BUSINESS OR HOBBY – WHICH DO YOU HAVE? A LOOK AT IRC §183

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I. INTRODUCTION

Business or hobby, which do you have? This is an important question for most taxpayers who have activities which are not their primary source of income especially if the activity is not currently showing a profit. While under the broad based language of IRC §61[1], the income received from an activity, whether a business or not, would be included in gross income and taxed. The question revolves around the ability to write off the expenses incurred in producing that income. Deductions are generally a matter of legislative grace and as such, in order to deduct any expenses incurred to produce such income there must be a statute which allows the deduction.

Generally, individuals believe they should be able to deduct, for income tax purposes, expenses they incur while engaging in an activity they loosely perceive as a business. If these taxpayers were asked if they desired to make a profit the answer would most certainly be yes. The tax code requirements to answer the question are far from the desire of the taxpayer. The yardstick which must be applied is what makes an activity a trade or business for tax purposes, thus rendering the expenses incurred tax deductible. While trade or business has not been defined in the code or regulations there are some basic and common sense concepts which must be applied to determine whether or not a business exists. The United States Supreme Court has indicated that:

> We accept the fact that to be engaged in a trade or business, the taxpayer must be involved in the activity with continuity and regularity and that the taxpayer's primary purpose for engaging in the activity must be for income or profit. A sporadic activity, a hobby, or an amusement diversion does not qualify.[2]

Thus it is clear that the activity must be ongoing and the primary purpose must be to produce a profit. It might be noted here that producing a profit is not determinative it is the motive of the taxpayer which must be considered.

What if the activity is not a *per se* trade or business, but the expenses were incurred for the production or collection of income, or for the management, conservation, or maintenance of property held for the production of income?[3] Are these incidental types of expenses deductible? The answer is clearly *yes* under IRC §212; however, here also a profit motive must exist and the

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[1] I.R.C. §61(a) GENERAL DEFINITION. – Except as otherwise provided in this subtitle, gross income means all income from whatever source derived, including (but not limited to) the following items: . . .

[2] R.P. Groetzinger, 87-1 USTC ¶9191 – "Of course, not every income-producing and profit-making endeavor constitutes a trade or business. The income tax law, almost from the beginning, has distinguished between a business or trade, on the one hand, and "transactions entered into for profit but not connected with . . . business or trade," on the other. See Revenue Act of 1916, §5(a) Fifth, 89 Stat. 759. Congress "distinguished the broad range of income or profit producing activities for those satisfying the narrow category of trade or business." Whipple v. Commissioner [63-1 USTC ¶9466], 373 U.S. 198, 197 (1968).

[3] I.R.C. §212 In the case of an individual, there shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year -- (1) for the production or collection of income; (2) for the management, conservation, or maintenance of property held for the production of income; or (3) in connection with the determination, collection, or refund of any tax.

activity must not be a hobby.[4] The statute limits deductible losses for individuals to losses incurred in a trade or business; losses incurred in any transaction entered into for profit, though not connected with a trade or business; and losses of property not connected with a trade or business or a transaction entered into for profit, if such losses arise from fire, storm, shipwreck, or other casualty, or from theft.[5] In light of the above provisions it is apparent that when considering the deductibility of expenses and losses for individuals, being able to establish a genuine profit motive is critical with the exception of a casualty or theft loss.

II. BUSINESS V. HOBBY

The primary section which allows the deduction of business expenses is IRC §162; it states: "There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, . . ."[6] In order to deduct expenses under §162 the taxpayer must be *carrying on a trade or business*. As discussed above in the introduction the question is what is a trade or business? The term trade or business is not defined in the statute or in the regulations. However, it appears clear that some basic elements must be present in order to have a business; these are: 1) the activity must be regularly engaged in, and 2) there must be a profit motive.[7] Thus a hobby, or an activity not engaged in for a profit, would not be a business and expenses incurred in the pursuit of such an activity would not be deductible.

[4] Reg. §1.212-1(c) In the case of taxable years beginning before January 1, 1970, expenses of carrying on transactions which do not constitute a trade or business of the taxpayer and are not carried on for the production or collection of income or for the management, conservation, or maintenance of property held for the production of income, but which are carried on primarily as a sport, hobby, or recreation are not allowable as nontrade or nonbusiness expenses. The question whether or not a transaction is carried on primarily for the production of income or for the management, conservation, or maintenance of property held for the production or collection of income, rather than primarily as a sport, hobby, or recreation, is not to be determined solely from the intention of the taxpayer but rather from all the circumstances of the case. For example, consideration will be given to the record of prior gain or loss of the taxpayer in the activity, the relation between the type of activity and the principal occupation of the taxpayer, and the uses to which the property or what it produces is put by the taxpayer. For provisions relating to activities not engaged in for profit applicable to taxable years beginning after December 31, 1969, see section 183 and the regulations thereunder.

[5] I.R.C. §165(c) Limitation on losses of individuals: In the case of an individual, the deduction under subsection (a) shall be limited to-- (1) losses incurred in a trade or business; (2) losses incurred in any transaction entered into for profit, though not connected with a trade or business; and (3) except as provided in subsection (h), losses of property not connected with a trade or business or a transaction entered into for profit, if such losses arise from fire, storm, shipwreck, or other casualty, or from theft.

[6] I.R.C. §162(a) In general: There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including-- (1) a reasonable allowance for salaries or other compensation for personal services actually rendered; (2) traveling expenses (including amounts expended for meals and lodging other than amounts which are lavish or extravagant under the circumstances) while away from home in the pursuit of a trade or business; and (3) rentals or other payments required to be made as a condition to the continued use or possession, for purposes of the trade or business, of property to which the taxpayer has not taken or is not taking title or in which he has no equity.
For purposes of the preceding sentence, the place of residence of a Member of Congress (including any Delegate and Resident Commissioner) within the State, congressional district, or possession which he represents in Congress shall be considered his home, but amounts expended by such Members within each taxable year for living expenses shall not be deductible for income tax purposes in excess of $3,000. For purposes of paragraph (2), the taxpayer shall not be treated as being temporarily away from home during any period of employment if such period exceeds 1 year. The preceding sentence shall not apply to any Federal employee during any period for which such employee is certified by the Attorney General (or the designee thereof) as traveling on behalf of the United States in temporary duty status to investigate or prosecute, or provide support services for the investigation or prosecution of, a Federal crime.

[7] *Supra* note 2.

The intention of Congress to allow deductions for *bona fide* business ventures and to stop the deduction of losses for personally motivated activities like hobbies, has been an on-going process. Former Code §270, which was repealed for tax years beginning after 1969, indicated that if expenses of an activity exceeded income by more than $50,000 for five consecutive years then taxable income was recomputed. This section was repealed as it was ineffective in deterring the deductibility of losses on activities which was not engaged in for profit.[8] The provision was replaced with IRC §183 which currently controls the deduction of expenses related to an activity *not engaged in for a profit.* This statute provides the general rule:

> In the case of an activity engaged in by an individual or an S corporation, if such activity is not engaged in for profit, no deduction attributable to such activity shall be allowed under this chapter [chapter 1 Normal Taxes and Surtaxes under Subtitle A Income Taxes] except as provided in this section.[9]

Section 183 is a mixed section in that it is an allowance section as well as a disallowance section. Without this section the income from the activity would be included in gross income under §61 and no deductions would be allowed against the income except as might be allowed by another code section without regard to the nature of the activity; for example, real property taxes which are allowed under §164.[10] This is the result because, as discussed in the introduction, in order to take a deduction of any kind there must be a code section which allows the deduction. In fact, if one looks at hobby expenses as generally personal in nature §262 makes the statement, "[e]xcept as otherwise expressly provided in this chapter, no deduction shall be allowed for personal, living, or family expenses."[11]

Section 183 is a disallowance section in that it disallows all deductions related to the activity. It is an allowance section in that it allows certain expenses attributable to the activity but only to the extent of income derived from the activity.[12] The deductions allowed are as follows and must be taken in the order given: First, items which would be deductible regardless of the activities tax status (e.g. real property taxes), and next expenses which would be deductible had the activity been a trade or business.[13] Under the regulations the latter expenses are further broken down in that expenses which do not adjust the basis in property will be considered first and if income from the activity still exceeds the deductions, expenses which adjust the basis in property will be considered

[8] CCH-EXP 2005FED ¶44,394.01 – Under former Code Sec. 270, an individual's taxable income was subject to recomputation if the deductions attributable to a trade or business exceeded the trade or business income by more than $50,000 for five successive years. The aim of the provision was to eliminate recurring hobby losses of wealthy individuals and at the same time to preserve or protect the deductions of legitimate business operations. However, Code Sec. 270 was repealed, effective for taxable years beginning after 1969, because the provisions proved to be ineffective. It was a fairly easy matter for an individual affected to bring his deductions under $50,000 for a year so as to interrupt the five successive year period.

[9] Tax Reform Act of 1969 (P.L. 91-172) and I.R.C. §183(a).

[10] I.R.C. §164(a) GENERAL RULE. --Except as otherwise provided in this section, the following taxes shall be allowed as a deduction for the taxable year within which paid or accrued: 164(a)(1) State and local, and foreign, real property taxes.

[11] I.R.C. §262(a).

[12] I.R.C. §183(a) GENERAL RULE. --In the case of an activity engaged in by an individual or an S corporation, if such activity is not engaged in for profit, no deduction attributable to such activity shall be allowed under this chapter except as provided in this section.

[13] 183(b) DEDUCTIONS ALLOWABLE. --In the case of an activity not engaged in for profit to which subsection (a) applies, there shall be allowed -- 183(b)(1) the deductions which would be allowable under this chapter for the taxable year without regard to whether or not such activity is engaged in for profit, and 183(b)(2) a deduction equal to the amount of the deductions which would be allowable under this chapter for the taxable year only if such activity were engaged in for profit, but only to the extent that the gross income derived from such activity for the taxable year exceeds the deductions allowable by reason of paragraph (1).

to the extent of any remaining income.[14]

It is important to note that §183 does not change the procedural requirements of §62 that specify which deductions, for individuals, can be taken in arriving at Adjusted Gross Income. Thus, in most cases that do not involve rental type income, the deductions allowed would be itemized deductions that, with the exception of the otherwise allowable items, would be part of the taxpayer's miscellaneous itemized deductions which are subject to reduction by 2% of Adjusted Gross Income.

The statute is clear that the deductibility of expenses incurred in an activity not engaged in for a profit are limited to the income from the activity which would act to disallow the deduction of any net losses from the activity. The remaining issues to discuss would include; 1) To whom does §183 apply? 2) What is the statutory definition of an activity not engaged in for a profit? and 3) How does one determine the nature of a given activity?

A. TO WHOM DOES §183 APPLY?

The provisions of §183 apply to individuals and S-corporations.[15] This would extend to partners in partnerships so long as the partner was an individual.

> Section 183(a) of the Internal Revenue Code of 1954 provides that, in the case of an activity engaged in by an individual or an electing small business corporation (as defined in section 1371(b)), if such activity is not engaged in for profit, no deduction attributable to such activity is allowed, except as provided in section 183. Section 703(a) provides in general that the taxable income of a partner shall be computed in the same manner as in the case of an individual.
>
> Held, section 183 of the Code applies to the activities of a partnership, and the provisions of section 183 are applied at the partnership level and reflected in the partners' distributive shares.[16]

[14] Reg. §1.183-1(b) Deductions allowable--(1) Manner and extent. If an activity is not engaged in for profit, deductions are allowable under section 183(b) in the following order and only to the following extent: (i) Amounts allowable as deductions during the taxable year under Chapter 1 of the Code without regard to whether the activity giving rise to such amounts was engaged in for profit are allowable to the full extent allowed by the relevant sections of the Code, determined after taking into account any limitations or exceptions with respect to the allowability of such amounts. For example, the allowability of interest expenses incurred with respect to activities not engaged in for profit is limited by the rules contained in section 163(d). (ii) Amounts otherwise allowable as deductions during the taxable year under Chapter 1 of the Code, but only if such allowance does not result in an adjustment to the basis of property, determined as if the activity giving rise to such amounts was engaged in for profit, are allowed only to the extent the gross income attributable to such activity exceeds the deductions allowed or allowable under subdivision (i) of this subparagraph. (iii) Amounts otherwise allowable as deductions for the taxable year under Chapter 1 of the Code which result in (or if otherwise allowed would have resulted in) an adjustment to the basis of property, determined as if the activity giving rise to such deductions was engaged in for profit, are allowed only to the extent the gross income attributable to such activity exceeds the deductions allowed or allowable under subdivisions (i) and (ii) of this subparagraph. Deductions falling within this subdivision include such items as depreciation, partial losses with respect to property, partially worthless debts, amortization, and amortizable bond premium.

[15] *Supra* note 7.

[16] Rev. Rul. 77-320, 1977-2 CB 78.

B. WHAT IS THE STATUTORY DEFINITION OF AN ACTIVITY NOT ENGAGED IN FOR A PROFIT?

An activity not engaged in for a profit is defined as follows: "For purposes of this section, the term 'activity not engaged in for profit' means any activity other than one with respect to which deductions are allowable for the taxable year under section 162 or under paragraph (1) or (2) of section 212."[17] Thus the activity is one which is not a trade or business, nor a transaction entered into for the production of income.

C. HOW DOES ONE DETERMINE THE NATURE OF A GIVEN ACTIVITY?

The regulations under §183 provide a nonexclusive list of nine relevant factors that must be considered and are indicative of intent. These relevant factors are discussed in the following enumerated paragraphs:

I. *Manner in which the taxpayer carries on the activity*. The fact that the taxpayer carries on the activity in a businesslike manner and maintains complete and accurate books and records may indicate that the activity is engaged in for profit. Similarly, where an activity is carried on in a manner substantially similar to other activities of the same nature which are profitable, a profit motive may be indicated. A change of operating methods, adoption of new techniques or abandonment of unprofitable methods in a manner consistent with an intent to improve profitability may also indicate a profit motive.

II. *The expertise of the taxpayer or his advisors.* Preparation for the activity by extensive study of its accepted business, economic, and scientific practices, or consultation with those who are expert therein, may indicate that the taxpayer has a profit motive where the taxpayer carries on the activity in accordance with such practices. Where a taxpayer has such preparation or procures such expert advice, but does not carry on the activity in accordance with such practices, a lack of intent to derive profit may be indicated unless it appears that the taxpayer is attempting to develop new or superior techniques which may result in profits from the activity.

III. *The time and effort expended by the taxpayer in carrying on the activity.* The fact that the taxpayer devotes much of his personal time and effort to carrying on an activity, particularly if the activity does not have substantial personal or recreational aspects, may indicate an intention to derive a profit. A taxpayer's withdrawal from another occupation to devote most of his energies to the activity may also be evidence that the activity is engaged in for profit. The fact that the taxpayer devotes a limited amount of time to an activity does not necessarily indicate a lack of profit motive where the taxpayer employs competent and qualified persons to carry on such activity.

IV. *Expectation that assets used in activity may appreciate in value.* The term "profit" encompasses appreciation in the value of assets, such as land, used in the activity. Thus, the taxpayer may intend to derive a profit from the operation of the activity, and may also intend that, even if no profit from current operations is derived, an overall profit will result when appreciation in

[17] I.R.C. §183(c) Activity Not Engaged In For Profit Defined.

the value of land used in the activity is realized since income from the activity together with the appreciation of land will exceed expenses of operation.[18]

V. *The success of the taxpayer in carrying on other similar or dissimilar activities.* The fact that the taxpayer has engaged in similar activities in the past and converted them from unprofitable to profitable enterprises may indicate that he is engaged in the present activity for profit, even though the activity is presently unprofitable.

VI. *The taxpayer's history of income or losses with respect to the activity.* A series of losses during the initial or start-up stage of an activity may not necessarily be an indication that the activity is not engaged in for profit. However, where losses continue to be sustained beyond the period which customarily is necessary to bring the operation to profitable status such continued losses, if not explainable, as due to customary business risks or reverses, may be indicative that the activity is not being engaged in for profit. If losses are sustained because of unforeseen or fortuitous circumstances which are beyond the control of the taxpayer, such as drought, disease, fire, theft, weather damages, other involuntary conversions, or depressed market conditions, such losses would not be an indication that the activity is not engaged in for profit. A series of years in which net income was realized would of course be strong evidence that the activity is engaged in for profit.

VII. *The amount of occasional profits, if any, which are earned*. The amount of profits in relation to the amount of losses incurred, and in relation to the amount of the taxpayer's investment and the value of the assets used in the activity, may provide useful criteria in determining the taxpayer's intent. An occasional small profit from an activity generating large losses, or from an activity in which the taxpayer has made a large investment, would not generally be determinative that the activity is engaged in for profit. However, substantial profit, though only occasional, would generally be indicative that an activity is engaged in for profit, where the investment or losses are comparatively small. Moreover, an opportunity to earn a substantial ultimate profit in a highly speculative venture is ordinarily sufficient to indicate that the activity is engaged in for profit even though losses or only occasional small profits are actually generated.

VIII. *The financial status of the taxpayer*. The fact that the taxpayer does not have substantial income or capital from sources other than the activity may indicate that an activity is engaged in for profit. Substantial income from sources other than the activity (particularly if the losses from the activity generate substantial tax benefits) may indicate that the activity is not engaged in for profit especially if there are personal or recreational elements involved.

IX. *Elements of personal pleasure or recreation.* The presence of personal motives in carrying on of an activity may indicate that the activity is not engaged in for profit, especially where there are recreational or personal elements involved. On the other hand, a profit motivation may be indicated where an activity lacks any appeal other than profit. It is not, however, necessary that an activity be engaged in with the exclusive intention of deriving a profit or with the intention of maximizing profits. For example, the

[18] See, however, paragraph (d) of §1.183-1 for definition of an activity in this connection.

> availability of other investments which would yield a higher return, or which would be more likely to be profitable, is not evidence that an activity is not engaged in for profit. An activity will not be treated as not engaged in for profit merely because the taxpayer has purposes or motivations other than solely to make a profit. Also, the fact that the taxpayer derives personal pleasure from engaging in the activity is not sufficient to cause the activity to be classified as not engaged in for profit if the activity is in fact engaged in for profit as evidenced by other factors whether or not listed in this paragraph.[19]

The regulations under §183 indicate that a determination is to be made using *objective standards* taking into account all the *facts and circumstances*. No single factor is determinative. There is also no apparent weighting of the factors presented. There is an indication that a reasonable expectation of profit is not required; however, the facts and circumstances must "indicate that the taxpayer entered into the activity, or continued the activity, with the objective of making a profit."[20] The regulations go on to indicate that, "In determining whether an activity is engaged in for profit, greater weight is given to objective facts than to the taxpayer's mere statement of his intent."[21]

The Courts appear to accept the idea that the taxpayer's statements to the effect that they had a profit motive must be supported by the facts and circumstances. Several examples of this emphasis on facts and circumstances appear in the following delineated cases. The Tamms case stated, "The taxpayer's characterization will not be accepted … when it appears that his characterization is artificial and cannot be reasonably supported under the facts and circumstances of the case."[22] The Tinnell case provided, "Whether the requisite profit objective exists is a question of fact to be resolved after considering all the pertinent facts and circumstances."[23] The Parker case provides, "In considering whether a taxpayer engaged in an activity for profit, greater weight is given to objective factors, taking into account all of the facts and circumstances, than to a taxpayer's mere statement of intent."[24]

In an attempt to further clarify the factors used in determining the presence or absence of a profit motive and thus determine whether an activity is controlled by the provisions of §183 (activities not engaged in for a profit) or §162 (trade or business expenses), court cases that were heard during the period 1999 through 2004 were looked at to see what factors were used in the Judge's decisions.

During the time period considered many cases dealing with tax shelters were decided using the provisions of §183. The tax shelter type cases were not considered as the allowance or disallowance of any losses were based on whether the transactions were tax motivated and if they had economic substance. This left 57 cases in which the *relevant factors* from the regulations were applied. Of these cases 42 found that the activity was not engaged in for a profit and thus §183 was applied and in 15 cases a profit motive was established and the activity was treated as a trade

[19] Reg. §1.183-2(b)(1) thru (9).

[20] Reg. §1.183-2(a) . . .The determination whether an activity is engaged in for profit is to be made by reference to objective standards, taking into account all of the facts and circumstances of each case. Although a reasonable expectation of profit is not required, the facts and circumstances must indicate that the taxpayer entered into the activity, or continued the activity, with the objective of making a profit. In determining whether such an objective exists, it may be sufficient that there is a small chance of making a large profit. Thus it may be found that an investor in a wildcat oil well who incurs very substantial expenditures is in the venture for profit even though the expectation of a profit might be considered unreasonable. In determining whether an activity is engaged in for profit, greater weight is given to objective facts than to the taxpayer's mere statement of his intent.

[21] Ibid.

[22] Jeffrey Tamms v. Commissioner, TC Memo. 2001-201.

[23] James Tinnell v. Commissioner, TC Memo. 2001-106.

[24] John G. Parker and Janice E. Parker v. Commissioner, TC Memo. 2002-76.

or business. Table 1 below gives some indication as to the types of activities represented in the cases considered.

Table 1 Types of activities litigated

Type of Business	**No Profit Motive**	**Profit Motive**
Artist/Musician	2	
Airplanes	1	
Automobile/Motorcycle Racing	3	
Cattle Ranching/ Farming	9	
Charter Fishing/Fishing	2	1
Computer Software design	1	
Consulting	2	
Dance Company	1	
Direct Marketing	2	
Dog Breeding/Showing	1	
Horse related activities	13	6
Import Export/Jade activity	1	1
Mining/Meteorite and Pyrite collection	1	1
Leasing activity		1
Lodge/Timber activity	1	
Photography		1
Real Estate		1
Videotape activity	1	
Volleyball organization		1
Writing	1	2

In looking at the relevant factors used in the cases where no profit motive was established 100% were found not to have run their activity in a businesslike manner (see table 2 below, factor 1.) In many of these cases the taxpayers kept adequate to good records; however, simply having records which allow the individual to document expenses as attributable to the activity does not appear sufficient to establish that it was operated in a businesslike manner. In the Priento case, the court found that the individual did not run the activity in a businesslike manner and while several factors were considered the lack of a business plan appeared to weigh heavy against the individual. In this case the court stated:

> Petitioners hired professionals to keep books and records and to prepare their returns. They also hired professionals to work in the horse activity as grooms, braiders, horseshoers, and veterinarian. While these facts weigh in petitioners favor, they are not the only facts presented to the Court. . .
>
> . . . Even though they had records reporting substantial losses, petitioners never developed a written business plan or made a budget. Dr. and Mrs. Prieto testified that the "business plan" of the horse activity was to buy, train (develop), show, and sell horses. This is not a plan; this is merely a statement of what the horse activity did. While petitioners wrote out "business goals" for 1994 and 1995, they never developed a plan to achieve these goals.[25]

[25] Victor A. and Marion W. Prieto v. Commissioner TC Memo. 2001-266.

In the Zarins case, the individual had a tree farming activity and the court found the venture was not operated in a business-like manner and indicated:

> There is no evidence establishing that petitioner had a business plan. Petitioner wanted to sell evergreen trees and some of the trees that were growing indigenously on the land to nurseries and to individuals, and he knew that he could not sell the trees he planted for 10 years. However, the fact that he planted trees without keeping records of the number planted and that he had no specific concept for operating a profitable tree farm shows that he did not have a business plan.
>
> Petitioners contend in their brief that they planned to plant about 500- 1000 seedlings each year and to sell 300-1000 trees for $9,000- $30,000 per year around years 10 to 12. However, statements in a brief are not evidence.[26]

In the Tamms case, where profit motive was found one of the favorable factors the court considered was that the individual had a business plan:

> On the basis of the totality of the evidence in the record, we conclude that for the years in issue, petitioner had a good faith expectation of profit from his Schedule C activity. In reaching this conclusion, we view the following factors as being particularly persuasive: Petitioner carried on his activity in a businesslike manner, keeping, as respondent acknowledges on brief, "fairly extensive financial records for his Schedule C activity." Petitioner responded to JJT's lack of profitability in earlier years by developing a successful business plan to expand JJT's undertakings into producing photography exhibitions. Since 1994, petitioner has regularly produced photography exhibitions each year. As a consequence, since 1995 JJT has reported net profits each year.[27]

As might be expected, factor six from table two, *The taxpayer's history of income or losses with respect to the activity*, was found unfavorable (97%) as profitable activities would not likely be adjudicated. While under the regulations, as discussed above, *a reasonable expectation of profit is not required*, no business can continue without profits. If a business activity has been going on for a period of time without meaningful profits, in the absence of compelling evidence in the form of a business plan which details how profits are to be forthcoming in the future, it is apparent that the individual's dominant motive is something other than to make a profit.

As the overall importance of a business plan's existence and objective evidence to show that it has been acted upon is considered, other major factors, from table 2, which appear to have significant influence as it relates to the existence of a business plan and profit motive were:

> **Factor 2** *The expertise of the taxpayer or his advisors*, 74% of the cases found this unfavorable and only 5% favorable. In one case dealing with an author, while the court found that the taxpayer had some expertise in technical writing, "Petitioner did not seek expert advice on how to start or maintain a business as a fiction writer or as a writer of political commentary or about guns. Petitioner did not consult with anyone on the economics of conducting a writing activity."[28]

[26] Andris Zarins and Zigrida A. Zarins v. Commissioner, TC Memo. 2001-68.
[27] Jeffrey Tamms v. Commissioner, TC Memo. 2001-201.
[28] McCarthy T.C. Memo. 2000-197.

> **Factor 8** *The financial status of the taxpayer*, appeared to have significant influence with 71% being unfavorable, with none being favorable, and 29% neutral. In a case dealing with a horse activity the court considered the effect of, "Substantial income from sources other than the activity in question, particularly if the activity's losses generate substantial tax benefits, may indicate that the activity is not engaged in for profit. Sec. 1.183-2(b)(8), Income Tax Regs. From 1991 through 1998, petitioners' net profit from Dr. Prieto's medical practice averaged $638,253. This factor weighs against petitioners."[29]
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> **Factor 9** *Elements of personal pleasure or recreation*, 74% unfavorable with 24% being neutral. In a case dealing with automobile racing, "Elements of personal pleasure or recreation may signal the absence of a profit motive. Sec. 1.183-2(b)(9) , Income Tax Regs. The evidence clearly shows that Tony enjoyed and obtained pleasure from his stock car activity. This factor favors respondent."[30]

Table 2: Factors used in cases which were found to be unfavorable to the taxpayer

Factor*	**1**	**2**	**3**	**4**	**5**	**6**	**7**	**8**	**9**
Unfavorable to Taxpayer	100%	74%	43%	57%	29%	93%	74%	71%	74%
Favorable to Taxpayer	0%	5%	24%	2%	0%	0%	0%	0%	2%
Neutral to Taxpayer	0%	21%	33%	41%	71%	7%	26%	29%	24%
Not Specifically used	0%	0%	0%	0%	0%	0%	0%	0%	0%

* Numbers correspond to relevant factors given above

Of the cases which found the activity in question to have a profit motive, basically all but one of the factors were generally found to be favorable or neutral (see table 3 below.) The taxpayer's history of income or losses with respect to the activity, factor 6, is the one notable exception. This factor was discussed above as being a significant issue in cases where no profit motive was found and in table 3, 67% of the cases which were found to have a profit motive found this factor unfavorable. This would be the logical outcome as discussed above in that the Government would not take a profitable business to court to show that it lacked a profit motive. This would tend to show that having an adequate written business plan which is being objectively acted upon should encompass enough of the factors to produce a favorable outcome and be sufficient to establish a profit motive.

[29] Victor A. and Marion W. Prieto v. Commissioner, TC Memo. 2001-266.
[30] Tony L. Zidar and Kathleen I. Zidar v. Commissioner, TC Memo. 2001-200.

Table 3: Factors used in cases which were found to be favorable to the taxpayer

Factor*	**1**	**2**	**3**	**4**	**5**	**6**	**7**	**8**	**9**
Unfavorable to Taxpayer	0%	7%	0%	0%	7%	67%	13%	0%	7%
Favorable to Taxpayer	80%	67%	87%	53%	33%	0%	27%	47%	47%
Neutral to Taxpayer	20%	20%	7%	47%	53%	27%	53%	47%	40%
Not Specifically used	0%	6%	6%	0%	7%	6%	7%	6%	6%

Numbers correspond to relevant factors given above

III. Burden of Proof and §7491

As part of the Internal Revenue Service Restructuring and Reform Act of 1998[31] IRC §7491 was added to the code. This provision acts to move the burden of proof from the taxpayer to the government in certain given circumstances. The section only applies to I.R.S. examination which commenced after July 22, 1998. The two basic requirements which must be met to invoke this section are: 1) the taxpayer must have complied with the requirements under the code to substantiate any item; and 2) taxpayer must maintain all records required by the code and have cooperated with reasonable requests made by the Secretary for witnesses, information, documents, meetings, and interviews.[32]

Only 13 cases were found where this section was discussed. In all of these cases §7491 was not applied either because it could not be established that the examination in question started after July 22, 1998, or because neither party brought up the issue.

It is unlikely that IRC §7491 would cause a substantial change in the outcome of these cases because the evidence necessary to support the profit motive would still have to be presented by the taxpayer. If anything IRC §7491, as applied to the question of profit motive, merely reverses the burden of proof back to the IRS if the taxpayer can minimally establish the basic elements of the pertinent nine factors above.

IV. Conclusion

In conclusion it is clear that in order to establish that an activity is engaged in for profit the individual must demonstrate with objective evidence the existence of such a motive. The regulations present nine factors which might be considered in addressing the existence of a profit motive and based on the finding of this article a pervasive element which must exist is a written business plan which can be shown, through objective means, to have been acted upon. The Government should not try to assess the reasonableness of the business' likelihood of generating a

[31] Internal Revenue Service Restructuring and Reform Act of 1998, Pub. L. 105-206.

[32] I.R.C. §7491(a) Burden shifts where taxpayer produces credible evidence .
(1) General rule -- If, in any court proceeding, a taxpayer introduces credible evidence with respect to any factual issue relevant to ascertaining the liability of the taxpayer for any tax imposed by subtitle A or B, the Secretary shall have the burden of proof with respect to such issue.
(2) Limitations -- Paragraph (1) shall apply with respect to an issue only if-- (A) the taxpayer has complied with the requirements under this title to substantiate any item; (B) the taxpayer has maintained all records required under this title and has cooperated with reasonable requests by the Secretary for witnesses, information, documents, meetings, and interviews; and (C) in the case of a partnership, corporation, or trust, the taxpayer is described in section 7430(c)(4)(A)(ii).
Subparagraph (C) shall not apply to any qualified revocable trust (as defined in section 645(b)(1)) with respect to liability for tax for any taxable year ending after the date of the decedent's death and before the applicable date (as defined in section 645(b)(2)).

profit as the regulations indicate that a *reasonable expectation of profit* is not required. However it is clear that presenting only the verification of expenses and the individual's statements that the activity is a business engaged in for profit will not be convincing to the Internal Revenue Service or the Courts.