















to claiming expenses under IRC § 162. An expense may qualify as ordinary and necessary if it is appropriate and helpful in carrying on a trade or business, is commonly and frequently incurred in the type of business conducted by the taxpayer, and is not a capital expenditure.” **Welch v. Helvering**, 290 U.S. 111 (1933).

A trade or business expense deduction under IRC § 162, however, is not permitted with respect to a taxpayer’s residence unless specifically permitted in certain limited circumstances by IRC § 280A. An examiner should consult the rules of IRC § 280A (which generally supersede the IRC § 183 rules) if the taxpayer’s deductions are suspect and involve a personal residence. See e.g., Rev. Rul. 2004-32.

## **Multiple Activities**

Treas. Regs. § 1.183-1(d) provides that if a taxpayer engages in two or more separate activities, deductions and income from each separate activity are not aggregated either in determining whether a particular activity is engaged in for profit or in applying IRC § 183. Multiple undertakings may be treated as one activity if the undertakings are sufficiently interconnected.

The regulations define an activity and provide that where the taxpayer is engaged in several undertakings, each of these may be a separate activity, or several undertakings may constitute one activity. In ascertaining the activity or activities of the taxpayer, all the facts and circumstances of the case must be taken into account. 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. The taxpayer's characterization will not be accepted, however, when it appears that his characterization is artificial and cannot be reasonably supported under the facts and circumstances of the case.

If the taxpayer engages in two or more separate activities, deductions and income from each separate activity are not aggregated either in determining whether a particular activity is engaged in for profit or in applying IRC § 183.

## **Farming Activities and Farmland Appreciation**

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. Thus, the farming and holding of the land will be considered a single activity only if the income derived from farming exceeds the deductions attributable to the farming activity which are not directly attributable to the holding of the land (that is, deductions other than those directly attributable to the holding of the land such as



interest on a mortgage secured by the land, annual property taxes attributable to the land and improvements, and depreciation of improvements to the land). Treas. Regs. § 1.183-1(d).

Some courts have avoided the restrictive rule discussed in the preceding paragraph by finding that the taxpayer did not purchase or hold the land primarily with the intent to profit from increase in its value. Instead, these courts have found the taxpayer purchased and held the land for farming. See e.g., **Engdahl v. Comr.**, 72 T.C. 659 n.4 (1979), acq. 1979-C.B.1. On distinguishable facts, an opposite conclusion was reached in **Burrus v. Comr.**, T.C. Memo 2003-285.

## **Taxpayer's Subject to IRC § 183 Activities Not Engaged in For Profit**

The IRC § 183 activities not engaged in for profit rules applies to (1) individuals; (2) S corporations; (3) partnerships; (4) and trusts and estates. IRC § 183 does not apply to C corporations.

### **Individuals**

The provisions under IRC § 183(a) specifically applies to individuals.

### **S corporations**

The provisions under IRC § 183(a) specifically applies to S corporations. Treas. Regs. §1.183-1(f) provides that IRC § 183 and this section shall be applied in determining the allowable deductions of an electing small business corporation.

### **Partnerships**

Rev. Rul. 77-320 holds that IRC § 183 of the Code applies to the activities of a partnership, and the provisions of IRC § 183 are applied at the partnership level and reflected in the partners' distributive shares. IRC § 703(a) provides in general that the taxable income of a partner shall be computed in the same manner as in the case of an individual.

### **Trusts and Estates**

Treas. Reg. § 1.183-1(a) states that "Pursuant to § 641(b), the taxable income of an estate or trust is computed in the same manner as in the case of an individual with certain exceptions not here relevant. Accordingly, where an estate or trust engages in an activity or activities which are not for profit, the rules of IRC § 183 apply in computing the allowable deductions of such trust or estate."

### **C Corporations**

The provisions of IRC § 183 do not apply to C corporations.

## Presumption that Activity is Engaged in for Profit

IRC § 183(d) provides a presumption that an activity is engaged in for profit if the activity is profitable for 3 years of a consecutive 5 year period or 2 years of a consecutive 7 year period for activities that consist of breeding, showing, training, or racing horses.

This presumption rule applies only after an activity incurs a third profitable (or second) profitable year within a 5 year (or 7 year) presumption period that begins with the first profitable year.

**Note:** Treasury Regulation § 1.183-1(c) has not been updated to reflect the 1986 amendment increasing the number of profit years required from two to three out of five years for activities other than horse racing, breeding or showing).

**Example 1** – A taxpayer has the following profits and losses with a car racing activity (5 year presumption period):

Example 1 profits and losses	
Tax Year	Gain or (Loss)
2000	(30,000)
2001	5,000
2002	(60,000)
2003	2,000
2004	5,000
2005	(70,000)
2006	3,000
2007	(63,000)

The first 5 year presumption period begins with the first profit year of 2001, but the benefit of the presumption does not begin until the third profit year of 2004. The presumption is not available for 2001 through 2003 because it does not apply until the third profit year. The presumption is available during the first presumption period only in 2004 and 2005. The second five year presumption period begins with the 2003 profit year and runs through 2007. The presumption applies to the third profit year of 2006 and will be of benefit to the taxpayer for 2006 and 2007.

If the taxpayer meets the presumption rule, the Service can still argue that the activity is not engaged in for profit; however, the burden of proving that the activity is not engaged in for profit shifts to the Service. In addition, examiners cannot use IRC § 183(d) as the sole basis for

disallowing losses under IRC § 183 even if it is shown that the taxpayer has not met the presumption rule.

Examiners should be alert for situations where the taxpayer may have manipulated income and or expenses to meet the presumption rule determination.

## **Election to Postpone Determination**

Under IRC § 183(e), a taxpayer may elect to postpone a determination of whether the presumption applies until the close of the fourth taxable year (or the sixth year for qualifying horse activities) following the **first** taxable year in which the taxpayer engages in the activity. An electing taxpayer may file returns in the interim on the assumption that the activity is conducted for profit.

If an activity that is generating losses has not yet been carried on for the full profit presumption period, the taxpayer may elect to postpone a determination of whether or not an activity is engaged in for profit.

The examiner should first determine whether or not the activity is engaged in for profit from all available facts without regard to the presumption test or the possible election to postpone determination under IRC § 183(e). This determination should take into account the “nine relevant factors” listed in Treas. Reg. § 1.183-2(b) as well as the pertinent facts.

Upon the filing of all or a sufficient number of the returns of the presumption period, the case file will be returned to the examiner for a determination if the activity is presumed to be an activity engaged in for profit.

### **Making the Election**

Form 5213, Election to Postpone Determination as To Whether the Presumption Applies That an Activity Is Engaged in for Profit, is used when taxpayers wish to postpone an IRS determination as to whether the presumption applies that they are engaged in an activity for profit. An election made by a partnership or an S corporation is binding on all persons who were partners or shareholders at any time during the presumption period.

The election to postpone determination generally can be filed anytime within three years after the due date of the return (determined without regard to extensions) for the first year of the activity but not later than 60 days after the taxpayer receives written notice from the IRS proposing to disallow deductions attributable to the activity.

**Note:** Form 5213 is rarely used by the taxpayer until an examiner proposes to disallow the activity as not engaged in for profit.

The examiner should determine if the taxpayer wants, and is eligible to elect to postpone the determination under IRC § 183(e). If the taxpayer makes the decision to make the election, all

legal and procedural implications should be explained. If the taxpayer is eligible to make the election but does not wish to, the examiner should obtain a written statement from the taxpayer or his representative stating that the taxpayer does not wish to elect the provisions of IRC § 183(e).

### **Placing in Suspense**

If there is an election to postpone the determination, the examiner will generally close the case to suspense until the end of the presumption period. Upon the filing of all or a sufficient number of the returns of the presumption period, the case file will be returned to the examiner for a final determination if the activity is engaged in for profit.

If the taxpayer wishes to make an §183(e) election to postpone determination, the examiner should:

1. secure fully completed and properly signed Form 5213,
2. requisition all returns beginning with the initial year,
3. obtain AMDISA, IMFOLT, IMFOLR for all tax returns,
4. perform audit functions as warranted, paying particular attention to the full development of the activity not engaged in for profit issue,
5. examine and complete any open years prior to placing in suspense,
6. prepare a report on each of the open years of the IRC § 183 adjustments,
7. attach a completed Form 3198, Special Handling Notice for Examination Case Processing, checking the blocks “Suspense Cases” and “Sec. 183 (Form 5213),”
8. make appropriate comments in the workpapers to document the election,
9. advise the taxpayer of the suspense process and to retain all pertinent books and records for each of the presumptive years,
10. attach the Form 5213 to the back of the first year’s return with the form number showing above the tax return, and, if applicable,
11. resolve all other issues through partial assessments or unagreed procedures prior to sending the case to Technical Services for suspense.

A partially agreed report should be prepared if there are other issues which are agreed and generate a deficiency. One report will contain the agreed issues and the other report only the IRC § 183(a) issue as unagreed. IRM 4.10.8.5 contains the report writing instructions for partially agreed cases.

The Form 4549-A, Income Tax Discrepancy Adjustments, in the “Other Information” section should include the following statement:

“You have elected to postpone the determination with respect to the presumption that this activity is engaged in for profit by filing Form 5213 on (insert date) and thus, this issue will be suspended.

On the unagreed report, the IRC § 183(a) issue should be written up as if the case will go directly to Appeals. The Form 3198 should indicate in the Other Section “Partial Agreement Secured and Processed.”

If there are other unagreed issues besides the § 183 (a) issue, the unagreed report will contain both the unagreed issue(s) and the IRC § 183(a) issue(s) before the case is forwarded to Appeals. The Form 3198 should be notated “Case to be forwarded to Technical Services for suspense after resolution of unrelated issues.”

It is the IRS’s position that the interest suspension period specified in IRC § 6404(g) is tolled (ceases to run) during the time the IRC § 183 election is in effect and for the particular activity to which the election relates.

### **Statute of Limitations**

The filing of Form 5213 automatically extends the period of limitations for assessing any income tax deficiency specifically attributable to the activity during any year in the presumption period.

Under IRC § 183(e)(4), if a taxpayer elects a postponement, the statutory period for the assessment of any deficiency attributable to the issue is extended to 2 years after the due date (without extensions) for filing the return for the last taxable year in the 5 or 7 year presumption period to which the election relates.

For example, for an activity subject to a 5 year presumption period that began in 2004 and ends in 2008, the period of limitations automatically extends to April 15, 2011, for all tax years in the presumption period that would otherwise expire before that date with regards to the § 183 issue.

**Note:** The automatic extension applies only to those deductions attributable to the activity and to any deductions (such as medical expenses or charitable contribution deductions) that are affected by changes to AGI. It does not extend the statute of limitations for issues not related to the IRC § 183 issue.

# Chapter 2: Examination Techniques

## Examination Techniques Overview

Once an examiner believes there is a possible activity not engaged in for profit issue, the case must be adequately developed. In order to adequately develop an IRC § 183 issue, the **examiner must address** each of the nine relevant factors contained in Treas. Reg. 1.183-2(b). The nine factors found in the regulations along with a discussion of each factor are contained in [Appendix A](#).

An IRC § 183 issue will not be sustained in Appeals or in the courts if it has not been properly developed and documented.

Included below are examination techniques specific to the IRC § 183 issue. Some of these techniques are the same or similar to techniques performed on a typical case.

## Pre-audit Analysis

It is not always easy to determine from looking at the return if an activity is not engaged in for profit. Examiners should be alert to see if there is a “reasonable” indication that there is a “likelihood” of an activity not engaged in for profit in the pre-audit stage of the examination. The amount of pre-plan time spent will vary with the complexity of the case.

Examiners should consider the following in their pre-audit analysis:

- Are there activities with large expenses and little or no income?
- Are losses offsetting other income on the return?
- Does the activity result in a large tax benefit to the taxpayer?
- Does the history of the activity show that it is generating any profit in any years?

Examples of possible IRC § 183 activities include but are not limited to:

### Possible IRC § 183 activities

Fishing	Horse Racing	Horse Breeding
Farming	Motorcross Racing	Auto Racing
Craft Sales	Bowling	Stamp Collecting
Dog Breeding	Yacht Charter	Artists
Gambling	Fishing	Bowling
Direct Sales	Photography	Writing
Entertainers	Airplane Charter	Rentals

An in-depth pre-audit analysis is essential to conducting a quality examination. Examiners should prepare a comparative analysis of the taxpayer's returns for multiple years to assist in the identification of:

- large, unusual and questionable items,
- missing schedules,
- inconsistencies between different years, and
- audit potential.

A successful taxpayer interview depends upon what is done before the interview. The examiner should obtain as much information about the taxpayer, be organized, and prepare an interview outline that is tailored to the taxpayer under examination.

Information may be obtained by the use of internal sources such as IDRS, CFOL, MACS/CDE, IRP transcripts and YK-1 to learn everything possible about the taxpayer. External electronic sources of information such as Accurant, Google, Yahoo, and Altavista should also be searched. This information should be compared with the taxpayer's return.

Examiners should perform any preliminary research including reviewing applicable code sections, regulations, court cases, revenue rulings and procedures, and ATGs.

As preliminary information is gathered, it should be carefully reviewed and documented.

## **Information Document Request**

The initial Information Document Request (IDR) for a possible IRC § 183 case should be tailored to the specific taxpayer under examination but will more than likely be the same as for a typical case.

The examiner should not issue an IDR asking the taxpayer to respond to each of the nine factors. This should be done in person with the taxpayer present and the examiner documenting responses. Also, examiners should not request the Business Plan with the first IDR as this should be addressed at the initial interview.

Subsequent IDR's should address other needed information to complete the examination.

An example of an IDR with possible items an examiner might request to assist in determining if a **yacht charter activity** is an activity engaged in for profit is in [Appendix E](#).

## **Initial Interview**

An examiner may not become aware that there is a possible IRC § 183 activity until the initial interview with the taxpayer and/or representative. A subsequent interview may be necessary to gather the factual information to evaluate each of the nine factors contained in Treas. Reg. § 1.183-2(b). The nine factors found in the regulations along with a discussion of each factor are in

[Appendix A](#). An effective and well documented interview is vital to the success in developing an IRC § 183 issue.

The business history should be developed and documented in the examiner's workpapers. Interviews provide information about the taxpayer's financial history, business/activity operations, and accounting records. Interviews should be used to obtain information needed to reach informed judgments about the scope of an examination and the resolution of issues. Interviews can be used to obtain leads, develop information and establish evidence.

A list of possible interview questions to consider for each of the nine factors used in determining whether an IRC § 183 issue present is in [Appendix B](#). Not all of these questions are warranted in every case and questions should be tailored to address items specific to the taxpayer under examination. This interview plan is a guide, which should be modified based upon the responses of the taxpayer and should not be used as an inflexible outline.

Examiners should use short questions that can be easily understood and in a logical order. Sufficient questions should be asked to give a clear understanding of the taxpayer's operations. Follow-up questions should be used to clarify questionable areas. If both the taxpayer and preparer/authorized representative are present for the interview, direct the questions to the taxpayer. Listen to the answers and follow up on any answers that are incomplete or unclear.

The examiner should consider preparing Memorandum of Interview summarizing information obtained and statements made. This will become part of the case file to aid in the case development.

### **Authority to conduct interviews**

The authority to conduct interviews and request information is granted by IRC § 7602.

Every attempt should be made to schedule the initial appointment with the taxpayer. IRC § 7521(c) permits a representative authorized by the taxpayer to represent that taxpayer at any interview. Although a request for the taxpayer's voluntary presence should be made through his/her representative, the taxpayer's presence will not be mandated as long as the person being interviewed has first hand knowledge of the taxpayer's business, business practices, bookkeeping methods, accounting practices and the daily operation of the business. That person must commit to having first hand knowledge of the information requested and affirm that the examiner can rely upon the information provided.

A representative may claim to have first hand knowledge, but when questions are asked it is clear he/she is unable to give adequate answers. If an examiner determines that the representative does not have sufficient knowledge of the taxpayer and his/her business to provide factual information, the examiner should request a subsequent interview with the individual who possesses that information. The examiner should not conduct the audit with someone who will serve as a courier, shuffling back and forth between the examiner and the taxpayer with IRS questions and client answers.



If the taxpayer's representative does not comply with the request to interview someone more knowledgeable, including the taxpayer, the examiner should consider management involvement, issuing an administrative summons to the taxpayer (IRC § 7521(c) and/or by-passing the representative. More information can be found in IRM 4.10.2.and 4.11.55.2.

The examiner may need to use third party contacts order to obtain corroborating information from third parties.

## **Place of Examination**

IRC § 7605(a) states, in part, that “the time and place of examination shall be such time and place as may be fixed by the Secretary and as are reasonable under the circumstances.”

For office examination cases the examination will be conducted in the office of the IRS closest to the taxpayer's residence in the assigned area.

For field examinations an examination will be conducted at the location where the original books, records and source documents are maintained. This is usually the taxpayer's principal place of the business/activity being examined.

On a case-by-case basis, examiners should consider requests by the taxpayer or representative to change the place of the examination (Treas. Reg. § 301.7605-1(e).) In considering these requests, the following factors should be considered:

- The location of the taxpayer's current residence and location of the business/activity.
- The location where the books and records and source documents are maintained.
- The physical restrictions at the activity which could cause disruption of taxpayer's daily operations.

## **Business/Activity Tour**

Viewing the facilities and observing the activities is an opportunity to acquire an overview of the operation, establish that books and records accurately reflect operations, observe and test internal controls, clarify information obtained through interviews, and identify potential audit issues.

Treas. Reg. § 301.7605-1 states “regardless of where an examination takes place, the Service may visit the taxpayer's place of business or residence to establish facts that can only be established by direct visit, such as inventory or asset verification.” The visit can show evidence of financial status, equipment usage, undisclosed aspects of the operation, etc.

Tours should be conducted after the initial interview and early in the examination process. Examiners should be alert to the physical surroundings and confirm that assets identified on the tax return are physically present and identify assets that are physically present but are not represented on the return. Examiners should ask questions to confirm an understanding of what is observed.

When determining the validity of office in the home deductions, the office or activity should be toured.

Examiners should document that a tour was completed and describe the results, including observations and resolution of any questions. If a tour of the business/activity is not conducted, the reason(s) for not conducting the tour should be documented in the workpapers.

A Tax Compliance Officer (TCO) does not always have the opportunity to perform a physical tour of the taxpayer's activity. However, the TCO can inspect any photographs that the taxpayer may have of the activity.

## Factual Development

Examiners must determine whether the taxpayer engaged in the activity with an objective of earning a profit. Although a "reasonable" expectation of profit is not required, the profit objective must be bona fide, as determined from a consideration of the facts and circumstances.

Treas. Reg. §1.183-2(b) ([Appendix A](#)) contains nine relevant factors to be used in determining whether a taxpayer is conducting an activity with the intent to make a profit. An IRC §183 case is not adequately developed until all nine relevant factors are considered and documented. No one factor is more important or heavily weighted; a numerical majority does not decide the issue.

The examiner should obtain copies of prior year returns from the inception of the activity and should prepare a comparative analysis schedule of income and losses (expenses) since the inception of the business through the present as shown in [Appendix D](#). All trends in profits or losses should be addressed and explained. Any unusual income items or expense items that occur and then "drop off" may mean the taxpayer's profit is contrived. The examiner should consider whether the profits shown were manipulated in order to meet the presumption test.

Examiners should be alert to the nature of the gross receipts that have been reported and determine if the income source truly exists or relates to the activity. Income may have been "created" in order to make it appear as though the activity earned income.

The case file should reflect an adequately documented interview. Each of the nine factors **must** be addressed and documented. Sample questions for each factor are contained in [Appendix B](#).

A taxpayer who claims a business expense deduction has the burden of proof. Deductions are strictly a matter of legislative grace, and taxpayers bear the burden of proving that they are entitled to the deductions claimed. **Hawthorne v. Comr**, T.C. Memo 1999-31 (citing **Indopco, Inc. v. Comr**, 503 U.S. 79, 84, (1992)).

A taxpayer seeking a deduction must be able to point to an applicable statute and show that he comes within its terms. **New Colonial Ice v. Helvering**, 292 U.S. 435, 440 (1934). Also see **Indopco, Inc. v. Comr**, 503 U.S. 79, 84, (1993); **Rockwell v. Comr**, 512 F.2d 882, 886 (1975), aff'g TC Memo 1972-133.

To take any deduction, the taxpayer must be able to cite an authority: Code, regulations, revenue rulings, notices. This includes the burden of substantiating the amount and purpose of the deduction claimed. IRC § 6001 imposes a broad recordkeeping responsibility on all taxpayers, requiring them to maintain adequate records to substantiate the liability. IRC § 6001 gives the IRS authority to require whatever records it deems necessary. If the taxpayer proves that a portion of the expenditure was made for a deductible purpose, the taxpayer may allocate that portion to the deductible purpose when the record contains sufficient evidence for a reasonable allocation. See **Dillon v. Commissioner**, 902 F.2d 406 (5th Cir. 1990).

IRC § 6201 provides examiners with the authority to resolve issues and to make determinations of tax liability. It also provides broad authority to exercise professional judgment to weigh conflicting factual information, data, and opinions on issues of law to determine the correct tax liability.

### **Factual Development of IRC § 162 Ordinary and Necessary Business Expenses**

Like any other examination, the examiner should evaluate each large, unusual or questionable item to determine its deductibility as a business expense. IRC § 162 allows the deduction of ordinary and necessary expenses paid or incurred to carry on any trade or business. Examiners should be alert for personal expenses which may be disguised as business deductions.

### **Factual Development of Other Non § 183 Issues**

Whether or not it is determined that an activity is engaged in for profit, the examiner should consider whether other Internal Revenue Code sections apply and treat as alternative positions. Substantiation of all large, unusual or questionable items should be performed on each examination.

Some of the other Internal Revenue Code sections include, but are not limited to:

- IRC § 704 partnership loss limitations
- IRC § 1366 S corporation stock or debt basis limitations
- IRC § 465 at-risk limitations
- IRC § 469 passive activity loss limitations
- IRC § 162 ordinary and necessary
- IRC § 274(d) record keeping requirements
- IRC § 179 election to expense certain depreciable assets
- IRC § 167 and 168 depreciation
- IRC § 212 expenses for production of income
- IRC § 280A disallowance of certain expenses in connection with business use of the home, rental of vacation homes, motor homes, houseboats, yachts, etc.
- IRC § 195 start up expenses

Taxpayers may use the activity to claim personal expenses. Examiners should be on the alert for any one or a combination of the following:

- Deducting all or most of the cost of maintaining a personal residence. See IRC § 280A. Taxpayers sometimes erroneously claim that the “exclusive use” restriction of IRC § 280A can be avoided by placing business-related items in any given room of the house. The taxpayers sometimes cite the IRC § 280A(c)(2) exception for storage use (storage on a regular basis of inventory or product samples). For example, the taxpayer may erroneously claim that if a poster, calendar, desk, file cabinet, telephone or other business item is placed in a room that secures the room’s business status without regard to the fact that the room is used for personal purposes as a kitchen, bathroom, child’s bedroom, etc.
- Paying children and/or family members for household duties that are not ordinary and necessary to the operation of any business (e.g. disposing of trash, mowing the lawn, answering the telephone, washing cars). Also, the payment may be excessive for the services performed.
- Deducting family education expenses by claiming an Education Assistance Program for family members claimed as employees. See IRC §127.
- Deducting excessive car and truck expenses when the vehicle was used for both personal and business use. Taxpayers sometimes claim a business purpose for every trip, whether it is to commute to a regular job or a trip to the grocery store, golf course, church, etc. Taxpayers sometimes erroneously argue that the trips are deductible given that there is always a potential of recruiting new clients.
- Deducting personal furniture, home entertainment equipment, children’s toys, etc.
- Deducting personal travel, meals, and entertainment under the guise that since everyone is a potential client, these are deductible, not personal expenses.
- Deducting 100% of personal medical expenses merely by “employing” a family member who is not a bona fide employee and creating a medical reimbursement plan.

## **Income Tax Savings Benefit Analysis**

The examiner needs to obtain information regarding the history of the activity under consideration. This information should be reviewed to see if any profits are being generated in any years and to determine the overall history of losses exceeding the profits. Completing an analysis of tax savings is important in developing a § 183 case. The analysis should begin, if possible, with the first year of the activity.

This analysis should be discussed with the taxpayer and included in the examination report.

A template that can be used in performing an income tax savings benefit analysis is in [Appendix C](#).

# Chapter 3: Supporting Law

## Internal Revenue Code

Various code sections may come into play whenever there is an adjustment that may involve IRC §183, including but not limited to the following:

**§ 67(a)** – In the case of an individual, the miscellaneous itemized deductions are allowed only to the extent that the aggregate of such deductions exceeds 2% of AGI.

**§ 67(c)** – In the case of pass-thru entities (1120S and 1065), a partner or S corporation shareholder must take into account separately his/her distributive or pro rata share of the partnership's or S corporation's miscellaneous itemized deductions which are subject to the 2% limitation in IRC § 67(a);

**§ 68(a)** – Overall limitation on itemized deductions.

**§ 162** – A deduction is allowed for all the ordinary and necessary expenses paid or incurred in carrying on any trade or business.

**§ 183** – Provides, generally, that if an activity is not engaged in for profit, deductions are allowable in the following order and only to the following extent:

1. amounts allowable as deductions during the taxable year without regard to whether the activity was engaged in for profit are allowable in full (e.g. home mortgage interest, real estate taxes, etc.);
2. amounts that would otherwise be allowable if the activity were engaged in for profit and that would not result in an adjustment to the basis of the property if allowed are allowed only to the extent the gross income derived from the activity exceeds the deductions allowed or allowable in (1);
3. amounts that would otherwise be allowable if the activity were engaged in for profit that would result in an adjustment to the basis of the property if allowed are allowed only to the extent that gross income derived from the activity exceeds the deductions allowed or allowable in (1) and (2).

**§ 212** – An itemized deduction is allowed for individuals for all the ordinary and necessary expenses paid or incurred for the production or collection of income, for the management, conservation, or maintenance held for the production of income; or in connection with the determination, collection, or refund of any tax.

**§ 262** – Except as otherwise expressly provided, no deduction shall be allowed for personal, living, or family expense.

**§ 280A** – A trade or business expense deduction under IRC § 162 is not permitted with respect to a taxpayer’s residence unless specifically permitted in limited circumstances by IRC § 280A(a). In order for allocable expenses to be deductible, the portion of the taxpayer’s residence must be used **exclusively** by the taxpayer on a regular basis as a principal place of business for the taxpayer’s trade or business, or to meet or deal with patients, clients or customers in the normal course of the taxpayer’s trade or business. If the taxpayer is an employee, the exclusive and regular use of a portion of the taxpayer’s residence must be for the convenience of the taxpayer’s employer before any expenses relating to the part of the taxpayer’s residence may be deducted.

**§ 465** – This code section limits a taxpayer’s deduction for losses from an activity to the amount at risk. IRC § 465 applies to activities in which the taxpayer is engaged in carrying on a trade or business or for the production of income. Therefore, for the rules of IRC § 465 to apply, the taxpayer must be engaged in the activity for profit. Accordingly, an activity subject to IRC § 183 cannot be subject to IRC § 465 in the same year. If IRC § 465 applies, any loss in excess of the taxpayer’s amount at-risk cannot be deducted in the current year. If the taxpayer has no personal liability, but has pledged property as security for repayment of the debt, the amount at-risk is the fair market value of the pledged property, less any superior liens. If the taxpayer pledges property that is used in the activity as security, that property does not increase the amount at-risk. There is a special rule for real estate activities – a nonrecourse loan qualifies as an amount at-risk if it is “qualified non-recourse financing.”

**§ 469** – Passive losses in excess of passive income are nondeductible. A passive activity is any rental activity or any business activity in which the taxpayer does not materially participate. If the average customer use is 7 days or less, the rental activity falls outside the rental definition and is treated like a business subject to material participation. If the average customer use is 30 days or less, and there are **significant** personal services, the activity falls outside the rental definition and is treated like a business subject to material participation.

**§ 704** – A partner’s distributive share of partnership loss shall be allowed only to the extent of the adjusted basis of such partner’s interest in the partnership.

**§ 1366** – A S corporation’s shareholder’s pro rata share of loss is not deductible if the loss exceeds the shareholder’s basis in his or her stock, plus certain debt basis.

## Treasury Regulations

Below are applicable Treasury regulations:

**1.183-1** – General information for IRC § 183.

**Caution:** Treasury Regulation § 1.183-1(c) has not been updated to reflect the 1986 amendment increasing the number of profit years required from two to three out of five years for activities other than horse racing, breeding or showing).

**1.183-2** – Nine relevant factors to be used in determining if an activity is engaged in for profit. These factors are included in their entirety in [Appendix A](#).

## Revenue Rulings

**Rev. Rul. 55-258** – holds that income received in an activity not engaged in for profit must be included in taxable income but is not subject to self-employment tax.

**Rev. Rul. 75-14** – holds that the rental of a house to a relative at less than the full fair market value and less than the total expenses attributable to the house is an activity not engaged in for profit within the meaning of IRC § 183. Therefore, the taxpayer may only deduct the expenses to the extent allowable under Treas. Reg. 1.183-1(b)(1) provided he itemizes deductions.

**Rev. Rul. 77-320** – holds that IRC § 183 of the Code applies to the activities of a partnership, and the provisions of IRC § 183 are applied at the partnership level and reflected in the partners' distributive shares.

**Rev. Rul. 2004-32** – holds that taxpayers cannot use schemes designed to create the appearance of having a home-based business, where none actually exists, for the purpose of converting otherwise nondeductible personal, living or family expenses into purportedly legitimate deductions.

## Case Law

There are numerous court cases which discuss IRC § 183. Some opinions are taxpayer-favorable while other opinions support the Government's position.

Where the specific facts warrant, the examiner should cite cases both favorable and unfavorable to the Government. The taxpayer or authorized representative should be requested to provide any cases which defend the taxpayer's position.

# Chapter 4: Report Writing

## Calculating the Examination Adjustments under IRC § 183

When the examiner has determined that the taxpayer falls under the provisions of IRC § 183, it is important to calculate the proper adjustments.

A common error is for the examiner to simply disallow the net loss from the activity. Income must be reported on the 1040, line 21, as unearned income and expenses that fall in category 2 and/or 3 are deductible only as miscellaneous itemized deductions. These category 2 and/or 3 deductions are subject to the 2% of AGI limitations (IRC §67) and the overall limitation on itemized deductions (IRC § 68). Also, an individual may be subject to alternative minimum tax since miscellaneous deductions are not deductible for alternative minimum tax purposes.

### Gross Income

Treas. Reg. 1.183-1(e) provides that for purposes of IRC § 183, gross income derived from an activity not engaged in for profit includes the total of all gains derived from the sale, exchange, or other disposition of property, and all other gross receipts derived from such activity. Gross income may be determined from any activity by subtracting the cost of goods sold from the gross receipts as long as the taxpayer consistently does so and follows generally accepted methods of accounting in determining such income.

### Deductions

If an activity is not engaged in for profit, deductions are allowable under IRC § 183(b) in the following order on the Schedule A and only to the following extent:

- Category 1 – First, deduct expenses that are allowable without regard to the taxpayer's profit motive from the gross income produced by the activity. For example, taxes, mortgage interest, casualty and theft losses, and contributions. These expenses are not limited by gross income from the activity since they are allowable under other sections of the Internal Revenue Code regardless of whether or not such activity is engaged in for profit. These expenses should appear in the proper places on the Schedule A and be allowed in full after taking into account any limitations such as the limitation on excess investment interest.
- Category 2 – Second, deduct expenses that would be allowable if the activity were to be engaged in for profit. For example, rent, labor, wages, travel, transportation, etc. These expenses are limited to the amount of gross income less the expenses in Category 1.
- Category 3 – Third, allow deductions which lead to basis adjustments (e.g. depreciation, amortization and the portion of casualty losses that is not deductible in Category 1). These expenses are limited to the amount of gross income from the activity less the expenses in Categories 1 and 2. If there is any gross income remaining after Category 1 and 2 items, the depreciation must be allocated to each depreciable asset.



The allowed expenses are reported as itemized deductions possibly subject to the overall limitation on itemized deductions and subject to the 2% AGI floor for miscellaneous itemized deductions. Also, for alternative minimum tax purposes, no deduction is allowed for miscellaneous items, as defined in IRC § 67(b).

## Incorrect Computation Example

The following is **an incorrect computation and examiners should not use this method.**

Schedule C has gross receipts of \$13,000 from a direct sales activity not engaged in for profit. After expenses of \$50,000, the per return ordinary loss is \$37,000.

An example for incorrect computation	
<b>Gross Receipts</b>	\$13,000
<b>Less Expenses (Mortgage Interest)</b>	\$-2,000
<b>Less Expenses (Supplies, Repairs, Etc.)</b>	\$-11,000
<b>Balance of Gross Receipts</b>	\$0
<b>Remaining Expenses (\$50,000 – 13,000) = Incorrect Adjustment</b>	\$37,000

In the above example, AGI would only have been increased by \$37,000 and no adjustments would have been made on the Schedule A.

The **correct method** would have been to increase AGI by \$50,000 by:

1. removing the \$13,000 of gross receipts from the Schedule C;
2. reclassifying the \$13,000 of gross receipts from Schedule C to other income (line 21 of the Form 1040);
3. removing all \$50,000 in expenses from the Schedule C;
4. allowing \$2,000 as a Schedule A mortgage expense deduction (Category 1 item); and
5. allowing \$11,000 (Category 2 items) as Schedule A miscellaneous itemized deductions subject to the 2% AGI limitation.

By utilizing this method there will be an additional adjustment due to the miscellaneous itemized deductions limitation and possible other adjustments due to the possible overall limitation on itemized deductions, and other items (e.g., exemption deduction, AMT and change in AGI which could affect other items on the return.)

Activities not engaged in for profit expenses are deductible only as Schedule A items, therefore individual's who do not itemize cannot claim any deductions attributable to an IRC § 183 activity.

IRC § 183 adjustments are permanent adjustments unlike passive activity losses which are timing adjustments. Any adjustments made due to IRC §183 are not permitted to be carried forward.

## **IRC § 183(b) Computation Example**

The following computation shows how to **correctly compute** the deductions allowable under IRC § 183(b).

An examiner is auditing a horse breeding activity and made the determination that it is not engaged in for profit. The AGI per return is \$125,000 which includes the Schedule F loss of \$64,000. All expenses on the Schedule F have been verified. The Schedule F loss is computed as follows:

### **The Schedule F loss computation**

<b>Schedule F Gross Income</b>	\$23,200
<b>Expenses</b>	\$87,200
<b>Schedule F Loss Per Return</b>	(\$64,000)

Step 1 – Remove gross income of \$23,200 from the Schedule F.

Step 2 – Reclassify income of \$23,200 as other income – unearned, to line 21 of the Form 1040.

Step 3 – Remove all \$87,200 expenses from the Schedule F.

Step 4 – Compute corrected AGI

### **The corrected AGI computation**

<b>AGI Per Return</b>	\$125,000
<b>Less Schedule F Gross Income</b>	(\$23,200)
<b>Plus Other Income-Unearned</b>	\$23,200
<b>Plus Disallowed Expenses</b>	\$87,200
<b>Corrected AGI</b>	\$212,200

Step 5 – Sort expenses into Categories 1, 2 and 3

<b>Expenses sorted into different categories</b>				
<b>Expense</b>	<b>Amount</b>	<b>Category 1</b>	<b>Category 2</b>	<b>Category 3</b>
Real estate taxes	6,000	6,000		
Mortgage interest	12,000	12,000		
Insurance	1,600		1,600	
Utilities	4,200		4,200	
Cell Phone	400		400	
Veterinary Visits	2,000		2,000	
Auto	6,000		6,000	
Repairs	16,000		16,000	
Feed	8,000		8,000	
Depreciation	31,000			31,000
<b>Total</b>	<b>87,200</b>	<b>18,000</b>	<b>38,200</b>	<b>31,000</b>

Step 6 – Determine amount of Category 1, 2 and 3 expenses allowable.

**Determine amount of Category 1, 2 and 3 expenses allowable**

<b>Gross Income</b>	\$23,200
<b>Less Category 1 Expenses</b>	(18,000)
<b>Maximum Category 1 and 2 Deductions</b>	\$5,200
<b>Less Category 2 Expenses*</b>	(5,200)
<b>Remaining Gross Income to offset Against Category 3 Expenses</b>	0

\* Category 2 items which are deductible to the extent of gross income remaining after Category 1 items (and subject to IRC §§ 67 and 68).

The Category 2 expenses of \$5,200 must further be reduced under IRC §67 by \$4,244 (2% of the corrected AGI – 2% X 212,200). The itemized deduction limitation under IRC § 68 applies but not enough facts have been presented to determine this limitation.

There is no amount of gross income remaining for Category 3 expenses.

In this example, if the loss had simply been disallowed it would have resulted in a \$64,000 adjustment. By moving the expenses to the Schedule A it resulted in an additional adjustment of \$4,244 due to the miscellaneous itemized deduction limitation under IRC § 67 and possibly other adjustments due to the change in AGI.

## **RGS Input**

### **Leadsheets**

A leadsheet is available on IRC § 183 Activities Not Engaged in for Profit and should be used when the examiner determines that there is a possibility that an activity is not for profit. This issue should be categorized as de minimis with Per Return and Per Exam fields being zero. The compliance information will be completed with Reason Code 52, Form/Schedule X and Line number 99. For the NAICS code, enter “D.”

All workpapers and supporting documentation pertaining to the development of the IRC § 183 issue should be contained in the Activities Not Engaged in for Profit leadsheet and should be included with the report issued to the taxpayer. The supporting documentation should include a schedule which shows how each category 1, 2 and 3 expenses were arrived at along with the factual development of the case addressing each of the nine relevant factors found in Treas. Reg. § 1.183-2(b) used in determining whether a taxpayer is conducting an activity with the intent to make a profit.

The actual adjustments should be made in each income and expense leadsheet and reference made to the documentation contained in the IRC § 183 leadsheet. If an expense item is adjusted because of lack of verification or reasons other than IRC § 183, the supporting documentation and conclusions should be contained in each individual issue leadsheet and be treated as an alternative position in the event that, on appeal, the primary activity not engaged in for profit position is overturned.

### **Entering Adjustments in Report Generation Software (RGS)**

After determining the expense categories and limitations, the adjustments need to be entered in RGS.

Each income and expense item on the schedule used to report the activity should be disallowed. Items should not be combined into one adjustment. The issues for these items may already be classified and created. Reason Code 10 or 14 should be used only if the item is allowed in full elsewhere on the return. All adjustments using Reason Code 10 or 14 must net to zero. Appropriate reason codes should be used for other adjustments.

Reason Code 10 description is “Income/Expenses entered on wrong item to reduce tax or increase credits.” This reason code should be made to issues when penalties are applied

Reason Code 14 description is “Taxpayer entered item on the wrong form, schedule or line” for any expense disallowed which has been allowed in full on the Schedule A. In this example, Reason Code 14 would be used for all of the Category 1 expenses. This reason code should be made when no penalties have been asserted and the item has been allowed in full on the Schedule A.

An issue must be created moving the “earned income” to “unearned income (line 21 of Form 1040)” for the activity. This income should be categorized as “other income – unearned.” Issues must be created separately for any Category 1 expenses fully allowable on Schedule A, e.g. mortgage interest, real estate taxes. An additional issue must be added for any other Category 2 and 3 allowable miscellaneous itemized deductions (these items may be grouped into one adjustment.) These Category 2 and 3 expenses are limited by the gross income from the activity after subtracting Category 1 expenses.

### **Partnerships and S Corporations**

Where a flow through entity is engaged in several activities, if the activities are separate, the expenses and income from both may not be aggregated in order to apply the limits of IRC § 183.

Flow through entities are required to ‘separately state’ certain items of income and deductions. Items must be ‘separately stated’ if the item would result in a tax liability for any partner/shareholder different from the person’s tax liability, if the items weren’t ‘separately stated.’ E.g. charitable contributions, portfolio income, IRC § 179 deduction, investment interest expense.

Each income and expense item on the schedule used to report the activity should be disallowed. Income from an activity not engaged in for profit should be categorized separately in RGS as “Other Income” for both the Schedule K and K-1. Similarly, expenses should be grouped by category (1, 2 or 3) and categorized as ‘other deductions’ and deducted only up to the extent of hobby income. Any remaining deductions should be categorized as non-deductible expenses. The non-deductible expenses will result in a reduction in the investor basis. An issue should be created in RGS to reflect the non-deductible expenses.

### **1040 Schedule C Example**

An examiner is auditing a Schedule C bass fishing activity not engaged in for profit with \$3,000 of gross income. The taxpayer had \$120,000 of AGI. The following Schedule C expenses were reported and verified by the taxpayer:

<b>1040 Schedule C Example</b>				
<b>Expense</b>	<b>Amount</b>	<b>Category 1</b>	<b>Category 2</b>	<b>Category 3</b>
Property taxes	700	700		
Mortgage interest	900	900		
Insurance	400		400	
Utilities	700		700	
Auto/Travel	23,000		23,000	
Bait/Tackle	2,000		2,000	
Entrance Fees	8,000		8,000	
Depreciation	28,000			28,000
<b>Total</b>	<b>63,700</b>	<b>1,600</b>	<b>34,100</b>	<b>28,000</b>

Total expenses reported on the Schedule C were \$63,700 resulting in a net loss of \$60,700. The Schedule C was classified as a potential activity not for profit and all income and expense items were classified.

- Category 1 expenses total \$1,600
- Category 2 expenses total \$34,100
- Category 3 expenses total \$28,000

Category 1 expenses of \$1,600 are allowed in full leaving \$1,400 remaining of gross income for Category 2 and 3 expenses. Since Category 2 expenses totaling \$34,100 exceed the remaining gross income of \$1,400, the taxpayer is allowed only \$1,400 of the Category 2 expenses. None of the Category 3 expenses may be allowed since there is no remaining gross income remaining.

**Step 1 – Remove Income from Schedule C**

The first step in RGS is to remove the Schedule C income. Enter \$3,000 in the Per Return field Enter zero in the Per Exam field. For the NAICS code enter “D” in the Per Exam field (the Schedule C is disallowed in full).

**Step 2 – Add an issue for Other Income – Unearned**

Add an issue as a New Issue Resulting from a Classified Issue. Categorize the adjustment as Other Income – unearned (this income is not subject to self employment tax). Enter zero in the Per Return field. Enter \$3,000 in the Per Exam Field.

**Step 3 – Remove All Schedule C Expenses**

In the example, all Schedule C expenses have been classified. Disallow the Category 1 expenses

in full by entering zero in the Per Exam field. Use Reason code 10 or 14 only if the item is allowed in full elsewhere on the return. Enter “D” in the NAICS code Per Exam field. Note that if these issues had not been classified the examiner would need to add each individual expense item as a separate adjustment into RGS.

**Step 4 – Allow Category 1 Expenses on Schedule A**

Category 1 expenses are allowable in full on Schedule A without regard to gross income limitations. Add each issue as a New Issue Resulting from a Classified Issue. In this example there are two separate adjustments – one to mortgage interest and one to real estate taxes. Use Reason Code 10 or 14.

**Step 5 – Allow Category 2 and 3 Expenses on Schedule A**

The remaining allowable expenses (\$3,000 income less \$1,600 category 1 expenses) are limited to the remaining income from the activity and entered as Schedule A Miscellaneous Itemized Deductions subject to 2% of AGI. One adjustment can be made for the combined expenses. In this example, the taxpayer will have \$1,400 of Category 2 expenses. There is no remaining income with which to offset Category 3 expenses.

<b>AGI Per Return</b>	120,000
<b>Sch C Expenses Disallowed</b>	63,700
<b>Removal of Sch C Income</b>	-3,000
<b>Increase of Other Income-Unearned</b>	3,000
<b>Corrected AGI</b>	183,700

In the above example the taxpayer’s per return AGI was \$120,000. After the adjustments it is now \$183,700. Miscellaneous itemized deductions are limited to the amount that they exceed 2% of AGI ( $2\% \times \$183,700 = \$3,674$ ). In this example, the taxpayer would get no tax deduction for the \$1,400 in Category 2 expenses since they did not exceed the 2% of AGI.

If the examiner had chosen (incorrectly) to simply disallow the loss from the Schedule C activity it would have resulted in a total adjustment of \$ 60,700 to AGI.

By correctly removing the income and expenses from the Schedule C and treating the income as unearned, the adjustments result in an increase in AGI of \$63,700 and an increase in total itemized deductions of \$1,600 for a total adjustment of \$62,100 ( $\$63,700 - \$1,600$ ). In this example none of the miscellaneous itemized deductions exceeded the corrected AGI 2% limitation ( $\$3,674$ ). By correctly reclassifying the income and expenses, it results in a \$62,100 increase of taxable income rather than the \$60,700 had an adjustment been made to simply disallow the loss. Also, the taxpayer may have other items on their tax return that could be affected by the increase in AGI.

**Partnerships, S Corporations, Trusts and Estates**

The IRC § 183 activities not engaged in for profit rules are applied at the entity level for partnership, S corporations, trusts and estates. These rules apply on an activity by activity basis and the income and deductions arising in one activity cannot be combined with the income and deductions from another activity in an entity. The identification of whether there is one or two activities is necessary to apply the rules of IRC § 183. This is discussed in more detail in Chapter 1 of this guide.

**In Magassy vs. Commr**, TC Memo 2004-4, the taxpayer (an S corporation) had the burden of proving that it was engaged in the activity of restoring, chartering, and selling a yacht with the actual and honest objective of realizing profit. The court determined that the S corporation was involved in an activity that was not engaged in for a profit.

Income from an IRC § 183 issue for these type of entities determined not to be engaged in for profit should be removed from ordinary income and reclassified as separately stated income (generally as other income). All expenses should be grouped by category and separately stated and limited to gross income from the activity. There would seldom be any Category 1 expenses other than possibly investment interest or contributions. The limitation is determined at the entity level.

Even if the expenses of the activity may not be of beneficial use to the shareholder/partner due to the gross income limitation, they will still result in a reduction in the basis of the shareholder/partner.

### **S Corporation Example**

An S corporation has gross receipts of \$4,000 from a car racing activity not engaged in for profit. After expenses of \$55,000 the ordinary loss is \$51,000. The interest expense is in connection with the purchase of the race car.

<b>Expense</b>	<b>Amount</b>	<b>Category 1</b>	<b>Category 2</b>	<b>Category 3</b>
Entrance Fees	10,000		10,000	
Interest	12,000		12,000	
Insurance	400		400	
Utilities	1,600		1,600	
Auto and Travel	13,000		13,000	
Repairs	2,000		2,000	
Depreciation	16,000			16,000
<b>Total</b>	<b>55,000</b>	<b>0</b>	<b>39,000</b>	<b>16,000</b>



All of the income and expenses should be removed from the ordinary business operations of the S corporation return. The income should then be separately stated and reported on line 10 of the 1120S Schedule K. This income would then be reported on the shareholder's individual income tax return on line 21 as other income – unearned.

The interest expense in this example is not included as a Category 1 expense since it would not be deductible on the 1040 Schedule A because the interest is not home mortgage interest or investment interest.

Category 2 expenses would be allowed up to the \$4,000 of gross income from the car racing activity and would be separately stated on line 12d of the 1120S Schedule K. The remaining non-deductible expenses of \$51,000 would be reported as non-deductible expenses on line 16c of the 1120S Schedule K and K-1. The shareholder would then have \$4,000 as a miscellaneous itemized deduction.

The \$51,000 in non-deductible expenses will result in a reduction in the shareholder's stock basis and the Accumulated Adjustments Account (AAA) of the S corporation.

## **Taxpayer Penalties**

When proposing audit adjustments, penalties should always be considered. All penalties including the accuracy-related and fraud penalties are important deterrents to non-compliance.

The IRS asserts the accuracy related penalty under IRC § 6662 for negligence or disregard of rules or regulations and/or a substantial understatement of income tax in appropriate cases.

Whether the accuracy related penalty applies to the activity must be determined on a case-by-case basis and will depend on the specific facts and circumstances of each case. It is the examiner's responsibility to develop the facts and circumstances.

IRC § 6662 imposes an accuracy related penalty in the amount equal to 20% of the portion of an underpayment attributable to, among other things:

- IRC § 6662(b)(1) - negligence or disregard of rules or regulations,
- IRC § 6662(b)(2) - any substantial understatement of income tax.

See also IRC § 6662(b)(3) for substantial or gross valuation misstatement and IRC § 6662A for accuracy-related penalty on understatements with respect to reportable transactions.

The penalty applies only when a tax return is filed. There is no stacking of the accuracy-related penalty components. The maximum accuracy-related penalty imposed on any portion of an underpayment is 20% (40% in the case of a gross valuation misstatement), even if that portion of the underpayment is attributable to more than one type of misconduct (e.g. negligence and substantial valuation misstatement). Treas. Reg. § 1.6662-2(c).

No accuracy-related penalty under IRC § 6662 is imposed if it is shown that the taxpayer had reasonable cause for the position taken and that the taxpayer acted in good faith. IRC § 6664(c).

Circumstances that may indicate reasonable cause and good faith include an honest misunderstanding of fact or law that is reasonable in light of all of the facts and circumstances, including the experience, knowledge and education of the taxpayer. Reliance on an information return, professional advice, or other facts may constitute reasonable cause and good faith if, under all the circumstances, such reliance was reasonable and the taxpayer acted in good faith. For a taxpayer to have reasonable cause, the taxpayer must have exercised ordinary business care and prudence regarding their tax affairs.

For purposes of IRC § 6662, the term “underpayment” is defined as “the amount by which any tax imposed exceeds the excess of the sum of the amount shown as the tax by the taxpayer on his return, plus amounts not so shown previously assessed (or collected without assessment), over the amount of rebates made.”

Taxpayer penalty procedures and case development instructions can be found in IRM 20.1.5, Return Related Penalties. This IRM covers the accuracy related penalties under IRC § 6662 and the fraud penalty under IRC § 6663.

### **Negligence or Disregard of Rules or Regulations**

Negligence is any failure to make a reasonable attempt to comply with the provisions of the Code and includes any failure by the taxpayer to keep adequate books and records or to substantiate items properly. Negligence includes the failure to exercise due care or the failure to do what a reasonable and prudent person would do under the circumstances. Negligence is strongly indicated when a taxpayer fails to make a reasonable attempt to ascertain the correctness of a deduction, credit or exclusion on a return which would seem to a reasonable and prudent person to be “too good to be true” under the circumstances. A return position is not attributable to negligence if there is a reasonable basis for that position. Treas. Reg. § 1.6662-3(h)(1).

Disregard includes any careless, reckless, or intentional disregard of rules or regulations. Treas. Reg. § 1.666-3(b)(2) defines “rules or regulations,” “careless,” “reckless,” and “intentional” as follows:

- “Rules or regulations” include the provisions of the Code, temporary or final Treasury regulations issued under the Code and revenue rulings or notices (other than notices of proposed rulemaking) issued by the IRS and published in the Internal Revenue Bulletins.
- “A disregard of rules or regulations is ‘careless’ if the taxpayer does not exercise reasonable diligence to determine the correctness of a return position that is contrary to the rule or regulation.”
- “A disregard is ‘reckless’ if the taxpayer makes little or no effort to determine whether a rule or regulation exists, under circumstances which demonstrate a substantial deviation from the standard of conduct that a reasonable person would observe.”
- “A disregard is ‘intentional’ if the taxpayer knows of the rule or regulation that is disregarded.”

## **Substantial Understatement**

For individual taxpayers a substantial understatement of income tax exists for a taxable year if the amount of understatement exceeds the greater of 10% of the tax required to be shown on the return or \$5,000. An “understatement” is defined as the excess of any tax required to be shown on the return over the tax actually shown on the return, less any rebate. IRC § 6662(d). This excess is determined without regard to items to which IRC § 6662A applies. The amount of any reportable transaction understatement is, as determined under § 6662A(b), is added to this excess to determine whether the understatement is “substantial” (i.e. whether it is more than the greater of 10% of the tax required to be shown on the return or \$5,000). See IRC § 6662A(e)(1).

For purposes of determining the amount of the understatement, for items not attributable to a “tax shelter,” the understatement is reduced by the understatement attributable to any item (1) for which there is or was substantial authority for the tax treatment; or (2) for which the taxpayer has adequately disclosed the relevant facts affecting the tax treatment and for which there is a reasonable basis for the taxpayer’s tax treatment. IRC § 6662(d). The taxpayer also is required to substantiate the position and keep adequate books and records. IRC § 6662(d)(2)(B); Treas. Reg. § 1.6662-4(e)(2)(iii); see Treas. Reg. § 1.6662-3(b)(3).

“Substantial authority” is an objective standard and involves an analysis of the law and the application of that law to the relevant facts. It is a more stringent standard than “reasonable basis” but less stringent than a 50% likelihood of the possibility of being upheld. Treas. Reg. § 1.6662-4(d)(2). Whether authority is substantial depends on the weight of supporting authority relative to contrary authority, the relevance and persuasiveness of the authority, and the type of document providing the authority. Treas. Reg. § 1.6662-4(d)(3).

Reasonable basis is a relatively high reporting standard and is not satisfied by a return position that is merely arguable or merely colorable. Treas. Reg. § 1.6662-3(b)(3). A position will generally satisfy the reasonable basis standard if the position is reasonably based on applicable statutory provisions, regulations, revenue rulings, revenue procedures, court cases, and other documents listed in Treas. Reg. § 1.6662-4(d)(3)(iii). Treas. Reg. § 1.6662-3(b)(3).

## **Reasonable Cause Exception**

No accuracy-related penalty under IRC § 6662 is imposed with respect to any portion of the underpayment if the taxpayer acted with reasonable cause and good faith. IRC § 6664(c). See also, IRC § 6664(d) for reasonable cause regarding reportable transactions. The determination of whether a taxpayer acted with reasonable cause and in good faith is made on a case-by-case basis, and all relevant facts and circumstances are taken into account. Treas. Reg. § 1.6664-4(b). Generally the most important factor is the extent of the taxpayer’s effort to assess the taxpayer’s proper tax liability. Treas. Reg. § 1.6664-4(b)(1).

Circumstances that may indicate reasonable cause and good faith include an honest misunderstanding of fact or law that is reasonable in light of all of the facts and circumstances, including the experience, knowledge, and education of the taxpayer. Reliance on an information return, professional advice, or other facts may constitute reasonable cause and good faith if,

under all the circumstances, such reliance was reasonable and the taxpayer acted in good faith.  
Treas. Reg. § 1.6664-4(b)(1).

A taxpayer cannot rely on professional advice if the taxpayer fails to disclose a relevant fact that the taxpayer reasonably should have known was relevant if the advice is based on unreasonable assumptions, or if the advice relies upon the undisclosed position that a regulation is invalid.  
Treas. Reg. § 1.6664-4(c)(1).

## **Return Preparer Penalties**

The primary purpose of return preparer penalties is to bring non-compliant tax return preparers into compliance. In preparer penalty cases, the IRS focuses on the conduct of the preparer rather than the taxpayer. All examiners should consider if any of the following preparer penalties are applicable.

- IRC § 6694(a) Understatements Due to Unreasonable Positions
- IRC § 6694(b) Understatement Due to Willful or Reckless Conduct
- IRC § 6701 Aiding and Abetting Understatement of Tax Liability

The IRS recognizes that the vast majority of return preparers and practitioners are ethical, honest and serve their clients' best interests by preparing complete and accurate tax returns.

Taxpayers are sometimes advised by preparers to claim activities which are not engaged in for profit or are sham. Examiners should consider preparer penalties if deductions claimed are not ordinary and necessary expenses incurred during the taxable year in carrying on a trade or business or for profit activity.

Examiners should also consider whether an attempt has been made to characterize personal expenses as business expenses.

Preparer penalty procedures and case development instructions can be found in IRM 20.1.6, Preparer, Promoter Penalties

IRC § 6694 provides for penalties on tax return preparers who unreasonably or willfully understate a taxpayer's tax liability. IRC § 6694 was amended by the Small Business and Work Opportunity Tax Act of 2007 (SBWOTA) which was enacted into law on May 25, 2007, for tax returns prepared after May 25, 2007. SBWOTA extended the application of the income tax return preparer penalties to all tax return preparers, altered the standards of conduct, and increased applicable penalties. IRC § 6694 was again amended by the Tax Extenders and Alternative Minimum Tax Relief Act of 2008 (TEAMTRA). TEAMTRA reorganized IRC § 6694 and added a section regarding tax shelters and reportable transactions. The tax shelter reportable transaction addition to IRC § 6694 was effective as of October 3, 2008. The rest of TEAMTRA, as it pertained to IRC § 6694, was retroactively effective as of May 25, 2007. This effective date eliminated the applicability of the SBWOTA amendments as they pertain to IRC § 6694.

Prior to May 25, 2007, IRC § 7701(a)(36) defined income tax return preparer as any person who prepared for compensation, or employs one or more persons to prepare for compensation, an income tax return or claim for refund, or a substantial portion of an income tax return or claim for refunded. After May 24, 2007, IRC § 7701(a)(36) defined tax return preparer as any person that prepared for compensation, or employs one or more persons to prepare for compensation, a tax return or claim for refund, or a substantial portion of a tax return or claim for refund, and is no longer limited to persons who prepare income tax returns.

## IRC § 6694(a) Understatement Due to Unreasonable Positions

Prior to May 25, 2007, the amount of the IRC § 6694(a) penalty was \$250 and the penalty only applied to income tax returns and claims for refund. After May 24, 2007, the penalty applied to all tax returns and claims for refund, including estate and gift tax returns, generation-skipping transfer tax returns, employment tax returns, and excise tax returns. The amount of the penalty was increased to \$1,000 or 50% of the income derived (or to be derived) by the tax return preparer with respect to all tax returns.

The amendment also changed the standard for the penalty. The below table provides a comparison of IRC § 6694(a) standards.

IRC § 6694(a) is applied if:		
Prior to May 25, 2007	After May 24, 2007	After Oct. 2, 2008
<ul style="list-style-type: none"> <li>• There was an understatement,</li> <li>• there was not a <b>realistic possibility</b> (i.e. one in three chance) that the position would be sustained on its merits,</li> <li>• the <b>income tax return preparer</b> knew (or reasonably should have known) of such position, <b>AND</b></li> <li>• such position was not disclosed or was <b>frivolous</b>.</li> </ul>	<ul style="list-style-type: none"> <li>• There was an understatement,</li> <li>• there was <b>no substantial authority</b> for the position,</li> <li>• the <b>tax return preparer</b> knew (or reasonably should have known) of such position, <b>AND</b></li> <li>• such position was not disclosed or there was <b>no reasonable basis</b> for it.</li> </ul>	<ul style="list-style-type: none"> <li>• There was an understatement,</li> <li>• there was <b>no substantial authority</b> for the position,</li> <li>• the <b>tax return preparer</b> knew (or reasonably should have known) of such position, <b>AND</b></li> <li>• such position was not disclosed or there was <b>no reasonable basis</b> for it, <b>OR</b> if the position is with respect to a tax shelter or reportable transaction, there was <b>no reasonable belief</b> that the position would more likely than not be <b>sustained on the merits</b>.</li> </ul>

<b>IRC § 6694(a) is applied if:</b>		
<b>Prior to May 25, 2007</b>	<b>After May 24, 2007</b>	<b>After Oct. 2, 2008</b>
Penalty \$250	Penalty greater of \$1,000 or 50% of the income derived by the preparer.	Penalty greater of \$1,000 or 50% of the income derived by the preparer.

IRC § 6694(a) does not apply if the position taken is adequately disclosed and there was a reasonable basis for such position, or, if the position is with respect to a tax shelter or reportable transaction, there was no reasonable belief that the position would more likely than not be sustained on the merits. IRC § 6694(a)(3).

The preparer generally may rely in good faith without verification upon information furnished by the taxpayer and upon information and advice furnished by another advisor, another tax return preparer, or another party (including another advisor or another tax return preparer at the tax return preparer's firm). The preparer is not required to audit, examine or review books and records, business operations, or documents or other evidence in order to verify independently information provided by the taxpayer, advisor, other tax return preparer or other party. Treas. Reg. § 1.6694(e).

However, the preparer:

- may not ignore the implications of information furnished to the preparer or actually known by the preparer,
- must make reasonable inquiries if the information as furnished appears to be incorrect or incomplete,
- must make appropriate inquiries to determine the existence of facts and circumstances required by a Code section or regulation as a condition to the claiming of a deduction.

Treas. Reg. § 1.6694-1(e).

The statute of limitations for IRC § 6694(a) expires three years from the later of the due date of the underlying related return or the date the return was filed. Remember, extending the statute on a taxpayer's return does not extend the statute for the return preparer penalty case. Use Form 872-D, Consent to Extend the Time on Assessment of Tax Return Penalty.

### **IRC § 6694(b) Willful or Reckless Conduct**

SBWOTA increased the amount of the penalty under IRC § 6694(b) and made that penalty applicable with respect to all tax returns. The standard for application of the IRC § 6694(b) penalty, however, was not changed. Both prior to and after SBWOTA, the IRC § 6694(b) penalty applies if any part of an understatement of liability on a return, amended return, or claim for refunds is due:

- to a willful attempt in any manner to understate the liability for tax by a return preparer (income tax return preparers only prior to SBWOTA); or
- to any reckless or intentional disregard of rules or regulations by a tax return preparer (income tax return preparers only prior to SBWOTA).

The criteria to consider for the imposition of IRC § 6694(b) are:

- a tax return preparer,
- an understatement of income tax liability,
- an understatement due to a willful attempt to understate the income tax liability or due to any reckless or intentional disregard of the rules or regulations.

SBWOTA increased the IRC § 6694(b) penalty to the greater of \$5,000 or 50% of the income derived (or to be derived) by the tax return preparer with respect to returns, amended returns, and claims for refund prepared on or after May 26, 2007. Former IRC § 6694(b) (returns prepared prior to May 26, 2007) applied only to preparers of income tax returns and the penalty was \$ 1,000.

Under IRC § 7427, the IRS bears the burden of proof on the issue of whether the preparer **willfully** attempted to understate the tax liability.

The preparer bears the burden of proof on issues such as whether:

- the preparer recklessly or intentionally disregarded a rule or regulation.
- a position contrary to a regulation represents a good faith challenge to the validity of the regulation.
- disclosure was adequately made (Treas. Reg. § 1.6694-3(h)).

If both IRC § 6694(a) and IRC § 6694(b) penalties apply to a tax return preparer, the IRC § 6694(b) penalty amount must be reduced by the IRC § 6694(a) penalty amount per IRC § 6694(b)(3).

There is no statute of limitations for IRC § 6694(b).

### **IRC § 6701 Aiding and Abetting**

IRC § 6701 imposes a \$1,000 penalty (\$10,000 if the prohibited conduct relates to a corporation's tax return) for aiding or assisting in the understatement of tax.

The penalty is imposed on a person who:

- aids or assists in, procures or advises with respect to, the preparation or presentation of any portion of a return, affidavit, claim or other document; regardless of whether a fee is charged,
- knows (or has reason to know) that such portion will be used in connection with any material matter arising under the internal revenue laws; **and**

- knows that such portion (if used) would result in an understatement of another person's tax liability, even if no actual understatement exists.

A "document" for these purposes can be any portion of a return, affidavit, claim or other document. Therefore, a single letter distributed and used by many taxpayers can lead to multiple penalties.

It is not necessary for the taxpayer whose tax is understated to either have knowledge of or give his consent to the actions which result in the understatement. To aid in an understatement, it is not necessary to actually prepare the tax return or document that leads to the understatement. A person who controls the activities of subordinates and either orders the subordinate to act or does not prevent their participation is subject to the penalty.

The IRS bears the burden of proof with respect to this penalty.

If the IRC § 6701 penalty is asserted, no penalties under IRC § 6694(a) or IRC § 6694(b) can be assessed.

There is no statute of limitations for IRC § 6701.

## **Unagreed Reports**

The examiner may find that the taxpayer will not agree to the proposed adjustments from an IRC § 183 activity not engaged in for profit issue. Therefore, the examiner should prepare the report showing the facts, law and argument, taxpayer's position and conclusion. Since the report is the government's position, all pertinent information must be included in the case write-up. Any relevant computations or documents should be attached to the report.

In cases where the IRS has been unsuccessful on IRC § 183 issues it is largely due to inadequate development and/or application of the tax law. Some of the reasons mentioned in Appeals feedback include:

- Alternative arguments were not addressed.
- Disallowed expenses were not first verified as to whether they would be deductible at all or were personal in nature.
- The nine factors in Treas. Reg. §1.183-2(b) were not addressed.
- No mention was made of whether there would ever be a realistic possibility of a profit.
- No mention was made documenting the history of the activity including losses incurred and taxes saved in the prior period.
- Lack of factual development.

It is important the case be fully developed in order to be sustained in Appeals or the courts. Any alternative positions should be addressed in the unagreed report.



If the examiner determines that there are other adjustments unrelated to the IRC § 183 issue, the examiner should attempt to secure a partial agreement of these adjustments.

## **Rebuttals**

Rebuttals issued by examiners to the taxpayer's protest to the 30 day letter should be shared with the taxpayer and their authorized representative. The goal of this sharing is to resolve factual disputes before the case is submitted to Appeals.

Rebuttals should focus on the points raise in the protest. Sometimes the protest raises valid points that the unagreed write-up does not address.

## **Alternative positions**

If it is determined that there is no profit motive and the taxpayer does not agree, the examiner should also consider an alternative position in the event that, on appeal, the primary activity not engaged in for profit position is overturned.

An alternative position for an issue in an unagreed case is a secondary position that the IRS may ultimately rely on if the primary position cannot be upheld. An alternative position is recommended as Appeals generally is not permitted to raise new issues.

Alternative positions should be developed when appropriate. If the IRC § 183 issue is not sustained, the examiner must have addressed whether the taxpayer meets the requirements under other code sections, i.e. 162, 179,195, 262, 274(d), 280A, 465, 469, etc. or due to lack of substantiation of the expense.

IRC § 183 adjustments are permanent adjustments and should generally be treated as the primary position (unless the alternative issues convert the loss into a profit). The passive activity loss rules of IRC § 469, the at risk limitations of IRC § 465, and the basis limitations of IRC §1366 and § IRC § 704 are timing adjustments and should be treated as alternative positions when the §183 issue is also present.

The examiner should discuss the alternative position with the taxpayer and/or authorized representative prior to issuing the examination report. The unagreed report should outline all alternative positions that may be applicable if the primary position is not sustained.

The facts, applicable law, taxpayer's position, and conclusions for the alternative position on an issue should be presented on a separate lead sheet from the primary position.

Further procedures regarding alternative positions can be found in IRM 4.10.8.11.

## **Inadequate Books and Records**

IRC § 6001 contains the requirements for taxpayers to maintain and keep records.

Treas. Regs. § 1.6001-1(a) provides that taxpayers must keep permanent books of account or records, including inventories, as are sufficient to establish the amount of gross income, deductions, credits, or other matters required to be shown in the taxpayer's returns.

Treas. Regs. § 1.6001-1(e) provides that the books or records required by this section shall be kept at all times available for inspection by authorized internal revenue officers or employees, and shall be retained so long as the contents thereof may become material in the administration of any internal revenue law.

If the taxpayer has not kept adequate books and records this should be documented in the examiner's workpapers. It is relevant in the nine factor regulatory analysis. See Treas. Regs. § 1.183-2(b)(1).

Whenever the taxpayer's books and records are deemed inadequate for purposes of an examination of income, the examiner should consider the issuance of an inadequate records notice at the conclusion of the examination. The procedures for issuance of an inadequate records notice can be found in IRM 4.10.8.16.

# Appendix

This appendix provides additional information that will assist in the development of IRC § 183 activity not for profit cases.

A –Treas. Regs. § 1.183-2(b) (9 Relevant Factors)

B – Suggested Questions for each of 9 Relevant Factors

C – Tax Savings Benefit Analysis

D – Year by Year Comparative Analysis of Income, Expenses and Losses

E – Sample IDR for Yacht Charter

## Appendix A - Treas. Regs. § 1.183-2(b)

The nine relevant factors used to evaluate whether an activity is engaged in for profit with a brief explanation of each factor are included below.

### Factor 1

**(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.

The examiner needs to inquire about the books and records maintained for the activity during the Initial Interview. The examiner should document in the workpapers regarding the sophistication of the taxpayer's books and records. The examiner should determine if the taxpayer maintains checking accounts for the activity which are separate from the accounts used for the taxpayer's personal living expenses.

Depending upon the volume, the examiner should obtain photocopies of the taxpayer's entire set of books and records. If photocopying the entire set of books and records proves to be cost prohibitive, the examiner should only photocopy samples representative of the overall books and records.

**The presence of sophisticated books and records does not automatically equate to profit motive. The taxpayer must be relying upon these records in order to operate the activity**

**and make decisions or changes. The examiner needs to document how these records are utilized by the taxpayer.**

The taxpayer should have a formal written Business Plan. This plan should demonstrate the taxpayer's financial and economic forecast for the activity. The plan should not be a "fantasy profit and loss statement." In other words, some taxpayers may wish to submit a business plan that is nothing more than a Schedule F or C, which unrealistically overstates the gross receipts and unrealistically understates the expenses for the activity.

The examiner should not request the business plan in the first IDR. Otherwise, the examiner will possibly receive a "canned" document. The examiner should inquire as to the business plan during the Initial Interview and follow-up with a subsequent appointment and/or IDR.

A business plan should show a short range and long range forecast for the activity. The forecast should allow for changes due to potential unforeseen and fortuitous circumstances.

The plan should be realistic. The examiner should perform quantitative analyses in order to determine the reasonableness of the projected gross receipts and various expense items. The examiner may consult with IRS economists in order to review the business plan.

**The examiner should determine if the taxpayer followed the plan and if the original plan was not successful did the taxpayer made any amendments to the plan to increase profitability.**

The examiner needs to document the taxpayer's method of operation. The examiner should document the daily operation as well as the history of the activity's operation in the workpapers. Denote changes in the method of operation over the years and indicate why these changes were initiated. Most of this information will be gathered during the Initial Interview.

The examiner needs to document the efficiency of the taxpayer's operation. Denote the taxpayer's use of any experts or specialists. Indicate if any changes were initiated and why. Obtain names, position titles, and addresses. Most of this information will be gathered during the Initial Interview.

The examiner will note whether the taxpayer is making changes to the operation that will result in improved operational efficiency.

The examiner needs to review the actual copy of any advertising in instances where the taxpayer has deducted such expenditures. Many taxpayers will buy advertising space for "vanity" ads. These spaces are sometimes purchased to place photographs of their children. These ads may wish the children "Best of luck" prior to upcoming competitions. The examiner should use professional judgment to determine whether the advertisements truly represent promotion of the taxpayer's activity.

The examiner needs to be alert for the children's activities being deducted on the parents' tax return. The examiner needs to review reports and determine who actually competes in certain

activities. The parents may contend that the children are promoting the activity through the competitions. The examiner needs to consider the substance of the facts.

Depreciation and Inventory can be viable issues for the examiner to consider as an aside from IRC § 183. The examiner should develop a clear understanding of the taxpayer's activity and verify that the proper tax treatment is used for the activity.

### **Summary of Factor 1**

The examiner must document the manner in which the taxpayer carries on the activity. Most of this information will be gathered during the Initial Interview and the tour of the operation. It is important for the examiner to document a clear understanding of the activity. Assumptions should not be made that each activity operates the same as another similar activity.

### **Factor 2**

**(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.

Factor 2 addresses the expertise of the taxpayer or his or her advisors. The examiner should document the extent to which the taxpayer has relied upon his or her advisors. The examiner should also document the instances where the taxpayer received advice from his or her advisors, but failed to heed this advice.

The Initial Interview should include questions regarding the taxpayer's expertise, the use of any experts, and any changes or decisions regarding the operation of the activity.

The examiner should establish and document the taxpayer's background in the activity and determine how long the taxpayer has been engaged in the activity. Many times the taxpayer was involved in the activity in some capacity during youth and later became involved again as an adult. These adults have re-entered the activity after they have obtained the financial wherewithal to commence the activity. The examiner should establish a history of the taxpayer's growth of knowledge within the activity and how this knowledge was obtained.

The examiner should establish if the taxpayer has used any advisors or experts in the operation of the activity. Obtain names, position titles, and addresses of these advisors. Document how the advisors were chosen by the taxpayers. Establish the credentials of the advisors. Document if a personal relationship exists between the taxpayer and his advisors.

The examiner needs to document specific instances where the taxpayer was provided advice that was implemented in the activity. Describe how this information affected the operation and any resulting changes. Document whether the advised changes were successful or unsuccessful.

The examiner also needs to document specific instances whereby the taxpayer was advised by his or her experts to make changes and the taxpayer ignored the advice. The examiner should document why the taxpayer chose to ignore this advice. Many taxpayers will provide names of advisors in an effort to demonstrate profit motivation. However, if the taxpayer chooses not to implement the suggested changes and cannot provide just cause for doing so, then the taxpayer's use of advisors is questionable.

## **Summary of Factor 2**

The examiner should document the expertise and knowledge of the taxpayer regarding the activity. The examiner should also document any advisors or experts that the taxpayer has used. Documentation should be prepared which shows specific instances where the taxpayer has followed the advice of the advisor.

Documentation should also show how the advice affected the operation of the activity. The examiner should especially note instances when the taxpayer has ignored the recommendations of the advisor and why that decision was made.

## **Factor 3**

**(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.

This factor addresses how much time and effort is expended by the taxpayer in carrying on the activity. In addition to the taxpayer's time, the examiner needs to consider the amount of time expended by any other individuals involved in the activity. The development of this factor may lead to the development of an alternative position under the provisions of IRC § 469 for Passive Activities.

The examiner needs to establish precisely how much time the taxpayer devotes to this activity as well as all other activities. The amount of time devoted to the activity may be an indicator of profit motive. If the taxpayer devotes a limited amount of time to the activity, then the taxpayer may be lacking a profit motive. However, if the taxpayer employs competent and qualified individuals to operate the activity, then the taxpayer's time and effort will be reduced. Time and

effort expended reading magazines, journals, and other periodicals are consistent with engaging in a hobby.

After the examiner determines the amount of time that the taxpayer devotes to the activity, then the examiner should consider the possibility that the provisions under IRC § 469 may apply to the taxpayer. If the examiner determines that IRC § 469 may be applicable, then the examiner could use IRC § 469 as an alternative position to IRC §183.

The examiner should prepare an analysis that shows how much time is devoted to the activity as well as a breakdown of how that time is spent. For example, the examiner should designate how much is spent attending seminars, reading magazines and journals, or how much time is spent performing repairs and maintenance and so forth.

The examiner should note specifically the amount of time that the taxpayer devotes to other activities.

### **Summary of Factor 3**

The examiner should consider the amount of time that the taxpayer devotes to the activity. The time analysis should precisely detail how much time the taxpayer devotes to each task related to the activity. The examiner should consider whether IRC § 469 Passive Activity provisions might be applicable. IRC § 469 could provide an alternative position for IRC §183.

### **Factor 4**

**(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(d) for definition of an activity in this connection.

A taxpayer’s “profit” expectations may include appreciation in the value of assets used in the activity. The courts have differed in their application of this factor. Some have included unrealized appreciation in boats, limousines, equipment and real property in determining if the taxpayer had a bona fide profit motive.

Factor 4 has been the most difficult of the nine relevant factors for examiners to correctly develop. The taxpayer has generally been successful with respect to this factor because of the potential for land appreciation. However, proper development of this factor can overcome the potential for land appreciation.

Factor 4 hinges on whether the operation of the taxpayer’s activity and the holding of the land are considered to be a separate or single activity.

According to the Treasury Regulations, Factor 4 states that the term “profit” also includes the appreciation of assets, such as land, used in the activity. An overall profit may occur, in spite of losses from current operations, if the appreciation of the assets is realized.

The examiner needs to prepare an analysis that shows the history of the activity. Beginning with gross receipts, the examiner needs to separate current operating expenses from the costs of carrying the assets. These carrying costs would include depreciation and related interest expense.

The examiner needs to determine if gross receipts exceed current operating expenses with a resulting net profit. For the purpose of this calculation, depreciation expense and related interest expense should be excluded.

As previously mentioned, taxpayers can frequently show potential appreciation of asset value, usually with respect to the land. However, the appreciation of the assets may only be used as a consideration for overall profitability if the operation of the activity and the holding of the assets are considered to be a single activity.

If the operation of the activity and the holding of the assets are considered to be separate activities, then the appreciation of the assets will not be considered for overall profit. In other words, if the operation of the activity and the holding of the assets are considered to be separate activities, the history of operational losses cannot be offset by the potential gain from asset appreciation.

In order to show that the operation of the activity and the holding of the assets should be treated as separate activities, the examiner needs to refer to the previous analysis. If gross receipts do not exceed current operating expenses, then the operation of the activity and the holding of the assets will be considered as two separate activities. As two separate activities, the history of losses cannot be offset by the appreciation of the assets.

Factor 4 relies upon future asset gain potential to offset current losses. The examiner should inquire during the Initial Interview if the taxpayer intends to retire on the site. Frequently taxpayers have purchased these properties for the purpose of future retirement. If the taxpayer intends to retire on the property, then no future gain will be realized. Tax Court cases have gone both ways with respect to taxpayers who have expressed retirement purposes as an intention for land acquisition. Nonetheless, the examiner should document such intentions, if known. Since no one factor is determinative by itself, the examiner should address the taxpayer’s intention for holding the land.

The examiner should consider the potential for appreciation of the activity assets, especially the land. This information can be gathered from comparables.

Comparables would show land values for properties similar to the taxpayer’s parcel.

Comparables can be obtained from area realtors. Comparables are extremely important in determining land valuation. The potential for asset appreciation should be documented on a separate workpaper in the examiner’s case file.

#### **Summary of Factor 4**



The examiner needs to determine if a potential for asset appreciation exists within the activity exists. The examiner also needs to determine whether the operation of the activity and the holding of the land are considered a single activity or separate activities. In the instances of single activities, the history of losses from current operations will be offset by the future potential gain. In the instances of separate activities, the taxpayer cannot offset current operating losses by future potential gains. A determination of separate activities will frequently result in the taxpayer not meeting Factor 4.

## **Factor 5**

**(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.

The examiner needs to document the taxpayer's financial success in other activities. This information will be gathered from prior year tax returns as well as the years under examination.

The examiner will prepare a worksheet that details the history of other activities. This detail should show the profits and losses derived from the activities. In general, many taxpayers have achieved financial success in other business endeavors and yet failed in the operation of the activity in question.

The examiner should focus on activities in addition to the taxpayer's primary source of income. For example, if the taxpayer is a medical doctor, the examiner should not focus on his or her success with his or her medical practice. The examiner should focus on success or failure of other unrelated ventures that were conducted in addition to the medical practice, such as the operation of a restaurant or a kennel.

In addition to the aforementioned worksheet, the examiner needs to document any specific instances where the taxpayer has abandoned certain activities when those activities have proven to be unsuccessful.

### **Summary of Factor 5**

The examiner needs to document the financial successes that the taxpayer has had with other activities. A statement should also address specific instances where the taxpayer has abandoned any activities.

## **Factor 6**

**(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.

The examiner needs to document the history of income or losses generated by the activity. This documentation should be prepared on a detailed worksheet with any narrative as necessary. While this factor may present the taxpayer in a negative light, examiners should not use this relevant factor by itself in reaching a conclusion regarding the profit motive of the activity.

Some of the nine relevant factors will overlap through the course of the examination process. Information developed for one factor may be used in the development of other factors. Factor 6 is one of the most important factors of the nine. This factor supports the framework of this Code section.

The examiner needs to prepare a worksheet that shows a history of the activity's profits and losses such as that shown in [Appendix D](#). The examiner will need to gather prior year tax information using Integrated Data Retrieval System (IDRS). The examiner should order the original returns for any prior years that are no longer "online." These returns would be ordered for review purposes using local procedures. The examiner can copy the original returns and place them in the administrative file. The taxpayer can also be requested to provide copies of the applicable returns.

The examiner should prepare the worksheet with a separate column that shows the amount of depreciation that was deducted in each tax period. This separation is required for use in the development of other relevant factors. If the taxpayer has deducted other land carrying costs, such as real estate taxes or related interest expense, then these expenses should be shown in a separate column. Such real estate taxes and mortgage interest would be deductible on Schedule A subject to AGI phase-out limitations.

### **Summary of Factor 6**

IRC § 183 focuses on the lack of profit potential for a specific activity. The question regarding profit motive is initially triggered by history of losses. For this reason, the development of this relevant factor provides the framework for this section. Examiners should not base any conclusions using this relevant factor alone.

### **Factor 7**

**(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.

The examiner needs to address the amount of occasional profits that the taxpayer has derived from the activity. In most instances where the provisions of IRC § 183 are considered, the taxpayer will have few profits, if any.

The examiner needs to consider whether the taxpayer has generated any profits from the activity. A worksheet would be a useful tool in showing these profits or the lack thereof.

The examiner should pinpoint the exact source of the gross receipts reported for the activity on the tax return. There have been instances where taxpayers have reported gross receipts, which were derived from sources other than the activity, onto the Schedule for the activity. The misplacement of income may be an error, or it may be a deliberate attempt to show revenue where revenue did not exist.

If the examiner determines that certain gross receipts were mistakenly reported on the activity's Schedule, the examiner should not include these gross receipts in any of the worksheets prepared for the purpose of developing the IRC § 183 issue. If any worksheets are prepared with the omission of any such gross receipts, a footnote should be included on each worksheet disclosing such omission.

### **Example**

A Schedule C for a dog breeding activity contained gross receipts for \$3,200. Upon further development, the examiner discovered that the entire amount of the gross receipts pertained to a separate activity, other than the dog breeding. The examiner did not include the \$3,200 of misplaced gross receipts in any worksheets during the development of the IRC § 183 issue. The examiner did incorporate footnotes that disclosed that \$3,200 of gross receipts was erroneously reported on the Schedule C.

If as in the aforementioned example, a significant sum of gross receipts was misreported on the activity's Schedule and significant misrepresentation for the profitability results, the examiner should consider the implications of such misplacement. Civil fraud may be a consideration depending upon the overall impact.

If the examiner in the previous example had not excluded the misplaced gross receipts from the various IRC § 183 worksheets, then a true picture of the taxpayer's activity would not have been portrayed.

Some taxpayers have fabricated income for the activity in an effort to put forth an appearance of profit motive. The examiner needs to verify the income. Such fabrication raises consideration of potential fraud.

### **Summary of Factor 7**

The examiner should consider the amount of occasional profits that the activity may generate. However, the examiner should determine the source of the gross receipts just in the event the gross receipts have been misreported on the tax return. Such misplacement could misstate the profitability of the activity and should be removed from the IRC § 183 issue development with footnotes or disclosures to that effect.

### **Factor 8**

**(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.

This factor addresses the financial status of the taxpayer. In some instances, the taxpayer may have the financial wherewithal to sustain a history of financial losses for the activity. Certain taxpayers may receive a tax benefit from the losses incurred by the activity as these losses will offset other substantial sources of income.

In general, taxpayers with other substantial sources of income have the financial wherewithal to sustain significant losses from activities that appear to meet the criteria of the provisions set forth under IRC § 183.

Misinformation has been written that advises taxpayers to enter into certain activities for the purpose of deriving a tax benefit. Taxpayers with other substantial sources of income have the financial wherewithal to enter such activities irrespective of the motivation. The examiner needs to understand why the taxpayer has not abandoned an unsuccessful activity when other taxpayers who lack the same financial wherewithal would most likely abandon the unprofitable activity.

Many Tax Court cases have been pursued which involve taxpayers that have other substantial sources of income that have engaged in historically unprofitable activities without abandonment. In general, taxpayers who have other substantial sources of income have not fared as well in Tax Court litigation as taxpayers who do not have such financial wherewithal.

The examiner needs to document the financial status of the taxpayer in the workpapers. The examiner should also make a statement to the effect that the financial status has enabled the taxpayer to sustain a history of losses in the activity.

Earlier text directed the examiner to prepare a tax savings benefit analysis. This spreadsheet would show possible motivation for certain taxpayers to continue participation in an unsuccessful financial endeavor.

### **Summary of Factor 8**

In general, taxpayers who have other substantial sources of income have the financial wherewithal to sustain a history of losses with respect to not for profit activities. Some taxpayers actually derive a tax benefit from participation in these activities since the losses offset the other sources of substantial income.

### **Factor 9**

**(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.

Section 183 has been referred to as the “hobby loss” section because many taxpayers have engaged in unprofitable activities due to the pleasurable attributes of the activities. Factor 9 addresses the elements of personal pleasure or recreation of the activity.

The examiner must develop an understanding of the taxpayer’s activity. This understanding must be documented in the workpapers. The examiner must document all tasks that the taxpayer performs within the activity.

Some taxpayers will attempt to downplay any pleasurable aspects of the activity. Many taxpayers will express a passion for their activity. A skilled examiner will be able to draw this passion from the taxpayer through conversation. The courts do not mandate that taxpayers cannot enjoy the method by which they derive their income. Many taxpayers resist the phraseology of “hobby

loss” in reference to IRC § 183. Examiners may wish to refrain from that terminology and refer to the actual title “Activity Not Engaged in for Profit.”

## **Summary of Factor 9**

The examiner needs to address the pleasurable and recreational aspects of the activity. By this point in the examination, the taxpayer is aware of the direction that the exam is going. The taxpayer knows about the nine relevant factors. A taxpayer with a savvy representative has been advised to downplay the pleasurable aspects and emphasize the hard work of the activity. Skilled listening will help the examiner to document and sort the details regarding this relevant factor.

## **Appendix B - Suggested Interview Questions for Each of 9 Relevant Factors**

The following are suggested possible interview questions for each of the nine factors contained in Treas. Regs. §1.183-2(b)(1) through (9) which may be used by examiners to establish if an activity is or is not for profit. Other factors not listed may also need to be considered.

These questions should not be considered all-inclusive. The interview should be tailored to each specific taxpayer. The questions should be asked of the taxpayer in an interview and not be given to the taxpayer and/or authorized representative to complete.

### **1.183-2(b)(1) Manner in which the taxpayer carries on the activity**

- Background and general description of the business.
  - When did the taxpayer first include (first Schedule C, F, 1120S, 1065, etc.) this business for tax purposes?
  - General industry, what specialized niche?
  - Where is business conducted?
  - What geographical area?
  - Specific demographic target population?
  - Is the business seasonal?
  - Did the taxpayer have a business plan?
  - Was the plan followed?
  - How did the taxpayer propose to compete with similar businesses?
  - When/how did the idea for the business activity originate?
  - Was a business plan written-up?
  - What were the financial requirements to start the business?
  - How were the funds obtained?
  - Bank loans, investors, personal savings, family, etc.?
  - What documentation is available?
  - How is the business currently being financed?
  - What financial risks are involved in this type of business?
  - Is any type of business insurance carried?
  - Are policies in the business name?

- Did the taxpayer carry on any of these same policies prior to starting the business?
- Did the taxpayer stand to lose or have expenses beyond what he normally incurs?
- Does the activity involve multiple undertakings; and if so, what is the organizational and economic interrelationship between them?
- Does taxpayer have a license to operate?
- Is the activity in an area zoned for business?
- Is the taxpayer's telephone number listed in the white/yellow pages?
- Does the taxpayer have an internet site?
- How do customers find out about the business?
- Are signs posted?
- Is the activity still being conducted?
- Are any relatives employed in the business?
- If relatives are employed, how is wage determined?
- How are the business records maintained?
  - Describe the system for recording income and expenses.
  - Are budgets prepared?
  - When and by whom are expenses recorded?
  - What types of journals are maintained?
  - Are books on cash or accrual?
  - Are books and records accurate and complete? If not, why not?
  - Are books comparable to types of books kept by others in same activity?
  - Is a computer used? What software program is used?
  - Are financial statements prepared?
  - How often and by whom?
  - Is an accountant or bookkeeper involved?
  - What do they do and how often?
  - Have they given any advice on the business?
  - Are separate bank account(s) used for the business?
  - If no, why not?
  - Are ATM (cash or credit/debit) cards used on the account(s)?
  - Are there transfers between business and personal accounts?
  - If yes, how are they kept track of in the business books?
  - Are the bank statements used to determine business and expenses for the year?
- What efforts are made in terms of attracting customers and securing suppliers or products necessary for the business?
  - What advertising and promotion activity did the taxpayer perform to gain clients/buyers?
  - What other relationship did the taxpayer have with his clients/buyers?
  - What other relationship did the taxpayer have with his suppliers?
  - What other relationship did the taxpayer have with his employees?
  - What forms of advertising have been used? How often? How much?
  - How effective was the advertising? Have ineffective methods been discontinued?
  - Have steps been taken to improve profitability?
  - Any changes in operating methods? What changes?
- When is a profit expected?
  - What type of profit expectations are there?

- What is maximum profit expected?
- When will profit occur?
- Is it reasonable to expect any profit will result?
- How many “widgets” must be sold in order to obtain a profit?

**1.183-2(b)(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 are experts therein, may indicate that the taxpayer has a profit motive where the taxpayer carries on the activity in accordance with such practices.

- What background information was gathered about this type of activity prior to beginning the business?
  - Has the taxpayer ever been employed in this area before?
  - When, where, for whom, how long, what experience specifically pertains to this activity?
- Does the taxpayer have any education which is relevant?
  - Educational institution?
  - Degree, classes, how does it apply to this business or how did it prepare the taxpayer in any way to enter this field of business?
  - Does the education relate to any other business or employment activities?
- Did the taxpayer rely on the advice of others in starting or developing the business?
  - Did the taxpayer consult with experts?
  - What are the credentials of others in starting or developing the business?
  - What experience, education, degrees, business success do they possess which qualify them to advise the taxpayer?
  - How did the taxpayer decide to rely on the person(s) advice?
  - Was there any kind of previous personal, family or business relationship with the advisor?
- Did the taxpayer prepare for the activity by conducting research or an extensive study of its accepted business, economic, and scientific practices?
  - What types of journals, publications, or other reference material did the taxpayer study in preparation to enter this business?
  - What did the taxpayer learn which entered into the decision to engage in this business activity?
  - What professional publications does the taxpayer now subscribe to and what specific benefit does the taxpayer derive?
- What other life experiences does the taxpayer have which would have prepared the taxpayer to engage in this type of activity?
- What related organizations does the taxpayer belong to? How long?

**1.183-2(b)(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 recreation aspects, may indicate an intention to derive profit.



Note – This factor may be given greater weight (in taxpayer’s favor) if there are no substantial personal or recreational aspects present.

- For the taxpayer personally, is this a full-time or part- time activity?
  - How many hours per week? per month? per year? per season? are spent on this activity?
  - What tasks does taxpayer perform?
  - Is this more or less time than others in the same line of work devote?
  - Did the taxpayer have to give up or reduce the time devoted to a different job or occupation?
  - If personal time was given up, what did the taxpayer previously do with that time?
  - If time is not devoted to the activity, did the taxpayer employ competent and qualified persons to carry on the activity?
- Who is involved with the day to day business operations?
  - Does the activity have employees?
  - How many?
  - What are their duties and who does what?
  - What are their hours? Full-time or part-time? Salaries?
  - Are employment tax returns filed?
  - Are any relatives involved with the business in any respect?
  - Are information returns prepared?
  - What are the taxpayer’s own duties and responsibilities with respect to the business?
  - If someone other than the taxpayer is running the business for them, what qualifications and relevant business background do they have?
  - What decisions do they make?

#### **1.183-2(b)(4) Expectation that assets used in activity may appreciate in value**

The term "profit" encompasses appreciation in the value of assets 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 when appreciation in the value of the land used in the activity realized since income from the activity together with appreciation of land will exceed expenses of operation.

- List assets used in the activity.
  - Were the assets held prior to starting the business?
  - Was depreciation previously taken as a deduction?
  - What was the prior use?
  - How and when were the assets acquired (verify taxpayer’s basis)?
  - Are any assets used personally?
  - How much is each asset worth today?
  - Has anyone ever offered to buy any of the assets?
  - Is it likely the assets will appreciate in value?
  - Why does the taxpayer expect the appreciation to occur?
  - At what rate are assets expected to appreciate?
  - Over what period of time (how many years)?

- What are the taxpayer’s plans for the appreciated asset(s)?
- At what point does the taxpayer intend to realize the inherent gain for tax purposes?
- Will the gain on appreciated assets offset operating losses – to the extent that the overall net result on the business is a profit?

**1.183-2(b)(5) The success of the taxpayer in other similar or dissimilar activities**

The fact that the taxpayer has engaged in similar activities in the past and converted these from unprofitable to profitable enterprises may indicate that he is engaged in the present activity for profit, even though the activity is presently unprofitable.

- What other activities has the taxpayer had previous success?
  - Which, if any, were converted from unprofitable into profitable ventures (describe how the taxpayer was involved in this process – what did the taxpayer do to convert it)?
  - What happened to that prior business?
  - Ultimately, were the business(s) profitable on an overall net basis?

**1.183-2(b)(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 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 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 by strong evidence that the activity is engaged in for profit.

The examiner should prepare a comparative schedule of income and losses (expenses) since inception of the business through the present. [Appendix D](#) contains a sample year by year analysis of income and expenses.

Year	XXXX12	XXXX12	XXXX12	XXXX12	XXXX12
Gross Income					
Expenses (Other than Depreciation)					
Depreciation					
(Losses) or Gains					

- Is there a trend toward profitability?

- Are there any profitable years?
- Are there consistent losses?
- Do the losses increase from year to year?
- Have losses continued beyond what would ordinarily be considered customary?
- What is the taxpayer's explanation for continuing with an unprofitable activity?
- Did the taxpayer change operating methods, adopt new techniques, or abandon nonprofitable methods in a manner consistent with intent to improve profitability.
- Why did the taxpayer continue the operation if it continued to lose money?
- Were there unforeseen circumstances?
- Were they beyond the control of the taxpayer?
- What happened and when?
- How did this change the taxpayer's business plans and what action was taken to deal with the unforeseen circumstances?

### **1.183-2(b)(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 ordinary sufficient to indicate the activity is engaged in for profit even though losses or only occasional small profits are actually generated.

- What profits have been earned in any year?
  - Is this a highly speculative business?
  - Is there any change that the activity could generate a substantial profit in the future which would recover prior losses and the taxpayer's investment?
- What amount of an investment has the taxpayer made in the business?
  - Is this amount significant in relation to the taxpayer's net worth?
  - What percent of the taxpayer's net worth has been invested in this venture (obtain financial statements or other evidence of taxpayer's net worth)?

### **1.183-2(b)(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 the 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.

Note – When substantial tax benefits are being derived, greater weight may be given to the possibility the activity is not for profit, especially if personal or recreational elements are present.

- Does the taxpayer have substantial income or capital (investments, etc.) from other sources (list types, sources and amounts)?
  - What tax benefit does the taxpayer receive from the losses on the activity?
  - Are there other economic reasons for the taxpayer to be engaged in the activity? E.g. reduced property taxes for farmland, low interest loans, or federal grants?
  - Can the taxpayer otherwise afford (based on taxpayer's net worth) to continue with the activity regardless of continued losses?

### **1.183-2(b)(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.

- Was the taxpayer involved or interested in this, or a related activity, prior to establishing it as a business for tax purposes?
  - Are elements of fun or recreation generally associated with it by either the taxpayer, members of the taxpayer's family or by the taxpayer's friends?
  - If there are any personal benefits (other than that of succeeding in the business) to being in this business, are they substantial?
  - If the taxpayer previously engaged in the activity for other than business purposes, what currently distinguishes the activity as a business over what was done before?
  - Would the taxpayer continue the activity even if he or she never made a profit?

## **Appendix C - Tax Savings Benefit Analysis**

Completing an analysis of tax savings is important in developing a § 183 case. The analysis should begin, if possible, with the first year of the activity.

This analysis may also be applicable with respect to property tax savings when a taxpayer has derived such a tax benefit due to agricultural status (also known as an agriculture exemption.

The examiner should discuss this analysis with the taxpayer and also include this analysis in any report issued to the taxpayer.

<b>Tax Period</b>	<b>Tax With Loss</b>	<b>Tax Without Loss</b>	<b>Tax Savings</b>
1995			
1996			
1997			
1998			
1999			
2000			
2001			
2002			
2003			
2004			
2005			
2006			
2007			
2008			
<b>Totals</b>			

## **Appendix D - Comparative Analysis Income, Expense and Losses**

Completing an analysis of the year by year income, expense and loss of an activity is important in developing a § 183 case. Losses that continue beyond the start up stage are an indication that no profit motive is present. However, it is important to remember that losses sustained because of unforeseen circumstances beyond the taxpayer’s control (fire, drought, theft, etc.), do not preclude a profit motive.

All trends in profits or losses should be addressed and explained. Any unusual income items or expense items that occur and then “drop off” may mean the taxpayer’s profit is contrived. The examiner should consider whether the profits shown were manipulated in order to meet the presumption test. An occasional small profit from an activity generating large losses does not mean that the activity is engaged in for profit.

The examiner should discuss this analysis with the taxpayer and also include this analysis in any report issued to the taxpayer. Below is a sample of a 1040 Schedule C year by year income, expense and loss analysis:

<b>Income, Expense and Loss Analysis</b>					
<b>Year</b>	<b>2003</b>	<b>2004</b>	<b>2005</b>	<b>2006</b>	<b>2007</b>
Income					
Gross Receipts					
Cost of Goods Sold					
Gross Profit					
Other Income					
<b>Gross Income</b>					
Expenses					
Advertising					
Car and Truck					
Commissions and Fees					
Contract Labor					
Depletion					
Deprecation					
Employee Benefit Programs					
Insurance (Other than Health)					
Interest					
Legal and Professional					
Office Expense					
Pension and Profit Sharing Plans					
Rent or Lease					
Repairs and Maintenance					
Supplies					

<b>Income, Expense and Loss Analysis</b>					
<b>Year</b>	<b>2003</b>	<b>2004</b>	<b>2005</b>	<b>2006</b>	<b>2007</b>
Taxes and Licenses					
Travel, Meals, and Entertainment					
Utilities					
Wages					
Other Expenses					
Office in Home Expenses					
<b>Total Expenses</b>					
<b>Gross Income Less Expenses</b>					

## **Appendix E - Example of an IDR for a Yacht Charter Activity**

Below is a listing of possible items an examiner might request to assist in determining if a **yacht charter activity** is an activity engaged in for profit. Some of the items would best be answered in a face to face interview. Examiners should tailor IDR's to the specific taxpayer under examination.

1. Statement of taxpayer's sailing experience.
2. Copies of experience profiles submitted by potential charterers.  
**Note to examiner:** Is this a crewed charter where the yacht comes with a permanent captain and cook? Or, is this a bareboat charter where the charterer captains the yacht himself?
3. Purchase agreement, Bill of Sale and Invoice, and all canceled checks showing verification of yacht purchase.
4. Statement of actions taken to investigate boat chartering business before entering into this business.
5. Name and address of all charterers and their lease agreement.
6. Schedule of fees or charges billed to charterers.
7. Copies of original loan agreements/promissory notes on financed portion of property.
8. Insurance policy(s) on yacht and its contents (collision and liability).  
**Note to examiner:** Does policy cover rental of boat? Is it a commercial or personal asset?
9. Copy of First Preferred Ship Mortgage.  
**Note to examiner:** The Preferred Ship Mortgage provides the financier of a vessel competitive status among competing claims that might arise against a vessel. The lender

of an ocean vessel, if eligible, secures a loan with a Preferred Ship Mortgage. Otherwise, in a foreclosure situation the lender will be ranked first among the various maritime creditors that may be competing to collect on a vessel's proceeds.

10. Promotional materials and charter sailing brochures for yacht.
11. Invoices and ad copies for advertisements on availability of yacht for rental.
12. Copies of any management agreements or management contracts for boat supervision, maintenance, or operation.
13. Ships log(s) for engine and/or boat use.
14. Maintenance records and service check performance records.
15. Certificate of Origin.
16. Certification of Documentation from U.S. Coast Guard.
17. Copy of commercial captain's license.  
**Note to examiner:** Is potential charterer required to provide taxpayer a copy of their captain's license?
18. Shipping document or other record which verifies delivery date of property.
19. Copy of any prospectus, private placement memorandum or other promotional material received when yacht was purchased.
20. Yacht operating budgets.
21. Break-even point calculations for chartering activity.
22. All books and records pertaining to the boat business.
23. Copies of your federal tax return for XXXX though XXXX (including any amendments thereto).
24. Please, complete the attached "Statement of Supplementary Examination."
25. Please complete a Schedule of Boat Use and Schedule of Taxpayer/Shareholder/Partner Time Spent to Operate the Activity of Boat Chartering."