Section 183 of the Internal Revenue Code: The Need for Statutory Reform

[N]o sooner were the apparent leaks in the dike plugged than new ones appeared.

—Remarks of Commissioner of Internal Revenue Jerome Kurtz, 1977[1]

INTRODUCTION

Taxpayer abuse of tax shelters[2] has increased dramatically since the early 1970's.[3] Despite prolonged efforts by the Treasury Department and Congress to stop the abuse of these shelters, it continues to flourish.[4]

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1. Address at the 30th Annual Federal Tax Conference of the University of Chicago Law School (Oct. 26, 1977), *reprinted in* 55 TAXES 774 (1977).

2. The American Bar Association defines the term "tax shelter" as:

> an investment which has as a significant feature for federal income or excise tax purposes either or both of the following attributes: (1) deductions in excess of income from the investment being available in any year to reduce income from other sources in that year, and (2) credits in excess of the tax attributable to the income from the investment being available in any year to offset taxes on income from other sources in that year. Excluded from the term are investments such as, but not limited to, the following: municipal bonds; annuities; . . . and real estate where it is anticipated that deductions are unlikely to exceed gross income from the investment in any year, and that any tax credits are unlikely to exceed the tax on the income from that source in any year.

ABA Comm. on Ethics and Professional Responsibility, Formal Op. 346 (revised) (1982), *reprinted in* 68 A.B.A. J. 471, 471 n.1 (1982). Congress, however, defines a "tax shelter" as:

> (I) a partnership or other entity,
> (II) any investment plan or arrangement, or
> (III) any other plan or arrangement, if the principal purpose of such partnership, entity, plan, or arrangement is the avoidance or evasion of Federal income tax.

I.R.C. § 661(b)(2)(C)(ii) (1982). Finally, Professor George Cooper defines "tax shelters" as "investments by individual taxpayers in amortizable assets or depletable property, under arrangements that have been structured with care to produce favorable tax results for the investor, using . . . deferral, capital gains conversion, and leverage." Cooper, *The Taming of the Shrewd: Identifying and Controlling Income Tax Avoidance,* 85 COLUM. L. REV. 656, 667 (1985).

3. In 1973, there were only 400 tax shelter cases under investigation. In 1983, 325,000 tax shelter cases were investigated. *Abuse a Tax Shelter, Get an Audit,* L.A. Times, Oct. 5, 1983, § IV, at 2, col. 1. The annual revenue loss from these shelters is estimated to be $3.5 billion. *I.R.S. to Widen Crackdown on Tax Cheats,* L.A. Times, Apr. 7, 1983, § I, at 17, col. 1. Roscoe L. Egger, the Commissioner of the Internal Revenue Service, designates this type of tax shelter an "abusive tax shelter." He differentiates between abusive and nonabusive shelters in the following manner:

> *Nonabusive tax shelters* involve transactions with legitimate economic reality, where the economic benefits outweigh the tax benefits. Such shelters seek to defer or minimize taxes.
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> *Abusive tax shelters* involve transactions with little or no economic reality, inflated appraisals, unrealistic allocations, etc., where the claimed tax benefits are disproportionate to the economic benefits. Such shelters typically seek to evade taxes.

Egger, *Warning: Abusive Tax Shelters Can Be Hazardous,* 68 A.B.A. J. 1674, 1674 (1982). *See generally* Note, *Abusive Tax Shelters: Will the Latest Tools Really Help?,* 57 S. CAL. L. REV. 431, 431-32 (1984) (discusses the proliferation of abusive tax shelters and whether recent Congressional and Treasury Department measures will be sufficient to combat the abuse).

4. According to an industry newsletter, taxpayers invested approximately $8.4 billion in

The tax advantages of these shelters are enhanced by the application of the "not engaged in for profit" test of section 183 of the Internal Revenue Code.[5] Under section 183, if the taxpayer participates or invests in an activity which is "not engaged in for profit," he is not allowed a deduction for any expenses or losses attributable to that activity.[6] Yet whether an activity is engaged in for profit is often difficult to determine because no clear judicial or legislative standard exists. Since Congress enacted section 183 in 1969,[7] courts have applied one of three different standards to determine whether a taxpayer possessed the requisite profit motive.[8]

The weakness of the "not engaged in for profit" test is readily apparent when examining the application of section 183 to limited partnerships[9] formed to invest in intellectual or artistic property.[10] The limited partnership purchases the work of art, be it a film, video, book, or master recording, by advancing a nominal amount of cash and securing the balance of the purchase price with a nonrecourse note.[11] As a result of his initial outlay, the taxpayer receives immediate and substantial payments in the form of tax savings,[12] which often may equal or exceed his initial investment.[13]

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tax advantaged investments (limited partnerships registered with the Securities and Exchange Commission) in 1983, compared to approximately $5.5 billion in 1982. ROBERT A. STANGER AND COMPANY, THE STANGER REPORT (1984).

5. All section citations hereinafter are to the Internal Revenue Code of 1954 (I.R.C.) as amended.

6. *See infra* note 18.

7. Tax Reform Act of 1969, Pub. L. No. 91-172, § 213(a), 83 Stat. 571 (1969) (codified at I.R.C. § 183 (1982)).

8. *See infra* notes 41-57 and accompanying text.

9. This Note focuses on cases involving limited partnerships to highlight the deficiencies in the application and structure of section 183 of the Code. With the passage of the new Tax Reform Act, however, it is probable that the use of limited partnerships as tax shelters will diminish. *See* STAFF OF JOINT COMM. ON TAXATION, 99TH CONG., 2D SESS., SUMMARY OF CONFERENCE AGREEMENT ON H.R. 3838 (TAX REFORM ACT OF 1986) (West 1986). Changes in the at-risk rules, interest deduction limitation, and limitations on losses and credits from passive activities will combine to make the use of limited partnership tax shelters less appealing. *See* PRENTICE-HALL INFORMATION SERVICES, TAX IDEAS, PRENTICE-HALL'S EXPLANATION OF THE TAX REFORM ACT OF 1986 501-17 (October 1, 1986). It is likely, however, that individual taxpayer abuse of section 183 will increase in the near future.

10. Tax shelters involving fine art have become quite commonplace. William Noe, President of the Resource Development Corporation and New Masters, Inc., an organization that packages tax shelters, states that "any reproductive art with an element of economic risk is suitable for a tax shelter. These include motion pictures, records, television tapes, books, ceramics, or anything else that requires a master plate, film, mold, or die." Maindenberg, *Tax Shelters in Original Art*, N.Y. Times, Oct. 28, 1979, § 3, at 2, col. 3. *See also* L. DEBOFF, THE DESKBOOK OF ART LAW 1984 SUPPLEMENT XIV 20-29 (1984) (discussing fine art investments as tax shelters); R. TANNEHAUSER & C. TANNEHAUSER, TAX SHELTERS: A COMPLETE GUIDE 21-27 (1978) (discussing various investments as tax shelters).

11. A nonrecourse debt is a debt in which the borrower is not personally liable. Upon default the lender looks only to the underlying secured property for satisfaction. Real property may be acquired by incurring a nonrecourse debt when (1) a third party lends purchase funds and secures the debt with the purchased property; (2) the vendee assumes or takes subject to an existing mortgage. Note, *Federal Income Tax Treatment of Nonrecourse Debt*, 82 COLUM. L. REV. 1498, 1498 n.1 (1982).

12. *See, e.g., infra* notes 67-85 and accompanying text.

13. *Id.* A $3,000 investment netted Fox $11,345 in tax deductions.

Part I of this Note examines the various court-manufactured standards for determining whether an individual[14] is engaged in an activity for profit, and it finds them all unsatisfactory. Part II then evaluates section 183 in light of recent Tax Court decisions and argues that the current legal standards contained within the statutory framework are inadequate, particularly when applied to investments in intellectual and artistic property. Finally, Part III concludes that section 183 leaves too much to judicial discretion and intuition. It suggests that an equitable and efficient solution can ultimately be achieved only through legislative reform of section 183.

I. THE LEGAL STANDARDS

A. *The Statute*

In 1969 Congress enacted section 183 of the Internal Revenue Code[15] as a replacement for Code section 270.[16] The new statute was intended to deal with taxpayers who used losses from hobby activities to offset income from other sources.[17] Section 183,[18] which applies to individuals, trusts, estates,

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14. In Rev. Rul. 77-320, 1977-2 C.B. 78, the Treasury asserted that § 183 applies to the activities of partnerships and that its provisions should be applied at the partnership level and reflected in the partners' distributive shares. The United States Court of Appeals for the 11th Circuit affirmed the Treasury's stance in its decision in Brannen v. Comm'r, 722 F.2d 695 (11th Cir. 1984): "Since the partnership is treated as an entity distinct from its partners, it would be inconsistent to examine profit motive on a partner rather than a partnership level. Accordingly, this Court [holds that] the profit test should be applied at the partnership level." *Id.* at 704. *Accord* Deegan v. Comm'r, 49 T.C.M. (CCH) 1421, 1429 (1985), *aff'd,* 787 F.2d 825 (2d Cir. 1986); Hager v. Comm'r, 76 T.C. 759, 782 (1981); Van Raden v. Comm'r, 71 T.C. 1083, 1103 (1979), *aff'd,* 650 F.2d 1046 (9th Cir. 1981).

15. *See supra* note 7.

16. Section 183 was enacted as a replacement for I.R.C. § 270. Section 270 applied only if an activity was engaged in for profit. It did not permit an individual to deduct losses in excess of $50,000 when such excess losses had been incurred in any activity for five consecutive years. Section 270 was ineffective for two reasons: (1) many deductions were excluded by statute from the computation of loss, and (2) taxpayers could usually rearrange income and deductions to defeat the five-year string. Furthermore, when § 270 did apply, it was overly harsh, requiring the taxpayer to pay in one year the additional tax attributable to a five-year period. *See* S. REP. No. 552, 91st Cong., 1st Sess. 102-03, *reprinted in* 1969 U.S. CODE CONG. & ADMIN. NEWS 2027, 2134.

17. Section 183 was enacted out of a concern that taxpayers were often deducting hobby losses, particularly hobby losses incurred in farming. The Treasury Department, the House, and the Senate therefore all listed their provisions for the new § 183 under the general topic of "Farm Losses." The House Ways and Means Committee and the Senate Finance Committee, however, entitled their respective provisions "Hobby Losses." H.R. REP. No. 413, 91st Cong., 1st Sess. 62, 71, *reprinted in* 1969 U.S. CODE CONG. & ADMIN. NEWS 1645, 1717; S. REP. No. 552, 91st Cong., 1st Sess. 95, 102, *reprinted in* 1969 U.S. CODE CONG. & ADMIN. NEWS 2027, 2133.

18. The relevant portions of § 183 provide:

> § 183. Activities not engaged in for profit
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> (a) General rule.—In the case of an activity engaged in by an individual or an S corporation, if such activity is not engaged in for profit, no deduction attributable to such activity shall be allowed under this chapter except as provided in this section.
>
> (b) Deductions allowable.—In the case of an activity not engaged in for profit

and subchapter S corporations,[19] affects only deductions from activities that are "not engaged in for profit." Although deductions from these activities are allowed, they are limited to the amount of gross income from the respective activities.[20] Deductions allowed by other provisions that do not require a profit motive do not fall within the scope of section 183 and thus are not limited to the amount of gross income.[21]

Section 183 defines an "activity not engaged in for profit" as an activity other than one for which deductions are allowable under section 162 or under paragraphs (1) or (2) of section 212.[22] Under section 162,[23] the ordinary and necessary expenses of a trade or business qualify for deduction. In

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to which subsection (a) applies, there shall be allowed—

(1) the deductions which would be allowable under this chapter for the taxable year without regard to whether or not such activity is engaged in for profit, and

(2) a deduction equal to the amount of the deductions which would be allowable under this chapter for the taxable year only if such activity were engaged in for profit, but only to the extent that the gross income derived from such activity for the taxable year exceeds the deductions allowable by reason of paragraph (1).

(c) Activity not engaged in for profit defined.—For purposes of this section, the term "activity not engaged in for profit" means any activity other than one with respect to which deductions are allowable for the taxable year under section 162 or under paragraph (1) or (2) of section 212.

(d) Presumption.—If the gross income derived from an activity for 2 or more of the taxable years in the period of 5 consecutive taxable years which ends with the taxable year exceeds the deductions attributable to such activity (determined without regard to whether or not such activity is engaged in for profit), then, unless the Secretary establishes to the contrary, such activity shall be presumed for purposes of this chapter for such taxable year to be an activity engaged in for profit. In the case of an activity which consists in major part of the breeding, training, showing, or racing of horses, the preceding sentence shall be applied by substituting the period of 7 consecutive taxable years for the period of 5 consecutive taxable years.

19. I.R.C. § 183(a) (1982); Treas. Reg. § 1.183-1(a) (1972).

20. I.R.C. § 183(a), (b) (1982). The order in which the deductions may be taken is described in Treas. Reg. § 1.183-1(b) (1972).

21. I.R.C. § 183(a), (b) (1982); Treas. Reg. § 1.183-1(a), (b) (1972).

22. I.R.C. § 183(c) (1982). The standard for determining whether an activity is "not engaged in for profit" is the same whether the expenses would be deductible under § 162 or § 212. *See* Appley v. Comm'r, 39 T.C.M. (CCH) 386, 394 (1979); Treas. Reg. § 1.183-2(a) (1972).

23. I.R.C. § 162 (1982). The relevant portions of § 162 provide:

§ 162. Trade or business expenses

(a) In general.—There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including—

(1) a reasonable allowance for salaries or other compensation for personal services actually rendered;

(2) traveling expenses (including amounts expended for meals and lodging other than amounts which are lavish or extravagant under the circumstances) while away from home in the pursuit of a trade or business; and

(3) rentals or other payments required to be made as a condition to the continued use or possession, for purpose of the trade or business of property to which the taxpayer has not taken or is not taking title or in which he has no equity.

addition, section 212[24] permits deduction of ordinary and necessary expenses incurred for the production or collection of an individual's income. As a result, the definition of an "activity not engaged in for profit" in section 183 is no more than a reiteration of the general principles concerning the deductibility of business or profit-oriented expenses.[25] Other relevant factors used to determine whether an activity is engaged in for profit are contained in the legislative history and regulations.[26]

Section 183 creates a rebuttable presumption that an activity is "engaged in for profit."[27] If the activity has been profitable for two of the last five years (two of the last seven years for activities related to horses), then absent a government showing to the contrary, the deduction is not limited to the amount of gross income from the activity.[28]

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24. I.R.C. § 212 (1982) may be thought of as a rough equivalent of § 162 for expenses of profit-seeking activities that are not part of a trade or business. Section 212 provides:

> § 212. Expenses for production of income
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> In the case of an individual, there shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year—
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> (1) for the production or collection of income;
>
> (2) for the management, conservation, or maintenance of property held for the production of income; or
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> (3) in connection with the determination, collection, or refund of any tax.

25. Under I.R.C. § 162 and § 212, the deduction is intended to so apply, if the activity is engaged in for profit. S. REP. No. 552, 91st Cong., 1st Sess. 95, 103 *reprinted in* 1969 U.S. CODE CONG. & ADMIN. NEWS 2027, 2134. Case law reflects some confusion as to what the appropriate degree of profit motive must be to have an activity classified as "engaged in for profit." For example, it is not clear whether profit motive has to be the dominant intent, at least a substantial motive, or merely one of the taxpayer's motives. *See, e.g., Examination Tax Shelters Handbook,* [I Audit] Internal Revenue Man. (CCH) 7299-7, at ¶ 873 (June 27, 1985) (at issue is whether a transaction fails the "profit motive" test if the prospective nontax return is not at least as high as the going rate of return on risk free investments); Rice's Toyota World, Inc. v. Comm'r, 81 T.C. 184, 202, 209 (1983), *aff'd in part, rev'd in part,* 752 F.2d 89 (4th Cir. 1985) (at issue is whether the potential of a nontax return influences the taxpayer); Surloff v. Comm'r, 81 T.C. 210, 233 (1983) (at issue is whether a nontax return is the primary goal of taxpayer); Hilton v. Comm'r, 74 T.C. 305, 353 n.23, 355-56 (1980), *aff'd per curiam,* 671 F.2d 316 (9th Cir. 1982), *cert. denied,* 459 U.S. 907 (1982) (at issue is whether the prospective nontax return must be at least as great as the discount rate used by the Internal Revenue Service in its annuity tables); Ginsburg v. Comm'r, 35 T.C.M. (CCH) 860, 868 (1976) ("profit motives" test is whether there is any potential nontax return at all). *See* Carey & Gallagher, *Requisite Greed: The Section 183 Regulations,* 19 LOY. L. REV. 41 (1972-73).

26. *See infra* notes 29-40 and accompanying text.

27. I.R.C. § 183(d) (1982). *See supra* note 18.

28. If the taxpayer has engaged in the activity for less than 5 years (7 years for a horse-related activity), he may elect that a determination of whether the presumption applies not be made before the end of the fourth year (sixth year for a horse-related activity) following the first year that he engaged in the activity. Otherwise, the presumption cannot apply until after the second profitable year. I.R.C. § 183(e)(1) (1982). If made, the election extends the statute of limitations for deficiencies related to the activity. I.R.C. § 183(e)(4) (1982). The Tax Reform Act will amend § 183(d) so that an activity is presumed to be operated for a profit, rather than as a hobby, if it is profitable in three out of five years. Horse breeding, training, showing, and racing is presumed to be operated for profit if profitable in two out of seven consecutive years. Prentice-Hall Information Services, *supra* note 9, at 135, ¶ 130.

B. *The Regulations*

Under the regulations to section 183, a taxpayer must have the "objective of making a profit"[29] in order for an activity to be classified as carried on for profit.[30] The regulations, however, do not explicitly state whether any profit motive is sufficient, or whether the objective of making a profit must be a substantial, or even the primary purpose for engaging in the activity.[31]

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29. Treas. Reg. § 1.183-2(a) (1972).

30. The term "profit" is not defined in the Code. Prior to the adoption of § 183, the Treasury recommended that the "reasonably anticipated profit be an economic profit, not a 'tax savings' profit." TREAS. DEPT., 91ST CONG., 1ST SESS., TECHNICAL MEMORANDUM OF TREASURY POSITION ON H.R. 1327035 (Comm. Print 1969). By contrast, the Senate Finance Committee only wanted to limit the disallowance of deduction for losses under § 183 to cases in which it was "generally appropriate." S. REP. No. 552, 91st Cong., 1st Sess. 103-04, *reprinted in* 1969 U.S. CODE CONG. & ADMIN. NEWS 2027, 2134. In their final form, the regulations did not stipulate that profit mean economic profit.

31. The bill passed by the House of Representatives in 1969 would have required a reasonable expectation of profit. The Senate Finance Committee, however, rejected this requirement, stating that:

> The committee is concerned, however, that requiring a taxpayer to have a "reasonable expectation" of profit may cause losses to be disallowed in situations where an activity is being carried on as a business rather than as a hobby. Accordingly, the committee has modified the House bill to provide that in determining whether losses from an activity are to be allowed, the focus is to be on whether the activity is engaged in for profit rather than whether it is carried on with a reasonable expectation of profit. This will prevent the rule from being applicable to situations where many would consider that it is not reasonable to expect an activity to result in a profit even though the evidence available indicates that the activity actually is engaged in for profit. For example, it might be argued that there was not a "reasonable" expectation of profit in the case of a bona fide inventor or a person who invests in a wildcat oil well. A similar argument might be made in the case of a poor person engaged in what appears to be an inefficient farming operation. The committee does not believe that this provision should apply to these situations or that the House intended it to so apply, if the activity is engaged in for profit.

S. REP. No. 552, 91st Cong., 1st Sess. 103, *reprinted in* 1969 U.S. CODE CONG. & ADMIN. NEWS 2027, 2133.

Case law reflects some confusion as to what the appropriate degree of profit motive must be to have an activity classified as engaged in for profit. For example, it is not clear whether profit motive has to be the dominant intent, at least a substantial motive, or merely one of the taxpayer's motives. *See, e.g., Examination Tax Shelters Handbook,* [I Audit] Internal Revenue Man. (CCH) 7299-7, at ¶ 873 (June 27, 1985), (suggesting that a transaction fails the "profit motive" test if the prospective nontax return is not at least as high as the going rate of return on risk free investments); *Hilton,* 74 T.C. at 353 n.23, 355-56 (suggesting that the prospective nontax return must be a least as great as the discount rate used by the Internal Revenue Service in its annuity tables); *see also* Dean v. Comm'r, 83 T.C. 56, 98 (1984) (at issue is whether nontax return is an "actual and honest objective"); Estate of Baron, 83 T.C. 542, 558 (1984), *aff'd,* 798 F.2d 65 (2nd Cir. 1986) (at issue is whether the amount of potential nontax return is sufficiently large in relation to the tax benefits); Surloff v. Comm'r, 81 T.C. 210, 233 (1983) (at issue is whether nontax return is the primary goal of taxpayer); Ginsburg v. Comm'r, 35 T.C.M. (CCH) 860, 868 (1976) ("profit motive" test is whether there is any potential nontax return at all). For an excellent theoretical analysis of the problem, see Samansky, *Hobby Loss or Deductible Loss: An Intractable Problem,* 34 U. FLA. L. REV. 46, 55-60 (1981). *See also* Carey & Gallagher, *supra* note 25; Rhodes, *Hobby Losses — A New Challenge,* 56 A.B.A. J. 893 (1970); Sharpe, *New "Hobby Loss" Rule Is Tougher But "Engaged In For Profit" Dilemma Remains,* 32 J. TAX'N 289 (1970).

The regulations do state that "[t]he determination of whether an activity is engaged in for profit is to be made by reference to objective standards."[32] While the term "objective standards" is not defined, it normally means that objective facts should give the court information concerning whether the taxpayer had a reasonable expectation of achieving a profit.[33] Moreover, according to the regulations a taxpayer's statement concerning his intent, a subjective factor, will also be accorded some weight.[34]

The regulations list nine factors, derived from case law,[35] that are among those to be taken into account "[i]n determining whether an activity is engaged in for profit."[36] These factors are intended to be neither comprehensive nor determinative of the question. No single factor is considered conclusive. The regulations further state that the determination of whether a profit motive exists should not be made on the basis that the number of factors which indicate a "for profit" activity exceed those which indicate a "not for profit" activity.[37] The nine factors are: (1) manner in which the taxpayer carries on the activity, (2) expertise of the taxpayer or his advisors, (3) time and effort expended by the taxpayer in carrying on the activity, (4) expectation that assets used in the activity may appreciate in value, (5) success of the taxpayer in carrying on other similar or dissimilar activities, (6) taxpayer's history of income or losses with respect to the activity, (7) amount of occasional profits from the activity, (8) financial status of the taxpayer, and (9) elements of personal pleasure or recreation from the activity.[38]

As stated earlier, the regulations require the taxpayer to have an objective of making a profit if he is to be allowed deductions for losses attributable to his activity.[39] To determine whether he has the requisite profit motive, one must necessarily examine the taxpayer's subjective intent. While the profit motive is subjective, the factors used to determines its presence or absence are predominantly objective.[40]

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32. Treas. Reg. § 1.183-2(a) (1972).

33. Objective facts would be those that are important to an average or reasonable person; they would not include a particular person's idiosyncrasies. *See* Blum, *Motive, Intent, and Purpose in Federal Income Taxation,* 34 U. CHI. L. REV. 485, 498 (1967).

34. "In determining whether an activity is engaged in for profit, greater weight is given to objective facts than to the taxpayer's mere statement of his intent." Treas. Reg. § 1.183-2(a) (1972).

35. *See* Lee, *A Blend of Old Wines in a New Wine Skin: Section 183 and Beyond,* 29 TAX L. REV. 347, 390-97 (1974).

36. Treas. Reg. § 1.183-2(b) (1972).

37. *Id.* "The intention of the drafters was that the list be merely used as an aid in the ultimate determination of the intention of the taxpayer." Lee, *supra* note 35, at 396. Any implication that all factors are to be weighted equally, however, is not in accord with existing case law. *Id.*

38. Treas. Reg. § 1.183-2 (1972). For a detailed discussion of the nine factors, see Lee, *supra* note 35, at 397-444; Burns & Groomer, *Effects of Section 183 on the Business/Hobby Controversy,* 58 TAXES 195, 197-205 (1980).

39. Treas. Reg. § 1.183-2(a) (1972).

40. Carey & Gallagher, *supra* note 25, at 69-70. It should be noted that the ninth factor is not an "objective" fact.

C. The Primary Purpose Standard

The standard applied under prior law was the primary purpose standard. The primary purpose standard for determining whether a person is engaged in a trade or business is "whether the taxpayer's primary purpose and intention in engaging in the activity is to make a profit."[41] Although courts commonly emphasize that the taxpayer must have a "predominant purpose" of making a profit for the losses to be deductible,[42] they ordinarily decide cases in a way that avoids comparing profit motive with other motives.[43] In general, when a court holds for the government it finds that the taxpayer did not have a predominant purpose of making a profit.[44] By deciding the question in this manner, the court does not reach the more difficult issue of whether making a profit was the primary purpose of engaging in the activity. When holding for the taxpayer, the court will either minimize consideration of the taxpayer's personal pleasure or stress solely the manner in which the activity was conducted.[45] The primary purpose standard, as a result, is less helpful in determining the ultimate findings of fact than it is a convenient conclusory label.

The primary purpose standard is also unsatisfactory because it cannot adequately contend with mixed motive cases.[46] The personal pleasure that a

41. Snyder v. United States, 674 F.2d 1359, 1362 (10th Cir. 1982). In *Snyder,* the taxpayer, a practicing attorney, began work on a photography book of the Colorado high country. After investing a substantial sum of money into sophisticated photographic equipment and devoting substantial time to taking pictures, Snyder sent letters to publishing houses soliciting their interest in his book. Several publishers initially expressed an interest, but no one offered to buy or publish the book. On his tax return Snyder claimed depreciation deductions and business expenses attributable to his "nature photography" activity. The Commissioner disallowed the deductions attributable to the photography book, as did the district court. On appeal to the United States Court of Appeals for the Tenth Circuit, the lower court's decision was reversed and remanded on the ground that the trial court's findings of fact were not sufficient to allow the court of appeals to review properly the finding. In *obiter dictum,* the court suggested that the trial judge determine whether the taxpayer's primary purpose and intention in engaging in the activity was to make a profit. *Id.* at 1364. For other cases utilizing the "primary purpose" standard, *see* Golanty v. Comm'r, 72 T.C. 411, 425 (1979), *aff'd,* 647 F.2d 170 (9th Cir. 1981); Allen v. Comm'r, 72 T.C. 28, 33 (1979). *Contra* Dreicer v. Comm'r, 665 F.2d 1292 (D.C. Cir. 1981). *See also* Note, *On Deducing a Deductible Loss: The Continuing Search for an Appropriate Legal Standard in* Dreicer v. Commissioner *and* Snyder v. United States, 15 CONN. L. REV. 847, 852-53 (1983) (thorough analysis of the *Snyder* decision).

42. *See* Lee, *supra* note 35, at 389 n.134; Crouch, *How Treasury's Final Regulations on the New Hobby Loss Rules Operate,* 38 J. TAX'N 184 (1973). *But see* Samansky, *supra* note 31, at 56 n.46.

43. Samansky, *supra* note 31, at 55-56. Samansky contends that when courts avoid comparisons they are in effect adopting an all or nothing approach. They are consequently also able to sidestep the difficult issue of whether a partial deduction will be allowed under I.R.C. § 183 when the taxpayer's business purpose is not primary but is more than merely incidental. *Id.*

44. *See* Hires v. Comm'r, 40 T.C.M. (CCH) 342 (1980); Sealy v. Comm'r, 39 T.C.M. (CCH) 847 (1980).

45. *See* Fisher v. Comm'r, 40 T.C.M. (CCH) 398 (1980); Sparre v. Comm'r, 39 T.C.M. (CCH) 1044 (1980).

46. For a detailed analysis of the weaknesses of the primary purpose standard with respect to mixed motive cases, see Samansky, *supra* note 31, at 55-59.

taxpayer receives from an activity will inarguably influence a court's decision on the deductibility of losses.[47] If the requisite motive of making a profit exists, however, it is unclear why the additional motive of personal pleasure should affect the deductibility of losses.[48] It appears unjust to penalize a taxpayer who, in addition to his objective of making a profit, also derives enjoyment from his activity.

D. *The Bona Fide Expectation Standard*

Since section 183 was enacted, courts have generally disregarded the application of the primary purpose standard and instead have stated that losses are deductible if the taxpayer has a bona fide expectation and intention of making or realizing a profit.[49] Given the difficulty in determining a person's bona fide expectation, the courts have attempted to ascertain the taxpayer's true "intent" by focusing mainly on profit objectives rather than profit expectations.[50] Since intent is deduced from conduct, the test asks nothing more than whether the taxpayer is actively seeking a profit. The taxpayer's most important task, therefore, is to act as if he intends to realize a profit.[51]

Focusing exclusively on intent to make a profit in determining whether losses should be deductible raises several problems.[52] First, analyzing subjective "intent" is too vague to be an effective standard. Second, an intent

47. *Id.* at 57. To some extent, the regulations require such a result: "[D]eductions are not allowable under section 162 or 212 for activities which are carried on primarily as a sport, hobby, or for recreation." Treas. Reg. § 1.183-2(a) (1972). Further, "[t]he 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." *Id.* at § 1.183-2(b)(9).

48. *See, e.g.*, Shine, *Some Tax Problems of Authors and Artists*, 13 TAX L. REV. 439, 446 (1958) (discussion of the problem of mixing pleasure with business for authors and artists).

49. Dreicer v. Comm'r, 48 T.C.M. (P-H) 1533 (1979), *rev'd*, 665 F.2d 1291 (D.C. Cir. 1981). The Tax Court held that Dreicer's "activity of traveling around the world allegedly to obtain material for a manuscript was an 'activity . . . not engaged in for profit' within the meaning of section 183(a), since he did not have a bona fide expectation of profit." *Id.* at 1542.

50. In theory, the bona fide expectation standard may be considered a more rigid test than the primary purpose standard because it requires the taxpayer to show that he had both a bona fide expectation and intention of making a profit from engaging in the activity.

51. In Churchman v. Comm'r, 68 T.C. 696 (1977), the taxpayer, a prize-winning artist, had been successful in art shows but had lost money for twenty years. Nonetheless, the court stated that:

> It is abundantly clear from her testimony and from the objective evidence that petitioner is a most dedicated artist, craves personal recognition as an artist, and believes that selling her work for a profit reprcsents the attainment of such recognition. Therefore, petitioner intends and expects to make a profit. For section 183 purposes, it seems to us irrelevant whether petitioner intends to make a profit because it symbolizes success in her chosen career or because it is the pathway to material wealth. In either case, the essential fact remains that petitioner does intend to make a profit from her artwork and she sincerely believes that if she continues to paint she will do so.

Id. at 702-03.

52. *See* Samansky, *supra* note 31, at 59-60.

to make a profit may accompany an intent to gain personal pleasure or enjoyment from the activity. Finally, in order to objectively determine whether a taxpayer has the requisite subjective intent of making a profit, the courts must examine the taxpayer's objective actions. Consequently, a well-advised hobbyist could deduct losses simply by presenting good records and other outward evidence of good business practices.[53]

E. *The Actual and Honest Profit Objective*

The difficulty of focusing on intent lead to the abandonment of the bona fide expectation standard.[54] The "actual and honest profit objective" standard, the approach that best reflects the language of the statute and its regulations, is the standard currently used to determine whether an activity is engaged in for profit.[55] This standard is nonetheless unacceptable for several reasons, most involving the inherent difficulties of analyzing subjective "intent." First, the standard fails to address the applicability of section 183 to persons who have either substantial or secondary profit motives. A person might have a substantial profit objective that equals, or perhaps even

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53. For example, tax specialists will often advise their "gentlemen farmer" clients to:

> (1) Keep good financial records that are used throughout the year for decision-making and planning purposes. Make certain that expenses related to the land can be separated if necessary. (2) Before and throughout the years of operation consult a number of experts. Obtain written advice and follow it. This should also include information about available markets. (3) Devote considerable time to the activity, especially to managerial and financial duties. (4) Avoid swimming pools, tennis courts, etc., on the property. Keeping them separate from farm operations does not remove their potential damages. (5) Hire qualified personnel to do the things you cannot do competently. (6) Testify in court. Appear forthright, honest, and knowledgeable about the operation and about the type of activity in general. Some extras that should help: (1) Have a profit plan in writing and update it periodically. (2) Keep nonfinancial records on the animals, crops, etc. (3) Document extraordinary events that affect the operation. (4) Advertise frequently in the manner appropriate to the activity. (5) Select and use a business name. Register it when appropriate. (6) Implement some cost-cutting measure when possible. (7) Periodically, obtain information about fair market values for all assets used in the business. Warnings to the taxpayer are: (1) Anyone converting from a hobby must be considerably more conscientious than anyone else. (2) Do not continue unsuccessful methods. (3) Be careful about using the farm facilities for socializing or attending functions related to the activity that cannot be justified as good for business. (4) Be careful about arranging transactions to insure profits occur. This may be held against you. (5) An expert witness may damage your case. If all else fails, the taxpayer should either earn a profit or decide no profit can be made and abandon the activity before the court date. While this may be personally and financially objectionable to the owner, it may be the only action that will convince the court that a profit motive did exist.

Burns & Groomer, *supra* note 38, at 206.

54. *See supra* note 49.

55. Dreicer v. Comm'r, 78 T.C. 642, 646 (1982), *aff'd mem.*, 702 F.2d 1205 (D.C. Cir. 1983); *accord* Swigert v. Comm'r, 44 T.C.M. (CCH) 992, 994 (1982); Bryson v. Comm'r, 44 T.C.M. (CCH) 602, 604 (1982); Tarutis v. Comm'r, 44 T.C.M. (CCH) 48, 53-54 (1982).

surpasses, a desire for personal pleasure. Section 183 should not prevent loss deductions because of a coexisting enjoyment motive.[56] By contrast, a taxpayer may actually and honestly desire a profit but be unwilling to work for it. Section 183 deductions should not be permitted merely because a person entertains a hope of making a profit.

Second, because the court must examine a taxpayer's objective actions to determine if he has the subjective intent of making a profit, a well-advised taxpayer could deduct hobby losses by merely going through business-like motions.[57] By disguising the true motive of his transaction, the taxpayer can greatly alter his tax liability.

Although the "actual and honest profit objective" standard most closely mirrors the language of the statute and its regulations, it fails to deal with the practical and theoretical problems that the courts face in implementing the statute. The standard, as a result, has little value.

II. Recent Section 183 Cases

Courts often invoke section 183's "not engaged in for profit" language to disallow a taxpayer's share of partnership losses.[58] Particularly troublesome for taxpayers, tax shelter promoters, and their respective legal counsel has been the inability of the courts to promulgate a concise, unambiguous legal standard. Although the regulations to section 183 purport to give some guidance,[59] judges have not applied them in a consistent manner. While some judges openly express their reliance upon them,[60] others only make passing reference to them,[61] leaving it to the reader to decide whether and to what extent the factors weighed in the court's decision. Moreover, in a recent Tax Court case,[62] the judge declined to rely upon any of the nine factors, relying instead on the "facts and circumstances"[63] of the particular situation. This judicial vacillation serves only to perpetuate the opportunities for tax exploitation by resourceful promoters and skillful attorneys.

56. *But see* Note, *supra* note 41, at 860 (author argues that a taxpayer's enjoyment of an activity should affect the deductibility of losses because the taxpayer is "better off" than a person who loses money in an activity that he or she does not enjoy).

57. *See supra* note 53.

58. *See, e.g.,* Deegan v. Comm'r, 49 T.C.M. (CCH) 1421, 1429 (1985), *aff'd,* 787 F.2d 825 (2d Cir. 1986) (partnership's acquisition and exploitation of movie not an activity engaged in for profit); Polakof v. Comm'r, 49 T.C.M. (CCH) 1300, 1307 (1985) (partnership's acquisition and distribution of four movies lacked a profit motive and was not an activity engaged in for profit); Cronin v. Comm'r, 49 T.C.M. (CCH) 805, 814 (1985) (partnership's acquisition and distribution of a master recording not an activity engaged in for profit).

59. *See supra* notes 29-40 and accompanying text.

60. *Deegan*, 49 T.C.M. at 1429-30; *Polakof*, 49 T.C.M. at 1308 n.13; *Cronin*, 49 T.C.M. at 815.

61. Sheid v. Comm'r, 50 T.C.M. (CCH) 663, 669-70 (1985) (partnership business of owning a movie constituted an activity engaged in for profit).

62. *Id.*

63. *Id.* at 670.

Two recent cases, *Fox v. Commissioner*[64] and *Siegel v. Commissioner*,[65] highlight the difficulty and inherent ambiguity in applying the section 183 "not engaged in for profit" language. This Note examines the courts' use of the nine regulation factors in an attempt to reconcile the conflicting decisions. In a third case, *Sheid v. Commissioner*,[66] this Note examines the soundness of the court's decision to rely solely on the facts and circumstances of the case.

A. *Fox* and *Siegel*

Fox v. Commissioner involved the activities of Resource Investments, a corporation active in the organization of limited partnerships and the solicitation of affluent individuals to invest in them. Before its involvement with J.W. Associates, Resource had focused on the organization of movie and T.V.-documentary investments. Typically, Resource would organize a limited partnership which would then make leveraged investments in Resource-recommended properties by using extensive nonrecourse financing. J.W. Associates was a partnership set up by Resource to invest in the publishing rights of "An Occult Guide to South America" by John Wilcock.[67] Resource hoped to capitalize on Wilcock's success as a travel guide author[68] and the current fad for books on the occult.

In April of 1976 J.W. Associates purchased all rights, interests, and title to *An Occult Guide to South America*.[69] As consideration for the purchase agreement, the partnership agreed to pay $600,000, $163,000 in cash and $495,000 in a nonrecourse note.[70] In return, the seller gave J.W. Associates

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64. 80 T.C. 972 (1983).

65. 78 T.C. 659 (1982).

66. 50 T.C.M. (CCH) 663 (1985).

67. *Fox*, 80 T.C. at 978-79.

68. *Id.* at 979. Wilcock had previously authored or co-authored several books in the travel field, including nine travel guides in the Arthur Fromme series of books and several TWA Getaway Guides. Over the 10 years prior to 1986, the Arthur Fromme books Wilcock authored or co-authored sold a total of several hundred thousand copies. In addition, Wilcock had published "The Autobiography and Sex Life of Andy Warhol" and at least two editions of "The Witches Almanac." *Id.* at 978.

69. J.W. Associates actually purchased the film from Laurel Tape and Film, Inc. Laurel Tape and Film was the wholly owned subsidiary of a company controlled by George A. Romero. Romero was also the general partner of J.W. Associates. *Id.* at 982.

70. With regard to the nonrecourse note, the contract stated:

> Said note will be substantially in the form of Schedule "B" attached hereto; said note will be secured by a purchase money security interest in the manuscript which will be set forth in a security agreement of even date from Buyer to Seller substantially in the form of Schedule "C" attached hereto; and said note will be payable on August 1, 1986 with interest as hereinafter provided.
>
> . . . .
>
> . . . It is understood and agreed that neither the Obligor nor any of its Partners shall be personally liable in any way for a default of the note due August 1, 1986, or a default of this Agreement. If Buyer defaults, Buyer shall have no

an appraisal which estimated the average potential revenues from the book at $700,000.[71]

Immediately thereafter, Resource began soliciting various wealthy individuals with their partnership offering. Resource distributed a private placement memorandum attempting to sell fifty-five units of limited partnership interest in J.W. Associates at $3,000 per unit.[72] The memo included an accountant's projections of taxable income (or loss), cash flow, and net after-tax benefits to the limited partners.[73] The memo estimated that sales of 800,000 to 1.3 million copies of *An Occult Guide to South America* would have to be reached, depending upon the mix between hard-cover and soft-cover sales, to pay off the nonrecourse note.[74] Later in the memo, however, the accountant stated that there could be no "assurance that the books can be marketed at all, at any price."[75] There was, consequently, no assurance that the limited partnership would earn any profits.[76] The memo did nonetheless anticipate that "each Partner will be entitled to certain items of income tax deduction and credit which may be used to offset other income for 1976

> obligation whatsoever to return to Seller any proceeds previously received by Buyer which exceed the portion of those proceeds which should have been paid to Seller, in the first instance, i.e., 50% or 80% thereof.

Id. at 983-84. It should also be noted that there is an error in the contract. $163,000 plus $495,000 equals $658,000; not $660,000.

71. *Id.* at 984.

72. *Id.* at 985-86.

73. *Id.* at 986. The accountant projected net after-tax benefits under three possible scenarios: (1) the book earns the partnership $10,000 of proceeds, (2) the book earns the partnership $300,000 of proceeds, and (3) the book earns the partnership $1.2 million of proceeds. The result of these projections, assuming a 50 percent tax bracket, is as follows:

Proceeds to	After-Tax Benefits to 55 Units				
Partnerships	1976	1977	1978	1979	1980
$ 10,000	$168,658	$83,888	$51,646	$23,063	$ 245
300,000	$168,658	$81,465	$49,224	$49,224	$19,698
1,200,000	$168,658	$72,645	$36,352	$36,776	$91,042

Another projection, on page 1 of the memorandum, showed that if only the initial 15,000 copies of the book were sold, the yearly tax deducations would be as follows:

Year	Deductions
1976	$6,033
1977	3,000
1978	1,833
1979	800

Id. at 986.

74. *Id.*

75. *Id.* The memo further stated that:

> The Limited Partnership has no assurance of earning any profits or cash flow. The Limited Partnership does anticipate, however, that each Partner will be entitled to certain items of income tax deduction and credit which may be used to offset other income for 1976 and subsequent years. . . . [N]or can there be any assurance that the books can be marketed at all, at any price.

Id.

76. *Id.*

and subsequent years."[77] Stuart I. Fox purchased one unit in the limited partnership.

Stein and Day, Inc.,[78] was the distributor for the book. Its promotional campaign focused on small advertisements in such publications as *The New York Times Book Review,* the *Village Voice,* and *The New York Arts Journal.* Ads were also placed in *Publishers Weekly* and *Library Journal.*[79] An initial review of the book was very favorable.[80] Despite all this, the returns on the book were nominal.[81]

On its 1976 tax return, J.W. Associates reported gross receipts of $4,859.[82] It claimed $344,873[83] in deductions, of which $329,000 was designated "amortization deduction."[84] These figures resulted in a net loss of $340,014. On its 1977, 1978, 1979, and 1980 tax forms, J.W. Associates reported net losses of $171,524, $125,223, $62,017, and $868, respectively. The actual per unit deduction that Fox received in 1976 was $6,059. The corresponding per unit deductions amounted to $3,057 in 1977 and $2,229 in 1978.[85]

The Commissioner filed suit, alleging that none of the claimed losses were deductible because the partnership's activity was not engaged in for profit within the meaning of section 183. At the trial, Judge Nims set out the analysis that he would employ in determining the "not engaged in for profit" question, expressly mentioning the regulation's nine factors.[86] The court noted that several factors weighed in favor of Fox's assertion that the limited partnership was being operated in a business-like fashion. First, the partnership had acquired a reputable distributor, Stein and Day, Inc., to assist in the marketing of the book.[87] Second, although Wilcock was not a best-

77. *Id.*

78. *Id.* at 981. During the mid-1970s, Stein & Day, Inc., distributed approximately 100 new titles each year. *Id.* at 980.

79. *Id.* at 989.

80. *Id.* The March, 1977 issue of *High Times* carried a favorable review of the book.

81. *Id.* at 989-90. The actual sales to and returns from the bookstores of *An Occult Guide to South America* were as follows:

Period	Gross Proceeds	Actual Returns
11/76-12/76	$3,044.54	$ 78.00
1/77-12/77	1,056.09	1,365.65
1/78-12/78	424.48	397.56
1/79-9/79	1,043.94	58.95

Id.

82. *Id.* at 990.

83. *Id.* The deductions included a $2,000 accounting expense deduction, a $12,646 interest expense deduction, a $1,227 "Distribution Commissions" deduction, and a $329,000 amortization deduction. *Id.*

84. *Id.* The partnership reported its amortizable property as "[b]ook rights, plates and dies." The partnership claimed a $658,000 basis in these assets. Using the income forecast method of accounting, the partnership deducted 50 percent of this basis for amortization. *Id.* at 990-91.

85. *Id.* at 975, 990-91.

86. *Id.* at 1005-07.

87. *Id.* at 1008; *see supra* note 78.

selling author, several of his books had sold well.[88] Unfortunately for Fox, these were the only two factors that the court found to be in his favor.

Upon a "closer examination of J.W. Associates' conduct,"[89] the court found that the remaining factors did not support Fox's claim. The court stressed that the size of the nonrecourse note was not determined by negotiation, but rather determined unilaterally by Resource.[90] The court also questioned the credibility of the appraisals given to the partnership by the seller at the closing. Since the appraisals were furnished by the seller (Wilcock's agent wrote one of them), the court concluded that a genuine profit-motivated partnership would not have accepted them.[91] The court similarly questioned the partnership's "true regard for the profitability of the activity" because of the noticeable lack of arm's length negotiations.[92] The single most determinative factor, however, was the private placement memorandum. The court stressed that the substance of these letters, containing projections involving the sale of only 15,000 books, was clear evidence that tax deductions were the sole motivation for participation in the J.W. Associates partnership.[93]

The court announced that based on all of the facts, Fox failed to meet his burden of showing that J.W. Associates was engaged in its book publishing activity for profit.[94] The deductions claimed were accordingly limited by the provisions of section 183.

In *Siegel v. Commissioner,*[95] Charles H. Siegel purchased two units, amounting to a 9.9% interest, in D.N. Company, a limited partnership which was formed with the intent of purchasing and exploiting[96] a movie entitled "Dead of Night."[97] "Dead of Night" is a low budget horror film involving a young soldier killed in combat in an area meant to remind the viewer of Vietnam who then returns to his small home town as a zombie. After killing a truck driver, a neighborhood dog, the family doctor, and an old girlfriend, Andy climbs into a grave in a cemetery where he dies beneath his own predated headstone.[98] Siegel had no expertise in the movie industry

88. *See supra* note 68.

89. *Id.*

90. *Id.* at 1009. The court added that "[a]s long as the nonrecourse note was sufficiently large in comparison to the cash portion of the purchase price such as to achieve anticipated tax benefits, such benefits would make the limited partners essentially unconcerned about the nominal aggregate purchase price." *Id.*

91. *Id.* at 1009-10.

92. *Id.* at 1010 (quoting Brannen v. Comm'r, 78 T.C. 471, 509 (1982), *aff'd,* 722 F.2d 695 (11th Cir. 1982)).

93. *Fox,* 80 T.C. at 1010-11.

94. *Id.* at 1013.

95. 78 T.C. 659 (1982).

96. *Id.* at 661-62.

97. *Id.* at 678-79. Prior to the completion of the film, it was referred to as "The Veteran," "The Night Walk," and "When Andy Comes Home." After the film entered distribution, it was first titled "Dead of Night" and later "Deathdream." *Id.*

98. *Id.* at 678. John Marley and Lynn Carlin both received Academy Award nominations for their roles in the film. *Id.*

and had never viewed the film. Even though Siegel knew that the investment was highly risky, he thought that the limited partnership had some profit potential and would provide favorable tax benefits as well.[99]

Another limited partnership venture, Maditax, Inc., was originally supposed to purchase "Dead of Night" from David Perlmutter, president of Quadrant Films, Limited, and producer of the film. The parties agreed to a total purchase price of $1,000,000, $175,000 payable in cash and the balance evidenced by a nonnegotiable nonrecourse promissory note.[100] The transaction encountered several difficulties before the closing date, however, and the sale was never completed.

Perlmutter than contacted Richard Bridges, general partner of D.N. Company. Their discussions led to the eventual purchase of "Dead of Night." Under their agreement, the purchase price was only $900,000, $147,500 payable in cash and the balance of $752,500 represented by a nonnegotiable nonrecourse promissory note secured only by the film itself.[101] The contract entitled D.N. Company to receive a percentage of the film's gross receipts in the United States and Europe[102] as well as a percentage of the profits made from any television syndication.[103]

The film premiered in Tampa, Florida, and in a two-week span had approximately eighty bookings.[104] During this time period, however, the European distributor of "Dead of Night," Europix,[105] was having financial difficulties. D.N. Company consequently received no money from foreign distribution of the film.

After its initial two-week premiere, "Dead of Night" had little commercial success. The film underwent several title changes with the hope of increasing audience response to the picture, but the efforts were unsuccessful.[106] Bridges also attempted to exploit the film by selling the television rights to a television syndication,[107] but even this proved unprofitable.

On its U.S. Partnership Return of Income for the taxable year beginning October 1, 1974, and ending December 31, 1974, D.N. Company claimed a depreciable basis for the film "Dead of Night" of $900,000.[108] D.N. Com-

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99. *Id.* at 662. Siegel received a document entitled "The D.N. Company Tax Recap for 1 Unit" which stated that "in return for the purchase of one unit at $11,700, an investor could expect to realize, assuming a tax bracket of 53 percent, total tax reductions of $21,513, or a profit, resulting from the tax reduction over three years, of $9,813." *Id.*

100. *Id.* at 665. Mr. Perlmutter agreed to the $1,000,000 purchase price, $825,000 of which was evidenced by a nonrecourse note, principally because "if the note were paid, [my] Canadian investors in the film would receive twice as much as they had initially invested." *Id.*

101. *Id.* at 666.

102. *Id.* at 668.

103. *Id.*

104. *Id.* at 669-70.

105. *Id.* at 671; *see supra* text accompanying note 102.

106. *Siegel,* 78 T.C. at 674.

107. *Id.* at 875-76.

108. *Id.* at 680.

pany also declared deductions totaling \$210,779,[109] of which \$136,125 was attributable to its depreciation deduction.[110] These figures resulted in a net loss of \$203,350. The pattern of net losses continued for the following four years.[111]

On his 1974 tax return, Mr. Siegel claimed an investment in D.N. Company of \$89,100.[112] Based on his investment in the company, Siegel claimed a loss of \$20,132 plus additional first-year depreciation of \$2,000.[113] For the 1975 and 1976 tax years, Siegel claimed losses from D.N. Company of \$23,282 and \$29,117, respectively.[114] The Commissioner challenged the deductions attributable to the D.N. Company, alleging among other things that the acquisition of the film "Dead of Night" was an activity not engaged in for profit within the meaning of Code section 183 and that losses claimed by the partnership were therefore disallowed.[115]

The court conceded that the case was an extremely difficult one, with facts both supporting and contradicting Siegel's claim. The court stated that when analyzing the nine factors listed in section 1.183-2(b) of the Income Tax Regulations it would "proceed on a factor-by-factor basis mindful, of course, that we will not simply add up the 'score' and determine the outcome, but rather attempt to weigh all of the factors in reaching our ultimate conclusion."[116]

The court's "ultimate conclusion" was that D.N. Company's purchase and exploitation of "Dead of Night" was an activity engaged in for profit, and thus the partnership was entitled to the deductions claimed under section 162 except to the extent otherwise not allowable.[117] Several factors led the court to this decision. First, the court indicated that although the partnership's general partner, Bridges, had little movie experience, the person he hired to promote the film, Kilgore,[118] did. Kilgore's expertise in the movie field thus gave the partnership the requisite air of professionalism. Second, Bridges' business-like manner impressed the court, which interpreted his constant letter writing and negotiating sessions as actions seeking to protect the partnership interest.[119]

Finally, the court found that several unforeseeable independent events contributed to the partnership's losses.[120] For example, it could not be fo-

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109. *Id.*
110. *Id.* at 681.
111. *Id.* at 680. The net losses for 1975, 1976, 1977, and 1978 were \$235,172, \$311,033, \$41,537, and \$49,068, respectively. *Id.*
112. *Id.* at 682.
113. *Id.*
114. *Id.*
115. *Id.* at 683.
116. *Id.* at 700.
117. *Id.* at 704-05.
118. *Id.* at 702.
119. *Id.* at 701.
120. *Id.* at 703.

reseen that Europix would experience financial difficulties and be unable to remit D.N. Company's share of the proceeds. The court additionally noted that but for a critical oversight by Kilgore,[121] the partnership would have had more money available to inject into the promotional and advertising stage of the film campaign. Lastly, the court suggested that the opening scene of the movie, in which Andy is killed in a combat zone reminiscent of the Vietnam war, probably "turned-off" a majority of the younger movie-going audience.[122] The court concluded that while these factors did not totally explain the partnership's losses, they did show that the partnership "was off to a very poor start from which it never recovered"[123] and that there were several independent factors working against the film.

The courts in both *Fox* and *Siegel* faced essentially the same question: was the limited partnership engaged in an activity for profit or was it simply a means by which the investor could realize substantial tax benefits through avoidance and minimization? Both courts applied the "not engaged in for profit" language of section 183, and both courts expressly took into account the nine factors set out in the regulations. Yet even though the two cases were very similar on their facts, each court reached a different result. This is troubling not only from a fairness or equity standpoint, but also because of the effect it could have on a tax system based on voluntary compliance.[124]

The problem appears to lie in the lack of a clear judicial or legislative standard, and particularly in the application of the nine factors found in the Treasury Regulations. In theory, these factors provide the court with a set of objective criteria which, when applied to a particular case, allows the court to objectively ascertain the subjective intent of the taxpayer without ever having to "get inside his head." While theoretically a plausible venture, the problem is that the objective has not fully separated itself from the subjective. While the factors may in and of themselves exist as objective entities, the application of several of them necessitates subjective interpretation on the part of the court.[125] The factors have not succeeded in erad-

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121. *Id.* Kilgore spent $80,000 out of the $130,000 allotted for distribution of the film on advance prints alone. This expense restricted the size of the promotional campaign. *Id.*

122. *Id.*

123. *Id.* at 703-04.

124. Our tax system is a voluntary compliance system because each taxpayer voluntarily files a tax return assessing income and amount of taxes due. Former Commissioner Egger argues that openly touting abusive tax shelters as proper investments erodes public confidence in the tax system and weakens voluntary compliance. Egger, *supra* note 3, at 1675. Egger estimates that $75 to $80 billion a year in tax revenues are lost due to "normally law abiding citizens" cheating on their tax returns. Tax Cheats, *supra* note 3, at 17, col. 1.

125. For example, there is no mathematically precise answer to the question of how one operates in a business-like matter. *Compare* Churchman v. Comm'r, 68 T.C. 696, 702 (1977) ("Although she did not keep a complete set of books pertaining to her artistic activities, petitioner kept all of the receipts for her art expenses and kept a journal recording what she sold and to whom. These facts indicate . . . a business-like manner [carried on] for profit.") *with* Stanley v. Comm'r, 40 T.C.M. (CCH) 516, 524 (1980) ("Although Mrs. Stanley kept

icating the subjective from "not engaged in for profit" inquiries; they have simply hidden it behind a veil of objectivity.

A re-examination of *Fox* and *Siegel* demonstrates the forced reliance on subjective interpretation in the application of the nine regulation factors. For example, the *Siegel* court looked favorably on Bridges' efforts to keep the limited partners advised of what was happening with the movie. The court interprcted Bridges' letters as showing good business sense, something that someone actively engaged in making a profit would do. What the *Siegel* court does not address, however, is that in each letter that Bridges wrote to the partners he never failed to stress the tax benefits they would receive from the movie venture.[126] Thus, although Bridges adhered to the requisite form of a profit-motivated businessman, the substance of the letters leaves the true intent of the partnership unclear.[127]

Several other elements common to each case were approached differently by each court. First, in *Fox* the court regarded the lack of expertise of those associated with the partnership as dispositive of whether the activity was engaged in for profit. The fact that the partnership hired Stein and Day, a well-established publishing and distribution firm, to aid in the exploitation of the book had little effect on the court. In *Siegel,* the level of expertise that Siegel[128] and his co-investors possessed was similar to that possessed by the investors in the limited partnership in *Fox.* Unlike the court in *Fox,* however, the *Siegel* court emphasized the qualities of the person hired by the partnership to exploit the movie. After citing several of Kilgore's qualifications, the court concluded that "Mr. Kilgore was basically a very enthusiastic individual."[129] Again the court's subjectivity is called into play during the application of the objective factors.

Second, the *Fox* court noted Fox's lack of expertise and general noninvolvement with the actual workings of the limited partnership and found that Fox's actions reflected those of an investor solely interested in realizing a tax profit.[130] By contrast, the court in *Siegel* never questioned Siegel's motive for investing in the limited partnership. Had it done so, the court would have found that Siegel, too, had no expertise in the movie industry, that he did not become involved in the operational aspect of the limited

some records of her activities in a business like manner, . . . the 'trappings of a business' are insufficient to demonstrate that an activity is carried on for profit.").

126. *Siegel,* 78 T.C. at 672-73.

127. The *Fox* court, by contrast, stressed the significance of the tax benefit information contained within J.W. Associates' memorandum and letters: "The substance of these letters, totally acquiesced in by the petitioners for all that appears in the record before us, are tantamount to admissions by petitioners that unwarranted tax deductions solely motivated their participation in the J.W. Associates partnership." *Fox,* 80 T.C. at 1011.

128. Prior to investing in the D.N. Company, Siegel had invested in two apartment projects, one oil drilling venture, and a raw land investment. He had no movie experience. *Siegel,* 78 T.C. at 661.

129. *Id.* at 702.

130. *Fox,* 80 T.C. at 1012-13.

partnership, and that he had been advised of the potential tax benefits before he invested his money.

Third, the court in *Fox* indicated that the lack of "arm's length" negotiation over the purchase price was indicative of a lack of a profit motive.[131] In *Siegel,* however, the court did not question the propriety of the purchase price, even though Perlmutter admittedly decided on the $825,000 nonrecourse note figure only because "if the note were paid, [my] Canadian investors in the film would receive twice as much as they had initially invested."[132]

Finally, the *Fox* court did not recognize any outside independent events that might have influenced the profitability of J.W. Associates.[133] The *Siegel* court, however, implied that but for the occurrence of any one of three outside independent events—Europix's financial difficulties, Kilgore's "critical mistake," and the similarity of the opening scene of the movie to the Vietnam War—the movie could have been a financial success.[134]

As the preceding discussion demonstrates, the nine factors do not greatly aid the court in achieving any high degree of uniformity and objectivity in deciding section 183 cases. A recent Tax Court case attempted to circumvent the problems that arise when applying the nine factors.[135] In *Sheid v. Commissioner,* the court declined to base its decision on a factor-by-factor analysis of the case, choosing instead to examine all the facts and circumstances involved.[136]

B. Sheid

Harvey L. Sheid purchased a 3-1/3 percent interest in JHE Property Ltd. (hereinafter JHE) for $10,000.[137] JHE was formed by Edwin D. Abramson, the sole general partner, for the purposes of acquiring and exploiting a film entitled "The First Roman."[138] The United States and Canadian rights to the film were purchased by Allied Artists.[139] Their agreement with the European producer of the film, CCC Filmkunst and Company, GMBH K.G., called for a purchase price of $1,200,000, $280,000 payable in cash and $920,000 evidenced by a nonrecourse note, payable from twenty percent of any proceeds that the distributor might collect.[140] During negotiations for

131. *Id.* at 1009.
132. *Siegel,* 78 T.C. at 665.
133. The factors that the court relied upon are set out at *Fox,* 80 T.C. at 1008-13.
134. *Siegel,* 78 T.C. at 703. *See supra* notes 50-51 and accompanying text.
135. Sheid v. Comm'r, 50 T.C.M. (CCH) 663 (1985).
136. *Id.* at 670.
137. *Id.* at 665.
138. *Id.* at 664-65.
139. *Id.* at 666. "Allied was a distribution and production company which during 1971 and 1972 was classified as either the largest of the independent distribution companies or the smallest of the majors." *Id.* at 665.
140. *Id.* at 666. The principal source of film revenue was from movie theater showings. *Id.* at n.7.

the film, Peter Strauss, executive vice president of Allied, estimated the "upside" potential of the movie to be approximately five million dollars. At worst, Allied could recover the $280,000 cash investment from its eighty percent share of the distributor gross.[141]

Strauss approached Abramson[142] about the possibility of forming an investment group that would assume Allied's purchase understanding and contract with Allied as the distributor.[143] Abramson was impressed with "The First Roman" and asked for an estimate of the film's potential. Abramson had never had any business dealings with Allied, but he was aware of their reputation in the distribution field and was particularly impressed that Allied was willing to take on the responsibilities of marketing the film.[144] Strauss later informed Abramson that he would estimate "television sales at $800,000, nontheatrical and Canadian sales at $200,000, and theatrical distribution film rentals at $2,750,000," totaling $3,750,000.[145]

Abramson also agreed with Strauss' perception of the film's mass appeal. "The First Roman" was a "sandal and sword"[146] type film. The popularity of these films runs in cycles, and several have been very profitable. While there had been several successful "sandal and sword" films in the late 1950's and early 1960's, there had been none between then and the early 1970's. Strauss felt that the time for another series of these films had arrived, and both he and Abramson believed that much money could be made on a film introduced at the beginning of the cycle.[147]

The film opened in 1972 with disappointing results, and did no better in 1973. JHE's share of the film's revenue as reported on its 1972 tax form was $206.50. Using the income forecast method of depreciation, the partnership's depreciation deduction came to $786,269.91.[148] The partnership's distributive loss totaled $787,320.06,[149] of which Sheid's respective share equalled $226,217.75.[150] The Commissioner challenged the amount of Sheid's deduction attributable to JHE's loss.

In his opinion, Judge Whitaker stated that although a profit objective may be analyzed in relation to the nine factors set out in section 183's regulations, "those factors are not applicable or appropriate for every case. The facts and circumstances remain the primary test."[151] The court then

141. *Id.*

142. *Id.* Abramson was a certified public accountant who specialized in doing work for businesses in the entertainment field and for entertainers.

143. *Id.*

144. *Id.* at 666-67.

145. *Id.* at 667.

146. *Id.* at 666. The film was described as being similar to "David and Bathsheba," "The Robe," "Solomon," and "Hercules."

147. *Id.* at 666-67.

148. *Id.* at 668.

149. *Id.*

150. $787,320.06 multiplied by 3-1/3 percent equals $26,217.75.

151. *Sheid,* 50 T.C.M. at 670.

proceeded to evaluate certain facts that it considered dispositive of the profit objective issue.

First, the court stressed that Allied had nothing to gain by marketing the film solely as an abusive tax shelter.[152] While this might be true, the court failed to address the benefit that JHE would realize by operating as a tax shelter. For example, in its description of the facts the court made note of a confidential JHE memorandum that described the terms of the offering, the purchase price, and the tax consequences.[153] The court also mentioned that several Allied internal documents described the arrangement as a "tax shelter."[154] Without further explanation, however, the court concluded that the realization of tax benefits was not the predominant objective of either the general or the limited partners.[155] JHE acquired the film, the court ruled, with a predominant profit objective.[156]

Second, the court was strongly influenced by Allied's expertise in the movie distribution field. For example, the court decided that the analysis and initial profit projections that Allied gave to Abramson were reasonable because they were based on the "experience of knowledgeable persons."[157] In the court's judgment, Abramson was perfectly justified in not seeking a more formal and more objective appraisal.[158]

Lastly, the court found that Allied and Abramson had bargained at arm's length, despite the fact that Allied unilaterally set the purchase price with respect to Abramson.[159] The court thus decided that the fair market value of the film was its purchase price. In rejecting the Commissioner's argument that a profit motive was negated by the fact that the price of the movie so far exceeded its fair market value as to preclude JHE from making a profit, the court stated that because of the arm's length negotiations, appraisal testimony would have had little relevance.[160]

The court concluded that Abramson had conclusively established a good faith profit intent, and that the partnership was therefore engaged in exploiting "The First Roman" with a predominant profit objective.[161]

152. *Id.* at 669.
153. *Id.* at 667.
154. *Id.*
155. *Id.* The court stated that: "The fact that some employees of Allied may internally have referred to JHE as a 'tax shelter' is irrelevant." *Id.* at 669, n.20. Contrast this attitude with that seen in *Fox, supra* note 93.
156. *Sheid,* 50 T.C.M. at 669-70.
157. *Id.* at 670.
158. *Id. But see Fox,* 80 T.C. at 1009-10 (inconsistent with business-like conduct to have an interested party furnish an appraisal).
159. *Sheid,* 50 T.C.M. at 670.
160. *Id.*
161. *Id.*

C. *The Lessons of* Fox, Siegel, *and* Sheid

The *Sheid* decision sheds no more light on the problem of subjectivity in the application of the section 183 regulations than did either *Fox* or *Siegel.* Since the *Sheid* court declined to use section 183's regulations, it was not constrained to make the objective inquiries that the regulations impose which, as *Fox* and *Siegel* make evident, require determinations of subjective matters. It failed, however, to articulate any type of an objective standard. Instead, the *Sheid* court relied on its own intuition and discretion.

Neither *Fox, Siegel,* nor *Sheid* present a concise and unambiguous standard by which a court can determine whether an activity is engaged in for profit. Each decision turned on the particular court's subjective analysis of the facts. Aside from the obvious problems involved with the application of any subjective test, the most troubling feature of the three decisions is the difference in their evaluation and interpretation of the same facts. For example, the *Fox* court found the presence of tax benefit information in the partnership's memorandum and subsequent letters as critical to its findings that the partnership was not engaged in the activity for profit.[162] The *Sheid* court, by contrast, downplayed the presence of the tax benefit information contained in the partnership's memorandum,[163] and gave no weight to Allied internal documents which described the arrangement as a "tax shelter."[164] Another example involves the use of appraisals. The courts in both *Fox* and *Siegel* refused to accept projections and valuations made by persons associated with the transaction.[165] In *Sheid,* however, the court accepted the selling party's projection and valuation because the party's figure was based on the "experience of knowledgeable persons."[166]

The conflicting standards and approaches used in the courts' decisions result only in confusion and uncertainty among both taxpayers and courts. As one commentator aptly put it: "Confusion and uncertainty about the standard for the profit motive test and the situations to which it applies have made it into a doctrine with great *in terrorem* effect that can be and is invoked whenever a situation is too exploitative to suit the taste of a court."[167] As *Fox, Siegel,* and *Sheid* make evident, which factor is given the ultimate weight is often left to "intuitive judicial judgment."[168]

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162. *See supra* note 127 and accompanying text. *But see Siegel,* 78 T.C. at 672-74 (the court ignored the presence of tax benefit information in a letter sent to the limited partners by the general partner).

163. *Sheid,* 50 T.C.M. at 667.

164. *Id.*

165. *Fox,* 80 T.C. at 1009-10; *Siegel,* 78 T.C. at 689.

166. *Sheid,* 50 T.C.M. at 670.

167. Cooper, *supra* note 2, at 685.

168. Estate of Baron v. Comm'r, 83 T.C. 542, 559 (1984), *aff'd,* 798 F.2d 65 (2d Cir. 1986).

IV. THE NEED FOR STATUTORY REFORM

Uncertainty and confusion over the application of the "not engaged in for profit" criteria has produced both equity[169] and efficiency[170] problems. Only two classes of people are likely to benefit from this uncertainty: those who promote the shelters and those who invest in them.

The courts and the Internal Revenue Service aggressively apply the "not engaged in for profit" test to distinguish between activities in which tax deductions and credits will be recognized and those in which they will not. The lack of a clear and concise standard, however, has greatly hindered their efforts. In particular, the ambiguity in the application of the nine factors found in the regulations to section 183 has led the courts farther away from a clearly definable standard and closer to a more subjective, more intuitive approach. *Fox, Siegel,* and *Sheid* reflect the inconsistencies inherent in the application of section 183's regulations. A closer analysis of the cases reveals, however, that the problem lies not as much in the application of section 183 as in the section itself: the "not engaged in for profit" test is simply not adequate to deal with the wide variety of tax shelter schemes presently available.

In *Fox, Siegel,* and *Shied,* for example, it was the presence of nonrecourse debt that generated the tax benefits that appcaled to the investors. But for the presence of the debt, it is doubtful that any of the three ventures would have been as successful in attracting investors. Neither the two movies nor the book, solely on their own artistic merit, had a legitimate chance at making a real profit. Only when coupled with the leveraged debt[171] was the potential for a tax profit greatly magnified.[172]

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169. The Commissioner of Internal Revenue has recently stated:

> [T]he viability of our tax administration system depends to a great extent on taxpayers' perceptions that the system is fair and equitable and is administered in a fair but firm manner. When abusive, illegal, and fraudulent tax shelters are openly touted as proper investments, public confidence in the tax system declines rapidly, producing the likelihood of reduced revenues and voluntary compliance and all that that implies.

Egger, *supra* note 3, at 1675.

170. In its simplest sense, abusive tax shelters are not efficient because they produce tax benefits from investments that are, in economic terms, losing money. Prof. Cooper argues that "[t]he existence of tax . . . opportunities on levered transactions causes the law to encourage investment in economically unsound ventures violating every efficiency objective, and it invites transactions that undermine the equity of the system and create an impression of rampant abuse." Cooper, *supra* note 2, at 714.

171. Professor Cooper states:

> The basic, hard-core problem is leverage. Leverage is what moves transactions from the intended exempt-equivalent stage to the better-than-exempt situation and thereby raises serious efficiency problems . . . . Leverage is also what provides "cheap," tax-subsidized access to tax benefits, which is so critical to making gimmicky deals work.

Cooper, *supra* note 2, at 715-16.

172. *See* Note, *supra* note 3, at 435 n.27.

In none of the above cases did the courts' application of the "not engaged in for profit" test of section 183 account for the importance of the leveraged debt to the overall profitability of the tax shelter. Ignoring the presence of the nonrecourse debt and focusing primarily on the ability of a shelter to generate a net profit figure does not adequately address the question of true profit motive. In these situations, courts can do no more than attempt to determine the subjective intent of the investor from the putatively objective criteria found in the regulations. This invariably leads to the difficulties encountered in the above cases, most notably those of defining a business-like manner, valuation, and profit.

One commentator suggests that the key to combatting the tax shelter is to focus on its use of leveraged debt and its economic consequences outside of section 183.[173] This approach, however, would be only slightly more useful than the analysis the courts presently employ. By making the presence of debt in a tax shelter a "tenth" factor, the courts would benefit from an expanded arsenal with which to combat tax abuse. Promulgating this as a new factor, however, would also necessarily diminish its effectiveness. As an additional factor, its application would be subject to the same vagaries of judicial discretion noted in *Fox* and *Siegel*. Focusing on the presence of debt, then, becomes but another stopgap measure in the catchup battle against abusive tax shelters.

A more workable alternative to the "not engaged in for profit" dilemma would be to rewrite section 183 so that it contains a rebuttable presumption that the taxpayer is *not* engaged in an activity for profit. This approach has three principle benefits. First, it substitutes judicial discretion for the will of the legislature. Second, it is a more direct attack on potential taxpayer abuse. Finally, it provides taxpayers and courts with a more clear, concise, and workable rule. Giving the taxpayer an affirmative duty to prove that he was engaged in an activity for profit will better prevent section 183 abuse because if the taxpayer cannot carry his burden of proof, the activity will be presumed to be not engaged in for profit and all tax benefits will be lost.

Conclusion

Uncertainty and ambiguity in the application of the section 183 "not engaged in for profit" test has been a major factor in the recent proliferation of abusive tax shelters. Today, neither the statutory framework nor the court-manufactured legal standard has been able to sufficiently deal with determining whether an activity is engaged in for profit. The Tax Court attempted to remedy this in *Sheid v. Commissioner* by removing the court's

173. Cooper, *supra* note 2, at 717. Cooper suggests that a complete reform requires an attack on all leverage since leveraged tax benefits are inherently abusive.

reliance on the nine regulation factors. This approach, however, only begs the question. Even if a court does not overtly rely on the regulation's nine factors, it is still not clear what a taxpayer must show to arrive at the required profit motive. A more workable approach would be to structure section 183 so that it contains a rebuttable presumption that the taxpayer is not engaged in an activity for profit. This approach will be much easier for courts to administer, will lessen taxpayer abuse, and will achieve a greater degree of equity and efficiency for all.

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