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The ABCs of Hobby Losses and Profit Motive

by Robert W. Wood*

Understandably, the Internal Revenue Code favors expenses with a profit motive. For example, §162¹ generally allows deductions for ordinary and necessary expenses of carrying on a trade or business. Similarly, §212 generally allows ordinary expenses paid or incurred for the production of income or for investment. Deductions under §§162 or 212 may be used to offset unrelated income.

In sharp contrast, the “hobby loss” rules of §183 limit deductions for activities not engaged in for profit.² Taxpayers subject to §183 hobby loss rules include individuals, S corpo-

rations, trusts, estates, and partnerships, but not C corporations.³ A taxpayer may deduct expenses for §183 activities only to the extent that he has gross income from the activity during a particular taxable year.⁴ Losses attributable to §183 activities not engaged in for profit are disallowed, and they do not carry forward to the next taxable year.⁵

Because §183’s hobby loss limitation can significantly increase a taxpayer’s income tax liability, taxpayers often wish to establish a profit motive to avoid §183’s limits. This article examines the fundamental rules of §183’s hobby loss rules.

Which Activities Are Subject to Hobby Loss Rules?

Section 183 originally was adopted primarily to curtail the deduction of farm hobby losses.⁶ However, it has been applied to acting,⁷ art

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This commentary is not intended as legal advice and cannot be relied upon for any purpose without the services of a qualified professional.

¹ All references to “§” or “Section” are to the Internal Revenue Code, as amended, and the regulations promulgated thereunder, unless otherwise indicated.

² Section 183(c) defines an “activity not engaged in for profit” as any activity other than one with respect to

which deductions are allowable for the taxable year under §162 or under §212(1) or §212(2).

³ §183(a) (individuals and S corporations); Regs. §1.183-1(a) (trusts and estates); Rev. Rul. 77-320, 1977-2 C.B. 78 (partnerships).

⁴ §183(a), §183(b).

⁵ See §183(b)(2); see also *Bunney v. Comr.*, T.C. Memo 2003-233; *Garbini v. Comr.*, T.C. Summ. Op. 2004-7; *Hastings v. Comr.*, T.C. Memo 2002-310; *Bush v. Comr.*, T.C. Memo 2002-33; *Thomas v. Comr.*, T.C. Memo 2002-200; *Baldwin v. Comr.*, T.C. Memo 2002-162.

⁶ S. Rep. No. 552, 91st Cong., 1st Sess. (1969).

⁷ *Regan v. Comr.*, 38 T.C.M. 1330 (1979); *Kellner v. Comr.*, T.C. Memo 1986-524.

work,⁸ writing,⁹ auto racing,¹⁰ gunsmithing,¹¹ practicing law,¹² making movies and videotapes,¹³ operating a talent agency,¹⁴ dog breeding,¹⁵ horse breeding,¹⁶ cattle ranching,¹⁷ farming,¹⁸ operating a bed and breakfast,¹⁹ aircraft rentals,²⁰ boat chartering,²¹ boat racing,²² fishing,²³ golfing,²⁴ venture capitalization,²⁵ used car sales,²⁶ mining and drilling,²⁷ sound recordings,²⁸ Amway distributorships,²⁹ and tax shelters.³⁰

The IRS has also identified photography, stamp collecting, bowling, gambling, motocross racing, horse racing, art, entertainment, and craft sales as possible §183 activities.³¹ Moreover, the IRS has used §183 to

⁸ *Churchman v. Comr.*, 68 T.C. 696 (1977); *Stasewich v. Comr.*, T.C. Memo 2001-30.

⁹ *McCarthy v. Comr.*, T.C. Memo 2000-197; *Miller v. Comr.*, *Trudel v. Comr.*, T.C. Memo 2002-39.

¹⁰ *Casida v. Comr.*, 38 T.C.M. 1054 (1979); *Riddle v. Comr.*, T.C. Memo 1994-133; *Smith v. Comr.*, T.C. Memo 1989-198; *Franz v. Comr.*, T.C. Memo 1984-506; *Spear v. Comr.*, T.C. Memo 1994-354; *Zidar v. Comr.*, T.C. Memo 2001-200; *Emerson v. Comr.*, T.C. Memo 2000-137.

¹¹ *Cox v. Comr.*, 45 T.C.M. 138 (1982).

¹² *Cohen v. Comr.*, 48 T.C.M. 5 (1984), *aff'd by unpub. opin.*, 1985 U.S. App. LEXIS 31501 (10th Cir. 1985).

¹³ *Polakof v. Comr.*, 820 F.2d 321 (11th Cir. 1987); *Canfield Est. v. Comr.*, T.C. Memo 1987-294; *Clayden v. Comr.*, 90 T.C. 656 (1988).

¹⁴ *Bush v. Comr.*, T.C. Memo 2002-33.

¹⁵ *Spranger v. Comr.*, T.C. Memo 1999-93; *Murdoch v. Comr.*, T.C. Summ. Op. 2002-17.

¹⁶ *Lundquist v. Comr.*, 211 F.3d 600 (11th Cir. 2000); *Kuberski v. Comr.*, T.C. Memo 2002-200.

¹⁷ *Kahla v. Comr.*, T.C. Memo 2000-127; *Stonecipher v. Comr.*, T.C. Memo 2000-378.

¹⁸ *Burton v. Comr.*, T.C. Summ. Op. 2001-155; *Garbini v. Comr.*, T.C. Summ. Op. 2004-7.

¹⁹ *Hogan v. Comr.*, T.C. Summ. Op. 2003-8.

²⁰ *Wesinger v. Comr.*, T.C. Memo 1999-372; *Akers v. Comr.*, T.C. Memo 1981-627.

²¹ *Carter v. Comr.*, 645 F.2d 784 (9th Cir. 1981); *Hilliard v. Comr.*, T.C. Memo 1995-473.

²² *Rexroad v. Comr.*, T.C. Memo 1985-189.

²³ *Harris v. Comr.*, T.C. Memo 1988-195; *Peacock v. Comr.*, T.C. Memo 2002-122.

²⁴ *Krause v. Comr.*, T.C. Memo 1987-193; *Courville v. Comr.*, T.C. Memo 1996-134.

²⁵ *Salzman v. Comr.*, T.C. Memo 1988-86.

²⁶ *Mayo v. Comr.*, T.C. Summ. Op. 2003-51.

²⁷ *Tallal v. Comr.*, T.C. Memo 1984-486; *Hendrick v. Comr.*, T.C. Summ. Op. 2002-115.

²⁸ *Call v. Comr.*, T.C. Memo 1985-318.

²⁹ *Theisen v. Comr.*, T.C. Memo 1997-539; *Landrum v. Comr.*, T.C. Summ. Op. 2001-112.

³⁰ *Hill v. Comr.*, 204 F.3d 1214 (9th Cir. 2000); *Copeland v. Comr.*, T.C. Memo 2000-181.

³¹ IRC §183: Activities Not Engaged in For Profit (ATG) (Audit Guide Rev. 6/09), available at www.irs.gov.

attack various tax shelter activities.³² Section 183 limitations do not apply to deductions that do not require a profit motive, such as interest and taxes.³³

Nine Objective Factors for Determining Profit Motive

A court will examine a taxpayer's intent in entering into an activity to determine whether he had the requisite profit motive to avoid the hobby loss rule.³⁴ The taxpayer bears the burden to prove the requisite profit motive.³⁵ Whether the taxpayer had a profit motive generally is a question of fact, for which a court will weigh all the facts and circumstances, giving greater weight to objective facts than to a taxpayer's mere statement of subjective intent.³⁶

The regulations identify nine objective factors (none individually determinative) to aid in determining whether an activity was engaged in for profit: (1) the extent to which the taxpayer carries on the activity in a businesslike manner; (2) the taxpayer's expertise or reliance on the advice of experts; (3) the time and effort the taxpayer expends in carrying on the activity; (4) the expectation that the assets used in the activity may appreciate in value; (5) the taxpayer's success in similar activities; (6) the taxpayer's history of income or loss from the activity; (7) the amount of occasional profits, if any; (8) the taxpayer's financial status; and (9) the elements of personal pleasure or recreation.³⁷

IRS examiners are to address each of these nine factors to properly develop a §183 case.³⁸ The regulations anticipate that other factors may be relevant in determining profit motive.³⁹

Manner in Which the Taxpayer Carries on the Activity

The "businesslike operation" of an activity is probably the most important factor in the cases that find

³² See, e.g., *Rose v. Comr.*, 868 F.2d 851 (6th Cir. 1989), *aff'g*, 88 T.C. 386 (1987); *Baron Est. v. Comr.*, 798 F.2d 65 (2d Cir. 1986).

³³ §183(b)(1).

³⁴ *Hayden v. Comr.*, 889 F.2d 1548, 1552 (6th Cir. 1989), *aff'g* T.C. Memo 1988-310; *Dreicer v. Comr.*, 78 T.C. 642, 644-645 (1982), *aff'd by unpub. opin.*, 702 F.2d 1205 (D.C. Cir. 1983).

³⁵ *Bot v. Comr.*, 353 F.3d 595, 599-600 (8th Cir. 2003), *aff'g* 118 T.C. 138 (2002); *Morrissey v. Comr.*, T.C. Summ. Op. 2009-135.

³⁶ Regs. §1.183-2(a); *Engdahl v. Comr.*, 72 T.C. 659 (1979); *Doxtator v. Comr.*, T.C. Memo 2005-113.

³⁷ Regs. §1.183-2(b); *Antonides v. Comr.*, 91 T.C. 686, 694 (1988), *aff'd*, 893 F.2d 656 (4th Cir. 1990).

³⁸ IRC §183: Activities Not Engaged in For Profit (ATG) (Audit Guide Rev. 6/09), available at www.irs.gov.

³⁹ Regs. §1.183-2(b).

the taxpayer had an adequate profit motive. Conducting the activity in a businesslike manner, keeping accurate books and records, and operating the activity similarly to comparable but profitable businesses may provide a strong indication that the taxpayer has the necessary profit motive.⁴⁰ Conversely, a taxpayer's failure to carry on an activity in a businesslike manner can be damning evidence of an inadequate profit motive.⁴¹

A taxpayer who maintains good books and records for his activity is more likely to establish the requisite profit intent than a taxpayer who fails to do so.⁴² A taxpayer may also demonstrate a profit motive by presenting evidence that he changed operating methods in an attempt to improve profitability,⁴³ if, for example, the change was in response to a period of losses or was pursuant to professional advice.⁴⁴ Conversely, a taxpayer's failure to implement any operating changes after continued losses may indicate a lack of profit motive.⁴⁵

Expertise of the Taxpayer or Advisors

A taxpayer demonstrates a profit motive when he studies the accepted business, economic, and scientific practices of an activity and follows such accepted practices, or when he consults with experts and obtains expert advice, or when he hires expert management.⁴⁶ A taxpayer who consults experts about operating methods and profit potential, both before undertaking the activity, and periodically over the life of the activity, is more likely to prove an adequate profit motive.⁴⁷ A failure to follow recommended practices, unless the taxpayer proves that he tried to develop new techniques, indicates the taxpayer lacked the profit intent necessary to avoid §183 hobby loss limitation.⁴⁸

⁴⁰ *Ellis v. Comr.*, 47 T.C.M. 991 (1984).

⁴¹ *Weiss v. Comr.*, T.C. Memo 1999-17.

⁴² Regs. §1.183-2(b)(1). See also *Engdahl v. Comr.*, 72 T.C. 659 (1979), *acq.*, 1979-2 C.B. 1; *Harvey v. Comr.*, 54 T.C.M. 1508 (1988) *Windisch v. Comr.*, T.C. Memo 1996-369; *Filios v. Comr.*, 224 F.3d 16 (1st Cir. 2000); *Magassy v. Comr.*, T.C. Memo 2004-4; *Bangs v. Comr.*, T.C. Memo 2006-83.

⁴³ Regs. §1.183-2(b)(1); *Dwyer v. Comr.*, 61 T.C.M. 2187 (1991); *Hatch v. Comr.*, 57 T.C.M. 280 (1989).

⁴⁴ *Allen v. Comr.*, 72 T.C. 28 (1979), *acq.*, 1979-2 C.B. 1; *Daugherty v. Comr.*, 45 T.C.M. 1224 (1983).

⁴⁵ *Lewis v. Comr.*, 64 T.C.M. 269 (1992); *Stubblefield v. Comr.*, 56 T.C.M. 405 (1988).

⁴⁶ See Regs. §1.183-2(b)(2); *Dwyer v. Comr.*, 61 T.C.M. 2187 (1991); *Holmes v. Comr.*, 184 F.3d 536 (6th Cir. 1999); *Mills v. U.S.*, 699 F. Supp. 1245 (E.D. Ohio 1988); *Deerman v. Comr.*, T.C. Memo 1974-84.

⁴⁷ See, e.g., *Engdahl v. Comr.*, 72 T.C. 659 (1979), *acq.*, 1979-2 C.B. 1; *Seebold v. Comr.*, 55 T.C.M. 723 (1988); *Harvey v. Comr.*, 54 T.C.M. 1508 (1988).

⁴⁸ Regs. §1.183-2(b)(2); *Call v. Comr.*, T.C. Memo 1985-318;

Time and Effort Expended by the Taxpayer in Carrying on the Activity

A taxpayer who devotes much of his personal time and effort to carrying on an activity, particularly if there are no substantial personal or recreational elements, demonstrates a profit motive.⁴⁹ The fact that a taxpayer devotes his efforts to the activity after withdrawing from another occupation or otherwise losing some other source of income may further bolster a position that he intended to profit from the activity.⁵⁰ Even so, the fact that a taxpayer devotes a limited time to an activity does not necessarily indicate a lack of profit motive, if the taxpayer employs competent and qualified persons to carry on such activity.⁵¹ Moreover, nothing requires an activity to be a taxpayer's sole or principal occupation for it to have a profit motive.⁵²

Expectation That Assets Used in the Activity May Appreciate in Value

A bona fide expectation that assets used in the activity will appreciate in value may indicate a profit motive.⁵³ However, each case must be judged on the totality of the facts and circumstances; this factor alone may be insufficient to prove profit motive.⁵⁴ Moreover, if a taxpayer fails to consider the possibility of asset appreciation before purchasing the requisite assets for a given activity, this may indicate that the taxpayer was not expecting an increase in the value of the acquired assets.⁵⁵ Therefore, a taxpayer who desires to prove a profit motive should endeavor to document any expected asset appreciation.⁵⁶

Taxpayer's Success in Carrying on Other Similar or Dissimilar Activities

The fact that a taxpayer previously engaged in similar activities and converted them from unprofitable to profitable enterprises may indicate that the

Golanty v. Comr., 72 T.C. 411 (1979), *aff'd by unpub. opin.*, 647 F.2d 170 (9th Cir. 1981).

⁴⁹ Regs. §1.183-2(b)(3); *Christensen v. Comr.*, 56 T.C.M. 425 (1988); *Schwartz v. Comr.*, T.C. Memo 2003-86.

⁵⁰ Regs. §1.183-2(b)(3); *Burleson v. Comr.*, 46 T.C.M. 1394 (1983); *Wood v. Comr.*, 34 T.C.M. 817 (1975).

⁵¹ Regs. §1.183-2(b)(3); *Palmer v. Comr.*, T.C. Memo 1981-354; *Hughes v. Comr.*, T.C. Memo 1989-528.

⁵² *Mercer v. Comr.*, 376 F.2d 708 (9th Cir. 1967).

⁵³ Regs. §1.183-2(b)(4); *Hillman v. Comr.*, T.C. Memo 1999-255; *Stanley v. Comr.*, T.C. Memo 1997-54.

⁵⁴ *Sanders v. Comr.*, T.C. Memo 1999-208; *Beltran v. Comr.*, T.C. Memo 1982-153; *Jasionowski v. Comr.*, 66 T.C. 312 (1976); *Lujan v. Comr.*, T.C. Memo 1992-417.

⁵⁵ *Scull v. Comr.*, T.C. Memo 1983-33.

⁵⁶ See Marsh & Bizzell, "Farm Losses and the Limitations on Activities Not Engaged in for Profit," 11 *J. Agric. Tax'n & L.* 291, 294 (1990); Paris & Schenkel, "Equine Endeavors: Hobby v. Business," *Fla. Bar J.* 33, 34 (1989).

present activity (even if unprofitable) has a profit motive.⁵⁷ The fact that the activity previously was profitable should also count strongly in the taxpayer's favor.⁵⁸ If a taxpayer has both prior success and failure in a given activity, this factor should be considered neutral.⁵⁹ Nevertheless, the taxpayer's success in other unrelated activities may also support his profit motive in the challenged activity.⁶⁰

Taxpayer's History of Income or Losses with Respect to the Activity

A series of years in which the taxpayer realized net income from the activity is strong evidence of an adequate profit motive.⁶¹ On the other hand, sustained losses that cannot be explained by normal business risks, depressed market conditions, drought, casualty losses, or other extraordinary events weigh against establishment of profit intent.⁶² A taxpayer who without adequate explanation incurs a long period of heavy losses, or has a very high ratio of expenses to income, will likely fail the profit intent test and be subject to §183 limits.⁶³

However, a series of initial or startup losses can be incurred in an activity engaged in for profit.⁶⁴ Moreover, losses sustained because of unforeseen or fortuitous circumstances beyond the taxpayer's control, such as drought, disease, fire, theft, weather damages, other involuntary conversions, or depressed market conditions, would not be an indication that the activity lacks a profit objective.⁶⁵

Profits Actually Earned and Possibility of Ultimate Profit

A taxpayer who generates only infrequent and small profits, and typically generates large losses, is less likely to have a profit motive.⁶⁶ Yet even a few profitable years in a long history of losses can persuade a court that the taxpayer had the necessary

profit motive, but not if the court believes the profitable years were artificially created or fortuitous.⁶⁷

Conversely, a taxpayer whose occasional profits are large, or who has an opportunity to earn a substantial ultimate profit in a highly speculative venture, may demonstrate an adequate profit intent to escape §183 hobby loss rules.⁶⁸ Similarly, a taxpayer who demonstrates that his expectation of eventual profit outweighs his cumulative losses is likely to establish his profit objective.⁶⁹ Nevertheless, a taxpayer with a wholly unrealistic profit expectation will be considered to lack a profit motive.⁷⁰ It may, however, be sufficient that the activity in question has a small chance of making a large profit.⁷¹

Taxpayer's Financial Status

The fact that a taxpayer lacks substantial income or capital from sources other than the activity, or that he has modest means, may indicate a profit motive.⁷² Conversely, if a taxpayer is wealthy, that could be a negative factor in determining his profit intent.⁷³ For example, in *Phemister v. Comr.*,⁷⁴ the taxpayers (a physician and his wife) reported over \$1.9 million of income from Dr. Phemister's wages and business income but reported over \$500,000 of losses from their horse activity. In holding that the horse activity lacked a profit motive, the Tax Court noted that the taxpayers used its losses to reap significant tax benefits. Even so, the fact that a taxpayer is wealthy will not necessarily lead to the conclusion that every activity he undertakes will lack a profit motive.⁷⁵

Elements of Personal Pleasure or Recreation

Although it may be a sad reflection of the view the Code and the courts take toward deductions, the presence of personal motives in carrying on of an activity, especially where there are recreational or personal el-

⁵⁷ Regs. §1.183-2(b)(5); *Arrington v. Comr.*, T.C. Memo 1983-673; *Lamb v. Comr.*, T.C. Memo 1996-166.

⁵⁸ *Brooks v. Comr.*, 274 F.2d 96 (9th Cir. 1959), *rev'g* 30 T.C. 1087 (1958).

⁵⁹ *De Mendoza v. Comr.*, T.C. Memo 1994-314.

⁶⁰ *Jasienski v. Comr.*, 64 T.C.M. 1369 (1992); *Ellis v. Comr.*, 47 T.C.M. 991 (1984).

⁶¹ Regs. §1.183-2(b)(6); *Appley v. Comr.*, 39 T.C.M. 386 (1979).

⁶² Regs. §1.183-2(b)(6).

⁶³ *Eastman v. U.S.*, 635 F.2d 833 (Ct. Cl. 1980); *Howard v. Comr.*, 55 T.C.M. 575 (1988); *Follun v. Comr.*, T.C. Memo 2007-164, *aff'd by unpub. opin.*, 267 Fed. Appx. 309 (4th Cir. 2008).

⁶⁴ Regs. §1.183-2(b)(6); *Westphal v. Comr.*, T.C. Memo 1994-537; *Upton v. Comr.*, T.C. Memo 1990-250.

⁶⁵ Regs. §1.183-2(b)(6).

⁶⁶ Regs. §1.183-2(b)(7); *Power Est. v. Comr.*, T.C. Memo 1983-552, *aff'd*, 736 F.2d 826 (1st Cir. 1984); *Zidar v. Comr.*, T.C. Memo 2001-200; *Morrissey v. Comr.*, T.C. Summ. Op. 2009-135.

⁶⁷ *Thacker v. Comr.*, 28 T.C.M. 1433 (1969); *Brown v. Comr.*, 36 T.C.M. 77 (1977); *Schirmer v. Comr.*, 89 T.C. 277 (1987), *acq.*, 1989-1 C.B. 1.

⁶⁸ Regs. §1.183-2(b)(7); *Tinnell v. Comr.*, T.C. Memo 2001-106; *Chech v. Comr.*, T.C. Memo 1992-658.

⁶⁹ *Eisenman v. Comr.*, 56 T.C.M. 330 (1988); *Feistman v. Comr.*, T.C. Memo 1982-306; *Torres v. Comr.*, 88 T.C. 702 (1987); *Rufus v. Comr.*, T.C. Memo 1983-570.

⁷⁰ *Antonides v. Comr.*, 91 T.C. 686 (1988), *aff'd*, 893 F.2d 656 (4th Cir. 1990); *Kraettli v. Comr.*, 56 T.C.M. 29 (1988); *McCarthy v. Comr.*, T.C. Memo 1997-436.

⁷¹ Regs. §1.183-2(a).

⁷² Regs. §1.183-2(b)(8); *Schwartz v. Comr.*, T.C. Memo 2003-86; *Snyder v. Comr.*, 54 T.C.M. 953 (1987).

⁷³ *Westbrook v. Comr.*, 68 F.3d 868 (5th Cir. 1995); *Purdey v. Comr.*, 58 T.C.M. 947 (1989), *aff'd by unpub. opin.*, 922 F.2d 833 (3d Cir. 1990).

⁷⁴ T.C. Memo 2009-201.

⁷⁵ *Harrison v. Comr.*, T.C. Memo 1996-506; *Hellings v. Comr.*, T.C. Memo 1994-24.

ements involved, may indicate a lack of a profit motive for the activity.⁷⁶ Numerous cases have found that taxpayers' pleasure in the activity or other personal motives outweighed their profit motives.⁷⁷ Similarly, significant recreational facilities associated with the taxpayer's activity, or the taxpayer's recreational use of the assets, often has been regarded as strong evidence of an inadequate profit motive.⁷⁸ Nevertheless, a legitimate for-profit business enterprise does not become a hobby merely because the taxpayer finds the activity pleasurable.⁷⁹

Presumption of Profit Intent

An optimal way to avoid getting bogged down with analyzing the nine factors in determining profit motive is simply to turn a profit more often than not. Section 183 includes a presumption that a taxpayer engaged in an activity for profit if the activity was profitable for three of the last five years (two of the last seven years for activities related to horses) ending with the current taxable year.⁸⁰ Of course, the government may rebut this presumption.⁸¹ Moreover, a taxpayer may elect to delay a determination of whether the presumption applies until after the close of the fourth taxable year (sixth year in the case of horses) that follows the first the taxable year in which he engaged in the activity.⁸² If the presumption is found not to apply, the taxpayer must establish a profit motive to avoid application of §183.

Examining Each "Activity"

Section 183 applies to deductions attributable to "an activity."⁸³ Accordingly, sometimes it becomes important to determine whether a taxpayer engaged in one or multiple activities.⁸⁴ Depending on the facts and circumstances, a taxpayer's multiple endeavors may be categorized as a single activity or multiple ac-

tivities. Generally, the IRS will accept the taxpayer's characterization of several endeavors as a single activity or multiple activities, as long as the facts and circumstances bear out that characterization.⁸⁵

Topping v. Comr.,⁸⁶ considered this single/multiple activity dilemma. It involved a horse activity and a design activity. The design activity included designing clients' horse barns. For several years, the taxpayer reported the horse activity as generating business losses, but the design activity as generating business income.

The IRS assessed a deficiency against the taxpayer on the basis that the horse activity was not engaged in for profit. In Tax Court, the taxpayer presented evidence that she primarily developed clients for her design activity by participating in equestrian events. Noting that the taxpayer's combined horse and design activities had produced a profit for six out of seven years, the Tax Court held that the taxpayer's horse and design activities constituted a single activity with a profit motive.

Deductions Allowed Under §183: The "Tier System"

When a taxpayer's activity lacks a profit motive, he may deduct expenses for the activity only to the extent permitted by §183.⁸⁷ A three-tier system governs these deductions.

Tier One deductions consist of items that are allowable regardless of whether the activity has a profit motive.⁸⁸ Tier One deductions include items such as some types of taxes, casualty and theft losses, bad debts, worthless securities, tax-related expenses, qualified residence interest, medical expenses, charitable contributions, etc.⁸⁹

Next, the taxpayer may deduct Tier Two items, but only to the extent of gross income from the activity reduced by Tier One deductions.⁹⁰ Tier Two items are items that would be allowable if the activity were engaged in for profit, and are generally operating expenses such as rent, utilities, maintenance, labor, supplies, insurance, advertising, etc. Tier One items that

⁷⁶ Regs. §1.183-2(b)(9); *Keely v. Comr.*, T.C. Memo 1984-173; *Ballard v. Comr.*, T.C. Memo 1996-68; *Follum v. Comr.*, T.C. Memo 2007-164, *aff'd by unpub. opin.*, 267 Fed. Appx. 309 (4th Cir. 2008).

⁷⁷ *Burger v. Comr.*, 809 F.2d 355 (7th Cir. 1987); *Worley v. Comr.*, 39 T.C.M. 1090 (1980); *Takahashi v. Comr.*, 87 T.C. 126 (1986); *McCarthy v. Comr.*, T.C. Memo 1997-436.

⁷⁸ See, e.g., *Duffy v. Comr.*, 690 F.2d 889 (Ct. Cl. 1982); *Roehning v. Comr.*, 57 T.C.M. 978 (1989); *Harris v. Comr.*, 55 T.C.M. 769 (1988); *Howard v. Comr.*, 55 T.C.M. 575 (1988); *Keely v. Comr.*, 47 T.C.M. 1455 (1984).

⁷⁹ *Jackson v. Comr.*, 59 T.C. 312 (1972).

⁸⁰ §183(d).

⁸¹ §183(d); see also *Novak v. Comr.*, T.C. Memo 2000-234.

⁸² §183(e); see also *Wadlow v. Comr.*, 112 T.C. 247, 250-251 (1999).

⁸³ §183(a); Regs. §1.183-1(d).

⁸⁴ Regs. §1.183-1(d)(1).

⁸⁵ Regs. §1.183-1(d)(1).

⁸⁶ T.C. Memo 2007-92.

⁸⁷ §183(a).

⁸⁸ §183(b)(1). Regs. §1.183-1(b)(1)(i).

⁸⁹ See Regs. §1.183-1(b)(2)(i); see also S. Rep. No. 552, 91st Cong., 1st Sess. 104 (1969). FICA and FUTA taxes are probably not deductible under Tier One because they were not deductible under former §270, the predecessor of §183. Rev. Rul. 70-345, 1970-2 C.B. 72.

⁹⁰ §183(b)(2).

result in no basis adjustment are considered Tier Two items.⁹¹

A taxpayer may deduct Tier Three items only to the extent of gross income reduced by both Tier One and Tier Two items.⁹² Tier Three items are deductions that would be allowable if the activity had been conducted for profit, but require a basis adjustment. Tier Three items include depreciation, partial losses with respect to property, partially worthless debts, amortization, and amortizable bond premiums. If an activity includes more than one depreciable asset, the Tier Three deduction and corresponding basis adjustment is allocated to each asset according to a formula that weighs the depreciation deduction contributed by each asset.⁹³

Interplay with Other Code Sections

Questions may arise regarding how §183 hobby loss rules interact with other Code sections. For example, §469 generally defers passive activity losses and credits until the taxpayer disposes of his entire interest in a passive activity in a taxable transaction.⁹⁴ An activity subject to §183 generally is not subject to §469 in the same taxable year.

Section 67 imposes a floor of 2% of an individual's adjusted gross income for miscellaneous itemized deductions.⁹⁵ Under temporary regulations, expenses for an activity for which a deduction is otherwise allowable under §183 are subject to the 2% floor.⁹⁶ Hence, except for §183 Tier One items specifically excluded from the definition of miscellaneous itemized deductions (such as interest, taxes, casualty losses, etc.), items allowed under §183 still may be disallowed under §67.

Section 465 limits a taxpayer's deduction for losses from an activity to the amount that the taxpayer has

“at risk” in the activity.⁹⁷ Section 465 applies to taxpayer's trade or business activities engaged in for the production of income.⁹⁸ As such, an activity subject to §183, which necessarily lacks a profit motive, cannot be subject to §465 in the same taxable year.

Conclusion

A taxpayer who casually engages in an activity, generates losses, and then attempts to deduct them places himself at risk of running afoul of §183 hobby loss rules. Any taxpayer wishing to avoid §183 harsh results should take steps to help provide evidence of a profit motive. For example, the taxpayer may want to do the following:

1. Maintain a separate bank account and appropriate books and records concerning the financial aspects of the activity.
2. Keep records of the nature and extent of his participation in the activity, which should be significant in terms of both time and importance to the activity.
3. Prepare a detailed written business plan, including the project goals, start-up costs, advertising, projected results, and parameters for discontinuing an unsuccessful venture;
4. Document any expected asset appreciation related to the activity;
5. Consider changes in his operating methods if the activity is not very successful, or document the reasons for failing to make changes.
6. Acquire a reasonable level of expertise in the field and/or regularly consult experts, especially regarding operating methods and profit potential.
7. Try to minimize the obviously personal or recreational aspects of the activity.

As with the application of any complicated Code provision, a taxpayer almost always helps himself by consulting a competent tax professional, and §183 is no exception. With proper planning, and perhaps some luck, a taxpayer may be able to avoid the pitfalls of §183 by taking proper steps to ensure that responding to an audit does not become his main hobby.

⁹¹ Regs. §1.183-1(b)(1)(ii).

⁹² Regs. §1.183-1(b)(1)(iii).

⁹³ Regs. §1.183-1(b)(2)(i).

⁹⁴ §469(a), (b), (g).

⁹⁵ §67(a).

⁹⁶ Regs. §1.67-1T(a)(1)(iv).

⁹⁷ §465(a).

⁹⁸ §465(c)(3).