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TAX PLANNING FOR THE HOBBY ENTHUSIAST

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In these days of high tax activity in areas such as capital gains, collapsible corporations, estate tax marital deductions, and travel and entertainment expenses, perhaps a look should be taken at an area which heretofore has received relatively little attention. I refer to the tax treatment of secondary businesses, or so-called "hobby losses." Americans enjoy the highest living standard in the history of mankind, and along with that living standard is the ever-increasing amount of leisure time enjoyed by persons in nearly all levels of our society. Booksellers tell us there is a revolution in reading; sports enthusiasts point to the recent booms in skiing and water sports; labor leaders press for shorter work weeks. People are beginning to devote much of this new-found leisure to revenue-raising hobbies, or secondary businesses. For example, many salaried employees enjoy being their own boss in some small enterprise of interest to them, such as a photography shop, and increasing numbers of city-bound executives operate a farm for relaxation and secondary income. Sound tax planning in this area is essential, and, if ignored, could prove to be unnecessarily expensive to the hobby enthusiast.

The basic authority for any "hobby" deductions is the same as for all other so-called business expenses: § 162 of the Internal Revenue Code of 1954.[1] This famous section, of course, permits as deductions the ordinary and necessary expenses incurred in carrying on a trade or business, but just what is a trade or business? It is in drawing this line that the problems arise, since any general definition must necessarily be in general terms. In fact, neither the law nor the regulations attempt any definition.[2] Several court decisions have stated definitions not entirely incompatible,[3] but other principles developed in specific areas are much more important in determi-

[1] INT. REV. CODE OF 1954, § 162(a).

[2] 2 P-H 1961 FED. TAX SERV., ¶ 11,014.

[3] Flint v. Stone Tracey Co., 200 U.S. 107, 171 (1911). Helvering v. Wilmington Trust Co., 124 F.2d 156 (3d Cir. 1941).

ning the allowability of these deductions. For example, it is well settled that a person may carry on more than one trade or business at the same time,[4] and furthermore, the activities giving rise to the deduction need not be in connection with his *principal* trade or business.[5]

The most difficult requirement to prove (and also the one least susceptible to generalization) is that of a profit motive. The question nearly always arises in situations where the activity sustains losses most of the time, and the taxpayer claims these losses as business expenses. The basic case on profit motive is *Doggett* v. *Burnet*,[6] in which appears this oft-quoted statement: "The proper test is not the *reasonableness* of the taxpayer's belief that a profit will be realized, but whether it is entered into and carried on *in good faith* for the purpose of making a profit, or in the belief that a profit can be realized thereon, and that it is not conducted merely for pleasure, exhibition, or social diversion." (Emphasis added.) Miss Doggett spent considerable time publishing and selling the works of a religious prophetess, Joanna Southcott, apparently without much chance for profit. She was, however, allowed a deduction for business loss, since she acted in good faith in reliance upon the expectation of eventual profit. At first glance, the case seems to be weakened by the fact that she spent *all* her time at this one activity, whereas most hobby problems arise when the activity is secondary to a much more lucrative primary business. However, many cases of the latter type cite the *Doggett* case with approval, so that its language must be taken as an established interpretation.[7] This rule has been especially helpful to taxpayers who breed and race thoroughbred horses—a highly speculative operation with much relation to faith and little to reasonableness.

In addition to good faith expectation, courts consider other aspects of motive, including the financial status of the taxpayer apart from the questioned activity. Those with large

[4] L. T. Alverson, 35 BTA 482 (1937).

[5] Ignaz Schwinn, 9 BTA 1304 (1928).

[6] Doggett v. Burnet, 65 F.2d 191, 194 (D.C. Cir. 1933).

[7] *But see* George T. McLean, 60 P-H TAX CT. MEM. 128 for a misinterpretation of the rule.

outside incomes are likely to be indulging in a pure hobby, such as Mr. Chaloner's amatuer authorship attempts in 1932.[8] Mr. Chaloner expended large sums for secretarial work, stationery, etc. over nearly twenty years, never realizing sufficient income from sale of books to cover the expenditures. The court concluded that he would have abandoned his unsuccessful writing career much sooner had he been dependent upon it for a livelihood. Another richly-endowed taxpayer in a similar situation who exercised reasonable business prudence and abandoned his dog-raising enterprise when it proved unsuccessful, was allowed deductions exceeding $10,000 for losses sustained.[9] Thus, a taxpayer's outside wealth tends to cause a closer scrutiny on the part of the Internal Revenue Service, but does not automatically disqualify deductions or losses as mere hobbies.

Another problem involved in the hobby-business distinction is determining when one continuing activity ceases to be a hobby and commences to become a business. One interesting case along this line involved the builder of the famous racing boats "Slo-Mo-Shun."[10] These boats were owned by a corporation whose sole owner had discussed with advisors the profitability of producing racing boats on a commercial basis and decided to follow it through. However, after winning top race awards in the tax years involved, he did nothing more than continue to race his boats and experiment with boat designs. The court concluded that such action was consistent with a hobby, not a business, ruling that in spite of the builder's good faith profit motive (the *Doggett* case rule) the losses were not deductible. The true distinction here lies in the area of a substantial change in the amount of activity carried on. In the above case, there was no substantial change. In others, such as *Helvering* v. *Ackerman*,[11] a substantial increase in the amount invested in the activity, either in terms of money or time, preferably both, will be sufficient to change its status from hobby to business.

[8] John A. Chaloner, 69 F.2d 531 (D.C. Cir. 1934).

[9] Helvering v. Ackerman, 71 F.2d 586 (9th Cir. 1935).

[10] American Properties, Inc. v. Comm., 262 F.2d 150 (9th Cir. 1958).

[11] 71 F.2d 586 (9th Cir. 1935), dog raising.

One further aspect of hobbies should be examined at this point. This aspect was first expressly mentioned (though doubtless implied for many years) in 1960. An enterprising attorney and his wife took a world trip for the multiple purposes of: (1) acquiring information to be used in a book on world travel, (2) seeing their son and his new bride in Japan, and (3) enjoying world travel generally. He claimed of course that he intended in good faith to make a profit from engaging in the business of writing. The court's ruling was, however, that in addition to good faith, "there must either have been some prior activity on the part of the taxpayer in this field of endeavor or there must be an intention to devote at least a part of their time and efforts in the future to writing."[12] Thus, a "business" cannot be a "one-shot affair," so to speak, under § 162(a).

The same case raises an interesting point which has received astonishingly little attention. The court specifically mentions § 162(a) in its opinion, but omits any discussion whatever of § 212(1) or (2). The latter section provides, among other things, for a deduction of all "ordinary and necessary expenses paid or incurred . . . for the production or collection of income or for the management, conservation, or maintenance of property held for the production of income." Was Mr. Wright in the above case taking his trip for the production or collection of income, conceding the fact that it was not a business? The regulations indicate that if his trip was *primarily* for recreation or hobby purposes, no deduction would be allowed, and that in determining this fact consideration would be given to the taxpayer's prior gain or loss in the activity (no activity by Mr. Wright), the relation between the activity and his principal occupation (attorney), and the uses to which the property was put.[13] While a loose interpretation of the language of the statute would lead one to believe that there were three degrees of activity—business, production or collection of income, and hobby—the regulations effectively refute this possibility by setting up substantially the same criteria as the courts have set up under § 162(a). In fact, the

[12] Kerns Wright v. Comm., 274 F.2d 883 (6th Cir. 1960).

[13] Treas. Reg. § 1.212-1(c) (1957).

courts never seem to make a clear distinction in hobby cases as to which section of the law they are referring.

The immediate conclusion, then, is that there is no distinction here. A hobby under § 162(a) is always a hobby under § 212 and vice versa. Since the point has not been raised, it would certainly be worth an argument in the future in a case similar to the *Kerns Wright* case. Still a third section of the Code relates to hobbies from substantially the same viewpoint—§ 165(c), concerning losses not compensated by insurance. The losses are again limited, as to individuals, to those incurred in a trade or business, and a trade or business is again interpreted in the same manner.

By far the most popular hobby that has come under close scrutiny by the Internal Revenue Service has been farming. The "gentleman farmer" is in evidence throughout the country; the most well-known area currently being the famous "hunt country" of northern Virginia brought into the news by President and Mrs. Kennedy. Farms may be operated as either a business or a hobby, just as may many other enterprises, but a few special rules concerning them have developed. In the first place, farming for pleasure is the only specific hobby to become the subject of a Treasury Regulation.[14] § 1.162-12 points out that if the farm is operated as a hobby and expenses exceed receipts, the receipts may be ignored in the income statement, and the expenses will not be deductible. Nothing is said concerning the situation in which the farm is operated as a hobby and receipts exceed expenditures. Are all the receipts taxable, the deduction for expenses not being allowed, or are only the net receipts taxed? Since the former would amount to a gross receipts tax and not a net income tax, the obvious result is that only the net income would be taxable. Obvious or not, nothing is mentioned in the Code, Regulations, or Rulings on the matter. Concerning hobbies other than farms, there is no statement whatever covering the possible situations above, only the situation where net losses are not deductible. Presumably, however, the same rules apply. Therefore where receipts exceed expenditures, the activity is

[14] Treas. Reg. § 1.165-6(2) and (3) (1960). Treas. Reg. § 1.162-12 (1958).

taxed as a business whether it would be one for loss deduction purposes or not. Such treatment is only fair.

Secondly the courts and the Internal Revenue Service pay close attention as to whether the taxpayer uses his farm for entertaining, social diversion, or exhibition. If so, it is likely to be considered a hobby[15] and has been so held in the case of a taxpayer who made large expenditures for plants, bushes, and other objects for landscaping beauty,[16] since such acts indicate a pleasure motive. It is proper, however, for the farm to serve several purposes, such as a residence and location of the taxpayer's manufacturing business,[17] so long as they are not inconsistent with the operation of the farm as a business also.

In summary, the question of whether a given activity is conducted tax-wise as a hobby or a business is a question of fact to be determined with reference to the particular circumstances. The basic requirement is to show that the activity was undertaken primarily for profit. The mere fact that losses have been incurred over a number of years is not of itself determinative, nor is the fact that the taxpayer conducts more than one business, or that he derives pleasure from it, provided the taxpayer in good faith reasonably expects a profit in the future. Other circumstances to be considered include the taxpayer's financial situation, whether or not he exercised reasonable judgment consistent with a profit motive, and whether or not the activity is of a recurring nature. The taxpayer's own testimony as to his profit motive is admissible, but it is not conclusive. Apparently these considerations are the same under three different Code sections—business expenses § 162(a), losses § 165(c), and expenses for the production of income § 212—but the possibility of a different criterion under 212 has not been raised. Such an argument may prove successful in the non-recurring type of case.

For the imaginative taxpayer who not only derives pleasure from his hobby, but also from obtaining the maximum ad-

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[15] G.C.M. 21103, 1939-1 Cum. Bul. 164.

[16] Lewis Greenspon, 23 TC 138 (1954).

[17] 59 P-H TAX CT. MEM. 143 (1959).

vantage from all his activities, business-wise and tax-wise, the possibility of pursuing his hobby on a commercial basis in corporate form should be considered. Such a course involves many business ramifications beyond the scope of this paper and a few tax pitfalls. These reasons probably account for the fact that seldom is any activity incorporated that is limited enough to approach the border line between hobby and business. In certain circumstances, however, the corporate form may have a distinct advantage. For example, the mere fact of incorporation would seem to serve as evidence of a business motive as opposed to personal pleasure. One does not incorporate activities without considerable thought, so that while incorporation would clearly not be conclusive of a profit motive, it should be considered as evidence. This point has not been raised with respect to hobby cases. But incorporation may have the opposite effect should the Internal Revenue Service take the position that incorporation is simply a tax dodge to permit deduction of what would otherwise be personal expenses. The ultimate issue would still be the same as with individual activity: was the activity undertaken with profit as the primary motive? The revolutionary theory of looking behind the form of transactions to the real substance was established in the famous case of *Gregory* v. *Helvering*, which involved a subsidiary corporation organized to avoid taxes on liquidating dividends, but which met all the legal requirements of a statutory reorganization. The Supreme Court held that it was a mere device brought into existence for no purpose other than to transfer the stock in a tax-free manner. "To hold otherwise would be to exalt artifice above reality."[18]

The sham versus substance idea in corporations was then applied in areas other than reorganizations, including the case of sole stockholder corporations where there was no new business purpose dissociated from the taxpayer as such. A sole shareholder of a personal holding company was disallowed a loss on a sale to the corporation, the court saying that the *Gregory* case "gives support to the natural conclusion that transactions which do not vary, control, or change the flow of

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[18] 293 U.S. 465 (1935).

economic benefits are to be dismissed from consideration."[19] The mere fact that one of the objects of the move is to avoid or reduce taxes will not make the whole transaction a sham. It is the absence of a business motive which brings about the piercing of the corporate veil.[20] An analysis of the cases shows that a business purpose is nearly always present when the corporation continues in operation for a long time and actually conducts business of some sort.[21] Problems most frequently arise with short-lived corporations performing one or two operations only and with holding companies receiving investment income only.

Of course, with reference to hobbies, sham versus substance could create problems for someone carrying on activities which were *obviously* hobbies. As a tax scheme one might incorporate the hobby which, when accounted for on an economic basis, would almost certainly lose money each year. As a result, the value of the stock in the corporation would depreciate in value until it finally became worthless. At that point, upon a sale of the stock, a loss would be realized. There being no business by hypothesis, an easy analogy to the *Gregory* doctrine can be made, attributing all the loss to the individual, sole shareholder, and thereby bringing the case back within the limitations of § 165(c).

If the *Gregory* doctrine were the only consideration adverse to incorporation of the secondary activity, then one could simply apply the nothing-ventured, nothing-gained maxim and merrily incorporate. *Gregory's* application simply puts the taxpayer back in his former position, tax-wise, that is, an individual with a disallowed hobby loss. But in certain circumstances conducting a hobby-type business in corporate form not only might result in disallowance of the losses by the corporation and by the individual, but also might result in taxation as income to the individual of all expenditures in the hobby operation by the corporation! The *American Properties* case,[21a] is a case in point, where the net loss resulting from

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19 Higgins v. Smith, 308 U.S. 473 (1940).

20 Chisholm v. Comm. 79 F.2d 14 (2d Cir. 1935).

21 Humphreys v. Comm. 88 F.2d 430 (2d Cir. 1937).

21a *Supra* note 10.

racing boat operations was disallowed to both the corporation and its sole shareholder, and taxed as a dividend paid to the owner. The theory relied upon was the well-settled doctrine that payments made by a corporation for the personal benefit of its controlling owner are in effect distributions to him. The doctrine formerly was developed in tax evasion cases, such as *Davis* v. *U. S.*,[22a] where checks payable to the corporation were cashed and concealed and were actually being used by the dominant shareholder for personal purposes, and in ordinary and necessary business expenses cases, such as *Louis Greenspon*,[22a] where a pipe-laying corporation made large expenditures for landscaping the dominant shareholder's farm, which he used allegedly for entertainment of customers. In each of those cases, the corporate expenditures were held to constitute taxable income to the shareholder. A comparison of the situations reveals one interesting difference. In the *Greenspon* case, the payments were termed constructive dividends, paid out of surplus of the corporation. *American Properties* followed this analogy. But the *Davis* case based its conclusion on the broader theory that it was not necessary for the payment to be made out of surplus (there was not sufficient surplus in Davis' corporation to cover his illegal concealments), because the proper bases of taxation were the "command over property and the enjoyment of its economic benefit." In fact, he derived sufficient economic value even where creditors of the corporation could have set aside the payments as in fraud of them, so that his title to the money was defeasible. The cases are distinguishable in that *Davis* was a criminal prosecution for tax evasion while *Greenspon* was a deficiency assessment only, with no fraud involved. The *American Properties* case further confuses the issue with respect to hobbies by citing *Davis* with approval but then limiting its decision by citing *Greenspon*, and showing that the corporation had sufficient surplus to cover the expenses of the racing boats. What then would be the result in the case of a taxpayer who owns or controls a corporation with no accumulated earnings, where the corporation expends funds for the personal hobby of the individual taxpayer? Would the expenditures be taxable, following the *Davis* case, or would they be a mere return of

22 226 F.2d 331 (6 Cir. 1955).

22a *Supra* note 16.

capital to the shareholder, resulting in a reduction of the basis of his stock? The Internal Revenue Service raised this very question in 1957 in *Simon* v. *Comm.*[23] where the court determined the issue in favor of the taxpayer. *Davis* and a subsequent criminal case, *Bernstein* v. *U. S.*,[24] were distinguished on the ground that in criminal cases the amount of tax is not significant, and that in each there appeared to be some earnings out of which a dividend could have been paid, whereas in civil cases the amount of tax is all-important.

One further point should be noted with respect to hobbies and corporations. *American Properties* is the only case specically dealing with hobbies, and in it the corporation had been in existence for some time as a real estate corporation. Subsequently, it decided to participate in racing activities also, although failing to meet the standard of a business. Hence, the distributions to the shareholder-owner were accumulated surplus derived from real estate operations, not racing. Of course, expenditures for boat racing are not ordinary and necessary to the real estate business. Some of the *American Properties* problems could be avoided, perhaps by incorporating a new entity with an express charter relating to the hobby activities. If the activities then fail to meet the standards of a trade or business, payments by the corporation would not come from some other retained earnings, but only from the hobby receipts and accumulated surplus, if any.

If the proposed hobby activity is one in which the prospects for profit are quite speculative or highly irregular, a decision not to incorporate would be advisable. If the business is incorporated, it is taxed as a separate entity, and the early initial losses typically incurred by infant businesses could not be offset against the taxpayer's individual income. They could only lie idle, to be used to offset income realized in future years, and the individual taxpayer's taxes will have remained as high as ever. If there were no corporation, initial losses would be properly offset against income from other sources immedi-

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[23] 248 F.2d 869 (8th Cir. 1957).

[24] 234 F.2d 475 (5th Cir. 1956).

ately and would not lie idle. Corporations are entitled to a three year net operating loss carry-back and a five year net operating loss carry-forward, but since the corporation is a separate entity, losses may only be offset by the corporation's gains. The individual has the same carry-back and carry-forward provisions available to him and in addition has his income from other sources constantly available. In the typical case of the secondary activity on the borderline between hobby and business, the carry-back and carry-over provisions would probably not be used since the losses are not likely to exceed the taxpayer's income from other sources. In fact, it is just this situation which prompted the introduction of § 270,[25] limiting losses by individuals to $50,000 in each of five consecutive years, except for unusual cases such as casualty losses or losses by farmers due to drought. Not too many secondary business will incur losses on such a scale as this, however.

Another obvious point to consider in incorporation of this second business is the change in tax rates. Many taxpayers considering such a move will be in tax brackets in excess of 30%, the corporate rate on the first $25,000, and even in excess of 52%, the current surtax rate. If the corporate rates in the future work a hardship, as for example when the taxpayer retires from this principal activity, but continues to operate his hobby business, then § 1371[26] would permit the corporation to elect to be taxed as a partnership. There are specific requirements to be met, but the average "hobby-type" operation would certainly be within them. A big advantage to be derived here is the fact that ultimately the taxpayer would want his activity liquidated and earnings distributed. The § 1371 election avoids the double taxation involved in a complete liquidation, by eliminating the tax on the corporation and placing it year by year on the shareholders. At the same time the other legal advantages of the corporate form, such as limited liability, remain in effect. Should the hobby operation be a marginal one, earning profits some years and incurring losses in others, the net operating loss deduction is still available with all its advantages to the individual (but then subject to the $50,000 limitation of § 270).

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[25] INT. REV. CODE OF 1954, § 270.

[26] INT. REV. CODE OF 1954, § 1371.

For those taxpayers contemplating the operation of a hobby-type business but who are reluctant to use the corporate form because of the possibility of being forced to take a capital loss on the sale of the business should it prove unsuccessful, § 1244 provides relief.[27] Stock losses coming within this section qualifiy as ordinary losses, rather than capital losses, thereby avoiding the $1,000 limitation imposed on the latter. Again, there are specific requirements to be met, including the fact that only the shareholders to whom the stock was issued by the corporation are permitted the preferred treatment, but the typical hobby business will also comply with these requirements.

In summary, one should consider the operation of the tax law as to corporations as well as to individuals in contemplating a transition from hobby to business or initiation of a commercial hobby-business. There are also sound business considerations which cannot be overlooked and which should be paramount in making such a decision. However, the corporation as evidence of an intention to operate a business and not a hobby, plus the tax concessions offered under § 1371 (election to be taxed as a partnership) and § 1244 (ordinary loss on sale, exchange, or worthlessness of stock) certainly are important aspects of tax planning for hobby activities.

It must be realized that in order to deduct hobby losses or expenses, the taxpayer must actually be conducting his enterprise on a commercial basis. Those hobby enthusiasts who are content to continue their activities as hobbies must also be content with the distinct disadvantages in doing so. The situation is just and proper, since a hobby, so long as it remains a hobby, is purely a personal matter, and no one has ever advocated deduction of personal expenses.

Should a taxpayer decide to commercialize his venture, there are a number of things that may be done which would establish it as a business (not only in his eyes but also those of the Internal Revenue Service). The Service has not laid down any specific steps to be taken in this connection, but rather accepts a showing of those acts which are customarily per-

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27 INT. REV. CODE OF 1954, § 1244.

formed by any businessman in the formation of a venture. The possibility of making a profit should be discussed with family, friends, and financial advisers. Other persons already engaged in the particular type of industry should be consulted, so that the taxpayer is familiar with the problems involved in the enterprise as a commercial venture (even though the taxpayer may have conducted his hobby for some time and become expert in the field). Provision should be made for adequate accounting records which accurately reflect revenues and expenditures. Many taxpayers lose in their attempts to show a business operation through failure to keep good records. If the hobbyist is not already doing so, he should subscribe to trade journals in his field when changing to a commercial venture, so as to be abreast of current developments and problems. A little advance planning in this area may certainly result in substantial tax saving; particularly in view of the fact that most new businesses incur initial losses.