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A REVIEW OF HOBBY AND BUSINESS LOSS RULES: EVIDENCE FROM RECENT DEVELOPMENTS

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ABSTRACT

When we think of a hobby, we think of something that is engaged in for recreational or pleasure purposes such as painting, writing, coaching, golfing, horse farming, film producing, developing athletic abilities to win say an Olympic Metal, working on arts and crafts, creating music, opening a bed and breakfast or a country estate, to name a few. These recreational activities are expensive to pursue but may also have a money making aspect as well. On the other hand, strictly speaking a business is an economic activity engaged primarily to generate a profit. One can see where a hobby could be pursued for pleasure and profit. Also one could see where there could be a tax motivation to deduct the losses from a hobby operation by having it categorized as a business to offset other taxable income. So how to distinguish? Or rather, where is the "line drawn in the sand" that distinguishes between a hobby and a business is here explored as the lines may be blurred from the interpretation of the Internal Revenue Service and from Tax Court Case tried. Also, from the literature review, what is the "unofficial" interpretation that seems to emerge.

JEL: K34

KEYWORDS: Hobby Loss, Business Loss, Income Tax Deductible

INTRODUCTION

Retired American television anchor and journalist, Jane Pauley was discussing her experience with her retirement one morning on a talk show, and commented that retirement today is very different then it was for prior generations. Today our youthful retirees see retirement as a "revolving door", with one door closing while another one opens up to the next activity in life. Baby Boomers are entering retirement these days looking to pursue new and old interests. Many find themselves using their time to turn lifelong passions into business ventures. Others, who are not retirees, who were affected by the recession, were forced to look for income from other sources through creative enterprise. This proliferation of new "startups" has caught the attention of the IRS because many of these businesses suffer losses in their early years. These losses, if correctly classified as a business loss are deductible from taxable income while a hobby loss is drastically limited. Thus, the distinction has significant tax consequences, and is presented here for consideration; Hobby or a Business?

A hobby is a pursuit undertaken for recreational or personal purposes. Losses are deductible only to the extent of income. IRC (Internal Revenue Code) Sect. (Section) 183 governs the treatment of these losses. If the taxpayer takes the standard deduction, and does not itemize and the hobby generated say $2,000 of income, and incurred expenses amounted to say $3,400 the income of $2,000 would be reported on line 21 on the front page of the 1040, as other income in the full amount and no deduction could be taken for the expenses since the standard deduction was take. If the taxpayer itemized then it is possible that some or possibly all of the $3,400 of the expenses could be taken as a miscellaneous deduction which is first subjected to 2% of gross income. For example if the adjusted gross income of the taxpayer say was

$50,000 then 2% of this is $1, 000 which would be subtracted from all of the itemized deductions in the miscellaneous category. Also the income is not allowed a contribution to a self-employed retirement account. The good news is that the income is not subjected to a self-employment tax.

A business is a pursuit undertaken with a profit motive. IRC Sect. 162 governs these losses which are fully deductible. Losses are defined as excessive expenses that are ordinary and necessary to carrying on a trade or business. The same hobby as mentioned above, if it were proper to categorize as a business, would be allowed to deduct the fully loss of $1,400 from other taxable income. This example shows how this discussion has monetary consequences to the affected taxpayer. When we think of a hobby, we think of something that is engaged in for recreational or pleasure purposes such as painting, writing, coaching, golfing, horse farming, film producing, developing athletic abilities to win an Olympic Metal, working with arts and crafts, creating music, opening a bed and breakfast establishment or a country estate, to name a few. These recreational activities are expensive to pursue and may also have a money making aspect as well. On the other hand, strictly speaking, a business is an economic activity engaged primarily to generate a profit. One can see where a hobby could be pursued for pleasure and profit. Also one could see where there could be a tax motivation to deduct the losses from a hobby operation by having it categorized as a business to offset other taxable income. So how to distinguish? Or rather, where is the "line drawn in the sand" that distinguishes between a hobby and a business is discussed herein.

The 1943 Line in the Sand

The IRS (Internal Revenue Service) made the distinction, with Section § 270 of the IRS Code, which Congress enacted in 1943, stating that if gross loss was more than $50,000 for five consecutive years then the activity was not considered a business venture. This was written with specific applications for farm losses in mind. One loophole here was that one could interrupt the five year losses to avoid the threshold. Actually the first hobby loss provision of the Internal Revenue Code was known as the Marshall Field Bill. Some believed that Mr. Field as operation his liberal newspapers, PM and the Chicago Sun as a sole proprietorship and because they were both losing money at the time that the Federal Government was in a sense "financing these publications out of taxes Mr. Field would have had to pay. The Act was intended to limit the ability of wealthy individuals with multiple sources of income to apply losses incurred in "side-line" diversions to reduce their overall tax liability (TIG, 2007).

The 1969 Line in the Sand

So, I n 1969 Congress replaced Section § 270 with Section § 183, which is the current application. Section § 183 makes reference to objective standards that take into account the specifics of each case. Presented below are the nine criteria to be considered according to the IRS regulation. According to Diamond (1970) the current IRS section addresses the much litigated topic of "activity not engaged for profit from a prospective that was not presented before. The underlying question as to the application of section 183 is one of the taxpayer's intent. The Senate report states that "an objective rather than a subjective approach is to be employed" (S. Rep. No. 91-552 at 104, p. 611). It is believed that the result intended by the legislative drafters was that in order to get a deduction, the taxpayer needs objective (or tangible) evidence of subjective intent. According to the Court of Appeals for the Ninth Circuit "The rule is that a taxpayer's venture is a trade or business if he has a good faith expectation of profit from that venture, irrespective of whether or not others might view that expectations a reasonable (Mercer v. Commissioner, 1967).

Nine Factors for Determining in Whether a Taxpayer Engages in an Activity for Profit According to Regs. Sec. § 1.183-2(B)

How the taxpayer carries out the activity (books, records, business plan).

The taxpayer's expertise.
The taxpayer's time and effort in carrying out the activity.
An expectation that assets used in an activity, such as land, may appreciate in value.
The taxpayer's success in this and other activities.
The taxpayer's history of income or losses from the activity. The relative amounts of the profits and losses (occasional income?).
The taxpayer's financial status.
Whether the activity provides recreation or involves "personal motives."

More on the Nine Factors
No one of the factors is more heavily weighed than others.
The IRS may consider factors that are not listed.
The determination is not made by counting how many criteria are satisfied.
The determination is made by an examination of all the factors taken holistically.
The IRS can be subjective in its determination
If IRS asserts the activity is of a personal nature, then the taxpayer has the burden to prove the contrary.
The IRS shifts burden of proof to the taxpayer.

Noticeable here is that there is no mention of a need to prove a reasonable expectation of profit which is unusual since a "business is defined as a pursuit undertaken with a profit motive". The IRS is more liberal in its categorization of a business pursuit with this last application. The IRS has recognized that there are instances where businesses that sustain extended losses may eventually bloom and become profitable. So even though one does not expect to make a profit; what matters is that there is hope that a profit will be made. So one does not have to be definitely sure of a profit but rather needs an aspiration of a profit. This can be seen as a polarization: being either a liberal interpretation from the taxpayer's point of view and/or a quagmire of a tax law to enforce by the IRS. This paper will proceed to explore this area to determine its central point by first zooming into two major areas of literature review from the Treasury Inspector General for Tax Administration from the two different years of study. The objectives, the scope and methodology and results will be delineated and compared. This will then be followed by other literature review generated on behalf of specific Tax Court cases. Concluding comments will summarize these findings and outline areas for further research.

LITERATURE REVIEW

In September 7. 2007 the Treasure Inspector General for Tax Administration (TIGTA) issued its audit report entitled "Significant Challenges Exist in Determining Whether Taxpayers With Schedule C Losses are Engaged in Tax Abuse" Reference Number 2007-30-173 . The TIGTA was formed in 1998 independent governmental agency that provides oversight of IRS activities according to the treasury department's website (www.treasury.gov/tigta). The title of the report, highlights the focus for the audit and the information that it was interested in asserting; being how is the IRS handling this application of tax law. This very substantial and substantive report that was the culmination of a nine month audit, prepared through the application of Generally Auditing Standards preformed by an audit team staff of six. The entire audit report of 23 pages is included in Appendix 1 as a supplement. Its literature is summarized here below.

Objective

The overall objective of the audit was to determine what actions the IRS is taking to address non-compliant high-income SB/SE Division taxpayers who claim business losses on a U.S. Individual Income Tax Return (Form 1040) Profit or Loss From Business (Schedule C) for activities considered to be not-for-profit (TIGTA, 2007, p. 10).

Scope and Methodology

Source: IRS Individual Return Transaction File, a computer extract of Tax Years 2002-2005 with attached Schedule C showing no profits, only losses over 4 consecutive Tax Years. The fourth year is used as a barometer, since new startups will predictable experience a loss, but somewhere beyond that, viable business should thrive. Sample identified 1,483,246 taxpayers that met this criterion

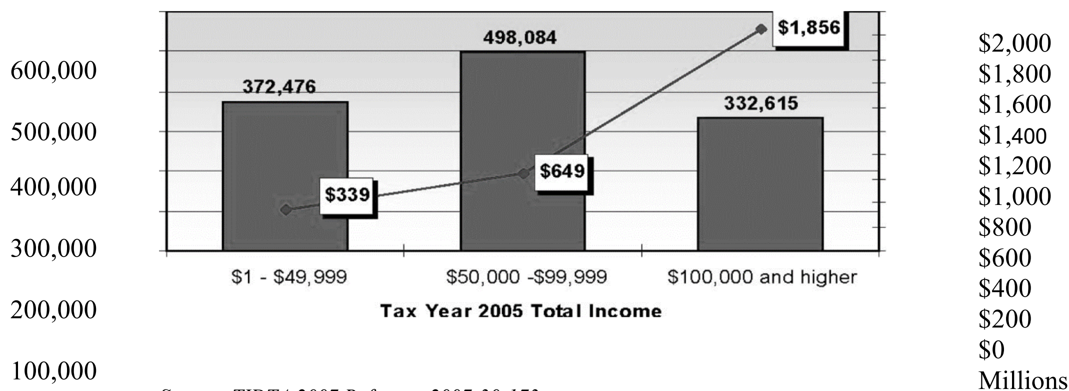
Calculated the additional taxes that would have been owed if taxpayers had not taken the Schedule C losses in Tax Year 2005. This was accomplished by using each taxpayer's filing status for Tax Year 2005 and applying the appropriate tax rate

Findings: Total 2005 tax avoidance $2,843,919,493 for 1,203,175 taxpayers

Findings Explored

The report states that 73% of these tax returns were prepared by tax practitioners. Since the majority of these tax returns that take the business loss are prepared by CPA firms, then the topic turns to the consideration of the ethical tax dilemma which is addressed by Stuebs (2012). "Practitioners not only have obligations to their clients bt are also obligated to uphold the tax system. Balancing professional responsibilities with other incentives and pressures introduces an ethical dimension to the issue (Stuebs, 2012, p. 380). The following is Figure 1 taken from the audit report that graphically represents the findings. The graph shows that there were 372,476 taxpayers who had taxable income in the 1-$49,999 range who took losses, that if were disallowed would have brought in $339,000,000 more tax revenue. Likewise there were 498,084 taxpayers in the $50,000-$99,999 income range who took losses, that if were disallowed would have brought in $649,000,000 more tax revenue. Finally the most dramatic, were the 332,615 taxpayers who had taxable income higher than $100,000 took losses, that if were disallowed would have brought in $1,856,000 more in tax revenues. If we add up the taxpayers in the three income brackets of 372,476 + 498,084 + 332, 615 = 1,203,175 taxpayers identified. Along with their dollar amount avoided by income bracket of $339,000,000 + $649,000,000 + 1,856,000,000 = $2,844,000,000 or the $2.8 million rounded. The table accentuates that fact that the major portion of the revenue is being lost to high income taxpayers who aggressively take the loss deductions, probably to avoid taxes.

Figure 1: The Tax Year 2005 Taxpayers Who Potentially Avoided Paying Taxes by Claiming Schedule C Losses Over Consecutive Tax Years 2002-2005



Source: TIDTA 2007 Reference2007-30-173

The above table shows the number taxpayers who on their 2005 tax returns took a loss on Schedule C. These same identified taxpayers also took losses in the three prior tax years of 2002, 2003and 2004. This was at least their four year of Schedule C tax losses, leading to suspicion of abuse of the business entity application. It is further stratified into three income groups with those over $100,000 having the dominate tax consequence of loss revenues for one tax year of 2005 to be estimated at $1,856,000,000 from 332,615 taxpayers. In 2016, as a follow up to the September 2007 TIGTA report, another audit was undertaken. The title of the audit report is "*Opportunities Exist to Identify and Examine Individual Taxpayers Who Deduct Potential Hobby Losses to Offset Other Income,* dated April 12, 2016, Reference Number 2016-30-031. Here again another very substantial and substantive report was the result of a seven month audit, preformed by an audit team of six. The complete report is included in Appendix 2 as a supplement.

Objective

"To determine whether the IRS was maximizing opportunities to identify the most significant Schedule C, *Profit or Loss From Business,* noncompliance. The overall objective of this review, was to determine whether the IRS is taking sufficient action to minimize improper Schedule C losses claimed by taxpayers and the resulting loss of revenue to the Government (Source: TIGTA 2007)."

Scope and Methodology

This audit was not a replication of the audit preformed in 2007. Thus it is difficult to make comparisons of findings that are taken from different studies. However, the focus was similar; to find out how much abuse continues in this tax law area? Taken from the report is Tabla 1 below. A total of 687,382, taxpayers is calculated when the number of taxpayers are added up for each gross receipts group. These taxpayers who reported a loss in 2013, also reported a loss in the three prior tax years of 2010-2012. This was the same condition used in the earlier study, four years of losses also presented is the stratified group's average Schedule C loss along with the taxpayers average total positive income that does not include the loss. The losses reported were calculated to be over $7.1 billion dollars. The tax effect in terms of lost tax revenue was not given in the report. However this can be compared to some of the data reported by the 2007 audit. In that there is a tremendous decline by approximately half in the number of taxpayers doing the same: that is taking losses from activities into the fourth year or more of operations. . There, 1,483,246 taxpayers reported a loss in 2005, of them it was statistically estimated that 1,203.175 who also took a loss on the three prior years of 2002-2004 avoided paying approximately $2,800,000,000. This 2016 report does not give a calculated tax effect, but clearly we see the number of taxpayers taking a loss, into a fourth year declining to 687,382. In the 2016 report the number of taxpayers taking these losses is down nearly 50%. This shows improvement in the IRS's ability to curtail the deductions of these losses. However a replication of the study 2007 would have been more useful in supplying a solid comparison, especially the amount of lost revenue taken as a whole.

Table 1 shows the number taxpayers who on their 2014 tax return took a loss on Schedule C. These same identified taxpayers also took losses in the three prior tax years of 2011, 2012 and 2013. This was at least their four year of Schedule C tax losses, leading to suspicion of abuse of the business entity application. It is further classified by gross receipts reported on Schedule C and loss taken with the higher bracket taking the most aggressive losses. Cohn (2016) brings attention to the Treasury Inspector General for Tax Administration audit April 12, 2016 that does report an amount for a small subgroup for taxpayers in a sample of 100 tax returns 88% showed an indication that the so called Schedule C businesses were not engaged for profit but looked more akin to a hobby.

Table 1: Tax Year 2013 Gross Receipts, Average Loss, & Total Positive Income for Selected Taxpayers. Source: IRS Individual Return Transaction File for Processing Year 2014

Gross Receipts	Taxpayers	Average Loss	Average Total Positive Income
$0	157,913	$7,993	$198,960
$1 to $4,999	312,828	$6,825	$107,136
$5,000 to $9,999	76,258	$13,794	$106,697
$10,000 to $14,999	35,547	$19,004	$110,070
$15,000 to $19,999	20,374	$24,236	$119,289
$20,000 or more	84,462	$108,454	$251,883

Source: IRS Individual Return Transaction File for Processing Year 2014.

"The TGTA estimates that 77,511 returns in a sample population of specified taxpayers may have inappropriately used hobby losses expenses to reduce taxes by as much a 70.9 million in 2013" (Cohn, 2016). These taxpayers were identified that had tax losses in years 2010-2013, four years, similar to the 2007 study, had also losses greater than $20,000 and reported revenues of $20,000 or less. These parameters of specific dollar amounts were not specified in the earlier report. The earlier report looks at all losses that were reported by all taxpayers for the fourth year in a row. However the nine criteria and their application make the categorization of a business seem very subjective, and there appears to be much leeway in their interpretation especially when they are evaluated holistically. However there is a defining parameter in Sec. 183 (d) that states that if there is a profit in the three of the past five years then the activity may be defined as a business. If the activity consists of breeding, training, showing or racing horses then the rule is more liberal. In these cases, there is a need to show a profit for the two of the last seven years. Keep in mind this is a rolling period, so the look back of five years must have three years of profit to meet the test. So then a question arises, "If an activity has a loss in three out of five consecutive years, is it automatically deemed a hobby? The answer is not necessarily. The other factors mentioned in the Regulations can be relied upon to determine that the activity is, in fact, a business. The burden to prove it is not a hobby is generally on the taxpayer. However, meeting the 3 years of profit out of 5 year shifts the burden of proof to the IRS (Pope, Anderson & Kramer, 2013).

Business income and expenses are reported on Schedule C for individual taxpayers. The business loss is fully deductible in the current year and can offset other income. It can also be carried back or forward to offset income in past or future years. The following is a synopsis of several actual cases where each were appealed by the taxpayer after the agent disallowed the business categorization of the activity loss and deemed it as a hobby loss. The order of appeal is first at the agent's level, then the manager's level, then the appeals level and finally tax court The Tax Court, although run by the IRS hears the cases and rules on them independently. In some of the cases the taxpayer was successful while the in others was not. Also, factor in the of demands of the appeal process in terms of time and money

Unsuccessful Tax Court Cases

In Van Wickler claimed approximately $2.73 million expenses in Schedule F – profit or loss from farming in regard to another favorite activity of horse breeding. The court concluded that this was a hobby. The courts concluded that they were not allowed to deduct their horse breeding expenses. Also noted here in was that in 2010 Mitt and Ann Romney's 2000 tax return showed a similar penchant for horses when their tax return reflected Ann's pastime as a passive investment in a business with a loss of $77,731 (Fay & Roush, 2013). Dr. Daniel Hendricks, a surgeon from West Virginia and his wife purchased a large farm in 1968 for $50,000 in the local area. He raised grain and raised cattle and worked on the farm on Saturday, Sundays and during the week days. He eventually ceased farming and continued to only raise the cattle. The property had a barn and two sheds and no recreational structures or

facilities. He had 70 to 100 heads of cattle. The tax returns for 1987,1988 and 1989 were audited and the agent disallowed the farm business loss as it was constituted to be a hobby and the Hendricks were assess additional taxes and fees of approximately $40,000. They appealed and the outcome was the same. Then another appeal was made and the Tax Court again affirmed there was missing a profit motive. They were unable to defend their position three times (Hendricks v. Commissioner of Internal Revenue, 1994)

Here is another horse case, this time under the jurisdiction of Canadian law. It again is another familiar sounding case of an Alberta physician who spent his income raising expensive Arabian horses. He tried to show true devotion to his business to improve his breed. He was losing $150,000 per year on his business. He was using his own personal income to finance the business. In this case Canadian law can decide and did decide that the business plan was not sound and they did restrict the reduction to be no more than $8,050 per year in case of a farm (Allentuck, 1995). Aggregating new activities to avoid hobby loss rules was an argument that was propped in the Morton Case. According to Harmon & Kulsrud (2009) "hiding a hobby loss activity within a legitimate business is not a new phenomenon. Here is the logic that a loss should be allowed if it is used in conjunction in another profitable activity, since without it the business would suffer. However, in the Morton case, Peter Morton who is the cofounder of the Hardrock Café, tried unsuccessfully to deduct the cost of his jet business which lost money every year contending the aggregation activity citing somehow that it added value to his Hardrock Café business (Morton v. United States, 2011).

<u>Successful Court Cases</u>

In 1978 Marjorie Westpal after graduation from law school worked for various law firms and then she went out on her own to establish her own law practice. However, for 1989 and 1990, her combined expenses exceeded her income by 50,000 when she only had income of 7,000 and the IRS saw to disallow this under section 183. The courts allowed the loses saying that she had a profit motive and that it often takes time for lawyers to get a practice going (Wagenbrenner, 1995). Successful in defeating the IRS in 1999 was Susan Loggans who won in tax court after she had deducted $1.6 million over 6 years of losses she had taken against her other lucrative income to support her argument, her horses were not a hobby but a business. Initially the IRS demanded $620,000 in back taxes penalties and interest. The recommendation here is to resist writing off non-business expenses that are rather extreme and demonstrate two critical points. One is that you run it as a business and two is that your intent is to make a profit. Ms. Loggans did give up this business because of the IRS audit. She felt it was not worth it to continue, due to the IRS's resistance (Novack, 2001).

Lee Storey was a prominent lawyer with a California firm, when she became interested in her husband's past experiences as a member of the "Up with People" group and organization. She decided to make a documentary about the group. She took a sabbatical from her job, she archived old footage of the organization, she keep good accounting records, sought education regarding the film making processed, obtained insurance, and was able to make and market a DVD on the documentary which is called "Smile Until it Hurts". Her husband is in the documentary for a brief window of time. The Storey's took on their tax returns for 2006, 2007 and 2008 loss from this activity which the IRS disallowed. The agent deemed this activity as a hobby not as a business since the interest in the endeavor was sparked by a personal interest. The IRS assessed back taxes and fees for these three years in the area of $260,000. Lee Storey appealed and the judge for the Tax Court ruled in her favor. The judge had expressed that she was initially inclined to rule that it was a hobby since the activity was to create a documentary which has the purpose to educate, not to make a profit. Actually, the film was never profitable. However, when the facts of the case were evaluated using the nine criteria of Section 183, it was determined there was a profit motive. This was a great win for the film making industry which, in some cases, does struggle with long periods of financial outlay before profits are randomly realized. "The tax payer derives apparent personal pleasure from an endeavor and has substantial income from other sources tax payer actions must support the

intention to generate a profit, otherwise the IRS will disallow the loses and expenses will be deductible only to the extent of revenue generated (T.C. Memo 2012-115)."

CONCLUSION

The goal of this paper is to explore what is the application of the tax law governing Hobby and Business Losses on the formal basis and the informal basis and to discover and possible nuances. The Internal Revenue Service has been trying successfully and unsuccessfully since 1943 to clamp done on what may be perceived as an abuse of the business loss deduction. The original tax section of made the distinction, with Section § 270 of the IRS Code, stating that if gross loss was more than $50,000 for five consecutive years then the activity was not considered a business One loophole here was that one could interrupt the five year losses to avoid the threshold. So in 1970 Congress passed Section § 183 of the IRS Code which was not much of a remedy, as it muddy up the distinction that a profit motive must be in place and it is to be objectively established. This is to make a subjective motive on the behalf of a taxpayer objective. This is established an esoteric tax law blurring areas of black and white. Since this was becoming very unwieldy to manage, the Treasury Inspector General preformed an audit first in 2007.

This was a very comprehensive with tangible results that stated, in 2005 there were approximately 1,203,175 taxpayers who took a Schedule C loss that year and in the prior three years and their combined loss of revenue to the IRS for just that one year of 2005 was estimated at $2.8 million. Because of this audit procedures were adopted to focus in on this group. In 2016 the Treasury Inspector General came back to do a measure up audit. The focus was the same for a different tax period. Here 2014 was the targeted tax year, those who reported Schedule C losses and in the three prior years. It was reported that 687,382 fell into this category. The audit fell short in my evaluation, because it did not estimate the approximate amount of lost tax revenues this would have been in 2014. This would have made this a true clean comparison as a measure up study. What is evident is that in 2014 about half of the taxpayers were taking business losses in the fourth year as were taking them in 2005.

This was the improvement that was desired by the IRS. What is interesting and adds to the body of knowledge is that although the Section § 183 goes to great lengths of defining and elaborating on the nine areas of criteria the one targeted area used for the TIGTA's audit , who is still taking a loss in the fourth tax year? This was followed up by focusing on several Tax Court Cases. The Tax Court is administered by the IRS; however it is an independent body. It does not have jurors as the case is decided by the one presiding judge, adding to the subjectivity. From the seven presented cases the nays were four to three. This is not to appear as a represented sample. Two were denied for horse breeding, another for a farm and the third for a jet business deducted to supplement business from the Hardrock Café. All taxpayers in very high tax brackets that have heavy tax consequence. The three that were successful was the young lawyer starting out, the Up with People documentary and the Loggans horse breeding case. Again, these are all taxpayers that have large tax consequence. All these cases were denied at the IRS level; however the Tax Court truly seems to have its own independent mindset that is much more reflective and insightful. Both sides of the problem have been exposed, (1) the taxpayer with the motive to reduce taxable income for an activity that he/she labels as a business for the tax benefit or (2) the entrepreneur who uses vast amount of their own capital to wish upon a great break some day, be it with the horses or the next New York Times best seller. The American Dream is that anything is possible, and possibilities fuel our innovativeness. However, it cannot be said definitely why each was allowed or disallowed, which in itself adds to the body of knowledge in its own ambiguous way.

To establish the activity is a business and not a hobby review the nine criteria to ascertain alignment with the IRS. To add strength to the case, generate profit in at least three of the five year rolling period. Looks like that a loss in a fourth year will bring attention to this area, even though that is not mentioned as a bench mark by the IRS but was used in the TIGTA's audits. One of the limits of the paper is that it does

not address the magnitude of this issue in terms of its total effect as a percentage of lost tax revenue. The dollar amounts and the number of taxpayers seem tremendous, but what is the total that they are out of? Also, how many cases come to Tax Court each year on this issue? How many are successful and unsuccessful? What about looking at this topic from its other side; how many business activities are categorized as a hobby gain to avoid paying self-employment taxes? These are all viable topics for future research.

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