Horse Losses and Other Pleasures
By Calvin H. Johnson

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Current law denies the deduction of losses from equestrian and other such activities if not undertaken for profit. The IRS wins almost all the contested cases, but the test is too indeterminate for the Service to enforce on a tax return.

The following proposal would defer the deduction of business losses until the claimed future income from the activity comes in. Loss deferral would apply automatically to activities specified by statute, including those associated with horses, dogs, airplanes, cars, and collectibles, and to activities from which significant participants derive recreation or pleasure. Deferral is limited to activities suppressed as a result of recreational value to encourage the general diversification of investments and to allow room for congressionally intended tax incentives.

Losses unabsorbed by future revenue or capital gain would be allowed when the taxpayer sells or abandons the activity, but only for expenses incurred when the activity had an expected positive present value. If the investment proves unjustified in hindsight, we should be skeptical that the expenditures were an investment, and we should allow the losses only at termination and only through a refund claim.

The proposal is offered as a part of the Shelf Project, a collaboration of tax professionals developing methods of raising revenue in ways that improve the fairness and efficiency of the tax base. The Shelf Project has 74 proposals so far. Comments are welcome either as public debate, directed to the Tax Notes editor, or privately to cjohnson@law.utexas.edu.

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You can make a small fortune in the horse business...provided you start with a large fortune.

— Anonymous

Under current law, a taxpayer may deduct expenses incurred for profit or business, but not expenses that exceed revenues in activities that are not for profit. Separating the terms “for profit” from “not for profit” is fundamentally a test of a taxpayer’s state of mind; however, we cannot truly know the mind of man nor see the future to know if the claimed future profits are fictitious. Current law uses a list of nine unweighted factors to separate for-profit and not-for-profit activities. Those factors deny courts the ability to use standard economic tests of net present value and expected (probability-discounted) value. The factors are also too vague to be enforced on the tax return.

Even after an intrusive audit and expensive litigation, current law generates arbitrary outcomes. Judges announce results one way and declare what the taxpayer’s found mental state is, but the lucky winners are not separated from the losers by anything convincing, real, or important. Thus, three-quarters of the taxpayers in the horse business lose the deduction of horse-related losses in their litigation, but some lucky taxpayers with 10 or more years of hopeless losses are considered to have a profit objective in horses. Many more are never audited.

Distinguishing for profit from not for profit has

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plagued the tax system since its beginning, with no satisfactory resolution. For example, in two cases decided in the same year — one involving 1913, the first tax year — two wealthy New York City residents sought to deduct the farm expenses on their country estates outside the city. One case succeeded, but Learned Hand, then a district court judge, denied the loss in the other.\(^3\) There was no convincing distinction between the facts; the outcome depended on the judge — and it still does. Even after wasteful litigation, the results seem as arbitrary as rolling dice, except that rolling dice would be a cheaper way to resolve the dispute.

The nine-factor list is also seriously flawed in denying the use of the standard economic yardsticks of an investment and by treating future capital gain as a justifying factor. The standard economic tools by which all investments are evaluated are net present value and (probability-discounted) expected value. The regulations, however, disallow both tools. The regulations also list (possible) future capital gain as a justifying factor in finding that the activity was for profit. Future capital gain should delegitimize current deductions, however, and force capitalization; immediate ordinary deductions, mismatched with future capital gain, create an artificial negative tax, and negative tax should never be available on non-merit goods. In denying the use of net present value and expected value, and allowing consideration of future capital gain, the regulations justify the deduction of expenses for activities that would not occur in the absence of tax and are distinctly unjustified by their economic merit. In creating an unenforceable test, the regulations subsidize recreational high-income consumption when that consumption should be the first thing taxed.

Subsidizing horses, for example, diverts resources away from more productive uses. Horses ceased to be a cutting-edge technological innovation at the Charge of the Light Brigade. Equestrian activities are fun and prestigious for their own sake — not just for the revenue, but as pleasure activities — but they need to be conducted with after-tax money.

This Shelf Project proposal would defer the deduction of business losses from section 183 activities until income or capital gain comes in from the activity. In all the cases, the taxpayer is relying on future profits to justify the for-profit motive because the current revenue is insufficient to cover the loss. Best accounting practice matches the current expenses against the future revenue to which it relates. Under the proposal, losses would be used against the first revenue or first capital gain from the activity. That remedy is consistent with our treatment of investment interest, capital expenditures, start-up costs, net operating losses, and passive activity loss limitations, all of which defer the taxpayer’s net losses.

Deferral of all business losses is justified in theory, but the proposal here focuses on hobby losses. Automatic deferral of losses would be required for a statutory list of activities, drawn from hobby loss cases that taxpayers have lost. Regulations could add to the list, and the IRS could supplement the automatic deferral list once it has won two cases regarding a particular activity. Beyond the list, losses would be capitalized if the IRS could show that significant participants derive significant pleasure or recreation from the activities, as indicated in the decided cases, for instance. Participants willing to take losses for the pleasure drive down the expected profit from an activity. When the market will suppress returns because of the pleasure that some bidders get from activities, that will mean that the taxpayer has gone into an activity with a reasonable expectation of low returns. We do not need to inquire into the specific taxpayer’s state of mind.

If a taxpayer abandons an activity without having recovered his costs against revenue, unabsorbed losses would be deducted at that time, but only for expenses incurred when the activity had a positive economic value — that is, a positive expected net present value. The law should reflect justifiable skepticism that the taxpayer can meet that test, given how things turned out when the activity was abandoned. Because of that skepticism, the deduction would be available only through a refund claim and refund suit.

Although a broader rule for deferral of business losses might be justified, the proposal is limited to activities that some participants find to have recreational or pleasure values. Beyond losses accepted for pleasurable activities, the term “activity” needs to be defined broadly to encourage diversification. Risk is like toxic waste, and the tax law should encourage taxpayers to diversify to moderate risk

\(^3\) Compare Plant v. Walsh, 280 F. 722 (D. Conn. 1922) (finding that the taxpayer intended to eventually make a profit, despite extended years without any) with Thatcher v. Lowe, 288 F. 994 (S.D.N.Y 1922) (in which Hand said, “I cannot see in this case even the first intimation of a reason to suppose that [the taxpayer] in his lifetime carried on this farm with the hope of a profit”). Hand characterized the property in both cases as “country estates.” Hand, an especially respected and influential judge, has been quoted by law reviews and the Supreme Court more than any other non-Supreme Court jurist. Geoffrey Stone, Perilous Times: Free Speech in Wartime From the Sedition Act of 1798 to the War on Terrorism 200 (2004).
by allowing losses from one activity to be used against profits from another. If the taxpayer does not diversify, the NOLs from a single activity have no immediate use. Beyond activities with pleasure values, moreover, the low expected returns might be the result of congressionally engineered tax subsidies.

The proposal would leave intact the use of the not-for-profit doctrine against artificial accounting losses generated by tax shelters, without codifying it, however.

A. Critique of Current Law

1. For profit. Sections 162 and 212 allow the deduction of business expenses and expenses incurred for the production of income. Section 183 allows a deduction for the expenses of an activity not engaged in for profit not to exceed the gross income from the activity. Expenses such as casualty losses, some interest, and some state taxes are allowed without business or profit motive, but they first reduce the revenue from the activity and so lower the ceiling of the section 183 limitation, so there is less room for the use of expenses that require a profit motive.

The test for whether an activity is for profit or not for profit has some internal contradictions. It is said to be an objective test, but it is necessarily a subjective test — despite efforts to avoid that label — because there is no other meaning for “for profit” except as a mental state. Deductibility depends on the taxpayer’s purpose, motive, intention, or objective. Business expenses consistently have been defined, from early in the income tax’s existence, as expenditures for the purpose of a profit. Purpose, motive, intention, and objective all concern a taxpayer’s state of mind. Moreover, the regulations and case law foreclose the use of reasonable expectations of profit — a non-subjective standard — even as evidence of state of mind.

The taxpayer can be incurring the costs for profit even if objectively, profit is unlikely, even delusional. According to the regulations, to avoid the section 183 limitation, the activity needs no reasonable expectation of profit, as long as the taxpayer has the purpose of making a profit. Taxpayers do not even need to expect or predict that they will make a profit; it is enough to desire to make a profit. Profits are desirable — more so than losses — so no one would reject a profit if it is available. Thus, if having the purpose of making a profit means only that the taxpayer desires some profits but does not expect any, it is difficult to see any substance to the test or how a taxpayer would ever flunk the test if applied literally.

A but-for test would treat the activity as not for profit if the expenses would be continued even if the taxpayer were told that there would be no future profits. The cases discussed above, however, say that an expectation of future profits is unnecessary as long as the profits are a goal. So even a but-for test does not seem to be required. Shelter promoters tell shelter buyers that they can report their fake losses if they have the right state of mind, and the buyers shape their minds accordingly. If

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11 John W. Lee, “A Blend of Old Wines in a New Wineskin: Section 183 and Beyond,” 29 Tax L. Rev. 347, 406 (1974) (arguing that the test is objective and criticizing a court case as “tainted by a subjective approach”). As noted in the text, a state of mind purpose is per se a subjective condition.

12 Reg. section 1.183-2(b); S. Rep. No. 91-552, at 104 (1969) (saying that the committee had “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”); but see Dodge v. Commissioner, 188 F.3d 507 (6th Cir. 1999) (affirming the Tax Court’s decision that the taxpayer had no reasonable chance of making a profit).

13 In Rizzi’s Toyota World Inc. v. Commissioner, 752 F.2d 89, 94 (4th Cir. 1985), said that the economic substance test “requires an objective determination of whether a reasonable possibility of profit from the transaction existed apart from tax benefits.” But it is plausible that the antiabuse economic substance doctrine has a different purpose than the identification of hobby losses.

14 Dreicer v. Commissioner, 665 F.2d 1292, 1299 (D.C. Cir. 1981). In Dreier, which involved the author of an unprofitable book, the D.C. Circuit initially reversed, saying the Tax Court’s decision had improperly hinged on the taxpayer’s lack of profit expectations when the court should have been looking at his objective to make a profit, even though he did not expect a profit. On remand, the Tax Court again found against the taxpayer because he had failed to show that he had an actual and honest objective of making a profit. 78 T.C. 642, 646 (1982), aff’d, 702 F.2d 1205 (D.C. Cir. 1983).
horse owners can convince themselves they would like to make a profit, even without an expectation that they will, that literally satisfies the test.

The regulations also foreclose considering the normal tools of economic decision-making. All valuations and allocations of capital investments, under good economic theory, depend on the expected net present value of the investment. Under a present-value analysis, future cash flows from the activity are discounted to their present value by the discount rate brought in from the best alternative risk-free investment. All time value analysis is a way of comparing the investment under consideration with the alternative investment that forms the discount rate. Investments with a negative net present value should not be undertaken. The money should be left in the best alternative or should not be borrowed. All real economic evaluation is expected value. Expected value is also calculated by discounting by probability, so each future cash flow is worth only the amount of the cash flow times the likelihood that it will happen.

Under the regulations, however, investments with a negative expected net present value can qualify as if they were for profit. The regulations state that "the availability of other investments which would yield a higher return, or which would be more likely to be profitable, is not evidence that an activity is not engaged in for profit." In the economic world of real decision-making, the fact that the investment has a lower return than alternatives or that profits are unlikely means the investment has a negative expected present value. And that is proof that the investment should not be undertaken by reason of the economic return. Opportunity costs of both labor and capital are part of the economic evaluation of a project. By precluding a test of economic value in the absence of tax, current law condones transactions that are nonsensical in the real pretax world.

In reporting on section 183, the Senate Finance Committee said that it intended the use of an objective rather than subjective approach to determine whether the taxpayer has the requisite purpose. The regulations consistently say that "the determination whether an activity is engaged in for profit is to be made by reference to objective standards, taking into account all of the facts and circumstances of each case." Because the test is about a state of mind, and because no actual or reasonable expectation of profit or positive expected net present value is required, the Senate report and the regulations use the term "objective" in an odd, constrained sense that I cannot understand.

Given the taxpayer does not need to expect profit nor a positive net present value nor have to abandon the activity if told there is no profit, I am not sure what the test means. Taxpayers lose cases, however, on the grounds that they failed to show they had an "actual and honest objective of making a profit."

Even a state of mind test has to rely on evidence external to the mind — "even the devil does not know what the thought of man is." Whatever the devil knows, the courts have to reach a conclusion about a taxpayer's motive based on external evidence. In every decided case, the courts have to announce the taxpayer's state of mind.

The requirement of an objective standard at least downgrades the importance of the taxpayer's own testimony. Thus, the regulations under section 183 provide that "greater weight is given to objective facts than to the taxpayer's mere statement of his intent." The taxpayer can testify about his own state of mind — without fear of a penalty for perjury because state of mind is private to the taxpayer — but no tax system should rely only on a taxpayer's own description of his state of mind. Even if the testimony were honest, the human mind is plastic enough to shape itself into the most valuable state of mind. The cartoonish version of the for-profit test is that the taxpayer can claim a deduction if he is pure of mind, and given the rewards of the tax savings, the taxpayer will be pure of mind.

2. The nine-factor test. The regulations under section 183 list the following nine factors to be considered in determining whether the taxpayer has the requisite for-profit purpose:

1. Businesslike records. Maintaining complete and accurate books and records in a business-like manner is a favorable factor.

2. Expertise. Preparation by extensive study of or consultation with experts on accepted business, economic, and scientific practices is a favorable factor.

14For a further explanation of net present value, see, e.g., Stewart Myers and Richard Brealey, Principles of Corporate Finance, ch. 3 (2000).
15Probability discounting to determine expected value is further explained in S. Christian Albright et al., Data Analysis and Decision Making, ch. 7 (2009).
16Reg. section 1.183-2(b)(9).
18Reg. section 1.183-2(a) (emphasis added).
19Dreicer, 78 T.C. at 646.
20Brogden v. Metropolitan Railway Company (1876-1877), L.R. 2 App. Cas. 666 (holding that a binding contract can be found by conduct).
21Reg. section 1.183-2(a).
3. Extensive time. Extensive time and effort by the taxpayer is a favorable factor if the time does not have substantial recreational aspects.
4. Appreciation. Expected appreciation in land or other assets counts as a profit.
5. Track record of success. Taxpayer success in other activities is a favorable factor, especially if the taxpayer has turned around unprofitable activities.
6. Continuing losses. Losses that continue beyond the period that customarily is necessary to bring the operation to profitable status and that are not explained by unforeseen events are an unfavorable factor.
7. Occasional profit. A large enough occasional profit is a favorable factor.
8. The taxpayer’s financial status. The taxpayer not having substantial income from other sources is a favorable factor.
9. Personal pleasure or recreation. Recreational or personal elements are an unfavorable factor.

The regulations also say that all the facts and circumstances are to be taken into account, including some not listed, and that no single factor is determinative. A count of factors, lined up as favorable versus unfavorable, does not determine the outcome.\textsuperscript{22}

The nine-factor test is unhelpful. First, no weight is assigned to any factor, and none of the factors is tied to a theory. Seventh Circuit Judge Richard A. Posner described such multifactor tests as “semantic vapors” that provide no objective basis for a legal decision.\textsuperscript{23} The nine factors here are especially vaporous. They provide words that can justify a decision retroactively, but they do not help courts reach those decisions or encourage consistency.

Some of the nine factors should be given little weight. For instance, the case law seems to treat the time spent (factor 3) as a makeweight: “Cases holding against the taxpayer usually do not mention the amount of time devoted, while those holding for the taxpayer usually mention it only in passing.”\textsuperscript{24} Taxpayers can also manufacture factors. Formal requirements, such as those for meticulous records (factor 1) and consulting experts (factor 2), can be used to disguise a hobby, at least once a taxpayer is alerted to the list treating records and consulting experts as favorable factors.\textsuperscript{25}

Extensive records and consultation with experts are also consistent with intense hobbies. The records and consulting may be a signal that the hobby is intense, but not necessarily that profits were the taxpayer’s motivation.

The explanation in the regulations also neutralizes some factors in describing them. For example, they list personal pleasure or recreation from an activity as an unfavorable factor and simultaneously say that an activity will “not be treated as not engaged in for profit merely because the taxpayer has purposes or motivations other than solely to make a profit.”\textsuperscript{26} If the point is to separate consumption or recreation from necessary expenses that need to be subtracted from revenue to compute net income, the recreational or personal aspects of the loss should be determinative.

Future appreciation of the land or other property used for the activity (factor 4) is treated as sufficient to qualify the activity as for profit, if the appreciation is large enough to cover the losses and if the operations and possession of the property are within the same activity. The regulations say it is unnecessary for the taxpayer to recognize profit in the current year as long as he intends an “overall profit when appreciation in the value of land used in the activity is realized.”\textsuperscript{27} Consistent with that approach, the courts sometimes allow consideration of future capital appreciation in determining, for example, that while profits and losses must be computed annually, unrealized appreciations in value may equal, at least, the realized losses.\textsuperscript{28} However, appreciation may be considered to offset operating losses only if the appreciation and losses are part of the same activity, judged from all the facts and circumstances. Courts commonly treat farm and horse operations as different activities

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\textsuperscript{22}Reg. section 1.183-2(b)(9).
\textsuperscript{23}Reg. section 1.183-2(b)(5).
\textsuperscript{24}Sanderson v. Commissioner, T.C. Memo. 1964-284. Accord Eisenman v. Commissioner, T.C. Memo. 1988-467 (saying that “real possibility” horse costs would be recovered by appreciation of the value of the horses); Thompson v. United States, No. H-81-946 (D. Conn. 1989) (upholding jury verdict because although the taxpayer sustained consistent and long-term losses, a rational person could have found that the appreciation of the horses’ value would turn a profit); and George v. Commissioner, 22 B.T.A. 189, 195 (1931) (concluding that the taxpayer planted the orchard to increase the value of his property and reduce the costs of carrying the land until sale).
from holding the underlying land for sale and thus deny that the money-losing operations were conducted for profit.\textsuperscript{29}

Treating future capital gain as a justification for ordinary deductions is unwarranted under accounting and economic policy. Generally accepted accounting principles require matching expenses to the future income to which they relate.\textsuperscript{30} If the current expenses cause future capital gain, they need to be deferred to offset the gain. When the future gain is eligible for the lower tax on capital gain (a maximum rate of 20 percent), the immediate deduction at the ordinary rate of 39.6 percent for the costs incurred for the capital gain creates a negative tax or subsidy that will cause taxpayers to undertake investments that they normally would not in the absence of tax and that should not be undertaken. To take one example, the mismatch of an ordinary deduction for an expense and the capital gain for the return can turn an unacceptably low profit of a 0.2 percent pretax return into an acceptable 7.4 percent after-tax return.\textsuperscript{31} Ordinary tax accounting should never create a negative tax subsidy on ordinary activity. The tax system needs to collect revenue from ordinary profitable transactions, not give revenue away to subsidize activities that would not be undertaken in the real nontax world.

The nine factors also work within the general rule that the determination of a for-profit purpose will take into account “all the facts and circumstances with respect to the activity,” even beyond the listed factors.\textsuperscript{32} A facts and circumstances test makes the question a factual determination, not a legal one. To quote one famous formulation of the facts and circumstances test: “One struggles in vain for any verbal formula that will supply a ready touchstone. The standard set up by the statute is not a rule of law; it is rather a way of life. Life in all its fullness must supply the answer to the riddle.”\textsuperscript{33}

The deduction of losses under a facts and circumstances test must be determined on a case-by-case basis by the legal trier of fact — the judge or jury.\textsuperscript{34} Apparently, there must be a court case with a jury or judge as the trier of fact for the issue of deductibility to be settled. Appellate courts’ role in uniform justice is limited to reversing findings that are clearly erroneous.\textsuperscript{35}

The existence of a facts and circumstances test means there is no rule of law in the area. And life in all its fullness does not in fact provide answers to any riddles. Life in all its fullness, to quote William Shakespeare’s characterization, “is a tale told by an idiot, full of sound and fury, signifying nothing.”\textsuperscript{36}

To find an answer, you need a theory, a rationale consistent with the purpose of the income tax. Life also does not tell the judge and jury how to make the decision. The for-profit test does not allow for a uniform system of tax across the continent, and justice requires consistency.\textsuperscript{37}

Further, a “life in all its fullness” test cannot be administered by requiring the taxpayer to pay the tax due with his tax return. Tax is collected most efficiently through the tax return and its instructions, but vague tests, including the factors used under the for-profit requirement, are enforced only through audits and litigation. A taxpayer may take a position on a tax return without penalty if he has substantial authority for his position.\textsuperscript{38} Under a facts and circumstances test, the taxpayer almost always has some facts in his favor, so he can claim

\textsuperscript{29}Reg. section 1.183-1(d)(1). For cases denying that farm operations and the holding of the underlying land for its ultimate appreciation were the same activity, see DiDonato v. Commissioner, T.C. Memo. 2013-11; and Hambleton v. Commissioner, T.C. Memo. 1982-234.

\textsuperscript{30}INDOPCO Inc. v. Commissioner, 503 U.S. 79, 84 (1992) (saying that “the Code endeavors to match expenses with the revenues of the taxable period to which they are properly attributable, thereby resulting in a more accurate calculation of net income for tax purposes”).

\textsuperscript{31}Assume, for example, that the taxpayer incurs $100\textdagger in operating costs to carry land to realize another $101\textdagger gain in five years. In a real economic decision, the resources would not be used in this way because a $1\textdagger profit in five years is only 20 basis points (0.2 percent) per year — too low to justify the investment: $100\textdagger x (1 + i)^{5} = $101\textdagger, where “i” is 0.2 percent. With an ordinary tax rate of 40 percent and a capital gain rate of 15 percent, however, the transaction after tax becomes $100\textdagger x (1 - 40 percent), or a $60 cost to get $101\textdagger - 15 percent (of $101\textdagger), or $85.85. A $60\textdagger after-tax cost to get an $85.85 after-tax return is a fine 14 percent profit, or a 7.4 percent after-tax annual return rate. $60\textdagger x (1 + i)^{5} = $85.85, where “i” is 7.4 percent. The ordinary deduction of expenses to create capital gain has increased profit from 0.2 to 7.4 percent under the assumptions of the example.

\textsuperscript{32}Reg. section 1.183-2(b).

\textsuperscript{33}Welch v. Helvering, 290 U.S. 111, 115 (1933) (holding that payments of the father’s debts discharged in bankruptcy were nondeductible either because the payments were from capital investments or were personal expenditures), cited with approval in Duberstein v. United States, 363 U.S. 278, 289, n.10 (1960) (status as a tax-exempt gift was to be determined by the trier of fact).

\textsuperscript{34}But see Glick, supra note 25, at 863 (calling for the determination of for-profit status by the trier of fact on a case-by-case basis with only limited appellate review). These cases should be decided consistently as a matter of law across the country on the tax return, without a trial by judge or jury.

\textsuperscript{35}For a description of the review of factual determinations, see United States v. United States Gypsum Co., 333 U.S. 364, 395 (1948).

\textsuperscript{36}Macbeth, Act 5, Scene 5.

\textsuperscript{37}See, e.g., American Trucking Association Inc. v. Smith, 496 U.S. 167 (1990) (saying that evenhanded administration of justice requires the same results for different parties in the same circumstances).

\textsuperscript{38}Section 6662(d)(2)(B)(i).
the expenses on his tax return. In Osteen v. Commissioner,\(^{39}\) for instance, the Eleventh Circuit held that the taxpayer had sufficient authority for his position that horse breeding was a for-profit activity to avoid a penalty, even though he lost on the merits, because other taxpayers had won horse-breeding cases with similar facts. Taxpayers lose an estimated three-quarters of the horse cases once they are litigated,\(^{40}\) but the IRS audits only 1 percent of individual returns.\(^{41}\) So even when the law is taxpayer-adverse, taxpayers win by default in essentially every case. The IRS is stretched so thin that it cannot litigate its meritorious cases or devote the resources sometimes needed to find taxpayer error. Because it cannot be enforced on the tax return, a life in all its fullness rule prohibiting the deduction of hobby losses is in most cases an unenforceable nullity.

The hobby loss rule needs to be a rule of law enforceable on the tax return and without regard to motive. It also should prevent a subsidy for transactions without pretax economic merit. That is, there should be no deduction for business losses incurred when the activity had a negative expected net present value.

Supreme Court Justice Oliver Wendell Holmes Jr. argued that the inevitable course of the common law has been to replace rules about state of mind with external, objective standards.\(^{42}\) Now is the time to replace the bad economic theory of the subjective and inadministrable not-for-profit standard with a clean, simple, objective requirement that the losses be capitalized.

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\(39\) Osteen v. Commissioner, 62 F.3d 356 (11th Cir. 1995), aff’d in part and rev’d in part T.C. Memo. 1999-519. Accord Drummond v. Commissioner, 155 F.3d 558 (4th Cir. 1998), aff’d in part and rev’d in part T.C. Memo. 1997-71 (affirming that the taxpayer had no profit motive but reversing the Tax Court’s disallowance of penalties based on the return position because the taxpayer spent a lot of time on horses, and his accountant advised him it was all right to report the losses); and McKeever v. Commissioner, T.C. Memo. 2000-288 (no negligence penalty because the return position was consistent with the understanding of the taxpayers’ accountant of the law although the taxpayer had no profit motive). But see Meaney v. Commissioner, 59 F.3d 1246 (11th Cir. 1995) (upholding a penalty on the reporting position in a not-for-profit case); and Hastings v. Commissioner, T.C. Memo. 2002-310 (penalty upheld). See discussion in Michael Cook and Corby Brooks, "Determining Whether Substantial Authority Exists in Facts and Circumstances Case," 111 J. Tax’n 173 (2009) (noting, for instance, that the substantial authority standard that must be met to avoid a penalty on a tax return fits legal issues better than factual issues).

\(40\) See the description of the sample, supra note 1.

\(41\) 2012 IRS Data Book, Table 9a (Mar. 2013).

\(42\) Holmes, The Common Law 38 (1881).

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**B. Explanation of the Proposal**

The proposal would require the taxpayer to defer the deduction of business losses in specified recreational activities for which taxpayers usually lose the litigated cases. Beyond those from activities on the statutory list, losses would be deferred under a general standard: If the activity has recreational values such that some bidders accept losses or significantly below-market returns, the losses would be deferred. If the IRS wins two cases regarding an activity, a revenue procedure may provide for automatic deferral of the losses from that activity.

Taxpayers would then use the deferred losses against the first future revenue or capital gain from the activity. If the taxpayer abandoned the activity without recovering all the losses, he would deduct the unabsorbed losses, but only through a refund claim and possibly a refund suit, and only for the expenses paid when the activity passed a true economic test — that is, when it had a positive reasonably expected present value.

**1. Rationales for deferral.** In all loss cases, the taxpayer has insufficient revenue to cover the current expenses. To justify a profit motive, the taxpayer relies on the future profit attributable to expenses since there is no current profit. If we first take the taxpayer’s justification at face value, the claim implies that expenditures are investments or capital expenditures, and not expired costs or immediate economic losses. Investments are not lost when made because they are made in the expectation that the future profits are worth at least the amount invested. Without that expectation, an investment would not have been made. In general, deductions should be allowed only for expenditures that have lost their value.\(^{43}\) An expenditure is not a loss if it produces future income, even if the expenditure exceeds current revenue.

Within the GAAP framework, accounting reflects income only if expenses are matched against the revenue to which they relate. The fundamental accounting principle of matching says that the annual report of profits is not a fair sample of the company’s true performance if expenses are not matched with revenue. The immediate deduction of expenses that cause future income is a mismatch. In accounting, expenditures best matched to future income are considered assets on the balance sheet and are to be carried over to the future years and

subtracted from future income.\textsuperscript{44} The tax law adopts most fundamental accounting principles, including matching. As the Supreme Court has said, “The Code endeavors to match expenses with the revenues of the taxable period to which they are properly attributable, thereby resulting in a more accurate calculation of net income for tax purposes.”\textsuperscript{45}

Under the fundamental principles of an income tax, investments are capital expenditures that produce basis, not immediate deductions. An “asset” in accounting parlance is “basis” in tax parlance, and investments in an income tax system create basis when made, not deductions.

One reason for a strong law of capitalization is that an immediate deduction for an investment means, as an economic matter, that tax will not reduce the pretax return rate from the investment — the internal rate of return will be the same both before and after tax. Creating basis rather than immediate deductions for capital expenditures is also the only treatment consistent with borrowing or incurring a liability to buy.\textsuperscript{46}

The proposed denial of deductions in the year they are incurred appropriately applies both to (1) losses incurred for future profit, because they are from investments; and (2) the excess of expenses over revenue voluntarily incurred without future profit, because they are for recreation or consumption. Personal consumption expenses are the heart of the tax base. They are not losses in the economic sense because of the consumption values the taxpayer buys in return. Losses are involuntary events. If the taxpayer keeps making expenditures in excess of revenue, the continuation of the expenditures is good evidence that they are not involuntary losses, but consumption or investment.\textsuperscript{47} The difference between investment and recreation depends on the future profit. Luckily, because we cannot know whether there will be future profits, it makes no difference to deny the immediate deduction.

Revenue is a strong attractor under the logic of deferral. If the taxpayer has revenue for the year, the expenses of a hobby are deducted against the revenue that it creates, even if the expenses are pleasurable or recreational enough that they would be incurred without the revenue. However, expenses that exceed current revenue and thus are justified only by future revenue are deferred by the strong magnetism to be matched against that future revenue. Current limitations on hobby losses make them permanently nondeductible if they lack the requisite profit motive in the year incurred. The proposal would liberalize current law by allowing losses to be carried forward to future years to be absorbed by any future revenue, without regard to the taxpayer’s state of mind.

The strong attractor idea also is arguably required to justify any deduction whatsoever. If the costs of the pleasures of a country estate or Appaloosa horses are purely recreational or consumption, then like all consumption expenses, they should be part of taxable income and never deducted. However, as under the current hobby loss limitations, the proposal would allow the costs of the pleasurable hobby to be deducted against revenue from the hobby if those expenses create the revenue. Taxing the revenue on a gross receipts basis without taking into account that the expenses were necessary for the revenue to come into existence is overtaxing. It is only the expenses in excess of current revenue — those not “strongly attracted” to current revenue — that are the issue under the current hobby loss limitations and this proposal.

The strong attractor idea also justifies a carryback to shelter income received in previous years from the activity. The proposal would allow a carryback and refund of prior tax paid on revenue from the activity, with the carryback period conforming to the general rule for NOLs under section 172(b) — which now allows a two-year carryback period. NOL carrybacks are allowed by section 172(b) only for business losses, but the strong attractor idea justifies giving the benefit of a carryback to activities that would be undertaken even without the profit.

The strong attractor idea justifies the proposed rule that the first revenue from a hobby would be sheltered by and absorb the loss carried over from a prior year. An alternative model would require the losses to be amortized over a set period. Under current law, start-up expenses, defined as costs qualifying as expenses before the business begins, are deducted over a 15-year period from the year.

\begin{footnotes}
\item[44]One of the best judicial discussions of the accounting theory behind capitalization is the panel decision in NCNB Corp. v. United States, 651 F.2d 942 (4th Cir. 1981) (Murnaghan, J.), rev’d en banc, 684 F.2d 285 (4th Cir. 1982).
\item[45]INDOPCO, 503 U.S. at 84.
\item[47]A single expenditure might also be an investment in part and a recreational expenditure in part because the expenditure creates some future value, but not enough future returns to create an expected present value equal to the full amount of the expenditure. But even in that case, denial of the immediate deduction in full is justified because neither the investment nor recreational aspects of the single expenditure justify an immediate deduction.
\end{footnotes}
the business starts. Another alternative would be to treat early losses as a necessary gateway to income for the entire life of the activity, and if the activity is expected to continue indefinitely, the costs would not be recognized deductions until the activity is abandoned. Under the strong attractor idea underlying this proposal, the first future revenues absorb loss carryforwards. Those losses have already been considered expenses in the year incurred, and they will be recognized as expenses against income at the first opportunity.

Deferral for section 183 losses has several analogues in current law. The core rationale treats the losses as investments for the future income — that is, capital expenditures. Capital expenditures are disallowed when incurred by section 263, but they will be recognized as expenses when incurred, and they will be considered recovered.

Section 163(d), to take a similar example, defers the deduction of interest incurred to purchase or carry investments, when the interest exceeds the deduction of interest incurred to purchase or carry investments. Capital expenditures are disallowed when incurred by section 263, but they create basis that is allowed whenever capital is considered recovered.

The proposal could also reasonably be viewed as an extension of the limitation of passive activity losses to cases in which the taxpayer materially participates in the activity. Section 469 defers loss deductions from a passive activity until income comes in from the activity or similar ones, or until the taxpayer abandons the activity as a whole. The limitation protects ordinary sources of income, including salary and investment income from tax shelters. Section 469 is the successor to an earlier proposal to limit artificial accounting losses. The term “artificial accounting losses” is a better descriptor than “passive activity” for the tax shelters that section 469 was intended to target. Section 469 was adopted by the Tax Reform Act of 1986 because prior accounting under the ordinary rules allowed large fake losses. Marketable and readily available tax shelters were reaching epidemic levels in the years before the act. TRA 1986 cut the maximum tax rate almost in half, but it tried to maintain distributional neutrality by requiring that the richest taxpayers, who would benefit from the rate cut, give up their tax shelters and confess their true income. Both in cutting rates and curtailing shelters, the 1986 act improved the economic efficiency of the tax system. Without the anti-shelter restrictions of section 469, Congress could not have cut the tax rates.

As passed, the section 469 limitation does not apply to activities in which the taxpayer is a material participant. A passive activity is one in which the taxpayer does not have material participation. Under current regulations, the material participation requirement is generally satisfied if the individual spends more than 500 hours a year in the activity, which is about one quarter of a year’s worth of full-time, 40-hour weeks. The exemption can be traced to former Senate Finance Committee Chair Russell Long, who argued that a person who lost money in business should be able to deduct losses immediately: “It is not a general tax avoidance scheme for people to go broke in order to claim

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48 Section 195. In 2004 Congress liberalized the amortization for smaller start-up costs by allowing up to $5,000 a year for costs under $50,000. Section 195(b)(1). See generally Boris I. Bittker and Lawrence Lokken, Federal Taxation of Income, Estates and Gifts, para. 26.4. One might be justifiably skeptical that the section 195 regime means anything in practice since the 15-year amortization begins with the start of business as determined under Treasury regulations (section 195(b)(1)(B)), but no regulations have been proposed in the 33 years since section 195 was enacted.
49 See INDOPCO, 503 U.S. 79 (capitalizing the professional fees expended in a merger, apparently as a cost of a stronger corporate structure that would be of value as long as the corporate group survives).
50 See generally Bittker and Lokken, supra note 48, at para. 52.5.
51 Section 163(d)(2).
52 Section 163(d)(4)(B).
54 The term “passive activity” is an oxymoron, not unlike “active passivity,” and it is difficult to think literally why either passivity or activity, or a mixture of the two, is a source of concern. The term “passive activity” also does a poor job of describing the artificial deductions targeted by section 469.
55 Jeffrey H. Birnbaum and Alan S. Murray, Showdown at Gucci Gulch 119 (1987) (David Brockway, staff director of the Joint Committee on Taxation, able to say that thanks to section 469, they could cut the top individual tax rate nearly in half without giving a windfall to the wealthy); former Sen. Daniel Moynihan, “A Death Knell for Tax Shelters?” The New York Times, July 7, 1986, at A17 (shelter limits are as much at the heart of tax reform as the tax rate reduction itself).
56Reg. section 1.469-5T(a)(1). Fifty weeks times 40 hours is 2,000 hours (allowing two weeks vacation), and 500 hours is a quarter of that.
tax deductions.” Although, as Long suggested, it is irrational to lose $100 just to deduct $100, business people are still willing to take deductions for fake losses or immediate deductions for recreation or investment. Artificial accounting losses representing a fake diminution of wealth are generated even within and by a business.

The distinction between material participation and passive activities subject to limitation has been criticized as a scheme to give tax benefits from fake deductions to insiders who can satisfy the material participation threshold, while protecting them from the onslaught of outside capital from investors who are unwilling to spend a quarter of their time on the activity. The proposal would apply the same rules to insiders as to outsiders on section 183 losses, without regard to material participation.

2. Scope definition. The deferral of losses is a sound remedy for business losses even beyond those from recreational or pleasurable activities, but the proposal would limit the scope of the remedy to listed activities in which most taxpayers have lost their hobby loss cases plus activities in which some participants get recreational value. The proposal would identify a list of per se deferred losses in the statute, drawn from decided cases that taxpayers have lost. Because taxpayers usually lose their cases regarding for-profit motive, losses from the following activities would be listed as section 183 losses: breeding or racing horses; breeding or showing dogs; racing or collecting cars; the operation of residential farms and ranches; chartering or racing boats; collecting; painting and photography; creating music; comedy and acting; and fiction or nonfiction writing. The government need not win all the cases for an area to be considered a per se deferred loss activity. That is because the presence of significant recreational bidders will drive expenses up and revenues down, and because capitalization is an appropriate result, even for losses incurred for future revenue. Regulations could add to the list of activities for which the deferral remedy would be applied automatically, and the IRS would be allowed to add to the list through revenue procedures, once it has won two cases on the argument that losses of a particular kind in specific activities were commonly accepted as for recreation or pleasure. The scope of section 183 losses, which are those deferred under the proposal, would be those listed by statute, regulation, or revenue procedure (including the list above), and the backup or default rule would be “other activities for which some significant participants accept low returns by reason of the pleasure or recreation of the activity.”

Deferral would be required under the backup rule, beyond the list of specified section 183 losses, if there are significant participants who derive pleasure or recreation from an activity. The existence of bidders who do not need to make a profit from the activity creates a demand without profit, which means that those taxpayers bid up the price of the factors going into the activity and accept lower revenue from the return. Because the market will suppress the profits from activities with usual pleasure or recreation, there is no need to inquire into the specific taxpayer’s state of mind. The taxpayer probably went into a pleasurable or recreational activity expecting that it would have a market-suppressed pretax return or that he at least could have ascertained that low pretax return by reasonable investigation. Deferring the losses to

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58. See, e.g., Federman v. Commissioner, T.C. Memo. 1982-306 (stamp and coin collecting expenses); and Stanley v. Commissioner, T.C. Memo. 1980-217 (stamp collecting expenses).
match future income is also an appropriate remedy beyond hobby losses so that even weak suspicions that money spent is for recreation are sufficient to trigger loss deferral for that activity. A taxpayer would still be able to enjoy the activity and deduct its costs against revenue, but once the expenses exceed the revenue, the net loss would be deferred.

3. Proving real losses. If an expenditure is made with the expectation that it is a rational investment, but the investment later loses value, it is important that the tax system allow the loss to reduce taxable income. An investment loss means that the taxpayer has a lower standard of living, and we compute taxable income by determining what share of the total tax burden the taxpayer’s standard of living can bear. The standard Haig-Simon definition of income includes both consumption and investment; the horse losses when voluntarily incurred are either one or the other. But the Haig-Simon standard also subtracts reductions in the value of investments to reach the normative definition of taxable income when the subsequent reduction occurs.69

The taxpayer not stopping an activity is a signal that the continuing expenses are not a loss. Losses are involuntary, unwanted events, like thefts. If the taxpayer continues incurring the expenses, they do not look like thefts. The activity might have lost value after the expenses were incurred, but we can be skeptical. The realization rule, for instance, provides that losses are mere fluctuations in value and are not recognized for tax purposes until sale or another realization event. Section 469, containing the passive activity rules, continues to reflect skepticism that the losses are just from artificial accounts, until the activity is terminated. At abandonment, however, the absence of continuing value means the unabsorbed excess expenses are no longer plausible investments. Once the taxpayer has terminated the activity, the proposal would allow tax recognition of the unabsorbed losses, if the expenses were economically justified beyond the pleasure or recreational values when the expenses were incurred.

The proposal would allow the taxpayer to deduct loss carryovers that have not been absorbed by revenue and capital gains by the time the taxpayer abandons the activity, but only if the expenditure was economically rational without recreation or pleasure when the expense was incurred. In calculating the expected present value, the value of the taxpayer’s time, at its highest non-recreational use, would be subtracted from revenues, because opportunity costs are part of the economic cost of an activity. Giving free time to an activity is a signal that the time has recreational value.

The deduction on abandonment would be allowed only under a procedure that incorporates the appropriate skepticism that the taxpayer will be able to prove economic rationality for expenditures that in retrospect turn out to have been unjustified as investments. Under the standard tools of modern finance, an expenditure is rational even without recreational or consumption value only if it had a positive expected net present value when made, using reasonable projections of future revenues. Determining positive expected present value requires discounting projected future cash flows to present value by the taxpayer’s discount rate — that is, the best alternative return on an investment that is risk free or has hedged risks. The future cash flows must also be discounted to an expected value, by the percentage of likelihood that the cash flows will occur.

If bidders, including the taxpayer, find pleasure or recreation in an activity, we should not expect the taxpayer to be able to make the required showing for the full value of the investment, because bidders seeking recreation or pleasure accept low revenues and high expenses from the activity. The market accepts and expects that horses will produce expenses that are greater than the value of the revenue. That is true both when the horse expenses are incurred and when the equestrian activities are abandoned. The taxpayer might, however, be able to show that some fraction of his expenses had value under the expected net present value yardstick at the time incurred.

It is said that the owl of wisdom flies only at dusk, meaning that we see many things only in hindsight. The question will thus be whether the expenditures were rational investments that turned out, against expectations, to be lost or recreational all along. At abandonment, there will be some additional evidence of profit motive to distinguish lost investments from recreation. A string of 20 years of horse losses looks like a recreational expense rather than a rational investment. We can distinguish hopeless losses from rationally dogged development expenses in hindsight, when all the profits have come in, better than when all the supposed profits are in the future and are still based on speculations or delusion. Applying real results rather than mere claims, delusions, and speculations will improve the quality of the decision-making.

The procedure for claiming losses at abandonment should incorporate the skepticism that the taxpayer will be able to make his case. The proposal

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69 Henry Simon, Personal Income Taxation 50 (1938) (defining income as consumption plus or minus change in wealth).
70 Id.
would require the taxpayer to report tax while ignoring the unabsorbed losses. To get the deductions, the taxpayer would have to make a refund claim with the IRS, showing the positive expected net present value under reasonable projections of future value, with an appropriate discount rate and discounting for the probability of future cash flows. If the IRS denies the claim, taxpayers would need to initiate a refund suit, which they usually do only if they think the likelihood of success is worth the cost of litigation. The requirement of a refund claim eliminates the taxpayer advantages to taxpayers created by low audit rates (near 1 percent of returns) and to overburdened IRS agents, who inevitably miss or misidentify their best case regarding issues on audit. The refund claim procedure also takes away the taxpayer advantage of problematic tax collection. Given that the market will suppress the returns from horses and other hobbies, we should expect that few refund claims will be successful or even be made.

4. Limiting to hobbies. While the capital expenditure rationale comfortably covers business losses beyond those with some hobby value, this proposal would limit its remedy to the activities in which some bidders get recreation or pleasure. The hobby loss problem is big enough on its own that the proposal does not need to draw the political opposition that would come from addressing activities beyond hobbies. For those other activities, moreover, there are countervailing considerations of encouraging diversification and preserving tax incentives, which do not seem serious for activities with hobby value.

a. Diversification. Taxpayers need to be encouraged to diversify their investments to reduce the toxic effect of risk. Risky investments systematically do more harm on the loss side than the same amount of gain gives benefits because of differences in the effect on standard of living. Taxpayers tend to spend the dollars first on the most desperate needs and then, in a more or less continuous function, on ever less critical needs. Losses can leave you out on the street without money to pay the rent and trying to survive eating sand. Gains buy you bonbons. Taxpayers illustrate the variable value of dollars by saving for a rainy day or for retirement when less money will come in and by buying insurance and avoiding high-risk gambles with their nest egg.

Every taxpayer needs to diversify his investments to reduce toxic risks. The tax law largely encourages diversification not only by allowing losses from one activity to be deducted against profits from another, but also by not giving government checks out for overall NOLs. The NOL limitations, under which tax is generally not refunded on overall losses, mean that the taxpayer often must diversify to take losses. The taxpayer who diversifies will thus get the use of his losses, whereas the taxpayer who does not will lose the deductions. To encourage diversification, the definition of activity needs to be broad enough to include all the diversifying investments. But limitations on losses become less meaningful as the definition of activity is broadened.

When one of the activities has hobby value, diversification is a less plausible need. Thus, a doctor or lawyer does not credibly hedge fees from medical or legal services with an investment in horses. The return from horse investments is below normal, even negative, because people enjoy horses. Lawyers and doctors use their legal and medical fees to fund an expenditure on horses not as a diversification of their income sources, but because they are seeking the prestige, recreation, or pleasure from equestrian activity. Hobbies also have a tendency to produce a natural definition of activity. For the lawyer and doctor, the horse losses stand out enough from the legal and medical fees that we know the horses are not part of the legal and medical practice. If we defined activity so broadly that the law practice and country estate are the same activity, the loss limitations would have no effect.

Perhaps we should expand the deferral-deduction remedy to business losses beyond hobbies and define activity to allow appropriate diversification. That seems, however, to be a battle for another day. Restricting the remedy to activities with some recreational value limits the scope of the deferral remedy. Restricting the remedy to activities with some recreational value avoids the serious problem of deciding what constitutes appropriate diversification in every case.

The proposal would exempt C corporations from the remedy. That is equivalent to defining all the income and losses of the C corporation as part of the same activity. C corporations are subject to the NOL carryover rules, that is, a corporation gets only a carryforward or carryback, and not a refund check, if it lacks sufficient revenue in the current year or carryback years to use its losses, but all the corporation’s income may be sheltered, whether related or not. A corporation’s business is any business. For

71NOL carrybacks can lead to an immediate refund of tax paid in the prior two years, but after carrybacks, the taxpayers must carry forward their losses to use against income in the following 20 years. Section 172. Cf. section 1211, which similarly limits capital losses to the amount of capital gain (for individuals, however, only after a small, $3,000 “dribble out” rule allowing capital losses to be used against ordinary income is applied).
the C corporation, the need to encourage diversification seems to dominate. The proposal leaves intact the doctrine of constructive dividends, under which shareholders have a dividend when their corporation pays for their recreations and hobbies. But not all business losses of a corporation can be considered dividends to the shareholders.

b. Tax expenditures. Narrow application of the capitalization remedy to recreational losses would also avoid dealing with the problem of losses that arise from intentional tax subsidies. When Congress adopts an accounting principle that understates economic income for the expressed reason of subsidizing the investment, there tends to be an implicit tax, which is defined as a market reaction accepting low revenue that does not meet expenses. High-tax-bracket buyers bid up the price of the investment, counting on the negative tax from the understatement of economic income to justify the investment. The lower revenue from the market implicit tax reaction will sometimes mean that there are pretax losses from the subsidized activity.

Accelerated depreciation, for example, overstates the loss in the value of the investment. Expensing of research and development allows rational and valuable investments to be treated as if they were worthless when made. Both subsidies can be justifiably criticized. They encourage investments with inferior returns in projects we probably do not want to subsidize and would not subsidize with better budget control. Suspending losses, however, would underrate the value of subsidies that Congress in fact intended, for better or worse. We might well rationally expand the capitalization of business losses to take away the ill-considered tax subsidies, but that too seems to be a battle for another day.

Rational subsidies are not a problem within activities with hobby value. If the hobbies are viewed as investments, they are investments with inferior, usually negative, returns. We should be encouraging taxpayers to shift out of those investments. If we view horses as investments, they are like the paradigm of the buggy whip industry — that is, industries for which we should be encouraging less investment and a shift away, as fast as possible. As stated earlier, horses ceased to be cutting-edge innovation at the Charge of the Light Brigade in 1854. Horses and equestrian activities are fine, even fun, as a consumption choice. But as such, they need to be paid for out of normal after-tax income, without subsidy, because high-end consumption is the normative heart of the tax base.

5. Effect on anti-shelter use. The proposal regarding losses some have considered pleasurable or recreational does not encompass, but is intended to leave intact, case law that has used the not-for-profit doctrine as a way to combat the artificial accounting losses claimed in tax shelters. There have been many cases in which the courts used the not-for-profit doctrine against tax shelters when there was no plausible recreational or consumption value to the taxpayer. Shelters that lost their promised tax shelter benefits under the not-for-profit doctrine include such non-recreational activities as coal mining and truck trailer leasing. The hobby loss cases have been characterized as requiring a requisite greed, but the absence of greed does not seem to be a plausible description of the taxpayer’s motives in the shelter cases. In Rose v. Commissioner, the Tax Court expressed its wholesale condemnation of generic tax shelters, defined as those that did not have a pretax profit motive.

The absence of pretax profit is often a reliable signal that the losses are artifacts of bad accounting. Some reported losses are not treated as constructive dividends. See, e.g., Jack’s Maintenance Contractors Inc. v. Commissioner, 703 F.2d 154 (5th Cir. 1983) (payment of shareholder’s criminal defense costs); Rose v. Commissioner, 81 T.C. 210, 232 (1983), aff’d, 788 F.2d 695 (11th Cir. 1986) (coal mines); Surloff v. Commissioner, 84 T.C. 210, 221 (1985) (truck trailers). For other uses of the not-for-profit doctrine against tax shelters, see Barnard v. Commissioner, 731 F.2d 230 (4th Cir. 1984) (nonrecourse liability paid to seller for book publishing); Brannen v. Commissioner, 722 F.2d 695 (11th Cir. 1984) (nonrecourse liability to seller for purchase of movie); and Estate of Baron v. Commissioner, 798 F.2d 65 (2d Cir. 1986) (same). For a longer list of not-for-profit tax shelter cases, see, e.g., Johnson, “The Front End of the Crude Rule,” Tax Notes, Apr. 30, 1990, p. 593, at n.19. 77

75See Johnson, “Measure Tax Expenditures by Internal Rate of Return,” Tax Notes, Apr. 15, 2013, p. 273 (arguing that accelerated depreciation motivates inferior investments); and Johnson, “Capitalize Costs of Software Development,” Tax Notes, Aug. 10, 2009, p. 603 (presenting a model in which the return on the development of computer games went from 10 percent pretax to 20 percent after tax, even assuming the games generated only negative economic externalities).
pretax transactions, and the absence of pretax profits is a sign that the transaction had no pretax economic substance. Often, there are other doctrines that are arguably better suited to reach the artificial losses. Still, the not-for-profit doctrine is an established alternative tool that should still be available in the IRS’s quiver of anti-shelter arrows.

In the wake of *Knetsch v. United States*,78 for instance, a lack of a possible pretax profit is now perceived as fatal to the transaction. The taxpayer in *Knetsch* “bought” a single-premium annuity policy that promised an annual return of 3.5 percent. He paid the insurance company with a note that bore an interest charge of 4.5 percent per year. On the face of the transaction, the taxpayer lost 1 percent of the purchase price, or $40,000 every year, and he in fact paid that amount each year to cover that loss. The explanation for that apparently irrational behavior is that the 3.5 percent return was tax exempt currently because buildup on an annuity or life insurance policy is not taxed currently and will never be taxed if it is distributed after death.79 The full 4.5 percent in interest, by contrast, was deducted currently, generating a loss that would save tax by reason of the shelter that was worth many times more than the $40,000 the taxpayer paid. The loss was fake. The purchase price was nonrecourse liability that the insurance company could not collect except from the policy itself. As the Supreme Court found, there was no change in beneficial interest, except for tax.80 In Posner’s wonderful words, the losses did not “impinge on the world.”81 The annual $40,000 in cash was a purchase price for artificial tax deductions. The absence of pretax profit could have been used as a satisfying alternative rationale for the outcome of *Knetsch*.82

The not-for-profit test has been used within the anti-shelter branch of the doctrine to require a reasonable profit, and not just a scintilla of unlikely profit.83 The doctrine has been used against paired currency options and the like, constructed to leave no economic loss but generate a multimillion-dollar claimed tax loss.84 The sham transaction doctrine could have been applied which is the rationale used in *Knetsch*, but the courts used the not-for-profit doctrine instead.

Not-for-profit doctrine was also used against inflated nonrecourse liabilities, which reached epidemic levels before TRA 1986. A nonrecourse liability to the seller of property, secured only by the property sold, is inflated by rational self-interest of the parties because neither the buyer nor the seller is economically hurt by the inflation. Including the inflated liability in basis increases the tax deductions without cost.85 The reported cases describe shelters in which the nonrecourse purchase debt to the seller is two to 20 times greater than the fair market value of the purchased property.86 In the nonrecourse setting, the courts could reasonably have used the decisions that took the inflated debt out of basis because it was not bona fide debt.87 They chose to use the not-for-profit doctrine instead.


84See Fidelity International Currency Advisor A Fund LLC v. United States, 747 F. Supp. 2d 49 (D. Mass. 2010); and Jade Trading LLC v. United States, 598 F.3d at 1377 (2010) (noting that a paired option transaction was virtually guaranteed to be unprofitable and that “no reasonable investor would engage in such a transaction to earn a profit”).

85For a longer description of nonrecourse liabilities, see Johnson, supra note 75, at 593.

86See Bryant v. Commissioner, 790 F.2d 1463 (9th Cir. 1986) ($400 purchase price for beavers worth $3.25 each; while liability was not nonrecourse in form, it could be satisfied by the return of beavers at their stipulated inflated value); Brannen v. Commissioner, 722 F.2d 695 ($1.4 million nonrecourse liability secured by $85,000 movie); and West v. Commissioner, 88 T.C. 152, 160 (1987) ($180,000 purchase price for movie print worth $150). Sometimes there is essentially no commercial value to the collateral securing the nonrecourse liability because the property had to be made or developed to be worth anything, but it never was. See Helba v. Commissioner, 87 T.C. 983, 1014 (1986) (video tapes); Hagler v. Commissioner, 86 T.C. 598, 617 (1986) ($1.2 million note secured by rights under computer programs that were not yet developed); Moore v. Commissioner, 85 T.C. 72, 101 (1985) (diamond distributorships); and Surloff, 81 T.C. 210, 235, add, 788 F.2d 695. For even more cases, see Johnson, supra note 74, at n.15-16; Adam Chinn, Note, “Attacking Tax Shelters: Section 183 Leaves the Farm and Goes to the Movies,” 61 N.Y.U. L. Rev. 89 (1987) (soundly describes the cases as explained by the nonrecourse liability used to purchase the activity).

87See Odendahl v. Commissioner, 748 F.2d 908, 913 (4th Cir. 1984) (nonrecourse liability for excess of FMV of purchase...
Congress in 2010 codified the economic substance doctrine and added a 40 percent automatic penalty that applies regardless of the taxpayer’s intent or reliance on tax opinions from counsel.\(^8\) It may well be that the codified economic substance doctrine will defeat the losses that “do not impinge on the world” without the not-for-profit doctrine. But the not-for-profit doctrine gives the IRS an additional weapon, and none of the litigated case against fake loss shelters was in error. So the intent here is to leave the doctrine alone, even if the shelter is not covered by the definition of section 183 losses. The proposal, codified in a revised section 183, would be restricted to hobby losses with some recreational value for the reasons articulated.

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\(^8\) Health Care and Education Reconciliation Act of 2010, section 1409 (adding section 7701(o)).

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