

# VALUATION OBSERVATIONS

*Some practical observations from a practicing  
business appraiser.*

## VLC

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### IS IT REALLY A BUSINESS? OR JUST A HOBBY?

Internal Revenue Code 183(d) presumes an activity is conducted for profit if the gross income exceeds the attributable deductions for 3 out of 5 consecutive years, with this presumption applying only after the third profit year. The rule changes to “2 out of 7 years” for activities involving horses. This appears to be a bright line rule. But there is more.

The Supreme Court held in *Commissioner v. Roetzinger*, 480 U.S. 23, 35 (1987) that “if one’s \*\*\* activity is pursued full time, in good faith, and with regularity, to the production of income for a livelihood, and is not a mere hobby, it is a trade or business”. The Court recognized that Mr. Roetzinger devoted time with regularity, but was not satisfied that he looked to this activity for a production of income for his livelihood.

So what exactly is a business in the eyes of the IRS? Essentially, the test for determining whether an activity is engaged in for profit is whether the taxpayer engages in the activity with the primary objective of making a profit. In resolving the question, greater weight is given to the objective facts than to the taxpayer’s statement of intentions. To assist in determining whether an activity is engaged in for profit, the IRS derived a nonexclusive list of factors. *Income Tax Regs., Section 1.183-2(b)*. These factors are:

1. The manner in which the taxpayer carries on the activity;
2. the expertise of the taxpayer or his advisers;
3. the time and effort expended by the taxpayer in carrying on the activity;
4. the expectation that assets used in the activity may appreciate in value;
5. the success of the taxpayer in carrying on similar or dissimilar activities;
6. the history of income or losses with respect to the activity;
7. the amount of occasional profit, if any;
8. the financial status of the taxpayer; and
9. any elements of personal pleasure or recreation.

Remember, it is an objective analysis where no single factor, nor simple majority of factors, is controlling. Let’s take a look at a few examples.

The Tax Court sustained the IRS’s deficiency against an individual who claimed business deductions for expenses for a motorcycle instruction business, because he failed to demonstrate that the activity was a business entered into for profit and not a hobby. *Jones v. Commissioner* T.C. Summary Opinion 2007-21.

There was nothing in the record to reasonably suggest that the activity, as Mr. Jones operated it, would ever be profitable. Additionally, there was little to distinguish the personal aspects of the activity from the business aspects. Mr. Jones had no business license, no business insurance, no business bank account, and no books of accounts that one would generally associate with a trade or business. The Court also made note that most of the expenditures (helmet, jacket, etc.) would relate to a hobby as well as a business activity.

A similar result was found in *Jun Xia v. Commissioner* T.C. Summary Opinion 2007-10. Mr. Xia was a pharmacist, employed by Rite Aid. The Court held that he was not entitled to deduct expenses incurred in his endeavors to develop new products because he did not engage in the activity for profit. What concerned the Court most was the history of losses. While a person may start with a bona fide expectation of profit, even if it is unreasonable, there is a time when, in light of the recurring losses, the bona fides of that expectation must cease. There was nothing in the record to reasonably suggest that the activity would ever be profitable. Also, Mr. Xia did not maintain the type of books and records that one would generally associate with a trade or business. The Court stated that the “activity seems to be more an intellectual pastime rather than an actual trade or business.”

Mr. Wesley was found by the Tax Court not to have a profit-seeking motive with regard to his recording and music-producing activities. *Wesley v. Commissioner* T.C. Memo 2007-78. He did not maintain complete and accurate books and records of his recording activity. There was no evidence of regular or continuous steps to promote his recording endeavors. There was no evidence that the recording equipment would potentially appreciate. With wear and tear over time, the equipment would instead more likely depreciate in value. Most importantly in this case was that he earned substantial income from his employment as an engineer and had the financial means to make large expenditures for an unrelated personal pursuit or hobby.

The same battle was lost in *Storer et. ux. v. Commissioner* T.C. Summary Opinion 2007-56. The Tax Court carefully analyzed each of the factors in Reg 1.183(2)(b) and concluded that the photography activity did have some of the characteristics of a business, but found that those characteristics were insufficient to demonstrate the activity was carried on for profit.

The IRS looks beyond the bright line rule and explores deeper. If you would like additional information, or have a question, please do not hesitate to call.

Very truly yours,

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Terri Lastovka is the founder of Valuation & Litigation Consulting, LLC. Her practice focuses on business valuations and litigation consulting in the areas of domestic relations, gift and estate tax, probate, shareholder disputes, economic damages, and forensic accounting. She draws from a wide range of experiences, including public accounting, law, banking, and CFO. She has received extensive training from the American Society of Appraisers in the area of business valuation and works closely with members of the bar to effectuate practical settlements. Terri also serves as the Director of Legal & Finance for Journey of Hope, a grass roots non-profit organization providing financial support to cancer survivors.