Section 183: Work Horse or Hobby Loss

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Comment

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The income tax laws of this country represent a compromise among varied and conflicting interests. As these interests multiply, the volume of income tax laws increases and becomes more complex to accommodate the inevitable conflicts among these interests. One authority, Louis Eisenstein, has classified the forces behind the enactment of tax laws as "conflicting ideologies."1 As battles are won by different ideologies, our tax law maze gets worse:

The power to tax is the power to reallocate the distribution of worldly goods among different groups in our society. Every tax system necessarily affects that distribution, whether or not it is expressly designed to do so. Therefore, our income tax is doomed to be an elaborate hodgepodge as long as it represents an uneasy compromise among contending interests.2

These "contending interests" were in plain view during the most recent congressional attempt, of a large magnitude, to create a more equitable income tax law. The Tax Reform Act of 1969,3 while closing and minimizing certain loopholes or preferences,4 opened others.5 The new provisions of the Act are a mixture of highly technical and complex laws6 which affects a small number of specially situated taxpayers, and non-technical provisions which affect a large portion of all taxpayers.7 The subject of this comment is a provision that falls somewhere in the middle: new Code Section 183.8

Section 183 and its predecessors9 have come to be known as "hobby loss"

2. Id. at 3.
4. I.R.C. as amended §§ 301, 211.
5. Id. § 804.
6. Id. § 101.
7. Id. §§ 801, 802.
8. Id. § 183.
provisions. They were enacted to curtail or severely limit the practice of off-setting losses incurred in hobby-like activities against income from the taxpayers principal business or the source of his livelihood. This was done because some taxpayers were enjoying their sports, hobbies, or avocations at the expense of the federal revenue.\footnote{Sharpe, \textit{New 'Hobby Loss' Rule is Tougher but Engaged in for Profit Dilemma Remains}, 32 J. Tax. 289 (1970).} While Section 183 applies to any activity not engaged in for profit,\footnote{I.R.C. as amended § 183(a).} the Congress and Treasury apparently consider it particularly applicable to gentleman farming.\footnote{Hearings on H.R. 13270 Before the Senate Comm. on Finance, 91st Cong., 1st Sess. 34-36 (1969).} This is indicated by its placement in the Tax Reform Act under Subtitle B-Farm Losses, etc.\footnote{Pub. L. No. 91-172, Title II, Subtitle B.} It should be noted that although many examples of court cases may be couched in terms of farmers, horsemen and cattlemen, the principles applied to them are equally applicable to any activity capable of being considered a hobby.

Before enactment of Section 183, there were two methods used by the Commissioner of Internal Revenue to disallow deductions from a hobby-like activity that would otherwise offset other ordinary income.

The method most frequently used was the application against the taxpayer of Sections 165, 162 and 212 and the regulations thereunder.\footnote{Treas. Reg. §§ 1.165-1(e)(1)-(2), 1.165-6 (1960); Treas. Reg. § 1.162-12 (1961); Treas. Reg. § 1.212-(c) (1957).} These sections provided for the deduction of losses, trade or business expenses, or expenses incurred for the production of income during a taxable year. These sections and the regulations indicated that a profit intent was required for the deduction of certain losses as well as for the deduction of expenses either incurred in a trade or business or for the production of income. The courts in disallowing deductions under these sections would merely find that the taxpayer's operations were carried on primarily as a sport, hobby, or recreation and without the requisite profit intent.\footnote{Treas. Reg. § 1.162-12 (1961); Treas. Reg. § 1.212-1(c) (1957).} As will be pointed out, this method and the pertinent court cases interpreting it form the body and perhaps the soul of the new Section 183.

The second possible means of disallowing hobby-like deductions was afforded by Section 270. This section, however, did not apply only to hobbies. It applied to any activity which incurred the specified amount of consecutive losses. The effectiveness of this section and its predecessors will also be discussed to give the proper background for understanding Section 183 because it would appear that many of the regulations and cases under Section 270 still have vitality.
There are no explanations in the Code or in the various Committee Reports which specify or identify any kind of deduction which was allowable prior to the enactment of Section 183 but which is not allowable now. Apparently, any item which passes the deduction tests applicable to other Code provisions also will pass the tests of Section 183. Because of this, it becomes obvious that Section 183 is a "taxpayer provision" since there is nothing new in the law which adversely affects the taxpayer. The Congress may have codified some case law and regulation, but it was all there before. Section 183 merely appears to codify the Treasury's general policy which had allowed "netting". What Section 183 has done is to put forth a presumption which is to operate in the taxpayer's favor.

It is difficult at this time to guess how the regulations will interpret Section 183. It would appear that the Senate Finance Committee expected an extensive interpretative job from the Treasury Department. The Finance Committee report indicated that concern had been expressed as to whether there would be reasonable administration of the new law. With this in mind, the Finance Committee suggested that, "the Treasury Department should establish two advisory groups drawn from the cattle and horse industries . . . to assist the Commissioner of Internal Revenue in establishing standards for the application of these rules [section 183] to achieve reasonable results and to resolve policy questions in their application from time to time." The Commissioner, in compliance with the Finance Committee request, announced the formation of advisory committees from the horse industry and the cattle industry and stated "[a] primary purpose of the committee[s] will be to apply . . . [their] special expertise to counseling the IRS in implementing important changes in the tax law. . . ." It is hoped that the Commissioner, with the help of these advisory groups, can produce workable regulations to help the taxpayer make an informed and certain appraisal of his tax status as affected by Section 183. It certainly would be a pleasant change if Section 183 could be saved from an existence similar to the many other Code sections which led Mr. Eisenstein to make the following comment: "The Internal Revenue Code, indeed, is a remarkable essay in sus-

16. Treas. Reg. § 1-162-12 (1961); see Your Federal Income Tax 27, (1971 ed.); the term "netting" is normally used to refer to the process of allowing deductions to the extent of the income from the activity thereby eliminating any effect of the activity in the taxpayers return.
17. I.R.C. as amended § 183(d).
21. Id.
Background and The Ineffectiveness of Section 183's Predecessors

Enacted in 1943, Section 130 denied a deduction from gross income for the excess of annual losses over $50,000\textsuperscript{23} when the losses from the trade or business exceeded that amount for five consecutive years.\textsuperscript{24} Not all the deductions allowable to the taxpayer were included in the computation of this $50,000 amount however.\textsuperscript{25} In the event the test was met, the taxable income of the individual was to be recomputed for each of the five consecutive taxable years.\textsuperscript{26} In this recomputation, deductions were allowed to the extent of $50,000 plus the gross income derived from the trade or business.\textsuperscript{27}

After taxable income for each of the five years was recomputed, the tax for each year was redetermined on the basis of the revised taxable income\textsuperscript{28} and for any of the above taxable years deficiencies were assessable, they would all be assessed and collected in one taxable year. In this regard, an extension of the statute of limitations was provided for the effective operation of this provision. This provision kept all taxable years open in the five consecutive taxable years until one year after the normal statute of limitations for the fifth of the five consecutive taxable years had run.\textsuperscript{29}

The many failures of this provision should have been abundantly clear when the Internal Revenue Code of 1954 was enacted. In spite of this, the above rules were re-enacted substantially unchanged.\textsuperscript{30} Congress only felt a need to exclude additional allowable deductions (specially treated deductions) from the loss incurred for the purposes of the $50,000 tests previously mentioned.\textsuperscript{31} An analysis of these specially treated deductions indicates an

\begin{itemize}
  \item \textsuperscript{22} A. Eisenstein, Ideologies of Taxation (1961).
  \item \textsuperscript{23} \textit{Int. Rev. Code} of 1939, § 130. [Hereinafter cited as I.R.C. 1939].
  \item \textsuperscript{24} \textit{Id.} § 130(a).
  \item \textsuperscript{25} \textit{Id.} Taxes and interest deductions were excluded for the purposes of the $50,000 loss test.
  \item \textsuperscript{26} \textit{Id.} § 130(b).
  \item \textsuperscript{27} \textit{Id.} § 130(a).
  \item \textsuperscript{28} \textit{Id.} § 130.
  \item \textsuperscript{29} \textit{Id.} § 130(c).
  \item \textsuperscript{30} \textit{Int. Rev. Code} of 1954, § 270.
  \item \textsuperscript{31} \textit{Id.} Section 270 added to the list of specially treated deductions the following:
    \begin{enumerate}
      \item Casualty and abandonment losses connected with the trade or business deductible under § 165(c)(1);
      \item Losses and expenses of the trade or business of farming which are directly attributable to drought;
      \item The net operating losses allowed under § 172;
      \item Expenditures (such as research and experimental expenditures) which at the taxpayer's option may be either deducted as expenses when incurred or capitalized.
    \end{enumerate}
\end{itemize}
intention on the part of Congress to remove from the potential application of the "hobby loss" provision those deductible items which might occur by reason of events beyond the taxpayer's control or which might occur in an unusually risky business.\textsuperscript{32} The reason behind the special treatment of the net operating loss was somewhat different, however:

In addition to the changes made by the House Bill, your Committee has provided that the net operating loss deduction is not to be taken into account in determining whether a taxpayer's losses from a trade or business exceed $50,000 for five consecutive years. Otherwise, an unusually large loss in one year might have the effect of creating losses in five consecutive years and bringing the taxpayer within the application of this provision.\textsuperscript{33}

After Section 270 or its predecessor had been in existence for twenty-six years, the Congress finally decided the results they had hoped for were not materializing. As stated in identical language in both the Senate and House Committee Reports:

The hobby loss provision generally has been of very limited application. It is often possible for a taxpayer to slightly rearrange his income and deductions so as to break the required string of five years. In addition, exclusion of certain specially treated deductions from the loss computations means that a number of expenses are not considered to give rise to a loss even though they are, in fact, deducted. Moreover, in the few cases in which the hobby loss provision has applied so as to disallow the deduction of the loss, the taxpayer has been faced in one year with a combined additional tax attributable to a five-year period.\textsuperscript{34}

With these broad assertions, the Congress changed weapons and moved steadily ahead in the attempt to curtail or minimize the use of hobby losses. The Congress evidently had not been asleep the last twenty-six years. They were merely watching the courts and the Treasury Department deal with the hobby loss problem in a different and more effective manner. Apparently, the Congress heeded their experience, since their new weapon, Section 183, was primarily a codification of old case law and regulations under the general loss,\textsuperscript{35} the trade or business expenses,\textsuperscript{36} and expenses for the production of income,\textsuperscript{37} sections of the Code.

\textit{A New Word in Town—Activity}

The word "activity" appears in all four sections of the new hobby loss provi-
sion, but the word is not defined. It does appear clear, however, that an "activity" is the new basic unit of hobby loss—a word of art to replace the time-worn phrase "trade or business".

The wording of the new section suggests that the test of profit intent and all the other new rules will be applied separately to each distinct activity. Herein lies the problem. What is an activity? The word "activity" appears to be a compromise word used by the draftsmen because they could not use the very term they wanted to define, "trade or business". On the surface, the word "activity" would appear to have a more narrow definition than trade or business, since in the generic sense each trade or business could carry on several activities, but the contrary may also be true. It appears the non-descriptive nature of the word "activity" may foster academic argument, but the problem should be settled by the indication in the House Report that in computing the amount of loss arising from the activity, "... all deductions attributable to the activity will be taken into account. As under present law, [Section 270] the loss would be determined separately with respect to each activity carried on by the individual." Therefore, it would appear that an analysis of prior law will give us an idea of what the new regulation should encompass to define an "activity".

The regulations under repealed Section 270 indicated that if an individual carried on several trades or businesses, the deductions and income attributable to each trade or business would not be aggregated for the purpose of that Section's profit test. The regulations emphatically stated that, "... each trade or business shall be considered separately." In this regard, the trade or business carried on by the individual leading to the loss had to be the same in each year to incur the Section 270 sanctions. However, the mere use of different forms of carrying on the same business did not prima facie create separate trades or businesses. If the taxpayer used partnership, joint venture, and sole proprietorship forms to carry on the same business activity, all the individual's profits and losses from the activity were aggregated to determine the applicability of the section. The reason for this is that the partnership or joint venture business was considered to be the business of each partner to the extent of his distributive share. The old law, under Section 270, went so far as to state that if it was established for tax purposes that a husband and wife were partners in the same trade or

40. Id.
41. Id.
42. Id. See also Rev. Rul. 221, 1953-2 CUM. BULL. 182.
business or that they were acting independently of one another in the same trade or business with his or her own money, they were to be considered as involved in separate trades or businesses even if they filed a joint return.\textsuperscript{44} Nor did the fact that several activities stemmed from a common commodity or parcel of land make them one business:

Where several business activities emanate from a single commodity, such as oil and gas or a tract of land, it does not necessarily follow that such activities are one business . . . . Where it is shown that such business activities are separately conducted and are not closely interrelated with each other, they are considered as separate business activities . . . \textsuperscript{46}

In two often cited cases on the point of separate businesses or activities, the government's "one business" contention was not very successful. In \textit{Davis v. Commissioner},\textsuperscript{46} the taxpayer carried on farming, livestock, and packing activities through four proprietorships in Mexico, Texas, Florida, and the Bahamas. The Commissioner alleged that the four proprietorships constituted one business and therefore combined the individual losses, resulting in disallowance of deductions which exceeded the statutory amount.\textsuperscript{47}

The Commissioner used two criteria in arguing that the taxpayer's four activities were but one business. The first was a so-called "nature test": "... activities which are the same or substantially \textit{similar in nature} constitute a single trade or business even where conducted at more than one location."\textsuperscript{48} The second test asked the court to consider all the activities carried on by the taxpayer as one business "unless they are separately conducted for a bona fide business purpose."\textsuperscript{49}

The taxpayer, on the other hand, asserted the controlling test should be whether or not there was a practical economic interrelationship between the two agricultural enterprises.\textsuperscript{50} He stressed the geographical separation, independent management and personnel, differences in markets, sources of supply and differing financial and economic problems. The court in the final analysis, while citing many of the differences between the operations that the taxpayer had noted, simply stated that based on the facts and circumstances of the case the activities constituted separate businesses. While the court stated the taxpayer's test was to be commended, it concluded it would have found the same way under both of the Commissioner's tests.\textsuperscript{51}

\begin{footnotes}
\item[46] 29 T.C. 878 (1958).
\item[47] \textit{Id.} at 888.
\item[48] \textit{Id.} at 887 (emphasis added).
\item[49] \textit{Id.} at 888.
\item[50] \textit{Id.}
\item[51] \textit{Id.} at —.
\end{footnotes}
In the second case, Collins v. Commissioner, the court held that the taxpayer's ownership and operation of two professional football teams, under different franchises and in different but successive years, constituted separate businesses, and the losses of one could not be tacked onto the losses of the other. The Commissioner asserted that as in Davis, the nature of the businesses must be considered and if two enterprises of an individual are in the same line of business, they should be treated as a single trade or business. The court, in rejecting this test as conclusive, stated,

While the fact that an individual carries on two or more enterprises which engage in identical or similar activities may be a factor suggesting that the enterprises are in reality a single trade or business, this fact may be outweighed by other considerations in a given case. Again, the court justified its result by noting such facts as the taxpayer’s separate books of accounts, separate bank accounts, separate management, geographical differences, different offices and lack of economic or other interrelationships.

From the above analysis of the law under Section 270, it would certainly appear that we will see a lot of it in the new regulations under Section 183. What the regulations will most likely do is make a general statement to the effect that the question of what constitutes a separate activity will be decided on its own facts and circumstances. The most important fact will most likely be how the taxpayer has treated his operations. If they are treated as one, for instance, then unless it can be shown that there is an artificial grouping merely for tax avoidance, the taxpayer should prevail. The burden of proof would apparently fall on the taxpayer whose claim to one or multiple activities results in Section 183 not being applicable.

With this in mind, the taxpayer with a potential hobby loss problem should be able to do some reliable tax planning. He should know the basic indicia necessary to separate or consolidate his multiple operations. At the very least, the taxpayer who wants to separate his operations should maintain separate books of accounts, separate bank accounts, separate management and separate employees where possible. Anything done by the taxpayer to show his various operations are autonomous should be in the taxpayer's favor, no matter how small.

*Deductions Allowable—A Major Issue May Develop*

The general thrust of Section 183 is that no deductions attributable to an ac-
tivity not engaged in for profit will be allowed except as further provided within the Section.\textsuperscript{55} The exception provided codifies a rule which allows the “netting” of income and deductions.\textsuperscript{56} The wording of that exception in Section 183(b) is as follows:

In the case of an activity not engaged in for profit to which subsection (a) applies, there shall be allowed:

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

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).\textsuperscript{57}

The apparent purpose of this provision is to allow deductions up to the amount of income derived from the activity which has already been determined not to be engaged in for profit. A problem arises, however, when there are deductions which change character from those allowable under Section 183(b)(1) to those allowable under Section 183(b)(2), depending on whether the activity is engaged in for profit or not.

Deductions allowable under Section 183(b)(1) include interest, taxes and the long-term capital gain deduction. Deductions allowable under Section 183(b)(2) include any item deductible under any provision of the Code for activities engaged in for profit. To illustrate the point, consider the problem with the capital gains deduction. Although it is a deduction allowable under Section 183(b)(1), how is the capital gain deduction computed?

For example, assume the taxpayer has only two reportable transactions: a long-term capital gain of $10,000 and a bad debt of $6,000. With these facts in mind, compare the following two computations. For the first computation, if the activity is treated as if it were engaged in for profit, then the $10,000 long-term capital gain would not be netted against the $6,000 bad debt since the bad debt would constitute an ordinary deduction under Section 162. The capital gain deduction would be taken first and only $5,000 of income would remain. From this there would be taken the ordi-

\textsuperscript{55} I.R.C. as amended § 183(a).

\textsuperscript{56} Treas. Reg. § 1.162-12; see note 16 supra.

\textsuperscript{57} I.R.C. as amended § 183(b) (emphasis added). The underlined words in this subsection indicate that the deductions allowable include interest, state taxes and the capital gain deduction. The significance of these words will appear in the analysis of the presumption to follow; see text accompanying note —, infra.
nary deduction for the bad debt of $6,000 leaving a net loss of $1,000. Therefore, the taxpayer would be allowed the $5,000 capital gain deduction and the $5,000 bad debt deduction to eliminate all taxable income from the activity.

If the computation is made on the basis that the activity was not engaged in for profit, however, the $6,000 bad debt would be treated as a short-term capital loss which must be netted against the long-term capital gain before arriving at the capital gain deduction. The result would be to have a net long-term capital gain of $4,000 reduced by the capital gain deduction of $2,000 leaving a net gain from the activity of $2,000.

<table>
<thead>
<tr>
<th>Activity Engaged in for Profit</th>
<th>Activity Not Engaged in for Profit</th>
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<tbody>
<tr>
<td>Long-term capital gain</td>
<td>Long-term capital gain</td>
</tr>
<tr>
<td>Bad debt—ordinary loss</td>
<td>Bad debt—short term capital loss</td>
</tr>
<tr>
<td>Long-term capital gain net of 50% capital gain deduction</td>
<td>Net long-term capital gain</td>
</tr>
<tr>
<td>Bad debt ordinary loss</td>
<td>50% capital gain deduction</td>
</tr>
</tbody>
</table>

| $10,000 | $10,000 |
| 6,000   | (6,000) |
| 5,000   | (6,000) |

It would appear that the wording of Section 183(b) has the purpose of allowing the maximum deductions up to the gross income of the activity. Therefore, it appears the taxpayer should compute his allowable deductions under both methods and select that method which allows the most deductions up to the point of eliminating any gross income from the activity. The draftsmen's idea appears clear but the wording of Section 183(b) will lead to many confusing interpretations. The regulations may not touch on this area but may instead only emphasize the order in which deductions should be taken. If so, the regulations will probably direct that those deductions allowable under Section 183(b)(1) be taken first (interest, taxes, etc.) and then, to the extent there is still gross income, will allow deductions for expenditures deductible only when an activity is engaged in for profit. Of this second group, the Senate Finance Committee indicated their intent that the deductions to be allowed first are those involving a basis adjustment such as depreciation.\(^5\)

Except for this language, depreciation in a hobby loss situation would not have been allowed since the depreciation would not have been incurred either in connection with a trade or business or for the production of income.\(^5\)

Now, however, Section 183 allows the depreciation deduction to the extent these deductions fall under Section 183(b)(2). The question that arises is


\(^{59}\). I.R.C. as amended § 167(a) (1961); see Yanow v. Commissioner, 44 T.C. 444 (1965).
just how does Section 183 fit into the “allowed or allowable” wording under Section 167. An illustration may help clarify the problem.

Assume that an activity not engaged in for profit produces income of $10,000, incurs potential depreciation expense in the amount of $9,000 and has other business expenses of $10,000. Total deductions would only be allowable to the extent of the $10,000 income, thereby disallowing $9,000 in deductions. The breakdown of the deductions allowed would be $9,000 of depreciation expense and $1,000 of the other expenses. Further, assume that the depreciation expense was incurred on a Section 1245 asset and that it is sold immediately thereafter for $9,000. Under Section 1245 the taxpayer would be required to include $9,000 in ordinary income to recapture the depreciation taken whereas under prior law the other expenses which were disallowed would have offset the hobby income first and the basis of the Section 1245 asset would not have been reduced and no gain would have been recognized. Although in both instances $9,000 of deductions would be disallowed, under Section 183 the taxpayer has $9,000 of ordinary income or, in effect, no benefit at all for the depreciation.

Therefore, although Section 183 is basically a “taxpayer provision,” it still has some sting to it.

A Presumption with Problems

The Congress, in trying to make the administration of the new law a bit more simple or systematic for the Treasury Department, may have opened a Pandora’s box. The presumption contained in the law provides:

If the gross income derived from an activity for 2 or more of the taxable years in the period of 5 consecutive taxable years which ends with the taxable year exceeds the deductions attributable to such activity (determined without regard to whether or not such activity is engaged in for profit), then, unless the Secretary or his delegate establishes to the contrary, such activity shall be presumed for the purposes of this chapter for such taxable year to be an activity engaged in for profit. In the case of an activity which consists in major part of the breeding, training, showing, or racing of horses, the preceding sentence shall be applied by substituting the period of 7 consecutive taxable years for the period of 5 consecutive taxable years.60

The presumption as enacted is a rebuttable presumption in favor of the taxpayer: if gross income exceeds certain deductions in two out of five or seven years, the activity will be presumed to be engaged in for profit.61

60. I.R.C. as amended § 183(d) (emphasis added).
61. In contrast to the rebuttable presumption in favor of the taxpayer provided in Section 183(d), it has been suggested that a failure to meet this presumption might act as a presumption in itself that the taxpayer was not engaged in an activity for profit—
This version of the presumption was put forth by the Senate Finance Committee\(^\text{62}\) and was accepted by the Conference Committee.\(^\text{63}\) The original House version of the presumption provided for a presumption against the activity being engaged in for profit if the activity produced losses of $25,000 or more in three out of five years.\(^\text{64}\)

It should be understood that the "gross profit" test in Section 183 is not a minimum condition which must be met in order to qualify as an activity engaged in for profit but rather is a condition which, if satisfied, creates a rebuttable presumption that the activity is indeed an activity engaged in for profit, and it places the burden of establishing otherwise on the Treasury Department. The taxpayer who fails to meet this criterion can still qualify his activity as a business, provided he can show that his operations were conducted with a profit-making motive or intent. With this in mind, it is useful to examine some of the difficulties which will be encountered in the application of the above presumption.

"... which consists in major part ..."

For those activities which consist in major part of the breeding, training, showing, or racing of horses, the period in which gross income must exceed certain deductions twice is changed from five years to seven years. The problem with this, of course, is what constitutes "in major part."

Webster's Dictionary defines the word "major" in this way: "the greater in dignity, rank, importance, or interest."\(^\text{65}\) The operative word here is "greater"; however, in returning to the dictionary, "greater" is defined as "major."\(^\text{66}\) In going through this circuitous approach it becomes apparent that "major" should be defined according to its ordinary usage—one-half or more. It would certainly appear that the regulations will have to take this fifty or more percent approach. The problem is the choice of the base on which to apply the fifty percent test. The base could be total assets used in

\(^{\text{64}}\) H.R. REP. No. 13270, 91st Cong., 1st Sess. 213(a) (1969) (as passed by the House of Representatives).
\(^{\text{65}}\) WEBSTER'S 3RD NEW INTERNATIONAL DICTIONARY (unabridged) 1363 (1966).
\(^{\text{66}}\) Id. at 994.
the activity, gross income attributable to the activity, deductions attributable to the activity, or perhaps a three-factor ratio similar to those used by many states in apportioning income for the purpose of state taxation for those corporations which have operations both within and without the state. These three factor ratios usually include a property factor, sales or income factor, and an employee or payroll factor. Generally, these three factors produce a reasonable allocation, and something of this nature should be considered by the Treasury Department for inclusion in the regulations. Most likely, however, the Treasury Department will take an approach similar to fifty percent of deductions because of its deceptive ease of application. What could happen, of course, under this approach is that a taxpayer could make large capital expenditures for assets with a relatively long life which would not give rise to substantial current year deductions, while a much smaller activity might give rise to larger current deductions if the bulk of its expenditures are for feed, labor and other currently deductible costs. No matter what test is chosen for the purpose of the administration of the phrase “in major part” some taxpayers will be adversely affected by it. For this reason, although the Treasury Department will produce some “rule of thumb” for its agents to apply, it should not be a strict mechanical rule. The courts will have the final say as triers of fact. Most likely the courts will ask only one simple question: Does the activity look more like a work horse than a hobby horse? If the answer is “yes,” the taxpayer uses an overall seven-year period instead of the normal five-year period in computing income for the presumption.

“... deductions attributable to such activity ...”

Under prior law there were certain items which were not considered to be deductions attributable to a trade or business for the purposes of the $50,000 loss test. The Congress has not specifically said these items will not be treated as before, but the implication is there since they were not specifically excluded in the new statutory provision. The Congress has also listed the deductibility of certain items without inclusion in the mathematical loss test as one of the reasons for the change in the law. Therefore, although some of the old reasons for having specially treated deductions still remains, the legislative intent appears clear. There are, however, at least two deductible items which will not be used for purposes of computing the presumption’s profit test: the net operating loss deduction which was specifically elim-

67. D.C. CODE ANN. 47-1580(a) (1964); CODE VA. ANN. 58.131.2.17 (Michie ed. 1969).
68. INT. REV. CODE of 1954, § 270.
69. See text accompanying note 34, supra.
inated from the computation in the Senate Finance Committee report,\textsuperscript{70} and second, the deduction for capital gains.\textsuperscript{71}

The treatment of the capital gain deduction was a boon to the taxpayer under prior law. This allowed a taxpayer who could not show a profit from his normal business operations to sell capital assets or assets which could qualify for capital gain treatment and have the entire gain included in gross income while not recognizing the fifty percent capital gain deduction. The basis for this treatment of capital gains arose from the landmark case of \textit{McDonald v. Commissioner}.\textsuperscript{72} The Tax Court held that one hundred percent of the gain was to be included in gross income in determining the loss for the purposes of Section 270 although only fifty percent was taxable. In a Revenue Ruling issued following \textit{McDonald}, it was expressly stated for the purposes of Section 270 of the Code, capital gain must be included in full in gross income and the capital gain deduction of 50 percent of the excess of the net long-term capital gain over net short-term capital loss \textit{does not constitute a deduction attributable to a trade or business} carried on by an individual in determining whether such deductions for each of five consecutive taxable years exceeded gross income derived from such trade or business by more than $50,000.\textsuperscript{73}

It would appear that since the rationale of \textit{McDonald} and the above mentioned Revenue Ruling is still sound, the same capital gain treatment will be afforded under Section 183. The prior law used the words “attributable to a trade or business” while the new law uses the words, “deduction attributable to such activity”. As previously mentioned, the difference between the words “trade or business” and the word “activity” is purely academic. The draftsmen could not use the term they were trying to define, so they compromised on the undefined word “activity.” With this in mind, it would seem very difficult indeed for the Treasury Department not to follow its own precedent and the precedent of the Tax Court.

\textit{Effective Date}

Some doubt has been raised as to the manner in which the presumption will apply and as to which years it will consider. It has been suggested by at least one commentator that the presumption will consider both pre-1970 years and post 1969 years. The commentator supports this conclusion by noting that the lawmakers deleted a specific reference in the law that the presump-

\textsuperscript{71} I.R.C. as amended § 1202.
\textsuperscript{72} 23 T.C. 1052 (1955).
tion *would* consider all years, past and future. This deletion, he states, was made since the reference was considered superfluous by the lawmakers.\(^7\) Another viewpoint is that to have the presumption act only prospectively from December 31, 1969 "would have the strange and doubtless unintended result of delaying the effectiveness of the presumption until 1975 in all cases."\(^7\)

In this regard, it could easily be conceded that the normal operation of a presumption is as an aid in the administration of the law and that no good reason exists for not applying the presumption to past years in order to allow the presumption to be fully operative in 1970. Forgetting the practical matters, the law seems plain on its face. The Senate Finance Committee had originally written the presumption provision as being "applicable to prior taxable years."\(^7\) However, this reference to prior taxable years for the operation of the presumption was deleted by the Conference Committee.\(^7\) Implicit in this deletion had to be the thought that the Conference Committee wanted the presumption, like the remainder of the section, to be applicable only to years after December 31, 1969. For some people this was not enough, and at least one individual decided to go to the source. Former Senator George A. Smathers\(^7\) wrote to Senator Russell B. Long, Chairman of the Senate Finance Committee, and questioned him on the operation of the presumption. Senator Long replied that the presumption period "would begin running as of 1970 and not . . . as the Senate bill proposed. . . ."\(^7\)

In considering the plain words of the law and Senator Long’s letter, there appears to be no escape from the fact that the presumption will only operate prospectively. However, since Section 270 was repealed and Section 183 was made effective on the same date, December 31, 1969, two strange results occur. The Section 183 presumption cannot be used for at least two years and the Section 270 five consecutive years test is inoperative for taxpayers who began a string of $50,000 or more losses in 1966. Thus no taxpayer can have the use of the favorable presumption until at least 1972 and to get it in 1972 the years 1970 and 1971 must be profit years. Similarly, if a taxpayer has had a yearly loss of $75,000 from his activity for the past four years and again incurs a $75,000 loss in 1970, these five consecutive years of $75,000 loss will not operate Section 270 because the fifth of the five consecutive years was a year after the date of Section 270's repeal.

\(^7\) Dickinson, 241 T.M., Farm and Ranch Losses, 421 at n.151 (1970).
\(^7\) CONF. REP. No. 91-782, 91st Cong., 1st Sess. 299 (1969).
\(^7\) Former Senator from the state of Florida, now a partner in the Washington, D.C. firm of Smathers & Merrigan. General counsel for the American Horse Council.
\(^7\) Letter from Senator Russel B. Long to George A. Smathers, Mar. 11, 1970, on file at Catholic University Law Review Office.
A Draftman's Nightmare

In discussing the ambiguities of the presumption provided in Section 183, one point should be noted which would constitute a major flaw in the wording of the provision. The effect of this flaw, for all practical purposes, strikes a near fatal blow to the newest of the hobby loss provisions.

In order to find this potential flaw, the "deductions allowable" subsection as well as the "presumption" subsection must be reviewed. In the "deductions allowable" subsection, the words "without regard to whether or not such activity is engaged in for profit" were construed by the Senate Committee to mean those deductions which fell into the category of or are similar to interest, taxes (state and local property taxes), and the capital gains deduction. These same words are used in the presumption subsection in describing those deductions which must be exceeded by gross income in order to operate the presumption in favor of the taxpayer.

The ramifications of this unfortunate choice of wording will not be evident for some time. However, it does not take a crystal ball to foresee what tack some taxpayers might take. The taxpayer could argue the quoted phrase should receive the identical construction in both subsections. The taxpayer could then argue that since the meaning of that phrase was made clear in the Senate Finance Committee reports as it relates to "deductions allowable" and that since no explanation of that phrase exists as it relates to the presumption, they must be one and the same. If a taxpayer was successful with this line of argument, the presumption provision would switch from an administrative aid to an administrative headache. The presumption would operate to put practically all taxpayers within its semi-protective arms. The Treasury Department would be in a position which would require it to overcome the rebuttable presumption as a matter of course. This would clog the administrative machinery to the point that Congress might have to rewrite the presumption. Short of this, the regulations will most likely try to solve the problem. What the regulations most likely will do in this area is follow the approach the Treasury Department concludes the draftsmen intended to take. That approach will most likely be that the presumption will operate in a taxpayer's favor if gross income exceeds the deductions attributable to the activity determined as if the activity were engaged in for profit. Although most observers may agree that the latter is what the draftsmen intended, all observers must agree that this is not what they wrote into the law.

80. I.R.C. as amended § 183(b).
82. I.R.C. as amended § 183(d).
Profit Intent and Profit As A General Principle of Deductibility

Profit intent as a prerequisite for deductibility is common to many Code sections. There must be a profit intent under Section 162 in order to deduct ordinary and necessary business expenses. There must be a profit intent under Section 165(c) in order to deduct losses incurred by an individual. There must be a profit intent under Sections 212(1) and (2) in order to deduct non-business expenses incurred for the production or collection of income or the maintenance of income producing property. There must be a profit intent under Section 167 in order to deduct depreciation charges. Profit intent is the sine qua non of deductibility, except as expressly provided in Section 183.

Since profit intent is not a new idea and since it has been the subject of voluminous litigation, this comment will not discuss the factors which are considered in determining a profit intent in general. What will be discussed is how the enactment of Section 183 and its legislative history has effected this vast area of case law.

The Profit Intent and Section 183

Section 183(a), stated in the converse, requires that for deductions attributable to an activity to be deductible, that activity must be engaged in for profit. In other words, there must be a "profit intent." However, mere subjective profit intent is not enough. There must be some outward manifestations of this profit intent sufficient to satisfy an objective test. A profit intent test, as a condition for allowance of farm loss deductions, has been a part of the regulations and case law for a long time. It is this type of profit intent that Section 183 codified. Section 183 requires that for an expenditure to be deductible under it the taxpayer must first show that the related activity constitutes a trade or business or is undertaken for the production of "income". These requirements were included in Section 183 by incorporating all the case law, regulations and rulings by reference, as they pertain to Section 162 or Sections 212(1) and (2).

Apparently, however, this incorporation by reference was not meant to be

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84. An excellent analysis of much of the old case law can be found in Mertens, Law of Federal Income Taxation, § 28.72-28.74 (1969) and in Dickinson, 241 T.M. Farm and Ranch Losses (1970). Both sources outline many factors which have been considered important in determining a taxpayer's profit intent. Many of these factors will most likely be included in the forthcoming regulations interpreting Section 183.
85. See Treas. Reg. § 1.212-1(c) (1957).
86. See Weir v. Commissioner, 109 F.2d 996 (3d Cir. 1940); Parish v. Commissioner, 36 B.T.A. 1114, 103 F.2d 63 (5th Cir. 1939); Whitney v. Commissioner, 73 F.2d 589 (3d Cir. 1934); Treas. Reg. 118 § 39.23(e)-5 (1953).
87. I.R.C. as amended § 183(c).
Section 183: Work Horse or Hobby Loss

complete. Under prior law, many court cases and the Treasury Department took the position that the expectation of a profit had to be reasonable.88 The House apparently tried to codify this view when it included in its version of Section 183 a denial of deductions “arising from an activity carried on by him [taxpayer] where the activity was not operated with a reasonable expectation of realizing a profit from it.”89 This test was not well received by the Senate Finance Committee which expressed many difficulties with it. The Senate Finance Committee indicated it was in basic agreement with the approach of the House but it was concerned “that requiring a taxpayer to have a ‘reasonable expectation’ of profit may cause losses to be disallowed in situations where an activity is being carried on as a business rather than as a hobby.”90 To stress this point, the Senate Finance Committee used examples of an individual who was a bona fide inventor or a person who invests in wildcat oil wells.91 The Finance Committee indicated it felt the conclusion could be reached that these people really had no reasonable expectation of profit when in fact the activity was engaged in for profit. It was further pointed out that the “reasonable expectation” test might operate against a poor person who was engaged in an inefficient farming operation.92 Accordingly, the Finance Committee modified the House Bill to provide that in determining whether losses from an activity are to be allowed, the focus is to be on whether the activity is engaged in for profit.93 Since the Senate’s approach or test was eventually the rule which was accepted by the Conference Committee94 and enacted into law, the Finance Committee report on this point would appear to have particular significance.

The Finance Committee stated that the determination of whether an activity is engaged in for profit should be made on an objective rather than a subjective basis.95 The Finance Committee thought that although a reasonable expectation of profit is not to be required, the facts and circumstances would have to indicate that the taxpayer entered the activity, or continued the activity with the objective of making a profit.96

91. Id.
92. Id.
93. Id.
96. Id.
From the expressions of the Finance Committee, it would appear the reasonable expectation of profit test is not completely dead. It will not satisfy the requirements of Section 183 alone, but it would certainly play a part in the now required objective fact determination.

On a practical basis, it remains to be seen whether or not a court, which believes there is a reasonable expectation of profit for the taxpayer's activity and is convinced of the taxpayer's subjective profit intent, will use Section 183 to deny the taxpayer his losses from the activity involved.

**What Is This Thing Called Profit?**

Most taxpayers and courts have understood a profit to constitute the excess of income over deductions and have looked to the taxpayer's tax return to determine whether or not a profit had been made. However, some taxpayers have sought to expand this definition of profit to include consideration of the entire economic status of the activity. One of the main items usually pointed to in this regard is the unrealized appreciation of the activity's assets. In *Blake v. Commissioner*,97 one of the earliest cases to consider unrealized appreciation, the taxpayer sustained losses in operating a horse farm for 12 consecutive years. The court in allowing the taxpayer's loss deductions appeared to place great weight on the taxpayer's testimony that the real estate holding of his farm and his horses had appreciated substantially in value.98 In the subsequent cases of *Ellsworth v. Commissioner*99 and *Estate of Lillian Soloman v. Commissioner*,100 the tax court gave considerable weight to the appreciation factor in the taxpayer's breeding herd. The court in *Ellsworth*, in the light of 13 years of consecutive losses, cited the testimony of three expert witnesses as "convincing" on the fact that a profit could be realized if the taxpayer were to sell his herd.101

This "economic profit" concept has apparently been accepted by the Treasury Department since in its statement of position on the Tax Reform Act it recommended to the Senate Finance Committee that it be made clear that the hobby loss provision contemplated an economic profit.102

Although the Finance Committee did not make this clear, the reasoning of the court cases in this area cannot be ignored. Therefore, it would appear that the forthcoming regulations should include a reference to this "eco-
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The Congress in trying to codify an objective approach to the entire hobby loss problem while repealing the previous mechanical approach may have temporarily set the Treasury Department back a few paces. This, of course, must be assumed to be the intention of Congress, since it provided a favorable presumption for the taxpayer. It is also clear from the conflict in the House and Senate Bills that one of the Treasury Department approaches in determining when a hobby exists has been eliminated. But it is unlikely that Congress intended to set the Treasury Department as far back as it has. Before the enactment of Section 183, the Treasury Department was regularly using Sections 165, 162, and 212(1) and (2) to attack situations in which it felt taxpayers were operating an activity for pleasure rather than profit and offsetting other income with losses generated by the pleasure operations. Undoubtedly, this approach will continue to be taken by the Treasury Department with whatever slight modifications it deems necessary. The problem is that much of the Treasury Department’s time will now be spent trying to convince taxpayers and courts that its approach is correct. They must contend with all the normal problems attending the codification of voluminous case law as well as the problems created by the provision’s special features. It would certainly appear that the Treasury Department would have been happier with the repeal of Section 270 alone, without any Congressional attempt to codify the hobby loss case law into a new hobby loss provision.

In hobby loss cases now, the Treasury Department is forced to overcome the legal ambiguities of Section 183 by arguing the purpose and the intent of the law before embarking on the arduous job of arguing the facts.

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