

Avoiding Hobby Loss Classification: Meeting the Nine Factor Test, the 183(d) Safe Harbor, and Withstanding IRS Challenges

THURSDAY, JANUARY 21, 2021, 1:00-2:50 pm Eastern

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Avoiding Hobby Loss Classification

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§ 183: Background

- “Hobby loss” provisions have been part of the Internal Revenue Code since enacted as § 270 under the Revenue Act of 1943. Current § 183 was adopted in 1969.
- The general purpose of hobby loss limitations is to limit the ability of taxpayers from deducting expenses of their “hobbies” (i.e. non-profit making activities) against their other sources of income.
- § 183 is not a disallowance provision, but rather a provision which allows deductions not otherwise allowed under § 162 or § 212.

§ 183: Background

- §§ 183(a) and (b) limit the deductions available with respect to an activity not engaged in for profit to the gross income derived by such activity (and other deductions allowed elsewhere under the Code).
- § 183 applies to individuals, partnerships, estates, trusts, and S corps, but not to C corps. For pass-throughs, determined at the entity level.
- § 183 is often used to determine whether a profit motive exists under § 162, making § 183 relevant also in § 162 analysis.

§ 183(b): Allowed Deductions

- In an activity not engaged in for profit, deductions still may be allowed.
- Deductions attributable to an activity “not for profit” are divided as follows:
 - Deductions allowable without regard to whether the activity is for profit (such as home mortgage interest or casualty losses). These items may be deducted in full.
 - Deductions that would have been allowable under § 162 or § 212 if the activity was for profit, but that do not result in a basis reduction. These items may be deducted up to the activity’s income.
 - Deductions that would have been allowable under § 162 or § 212 if the activity was for profit, but that do result in a basis reduction (i.e. depreciation). Allowed to the extent gross income exceeds the sum of Tier 1 and Tier 2 deductions.
- See Treas. Reg. §1.183-1(b)

§ 183: Activities Not Engaged in For Profit



- An “activity not engaged in for profit” is an activity other than those for which deductions are allowed under §§ 162, 212(1), or 212(2).
- Multiple activities are not aggregated. In determining whether several undertakings constitute a single vs. separate activities, look to:
 - Degree of organizational and economic interrelationship;
 - Business purpose served by carrying on various undertakings; and
 - The similarity of various undertakings.
- Cases have disallowed aggregating activities, for example, where farmland was rented separately from the farmhouse. *Meinhardt*, TC Memo 2013-85.

§ 183: Activities Not Engaged in For Profit



- Determining whether an activity is engaged in for profit is made according to the objective facts and circumstances. Greater weight is given to objective facts than the taxpayer's purported subjective intent.
- If a taxpayer has an objective profit motive, there is no requirement that this motive be reasonable. Even a small chance of making a profit may be sufficient.
- The sought-after profit should be a true economic profit, without regard to tax savings. However, tax benefit does not necessarily negate the potential for a profit motive.
- An expectation that assets used in an activity will appreciate in value to produce an overall profit may be sufficient even if no operational profit realized.

§ 183: The Nine Factors

- The regulations at Treas. Reg. § 1.183-2(b) set forth a series of nine factors to be analyzed in determining whether an objective profit motive exists.
- No single factor is determinative.
- The number of factors favoring one outcome versus another is not controlling (i.e. if there are 5 finding no profit motive and 4 finding a profit motive, a profit motive still may be found to exist).
- These factors should be evaluated prioritizing objective evidence over subjective statements from the taxpayer.

§ 183: The Nine Factors

- *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. Similarly, where an activity is carried on in a manner substantially similar to other activities of the same nature which are profitable, a profit motive may be indicated. 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.
- *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. Where a taxpayer has such preparation or procures such expert advice, but does not carry on the activity in accordance with such practices, a lack of intent to derive profit may be indicated unless it appears that the taxpayer is attempting to develop new or superior techniques which may result in profits from the activity.

§ 183: The Nine Factors

- 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.
- 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.

§ 183: The Nine Factors

- 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.
- 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 engaged in for profit. A series of years in which net income was realized would of course be strong evidence that the activity is engaged in for profit.

§ 183: The Nine Factors

- 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.
- 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.

§ 183: The Nine Factors

- *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.

§ 183: Effect of the TCJA

- The Tax Cuts and Jobs Act, through § 67(g), eliminates the ability of taxpayers to take miscellaneous itemized deductions for years 2018-2025, such deductions previously having been limited to the 2%-of-AGI floor.
- Deductions previously allowed under § 183 to activities not engaged in for profit are included in the losses disallowed under § 67(g)
- For tax years covered by the TCJA, income from a “hobby” is taxable but the deductions with respect to that activity are not deductible.

§ 183: Effect of the TCJA

- The result of these TCJA changes raise the importance of qualifying as a “trade or business” under § 162.
- In addition to having a profit motive (often relying on the § 183 factors), § 162 requires the taxpayer participate in the activity with continuity and regularity.
- If a taxpayer cannot qualify as a § 162 “trade or business,” the costs of the hobby increased via loss of expense deductions.

Avoiding Hobby Loss Classification

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§ 183 Activities not engaged in for profit.

(a) General rule. In the case of an activity engaged in by an individual or an S corporation, if such activity is not engaged in for profit, no deduction attributable to such activity shall be allowed under this chapter except as provided in this section.

Under TCJA through 2025 no deduction at all.

Tax Reform Act Of 1969

From Joint Committee Report:

Prior law contained a so-called "hobby loss" provision (section 270) which limited to \$50,000 per year the amount of losses from a trade or business carried on by an individual that could be used to offset other income. This limitation only applied, however, where the losses from the business exceeded \$50,000 per year for a period of at least 5 consecutive years

.....

In making the determination of whether an activity is not engaged in for profit, it is intended that an **objective rather than a subjective approach** be employed. Thus, although a **reasonable expectation of profit is not required**, the facts and circumstances (without regard to the taxpayer's subjective intent) have to indicate that the taxpayer entered the activity, or continued the activity, with the **objective of making a profit**

Statute Extension

§ 183 Activities not engaged in for profit.

(1) In general.

A determination as to whether the presumption provided by subsection (d) applies with respect to any activity shall, if the taxpayer so elects, not be made before the close of the fourth taxable year (sixth taxable year, in the case of an activity described in the last sentence of such subsection) following the taxable year in which the taxpayer first engages in the activity.

(4) Time for assessing deficiency attributable to activity.

If a taxpayer makes an election under paragraph (1) with respect to an activity, the statutory period for the assessment of any deficiency attributable to such activity shall **not expire before the expiration of 2 years after** the date prescribed by law (determined without extensions) for filing the return of tax under chapter 1 for the **last taxable year in the period of 5 taxable years (or 7 taxable years) to which the election relates**. Such deficiency may be assessed notwithstanding the provisions of any law or rule of law which would otherwise prevent such an assessment.

The Form

When To File File this form within 3 years after the due date of your return (determined without extensions) for the first tax year in which you engaged in the activity. However, if you received a written notice that the IRS proposes to disallow deductions attributable to an activity not engaged in for profit (under Internal Revenue Code section 183) and you want a postponement of the determination, you must file this form within 60 days after receiving the notice. This 60-day period does not extend the 3-year period referred to above.

Form 5213 (Rev. February 2005) Department of the Treasury Internal Revenue Service	Election To Postpone Determination as To Whether the Presumption Applies That an Activity Is Engaged in for Profit ▶ To be filed by individuals, estates, trusts, partnerships, and S corporations.	OMB No. 1545-0195
Name(s) as shown on tax return		Identifying number as shown on tax return
Address (number and street, apt. no., rural route) (or P.O. box number if mail is not delivered to street address)		
City, town or post office, state, and ZIP code		
The taxpayer named above elects to postpone a determination as to whether the presumption applies that the activity described below is engaged in for profit. The determination is postponed until the close of: <ul style="list-style-type: none"> • The 6th tax year, for an activity that consists mainly of breeding, training, showing, or racing horses or • The 4th tax year for any other activity. after the tax year in which the taxpayer first engaged in the activity.		
1 Type of taxpayer engaged in the activity (check the box that applies):		
<input type="checkbox"/> Individual <input type="checkbox"/> Partnership <input type="checkbox"/> S corporation <input type="checkbox"/> Estate or trust		
2a Description of activity for which you elect to postpone a determination		

Regulation

Reg § 1.183-2. Activity not engaged in for profit defined.

(b) Relevant factors. In determining whether an activity is engaged in for profit, all facts and circumstances with respect to the activity are to be taken into account. **No one factor is determinative in making this determination.** In addition, it is **not intended** that only the factors described in this paragraph are to be taken into account in making the determination, or that a determination is to be made on the basis that **the number of factors** (whether or not listed in this paragraph) **indicating a lack of profit objective exceeds the number of factors indicating a profit objective**, or vice versa. Among the factors which should normally be taken into account are the following:

Not True In Practice

(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.

(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.

(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.

(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 engaged in for profit. A series of years in which net income was realized would of course be strong evidence that the activity is engaged in for profit.

(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



(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. See, however, paragraph (d) of §1.183-1 for definition of an activity in this connection.

Activity Defined

Reg § 1.183-1. Activities not engaged in for profit.

(d) Activity defined.

(1) Ascertainment of activity. Generally, the most significant facts and circumstances in making this determination are the degree of organizational and economic interrelationship of various undertakings, the business purpose which is (or might be) served by carrying on the various undertakings separately or together in a trade or business or in an investment setting, and the similarity of various undertakings. **Generally, the Commissioner will accept the characterization by the taxpayer of several undertakings either as a single activity or as separate activities.**Where land is purchased or held primarily with the intent to profit from increase in its value, and the taxpayer also engages in farming on such land, the farming and the holding of the land will ordinarily be considered a single activity only if the farming activity reduces the net cost of carrying the land for its appreciation in value.

(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.



(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. Where a taxpayer has such preparation or procures such expert advice, but does not carry on the activity in accordance with such practices, a lack of intent to derive profit may be indicated unless it appears that the taxpayer is attempting to develop new or superior techniques which may result in profits from the activity.

(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. Similarly, where an activity is carried on in a **manner substantially similar to other activities of the same nature which are profitable**, a profit motive may be indicated. 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.

Factor 1 Businesslike - Subfactors

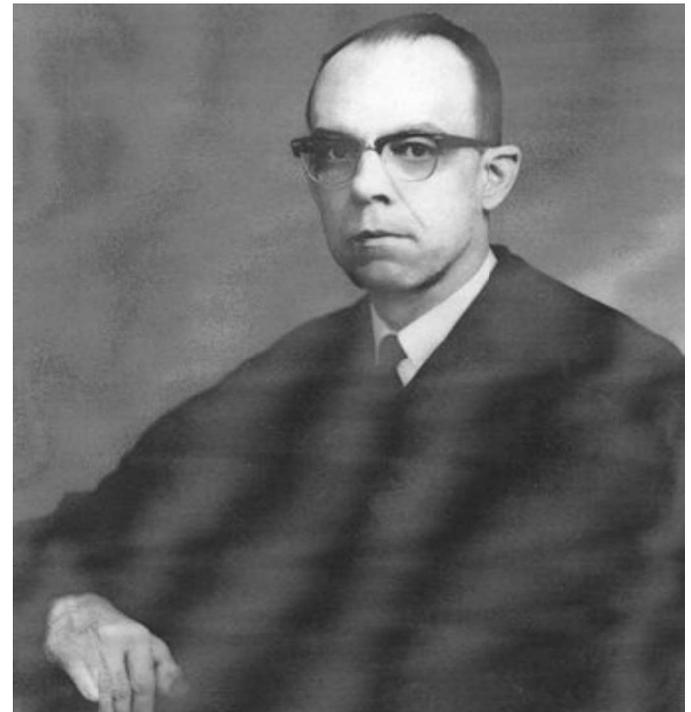
- (a) - complete and accurate books and records
- (b) - carried on in a manner substantially similar to profitable undertakings
- (c) - change of operating methods, adoption of new techniques, abandonment of unprofitable activities
- (d) - business plan
- (e) - advertising

Hero To The Pursuers Of Improbable Profits

Spottswood W. Robinson III

1916-1998

Wrote DC Circuit opinion in Maurice Dreicer



Maurice Dreicer's Search For The Perfect Steak



Maurice Dreicer

TC Memo 1979-395- DC Circuit 665 F.2d 1292 (1981)- 78 TC 469 (4/19/1982)

Multimedia personality writing book about search for the perfect steak,. Heir to fortune from country's top jewelry store in late 19th and early 20th century

Years litigated - 1972 - 1973 Deficiency \$39k Losses \$50k

Loss history - 1967 -1976 \$259K

We hold that a taxpayer engages in an activity for profit, within the meaning of Section 183 and the implementing regulations, **when profit is actually and honestly his objective though the prospect of achieving it may seem dim.**

Tax Court Had It Wrong

Indeed, the notion that such an expectation was a precondition to deductibility pervades the court's treatment of Dreicer's claim thereto,¹ and became the decisive factor in its ruling:

In conclusion, after a careful review of all the facts and circumstances of this case, we hold that [Dreicer's] activity of traveling around the world allegedly to obtain material for a transcript was an "activity ... not engaged in for profit" within the meaning of section 183(a), since **he did not have a *bona fide expectation of profit***. Accordingly, the losses incurred by him during 1972 and 1973 are not deductible.^[70]

By thus hinging its decision on Dreicer's profit expectations instead of his profit objectives, the Tax Court utilized the wrong test. The statute, its legislative history and the implementing Treasury regulation make explicit that **the objective, not the expectation, of making a profit is to govern determinations** on whether a taxpayer is engaged in a business or a hobby, and the two criteria are not the same. One may embark upon a venture for the sincere purpose of eventually reaping a profit but in the belief that the probability of financial success is small or even remote. He therefore does not really expect a profit, but nonetheless is willing to take the gamble.

Lowell G. Den Besten - Wins

[TC Memo 2019-154](#) - Cutting horses

Years litigated - 2006-2010 - Deficiency over \$250k

Loss every year since 1997.

For each year in issue petitioner reported his cutting horse activity on Schedule F, Profit or Loss From Farming. Petitioner reported his seed business during the same years on Schedule C

Positions taken by a taxpayer in a tax return are treated as admissions and cannot be overcome without proof that they are erroneous

Reporting activities on separate schedules is an admission that the taxpayer views the activities as separate



James And Elaine Donoghue - Losing Winners

TC Memo 2019-71 - Thoroughbred horses -

Years 2010-2012 - Deficiency \$30k+ -

Marestelle Farm was a “virtual farm”. Paid others

Total losses 1985 -2012 \$975k \$200k disallowed



It is undisputed that **petitioners received a total of over \$100,000 in wage and Social Security income**

Edward Kurdziel - Captain Eddie Goes Down in Flames

TC Memo 2019-20 - Historic airplane RAF Fairey Firefly

2007-2010 - Losses 500k+

Started in 1994 - total losses? Eight years to restore

Returns listed the business as being "Airplane leasing"

Plane was not leased and TP was not trying to lease it

No separate accounts. Claimed it was nonbusiness for pp tax.

If Captain Eddie had looked at selling once a year and made a documented decision to continue to hold, that might have been enough.



Finis Welch - Big Win On Huge Losses

TCM 2017-229 - Cutting horses

2007-2010 \$4.8M Deficiency

Center Ranch is now a multioperational, 8,700-acre ranch

Respondent argues that petitioner must have a profit motive that expects recoupment of all of Center Ranch's past losses. This expectation is too much.

An overall profit is present if net earnings and appreciation are sufficient to recoup the losses sustained in the 'intervening years' between a given tax year and the time at which future profits were expected



Woody B Tuff - Key To Finis Welch Narrative

Proven stallion lifetime earnings \$340,000, Yet unproven stud

Stud fee of \$1,500 in years at issue.

But by 2013 his stud fee had increased to \$2,000

By 2014 it had increased to \$5,000 plus a chute fee.

Center Ranch can expect to collect semen from Woody Be Tuff until he is in his mid-20s



Richard Brewster Main

TC Memo 2016-127 - Restoring 1955-6 Plymouths

Year of loss 2009 - \$27k+ deficiency

Lost some on substantiation



Although his manner of carrying on this activity was unsophisticated, it was businesslike. He had experience operating a business and expertise relating to Plymouths; advertised online, in print, and at live events; traveled outside California to acquire cars at bargain prices;abandoned unprofitable aspects of his automobile activity

Richard Cribbs - Night Of The Mutant Deer

Alabama Tax Tribunal 15-259 - Hunting ground

Years 2010-2011 - Losses \$100k+



“if I went into it to be a gentleman farmer, I’m a sure enough dumb man sitting here in Alabama

his family hunted only four times on the farm for cull deer during the two years in issue

William D Evans - Like a Hobby Loss case

TC Memo 2014-237

Sponsored sons motocross racing.

Years 2006-2007 - Deficiency \$100k



He competed in nationally televised races and was featured in various motocross magazines, including Amateur MX Magazine and Racer X Magazine. Sponsors, including American Honda, Carl's Cycle Sales, Western Power Sports, and Step One Graphics, started “coming out of the woodwork” to support him. At this point Mr. Evans realized that his son's talent and “star power” might help to boost DEC's business. He consulted with his certified professional accountant (C.P.A.), Bill Anderson, who advised him that supporting Ben's motocross racing could be a valid promotional activity for DEC. DEC subsequently became one of Ben's sponsor

Susan Crile Don't Need No Stinkin Business Plan

TC Memo 2014-202 - Painter and printmaker

Years 2004-2005 - 2007-2009

Deficiency \$80k+

Bifurcated case

We conclude that petitioner's art business and her salaried position as a professor constitute two distinct activities

Show prominence in field



Business Plan - Susan Crile

Although petitioner did not have a written business plan, she had a business plan and she pursued it consistently.A taxpayer need not conduct a formal marketing study in order to have a profit motiveWhile conceding that petitioner and her advisors have the requisite artistic expertise, respondent contends that she lacks expertise in the economics of being an artist. But **petitioner does not need an economics degree to know how to sell art.**

Mel Annuzzi - Partner With Your Trainer

TC Memo 2014-233 - Thoroughbred racing breeding

2009 - 2010 - \$50k+ deficiency Five profit years since 1981

\$500k overall losses

Co-owned horses with trainer

Simply put, petitioners race their horses.

They hope to make money by winning purses at horse races, by selling race horses at a profit, and by breeding foals that they can race successfully or sell.



Annuzzi Business Plan - Not

The evidence established that formal cashflow projections for a horse racing business would be speculative. **It is nearly impossible to predict whether a particular horse, however promising, will finish first, second, or third in future races.** It is equally difficult to predict whether a promising horse will suffer an injury that will suddenly end its moneymaking career. **Petitioners established that they were able to run ACS, a profitable concrete business, without a written business plan or formal income projections.** Their decision to forgo the creation of such documents for their thoroughbred activity does not evidence the lack of a profit objective.

Thomas Gullion Needed A Better Accountant

TC Summary 2013-65 - Saxophone player - TP win

Years 2008-2009 Deficiency \$20k

2004-2010 Total loss \$130,203



The initial auditor mischaracterized almost all facts in my case (stating that I moved to the country in Wisconsin as part of an elaborate tax dodging scheme) and made wild, unsubstantiated judgments (such as “it’s impossible to make a living as a musician in rural America”). The appeals officer wouldn’t consider examining the facts in the case at all.

John Dalton Parks III - Run For Your Life

TC Summary 2012-105 - Independent track coach

Years 2006-2008 Deficiency \$12k Loss \$87k+

Total loss 2003-2011 \$153k



*In October 2006 **petitioner consulted with Loren Seagrave concerning ways to increase the profitability of his private coaching activity.** Seagrave is recognized as an expert in sprint and power development and coaches several Olympic and world champion track athletes. Petitioner paid Seagrave for his advice, which was to speak at more regional and national clinics, training camps, and universities. He also advised petitioner to advertise and develop opportunities to enter the professional track ranks by showcasing the abilities of his most gifted runners.*

Peter Morton - Hard Rock In The Sky

Court Of Claims 08-804C - April 27, 2011

Gulfstream aircraft

Years 1999-2001 - \$9.8M Refund claim

Business status also raised 1031 issue



Case law supports Plaintiff's "unified business enterprise" theory and would allow him to take deductions for aircraft use that furthers the business purpose of entities other than RWB. This deduction may be allowed despite the fact that the aircraft is titled in RWB's name, and RWB did not use the aircraft to further its particular profit motive. As long as Plaintiff used it to further a profit motive in his overall trade or business, the deduction is allowed.

Merrill Roberts - Goofy Regulation

Seventh Circuit 830 F.3d 247 April 25 2016 TCM 2014-74

Years 2005 and 2006 - Deficiency \$200k+



The Tax Court's ruling that Roberts' horse-racing enterprise was a hobby in 2005 and 2006 but became a business in 2007 and remained so in 2008, and apparently has been one in every year since given the IRS's failure to challenge his horse-racing deductions for any year since 2008, is untenable; it amounts to saying that a business's start-up costs are not deductible business expenses

We mustn't be too hard on the Tax Court. It felt itself imprisoned by a goofy regulation (26 C.F.R. § 1.183-2

Other Important Taxpayer wins

WP Realty TCM 2019-120 Golf course operation 2005-2016 \$36M in losses

Cecile Barker - TCM 2018-67 - Hulk Hogan, Peter Thiel

Ralph Vitale 4th Circuit 86 AFTR2nd 2000-5059 - Book about legal brothels

Gloria Churchman - 68 TC 696 (1977) sculptor

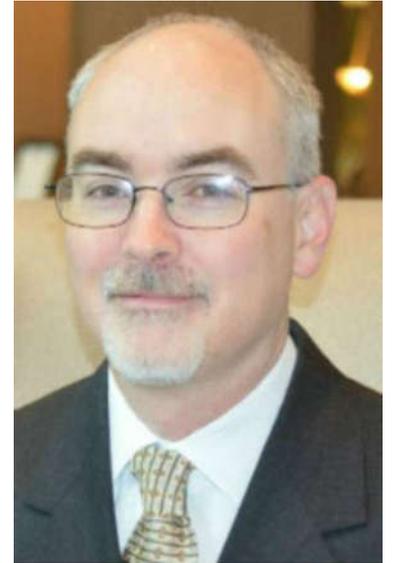
Today's Presenter

Kreig D. Mitchell

Tax attorney in Houston, Texas. Focuses on IRS and state tax disputes.

Kreig has worked for the IRS as an attorney and then an appeals officer. He's led a tax controversy team for a boutique consulting firm, worked in the tax departments for two Fortune 500 companies, worked for one of the Big Four accounting firms, and has had his own tax practice for several years.

Having worked in just about every tax role available has provided him with a unique insight into the IRS, its operations, and our tax laws.



Overview

- ▶ IRS Audit
 - Types of Audits
 - Issue Identification
 - Risk Analysis
 - Audit Process
 - Electing to Postpone Determination
- ▶ IRS Appeals
 - Settling Cases in Appeals

IRS Audit

- ▷ Small Business/Self-Employed
 - Under \$10 million in assets
 - Hobby loss cases common
- ▷ Large Business & International
 - Over \$10 million in assets
 - Hobby loss cases not likely

Types of Audits

- ▷ Correspondence - five service centers, tax examiners
 - Hobby loss issue not likely
- ▷ Office - IRS offices, tax compliance officers
 - Hobby loss issues possible
- ▷ Field - revenue agents
 - Hobby loss issues often considered

Issue Identification

- ▷ IRS Classification:
 - Large, unusual or questionable (LUQs)
 - Discriminant Function System (DIF) Scores
 - Compliance Initiative Project (CIP)
 - IRS determination made before audit
- ▷ Routine Audits
- ▷ Whistleblower Claims

Risk Analysis

- ▷ Is the tax loss material?
- ▷ Loss likely to occur over several years
 - TIGTA: IRS doesn't pull multi-year loss returns
- ▷ Home based businesses (list a different address)
- ▷ NAIC codes for CIP (pick a different code)
- ▷ Combining vs. subdividing activities (report on same or different schedules)

Risk Analysis

- ▷ Offsetting attributes available, e.g., missed deductions, missed tax credits, cost segregation, inventory method, loss carryovers?
- ▷ Application of 9 factors - focus on recreation or pleasure aspect first
- ▷ Substantiation:
 - available or
 - that can be created

Audit Process

- ▷ IRS Technical Guidance available
- ▷ Workpapers and leadsheet
- ▷ Interviews
- ▷ Business tour
- ▷ IRS Information Document Requests
- ▷ IRS explanation or revenue agent report

Audit Process

- ▶ Often other basis for disallowing losses
- ▶ Other basis may be easier to defend on audit:
 - Substantiation vs. hobby loss
 - Start-up vs. hobby loss
- ▶ Probability of settlement for issues in Appeals
- ▶ Don't forego group manager meeting

Electing to Postpone Determination

- ▷ Postpone application of presumption
- ▷ Form 5213, no later than 60 days of IRS determination / activity has to be on return
- ▷ Audit closed to IRS Tech Services until presumption years filed
- ▷ Other issues will be examined first
- ▷ Usually limited suspension as IRS audit cover 2-3 years in past

Electing to Postpone Determination

- ▷ Used when:
 - Business to make a profit soon
 - Forced profits, reduced expenses
 - Factors likely to change
 - Possibility that a new examiner will have a different view

IRS Appeals

- ▷ Quality of the IRS explanation / report is important
 - Alternative positions
- ▷ Quality of the protest is important
 - Incorporate testimony
 - FOIA vs. Taxpayer First Act
 - The transmittal letter
 - The case activity record
- ▷ IRS audit failures not so important

Settling Cases in Appeals

- ▷ Not an Appeals Coordinated Issue
- ▷ Hazards of litigation analysis
- ▷ Settlement range / percentage
 - 20% to 80%, generally
 - Know your Plan A & B up front
 - Trade issues - not likely
 - Trade years - possible
 - All else fails, try for penalties

Settling Cases in Appeals

- ▶ The conference
 - Taxpayer participation - yes
- ▶ The appeals officer approach:
 - Already made adverse determination - usually not disclosed up front
 - On the fence - will provide hints
 - Already made favorable determination - may offer up front--stop talking!

Settling Cases in Appeals

- ▶ Settle based on:
 - Facts/law
 - Calculation
- ▶ Be prepared for both
- ▶ Closing agreements
- ▶ Docketed cases