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## **Hobby or Business: IRS Scrutinizes Brothel-Hopping**

**Attorney Robert W. Wood comments on the very spicy Vitale decision.**

**Most sophisticated businesspeople know that the IRS has long battled with taxpayers seeking to deduct as "business expenses" something that turns out to be motivated by pleasure more than profit. Most famous examples of these so-called "hobby loss" cases involve horse breeding, horse racing, car racing, and a variety of other pastimes. One clearly can have a legitimate business (and either make or lose money) in these fields. Yet, the IRS levels particular scrutiny in many such cases.**

**Not surprisingly, profits help. The IRC presumes that if you make a profit in three out of five consecutive years, then you may have a legitimate business. But if you fall short of this presumption, you'll have to find other ways of convincing the IRS that you are truly in business. If you are unlucky enough to have a loss every year for 20 years, you will have to do a very good job of convincing them, and few such taxpayers can do so.**

### **Steamy 'Business'**

**An amusing recent Tax Court case concerning this age-old business vs. pleasure dichotomy involves the world's oldest profession. In *Ralph Louis Vitale, Jr. v. Commissioner*, T.C. Memo. 1999-131, Doc 1999-14693 (31 original pages), 1999 TNT 77-6, Mr. Vitale claimed that he was engaged in the trade or business of writing about prostitution. The story began back in 1992, when Mr. Vitale was still employed full-time. Anticipating his 1997 retirement, he began writing fiction. In 1993, he began researching a story about brothels in Nevada. How did he begin his research?**

**You guessed it: He visited numerous houses of ill repute. Although he paid prostitutes in cash (apparently a kind of industry standard), he kept a detailed journal of his numerous "research" visits. To the chagrin of the more prurient tax case reader, it's not clear exactly what appears in the journals. Ultimately, Vitale submitted the manuscript to a so-called joint venture publisher (sometimes known as a "vanity" publisher), paying \$4,375 to publish and market 10,000 copies of the book.**

**Despite the shadowy nature of his publishing effort, Vitale actually received \$2,600 in royalties on the book in 1996. Of course, he was still significantly in the red on his project (and I don't mean red garters). To make matters worse, the publisher filed for bankruptcy in 1996. Vitale filed a proof of claim for unpaid royalties and got his rights to the book back. He then began marketing the book to publishers and agents.**

**The IRS disallowed Mr. Vitale's deductions for 1993 and 1994 relating to the writing based on lack of profit motive. So Mr. Vitale went to the Tax Court, and the Tax Court apparently liked him (or at least his book). The Tax Court concluded that Vitale did have a profit motive after all. The court delicately noted that the "recreational" aspect of his writing weighed against his case. However, the court concluded that such factors were outweighed by the businesslike manner of his recordkeeping, the diligence of his marketing, and the not atypical start-up nature of his losses.**

### **The Pen Is Mightier Than the Sword?**

**Although Mr. Vitale truly "scored" in this case (meaning, of course, that he beat the IRS on the tough "for profit" motive test), he ended up winning the battle but losing the war. Unlike President Clinton's recent experience, there was no celebratory cigar for Mr. Vitale. The court denied virtually all of his claimed deductions for lack of substantiation. (I guess in the heat of his brothel visits he forgot to ask for a receipt.) Indeed, the court pointed out that Mr. Vitale's cash payments to prostitutes were "so personal in nature as to preclude their deductibility." (These weren't journalistic interviews then?) Still, the court declined to impose negligence or accuracy-related penalties, finding that Mr. Vitale made a reasonable attempt to comply with the tax laws.**

**As for me, I'm thinking of writing a book, preferably about what it is like to stay at all of the world's most fabulous and exotic (and expensive) resorts. I'm afraid there will be some dreary (and probably expensive) research. Well, somebody has to do it....**

***Settling Employers: Do You Withhold or Not?*, Vol. 82, No. 13, Tax Notes (March 29, 1999), p. 2001.**