capital assets such as the plant and machinery of a manufacturing business, preparatory to the actual beginning of business operations.*⁵⁰⁰

It is clear that the *Miner* court was applying what it believed to be the general accounting rules for acquisition of an asset used in a taxpayer's trade or business to the activity of raising cattle. The Supreme Court in *United States v. Catto* pointed out, however, that the general accounting rules (capitalization) applicable to the costs incurred in the development of assets used in a trade or business, the basis for the *Miner* holding, contain an exception for farmers.⁵⁰¹

(aspects of expense in current maintenance of an existing but nonproducing asset and of capital costs in acquisition of a future productive asset), no option was available—they must be capitalized. Moreover, the Ninth Circuit recently pointed out in *Maple v. Commissioner*, 440 F.2d 1055 n.3 (9th Cir. 1971), that were not developmental expenses currently deductible under the pre-Tax Reform Act law, there would have been little need for new section 278 which requires capitalization of expenses incurred in the first four years of developing a citrus grove. In addition, IRS, U.S. TREASURY DEP'T, PUBLICATION NO. 225, FARMER'S TAX GUIDE 27 (1973), has returned to this analysis in 1968 and subsequent editions: "Pre-productive period. When your land is in this period, you have an option of deducting or capitalizing your expenditures *that are current ordinary and necessary business expenses*. For example, this option would apply to amounts spent for upkeep expenses, taxes, interest, and other carrying charges, water for irrigation, fertilizer, cultivating and spraying trees."

⁴⁹⁹ 21 T.C.M. 1173 (1962).

⁵⁰⁰ *Edwin H. Miner*, 21 T.C.M. 1173, 1177 (1962) (emphasis added).

⁵⁰¹ 384 U.S. 102, 106 (5th Cir. 1966).

Farm tax accounting rules traditionally divide the life of a farm into three states: preparatory, developmental and productive.⁵⁰² Preparatory expenses are those incurred prior to the raising of agricultural commodities or products in order that the farmer may begin the growing process.⁵⁰³ Such expenses (typically clearing land, leveling and conditioning land, planting trees and building irrigation systems) may not be deducted under section 162, but must be capitalized.⁵⁰⁴ Developmental expenditures are incurred by the taxpayer so that the growing process, once commenced, may continue in the desired manner.⁵⁰⁵ These expenses correspond to start-up costs in other areas. Such expenditures are said to have both capital and business or ordinary natures: they are ordinary in that they are similar to the expenses required to maintain or keep up the agricultural items (*e.g.*, trees or livestock) once they become productive; at the same time they might be considered as part of, and directly related to, the cost of acquiring a producing agricultural item, and as such display the characteristics of capital outlays.⁵⁰⁶ Because of this dual nature, the Service has long permitted taxpayers the option of currently deducting or capitalizing such developmental expenditures⁵⁰⁷—purely capital expenditures cannot be deducted during the developmental period and after the productive stage is reached, such upkeep or maintenance expenditures must be currently deducted.⁵⁰⁸ The policy supporting an election during the developmental period is apparently to enable farmers who have no outside income to capitalize such expenses rather than creating net operating losses which might expire prior to earning offsetable taxable income.⁵⁰⁹ The productive state is reached when the farm becomes a full-fledged operating business—generally when crops

⁵⁰² See DICKINSON, FARM AND RANCH EXPENSES AND CREDITS, BNA TAX MANAGEMENT PORTFOLIO No. 208, A-8 (1969); Comment, *Deductible Development and Conservation Expenditures for Farmers*, 7 HOUSTON L. REV. 277, 236 (1969).

⁵⁰³ Robert L. Maple, 27 T.C.M. 944, 950 (1968), *aff'd*, 440 F.2d 1055 (9th Cir. 1971). In *Maple* the Commissioner argued that preparatory expenses are "initial nonrecurring, basic, one-shot expenses or an expense that is capital in nature or is a component of the cost of acquiring a complete capital asset."

⁵⁰⁴ Min. 6030, 1946-2 C.B. 45, 46, *declared obsolete* in Rev. Rul. 67-123, 1967-1 C.B. 383, 386; IRS, U.S. TREASURY DEP'T, PUBLICATION No. 225 FARMER'S TAX GUIDE 27 (1973).

⁵⁰⁵ Robert L. Maple, 27 T.C.M. 944 (1968).

⁵⁰⁶ *Maple v. Comm'r*, 440 F.2d 1055, 1056-57 (9th Cir. 1971); Richard R. Wilbur, 43 T.C. 322, 328 (1964).

⁵⁰⁷ See Reg. § 1.162-12; *Maple v. Comm'r*, 440 F.2d 1055 (9th Cir. 1971).

⁵⁰⁸ *Whitman v. United States*, 248 F. Supp. 845, 852 (W.D. La. 1965).

⁵⁰⁹ *Ashworth v. United States*, 71-2 U.S.T.C. ¶ 9710, at 87,757 (S.D. Ill. 1971).

are sold in commercial quantities or in the case of livestock when the herd has reached the size considered minimal for profit, regardless of whether a profit is actually realized.⁵¹⁰ Expenses identical with developmental expenditures must be expensed in this stage, the option to capitalize is lost.

The *Farmer's Tax Guide*, a publication of the Internal Revenue Service, abandoned the above long-standing nomenclature in 1968 and now refers to the preproductive, a combination of the preparatory and developmental stages, and productive periods, and denominates former "preparatory costs" as "preparatory and development costs."⁵¹¹ The *Guide* continues to provide that in the preproductive period ordinary and necessary business expenses, such as upkeep expenses, irrigation, fertilizer and cultivation of trees, may at the option of the taxpayer be deducted or capitalized. In short, expenses formerly described as developmental expenses still can be currently deducted or capitalized prior to commencement of the productive period.⁵¹²

Because *Miner's* "preparatory to actual beginning of business operations" phraseology was virtually identical with the pre-1967 farm accounting term "preparatory state," some courts and commentators thought they were synonymous.⁵¹³ This conclusion was erroneous.

The Ninth Circuit in *Maple v. Commissioner*⁵¹⁴ rejected the very analogy drawn in *Miner* on the basis of these farm tax accounting principles. There the Commissioner leveled the following capitalization argument:

Expenses incurred prior to production are capital in nature if they are necessary to make productive the item involved. The Commissioner suggests that if a man wishes to produce shoes, he can buy a shoe factory or he can build one. The cost of getting ready to begin the

⁵¹⁰ Compare *Whitman v. United States*, 248 F. Supp. 845 (W.D. La. 1965), with Comment, *Deductible Development and Conservation Expenditures for Farmers*, 7 HOUSTON L. REV. 227, 236-37 (1969).

⁵¹¹ DICKINSON, FARM AND RANCH EXPENSES, AND CREDITS, BNA TAX MANAGEMENT PORTFOLIO No. 208, A-9 (1969); 1973 IRS, U.S. TREASURY DEP'T, PUBLICATION No. 225 FARMER'S TAX GUIDE 27 (1973).

⁵¹² One commentator has questioned whether these changes signify the abandonment of the case law "preparatory period." DICKINSON, note 511 *supra* at A-10. It is more likely that the changes were intended to circumvent the defenses to such doctrine which had been raised by cases such as *Whitman*.

⁵¹³ See *Whitman v. United States*, 248 F. Supp. 845, 854 (W.D. La. 1965); *Cenac v. United States*, 67-2 U.S.T.C. ¶ 9576 (E.D. La. 1966). See generally Young, *The Role of Motive in Evaluating Tax Sheltered Investments*, 22 TAX LAWYER 275, 298 (1969); Allington, *Farming as a Tax Shelter* 14 S.D. L. REV. 181, 205 (1969).

⁵¹⁴ 440 F.2d 1055 (9th Cir. 1971).

manufacture of shoes, however, must be capitalized whether that cost is embodied in the cost of building a factory or in the price paid for one that is already built.⁵¹⁵

In short, the government argued that under the amassing of capital assets theory, a farmer, or in that particular case an orchard grower, has to capitalize his costs in acquiring his ultimately income producing assets. *Maple* rejected this argument, earlier adopted by *Miner*.

The Commissioner is right about shoemakers. *But shoemakers and farmers are not treated in parallel ways by the code and by the regulations. The cost of developing orchards, farms, or ranches, even prior to the time when they are productive, may often be deducted rather than capitalized, even though analogous development costs in other industries would have to be capitalized (See Income Tax Regulations § 1.162-12; Estate of Richard R. Wilbur (1964) 43 T.C. 22.)* In the field of agriculture the manner in which the expense was incurred will often determine whether it is a capital expenditure or a business expense. If a dairy farmer buys his cows fully mature, he must capitalize their purchase price; if he buys them as calves, he may deduct the cost of raising them to maturity, even though that expense is as much a cost of obtaining an income-producing business as is the purchase of the mature cows. We must analyze the precise path the taxpayer-farmer actually took and we must ask whether the expense in question was purely capital in nature or fell within what the Tax Court has termed the "band of grey" between capital and business expenses that exists only in agriculture. (Estate of Richard R. Wilbur, *supra* at 328.)

*The band of grey exists because many of the costs of running a producing farm are identical to the costs of creating a producing farm. A farmer feeds his mature cows to obtain continued milk production; he gives the same feed to his calves to bring them to maturity. A strictly logical distinction can, of course, be drawn between these two expenditures based upon difference in their purposes, but the tax law does not distinguish them. Expenses of maintaining agriculture items in the preproductive state are deductible if they are sufficiently similar to the expenses that will be required to maintain them once they are productive. (See Estate of Richard R. Wilbur, *supra*.)*⁵¹⁶

Thus, the conceptual underpinning of *Miner* and its progeny is in error. Furthermore, since expenses such as feed and depreciation incurred in building up a herd by the natural increase method are identical to those which will be incurred when the herd reaches the projected size at which it is expected to be profitable, they qualify as developmental expenditures currently deductible at the taxpayer's option. It should be no surprise,

⁵¹⁵ *Maple v. Comm'r*, 440 F.2d 1055, 1056 (9th Cir. 1971).

⁵¹⁶ *Id.* at 1056-57 (emphasis added).

therefore, that when the government subsequently relied upon the *Miner* amassing of capital assets rationale in *Whitman v. United States*,⁵¹⁷ which carefully considered the farm accounting rules, the district court noted that while it felt that the conclusion in *Miner* remained open to debate, the taxpayer's beef raising activities had passed the preparatory stage and "were firmly entrenched in the development stage." The taxpayer in *Whitman* clearly utilized in large part the natural increase method: he began with six cows in 1959, had 55 cattle at trial in 1965 and intended to build the herd up to 120 to 160 head by 1967 or 1968.

The Tax Court again in *Loy D. Mercer*⁵¹⁸ held that the taxpayer, who owned six head of cattle and estimated that a herd of 150 was necessary for profit, was at most preparing to go into the beef raising business if and when he obtained land of his own and capital for improvements. The Ninth Circuit, which subsequently decided *Maple*, did not agree.

It seems clear from a reading of the opinion of the Tax Court that its decision was in essence a conclusion that the taxpayer's venture was not aimed at profit because a reasonable man would not expect a profit from such a venture, and that while he might in the future get into such a business, he had not yet done so in the years in question. . . .

Here the taxpayer entered into a venture with a good faith expectation of profit. Whether that expectation was foolhardy or shrewd is of no moment. The taxpayer expended his effort and capital to the limit of his available time and resources. There can be no conclusion other than that the taxpayer's venture, though small in results, was a trade or business. . . .⁵¹⁹

Miner also contained a theme that some decisions treated as part of the profit motivation requirement and others as part of the preparatory to beginning a trade or business requirement. The Tax Court found that the taxpayer had no profit motive, because he was "fully aware that he could not, conceivably have realized a profit from those beef-raising activities in which he was actually engaged. Nor could he have had even an expectation of a profit for at least 3 years after the last of the taxable year."⁵²⁰ The unarticulated premise was that activities must be directed towards making a profit in the reasonably near future to be profit motivated.

⁵¹⁷ 248 F. Supp. 845, 854 (W.D. La. 1965).

⁵¹⁸ 25 T.C.M. 467 (1966), *rev'd*, 376 F.2d 708 (9th Cir. 1967).

⁵¹⁹ *Mercer v. Comm'r*, 376 F.2d 708, 710-11 (9th Cir. 1967).

⁵²⁰ *Edwin H. Miner*, 21 T.C.M. 1173, 1177 (1962).

This premise was clearly exposed in *Harold I. Snyder*,⁵²¹ a subsequent hobby loss preparatory decision. *Snyder* acknowledged that the taxpayer's intent to carry on the activity with the hope and expectation of making a profit is of prime importance, but added that the taxpayer's effort must be directed toward the accomplishment of that purpose in the reasonably near future. While the court did not expect livestock breeding to show a profit overnight, it thought that "there must be some expectation at the time the operation is commenced that the business will produce a profit in the not too remote future." The conclusion reached was that the taxpayer lacked a profit motive and the operations at best were more in the nature of preparing to enter a business rather than the conduct of a business.

The district court in *Riddle v. United States*⁵²² also clearly viewed this approach as an element of the preparatory to engaging in a trade or business concept: "whether [the taxpayer] was primarily or predominantly concerned with making a profit during the immediate tax year or making a profit at some time in the future, is the ultimate issue." If the latter, then the activity would constitute mere preparation for engaging anew in or for resuming a trade or business.

Judge Pierce, the trier of fact in *Miner*, later elaborated in *Charles A. Dun Leavey*⁵²³ on the other hand that the requisite present intention to earn a profit is not satisfied by a mere hope that at some indefinite time in the future the activity will yield a profit. The court found it perfectly evident that the taxpayer in the tax year had no present intention, hope or expectation to realize a profit in that year.

Thus, the requirement that a profit not be too remote, or in its extreme form that a profit must be expected in the tax year, is tied into the preparatory theory in some cases and into profit intention in others. It is submitted that this requirement is in error in both instances. As the court pointed out in *Cenac v. United States*,⁵²⁴ as long as a farm is in the preparatory stage it is not a business even though being prepared primarily to be an activity for profit. Once it has been prepared for operation and is in the developmental stage it may be considered a busi-

⁵²¹ 25 T.C.M. 1326 (1966). See generally DICKINSON, FARM AND RANCH LOSSES, BNA TAX MANAGEMENT PORTFOLIO No. 241, A-23 (1970).

⁵²² 205 F. Supp. 357, 360 (D. Colo. 1962).

⁵²³ 24 T.C.M. 865 (1965).

⁵²⁴ 67-2 U.S.T.C. ¶ 9576, at 84,875 (E.D. La. 1966).

ness, although not yet productive. The expectation of profit, however, indeed can be only an "expectation of making a profit out of [the] activities once they . . . reach the productive period."

Similarly, the widespread recognition of the formative or start-up period, which may last 10 to 15 years in a livestock breeding operation, as an exception to the factor of continued losses in determining profit motivation effectively limits or even negates any requirement that profit must be obtained in the reasonably near future. Furthermore, the belief that a mere hope for a profit in the indefinite future is not sufficient is clearly based on a reasonable expectation of profit approach, precluded in the application of section 183. For instance, in *Hicks v. United States*,⁵²⁵ the government requested that the jury be charged: "The plaintiff's expectation of profit must have been reasonable. A vain hope that on some remote day a profit will result is not enough to make the operation of a farm a business." The judge refused to give the instruction because he was of the opinion that "it is a question of good faith and a bona fide expectation of making a profit that is controlling."⁵²⁶

It may be noted that *Miner* and many of its progeny could easily have been decided on traditional profit motivation grounds. This is clearly evidenced, for example, by *Edward R. Godfrey*,⁵²⁷ decided several months after *Miner* by the same judge on virtually identical facts and with almost word for word reasoning. After going through a preparatory for future entry into a cattle raising business analysis, the Tax Court concluded that the taxpayer's primary purpose in buying the farm as a whole was not to establish a profitable business, but rather "to gratify his desire to establish a substantial country estate."⁵²⁸ The Sixth Circuit affirmed on precisely this ground.

In summary, once a farm activity reaches the stage that its expenses are of the same character as those currently deductible when the farm is productive and profitable—classic start-up costs—the Commissioner cannot in the face of existing farm tax accounting rules successfully capitalize such expenditures as prepara-

⁵²⁵ 72-1 U.S.T.C. ¶ 9383, at 84,324-325 (S.D. Miss. 1972); accord, *Brooks v. Comm'r*, 274 F.2d 96, 99 (9th Cir. 1959) (Tax Court ruled testimony of prospective monetary gain was "hope" and not based on fact; Ninth Circuit reversed because proper test is good faith purpose or belief of making a profit).

⁵²⁶ *Hicks v. United States*, 72-1 U.S.T.C. ¶ 9383, at 84,324 (S.D. Miss. 1972).

⁵²⁷ 22 T.C.M. 1 (1963), *aff'd on other grounds*, 335 F.2d 82 (6th Cir. 1964), *cert. denied*, 379 U.S. 966 (1965).

⁵²⁸ *Edward R. Godfrey*, 22 T.C.M. 1, 5 (1963).

tory to engaging in the business of farming. The virtual invitation to the taxpayer in the section 1.183-2(b) of the regulations factor of history of income or losses to rely upon a start-up period defense⁵²⁹ may pose an almost irresistible temptation to the Commissioner to dust off and apply *Miner* and its progeny when that defense is utilized.⁵³⁰ A commentator earlier suggested, however, that in view of the "increasing disenchantment among the courts with what are essentially inaccurate methods of determining income for farmers" the Treasury might "tighten up" the regulations permitting the deduction of the costs of raising breeding livestock.⁵³¹ It has not done so and, instead, with the failure of

⁵²⁹ Moreover, the natural increase method has expressly been sanctioned by the courts. *E.g.*, Joan F.W. Farris, 31 T.C.M. 821 (1972). In several decisions, natural increase was not explicitly considered as a factor although the facts indicate that the livestock herd had increased primarily through that method. *Whitman v. United States*, 248 F. Supp. 845, 847 (W.D. La. 1965); *Mary Ellis Turner*, 23 T.C.M. 1186 (1964); *Rowe B. Metcalf*, 22 T.C.M. 1402 (1963).

⁵³⁰ Indeed, the writer has encountered just such reliance by a revenue agent on *Godfrey* in an audit initially involving only section 183 in which the taxpayer utilized in large part the initial stage factor of the regulations to explain substantial losses. It seemed obvious that the agent had been advised to rely on the preparatory to engaging in a trade or business concept. The agent cited only *Godfrey* in the face of a taxpayer memorandum setting forth many of the farm loss decisions cited previously in this article.

⁵³¹ Allington, *Farming as a Tax Shelter*, 14 S.D.L. REV. 181, 202 (1969). The conclusion of judicial "disenchantment" was derived from (1) the Supreme Court's statement in *United States v. Catto*, 384 U.S. 102, 115 n.23 (1966), that it did not have to determine the correctness of the Treasury's interpretation of the legislative history of the predecessor to section 1231(b)(3) as precluding amendment of the regulations to require cash-basis ranchers to capitalize the costs of raising breeding livestock; and (2) the Tax Court's observation in *George L. Schultz*, 50 T.C. 688 (1968), *aff'd*, 420 F.2d 490 (3d Cir. 1970), that despite the fact that the Commissioner might have painted himself into a corner in permitting cash basis agriculturists to expense the costs of raising farm commodities even though they may be entitled to capital gains on their sale, it would not put him in the same position in other areas where the underlying considerations were different. These cases were viewed as an invitation to tighten up the regulations.

In *Schultz* the taxpayer purchased raw whiskey in bulk to hold for the normal aging period (four years). The divided Tax Court found that his purpose was to purchase four year old bourbon and, therefore, the insurance and storage costs over the four year old whiskey. Accordingly, one commentator has reasoned that *Schultz* lends support to the capitalization of expenses of developing a breeding herd: "the expenses are being incurred to obtain a different asset (breeding animals) than the original property (immature animals)." Allington, *Farming as a Tax Shelter*, 14 S.D.L. REV. 181, 203 (1969). Indeed, the district court in *Ashworth v. United States*, 71-2 U.S.T.C. ¶ 9710 (S.D. Ill. 1971), followed essentially this tack, reasoning that the expenses incurred in order to begin growing orange trees are not development expenses incurred in order to begin growing oranges so that the costs of raising a seedling to the point where it can be transplanted to the orchard must be capitalized. However, *Maple v. Comm'r*, 440 F.2d 1055 (9th Cir. 1971), holds to the contrary. Furthermore, in *Daniel D. Kinley*, 51 T.C. 1000, 1004 (1959), *aff'd*, 70-2 U.S.T.C. ¶ 9462 (2d Cir. 1970), the Tax Court rejected the Commissioner's argument that the taxpayer grew pine trees which were converted into marketable Christmas trees which, through proper care during their growth, matured into marketable trees.

case law to consistently achieve matching of such deductions and future related income, has turned to legislative remedies. The first tack taken, recapture of farm losses under section 1251, is similar to the approach earlier provided for recapture of accelerated depreciation with respect to real estate but only deals with the distortion arising from allowance of ordinary deductions offset only by capital gain income and not with the deferral aspect.⁵³² Yet the deferral aspect alone has been described as the essence of a tax shelter: "the deferral or postponement of tax on current income . . . by accelerating future deductions into the current tax year."⁵³³ The interest free loan from the government in the form of the deferred taxes may be viewed as the investment in the activity generating the tax shelter, so that in many instances the taxpayer is in effect investing the government's tax dollars rather than his own money. This inherent defect in any recapture approach plus the numerous exceptions to section 1251 and the other recapture provisions as well as the ingenuity of taxpayers and their tax and investment advisors in finding shelters, and the recent boom in such shelters, undoubtedly underlies the administration's LAL proposals.

STATUTORY APPROACHES: SECTION 1251

Section 1251 recaptures as ordinary income gain realized upon the disposition of "farm recapture property" to the extent of the balance in a taxpayer farmer's "excess deduction account" (EDA), but does not affect the current deductibility of farm losses.⁵³⁴ Every farmer must maintain such an account unless he elects to use inventories and charge to capital account all expenses properly chargeable thereto, essentially development costs.⁵³⁵ The policy underlying the election is that section 1251 is directed against combining (1) a current ordinary loss for various farm expenditures the Treasury believed were capital in nature, *e.g.*, development expenditures, and (2) capital gain treatment on the sale of the asset to which the expenditure relates.⁵³⁶ Capitalization of such

⁵³² Davenport, *Farm Losses Under the Tax Reform Act of 1969: Kcepin' 'Em Happy Down on the Farm*, 12 B.C. IND. & COM. L. REV. 319, 325 (1971).

⁵³³ TAX REFORM BILL OF 1973, ADMINISTRATION'S PROPOSALS FOR TAX CHANGE WITH TREASURY EXPLANATION, 93D CONG., 1ST SESS. 95 (Comm. Print 1973).

⁵³⁴ I.R.C. §§ 1251(b), 1251(c), and 1251(e)(1). *See* H.R. REP. No. 91-413 (Part 1), 91st Cong., 1st Sess. 66 (1969).

⁵³⁵ I.R.C. § 1251(b)(4); Prop. Reg. § 1.1251-2(d)(3)(iii), 36 Fed. Reg. 25015 (Dec. 28, 1971).

⁵³⁶ H.R. No. 91-413 (Part 1), 91st Cong., 1st Sess. 66 (1969).

expenditures would more nearly match these deductions with their related income and preclude a current ordinary deduction.

Each farmer required to maintain an EDA must increase it each year by an amount equal to his farm net loss; subtractions are made for farm net income, amounts recaptured under section 1251 and deductions from which the farmer did not obtain any tax benefit.⁵³⁷ Derived from a more modest exception designed to exclude from the application of farm loss recapture bona fide farmers who supplemented their farm income with part-time or off-season employment, additions are made to the EDA of an individual and certain subchapter S corporations only if the taxpayer has nonfarm adjusted gross income in excess of \$50,000 and then only to the extent that his farm net loss exceeds \$25,000.⁵³⁸

In a literal sense sections 1251 and 183 cannot overlap since (1) section 1251 does not affect the current deductibility of farm losses and (2) section 183 is equally inapplicable to deductions incurred in a trade or business because that term presupposes a profit motive and farm net loss, without which no additions are made to EDA, and is defined as the amount by which deductions allowed or allowable that are "directly connected with the carrying on of the trade or business of farming" exceed the gross income derived from such trade or business.⁵³⁹ In a practical sense, however, due to the liberal nonfarm adjusted income and farm net loss floors, the Service may seek to apply section 183 in many circumstances in which it would have been satisfied with recapture under section 1251 had it been applicable.⁵⁴⁰ Of course, running the section 183 gauntlet offers no protection against farm loss recapture where these floors are exceeded. Application of section 183 will yield similar but not identical economic results to recapture under section 1251 in limited circumstances. Where tier 3 section 183 deductions are disallowed, the net effect is to reduce the gain which would have been realized upon disposition of property used in the activity had the deduction been allowed, in which case the basis of the asset would have been reduced, thereby

⁵³⁷ I.R.C. § 1251(b).

⁵³⁸ I.R.C. § 1251(b)(2)(B). See Tax Reform Proposals contained in the message from the President of April 21, 1969, and presented by Representatives of the Treasury Department, 91st Cong., 1st Sess. 52 (Comm. Print 1969). These floors render section 1251 highly ineffectual. See Daveuport, *Farm Losses Under the Tax Reform Act of 1969: Keepin' 'Em Happy Down on the Farm*, 12 B.C. IND. & COM. L. REV. 319, 348 (1971).

⁵³⁹ I.R.C. § 1251(e)(2).

⁵⁴⁰ Sang, *Cattle and Hobby Farming, Summer Rentals and Yachts as Shelters*, 31 N.Y.U. INST. (Part 1) 801, 836 (1973).

increasing the gain realized by an equivalent amount. But for the deferral aspect of section 1251, this is the same as allowing an ordinary loss, making a basis adjustment and then later recapturing the amount of gain arising from the basis adjustment as ordinary income. Since tier 2 deductions ordinarily would not be added to basis if disallowed, the similarity breaks down there. A further instance of the uneven results of the various approaches applied to curb or prevent tax shelters, for example, from farming operations, is that successful application of the preparatory to engaging in a trade or business rationale would result in the equivalent of capitalization of what would be tier 2 deductions under section 183, thereby creating rough symmetry with section 1251 but asymmetry with section 183. Section 1251 at best precludes enjoyment of current ordinary deduction with future related income being entitled to capital gains treatment; it does not affect the tax swing arising from deferral of taxes. The LAL does.

LAL PROPOSALS

The LAL is designed to eliminate tax shelters which, through deferral of taxes (possibly equaling or exceeding the amount of the taxpayer's investment), may enable the taxpayer to purchase his investment through an interest free loan of the government's tax dollars. Underlying the LAL is the assumption that matching income with expenses to arrive at a reasonable reflection of annual net income is fundamental to the federal income tax system. Under this view, a current expense is deductible in the taxable year paid or incurred because it is necessary to produce that year's income and is usually consumed in the process. On the other hand, capital expenditures preceding the receipt of the income which they produce over a number of years can properly in this model be deducted in the future as the income comes in and the original investment is gradually consumed.⁵⁴¹ Of course, this model is not faithful in all circumstances to the current definition of capital expenditures.⁵⁴² The Treasury would have been more forthright, although possibly with less appeal to Congress, to admit that present law does not require matching deductions with related income, but that a new rule so providing is

⁵⁴¹ TAX REFORM BILL OF 1973, ADMINISTRATION'S PROPOSALS FOR TAX CHANGE WITH TREASURY EXPLANATION, 93D CONG., 1ST SESS. 95 (Comm. Print 1973).

⁵⁴² *Briarcliff Candy Corp. v. Comm'r*, 475 F.2d 775 (2d Cir. 1973).

necessary to eliminate tax deferral. The Treasury hinted at this conclusion in its statement that only with the benefit of hindsight in advance would it be possible to determine whether some costs should be deductible in the current year or in later years, and that such hindsight is not available under the annual accounting principle so that current law provides some degree of flexibility in the timing of deductions.⁵⁴³

Unlike section 183 which disallows the deductions to which it applies, section 1251 which recaptures deductions, and the preparatory to engaging in a trade or business concept under which deductions are capitalized, the LAL defers deductions of individuals and subchapter S corporations. Certainly from the taxpayer's standpoint deferral is preferable to disallowance or capitalization, but not to recapture.⁵⁴⁴ Under the LAL an "artificial accounting loss" is not deductible currently but is suspended through addition of an amount equal to such loss in a "Deferred Loss Account" (DLA). Suspended losses are subtracted from the DLA and taken as deductions in succeeding taxable years against the first net related income (in excess of such year's accelerated deductions) or taken into account upon the sale or other disposition of the property to which the deferred loss is attributable.⁵⁴⁵ In the case of a sale or other disposition of such property in which the proceeds do not constitute related income, as would be the case with capital gain, the net balance in the DLA attributable to such property is subtracted from it and added to the adjusted basis of the property.⁵⁴⁶ Such addition would balance out for example earlier negative basis adjustments made with respect to depreciation deductions which were deferred.

An artificial accounting loss is the amount by which accelerated deductions for the taxable year exceed associated net related income for that year.⁵⁴⁷ The former is the heart of the LAL, but the latter determines the severity of its impact on various classes of investments.⁵⁴⁸ An accelerated deduction is broadly defined as

⁵⁴³ TAX REFORM BILL OF 1973, ADMINISTRATION'S PROPOSALS FOR TAX CHANGE WITH TREASURY EXPLANATION, 93D CONG., 1ST SESS. 96 (Comm. Print 1973).

⁵⁴⁴ Feinschreiber, *1973 Tax Reform: The Administration's Proposals*, 51 TAXES 393, 399 (1973).

⁵⁴⁵ TAX REFORM BILL OF 1973, ADMINISTRATION'S PROPOSALS FOR TAX CHANGE WITH TREASURY EXPLANATION, 93D CONG., 1ST SESS. 97 (Comm. Print 1973).

⁵⁴⁶ *Id.* at 97, 102.

⁵⁴⁷ *Id.* at 96-97.

⁵⁴⁸ Feinschreiber, *1973 Tax Reform: The Administration's Proposals*, 51 TAXES 393, 399 (1973). The LAL has been described as too lenient in this context as to taxpayers engaged full time in activities for which special tax preferences have been provided. Mc-

one that clearly relates to some future expected profit and has little or no relationship to income reported in the current year—the similarity to preparatory expenses is obvious. The Treasury has provided illustrations of accelerated deductions and others are to be specifically identified from time to time in the regulations:

- (1) Intangible drilling and development costs,
- (2) Accelerated depreciation or amortization in excess of straight line in the case of net leased personal property, *e.g.*, equipment leasing shelters,
- (3) Accelerated depreciation in excess of straight line in the case of improved real estate held for rental or sale and, similarly, amortization in excess of straight line in the case of rehabilitation housing,
- (4) Construction period preopening costs as to improved real estate held for rental or sale, and
- (5) In the area of farm losses, prepaid feed and expenditures traditionally denominated development costs—to avoid this terminology the Treasury awkwardly describes this category as expenses relative to crops or livestock that will not produce income until a future time, which are annually recurring and often in the nature of inventories.⁵⁴⁹

Under the dubious rationale that only the net increase in accelerated deductions can create a loss distortion, an exception is carved out purportedly for the ordinary farmer—the analogue of the section 1251 floors—by providing that the LAL is applicable to farm losses only if there has been an increase in the level of operations or investments in the nature of inventories, *i.e.*, development expenditures. Thus, farming substantially the same acreage without a major change in the nature of the operation is ordinarily to be accepted on audit as evidence that any losses are not artificial. However, an abnormally large and material expenditure in the nature of an accelerated deduction is treated as an exception to the no increase exception, but with a safe haven for development costs up to a 20 per cent variation from the prior year's expenditures of the same nature, and greater variations may be justified by the facts and circumstances.⁵⁵⁰

Daniel, *Tax Reform and the Revenue Act of 1971: Lesions, Lagniappes and Lessons*, 14 B.C. IND. & COM. L. REV. 813, 857 (1973).

⁵⁴⁹ TAX REFORM BILL OF 1973, ADMINISTRATION'S PROPOSALS FOR TAX CHANGE WITH TREASURY EXPLANATION, 93D CONG., 1ST SESS. 97-100 (Comm. Print 1973).

⁵⁵⁰ *Id.* at 100.

Associated net related income is computed without regard to accelerated deductions, which are then allowed up to the amount of such net income with only the excess being deferred. The net effect is identical to the tier system under section 183—non-accelerated deductions in effect are first allowed against associated gross related income and then accelerated deductions are treated in effect as tier 2 and 3 deductions allowable up to the remaining amount of gross income. But here the analogue of the scope of the section 183 activity issue is even more significant.⁵⁵¹ Unlike the activity portion of the section 183 regulations, the scope of related income is overtly articulated in terms of the underlying tax policy towards providing particular accelerated deductions as incentives and thus varies from accelerated deduction to deduction. Accordingly, in recognition of the current tax policy of providing incentives for oil and gas drilling, related income in the context of intangible drilling costs includes mineral income from all oil and gas properties. Furthermore, any artificial loss attributable to a dry hole is allowable in full against any category of income.⁵⁵² Similarly, reflecting the more favorable accelerated depreciation rates currently allowed residential rental property as defined in section 167(j)(2)(B) and property held primarily for sale, the class of related income here is broad, including both rental income from all residential real estate and sales income from real property held primarily for sale.⁵⁵³ A partner or subchapter S corporation shareholder is entitled to treat his undistributed share of a partnership or corporate LAL item, respectively, as if he owned a comparable interest in the partnership or corporate property outright.⁵⁵⁴ Conversely, related income from nonresidential real property and net leased personal property, which does not enjoy equal accelerated depreciation rates includes only the rental income from the particular property to which the accelerated deductions are attributable.⁵⁵⁵ Again the Treasury pursued a liberal tack as to accelerated farm losses: Income from all farming units in which the taxpayer is personally engaged as a trade or business as distinguished from units in

⁵⁵¹ *Id.* at 97.

⁵⁵² *Id.* at 98.

⁵⁵³ *Id.* at 99.

⁵⁵⁴ *Id.* at 104.

⁵⁵⁵ *Id.* at 99. Generally each building is treated as a separate property, but one or more buildings on a single (or continuous) tract or parcel managed and operated as a unit are treated as a single property.

which he is a passive investor constitutes a single class.⁵⁵⁶ The distinction here is between the bona fide farmer and the investor—a distinction which will probably prove hard to draw in actual practice.⁵⁵⁷

Perhaps the most significant aspect of the liberal categories of related income is the opportunity it offers for pyramiding—sheltering taxable income from a tax shelter that has turned around, begun to generate taxable income rather than tax losses, with a new tax shelter, committed for after the effective date of the LAL. Before the LAL was proposed pyramiding was often the only acceptable solution to the tax problems inherent in a shelter which has turned around,⁵⁵⁸ and if the LAL is enacted as proposed in years to come undoubtedly there will be a booming market in second, related income tax shelters.

The Secretary of the Treasury noted that the LAL permits a taxpayer to shelter income from the investment itself, thereby leaving a substantial area in which tax incentives may operate. He was obviously referring to tax-free cash flow, which in the context of rental real estate consists of net rental income from an activity, in excess of operating costs and debt amortization, sheltered by either the accelerated depreciation or a combination of the straight line and accelerated components of the total depreciation allowable with respect to the activity. Thus, the Secretary continued, a taxpayer may still buy investments that yield tax-free income for substantial periods, but he must use his own money, rather than tax dollars, to purchase them.⁵⁵⁹

The thrust of the complex effective dates in the administration proposal, which are very likely to be pushed to later dates in any final legislation, is to leave unaffected presently existing tax shelters or those for which commitments have been made, reflecting a policy choice not to disturb investments made in reliance upon existing law.⁵⁶⁰ Thus, by and large, the LAL as presently proposed would be applicable to taxable years beginning after December 31, 1973, but even then only as to transactions entered into or commitments made after April 30, 1973. Thus, depreciation or amortization arising from real estate and equipment leas-

⁵⁵⁶ *Id.* at 100.

⁵⁵⁷ *See, e.g.,* *Maple v. Comm'r*, 440 F.2d 1055 (9th Cir. 1971).

⁵⁵⁸ *See* Ehrenkranz, *The "Investment" Limited Partnership (Other Than Real Estate): Problems and Potentials*, 26 N.Y.U. INST. 147, 165 (1968).

⁵⁵⁹ TAX REFORM BILL OF 1973, ADMINISTRATION'S PROPOSALS FOR TAX CHANGE WITH TREASURY EXPLANATION, 93D CONG., 1ST SESS. 15 (Comm. Print 1973).

⁵⁶⁰ *Id.* at 17; *cf. id.* at 75.

ing (net leased personal property) tax shelters will never be affected by the LAL if acquired, constructed or leased prior to May 1, 1973 or thereafter but pursuant to a commitment that was binding on April 30, 1973. A similar exclusion is provided for intangible drilling costs paid or incurred prior to the effective date, but it will not have the long lasting effect that the existing real estate tax shelter exclusion will have.⁵⁶¹ On the surface, the exclusion for existing farm tax shelters appears more limited than, for example, that provided for real estate. The specific effective date discussion excludes only costs paid or incurred prior to May 1, 1973, or thereafter but committed for on April 30, 1973. The closer parallel would have been to exclude development costs for crops or livestock acquired prior to the effective date. In reality, however, the no increase rule will in most instances be the vehicle by which taxpayers owning existing farm tax shelters (other than one-shot, prepaid feed shelters) will continue to be excluded from the LAL, in many instances longer than a real estate tax shelter would be able to benefit from the exclusion—most real estate tax shelters run around in six to ten years, while breeding herds commonly remain in a start-up stage for ten to 15 years. In this context, unlike the articulated rationale that only a net increase in accelerated deductions creates a loss distortion, the no increase rule is workable and justifiable. Ironically, the intended policy underlying the no increase rule—to provide an exception for the ordinary farmer⁵⁶²—would have been better met by providing a floor for accelerated deductions or on non-related income to enable a new ordinary farmer to enter into a farming activity without being affected by the LAL. Undoubtedly, the Treasury's unfortunate experience in the Tax Reform Act of 1969 with the section 1251 floors dissuaded it from following this approach.

The administration's proposals as to the effective date are silent in a very important area: syndications or limited partnerships, the usual vehicle for marketing residential real estate tax shelters. The basic question is whether the effective date applies to the date that the partnership acquired or committed for the construction or purchase of a depreciable asset or construction period preopening expenses or to the date that the investor acquired or committed to acquire his partnership interest. Under the gen-

⁵⁶¹ *Id.* at 102-03.

⁵⁶² *Id.* at 100.

eral rules applicable to taxation of partners and partnerships, the effective date would apply at the partnership level and not at the partner level. Furthermore, under such rules a transferee partner would step into the shoes of his transferor (subject to the termination rule). If this is the case, a premium will be placed on unsold and resale of partnership interests in preeffective date tax shelter partnerships.⁵⁶³

The LAL frequently overlaps with the various recapture provisions and in some circumstances might produce unintended results, unless conforming amendments are added to sections 1250 and 1251 or the LAL itself contains special provisions. Assume that the total amount of the accelerated portion (100M) of the double declining balance depreciation (200M) taken with respect to a parcel of improved residential real property in 1974 constitutes an artificial accounting loss. Thus, 100M would have been added to the DLA in 1974 and the basis of the property would have been reduced by 200M. Assume further than in 1975 while a 100M balance remains in the DLA the property is sold for 200M above basis. Under the current LAL proposals the adjusted basis of the property would be increased by 100M, and 100M subtracted from the DLA, resulting in a gain of 100M.⁵⁶⁴ Under section 1250 this entire gain would be taxed as ordinary income, i.e., recaptured, since additional depreciation (accelerated or recapturable depreciation) is defined in section 1250 as depreciation adjustments in excess of the amount of adjustments that would have resulted if such adjustments had been determined for each year under the straight-line method of depreciation.⁵⁶⁵ Thus, additional depreciation would be 100M (200M total adjustments less 100M adjustments under straight-line method). However, the purpose of section 1250 was to prevent conversion of ordinary income into capital gain by taking depreciation while gain on the sale is treated as capital gain—Congress believed that this occurred when depreciation deductions reduced basis faster than actual decline in the value of the property. But due to the general inflationary increases in the value of improved real estate it limited recapture to “what may truly be called excess depreciation deductions” (depreciation in excess of straight line).⁵⁶⁶ Yet

⁵⁶³ See Rollin & Michi, *Tax Shelters Attacked*, 59 A.B.A.J. 780, 782 (1973).

⁵⁶⁴ TAX REFORM BILL OF 1973, ADMINISTRATION'S PROPOSALS FOR TAX CHANGE WITH TREASURY EXPLANATION, 93D CONG., 1ST SESS. 102 (1973).

⁵⁶⁵ I.R.C. § 1250(b)(1).

⁵⁶⁶ S. REP. NO. 88-830, 88th Cong., 2d Sess. 131-32 (1964).

when the LAL applies, such excess depreciation deductions never offset ordinary income.

Similarly, under section 1251, additions would be made to the EDA for developmental expenses constituting farm net losses in excess of \$25,000 (if the individual taxpayer has nonfarm adjusted income of \$50,000), but if those expenditures were more than 25 per cent in excess of the prior year's developmental expenditures, they would be deferred and added to the DLA under the LAL proposals. If the farm property were sold in the following year for an amount in excess of adjusted basis equal to the sum of the amounts added to the DLA and the EDA, recapture of farm losses would result, although such losses had never been offset against nonfarm income.

One approach to avoid such overlap would be to modify the definition of recapturable losses in the various recapture provisions to exclude losses added to the DLA. This would probably entail extremely cumbersome modifications to cover the partnership back-up provisions (section 751) to the recapture provisions. The simpler approach would be to provide in the LAL itself that where a deferred loss is recaptured, or section 751 applies by virtue of potential recapture, upon the disposition of the property, that it will be allowed as an ordinary deduction rather than being added to basis. This is the approach taken when addition of a deferred loss to basis would result in or increase a capital loss on the disposition.⁵⁶⁷

On a literal plane section 183 and the LAL cannot overlap, just as sections 183 and 1251 cannot. Where deductions turn on a profit motive, the LAL is applicable only if the activity is engaged in for profit, conversely, section 183 applies only if it is not engaged in for a profit. Yet in reality the LAL accomplishes what the Service has long attempted to achieve under the definition of trade or business, either through the profit motive test or other glosses, *i.e.*, matched income and deductions. In an ideal world, the LAL would eliminate the temptation for the Service to attempt utilization of section 183 and the various trade or business definitions to match income and deductions, and section 183 would be limited to activities in which the primary motive was personal or tax reduction without an ultimate before-tax economic profit. But in the real world, we may expect, at least initially, the Service

⁵⁶⁷ TAX REFORM BILL OF 1973, ADMINISTRATION'S PROPOSALS FOR TAX CHANGE WITH TREASURY EXPLANATION, 93D CONG., 1ST SESS. 102 (1973).

will launch alternative attacks relying on section 183, the LAL provisions and the common-law capitalization doctrines, all yielding different results.⁵⁶⁸ Certainly where LAL does not apply (pure hobby loss activities and certain tax deferral situations such as real estate tax shelters in operation prior to the effective date of the LAL, farming tax shelters without an increase in the level of developmental expenditures, real estate where straight-line depreciation results in losses such as dual use beach houses, or the expenses of writers, artists or inventors) section 183 will be invoked frequently even if the LAL is enacted.

Conclusion

A leading commentator on the current farm tax rules has criticized section 183 stringently on the grounds that it does nothing to curb the liberal cash accounting rules accorded farmers. Indeed, the argument continues that the pro-taxpayer presumption of section 183(d) creates a haven for hobby operations, because few cash basis farmers, with their control over deferment or anticipation of expenses and income, will fail to show a profit in two out of five years.⁵⁶⁹ As discussed above, presence of a bona fide profit motive is not, however, inconsistent with deferral of taxes through accelerated deductions, farming or otherwise, or with the tax swing created by enjoyment of current ordinary deductions with corresponding future income being taxed as capital gain. Furthermore, this commentator acknowledges that the House's negative presumption as well as the Treasury's earlier proposal to strengthen section 270 by making it applicable where in three out of five consecutive years the taxpayer incurred losses in excess of \$50,000 annually would have had erratic results and would have applied where there was true economic loss as well as losses created by accelerated deductions.

The real criticism, therefore, must be of the pro-taxpayer presumption. It is submitted that such criticism too is misplaced. While it may be true that the presumption will usually be available where accelerated deductions alone are involved, this is only as it should be. For a profit motive test is inapplicable to accelerated deductions as long as the taxpayer expects an overall

⁵⁶⁸ Compare the alternative sections 269, 482 and 1551 together with sham arguments that the Commissioner launched against multiple surtax exemptions.

⁵⁶⁹ Davenport, *Farm Losses Under the Tax Reform Act of 1969: Keepin' 'Em Happy Down on the Farm*, 12 B.C. IND. & COM. L. REV. 319, 330-33 (1971).

economic profit after completion of the start-up loss period (possibly caused by the accelerated deductions themselves). Furthermore, a survey of the vast body of hobby loss cases, decided in favor of both the government and of the taxpayers, reveals that in only a handful would the presumption have applied. Moreover, in situations not involving accelerated deductions, but where the taxpayer through manipulation of items particularly within his control, such as expenses, has created the requisite two profit years, the Service will undoubtedly find that the presumption is readily rebutted. The *Barcus* case points in this direction. Accordingly, section 183 should properly be viewed as neutral vis-à-vis accelerated deductions, whether farm or otherwise, as long as an economic gain is ultimately expected. Not only should this state of affairs not be disturbing, but also neither the House negative two out of five year presumption nor the Treasury's suggested strengthened section 270, which basically followed the same approach, should be the remedy for either accelerated deductions or the mismatching of ordinary deductions with capital gain. If tax reform is directed primarily at the elimination of such mismatching, then the goal should be a strengthened section 1251 in farming areas and a similar strengthening of the depreciation recapture provisions. On the other hand, if the reform is aimed at deferral aspects as well as the mismatching of capital gain and ordinary losses, then an approach along the lines of the LAL is in order.

The merit of section 183 should, therefore, not be sought in the tax shelter area, instead, it should be sought in clarification of the vast sea of the hobby loss decisions dealing with the different problem of taxpayers' subsidizing with tax dollars their (usually personal) activities in which they never expect an economic profit. Section 183 itself affords relatively little. It resolves a few questions such as the reasonable expectation of profit versus bona fide expectation of profit controversy and possibly the subjective versus objective approach, but its most significant contribution is the more precise mechanism for allowing deductions to the extent of gross income from an activity which is not engaged in for profit, *i.e.*, the tier system. This benefit probably offsets the confusion created by the new concept of activity, really the section 270 separate business revisited.

The section 183 regulations on the other hand, while by and large doing a credible job in explicating the mechanics of the provision (the activity portion is the most controversial), do a truly

commendable job in charting the heretofore boundless sea of cases and isolating the factors establishing profit motive. With minor exceptions set forth above, the nine regulation factors faithfully distill from these cases a framework upon which future decisions can build, particularly if the primary sources—presection 183 cases—are used to add depth to this road map provided in the regulations. If this occurs, this aspect alone should justify the time devoted to the hobby loss area by Congress and subsequently the administration in drafting the regulations.

In addition to the inevitable interstitial development of section 183, a major task remains with the courts: separating and identifying in the cases which come before them the profit motive and tax deferral elements. From this should flow not only the meaning of the term profit, presently undefined by the code or the regulations, but hopefully for the first time a clear distinction between the profit motive test and the melange of concepts such as the continuity, the holding one's self out to others and the preparatory to engaging in a trade or business doctrines. This distinction is vitally necessary as is shown by the tortuous development of case law considering the latter concepts. The sharp exposure by the LAL of the underlying issues here should manifest that neither these doctrines nor the profit motive prerequisite, all derived to one degree or another from the term "trade or business," are suited for dealing with accelerated deductions, *i.e.*, matching of income and expense. Should the LAL be enacted, it is hoped that it and section 183 together with the residual effects of the recapture provisions will come to be the exclusive tools applied to the problems of hobby losses and accelerated deductions, with the various other doctrines, particularly the preparatory to engaging in a trade or business doctrine, falling into the oblivion that they so richly deserve.