WORKING PAPER

No. 04-01A February 2004

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CURRENT STATUS AND CONSIDERATIONS OF HOBBY LOSSES

BY
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Abstract: Various otherwise legitimate "at risk" entrepreneurial startup activities—especially family oriented businesses—are subjected to constrictive guidelines established by statute and the courts, possibly discouraging otherwise promising entrepreneurial activities by timid taxpayers not wishing to be aggressive. Conversely, the hobby loss rules act to prevent the expensing of what otherwise would be personal expenses disguised as "valid" business expenses, thereby causing significant losses of revenue to the Treasury. Somewhere between the two extremes are legitimate activities entered into for the purpose of making profits yet are treated with hostility by the service.

This paper explores the background and current status of the hobby loss rules and their possible unexpected impact on the small entrepreneur.

The Entrepreneurial Saga Begins

The hobby loss restriction has been a valued part of the IRS armada for many years, restricting attempts by taxpayers to claim expenses (and thus deductions from income) beyond rather meager income derived from the taxpayers' "pet" projects. The logic behind such restrictions is otherwise reasonable—i.e., if the taxpayer is not earning a profit from their activity, there must be some other alternative reasoning behind the activity—that usually being it is assumed the activity is purely for the taxpayer's pleasure and thus the activity is being attempted to be paid for at the government's expense.

Such an audit approach is simple: it doesn't require much effort to handle the situation to disallow such deductions. Unfortunately, the end result accordingly is extremely easy to then overlook or ignore other tangible or intangible aspects of the alleged business "effort," particularly when the business activity is abandoned when the entrepreneur is convinced that the service does not deem the activity to be a viable entity. Of course, some entrepreneurs go on to prove the service wrong, but it is doubtful many continue after a disastrous audit event.

While this tough approach is understandable from a revenue enhancement viewpoint, it is arguably quite lacking in considerations otherwise relevant in the business world and that are otherwise available to entities that, for whatever reason, from the Code's viewpoint, were otherwise "legitimately" established. There has always been a seeming presumption of legitimacy the more complex the business form (i.e., the establishment of a corporation or partnership), but of course, even this legitimacy can be- and sometimes is—challenged.

It is almost automatically and naturally assumed if someone has incorporated or developed a partnership agreement for the business entity, "serious" business reasons must exist for the expenditure of scarce capital. In fact, the Code encourages such
expenditures by allowing the amortization of the start up expenses over a sixty month period.

This postulate, however does not seem to consider that such start up costs are not inconsequential to an individual taxpayer, and often the individual naturally wishes to minimize the beginning and ongoing operating costs of the business activity to both enhance the possibility of the survival of the business by conserving otherwise scare capital. Further, the taxpayer is also being prudent in wishing to minimize their personal exposure to loss of personal capital if the activity later collapses or becomes otherwise unfeasible. While certain theoretical lip service is given to these notions, it appears in reality this risk is often not seriously considered by the Code nor by the Service.

Interestingly, there has been the most “hostility” in most any form of activity whereby a child and a parent are joint venturing some activity, usually in the area of music, sports and/or art. This area, while others certainly exist, provides some valuable insight into the presumptions versus everyday reality. A hypothetical yet illustrative case might be useful to explore the various ramifications of the matter:

*Our Hypothetical Case*

Assume the taxpayer has gifted and very talented child in music or dance. Unfortunately, many such children exist, and thus simple economics precludes outside third party agencies in fronting funds to cover costs to develop, produce or market every child with outstanding potential. Thus, a fairly commonly litigated avenue develops: child’s parent becomes child’s agent or business manager. Parent establishes a business activity-management, consulting, production or some similar such “for profit” activity. Unfortunately, the income level is paltry at best in the early years, and expenses far exceed revenues. As everyone knows, the music and/or entertainment business is a tough business, and it takes quite some time to make it big, if at all. And thus the tax “rub”-you are expected, in general, to make a profit at least two out of five years. And then, before the fourth or fifth year of full operations, imagine you get an audit of the third or fourth year of the business. Of course, no profit has yet been earned, but things may be starting to look better.

*And so “our task” begins- the Proof of a For-Profit Business*

While we generally view the tax code as designed to reward risk takers, it does not do so here, and in essence shuts down the tax advantages in very short order. Interestingly, the service does recognize that even horse racing takes time, and additional time is granted to achieve a profit (seven as opposed to five years). Unfortunately, sometimes it takes ten or more years to generate a profit, if then, in some businesses- including horses!

While sometimes hostile to the so-called hobby business, the courts have been gracious in providing clearer and more articulately defined guidelines than those of the service. As gratifying as it is to have these clarifications or enhancements, even these precepts
arguably fall short and are in some cases seemingly openly hostile to the entrepreneurial spirit.

Deductibility?

The first real “test” is whether the talent manager/agent’s expenses can be deductible in the first place. *Welch v. Helvering*, 54 S. Ct. 8 (1933), teaches an expense is necessary, and accordingly deductible, if a prudent person would incur the same expense and the expense is expected to be appropriate and helpful in the taxpayer’s business. In *Blackmer v. Commissioner*, 70 F2d 255 (1934), the court teaches that a “necessary expense” is one that is *appropriate and helpful*, rather than necessarily *essential* to the taxpayer business. *Commissioner v. Tellier*, 383 US 687 (1966) held that “normal and necessary” means that the expenditure must be normal, usual and customary, as well as appropriate and necessary and helpful to the operation of the business. *James M. Green, T.C. Memo 1989-599* held if the taxpayer is not engaged in profit, no deduction attributable to such activity is allowed as a deduction, and conversely, if truly engaged in for profit, the deduction is allowed. *Flint v. Stone Tracy Co.*, 220 US 107 (1911) defines a ‘business’ as “that which occupies the time, attention, and labor of men for the purpose of a livelihood or profit.” Interestingly, in *Holmes v. Commissioner*, 83 AFTR 2d 99-298, 184 F3rd 536 (1999), the Tax Court held that “an activity is engaged in for profit if the taxpayer entertained an actual and honest, even though unreasonable or unrealistic, profit objective in engaging in the activity” (emphasis added). Finally, the Tax Court held in *Lou Levy*, 30 T.C. 1315 (1958), that an artist’s agent who invests money in hopes that artist will become a star *may deduct* the related expenses.

In *Valerie Jean Genck v. Commissioner*, T.C. Memo 1998-105, the Court allowed the taxpayer’s expensing of its rental of recording studio used in production of CDs and blank CD’s as supplies as opposed to capitalization of those expenses. In *Charles Hutchinson v. Commissioner*, 13 BTA 1187 (1928), theatrical clothes (visa vie. “everyday” clothes) were allowed as deduction. Conversely, the court held that wigs, makeup, skin care, and hair care were not deductible *unless proven* for business use.

Thus, the business expense must be “normal and necessary” but not “essential” to the taxpayer’s business, and the business - or our activity intent upon profit- depends on whether an actual and honest, albeit unreasonable or unrealistic, profit objective was envisioned.

*Whose income/deduction?*

Another major question raised consistently by the service is whether the income or deduction is attributable to parent/agent or to the child/performer? A good working definition of a talent or personal manager was given in *Waishren v. Peppercorn Products, Inc. 41 Cal. App. 4th 246*, where the court noted that a talent/personal manager’s primary function is to advertise, counsel, direct and coordinate the artist in the development of his or her career, including directing the personal affairs of the artist/client. In *Anthony J.*
Carino, Jr., T.C. Summary Opinion 2002-140, the execution of the personal management agreement by Mr. Carino, the petitioner, and his daughter did not constitute a change in “Mr. Carino’s relationship with his daughter from parent to manager for profit.” ... “He has no agreement or understanding in place providing him with a percent or interest in any future earnings...”

In Fritschle v. Commissioner, 79 T.C. 152 (1982), the central issue was whether the income received by taxpayer and claimed to belong to her children by the Service was actually taxpayer’s—not the children’s. Held: Payment for work done at home mostly by taxpayer’s children was taxable to taxpayer; as she had sole responsibility for performance of all work and children helped. IRC §73 was not applicable since the children were not the actual earners of income. The critical factor viewed by the court was the predominate command of the taxpayer over the income, citing Harrison v. Shaffner, 312 US 579 (1941). The court in Johnson v. Commissioner, 78 T.C. 882 (1982), noted that the true earner cannot always be identified by pointing “to the one actually turning the spade or dribbling the ball.” Thus, a true earner cannot always be clearly identified, and accordingly the issue of who controls the earning of the income is also critical. Recall §73 normally operates to tax a minor child on income he is deemed, in the tax sense, to have earned. If, on the other hand, it seems that if there was a finding in Fritschle that it was the services of children that were being contracted for and the children were the true earners of the income, then §73 would tax the children on the income. For example, a baseball bonus paid to mother was actually income to major league baseball player. Allen v. Commissioner, 50 T.C. 466 (1968), aff’d, 401 F. 2d 398 (3rd Cir. 1969). Even though the contract of employment was made directly by the parent and the parent receives the compensation for the services, it would be considered taxable to the child because earned by the child. H. Rept. 1365, 1944 CB 821. In reality, this language merely recognizes parents must be the contracting party when, due to their legal capacity, minor children cannot enter into valid contracts. Critically, it must still be shown that the services of the child were being contracted for and—more importantly—that the children controlled the earning of the income. Fritschle (emp. added.)

In Cecil Randolph Hundley, 48 T.C. 339 (1967), the business expense deduction was allowed for a pro baseball player by the parent/agent. The agreement between the two was based on time spent in training and representing player/child, and it was clear that the ultimate receipt of payment was uncertain and undeterminable. But, payments were made to agent/parent after services were rendered but while taxpayer parent was still engaged in the agent/manager trade or business. The court looked at the following primary elements: the time spent in coaching, training, and representing player, which included the diligent “cultivation of clubs, traveling.” The court noted the agreement may not be arms length in the normal sense and must be carefully scrutinized, but that the agreement stood “every searching test.” Further helping the case were independent witnesses who observed and testified as to the contract’s existence.
Thus, it appears that while the service will still attack the notion of whom has earned the income in some cases, it is clear the courts will side with the taxpayer on this issue if the child did not control the earning of their income.

The Nine (Plus) "Prong" Test(s)

Treas. Reg. §1.183-2 is by far the most litigated aspect of an alleged hobby activity, yet-in casual reading- it seems to be broad and general enough to consider all valid points that would be raised by an entrepreneur. Unfortunately, the interpretation of the regulation has often been extremely restrictive. Treas. Reg. §1.183-2(a) notes in part that "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... it may be sufficient that there is a small chance of making a large profit... 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" (emphasis added).

Thus, the regulation gives credence for viewing all, not just limited, aspects of the taxpayer's situation. The example of a wildcatter is quite illustrative in that few expenditures of capital can be so worthless or so enriching. It is opined that such an argument can be easily raised for a child artist's expenses, as well as any new business venture.

Treas. Reg. §1.183-2(b) views the following matters as critical: the (1) manner in which the taxpayer carries on the activity; (2) the expertise of the taxpayer or his advisors; (3) the time and effort expended by the taxpayer in carrying on the activity; (4) the expectation that assets used in activity may appreciate in value; (5) the success of the taxpayer in carrying on other similar or dissimilar activities; (6) the taxpayer's history of income or losses with respect to the activity; (7) the amount of occasional profits, if any, which are earned; (8) the financial status of the taxpayer; and (9) elements of personal pleasure or recreation. The court in Abramson v. Commissioner, 86 T.C. 360, 371 (1986) noted that while 1.183-2(b) has nine points it found that no single item is controlling. "A profit objective may be analyzed in relation to the nine factors set out in section 183 regulations, but those factors are not applicable or appropriate for every case. The facts and circumstances of the case in issue remain the primary test" (emphasis added). A review of the nine points and judicial reviews notes some interesting and instructive contrasts.

Manner in which the taxpayer carries on the activity. The Service views as important the carrying on the activity in a businesslike manner, keeping books and records, following similar business practices of other similar businesses, and the change of operating methods and/or adoption of new techniques and/or abandonment of
unprofitable methods to improve profitability. In *James T. Tarkowski, T.C. Memo 1989-379*, the court noted there was no profitability, no detailed business records, no plan of business, no information on how much time spent, all being elements which are needed to be considered in a business versus hobby determination. *Lundquist v. Commissioner, T.C. Memo 1999-83*, noted, among other things, that intermingling of accounts indicates that an activity is more closely related to hobby rather than business. *Golanty v. Commissioner, 72 T.C. 411 (1979)*, notes that in order to claim business deductions... the “burden now rests on persons to show that they intended to make profit.” Taxpayer had substantial other income to live comfortably despite losses from horse breeding.

*Lou Levy, 30 T.C. 1315 (1958)*, held that an artist’s agent who invests money in hopes that the artist will become a star may deduct the related expenses. In contrast, in *Saul H. Nova, T.C. Memo 1993-563*, the case involved an agent/father’s treatment of his son’s golf career via deductions on the father’s tax return as a business expense. The litigated issue did not revolve around the notion of a contract existing (i.e., the *Carino* issue) between father and son, rather the court held the sponsorship did not qualify as an activity engaged in for profit because of taxpayer’s “failure to calculate when he would receive a return on his investment” before entering into the agreement. Further, the court pursued a line of reasoning that the taxpayer failed “to require his son to meet goals or financial conditions in order to maintain sponsorship.” *Christopher J. Bush, T.C. Memo 2002-33*, further amplifies the judicial view of business principles and foundations on these matters: the decision was founded on the notion that “petitioner failed to create any type of budget or break-even analysis” in order to determine if a profit could possibly result from the venture. There, the taxpayer did not exhibit any effort to making the achievement of profits possible or amount of capital necessary to achieve a profit. There was no showing of attempting to obtain other clients, other than the child. There was neither “required” expertise in dance nor any expertise in professional talent management. The court noted that the personal satisfaction Mr. Bush received from seeing child succeed “proved” the activity was not for profit. Bush did operate the activity by keeping separate bank accounts and also claimed their intent was for profit.

In *Sullivan v. Commissioner, T.C. Memo 1998-367*, the profit motive was found lacking when there was no significant attempt to change operations to improve profitability. *Jesse Rupert, T.C. Memo 2001-179*, noted little or no history of engaging in activity for profit nor is there personal involvement, and then too is considered not for profit. The potential for profit was cited in *H. Comely Plunkett, T.C. Memo 1984-170*, including consideration as to whether the activity was likely to achieve a profit in the future. *David Krebs, T.C. Memo 1992-154*, was successful for the taxpayer, noting a businesslike conduct of activity, time and effort expenditure, and knowledge in business indicated bona fide profit objective. In *Rick Richards v. Commissioner, T.C. Memo 1999-163*, the taxpayer and wife were respectively engaged in writing and acting/modeling for profit and the court upheld their deductions despite losses. They had hired agents to negotiate screenplay prices, but unfortunately failed to profit due to entertainment business’s natural precarious nature. Wife had kept journal of auditions and callbacks, had a long history in the profession, and was in various plays, commercials, and TV shows. *Wiles, Jr. v. US, 312 F2d 574 (1962)*, held that a business expense deduction was not allowed
because a persistent failure to make a profit is a (not the sole) factor that may be considered. Losses that continue beyond the period usually necessary for an activity to become profitable may indicate the activity isn’t engaged in for profit.

The courts seem to be constantly raising the bar (see Bush above) on what is deemed (or is considered) to be a normal business activity. A review of these cases suggests that these activities are being held to a higher standard than many existing and legitimate enterprises. It is suggested that numerous operating but yet otherwise “legitimate” (perhaps more appropriately, profitable) business owners do not prepare a budget, much less a break even analysis (the owners may not even know what they are and/or how to use them). While it is true that new computer programs make this task ever so much simpler, it is suggested that the nature of most new businesses are such that they simply cannot be compared to the larger well established or theoretical business practices espoused at times by the courts. Similarly, few small businesses actually prepare a business plan, unless required to by a bank or some other funding source. While the ability to obtain a canned program to accomplish this “requirement” is available, often this activity is perceived as a necessary evil to accomplish an end and thus rarely completed unless explicitly required, and when done, probably with little real realistic planning associated therewith.

It is suggested that the cumulative overhead to establish such requirements could be prohibitive to many an entrepreneur and the courts are knowingly or unknowingly using these “theoretical” devices as devices to deny the existence of a for-profit entity. For example, it is often opined that a business cannot realistically exist if the bank account is the same for the individual’s personal and/or business purposes. Yet, the same computer programs discussed previously can easily segregate the data and separate out the business versus the personal dimensions, one or two bank accounts notwithstanding. Yet, this fact is often overlooked in rationale decisions on the subject. For example, numerous businesses— including construction companies— can run various distinct and important “jobs” through one bank account, and no one complains. Yet the Service and the courts always seem to raise the single bank account as a death knoll for the struggling start up business. In summary, the courts seem to be suggestively requiring a separate bank account, financial statements, record maintenance, good bookkeeping, budgets, break even analysis, corrective methods to achieve better results, return on investment analysis, contractual arrangements (but this is arguable as seen below), and other fairly high brow operational aspects often foreign to many a new entrepreneur for this prong to be met.

The expertise of the taxpayer or his advisors. Points considered by the Service include taxpayer’s extensive study of accepted business, economic, and scientific practices, or consultation in accordance with such practices, which should not significantly vary unless the taxpayer is attempting to develop new or superior techniques in the business at issue. In Kathleen A. Carr, T.C. Memo 1996-390, it was held that expenses from a talent manager in developing and promoting an artist’s career are essential to the business, thus deductible. “Talent Managers” are responsible to get their client’s work in order to generate income for their business. Here, the taxpayer “organized, advertised, and put on showcases for directors, producers, and casting people involved in the entertainment
industry to demonstrate the talents of her artistry." Accordingly, ordinary and necessary expenses of a personal manager are deductible if they were incurred while developing careers of client. As expected, the manager must show expenses were indeed designed to expose their clients to the industry. The taxpayer bore the burden of proving entitled to any deduction claimed. Colonial Ice v. Helvering, 292 US 453 (1934). "Normal and necessary" means that the expenditure must be normal, usual and customary, as well as appropriate and necessary and helpful to the operation of the business. Commissioner v. Tellier, 383 US 687 (1966).

In David Krebs, T.C. Memo 1992-154, the court looked to a businesslike conduct of activity, time and effort, and noted that a knowledge in the business indicated bona fide profit objective. Similarly, in Clayden v. Commissioner, 90 T.C. 656 (1988), the court noted that knowledge of the industry or consultation from those who know the industry shows the business was intended for profit. In Rick Richards v. Commissioner, T.C. Memo 1999-163, the taxpayer hired agents to negotiate screenplay prices, his wife kept journal of auditions and callbacks, she had a long history in profession, and was in various plays, commercials, TV shows. Lou Levy, 30 T.C. 1315 (1958), artist's agent (experienced in the area) who invests money in hopes that they become a star may deduct the related expenses.

In this area, the courts seemingly are willing to accept the taxpayer's hiring or engaging someone with expertise, again, forgetting the average person may not have the resources to afford such advice. While there is no doubt expertise is essential in today's complex world, it also seems that self education, including courses on similar matters, would also be as effective, and while this self education is mentioned in the regulation, the service and the courts seem to place a premium on prior experience and paid or other consultants, as opposed to self educational methods. That said, there are nonetheless court cases that do recognize the self education of the taxpayer as being an important factor.

The time and effort expended by the taxpayer in carrying on the activity. The regulation suggests an investigation of substantial personal time and effort devoted, particularly if the activity does not have substantial personal or recreational aspects, including withdrawal from prior occupation to devote to the activity. A limited amount of time to an activity does not indicate a lack of profit motive where competent and qualified persons carry on such activity. David Krebs, T.C. Memo 1992-154, noted a businesslike conduct of activity, time and effort, and knowledge in business indicated bona fide profit objective. Rick Richards v. Commissioner, T.C. Memo 1999-163, taxpayer and wife were respectively engaged in writing and acting/modeling for profit, and had a long history in profession. Conversely, in James T. Tarkowski, T.C. Memo 1989-379, there was no profitability, no detailed business records, no plan of business, no detail as to how much time spent, all which the court said need to be considered in business versus hobby analysis. In Kathleen A. Carr, T.C. Memo 1996-390, expenses from a talent manager in developing and promoting an artist's career are essential to the business, thus deductible. "Talent Managers" are responsible to get their client's work in order to generate income
for their business. Here, the taxpayer organized, advertised, and put on showcases for directors, producers, and casting people involved in the entertainment industry to demonstrate the talents of her client's artistry.

Time and effort is not clearly defined as to being viewed as those during the normal work day as opposed to being all available time. Most entrepreneurs are engaged in long hours during non-business hours, yet these hours do not seem to be as critical as those "burned" during a so-called normal business day. And again, if paid or other agents can do the work, the courts seem to have little trouble with this prong. Unfortunately, most entrepreneurs only know one type of worker-themselves and perhaps their immediate family.

**Expectation that assets used in activity may appreciate in value.** The expectation in this alternative prong is that the value of the entity's assets will increase in economic value, accordingly allowing the business owner to eventually report an economic profit, despite possible year to year operating losses. *James Timnell v. Commissioner, T.C. Memo 2001-106*, sales from CD's were shown to have realistic future profit potential from an otherwise speculative activity. Logically, there is no doubt that early recordings of successful artists are viewed as extremely valuable. Of course, traditional assets, such as but not limited to real estate, can be more readily shown to have appreciable value despite the fact the properties may not be currently generating a positive cash flow.

It is rather interesting that this in aspect there is no human "appreciation" considered by the Service or the courts, rather seemingly the Code and accordingly the Service view "assets" as being the traditional brick & mortar and even technological type of assets as opposed to the most scare and unique resource of all: human resources. Naturally, perhaps some would be taken back if we were to view a human as a balance sheet asset (although in some foreign countries, human capital is recognized and has been debated in the United States), but it would seem that, in conjunction with the other regulation guidance, it would be natural that the human potential for appreciation be considered rather than ignored. If anything, the human being has such an enormous amount of untapped yet trainable potential- witness the countless tax dollars spent in education. Yet when it comes to providing a clear and precise path for a prodigy child in their personal and tax lives, the code suddenly seems to recoil back and say such is nonsense. The paradox is amazing.

**The success of the taxpayer in carrying on other similar or dissimilar activities.** The service and courts consider whether the taxpayer had engaged in similar activities in the past and/or converting them from unprofitable to profitable enterprises despite the activity is presently unprofitable. In *Rick Richards v. Commissioner, T.C. Memo 1999-163*, the court noted the long history in profession, and the fact the taxpayer was in various plays, commercials, and TV shows. Conversely, in *Christopher J. Bush, T.C. Memo 2002-3*, there was no showing of the taxpayer attempting to obtain other clients, other than the child, and there was not found any required expertise in dance nor any expertise in professional talent management.
The Service and the courts seem to believe a true business should be expansive (i.e., here obtain new clients), and quite often this is the ultimate course of the business. Yet, with limited resources, it must also be agreed that expansive activities too early in the life cycle could doom the business. Contrast and witness the multiple failures of the attempted gigantic mergers of firms with vast amounts of human and financial capital. Further, with expansion comes dilution of quality and even more time requirements, something that often a struggling entrepreneur simply (and likely) does not have.

The taxpayer’s history of income or losses with respect to the activity. The regulation notes that a series of losses during the initial or start-up stage may not necessarily be an indication that the activity is not engaged in for profit, but such losses should not continue beyond the period which “customarily is necessary” to become profitable. Fortuitously, losses sustained because of unforeseen circumstances beyond the control of the taxpayer should not be considered by IRS auditors. In *Stella Waitzkin*, T.C. Memo 1992-216, a profit motive was established despite recording losses for 10 years, even if taxpayer had other sources of income. The taxpayer had gained greater recognition and revenues each year. Compare: *John G. Parker v. Commissioner*, T.C. Memo 2002-76 where the court held the petitioner was not engaged in “for profit” activities, with one reason being he had a record of substantial losses over many years. *Christopher J. Bush*, T.C. Memo 2002-33, the taxpayer did not exhibit any effort to making the achievement of profits possible or consider the amount of capital necessary to achieve a profit.

Perhaps the most subjective of all the prongs, the regulation attempted to establish some firm time line as to an “acceptable” loss period. As can be seen from the various cases, such a time line is practically unrealistic, as each situation is unique. But yet, this three strikes and you are out mentality pervades.

The amount of occasional profits, if any, which are earned. The regulation suggests a comparison of profits versus losses incurred compared to the taxpayer's investment (and assets of the business), and views occasional small profits versus a large investment are not persuading that a for-profit enterprise exists, while large occasional profits from small loss/investment criteria more compelling. The regulation notes: “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.” *Hirsch v. Commissioner*, 11 AFTR 2d 1156 (1965), noted that a profit or income motive must dominate the taxpayer’s business in order to consider the activity a trade or business. Tempering that rather strict view is *Hunter v. Commissioner*, 91 T.C. 371 (1988), where the taxpayer must have “an expectation” to make a profit, although such a view might not be reasonable but nonetheless allowable as long as they enter into the activity with the profit motive and continue the activity in such a manner. In *Stella Waitzkin*, T.C. Memo 1992-216, a profit motive was established despite recording losses for 10 years, despite the taxpayer having other sources of income as the result of the taxpayer gaining greater recognition and revenue each year. Conversely, in *John G. Parker v. Commissioner*, T.C. Memo 2002-76 petitioner was not
engaged in a “for profit” activity, with one reason being he had a record of substantial losses over many years.

It would seem here our case of a child prodigy is truly on point with this prong of the tests, as it cannot be denied that certain outcomes (such as singing, sports, and the like) could be highly lucrative. However, the service argues such is not the case when dealing with human as opposed to “capital” resources, visa vie oil fields and the like.

The financial status of the taxpayer. The regulation urges a comparison of alternative income and capital versus the suspect activity. It also suggests that 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. For example, in S. K. Johnson III et ux, T.C. Memo 1997-475 the court noted the “fact that taxpayers could afford to operate activity at a loss was irrelevant.”

In general, this one prong is often used to attempt to show that the “true” intent of the taxpayer was simply to provide a tax write off while assisting their child. No doubt this can be the case in numerous audits, however, the regulation is also clear that the review must consider all aspects of the matter, and not a “cookie cutter” or one size fits all type of approach. Thankfully, it is clear all attributes must be considered.

Elements of personal pleasure or recreation. While personal pleasure or recreation is considered, it is not necessary that an activity have exclusive intention a profit or maximizing profits. The regulation notes: “[a]n 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.” In Henry L. Sutherland, T.C. Memo 1966-155, if the motivation of acting as agent for child was primary for child’s benefit as opposed to purposes of § 183 [activity engaged in for profit, aka the. 3 of 5 year rule], he cannot deduct expenses. In Christopher J. Bush, T.C. Memo 2002-3, the court noted the personal satisfaction of Mr. Bush received from seeing child succeed “proved” the activity was not for profit. Conversely, in Cecil Randolph Hundley, 48 T.C. 339 (1967) the business expense deduction was allowed for pro baseball player by the parent/agent. As noted previously, the agreement between the two was based on time spent in training and representing player/child, and it was clear that the ultimate receipt of payment was uncertain and undeterminable. The court looked at the following primary elements: the time spent in coaching, training, and representing player, which included the diligent “cultivation of clubs, traveling,” etc. The court noted the agreement may not be arms length in the normal sense and must be carefully scrutinized, but that the agreement “stands every searching test.”
The service and the courts seem to enjoy using this prong as a reason why the situation obviously cannot be for profit. The Bush case above was ample example of assuming the worse and ignoring the realities of the situation. However, the Hundley case shows a clear example of where, if properly handled, the personal enjoyment factor is sufficiently negated. To say personal enjoyment is a tipping of the scales seems to be an excessive weighing of the situation, as few people, when being truthful, will admit to doing something constantly if they did not enjoy the situation.

Summary

It would appear to at successfully defend from a hobby loss attack, the following must be achieved, documented, and/or considered: the taxpayer must attempt to follow strictly the guidelines of Treas. Reg. §1.183 and consider the various court rulings outlined previously. These requirements seem to include (but appear to be ever evolving expansively): a business plan, a break even analysis, a budget, separate bank accounts, a good accounting system, the conducting the business in a businesslike manner for profit, utilizing contractual arrangements (although subject to very close scrutiny), and preferably “forming” or conducting the entity as a formal business entity, such as a corporation, LLC, or partnership. There should be consideration of hiring and engaging outside experts, and/or proof of extensive and documented self study, and preferably actual working experience in the area. There appears to be a premium placed on the high devotion of personal time (particularly if one quits a former job and concentrates on the new activity) and effort to activity during normal business hours, although hired agents are acceptable. If profits are not forthcoming there is an expectation of entity assets appreciating in value, but not human resources. There appears to be a definite emphasis on the entity obtaining more or new clients as quickly as possible. The courts and service will review the profit and loss history, although history is an oxymoron due to short time period involved and the definite bias towards the 2 of 5 year rule. The view of speculative risks and therefore occasional profits for highly speculative ventures is ordinarily sufficient but again, not with human resources alone. The activity is likely to be highly scrutinized if the owner has other financial resources and appears to be benefiting from a tax write-off. And finally, while not in and of itself sufficient per the regulation, the notion of personal enjoyment is usually looked upon as the icing on the cake, so to speak.

Now, frankly, just looking at the size of the preceding “summary” paragraph is frightening enough. All of this certainly sounds like a wonderful business approach in a perfect world; indeed, it would look very nice—paper wise. But if all the effort is expended on maintaining records and expending funds on how to do the business, there is little if any time or other resources to actually obtain business and to run the business. There is no doubt the courts review the cases individually and with great detail. However, it is suggested that the courts sometimes may forget to recall the trials and tribulations of individuals versus corporate situations, where more structure is normally expected. There is no doubt some chose to attempt to take advantage of a system for tax reasons, but many persons also are attempting to legitimately forge a better tomorrow for
themselves and their families. It is frustrating to see the number of cases that put this effort on their head, particularly in a child prodigy.