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ELEMENTS OF TAX SHELTERS

In recent years, there has been a great concern about high income individuals who are able to eliminate or substantially reduce their income tax liability through the use of various tax shelters. The interest in tax shelters is quite diverse and is not always confined to just the very highest tax bracket taxpayers. Taxes are increasing at almost every level of government. In 1974, the average taxpayer's fastest rising cost was not food or fuel—it was taxes.

Historically, tax shelters have existed because there has been a need for capital not available from general lending sources. The deductions flowing from the investment have been intended to justify the risks involved. The ingenuity of taxpayers, their advisors and promoters of certain investments have in many cases created highly leveraged situations whereby the taxpayer's economic situation has been disproportionate to the tax benefits flowing from the investment. In due time, just about every tax savings plan used in tax shelters seems to be ruined by overexposure and greed. Promoters of certain tax sheltered programs have found no lack of greedy taxpayers who put “saving taxes” ahead of the economic aspects of the investment.

There are several elements that make up a typical tax sheltered investment (though not all elements are found in every investment). The basic element is the “deferral” concept whereby deductions are accelerated in order to reduce the tax liability in early years. In some respects, this deferral of tax liability to later years can be viewed as an “interest-free loan” by the Government, repayable when the investment produces net taxable income or is sold or otherwise disposed of in a taxable transaction.

A second element is the “leverage” gained by the use of borrowed funds to achieve the accelerated deductions which reduce the taxpayer’s

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1 In 1973, seven persons with adjusted gross income in excess of $1 million paid no federal tax, and a total of 3,068 persons with adjusted gross income in excess of $50,000 escaped tax liability.

2 A taxpayer may have an extraordinary large income year. See Estate of Frank Cohen, T.C. Memo, 1970-272 (winner of Irish sweepstakes entered into bond purchase deal for prepaid interest deductions; cattle deals for prepaid feed expense deductions; and prepaid state tax liability).

3 Inflation and the wage spiral have put many taxpayers into higher income tax brackets. The progressive structure of the tax brackets provides incentive for seeking tax shelter.

4 Tax-savings plans currently under attack by IRS include:
income. If the borrowing can be done on a nonrecourse basis (i.e. where the lender looks only to the investment for repayment), the taxpayer's economic position is further enhanced with respect to his exposure to risk of loss.

A third basic element to most tax shelters is the "conversion" of ordinary income to capital gain at the time of sale or disposition of the assets comprising the tax sheltered investment. Conversion occurs when the portion of the gain which reflects the accelerated deductions taken against ordinary income is taxed as capital gain.\(^5\)

The Tax Reform Act of 1969 did not seek to eliminate any forms of tax shelter. Rather the approach was to tax the accumulation of too many "tax preference items" in any year. There has also been a disturbing rise in dubious investment schemes which have involved a combination of bad management and apparent outright swindling where incoming funds have simply been pocketed.\(^6\)

"Hobby farming" activities,\(^7\) recreational property investments and yachts generally do not have most of the tax advantages generally associated with tax shelters. There is usually some pleasure element involved.\(^8\) Hence, the "tax shelter" element of such investments is one of degree. The element of deferral of income is generally predominant with the leverage and conversion elements being secondary in nature.\(^9\)

**REQUIREMENTS OF THE INVESTOR**

In the case of traditional tax shelters such as oil, cattle or real estate, there is a tremendous emphasis on matching the tax-sheltered investment to the tax and non-tax requirements of the investor. Analysis of the

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\(^6\) e.g. Wheatheart, Inc., Perryton, Texas, sponsor of one of the nation's largest cattle feeding tax shelters, collapsed in January, 1975 amid charges of fraud and mismanagement after lenders and investors had poured more than $37 million into its operation. According to newspaper accounts, federal investigators indicate that $20 million of that money has apparently vanished.

\(^7\) The term "hobby farming" is often used to refer to investments in citrus groves or other tree farming activities, including vineyards. It is also used to cover a great multitude of activities involving farmland. The term "citrus grove" itself is often used to cover all tree-farming activities. While citrus groves and certain vineyard investments may be thought of as tax shelters in the usual sense, the term "hobby farming" as used herein refers to all farm-related investments which may or may not have the features of a tax shelter.

\(^8\) The taxpayer is generally an "active participant" as opposed to being an investor in fractional interest in a venture (probably a limited partnership) located a substantial distance away.

\(^9\) In the case of yachts, the "conversion" element is nonexistent because of a yacht's general rapid depreciation in value.
investor's tax bracket, his sources of income,\textsuperscript{10} nature of itemized deductions,\textsuperscript{11} need for funds in other business activities and sophistication and temperament must all be thorough.

In the case of hobby farming, recreational property and yachts, the nature of the underlying investment is often the overriding consideration. Very often the investor will be making the purchase with mixed motives and the tax aspects may not predominate initially.\textsuperscript{12}

\textbf{ECONOMIC CONSIDERATIONS}

\textbf{a) Status of Rural Land and Farms}

While private ownership of forests is not decreasing,\textsuperscript{13} farmland is succumbing to the expanding maw of urbanization at an alarming rate.\textsuperscript{14} In certain areas of the country, the shrinkage is very noticeable. Connecticut's farmland has shrunk by half in 25 years and since World War II, the farmland in Massachusetts has dropped from more than 2 million acres to about 700,000 acres and an annual loss of another 20,000 acres is predicted.

In certain parts of the country, such as the outlying Chicago area encompassing four or five counties, land that sold for $1,000 an acre in 1965 has quadrupled in price.\textsuperscript{15} There is always the temptation for urban farmers to sell-out to developers or speculators. In many in-

\textsuperscript{10} Since the introduction of the maximum tax on earned income, the emphasis is on reducing unearned income and the ability of the investor to absorb "tax preference income". See Code Sections 56 and 57. If an investor can utilize the maximum tax on earned income, he generally does not want more than $30,000 of the tax-sheltered preference income. Availability of income averaging is also an interrelated factor.

\textsuperscript{11} Itemized deductions can be wasted if the amount of the tax shelter for the year is too great.

\textsuperscript{12} A very typical situation may involve a doctor who invests in a ski chalet with the idea of renting the property full-time during his peak professional years and later using the facility himself. Here the potential appreciation in value of the investment may be a valid consideration.

\textsuperscript{13} There are roughly four million owners of private, nonindustrialized forests in tracts of less than 5,000 acres. Such forests occupy 296 million acres, constituting 59 percent of the commercial land in the U.S.

\textsuperscript{14} Current predictions are that 2.2 million acres are lost annually, up from an estimated 1.5 million acres in 1970. About 20 percent of all U.S. farms are within what can be considered "urban" areas. These farms produce about a quarter of the total agricultural sales in the country.

\textsuperscript{15} The urban sprawl has an effect on idling cropland, isolating farms, increasing land costs and production problems arising from odors, waste disposal and other land use incompatibilities. Urban farmers generally put off long term investment projects, defer maintenance and planning programs stagnate. Increasing real estate taxes often force a sale of some acreage. Urbanization often influences switches to crops requiring less acreage such as vegetables. Theft and all forms of vandalism are much greater.
stances, land speculators have allowed farmers to lease the land at very reasonable rates so that the land is being "employed".18

b) Need for Land Survey

Many rural properties, having been owned by the same family for several generations, consisting of substantial acreage, have not been surveyed and there are no accurate maps.17 The owner in possession is confident of his acreage since no one has ever questioned as to what he believes are his boundary lines. He is not about to pay for the cost of a survey and is usually not too receptive to the idea that the prospective buyer be given a month or two to get a survey done.18 A "deed plot plan" is not a survey. It is just a diagram of the property prepared from the deed. While some areas are getting aerial maps from federal, state or local government agencies, many deeds remain so vague and incomplete that the only real solution is a "boundary line agreement" wherein everyone concerned agrees as to the proper boundary lines.

This problem exists virtually throughout the country in varying degrees, dependent upon the shortage of licensed surveyors and local conditions. Failure to secure a formal survey often results in problems that nullify all of the economic and tax advantages of the investment.19

c) State Environmental Laws

The trend toward more and more leisure time combined with increasing incomes has affected the demand for seasonal/recreational housing. Some three million families in the U.S. now own vacation homes. This represents about 5% of American families. In addition to the 10 to 12 million persons included in these families, it is estimated that another several million persons occupy rental units. More than one

18 Such deals usually involve smaller plots that may be scattered. There is no guarantee of when the leased land will become a shopping center, highrise or highway. For the tax consequences of the absentee owner, see Bravenec, "Tax Consequences When Farm Owner and Operator Are Different Taxpayers", 43 Journal of Taxation 296 (Nov. 1975).

17 Lawyers are all too familiar with the typical deed which states something about "a point beginning at a tall elm tree in the Northeast, proceeding along a stone wall bounded by land of Smith to a point marked by a pile of rocks, then westerly along a stream bounded by the land of Jones, etc. etc., being 100 acres, more or less." Today, the elm tree has died and was removed ten years ago; the stone wall has been plowed under and the stream has dried up. Smith, Jones and everyone else mentioned have long since gone to their reward.

18 Title insurance policies usually do not insure acreage nor guarantee acreage without a certified map and boundary line agreement between the buyer and all abutters.

19 In addition to knowing what is being purchased as far as the land itself, almost as important is detailed knowledge of the source, availability, quality and abundance of water on the land. Most rural areas are not served by a public water supply.
out of every ten new homes now under construction is a vacation home.\textsuperscript{20}  

Virtually everyone recognizes that there is only so much land and that it is the American dream to own land at the right place at the right time to make a big profit.\textsuperscript{21} The future of land development in this country may be vastly different than the development of the past 30 years.

Many states have enacted comprehensive land use environmental laws that curtail and control land development.\textsuperscript{22} Local and state ordinances may affect zoning, subdivision, use of shoreland, floodplains and wetlands, lot size, building setbacks, tree cutting along shores and location and size of waste disposal systems. In Maine, all of the foregoing are controlled. In fact, lakefront owners in most areas of Maine cannot bring in a load of sand for a beach or fill in an erosion area without first securing a permit.

It is vital that the investor be aware of the impact of any present (or future) environmental land use controls on his intended use of any property purchased. The ability to subdivide property on an indiscriminate basis may become a part of history in most areas in the not too distant future.

The status of rural land and the underlying economics vary throughout the country depending upon problems of financing, material and construction costs and availability of land parcels and the cost thereof. The failure of many reputable developers\textsuperscript{23} has not seemed to have resulted in any price deflation. The status of the economy and increasing auto and gas costs may have merely moved the investor interest.
away from developments that are five or six hours from urban areas to land and developments that are closer to urban areas.²⁴

II. TAX PROVISIONS AFFECTING HOBBY FARMING

In analyzing investments in farms, recreational property or yachts, the relevant provisions of the tax law must be considered.

1. Availability of Tax Benefits to “Farmers”

The Regulations and case law make it clear that the non-resident absentee investor can qualify as a “farmer” for tax purposes and as such can use the cash basis method of accounting.²⁵ This fundamental concept produces the deferral of income through ordinary deductions in the early years of investment and conversion of income into capital gains in later years.²⁶

The desirability of allowing farmers to work with a simplified accounting method has produced what has come to be regarded as a “loophole” in the tax law—the shifting of income and deductions. In an effort to prevent certain farmer-taxpayers from exploiting the advantages of the cash basis method, the Tax Reform Act of 1969 introduced a number of complex provisions affecting all farmers.

2. Holding Period and Depreciation Recapture

While a farmer’s expenses can generally be deducted as incurred, Section 1231(b)(3) imposes a longer holding period for horses and breeding livestock. This period is set at two (2) years in the case of cattle and horses held for draft, breeding, dairy or sporting purposes and one (1) year for other livestock.²⁷

Since 1969 under Section 1245(a)(2)(c) livestock is subject to depreciation recapture. The effect of the recapture provision depends generally upon the size of the initial herd since under the cash basis

²⁴ Lower nationwide speed limits have also contributed to a decreased “per-hour” distance range.


²⁶ The one-year holding period applies principally to hogs, but also to foxes, minks, chinchillas and other animals, except poultry. See Cedarsburg Fox Farms, Inc., 283 F.2d 711 (CA 7, 1960) (foxes); U.S. v. Cook, 270 F.2d 725 (CA 8, 1959) (minks); W. W. Greer, Jr., 17 T.C. 965 (1951) (chinchillas); C. A. Sykes, 57 T.C. 618 (1972) (breeding bees not “livestock” under Section 1231).
method, additions to the herd will have a zero basis and no depreciation will be deducted with respect thereto.\footnote{The costs of raising new animals born into the herd will be expensed rather than capitalized.}

3. Recapture of Farm Losses—Section 1251

Section 1251 involves an approach in the tax law which leaves intact the basic deductibility of current farm losses under the cash basis method, but which requires that some or all of the gain otherwise qualifying as capital gain be recaptured as ordinary income.\footnote{See Bravenec, "Tax Planning To Control Recapture of Farm Losses: How To Manage 'Excess Deductions'," 42 Journal of Taxation 312 (May 1975).} Unless a taxpayer has both a farm loss of $25,000 and nonfarm income for the year of $50,000, Section 1251 is not applicable. If both of the foregoing are met, then the farm losses in excess of $25,000 are recorded in a so-called "Excess Deductions Account" or EDA,\footnote{Section 1251(b) (2) (B).} which is a running account. The exclusions apply only to individuals and Subchapter S corporations and not to regular corporations or trusts.

The EDA serves to convert otherwise Section 1231 gains and certain other capital gains into ordinary income to the extent of the balance in the EDA upon the disposition of "farm recapture property".\footnote{Defined under Section 1251(e) (i) as depreciable property and land (other than Section 1250 property) used in the business of farming; breeding and other livestock falling within the meaning of Section 1231(b) (3); and certain unharvested crops.}

Section 1251 does not depend upon whether the depreciation recapture rules of Section 1245 apply. Hence, there can be "double" recapture on the disposition of the same piece of property, since the depreciation deductions taken that are subject to recapture under Section 1245 can give rise to farm losses that increase the EDA. Where property which is sold is subject to both Section 1245 and Section 1251, the two apply consecutively with Section 1245 applying first.

There is no provision for matching particular expenses with particular assets. Hence, a farm loss attributable to the expenses of raising breeding cattle can be recaptured upon the sale of some other type of recapture property (other than land). Depreciation recapture under Section 1245 would have to await the sale of the cattle.

In the case of a disposition of farmland, the amount of recapture under Section 1251 is subject to a special limitation. The gain is treated as ordinary income only to the extent of the amount of deductions taken in the taxable year and on the four preceding taxable years under Sections 175 (relating to soil and water conservation expenditures) and 182 (relating to land clearance expenditures).\footnote{Sections 1251(c) (2) (C) and 1251(e) (5). The four preceding years taken into account include pre-1970 tax years.} Other land expenses are not subject to recapture.
There are special rules governing gifts of "farm recapture property"; tax-free reorganizations and incorporations under Section 351; like-kind exchanges under Section 1031; and involuntary conversions under Section 1033.88

The effect of Section 1251 on the typical investor is probably not too great.84 Obviously, a taxpayer must know the amount in the EDA and whether the farm losses that increased the EDA produced for him a tax benefit.85

From a tax planning point of view, it may be possible to delay recapture of the EDA since mere passage of time does not increase the EDA (nor is there any element of imputed interest). At death, the EDA is wiped out. A delay may also allow the EDA to be reduced by subsequent farm income.86 It has been suggested that by using nonrecognition transactions under Section 1031 or incorporating part or all of the farm business that such a delay may be affected.87

4. Recapture of Land Improvement Deductions

Where tax deductions are taken under Sections 178 and 182 after 1969, any gain on sale of the land is converted into ordinary income to the extent of a percentage of such deductions under Section 1252.88 This provision is independent of the farm gain recapture rule of Section 1251. While both Sections 1251 and 1252 apply to deductions taken under Sections 175 and 182, Section 1251 has the "$25,000 and $50,000" limits. Thus, even if Section 1251 is avoided, Section 1252 may apply with the effect that investments in land conservation are taxed harder than investments in livestock.

The sliding percentage,89 which is similar in concept to Section 1250, ends after the ninth year. Section 1252 does not apply if a taxpayer disposes of farmland for which the holding period is in excess of nine years or with respect to which no deductions have been allowed under Sections 175 and 182.40 Section 1251 can apply where

88 See Sections 1251(b)(5)(B); 1251(b)(6); and 1251(d)(5)(B).
84 In 1969, with proposed lower limits before establishment of an EDA, it was estimated that less than 10,000 investors would be affected.
85 A taxpayer can avoid setting up an EDA by making an election to inventory assets. This means, however, giving up current deductions, including deductions under Sections 175, 180, 182 and utilizing the more complicated accrual method of accounting.
86 If there is recapture in one year, subsequent income in another year does not serve to recover any of the recapture because there are no carryback provisions.
87 Bravenec, supra. Note 21—particularly with respect to the planning possibilities using a corporation.
89 For land held less than five years, the percentage is 100. Each year thereafter, the percentage is reduced by 20.
40 Reg. § 1.1252-1(b).
Section 1252 does not (i.e. the land has been held for over nine years) if there have been deductions taken under Sections 175 and 182 within four years of disposition and there is a balance in the EDA.

There can be very interesting allocation problems where part of farmland is sold. The rules under Section 1252 override the non-recognition provisions of the Code (such as a Section 337 liquidation sale by a corporation) and apply to most distributions by a corporation of Section 1252 farmland.

5. Deductibility of Prepaid Feed Expenses

The failure of several cattle breeding syndications in the late 1960's led to increased interest in the early 1970's in cattle feeding as a form of tax shelter. This was at a time when cattle coming off the feedlot were fetching record high prices.

Following the natural harvesting of feed in the fall and marketing of cattle in the spring, feed cattle and their feed are purchased prior to year end and fattened in the next year. The feedlot operation looks to the shifting of income and deductions (i.e. "deferral") by having deductions in one year and income in the next. The deferral can be delayed where the taxpayer enters successive feeding ventures. Assuming the investment produces a profit, the gain is ordinary income because the feeder cattle are inventory, held for sale.

Since the heart of the cattle feeding venture is the deductibility of the prepaid feed costs, that issue has received varying degrees of at-

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41 Reg. § 1.1252-1(a)(4). Allocation of Sections 175 and 182 expenses are presumably made on a per acreage basis, unless a different method of allocation can be supported.
42 Reg. § 1.1252-1(d)(1) and (2).
43 e.g. Black Watch Farms, Wappinger Falls, New York, one of the country's biggest and most publicized syndications of breeding livestock herds, failed in 1970.
44 In mid-July, 1972, cattle coming off feedlots were selling for $38 per hundred pounds, a 20-year high.
45 Feeder cattle are purchased when they are approximately 10 to 18 months old (weighing 400-600 pounds) and are ready for slaughter at 2 to 2½ years of age, when the animal's weight has nearly doubled. The "feedlot" generally consists of grain-storage facilities and feed-handling machinery surrounded by acres of steel pens. Cattle are confined by the thousands and fattened. The feedlot is essentially a service company that charges ranchers a markup on the grain their cattle eat.
46 Cattle prices are volatile. The years 1973 and 1974 were disastrous for the industry. Losses per head ran between $100 to $200, close to the average equity per head. In 1975, the situation turned around and there was a shortage of cattle available for market reminiscent of 1972. Feed costs which were 50-63¢ per pound in 1973 had dropped back to 33-35¢ per pound. Invesors in 1973-74 were whipsawed into huge losses when grain prices pushed up feed costs.
47 Another tax shelter utilizing prepaid feed deductions is catfish farming. In 1971, catfish farming had potentials of becoming a major industry. Catfish are a very high yield cash crop per acre and by 1973 there were as many as 55,000 acres
tention from IRS over nearly two decades. The current Service position is basically summed up by Rev. Rul. 73-530, finally as Rev. Rul. 75-152.

Rev. Rul. 75-152 sets forth three tests for deductibility of prepaid feed expenses:

1. The expenditure must be a purchase and not a deposit for a future purchase;
2. There must be a business purpose for the prepayment;
3. The deduction does not result in a material distortion of income.

The last test gives rise to the greatest conceptual difficulties as it could, if upheld, virtually eliminate the cash basis method of accounting with respect to feed.

6. Depreciation for Horses and Livestock and Farm Related Items

Breeding cattle and horses are depreciable and the purchase cost (less salvage value) is recoverable over the useful life of the animal in the taxpayer’s business. The problems are usually centered around the useful life and methods of depreciation available.

Depreciation for a farm related item requires that they be employed in the business of farming.
7. Sale of "Culls"

Most ranch operations involve the sale from time to time of a certain percentage of the herd either to maximize available grazing capacity or to eliminate weak animals from the herd. The tax issue is whether the sales result in capital gain or ordinary income and there are cases going both ways.\textsuperscript{54}

8. Availability of Investment Credit for Livestock and Farm Related Items

Livestock, but not horses, purchased after August 15, 1971, having a useful life of three or more years qualify for the investment credit.\textsuperscript{65} Livestock includes cattle, hogs, sheep, goats, mink and other fur-bearing animals.\textsuperscript{65}

The credit is reduced (or eliminated) if within six months before or after the acquisition there has been a "wash-sale" of substantially identical livestock where there is no investment credit recapture.\textsuperscript{67}

The problem area appears to be in determining what are "substantially identical" livestock as this depends upon the usage of the taxpayer which is probably a subjective matter.\textsuperscript{68}

Investment credit for farm related items generally involves the question of whether the facility constitutes qualified "tangible personal property." In the case of orchard and citrus groves, the investment credit is available when the trees or vines produce fruit in sufficient quantity to be harvested and marketed. The cost is deemed to include the bedding costs.\textsuperscript{69}


\textsuperscript{65} See Rev. Rul. 71-488, 1971-2 CB 60 (macadamia nuts).
9. Requirement of Capitalization of Preparatory Expenses

In the case of citrus groves\(^{61}\) planted or replanted after 1969 and almond groves\(^{62}\) planted or replanted after 1970, costs of development must generally be capitalized if the amount is incurred before the close of the fourth taxable year beginning with the taxable year in which the trees are planted.\(^{63}\) This requirement does not apply to groves replanted after having been lost or destroyed as the result of a casualty.\(^{64}\) Since the capitalization period is not affected by sale or other disposition of the citrus or almond groves, a purchaser of a developing grove must know when the grove was planted and the seller's tax year in order to properly reflect his future costs of development.

In the case of other farming ventures (i.e. other than citrus and almond groves, such as vineyards), the utilization of Sections 175\(^{65}\) and 180\(^{66}\) can produce accelerated deductions in the early years, provided that the land is "used in farming". Uncleared land upon purchase is generally not so used.

The only major investment expenses, apart from the initial land clearing costs, which cannot be expensed for non-citrus/almond groves are the costs of bedding, ditching and acquisition of the vines or trees. Just how young the trees can be and at what point the expenses become deductible is illustrated by the case of Robert Maple\(^{67}\) where grove developers were able to deduct all the expenses paid to a nursery for caring for their trees.\(^{68}\) In a recent ruling dealing with pistachio nuts IRS has indicated that the costs of raising the pistachio nut seedlings were capital in nature and not currently deductible. The Service also issued a nonacquiescence for both Maple and Wagner Mills, Inc.\(^{69}\)

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\(^{61}\) Defined by Reg. § 1.278-1(a)(2)(i) to include "orange, grapefruit, lemon, lime, citron, tangelo and tangerine trees". Vineyards are not considered "citrus groves".

\(^{62}\) Defined as one or more trees of the species Prunus amygdalus. Reg. § 1.278-1(a)(2)(ii).

\(^{63}\) Section 278(a); Reg. § 1.278-1(a)(1).

\(^{64}\) Section 278(b). Such expenses may be deducted.

\(^{65}\) Section 175 allows an election for deduction of expenses attributable to soil and water conservation or prevention of erosion. There is a limitation on deductibility that cannot exceed 25% of gross income from farming for any year. There is an unlimited carryover provision for unused deductions.

\(^{66}\) Section 180 allows an election for deduction of expenses attributable to purchase of fertilizer and similar materials used to enrich, neutralize or condition farm land. There is a similar limitation on deductibility as found in Section 175.

\(^{67}\) 440 F.2d 1055 (CA 9, 1971), aff'd T.C. Memo 1968-194.

\(^{68}\) This was a pre-Section 278 case. Accord.: Wagner Mills, Inc., T.C. Memo 1974-274 (preproduction costs of citrus seedlings).

\(^{69}\) Rev. Rul. 75-405, IRB 1975-38, 8. See also: Gordon J. Harnsson, 61 T.C. 216 (1973) (payments held part of purchase price).
10. Use of Corporation In Farming Activities

Since it is generally the goal of the investor to secure any early deductions from the farming venture as losses deductible on his individual return, it is interesting therefore to note several litigated cases where the taxpayers have used a corporation for one reason or another, to secure title to the farmland. The tax results have generally been disastrous as the courts have shown a consistent reluctance to ignore the corporate entity and thus allow the tax losses to pass through.\textsuperscript{70}

The use of a Subchapter S election likewise has tax risks if the corporation is later found not to qualify for the election, especially because of the nature of its income.\textsuperscript{71}

A more disturbing trend has been the attack by IRS on the tax status of limited partnerships. The Service has successfully treated certain arrangements in the form of limited partnerships as "associations taxable as a corporation".\textsuperscript{72}

While the income tax aspects of using a corporation for farming activities are troublesome and generally disadvantageous, there may be many valuable estate planning opportunities through such use which may outweigh the income tax disadvantages.\textsuperscript{78} This would especially be true for the established farming venture.

Some of the advantages would be:

a) Preservation of the farm unit;\textsuperscript{74}
b) Favorable valuation of minority interests in a farm corporation;  

c) Satisfaction of requirements of different classes of owners;  

d) Reducing donor's gross estate through gifts;  

e) Qualifying for tax treatment under Sections 303, 6166, 6161.  

11. Charitable Contributions of Farm Land, Crops and Recreational Property

There are many income tax planning advantages in making contributions of farm land, recreational property and crops to qualified charities. In the case of an outright gift of land, the problem generally is in the area of valuation and a first class appraisal by a qualified expert is essential in order for the deduction to hold up upon audit. The Service has ruled that a gift of a remainder interest in a summer "palace" complex to a college qualifies as an "undivided interest" in a "personal residence" under § 170-(F)(3)(B)(i). The owner reserved the right for life to use the property for summer vacations and to store personal property there.

There are also more sophisticated planning possibilities in the case of contributions of scenic or restrictive easements. The Service has issued several recent rulings which indicate the type of easements which qualify for the deduction and the manner of valuing the interest transferred.

HOBBY FARMING CASES

Appendix A lists selected "hobby farming" cases grouped into various categories. There is a brief description of the relevant factors.

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75 See: W. G. Clark, Jr., v. U.S., 75-1 USTC ¶ 13,076 (D. N.C. 1975) (40% of discount allowed); Rosberg v. U.S., 475 F.2d 591 (Cr. Cl. 1973) (discount for factor of deferred capital gains on corporate assets); Estate of Ethel C. Dooly, T.C. Memo 1972-164 (valuation of ranch corporation stock); Obermer, 238 F. Supp. 29 (D.C. Hawaii 1964) (one-third discount); Hamm, 325 F.2d 934 (CA 8, 1963) (27% discount).


78 Rev. Rul. 75-366, IRB 1975-34, 25 (Section 6166).


80 Rev. Rul. 75-420, IRB 1975-406. The college used the complex during the academic year for educational purposes. Restrictions on conveyance and making structural or decorative changes without the donor's consent did not affect the deduction.

81 Rev. Rul. 75-373, IRB 1975-35, 11 (easement in perpetuity to beachfront); Rev. Rul. 75-358, IRB 1975-34, 10 (restriction on state landmark mansion owner qualified as open space easement under Reg. § 1.170A-7(b)(1)(ii)); Rev. Rul. 74-583, 1974-2 CB 80 (right of way easement for hiking and skiing). See also: Rev. Rul. 73-330, 1973-2 CB 426 (valuation of open space easement); Browne, Jr. and Van Dorn, "Charitable Gifts of Partial Interests In Real Property For Conservation Purposes," 29 Tax Lawyer 69 (Fall 1975).
with an indication as to whether the losses were allowed in each case. With the exception of the case of Francis X. Benz, the cases do not discuss the tax affect of Section 183 (discussed below).

The common thread running through the cases is the recognition that the question of whether a taxpayer was engaged in the business of farming (or cattle-raising or horse-raising, etc.) is basically factual in nature and its resolution depends on whether the taxpayer's dominant motive was to make a profit. For the Tax Court, the resolution of that question depends upon the taxpayer's "subjective" intent. This approach accounts for such decisions as Harold M. Clark and Woodrow L. Wroblewski.

Even though Section 183 was intended to at least in part remove the subjectivity from an inquiry into whether the taxpayer was engaged in an activity for profit the "hobby farming" cases in the Appendix provide a very important frame of reference for tax planning and the eventual development of the case law under Section 183.

**SECTION 183—ACTIVITIES NOT ENGAGED IN FOR PROFIT: LIMITATION ON LOSS DEDUCTIONS**

In connection with the taxpayer's motive, overshadowing the entire tax sheltered investment area is Section 183 governing the allowability of losses in connection with "activities not engaged in for profit". While this concept is generally associated with the hobby farming area, its application can extend to virtually every tax venture operated at a tax loss. The real question concerning Section 183 is whether it can be treated as merely a codification of prior case law or whether that section and the regulations thereunder introduce substantive new features to the tax law.

a) Repeal of Section 270

Section 183 repealed Section 270 which contained a statutory prohibition against deductibility of successive large losses from a venture.
By its terms, Section 183 applies only to individuals, Subchapter S corporations and estates and trusts.\(^9\)

**b) Definition of “Activity Not Engaged In For Profit”**

The heart of Section 183 is the definition of the term “activity not engaged in for profit”, which in turn depends upon the taxpayer's intent. There is a presumption under Section 183(d) in favor of the taxpayer if there is gross income from the activity for two or more of the tax years in the five consecutive year period ending with such year. (For horse raising activities, the period is seven years). Under Section 183(e), the taxpayer can elect to postpone determination of whether the presumption applies until he has engaged in the activity for the requisite period.\(^9\)

The IRS appears to be handling the foregoing election in either of two ways depending upon the district involved. In some areas, the agent has been handling the election by filling out the requisite forms, handling any other issues in a regular manner and sending the case to the District Director.

The other procedure that is being used is for the auditing agent to drop the case where the taxpayer claims the election and thereby force him to go to District or Appellate Conference to have the mechanics implemented. The agent may not be eager to resolve other unrelated issues and hence the taxpayer could wind up with a fully unagreed upon case to take to conference.

Obviously, there are some practical considerations involved in seeking the “2 out of 5(7) year rule” election. The amount of the loss involved, the cost of potential multiple audits and conferences and the realistic expectation of having a profit in two out of the five (seven) years must all be considered.

If an activity is not engaged in for profit, allowable deductions are governed by a “tier system” under Section 183(b) and Regulations §\(^1.183-1(b)\).\(^9\) In Rev. Rul. 73-219,\(^9\) the Service took the position for each of five consecutive years. Taxpayers apparently found it easy to break the 5-year string.

\(^9\) Reg. § 1.183-1(a). The application to estates and trusts follows from Section 641(b) which provides for computation of taxable income of an estate or trust in the same basic manner as in the case of an individual. cf. *International Trading Co.*., 73-2 USTC ¶ 9582 (CA 7, 1973) rev'g 57 T.C. 455 (1972); *Five Lakes Outing Club v. U.S.*, 72-2 USTC ¶ 9716 (CA 8, 1972).

\(^9\) IRS has issued the following forms to be used in connection with such an election: Form 5213—Election To Postpone Determination With Respect to the Presumption That an Activity Is Engaged In For Profit; Form 5214—Consent Extending Period of Limitations For Assessment of Income Tax.

\(^9\) The Regulations divide allowable expenses into three categories:

a) Deductions which by their nature are otherwise allowable such as interest, real estate taxes, etc.

b) Deductions which would otherwise be allowable if the activity was engaged in
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that interest paid on an insurance policy loan, the proceeds of which were used to acquire recreational property, fell within the "tier one" deduction of Section 183.94

c. One “Activity” or More

A major question not resolved by the Regulations is whether two or more operations are to be considered as one “activity” or several “activities”. Under Section 270, the Service argued for a broad definition of “trade or business” so as to aggregate losses from several operations so as to activate that section.95 There should be a tendency to reverse this approach so as to isolate loss activities and prevent them from being shielded by profitable operations. The Regulations indicate that the taxpayer’s characterization will be recognized to some degree unless it fails to meet an “organizational and economic inter-relationship” test.96 This facet of Section 183 is coupled with the requirement that for purposes of the two out of five (seven) year test the activity must be “substantially the same.”97

Since the degrees of diversification of an activity can be substantial over a several year period, it is worthwhile to note that the courts have generally placed great emphasis on a taxpayer ceasing to conduct an unprofitable activity as soon as it was realized that losses would be incurred.98

While the Regulations seem aimed at preventing a taxpayer from taking a profitable operation and using that as a “shell” for a “hobby loss”, there are real practical problems in determining how different activities simultaneously carried on are to be viewed. There is no answer as to whether unrealized appreciation in farmland or recreational property can be taken into account in determining the applicability of Section 183.

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for profit, which do not involve an adjustment to basis to the extent that gross income is in excess of the tier 1 deductions.
c) Deductions involving basis adjustment such as depreciation to the extent gross income exceeds the first two tier deductions.

Where there are multiple assets in the third tier, the deduction is spread proportionately among the assets under the rules of Reg. § 1.183(b)(2).

94 1973-1 CB 134.
95 There is no specific authority for such a “tracing concept” like Section 265 (interest incurred to carry or acquire tax exempt obligations). Rev. Rul. 74-28, 1974-1 CB 67 deals with the treatment of deductions where an apartment is rented as an activity not engaged in for profit.
96 See: Reg. § 1.183-1(d); Joseph M. Collins, 34 T.C. 592 (1960) (NA); Arthur V. Davis, 29 T.C. 878 (1958) (unsuccessful attempt to combine farming operation in Texas, Mexico, Florida and the Bahamas).
97 Reg. § 1.183-(d) (1).
98 Reg. §§ 1.183-1(c) (1) (ii); 1.183-1(c) (2) Ex. (2) (ii).
99 See: e.g. Jefferson Patterson v. U.S., 72-1 USTC ¶ 9420 (Ct. Cl. 1972) (cattle operation on farm dropped and tobacco planted); K. B. Schley, Jr., 375 F.2d 747 (CA 2, 1967) (failure to cut losses a significant factor).
The Regulations to Section 183 conclude a detailed listing of eleven of the factors that have been generally stated in the cases, but there is no explanation of the relative weights of these factors, nor any indication of how many of these factors are needed to draw a conclusion one way or the other. By employing an objective standard as opposed to a subjective standard, the Regulations would appear inconsistent with the approach of many cases and it remains to be seen how the courts will react in future cases.  

**d) Relation to Section 1251**

Section 183 does not theoretically overlap Section 1251 since the latter section deals only with situations which have passed the Section 183 hurdle. Hence, Section 183 can be more of a problem since the Service may seek to apply that section and disallow deductions as opposed to having deductions currently deductible under Section 1251 possibly recaptured at some future time.

**RECREATIONAL PROPERTY**

**a) Deductibility of Expenses Incurred In Connection With Rental of Property—Case Law**

A taxpayer who acquires vacation property will very often rent it out when not using it himself. The question is the extent to which he can deduct carrying costs and depreciation of the facility. The provisions of the tax relating to rental property are such that tax deductions have been available even where the rental season is quite short. In one case, a summer residence was rented for the two month season of July and August and a deduction on the full year was allowed on the theory that the property had to be "kept-up" during the other ten-month period.

In the case of John R. Carkhuff the Service was able to marshal a set of facts involving the rental of a summer residence so as to place the rental within the scope of the "hobby loss" cases. There followed other cases where taxpayers were unable to show an "expectation of economic profit" motive. Typical of these cases was a failure by the taxpayer to show that prior to purchase of the facility, there was an investigation made as to rentability; what portion of the expenses

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99 See: Appendix A—Cases on "Hobby Losses".
100 C.B. Jones, 22 T.C. 407 (1954). The rental of a single piece of property has been held to constitute the operation of a "trade or business" under Section 162 even where operated through an agent. G. T. Papp, T.C. Memo 1962-82; A. L. Latigha, T.C. Memo, 1961-273.
related to personal usage; adequate books and records were kept; and
that the improvements made were consistent with the type found in
rental property.

The cases that have allowed deductions, have placed great em-
phasis on the holding out of the property in question for rental sub-
stantially all of the year. In various parts of the country, all-year
condominium complexes have been developed where a resident rental
agent manages the property. If the taxpayer keeps his personal usage
to a minimum, tax deductions will apparently be available despite the
fact that many such arrangements cannot make a profit for tax pur-
poses, thanks to high rental agent commissions and frequent replacement
of expensive interior items.

b) Effect of Section 183, and Proposed Law Changes

If Carkhuff put vacation property into the "hobby loss" area, the
Regulations to Section 183 evidence an intent to keep them there. Reg. § 1.183-1(d)(3) deals with a beach house used one month out
of a three-month season for personal purposes. The example assumes
that the rental for two months constitutes an activity which is not
engaged in for profit.

The past emphasis of accelerating tax write-offs by using the shortest
permissible useful lives for assets and accelerated depreciation may be
a thing of the past. In many cases, a more modest write-off program
and proper timing of deductions can result in profits which can trigger
the two out of five year presumption under Section 183(d).

Where vacation property has previously been rented in a casual
manner, taxpayers will not have to handle rentals in a more business-
like fashion. In many instances, a sharp increase in rental activity com-
bined with less personal usage could put the operation into an economi-
cally profitable situation for purposes of Section 183.

One tax planning technique has been for the owner to ostensibly
put his vacation property into full year rental and pay himself rent
when he uses the property. This technique (successfully used in the
case of yachts) has the effect of increasing gross income.

Proposed legislation would seriously affect the amount of personal
usage for tax years after 1975. Under a proposal, deductions could
not exceed income derived from the vacation property if the property

103 Raymond J. Wachtler, 75-1 USTC ¶ 9172 (D.C. Wash. 1974); William K.
Coors, 60 T.C. 368 (1973).

104 While a Section 183 and the proposed changes are inapplicable to corpo-
rations, a regular corporation would not appear to be an appropriate vehicle for
holding vacation property because losses would not flow through to the indi-
vidual taxpayer. Section 183 and the proposed changes would reach a Subchapter
S corporation. It is doubtful that a Sub-S election could be made in the absence
of providing substantial services for tenants. See: Max Feingold, 49 T.C. 461
(1968).

is owner-occupied for personal purposes for the greater of two weeks or 5% of the actual rental time. Where the limitation applies, the deductions treated as being attributable to the rental activities would be limited to the proportion which actual rental use bears to total actual use of the property times the business expenses attributable to the vacation home. (This provision, if enacted, is expected to raise an additional $10 million in tax revenues). The use of a corporation to hold a summer residence in order to avoid Section 183 and the proposed law would appear inappropriate. Regardless of the ultimate form of future legislation, if any, taxpayers must consider personal usage as the prime factor that can result in loss of tax deductions.

c) Deductibility of Expenses of Abandoned Recreational Property Held For Sale

Many times, the question arises as to what expenses are deductible in connection with vacation or residential property that has been abandoned by the owner as far as personal usage and is being held for sale. The key question is whether the property has been “converted” into “Section 212” property.\(^{106}\) It is the Service’s position that an honest offer to rent after giving up the property for personal usage is an essential feature to a successful conversion.\(^{107}\) The courts, however, have relied upon a combination of factors which include an offer of the property for sale, plus abandonment and the expectation of profit by the taxpayer on post-conversion appreciation.\(^{108}\) Placement of property on the market for immediate sale generally would strongly indicate a view contrary to the requisite intent to realize capital appreciation and result in no “conversion” of the property and hence denial of deductions. In one case,\(^{109}\) a taxpayer did list an abandoned summer home for sale immediately but the asking price was triple the then estimated fair market value of the property. This action was viewed by the court as merely making the property a visible commodity on a demanding market.\(^{110}\)

A failure to sell the property in the near future after the abandonment may raise the question as to whether the expectation of profit was

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\(^{106}\) Reg. § 1.212(h).

\(^{107}\) See: *Mary L. Robinson*, 2 T.C. 305.


\(^{109}\) *Lowery*, supra.

\(^{110}\) A period of six years went by from the time of abandonment to the time of sale at the original asking price, cf. *I. Meredith*, 65 T.C. #4 (1975) (beach house for sale 21 years not held for Section 212 purposes); *R. G. Clapham*, 63 T.C. 505 (1974) (intermittent rental not abandonment of residence).
“reasonable” and it is not entirely clear whether just the offer to sell
the property to the public is sufficient to allow deductibility of expenses
incurred in connection with the upkeep of the property. It may be in
that case difficult to establish that there has been sufficient capital
appreciation to trigger Section 212 or that the anticipated rise in the
value of the property was a reasonable expectation.\textsuperscript{111}

\textbf{YACHTS}

The most significant characteristic of yachts, apart from their high
initial cost, is the extremely high annual operating costs. Taxpayers
have long sought a tax shelter by either entering into the charter boat
business or by seeking tax deductions for business entertainment con-
ducted on the yacht.

\textbf{Chartering}

In the case of chartering, the rules have developed through the case
law and the operation must be conducted in a business-like fashion
where there is a reasonable expectation to ultimately make a profit.\textsuperscript{112}

\textbf{Business Entertainment Deductions}

Far more troublesome are situations where the taxpayer seeks to
deduct business entertainment expenses incident to the use of a yacht.
Under Section 274\textsuperscript{118} a yacht is classified as an “entertainment facility”
and expenditures with respect thereto are deductible only if the yacht
is used primarily for the furtherance of the taxpayer’s trade or
business.\textsuperscript{114}

Whether a yacht is used “primarily” as a “facility” involves a com-
putation made on the basis of actual usage and not availability for
use. For this purpose, the yacht must be used for business purposes
more than 50 percent of the days of actual usage.\textsuperscript{115}

\begin{footnotesize}
\begin{itemize}
\item \textsuperscript{111} See \textit{Hulet P. Smith}, 68-2 USTC \textsection 9455 (CA 9, 1968) (offer for sale, plus
abandonment sufficient to convert property into Section 212 asset). For problems
dealing with basis on sale where property not rented, see \textit{Matarrese}, T.C. Memo
1975-184 (basis not reduced for depreciation in years not rented).
\item \textsuperscript{112} \textit{Justin A. McNamara}, T.C. Memo 1973-3 (lack of advertisement of yacht
for charter; lack of effort to generate revenue; deductions disallowed); \textit{Thomas
W. Jackson}, 59 T.C. 312 (1972) (market researched; unforeseen bad weather be-
yond taxpayer’s control; personal use limited; deductions allowed); \textit{Donald A.
McCormick}, T.C. Memo 1969-261 (2 yachts used in oceanography business run
in casual manner not befitting taxpayer; lack of investigation of market prospects;
deductions disallowed); See also: \textit{Ernst H. Martin}, 50 T.C. 341 (Acq.).
\item \textsuperscript{113} See Reg. \textsection 1.274-2(a).
\item \textsuperscript{114} Reg. \textsection 1.274-2(e)(2)(i). An airplane is not considered an “entertainment
facility” and deductions for use thereof are allowable even though the plane is
not used “primarily for business”. See: Reg. \textsection 1.274-2(e)(4)(ii)(b) allowing deduc-
\item \textsuperscript{115} Reg. \textsection 1.274(e)(4). If this 50 percent limitation is not met, there will be
no deduction allowable. Thus, if a yacht is only actually used 60 days during the
\end{itemize}
\end{footnotesize}
Even if the taxpayer succeeds in proving that his yacht was used primarily as a facility for business purposes, deductions are limited to usage that is "directly related" to his trade or business. The meaning of "directly related" has led to considerable litigation with the question being whether that term encompasses "goodwill entertainment".

The leading cases are *Hippodrome Oldsmobile, Inc. v. U.S.* and *D.A. Foster Trenching Co.* In *Hippodrome*, the District Court dealt with the problem of record keeping and rejected the Service's requirement for a guest-by-guest breakdown of the annual accounting items of a yacht used to entertain business customers. The accepted practice in the taxpayer's locality was the use of the "soft sell". On appeal, the issue was whether the entertainment was "directly related to the taxpayer's business". Although the taxpayer or a representative was on board the yacht, the customer had to initiate any business discussions. The Circuit Court concluded the "soft sell approach" constituted "goodwill" entertainment and that it was not deductible.

A similar result was reached by the Court of Claims in *D.A. Foster Trenching Co.* where the taxpayer had no sales representative aboard its yacht and where there was no active conduct of the taxpayer's trade or business that was "directly related". *Hippodrome* represents the stricter of the two decisions because it indicates that not only must the taxpayer's representative be aboard, but that he engage in active selling. The Court of Claims suggested in *Foster Trenching* that advertising displays may have made the yacht a "floating hospitality room" that automatically qualified as a directly related expense.

In *P. Handelman* the Tax Court found that a list of guests compiled from the office records of a lawyer who used his yacht to

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year, the 50 percent test would be met if 31 of those days involved business use. In considering "actual days usage" entertainment which is "associated" with a business meeting (i.e. either before or after such meeting) is considered as business related. See *LeRoy W. Gillis, T.C. Memo 1973-96* (personal usage exceeded 50 percent of total usage).

116 Regulations § 1.274-2(e)(1) and 1.274-2(e)(4).

117 "Goodwill entertainment" is generally defined as "the general expectation of the taxpayer deriving income in the future as the result of entertaining prospective customers or clients in the present."


119 473 F.2d 1398 (Ct. Cl. 1973).

120 See also: *Harlan H. Hilliker, T.C. Memo 1972-183* (no showing as to specific relationship between those who used boat and business generated) and *St. Petersburg Bank & Trust Co., 362 F. Supp. 674* (D.C. Fla. 1973) (appeal to CA dismissed in unreported opinion). (Bank's goodwill expenses incurred in giving cocktail and dinner parties, barbecues and dove shoots disallowed).

121 The court rejected taxpayer's claim that the expenses qualified as being related to a "clear business setting". See also: *LeRoy W. Gillis, T.C. Memo 1973-96* (salesman's use of boat to promote sales constituted "general goodwill").

122 509 F.2d 1067 (CA 2, 1975) rev'd and rem'd *T.C. Memo 1973-57*. 
entertain clients and potential sources of business satisfied the substantiation requirements of Section 274.\textsuperscript{128} The Second Circuit, however, reversed the decision citing *Hippodrome* and *Foster Trenching* for the proposition that the most the taxpayer showed was that the yacht expenses were not directly related to the taxpayer’s business; not in the furtherance of the taxpayer’s business; and not properly substantiated.\textsuperscript{124}

The case of *J. Wade Harris*\textsuperscript{125} may stand for the proposition that “it pays to be pushy”. Counting dockside entertainment of guests as use of the yacht in establishing primary use, the Tax Court found that the relationship of the expenses to the surgeon-taxpayer’s business was satisfied by the aggressive tactics employed on board the yacht. The taxpayer actually initiated business conversations on his yacht with all guests about patients referred to him by the doctor/guests. Hence, *Hippodrome Oldsmobile* was distinguishable. The tax Court also determined that record keeping requirements required by Regs. §§ 1.274-5(b)(3)(V) and (c)(1) were met.\textsuperscript{126}

The Tax Court allowed corroboration of the business relationship by reference to the taxpayer’s referral records which established that patients had been or were later referred by two doctor/guests. Testimony of the taxpayer’s wife as to the practice of having business discussions on board was regarded as too general and was not acceptable.\textsuperscript{127}

**Corporate Owned Yachts**

Many cases deal with the situation where a controlled corporation owns the yacht and the taxpayer makes use thereof.\textsuperscript{128} Where the corporation owns the yacht, the substantiation requirements of Section 274 must still be met. Failure to comply with these requirements not only results in disallowance of the deduction at the corporate level, but results also in a constructive dividend to the shareholder, mea-

\textsuperscript{128} *LaForge v. C.I.R.*, 434 F.2d 370 (CA 2, 1970).

\textsuperscript{124} See also: *Herbert W. Virgin*, 75-1 USTC ¶ 9288 (D.C. Fla. 1974). (Boat racing activities of a doctor found not specifically related to his professional services by jury).

\textsuperscript{125} T.C. Memo 1975-276.

\textsuperscript{126} *Harris* also deals with nonrecognition of gain—on the exchange of yachts under Section 1031; recapture of depreciation under Section 1245(b)(4); and investment credit recapture. Apparently, meeting the “directly related” test automatically satisfied the requirement that the entertainment be appropriate to the taxpayer’s business under Reg. § 1.274-2(c)(3)(iii).

\textsuperscript{127} Contra. *George Durgom*, T.C. Memo 1974-58 (wife’s testimony accepted in connection with use of residence for entertainment of husband’s clients).

sured by the fair rental value of the yacht for the period the yacht was used by the individual taxpayer.  

In *Offshore Operations Trust* the Tax Court determined that this "rental value" should include the value of "standby" status of the corporate owned yacht for the period that the yacht was made available to the corporation’s president and not put up for charter rental.  

The recent Service acquiescence of the case of *Henry Schwartz Corp.* raises the question as to whether the amount of the disallowed yacht expenses represent the amount of any constructive dividend. In *Schwartz*, some of the disallowed corporate expenses were business related but failed the Section 274 tests. Utilizing the old *Cohan* rule only part of the disallowed expenses were treated as constructive dividends.

While *Schwartz* dealt with disallowed automobile expenses at the corporate level, it may be that the Service now agrees that the "fair rental value" as the measure of a constructive dividend is not equal to actual corporate expenses or acquisition cost. The constructive dividend may equal only the actual non-business portion translated into "fair rental value".

Because of the distinct pleasure element of yachts and the strict requirements of Section 274 and the interpretation under the case law, any taxpayer seeking a tax shelter from his yacht must be careful about documenting business usage and particularly the relationship of the yacht’s use to his trade or business.

For taxpayers who use their yacht only occasionally for business, it is doubtful that compliance with Section 274 will be met.

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129 Nicholls, North, Buse Co., supra. and cases cited therein. (Evidence concerning fair rental value of a yacht used on Lake Michigan was introduced in the form of rental rates paid for similar crafts used on the East Coast. The court did not deem this evidence controlling).

130 T.C. Memo 1973-212.

131 Other cases have not seemed to take any “standby” value specifically into account. In *Offshore Operations Trust*, the corporation's president had made rental payments to the corporation for the “value” of his actual usage of the yacht. The Tax Court determined the actual value, including “standby value” was twice as much. cf. *Palo Alto Town & Country Village, Inc.*, T.C. Memo 1973-223 (standby costs for chartered airplane not allowed as deductions).


133 *George M. Cohan*, 39 F.2d 540 (CA 2).

134 In *Frederick Von Hessert*, T.C. Memo 1961-226, the amount of the constructive dividend was equal to the cost of the yacht even when actual business use by the corporation was substantial. A reimbursement program for personal usage, if consistently followed, would appear to preclude application of acquisition cost as the amount of the dividend. *Robert R. Walker*, 362 F.2d 140 (CA 7, 1966); cf. *Offshore Operations Trust*, supra.
### FARM OPERATIONS

#### Taxpayer | Citations | Factors In Decision | Losses
--- | --- | --- | ---
Kenneth B. Schley, Jr. | 375 F.2d 747 (CA 2, 1967) aff'g T.C. Memo 1965-111 | Long history of losses; non-farm income; incompetent management; no effort to cut losses | x
Jean A. Lowenthal | T.C. Memo 1968-79 | Full time effort; employment of laborers; no substantial outside income. | x
Frank M. Austin | T.C. Memo 1969-8 | Only receipts were federal payments for inactivity; large personal residence. | x
Norman P. Gross v. U.S. | 71-2 USTC ¶9715, 28 AFTR 2d 71-5888, (N.D. Fla. 1971) | Architect and wife found by jury not to be engaged in trade or business of farming; poor records | x

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* A = Allowed; D = Disallowed
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<th>Taxpayer</th>
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<th>Factors In Decision</th>
<th>Losses</th>
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<tbody>
<tr>
<td>James S. Abrams v. U.S.</td>
<td>449 F.2d 662 (CA 2, 1971)</td>
<td>Cattle and horse racing activities; admission of losses for years subsequent to tax</td>
<td></td>
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<tr>
<td></td>
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<td>years in question not in error. Jury verdict affirmed.</td>
<td></td>
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<tr>
<td>Jefferson Patterson v. U.S.</td>
<td>72-1 USTC ¶9420, 29 AFTR 2d 72-1181 (Ct. Cls. No. 155-68, 1972)</td>
<td>Competent management; cutting of losses; excellent records; very comprehensive case</td>
<td>x</td>
</tr>
<tr>
<td>Woodrow L. Wroblewski</td>
<td>T.C. Memo 1973-37</td>
<td>Operation begun for health reasons; lack of outside income</td>
<td>x</td>
</tr>
<tr>
<td>Clair E. Gurley</td>
<td>74-1 USTC ¶9311 (D.C. N. Mex. 1973)</td>
<td>Ranch operation; jury trial; statement of factors to be considered</td>
<td>x</td>
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<tr>
<td><strong>CATTLE</strong></td>
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<tr>
<td>Loy D. Mercer</td>
<td>376 F.2d 708 (CA 9, 1967) rev'g. T.C. Memo 1966-82</td>
<td>Reliance of professional breeders; good faith expectation of profit; size of operation in relation to resources</td>
<td>x</td>
</tr>
<tr>
<td>Billy V. Wann</td>
<td>T.C. Memo 1968-246</td>
<td>Inadequate acreage and facilities; residence on ranch; fulltime jobs elsewhere</td>
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<tr>
<td>Blackman v. U.S.</td>
<td>68-2 USTC ¶9655, 22 AFTR 2d 5860 (N.D. Tex. 1968)</td>
<td>Ranching operation; jury trial—factors not stated</td>
<td>x</td>
</tr>
</tbody>
</table>

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**Notes:**
- *Cattle and horse racing activities* refers to the activities related to cattle and horse racing.
- *Operation begun for health reasons* indicates the operation started due to health reasons.
- *Reliance of professional breeders* refers to the reliance on professional breeders.
- *Inadequate acreage and facilities* indicates inadequate land and facilities.
- *Ranching operation* refers to the ranching activity.
- *Factors not stated* indicates that specific factors were not stated in the case.
George W. Hicks v. U.S. 72-1 USTC ¶9383, 29 AFTR 2d 72-734 (D.C. Miss. 1972) Cattle operation and pecan farm; jury trial; detailed discussion of law; factors not given

Walter E. Edge, Jr. T.C. Memo 1973-274 Long history of unprofitability; attention to operations by taxpayer; subjective intent test used; no recreational facilities or farm; independent income present

Harris L. Wood T.C. Memo 1975-189 Taxpayer lived on farm part-time; 90% of time spent running cattle operation; son worked at farm

HORSES AND DOGS
Charles B. Pennington T.C. Memo 1967-111 Horse breeding; only 30-40 days spent annually at ranch; good faith expectation of profits; horse shows good advertising

Margit S. Besseney 379 F.2d 252 (CA 2, 1967) Horse breeding; outside income; love of horses

Everett E. Fisher T.C. Memo 1968-212 Breeding and race horses; requirement that foals be turned over to a partnership

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<table>
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<td><em>HORSES AND DOGS</em> (con’t.)</td>
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<tr>
<td>Mildred Van Cleve</td>
<td>T.C. Memo 1968-241</td>
<td>Kennel operation; continuation of lifelong hobby; failure to procure stud dogs or cut expenses</td>
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<tr>
<td>Robert E. Currie</td>
<td>T.C. Memo 1969-4</td>
<td>Dogs and ponies; pleasure element. Apple trees on 10 acres</td>
<td>x (dogs)</td>
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<tr>
<td>James D. Bowman</td>
<td>T.C. Memo 1969-23</td>
<td>Stable operation not sufficiently connected with taxpayer’s engineering business; social aspects predominant</td>
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<tr>
<td>Alden B. Starr</td>
<td>T.C. Memo 1969-35</td>
<td>Breeding and raising horses: utilitarian operation; accurate records; good faith expectation of profit despite objective evidence to contrary</td>
<td></td>
</tr>
<tr>
<td>George A. Montgomery</td>
<td>69-2 USTC ¶9615, 24 AFTR 2d 69-5501 (N.D. Ga., 1969)</td>
<td>Horse farm and stable; jury trial. Substantial outside income; statements of law only.</td>
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<td>George Thacker</td>
<td>T.C. Memo 1969-276</td>
<td>Horse breeding; no substantial other income; efficient operation; profit in 2 of 8 years.</td>
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<td>W. Jane Luce</td>
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<td>Horses: pleasure element; absence of stable or farm name</td>
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<td>Morris A. Stoltzfus</td>
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<td>Horse raising: investigation prior to entering business; professional advice and management: First years: Later years:</td>
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<td>Glenn H. Morton</td>
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<td>Horse raising by doctor: pleasure element emphasized; no facilities; lack of market research</td>
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<td>Celeste B. Smith</td>
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<td>Woman ran dog kennel; father a veterinarian; lack of concern of economics; vacillation of objectives</td>
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<td>Helis v. Usry</td>
<td>71-1 USTC ¶9365, 27 AFTR 2d 71-1266 (E.D. La. 1971)</td>
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<td>Racing and breeding stables: expert advice; expenses controlled; accurate records; multiple issue, non-jury case</td>
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<td>Edward J. Drew</td>
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<td>Raising and training jumping horses; no market; pleasure element; no advice sought;</td>
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<td>P.T. Kilman v. U.S.</td>
<td>73-2 USTC ¶9548 (D.C. Tex. 1972)</td>
<td>Doctor ran dog kennel and farm: jury trial; subjective test of profit motive in instructions by judge; statement of law only</td>
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<td>James S. Bishop</td>
<td>T.C. Memo 1972-167</td>
<td>Horse raising; modest outside income; large costs; much physical labor; advertising in shows</td>
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<td>Rex B. Foster &amp; Rex B. Foster, Jr.</td>
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<td>Shetland pony and Tennessee Walking Horse operation: conversion from one breed to another to get more marketable pony; absence of personal use; advertised breed; time expended and physical labor</td>
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<td>Kenneth P. Brown v. U.S.</td>
<td>73-2 USTC ¶9744 (D.C. Tenn. 1973)</td>
<td>Show horse operation: jury trial; expenses also held not</td>
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**Losses**

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<td>related to taxpayer’s medical practice as advertising expense; other issues: use of corporate car and boat destruction of diseased horse not a casualty loss</td>
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<td>James Coe</td>
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<td>Raising and breeding American saddle horses: loss on sale of one horse</td>
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<td>Francis X. Benz</td>
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<td>Raising, training and breeding German Short hair pointers by businessman. Section 183 discussed</td>
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<td>Willard Deerman</td>
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<td>Exploration of type of horse to raise and potential markets; hiring of qualified trainers; businesslike concern and record keeping</td>
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<tr>
<td>Riley Smith</td>
<td>74-2 USTC ¶9751 (D.C. Ala. 1974)</td>
<td>Multiple issue case. Dog business; burden of proof discussed and law</td>
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**OTHER CASES—ACTIVITIES NOT ENGAGED IN FOR PROFIT**

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<td>T.C. Memo 1969-241</td>
<td>Oregon Myrtle trees in Md.: no market; failure to grow and no income; low bracket of taxpayer; devotion of full time to venture</td>
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<td>T.C. Memo 1971-127; aff'd CA-10 unpublished opinion</td>
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<td>Arthur H. Eppler</td>
<td>58 T.C. 691 (1972); aff'd CA-7 unpublished opinion</td>
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<td>Leonard F. Barcus</td>
<td>T.C. Memo 1973-138 aff'd 492 F.2d 1237 (CA 2, 1974)</td>
<td>Purchase of antiques used to furnish home: lack of profit motive; appreciation in value alone not enough</td>
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<td>Jack H. Vestal v. U.S.</td>
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<td>Photographing wildlife with income from lectures, slide shows and sales to publishers</td>
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<td>Bette P. Hollander</td>
<td>T.C. Memo 1975-157</td>
<td>Sale of art work: wide disparity between income and expenses alone sufficient to bar deduction</td>
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