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ART FOR IRS' SAKE: HOBBY LOSS RULES AND ARTISTIC ENDEAVORS

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In Crile v. Commissioner, T. C. Memo. 2014-202 (Oct. 2, 2014), the United States Tax Court recently ruled that a tenured art professor's artistic endeavors constituted a "business" rather than a "hobby." Internal Revenue Code Section 183 limits taxpayers' deductions to the extent of income earned if the activity is not engaged in for profit, i.e. a hobby, rather than a business. In this presentation, we examine the nine factors considered by the court in distinguishing between businesses and hobbies and discuss how the facts and circumstances of the taxpayer in this case prompted the court to decide in her favor. Practical recommendations are made to assist taxpayers to determine whether their art constitutes a hobby or an activity engaged in for profit and how to strategize their activities so that they too can deduct expenses despite the fact that a profit may not have been realized.

Keywords: Tax Law, Hobby losses, Business and Trade Deductions

INTRODUCTION

How do tax courts distinguish between a fully deductible business expense and the limited deductions available to activities labeled as hobbies? And when the hobby involves the arts - how do these courts determine when the exercise of artistic expression is a hobby and when it is a business? A recent decision of the United States Tax Court tackled these very questions, giving us insight into the criteria utilized to differentiate the two and at the same time helping us discern how an artists' activities are viewed by the IRS.

In general, taxpayers may deduct ordinary and necessary expenses for conducting a trade or business. An ordinary expense is an expense that is common and accepted in the taxpayer's trade or business and a necessary expense is one that is appropriate for the business. Generally, an activity qualifies as a business if it is carried on with the reasonable expectation of earning a profit. The hobby loss rules were created by the Internal Revenue Service to prevent taxpayers from entering into ventures primarily to incur expenses they can deduct from other income. If the activity is classified as a hobby, limitations are placed on expenses one can deduct. Controversies often arise due to the classification of an activity by a taxpayer. Before looking at the specific case, it is important to look at the relevant statutes.

STATUTORY OVERVIEW

Code Section 162(a) allows as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business. To be entitled to the deduction, the taxpayer must be engaged in the activity with a profit motive.

Code Section 183 provides in pertinent part that if an activity is not engaged in for profit, no deduction attributable to it is allowed except to the extent of gross income.

Sec. 1.183-2(b) of the Income Tax Regulations sets forth a nonexclusive list of nine factors relevant in ascertaining whether the taxpayer conducted an activity with the intent to earn a profit. They are (1) the manner in which the taxpayer conducts the activity; (2) the expertise of the taxpayer or her advisers; (3) the time and effort

spent by the taxpayer in carrying on the activity; (4) the expectation that assets used in the activity may appreciate in value; (5) the success of the taxpayer in carrying on other or dissimilar activities; (6) the taxpayer's history of income or losses with respect to the activity; (7) the amount of occasional profits, if any; (8) the financial status of the taxpayer; and (9) elements of personal pleasure or recreation. Petitioner bears the burden of proving that she conducted her art business with a predominant, primary or principal objective of earning a profit.

CRILE V COMMISSIONER

Facts

Susan Crile, the petitioner was an artist and a full time tenured art professor at Hunter College, CUNY, in New York City. Petitioner had a long, varied and distinguished career as an artist, though rarely profitable. During the academic year, Ms. Crile devoted approximately 30 hours a week to her art working at a small studio in her Manhattan apartment. During the summer, she worked full time on her art business using a large studio upstate. During the petitioner's career, she created more than 2,000 pieces of art. Her artwork hangs in the permanent collection of at least 25 museums. Petitioner's artwork was acquired by for-profit as well as nonprofit entities. She had been represented by at least five New York art galleries and has received recognition from prestigious art organizations. Additionally, she devoted hundreds of hours a year to the administrative aspects of her business that were unrelated to her job as an art professor. She conducted her activity as a business by keeping detailed and accurate records and by pursuing a business plan that included marketing. During the years in issue from 2004-2009, the petitioner worked on five main projects. Crile deducted all the expenses related to her painting as a business expense during the disputed periods.

The IRS determined deficiencies with respect to her Federal Income tax for 2004-2005 and 2007-2009. The determinations of the IRS were based on two theories. First, the classification of the petitioner's activity as an artist was an "activity not engaged in for profit" within the meaning of Code § 183 and therefore was not entitled to claim deductions in excess of income. Second, if petitioner was engaged in a trade or business, the deductions were not ordinary and necessary business expenses within the meaning of Code § 162(a). The petitioner's main source of income during the years in issue were from teaching. Additionally, her achievements as an artist secured her tenured teaching position. It was expected that she continues to make and exhibit art as a tenured faculty member.

Holding

The Tax Court held that the petitioner's art business was properly classified as a trade or business.

Analysis

The regulations specify that, in determining whether section 183 applies for a particular activity, a threshold determination must be made as to the scope of that activity. The "activity" to be considered under section 183 may encompass a single undertaking or multiple undertakings. In ascertaining whether multiple undertakings constitute a single activity, all the facts and circumstances are taken into account. Significant facts include: (1) the degree of organizational and economic interrelationship of various undertakings; (2) the business purpose which is (or might be) served by carrying on the various undertakings separately or together; and (3) the similarity of various undertakings. The IRS argued that "petitioner's bifurcation of her art activity as an 'artist' separate from that of 'artist professor' for Hunter College is artificial and is not supported by the facts and circumstances of this case." It is undisputed that petitioner's activity as a professor is a "trade or business." The Tax Court concluded that petitioner's art business and her salaried position as a professor constitutes two distinct activities. The court noted that the regulations provide that the IRS will generally "accept the characterization by the taxpayer of several undertakings either as a single activity or as separate activities" and opined that the taxpayer's characterization will be rejected only where it "is artificial and cannot be reasonably supported under the facts and circumstances of the case."

The regulations set forth a nonexclusive list of nine factors relevant in ascertaining whether the taxpayer conducted an activity with the intent to earn a profit. They are: (1) the manner in which the taxpayer conducts the activity; (2) the expertise of the taxpayer or her advisers; (3) the time and effort spent by the taxpayer in carrying on

the activity; (4) the expectation that 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 losses with respect to the activity; (7) the amount of occasional profits, if any; (8) the financial status of the taxpayer; and (9) elements of personal pleasure or recreation. No one factor or group of factors is controlling and it is not necessary that a majority of factors point to one outcome.

The court looked at the first factor, the manner in which the petitioner conducted her activity. Conducting a business in a businesslike manner may show that the taxpayer intended to earn a profit. Citing Churchman v. Commissioner, 68 T.C. 696 (1977), where the tax court held that a taxpayer who had been involved in art activities for 20 years had a profit motive. Petitioner had kept records that are substantially similar to those maintained by the taxpayer in Churchman. Petitioner also had a business plan which is evidence of a profit motive. The Churchman petitioner or Crile had a business plan?

A second factor, a taxpayer's expertise, research, and study of the accepted practices in an industry, as well as her consultation with experts, may indicate a profit motive. In cases involving artists, the Tax Court considered (among other things) the taxpayer's education, teaching activities, public recognition, and skills. In Churchman, 68 T.C. at 702, the court found that the taxpayer had the requisite expertise as an artist where she studied art for 2½ years, taught art at the college level, had her works shown in commercial galleries at least once a year, and was the subject of articles and critical reviews in newspapers and magazines. By these standards, there is was no dispute that petitioner ranks at the top of the scale in terms of expertise as an artist.

The third factor, taxpayer's time and effort indicates a profit motive because the petitioner devoted a considerable time and effort to her art business. The court noted, "Petitioner devoted roughly 30 hours per week to her art business during the academic year and worked on her art full time during the summer. These facts compare favorably to those of other cases in which the taxpayer was found to be engaged in a trade or business."

The fourth factor is the expectation of appreciation in value. An expectation that assets used in the activity will appreciate in value may indicate a profit motive. The Court noted, "During 2004-2009 petitioner had an inventory of at least 1,500 pieces of art available for sale. She had an extensive exhibition record, numerous positive critical reviews, current or prior representation by five galleries, and multiple awards and accolades evidencing her public recognition. At least 25 museums had acquired her works, as well as dozens of major corporations and government institutions. She had a long history of sales with proceeds approaching \$1,200,000. She earned income of almost \$112,000 from sale of art in 1995, and she could plausibly expect that such good years would recur."

The fifth factor examines the taxpayer's success in other activities. The Tax Court noted, "A track record of success in other business ventures may indicate that the taxpayer has the entrepreneurial skills and determination to succeed in subsequent endeavors. This in turn may imply that the taxpayer, when embarking on these endeavors, does so with the expectation of making a profit. In a typical section 183 case, the taxpayer achieves considerable success in a business activity and later embarks on a new activity that the IRS regards as a hobby or sport. Here the sequence is reversed. Petitioner embarked on the challenged activity (as an artist) a decade before she secured her salaried position (as a professor). And she practiced as an artist for 25 years before becoming a full professor in 1996."

The sixth factor reviews the history of income or losses. The regulations indicate that the fact that a taxpayer incurs a series of losses beyond an activity's startup years may imply the absence of a profit objective. This inference may not arise where losses are due to "customary business risks or reverses" or to "unforeseen or fortuitous circumstances which are beyond the control of the taxpayer." Petitioner had reported losses for at least 18 out of the last 20 years. Citing Waitzkin, 63 T.C.M. at 2745, "It is well recognized that profits may not be immediately forthcoming in the creative art field. Many artists have to struggle throughout their careers. This does not mean that serious artists do not intend to profit from their activities." Although the petitioner demonstrated the economic hardships for artists during the years in issue, the sixth factor favored the respondent.

The seventh factor examines the amount of occasional profits. According to the regulations, the fact that a taxpayer derives some profits from an otherwise money losing venture may support the existence of a profit motive. Moreover, "an opportunity to earn a substantial ultimate profit in a highly speculative venture is ordinarily sufficient

to indicate that the activity is engaged in for profit even though losses or only occasional small profits are actually generated.”

The eighth factor reviews the taxpayer’s financial status. The fact that a taxpayer lacks substantial income or capital from sources other than the activity may indicate that she engages in the activity for profit. An activity that produces losses, if recognized as a trade or business, will normally generate tax benefits for a taxpayer with other income. The receipt of such tax benefits, standing alone, does not establish that the taxpayer lacks a profit motive for the activity. See Engdahl, 72 T.C. at 670. Petitioner earned a salary from her position at Hunter College and derived relatively modest income from investments. Petitioner was a practicing artist for over a decade before she began teaching at Hunter College. The court found that petitioner’s art business was her primary activity and she did not become an artist in order to shield her other income from taxes concluding that this factor is neutral.

The ninth factor examines elements of personal pleasure. The fact that a taxpayer derives personal pleasure from an activity, or finds it recreational, may suggest that she engages in it for reasons other than making a profit. However the court pointed out that the derivation of personal pleasure, however, “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.”

After an analysis of the nine factors, the Tax Court found “The first, second, third, and fourth factors set forth in section 1.183-2(b), Income Tax Regs., strongly support the conclusion that petitioner engaged in her art activity with an actual and honest expectation of profiting from it. We conclude that the fifth, eighth, and ninth factors slightly favor petitioner or are neutral. Only the sixth and seventh factors, focusing on losses and occasional profits, favor respondent, but they favor him less strongly in these cases than in many section 183 cases. In a qualitative as well as a quantitative sense, we conclude that the balance of factors favors petitioner and that she has met her burden of proving that in carrying on her activity as an artist, she had an actual and honest objective of making a profit.”

LESSONS LEARNED AND IMPLICATIONS DERIVED FROM THE CRILE CASE

The popular stereotype of artists is that they are creative, eccentric and impulsive, rather than organized, methodical, and systematic. Whether this is true or not is irrelevant – except in the area of record keeping. The ability to keep precise and orderly records appears to be the key to an artist convincing the IRS (or the Tax Court) that her activities constitute a business rather than a hobby.

As has been indicated, characterizing the artist’s endeavors as a hobby could deprive the artist of the right to deduct all expenses incurred in producing her art. The need to maximize deductions is especially compelling to an artist because the costs are often high – studio space, materials, etc.... – but the rewards are often minimal. Their artistic careers often do not yield a living wage compelling them perhaps to seek other sources of income. And once they have procured a steady source of alternative income they may experience an even harder time convincing the IRS that their artistic pursuits are a business rather than a hobby.

This is the precise dilemma experienced by Susan Crile and her case serves as a blueprint for other artists to follow if they have a similar work history. Crile did a number of things “right.” She developed a business plan (although not written), developed a marketing strategy, kept careful records of all her paintings and sales, and devoted a significant amount of time to her art. She was accomplished enough as an artist to have been represented by legitimate art galleries, a number of her works were owned by museums, she had several exhibitions and she received various prizes for her work. Her case demonstrates that artists must contribute a significant amount of time, which Crile did, to administrative matters to ensure that their pursuits are viewed as professional rather than an amusement.

Interestingly, the type of secondary work she obtained complicated Crile’s case. As an art professor, Crile was required to continue painting and exhibiting. She had to do this in order to get tenure and to keep her job. The IRS contended that her painting was in support of her primary work, that of teaching, and that her career as an artist was secondary to that. It claimed that “[p]etitioner’s bifurcation of her art activity as an ‘artist’ separate from that of

'artist professor' for Hunter College is artificial and is not supported by the facts and circumstances of this case." The IRS "single activity" argument is that Crile could only claim her art-related expenses, not as business expenses on Schedule C, but rather as unreimbursed employee business expenses on Schedule A, Itemized Deductions. As such, they were subject to the floor created by sections 62(a) and 67(a) and to adverse alternative minimum tax consequences. That put Crile in a Catch-22 situation.

A teaching career is a common choice for artists. It allows them to teach what they know and provides them with a steady income and benefits. It also allows for summers off during which time they have the opportunity to pursue their art. The fact that the IRS used this as a strategic weapon against the artist is rather disturbing and points out the blurring of lines between the two pursuits. Artists must be sensitive to the fact that their various pursuits are symbiotic may provide grounds to the IRS to deny deductions.

The solution to this problem appears to be the one pursued by Crile. Artists should keep detailed and organized records of their works, where they are marketed, who is selling them, all offers and ultimate disposition. They should document all expenses and be prepared to explain and rationalize how they relate to their art. They should develop a business plan that includes a marketing plan, preferably in writing. They have to devote significant and consistent amounts of time to their work – not only to the creation of art but also to the business of art. If possible, they should also be able to demonstrate steady sales, exhibits and recognition of their status as an artist. In other words, they must professionalize themselves regardless of what other type of job they are doing. They can be as creative and as eccentric as they wish but they must also discover and encourage their inner accountant to provide orderly and meticulous documentation.

CONCLUSION

The Crile case highlights the confusion that artists confront in the determination of whether their work constitutes a hobby or a business. The case outlines the nine criteria provided by IRS regulations that are used to distinguish between the two. It also provides insight into how the Tax Court navigates between an artist's art and other jobs that the artist may pursue, the artist who wishes to fully deduct the full amount of expenses related to artistic endeavors rather than be limited to the hobby loss rules would do well to follow Susan Crile's example. Diligence – in record keeping, working, and in pursuing sales of one's art – seem to be the best defense against the IRS' attempt to limit deductions.

REFERENCES

26 U.S.C. § 162

26 U.S.C. § 183

Churchman v. Commissioner, 68 T.C. 696 (1977)

Crile v. Commissioner, T.C. Memo 2014-202 (2014)

Engdahl v. Commissioner 72 T.C. 659

Giles v. Commissioner, T.C. Memo 2005-28

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Treas. Reg. § 1.183-1

Treas. Reg. § 1.183-2(b) (1)

Waitzkin, 63 T.C.M at 2745