

Aggregating Activities to Avoid the Hobby Loss Rules

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Sec. 183 limits deductions for activities that are “not engaged in for profit,” commonly called hobbies. To sidestep this requirement, taxpayers often attempt to combine activities that would separately be considered hobbies with other activities to avoid the Sec. 183 limits. In fact, the regulations under Sec. 183¹ specifically allow the aggregation of undertakings into one activity. By doing this, a taxpayer may combine an activity that is unprofitable and does not meet the presumption of being “engaged in for profit” into another for-profit activity so the deduction limitations of Sec. 183 do not apply.

Historically, the courts have sanctioned this treatment but required that the two activities be somewhat similar in kind. For example, a farmer was allowed to aggregate his rodeo and horse breeding activities,² and another taxpayer was allowed to aggregate his farming, hunting, riding lesson, crabbing, horse breeding, horse boarding, and horse racing activities.³ However, the Tax Court recently relaxed the similarity requirement in *Topping*,⁴ where the court aggregated the taxpayer’s barn and interior design business with her equestrian activities. A review of the cases suggests that these undertakings are arguably the two most disparate activities that the courts have allowed a taxpayer to combine. Nevertheless, the court’s reasons for doing so seem rational and justified. This article

explores those reasons and examines other cases in which taxpayers have not been so lucky.

Overview of Sec. 183

Sec. 183 generally provides that taxpayers cannot deduct expenses attributable to any activity not engaged in for profit. However, this wholesale disallowance of deductions is relaxed in Sec. 183(b), which permits deductions related to such activities to the extent of gross income from those activities. The provision applies to individuals and S corporations but not to C corporations.

Activity Not Engaged In for Profit

The critical test of Sec. 183 is determining whether an activity is profit oriented

¹ Regs. Sec. 1.183-1(d)(1).

² *Estate of Brockenbrough*, T.C. Memo. 1998-454.

³ *Hoyle*, T.C. Memo. 1994-592.

⁴ *Topping*, T.C. Memo. 2007-92.

or merely a hobby. Unfortunately, the Code is not very helpful in making this distinction. Sec. 183 simply states that “the term ‘activity not engaged in for profit’ means any activity other than one with respect to which deductions are allowable . . . under section 162 or under . . . section 212.”⁵ Regs. Sec. 1.183-2(a) does provide some guidance, indicating that all facts and circumstances should be taken into account in making the determination and then listing nine factors—all derived from pre-1969 case law—that should ordinarily be considered:⁶

- How the taxpayer carries on the activity;
- The expertise of the taxpayer or his or her advisers;
- The time and effort the taxpayer expends in carrying on the activity;
- An expectation that assets used in the activity may appreciate in value;
- The taxpayer’s success in carrying on other similar or dissimilar activities;
- The taxpayer’s history of income or losses with respect to the activity;
- The amount of occasional profits earned, if any;
- The taxpayer’s financial status; and
- Elements of personal pleasure or recreation.

The regulations do not weight the factors in any manner, explaining that no one factor is determinative. Moreover, they make it clear that this is not an exhaustive list and that other factors may exist. It is also worth noting that because the IRS distilled these factors from prior case law, the courts believe such prior law “has a role to play in their application.”⁷

Expectation of profit: It should be emphasized that the regulations indicate that a “reasonable expectation of profit is not required.” However, the facts and circumstances must demonstrate that there was an objective of making a profit. Case law echoes this sentiment, stating that the taxpayer need not show a realistic expectation of profit but only an actual, honest one.⁸

Presumption: To reduce litigation over the above factors, Sec. 183(d) states that if any activity has been profitable in three or more of five consecutive years (two of seven years for most horse activities), the activity is presumed to be engaged in for profit. The presumption does not provide immunity. Rather, it is rebuttable, merely shifting the burden of proof from the taxpayer to the IRS.

Election: The taxpayer may elect that the above presumption not be made until the fourth year (sixth year for horse activities) after the start of the activity. This gives the taxpayer more time to meet the presumption. The downside is that by making the election, the taxpayer extends the statute of limitation for assessment for two years after the end of the fifth year (seventh for horses) of the activity. Thus, the IRS can go back over the entire activity time covered by the election and assess a deficiency.⁹ Moreover, some practitioners believe that by filing the form, the taxpayer is sending a clear signal to the government that a problem may exist.

Treatment

If the activity is determined not to be engaged in for profit, there are several ramifications:

- Deductions for the activity are limited to gross income from the activity.
- All deductions are itemized deductions.¹⁰ However, otherwise allowable deductions such as interest expense and property taxes are deductible in full as itemized deductions, while other deductions related to the activity are considered miscellaneous itemized deductions subject to the 2% floor and the deduction cutback rule.
- Income is included in gross income, thereby increasing adjusted gross income and potentially increasing the deductible threshold for miscellaneous itemized deductions.

Further discussion of the above topics is beyond the scope of this article.

EXECUTIVE SUMMARY

- Sec. 183 limits the deduction for activities not engaged in for profit. In determining whether an activity is engaged in for profit, the regulations allow taxpayers in some circumstances to aggregate separate activities for tax purposes.
- The regulations provide the general factors considered when deciding whether a taxpayer can aggregate activities. The three primary factors are the degree of organization and economic interrelationship of the activities, the business purpose for treating the activities as separate activities or as one activity, and the similarity of the activities.
- The courts have generally required a close similarity between the activities; however, in the *Topping* case, the Tax Court relaxed this requirement considerably and allowed a taxpayer to combine her equestrian activities with her home and barn design activity.

Aggregation

Hiding a hobby—a loss activity—within a legitimate business that is profitable is not a new phenomenon, notwithstanding recent judicial activity in the area. This has long been a strategy for taxpayers and a

5 Sec. 183(c).

6 Regs. Sec. 1.183-2(b).

7 *Jasionowski*, 66 T.C. 312 (1976).

8 *Dreicer*, 78 T.C. 642 (1982). In *Ellsworth*, T.C. Memo. 1962-32, the taxpayer’s dairy cattle activity, Folly Farm, had 13 years of uninterrupted losses

totaling almost \$700,000, yet the court held that the activity was a business rather than a hobby.

9 Sec. 183(e).

10 Regs. Sec. 1.183-1(b)(1).

concern for the government, so it is not surprising that the regulations acknowledge the possibility. Regarding the combination of one or more activities, Regs. Sec. 1.183-1(d)(1) does not specifically define the scope of an activity, nor does it use the word “aggregation.”¹¹ However, the regulations explain that “where the taxpayer is engaged in several undertakings, each of these may be a separate activity, or several undertakings may constitute one activity.” The regulations state that this determination must be made using all the facts and circumstances and then list the following as generally being the most significant:

- The degree of organization and economic interrelationship of various undertakings;
- The business purpose that is (or might be) served by carrying on the various undertakings separately or together in a trade or business; and
- The similarity of various undertakings.¹²

The regulation goes on to say that generally “the Commissioner will accept the characterization by the taxpayer. . . . The taxpayer’s characterization will not be accepted, however, when it appears to be artificial and cannot be reasonably supported.”¹³ There are no relevant examples in the regulations, but several cases have interpreted this language.

Aggregation Not Allowed

In *Schlafer*,¹⁴ the taxpayer owned an auto dealership and ran a stock car racing activity. On his 1984 and 1985 returns, he attempted to offset his racing losses of about \$23,000 each year against the profits of his car dealership. At trial, Schlafer contended in part that the expenses incurred in the racing activity were merely advertising for his car dealership. He explained that the cars prominently carried the logo of his dealership, and ads for the dealership he placed in racing programs showed the race car with the logo. In de-

nying the deduction, the Tax Court held that the two undertakings were separate activities. In so holding, the court first cited the regulations above and then found that the taxpayer kept the activities separate and distinct.

The assets used in the racing activity were not on the books of the dealership; when the dealership paid for racing repairs or assets, the amounts were shown as receivables from the taxpayer personally; and the income and expenses were treated separately on the tax return. Based on these findings, the court held that the required organizational and economic interrelationship required by the regulations did not exist. The court found as fact that the racing car and uniforms did display the dealership logo, and there was some mixed advertising, but it did not discuss this in the holding. It appeared that the court implicitly found that the interrelationship between the activities was insufficient given the other factors mentioned.

Practice tip: A close reading of *Schlafer* suggests that had the taxpayer paid attention to what may seem like perfunctory administrative details (e.g., accounting for both activities as if they were one single business), there would have been a different outcome. A practitioner can add real value by suggesting what can be done both substantively and administratively to ensure that the interrelationship test is met. It should be noted that an abundance of authority suggests the most important factor used in determining whether an activity was engaged in for profit is not necessarily whether it was profitable but whether it was carried on in a businesslike manner.¹⁵ Accountants can help the client meet this requirement in a number of ways, such as developing a business plan that contains strategies in which the various activities are all part of a single organization and each is critical to the success of the whole enterprise.

The interrelationship principle was again the focus in the *De Mendoza* decision.¹⁶ In this case, a practicing lawyer who bought and sold polo ponies could not aggregate that undertaking with the legal fees from clients he met through the polo activity. The court held that the two undertakings were formed and operated separately and that the polo activity did not depend on the law business, so there was very little organizational or economic interrelationship.

The court also held that if the law firm benefited from the polo activity, the benefit was incidental. The attorney produced three different lists of polo-law clients. However, the attorney had started keeping these lists in 1987, although the polo activity was started in 1982. The court said this was “more of an afterthought than part of a bona fide business plan,” stating that even if the fees from the polo-law clients were used to compute the income or loss of the polo activity, that activity still would have generated a loss. The court also considered that the undertakings—law and polo—were not similar. Despite the holding, this case, like *Schlafer*, again suggests that the taxpayer clearly would have had a better chance of succeeding if the taxpayer had incorporated the polo activity into a strategic plan consisting of both activities.

The lack of interrelationship was again evident in *Wilkinson*,¹⁷ a case with facts very similar to *De Mendoza*. A plastic surgeon who engaged in equestrian activities to attract wealthy clients could not aggregate this activity with his surgery practice. The court found it significant that the land for the surgeon’s ranch was purchased and held separately from the surgery practice and that the deductions for the horse activities were claimed separately with no mention of the practice. The court stated that the only connection between the two was the “rather vague” statement that publicity from the

11 Under prior law, a similar problem existed but the unit of measurement was not “activity” but rather “trade or business.” Arguably the former is more narrow than the latter, but it is unclear whether the change in language was a conscious effort to redefine the test.

12 Regs. Sec. 1.183-1(b)(1).

13 Id.

14 *Schlafer*, T.C. Memo. 1990-66.

15 See Burns and Groomer, “Effects of Section 183 on the Business/Hobby Controversy,” 58 *Taxes* 195 (1980). After evaluating over 150 Tax Court cases, the authors conclude that the most important factor in determining whether an activity was a business was whether it was conducted in a businesslike manner.

16 *De Mendoza*, T.C. Memo. 1994-314.

17 *Wilkinson*, T.C. Memo. 1996-39.

surgeon's polo playing brought in patients, but there was no corroboration. The court concluded, "To us, it is at least as far fetched and unconvincing as was the alleged connection between a legal practice and polo in *De Mendoza*."

The *Zdun* case¹⁸ supplies another example. A dentist claimed that his dental practice and running an apple orchard were a single activity. He argued that he could not practice holistic dentistry without his orchard. The court first noted that the dentist practiced dentistry throughout the year but did not store apples, so they were available only during the growing season. The implication was clearly that he could practice dentistry most of the year without the apples. Further, the petitioner testified that only 10–15% of his patients took the apples even when free. The court found no organizational or economic relationship between the two undertakings. The court also failed to accept the dentist's testimony of a business purpose and found no similarity between the two undertakings.

In summary, all these cases failed to prove any organizational or economic interrelationship, failed to show any business purpose for the hobby activity, and failed to show any similarity among the undertakings. Further, there was no evidence that the hobby activity helped the primary business. The clear lesson from these decisions is that taxpayers may have difficulty if they enter activities without a well-conceived business plan that demonstrates how the activities are interdependent.

Aggregation Allowed

Although the cases above might suggest that aggregation of activities is an unreachable goal, in fact courts have allowed aggregation in a number of situations. One thing that is clear from these taxpayer victories is that the secondary activities were much more similar to the primary business than in the cases discussed above.

Keanini

In *Keanini*,¹⁹ a married couple conducted two activities, a poodle breeding business and a dog grooming business. Before starting the businesses, the wife worked as a dog groomer and attended a three-month seminar on starting a business. The taxpayers lived in Hawaii and were the only certified dog groomers in the state. The couple started breeding part-time at their personal residence but soon built a kennel and started breeding, selling, and showing poodles on a full-time basis, acquiring breeding dogs from the mainland. A written contract with every dog sold stipulated that the couple would get a puppy from the first litter at no cost and that the purchaser would always bring his or her dogs to them for grooming. A dog expert testified that the taxpayers carried on the breeding and grooming within a single business.

The court, citing the regulations, found this to be an integrated activity. They were similar activities operated within a single business; the taxpayers carried on the activities at the kennel; the goodwill from winning national championships for showing dogs benefited both the breeding and grooming businesses; and the petitioners' sales contracts generated grooming business. Noting that the activities shared common customers, goodwill, and physical facilities, the court found a close organizational and economic relationship between the two undertakings.

Hoyle

In *Hoyle*,²⁰ the taxpayer owned a farm on which he pursued many undertakings, including farming, hunting, crabbing, riding lessons, horse boarding, game-bird breeding, and thoroughbred horse racing. The court found that all the activities occurred on the same land and that the same accountant maintained all the tax records for all the undertakings. Keeping separate checkbooks for each undertaking did not mean the taxpayer was treating them separately; it was just a common way to keep income and expenses separate.

The court also concluded that holding the land for appreciation was one of the undertakings combined into the single activity. Regs. Sec. 1.183-1(d)(1) specifically states that if land is bought or held for appreciation, the holding and farming of the land will be a single activity only if the farming part is profitable. In *Hoyle*, the taxpayer's primary intent was not to hold land for appreciation but to operate a farm, so the two could be aggregated. Had the situations been reversed, the regulations would have required a different result.

Estate of Brockenbrough

In *Estate of Brockenbrough*,²¹ the taxpayer and his spouse bought a farm where they planned to live upon retirement. The taxpayer decided to raise quarter horses. Before starting, he spoke with several experts in the business. He also consulted a CPA about the records he would need to maintain, kept detailed records as instructed, and used a separate checking account for the horse business. In order to publicize his horse business and raise some additional revenue, the taxpayer entered the rodeo business. Again, he consulted with experts. He produced three rodeos in two years, using his land, buildings, equipment, horses, and cattle. The taxpayer hired a professional to manage both the horse breeding and rodeo businesses. Both businesses were liquidated after the manager was fired for theft and no other manager could be found.

In deciding to aggregate the two businesses, the court cited the factors mentioned in the regulations and then summarized additional considerations derived from previous cases about the undertakings:

- Whether there was a close organizational and economic relationship between the two undertakings;
- Whether the undertakings were conducted in the same place;
- Whether the undertakings were part of an effort to produce revenue from the land;

¹⁸ *Zdun*, T.C. Memo. 1998-296.

¹⁹ *Keanini*, 94 T.C. 41 (1990).

²⁰ *Hoyle*, T.C. Memo. 1994-592.

²¹ *Estate of Brockenbrough*, T.C. Memo. 1998-454.

- Whether the undertakings were formed as separate businesses;
- Whether one undertaking benefited from the other;
- Whether the taxpayer used one undertaking to advertise the other;
- The degree of shared management among the undertakings;
- The degree to which one person managed both undertakings; and
- The degree to which the activities shared books and records.

Considering these factors, the court found that the two businesses were one activity. They were both done on the same land; both were attempts to generate income from the farm; some of the same assets were used for both businesses; the rodeos were used to advertise and sell the horses raised on the farm; the same accountant and the same checking account were used for both businesses; and both activities were reported on the same schedule each year. The court cited *Hoyle* for the proposition that the taxpayer could aggregate all sources of revenue for the farm. Other cases were cited in which the courts aggregated different activities in which horses were used in both, such as horse farming and stallion syndication²² and horse farming and horse racing.²³

Tobin

In *Tobin*,²⁴ the taxpayer had a farm on which she had previously raised corn and tobacco. She had leased the tobacco acreage and engaged in a corn set-aside program, so she no longer raised tobacco or corn. In an attempt to increase farm revenue, she developed part of her farm into a public display garden. Before doing so, she considered other possibilities and visited public display gardens in Europe and the United States. She ultimately built a conservatory as an addition to her home and filled it with plants. She also developed a rose garden and other display gardens around her property. She gave tours of these gardens, the conservatory, and her house.

In finding that the farm and garden undertakings were one activity, the court applied the regulations and the factors listed in *Brockenbrough*. The court found that both undertakings were conducted at the farm, on the farmland, and were attempts to make the farm profitable. The taxpayer developed the garden to replace the lost tobacco income. Both the garden and the farm required planting, tending, and harvesting. The taxpayer managed them as one activity, and they both shared the same employees, the same accountant, the same checking account, and were reported on the same Schedule F. Based on this, the court found the two undertakings to be one activity.

The court also separately addressed several of the IRS's arguments against aggregation. First, the IRS argued that the activities should not be aggregated because the garden was operated as a joint venture with an unrelated person who lived with the taxpayer and the farm was not, and the successes of the farm and the garden did not depend on each other, which was a factor in the *De Mendoza* (law-polo) case. The court simply stated that it disagreed with the Service and that it had not cited any case or reason to support these arguments.

Finally, the IRS argued that the two undertakings were too dissimilar to be one activity and that Tobin had no business reason for operating the two activities as one. In rejecting this argument, the court analogized Tobin's case to *Hoyle*, in which the Tax Court allowed the taxpayers to aggregate activities at a farm such as guided hunting, a gun club, and crabbing, and they had multiple other undertakings such as growing raspberries, soybeans, corn, and grain and raising horses, game birds, and racing horses. As it had with these various activities in *Hoyle*, the Tax Court found that the display garden was an attempt to supplement the income from the farm, so the operation of the farm and the garden was one activity for this purpose.

Mullins

In *Mullins*,²⁵ the taxpayer had bought several parcels of land intending to raise cattle on them. He personally worked to clear the land for grazing, spending most of his free time there. He paid for all his business transactions out of his personal checkbook, but an accountant separated the business from the personal activity for recordkeeping purposes. Over the next 22 years, the cattle raising business made a small profit in only one year, but the taxpayer sold timber and certain land parcels at large gains. The District Court, in determining whether the taxpayer entered into the cattle raising business for profit, discussed the effect of the taxpayer's expectation that assets used in an activity may appreciate in value. The taxpayer raised the same argument as the taxpayer in *Hoyle*, i.e., that Regs. Sec. 1.183-1(d)(1) specifically states that if land is purchased primarily for appreciation, farming on the land is part of the same activity only if it makes a profit.

Even though there was no direct testimony on this issue, based on the taxpayer's vast business experience, the court determined that he had entered into his cattle breeding business with the expectation that the land he bought for it would appreciate in value. However, the court further found that the taxpayer had not purchased the land for the primary purpose of appreciation, but rather with the primary purpose of raising beef cattle for a profit. Therefore, it did not matter that the cattle business was not profitable and the landholding and cattle business were considered to be one activity according to Sec. 183.

Mitchell

Another farming aggregation case was the 2006 *Mitchell* decision.²⁶ Mitchell, a CPA and lawyer, inherited a family farm in 1992 and immediately set out to make it profitable before bequeathing it to his children. As the court pointed out, Mitchell had not been too successful in this regard, losing about \$90,000 from

22 *Scheidt*, T.C. Memo. 1992-9.

23 *Mary*, T.C. Memo. 1989-118; *Yancy*, T.C. Memo. 1984-431.

24 *Tobin*, T.C. Memo. 1999-328.

25 *Mullins*, 334 F. Supp. 2d 1042 (E.D. Tenn. 2004).

26 *Mitchell*, T.C. Memo. 2006-145.

the farming activity from 1992 to 1999. In fact, the 2006 decision was the third time that Mitchell had been before the Tax Court to determine whether or not he engaged in his farming activity for profit.

The first issue before the court was whether Mitchell could treat his tree planting, timber harvesting, and haying undertakings as one activity. Relying on the regulations and cases discussed above, the Tax Court had no difficulty aggregating these and treating them as a single activity. It pointed out that all the activities were agricultural in nature and were performed at the family farm in an attempt to make the farm profitable. In addition, the court believed that all the facts supported a single activity. Mitchell did not form any of the undertakings as separate businesses; he served as the only manager for all the activities and was the only accountant; and he used one checking account to pay the expenses and deposit the revenues from all the undertakings. However, even though the court found that a single activity existed, after applying the nine-factor test of the regulations it did not believe that Mitchell engaged in the farming activities for profit. Moreover, the court imposed the Sec. 6662(a) accuracy-related penalty on Mitchell's underpayments due to the disallowance of the losses from the farm.

Topping

The most recent case involving aggregation holds the greatest hope for taxpayers. In *Topping*,²⁷ the 46-year-old taxpayer was in the midst of a bitter divorce. She had no job or education and no means to support herself. However, she did have the talent to draw structural designs free-hand. The taxpayer decided to use this skill and go into the business of designing horse barns and homes. She had been involved in equestrian activities for most of her life and planned to use her prominence in the equestrian world to meet wealthy clients for her design business. To this end, after her divorce she kept her membership in an exclusive private riding club, participated in amateur riding and equestrian competitions at the club, and socialized with the wealthy members dur-

ing and after the horse shows. She relied on contacts made at the club to advance her design business. Not wanting her clients to think she needed the work, the taxpayer never advertised her business but relied on referrals and contacts made at the club. In fact, all her income came from the equestrian contacts.

During the years at issue, 1998–2001, Topping had net losses of over \$600,000 from the horse activity that she used to offset the income from her design business. As might be expected, the Service believed that the taxpayer was trying to deduct the losses of a separate activity not engaged in for profit—her equestrian hobby—by combining it with her for-profit design business. The *Topping* decision is of particular importance because unlike the farming cases, the equestrian undertaking and the design business were two very dissimilar activities. Indeed, Topping's circumstances closely resembled those of the lawyer in *De Mendoza*, who lost in his effort to combine his real estate law practice and his polo activity.

In analyzing Topping's situation, the court once again relied on the regulations and the factors from *Brockenbrough*. However, in a change from prior decisions, the court was able to find a close organizational and economic relationship between the two undertakings. It pointed to a number of facts that supported this conclusion:

- The taxpayer's success in her equestrian undertakings created goodwill that benefited her design business;
- She formed both undertakings as a single integrated business;
- She had a business plan for this integration;
- She and her assistant managed both undertakings and the assets; and
- The same set of books was used for both activities.

On the other hand, the IRS seemed to believe that the taxpayer's story was simply something she concocted to write off her equestrian expenses. It tried to convince the court of this view by essentially saying that this is not the way *real* businesses are run. To support its claim,

the IRS pointed out that real businesses do not obtain clients by belonging to elite private clubs and hobnobbing with the wealthy. Instead, real design businesses use conventional advertising methods that use traditional media such as equestrian-related magazines, websites, or newspapers. However, the court dismissed this assertion by stating that the taxpayer testified that traditional advertising was not welcomed by the taxpayer's clientele and noting that she was correct in her belief; her methods had been very successful. In a telling observation, the court emphasized that the question is not whether a particular mode of doing business is wise but whether the taxpayer honestly believed the method would help make the overall undertaking profitable.

In challenging the taxpayer's position, the IRS cited *De Mendoza*, *Wilkinson*, and *Zdun*, where aggregation was not allowed because the activities were too dissimilar. Apparently, the Service believed that Topping's activities were likewise dissimilar. However, the court found that the reason for nonaggregation in the prior cases was that there simply was not enough evidence in any of those situations to find the necessary integration and interdependence or the necessary benefit from one to the other that existed in *Topping*. The court also rejected the government's argument that the taxpayer had not started riding horses for the purpose of promoting the design business. While conceding that truth, the court stated that she merely converted her hobby into part of an integrated business.

Finally, the IRS seized on what could have been a crucial misstep. During all the years at issue, Topping's CPA had reported each activity on a separate Schedule C. The Service argued that Topping should be held to that determination. However, the court found a "plethora" of evidence that this was one activity, so the taxpayer overcame taking that inconsistent position. In this regard, Topping probably was quite fortunate. Separate reporting by itself could very well have been fatal to her contention that the activities should be aggregated.

27 *Topping*, T.C. Memo. 2007-92.

Practice tip: Topping's good fortune should not be lost on practitioners. Advisers who sense that their clients may have a Sec. 183 problem and want to build a case for aggregation should avoid separate reporting and should report all activities on a single Schedule C.

As noted at the beginning of this article, the equestrian and design businesses are the most disparate activities that a court has aggregated to date. Yet the court followed the regulations and came to the correct result. The regulations look at organizational and economic interrelationships. In *Topping*, the undertakings were managed together and used many of the same assets, and the equestrian activities led to all the gross income for the design business.

The regulations indicate that in ascertaining whether activities should be combined, a key factor to be taken into account is the business purpose served by carrying on the various undertakings separately or together. In *Topping*, there was a business plan or strategy from the very beginning to carry them out together, and the taxpayer had an actual belief that it would be successful. It is interesting to note, however, that she had not committed the plan to writing and had not made a formal market study or cashflow projections. The court dismissed these omissions, explaining that the taxpayer had discussed her plan for the venture with her accountant and a longtime friend who had successfully started her own business. In other situations, however, courts might not be so forgiving. For this reason, practitioners should advise their clients to take such steps—investigate the market, identify the competition, make projections, develop a marketing strategy—and incorporate them as part of a written plan.

Finally, the regulations indicate that the similarity of the undertakings is one possible factor that should be considered in determining whether aggregation is appropriate. Here, of course, they were very dissimilar. But the court had little concern about whether the activities were similar or dissimilar. Instead, it focused on the

relationship between the two activities. The court found that in the law-polo case, the plastic surgeon-horse case, and the dentist-orchard case there was no integration or interdependence, unlike Topping's situation. In the latter case, the court simply looked at all the factors and held that there was a single activity. The court also mentioned at least twice that the taxpayer's strategy was successful, observing that her *combined* activity showed a significant profit in each year under audit.

The opinion in *Topping* is significant in that the similarity of the activities was not the controlling factor. Instead, the relationship between the activities was of principal importance. It is now clear that if two activities are dissimilar but interdependent, aggregation can still occur.

No Aggregation but Related

In a case where aggregation is not allowed, a taxpayer may be able to meet the Code's profit motive requirement by instead attributing a profit motive from one activity to another activity. In *Campbell*,²⁸ the taxpayer was a shareholder in a corporation whose business was to invest in and develop psychiatric health care facilities. The officers and employees of this corporation engaged in significant business travel. For convenience, all the shareholders created a partnership to provide such transportation. The partnership bought an airplane and leased it to the corporation. The airplane was used 77% by the corporation and 23% by unrelated parties, generating large losses for the partnership. The Tax Court found that the sole motive of the partnership for entering into the airplane leasing business was to provide the corporation with air transportation so the corporation could profit, while generating paper losses for the partners; thus, there was no profit motive for the partnership and the partners could not deduct its expenses.

In reversing the Tax Court's decision, the Sixth Circuit never mentioned the idea of aggregating these two undertakings. However, it held that each partner, while not profiting directly from the partner-



ship, benefited through dividends and a large increase in stock price from the use of the partnership's airplane. "The profits generated by [the corporation] through the use of the [partnership's] plane, therefore, made the venture [partnership] an activity engaged in for profit."

The IRS strongly disagreed with the court's attribution of profit motive and issued a nonacquiescence to the decision.²⁹ According to the IRS, the attribution of the corporation's profit motive to the partnership violated the "separate taxable entity concept" that had been established by the Supreme Court in *Moline Properties, Inc.*³⁰ In support of its conclusion, the Sixth Circuit cited several cases, the most relevant of which is *Horner*.³¹ In that 1960 case, the taxpayer, who was president, general manager, and major shareholder of a corporation, bought inventory on his

28 *Campbell*, 868 F.2d 833 (6th Cir. 1989), nonacq. 1993-1 C.B. 1.

29 AOD 1993-001 (6/14/93).

30 *Moline Properties, Inc.*, 319 U.S. 436 (1943).

31 *Horner*, 35 T.C. 231 (1960).

personal account and resold it through the corporation. When the corporation failed, the taxpayer had to pay for these purchases personally. In holding that these were ordinary losses from a transaction entered into for profit, that court said:

If one enters into the activity of furnishing a corporation with goods to sell, upon his own credit, with the expectation of deriving gain when the goods are sold he certainly is engaging in a transaction entered into for profit. In this case, the expectation was that the profits would come to Horner either as salary as president and general manager, from dividend on his stock, or as an increase in the value of his stock.

The court's approach in *Campbell* is unique in applying the profit motive of one undertaking to another undertaking without aggregating them. Nevertheless, practitioners may find this argument useful when aggregation is unavailable.

Potential Penalties

In several of the cases reviewed, the taxpayers were subject to the understatement of tax penalty of Sec. 6662.³² This penalty will always be of concern in Sec. 183 cases due to the factual nature of the controversy. The tax professional must weigh the risks of having the penalty assessed versus the tax savings achieved by aggregating separate activities on a return. In this regard, the Sec. 6694 tax return preparer penalty can also become a concern if a preparer takes an aggressive position with respect to aggregating activities on a return and does not fully disclose the position.

Conclusion

The developments discussed above demonstrate that combining a loss activity—one that by itself is not engaged in for profit—with another activity that is engaged in for profit continues to be a

successful strategy to avoid the limitations of Sec. 183. The most recent case, the decision in *Topping*, is an extremely important development because it shows that a taxpayer can possibly aggregate dissimilar activities. Of course, only time will tell if the *Topping* decision is an anomaly or a precursor of favorable results to come. However, by following the pattern laid out in *Topping* and other cases summarized here, the taxpayer will be in a much better position to attain the desired result.

In conducting the activities, taxpayers should not forget that the major requirement for aggregation is showing that there is an organizational and economic relationship between the two activities—regardless of the similarity of the activities. The taxpayer must be prepared to prove that the two activities are interdependent and, like *Topping*, be able to present a convincing case that a valid business purpose is served by carrying on the two activities as one business and that one activity benefits the other.

Taxpayers have had relative ease in meeting these requirements when the activities they are combining are similar in nature. This has been shown in cases involving dog breeding and grooming, raising horses and producing rodeos, and different types of farming activities. In contrast, where the activities are dissimilar, satisfying the tests becomes far more difficult and the taxpayer and the practitioner must give attention to a number of details—both administrative and substantive—if aggregation is to be allowed.

The key is to avoid practices that suggest the activities are separate and distinct and to adopt practices that indicate the activities are related and interdependent. The court in *Topping* laid out the pattern for success. For example, separate books, separate checking accounts, and separate locations for each activity do not support aggregation. The taxpayer should account for the activities as one entity using the same books and records as well as the

same accountants. This is particularly true when reporting for tax purposes. The taxpayer should also combine the results of operations from the activities on one form (e.g., one Schedule C or one Schedule F) and not report them on two separate forms.

Similarly, a taxpayer can show organizational interdependence by having all the activities managed as one entity and much of the work done by the same employees and can establish an economic relationship by demonstrating that the activities of one entity benefit the other, such as using one activity to advertise the other. It is very important that the taxpayer be consistent in carrying on the activities; that is, in all respects he or she should conduct the activities as one because a single inconsistency may be fatal to aggregation. As a last resort, if aggregation is not achievable, the taxpayer may be able to attribute one business's profit motive to another. In all cases, taxpayers should have a written business plan that underscores how the activities are related. If taxpayers follow these tips, they may be allowed to aggregate activities and avoid the problems of Sec. 183.

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EditorNotes

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³² Sec. 6662 generally imposes a penalty equal to 20% of the amount of the tax underpayment unless the taxpayer has a reasonable basis for a position. In the case of a substantial underpayment, the taxpayer must show substantial authority for the position to avoid the penalty.