

1996

The Primary Profit Objective Test: An Unworkable Standard?

Michelle B. O'Connor
Arnold & Porter

Follow this and additional works at: <http://lawcommons.luc.edu/lucj>

 Part of the [Tax Law Commons](#)

Recommended Citation

Michelle B. O'Connor, *The Primary Profit Objective Test: An Unworkable Standard?*, 27 Loy. U. Chi. L. J. 491 (1996).
Available at: <http://lawcommons.luc.edu/lucj/vol27/iss3/3>

This Article is brought to you for free and open access by LAW eCommons. It has been accepted for inclusion in Loyola University Chicago Law Journal by an authorized administrator of LAW eCommons. For more information, please contact law-library@luc.edu.

The Primary Profit Objective Test: An Unworkable Standard?

*Michelle B. O'Connor**

I. INTRODUCTION

One of the underlying themes of the Internal Revenue Code (the "Code")¹ is the denial of deductions for personal expenses. Under the Code, a taxpayer generally may deduct only those expenses paid or incurred in connection with an activity entered into and carried on for profit.² Early in the development of the law of federal income taxation, courts attempted to draw a dividing line between business and personal expenses. In this attempt, courts considered whether a taxpayer entered into or engaged in an activity with a motive or objective to generate a profit.³ This examination of a taxpayer's profit motive is

* The author graduated from Washington & Lee University School of Law in 1991. She served as a law clerk for the Honorable Stephen J. Swift, United States Tax Court, from 1991 to 1993. She currently works as an associate at Arnold & Porter, of Washington, D.C.

1. The Internal Revenue Code of 1986 is codified at 26 U.S.C. §§ 1-9722 (1988) [hereinafter the "Code"].

2. The distinction between personal and business expenditures is summarized in the Treasury Regulations as follows:

Deductions are allowable under section 162 for expenses of carrying on activities which constitute a trade or business of the taxpayer and under section 212 of the Code for expenses incurred in connection with activities engaged in for the production or collection of income or for the management, conservation, or maintenance of property held for the production of income.

Treas. Reg. § 1.183-2(a) (1972). Except as provided in § 183 and its corresponding Treasury Regulation § 1.183-1, the Code does not allow deductions for expenses incurred in connection with activities not engaged in for profit. *Id.*

Numerous examples of the distinction between business and personal expenses exist in the Internal Revenue Code. *See, e.g.*, I.R.C. § 119(a)(2) (1995) (excluding the value of lodging provided by employer from employee's gross income only if "the employee is required to accept such lodging on the business premises of his employer as a condition of his employment"); I.R.C. § 165(c) (1995) (allowing individuals to deduct only "(1) losses incurred in a trade or business; (2) losses incurred in any transaction entered into for profit" and (3) certain casualty and theft losses); I.R.C. § 262 (1995) ("Except as otherwise expressly provided in this chapter, no deduction shall be allowed for personal, living, or family expenses."); I.R.C. § 280A (1995) ("Except as otherwise provided in this section . . . no deduction . . . shall be allowed with respect to the use of a dwelling unit which is used by the taxpayer during the taxable year as a residence.").

3. *See, e.g.*, *Aviation Club of Utah v. Commissioner*, 162 F.2d 984, 986 (10th Cir. 1947); *Seaman v. United States*, 156 F.2d 719, 723-24 (7th Cir. 1946); *Coffey v. Commissioner*, 141 F.2d 204, 205 (5th Cir. 1944); *Paine v. Commissioner*, 102 F.2d

commonly referred to as the "profit objective test." As stated by the United States Supreme Court:

For income tax purposes Congress has seen fit to regard an individual as having two personalities: "one is [as] a seeker after profit who can deduct the expenses incurred in that search; the other is [as] a creature satisfying his needs as a human and those of his family but who cannot deduct such consumption and related expenditures."⁴

In determining whether a taxpayer's objective in making an investment included profit, courts have applied one of two tests. The majority of courts apply a test which considers whether a taxpayer acted pursuant to "any" or "a" profit objective when she entered into or carried on the activity in question.⁵ This test is referred to as the "actual and honest" test.⁶ A number of courts, however, have applied a test that

110, 112 (1st Cir. 1939).

4. *United States v. Gilmore*, 372 U.S. 39, 44 (1963) (footnote omitted) (quoting S. SURREY & W. WARREN, *CASES ON FEDERAL INCOME TAXATION* 272 (1960)); see also Adam D. Chinn, Note, *Attacking Tax Shelters: Section 183 Leaves the Farm and Goes to the Movies*, 61 N.Y.U. L. REV. 89, 89-90 (1986) [hereinafter *Tax Shelters*] (concluding that § 183 of the Code was intended to make a distinction between business expenses and personal hobby expenses); see also Joel E. Miller, *Supreme Court in Portland Golf Club Reserves on a Key Profit-Intent Question and Adopts a Pervasive Estoppel-by-Reporting Rule*, 15 REV. TAX'N INDIVIDUALS 108, 110 (1991) (explaining that several deduction provisions of the Code incorporate the "profit/income concept" which allows deductions only if the taxpayer intended to earn a profit in carrying on an activity) For further discussion of *Portland Golf Club v. Commissioner*, 497 U.S. 154 (1990), see *infra* notes 36, 114-16, and accompanying text.

Most of the case law considering the profit objective test issue has arisen in the context of hobbies. *Faulconer v. Commissioner*, 748 F.2d 890 (4th Cir. 1984), provides a good example of a typical case that arises in the hobby-loss context. In *Faulconer*, the taxpayer incurred substantial losses in five out of seven years in connection with certain cattle and horse breeding activities. *Id.* at 891-92. In considering whether the taxpayer's activities constituted a trade or business, the court analyzed whether the taxpayer carried on the activity with a profit objective. *Id.* at 895. In making its determination, the court considered, by way of example only, the following factors: (1) the "manner in which the taxpayer carried on the activity[;]" (2) the expertise of the taxpayer; (3) "the time and effort expended by the taxpayer in carrying on the activity[;]" and (4) the income and losses generated by the activity. *Id.* at 896-901. However, in recent years, the profit objective test has been increasingly applied in a purely business context (i.e., a context lacking the recreational aspects traditionally associated with hobbies). See *infra* notes 62-64 and accompanying text.

Indeed, many courts have attempted to apply the primary profit objective test in business situations where significant tax benefits were recognized by a taxpayer. In many of these "tax shelter" type situations, there is absolutely no recognizable manner in which a taxpayer might be found to have entered into an activity as a hobby. For a discussion of these cases, see *infra* notes 48-54 and accompanying text.

5. See *infra* notes 55-57 and accompanying text (discussing the application of the actual and honest test by several lower courts).

6. See, e.g., *Smith v. Commissioner*, 937 F.2d 1089, 1093 (6th Cir. 1991) ("Under §

considers whether a taxpayer acted pursuant to a "primary," "predominant," "dominant," or "principal" profit objective when she entered into or carried on the activity in question.⁷ This test is referred to as the "primary" test.⁸

The primary test, however, presents both practical and theoretical problems.⁹ First, neither the Code nor the regulations require a taxpayer to show that the objective to earn a profit was the most important reason he or she entered into or carried on an activity.¹⁰ Second, the restrictive nature of the primary test is incompatible with the reality of the individual decision-making process.¹¹ Additionally, its restrictive

183, an activity is engaged in for profit if the taxpayer entertained an actual and honest . . . profit objective by engaging in the activity."); *Evans v. Commissioner*, 908 F.2d 369, 373 (8th Cir. 1990) (claiming that if an activity was entered into for the actual and honest purpose of making a profit, it can be considered a trade or business); *Burger v. Commissioner*, 809 F.2d 355, 358 (7th Cir. 1987) ("It is well settled that a taxpayer's expectation of profit need not be reasonable; instead, only a good faith expectation of profit is required.") (citation omitted). See also *infra* notes 55-57 and accompanying text (discussing the actual and honest test).

7. See *infra* notes 58-101 and accompanying text.

8. See, e.g., *Landreth v. Commissioner*, 859 F.2d 643, 645 (9th Cir. 1988) ("allow[ing] taxpayers to deduct losses . . . only if they can show that their primary motive for entering into the transactions was economic profit"); *Lamont v. Commissioner*, 339 F.2d 377, 380 n.4 (2d Cir. 1964) ("Words such as 'basic,' 'dominant,' and 'primary,' describ[e] the degree of necessary profit motivation . . ."); *Early v. Atkinson*, 175 F.2d 118, 122 (4th Cir. 1949) (finding that "purpose to derive a gain must be the chief or primary one"); *Estate of McGlothlin v. Commissioner*, 44 T.C. 611, 621 (1965) (stating the "prime motive" for entering a transaction must be the expectation of profit in order to deduct), *aff'd*, 370 F.2d 729 (5th Cir. 1967). See also *infra* notes 48-54, 58-99, and accompanying text (discussing the primary test).

9. See *infra* part III.A-B.

10. See *infra* notes 31-47 and accompanying text (discussing Code § 183 and the regulations thereunder).

11. See *infra* part IV (discussing the incompatibility of the primary test with the process of individual decision-making). In a business context, a taxpayer must consider tax incentives and disincentives when making investment decisions. See *infra* notes 133-42 and accompanying text (discussing judicial opinions acknowledging that a taxpayer must necessarily take into account tax incentives when deciding whether or not to make a particular investment).

Whether tax incentives rank more importantly to a taxpayer than earning a profit depends upon many variables, such as the risk and potential return of a particular investment. Congress has recognized the significance of tax incentives on many occasions by providing tax benefits to encourage certain types of investments that would be too risky from a purely profit-oriented perspective. See, e.g., I.R.C. § 168 (1995) (providing for accelerated depreciation). Congress originally enacted § 168 in 1981 because Congress believed that the old depreciation rules did not provide "the investment stimulus that is essential for economic expansion." S. REP. NO. 144, 97th Cong., 1st Sess. 47 (1981), reprinted in 1981 U.S.C.C.A.N. 105, 152; see also I.R.C. §§ 38(b)(2), 51, 52 (1995) (targeted jobs tax credit); I.R.C. § 42 (1995) (low income housing tax credit); I.R.C. § 41 (1995) (credit for qualified research activities); I.R.C. § 47 (1995) (tax credit for qualified rehabilitation of certain historic buildings).

nature creates problems for the courts, the Commissioner, and taxpayers.

Indeed, the primary test provides no workable standard for courts to use in determining whether an activity is "for profit."¹² The lack of such a standard is due in part to the inherent difficulty involved in any comparison of individual motivations.¹³ Critics of the primary test have, accordingly, suggested that the primary test should be limited to apply solely to the hobby context.¹⁴

Instead of requiring a taxpayer to show that a profit objective induced the taxpayer to enter into or carry on an activity under the primary test, courts should utilize existing judicial doctrines to deal with investments perceived to be overreaching or abusive.¹⁵ This will enable courts to curb illegitimate or abusive investment activities without creating and struggling with unworkable standards for determining the existence of a profit objective.

This Article examines the two tests which courts use to determine whether a taxpayer has entered into an investment with a profit objective: the actual and honest test and the primary test. First, this Article reviews the early development of the profit objective analysis by the courts and examines the statutory measures Congress has employed in differentiating between business and personal expense deductions and the corresponding treasury regulations.¹⁶ Next, the Article traces the judicial development of the profit objective test, focusing on the primary test.¹⁷ Then, this Article examines how the primary test is incompatible with an individual's decision to invest¹⁸ and discusses alternative methods to the primary test for determining profit objective.¹⁹ Finally, this Article concludes that the primary test represents

12. See *infra* notes 65-99 and accompanying text (discussing difficulties faced by courts applying primary test).

13. See *infra* notes 65-99 and accompanying text (discussing different applications of the primary test by courts).

14. See *infra* notes 102-07 and accompanying text. Although this Article does not address fully the considerations involved in the hobby context, such a limitation equally lacks any statutory basis and is inherently inconsistent with the individual decision-making process.

15. See *infra* notes 148-52 and accompanying text (discussing the existing judicial doctrines and statutory measures for curbing abuse of tax benefits, such as the sham transaction doctrine, the step-transaction doctrine, the business purpose doctrine, and the substance over form doctrine).

16. See *infra* part II.

17. See *infra* part III.

18. See *infra* part IV.

19. See *infra* part V.

an unworkable test that should be abandoned by the courts in favor of other judicial doctrines, specifically the actual and honest test.²⁰

II. EARLY DEVELOPMENT OF THE PROFIT OBJECTIVE TEST

A. *Judicial Development*

The profit objective test originated as a doctrine developed by the courts²¹ to distinguish between business and hobby activities for purposes of the business deductions provided under section 162²² and other Code sections.²³ Courts applying this doctrine generally considered whether an activity was “motivated by a desire for profit.”²⁴ To

20. *See infra* part VI.

21. *See* Schley v. Commissioner, 375 F.2d 747, 748 (2d Cir. 1967) (discussing § 165(a) and (c)); Teitelbaum v. Commissioner, 346 F.2d 266, 269 (7th Cir. 1965) (discussing farm losses); White v. Commissioner, 227 F.2d 779, 780 (6th Cir. 1955) (discussing § 23(e) of the 1939 Code, the predecessor of § 162 of the 1988 Code), *cert. denied*, 351 U.S. 939 (1956); Coffey v. Commissioner, 141 F.2d 204, 205 n.3 (5th Cir. 1944) (discussing operation of farm for recreation); Helvering v. Highland, 124 F.2d 556, 560-61 (4th Cir. 1942) (comparing an estate to an individual for deduction purposes); Farish v. Commissioner, 103 F.2d 63, 65 (5th Cir. 1939) (finding profit motive where businessman hired successful horse trainer for race horse business); Commissioner v. Widener, 33 F.2d 833 (3d Cir. 1929) (concluding that racing stables were entered into with profit motive because of selective breeding and investment decisions); Vanderbilt v. Commissioner, 16 T.C.M. (CCH) 1081, 1087 (1957) (discussing 1939 Code § 23(a)(2) which is similar to 1954 Code § 212). Although the considerations discussed in this Article generally apply equally to deductions under § 212, this Article only addresses § 162.

22. Section 162 of the Code provides, in relevant part, that “[t]here 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” I.R.C. § 162 (1995) (amendments not relevant to the discussion herein have been omitted). There are a number of other Code sections that require the taxpayer to demonstrate that his or her activity was entered into or carried on “for profit,” such as §§ 165 and 212. However, this Article focuses only on § 162.

It is important to note that while § 162 provides the general rule regarding the deductibility of business expenses, other Code sections provide additional rules regarding specific expenses, some of which are stricter and some of which are more permissive than the general rule under § 162. I.R.C. § 162 (1995). For example, although a taxpayer generally cannot deduct losses on his or her property (such as the taxpayer’s principal residence, car, or other similar real or personal property), § 165(c) permits the taxpayer to deduct casualty and theft losses not incurred in a trade or business under certain specified conditions. I.R.C. § 165(c) (1995). While § 162 would appear to permit deduction of capital losses by a business, § 165(f) limits such losses by providing that “[l]osses from sales or exchanges of capital assets shall be allowed only to the extent allowed in sections 1211 and 1212.” I.R.C. § 165(f) (1995). Section 1211(a) in turn permits a corporation to deduct capital losses only to the extent of capital gains. I.R.C. § 1211(a) (1995).

23. *See supra* note 21.

24. *See supra* note 21.

explain the different treatment of business and hobby activities, courts rationalized that an individual engaged in a hobby activity would more likely remain in the activity, despite its lack of profitability, than an individual who engaged in the same activity solely to earn a profit.²⁵ While this presumption may be true, it is also true that taxpayers often continue a "business" activity long after it has become unprofitable.²⁶

B. Statutory Measures

Enacted in 1954, section 270 of the Code²⁷ represented an early attempt by Congress to combat excessive deduction of losses from hobby activities. Although practitioners and courts commonly referred to section 270 as the "hobby loss" provision, the name was a misnomer because section 270 on its face applied only to expenses "attributable to a trade or business."²⁸ Further, section 270, as drafted, affected very few activities, mainly those of very rich investors who failed to obtain proper tax advice prior to reporting significant losses, *i.e.*, those losses of \$50,000 or more per year, over a period of five

25. See, *e.g.*, Coffey v. Commissioner, 141 F.2d 204, 205 (5th Cir. 1944) (comparing a business venture, which is entered into for profit, to a hobby, which is entered into for pleasure or recreation); Paine v. Commissioner, 102 F.2d 110, 112 (1st Cir. 1939) (holding the building of a single boat would not be a business venture as there could not be expectations of profit); Candler v. Commissioner, 76 F.2d 548, 549 (5th Cir. 1935) (determining that a loss could not be deducted as the activity was not entered into with the "expectation of making a profit").

26. See, *e.g.*, Donald C. Langevoort, *Theories, Assumptions and Securities Regulation: Market Efficiency Revisited*, 140 U. PA. L. REV. 851, 859-60 (1992) (discussing the tendency of investors to hold stocks longer than would be expected in light of the theory that a person will part with an item only if paid a price "substantially higher" than its cost to that person).

27. Internal Revenue Code of 1954, ch. 736, § 270, 68A Stat. 3, 81 (repealed in 1969). Section 270 of the Code provided in relevant part:

(a) **Recomputation of Taxable Income.**—If the deductions allowed by this chapter or the corresponding provisions of prior revenue laws (other than specially treated deductions, as defined in subsection (b)) allowable to an individual (except for the provisions of this section or the corresponding provisions of prior revenue laws) and attributable to a trade or business carried on by him for 5 consecutive taxable years have, in each of such years (including at least one year to which this subtitle applies), exceeded by more than \$50,000 the gross income derived from such trade or business, the taxable income (computed under section 63 or the corresponding provisions of prior revenue laws) of such individual for each of such years shall be recomputed. For the purposes of such recomputation in the case of any such taxable year, such deductions shall be allowed only to the extent of \$50,000 plus the gross income attributable to such trade or business, except that the net operating loss deduction, to the extent attributable to such trade or business, shall not be allowed.

Id.

28. See *id.*

consecutive years. For the handful of cases to which section 270 actually applied, the provision merely limited the amount of losses that could be deducted by the taxpayer to \$50,000 per year.²⁹ However, as section 270 failed to provide any anti-abuse mechanisms, a taxpayer could easily shift losses from an activity from one year to another to avoid reporting losses of \$50,000 or more in five consecutive years. As such, section 270 proved incapable of meeting Congress' goals of reducing hobby loss deductions. Thus, largely because of its ineffectiveness, Congress repealed section 270 in 1969.³⁰

In the Tax Reform Act of 1969,³¹ Congress enacted a new hobby loss provision, found in section 183 of the Code.³² Section 183

29. *See id.*

30. Tax Reform Act of 1969, Pub. L. No. 91-172, § 213(b), 83 Stat. 487, 572 (1969).

31. Tax Reform Act of 1969, Pub. L. No. 91-172, §213, 83 Stat. 487, 571-72 (codified at I.R.C. § 183 (1994)).

32. Section 183 of the Code, entitled "ACTIVITIES NOT ENGAGED IN FOR PROFIT," provides:

(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 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 3 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 "2" for "3" and "7" for "5".

(e) **SPECIAL RULE.**

(1) **IN GENERAL.**—A determination as to whether the presumption provided by subsection (d) applies with respect to any activity shall, if

essentially codified the courts' traditional practice of limiting a taxpayer's deductions under section 162 for an activity not "initiate[d] or conduct[ed] . . . in good faith with an intention of making a profit."³³ Under section 183, a taxpayer may deduct expenses incurred in connection with an activity "not engaged in for profit" (defined as an activity other than one for which deductions are allowable under sections 162 and 212) to the extent that income generated by the activity exceeds the deductions allowable to the taxpayer under the other provisions of the Code.³⁴ Thus, section 183 operates as an allowance provision authorizing limited deductions with respect to an activity that does not fall within the classification of a "trade or business."³⁵ In this

the taxpayer so elects, not be made before the close of the fourth taxable year, (sixth taxable year, in the case of an activity described in the last sentence of such subsection) following the taxable year in which the taxpayer first engages in the activity. For purposes of the preceding sentence, a taxpayer shall be treated as not having engaged in an activity during any taxable year beginning before January 1, 1970.

(2) INITIAL PERIOD.—If the taxpayer makes an election under paragraph (1), the presumption provided by subsection (d) shall apply to each taxable year in the 5-taxable year (or 7-taxable year) period beginning with the taxable year in which the taxpayer first engages in the activity, if the gross income derived from the activity for 3 (or 2 if applicable) or more of the taxable years in such period exceeds the deductions attributable to the activity (determined without regard to whether or not the activity is engaged in for profit).

(3) ELECTION.—An election under paragraph (1) shall be made at such time and manner, and subject to such terms and conditions, as the Secretary may prescribe.

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

I.R.C. § 183 (1995).

33. *International Trading Co. v. Commissioner*, 275 F.2d 578, 584 (7th Cir. 1960) (quoting 4 MERTENS, LAW OF FEDERAL INCOME TAXATION 18 (1954)).

34. See I.R.C. § 183 (1995).

35. See *id.* At first glance, § 183(a) appears to be a disallowance provision because the plain language of § 183(a) denies a deduction for an activity "not engaged in for profit." Section 183(c), however, defines an activity "not engaged in for profit" as an activity for which deductions are not available under § 162 or § 212. Section 183(c) thus refers the reader to § 162 or § 212 to make the ultimate decision regarding profit objective. Upon such a determination, § 183(b) (providing certain limited deductions) may then apply, depending upon the outcome of the determination under § 162 or § 212. See *supra* note 32 for the language of § 183.

way, section 183 represents a continuation of judicial doctrine and Internal Revenue Service ("IRS") policy permitting taxpayers to deduct certain expenses incurred in connection with an activity that did not constitute a "trade or business."³⁶

The legislative history of section 183 suggests that Congress perceived the judicial profit objective test to be an effective measure to limit deductions generated by hobby activities. Section 183, as enacted, does not impose any new restrictions on the deductibility of hobby losses. Instead, it incorporates by reference the profit objective test. Importantly, the legislative history of section 183 contains no indication that Congress somehow intended to change the existing profit objective test.³⁷ The pertinent legislative history of Code section 183 discusses the judicial profit objective test as follows:

[A]lthough a reasonable expectation of profit is not to be required, the facts and circumstances (without regard to the taxpayer's subjective intent) would have to indicate that the taxpayer entered the activity, or continued the activity, with *the objective of making a profit*.³⁸

Perhaps even more importantly, the express language of section 183 refers to "an activity not engaged in for profit."³⁹ Neither section 183 nor any other section of the Code includes the word "primarily" (or any other word denoting degree or amount) to describe the requisite profit objective under section 162.⁴⁰

36. *See, e.g.*, *Portland Golf Club v. Commissioner*, 497 U.S. 154, 164 n.15 (1990) ("Even before the enactment of § 183, . . . the courts and the Commissioner had not required that revenues earned in activities showing a net loss be declared as taxable income."). *See also* Miller, *supra* note 4, at 111-13 and cases cited therein (explaining that § 183 reflects the IRS's continued allowance of zeroing out by the taxpayer engaged in a not-for-profit activity).

37. *See* H.R. REP. NO. 413 (Part 1), 91st Cong., 1st Sess., pt. 1, at 71 (1969), *reprinted in* 1969 U.S.C.C.A.N. 1645, 1717; S. REP. NO. 552, 91st Cong., 1st Sess. 102 (1969), *reprinted in* 1969 U.S.C.C.A.N. 2027, 2133.

38. S. REP. NO. 552, *supra* note 37, at 104, *reprinted in* 1969 U.S.C.C.A.N. 2134 (emphasis added); *see also* H.R. REP. NO. 413, *supra* note 37, at 71, *reprinted in* 1969 U.S.C.C.A.N. 1717-18.

39. *See* I.R.C. § 183.

40. The absence of the word "primary" in § 183 is particularly conspicuous in light of the numerous references to "primary" in other sections of the Code. *See, e.g.*, I.R.C. § 144(a)(8)(A) (1995) (providing that "more than 25% of the net proceeds of the issue are to be used to provide a facility the *primary* purpose of which is one of the following") (emphasis added); I.R.C. § 281(d)(1)(B) (1995) ("the *primary* business of which is the providing of railroad terminal and switching facilities") (emphasis added); I.R.C. § 502(a) (1995) ("[a]n organization operated for the *primary* purpose of carrying on a trade or business") (emphasis added); I.R.C. § 274(e)(4) (1995) ("[e]xpenses for recreational, social, or similar activities (including facilities therefore) *primarily* for the benefit of employees") (emphasis added); I.R.C. § 593(d)(1)(B) (1995) ("any loan,

C. Treasury Regulations Under Section 183

The regulations under section 183 reflect the factors considered by courts prior to the enactment of section 183 in making their determination of whether a taxpayer entered into or engaged in an activity with a profit objective.⁴¹ The factors include:

- (1) [the] manner in which the taxpayer carries on the activity;
- (2) [t]he expertise of the taxpayer or his advisors;
- (3) [t]he time and effort expended by the taxpayer in carrying on the activity;
- (4) [the] [e]xpectation that assets used in [the] activity may appreciate in value; . . .
- (5) [t]he success of the taxpayer in carrying on other similar or dissimilar activities; . . .
- (6) [t]he taxpayer's history of income or losses with respect to the activity;
- (7) the amount of occasional profits, if any, which are earned; . . .
- (8) [t]he financial status of the taxpayer; . . . [and]
- (9) [the] [e]lements of personal pleasure or recreation.⁴²

whether or not evidenced by a security . . . the *primary* obligor on which is—(i) a government or political subdivision or instrumentality thereof”) (emphasis added); I.R.C. § 643(f) (1995) (“[Two] or more trusts shall be treated as 1 trust if . . . such trusts have substantially the same grantor or grantors and substantially the same *primary* beneficiary or beneficiaries . . .”) (emphasis added); I.R.C. § 704(e)(3) (1995) (“The ‘family’ of any individual shall include only his spouse, ancestors, and lineal descendants, and any trusts for the *primary* benefit of such persons.”) (emphasis added); see also John A. McGuire, *Tax Shelters*, 13 J. REAL EST. TAX’N 362, 368 n.32 (1986) (emphasizing that “primarily” was typically inserted by Congress expressly where it intended “primarily” to apply and thus not applicable to § 183); John H. Young, *The Role of Motive in Evaluating Tax Sheltered Investments*, 22 TAX LAW. 275, 276 (1969) (“Today of course the Internal Revenue Code is replete with references to ‘the purpose’, ‘the principle purpose’, ‘one of its principle purposes’, . . . and so forth, all relating to tax motivation.”) (footnotes omitted).

41. Compare Treas. Reg. § 1.183-2(b) (1995) (listing relevant factors in determining whether activities are entered into or engaged in for profit) with *Schley v. Commissioner*, 375 F.2d 747, 750 (2d Cir. 1967) (factors considered by courts include a taxpayer's personal enjoyment of farming, a substantial independent source of income, and the magnitude of losses over a period of years); see also *Teitelbaum v. Commissioner*, 346 F.2d 266, 269 (6th Cir. 1955) (taxpayer did not keep records of income or expenses); *White v. Commissioner*, 227 F.2d 779, 780 (6th Cir. 1955) (taxpayer claimed substantial losses during a 17-year period; there was no reasonable probability that a profit would ever be generated); *Helvering v. Highland*, 124 F.2d 556, 561 (4th Cir. 1942) (taxpayer's conduct not business-like; no separate office maintained in connection with activity); *Vanderbilt v. Commissioner*, 16 T.C.M. (CCH) 1081, 1085 (1957) (factors considered include: taxpayer's independent sources of income; losses over a number of years; attention or inattention to business details such as record-keeping; and hobby qualities of activity).

42. Treas. Reg. § 1.183-2(b) (1995). The regulations provide a safe harbor provision which deems an activity to be “for profit” where a profit is generated over a specified period of years. For activities not involving breeding or showing horses, an activity that generates a profit for at least two years in a five consecutive year period will automatically be considered to be “for profit.” Treas. Reg. § 1.183-1(c)(ii) (1994). As breeding or showing horses is an activity that generally takes a longer period to

The regulations provide several examples of activities that will or will not be considered "for profit." All of the examples except one relate to hobby-type activities. The only non-hobby example involves a typical tax shelter activity, wildcat oil drilling, and is derived directly from the legislative history of section 183.⁴³ This example, however, focuses on the likelihood that profits will be generated by the activity and does not take into account the tax benefits to be generated by the activity.⁴⁴

As acknowledged by the courts, the case law developing the profit objective test and the regulations incorporating the factors considered by the courts in developing such a test do not, on their face, apply to activities outside the hobby context.⁴⁵ Instead, the factors under the regulations focus on the distinction between a hobby and a business activity.⁴⁶ Thus, the factors are not easily adapted to a business context where the business versus personal distinction expense is not an issue. Like section 183, the regulations do not impose any additional requirements for the deductibility of business expenses, nor do they indicate that the profit objective test under section 162 requires a showing that the objective to earn a profit was the taxpayer's primary or main objective.⁴⁷

generate a profit, such an activity will be deemed to be for profit if it generates a profit for two years in a seven consecutive year period. Treas. Reg. § 1.183-1(c)(i) (1994).

43. The pertinent example in the regulations reads as follows:

Example (5). A, an independent oil and gas operator, frequently engages in the activity of searching for oil on undeveloped and unexplored land which is not near proven fields. He does so in a manner substantially similar to that of others who engage in the same activity. The chances, based on the experience of A and others who engaged in this activity, are strong that A will not find a commercially profitable oil deposit when he drills on land not established geologically to be proven oil bearing land. However, on the rare occasions that these activities do result in discovering a well, the operator generally realizes a very large return from such activity. Thus, there is a small chance that A will make a large profit from his oil exploration activity. Under these circumstances, A is engaged in the activity of oil drilling for profit.

Treas. Reg. § 1.183-2(c) (Example 5) (1995).

44. See Treas. Reg. § 1.183-2 (1994).

45. See, e.g., *Estate of Baron v. Commissioner*, 83 T.C. 542, 554 (1984), *aff'd*, 798 F.2d 65 (2d Cir. 1986) (indicating that factors set forth in Treasury Regulations under § 183 are not easily adapted to the tax shelter context).

46. Treas. Reg. § 1.183-2(b) (1994).

47. See Samuel Franklin Painter, Comment, *Art Investment Expense Deduction and the Primary Purpose Requirement*, 28 WASH. & LEE L. REV. 230, 238 (1971) (noting that no "primary" profit objective requirement exists under the regulations).

Given that § 183 does not apply unless an activity is not a trade or business under § 162 (or is not for profit under § 212), at least one court has noted that the § 183 regulations should have been promulgated under § 162 or § 212. See *Brannen v. Commissioner*, 78 T.C. 471, 507 (1982), *aff'd*, 722 F.2d 695 (11th Cir. 1984).

III. JUDICIAL DEVELOPMENT OF THE PRIMARY PROFIT OBJECTIVE TEST

The primary test apparently originated in dicta in *Helvering v. National Grocery Co.*,⁴⁸ a Supreme Court opinion rendered prior to the enactment of section 183.⁴⁹ In that case, the taxpayer/corporation argued that the IRS had imposed an unconstitutional fifty percent tax on its accumulated income.⁵⁰ It claimed that the statute was unconstitutional because the imposition of the tax depended upon the taxpayer's state of mind.⁵¹

In addressing the taxpayer's argument, the Supreme Court observed, in a footnote, that there are many instances where intent factors into a determination of income tax liability.⁵² The Supreme Court referred to the primary test and stated that: "the deductibility of losses under [section 165(c)(1)—losses incurred in connection with a trade or business activity] may depend upon whether the taxpayer's motive in entering into the transaction was primarily profit."⁵³ Despite the fact that the Supreme Court did not explicitly address the issue of the primary profit objective test in *National Grocery*, a number of courts subsequently cited the opinion for the proposition that a taxpayer must establish a primary profit objective in order to obtain deductions under section 162, among other Code sections.⁵⁴

48. 304 U.S. 282, 289 n.5, *reh'g denied*, 305 U.S. 669 (1938).

49. Congress enacted § 183 of the Code in 1969. See *supra* notes 31-32 and accompanying text.

50. *National Grocery*, 304 U.S. at 286.

51. *Id.* at 289. In essence, the statute required the court to determine whether the taxpayer had accumulated the income to avoid the surtax on distributions to shareholders. *Id.*

52. *Id.* at 289 n.5.

53. *Id.*

54. See, e.g., *Friedman v. Commissioner*, 869 F.2d 785, 790 (4th Cir. 1989) (determining tax liability by a "primarily for profit" standard); *Landreth v. Commissioner*, 859 F.2d 643, 645 (9th Cir. 1988) ("Congress intended the subjective 'primarily for profit standard'"); *Knetsch v. United States*, 348 F.2d 932, 936 (Ct. Cl. 1965), *cert. denied*, 383 U.S. 957 (1966) ("determinative question is whether . . . primarily for profit"); *Lamont v. Commissioner*, 339 F.2d 377, 380 n.4 (2d Cir. 1964) ("profit as being the basic and dominant motive"); *Austin v. Commissioner*, 298 F.2d 583, 584 (2d Cir. 1962) ("in determining the deductibility of a loss, the primary motive must be ascertained"); *Fox v. Commissioner*, 190 F.2d 101, 104 (2d Cir. 1951) ("hope of monetary gain . . . is what is controlling"); *Feine v. McGowan*, 188 F.2d 738, 740 (2d Cir. 1951) ("whether the taxpayer's motive in entering into the transaction was primarily [for] profit") (quoting *National Grocery*, 304 U.S. at 289 n.5); *Early v. Atkinson*, 175 F.2d 118, 122 (4th Cir. 1949) ("state of mind determines the deductibility"); *Weir v. Commissioner*, 109 F.2d 996, 998 (3d Cir.), *cert. denied*, 310 U.S. 637 (1940) ("intent is frequently material to tax questions"); *Estate of McGlothlin v. Commissioner*, 44 T.C. 611, 621 (1965), *aff'd*, 370 F.2d 729 (5th Cir. 1967) ("not

A. Lower Court and Appellate Court Opinions

In evaluating whether a taxpayer engaged in an activity for profit, most courts apply the actual and honest test.⁵⁵ This test focuses on whether or not the taxpayer had a profit objective in entering into or engaging in an activity and does not seek to ascertain the amount or degree of the taxpayer's profit objective. In making this threshold determination, courts generally consider the factors listed under the section 183 regulations.⁵⁶ While some of the factors enumerated require consideration of the taxpayer's motivations for entering into or carrying on an activity, courts applying the actual and honest test generally do not compare a taxpayer's various objectives (i.e., hobby versus profit) to determine whether an activity was for profit.⁵⁷ In

allowed unless taxpayer *personally* expected to profit") (emphasis in original); *Arata v. Commissioner*, 31 T.C. 346, 353 (1958), *aff'd in part and rev'd in part*, 277 F.2d 576 (2d Cir. 1960) ("necessary that the 'taxpayers' motive in entering into the transaction was primarily [for] profit") (quoting *National Grocery*, 304 U.S. at 289 n.5).

55. See, e.g., *Smith v. Commissioner*, 937 F.2d 1089, 1093 (6th Cir. 1991) (explaining that "[u]nder § 183, an activity is engaged in for profit if the taxpayer entertained an actual and honest . . . profit objective by engaging in the activity."); *Evans v. Commissioner*, 908 F.2d 369, 373 (8th Cir.) ("actual and honest" and "bona fide"), *on remand*, 61 T.C.M. (CCH) 2917 (1990), *modified*, 62 T.C.M. (CCH) 614 (1991); *Burger v. Commissioner*, 809 F.2d 355, 358 (7th Cir. 1987) ("good faith expectation of profit"); *Cornfeld v. Commissioner*, 797 F.2d 1049, 1051 (D.C. Cir. 1986) ("actual and honest"); *Faulconer v. Commissioner*, 748 F.2d 890, 895 n.10 (4th Cir. 1984) (explaining that the activity must be engaged in for "'the purpose of making a profit"; "nothing in section 183 or its legislative history . . . requir[es] this purpose to be predominant") (citation omitted); *Estate of Power v. Commissioner*, 736 F.2d 826, 829 (1st Cir. 1984) ("facts and circumstances must indicate that the taxpayer . . . [had the] objective of making a profit") (quoting *Treas. Reg. § 1.183-2(a)* (1994)); *Schley v. Commissioner*, 375 F.2d 747, 749 (2d Cir. 1967) (taxpayer must be motivated by "a desire for profit"); *Marine v. Commissioner*, 92 T.C. 958, 988 (1989), *aff'd*, 921 F.2d 280 (9th Cir.) ("actual and honest") (citation omitted), *cert. denied*, 502 U.S. 819 (1991); *McCrary v. Commissioner*, 92 T.C. 827 (1989) ("actual and honest"); *Levy v. Commissioner*, 91 T.C. 838, 871 (1988) ("actual and honest"); *Rybak v. Commissioner*, 91 T.C. 524, 568 (1988) ("a profit objective"); *Ferrell v. Commissioner*, 90 T.C. 1154, 1182 (1988) ("a profit objective"); *Drobny v. Commissioner*, 86 T.C. 1326, 1340 (1986) ("actual and honest"); *Feldman v. Commissioner*, 65 T.C.M. (CCH) 1747 (1993) ("actual and honest") (quoting *Hirsch v. Commissioner*, 315 F.2d 731, 736 (9th Cir. 1963)), *aff'd*, 20 F.3d 1128 (11th Cir. 1994); *Dunwoody v. Commissioner*, 64 T.C.M. (CCH) 1556, 1561 (1992) ("actual and honest"); *Moody v. Commissioner*, 62 T.C.M. (CCH) 1357, 1360 (1991) ("actual and honest") (quoting *Dreker v. Commissioner*, 78 T.C. 642, 644-45 (1982), *aff'd*, 702 F.2d 1205 (D.C. Cir. 1983)); *Schillinger v. Commissioner*, 60 T.C.M. (CCH) 1470, 1477 (1990), *aff'd*, 1 F.3d 954 (9th Cir. 1993) ("actual and honest") (quoting *Dreker*, 78 T.C. at 644-45); *Adler v. Commissioner*, 58 T.C.M. (CCH) 594, 597 (1989) ("actual and honest"); *Bass v. Commissioner*, 55 T.C.M. (CCH) 126, 130 (1988) ("actual and honest").

56. See *supra* note 42 and accompanying text for a list of these factors.

57. See *supra* note 55 (citing cases in which the court applied the actual and honest test).

part, because the courts need not make such a comparison under the actual and honest test, little debate has arisen over the viability of this test.

Some courts, however, apply the stricter primary test, which asks whether the objective to earn a profit was of "first importance" to the taxpayer.⁵⁸ Thus, unlike the actual and honest test, it appears that a court must compare a taxpayer's various objectives for entering into or carrying on the activity in question when applying the primary test.

Since *National Grocery*, courts have applied the primary test in both the hobby context and the business context.⁵⁹ As discussed above, the hobby context involves the business versus personal distinction.⁶⁰ However, in the business context, the two taxpayer objectives that are generally at issue are the objective to earn a profit and the objective to obtain tax benefits.⁶¹

Application of the primary test in the business context became particularly noticeable during the 1980s with the proliferation of tax shelters.⁶² Tax shelter cases reviewed by courts during this period generally involved similar factual patterns, including, for example, highly leveraged investments and large deductions in relation to the amount of cash actually invested.⁶³ In an attempt to disallow excessive

58. See, e.g., *Landreth*, 859 F.2d at 645 ("primarily for profit") (quoting *National Grocery*, 304 U.S. at 289 n.5); *Lamont*, 339 F.2d at 380 n.4 ("basic, dominant and primary"); *Early*, 175 F.2d at 122 ("purpose to derive a gain must be the chief or primary one"); *McGlothlin*, 44 T.C. at 621 ("prime" motive); *Wayno v. Commissioner*, 63 T.C.M. (CCH) 1935, 1940 (1992), *aff'd*, 12 F.3d 1111 (9th Cir. 1993) ("primary") (citation omitted), *cert. denied*, 115 S. Ct. 1174 (1995). See also *supra* notes 48-54 (tracing the development of the primary profit objective test).

59. See, e.g., *Agro Science Co. v. Commissioner*, 934 F.2d 573, 576 (5th Cir.), *cert. denied*, 502 U.S. 907 (1991) (determination of profit motive of partnership); *Simon v. Commissioner*, 830 F.2d 499, 500 (3d Cir. 1987) (predominant purpose of limited partnership); *Brannen v. Commissioner*, 722 F.2d 695, 704 (11th Cir. 1984) ("concluded that the profit test should be applied on the partnership level"); *Nickerson v. Commissioner*, 700 F.2d 402, 404 (7th Cir. 1983) (applying test for purpose of renovation of farm); *Fox v. Commissioner*, 82 T.C. 1001, 1022 (1984) ("determine which of petitioner's two motives was primary"); *Surloff v. Commissioner*, 81 T.C. 210, 233 (1983) ("burden . . . to show that the partnerships were engaged in the coal business with the dominant objective of realizing a profit").

60. See *supra* note 4 and accompanying text (discussing application of the profit objective test in the hobby context).

61. See *infra* notes 75-99 and accompanying text (discussing opinions in the business context which have compared various taxpayer objectives).

62. See Ivan H. Humphreys, *Tax Shelters: Establishing Profit Motive in Tax Shelters*, 3 J. TAX'N INVESTMENTS 250 (1986) (discussing the application of § 183 to tax shelters in the Tax Court).

63. To better understand the context outside of the hobby area in which courts have utilized the primary test, consider the following example: Taxpayer A invests in a wind turbine which ostensibly will generate an energy source that the taxpayer can offer for

deductions from activities perceived to be abusive, courts increasingly applied the profit objective test and the underlying primary test.⁶⁴

As illustrated by the multitude of cases decided during this period, no single, uniform standard exists for applying the primary test.⁶⁵ This lack of uniformity can be attributed in part to the varying language and standards used by the courts to identify and apply the primary test.⁶⁶ Additionally, the courts' failure to explicitly indicate the method

sale. Taxpayer A's investment is represented by a \$5,000 cash down payment and a \$115,000 long-term debt obligation. The long-term debt obligation is secured only by Taxpayer A's interest in the wind turbine. Taxpayer A claims depreciation deductions and investment tax credits based on the full \$120,000 purchase price. Taxpayer A never makes any payments on the long-term debt obligation.

The example set forth above is based on an actual case decided by the Tax Court. *See Baxter v. Commissioner*, 50 T.C.M. (CCH) 545 (1985), *aff'd in part and rev'd in part*, 816 F.2d 493 (9th Cir. 1987). In its opinion in which it determined that the taxpayer lacked a primary profit objective, the Tax Court applied the factors under the § 183 regulations and determined that the taxpayer was primarily motivated by the desire to obtain tax benefits. *Id.* at 547-49. The Tax Court did not, however, set forth any rationale for requiring a primary profit objective, nor did it explain how it determined that the taxpayer's objective to earn a profit was less important than his objective to obtain tax benefits. *See id.*

Instead of using the profit objective analysis to disallow business deductions, the court could have determined the value of the wind turbine and held that because the debt was not supported by value, the taxpayer could only deduct interest on the portion of the debt representing the true value of the wind turbine. *See infra* notes 133-38 and accompanying text (discussing the difficulty of applying the primary test to transaction and investment decisions).

64. *See infra* notes 111-32.

65. *See infra* notes 66-90 and accompanying text.

66. Judge Swift of the United States Tax Court discussed the proposition that the primary test has not been developed uniformly by the courts in his concurring opinion in *Peat Oil & Gas Assocs. v. Commissioner*, 100 T.C. 271 (1993), *aff'd sub nom Ferguson v. Commissioner*, 29 F.3d 98 (2d Cir. 1994). Judge Swift noted:

[T]he courts have not been consistent in the language used to describe the quantity or level of profit objective that must be established [T]he inconsistent profit-objective language that has been used has included, among other language, the following: "Basic", "dominant", "primary", "predominant", "substantial", "reasonable", "bona fide", and "actual and honest". As one court commented, we have been "glutted with tests. Many such tests proliferate because they give the comforting illusion of consistency and precision. They often obscure rather than clarify."

Id. at 280 (Swift, J., concurring) (citation omitted).

For a further discussion of the lack of uniform language used by courts to describe the primary test, see *Rose v. Commissioner*, 88 T.C. 386, 411-14 (1987) (discussing different words used to describe the profit objective test), *aff'd*, 868 F.2d 851 (6th Cir. 1989); *Johnson v. United States*, 11 Cl. Ct. 17, 26-28 (1986) (discussing various profit objective tests applied in the tax shelter context by the Tax Court); *Packard v. Commissioner*, 85 T.C. 397, 418 (1985) (noting that courts have not clarified the quantity or degree of profit objective necessary for a transaction to be recognized for tax purposes).

used to compare a taxpayer's various objectives exacerbates the confusion surrounding the primary test.⁶⁷

A few examples of the different language used by the courts to describe the stricter test of profit objective include "primary," "principal," "predominant," "overriding," and "substantial."⁶⁸ Some courts have even used different language within the same opinion to describe the requisite profit objective.

For instance, in its opinion in *Polakof v. Commissioner*,⁶⁹ the United States Court of Appeals for the Ninth Circuit first indicated that "[p]etitioners must be engaged in a trade or business with an *actual* profit objective."⁷⁰ Two paragraphs later, the court stated that the taxpayers in that case were required to show a "*dominant* profit objective."⁷¹ Likewise, in *Nickeson v. Commissioner*,⁷² the United States

67. *See, e.g.*, *Antonides v. Commissioner*, 893 F.2d 656, 659 (4th Cir. 1990) ("[T]he determination of whether an activity is engaged in for profit must involve consideration of all relevant facts and circumstances."); *Imbesi v. Commissioner*, 361 F.2d 640, 644-45 (3d Cir. 1966) (stating that the primary intent or motive of the taxpayer is not usually at issue "because the usual enterprise is surrounded by the conventional characteristics of a business or profession"; as such, a predominant profit motive is simply taken for granted); *Engdahl v. Commissioner*, 72 T.C. 659, 666 (1979) (stating only that "[g]reater weight is to be given to objective facts than to petitioners' mere statement of their intent" before beginning its analysis), *acq.* 1979-2 C.B. 1; *Monfore v. United States*, 214 Ct. Cl. 705, 722-25 (1977) (explaining that the existence of a profit motive is determined by weighing various factors including: the consistency between the taxpayer's subjective intent and other objective evidence; the taxpayer's actual success in making a profit, the taxpayer's acquisition of his enterprise; evidence of business-like management by the taxpayer; and the maintenance of records by the taxpayer); *Seebold v. Commissioner*, 55 T.C.M. (CCH) 723, 726-27 (1988) (reviewing briefly the factors listed in *Treas. Reg. 1.183-2(b)*); *Harvey v. Commissioner*, 54 T.C.M. (CCH) 1508, 1511 (1988) (concluding, with little explanation, that the taxpayers evidenced the requisite profit motive); *see also* Allan J. Samansky, *Hobby Loss or Deductible Loss: An Intractable Problem*, 34 U. FLA. L. REV. 46, 55-59 (1981) (stating that because of the uncertainty surrounding the definition, "[t]he primary purpose test is unsatisfactory").

68. *See supra* notes 58, 66, and accompanying text.

69. 820 F.2d 321, 323 n.1 (9th Cir. 1987), *cert. denied*, 484 U.S. 1025 (1988).

70. *Id.* (emphasis added).

71. *Id.* at 323 (emphasis added). In response to the taxpayer's argument that the Tax Court had improperly required a principal or primary profit objective, as opposed to a basic objective, the court rejected any distinction between the two tests. *Id.* at 323 n.2. This contrasts with the views of other courts, which have recognized a distinction between requiring a "principal" profit objective and requiring an "actual and honest" profit objective. *See, e.g.*, *Simon v. Commissioner*, 830 F.2d 499, 500 (1987) (giving different definitions of the words "primary" and "profit": "'[p]rimary' . . . means 'of first importance' or 'principally,' while 'profit' means economic profit independent of tax savings") (citations omitted); *Peat Oil & Gas Assocs.*, 100 T.C. at 289 (Ruwe, J., concurring) (explaining that "[t]he distinction between finding that the taxpayers had a profit objective and finding that profit was their *primary* objective cannot be dismissed as mere semantics"); *Fox v. Commissioner*, 82 T.C. 1001, 1022 (1984) (explaining

Court of Appeals for the Tenth Circuit initially stated that the appropriate test for profit objective is whether the taxpayer engaged in the activity “in good faith, with the dominant hope and intent of realizing a profit.”⁷³ However, on the same page the court noted that “the Tax Court made the determination crucial to the instant case—whether the taxpayers had an actual and honest profit objective.”⁷⁴

One court has even used different language within the same paragraph to describe the primary test. In *Nickerson v. Commissioner*,⁷⁵ the United States Court of Appeals for the Seventh Circuit stated:

Petitioners bear the burden of proving that their primary purpose . . . was to make a profit. In meeting this burden, however, “it is sufficient if the taxpayer has a bona fide expectation of realizing a profit, regardless of the reasonableness of such expectation.”⁷⁶

The actual method of applying the primary test—although difficult in many cases to ascertain precisely—has also been inconsistent. Many of the courts that have seemingly adopted the primary test have applied it in the same manner as the actual and honest test (*i.e.*, such courts apply the factors under Code section 183) without comparing profit versus other objectives.⁷⁷

that “primary” and “profit motive” mean different things in a § 162(c)(2) analysis); *Surloff v. Commissioner*, 81 T.C. 210, 233 (1983) (detailing the different meanings of “primary” and “profit”).

72. 962 F.2d 973, 976 (10th Cir. 1992).

73. *Id.* (citations omitted).

74. *Id.*

75. 700 F.2d 402 (7th Cir. 1983). In *Nickerson*, the taxpayer purchased a farm and worked there on weekends. *Id.* at 403. The Tax Court found that the taxpayer lacked a profit objective, concluding, among other things, that the activity was merely a hobby that the taxpayer engaged in for pleasure. *Id.* The Seventh Circuit reversed the Tax Court’s holding, noting that the fact that the taxpayer entered into the activity because of “fond memories of youth” did not preclude a finding that the taxpayer had a profit objective. *Id.* at 407.

76. *Id.* at 404 (citations omitted).

77. *See, e.g., Nickerson*, 962 F.2d at 976 (“whether the taxpayers had an actual and honest profit objective”); *Bryant v. Commissioner*, 928 F.2d 745, 750 (6th Cir. 1991) (“the court should determine from the facts and circumstances surrounding the investment whether the taxpayer entered the activity with the objective of making a profit”); *Surloff*, 81 T.C. at 209 (“whether [the transaction] had any economic substance”); *Christensen v. Commissioner*, 56 T.C.M. (CCH) 425, 430 (1988) (“had an ‘actual and honest objective of making a profit’”) (quoting *Dreicer v. Commissioner*, 78 T.C. 642, 645 (1982)); *Seebold v. Commissioner*, 55 T.C.M. (CCH) 723, 726 (1988) (reviewing the factors listed in Treasury Regulation 1.183-2(b)); *Harvey v. Commissioner*, 54 T.C.M. (CCH) 1508, 1511 (1988) (analyzing the relevant factors used to determine whether a taxpayer entered into an activity with a profit motive). For a discussion of cases where the courts have engaged in a comparison of objectives, see *infra* notes 87-101 and accompanying text.

For example, in *Thomas v. Commissioner*,⁷⁸ the taxpayer invested in a coal mining venture promoted as a "tax-sheltered investment."⁷⁹ The promotional materials given to investors focused on the potential tax benefits and indicated that the risks of loss associated with the investment were significant, but were vague about the amount of profit the investment was expected to yield.⁸⁰ The purchase price of the taxpayer's investment consisted of a cash down payment and a non-recourse note in an amount that was approximately twice the cash down payment.⁸¹ Investors in the mining operation sustained losses in the first three years of operation and reported a small profit in the fourth year,⁸² at which time operations were completely shut down because of various safety concerns and difficulties with contractors.⁸³

The *Thomas* court determined that the mining venture was not "run in a businesslike fashion," the "anticipated economic projections were not met by the [mining operation]," and "there was virtually no meaningful investigation into the marketability of the coal."⁸⁴ The court acknowledged that the taxpayer could have had at least a "subsidiary" intent to earn a profit;⁸⁵ however, it summarily concluded without further analysis that "the primary objective of the . . . [mining operation] was to secure tax benefits rather than to earn an economic profit."⁸⁶

In opinions in which courts have indicated that they compared the taxpayer's various objectives, the method of comparison used is generally not explicitly set forth in the opinion. In *Fox v. Commissioner*,⁸⁷ the taxpayer invested in speculative hedging transactions that involved the purchase and/or sale of offsetting options on United States Treasury bills.⁸⁸ The taxpayer reported large losses in connection with the transactions, which the IRS disallowed on the grounds that the transactions⁸⁹ had not been "entered into primarily for profit."⁹⁰

In determining whether the taxpayer entered into the transactions pursuant to a primary profit objective, the Tax Court assumed, without

78. 84 T.C. 1244 (1985), *aff'd*, 792 F.2d 1256 (4th Cir. 1986).

79. *Id.* at 1252-53.

80. *Id.* at 1251-52, 1272-73.

81. *Id.* at 1256.

82. *Id.* at 1267.

83. *Id.* at 1263.

84. *Id.* at 1276-78.

85. *Id.* at 1272-73.

86. *Id.* at 1279-80.

87. 82 T.C. 1001 (1984).

88. *Id.* at 1002.

89. *Id.* at 1004-05, 1014-16.

90. *Id.* at 1019.

explanation, that the taxpayer had at least "some" profit objective.⁹¹ However, without any analysis whatsoever, the court stated: "We conclude without great difficulty that petitioner was motivated primarily by tax considerations, and not primarily by the desire for economic profit"⁹²

In *Estate of Baron v. Commissioner*,⁹³ the Tax Court made a dollar-for-dollar comparison of the tax benefits and the before-tax profit.⁹⁴ Its decision appears to be the only opinion in which a court has explicitly set forth its method of comparison.⁹⁵ In *Estate of Baron*, the taxpayer purchased the rights to a copy of a soundtrack to a major motion picture.⁹⁶ The purchase price reflected a cash payment equaling approximately one-sixth of the purchase price and a non-recourse note representing the remainder of the purchase price.⁹⁷ The taxpayer knew little about the movie and soundtrack business and appeared to be focused on the potential tax benefits, and the taxpayer, in fact, received a four to one write-off.⁹⁸

In determining that the taxpayer was not entitled to deduct expenses paid in connection with his investment, the Tax Court concluded that the taxpayer lacked the requisite profit objective:

[T]he presence of a potential \$70,000 profit on [the taxpayer's] cash investment is not sufficient to cause us to conclude that [the taxpayer] had a profit objective aside from the net tax benefits of \$365,000 which he anticipated being able to obtain.⁹⁹

The Tax Court in *Estate of Baron* did not cite any authority for its determination that \$70,000 was insufficient to support a finding that the taxpayer engaged in the activity in question for profit.¹⁰⁰

91. *Id.*

92. *Id.* at 1023. It is unclear from the opinion what result the court would have reached if it had considered whether the taxpayer acted pursuant to "any" profit objective.

93. 83 T.C. 542 (1984), *aff'd*, 798 F.2d 65 (2d Cir. 1986).

94. *Id.* at 556.

95. *Id.* at 558-59.

96. *Id.* at 543.

97. *Id.* The Tax Court first determined that the taxpayer was not entitled to depreciation deductions based on the value of the nonrecourse note because the note was "too contingent" to be considered valid debt. *Id.* at 549.

98. *Id.* at 554-56.

99. *Id.* at 559.

100. *Estate of Baron* exemplifies the confusion that has arisen in the courts' attempts to formulate an appropriate test for profit objective in the business context. *See id.* at 558-59 (explaining that the test they are announcing may be "less-than-precise"). In addition to applying a dollar-for-dollar comparison of the taxpayer's objectives, the court inconsistently described the profit objective test as requiring both a "bona fide" profit objective, and in rejecting the requirement of a "primary" or "dominant" profit

In addition to using an arbitrary method to compare the taxpayer's various objectives, the *Estate of Baron* opinion further muddied the waters in the profit objective area by introducing an entirely new test for profit objective:

We conclude that an intermediate position will usually be in order, namely, that the disparity between *before-tax* profit and tax benefits be weighed in the context of all the factors involved in determining the existence of the requisite profit objective, rather than applying a "primary or dominant" test for nontax factors. . . .¹⁰¹

Despite advancing this new test, no authority explicitly addresses the "intermediate" test of *Estate of Baron*, and it does not appear that this test has subsequently been applied by the Tax Court.

B. Criticism of the Primary Test

The adoption and application of the primary test has not gone unnoticed by other courts, some of which have rejected the primary test as unsupported by the statutory language and the legislative history of section 183 as well as by the regulations under section 183.¹⁰² For example, in *Faulconer v. Commissioner*,¹⁰³ the United States Court of Appeals for the Fourth Circuit considered whether a taxpayer engaged

objective, adopting some unspecified "intermediate" profit objective where "all the factors involved in determining the existence of the requisite profit objective" would be weighed. *Id.* at 558.

101. *Id.* at 558 (footnote omitted).

102. *See, e.g.*, *Faulconer v. Commissioner*, 748 F.2d 890, 895-96 n.10 (4th Cir. 1984) (noting that neither the statutory language nor the legislative history requires that the primary purpose test be predominant); *Lamont v. Commissioner*, 339 F.2d 377, 380 (2d Cir. 1964) (stating that in analyzing profit, the question is whether the activities are "carried on in good faith," thus rejecting the primary purpose test); *Peat Oil & Gas Assocs. v. Commissioner*, 100 T.C. 271, 280 (1993) (Swift, J., concurring) (stating that the "primary" profit objective test is not grounded in any statutory or regulatory language, is "contrary to commercial and financial reality," and is a rule which only applies to an activity undertaken as a hobby), *aff'd*, 29 F.3d 98 (2d Cir. 1994); *Sheldon v. Commissioner*, 94 T.C. 738, 771-72 (1990) (Wells, J., dissenting) (citing *Estate of Baron*, 83 T.C. at 558 for support in adopting the "actual and honest profit objective for § 183 purposes"); *Levy v. Commissioner*, 91 T.C. 838, 871 (1988) (stating that the profit-objective test is satisfied by "an actual and honest profit objective"); *Johnson v. United States*, 11 Cl. Ct. 17, 27 (1986) (stating that the "primary" requirement should be limited to the "hobby loss" situation); McGuire, *supra* note 40 (discussing the Tax Court's incorrect insertion of the primary test into § 183 without the proper statutory support); William L. Raby, *Tax Shelters: How Much Profit Potential Is Enough?*, 60 TAX NOTES 327, 327-30 (1993) (comparing the divergent opinions in *Peat Oil & Gas Assocs.* between the primary objective test and the actual and honest profit objective test in the court's concurring opinions); Samansky, *supra* note 67, at 59 (stating that "the primary purpose test is unsatisfactory").

103. 748 F.2d 890 (4th Cir. 1984).

in a horse and cattle breeding activity for profit. In holding that the taxpayer conducted the activity "for profit," the Court noted:

We find nothing in section 183 or its legislative history . . . requiring [the profit objective] . . . to be predominant. Section 183 requires simply that an activity be "engaged in for profit." The Senate report indicates only that under section 183 a taxpayer must have entered or continued an activity with "the objective of making a profit."¹⁰⁴

A number of other courts have rejected the application of a primary test in the business context only.¹⁰⁵ In *Johnson v. United States*,¹⁰⁶ the United States Claims Court (now called the United States Court of Federal Claims) criticized the application of a primary test in the business context, stating:

Other factors, however, suggest that a primary or dominant standard is not appropriate in the business setting. Neither section 183 nor the Treasury regulations issued under it require a primary or dominant profit motive. . . . Economic and tax motives regularly operate side by side to influence business transactions, and it would be unfair and contrary to the realities of the marketplace to apply a "primary or dominant" test to them.¹⁰⁷

While the Code does not impose a primary profit objective requirement in any context, the Claims Court's approach in *Johnson* (namely, the application of a primary test in the hobby context only) would appear in accord with several recent Supreme Court cases such as *Commissioner v. Groetzinger*¹⁰⁸ and *Portland Golf Club v. Commissioner*,¹⁰⁹ that refer to the profit objective test under section 162 of the Code. However, as indicated below, the Supreme Court has not yet directly addressed this issue.¹¹⁰ Therefore, such recent opinions should not be interpreted as conclusive authority on this issue.

104. *Id.* at 896 n.10 (citations omitted).

105. See *Peat Oil & Gas Assocs.*, 100 T.C. at 283-84 (Swift, J., concurring); *Levy*, 91 T.C. at 855-56; *Johnson*, 11 Cl. Ct. at 26-27; see generally McGuire, *supra* note 40 (rejecting primary test in the business context); Raby, *supra* note 102 (same).

106. 11 Cl. Ct. 17 (1986). In *Johnson*, the taxpayer purchased certain computer equipment which he in turn leased back to the seller. *Id.* at 20. The purchase price of the computer equipment was reflected by a \$55,000 recourse note and a \$310,000 nonrecourse note. *Id.* at 23.

107. *Id.* at 26, 27 (citations omitted).

108. 480 U.S. 23, 23 (1987).

109. 497 U.S. 154, 164 (1990).

110. See *infra* part III.C.

C. *Supreme Court Cases Discussing Profit Objective*

In 1987, the Supreme Court in *Groetzinger*,¹¹¹ for the first time since its opinion in *National Grocery*,¹¹² mentioned specifically the primary profit objective test under section 162.¹¹³ In *Groetzinger*, the Supreme Court considered whether a taxpayer could deduct losses incurred in gambling in excess of the taxpayer's gambling winnings.¹¹⁴ In holding that the taxpayer was in the trade or business of gambling, and, therefore, that his losses were deductible, the Supreme Court noted:

We accept the fact that to be engaged in a trade or business, the taxpayer must be involved in the activity with continuity and regularity and that the taxpayer's *primary* purpose for engaging in the activity must be for income or for profit. A sporadic activity, a hobby, or an amusement diversion does not qualify.¹¹⁵

In using the word "primary" in *Groetzinger*, the Supreme Court apparently invoked the traditional dichotomy in the Code between business activities (for which deductions under Code sections 162 and 212 are available) and personal activities (for which deductions under Code section 162 are not available).¹¹⁶ The subject matter of *Groetzinger*—gambling, an activity generally thought to be one that is engaged in for recreational purposes—suggests that the Supreme Court might construe the primary test as applying only in cases in which the issue involves the business/personal distinction.

In another recent opinion, *Portland Golf Club*,¹¹⁷ the Supreme Court discussed the primary profit objective requirement in the context of a nonprofit organization that attempted to deduct expenses relating to nonexempt income, *i.e.*, income not related to the organization's exempt purpose, from its exempt investment income. Although the Supreme Court quoted the language from *Groetzinger* referring to a primary profit objective, the Court further stated that:

The Code's limitation on deductibility . . . reflects the view that taxpayers should not be allowed to deduct what are, in essence,

111. 480 U.S. 23 (1987).

112. 304 U.S. 282 (1938). *See supra* notes 48-54 and accompanying text (discussing *National Grocery Co.*).

113. *Groetzinger*, 480 U.S. at 23.

114. *Id.* at 24-25.

115. *Id.* at 35 (emphasis added).

116. *See supra* notes 2-4 and accompanying text (discussing distinction in the Code between business and personal expenses).

117. 497 U.S. 154 (1990).

personal expenses simply because the activity in question generates some receipts.¹¹⁸

While the Supreme Court did not directly address the validity or the applicability of the primary test as such, its opinion in *Portland Golf Club* might be read as suggesting that the Supreme Court would limit the application of the primary test to the hobby context in its future opinions.¹¹⁹

Some courts have cited the Supreme Court's "primary" language in *Groetzinger* as support for a primary profit objective requirement in all contexts, including the business context.¹²⁰ In *Antonides v. Commissioner*,¹²¹ the Fourth Circuit implicitly overruled its language in *Faulconer v. Commissioner*,¹²² in which the court discussed the lack of support for a primary test in the language of section 183 and its accompanying regulations. The Fourth Circuit cited *Groetzinger*¹²³ as requiring a primary profit objective (as opposed to an actual and honest profit objective), "for deductions to be allowable under section 162."¹²⁴ The Fourth Circuit did not, however, limit its holding to cases arising in the hobby context.¹²⁵

At least one judge has read *Groetzinger* even more expansively. In his concurring opinion in *Peat Oil & Gas Associates v. Commissioner*,¹²⁶ Judge Ruwe relied in part on *Groetzinger*, and suggested that the "actual and honest" and "primary" profit objective tests actually

118. *Id.* at 166 n.16.

119. As indicated above, however, such a limitation would not cure the inherent problem in the application of the primary test to any context—namely, that the test lacks a statutory basis and does not provide a workable standard. See *supra* notes 39-40 and accompanying text.

120. See, e.g., *Antonides v. Commissioner*, 893 F.2d 656, 659 (4th Cir. 1990); *Peat Oil & Gas Assocs.*, 100 T.C. at 289 (Ruwe, J., concurring); *Clayton v. Commissioner*, 65 T.C.M. (CCH) 2371, 2373 (1993); *Little v. Commissioner*, 65 T.C.M. (CCH) 3025, 3029 (1993); *Doerries v. Commissioner*, 62 T.C.M. (CCH) 484, 488 (1991); *Resser v. Commissioner*, 62 T.C.M. (CCH) 617, 626 (1991); *Dutton v. Commissioner*, 60 T.C.M. (CCH) 606, 610 (1990); *Klepetko v. Commissioner*, 60 T.C.M. (CCH) 1489, 1493 (1990); *Sloan v. Commissioner*, 55 T.C.M. (CCH) 1238, 1240 (1988); *Williams v. Commissioner*, 53 T.C.M. (CCH) 1203, 1205 (1987); see also *Miller*, *supra* note 4, at 110 n.11 (discussing *Groetzinger* and courts citing to the *Groetzinger* Court's "primary" language).

121. 893 F.2d 656 (4th Cir. 1990). In *Antonides*, the taxpayer invested in a partnership that was formed to run a yacht-chartering business. *Id.* at 657. The purchase price of the partnership interest was reflected by an \$18,958 cash payment, and the remainder of the purchase price was financed with a \$75,832 full recourse loan. *Id.*

122. 748 F.2d 890, 895-96 n.10 (4th Cir. 1984).

123. 480 U.S. 23, 25 (1987).

124. *Antonides*, 893 F.2d at 659.

125. *Id.*

126. 100 T.C. 271, 287-88 (1993) (Ruwe, J., concurring).

reflect a two-pronged profit objective test required under section 183 of the Code.¹²⁷ Judge Ruwe noted:

[T]he mere existence of a profit objective will not necessarily result in the allowance of deductions. A taxpayer still must meet the separate subjective test inherent in sections 162 and 183 requiring that the taxpayer's *primary* purpose for engaging in the activity was to make a profit.¹²⁸

As support for his interpretation of section 183, Judge Ruwe cites to several Circuit Court opinions that can be interpreted to suggest that the profit objective test is a two-part test.¹²⁹ For example, in *Estate of Baron v. Commissioner*,¹³⁰ the United States Court of Appeals for the Second Circuit, discussing a "quantitative" profit objective, stated:

Where a *bona fide* expectation of economic gain exists, the possibility of significant tax benefits will not *per se* preclude the taxpayer from taking deductions for depreciation on the investment Here, however, [the taxpayer] failed to demonstrate any reasonable expectation of profit. We therefore need not comment on the precise extent to which a transaction must be profit-motivated for a taxpayer to be entitled to tax benefits arising from the transaction.¹³¹

However, there does not appear to be any opinion in which a court has expressly held that there is a two-part profit objective test under section 183. Further, as indicated above, the Code, including section 183 and the regulations thereunder, does not provide any support for imposing a primary profit objective requirement, either alone or as part of a two-part profit objective test.¹³²

127. *Id.* at 289 (Ruwe, J., concurring).

128. *Id.* at 288 (Ruwe, J., concurring) (emphasis added) (citation omitted).

129. *See, e.g.,* *Agro Science v. Commissioner*, 934 F.2d 573, 576 (5th Cir.) (holding that expenditures may only be deducted under §§ 162, 174 and 212 if the facts and circumstances indicate that the taxpayer made them primarily in furtherance of some bona fide profit objective independent of tax consequences), *cert. denied*, 502 U.S. 907 (1991); *Estate of Baron v. Commissioner*, 798 F.2d 65, 72-75 (2d Cir. 1986) (discussing quantitative versus qualitative aspects of the profit objective test); *see also* *Sanderson v. Commissioner*, 50 T.C.M. (CCH) 1033, 1040 n.15 (1985) (suggesting that the profit objective test under Code § 183 is more stringent than the profit objective test applied under the sham transaction doctrine); Philip P. Storrer and Franklin Lowenthal, *Use of Present Value in Determining Profit Motive*, 13 REV. TAX'N INDIVIDUALS 150, 154 n.20 (1989) (stating that a modicum of profit is sufficient to avoid a showing of sham while something more is required to avoid a not-for-profit finding under § 183).

130. 798 F.2d 65 (2d Cir. 1986).

131. *Id.* at 72 (emphasis in original).

132. *See supra* notes 37-47 and accompanying text (discussing lack of support for the primary test in § 183 and in the regulations under § 183).

IV. INCOMPATIBILITY WITH THE INDIVIDUAL DECISION-MAKING PROCESS

The primary test is particularly problematic in that the test is wholly incompatible with the individual decision-making process.¹³³ Investors in the marketplace regularly take into account tax incentives when structuring transactions and making investment decisions.¹³⁴ The primary test ignores this reality by requiring investors to discount tax consequences that may very likely determine whether the investment will be financially advantageous.

As stated by the Claims Court in *Johnson v. United States*:¹³⁵

133. See *Peat Oil & Gas Assocs.*, 100 T.C. at 280 (Swift, J., concurring); *Levy*, 91 T.C. at 871-72. As stated by Bittker & McMahon in their treatise on individual federal income taxation:

Taxpayers often organize corporations, establish trusts, make gifts, sell property, and borrow money—to mention only a few obvious areas—in ways or at times selected to reduce their tax liabilities. In many cases, the tax savings is so clearly granted by the statute that even the most severe moralist would direct any criticism at Congress rather than at the taxpayer. When the Code requires taxpayers to pick one of several options to be chosen (e.g., cash or accrual accounting, immediate expensing versus capitalization, and depreciation of certain investments), for example, it would be quixotic of them to gladden the heart of the Commissioner of Internal Revenue by electing the most costly.

BORIS BITTKER & MARTIN MCMAHON, *FEDERAL INCOME TAXATION OF INDIVIDUALS*, ¶1.3 at 1-23 (2d ed. 1995).

134. BITTKER & MCMAHON, *supra* note 133.

135. 11 Cl. Ct. 17 (1986). An individual enters into an activity for many complicated reasons, some of which may include a desire to earn a profit, others of which may be personal and more significant than the desire to earn a profit. See, e.g., Donald C. Langevoort, *Theories, Assumptions and Securities Regulation: Market Efficiency Revisited*, 140 U. Pa. L. Rev. 851, 859-61 (1992) (discussing rationality and investor behavior). Langevoort notes in his article that investor decision-making is influenced by a variety of internal and external factors. *Id.* For example, Langevoort notes: "A second phenomenon is the tendency of people to be overconfident in their predictive abilities. In dealing with uncertain events, they overweigh the skill element of their decisions, and discount the element of chance Investors may therefore systematically underestimate the levels of risk they assume." *Id.* at 859. See also Donald C. Langevoort, *Disclosures that "Bespeak Caution,"* 49 BUS. LAW 481, 503 n.43 (1994) (finding that the courts are often impatient with apparently sophisticated investors who seem to act without due caution).

Where a taxpayer shows an intent to make a profit, assuming that the activity meets the other tax law requirements, the taxpayer should be entitled to deduct expenses paid or incurred in connection with the activity. No court would suggest that the actions of a corporation's board of directors should be closely scrutinized to determine if each and every such action were primarily motivated by profit, as such actions often are motivated by nonprofit considerations, such as community pressure and long-term business considerations that are inherently inconsistent with earning a profit. See, e.g., Dennis J. Block et al., *The Business Judgment Rule in Shareholder Derivative Litigation*, PRAC. L. INST., Oct.-Nov. 1991, at 429. The authors note:

Economic and tax motives regularly operate side by side to influence business transactions, and it would be unfair and contrary to the realities of the marketplace to apply a "primary or dominant" test to them.¹³⁶

The Supreme Court often has recognized the close relationship between tax objectives and other business objectives in cases such as *Frank Lyon Co. v. United States*.¹³⁷ In *Frank Lyon*, the Supreme Court held that a taxpayer could deduct expenses paid or incurred in connection with leasing transactions unless the taxpayer has no business purposes other than obtaining tax benefits in entering the transaction.¹³⁸

Also, during the same time period in which it decided *National Grocery*,¹³⁹ the Supreme Court recognized in other opinions that a taxpayer's desire to minimize his or her tax bill by taking advantage of beneficial provisions in the Code is legitimate and will not result in a denial of tax benefits as long as the transaction is not a sham.¹⁴⁰ In *Gregory v. Helvering*,¹⁴¹ the Supreme Court explained:

The legal right of a taxpayer to decrease the amount of what otherwise would be his taxes, or altogether to avoid them, by means which the law permits, cannot be doubted.¹⁴²

Other courts have also recognized the legitimacy of taxpayers relying on the beneficial provisions under the Code in structuring transactions and in making business decisions.¹⁴³ The Tax Court

Because businessmen and women are correctly perceived as possessing skills, information and judgment not possessed by reviewing courts and because there is great social utility in encouraging the allocation of assets and the evaluation and assumption of economic risk by those with such skill and information, courts have long been reluctant to second-guess such decisions when they appear to have been made in good faith.

Id.

136. *Johnson*, 11 Cl. Ct. at 27.

137. 435 U.S. 561 (1978).

138. *Id.* at 562.

139. 304 U.S. 282 (1938); see also *supra* notes 48-54 and accompanying text (discussing *National Grocery*).

140. See *infra* note 151 (discussing sham transactions).

141. 293 U.S. 465 (1935).

142. *Id.* at 469 (citations omitted). See also *Knetsch v. United States*, 364 U.S. 361, 365 (1960) (quoting *Gregory* for the same proposition that a taxpayer has a right to avoid taxes as much as the law permits).

143. See, e.g., *Commissioner v. Brown*, 380 U.S. 563, 579-80 (1965) (Harlan, J., concurring); *Peat Oil & Gas Assocs. v. Commissioner*, 100 T.C. 271, 276 (1993); *Levy v. Commissioner*, 91 T.C. 838, 853, 871-72 (1988); *Friendship Dairies, Inc. v. Commissioner*, 90 T.C. 1054, 1064 (1988); *Johnson*, 11 Cl. Ct. at 27; *Estate of Thomas v. Commissioner*, 84 T.C. 412, 432 (1985).

stated this principle in *Fox v. Commissioner*,¹⁴⁴ as follows:

Tax planning is an economic reality in the business world and the effect of tax laws on transactions is routinely considered along with other factors. Congress has often turned this fact into a tool by which to encourage particular conduct and achieve certain policy goals. *Numerous provisions of the Internal Revenue Code attest to this.*¹⁴⁵

Even the IRS recognizes that taxpayers regularly take tax consequences into account when planning transactions. In Revenue Procedure 75-21,¹⁴⁶ the IRS set forth guidelines for the deductibility of expenses paid or incurred in connection with equipment leasing activities.¹⁴⁷ The guidelines do not require a dominant or primary profit objective, rather, the amount or degree of profit objective required under the Service's guidelines is met if the taxpayer/lessor expects to receive "a profit from the transaction, apart from the value of or benefits obtained from the tax deductions, allowances, credits, and other tax attributes arising from [the leasing] transaction."¹⁴⁸

The recognition by the courts and by the IRS of the close relationship between tax and other business motivations suggests that taxpayers' deductions should not be disallowed unless taxpayers have *no* profit objective, unless the transaction has no business purpose or is a sham, or unless allowing the deductions at issue would violate some provision in the Code other than the profit objective test under section 162.

Further, a primary test may often conflict with congressional policy to provide tax benefits for certain types of investments. As indicated above, Congress has, on many occasions, provided tax benefits for the very purpose of encouraging taxpayers to invest in a specific activ-

144. 82 T.C. 1001 (1984).

145. *Id.* at 1025 (citations omitted) (emphasis added). In *Fox*, the Tax Court recognized that in some cases, tax benefits may be the main objective of a taxpayer entering into a transaction, and may even be the *primary* reason that the taxpayer invests in a particular investment. *See id.* at 1021.

Courts have recognized the principle that a taxpayer's other objectives operate side-by-side with a profit objective in the hobby context. In *Jackson v. Commissioner*, the Tax Court noted that: "[A] business will not be turned into a hobby merely because the owner finds it pleasurable; 'suffering has never been made a prerequisite to deductibility.'" 59 T.C. 312, 317 (1972), *acq.*, 1973-2 C.B. 2 (quoting *Wilson v. Eisner*, 282 F. 38, 42 (2d Cir. 1922)).

146. *Reprinted in* Rev. Proc. 75-21, 1975-1 C.B. 715; *see also* MACON & UMBRECHT, *TAX ASPECTS OF EQUIPMENT LEASING—LEVERAGED LEASING* 313, 430-36 (3d ed. 1988) (discussing how to structure equipment leases to maximize tax benefits).

147. Rev. Proc. 75-21, 1965-1 C.B. 715, 716.

148. *Id.*

ity or type of property.¹⁴⁹ Of course, tax benefits are sometimes used in ways not intended by Congress, as repeatedly illustrated by the many abusive tax shelters promoted during the last two decades.¹⁵⁰ However, where taxpayers legitimately obtain tax benefits, the courts should not legislate additional requirements on the conferral of such benefits.

V. ALTERNATIVES TO THE PRIMARY TEST

Courts and Congress have developed other tools, aside from the primary test, to prevent overreaching by taxpayers. The sham transaction,¹⁵¹ substance over form,¹⁵² step-transaction¹⁵³ and business

149. See *supra* note 11 and accompanying text.

150. See Miller, *supra* note 4, at 108-09 (stating that tax benefits often are provided for the purpose of influencing taxpayer behavior and authorities cited therein).

151. See Kent N. Schneider & Ted D. Englebrecht, *The Tax Court's Unified Approach to Analyzing Generic Tax Shelters*, 6 J. TAX'N INVESTMENTS 308, 309-11 (1988). The sham transaction doctrine was developed by courts to deny legal effect to transactions that are fictitious. *Id.* at 309. Under this doctrine, the economic reality of a particular transaction is evaluated to determine if the transaction has economic significance beyond the tax benefits generated by the transaction (i.e., whether there is any reasonable chance that the transaction will generate a profit). *Id.* at 310. The sham transaction doctrine generally involves a two-step inquiry by courts into the business purpose and economic substance of the transaction. *Rose v. Commissioner*, 88 T.C. 386, 408-409 (1987), *aff'd*, 868 F.2d 851 (6th Cir. 1989). The business purpose inquiry involves consideration of the taxpayer's subjective purpose for entering the transaction. *Id.* at 411. Courts generally look at both objective and subjective factors to determine the taxpayer's objective in entering the transaction, i.e., whether the taxpayer had an "actual and honest" profit objective. *Id.* at 411-12. Failure to establish that a transaction had a business purpose other than tax avoidance will not result in the transaction being classified as a sham if the taxpayer can establish the presence of the second part of the test—economic substance. *Id.* at 408 n.17. Economic substance means that a transaction has some economic effect, other than tax consequences. *Id.* See also *Packard v. Commissioner*, 85 T.C. 397, 417-18 (1985) (holding that a transaction is a sham if the taxpayer was motivated by no business purposes other than obtaining tax benefits in entering the transaction and the transaction has no economic substance because no reasonable possibility of a profit exists). If a transaction lacks economic substance, the taxpayer will not be entitled to deduct expenses claimed in connection with the transaction. *Id.* at 416.

152. Under the substance over form doctrine, the court looks beyond the form in which the taxpayer has cast a particular transaction to analyze the underlying substance of the transaction. For example, where a taxpayer characterizes a transfer of money to a third party as a loan by executing all of the necessary documents, but the third party never makes any payments on the loan, the court may consider whether the parties actually intended for the transfer to constitute a valid debt. See BITTKER & MCMAHON, *supra* note 133, at ¶ 1.3; see, e.g., Schuyler M. Moore, *Form v. Substance: When Will Courts Respect the Form of a Transaction?*, 66 J. TAX'N 66 (1987); Alan Gunn, *Tax Avoidance*, 76 MICH. L. REV. 733 (1978).

153. Closely related to the substance over form doctrine, the step transaction doctrine seeks to ascertain the "real" nature of a multi-step transaction by looking at all of the steps of a transaction as a whole. See BORIS BITTKER & JAMES S. EUSTICE, *FEDERAL*

purpose doctrines¹⁵⁴ represent judicially-created principles courts use to deny the particular tax effect sought by a taxpayer where the transaction or the form of the transaction lacks substance or business purpose. These doctrines, although often treated as interchangeable by the courts, serve as an effective method of preventing abuse of tax benefits provided under the Code.¹⁵⁵

In addition to these judicial doctrines, in the Tax Reform Act of 1986,¹⁵⁶ Congress enacted several provisions to combat what it perceived to be a proliferation of "abusive" tax shelters. These provisions included an expansion of the existing at-risk rules, and rules providing limitations on the deduction of so-called "passive" losses.¹⁵⁷

INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS ¶ 14.51 (5th ed. 1987); Moore, *supra* note 152, at 68 (discussing the use of sham transaction doctrine in tax shelter cases). Courts have applied the step-transaction doctrine in three instances: (i) where, at the time the first step is taken, there is a binding commitment to take the later step, (ii) where the legal or economic effect of one step would have been nonexistent in the absence of the other steps taken, and (iii) where the end result indicates that the separate steps are merely parts of a prearranged transaction designed to achieve the ultimate intended result. See BITTKER & MCMAHON, *supra* note 133, ¶ 1.3 at 1-29; Robert W. Wood, *Is the Step Transaction Doctrine Still a Threat for Taxpayers?*, 72 J. TAX'N 296 (1990).

154. The business purpose doctrine was originally established by the Supreme Court in *Gregory v. Helvering*, 293 U.S. 465 (1935). *Gregory* involved a taxpayer/shareholder who created a new corporation for the purpose of avoiding taxation resulting from distribution by the original corporation of marketable securities to the taxpayer. *Id.* at 469. The Supreme Court determined that the new corporation had been formed for the sole purpose of avoiding taxation, holding that the transaction was "a mere device which put on the form of a corporate reorganization as a disguise for concealing its real character." *Id.* The existence of a business purpose prevents an activity from being characterized as a sham. *Id.*

155. See, e.g., *Estate of Baron v. Commissioner*, 798 F.2d 65, 71 (2d Cir. 1986); *Brannen v. Commissioner*, 722 F.2d 695, 704 (11th Cir. 1984); *Flowers v. Commissioner*, 80 T.C. 914, 915 (1983); *Pitts v. Commissioner*, 63 T.C.M. (CCH) 1742, 1746 (1992); *Miller v. Commissioner*, 52 T.C.M. (CCH) 239, 242 (1986); *Seely v. Commissioner*, 51 T.C.M. (CCH) 1087, 1093 (1986) (stating that taxpayer invested in "S" corporation, not in partnership); *Harmon v. Commissioner*, 51 T.C.M. (CCH) 1491, 1498 (1986); see also BITTKER & MCMAHON, *supra* note 133, ¶ 1.3 at 1-22 (noting that in applying the Code, courts distinguish between "tax avoidance" and "tax evasion" and also between "form" and "substance," taking transactions at face value for tax purposes only if they are imbued with a "business purpose" or "reflect economic reality").

156. Pub. L. No. 99-514, 100 Stat. 2085 (1986).

157. I.R.C. §§ 465, 469 (1995). Originally enacted under the Tax Reform Act of 1976, the purpose of the at-risk rules codified in § 465 of the Code is to prevent taxpayers from deducting losses from an activity in excess of their actual investment in the activity. Pub. L. No. 94-455, 90 Stat. 1531 (1995). Prior to 1986, the at-risk rules were fairly limited in their application. *Id.* The Tax Reform Act of 1986 expanded the at-risk rules to limit deductions for business expenses paid or incurred in connection with highly leveraged investments such as tax shelters. See BITTKER & MCMAHON, *supra* note 133, at ¶ 19.4 (discussing at-risk rules under § 465); Thomas G. Tracy &

Despite the decrease in the promotion of tax shelters as investments since the enactment of the Tax Reform Act of 1986, courts continue to apply the "primary" profit objective test in the business context.¹⁵⁸ The problems with the primary test justify a continuing concern because even when a taxpayer invests in an activity that is not considered to be an "abusive" tax shelter, the taxpayer must take into account the available tax benefits. A recent Tax Court case, *Warden v. Commissioner*,¹⁵⁹ provides an example of the kinds of cases in which the IRS and the Tax Court currently apply the primary test. In *Warden*, the taxpayers owned and operated a yacht for charter.¹⁶⁰ The taxpayers took steps consistent with operating the boat for profit, such as maintaining a detailed log of the use and maintenance of the boat, running advertisements in the classified section of the newspaper, and paying for a listing in the yellow pages of the local phone book.¹⁶¹ However, due to mechanical difficulties with the boat, the taxpayers only chartered the boat several times and ended up attempting to sell the boat at a loss several years later.¹⁶²

Mike Johnston, *The Effect of the Tax Reform Act of 1986 on Tax Shelters*, 17 TAX ADVISER 696, 706-10 (1986). Under § 465, taxpayers are not entitled to deduct losses from activities in excess of the amount the taxpayer is "at-risk." I.R.C. § 465(a)(1) (1995). Taxpayers are considered "at-risk" for the amounts of money and the adjusted basis of property contributed to the activity. I.R.C. § 465(b)(1)(A) (1995). In addition, taxpayers are considered at risk for amounts of money borrowed in connection with the activity where the taxpayer is personally liable for the borrowed amount and where the taxpayer has pledged property as security for the debt (but only to the extent of net fair market value of the pledged property). I.R.C. § 465(b)(1)(B), (b)(2)-(b)(6) (1995).

Under the Tax Reform Act of 1986, subject to certain rules and limitations, "passive" losses generally can be applied only against passive income. See I.R.C. § 469 (1995); see also BITTKER & MCMAHON, *supra* note 133, at ¶ 19.5 (discussing passive loss rules); Ivan H. Humphreys, *Tax Shelters: The Search for Passive Income*, 4 J. TAX'N INVESTMENTS 289 (1986) (stating that it is clear taxpayers expecting passive losses are seeking passive income to "soak-up" those passive losses); Tracy & Johnston, *supra*, at 696-706 (noting that subject to certain exceptions, net passive activity losses and credits cannot be applied against other income of an individual). "Passive" losses are those losses generated by "passive" activities. Humphreys, *supra*, at 290. A passive activity is defined as one in which the taxpayer does not "materially participate." I.R.C. § 469(c) (1995). Rental activity is almost always treated as passive activity. I.R.C. § 469(c)(2) (1995). "Material participation" requires active involvement by the taxpayer in the operations of the activity. I.R.C. § 469(h) (1995). Merely approving decisions made by a paid advisor is not sufficient to constitute material participation. I.R.C. § 469(c)(2) (1995). See generally BITTKER & MCMAHON, *supra* note 133, at ¶ 19.3 (describing other statutory measures enacted specifically to deal with abusive tax shelters).

158. See *supra* notes 133-34.

159. 69 T.C.M. (CCH) 2432 (1995).

160. *Id.* at 2433.

161. *Id.* at 2434.

162. *Id.* at 2437.

The Tax Court found that, although the taxpayers “honestly hoped that their yachting activity would generate a profit,” the taxpayers failed to show that their *primary objective* was to earn a profit.¹⁶³ In so holding, the court pointed to “significant” recreational elements as the taxpayer’s reason for engaging in the activity.¹⁶⁴ Had the court applied the actual and honest test rather than the primary test, it might well have reached a different holding.¹⁶⁵

VI. CONCLUSION

The lack of statutory support for a primary test, the fact that such a test is inherently inconsistent with the process of individual decision-making, and the range of alternative measures available to curtail abusive investments, reveal that the primary test is simply not viable. Courts should apply the actual and honest test to determine whether an activity has been entered into or carried on “for profit.”

Measuring or comparing various taxpayer objectives is unrealistic in the business context, where taxpayers concurrently attempt to further several objectives, including earning a profit. Applying the actual and honest test in the business context does not require courts to measure the amount or degree of a taxpayer’s profit objective. Unlike the primary test, the actual and honest test provides courts and taxpayers with clear-cut guidelines regarding which activities will be treated as “for profit” activities under section 162 of the Code. Applied in combination with the at-risk rules, the passive activity loss rules, and the judicially devised doctrines described above, the actual and honest test assures that taxpayers who make investment decisions solely for tax reasons will not be entitled to take deductions for expenses claimed in connection with those investments.

163. *Id.* at 2438.

164. *Id.*

165. *See id.*