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Allan J. Samansky

HOBBY LOSS OR DEDUCTIBLE LOSS: AN INTRACTABLE PROBLEM

ALLAN J. SAMANSKY*

Breeding horses or dogs, painting, and stamp collecting are a few examples of the many activities that are carried on as hobbies by some individuals and as endeavors to make a profit by others. This article explores the deductibility of losses from such activities.[1]

First, the article presents and evaluates current law. Under section 183 of the Internal Revenue Code of 1954, losses from activities that are "not engaged in for profit" can generally not be deducted; however, losses from businesses or profit-oriented activities qualify for deduction.[2] Distinguishing between those activities considered to be hobbies and those considered to be for profit has been a constant problem. Courts often state that losses can be deducted only if the taxpayer has the primary purpose of making a profit,[3] but then apply a different standard and allow losses to be deducted whenever the taxpayer acts as if he intends to make a profit.[4] Neither standard is completely satisfactory.

The article then presents a theoretical analysis of the problem by discussing what rules are needed for fairness and economic efficiency. The fundamental problem with respect to each goal is that the activity may provide both pecuniary and nonpecuniary returns while only the pecuniary return is taxable. However, it is impossible to bifurcate the expenditure into one portion allocable to the pecuniary return and another allocable to the nonpecuniary return. The result is that there is no completely satisfactory rule for deducting losses from activities that may be carried on for both pleasure and profit.

In the final section, the article suggests that the Internal Revenue Code be amended. The proposed amendment would both make it easier to classify activities as either engaged in for profit or not and reduce the significance of the classification. In most cases activities would be determined to be not for profit according to an objective standard. Losses from a not-for-profit activity would never be deductible against income from other sources but would be

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*B.A., Harvard College 1967; M.A., University of California at Berkeley 1968; J.D., University of Pennsylvania 1974. Assistant Professor of Law, Ohio State University College of Law.

1. This article does not address losses from property, such as a vacation home, that is, at various times, either rented to others or used for personal purposes. The personal and business uses of the property are bifurcated in a way that is not possible for an activity like horsebreeding. Losses incurred in owning and maintaining such property therefore present different issues than do losses from an activity that may be a hobby. See *infra* note 6.

2. I.R.C. § 165(c) (1976).

3. *See infra* notes 45-63 and accompanying text.

4. *See infra* notes 65-75 and accompanying text.

deductible against any income realized from that activity in subsequent or previous years.

THE LAW

The Statute

In 1969 Congress enacted section 183 of the Internal Revenue Code[5] to deal with the problem of taxpayers using losses from hobbies to offset income from other sources.[6] Section 183,[7] which applies to individuals, trusts, estates,

5. Tax Reform Act of 1969, Pub. L. No. 91-172, § 213(a), 83 Stat. 571 (currently codified at 26 U.S.C. § 183 (1976)).

Section 183 was enacted as a replacement for I.R.C. § 270. Section 270, which applied only if an activity was pursued for profit, did not allow an individual to deduct losses in excess of $50,000 when such excess losses had been incurred in any activity for five consecutive years. Section 270, however, had been ineffective. Many deductions were excluded by statute from the computation of loss, and taxpayers could usually rearrange income and deductions to break the five-year string. In addition, if it applied, § 270 was overly harsh, requiring the taxpayer to pay in one year the additional tax attributable to a five-year period. *See* S. REP. No. 552, 91st Cong., 1st Sess. 102-03 (1969).

In 1969 the Nixon Administration proposed amending § 270. The most important change would have disallowed losses from any activity in excess of $50,000, if such excess losses existed in any three of five consecutive years. U.S. TREASURY DEPARTMENT, TAX REFORM PROPOSALS, 91st Cong., 1st Sess. 209-12 (1969). The House Committee on Ways and Means agreed that § 270 had to be strengthened. It proposed that losses should not be deductible if the taxpayer did not have a reasonable expectation of profit. If the losses exceeded $25,000 in any three of five consecutive years, then there would be a rebuttable presumption that the taxpayer did not have a reasonable expectation of profit. H.R. 13270, 91st Cong., 1st Sess. § 213(a) (1969) (as reported by the House of Representatives Committee on Ways and Means and passed by the House of Representatives); H.R. REP. No. 413, 91st Cong., 1st Sess. 71 (1969). The Senate Finance Committee declared that it was "in basic agreement with the approach taken by the House." S. REP. No. 552, 91st Cong., 1st Sess. 103 (1969). The Committee, however, made two major changes in the House bill. First, it rejected the requirement that the expectation of profit be reasonable. Second, it replaced the presumption in the House bill with a rebuttable presumption that would operate in favor of the taxpayer. These provisions were contained in a new § 183 and § 270 was repealed. With minor changes the provision approved by the Finance Committee is present § 183. H.R. 13270, 91st Cong., 1st Sess. § 213(a) (1969) (as amended by the Senate Finance Committee); S. REP. No. 552, 91st Cong., 1st Sess. 102-05 (1969); I.R.C. § 183 (1976).

6. The impetus for enacting § 183 was a concern that taxpayers were often deducting hobby losses, particularly hobby losses incurred in farming. Thus, the proposal from the Treasury Department for amending § 270, the House provision for amending § 270, and the Senate provision for the new § 183 were all listed under the general topic of " Farm Losses." Both the House Ways and Means Committee and the Senate Finance Committee entitled their discussions of their respective provisions "Hobby Losses." U.S. TREASURY DEPARTMENT, TAX REFORM PROPOSALS, 91st Cong., 1st Sess. 203 (1969); H.R. REP. No. 413, 91st Cong., 1st Sess. 62, 71 (1969); S. REP. No. 552, 91st Cong., 1st Sess. 95, 102 (1969).

As enacted, § 183 is not restricted to hobbies. It applies to holding property when the property is used at times for personal purposes and at other times is rented. *See, e.g.,* Treas. Reg. § 1.183-1(d)(3) (1971); McKinney v. Commissioner, 41 T.C.M. (CCH) 1272 (1981). Section 280A now provides certain mechanical rules for "dwelling units" that will often make reference to § 183 unnecessary in this area. *See* Lang, *When a House Is Not Entirely a Home: Deductions Under Internal Revenue Code § 280A for Home Offices, Vacation Homes, Etc.,* 1981 UTAH L. REV. 275, 298-99.

and Subchapter S corporations,[8] only affects deductions from activities that are "not engaged in for profit." It allows deductions with respect to these activities, but limits them to the amount of gross income from the respective activities.[9] However, deductions allowed by other provisions without a profit motive, such as an interest expense, are not affected by section 183 and thus are not limited by the amount of gross income.[10]

Section 183 defines an "activity not engaged in for profit" as any activity

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Section 183 may also apply to some investments that are entered into only for tax savings, not economic profit. The Treasury Department had recommended to the Senate Finance Committee that the section make clear that the anticipated profit must be "an economic profit, not a 'tax savings' profit." TAX REFORM ACT OF 1969, TECHNICAL MEMORANDUM OF TREASURY POSITION, 91st Cong., 1st Sess. 35 (Comm. Print 1969). The Senate Finance Committee, however, took no action in response to this recommendation. The proposed regulations to § 183, but not the final regulations, referred to an "economic profit." 36 Fed. Reg. 16,112, 16,117 (1971). *Cf.*, Rev. Rul. 79-300, 1979-2 C.B. 112 (§ 183 does not apply to construction and operation of low and moderate income housing but implies that it could apply to other real estate investments).

7. The relevant portion of § 183 follows:

§ 183. Activities not engaged in for profit.

(a) General rule. — In the case of an activity engaged in by an individual or an electing small business corporation (as defined in section 1371(b)), 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 2 or more of the taxable years in the period of 5 consecutive taxable years which ends with the taxable year exceeds the deductions attributable to such activity (determined without regard to whether or not such activity is engaged in for profit), then, unless the Secretary establishes to the contrary, such activity shall be presumed for purposes of this chapter for such taxable year to be an activity engaged in for profit. In the case of an activity which consists in major part of the breeding, training, showing, or racing horses, the preceding sentence shall be applied by substituting the period of 7 consecutive taxable years for the period of 5 consecutive taxable years.

8. I.R.C. § 183(a) (1976); Treas. Reg. § 1.183-1(a) (1971).

9. I.R.C. § 183(a), (b) (1976). The order in which the deductions may be taken is described in Treas. Reg. § 1.183-1(b) (1971).

Prior to the enactment of § 183, taxpayers were allowed to deduct appropriate expenses from hobbies to the extent of income (or, equivalently, did not have to report the income), although it was difficult to find statutory justification for this rule. *See, e.g.,* Treas. Reg. § 1.162-12(b) (1956); Martin v. Commissioner, 50 T.C. 341, 364-65 (1968); V.H. Monnette & Co. v. Commissioner, 45 T.C. 15, 41, 44 (1965), *aff'd per curiam,* 374 F.2d 116 (4th Cir. 1967).

10. I.R.C. § 183(b) (1976).

other than one for which deductions are allowable under section 162 or under paragraph (1) or (2) of section 212.[11] These provisions allow deductions for appropriate expenses incurred in connection with a trade or business, a profit-seeking activity, or property held for production of income. Section 183 thus incorporates into the definition of an "activity not engaged in for profit" general principles concerning deductibility of business or profit-oriented expenses. Hobby loss cases arising under the law prior to section 183 were based on these general principles and, therefore, retain vitality.[12] The legislative history and regulations of section 183 also discuss relevant factors for determining whether an activity is engaged in for profit.[13]

Section 183 has added to the Internal Revenue Code a rebuttable presumption concerning whether an activity is engaged in for profit.[14] If an activity has been profitable for two out of the last five years (two out of the last seven years for activities related to horses),[15] then, unless the government shows otherwise, it will be presumed the activity was engaged in for profit.[16] While the presumption is of minor technical import,[17] it probably gives the

11. I.R.C. § 183(c) (1976). The standard for determining whether an activity is not engaged in for profit is the same whether the expenses would be deductible under § 162 or § 212. *See* Appley v. Commissioner, 39 T.C.M. (CCH) 386, 394 (1979); Treas. Reg. § 1.183-2(a) (1971). *But see* Lamont v. Commissioner, 339 F.2d 377, 380 n.4 (2d Cir. 1964).

12. Cases involving years both before and after the effective date of § 183 have produced the same result for all the years. *See, e.g.,* Nittler v. Commissioner, 39 T.C.M. (CCH) 422 (1979); Hurd v. Commissioner, 37 T.C.M. (CCH) 499 (1978); Jasinowski v. Commissioner, 66 T.C. 312, 321-22 (1976); Benz v. Commissioner, 63 T.C. 375 (1974).

13. *See infra* notes 19-30 and accompanying text.

14. I.R.C. § 183(d) (1976).

15. The seven-year time period for horse-related activities resulted from an amendment offered on the floor of the Senate by Senator Cooper. 115 CONG. REC. 38,296 (1969).

16. If the taxpayer has engaged in the activity for less than five years (seven years for a horse-related activity), he may elect that a determination of whether the presumption applies not be made before the end of the fourth year (sixth year for a horse-related activity) following the first year that he engaged in the activity. Otherwise the presumption cannot apply until after the second profit year. Treas. Reg. § 183(c)(1)(ii) (1971). If made, the election extends the statute of limitations for deficiencies related to the activity. I.R.C. § 183(e) (1976).

17. The presumption may only affect allocation of the production burden. In this case, the government, not the taxpayer, would first have to present evidence that the activity was not engaged in for profit when the conditions for presumption were satisfied. If the government could not produce credible evidence, the taxpayer would win the case without presenting evidence on this issue. Because there will always be some evidence that the activity was not engaged in for profit, this possibility should not trouble the Internal Revenue Service. The presumption may also affect the burden of persuasion concerning whether the activity was engaged in for profit. This effect would be significant only when the trier of fact is completely undecided on this issue, a situation which should be quite unusual. *See* F. JAMES, JR. & G. HAZARD, CIVIL PROCEDURE 253-61 (2d ed. 1977). Senator Gore, in reporting his individual views on the bill that became the Tax Reform Act of 1969, assumed the presumption would affect the burden of persuasion. S. REP. No. 552, 91st Cong., 1st Sess. 311, 338 (1969).

The only case where the presumption even arguably has applied is Dunn v. Commissioner, 70 T.C. 715 (1978). In *Dunn,* the taxpayer contended that his horse racing activity had become a business in 1969. The years at issue were 1970 and 1971, and a small profit was earned in 1974 and 1975. It was not clear if the taxpayer had made a valid election to defer qualifying taxpayer a psychological advantage.[18]

The Regulations

For an activity to be carried on for profit, the taxpayer must have the "objective of making a profit."[19] According to the regulations, the taxpayer's expectation of profit need not be reasonable; a bona fide expectation is sufficient.[20] The regulations also state that determination of whether an activity is engaged in for profit must be made by "reference to objective standards."[21] It is not clear what is meant by "objective standards," but objective facts (such as probability of a profit) should primarily give information concerning a reasonable, not a bona fide, expectation.[22] In any event it is clearly implied that

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determination of whether the conditions for the presumption were satisfied. The court held that, whether or not the presumption was in effect, the activity was not carried on for profit.

18. No cases where the presumption is clearly in effect have been litigated. For a case where it was not clear whether the presumption was in effect, see *supra* note 17. A possible reason for the paucity of cases is that the Internal Revenue Service may be conceding whenever the presumption is in effect. It is interesting to note that the following sentence appeared in a recent article on hobbies in a popular magazine: "If you manage to make a profit in any two years in a five-year period, then the Internal Revenue Service will *assume automatically* that your hobby is a business." Main, *Hobbyists Get Down to Business*, MONEY, July 1980, at 38, 41 (emphasis added).

19. Treas. Reg. § 1.183-2(a) (1971).

20. *Id.* Before § 183 was enacted, it was not clear whether a reasonable expectation of profit was required. Some cases stated that it was required, but they were not decided for the government solely on the ground that profit was unlikely. *See, e.g.,* Schley v. Commissioner, 24 T.C.M. (CCH) 588 (1965), *aff'd,* 375 F.2d 747 (2d Cir. 1967); Conyngham v. Commissioner, 23 T.C.M. (CCH) 1179 (1964). More commonly the courts required only a bona fide expectation of profit. *See, e.g.,* Patterson v. United States, 459 F.2d 487 (Ct. Cl. 1972); Bessenyey v. Commissioner, 45 T.C. 261 (1965), *aff'd,* 379 F.2d 252 (2d Cir.), *cert. denied,* 389 U.S. 931 (1967).

The bill passed by the House of Representatives in 1969 would have required a reasonable expectation of profit. The Senate Finance Committee, however, rejected this requirement, saying: "The committee is concerned, however, that requiring a taxpayer to have a 'reasonable expectation' of profit may cause losses to be disallowed in situations where an activity is being carried on as a business rather than as a hobby. Accordingly, the committee has modified the House bill to provide that in determining whether losses from an activity are to be allowed, the focus is to be on whether the activity is engaged in for profit rather than whether it is carried on with a reasonable expectation of profit. This will prevent the rule from being applicable to situations where many would consider that it is not reasonable to expect an activity to result in a profit even though the evidence available indicates that the activity actually is engaged in for profit. For example, it might be argued that there was not a 'reasonable' expectation of profit in the case of a bona fide inventor or a person who invests in a wildcat oil well. A similar argument might be made in the case of a poor person engaged in what appears to be an inefficient farming operation. The committee does not believe that this provision should apply to these situations or that the House intended it to so apply, if the activity actually is engaged in for profit." S. REP. No. 552, 91st Cong., 1st Sess. 103 (1969).

21. Treas. Reg. § 1.183-2(a) (1971).

22. "Objective" facts would not include a particular person's idiosyncracies, such as unwarranted optimism concerning demand for a product. If such idiosyncratic facts are not considered, then the facts still available would be those that are important to an average

the taxpayer's statement should be given some weight,[23] and, therefore, in at least some cases subjective evidence will be permitted.[24]

Regulation section 1.183-2 lists nine factors that are among those to be taken into account in determining whether an activity is engaged in for profit, but the inclusion and discussion of these factors are only marginally helpful. It is stated that these factors are not exclusive, that no one factor should be considered determinative, and that a comparison of the number of factors indicating a profit motive with those that do not, cannot be used to indicate whether there is a profit motive.[25] The nine factors, which have been derived from prior case law,[26] are: (1) manner in which taxpayer carries on the activity, (2) expertise of the taxpayer or his advisors, (3) time and effort expended by the taxpayer in carrying on the activity, (4) expectation that assets used in the activity may appreciate in value, (5) success of the taxpayer in carrying on other similar or dissimilar activities, (6) taxpayer's history of income or losses with respect to the activity, (7) amount of occasional profits from the activity, (8) financial status of the taxpayer, and (9) elements of personal pleasure or recreation from the activity.[27]

Six examples provided in the regulations[28] are also not very helpful. None of them present the common but difficult situation of a high income taxpayer with large losses from an enjoyable activity that is conducted in a businesslike fashion. By avoiding the difficult situations, the examples do not help indicate what standards should be used in these cases.

The regulations do not explicitly state whether any bona fide intent to make a profit is sufficient or whether the intent must be a substantial or possibly the predominant reason for engaging in the activity. The first seven of the nine factors can only indicate if there is some intent to make a profit. Their inclusion in the regulations does not indicate how substantial that intent must be. The eighth factor, financial status of the taxpayer, could be

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or reasonable person. *See* Blum, *Motive, Intent, and Purpose in Federal Income Taxation,* 34 U. CHI. L. REV. 485, 498 (1967).

This problem of determining a person's bona fide (or subjective) intent by means of objective evidence has been largely resolved by looking to a person's actions. Courts hold that an activity is engaged in for profit if the taxpayer acts as if he intends to make a profit. *See infra* notes 65-76 and accompanying text. This approach, however, is unsatisfactory. The taxpayer will simply conduct his hobby in a businesslike manner for the sole purpose of deducting his losses. Taking such steps as keeping accurate books and records and consulting with experts will usually not substantially impair his pleasure. *Id.*

23. The regulations state: "In determining whether an activity is engaged in for profit, greater weight is given to objective facts than to the taxpayer's mere statement of his intent." Treas. Reg. § 1.183-2(a) (1971).

24. *See infra* notes 26-27 and accompanying text.

25. Treas. Reg. § 1.183-2(b) (1971).

26. For a detailed discussion of these factors and the cases from which they were derived, see Lee, *A Blend of Old Wines in a New Wineskin: Section 183 and Beyond,* 29 TAX L. REV. 347, 397-444 (1974); Burns & Groomer, *Effects of Section 183 on the Business/Hobby Controversy,* 58 TAXES 195 (1980).

27. It might be noted that the ninth factor is clearly not an "objective" fact.

28. Treas. Reg. § 1.183-2(c) (1971). For a discussion of the examples and the cases from which they were derived, see Lee, *supra* note 26, at 392-95.

used merely to help determine whether the taxpayer has some intent to make a profit or could be used to compare profit and nonprofit motives. A wealthy individual will usually be more motivated by the recreational aspects in an activity than one who is not so wealthy. The ninth factor is "elements of personal pleasure or recreation." The last explanatory sentence for this factor states:

> [T]he fact that the taxpayer derives personal pleasure from engaging in the activity is not sufficient to cause the activity to be classified as not engaged in for profit if the activity is, in fact, engaged in for profit as evidenced by other factors whether or not listed in this paragraph.[29]

Although this sentence is somewhat puzzling, it seems to say that the amount of pleasure alone can never cause an activity to be considered not engaged in for profit. If this interpretation is correct, then the profit motive need not be stronger than personal motives for the activity to be considered engaged in for profit. However, this interpretation is contradicted elsewhere; the regulations under section 183 also state that an activity carried on "primarily" for nonpecuniary purposes is an activity not engaged in for profit.[30] Neither the statute nor the regulations thus establish a single standard for determining whether an activity is engaged in for profit.

A Typical Case

The issue of whether losses should not be deductible because incurred in a hobby or other personal activity has been extensively litigated. No leading cases, however, provide guidance for all others. Each case is decided on its facts, and no case is strong precedent for another. A comprehensive discussion of the cases would become mired in the details and idiosyncracies of each case and would not effectively illustrate similarities or differences in the cases. This article will therefore discuss the caselaw through a limited number of examples.

The facts and reasoning of a recent case illustrate both the difficulty of separating an individual's intent to make a profit from other reasons for engaging in an activity and judicial reaction to this difficulty. The case, *Appley v. Commissioner*,[31] is a typical hobby loss case although the losses were particularly dramatic, totaling over $450,000 in twelve years.[32] Despite these

29. Treas. Reg. § 1.183-2(b)(9) (1971).

30. "[D]eductions are not allowable under section 162 or 212 for activities which are carried on primarily as a sport, hobby, or for recreation." Treas. Reg. § 1.183-2(a) (1971). Similarly the regulations under I.R.C. § 212 indicate that the test for determining whether losses are deductible for years prior to 1970 is that the activity be carried on "primarily for the production of income" and not "primarily as a sport, hobby, or recreation." Treas. Reg. § 1.212-1(c) (1956). *See also* Treas. Reg. § 1.183-1(d)(3) Ex. 1 (1971).

31. 39 T.C.M. (CCH) 386 (1979).

32. In Ellsworth v. Commissioner, 21 T.C.M. (CCH) 145 (1962), farm losses totaled nearly $700,000 over a thirteen-year period and the court allowed the taxpayer to deduct the losses. Thus, the losses in *Appley*, though large, are not record-breaking for a case in which the taxpayer prevailed.

huge losses, which had been incurred in breeding horses, Judge Dawson of the Tax Court held in a memorandum decision that the activity was engaged in for profit and that the taxpayer could accordingly deduct the losses from other income.[33] The government did not appeal.

Appley, a noted authority on management,[34] was president of the American Management Association from 1948 to 1968. Between 1965 and 1973 his adjusted gross income averaged approximately $123,500 before deduction of losses from his farm. With no prior horsebreeding experience, Appley began raising horses in 1964 with the purchase of five Morgan horses.[35] He anticipated a large potential market for Morgan horses, although the market at that time was limited.

Initially there were problems in operating the farm. Between 1965 and 1970 Appley successively hired and fired two trainers. Then in early 1971 he hired Frederick Herrick, who was the outstanding trainer and breeder of Morgan horses, and decided to increase the size of his herd. From 1971 to 1977 the number of horses varied between twenty and forty-six and in 1979 the farm employed between three and five persons, depending on the season.

The farm always had significant revenues from selling horses and from such items as stud fees but incurred substantial losses through 1976.[36] The

33. In 1965, Appley placed the farm in a wholly owned corporation that elected to be taxed under Subchapter S of the Internal Revenue Code. As a result, the losses and profits would "pass through" the corporation and the computation of Appley's gross income would take the losses and income directly into account. Ownership of the farm by the Subchapter S corporation did not affect the issues that are of concern to us; I.R.C. § 183 was still applicable. Accordingly, the fact that Appley did not personally own the farm is ignored in the rest of the article.

34. Appley has written four books on management and administration and has published articles in such publications as *Business Week* and *Finance*. Several presidents of the United States have consulted him. 39 T.C.M. at 386.

35. Appley had previously raised chickens and at one point had about 500. He terminated this when he became dissatisfied with the results. He also considered raising cattle but decided that the likelihood of profits was too small. *Id.* at 387.

36. Profit and loss figures from 1965 to 1978 follow:

Year	Income
1965	($19,400)
1966	(16,900)
1967	(13,600)
1968	(32,300)
1969	(34,000)
1970	(30,000)
1971	(54,500)
1972	(62,800)
1973	(46,700)
1974	(66,200)
1975	(56,100)
1976	(20,900)
1977	1,400
1978	4,800

Id.

amount of the loss was lower in 1976 than in the immediately preceding years, and there were small profits in 1977 and 1978. Losses totaling $143,200 from 1972 through 1974 were in dispute. With some support from the evidence, the Internal Revenue Service argued that improved results from 1976 through 1978 reflected actions taken only to strengthen the taxpayer's case and not typical operations.[37]

The farm was operated in a businesslike manner. Appley always kept meticulous financial and breeding records and devoted substantial time, although less than the equivalent of a full-time occupation, to the farm. He had also become very active in the American Morgan Horse Association. Through his involvement in the organization, the market for Morgan horses improved considerably.[38]

In all likelihood Appley both enjoyed breeding horses and expected that the farm would eventually become profitable. The size of the horsebreeding operation, as well as the size of the losses, was so large that the activity probably was more than a hobby. In addition, a managerial expert such as Appley probably would have regarded nonprofitability in such an extensive activity as failure. On the other hand, Appley might never have expected sufficient profits from the farm to justify initial losses. If he had been interested only in financial return, he probably would never have started such a risky business in which he had no experience. Perhaps the combination of nonpecuniary satisfaction, such as the prestige and enjoyment of breeding horses, with the goal and challenge of making a profit lured Appley into horsebreeding.

Comparing Appley's pecuniary and nonpecuniary motives, however, is extremely difficult. He must always have been aware that he might have to justify deducting his losses and could be expected to have taken actions that would strengthen his case. For example, even if Appley had not been so inclined, he might have kept meticulous farm records as ostensible evidence of his profit motive. A more fundamental problem in analyzing Appley's motives is that many of his actions would have been consistent with both pecuniary and nonpecuniary motives. Thus, a dedicated cost-conscious hobbyist as well as a determined entrepreneur might keep good records. Appley went to horse shows in which his horses competed. It could be argued that his attendance showed he was interested in the glamour and prestige of breeding horses. It might also be argued that it was good business to observe how his horses performed.

37. Brief for Respondent at 40, Appley v. Commissioner, 39 T.C.M. (CCH) 386 (1976). The taxpayer vigorously contested this point. Reply Brief for Petitioner at 40-41. In 1972, 1973, and 1974, six or seven horses were annually sold by the farm. In 1975, twelve horses and in 1976 thirty-three horses were sold. 39 T.C.M. at 390. The size of the herd was accordingly reduced from forty-five horses in 1975 to twenty-five in 1976 and 1977. *Id.* at 388. The sale of horses raised revenues and reduced costs. In addition, from late 1976 through 1978, at which time it was discontinued, the farm offered its trainer's services to outsiders. This may have been done only to obtain a short-term boost in profits. Revenues from training horses were $11,297 in 1977, only $666 in 1976 and $202 in 1975. Similarly, revenues from boarding horses increased to $28,966 in 1977 from $12,657 in 1976. *Id.* at 390.

38. During the years 1972 through 1974 Appley devoted approximately 25 to 30 percent of his time to the farm and another 25 percent to the American Morgan Horse Association.

Nevertheless, Judge Dawson at the beginning of his opinion stated that, for the activity of breeding horses to be engaged in for profit, Appley must have the "*predominant* purpose of making a profit."[39] Presumably, the pecuniary motives had to be stronger than the nonpecuniary motives. However, Judge Dawson also found as the "Ultimate Finding of Fact" that Appley had a "bona fide intention and good faith expectation of earning a profit."[40] If this is the appropriate standard, the intensity of Appley's pleasure is not relevant to the deductibility of losses and a comparison of pecuniary and nonpecuniary motives is not needed. Which standard Judge Dawson has adopted is unclear. He ignored the recreational aspects of breeding horses and thus was able to find for Appley under either standard solely on the basis of an intent to make a profit.

The opinion consisted mainly of a discussion of the nine factors from the regulations.[41] Operating the farm in a businesslike manner, consulting with experts, and devoting substantial effort to the farm were in Appley's favor. Judge Dawson was also favorably impressed by the downward trend of losses from 1974 to 1976 and small profits in 1977 and 1978.[42] In discussing the ninth factor, elements of personal pleasure or recreation, Judge Dawson minimized any personal pleasure. He simply noted that there were no recreational facilities at the farm and that Appley drove the horses only occasionally.[43] Of course, these two facts do not negate the possibility of substantial personal pleasure. Appley's testimony that his pleasure in seeing his horses win was similar to Dr. Land's pleasure in witnessing the Polaroid camera's success was noted at the end of the opinion.[44] The implication, which seems correct, is that this is not the type of pleasure that should cause an activity to be deemed not engaged in for profit. However, this type of pleasure also seems inseparable from the recreational aspects of breeding horses and going to horse shows.

The *Appley* opinion is unsatisfactory because the recreational aspects of breeding horses were ignored. Consequently, Judge Dawson avoided two extremely difficult but important questions. First, how strong was Appley's intent to make a profit? He may have been motivated to a large extent by the enjoyment inherent in the activity and may not have been overly concerned about profits. Second, should the enjoyment itself affect the deductibility of the losses? Hobby loss cases typically avoid these issues.

Cases in General

Primary Purpose Test

The opinion in *Appley v. Commissioner*[45] is typical. Courts frequently

39. 39 T.C.M. at 394 (emphasis added).

40. *Id.*

41. See *supra* text accompanying notes 25-27.

42. *See supra* notes 36-37 and accompanying text.

43. In its statement of facts the court noted that Appley had won an award for Reserve Grand Champion Amateur Driver at the Grand National Morgan Horse Show. 39 T.C.M. at 392. This fact was not mentioned in the court's opinion.

44. 39 T.C.M. at 396.

45. *See supra* notes 31-44 and accompanying text.

state that the taxpayer must have a "predominant purpose" of making a profit for the losses to be deductible,[46] then decide the case in a way that avoids comparing the profit motive with other motives. When holding for the government, the court will find that the taxpayer did not have a bona fide intent of making a profit.[47] When holding for the taxpayer, the court will minimize the taxpayer's personal pleasure.[48]

Two recent Tax Court decisions involving horsebreeding, in addition to *Appley*, exemplify this practice. In both, the court stated that the taxpayer's "predominant purpose" must be to make a profit. One of the cases, *Golanty v. Commissioner*,[49] held that the activity was not engaged in for profit. The Tax Court concluded that the taxpayer "did not truly expect to make a profit from her horsebreeding venture"[50] despite extensive efforts by the taxpayer.[51] The other case, *Engdahl v. Commissioner*,[52] held that the horsebreeding was engaged in for profit. Engdahl, an orthodontist with an annual income of approximately $85,000, and his wife had been raising American saddle bred horses without profit since 1964. Annual losses averaged $16,500.

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46. Many articles have concluded that courts in general allow losses to be deducted only if the intent to make a profit is the predominant purpose. The articles, however, cite cases in which the predominant purpose test is invoked but do not analyze whether the court is actually using this test. *See* Lee, *supra* note 26, at 389 n.134; Crouch, *How Treasury's Final Regulations on the New Hobby Loss Rules Operate*, 38 J. TAX'N 184 (1973); Oshins, *Proposed Regulations Provide New Rules for the Hobby Loss Game*, 35 J. TAX'N 214 (1971); Note, *The Effect of Unrealized Appreciation in Determining Profit Motives in Farming Enterprises*, 16 KAN. L. REV. 529 n.4 (1968). *See also* Sharpe, *What the Taxpayer Should Do to Have the Courts Recognize His Farm as a Business*, 28 J. TAX'N 48 (1968); Knobbe, *Farm and Ranch Losses*, 241-3 T.M.P. (BNA) A-12 (1979).

47. *See, e.g.*, Hires v. Commissioner, 40 T.C.M. (CCH) 342 (1980); Sealy v. Commissioner, 39 T.C.M. (CCH) 847 (1980); Golanty v. Commissioner, 72 T.C. 411 (1979), *aff'd in unpublished opinion*, (9th Cir. Mar. 25, 1981); Barton v. Commissioner, 40 T.C.M. (CCH) 382 (1979); Nittler v. Commissioner, 39 T.C.M. (CCH) 422 (1979); Whitener v. Commissioner, 39 T.C.M. (CCH) 301 (1979); Holleson v. Commissioner, 38 T.C.M. (CCH) 1058 (1979); Pickering v. Commissioner, 38 T.C.M. (CCH) 964 (1979), *aff'd mem.* 81-2 U.S.T.C. (CCH) ¶ 9433 (6th Cir. 1981); Dunn v. Commissioner, 70 T.C. 715 (1978); Carter v. Commissioner, 37 T.C.M. (CCH) 859 (1975), *aff'd*, 81-2 U.S.T.C. (CCH) ¶ 9441 (9th Cir. 1981); Eppler v. Commissioner, 58 T.C. 691 (1972), *aff'd in unpublished opinion*, (7th Cir. Oct. 24, 1973). *See also* Hirsch v. Commissioner, 315 F.2d 731 (9th Cir. 1963).

48. *See, e.g.*, Wright v. United States, 249 F. Supp. 508 (D. Nev. 1965); Fisher v. Commissioner, 40 T.C.M. (CCH) 398 (1980); Sparre v. Commissioner, 39 T.C.M. (CCH) 1044 (1980); Engdahl v. Commissioner, 72 T.C. 659 (1979); Appley v. Commissioner, 39 T.C.M. (CCH) 386 (1979); Wise v. Commissioner, 16 T.C.M. (CCH) 361 (1957), *aff'd mem.*, 260 F.2d 354 (6th Cir. 1958).

49. 72 T.C. 411 (1979), *aff'd in unpublished opinion*, (9th Cir. Mar. 25, 1981).

50. *Id.* at 427.

51. *Id.* at 428. Golanty was trying to produce and sell superior offspring through proper selection of breeding horses. By the end of the last year at issue, 1973, she had purchased or leased nineteen horses, and ten foals had been born into the herd. The horses were kept at a ranch that had no recreational facilities such as a swimming pool. An employee lived at the ranch, and Golanty traveled there approximately three times a week, often staying overnight. She had consistently lost money since 1967, with losses of approximately $27,500 per year for the two years at issue, but there was some indication that the price at which she could sell horses was going up. *Id.* at 429.

52. 72 T.C. 659 (1979).

It is hard to believe that they would continue to breed horses through the years in issue, 1971 through 1973, if they had been motivated solely by profit. Operating revenues were above $1,000 in only one year between 1964 and 1975, and gross proceeds from sale of horses were insignificant.[53] The Tax Court, however, rejected the contention that the taxpayers "received pleasure and recreational benefits from their horse activities."[54] The factors that convinced the court were that the taxpayers did much physical work on the ranch, that they did not ride the horses, and that they did not use their ranch for social purposes. These factors, however, are not inconsistent with the taxpayers' receiving recreational benefits. In addition, the court mentioned but gave no weight to the taxpayers' attendance at social affairs during horse shows.

The enjoyment that a taxpayer obtains from an activity may, of course, influence a court's decision on deductibility of losses. The enjoyment plus other factors will usually convince the court that the taxpayer did not strongly desire a profit.[55] Thus, courts rarely conclude that there was a strong desire to make a profit but that losses are not deductible because there was a stronger desire for the recreational aspects.[56] However, losses incurred in collecting such items as art work or antiques provide an instructive exception.

53. The court mentioned at the end of its opinion that the taxpayers' farm had appreciated by approximately $142,000 and that the remaining four horses had appreciated by approximately $18,750. However, the fixed costs of owning the farm were not offset by the horsebreeding; the taxpayers would have had smaller losses if they had held the farm as a passive investment. 72 T.C. at 663-64. Therefore, owning the farm should have been considered an activity separate from breeding horses. Treas. Reg. § 1.183-1(d) (1971). In addition, testimony concerning values of both the farm and horses was offered only by petitioners' witnesses, who were inexperienced in appraisals and had not prepared data supporting their testimony. Brief for Respondent at 15-17. The average estimated price of over $5,000 for each of the four horses was in excess of the price that the taxpayers had received for any horse. Brief for Petitioner at 20, 72 T.C. at 664. Therefore, the court probably added the statement concerning unrealized appreciation to buttress a decision based on other facts.

54. 72 T.C. at 670.

55. *See, e.g.*. Bessenyey v. Commissioner, 379 F.2d 252 (2d Cir.), *cert. denied*, 389 U.S. 931 (1967); Ballich v. Commissioner, 37 T.C.M. (CCH) 1851-40 (1978); Benz v. Commissioner, 63 T.C. 375 (1974); Barcus v. Commissioner, 32 T.C.M. (CCH) 660 (1973), *aff'd mem.*, 492 F.2d 1237 (2d Cir. 1974); Porter v. Commissioner, 28 T.C.M. (CCH) 1489 (1969), *aff'd per curiam*, 437 F.2d 39 (2d Cir. 1970); Schley v. Commissioner, 24 T.C.M. (CCH) 588 (1965), *aff'd*, 375 F.2d 747 (2d Cir. 1967); Estate of Hailman v. Commissioner, 17 T.C.M. (CCH) 812 (1958).

56. *But see* Godfrey v. Commissioner, 335 F.2d 82 (6th Cir. 1964); Lihme v. Anderson, 18 F. Supp. 566 (S.D.N.Y. 1936); Tyler v. Commissioner, 6 T.C.M. (CCH) 275 (1947).

Even in those few cases where only the amount of pleasure seems the reason the loss was disallowed, courts will usually not explicitly apply the predominant purpose test. For example, in Wright v. Commissioner, 274 F.2d 883 (6th Cir. 1960), the taxpayers took an around-the-world trip on which they visited relatives. They worked hard on a book describing their trip but were unable to have it published. The court held that writing the book was not a trade or business because it was only an isolated literary endeavor. For the losses to be deductible, the writing would have to be part of an ongoing effort. In cases where courts conclude that personal motives outweigh the profit motive, they may also hold that the taxpayer is merely preparing to enter a trade or business. *See* Snyder v. Commissioner, 25 T.C.M. (CCH) 1326 (1966); Godfrey v. Commissioner, 22 T.C.M. (CCH) 1 (1963), *aff'd*, 335 F.2d 82 (6th Cir. 1964). *See also* Imbesi v. Commissioner, 361 F.2d 640 (3d Cir. 1966) (invoking the primary purpose test but then remanding to the Tax Court).

In collectable cases, courts have concluded that the taxpayers intended to increase their collections' value but have not allowed the losses because the taxpayers' primary motives were to enjoy the collections.[57] The courts' decisions to use the primary purpose test can be explained by the fact that gains in the collections would not be realized for an indefinite time. Therefore, the taxpayers wanted to deduct losses currently, even though the economic gains probably would not be subject to tax for many years. Furthermore, if taxpayers still held the collections at death, the gains would completely escape income taxation.[58]

Unless collecting is involved, the amount of pleasure that the taxpayer derives from an activity will usually not by itself cause the activity to be classified as not engaged in for profit.[59] Losses will be deductible as long as the court is convinced that the taxpayer had the necessary intent of making a profit. For example, the taxpayer in *Churchman v. Commissioner,*[60] a prize-winning artist, had been successful in art shows but had lost money for twenty years. In two of the three years at issue, she had no art-related income whatsoever. The court found that the taxpayer "craved personal recognition as an artist and believed that selling her work for a profit represented the attainment of such recognition."[61] If the court had applied the primary purpose test, it would have disallowed deductions for the art-related losses. Churchman's primary purpose was to be a successful artist, and earning a profit was not an end in itself but an indicator of success. In fact, the court recognized that she may have intended to make a profit only "because it symbolized success in her chosen career."[62] Presumably she would continue painting even if she had no expectation of a profit. The Tax Court, nevertheless, held that the taxpayer could deduct her losses because she had an intent of making a profit.[63]

The primary purpose test is unsatisfactory. A person should not be penalized because she hopes to be a famous artist as well as to make a profit. The primary purpose test might seem more appropriate if the taxpayer's purpose were to obtain recreation, but achieving a goal and recreation are often inseparable. Churchman's painting probably was a form of recreation since it served the same function for her that hobbies do for many other

57. Wrightsman v. United States, 428 F.2d 1316 (Ct. Cl. 1970); Stanley v. Commissioner, 40 T.C.M. (CCH) 516 (1980).

58. I.R.C. § 1014 (1976 & Supp. III 1979).

59. *See supra* note 55.

60. 68 T.C. 696 (1977).

61. *Id.* at 702.

62. *Id.* at 703.

63. In *Golanty v. Commissioner,* the Tax Court cites *Churchman* as support for the following sentence: "The test for determining whether an individual is carrying on a trade or business so that his expenses are deductible under section 162 is whether the individual's *primary purpose and intention* in engaging in the activity is to make a profit." 72 T.C. 411, 425 (1979), *aff'd in unpublished opinion,* (9th Cir. Mar. 25, 1981) (emphasis added). As the text makes clear, *Churchman* does not support the primary purpose test. The citation indicates that Judge Forrester, who wrote the *Golanty* opinion, had not focused on which test he was using.

people. Likewise, Appley both received the satisfaction of being an entrepreneur and enjoyed the recreational aspects of horsebreeding.[64] In addition, it is not clear why an intent to obtain recreation should affect the deductibility of losses as long as there is a bona fide intent to make a profit. A horsebreeder who makes a profit can deduct all ordinary and necessary expenses regardless of personal enjoyment. It seems unjust to penalize a breeder unable to make a desired profit for also desiring personal enjoyment.

Intent and Expectation

Courts often disregard the primary purpose test and assert that losses are deductible as long as the taxpayer intends and expects to make a profit.[65] Usually, "intent" and "expectation" are not discussed separately.[66] When section 183 is applicable, any expectation need not be reasonable, but need only be in good faith.[67] Most cases before enactment of section 183 were consistent with this rule.[68] It is, of course, extremely difficult to determine a person's bona fide expectation. Therefore, the test is really that the taxpayer must intend to make a profit. Intent is ascertained from conduct. The taxpayer must be actively seeking a profit.

In *Churchman*, the Tax Court merely found it "conceivable" that the taxpayer might recoup her losses.[69] Nevertheless, Churchman was allowed to deduct her losses because she "carried on her artistic activities in a businesslike manner for profit."[70] She sent announcements of her shows to galleries, made posters, and wrote books to make her work more available. As a result of such actions, the Tax Court concluded that she "does intend to make a profit from her artwork and she *sincerely believes* that if she continues to paint she will do so."[71]

Accordingly, what is most important, regardless of what standard the court invokes, is that the taxpayer act as if he intends to make a profit. Thus, the horsebreeder in *Appley*[72] lost over $450,000 in twelve years but was able to deduct these losses because of consistent businesslike behavior.[73] Of course,

64. See *supra* text accompanying notes 31-38.
65. *See, e.g.*, Patterson v. United States, 459 F.2d 487 (Ct. Cl. 1972); Howard v. Commissioner, 41 T.C.M. (CCH) 1554 (1981); Lanier v. Commissioner, 40 T.C.M. (CCH) 863 (1980); Worley v. Commissioner, 39 T.C.M. (CCH) 1090 (1980); Churchman v. Commissioner, 68 T.C. 696 (1977); Benz v. Commissioner, 63 T.C. 375 (1974); McCormick v. Commissioner 28 T.C.M. (CCH) 1337 (1969); de Grazia v. Commissioner, 21 T.C.M. (CCH) 1572 (1962); Ellsworth v. Commissioner, 21 T.C.M. (CCH) 145 (1962); Estate of Hailman v. Commissioner, 17 T.C.M. (CCH) 812 (1958).
66. *But see* Dreicer v. United States, 81-2 U.S.T.C. (CCH) ¶ 9683 (D.C. Cir. Sept. 24, 1981).
67. *See supra* note 20 and accompanying text.
68. *See supra* note 20.
69. 68 T.C. 696, 703 (1977).
70. *Id.* at 702.
71. *Id.* at 703 (emphasis added).
72. 39 T.C.M. (CCH) 386 (1979).
73. *See supra* notes 34-39 and accompanying text.

there are exceptions. In *Golanty*,[74] for example, the Tax Court was convinced that the taxpayer must have known that she could not make a profit. Her breeding herd was too small.[75] Therefore, it disallowed the losses even though she devoted extensive efforts to horsebreeding. However, in *Golanty* the taxpayer's failure to advertise sufficiently and in one instance her disregard of an expert's advice also clearly hurt her case.[76]

Requiring only an intent to make a profit for losses to be deductible is unsatisfactory for several reasons. First, the standard is vague; intent may be very strong or quite weak. For example, a person may desire profit but be unwilling to work for it. Second, even a strong intent to make a profit may coexist with enjoyment or recreation. Perhaps the taxpayer's enjoyment should at times affect deductibility of losses since the taxpayer is better off than a person who loses money in an activity that he does not enjoy. Finally, a court must examine a person's actions to determine if he has the intent of making a profit. A well-advised individual could deduct hobby losses merely by presenting good records and other evidence of ostensibly good business practices. Consultation with experts and accountants is not overly burdensome. A dedicated hobbyist probably would follow most expert or professional advice in any event.[77]

On the other hand, requiring a *reasonable* expectation of profit presents separate problems. Many profitable ventures would initially have been judged as unreasonable. In addition, a person who loses money in an activity that is not commonly perceived as enjoyable has to show only a bona fide expectation of profit to deduct the loss. Placing a heavier burden on some taxpayers solely because they engage in activities that others pursue as hobbies seems unfair.

THE APPROPRIATE TEST

The correct standard for deducting losses incurred in an activity carried on for mixed motives should both be fair and promote optimal use of economic resources.[78] The fundamental difficulty in achieving each goal stems from the fact that the activity may provide both pecuniary and nonpecuniary

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74. 72 T.C. 411 (1979), *aff'd in unpublished opinion,* (9th Cir. Mar. 25, 1981). For a discussion of the case, see *supra* notes 49-51 and accompanying text.

75. 72 T.C. at 427-28.

76. *Id.* at 430-32.

77. *See* Burns & Groomer, *supra* note 26 (recommending certain action to ensure deductible losses). *See also* Rhodes, *Hobby Losses — A New Challenge,* 56 A.B.A.J. 893 (1970).

78. There has been virtually no analysis of what the appropriate test should be. A recent article on the correct approach for deductibility of mixed business and personal expenses did not consider losses from activities that are carried on for mixed motives. *See* Halperin, *Business Deductions for Personal Living Expenses: A Uniform Approach to an Unsolved Problem,* 122 U. PA. L. REV. 859 (1974). The articles that directly discuss § 183 or the hobby loss issue sometimes state, without discussion, that a particular test is appropriate but offer no analysis. *See* Carey & Gallagher, *Requisite Greed: The Section 183 Regulations,* 19 LOY. L. REV. 41, 77 (1972) (primary motive test); Sharpe, *New Hobby Loss Rule Is Tougher but Engaged in for Profit Dilemma Remains,* 32 J. TAX'N 289, 290 (1970) (loss allowed if taxpayer would abandon activity in event unable to make a profit). See also *supra* note 46.

returns while only the pecuniary return is taxable. First only the theoretically correct approach is discussed. Then, after an examination of equity and efficiency, administrative feasibility is considered.

Fairness

An income tax is usually considered fair because income is an indication of a person's ability to pay.[79] The profound practical and theoretical problems in defining income are largely ignored below. Conclusions are drawn from simple comparisons between representative taxpayers. Initially, however, it is necessary to posit some standard for measuring income. The most reasonable one is that income should measure control over economic resources. A tax reduces private consumption of economic resources in order to provide for public use and redistribution. Thus, it is appropriate that the sacrifice be apportioned according to one's capacity to use economic resources.[80]

An income tax should tax net income — income after expenses of earning that income. A person's economic well-being is measured by what is left after the costs of earning that income. Therefore, a loss from an activity pursued solely for profit should be deductible. The loss is an expense of earning income and reduces the amount of money available for personal purposes. It should not matter whether the activity is one that *others* may find enjoyable. Other things being equal, a person with a salary of $100,000 who loses $20,000 in an unsuccessful business venture that he does not enjoy has the same ability to pay tax as someone else with an $80,000 salary and no business losses.

79. *See* R. GOODE, THE INDIVIDUAL INCOME TAX 11 (1976).

80. Professor Haig explored the role of sensations — "intangible psychological experiences" — for the concept of income in his classic essay. Haig, *The Concept of Income,* in THE FEDERAL INCOME TAX 2 (R. Haig ed. 1921), *reprinted in* AMERICAN ECONOMIC ASS'N, READINGS IN THE ECONOMICS OF TAXATION 54, 55 (R. Musgrave & C. Sharp eds. 1959). His premise is that income is comprised of sensations, the satisfaction of wants and desires. Objects are desirable only because they yield pleasurable sensations. However, he quickly determines that, for the concept of income to have any utility, it must be measured by a common unit of value — money. *Id.* at 5, AMERICAN ECONOMIC ASS'N at 57-58. It follows that income should include only control over economic goods and not the achievement of any general level of psychic well-being. "It is necessary as a practical proposition to disregard the intangible psychological factors and have regard either for the money-worth of the goods and services utilized during a given period or for the money itself received during the period supplemented by the money-worth of such goods and services as are received directly without a money transaction." *Id.* at 6, AMERICAN ECONOMIC ASS'N at 58.

That income involves control over economic goods and services was accepted by Professor Henry Simons, who wrote "[p]ersonal income connotes, broadly, the exercise of control over the use of society's scarce resources. It has to do not with sensations, services, or goods but rather with rights which command prices (or to which prices may be imputed)." H. SIMONS, PERSONAL INCOME TAXATION 49 (1938).

Many modern writers accept this approach. *See* Andrews, *Personal Deductions in an Ideal Tax,* 86 HARV. L. REV. 309, 356 (1972); Turnier, *Evaluating Personal Deductions in an Income Tax — The Ideal,* 66 CORNELL L. REV. 262, 270-73 (1981); Warren, *Would a Consumption Tax Be Fairer Than an Income Tax,* 89 YALE L.J. 1081, 1084 (1980). The exclusion of psychic benefits from taxable income is questioned by Professor Halperin, but he ultimately concludes that an employee should not be taxed on the pleasure from his job. Halperin, *supra* note 78, at 880-85.

A person who loses money in an activity pursued both for enjoyment and for profit can be compared to a person who loses money and receives no enjoyment. Assume both have salaries of $100,000, lose $20,000 in their respective ventures while receiving no revenues and are similar in all relevant ways other than the enjoyment from the activity. Despite their equal money incomes, the person who enjoys the activity ("Amateur") is better off than the second person ("All Business") because of the pleasure received. Thus, it seems appropriate that Amateur should pay more tax than All Business if Amateur's enjoyment is the type that people normally purchase by engaging in hobbies. In this case Amateur has more real income than All Business; they have equal monetary incomes, but Amateur also derives pleasure from the use of economic resources. All Business may choose to use some of his income to purchase the pleasure that Amateur already has received. If Amateur's pleasure is not the type often purchased, then it is less clear that he should pay more tax than All Business. For example, Amateur's pleasure may be similar to that of an entrepreneur in seeing his product succeed.[81] Such pleasure is not the type normally associated with consumption or use of resources. In fact, assessing the value of such pleasure is artificial since people do not normally think of paying for such happiness.

Even if this distinction between two types of pleasure is rejected as too fuzzy, the point remains that Amateur may be receiving something from the activity that he would otherwise be willing to purchase. Activities such as horsebreeding or painting that are often carried on as hobbies are likely to produce pleasure even for those who also seek profit. Assume Amateur receives this type of pleasure. All Business, who receives no pleasure, can deduct his loss. Amateur's additional tax liability could result either from his being denied a full deduction for his loss or his being allowed a full deduction but having additional income imputed from the pleasure received. However, the two steps will produce the same result; the deduction will be decreased or income will be increased by an equivalent amount. If Amateur's income is increased, the appropriate amount is what Amateur would pay for the pleasure.[82] If he would pay $5,000, then, with his $100,000 salary and $20,000 loss, he has $80,000 in cash and $5,000 of enjoyment. He has the same real income and the same ability to pay as if his net money income were $85,000 with no enjoyment. Amateur's income, however, should not include more than $20,000, the amount of the loss, regardless of how much he enjoys the activity. The loss can be thought of as the cost of enjoyment, and income does not include the difference between an item's cost and its higher subjective value to the taxpayer.[83] A result equivalent to increasing Amateur's income is reached if Amateur offsets his deduction of the loss by the value of the pleasure to him.

The same conclusion follows from a comparison between Amateur and one who engages in an activity like horsebreeding with no expectation or intent of making a profit. This person ("Hobbyist") cannot deduct his losses;

81. See *supra* text accompanying note 44.
82. *See generally* Halperin, *supra* note 78.
83. Economists call this difference consumer surplus.

they are purely personal expenses.[84] Another person may choose to spend the same amount on personal travel as Hobbyist spends on horsebreeding, and there is no apparent reason for the income tax to favor one personal expense over another. Neither is deductible. If Amateur receives enjoyment comparable to that of Hobbyist and can deduct his losses, then Amateur will be treated favorably relative to Hobbyist. For example, assume that Amateur and Hobbyist each has salary income of $100,000 and loses $20,000 in horsebreeding and that each derives the same amount of pleasure from breeding horses, although Amateur also hopes to make a profit. Other things being equal, they should pay the same amount of tax. Amateur's intent to make a profit, the only distinguishing factor between Amateur and Hobbyist, does not by itself make him less able than Hobbyist to pay tax. For Amateur and Hobbyist to be treated equally, either Amateur should not be allowed to deduct his loss, or, equivalently, Amateur's loss could be allowed but his income increased by the same amount. If Amateur enjoys breeding horses but his pleasure is less than Hobbyist's, then either Amateur's income should be increased by the amount he would be willing to lose solely to obtain that enjoyment or his deduction should be reduced by that same amount.

The rule therefore appears to be that Amateur should offset his deductible loss by the value of the pleasure from the activity, or, equivalently, be allowed the full deduction but increase his income by an equivalent amount. There is, however, a third comparison that makes it appear that Amateur *should* be able to deduct his total loss and *not* have any imputed income because of his enjoyment. Amateur, who has $100,000 of salary income and $20,000 of expenses in breeding horses, could be compared with a successful horsebreeder ("Professional"), who has proceeds of $100,000 from breeding horses and $20,000 of expenses. If both receive equivalent enjoyment, they should pay the same amount of tax. They receive the same enjoyment from breeding horses and have the same amount of money available for other purposes. Professional will be able to deduct all expenses and not have any tax consequences from his enjoyment; appropriate expenses are always deductible to the extent of any revenues. To be treated fairly, Amateur should also be able to deduct his expenses.[85]

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84. I.R.C. § 262 (1976).

85. The same analysis and conclusions could be derived from use of the Haig-Simon definition of income: "[T]he algebraic sum of (1) the market value of rights exercised in consumption and (2) the change in the value of the store of property rights between the beginning and end of the period in question." H. SIMON, PERSONAL INCOME TAXATION 50 (1938). According to this definition, income represents the individual's control over goods and services. The important concept is the individual's ability to consume and to accumulate rights for future consumption. The inflow of wealth is only relevant because it can be used (possibly with adjustments) to determine the amount that is available to be consumed or accumulated.

The issue presented in the text is whether Amateur's enjoyment should be considered taxable consumption. If the enjoyment is considered consumption, then Amateur should include it in income at the value that he places on it. *See* Halperin, *supra* note 78. The discussion in the text illustrates that this enjoyment is considered part of the taxable consumption of the hobbyist but not of the person who makes a profit.

The problem presented by this comparison would not disappear with some more nearly perfect income tax. It is inevitable that enjoyment of one's work or of a profitable activity will not increase tax liability.[86] For example, an attorney cannot be taxed on his love for arguing cases; such pleasure is too similar to general happiness. A successful horsebreeder's enjoyment could be distinguished from that of the attorney because horsebreeding is an activity that others pay to pursue as a hobby. However, different tax treatment of the two is unfair. Certainly, a successful horsebreeder or photographer would feel discriminated against if required to recognize the pleasure he derives from his work as income while an attorney who enjoys arguing cases before a jury just as much is not taxed on his enjoyment. Furthermore, the tax can be paid only in cash. The attorney who loves to practice or the successful horsebreeder will not have the option of cashing in some of his satisfaction to pay the tax. Cash income will be used to pay the tax accruing on pleasure from work. If enjoyment causes increased tax liability, the lawyer and horsebreeder may be forced to leave their professions and find activities they enjoy less.

The result is that there is no fair tax treatment of a taxpayer such as Appley,[87] who loses money in an activity that he both enjoys and hopes will be profitable. If the deduction for Appley's losses is allowed, a hobbyist will feel unfairly treated. If Appley and the hobbyist receive comparable enjoyment from breeding horses, they should have similar tax treatment. The expectation of profit, whether reasonable or not, does not by itself reduce one's ability to pay. On the other hand, if Appley's deduction is not allowed, he will feel unfairly treated. Appley's losses will not be deductible only because he enjoys breeding horses. However, the horsebreeder who makes a profit may enjoy it just as much or more, but his deductions are not affected by the enjoyment.[88]

Efficiency

One allocation of resources can be said to be more efficient than a second if under the first allocation at least one person is better off and no one is worse off.[89] This definition of efficiency is intended to be a noncontroversial

86. Conditions of employment, such as air conditioning or a well furnished office, raise a separate issue. Because such amenities directly involve identifiable economic resources, it can be argued that the value of such amenities should be included in income. *See* Halperin, *supra* note 78, at 893-94.

87. 38 T.C.M. (CCH) 386 (1979).

88. In one respect, however, someone such as Appley or the pure hobbyist is treated like the person who makes a profit. Appley and the hobbyist are able to deduct expenses to the extent of gross revenues from the activity. Therefore, a person who is losing money in an activity never includes his enjoyment in income to the extent there are revenues. *See supra* note 85. Any other rule would be inconsistent with allowing the person who makes a profit to deduct all his expenses. He can always deduct his expenses because he has sufficient revenues.

89. This is a strict definition of efficiency. A weaker and more controversial definition is that one allocation is more efficient than a second if the gainers under the first allocation are sufficiently better off that they could fully compensate the losers and still be better

measure of the operation of the economy. Presumably everyone would agree that it is desirable to make someone better off if no one else will be worse off; it will always be desirable to move from one particular allocation of resources to another that is more efficient.[90] If there are no possible allocations of resources that are more efficient than one particular allocation, then that allocation is called "Pareto optimal."[91] There are many different allocations of resources that are Pareto optimal, each corresponding to a different initial income distribution.

Under very restrictive conditions the allocation of resources in a market economy will always be Pareto optimal. Although these conditions are not satisfied in our economy (and it is inconceivable that they ever would be),[92] the economic effect of a tax is usually evaluated according to whether the tax is neutral – i.e., the tax should not directly affect economic decisions. Any change in allocation of resources caused by the tax would, it is assumed, cause the economy to be less efficient.[93] For example, if a person would start an activity such as horsebreeding in the absence of any tax, an efficient tax would not change this decision. Instinctively it does seem correct that a perfect tax should not affect the incentives for engaging in any activities.

A person who engages in an activity solely for enjoyment should not, for reasons of economic efficiency, be able to deduct his losses. This can be illustrated by a simple example. Assume the individual receives $100 worth of enjoyment from the activity but expects a $110 loss. In a world without tax he would not pursue the activity. If there were an income tax and the $110 were deductible, however, he would probably pursue the activity. In this case the activity's net cost to the individual would be reduced by the tax saved through the deduction. The net cost would thus probably be less than $100, but the $100 of enjoyment would not be reduced by the tax. On the other hand, if an individual loses money in an investment that he pursues solely for profit, he should, for reasons of economic efficiency, be able to deduct the loss. Because the government will share in any profit, it should also share in losses. Otherwise, the income tax will discourage the activity. Despite complications

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off. *See* Coleman, *Efficiency, Exchange and Auction: Philosophic Aspects of the Economic Approach to Law*, 68 CALIF. L. REV. 221, 239-42 (1980).

90. It may, however, be more desirable to move from one allocation to another in which some will be made worse off than to move to an allocation that is more efficient. This will occur when the initial income distribution is unsatisfactory.

91. *See* Coleman, *supra* note 89, at 226.

92. Among other requirements every industry must be perfectly competitive. *See* T. SCITOVSKY, WELFARE AND COMPETITION 182-85 (1971).

93. This assumption is not necessarily true. A tax that affects economic decisions, which is any tax other than a lump-sum tax, may correct existing inefficiencies. *See* Lipsey & Lancaster, *The General Theory of Second Best*, 24 REV. ECON. STUD. 11 (1957). However, in the absence of specific knowledge to the contrary, it is usually assumed that the changes in economic activity caused by a tax will make the economy less efficient. *See* R. MUSGRAVE & P. MUSGRAVE, PUBLIC FINANCE IN THEORY AND PRACTICE 452 (1973); Klein, *Income Taxation and Commuting Expenses: Tax Policy and the Need for Nonsimplistic Analysis of "Simple" Problems*, 54 CORNELL L. REV. 871, 879 (1969). *See generally* Rubin, *Predictability and the Economic Approach to Law: A Comment on Rizzo*, 9 J. LEGAL STUD. 319, 321 (1980).

such as those arising from the progressive tax rates, this conclusion is acceptable for the instant analysis.[94]

For an individual motivated by both pleasure and profit, however, neither full deductibility nor disallowance of the loss will be efficient. Consider the following example. An individual expects an $80 loss in an activity that he both enjoys for its own sake and hopes will return pecuniary profit. In an unenjoyable activity with the same risk and expected return, he would be willing to lose $50, and he would pay $30 solely for the personal pleasure he obtains from this activity. Therefore, in a world without tax, the individual would pursue the activity.

If none of the loss is deductible, the individual would abandon the activity. Thus, with a 50 percent marginal tax bracket, the individual's after-tax pecuniary profit would be only half as large as the before-tax return. If the individual were willing to invest $50 for a certain expected pecuniary return, he will probably be willing to invest $25 for an expected return half as large.[95] The personal pleasure and the $30 that he was willing to pay for it would not be affected by the income tax.[96] Therefore, the individual would be willing to lose only $55, which is less than his $80 loss. On the other hand, if the loss were deductible, the after-tax cost would be only $40, less than the $55 he is willing to lose. The tax would then increase the relative attractiveness of the activity, encouraging expansion of present operations or enticing other individuals to pursue the activity.

In the above example, $50 of the loss, the amount that the individual

94. The deduction of the loss will offset some income that would have been taxed at the top bracket if there had been no deduction and possibly some income that would have been taxed at a lower bracket. Profit from the investment in a subsequent year will be taxed at the top bracket that the income would have been taxed if there had been no return or possibly at a higher bracket. Therefore, with a progressive tax and full offset for losses, it is likely that any profit from the investment will be taxed at a higher bracket than the income offset by the loss would have been. Thus, risky investments, which produce losses in a current year in the hope of profits in a subsequent year, will be discouraged by a progressive income tax, and the decline in such investments will probably be inefficient. *See supra* notes 92-93 and accompanying text. Of course, the effect of the progressive income tax will be even more severe, with a greater deleterious effect on efficiency, if there is not enough income to fully offset the loss. This problem is mitigated by the loss carryover provisions of the Internal Revenue Code. *See* I.R.C. § 172 (1976 & Supp. III 1979).

Even a proportional income tax with losses fully offset by other income will have a distorting effect on the amount of risky investment. Because the government is sharing in both losses and future profits, the risk to the individual investor is affected. The same investment, as compared to a world without tax, will involve less potential loss to the investor (because the loss is deductible) but will return less if successful. Whether risk-taking will be encouraged or discouraged is impossible to predict. *See* R. MUSGRAVE & P. MUSGRAVE, *supra* note 93, at 482-84; Schneider, *The Effects of Progressive and Proportional Income Taxation on Risk-Taking*, 33 NAT'L TAX J. 67 (1980).

95. It is possible that the income tax will change the individual's willingness to assume risk. Because the income tax reduces the "stakes of the bet," the individual's willingness to assume risk is probably also affected. See *supra* note 94.

96. It is assumed that the taxability of income does not affect the individual's appreciation of nonpecuniary pleasure. The income tax could either increase or decrease his demand for nonpecuniary pleasure.

would be willing to pay only for the pecuniary return, should be deductible. If \$50 is deductible, his after-tax cost of the loss would be \$55 (\$30 plus 50% of \$50), which equals the exact amount he is willing to lose. The conclusion from this example is that the amount of the loss that should be deductible is the amount that would have been expended for the same expected pecuniary return in a nonenjoyable activity. This rule corresponds to one result obtained in the fairness discussion; i.e., the deduction for the loss should be offset by the value of enjoyment.[97] The two rules will produce the same deduction whenever the amount that would have been spent for the expected pecuniary return and the amount that would have been spent for the enjoyment from the activity equal the total loss.

Consider now the case of an individual who loses \$50 in an activity; in a world without tax he would spend \$50 for a nonenjoyable investment with the same risk and expected return and would also spend \$50 solely for the enjoyment. In other words, either the enjoyment from the activity or the expected monetary return would alone be sufficient to cause the individual to engage in the activity.[98] If we introduce an income tax and if the individual is in the 50 percent bracket, it is easy to see that any tax treatment of the losses might not affect his willingness to carry on the activity. With his expected after-tax pecuniary return reduced by 50 percent (for which we can assume he would be willing to invest \$25) and with enjoyment worth \$50, he might still continue carrying on the activity at the same level whether the after-tax cost of his loss was \$50 or \$25.

It is beyond the scope of this article to develop rules for such cases. Assumptions about people's motives would have to be made and the consequences worked out. It seems clear, however, that a range of amounts could be deductible, all of which are acceptable on grounds of efficiency, and that the amount that would have been spent solely for the expected pecuniary return would be in that range.

Choosing a Standard

A rule that might be justified on grounds of fairness and efficiency is that the taxpayer with an intent to make a profit should offset his deduction of a loss by the amount that he would be willing to pay for the enjoyment. This rule, however, would be impossible to administer, and the predominant purpose test could be seen as an approximation to it. If the taxpayer's pre-

97. In the instant example, this rule would also result in a deduction of \$50. See *supra* text accompanying notes 82-84.

98. An economist might contend that this individual would never carry on the activity at this level. The individual's pecuniary and nonpecuniary return from the activity is greater than the cost. Therefore, an economist might contend, the sum of the extra enjoyment and extra monetary return from expanding the activity would probably be greater than the extra cost from expanding it, and the individual would accordingly expand the activity. I do not believe this will necessarily happen. First, it may be doubted whether individuals are rational to such a degree. Second, the world may not be incremental in this way. Expanding the activity slightly may not increase the pleasure of the individual or result in a higher expected return.

dominant purpose for engaging in an activity is to receive personal pleasure, then he will usually receive a substantial amount of pleasure from the activity. The assumption that the value of his enjoyment roughly equals the amount of his loss will then seem reasonable, and no deduction should be allowed. On the other hand, if the taxpayer's predominant purpose is to make a profit, the assumption that his personal pleasure is relatively small will be reasonable, and a deduction for his loss should be allowed in full.

It is often impossible, however, to determine the taxpayer's predominant purpose. This problem is compounded by the fact that certain types of pleasure should not enter into this analysis. The entrepreneur's joy in seeing his product succeed should not affect the deduction for loss, and, therefore, motivation to achieve such pleasure should not weigh against the taxpayer in the predominant purpose test.[99] In addition, the profitable horsebreeder receives personal enjoyment and recreation without adverse tax consequences. The person who loses money but hopes to make a profit will be unfairly treated relative to the one who makes a profit if the predominant purpose test is applied to the former.[100]

The courts' present approach, although imperfect, may be the best alternative. If the taxpayer tries hard to make a profit, then the loss should be deductible. The effort to make a profit often interferes with recreational aspects; therefore, not including personal enjoyment in income may not overly favor someone like Appley,[101] relative to a pure hobbyist. A meager attempt to make a profit, however, indicates that the taxpayer is obtaining substantial enjoyment. Refusing to allow the deduction therefore seems reasonable.

One change in present law is suggested. When it appears that the taxpayer is receiving substantial personal enjoyment of the type that hobbyists typically receive, courts should decide against the taxpayer in cases in which a decision based just on his intent would be close. Courts presently allow losses to be deducted whenever there is a substantial intent to make a profit.[102] The proposed change would move the law somewhat closer to the predominant purpose test. The suggested change should be fair because the taxpayer's substantial enjoyment is similar to that of the hobbyist. A person who makes a profit may receive similar enjoyment, but the taxpayer without profit would probably more closely resemble the hobbyist and should be taxed like him. Furthermore, the suggested change promotes efficiency. Because the taxpayer who is receiving substantial personal enjoyment often is carrying on the activity to a large extent for such enjoyment, disallowing the deduction is consistent with neutrality. The problem remains that a taxpayer may feign a profit motive in order to obtain a deduction.[103] The suggested change, however, should mitigate this problem.

Even with the suggested change, the law would remain unsatisfactory. The

99. See *supra* text accompanying note 44.
100. See *supra* text accompanying notes 85-88.
101. See *supra* text accompanying note 87.
102. *See supra* notes 59-76 and accompanying text.
103. *See supra* note 77 and accompanying text.

requirement of intent to make a profit is vague, and judicial action would still be unpredictable. The next section therefore suggests a change in the statute.

AMENDING SECTION 183

Determining whether an activity is engaged in for profit cannot be done satisfactorily. People have varied motives for engaging in activities, and drawing any line between those activities that are for profit and those that are not is artificial. A change in the law is suggested that would both make it easier to classify an activity and reduce the consequences of such classification.[104]

Under the new provision an activity would be classified as "objectively not for profit" without reference to the proclivities or conduct of the particular taxpayer. The test would be whether the activity is of the type that generally provides entertainment or recreation.[105] It would be expected that a significant number of people would be carrying on an activity that meets this test with no expectation of profit. Raising horses or dogs or painting would by this standard usually be activities that are objectively not for profit but a five hundred acre corn farm would not. A twenty acre farm probably would be an objectively not for profit activity. Losses from an "objectively not for profit" activity would never be deductible against income from other sources but would be placed in a special account. Such losses would then be deductible against any income realized from that activity in subsequent or previous years.[106] For administrative purposes, some limit, perhaps fifteen years, could be placed on the right to carry forward or back losses in the special account.

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104. Under the present statute the consequences of a determination that an activity is or is not engaged in for profit are overly severe. Too much importance is placed on the annual accounting period. Expenses are deductible to the extent of gross income in the same year; expenses should also be deductible to the extent of gross income in a subsequent year.

When the court knows that there is a profit in a year subsequent to the years at issue, it will usually decide the case for the taxpayer. *See* Rood v. United States, 184 F. Supp. 791 (D. Minn. 1960); Appley v. Commissioner, 39 T.C.M. (CCH) 386 (1979); Regan v. Commissioner, 38 T.C.M. (CCH) 1330 (1979). In Dunn v. Commissioner, 70 T.C. 715 (1978), the court decided against the taxpayer even though there was a profit in a subsequent year. However, this profit was very small and occurred while the taxpayer was winding up the business. Therefore, it was clear that there would never be significant profits.

105. This approach is similar to that of I.R.C. § 274(a) (1976) in connection with expenses for items that are "generally considered to constitute entertainment, amusement, or recreation."

106. There have been similar proposals, but never in this context. The Treasury Department's Tax Reform Studies and Proposals, released in 1969, proposed that, if a farmer did not give up special tax accounting rules, only $15,000 of his farm loss (with certain modifications) would be deductible against non-farm income with the excess carried forward or back. U.S. TREASURY DEPARTMENT, TAX REFORM STUDIES AND PROPOSALS, 91st Cong., 1st Sess. 152-58 (Comm. Print 1969). This suggestion was the precursor of § 1251, enacted in 1969. Tax Reform Act of 1969, Pub. L. No. 91-172, § 214, 83 Stat. 571. Under § 1251 any excess losses from farming are placed in an "excess deduction account"; subsequent capital gain on the sale of the farm or farm assets is converted into ordinary income to the extent

The classification of an activity as objectively not for profit under the suggested provision would not depend on any attributes of the taxpayer. The suggested standard will unavoidably result in some taxpayers not being able to deduct their losses even though it is clear that their sole motivation is to earn a profit. However, mistakes are inevitably made under the present law as well in the quest for elusive motives. An objective test may produce fewer erroneous decisions. Furthermore, the consequences of an incorrect classification would not be as severe under the new provision.

It would be possible that a particular taxpayer's activity that did not qualify as objectively not for profit might be determined to be not engaged in for profit according to all the facts and circumstances. For such a determination the standard should approximate present law, although the amended statute should provide a presumption favoring the taxpayer. If the presumption were rebutted, losses would be treated like losses from an activity that qualified under the objective test: nondeductible in the current year but deductible against future or past profits from the activity.

There is no theoretically correct standard for determining whether a loss from an activity carried on with mixed motives should be deductible. A reasonable rule providing predictability is therefore the best choice. Because the issue would, in most cases, no longer depend on the taxpayer's intent, the proposed changes should greatly reduce litigation. The precedential effect of cases will be enhanced.

Under existing law many individuals who do not expect to make a profit from an activity such as horsebreeding are able to deduct losses from the activity against other income.[107] This result is unfair to those required to pay for recreation with after-tax dollars. It is also inefficient because it makes pursuit of such activities more attractive than if no income tax existed. The proposed changes would allow the deduction of losses only against income earned in the same activity. This would clearly improve the fairness and efficiency of the income tax in cases involving individuals who do not expect to make a profit.

Most individuals who have losses in an activity that they both enjoy and expect to be profitable can probably deduct those losses against other income under present law. Others, however, will not be allowed to deduct the losses. Neither result is fair to all taxpayers or is preferable on the basis of efficiency.[108] The proposed changes seem as fair as possible given the constraints of any

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of the excess deduction account. Under the Tax Reform Act of 1976, no addition to the excess deduction account is made for losses in years that begin after 1975. I.R.C. § 1251(b)(2)(E) (1976).

In H.R. 10612, 94th Cong., 1st Sess. (1975) the House of Representatives proposed that certain "artificial accounting losses" be deductible only from related income and that such losses be carried over to prior and subsequent years in which there would be related income. The final bill, which became the Tax Reform Act of 1976, did not contain this proposal. However, I.R.C. § 465, enacted in 1976 and amended in 1978, generally limits losses from non-real estate activities to the amount "at risk." Any disallowed loss can be carried forward and deducted if the amount at risk increases (such as by the earning of a profit).

107. See *supra* text accompanying notes 69-77.

108. See *supra* text accompanying notes 87-88, 97-98.

income tax. Perfect fairness is unattainable. The individual who enjoys his job cannot be taxed on the imputed income from this enjoyment and will be treated preferentially as compared to the hobbyist.[109] Consequently, there is no fair tax treatment of the person with mixed motives who loses money. The proposed changes would in this case also be acceptable on the efficiency criterion. Efficiency requires a certain minimum amount to be currently deductible for most persons with mixed motives.[110] Because these individuals expect to make a profit, however, they should not be overly discouraged if they only have the right to deduct losses from future profits of the activity.

Under the proposed changes, the number of those individuals unable to deduct losses, even though they receive little pleasure from the activity, would increase. With respect to these individuals, the proposed changes would be both unfair and inefficient and would compare unfavorably with present law. Because these individuals will be able to deduct losses from their expected future profit, however, the income tax should not overly discourage them from engaging in the activity. The adverse effect on efficiency should therefore be minor. On the other hand, the tax will still be unfair if these individuals, despite their expectations, do not succeed in earning a profit.

On balance, the proposed changes improve the present statute. Increased predictability should decrease litigation. The changes should also foster a more equitable and efficient federal income tax.

109. See *supra* text accompanying notes 85-86.

110. *See supra* notes 95-97 and accompanying text.