# *Understanding the Difference Between Tax Deductible Business Losses and Non-Deductible Hobby Losses*

Seminar Topic: This material will discuss the provisions and cases relating to non-deductible hobby losses and keys to securing tax deductions as a true business loss.

This material is intended to be a guide in general and is not legal advice. If you have any specific question regarding the state of the law in any particular jurisdiction, we recommend that you seek legal guidance relating to your particular fact situation.

The course materials will provide the attendee with the knowledge and tools necessary to identify the current legal trends with respect to these issues. The course materials are designed to provide the attendee with current law, impending issues and future trends that can be applied in practical situations.

Disclaimer: The views expressed herein are not a legal opinion. Every fact situation is different and the reader is encouraged to seek legal advice for their particular situation.

The Apex Jurist, **www.ApexJurst.com** is
Published by ApexCLE, Inc.
**www.ApexCLE.com**

119 South Emerson St.,
Suite 248
Mount Prospect, Illinois 60056

Ordering Information:

Copies of this monograph may be ordered direct from the publisher for $64.95 plus $4.25 shipping and handling. Please enclose your check or money order and shipping information. For educational, government or multiple copy pricing, please contact the publisher.

**Library of Congress Cataloging-in-Publication Data**

ApexCLE, Inc.

1. ApexCLE, Inc. 2. Law-United States – Guide-books.

3. Legal Guide 4. Legal Education.

# *About the Author and Presenter*

## *Stuart Duhl*

Stuart Duhl serves as a business and legal counselor to his clients. He assists business owners with a variety of tax and corporate problems, and plays a major role in planning objectives for the future of their businesses. He also represents a number of family-owned businesses and assists them with succession planning and other family business issues. In the non-profit organization area, Mr. Duhl advises clients on obtaining tax-exempt status, and setting strategic planning goals to meet charitable objectives.

His business clients range in size from small, one or two person operations, to those with sales of over one hundred million dollars and include a variety of industries, including construction, real estate, multi-level sales, debt collection, retail sales, commercial cleaning, moving, technology, and food brokerage.

He has also assisted companies with their business strategies in China as a former member of the executive committee of the China Alliance.

Stuart has been listed in the Best Lawyers in America directory and Leading Lawyers Network. He is also an adjunct professor of law at Loyola University Law School in Chicago teaching courses in Federal Income Taxation, Corporate and Tax Ethics, and Tax Audits, Procedure and Ethics. Mr. Duhl also acts as a mediator in business disputes.

Stuart is admitted to practice in Illinois and is a member of the American Bar Association, the Illinois State Bar Association, the Chicago Bar Association, and the Chicago Council of Lawyers. He is also a member of the Attorneys for Family Held Enterprises (AFHE) and the Chicago Chapter of the Association for Conflict Resolution.


| | |
|---|---|
| Author's Email Address: | SDuhl@harrisonheld.com |
| Author's Website: | http://www.harrisonheld.com/ |
| Author's Mailing Address: | Harrison & Held, LLP<br>333 West Wacker Drive Ste. 1700<br>Chicago, IL 60606 |
| Author's Phone Number: | 312 753-6192 |

# Table of Contents

## Contents

## Timed Agenda:

| Time | Description |
|---|---|
| 00:00:00 | Program Start |
| 00:00:20 | Introduction |
| 00:00:41 | Understanding the Difference Between Tax Deductible Business Losses and Non-Deductible Hobby Losses |
| 00:02:58 | Introduction |
| 00:04:17 | Code and Regulations |
| 00:06:08 | Section 183(d) |
| 00:08:44 | Regulations |
| 00:09:11 | Manner in which the Taxpayer carries on the activity. |
| 00:10:22 | The expertise of the Taxpayer or his advisors. |
| 00:11:09 | The time and effort expended by the Taxpayer in carrying on the activity. |
| 00:12:05 | Expectation that assets used in activity may appreciate in value. |
| 00:13:03 | The success of the Taxpayer in carrying on other similar or dissimilar activities. |
| 00:13:55 | The Taxpayer's history of income or losses with respect to the activity. |
| 00:14:43 | Elements of personal pleasure or recreation. |
| 00:15:28 | Regulations |
| 00:16:04 | Example (3) |
| 00:18:40 | Examples (1) and (4) |
| 00:23:05 | Representative Cases |
| 00:24:00 | Kimbrough v. Commissioner, 55 T.C.M. 730 (1988). |
| 00:27:46 | Delia v. Commissioner, T.C. Memo 2016-71. |
| 00:30:35 | Gullion v. Commissioner, T.C. Summary Opinion 2013-65. |
| 00:34:11 | Morton v. United States, 2011-1 USTC |

| | |
|---|---|
| 00:36:52 | Roberts v. Commissioner, No. 15-3396 (7th Cir. 2016) |
| 00:44:50 | DKD Enterprises v. Commissioner, #11-2526 (8th Cir. 2012) |
| 00:48:25 | Walthall v. Commissioner, T.C. Summary Opinion 2012-65. |
| 00:50:01 | Hess v. Commissioner, T.C. Summary Opinion 2016-27. |
| 00:53:56 | Romanowski v. Commissioner, T.C. Memo 2013-55. |
| 01:00:12 | Program End |

# Understanding the Difference Between Tax Deductible Business Losses and Non-Deductible Hobby Losses

## Introduction.

Quite frequently we see Taxpayers who have a full time job or who are otherwise engaged in managing their investments undertake a new activity – either as a substitution for their existing business or, more likely, as a sidelight (or "hobby") to their existing business. To the extent that varying amounts of money are expended in this new activity over a period of years, without a corresponding or greater amount of revenue generation, those Taxpayers seek to deduct their losses against other income on their federal income tax return. This attempt to secure some tax benefit from these losses (generally characterized by the IRS as "hobby losses") is frequently met with an IRS audit disallowing the deductions under Section 183 of the Internal Revenue Code.

Code and Regulations. Section 183 of the Internal Revenue Code essentially disallows a deduction in the case of an activity "not engaged in for profit" except to the extent of the gross income from the activity or to the extent such deductions would otherwise be allowable whether or not such activity is engaged in for profit.

An "activity not engaged in for profit" means any activity other than one to which deductions would be allowed under Section 162 or Section 212. If

deductions are otherwise considered to be trade or business expenses, or are expenses deductible under Section 212, Section 183 is not applicable.

Section 183(d) creates a presumption: if the gross income from the activity for three or more taxable years in the period of five consecutive taxable years exceeds the deductions, such activity is presumed to be for profit. In the case of horse breeding, training, showing or racing horses, it is two out of seven years.

And, under a special rule to allow for start-up time, the Taxpayer may elect to have the presumption not be made until the fourth taxable year (6th if it relates to horses) following the taxable year in which the activity is first engaged.

The Regulations elaborate further in defining an "activity not engaged in for profit." Section 1.183-2. Although a reasonable expectation of profit is not required, the facts and circumstances must indicate that the Taxpayer entered into the activity, or continued the activity, with the objective of making a profit. In determining whether such an objective exists, it may be sufficient that there is a small chance of making a large profit. 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.

The Regulations also list a number of factors to be taken into account (but not to the exclusion of other factors). As the cases in these materials

describe, these factors are given considerable weight by the courts in deciding hobby loss cases

1. *Manner in which the Taxpayer carries on the activity.* The fact that the Taxpayer carries on the activity in a businesslike manner and maintains complete and accurate books and records may indicate that the activity is engaged in for profit. … A change of operating methods, adoption of new techniques or abandonment of unprofitable methods in a manner consistent with an intent to improve profitability may also indicate a profit motive.

2. *The expertise of the Taxpayer or his advisors.* Preparation for the activity by extensive study of its accepted business, economic, and scientific practices, or consultation with those who are expert therein, may indicate that the Taxpayer has a profit motive where the Taxpayer carries on the activity in accordance with such practices.

3. *The time and effort expended by the Taxpayer in carrying on the activity*. The fact that the Taxpayer devotes much of his personal time and effort to carrying on an activity, particularly if the activity does not have substantial personal or recreational aspects, may indicate an intention to derive a profit. A Taxpayer's withdrawal from

another occupation to devote most of his energies to the activity may also be evidence that the activity is engaged in for profit. The fact that the Taxpayer devotes a limited amount of time to an activity does not necessarily indicate a lack of profit motive where the Taxpayer employs competent and qualified persons to carry on such activity.

4. *Expectation that assets used in activity may appreciate in value*. The term "profit" encompasses appreciation in the value of assets, such as land, used in the activity. Thus, the Taxpayer may intend to derive a profit from the operation of the activity, and may also intend that, even if no profit from current operations is derived, an overall profit will result when appreciation in the value of land used in the activity is realized since income from the activity together with the appreciation of land will exceed expenses of operation. …

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

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

7. *The amount of occasional profits, if any, which are earned*. The amount of profits in relation to the amount of losses incurred, and in relation to the amount of the Taxpayer's investment and the value of the assets used in the activity, may provide useful criteria in determining the Taxpayer's intent. An occasional small profit from an activity generating large losses, or from an activity in which the

Taxpayer has made a large investment, would not generally be determinative that the activity is engaged in for profit. However, substantial profit, though only occasional, would generally be indicative that an activity is engaged in for profit, where the investment or losses are comparatively small. Moreover, an opportunity to earn a substantial ultimate profit in a highly speculative venture is ordinarily sufficient to indicate that the activity is engaged in for profit even though losses or only occasional small profits are actually generated.

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

9. *Elements of personal pleasure or recreation*. The presence of personal motives in carrying on of an activity may indicate that the activity is not engaged in for profit, especially where there are recreational or personal elements involved. On the other hand, a profit motivation may be indicated where an activity lacks any appeal other

than profit. It is not, however, necessary that an activity be engaged in with the exclusive intention of deriving a profit or with the intention of maximizing profits. For example, the availability of other investments which would yield a higher return, or which would be more likely to be profitable, is not evidence that an activity is not engaged in for profit. An activity will not be treated as not engaged in for profit merely because the Taxpayer has purposes or motivations other than solely to make a profit. Also, the fact that the Taxpayer derives personal pleasure from engaging in the activity is not sufficient to cause the activity to be classified as not engaged in for profit if the activity is in fact engaged in for profit as evidenced by other factors whether or not listed in this paragraph.

The Regulations also contain several examples related to the foregoing. One of the detailed examples in the Regulations is Example (3):

> The Taxpayer, very successful in the business of retailing soft drinks, raises dogs and horses. He began raising a particular breed of dogs many years ago in the belief that the breed was in danger of declining, and he has raised and sold the dogs in each year since. The Taxpayer recently began raising and racing thoroughbred horses. The losses from the Taxpayer's dog and

horse activities have increased in magnitude over the years, and he has not made a profit on these operations during any of the last 15 years. The Taxpayer generally sells the dogs only to friends, does not advertise the dogs for sale, and shows the dogs only infrequently. The Taxpayer races his horses only at the "prestige" tracks at which he combines his racing activities with social and recreational activities. The horse and dog operations are conducted at a large residential property on which the Taxpayer also lives, which includes substantial living quarters and attractive recreational facilities for the Taxpayer and his family. Since (i) the activity of raising dogs and horses and racing the horses is of a sporting and recreational nature, (ii) the Taxpayer has substantial income from his business activities of retailing soft drinks, (iii) the horse and dog operations are not conducted in a businesslike manner, and (iv) such operations have a continuous record of losses, it could be determined that the horse and dog activities of the Taxpayer are not engaged in for profit.

Compare, also the following Examples (1) and (4) relating to farm activities:

The Taxpayer inherited a farm from her husband in an area which was becoming largely residential, and is now nearly all so. The farm had never made a profit before the Taxpayer inherited it, and the farm has since had substantial losses in each year. The decedent from whom the Taxpayer inherited the farm was a stockbroker, and he also left the Taxpayer substantial stock holdings which yield large income from dividends. The Taxpayer lives on an area of the farm which is set aside exclusively for living purposes. A farm manager is employed to operate the farm, but modern methods are not used in operating the farm. The Taxpayer was born and raised on a farm, and expresses a strong preference for living on a farm. The Taxpayer's activity of farming, based on all the facts and circumstances could be found not to be engaged in for profit.

The Taxpayer inherited a farm of 65 acres from his parents when they died 6 years ago. The Taxpayer moved to the farm from his house in a small nearby town, and he operates it in the same manner as his parents operated the farm before they died. The Taxpayer is employed as a skilled machine operator in a nearby factory, for which he is paid

approximately $8,500 per year. The farm has not been profitable for the past 15 years because of rising costs of operating farms in general, and because of the decline in the price of the produce of this farm in particular. The Taxpayer consults the local agent of the state agricultural service from time-to-time, and the suggestions of the agent have generally been followed. The manner in which the farm is operated by the Taxpayer is substantially similar to the manner in which farms of similar size, and which grow similar crops in the area are operated. Many of these other farms do not make profits. The Taxpayer does much of the required labor around the farm himself, such as fixing fences, planting crops, etc. The activity of farming could be found, based on all the facts and circumstances, to be engaged in by the Taxpayer for profit.

In Example (4) where the Taxpayer prevails, as compared to Example (1), where the Taxpayer does not prevail, there is a considerable difference in operations, time involved by Taxpayer, the use of expertise, and the reasons for the losses.

## Representative Cases

### *Kimbrough v. Commissioner*, 55 T.C.M. 730 (1988).

Taxpayer taught at a local high school in Chicago where he coached girls' basketball and golf. His income was $20,889 for 1981 and $31,265 for 1982. He had been on his college golf team and, in 1976, began an apprenticeship with the PGA. During that apprenticeship, he served as an unpaid assistant to a golf professional at a nearby golf course. He was elected a member of the PGA in 1985.

Taxpayer went to the golf course each day after school, weather permitting. He also practiced indoors and during the winter went to Florida twice a month to play golf. During the summer, he devoted 12 hours per day to golf.

From 1978 through 1982, his expenses from his golfing activity exceeded his income. The expenses were disallowed by the IRS for 1981 and 1982 to the extent they exceeded his income.

The Tax Court ruled for the Taxpayer indicating that:

1. His golfing activity was profit motivated.

2. He entered into golf tournaments to win prize money.

3. He maintained complete books and records on his income and expenses.

4. He attended a business course for golfers and assisted a professional golfer.

5. He devoted a substantial amount of time to the activity.

6. His winnings steadily increased each year.

## *Delia v. Commissioner*, T.C. Memo 2016-71.

Taxpayer had a full time job in 2011 as an event planner. She had learned the art of hair braiding and opened a hair salon in 2004. She signed a lease which continued on through 2011. She undertook marketing efforts and maintained a website. She also kept separate books and records. She spent weekends at the salon and also weeknights. She had fewer than 15 customers in 2011 generating only $325 in revenue. She closed the salon in 2012 never having generated a profit. She attributed her failure to a change in taste of African women away from hair braiding and too much competition.

The IRS disallowed her losses for 2011. The Tax Court nevertheless held for the Taxpayer, finding that:

1. She had a profit motive.

2. She failed for reasons beyond her control.

3. She kept business records and undertook marketing efforts.

## *Gullion v. Commissioner*, T.C. Summary Opinion 2013-65.

Taxpayer had been performing on the saxophone since the age of eight and professionally since the age of 16. In 2002, he continued to play but started work as a computer programmer. For 2008, he had $42,951 in wages, and $131,897 in 2009. Also, in 2008 and 2009, he reported gross receipts of $2,625 and $2,931 from his musical activities as well as $35,541 and $28,934 in expenses. He had no profit from 2004-10 but a small profit in 2011.

The IRS disallowed his losses in 2008 and 2009 from his musical activities.

The Court upheld the Taxpayer for the following reasons:

1. Taxpayer had considerable expertise in the music industry.

2. He spent a great deal of time on his musical activities having organized a jazz festival.

3. In his early years, he earned money from his musical activities.

4. Many jazz clubs closed making it more difficult to earn money.

5. His intention was to leave his job as a computer programmer and focus on his music.

## *Morton v. United States*, 2011-1 USTC

Taxpayer, Peter Morton, was a co-founder of the Hard Rock Café. He also owned or controlled several businesses related to the Café. One of the businesses was an S corporation that owned and operated a Gulfstream jet. This corporation was not profitable but the jet was used in connection with his other profitable businesses.

The IRS disallowed the losses from the S corporation. Morton argued that the S corporation should be joined with all of his businesses and should not be isolated as a separate "hobby" loss. The court held that as long as Taxpayer used the aircraft to further a profit motive in his overall trade or business, the deduction shall be allowed.

## *Roberts v. Commissioner*, No. 15-3396 (7th Cir. 2016)

In 2014, the Tax Court held that the Taxpayer had deducted the expenses of his horse-racing enterprise on his federal income tax returns for 2005 and 2006 erroneously because the enterprise was a hobby rather than a business. The court assessed tax deficiencies of $89,710 for 2005 and $116,475 for 2006. But, it also ruled that his business had ceased to be a hobby, and had become a bona fide business in 2007. Taxpayer appealed the decision as it related to 2005-06.

The facts were as follows: from 1969, when he was about 28, to the mid-1990s, Taxpayer grew to be a successful owner and operator of restaurants,

bars, and nightclubs in Indianapolis. He began withdrawing from the business in the mid-1990s, though he remained a paid consultant to the new owners. In 1998 or 1999, he became interested in the horse-racing business. He bought his first two horses, for $1,000 each in 1999, and netted $18,000 in earnings from racing them. He also built a horse track on land that he owned in Indianapolis. Two years later, he owned racing horses and he also had acquired a breeding stallion. The following year he passed the state's licensed-trainer test and obtained his horse-training license.

In 2005, he decided to build a bigger and better horse-training facility. He then bought a much larger tract of land for about $1 million. Between the acquisition of the new land and the end of the year, he invested between $500,000 and $600,000 in improvements for the training of racehorses. He trained and bathed the horses himself. He testified that he spent 12 hours a day working with the horses on race days and about 8 hours a day on other days. He was also involved (though peripherally) in lobbying the Indiana legislature on behalf of horse racing. The goal of the lobbying, achieved in 2007, was legislation that would permit slot machines at racetracks. Because part of the revenue generated by the slot machines would be added to the purse money (the money received by owners of horses that win races), Roberts could expect to benefit financially from the advent of the slot machines. In the same period,

he served on the boards of two professional horse-racing associations in "leadership roles."

Taxpayer's horse-racing activities, which included boarding, breeding, training, and racing horses were not profitable in 2005 and 2006. In 2005, his expenses exceeded his earnings by $153,420. The loss declined to $30,604 in 2006 but increased to $98,251 in 2007 and to $291,888 in 2008 (but 2007 and 2008 were not involved in the appeal). He deducted the losses on his tax returns from his other income, mainly income from consulting in the restaurant business and from renting and selling real estate.

The Seventh Circuit held for the Taxpayer, stating:

1. The fact that Taxpayer became involved in horse racing because he was greatly reducing his involvement in his original business (thus signaling a career change), and the further fact that he assisted in lobbying designed to increase the profitability of horse racing, contradict the hobby hypothesis.

2. He conducted it in a businesslike way (factor 1). He prepared by extensive study (to obtain a training license) (factor 2). He largely withdrew from his previous businesses in order to devote "most of his energies" to his horse-racing enterprise (factor 3). He expected to derive an eventual profit from the enterprise, including profit in the

form of appreciation of the value of the land and buildings used in the enterprise (factor 4).

3. The fact that Taxpayer does not have substantial income or capital from sources other than the activity may indicate that an activity is engaged in for profit (factor 8).

4. The fact that Taxpayer derived 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.

Now, despite the foregoing cases, Taxpayers do not always win. The following cases show IRS victories.

### *DKD Enterprises v. Commissioner*, #11-2526 (8th Cir. 2012)

Debra Dursky was the sole shareholder and sole employee of the corporation. Its principal source of income was information technology consulting. Before 2003, Dursky and another woman (Watson) operated a cattery to breed, show and sell pedigree show kittens as an unincorporated venture. In order to expand the cattery, DKD took it over.

The kittens owned by DKD were entered in national competitions and won four national championships. Watson received a small salary for her time devoted to the cattery. The cattery produced no revenue in 2003, $250 in 2004, and $1,525 in 2005. In 2006, DKD abandoned the operation due to increased costs, breeding problems and inadequate revenues. The Tax Court upheld the IRS's determination of substantial deficiencies for 2003-05 due to losses from operating the cattery.

The Eighth Circuit affirmed:

1. The Tax Court had rejected testimony to the effect that Dursky and Watson intended to operate the cattery for profit. It found that the cattery was Dursky's personal hobby.

2. Dursky expended sums with the expectation that she would be able to write off such amounts.

## *Walthall v. Commissioner*, T.C. Summary Opinion 2012-65.

Taxpayer invested in "fixer-upper" homes with the ostensible goal of creating revenues and ultimately profits from the sale of the homes. Taxpayer claimed to have viewed homes on a daily basis, logging most of the miles on his daily commute to work. The Tax Court held for the IRS.

1. There was no indication that Taxpayer made appointments with realtors or sellers to see the interior of homes they claim to have viewed.

2. The homes they claim to have viewed on weekends were near Taxpayer husband's mother's home.

## *Hess v. Commissioner*, T.C. Summary Opinion 2016-27.

The issue in this case was whether Taxpayers, husband and wife, engaged in activities for Amway Corp. for profit.

Husband was employed as a software manager for Verizon Business Network Services, Inc. (Verizon), in 2010. Before that he had worked as a software engineer for MCI, Inc., a company that Verizon acquired in 2006. Wife was a housewife who looked after their six children. Amway was a supplier of household, health, and cosmetic products that were sold by individual distributors through direct marketing. Amway distributors were able to purchase Amway products at a wholesale rate and then sell those products at normal retail prices to earn a profit.

Amway distributors were able to generate revenue by: (1) selling products directly to consumers; (2) earning points through Amway's reward point system; and (3) sponsoring other individuals who joined Amway as

distributors. To maximize Amway-related income, a distributor had to sell Amway products and also try to enlist other individuals as Amway distributors.

Amway was petitioners' first independent business venture, and they did not consult with anyone other than their sponsoring distributors before deciding to become Amway distributors. Petitioners conducted their Amway activity in their free time on evenings and weekends.

Petitioners attended Amway training functions and each of Amway's quarterly meetings, and they also attended local monthly meetings.

Petitioners met with prospective distributors and showed them promotional materials in an effort to have them become members of petitioners' downline. They met with prospective distributors 10 times total during 2010, the year in issue. However, they were unable to definitively provide the Court with names or any other evidence to show who they added as member of their downline.

Petitioners did not create a business plan before beginning their Amway activity or for any of the years that followed.

Petitioners also did not create a budget, an estimate of revenue or expenses, or a profit and loss statement or maintain a general ledger before beginning their Amway activity or for any of the years that followed. Instead, petitioners carefully maintained receipts to substantiate all expenses they had incurred for their Amway activity. Although petitioners maintained records of

their expenses, they did not introduce any records showing how much product they sold, to whom they sold product, or the names of their alleged downline distributors.

After becoming Amway distributors in 2005, petitioners reported losses from their Amway activities through 2011.

Despite generating losses from their Amway activity year after year, petitioners operated the activity in the same manner regardless of the prior year's results and did not seek advice from anyone other than their sponsoring distributors.

The Court upheld the IRS.

1. Petitioners did not create a business plan, budget, or estimate of revenues and expenses; nor did they introduce records demonstrating the amount of product they sold, who their customers were or how many customers they had, or who their downline distributors were or how many downline distributors they had. The Court concluded that petitioners did not operate their Amway activity in a businesslike manner.

2. Amway was petitioners' first independent business venture, and they had no experience operating a direct marketing

distributorship before becoming Amway distributors. Petitioners obtained advice only from their sponsoring distributors.

3. Petitioners' gross income from the sale of Amway products never exceeded their expenses. Petitioners reported a net loss in each year from 2005 to 2011. Petitioners' lack of gross receipts, while reporting increasingly larger losses for each year from 2006 to 2011, indicates a lack of profit objective, especially when considering that petitioners did not change the way in which they conducted their Amway activity.

## *Romanowski v. Commissioner*, T.C. Memo 2013-55.

In this case, Taxpayers were disallowed deductions for expenses incurred during 2003-2004 in a horse breeding operation.

Mr. Romanowski played professional football for 16 years, ending his career in September, 2003. Mrs. Romanowski cared for their children.

At the suggestion of a Denver tax lawyer, they entered into a tax shelter horse breeding program with a company named ClassicStar. In addition to reviewing the due diligence booklet, they reviewed loss projections which allegedly could be used to offset their other taxable income. They entered the program in 2003.

Petitioners created Romanowski Thoroughbreds, LLC ("LLC") to operate their activities. Petitioners were the sole owners, officers, and directors of LLC. During the tax years at issue, LLC did not maintain any bank accounts, credit cards, or lines of credit separate from Petitioners.

In December, 2003, Petitioners wrote a $300,000 check to ClassicStar as a deposit toward the cost of their participation in the breeding program. On December 31, 2003, they signed a mare lease and board agreement (mare lease agreement) with ClassicStar. The mare lease agreement stated that ClassicStar "is engaged in the business of leasing Thoroughbred mares for breeding purposes." On the same day, Petitioners also signed secondary documents with ClassicStar, including a boarding agreement, a foal agreement, and a nominee agreement.

Pursuant to the mare lease agreement, LLC agreed to spend $13,092,072 on the breeding program to produce foals. This $13,092,072 was due at the time Petitioners signed the mare lease agreement, and the December 26, 2003, $300,000 deposit was applied toward the amount due. On December 29, 2003, LLC borrowed a total of $11,775,732 from National Equine Lending Co. ("NELC"). The total amount borrowed from NELC comprised two loans: a short-term loan of $5,229,366 and a long-term loan of $6,546,366. Petitioners both signed promissory notes on behalf of LLC for the NELC loans. Also on December 29, 2003, Petitioners personally borrowed $1,017,127 from

Keybank National Association. Both Petitioners signed the Key Bank promissory note in their individual capacities. Petitioners also signed disbursement requests for both the Key Bank and NELC loans under which the proceeds of each loan were purportedly distributed directly to ClassicStar, minus certain fees.

Each loan was secured by the prospective foals and LLC's rights under the mare lease agreement. Petitioners did not shop for loans from other lenders. Petitioners were told that they were personally liable on the NELC loans; however, they actually were not.

When Petitioners signed the mare lease agreement, they had not negotiated or seen a list of the horse pairings they would receive for their breeding program. Rather, they relied on ClassicStar to pick the horse pairings they would receive and to set the fees and expenses they would pay for each pairing. The same day Petitioners signed the mare lease agreement, they received a list of the horse pairs.

The Court held that the activities were not engaged in for profit.

1. Petitioners had no discernable business plan or profit projections other than projections provided by an accountant who did accounting work for ClassicStar.

2. Petitioners took no steps toward racing the foals.

3. Although Petitioners claimed to have relied on the advice of ClassicStar, ClassicStar was not an expert hired by Petitioners. Rather, it was a for-profit company with which Petitioners (through LLC) had entered into business. The Court did not believe reliance on such advice was reasonable.

4. Petitioners introduced records indicating that they collectively spent 193 hours during 2003 and 88 hours during 2004 participating in horse-breeding-related activities such as visiting the ClassicStar facilities, reading about the horse industry, discussing the industry and financials with Mr. Atherton and ClassicStar personnel, and reviewing the ClassicStar materials. The Court found this factor to be neutral.

5. Petitioners recognized that their horse-breeding activities did not generate any net profit. Although they might have had a very small chance to make a profit had they sold the six thoroughbred foals bred for them, Petitioners instead entered into a circular transaction which had no profit potential; instead the Petitioners' Key Bank loan was paid off as a result of the contribution.

The following case, which probably could have reached a different result, was decided favorably for the Taxpayer and is worth reviewing in detail.

### *Crile v. Commissioner*, T.C. Memo 2014-202.

Petitioner was an artist and a tenured professor of studio art. With respect to her federal income tax for 2004-2005 and 2007-2009, the IRS determined deficiencies in tax and accuracy-related penalties contending that Petitioner's activity as an artist was not engaged in for profit within the meaning of section 183.

Petitioner had a long, varied, and distinguished career as an artist. She worked for more than 40 years in media that included oil, acrylic, charcoal, pastels, printmaking, lithograph, woodcut, and silkscreen. She exhibited and sold her art through leading galleries; she received numerous professional accolades, residencies, and fellowships; and she was a full-time tenured professor of studio art at Hunter College in New York City.

During the academic year, she devoted roughly 30 hours per week to her art, working mainly at a small studio in her Manhattan apartment. During the summer, she worked full time on her art business at a larger studio in upstate New York. The amount of time it took Petitioner to create a finished work of art varied greatly – from one week to two years – depending on its size and complexity. During her career, Petitioner created more than 2,000 pieces of art.

Petitioner had been represented during her career by at least five New York art galleries. Petitioner also had affiliations with other art dealers and print publishers that sold her work.

Petitioner performed considerable research in connection with her art, sometimes involving international travel under difficult conditions. During the first Gulf War she painted a series entitled "Fires of War," which enjoyed considerable critical and commercial success. To secure documentation for these works, she traveled to Kuwait and accompanied firefighters to burning oil fields.

Petitioner's sales records were accurate but sometimes incomplete. She retained all price lists created by galleries in connection with her exhibitions. These price lists included the title, medium, dimensions, and asking price for each exhibited work. As her works sold in later years, petitioner annotated these lists and the associated index cards with information about those sales.

More recently Petitioner switched to a digital recordkeeping system. She was in the process of moving the information on the index cards to the digital database. She hired assistants to help her with this.

She also kept records of all invoices related to her art business and all receipts for business and personal expenses. During four of the five years at issue, Petitioner hired a bookkeeper to assist her.

Petitioner generated substantial income from sale of her artwork.

The Court found that Petitioner sold a total of 356 works of art during 1971-2013. These sales generated gross proceeds of approximately $1,197,150. After subtracting gallery commissions and other reductions, Petitioner earned income of approximately $667,902 from sales of her art during these years.

Petitioner's best year was 1995, when she reported gross receipts of $111,815 from sales of her art. Her best recent year was 2013, when she earned $75,000 from sales of her art. Despite substantial gross receipts, Petitioner never reported a net profit from her art business. For 1995 she reported a profit of $34,204 on her Schedule C, Profit or Loss From Business, but this was offset by a net operating loss carryforward. Petitioner had not filed her 2013 tax return at the time of trial, but she expected to report a net profit for that year.

Petitioner practiced as an artist for a decade before she began teaching. From 1983 to 1989 petitioner served as a visiting assistant professor, and subsequently as a substitute assistant professor, in the Department of Art and Art History at Hunter College in New York City. She obtained full-time employment there as an Associate Professor in 1989, and she received tenure in 1994. In 1996 she became a full professor at Hunter College. During the tax years at issue, she earned between $85,999 and $106,058 annually from her teaching position.

Petitioner's theory for claiming deductions was that most experiences an artist has may contribute to her art and that most people with whom an artist socializes may become customers or otherwise advance her career. Interestingly, the trial court established that a significant number of the deductions she claimed were not ordinary and necessary expenses of conducting her art business but were "personal, living, or family expenses" non-deductible under section 262(a). The latter expenses included telephone and cable television bills, newspaper and magazine subscriptions, gratuities to doormen in her apartment building, taxicabs to the opera, museums, and social events, restaurant meals with friends and acquaintances, and international travel to gain inspiration from paintings in European museums. It was clear to the Court that the economic losses she actually sustained in her art business were substantially smaller than the tax losses reported on her Schedules C, owing to the inclusion of many personal expenses when calculating her business income.

The Court still concluded that Petitioner's art business was an activity entered into for profit.

1. Petitioner kept business records. She kept all original receipts and invoices related to her art business. She kept detailed and relatively accurate records, going back to 1971, of sales of her artwork, including the sale price and the identity of the buyer. Her sales records

were not complete, but these lapses were often due to circumstances beyond her control, such as galleries' failures to provide relevant data. Petitioner hired a bookkeeper during four of the five years at issue who put her expenses into a Quicken program, which was supplied to her accountant. While it does not appear that Petitioner used her records for the purpose of controlling costs, she did use them for purposes of marketing her works to collectors, galleries, and museum curators.

2. Although Petitioner did not have a written business plan, she had a business plan and she pursued it consistently. She understood the general factors that affect the pricing of art. She then worked to enhance her credentials and professional stature in each of these respects, in an effort to increase the value of her art.

3. Petitioner's marketing efforts demonstrated a profit objective. She was represented by a gallery throughout the period at issue.

4. Petitioner treated other aspects of her art business in a professional manner. She had a "relatively large inventory" and kept track of her artwork efficiently. Her catalog included information about

each work, including the title, dimension, media, exhibition history, asking price, gallery commission, and a digital or film image of the piece.

5. A taxpayer's change of operating methods, adoption of new techniques, or abandonment of unprofitable activities may indicate a profit objective. Before 2004, Petitioner was represented by the Graham Gallery. Although she had several exhibitions there, she regarded the other artists that it exhibited as "conservative" in style. Because she thought that the Graham Gallery was not attracting the types of collectors who would be interested in her work, she switched in 2004 to Michael Steinberg Fine Art in the hope that her sales would improve. Petitioner likewise embarked in a new direction during 2004-2009 with her "Printing on Silk" project in India. She undertook this project when colleagues suggested that she expand the market for her work by producing images on silk.

6. All in all, the Court concluded that Petitioner conducted her art activity in a businesslike manner, indicating that she had the requisite profit objective.

7. The Court also found that Petitioner ranked at the top of the scale in terms of expertise as an artist.

8. Although Petitioner did not retain professional business consultants, her principal "advisors" were the galleries that represented her. Throughout her career, she was represented by five New York galleries. These galleries exhibited her work, arranged openings and customer receptions, and marketed her work to collectors. The expertise of Petitioner's advisors was indisputable.

9. Petitioner devoted roughly 30 hours per week to her art business during the academic year and worked on her art full time during the summer. These facts compared favorably to those of other cases in which the taxpayer was found to be engaged in a trade or business.

10. The testimony established that it is difficult to predict when success will occur in the art world, but that the prices paid for works by established artists often increase dramatically toward the end of their careers. Thus, the Court found that Petitioner entertained a reasonable expectation that her artwork, over the course of her career, would appreciate significantly in value, and that this expectation explained her willingness to continue to sustain operating losses.

11. The Court found that a history of losses is less persuasive in the art field than it might be in other fields because it often takes many years to achieve economic success in the creative arts.

12. The core expenses of Petitioner's art business did not seem wildly out of line with the levels of income she historically generated from sale of her art. Although it was clear that many expenses she claimed were personal, her over claiming of deductions on her tax returns did not show that she lacked an intent to derive an economic profit from selling art.

## Advice to Clients.

Noting the Regulations and Cases, professionals should advise their clients to do the following if their clients seek to deduct losses relating to an activity which might otherwise be considered to be a hobby.

1. Carry on the activity in a businesslike manner maintaining complete and accurate books and records. If the business in unprofitable for a period of years, abandon unprofitable methods and adopt new techniques to improve profitability. Factor 1. See *Crile, Kimbrough, Delia*.

2. Take a course, get advice from an expert, or otherwise develop expertise in the activity. Factor 2. See *Kimbrough, Delia, Roberts*.

3. Develop a business plan with marketing goals and profit objectives. Factor 1. See *Crile*.

4. Devote as much personal time to the activity as possible. Factor 3. See *Kimbrough, Gullion, Roberts*.

5. Attempt to generate profit from the activity as soon as possible. Factors 6, 7. See *Gullion*.