



## ISSUES

1. Whether the Petitioners' [Redacted] attempts constitute activities engaged in for profit under Internal Revenue Code (IRC) § 183(a) and Treasury Regulation 1.183-2(a).
2. Whether the negligence penalties should be assessed.

## LAW AND ANALYSIS

Regulation 1.183-2 defines an activity not engaged in for profit. Treasury Regulation 1.183-2(b) lists nine relevant factors to use in determining whether an activity is engaged in for profit:

1. The manner in which the taxpayer carried on the activity.
2. The expertise of the taxpayer or his or her advisers.
3. The time and effort expended by the taxpayer in carrying on the activity.
4. The expectation that the assets used in the activity may appreciate in value.
5. The success of the taxpayer in carrying on other similar or dissimilar activities.
6. The taxpayer's history of income or loss with respect to the activity.
7. The amount of occasional profits, if any, which are earned.
8. The financial status of the taxpayer.
9. Elements of personal pleasure or recreation.

No single factor or set of factors is conclusive in determining whether an activity is engaged in for profit, nor is the number of these factors for or against the taxpayer necessarily conclusive in that respect. Golanty v. Commissioner, 72 T.C. 411, 426, 1979 WL 3683 (1979), *aff'd without published opinion*, 647 F.2d 170 (9th Cir.1981); sec. 1.183-2(b), Income Tax Regs. All facts and circumstances with respect to the activity must be taken into account. Sec. 1.183-2(b), Income Tax Regs.

*1. The manner in which the taxpayer carried 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.<sup>1</sup>*

Audit position:

	<u>2009</u>	<u>2010</u>	<u>2011</u>
Projected Highest Gross Income Possible	4,750	36,650	9,300
Claimed expenses	<u>15,887</u>	<u>22,437</u>	<u>18,465</u>
Projected highest possible net profits	<u>(11,137)</u>	<u>14,213</u>	<u>(9,165)</u>

Taking into account the expenses claimed on your tax returns, you projected that even had [Redacted] taken the highest cash prizes from the events in which he intended to compete, you would incur losses in 2009 and 2011. Due to various limitations, your good faith expectation was that a profit could not be made in two out of three years of operation.

Petitioner position:

As part of the appeals process, the POA sent a letter outlining the Petitioners' plan to get into and expand their [Redacted] business. Petitioners kept records that were modest, but did, in fact, identify the income and expenses related to this activity from their personal funds. It was part of their plan to wait until the sale of the [Redacted] to have the time and capital to focus on the [Redacted]. The plan was to [Redacted]for five years and use the capital from the sale of the [Redacted] to fund the business during the start-up phase to attempt to get to a point that it would be profitable. The following are some quotes from information the POA submitted during the appeals process:

“1. The taxpayers previously owned and operated a business activity known as the [Redacted]. This was their primary business activity and was sold in August 2008. During the tenure of business ownership from 1985 to 2008 the taxpayers were active in the operation of the [Redacted] and it was through this involvement, they realized that they could devote a majority of their time to [Redacted] that they had been involved in since 1985.<sup>2</sup>”

“2. The taxpayers then developed a written business plan and in the tax year 2009, when they had full time to devote to the business activity, they would then

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<sup>1</sup> These numbered comments in italics are taken from the non-exclusive list of relevant factors for determining whether an activity is engaged in for profit from Treasury Regulation 1.183-2(b). The regulation says these are “among” the factors, indicating other factors could be considered.

<sup>2</sup> These quotes are from a letter sent by [Redacted], the POA for the Petitioners, received 11/5/13.

start actively participating in the activity of [Redacted] and getting expert training for themselves and [Redacted] in order to [Redacted] at a very competitive level. Each year they were [Redacted] and [Redacted] to become proficient in order to start reaping the rewards of this business activity. This advance training of [Redacted] and gaining the experience in the [Redacted] was their drive and intent for the future.”

“3. The office auditor alluded to the fact that at the events they were participating and the money to have been received from these events would not have produced the money to cover their expenses they were incurring. This business is not unlike a [Redacted] in [Redacted] or the [Redacted] in [Redacted], in which each event you participate in and the potential of the winnings in each event, but also the accumulation of points in order to be involved in the finals, where the larger money is available...”

The POA also included articles and advertisements with his letter that showed various events that the Petitioner was either [Redacted] in or that he was attempting to qualify to [Redacted] in, which paid much greater sums. He also included some articles about [Redacted] large sums of money, in a couple of cases within a couple years of starting to [Redacted]. One of the events the Petitioner [Redacted] in during 2010 had a top prize of \$15,300 which equals 70 percent of their loss for that year. Because of the fact that [Redacted] enables the [Redacted] to move up into the [Redacted] venues, the statement that he would not have been able to break even in 2 of the 3 years audited is not conclusive to determine whether the Petitioner was engaged in this activity to make a profit. He was [Redacted] to [Redacted] to be [Redacted] for [Redacted] in addition to the immediate [Redacted].

After reviewing the information provided and the entire history of the Petitioners [Redacted] activity, especially the fact that they stopped after the fourth year in keeping with their original business plan, it is convincing that this was conducted with the intent to make a profit.

Even though the auditor pointed out the accuracy was not perfect, the Petitioners did keep a log of [Redacted] expenses along with the receipts.

This factor favors the Petitioner.

*2. The expertise of the taxpayer or his or her advisers.*

*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.*

The Petitioner owned and operated an [Redacted] that hosted [Redacted] for 23 years prior to attempting to [Redacted] in the [Redacted]. He was certainly familiar with the activity and the people that had the expertise. He claims that he used trainers for [Redacted] and [Redacted].

“The operation of (the 5 yr. plan) started in 2009 and from 2009-2011 the progression in the business plan has been followed, by providing advanced [Redacted] for [Redacted] and [Redacted] to attempt to advance to a level of the larger &15,000 to \$102,000 [Redacted] provided by these [Redacted].” Parenthesis added.

This factor is in favor of the Petitioner.

*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.*

In this case, the Petitioner was [Redacted] and had no other occupation. He spent 30 to 40 hours per week during the [Redacted] season and 15 to 20 during the [Redacted] season. This was his primary occupation for 4 years.

This factor favors the Petitioner.

*4. The expectation that the assets used in the activity may appreciated in value.*

*The term “profit” encompasses appreciation in the value of assets, such as land, used in the activity. Thus, the taxpayer may intend to derive a profit from the operation of the activity, and may also intend that, even if no profit from current operations is derived, an overall profit will result when appreciation in the value of land used in the activity is realized since income from the activity together with the appreciation of land will exceed expenses of operation. See, however, paragraph (d) of §1.183-1 for definition of an activity in this connection.*

In this case, there was little expectation that there would be any increase in value of the assets used in the activity. Other than the [Redacted], the only assets were personal property like the [Redacted] and [Redacted]. That type of asset tends to decrease in value over time, especially while being used.

This factor is neutral.

*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 Petitioner owned a [Redacted] for 23 years. While that was not especially profitable during its operation, they did make a profit on the sale of the assets. This did give them the opportunity to be involved and study all aspects of [Redacted].

This factor is neutral.

*6. The taxpayer’s history of income or loss 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.*

It is true that they had losses for 4 years in a row. However, they discontinued at that point, which is what a prudent business person would do and was in keeping with the business plan provided. The losses could be indicative of being not engaged in for profit, but changing or stopping the activity is what a business person would do in response to losses.

This factor seems to be against the Petitioner until they stopped the activity. Stopping according to the business plan favors the argument that they had a profit motive.

*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.*

There were no profits during the four years the Petitioner engaged in this activity. This factor weighs against the Petitioner.

*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.*

Petitioner's position:

It was part of their business plan to try the [Redacted] after the sale of their [Redacted]. They determined that they had the capital to be able to [Redacted] for five years and then be able

to judge the viability of [Redacted] for profit. The proceeds from selling the real property were significant, but since that was a one-time event and they were otherwise beginning their [Redacted], their capital was relatively modest. In fact after four years they decided not to continue.

This factor favors the Petitioner.

*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.*

“Business will not be turned into a hobby, so that the taxpayer is then barred from deducting losses from that hobby, merely because the owner finds it pleasurable; suffering has never been made a prerequisite to deductibility. 26 U.S.C.A. § 183(a); 26 C.F.R. § 1.183-2(b)(9)<sup>3</sup>.”

The Petitioner obviously enjoys the [Redacted]and [Redacted], but he could [Redacted] on an occasional basis if enjoyment was the primary motivation and not accumulating the [Redacted] to [Redacted] to the [Redacted] with the [Redacted] available. The fact that this was their primary activity for the four years they were involved with [Redacted] and they sought out [Redacted] and advice indicates that they were trying to improve their [Redacted] their [Redacted] [Redacted] to enter the more [Redacted].

This factor favors the Petitioner.

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<sup>3</sup> T.C. Memo. 2012-59, 2012 WL 695495.

## CONCLUSION

First issue – After reviewing the recommended relevant factors to determine whether an activity is engaged in for a profit from Treasury Regulation 1.183-2(b), it appears the majority of those factors indicate that the Petitioner did intend to make a profit. There were a couple more of the factors that were neutral and a couple factors that weighed against the Petitioners. The strongest factor against the Petitioners was that there were only losses. However, the Petitioners responded to the losses according to their business plan and stopped [Redacted]. When reviewing the entire history of the Petitioners' [Redacted], it is convincing that there was a profit motive. The losses from that activity are allowed.

Second issue – The NODD included negligence penalties as allowed for by Idaho Code section 63-3046(a) and Tax Enforcement Rule 410-02(c). Audit asserted a five percent negligence penalty. The penalties are abated in this decision, as the Tax Commission has found for the Petitioner.

There were some audit adjustments for having double counted health insurance premiums. The remaining tax amounts are due to the medical insurance adjustments.

For the taxable year 2011, the grocery credit was \$60 per exemption if your taxable income is more than \$1,000 and \$80 per exemption if your taxable income is \$1,000 or less. Audit made adjustments to the grocery credits claimed in both 2010 and 2011 because of the increased amount of taxable income. The 2010 adjustment was reversed. For taxable year 2011, the taxable income is still greater than \$1,000 because of the health insurance adjustment. In the 2011 taxable year the grocery credit was reduced by \$40.

Audit disallowed the Investment Tax Credits claimed for not having a business purpose. The Commission reversed that by determining that the activity was a business, however, one of

the items claimed during 2009 was a [Redacted]. [Redacted] are not allowable investment property per Internal Revenue Code section 48(a)(6). The cost of the [Redacted] was \$4,000 and the related credit was \$120. That remains as an adjustment.

THEREFORE, the NODD dated April 15, 2013, and directed to [Redacted][Redacted] is hereby MODIFIED.

<u>YEAR</u>	<u>TAX</u>	<u>INTEREST</u>	<u>TOTAL</u>
12/31/08	\$ 2	\$ 0	\$ 2
12/31/09	142	24	166
12/31/10	120	14	134
12/31/11	40	3	<u>43</u>
		TOTAL	<u>\$345</u>

Interest is calculated through June 16, 2014, and will continue to accrue at the rate set forth in Idaho Code section 63-3045.

DEMAND for immediate payment of the foregoing amount is hereby made and given.

An explanation of the Petitioners' right to appeal this decision is enclosed.

DATED this \_\_\_\_\_ day of \_\_\_\_\_ 2014.

IDAHO STATE TAX COMMISSION

\_\_\_\_\_  
COMMISSIONER

**CERTIFICATE OF SERVICE**

I hereby certify that on this \_\_\_\_\_ day of \_\_\_\_\_ 2014, a copy of the within and foregoing DECISION was served by sending the same by United States mail, postage prepaid, in an envelope addressed to:

[Redacted]

Receipt No.

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